NAIC

National Association of Insurance Commissioners

Accounting Practices and Procedures Manual

As of March 2015

Volume I

NAIC
National Association of Insurance Commissioners

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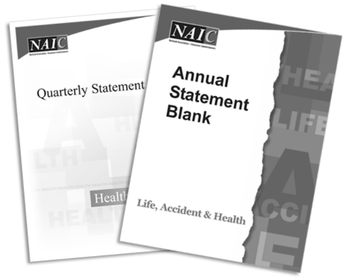
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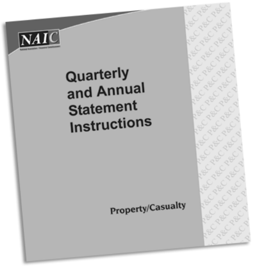
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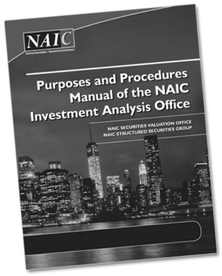
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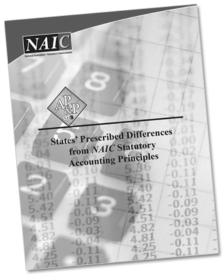
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States' Prescribed Differences from NAIC Statutory Accounting Principles

States' Prescribed Differences from NAIC Statutory Accounting Principles

The Accounting Practices and Procedures Manual presents a comprehensive basis of accounting that should be followed if not in conflict with state statutes and/or regulations. Should the domiciliary state set forth accounting guidance that differs from the AP&P Manual, disclosures of such must be made. This publication provides information regarding each state's prescribed differences from NAIC statutory accounting principles, including a citation to the respective state statute and/or regulation. Updated annually.

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MAINTENANCE PROCESS

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

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DEDICATION

The *Accounting Practices and Procedures Manual* is dedicated to Norris Clark, California Department of Insurance (retired), Chair of the Codification of Statutory Accounting Principles Working Group, and its successors, the Statutory Accounting Principles and Emerging Accounting Issues (E) Working Groups from September 1994 through July 2004, and to Joseph Fritsch, New York Department of Financial Services (retired), Chair of the Statutory Accounting Principles (E) Working Group from 2004 through December 2012.

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

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How to Use This Manual

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- Statements of Statutory Accounting Principles
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- Appendix A – Excerpts of NAIC Model Laws
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The arrangement of material as indicated above is included in the Table of Contents at the front of each Volume. A detailed Table of Contents also proceeds each section covering the material within.

Summary of Changes:

This section provides a summary of the changes that were made to the As of March 2014 version of the *Accounting Practices and Procedures Manual* to create the As of March 2015 version. This is divided into substantive revisions to statutory accounting principles, nonsubstantive revisions to statutory accounting principles, and revisions to the appendices included in the Manual. This is a key resource for users who are looking to identify changes from the prior edition.

Preamble:

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

Statements of Statutory Accounting Principles:

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

changes to the SSAPs. Completely superseded SSAPs are no longer authoritative and have been removed from the printed Manual but are available for reference on the "Updates to the Accounting Practices and Procedures (AP&P) Manual" webpage (www.naic.org/committees _e_app_manual_updates.htm). The completely superseded SSAPs have been retained in Appendix H – Superseded SSAPs and Nullified Interpretations within the AP&P Folio View CD-ROM.

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

> TYPE OF ISSUE – SSAPs designated as Common Area apply to all insurers. Although the nomenclature or terms provided in the prescribed annual statement forms may vary among different types of insurers, only one set of nomenclature or terms may have been used in the SSAP. For example, the Statement of Income found in the Property and Casualty Annual Statement shall be considered as synonymous with the Summary of Operations found in the Life and Health Annual Statement.
>
> ISSUED – Date when the SSAP was adopted by the NAIC. SSAPs designated with Initial Draft were adopted by the NAIC Plenary in March 1998 as part of the Codification Project (SSAP Nos. 1-73). The date included for SSAP No. 74, and subsequent SSAPs, denotes when the Statutory Accounting Principles (E) Working Group adopted the SSAP.
>
> EFFECTIVE DATE – Date representing when the SSAP is effective. Many times there are additional details relative to the transition provided within the SSAP.
>
> AFFECTS/AFFECTED BY – A useful tool for tracking relationships between statements and interpretations is contained within these sections. The "affects" section is used when a SSAP substantively amends or supersedes previously issued SSAPs. Nullified INTs are also noted in this section. Readers are referenced to another SSAP in the "affected by" section if the SSAP has been substantively amended or superseded. Text within paragraphs substantively amended or superseded may also be "shaded" to notify readers that revised guidance is available.
>
> INTERPRETED BY – This section includes a reference to the applicable Interpretation (INT) of the Emerging Accounting Issues (E) Working Group contained within Appendix B of the Manual which provides interpretative guidance as a result of issues raised by users of the Manual or related GAAP guidance. INTs are generally effective when adopted. Readers should note that the Manual only contains the INTs finalized through December 2014 due to the fact that the Manual is published annually. Readers may use the NAIC website, as indicated on the inside front cover of the Manual, to keep abreast of recently issued INTs.

Refer to the Relevant Literature and Effective Date and Transition sections of the SSAP for details of substantive and nonsubstantive changes.

Appendix A – Excerpts of NAIC Model Laws:

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

Appendix B – Interpretations of the Emerging Accounting Issues (E) Working Group:

The Emerging Accounting Issues (E) Working Group (EAIWG) is responsible for responding to SAP questions that generally relate to application, interpretation and clarification. Appendix B includes the final interpretations of the EAIWG through December 2014. Once an INT is

finalized, the related SSAP will contain reference to the applicable INT. Interpretations that have been nullified are removed from the printed Manual and posted for reference on the "Updates to the Accounting Practices and Procedures (AP&P) Manual" webpage (www.naic.org/committees_e_app_manual_updates.htm). The nullified INTs are retained in Appendix H – Superseded SSAPs and Nullified Interpretations within the AP&P Folio View CD-ROM.

Appendix C – Actuarial Guidelines:

The NAIC Life Actuarial (A) Task Force and Health Actuarial (B) Task Force have been asked on many occasions to assist a particular state insurance department in interpreting a statute dealing with an actuarial topic relative to an unusual policy form or situation not contemplated at the time of original drafting of a particular statute. The Life Actuarial (A) Task Force and Health Actuarial (B) Task Force, in developing interpretations or guidelines, must often consider the intent of the statute, the reasons for initially adopting the statute and the current situation. The Life Actuarial (A) Task Force and Health Actuarial (B) Task Force feel that for those situations which are sufficiently common to all states, the publishing of actuarial guidelines on these topics would be beneficial to the regulatory officials in each state and would promote uniformity in regulation which is beneficial to everyone. To this end, the Life Actuarial (A) Task Force and Health Actuarial (B) Task Force have developed certain actuarial guidelines and will continue to do so as the need arises. The guidelines are not intended to be viewed as statutory revisions but merely a guide to be used in applying a statute to a specific circumstance.

Appendix D – GAAP Cross-Reference to SAP:

As expressed in the Statement of Concepts, SAP utilizes the framework established by Generally Accepted Accounting Principles (GAAP). Appendix D includes GAAP pronouncements that have been considered in the development of SAP. This listing includes GAAP pronouncements issued through December 2014. This Appendix is a valuable and efficient tool for readers who are interested in the status of a particular GAAP pronouncement in the SAP model.

Appendix E – Issue Papers:

This section includes all of the issue papers associated with SSAPs adopted by the Statutory Accounting Principles (E) Working Group through December 2014. The issue papers are used as the first step in developing new SSAPs and contain a recommended conclusion, discussion and relevant literature section. Issue papers **DO NOT** constitute an authoritative level of statutory accounting, as supported by the statutory hierarchy, and should only be used as reference material. Nevertheless, issue papers are an important part of the Manual because they reference the history and discussion of the related SSAP. The "Relevant Statutory Accounting and GAAP Guidance" section of the issue paper contains excerpts of accounting guidance in place at the time the Statutory Accounting Principles (E) Working Group considered (but not necessarily adopted) when forming the conclusions reached in the resultant SSAP.

Appendix F – Policy Statements:

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

Appendix G – Implementation Guide for Model Audit Rule:

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

Appendix H – Completely Superseded SSAPs and Nullified Interpretations

In 2013, the Statutory Accounting Principles (E) Working Group adopted a proposal to remove completely superseded SSAPs and nullified interpretations (INTs) from the printed Manual and

include these items on the "Updates to the Accounting Practices and Procedures (AP&P) Manual" webpage (www.naic.org/committees_e_app_manual_updates.htm). By including on this password-protected updates page, all who annually subscribe to the printed *Accounting Practices and Procedures Manual* will continue to have access to the superseded and nullified guidance for historical purposes. The completely superseded SSAPs and nullified INTs have been retained in Appendix H – Superseded SSAPs and Nullified Interpretations within the AP&P Folio View CD-ROM.

How to Use this Manual …

... to account for a certain item under NAIC SAP

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

... to compare SAP to GAAP for a particular issue

Appendix D is an excellent reference for users who are interested in determining how SAP addresses an issue that has been adopted by GAAP. Appendix D provides a reference to the SSAP or INT that addresses a particular GAAP pronouncement. As indicated in the Preamble, users should not utilize GAAP until and unless adopted by the NAIC. Within the body of the applicable SSAP or INT, readers will find documentation as to the reason for adoption, rejection, or adoption with modification of a particular GAAP pronouncement.

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

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

... to obtain updates to the latest published Manual

The Manual contains information as of December 2014. Please note that there will be modifications to the accounting pronouncements included in the Manual from year to year, as such guidance is subject to the maintenance process. To address this, the NAIC has a website dedicated to providing updates on the latest information impacting statutory accounting. A user must pre-order the As of March 2016 Manual in order to obtain access to the changes occurring during 2015 that are maintained within this password-protected website. Once access is granted, a user may enter the website and download an issue paper, statement of statutory accounting principles, appendix or interpretation that affects the Manual. This website also includes the latest minutes of the Statutory Accounting Principles (E) Working Group and Emerging Accounting Issues (E) Working Group. To learn more about how to obtain updates to the latest published Manual, refer to the Maintenance Process page, which precedes the Table of Contents.

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

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

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

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

Name	Title	Issue	Phone	Email
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Josh Arpin	Accounting and Reinsurance Policy Advisor	Statutory Accounting Reinsurance	(816) 783-8481	jarpin@naic.org
SVO		SVO P&P Manual	(212) 398-9000	SVOinquirydesk@naic.org
Statutory Accounting & Reporting Help Line		Annual Statement Reporting & Statutory Accounting	(816) 783-8400	

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Summary of Changes to the *As of March 2014 Version* of the *Accounting Practices and Procedures Manual* included in the *As of March 2015 Version*

The following represents a summary of the changes that were made to the *As of March 2014* version of the *Accounting Practices and Procedures Manual* (Manual) to create the *As of March 2015* version.

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

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

The third section summarizes any revisions to the appendices in the Manual.

1. Substantive Revisions – Statutory Accounting Principles

Section	Reference	Description
SSAP No. 40R SSAP No. 48	2013-17	Revisions related to wholly-owned single real estate held in an LLC, which meets specific conditions, with an effective date of Jan. 1, 2015.
SSAP No. 106 SSAP No. 35R	2014-01 2014-13	New SSAP moves guidance on the Affordable Care Act Section 9010 from SSAP No. 35R and includes nonsubstantive edits to the disclosures.
SSAP No. 107 SSAP No. 35R	2014-12 2013-28	New SSAP addresses the risk-sharing provisions of the Affordable Care Act known as risk adjustment, reinsurance and risk corridors. With this adoption, the disclosures previously located within SSAP No. 35R are moved to this SSAP and INT 13-04 is nullified.

2. Nonsubstantive Revisions – Statutory Accounting Principles

Section	Reference	Description
Preamble	2013-35	Revisions clarify that as of Sept. 15, 2009, AICPA SOPs will no longer be reviewed for statutory accounting.
SSAP No. 1 SSAP No. 4	2014-16	Revisions clarify the guidance for restricted assets.
SSAP No. 3 SSAP No. 68	2013-29	Revisions clarify that the disclosure exemption for mergers with shell entities does not change the Jan. 1 date to determine the cumulative effect in accounting principle.
SSAP No. 11	2014-07	Revisions identify the adoption of specific paragraphs from *Accounting Principles Board Opinion (APB) 12, Omnibus Opinion – 1967* and add guidance to reflect previously adopted GAAP, with minor technical edits.
SSAP No. 16R	2014-04	Revisions make the capitalization policy disclosure consistent with other SSAPs.

SSAP No. 19 SSAP No. 22	2014-05	Revisions adopt with modification *ASU 2014-05–Service Concession Arrangements* to clarify that service concession arrangements are not within the scope of SSAP No. 22 and shall not be recognized as property, plant or equipment in SSAP No. 19.
SSAP No. 26 SSAP No. 43R	2014-02	Revisions incorporate a new “structured note” disclosure and clarify that the guidance in SSAP No. 43R pertains to structured securities, not structured notes.
SSAP No. 35R	2013-28	Revisions include disclosures pertaining to the risk-sharing provisions of the Affordable Care Act programs (risk adjustment, reinsurance and risk corridors). These disclosures were subsequently moved to SSAP No. 107.
SSAP No. 55	2014-19	Revisions clarify that claims-related losses for extra contractual obligations and bad faith lawsuits are to be included in losses. Also, technical revisions related to prepaid adjustment expenses.
SSAP No. 56	2014-18	Revisions clarify the reporting of separate accounts disclosures.
SSAP No. 57	2014-06	Revisions to the disclosure requirements, with corresponding terminology revisions.
SSAP No. 86	2013-32	Revisions adopt *ASU 2013-10–Inclusion of the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) as a Benchmark Interest Rate for Hedge Accounting Purposes.* This ASU defines a benchmark interest rate and eliminates the restriction on different rates for similar hedges.
	2014-09	Revisions reject *ASU 2014-03–Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps—Simplified Hedge Accounting Approach (PCC)* as not applicable.
	2014-11	Revisions clarify the reporting of derivatives between Schedule DB and the balance sheet.
SSAP No. 92 SSAP No. 102	2013-37	Revisions adopt by reference *ASU 2011-09–Disclosures about an Employer’s Participation in a Multiemployer Plan* and incorporate limited additional disclosures for multiemployer plans.
SSAP No. 97	2013-31	Revisions add reference in Appendix B – Determining the Valuation Method, to the SSAP’s downstream holding company guidance.
SSAP No. 101	2014-20	Revisions clarify the RBC authorized control level used in the DTA calculation.
SSAP No. 104R	2014-17	Revisions adopt *ASU 2014-12–Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period* with an effective date of Jan. 1, 2016, with early adoption permitted.

3. Revisions to the Appendices

Section	Reference	Description
Appendix A	2014-21	Revisions incorporate changes to *Appendix A-010: Minimum Reserve Standards for Individual and Group Health Insurance Contracts* to allow the 2012 Group Long-Term Disability Table adopted by the Health Actuarial (B) Task Force with a Jan. 1, 2017, effective date and early adoption permitted.

Appendix B	2013-04 (EAIWG) 2014-12 (SAPWG)	*INT 13-04: Accounting for the Risk-Sharing Provisions of the Affordable Care Act* was adopted to provide temporary guidance on the risk-sharing provisions. This INT was subsequently nullified by SSAP No. 107 and moved to Appendix H.
	2014-26 (SAPWG)	Placement revisions move GAAP guidance identified as rejected from INT 99-00 into Issue Paper No. 99. INT 99-00 was nullified and moved to Appendix H.
Appendix C	2014-22	*Actuarial Guideline XLVII: Application of Company Experience in the Calculation of Claim Reserves Under the 2012 Group Long-Term Disability Valuation Table* has been added. *Actuarial Guideline XLVIII: Actuarial Opinion and Memorandum Requirements for the Reinsurance of Policies Required to be Valued Under Sections 6 and 7 of the NAIC Valuation of Life Insurance Policies Model Regulation* (Model 830) has been added. Actuarial Interpretations 38 through 41 have been added to Appendix C2.
Appendix D	2013-35	Revisions update the appendix based on the consideration of GAAP through the statutory review process. These revisions are not tracked as changes. Additionally, revisions clarify that as of Sept. 15, 2009, AICPA SOPs will no longer be reviewed for statutory accounting.
Appendix E		Revisions reflect the rejection of the following GAAP guidance as not applicable to statutory accounting in *Issue Paper No. 99—Nonapplicable GAAP Pronouncements* (Issue Paper No. 99):
	2013-34	• *ASU 2012-04–Technical Corrections and Improvements*
	2014-03	• *ASU 2013-12–Definition of a Public Business Entity, An Addition to the Master Glossary*
	2014-14	• *ASU 2014-10–Development Stage Entities*
	2013-35	• *SOP 09-1–Performing Agreed-Upon Procedures Engagements That Address the Completeness, Accuracy, or Consistency of XBRL-Tagged Data*
	2014-26 2014-08	Placement revisions move GAAP guidance identified as rejected from INT 99-00 into Issue Paper No. 99. Additionally, revisions add reference of the original SSAP that corresponds with each issue paper, as well as the current authoritative SSAP guidance.
		The following issue papers were adopted or amended:
	2014-01	• *Issue Paper No. 148—Affordable Care Act Section 9010 Assessment*
	2014-13 2013-17	• *Issue Paper No. 149—Wholly-Owned Single Real Estate Property in an LLC*
	2014-12	• *Issue Paper No. 150—Accounting for the Risk-Sharing Provisions of the Affordable Care Act*
Appendix F	N/A	No revisions have been made to this appendix.
Appendix G	N/A	No revisions have been made to this appendix.
Appendix H	2014-26 2013-04 (EAIWG) 2014-12 (SAPWG)	Revisions add nullified INTs: • *INT 99-00: Compilation of Rejected EITFs* • *INT 13-04: Accounting for the Risk-Sharing Provisions of the Affordable Care Act*

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Statutory Accounting Principles
Preamble

Interpreted by: INT 00-20

I. Accounting Practices and Procedures Promulgated by the NAIC

1. The NAIC, through its committees and working groups, facilitates many projects of importance to the insurance regulators, industry, and users of statutory financial information. That is evidenced by the mission statement and charges of the NAIC Accounting Practices and Procedures Task Force of the Financial Condition (E) Committee (Accounting Practices and Procedures (E) Task Force).

2. The mission of the Accounting Practices and Procedures (E) Task Force is to identify, investigate and develop solutions to accounting problems with the ultimate goal of guiding insurers in properly accounting for various aspects of their operations and to modify the NAIC *Accounting Practices and Procedures Manuals for Property and Casualty Insurance Companies*, *for Life, Accident and Health Insurance Companies*, and *for Health Maintenance Organizations* (Accounting Practices and Procedures manuals) to reflect changes necessitated by task force action and to study innovative insurer accounting practices which affect the ability of regulators to determine the true financial condition of insurers.

3. To carry out the mission, the Accounting Practices and Procedures (E) Task Force is charged with carrying out the following initiatives:

- Provide authoritative guidance to insurance regulators on current statutory accounting issues.
- Continue evaluation of statutory accounting principles for purposes of development, expansion and codification.
- Extend evaluation of statutory accounting principles to address areas specific to health entities.
- The Codification of Statutory Accounting Principles (E) Working Group (Statutory Accounting Principles (E) Working Group as of January 1, 2000) will maintain codified statutory accounting principles by providing periodic updates to the guidance which address new statutory issues and new generally accepted accounting principles (GAAP) pronouncements as they develop.

4. This comprehensive guide to Statutory Accounting Principles, composed of the Preamble, the Statements of Statutory Accounting Principles (SSAPs), and the Appendices, is intended to respond to the initiatives noted above. The guide and interpretations of the Emerging Accounting Issues (E) Working Group shall be referred to as the *Accounting Practices and Procedures Manual* - version effective January 1, 2001 (during the transition period until the 1998 version is no longer maintained and updated by the NAIC). The 1998 version of the *Accounting Practices and Procedures Manual* will be maintained and published until December 31, 2000. However, this Manual is not intended to preempt states' legislative and regulatory authority. It is intended to establish a comprehensive basis of accounting recognized and adhered to if not in conflict with state statutes and/or regulations, or when the state statutes and/or regulations are silent.

5. The principles established by this Manual are effective January 1, 2001. Accounting changes adopted to conform to the provisions of these statements shall be reported as adjustments to unassigned funds (surplus) in the period of the change in accounting principle; however, specific effective dates, and transition or grandfathering rules, if any, are contained in each SSAP.

II. Background

A. An Accounting Environment for Insurance Companies

6. Accounting is the process of accumulating and reporting financial information about an economic unit or group of units. Relative to commercial enterprises, the users of accounting information include management, investors, potential investors, lenders, investment analysts, regulators, and customers. Although customers of most commercial enterprises have no direct financial interest therein and generally are only concerned with the price to be paid for the product or service purchased, they may use accounting information to make choices as to the entity with which they engage in a business transaction. This is particularly relevant to purchases of insurance products inasmuch as insurance contracts involve a promise to pay which may extend years into the future. Insurance products may provide benefits well in excess of the purchase price or premium. The benefits ultimately received are almost always greater than the price (premium) paid and can only be estimated at the time the product (policy) is purchased.

7. Insurance is regulated on a state by state basis in the United States. Each state has its own regulatory framework generally led by an insurance commissioner. Insurance commissioners are charged with overseeing the financial condition of insurance companies doing business in their jurisdictions and they require meaningful financial, statistical, and operating information about the companies. This financial oversight is designed to help ensure that policyholders and claimants receive the requisite benefits from the policies sold, often times such products having been sold years or decades prior to when the benefits are due. Frequently, this regulatory perspective differs markedly from the perspectives of other users of insurers' accounting information. In recognition of these special concerns and responsibilities, statutory accounting principles have been established by statute, regulation, and practice.

B. Statutory Accounting Principles (SAP)

8. In simplest terms, SAP has been those accounting principles or practices prescribed or permitted by an insurer's domiciliary state. Statutory accounting practices have been interspersed in the insurance laws, regulations, and administrative rulings of each state, the Accounting Practices and Procedures manuals, the Annual Statement Instructions, the NAIC *Financial Condition Examiners Handbook,* the *Purposes and Procedures Manual of the NAIC ~~Securities Valuation~~Investment Analysis Office*, and NAIC committee, task force, and working group minutes. In addition, there are many statutory practices widely accepted by both insurers and regulators which have never been codified.

9. SAP is conservative in some respects but not unreasonably conservative over the span of economic cycles, or in recognition of the primary statutory responsibility to regulate for financial solvency. SAP attempts to determine at the financial statement date an insurer's ability to satisfy its obligations to its policyholders and creditors.

C. Comparison Of GAAP And SAP

10. The objectives of GAAP reporting differ from the objectives of SAP. GAAP is designed to meet the varying needs of the different users of financial statements. SAP is designed to address the concerns of regulators, who are the primary users of statutory financial statements. As a result, GAAP stresses measurement of emerging earnings of a business from period to period, (i.e., matching revenue to expense), while SAP stresses measurement of ability to pay claims in the future. This difference is illustrated by the fact that statutory policy reserves are intentionally established on a conservative basis emphasizing the long-term nature of the liabilities. Under GAAP, the experience expected by each

company, with provision for the risk of adverse deviation, is used to determine the reserves it will establish for its policies. GAAP reserves may be more or less than the statutory policy reserves.

11. Some other differences between SAP and GAAP have included:

- GAAP has recognized certain assets which, for statutory purposes, have been either nonadmitted or immediately expensed. Policy acquisition costs are expensed as incurred under SAP since the funds so expended are no longer available to pay future liabilities. Insurance company financial statements prepared in accordance with GAAP defer costs incurred in the acquisition of new business and amortize them over the premium recognition period.

- Deferred income taxes have, historically, not been recognized under SAP.

- The methods of accounting for certain aspects of reinsurance under GAAP may have varied from SAP, e.g., credit for reinsurance in unauthorized companies.

D. Purpose of Codification

12. The purpose of the codification of statutory accounting principles is to produce a comprehensive guide to SAP for use by insurance departments, insurers, and auditors. Statutory accounting principles, as they existed prior to codification did not always provide a consistent and comprehensive basis of accounting and reporting. The prescribed or permitted statutory accounting model resulted in practices that could have varied from state to state. Insurance companies were sometimes uncertain about what rules to follow and regulators were sometimes unfamiliar with the accounting rules followed by insurers in other states. As a result, insurers' financial statements were not always prepared on a comparable basis.

13. In engaging this project, it was necessary to revisit principles that had been developed over a long period of time and to consider recently identified accounting issues not currently addressed by SAP. In many cases, previously available choices of accounting methods were eliminated. Also considered was the current state of the regulatory environment and the tools more recently developed, such as risk-based capital (RBC). These new financial analytical tools allowed for a reconsideration of the level of conservatism necessary to achieve regulatory objectives.

14. The Codification project will result in more complete disclosures and more comparable financial statements, which will make the insurance departments' analysis techniques more meaningful and effective. The project will provide examiners and analysts with uniform accounting rules against which companies' financial statements can be evaluated. RBC, an important tool used by the states to measure solvency of insurers, will be reported more consistently with the benefit of codification.

E. History of Codification

15. In 1989, the NAIC adopted a Solvency Agenda designed to enhance the ability of state regulators to protect insurance consumers from the financial trauma of insurer insolvency. In recognition of the fact that enhancement of solvency regulation is an ongoing process, the agenda was updated in 1991. Since 1991, most major initiatives of the 1991 Solvency Agenda have been accomplished. They include: 1) revision of the NAIC *Financial Condition Examiners Handbook*, 2) development of a risk-based capital approach to define required levels of capital and surplus, 3) development of a model law on authorized insurer investments, 4) creation of a centralized financial analysis unit to perform comprehensive analysis of insurance companies who may be troubled, 5) development of computerized analytical routines for use by state insurance departments, and 6) creation of an NAIC education fund.

16. The codification project is also a direct result of the 1991 Solvency Agenda. The goal was "evaluation of existing statutory accounting principles as presently outlined in the *Accounting Practices and Procedures Manual* for purposes of further development, expansion, and codification."

17. Beginning in 1994, the NAIC's efforts to codify SAP were strengthened and reorganized recognizing the need for expediency. There was both a commitment of substantial financial resources as well as the selection of a team of dedicated regulators who were willing to commit the time and effort necessary to accomplish one of the most significant undertakings that has been faced by the NAIC.

18. Recognition of this effort was given by the AICPA when in 1995 they issued *Statement of Position 95-5—Auditor's Report on Statutory Financial Statements of Insurance Enterprises* (SOP 95-5) so that an auditor's opinion on a "prescribed or permitted" basis could continue until codification was completed. SOP 95-5 states "The codification is expected to result in a hierarchy of statutory accounting practices that will provide a comprehensive basis of accounting that can be applied consistently to all insurance enterprises." At that time, it was believed that once Codification was effective, in order for certified public accountants (CPAs) to issue opinions on statutory statements, SAP had to be considered an "Other Comprehensive Basis of Accounting" (OCBOA) by the American Institute of Certified Public Accountants (AICPA).

19. Codification is not intended to preempt state legislative and regulatory authority. While Codification is expected to be the foundation of a state's statutory accounting practices, it may be subject to modification by practices prescribed or permitted by a state's insurance commissioner. Statutory financial statements will continue to be prepared on the basis of accounting practices prescribed or permitted by the states. As a result, in 1998 the AICPA's Insurance Companies Committee determined that it will not be necessary for the Auditing Standards Board to grant the Codification status as an OCBOA since it will not be the sole basis for preparing statutory financial statements. Further, auditors will be permitted to continue to provide audit opinions on practices prescribed or permitted by the insurance department of the state of domicile.

F. Scope of Project

20. The conceptual framework used in developing and maintaining statutory accounting principles for insurance companies is summarized in the Statutory Accounting Principles Statement of Concepts. The application of the concepts of conservatism, consistency and recognition assure that guidance developed and codified as part of this project is consistent with the underlying objectives of statutory accounting.

21. This Guide has been developed using the body of statutory accounting principles as prescribed in the statutory hierarchy of accounting guidance, which is incorporated into the Statement of Concepts. This hierarchy provides the guidance for judging the presentation of statutory financial statements in conformance with statutory accounting principles.

September 20, 1994

III. Statutory Accounting Principles Statement of Concepts

Purpose of Statement of Concepts for Statutory Accounting Principles

22. This document states the fundamental concepts on which statutory financial accounting and reporting standards are based. These concepts provide a framework to guide the National Association of Insurance Commissioners ("NAIC") in the continued development and maintenance of statutory accounting principles ("SAP" or "statutory basis") and, as such, these concepts and principles constitute an accounting basis for the preparation and issuance of statutory financial statements by insurance companies in the absence of state statutes and/or regulations.[1]

23. The NAIC and state insurance departments are primarily concerned with statutory accounting principles that differ from GAAP reflective of the varying objectives of regulation. Recodification of areas where SAP and GAAP are parallel is an inefficient use of limited resources.

24. SAP utilizes the framework established by GAAP.[2] This document integrates that framework with objectives exclusive to statutory accounting. The NAIC's guidance on SAP is comprehensive for those principles that differ from GAAP based on the concepts of statutory accounting outlined herein. Those GAAP pronouncements that are not applicable to insurance companies will not be adopted by the NAIC. For those principles that do not differ from GAAP, the NAIC may specifically adopt those GAAP Pronouncements to be included in statutory accounting. GAAP Pronouncements do not become part of SAP until and unless adopted by the NAIC.

25. The body of statutory accounting principles is prescribed in the statutory hierarchy of accounting guidance. This hierarchy provides the framework for judging the presentation of statutory financial statements in conformance with statutory accounting principles.

26. Statutory requirements vary from state to state. While it is desirable to minimize these variations, to the extent that they exist it is the objective of NAIC statutory accounting principles to provide the standard against which the exceptions will be measured and disclosed if material.

Objectives of Statutory Financial Reporting

27. The primary responsibility of each state insurance department is to regulate insurance companies in accordance with state laws with an emphasis on solvency for the protection of policyholders. The ultimate objective of solvency regulation is to ensure that policyholder, contract holder and other legal obligations are met when they come due and that companies maintain capital and surplus at all times and in such forms as required by statute to provide an adequate margin of safety. The cornerstone of solvency measurement is financial reporting. Therefore, the regulator's ability to effectively determine relative financial condition using financial statements is of paramount importance to the protection of

[1] As stated in the NAIC's constitution, the NAIC is an association of chief insurance regulatory officials of the 50 states, the District of Columbia, American Samoa, Guam, Puerto Rico, and the Virgin Islands whose objective is to serve the public by assisting several state insurance supervisory officials, individually and collectively, in achieving the following fundamental insurance regulatory objectives:

1. Maintenance and improvement of state regulation of insurance in a responsive and efficient manner;
2. Reliability of the insurance institution as to financial solidity and guaranty against loss;
3. Fair, just, and equitable treatment of policyholders and claimants.

[2] The GAAP framework applicable to insurance accounting is set forth in *Statements of Financial Accounting Concepts One, Two, Five, and Six*. These documents, promulgated by the Financial Accounting Standards Board, set forth the objectives and concepts which are used in developing accounting and reporting standards.

policyholders. An accounting model based on the concepts of conservatism, consistency, and recognition is essential to useful statutory financial reporting.

28. Statutory reporting applies to all insurers authorized to do business in the United States and its territories, and requires sufficient information to meet the statutory objectives. However, statutory reporting as contained in this guide is not intended to preempt state legislative and regulatory authority. The SAP financial statements include the balance sheet and related summary of operations, changes in capital and surplus, and cash flow statements. Because these basic financial statements cannot be expected to provide all of the information necessary to evaluate an entity's short-term and long-term stability, management must supplement the financial statements with sufficient disclosures (e.g., notes to financial statements, management's discussion and analysis, and supplementary schedules and exhibits) to assist financial statement users in evaluating the information provided.

Concepts

Conservatism

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

30. Conservative valuation procedures provide protection to policyholders against adverse fluctuations in financial condition or operating results. Statutory accounting should be reasonably conservative over the span of economic cycles and in recognition of the primary responsibility to regulate for financial solvency. Valuation procedures should, to the extent possible, prevent sharp fluctuations in surplus.

Consistency

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

Recognition

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

33. The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which are unavailable due

to encumbrances or other third party interests should not be recognized on the balance sheet but rather should be charged against surplus when acquired or when availability otherwise becomes questionable.

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

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

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

Conclusion

37. This document states the fundamental concepts for financial statements presented on the basis of SAP. These concepts summarize the conceptual framework that the NAIC uses in developing and maintaining statutory accounting principles for insurance companies. These concepts will also assure that guidance will be provided consistently with the underlying objectives of statutory accounting and will aid in the review of emerging accounting issues.

38. The multitude of unique circumstances and individual transactions makes it virtually impossible for any codification of accounting principles to be totally comprehensive. Application of SAP, either contained in the SSAPs or defined as GAAP and adopted by the NAIC, to unique circumstances or individual transactions should be consistent with the concepts of conservatism, consistency, and recognition.

IV. Statutory Hierarchy

The following Hierarchy is not intended to preempt state legislative and regulatory authority.

Level 1:

- SSAPs, including GAAP reference material to the extent adopted by the NAIC from the FASB Accounting Standards Codification[3] (FASB Codification or GAAP guidance)[4, 5].

Level 2:

- Consensus positions of the Emerging Accounting Issues (E) Working Group as adopted by the NAIC

Level 3:

- NAIC Annual Statement Instructions
- *Purposes and Procedures Manual of the NAIC Investment Analysis*~~*Securities Valuation*~~ *Office*

Level 4:

- Statutory Accounting Principles Statement of Concepts[6]

Level 5:

- Sources of nonauthoritative GAAP accounting guidance and literature, including: (a) practices that are widely recognized and prevalent either generally or in the industry, (b) FASB Concept Statements, (c) AICPA Issue Papers, (d) International Financial Reporting Standards, (e) Pronouncements of professional associations or regulatory agencies, (f) Technical Information Service Inquiries and Replies included in the AICPA Technical Practice Aids, and (g) Accounting textbooks, handbooks and articles.

[3] Effective September 15, 2009, the FASB Codification is the source of authoritative U.S. generally accepted accounting principles. As of that date, the FASB Codification superseded all then-existing non-SEC accounting and reporting standards. All other nongrandfathered, non-SEC accounting literature not included in the FASB Codification is nonauthoritative. As of September 15, 2009, AICPA Statements of Position are no longer reviewed as part of the statutory maintenance process as they are no longer considered authoritative GAAP literature. If the AICPA were to address an issue that affects the FASB Codification, an accounting standard update (ASU) would be issued and reviewed for applicability to statutory accounting.

[4] FAS 133 Implementation Issues are excluded from the NAIC hierarchy and statutory accounting standard review process unless considered significant and relevant to statutory accounting and specifically requested for review as part of the maintenance process, or in accordance with future projects in which review of a specific FAS 133 Implementation Issue would be considered beneficial. (These items are excluded from the maintenance process as SSAP No. 86 only adopts the framework of the guidance included in FAS 133.)

[5] FASB Staff Positions (FSPs) adopted after May 9, 2008, are reviewed as part of the statutory accounting maintenance review process. FSPs adopted prior to May 9, 2008, were reviewed as part of the maintenance process if considered to be 'Board-directed'. (Board-directed FSPs were issued to provide narrow and limited revisions to the FASB statements or FASB interpretations formerly provided in FASB Technical Bulletins.) FSPs that were not considered 'Board-directed' were considered to provide application guidance similar to that found in FASB Staff Implementation Guides and Staff Announcements and were not reviewed as part of the statutory accounting maintenance review process.

[6] The Statutory Accounting Principles Statement of Concepts incorporates by reference FASB Concepts Statements One, Two, Five and Six to the extent they do not conflict with the concepts outlined in the statement. However, for purposes of applying this hierarchy the FASB Concepts Statements shall be included in Level 5 and only those concepts unique to statutory accounting as stated in the statement are included in Level 4.

39. If the accounting treatment of a transaction or event is not specified by the SSAPs, preparers, regulators and auditors of statutory financial statements should consider whether the accounting treatment is specified by another source of established statutory accounting principles. If an established statutory accounting principle from one or more sources in Level 2 or 3 is relevant to the circumstances, the preparer, regulator or auditor should apply such principle. If there is a conflict between statutory accounting principles from one or more sources in Level 2 or 3, the preparer, regulator or auditor should follow the treatment specified by the source in the higher level—that is, follow Level 2 treatment over Level 3. Revisions to guidance in accordance with additions or revisions to the NAIC statutory hierarchy should be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*.

40. Because of developments such as new legislation or the evolution of a new type of business transaction, there sometimes are no established statutory accounting principles for reporting a specific transaction or event. In those instances, it might be possible to report the event or transaction on the basis of its substance by selecting a statutory accounting principle that appears appropriate when applied in a manner similar to the application of an established statutory principle to an analogous transaction or event. In the absence of a SSAP or another source of established statutory accounting principles, the preparer, regulator or auditor of statutory financial statements may consider other accounting literature, depending on its relevance in the circumstances. Other accounting literature includes the Statutory Accounting Principles Statement of Concepts and GAAP reference material and accounting literature identified in Level 5. The appropriateness of other accounting literature depends on its relevance to the particular circumstances, the specificity of the guidance, and the general recognition of the issuer or author as an authority. For example, the Statutory Accounting Principles Statement of Concepts would be more authoritative than any other sources of accounting literature. Similarly, FASB Concepts Statements would normally be more influential than other sources of nonauthoritative GAAP pronouncements.

V. Statements of Statutory Accounting Principles

41. This Manual consists primarily of Statements of Statutory Accounting Principles (SSAPs). SSAPs are the primary Accounting Practices and Procedures promulgated by the NAIC. These statements are the result of issue papers that have been exposed for public comment and finalized. Finalized issue papers are in Appendix E. While it is not intended that there be any significant differences between an underlying issue paper and the resultant SSAP, if differences exist, the SSAP prevails and shall be considered definitive.

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

43. Once promulgated, statements will only be amended or superseded through the issuance of new SSAP pronouncements. If it is necessary to substantially modify or augment the guidance in a SSAP, a new statement will be promulgated and/or the statement will be reissued with "revised" in the title. Non-substantial changes will be included in the existing statement with changes tracked (i.e., new text will be underlined and deleted text as strikethrough) in the next printing of the Manual. Then no changes will be shown after the initial year. A useful tool for tracking of the relationships between statements is contained in the "Status" section of each statement which includes sections labeled "Affects" and "Affected By." As SSAPs are issued in the future that modify or augment the guidance previously provided, these sections will identify the relationships between statements.

VI. Materiality

44. Those who make accounting decisions and those who make judgments as regulators and auditors continually confront the need to make judgments about materiality. Materiality judgments are primarily quantitative in nature. They pose the question: Is this item large enough for users of the information to be influenced by it? However, the answer to that question will usually be affected by the nature of the item; items too small to be thought material if they result from routine transactions may be considered material if they arise in abnormal circumstances.

45. Materiality judgments are concerned with screens or thresholds. Is an item, an error, or an omission large enough, considering its nature and the attendant circumstances, to pass over the threshold that separates material from immaterial items? The more important a judgment item is, the finer the screen should be that will be used to determine whether it is material. For example:

- Circumstances where an accounting adjustment puts an insurer in danger of being in breach of a covenant or regulatory requirement may justify a lower materiality threshold than if its position were stronger. For example, an error resulting from an insurer incorrectly reporting certain nonadmitted assets as admitted assets might be considered material if the classification of those assets as nonadmitted would cause the insurer to trigger an event under the Risk-Based Capital requirements.

- A failure to disclose separately a nonrecurrent item of revenue may be material at a lower threshold than would otherwise be the case if the revenue turns a loss into a profit or reverses the trend of earnings from a downward to an upward trend.

- A miscategorization of assets or liabilities that would not be material in amount to the basic financial statements, but would cause the insurer to trigger an event under the Risk-Based Capital requirements, might be material.

- Amounts too small to warrant disclosure or correction in normal circumstances may be considered material if they arise from abnormal or unusual transactions or events.

46. Almost always, the relative rather than the absolute size of a judgment item determines whether it should be considered material in a given situation. Losses from bad debts that could be shrugged off as routine by a large insurer may threaten the continued existence of a small one. An error in reserve valuation may be material in a small insurer for which it cut earnings in half but immaterial in an insurer for which it might make a barely perceptible ripple in the earnings.

47. Another factor in materiality judgments is the degree of precision that is attainable in estimating the judgment item. The amount of deviation that is considered immaterial may increase as the attainable degree of precision decreases. For example, accounts payable usually can be estimated more accurately than can contingent liabilities arising from litigation or threats of it, and a deviation considered to be material in the first case may be quite trivial in the second.

48. Individual judgments are required to assess materiality. The essence of the materiality concept is clear. The omission or misstatement of an item in a statutory financial statement is material if, in the light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the statutory financial statement would have been changed or influenced by the inclusion or correction of the item.

49. The provisions of this Manual need not be applied to immaterial items.$^{\text{(INT 00-20)}}$

VII. Relationship to GAAP

50. As expressed in the Statement of Concepts, SAP utilizes the framework established by GAAP. This Manual integrates that framework with objectives exclusive to statutory accounting. The NAIC's guidance on SAP is comprehensive for those principles that differ from GAAP based on the concepts of statutory accounting outlined herein. GAAP guidance that is not applicable to insurance companies will not be adopted by the NAIC. For those principles that do not differ from GAAP, the NAIC may specifically adopt GAAP guidance to be included in statutory accounting. Elements of the FASB Codification do not become part of SAP until and unless adopted by the NAIC. Future SAP pronouncements will specifically identify any element of the FASB Codification that is to be included in SAP whether in whole, in part, or with modification as well as any rejected GAAP guidance. GAAP guidance which SAP has not yet addressed shall not be considered as providing authoritative statutory guidance.

VIII. Relationship to Developments within NAIC

51. Various NAIC committees and their working groups will be involved in issues, at any point in time, that could impact accounting guidance. Recommendations that affect accounting guidance must be referred to the Accounting Practices and Procedures (E) Task Force which has the responsibility for the maintenance of this Manual for determination of appropriate inclusion in SAP.

52. There are instances where the Codification of Statutory Accounting Principles (E) Working Group (Statutory Accounting Principles (E) Working Group as of January 1, 2000) has established an accounting principle in a SSAP but deferred maintenance and update of the detailed guidance to other NAIC task forces and their working groups. Those instances are specifically set forth in the individual SSAPs and include specific guidance for calculation of the Interest Maintenance Reserve (IMR), the Asset Valuation Reserve (AVR), the provision for overdue reinsurance, and periodic update to the *Purposes and Procedures Manual of the NAIC* Investment Analysis~~*Securities Valuation*~~ *Office*.

53. Changes to statutory accounting principles are not authoritative until approved by the general membership of the NAIC.

IX. Permitted Accounting Practices

54. In instances where the domiciliary state regulator is considering approval of a request for an accounting practice that departs from the NAIC *Accounting Practices and Procedures Manual* (Manual) and state prescribed accounting practices, the domiciliary regulator must provide Notice as defined in paragraphs 55-57.

55. No domiciliary state regulatory authority shall grant an approval to use an accounting practice, as described in paragraph 54, unless it provides Notice at least 5 days in advance of such approval.

56. This Notice must disclose the following information regarding the requested accounting practice request to all other states in which the insurer is licensed prior to the financial statement filing date:

a. The nature and a clear description of the permitted accounting practice request;

b. The quantitative effect of the permitted accounting practice request with all other approved permitted accounting practices currently in effect as disclosed in Appendix A-205: Illustrative Disclosure of Differences Between NAIC Statutory Accounting Practices and Procedures and Accounting Practices Prescribed or Permitted by the State of Domicile, for that insurer in the domiciliary state;

c. The effect of the requested permitted accounting practice on a legal entity basis and on all parent and affiliated United States insurance companies, if applicable; and

d. Identify any potential effects on and quantify the potential impact to each financial statement line item affected by the request. The potential impact may be determined by comparing the financial statements prepared in accordance with NAIC SAP and the financial statements incorporating the requested permitted accounting practice.

57. The granting of approval for an accounting practice request by the domiciliary state regulator does not preempt or in any way limit any individual state's legislative and regulatory authority.

X. Financial Statements

A. Annual Financial Statement

58. Each state requires all insurance companies doing business in that state to file an annual financial statement. All states use the annual statement blank promulgated by the NAIC, but each state retains the authority to make changes in those statements. Changes made by states generally require only supplemental information and do not change the basic financial information.

59. To the extent that disclosures required by a SSAP are made within specific notes, schedules, or exhibits to the annual statement, those disclosures are not required to be duplicated in a separate note. Annual statutory financial statements which are not accompanied by annual statement exhibits and schedules (e.g., annual audit report) shall include all disclosures required by the SSAPs based on the applicability, materiality and significance of the item to the insurer. Certain disclosures, as noted in individual SSAPs, are required in the annual audited statutory financial statements only.

B. Interim Financial Statements

60. Interim financial statements, including quarterly statements, shall follow the form and content of presentation prescribed by the domiciliary state for the quarterly financial statements. The NAIC quarterly statement form has been adopted by each state with minor variations as required by certain states.

61. The interim financial information shall include disclosures sufficient to make the information presented not misleading. It may be presumed that the users of the interim financial information have read or have access to the annual statement for the preceding period and that the adequacy of additional disclosure needed for a fair presentation, except in regard to material contingencies may be determined in that context. Accordingly, footnote disclosure which would substantially duplicate the disclosure contained in the most recent annual statement or audited financial statements, such as a statement of significant accounting policies and practices, details of accounts which have not changed significantly in amount or composition since the end of the most recently completed fiscal year, may be omitted. However disclosure shall be provided where events subsequent to the end of the most recent fiscal year have occurred which have a material impact on the insurer. Disclosures shall encompass, for example, significant changes since the end of the period reported on the last annual statement in such items as: statutory accounting principles and practices, estimates inherent in the preparation of financial statements, status of long term contracts, capitalization including significant new borrowings or modifications of existing financial arrangements, and the reporting entity resulting from business combinations or dispositions. Notwithstanding the above, where material noninsurance contingencies exist, disclosure of such matters shall be provided even though a significant change since year end may not have occurred.

Permitted Practices Advance Notification Requirement Implementation Questions and Answers

1. Q: **Why is the issue of permitted accounting practices important?**

   A: Since the Codification of the NAIC *Accounting Practices and Procedures Manual* (AP&P Manual), there has been continued emphasis on uniformity among the states. With the adoption of Codification, the belief was that permitted accounting practices would be limited. The intent of the policy statement on permitted accounting practices is to provide notification prior to granting permitted accounting practices to other states in which an insurer is licensed. Proactive notification encourages communication between state insurance regulators who share a common interest in the solvency of insurance companies writing business in their state.

2. Q: **What is the difference between a permitted accounting practice and a prescribed practice?**

   A: **Permitted** accounting practices include practices specifically requested by an insurer that depart from NAIC Statutory Accounting Principles (SAP) and state prescribed accounting practices, as described below, and have received approval from the insurer's domiciliary state regulatory authority.

   Prescribed accounting practices are those practices that are incorporated directly or by reference by state laws, regulations and general administrative rules applicable to all insurance enterprises domiciled in a particular state. The NAIC AP&P Manual is not intended to preempt states' legislative and regulatory authority.

   If a reporting entity requests an accounting practice that differs from state prescribed accounting practices, but is in accordance with NAIC SAP, advance notice of approval is not required.

3. Q: **Does a permitted accounting practice request require approval/consensus from other states before it is granted by the domiciliary state?**

   A: No, the domiciliary state regulatory authority does not need approval or consensus from other state regulatory authorities to grant a permitted accounting practice. The granting of approval for an accounting practice request by the domiciliary state regulator does not preempt or in any way limit any individual state's legislative and regulatory authority.

   If a state does not comply with the advance notice provision but approves a permitted practice, the lack of notice does not invalidate the permitted practice for the reporting entity. In addition, the reporting entity is required to disclose accounting practices that depart from the NAIC accounting practices and procedures, which affect statutory surplus or risk based capital pursuant to *SSAP No. 1—Disclosure of Accounting Policies, Risks & Uncertainties, and Other Disclosures*.

4. Q: **How does the domestic regulator communicate an insurer's request for a permitted accounting practice to other states?**

   A: The NAIC can facilitate the communication of this information through the Permitted Practice Database within the Exam Tracking System. In order to develop a repository of all permitted accounting practice notifications, all regulatory authorities should distribute permitted accounting practice notifications using the procedures prescribed by the NAIC members. When providing permitted accounting practice notifications, the regulatory authority will provide the following information in instances where they are considering approval of a request:

- Detailed description of the permitted accounting practice request, including the specific NAIC Statutory Accounting Principles or state prescribed practices from which the practice departs
- Whether the permitted accounting practice was granted the previous year
- The financial statement filing date in which the permitted accounting practice will be reflected and the timeframe for which the permitted accounting practice is granted (e.g., indefinitely, until withdrawn, specific date – month, day, year)
- Explanation for providing less than the required advance notice
- The financial statement line items the permitted accounting practice will affect and the respective financial impact for each line item identified
- The total financial impact to capital and surplus for all approved/requested permitted accounting practices
- The effect of the permitted accounting practice on a legal entity basis and on all parent and affiliated U.S. insurance companies, if applicable
- Whether the permitted accounting practice is approved or the decision is pending

Grandfather Clause: Please note that those permitted accounting practices that have been granted prior to December 2004 for an indefinite time period do not require a new notice to other states and are not required to be filed through the ETS system. If the permitted accounting practice is considered by the state for reaffirmation annually then annual advance notice is required.

5. Q: **If a Department of Insurance received a request for a permitted accounting practice from an insurer licensed in only one state, is the Department required to comply with communication requirements outlined in the Preamble?**

A: No, an insurer licensed in only one state is not subject to the permitted accounting practices communication policy included in the Preamble. The goal of the permitted accounting practices communication policy is to encourage open communication between state regulatory authorities and promote uniformity. As permitted accounting practices granted to an insurer licensed in only one state would not impact states outside of the domiciliary state, they do not need to be communicated to other regulatory authorities.

6. Q: **Are requests for permitted accounting practices kept confidential?**

A: The communication of permitted accounting practices will be facilitated through the NAIC's Permitted Practice Database of the Exam Tracking System, which is a confidential, regulator-only system and/or through regulator-to-regulator e-mail exchange.

7. Q: **Is a state required to provide advance notification for accounting practices that are explicitly permitted under the AP&P Manual, with the approval of the commissioner?**

A: No, for example, a reporting entity is required to obtain domiciliary commissioner approval for a capital contribution as described in *SSAP No. 72—Surplus and Quasi-Reorganizations*, paragraph 8:

> 8. Notes or other receivables received as additional capital contributions satisfied by receipt of cash or readily marketable securities prior to filing of the statutory financial

> statement shall be treated as a Type I subsequent event in accordance with SSAP No. 9 and as such shall be considered an admitted asset based on the evidence of collection and approval of the domiciliary commissioner. To the extent that the notes or other receivables are not satisfied, they shall be nonadmitted.

These types of transactions are not a departure from NAIC SAP and do not require a request for a permitted accounting practice.

8. Q: When will the permitted accounting practices communication policy become effective?

A: The Statutory Accounting Principles (E) Working Group, the Accounting Practices and Procedures (E) Task Force and the Financial Condition (E) Committee held a joint conference call to approve the guidance on November 30, 2004. The policy became effective in December 2004 upon approval by the Executive/Plenary Committee. The policy will be incorporated into the *Accounting Practices and Procedures Manual* and the Financial Regulation Standards and Accreditation (F) Committee will consider such changes to the *NAIC Financial Regulations Standards and Accreditation Manual* during the normal maintenance process.

9. Q: When submitting a permitted accounting practice request, is the financial statement effect quantified for all affiliates, or only those materially affected?

A: It is important that the insurer identify any potential effects on and quantify the potential impact to each financial statement line item on a legal entity basis and on all parent and affiliated U.S. insurance companies, if applicable. The notification from the regulator should only include the effect on a legal entity basis for those entities materially affected positively or negatively by the permitted accounting practice.

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Statement of Statutory Accounting Principles No. 1

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

STATUS

Type of Issue:	Common Area
Issued:	Initial Draft
Effective Date:	January 1, 2001
Affects:	No other pronouncements
Affected by:	No other pronouncements
Interpreted by:	No other pronouncements

STATUS 1

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

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for the disclosure of accounting policies, risks and uncertainties, the use of accounting practices which depart from NAIC statutory accounting practices and procedures, and other disclosures.

2. Separate statements of statutory accounting principles have disclosure requirements specific to the topics addressed in those statements. Additional disclosure requirements not addressed in other statements are included herein.

SUMMARY CONCLUSION

3. Refer to the preamble for further discussion of disclosure requirements. The disclosures required under paragraph 6 concerning changes in accounting policies shall be made for each financial statement presented. The disclosures required under paragraphs 9, 10, 12, 13, 15 and 16 shall be included in the annual audited statutory financial reports only.

Accounting Policies and Practices

4. Accounting policies are defined as the specific accounting principles and the methods of applying those principles that are utilized in preparing the statutory financial statements.

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

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

7. NAIC statutory accounting practices and procedures are those that are set forth in the *Accounting Practices and Procedures Manual*. If a reporting entity employs accounting practices that depart from the NAIC accounting practices and procedures, disclosure of the following information about those accounting practices that affect statutory surplus or risk-based capital shall be made at the date each financial statement is presented:

a. A description of the accounting practice;

b. A statement that the accounting practice differs from NAIC statutory accounting practices and procedures; and

c. The monetary effect on net income and statutory surplus of using an accounting practice which differs from NAIC statutory accounting practices and procedures.

d. If an insurance enterprise's risk-based capital would have triggered a regulatory event had it not used a prescribed or permitted practice, that fact should be disclosed in the financial statements.

These disclosures shall be disclosed in Note 1 as illustrated in Appendix A-205. Additionally, a reference to Note 1 shall be included in the individual notes to financial statements impacted by the prescribed or permitted practices as applicable.

8. Disclosure of the following information shall be made about accounting practices when NAIC statutory accounting practices and procedures do not address the accounting for the transaction:

a. A description of the transaction and of the accounting practice used; and

b. A statement that NAIC statutory accounting practices and procedures do not address the accounting for the transaction.

Risks and Uncertainties

9. Companies shall make disclosures in their financial statements about risks and uncertainties existing as of the date of those statements in the following areas:

a. Nature of operations;

b. Use of estimates in the preparation of financial statements;

c. Certain significant estimates; and

d. Current vulnerability due to certain concentrations.

Nature of Operations

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

Use of Estimates in the Preparation of Financial Statements

11. Financial statements shall include an explanation that the preparation of financial statements in conformity with the annual statement instructions and the *Accounting Practices and Procedures Manual* requires the use of management's estimates.

Certain Significant Estimates

12. Disclosure regarding an estimate shall be made when known information available prior to issuance of the financial statements indicates that both of the following criteria are met:

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

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

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

Current Vulnerability Due to Certain Concentrations

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

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

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

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

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

16. Concentrations, including known group concentrations, described below require disclosure if they meet the criteria of paragraph 15 of this statement. (Group concentrations exist if a number of counterparties or items that have similar economic characteristics collectively expose the reporting entity to a particular kind of risk.) Some concentrations may fall into more than one category:

a. Concentrations in the volume of business transacted with a particular customer, supplier, or lender. The potential for the severe impact can result, for example, from total or partial loss of the business relationship. For the purposes of this statement, it is always considered at least reasonably possible that any customer will be lost in the near term;

b. Concentrations in revenue from particular products or services. The potential for severe impact can result, for example, from volume or price changes for a particular source of revenue;

c. Concentrations in the available sources of labor, services, licenses, or other rights used in the entity's operations;

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

Other Disclosures

17. For each year that a balance sheet is presented (annual), reporting entities shall disclose the following information in the financial statements:

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

b. The amount and nature of any assets pledged to others as collateral or otherwise restricted (e.g., not under the exclusive control, assets subject to a put option contract, etc.)[1] in the general and separate accounts[2] by the reporting entity in comparison to total assets and total admitted assets. (Pursuant to SSAP No. 4, paragraph 6, all assets pledged as collateral or otherwise restricted shall be reported in this disclosure regardless if the asset is considered an admitted asset.) This disclosure shall include the following items:

i. Reported assets subject to contractual obligation for which liability is not shown;

ii. Collateral held under security lending agreements;

iii. Assets subject to repurchase agreements;

iv. Assets subject to reverse repurchase agreements;

v. Assets subject to dollar repurchase agreements;

vi. Assets subject to dollar reverse repurchase agreements;

vii. Assets placed under option contracts;

viii. Letter stock or securities restricted as to sale – excluding FHLB stock;

ix. FHLB capital stock;

x. Assets on deposit with states;

xi. Assets on deposit with other regulatory bodies;

xii. Pledged as collateral to the FHLB (including assets backing funding agreements);

xiii. Assets pledged as collateral not captured in other categories; and

xiv. Other restricted assets.

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

Supplemental Investment Disclosure

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

[1] The aggregate information captured within this disclosure is intended to reflect the information reported in the Annual Statement Investment Schedules in accordance with the coding of investments that are not under the exclusive control of the reporting entity, including assets loaned to others and the information reported in the General Interrogatories.

[2] Restricted assets in the separate account are not intended to reflect amounts "restricted" only because they are insulated from the general account or because they are attributed to specific policyholders. Separate account assets shall be captured in this disclosure only if they are restricted outside of these characteristics.

20. The Life, Accident and Health and Fraternal Annual Statement Instructions include instructions for completing Schedule 1 Selected Financial Data. This Supplemental schedule is required to be included in the annual audit report for Life, Accident and Health and Fraternal reporting entities.

Subprime Mortgage Related Risk Exposure

21. Reporting entities shall disclose information pertaining to subprime mortgage related risk exposure and related risk management practices, regardless of the materiality of the exposure, in the statutory financial statements. These disclosures are not required in the annual audited financial statements. Although definitions may differ among reporting entities, the following features are commonly recognized characteristics of subprime mortgage loans:

a. An interest rate above prime to borrowers who do not qualify for prime rate loans;

b. Borrowers with low credit ratings (FICO scores);

c. Interest-only or negative amortizing loans;

d. Unconventionally high initial loan-to-value ratios;

e. Low initial payments based on a fixed introductory rate that expires after a short initial period, then adjusts to a variable index rate plus a margin for the remaining term of the loan;

f. Borrowers with less than conventional documentation of their income and/or net assets;

g. Very high or no limits on how much the payment amount or the interest rate may increase at reset periods, potentially causing a substantial increase in the monthly payment amount, and/or;

h. Include substantial prepayment penalties and/or prepayment penalties that extend beyond the initial interest rate adjustment period.

22. To the extent such information is available, reporting entities shall consider exposure to subprime mortgage related risk through the following sources:

a. Direct investments in subprime mortgage loans;

b. Direct investments in securities with underlying subprime exposure, such as residential mortgage backed securities, commercial mortgage backed securities, collateralized debt obligations, structured securities (including principal protected notes), hedge funds, credit default swaps, and special investment vehicles;

c. Equity investments in subsidiary, controlled or affiliated entities with significant subprime related risk exposure;

d. Underwriting risk on policies issued for Mortgage Guaranty or Financial Guaranty insurance coverage.

23. As it relates to the exposure described above, reporting entities shall provide the following information:

a. A narrative description of the manner in which the reporting entity specifically defines its exposure to subprime mortgage related risk in practice. Disclose the general categories of information considered in determining exposure to subprime mortgage related risk.

Differentiation should be made between exposure to unrealized losses due to changes in asset values versus exposure to realized losses resulting from receiving less than anticipated cash flows or due to potential sale of assets to meet future cash flow requirements. Risk management or mitigation strategies shall also be disclosed.

b. Direct exposure through investments in subprime mortgage loans. Disclose the following information for the aggregate amount of directly held subprime mortgage loans: book adjusted carrying value (excluding accrued interest); fair value; value of land and buildings; any other-than-temporary impairment losses recognized to date; default rate for the subprime portion of the loan portfolio. This information shall be segregated by the categories of Mortgages in the Process of Foreclosure, Mortgages in Good Standing and Mortgages with Restructured Terms.

c. Direct exposure through other investments. Reporting entities shall consider subprime mortgage related risk exposure through other investments for the following types of investments:

i. Residential mortgage backed securities

ii. Commercial mortgage backed securities

iii. Collateralized debt obligations

iv. Structured securities (including principal protected notes)

v. Equity investments in subsidiary, controlled or affiliated entities with significant subprime mortgage related risk exposure (a general description of the nature and extent of the SCA's exposure should be included)

vi. Other assets (including but not limited to hedge funds, credit default swaps, special investment vehicles)

Aggregated by the above investment types, reporting entities shall disclose the following: actual cost; book adjusted carrying value; fair value; any other-than-temporary impairment losses recognized to date.

d. Underwriting exposure to subprime mortgage risk through Mortgage Guaranty or Financial Guaranty insurance coverage. Disclose the following information, by coverage type, related to underwriting exposure on policies issued for Mortgage Guaranty coverage or Financial Guaranty coverage and any other lines of insurance expected to be impacted: the aggregate amount of subprime related losses paid in the current year; the aggregate amount of subprime related losses incurred in the current year; the aggregate amount of subprime related case reserves at the end of the current period; the aggregate amount of subprime related IBNR reserves at the end of the current period.

Stress Liquidity Risks

24. Reporting entities may be requested to complete disclosures pertaining to stress liquidity risks pursuant to inquiries and templates, or variations thereof, included in the *NAIC Financial Condition Examiners Handbook*. These disclosures may be considered confidential, therefore are not captured within the statutory financial statements. As noted in the *NAIC Financial Condition Examiners Handbook,* requests for reporting entities to complete these templates may occur at any time and are not limited to instances of comprehensive statutory examinations.

Relevant Literature

25. This statement adopts Accounting Principles Board Opinion No. 22, Disclosure of Accounting Policies, Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins, Chapter 2A, “Comparative Financial Statements,” AICPA Statement of Position No. 94-5, Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises, and AICPA Statement of Position No. 94-6, Disclosures of Certain Significant Risks and Uncertainties. The disclosure of certain accounting policies within specific notes to the Annual Statement is required by the Annual Statement Instructions.

Effective Date and Transition

26. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*.

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 77—Disclosure of Accounting Policies, Risks & Uncertainties, and Other Disclosures*

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Statement of Statutory Accounting Principles No. 2

Cash, Drafts, and Short-Term Investments

STATUS

Type of Issue:	Common Area
Issued:	Initial Draft
Effective Date:	January 1, 2001
Affects:	Nullifies and incorporates INT 08-10
Affected by:	No other pronouncements
Interpreted by:	No other pronouncements

STATUS 1

SCOPE OF STATEMENT 3

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Cash, Drafts, and Short-Term Investments

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles and related reporting for cash, drafts, and short-term investments.

SUMMARY CONCLUSION

Cash

2. Cash constitutes a medium of exchange that a bank or other similar financial institution will accept for deposit and allow an immediate credit to the depositor's account.

3. Also classified as cash for financial statement purposes, although not falling within the above definition of cash, are savings accounts and certificates of deposit in banks or other similar financial institutions with maturity dates within one year or less from the acquisition date, and cash equivalents. Cash equivalents are short-term, highly liquid investments that are both (a) readily convertible to known amounts of cash, and (b) so near their maturity that they present insignificant risk of changes in value because of changes in interest rates. Only investments with original maturities[1] of three months or less qualify under this definition. Securities with terms that are reset at predefined dates (e.g., an auction-rate security that has a long-term maturity and an interest rate that is regularly reset through a Dutch auction) or have other features an investor may believe results in a different term than the related contractual maturity shall be accounted for based on the contractual maturity at the date of acquisition, except where other specific rules within the statutory accounting framework currently exist.

4. Cash meets the definition of an asset as defined in *SSAP No. 4—Assets and Nonadmitted Assets* (SSAP No. 4), and is an admitted asset to the extent it conforms to the requirements of this statement.

Treatment of Negative Cash Balances

5. If a reporting entity has multiple cash accounts, the net amount of all accounts shall be reported jointly. Cash accounts with positive balances shall not be reported separately from cash accounts with negative balances. If in the aggregate, the reporting entity has a net negative cash balance, it shall be reported as a negative asset and shall not be recorded as a liability.

Drafts

6. A draft is defined as an order to pay a sum certain in money. It is signed by the drawer (e.g., the insurance company or its agent), and payable to order or bearer (e.g., the policyholder). When the draft is presented to the drawee (i.e., the bank), it is paid only upon approval by the reporting entity.

7. Drafts and checks have different legal characteristics. A check is payable on demand, whereas a draft must be approved for payment by the reporting entity before it is honored by the bank. Because of these different characteristics, a draft meets the definition of a liability as defined by *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets*. Outstanding checks are accounted for as a reduction of cash.

8. A reporting entity that utilizes instruments meeting the definition of drafts shall elect one of the following accounting methods:

[1] Original maturity means original maturity to the entity holding the investment. For example, both a three-month U.S. Treasury bill and a three-year Treasury note purchased three months from maturity qualify as cash equivalents. However, a Treasury note purchased three years ago does not become a cash equivalent when its remaining maturity is three months.

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

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

9. The method elected by a reporting entity to account for drafts issued and outstanding shall remain consistent from year to year. Procedures for changes in the accounting method shall be governed by *SSAP No. 3—Accounting Changes and Corrections of Errors* (SSAP No. 3).

Short-Term Investments

10. All investments with remaining maturities (or repurchase dates under repurchase agreements) of one year or less at the time of acquisition (excluding those investments classified as cash equivalents as defined in paragraph 3) shall be considered short-term investments. Short-term investments include, but are not limited to, bonds, commercial paper, money market instruments, repurchase agreements, and collateral and mortgage loans which meet the above criteria. Short-term investments shall not include certificates of deposit.

11. All short-term investments shall be accounted for in the same manner as similar long-term investments. Investments in money market funds shall be reported in accordance with the guidance in the *Purposes and Procedures Manual of the NAIC Investment Analysis~~Securities Valuation~~ Office*.

12. Short-term investments meet the definition of assets as defined in SSAP No. 4 and are admitted assets to the extent they conform to the requirements of this statement.

Disclosures

13. The following disclosures shall be made for short-term investments in the financial statements:

a. Fair values in accordance with *SSAP No. 100—Fair Value Measurements*;

b. Concentrations of credit risk in accordance with *SSAP No. 27—Disclosure of Information* a*bout Financial Instruments with Off-Balance-Sheet Risk* and *Financial Instruments with Concentrations of Credit Risk*;

c. Basis at which the short-term investments are stated.

14. Refer to the preamble for further discussion regarding disclosure requirements. The disclosures in paragraph 13.b. shall be included in the annual audited statutory financial reports only.

Effective Date and Transition

15. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with SSAP No. 3. Guidance in paragraph 3 related to terms reset at predefined dates was previously included within *INT 08-10: Contractual Terms of Investments and Investor Intent* and was effective for periods beginning December 5, 2008.

REFERENCES

Other

- *Purposes and Procedures Manual of the NAIC Investment Analysis~~Securities Valuation~~ Office*

Relevant Issue Papers

- *Issue Paper No. 2—Definition of Cash*
- *Issue Paper No. 12—Accounting for Drafts Issued and Outstanding*
- *Issue Paper No. 28—Short-term Investments*

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Statement of Statutory Accounting Principles No. 3

Accounting Changes and Corrections of Errors

STATUS

Type of Issue:	Common Area
Issued:	Initial Draft
Effective Date:	January 1, 2001
Affects:	Nullifies and incorporates INT 00-05 and INT 01-27
Affected by:	No other pronouncements
Interpreted by:	No other pronouncements

STATUS **1**

SCOPE OF STATEMENT **3**

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Mergers 4
Disclosures 4
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Accounting Changes and Corrections of Errors

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for changes in accounting, which include changes in accounting principles, estimates, and reporting entities, and for corrections of errors in previously issued financial statements.

SUMMARY CONCLUSION

2. An accounting change is defined as a change in an accounting principle, an accounting estimate, or the reporting entity. The correction of an error in previously issued financial statements is not deemed to be an accounting change. The treatment of a change resulting from an insurance department examination will depend on whether the change resulted from a correction of an error, a change in accounting principle, or a change in estimate.

Change in Accounting Principle

3. A change in accounting principle results from the adoption of an accepted accounting principle, or method of applying the principle, which differs from the principles or methods previously used for reporting purposes. A change in the method of applying an accounting principle shall be considered a change in accounting principle.

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

5. The cumulative[1] effect of changes in accounting principles shall be reported as adjustments to unassigned funds (surplus) in the period of the change in accounting principle. The cumulative effect is the difference between the amount of capital and surplus at the beginning of the year and the amount of capital and surplus that would have been reported at that date if the new accounting principle had been applied retroactively for all prior periods.

Change in Accounting Estimate

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

7. A change in accounting estimate shall be included in the statement of income in the period when the change becomes known.

[1] If additional changes are identified in subsequent quarters of a fiscal year related to a change in accounting principles recognized initially during the first quarter, such changes shall be considered part of the cumulative effect of the change in accounting principle. The cumulative effect is the difference between the amount of capital and surplus at the beginning of the year and the amount of capital and surplus that would have been reported at that date if the new accounting principle had been applied retroactively for all prior periods. For example, adjustments to an amount recorded as of January 1, 2001, would be recorded as changes in accounting principle rather than corrections of an error through the period of 2001.

8. If the effect of a change in accounting principle is inseparable from the effect of a change in accounting estimate, then the change shall be considered as a change in accounting estimate for purposes of applying the accounting principles set forth in this statement.

Correction of an Error

9. Errors in financial statements result from mathematical mistakes, mistakes in the application of accounting principles, or oversight or misuse of facts that existed at the time the financial statements were prepared. In contrast, a change in accounting estimate results from new information, or subsequent developments and, accordingly, from better insight or improved judgment. Thus, an error is distinguished from a change in estimate.

10. Corrections of errors in previously issued financial statements shall be reported as adjustments to unassigned funds (surplus) in the period an error is detected. If a reporting entity becomes aware of a material error in a previously filed financial statement after it has been submitted to the appropriate regulatory agency, the entity shall file or be directed to file an amended financial statement if approved by its domiciliary regulator.

Impact on Historical Schedules

11. Changes which do not affect assets, liabilities, revenues, expenses, or surplus but which materially affect historical information in the financial statement supplemental schedules (e.g., Schedule P for property and casualty insurers or Schedule O for life and accident and health insurers) shall be reflected in the current year's schedules with appropriate notations made directly to the affected schedules and in the notes to the financial statements.

Mergers

12. For mergers, prior years' amounts in the Annual Statement shall be restated as if the merger had occurred as of January 1 of the prior year. Additionally, restatement shall be required for the two most recent years included in the Five Year Historical Summary. The Five Year Historical Summary shall include a footnote indicating that the other three years have not been restated. A reporting entity that merges with an entity which effectively is a shell company[2] (i.e., the reporting entity has no outstanding underwriting liabilities) shall be exempt from ~~the above requirements~~prior year restatement.

Disclosures

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

a. A brief description of the change, encompassing a general disclosure of the reason and justification for change or correction;

b. The impact of the change or correction on net income, surplus, total assets, and total liabilities for the two years presented in the financial statements (i.e., the balance sheet and statement of income and operations); and

c. The effect on net income of the current period for a change in estimate that affects several future periods, such as a change in the service lives of depreciable assets or actuarial assumptions affecting pension costs. Disclosure of the effect on those income statement amounts is not necessary for estimates made each period in the ordinary course of

[2] When one of the entities is a "shell company," the prior ~~period~~year amounts shall only consist of the "non-shell company." The merger with a shell entity shall be reflected as of January 1 of the current year.

accounting for items such as uncollectible accounts; however, disclosure is recommended if the effect of a change in the estimate is material; and

d. When subsequent financial statements are issued containing comparative restated results as a result of the filing of an amended financial statement, the reporting entity shall disclose that the prior period has been restated and the nature and amount of such restatement.

14. Refer to the preamble for further discussion regarding disclosure requirements.

Relevant Literature

15. This statement rejects *Accounting Research Bulletin No. 51, Consolidated Financial Statements*, *FASB Interpretation No. 46, Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51,* and *FASB Statement No. 94, Consolidation of All Majority-Owned Subsidiaries, an amendment of ARB 51, with related amendments of APB Opinion No. 18 and ARB No. 43, Chapter 12*.

16. This statement rejects paragraphs 1—19 and 26—27 of *Accounting Principles Board Opinion No. 9, Reporting the Results of Operations,* which address the treatment of extraordinary items and prior period adjustments and the related *AICPA Accounting Interpretations, Reporting the Results of Operations: Unofficial Accounting Interpretations of APB Opinion No. 9*. This statement also rejects *Accounting Principles Board Opinion No. 20*, *Accounting Changes, AICPA Accounting Interpretations, Accounting Changes: Accounting Interpretations of APB Opinion No. 20, FASB Interpretation No. 20, Reporting Accounting Changes under AICPA Statements of Position, an interpretation of APB Opinion No. 20* and *FASB Statement No. 154, Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20 and FASB Statement No. 3 (FAS 154). FASB Statement No. 16*, *Prior Period Adjustments,* is rejected as corrections of errors in previously issued financial statements are reported as adjustments to unassigned funds (surplus).

Effective Date and Transition

17. This statement is effective for years beginning January 1, 2001. The guidance in the footnote to paragraph 5 was originally contained within *INT 01-27: Accounting Change versus Correction of Error* and was effective October 16, 2001. The guidance in the footnote to paragraph 12 was originally contained within *INT 00-05: Exemption to Merger Disclosure in SSAP No. 3* and was effective June 12, 2000.

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 1—Consolidation of Majority-owned Subsidiaries*
- *Issue Paper No. 3—Accounting Changes*

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Statement of Statutory Accounting Principles No. 4

Assets and Nonadmitted Assets

STATUS

Type of Issue:	Common Area
Issued:	Initial Draft
Effective Date:	January 1, 2001
Affects:	Supersedes SSAP No. 87 with guidance incorporated August 2011 Nullifies and incorporates INT 01-03
Affected by:	No other pronouncements
Interpreted by:	INT 01-31

STATUS **1**

SCOPE OF STATEMENT **3**

SUMMARY CONCLUSION **3**

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Disclosure 4
Relevant Literature 4
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Assets and Nonadmitted Assets

SCOPE OF STATEMENT

1. This statement establishes the definition of an “asset” for use in statutory accounting and establishes the criteria for consistent treatment of nonadmitted assets.

SUMMARY CONCLUSION

2. For purposes of statutory accounting, an asset shall be defined as: probable[1] future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. An asset has three essential characteristics: (a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (b) a particular entity can obtain the benefit and control others’ access to it[2], and (c) the transaction or other event giving rise to the entity’s right to or control of the benefit has already occurred. These assets shall then be evaluated to determine whether they are admitted. The criteria used is outlined in paragraph 3.

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

a Specifically identified within the *Accounting Practices and Procedures Manual* as a nonadmitted asset; or

b Not specifically identified as an admitted asset within the *Accounting Practices and Procedures Manual*.

If an asset meets one of these criteria, the asset shall be reported as a nonadmitted asset and charged against surplus unless otherwise specifically addressed within the *Accounting Practices and Procedures Manual*. The asset shall be depreciated or amortized against net income as the estimated economic benefit expires. In accordance with the reporting entity's written capitalization policy, amounts less than a predefined threshold of furniture, fixtures, equipment, or supplies, shall be expensed when purchased.

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

5. The reporting entity shall maintain a capitalization policy containing the predefined thresholds for each asset class to be made available for the department(s) of insurance.

[1] *FASB Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements*, states:
Probable is used with its usual general meaning, rather than in a specific accounting or technical sense (such as that in *FASB Statement No. 5, Accounting for Contingencies*, paragraph 3), and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved.

[2] If assets of an insurance entity are pledged or otherwise restricted by the action of a related party, the assets are not under the exclusive control of the insurance entity and are not available to satisfy policyholder obligations due to these encumbrances or other third party interests. Thus, pursuant to paragraph 2(c), such assets shall not be recognized as an admitted asset on the balance sheet. Additional guidance for assets pledged as collateral is included in INT 01-31.

Assets Pledged as Collateral or Otherwise Restricted

6. Assets that are pledged to others as collateral or otherwise restricted (not under the exclusive control of the insurer, subject to a put option contract, etc.) shall be identified in the investment schedules pursuant to the codes in the annual statement instructions, disclosed in accordance with *SSAP No. 1—Disclosure of Accounting Policies, Risks & Uncertainties, and Other Disclosures* (SSAP No. 1), reported in the general interrogatories, and included in any other statutory schedules or disclosure requirements requesting information for assets pledged as collateral or otherwise restricted. Restricted assets should be reviewed to determine admitted or nonadmitted assets status in the statutory financial statements per the terms of their respective SSAPs. Asset restrictions may be a factor in determining the admissibility of an asset under a respective SSAP[3]. However, determining that a restricted asset is an admitted asset does not eliminate the statutory requirements to document and identify the asset as one that is pledged as collateral or otherwise restricted.

7. Assets pledged as collateral are one example of assets that are not under the exclusive control of the insurer, and are therefore restricted, even if the assets are admitted under statutory accounting guidelines (e.g., the asset is substitutable and/or other related SSAP conditions are met). As such, the asset shall be coded as pledged in the investment schedules pursuant to the annual statement instructions, disclosed in accordance with SSAP No. 1, reported in the general interrogatories, and included in any other statutory schedules or disclosure requirements requesting information for assets pledged as collateral or otherwise restricted.

Disclosure

~~6.~~8. The financial statements shall disclose if the written capitalization policy and the resultant predefined thresholds changed from the prior period and the reason(s) for such change.

Relevant Literature

~~7.~~9. This statement adopts *FASB Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements,* paragraphs 25-33.

Effective Date and Transition

~~8.~~10. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*. Guidance reflected in paragraphs 3, 5 and 8, incorporated from SSAP No. 87, was originally effective for years beginning on and after January 1, 2004. The guidance in footnote 2 to paragraph 2 was originally contained within *INT 01-03: Assets Pledged as Collateral or Restricted for the Benefit of a Related Party* and was effective June 11, 2001.

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 119—Capitalization Policy, An Amendment to SSAP Nos. 4, 19, 29, 73, 79 and 82*

[3] An example of such a situation is detailed in footnote 2 pertaining to assets restricted by the action of a related party. This is only a single example and each restricted asset would need to be reviewed to ensure it qualifies as an admitted asset.

Statement of Statutory Accounting Principles No. 5 - Revised

Liabilities, Contingencies and Impairments of Assets

STATUS

Type of Issue:	Common Area
Issued:	Initial draft; substantively revised – October 18, 2010
Effective Date:	January 1, 2001; substantive revisions – December 31, 2011
Affects:	Nullifies and incorporates INT 04-05, INT 08-06
Affected by:	No other pronouncements
Interpreted by:	No other pronouncements

STATUS **1**

SCOPE OF STATEMENT **3**

SUMMARY CONCLUSION **3**

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Joint and Several Liabilities 3
Loss Contingencies or Impairments of Assets 4
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APPENDIX A – DISCLOSURE ILLUSTRATIONS **13**

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Liabilities, Contingencies and Impairments of Assets

SCOPE OF STATEMENT

1. This statement defines and establishes statutory accounting principles for liabilities, contingencies and impairments of assets.

SUMMARY CONCLUSION

Liabilities

2. A liability is defined as certain or probable[1] future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or to provide services to other entities in the future as a result of a past transaction(s) or event(s).

3. A liability has three essential characteristics: (a) it embodies a present duty or responsibility to one or more other entities that entails settlement by probable[1] future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand, (b) the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice, and (c) the transaction or other event obligating the entity has already happened. This includes, but is not limited to, liabilities arising from policyholder obligations (e.g., policyholder benefits, reported claims and reserves for incurred but not reported claims). Liabilities shall be recorded on a reporting entity's financial statements when incurred.

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

Joint and Several Liabilities

5. Joint and several liability arrangements for which the total obligation amount under the arrangement is fixed[2] at the reporting dates shall be measured and reported as the sum of:

a. The amount the reporting entity agreed to pay on the basis of the agreements among its co-obligors, and

b. Any additional amount the reporting entity expects to pay on behalf of its co-obligors. When an amount within management's estimate of the range of a loss appears to be a better estimate than any other amount within the range, that amount shall be the additional amount included in the measurement of the obligation. If no amount within the range is a better estimate than any other amount, then the midpoint shall be used.

[1] *FASB Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements*, states:
Probable is used with its usual general meaning, rather than in a specific accounting or technical sense (such as that in *FASB Statement 5, Accounting for Contingencies*, paragraph 3), and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved.

[2] Examples of items within the scope of this guidance include debt arrangements, other contractual obligations, and settled judicial litigation and judicial rulings. Loss contingencies, guarantees, pension and other postretirement benefit obligations and taxes are excluded from this guidance and shall be accounted for under the statutory accounting provisions specific to those topics.

Loss Contingencies or Impairments of Assets

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

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

b. Reasonably Possible—The chance of the future event or events occurring is more than remote but less than probable;

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

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

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

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

b. The amount of loss can be reasonably estimated.

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

10. Additionally, in instances where a judgment, assessment or fine has been rendered against a reporting entity, there is a presumption that the criteria in paragraph 8.a. and 8.b. have been met. A judgment is considered "rendered" when a court enters a verdict, notwithstanding the entity's ability to file post-trial motions and to appeal. The amount of the liability shall include the anticipated settlement amount, legal costs, insurance recoveries and other related amounts and shall take into account factors such as the nature of the litigation, progress of the case, opinions of legal counsel, and management's intended response to the litigation, claim, or assessment.

11. When the condition in paragraph 8.a. is met with respect to a particular loss contingency, and the reasonable estimate of the loss is a range, which meets the condition in paragraph 8.b., an amount shall be accrued for the loss. When an amount within management's estimate of the range of a loss appears to be a better estimate than any other amount within the range, that amount shall be accrued. When, in management's opinion, no amount within management's estimate of the range is a better estimate than any other amount, however, the midpoint (mean) of management's estimate in the range shall be accrued. For purposes of this paragraph, it is assumed that management can quantify the high end of the range. If management determines that the high end of the range cannot be quantified, then a range does not exist, and management's best estimate shall be used.

12. The use of the midpoint in a range will be applicable only in the rare instance where there is a continuous range of possible values, and no amount within that range is any more probable than any other. This guidance is not applicable when there are several point estimates which have been determined

as equally possible values, but those point estimates do not constitute a range. If there are several point estimates with equal probabilities, management should determine their best estimate of the liability.

Tax Contingencies

13. As directed by SSAP No. 101, tax loss contingencies (including related interest and penalties) for current and all prior years, shall be computed in accordance with this SSAP, with the following modifications:

a. The term "probable" as used in this standard shall be replaced by the term "more likely than not (a likelihood of more than 50 percent)" for federal and foreign income tax loss contingencies only.

b. For purposes of the determination of a federal and foreign income tax loss contingency, it shall be presumed that the reporting entity will be examined by the relevant taxing authority that has full knowledge of all relevant information.

c. If the estimated tax loss contingency is greater than 50 percent of the tax benefit originally recognized, the tax loss contingency recorded shall be equal to 100 percent of the original tax benefit recognized.

As noted in SSAP No. 101, state taxes (including premium, income and franchise taxes) shall also be computed in accordance with this SSAP. These items (as detailed in SSAP No. 101) are not impacted by the modifications detailed in paragraphs 13.a.-13.c.

Gain Contingencies

14. A gain is defined as an increase in surplus which results from peripheral or incidental transactions of a reporting entity and from all other transactions and other events and circumstances affecting the reporting entity except those that result from revenues or investments by owners. If, on or before the balance sheet date, (a) the transaction or event has been fully completed, and (b) the amount of the gain is determinable, then the transaction or event is considered a gain, and is recognized in the financial statements. The definition of a gain excludes increases in surplus that result from activities that constitute a reporting entity's ongoing major or central operations or activities. Because investment activities are central to an insurer's operations, increases in surplus that result from such investment activities are excluded from the definition of gains. Revenues are inflows or other enhancements of assets of a reporting entity or settlements of its liabilities (or a combination of both) from providing products, rendering services, or other activities that constitute the reporting entity's ongoing major or central operations. Investments by owners include any type of capital infused into the surplus of the reporting entity.

15. A gain contingency is defined as an existing condition, situation, or set of circumstances involving uncertainty as to possible gain (as defined in the preceding paragraph) to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur (e.g., a plaintiff has filed suit for damages associated with an event occurring prior to the balance sheet, but the outcome of the suit is not known as of the balance sheet date). Gain contingencies shall not be recognized in a reporting entity's financial statements. However, if subsequent to the balance sheet date but prior to the issuance of the financial statements, the gain contingency is realized, the gain shall be disclosed in the notes to financial statements and the unissued financial statements should not be adjusted to record the gain. A gain is generally considered realizable when noncash resources or rights are readily convertible to known amounts of cash or claims to cash.

Guarantees

16. A guarantee contract is a contract that contingently requires the guarantor to make payments (either in cash, financial instruments, other assets, shares of its stock, or provision of services) to the guaranteed party based on changes in the underlying that is related to an asset, a liability, or an equity security of the guaranteed party. Commercial letters of credit and loan commitments, by definition, are not considered guarantee contracts. Also excluded from the definition are indemnifications or guarantees of an entity's own performance, subordination arrangements or a noncontingent forward contract. This definition could include contingent forward contracts if the characteristics of this paragraph are met.

17. The following guarantee contracts are not subject to the guidance in paragraphs 20-25 and paragraphs 29-32:

a. Guarantees already excluded from the scope of SSAP No. 5R;

b. Guarantee contracts accounted for as contingent rent;

c. Insurance contract guarantees, including guarantees embedded in deposit-type contracts;

d. Contracts that provide for payments that constitute a vendor rebate by the guarantor based on either the sales revenue or the number of units sold by the guaranteed party;

e. A guarantee or indemnification whose existence prevents the guarantor from being able to either account for a transaction as the sale of an asset that is related to the guarantee's underlying or recognize in earnings the profit from that sale transaction;

f. Registration payment arrangements; and

g. A guarantee that is accounted for as a credit derivative instrument at fair value under SSAP No. 86, as described in paragraph ~~53~~54.e. of SSAP No. 86.

18. The following types of guarantees are exempted from the initial liability recognition in paragraphs 20-25, but are subject to the disclosure requirements in paragraphs 29-32:

a. Guarantee that is accounted for as a derivative instrument, other than credit derivatives within SSAP No. 86;

b. Guarantee for which the underlying is related to the performance of nonfinancial assets that are owned by the guaranteed party, including product warranties;

c. Guarantee issued in a business combination that represents contingent consideration;

d. Guarantee in which the guarantor's obligation would be reported as an equity item;

e. Guarantee by an original lessee that has become secondarily liable under a new lease that relieved the original lessee from being the primary obligator;

f. Guarantees (as defined in paragraph 16) made to/or on behalf of directly or indirectly wholly-owned insurance or non-insurance subsidiaries[3]; and

[3] The exclusion for wholly-owned subsidiaries includes guarantees from a parent to, or on behalf of, a direct wholly-owned insurance or non-insurance subsidiary as well as guarantees made from a parent to, or on behalf of, an indirect wholly-owned insurance or non-insurance subsidiary. The "wholly-owned" exclusion in paragraph 18.f. does not include guarantees issued from one subsidiary to another subsidiary, regardless if both subsidiaries are wholly-owned (directly or indirectly) by a parent company.

g. Intercompany and related party guarantees that are considered "unlimited" (e.g., typically in response to a rating agency's requirement to provide a commitment to support).

19. With the exception of the provision for guarantees made to/or on behalf of a wholly-owned subsidiaries in paragraph 18.f. and "unlimited" guarantees in 18.g., this guidance does not exclude guarantees issued as intercompany transactions or between related parties from the initial liability recognition requirement. Thus, unless the guarantee is provided on behalf of a wholly-owned subsidiary or considered "unlimited," guarantees issued between the following parties are subject to the initial recognition and disclosure requirements:

a. Guarantee issued either between parents and their subsidiaries or between corporations under common control;

b. A parent's guarantee of its subsidiary's debt to a third party; and

c. A subsidiary's guarantee of the debt owed to a third party by either its parent or another subsidiary of that parent.

20. At the inception of a guarantee, the guarantor shall recognize in its statement of financial position a liability for that guarantee. Except as indicated in paragraph 22, the objective of the initial measurement of the liability is the fair value[4] of the guarantee at its inception.

21. The issuance of a guarantee obligates the guarantor (the issuer) in two respects: (a) the guarantor undertakes an obligation to stand ready to perform over the term of the guarantee in the event that the specified triggering events or conditions occur (the noncontingent aspect) and (b) the guarantor undertakes a contingent obligation to make future payments if those triggering events or conditions occur (the contingent aspect). Because the issuance of a guarantee imposes a noncontingent obligation to stand ready to perform in the event that the specified triggering event occurs, the provisions of paragraph 8 should not be interpreted as prohibiting the guarantor from initially recognizing a liability for that guarantee even though it is not probable that payments will be required under that guarantee.

22. In the event that, at the inception of the guarantee, the guarantor is required to recognize a liability under paragraph 8 for the related contingent loss, the liability to be initially recognized for that guarantee shall be the greater of (a) the amount the satisfies the fair value objective as discussed in paragraph 20 or (b) the contingent liability amount required to be recognized at inception of the guarantee by paragraph 8. For many guarantors, it would be unusual for the contingent liability under (b) to exceed the amount that satisfies the fair value objective at the inception of the guarantee.

23. The offsetting entry pursuant to the liability recognition at the inception of the guarantee depends on the circumstances in which the guarantee was issued. Examples include:

a. If the guarantee was issued in a standalone transaction for a premium, the offsetting entry would the consideration received.

b. If the guarantee was issued in conjunction with the sale of assets, a product, or a business, the overall proceeds would be allocated between the consideration being remitted to the guarantor for issuing the guarantee and the proceeds from that sale. That allocation would affect the calculation of the gain or loss on the sale transaction.

[4] As practical expedients, when a guarantee is issued in a standalone arm's-length transaction, the liability recognized at the inception of the guarantee should be the premium received or receivable by the guarantor. When a guarantee is issued as part of a transaction with multiple elements, the liability recognized at the inception of the guarantee should be an estimate of the guarantee's fair value. In that circumstance, guarantors should consider what premium would be required by the guarantor to issue the same guarantee in a standalone arm's-length transaction.

c. If a residual value guarantee were provided by a lessee-guarantor when entering into an operating lease, the offsetting entry would be reflected as prepaid rent, which would be nonadmitted under SSAP No. 29.

d. If a guarantee were issued to an unrelated or related party for no consideration on a standalone basis, the offsetting entry would be to expense.

24. Except for the measurement and recognition of continued guarantee obligations after the settlement of a contingent guarantee liability described in paragraph 25, this standard does not describe in detail how the guarantor's liability for its obligations under the guarantee would be measured subsequent to initial recognition. The liability that the guarantor initially recognized in accordance with paragraph 20 would typically be reduced (as a credit to income) as the guarantor is released from risk under the guarantee. Depending on the nature of the guarantee, the guarantor's release from risk has typically been recognized over the term of the guarantee (a) only upon either expiration or settlement of the guarantee, (b) by a systematic and rational amortization method, or (c) as the fair value of the guarantee changes (for example, guarantees accounted for as derivatives). The reduction of liability does not encompass the recognition and subsequent adjustment of the contingent liability recognized under paragraph 8 related to the contingent loss for the guarantee. If the guarantor is required to subsequently recognize a contingent liability for the guarantee, the guarantor shall eliminate any remaining noncontingent liability for that guarantee and recognize a contingent liability in accordance with paragraph 8.

25. After recognition and settlement of a contingent guarantee liability in accordance with paragraph 8, a guarantor shall assess whether remaining potential obligations exist under the guarantee agreement. If the guarantor still has potential obligations under the guarantee contract, the guarantor shall recognize the remaining noncontingent guarantee that represents the current fair value of the potential obligation remaining under the guarantee agreement. This noncontingent guarantee liability shall be released in accordance with paragraph 24.

Disclosures

26. Disclose the following information for each joint and several liability arrangements accounted for under paragraph 5. If co-obligors are related parties, disclosure requirements in *SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties* also apply.

a. The nature of the arrangement including: 1) how the liability arose, 2) the relationship with co-obligors, and 3) the terms and conditions of the arrangements.

b. The total outstanding amount under the arrangement, which shall not be reduced by the effect of any amounts that may be recoverable from other entities.

c. The carrying amount, if any, of the entity's liability and the carrying amount of a receivable recognized, if any.

d. The nature of any recourse provisions that would enable recovery from other entities of the amounts paid, including any limitations on the amounts that might be recovered.

e. In the period the liability is initially recognized and measured or in a period the measurement changes significantly: 1) the corresponding entry, and 2) where the entry was recorded in the financial statements.

27. If a loss contingency or impairment of an asset is not recorded because only one of the conditions in paragraph 8 a. or8 b. is met, or if exposure to a loss exists in excess of the amount accrued pursuant to the provisions described above, disclosure of the loss contingency or impairment of the asset shall be made in the financial statements when there is at least a reasonable possibility that a loss or an additional

loss may have been incurred. The disclosure shall indicate the nature of the contingency and shall give an estimate of the possible loss or range of loss or state that such an estimate cannot be made. (Disclosures for tax contingencies as identified in paragraph 13 shall be completed as instructed within SSAP No. 101.)

28. Disclosure is not required of a loss contingency involving an unasserted claim or assessment when there has been no manifestation by a potential claimant of an awareness of a possible claim or assessment unless it is considered probable that a claim will be asserted and there is a reasonable possibility that the outcome will be unfavorable.

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

30. A guarantor shall disclose the following information about each guarantee, or each group or similar guarantees (except product warranties addressed in paragraph 32), even if the likelihood of the guarantor's having to make any payments under the guarantee is remote. In addition, the nature of the relationship to the beneficiary of the guarantee or undertaking (affiliated or unaffiliated) shall also be disclosed:

a. The nature of the guarantee, including the approximate term of the guarantee, how the guarantee arose, and the events and circumstances that would require the guarantor to perform under the guarantee, the ultimate impact to the financial statements (specific financial statement line item) after the settlement of the contract guarantee if action under the guarantee was required (e.g., increase to the investment, dividends to stockholder, etc) and the current status (that is, as of the date of the statement of financial position) of the payment/performance risk of the guarantee. For example, the current status of the payment/performance risk of a credit-risk-related guarantee could be based on either recently issued external credit ratings or current internal groupings used by the guarantor to manage its risk. An entity that uses internal groupings shall disclose how those groupings are determined and used for managing risk.

b. The potential amount of future payments (undiscounted) the guarantor could be required to make under the guarantee. That maximum potential amount of future payments shall not be reduced by the effect of any amounts that may possibly be recovered under recourse or collateralization provisions in the guarantee (which are addressed under (d) below). If the terms of the guarantee provide for no limitation to the maximum potential future payments under the guarantee, that fact shall be disclosed. If the guarantor is unable to develop an estimate of the maximum potential amount of future payments under its guarantee, the guarantor shall disclose the reasons why it cannot estimate the maximum potential amount.

c. The current carrying amount of the liability, if any, for the guarantor's obligations under the guarantee (including the amount, if any, recognized under paragraph 8), regardless of whether the guarantee is freestanding or embedded in another contract.

d. The nature of (1) any recourse provisions that would enable the guarantor to recover from third parties any of the amounts paid under the guarantee and (2) any assets held either as collateral or by third parties that, upon the occurrence of any triggering event or condition under the guarantee, the guarantor can obtain and liquidate to recover all or a portion of the amounts paid under the guarantee. The guarantor shall indicate, if estimable, the approximate extent to which the proceeds from liquidation of those assets would be expected to cover the maximum potential amount of future payments under the guarantee.

31. An aggregate compilation of guarantee obligations shall include the maximum potential of future payments of all guarantees (undiscounted), the current liability (contingent and noncontingent) reported in the financial statements, and the ultimate financial statement impact based on maximum potential payments (undiscounted) if performance under those guarantees had been triggered.

32. As product warranties are excluded from the initial recognition and initial measurement requirements for guarantees, a guarantor is not required to disclose the maximum potential amount of future payments. Instead the guarantor is required to disclose for product warranties the following information:

a. The guarantor's accounting policy and methodology used in determining its liability for product warranties (Including any liability associated with extended warranties).

b. A tabular reconciliation of the changes in the guarantor's aggregate product warranty liability for the reporting period. That reconciliation should present the beginning balance of the aggregate product warranty liability, the aggregate reductions in that liability for payments made (in cash or in kind) under the warranty, the aggregate changes in the liability for accruals related to product warranties issued during the reporting period, the aggregate changes in the liability for accruals related to preexisting warranties (including adjustments related to changes in estimates), and the ending balance of the aggregate product warranty liability.

33. The financial statements shall contain adequate disclosure about the nature of any gain contingency. However, care should be exercised to avoid misleading implications as to the likelihood of realization.

34. Refer to the preamble for further discussion regarding disclosure requirements.

Relevant Literature

35. This statement adopts *FASB Statement No. 5, Accounting for Contingencies* (FAS 5), *FASB Statement 114, Accounting by Creditors for Impairment of a Loan* only as it amends in part FAS 5 and paragraphs 35 and 36 of *FASB Statement of Financial Accounting Concepts No. 6—Elements of Financial Statements. FASB Interpretation No. 14, Reasonable Estimation of the Amount of a Loss, An Interpretation of FASB Statement No. 5* (FIN No. 14) is adopted with the modification to accrue the loss amount as the midpoint of the range rather than the minimum as discussed in paragraph 3 of FIN No. 14. This statement adopts with modification *ASU 2013-04, Obligations Resulting from Joint and Several Liability Arrangements for Which the Total Amount of the Obligation is Fixed at the Reporting Date* with the same statutory modification adopted for FIN 14.

36. This statement adopts with modification *FASB Interpretation No. 45: Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, an interpretation of FASB Statements No. 5, 57, and 107 and rescission of FASB Interpretation No. 34* (FIN 45), *FASB Interpretation No. 45-3, Application of FASB Interpretation No. 45 to Minimum Revenue Guarantees Grated to a Business or Owner* (FSP FIN 45-3)*, and FASB Staff Position FAS 133-1 and FIN 45-4, Disclosures about Credit Derivatives and Certain Guarantees, An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45* (FSP FAS 133-1 and FIN 45-4). Statutory Modifications to FIN 45 include initial liability recognition for guarantees issued as part of intercompany or related party

transactions, assessment and recognition of non-contingent guarantee obligations after recognition and settlement of a contingent obligation and revise the GAAP guidance to reflect statutory accounting terms and restrictions. Under this statement, intercompany and related party guarantees (including guarantees between parents and subsidiaries) should have an initial liability recognition unless the guarantee is considered "unlimited" or is made to/or on behalf of a wholly-owned subsidiary. (An example of an intercompany "unlimited" guarantee would be a guarantee issued in response to a rating agency's requirement to provide a commitment to support.) In instances in which an "unlimited" guarantee exists or a guarantee has been made to/or on behalf of a wholly-owned subsidiary, this statement requires disclosure, pursuant to the disclosure requirements adopted from FIN 45. The adoption of FIN 45 superseded the previously adopted guidance *in FASB Interpretation No. 34, Disclosure of Indirect Guarantees of Indebtedness of Others, An interpretation of FASB Statement No. 5.* This statement also adopts Accounting Principles Board Opinion No. 12, Omnibus Opinion—1967, paragraphs 2 and 3 with the modification that AVR, IMR and Schedule F Penalty shall be shown gross. Appropriation of retained earnings discussed in paragraph 15 of FAS 5 is addressed in *SSAP No. 72—Surplus and Quasi-Reorganizations.*

37. This statement adopts with modification the guidance in paragraphs 7-11 of *FSP EITF 00-19-2, Accounting for Registration Payment Arrangements*. This guidance specifies that the contingent obligation to make future payments or otherwise transfer consideration under a registration payment arrangement, whether issued as a separate agreement or included as a provision for a financial instrument, other agreement, should be separately recognized and measured in accordance with *FAS 5, Accounting for Contingencies*. The guidance in FSP EITF 00-19-2 is modified as follows:

a. Registration payment arrangements meet the definition of a loss contingency in accordance with paragraph 7.

b. Financial instruments shall be accounted for in accordance with the statutory accounting principles for that specific asset type. Registration payment arrangement obligations shall be separate from the measurement and recognition of financial instruments subject to such arrangements.

c. Transition revisions resulting from application of this guidance shall be accounted for as a change in accounting principle pursuant to *SSAP No. 3—Accounting Changes and Corrections of Errors* (SSAP No. 3). In accordance with SSAP No. 3, the cumulative effect of changes in accounting principles shall be reported as adjustments to unassigned funds in the period of change in the accounting principles.

Effective Date and Transition

38. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*.

39. The guidance for guarantees included within paragraphs 16-25 and 30-32 shall be applicable to all guarantees issued or outstanding as of December 31, 2011. Thereafter, disclosure of all guarantees shall be annually reported, with interim reporting required for new guarantees issued, and/or existing guarantees when significant changes are made. Guidance in paragraph 37 was previously reflected within *INT 08-06: FSP EITF 00-19-2, Accounting for Registration Payment Arrangements* and was effective September 22, 2008.

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 20—Gain Contingencies*
- *Issue Paper No. 135—Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*

APPENDIX A – DISCLOSURE ILLUSTRATIONS

Example illustration for paragraph 30.a., including the potential maximum guarantee from paragraph 30.b.:

Nature and circumstances of guarantee and key attributes, including date and duration of agreement	Liability recognition of guarantee. (Include amount recognized at inception. If no initial recognition, document exception allowed under SSAP No. 5R.)	Ultimate financial statement impact if action under the guarantee is required	Maximum potential amount of future payments (undiscounted) the guarantor could be required to make under the guarantee. If unable to develop an estimate, this should be specifically noted	Current status of payment or performance risk of guarantee. Also provide additional discussion as warranted

Example Illustration – Paragraph 31:

1. Aggregate Maximum Potential of Future Payments of All Guarantees (undiscounted) the guarantor could be required to make under guarantees. (This amount should agree to the total amount reported for all guarantees within paragraph 30.b. (illustrated above), thus it excludes guarantees for which estimates of potential future payment cannot be made.)	$
2. Current Liability Recognized in F/S:	
a. Noncontingent Liabilities	$
b. Contingent Liabilities	$
3. Ultimate Financial Statement Impact if action under the guarantee is required. (This should equal the total reported in line 1 reflected in the applicable financial statement line items.)	
a. Investments in SCA	$
b. Joint Venture	$
c. Dividends to Stockholders (capital contribution)	$
d. Expense	$
e. Other	$

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Statement of Statutory Accounting Principles No. 6

Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due From Agents and Brokers

STATUS

Type of Issue:	Common Area
Issued:	Initial Draft
Effective Date:	January 1, 2001
Affects:	Nullifies and incorporates INT 99-27, INT 01-01, INT 02-02, INT 02-20
Affected by:	No other pronouncements
Interpreted by:	No other pronouncements

STATUS 1

SCOPE OF STATEMENT 3

SUMMARY CONCLUSION 3

Determination of Due Date 3
Impairment 4
Wash Transactions 5
Disclosures 5
Effective Date and Transition 5

REFERENCES 5

Relevant Issue Papers 5

APPENDIX A – NONADMITTANCE OF PREMIUM RECEIVABLES (PARAGRAPH 9.a.) 6

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Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due From Agents and Brokers

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for direct and group billed uncollected premiums, bills receivable for premiums, and amounts due from agents and brokers (collectively referred to as agents).

2. This statement does not address uncollected and deferred premiums for life considerations.

SUMMARY CONCLUSION

3. Premium transactions conducted directly with the insured result in uncollected premium balances.

4. Bills receivable, which are generally interest bearing, are used by reporting entities as a method of financing premiums.

5. Amounts due from agents result from various transactions ranging from premiums collected by the agents on behalf of the reporting entity to amounts advanced to the agent by the reporting entity to finance agency operations.

6. Uncollected premium balances, bills receivable for premiums, and amounts due from agents meet the definition of an asset as defined in *SSAP No. 4—Assets and Nonadmitted Assets,* and are admitted assets to the extent they conform to the requirements of this statement[1]. Premiums owed by agents shall be reflected net of commissions, if permitted by the contract. Balances resulting from advances to agents, which are primarily encountered in the life insurance industry, are nonadmitted if (a) the amounts are in the form of unsecured loans or advances, (b) the contractual terms for repayment are through application of future renewal commissions and/or other credits, or (c) the terms of repayment do not provide readily available cash for the satisfaction of policyholder liabilities.

Determination of Due Date

7. The due date for all premium balances addressed by this statement is determined as follows:

   a. Original and deposit premiums—governed by the effective date of the underlying insurance contract and not the agent/reporting entity contractual relationship;

   b. Endorsement premiums—governed by the effective date of the insurance policy endorsement;

   c. Installment premiums—governed by the contractual due date of the installment from the insured;

   d. Audit premiums and retrospective premiums—governed by insurance policy or insurance contract provisions. If the due date for receivables relating to these policies is not

[1] Premiums billed prior to the effective date do not meet the definition of an asset per SSAP No. 4. Therefore, an asset/receivable should not be recognized on the financial statements until the effective date of the underlying policy/contract (i.e. the effective date of the contract gives rise to the entity's right). The mailing of a premium billing has no determination in the reporting of such premiums as an asset. Additionally, advance premiums are only recognized when the reporting entity receives cash payment for premiums prior to the effective date of the contract. In the event that the reporting entity bills and receives payment for premiums prior to the effective date, the reporting entity will recognize the receipt of cash with a corresponding credit to advance premiums (in this case a receivable is not recognized as the payment is received prior to the effective date).

addressed by insurance policy provisions or insurance contract provisions, any uncollected audit premium (either accrued or billed) is nonadmitted.

8. The provisions of paragraph 7 shall be applied to all balances due except those arising from force placed insurance obtained by a lender for collateral protection, certain policies, known as Trustee Sales Guarantees (TSGs), issued by title insurance companies to lenders on defaulted real estate loans and crop/hail policies. For forced placed insurance policies, the due date for purposes of applying paragraph 9 shall be the date of billing. For TSGs, the due date for purposes of applying paragraph 9 shall be the expiration of the grace period given to the defaulted debtor, which is provided by statute. Crop/hail premiums are considered installment premiums in accordance with paragraph 7 and accordingly, the due date for purposes of applying paragraph 9 shall be governed by the contractual due date of the installment.

Impairment

9. Nonadmitted amounts are determined as follows:

a. Uncollected Premium—To the extent that there is no related unearned premium, any uncollected premium balances which are over ninety days due shall be nonadmitted. If an installment premium is over ninety days due, the amount over ninety days due plus all future installments that have been recorded on that policy shall be nonadmitted[2];

b. Bills Receivable—Bills receivable shall be nonadmitted if either of the following conditions are present:

i. If any installment is past due, the entire bills receivable balance from that policy is nonadmitted; or

ii. If the bills receivable balance due exceeds the unearned premium on the policy for which the note was accepted, the amount in excess of the unearned premium is nonadmitted.

c. Agents' Balances—The uncollected agent's receivable on a policy by policy basis which is over ninety days due shall be nonadmitted regardless of any unearned premium;

i. If amounts are both payable to and receivable from an agent on the same underlying policy, and the contractual agreements between the agent and the reporting entity permit offsetting, the nonadmitted portion of amounts due from that agent shall not be greater than the net balance due, by agent;

ii. If reconciling items between a reporting entity's account and an agent's account are over ninety days due, the amounts shall be nonadmitted.

10. After calculation of nonadmitted amounts, an evaluation shall be made of the remaining admitted assets in accordance with *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets* (SSAP No. 5R), to determine if there is impairment. If, in accordance with SSAP No. 5R, it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made. If it is reasonably possible a portion of the balance is uncollectible and is therefore not written off, disclosure requirements outlined in SSAP No. 5R shall be followed.

[2] Installment premiums include monthly billed premiums on group accident and health policies. For group accident and health contracts, the existence of a nonadmitted *de minimus* over ninety-day balance would not cause future installments that have been recorded on that policy to also be nonadmitted. The *de minimus* over ninety-day balance itself shall be treated as nonadmitted as it is over ninety days old, and pursuant to paragraph 10, the entire current balance is subject to a collectability analysis.

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

Wash Transactions

12. Amounts due from agents (affiliated or nonaffiliated) that are collected prior to the date of the financial statements and then repaid to the agent by the reporting entity or one of the reporting entity's affiliates subsequent to the date of the financial statements shall be accounted for in accordance with the substance of the transaction (a wash transaction) and not its form. Accordingly, the payments received shall be accounted for as deposits and a liability shall be established for the same amount. The amounts due shall be reestablished as an asset and subjected to asset collectibility and nonadmitted asset calculations using the original due date of the receivable.

13. Short-term financing by third parties shall also be considered a wash transaction if the substance of the transaction is to avoid the nonadmitted asset principle set forth in this statement.

Disclosures

14. Refer to the preamble for further discussion regarding disclosure requirements.

Effective Date and Transition

15. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*. The guidance in the footnote to paragraph 6 was originally contained within *INT 02-02: SSAP No. 6 and Billing of Premium Before Effective Date* and was effective March 18, 2002. The guidance in the footnote to paragraph 9 was originally contained within *INT 01-01: Application of SSAP No. 6 Paragraph 9.a. to de minimus Receivable Balances of Group Accident and Health Policies* and was effective March 26, 2001.

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 6—Amounts Due From Agents and Brokers*
- *Issue Paper No. 10—Uncollected Premium Balances*
- *Issue Paper No. 21—Bills Receivable For Premiums*

APPENDIX A – NONADMITTANCE OF PREMIUM RECEIVABLES (PARAGRAPH 9.a.)

The application of paragraph 9.a. (uncollected installment premium) can be illustrated through the following journal entries:

Worker’s compensation policy written on 1/1/X1 for $120,000 billed on installment basis at the end of each month.

Required Journal Entries:

1/1/X1	Installments booked but deferred and not yet due	120,000	
	Written premium		120,000
	Change in unearned premium reserve	120,000	
	Unearned premium reserve		120,000

Initial journal entry written on effective date of policy

1/30/X1	Premiums in course of collection	10,000	
	Installments booked but deferred and not yet due		10,000
	Unearned premium reserve	10,000	
	Change in unearned premium reserve		10,000

Monthly journal entry to record installments

Balance of accounts on 4/30/X1:

Installments booked but deferred and not yet due	80,000
Unearned premium reserve	80,000
Premiums in course of collection	40,000
Written premium	120,000
Change in unearned premium reserve	80,000
Earned premium	40,000

If no collections have been made as of 4/30/X1 then paragraph 9.a. would stipulate that the entire balance of $40,000 residing in the premiums in course of collection account would be nonadmitted. As the installments receivable and unearned premium reserve offset one another, no further amounts would be deemed nonadmitted at this point. In fact, as long as any of the premiums in course of collection account are 90 days past the contractual due date of the installment, then all subsequent installment billings would automatically be nonadmitted (i.e., May, June, July receivables of $10,000).

Statement of Statutory Accounting Principles No. 7

Asset Valuation Reserve and Interest Maintenance Reserve

STATUS

Type of Issue:	Life, Accident and Health
Issued:	Initial Draft
Effective Date:	January 1, 2001
Affects:	No other pronouncements
Affected by:	No other pronouncements
Interpreted by:	No other pronouncements

STATUS **1**

SCOPE OF STATEMENT **3**

SUMMARY CONCLUSION **3**

Effective Date and Transition 3

REFERENCES **3**

Other 3

Relevant Issue Papers 3

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Asset Valuation Reserve and Interest Maintenance Reserve

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for an asset valuation reserve (AVR) and an interest maintenance reserve (IMR) for life and accident and health insurance companies, excluding separate accounts. Separate account AVR/IMR reporting is addressed in *SSAP No. 56—Separate Accounts.*

SUMMARY CONCLUSION

2. Life and accident and health insurance companies shall recognize liabilities for an AVR and an IMR. The AVR is intended to establish a reserve to offset potential credit-related investment losses on all invested asset categories excluding cash, policy loans, premium notes, collateral notes and income receivable. The IMR defers recognition of the realized capital gains and losses resulting from changes in the general level of interest rates. These gains and losses shall be amortized into investment income over the expected remaining life of the investments sold. The IMR also applies to certain liability gains/losses related to changes in interest rates. These gains and losses shall be amortized into investment income over the expected remaining life of the liability released.

3. The IMR and AVR shall be calculated and reported as determined per guidance in the SSAP for the specific type of investment (e.g. SSAP No. 43R for loan-backed and structured securities), or if not specifically stated in the respective SSAP, in accordance with the NAIC *Annual Statement Instructions* for Life and Accident and Health Insurance Companies.

Effective Date and Transition

4. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*.

REFERENCES

Other

- NAIC Annual Statement Instructions for Life and Accident and Health Insurance Companies

Relevant Issue Papers

- *Issue Paper No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*

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Statement of Statutory Accounting Principles No. 9

Subsequent Events

STATUS

Type of Issue:	Common Area
Issued:	Initial Draft
Effective Date:	January 1, 2001
Affects:	No other pronouncements
Affected by:	No other pronouncements
Interpreted by:	No other pronouncements

STATUS **1**
SCOPE OF STATEMENT **3**
SUMMARY CONCLUSION **3**
Key Terms 3
Recognition Guidance 3
Disclosures 5
Relevant Literature 5
Effective Date and Transition 5
REFERENCES **5**
Relevant Issue Papers 5

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Subsequent Events

SCOPE OF STATEMENT

1. This statement defines subsequent events and establishes the criteria for recording such events in the financial statements and/or disclosing them in the notes to the financial statements. The conclusions in this statement apply to both quarterly and annual statement filings.

SUMMARY CONCLUSION

Key Terms

2. Subsequent events shall be defined as events or transactions that occur subsequent to the balance sheet date, but before the issuance of the statutory financial statements and before the date the audited financial statements are issued, or available to be issued. The issuance of the statutory financial statements includes not only the submission of the Quarterly and Annual Statement but also the issuance of the audit opinion by the reporting entity's certified public accountant.

3. Material subsequent events shall be considered either:

a. Type I – Recognized Subsequent Events: Events or transactions that provide additional evidence with respect to conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements;

b. Type II – Nonrecognized Subsequent Events: Events or transactions that provide evidence with respect to conditions that did not exist at the balance sheet date but arose after that date.

4. **Financial statements are issued**. Financial statements are considered issued when they are widely distributed to shareholders and other financial statement users for general use and reliance in a form and format that complies with SAP.

5. **Financial statements are available to be issued**. Financial statements are considered available to be issued when they are complete in a form and format that complies with SAP and all approvals necessary for issuance have been obtained, for example, from management, the board of directors, and/or significant shareholders. The process involved in creating and distributing the financial statements will vary depending on an entity's management and corporate governance structure as well as statutory and regulatory requirements. An entity that has a current expectation of widely distributing its financial statements to its shareholders and other financial statement users shall evaluate subsequent events through the date that the financial statements are issued. All other entities shall evaluate subsequent events through the date that the financial statements are available to be issued.

Recognition Guidance

6. An entity shall recognize in the financial statements the effects of all material Type I subsequent events that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements. Any changes in estimates resulting from the use of such evidence shall be recorded in the financial statements unless specifically prohibited, (e.g., subsequent collection of agents balances over 90 days due when determining nonadmitted agents balances as prohibited by *SSAP No. 6—Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due From Agents and Brokers*).

7. For material Type I subsequent events, the nature and the amount of the adjustment shall be disclosed in the notes to the financial statements only if necessary to keep the financial statements from being misleading.

8. Material Type II subsequent events shall not be recorded in the financial statements, but shall be disclosed in the notes to the financial statements. For such events, an entity shall disclose the nature of the event and an estimate of its financial effect, or a statement that such an estimate cannot be made.

9. An entity also shall consider supplementing the historical financial statements with pro forma financial data. Occasionally, a nonrecognized subsequent event may be so significant that disclosure can best be made by means of pro forma financial data. Such data shall give effect to the event as if it had occurred on the balance sheet date. In some situations, an entity also shall consider presenting pro forma statements. If an event is of such a nature that pro forma disclosures are necessary to keep the financial statements from being misleading, disclosure of supplemental pro forma financial data shall be made including the impact on net income, surplus, total assets, and total liabilities giving effect to the event as if it had occurred on the date of the balance sheet.

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

11. The following are examples of Type I recognized subsequent events:

a. If the events that gave rise to litigation had taken place before the balance sheet date and that litigation is settled, after the balance sheet date but before the financial statements are issued or are available to be issued, for an amount different from the liability recorded in the accounts, then the settlement amount should be considered in estimating the amount of liability recognized in the financial statements at the balance sheet date.

b. Subsequent events affecting the realization of assets, such as receivables and inventories or the settlement of estimated liabilities, should be recognized in the financial statements when those events represent the culmination of conditions that existed over a relatively long period of time. For example, a loss on an uncollectible trade account receivable as a result of a customer's deteriorating financial condition leading to bankruptcy after the balance sheet date but before the financial statements are issued or are available to be issued ordinarily will be indicative of conditions existing at the balance sheet date. Thus, the effects of the customer's bankruptcy filing shall be considered in determining the amount of uncollectible trade accounts receivable recognized in the financial statements at the balance sheet date.

12. The following are examples of Type II nonrecognized subsequent events:

a. Sale of a bond or capital stock issued after the balance sheet date but before financial statements are issued or are available to be issued

b. A business combination that occurs after the balance sheet date but before financial statements are issued or are available to be issued

c. Settlement of litigation when the event giving rise to the claim took place after the balance sheet date but before financial statements are issued or are available to be issued

d. Loss of plant or inventories as a result of fire or natural disaster that occurred after the balance sheet date but before financial statements are issued or are available to be issued

e. Losses on receivables resulting from conditions (such as a customer's major casualty) arising after the balance sheet date but before financial statements are issued or are available to be issued

f. Changes in the fair value of assets or liabilities (financial or nonfinancial) or foreign exchange rates after the balance sheet date but before financial statements are issued or are available to be issued

g. Entering into significant commitments or contingent liabilities, for example, by issuing significant guarantees after the balance sheet date but before financial statements are issued or are available to be issued

Disclosures

13. In addition to the disclosure of subsequent events as required throughout this statement, for annual and interim reporting periods, reporting entities shall disclose the dates through which subsequent events have been evaluated for statutory reporting and for audited financial statements along with the dates the statutory reporting statements and the audited financial statements were issued, or available to be issued. In the audited financial statements, reporting entities shall specifically identify subsequent events identified after the date subsequent events were reviewed for statutory reporting.

14. Refer to the preamble for further discussion regarding disclosure requirements.

Relevant Literature

15. The above guidance was originally adopted to be consistent with the AICPA *Statement on Auditing Standards No. 1*, Section 560, *Subsequent Events*. In 2009, *FASB Statement No. 165, Subsequent Events* (FAS 165), was adopted for statutory accounting. The adoption of this guidance should not result in significant changes in the subsequent events that an entity reports, through either recognition or disclosure, in its financial statements. FAS 165 introduced the concept of available to be issued and requires additional disclosures on the dates for which an entity evaluated subsequent events as well as the date the financial statements were issued, or available to be issued. Guidance within ASU 2010-09 (modifications to Subtopic 855-10 in the FASB Codification) has been rejected for statutory accounting.

Effective Date and Transition

16. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*. Changes adopted as a result of FAS 165, are effective for years ending on and after December 31, 2009.

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 9—Subsequent Events*

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Statement of Statutory Accounting Principles No. 11

Postemployment Benefits and Compensated Absences

STATUS

Type of Issue:	Common Area
Issued:	Initial Draft
Effective Date:	January 1, 2001
Affects:	No other pronouncements
Affected by:	No other pronouncements
Interpreted by:	No other pronouncements

STATUS **1**

SCOPE OF STATEMENT **3**

SUMMARY CONCLUSION **3**

Sabbatical Leave and Other Similar Benefits 5
Sick-Pay Benefits 5
Deferred Compensation Arrangements Accounted for Individually 5
Consolidated/Holding Company Plans 6
Disclosures 6
Relevant Literature 6
Effective Date and Transition 7

REFERENCES **7**

Relevant Issue Papers 7

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Postemployment Benefits and Compensated Absences

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for postemployment benefits and for compensated absences.

2. The scope of this statement includes:

a. All forms of postemployment benefits that meet the conditions in paragraph 5.

b. Split-dollar life-insurance arrangements if the arrangement is, in substance, an individual deferred compensation contract.

c. Other deferred compensation contracts.

d. Compensated Absences.

3. The scope of this statement does not include:

a. Benefits paid to active employees other than compensated absences.

b. Benefits paid at retirement or provided through a pension or postretirement benefit plan, including special or contractual termination benefits payable upon termination from a pension or other postretirement plan. Guidance for these benefits is addressed in SSAP No. 102 and SSAP No. 92 respectively.

c. Individual deferred compensation contracts, if those contracts taken together are equivalent to a defined benefit pension plan or other postretirement plan. Guidance for these benefits is addressed in SSAP No. 102 and SSAP No. 92 respectively.

d. Other postemployment benefits that do not meet the conditions in paragraph 5. Such postemployment benefits shall be assessed as contingent liabilities in accordance with SSAP No. 5R.

e. Stock compensation plans accounted for under *SSAP No. 104R—Share-Based Payments.*

SUMMARY CONCLUSION

~~2.~~4. Postemployment benefits are all types of benefits provided by an employer to former or inactive employees or agents, their beneficiaries, and covered dependents, after employment but before retirement. Those benefits include, but are not limited to, salary continuation, supplemental unemployment benefits, severance benefits, disability-related benefits (including workers' compensation), job training and counseling, ~~and~~ continuation of benefits such as health care benefits and life insurance coverage, and special or contractual termination benefits payable before retirement and that are not payable from a pension or other postretirement plan. Compensated absences include, but are not limited to, benefits such as vacation, sick pay, sabbatical leave and other similar benefits, and holidays.

~~3.~~5. A reporting entity shall accrue a liability for postemployment benefits and for employees' compensation for future absences if all of the following conditions are met:

a. The reporting entity's obligation relating to compensated absences and postemployment benefits is attributable to employees' services already rendered;

b. The obligation relates to rights that vest[1] or accumulate[2];

c. Payment is probable; and

d. The amount can be reasonably estimated.

6. A liability for amounts to be paid as a result of employees' rights to compensated absences shall be accrued, considering anticipated forfeitures, in the year in which earned. Furthermore, the definition of a liability does not limit an employer's liability for compensated absences solely to rights to compensation for those absences that eventually vest. The definition also encompasses a constructive obligation for reasonable estimable compensation for past services that, based on the employer's past practices, probably shall be paid and can be reasonably estimated.

7. Individual facts and circumstances must be considered in determining when nonvesting rights to compensated absences are earned by services rendered. The requirement to accrue a liability for nonvesting rights to compensated absences depends on whether the unused rights expire at the end of the year in which earned, or accumulate and carried forward to succeeding years, thereby increasing the benefits that would otherwise be available in those latter years. If the rights expire, a liability for future absences shall not be accrued at year-end because the benefits to be paid in subsequent years would not be attributable to employee services rendered in prior years. If unused rights do accumulate and increase the benefits otherwise available in subsequent years, a liability shall be accrued to the extent that it is probable that employees will be paid in subsequent years for the increased benefits attributable to the accumulated rights and the amount can be reasonably estimated.

~~4. In the unlikely situation in which a reporting entity does not accrue a liability in accordance with paragraph 3 only because the amount cannot be reasonably estimated (i.e., condition d. is not met), that fact and the reasons therefore shall be disclosed in the financial statements.~~

~~5.~~8. A reporting entity shall accrue a liability for employees' compensated absences and postemployment benefits reimbursable under service agreements with an affiliate, if all of the conditions of paragraph ~~3~~5 are met.

~~6.~~9. Postemployment benefits provided to employees or agents in connection with their termination can include special termination benefits and contractual termination benefits. Special termination benefits are defined as those that are offered only for a short period of time in exchange for employees' voluntary termination of service; contractual termination benefits are defined as those required by the terms of a plan only if a specified event, such as a facility closing, occurs. An employer that offers special termination benefits to employees or agents shall recognize a liability and an expense when the employees or agents accept the offer and the amount can be reasonably estimated. An employer that provides contractual termination benefits shall recognize a liability and an expense when it is probable that employees or agents will be entitled to benefits and the amount can be reasonably estimated. The cost of such termination benefits shall include the amount of any lump-sum payments and the present value of any expected future payments.

~~7. An employer is not required to accrue a liability for nonvesting accumulating rights for compensated absences if the right to receive those benefits is contingent upon future events and continued employment.~~

[1] In this statement, vested rights are those for which the reporting entity has an obligation to make payment even if an employee terminates; thus, they are not contingent on an employee's future service.

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

Sabbatical Leave and Other Similar Benefits

~~8.~~10. An entity may provide its employees with a benefit in the form of a compensated absence known as a sabbatical leave (sabbatical) whereby the employee is entitled to paid time off after working for an entity for a specified period of time. During the sabbatical, the individual continues to be a compensated employee and is not required to perform any duties for the entity. This issue is limited to those arrangements under which the sabbatical or other similar benefit arrangement is unrestricted (i.e., the employee is not required to perform any direct or indirect services for or on behalf of the entity during the absence). Arrangements in which employees are required to engage in research or public service to enhance the reputation of or otherwise benefit the entity are not within the scope of this statement.

~~9.~~11. An employee's right to a compensated absence under a sabbatical or other similar benefit arrangement (a) that requires the completion of a minimum service period and (b) in which the benefit does not increase with additional years of service accumulates pursuant to paragraph ~~3~~5.b. of this Statement for arrangements in which the individual continues to be a compensated employee and is not required to perform duties for the entity during the absence. Therefore, assuming all of the other conditions of paragraph ~~3~~5 are met, the compensation cost associated with a sabbatical or other similar benefit arrangement should be accrued over the requisite service period.

Sick-Pay Benefits

12. The employer’s actual administration of sick-pay benefits shall determine the appropriate accounting. In accounting for compensated absences, the form of an employer’s policy for compensated absences shall not prevail over actual practices. If sick-pay benefits are treated as compensated absences (e.g., employees are paid sick leave benefits even though absences are not the result of illness, or employees are allowed to take compensated terminal leave for accumulated unused sick-pay benefits prior to retirement), they shall be captured within paragraph 5. Otherwise, an employer is not required to accrue a liability for nonvesting accumulating rights to receive sick-pay benefits (compensation for an employee’s absence due to illness.) This statement does not prevent an employer from accruing a liability for such non-vesting, accumulating sick-pay benefits if the criteria in paragraph 5 is met.

Deferred Compensation Arrangements Accounted for Individually

13. To the extent the terms of a contract attribute all or a portion of the expected future benefits to an individual year of the employee's service, the cost of those benefits shall be recognized in that year. To the extent the terms of the contract attribute all or a portion of the expected future benefits to a period of service greater than one year, the cost of those benefits shall be accrued over that period of the employee's service in a systematic and rational manner. If elements of both current and future services are present, only the portion applicable to the current services shall be accrued.

14. Some deferred compensation contracts provide for periodic payments to employees or their surviving spouses for life with provisions for a minimum lump-sum settlement in the event of the early death of one or all of the beneficiaries. The estimated amount of future payments to be made under such contracts shall be accrued over the period of active employment from the time the contract is entered into.

15. The amounts to be accrued periodically under paragraph 13 shall result in an accrued amount at the full eligibility date equal to the then present value of all of the future benefits expected to be paid. Such estimates shall be based on the life expectancy of each individual concerned (based on the most recent mortality tables available) or on the estimated cost of an annuity contract rather than on the minimum payable in the event of early death. At the end of that period the aggregate amount accrued shall equal the then present value of the benefits expected to be provided to the employee, any beneficiaries, and covered dependents in exchange for the employee's service to that date.

Consolidated/Holding Company Plans

~~10.~~16. The employees of many reporting entities are eligible for certain compensated absence and postemployment benefits granted by a parent company or holding company. An entity with employees who are eligible for those benefits and is not directly liable for those related obligations shall recognize an expense equal to its allocation from the parent company or holding company of the benefits earned during the period. A liability shall be established for any such amounts due but not yet paid.

~~11.~~17. The reporting entity shall disclose in the financial statements that its employees participate in a plan sponsored by the holding company for which the reporting entity has no legal obligation. The amount of expense incurred and the allocation methodology utilized by the provider of such benefits shall also be disclosed. If the reporting entity is directly liable for the benefits, then the requirements outlined in paragraphs 2-15~~7~~ shall be applied.

Disclosures

~~12.~~18. The following disclosures shall be made for defined benefit postemployment plans for which the reporting entity is directly liable (i.e., the plan resides directly in the reporting entity):

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

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

c. The amount of net periodic benefit cost recognized, showing separately the service cost component, the interest cost component, the expected return on plan assets for the period, the gain or loss component~~amount of recognized gains and losses~~, the ~~amount of~~ prior service cost or credit component~~recognized~~, the transition asset or obligation component, and the amount of gain or loss recognized due to ~~a~~ settlements or curtailments;~~ and~~

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

e. The nature and effect of significant nonroutine events, such as amendments, combinations, divestures, curtailments and settlements.

19. ~~e.~~ If it is not practicable to estimate, and therefore, not accrue the liability (i.e., conditions a, b and c of paragraph 5~~3~~ are met but condition d is not), that fact and the reasons therefore shall be disclosed in the financial statements. Refer to the Preamble for further discussion regarding the disclosure requirements.

Relevant Literature

~~13.~~20. This statement adopts:

a. *FASB Statement No. 43, Accounting for Compensated Absences* (FAS 43),~~.~~

b. ~~This statement also adopts~~ *FASB Statement No. 112, Employers' Accounting for Postemployment Benefits: an amendment of FASB Statements No. 5 and 43*,~~,~~

c. ~~and the provisions of~~ *FASB Statement No. 88, Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*, as modified by *FAS 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans* (FAS 158), paragraph 15 regarding guidance for termination benefits,~~.~~

d. ~~In addition, this statement adopts paragraph 13 of *FASB Statement No. 132, Employers' Disclosures about Pensions and Other Postretirement Benefits* and paragraph 17 of~~ *FASB Statement No. 132(R), Employers' Disclosures about Pensions and Other Postretirement Benefits*, as modified by FAS 158, paragraphs 5(a), 5(b), 5(h), 5(g) and 8(m) to address disclosure requirements related to termination benefits ~~with modification to reject reduced disclosure requirements for nonpublic entities.~~, and

e. *APB 12: Omnibus Opinion*, paragraphs 6, 6A and 7.

21. This statement adopts with modification:

a. ~~This statement also adopts~~ FASB *Emerging Issues Task Force Issue No. 06-2—Accounting for Sabbatical Leave and Other Similar Benefits Pursuant to FASB Statement No. 43* with modification that the changes resulting from the adoption of EITF 06-2 are in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*.

Effective Date and Transition

~~14.~~22. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*.

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 11—Compensated Absences*
- *Issue Paper No. 13—Employers' Accounting for Postemployment Benefits*

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Statement of Statutory Accounting Principles No. 12

Employee Stock Ownership Plans

STATUS

Type of Issue:	Common Area
Issued:	Initial Draft
Effective Date:	January 1, 2001
Affects:	No other pronouncements
Affected by:	No other pronouncements
Interpreted by:	No other pronouncements

STATUS **1**
SCOPE OF STATEMENT **3**
SUMMARY CONCLUSION **3**
Leveraged ESOPs 3
Nonleveraged ESOPs 4
Pension Reversion ESOPs 4
Issues Related to Accounting for Income Taxes 4
Disclosures 5
Relevant Literature 5
Effective Date and Transition 5
REFERENCES **5**
Relevant Issue Papers 5

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Employee Stock Ownership Plans

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for the plan sponsors' accounting for Employee Stock Ownership Plans (ESOPs).

SUMMARY CONCLUSION

2. An ESOP is an employee benefit plan that is described by the Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code of 1986 as a stock bonus plan, or a combination stock bonus and money purchase pension plan, designed to invest primarily in employer stock. For such plans, reporting entities shall adopt AICPA *Statement of Position 93-6, Employers' Accounting for Employee Stock Ownership Plans* (SOP 93-6) except that debt obligations of ESOPs shall be reported consistent with *SSAP No. 15—Debt and Holding Company Obligations*, and the related income tax effects shall be accounted for consistent with *SSAP No. 101—Income Taxes, A Replacement of SSAP No. 10R and SSAP No. 10* (SSAP No. 101), as further clarified in this statement. There are two basic forms of ESOPs: leveraged and nonleveraged. A summary of the financial reporting for each is provided below.

Leveraged ESOPs

3. A leveraged ESOP borrows money to acquire shares of the employer company (sponsor). The money may be borrowed from the plan sponsor or from an outside lender, with or without a guarantee from the plan sponsor. The debt usually is collateralized by the employer's shares. Debt obligations of an ESOP shall be reported as borrowed money by company sponsors, except when the ESOP has both the ability and intent to satisfy the debt from sources other than dividends on the company stock, contributions from the company or the sale or exchange of the company's securities.

4. The sponsor shall record the issuance of shares or the sale of treasury shares to an ESOP when it occurs. The consideration recorded for the stock issued is unearned compensation and the unearned ESOP shares shall be recorded as a separate reduction of unassigned funds (surplus).

5. The unearned shares initially held by the ESOP in a suspense account are called suspense or unallocated shares. As the debt is repaid (generally from employer contributions and dividends on the employer's stock), suspense shares are released and must be allocated to individual accounts as of the end of the ESOP's fiscal year. As ESOP shares are committed to be released, unearned ESOP shares shall be credited and, depending on the purpose for which the shares are released, either (a) compensation cost, (b) dividends payable, or (c) compensation liabilities shall be charged consistent with SOP 93-6.

6. Because employers control the use of dividends on unallocated shares, dividends on unallocated shares are not considered dividends for financial reporting purposes (although such dividends are generally subject to normal dividend requirements under state statutes or regulations). Dividends on unallocated shares used to pay debt service shall be reported as a reduction of debt or of accrued interest payable. Dividends on unallocated shares paid to participants or added to participant accounts shall be reported as compensation cost. Dividends on allocated shares shall be charged to unassigned funds (surplus).

7. If the ESOP sells the suspense shares and uses the proceeds to repay the debt, the employer shall report the release of the suspense shares as a credit to unearned ESOP shares based on the cost of the shares to the ESOP, charge debt and accrued interest payable, and recognize the difference in paid-in capital. However, if there is a difference between the amount paid to an outside lender and the net carrying amount of the debt, such difference shall be reported as a capital gain or loss on extinguishment

of debt and, accordingly, shall be charged to operations and disclosed in the financial statements with other disclosures required by paragraph 17.

8. If an employer reacquires the suspense shares from the ESOP, the purchase of the shares shall be accounted for as a treasury stock transaction consistent with SOP 93-6.

Nonleveraged ESOPs

9. Employers with nonleveraged ESOPs shall report compensation cost equal to the contribution called for in the period under the plan.

10. Employers with nonleveraged ESOPs shall charge dividends on shares held by the ESOPs to unassigned funds (surplus), except that dividends on suspense account shares of pension reversion ESOPs shall be accounted for the same way as dividends on suspense account shares of leveraged ESOPs.

Pension Reversion ESOPs

11. Pension reversion ESOPs are created by transferring the assets of a defined benefit pension plan to existing or newly created ESOPs and may be leveraged or nonleveraged. Pension reversion ESOPs shall be accounted for consistent with SOP 93-6.

Issues Related to Accounting for Income Taxes

Leveraged ESOPs

12. The amount of ESOP-related expense for a leveraged ESOP for a period may differ from the amount of the ESOP-related income tax deduction (prescribed by income tax rules and regulations) for that period. Such differences shall be reported in accordance with SSAP No. 101.

13. If the cost of shares committed to be released is greater than their fair value, the employer shall credit the tax effect of the amount by which the deductible expense exceeds the book expense to unassigned funds. Conversely, if the cost of shares committed to be released is less than their fair value, the employer shall charge the tax effect of the amount by which the book expense exceeds the deductible expense to unassigned funds. Such amounts shall be limited to the amount of previous credits to unassigned funds related to cost exceeding fair value of ESOP shares committed to be released in previous periods.

14. The tax benefit of tax-deductible dividends on allocated ESOP shares shall be recorded as a reduction of income tax expense.

Nonleveraged ESOPs

15. Reporting entities with nonleveraged ESOPs may accrue compensation cost for financial reporting purposes earlier than the cost is deductible for income tax purposes. Accruing the compensation cost earlier for financial reporting purposes creates a temporary difference that shall be accounted for in accordance with SSAP No. 101.

Other

16. Under federal income tax regulations, employer securities (such as convertible preferred stock) that are held by participants in an ESOP and are not readily tradable on an established market must include a put option. Securities subject to such repurchase obligations shall be reported as outstanding and as a component of capital stock and/or gross paid-in and contributed surplus in accordance with *SSAP No. 72—Surplus and Quasi-reorganizations*.

Disclosures

17. An employer sponsoring an ESOP shall disclose the following information about the plan, if applicable:

a. A description of the plan, the basis for determining contributions, including the employee groups covered, and the nature and effect of significant matters affecting comparability of information for all periods presented. For leveraged ESOPs and pension reversion ESOPs, the description shall include the basis for releasing shares and how dividends on allocated and unallocated shares are used;

b. A description of the accounting policies followed for ESOP transactions, including the method of measuring compensation and the classification of dividends on ESOP shares;

c. The amount of compensation cost recognized during the period;

d. The number of allocated shares, committed-to-be-released shares, and suspense shares held by the ESOP at the balance sheet date;

e. The fair value of unearned ESOP shares at the balance sheet date; and

f. The existence and nature of any repurchase obligation, including disclosure of the fair value of the shares allocated as of the balance sheet date, which are subject to a repurchase obligation.

18. Refer to the preamble for further discussions regarding disclosure requirements. The disclosures in paragraph 17 shall be included in the annual audited statutory financial reports only.

Relevant Literature

19. This statement adopts SOP 93-6 with a modification to reject paragraphs 13 and 25 to the extent they require reporting all debt obligations of an ESOP as liabilities, paragraphs 28-34, 44, and 53.b. as they relate to earnings per share, and paragraph 37 as it relates to reporting gains and losses on extinguishment of debt.

20. This statement rejects *FASB Emerging Issues Task Force No. 89-11, Sponsor's Balance Sheet Classification of Capital Stock with a Put Option Held by an Employee Stock Ownership Plan*.

Effective Date and Transition

21. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*.

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 78—Employee Stock Ownership Plans*

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Statement of Statutory Accounting Principles No. 15

Debt and Holding Company Obligations

STATUS

Type of Issue:	Common Area
Issued:	Initial Draft
Effective Date:	January 1, 2001
Affects:	Nullifies and incorporates INT 00-08, INT 00-10, INT 04-07, INT 04-15, INT 08-08
Affected by:	No other pronouncements
Interpreted by:	No other pronouncements

STATUS **1**

SCOPE OF STATEMENT **3**

SUMMARY CONCLUSION **3**

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Debt and Holding Company Obligations

SCOPE OF STATEMENT

1. The purpose of this statement is to establish statutory accounting principles for recording debt and related disclosure requirements, including holding company obligations and any related guarantees in the financial statements of an insurance company subsidiary, and debt obligations of Employee Stock Ownership Plans (ESOPs).

SUMMARY CONCLUSION

Debt

2. Debt shall be reported as a liability unless (a) it is debt on real estate in accordance with *SSAP No. 40R—Real Estate Investments* (i.e., reported as a reduction in the carrying value of real estate), (b) it is offset against another asset in accordance with *SSAP No. 64—Offsetting and Netting of Assets and Liabilities*, or (c) other treatment is specified elsewhere within the *Accounting Practices and Procedures Manual*. Instruments that meet the requirements to be recorded as surplus as specified in *SSAP No. 72—Surplus and Quasi-Reorganizations* are not considered debt.

3. Debt discount or premium, if any, shall be reported in the balance sheet as a direct deduction from or addition to the face amount of the note. Discount or premium shall be amortized over the life of the note using the interest method.

4. Interest on debt shall be accrued and charged to operations over the life of the debt, except when capitalized in accordance with *SSAP No. 44—Capitalization of Interest*. Interest payable shall include interest payable on all debt reported as a liability, approved interest on surplus notes, and interest payable on debt reported as a reduction in the carrying value of real estate.

5. Debt issuance costs (e.g., loan fees and legal fees) do not meet the definition of an asset as defined in *SSAP No. 4—Assets and Nonadmitted Assets*. Accordingly, these costs shall be charged to operations in the period incurred.

6. Debt obligations of ESOPs shall be reported as debt by company sponsors, except when the ESOP has both the ability and intent to satisfy the debt from sources other than dividends on the company stock, contributions from the company, or the sale or exchange of the company's securities. ESOPs are addressed in *SSAP No. 12—Employee Stock Ownership Plans*.

7. Debt which is subject to a troubled debt restructuring shall be accounted for in accordance with *SSAP No. 36—Troubled Debt Restructuring*.

8. Convertible debt securities that are convertible into common stock of the issuer or an affiliated company at a specified price at the option of the holder and which are sold at a price not significantly in excess of the face amount shall be accounted for solely as debt at the time of issuance. An expense shall be recognized, equal to the fair value of additional securities granted or other consideration issued to induce conversion subsequent to the issuance of convertible debt securities. This guidance applies regardless of who initiates the offer, the debt holder or the debtor, and whether the offer applies to all debt holders.

9. Proceeds from debt issued with detachable stock purchase warrants shall be allocated based on the relative fair value of the two securities at the time of issuance. The value attributable to the warrants shall be accounted for as paid-in capital.

10. Other types of debt securities, e.g., capital notes, shall be accounted for in accordance with the substance of the transaction.

11. A reporting entity shall derecognize a liability if, and only if, it has been extinguished. A liability has been extinguished if either of the following conditions is met:

a. The reporting entity pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes delivery of cash, other financial assets, goods or services, or reacquisition by the debtor of its outstanding debt securities; or

b. The reporting entity is legally released from being the primary obligor under the liability, either judicially or by the creditor.

Convertible Debt Securities with Beneficial Conversion Features

12. Entities may issue convertible debt securities and convertible preferred stock with a nondetachable conversion feature that is in-the-money at the commitment date (a "beneficial conversion feature"). Those securities may be convertible into common stock at the lower of a conversion rate fixed at the commitment date or a fixed discount to the market price of the common stock at the date of conversion. Certain convertible securities may have a conversion price that is variable based on future events such as a subsequent round of financing at a price lower than the convertible securities' original conversion price, a liquidation or a change in control of the company, or an initial public offering at a share price lower than an agreed-upon amount.

13. Convertible debt securities and convertible preferred stock with beneficial conversion features are to be valued according to the appropriate statutory accounting statement; *SSAP No. 26—Bonds, Excluding Loan-Backed and Structured Securities* or *SSAP No. 32—Investments in Preferred Stock (including investments in preferred stock of subsidiary, controlled, or affiliated entities).*

Accounting for Changes in Line-of-Credit or Revolving-Debt Arrangements

14. A line-of-credit or revolving-debt arrangement is an agreement that provides the borrower with the option to make multiple borrowings up to a specified maximum amount to repay portions of previous borrowings, and to then reborrow under the same contract. Line-of-credit and revolving-debt arrangements may include both amounts drawn by the debtor (a debt instrument) and a commitment by the creditor to make additional amounts available to the debtor under predefined terms (a loan commitment). In most situations, a debtor incurs costs to establish line-of-credit or revolving-debt arrangements, and some or all of the costs are deferred and amortized over the term of the arrangement.

15. Modifications to or exchanges of line-of-credit or revolving-debt arrangements, including the accounting for unamortized costs at the time of the change, fees paid to or received from the creditor and third-party costs incurred shall be expensed when incurred.

Holding Company Obligations

16. In situations where the reporting entity does not guarantee the obligation of the holding company, there is no legal obligation on the part of the reporting entity. Therefore, the reporting entity shall not record the obligation of its parent holding company unless the obligation relates to services or benefits incurred by a non-insurance parent company or holding company on its behalf. In these situations, the reporting entity shall recognize an expense for its share of the services or benefits provided to it during the period by the parent company or holding company based on an allocation from the parent or holding company. A liability shall be established for any such amounts due, but not yet paid. The amount of expense incurred and the allocation methodology utilized by the provider of such benefits shall also be disclosed. *SSAP No. 11—Postemployment Benefits and Compensated Absences* (SSAP No. 11), *SSAP No. 92—Accounting for Postretirement Benefits Other Than Pensions, A Replacement of SSAP No. 14* (SSAP No. 92) and *SSAP No. 102—Accounting for Pensions, A Replacement of SSAP No. 89* (SSAP No. 102)

address specific examples where the obligation relates to benefits provided to the subsidiary by a non-insurance parent company or holding company.

17. If the reporting entity guarantees an obligation of the holding company, the guidance in *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets* shall be followed for determining the recording and disclosure of the guarantee. SSAP Nos. 11, 92 and 102 provide specific accounting and disclosure guidelines for employee benefit plans when the reporting entity is directly liable for obligations under the plan.

Accounting for the Settlement of the Equity-Settled Portion of a Convertible Debt Instrument That Permits or Requires the Conversion Spread to Be Settled in Stock

18. Upon settlement of a security with the characteristics of Instrument C in *FASB Emerging Issues Task Force 90-19, Convertible Bonds with Issuer Option to Settle for Cash upon Conversion*, by payment of the accreted value of the obligation (recognized liability) in cash and settlement of the conversion spread (unrecognized equity instrument) with stock, only the cash payment should be considered in the computation of gain or loss on extinguishment of the recognized liability. That is, any shares transferred to settle the embedded equity instrument (referred to as the excess conversion spread in EITF 90-19) would not be considered in the settlement of the debt component.

Accounting for Federal Home Loan Banks

19. Funding agreements issued to a federal home loan bank (FHLB) shall be evaluated on an individual basis, and shall be accounted for according to the substance of the individual arrangement and entity licensing. If the arrangement is in substance a funding agreement, including that the funds are used in an investment spread capacity, it shall be accounted for consistent with other funding agreements in accordance with *SSAP No. 52—Deposit-Type Contracts*. If the arrangement is in substance a borrowing agreement, it shall be accounted for in accordance with this statement, consistent with other borrowed money.

Disclosures

20. The financial statements shall disclose the following items related to debt, including FHLB borrowings accounted for under this SSAP:

a. Date issued;

b. Pertinent information concerning the kind of borrowing (e.g., debentures, commercial paper outstanding, bank loans, and lines of credit);

c. Face amount of the debt;

d. Carrying value of debt;

e. The rate at which interest accrues;

f. The effective interest rate;

g. Collateral requirements;

h. Interest paid in the current year;

i. A summary of significant debt terms and covenants and any violations;

j. The combined aggregate amount of maturities and sinking fund requirements for each of the five years following the latest balance sheet presented;

k. If debt was considered to be extinguished by in-substance defeasance prior to the effective date of this statement and any of the debt remains outstanding, a general description of the transaction and the amount of debt that is considered extinguished at the end of the period; and

l. If assets are set aside after the effective date of this statement solely for satisfying scheduled payments of a specific obligation, a description of the nature of restrictions placed on those assets.

21. FHLB borrowings accounted for under SSAP No. 15 should follow the disclosure requirements required in paragraph 20 as well as the disclosure requirements included in *SSAP No. 30—Investments in Common Stock (excluding investments in common stock of subsidiary, controlled or affiliated entities)*, paragraph 16.

22. Refer to the preamble for further discussion regarding disclosure requirements.

Relevant Literature

23. This statement adopts *Accounting Principles Board Opinion No. 14, Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants* and *FASB Statement No. 84, Induced Conversions of Convertible Debt*.

24. This statement adopts *Accounting Principles Board Opinion No. 21, Interest on Receivables and Payables,* with a modification to require that debt issuance costs be charged to operations.

25. This statement adopts *Accounting Principles Board Opinion No. 26, Early Extinguishment of Debt* with modification to require that gains and losses from extinguishment of debt be reported as capital gains or losses, and charged to operations.

26. This statement adopts paragraphs 13 and 25 of AICPA *Statement of Position 93-6, Employers' Accounting for Employee Stock Ownership Plans* (SOP 93-6) with a modification to exclude debt obligations when the ESOP has both the ability and intent to satisfy the debt from sources other than dividends on the company's stock, contributions from the company, or the sale or exchange of the company's securities. This statement rejects paragraph 37 of SOP 93-6 as it relates to reporting gains and losses on extinguishment of debt which shall be accounted for consistent with *SSAP No. 24—Discontinued Operations and Extraordinary Items.*

27. This statement adopts *FASB Emerging Issues Task Force No. 90-19, Convertible Bonds with Issuer Option to Settle for Cash upon Conversion* with a modification to reject guidance related to earnings per share.

28. This statement adopts *FASB Technical Bulletin No. 80-1, Early Extinguishment of Debt through Exchange for Common or Preferred Stock,* with a modification to reject guidance related to classification of the loss as an extraordinary item.

29. This statement adopts the following pronouncements:

a. *Accounting Principles Board Opinion No. 12, paragraphs 16 and 17, Omnibus Opinion—1967*;

b. AICPA *Accounting Interpretations of APB 21, Interest on Receivables and Payables*;

c. AICPA *Accounting Interpretations of APB 26, Early Extinguishment of Debt*;

d. *FASB Emerging Issues Task Force No. 85-9, Revenue Recognition on Options to Purchase Stock of Another Entity;*

e. *FASB Emerging Issues Task Force No. 85-17, Accrued Interest upon Conversion of Convertible Debt*;

f. *FASB Emerging Issues Task Force No. 85-29, Convertible Bonds with a "Premium Put"*;

g. *FASB Emerging Issues Task Force No. 86-8, Sale of Bad-Debt Recovery Rights;*

h. *FASB Emerging Issues Task Force No. 86-15, Increasing-Rate Debt*;

i. *FASB Emerging Issues Task Force No. 86-18, Debtor's Accounting for a Modification of Debt Terms*;

j. *FASB Emerging Issues Task Force No. 86-28, Accounting Implications of Indexed Debt Instruments*;

k. *FASB Emerging Issues Task Force No. 86-36, Invasion of a Defeasance Trust*;

l. *FASB Emerging Issues Task Force No. 95-15, Recognition of Gain or Loss When a Binding Contract Requires a Debt Extinguishment to Occur at a Future Date for a Specified Amount*.

30. This statement rejects *FASB Statement No. 4, Reporting Gains and Losses from Extinguishment of Debt* and *FASB Statement No. 64, Extinguishments of Debt Made to Satisfy Sinking-Fund Requirements—an Amendment of FASB Statement No. 4*. This statement also rejects *FASB Emerging Issues Task Force No. 84-40, Long-Term Debt Repayable by a Capital Stock, FASB Emerging Issues Task Force No. 98-5, Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios,* and *FASB Emerging Issues Task Force No. 98-14, Debtor's Accounting for Changes in Line-of-Credit or Revolving-Debt Arrangements*.

Effective Date and Transition

31. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors.* The guidance in paragraphs 12 and 13 was originally contained within *INT 00-08: EITF 98-5: Accounting for Convertible Securities with Beneficial Conversion Features or Continently Adjustable Conversion Ratios* and was effective September 11, 2000. The guidance in paragraphs 14 and 15 was originally contained within *INT 00-10: EITF 98-14: Debtor's Accounting for Changes in Line-of-Credit or Revolving-Debt Arrangements* and was effective June 12, 2000. The guidance in paragraph 18 was originally contained within *INT 04-15: EITF 03-7: Accounting for the Settlement of the Equity-Settled Portion of a Convertible Debt Instrument That Permits or Requires the Conversion Spread to be Settled in Stock (Instrument C of Issue No. 90-19)* and was effective December 5, 2004. Guidance in paragraph 19 was previously included within *INT 08-08: Balance Sheet Presentation of Funding Agreements Issued to a Federal Home Loan Bank* and was effective for periods beginning March 15, 2009. Guidance in paragraphs 20-21 related to FHLB agreements and borrowings was initially effective January 1, 2014.

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 80—Debt*
- *Issue Paper No. 95—Holding Company Obligations*

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Statement of Statutory Accounting Principles No. 16 - Revised

Electronic Data Processing Equipment and Accounting for Software

STATUS

Type of Issue:	Common Area
Issued:	Initial draft; substantively revised – October 18, 2010
Effective Date:	January 1, 2001, January 1, 2002, and January 1, 2004
Affects:	Supersedes SSAP No. 79, SSAP No. 81 and SSAP No. 82 Nullifies and incorporates INT 04-13
Affected by:	No other pronouncements
Interpreted by:	INT 01-18

STATUS 1
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Electronic Data Processing Equipment and Accounting for Software

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for electronic data processing (EDP) equipment and provisions for the accounting of other software.

SUMMARY CONCLUSION

EDP Equipment and Operating / Nonoperating System Software

2. EDP equipment and software generally meet the definition of assets established in *SSAP No. 4—Assets and Nonadmitted Assets*. EDP equipment and operating system software are admitted assets to the extent they conform to the requirements of this statement. Nonoperating system software are nonadmitted assets.

3. EDP equipment and operating system software shall be depreciated over the lesser of its useful life or three years. Nonoperating system software shall be depreciated over the lesser of its useful life or five years. In either case, the methods detailed in *SSAP No. 19—Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements* (SSAP No. 19) shall be used.

4. The aggregate amount of admitted EDP equipment and operating system software (net of accumulated depreciation) shall be limited to three percent of the reporting entity's capital and surplus as required to be shown on the statutory balance sheet of the reporting entity for its most recently filed statement with the domiciliary state commissioner adjusted to exclude any EDP equipment and operating system software, net deferred tax assets and net positive goodwill.(INT 01-18)

5. In accordance with the reporting entity's written capitalization policy, amounts less than a predefined threshold shall be expensed when purchased, otherwise the EDP Equipment, operating and nonoperating system software assets shall be capitalized and depreciated in accordance with paragraph 3. The reporting entity shall maintain a capitalization policy containing the predefined thresholds for each asset class to be made available for the department(s) of insurance.

Research and Development Costs Incurred to Obtain or Develop Computer Software

6. Guidance on the accounting for research and development costs is provided in *SSAP No. 17—Preoperating and Research and Development Costs* (SSAP No. 17), and requires all research and development costs to be expensed when incurred. Pursuant to the guidance adopted within that SSAP:

a. To the extent that the acquisition, development, or improvement of a process by an enterprise for use in its selling or administrative activities includes costs for computer software, those costs are not research and development costs.

b. Costs incurred to purchase or lease computer software developed by others are not research and development costs unless the software is for use in research and development activities.

c. Costs incurred by an enterprise in developing computer software internally for use in its research and development activities are research and development costs. This includes costs incurred during all phases of software development because all of those costs are incurred in research and development activities.

7. Costs for computer software determined to be research and development costs shall be accounted for and disclosed in accordance with SSAP No. 17. Software costs not considered to be research and development costs shall be accounted for in accordance with this SSAP.

Accounting for the Costs of Computer Software to be Sold

8. This Statement adopts with modification *FASB Codification 985-20, Software - Costs of Software to be Sold, Leased or* Marketed (ASC 985-20) to preclude the capitalization of software development costs and to reject guidance regarding the treatment of capitalized costs. Additionally, this Statement rejects *FASB Codification 985-330, Software - Inventory (ASC 985-330)*. Statutory modifications to ASC 985-20 and rejection of ASC 985-330 precludes capitalization of costs, and requires such costs to be expensed, for:

a. Costs of producing product masters incurred subsequent to establishing technological feasibility. Those costs include coding and testing performed subsequent to establishing technological feasibility.

b. Software production costs for computer software that is to be used as an integral part of a product or process.

c. All indirect costs, including overhead related to programmers and the facilities they occupy.

d. Costs incurred for duplicating computer software, documentation and training materials from product masters and for physically packaging the product for distribution.

Software Revenue Recognition

9. This Statement adopts with modification *FASB Codification 985-605, Revenue Recognition* (ASC 985-605), as revised by *ASU 2009-14, Certain Revenue Arrangements That Include Software Elements* (ASU 2009-14), for statutory accounting terms and concepts:

a. References to GAAP guidance outside FASB Codification topic 985-605 shall be followed only to the extent in which that specific GAAP guidance has been adopted[1] for statutory accounting. The guidance within the applicable SSAP or statutory interpretation shall be considered the authoritative statutory guidance.

b. Any references to the accounting for capitalized development costs is rejected as all development costs are required to be expensed when incurred.

Costs of Computer Software Developed or Obtained for Internal Use and Web Site Development Costs

10. This Statement adopts with modification *FASB Codification 350-40, Internal Use Software* (ASC 350-40) for statutory accounting terms and concepts. This Statement also adopts *FASB Codification 350-50, Website Development Costs* (ASC 350-50) in its entirety.

[1] If statutory accounting principles do not address the FASB Codification reference, consideration of whether the GAAP guidance is adopted for statutory accounting shall be determined in accordance with the respective pre-codification GAAP guidance.

11. The modifications to ASC 350-40 are as follows:

a. ASC 350-40-15-4 states that the accounting for costs of reengineering activities, which often are associated with new or upgraded software applications, is not included within scope. This guidance is expanded to require that such costs be expensed as incurred.

b. ASC 350-40-25-16 is amended to require that entities that license internal-use computer software follow the operating lease provisions outlined in *SSAP No. 22—Leases.*

c. ASC 350-40-35-4 is amended to require entities to follow the amortization guidelines as established in paragraph 10 of *SSAP No. 19—Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements*

d. ASC 350-40-35-5 is amended to require that capitalized operating system software shall be depreciated for a period not to exceed three years. Capitalized nonoperating system software shall be depreciated for a period not to exceed five years. This is consistent with paragraph 3 of this Statement.

e. ASC 350-40-35-9 is amended to require that if during the development of internal use software, an entity decided to market the software to others, the entity shall immediately expense any amounts previously capitalized.

f. ASC 350-40-50-1 is amended to require entities to follow the disclosure provisions provided in paragraph 14 of this SSAP and paragraph 5 of SSAP No. 17.

g. Any software costs capitalized in accordance with paragraphs 10 and 11 shall be deemed either operating or nonoperating system software costs. Entities shall make this determination in accordance with the definitions of operating and nonoperating system software contained in the Glossary. As noted in paragraph 2, nonoperating system software is a nonadmitted asset.

Non-Software Deliverables in Arrangements Containing More-Than-Incidental Software

12. In an arrangement that includes software that is more than incidental to the products or services as a whole, software and software-related elements are included within the scope of this guidance. Software-related elements include software products and services as well as any non-software deliverable(s) for which a software deliverable is essential to its functionality. For example, in an arrangement that includes software, computer hardware that will contain the software, and additional unrelated equipment, if the software is essential to the functionality of the hardware, the hardware would be considered software-related and, therefore, included within the scope of this guidance. However, because the software is not essential to the functionality of the unrelated equipment, the equipment would not be considered software-related and would, therefore, be excluded from the scope.

13. In accordance with the reporting entity's written capitalization policy, amounts less than a predefined threshold of costs incurred within the scope of paragraphs 10 and 11 shall be expensed when incurred. The reporting entity shall maintain a capitalization policy containing the predefined thresholds for each asset class to be made available for the department(s) of insurance.

Disclosures

14. The disclosures in this paragraph are specific to EDP equipment and operating and nonoperating system software, but shall also be followed as directed under paragraph 11.f.

a. Depreciation and amortization expense for the period;

b. For EDP equipment and operating system software, balances of major classes of depreciable assets, by nature or function, at the balance sheet date;

c. For EDP equipment and operating system software, accumulated depreciation and amortization, either by major classes of depreciable assets or in total, at the balance sheet date; and

d. A general description of the method or methods used in computing depreciation with respect to major classes of depreciable assets.

15. The financial statements shall ~~D~~disclose if the written capitalization policies~~, identified in paragraphs 5 and 13,~~ and the resultant thresholds have changed from the prior period and the reason(s) for such change.

16. Refer to the preamble for further discussion regarding disclosure requirements. The disclosures in paragraph~~s~~ 14 ~~and 15~~ shall be included in the annual audited statutory financial reports only.

Effective Date and Transition

17. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*. The guidance in paragraph 12 was originally contained within *INT 04-13: EITF 03-5: Applicability of AICPA Statement of Position 97-2 to Non-Software Deliverables in an Arrangement Containing More-Than-Incidental Software* and was effective December 5, 2004.

18. EDP equipment and operating system software capitalized prior to January 1, 2001 shall be depreciated over the lesser of its remaining useful life or three years. Nonoperating system software capitalized prior to January 1, 2001 shall be depreciated over the lesser of its remaining useful life or five years.

Relevant Literature

19. The revisions to this Statement, adopted in October 2010, result from incorporating previously adopted statutory accounting guidance from SSAP No. 17, SSAP No. 79, SSAP No. 81, SSAP No. 82 and SSAP No. 87 into this Statement. Revisions to incorporate the previously adopted statutory accounting guidance within this SSAP shall not be considered new statutory accounting guidance. This Statement also adopts with modification ASU 2009-14, which revises the previous GAAP guidance adopted under SSAP No. 81. The GAAP revisions adopted within ASU 2009-14 are considered nonsubstantive and are effective immediately.

20. This Statement references GAAP guidance in accordance with the current FASB Codification. The references to the FASB Codification are intended to reflect the previously adopted pre-codification GAAP guidance as communicated within SSAP No. 17, SSAP No. 81 and SSAP No. 82:

a. The pre-codification GAAP guidance reflected within SSAP No. 17 and incorporated within paragraph 8 through reference to the FASB ASC 985-20 includes:

i. *FASB Statement No. 86, Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed* was adopted with the exception of paragraphs 5 and 6 and paragraphs 8-11. Those paragraphs were rejected to preclude the capitalization of software development costs.

ii. *FASB Emerging Issues Task Force No. 96-14, Accounting for Costs Associated with Modifying Computer Software for the Year 2000* was adopted. This guidance was not included within the FASB Codification as it is considered no longer technologically helpful.

b. The pre-codification GAAP guidance reflected within SSAP No. 81 and incorporated within paragraph 9 through reference to the FASB ASC 985-605 includes:

i. *AICPA Statement of Position 97-2, Software Revenue Recognition* paragraphs 6-91 was adopted with certain modifications.

ii. *AICPA Statement of Position 98-9, Modification of SOP 97-2 Software Revenue Recognition, With Respect to Certain Transactions* paragraphs 6-8 was adopted. (Note: The adopted paragraphs reflect all of the changes to SOP 97-2.)

iii. *FASB Emerging Issues Task Force No. 00-3, Application of AICPA Statement of Position 97-2 to Arrangements That Include the Right to Use Software Stored on Another Entity's Hardware* was adopted in its entirety.

iv. *AICPA Statement of Position 98-4, Deferral of the Effective Date of a Provision of SOP 97-2, Software Revenue Recognition* was considered not applicable because the effective date was inconsistent with SSAP No. 81.

c. The pre-codification GAAP guidance reflected within SSAP No. 82 and incorporated within paragraphs 10 and 11 through reference to the FASB ASC 350-40 includes:

i. *AICPA Statement of Position 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use* paragraphs 11-42 and paragraph 93 were adopted with modification.

ii. *FASB Emerging Issues Task Force No. 00-2, Accounting for Web Site Development Costs* was adopted in its entirety.

21. SSAP No. 16, SSAP No. 17 and SSAP No. 79 were effective for years beginning January 1, 2001. SSAP No. 81 and SSAP No. 82 were effective for years beginning January 1, 2002. SSAP No. 87 was effective for years beginning on and after January 1, 2004. Transition guidance from the initial adoption of these SSAPs has expired and is not duplicated within this Statement.

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 16—Electronic Data Processing Equipment and Software*
- *Issue Paper No. 17—Preoperating and Research and Development Costs*
- *Issue Paper No. 109—Depreciation of Non-Operating System Software – An Amendment to SSAP No. 16*
- *Issue Paper No. 111—Software Revenue Recognition*
- *Issue Paper No. 112—Accounting for the Costs of Computer Software Developed or Obtained for Internal Use and Web Site Development Costs*

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Statement of Statutory Accounting Principles No. 17

Preoperating and Research and Development Costs

STATUS

Type of Issue:	Common Area
Issued:	Initial Draft
Effective Date:	January 1, 2001
Affects:	Nullifies and incorporates INT 99-18, INT 08-04
Affected by:	No other pronouncements
Interpreted by:	No other pronouncements

STATUS **1**
SCOPE OF STATEMENT **3**
SUMMARY CONCLUSION **3**
Disclosures 3
Relevant Literature 3
Effective Date and Transition 4
REFERENCES **4**
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Preoperating and Research and Development Costs

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for organizational costs, research and development costs, and start-up costs for new and existing entities.

SUMMARY CONCLUSION

2. Preoperating, including organization and startup costs, and research and development costs shall be expensed as incurred. Preoperating and research and development costs are incurred for such new projects as: (a) arranging operations for a new entity (e.g., legal, actuarial and accounting costs associated with regulatory approval and licensing and issuance of stock), (b) establishing production, sales or service facilities at a new site, (c) changing operations or production significantly, or (d) developing and producing a new product, adopting a new process or offering a new service. Also included in research and development costs are all nonrefundable advance payments for goods or services that will be used or rendered for research and development activities. These nonrefundable advance payments shall be expensed when the advance payment is made.

3. Costs associated with business process reengineering activities, whether done internally or by third parties, shall be expensed when incurred. The total consulting contract price (or the sum of the linked contracts with the same vendor) in a business process reengineering project shall be allocated to each activity based on the relative fair values when a third party is used to complete such a project.

4. Preoperating, including organization and start-up costs, and research and development costs specifically exclude tangible assets acquired in connection with such activities.

Disclosures

5. Disclosure shall be made in the financial statements of the total research and development costs charged to expense in each period for which an income statement is presented. The disclosure shall be included in the annual audited statutory financial report only.

6. Refer to the preamble for further discussion regarding disclosure requirements.

Relevant Literature

7. This statement adopts *FASB Statement No. 2, Accounting for Research and Development Costs* and *FASB Interpretation No. 6, Applicability of FASB Statement No. 2 to Computer Software*. From January 1, 2001 through October 2010, this statement also adopted *FASB Statement No. 86*, *Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed* (FAS 86), with the exception of paragraphs 5 and 6 and paragraphs 8-11. These paragraphs have been rejected to preclude the capitalization of software development costs. *FASB Emerging Issues Task Force No. 96-14, Accounting for the Costs Associated with Modifying Computer Software for the Year 2000* (EITF 96-14) and *FASB Emerging Accounting Issues Task Force No. 97-13: Accounting for Costs Incurred in Connection with a Consulting Contract or an Internal Project that Combines Business Process Reengineering and Information Technical Transformation* (EITF 97-13) are adopted. Effective October 2010, FAS 86 and EITF 96-14 were rejected as FASB issued new GAAP guidance, which is reviewed in SSAP No. 16R.

8. This statement rejects *FASB Statement No. 7*, *Accounting and Reporting by Development Stage Enterprises, FASB Interpretation No. 7, Applying FASB Statement No. 7 in Financial Statements of Established Operating Enterprises, an interpretation of FASB Statement No. 7* and *FASB Emerging Issues Task Force No. 07-3, Accounting for Nonrefundable Advance Payments for Goods or Services Received for Use in Future Research and Development Activities.*

Effective Date and Transition

9. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*. Guidance reflected in paragraph 2 was previously included in *INT 08-04: FASB Emerging Issues Task Force No. 07-3, Accounting for Nonrefundable Advance Payments for Goods or Services Received for Use in Future Research and Development Activities* and was originally effective May 31, 2008.

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 17—Preoperating and Research and Development Costs*

Statement of Statutory Accounting Principles No. 19

Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements

STATUS

Type of Issue:	Common Area
Issued:	Initial Draft
Effective Date:	January 1, 2001
Affects:	Supersedes SSAP No. 87 with guidance incorporated August 2011 Nullifies and incorporates INT 09-05
Affected by:	No other pronouncements
Interpreted by:	INT 01-18

STATUS **1**

SCOPE OF STATEMENT **3**

SUMMARY CONCLUSION **3**

Furniture, Fixtures and Equipment 3
Leasehold Improvements Paid by the Reporting Entity as Lessee 3
Maintenance Costs Paid by Lessee 3
Depreciation and Amortization 4
Disclosures 4
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Effective Date and Transition 5

REFERENCES **5**

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Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for furniture, fixtures, and equipment (excluding electronic data processing equipment and software that is addressed in *SSAP No. 16R—Electronic Data Processing Equipment and Accounting for Software* (SSAP No. 16R), leasehold improvements paid by the reporting entity as lessee, and depreciation of property and amortization of leasehold improvements. Concession service arrangements, as defined in SSAP No. 22, are not leases, nor should they be recognized as property, plant or equipment. Therefore, these arrangements, and improvements to infrastructures within concession service arrangements, are outside of the scope of this standard.

SUMMARY CONCLUSION

Furniture, Fixtures and Equipment

2. Furniture, fixtures and equipment generally meet the definition of assets established in *SSAP No. 4—Assets and Nonadmitted Assets* (SSAP No. 4). Such items also meet the criteria defining nonadmitted assets in SSAP No. 4. Accordingly, these assets shall be depreciated against net income as the estimated economic benefit expires and the undepreciated portion of these assets shall be reported as nonadmitted assets and charged against surplus.(INT 01-18)

3. In accordance with the reporting entity's written capitalization policy, amounts less than a predefined threshold of such assets shall be expensed when purchased. The reporting entity shall maintain a capitalization policy containing the predefined thresholds for each asset class to be made available for the department(s) of insurance.

Leasehold Improvements Paid by the Reporting Entity as Lessee

4. Leasehold improvements shall be defined as lessee expenditures that are permanently attached to an asset that a reporting entity is leasing under an operating lease.

5. Leasehold improvements that increase the value and enhance the usefulness of the leased asset meet the definition of assets established in SSAP No. 4. Within that definition, such items also meet the criteria defining nonadmitted assets. Accordingly, such assets shall be reported as nonadmitted assets and charged against surplus. These nonadmitted assets shall be amortized against net income over the shorter of their estimated useful life or the remaining life of the original lease excluding renewal or option periods. Leasehold improvements that do not meet the definition of assets shall be charged to expense when acquired.

6. In accordance with the reporting entity's written capitalization policy, amounts less than a predefined threshold of such assets shall be expensed when purchased. The reporting entity shall maintain a capitalization policy containing the predefined thresholds for each asset class to be made available for the department(s) of insurance.

Maintenance Costs Paid by Lessee

7. Maintenance costs incurred by the lessee for maintenance on the leased item that do not increase the value and enhance the usefulness of the leased asset shall be expensed when incurred. Reimbursable deposits shall be reflected as nonadmitted assets. Deposits paid to the lessor, reimbursable when the lessee incurs costs for lease maintenance activities, shall be recorded as nonadmitted assets. When the

amount on deposit is less than probable of being returned, the deposit shall be recognized as an additional lease expense.

Depreciation and Amortization

8. Depreciable assets include all tangible capital assets classified as either admitted or nonadmitted in accordance with SSAP No. 4. Land shall not be considered a depreciable asset.

9. The acquisition cost of depreciable assets, net of salvage, shall be depreciated against net income over the estimated useful lives of the assets in a systematic and rational manner. The acquisition cost of a leasehold improvement shall be amortized against net income over the shorter of its estimated useful life or the original lease term excluding options or renewal periods. For leasehold improvements capitalized subsequent to inception of the lease, the cost shall be amortized over the shorter of its estimated useful life or the remaining original lease term excluding options or renewal periods. Amounts capitalized for leasehold improvements in periods subsequent to the original lease term (i.e., during renewal periods), are amortized utilizing the shorter of the estimated useful life of the asset or the remaining term of the renewal period.

10. A variety of systematic depreciation and amortization methods is available such as the straight-line method, sum-of-the-years' digits method, and various declining balance methods. The depreciation or amortization method selected shall be that which most appropriately allocates the cost of the depreciable asset or leasehold improvement over its estimated useful life. The use of the sinking fund or constant yield methods of depreciation does not constitute acceptable statutory accounting practice.

11. Useful lives of depreciable assets and leasehold improvements can be obtained from contractors, appraisers, engineers, and manufacturers, or they may be based on prior experience. Estimates published by the Internal Revenue Service can be helpful in the selection of useful lives for specific assets.

12. Changes in the estimated useful lives of depreciable assets or leasehold improvements from one period to another shall be considered a change in accounting estimate and shall be accounted for in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors* (SSAP No. 3).

13. Changes in depreciation or amortization methods from one period to another shall be considered a change in accounting principle and shall be accounted for in accordance with SSAP No. 3.

14. Depreciation and amortization expense shall be recorded in the statement of income in accordance with *SSAP No. 70—Allocation of Expenses*.

Disclosures

15. The following disclosures shall be made in the financial statements:

a. Depreciation and amortization expense for the period;

b. A general description of the method or methods used in computing depreciation and amortization with respect to major classes of depreciable assets and leasehold improvements.

16. The financial statements shall disclose if the written capitalization policy and the resultant predefined thresholds changed from the prior period and the reason(s) for such change.

17. Refer to the preamble for further discussion regarding disclosure requirements. The disclosures in paragraph 15 shall be included in the annual audited statutory financial reports only.

Relevant Literature

18. This statement adopts paragraphs 4 and 5 of *Accounting Principles Board Opinion No. 12, Omnibus* Opinion*—1967*. This statement also adopts *AICPA Practice Bulletin No. 1, Purpose and Scope of AcSEC Practice Bulletins and Procedures for Their Issuance, Exhibit A*.

19. This statement rejects *Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins, "*Chapters 9A and 9C;" however, it is considered appropriate to use the concepts of depreciating assets discussed in the GAAP guidance, which requires that the acquisition cost less salvage value be recorded as an expense over the estimated useful life of the asset, as the basis for the statutory guidance in this statement. *FASB Emerging Issues Task Force No. 08-3: Accounting by Lessees for Maintenance Deposits* is adopted with modification to require reimbursable deposits to be reflected as nonadmitted assets.

Effective Date and Transition

20. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with SSAP No. 3. Guidance reflected in paragraphs 3, 6 and 16, incorporated from SSAP No. 87, was originally effective for years beginning on and after January 1, 2004. Guidance in paragraph 7 related to maintenance costs paid by lessee was previously included within *INT 09-05: FASB Emerging Issues Task Force No. 08-3: Accounting by Lessees for Maintenance Deposits* and was effective for periods beginning September 21, 2009.

21. The use of the sinking fund or constant yield method does not constitute acceptable statutory accounting practice and these methods shall not be applied to new properties acquired since December 3, 1990 (the date the Emerging Accounting Issues (E) Working Group reached its conclusion regarding this method) nor if the reporting entity changes its existing properties' method of depreciation. This conclusion would not impact those properties currently being depreciated using the constant yield method.

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 19—Furniture, Fixtures, and Equipment*
- *Issue Paper No. 31—Leasehold Improvements Paid by the Reporting Entity as Lessee*
- *Issue Paper No. 67—Depreciation of Property and Amortization of Leasehold Improvements*
- *Issue Paper No. 119—Capitalization Policy, An Amendment to SSAP Nos. 4, 19, 29, 73, 79 and 82*

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Statement of Statutory Accounting Principles No. 20

Nonadmitted Assets

STATUS

Type of Issue:	Common Area
Issued:	Initial Draft
Effective Date:	January 1, 2001
Affects:	Nullifies and incorporates INT 09-03
Affected by:	No other pronouncements
Interpreted by:	No other pronouncements

STATUS **1**

SCOPE OF STATEMENT **3**

SUMMARY CONCLUSION **3**

Relevant Literature 4
Effective Date and Transition 5

REFERENCES **5**

Relevant Issue Papers 5

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Nonadmitted Assets

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for nonadmitted assets which are not specifically addressed in other statements.

SUMMARY CONCLUSION

2. The definition and accounting treatment for nonadmitted assets is outlined in *SSAP No. 4—Assets and Nonadmitted Assets* (SSAP No. 4) as follows:

> 3. As stated in the Statement of Concepts, "The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which are unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet," and are, therefore, considered nonadmitted.

SSAP No. 4 defines nonadmitted assets as follows:

> A nonadmitted asset shall be defined as an asset meeting the criteria in paragraph 2, which is accorded limited or no value in statutory reporting, and is one which is:
>
> a. Specifically identified within the *Accounting Practices and Procedures Manual* as a nonadmitted asset; or
>
> b. Not specifically identified as an admitted asset within the *Accounting Practices and Procedures Manual*.
>
> If an asset meets one of these criteria, the asset shall be reported as a nonadmitted asset and charged against surplus unless otherwise specifically addressed within the *Accounting Practices and Procedures Manual*. The asset shall be depreciated or amortized against net income as the estimated economic benefit expires. In accordance with the reporting entity's written capitalization policy, amounts less than a predefined threshold of furniture, fixtures, equipment, or supplies, shall be expensed when purchased.

3. This statement shall not be considered an all-inclusive list of nonadmitted assets. Certain admitted assets and nonadmitted assets are addressed in other SSAPs.

4. Consistent with paragraph 2, the following assets shall be nonadmitted:

a. Deposits in Suspended Depositories—Amounts on deposit with suspended depositories may not be fully recoverable. Any amounts not reasonably expected to be recovered shall be written off in accordance with *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets* (SSAP No. 5R). Amounts in excess of that written off shall be nonadmitted as they are not available to satisfy obligations to policyholders;

b. Bills Receivable Not for Premium and Loans Unsecured or Secured by Assets That Do Not Qualify As Investments—In accordance with SSAP No. 5R, amounts determined to be uncollectible or otherwise impaired shall be written off. Amounts in excess of that written off are not considered to be properly collateralized as there are no underlying assets which would otherwise be admitted assets. Such amounts shall be nonadmitted as they may be of questionable economic value if needed to fulfill policyholder obligations. Receivables arising from working capital finance programs designated by the Securities Valuation Office are subject to the guidance in SSAP No. 105;

c. Loans on Personal Security, Cash Advances To, Or In The Hands Of, Officers Or Agents And Travel Advances—In accordance with SSAP No. 5R, amounts determined to be uncollectible or otherwise impaired shall be written off. Amounts in excess of that written off typically are unsecured and as such have no underlying assets which would otherwise be admitted assets. Such amounts shall be nonadmitted as they may be of questionable economic value if needed to fulfill policyholder obligations. Some of these items may also be considered prepaid expenses which, per *SSAP No. 29—Prepaid Expenses*, are nonadmitted;

d. All "Non-Bankable" Checks—Examples of "non-bankable" checks are NSF (non-sufficient funds) checks, post-dated checks, or checks for which payment has been stopped. Although these checks may still maintain probable future benefits (and thus meet the definition of assets), at the date on which they are non-bankable they are not available for policyholder obligations and shall be nonadmitted until the uncertainty related to the probable future benefit is resolved and the checks are converted to available funds;

e. Trade Names And Other Intangible Assets[1]—These assets, by their nature, are not readily marketable and available to satisfy policyholder obligations and shall be nonadmitted;

f. Automobiles, Airplanes and Other Vehicles—Automobiles, airplanes and other vehicles meet the definition of assets established in SSAP No. 4. However, they are not readily available to satisfy policyholder obligations and as a result the undepreciated portion shall be nonadmitted. The accounting for these assets shall be consistent with the accounting for equipment provided in *SSAP No. 19—Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements* or for commercial airplane leveraged leases, refer to the guidance in SSAP No. 22;

g. Company's Stock as Collateral for Loan—When a reporting entity lends money and accepts its own stock as collateral for the loan, it shall report the amount of the loan receivable and any related accrued interest on the loan as a nonadmitted asset. The asset is nonadmitted as the collateral could not be used to satisfy the obligation in the event of default.

Relevant Literature

5. This statement adopts with modification *FASB Emerging Issues Task Force No. 08-7: Accounting for Defensive Intangible Assets* to nonadmit defensible intangible assets. This statement rejects Chapters 3A and 11 of *Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins*.

[1] Defensible intangible assets are defined as an intangible asset acquired in a business combination or an asset acquisition that an entity does not intend to actively use but does intend to prevent others from using. These may also be referred to as a "locked-up asset" because while the asset is not being actively used, it is likely contributing to an increase in the value of other assets owned by the entity. These assets are not readily available to satisfy policyholder obligations and shall be nonadmitted.

Effective Date and Transition

6. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*. The guidance reflected in footnote 1, incorporated from *INT 09-03: EITF 08-7: Accounting for Defensive Intangible Assets*, was effective June 13, 2009. With the adoption of *SSAP No. 105—Working Capital Finance Investments*, revisions were incorporated into paragraph 4.b. These revisions from SSAP No. 105 are retained for historical purposes within *Issue Paper No. 147—Working Capital Finance Investments*.

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 90—Nonadmitted Assets*
- *Issue Paper No. 147—Working Capital Finance Investments*

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Statement of Statutory Accounting Principles No. 21

Other Admitted Assets

STATUS

Type of Issue:	Common Area
Issued:	Initial Draft
Effective Date:	January 1, 2001
Affects:	No other pronouncements
Affected by:	No other pronouncements
Interpreted by:	No other pronouncements

STATUS 1

SCOPE OF STATEMENT 3

SUMMARY CONCLUSION 3

Collateral Loans 3
Cash Value of Structured Settlements 4
The Amount That Could Be Realized on Life Insurance Where the Reporting Entity is Owner and Beneficiary or Has Otherwise Obtained Rights to Control the Policy 4
Receivables for Securities 4
Other Amounts Receivable Under Reinsurance Contracts 5
Guaranteed Investment Contracts 5
State Guaranty Association Loan Agreements 5
Relevant Literature 6
Effective Date and Transition 6

REFERENCES 6

Relevant Issue Papers 6

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Other Admitted Assets

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for admitted assets which are not specifically addressed in other statements.

SUMMARY CONCLUSION

2. The definition and accounting treatment for admitted assets is outlined in paragraphs 2 and 3 of *SSAP No. 4—Assets and Nonadmitted Assets* (SSAP No. 4) as follows:

> 2. For purposes of statutory accounting, an asset shall be defined as: probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. An asset has three essential characteristics: (a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (b) a particular entity can obtain the benefit and control others' access to it, and (c) the transaction or other event giving rise to the entity's right to or control of the benefit has already occurred. These assets shall then be evaluated to determine whether they are admitted. The criteria used is outlined in paragraph 3.
>
> 3. As stated in the Statement of Concepts, "The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which are unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet," and are, therefore, considered nonadmitted. For purposes of statutory accounting principles, a nonadmitted asset shall be defined as an asset meeting the criteria in paragraph 2, which is accorded limited or no value in statutory reporting, and is one which is:
>
> a. Specifically identified within the *Accounting Practices and Procedures Manual* as a nonadmitted asset; or
>
> b. Not specifically identified as an admitted asset within the *Accounting Practices and Procedures Manual*.
>
> If an asset meets one of these criteria, the asset shall be reported as a nonadmitted asset and charged against surplus unless otherwise specifically addressed within the *Accounting Practices and Procedures Manual*. The asset shall be depreciated or amortized against net income as the estimated economic benefit expires. In accordance with the reporting entity's written capitalization policy, amounts less than a predefined threshold of furniture, fixtures, equipment, or supplies, shall be expensed when purchased.

3. Consistent with paragraph 2, the following assets shall be considered admitted and shall be reported in accordance with SSAP No. 4. These admitted assets are not addressed in other statements.

Collateral Loans

4. Collateral loans are unconditional obligations for the payment of money secured by the pledge of an investment[1] and meet the definition of assets as defined in SSAP No. 4, and are admitted assets to the extent they conform to the requirements of this statement. The outstanding principal balance on the loan and any related accrued interest shall be recorded as an admitted asset subject to the following limitations:

[1] Investment defined as those assets listed in Section 3 of Appendix A-001: *Investments of Reporting Entities*.

a. Loan Impairment—Determination as to the impairment of a collateral loan shall be based on current information and events. When it is considered probable that any portion of amounts due under the contractual terms of the loan will not be collected the loan is considered impaired. The impairment shall be measured based on the fair value of the collateral less estimated costs to obtain and sell the collateral. The difference between the net value of the collateral and the recorded asset shall be written off in accordance with *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets* (SSAP No. 5R);

b. Nonadmitted Asset—In accordance with *SSAP No. 20—Nonadmitted Assets*, collateral loans secured by assets that do not qualify as investments shall be nonadmitted. Further, any amount of the loan outstanding which is in excess of the permitted relationship of fair value of the pledged investment to the collateral loan shall be treated as a nonadmitted asset.

Cash Value of Structured Settlements

5. The reporting of the present value of structured settlement annuities where the reporting entity is the owner and payee as described in SSAP No. 65, paragraph 17.a. shall account for the annuity an admitted asset at its net present realizable value. The annuity described is reported as an other-than-invested asset. Income from the annuities shall be recorded as miscellaneous income. The present value of the annuity and the related amortization schedule shall be obtained from the issuing life insurance company at the time the annuity is purchased. When the reporting entity is the owner and payee, no reduction shall be made to loss reserves.

The Amount That Could Be Realized on Life Insurance Where the Reporting Entity is Owner and Beneficiary or Has Otherwise Obtained Rights to Control the Policy

6. The amount that could be realized on life insurance policies where the reporting entity is the owner and beneficiary, or has otherwise obtained the rights to control the policy, is similar to a cash deposit that is realizable on demand. As such, the amount that could be realized on a life insurance policy as of the date to which premiums have been paid shall be reported as an admitted asset. In determining the amount that could be realized, reporting entities shall consider the cash surrender value as well as other contractual terms which limit or provide for additional realizable amounts. Amounts recoverable by the reporting entity at the discretion of the issuing company shall not be included. Amounts realizable beyond one year from the surrender date shall be discounted. For group policies or a group of individual life policies, reporting entities shall assume surrender on a policy by policy or certificate by certificate basis, unless contractual terms only allow for surrender of all policies or certificates as a group, in which case the amount that could be realized shall be determined on a group basis.

Receivables for Securities

7. Sales of securities are recorded as of the trade date. A receivable due from the broker is established in instances when a security has been sold, but the proceeds from the sale have not yet been received. Unless the receivable for securities, other than a receivable arising from the sale of a security which was acquired on a "To Be Announced" ("TBA") basis, or from the sale of securities that are received as stock distributions that may be restricted (unregistered) or in physical form, and which has yet to be actually received (see paragraph 10), meets the criteria set forth in paragraph 9, the receivable for securities is an admitted asset to the extent it conforms to the requirements of this statement.

8. An evaluation shall be made in accordance with SSAP No. 5R, to determine if there is impairment. If, in accordance with SSAP No. 5R, it is probable the balance or any portion thereof is uncollectible, any such deemed uncollectible receivable shall be written off and charged against income in the period the determination is made. If it is reasonably possible, but not probable, the balance or any

portion thereof is uncollectible and is therefore not written off, the disclosure requirements outlined in SSAP No. 5R shall be followed.

9. Receivables for securities not received within 15 days from the settlement date shall be nonadmitted and shall be classified as "other-than-invested assets."

10. Receivables arising from the secondary sale of securities acquired on a TBA basis, or from stock distributions that may be restricted (unregistered) or in physical form, which have not yet been received by the seller in the secondary sale transaction, may be admitted until the security is exchanged for payment. TBA securities are originally purchased well in advance of the actual date of security issuance (frequently 90 days or more). Accordingly, secondary sales of securities so acquired may occur before the date of issuance. Sales of securities so acquired always include a provision that requires simultaneous delivery of the security and receipt of consideration. Upon the secondary sale, and prior to the actual receipt, of a security acquired on a TBA basis, the seller in the secondary sale transaction records a liability for the book value of the security thus sold and a receivable for the consideration reflected in the secondary sale transaction. Profits or losses emanating from the secondary sale transaction are recorded in the same manner as profits and losses emanating from any other sale transaction involving an investment.

Other Amounts Receivable Under Reinsurance Contracts

11. Amounts receivable from Servicemen's Group Life Insurance (SGLI) or Federal Employees' Group Life Insurance (FEGLI) pools and Federal Crop Insurance programs shall be reported as admitted assets.

Guaranteed Investment Contracts

12. Guaranteed Investment Contracts (GICs) purchased for investment purposes meet the definition of assets as defined in SSAP No. 4, and are admitted assets to the extent they conform to the requirements of this statement.

13. Purchases for which all contractual rights and ownership of the GIC result in an investment similar to a corporate bond shall be accounted for in accordance with the guidance in *SSAP No. 26—Bonds, Excluding Loan-Backed and Structured Securities*.

14. An investment in a GIC payment stream is created when an intermediary purchases individual GICs, pools them, and sells the rights to the payment stream. These investments shall be reported as other long-term invested assets and shall be carried at amortized cost.

15. If, in accordance with SSAP No. 5R, it is probable that the carrying value of a GIC is not fully recoverable the investment shall be considered impaired. Accordingly, the cost basis of the investment shall be written down to the undiscounted estimated cash flows and the amount of the write down shall be accounted for as a capital loss. The new cost basis shall not be changed for subsequent recoveries in fair value.

State Guaranty Association Loan Agreements

16. State guaranty associations have the statutory authority to reinsure any or all of the policies of an impaired or insolvent insurer and borrow funds. When this is done in the case of reinsurance, the assuming carrier receives assets supporting the liabilities from the insolvent company's estate and/or the responsible state guaranty association. If available, the state guaranty association transfers cash at the closing of the transaction. Loan agreements may be utilized in the event a guaranty association does not have the funds on hand or is unable to raise the funds by the closing date. In the case of adverse cash flow situations, guaranty associations may enter into loan agreements with insurers to provide funds that will

allow the association to perform its duties as required by statute. These loan agreements are essentially credit risk free because the notes are backed by all member insurers of an association.

17. Loan agreements issued by state guaranty associations taken by an insurance company in connection with funding an assumption reinsurance agreement or as interim financing meet the definition of assets as defined in SSAP No. 4, are admitted assets to the extent they conform to the requirements of this statement, and shall be reported as a note receivable—other-than-invested assets.

Relevant Literature

18. This statement is consistent with *FASB Statement No. 114, Accounting by Creditors for the Impairment of a Loan* which was adopted with modification in *SSAP No. 37—Mortgage Loans*. This statement is consistent with *Accounting Principles Board Opinion No. 21, Interest on Receivables and Payables* which was adopted in *SSAP No. 15—Debt and Holding Company Obligations.*

19. This statement adopts *FASB Emerging Issues Task Force No. 88-5, Recognition of Insurance Death Benefits* and *FASB Technical Bulletin 85-4, Accounting for Purchases of Life Insurance* with the modification that the entity must be the owner and the beneficiary. This statement also adopts with modification *FASB Emerging Issues Task Force No. 06-05, Accounting for Purchases of Life Insurance – Determining the Amount That Could be Realized in Accordance with FASB Technical Bulletin No. 85-4*. Guidance has been included within this SSAP to clarify how to determine the amount that could be realized on life insurance in situations where the reporting entity is the owner and beneficiary or has otherwise obtained rights to control the policy.

Effective Date and Transition

20. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors.*

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 87—Other Admitted Assets*

Statement of Statutory Accounting Principles No. 22

Leases

STATUS

Type of Issue:	Common Area
Issued:	Initial Draft
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Affects:	Nullifies and incorporates INT 00-02, INT 00-27, INT 02-15, INT 04-20, INT 09-05 Nullifies INT 04-18
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STATUS **1**

SCOPE OF STATEMENT **3**

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Leases

SCOPE OF STATEMENT

1. The purpose of this statement is to establish statutory accounting principles for leases by lessors and lessees. It addresses:

   a. Accounting and reporting by lessees;

   b. Accounting and reporting by lessors;

   c. Sale-leaseback transactions;

   d. Leveraged leases for lessors;

   e. Related party leases; and

   f. Disclosures.

SUMMARY CONCLUSION

2. A lease is defined as an agreement conveying the right to use property, plant, or equipment (land and/or depreciable assets) usually for a stated period of time. This definition does not include agreements that are contracts for services that do not transfer the right to use property, plant, or equipment from one contracting party to the other (i.e., employee lease contracts) or service concession arrangements[1]. On the other hand, agreements that do transfer the right to use property, plant, or equipment meet the definition of a lease even though substantial services by the contractor (lessor) may be called for in connection with the operation or maintenance of the assets.

3. Integral equipment subject to a lease shall be evaluated as real estate per *SSAP No. 40R—Real Estate Investments.* Integral equipment or property improvements for which no statutory title registration system exists, the criterion in this SSAP (that the lease transfers ownership of the property to the lessee by the end of the lease term) is met in lease agreements that provide that, upon the lessee's performance in accordance with the terms of the lease, the lessor shall execute and deliver to the lessee such documents (including, if applicable, a bill of sale for the equipment) as may be required to release the equipment from the lease and to transfer ownership thereto to the lessee. This criterion is also met in situations in which the lease agreement requires the payment by the lessee of a nominal amount (for example, the minimum fee required by statutory regulation to transfer ownership) in connection with the transfer of ownership. Notwithstanding the foregoing guidance, a provision in a lease agreement that ownership of the leased property is not transferred to the lessee if the lessee elects not to pay the specified fee (whether nominal or otherwise) to complete the transfer of ownership is a purchase option. Such a provision would not satisfy this SSAP.

Determining Whether an Arrangement Contains a Lease

4. Determining whether an arrangement contains a lease that is within the scope of this SSAP should be based on the substance of the arrangement. Separate contracts with the same entity or related

[1] A service concession arrangement is an arrangement between a public sector entity grantor and an operating entity under which the operating entity operates the grantor's infrastructure (for example, airports, roads, bridges, tunnels, prisons and hospitals) for a specified period of time. A public-sector entity includes a governmental body or an entity to which the responsibility to provide public service has been delegated. In a service concession arrangement, both of the following conditions exist:

   a. The grantor controls or has the ability to modify or approve the services that the operating entity must provide with the infrastructure, to whom it must provide them, and at what price.

   b. The grantor controls, through ownership, beneficial entitlement, or otherwise, any residual interest in the infrastructure at the end of the term of the arrangement.

parties that are entered into at or near the same time are presumed to have been negotiated as a package and should, therefore, be evaluated as a single arrangement in considering whether there are one or more units of accounting. That presumption may be overcome if there is sufficient evidence to the contrary.

Property, Plant or Equipment

5. Property, plant or equipment, as used in this SSAP, includes only land and/or depreciable assets. Therefore, inventory (including equipment parts inventory) and minerals, precious metals or other natural resources cannot be the subject of a lease for accounting purposes because those assets are not depreciable. Additionally, intangibles (for example, motion picture film licensing rights or workforce) and rights to explore for minerals, precious metals or other natural resources are not depreciable assets (they are amortized or depleted) so they may not be the subject of a lease.

6. Although specific property, plant or equipment may be explicitly identified in an arrangement, it is not the subject of a lease if fulfillment of the arrangement is not dependent on the use of the specified property, plant or equipment. A warranty obligation that permits or requires the substitution of the same or similar property, plant or equipment when the specified property, plant, or equipment is not operating properly does not preclude lease treatment. In addition, a contractual provision (contingent or otherwise) permitting or requiring the owner/seller to substitute other property, plant or equipment for any reason on or after a specified date does not preclude lease treatment prior to the date of substitution.

7. Property, plant or equipment has been implicitly specified if, for example, the seller owns or leases only one asset with which to fulfill the obligation and it is not economically feasible or practicable for the owner/seller to perform its obligation through the use of alternative property, plant or equipment.

Right to Use Property, Plant or Equipment

8. An arrangement conveys the right to use property, plant or equipment if the arrangement conveys to the purchaser (lessee) the right to control the use of the underlying property, plant or equipment. The right to control the use of the underlying property, plant or equipment is conveyed if any one of the following conditions is met:

a. The purchaser has the ability or right to operate the property, plant or equipment or direct others to operate the property, plant or equipment in a manner it determines while obtaining or controlling more than a minor amount of the output or other utility of the property, plant or equipment,

b. The purchaser has the ability or right to control physical access to the underlying property, plant or equipment while obtaining or controlling more than a minor amount of the output or other utility of the property, plant or equipment, or

c. Facts and circumstances indicate that it is remote that one or more parties other than the purchaser will take more than a minor amount of the output or other utility that will be produced or generated by the property, plant or equipment during the term of the arrangement, and the price that the purchaser (lessee) will pay for the output is neither contractually fixed per unit of output nor equal to the current market price per unit of output as of the time of delivery of the output.

Reassessment of the Arrangement

9. The assessment of whether an arrangement contains a lease should be made at inception of the arrangement based on all of the facts and circumstances. A reassessment of whether the arrangement contains a lease after the inception of the arrangement shall be made only if (a) there is a change in the contractual terms, (b) a renewal option is exercised or an extension is agreed to by the parties to the

arrangement, (c) there is a change in the determination as to whether or not fulfillment is dependent on specified property, plant, or equipment, or (d) there is a substantial physical change to the specified property, plant, or equipment. A reassessment of an arrangement should be based on the facts and circumstances as of the date of reassessment, including the remaining term of the arrangement. Changes in estimate (for example, the estimated amount of output to be delivered to the purchaser or other potential purchasers) would not trigger a reassessment. Facts and circumstances that may affect whether to perform a reassessment may include any of the following:

a. Change in contractual terms. The arrangement should be reassessed under this guidance if the contractual arrangement among the parties involved changes, unless the change only renews or extends the arrangement.

b. Renewal or extension. A renewal or extension of the arrangement that does not include modification of any of the terms in the original arrangement prior to the end of the term of the original arrangement should be evaluated under the guidance only with respect to the renewal or extension period. The accounting for the remaining term of the original arrangement should continue without modification. The exercise of a renewal option that was included in the lease term at the inception of the arrangement would not be considered a renewal for the purpose of reevaluating the arrangement.

c. Dependency upon specific property, plant, or equipment. A change in the determination as to whether or not fulfillment is dependent on specified property, plant, or equipment requires a reassessment of the arrangement under this guidance to determine whether the arrangement contains a lease on a prospective basis.

d. Physical change to specific property, plant, or equipment. A substantial physical change to the specified property, plant, or equipment requires a reassessment of the arrangement under the guidance to determine whether the arrangement contains a lease on a prospective basis. For purposes of determining if a physical change to the specified property, plant, or equipment gives rise to a reassessment, increases or decreases in productive capacity that result from adding or subtracting a physically distinct unit of property, plant, or equipment should be ignored if fulfillment of the arrangement is dependent upon a distinct unit of property, plant, or equipment that remains unchanged.

10. When an arrangement (or a portion of an arrangement) ceases to be a lease or becomes a lease due to a modification to the arrangement or other change discussed above, the following guidance shall be applied to account for the revised categorization of the arrangement:

a. Supply arrangement to operating lease for the Purchaser/Lessee. Any recognized asset (such as a prepaid asset or a derivative) for the purchase contract is considered part of the minimum lease payments and is initially recognized as prepaid rent. Any recognized liability (such as a payable or a derivative) for the purchase contract is considered a reduction of the minimum lease payments and is initially recognized as a lease payable.

b. Supply arrangement to operating lease for the Seller/Lessor. Any recognized liability (such as a deferred revenue or derivative) for the sales contract is considered part of the minimum lease payments and is initially recognized as deferred rent. Any recognized asset (such as a receivable or derivative) for the sales contract is considered a reduction of the minimum lease payments and is initially recognized as a lease receivable provided the asset is recoverable from future receipts.

c. Operating lease to supply arrangement for the Purchaser/Lessee. Any recognized prepaid rent or rent payable is initially recognized as an asset or liability associated with the purchase contract.

d. Operating lease to supply arrangement for the Seller/Lessor. Any recognized deferred rent or rent receivable is initially recognized as a liability or an asset associated with the sales contract, subject to a recoverability test.

Multiple Element Arrangements That Contain a Lease

11. If an arrangement contains a lease and related executory costs, as well as other non-lease elements, the classification, recognition, measurement and disclosure requirements of this SSAP shall be applied by both the purchaser and the supplier to the lease element of the arrangement. Other elements of the arrangement not within the scope of this SSAP shall be accounted for in accordance with other applicable generally accepted accounting principles. For purposes of applying this SSAP, payments and other consideration called for by the arrangement shall be separated at the inception of the arrangement or upon a reassessment of the arrangement into (a) those for the lease, including the related executory costs and profits thereon, and (b) those for other services on a relative fair value basis.

Accounting and Reporting by Lessees

12. All leases shall be considered operating leases. Rent on an operating lease shall be charged to expense over the lease term as it becomes payable, except as provided in paragraphs 13 and 14.

13. As discussed in *FASB Technical Bulletin 85-3, Accounting for Operating Leases with Scheduled Rent Increases,* the effects of scheduled rent increases normally shall be recognized on a straight-line basis over the lease term.

14. Lease agreements may also include incentives for the lessee to sign the lease, such as an up-front cash payment to the lessee, payment of costs for the lessee (such as moving expenses), or the assumption by the lessor of the lessee's preexisting lease. As discussed in *FASB Technical Bulletin 88-1, Issues Relating to Accounting for Leases: Time Pattern of the Physical Use of the Property in an Operating Lease; Lease Incentives in an Operating Lease; Applicability of Leveraged Lease Accounting to Existing Assets of the Lessor; Money-Over-Money Lease Transactions; Wrap Lease Transactions,* incentives paid to or payments made on behalf of the lessee shall be considered reductions of minimum lease payments (i.e., the payments that the lessee is obligated to make or can be required to make in connection with the leased properties.) These incentives shall be recognized over the lease term on a straight-line basis unless the use of another systematic and rational allocation basis is more representative of the time pattern in which the leased property is physically employed. The lessee's immediate recognition of expenses or losses (e.g., moving costs, losses on subleases, write-offs of leasehold improvements) shall not be changed by this guidance.

15. For the early termination or non-use of leased property benefits, the lessee shall recognize liabilities, initially measured at fair value, as follows:

a. Liabilities for costs to terminate a contract before the end of its term shall be recognized when the entity terminates the contract in accordance with the contract terms (i.e., gives written notice of termination or negotiated termination with the lessor).

b. Liabilities for costs that will continue to be incurred under a contract for its remaining term without economic benefit shall be recognized as the cease-date (the date the entity ceases using the right conveyed by the contract – i.e., the right to use a leased property). The fair value of the liability at the cease-use date shall be determined based on the remaining lease rentals, adjusted for the effects of any prepaid or deferred items recognized under the lease, and reduced by estimated sublease rentals that could be reasonably obtained for the property, even if the entity does not intend to enter into a sublease. Remaining lease rentals shall not be reduced to an amount less than zero.

Maintenance Costs Incurred by Lessee

16. Maintenance costs incurred by the lessee for maintenance on the leased item that do not increase the value and enhance the usefulness of the leased asset shall be expensed when incurred pursuant to *SSAP No. 19—Furniture, Fixtures, and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements* (SSAP No. 19). Reimbursable deposits shall be reflected as nonadmitted assets. Deposits paid to the lessor, reimbursable when the lessee incurs costs for lease maintenance activities, shall be recorded as nonadmitted assets. When the amount on deposit is less than probable of being returned, the deposit shall be recognized as an additional lease expense.

Accounting for Contingent Rent for Lessees

17. A lessee should recognize contingent rental expense (in annual periods as well as in interim periods) prior to the achievement of the specified target that triggers the contingent rental expense, provided that achievement of that target is considered probable. Previously recorded rental expense should be reversed into income at such time that it is probable that the specified target will not be met.

Accounting and Reporting by Lessors

18. All leases, except leveraged leases as defined in paragraph 34, shall be considered operating leases and accounted for by the lessor as follows:

a. The leased property shall be included in the same balance sheet category it would be had the property not been leased. The property shall be depreciated following the lessor's normal depreciation policies for such assets;

b. Rental income shall be reported as investment income as it becomes receivable according to the provisions of the lease. However, as discussed in paragraphs 13 and 14 of this statement, rentals may be recognized before they become due, if rentals vary from the straight-line basis. The guidance in *SSAP No. 34—Investment Income Due and Accrued* shall be applied to the receivable balance; and

c. Initial direct costs shall be charged to expense when incurred and shall not be deferred and allocated over the lease term. Initial direct costs are those incremental costs that the lessor has incurred in directly evaluating, negotiating, administering, and closing a lease transaction.

19. The sale of property subject to an operating lease, or of property that is leased by or intended to be leased by the third-party purchaser to another party, shall not be treated as a sale if the seller or any party related to the seller (related party is defined in *SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties* (SSAP No. 25)) retains substantial risks of ownership in the leased property.

Accounting for Contingent Rent for Lessors

20. Contingent rental income shall be recognized as revenue when the changes in the factor(s) on which the contingent lease payments is (are) based actually occur.

Sale-Leaseback Transactions

21. Sale-leaseback transactions involve the sale of property by the owner and a lease of the property back to the seller. Sale-leaseback accounting is a method of accounting in which the seller-lessee records the sale, removes all property and related liabilities from its balance sheet.

22. A sale of property that is accompanied by a leaseback of all or any part of the property for all or part of its remaining economic life shall be accounted for by the buyer-lessor and seller-lessee as a purchase and operating lease and a sale and an operating lease, respectively, unless the sale-leaseback includes sale of nonadmitted assets to a related party.

23. When applying sale-leaseback accounting, the sale and gains and losses thereon, shall be recognized in accordance with paragraphs 2 and 3 of *FASB Statement No. 28, Accounting for Sales with Leasebacks* (refer to Appendix A, paragraphs 46-49), except for sale-leaseback transactions involving real estate that are settled entirely in cash.

24. A sale of real estate, settled entirely in cash, that is accompanied by a leaseback of all or any part of the property for all or part of its remaining economic life shall be accounted for by the buyer-lessor and seller-lessee as a purchase and operating lease and a sale and an operating lease, respectively. The sale and gain or loss shall be recognized directly to special surplus funds and subsequently amortized to unassigned funds (surplus) over the lease term.

25. If the transaction involves a sale of nonadmitted assets to a related party, the transaction shall be accounted for by the deposit method (refer to Appendix A, paragraphs 42 and 43).

26. Paragraphs 26-33 present the additional standards of statutory accounting by a seller-lessee for sale-leaseback transactions regarding the lease term and sale-leaseback transactions involving real estate, including real estate with equipment, such as office buildings with furniture and fixtures. A sale-leaseback transaction involving real estate with equipment includes any sale-leaseback transaction in which the equipment and the real estate are sold and leased back as a package, irrespective of the relative value of the equipment and the real estate. Those paragraphs also address sale-leaseback transactions in which the seller-lessee sells property improvements or integral equipment[2] to a buyer-lessor and leases them back while retaining the underlying land.[3]

27. Sale-leaseback accounting shall be used by a seller-lessee only if a sale-leaseback transaction includes all of the following:

a. A normal leaseback as described in paragraph 28.

b. Payment terms and provisions that adequately demonstrate the buyer-lessor's initial and continuing investment in the property (refer to Appendix A, paragraphs 50-58).

[2] The terms *property improvements* or *integral equipment* as used in paragraphs 26-33 of this section refer to any physical structure or equipment attached to the real estate, or other parts thereof, that cannot be removed and used separately without incurring significant cost.

[3] Paragraphs 38 and 39 of FAS 66 address transactions in which the seller sells property improvements to a buyer and leases the underlying land to the buyer of the improvements. Under certain circumstances, paragraph 38 of FAS 66 precludes sales recognition for such transactions and requires that they be accounted for as leases of both the land and improvements. Paragraphs 26-33 of this section are not intended to modify paragraph 38 of FAS 66; thus, they do not address a sale-leaseback transaction that does not qualify for sales recognition under the provisions of paragraph 38 of FAS 66. However, those paragraphs do address a sale-leaseback transaction that qualifies for sales recognition under the provisions of paragraph 39 of FAS 66.

c. Payment terms and provisions that transfer all of the other risks and rewards of ownership as demonstrated by the absence of any other continuing involvement by the seller-lessee described in paragraphs 31-33 of this section and paragraphs 25-39 and 41-43 of FAS 66.

d. Admitted assets, if the buyer-lessor is a related party, or either admitted or nonadmitted assets if the buyer-lessor is not a related party. For purposes of this paragraph, related parties include those identified in SSAP No. 25 and entities created for the purpose of buying and leasing nonadmitted assets for the reporting entity and/or its affiliates.

28. A normal leaseback is a lessee-lessor relationship that involves the active use of the property by the seller-lessee in consideration for payment of rent, including contingent rentals that are based on the future operations of the seller-lessee,[4] and excludes other continuing involvement provisions or conditions described in paragraphs 31-33 of this section. The phrase active use of the property by the seller-lessee refers to the use of the property during the lease term in the seller-lessee's trade or business, provided that subleasing of the leased back property is minor.[5] If the present value of a reasonable amount of rental for that portion of the leaseback that is subleased is not more than 10 percent of the fair value of the asset sold, the leased back property under sublease is considered minor. Active use of the property may involve the providing of services where the occupancy of the property is generally transient or short-term and is integral to the ancillary services being provided. Those ancillary services include, but are not limited to, housekeeping, inventory control, entertainment, bookkeeping, and food services. Thus, the use of property by a seller-lessee engaged in the hotel or bonded warehouse business or the operation of a golf course or a parking lot, for example, is considered active use.

29. Terms of the sale-leaseback transaction that are substantially different from terms that an independent third-party lessor or lessee would accept represent an exchange of some stated or unstated rights or privileges. Those rights or privileges shall be considered in evaluating the continuing involvement provisions in paragraphs 31-33 of this section. Those terms or conditions include, but are not limited to, the sales price, the interest rate, and other terms of any loan from the seller-lessee to the buyer-lessor. The fair value of the property used in making that evaluation shall be based on objective evidence, for example, an independent third-party appraisal or recent sales of comparable property.

Continuing Involvement

30. A sale-leaseback transaction that does not qualify for sale-leaseback accounting because of any form of continuing involvement by the seller-lessee other than a normal leaseback shall be accounted for by the deposit method or as a financing (refer to Appendix A, paragraphs 42 and 45), whichever is appropriate under FAS 66. If the criteria of paragraph 27.d. is not met, the sale-leaseback shall be accounted for by the deposit method under FAS 66. The provisions or conditions described in paragraphs 31-33 of this section are examples of continuing involvement for the purpose of applying paragraphs 26-33.

31. Paragraphs 25-39 and 41-43 of FAS 66 describe forms of continuing involvement by the seller-lessee with the leased property that result in the seller-lessee not transferring the risks or rewards of

[4] Paragraphs 26-33 distinguish between contingent rentals that are based on the future operations of the seller-lessee and those that are based on some predetermined or determinable level of future operations of the buyer-lessor. The latter type of contingent rental is addressed in paragraph 32.e.

[5] The term *minor* is used here in the context of the underlying the classification criteria of this section. In that context, a test based on a 90 percent recovery test could be used as a guideline; that is, if the present value of a reasonable amount of rental for the leaseback represents 10 percent or less of the fair value of the asset sold, the seller-lessee could be presumed to have transferred to the [buyer-lessor] the right to substantially all of the remaining use of the property sold, and the seller-lessee could be presumed to have retained only a minor portion of such use.

ownership to the buyer-lessor. Two examples of continuing involvement specified in those paragraphs that are frequently found in sale-leaseback transactions are provisions or conditions in which:

a. The seller-lessee has an obligation or an option[6] to repurchase the property or the buyer-lessor can compel the seller-lessee to repurchase the property.

b. The seller-lessee guarantees the buyer-lessor's investment or a return on that investment for a limited or extended period of time.

32. Other provisions or conditions that are guarantees and that do not transfer all of the risks of ownership shall constitute continuing involvement for the purpose of applying paragraphs 26-33 to sale-leaseback transactions and include, but are not limited to, the following:

a. The seller-lessee is required to pay the buyer-lessor at the end of the lease term for a decline in the fair value of the property below the estimated residual value on some basis other than excess wear and tear of the property levied on inspection of the property at the termination of the lease.

b. The seller-lessee provides nonrecourse financing to the buyer-lessor for any portion of the sales proceeds or provides recourse financing in which the only recourse is to the leased asset.

c. The seller-lessee is not relieved of the obligation under any existing debt related to the property.

d. The seller-lessee provides collateral on behalf of the buyer-lessor other than the property directly involved in the sale-leaseback transaction, the seller-lessee or a related party to the seller-lessee guarantees the buyer-lessor's debt, or a related party to the seller-lessee guarantees a return of or on the buyer-lessor's investment.

e. The seller-lessee's rental payment is contingent on some predetermined or determinable level of future operations of the buyer-lessor.[7]

33. The following provisions or conditions also shall be considered examples of continuing involvement for the purpose of applying paragraphs 26-33 to sale-leaseback transactions:

a. The seller-lessee enters into a sale-leaseback transaction involving property improvements or integral equipment[8] without leasing the underlying land to the buyer-lessor. [9]

[6] A right of first refusal based on a bona fide offer by a third party ordinarily is not an obligation or an option to repurchase. An agreement that allows the seller-lessee to repurchase the asset in the event no third-party offer is made is an option to repurchase.

[7] Paragraphs 26-33 distinguish between contingent rentals that are based on the future operations of the seller-lessee and those that are based on some predetermined or determinable level of future operations of the buyer-lessor.

[8] The terms *property improvements* or *integral equipment* as used in paragraphs 26-33 of this section refer to any physical structure or equipment attached to the real estate, or other parts thereof, that cannot be removed and used separately without incurring significant cost.

[9] Paragraphs 38 and 39 of FAS 66 address transactions in which the seller sells property improvements to a buyer and leases the underlying land to the buyer of the improvements. Under certain circumstances, paragraph 38 of FAS 66 precludes sales recognition for such transactions and requires that they be accounted for as leases of both the land and improvements. Paragraphs 26-33 of this section are not intended to modify paragraph 38 of FAS 66; thus, they do not address a sale-leaseback transaction that does not qualify for sales recognition under the provisions of paragraph 38 of FAS 66. However, those paragraphs do address a sale-leaseback transaction that qualifies for sales recognition under the provisions of paragraph 39 of FAS 66.

b. The buyer-lessor is obligated to share with the seller-lessee any portion of the appreciation of the property.

c. Any other provision or circumstance that allows the seller-lessee to participate in any future profits of the buyer-lessor or the appreciation of the leased property, for example, a situation in which the seller-lessee owns or has an option to acquire any interest in the buyer-lessor.

Leveraged Leases for Lessors

34. Generally, leveraged leases are those in which the lessor acquires, through the incurrence of debt (such that the lessor is substantially "leveraged" in the transaction), property, plant or equipment with the intentions to lease the asset(s) to the lessee. Leveraged leases are defined as those leases that meet the criteria set forth in paragraph 42.a.-d. (and the related paragraphs to which 42 refers) of *FASB Statement No. 13, Accounting* for *Leases* (FAS 13). Leases which meet the preceding definition shall be accounted for in accordance with paragraphs 43-47 (and the related paragraphs to which 43-47 refer) of FAS 13. Pursuant to paragraph 46 of FAS 13, as updated by FSP FAS 13, any estimated residual value and all other important assumptions affecting estimated total net income shall be reviewed at least annually. The projected timing of income tax cash flows generated by the lease is an important assumption and shall be reviewed annually, or more frequently, if events or changes in circumstances indicate that a change in timing has occurred or is projected to occur. The lessor shall record its investment net of the nonrecourse debt. In cases where the asset being leased is a nonadmitted asset, any net leveraged lease asset shall be nonadmitted. However, leveraged leases involving commercial airplanes are admitted assets.

Related-Party Leases

35. This statement applies to arms-length transactions. To the extent that leases between related parties are, in substance, arms-length transactions the guidance in this statement shall be applied. The determination of whether related party leases qualify as arms-length transactions is addressed in SSAP No. 25.

Disclosures

36. The following disclosures shall be made in the financial statements of lessees:

a. A general description of the lessee's leasing arrangements including, but not limited to, the following:

i. Rental expense for each period for which an income statement is presented, with separate amounts for minimum rentals, contingent rentals, and sublease rentals. Rental payments under leases with terms of a month or less that were not renewed need not be included;

ii. The basis on which contingent rental payments are determined;

iii. The existence and terms of renewal or purchase options and escalation clauses; and

iv. Restrictions imposed by lease agreements, such as those concerning dividends, additional debt, and further leasing.

v. Identification of lease agreements that have been terminated early or for which the lessee is no longer using the leased property benefits, and the liability recognized in the financial statements under these agreements.

b. For leases having initial or remaining noncancelable lease terms in excess of one year:

i. Future minimum rental payments required as of the date of the latest balance sheet presented, in the aggregate and for each of the five succeeding years; and

ii. The total of minimum rentals to be received in the future under noncancelable subleases as of the date of the latest balance sheet presented.

c. For sale-leaseback transactions:

i. A description of the terms of the sale-leaseback transaction, including future commitments, obligations, provisions, or circumstances that require or result in the seller-lessee's continuing involvement; and

ii. For those accounted for as deposits, (a) the obligation for future minimum lease payments as of the date of the latest balance sheet presented in the aggregate and for each of the five succeeding years and (b) the total of minimum sublease rentals, if any, to be received in the future under noncancelable subleases in the aggregate and for each of the five succeeding years.

37. When leasing is a significant part of the lessor's business activities in terms of revenue, net income, or assets, the following information with respect to leases shall be disclosed in the financial statements:

a. For operating leases:

i. The cost and carrying amount, if different, of property on lease or held for leasing by major classes of property according to nature or function, and the amount of accumulated depreciation in total as of the date of the latest balance sheet presented;

ii. Minimum future rentals on noncancelable leases as of the date of the latest balance sheet presented, in the aggregate and for each of the five succeeding years;

iii. Total contingent rentals included in income for each period for which an income statement is presented; and

iv. A general description of the lessor's leasing arrangements.

b. For leveraged leases:

i. A description of the terms including the pretax income from the leveraged leases. For purposes of presenting the investment in a leveraged lease in the lessor's balance sheet, the amount of related deferred taxes shall be presented separately (from the remainder of the net investment);

ii. Separate presentation (from each other) shall be made of pretax income from the leveraged lease, the tax effect of pretax income, and the amount of investment tax credit recognized as income during the period; and

iii. When leveraged leasing is a significant part of the lessor's business activities in terms of revenue, net income, or assets, the components of the net investment balance in leveraged leases shall be disclosed.

38. Companies shall disclose the effect on the balance sheet and the income statement resulting from a change in lease classification under paragraph 3, for leases that at inception would have been classified differently had the guidance in paragraph 3 been in effect at the inception of the original lease.

39. Refer to the preamble for further discussion regarding disclosure requirements.

Relevant Literature

40. This statement rejects FAS 13*,* as amended and interpreted, except for certain of the guidance on operating leases, sale-leaseback transactions and leveraged leases (i.e., paragraphs 15, 16.(b., c., d.), 19.(a., b.), 23.(b., c.), 36, 37, 39.c. and, 42-47). A complete list of all FASB Statements, Interpretations and Technical Bulletins adopted and rejected in this statement is as follows:

a. Accounting Standards Codification (ASC) 420-10-25 paragraphs 11-13 and ASC 420-10-30 paragraph 8 regarding the recognition of costs to terminate an operating lease before the end of the term and costs that will continue to be incurred under the contract for its remaining term without economic benefit are adopted. Other provisions of ASC 420 are rejected in SSAP No. 24.

b. *ASU 2014-05, Service Concession Arrangements* (Adopted with modification to only exclude service concession arrangements from the lease definition.)

~~b.~~c. *FASB* Statement *No. 13, Accounting for Leases*, [paragraphs 15, 16.(b., c., d.), 19.(a., b.), 23.(b., c.), 36, 37, 39.c., 42-47 adopted; all other paragraphs rejected];

~~c.~~d. *FASB* Statement *No. 22, Changes in the Provisions of Lease Agreements Resulting from Refundings of Tax-Exempt Debt (an amendment of FASB Statement No. 13)* [rejected in its entirety];

~~d.~~e. *FASB* Statement *No. 23, Inception of the Lease (an amendment of FASB Statement No. 13)* [paragraph 10 adopted; all other paragraphs rejected];

~~e.~~f. *FASB Statement No. 27, Classification of Renewals or Extensions of Existing Sales-Type or Direct Financing Leases (an amendment of FASB Statement No. 13)* [rejected in its entirety];

~~f.~~g. *FASB Statement No. 28, Accounting for Sales with Leasebacks (an amendment of FASB Statement No. 13)* [adopted in its entirety, except guidance on capital leases is not applicable other than those leases that qualify as leveraged leases and modifications for sale-leaseback transactions involving real estate settled entirely in cash];

~~g.~~h. *FASB Statement No. 29, Determining Contingent Rentals (an amendment of FASB Statement No. 13)* [paragraphs 8 and 11 adopted; all other paragraphs rejected];

~~h.~~i. *FASB Statement No. 98, Accounting for Leases*:

- *Sale-Leaseback Transactions Involving Real Estate*
- *Sales-Type Leases of Real Estate*
- *Definition of the Lease Term*

- *Initial Direct Costs of Direct Financing Leases*

(an amendment of FASB Statements No. 13, 66 and 91 and a rescission of FASB Statement No. 26 and Technical Bulletin No. 79-11) (paragraphs 1-13, 17-22.a., b., d., and e. adopted, paragraph j. adopted with modification to exclude references to sales-type lease classification criterion, paragraphs 27, 30, 31, adopted with modification to reference applicable statements of statutory accounting principles and reject guidance associated with capital leases; all other paragraphs rejected);

~~i.~~j. *FASB Statement No. 109, Accounting for Income Taxes* [paragraphs 256-258 adopted; all other paragraphs addressed in *SSAP No. 101—Income Taxes, A Replacement of SSAP No. 10R and SSAP No. 10* (SSAP No. 101)];

~~j.~~k. *FASB Statement No. 145, Rescission of FASB Statements No. 4, 44, and 64, Amendment of* FASB *Statement No. 13 and Technical Corrections* [paragraph 9.c.c. adopted; all other paragraphs rejected];

~~k.~~l. *FASB Interpretation No. 19, Lessee Guarantee of the Residual Value of Leased Property (an* interpretation *of FASB Statement No. 13)* [rejected in its entirety];

~~l.~~m. *FASB Interpretation No. 21, Accounting for Leases in a Business Combination (an interpretation of FASB Statement No. 13)* [rejected in its entirety];

~~m.~~n. FASB Interpretation No. 23, Leases of Certain Property Owned by a Governmental Unit or A*uthority (an interpretation of FASB Statement No. 13)* [rejected in its entirety];

~~n.~~o. *FASB Interpretation No. 24, Leases Involving Only Part of a Building (an interpretation of FASB Statement No. 13)* [rejected in its entirety];

~~o.~~p. *FASB Interpretation No. 26, Accounting for Purchase of a Leased Asset by the Lessee during the Term of the Lease (an interpretation of FASB Statement No. 13)* [rejected in its entirety];

~~p.~~q. *FASB Interpretation 27, Accounting for a Loss on a Sublease (an interpretation of FASB* Statement *No. 13 and APB Opinion No. 30)* [adopted in its entirety];

~~q.~~r. *FASB Technical Bulletin 79-10, Fiscal Funding Clauses in Lease Agreements* [rejected in its entirety];

~~r.~~s. *FASB Technical Bulletin 79-12, Interest Rate Used in Calculating the Present Value of Minimum Lease Payments* [rejected in its entirety];

~~s.~~t. *FASB Technical Bulletin 79-13, Applicability of FASB Statement No. 13 to Current Value Financial Statements* [rejected in its entirety];

~~t.~~u. *FASB Technical Bulletin 79-14, Upward Adjustment of Guaranteed Residual Values* [rejected in its entirety];

~~u.~~v. *FASB Technical Bulletin 79-15, Accounting for Loss on a Sublease Not Involving the Disposal of a Segment* [adopted in its entirety];

~~v.~~w. *FASB Technical Bulletin 79-16(R), Effect of a Change in Income Tax Rate on the Accounting for Leveraged Leases* [adopted in its entirety];

~~w.~~x. *FASB Technical Bulletin 79-17, Reporting Cumulative Effect Adjustment from Retroactive Application of FASB Statement No. 13* [rejected in its entirety];

~~x.~~y. FASB *Technical Bulletin 79-18, Transition Requirement of Certain FASB Amendments and Interpretations of FASB Statement No. 13* [rejected in its entirety];

~~y.~~z. *FASB Technical Bulletin 85-3, Accounting for Operating Leases with Scheduled Rent Increases* [adopted in its entirety];

~~z.~~aa. *FASB Technical Bulletin 86-2, Accounting for an Interest in the Residual Value of a Leased Asset*:

- *Acquired by a Third Party or*
- *Retained by a Lessor That Sells the Related Minimum Rental Payments*

[adopted in its entirety];

~~aa.~~bb. *FASB Technical Bulletin 88-1, Issues Related to Accounting for Leases*:

- *Time Pattern of the Physical Use of the Property in an Operating Lease*
- *Lease Incentives in an Operating Lease*
- *Applicability of Leveraged Lease Accounting to Existing Assets of the Lessor*
- *Money-Over-Money Lease Transactions*
- *Wrap Lease Transactions*

[paragraphs 1-12 adopted; all other paragraphs rejected];

~~bb.~~cc. *FASB Staff Position 13-2: Accounting for a Change or Projected Change in the Timing of Cash Flows Relating to Income Taxes Generated by a Leveraged Lease Transaction* [adopted in its entirety];

~~cc.~~dd. *FASB* Emerging *Issues Task Force No. 85-16, Leveraged Leases* [adopted in its entirety];

~~dd.~~ee. *FASB Emerging Issues Task Force No. 86-17, Deferred Profit on Sale-Leaseback* Transaction *with Lessee Guarantee of Residual Value* [rejected in its entirety];

~~ee.~~ff. *FASB Emerging Issues Task Force No. 86-33, Tax Indemnifications in Lease Agreements* [adopted in its entirety];

~~ff.~~gg. *FASB Emerging Issues Task Force No. 86-43, Effect of a Change in Tax Law or Rates on Leveraged Leases* [adopted in its entirety];

~~gg.~~hh. *FASB Emerging Issues Task Force No. 87-7, Sale of an Asset Subject to a Lease and Nonrecourse Financing: "Wrap Lease Transactions"* [rejected in its entirety];

~~hh.~~ii. *FASB Emerging Issues Task Force No. 87-8, Tax Reform Act of 1986:Issues Related to the Alternative Minimum Tax [Issue No. 10 adopted];*

~~ii.~~jj. *FASB Emerging Issues Task Force No. 88-10, Costs Associated with Lease Modification or Termination*, previously adopted in its entirety in SSAP No. 22, has been nullified with the adoption of ASC 420-10-25 paragraphs 11-13 and ASC 420-10-30 paragraph 8;

~~jj.~~kk. *FASB Emerging Issues Task Force No. 88-21, Accounting for the Sale of Property Subject to* the *Seller's Preexisting Lease* [rejected in its entirety];

~~kk.~~ll. *FASB Emerging Issues Task Force No. 89-16, Consideration of Executory Costs in Sale-Leaseback Transactions* [adopted in its entirety];

~~ll.~~mm. *FASB Emerging Issues Task Force No. 90-14, Unsecured Guarantee by Parent of Subsidiary's Lease Payments in a Sale-Leaseback Transaction* [adopted in its entirety];

~~mm.~~nn. *FASB Emerging Issues Task Force No. 90-15, Impact of Nonsubstantive Lessors,* Residual *Value Guarantees, and Other Provisions in Leasing Transactions* [rejected in its entirety];

~~nn.~~oo. *FASB Emerging Issues Task Force No. 90-20, Impact of an Uncollateralized Irrevocable Letter of Credit on a Real Estate Sale-Leaseback Transaction* [adopted in its entirety];

~~oo.~~pp. *FASB Emerging Issues Task Force No. 92-1, Allocation of Residual Value or First-Loss Guarantee to Minimum Lease Payments in Leases Involving Land and Building(s)* [rejected in its entirety];

~~pp.~~qq. *FASB Emerging Issues Task Force No. 93-8, Accounting for the Sale and Leaseback of an* Asset *That Is Leased to Another Party* [adopted in its entirety];

~~qq.~~rr. *FASB Emerging Issues Task Force No. 95-17, Accounting for Modifications to an Operating Lease That Do Not Change the Lease Classification* [adopted in its entirety];

~~rr.~~ss. *FASB Emerging Issues Task Force No. 96-21, Implementation Issues in Accounting for Leasing Transactions involving Special-Purpose Entities* [rejected in its entirety];

~~ss.~~tt. *FASB Emerging Issues Task Force No. 98-9, Accounting for Contingent Rent* (adopted with modification);

~~tt.~~uu. *FASB Emerging Issues Task Force No. 00-11, Lessors' Evaluation of Whether Leases of Certain Integral Equipment Meet the Ownership Transfer Requirements of FASB Statement 13* [adopted with modifications to GAAP references];

~~uu.~~vv. *FASB Emerging Issues Task Force No. 08-3: Accounting by Lessees for Maintenance Deposits* (adopted with modification) to require reimbursable deposits to be reflected as nonadmitted assets.

Effective Date and Transition

41. This statement is effective for years beginning January 1, 2001. The provisions of this statement shall be applied to all new leases entered into, or for existing leases which are renewed, on or after January 1, 2001. The guidance in paragraph 3 was originally contained within *INT 02-15: EITF 00-11: Lessors' Evaluation of Whether Leases of Certain Integral Equipment Meet the Ownership Transfer Requirements of FASB Statement 13* and should be applied to (a) leases for which lease inception occurs after January 1, 2003, and (b) leases modified after January 1, 2003, that meet the criteria in paragraph 9 of FAS 13 to be considered as new agreements. The guidance in paragraphs 4-11 was originally contained within *INT 04-20: EITF 01-8: Determining Whether an Arrangement Contains a Lease* and was effective March 13, 2005. Guidance in paragraph 16 related to maintenance costs incurred by lessee was previously

included within *INT 09-05: EITF 08-3: Accounting by Lessees for Maintenance Deposits* and was effective for periods beginning September 21, 2009. The guidance in paragraphs 17 and 18 was originally contained within *INT 00-27: EITF 98-9: Accounting for Contingent Rent* and was effective September 11, 2000. The guidance in paragraph 34 regarding commercial airplanes was originally contained within *INT 00-02: Accounting for Leveraged Leases Involving Commercial Airplanes Under SSAP No. 22—Leases* and was effective March 13, 2000.

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 22—Leases*

APPENDIX A – APPLICATIONS OF THE STANDARDS TO SPECIFIC ASPECTS OF ACCOUNTING FOR SALE-LEASEBACK TRANSACTIONS

Deposit Method

42. Paragraphs 25 and 30 of this statement describe certain circumstances in which it is appropriate to account for a transaction using the deposit method. If a sale-leaseback transaction is accounted for by the deposit method, lease payments decrease and collections on the buyer-lessor's note, if any, increase the seller-lessee's deposit account. The property and any related debt continue to be included in the seller-lessee's balance sheet, and the seller-lessee continues to depreciate the property. Under the provisions of paragraph 21 of FAS 66, a seller-lessee that is accounting for any transaction by the deposit method shall recognize a loss if at any time the net carrying amount of the property exceeds the sum of the balance in the deposit account, the fair value of the unrecorded note receivable, and any debt assumed by the buyer.

43. If a sale-leaseback transaction accounted for by the deposit method subsequently qualifies for sales recognition under this statement and SSAP No. 40R, the transaction is accounted for using sale-leaseback accounting, and the gain or loss is recognized in accordance with the provisions of paragraph 46 of this statement. In addition, the leaseback is classified and accounted for in accordance with this statement as if the sale had been recognized at the inception of the lease. The change in the related lease accounts that would have been recorded from the inception of the lease had the transaction initially qualified for sale-leaseback accounting is included in computing the gain or loss recognized in accordance with paragraph 46 of this statement.

Financing Method

44. Paragraphs 31-33 describe some common forms of continuing involvement with the property by the seller that preclude a sale-leaseback transaction from sale-leaseback accounting. Depending on the nature and duration of the continuing involvement with the property, those provisions may require a sale-leaseback transaction to be accounted for as a financing. If a sale-leaseback transaction is reported as a financing, lease payments, exclusive of an interest portion, decrease and collections on the buyer-lessor's note increase the seller-lessee's liability account with a portion of the lease payments being recognized under the interest method. The seller-lessee reports the sales proceeds as a liability, continues to report the real estate or the real estate and equipment as an asset, and continues to depreciate the property.

45. If a sale-leaseback transaction accounted for as a financing subsequently qualifies for sales recognition under this statement and SSAP No. 40R, the transaction is then recorded using sale-leaseback accounting, and the cumulative change in the related balance sheet accounts is included in the computation of the gain recognized in accordance with the provisions of paragraph 46 of this statement. In addition, the leaseback is classified and accounted for as an operating lease as if the sale had been recognized at the inception of the lease. The change in the related lease accounts from the inception of the lease to the date the sale is recognized is included in the gain recognized in accordance with paragraph 46 of this statement.

Sale-Leaseback Transactions

46. A sale-leaseback transaction that qualifies for sales recognition under the provisions of this statement is accounted for using sale-leaseback accounting by the seller-lessee. The proper approach is first to determine the gain that would be recognized under SSAP No. 40R as if the transaction were a sale without a leaseback and then to allocate that gain as provided by this statement over the remaining lease term. The gain to be deferred and amortized in proportion to the leaseback is the gain that would otherwise be recognized in that year under the provisions of SSAP No. 40R, except for the amount that can be currently recognized[9]. The total gain is recognized immediately if the leaseback is considered minor under the context of paragraph 48.a. of this statement. The gain to be recognized currently under

paragraph 48.b. of this statement is the amount of gain in excess of the present value of the minimum lease payments if the leaseback is classified as an operating lease.

47. Sale-leaseback transactions involve the sale of property by the owner and a lease of the property back to the seller. A sale of property that is accompanied by a leaseback of all or any part of the property for all or part of its remaining economic life shall be accounted for by the seller-lessee in accordance with the provisions of paragraph 48 and shall be accounted for by the purchaser-lessor in accordance with the provisions of paragraph 49.

48. Any profit or loss on the sale[10] shall be deferred and amortized in proportion to the related gross rental charged to expense over the lease term unless:

a. The seller-lessee relinquishes the right to substantially all of the remaining use of the property sold (retaining only a minor portion of such use)[10], in which case the sale and the leaseback shall be accounted for as separate transactions based on their respective terms. However, if the amount of rentals called for by the lease is unreasonable under market conditions at the inception of the lease, an appropriate amount shall be deferred or accrued, by adjusting the profit or loss on the sale, and amortized as specified in the introduction of this paragraph to adjust those rentals to a reasonable amount.

b. The seller-lessee retains more than a minor part but less than substantially all of the use of the property through the leaseback and realizes a profit on the sale[9] in excess of the present value of the minimum lease payments over the lease term because the leaseback is classified as an operating lease. In that case, the profit on the sale in excess of either the present value of the minimum lease payments or the recorded amount of the leased asset, whichever is appropriate, shall be recognized at the date of the sale. For purposes of applying this provision, the present value of the minimum lease payments for an operating lease shall be computed using the interest rate that would be used to apply the 90 percent recovery criterion[10].

c. The fair value of the property at the time of the transaction is less than its undepreciated cost, in which case a loss shall be recognized immediately up to the amount of the difference between undepreciated cost and fair value.

49. The purchaser-lessor shall record the transaction as a purchase and an operating lease.

Initial and Continuing Investment in Real Estate

50. Adequacy of a buyer's initial investment shall be measured by (a) its composition (paragraphs 51-52 and (b) its size compared with the sales value of the property (paragraph 53).

51. The buyer's initial investment shall include only: (a) cash paid as a down payment, (b) the buyer's notes supported by irrevocable letters of credit from institutions that are listed by the Securities

[9] "Profit or loss on the sale" is used in this paragraph to refer to the profit or loss that would be recognized on the sale if there were no leaseback. For example, on a sale of real estate subject to the *SSAP No.—40 Real Estate Investments* (SSAP No. 40R) the profit on the sale to be deferred and amortized in proportion to the leaseback would be the profit that could otherwise be recognized in accordance with SSAP No. 40R.

[10] "Substantially all" and "minor" are used here in the context of the concepts underlying the classification criteria of FASB Statement No. 13. In that context, a test based on the 90 percent recovery criterion of Statement No. 13 could be used as a guideline; that is, if the present value of a reasonable amount of rental for the leaseback represents 10 percent or less of the fair value of the asset sold, the seller-lessee could be presumed to have transferred to the purchaser-lessor the right to substantially all of the remaining use of the property sold, and the seller-lessee could be presumed to have retained only a minor portion of such use.

Valuation Office of the National Association of Insurance Commissioners as meeting credit standards, (c) payments by the buyer to third parties to reduce existing indebtedness on the property, and (d) other amounts paid by the buyer that are part of the sales value. Other consideration received by the seller, including other notes of the buyer, shall be included as part of the buyer's initial investment only when that consideration is sold or otherwise converted to cash without recourse to the seller.

52. The initial investment shall not include:

a. Payments by the buyer to third parties for improvements to the property

b. A permanent loan commitment by an independent third party to replace a loan made by the seller

c. Any funds that have been or will be loaned, refunded, or directly or indirectly provided to the buyer by the seller or loans guaranteed or collateralized by the seller for the buyer.

53. The buyer's initial investment shall be adequate to demonstrate the buyer's commitment to pay for the property and shall indicate a reasonable likelihood that the seller will collect the receivable. Lending practices of independent established lending institutions provide a reasonable basis for assessing the collectibility of receivables from buyers of real estate. Therefore, to qualify, the initial investment shall be equal to at least a major part of the difference between usual loan limits and the sales value of the property.

54. The buyer's continuing investment in a real estate transaction shall not qualify unless the buyer is contractually required to pay each year on its total debt for the purchase price of the property an amount at least equal to the level annual payment that would be needed to pay that debt and interest on the unpaid balance over no more than (a) 20 years for debt for land and (b) the customary amortization term of a first mortgage loan by an independent established lending institution for other real estate. For this purpose, contractually required payments by the buyer on its debt shall be in the forms specified in paragraph 51 as acceptable for an initial investment. Except as indicated in the following sentence, funds to be provided directly or indirectly by the seller (paragraph 52.c.) shall be subtracted from the buyer's contractually required payments in determining whether the initial and continuing investments are adequate. If a future loan on normal terms from an established lending institution bears a fair market interest rate and the proceeds of the loan are conditional on use for specified development of or construction on the property, the loan need not be subtracted in determining the buyer's investment.

Release Provisions

55. An agreement to sell property (usually land) may provide that part or all of the property may be released from liens securing related debt by payment of a release price or that payments by the buyer may be assigned first to released property. If either of those conditions is present, a buyer's initial investment shall be sufficient both to pay release prices on property released at the date of sale and to constitute an adequate initial investment on property not released or not subject to release at that time in order to meet the criterion of an adequate initial investment for the property as a whole.

56. If the release conditions described in paragraph 55 are present, the buyer's investment shall be sufficient, after the released property is paid for, to constitute an adequate continuing investment on property not released in order to meet the criterion of an adequate continuing investment for the property as a whole (paragraph 54).

57. If the amounts applied to unreleased portions do not meet the initial and continuing-investment criteria as applied to the sales value of those unreleased portions, profit shall be recognized on each released portion when it meets the criteria in SSAP No. 40R, paragraph ~~18~~19 as if each release were a separate sale.

58. Tests of adequacy of a buyer's initial and continuing investments described in paragraphs 31-33 shall be applied cumulatively when the sale is consummated and annually afterward. If the initial investment exceeds the minimum prescribed, the excess shall be applied toward the required annual increases in the buyer's investment.

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Statement of Statutory Accounting Principles No. 23

Foreign Currency Transactions and Translations

STATUS

Type of Issue:	Common Area
Issued:	Initial Draft
Effective Date:	January 1, 2001
Affects:	No other pronouncements
Affected by:	No other pronouncements
Interpreted by:	No other pronouncements

STATUS 1
SCOPE OF STATEMENT 3
SUMMARY CONCLUSION 3
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Foreign Currency Transactions and Translations

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for accounting for foreign currency transactions and translations.

SUMMARY CONCLUSION

2. A foreign currency transaction is a transaction denominated in a currency other than the reporting entity's functional currency. The reporting entity's functional currency is defined as the currency of the primary economic environment in which the reporting entity operates. Foreign currency translation is the translation of financial statements, denominated in the reporting entity's functional currency, into U.S. dollars prior to their incorporation into financial statements through consolidation or the equity method of accounting.

3. For the purposes of this statement, a U.S. domiciled reporting entity's reporting currency shall be defined as the U.S. dollar, regardless of the primary economic environment in which the reporting entity operates. In order to ensure consistency, all elements of statutory financial statements shall be reported in U.S. dollars.

4. Each foreign currency transaction shall be examined and a determination made if the foreign currency transaction was made in support of insurance operations denominated in the same foreign currency. For example, some reporting entities engage in insurance operations in foreign countries with the premiums collected and claims paid in local currency. As in any insurance operation there will at times be uncollected premiums, policy reserves, unpaid claims, and other incomplete transactions that must be recorded in the reporting entity's balance sheet. Premiums, reserves, and claims normally are recorded in U.S. dollars at the rate of exchange that is in effect at the time the policy is written, or when the claim is incurred. Changes in exchange rates, while not affecting the foreign policyholder, do affect the value of the foreign business as it is recorded in U.S. dollars.

5. Foreign currency transactions made in support of insurance operations denominated in the same foreign currency, such as foreign branches, shall be accounted for as follows:

a. Canadian Insurance Operations—Canadian insurance operations, resulting in less than 10% of the reporting entity's admitted assets, less than 10% of the reporting entity's liabilities and less than 10% of the reporting entity's net premium, can be translated to U.S. dollars by making an adjustment to the net assets of the foreign operation. The adjustment is calculated by summarizing the assets and liabilities in the foreign currency and in U.S. dollars. The net value is converted to U.S. dollars at the current rate of exchange and compared with the net value in U.S. dollars recorded by the reporting entity. Any difference in the net value to current exchange rates is recorded as a separate asset or liability and the change in the foreign exchange adjustment is recorded as an unrealized capital gain or loss;

b. All Other Foreign Insurance Operations—All other foreign insurance operations must be translated to U.S. dollars as follows: each financial statement line shall be translated to U.S. dollars by applying the following exchange rates: (i) for assets and liabilities, the exchange rate at the balance sheet date shall be used and (ii) for revenues, expenses, gains, losses and surplus adjustments, the exchange rate at the dates on which those elements are recognized shall be used. Because translation at the exchange rates at the dates the numerous revenues, expenses, gains, losses and surplus adjustments are recognized is generally impractical, an appropriately weighted average exchange rate for the period may be used to translate those elements. Gains or losses due to translating foreign operations to U.S. dollars shall be recorded as unrealized capital gains or losses.

6. All other foreign currency transactions shall be accounted for as follows:

a. Assets and liabilities denominated in foreign currencies shall be accounted for at their U.S. dollar equivalent values using exchange rates at the balance sheet date. Income and expenses recognized during an accounting period shall be recorded at an appropriately weighted average exchange rate;

b. Changes in balance sheet asset and liability values due to fluctuations in foreign currency exchange rates shall be recorded as unrealized capital gains and losses until the asset is sold or exchanged or the liability is settled. Upon settlement, previously recorded unrealized capital gains and losses shall be reversed and the foreign exchange profit or loss for the entire holding period shall be recorded as a realized capital gain or loss;

c. Transactions involving settlement in cash, such as purchases, payment of expenses, sales, and receipt of income, shall be recorded at their U.S. dollar equivalent value based on the foreign currency exchange rate as of the transaction date. Any foreign currency exchange gains or losses on purchases, payment of expenses, sales, maturities or changes in income or expense accruals shall be recorded as a capital gain or loss realized on the purchase, sale or maturity.

7. Nominal information such as par value of investments may be expressed in the foreign currency or U.S. dollar equivalent (description of issue), but where the information is displayed comparatively (column of par values), U.S. dollar equivalent amount shall be used. The U.S. dollar equivalent amount is translated utilizing the exchange rate at the balance sheet date. Ratios and factors shall be based on data that is entirely consistent with respect to currency.

8. A currency in a highly inflationary environment (one that has cumulative inflation of approximately 100% or more over a three year period) is not considered stable enough to serve as a functional currency and the more stable currency of the reporting parent is to be used instead. If a reporting entity's books of record are not maintained in its functional currency, remeasurement into the functional currency is required. That remeasurement is required before translation into the reporting currency. The remeasurement process is intended to produce the same result as if the reporting entity's books of record had been maintained in the functional currency. The remeasurement of and subsequent accounting for transactions denominated in a currency other than the functional currency shall be recognized as a realized gain or loss in the statement of operations.

Relevant Literature

9. This statement rejects *FASB Statement No. 52, Foreign Currency Translation*, *FASB Emerging Issues Task Force No. 87-12, Foreign Debt-for-Equity Swaps, FASB Emerging Issues Task Force No. 87-26, Hedging of Foreign Currency Exposure with a Tandem Currency, FASB Emerging Issues Task Force No. 92-4, Accounting for a Change in Functional Currency When an Economy Ceases to Be Considered Highly Inflationary, FASB Emerging Issues Task Force No. 95-2, Determination of What Constitutes a Firm Commitment for Foreign Currency Transactions Not Involving a Third Party, FASB Emerging Issues Task Force No. 96-15, Accounting for the Effects of Changes in Foreign Currency Exchange Rates on Foreign-Currency-Denominated Available-for-Sale Debt Securities* and *FASB Interpretation No. 37, Accounting for Translation Adjustments upon Sale of Part of an Investment in a Foreign Entity, an interpretation of FASB Statement No. 52*, and *Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins*, Chapter 12.

Effective Date and Transition

10. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*.

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 81—Foreign Currency Transactions and Translations*

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Statement of Statutory Accounting Principles No. 24

Discontinued Operations and Extraordinary Items

STATUS

Type of Issue:	Common Area
Issued:	Initial Draft
Effective Date:	January 1, 2001
Affects:	Nullifies and incorporates INT 02-17
Affected by:	No other pronouncements
Interpreted by:	INT 08-05

STATUS **1**

SCOPE OF STATEMENT **3**

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Discontinued Operations and Extraordinary Items

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles related to the accounting and reporting for the effects of the disposal of a segment of a business and extraordinary items.

SUMMARY CONCLUSION

Definitions

2. The following definitions shall apply:

a. "Discontinued operations" shall be defined as the operations of a segment of a business that has been sold, abandoned, spun off (INT 08-05), or otherwise disposed of or, although still operating, is the subject of a formal plan for disposal;

b. A "segment" of a business shall be defined as a component of an entity, likely in the form of a subsidiary, whose activities represent a separate major type of business or class of customer. The assets, results of operations, and activities of a segment must be clearly distinguished, physically and operationally and for financial reporting purposes, from the other assets, results of operations, and activities of the entity. The fact that the results of operations of the segment being sold or abandoned cannot be separately identified strongly suggests that the transaction should not be classified as the disposal of a segment of the business. The disposal of a segment of a business shall be distinguished from other disposals of assets incident to the evolution of the entity's business, such as the disposal of a line of business or the shifting of marketing activities from one location to another;

c. "Measurement date" shall be defined as the date on which management having authority to approve the action commits itself to a formal plan to dispose of a segment of the business, whether by sale or abandonment. The plan, at a minimum, should include identification of the major assets to be disposed of, the expected method of disposal, the period expected to be required for completion of the disposal, an active program to find a buyer if disposal is to be by sale, the estimated results of operations of the segment from the measurement date to the disposal date (defined below), and the estimated proceeds or salvage to be realized by disposal;

d. "Disposal date" shall be defined as the date of closing the sale if the disposal is by sale or the date that operations cease if the disposal is by abandonment;

e. "Extraordinary items" shall be defined as those events or transactions which meet both of the following criteria:

i. Unusual nature—the underlying event or transaction possesses a high degree of abnormality and is clearly unrelated to, or only incidentally related to, the ordinary and typical activities of the reporting entity, taking into account the environment in which the reporting entity operates; and

ii. Infrequency of occurrence—the underlying event or transaction would not reasonably be expected to recur in the foreseeable future, taking into account the environment in which the reporting entity operates.

Discontinued Operations

3. If a loss is expected from the proposed sale or abandonment of a segment of business, the estimated loss shall be accrued at the measurement date, as defined in paragraph 2. If a gain is expected, it shall be recognized when realized, which ordinarily is the disposal date. This accounting is consistent with the accounting provided for in *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets*.

4. The determination of whether a gain or loss results from the disposal shall be made at the measurement date based on estimates at that date of the net realizable value of the segment after giving consideration to any estimated costs and expenses directly associated with the disposal and, if a plan of disposal is to be carried out over a period of time and contemplates continuing operations during that period, to any estimated income or losses from operations. If it is expected that net losses from operations will be incurred between the measurement date and the expected disposal date, the computation of the gain or loss on disposal shall also include an estimate of such amounts. If it is expected that net income will be generated from operations during that period the computation shall include the estimated net income, limited however to the amount of any loss otherwise recognizable for the disposal, with any remainder accounted for when realized. Any changes in the original estimate shall be accounted for in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*.

5. The results of a reporting entity's discontinued operations shall be reported consistently with the entity's reporting of continuing operations (i.e., no separate line item presentation in the balance sheet or statement of operations aggregating current and future losses from the measurement date).

6. Additionally, the financial statements for the period encompassing the measurement date and the year subsequent shall contain the following:

a. The identity of the segment of business that has been or will be discontinued;

b. The expected disposal date, if known (see definition in paragraph 2);

c. The expected manner of disposal;

d. A description of the remaining assets and liabilities of the segment at the balance sheet date; and

e. The amounts related to the discontinued operations and the effect on the financial statements, including the balance sheet and income statement line items which have been affected.

7. If material revisions are made to the estimates of the cost to dispose of a segment in years subsequent to the disclosure required in paragraph 6, the nature and the effect of the revisions to the estimates shall be disclosed for the period in which the revision was made including the effect on income or loss from operations and the effect on the carrying amount of the remaining assets and liabilities of the segment at the balance sheet date. Examples of circumstances in which those types of adjustments may arise include the following:

a. The resolution of contingencies that arise pursuant to the terms of the disposal transaction, such as the resolution of purchase price contingencies and indemnification issues with the purchaser.

b. The resolution of contingencies that arise from and are directly related to the operation of the component prior to its disposal, such as environmental and product warranty obligations retained by the seller.

c. The settlement of employee benefit plan obligations (pension, postemployment benefits other than pensions, and other postemployment benefits), provided that the settlement is directly related to the disposal transaction[1].

Extraordinary Items

8. Extraordinary items, as defined in paragraph 2, shall be reported consistently with the reporting entity's reporting of continuing operations (i.e., no separate line item presentation in the balance sheet or statement of operations). Such items shall not be charged directly to surplus unless specifically addressed elsewhere within the *Accounting Practices and Procedures Manual*.

9. The nature of an extraordinary event or transaction and the principal items entering into the determination of an extraordinary gain or loss shall be disclosed in the financial statements. This disclosure shall include the line items, which have been affected by the estimate of the extraordinary item.

10. Material events or transactions that are either unusual or occur infrequently, but not both, are not considered extraordinary items. However, such material events or transactions shall be disclosed in the financial statements.

Business Interruption Insurance Recoveries

11. Business interruption (BI) insurance is designed to protect the prospective earnings or profits of the insured entity. That is, BI insurance provides coverage if business operations are suspended due to the loss of use of property and equipment resulting from a covered cause of loss. BI insurance coverage generally provides for reimbursement of certain costs and losses incurred during the reasonable period required to rebuild, repair, or replace the damaged property. The types of costs and losses covered typically include:

a. Gross margin that was "lost" or not earned due to the suspension of normal operations

b. A portion of fixed charges and expenses in relation to that lost gross margin

c. Other expenses incurred to reduce the loss from business interruption (for example, rent of temporary facilities and equipment, use of subcontractors, and so forth)

An entity may choose how to classify BI insurance recoveries in the statement of operations, as long as that classification is not contrary to existing statutory accounting principles.

Disclosures

12. The following information should be disclosed in the notes to the financial statements in the period(s) in which BI insurance recoveries are recognized:

a. The nature of the event resulting in business interruption losses

[1] Paragraph 51 of *SSAP No. 102—Accounting for Pensions, A Replacement of SSAP No. 89* and paragraph ~~80~~81 of *SSAP No. 92—Accounting for Postretirement Benefits Other than Pensions, A Replacement of SSAP No. 14* define settlement as "a transaction that (a) is an irrevocable action, (b) relieves the employer (or the plan) of primary responsibility for a pension benefit obligation, and (c) eliminates significant risks related to the obligation and the assets used to effect the settlement." A settlement is directly related to the disposal transaction if there is a demonstrated direct cause-and-effect relationship and the settlement occurs no later than one year following the disposal transaction, unless it is delayed by events or circumstances beyond an entity's control (refer to paragraph 22 of *SSAP No. 90—Accounting for the Impairment or Disposal of Real Estate Investments, Discontinued Operations)*.

b. The aggregate amount of BI insurance recoveries recognized during the period and the line item(s) in the statement of operations in which those recoveries are classified (including amounts defined as an extraordinary item pursuant to this SSAP).

13. Refer to the preamble for further discussion regarding disclosure requirements.

Relevant Literature

14. This statement adopts the accounting principles relating to the accounting for the disposal of a segment of a business included in *Accounting Principles Board Opinion No. 30*, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions,* (APB No. 30), paragraphs 13-18 and adopts the definition of an extraordinary item included in paragraph 20 of APB 30. This statement also adopts *AICPA Accounting Interpretations, Reporting the Results of Operations: Accounting Interpretations of APB Opinion No. 30*, relating to the definition of extraordinary items and terminology relevant to the disposal of a segment and the criteria for recording a related loss. This statement also adopts *FASB Emerging Issues Task Force No. 85-36, Discontinued Operations with Expected Gain and Interim Operating Losses.* This statement adopts with modification *Emerging Issues Task Force No. 01-13: Income Statement Display of Business Interruption Insurance Recoveries*, with changes of GAAP references to statutory terminology.

15. This statement rejects all other paragraphs of APB 30 and all other interpretations of APB 30 relating to the accounting and reporting of discontinued operations, extraordinary items and unusual or infrequently occurring events and transactions. This statement rejects *FASB Statement No. 146, Accounting for Costs Associated with Exit or Disposal Activities, FASB Emerging Issues Task Force No. 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring),* and *FASB Emerging Issues Task Force No. 95-18, Accounting and Reporting for a Discontinued Business Segment When the Measurement Date Occurs after the Balance Sheet Date but before the Issuance of Financial Statements*.

16. This statement adopts subparagraphs a through c from paragraph 44 of *FASB Statement No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets* (FAS 144). This statement also defers the implementation of all other paragraphs of FAS 144 to *SSAP No. 90—Accounting for the Impairment or Disposal of Real Estate Investments*.

Effective Date and Transition

17. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with SSAP No. 3. The guidance in paragraphs 11 and 12 was originally contained in *INT 02-17: EITF 01-13: Income Statement Display of Business Interruption Insurance Recoveries* and was effective Sept. 10, 2002.

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 24—Discontinued Operations and Extraordinary Items*

Statement of Statutory Accounting Principles No. 25

Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties

STATUS

Type of Issue:	Common Area
Issued:	Initial Draft
Effective Date:	January 1, 2001
Affects:	Supersedes SSAP No. 96 with guidance incorporated August 2011 Nullifies and incorporates INT 03-16
Affected by:	No other pronouncements
Interpreted by:	No other pronouncements

STATUS **1**

SCOPE OF STATEMENT **3**

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Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties

SCOPE OF STATEMENT

1. Related party transactions are subject to abuse because reporting entities may be induced to enter transactions that may not reflect economic realities or may not be fair and reasonable to the reporting entity or its policyholders. As such, related party transactions require specialized accounting rules and increased regulatory scrutiny. This statement establishes statutory accounting principles and disclosure requirements for related party transactions.

2. If a company receives the stock of an affiliated company as a capital contribution rather than through a purchase, the transaction shall be accounted for according to *SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties* (SSAP No. 25)*, SSAP No. 95—Exchange of Nonmonetary Assets, A Replacement of SSAP No. 28—Nonmonetary Transactions* (SSAP No. 95), or *SSAP No. 97,* based on the details of each transaction. The statutory purchase method within *SSAP No. 68—Business Combinations* (SSAP No. 68) is not applicable for stock received as a capital contribution.

SUMMARY CONCLUSION

3. Related parties are defined as entities that have common interests as a result of ownership, control, affiliation or by contract. Related parties shall include but are not limited to the following:

a. Affiliates of the reporting entity, as defined in paragraph 4;

b. Trusts for the benefit of employees, such as pension and profit-sharing trusts and Employee Stock Ownership Plans that are managed by or under the trusteeship of management of the reporting entity, its parent or affiliates;

c. The principal owners of the reporting entity;

d. The management of the reporting entity, its parent or affiliates (including directors);

e. Members of the immediate families of principal owners and management of the reporting entity, its parent or affiliates and their management;

f. Parties with which the reporting entity may deal if either party directly or indirectly controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interest;

g. A party which can, directly or indirectly, significantly influence the management or operating policies of the reporting entity, which may include a provider who is contracting with the reporting entity. This is not intended to suggest that all provider contracts create related party relationships;

h. A party which has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests;

i. Attorney-in-fact of a reciprocal reporting entity or any affiliate of the attorney-in-fact; and

j. A U.S. manager of a U.S. Branch or any affiliate of the U.S. manager of a U.S. Branch.

4. An affiliate is defined as an entity that is within the holding company system or a party that, directly or indirectly, through one or more intermediaries, controls, is controlled by, or is under common control with the reporting entity. An affiliate includes a parent or subsidiary and may also include partnerships, joint ventures, and limited liability companies as defined in *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies* (SSAP No. 48). Those entities are accounted for under the guidance provided in SSAP No. 48, which requires an equity method for all such investments. An affiliate is any person that is directly or indirectly, owned or controlled by the same person or by the same group of persons, that, directly or indirectly, own or control the reporting entity.

5. Control is defined as the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of the investee, whether through the (a) ownership of voting securities, (b) by contract other than a commercial contract for goods or nonmanagement services, (c) by contract for goods or nonmanagement services where the volume of activity results in a reliance relationship (d) by common management, or (e) otherwise. Control shall be presumed to exist if a reporting entity and its affiliates directly or indirectly, own, control, hold with the power to vote, or hold proxies representing 10% or more of the voting interests of the entity.

6. Control as defined in paragraph 5 shall be measured at the holding company level. For example, if one member of an affiliated group has a 5% interest in an entity and a second member of the group has an 8% interest in the same entity, the total interest is 13%, and therefore, each member of the affiliated group shall be presumed to have control. This presumption will stand until rebutted by an evaluation of all the facts and circumstances relating to the investment based on the criteria in *FASB Interpretation No. 35, Criteria for Applying the Equity Method of Accounting for Investments in Common Stock, an Interpretation of APB Opinion No. 18*. The corollary is required to demonstrate control when a reporting entity owns less than 10% of the voting securities of an investee. The insurer shall maintain documents substantiating its determination for review by the domiciliary commissioner. Examples of situations where the presumption of control may be in doubt include the following:

a. Any limited partner investment in a limited partnership, unless the limited partner is affiliated with the general partner.

b. An entity where the insurer owns less than 50% of an entity and there is an unaffiliated individual or group of investors who own a controlling interest.

c. An entity where the insurer has given up participation rights[1] as a shareholder to the investee.

7. Transactions between related parties must be in the form of a written agreement. The written agreement must provide for timely settlement of amounts owed, with a specified due date. Amounts owed to the reporting entity over ninety days from the written agreement due date shall be nonadmitted, except to the extent this is specifically addressed by other statements of statutory accounting principles (SSAPs). If the due date is not addressed by the written agreement, any uncollected receivable is nonadmitted.

Related Party Loans

8. Loans or advances (including debt, public or private) made by a reporting entity to its parent or principal owner shall be admitted if approval for the transaction has been obtained from the domiciliary commissioner and the loan or advance is determined to be collectible based on the parent or principal

[1] The term "participating rights" refers to the type of rights that allows an investor to effectively participate in significant decisions related to an investee's ordinary course of business and is distinguished from the more limited type of rights referred to as “protective rights”. Refer to the sections entitled: “Protective Rights” and “Substantive Participating Rights” in EITF 96-16, *Investor's Accounting for an Investee When the Investor Owns a Majority of the Voting Stock but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights*. The term “participating rights” shall be used consistent with the discussion of substantive participating rights in this EITF.

owner's independent payment ability. An affiliate's ability to pay shall be determined after consideration of the liquid assets or revenues available from external sources (i.e., determination shall not include dividend paying ability of the subsidiary making the loan or advance) which are available to repay the balance and/or maintain its account on a current basis. Evaluation of the collectibility of loans or advances shall be made periodically. If, in accordance with *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets – Revised* (SSAP No. 5R), it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made.

9. Loans or advances by a reporting entity to all other related parties shall be evaluated by management and nonadmitted if they do not constitute arm's-length transactions as defined in paragraph 12. Loans or advances made by a reporting entity to related parties (other than its parent or principal owner) that are economic transactions as defined in paragraph 12 shall be admitted. This includes financing arrangements with providers of health care services with whom the reporting entity contracts with from time to time. Such arrangements can include both loans and advances to these providers. Evaluation of the collectibility of loans or advances shall be made periodically. If, in accordance with SSAP No. 5R, it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made.

10. Any advances under capitation arrangements made directly to providers, or to intermediaries that represent providers, that exceed one month's payment shall be nonadmitted assets.

11. Indirect loans are loans or extensions of credit to any person who is not an affiliate, where the reporting entity makes loans or extensions of credit with the agreement or understanding that the proceeds of the transactions, in whole or in substantial part, are to be used to make loans or extensions of credit to, to purchase assets of, or to make investments in, any affiliate of the reporting entity making the loans or extensions of credit. The admissibility of indirect loans made by a reporting entity for the benefit of its parent or principal owner shall be determined in accordance with the guidelines in paragraph 8. Indirect loans or advances made for the benefit of all other related parties shall be evaluated and accounted for consistent with loans or advances to related parties as described in paragraphs 9 and 10.

Transactions Involving the Exchange of Assets or Liabilities

12. An arm's-length transaction is defined as a transaction in which willing parties, each being reasonably aware of all relevant facts and neither under compulsion to buy, sell, or loan, would be willing to participate. A transaction between related parties involving the exchange of assets or liabilities shall be designated as either an economic transaction or non-economic transaction. An economic transaction is defined as an arm's-length transaction which results in the transfer of the risks and rewards of ownership and represents a consummated act thereof, i.e., "permanence." The appearance of permanence is also an important criterion in assessing the economic substance of a transaction. In order for a transaction to have economic substance and thus warrant revenue (loss) recognition, it must appear unlikely to be reversed. If subsequent events or transactions reverse the effect of an earlier transaction prior to the issuance of the financial statements, the reversal shall be considered in determining whether economic substance existed in the case of the original transaction. Subsequent events are addressed in *SSAP No. 9—Subsequent Events*. An economic transaction must represent a bonafide business purpose demonstrable in measurable terms. A transaction which results in the mere inflation of surplus without any other demonstrable and measurable betterment is not an economic transaction. The statutory accounting shall follow the substance, not the form of the transaction.

13. In determining whether there has been a transfer of the risks and rewards of ownership in the transfer of assets or liabilities between related parties, the following—and any other relevant facts and circumstances related to the transaction—shall be considered:

a. Whether the seller has a continuing involvement in the transaction or in the financial interest transferred, such as through the exercise of managerial authority to a degree usually associated with ownership;

b. Whether there is an absence of significant financial investment by the buyer in the financial interest transferred, as evidenced, for example, by a token down payment or by a concurrent loan to the buyer;

c. Whether repayment of debt that constitutes the principal consideration in the transaction is dependent on the generation of sufficient funds from the asset transferred;

d. Whether limitations or restrictions exist on the buyer's use of the financial interest transferred or on the profits arising from it;

e. Whether there is retention of effective control of the financial interest by the seller.

14. A transaction between related parties may meet the criteria for treatment as an economic transaction at one level of financial reporting, but may not meet such criteria at another level of financial reporting. An example of such a transaction is a reporting entity purchasing securities at fair value from an affiliated reporting entity that carried the securities at amortized cost. This transaction meets the criteria of an economic transaction at this level of financial reporting, and therefore, the selling reporting entity would record a gain and the acquiring reporting entity would record the securities at their cost (fair value on the transaction date). At the common parent level of reporting, this transaction has resulted in the mere inflation of surplus, and therefore, is a non-economic transaction. The parent reporting entity shall defer the net effects of any gain or increase in surplus resulting from such transactions by recording a deferred gain and an unrealized loss. The deferred gain shall not be recognized by the parent reporting entity unless and until arms-length transaction(s) with independent third parties give rise to appropriate recognition of the gain.

15. A non-economic transaction is defined as any transaction that does not meet the criteria of an economic transaction. Similar to the situation described in paragraph 14, transfers of assets from a parent reporting entity to a subsidiary, controlled or affiliated entity shall be treated as non-economic transactions at the parent reporting level because the parent has continuing indirect involvement in the assets.

16. When accounting for a specific transaction, reporting entities shall use the following valuation methods:

a. Economic transactions between related parties shall be recorded at fair value at the date of the transaction. To the extent that the related parties are affiliates under common control, the controlling reporting entity shall defer the effects of such transactions that result in gains or increases in surplus (see paragraph 14);

b. Non-economic transactions between reporting entities, which meet the definition of related parties above, shall be recorded at the lower of existing book values or fair values at the date of the transaction;

c. Non-economic transactions between a reporting entity and an entity that has no significant ongoing operations other than to hold assets that are primarily for the direct or indirect benefit or use of the reporting entity or it's affiliates, shall be recorded at the fair value at the date of the transaction; however, to the extent that the transaction results in a gain, that gain shall be deferred until such time as permanence can be verified;

d. Transactions which are designed to avoid statutory accounting practices shall be reported as if the reporting entity continued to own the assets or to be obligated for a liability directly instead of through a subsidiary.

Examples of transactions deemed to be non-economic include security swaps of similar issues between or among affiliated companies, and swaps of dissimilar issues accompanied by exchanges of liabilities between or among affiliates.

Transactions Involving Services

17. Transactions involving services between related parties can take a variety of different forms. One of the significant factors as to whether these transactions will be deemed to be arm's length is the amount charged for such services. In general, amounts charged for services are based either on current market rates or on allocations of costs. Determining market rates for services is difficult because the circumstances surrounding each transaction are unique. Unlike transactions involving the exchange of assets and liabilities between related parties, transactions for services create income on one party's books and expense on the second party's books, and therefore, do not lend themselves to the mere inflation of surplus. These arrangements are generally subject to regulatory approval.

18. Transactions involving services provided between related parties shall be recorded at the amount charged. Regulatory scrutiny of related party transactions where amounts charged for services do not meet the fair and reasonable standard established by Appendix A-440, may result in (a) amounts charged being recharacterized as dividends or capital contributions, (b) transactions being reversed, (c) receivable balances being nonadmitted, or (d) other regulatory action. Expenses that result from cost allocations shall be allocated subject to the same fair and reasonable standards, and the books and records of each party shall disclose clearly and accurately the precise nature and details of the transaction. See *SSAP No 70—Allocation of Expenses* for additional discussion regarding the allocation of expenses.

Disclosures

19. The financial statements shall include disclosures of all material related party transactions. In some cases, aggregation of similar transactions may be appropriate. Sometimes, the effect of the relationship between the parties may be so pervasive that disclosure of the relationship alone will be sufficient. If necessary to the understanding of the relationship, the name of the related party should be disclosed. Transactions shall not be purported to be arm's-length transactions unless there is demonstrable evidence to support such statement. The disclosures shall include:

a. The nature of the relationships involved;

b. A description of the transactions for each of the periods for which financial statements are presented, and such other information considered necessary to obtain an understanding of the effects of the transactions on the financial statements. Exclude reinsurance transactions, any non-insurance transactions which involve less than ½ of 1% of the total admitted assets of the reporting entity, and cost allocation transactions. The following information shall be provided if applicable:

i. Date of transaction;

ii. Explanation of transaction;

iii. Name of reporting entity;

iv. Name of affiliate;

v. Description of assets received by reporting entity;

vi. Statement value of assets received by reporting entity;

vii. Description of assets transferred by reporting entity; and

viii. Statement value of assets transferred by reporting entity.

c. The dollar amounts of transactions for each of the periods for which financial statements are presented and the effects of any change in the method of establishing the terms from that used in the preceding period;

d. Amounts due from or to related parties as of the date of each balance sheet presented and, if not otherwise apparent, the terms and manner of settlement;

e. Any guarantees or undertakings, written or otherwise, shall be disclosed in accordance with the requirements of SSAP No. 5R. In addition, the nature of the relationship to the beneficiary of the guarantee or undertaking (affiliated or unaffiliated) shall also be disclosed;

f. A description of material management or service contracts and cost-sharing arrangements involving the reporting entity and any related party. This shall include, but is not limited to, sale lease-back arrangements, computer or fixed asset leasing arrangements, and agency contracts, which remove assets otherwise recordable (and potentially nonadmitted) on the reporting entity's financial statements;

g. The nature of the control relationship whereby the reporting entity and one or more other enterprises are under common ownership or control and the existence of that control could result in operating results or financial position of the reporting entity significantly different from those that would have been obtained if the enterprises were autonomous. The relationship shall be disclosed even though there are no transactions between the enterprises; and

h. The amount deducted from the value of an upstream intermediate entity or ultimate parent owned, either directly or indirectly, via a downstream subsidiary, controlled, or affiliated entity, in accordance with the *Purposes and Procedure Manual of the NAIC Investment Analysis*~~*Securities Valuation*~~ *Office*, "Procedures for Valuing Common Stocks and Stock Warrants."

20. Refer to the preamble for further discussion regarding disclosure requirements.

Relevant Literature

21. This statement adopts *FASB Statement No. 57, Related Party Disclosures* with a modification to paragraph 3 to require disclosure of compensation arrangements, expense allowances, and other similar items in the ordinary course of business.

22. This statement rejects AICPA *Accounting Interpretations, Business Combinations: Accounting Interpretations of APB Opinion No. 16, #39*, "Transfers and Exchanges Between Companies Under Common Control."

23. Guidance in paragraph 7 was incorporated from SSAP No. 96 as discussed in *Issue Paper No. 128—Settlement Requirements for Intercompany Transactions, An Amendment to SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties*. SSAP No. 96 was nullified in 2011 with the guidance from that SSAP retained within this SSAP.

Effective Date and Transition

24. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*.

25. Guidance reflected in paragraph 7, incorporated from SSAP No. 96, is effective for reporting periods ending December 31, 2007. Early adoption is permitted. A change resulting from the application of this paragraph shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors* (SSAP No. 3). Guidance reflected in paragraph 2, incorporated from *INT 03-16: Contribution of Stock*, was originally effective December 7, 2003.

REFERENCES

Other

- *Purposes and Procedures Manual of the NAIC Investment Analysis~~Securities Valuation~~ Office*

Relevant Issue Papers

- *Issue Paper No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties*

- *Issue Paper No. 128—Settlement Requirements for Intercompany Transactions, An Amendment to SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties*

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Statement of Statutory Accounting Principles No. 26

Bonds, Excluding Loan-Backed and Structured Securities

STATUS

Type of Issue:	Common Area
Issued:	Initial Draft
Effective Date:	January 1, 2001
Affects:	Supersedes SSAP No. 99 with guidance incorporated November 2010 Nullifies and incorporates INT 02-05
Affected by:	No other pronouncements
Interpreted by:	INT 01-25, INT 06-02, INT 06-07, INT 07-01

STATUS **1**

SCOPE OF STATEMENT **3**

SUMMARY CONCLUSION **3**

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Bonds, Excluding Loan-Backed and Structured Securities

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for bonds, excluding loan-backed and structured securities.

SUMMARY CONCLUSION

2. Bonds shall be defined as any securities representing a creditor relationship, whereby there is a fixed schedule for one or more future payments. This definition includes:

a. U.S. Treasury securities,(INT 01-25)

b. U.S. government agency securities,

c. Municipal securities,

d. Corporate bonds,

e. Bank participations,

f. Convertible debt, including mandatory convertible debt as defined in paragraph 9,

g. Certificates of deposit that have a fixed schedule of payments and a maturity date in excess of one year from the date of acquisition,

h. Commercial paper,

i. Exchange Traded Funds, which qualify for bond treatment, as identified in the *Purposes and Procedures Manual of the NAIC Investment Analysis~~Securities Valuation~~ Office*, and

j. Class 1 Bond Mutual Funds, as identified in the *Purposes and Procedures Manual of the NAIC Investment Analysis~~Securities Valuation~~ Office*.

Loan-backed and structured securities meet this definition, but are excluded from the scope of this statement, and are addressed in *SSAP No. 43R—Loan-Backed and Structured Securities.* Securities which meet the definition above, but have a maturity date of one year or less from the date of acquisition are addressed in *SSAP No. 2—Cash, Drafts, and Short-term Investments*. Mortgage loans and other real estate lending activities made in the ordinary course of business meet the definition above, but are not addressed in this statement. These types of transactions are addressed in *SSAP No. 37—Mortgage Loans* and *SSAP No. 39—Reverse Mortgages*. Investments in a debt instrument of a certified capital company (CAPCO) shall be reported as a bond in accordance with *INT 06-02: Accounting and Reporting for Investments in a Certified Capital Company (CAPCO)*.

3. Bonds meet the definition of assets as defined in *SSAP No. 4—Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this statement.

Acquisitions and Sales

4. A bond acquisition or disposal shall be recorded on the trade date, not the settlement date, except for the acquisition of private placement bonds which shall be recorded on the funding date. At acquisition, bonds shall be reported at their cost, including brokerage and other related fees.

5. For reporting entities required to maintain an Interest Maintenance Reserve (IMR), the accounting for realized capital gains and losses on sales of bonds shall be in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*. For reporting entities not required to maintain an IMR, realized gains and losses on sales of bonds shall be reported as net realized capital gains or losses in the statement of income.

Amortized Cost

6. Amortization of bond premium or discount shall be calculated using the scientific (constant yield) interest method taking into consideration specified interest and principal provisions over the life of the bond $^{\text{(INT 07-01)}}$. Bonds containing call provisions (where the issue can be called away from the reporting entity at the issuer's discretion), except "make whole" call provisions, shall be amortized to the call or maturity value/date[1] which produces the lowest asset value (yield to worst). Although the concept for yield to worst shall be followed for all callable bonds, make whole call provisions, which allow the bond to be callable at any time, shall not be considered in determining the timeframe for amortizing bond premium or discount unless information is known by the reporting entity indicating that the issuer is expected to invoke the make whole call provision.

Balance Sheet Amount

7. Bonds, except mandatory convertible securities addressed in paragraph 9, shall be valued and reported in accordance with this statement, the *Purposes and Procedures Manual of the NAIC Investment Analysis*~~*Securities Valuation*~~ *Office*, and the designation assigned in the NAIC *Valuations of Securities* product prepared by the NAIC Securities Valuation Office. For reporting entities that maintain an Asset Valuation Reserve (AVR), the bonds shall be reported at amortized cost, except for those with an NAIC designation of 6, which shall be reported at the lower of amortized cost or fair value. For reporting entities that do not maintain an AVR, bonds that are designated highest-quality and high-quality (NAIC designations 1 and 2, respectively) shall be reported at amortized cost; with all other bonds (NAIC designations 3 to 6) reported at the lower of amortized cost or fair value.

8. The premium paid on a zero coupon convertible bond that produces a negative yield as a result of the value of a warrant exceeding the bond discount shall be written off immediately so that a negative yield is not produced. The full amount of the premium should be recorded as amortization within investment income on the date of purchase.

9. Mandatory convertible securities are defined as a type of convertible bond that has a required conversion or redemption feature. Either on or before a contractual conversion date, the holder must convert the mandatory convertible security into the underlying common stock. Mandatory convertible securities are subject to special reporting instructions and are therefore not assigned NAIC designations or unit prices by the SVO. The balance sheet amount for mandatory convertible securities shall be reported at the lower of amortized cost or fair value during the period prior to conversion. This reporting method is not impacted by NAIC designation or information received from credit rating providers (CRPs). Upon conversion, these securities will be subject to the accounting guidance of the statement that reflects their revised characteristics.

10. For reporting entities required to maintain an AVR, the accounting for unrealized gains and losses shall be in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve* (SSAP No. 7). For reporting entities not required to maintain an AVR, unrealized gains and losses shall be recorded as a direct credit or charge to unassigned funds (surplus).

[1] For continuously callable bonds with a lockout period, the first call date after the lockout period shall be used in determining the amortization of any premium. If there is no lockout period, and make whole call provisions are not included, any premium for continuously callable bonds shall be expensed completely at acquisition. (For continuously callable bonds, the first call date after the lockout period, or the date of acquisition if no lockout period exists, shall be used as the "effective date of maturity" for reporting in Schedule D, Part 1.)

Impairment

11. An other-than-temporary (INT 06-07) impairment shall be considered to have occurred if it is probable that the reporting entity will be unable to collect all amounts due according to the contractual terms of a debt security in effect at the date of acquisition. A decline in fair value which is other-than-temporary includes situations where a reporting entity has made a decision to sell a security prior to its maturity at an amount below its carrying value. If it is determined that a decline in the fair value of a bond is other-than-temporary, an impairment loss shall be recognized as a realized loss equal to the entire difference between the bond's carrying value and its fair value at the balance sheet date of the reporting period for which the assessment is made. The measurement of the impairment loss shall not include partial recoveries of fair value subsequent to the balance sheet date. For reporting entities required to maintain an AVR/IMR, the accounting for the entire amount of the realized capital loss shall be in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*. Credit related other-than-temporary impairment losses shall be recorded through the AVR; interest related other-than-temporary impairment losses shall be recorded through the IMR.

12. In periods subsequent to the recognition of an other-than-temporary impairment loss for a bond, the reporting entity shall account for the other-than-temporarily impaired security as if the security had been purchased on the measurement date of the other-than-temporary impairment. The fair value of the bond on the measurement date shall become the new cost basis of the bond and the new cost basis shall not be adjusted for subsequent recoveries in fair value. The discount or reduced premium recorded for the security, based on the new cost basis, shall be amortized over the remaining life of the security in the prospective manner based on the amount and timing of future estimated cash flows. The security shall continue to be subject to impairment analysis for each subsequent reporting period. Future declines in fair value which are determined to be other-than temporary shall be recorded as realized losses.

Income

13. Interest income for any period consists of interest collected during the period, the change in the due and accrued interest between the beginning and end of the period as well as reductions for premium amortization and interest paid on acquisition of bonds, and the addition of discount accrual. In accordance with *SSAP No. 34—Investment Income Due and Accrued*, investment income shall be reduced for amounts which have been determined to be uncollectible. Contingent interest may be accrued if the applicable provisions of the underlying contract and the prerequisite conditions have been met.

14. A bond may provide for a prepayment penalty or acceleration fee in the event the bond is liquidated prior to its scheduled termination date. Such fees shall be reported as investment income when received.

Origination Fees

15. Origination fees represent fees charged to the borrower in connection with the process of originating or restructuring a transaction such as the private placement of bonds. The fees include, but are not limited to, points, management, arrangement, placement, application, underwriting, and other fees pursuant to such a transaction. Origination fees shall not be recorded until received in cash. Origination fees intended to compensate the reporting entity for interest rate risks (e.g., points), shall be amortized into income over the term of the bond consistent with paragraph 6 of this statement. Other origination fees shall be recorded as income upon receipt.

Origination, Acquisition, and Commitment Costs

16. Costs related to origination when paid in the form of brokerage and other related fees shall be capitalized as part of the cost of the bond, consistent with paragraph 4 of this statement. All other costs,

including internal costs or costs paid to an affiliated entity related to origination, purchase or commitment to purchase bonds shall be charged to expense when incurred.

Commitment Fees

17. Commitment fees are fees paid to the reporting entity that obligate the reporting entity to make available funds for future borrowing under a specified condition. A fee paid to the reporting entity to obtain a commitment to make funds available at some time in the future, generally, is refundable only if the bond is issued. If the bond is not issued, then the fees shall be recorded as investment income by the reporting entity when the commitment expires.

18. A fee paid to the reporting entity to obtain a commitment to be able to borrow funds at a specified rate and with specified terms quoted in the commitment agreement, generally, is not refundable unless the commitment is refused by the reporting entity. This type of fee shall be deferred, and amortization shall depend on whether or not the commitment is exercised. If the commitment is exercised, then the fee shall be amortized in accordance with paragraph 6 of this statement over the life of the bond as an adjustment to the investment income on the bond. If the commitment expires unexercised, the commitment fee shall be recognized in income on the commitment expiration date.

Exchanges and Conversions

19. If a bond is exchanged or converted into other securities (including conversions of mandatory convertible securities addressed in paragraph 9), the fair value of the bond surrendered at the date of the exchange or conversion shall become the cost basis for the new securities with any gain or loss realized at the time of the exchange or conversion. However, if the fair value of the securities received in an exchange or conversion is more clearly evident than the fair value of the bond surrendered, then it shall become the cost basis for the new securities.

Disclosures

20. The financial statements shall include the following disclosures:

a. Fair value in accordance with *SSAP No. 100—Fair Value Measurements*;

b. Concentrations of credit risk in accordance with *SSAP No. 27—Disclosure of Information* a*bout Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* (SSAP No. 27);

c. The basis at which the bonds are stated;

d. Amortization method;

e. For each balance sheet presented, the book/adjusted carrying values, fair values, excess of book/carrying value over fair value or fair value over book/adjusted carrying values for each pertinent bond category issued by:

i. U.S. Governments;

ii. All Other Governments;

iii. States, Territories and Possessions (Direct and Guaranteed);

iv. Political Subdivisions of States, Territories and Possessions (Direct and Guaranteed);

v. Special Revenue & Special Assessment Obligations and all Non-Guaranteed Obligations of Agencies and Authorities of Governments and Their Political Subdivisions;

vi. Industrial & Miscellaneous (Unaffiliated);

vii. Hybrid Securities;

viii. Parent, Subsidiaries and Affiliates;

f. For the most recent balance sheet, the book/adjusted carrying values and the fair values of bonds due:

i. In one year or less;

ii. After one year through five years;

iii. After five years through ten years;

iv. After ten years; and

g. For each period for which results of operations are presented, the proceeds from sales of such bonds and gross realized gains and gross realized losses on such sales.

h. For each balance sheet presented, all bonds in an unrealized loss position for which other-than-temporary declines in value have not been recognized

i. The aggregate amount of unrealized losses (that is, the amount by which cost or amortized cost exceeds fair value) and

ii. The aggregate related fair value of bonds with unrealized losses.

i. The disclosures in paragraphs 20.h.i. and 20.h.ii. should be segregated by those bonds that have been in a continuous unrealized loss position for less than 12 months and those that have been in a continuous unrealized loss position for 12 months or longer using fair values determined in accordance with SSAP No. 100.

j. As of the most recent balance sheet date presented, additional information should be included describing the general categories of information that the investor considered in reaching the conclusion that the impairments are not other-than-temporary.

k. When it is not practicable to estimate fair value in accordance with SSAP No. 100, the investor should disclose the following additional information, if applicable, as of each date for which a statement of financial position is presented in its annual financial statements:

i. The aggregate carrying value of the investments not evaluated for impairment, and

ii. The circumstances that may have a significant adverse effect on the fair value.

l. Separately identify structured notes, on a CUSIP basis, with information by CUSIP for actual cost, fair value, book/adjusted carrying value, and whether the structured note is a mortgage-referenced security.[2]

21. Refer to the preamble for further discussion regarding disclosure requirements. The disclosures in paragraphs 20.b., 20.e., 20.f., 20.g., 20.h., 20.i., 20.j. and 20.k. shall be included in the annual audited statutory financial reports only.

Relevant Literature

22. This statement adopts *AICPA Statement of Position 90-11, Disclosure of Certain Information by Financial Institutions About Debt Securities Held as Assets,* and *AICPA Practice Bulletin No. 4, Accounting for Foreign Debt/Equity Swaps*. This statement also adopts *FASB Staff Position 115-1/124-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*, paragraph 16, with modification to be consistent with statutory language in the respective statutory accounting statements.

23. This statement rejects the GAAP guidance for debt securities, which is contained in *FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities, FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases, FASB Emerging Issues Task Force No. 89-18, Divestitures of Certain Investment Securities to an Unregulated Commonly Controlled Entity under FIRREA,* and *FASB Emerging Issues Task Force No. 96-10, Impact of Certain Transactions on Held-to-Maturity Classifications Under FASB Statement No. 115.*

Effective Date and Transition

24. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors.* The guidance in paragraphs 11 and 12 was previously included within *SSAP No. 99—Accounting for Securities Subsequent to an Other-Than-Temporary Impairment* and was effective for reporting periods beginning on January 1 2009, and thereafter, with early adoption permitted. In 2010, the guidance from SSAP No. 99 was incorporated within the impacted standards, with SSAP No. 99 superseded. The original impairment guidance included in this standard, and the substantive revisions reflected in SSAP No. 99 are retained for historical purposes in Issue Paper No. 131. Guidance reflected in paragraph 8, incorporated from *INT 02-05: Accounting for Zero Coupon Convertible Bonds*, was originally effective December 8, 2002. Guidance adopted in December 2013 clarifying the 'yield to worst' concept for bonds with make whole call provisions is a nonsubstantive change initially effective January 1, 2014, unless the company has previously been following the guidance. (Companies that have previously been following the original intent, as clarified in the revisions, should not be impacted by these changes.)

REFERENCES

Other

- *Purposes and Procedures Manual of the NAIC Investment Analysis~~Securities Valuation~~ Office*
- NAIC Valuation of Securities product prepared by the Securities Valuation Office

[2] Determination of a "structured note" and "mortgage-referenced security" for this disclosure shall follow the definitions adopted within the *Purposes and Procedures Manual of the NAIC Investment Analysis Office.*

Relevant Issue Papers

- *Issue Paper No. 26—Bonds, Excluding Loan-Backed and Structured Securities*
- *Issue Paper No. 131—Accounting for Certain Securities Subsequent to an Other-Than-Temporary Impairment*

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Statement of Statutory Accounting Principles No. 27

Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk

STATUS

Type of Issue:	Common Area
Issued:	Initial Draft
Effective Date:	January 1, 2001
Affects:	No other pronouncements
Affected by:	No other pronouncements
Interpreted by:	No other pronouncements

STATUS **1**

SCOPE OF STATEMENT **3**

SUMMARY CONCLUSION **3**

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Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for disclosure of information about financial instruments with off-balance-sheet risk and financial instruments with concentration of credit risk.

SUMMARY CONCLUSION

2. A financial instrument shall be defined as cash, evidence of an ownership interest in an entity, or a contract that both:

a. Imposes on one entity a contractual obligation (i) to deliver cash or another financial instrument to a second entity or (ii) to exchange other financial instruments on potentially unfavorable terms with the second entity; and

b. Conveys to that second entity a contractual right (i) to receive cash or another financial instrument from the first entity or (ii) to exchange other financial instruments on potentially favorable terms with the first entity.

3. Examples of the financial instruments, which encompass both assets and liabilities recognized and not recognized in the financial statement, to which this statement applies include, but are not limited to, short-term investments, bonds, common stocks, preferred stocks, mortgage loans, derivatives[1], financial guarantees written, standby letters of credit, notes payable and deposit-type contracts.

Disclosure of Extent, Nature, and Terms of Financial Instruments with Off-Balance-Sheet Risk

4. For financial instruments[2] with off-balance-sheet risk, except as noted in paragraphs 14 and 15 of *FASB Statement No. 105, Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* (FAS 105), a reporting entity shall disclose in the financial statements the following information by class of financial instrument:

a. The face or contract amount (or notional principal amount if there is no face or contract amount); and

b. The nature and terms including, at a minimum, a discussion of (i) the credit and market risk of those instruments, (ii) the cash requirements of those instruments, and (iii) the related accounting policy pursuant to the requirements of *APB Opinion No. 22, Disclosure of Accounting Policies*.

5. Additional disclosures related to derivatives and embedded credit derivatives are addressed in *SSAP No. 86—Accounting for Derivative Instruments and Hedging, Income Generation, and Replication (Synthetic Asset) Transactions* (SSAP No. 86*)*.

[1] The financial instruments captured within this Statement shall include financial instruments that contain embedded derivatives that are not separately recognized as financial instruments with derivatives under SSAP No. 86, and that expose the holder to the possibility (however remote) of making future payments.

[2] See Footnote 1

Disclosure of Credit Risk of Financial Instruments with Off-Balance-Sheet Credit Risk

6. For financial instruments[3] with off-balance-sheet credit risk, except as noted in paragraphs 14 and 15 of FAS 105, an entity shall disclose in the financial statements the following information by class of financial instrument:

a. The amount of accounting loss the entity would incur if any party to the financial instrument failed completely to perform according to the terms of the contract and the collateral or other security, if any, for the amount due proved to be of no value to the entity; and

b. The entity's policy of requiring collateral or other security to support financial instruments subject to credit risk, information about the entity's access to that collateral or other security, and the nature and a brief description of the collateral or other security supporting those financial instruments.

Disclosure of Concentrations of Credit Risk of All Financial Instruments

7. Except as noted in paragraph 14 of FAS 105, a reporting entity shall disclose all significant concentrations of credit risk arising from all financial instruments[4] whether from an individual or group. Group concentrations of credit risk exist if a number of individuals or groups are engaged in similar activities and have similar economic characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic or other conditions. The following shall be disclosed in the financial statements about each significant concentration:

a. Information about the (shared) activity, region, or economic characteristic that identifies the concentration;

b. The amount of the accounting loss due to credit risk the entity would incur if parties to the financial instruments that make up the concentration failed completely to perform according to the terms of the contracts and the collateral or other security, if any, for the amount due proved to be of no value to the entity; and

c. The entity's policy of requiring collateral or other security to support financial instruments subject to credit risk, information about the entity's access to that collateral or other security, and the nature and a brief description of the collateral or other security supporting those financial instruments.

Annual and Quarterly Disclosure Requirements

8. Refer to the preamble for further information regarding disclosure requirements. The disclosures in paragraph 7 shall be included in the annual audited statutory financial reports only.

Relevant Literature

9. This statement adopts the provisions of FAS 105 with the following modifications:

a. The disclosures required in paragraph 17 of FAS 105 shall distinguish between derivatives entered into for hedging purposes and for other-than-hedging purposes.

[3] See Footnote 1

[4] See Footnote 1

b. Paragraph 19 of FAS 105 is rejected. It addresses voluntary disclosures not required by this statement.

Effective Date and Transition

10. This statement is effective for years beginning January 1, 2001.

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 27—Disclosure of Information about Financial Instruments with Concentration of Credit Risk*
- *Issue Paper No. 33—Disclosures about Fair Value of Financial Instruments*
- *Issue Paper No. 85—Derivative Instruments (as it relates to disclosure about financial instruments with off-balance-sheet risk)*

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Statement of Statutory Accounting Principles No. 29

Prepaid Expenses

STATUS

Type of Issue:	Common Area
Issued:	Initial Draft
Effective Date:	January 1, 2001
Affects:	Supersedes SSAP No. 87 with guidance incorporated August 2011 Nullifies and incorporates INT 08-04
Affected by:	No other pronouncements
Interpreted by:	No other pronouncements

STATUS **1**

SCOPE OF STATEMENT **3**

SUMMARY CONCLUSION **3**

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Prepaid Expenses

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for the accounting for prepaid expenses. This statement does not address accounting for deferred policy acquisition costs and other underwriting expenses, income taxes, and guaranty fund assessments. This statement does not address nonrefundable advance payments for goods or services received for use in future research and development activities, which are addressed in *SSAP No. 17—Preoperating and Research and Development Costs.*

SUMMARY CONCLUSION

2. A prepaid expense is an amount which has been paid in advance of receiving future economic benefits anticipated by the payment. Prepaid expenses generally meet the definition of assets in *SSAP No. 4—Assets and Nonadmitted Assets* (SSAP No. 4). Such expenditures also meet the criteria defining nonadmitted assets as specified in SSAP No. 4, (i.e., the assets are not readily available to satisfy policyholder obligations). Prepaid expenses shall be reported as nonadmitted assets and charged against unassigned funds (surplus). They shall be amortized against net income as the estimated economic benefit expires.

3. In accordance with the reporting entity's written capitalization policy, prepaid expenses less than a predefined threshold shall be expensed when purchased. The reporting entity shall maintain a capitalization policy containing the predefined thresholds for each asset class to be made available for the department(s) of insurance.

Disclosures

4. The financial statements shall disclose if the written capitalization policy and the resultant predefined thresholds changed from the prior period and the reason(s) for such change.

Relevant Literature

5. This statement rejects *AICPA Practice Bulletin No. 13, Direct-Response Advertising and Probable Future Benefits, AICPA Statement of Position 93-7, Reporting on Advertising Costs* and *FASB Emerging Issues Task Force No. 88-23, Lump-Sum Payments under Union Contracts*.

Effective Date and Transition

6. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*. Guidance reflected in paragraphs 3 and 4, incorporated from SSAP No. 87, was originally effective for years beginning on and after January 1, 2004.

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 29—Prepaid Expenses (excluding deferred policy acquisition costs and other underwriting expenses, income taxes and guaranty fund assessments)*

- *Issue Paper No. 119—Capitalization Policy, An Amendment to SSAP Nos. 4, 19,29, 73, 79 and 82*

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Statement of Statutory Accounting Principles No. 30

Investments in Common Stock (excluding investments in common stock of subsidiary, controlled or affiliated entities)

STATUS

Type of Issue:	Common Area
Issued:	Initial Draft
Effective Date:	January 1, 2001
Affects:	Nullifies INT 02-07
Affected by:	No other pronouncements
Interpreted by:	INT 06-02, INT 06-07

STATUS 1

SCOPE OF STATEMENT 3

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Investments in Common Stock (excluding investments in common stock of subsidiary, controlled, or affiliated entities)

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for common stocks.

2. Investments in common stock of subsidiaries, controlled or affiliated entities (investments in affiliates) are not within the scope of this statement. They are addressed in *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities, A Replacement of SSAP No. 88*.

SUMMARY CONCLUSION

3. Common stocks (excluding investments in affiliates) are securities which represent a residual ownership in a corporation and shall include:

a. Publicly traded common stocks;

b. Master limited partnerships trading as common stock and American deposit receipts only if the security is traded on the New York, American, or NASDAQ exchanges;

c. Publicly traded common stock warrants;

d. Shares of mutual funds, except for certain money market funds, Class 1 Bond Funds, and Exchange Traded Funds, which qualify for bond or preferred stock treatment, as designated in the *Purposes and Procedures Manual of the NAIC Investment Analysis~~Securities Valuation~~ Office*, regardless of the types or mix of securities owned by the fund, e.g., bonds, stocks, money market instruments, or other type of investments;

e. Common stocks that are not publicly traded, including equity interests in certified capital companies in accordance with *INT 06-02: Accounting and Reporting for Investments in a Certified Capital Company (CAPCO)*; and

f. Common stocks that are restricted as to transfer of ownership. Restricted stock shall be defined as a security for which sale is restricted by governmental or contractual requirement (other than in connection with being pledged as collateral), except where that requirement terminates within one year or if the holder has the power by contract or otherwise to cause the requirement to be met within one year. Any portion of the security that can be reasonably expected to qualify for sale within one year is not considered restricted. Regardless of redemption timeframe, FHLB capital stock is considered restricted stock until actual redemption by the FHLB.

4. Common stocks meet the definition of assets as defined in *SSAP No. 4—Assets and Nonadmitted* Assets and are admitted assets to the extent they conform to the requirements of this statement.

Acquisitions and Sales

5. At acquisition, common stocks shall be reported at their cost, including brokerage and other related fees. Common stock acquisitions and dispositions shall be recorded on the trade date. Private placement stock transactions shall be recorded on the funding date.

6. A reporting entity can subscribe for the purchase of stock, but not be required to make payment until a later time. Transactions of this nature are common in the formation of corporations. Common stock acquired under a subscription represents a conditional transaction in a security authorized for issuance but

not yet actually issued. Such transactions are settled if and when the actual security is issued and the exchange or National Association of Securities Dealers (NASD) rules that the transactions are to be settled. Common stock acquired under a subscription shall be recorded as an admitted asset when the reporting entity or its designated custodian or transfer agent takes delivery of the security and the security is recorded in the name of the reporting entity or its nominee (i.e., the accounting for such common stock acquisitions shall be on the settlement date).

Balance Sheet Amount

7. Investments in unaffiliated common stocks shall be valued at fair value. For FHLB capital stock, which is only redeemable at par, the fair value shall be presumed to be par, unless considered other-than-temporarily impaired.

8. For reporting entities required to maintain an Asset Valuation Reserve (AVR), the accounting for unrealized capital gains and losses shall be in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve* (SSAP No. 7). For reporting entities not required to maintain an AVR, unrealized capital gains and losses shall be recorded as a direct credit or charge to surplus.

Impairment

9. For any decline in the fair value of a common stock which is determined to be other than temporary [INT 06-07] the common stock shall be written down to fair value as the new cost basis and the amount of the write down shall be accounted for as a realized loss. For those reporting entities required to maintain an AVR, realized losses shall be accounted for in accordance with SSAP No. 7. Subsequent fluctuations in fair value shall be recorded as unrealized gains or losses. Future declines in fair value which are determined to be other than temporary shall be recorded as realized losses. A decline in fair value which is other than temporary includes situations where a reporting entity has made a decision to sell a security at an amount below its carrying value.

Income

10. Dividends on common stock shall be recorded as investment income on the ex-dividend date with a corresponding receivable to be extinguished upon receipt of cash (i.e., dividend income shall be recorded on stocks declared to be ex-dividends on or prior to the statement date).

11. For reporting entities required to maintain an AVR, the accounting for realized capital gains and losses on sales of common stock shall be in accordance with SSAP No. 7. For reporting entities not required to maintain an AVR, realized gains and losses on sales of common stock shall be reported as realized gains/losses in the statement of operations.

Stock Splits, Stock Dividends, Payment in Kind Dividends, and Stock Exchanges

12. Stock splits, stock dividends, payment in kind dividends, and stock exchanges shall be accounted for in accordance with *SSAP No. 95—Exchange of Nonmonetary Assets, A Replacement of SSAP No. 28—Nonmonetary Transactions* (SSAP No. 95).

FHLB Capital Stock

13. FHLB capital stock is held by reporting entities that are members of an FHLB. Each reporting entity must acquire FHLB capital stock for membership and maintain capital stock holding sufficient to

support its business activity (borrowings[1]) in accordance with the respective FHLB's capital plan. The price of FHLB capital stock cannot fluctuate, and all FHLB capital stock must be purchased, repurchased or transferred at its par value. FHLB capital stock is restricted for redemption in accordance with the FHLB capital plan and shall be coded as restricted within the financial statements (e.g., investment schedules and general interrogatories).

14. Acquisition of FHLB capital stock allows members to conduct business activity (borrowings) from an FHLB. The amount of capital stock acquired determines the reporting entity's eligible borrowing amount. At a minimum, all borrowings from an FHLB (regardless of structure) must also be fully collateralized in accordance with the FHLB capital plan, which determines the amount of collateral required by type of pledged instrument. Collateral pledged to an FHLB shall be coded as restricted within the financial statements (e.g., investments schedules and general interrogatories). Collateral pledged to an FHLB is considered an admitted asset if all of the following conditions are met:

a. the asset would have been admitted under SSAP No. 4;

b. the pledging insurer continues to receive the income on the pledged collateral;

c. the pledging insurer can remove and substitute other securities with little or advance notice to the FHLB as long as the insurer complies with related investment quality and market value provisions; and

d. there has been no uncured default or event to indicate an impairment or loss contingency for the pledged assets.

Disclosures

15. The following disclosures regarding common stocks shall be made in the financial statements:

a. Basis at which the common stocks are stated; and

b. A description, as well as the amount, of common stock that is restricted outside of FHLB agreements and the nature of the restriction. (Disclosures of FHLB capital stock are captured in paragraph 16.)

c. For each balance sheet presented, all common stocks in an unrealized loss position for which other-than-temporary declines in value have not been recognized

i. The aggregate amount of unrealized losses (that is, the amount by which cost or amortized cost exceeds fair value) and

ii. The aggregate related fair value of common stocks with unrealized losses.

d. The disclosures in (i) and (ii) above should be segregated by those common stocks that have been in a continuous unrealized loss position for less than 12 months and those that have been in a continuous unrealized loss position for 12 months or longer using fair values determined in accordance with *SSAP No. 100—Fair Value Measurements*.

[1] Membership in an FHLB allows reporting entities to take advances / borrow from the FHLB. These borrowings can be structured in a variety of ways, for example: debt, funding agreements, repurchase agreements, securities lending, etc. Borrowings from an FHLB shall be reflected in the financial statements in accordance with the SSAP that addresses the substance of the agreement.

e. As of the most recent balance sheet presented, additional information should be included describing the general categories of information that the investor considered in reaching the conclusion that the impairments are not other-than-temporary.

f. When it is not practicable to estimate fair value, the investor should disclose the following additional information, if applicable, as of each date for which a statement of financial position is presented in its annual financial statements:

i. The aggregate carrying value of the investments not evaluated for impairment, and

ii. The circumstances that may have a significant adverse effect on the fair value.

FHLB Disclosures

16. For FHLB agreements, the following information shall be disclosed in the financial statements for current and prior year and between general account and separate account activity. The information in the disclosures shall be presented gross even if a right to offset per SSAP No. 64 exists.

a. General description of FHLB agreements, with information on the nature of the agreement, type of borrowing (advances, lines of credit, borrowed money, etc.) and use of the funding.

b. Amount of FHLB capital stock held, in aggregate, and classified as follows: i) membership stock (separated by Class A and Class B); ii) Activity Stock; and iii) Excess Stock. For membership stock, report the amount of FHLB capital stock eligible for redemption[2] and the anticipated timeframe for redemption: i) less than 6 months, ii) 6 months to 1 year, iii) 1 year to 3 years, and iv) 3 to 5 years.

c. Amount (fair value and carrying value) of collateral pledged to the FHLB as of the reporting date, In addition, report the maximum amount of collateral pledged to the FHLB at any time during the current reporting period. (Maximum shall be determined on the basis of carrying value, but with fair value also reported)

d. Aggregate amount of borrowings at the reporting date from the FHLB, reflecting compilation of all advances, loans, funding agreements, repurchase agreements, securities lending, etc., outstanding with the FHLB, and classify whether the borrowing is in substance: i) debt (*SSAP No. 15—Debt and Holding Company Obligations*), ii) a funding agreement (*SSAP No. 52—Deposit-Type Contracts*), or iii) Other. For funding agreements, report the total reserves established. Report the maximum amount of aggregate borrowings from an FHLB at any time during the current reporting period, the actual or estimated maximum borrowing capacity as determined by the insurer, with a description of how the borrowing capacity was determined, and whether current borrowings are subject to prepayment penalties.

17. The disclosures in paragraphs 15.c. through 15.f. shall be included in the annual audited statutory financial reports only. The FHLB disclosures in paragraph 16 are required in all interim and annual financial statements regardless if the activity is materially different from the activity reported during the prior reporting period. Refer to the Preamble for further discussion regarding disclosure requirements.

[2] For FHLB membership stock to be eligible for redemption, written notification must have been provided to the FHLB prior to the reporting date.

Relevant Literature

18. This statement rejects *FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities*.

Effective Date and Transition

19. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*. Revisions adopted to this statement in October 2013 amending SSAP No. 15 and SSAP No. 52 to incorporate FHLB disclosure information are initially effective for interim and annual reporting periods after January 1, 2014.

REFERENCES

Other

- *Purposes and Procedures Manual of the NAIC Investment Analysis~~Securities Valuation~~ Office*
- NAIC Valuation of Securities product prepared by the Securities Valuation Office

Relevant Issue Papers

- *Issue Paper No. 30—Investments in Common Stock (excluding investments in common stock of subsidiary, controlled, or affiliated entities)*

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Statement of Statutory Accounting Principles No. 32

Investments in Preferred Stock (including investments in preferred stock of subsidiary, controlled, or affiliated entities)

STATUS

Type of Issue:	Common Area
Issued:	Initial Draft
Effective Date:	January 1, 2001
Affects:	Supersedes SSAP No. 99 with guidance incorporated November 2010 Nullifies and incorporates INT 99-29
Affected by:	No other pronouncements
Interpreted by:	INT 06-02; INT 06-07

STATUS 1

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Investments in Preferred Stock (including investments in preferred stock of subsidiary, controlled, or affiliated entities)

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for preferred stock.

2. Investments in preferred stock of subsidiaries, controlled or affiliated entities, including preferred stock interests of certified capital companies (CAPCO) per *INT 06-02: Accounting and Reporting for Investments in a Certified Capital Company (CAPCO)* are included within the scope of this statement.

SUMMARY CONCLUSION

3. Preferred stock which may or may not be publicly traded, is defined as any class or series of shares the holders of which have any preference, either as to the payment of dividends or distribution of assets on liquidation, over the holder of common stock (as defined in *SSAP No. 30—Investments in Common Stock (excluding investments in common stock of subsidiary, controlled, or affiliated entities)*) issued by an entity. Preferred stock shall include but not be limited to:

a. Redeemable preferred stock, including mandatory sinking fund preferred stock and preferred stock redeemable at the option of the holder;

b. Perpetual preferred stock, including nonredeemable preferred stock and preferred stock redeemable at the option of the issuer; and

c. Exchange Traded Funds, which qualify for preferred stock treatment, as identified in the *Purposes and Procedures Manual of the NAIC Investment Analysis~~Securities Valuation~~ Office.*

4. Redeemable preferred stock is defined as preferred stock that must be redeemed by the issuing enterprise or is redeemable at the option of the reporting entity. It includes mandatory sinking fund preferred stock and payment-in-kind (PIK) preferred stock.

5. Mandatory sinking fund preferred stock is defined as redeemable preferred stock subject to a 100% mandatory sinking fund, annual installments of which will (a) commence not more than 10 years from the date of issue or December 31, 1978, if outstanding on that date; (b) be not less than 2% of the number of shares issued (or outstanding on December 31, 1978, if issued prior to that date); (c) provide for the redemption of the entire issue over a period not longer than 40 years from the date of issue, or December 31, 1978, if outstanding on that date. Redeemable preferred stock which is subject to a 100% mandatory sinking fund, but which does not, at date of issue or December 31, 1978, if outstanding at that time, meet one or more of the other requirements above, shall be considered as mandatory sinking fund preferred stock at the time the deficiency is cured through the passage of time or otherwise.

6. PIK preferred stock is defined as redeemable preferred stock on which, at the option of the issuer, dividends can be paid in additional securities rather than cash.

7. Perpetual preferred stock is defined as preferred stock with no redemption or sinking fund features or preferred stock redeemable at the option of the issuer.

8. Restricted preferred stock is defined as a security for which sale is restricted by governmental or contractual requirement (other than in connection with being pledged as collateral) except where that requirement terminates within one year or if the holder has the power by contract or otherwise to cause the requirement to be met within one year. Any portion of the security that can be reasonably expected to qualify for sale within one year is not considered restricted.

9. Preferred stocks meet the definition of assets as defined in *SSAP No. 4—Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this statement.

Acquisitions and Sales

10. At acquisition, preferred stock shall be reported at cost, including brokerage and other related fees. PIK stock received as dividends shall be recorded at fair value. Acquisitions and dispositions shall be recorded on the trade date. Private placement stock transactions shall be recorded on the funding date.

11. A reporting entity can subscribe for the purchase of stock, but not be required to make payment until a later time. Transactions of this nature are common in the formation of corporations. Preferred stock acquired under a subscription represents a conditional transaction in a security authorized for issuance but not yet actually issued. Such transactions are settled if and when the actual security is issued and the exchange or National Association of Securities Dealers (NASD) rules that the transactions are to be settled. Preferred stock acquired under a subscription shall be recorded as an admitted asset when the reporting entity or its designated custodian or transfer agent takes delivery of the security and the security is recorded in the name of the reporting entity or its nominee, (i.e., the accounting for such preferred stock acquisitions shall be on the settlement date).

Amortization

12. Redeemable preferred stock purchased at a premium shall be amortized to reduce the carrying value to the call or redemption value over the period to the call or earliest redemption date, whichever produces the lowest asset value (yield to worst). Redeemable preferred stock purchased at a discount shall be amortized to increase the carrying value to par value over the period to maturity or the latest redemption date.

13. PIK preferred stock shall be amortized to the lower of the call price or par value, measured in either case at the end of the stock dividend period and based on all of the shares expected to be held at the end of that period, including those received as dividends.

14. Amortization shall be calculated using the interest method and shall be reported as increases or decreases in dividends collected during the year.

Balance Sheet Amount

15. The NAIC Securities Valuation Office classifies preferred stocks into six redeemable preferred stock quality categories (designations RP1 through RP6) and six perpetual preferred stock quality categories (designation P1 through P6.) Preferred stocks shall be classified in accordance with the *Purposes and Procedures Manual of the NAIC Investment Analysis~~Securities Valuation~~ Office* and the designation assigned in the *Valuations of Securities* product prepared by the NAIC Securities Valuation Office.

16. Preferred stock shall be valued based on (a) the underlying characteristics of the security, (b) the quality rating of the security as defined in the *Purposes and Procedures Manual of the NAIC Investment Analysis~~Securities Valuation~~ Office* and assigned in the NAIC *Valuations of Securities* product, and (c) whether an Asset Valuation Reserve (AVR) is maintained by the reporting entity. For reporting entities that maintain an AVR, redeemable preferred stocks and perpetual preferred stocks designated highest-quality, high-quality and medium-quality (NAIC designations RP1 to RP3 and P1 to P3, respectively) shall be reported at book value; redeemable preferred stocks and perpetual preferred stocks that are designated low quality, lowest quality and in or near default (NAIC designations RP4 to RP6 and P4 to P6, respectively) shall be reported at the lower of book value or fair value. For reporting entities that do not maintain an AVR, redeemable preferred stocks designated highest-quality and high-quality (NAIC designations RP1 and RP2, respectively) shall be reported at book value; perpetual preferred stocks

designated highest-quality and high-quality (NAIC designations P1 and P2, respectively) shall be reported at fair value; and redeemable preferred stocks and perpetual preferred stocks that are designated medium quality, low quality, lowest quality and in or near default (NAIC designations RP3 to RP6 and P3 to P6, respectively) shall be reported at the lower of book value or fair value.

17. Step-up preferred stock (a security with the structure of a preferred stock, that has the cash flow characteristics of a debt instrument) is considered a security with characteristics of both debt and equity, and the accounting and valuation of such securities shall be consistent with SVO guidelines as stipulated in the *Purposes and Procedures Manual of the NAIC* *Investment Analysis*~~*Securities Valuation*~~ *Office*.

18. For reporting entities required to maintain an AVR, the accounting for unrealized gains and losses shall be in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve* (SSAP No. 7). For reporting entities not required to maintain an AVR, unrealized gains and losses shall be recorded as a direct credit or charge to unassigned funds (surplus).

Reporting Entities That Do Not Maintain An AVR

19. Highest-quality or high-quality redeemable preferred stocks (NAIC designations 1 and 2), which have characteristics of debt securities, shall be valued at cost or amortized cost. All other redeemable preferred stocks (NAIC designations 3 to 6) shall be reported at the lower of cost, amortized cost, or fair value.

20. Highest-quality or high-quality perpetual preferred stocks (NAIC designations 1 and 2), which have characteristics of equity securities, shall be reported at fair value. All other perpetual preferred stocks (NAIC designations 3 to 6) shall be reported at the lower of cost or fair value.

Reporting Entities That Do Maintain An AVR

21. Highest-quality, high-quality or medium quality redeemable preferred stocks (NAIC designations 1 to 3), which have characteristics of debt securities, shall be valued at cost or amortized cost. All other redeemable preferred stocks (NAIC designations 4 to 6) shall be reported at the lower of cost, amortized cost, or fair value.

22. Highest-quality, high-quality or medium quality perpetual preferred stocks (NAIC designations 1 to 3), which have characteristics of equity securities, shall be valued at cost. All other perpetual preferred stocks (NAIC designations 4 to 6) shall be reported at the lower of cost or fair value.

Impairment of Redeemable Preferred Stock

23. An other-than-temporary (INT 06-07) impairment shall be considered to have occurred if it is probable that the reporting entity will be unable to collect all amounts due according to the contractual terms of the security in effect at the date of acquisition. A decline in fair value which is other-than-temporary includes situations where the reporting entity has made a decision to sell a security prior to its maturity at an amount below its carrying value (i.e., amortized cost). If it is determined that a decline in the fair value of a redeemable preferred stock is other-than-temporary, an impairment loss shall be recognized as a realized loss equal to the entire difference between the redeemable preferred stock's carrying value and its fair value at the balance sheet date of the reporting period for which the assessment is made. The measurement of the impairment loss shall not include partial recoveries of fair value subsequent to the balance sheet date. For reporting entities required to maintain an AVR, realized losses shall be accounted for in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*.

24. In periods subsequent to the recognition of other-than-temporary impairment loss for a redeemable preferred stock, the reporting entity shall account for the other-than-temporarily impaired security as if the security had been purchased on the measurement date of the other-than-temporary impairment, and in accordance with paragraph 19 or paragraph 21, as applicable. The fair value of the redeemable preferred stock on the measurement date shall become the new cost basis of the redeemable preferred stock and the new cost basis shall not be adjusted for subsequent recoveries in fair value. The discount or reduced premium recorded for the security, based on the new cost basis, shall be amortized over the remaining life of the security in the prospective manner based on the amount and timing of future estimated cash flows. The security shall continue to be subject to impairment analysis for each subsequent reporting period. Future declines in fair value which are determined to be other-than-temporary shall be recorded as realized losses.

Impairment of Perpetual Preferred Stock

25. If it is determined that a decline in the fair value of a perpetual preferred stock is other-than-temporary (INT 06-07), an impairment loss shall be recognized as a realized loss equal to the entire difference between the perpetual preferred stock's carrying value and its fair value at the balance sheet date of the reporting period for which the assessment is made. The measurement of the impairment loss shall not include partial recoveries of fair value subsequent to the balance sheet date. For reporting entities required to maintain an AVR, realized losses shall be accounted for in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*. A decline in fair value which is other-than-temporary includes situations where the reporting entity has made a decision to sell a security at an amount below its carrying value.

26. In periods subsequent to the recognition of an other-than-temporary impairment loss for a perpetual preferred stock, the reporting entity shall account for the other-than-temporarily impaired security as if the security had been purchased on the measurement date of the other-than-temporary impairment, and in accordance with paragraph 20 or paragraph 22, as applicable. The fair value of the perpetual preferred stock on the measurement date shall become the new cost basis of the perpetual preferred stock and the new cost basis shall not be adjusted for subsequent recoveries in fair value. Future declines in fair value which are determined to be other-than-temporary, shall be recorded as realized losses.

Income

27. Dividends on preferred stock (whether cumulative or noncumulative), other than mandatorily redeemable preferred stock, shall be recorded as investment income on the ex-dividend date with a corresponding receivable to be extinguished upon receipt of cash (i.e., dividend income shall be recorded on preferred stock declared to be ex-dividend on or prior to the statement date).

28. Dividends on mandatorily redeemable preferred stock shall be accrued to the redemption price, even if not declared, using the interest method over the period ending on the redemption date.

29. Cash dividends paid on PIK stock during the stock dividend period shall be accounted for as a reduction in the investment.

Exchanges and Conversions

30. If preferred stock is exchanged or converted into other securities, the fair value of the preferred stock surrendered at the date of the exchange or conversion shall become the cost basis for the new securities with any gain or loss realized at the time of the exchange or conversion. However, if the fair value of the securities received in an exchange or conversion is more clearly evident than the fair value of the preferred stock surrendered, then it shall become the cost basis for the new securities.

Disclosures

31. The following disclosures regarding preferred stocks shall be made in the financial statements:

a. Fair values in accordance with *SSAP No. 100—Fair Value Measurements;*

b. Concentrations of credit risk in accordance with SSAP No. 27;

c. Basis at which the preferred stocks are stated; and

d. A description, as well as the amount, of preferred stock that is restricted and the nature of the restriction.

e. For each balance sheet presented, all preferred stocks in an unrealized loss position for which other-than-temporary declines in value have not been recognized

i. The aggregate amount of unrealized losses (that is, the amount by which cost or amortized cost exceeds fair value) and

ii. The aggregate related fair value of preferred stocks with unrealized losses.

f. The disclosures in (i) and (ii) above should be segregated by those preferred stocks that have been in a continuous unrealized loss position for less than 12 months and those that have been in a continuous unrealized loss position for 12 months or longer using fair values determined in accordance with *SSAP No. 100—Fair Value Measurements.*

g. As of the date of the most recent balance sheet presented, additional information should be included describing the general categories of information that the investor considered in reaching the conclusion that the impairments are not other-than-temporary.

h. When it is not practicable to estimate fair value, the investor should disclose the following additional information, if applicable, as of each date for which a statement of financial position is presented in its annual financial statements:

i. The aggregate carrying value of the investments not evaluated for impairment, and

ii. The circumstances that may have a significant adverse effect on the fair value.

32. Refer to the preamble for further discussion regarding disclosure requirements. The disclosure requirements of paragraphs 31.b., 31.e., 31.f., 31.g. and 31.h. shall be included in the annual audited statutory financial reports only.

Relevant Literature

33. This statement rejects *FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities* and *FASB Emerging Issues Task Force No. 86-32, Early Extinguishment of a Subsidiary's Mandatorily Redeemable Preferred Stock*. This statement adopts *FASB Staff Position 115-1/124-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments,* paragraph 16, with modification to be consistent with statutory language in the respective statutory accounting statements.

Effective Date and Transition

34. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors.* The guidance in paragraphs 23-26 was previously included within *SSAP No. 99—Accounting for Securities Subsequent to an Other-Than-Temporary Impairment* and was effective for reporting periods beginning on January 1, 2009, and thereafter, with early adoption permitted. In 2010, the guidance from SSAP No. 99 was incorporated within the impacted standards, with SSAP No. 99 superseded. The original impairment guidance included in this standard, and the substantive revisions reflected in SSAP No. 99 are retained for historical purposes within Issue Paper No. 131. The guidance in paragraphs 2 and 3 to SSAP No. 32 was originally superseded January 1, 2005, by guidance included in *SSAP No. 88—Investments in Subsidiaries, Controlled and Affiliated Entities, A replacement of SSAP No. 46*, and then subsequently reflected in *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities, A Replacement of SSAP No. 88.* In 2011, the guidance related to preferred stock of SCAs from SSAP No. 97 was incorporated into this statement and revised to reflect a definition of preferred stock. The original guidance included in this statement, and the substantive revisions reflected in SSAP No. 88 and SSAP No. 97 (including the title change already reflected in SSAP No. 32) are retained for historical purposes within Issue Paper Nos. 32 and 118.

REFERENCES

Other

- *Purposes and Procedures Manual of the NAIC Investment Analysis~~Securities Valuation~~ Office*
- NAIC Valuation of Securities product prepared by the Securities Valuation Office

Relevant Issue Papers

- *Issue Paper No. 32—Investments in Preferred Stock (excluding investments in preferred stock of subsidiary, controlled, or affiliated companies)*
- *Issue Paper No. 131—Accounting for Certain Securities Subsequent to an Other-Than-Temporary Impairment*

Statement of Statutory Accounting Principles No. 34

Investment Income Due and Accrued

STATUS

Type of Issue:	Common Area
Issued:	Initial Draft
Effective Date:	January 1, 2001
Affects:	Supersedes SSAP No. 99 with guidance incorporated November 2010
Affected by:	No other pronoucements
Interpreted by:	No other pronouncements

STATUS **1**

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Investment Income Due and Accrued

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for investment income due and accrued.

SUMMARY CONCLUSION

2. Investment income due shall be defined as investment income earned and legally due to be paid to the reporting entity (i.e., receivable) as of the reporting date. Investment income accrued shall be defined as investment income earned as of the reporting date but not legally due to be paid to the reporting entity until subsequent to the reporting date.

3. In general, gross investment income shall be recorded as earned and shall include investment income collected during the period, the change in investment income due and accrued, the change in unearned investment income plus any amortization (e.g., discounts or premiums on bonds, origination fees on mortgage loans, etc.) Immediate amortization of premium which occurs upon recognition of an other-than-temporary impairment loss for a debt security with a recorded premium shall be reported as a realized loss and shall not be included in investment income.

4. Investment income due and accrued shall be recorded as an asset in accordance with *SSAP No. 4—Assets and Nonadmitted Assets* (SSAP No. 4). An evaluation shall be made of such assets in accordance with *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets* (SSAP No. 5R), to determine whether an impairment exists. Amounts determined to be uncollectible shall be written off through the statement of operations. Then an evaluation shall be made to determine nonadmitted amounts.

5. This two-step process is set forth below.

   a. Investment income due and accrued shall be assessed for collectibility. If, in accordance with SSAP No. 5R, it is probable the investment income due and accrued balance is uncollectible, the amount shall be written off and shall be charged against investment income in the period such determination is made;

   b. Any remaining investment income due and accrued (i.e., amounts considered probable of collection) representing either (1) amounts that are over 90 days past due (generated by any invested asset except mortgage loans in default), or (2) amounts designated elsewhere in the *Accounting Practices and Procedures Manual* as nonadmitted shall be considered nonadmitted assets and recognized through a direct charge to surplus in accordance with SSAP No. 4. These nonadmitted amounts shall be subject to continuing assessments of collectibility and, if determined to be uncollectible, a write-off shall be recorded in the period such determination is made in accordance with paragraph 5.a.

6. Accrued interest on mortgage loans that are in default (as defined in *SSAP No. 37—Mortgage Loans*) shall be recorded as Investment Income Due and Accrued when such interest is deemed collectible. Interest can be accrued on mortgage loans in default if deemed collectible; if interest is deemed uncollectible, it shall not be accrued and any previously accrued amounts are to be written off in accordance with the guidelines in paragraph 5.a. If a mortgage loan in default has interest 180 days past due which has been assessed as collectible, all interest shall be considered a nonadmitted asset and recognized through a direct charge to surplus as outlined in paragraph 5.b.

Disclosures

7. The following disclosures shall be made for investment income due and accrued in the financial statements. (SSAP No. 37 captures disclosures for mortgage loans on nonaccrual status pursuant to paragraph 6.)

a. The bases by category of investment income for excluding (nonadmitting) any investment income due and accrued;

b. Disclose total amount excluded.

8. Refer to the preamble for further discussion regarding disclosure requirements.

Effective Date and Transition

9. This statement adopts *FASB Staff Position 115-1/124-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments,* paragraph 16, with modification to be consistent with statutory language in the respective statutory accounting statements.

10. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors.* The guidance in paragraph 3 was previously included within *SSAP No. 99—Accounting for Securities Subsequent to an Other-Than-Temporary Impairment* and was effective for reporting periods beginning on January 1, 2009, and thereafter, with early adoption permitted. In 2010, the guidance from SSAP No. 99 was incorporated within the impacted standards, with SSAP No. 99 superseded. The original paragraph 3 guidance from this standard, and the substantive revisions reflected in SSAP No. 99 are retained for historical purposes within Issue Paper No. 131.

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 34—Investment Income Due and Accrued*
- *Issue Paper No. 131—Accounting for Certain Securities Subsequent to an Other-Than-Temporary Impairment*

Statement of Statutory Accounting Principles No. 35 - Revised

Guaranty Fund and Other Assessments

STATUS

Type of Issue:	Common Area
Issued:	Finalized March 13, 2000; substantively revised October 18, 2010, December 15, 2013, and June 12, 2014
Effective Date:	January 1, 2001; substantive revisions detailed in Issue Paper No. 143 are effective January 1, 2011
Affects:	Nullifies INT 03-01 Nullifies and incorporates INT 07-03
Affected by:	SSAP No. 106
Interpreted by:	INT 02-22

STATUS 1

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Guaranty Fund and Other Assessments

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for guaranty fund and other assessments.

2. Guaranty fund assessments represent a funding mechanism employed by states to provide funds to cover policyholder obligations of insolvent reporting entities. Most states have enacted legislation establishing guaranty funds for both life and health insurance and for property and casualty insurance to provide for covered claims or to meet other insurance obligations of insolvent reporting entities in the state.

3. This statement addresses other assessments including but not limited to workers' compensation second injury funds and for funds that pay operating costs of an insurance department, a state guaranty fund, and/or the workers' compensation board. This statement also addresses health related assessments including but not limited to state health insurance high-risk pools, health insurance small group and individual reinsurance pools, state health demographic ~~or~~and risk adjustment assessments. Guidance regarding the Affordable Care Act Section 9010 assessment is provided in *SSAP No. 106—Affordable Care Act Section 9010 Assessment* (SSAP No. 106)~~ and the Affordable Care Act Section 9010 assessment~~.

SUMMARY CONCLUSION

4. This statement adopts with modification guidance from *Accounting Standard Codification 405-30,* Insurance-*Related Assessments* (ASC 405-30) as reflected within this SSAP. Consistent with ASC 405-30-25-1, entities subject to assessments shall recognize liabilities for insurance-related assessments when all of the following conditions are met (paragraph 14~~15~~ provides guidance on applying the recognition criteria):

a. An assessment has been imposed or information available prior to issuance of the statutory financial statements indicates that it is probable that an assessment will be imposed.

b. The event obligating an entity to pay an imposed or probable assessment has occurred on or before the date of the financial statements.

c. The amount of the assessment can be reasonably estimated.

Guaranty fund and other assessments shall be charged to expense (Taxes, Licenses and Fees) and a liability shall be accrued when the above criteria are met except for certain health related assessments which shall be reported as a part of claims. Health related assessments that are reported as a part of claims instead of taxes, licenses and fees are those assessments that are designed for the purpose of spreading the risk of severe claims or adverse enrollment selection among all participating entities, and where the funds collected via the assessment are re-distributed back to the participating entities based upon the cost of specific claims, enrollment demographics, or other criteria affecting health care expenses. This standard does not permit liabilities for guaranty funds or other assessments to be discounted.

~~5. *ASU 2011-06: Other Expenses – Fees Paid to the Federal Government by Health Insurers* (ASU 2011-06) is adopted with modifications reflected in this statement. ASU 2011-06 provides specific guidance related to the assessment in Section 9010 of the Affordable Care Act and the statutory accounting guidance is included in paragraphs 16-21.~~

~~6.~~5. For refunded guaranty or other fund assessments and assessments used to fund state operating expenses, reporting entities shall credit the refund or charge the assessment to expense when notification of the refund or assessment is made.

~~7.~~6. For premium-based guaranty fund assessments, except those that are prefunded, paragraph 4.a. is met when the insolvency has occurred. For purposes of applying this guidance, the insolvency shall be considered to have occurred when a reporting entity meets a state's (ordinarily the state of domicile of the insolvent reporting entity) statutory definition of an insolvent reporting entity. In most states, the reporting entity must be declared to be financially insolvent by a court of competent jurisdiction. In some states, there must also be a final order of liquidation. Prefunded guaranty-fund assessments and premium-based administrative type assessment are presumed probable when the premiums on which the assessments are expected to be based are written. Loss-based administrative-type and second injury fund assessments are presumed probable when the losses on which the assessments are expected to be based are incurred.

~~8.~~7. Paragraph 4.b. requires that the event obligating an entity to pay an imposed or probable assessment has occurred on or before the date of the financial statements. Based on the fundamental differences in how assessment mechanisms operate, the event that makes an assessment probable (for example, an insolvency) may not be the event that obligates an entity. The following defines the event that obligates an entity to pay an assessment:

a. For premium-based assessments, the event that obligates the entity is generally writing the premiums or becoming obligated to write or renew (such as multiple-year, noncancelable policies) the premiums on which the assessments are expected to be based. Some states, through law or regulatory practice, provide that an insurance entity cannot avoid paying a particular assessment even if that insurance entity reduces its premium writing in the future. In such circumstances, the event that obligates the entity is a formal determination of insolvency or similar triggering event. For example, in certain states, an insurance entity may remain liable for assessments even though the insurance entity discontinues the writing of premiums. In this circumstance, the underlying cause of the liability is not the writing of the premium, but the insolvency. Regulatory practice would be determined based on the stated intentions or prior history of the insurance regulators.

b. For loss-based assessments, the event that obligates an entity is an entity's incurring the losses on which the assessments are expected to be based.

~~9.~~8. Paragraph 4.c. requires that the amounts can be reasonably estimated. For retrospective-premium-based guaranty fund assessments, a reporting entity's estimate of the liability shall reflect an estimate of its share of the ultimate loss expected from the insolvency. The reporting entity shall also estimate any applicable premium tax credits and policy surcharges. An entity need not be able to compute the exact amounts of the assessments or be formally notified of such assessments by a guaranty fund to make a reasonable estimate of its liability. Entities subject to assessments may have to make assumptions about future events, such as when the fund making the assessment will incur costs and pay claims to determine the amounts and the timing of assessments. The best available information about market share or premiums by state and premiums by line of business generally should be used to estimate the amount of future assessments. Estimates of loss-based assessments should be consistent with estimates of the underlying incurred losses and should be developed based upon enacted laws or regulations and expected assessment rates. Premium tax credits or policy surcharges may only be considered in the estimate if it is probable they will be realized. Because of the uncertainties surrounding some insurance-related assessments, the range of assessment liability may have to be re-evaluated regularly during the assessment process. Changes in the amount of the liability (or asset) as information becomes available over time and revisions to estimates in the amount or timing of the payments shall be recorded in taxes, licenses and fees.

~~10.~~9. In accordance with SSAP No. 5R, when the reasonable estimate of the loss is a range, the amount in the range that is considered the best estimate shall be accrued. When, in management's opinion, no amount within management's estimate of the range is a better estimate than any other amount, however, the midpoint (mean) of management's estimate in the range shall be accrued. For purposes of this statement, it is assumed that management can quantify the high end of the range. If management determines that the high end of the range cannot be quantified, then a range does not exist, and management's best estimate shall be accrued.

Reporting Assets for Premium Tax Offsets and Policy Surcharges

~~11.~~10. The liability for accrued assessments shall be established gross of any probable and estimable recoveries from premium tax credits and premium surcharges. When it is probable that a paid or accrued assessment will result in an amount that is recoverable from premium tax offsets or policy surcharges, an asset shall be recognized for that recovery in an amount that is determined based on current laws, projections of future premium collections or policy surcharges from in-force policies, and as permitted in accordance with paragraphs ~~11~~10.a., ~~11~~10.b. and ~~11~~10.c. Any recognized asset from premium tax credits or policy surcharges shall be re-evaluated regularly to ensure recoverability. Upon expiration, tax credits no longer meet the definition of an asset and shall be written off.

a. For assessments paid before premium tax credits are realized or policy surcharges are collected, an asset results, which represents a receivable for premium tax credits that will be taken and policy surcharges which will be collected in the future. These receivables, to the extent it is probable they will be realized, meet the definition of assets, as specified in *SSAP No. 4—Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this statement. The asset shall be established and reported independent from the liability (not reported net).

b. Assets recognized from accrued liability assessments shall be determined in accordance with the type of guaranty fund assessment as detailed in the following subparagraphs. Assets recognized from accrued liability assessments meet the definition of an asset under SSAP No. 4, and are admitted assets to the extent they conform to the requirements of this statement.

i. For retrospective-premium-based and loss-based assessments, to the extent that it is probable that accrued liability assessments will result in a recoverable amount in a future period from business currently in-force considering appropriate persistency rates for long-duration contracts, an asset shall be recognized at the time the liability is recorded. In-force policies do not include expected renewals of short-term contracts.

ii. For prospective-premium-based assessments, the recognition of assets from accrued liability assessments is limited to the amount of premium an entity has written or is obligated to write and to the amounts recoverable over the life of the in-force policies. This SSAP requires reporting entities to recognize prospective-based-premium assessments as the premium is written or obligated to be written by the reporting entity. Accordingly, the expected premium tax offset or policy surcharge asset related to the accrual of prospective-premium-based assessments shall be based on and limited to the amount recoverable as a result of premiums the insurer has written or is obligated to write.

c. An asset shall not be established for paid or accrued assessments that are recoverable through future premium rate structures.

~~12.~~11. An evaluation of assets recognized under paragraph ~~11~~10 shall be made in accordance with *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets* (SSAP No. 5R) to determine if there is any impairment. If, in accordance with SSAP No. 5R, it is probable that the asset is no longer realizable, the asset shall be written off to the extent it is not realizable and charged to income in the period the determination is made. Considering expected future premiums other than on in-force policies in evaluating recoverability of premium tax offsets or policy surcharges is not permitted.

Acting as an Agent for Collection and Remittance of Fees and Assessments

~~13.~~12. In certain circumstances, a reporting entity acts as an agent for certain state or federal agencies in the collection and remittance of fees or assessments. In these circumstances, the liability for the fees and assessments rests with the policyholder rather than with the reporting entity. The reporting entity's obligation is to collect and subsequently remit the fee or assessment.(INT 02-22) When both the following conditions are met, an assessment shall not be reported in the statement of operations of a reporting entity:

a. The assessment is reflected as a separately identifiable item on the billing to the policyholder; and

b. Remittance of the assessment by the reporting entity to the state or federal agency is contingent upon collection from the insured.

~~14.~~13. The impact to the statement of operations depends on the nature of the charge:

a. For charges which are the ultimate responsibility of the policyholder, follow existing guidance in paragraph ~~13~~12, and pass these charges and recoveries through the balance sheet with no impact to the statement of operations.

b. For charges which are the ultimate responsibility of the reporting entity and may be recovered all or in part, apply gross or net reporting in the statement of operations as appropriate based on the nature of the charge and recovery. For example, charges which are considered in rate development or for which the recovery is classified as premium should be reported gross, charges for which recovery is considered a reduction of the expense should be reported net.

c. For collection or administrative fees, report such fees as revenue in the statement of operations as "Finance and Service Charges Not Included in Premiums" or "Aggregate Write-Ins for Miscellaneous Income".

Applying the Recognition Criteria

~~15.~~14. Application of the recognition criteria in paragraph 4:

a. *Retrospective-premium-based guaranty-fund assessments* - An assessment is probable of being imposed when a formal determination of insolvency occurs[1]. At that time, the premium that obligates the entity for the assessment liability has already been written. Accordingly, an entity that has the ability to reasonably estimate the amount of the assessment shall recognize a liability for the entire amount of future assessments related to a particular insolvency when a formal determination of insolvency is rendered.

[1] As detailed within paragraph ~~7~~6 for premium-based guaranty-fund assessments, an insolvency shall be considered to have occurred when a reporting entity meets a state's (ordinarily the state of domicile of the insolvent reporting entity) statutory definition of an insolvent reporting entity. In most states, the reporting entity must be declared to be financially insolvent by a court of competent jurisdiction. In some states, there must also be a final order of liquidation.

b. *Prospective-premium-based guaranty-fund assessments* - The event that obligates the entity for the assessment liability generally is the writing of, or becoming obligated to write or renew, the premiums on which the expected future assessments are to be based (for example, multiple-year contracts under which an insurance entity has no discretion to avoid writing future premiums). Therefore, the event that obligates the entity generally will not have occurred at the time of the insolvency. Law or regulatory practice affects the event that obligates the entity in either of the following ways:

i. In states that, through law or regulatory practice, provide that an entity cannot avoid paying a particular assessment in the future (even if the entity reduces premium writings in the future), the event that obligates the entity is a formal determination of insolvency or a similar event. An entity that has the ability to reasonably estimate the amount of the assessment shall recognize a liability for the entire amount of future assessments that cannot be avoided related to a particular insolvency when a formal determination of insolvency occurs.

ii. In states without such a law or regulatory practice, the event that obligates the entity is the writing of, or becoming obligated to write, the premiums on which the expected future assessments are to be based. An entity that has the ability to reasonably estimate the amount of the assessments shall recognize a liability when the related premiums are written or when the entity becomes obligated to write the premiums.

c. *Prefunded-premium-based guaranty-fund assessments* - A liability for an assessment arises when premiums are written. Accordingly, an entity that has the ability to reasonably estimate the amount of the assessment shall recognize a liability as the related premiums are written.

d. *Other premium-based assessments* - Other premium-based assessments shall be accounted for in the same manner as prefunded premium-based guaranty-fund assessments.

e. *Loss-based assessments* - An assessment is probable of being asserted when the loss occurs. The obligating event of the assessment also has occurred when the loss occurs. Accordingly, an entity that has the ability to reasonably estimate the amount of the assessment shall recognize a liability as the related loss is incurred.

f. *Administrative-type assessments* – As this assessment is typically an annual amount per entity assessed to fund operations of the guaranty association, regardless of the existence of an insolvency, such assessments are generally expensed in the period assessed.

~~Affordable Care Act Section 9010 Assessment~~

~~16. The Affordable Care Act (ACA) imposes an assessment on entities that issue health insurance for each calendar year beginning on or after January 1, 2014. Pursuant to Section 9010 of the ACA, a reporting entity's portion of the assessment is paid no later than September 30 of the applicable calendar year (the fee year) beginning in 2014 and is not tax deductible. The amount of the assessment for the reporting entity is based on the ratio of the amount of an entity's subject net health premiums written for any U.S. health risk during the preceding calendar year (data year) to the aggregate amount of subject net health premiums written by all subject U.S. health insurance providers during the preceding calendar year. The ACA includes some significant exclusions regarding which entities are required to pay the assessment. This guidance applies to all entities that are subject to the fee. The guidance in this Section (paragraphs 16-21) applies to the unique facts and circumstances in the ACA; accordingly, an entity~~

~~should apply judgment when evaluating the facts and circumstances of other assessments arrangements before analogizing to the guidance for Section 9010 of the ACA.~~

~~17. Throughout this discussion of the Section 9010 assessment of the ACA, the following terms apply:~~

~~a. The term "data year" means the calendar year immediately before the fee year. For example, 2014 is the data year for fee year 2015.~~

~~b. The term "fee year" means the calendar year in which the assessment must be paid to the U.S. Treasury.~~

~~18. A reporting entity's portion of the annual assessment becomes payable to the U.S. Treasury once the reporting entity provides health insurance (in the fee year) for any subject U.S. health risk for each calendar year beginning on or after January 1, 2014.~~

~~19. The liability related to the Section 9010 ACA assessment shall be estimated and recorded in full once the entity provides qualifying health insurance (typically January 1) in the applicable calendar year in which the assessment is paid (fee year) with a corresponding entry to expense. The Section 9010 ACA assessment shall be recognized in full on January 1 of the fee year, in the operating expense category of Taxes, Licenses and Fees.~~

~~20. Liability recognition of the Section 9010 fee is not required in the data year. In the data year, the reporting entity is required to reclassify from unassigned surplus to special surplus an amount equal to its estimated subsequent fee year assessment. This segregation in special surplus is accrued monthly throughout the data year. The reclassification from unassigned surplus to special surplus does not reduce total surplus. On January 1 of the fee year, the prior year segregation in special surplus is reversed and the full current fee year assessment liability shall be accrued.~~

~~21. The Section 9010 ACA annual assessment does not represent a cost related to the acquisition of policies that is consistent with the definition of acquisition costs in *SSAP No. 71—Policy Acquisition Costs and Commissions*.~~

Disclosures

~~22.~~15. ~~For guaranty fund and other non-Section 9010 ACA assessments, a~~A reporting entity shall disclose the following:

a. Describe the nature of any assessments that could have a material financial effect, by type of assessment, and state the estimate of the liability, identifying whether the corresponding liability has been recognized under paragraph 4, a liability has not been recognized as the obligating event has not yet occurred, or that an estimate cannot be made.

b. For assessments with liabilities recognized under paragraph 4, disclose the amount of the recognized liabilities, any related asset for premium tax credits or policy surcharges, the periods over which the assessments are expected to be paid, and the period over which the recorded premium tax offsets or policy surcharges are expected to be realized.

c. Disclose assets recognized from paid and accrued premium tax offsets or policy surcharges, and include a reconciliation of assets recognized within the previous year's Annual Statement to the assets recognized in the current year's Annual Statement. The reconciliation shall reflect, in aggregate, each component of the increase and decrease in paid and accrued premium tax offsets and policy surcharges, including the amount charged off.

d. Disclosures shall be made in accordance with paragraph 27 of SSAP No. 5R when there is at least a reasonable possibility that the impairment of an asset from premium tax offsets or policy surcharges may have been incurred.

~~23. For the Section 9010 ACA assessment:~~

~~a. For the annual reporting period ending December 31, 2013, and thereafter, a reporting entity subject to the assessment under section 9010 of the Affordable Care Act, shall provide a disclosure of the assessment payable in the upcoming year consistent with the guidance provided under *SSAP No. 9—Subsequent Events* for a Type II subsequent event. The disclosure shall provide information regarding the nature of the assessment and an estimate of its financial impact, including the impact on its risk-based capital position as if it had occurred on the balance sheet date. In accordance with SSAP No. 9, paragraph 9, the reporting entity shall also consider whether there is a need to present pro forma financial statements regarding the impact of the assessment, based on its judgment of the materiality of the assessment.~~

~~b. Additionally, for annual reporting periods ending on or after December 31, 2014, the disclosure in paragraph 23.a. is expanded to include information on the amounts reflected in special surplus in the data year. The disclosure shall provide information regarding the nature of the assessment and the Total Adjusted Capital and Authorized Control Level (in dollars) before and after adjustment (as reported in its estimate of special surplus applicable to the 9010 fee) to reflect the fee as of the annual reporting date as if it had been reported on the balance sheet date. The disclosure shall also provide a statement as to whether an RBC action level would have been triggered had the fee been reported as of the balance sheet date.~~

~~24.~~16. Refer to the preamble for further discussion regarding disclosure requirements.

Relevant Literature

~~25.~~17. This statement adopts GAAP guidance for recording guaranty fund and other assessments, which is contained in *Accounting Standards Codification 405-30, Insurance Related Assessments* (ASC 405-30) to the extent reflected in this SSAP. Statutory accounting modifications from ASC 405-30 are as follows:

a. The option to discount accrued liabilities (and reflect the time value of money in anticipated recoverables) is rejected for statutory accounting. Liabilities for guaranty funds or other assessments shall not be discounted.

b. The use of a valuation allowance for premium tax offsets and policy surcharges no longer probable for realization has been rejected for statutory accounting. Evaluation of assets shall be made in accordance with SSAP No. 5R, and if it is probable that the asset is no longer realizable, the asset shall be written off and charged to income in the period the determination is made.

c. Guidance within ASC 405-30 pertaining to noninsurance entities has been rejected as not applicable for statutory accounting.

~~26.~~18. This statement also adopts with modification *Emerging Issues Task Force No. 06-3: How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That is, Gross versus Net Presentation)* (EITF 06-3), now included in *Accounting Standards*

Codification 605-45, Revenue Recognition, Principal Agent Considerations to the extent reflected in paragraph ~~14~~13 of this statement.

~~27. *ASU 2011-06: Other Expenses – Fees Paid to the Federal Government by Health Insurers* is adopted with modifications: 1) to require full expense recognition on January 1 of the fee year, 2) to require the reclassification from unassigned surplus to special surplus in the data year for the estimated amount payable, and 3) other modifications for statutory accounting terminology as reflected in paragraphs 16-21.~~

Effective Date and Transition

~~28.~~19. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*. Substantive revisions to paragraphs 4, ~~7~~6, ~~8~~7, ~~9~~8, ~~11~~10, ~~12~~11, ~~15~~14 and ~~22~~15 are initially effective for the reporting period beginning January 1, 2011. The result of applying this revised Statement shall be considered a change in accounting principle in accordance with SSAP No. 3. Pursuant to SSAP No. 3, the cumulative effect of changes in accounting principles shall be reported as an adjustment to unassigned funds (surplus) in the period of the change in accounting principle. The cumulative effect recognized through surplus from initial application of this Statement shall reflect the removal of liabilities established under SSAP No. 35, and the re-establishment of liabilities required under SSAP No. 35R. If there is no change in the liabilities recognized (for example, retrospective-premium based assessments), no cumulative effect adjustment shall occur. With regards to assets, the entity shall complete an assessment of the SSAP No. 35 asset reported as of the transition date. If it is determined that the reported asset exceeds what is allowed under SSAP No. 35R, then the excess asset shall be written-off, through unassigned funds, so the ultimate asset reflected corresponds with what is permitted under SSAP No. 35R. Although it is possible that the excess asset will be reinstated once the liability assessment is recognized (prospective-premium based assessments), it is inappropriate to continue to reflect an asset for assessments that are not reflected within the financial statements. The guidance in paragraph ~~14~~13 adopted with modification *Emerging Issues Task Force No. 06-3: How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That is, Gross versus Net Presentation)* and was incorporated from INT 07-03 and effective September 29, 2007. The Section 9010 ACA fee has specific guidance (adopted December 2013)~~detailed in paragraphs 16-21~~ that ~~is~~was ~~initially~~ effective for annual reporting periods beginning January 1, 2014, and was moved to SSAP No. 106 in June 2014.

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 35—Accounting for Guaranty Fund and Other Assessments*
- *Issue Paper No. 143—Prospective-Based Guaranty Fund Assessments*
- *Issue Paper No. 148—Affordable Care Act Section 9010 Assessment*

EXHIBIT A – PRIMARY METHODS OF GUARANTY FUND ASSESSMENTS

a. *Retrospective-premium-based assessments* - Guaranty funds covering benefit payments of insolvent life, annuity, and health insurance entities typically assess entities based on premiums written or received in one or more years before the year of insolvency. Assessments in any year are generally limited to an established percentage of an entity's average premiums for the three years preceding the insolvency. Assessments for a given insolvency may take place over several years.

b. *Prospective-premium-based assessments* - Guaranty funds covering claims of insolvent property and casualty insurance entities typically assess entities based on premiums written in one or more years after the insolvency. Assessments in any year are generally limited to an established percentage of an entity's premiums written or received for the year preceding the assessment. Assessments for a given insolvency may take place over several years.

c. *Prefunded-premium-based assessments* - This kind of assessment is intended to prefund the costs of future insolvencies. Assessments are imposed before any particular insolvency and are based on the current level of written premiums. Rates to be applied to future premiums are adjusted as necessary.

d. *Administrative-type assessments* - These assessments are typically a flat (annual) amount per entity to fund operations of the guaranty association, regardless of the existence of an insolvency.

e. *Other premium-based assessments* - Entities are subject to a variety of other insurance-related assessments. Many states and a number of local governmental units have established other funds supported by assessments. The most prevalent uses for such assessments are (*a*) to fund operating expenses of state insurance regulatory bodies (for example, the state insurance department or workers' compensation board) and (*b*) to fund second-injury funds.

    i. *Premium-based* - The assessing organization imposes the assessment based on the entity's written premiums. The base year of premiums is generally either the current year or the year preceding the assessment.

    ii. *Loss-based* - The assessing organization imposes the assessment based on the entity's incurred losses or paid losses in relation to that amount for all entities subject to that assessment in the particular jurisdiction.

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Statement of Statutory Accounting Principles No. 36

Troubled Debt Restructuring

STATUS

Type of Issue:	Common Area
Issued:	Initial Draft
Effective Date:	January 1, 2001
Affects:	Nullifies and incorporates INT 03-12
Affected by:	No other pronouncements
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STATUS **1**

SCOPE OF STATEMENT **3**

SUMMARY CONCLUSION **3**

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Determining Whether a Debtor Is Experiencing Financial Difficulties 4
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Troubled Debt Restructuring

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for troubled debt restructuring.

SUMMARY CONCLUSION

2. A troubled debt restructuring is defined as a debt restructuring whereby the creditor, for economic or legal reasons related to the debtor's financial difficulties, grants a concession to the debtor that it would not otherwise grant. That concession either stems from an agreement between the creditor and the debtor or is imposed by law or a court. Many troubled debt restructurings involve modifying terms to reduce or defer cash payments required of the debtor in the near future to help the debtor attempt to improve its financial condition and eventually be able to pay the creditor. The creditor, for example, may accept cash, other assets, or an equity interest in the debtor in satisfaction of the debt though the value received is less than the amount of the debt, because the creditor concludes the concession will maximize recovery of its investment. A debtor in a troubled debt restructuring can obtain funds from sources other than the existing creditor, if at all, only at effective interest rates (based on market prices) so high that it cannot afford to pay them. A troubled debt restructuring shall include debt that is fully satisfied by foreclosure, repossession, or other transfer of assets or by grant of equity securities by the debtor that is, in a technical sense, not restructured.

3. The determination of whether a debt restructuring is considered a troubled debt restructuring, as defined above, shall be made independently for the debtor and the creditor.

4. A debt restructuring shall not necessarily be considered a troubled debt restructuring for purposes of this statement even if the debtor is experiencing some financial difficulties. In general, a debtor that can obtain funds from sources other than the existing creditor at market interest rates at or near those for nontroubled debt is not involved in a troubled debt restructuring. For example, a troubled debt restructuring is not involved if:

a. The fair value of cash, other assets, or an equity interest accepted by a creditor from a debtor in full satisfaction of its receivable at least equals the creditor's recorded investment in the receivable;

b. The fair value of cash, other assets, or an equity interest transferred by a debtor to a creditor in full settlement of its payable at least equals the debtor's carrying amount of the payable;

c. The creditor reduces the effective interest rate on the debt primarily to reflect a decrease in market interest rates in general or a decrease in the risk so as to maintain a relationship with a debtor that can readily obtain funds from other sources at the current market interest rate;

d. The debtor issues, in exchange for its debt, new marketable debt having an effective interest rate based on its market price that is at or near the current market interest rates of debt with similar maturity dates and stated interest rates issued by nontroubled debtors; or

e. The debtor, in connection with bankruptcy proceedings, enters into debt restructuring that results in a general restatement of most of the debtor's liabilities.

Determining Whether a Creditor Has Granted a Concession

5. A creditor has granted a concession when, as a result of the restructuring, it does not expect to collect all amounts due, including interest accrued at the original contract rate. In that situation, and if the payment of principal at original maturity is primarily dependent on the value of collateral, an entity shall consider the current value of that collateral in determining whether the principal will be paid.

6. A creditor may restructure a debt in exchange for additional collateral or guarantees from the debtor. In that situation, a creditor has granted a concession when the nature and amount of that additional collateral or guarantees received as part of a restructuring do not serve as adequate compensation for other terms of the restructuring. When additional guarantees are received in a restructuring, an entity shall evaluate both a guarantor's ability and its willingness to pay the balance owed.

7. If a debtor does not otherwise have access to funds at a market rate for debt with similar risk characteristics as the restructured debt, the restructuring would be considered to be at a below-market rate, which may indicate that the creditor has granted a concession. In that situation, a creditor shall consider all aspects of the restructuring in determining whether it has granted a concession.

8. A temporary or permanent increase in the contractual interest rate as a result of a restructuring does not preclude the restructuring from being considered a concession because the new contractual interest rate on the restructured debt could still be below market interest rates for new debt with similar risk characteristics. In that situation, a creditor shall consider all aspects of the restructuring in determining whether it has granted a concession.

Determining Whether a Debtor Is Experiencing Financial Difficulties

9. In evaluating whether a receivable is a troubled debt restructuring, a creditor must determine whether the debtor is experiencing financial difficulties. In making this determination, a creditor shall consider the following indicators:

a. The debtor is currently in payment default on any of its debt. In addition, a creditor shall evaluate whether it is probable that the debtor would be in payment default on any of its debt in the foreseeable future without the modification. That is, a creditor may conclude that a debtor is experiencing financial difficulties, even though the debtor is not currently in payment default.

b. The debtor has declared or is in the process of declaring bankruptcy.

c. There is substantial doubt as to whether the debtor will continue to be a going concern.

d. The debtor has securities that have been delisted, are in the process of being delisted, or are under threat of being delisted from an exchange.

e. On the basis of estimates and projections that only encompass the debtor's current capabilities, the creditor forecasts that the debtor's entity-specific cash flows will be insufficient to service any of its debt (both interest and principal) in accordance with the contractual terms of the existing agreement for the foreseeable future.

f. Without the current modification, the debtor cannot obtain funds from sources other than the existing creditors at an effective interest rate equal to the current market interest rate for similar debt for a nontroubled debtor.

The above list of indicators is not intended to include all indicators of a debtor's financial difficulties.

Evaluating Whether a Restructuring Results in a Delay in Payment That is Insignificant

10. A restructuring that results in only a delay in payment that is insignificant is not a concession. The following factors, when considered together, may indicate that a restructuring results in a delay in payment that is insignificant:

a. The amount of the restructured payments subject to the delay is insignificant relative to the unpaid principal or collateral value of the debt and will result in an insignificant shortfall in the contractual amount due.

b. The delay in timing of the restructured payment period is insignificant relative to any one of the following:

i. The frequency of payments due under the debt

ii. The debt's original contractual maturity

iii. The debt's original expected duration

11. If the debt has been previously restructured, an entity shall consider the cumulative effect of the past restructurings when determining whether a delay in payment resulting from the most recent restructuring is insignificant.

Accounting by Debtors

12. A debtor shall account for a troubled debt restructuring according to the type of the restructuring (transfer of assets in full settlement, grant of equity interest in full settlement, modification of terms or combination of types). Generally, troubled debt restructuring involving the transfer of assets or the grant of an equity interest shall be accounted for at the fair value of the assets transferred or the equity interest granted.

13. A debtor in a troubled debt restructuring involving only modification of terms of a payable—that is, not involving a transfer of assets or grant of an equity interest—shall account for the effects of the restructuring prospectively from the time of restructuring, and shall not change the carrying amount of the payable at the time of the restructuring unless the carrying amount exceeds the total future cash payments specified by the new terms. That is, the effects of changes in the amounts or timing (or both) of future cash payments designated as either interest or face amount shall be reflected in future periods. Interest expense shall be computed in a way that a constant effective interest rate is applied to the carrying amount of the payable at the beginning of each period between restructuring and maturity. The new effective interest rate shall be the discount rate that equates the present value of the future cash payments specified by the new terms (excluding amounts contingently payable) with the carrying amount of the payable.

14. If the total future cash payments specified by the new terms of a payable, including both payments designated as interest and those designated as face amount, are less than the carrying amount of the payable, the debtor shall reduce the carrying amount to an amount equal to the total future cash payments specified by the new terms and shall recognize a gain on restructuring of payables equal to the amount of the reduction. Thereafter, all cash payments under the terms of the payable shall be accounted for as reductions of the carrying amount of the payable, and no interest expense shall be recognized on the payable for any period between the restructuring and maturity of the payable.

15. A debtor shall not recognize a gain on a restructured payable involving indeterminate future cash payments as long as the maximum total future cash payments may exceed the carrying amount of the payable. Amounts designated either as interest or as face amount by the new terms may be payable contingent on a specified event or circumstance (e.g., the debtor may be required to pay specified

amounts if its financial condition improves to a specified degree within a specified period). To determine whether the debtor shall recognize a gain according to the provisions of paragraphs 13 and 14, those contingent amounts shall be included in the "total future cash payments specified by the new terms" to the extent necessary to prevent recognizing a gain at the time of restructuring that may be offset by future interest expense. Thus, the debtor shall apply *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets* (SSAP No. 5R) in which probability of occurrence of a gain contingency is not a factor and shall assume that contingent future payments will have to be paid. The same principle applies to amounts of future cash payments that must sometimes be estimated to apply the provisions of paragraphs 13 and 14. For example, if the number of future interest payments is flexible because the face amount and accrued interest is payable on demand or becomes payable on demand, estimates of total future cash payments shall be based on the maximum number of periods possible under the restructured terms.

16. If a troubled debt restructuring involves amounts contingently payable, those contingent amounts shall be recognized as a payable and as interest expense in future periods in accordance SSAP No. 5R. Thus, in general, interest expense for contingent payments shall be recognized in each period in which (a) it is probable that a liability has been incurred and (b) the amount of that liability can be reasonably estimated. Before recognizing a payable and interest expense for amounts contingently payable, however, accrual or payment of those amounts shall be deducted from the carrying amount of the restructured payable to the extent that contingent payments included in "total future cash payments specified by the new terms" prevented recognition of a gain at the time of restructuring (paragraph 15).

Accounting by Creditors

17. A creditor shall account for a troubled debt restructuring according to the type of the restructuring (receipt of assets in full satisfaction, modification of terms, combination of types). Generally, troubled debt restructuring involving the transfer of assets shall be accounted for at the fair value of the assets received. Troubled debt restructuring involving modification of terms shall be accounted for at fair value (as determined by acceptable appraisal methodologies) in accordance with *SSAP No. 100—Fair Value Measurements (SSAP No. 100)*. If the restructured loan is collateral dependent, fair value shall be the fair value of the collateral. If the restructured loan is not collateral dependent, fair value shall be determined in accordance with SSAP No. 100. If the determined fair value of the loan is less than the recorded investment in the loan (including accrued interest, net deferred loan fees or costs, and unamortized premium or discount), a new cost basis shall be established at the fair value with the difference being recorded as a realized loss in the statement of operations. After the troubled debt restructuring, a creditor shall account for the assets consistent with the statutory guidance for such assets.

18. A creditor shall account for assets, including foreclosed property and equity interests in corporations, joint ventures, or partnerships, received in satisfaction of the loan at their fair value (as determined by acceptable appraisal methodologies) at the time of restructuring or at the book value of the loan if lower. If the fair value is less than the book value, the required writedown shall be recognized as a realized capital loss. The creditor shall reclassify the asset from loans to the appropriate asset account, such as real estate or other invested assets, at the time that the creditor obtains clear title to the asset except for mortgage loans which shall be reclassified at the beginning of the redemption period unless it is probable that the mortgage loan will be redeemed. After the troubled debt restructuring, a creditor shall account for the assets received in satisfaction of the loan consistent with the statutory guidance for similar assets.

19. Any fees received in connection with a modification of terms of a troubled debt restructuring shall be applied as a reduction of the recorded investment in the loan. All costs associated with the restructuring, including direct loan origination costs, shall be charged to expense as incurred.

Disclosure by Debtors

20. A debtor in a troubled debt restructuring shall disclose in the financial statements the following information about troubled debt restructurings that have occurred during a period for which financial statements are presented:

a. For each restructuring or separate restructuring within a fiscal period for the same category of payables, (e.g., accounts payable or subordinated debentures), a description of the principal changes in terms, the major features of settlement, or both;

b. Aggregate gain on restructuring of payables and the related income tax effect; and

c. Aggregate net gain or loss on transfers of assets recognized during the period.

21. A debtor shall disclose in financial statements for periods after a troubled debt restructuring the extent to which amounts contingently payable are included in the carrying amount of restructured payables. A debtor shall also disclose total amounts that are contingently payable on restructured payables and the conditions under which those amounts would become payable or would be forgiven.

22. Refer to the preamble for further discussion regarding disclosure requirements.

Disclosure by Creditors

23. A creditor shall disclose in the financial statements the information captured in paragraphs 23.a., 23.b. and 23.c. about troubled debt restructuring as of the date of each balance sheet presented. Disclosures captured from paragraphs 23.d. and 23.e. are required in the statutory audited financial statements only:

a. As of the date of each statement of financial position presented, the recorded investment in the loans for which impairment has been recognized in accordance with this statement and the related realized capital loss

b. The amount of commitments, if any, to lend additional funds to debtors owing receivables whose terms have been modified in troubled debt restructuring

c. The creditor’s income recognition policy for interest income on an impaired loan

d. For troubled debt restructurings that occurred during the annual reporting period, aggregated by type of instrument, qualitative and quantitative information on (1) how the items were modified and (2) the financial effects of the modifications

e. If restructured within the previous 12 months and there has been a payment default during that period, disclose qualitative and quantitative information about the defaulted instruments, aggregated by type of instrument, including: (1) type of instruments that defaulted and (2) the amount of recorded investments for which default occurred

24. Refer to the preamble for further discussion regarding disclosure requirements.

25. This statement is not intended to modify the requirement for life and health insurers to complete the Annual Statement exhibit disclosing long-term mortgage loans in good standing with restructured terms.

Relevant Literature

26. This statement adopts with modification *FASB Statement No. 15*, *Accounting by Debtors and Creditors for Troubled Debt Restructurings* (FAS 15) to specify that creditors shall reclassify assets obtained in a troubled debt restructuring from loans to the appropriate asset account at the time the creditor obtains clear title to the asset, except for mortgage loans which shall be reclassified at the beginning of the redemption period unless it is probable that the mortgage loan will be redeemed and with modification to require that gains and losses from extinguishment of debt be reported as capital gains or losses, and charged to operations. In August 2012, this statement was revised to adopt paragraphs 310-40-15-13 through 310-40-15-18 and 310-40-15-20 of the FASB Codification incorporated through *FASB ASU 2011-02, A Creditors Determination of Whether a Restructuring Is a Troubled Debt Restructuring*. Also in August 2012, this statement adopted with modification the disclosure requirements included in paragraphs 310-10-50-33 through 310-10-50-34 of the FASB Codification originally incorporated from *ASU 2010-20, Receivables (Topic 310), Disclosures About the Credit Quality of Financing Receivables and the Allowance for Credit Losses*, deferred by *ASU 2011-01, Receivables (Topic 310), Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20* and reinstated through ASU 2011-02. These disclosure requirements have been modified to be applicable for all troubled debt restructurings within the scope of SSAP No. 36, rather than limited to troubled debt restructurings of "financing receivables." The revisions adopted in August 2012 from ASU 2011-02 and ASU 2010-20 are effective January 1, 2013, with early application permitted.

27. This statement adopts paragraphs 9, 22, and 25 of *FASB Statement No. 114*, *Accounting by Creditors for Impairment of a Loan* (FAS 114). Paragraphs 6.d., 13 and 21 of FAS 114 are rejected. *FASB Statement No. 118*, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures* is adopted as it relates to troubled debt restructuring.

28. This statement adopts *FASB Technical Bulletin 81-6, Applicability of Statement 15 to Debtors in Bankruptcy Situations* and *FASB Technical Bulletin 80-2, Classification of Debt Restructuring by Debtors and Creditors*. It also adopts *FASB Emerging Issue Task Force No. 87-18, Use of Zero Coupon Bonds in a Troubled Debt Restructuring*, *FASB Emerging Issue Task Force No. 87-19, Substituted Debtors in a Troubled Debt Restructuring*, *FASB Emerging Issue Task Force No. 89-15*, *Accounting for a Modification of Debt Terms When the Debtor is Experiencing Financial Difficulties* consistent with the modifications to FAS 15 discussed in this statement, *FASB Emerging Issues Task Force No. 96-22, Applicability of the Disclosures Required by FASB Statement No. 114 When a Loan Is Restructured in a Troubled Debt Restructuring into Two (or More) Loans* and *FASB EITF 02-4: Determining Whether a Debtor's Modification or Exchange of Debt Instruments is Within the Scope of FASB Statement No. 15.*

29. Although *FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases* (FAS 91) was rejected in *SSAP No. 26—Bonds, Excluding Loan-Backed and Structured Securities*, this statement is consistent with paragraph 14 of *FAS No. 91.*

30. This statement rejects *FASB Emerging Issues Task Force No. 94-8, Accounting for Conversion of a Loan into a Security in a Troubled Debt Restructuring* and *FASB Technical Bulletin 94-1*, *Application of Statement 115 to Debt Securities Restructured in a Troubled Debt Restructuring.*

Effective Date and Transition

31. This statement is effective for years beginning January 1, 2001. The provisions of this statement shall be applied to all troubled debt restructurings entered into on or after January 1, 2001. The adoption of *FASB EITF 02-4: Determining Whether a Debtor's Modification or Exchange of Debt Instruments is within the Scope of FASB Statement No. 15* was incorporated from INT 03-12 and effective December 7, 2003.

REFERENCES

Other

- *Purposes and Procedures Manual of the NAIC Investment Analysis~~Securities Valuation~~ Office*

Relevant Issue Papers

- *Issue Paper No. 36—Troubled Debt Restructurings*

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Statement of Statutory Accounting Principles No. 37

Mortgage Loans

STATUS

Type of Issue:	Common Area
Issued:	Initial Draft
Effective Date:	January 1, 2001
Affects:	Nullifies and incorporates INT 99-04
Affected by:	No other pronouncements
Interpreted by:	INT 06-07

STATUS **1**
SCOPE OF STATEMENT **3**
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Mortgage Loans

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for the accounting and reporting of mortgage loans and related fees.

SUMMARY CONCLUSION

2. A mortgage loan is defined as a debt obligation that is not a security, which is secured by a mortgage on real estate. (A security is a share, participation, or other interest in property or in an enterprise of the issuer or an obligation of the issuer that (a) either is represented by an instrument issued in bearer or registered form, or if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer, (b) is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment, and (c) either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations).

3. Mortgage loans meet the definition of assets as specified in *SSAP No. 4—Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this statement.

Commitment Fees

4. Commitment (or commitment standby) fees are fees paid to the reporting entity that obligate the reporting entity to make or acquire a loan or to satisfy an obligation of another party under a specified condition. A fee paid to the reporting entity to obtain a commitment to make funds available at some time in the future, generally, is refundable only if the loan is granted. If the loan is not granted, then the fees shall be recorded as investment income by the reporting entity when the commitment is no longer available.

5. A fee paid to the reporting entity to obtain a commitment to be able to borrow funds at a specified rate and with specified terms quoted in the commitment agreement, generally, is not refundable unless the commitment is refused by the reporting entity. This type of fee shall be deferred, and amortization shall depend on whether or not the commitment is exercised. If the commitment is exercised, then the fee shall be amortized in accordance with paragraph 9 over the life of the loan as an adjustment to the investment income on the loan. If the commitment expires unexercised, the commitment fee shall be recognized in income on the commitment expiration date.

Loan Origination Fees

6. Loan origination fees are defined as fees charged to the borrower in connection with the process of originating, refinancing, or restructuring a loan. The term includes, but is not limited to, points, management, arrangement, placement, application, underwriting, and other fees pursuant to a lending transaction. Nonrefundable loan origination fees shall not be recorded until received in cash. Nonrefundable fees representing points shall be deferred as part of the loan balance and amortized over the life of the loan in accordance with paragraph 9. Nonrefundable fees other than points shall be recorded in income upon receipt.

Loan Origination, Acquisition, and Commitment Costs

7. All costs incurred in connection with originating a loan, acquiring purchased loans or committing to purchase loans shall be charged to expense as incurred.

Initial Investment

8. For mortgage loans originated by the reporting entity, the initial investment in mortgage loans shall be recorded at the principal amount of the loan net of any amounts deferred under the provisions of paragraphs 5 and 6. For mortgage loans purchased by a reporting entity, the initial investment shall be recorded as the amount paid to the seller. Accordingly, there may be a premium or discount on such loans resulting from a difference between the amount paid and the principal amount.

Amortization

9. Premiums and discounts on acquired loans, and mortgage interest points and commitment fees (if such qualify for amortization as described in paragraphs 5 and 6) shall be recognized as an adjustment of yield over the life of the loan (i.e., the period of time until total principal proceeds of the loan are received in cash) to produce a constant effective yield each year to maturity. If the reporting entity holds a large number of similar loans for which the prepayments of principal are probable, (probable is used in the same context as in paragraph 6 in *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets*, which defines probable as the future event or events are likely to occur), and the timing and amount can be reasonably estimated, the reporting entity shall include estimates of future principal prepayments in the calculation of the constant effective yield necessary to apply the interest method. The amount recognized as an adjustment of yield shall be credited or charged to interest income in the calculation of net investment income.

Prepayments

10. Payments received in advance of due dates may produce prepaid interest which shall be recorded as a liability, Unearned Investment Income, on the reporting entity's balance sheet. The portion of the payments received in advance of due dates that represents prepayments of principal shall be recorded as a reduction in the mortgage loan balance.

11. A mortgage loan may provide for a prepayment penalty or acceleration fee in the event the loan is liquidated prior to its scheduled termination date. Such fees shall be reported as investment income when received.

Interest Income

12. Interest income shall be recorded as earned and shall be included in investment income in the Summary of Operations. Interest income shall include interest collected, the change in interest income due and accrued, and the change in unearned interest income as well as amortization of premiums, discounts, and deferred fees as specified in paragraph 9.

Accrued Interest

13. Reporting entities that use servicing agents for their mortgage loans shall report the Interest Due and Accrued asset on the balance sheet consistently with the income statement treatment of the charge for servicing costs. If interest income is reported net of servicing costs, which is usual when the servicing agent fee is based on a percentage retention of each interest payment, then the interest receivable in the balance sheet shall be net of the related servicing costs. If interest is reported gross, with the servicing costs reported as an expense item, then interest due and accrued shall be reflected as an asset at the gross amount, with an appropriate liability to reflect the related servicing cost accrual.

14. When a loan is determined to be in default (per the contractual terms of the loan), the accrued interest on the loan shall be recorded as investment income due and accrued if deemed collectible. If a loan in default has any investment income due and accrued which is 180 days past due and collectible, the investment income shall continue to accrue, but all interest related to the loan is to be reported as a

nonadmitted asset. If accrued interest on a mortgage loan in default is not collectible, the accrued interest shall be written off immediately and no further interest accrued.

15. Contingent interest represents income generated through the occurrence of specific economic events in relation to the borrower. For example, contingent interest may become payable upon the attainment of a given level of cash flow or income. Contingent interest may be reported as income when received or accrued. The proper accrual of such income does, however, require an analysis of the applicable provisions in the underlying agreement and the verification that the prerequisite conditions have been met.

Impairments

16. A mortgage loan shall be considered to be impaired when, based on current information and events, it is probable that a reporting entity will be unable to collect all amounts due according to the contractual terms of the mortgage agreement. According to the contractual terms means that both the contractual principal payments and contractual interest payments of the mortgage loan will be collected as scheduled in the mortgage agreement. A reporting entity shall measure impairment based on the fair value (as determined by acceptable appraisal methodologies) of the collateral less estimated costs to obtain and sell. The difference between the net value of the collateral and the recorded investment in the mortgage loan shall be recognized as an impairment by creating a valuation allowance with a corresponding charge to unrealized loss or by adjusting an existing valuation allowance for the impaired loan with a corresponding charge or credit to unrealized gain or loss. Subsequent to the initial measurement of impairment, if there is a significant change (increase or decrease) in the net value of the collateral, the reporting entity shall adjust the valuation allowance; however, the net carrying amount of the loan shall at no time exceed the recorded investment in the loan. For reporting entities required to maintain an asset valuation reserve (AVR), the unrealized gain or loss on impairments shall be included in the calculation of the AVR. If the impairment is other than temporary (INT 06-07), a direct write down shall be recognized as a realized loss, and a new cost basis is established. This new cost basis shall not be changed for subsequent recoveries in value. Mortgage loans for which foreclosure is probable shall be considered permanently impaired.

17. For loans that are in default, being voluntarily conveyed, or being foreclosed, the carrying value shall be adjusted for additional expenses, such as insurance, taxes, and legal fees that have been incurred to protect the investment or to obtain clear title to the property to the extent that these amounts are deemed to be recoverable from the ultimate disposition of the property. However, if these costs cannot reasonably be expected to be recovered, they shall not be added to the carrying value, and the costs shall be expensed.

Escrow Payments

18. Amounts paid to the reporting entity by the mortgagor to cover future tax payments, insurance premiums, and other costs related to the property requires the creation of escrow accounts in the general ledger to record these liabilities. If these amounts are held by the servicing agents, they shall be reported on the reporting entity’s balance sheet both as an asset and as a liability when they produce income for the reporting entity. This may occur if the servicing agent invests the escrow funds and is required to remit the income (or portion thereof) to the reporting entity.

Construction Loans

19. A construction loan is defined as a mortgage loan of less than three years in term, made for financing the cost of construction of a building or other improvement to real estate, which is secured by the real estate. The principal amount of a construction loan shall be the amount of funds disbursed to the borrower. If, in accordance with the terms of the contract, interest is deferred until the maturity of the loan, the accrued interest shall be included in the balance of the loan outstanding. The impairment test in

paragraph 16 shall be applied to all construction loans, regardless of whether there are any defaults. Accordingly, construction loans shall not be reported at an amount greater than the fair value of the property. The percentage of completion of the property shall be considered in determining fair values of property securing construction loans.

Disclosures

20. The following disclosures shall be made in the financial statements:

a. Fair values in accordance with *SSAP No. 100—Fair Value Measurements;*

b. Concentrations of credit risk in accordance with SSAP No. 27 as well as 1) information as to how and to what extent management monitors the credit quality of its mortgage loans in an ongoing manner, and 2) to assess the quantitative and qualitative risks arising from the credit quality of its mortgage loans. To meet these objectives reporting entities shall provide information, aggregated by type, about the credit quality of mortgage loans including the following;

i. A description of the credit quality indicator

ii. The recorded investment in mortgage loans by credit quality indicator

iii. For each credit quality indicator, the date or range of dates in which the information was updated for that credit quality indicator

c. Description of the valuation basis of the mortgage loans;

d. Information on the minimum and maximum rates of interest received for new loans made by category;

e. Maximum percentage of any one loan to the value of security at the time of the loan;

f. An age analysis of mortgage loans, aggregated by type, capturing: 1) recorded investment of current mortgage loans, 2) recorded investment of mortgage loans past due classified as 30-59 days past due, 60-89 days past due, 90-179 days past due, and greater than 180 days past due; 3) recorded investment of mortgage loans 90 days and 180 days past due still accruing interest; 4) interest accrued for mortgage loans 90 days and 180 days past due; and 5) recorded investment and number of mortgage loans where interest has been reduced, by percent reduced; and

g. Taxes, assessments, and amounts advanced not included in the mortgage loan total.

21. The following additional disclosures shall be made for impaired loans:

a. The total recorded investment in impaired loans, aggregated by type, at the end of each period and (i) the amount for which there is a related allowance for credit losses determined in accordance with this statement and the amount of that allowance and (ii) the amount for which there is no related allowance for credit losses determined in accordance with this statement;

b. The policy for recognizing interest income on impaired loans, including how cash receipts are recorded;

c. For each period for which results of operations are presented, the average recorded investment, aggregated by type, in the impaired loans during each period, the related amount of interest income recognized during the time within that period that the loans were impaired, the recorded investments on nonaccrual status pursuant to SSAP No. 34, paragraph 6 and, unless not practicable, the amount of interest income recognized using a cash-basis method of accounting during the time within that period that the loans were impaired; and

d. For each period for which results of operations are presented, the activity in the allowance for credit losses account, including the balance in the allowance for credit losses account at the beginning and end of each period, additions charged to operations, direct write-downs charged against the allowance, and recoveries of amounts previously charged off.

22. Refer to the preamble for further discussion regarding disclosure requirements. The disclosure requirements of paragraph 20.b. shall be included in the annual audited statutory financial reports only.

Relevant Literature

23. This statement adopts *FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan* (FAS 114), and *FASB Statement No. 118, Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures, an amendment of FASB Statement No. 114*, for collateral dependent loans with the following modifications:

a. Impairment shall be measured based on the fair value of the collateral less costs to obtain and sell, whereas that is just one option under FAS 114; and

b. The reporting entity is required to record any other than temporary impairment as a realized loss and shall not record subsequent recoveries in fair value.

24. This statement adopts disclosure requirements in paragraphs 310-10-50-7, 310-10-50-7A, 310-10-50-15, and 310-10-50-29(b) of *ASU 2010-20, Disclosures about the Credit Quality of Financing Receivables and the Allowance For Credit Losses* (ASU 2010-20) for mortgage loans only. Other disclosure requirements of ASU 2010-20, and the application of the adopted disclosures to other investments or receivables are rejected as not applicable for statutory accounting. This statement also adopts *FASB Emerging Issues Task Force Issue No. 84-19, Mortgage Loan Payment Modifications*.

25. This statement rejects *FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, *FASB Emerging Issues Task Force No. 88-17, Accounting for Fees and Costs Associated with Loan Syndications and Loan Participations,* and *AICPA Practice Bulletin 6, Amortization of Discounts on Certain Acquired Loans*.

Effective Date and Transition

26. This statement is effective for years beginning January 1, 2001. Initial recognition of the impairment losses resulting from the application of this statement shall apply to mortgage loans held at January 1, 2001, and be based on management's best estimates as of that date. Insurers shall release all unamortized amounts included in IMR related to prepayment penalties upon adoption of Codification and recognize such change in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors (SSAP No. 3).* A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with SSAP No. 3.

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 37—Mortgage Loans*

Statement of Statutory Accounting Principles No. 38

Acquisition, Development and Construction Arrangements

STATUS

Type of Issue:	Common Area
Issued:	Initial Draft
Effective Date:	January 1, 2001
Affects:	No other pronouncements
Affected by:	No other pronouncements
Interpreted by:	No other pronouncements

STATUS 1

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Acquisition, Development and Construction Arrangements

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for real estate acquisition, development and construction (ADC) arrangements and provides guidance on when to account for ADC arrangements as mortgage loans and when to account for ADC arrangements as investments in real estate or real estate joint ventures.

SUMMARY CONCLUSION

2. ADC arrangements shall be defined as lending agreements that are made to the owner of property to finance the acquisition, development and construction of real estate projects on the property in which the lender participates in the expected residual profits. Expected residual profit is the amount of profit, whether called interest or another name (e.g., equity kicker) above a reasonable amount of interest and fees expected to be earned by the lender. ADC arrangements shall include participations in loans and purchased loans that meet that definition of ADC arrangements.

3. If the lender is expected to receive over 50% of the expected residual profits of the project, the ADC arrangement shall be classified and accounted for as an investment in real estate in accordance with *SSAP No. 40R—Real Estate Investments*. If the lender is expected to receive 50% or less of the expected residual profits, the ADC arrangement shall be classified and accounted for as a loan or as a real estate joint venture, depending on the circumstances.

4. If any of the characteristics in paragraph 9.b. through 9.e. of *AcSEC Practice Bulletin 1*, "Exhibit I, ADC Arrangements" (PB1), or if a qualifying personal guarantee (as defined in PB1) is present, the ADC arrangement shall be classified and accounted for as a construction loan in accordance with *SSAP No. 37—Mortgage Loans*. Otherwise, the ADC arrangement shall be classified and accounted for as a real estate joint venture in accordance with *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies*.

5. The factors that are evaluated in determining the accounting treatment at inception may subsequently change for some ADC arrangements, for example, as a result of a renegotiation of the terms. Consequently, the accounting treatment for an ADC arrangement shall be periodically reassessed, as described in paragraph 20 of PB1. Any changes in classification shall result in a reclassification of the asset at the amount the asset should be reported at under its new classification with the net effect, if any, charged to income in the period that the change in classification is made.

6. Regardless of whether an ADC arrangement is accounted for as an investment in real estate, a joint venture, or a mortgage loan, the ADC arrangement meets the definition of an asset as defined in *SSAP No. 4—Assets and Nonadmitted Assets* and is an admitted asset to the extent it conforms to the requirements of this statement.

7. ADC arrangements may involve related parties, in which case, *SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties* shall also be followed.

Relevant Literature

8. This statement adopts PB1, "Exhibit I, ADC Arrangements" and *FASB Emerging Issues Task Force No. 86-21, Application of the AICPA Notice to Practitioners regarding Acquisition, Development, and Construction Arrangements to Acquisition of an Operating Property.*

Effective Date and Transition

9. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors.*

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 38—Acquisition, Development and Construction Arrangements*

Statement of Statutory Accounting Principles No. 39

Reverse Mortgages

STATUS

Type of Issue:	Common Area
Issued:	Initial Draft
Effective Date:	January 1, 2001
Affects:	No other pronouncements
Affected by:	No other pronouncements
Interpreted by:	INT 06-07

STATUS 1
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Reverse Mortgages

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for reverse mortgages.

SUMMARY CONCLUSION

2. A reverse mortgage loan is defined as a non-recourse loan with the following characteristics:

   a. It is secured by a mortgage against the primary residence of the borrower;

   b. It guarantees a stream of cash disbursements to the borrower, either for the life of the borrower with no limit or up to a set percentage of the value of the residence or as a line of credit which the borrower can draw upon as needed; and

   c. It has no maturity date and requires no repayment until one of the following events occur:

      i. The borrower dies;

      ii. The borrower sells the residence;

      iii. The residence ceases to be the borrower's primary residence; or

      iv. The borrower terminates the loan by paying back the outstanding balance.

3. A reverse mortgage meets the definition of an asset as defined in *SSAP No. 4—Assets and Nonadmitted Assets* and is an admitted asset to the extent it conforms to the requirements of this statement. Reverse mortgages shall be recorded as an other invested asset on the reporting entity's statement of financial position and Schedule BA, Other Long-Term Invested Assets, of the Annual Statement.

4. To be considered admitted assets, investments in reverse mortgages are limited to first lien mortgages only.

5. All expenses associated with acquiring reverse mortgages shall be recognized immediately as investment expense.

6. Revenue associated with originating or otherwise acquiring reverse mortgages, including non-refundable fees, shall be amortized to investment income on a straight line basis over the period from inception to the expected maturity date.

7. Generally, fees are not paid by the borrower at the time of closing but become payable when the outstanding balance of the reverse mortgage becomes due. In these situations, no accounting entries are recorded at the time of closing. Investment income shall be recognized and the outstanding balance of the loan shall increase as the fees are amortized.

8. If fees are paid by the borrower at the time of closing, a liability shall be established. Investment income shall be recognized and the liability shall decrease as the fees are amortized.

9. Interest is payable by the borrower when the outstanding balance of the reverse mortgage becomes due. Accrued interest shall be calculated on the outstanding balance of the loan on a monthly basis. As it is earned, accrued interest shall be recorded to investment income and added to the outstanding balance of the loan.

10. The outstanding balance of the reverse mortgage shall include the accumulation of amounts disbursed, accrued interest, and amortized origination fees (i.e., origination fees not paid by the borrower at the time of closing). Neither the fair value of the underlying collateral nor the obligation for future cash payments guaranteed by the lender are recorded.

11. The lender's equity in the appreciation of the property, if any, is not recorded until realized upon the sale of the home.

Valuation and Impairment

12. The major categories of risk affecting reverse mortgages are:

a. Mortality risk—risk of loan payments extending beyond the borrower's original projected life expectancy. Since most reverse mortgages guarantee a continuing monthly payment to the borrower, there is the possibility that the borrower will collect cash payments and accrue interest exceeding the ultimate disposal value of the collateral. In situations where loan payments extend beyond the borrower's original projected life expectancy, the reporting entity will experience a diminished yield, and may experience a loss. Reverse mortgage contracts shall be combined into groups which are of sufficient size to provide an actuarially and statistically credible basis for estimating life expectancy to project future cash flows;

b. Collateral risk—risk of deterioration in the value of the collateral such that it is insufficient to cover the loan balance. This risk shall be evaluated loan-by-loan and is based on information obtained from periodic real estate appraisals and other pertinent information;

c. Interest rate risk—risk of interest rates rising on adjustable rate reverse mortgages to the extent that accrued interest creates a collateral risk.

13. Reverse mortgages subject to the risks addressed in paragraph 12 shall be reported net of an appropriate actuarially calculated valuation reserve. Assumptions shall be applied consistently to similar loans. The assumptions, cash flow projections, and evaluation of risk shall be reviewed and updated at least annually. The fair value of the underlying collateral and the obligation for future cash payments guaranteed by the lender shall be considered in cash flow projections. Future appreciation in property value beyond the valuation date shall not be included in the projection of cash receipts.

14. If the impairment is temporary, any resulting adjustment shall be made to the valuation reserve (contra-asset) and unrealized gains and losses. Subsequent to the initial measurement of impairment, if there is a significant change (increase or decrease) in the risk factors affecting the value of the mortgage, the reporting entity shall adjust the valuation allowance in accordance with paragraph 13; however, the net carrying amount of the loan shall at no time exceed the recorded investment in the loan. The term recorded investment in the loan is distinguished from net carrying amount of the loan because the latter term is net of the valuation allowance, while the former term is not. The recorded investment (including accrued interest, net deferred loan fees, and unamortized premium or discount) in the loan does, however, reflect any direct write down of the investment. If the impairment is other than temporary (INT 06-07), the investment shall be written down to fair value as the new cost basis and the amount of the write down shall be accounted for as a realized loss. The new basis shall not be changed for subsequent recoveries in fair value. A reverse mortgage shall be considered to be impaired when, based on current information and events, it is probable that the reporting entity will be unable to collect all amounts due according to the contractual terms of the reverse mortgage. "According to the contractual terms" means that both the contractual principal payments and contractual interest payments of the loan will be collected as specified in the reverse mortgage agreement.

Disclosures

15. The following disclosures shall be made for reverse mortgages in the financial statements:

    a. A description of the reporting entity's accounting policies and methods, including the statistical methods and assumptions used in calculating the reserve;

    b. General information regarding the reporting entity's commitment under the agreement;

    c. The reserve amount which is netted against the asset value;

    d. Investment income or loss recognized in the period as a result of the re-estimated cash flows.

16. Refer to the preamble for further discussion regarding disclosure requirements.

Effective Date and Transition

17. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors.*

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 39—Reverse Mortgages*

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-Statement of Statutory Accounting Principles No. 40 – Revised

Real Estate Investments

STATUS

Type of Issue:	Common Area
Issued:	Initial Draft; substantively revised December 12, 2014
Effective Date:	January 1, 2001; substantive revisions detailed in Issue Paper No. 149 are effective January 1, 2015
Affects:	Supersedes SSAP No. 77 with guidance incorporated August 2012 Nullifies and incorporates INT 99-16, INT 99-22, INT 99-25, INT 08-02, INT 08-07 Nullifies INT 04-18
Affected by:	Paragraphs 11, 12 and 25 superseded by SSAP No. 90
Interpreted by:	INT 06-13

STATUS **1**

SCOPE OF STATEMENT **3**

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Real Estate Investments

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for real estate investments.

SUMMARY CONCLUSION

2. Real estate investments are defined as directly-owned real estate properties and single real estate property investments that are directly and wholly-owned through a limited liability company (LLC) that meet all of the criteria in paragraph 4. Real estate investments may be acquired in exchange for consideration (including but not limited to cash, a contract for deed or mortgage, or other non-cash consideration) obtained through foreclosure or voluntary conveyance in satisfaction of a mortgage loan, or received as contributed surplus. Real estate investments meet the definition of assets as defined in *SSAP No. 4—Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this statement.

3. Real estate investments include certain acquisition, development and construction arrangements (ADC) as defined in *SSAP No. 38—Acquisition, Development and Construction Arrangements* (SSAP No. 38).

4. A single real estate property investment that is wholly-owned by an LLC that is directly[1] and wholly-owned by the reporting entity shall be captured within this statement and reported on Schedule A – Real Estate if all of the following criteria are met. Real estate owned through an LLC that meets the stated criteria shall follow all statutory requirements within this statement[2]. Real estate owned through an LLC that does not meet the criteria shall be reported on Schedule BA – Other Long-Term Invested Assets. Regardless if reported on Schedule A or Schedule BA, all LLC's owned by the reporting entity shall be detailed in Schedule Y.

a. The real estate LLC has no transactions of its own other than transactions associated with an ownership structure utilized only for the ownership and management of a single real estate investment exclusively for the reporting entity (e.g., real estate taxes). A reporting entity may have more than one LLC that wholly-owns a single real estate property investment, but each LLC must separately comply with the paragraph 4 conditions, and be separately reported on Schedule A. All transactions of the LLC shall be reported as transactions of the reporting entity pursuant to the guidance in paragraphs 15-17.

b. The LLC only owns a single real estate property supported by an appraisal pursuant to paragraphs 13-14. A single real estate property can include multiple parcels of land and more than one structure; however, to be considered a single real estate property, the multiple of parcels of land and structure(s) must be contiguously located and managed together as a single asset (with reasonable allowances for public access routes). Criteria that may assist with determining a single real estate property would include the legal definition of the property, real estate tax assessments, postal address, the appraisal and the management and use of the property.

[1] For example, qualifying LLCs that are owned by a downstream holding company are not within scope of this statement regardless if the downstream holding company is wholly-owned by the reporting entity.

[2] The inclusion in this statement of real estate owned by a single member LLC is not an election by the reporting entity. All real estate owned in an LLC meeting the criteria in paragraph 4 are required to be captured within this statement, and are subject to this statement's requirements for valuation and admittance. Departures from the requirements within this SSAP, or continuing to follow SSAP No. 48 for these investments would be considered a departure from NAIC statutory accounting principles subject to permitted or prescribed practice disclosure requirements.

c. The reporting entity solely controls the real estate property in a manner similar to directly-owned real estate. As such, the reporting entity controls others' access to the real estate, and the real estate must be able to be sold exactly as, and as promptly as, directly-owned real estate.

d. The reporting entity solely and distinctly possesses all risks (other than the limitation of potential liability afforded by the LLC structure itself) and rewards of ownership of the real estate investment, without any constraints imposed by the LLC.

e. The reporting entity is the only member of the LLC. The LLC is not comprised of any other members, including: groups, competing interests, mutual beneficial interests, or co-venturers. The single-member ownership is required even if other members in the LLC are affiliates. An LLC comprised of affiliated parties is not within scope of this statement.

f. There shall be no apportionment by the LLC or the reporting entity of the appraised value, expenses or income from the single real estate property to any other entity or between the general or separate account.

5. Real estate investments shall be reported in accordance with the following balance sheet categories, with parenthetical disclosure of the amount of related encumbrances:

a. Properties occupied by the company – depreciated cost, less encumbrances;

b. Properties held for the production of income – depreciated cost, less encumbrances; and

c. Properties held for sale – lower of depreciated cost or fair value, less encumbrances and estimated costs to sell the property. (Paragraph 21 of *SSAP No. 90—Accounting for the Impairment or Disposal of Real Estate Investments* (SSAP No. 90) provides criteria that must be met for this real estate classification.).

6. Any real estate which is owned by and is more than 50% occupied by the reporting entity and its affiliates shall be considered property occupied by the company. "More than 50% occupied" shall mean that the square footage occupied by the reporting entity and its affiliates totals more than 50% of the rentable square footage of the property, including common areas. This shall include property occupied by the company which is not necessarily home office (e.g., claims processing, data processing and branch centers). Property which does not meet this 50% requirement shall be classified as property held for the production of income or property held for sale, consistent with SSAP No. 90.

7. Encumbrances represent outstanding mortgages or other debt related to the real estate investment and any unpaid accrued acquisition or construction costs. Participating mortgage loan liabilities are addressed in paragraphs 22-24. Interest expense shall be included in investment expenses.

8. The cost of real estate represents the fair value of the consideration exchanged plus any costs incurred to place the real estate asset in usable condition, including but not limited to, brokerage fees, legal fees, demolition, clearing and grading, fees of architects and engineers, any additional expenditures made for equipment and fixtures that are made a permanent part of the structure and certain interest costs as provided for in *SSAP No. 44—Capitalization of Interest*. Where cost includes both land and building, the cost shall be allocated among the assets purchased based on the relative values determined using appraisals, as described in paragraph 13. The cost shall be reduced by any amounts received for sales of rights or privileges in connection with the property or by any cash recoveries received after acquiring title to the property. The cost of real estate which has been foreclosed upon shall be initially established in accordance with *SSAP No. 36—Troubled Debt Restructuring*. The cost of contributed real estate shall be initially established in accordance with *SSAP No. 95—Exchanges of Nonmonetary Assets, A Replacement of SSAP No. 28—Nonmonetary Transactions* (SSAP No. 95) as a nonreciprocal transfer.

9. Internal preacquisition costs classified as nonoperating at the date of a property acquisition (that otherwise meet the requirements of paragraph 4 of FAS 67) shall be capitalized. If the entity subsequently determines that the property should have been classified as operating at the date of acquisition, such costs should be charged to expense and any additional costs shall be expensed as incurred. If internal preacquisition costs classified as operating at the date of acquisition were expensed as incurred, and the entity subsequently determines that the property should have been classified as nonoperating, the expensed costs shall remain as originally reported and shall not be reclassified to capitalized costs.

10. The cost of property included in real estate investments, other than land, shall be depreciated over the estimated useful life, not to exceed fifty years. Depreciation expense shall be included in investment expenses.

11. Properties occupied by the company and properties held for the production of income shall be carried at depreciated cost less encumbrances unless events or circumstances indicate the carrying amount of the asset (amount prior to reduction for encumbrances) may not be recoverable. Paragraph 5 of *FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (FAS 121), provides examples of events or changes in circumstances which indicate that the recoverability of the carrying amount of properties occupied by the company or properties held for the production of income should be assessed. If the events or changes in circumstances set forth in paragraph 5 of FAS 121 are present or if other events or changes in circumstances indicate that the carrying amount of properties occupied by the company or properties held for the production of income may not be recoverable, the entity shall determine whether an impairment loss must be recognized in accordance with paragraph 6 of FAS 121. Property occupied by the company shall be evaluated using the asset grouping approach of paragraph 8 of FAS 121. An impairment loss is measured as the amount by which the individual carrying amounts exceed the fair value of properties occupied by the company or properties held for the production of income. Fair value is determined in accordance with paragraph 13 of this statement. If the fair value of the asset is less than the carrying value, the asset shall be written down to the fair value thereby establishing a new cost basis. The new cost basis shall not be changed for subsequent recoveries in fair value. The adjustment shall be recorded in the statement of operations as a realized loss.

12. Properties that the reporting entity has the intent to sell or is required to sell shall be classified as properties held for sale and carried at the lower of depreciated cost or fair value less encumbrances and estimated costs to sell the property consistent with paragraph 16 of FAS 121. The intent to sell a property exists when management, having the authority to approve the action, has committed to a plan to dispose of the asset, either by sale or abandonment. Fair value of the asset shall be determined in accordance with paragraph 13 of this statement. Subsequent revisions to the fair value of the asset shall be accounted for in accordance with paragraph 17 of FAS 121.

13. The current fair value of real estate shall be determined on a property by property basis (i.e., increases in the fair value of one property shall not be used to offset declines in fair value of another). If market quotes are unavailable, estimates of fair value shall be determined by an appraisal (internal or third party), which is based upon an evaluation of all relevant data about the market, considering the following:

a. A physical inspection of the premises;

b. The present value of future cash flows generated by the property (Discounted Cash Flows), or capitalization of stabilized net operating income (Direct Capitalization);

c. Current sales prices of similar properties with adjustments for differences in the properties (Sales Comparison Approach);

d. Costs to sell the property if the reporting entity does not have the intent or ability to hold the real estate as an investment; and

e. Replacement costs of the improvements, less depreciation, plus the value of the land (Cost Approach).

14. For all properties held for the production of income, the reporting entity must maintain an appraisal that is no more than five years old as of the reporting date. For all properties held for sale, an appraisal shall be obtained at the time such property is classified as held for sale, and subsequently an appraisal shall be maintained that is no more than five years old as of the reporting date. However, if conditions indicate there has been a significant decrease in the fair value of a property, a current appraisal shall be obtained. Additionally, appraisals shall be obtained for real estate investments at the time of foreclosure or contribution. Contributed real estate shall be supported by an independent third party appraisal at the date of contribution. If any of the previous conditions exist but an appraisal has not been obtained, the related property shall be considered a nonadmitted asset until the required appraisals are obtained.

Income, Expenses, and Capital Improvements

15. Rental income on real estate leased is addressed in *SSAP No. 22—Leases*, which requires that rental income be included in investment income. Expenses incurred in operating the real estate investment, including but not limited to, real estate taxes, utilities, and ordinary repair and maintenance, shall be charged to expense as incurred and included in investment expenses.

16. Expenditures that are necessary to put the asset back into good operating condition or to keep it in good operating condition, shall be charged to expense as incurred. Expenditures that add to or prolong the life of the property shall be added to the cost of the real estate (capitalized) and depreciated over the remaining estimated useful life of the property. If the property was fully depreciated at the time capital improvements are incurred, the capital improvements shall be capitalized and depreciated over the remaining extended useful life of the asset.

17. A reporting entity shall include in both its income and expenses an amount for rent relating to its occupancy of its own buildings. The amount recorded shall be at a rate comparable to rent received from others and/or rental rates of like property in the same area. If this is unavailable, it shall be derived from consideration of the repairs, expenses, taxes, and depreciation incurred, plus interest added at an average fair rate on the carrying value of the reporting entity’s investment in its home office building.

Sale of Real Estate

18. Recognition of profit on sales of real estate investments shall be accounted for in accordance with *FASB Statement No. 66, Accounting for Sales of Real Estate* (FAS 66), except as modified in paragraph 20 of this statement, *FASB Emerging Issues Task Force No. 87-9*, *Profit Recognition on Sales of Real Estate with Insured Mortgages or Surety Bonds, FASB Emerging Issues Task Force No. 87-29, Exchange of Real Estate Involving Boot, FASB Interpretation No. 43, Real Estate Sales an interpretation of FASB Statement No. 66* (FIN 43) and *FASB Emerging Issues Task Force No. 00-13, Determining Whether Equipment is “Integral Equipment” Subject to FASB Statements No. 66 and No. 98* (INT 06-13). This statement applies to all sales of real estate including real estate with property improvements or integral equipment. The terms “property improvements” and “integral equipment” refer to any physical structure or equipment attached to the real estate that cannot be removed and used separately without incurring significant costs, such as an office building. Additionally, this guidance applies to all transfers of financial assets that are in substance real estate.

19. Profit shall be recognized in full when real estate is sold, provided (a) the profit is determinable, that is, the collectibility of the sales price is reasonably assured or the amount that will not be collectible

can be estimated, and (b) the earnings process is virtually complete, that is, the seller is not obliged to perform significant activities after the sale to earn the profit. Unless both conditions exist, recognition of all or part of the profit shall be postponed. Profit shall not be recognized by the full accrual method until all of the following criteria are met:

a. A sale is consummated;

b. The buyer's initial and continuing investments are adequate to demonstrate a commitment to pay for the property;

c. The seller's receivable is not subject to future subordination; and

d. The seller has transferred to the buyer the usual risks and rewards of ownership in a transaction that is in substance a sale and does not have a substantial continuing involvement with the property after the sale.

20. The calculation of the buyer's initial investment specified in paragraph 9 of FAS 66 shall be modified to reflect that buyer's notes must be supported by letters of credit from institutions that are listed by the Securities Valuation Office of the National Association of Insurance Commissioners as meeting credit standards to be included in determining the buyer's initial investment. Any profit or loss is considered a realized gain or loss in the year of the sale in accordance with FAS 66.

Real Estate Projects Under Development

21. Costs and initial rental operations of real estate projects under development, which include ADC arrangements accounted for as real estate under the provisions of SSAP No. 38, shall be accounted for in accordance with *FASB Statement No. 67, Accounting for Costs and Initial Rental Operations of Real Estate* Projects (FAS 67). Costs incurred in connection with real estate projects shall be expensed as incurred unless the criteria established in FAS 67 are met. The statement value of a real estate project, or parts thereof, held for sale or development and sale shall not exceed the estimated selling price in the ordinary course of business less estimated costs of completion (to stage of completion assumed in determining the selling price), holding, and disposal (net realizable value). If costs exceed net realizable value, capitalization of eligible costs shall continue, however, an allowance shall be provided to reduce the admitted value to estimated net realizable value.

Participating Mortgage Loans

22. A participating mortgage loan is established when the lender is entitled to participate in appreciation of the fair value of mortgaged real estate, the results of operations of the mortgaged real estate project, or in both. Mortgage loan participation features should be recorded at fair value at inception of the loan. The borrower should recognize a participation liability for the determined fair valued amount, with a corresponding debit to a debt discount account. The debt discount should be amortized by the interest method, using the effective interest rate. After inception, adjustment of the participation liability should occur at each reporting date to current fair value. The corresponding debit or credit should be to the related debt discount account. The revised debt discount should be amortized prospectively, using the effective interest rate method.

23. The real estate investment with the participating mortgage loan should be reported in accordance with paragraph 5, with no adjustment for appreciation of fair value.

24. Extinguishment of participating mortgage loans prior to the due date should be determined in accordance with *SSAP No. 103—Accounting for Transfers and Servicing of Financial Assets and* Extinguishments *of Liabilities* (SSAP No. 103). Gains or losses from early extinguishment should be

determined in considering the difference between the recorded amount of debt (including unamortized debt discount and the participation liability) and the amount exchanged to extinguish the debt.

Disclosures

25. An entity that recognizes an impairment loss shall disclose all of the following in financial statements that include the period of the impairment write-down:

a. A description of the impaired assets and the facts and circumstances leading to the impairment;

b. The amount of the impairment loss and how fair value was determined; and

c. The caption in the statement of operations in which the impairment loss is aggregated.

26. An entity that engages in retail land sales operations shall disclose:

a. Maturities of accounts receivable for each of the five years following the date of the financial statements;

b. Delinquent accounts receivable and the method(s) for determining delinquency;

c. The weighted average and range of stated interest rates of receivables;

d. Estimated total costs and estimated dates of expenditures for improvements for major areas from which sales are being made over each of the five years following the date of the financial statements; and

e. Recorded obligations for improvements.

27. An entity that holds real estate investments through an LLC, which qualifies for inclusion in this statement because all the criteria in paragraph 4 are met, shall separately report each investment on Schedule A, and code the real estate as wholly-owned through an LLC.

28. An entity that holds real estate investments with participating mortgage loan features should disclose:

a. Aggregate amount of participating mortgage obligations at the balance-sheet date, with separate disclosure of the aggregate participation liabilities and related debt discounts.

b. Terms of participations by the lender in either the appreciation in the fair value of the mortgaged real estate project or the results of operations of the mortgaged real estate project, or both.

29. Refer to the preamble for further discussion regarding disclosure requirements.

Relevant Literature

30. This statement adopts FAS 66*,* with modification to paragraph 10 to indicate that only letters of credit from institutions listed by the Securities Valuation Office of the National Association of Insurance Commissioners shall be included in determining the buyer's initial investment. Additionally, as they relate to FAS 66, the following are adopted: *FASB Emerging* Issues *Task Force Issue No. 86-6, Antispeculation Clauses in Real Estate Sales Contracts*, *FASB Emerging Issues Task Force No* 87-9*, Profit Recognition on Sales of Real Estate with Insured Mortgages or Surety Bonds, FASB Emerging Issues Task Force No* 87-29*, Exchange of Real Estate Involving Boot, FASB Emerging Issues Task Force*

No. 88-12, Transfer of Ownership Interest as Part of Down Payment under FASB Statement No. 66, FASB Emerging Issues Task Force No. 88-24, Effect of Various Forms of Financing under FASB Statement No. 66, FASB Emerging Issues Task Force No. 06-8: Applicability of the Assessment of a Buyer's Continuing Investment under FASB Statement No. 66 for Sales of Condominiums, with modification consistent to paragraph 9 of FAS 66, in which continuing investment payments made in the form of buyer's notes must be supported by letters of credit from institutions that are listed by the Securities Valuation Office of the National Association of Insurance Commissioners as meeting credit standards to be included in determining the buyer's initial investment, and *FASB Emerging Issues Task Force No. 07-6: Accounting for the Sale of Real Estate Subject to the Requirements of FASB Statement No. 66, When the Arrangements Includes a Buy Sale Clause*.

31. This statement adopts *FASB Interpretation No. 43, Real Estate Sales, an Interpretation of FASB Statement No. 66* (FIN 43), which clarifies that the phrase "all real estate sales" includes sales of real estate with property improvements or integral equipment that cannot be removed and used separately from the real estate without incurring significant costs. This statement adopts *FASB Emerging Issues Task Force No. 84-17, Profit Recognition on Sales of Real Estate with Graduated Payment Mortgages or Insured Mortgages, FASB Emerging Issues Task Force No. 89-13, Accounting for the Cost of Asbestos Removal, FASB Emerging Issues Task Force No. 89-14, Valuation of Repossessed Real Estate, FASB Emerging Issues Task Force No. 90-8, Capitalization of Costs to Treat Environmental Contamination, FASB Emerging Issues Task Force No. 95-23, The Treatment of Certain Site Restoration/Environmental Exit Costs When Testing a Long-Lived Asset for Impairment, FASB Emerging Issues Task Force 97-11: Accounting for Internal Costs Relating to Real Estate Property Acquisitions, FASB Emerging Issues Task Force No. 98-8: Accounting for Transfers of Investments That Are in Substance Real Estate* and *FASB Emerging Issues Task Force No. 00-13, Determining Whether Equipment is "Integral Equipment" Subject to FASB Statements No. 66 and No. 98,* which clarifies the term "integral equipment" as used in this statement.

32. This statement adopts FAS 121 for real estate investments except for paragraphs 13, 14.c. and 14.d. which are rejected in *SSAP No. 68—Business Combinations and Goodwill*. This statement adopts FAS 67, AICPA *Statement of Position 92-1, Accounting for Real Estate Syndication Income,* and AICPA *Statement of Position 92-3*, *Accounting for Foreclosed Assets*. This statement also adopts *FAS 152: Accounting for Real Estate Time-Sharing Transactions, an amendment to FASB Statements No. 66 and 67*. FAS 152 is adopted as it modifies previously adopted GAAP guidance in FAS 66 and FAS 67 to identify the guidance that should/should not be applied to real estate time-sharing transactions. This guidance is adopted as it impacts the scope of previous adopted GAAP guidance to prevent an unnecessary GAAP to SAP difference. However, real estate time-sharing transactions are considered not applicable for statutory accounting, and the GAAP guidance in SOP 04-2 is rejected in Issue Paper No. 99.

33. This statement adopts *AICPA Statement of Position 97-1: Accounting by Participating Mortgage Loan* Borrowers (SOP 97-1) regarding the borrower's accounting for a participating mortgage loan.

34. This statement rejects paragraph 52 of *FASB Statement No. 60, Accounting and Reporting by Insurance* Enterprises and *Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins*, "Chapter 10, Taxes, Section A—Real Estate and Personal Property Taxes."

Effective Date and Transition

35. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Correction of Errors*. Guidance in paragraphs 18-20 was previously included within *SSAP No. 77—Real Estate Sales* and was effective for years beginning January 1, 2002. The original guidance included in this standard from SSAP No. 77 is retained for historical purposes in Issue Paper No. 106. Guidance related to EITF 06-8 referenced in paragraph 30 was

incorporated from *INT 08-02: EITF 06-8: Applicability of the Assessment of a Buyer's Continuing Investment under FASB Statement No. 66 for Sales of Condominiums* and was effective for periods beginning May 31, 2008. The guidance reflected in paragraph 30 adopting *EITF 07-6: Accounting for the Sale of Real Estate Subject to the Requirements of FASB Statement No. 66, When the Agreement Includes a Buy-Sell Clause* was incorporated from *INT 08-07: EITF 07-6, Accounting for the Sale of Real Estate Subject to the Requirements of FASB Statement No. 66 When the Agreement Includes a Buy-Sell Clause,* and was effective September 22, 2008.

36. The substantive revisions to incorporate real estate property investments that are wholly-owned by an LLC that is directly and wholly-owned by the reporting entity in accordance with the criteria detailed in paragraph 4 are effective as of January 1, 2015. For these investments previously reported within SSAP No. 48 and owned as of the effective date, the reporting entity shall recognize a cumulative effect of a change in accounting principle as if the entity had followed this statement since acquisition of the property. The change from applying these substantive revisions shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors.*

37. To determine statement value for real estate owned through an LLC as of the paragraph 36 effective date, the reporting entity shall:

a. Allocate the original cost of the real estate investment to land and property other-than-land pursuant to paragraph 8.

b. To arrive at the current depreciated cost for property (excluding land), the entity shall apply the depreciation that would have occurred if this statement had been applied since acquisition, in accordance with the original expected useful life, adjusted for subsequent capital improvements pursuant to paragraph 16.

c. The depreciated cost calculated under paragraph 37.b. shall be compared to a current appraisal to determine if an impairment assessment is required under SSAP No. 90. Recognition of impairment shall result in a new cost basis for the property, with recalculation of the depreciation based on the property's remaining useful life, as limited by the terms of this statement.

d. The depreciated cost, reflecting any impairment from paragraph 37.c., less encumbrances, shall be recognized as the real estate investment as of the effective date.

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 23—Property Occupied by the Company*
- *Issue Paper No. 40—Real Estate Investments*
- *Issue Paper No. 106—Real Estate Sales – An Amendment to SSAP No. 40—Real Estate Investments*
- *Issue Paper No. 149—Wholly-Owned Single Real Estate Property in an LLC*

Statement of Statutory Accounting Principles No. 41

Surplus Notes

STATUS

Type of Issue:	Common Area
Issued:	Initial Draft
Effective Date:	January 1, 2001
Affects:	Nullifies and incorporates INT 04-02
Affected by:	No other pronouncements
Interpreted by:	No other pronouncements

STATUS **1**

SCOPE OF STATEMENT **3**

SUMMARY CONCLUSION **3**

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Surplus Notes

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for issuers and holders of surplus notes, and for holders of capital notes. Statutory accounting principles for issuers of capital notes are provided in *SSAP No. 15—Debt and Holding Company Obligations*.

SUMMARY CONCLUSION

Issuers of Surplus Notes

2. Reporting entities sometimes issue instruments that have the characteristics of both debt and equity. These instruments are commonly referred to as surplus notes, the term used herein, but are also referred to as surplus debentures or contribution certificates. These instruments are used for various reasons, including but not limited to:

a. Providing regulators with flexibility in dealing with problem situations to attract capital to reporting entities whose surplus levels are deemed inadequate to support their operations;

b. Providing a source of capital to mutual and other types of non-stock reporting entities who do not have access to traditional equity markets for capital needs;

c. Providing an alternative source of capital to stock reporting entities, although not for the purpose of initially capitalizing the reporting entity.

3. Surplus notes issued by a reporting entity that are subject to strict control by the commissioner of the reporting entity's state of domicile and have been approved as to form and content shall be reported as surplus and not as debt only if the surplus note contains the following provisions:

a. Subordination to policyholders;

b. Subordination to claimant and beneficiary claims;

c. Subordination to all other classes of creditors other than surplus note holders; and

d. Interest payments and principal repayments require prior approval of the commissioner of the state of domicile.

4. Proceeds received by the issuer must be in the form of cash or other admitted assets having readily determinable values and liquidity satisfactory to the commissioner of the state of domicile.

5. Interest shall not be recorded as a liability nor an expense until approval for payment of such interest has been granted by the commissioner of the state of domicile. All interest, including interest in arrears, shall be expensed in the statement of operations when approved for payment. Unapproved interest shall not be reported through operations, shall not be represented as an addition to the principal or notional amount of the instrument, and shall not accrue further interest, i.e., interest on interest.

6. As of the date of approval of principal repayment by the commissioner of the state of domicile, the issuer shall reclassify such approved payments from surplus to liabilities.

7. Costs of issuing surplus notes (e.g., loan fees and legal fees) shall be charged to operations when incurred.

8. Discount or premium, if any, shall be reported in the balance sheet as a direct deduction from or addition to the face amount of the note. Such discount or premium shall be charged or credited to the statement of operations concurrent with approved interest payments on the surplus note and in the same proportion or percentage as the approved interest payment is to the total estimated interest to be paid on the surplus note.

Holders of Capital or Surplus Notes

9. Investments in capital or surplus notes meet the definition of assets as defined in *SSAP No. 4—Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this statement.

10. Capital or surplus notes shall be accounted for in accordance with *SSAP No. 26—Bonds, Excluding Loan-Backed and Structured Securities* (SSAP No. 26). Holders of capital or surplus notes shall value their investment as follows:

a. Rated Notes

i. If the notes have been rated by an NAIC credit rating provider (CRP) and have a designation equivalent of NAIC 1, then amortized cost shall be used. If the notes are rated and monitored by two NAIC CRPs, the lowest of the ratings shall be assigned. In case of notes rated and monitored by three or more NAIC CRPs, the NAIC CRP ratings will be ordered according to their NAIC equivalents and the rating falling second lowest will be selected, even if that rating is equal to that of the first lowest.

ii. The *Purposes and Procedures Manual of the NAIC Investment Analysis~~Securities Valuation~~ Office* contains a listing of NAIC equivalent CRP designations as well as a listing of insurers that meet the requirements of paragraph 10.a.i.

b. Non-Rated Notes

i. If the notes are not CRP rated or have an NAIC designation equivalent of NAIC 2 through 6, then value as follows:

(a) At its outstanding face value, notwithstanding the payment of interest and/or principal, when the notes were issued by a reporting entity whose capital and surplus (excluding surplus notes included therein) is greater than or equal to the greater of 5% of its admitted assets (excluding separate accounts) or $6,000,000. The valuation shall be calculated using the most recently filed statutory financial statements of the entity that issued the notes;

(b) By applying a "statement factor" to the outstanding face amount of the capital or surplus notes, notwithstanding the payment of interest and/or principal when the notes were issued by a reporting entity whose capital and surplus (excluding surplus notes included therein) is less than or equal to the greater of 5% of its admitted assets (excluding separate accounts) or $6,000,000. The "statement factor" is equal to the total capital and surplus, including surplus notes, less the greater of 5% of admitted assets (excluding separate accounts) or $6,000,000, divided by the capital or surplus notes. The valuation should be calculated using the most recently filed statutory financial statements of the entity that issued the notes. Should the result of the "statement factor" yield a product less than zero, the capital or surplus notes shall be carried at zero and not a negative amount.

Capital or surplus debenture(s) must not be valued in excess of the lesser of the value determined above or amortized cost and are to be reported as other invested assets. If the notes are issued by an entity which is subject to any order of liquidation, conservation, rehabilitation or any company action level event based on its risk-based capital, then the valuation is at zero, notwithstanding any previous payments of interest and/or principal. The admitted asset value of a capital or surplus note shall not exceed the amount that would be admitted if the instrument was considered an equity instrument and added to any other equity investments in the issuer held directly or indirectly by the holder of the capital or surplus note. If the calculated value (after application of paragraph 10.b.i.(b)) is less than the outstanding face value, then that amount shall be accounted for as a nonadmitted asset.

11. A holder of a surplus note must value the note at zero in any period in which the issuer of the note is under regulatory action. Once the issuer is no longer under regulatory action, the holder values the note according to the guidance in paragraph 10.a. or 10.b. as appropriate.

12. Only interest that has been approved by the issuer's domiciliary commissioner shall be accrued as income by a holder of surplus notes in a manner consistent with SSAP No. 26.

Disclosures

13. The notes to the financial statements of a reporting entity that issues surplus notes shall disclose the following as long as the surplus notes are outstanding:

a. Date issued;

b. Description of the assets received;

c. Holder of the note or if public the names of the underwriter and trustee;

d. Amount of note;

e. Carrying value of note;

f. The rate at which interest accrues;

g. Maturity dates or repayment schedules, if stated;

h. Unapproved interest and/or principal;

i. Interest and/or principal paid in the current year;

j. Total interest and/or principal paid on surplus notes;

k. Subordination terms;

l. Liquidation preference to the reporting entity's common and preferred shareholders;

m. The repayment conditions and restrictions.

14. In addition to the above, a reporting entity shall identify all affiliates that hold any portion of a surplus debenture or similar obligation (including an offering registered under the Securities Act of 1933 or distributed pursuant to rule 144A under the Securities Act of 1933), and any holder of 10% or more of

the outstanding amount of any surplus note registered under the Securities Act of 1933 or distributed pursuant to Rule 144A under the Securities Act of 1933.

Relevant Literature

15. This statement adopts the *Purposes and Procedures Manual of the NAIC Investment Analysis~~Securities Valuation~~ Office*, "Procedures for Valuing Surplus Debentures." This statement rejects *AICPA Practice Bulletin No. 15, Accounting by the Issuer of Surplus Notes*, which requires surplus notes to be accounted for as debt and that interest be accrued over the life of the surplus note, irrespective of the approval of interest and principal payments by the insurance commissioner.

Effective Date and Transition

16. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3*—Accounting *Changes and Corrections of Errors*. The provisions of paragraph 3, which are required for an instrument to qualify as a surplus note, apply to all surplus notes issued or amended after December 12, 1991. Surplus notes issued on or before December 12, 1991, shall not be required to meet the provisions of paragraph 3 in order to be accounted for as a surplus note. Guidance reflected in paragraph 11, incorporated from *INT 04-02: Surplus Notes Issued by Entities Under Regulatory Action*, was originally effective June 13, 2004.

REFERENCES

Other

- *Purposes and Procedures Manual of the NAIC Investment Analysis~~Securities Valuation~~ Office, "Procedures for Valuing Surplus Debentures"*

Relevant Issue Papers

- *Issue Paper No. 41—Surplus Notes*

Statement of Statutory Accounting Principles No. 42

Sale of Premium Receivables

STATUS

Type of Issue:	Common Area
Issued:	Initial Draft
Effective Date:	January 1, 2001
Affects:	No other pronouncements
Affected by:	No other pronouncements
Interpreted by:	No other pronouncements

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Sale of Premium Receivables

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for the sale or factoring of premium receivables.

SUMMARY CONCLUSION

2. For purposes of this statement, receivables shall only include amounts due to the reporting entity for premium receivables (i.e., uncollected premium, agent's balances, and bills receivable).

3. A transfer of receivables can take the form of a transfer with recourse or a transfer without recourse:

a. Recourse means that the transferee has the right to receive payment from the transferor of those receivables for (i) failure of the debtors to pay when due, (ii) the effects of prepayments, or (iii) adjustments resulting from defects in the eligibility of the transferred receivables, for example defects in the legal title of the transferred receivables. When the transferor has the right to repurchase (a call) or the transferee has the right to require the transferor to repurchase (a put) the transferred receivables, the transfer shall be considered to have recourse;

b. Without recourse means that the transferor has surrendered all of the future economic implications of the risks and rewards embodied in the transferred receivables.

4. A transfer of receivables with recourse shall not be recognized as a sale. A transfer of receivables without recourse shall only be recognized if the transferor receives cash for the receivables. The sale shall be recognized when cash is received.

5. If a transfer qualifies to be recognized as a sale, the difference between (a) the sales price and (b) the receivables transferred shall be recognized as a gain or loss. If receivables are sold with servicing retained and the stated servicing fee is less than a current (normal) servicing fee rate (a servicing fee rate that is representative of servicing fee rates most commonly used in comparable servicing agreements covering similar types of receivables) or no servicing fee is specified, the gain or loss recognized by the sale of receivables shall be adjusted to recognize the deviation of the stated servicing fee rate from the commonly used servicing fee rate and a liability shall be established to provide for a normal servicing fee in each subsequent servicing period, which shall not be less than the estimated servicing costs. When the stated servicing fee is greater than a normal servicing fee the gain or loss shall not be adjusted and the excess servicing fee revenues shall not be recorded currently but shall be recorded when realized.

6. If the conditions of paragraph 3.b. are not met, or the transfer is for other than cash, the receivables shall remain on the transferor's financial statements. A liability shall be established in an amount equal to the greater of the carrying amount of the receivables transferred or the amount of the proceeds received. To the extent that the proceeds received are less than the carrying amount of receivables transferred, a loss shall be recorded. The carrying amount of the receivable balance shall be evaluated at each reporting period and adjusted for any uncollectible amounts. The liability shall be derecognized as the transferee receives cash. When the proceeds received are greater than the receivables transferred, the liability shall be derecognized on a pro rata basis as the receivables are collected.

Disclosures

7. For transfers of receivables reported as sales, the transferor's financial statements shall disclose:

  a. The proceeds to the transferor; and

  b. The gain or loss recorded on the sale.

8. Refer to the preamble for further discussion regarding disclosure requirements.

Relevant Literature

9. This statement rejects paragraph 83 of *FASB Statement No. 125*, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 125) to the extent that it permits sales recognition for sales of receivables with recourse provisions. FAS 125 is addressed in its entirety in *SSAP No. 18—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, which was superseded by *SSAP No. 91R—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. *SSAP No. 103—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* adopts with modification *FAS 166, Accounting for Transfers of Financial Assets—An Amendment of FASB Statement No. 104* and supersedes SSAP No. 91R.

Effective Date and Transition

10. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors.*

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 42—Sale of Premium Receivables*

Statement of Statutory Accounting Principles No. 43 - Revised

Loan-Backed and Structured Securities

STATUS

Type of Issue:	Common Area
Issued:	Initial draft; substantively revised September 2009
Effective Date:	January 1, 2001; substantive revisions detailed in Issue Paper No. 140 are effective September 30, 2009; December 2009 revisions to paragraph 25 are effective December 31, 2009; revisions to paragraphs 2, 3 and 4 adopted October 2010 are effective January 1, 2011
Affects:	Supersedes SSAP No. 98 and paragraph 13 of SSAP No. 99 Nullifies and incorporates INT 00-11
Affected by:	No other pronouncements
Interpreted by:	INT 06-07, INT 07-01

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Loan-Backed and Structured Securities

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for investments in loan-backed securities and structured securities. In accordance with *SSAP No. 103—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (SSAP No. 103), retained beneficial interests from the sale of loan-backed securities and structured securities are accounted for in accordance with this statement. In this statement loan-backed securities and structured securities are collectively referred to as loan-backed securities.

SUMMARY CONCLUSION

2. Loan-backed securities are defined as securitized assets not included in structured securities, as defined below, for which the payment of interest and/or principal is directly proportional to the payments received by the issuer from the underlying assets, including but not limited to pass-through securities, lease-backed securities, and equipment trust certificates.

3. Structured securities are defined as loan-backed securities which have been divided into two or more classes for which the payment of interest and/or principal of any class of securities has been allocated in a manner which is not proportional to payments received by the issuer from the underlying assets.

4. Loan-backed securities are issued by special-purpose corporations or trusts (issuer) established by a sponsoring organization. The assets securing the loan-backed obligation are acquired by the issuer and pledged to an independent trustee until the issuer's obligation has been fully satisfied. The investor only has direct recourse to the issuer's assets, but may have secondary recourse to third parties through insurance or guarantee for repayment of the obligation. As a result, the sponsor and its other affiliates may have no financial obligation under the instrument, although one of those entities may retain the responsibility for servicing the underlying assets. Some sponsors do guarantee the performance of the underlying assets.

5. Loan-backed and structured securities meet the definition of assets as defined in *SSAP No. 4—Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this statement.

6. The scope of this statement encompasses all types of loan-backed and structured securities, including, but not limited to, the following:

a. Loan-backed and structured securities acquired at origination,

b. Loan-backed and structured securities acquired subsequent to origination for which it is probable, at acquisition, that the reporting entity will be able to collect all contractually required payments receivable, and are accounted for at acquisition under SSAP No. 103,

c. Loan-backed and structured securities for which it is probable, either known at acquisition or identified during the holding period[1], that the reporting entity will be unable to collect all contractually required payments receivable, and

[1] Securities classified within the type of paragraph 6.a. or 6.b. may be required to change classification to type 6.c. when it becomes probable that the reporting entity will be unable to collect all contractually required payments receivable.

d. Transferor's beneficial interests in securitization transactions that are accounted for as sales under SSAP No. 103 and purchased beneficial interests in securitized financial assets[2].

7. At acquisition, loan-backed and structured securities, except for loan-backed or structured securities that are beneficial interests that are not of high credit quality or can contractually be prepaid or otherwise settled in such a way that the reporting entity would not recover substantially all of its recorded amount[3] (see paragraphs 20-23), shall be reported at cost, including brokerage and related fees. Acquisitions and dispositions shall be recorded on the trade date, not the settlement date, except for the acquisition of private placement loan-backed and structured securities which shall be recorded on the funding date. For securities where all information is not known as of the trade date (e.g., actual payment factors and specific pools), a reporting entity shall make its best estimate based on known facts.

8. Amortization of premium or discount shall be calculated using the scientific (constant yield) interest method and shall be recorded as an adjustment to investment income.(INT 07-01) The interest method results in a constant effective yield equal to the prevailing rate at the time of purchase or at the time of subsequent adjustments to book value. The amortization period shall reflect estimates of the period over which repayment of principal of the loan-backed and structured securities is expected to occur, not the stated maturity period.

9. Interest shall be accrued using the effective-yield method using the redemption prices and redemption dates used for amortizing premiums and discounts. Interest income consists of interest collected during the period, the change in the due and accrued interest between the beginning and end of the period as well as reductions for premium amortization and interest paid on acquisition of loan-backed and structured securities, and the addition of discount accrual. Contingent interest may be accrued if the applicable provisions of the underlying contract and the prerequisite conditions have been met.

10. For reporting entities required to maintain an IMR, the accounting for realized capital gains and losses on sales of loan-backed and structured securities shall be in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*. For reporting entities not required to maintain an IMR, realized gains and losses on sales of loan-backed and structured securities shall be recorded on the trade date and shall be reported as net realized capital gains or losses in the Statement of Income.

11. A loan-backed or structured security may provide for a prepayment penalty or acceleration fee in the event the investment is liquidated prior to its scheduled termination date. These fees shall be reported as investment income when received.

Collection of All Contractual Cashflows is Probable

12. The following guidance applies to loan-backed and structured securities for which it is probable that the investor will be able to collect all contractually required payments receivable. (Paragraphs 17-19 provide guidance for securities in which collection of all contractual cash flows is not probable and paragraphs 20-23 provide guidance for beneficial interests.) Prepayments are a significant variable element in the cash flow of loan-backed and structured securities because they affect the yield and determine the expected maturity against which the yield is evaluated. Falling interest rates generate faster prepayment of the mortgages underlying the security, shortening its duration. This causes the reporting entity to reinvest assets sooner than expected at potentially less advantageous rates. This is called prepayment risk. Extension risk is created by rising interest rates which slow repayment and can

[2] The accounting requirements related to these type of securities included in paragraphs 20-23 shall be determined at acquisition or initial transfer.

[3] As referenced in the Relevant Literature section, this statement adopts EITF 99-20, including the scope requirements of that guidance.

significantly lengthen the duration of the security. Differences in cash flows can also result from other changes in the cash flows from the underlying assets. If assets are delinquent or otherwise not generating cash flow, which should be reflected in the cash flow analysis through diminishing security cash flows, even if assets have not been liquidated and gain/losses have not been booked.

13. Changes in currently estimated cash flows, including the effect of prepayment assumptions, on loan-backed and structured securities shall be reviewed periodically, at least quarterly. The prepayment rates of the underlying loans shall be used to determine prepayment assumptions. Prepayment assumptions shall be applied consistently across portfolios to all securities backed by similar collateral (similar with respect to coupon, issuer, and age of collateral). Reporting entities shall use consistent assumptions across portfolios for similar collateral within controlled affiliated groups. Since each reporting entity may have a unique method for determining the prepayment assumptions, it is impractical to set standard assumptions for the industry. Relevant sources and rationale used to determine each prepayment assumption shall be documented by the reporting entity.

14. Loan-backed and structured securities shall be revalued using the currently estimated cash flows, including new prepayment assumptions, using either the prospective or retrospective adjustment methodologies, consistently applied by type of securities. However, if at anytime during the holding period, the reporting entity determines it is no longer probable that they will collect all contractual cashflows, the reporting entity shall apply the accounting requirements in paragraphs 17-19.

15. The prospective approach recognizes, through the recalculation of the effective yield to be applied to future periods, the effects of all cash flows whose amounts differ from those estimated earlier and the effects and changes in projected cash flows. Under the prospective method, the recalculated effective yield will equate the carrying amount of the investment to the present value of the anticipated future cash flows. The recalculated yield is then used to accrue income on the investment balance for subsequent accounting periods. There are no accounting changes in the current period unless the security is determined to be other than temporarily impaired.

16. The retrospective methodology changes both the yield and the asset balance so that expected future cash flows produce a return on the investment equal to the return now expected over the life of the investment as measured from the date of acquisition. Under the retrospective method, the recalculated effective yield will equate the present value of the actual and anticipated cash flows with the original cost of the investment. The current balance is then increased or decreased to the amount that would have resulted had the revised yield been applied since inception, and investment income is correspondingly decreased or increased.

Collection of All Contractual Cashflows is Not Probable

17. The following guidance applies to loan-backed and structured securities with evidence of deterioration of credit quality since origination for which it is probable, either known at acquisition or identified during the holding period, that the investor will be unable to collect all contractually required payments receivable, except for those beneficial interests that are not of high credit quality or can contractually be prepaid or otherwise settled in such a way that the reporting entity would not recover substantially all of its recorded amount determined at acquisition (see paragraphs 20-23).

18. The reporting entity shall recognize the excess of all cash flows expected at acquisition over the investor’s initial investment in the loan-backed or structured security as interest income on an effective-yield basis over the life of the loan-backed or structured security (accretable yield).[4] Any excess of

[4] A loan-backed or structured security may be acquired at a discount because of a change in credit quality or rate or both. When a loan-backed or structured security is acquired at a discount that relates, at least in part, to the security’s credit quality, the effective interest rate is the discount rate that equates the present value of the investor’s estimate of the security’s future cash flows with the purchase price of the loan-backed or structured security.

contractually required cash flows over the cash flows expected to be collected is the nonaccretable difference. Expected prepayments shall be treated consistently for determining cash flows expected to be collected and projections of contractual cash flows such that the nonaccretable difference is not affected. Similarly, the difference between actual prepayments and expected prepayments shall not affect the nonaccretable difference.

19. An investor shall continue to estimate cash flows expected to be collected over the life of the loan-backed or structured security. If, upon subsequent evaluation:

a. The fair value of the loan-backed or structured security has declined below its amortized cost basis, an entity shall determine whether the decline is other than temporary $^{\text{(INT 06-07)}}$. For example, if, based on current information and events, there is a decrease in cash flows expected to be collected (that is, the investor is unable to collect all cash flows expected at acquisition plus any additional cash flows expected to be collected arising from changes in estimate after acquisition (in accordance with paragraph 19.b.), an other-than-temporary impairment shall be considered to have occurred. The investor shall consider both the timing and amount of cash flows expected to be collected in making a determination about whether there has been a decrease in cash flows expected to be collected.

b. Based on current information and events, if there is a significant increase in cash flows previously expected to be collected or if actual cash flows are significantly greater than cash flows previously expected, the investor shall recalculate the amount of accretable yield for the loan-backed or structured security as the excess of the revised cash flows expected to be collected over the sum of (1) the initial investment less (2) cash collected less (3) other-than-temporary impairments plus (4) amount of yield accreted to date. The investor shall adjust the amount of accretable yield by reclassification from nonaccretable difference. The adjustment shall be accounted for as a change in estimate in conformity with *SSAP No. 3—Accounting Changes and Corrections of Errors* (SSAP No. 3), with the amount of periodic accretion adjusted over the remaining life of the loan-backed or structured security (prospective method).

Beneficial Interests

20. The following paragraphs provide statutory accounting guidance for interest income and impairment for a reporting entity that continues to hold an interest in securitized financial assets accounted for as sales under SSAP No. 103, or that purchases a beneficial interest in securitized financial assets that are not of high credit quality or can contractually be prepaid or otherwise settled in such a way that the reporting entity would not recover substantially all of its recorded amount, determined at acquisition or the date of transfer[5]. Beneficial interests that are of high credit quality and cannot contractually be prepaid or otherwise settled in such a way that the reporting entity would not recover substantially all of its recorded investment, shall be accounted for in accordance with paragraphs 12-16.

21. The reporting entity shall recognize the excess of all cash flows attributable to the beneficial interest estimated at the acquisition/transaction date (referred to herein as the transaction date) over the initial investment (the accretable yield) as interest income over the life of the beneficial interest using the effective yield method. If the holder of the beneficial interest is the reporting entity that transferred the financial assets for securitization, the initial investment would be the fair value of the beneficial interest

[5] The accounting requirements related to these types of securities included in paragraphs 20-23 shall be determined at acquisition or initial transfer. As referenced in the Relevant Literature section, this Statement adopts EITF 99-20 (as amended by FAS 166), including the scope requirements of that guidance.

as of the date of transfer, as required by SSAP No. 103. The amount of accretable yield shall not be displayed in the balance sheet.

22. The reporting entity that holds a beneficial interest shall continue to update the estimate of cash flows over the life of the beneficial interest. If upon evaluation:

a. Based on current information and events it is probable that there is a favorable (or an adverse) change in estimated cash flows from the cash flows previously projected, then the investor shall recalculate the amount of accretable yield for the beneficial interest on the date of evaluation as the excess of estimated cash flows over the beneficial interest's reference amount (the reference amount is equal to (1) the initial investment less (2) cash received to date less (3) other-than-temporary impairments recognized to date [as described in paragraph 22.b.] plus (4) the yield accreted to date. The adjustment shall be accounted for prospectively as a change in estimate in conformity with SSAP No. 3, with the amount of periodic accretion adjusted over the remaining life of the beneficial interest. Based on estimated cash flows, interest income may be recognized on a beneficial interest even if the net investment in the beneficial interest is accreted to an amount greater than the amount at which the beneficial interest could be settled if prepaid immediately in its entirety.

b. The fair value of the beneficial interest has declined below its reference amount; a reporting entity shall determine whether the decline is other-than-temporary. If, based on current information and events it is probable that there has been an adverse change in estimated cash flows (in accordance with paragraph 22.a.), then (1) an other-than-temporary impairment shall be considered to have occurred and (2) the beneficial interest shall be written down to the current estimate of cash flows at the financial reporting date discounted at a rate equal to the current yield used to accrete the beneficial interest with the resulting change being recognized as a realized loss. Determining whether there has been a favorable (or an adverse) change in estimated cash flows from the cash flows previously projected (taking into consideration both the timing and amount of the estimated cash flows) involves comparing the present value of the remaining cash flows as estimated at the initial transaction date (or at the last date previously revised) against the present value of the cash flows estimated at the current financial reporting date. The cash flows shall be discounted at a rate equal to the current yield used to accrete the beneficial interest. If the present value of the original cash flows estimated at the initial transaction date (or the last date previously revised) is less than the present value of the current estimate of cash flows expected to be collected, the change is considered favorable (that is, an other-than-temporary impairment shall be considered to have not occurred). If the present value of the original cash flows estimated at the initial transaction date (or the last date previously revised) is greater than the present value of the current estimated cash flows, the change is considered adverse (that is, an other-than-temporary impairment shall be considered to have occurred). However, absent any other factors that indicate an other-than-temporary impairment has occurred, changes in the interest rate of a "plain-vanilla," variable-rate beneficial interest generally shall not result in the recognition of an other-than-temporary impairment[6] (a plain-vanilla, variable-rate

[6] Changes in the interest rate of a "plain-vanilla," variable-rate beneficial interest (a plain-vanilla, variable-rate beneficial interest does not include those variable-rate beneficial interests with interest rate reset formulas that involve either leverage or an inverse floater) generally should not result in the recognition of an other-than-temporary impairment. For plain-vanilla, variable-rate beneficial interests, the yield is changed to reflect the revised interest rate based on the contractual interest rate reset formula. For example, if a beneficial interest pays interest quarterly at a rate equal to LIBOR plus 2 percent, the yield of that beneficial interest is changed prospectively to reflect changes in LIBOR. However, changes in the fair value of a plain-vanilla, variable-rate beneficial interest due to credit events should be considered when evaluating whether there has been an other-than-temporary impairment.

beneficial interest does not include those variable-rate beneficial interests with interest rate reset formulas that involve either leverage or an inverse floater).

23. All cash flows estimated at the transaction date are defined as the holder's estimate of the amount and timing of estimated future principal and interest cash flows used in determining the purchase price or the holder's fair value determination for purposes of determining a gain or loss under SSAP No. 103. Subsequent to the transaction date, estimated cash flows are defined as the holder's estimate of the amount and timing of estimated principal and interest cash flows based on the holder's best estimate of current information and events. A change in estimated cash flows is considered in the context of both timing and amount of the estimated cash flows.

Reporting Guidance for All Loan-Backed and Structured Securities

24. Loan-backed and structured securities shall be valued and reported in accordance with this statement, the *Purposes and Procedures Manual of the NAIC Investment Analysis~~Securities Valuation~~ Office*, and the designation assigned in the *NAIC Valuations of Securities* product prepared by the NAIC Securities Valuation Office or equivalent specified procedure. The carrying value method shall be determined as follows:

a. For reporting entities that maintain an Asset Valuation Reserve (AVR), loan-backed and structured securities shall be reported at amortized cost, except for those with an NAIC designation of 6, which shall be reported at the lower of amortized cost or fair value.

b. For reporting entities that do not maintain an AVR, loan-backed and structured securities designated highest-quality and high-quality (NAIC designations 1 and 2, respectively) shall be reported at amortized cost; loan-backed and structured securities that are designated medium quality, low quality, lowest quality and in or near default (NAIC designations 3 to 6, respectively) shall be reported at the lower of amortized cost or fair value.

Designation Guidance

25. For securities within the scope of this statement, the initial NAIC designation used to determine the carrying value method and the final NAIC designation for reporting purposes is determined using a multi-step process. The *Purposes and Procedures Manual of the NAIC Investment Analysis~~Securities Valuation~~ Office* provides detailed guidance. A general descripton of the processes is as follows:

a. Financial Modeling: The NAIC identifies securities where financial modeling must be used to determine the NAIC designation. NAIC designation based on financial modeling incorporates the insurers' carrying value for the security. For those securities that are financially modeled, the insurer must use NAIC CUSIP specific modeled breakpoints provided by the modelers in determining initial and final designation for these identified securities. Securities where modeling results in zero expected loss in all scenarios are automatically considered to have a final NAIC designation of NAIC 1, regardless of the carrying value. The three-step process for modeled securities is as follows:

i. Step 1: Determine Initial Designation – The current amortized cost (divided by remaining par amount) of a loan-backed or structured security is compared to the modeled breakpoint values assigned to the six (6) NAIC designations for each CUSIP to establish the **initial** NAIC designation.

ii. Step 2: Determine Carrying Value Method – The carrying value method, either the amortized cost method or the lower of amortized cost or fair value method, is then determined as described in paragraph 24 based upon the **initial** NAIC designation from Step 1.

iii. Step 3: Determine Final Designation – The final NAIC designation that shall be used for investment schedule reporting is determined by comparing the carrying value (divided by remaining par amount) of a security (based on paragraph 25.a.ii.) to the NAIC CUSIP specific modeled breakpoint values assigned to the six (6) NAIC designations for each CUSIP. This final NAIC designation shall be applicable for statutory accounting and reporting purposes (including establishing the AVR charges). The final designation is not used for establishing the appropriate carrying value method in Step 2 (paragraph 25.a.ii.).

b. Modified Filing Exempt Securities: The modified filing exempt method is for securities that are not subject to modeling under paragraph 25.a., and is further defined in the *Purposes and Procedures Manual of the NAIC Investment Analysis~~Securities Valuation~~ Office* and have a NAIC Credit Rating Provider (CRP) rating. The four-step process for these securities is similar to the three-step process described in paragraph 25.a.i. through 25.a.iii.

i. Step 1: Translate ARO Rating – Translate CRP Rating to the NAIC Designation Equivalent in accordance with the *Purposes and Procedures Manual of the NAIC Investment Analysis~~Securities Valuation~~ Office*. If the result is NAIC 1 or NAIC 6, the remaining steps do not need to be performed; use the NAIC 1 or NAIC 6 to establish the appropriate carrying value methodology per paragraph 24 and report the NAIC 1 or NAIC 6 as the Final Designation. For NAIC 2 through NAIC 5, proceed to Step 2.

ii. Step 2: Determine Initial Designation – Use the NAIC 2 through NAIC 5 from Step 1 to identify the appropriate breakpoints from the pricing matrix (see table, "NAIC Designations Breakpoints for Loan-Backed and Structured Securities" provided in Part Three Section 3 (c) (iv) (A) of the *Purposes and Procedures Manual of the NAIC Investment Analysis~~Securities Valuation~~ Office*) and compare to the amortized cost (divided by outstanding par) to determine the **initial** NAIC designation.

iii. Step 3: Determine Carrying Value Method – The carrying value method, either the amortized cost method or the lower of amortized cost or fair value method, is then determined as described in paragraph 24 based upon the **initial** NAIC designation determined in Step 2.

iv. Step 4: Determine Final Designation – If the appropriate carrying value methodology established in Step 3 results in the security being carried at amortized cost (including securities where the carrying value method is lower of amortized cost or fair value where the amortized cost is the lower value), then the **final** NAIC designation is the same as the **initial** NAIC designation. If the appropriate carrying value methodology established in Step 3 results in the security being carried at fair value (thus the carrying value method is lower of amortized cost and fair value, and the fair value is the lower value), use the converted ARO rating NAIC designation from Step 2 to identify the appropriate breakpoints from the pricing matrix and compare to the fair value (divided by outstanding par) to determine the **final** NAIC designation. This final NAIC designation shall be applicable for statutory accounting and reporting purposes (including establishing the AVR charges). The final NAIC designation is not used for establishing the appropriate carrying value method in Step 3 (paragraph 25.b.ii.).

c. All Other Loan-Backed and Structured Securities: For loan-backed and structured securities not subject to paragraphs 25.a. (financial modeling) or 25.b. (modified filing exempt), follow the established designation procedures according to the appropriate section of the *Purposes and Procedures Manual of the NAIC Investment Analysis~~Securities Valuation~~ Office*. The NAIC designation shall be applicable for statutory accounting and reporting purposes (including determining the carrying value method and establishing the AVR charges). The carrying value method is established as described in paragraph 24. Examples of these securities include, but are not limited to, equipment trust certificates, credit tenant loans (CTL), 5*/6* securities, interest only (IO) securities, and loan-backed and structured securities with SVO assigned NAIC designations.

Specific Interim Reporting Guidance for RMBS/CMBS Securities

26. The guidance in this paragraph shall be applied in determining the reporting method for residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS) acquired in the current year for quarterly financial statements. Securities reported as of the prior-year end shall continue to be reported under the prior-year end methodology for the current-year quarterly financial statements. For year-end reporting, securities shall be reported in accordance with paragraph 25, regardless of the quarterly methodology used.

a. Reporting entities that acquired the entire financial modeling database for the prior-year end are required to follow the financial modeling methodology (paragraph 25.a.) for all securities acquired in the subsequent year that were included in the financial modeling data acquired for the prior year-end.

b. Reporting entities that acquired identical securities (identical CUSIP) to those held and financially modeled for the prior year-end are required to follow the prior year-end financial modeling methodology (paragraph 25.a.) for these securities acquired subsequent to year-end.

c. Reporting entities that do not acquire the prior-year financial modeling information for current-year acquired individual CUSIPS, and are not captured within paragraphs 26.a. or 26.b., are required to follow the analytical procedures for non-financially modeled securities (paragraph 25.b. or paragraph 25.c. as appropriate). Reporting entities that do acquire the individual CUSIP information from the prior-year financial modeling database shall use that information for interim reporting.

d. Reporting entities that acquire securities not previously modeled at the prior year-end are required to follow the analytical procedures for non-financially modeled securities (paragraph 25.b. or paragraph 25.c. as appropriate).

Unrealized Gains and Losses and Impairment Guidance

27. For reporting entities required to maintain an AVR, the accounting for unrealized gains and losses shall be in accordance with paragraph 36 of this statement. For reporting entities not required to maintain an AVR, unrealized gains and losses shall be recorded as a direct credit or charge to unassigned funds (surplus).

28. The application of this reporting requirement resulting from NAIC designation (i.e., lower of cost or fair value) is not a substitute for other-than-temporary impairment recognition (paragraphs 33-37). For

securities reported at fair value where an other-than-temporary impairment has been determined to have occurred, the realized loss recognized from the other-than-temporary impairment shall first be applied towards the realization of any unrealized losses previously recorded as a result of fluctuations in the security's fair value due to the reporting requirements. After the recognition of the other-than-temporary impairment, the security shall continue to report unrealized gains and losses as a result of fluctuations in fair value.

29. If the fair value of a loan-backed or structured security is less than its amortized cost basis at the balance sheet date, an entity shall assess whether the impairment is other than temporary. Amortized cost basis includes adjustments made to the cost of an investment for accretion, amortization, collection of cash, previous other-than-temporary impairments recognized as a realized loss (including any cumulative-effect adjustments recognized in accordance with paragraphs 56-58 of this statement).

30. If an entity intends to sell the loan-backed or structured security (that is, it has decided to sell the security), an other-than-temporary impairment shall be considered to have occurred.

31. If an entity does not intend to sell the loan-backed or structured security, the entity shall assess whether it has the intent and ability[7] to retain the investment in the security for a period of time sufficient to recover the amortized cost basis. If the entity does not have the intent and ability to retain the investment for the time sufficient to recover the amortized cost basis, an other-than-temporary impairment shall be considered to have occurred.

32. If the entity does not expect to recover the entire amortized cost basis of the security, the entity would be unable to assert that it will recover its amortized cost basis even if it does not intend to sell the security and the entity has the intent and ability to hold. Therefore, in those situations, an other-than temporary impairment shall be considered to have occurred. In assessing whether the entire amortized cost basis of the security will be recovered, an entity shall compare the present value of cash flows expected to be collected from the security with the amortized cost basis of the security. If present value of cash flows expected to be collected is less than the amortized cost basis of the security, the entire amortized cost basis of the security will not be recovered (that is, a non-interest related decline[8] exists), and an other-than-temporary impairment shall be considered to have occurred. A decrease in cashflows expected to be collected on a loaned-backed or structured security that results from an increase in prepayments on the underlying assets shall be considered in the estimate of the present value of cashflows expected to be collected.

33. In determining whether a non-interest related decline exists, an entity shall calculate the present value of cash flows expected to be collected based on an estimate of the expected future cash flows of the impaired loan-backed or structured security, discounted at the security's effective interest rate.

a. For securities accounted for under paragraphs 12-16 – the effective interest rate of the loan-backed or structured security is the rate of return implicit in the security (that is, the contractual interest rate adjusted for any net deferred fees or costs, premium, or discount existing at the origination or acquisition of the security).[9]

[7] This assessment shall be considered a high standard due to the accounting measurement method established for the securities within the scope of this Statement (amortized cost).

[8] A non-interest related decline is a decline in value due to fundamental credit problems of the issuer. Fundamental credit problems exist with the issuer when there is evidence of financial difficulty that may result in the issuer being unable to pay principal or interest when due. An interest related decline in value may be due to both increases in the risk-free interest rate and general credit spread widening.

[9] See Footnote 1.

b. For securities accounted for under paragraphs 17-19 – the effective interest rate is the rate implicit immediately prior to the recognition of the other-than-temporary impairment.

c. For securities accounted for under paragraphs 20-23 – the reporting entity shall apply the guidance in paragraph 22.b.

34. When an other-than-temporary impairment has occurred because the entity intends to sell the security or has assessed that that they do not have the intent and ability to retain the investments in the security for a period of time sufficient to recover the amortized cost basis, the amount of the other-than-temporary impairment recognized in earnings as a realized loss shall equal the entire difference between the investment's amortized cost basis and its fair value at the balance sheet date. (This guidance includes loan-backed and structured securities previously held at lower of cost or market. For these securities, upon recognition of an other-than-temporary impairment, unrealized losses would be considered realized.)

35. When an other-than-temporary impairment has occurred because the entity does not expect to recover the entire amortized cost basis of the security even if the entity has no intent to sell and the entity has the intent and ability to hold, the amount of the other-than-temporary impairment recognized as a realized loss shall equal the difference between the investment's amortized cost basis and the present value of cash flows expected to be collected, discounted at the loan-backed or structured security's effective interest rate in accordance with paragraph 33. (This guidance includes loan-backed and structured securities previously held at lower of cost or market. For these securities, upon recognition of an other-than-temporary impairment, unrealized losses would be considered realized for the non-interest related decline. Hence, unrealized losses could continue to be reflected for these securities due to the reporting requirements.)

36. For reporting entities required to maintain an AVR or IMR, the accounting for unrealized gains and losses shall be in accordance with paragraph 36.a. For realized gains and losses, the AVR and IMR analysis required and provision to allocate gains and losses between AVR and IMR is the same regardless whether the realized loss results from an impairment write-down or whether there was a gain or loss upon sale. Guidance on specific scenarios resulting in realized gains and losses are addressed in paragraphs 36.b. through 36.f.:

a. Unrealized Gains and Losses – Record all unrealized gains and losses through AVR. At the time an unrealized gain or loss is realized, the accounting shall follow the premise in paragraph 36, as detailed in paragraphs 36.b. through 36.f. for specific transactions. Unrealized gains or losses that are realized shall be reversed from AVR before the recognition of the realized gain or loss within AVR and IMR. Gains and losses shall only be reflected in IMR when realized and as appropriate based on the analysis of interest and non-interest factors.

b. Other-Than-Temporary Impairment – Non-interest related other-than-temporary impairment losses shall be recorded through the AVR. If the reporting entity wrote the security down to fair value due to the intent to sell or does not have the intent and ability to retain the investment for a period of time sufficient to recover the amortized cost basis, the non-interest related portion of the other-than-temporary impairment losses shall be recorded through the AVR; the interest related other-than-temporary impairment losses shall be recorded through the IMR. The analysis for bifurcating impairment losses between AVR and IMR shall be completed as of the date when the other-than-temporary impairment is determined.

c. Security Sold at a Loss Without Prior OTTI – An entity shall bifurcate the loss into AVR and IMR portions depending on interest and non-interest related declines in accordance with the analysis performed as of the date of sale. As such, an entity shall report the loss in separate AVR and IMR components as appropriate.

d. Security Sold at a Loss With Prior OTTI – An entity shall bifurcate the current realized loss into AVR and IMR portions depending on interest and non-interest related declines in accordance with the analysis performed as of the date of sale. An entity shall not adjust previous allocations to AVR and IMR that resulted from previous recognition of other-than-temporary impairments.

e. Security Sold at a Gain With Prior OTTI – An entity shall bifurcate the gain into AVR and IMR portions depending on interest and non-interest factors in accordance with the analysis performed as of the date of sale. The bifurcation between AVR and IMR that occurs as of the date of sale may be different from the AVR and IMR allocation that occurred at the time of previous other-than-temporary impairments. An entity shall not adjust previous allocations to AVR and IMR that resulted from previous recognition of other-than-temporary impairments.

f. Security Sold at a Gain Without Prior OTTI – An entity shall bifurcate the gain into AVR and IMR portions depending on interest and non-interest factors in accordance with the analysis performed as of the date of sale.

37. For situations where an other-than-temporary impairment is recognized pursuant to paragraphs 34 and 35 of this statement, the previous amortized cost basis less the other-than-temporary impairment recognized as a realized loss shall become the new amortized cost basis of the investment. That new amortized cost basis shall not be adjusted for subsequent recoveries in fair value. Therefore, the prospective adjustment method shall be used for periods subsequent to loss recognition.

38. In periods subsequent to the recognition of an other than temporary impairment loss for a loan-backed or structured security, the reporting entity shall account for the other-than-temporarily impaired security as if the security had been purchased on the measurement date of the other-than-temporary impairment at an amortized cost basis equal to the previous amortized cost basis less the other-than-temporary impairment recognized as a realized loss. The difference between the new amortized cost basis and the cash flows expected to be collected shall be accreted as interest income. A reporting entity shall continue to estimate the present value of cash flows expected to be collected over the life of the loan-backed or structured security.

a. For securities accounted for under paragraphs 12-19, if upon subsequent evaluation, there is a significant increase in the cash flows expected to be collected or if actual cash flows are significantly greater than cash flows previously expected, such changes shall be accounted for as a prospective adjustment to the accretable yield in accordance with paragraphs 17-19. The security shall continue to be subject to impairment analysis for each subsequent reporting period. The new amortized cost basis shall not be changed for subsequent recoveries in fair value. Future declines in fair value which are determined to be other-than-temporary shall be recorded as realized losses.

b. For beneficial interests accounted for under paragraphs 20-23, a reporting entity shall apply the guidance in paragraphs 21-22 to account for changes in cash flows expected to be collected.

39. It is inappropriate to automatically conclude that a security is not other-than-temporarily impaired because all of the scheduled payments to date have been received. However, it also is inappropriate to automatically conclude that every decline in fair value represents an other-than-temporary impairment. Further analysis and judgment are required to assess whether a decline in fair value indicates that it is

probable that the holder will not collect all of the contractual or estimated cash flows from the security. In addition, the length of time and extent to which the fair value has been less than cost can indicate a decline is other than temporary. The longer and/or the more severe the decline in fair value, the more persuasive the evidence that is needed to overcome the premise that it is probable that the holder will not collect all of the contractual or estimated cash flows from the issuer of the security.

40. In making its other-than-temporary impairment assessment, the holder shall consider all available information relevant to the collectibility of the security, including information about past events, current conditions, and reasonable and supportable forecasts, when developing the estimate of future cash flows. Such information generally shall include the remaining payment terms of the security, prepayment speeds, the financial condition of the issuer(s), expected defaults, and the value of any underlying collateral. To achieve that objective, the holder shall consider, for example, industry analyst reports and forecasts, sector credit ratings, and other market data that are relevant to the collectibility of the security. The holder also shall consider how other credit enhancements affect the expected performance of the security, including consideration of the current financial condition of the guarantor of a security (if the guarantee is not a separate contract) and/or whether any subordinated interests are capable of absorbing estimated losses on the loans underlying the security. The remaining payment terms of the security could be significantly different from the payment terms in prior periods (such as for some securities backed by "nontraditional loans"[10]). Thus, the holder shall consider whether a security backed by currently performing loans will continue to perform when required payments increase in the future (including "balloon" payments). The holder also shall consider how the value of any collateral would affect the expected performance of the security. If the fair value of the collateral has declined, the holder needs to assess the effect of that decline on the ability of the holder to collect the balloon payment.

Origination Fees

41. Origination fees represent fees charged to the borrower in connection with the process of originating or restructuring a transaction. The fees include, but are not limited to, points, management, arrangement, placement, application, underwriting, and other fees pursuant to such a transaction. Origination fees shall not be recorded until received in cash. Origination fees intended to compensate the reporting entity for interest rate risks (e.g., points), shall be amortized into income over the term of the loan-backed or structured security consistent with paragraph 8 of this statement. Other origination fees shall be recorded as income upon receipt.

Origination, Acquisition, and Commitment Costs

42. Costs related to origination when paid in the form of brokerage and other related fees shall be capitalized as part of the cost of the loan-backed or structured security, consistent with paragraph 7 of this statement. All other costs, including internal costs or costs paid to an affiliated entity related to origination, purchase, or commitment to purchase loan-backed and structured securities, shall be charged to expense when incurred.

Commitment Fees

43. Commitment fees are fees paid to the reporting entity that obligate the reporting entity to make available funds for future borrowing under a specified condition. A fee paid to the reporting entity to

[10] A nontraditional loan may have features such as (a) terms that permit principal payment deferral or payments smaller than interest accruals (negative amortization), (b) a high loan-to-value ratio, (c) multiple loans on the same collateral that when combined result in a high loan-to value ratio, (d) option adjustable-rate mortgages (option ARMs) or similar products that may expose the borrower to future increases in repayments in excess of increases that result solely from increases in the market interest rate (for example, once negative amortization results in the loan reaching a maximum principal accrual limit), (e) an initial interest rate that is below the market interest rate for the initial period of the loan term and that may increase significantly when that period ends, and (f) interest-only loans that should be considered in developing an estimate of future cash flows.

obtain a commitment to make funds available at some time in the future, generally, is refundable only if the loan-backed or structured security is issued. If the loan-backed or structured security is not issued, then the fees shall be recorded as investment income by the reporting entity when the commitment expires.

44. A fee paid to the reporting entity to obtain a commitment to borrow funds at a specified rate and with specified terms quoted in the commitment agreement, generally, is not refundable unless the commitment is refused by the reporting entity. This type of fee shall be deferred, and amortization shall depend on whether or not the commitment is exercised. If the commitment is exercised, then the fee shall be amortized in accordance with paragraph 8 of this statement over the life of the loan-backed or structured security as an adjustment to the investment income on the loan-backed or structured security. If the commitment expires unexercised, the commitment fee shall be recognized in income on the commitment expiration date.

Giantization/Megatization of FHLMC or FNMA Mortgage Backed Securities

45. Giantization/megatization of mortgage backed securities is defined as existing pools of FHLMC or FNMA mortgage-backed securities (MBS) with like coupon and prefix which are repooled together by the issuing agency creating a new larger security. The new Fannie Mae “Mega” or Freddie Mac “Giant” is a guaranteed MBS pass-through representing an undivided interest in the underlying pools of loans.

46. Repooled FHLMC and FNMA securities meet the definition of substantially the same as defined in *SSAP No. 103—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. The transaction shall not be considered a sale/purchase and no gain or loss shall be recognized. To properly document the repooling, the transaction shall be reported through Schedule D of the Annual Statement as a disposition and an acquisition.

47. Transaction fees charged by the issuing agencies shall be capitalized and amortized over the life of the repooled security.

Structured Notes Acquired for a Specified Investment Strategy

48. To achieve certain strategic investment results, structured ~~note~~ securities may be issued in combination with other structured ~~note~~ securities as a unit or a pair. One strategy involves the purchase of two structured ~~notes~~securities with opposite interest rate reset provisions. Under that strategy, the fixed coupon rate or maturity date for each structured ~~note~~security would be determined shortly after issuance depending on movements in market interest rates. Following that reset date, the resulting yields on each of the structured ~~note~~ securities will move in opposite directions; however, the average yield of the two securities will generally reflect the market yield of the combined instruments in effect on the issuance date. In situations when structured ~~note~~ securities are issued in combination with other structured ~~note~~ securities as a unit or a pair, each structured ~~note~~ security shall be accounted for separately in accordance with the appropriate SSAP. The guidance in paragraph 8 of SSAP No. 103 on the accounting for transfers of entire financial assets or group of entire financial assets that qualify as sales shall be applied to each structured note upon transfer.

Disclosures

49. In addition to the disclosures required for invested assets in general, the following disclosures regarding loan-backed and structured securities shall be made in the financial statements. Regardless of the allowances within paragraph 59 of the Preamble, the disclosures in paragraph 49.f., 49.g. and 49.h. are required in separate, distinct notes to the financial statements:

a. Fair values in accordance with *SSAP No. 100—Fair Value Measurements* (SSAP No. 100).

b. Concentrations of credit risk in accordance with SSAP No. 27;

c. Basis at which the loan-backed and structured securities are stated;

d. The adjustment methodology used for each type of security (prospective or retrospective);

e. Descriptions of sources used to determine prepayment assumptions.

f. All securities within the scope of this statement with a recognized other-than-temporary impairment, disclosed in the aggregate, classified on the basis for the other-than-temporary impairment: (1) intent to sell, (2) inability or lack of intent to retain the investment in the security for a period of time sufficient to recover the amortized cost basis, or (3) present value of cash flows expected to be collected is less than the amortized cost basis of the security.

g. For each security with an other-than-temporary impairment, recognized in the current reporting period by the reporting entity, as the present value of cash flows expected to be collected is less than the amortized cost basis of the securities:

    i. The amortized cost basis, prior to any current-period other-than-temporary impairment.

    ii. The other-than-temporary impairment recognized in earnings as a realized loss.

    iii. The fair value of the security.

    iv. The amortized cost basis after the current-period other-than-temporary impairment.

h. All impaired securities (fair value is less than cost or amortized cost) for which an other-than-temporary impairment has not been recognized in earnings as a realized loss (including securities with a recognized other-than-temporary impairment for non-interest related declines when a non-recognized interest related impairment remains):

    i. The aggregate amount of unrealized losses (that is, the amount by which cost or amortized cost exceeds fair value) and

    ii. The aggregate related fair value of securities with unrealized losses.

i. The disclosures in (i) and (ii) above should be segregated by those securities that have been in a continuous unrealized loss position for less than 12 months and those that have been in a continuous unrealized loss position for 12 months or longer using fair values determined in accordance with SSAP No. 100.

j. Additional information should be included describing the general categories of information that the investor considered in reaching the conclusion that the impairments are not other-than-temporary.

k. When it is not practicable to estimate fair value, the investor should disclose the following additional information, if applicable:

i. The aggregate carrying value of the investments not evaluated for impairment, and

ii. The circumstances that may have a significant adverse effect on the fair value.

50. Refer to the preamble for further discussion regarding disclosure requirements. All disclosures within this statement, except disclosures included in paragraphs 49.b. and 49.k., shall be included within the interim and annual statutory financial statements. Disclosure requirements in paragraphs, 49.b. and 49.k. are required in the annual audited statutory financial statements only.

Relevant Literature

51. This statement adopts *FASB Emerging Issues Task Force No. 99-20*, *Exchange of Interest-Only and Principal-Only Securities for a Mortgage-Backed Security,* as amended by *FAS 166, Accounting for Transfers of Financial Assets, An Amendment of FAS 140,* and *FASB Staff Position EITF 99-20-1, Amendments to the Impairment Guidance of EITF Issue No. 99-20.* This statement adopts paragraphs 5, 7 and 9 of AICPA *Statement of Position 03-03, Accounting for Certain Loans or Debt Securities Acquired in a Transfer* (SOP 03-03) for loan-backed and structured securities only. With the exception of this specific adoption, consideration of SOP 03-03 is still pending consideration for statutory accounting.

52. This statement rejects *FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities* and *FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*.

53. This statement also rejects *FASB Emerging Issues Task Force No. 89-4, Accounting for a Purchased Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate, FASB Emerging Issues Task Force No. 90-2, Exchange of Interest-Only and Principal-Only Securities for a Mortgage-Backed Security, FASB Emerging Issues Task Force No. 93-18, Recognition of Impairment for an Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate*, *FASB Emerging Issues Task Force No. 96-12, Recognition of Interest Income and Balance Sheet Classification of Structured Notes,* and *FASB Emerging Issues Task Force No. 98-15, Structured Notes Acquired for a Specified Investment Strategy*.

Effective Date and Transition

54. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*.

55. For securities purchased prior to January 1, 1994, where historical cash flows are not readily available for applying the retrospective method, the reporting entity may use January 1, 1994 as the acquisition date and the then book value as the cost for purposes of determining yield adjustments in future periods.

56. This revised statement (except for the guidance in paragraph 25 inserted in December 2009) supersedes SSAP No. 98 and paragraph 13 of SSAP No. 99 effective September 30, 2009. For reporting entities that either early adopted the requirements of SSAP No. 98 or previously adopted a statutory accounting policy that was in accordance with the prescriptions of SSAP No. 98, and if such reporting entities do not intend to sell the security, and have the intent and ability to retain the investment in the security for a period of time sufficient to recover the amortized cost basis, those reporting entities shall recognize the cumulative effect of reversing the impact of the adoption of SSAP No. 98, or an equivalent statutory accounting policy, and paragraph 13 of SSAP No. 99 as an adjustment to the opening balance of

unassigned funds (surplus) as of July 1, 2009, with a corresponding adjustment to applicable financial statement elements.

57. The accounting and reporting requirements of this revised statement (except for the guidance in paragraph 25 inserted in December 2009) shall be applied to existing and new investments held by a reporting entity on or after September 30, 2009. For loan-backed and structured securities held at the beginning of the interim period of adoption (July 1, 2009) and continue to be held as of September 30, 2009, if a reporting entity does not intend to sell the security, and has the intent and ability to retain the investment in the security for a period of time sufficient to recover the amortized cost basis, the reporting entity shall recognize the cumulative effect of initially applying this revised statement as an adjustment to the opening balance of unassigned funds (surplus) as of July 1, 2009, with a corresponding adjustment to applicable financial statement elements. The cumulative effect on unassigned funds (surplus) shall be calculated by comparing the present value of the cash flows expected to be collected determined in accordance with the methodology in paragraph 33, as applicable, with the amortized cost basis of the loan-backed and structured security as of the beginning of the interim period in which this revised statement is adopted (July 1, 2009). The cumulative-effect adjustment shall include related tax effects. The discount rate used to calculate the present value of the cash flows expected to be collected shall be the rate in effect before recognizing any other-than-temporary impairments and not a rate that has been adjusted to reflect those impairments.

58. The amortized cost basis of a security for which an other-than-temporary impairment was previously recognized shall be adjusted by the amount of the cumulative-effect adjustment before taxes. The difference between the new amortized cost basis and the cash flows expected to be collected shall be accreted as interest income (see paragraph 38).

59. In the period of adoption, an entity shall provide the disclosures required by SSAP No. 3 for changes in accounting principles.

60. In December 2009, guidance in paragraph 25 was inserted and subsequent paragraphs were renumbered. These changes were related to a new method of determining the final NAIC designation. Substantive revisions related to determining the final NAIC designation, are effective for reporting periods ending on or after December 31, 2009. Changes related to determining the final NAIC designation will be accounted for on a prospective basis. No cumulative effect adjustments or application of the NAIC designation guidance to prior events or periods are permitted, similar to a change in accounting estimate.

61. In June 2010, nonsubstantive revisions were adopted to paragraphs 27 and 36 to clarify the accounting for gains and losses between AVR and IMR for SSAP No. 43R securities. As illustrated within paragraph 36, the AVR and IMR analysis required and provision to allocate gains and losses between AVR and IMR is the same regardless whether the security is written down as a result of an impairment analysis or whether the security was sold. Although the revisions to paragraphs 27 and 36 are considered nonsubstantive and are in accordance with the communicated intent provided in the Question and Answer Implementation Guide, it was identified that some entities had not correctly interpreted the Question and Answer Implementation Guide and such entities would need to make significant system changes to comply with the AVR and IMR bifurcation requirements for sale transactions. As a result, the revisions to paragraphs 27 and 36 adopted in June 2010 have an effective date of January 1, 2011 with early application allowed. Entities that have previously bifurcated gains and losses between AVR and IMR for sale transactions shall not reverse previous bifurcations, and shall not revert to a process that does not bifurcate gains and losses between AVR and IMR when conducting future sales transactions before the January 1, 2011 effective date. Thus, if an entity bifurcated gains and losses from sale transactions between AVR and IMR anytime after the adoption of SSAP No. 43R (September 2009), that entity must continue to bifurcate gains and losses resulting from sale transactions for SSAP No. 43R securities in accordance with the nonsubstantive revisions to paragraphs 27 and 36 adopted in June 2010.

62. The guidance in paragraph 48 was originally contained within *INT 00-11: EITF 98-15: Structured Notes Acquired for a Specified Investment Strategy* and was effective September 11, 2000. Revisions adopted in October 2010 to paragraphs 2, 3 and 4 are effective January 1, 2011. The nonsubstantive revisions clarify the definitions of loan-backed and structured securities.

REFERENCES

Other

- *Purposes and Procedures Manual of the NAIC Investment Analysis~~Securities Valuation~~ Office*
- *NAIC Valuation of Securities* product prepared by the Securities Valuation Office

Relevant Issue Papers

- *Issue Paper No. 43—Loan-Backed and Structured Securities*
- *Issue Paper No. 140—Loan-Backed and Structured Securities, Revised September, 2009*

APPENDIX A – QUESTION AND ANSWER IMPLEMENTATION GUIDE

SSAP No. 43R—Loan-Backed and Structured Securities – Revised (SSAP No. 43R), with an effective date of September 30, 2009, was issued to provide revised guidance on the accounting and impairment treatment for loan-backed and structured securities. SSAP No. 43R superseded *SSAP No. 43—Loan-backed and Structured Securities* (SSAP No. 43), *SSAP No. 98—Treatment of Cash Flows When Quantifying Changes in Valuations and Impairments, an Amendment of SSAP No. 43* (SSAP No. 98) and paragraph 13 of *SSAP No. 99—Accounting for Certain Securities Subsequent to an Other-Than-Temporary Impairment* (SSAP No. 99).

Questions regarding implementation of SSAP No. 43R were raised by reporting entities, regulators and auditors. It was determined that this Question & Answer Implementation Guide should be issued as an aid in understanding and implementing SSAP No. 43R due to the relatively high number of inquiries received.

This Q&A is effective for reporting periods ending on or after December 31, 2009. The Statutory Accounting Principles (E) Working Group assumes that industry made their best efforts to adopt the guidance set forth under SSAP No. 43R in the third quarter of 2009. The Statutory Accounting Principles (E) Working Group also acknowledges that at year-end 2009 there were many outstanding questions which resulted in this Q&A. It is recommended that any adjustment to the other-than-temporary impairment cumulative effect as a result of this Q&A be reflected in the 2009 Annual Statement with no restatement of the prior quarterly statement.

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1. ***Question*** - Are reporting entities permitted to establish an accounting policy to write down a SSAP No. 43R other-than-temporarily impaired security, for which a "non-interest" related decline exists, to fair-value regardless of whether the reporting entity intends to sell, or has the intent and ability to hold?

1.1 Pursuant to the guidance in SSAP No. 43R, optionality is not permitted. As such, an accounting policy that differs from SSAP No. 43R would be considered a departure from statutory accounting principles as prescribed by the NAIC *Accounting Practices and Procedures Manual.*

2. ***Question*** – Can a reporting entity avoid completing a cash-flow assessment or testing for a specific other-than-temporarily impaired security when the entity believes there is a clear cash-flow shortage (i.e., non-interest related impairment) and elect to recognize a full impairment for the SSAP No. 43R security (no impairment bifurcation), with fair value becoming the new amortized cost basis, and recognition of the full other-than-temporary impairment as a realized loss?

2.1 Under the basis of SSAP No. 43R, an entity is not permitted to elect a write-down to fair value in lieu of assessing cash flows and bifurcating "interest" and "non-interest" impairment components. As noted in paragraph 32, if the entity does not have the intent to sell, and has the intent and ability to hold, but does not expect to recover the entire amortized cost basis of the security, the entity shall compare the present value of cash flows expected to be collected with the amortized cost basis of the security. If present value of cash flows expected to be collected is less than the amortized cost basis of the security, the entire amortized cost basis of the security will not be recovered (a non-interest decline exists) and an other-than-temporary impairment shall be considered to have occurred. Pursuant to paragraph 35, when an other-than-temporary impairment has occurred because the entity does not expect to recover the entire amortized cost basis of the security even if the entity has no intent to sell and the entity has the intent and ability to hold, the amount of the other-than-temporary impairment recognized as a realized loss shall equal the difference between the investment's amortized cost basis and the present value of cash flows expected to be collected, discounted at the loan-backed or structured security's effective interest rate.

2.2 If the entity does not want to assess cash flows of an impaired security (fair value is less than amortized cost), the entity can designate the security as one the entity intends to sell, or one that the entity does not have the intent and ability to hold, providing it is reflective of the true intent and assessment of the ability of the entity. Once an impaired security has this designation, pursuant to paragraph 30 or 31, an other-than-temporary impairment shall be considered to have occurred. As detailed in paragraph 34, the amount of the other-than-temporary impairment recognized in earnings as a realized loss shall equal the entire difference between the investment's amortized cost basis and its fair value at the balance sheet date.

2.3 As addressed in question 3 of this Question and Answer Guide, reporting entities are not permitted to change assertions regarding their intent to sell or their lack of intent and ability to hold. Once the security has been identified as one the entity intends to sell, or as a security that the entity does not have the intent and ability to hold, that assertion shall not change as long as the entity continues to hold the security.

3. ***Question*** - Can reporting entities change their "intend to sell" or "unable to hold" assertions and recover previously recognized other-than-temporary impairments?

3.1 No, a reporting entity is not permitted to change assertions and reverse previously recognized SSAP No. 43R other-than-temporary impairments. Although an entity may elect to hold a security due to a favorable change in the security's fair value, once the security has been identified as one the entity intends to sell, or as a security that the entity does not have the intent and ability to hold for purposes of initially recognizing an other-than-temporary impairment, that assertion shall not change as long as the entity continues to hold the security.

3.2 Reporting entities that have recognized an other-than-temporary impairment on a SSAP No. 43R security in a manner corresponding with an assertion on the intent to sell or the lack of the intent and ability to hold, for which a subsequent other-than-temporary impairment has been identified, shall recognize a realized loss for the difference between the current amortized cost (reflecting the previously recognized SSAP No. 43R other-than-temporary impairment) and the fair value at the balance sheet date of the subsequent impairment. Thus, bifurcation of impairment between interest and non-interest related declines is not permitted for securities in which an other-than-temporary impairment was previously recognized on the basis that the reporting entity had the intent to sell, or lacked the intent and ability to hold, regardless if the entity has subsequently decided to hold the security.

3.3 Reporting entities shall reclassify a security as one for which there is an intent to sell, or for which there is not an intent or ability to hold, regardless if a bifurcated other-than-temporary impairment had previously been recognized, as soon as the entity realizes that they can no longer support a previous assertion to hold the security. In making such reclassifications, if the security is impaired, the difference between the amortized cost (reflecting the initial non-interest other-than-temporary impairment recognized) and fair value at the balance sheet date of the reclassification shall be recognized as a realized loss, with fair value reflecting the new amortized cost basis. Once such a reclassification occurs, and the security is classified as one for which there is an intent to sell, or for which there is not an intent and ability to hold, the security must continue to carry that assertion until it is no longer held by the reporting entity.

4. ***Question*** – Under SSAP No. 43R, in accordance with the cumulative adjustment provisions, is it possible for a previously other-then-temporarily impaired security to be completely "unimpaired" (not recognized as OTTI)?

4.1 Yes, a security that was previously determined to be other-than-temporarily impaired may be completely "unimpaired" under SSAP No. 43R if the other-than-temporary impairment is determined to be 100% interest related upon adoption. If there is any aspect of non-interest impairment (present value of cash flows expected to be collected is less than amortized cost) then the security would continue to be considered other-than-temporarily impaired under SSAP No. 43R. The amount recognized as a realized loss, if applicable, has changed. (Please refer to the cumulative effect adjustment guidance.)

4.2 Although *INT 06-07: Definition of Phrase "Other Than Temporary"* (INT 06-07) did not require a security to be considered other-than-temporarily impaired if the impairment was 100% caused by interest related declines, it has been identified that reporting entities may have been compelled to write-down such securities as other-than-temporarily impaired due to the time and/or extent to which the security had been impaired. Thus, in these instances, if there is no "non-interest" related decline, and the reporting entity does not have the intent to sell and has the intent and ability to hold until recovery of the amortized cost basis, then under the SSAP No. 43R cumulative effect transition provisions, such securities will be completely "unimpaired" (not recognized as OTTI).

5. ***Question*** – How do the regulators intend the phrase "intent and ability to hold" as used within SSAP No. 43R to be interpreted?

5.1 SSAP No. 43R paragraph 31 states in part "…the entity shall assess whether it has the intent and ability to retain the investment in the security for a period of time sufficient to recover the amortized cost basis. If the entity does not have the intent and ability to retain the investment for the time sufficient to recover the amortized cost basis, an other-than-temporary impairment shall be considered to have occurred."

5.2 The intent of this language within SSAP No. 43R is focused on ensuring that, as of the balance sheet date, after considering the entity's own cash or working capital requirements and contractual or regulatory obligations and all known facts and circumstances related to the impaired security, the entity does not have the intention of selling the impaired security and has the current intent and ability to hold the security to recovery. Due to impairment bifurcation provisions provided within SSAP No. 43R, and the amortized cost measurement method generally permitted for loan-backed and structured securities, the assessment of "intent and ability" is intended to be a high standard. Despite the intent of paragraph 31, it is identified that information not known to the entity may become known in subsequent periods and/or facts and circumstances related to an individual holding or group of holdings may change thereby influencing the entity's subsequent determination of intent and ability with respect to a security or securities.

5.3 If a reporting entity asserts that it has the intent and ability to hold a security, or group of securities, until recovery of the amortized cost, but sells or otherwise disposes the security or securities prior to such recovery, the reporting entity shall be prepared to justify this departure from their original assertion to examiners and auditors. SSAP No. 43R purposely does not identify specific circumstances in which a change in assertion would be justifiable, but requires judgment from management, examiners and auditors on whether future assertions warrant closer review.

5.4 Delaying recognition of other-than-temporary impairments is a cause of serious concern by the regulators, and entities that habitually delay such recognition through false assertions on the "intent and ability to hold" may face increased scrutiny and regulatory action by their domiciliary state. It is imperative that a reporting entity recognize the full other-than-temporary impairment as soon as the entity realizes that they will no longer be able to hold the security until recovery of the amortized cost basis. Greater scrutiny shall be placed on securities sold or otherwise disposed shortly after a financial statement reporting date if such securities had been excluded from the full other-than-temporary impairment recognition on the basis of the reporting entity's intent and ability to hold.

5.5 As noted in paragraph 3.3 of this question and answer guide, once a security is classified as one for which there is an intent to sell, or for which there is not an intent and ability to hold, the security must continue to carry that assertion until the security is no longer held by the reporting entity.

6. ***Question*** – How do contractual prepayments affect the determination of credit losses?

6.1 Paragraph 32 of SSAP No. 43R states that "A decrease in cash flows expected to be collected on a loan-backed or structured security that results from an increase in prepayments on the underlying assets shall be considered in the estimate of present value of cash flows expected to be collected." Paragraph 14 states that "Loan-backed and structured securities shall be revalued using the currently estimated cash flows, including new prepayment assumptions, using either the prospective or retrospective adjustment methodologies consistently applied by type of securities."

6.2 The language in paragraph 32 is consistent with GAAP, and the GAAP guidance related to the treatment of prepayments in the consideration of credit losses was intended to provide clarification for determining the "cash flows expected to be collected" on interest-only securities and other similar securities that can be contractually prepaid or otherwise settled in such a way that the holder would not recover substantially all of the investment. These securities are generally accounted for in accordance with paragraphs 17-23 of SSAP No. 43R, which requires that an entity estimate cash flows expected to be collected including both amount and timing. Therefore, for securities under SSAP No. 43R, excluding those accounted for under paragraphs 17-23, decreases in cash flows resulting in contractual prepayments should be considered yield adjustments rather than potential credit losses.

7. ***Question*** – Paragraph 36 states that AVR and IMR should be accounted for in accordance with SSAP No. 7, however paragraph 36 also states that AVR and IMR should be separated into two components if the entity has the intent to sell or does not have the intent and ability to retain the investment for a time sufficient to recover the amortized cost basis. This guidance is different from the treatment when the gain or loss is due to an actual sale and also different from the treatment for SSAP No. 26 investments. When an impairment is recognized, should an entity follow SSAP No. 7 when an investment changes by two or more NAIC categories (i.e., reported entirely in AVR) or stay within the guidance of SSAP No. 43R?

7.1 SSAP No. 43R includes specific guidance on the treatment for AVR and IMR of other-than-temporary impairment losses which indicates that an entity should bifurcate the loss into AVR and IMR portions depending on whether it is an interest or a non-interest related decline. It was the Statutory Accounting Principles (E) Working Group's intention that for those securities subject to SSAP No. 43R, an entity should report the gain or loss in separate AVR and IMR components regardless of whether the NAIC designation of the security has changed by two or more NAIC designations. The Statutory Accounting Principles (E) Working Group acknowledges that the actual language of SSAP No. 43R is inconsistent and not explicit on this point. In addition, the Statutory Accounting Principles (E) Working Group also notes that due to the rapid adoption of SSAP No. 43R, the annual statement instructions were not fully updated. As a result, a Form A and updates to the annual statement instructions are being prepared for 2010 review. The Form A and updates will address the issue of bifurcation of gains or losses on sales between AVR and IMR for those securities subject to SSAP No. 43R. Appropriate disclosures will also be included in the Form A. In June 2010, nonsubstantive revisions were adopted to paragraphs 27 and 36 to clarify the bifurcation of gains and losses between AVR and IMR. Guidance on the effective date for these nonsubstantive revisions is included within paragraph 61.

8. ***Question*** – If a security is sold and no previous other-than-temporary impairment was recognized, how should the entity record the loss within AVR and IMR?

8.1 As noted in paragraph 7.1, it was intended that reporting entities shall follow the guidance in SSAP No. 43R that indicates an entity shall bifurcate the loss into AVR and IMR portions depending on interest and non-interest related declines. As such, an entity should report the loss in separate AVR and IMR components as appropriate. The AVR/IMR analysis performed, and resulting AVR/IMR allocation, for SSAP No. 43R securities should be same regardless whether the security is written down as a result of an impairment analysis or whether the security was sold without any impairment. A Form A is being prepared to more directly address this issue in SSAP No. 43R. In June 2010, nonsubstantive revisions were adopted to paragraphs 27 and 36 to clarify the bifurcation of gains and losses between AVR and IMR. Guidance on the effective date for these nonsubstantive revisions is included within paragraph 61.

9. ***Question*** – If a security with a recognized other-than-temporary impairment is subsequently sold for a gain, how should the gain be recognized within AVR and IMR?

9.1 As noted in paragraph 7.1, it was intended that reporting entities that recognize an other-than-temporary impairment for securities within SSAP No. 43R that subsequently sell such securities for a gain, shall recognize the gain proportionately through AVR and IMR relative to analysis performed of the gain at the date of the sale. A Form A is being prepared to more directly address this issue in SSAP No. 43R. In June 2010, nonsubstantive revisions were adopted to paragraphs 27 and 36 to clarify the bifurcation of gains and losses between AVR and IMR. Guidance on the effective date for these nonsubstantive revisions is included within paragraph 61.

10. ***Question*** – Shall a cumulative effect adjustment be recorded to reflect other-than-temporary impairments for securities for which an other-than-temporary impairment was not previously recorded under SSAP No. 43 or for securities for which an other-than-temporary impairment was previously recorded under SSAP No. 43, but not to the extent required under SSAP No. 43R?

10.1 Paragraph 57 of SSAP No. 43R states that the cumulative effect applies to securities "for which an other-than-temporary impairment was previously recognized under SSAP No. 43." Does this imply that no cumulative effect should be recorded for securities for which an impairment was not previously recorded, and therefore any credit related impairment prior to July 1, 2009 is recorded in 3Q 2009 earnings? The following facts are provided to illustrate this scenario:

- At 6/30 the insurer owns a security whose fair value is less than cost and has undiscounted cash flows of $97. A $3 impairment is recorded. At 7/1 discounted cash flows (under SSAP No. 43R) are calculated as $90. The difference of $7 ($97-90) is recorded as a cumulative adjustment as required by SSAP No. 43R.

- At 6/30 the insurer owns a security whose fair value is less than cost but has undiscounted expected cash flows of $101. Therefore, no impairment is recorded. At 7/1 discounted cash flows (under SSAP No. 43R) are calculated as $90. Is the difference of $10 ($100-$90) recorded as a cumulative adjustment or does it get recorded as an impairment through earnings for the quarter ended 9/30/09?

10.2 The Statutory Accounting Principles (E) Working Group has concluded that in both cases a cumulative adjustment shall be recorded. If not, in the first example, a company that recognized a small impairment under SSAP No. 43 would not have to recognize any additional pre-7/1/09 credit-related impairment in their income statement, while in the second case, a company that did not happen to trigger an impairment under SSAP No. 43 would be required to recognize the entire pre-7/1/09 credit-related impairment in their 2009 income statement.

10.3 Recording cumulative adjustments for both scenarios is consistent with *SSAP No. 3—Accounting Changes and Corrections of Errors* (SSAP No. 3). SSAP No. 3 states that "a change in accounting principle results from an adoption of an accepted accounting principle, or method of applying the principle…The cumulative effect of changes in accounting principles shall be reported as adjustments to unassigned funds (surplus) in the period of the change in accounting principle. The cumulative effect is the difference between the amount of capital and surplus at the beginning of the year and the amount of capital and surplus that would have been reported at that date if the new accounting principle had been applied retroactively for all prior periods."

As a result of this Q&A item, the following nonsubstantive revisions have been made to paragraphs 56 and 57 of SSAP No. 43R as follows:

> 56. This revised statement supersedes SSAP No. 98 and paragraph 13 of SSAP No. 99 effective September 30, 2009. For reporting entities that either early adopted the requirements of SSAP No. 98 or previously adopted a statutory accounting policy that was in accordance with the prescriptions of SSAP No. 98, and if such reporting entities do not intend to sell the security, and have the intent and ability to retain the investment in the security for a period of time sufficient to recover the amortized cost basis, those reporting entities shall recognize the cumulative effect of reversing the impact of the adoption of SSAP No. 98, or an equivalent statutory accounting policy, and paragraph 13 of SSAP No. 99 as an adjustment to the opening balance of unassigned funds (surplus) as of July 1, 2009, with a corresponding adjustment to applicable financial statement elements.
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> 57. The accounting and reporting requirements of this revised statement shall be applied to existing and new investments held by a reporting entity on or after September 30, 2009. For loan-backed and structured securities held at the beginning of the interim period of adoption (July 1, 2009) and continue to be held as of September 30, 2009, if a reporting entity does not intend to sell the security, and has the intent and ability to retain the investment in the security for a period of time sufficient to recover the amortized cost basis, the reporting entity shall recognize the cumulative effect of initially applying this revised statement as an adjustment to the opening balance of unassigned funds (surplus) as of July 1, 2009, with a corresponding adjustment to applicable financial statement elements. The cumulative effect on unassigned funds (surplus) shall be calculated by comparing the present value of the cash flows expected to be collected determined in accordance with the methodology in paragraph 33, as applicable, with the amortized cost basis of the loan-backed and structured security as of the beginning of the interim period in which this revised statement is adopted (July 1, 2009). The cumulative-effect adjustment shall include related tax effects. The discount rate used to calculate the present value of the cash flows expected to be collected shall be the rate in effect before recognizing any other-than-temporary impairments and not a rate that has been adjusted to reflect those impairments.

11. ***Question*** – If a reporting entity had previously adopted SSAP No. 98, or had a company policy in accordance with SSAP No. 98, and had previously recognized an other-than-temporary impairment to fair value, if at September 30, 2009, the entity has the intent and ability to retain the security for a period of time to recover the amortized cost, is the entity permitted to make a cumulative effect adjustment to reflect a reversal of the previously recognized loss?

11.1 Yes, under the cumulative effect guidance within SSAP No. 43R the entity shall reflect a reversal of the previously recognized loss so that only any non-interest other-than-temporary impairment, determined by comparing the present value of cash flows expected to be collected with the amortized cost of the security, is reflected within the financial statements. (See question 4 regarding whether a previously recognized other-than-temporary impairment can be completely "unimpaired".)

12. ***Question*** – If a reporting entity had previously adopted SSAP No. 98, or had a company policy in accordance with SSAP No. 98, and had previously recognized an other-than-temporary impairment in accordance with SSAP No. 98, if an additional other-than-temporary impairment is necessary under SSAP No. 43R, should the additional other-than-temporary impairment be recognized as part of the cumulative effect adjustment permitted under SSAP No. 43R?

12.1 To further elaborate on this question, assume that an entity early adopted SSAP No. 98 or had an accounting policy similar to SSAP No. 98, and, for a particular security, the entity had previously recognized an other-than-temporary impairment. Assume, at September 30, 2009, the entity has the intent and ability to retain the security for a period of time sufficient to recover the amortized cost. Under SSAP No. 43R, should the cumulative catch-up adjustment recorded to unassigned funds (surplus) as of July 1, 2009 be only the amount required to reverse the previously recognized loss, or does the entity make the adjustment for the amount necessary to recognize the impairment in accordance with the requirements of SSAP No. 43R? The following facts are provided to illustrate this scenario:

o	Fair Value at 7/1/09	$75
o	PV of Expected Cash Flows at 7/1/09	$90
o	Amortized Cost at 7/1/09	$100
o	Impairment Under SSAP No. 98 Previously Recognized	$25
o	Cumulative Catch Adjustment if Apply Only Paragraph 56	$25
o	Cumulative Catch Adjustment if Apply Paragraphs 56 and 57	$15

12.2 The cumulative effect recorded by the entity relative to this previously impaired security would be the amount necessary to adjust surplus as of **July 1** to what it would have been had the requirements of SSAP No. 43R been applied as of that date. Therefore, in this example the cumulative effect adjustment (prior to the impact of related taxes and AVR and IMR, if any) is $15. Please note the emphasis as of July 1. If an additional other-than-temporary impairment is recognized during the third-quarter, this additional other-than-temporary impairment would not be included in the cumulative effect, but would be reflected as a recognized loss within the third-quarter financials.

13. ***Question*** – With respect to the calculation of the cumulative effect adjustment, paragraph 57 states the following: “The cumulative effect adjustment shall include related tax effects.” Because of the interrelated nature of realized gains and losses, AVR and IMR and taxes to AVR and IMR, should the cumulative effect adjustment also be net of AVR and IMR effects?

13.1 Yes. The impact of a cumulative effect adjustment of a new accounting standard typically reflects the net impact of adoption. Accordingly, the cumulative effect adjustment from adopting SSAP No. 43R should be presented net of taxes, AVR and IMR. Alternatively, the cumulative effect may exclude AVR and IMR impact if the AVR and IMR impact is reflected in applicable financial statement elements and the impact is reflected in capital and surplus.

14. ***Question*** – Are the disclosure requirements within paragraphs 49.f. and 49.g. of SSAP No. 43R required to be completed for the current reporting quarter only, or as a year-to-date cumulative disclosures?

14.1 The disclosures should reflect the year-to-date other-than-temporary impairments. The “fair value” reported within the disclosure is intended to reflect the fair value at the date of the other-than-temporary impairment, and shall not be updated due to the fluctuations identified at subsequent reporting dates. If a security has more than one other-than-temporary impairment identified during a fiscal reporting year, the security shall be included on the disclosure listing separately for each identified other-than-temporary impairment. Notation shall be included on the disclosure identifying the other-than-temporary impairments that were recognized for each respective reporting period. (Please note that question 16 addresses subsequent year disclosure for OTTI securities that continue to be held.)

15. ***Question*** – If an impairment loss is recognized based on the "present value of projected cash flows" in one period is the entity required to get new cash flows every reporting period subsequent or just in the periods where there has been a significant change in the actual cash flows from projected cash flows?

15.1 The guidance in paragraph 38 of SSAP No. 43R indicates that a reporting entity shall continue to estimate the present value of cash flows expected to be collected over the life of the loan-backed or structured security. This guidance is explicit that the reporting entity shall continue to estimate the present value of cash flows expected to be collected over the life of the loan-backed or structured security.

15.2 As provided in paragraph 2.2 of this Q&A, if the entity does not want to assess cash flows of an impaired security (fair value is less than amortized cost), the entity can designate the security as one the entity intends to sell, or one that the entity does not have the intent and ability to hold, providing it is reflective of the true intent and assessment of the ability of the entity. Reporting entities subject to the requirements of AVR and IMR should allocate the impairment loss between AVR and IMR accordingly.

16. ***Question*** – What disclosure information is required for securities recognized as OTTI on the basis of "present value of projected cash flows," in years subsequent to the OTTI?

16.1 Paragraph 49.g. is explicit that disclosure shall continue to occur for securities with other-than-temporary impairments that continue to be held by the reporting entity. As such, disclosure must continue in all future reporting periods, even over subsequent years, for which the security continues to be held.

17. ***Question*** – Do RMBS purchased in different lots result in a different NAIC designation for the same CUSIP? Can reporting entities use a weighted average method determined on a legal entity basis?

17.1 SSAP No. 43R and several other statements of statutory accounting principle require use of the scientific (constant yield) method of amortization. In addition to purchase price, the purchase date is an inherent part of this method and will typically result in different amortization values for different lots. Therefore, RMBS in different lots can result in a different NAIC designation for the same CUSIP. In accordance with the current instructions for calculating AVR and IMR, reporting entities are required to keep track of the different lots separately, which means reporting the different designations. Specific to the RMBS proposal only, for year-end 2009 and until an alternative long-term solution is developed, if companies' accounting and reporting systems do not accommodate this approach, a weighted-average method on a legal entity basis can be used. To the extent that a different accounting method applies to a legal entity's general and separate account, then the weighted average for each account should be calculated separately for the general account and separate account.

18. ***Question*** – The NAIC Designation process for RMBS may incorporate loss expectations that differ from the reporting entity's expectations related to OTTI conclusions. Should the reporting entities be required to incorporate recovery values obtained from data provided by the service provider used for the NAIC Designation process for impairment analysis as required by SSAP No. 43R?

18.1 In accordance with *INT 06-07: Definition of Phrase "Other Than Temporary*," reporting entities are expected to "consider all available evidence" at their disposal, including the information that can be derived from the NAIC designation.

19. ***Question*** **-** For companies that have separate accounts, can the NAIC designation be assigned based upon the total legal entity or whether it needs to be calculated separately for the general account and the total separate account?

19.1 *The answer to this question is identical to the answer for question 17.* SSAP No. 43R and several other statements of statutory accounting principle require use of the scientific (constant yield) method of amortization. In addition to purchase price, the purchase date is an inherent part of this method and will typically result in different amortization values for different lots. Therefore, RMBS in different lots can result in a different NAIC designation for the same CUSIP. In accordance with the current instructions for calculating AVR and IMR, reporting entities are required to keep track of the different lots separately, which means reporting the different designations. Specific to the RMBS proposal only, for year-end 2009 and until an alternative long-term solution is developed, if companies' accounting and reporting systems do not accommodate this approach, a weighted-average method on a legal entity basis can be used. To the extent that a different accounting method applies to a legal entity's general and separate account, then the weighted average for each account should be calculated separately for the general account and separate account.

20. ***Question*** - Should the initial or final designation be used to determine the AVR/IMR classification on sold securities?

20.1 The final designation should be utilized to determine the AVR/IMR classification on sold securities.

21. ***Question*** - Why is the final designation used for the AVR/IMR classification of realized gains and losses on sales? If the initial designation results in a NAIC 6 designation and the final designation is higher, how does this impact reporting for AVR/IMR?

21.1 With regards for AVR/IMR determination and other reporting purposes, the FINAL designation, after application of the multi-step method described in paragraph 25, shall be used. The initial designation, which is not used for any reporting purposes except for determining the carrying value method as described in paragraph 24, is only an interim step in determining the (final) NAIC designation. However, as noted in paragraph 25, securities assigned an NAIC 6 designation are not modified by the carrying value; therefore the final designation is also an NAIC 6. The same is true for securities assigned an NAIC 1 designation by the SVO. As NAIC 1 securities are assumed to have zero expected loss, the initial designation is not modified by the carrying value; therefore the final designation is also an NAIC 1. (Please see paragraph 25 and related subparagraphs for additional information related to the multi-step method.)

Statement of Statutory Accounting Principles No. 44

Capitalization of Interest

STATUS

Type of Issue:	Common Area
Issued:	Initial Draft
Effective Date:	January 1, 2001
Affects:	No other pronouncements
Affected by:	No other pronouncements
Interpreted by:	No other pronouncements

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Capitalization of Interest

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for capitalization of interest.

SUMMARY CONCLUSION

2. The historical cost of acquiring an asset generally includes the necessary costs incurred to bring it to the condition and location necessary for its intended use. If an asset requires a period of time in which to carry out the activities necessary to bring it to that condition and location, the interest cost incurred during that period as a result of expenditures for the asset shall be included as a part of the historical cost of acquiring the asset.

3. Interest cost shall be capitalized for the following types of assets:

a. Assets constructed or otherwise produced for an enterprise's own use (including assets constructed or produced for the enterprise by others for which deposits or progress payments have been made);

b. Assets intended for sale or lease that are constructed or otherwise produced as discrete projects (e.g., real estate developments);

c. Investments (equity, loans, and advances) accounted for by the equity method while the investee has activities in progress necessary to commence its planned principal operations provided that the investee's activities include the use of funds to acquire qualifying assets for its operations. The equity method is defined in *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities, A Replacement of SSAP No. 88* (SSAP No. 97).

4. Interest cost shall not be capitalized for the following types of assets:

a. Assets that are in use or ready for their intended use in the earning activities of the enterprise;

b. Assets that are not being used in the earning activities of the enterprise and that are not undergoing the activities necessary to get them ready for use;

c. Investments accounted for by the equity method after the planned principal operations of the investee begin;

d. Investments in regulated investees that are capitalizing both the cost of debt and equity capital;

e. Assets acquired with gifts and grants that are restricted by the donor or grantor to acquisition of those assets to the extent that funds are available from such gifts and grants. Interest earned from temporary investment of those funds that is similarly restricted shall be considered an addition to the gift or grant for this purpose;

f. Nonadmitted assets.

5. Capitalized interest meets the definition of an asset as defined in *SSAP No. 4—Assets and Nonadmitted Assets* and is an admitted asset to the extent it conforms to the requirements of this statement.

Capitalization

6. The amount of interest cost to be capitalized for qualifying assets shall be determined in accordance with paragraphs 12-16 of *FASB Statement No. 34*, *Capitalization of Interest Cost* (FAS 34) and paragraph 6 of *FASB Statement No. 62, Capitalization of Interest Cost in Situations Involving Certain Tax-Exempt Borrowings and Certain Gifts and Grants* (FAS 62).

7. The capitalization period shall be in accordance with paragraphs 17-19 of FAS 34 and paragraph 7 of FAS 62.

Disclosures

8. Disclosures shall be made in the financial statements in accordance with paragraph 21 of FAS 34.

9. Refer to the preamble for further discussion regarding disclosure requirements. The disclosure in paragraph 8 shall be included in the annual audited statutory financial reports only.

Impairment

10. Capitalized interest shall be assessed for impairment in conjunction with the assessment of the related asset. Interest capitalization shall not cease when such an assessment requires recognition of a lower value for the asset than acquisition cost; rather the provision required to reduce acquisition cost to such lower value shall be increased appropriately.

Relevant Literature

11. The statutory principles established in this statement adopt the GAAP accounting principles for capitalization of interest cost set forth in FAS 34, *FASB Statement No. 42, Determining Materiality for Capitalization of Interest Cost*, *FASB Statement No. 58, Capitalization of Interest Cost in Financial Statements That Include Investments Accounted for by the Equity Method*, and FAS 62, except that nonadmitted assets are ineligible for capitalization of interest.

Effective Date and Transition

12. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*.

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 44—Capitalization of Interest*

Statement of Statutory Accounting Principles No. 47

Uninsured Plans

STATUS

Type of Issue:	Common Area
Issued:	Initial Draft
Effective Date:	January 1, 2001
Affects:	No other pronouncements
Affected by:	No other pronouncements
Interpreted by:	INT 05-05

STATUS 1

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Uninsured Plans

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for all uninsured plans. This statement does not encompass policies written under the National Flood Insurance Program created by the Federal Emergency Management Agency (FEMA). Guidance for policies written under the National Flood Insurance Program is included in *SSAP No. 62R—Property and Casualty Reinsurance* (SSAP No. 62R).

SUMMARY CONCLUSION

2. For purposes of this statement, uninsured accident and health plans, including HMO administered plans, and uninsured property and casualty plans (collectively referred to as uninsured plans) are defined as plans for which a reporting entity, as an administrator, performs administrative services such as claims processing for a third party that is at risk, and accordingly, the administrator has not issued an insurance policy, regardless of whether an identification card is issued. In the case of uninsured accident and health plans, the administrator may arrange for the provision of medical services through a contracted or employed provider network. The plan (whether insured by another reporting entity or self insured) bears all of the insurance risk, and there is no possibility of loss or liability to the administrator caused by claims incurred related to the plan. The administrator, however, may be subject to credit risk with regard to the risk bearing entity. An uninsured accident and health plan may be either an Administrative Services Only (ASO) plan or an Administrative Services Contract (ASC) plan. Under an ASO plan, claims are paid from a bank account owned and funded directly by the uninsured plan sponsor; or, claims are paid from a bank account owned by the reporting entity, but only after the reporting entity has received funds from the uninsured plan sponsor that are adequate to fully cover the claim payments. Under an ASC plan, the reporting entity pays claims from its own bank accounts, and only subsequently receives reimbursement from the uninsured plan sponsor. No arrangement where the reporting entity receives a capitated payment for providing medical services to a third party shall qualify as an uninsured plan.

3. Uninsured accident and health plans also include Federal, state or other government department funded programs such as Medicare cost contracts where there is no underwriting risk to the reporting entity. Under Medicare cost contracts, service provided to recipients includes the direct delivery of health care for which the reporting entity is reimbursed based on costs incurred as provided for in regulations governing the administration of such contracts. Other such programs may include some Medicaid contracts for which administration or other non-underwriting services are provided.

4. Partially insured or combination plans exist, under which the reporting entity issues an insurance policy for some of the risks related to the claims (e.g. minimum premium and stop loss coverage), but acts as an administrator for some, or all, of the claims paid by the plan. Such plans shall be treated as two plans: an insured plan (the part for which the reporting entity has issued a policy) and an uninsured plan (the part that meets the definition in paragraph 2 of this statement). The components related to uninsured plans shall be accounted for using the accounting principles established in this statement; the components related to insured plans shall be accounted for as insurance.

Revenue/Expense Recognition

5. The administrator's statement of operations shall exclude all income and expenses related to claims, losses, premiums, and other amounts received or paid on behalf of uninsured ASO or uninsured ASC plans. An administrator acting as a provider of services, that provides such services through a salaried network, where the cost allocation of the service provided to insured vs. uninsured plans cannot be reasonably determined, shall report medical and hospital expenses on a gross basis by type of expense and report revenue from uninsured plans on a gross basis as fee for service income.

6. Commissions, expenses, and taxes paid by the administrator to administer such plans shall be reported on a gross basis by type of expense. Where the only functions provided are administrative, administrative fees and related reimbursements from the plan shall be deducted from general expenses. Reporting entities filing the health blank should deduct administrative fees and related reimbursements from general administrative expenses or claim adjustment expenses if the administrative services provided include services for claim adjustment expenses as defined in *SSAP No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses*. Where the reporting entity provides both administration and health care services directly, income from Medicare or similarly structured cost based reimbursement contracts is not recorded as premium but is recorded as revenue in the appropriate category. Health care services rendered as "medical and hospital" categorized by type and administrative expenses by type of expense shall be reported on an incurred basis.

7. Income from cost based reimbursement contracts is recorded as revenue because the service provided is for the direct delivery of care to recipients. There are risks associated with these plans in that all costs incurred under the contract may not be reimbursable and revenues may be adjusted based on subsequent challenges of costs included in filed cost reports. In addition, revenue may also be adjusted based on the performance under the terms of the contract or other external factors.

Amounts Receivable

8. Amounts receivable from uninsured plans for (a) claims and other costs paid by the administrator on behalf of the third party at risk and (b) fees related to services provided by the administrator to the plan meet the definition of assets as set forth in *SSAP No. 4—Assets and Nonadmitted Assets*. A receivable shall not be recorded for unpaid claims. A receivable related to Medicare or a similarly structured cost based reimbursement contract shall only be recorded when services have been rendered.

9. Specific funds received as reimbursements (or advance payments) for uninsured claims under a partially uninsured plan, including but not limited to the Medicare Part D program should be accounted for per this Statement. These funds include 'Reinsurance Payments' and 'Low Income Subsidy (cost-sharing portion)'. These funds are paid by the Government for a portion of claims above the out-of-pocket threshold or relate to PDP payments for all or a portion of the deductible, the coinsurance and the co-payment amounts for low-income beneficiaries. Refer to *INT 05-05: Accounting for Revenues Under Medicare Part D Coverage* for additional information and definitions of terms specifically related to Medicare Part D business.

10. An evaluation shall be made of the amounts receivable to determine any nonadmitted amounts. Next, an evaluation shall be made in accordance with *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets* (SSAP No. 5R), to determine whether there is an impairment. This two step process is set forth below:

a. Uncollected uninsured plan receivables (excluding Medicare and similar government plans) over ninety days due shall be accounted for as a nonadmitted asset;

b. Remaining amounts determined to be uncollectible shall be written off. If in accordance with SSAP No. 5R, it is "probable" the amount receivable is uncollectible, any uncollectible amount receivable shall be written off against operations in the period such determination is made. If it is "reasonably possible" the amount receivable is uncollectible, the disclosure requirements outlined in SSAP No. 5R paragraph 27 shall be made. This evaluation may consider irrevocable letters of credit to which the administrator is beneficiary, amounts on deposit with the administrator or other unrestricted funds available to the administrator.

11. The following shall provide additional guidance in determining the nonadmitted portion of amounts receivable from uninsured plans:

a. Amounts classified as nonadmitted assets collected subsequent to the date of the statutory financial statements shall not be used to decrease the nonadmitted asset otherwise calculated;

b. The due date is governed by the contractual billing date of the uninsured plan;

c. Medicare and similar government funded plans—Amounts due related to Medicare and similar government plans shall not be nonadmitted when they become over ninety days due. Appropriate reserves shall be established to cover costs incurred which may not be reimbursed upon final determination by the governing agencies under the cost contract or for adjustments to revenues based on performance under the terms of the contract or other external factors.

Liabilities

12. A liability shall be established for funds held by an administrator in its general assets for the benefit of an uninsured plan or for funds which may be owed by the administrator in connection with the administration of an uninsured plan. A liability relating to one plan shall not be offset by an asset relating to a different plan. Administrators shall not record aggregate reserves, claim/loss reserves, or liabilities (except for Medicare or similarly structured cost based reimbursement contracts) for any other claim costs paid by the administrator on behalf of uninsured plans.

Disclosures

13. The statutory financial statements shall provide the following:

a. Information with regard to the profitability to the administrator of all ASO plans and the uninsured portions of partially insured plans for which the reporting entity serves as an ASO administrator;

For the total and each category separately provided: (i) net reimbursement for administrative expenses (including administrative fees) in excess of actual expenses, (ii) total net other income or expense (including interest paid to or received from plans), and (iii) total net gain or loss from operations and (iv) the claim payment volume;

b. Information with regard to the profitability to the administrator of all ASC plans and the uninsured portions of partially insured plans for which the reporting entity serves as an ASC administrator;

For the total and each category separately provided: (i) gross reimbursement for medical cost incurred, (ii) gross administrative fees accrued, (iii) other income or expense (including interest paid to or received from plans), (iv) gross expenses incurred (claims and administrative), and (v) total net gain or loss from operations.

c. Information with regards to Medicare or similarly structured cost based reimbursement contracts shall include: (i) major components of revenue by payor, (ii) receivables from payors with account balances the greater of 10% of gross amounts receivable relating to uninsured accident and health plans or $10,000, (iii) recorded allowances and reserves for adjustment of recorded revenues, (iv) adjustments to revenue resulting from audit of receivables related to revenues recorded in the prior period.

14. Refer to the preamble for further discussion regarding disclosure requirements.

Effective Date and Transition

15. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*.

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 47—Uninsured Plans*

Statement of Statutory Accounting Principles No. 48

Joint Ventures, Partnerships and Limited Liability Companies

STATUS

Type of Issue:	Common Area
Issued:	Initial Draft
Effective Date:	January 1, 2001
Affects:	Nullifies and incorporates INT 01-10, 04-10, INT 08-03 Nullifies INT 01-24
Affected by:	No other pronouncements
Interpreted by:	INT 06-02, INT 06-07

STATUS **1**

SCOPE OF STATEMENT **3**

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Joint Ventures, Partnerships and Limited Liability Companies

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for investments in any joint ventures, partnerships, and limited liability companies, including investments in certified capital companies (CAPCO) per *INT 06-02: Accounting and Reporting for Investments in a Certified Capital Company (CAPCO)*, whether or not it is considered to be controlled by or affiliated with the reporting entity. Single real estate property investments that are wholly-owned by an LLC that is directly and wholly-owned by the reporting entity, and that meet the criteria established in *SSAP No. 40R—Real Estate Investments*, are excluded from this statement. This statement does not address the accounting for investments in partnerships and limited liability companies that invest in Low Income Housing Tax Credit Properties as discussed in *SSAP No. 93—Accounting for Low Income Housing Tax Credit Property Investments* (SSAP No. 93). However, investments in certain state Low Income Housing Tax Credit Property Investments that do not fall within the scope of SSAP No. 93 are covered by the requirements of this statement.

SUMMARY CONCLUSION

2. Investments in joint ventures shall include investments in corporate joint ventures and unincorporated joint ventures (also referred to as undivided interests in ventures). A corporate joint venture is defined as a corporation owned and operated by a small group (the joint venturers) as a separate and specific business or project for the mutual benefit of the members of the group. A corporate joint venture usually provides an arrangement under which each joint venturer may participate, directly or indirectly, in the overall management of the joint venture. Joint venturers thus have an interest or relationship other than as passive investors. An unincorporated joint venture is similar in its purpose but is not incorporated.

3. Investments in partnerships shall include investments in general partnership interests and limited partnership interests. A general partnership is defined as an association in which each partner has unlimited liability. Each partner assumes joint and several liability for all partnership debts. A limited partnership shall be defined as a partnership having two classes of partners: (a) general partners who manage the partnership, subject to the partnership agreement, and have personal liability for the general obligations of the partnership and (b) limited partners who are passive investors and have no personal liability beyond their investment.

4. A limited liability company is defined as a business organization which is a hybrid of a corporation and partnership whereby the owners have limited liability like a corporation and profits may pass through to the owners for tax purposes like a partnership if certain criteria are met. The owner’s personal liability is limited to his own acts and the owners can fully participate in the management of the business with no adverse impact on their limited liability.

5. Investments in the ventures defined in paragraphs 2-4 meet the definition of assets as defined in *SSAP No. 4—Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this statement. Investments in joint ventures, partnerships, and limited liability companies shall be reported in Other Invested Assets in the financial statements.

6. Investments in these ventures, except for joint ventures, partnerships and limited liability companies with a minor ownership interest, shall be reported using an equity method as defined in *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities, A Replacement of SSAP No. 88*, (SSAP No. 97) paragraphs 8.b.i. through 8.b.iv.

7. Investments reported using an equity method from SSAP No. 97, paragraph 8.b.ii. through 8.b.iv. may have fiscal year ends, not calendar year ends. To recognize a change to the reporting year-end of an equity method investee, including changes in, or the elimination of, previously existing differences (lag

period) due to the reporting entity's ability to obtain financial results from a reporting period that is more consistent with, or the same as, that of the reporting entity's, the guidance included in *FASB Emerging Issues Task Force No. 06-9: Reporting a Change in (or the elimination of) a Previously Existing Difference Between the Fiscal Year-End of a Parent Company and That of a Consolidated Entity or Between the Reporting Period of an Investor and That of an Equity Method Investee* that defines such reporting period changes as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors* shall be followed.

8. Joint ventures, partnerships and limited liability companies in which the entity has a minor ownership interest (i.e., less than 10%) or lacks control as stipulated in paragraphs 13 and 14, shall be recorded based on the underlying audited U.S. GAAP equity of the investee. Refer to SSAP No. 97 for guidance related to other-than-unqualified opinions. If audited U.S. GAAP basis financial statements of the investee are not available, joint ventures, partnerships, and limited liability companies in which the entity has a minor ownership interest (i.e., less than 10%) or lacks control as stipulated in paragraphs 13 and 14 may be recorded based on either of the valuation methodologies allowed under paragraphs 8.a. or 8.b. The amount to be recorded shall be defined as the initial investment in an investee at cost (as defined in paragraph 3 of *SSAP No. 68—Business Combinations and Goodwill)* plus subsequent capital contributions to the investee. The carrying amount of the investment shall be adjusted for the amortization of the basis difference (difference between the cost and the underlying GAAP equity), as well as to recognize the reporting entity's share of: (i) the audited U.S. GAAP basis earnings or losses of the investee after the date of acquisition, adjusted for any distributions received, or (ii) if audited U.S. GAAP basis financial statements of the investee are not available, the earnings or losses of the investee after the date of acquisition, adjusted for any distributions received, based on either one of the valuation methodologies allowed under paragraphs 8.a. or 8.b. If either one of the valuation methodologies allowed under paragraphs 8.a. or 8.b. is used to value the investment, documentation must be maintained regarding the reason that audited U.S. GAAP basis financial statements could not be provided.

a. Non U.S. joint ventures, partnerships, and limited liability companies in which the entity has a minor ownership interest of less than 10% and for which audited U.S. GAAP basis financial statements of the investee are not available, may be recorded based on:

i. the U.S. GAAP basis equity as set forth in the audited footnote reconciliation of the investee's equity and income to U.S. GAAP within the investee's audited foreign GAAP prepared financial statements or,

ii. the IFRS basis equity as set forth in the investee's audited IFRS financial statements prepared in compliance, both annually and quarterly, with IFRS as issued by the International Accounting Standards Board (IASB).

b. If audited U.S. GAAP basis financial statements of the investee are not available, joint ventures, partnerships, and limited liability companies in which the entity has a minor ownership interest of less than 10%, measured at the holding company level, may be recorded based on the underlying audited U.S. tax basis equity. For investments recorded based on the underlying audited U.S. tax basis equity, the reporting entity shall review investments held by the joint venture, partnership or limited liability company in accordance with the impairment guidance in paragraphs 16 and 17. The reporting entity must first attempt to obtain audited U.S. GAAP basis financial statements and, if such financial statements are unavailable, must maintain documentation regarding the reason that audited U.S. GAAP basis financial statements could not be provided.

A reporting entity's share of adjustments, excluding changes in capital contributions to the investee, that are recorded directly to the investee's stockholders' equity shall also be recorded as adjustments to the carrying value of the investment with an offsetting amount recorded to unrealized capital gains and losses on investments.

9. Entities may recognize their investment in joint ventures, partnerships, and limited liability companies in which the entity has a minor ownership interest based on an unaudited basis for investment determination (i.e., foreign GAAP, IFRS, or tax basis as allowed under paragraph 8) if annual audited information is not complete as of the annual statement filing deadline. The recorded investment shall be adjusted for annual audit adjustments, if any, as soon as annual audited information is available. If financial statements of an investee are not sufficiently timely for the reporting entity to apply an equity method to the investee's current results of operations, the reporting entity shall record its share of the earnings or losses of an investee from the most recent available financial statements. A lag in reporting shall be consistent from period to period.

10. If an additional investment, in whole or in part, represents, in substance, the funding of prior losses, the entity should recognize previously suspended losses only up to the amount of the additional investment determined to represent the funding of prior losses. Whether the investment represents the funding of prior losses depends on the facts and circumstances.

11. Judgment is required in determining whether prior losses are being funded and that all available information should be considered in performing the related analysis. The following are certain factors to consider in that regard. However, no one factor should be considered presumptive or determinative.

a. Whether the additional investment is acquired from a third party or directly from the investee. When the additional investment is purchased from a third party and the investee does not obtain additional funds either from the investor or the third party, it is unlikely that, in the absence of other factors, prior losses are being funded**.**

b. The fair value of the consideration received in relation to the value of the consideration paid for the additional investment. For example, if the fair value of the consideration received is less than the fair value of the consideration paid, it may indicate that prior losses are being funded to the extent that there is disparity in the value of the exchange.

c. Whether the additional investment results in an increase in ownership percentage of the investee. In instances in which the investment is made directly with the investee, the investor should consider the form of the investment and whether other investors are making simultaneous investments proportionate to their interests. Investments made without a corresponding increase in ownership or other interests, or a pro rata equity investment made by all existing investors, may indicate that prior losses are being funded.

d. The seniority of the additional investment relative to existing equity of the investee. An investment in an instrument that is subordinate to other equity of the investee may indicate that prior losses are being funded.

12. Upon making the additional investment, the investor should evaluate whether it has become otherwise committed to provide financial support to the investee.

13. Control is defined as the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of the investee, whether through the (a) ownership of voting securities, (b) by contract other than a commercial contract for goods or nonmanagement services, (c) by common management, or (d) otherwise. Control shall be presumed to exist if a reporting entity and its affiliates directly or indirectly, own, control, hold with the power to vote, or hold proxies representing 10% or more of the voting interests of the entity.

14. Control as defined in paragraph 13 shall be measured at the holding company level. For example, if one member of an affiliated group has a 5% interest in an entity and a second member of the group has an 8% interest in the same entity, the total interest is 13% and therefore each member of the affiliated group shall be presumed to have control. This presumption will stand until rebutted by an evaluation of all the facts and circumstances relating to the investment based on the criteria in *FASB Interpretation No. 35, Criteria for Applying the Equity Method of Accounting for Investments in Common Stock, an Interpretation of APB Opinion No. 18*. The corollary is required to demonstrate control when a reporting entity owns less than 10% of the voting interests of an investee. The insurer shall maintain documents substantiating its determination for review by the domiciliary commissioner. Examples of situations where the presumption of control may be in doubt include the following:

a. Any limited partner investment in a Limited Partnership, unless the limited partner is affiliated with the general partner.

b. An entity where the insurer owns less than 50% of an entity and there is an unaffiliated individual or group of investors who own a controlling interest.

c. An entity where the insurer has given up participation rights as a shareholder to the investee.

15. The reporting entity's share of undistributed earnings and losses of the investee shall be included in unrealized gains and losses of the reporting entity. The reporting entity's share of other changes in the investee's surplus (e.g., the change in the investee's nonadmitted assets) shall be recorded by the investor as a component of unrealized capital gains and losses on investments. Distributions received from an investee shall be recognized in investment income when declared to the extent that they are not in excess of the undistributed accumulated earnings attributable to the investee. Distributions declared in excess of the undistributed accumulated earnings attributable to the investee shall reduce the carrying amount of the investment.

Impairment

16. For any decline in the fair value of an investment in a joint venture, partnership, or limited liability company which is determined to be other than temporary(INT 06-07), the investment shall be written down to fair value as the new cost basis and the amount of the write down shall be accounted for as a realized loss. The write down shall first be considered as an adjustment to any portion of the investment that is nonadmitted (e.g., goodwill). The new cost basis shall not be changed for subsequent recoveries in fair value. Future declines in fair value, which are determined to be other than temporary, shall be recorded as realized losses.

17. An impairment shall be considered to have occurred if it is probable that the reporting entity will be unable to recover the carrying amount of the investment or there is evidence indicating inability of the investee to sustain earnings which would justify the carrying amount of the investment. Even if the fair value of an investment is below the carrying amount it is not necessarily indicative of a loss in value that is other than temporary. Similarly, the existence of investee operating losses may indicate a loss in value; however, it is not necessarily indicative of a loss in value that is other than temporary.

Disclosures

18. The significance of an investment to the reporting entity's financial position and results of operations shall be considered in evaluating the extent of disclosures of the financial position and results of operations of an investee. Disclosures as follows shall be made for all investments in joint ventures, partnerships, or limited liability companies that exceed 10% of the total admitted assets of the reporting entity:

a. (1) the name of each joint venture, partnership or limited liability company and percentage of ownership, (2) the accounting policies of the reporting entity with respect to investments in joint ventures, partnerships and limited liability companies and (3) the difference, if any, between the amount at which the investment is carried and the amount of underlying equity in net assets (i.e., nonadmitted goodwill or other nonadmitted assets) and the accounting treatment of the difference;

b. For joint ventures, partnerships, and limited liability companies for which a quoted market price is available, the aggregate value of each joint venture, partnership, or limited liability company investment based on the quoted market price; and

c. Summarized information as to assets, liabilities, and results of operations for joint ventures, partnerships, and limited liability companies either individually or in groups.

19. Any commitment or contingent commitment (e.g., guarantees or commitments to provide additional capital contributions) to a joint venture, partnership, or limited liability company shall be disclosed.

20. A reporting entity that recognizes an impairment loss shall disclose the following in the financial statements that include the period of the impairment write-down:

a. A description of the impaired assets and the facts and circumstances leading to the impairment; and

b. The amount of the impairment and how fair value was determined.

21. Any change due to the requirements of paragraph 7 shall be disclosed per SSAP No. 3.

22. Refer to the preamble for further discussion regarding disclosure requirements.

Relevant Literature

23. This statement adopts with modification *FASB Emerging Issues Task Force No. 06-9: Reporting a Change in (or the elimination of) a Previously Existing Difference between the fiscal Year-End of a Parent Company and That of a Consolidated Entity or between the Reporting Period of an Investor and That of an Equity Method Investee*. The modifications include:

a. Adopt the guidance that defines such reporting period changes as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors,* modified to apply only to equity method investments. For instances in which this change in accounting principle occurs, disclosure requirements of SSAP No. 3 shall be followed.

b. The consolidation guidance in EITF 06-9 is rejected.

c. Changes affecting companies reporting investments in SCA entities using the equity method: Investments in SSAP No. 97 paragraph 8.b.i. entities are required to be calendar year-end. Investments in SSAP No. 97 paragraphs 8.b.ii. through 8.b.iv. entities may have other fiscal year ends, thus this issue could apply to equity method investments under 8.b.ii. through 8.b.iv. or under equity method valued investments that fall within the scope of SSAP No. 48.

24. This statement is inconsistent with the guidance in paragraph 17 of *APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock* (APB 18), which addresses when control exists. APB 18 is addressed in its entirety and rejected in SSAP No. 97. This statement also rejects

AICPA *Statement of Position 78-9, Accounting for Investments in Real Estate Ventures* and *FASB Emerging Issues Task Force No. 00-01, Investor Balance Sheet and Income Statement Display under the Equity Method for Investments in Certain Partnerships and Other Ventures*.

Effective Date and Transition

25. This statement is effective for years beginning January 1, 2001. For investments made in joint ventures, partnerships and limited liability companies prior to January 1, 2001, if the joint venture, partnership or limited liability company does not prepare audited GAAP financial statements, and the reporting entity together with all other investors subject to this statement does not have sufficient voting power (pursuant to the joint venture, partnership or limited liability agreement) to force the preparation of audited GAAP financial statements, the reporting entity may then value its investment based on unaudited GAAP or audited tax-basis financial statements. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*. Guidance in paragraph 1 was previously included within *SSAP No. 93—Accounting for Low Income Housing Tax Credit Property Investments* and was effective for reporting periods beginning on January 1, 2006, and thereafter, with early adoption permitted. The original guidance included in this standard, and the substantive revisions reflected in SSAP No. 93 are retained for historical purposes in Issue Paper No. 125. Guidance in paragraph 7 was previously included within *INT 08-03: EITF 06-9: Reporting a Change in (or the elimination of) a Previously Existing Difference between the fiscal Year-End of a Parent Company and That of a Consolidated Entity or between the Reporting Period of an Investor and That of an Equity Method Investee* and was effective for periods beginning May 31, 2008. Guidance reflected in paragraphs 10, 11, and 12 incorporated from *INT 04-10: Accounting for Subsequent Investments in an Investee after Suspension of Equity Method Loss Recognition*, was originally effective December 5, 2004. Revisions adopted to paragraph 8 in August 2012 to clarify the requirement for the amortization of the basis differences shall be initially effective January 1, 2013, unless the company was previously amortizing the basis difference. (Companies that have previously amortized the basis difference shall not be impacted by these revisions.) For companies initially applying on January 1, 2013, the revisions should be applied prospectively for both new and existing minority-owned investments, with the effective date for this revision being used as the measurement date to determine any basis difference, which is attributable to goodwill, to be amortized on existing minority-owned investments.

26. The substantive revisions to incorporate single real estate property investments wholly-owned by an LLC that is directly and wholly-owned by the reporting entity in accordance with the criteria detailed in SSAP No. 40R are effective as of January 1, 2015. For these investments previously reported within the scope of this statement, the reporting entity shall follow the transition guidance in SSAP No. 40R.

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 48—Investments in Joint Ventures, Partnerships and Limited Liability Companies*
- *Issue Paper No. 125—Accounting for Low Income Housing Tax Credit Property Investments*
- *Issue Paper No. 149—Wholly-Owned Single Real Estate Property in an LLC*

Statement of Statutory Accounting Principles No. 49

Policy Loans

STATUS

Type of Issue:	Life, Accident and Health
Issued:	Initial Draft
Effective Date:	January 1, 2001
Affects:	Nullifies and incorporates INT 01-05
Affected by:	No other pronouncements
Interpreted by:	No other pronouncements

STATUS **1**
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Policy Loans

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for policy loans.

SUMMARY CONCLUSION

2. A policy (or contract) loan shall be defined as a loan to a policyholder, under the provisions of an insurance contract that is secured by the cash surrender value or collateral assignment of the related policy or contract. Policy loans shall include:

a. Cash loans, including loans resulting from early payment benefits or accelerated payment benefits, on contracts when the terms of the contract specify that such payments are policy loans secured by the policy;

b. Automatic premium loans, which are loans made in accordance with policy provisions whereby delinquent premium payments are automatically paid from the cash value at the end of the established grace period for premium payments.

3. Policy loans meet the definition of assets, as defined in *SSAP No. 4—Assets and Nonadmitted Assets* and are admitted assets, except as specified in paragraphs 5 and 6 of this statement. Policy loans are readily available to satisfy policyholder obligations as the terms of the policy loan allow the reporting entity to offset an outstanding policy loan balance against the cash surrender value of the policy.

4. Policy loans shall be carried at the unpaid balance of the loan. The unpaid balance of the loan shall include any unpaid principal plus any accrued interest which is 90 days or more past due.

5. If the unpaid balance of the loan exceeds the cash surrender value or policy reserves established for the policy, the policy generally lapses. Cash surrender value shall be defined as the cash value of the basic policy plus cash value of any policy accumulations such as paid-up additions. The excess of the unpaid balance of the loan over the cash surrender value shall be evaluated for collectibility. If the amount is considered uncollectible, it shall be written off as a reduction of investment income in the statement of operations during the period it is determined to be uncollectible. Except for collateral assignment loans, all other amounts in excess of the cash surrender value shall be considered nonadmitted assets. The change in this nonadmitted asset shall be recorded as a change in nonadmitted assets as applicable.

6. A loan resulting from early payment benefits or accelerated payment benefits and secured by an assignment of the policy to the reporting entity as collateral for the loan shall be an admitted asset, except that the amount of any loan (including accrued interest) in excess of the policy reserve for that policy shall be nonadmitted. Upon death, the entire death benefit is recorded as a death benefit expense. The policy proceeds shall be used to repay the loan. Any proceeds in excess of that needed to repay the loan are payable to the named beneficiary.

7. Interest income on policy loans shall be recorded as earned and included in investment income consistent with *SSAP No. 34—Investment Income Due and Accrued*. For interest received before it is earned, unearned interest income shall be recorded as a liability in accordance with *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets*.

8. Accrued interest income on policy loans that is past due 90 days[1] or more shall be reclassified from Investment Income Due and Accrued and included in the unpaid balance of the policy loan as defined in paragraph 4.

Effective Date and Transition

9. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*. The guidance in the footnote to paragraph 8 was originally contained within *INT 01-05: Classification of Accrued Interest on Policy Loans* and was effective March 26, 2001.

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 49—Policy Loans*

[1] Interest less than 90 days due is allowed to be reclassified from Investment Income Due and Accrued and included in the unpaid policy loan balance earlier. This is a classification issue and would not result in any amounts being admitted that would otherwise be nonadmitted.

Statement of Statutory Accounting Principles No. 50

Classifications and Definitions of Insurance or Managed Care Contracts In Force

STATUS

Type of Issue:	Common Area
Issued:	Initial Draft
Effective Date:	January 1, 2001
Affects:	Nullifies and incorporates INT 08-08 Nullifies INT 00-23 and INT 01-23
Affected by:	No other pronouncements
Interpreted by:	No other pronouncements

STATUS **1**

SCOPE OF STATEMENT **3**

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Classifications and Definitions of Insurance or Managed Care Contracts In Force

SCOPE OF STATEMENT

1. This statement provides a general framework for classifying insurance or managed care contracts into categories where the recognition of contract and policy reserves and related revenue, benefits, and claims is fundamentally different. Separate statements will establish the accounting principles for premium and income recognition and policy benefit and claim reserves for all contracts defined herein.

SUMMARY CONCLUSION

Overview

2. The primary purpose of insurance, including managed care coverage, is to provide economic protection from identified risks occurring or discovered within a specified period. These risks include death, disability, health benefits, outliving one's financial assets, and damage to property by an insured peril or damage or injury to the insured or third parties. The accounting for the contract is significantly influenced by the terms of the insurance or managed care contract.

3. In order to provide for a conservative, consistent, and comparable method of accounting for insurance or managed care contracts, premiums and related benefits shall be recognized considering the policy term, premium payment requirements, risks assumed and benefits provided under the contract using conservative assumptions as to interest, mortality, morbidity, and incurred costs for health benefits as applicable. The reserve and income recognition methods reflect the premium payment pattern and the insurance protection and/or benefits provided for in the insurance or managed care contract.

4. This statement establishes an overall framework for existing insurance or managed care contracts by identifying four broad categories of insurance or managed care contracts where the premium payment pattern and the protection and/or benefits provided are fundamentally different and, therefore, require different income recognition and reserving methods.

5. Insurance contracts providing any protection against death, disability, accident or illness in which the reporting entity assumes mortality or morbidity risk shall be classified as life or accident and health contracts, as applicable. Managed care contracts provide defined health care services to subscribers, members or policyholders, collectively referred to hereafter as subscribers, in return for fixed, periodic premiums (usually paid monthly) that are generally due at or before the beginning of the coverage period and shall be classified as health contracts. Contracts which insure against damage to property by an insured peril or damage or injury to the insured or third parties, generally over a fixed/limited period of time, shall be classified as property and casualty contracts. Contracts in which the reporting entity does not assume any mortality, morbidity, health benefit costs incurred, or casualty risk and which act exclusively as investment vehicles shall be classified as deposit-type contracts. Such classification shall be made at the inception of the contract and shall not change.

Life Contracts

6. The primary purpose of life insurance is to provide financial assistance to a beneficiary at the insured's death. The long period of coverage involving the risk of death, a risk which usually increases with age, is the distinguishing characteristic by which life insurance is set apart from other forms of insurance. Life insurance is often sold on a level premium basis under which the annual premium remains constant even though the expected policy benefits and services do not occur evenly over the duration of the contract. Premium revenue generally exceeds expected policy benefits in the early years of the contract and it is necessary to accrue, as premium revenue is recognized, a liability for costs that are expected to be paid in the later years of the contract.

7. The liability for expected costs relating to most types of life contracts is accrued over the current and expected renewal periods of the contracts. The net valuation premium is based upon an assumed interest rate and upon the frequency of death derived from mortality tables. The net premiums collected, after deducting benefits and other costs each year, are accumulated at interest. This accumulation, when combined with future net premiums and future investment income theoretically generates a sum sufficient to pay the claims resulting from the death or disabilities of the insured.

8. The liability which corresponds to this fund is referred to as the policy reserve. These contracts are generally expected to be in force for an extended period of time and require the performance of various functions and services for an undefined period of time and are generally not subject to unilateral changes in their provisions. The policy reserve is generally calculated as the excess of the present value of future benefits to be paid to or on behalf of policyholders less the present value of future net premiums, discounted at valuation interest and mortality.

9. Life insurance contracts shall include contracts with life contingencies, including, but not limited to:

- Whole life contracts
- Endowment contracts
- Term life contracts
- Supplementary contracts
- Group life contracts
- Franchise life contracts
- Universal life type contracts
- Variable life contracts
- Limited payment contracts
- Credit life contracts
- Annuity contracts

Life Contracts—Definitions

10. The contract for ordinary life insurance is between the company and the policy owner (often the insured). Many variations of ordinary life coverages are available to a purchaser of insurance, including participating, limited-payment periods, combinations of coverages, and decreasing (or increasing) death benefits. Industrial life insurance, also called “debit” insurance, is insurance under which premiums are paid monthly or more often, the face amount of the policy does not exceed a stated amount, and the words “industrial policy” are printed in prominent type on the face of the policy. Ordinary and industrial life insurance contracts are considered life contracts and include the types of coverage as described in the following paragraphs.

11. Whole life contracts provide a fixed amount of insurance coverage over the life of the insured and the related benefits are normally payable only upon the insured’s death. Premiums are paid over various periods as allowed by the terms of the policy contract. Whole life insurance contracts provide for nonforfeiture values, some common types being reduced paid up insurance, extended term insurance, and

cash values, and some provide for the payment of policy dividends. A level premium is usually paid for policies of this type, and the premium may be paid in annual or more frequent modes. An ordinary life (straight-life) policy stipulates that premiums are to be paid during the life of the insured.

12. Endowment contracts are principally savings contracts which incorporate an element of life insurance protection. Endowment insurance contracts provide a benefit if the insured survives the endowment period or the amount is paid to a beneficiary if the insured does not survive. A pure endowment contract only provides a benefit to the insured if he/she survives the endowment period. Endowment policies mature at a specified attained age of the insured or at the end of a specified period. Premium payments for endowment contracts are made over a specified period, but may also be made under a single-premium or limited-payment plan. Both whole life and endowment policies contain nonforfeiture or similar clauses which provide for a value in cash or some other form of insurance to be available in the event of failure to continue the required premiums.

13. Term life contracts provide insurance over a specified period of time. If the insured dies during this term, the face amount of the policy will be paid to the beneficiary. Policies for term insurance which are written for relatively short periods of time commonly grant the policyholder the right to renew for an additional period or periods up to a maximum age, such as 60 or 65, without requiring additional evidence of insurability. Rights to convert to whole life or endowment contracts may also be included in the contract. Term contracts may also be made for a period which will end when the insured reaches a certain age (for example, age 60 or 65). Such policies do not usually provide nonforfeiture values.

14. Supplementary contracts with life contingencies are a type of agreement between the insurance company and either the insured or the beneficiary, usually to provide for full or partial settlement of the amount payable upon the termination of an original contract. Generally, the proceeds are paid over the lifetime of one or more beneficiaries. This differs from a supplementary contract without life contingencies under which the proceeds are paid over a definite period without regard to the life of the beneficiary.

15. Group life contracts are insurance on the lives of a group of persons under a single master contract. Insurance of this type is customarily written on a yearly renewable term basis although some permanent group life is sold. Group life insurance is based on a master policy which usually precludes or disallows individual selection and is for the benefit of persons other than the policyholder. The individual insured members may receive certificates of insurance which evidence the contract. The contract is made by the policyholder and the insurer; there is no contract of insurance between the policyholder and the members. State statutes vary as to what constitutes a group and as to who may be a policyholder. Some states permit only employee-employer relationships in a group contract. Others permit union members, credit union members, or similar relationships in group contracts.

16. Franchise life contracts usually consist of individual policies offered to all persons in a general class (usually a work profession) who are related in some way such as belonging to a certain association.

17. Universal life and variable life contracts include those contracts which have terms that are not fixed and guaranteed relative to premium amounts, expense assessments, or benefits accruing to the policyholder. These contracts generally provide for death benefits and nonforfeiture values and may be issued on a fixed premium basis or on a flexible premium basis where the premiums are paid at the insured's discretion.

18. Limited-payment contracts are contracts with terms that are fixed and guaranteed and for which premiums are paid over a specified number of years or to a specified age. The insurance coverage continues for the remainder of the insured's life. A single-premium policy requires a lump-sum payment at the inception of the policy.

19. Credit life contracts are sold in connection with loans or other credit transactions not exceeding a stated duration and provide insurance protection against death. This form of insurance is generally issued in connection with the issuance of credit to an individual by a bank, retailer, finance company, or other similar organizations. This type of insurance most often protects the creditor to the extent of the unpaid balance of the loan in the form of decreasing term insurance; however, some credit life insurance is sold on a level-term basis.

20. An annuity contract is an arrangement whereby an annuitant is guaranteed to receive a series of stipulated amounts commencing either immediately or at some future date. The contract shall be issued to or for the benefit of an identifiable individual or group of individuals. Such a contract containing well-defined class-based (e.g. age, gender) annuity purchase rates used in defining either a specific or maximum purchase rate guarantee would constitute an annuity contract containing a life contingency that would require it to be classified as a life contract. Some examples of contracts issued for the benefit of a group of individuals include pension plan sponsors purchasing contracts for the benefit of their plan participants, employers or associations purchasing contracts for the benefit of their employees or members, and collective trusts purchasing contracts for the benefit of participating pension plans and their plan participants. The main types of annuity contracts with life contingencies are discussed below.

a. A deferred annuity provides for the accumulation of funds to be applied at some future period designated by the policyholder. Premium payments can be made in a lump sum amount (single premium deferred annuity), or periodically (flexible or fixed premium deferred annuity) as allowed by the policy contract. At the end of the accumulation period, the policyholder may elect to receive a lump sum distribution or may elect to receive periodic payments for life, or over a specific period, or some combination thereof;

b. A variable annuity is an annuity which includes a provision for benefit payments which vary in accordance with the rate of return of the underlying investment portfolio selected by the policyholder. The considerations for a variable annuity are usually invested in a separate account in which the value of the contract share varies according to the performance of the separate account before the commencement of annuity payments as well as after. Premium payments can be made in lump sum amounts or periodically as allowed by the policy contract. A minimum death benefit is often guaranteed during the annuity consideration accumulation period and these contracts are, therefore, classified as life contracts;

c. A straight-life annuity provides for periodic payments to the annuitant as long as the annuitant lives. Death of the annuitant constitutes completion of the contract and no further payments are made by the insurance company;

d. A life annuity with a period certain works essentially the same way as the straight-life annuity as the annuitant receives periodic payments for as long as the annuitant lives. However, if the annuitant dies before the end of the specified “certain” period, payments are continued to a beneficiary until the specified number of “certain” payments (i.e., the specified period in the contract) is completed;

e. A refund annuity is similar to the life annuity with a period certain in which the annuitant receives periodic payments for as long as the annuitant lives. There are two variants of this type of annuity. Under the cash refund annuity, a lump-sum payment is made at the death of the annuitant equal to the excess, if any, of the purchase price of the annuity over the sum of the annuity payments made to date of death. The installment refund annuity provides that annuity payments are to continue to a beneficiary after the death of the annuitant until the sum of all payments made equals the purchase price;

f. A joint and survivorship annuity provides for the continuation of payments after the death of one of the annuitants during the lifetime of the surviving annuitant.

Accident and Health Contracts

21. Health insurance policies or managed care contracts, offered by a health maintenance or similar organization, many life insurance and some property and casualty companies, may provide hospital, surgical, medical, loss of income, accidental death and dismemberment, or long term care coverage as well as other health related benefits. The insurance protection involving economic loss resulting from a medical condition (e.g., medical care expenses or the risk of disability) is the distinguishing characteristic by which accident and health insurance or managed care contracts are set apart from other forms of insurance. Health coverage is currently furnished under group or individual contracts. Coverage sold to individuals can be subdivided according to the reporting entity's right to continue the policy, limitations on the reporting entity's right to increase premiums, as well as other factors.

22. Accident and health contracts also include risk contracts with Medicaid and Medicare whereby the reporting entity assumes insurance risk.

23. Managed care contracts are contracts that provide defined health care services to subscribers in return for fixed, periodic premiums (usually paid monthly) that are generally due at or before the beginning of the coverage period. Managed care means a system or technique(s) generally used by reporting entities to affect access to and control payment for health care services. Managed care techniques most often include one or more of the following: 1) review of the medical necessity and appropriateness of services or site of services; 2) contracts with selected providers; 3) financial incentives for enrollees to use specific providers, services, or service sites; 4) controlled access to and coordination of services by a case manager; and 5) payor efforts to identify treatment alternatives and modify benefit restrictions for high cost patient care. Expenses for medical, hospital, pharmacy and other benefits are recognized based on the way the reporting entity provides for the contracted services. In some instances, this is through the payment of claims to providers as services are rendered which require a claims liability to be recorded as addressed in *SSAP No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses* (SSAP No. 55) or through capitated arrangements based on contracts with providers, where expense is recognized ratably over the contract period in accordance with SSAP No. 55.

24. Similar to life insurance contracts, a significant amount of accident and health contracts is sold to individuals and groups on a level premium basis under which the annual premium remains constant even though the expected policy benefits and services may not occur evenly over the duration of the contract. Premium revenue for level premium contracts generally exceeds expected policy benefits in the early years of the contracts and it is necessary to accrue, as premium revenue is recognized, a liability for costs that are expected to be paid in the later years of the contracts.

25. The liability for expected costs relating to accident and health contracts sold on a level premium basis is accrued over the current and expected renewal periods of the contracts. The net valuation premium is based upon an assumed interest rate, persistency, and the frequency of expected death and disability claims, generally derived from mortality and morbidity tables. The net premiums collected, after deducting benefits and other costs each year, are accumulated with interest. Similar to life insurance, this accumulation or policy reserve, when combined with future net premiums and future investment income theoretically generate a sum sufficient to pay the claims resulting from the death or disabilities of the insured or subscriber. The reserve is generally calculated as the excess of the present value of future benefits to be paid to or on behalf of insureds or subscribers less the present value of future net premiums, discounted at valuation interest, mortality, and morbidity.

26. Accident and health contracts shall include contracts with health benefits or disability contingencies, including, but not limited to:

- Managed care contracts
- Income replacement contracts
- Expense reimbursement contracts
- Credit accident and health contracts
- Continuing care contracts
- Long-term care contracts
- Accidental death and dismemberment contracts

Accident and Health Contracts—Definitions

27. Accident and health contracts provide protection against economic losses resulting from accident, sickness or medical condition. This coverage may be provided under individual policies, under group or franchise policies, managed care contracts, Medicaid or Medicare risk contracts or it may be provided under certain special types of policies, such as credit accident and health insurance.

28. The economic losses which accident and health policies cover, or the types of benefits provided, will vary with different policies. The broad categories of economic losses protected against are medical and hospital expense and income replacement. For example, payments for hospital, surgical, or medical expenses may be provided under a hospital expense policy, while under other policies, a more comprehensive form of coverage, known as major medical insurance, may be offered. Similarly, policies may provide monthly benefits for loss of income from disability, either on a short-term or a long-term basis, or only for disabilities due to accident. Loss of life from accident may be covered under accidental death policies, while under certain limited accident policies, only accidental death from air travel may be covered.

29. Accident and health policies may be categorized by the form of policy through which the coverage is provided; it may be categorized according to the benefits provided by the policy; or it may be categorized by the contingencies insured against. These variations in types of policies and the benefits provided must be considered in discussing the reserves for accident and health policies.

30. Credit accident and health insurance contracts are similar to credit life insurance except the insurance protection is in the form of disability insurance.

31. Long-term care contracts represent any contract or policy rider providing coverage for not less than 12 consecutive months for each covered person for one or more necessary diagnostic, preventive, therapeutic, rehabilitative, maintenance or personal care services, provided in a setting other than an acute care unit of a hospital. Under long-term care contracts, the insured event is generally the inability of the contract holder to perform certain activities of daily living as compared to medical contracts which generally provide insurance protection against accident or sickness or disabilities contracts which generally provide income replacement protection.

Property and Casualty Contracts

32. Contracts which insure against damage to property by an insured peril or damage or injury to the insured or third parties shall be classified as property and casualty contracts. Damages shall include both physical and financial damages. Premiums from property and casualty contracts are generally recognized as earned over the exposure period of the contract in proportion to the amount of insurance protection provided.

33. The exposure to insurance risk for most property and casualty insurance contracts does not vary significantly during the duration of the contract. Premiums from property and casualty contracts shall be recognized as earned premium as discussed in *SSAP No. 53—Property Casualty Contracts—Premiums* (SSAP No. 53).

34. These contracts shall include but shall not be limited to:

- Traditional property and casualty insurance contracts
- Title insurance contracts
- Mortgage and financial guaranty contracts

Property and Casualty Contracts—Definitions

35. Property and casualty contracts include a variety of types of coverage, including, but not limited to, fire, workers' compensation, automobile, multiple peril, professional and miscellaneous liability, and fidelity and surety bonds as further discussed below.

36. Types of insurance represent the perils that are insured by property and liability insurance companies and classified as property and casualty contracts. Some of the more important types of insurance are as follows:

a. Fire and allied lines, which include coverage for fire, windstorm, hail, and water damage (but not floods);

b. Ocean marine, which includes coverage for ships and their equipment, cargos, freight or money to be paid for use of the ships, and liability to third parties for damages. This type of insurance includes inland as well as ocean water transportation;

c. Inland marine, which covers property in transit. (It also includes floaters, which are policies that cover movable property, such as a tourist's personal property);

d. Workers' compensation, which compensates employees for injuries or illness sustained in the course of their employment;

e. Automobile, which covers personal injury or automobile damage sustained by the insured and the related liability to third parties for losses caused by the insured;

f. Multiple peril, which is a package coverage including most property and liability coverage except workers' compensation, automobile insurance, and surety bonds;

g. Professional liability, which covers physicians, surgeons, dentists, hospitals, engineers, architects, accountants, attorneys, and other professionals from liability arising from error or misconduct in providing or failing to provide professional service;

h. Miscellaneous liability, which covers most other physical and property damages not included under workers' compensation, automobile liability, and multiple peril policies. (Damages include death, cost of care, and loss of services resulting from bodily injury, as well as loss of use of property);

i. Fidelity bonds, which cover employers against dishonest acts by employees. Blanket fidelity bonds cover groups of employees;

j. Surety bonds, which provide for monetary compensation to third parties for failure by the insured to perform specifically covered acts within a stated period. (Most surety bonds are issued for persons doing contract construction, persons connected with court actions, and persons seeking licenses and permits. Surety bonds also include financial guarantees.); and

k. Prepaid legal expense plans are established through group policies purchased by companies who in turn offer coverage to electing employees. The plans are offered as an employee benefit to help certificate holders more cost effectively solve their legal problems. For a small monthly premium, employees may consult with and/or receive representation from a plan attorney regarding any one of several covered services (such as will preparation, divorce, child adoption, etc.). The group policies are written for a set period, generally one year (and can be up to three-years), with the sponsoring company as the group policyholder. Policies may be canceled by the policyholder with 45 days notice. The reporting entity sends monthly premium bills to participating employers based on the previous month's actual employee count. Monthly premium installments are withheld from the participating employee's paycheck and are remitted to the insurance company along with a detailed listing of the number of plan participants that month. Similar to group accident and health policies, premium amounts vary from month to month depending on the number of employees participating in the plan that month.

37. In addition to these types, insurance is provided by excess and surplus lines. Excess liability covers the insured against loss in excess of a stated amount, but only for losses as covered and defined in an underlying policy. The underlying amount is usually insured by another policy but can be retained by the insured. Surplus lines include coverage for risks that do not fit normal underwriting patterns, risks that are not commensurate with standard rates, or risks that will not be written by standard carriers because of general market conditions. These kinds of policies are generally written by carriers not licensed in the jurisdiction where the risk is located and generally are not subject to regulations governing premium rates or policy language.

38. Insurance is generally available to the individual as a means of protection against loss. There are instances, however, in which a person cannot obtain insurance in the voluntary insurance market. States have established involuntary plans to provide insurance to those with high risks whom otherwise would be excluded from obtaining coverage. A common example is the Automobile Insurance Plan (formerly called the Assigned Risk Plan). Under this plan, all companies writing automobile insurance in a state are allocated a share of the involuntary business on an equitable basis. Other states use a reinsurance plan, under which each insurer accepts all applicants but may place high-risk drivers in a reinsurance pool, with premiums paid to and losses absorbed by the pool. Still another approach is a joint underwriting association, in which one or more servicing companies are designated to handle high-risk drivers. All insurers in the state may be required to participate in the underwriting results. Another example of involuntary plans includes Fair Access to Insurance Requirements (FAIR) plans. FAIR plans are federally approved, state-supervised programs established to provide coverage for property in high-risk areas. Companies that operate in the state are assessed for any underwriting losses experienced by the FAIR plan.

39. Medical malpractice pools were established when health-care professionals and institutions were experiencing difficulty in obtaining liability insurance in the voluntary insurance market. The pools were established by law and currently exist in the majority of states. All insurers writing related liability insurance in such states are considered mandatory participants in the pools as a condition for their continuing authority to transact business in such states.

40. Workers' compensation pools are similar to FAIR plans. As with FAIR plans, companies operating in a given state are assessed a proportionate share, based on direct writings, of the underwriting results of the pool.

41. Title insurance insures, guarantees, or indemnifies owners of real property or the holders of liens or encumbrances thereon against loss or damage suffered by unidentified instances of defective titles, liens or encumbrances or the unmarketability of the title.

42. Mortgage guaranty insurance protects a lender against loss of all or a portion of the principal amount of a mortgage loan upon default of the mortgagor. This type of insurance provides no protection other than against loss due to default.

Deposit-Type Contracts

43. Deposit-type contracts do not incorporate insurance risk. Contracts issued by insurers that do not incorporate risk from the death or disability of policyholders (mortality or morbidity risk) are more comparable to financial or investment instruments issued by other financial institutions than to insurance contracts.

44. Deposit-type contracts shall include contracts without any life or disability contingencies, including, but not limited to, certain types of the following policy categories:

- Supplemental contracts
- Lottery payouts
- Structured settlements
- Guaranteed interest contracts
- Income settlement options
- Dividend and coupon accumulations
- Annuities certain
- Premium and other deposit funds
- Funding Agreements without well-defined class-based (e.g. age, gender) annuity purchase rates defining either specific or maximum purchase rate guarantees (see SSAP No. 15, paragraph 19, paragraph 20 of this statement and *SSAP No. 52—Deposit-Type Contracts*, paragraph 20.)

45. Under deposit-type contracts, the policyholder may assume all, some, or none of the investment risk, depending on the contract terms. Amounts can be deposited in lump sum, or periodically as allowed by the policy contract. Deposit-type contracts would include annuities certain, whose income payments have no reference to life contingencies and benefits are paid over a specified period (i.e., 10 years, 20 years, etc.).

Relevant Literature

46. This statement rejects the GAAP classifications (i.e., short-duration and long-duration) found in *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises*, *FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, and *FASB Statement No. 120, Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long Duration Participating Contracts*.

Effective Date and Transition

47. This statement is effective for years beginning January 1, 2001. The guidance in paragraph 36.k. was originally contained within *INT 01-23: Prepaid Legal Insurance Premium Recognition* and was effective June 11, 2001.

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 50—Classifications and Definitions of Insurance or Managed Care Contracts In Force*

Statement of Statutory Accounting Principles No. 51

Life Contracts

STATUS

Type of Issue:	Life, Accident and Health
Issued:	Initial Draft
Effective Date:	January 1, 2001
Affects:	Supersedes SSAP No. 80 with guidance incorporated November 2011 Nullifies and incorporates INT 00-30, INT 01-26
Affected by:	No other pronouncements
Interpreted by:	INT 00-03

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Life Contracts

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for income recognition and policy reserves for all contracts classified as life contracts defined in *SSAP No. 50—Classifications and Definitions of Insurance or Managed Care Contracts In Force*, except for credit insurance contracts which are discussed in *SSAP No. 59—Credit Life and Accident and Health Insurance Contracts* and separate account products which are discussed in *SSAP No. 56—Separate Accounts*.

SUMMARY CONCLUSION

Types of Premiums

2. The gross premium is the amount charged to the policyholder and taken into operations as premium income.

3. The net premium is the amount calculated on the basis of the interest and mortality table used to calculate the reporting entity's statutory policy reserves.

4. The difference between the gross premium and the net premium is referred to as "loading." Loading generally includes allowances for acquisition costs and other expenses but also includes the differences in mortality and interest assumptions utilized for pricing and statutory reserving purposes.

Premium Income Recognition

5. Premiums shall be recognized as income on the gross basis (amount charged to the policyholder) when due from policyholders under the terms of the insurance contract. As a result, premium income shall include first year and renewal premiums, as well as any related premium adjustments (i.e., retrospective premium contracts which are discussed in *SSAP No. 66—Retrospectively Rated Contracts*) provided for by the contract. The contractual due date shall be established through the predetermined billing procedure agreed to by the parties. In addition, premium income shall include single and flexible premium amounts when received from the policyholder. Further, the recognition of premium income and the change in loading shall be consistent with the assumptions made in calculating the related policy reserve.

6. Premium income shall include dividends, coupons, guaranteed annual pure endowments, and similar benefits provided by the insurance contract when such amounts are applied by the terms of the contract to provide additional paid-up insurance, annuities, or to shorten the endowment or premium-paying period. Premiums and considerations waived by the reporting entity under disability provisions contained in its policies and contracts, and reported in operations as a disability benefit, are included in premium income.

7. Premium income shall exclude premiums that have been received by the reporting entity prior to the reporting date but which are due on or after the next policy anniversary date (i.e., advance premiums as discussed in paragraph 27).

8. Premium income shall be reduced for premiums returned and allowances to industrial policyholders for the direct payment of premiums.

9. Premium income shall be increased by reinsurance premiums assumed and reduced by reinsurance premiums ceded. Reinsurance premiums assumed and ceded are defined and addressed in *SSAP No. 61R—Life, Deposit-Type and Accident and Health Reinsurance*.

10. Death or other benefits used to fund new policies shall be accounted for as a benefit payment and as a new premium, another type of income, or a liability, as appropriate.

Premium Adjustments

11. In the summary of operations, the change in gross deferred and uncollected premiums is recorded as premium income. Deferred premiums are further discussed in paragraphs 23-25. Since only the net premiums are included in the computation of reserves and reported as an asset, it is necessary to adjust the gross premium for an amount representing the change in loading on deferred and uncollected premiums. The change in loading is included as an expense in the summary of operations and is not shown as a reduction to premium income.

Uncollected Premium Balances

12. Gross premiums that are due and unpaid as of the reporting date, net of loading, shall be classified as uncollected premiums. Uncollected premium balances which are less than 90 days past due meet the definition of an asset, as defined in *SSAP No. 4—Assets and Nonadmitted Assets,* and are admitted assets to the extent they conform to the requirements of this statement.

Other Considerations Received

13. Considerations for supplementary contracts, dividends left on deposit to accumulate interest, and amounts deposited and accumulated for guaranteed interest and group annuity contracts shall be recognized as deposit-type funds or considerations for supplemental contracts, as appropriate. These amounts are further discussed in *SSAP No. 52—Deposit-Type Contracts*.$^{\text{(INT 00-03)}}$

Waiver of Monthly Deductions for Flexible Premium Universal Life Insurance Policies

14. Flexible premium universal life insurance policies do not require specified premiums as traditional policies do. The “waiver” benefit entities offer is a “waiver of monthly deductions” benefit as opposed to a “waiver of premium” benefit. The difference being specific premiums may or may not be required under the policy regardless of whether the insured is disabled or not. Waiver of a deduction is not to be considered revenue nor a benefit paid, therefore a calculation of the amount of the deduction need not be made for flexible premium universal life insurance policies.

Policy Reserves

15. Statutory policy reserves shall be established for all unmatured contractual obligations of the reporting entity arising out of the provisions of the insurance contract. Where separate benefits are included in a contract, a reserve for each benefit shall be established as required in Appendix A-820. These statutory policy reserves are generally calculated as the excess of the present value of future benefits to be paid to or on behalf of policyholders less the present value of future net premiums. Statutory policy reserves meet the definition of liabilities as defined in *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets* (SSAP No. 5R). The actuarial methodologies referred to in the following paragraph meet the criteria required for reasonable estimates in SSAP No. 5R.

16. The reserving methodologies and assumptions used in computation of policy reserves shall meet the provisions of Appendices A-820 and A-822 and the actuarial guidelines found in Appendix C of this Manual. Further, policy reserves shall be in compliance with those Actuarial Standards of Practice promulgated by the Actuarial Standards Board.

17. The preceding two paragraphs summarize the general reserve requirements for all types of life contracts. In addition to these general reserve requirements, Appendix A-820 provides additional guidance with respect to certain types of accumulation annuities that have flexible features (e.g., guaranteed nonforfeiture benefits such as interest guarantees, annuitization options, bailout features, partial withdrawals) which can create varying benefit streams if elected by the policyholder. Specific policies with such flexible features include most individual and some group annuity contracts, but exclude

any disability and accidental death benefits in these contracts. For benefits under these contracts, reserves shall be established according to the Commissioners' Annuity Reserve Valuation Method (CARVM). Generally under CARVM, the difference between all possible future guaranteed benefits streams, including guaranteed nonforfeiture benefits, over the future considerations is computed as of the end of each contract year. Each of these differences is discounted to the reporting date at the applicable valuation interest rate. A reserve is then recorded based on the greatest present value difference of each of the contract year calculations.

18. Unlike traditional life insurance contracts, flexible premium universal life-type contracts do not have guaranteed premiums and some assumption as to future premiums is required. Appendix A-585 establishes a minimum reserving method for universal life-type contracts by providing guidance on how to estimate future premiums on flexible premium universal life-type contracts so that traditional valuation methodologies can be used. Alternative minimum reserves shall be required, if applicable, for flexible premium universal life-type contracts if the guaranteed maturity premium is less than the valuation net premium. Appendix A-585 shall be used in establishing reserves for flexible premium universal life-type contracts.

19. Policy reserves for fixed premium universal life-type contracts shall also follow guidance in Appendix A-585. Certain fixed premium products offer the policyholder a secondary guarantee. A secondary guarantee provides the policyholder a guaranteed set of cash values, death benefits, and maturity benefits that will be provided regardless of the performance of the policy value. Appendix A-585 requires all guarantees to be considered when establishing policy reserves and shall be followed in establishing reserves for fixed premium universal life-type contracts.

20. Statutory policy reserves for those group annuity contracts or other contracts that, in whole or in part, establish the insurer's obligations by reference to a segregated portfolio of assets not owned by the insurer shall be established in accordance with the guidance in Appendix A-695. Statutory policy reserves for those contracts with nonlevel premiums or benefits, or contracts with secondary guarantees shall be established in accordance with the guidance in Appendix A-830. Statutory policy reserves for those group life contracts utilizing a separate account that meet the requirements outlined in paragraph 1 of Appendix A-200 shall be computed in accordance with the guidance in that appendix.

Valuation (Reserve) Method and Deferred Premiums

21. Reserves shall be established for all benefits guaranteed under the terms of the policy as of the reporting date using appropriate valuation methods, interest rates, mortality and morbidity rates, as applicable. However, as a practical expedient, reserves have been generally calculated as of the policy anniversary date (i.e., terminal reserves), not the reporting date. As a result, it is necessary to adjust the terminal reserve back to the reporting date. The components used to compute a terminal reserve shall consist of an interest rate, a mortality and/or morbidity table, and a valuation method (e.g., net level, full preliminary term, Commissioners' Reserve Valuation Method (CRVM), or CARVM). A terminal reserve is based on the assumption that all net premiums have been received, all interest earned, and all benefits paid to the end of the policy year.

22. Since terminal reserves are computed as of the end of a policy year and not the reporting date, the terminal reserve as of policy anniversaries immediately prior and subsequent to the reporting date are adjusted to reflect that portion of the net premium that is unearned at the reporting date. This is generally accomplished using either the mean reserve method or the mid-terminal method as discussed in the next four paragraphs. Other appropriate methods, including an exact reserve valuation, may also be used.

Mean Reserve Method

23. Under the mean reserve method, the policy reserve equals the average of the terminal reserve at the end of the policy year and the initial reserve (the initial reserve is equal to the previous year's terminal

reserve plus the net annual valuation premium for the current policy year). When reserves are calculated on the mean reserve basis, it is assumed that the net premium for a policy is collected annually at the beginning of the policy year and that policies are issued ratably over the calendar year.

24. However, as premiums are often received in installments more frequently than annually and since the calculation of mean reserves assumes payment of the current policy year's entire net annual premium, the policy reserve is overstated by the amount of net modal premiums not yet received for the current policy year as of the valuation date. As a result, it is necessary to compute and report a special asset to offset the overstatement of the policy reserve.

25. This special asset is termed "deferred premiums." Deferred premiums are computed by taking the gross premium (or premiums) extending from (and including) the modal (monthly, quarterly, semiannual) premium due date or dates following the valuation date to the next policy anniversary date and subtracting any such deferred premiums that have actually been collected. Deferred premium assets shall also be reduced by loading. Since the calculation of mean reserves assumes payment of the current policy year's entire net annual premium, deferred premium assets are considered admitted assets to compensate for the overstatement of the policy reserve.

Mid-Terminal Method

26. Under the mid-terminal method, the policy reserves are calculated as the average of the terminal reserves on the previous and the next policy anniversaries. These reserves shall be accompanied by an unearned premium reserve consisting of the portion of valuation premiums paid or due covering the period from the valuation date to the next policy anniversary date.

Advance Premiums

27. Advance premiums are those premiums that have been received by the reporting entity prior to the valuation date but which are due on or after the next policy anniversary date. The policyholder may remit one or more premiums in advance of specific due dates. Where premiums are remitted sufficiently far in advance, the premiums charged to the policyholder may be reduced or discounted to reflect the time value of money. The difference between the gross and discounted premium is ratably charged as interest in the summary of operations from the date of payment to the premium due date. At the premium due date, the amount received from the policyholder plus the accumulated interest equals the gross premium necessary to fund the policy. The total amount of such advance premiums, less any discount as of the valuation date, is reported as a liability in the statutory financial statement and is not considered premium income until due. The gross premium, not the net valuation premium, is recorded as the advance premium in recognition of the reporting entity's liability to refund such premiums in the event the policy is terminated.

Policyholder Dividend Liability

28. A reporting entity shall accrue, as applicable, the following items relating to participating policies. They are dividends due and unpaid, dividends apportioned (or not yet apportioned) for payment in the following twelve months, and dividends left on deposit to accumulate interest.

29. Dividends due and unpaid represent dividends payable to the policyholder in the current year but which have not been disbursed or otherwise applied at the reporting date.

30. Dividends payable in the following calendar year represent the estimated amount of all dividends declared by a reporting entity's board of directors prior to the end of the statement year which are not yet paid or due at the end of the year (dividends apportioned for payment) as well as all dividends payable in the following calendar year that have not been declared (dividends not yet apportioned for payment). For individual insurance the amount of this liability shall be equal to the aggregate amount of the dividends

estimated to be payable in the following calendar year whether or not declared or apportioned. For group insurance and pensions, the amount of liability is generally equal to the portion of the dividend payable in the following calendar year which has been earned in the current calendar year.

31. Dividends left on deposit with the reporting entity shall be recorded in the amount of the deposit and accrued interest thereon. At the balance sheet date, the interest accrued but not yet credited to the policyholders' accounts shall be established as part of this liability.

Coupons

32. Some entities issue policies that guarantee an annual return, usually evidenced by a coupon that is part of the policy and matures on the policy's anniversary. This return represents an annual pure endowment and is essentially a return of premium previously paid by the policyholder. For matured coupons that have been left to accumulate, the liability is determined in the same way as the liability for dividend accumulations. Interest accrued is calculated for each coupon from the date each matures. The liability for unmatured policyholder coupons shall be the face value of the coupon, discounted at interest and mortality.

Reserve Recognition

33. The difference between the policy reserves for life contracts at the beginning and end of the reporting period shall be reflected as the change in reserves in the summary of operations, except for any difference due to a change in valuation basis.

Change In Valuation Basis

34. A change in valuation basis shall be defined as a change in the interest rate, mortality assumption, or reserving method (e.g., net level, preliminary term, etc.) or other factors affecting the reserve computation of policies in force and meets the definition of an accounting change as defined in *SSAP No. 3—Accounting Changes and Corrections of Errors* (SSAP No. 3). Consistent with SSAP No. 3, any increase (strengthening) or decrease (destrengthening) in actuarial reserves resulting from such a change in valuation basis shall be recorded directly to surplus rather than as a part of the reserve change recognized in the summary of operations. The impact on surplus is based on the difference between the reserve under the old and new methods as of the beginning of the year. This difference shall not be graded in over time unless an actuarial guideline adopted by the NAIC prescribes a new method and a specific transition that allows for grading.

Supplemental Benefits

35. In addition to the basic policy benefit, the insurance contract may provide supplemental benefits. Supplemental benefits include, but are not limited to, accidental death benefits and waiver of premium benefits. If the terms of the contract provide for these benefits, appropriate reserves shall be established in accordance with the applicable standards within the *Accounting Practices and Procedures Manual*.

Unearned Income

36. Amounts assessed that represent compensation to the reporting entity for services to be provided in future periods and which are required to be refunded upon policy termination are not earned in the period assessed. Such amounts, if not already considered in the policy reserve, shall be reported as unearned income, a liability, and recognized as income as the related services are provided.

Accelerated Benefits

37. Accelerated benefits are benefits payable under a life insurance contract to a policyholder or certificateholder during the lifetime of the insured, in anticipation of death or upon the occurrence of

specified life-threatening or catastrophic conditions as defined by the policy or rider. These benefits reduce the death benefit otherwise payable under the life insurance contract and are payable upon the occurrence of a single qualifying event which results in the payment of a benefit amount fixed at the time of acceleration. When benefits are provided through the acceleration of benefits under group or individual life policies or riders to such policies, policy reserves shall be determined in accordance with Appendices A-820 and A-620. Reserves for such benefits in the aggregate shall be sufficient to cover policies upon which no claim has yet arisen as well as policies upon which an accelerated claim has arisen. Accounting guidance for accelerated benefit payments made in the form of a loan are addressed in *SSAP No. 49—Policy Loans*. In addition, accelerated benefit payments, for those accelerated benefits that reduce the policy, shall not be deferred but shall be charged to the summary of operations as a benefit expense when paid to the policyholder.

Additional Reserves Not Included Elsewhere

38. Additional actuarial liabilities are commonly held for such items as:

a. Provision for either nondeduction of deferred fractional premiums or return of premiums at death of the insured; and

b. Surrender values in excess of reserves otherwise required or carried.

Disclosures

39. For life and annuity reserves the financial statements shall disclose the following:

a. A description of reserve practices concerning the following:

i. Waiver of deduction of deferred fractional premiums upon death of insured;

ii. Return of portion of final premium for periods beyond the date of death; and

iii. Amount of any surrender value promised in excess of the reserve as legally computed;

b. The methods employed in the valuation of substandard policies;

c. The amount of insurance, if any, for which the gross premiums are less than the net premiums according to the valuation standards;

d. The method used to determine tabular interest, tabular less actual reserves released, and tabular cost (by formula or from the basic data for such items); and

e. The nature of significant other reserve changes.

40. Disclose the amount of annuity actuarial reserves and deposit liabilities by withdrawal characteristics for the categories of general account, separate account with guarantees, separate account nonguaranteed and the total as follows:

a. Subject to discretionary withdrawal:

i. With market value adjustment, where withdrawal of funds is payable at all times, or prior to specified maturity dates where such dates are more than one year after the statement date and;

(a) In a lump sum with adjustments to reflect general changes in interest rates, or asset values since receipt of funds by the insurer;

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

ii. At book value less current surrender charge, where the withdrawal of funds is payable at all times, or at any time within one year from the statement date in a lump sum subject to a current fixed surrender charge of 5% or more and it does not contain a meaningful bail out rate as described in paragraph 40.v.(d);

iii. At fair value, where the withdrawal of funds is payable at current fair value of the assets supporting the liabilities, the assets are stated at current fair value, and the liabilities are stated at the current fair value or per unit value of the assets supporting the liabilities. These liabilities are for contracts where the customer bears the entire investment risk;

iv. Total with adjustment or at fair value;

v. At book value without adjustment (minimal or no charge or adjustment), where the withdrawal of funds is either payable at all times, or at any time (including a withdrawal on a scheduled payment date) within one year from the statement date and:

(a) In a lump sum without adjustment;

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

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

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

b. Not subject to discretionary withdrawal;

c. Total gross;

d. Reinsurance ceded;

e. Total net.

41. If the reporting entity has reported life insurance premiums and annuity considerations deferred and uncollected on policies in force as of the financial statement date, disclose separately the amounts and the loading excluded for each of the following lines of business:

a. Industrial business;

b. Ordinary new business;

c. Ordinary renewal;

d. Credit life;

e. Group life;

f. Group annuity.

42. Disclose the aggregate amount of direct premiums written through managing general agents or third party administrators. For purposes of this disclosure, a managing general agent means the same as in Appendix A-225. If this amount is equal to or greater than 5% of surplus, provide the following information for each managing general agent and third party administrator:

a. Name and address of managing general agent or third party administrator;

b. Federal Employer Identification Number;

c. Whether such person holds an exclusive contract;

d. Types of business written;

e. Type of authority granted (i.e., underwriting, claims payment, etc.);

f. Total premium written.

43. Reporting entities shall disclose the relative percentage of participating insurance, the method of accounting for policyholder dividends, the amount of dividends, and the amount of any additional income allocated to participating policyholders in the financial statements.

44. Reporting entities shall disclose if the reserve amount calculated on the state prescribed or permitted valuation basis is materially different from the reserve amount calculated on the A-820 valuation basis[1]. Although the A-820 standard is viewed as a minimum one, it represents the baseline from which deviations are measured. The determination of whether difference meets the standard of materiality is subjective. Refer to the Preamble regarding further guidance on the criterion of materiality.

45. Refer to the preamble for further discussion regarding disclosure requirements.

Relevant Literature

46. This statement incorporates the requirements of Appendices A-225, A-235, A-585, A-620, A-641, A-695, A-812, A-815, A-817, A-820, A-821, A-822, A-830, the Actuarial Standards Board *Actuarial Standards of Practice,* and the actuarial guidelines found in Appendix C of this Manual.

47. This statement rejects *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises, FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments, FASB Statement 120, Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts,* AICPA *Practice Bulletin No. 8, Application of FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses From the Sale of Investments, to Insurance Enterprises,* the AICPA *Audit and Accounting Guide—Audits of Stock Life Insurance Companies,* AICPA *Statement of Position 95-1, Accounting for Certain Activities of Mutual Life Insurance Enterprises* relating to accounting and reporting for policy reserves for short and long duration contracts, and *FASB Interpretation No. 40, Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance and Other Enterprises, an interpretation of FASB Statements No. 12, 60, 97, and 113.*

[1] This issue applies to contracts issued January 1, 2001, and thereafter.

Effective Date and Transition

48. This statement is effective for years beginning January 1, 2001. Contracts issued prior to January 1, 2001 shall be accounted for based on the laws and regulations of the domiciliary state. State laws and regulations shall be understood to include anything considered authoritative by the domiciliary state under the individual state's statutory authority and due process procedures. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with SSAP No. 3. The guidance in paragraph 14 was originally contained within *INT 00-30: Application of SSAP No. 51 Paragraph 6 to Waiver of Deduction on Flexible Premium Universal Life Insurance Policies* and was effective December 4, 2000. The guidance in paragraph 44 was originally contained within *INT 01-26: SSAP No. 51 and Reserve Minimum or Required Amount* and was effective January 1, 2001.

REFERENCES

Other

- *NAIC Financial Condition Examiners Handbook*
- *Actuarial Standards Board Actuarial Standards of Practice*

Relevant Issue Papers

- *Issue Paper No. 51—Life Contracts*
- *Issue Paper No. 56—Universal Life-Type Contracts, Policyholder Dividends, and Coupons*
- *Issue Paper No. 110—Life Contracts, Deposit-Type Contracts and Separate Accounts, Amendments to SSAP No. 51—Life Contracts, SSAP No. 52—Deposit-Type Contracts, and SSAP No. 56—Separate Accounts*

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Statement of Statutory Accounting Principles No. 52

Deposit-Type Contracts

STATUS

Type of Issue:	Life, Accident and Health
Issued:	Initial Draft
Effective Date:	January 1, 2001
Affects:	Supersedes SSAP No. 80 with guidance incorporated November 2011 Nullifies and incorporates INT 08-08 Nullifies INT 00-23
Affected by:	No other pronouncements
Interpreted by:	INT 00-03

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Deposit-Type Contracts

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for income recognition and policy reserves for all contracts classified as deposit-type contracts defined in *SSAP No. 50—Classifications and Definitions of Insurance or Managed Care Contracts In Force* (SSAP No. 50).

SUMMARY CONCLUSION

Introduction

2. As discussed in SSAP No. 50, deposit-type contracts are those contracts that do not subject the reporting entity to any risks arising from policyholder mortality or morbidity. A mortality or morbidity risk is present if, under the terms of the contract, the reporting entity is required to make payments or forego required premiums contingent upon the death or disability (in the case of life and disability insurance contracts) or the continued survival (in the case of annuity contracts) of a specific individual or group of individuals.

3. Deposit-type contracts frequently grant policyholders significant discretion over the amount and timing of deposits and withdrawals. Reporting entities are frequently granted significant discretion over amounts that accrue to or that are assessed against policyholders.

4. Due to the absence of mortality and/or morbidity risk and the discretionary characteristics noted in the preceding paragraph, the accounting principles for income recognition and policy reserves for deposit-type contracts differ from the accounting for life contracts set forth in *SSAP No. 51—Life Contracts,* accident and health contracts established in *SSAP No. 54—Individual and Group Accident and Health Contracts*, and credit insurance contracts as discussed in *SSAP No. 59—Credit Life and Accident and Health Insurance Contracts*.

5. Categories of contracts that may not subject the reporting entity to risks arising from policyholder mortality or morbidity include, but are not limited to, certain types of the following policy categories:

- Supplemental contracts
- Lottery payouts
- Structured settlements
- Guaranteed interest contracts
- Income settlement options
- Dividend and coupon accumulations
- Annuities certain
- Premium and other deposit funds

Income Recognition

6. Contracts issued by a reporting entity that do not incorporate mortality or morbidity risk shall not be accounted for as insurance contracts. Amounts received as payments for such contracts shall not be reported as revenues but shall be recorded directly to an appropriate policy reserve account.[INT 00-03]

Policy Reserves

7. Statutory policy reserves shall be established for all contractual obligations of the reporting entity arising out of the provisions of the contract. Where separate benefits are included in a contract, a reserve for each benefit shall be established as required in Appendix A-820. Statutory policy reserves meet the definition of liabilities as defined in *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets* (SSAP No. 5R). The actuarial methodologies referred to in the following paragraph meet the criteria required for reasonable estimates in SSAP No. 5R.

8. The reserving methodologies and assumptions used in computation of policy reserves shall meet the provisions of Appendices A-820 and A-822, and the actuarial guidelines found in Appendix C of this Manual. Further, policy reserves shall be in compliance with those Actuarial Standards of Practice promulgated by the Actuarial Standards Board.

9. The policy reserve for contracts without life contingencies where the future benefits are fixed and guaranteed (e.g., certain supplemental contracts, lottery payouts, structured settlements, guaranteed interest contracts, income settlement options, annuities certain, and unmatured coupon accumulations) shall be based on the present value of the future guaranteed benefits discounted at the valuation interest rate. The policy reserve for all other contracts (e.g., certain premium and other deposit funds, and dividend and matured coupon accumulations) shall be based on the accumulated amounts paid plus an income accumulation based on the contract provisions, less any withdrawals and applicable surrender charges.

10. Statutory policy reserves for those group annuity contracts or other contracts that, in whole or in part, establish the insurer's obligations by reference to a segregated portfolio of assets not owned by the insurer shall be established in accordance with the guidance in Appendix A-695. Statutory policy reserves for those contracts with nonlevel premiums or benefits, or contracts with secondary guarantees shall be established in accordance with the guidance in Appendix A-830. Statutory policy reserves for those group life contracts utilizing a separate account that meet the requirements outlined in paragraph 1 of Appendix A-200 shall be computed in accordance with the guidance in that appendix.

11. Policy reserves shall be increased for reinsurance assumed and decreased for reinsurance ceded as further described in *SSAP No. 61R—Life, Deposit-Type and Accident and Health Reinsurance*.

Structured Settlements

12. Reporting entities that have accepted an assignment of obligations under structured settlements shall record those obligations consistent with the accounting and reporting provided for structured settlements in *SSAP No. 65—Property and Casualty Contracts*.

Cost Recognition

13. Interest credited to deposit-type contracts shall be recorded as an expense in the summary of operations when earned under the terms of the contract. Payments that represent a return of policyholder balances shall not be recorded as expenses. To the extent such payments differ from the recorded reserve, the difference shall be recorded in the summary of operations as a benefit expense.

Change In Valuation Basis

14. A change in valuation basis shall be defined as a change in the interest rate assumption or other factor affecting the reserve computation of policies in force and meets the definition of an accounting change as defined in *SSAP No. 3—Accounting Changes and Corrections of Errors* (SSAP No. 3). Consistent with SSAP No. 3, any increase (strengthening) or decrease (destrengthening) in actuarial reserves resulting from such a change in valuation basis shall be recorded directly to surplus rather than as

a part of the reserve change recognized in the summary of operations. The impact on surplus is based on the difference between the reserve under the old and new methods as of the beginning of the year. This difference shall not be graded in over time unless an actuarial guideline adopted by the NAIC prescribes a specific transition that allows for grading.

Unearned Income

15. Amounts assessed that represent compensation to the reporting entity for services to be provided in future periods and which are required to be refunded upon policy termination are not earned in the period assessed. Such amounts, if not already considered in the policy reserve, shall be reported as unearned income, a liability, and recognized as income as the related services are provided.

Additional Reserves Not Included Elsewhere

16. Additional actuarial liabilities are commonly held for such items as:

a. Surrender values in excess of reserves otherwise required or carried; and

b. Additional reserves required based on asset adequacy analysis as discussed in Appendix A-822.

17. Funding agreements issued to a Federal Home Loan Bank (FHLB) shall be evaluated on an individual basis, and shall be accounted for according to the substance of the individual arrangement and entity licensing. If the arrangement is in substance a funding agreement, including that the funds are used in an investment spread capacity, it shall be accounted for consistent with other funding agreements in accordance with this statement. If the arrangement is in substance a borrowing agreement, it shall be accounted for in accordance with *SSAP No. 15— Debt and Holding Company Obligations*, consistent with other borrowed money.

Disclosures

18. For life and annuity reserves, the financial statements shall disclose the following:

a. A description of reserve practices including the amount of any surrender value promised in excess of the reserve as legally computed;

b. The method of determination of tabular interest on funds not involving life contingencies; and

c. The nature of significant other reserve changes.

19. Disclose the amount of annuity actuarial reserves and deposit liabilities by withdrawal characteristics for the categories of general account, separate account with guarantees, separate account nonguaranteed and the total as follows:

a. Subject to discretionary withdrawal:

i. With market value adjustment, where withdrawal of funds is payable at all times, or prior to specified maturity dates where such dates are more than one year after the statement date and;

(a) In a lump sum with adjustments to reflect general changes in interest rates, or asset values since receipt of funds by the reporting entity; and

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

ii. At book value less current surrender charge, where the withdrawal of funds is payable at all times, or at any time within one year from the statement date in a lump sum subject to a current fixed surrender charge of 5% or more and it does not contain a meaningful bail out rate as described in paragraph 19.a.v.(d);

iii. At fair value, where the withdrawal of funds is payable at current fair value of the assets supporting the liabilities, the assets are stated at current fair value, and the liabilities are stated at the current fair value or per unit value of the assets supporting the liabilities. These liabilities are for contracts where the customer bears the entire investment risk;

iv. Total with adjustment or at fair value;

v. At book value without adjustment (minimal or no charge or adjustment), where the withdrawal of funds is either payable at all times, or at any time (including a withdrawal on a scheduled payment date) within one year from the statement date and:

(a) In a lump sum without adjustment;

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

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

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

b. Not subject to discretionary withdrawal;

c. Total gross;

d. Reinsurance ceded;

e. Total net.

20. For FHLB agreements accounted for under this statement, include information for the FHLB funding agreements with other reporting and disclosure requirements for deposit-type contracts under this statement and complete additional disclosure requirements in *SSAP No. 30—Investments in Common Stock (excluding investments in common stock of subsidiary, controlled or affiliated entities),* paragraph 16.

21. For life insurance claims, disclose the following information regarding the reporting entity’s use of retained asset accounts for beneficiaries. For purposes of this disclosure, retained asset accounts represent settlement of life insurance proceeds, which are retained by the insurance entity within their general account for the benefit of the beneficiaries. Amounts held outside of the insurance entity, for example in a non-insurance subsidiary, affiliated or controlled entity accounted for under *SSAP No. 97—Investments in Subsidiary, Controlled, and Affiliated Entities, A Replacement of SSAP No. 88*, such as an interest bearing account established in the beneficiary’s name with a bank or thrift institution (and subject to applicable Federal Deposit Insurance Corporation coverage) are only required to be described in the

context of the structure of the reporting entity's program in accordance with paragraph 21.a., but quantitative information regarding retained asset accounts transferred outside of the reporting entity are not required. (See illustration in Appendix A.)

a. A narrative description of how the accounts are structured and reported within the reporting entity's financial statements (e.g., as drafts written by the reporting entity and reported within cash and supplemental contracts without life contingencies; as accounts transferred into the beneficiary's name to an affiliated or unaffiliated bank or other financial institution in which the reporting entity has disposed of its liabilities and related assets, etc). This description should include all of the different interest rates paid to retained asset account holders during the reporting year and the number of times changes in rates were made during the reporting year. The description should also include a listing of all applicable fees charged by the reporting entity that are directly or indirectly associated with the retained asset accounts. Also, indicate if the retained asset account is the default method for satisfying life insurance claims.

b. Number and balance of retained asset accounts in force at the end of the current year and prior year segregated within "aging categories" of "up to 12 months," "13 to 24 months," "25 to 36 months," "37 to 48 months," "49 to 60 months," "over 60 months;"

c. Number and balance of retained asset accounts in force at the beginning of the year segregated between individual and group contracts;

d. Number and amount of retained asset accounts issued during the year segregated between individual and group contracts;

e. Investment earnings credited to retained asset accounts segregated between individual and group contracts;

f. Fees and other charges assessed to retained asset accounts during the year segregated between individual and group contracts;

g. Number and amount of retained asset accounts transferred to state unclaimed property funds segregated between individual and group contracts;

h. Number and amount of retained asset accounts closed/withdrawn during the year segregated between individual and group contracts;

i. Number and balance of retained asset accounts in force at the end of the year segregated between individual and group contracts.

22. The disclosures in paragraph 21 are not required in the annual audited financial statements. Refer to the Preamble for further discussion regarding disclosure requirements.

Relevant Literature

23. This statement incorporates the requirements of Appendices A-235, A-695, A-820, A-822, the Actuarial Standards Board *Actuarial Standards of Practice*, and the actuarial guidelines found in Appendix C of this Manual.

24. This statement rejects *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises*, *FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, *FASB Statement 120, Accounting and Reporting by Mutual Life Insurance* Enterprises *and by Insurance Enterprises for Certain Long-Duration Participating Contracts*, AICPA *Practice Bulletin No. 8,*

Application of FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses From the Sale of Investments, to Insurance Enterprises, the AICPA *Audit and Accounting Guide—Audits of Stock Life Insurance Companies*, AICPA *Statement of Position 95-1, Accounting for Certain Activities of Mutual Life Insurance Enterprises* relating to accounting and reporting for policy reserves for short and long duration contracts, and *FASB Interpretation No. 40, Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance and Other Enterprises, an interpretation of FASB Statements No. 12, 60, 97, and 113.*

Effective Date and Transition

25. This statement is effective for years beginning January 1, 2001. Contracts issued prior to January 1, 2001 shall be accounted for based on the laws and regulations of the domiciliary state. State laws and regulations shall be understood to include anything considered authoritative by the domiciliary state under the individual state's statutory authority and due process procedures. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with SSAP No. 3. Guidance in paragraph 17 was previously included within *INT 08-08: Balance Sheet Presentation of Funding Agreements Issued to a Federal Home Loan Bank* and was effective for periods beginning March 15, 2009. Guidance in paragraph 20 related to FHLB agreements was initially effective January 1, 2014.

REFERENCES

Other

- *NAIC Financial Condition Examiners Handbook*
- *Actuarial Standards Board Actuarial Standards of Practice*

Relevant Issue Papers

- *Issue Paper No. 52—Deposit-Type Contracts*
- *Issue Paper No. 110—Life Contracts, Deposit-Type Contracts and Separate Accounts, Amendments to SSAP No. 51—Life Contracts, SSAP No. 52—Deposit-Type Contracts, and SSAP No. 56—Separate Accounts*

APPENDIX A – DISCLOSURE ILLUSTRATIONS

The following illustrates the required reporting of 21.b. in tabular format:

	In Force			
	As of End of Current Year		As of End of Prior Year	
	(a) Number	(b) Balance	(c) Number	(d) Balance
Up to and including 12 Months		$		$
13 to 24 Months		$		$
25 to 37 Months		$		$
37 to 48 Months		$		$
49 to 60 Months		$		$
Over 60 Months		$		$
Total		$		$

The following illustrates the required reporting of 20.c. through 20.i. in tabular format:

	(a) Individual Number	(b) Individual Balance/Amount	(c) Group Number	(d) Group Balance/Amount
Number/Balance of Retained Asset Accounts at the Beginning of the Year		$		$
Number/Amount of Retained Asset Accounts Issued/Added During the Year		$		$
Investment Earnings Credited to Retained Asset Accounts During the Year	N/A		N/A	
Fees and Other Charges Assessed to Retained Asset Accounts During the Year	NA		NA	
Number/Amount of Retained Asset Accounts Transferred to State Unclaimed Property funds During the Year		$		$
Number/Amount of Retained Asset Accounts Closed/Withdrawn During the Year		$		$
Number/Balance of Retained Asset Accounts at the End of the Year		$		$

Statement of Statutory Accounting Principles No. 53

Property Casualty Contracts—Premiums

STATUS

Type of Issue:	Common Area
Issued:	Initial Draft
Effective Date:	January 1, 2001
Affects:	Nullifies and incorporates INT 99-23, INT 01-23, INT 02-11, INT 05-06
Affected by:	No other pronouncements
Interpreted by:	No other pronouncements

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Property Casualty Contracts—Premiums

SCOPE OF STATEMENT

1. This statement establishes general statutory accounting principles for the recording and recognition of premium revenue for property and casualty contracts as defined in *SSAP No. 50—Classifications and Definitions of Insurance or Managed Care Contracts In Force* (SSAP No. 50).

2. Specific statutory requirements for certain property and casualty premiums are addressed in the following statements: (a) *SSAP No. 57—Title Insurance*, (b) *SSAP No. 58—Mortgage Guaranty Insurance,* (c) SSAP *No. 60—Financial Guaranty Insurance,* (d) *SSAP No. 62R—Property and Casualty Reinsurance,* (e) *SSAP No. 65—Property and Casualty Contracts,* and (f) *SSAP No. 66—Retrospectively Rated Contracts and Contracts*.

SUMMARY CONCLUSION

3. Except as provided for in paragraph 4, written premium is defined as the contractually determined amount charged by the reporting entity to the policyholder for the effective period of the contract based on the expectation of risk, policy benefits, and expenses associated with the coverage provided by the terms of the insurance contract. Frequently, insurance contracts are subject to audit by the reporting entity and the amount of premium charged is subject to adjustment based on the actual exposure. Premium adjustments are discussed in paragraphs 10-13 of this statement.

4. For workers' compensation contracts, which have a premium that may periodically vary based upon changes in the activities of the insured, written premiums may be recorded on an installment basis to match the billing to the policyholder. Under this type of arrangement, the premium is determined and billed according to the frequency stated in the contract, and written premium is recorded on the basis of that frequency.

5. Premiums for prepaid legal expense plans shall be recognized as income on the gross basis (amount charged to the policyholder or subscriber exclusive of copayments or other charges) when due from policyholders or subscribers, but no earlier than the effective date of coverage, under the terms of the contract. Due and uncollected premiums shall follow the guidance in *SSAP No.6—Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due From Agents and Brokers* (SSAP No. 6), to determine the admissibility of premiums and related receivables.

6. Written premiums for all other contracts shall be recorded as of the effective date of the contract. Upon recording written premium, a liability, the unearned premium reserve, shall be established to reflect the amount of premium for the portion of the insurance coverage that has not yet expired. Flat fee service charges on installment premiums[1] (fees charged to policyholders who pay premiums on an installment basis rather than in full at inception of contract) are reported in the Other Income section of the Underwriting and Investment Exhibit as Finance and Service Charges. Flat fee service charges on installment premiums, which do not meet the requirements outlined in footnote 1 (e.g., policy may be cancelled for non-payment of fee or fee is refundable), shall be recorded as written premium on the effective date of the contract and subject to the unearned premium guidelines included in paragraph 8.

[1] If the policyholder elects to pay an installment rather than the full amount or the full remaining balance, the policyholder is traditionally charged a flat fee service charge on the subsequent billing cycle(s). The amount charged is primarily intended to compensate the insurer for the additional administrative costs associated with processing more frequent billings and has no relationship to the amount of insurance coverage provided, the period of coverage, or the lost investment income associated with receiving the premium over a period of time rather than in a lump sum. As described, there is no underwriting risk associated with this service charge. If a policyholder does not pay the service charge, the policy is not cancelled (unlike non-payment of premium), but instead the policy is converted back to an annual pay plan. If a policyholder cancels coverage, the premium is returned but the service charge is not, as the service charge is not a part of premium. Clarification of finance and service charges as other income should not be construed as having any bearing on whether such charges are subject to premium taxation, which remains an issue of state law and regulation.

7. The exposure to insurance risk for most property and casualty insurance contracts does not vary significantly during the contract period. Therefore, premiums from those types of contracts shall be recognized in the statement of income, as earned premium, using either the daily pro-rata or monthly pro-rata methods as described in paragraph 8. Certain statements provide for different methods of recognizing premium in the statement of operations for specific types of contracts. For contracts not separately identified in specific statements where the reporting entity can demonstrate the period of risk differs significantly from the contract period, premiums shall be recognized as revenue over the period of risk in proportion to the amount of insurance protection provided.

8. One of the following methods shall be used for computation of the unearned premium reserve:

a. Daily pro rata method—Calculate the unearned premium on each policy—At the end of each period, the calculation is made on each item of premium to ascertain the unexpired portion and to arrive at the aggregate unearned premium reserve;

b. Monthly pro rata method—This method assumes that, on average, the same amount of business is written each day of any month so that the mean will be the middle of the month. For example, one-year premiums written during the first three months of the year have, at the end of the year, the following unearned fractions: January-1/24; February-3/24; March-5/24.

9. Additional premiums charged to policyholders for endorsements and changes in coverage under the contract shall be recorded on the effective date of the endorsement and accounted for in a manner consistent with the methods discussed in paragraphs 4-8. This is done so that, at any point in time, a liability is accrued for unearned premium related to the unexpired portion of the policy endorsement.

Earned but Unbilled Premium

10. Adjustments to the premium charged for changes in the level of exposure to insurance risk (e.g., audit premiums on workers' compensation policies) are generally determined based upon audits conducted after the policy has expired. Reporting entities shall estimate audit premiums, the amount generally referred to as earned but unbilled (EBUB) premium, and shall record the amounts as an adjustment to premium, either through written premium or as an adjustment to earned premium. The estimate for EBUB may be determined using actuarially or statistically supported aggregate calculations using historical company unearned premium data, or per policy calculations.

11. EBUB shall be adjusted upon completion of the audit and the adjustment shall be recognized as revenue immediately. Upon completion of an audit that results in a return of premiums to the policyholder, earned premiums shall be reduced.

12. Reporting entities shall establish all of the requisite liabilities associated with the asset such as commissions and premium taxes. These liabilities shall be determined based on when premium is earned, not collected[2].

13. Ten percent of EBUB in excess of collateral specifically held and identifiable on a per policy basis shall be reported as a nonadmitted asset. To the extent that amounts in excess of the 10% are not anticipated to be collected, they shall be written off against operations in the period the determination is made.

[2] If an entity feels comfortable enough in their ability to collect the premium that an asset is recorded, they should also book the associated liabilities. Once an estimate of the premium has been made and the entity feels certain that it will be collected, it should also book the liabilities that will be due when they receive the cash. If the premiums were unearned and the policyholder had the ability to cancel, the definition of a liability has not been met.

Earned but Uncollected Premium

14. Reporting entities may utilize a voluntary procedure whereby policies are not cancelled for non-payment of the premium until after an extended cancellation period (example 30 days), as opposed to the shorter statutory cancellation period. There are other instances when a reporting entity provides coverage for periods when the payment has not been received. Prior to the cancellation of the policy the reporting entity acknowledges it is "at risk" and subject to "actual exposure" for a valid claim despite the fact that the reporting entity may not have received payment of the premium for this exposure. Reporting entities shall record earned but uncollected premium as direct and assumed written premium since the reporting entity is "at risk" and subject to "actual exposure" for the extended period of time when the policy is still in force and effective, whether or not the reporting entity collects a premium for this time period. Earned but uncollected premium would be charged to expenses **"**net gain or (loss) from agents or premium balances charged off" when it is determined to be uncollectible.

Advance Premiums

15. Advance premiums result when the policies have been processed, and the premium has been paid prior to the effective date. These advance premiums are reported as a liability in the statutory financial statement and not considered income until due. Such amounts are not included in written premium or the unearned premium reserve.

Premium Deposits on Perpetual Fire Deposits

16. Premium deposits on perpetual fire insurance risks should be charged as a liability to the extent of at least 90% of the gross amount of such deposit.

Premium Deficiency Reserve

17. When the anticipated losses, loss adjustment expenses, commissions and other acquisition costs, and maintenance costs exceed the recorded unearned premium reserve, and any future installment premiums on existing policies, a premium deficiency reserve shall be recognized by recording an additional liability for the deficiency, with a corresponding charge to operations. Commission and other acquisition costs need not be considered in the premium deficiency analysis to the extent they have previously been expensed. For purposes of determining if a premium deficiency exists, insurance contracts shall be grouped in a manner consistent with how policies are marketed, serviced and measured. A liability shall be recognized for each grouping where a premium deficiency is indicated. Deficiencies shall not be offset by anticipated profits in other policy groupings.

18. If a premium deficiency reserve is established in accordance with paragraph 17, disclose the amount of that reserve. If a reporting entity utilizes anticipated investment income as a factor in the premium deficiency calculation, the reporting entity's disclosures shall include a statement that anticipated investment income was utilized; however, the dollar amount need not be included. Reporting entities need to disclose by statement only that anticipated investment income was utilized in the calculation of premium deficiency reserves whether a reserve is recorded or not (i.e., the use of anticipated investment income mitigated the need for recording a premium deficiency reserve).

Disclosures

19. Disclose the aggregate amount of direct premiums written through managing general agents or third party administrators. For purposes of this disclosure, a managing general agent means the same as in Appendix A-225. If this amount is equal to or greater than 5% of surplus, provide the following information for each managing general agent and third party administrator:

a. Name and address of managing general agent or third party administrator;

b. Federal Employer Identification Number;

c. Whether such person holds an exclusive contract;

d. Types of business written;

e. Type of authority granted (i.e., underwriting, claims payment, etc.); and

f. Total premium written.

20. Refer to the preamble for further discussion regarding disclosure requirements.

Relevant Literature

21. This statement rejects *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises*.

Effective Date and Transition

22. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*. The guidance in paragraph 5 was originally contained within *INT 01-23: Prepaid Legal Insurance Premium Recognition* and was effective June 11, 2001. The guidance reflected in paragraph 12, incorporated from *INT 02-11: Recognition of Amounts Related to Earned but Unbilled Premium*, was effective September 10, 2002. The guidance reflected in paragraph 14, incorporated from *INT 05-06: Earned but Uncollected Premium*, was effective December 3, 2005.

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 53—Property Casualty Contracts—Premiums*

Statement of Statutory Accounting Principles No. 54

Individual and Group Accident and Health Contracts

STATUS

Type of Issue:	Common Area
Issued:	Finalized March 13, 2000
Effective Date:	January 1, 2001
Affects:	Nullifies and incorporates INT 00-23, INT 01-23
Affected by:	No other pronouncements
Interpreted by:	INT 05-05

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Individual and Group Accident and Health Contracts

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for income recognition and policy reserves for all contracts classified as individual and group accident and health contracts as defined in *SSAP No. 50—Classifications and Definitions of Insurance or Managed Care Contracts In Force*, except for credit accident and health contracts which are discussed in *SSAP No. 59—Credit Life and Accident and Health Contracts*.

SUMMARY CONCLUSION

Premium Income Recognition

2. Premiums shall be recognized as income on the gross basis (amount charged to the policyholder or subscriber exclusive of copayments or other charges related to the receipt of health care services) when due from policyholders or subscribers, but no earlier than the effective date of coverage, under the terms of the contract. Due and uncollected premiums shall follow the guidance in *SSAP No. 6—Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due From Agents and Brokers* (SSAP No. 6), to determine the admissibility of premiums and related receivables. Premiums waived by the reporting entity under disability provisions contained in its policies and contracts, and reported in operations as a disability benefit, are included in premium income.

3. Premium income shall exclude premiums that have been received by the reporting entity on or prior to the valuation date but which are due after the valuation date (i.e., advance premiums as discussed below).

4. Premium income shall be reduced for premiums returned and allowances to industrial policyholders for the direct payment of premiums.

5. Premium income shall be increased by reinsurance premiums assumed and reduced by reinsurance premiums ceded. Reinsurance premiums assumed and ceded are defined and addressed in *SSAP No. 61R—Life, Deposit-Type and Accident and Health Reinsurance*.

6. Advance premiums are those premiums that have been received by the reporting entity prior to or on the valuation date but which are due after the valuation date. The total amount of such advance premiums is reported as a liability in the statutory financial statements and is not considered premium income until due. The gross premium, not the net valuation premium, is recorded as the advance premium in recognition of the reporting entity's liability to refund such premiums in the event the policy is terminated.

7. As discussed in *SSAP No. 47—Uninsured Plans* (SSAP No. 47), amounts received on behalf of uninsured plans or the uninsured portion of partially insured plans shall not be reported as premium income. Administrative fees for servicing the uninsured plans shall be deducted from general expenses. Conversely, income relating to the insured portion of any plan shall be reported as premium income.

8. Specific funds to be received under the Medicare Part D program received as premiums for coverage that is not retrospectively rated should be accounted for under this Statement. These funds include 'Beneficiary Premium (supplemental benefit portion)', as these payments are considered to be standard premium payments that do not meet the definitions under SSAP No. 47 or *SSAP No. 66—Retrospectively Rated Contracts* (SSAP No. 66). Refer to *INT 05-05: Accounting for Revenues Under Medicare Part D Coverage* for additional information and definitions of terms specifically related to Medicare Part D business.

Reserve Requirements

9. The aggregate reserve for individual and group accident and health contracts generally consists of a policy reserve and a claim reserve as well as certain other miscellaneous reserves discussed in paragraph 24. The aggregate reserve reflects the future liabilities arising under accident and health policies. Policy reserves have traditionally been referred to as active life reserves and include unearned premium reserves. Policy reserves reflect that premiums cover future liabilities in addition to current claim costs and expenses. Claim reserves, sometimes referred to as disabled life reserves, are required on claims which involve continuing loss. The reserve in this case is a measure of the present value of future benefits or amounts not yet due as of the statement date (the unaccrued portion) which are expected to arise under claims which have been incurred as of the statement date. The aggregate reserve for individual and group accident and health contracts does not include claim liabilities which are the amounts payable at the reporting date (the accrued portion) and reflect the reporting entity's liability for benefits due as of the statement date. Claim liabilities are further discussed in *SSAP No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses*.

10. Policy reserves for individual and group accident and health contracts shall include an unearned premium reserve and, as applicable, an additional or contract reserve where constant or level premiums are assumed for certain noncancelable or guaranteed renewable contracts. The claim reserve shall consist of a reserve for the present value of amounts not yet due.

11. Statutory policy reserves shall be established for all unmatured contractual obligations of the reporting entity arising out of the provisions of the contract. Where separate benefits are included in a contract, a reserve for each benefit shall be established as required in Appendix A-820. A prospective gross premium valuation is the ultimate test of reserve adequacy as of a given valuation date. Statutory reserves meet the definition of liabilities as defined in *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets* (SSAP No. 5R). The actuarial methodologies referred to in the following paragraph meet the criteria required for reasonable estimates in SSAP No. 5R.

12. The reserving methodologies and assumptions used in calculating individual and group accident and health reserves shall meet the provisions of Appendices A-010, A-641, A-820 and A-822 (as applicable) and the actuarial guidelines found in Appendix C of this Manual (as applicable). Further, policy reserves shall be in compliance with those Actuarial Standards of Practice promulgated by the Actuarial Standards Board.

Policy Reserves

13. Unearned premium reserves shall be required for all accident and health contracts for which premiums have been reported for a period beyond the date of valuation other than premiums paid in advance. The minimum unearned premium reserve that applies to the premium period beyond the valuation date shall be based on the valuation net modal premium if contract reserves are required and the gross modal unearned premium reserve if contract reserves are not required. If premiums due and unpaid are carried as an asset, such premiums must be treated as premiums in force, subject to unearned premium reserve determination. The value of unpaid commissions, premium taxes, and the cost of collection associated with due and unpaid premiums must be carried as an offsetting liability. In no event shall the aggregate policy reserve for all contracts be less than the unearned gross premium under such contracts. Additionally, the reserve shall never be less than the expected claims for the period beyond the valuation date represented by the unearned premium reserve, to the extent not provided for elsewhere.

14. Contract or additional reserves on accident and health contracts shall be recorded when premiums and benefits are not earned or incurred at the same incidence over the policy period (e.g., contracts having premiums determined on an issue-age basis where premiums and related morbidity, risk of loss, and the cost of coverage are not evenly matched). This evaluation may be applied on a rating block basis if the total premiums for the block were developed to support the total risk assumed and expected expenses for

the block each year, and a qualified actuary certifies the premium development (e.g., community-rated contracts). The additional reserves shall be set aside from the early years' level premiums to pay the claims that experience indicates will be incurred as the policy continues in force. The fact that the reporting entity may have the right to increase premiums or to decline renewal of the policies for certain reasons has no bearing on whether or not a contract or additional reserve should be held. These reserves shall apply regardless of whether or not benefits are currently being received and are in addition to unearned premium reserves discussed in paragraph 13.

15. Contract or additional reserves shall also be recorded where, due to the gross premium structure, the future benefits exceed the future net premiums (e.g., group conversion policies) or where the contract provides for the extension of benefits after the termination of the coverage (e.g., deferred maternity and other similar benefits).

16. A terminal reserve for accident and health contracts is the policy reserve at the end of a policy year to cover the assumed difference between future benefits and future net premiums. The components used to compute a terminal reserve shall consist of an interest rate, a mortality and/or morbidity table, and a valuation method (e.g., net level, one-year full preliminary term, and two-year full preliminary term) and where allowed, other assumptions. A terminal reserve is based on the assumption that all net premiums have been received, all interest earned, and all benefits paid to the end of the policy year.

17. Since terminal reserves are computed as of the end of a policy year and not the reporting date, the terminal reserve as of policy anniversaries immediately prior to and subsequent to the reporting date are adjusted to reflect that portion of the net premium that is unearned at the reporting date. This is generally accomplished using either the mean reserve method or the mid-terminal method as discussed in paragraphs 23-26 of *SSAP No. 51—Life Contracts*. Other appropriate methods, including an exact reserve valuation, may also be used.

18. For individual and group accident and health contracts, negative reserves on any benefit shall be offset against positive reserves for other benefits in the same policy but the mean reserve on any policy shall never be taken as less than one-half the valuation net premium. The majority of group accident and health policies are written in conjunction with group life or other policies. If these policies are an experience rated package, positive or favorable margins on one of the contracts can offset the need to establish additional reserves on the other contracts.

Additional Reserves (Premium Deficiency Reserves)

19. When the expected claims payments or incurred costs, claim adjustment expenses and administration costs exceed the premiums to be collected for the remainder of a contract period, a premium deficiency reserve shall be recognized by recording an additional liability for the deficiency, with a corresponding charge to operations. For purposes of determining if a premium deficiency exists, contracts shall be grouped in a manner consistent with how policies are marketed, serviced and measured. A liability shall be recognized for each grouping where a premium deficiency is indicated. Deficiencies shall not be offset by anticipated profits in other policy groupings. Such accruals shall be made for any loss contracts, even if the contract period has not yet started.

Claim Reserves

20. Claim reserves shall be accrued for estimated costs of future health care services to be rendered that the reporting entity is currently obligated to provide or reimburse as a result of premiums earned to date and that would be payable after the reporting date under the terms of arrangements, regulatory requirements or other requirements if the insured's or subscriber's illness or disability were to continue. It shall include a reserve for disability benefits covered under premium waiver provisions. For individual and group disability claims with a duration of less than two years, reserves may be based on the reporting entity's experience, if credible, or other methods, as appropriate. Generally, reserves for disability income

claims with durations of greater than two years shall be determined based on a tabular method using the age of the insured at the date of disablement, the number of months the insured already has been disabled, and the number of months remaining in the benefit period.

Reserve Recognition

21. The difference between the aggregate reserve for accident and health contracts at the beginning and end of the reporting period shall be reflected as the change in reserves in the summary of operations, except for any difference due to a change in valuation basis.

Change In Valuation Basis

22. A change in valuation basis shall be defined as a change in the interest rate, mortality and morbidity assumptions, or reserving method (e.g., net level, preliminary term, etc.) or other factors affecting the reserve computation of policies in force and meets the definition of an accounting change as defined in *SSAP No. 3—Accounting Changes and Corrections of Errors* (SSAP No. 3). Consistent with SSAP No. 3, any increase (strengthening) or decrease (destrengthening) in actuarial reserves resulting from such a change in valuation basis shall be recorded directly to surplus rather than as a part of the reserve change recognized in the summary of operations. The impact on surplus is based on the difference between the reserve under the old and new methods as of the beginning of the year. This difference shall not be graded in over time unless an actuarial guideline adopted by the NAIC prescribes a new method and a specific transition that allows for grading.

Supplemental Benefits

23. In addition to the basic policy benefit, the contract may provide supplemental benefits. Supplemental benefits include, but are not limited to, accidental death benefits, dental and waiver of premium benefits. If the terms of the contract provide for these benefits, appropriate reserves shall be established in accordance with the applicable standards within the *Accounting Practices and Procedures Manual*.

Reserve Adequacy

24. As discussed in Appendix A-010, a prospective gross premium valuation is the ultimate test of the adequacy of a reporting entity’s accident and health reserves as of a given valuation date and shall be determined on the basis of unearned premium reserves, contract or additional reserves, claim reserves (including claim liabilities), and miscellaneous reserves combined; however, each component shall be computed separately.

Additional Reserves Not Included Elsewhere

25. Reserves for experience-rating refunds or the dividend liability in group policies are discussed in SSAP No. 66.

26. Additional actuarial or other liabilities are commonly held for such items as:

a. Surrender values in excess of reserves otherwise required or carried;

b. Additional reserves required based on asset adequacy analysis as discussed in Appendix A-822; and

c. Additional reserves for policies which contain conversion privileges or future contingent benefits.

Contracts Subject to Redetermination

27. This statement also applies to other contracts which are subject to redetermination such as Federal (and State) Groups – subject to rate adjustments through audits by the Office of Personnel Management (OPM). Reporting entities are required to give Federal Groups the lowest rates that are being charged to similar groups.

28. Amounts due from insureds or subscribers and amounts due to insureds or subscribers under contracts subject to redetermination meet the definitions of assets and liabilities as set forth in *SSAP No. 4—Assets and Nonadmitted Assets* and SSAP No. 5R, respectively.

29. Contract redeterminations shall be estimated based on the experience to date. The method used to estimate the liability shall be reasonable based on the reporting entity's procedures, and consistent among reporting periods. An examination of contract requirements in relation to the rates being charged and the current status of applicable audits (e.g., OPM, Centers for Medicare and Medicaid Services (or such other name that this entity shall be known as) and other Federal, state or government department) is a common method used to estimate such contract redeterminations.

30. Premium adjustments for contracts subject to redetermination are estimated for the portion of the policy period that has expired and shall be considered an immediate adjustment to premium. Accrued premium adjustments shall be recorded as a write-in for other-than-invested assets, with a corresponding entry to premiums; accrued return premium adjustments shall be recorded as a liability with a corresponding entry to premiums.

31. If, in accordance with SSAP No. 5R, it is probable that the additional premium adjustment is uncollectible, any uncollectible premium shall be written off against operations in the period the determination is made and the disclosure requirements outlined in SSAP No. 5R shall be made.

32. Premium adjustments for contracts subject to redetermination shall be determined and billed or refunded in accordance with the policy provisions or contract provisions. If such premiums are not billed in accordance with the policy provisions or contract provisions, or the policy provisions or contract provisions do not address the due date of such premiums, the accrual shall be nonadmitted. This is consistent with the guidance for audit premiums established in SSAP No. 6.

Disclosures

33. Disclose the aggregate amount of direct premiums written through managing general agents or third party administrators. For purposes of this disclosure, a managing general agent means the same as in Appendix A-225. If this amount is equal to or greater than 5% of surplus, provide the following information for each managing general agent and third party administrator:

a. Name and address of managing general agent or third party administrator;

b. Federal Employer Identification Number;

c. Whether such person holds an exclusive contract;

d. Types of business written;

e. Type of authority granted (i.e., underwriting, claims payment, etc.); and

f. Total premium written.

34. Reporting entities shall disclose the relative percentage of participating insurance, the method of accounting for policyholder dividends, the amount of dividends, and the amount of any additional income allocated to participating policyholders in the financial statements.

35. If a premium deficiency reserve is established in accordance with paragraph 19, disclose the amount of that reserve. If a reporting entity utilizes anticipated investment income as a factor in the premium deficiency calculation, disclosure of such shall be made in the financial statements.

36. The financial statements shall disclose the method used by the reporting entity to estimate premium adjustments for contracts subject to redetermination. The amount of net premiums that are subject to such adjustments, as well as the corresponding percentage to total net premiums, shall be disclosed.

37. Refer to the preamble for further discussion regarding disclosure requirements.

Relevant Literature

38. This statement incorporates the requirements of Appendices A-010, A-225, A-641, A-820, A-822 (as applicable), the Actuarial Standards Board *Actuarial Standards of Practice* and the actuarial guidelines found in Appendix C of this manual (as applicable).

39. This statement rejects *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises* relating to accounting and reporting for individual and group accident and health contracts.

Effective Date and Transition

40. This statement is effective for years beginning January 1, 2001. Contracts issued prior to January 1, 2001 shall be accounted for based on the laws and regulations of the domiciliary state. State laws and regulations shall be understood to include anything considered authoritative by the domiciliary state under the individual state's statutory authority and due process procedures. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with SSAP No. 3.

REFERENCES

Other

- *NAIC Financial Condition Examiners Handbook*
- *Actuarial Standards Board Actuarial Standards of Practice*

Relevant Issue Papers

- *Issue Paper No. 54—Individual and Group Accident and Health Contracts*

Statement of Statutory Accounting Principles No. 55

Unpaid Claims, Losses and Loss Adjustment Expenses

STATUS

Type of Issue:	Common Area
Issued:	Initial Draft
Effective Date:	January 1, 2001
Affects:	Supersedes SSAP No. 85 with guidance incorporated August 2011 Nullifies and incorporates INT 00-31, INT 01-28, INT 02-21, INT 03-17, INT 06-14
Affected by:	No other pronouncements
Interpreted by:	No other pronouncements

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Unpaid Claims, Losses, and Loss Adjustment Expenses

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for recording liabilities for unpaid claims and claim adjustment expenses for life insurance contracts and accident and health contracts and unpaid losses and loss adjustment expenses for property and casualty insurance contracts. This guidance applies equally to those entities with direct and reinsurance-assumed obligations. This statement applies to all insurance contracts as defined in *SSAP No. 50—Classifications and Definitions of Insurance or Managed Care Contracts In Force* (SSAP No. 50).

2. This statement does not address policy reserves for life and accident and health policies. These reserves are addressed in *SSAP No. 51—Life Contracts*, *SSAP No. 52—Deposit-Type Contracts*, *SSAP No. 54—Individual and Group Accident and Health Contracts* (SSAP No. 54), and *SSAP No. 59—Credit Life and Accident and Health Insurance Contracts.*

3. This statement does not address liabilities for punitive damages. These liabilities shall be recorded in accordance with *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets* (SSAP No. 5R).

SUMMARY CONCLUSION

4. Claims, losses, and loss/claim adjustment expenses shall be recognized as expenses when a covered or insured event occurs. In most instances, the covered or insured event is the occurrence of an incident which gives rise to a claim or the incurring of costs. For claims made type policies, the covered or insured event is the reporting to the entity of the incident that gives rise to a claim. Claim payments and related expense payments are made subsequent to the occurrence of a covered or insured event, and in order to recognize the expense of a covered or insured event that has occurred, it is necessary to establish a liability. Liabilities shall be established for any unpaid claims and unpaid losses (loss reserves), unpaid loss/claim adjustment expenses (loss/claim adjustment expense reserves) and incurred costs, with a corresponding charge to income. Claims related extra contractual obligations losses and bad-faith losses shall be included in losses. See individual business types for the accounting treatment for adjustment expenses related to extra contractual obligations and bad-faith lawsuits.

5. The liability for unpaid LAE shall be established regardless of any payments made to third-party administrators, management companies or other entities except for capitated payments under managed care contracts. ~~The establishment of the liability for LAE gross of any amounts paid to these entities results in more meaningful financial statements in that the financial condition of the reporting entity is more appropriately stated. Further, the liability for claim adjustment expenses on indemnity accident and health contracts should be established in an amount necessary to adjust all unpaid claims irrespective of payments made to third-party administrators, etc. This supports the concept of consistency found in the Preamble to the *Accounting Practices and Procedures Manual,* as there is no overriding difference between unpaid LAE for property/casualty insurers and unpaid claim adjustment expenses of health entities. The applicability of guidance to managed care contracts.~~ The liability for claims adjustment expenses on non-capitated payments under managed care contracts shall be established in an amount necessary to adjust all unpaid claims irrespective of payments made to third-party administrators, etc. The liability for claims adjustment expenses on capitated payments under managed care contracts shall be established in an amount necessary to adjust all unpaid claims irrespective of payments to third parties with the exception that the liability is established net of capitated payments to providers.

Property/Casualty

6. The following are types of future costs relating to property and casualty contracts, as defined in SSAP No. 50, which shall be considered in determining the liabilities for unpaid losses and loss adjustment expenses:

a. Reported Losses: Expected payments for losses relating to insured events that have occurred and have been reported to, but not paid by, the reporting entity as of the statement date;

b. Incurred But Not Reported Losses (IBNR): Expected payments for losses relating to insured events that have occurred but have not been reported to the reporting entity as of the statement date. As a practical matter, IBNR may include losses that have been reported to the reporting entity but have not yet been entered to the claims system or bulk provisions. Bulk provisions are reserves included with other IBNR reserves to reflect deficiencies in known case reserves;

c. Loss Adjustment Expenses: Expected payments for costs to be incurred in connection with the adjustment and recording of losses defined in paragraphs 6.a. and 6.b. Examples of expenses incurred in these activities are estimating the amounts of losses, disbursing loss payments, maintaining records, general clerical, secretarial, office maintenance, occupancy costs, utilities, computer maintenance, supervisory and executive duties, supplies, and postage. Loss adjustment expenses can be classified into two broad categories: Defense and Cost Containment (DCC) and Adjusting and Other (AO):

i. DCC include defense[1], litigation, and medical cost containment expenses, whether internal or external. DCC include, but are not limited to, the following items:

(a) Surveillance expenses;

(b) Fixed amounts for medical cost containment expenses;

(c) Litigation management expenses;

(d) Loss adjustment expenses for participation in voluntary and involuntary market pools if reported by accident year;

(e) Fees or salaries for appraisers, private investigators, hearing representatives, reinspectors and fraud investigators, if working in defense of a claim, and fees or salaries for rehabilitation nurses, if such cost is not included in losses;

(f) Attorney fees incurred owing to a duty to defend, even when other coverage does not exist; and

(g) The cost of engaging experts;

[1] Legal defense costs incurred under the definition of covered damages or losses as the only insured peril would be accounted for as losses, while legal defense costs incurred under a duty to defend would be accounted for as Defense and Cost Containment (DCC). For policies where legal costs are the only insured peril, the insurer would record the legal costs that reimburse the policyholder as loss and, to the extent the insurer participated in the defense, would record its legal costs as DCC. This is not intended to change the classifications of legal expenses for existing long tailed lines of liability coverage, such as medical malpractice and workers' compensation insurance.

ii. AO are those expenses other than DCC as defined in (i) above assigned to the expense group "Loss Adjustment Expense". AO include, but are not limited to, the following items:

(a) Fees and expenses of adjusters and settling agents;

(b) Loss adjustment expenses for participation in voluntary and involuntary market pools if reported by calendar year;

(c) Attorney fees incurred in the determination of coverage, including litigation between the reporting entity and the policyholder;

(d) Fees and salaries for appraisers, private investigators, hearing representatives, reinspectors and fraud investigators, if working in the capacity of an adjuster; and

(e) Adjustment expenses arising from claims related lawsuits such as extra contractual obligations and bad faith lawsuits.

Life, Accident and Health

7. The following future costs relating to life and accident and health indemnity contracts, as defined in SSAP No. 50, shall be considered in determining the liability for unpaid claims and claim adjustment expenses:

a. Accident and Health Claim Reserves: Reserves for claims that involve a continuing loss. This reserve is a measure of the future benefits or amounts not yet due as of the statement date which are expected to arise under claims which have been incurred as of the statement date. This shall include the amount of claim payments that are not yet due such as those amounts commonly referred to as disabled life reserves for accident and health claims. The methodology used to establish claim reserves is discussed in SSAP No. 54.

b. Claim Liabilities for Life/Accident and Health Contracts:

i. Due and Unpaid Claims: Claims for which payments are due as of the statement date;

ii. Resisted Claims in Course of Settlement: Liability for claims that are in dispute and are unresolved on the statement date. The liability either may be the full amount of the submitted claim or a percentage of the claim based on the reporting entity's past experience with similar resisted claims;

iii. Other Claims in the Course of Settlement: Liability for claims that have been reported but the reporting entity has not received all of the required information or processing has not otherwise been completed as of the statement date;

iv. Incurred But Not Reported Claims: Liability for which a covered event has occurred (such as death, accident, or illness) but has not been reported to the reporting entity as of the statement date.

c. Claim Adjustment Expenses for Accident and Health Reporting Entities are those costs expected to be incurred in connection with the adjustment and recording of accident and health claims defined in paragraphs 7.a. and 7.b. Certain claim adjustment expenses reduce the number or cost of health services thereby resulting in lower premiums or lower premium increases. These claim adjustment expenses shall be classified as cost containment expenses.

d. Claim Adjustment Expenses for Life Reporting Entities: Costs expected to be incurred (including legal and investigation) in connection with the adjustment and recording of life claims defined in paragraph 7.b. This would include adjustment expenses arising from claims-related lawsuits such as extra contractual obligations and bad-faith lawsuits.

Managed Care

8. The following costs relating to managed care contracts as defined in SSAP No. 50 shall be considered in determining the claims unpaid and claims adjustment expenses:

a. Claims unpaid for Managed Care Reporting Entities:

i. Unpaid amounts for costs incurred in providing care to a subscriber, member or policyholder including inpatient claims, physician claims, referral claims, other medical claims, resisted claims in the course of settlement and other claims in the course of settlement;

ii. Incurred But Not Reported Claims: Liability for which a covered event has occurred (such as an accident, illness or other service) but has not been reported to the reporting entity as of the statement date;

iii. Additional unpaid medical costs resulting from failed contractors under capitation contracts and provision for losses incurred by contractors deemed to be related parties for which it is probable that the reporting entity will be required to provide funding;

b. Claim Adjustment Expenses for Managed Care Reporting Entities are those costs expected to be incurred in connection with the adjustment and recording of managed care claims defined in paragraph 8.a. Certain claim adjustment expenses reduce the number or cost of health services thereby resulting in lower premiums or lower premium increases. These claim adjustment expenses shall be classified as cost containment expenses.

c. Liabilities for percentage withholds (“withholds”) from payments made to contracted providers;

d. Liabilities for accrued medical incentives under contractual arrangements with providers and other risk-sharing arrangements whereby the health entity agrees to share savings with contracted providers.

Managed Care and Accident and Health

9. Claim adjustment expenses for accident and health contracts and managed care contracts (identified in paragraphs 7.c. and 8.b.), including legal expenses, can be subdivided into cost containment expenses and other claim adjustment expenses:

a. Cost containment expenses: Expenses that actually serve to reduce the number of health services provided or the cost of such services. The following are examples of items that shall be considered “cost containment expenses” only if they result in reduced levels of costs or services:

i. Case management activities;

ii. Utilization review;

iii. Detection and prevention of payment for fraudulent requests for reimbursement;

iv. Network access fees to Preferred Provider Organizations and other network-based health plans (including prescription drug networks), and allocated internal salaries and related costs associated with network development and/or provider contracting;

v. Consumer education solely relating to health improvement and relying on the direct involvement of health personnel (this would include smoking cessation and disease management programs, and other programs that involve hands on medical education); and

vi. Expenses for internal and external appeals processes.

b. Other claim adjustment expenses: Claim adjustment expenses as defined in paragraph 7.c. or 8.b. that are not cost containment expenses. Examples of other claim adjustment expenses are:

i. Estimating the amounts of losses and disbursing loss payments;

ii. Maintaining records, general clerical, and secretarial;

iii. Office maintenance, occupancy costs, utilities, and computer maintenance;

iv. Supervisory and executive duties; and

v. Supplies and postage.

vi. This would include adjustment expenses arising from claims-related lawsuits such as extra contractual obligations and bad-faith lawsuits.

General

10. The liability for claim reserves and claim liabilities, unpaid losses, and loss/claim adjustment expenses shall be based upon the estimated ultimate cost of settling the claims (including the effects of inflation and other societal and economic factors), using past experience adjusted for current trends, and any other factors that would modify past experience. These liabilities shall not be discounted unless authorized for specific types of claims by specific SSAPs, including SSAP No. 54 and *SSAP No. 65—Property and Casualty Contracts*.

11. Various analytical techniques can be used to estimate the liability for IBNR claims, future development on reported losses/claims, and loss/claim adjustment expenses. These techniques generally consist of statistical analysis of historical experience and are commonly referred to as loss reserve projections. The estimation process is generally performed by line of business, grouping contracts with like characteristics and policy provisions. The decision to use a particular projection method and the results obtained from that method shall be evaluated by considering the inherent assumptions underlying the method and the appropriateness of those assumptions to the circumstances. No single projection method is inherently better than any other in all circumstances. The results of more than one method should be considered.

12. For each line of business and for all lines of business in the aggregate, management shall record its best estimate of its liabilities for unpaid claims, unpaid losses, and loss/claim adjustment expenses. Because the ultimate settlement of claims (including IBNR for death claims and accident and health

claims) is subject to future events, no single claim or loss and loss/claim adjustment expense reserve can be considered accurate with certainty. Management's analysis of the reasonableness of claim or loss and loss/claim adjustment expense reserve estimates shall include an analysis of the amount of variability in the estimate. If, for a particular line of business, management develops its estimate considering a range of claim or loss and loss/claim adjustment expense reserve estimates bounded by a high and a low estimate, management's best estimate of the liability within that range shall be recorded. The high and low ends of the range shall not correspond to an absolute best-and-worst case scenario of ultimate settlements because such estimates may be the result of unlikely assumptions. Management's range shall be realistic and, therefore, shall not include the set of all possible outcomes but only those outcomes that are considered reasonable. Management shall also follow the concept of conservatism included in the Preamble when determining estimates for claims reserves. However, there is not a specific requirement to include a provision for adverse deviation in claims.

13. In the rare instances when, for a particular line of business, after considering the relative probability of the points within management's estimated range, it is determined that no point within management's estimate of the range is a better estimate than any other point, the midpoint within management's estimate of the range shall be accrued. It is anticipated that using the midpoint in a range will be applicable only when there is a continuous range of possible values, and no amount within that range is any more probable than any other. For purposes of this statement, it is assumed that management can quantify the high end of the range. If management determines that the high end of the range cannot be quantified, then a range does not exist, and management's best estimate shall be accrued. This guidance is not applicable when there are several point estimates which have been determined as equally possible values, but those point estimates do not constitute a range. If there are several point estimates with equal probabilities, management should determine its best estimate of the liability.

14. If a reporting entity chooses to anticipate salvage and subrogation recoverables (including amounts recoverable from second injury funds, other governmental agencies, or quasi-governmental agencies, where applicable), the recoverables shall be estimated in a manner consistent with paragraphs 10-12 of this statement and shall be deducted from the liability for unpaid claims or losses. If a reporting entity chooses to anticipate coordination of benefits (COB) recoverables of Individual and Group Accident and Health Contracts, the recoverables shall be estimated in a manner consistent with paragraphs 10-12 of this statement and shall be deducted from the liability for unpaid claims or losses. A separate receivable shall not be established for these recoverables. In addition, these recoverables are also subject to the impairment guidelines established in *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets* (SSAP No. 5R) and an entity shall not reduce its reserves for any recoverables deemed to be impaired.

15. Changes in estimates of the liabilities for unpaid claims or losses and loss/claim adjustment expenses resulting from the continuous review process, including the consideration of differences between estimated and actual payments, shall be considered a change in estimate and shall be recorded in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors* (SSAP No. 3). SSAP No. 3 requires changes in estimates to be included in the statement of operations in the period the change becomes known. This guidance also applies to the period subsequent to the March 1 filing deadline for annual financial statements through the filing deadline of June 1 for audited annual financial statements.

Disclosures

16. The financial statements shall include the following disclosures for each year full financial statements are presented. The disclosure requirement in paragraph 16.d. is also applicable to the interim financial statements if there is a material change from the amounts reported in the annual filing. Life and annuity contracts are not subject to this disclosure requirement.

a. The balance in the liabilities for unpaid claims and unpaid losses and loss/claim adjustment expense reserves at the beginning and end of each year presented;

b. Incurred claims, losses, and loss/claim adjustment expenses with separate disclosures of the provision for insured or covered events of the current year and increases or decreases in the provision for insured or covered events of prior years;

c. Payments of claims, losses, and loss/claim adjustment expenses with separate disclosures of payments of losses and loss/claim adjustment expenses attributable to insured or covered events of the current year and insured or covered events of prior years;

d. The reasons for the change in the provision for incurred claims, losses, and loss/claim adjustment expenses attributable to insured or covered events of prior years. The disclosure should indicate whether additional premiums or return premiums have been accrued as a result of the prior-year effects;

e. A summary of management's policies and methodologies for estimating the liabilities for losses and loss/claim adjustment expenses, including discussion of claims for toxic waste cleanup, asbestos-related illnesses, or other environmental remediation exposures;

f. Disclosure of the amount paid and reserved for losses and loss/claim adjustment expenses for asbestos and/or environmental claims, on a direct, assumed and net of reinsurance basis (the reserves required to be disclosed in this section shall exclude amounts relating to policies specifically written to cover asbestos and environmental exposures). Each company should report only its share of a group amount (after applying its respective pooling percentage) if the company is a member of an intercompany pooling agreement; and

g. Estimates of anticipated salvage and subrogation (including amounts recoverable from second injury funds, other governmental agencies, or quasi-governmental agencies, where applicable), deducted from the liability for unpaid claims or losses.

17. All reporting entity types are required to disclose the dollar amount of any claims/losses related to extra contractual obligation lawsuits or bad faith lawsuits paid during the reporting period on a direct basis. The number of such claims paid shall be disclosed in a note.

18. Refer to the preamble for further discussion regarding disclosure requirements.

Relevant Literature

19. Although FASB *Statement No. 60, Accounting and Reporting by Insurance Enterprises* (FAS 60), is rejected in SSAP No. 50, this statement is consistent with the guidance provided for the recognition of claim costs in FAS 60 with the exception of the statutory requirement to accrue the midpoint of a range of loss or loss adjustment expense reserve estimates when no point within management's continuous range of reasonably possible estimates is determined to be a better estimate than any other point.

20. This statement also rejects *AICPA Statement of Position 92-4, Auditing Insurance Entities' Loss Reserves.*

21. Guidance in paragraphs 7.c., 8.b. and 9 was incorporated from SSAP No. 85. SSAP No. 85 was issued in 2002 to amend SSAP No. 55 and provide clarification regarding what costs should be classified as claim adjustment expenses on accident and health contracts. In August 2011, SSAP No. 85 was nullified and the guidance was incorporated into this SSAP. *Issue Paper No. 116—Claim Adjustment Expenses, Amendments to SSAP No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses* provides historical reference on the original guidance included in SSAP No. 55 as well as the revisions originally reflected in SSAP No. 85.

Effective Date and Transition

22. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with SSAP No. 3. Guidance reflected in paragraphs 7.c., 8.b. and 9, incorporated from SSAP No. 85, is effective for years ending on and after December 31, 2003. The guidance incorporated into paragraphs 1, 3, 6.c.ii., 7.d. and 9.b.vi. was originally included in *INT 03-17: Classification of Liabilities from Extra Contractual Obligation Lawsuits*, and was initially effective March 10, 2004. The guidance in paragraph 5 was previously included in *INT 02-21: Accounting for Prepaid Loss Adjustment Expenses and Claim Adjustment Expenses* effective for reporting periods ending on or after December 31, 2002, for all contracts except for capitated managed care contracts and December 31, 2006, for capitated managed care contracts. The guidance in paragraph 14 related to coordination of benefits was originally contained within *INT 00-31: Application of SSAP No. 55 Paragraph 12 to Health Entities* and was effective December 4, 2000. The guidance reflected in footnote 1, incorporated from *INT 06-14: Reporting of Litigation Costs Incurred for Lines of Business in which Legal Expenses Are the Only Insured Peril*, was effective June 2, 2007.

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses*
- *Issue Paper No. 116—Claim Adjustment Expenses, Amendments to SSAP No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses*

Statement of Statutory Accounting Principles No. 56

Separate Accounts

STATUS

Type of Issue:	Life, Accident and Health
Issued:	Finalized March 13, 2000
Effective Date:	January 1, 2001 - Revised disclosures adopted September 2009 are required within the 2010 annual financial statements
Affects:	Supersedes SSAP No. 80 with guidance incorporated August 2011
Affected by:	No other pronouncements
Interpreted by:	INT 00-03

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Separate Accounts

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for accounting and reporting for separate accounts in both the general account and separate account statements.

SUMMARY CONCLUSION

Introduction

2. Separate accounts are used to fund variable life insurance, variable annuities, modified guaranteed annuities and modified guaranteed life insurance, or various group contracts under pension or other employee benefit plans where funds are held in a separate account to support a liability. When separate accounts are established and filed accordingly, they may be used to fund guaranteed benefits. Separate account contracts may also be used to accumulate funds which are intended to be applied at some later time to provide life insurance or to accumulate proceeds applied under settlement or dividend options.

3. Assets held in separate accounts are owned by the insurer. All investment income and realized and unrealized capital gains and losses from assets allocated to a separate account, net of related investment expenses, are generally reflected in the separate account and, except for modified guaranteed annuities, modified guaranteed life insurance, and separate accounts established and filed to provide guaranteed benefits, investment performance is generally not guaranteed by the insurer. Charges relating to contract guarantees, administration, and investment management are deducted from separate accounts.

General Account Reporting

4. Insurance activities such as sales, underwriting and contract administration, premium collection and payment of premium taxes, claims, and benefits are functions of the insurance company distinct from the separate account and shall be accounted for as transactions of the general account.

5. For those separate account contracts classified as life contracts under *SSAP No. 50—Classification and Definitions of Insurance or Managed Care Contracts In Force,* premiums and annuity considerations shall be recorded as income in the Summary of Operations of the general account, and as transfers to premiums and considerations in the separate account statement. Deposit-type contracts shall be recorded in the general account in accordance with *SSAP No. 52—Deposit-Type Contracts*.(INT 00-03) Charges (e.g., fees associated with investment management, administration, and contract guarantees) assessed on the separate accounts, as well as the net gain from operations of the separate account, shall be recorded as income in the Summary of Operations of the general account. Expenses relating to investment management, administration, and contract guarantees pertaining to separate account operations, as well as benefits and surrenders incurred on behalf of separate account contracts classified as life contracts, net transfers between separate accounts, commissions, and premium taxes (if any) shall be recorded as expenses in the Summary of Operations of the general account.

6. The general account shall include the total assets and liabilities, including transfers due or accrued, of any separate accounts business which it maintains and, therefore, the surplus, if any, of its separate accounts business. Transfers to the general account due or accrued shall be reported on a net basis so that the asset and the liability totals of the general account are not overstated. Changes in the surplus of the separate accounts business of an insurer, except for changes resulting from the net gain from operations of the separate account, shall be charged or credited directly to the unassigned funds (surplus) of the general account.

7. Where a variable annuity contract or variable life insurance contract contains a guaranteed minimum death benefit, any reserve liability for such death benefit provision shall be recorded and held in the general account based on the reserving guidance in paragraphs 25 and 26. Any differences between the benefit paid and the separate account asset value of the contract shall be charged against or credited to the general account in its net gain from operations.

8. Separate account surplus may not become negative. For example, for separate account contracts which have annuitized (i.e., contracts in the payout stage), lower than expected mortality on variable annuity contracts containing mortality guarantees may cause a deficiency in the investment funds underlying the contract reserves. Thus the general account incurs an expense and the separate account realizes revenue to cover the deficiency, if necessary. Conversely, excess funds from higher than expected mortality will result in mortality gains, which are included in the Summary of Operations of the separate account and are ultimately recorded as equity in net income from separate account operations as discussed in paragraph 5.

9. Separate account surplus created through the use of the commissioners' reserve valuation method (CRVM), commissioners' annuity reserve valuation method (CARVM), or other reserving methods, shall be reported by the general account as an unsettled transfer from the separate account. The net change on such transfers shall be included as a part of the net gain from operations in the general account.

10. Surplus funds transferred from the general account to the separate account, commonly referred to as seed money, and earnings accumulated thereon shall be reported as surplus in the separate accounts until transferred or repatriated to the general account. The transfer of such funds between the separate account and the general account shall be reported as surplus contributed or withdrawn during the year.

11. If an Asset Valuation Reserve (AVR) is required for investments held by separate accounts, it is combined with the general account AVR and accounted for in the general account financial statements (see *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*). The criteria for determining when an AVR is required for separate accounts are described in paragraph 18 of this statement.

12. Reporting entities collect fees for managing Separate Account Guaranteed Investment Contracts (GICs), Synthetic GICs, as well as participating separate account group annuities. These are in the form of administrative fees, risk fees and some investment management fees. For defined contribution business, these are in the form of fees related to mutual fund management. These fees are meant to offset expenses and generate some profit.

13. Amounts receivable from contractholders for separate account management fees meet the definition of assets as set forth in *SSAP No. 4—Assets and Nonadmitted Assets*.

14. An evaluation shall be made of the amounts receivable to determine any nonadmitted amounts. Next, an evaluation shall be made in accordance with *SSAP No. 5R—Liabilities, Contingencies and* Impairments *of Assets* (SSAP No. 5R), to determine whether there is an impairment. This two step process is set forth below:

a. Uncollected separate account management fees receivable over ninety days due shall be accounted for as a nonadmitted asset. Reporting entities shall begin aging the receivable when it is contractually required to be billed, or in the absence of contract specifications, when the reporting entity actually sends the bill to the contractholder;

b. Remaining amounts determined to be uncollectible shall be written off. If in accordance with SSAP No. 5R, it is "probable" the amount receivable is uncollectible, any uncollectible amount receivable shall be written off against operations in the period such determination is made. If it is "reasonably possible" the amount receivable is uncollectible, the disclosure requirements outlined in SSAP No. 5R paragraph 27 shall be made.

Separate Account Reporting

15. The separate accounts annual statement is concerned with the flow of funds related to investment activities and obligations of the separate accounts and with the transfer of funds between the separate account and the general account. As a result, the separate account statement shall report only the assets, liabilities, and operations of the separate account and shall not include general account expenses related to investment management, administration, or contract guarantees pertaining to separate account operations which are recorded in the general account.

16. The separate account records premiums, considerations (net of loading for sales charges such as commissions and premium taxes) and receipts (other than for net investment income and realized capital gains and losses) as income transfers from the general account. Net investment income and realized and unrealized capital gains and losses relating to the investment operations of the separate account are recorded as income in the Summary of Operations. When the contract provides for such, expenses and taxes associated with the separate account investment operations shall be deducted in the determination of net investment income. Deposits and withdrawals on deposit-type contracts shall be recorded in the Summary of Operations. Benefits and surrenders, reserve transfers, policy loans, policyholder charges (e.g., fees associated with investment management, administration, and contract guarantees), and federal income taxes relating to the separate account are recorded as expense transfers to the general account in the Summary of Operations. The net change in aggregate reserves relating to separate account contracts is reported as an expense in the Summary of Operations.

17. Assets supporting fund accumulation contracts (GICs), which do not participate in underlying portfolio experience, with a fixed interest rate guarantee, purchased under a retirement plan or plan of deferred compensation, established or maintained by an employer, will be recorded as if the assets were held in the general account. Assets supporting all other contractual benefits shall be recorded at fair value on the date of valuation, or if there is no readily available market, then in accordance with the valuation procedures in the applicable contract.

Separate Account AVR and IMR Reporting

18. An AVR is generally required for separate accounts when the insurer, rather than the policyholder/contractholder, suffers the loss in the event of asset default or fair value loss. An AVR is required unless:

a. The asset default or fair value risk is borne directly by the policyholders; or

b. The regulatory authority for such separate accounts already explicitly provides for a reserve for asset default risk, where such reserves are essentially equivalent to the AVR.

19. Assets supporting traditional variable annuities and variable life insurance generally do not require an AVR because the policyholders/contractholders bear the risk of change in the value of the assets. However, an AVR is required for that portion of the assets representing the insurer's equity interest in the investments of the separate account (e.g., seed money).

20. Assets supporting typical modified guaranteed contracts, market value adjusted contracts, and contracts with book value guarantees similar to contracts generally found in the general account do require an AVR because the insurer is responsible for credit related asset or fair value loss.

21. Certain separate accounts are also required to maintain an Interest Maintenance Reserve (IMR). The IMR requirements for investments held in separate accounts are applied on an account by account

basis. If an IMR is required for a separate account, all of the investments in that separate account are subject to the requirement. If an IMR is not required for a separate account, none of the investments in that separate account are subject to the requirement.

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

23. If an IMR is required for investments held by separate accounts, it is kept separate from the general account IMR and accounted for in the separate accounts statement.

24. The AVR and IMR shall be calculated and reported in accordance with the NAIC *Annual* Statement Instructions *for Life, Accident and Health Insurance Companies*.

Policy Reserves

25. Statutory policy reserves shall be established for all contractual obligations of the insurer arising out of the provisions of the insurance contract. Where separate benefits are included in a contract, a reserve for each benefit shall be established as required in Appendix A-820. These statutory policy reserves are generally calculated as the excess of the present value of future benefits to be paid to or on behalf of policyholders less the present value of future net premiums. Statutory policy reserves meet the definition of liabilities as defined in *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets* (SSAP No. 5R). The actuarial methodologies referred to in the following paragraph meet the criteria required for reasonable estimates in SSAP No. 5R.

26. The reserving methodologies and assumptions used in computation of policy reserves shall also meet the provisions of Appendices A-200, A-250, A-270, A-255, A-585, A-588, A-620, A-695, A-820, A-822 and the actuarial guidelines found in Appendix C of this Manual. Where separate account contracts have guaranteed elements, the basis for determining the value of the liability shall be consistent with the basis used for asset values (i.e., valuation interest rates as defined in Appendix A-820 shall be used when assets are recorded as if held in the general account and current interest rates based on market rates shall be used when assets are recorded at fair value). Further, policy reserves shall be in compliance with those Actuarial Standards of Practice promulgated by the Actuarial Standards Board.

27. Statutory policy reserves for those group annuity contracts or other contracts that, in whole or in part, establish the insurer's obligations by reference to a segregated portfolio of assets not owned by the insurer shall be established in accordance with the guidance in Appendix A-695. Statutory policy reserves for those contracts with nonlevel premiums or benefits, or contracts with secondary guarantees shall be established in accordance with the guidance in Appendix A-830. Statutory policy reserves for those group life contracts utilizing a separate account that meet the requirements outlined in paragraph 1 of Appendix A-200 shall be computed in accordance with the guidance in that appendix.

Other Liabilities

28. The separate account shall accrue as a liability, subject to contractual provisions, amounts payable, including, but not limited to:

a. Fees associated with investment management, administration, and contract guarantees;

b. Investment expenses;

c. Investment taxes, licenses, and fees (Investment taxes such as real estate taxes, licenses and fees (excluding federal income taxes) are usually paid directly by the separate account but may be transferred to the general account for payment);

d. Federal income taxes;

e. Unearned investment income;

f. Net transfer due to (from) the general account;

g. Remittances and items not allocated;

h. Payable for investments purchased;

i. Net adjustments in assets and liabilities due to foreign exchange rates.

Seed Money

29. When a new separate account is initiated, the insurer may make a temporary transfer of surplus funds commonly referred to as seed money to the separate account. Such funds and earnings accumulated thereon shall be reported as surplus in the separate accounts statement until transferred or repatriated to the general account. The transfer of such funds to and from the separate account shall be reported as surplus contributed or withdrawn during the year.

Disclosures

30. Paragraphs 31-34 detail the separate account disclosure requirements that shall be included within the Life, Accident and Health Annual Statement Blank. Paragraphs 35-38 detail the separate account disclosure requirements that shall be included within the Separate Account Annual Statement Blank.

31. The general account financial statement shall include detailed information on the reporting entity's separate account activity. These disclosures shall include:

a. A narrative of the general nature of the reporting entity's separate account business.

b. Identification of the separate account assets that are legally insulated from the general account claims.

c. Identification of the separate account products that have guarantees backed by the general account. This shall include:

i. Identification of the total maximum guarantee for separate account products as of the reporting date;

ii. Amount of risk charges paid by the separate account to the general account for the past five (5) years[1] as compensation for the risk taken by the general account; and

iii. Amount paid by the general account due to separate account guarantees during the past five (5) years.

[1] Reporting entities are permitted to prospectively 'build' the five-year disclosure. Thus, upon the first year of application of the disclosure requirements, reporting entities should illustrate one year of the disclosure requirement. In the second year, the reporting entity would disclose two years, and so forth until the disclosure includes five years of disclosures.

d. Discussion of securities lending transactions within the separate account, separately including the amount of any loaned securities within the separate account, and if policy and procedures for the separate account differ from the general account.

32. For each grouping (as detailed in paragraph 33), the following shall be disclosed:

a. Premiums, considerations or deposits received during the year;

b. Reserves by the valuation basis of the investments supporting the reserves at the financial statement date. List reserves for separate accounts whose assets are carried at fair value separately from those whose assets are carried at amortized cost/book value;

c. Reserves by withdrawal characteristics, ~~i.e.,~~including whether or not the separate account is subject to discretionary withdrawal. For reserves subject to discretionary withdrawal, the below categories are included if applicable:

i. With ~~or~~ market value adjustment;

ii. ~~or to withdraw~~ at book value without market value adjustment and with surrender charge of 5% or more;

iii. at fair value;

iv. at book value without market value adjustment and with ~~or without~~ surrender charge of less than 5%;

d. Reserves for asset default risk, as described in paragraph 18.b., that are recorded in lieu of AVR.

33. For the disclosures required in paragraph 32, separate accounts shall be addressed in the following groupings (which are the same as those used for risk-based capital):

a. Separate Accounts with Guarantees:

i. Indexed separate accounts, which are invested to mirror an established index which is the basis of the guarantee;

ii. Nonindexed separate accounts, with reserve interest rate at no greater than 4% and/or fund long-term interest guarantee in excess of a year that does not exceed 4%;

iii. Nonindexed separate accounts, with reserve interest rate at greater than 4% and/or fund long-term interest guarantee in excess of a year that exceeds 4%.

b. Nonguaranteed Separate Accounts—Variable separate accounts, where the benefit is determined by the performance and/or fair value of the investments held in the separate account. Include variable accounts with incidental risks, nominal expense, and minimum death benefit guarantees.

34. Provide a reconciliation of the amount reported as transfers to and from separate accounts in the Summary of Operations of the separate accounts statement and the amount reported as net transfers to or from separate accounts in the Summary of Operations of the general accounts statement.

35. The Separate Account Annual Statement Blank shall include detailed information on the characteristics of the separate account assets, specifically categorizing separate account assets in accordance with the following characteristics:

a. Identification of separate account assets that are legally insulated from the general account and those which are not legally insulated.

b. Amount of separate account assets that represent seed money, other fees and expenses due to the general account, and additional required surplus amounts.[2] This disclosure shall include the amount of seed money and other fees and expenses currently included in the separate account, as well as the amount of seed money received and repaid to the general account during the current year. This disclosure shall also include information on insulation (if applicable)[3], the time duration for which seed money and other fees and expenses due the general account are retained in the separate account, and information on how whether seed money is invested pursuant to general account directives or in accordance with stated policies and procedures.

c. Identification of the separate account assets in which the investment directive is not determined by a contractholder. (In most instances, having multiple investment choices at the option of a contractholder would be considered a situation in which the investment directive is determined by a contractholder. This is not true for situations in which the asset is invested in a manner that mirrors the investment directives of the general account.) Situations in which the investment directive is not determined by the contractholder (and situations in which the reporting entity is the contractholder) shall include disclosure regarding whether the investments of the respective separate account assets, if included within the general account investments, would have resulted with the reporting entity exceeding any investment limitations imposed on the general account.

d. Identification of the separate account assets in which less than 100% of investment proceeds are attributed to a contractholder. This shall include identification of the separate account investment income attributed to the reporting entity during the reporting period and whether such income was transferred to the general account or reinvested within the separate account. Instances in which such income is reinvested within the separate account shall include disclosure on whether the subsequent investments, if categorized with investments in the general account, would have exceeded investment limitations imposed on the general account.

36. For all separate account assets not reported at fair value, indicate the measurement basis (amortized cost or other method) for each asset (or asset class) and whether the measurement method was grandfathered in under the transition guidance in this SSAP, or whether the measurement method is allowed under a prescribed or permitted practice. This disclosure shall include a comparison of the assets' reported value to fair value with identification of the resulting unrealized gain/loss that would have been recorded if the assets had been reported at fair value.

37. For all separate accounts that include securities lending transactions, disclose the reporting entity's use and policy of securities lending within the separate account, including the amount of loaned securities from the separate account at the reporting date, the percentage of separate account assets lent as of that date, a description for which type of accounts (e.g., book value accounts, market value account

[2] Additional Required Surplus Amounts is defined as additional or permanent surplus that is required to be retained in the separate account in accordance with state law or regulations. These amounts should not include reinvested separate account investment proceeds that have not been allocated to separate account contract holders.

[3] As seed money is considered a temporary transfer of funds, it is generally not considered insulated.

accounts) are lent, if the separate account policyholder is notified or approves of such practices, the policy for requiring collateral, whether the collateral is restricted and the amount of collateral for transactions that extend beyond one year from the reporting date. This disclosure requires the entity to provide the following information as of the date of the statement of financial position: (1) the aggregate amount of contractually obligated open collateral positions (aggregate amount of securities at current fair value or cash received for which the borrower may request the return of on demand) and the aggregate amount of contractually obligated collateral positions under 30-day, 60-day, 90-day, and greater than 90-day terms, (2) the aggregate fair value of all securities acquired from the sale, trade and use of the accepted collateral (reinvested collateral), and (3) information about the sources and uses of that collateral.

38. Identify all products reported as a separate account product under statutory accounting principles and identify whether each product was classified differently under GAAP. For products that resulted with different classifications between GAAP and SAP, identify the characteristic(s) of the product that prevented it from receiving a separate account classification under GAAP. This disclosure is applicable for all reporting entities. Thus, if GAAP financial statements were not filed, the reporting entity should complete this disclosure as if GAAP financials had been completed.

39. Refer to the preamble for further discussion regarding disclosure requirements.

Relevant Literature

40. This statement rejects AICPA *Statement of Position 03-1, Accounting and Reporting by* Insurance Enterprises *for Certain Nontraditional Long-Duration Contracts and for Separate Accounts* (SOP 03-1). The disclosure elements included within this SSAP are derived from the criteria for separate account reporting under SOP 03-1; however, this SSAP does not restrict separate account reporting pursuant to the criteria established in SOP 03-1.

41. This statement incorporates the requirements of Appendices A-200, A-250, A-255, A-270, A-585, A-588, A-620, A-695, A-812, A-820, A-821, A-822 the Actuarial Standards Board *Actuarial Standards of Practice*, and the actuarial guidelines found in Appendix C of this Manual.

Effective Date and Transition

42. This statement is effective for years beginning January 1, 2001. Contracts with assets held in a Separate Account that were issued in accordance with applicable state laws and regulations and issued prior to that effective date, for which assets and liabilities have been recorded using a consistent basis since issue, i.e., both assets and liabilities are recorded either as if in the general account ("book value") or as at fair value (current interest rates based on market rates shall be used for liabilities when assets are recorded at fair value), shall continue to be recorded using such basis until such time as the applicable contract terms or provisions are substantially changed, such as by a contract amendment modifying interest rate or withdrawal provisions. State laws and regulations shall be understood to include anything considered authoritative by the domiciliary state under the individual state's statutory authority and due process procedures. Changes that do not require change in the basis of recording would include: address changes, continued deposits, and other non-substantive changes such as these. For example, additional funds received after January 1, 2001 under contracts issued prior to January 1, 2001 may continue to be recorded using the basis in effect prior to January 1, 2001 until such time as a triggering change is made. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors.*

43. Disclosure revisions adopted in September 2009 to paragraphs 30-38 shall initially be reported within the 2010 annual financial statements, with annual reporting thereafter.

REFERENCES

Other

- *NAIC Financial Condition Examiners Handbook*
- Actuarial Standards Board *Actuarial Standards of Practice*

Relevant Issue Papers

- *Issue Paper No. 89—Separate Accounts*
- *Issue Paper No. 110—Life Contracts, Deposit-Type Contracts and Separate Accounts, Amendments to SSAP No. 51—Life Contracts, SSAP No. 52—Deposit-Type Contracts, and SSAP No. 56—Separate Accounts*

GLOSSARY

Guarantee

Represents an insurance company's general account contractual obligation to reimburse life insurance and annuity policyholders for their separate account investment losses including the return of principal, minimum crediting rates, minimum death, withdrawal, accumulation of income benefits and no-lapse guarantees, and for separate account mortality losses.

Total Maximum Guarantee

Is the difference between the total amount of liability the general account is subject to reimbursing as at the balance sheet date and the policyholder's contract value referenced by the guarantee (e.g., account value). For guarantees in the event of death, it is the minimum guaranteed amount available to the contractholder upon death in excess of the contractholder's contract value referenced by the guarantee (e.g., account balance) at the balance sheet date. For guarantees of amounts at annuitization, it is the present value of the minimum guaranteed annuity payments available to the contractholder determined in accordance with the terms of the contract in excess of the contract value referenced by the guarantee (e.g., account balance).

Insulation

The legal protection of separate account assets equal to the reserves and supporting contract liabilities from the general account liabilities of the insurance enterprise ensuring that the separate account contract holder is not subjected to insurer default risk to the extent of their assets held in the separate account.

Risk Charge

The contractual amount the general account charges the separate account policyholders’ account for compensation relating to the general account’s guarantee on separate account assets or contract performance.

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Statement of Statutory Accounting Principles No. 57

Title Insurance

STATUS

Type of Issue:	Property and Casualty
Issued:	Initial Draft
Effective Date:	January 1, 2001
Affects:	No other pronouncements
Affected by:	No other pronouncements
Interpreted by:	No other pronouncements

STATUS **1**

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Title Insurance

SCOPE OF STATEMENT

1. Title insurance insures that the policyholder has title to the property on the subject real estate as of the date of policy issuance, subject to exceptions and exclusions in the policy. When issued, a title policy has a one-time premium and reserves are established by the title insurance company. Title insurance differs from other lines of property and casualty insurance because its basic goal is risk elimination.

2. This statement establishes statutory accounting principles for title insurance and addresses areas where title insurance accounting differs from other lines of insurance. To the extent a topic is not covered by this statement, title insurance accounting shall comply with statutory accounting guidance for other lines of property and casualty insurance.

SUMMARY CONCLUSION

General

3. Title insurers perform many services in connection with the transfer of real estate; however, their principal function involves insuring, guaranteeing, or indemnifying owners of real property or the holders of liens or encumbrances thereon against loss or damage due to defective titles, liens, or encumbrances or, in most states, the unmarketability of the title.

4. In addition to insuring against defective records or examination of those records, an insurer insures against "non-record defects" such as:

a. Forgeries;

b. Fraud;

c. Confusion of name in change of title;

d. Incompetence (minors or persons of unsound mind);

e. Mistakes in public records;

f. Undisclosed or missing heirs;

g. Instruments executed under a fabricated or expired power of attorney;

h. Deeds delivered after death of grantor or grantee or without the consent of the grantor;

i. Deeds by persons supposedly single but actually married;

j. Wills not probated;

k. Liens against property (e.g., mechanics liens and tax liens);

l. Falsified records.

5. Before a title insurance policy is issued, the title insurer, or its agent, must search and examine public records concerning the ownership, liens, and encumbrances on the subject real estate together with information relating to persons having an interest in the real property as well as maps and other records to determine that title to the property is insurable, or defects can be overcome.

Premium Revenue and Loss Reserve Recognition

6. A variety of services are generally provided (either by the title insurance underwriter, its agent, or others) in connection with the transfer of title to real estate. Title insurance premiums frequently are determined in the rate-making process based on the bundle of services provided, including some or all of title search and examination and closing or escrow fees~~, referred to as “Gross All-Inclusive” premiums~~. By statute or custom, certain states exclude a combination of title search, ~~and~~ examination and closing or escrow fees from the rate-making process for title insurance premiums~~, referred to as “Gross Risk Rate” premiums~~. Premiums shall be recorded at the date of policy issuance, on a gross~~either the Gross All-Inclusive or Gross Risk Rate~~ premium basis, consistent with the rate-making method used. The premium related to a title insurance policy is due upon the effective date of the insurance and is not refundable. The term of a title insurance policy is indefinite because the policyholder is insured for as long as he or his heirs or devisees have an interest in the property.

7. Amounts paid to or retained by agents shall be reported as an expense.

8. A liability shall be established for all known unpaid claims and loss adjustment expenses (known claims reserve) with a corresponding charge to income. The known claim reserve is further detailed in the Title Annual Statement Operations and Investment Exhibit on Unpaid Losses and Loss Adjustment Expenses. The known claims reserve should be the estimated costs to settle reported claims based upon the most current information available to the company as of the balance sheet date. This amount cannot be less than the aggregate of the individual case reserves.

9. Premium revenue shall be deferred to the extent necessary to maintain a Statutory or Unearned Premium Reserve (SPR or UPR) determined in accordance with the reserve section of Appendix A-628.

10. If the actuarially determined liability (the sum of the known claims reserve, IBNR claims reserve, and loss adjustment expense reserve) exceeds the sum of the known claims reserve and SPR or UPR, a supplemental reserve shall be established that is equal to the difference between these sums. This calculation is explicitly detailed in the Title Annual Statement Operations and Investment Exhibit for Unpaid Losses and Loss Adjustment Expenses..

11. The actuarially determined liability for the sum of known claims reserve required in paragraph 8 and the IBNR claims and loss adjustment expenses required in paragraph 10 of this statement shall be determined consistently with the guidance detailed in *SSAP No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses* and consistent with paragraph 13 of this statement.

12. Assets acquired in settlement of claims (e.g., mortgages and real estate) shall be accounted for consistent with the guidance related to the asset acquired. For example, an impaired loan shall be accounted for in accordance with *SSAP No. 37—Mortgage Loans*, and real estate acquired in foreclosure shall be accounted for in accordance with *SSAP No. 40R—Real Estate Investments*.

Salvage and Subrogation

13. Salvage and subrogation shall be reflected as follows:

a. Paid losses shall be reported net of realized, but not anticipated, salvage and subrogation. Case basis loss and loss adjustment expense reserves shall not be reduced for anticipated salvage and subrogation, nor shall an asset be established;

b. Paid salvage and subrogation is not realized until a salvage asset or an actual payment pursuant to a subrogation right is in the direct control of the insurer and admissible as an asset for statutory reporting purposes in its own right;

c. Salvage assets and payments pursuant to a subrogation right shall be recorded at current fair value. Current fair value of real estate shall be established through an appraisal conducted by a qualified independent appraiser;

d. If a salvage asset is sold or revalued by the insurer within twelve months of realization for an amount less than the value at which it was originally placed on the books of the insurer, then the loss on disposition shall be treated as a decrease in paid salvage (same effect as an addition to the paid loss) on the corresponding claim. After twelve months, such salvage revaluation will be treated as a loss on disposition or change in value of an asset, and shall not be deducted from the salvage on the corresponding claim;

e. If a salvage asset is sold or revalued by the insurer within twelve months of realization for an amount greater than the value at which it was originally placed on the books of the insurer, then the gain on disposition shall be treated as an increase in paid salvage (same effect as a deduction to the paid loss) on the corresponding claim. After twelve months, such salvage revaluation shall be treated as a gain on disposition or change in value of an asset and shall not be added to the salvage on the corresponding claim;

f. In completing Schedule P and Part 3B, IBNR reserves may make an actuarially determined provision for the expected value of future salvage and subrogation on open claims and IBNR claims.

Reinsurance

14. Although by their nature, title claims relate to errors or omissions that occurred prior to the inception of the reinsurance agreement, title reinsurance contracts shall be accounted for as prospective reinsurance agreements if they meet all of the other criteria established in *SSAP No. 62R—Property and Casualty Reinsurance*.

Allocation of Expenses

15. This statement establishes uniform allocation rules to classify title insurance expenses within prescribed principal groupings. It is necessary to allocate those expenses which may contain characteristics of more than one classification, which this statement will refer to as allocable expenses.

16. Allocable expenses for title insurance companies shall be classified into the following categories on the expense section of the Operations and Investment Exhibit of the annual statement.

a. Title and Escrow Operating Expenses—Title and escrow operating expenses consist of all expenses incurred in relation to engaging in the business of title insurance, including costs associated with the following: (i) issuing or offering to issue a title insurance policy; (ii) soliciting or negotiating the issuance of a title insurance policy; (iii) guaranteeing, warranting or otherwise insuring the correctness of title searches affecting title to real property; (iv) handling of escrows, settlements or closings; (v) executing title insurance policies, effecting contracts of reinsurance, and abstracting, searching or examining titles. Also included are specifically identifiable and allocated expenses relating to the following activities; (i) supervision and training of employees and agents; (ii) operating costs for branch offices or agencies; (iii) underwriting activities; (iv) receiving and paying of premiums and commissions; (v) maintaining general and detailed records; (vi) data processing, advertising, and publicity, clerical, secretarial, office maintenance, supervisory, and executive duties; (vii) postage and delivery; and (viii) all other functions reasonably associated with the business of title insurance. Title and escrow operating expenses do not include losses, loss adjustment expenses (allocated or unallocated), expense of other operations, or investment expenses. The expenses include only amounts incurred directly by the insurer and do not include expenses incurred by any agents (regardless of ownership interest).

b. Title and Escrow Operating Expenses are further broken down in the annual statement by the distribution network that gives rise to the expense incurrence. Accordingly, expenses are specifically identified or allocated (in accordance with reasonable allocation procedures consistently applied) to either Direct Operations, Non-affiliated Agency Operations, or Affiliated Agency Operations.

c. Unallocated Loss Adjustment Expenses (ULAE)—ULAE are those indirect costs incurred by a title insurer, typically internal to the company, which are necessary to process claims or manage the claims settlement function and which are not incurred on a claim-specific basis. ULAE shall include all costs of outside parties involved in claims adjusting services, but shall not include any costs incurred by agents in settlement of title or other claims.

d. Investment Expenses—Investment expenses are those expenses incurred in the investing of funds and the pursuit of investment income, including specifically identifiable and allocated expenses related to such activities as: (i) initiating or handling orders and recommendations for investments; (ii) research, pricing, appraising, and valuing; (iii) disbursing funds and collecting income; (iv) safekeeping of securities and valuable papers; (v) maintaining general and detailed records; (vi) data processing; (vii) general clerical, secretarial, office maintenance, supervisory, and executive duties; (viii) supplies, postage, and the like; and (ix) all other functions reasonably attributable to the investment of funds. Real estate expenses and real estate taxes are attributable to the Investment Expenses group.

e. Other Operations—The amounts shown for this category represent the allocable expenses incurred by the company in operations other than title and escrow, unallocated loss adjustment, or investment activities.

17. Allocation to the above categories should be based on a method that yields the most accurate results. Specific identification of an expense with an activity that is represented by one of the categories above will generally be the most accurate method. Where specific identification is not feasible, allocation of expenses should be based upon pertinent factors or ratios such as studies of employee activities, salary ratios, or similar analyses.

18. Many companies operate within a group where personnel and facilities are shared. Shared expenses, including expenses under the terms of a management contract, shall be apportioned to the companies incurring the expense as if the expense had been paid solely by the incurring company. The apportionment shall be completed based upon specific identification to the company incurring the expense. Where specific identification is not feasible, apportionment shall be based upon pertinent factors or ratios. Any basis adopted to apportion expenses shall be that which yields the most accurate results and may result from special studies of employee activities, salary ratios, premium ratios or similar analyses. Expenses that relate solely to the operations of an insurance company, such as personnel costs associated with the adjusting and paying of claims, must be borne solely by the insurance company and are not to be apportioned to other companies within a group. Pertinent factors in making this determination shall include which entity has the ultimate obligation to pay the expense. Apportioned expenses are subject to presentation and allocation as provided in paragraphs 16 and 17.

Title Plant

19. Title plants are an integrated and indexed collection of title records consisting of documents, maps, surveys, or entries affecting title to real property or any interest in or encumbrance on the property,

which have been filed or recorded in the jurisdiction for which the title plant is established or maintained. They are tangible assets unique to the title insurance industry and are the principal productive asset used to generate title insurance revenue and to mitigate the risk of claims. Title plant shall be reported as an admitted asset, subject to the following valuation restrictions:

a. Costs incurred to construct a title plant, including the costs incurred to obtain, organize, and summarize historical information in an efficient and useful manner, shall be capitalized until the title plant can be used by the company to conduct title searches and issue title insurance policies. The capitalized costs shall be directly related to, and properly identified with, the activities necessary to construct the title plant;

b. Purchased title plants, including a purchased undivided interest in a title plant, shall be recorded at cost at the date of acquisition. For a title plant acquired separately, cost shall be measured by the fair value of the consideration given. For title plant acquired as part of a group of assets, cost shall be measured by the fair value of the consideration given and then cost shall be allocated to the title plant based on its fair value in relation to the total fair value of the group of assets acquired. For title plants acquired as part of a purchase of assets or in a business combination, cost shall be determined in accordance with *SSAP No. 68—Business Combinations and Goodwill*;

c. A backplant, i.e., a title plant that antedates the period of time covered by the existing title plant may be purchased or constructed. Costs to construct a backplant must be properly identifiable to qualify for capitalization;

d. Costs incurred after a title plant is operational to (i) convert the information from one storage and retrieval system to another, or (ii) modify or modernize the storage and retrieval system shall not be capitalized;

e. Costs incurred to maintain a title plant shall be expensed as incurred;

f. Costs incurred to perform title searches shall be expensed as incurred;

g. An investment in a title plant or plants in an amount equal to the actual cost shall be allowed as an admitted asset for title insurers. The aggregate carrying value of an investment in a title plant or plants shall not exceed the lesser of 20% of admitted assets or forty percent (40%) of surplus to policyholders, both as required to be shown on the statutory balance sheet of the insurer for its most recently filed statement with the domiciliary state commissioner; if the amount of the investment exceeds the above limits, the excess amount shall be recorded as a nonadmitted asset.

20. Certain circumstances may indicate that the value of the title plant may be impaired and, thus, the carrying value of the asset may not be recoverable. If there is an indication of possible impairment of value, the title plant shall be evaluated for impairment and recorded in accordance with *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets*. The following are examples of circumstances that may indicate impairment:

a. Effects of obsolescence, demand, and other economic factors;

b. A significant change in legal requirements or statutory practices in the jurisdiction for which the title plant is established and maintained;

c. A current period operating or cash flow loss combined with a history of such losses or projections that indicate continued losses associated with the revenue produced by the title plant;

d. Failure to maintain the title plant on a current basis and/or lack of appropriate maintenance to keep the title plant up to date; or,

e. Abandonment of a title plant.

21. A properly maintained title plant has an indeterminate life and does not diminish in value with the passage of time, and accordingly, shall not be depreciated.

22. A title insurer may (a) sell its title plant and relinquish all rights to its future use, (b) sell an undivided ownership interest in its title plant, or (c) sell a copy of its title plant or the right to use it. Accounting and presentation for each type of sale noted shall be as follows:

a. When a title insurer sells its title plant and relinquishes all rights to its future use, consideration received shall be presented as a separate component of revenue net of the carrying value of the title plant sold;

b. When a title insurer sells an undivided ownership interest in its title plant, consideration received shall be presented as a separate component of revenue net of the pro rata portion of the carrying value of the title plant;

c. When a title insurer sells a copy of its title plant or the right to use it, consideration received shall be presented as a separate component of revenue and the carrying value of the title plant shall not be reduced.

Disclosures

23. The financial statements shall disclose the following for each period presented:

~~a. The amount of premium revenue reported on the Gross All-Inclusive and on the Gross Risk Rate premium basis;~~

~~b.~~a. The amount of the known claims reserve, SPR/UPR, and the supplemental reserve;

~~c.~~b. Whether the insurer uses discounting in the calculation of its supplemental reserve, the method and rate used to determine the discount, and the amount of such discount.

24. Any material individual component of the reported expense categories shall be presented either on the face of the Summary of Operations or within the footnotes or related exhibits to the financial statements.

25. Refer to the preamble for further discussion regarding disclosure requirements.

Relevant Literature

26. This statement rejects *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises* (FAS 60); however, it is considered appropriate to use the factors to be considered in the determination of the ultimate cost of settling claims included in FAS 60 when establishing the reserves in accordance with paragraphs 8 and 10 of this statement.

27. This statement adopts *FASB Statement No. 61, Accounting for Title Plant*, with modification for carrying value restrictions. Restrictions on the total carrying value of an investment in a title plant or plants are determined by paragraph 19.g.

Effective Date and Transition

28. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*.

29. Additions to the SPR or UPR as a result of the provisions of paragraph 17.b.v. of Appendix A-628 shall be phased in pursuant to the provisions of paragraph 17.b.iv. of Appendix A-628.

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 57—Title Insurance*

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Statement of Statutory Accounting Principles No. 58

Mortgage Guaranty Insurance

STATUS

Type of Issue:	Property and Casualty
Issued:	Initial Draft
Effective Date:	January 1, 2001
Affects:	No other pronouncements
Affected by:	No other pronouncements
Interpreted by:	No other pronouncements

STATUS **1**

SCOPE OF STATEMENT **3**

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Mortgage Guaranty Insurance

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for mortgage guaranty insurance and addresses areas where mortgage guaranty insurance accounting differs from other lines of insurance. To the extent a topic is not covered by this statement and Appendix A-630, mortgage guaranty insurance accounting shall comply with statutory accounting guidance for other lines of property and casualty insurance.

2. Mortgage guaranty insurance protects a lender against loss of all or a portion of the principal amount of a mortgage loan upon default of the mortgagor. Mortgage guaranty insurance differs from other types of property and casualty insurance in that coverage is long-term, and in most cases premiums are level and paid monthly. Most states require issuers of mortgage guaranty contracts to be monoline insurers and impose limitations on the aggregate amount of risk insured based on geographic territories. Additionally, states may require mortgage guaranty insurers to reinsure with only selected reinsurers.

SUMMARY CONCLUSION

General

3. Mortgage guaranty insurance is provided on residential loans (one to four family residences, including condominiums and townhouses). Coverage can range from as little as 5% on pool insurance to as much as 100% of the outstanding loan amount on individual policies. Most policies cover 10% to 30% of the loan amount and are written on first mortgage loans where the loan amount is a high percentage (generally 80% to 95%) of the value of the mortgaged property.

4. Lenders obtain mortgage guaranty insurance to facilitate sales of mortgage loans in secondary markets. It also enables lenders to make a greater number of high ratio (above 80%) loans and allows them to diversify their portfolio of loans.

5. Mortgage guaranty insurers market directly to mortgage lenders. Individual mortgage loans or pools of mortgage loans are insured under individual insurance certificates or policies; each loan, however, is separately underwritten.

6. Mortgage guaranty insurance companies generally offer the following premium payment plans: (a) monthly premiums, (b) a single premium which provides coverage for periods ranging from three to 15 years, (c) nonlevel annual premiums, and (d) level annual premiums. All policies are renewable at the discretion of the lender. The mortgage guaranty insurer does not have an option to cancel or nonrenew the policy, except for fraud or nonpayment of the premium.

7. Premiums are based upon: (a) the percentage of insurance coverage provided, (b) the ratio of the insured mortgage loan to the property value or sales price, and (c) the term and/or premium payment method selected by the lender. Premiums are quoted as a percentage of the total mortgage loan insured and increase as insurance coverage and loan-to-value ratio increases.

8. If a default occurs, the mortgage guaranty insurer generally requires the lender to foreclose and tender merchantable title to the mortgaged property in order to make a claim. The insurer may then, at its option: (a) purchase the property for the lender’s cost (generally the entire remaining principal loan balance plus accumulated interest and allowable expenses), (b) pay the percentage of the lender’s cost specified by the policy, or (c) arrange for the lender to sell the property and reimburse the lender for any loss up to an agreed amount. Under settlement option (a), the insurer intends to resell the property with the expectation of reducing the amount of loss which would have resulted if option (b) had been elected.

Insured Risk

9. The nature of the insured risk is influenced by certain factors which set mortgage guaranty insurance apart from other types of insurance. These factors are addressed in paragraphs 10-12.

Exposure Period

10. The exposure period is significantly longer for mortgage insurance than for most other property and casualty insurance products. The exposure period can run for the term of the mortgage; however, the average policy life is seven years. The policy is terminated when the mortgage obligation is satisfied or the lender elects to cancel or not renew the policy. In contrast to mortgage guaranty insurance, most property and casualty products need not be renewed by the insurer at the expiration of the policy. Mortgage insurance is renewable at the option of the insured at the renewal rate quoted when the policy commitment was issued.

Losses

11. Losses are affected by the following factors specific to mortgage guaranty insurance:

a. The insured peril—the default of a borrower arises from the credit risk associated with mortgage loans. The frequency of loss is strongly influenced by economic conditions. The likelihood of individual default is further increased if the property has deteriorated since a borrower in financial difficulty will be less able to sell the property at a price sufficient to discharge the mortgage;

b. Mortgage insurance losses can be divided into three categories:

i. Normal losses associated with regular business cycles, interruptions in the borrower’s earning power, and errors made in evaluating the borrower’s willingness or ability to meet mortgage obligations;

ii. Defaults caused by adverse local economic conditions;

iii. Widespread defaults caused by a severe depression in the U.S. economy.

Loss Incidence

12. Losses are incurred over the exposure period which runs for the term of the mortgage. However, loss incidence peaks in the earlier years. When a loan has been delinquent two to four months, the policy requires the lender to notify the insurer. The lender generally agrees to institute foreclosure proceedings six to nine months from the date of delinquency. Foreclosure can require an additional 18 months which means a considerable delay between the delinquency and the presentation of the claim. Without adverse economic conditions, most delinquencies do not result in a loss payment. Once a claim is presented, payment normally is made within one or two months and ultimate loss costs can be known relatively quickly.

Pool Insurance

13. Mortgage guaranty insurance may be provided on pools of mortgage loans. Typically, pool insurance supports mortgage-backed securities or group sales. Unlike other pool or group products, each loan is individually underwritten.

14. Pool insurance may be provided on loans that are already insured by primary insurance, in which case the pool insurance provides an additional level of coverage, or it may be provided on loans without primary insurance (usually loans with loan-to-value ratios below 80%). Generally, pool insurance

provides 100% coverage and includes a stop-loss limit of liability which may range from 5% to 20% of the initial aggregate principal balance. Because of regulatory requirements in some states, pool insurance usually uses participating reinsurance arrangements to limit the exposure of any one mortgage insurer of a pool of loans to 25% of each mortgage insured.

15. Pool insurance policies are not cancelable by the insurer except for nonpayment of premium. These policies may be written on mortgage pools having terms of up to 30 years. However, the average policy life is 8 to 12 years.

16. Upon default, the insurer has the same options as with individual insured mortgage loans. However, pool insurance loss payments are reduced by settlements under primary insurance and subject to the stop-loss limit.

17. Three kinds of mortgage-backed securities which use pool insurance are:

a. Mortgage-backed bonds—Issued by banks, savings and loan associations and other mortgage lenders as a general obligation of the issuing institution. These bonds are collateralized by a pool of mortgages and have a stated rate of return and maturity date;

b. Mortgage revenue bonds—Issued by state and local housing authorities to support housing affordability for targeted income groups;

c. Mortgage pass-through certificates—Issued by banks, savings and loan associations, mortgage bankers, and others providing an undivided interest in a pool of mortgages with principal and interest payment passed to the certificate holder as received.

Premium Revenue Recognition

18. Written premium shall be recorded in accordance with *SSAP No. 53—Property Casualty Contracts—Premiums*. Premium revenue shall be earned as follows:

a. For monthly premium plans, revenues shall be earned in the month to which they relate;

b. For annual premium plans, revenues shall be earned on a pro rata basis over the applicable year;

c. For single premium plans, revenues shall be earned over the policy life in relation to the expiration of risk;

d. Additional first year premiums or initial renewal premiums on nonlevel policies shall be deferred and amortized to income over the anticipated premium paying period of the policy in relation to the expiration of risk.

Unpaid Losses and Loss Adjustment Expense Recognition

19. Unpaid losses and loss adjustment expenses shall be recognized in accordance with *SSAP No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses* (SSAP No. 55). For mortgage guaranty insurance contracts, the default shall be considered the incident that gives rise to a claim as discussed in SSAP No. 55. If a claim is ultimately presented, the date of default shall be considered the loss incurred date.

20. The process for estimating the liability shall include projections for losses that have been reported as well as those that have been incurred but not reported. The estimates shall be made based on historical data, trends, economic factors, and other statistical information including paid claims, reported losses, insurance in force statistics, and risk statistics.

21. Real estate and mortgages are acquired by mortgage guaranty insurers to mitigate losses. These assets shall be shown on the balance sheet at the lower of cost or net realizable value, net of encumbrances. Gains or losses from the holding or disposition of these assets shall be recorded as a component of losses incurred. Rental income or holding expenses shall be included in loss adjustment expenses.

Contingency Reserve

22. In addition to the unearned premium reserve, mortgage guaranty insurers shall maintain a liability referred to as a statutory contingency reserve. The purpose of this reserve is to protect policyholders against loss during periods of extreme economic contraction. The annual addition to the liability shall equal 50% of the earned premium from mortgage guaranty insurance contracts and shall be maintained for ten years regardless of the coverage period for which premiums were paid. With commissioner approval, when required by statute, the contingency reserve may be released in any year in which actual incurred losses exceed 35% of the corresponding earned premiums. Any such reductions shall be made on a first-in, first-out basis. Changes in the reserve shall be recorded directly to unassigned funds (surplus).

Premium Deficiency Reserve

23. When the anticipated losses, loss adjustment expenses, commissions and other acquisition costs, and maintenance costs exceed the recorded unearned premium reserve, contingency reserve, and the estimated future renewal premium on existing policies, a premium deficiency reserve shall be recognized by recording an additional liability for the deficiency with a corresponding charge to operations. Commissions and other acquisition costs need not be considered in the premium deficiency analysis to the extent they have been expensed. If an insurer utilizes anticipated investment income as a factor in the premium deficiency calculation, disclosure of such shall be made in the financial statements.

U.S. Mortgage Guaranty Tax and Loss Bonds

24. To obtain a current federal income tax benefit derived from annual additions to the statutory contingency reserve (for tax purposes, the mortgage guaranty account), mortgage guaranty insurers must purchase tax and loss bonds to the extent of the tax benefits. These bonds are noninterest bearing obligations of the U.S. Treasury and mature 10 years after issue. The usual purpose of tax and loss bonds is to satisfy taxes that will be due in 10 years when the tax benefit is reversed; however, the bonds may be redeemed earlier in the event of excess underwriting losses. These bonds are reported as admitted assets allowing mortgage insurers to conserve capital. In accordance with *SSAP No. 101—Income Taxes, A Replacement of SSAP No. 10R and SSAP No. 10*, temporary differences (as defined in that statement) do not include amounts attributable to the statutory contingency reserve to the extent that “tax and loss” bonds have been purchased.

Contingency Reserve (for Tax Purposes, the Mortgage Guaranty Account)

25. Under IRS Code Section 832(e), mortgage guaranty insurers are permitted to deduct the annual addition to the contingency reserve from gross income. The tax deduction is generally an amount equal to (a) 50% of earned premium, or (b) taxable income as computed prior to this special deduction if less than 50% of earned premium. Annual deductions not utilized for tax purposes during the current period may be carried forward for eight years on a basis similar to net operating losses. The amount deducted must be restored to gross income after ten years; however, it may be restored to gross income at an earlier date in the event of a taxable net operating loss.

26. The tax deduction is permitted only if special U.S. Mortgage Guaranty Tax and Loss Bonds are purchased in an amount equal to the tax benefit derived from the deduction. Upon redemption the tax and loss bonds can be used to satisfy the additional tax liability that arises when the deduction is restored to income.

Disclosures

27. Mortgage guaranty insurers shall make all disclosures required by other statements within the *Accounting Practices and Procedures Manual*, including but not limited to the requirements of SSAP No. 55, and *SSAP No. 1—Disclosure of Accounting Policies, Risks & Uncertainties, and Other Disclosures*.

28. Refer to the preamble for further discussion regarding disclosure requirements.

Effective Date and Transition

29. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*.

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 88—Mortgage Guaranty Insurance*

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Statement of Statutory Accounting Principles No. 59

Credit Life and Accident and Health Insurance Contracts

STATUS

Type of Issue:	Common Area
Issued:	Initial Draft
Effective Date:	January 1, 2001
Affects:	Nullifies and incorporates INT 01-29
Affected by:	No other pronouncements
Interpreted by:	No other pronouncements

STATUS **1**
SCOPE OF STATEMENT **3**
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Credit Life and Accident and Health Insurance Contracts

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for income recognition and policy reserves for all contracts classified as credit life and credit accident and health contracts defined in *SSAP No. 50—Classifications and Definitions of Insurance or Managed Care Contracts In Force*.

SUMMARY CONCLUSION

Definitions

2. Credit life and accident and health insurance contracts will be referred to collectively as “credit insurance” for purposes of this statement. Credit insurance is generally issued in connection with the issuance of credit to an individual by a bank, retailer, finance company, or other similar organization. This type of insurance most often protects the creditor to the extent of the unpaid balance of the loan. Contracts sold in connection with loans or other credit transactions not exceeding a stated duration shall be reported as credit insurance. Mortgage guaranty insurance is addressed in *SSAP No. 58—Mortgage Guaranty Insurance*. Credit policies are generally limited to issues of 120 months or less in most states. Credit insurance is sold as either an individual or group policy and may provide for single or joint life coverage.

3. Credit life insurance, generally in the form of decreasing term insurance, is issued on the lives of debtors to cover payment of loan balances in case of death. Credit accident and health insurance is insurance on a debtor to either provide indemnity for payments becoming due on a specific loan or other credit transaction while the debtor is disabled.

4. Premiums for credit insurance contracts shall be defined as the contractually determined amount charged by the reporting entity to the policyholder for the effective period of the contract.

Income Recognition

5. Consistent with *SSAP No. 51—Life Contracts*, premiums shall be recognized in the summary of operations as income on the gross basis (amount charged to the policyholder) when due from policyholders under the terms of the insurance contract.

Policy Reserves

6. Statutory policy reserves shall be established for all unmatured contractual obligations of the reporting entity arising out of the provisions of the insurance contract. Where separate benefits are included in a contract, a reserve for each benefit shall be established as required in Appendix A-820. The statutory policy reserves for credit life contracts are generally calculated as the excess of the present value of future benefits to be paid to or on behalf of policyholders less the present value of future net premiums. The statutory policy reserves for credit accident and health contracts generally consist of an unearned premium reserve, and other reserves, as required, as further discussed in paragraphs 11, 12, 13, and 14. Statutory policy reserves meet the definition of liabilities as defined in *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets* (SSAP No. 5R). The actuarial methodologies referred to in the following paragraph meet the criteria required for reasonable estimates in SSAP No. 5R.

7. The reserving methodologies and assumptions used in computation of policy reserves shall meet the provisions of Appendices A-010, A-820 and A-822, and the actuarial guidelines found in Appendix C of this Manual. Further, policy reserves shall be in compliance with those Actuarial Standards of Practice promulgated by the Actuarial Standards Board.

8. Policy reserves are established through either a gross unearned premium reserve or a mortality/morbidity reserve. The gross unearned premium reserve represents the estimated amount of

premium for insurance coverage that has not yet expired. The mortality/morbidity reserve represents the estimated amount of future anticipated benefits, discounted at valuation interest and mortality/morbidity, to be incurred on policies in force.

9. When the level of insurance risk is constant during the contract period, policy reserves shall be recognized over the period of risk using either the daily pro-rata or monthly pro-rata methods as described in *SSAP No. 53—Property Casualty Contracts—Premiums*. Policy reserves for contracts where the level of insurance risk is not constant throughout the contract period shall be recognized over the period of risk in proportion to the amount of insurance protection provided. Various methods may be used to accomplish this as described below. The reporting entity shall select the method that most closely reflects the pattern of insurance protection provided. To the extent that these methods do not reflect the pattern of insurance protection provided, the reporting entity shall modify or develop, if necessary, a method that recognizes net income from the policy over the exposure period of the contract in proportion to the amount of insurance protection provided.

10. Single premium credit life policy reserves shall be based on either a gross unearned premium reserve based on a refund formula, or a reserve based on assumed risks using mortality factors. In practice, various methods exist and are currently used to estimate the amount of gross unearned premiums applicable to the unexpired portion of the policies in force. For decreasing gross coverage, the gross unearned premium may be estimated using a Rule of 78's method; for decreasing net payoff coverage, either the Rule of 78's or the single-premium method is used; and for level coverage, the pro-rata method is generally used. The reporting entity shall select a method that reflects the pattern of insurance protection provided.

11. Except as noted in paragraph 12, policy reserves for credit A&H policies shall be based on either a gross unearned premium reserve using the pro rata, Rule of 78's, mean of pro rata and Rule of 78's, or actuarial methods. The gross unearned premium reserve is a measure of the single premium for the debt's remaining term and amount. Most states required reporting entities to record a gross unearned premium reserve using the Rule of 78's method. In practice, such a gross unearned premium reserve has been the average of the Rule of 78's and the pro rata methods. The reporting entity shall select a method that reflects the pattern of insurance protection provided. Also, the method should be consistent with the refund method actually used or required in the state.

12. For single premium credit disability policies issued on or after January 1, 2002, Appendix A-010 requires that a contract reserve be established using a standardized morbidity table. For single premium credit disability policies issued prior to January 1, 2002, reserves may be established either according to the standards in Appendix A-010 or paragraph 11. Once an insurer elects to calculate reserves for all contracts on the standard in Appendix A-010, all future valuations must be on that basis.

13. For all credit contracts in the aggregate, if the premium refund liability exceeds the aggregate recorded reserve, an additional liability shall be established. This premium refund (excess) liability may include consideration of commission, premium tax, and other expenses recoverable. The excess reserve shall be established for the surrender values (premium refund) in excess of the mortality reserves. As such, the surrender values may be net of commissions, premium taxes, etc. Additionally, the excess reserve is calculated on an aggregated basis by combining all credit life and accident and health policies and certificates.

14. When the anticipated benefits, expected dividends to policyholders and maintenance cost exceed the recorded policy reserve, a premium deficiency reserve shall be recognized by recording an additional liability for the excess deficiency with a corresponding charge to operations. Commission and other acquisition costs need not be considered in the premium deficiency analysis since they have previously been expensed.

15. The difference between the policy reserves at the beginning and end of the reporting period shall be reflected as the change in reserves or change in unearned premium, as appropriate, in the summary of operations, except for any difference due to a change in valuation basis as discussed in paragraph 16.

Change In Valuation Basis

16. A change in valuation basis shall be defined as a change in the interest rate, mortality assumption, or reserving method (e.g., net level, preliminary term, etc.) or other factors affecting the reserve computation of policies in force and meets the definition of an accounting change as defined in *SSAP No. 3—Accounting Changes and Corrections of Errors* (SSAP No. 3). Consistent with SSAP No. 3, any increase (strengthening) or decrease (destrengthening) in policy reserves resulting from such a change in valuation basis shall be recorded directly to surplus rather than as a part of the reserve change recognized in the Summary of Operations. The impact on surplus is based on the difference between the reserve under the old and new methods as of the beginning of the year. This difference shall not be graded in over time unless an actuarial guideline adopted by the NAIC prescribes a new method and a specific transition that allows for grading.

Disclosures

17. For life reserves the financial statements shall disclose the following:

a. A description of reserve practices concerning the following:

i. Waiver of deduction of deferred fractional premiums upon death of insured;

ii. Return of portion of final premium for periods beyond the date of death;

b. The methods employed in the valuation of substandard policies;

c. The amount of insurance, if any, for which the gross premiums are less than the net premiums according to the valuation standards;

d. The method used to determine tabular interest, tabular less actual reserves released, and tabular cost (by formula or from the basic data for such items);

e. The nature of significant other reserve changes.

18. If the company has reported life insurance premiums deferred and uncollected on policies in force as of the financial statement date, disclose separately the amounts and the loading excluded for credit life business.

19. Disclose the aggregate amount of direct premiums written through managing general agents or third party administrators. For purposes of this disclosure, a managing general agent means the same as in Appendix A-225. If this amount is equal to or greater than 5% of surplus, provide the following information for each managing general agent and third party administrator:

a. Name and address of managing general agent or third party administrator;

b. Federal Employer Identification Number;

c. Whether such person holds an exclusive contract;

d. Types of business written;

e. Type of authority granted (i.e., underwriting, claims payment, etc.);

f. Total premium written.

20. Refer to the preamble for further discussion regarding disclosure requirements.

Relevant Literature

21. This statement incorporates the requirements of Appendices A-010, A-225, A-812, A-818, A-820 and A-822, and the Actuarial Standards Board *Actuarial Standards of Practice* and the actuarial guidelines found in Appendix C of this Manual.

22. This statement rejects *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises* relating to accounting and reporting for credit life and accident and health insurance contracts.

Effective Date and Transition

23. This statement is effective for years beginning January 1, 2001. Contracts issued prior to January 1, 2001 shall be accounted for based on the laws and regulations of the domiciliary state. State laws and regulations shall be understood to include anything considered authoritative by the domiciliary state under the individual state's statutory authority and due process procedures. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with SSAP No. 3. The guidance in paragraph 13 pertaining to establishing the excess reserve for surrender values was originally contained within *INT 01-29: SSAP No. 59 and Application to Credit Life* and was effective December 10, 2001.

REFERENCES

Other

- NAIC *Financial Condition Examiners Handbook*
- Actuarial Standards Board *Actuarial Standards of Practice*

Relevant Issue Papers

- *Issue Paper No. 59—Credit Life and Accident and Health Insurance Contracts*

Statement of Statutory Accounting Principles No. 60

Financial Guaranty Insurance

STATUS

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Interpreted by:	No other pronouncements

STATUS **1**
SCOPE OF STATEMENT **3**
SUMMARY CONCLUSION **3**
Premium Revenue Recognition 3
Unpaid Losses and Loss Adjustment Expense Recognition 4
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Financial Guaranty Insurance

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for financial guaranty insurance and addresses areas where financial guaranty insurance accounting differs from other lines of insurance. To the extent a topic is not covered by this statement, financial guaranty insurance accounting shall comply with statutory accounting guidance for other lines of property and casualty insurance.

SUMMARY CONCLUSION

2. Financial guaranty insurance provides protection against financial loss as a result of default, changes in interest rate levels, differentials in interest rate levels between markets or products, fluctuations in exchange rates between currencies, inconvertibility of one currency into another, inability to withdraw funds held in a foreign country resulting from restrictions imposed by a governmental body, changes in the value of specific assets or commodities, financial or commodity indices, or price levels in general. Financial guaranty insurance does not provide protection from losses which occur due to fortuitous physical events, failure or deficiency in the operation of equipment, or the inability to extract natural resources. Additionally, it does not provide coverage from losses related to various types of bonds (e.g., individual or schedule public official bond; a contract bond; a court bond), credit insurance, guaranteed investment contracts, and residual value insurance.

3. Included in the definition of financial guaranty insurance is student loan insurance. Student loan insurance includes financial guarantees issued as a surety bond or financial guarantee policies issued to a bank or other lending financial institution, under which the insurer agrees to provide financial guaranty of each student loan made by the bank within specified underwriting criteria. As each loan is made, the premium for that loan is paid to the insurer by the bank from the proceeds of the loan that are retained by the bank at issuance. Usually repayment of the loan is expected to commence six months after graduation. If and when there is a default in repayment of the loan by the graduate, the insurer pays the bank or lending institution the unpaid principal and interest on the loan, takes possession of the loan, and initiates recovery efforts. Student loan insurance is subject to the provisions of this statement and the statutory contingency reserve.

Premium Revenue Recognition

4. Written premium shall be recorded in accordance with *SSAP No. 53—Property Casualty Contracts—Premiums* except that installment premiums, which may vary substantially over the term of the contract since the total amount insured and the premium rate are contingent upon the performance of the insured obligations, shall be recorded when received.

5. When premiums are paid on the installment basis, premium revenue shall be recognized in the statement of operations using the monthly pro-rata method. Premiums not paid on the installment basis shall be recognized in the statement of operations in proportion with the amount and expected coverage period of the insured risk.

6. When the anticipated losses, loss adjustment expenses, and maintenance cost exceed the recorded unearned premium reserve and contingency reserve, a premium deficiency reserve shall be recognized by recording an additional liability for the deficiency with a corresponding charge to operations. Commission and other acquisition costs need not be considered in the premium deficiency analysis since they have previously been expensed. If a reporting entity utilizes anticipated investment income as a factor in the premium deficiency calculation, disclosure of such shall be made in the financial statements.

Unpaid Losses and Loss Adjustment Expense Recognition

7. Unpaid losses and loss adjustment expenses shall be recognized in accordance with *SSAP No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses* (SSAP No. 55). Each financial guaranty insurer shall establish and maintain reserves for unpaid losses and loss adjustment expenses. The initial date of default shall be considered the incident which gives rise to a claim. Loss reserves shall include a reserve for claims reported and unpaid net of collateral.

8. A deduction from loss reserves shall be allowed for the time value of money by application of a discount rate equal to the average rate of return on the admitted assets of the financial guaranty insurer as of the date of the computation of the reserve. The discount rate shall be adjusted at the end of each calendar year. In addition, a reserve component for incurred but not reported claims shall be reasonably estimated, if deemed necessary by the financial guaranty insurer or required by the commissioner following an examination or actuarial analysis.

Contingency Reserve

9. In addition to the unearned premium reserve and the liability established for unpaid losses and loss adjustment expenses, financial guaranty insurers shall maintain a liability referred to as a statutory contingency reserve. The purpose of this reserve is to protect policyholders against loss during periods of extreme economic contraction.

10. The contingency reserve shall be the greater of fifty percent of premiums written for each category or the amount provided by applying the following percentages to the principal guaranteed in each calendar year. The premiums written shall be net of reinsurance if the reinsurer has established a contingency reserve.

a.	Municipal obligation bonds	0.55 percent
b.	Special revenue bonds	0.85 percent
c.	Investment grade Industrial Development Bonds (IDBs) secured by collateral or having a term of seven years or less, and utility first mortgage obligations	1.00 percent
d.	Other investment grade IDBs	1.50 percent
e.	Other IDBs	2.50 percent
f.	Investment grade obligations, secured by collateral or having a term of seven years or less	1.00 percent
g.	Other investment grade obligations not secured	1.50 percent
h.	Non-investment grade consumer debt obligations	2.00 percent
i.	Non-investment grade asset backed securities	2.00 percent
j.	All other non-investment grade obligations	2.50 percent

11. Additions to the reserve for items a. through e. in paragraph 10, equal to one-eightieth of the amounts derived by applying the appropriate contribution specified above, shall be made each quarter for a period of twenty (20) years. Additions to the reserve for items f. through j. in paragraph 10, equal to one-sixtieth of the amounts derived by applying the appropriate contribution specified above, shall be made each quarter for a period of fifteen (15) years.

12. For contingency reserves required to be maintained for 20 years, contributions may be discontinued if the total reserve established for all categories in paragraphs 10.a. through 10.e. exceeds the sum of the percentages contained therein multiplied by the unpaid principal guaranteed. For contingency reserves required to be maintained for 15 years, contributions may be discontinued if the total reserve established for all categories in paragraphs 10.f. through 10.j. exceeds the sum of the percentages contained therein multiplied by the unpaid principal guaranteed.

13. The contingency reserve may also be released in the following circumstances:

a. For contingency reserves required to be maintained for 20 years:

i. In any year in which actual incurred losses exceed 35% of the corresponding earned premiums, with commissioner approval;

ii. If the reserve has been in existence less than 40 quarters, upon demonstration that the amount is excessive in relation to the outstanding obligations under the insurer's financial guarantees, with commissioner approval;

iii. If the reserve has been in existence more than 40 quarters, upon demonstration that the amount is excessive in relation to the outstanding obligations under the insurer's financial guarantees, upon 30 days prior written notice to the commissioner.

b. For contingency reserves required to be maintained for 15 years:

i. In any year in which actual incurred losses exceed 65% of the corresponding earned premiums, with commissioner approval;

ii. If the reserve has been in existence less than 30 quarters, upon demonstration that the amount is excessive in relation to the outstanding obligations under the insurer's financial guarantees, with commissioner approval;

iii. If the reserve has been in existence more than 30 quarters, upon demonstration that the amount is excessive in relation to the outstanding obligations under the insurer's financial guarantees, upon 30 days prior written notice to the commissioner.

Any reductions shall be made on a first-in first-out basis. Changes in the reserve shall be recorded through unassigned funds (surplus).

Disclosures

14. Financial guaranty insurers shall make all disclosures required by paragraphs 15-17 as well as other statements within the *Accounting Practices and Procedures Manual*, including but not limited to the requirements of SSAP No. 55 and *SSAP No. 1—Disclosure of Accounting Policies, Risks & Uncertainties, and Other Disclosures*. (For disclosures within paragraph 16 and 17, all "expected" amounts and terms should be determined in accordance with management estimates.) In all instances, the insurer shall disclose when they elect to reflect timeframes or recognition principles from *FASB Statement No. 163*, *Accounting for Financial Guarantee Insurance Contracts—an interpretation of FASB Statement No. 60* (FAS 163) as permitted within the disclosure requirements.

15. An insurance enterprise shall disclose information that enables users of its financial statements to understand the factors affecting the present and future recognition and measurement of financial guarantee insurance contracts.

16. To meet the disclosure objective in paragraph 15, an insurance enterprise shall disclose the following information for each annual reporting statement, and in any interim period if a significant change has occurred in that interim period:

a. For financial guarantee insurance contracts where premiums are received as installment payments over the period of the contract, rather than at inception

i. The unearned premium revenue as of the reporting date, in proportion with the amount and expected coverage period of the insured risk, which would have been reflected if the premium had been received at inception[1].

b. A schedule of premiums (undiscounted) expected to be collected under all installment contracts detailing the following:

i. The four quarters of the subsequent annual period and each of the next four annual periods

ii. The remaining periods aggregated in five-year increments

c. A rollforward of the expected future premiums (undiscounted), including:

i. Expected future premiums – Beginning of Year

ii. Less - Premium payments received for existing installment contracts

iii. Add – Expected premium payments for new installment contracts

iv. Adjustments to the expected future premium payments

v. Expected future premiums – End of Year

d. For non-installment contracts for which premium revenue recognition has been accelerated, the amount and reasons for acceleration.

e. A schedule of the future expected earned premium revenue on non-installment contracts as of the latest date of the statement of financial position detailing the following:

i. The four quarters of the subsequent annual period and each of the next four annual periods

ii. The remaining periods aggregated in five year increments

f. For the claim liability[2]

i. The rate used to discount the claim liability. This rate[3] shall equal the average rate of return on the admitted assets of the financial guaranty insurer as of the annual date of the computation of the reserve

[1] If desired, a reporting entity that follows FAS 163 for GAAP may elect to report this disclosure in accordance with the revenue recognition principles of FAS 163.

[2] The reference to "claim liability" throughout the disclosure requirements shall reflect the "reserves for unpaid losses and loss adjustment expenses" from paragraphs 7 and 8 of this statement.

[3] The annual discount rate calculated pursuant to this paragraph shall be utilized for the subsequent year's quarterly financial statements. Per paragraph 8, the discount rate shall be adjusted at the end of each year.

ii. The significant component(s) of the change in the claim liability for the period (the accretion of the discount on the claim liability, changes in the timing, establishment of new reserves for defaults of insured contracts, changes or establishment of deficiency reserves, and changes or establishment of reserves for incurred but not reported claims), and the amount relating to each component(s).

g. A description of the insurance enterprise's risk management activities used to track and monitor deteriorating insured financial obligations, including the following:

i. A description of each grouping or category used to track and monitor deteriorating insured financial obligations

ii. The insurance enterprise's policies for placing an insured financial obligation in, and monitoring, each grouping or category

iii. The insurance enterprise's policies for avoiding or mitigating claim liabilities, the related expense and liability reported during the period for those risk mitigation activities (not including reinsurance), and a description of where that expense and that liability are reported in the statement of income and the statement of financial position, respectively.

17. An insurance enterprise shall disclose the following information for each annual and interim period related to the claim liability:

a. A schedule of insured financial obligations at the end of each interim period detailing, at a minimum, the following for each category or grouping of these financial obligations (see Appendix A):

i. Number of issued and outstanding financial guarantee insurance contracts

ii. Remaining weighted-average[4] contract period

iii. Insured contractual payments outstanding[5], segregating principal and interest

iv. Gross claim liability[6]

v. Gross potential recoveries[7]

vi. Discount, net (both claim liability and potential recoveries[8]

[4] Weighted average contract period shall be based on management's estimate of the weighted average life of the contracts. If desired, a reporting entity that follows FAS 163 for GAAP may elect to mirror the time period calculated under FAS 163.

[5] Contractual payments outstanding shall be based on management's estimates of receivables. If desired, a reporting entity that follows FAS 163 for GAAP may elect to mirror the time period calculated under FAS 163.

[6] Represents the unpaid losses and loss adjustment expenses calculated in accordance with SSAP No. 55 and SSAP No. 60, but excluding the effects of subrogation recoveries, ceded reinsurance and discounting.

[7] Includes (a) subrogation recoveries, which are deducted from the gross claim liabilities in accordance with paragraph 14 of SSAP No. 55 and (b) ceded reinsurance recoveries on unpaid losses, which are deducted from the gross claim liability in accordance with paragraph 104.a. of SSAP No. 62R.

[8] Represents the discounting effect of the gross claim liability, subrogation recoveries, and reinsurance recoveries.

vii. Net claim liability[9]

viii. Reinsurance recoverables[10]

ix. Unearned premium revenue[11]

18. Refer to the preamble for further discussion regarding disclosure requirements.

Effective Date and Transition

19. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*. The guidance in paragraph 3 was originally contained within *INT 00-04: Student Loan Insurance* and was effective June 12, 2000.

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 69—Financial Guaranty Insurance*

[9] Represents the gross claim liability less gross potential recoveries and the net discount. This line should reconcile to the sum of line 10, column 8 and column 9 (financial guaranty net unpaid losses and net unpaid loss adjustment expenses) of the Underwriting and Investment Exhibit, Part 2a – Unpaid Losses and Loss Adjustment Expenses.

[10] Represents reinsurance recoverables on paid losses which is reported as an asset with paragraph 20 of SSAP No. 62R. This line should reconcile to "Amounts recoverable from reinsurers" on the balance sheet.

[11] Unearned premium revenue (UPR) should be consistent with the UPR measurement principles of SSAP No. 60. UPR reported in this schedule may not reconcile to line 10, column 5 of the Underwriting and Investment Exhibit, Part 1a – Recapitulation of all Premiums. To the extent that this amount does not reconcile to line 10, column 5 of the Underwriting and Investment Exhibit, Part 1a – Recapitulation of Premiums, provide an additional reconciliation to line 10, column 5 of the Underwriting and Investment Exhibit, Part 1a in a footnote to the tabular disclosures required in paragraph 17.

APPENDIX A – DISCLOSURE ILLUSTRATION

A1. The example below assumes the insurance enterprise uses a surveillance list with four surveillance categories to track and monitor its insured financial obligations. The surveillance list and four surveillance categories are used for illustrative purposes only. The surveillance categories shown below describe the claim liability before the mitigating effects of potential recoveries. The following are brief descriptions of each surveillance category to provide context to the example:

a. Category A includes insured financial obligations that are still currently performing (that is, insured contractual payments are made on time but the likelihood of an event of default has increased since the financial guarantee insurance contract was first issued), but if economic conditions persist for an extended period of time, they may not be performing in the future. The issuer of the insured financial obligation may have experienced credit deterioration as a result of a general economic downturn. As a result, the present value of expected net cash outflows may exceed the unearned premium revenue of the financial guarantee insurance contract some time in the future.

b. Category B includes insured financial obligations that are currently characterized as potentially nonperforming and may require action by the insurance enterprise to avoid or mitigate an event of default.

c. Category C includes insured financial obligations that are characterized as nonperforming and for which actions to date by the insurance enterprise have not been successful in avoiding or mitigating an event of default. The insurance enterprise continues its efforts to cure the claim, but an event of default is imminent.

d. Category D includes insured financial obligations where an event of default has occurred.

	Surveillance Categories				
	A	B	C	D	Total
Number of policies	37	16	5	4	62
Remaining weighted-average contract period (in years)	16	14	11	12	
Insured contractual payments outstanding:					
Principal	$ 656,000,000	$ 409,000,000	$ 196,000,000	$ 111,000,000	$ 1,372,000,000
Interest	478,000,000	298,000,000	150,000,000	73,000,000	999,000,000
Total	$ 1,134,000,000	$ 707,000,000	$ 346,000,000	$ 184,000,000	$ 2,371,000,000
Gross claim liability	$ 1,045,000,000	$ 690,000,000	$ 330,000,000	$ 184,000,000	$ 2,249,000,000
Less:					
Gross potential recoveries	752,000,000	381,000,000	29,000,000	7,000,000	1,169,000,000
Discount, net	159,000,000	153,000,000	125,000,000	78,000,000	515,000,000
Net claim liability	$ 134,000,000	$ 156,000,000	$ 176,000,000	$ 99,000,000	565,000,000
Unearned premium revenue	$ 7,000,000	$ 4,000,000	$ 2,000,000	$ - (a)	$ 13,000,000
Reinsurance recoverables	$ 10,000,000	$ 19,000,000	$ 25,000,000	$ 27,000,000	$ 81,000,000

(a) In this instance, it is assumed that once an insured financial obligation is in Category D, the only remaining obligation of the insurance enterprise is making claim payments. As such, all related balances of the insured financial obligation are written off, including the unearned premium revenue.

Statement of Statutory Accounting Principles No. 61 - Revised

Life, Deposit-Type and Accident and Health Reinsurance

STATUS

Type of Issue:	Life and Accident and Health
Issued:	Initial draft; substantively revised December 18, 2012
Effective Date:	January 1, 2001; certified reinsurer changes effective December 31, 2012
Affects:	Nullifies and incorporates INT 02-04, INT 02-08, INT 02-09 Nullifies INT 00-23
Affected by:	No other pronouncements
Interpreted by:	INT 03-02

STATUS **1**

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Life, Deposit-Type and Accident and Health Reinsurance

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for life, deposit-type and accident and health reinsurance. This statement applies to life, deposit-type and accident and health contracts as defined in *SSAP No. 50—Classifications and Definitions of Insurance or Managed Care Contracts In Force* (SSAP No. 50).

SUMMARY CONCLUSION

Indemnity Reinsurance

2. Reinsurance is an agreement by which a reporting entity transfers all or part of its risk under a contract to another reporting entity. The entity that issued the policy is called the primary insurer, direct writer, or ceding entity and the entity to which the risk is transferred is called the reinsurer or assuming entity. The process of transferring the risk from the ceding entity to the reinsurer is known as a cession. If an assuming entity, in turn, transfers a portion of this risk, the process is called a retrocession. A retrocession is customarily made when the amount assumed is beyond the reinsurer's limits of retention.

3. There is no direct relationship between the reinsurer or the retrocessionaire and the ceding entity's policyholder unless there is a "cut-through endorsement." In the event of the ceding entity's insolvency, except in the case of a "cut-through endorsement," the policyholder or beneficiary under a contract that is reinsured has the same status as a policyholder or beneficiary of a policy that was not reinsured. An entity may not need to be licensed, have accredited reinsurer status or other means of authorization in a state in order to act as a reinsurer of a domestic entity. However, the domestic entity is not permitted to take reserve credits on the business ceded to any unauthorized reinsurers or certified reinsurers to the extent that they are not properly securitized by means of a trust, letter of credit or funds withheld or other acceptable forms of collateral.

4. Fronting arrangements, pools and association business are often accomplished using reinsurance contracts.(INT 03-02) The guidance included in this statement also applies to these types of contracts except as specifically exempted.

Retention

5. In formulating its rules for accepting applications for insurance, an entity must decide upon three areas of action—retaining, reinsuring, or declining the risks presented. Entities of various sizes have different desired capacities to write insurance on a single life and/or entire blocks of business or portfolios. An entity determines the amount of risk exposure it is able to accept and retain as its own insurance business. Having made this determination, the entity then decides what to do with any risks presented that exceed the maximum amount it is willing to retain. It has two choices—accept the additional risk and reinsure it, or decline the extra risk.

6. Business to be written is expected to be profitable, so the direct writing entity will generally want to retain as much of the risk as possible, consistent with its overall objectives. The entity also will want to avoid exposure to large losses that could jeopardize its financial condition and the policy values of its policyholders. Consequently, a common practice in the life insurance industry is for a reporting entity to establish a schedule for maximum amounts of insurance, called retention limits, which it will retain at its own risk on individual lives in various categories of insurance. By adopting a suitably chosen schedule of retention, the reporting entity eliminates exposure to large losses and reduces fluctuations in the cost of death claims from year to year, which could adversely affect the reporting entity's surplus position. In addition, the reporting entity can utilize aggregate stop loss reinsurance to protect it from aggregate claims exceeding a specific threshold.

7. There are also reasons why a reporting entity might retain less than its defined maximum. One is to transfer from the ceding entity to the reinsurer the part of the surplus strain that results from writing new life insurance. The ceding entity may wish to limit the risk of loss on substandard business. Testing new coverages or new classes of lives may lead to reinsurance.

Reinsurance Arrangements

8. Reinsurance can be on a facultative or an automatic basis. For facultative, each risk is handled separately at the time it is written. When the direct writing entity receives an application for a policy and it wishes to reinsure some or all of the risk, it negotiates with another entity for a transfer of all or a portion of that risk. For purely facultative cessions, the assuming entity is not obligated to assume any of the risk until its offer to reinsure is accepted. For facultative obligatory reinsurance, the assuming entity is obligated to reinsure the risk subject to its having sufficient available capacity.

9. For automatic reinsurance, the ceding entity agrees to reinsure with the reinsurance entity all cases which meet certain defined conditions for amounts as defined in the reinsurance agreement. The reinsurance entity is bound to accept all such amounts, up to a predetermined maximum. Amounts in excess of automatic limits set out in the reinsurance agreement may be handled as facultative cessions. When the amount lies within the automatic maximum limit, called the binding authority, the ceding entity issues its policy upon completion of its underwriting procedures and without securing the prior approval of the reinsurance entity. Notification of automatic reinsurance is sent to the reinsurer within a specified period after the ceding entity issues its policy.

10. By agreeing to accept all business automatically ceded to it, the reinsurer is relying on the underwriting judgment of the ceding entity and is bound to accept the case even when it, the reinsurer, may not agree with the underwriting action. The reinsurer is protected by the requirement that the ceding entity retains at its own risk its defined retention limit for the class of business that is involved and by the maximum which may be ceded automatically.

Types of Reinsurance Arrangements

11. Once an entity has decided to reinsure amounts in excess of its desired retention, it may proceed in one of several basic arrangements—coinsurance, modified coinsurance, yearly renewable term or non-proportional. Such contracts may have funds withheld.

Coinsurance

12. In this arrangement, the risks are reinsured on the same plan as that of the original policy. The direct writer and the reinsurer share in the risk in the same manner. The ceding entity pays the reinsurer a proportional part of the premiums collected from the insured. In return, the reinsurer reimburses the ceding entity for the proportional part of the death or accident and health claim payments and other benefits provided by the policy, including nonforfeiture values, policy dividends, experience rating refunds, commissions, premium taxes, and other direct expenses agreed to in the contract. The reinsurer must also establish the required reserves for the portion of the policy it has assumed. A single policy can be coinsured with more than one entity or under more than one reinsurance contract with the same entity as long as the combined total of reinsurance and the retention of the ceding entity is not more than 100% of the risk.

13. In coinsurance of participating policies, the reinsurer may reimburse the ceding entity for its portion of the dividends paid to the policyholder. In determining its schedule of dividends, the ceding entity takes into account the experience on the business as written. If the reinsurer reimburses dividends it will typically accept the ceding entity's schedule but may require input into the schedule. Changes to the schedule may have to be agreed to by the reinsurer. Coinsurance of all or a portion of a block of business also is used in situations where a severe strain is placed on the direct writing entity's surplus in the first

policy year. For example, the premium received by the direct writer during the first policy year usually is insufficient to pay the high first-year commissions and other costs of issue and to establish the initial reserve. In such an example, coinsurance relieves some of the surplus strain of adding large amounts of new insurance.

Modified coinsurance

14. The "modified coinsurance" or "modco" arrangement is a variation of coinsurance. The ceding entity has transferred all or a portion of the net policy liabilities on the reinsured policies to the reinsurer, and the reinsurer is required to indemnify the ceding entity for the same amount. The assets necessary to support the reserves for the original policies are maintained by the ceding entity instead of the reinsurer. This is accomplished by designating in the contract the transfer of the net policy liabilities to the assuming entity and an immediate transfer back to the extent of the modco deposit. Under modified coinsurance, the assuming entity shall transfer to the ceding entity the increase in the reserve on the reinsured portion. This transaction reflects the reinsurer's risk with respect to the reinsured business and its obligation to maintain the reserves supporting such obligation. In some cases, a policy may be reinsured partially on a coinsurance arrangement and partially on a modified coinsurance arrangement. This may be accomplished through the use of two contracts or in a single contract.

Yearly renewable term (YRT)

15. Under this arrangement of reinsurance, the ceding entity transfers the net amount at risk on the portion reinsured to the reinsurer and pays a one-year term premium. The "net amount at risk"—as defined in the contract—is usually the amount of insurance provided by the policy in excess of the ceding entity's reserve on it.

Non-proportional

16. Other forms of reinsurance are also available, such as catastrophe and stop loss coverage. These arrangements provide for financial protection to the ceding entity for aggregate losses rather than providing indemnification for an individual policy basis as described in the preceding three reinsurance arrangements. Catastrophic and stop loss reinsurance are written on an annual basis to protect the ceding entity from excessive aggregate losses. Usually, the coverage does not extend over the life of the underlying policy nor is there any requirement on the ceding entity to renew the arrangement.

Transfer of Risk

17. Reinsurance agreements must transfer risk from the ceding entity to the reinsurer in order to receive the reinsurance accounting treatment discussed in this statement. If the terms of the agreement violate the risk transfer criteria contained herein, (i.e., limits or diminishes the transfer of risk by the ceding entity to the reinsurer), the agreement shall follow the guidance for Deposit Accounting. In addition, any contractual feature that delays timely reimbursement violates the conditions of reinsurance accounting.

18. This paragraph applies to all life, deposit-type and accident and health reinsurance agreements except for yearly renewable term reinsurance agreements and non-proportional reinsurance agreements such as stop loss and catastrophe reinsurance. All reinsurance agreements covering products that transfer significant risk shall follow the guidance for reinsurance accounting contained in this statement. All reinsurance contracts covering products that do not provide for sufficient transfer of risk shall follow the guidance for Deposit Accounting.

19. Yearly renewable term (YRT) reinsurance agreements that transfer a proportionate share of mortality or morbidity risk inherent in the business being reinsured and do not contain any of the conditions described in Appendix A-791, paragraphs 2.b., 2.c., 2.d., 2.h., 2.i., 2.j. or 2.k., shall follow the

guidance for reinsurance accounting, including paragraphs 55-57 that apply to indemnity reinsurance. Contracts that fail to meet the requirements for reinsurance accounting shall follow the guidance for Deposit Accounting. For all treaties entered into on or after January 1, 2003, the deferral guidance in paragraph 3 of A-791 shall also apply to YRT agreements. Since YRT agreements only transfer the mortality or morbidity risks to the reinsurer, the recognition of income shall be reflected on a net of tax basis, as gains emerge based on the mortality or morbidity experience.

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

Accounting and Reporting of Reinsurance

21. The obligation of reporting reinsurance in force and of determining unpaid premiums and incurred claims and other balances is generally on the ceding entity because it knows the current status of the policies it has written directly and reinsured. A lag will develop between the time of the entry of the underlying policy transaction on the books of the ceding entity and the transmittal of information and its entry on the books of the assuming entity. The assuming entity shall estimate any material unreported premiums and related costs.

22. The ceding entity must report these items in its balance sheet:

a. Credits (deductions) to its policy and claim reserves and unpaid claims;

b. Premiums or other amounts payable on reinsured risks;

c. Amounts recoverable on claims, surrender values, dividends, experience rating refunds, taxes, commissions, and other expenses;

d. Modified coinsurance reserves; and,

e. Amounts receivable or payable for funds withheld.

23. Similarly, in its balance sheet, the assuming entity must report:

a. Reserves for reinsurance assumed reduced by any modified coinsurance reserves;

b. Reinsurance premiums receivable or other amounts receivable;

c. Amounts payable for claims, surrender values, dividends, experience rating refunds, taxes, commissions, and other expenses; and,

d. Amounts receivable or payable for funds withheld by the ceding entity.

24. While the premiums, commissions, expense allowances, reserves, claims, etc. will result in a net amount, the proper way to report them is in their separate classifications on the balance sheet. Each

reinsurance agreement must be accounted for separately. Certain assets and liabilities are created by entities when they engage in reinsurance contracts. Reinsurance assets meet the definition of assets as defined by *SSAP No. 4—Assets and Nonadmitted Assets* and are admitted to the extent they conform to the requirements of this statement.

Reinsurance Premiums

25. For all reinsurance arrangements, the assuming entity must report premiums under the terms of the reinsurance contract as income and establish any asset or liability consistent with the methods and assumptions used to establish its policy reserves and guidance contained in *SSAP No. 51—Life Contracts*, *SSAP No. 54—Individual and Group Accident and Health Contracts*, and *SSAP No. 59—Credit Life and Accident and Health Insurance Contracts*. The ceding entity shall reduce premium income by the amounts paid or payable to the reinsurers. The ceding entity shall reduce its deferred and uncollected premiums reported as an asset by the corresponding proportionate amount of any deferred and uncollected premium attributable to those insurance policies reinsured. When the ceding entity has collected the premium but has not remitted the proportionate share to the reinsurer, the ceding entity shall establish a liability for the amount due the reinsurer. The assuming entity shall record an asset for premiums receivable from the ceding entity.

26. If the assuming entity receives reinsurance premium prior to the due date, consistent with SSAP No. 51 paragraph 7 and SSAP No. 54, paragraph 6, advance premiums are reported as a liability for the reinsurer in the statutory financial statement and not considered income until due. Such amounts are not included in premium or the unearned premium reserve (if applicable) until the due date. If the ceding entity pays reinsurance premium prior to the due date, the amount of the prepaid item shall be reflected as a write-in admitted asset and it should not be recognized in the income statement until due. Such amounts are not included in ceded premiums or ceded unearned premium but should be subject to impairment analysis.

Reinsurance Benefit Payments

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

Reinsurance of Deposit-Type Contracts

28. At the outset of a reinsurance contract covering deposit-type contracts as defined in *SSAP No. 52—Deposit-Type Contracts*, the net consideration exchanged between the parties shall be recorded as a contra-liability (reduction of reserve) by the payer of the net considerations and as a liability (reserve) by the receiver. Throughout the life of the contract, receipts and disbursements shall be recorded through the asset/liability accounts.

Expenses

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

30. Commissions on direct business, commissions and expense allowances on reinsurance assumed, and commissions and expense allowances on reinsurance ceded are each accounted for separately in the summary of operations and on the balance sheet. Accordingly, for entities reporting on the Life, Accident

and Health Annual Statement, commissions and expense allowances on reinsurance ceded are reported as income in the summary of operations and the balance sheet provision for due and accrued amounts is reported as an asset. For entities reporting on the Health Annual Statement commissions and expense allowance on reinsurance ceded are reported as an offset to administrative expenses.

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

32. Some coinsurance contracts provide that the assuming entity pay to the ceding entity a commission that exceeds the first-year premium. In the absence of any guarantees for payment of future premiums, or other similar persistency guarantees, these commissions are accounted for on the cash basis. If, however, the contract contains a persistency guarantee which provides for return of the excess commission, the ceding entity must record the excess commission as a liability. This liability is then released as future premiums are paid to the assuming entity or the persistency guarantee otherwise expires. The rate of release is determined in accordance with the anticipated experience and reasonable commission rate for first-year and renewal premiums. Excess commissions such as these are a means of financing for the ceding entity.

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

Experience Refunds

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

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

Credits for Ceded Reinsurance

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

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

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

Reserves for Reinsurance Assumed

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

Accounting for Modified Coinsurance Arrangements

40. The following accounting applies to modified coinsurance arrangements:

a. Ceding Entity—In a modified coinsurance arrangement, the ceding entity retains the assets equal to the modified coinsurance reserve. This reserve represents a prepayment of the reinsurer's future obligation. Premiums paid or payable to the reinsurer net of any experience refunds shall result in the reduction of premium income. Policy benefit payments paid by the reinsurer shall reduce the ceding entity's reported policy benefits. Expense allowances paid by the reinsurer shall be reported separately in the summary of operations as they are earned. The modified coinsurance reserve is included in the category of policy reserves. The modified coinsurance reserve adjustment from period-to-period shall be reported separately in the summary of operations;

b. Assuming Entity (Reinsurer)—Premiums received or receivable by the reinsurer shall increase premium income net of any experience refunds and policy benefit payments paid by the reinsurer shall increase the reported policy benefits. Expense allowances paid by the reinsurer shall be reported separately in the summary of operations when payable. The statutory policy reserves exclude the modified coinsurance reserve. The modified coinsurance reserve adjustment from period-to-period shall be reported separately in the summary of operations. The reinsurer's accounting of its obligations shall be consistent with the ceding entity's accounting for the transfer of the obligations.

For separate accounts: The assuming reinsurer should account for the CRVM/CARVM expense allowances belonging to the assuming company when the ceding company holds the assets supporting the full account balance (prior to modification for CRVM/CARVM expense allowances) in its separate accounts as follows:

i. The assuming company records the CRVM/CARVM expense allowances in the Liabilities line, "Transfers to Separate Accounts due or accrued (net)" and includes them in the caption disclosure: "Including $_______, accrued for expense allowances recognized in reserves net of reinsurance"

ii. Period changes are recorded in the Summary of Operations Line, "Net transfers to or (from) Separate Accounts"

Accounting for Coinsurance With Funds Withheld Arrangements

41. The following accounting applies to coinsurance arrangements with funds withheld:

a. Ceding Entity—Premiums paid or payable to the reinsurer net of any experience refunds shall reduce premium income. Policy benefit payments paid by the reinsurer shall reduce the ceding entity's reported policy benefits. Expense allowances paid by the reinsurer shall be reported separately in the summary of operations as they are earned. A net reduction to policy reserves shall be taken for the portion of the obligation assumed by the reinsurer. Any amounts withheld by the ceding entity shall be recorded as a separate liability. Reporting entities filing the annual statement for life and accident and health insurers shall record any interest due or payable on the amounts withheld as a component of aggregate write-ins for miscellaneous deductions. Reporting entities filing the health annual statement shall record any interest due or payable on the amounts withheld as a component of aggregate write-ins for other income or expense.

b. Assuming Entity (Reinsurer)—Premiums received or receivable by the reinsurer net of any experience refunds shall increase premium income and policy benefit payments paid by the reinsurer shall increase the reported policy benefits. Expense allowances paid by the reinsurer shall be reported separately in the summary of operations when payable. The reinsurer shall record its share of the statutory policy reserves attributable to the business identified in the contract. Any funds withheld by the ceding entity shall be recorded as an accounts receivable. For reporting entities filing the annual statement for life and accident and health insurers shall record any interest earned or receivable on the funds withheld as a component of aggregate write-ins for miscellaneous income. Reporting entities filing the health annual statement shall record any interest earned or receivable on the funds withheld as a component of aggregate write-ins for other income or expense.

Uncollectible Reinsurance

42. The ceding and assuming companies must determine if reinsurance recoverables are collectible. If it is probable that reinsurance recoverables on paid or unpaid claim or benefit payments will be uncollectible, consistent with *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets*, these amounts shall be written off through a charge to the Statement of Operations utilizing the same accounts which established the reinsurance recoverables.

Reinsurance Ceded to a Certified Reinsurer

43. A certified reinsurer is an assuming insurance entity that does not meet the requirements to be considered an authorized reinsurer in the domestic state of the ceding insurance entity, but has been certified by such state and is required to provide collateral as security for its reinsurance obligations incurred under contracts entered into or renewed on or after the effective date of certification.

44. Credit for reinsurance ceded to a certified reinsurer is permitted if security is held by or on behalf of the ceding entity in accordance with the certified reinsurer's rating assigned by the domestic state of the ceding insurance entity, and in accordance with requirements of *Appendix A-785* of this manual. Such deposits are to be held under the control of the ceding entity. Additionally, any securities held under such an arrangement must be investments that the ceding entity is allowed to make under the provision of the investment sections of the insurance statutes of its domiciliary state. Other permissible arrangements include irrevocable trusts or "clean" letters of credit.

45. An upgrade in a certified reinsurer's assigned rating applies on a prospective basis, i.e., the revised collateral requirement applies only to contracts entered into or renewed on or after the effective date of the new rating (see A-785). A downgrade in a certified reinsurer's rating applies on a retroactive basis, i.e., the revised collateral requirement applies to all reinsurance obligations incurred by the assuming insurer under its certified reinsurer status. Notwithstanding a change in a certified reinsurer's rating or revocation of its certification, a reporting entity that has ceded reinsurance to such certified reinsurer is allowed a three (3)-month grace period before recording a provision for reinsurance due to collateral deficiency associated with such rating downgrade and increased collateral requirement for all reinsurance ceded to such assuming insurer under its certified reinsurer status, unless the reinsurance is found by the commissioner of the reporting entity's domestic state to be at high risk of uncollectibility.

46. With respect to reinsurance contracts involving a certified reinsurer, the contract must include a proper funding clause, which requires the certified reinsurer to provide and maintain security in an amount sufficient to avoid the imposition of any financial statement penalty on the ceding insurance entity for reinsurance ceded to the certified reinsurer. However, this does not preclude negotiation for higher contractual collateral amounts.

47. A liability is established by the ceding entity to offset credit taken in various balance sheet accounts for reinsurance ceded to a certified reinsurer in an amount proportionate to any deficiency in the amount of acceptable security that is provided by the certified reinsurer as compared to the amount of security that is required to be provided in accordance with the certified reinsurer's rating. In determining the amount of this liability, the ceding insurance entity must first determine the net obligations subject to collateral from the certified reinsurer, which is equal to the following:

a. Reserve credits taken including any Interest Maintenance Reserve (IMR) liability adjustment; plus

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

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

d. Amounts contractually due the assuming entity.

48. The liability for reinsurance with certified reinsurers due to collateral deficiency is then determined as follows:

a. The net obligations subject to collateral from the certified reinsurer as calculated in paragraph 47; less

b. The net obligations subject to collateral from the certified reinsurer as calculated in paragraph 47 multiplied by the ratio of the amount of collateral provided by the certified reinsurer to the amount of collateral required to be provided by the certified reinsurer in accordance with its rating assigned by the domestic state of the ceding entity.

49. The net liability defined in paragraphs 47 and 48 shall never be less than zero for any particular certified reinsurer. The change in liability for reinsurance with certified reinsurers is a direct charge or credit to surplus.

Unauthorized Reinsurance

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

a. Reserve credits taken including any Interest Maintenance Reserve (IMR) liability adjustment; plus

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

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

d. Deposits by or funds withheld from the reinsurer, as provided for in the reinsurance treaty and in compliance with the security requirements of Appendix A-785, pledged as security for the payment of reinsurance obligations. Such deposits or funds are typically held by the ceding entity or are placed in a trust or custodial account. Amounts placed in trust or custodial accounts are held subject to withdrawal by, and under the control of, the ceding entity; less

e. Amounts of reinsurance recoverables covered by a clean, irrevocable letter of credit issued by a qualified U.S. financial institution as defined in Appendix A-785; less

f. Amounts contractually due the assuming entity.

51. The net liability defined in paragraph 50 shall never be less than zero for any particular reinsurer. The change in liability for unauthorized reinsurance is a direct charge or credit to surplus.

Syndicated Letters of Credit

52. With a Syndicated Letter of Credit (Syndicated LC), the reinsurer enters into an agreement with a group of banks (the "Issuing Banks") and an agent bank (the "Agent"). Each Issuing Bank and the Agent is an NAIC-approved bank and a "qualified bank". This agreement requires the Agent to issue, on behalf of the each of the Issuing Banks, letters of credit in favor of the ceding insurer. The credit is issued (as an administrative matter) only through the Agent's letter of credit department. Each issuing bank signs the Syndicated LC through the Agent, as its attorney-in-fact. Syndicated LCs are consistent with A-785, in that the Syndicated LC is the legal equivalent of multiple letters of credit separately issued by each of the issuing banks. Reporting entities shall take a reduction in the liability on account of reinsurance recoverables secured by the Syndicated LC if all of the following conditions are met:

a. All listed banks on the letter of credit are qualified and meet the criteria of the NAIC SVO approved bank listing;

b. Banks are severally and not jointly liable; and

c. Specific percentages for each assuming bank are listed in the letter of credit.

Funds Held Under Reinsurance Treaties with Unauthorized Reinsurers or Certified Reinsurers

53. This liability is established for funds deposited by or contractually withheld from unauthorized reinsurers or certified reinsurers.

Accounting for Interest Maintenance Reserve (IMR)

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

Gains and Losses on Indemnity Reinsurance

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

56. Losses that occur in any year of an indemnity reinsurance contract are immediately recognized. For reinsurance of in-force blocks of business, gains that occur in the initial calendar year are accounted for in accordance with Appendix A-791, paragraph 3. If a retrocession of all or a portion of an in-force block of assumed business occurs contemporaneously with assuming the in-force block of business, any resulting net gain from assuming the in-force block of business and the retrocession shall be accounted for in accordance with Appendix A-791. Any resulting net loss shall be recognized immediately in earnings.

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

Recaptures and Commutations

58. A recapture or a commutation of a reinsurance agreement is a transaction which results in the complete and final settlement and discharge of all present and future obligations between the parties arising out of the agreement or a portion of the agreement. Commuted and recaptured balances shall be accounted for by writing them off through the accounts, exhibits and schedules in which they were originally recorded. The assumed reserves and reserve credits taken are eliminated by the reinsurer and ceding entity, respectively. The reinsurer and ceding entity must also make any required IMR liability adjustment changes. Any net gain or loss is reported in the summary of operations.

Deposit Accounting

59. To the extent that a reinsurance contract does not, despite its form, provide for sufficient transfer of risk amounts exchanged between the parties are to be accounted for and reported as follows:

a. At the outset of the reinsurance contract, the net consideration exchanged between the parties shall be recorded as an asset by the payer of the net considerations and as a liability by the receiver. The amount to be admitted as an asset is subject to the limitations for transactions with unauthorized reinsurers described in Appendix A-785. Throughout the life of the contract, receipts and disbursements shall be recorded through the asset/liability accounts. Income and losses shall be recognized by a party when, according to the terms of the contract, it has earned the amount and the other party has no recourse to repayment of such amount in future periods. When the contract is completed, or when there is a loss payment in excess of the deposit, any difference between consideration and recoveries shall be recorded as other miscellaneous insurance income or miscellaneous insurance loss;

b. No deduction shall be made from the policy or claim reserves on the balance sheet, schedules and exhibits.

Assumption Reinsurance

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

Accounting for Assumption Reinsurance Transactions

61. Accounting for assumption reinsurance transactions involves all existing assets and liabilities with respect to the assumed policies. This involves policy reserves, policy loans, net due and deferred premiums, dividend accumulations, dividend liability, policy claims, advance premiums, unearned

interest on policy loans, etc. The total effect of all of these assets and liabilities is collectively referred to as net policy liabilities.

62. Typically, because a block of in-force business has value, the sale transaction will result in a gain to the ceding entity. If the policies are somewhat mature and have reasonably large net policy liabilities, the transaction probably will result in a transfer of cash or other assets by the ceding entity. In this case, the net policy liabilities released by the ceding entity will be greater than the value of the assets transferred. If the policies are young and have very small net policy liabilities, the assuming entity may pay some amount in the purchase. The ceding entity is to follow accounting for indemnity reinsurance for the policies sold until it has been formally relieved of the legal liability by either consent from the policyholders or when the expiration period for objecting to the transfer has expired. Upon release of the liability or risk, the ceding entity shall recognize any gain or loss immediately. The gain or loss shall be the difference between the book value of the assets and liabilities including any unamortized IMR allocated or related to the block of business transferred. Direct and ceded balances are to be eliminated and gains are to be taken into income proportionally as the policyholders approve the transfer or at the end of the response period.

63. The assuming entity is to value the assets acquired at the date of acquisition at their fair values, and the reserves are to be established according to statutory requirements based on the benefits in the individual policies reinsured. If the liabilities exceed the assets, the difference represents goodwill that must be amortized into operations using the interest method over the life of the policies, but for a period not to exceed 10 years. Goodwill resulting from assumption reinsurance transactions shall be included in the total goodwill of an entity when calculating the amount of goodwill that is a nonadmitted asset pursuant to *SSAP No. 68—Business Combinations and Goodwill*. If the assets exceed the liabilities, the assuming entity shall record a deferred liability and amortize the amount into operations using the interest method over the expected life of the business but not to exceed ten years.

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

Accounting for Non-Economic Assumption Reinsurance Transactions

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

Disclosures

66. For life and annuity reserves the financial statements shall disclose the following:

a. A description of reserve practices concerning the following:

i. Waiver of deduction of deferred fractional premiums upon death of insured;

ii. Return of portion of final premium for periods beyond the date of death;

iii. Amount of any surrender value promised in excess of the reserve as legally computed;

b. The methods employed in the valuation of substandard policies;

c. The amount of insurance, if any, for which the gross premiums are less than the net premiums according to the valuation standards;

d. The method used to determine tabular interest, tabular less actual reserves released, and tabular cost (by formula or from the basic data for such items);

e. The method of determination of tabular interest on funds not involving life contingencies; and

f. The nature of significant other reserve changes.

67. Disclose the amount of annuity actuarial reserves and deposit liabilities by withdrawal characteristics for the categories of general account, separate account with guarantees, separate account nonguaranteed and the total as follows:

a. Subject to discretionary withdrawal:

i. With market value adjustment, where withdrawal of funds is payable at all times, or prior to specified maturity dates where such dates are more than one year after the statement date and;

(a) In a lump sum with adjustments to reflect general changes in interest rates, or asset values since receipt of funds by the entity;

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

ii. At book value less current surrender charge, where the withdrawal of funds is payable at all times, or at any time within one year from the statement date in a lump sum subject to a current fixed surrender charge of 5% or more and it does not contain a meaningful bail out rate as described in 67.v.(d) below;

iii. At fair value, where the withdrawal of funds is payable at current market value of the assets supporting the liabilities, the assets are stated at current fair value, and the liabilities are stated at the current fair value or per unit value of the assets supporting the liabilities. These liabilities are for contracts where the customer bears the entire investment risk;

iv. Total with adjustment or at fair value;

v. At book value without adjustment (minimal or no charge or adjustment), where the withdrawal of funds is either payable at all times, or at any time (including a withdrawal on a scheduled payment date) within one year from the statement date and:

(a) In a lump sum without adjustment;

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

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

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

b. Not subject to discretionary withdrawal;

c. Total gross;

d. Reinsurance ceded; and

e. Total net.

68. Reconcile the total annuity reserves and deposit fund liabilities amount disclosed to the appropriate sections of the Aggregate Reserve for Life Policies and Contracts Exhibit and the Deposit Funds and Other Liabilities without Life or Disability Contingencies Exhibit, of the Life, Accident & Health Annual Statement and the corresponding lines in the Separate Accounts Statement.

69. Disclosures shall be made consistent with the interrogatories made under the “Ceded Reinsurance Report” detailed in the NAIC *Annual Statement Instructions For Life, Accident and Health Insurance Companies* in the Notes to the Financial Statements section.

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

a. Claims incurred;

b. Claim adjustment expenses incurred;

c. Premiums earned; and

d. Other.

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

a. Claims incurred;

b. Claim adjustment expenses incurred;

c. Premiums earned; and

d. Other.

72. The financial statements shall disclose the impact on any reporting period in which a certified reinsurer’s rating has been downgraded or its certified reinsurer status is subject to revocation and additional collateral has not been received as of the filing date. The disclosure should include the following:

a. Name of certified reinsurer downgraded or subject to revocation of certified reinsurer status and relationship to the reporting entity;

b. Date of downgrade or revocation and jurisdiction of action;

c. Collateral percentage requirements pre and post downgrade or revocation;

d. Net obligation subject to collateral;

e. As of the end of the current quarter, the estimated impact of the collateral deficiency to the reporting entity as a result of the assuming entity's downgrade or revocation of certified reinsurer status, (At year-end the actual impact of the collateral deficiency on the provision for reinsurance shall be disclosed).

f. U.S. domiciled reinsurers are eligible for certified reinsurer status. If the reporting entity is a certified reinsurer, the financial statements shall disclose the impact on any reporting period in which its certified reinsurer rating is downgraded or status as a certified reinsurer is subject to revocation. Such disclosure shall include information similar to paragraphs 72.b., 72.c. and 72.d. and the expectation of its ability to meet the increased requirements.

73. Refer to the preamble for further discussion regarding disclosure requirements.

Relevant Literature

74. This statement adopts with modification *FASB Statement No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*. The statutory accounting principles established by this statement differ substantially from GAAP, reflecting much more detailed guidance, as follows:

a. Reserve credits taken by ceding companies as a result of reinsurance contracts are netted against the ceding entity's policy and claim reserves and unpaid claims;

b. First year and renewal ceding commissions on indemnity reinsurance of new business are recognized as income. Ceding commissions on ceded in-force business are included in the calculation of initial gain or loss;

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

d. Initial gains on indemnity reinsurance of in-force blocks of business have unique accounting treatment. A portion of the initial gain (equal to the tax effect of the initial gain in surplus) is reported as commissions and expense allowances on reinsurance ceded in the statement of operations. The remainder of the initial gain is reported on a net-of-tax basis as a write-in for gain or loss in surplus in the Capital and Surplus Account. In subsequent years, the ceding entity recognizes income on the reinsurance ceded line for the net-of-tax profits that emerged on the reinsured block of business with a corresponding decrease in the write-in for gain or loss in surplus;

e. This statement prohibits recognition of a gain or loss in connection with the sale, transfer or reinsurance of an in-force block of business between affiliated entities in a non-economic transaction. Any difference between the assets transferred by the ceding entity and the liabilities, including unamortized IMR, shall be deferred and amortized under the interest method;

f. This statement requires that a liability be established through a provision reducing surplus for unsecured reinsurance recoverables from unauthorized reinsurers;

g. This statement prescribes offsetting certain reinsurance premiums.

75. This statement incorporates Appendices A-785 and A-791.

Effective Date and Transition

76. This statement is effective for years beginning January 1, 2001, and, except as noted in paragraphs 77-80, applies to all reinsurance contracts entered into or amended subsequent to January 1, 1996. Changes resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors* (SSAP No. 3).

77. The accounting and reporting practices revised by this statement shall not apply to reinsurance agreements in force on January 1, 1996.

78. The requirements of paragraph 18 relating to reinsurance of deposit-type contracts shall be effective for all accounting periods beginning on or after January 1, 2001. The guidance in paragraph 19 pertaining to applying deferral guidance to YRT treaties was originally contained within *INT 02-08: Application of A-791 to YRT Reinsurance of a Block of Business* and was effective January 1, 2003. The guidance in paragraph 40 related to separate accounts was originally contained within *INT 02-04: Recognition of CARVM and CRVM Expense Allowances by the Assuming Reinsurer in a Modified Coinsurance Agreement* and was effective March 18, 2002. The guidance in paragraph 52 was originally contained within *INT 02-09: A-785 and Syndicated Letters of Credit* and was effective September 12, 2004.

79. Agreements which were: a) entered into on or after January 1, 1996, and which do not transfer risk shall be accounted for as deposits; b) amended on or after January 1, 1996, and which do not transfer risk shall be accounted for prospectively as deposits with the appropriate reclassification of outstanding reinsurance balances as deposits with no surplus impact. For arrangements which were amended on or after January 1, 1996, a change in accounting principle associated with the revised accounting in this statement shall be applied prospectively with no adjustment to surplus as required by SSAP No. 3.

80. The guidance related to certified reinsurers is applicable only to cedants domiciled in states that have enacted/promulgated the certified reinsurer collateral framework, and only for their cessions to reinsurers certified under that domestic law/rule, and shall be effective for all reporting periods beginning on or after December 31, 2012.

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 74—Life, Deposit-Type and Accident and Health Reinsurance*

GLOSSARY[1]

Assume

To accept or take over an insurance risk; the reverse of cede.

Assumption Reinsurance

The form of reinsurance that extinguishes the ceding entity's liability to the policyholder. The reinsurer directly assumes all the service and financial obligations of the original entity on the block of business being assumed. Unlike indemnity reinsurance, assumption reinsurance makes the assuming entity (reinsurer) directly liable to the policyholders. In some instances, the original entity may continue to administer and service the business but, if it does so, it does it as the agent of the reinsurer.

Automatic Maximum Limit

The amount of risk which can be automatically ceded if all other conditions are met. Also called the binding authority.

Authorized Reinsurer

An assuming entity is considered an authorized reinsurer if either: 1) it is licensed in the domiciliary state of the ceding entity; 2) it is an accredited reinsurer in the domiciliary state of the ceding entity; 3) it is domiciled and licensed in a state which employs standards regarding credit for reinsurance substantially similar to those of the domiciliary state of the ceding entity and maintains surplus of at least $20 million; 4) it maintains a trust for the benefit of all its U.S. policyholders and ceding entities equal to its U.S. liabilities plus a level of surplus prescribed in the NAIC model law on credit for reinsurance; or 5) it is a reinsurer accepting risks located in jurisdictions where the laws require reinsurance to be ceded to such entity.

Automatic Reinsurance

A reinsurance agreement under which the reinsurer is obligated to accept or assume risks which meet certain specific criteria based on the ceding entity's underwriting. The reinsurance is ceded on the underwriting judgment of the ceding entity without a case by case concurrence of the reinsurer, up to a specified amount, the automatic maximum limit. The ceding entity normally is required to keep its full stipulated retention for the class of business involved on any case ceded automatically. Often certain defined types of cases are not eligible for automatic treatment. Cases in excess of the automatic maximum limits or otherwise ineligible for automatic cover can usually be submitted for facultative consideration.

Binding Authority

The amount of risk over the ceding entity's retention which can be automatically ceded if all other conditions are met. Also called the automatic maximum limit.

Catastrophe Reinsurance

A form of non-proportional reinsurance offering the ceding entity protection against excess losses from multiple claims arising out of a single event or a single large loss. Typically, reinsurance benefits will be

[1] Definitions in this glossary are adapted from the Society of Actuaries' Reinsurance Section Treaty Committee paper, "Discussion of Reinsurance Provisions in a Life Reinsurance Agreements," dated August 1, 1994, and the glossary contained in *Life, Health, and Annuity Reinsurance*, by John E. Tiller, Jr., FSA, and Denise Fagerbert, FSA (ACTEX Publications, Inc.).

paid if at least a specified minimum number of claims exceeding a minimum threshold amount of benefits arises out of a single event. When these conditions are met, the ceding entity is reimbursed for a percentage (often 100%) of the claims over the threshold attachment point up to the maximum reinsurance benefit specified in the treaty.

Cede

To transfer an insurance risk from the entity originally issuing the policy to another insurance entity known as the reinsurer; the reverse of assume.

Certified Reinsurer

A certified reinsurer is an assuming insurance entity that does not meet the requirements to be considered authorized in the domestic state of the ceding insurer, but has been certified by such state and is required to provide collateral as security for its reinsurance obligations incurred under contracts entered into or renewed on or after the effective date of certification. The amount of security required to be provided by the certified reinsurer in order for a domestic ceding insurer to be eligible to receive financial statement credit for the reinsurance ceded is determined by an evaluation and rating that is assigned to the certified reinsurer by the domestic state of the ceding insurance entity.

Cession

The process of transferring risk from the ceding entity to the reinsurer.

Coinsurance

Indemnity life reinsurance in which the reinsurer participates in the risks and rewards of the policy provisions; the ceding entity retains its liability to the contractual relationship with the insured. The reinsurer is liable not only for its portion of the death benefit, but also all the nonforfeiture values. The reinsurer receives its proportionate share of the ceding entity's gross premium less a coinsurance allowance for commissions and other expenses. The reinsurer holds the reserve on its portion of the policy and usually retains any excess investment earnings.

Commutation

The termination of all obligations between the parties to a reinsurance agreement, normally accompanied by a final cash settlement. Commutation may be required by the reinsurance agreement or may be effected by mutual agreement.

Credit for Reinsurance

Negative entries (i.e., reductions) to the ceding entity's policy reserves and positive entries (i.e., increases) to the ceding entity's assets (amounts recoverable from reinsurers). In the context of reinsurance, the term "credit" is the opposite of its meaning in pure accounting terminology. In balance sheet accounting, a credit is a positive entry to a liability (reserve).

Cut Through Endorsement

An endorsement to a policy and referred to in a reinsurance agreement which requires that, in the event of the ceding entity's insolvency, any loss covered under the reinsurance agreement will be paid by the reinsurer directly to the insured (or a third party beneficiary).

Experience Rating Refund

A part of the profits under a reinsurance agreement which is returned to the ceding entity, allowing the ceding entity to share in a portion of profits realized on the reinsurance.

Facultative Reinsurance

Reinsurance under which the ceding entity has the option (faculty) of submitting and the reinsurer has the option of accepting or declining individual risks. Thus it is reinsurance that the ceding entity chooses to submit to a reinsurer for its consideration and which may be ceded to the reinsurer only if the reinsurer makes an offer to reinsure. The underwriting classification assigned to the risk for purposes of the reinsurance is determined by the reinsurer. Facultative reinsurance may be ceded under the facultative terms of an automatic treaty for risks that the ceding entity cannot or does not wish to cede automatically, or it may be ceded under a purely facultative treaty.

Facultative Obligatory Reinsurance

A form of reinsurance that shares aspects of both facultative and automatic reinsurance. As with facultative reinsurance, the ceding entity has no obligation to offer specific cases to the reinsurer. However, once a case is offered to the facultative obligatory reinsurer, the case is treated largely as if it were automatic. The reinsurer receives no underwriting information and is offered the case at the ceding entity's rating with the option to accept or reject the case. While not always stated in the treaty, it is usually understood that the case will be rejected by the reinsurer only if the reinsurer does not have available capacity (i.e., its own retention and automatic retrocession facilities).

Fronting Arrangement

A situation where one insurance entity issues policies to specified applicants and reinsures all or substantially all of the risks on the insurance to another insurance entity for a fee or portion of the profits. Fronting typically is used in jurisdictions where the reinsuring entity is not licensed to do business.

Funds Withheld

Assets that would normally be paid over to a reinsurer but are withheld by the ceding entity to permit statutory credit for nonadmitted reinsurance, to reduce a potential credit risk, or to retain control over investments. Under certain conditions, the reinsurer may withhold funds from the ceding entity.

Indemnity Reinsurance

The form of reinsurance under which the ceding entity secures reinsurance as a partial or total reimbursement on the risks assumed on policies it has issued or reinsured. Under indemnity reinsurance, the reinsurer has no relationship with the original policyholders; the ceding entity continues to administer and service the insurance on which it has secured reinsurance and remains fully responsible for all the interests of the policyholders. If the reinsurer cannot or does not honor its obligations to the ceding entity, the ceding entity would still be fully liable to its policyholders.

Indemnity reinsurance may be employed, not only between a direct writing entity and a reinsurer, but also between two reinsurers when retrocession of risks is being implemented.

Mod-Co Reserve Adjustment

The net of two modified coinsurance items: the interest on reserves (payable by the ceding entity to the reinsurer) and the increase in the reserve (payable by the reinsurer to the ceding entity) or decrease in the reserve (payable by the ceding entity to the reinsurer).

Modified Coinsurance

Indemnity life insurance that differs from coinsurance only in that the reserves are retained by the ceding entity, which represents a prepayment of all or a portion of the reinsurer's future obligation. Periodically an adjustment is made to the mean reserve on deposit with the ceding entity. This is usually done quarterly but may be done more frequently. If the reserve increases, the increase in mean reserve less interest on the mean reserve held at the end of the previous accounting period is paid by the reinsurer to the ceding entity. If the mean reserve decreases, the decrease and interest are paid by the ceding entity to the reinsurer. The appropriate interest rate is defined in the treaty.

Net Amount at Risk

The excess of the death benefit of a policy over the policy reserve. It is the amount which must come from surplus in the event of a death claim.

Non-Proportional Reinsurance

Reinsurance that is not secured on individual lives for specific individual amounts of reinsurance, but rather reinsurance that protects the ceding entity's overall experience on its entire portfolio of business, or at least a broad segment of it. The most common forms of non-proportional reinsurance are stop loss reinsurance and catastrophe reinsurance.

Non-proportional reinsurance is a form of casualty insurance. Usually neither the premium nor continuance of coverage is guaranteed beyond a specified term.

Pool

A method of allocating reinsurance among several reinsurers. Using this method, each reinsurer receives a specified percentage of risk ceded into the pool. Percentages may vary by reinsurer.

Proportional Reinsurance

Reinsurance on a particular life for a specified amount or share generally, though not necessarily, secured at the time the policy is issued to the insured. The continuation of coverage guarantees for the reinsurance generally parallel those in the life insurance coverage reinsured. Most life reinsurance conducted in the United States is done so on a proportional basis.

Recapture

The process by which the ceding entity recovers the liabilities transferred to a reinsurer. Reinsurance treaties often provide that if a ceding entity increases its retention, the ceding entity can, under previously agreed upon terms, take back (recapture) amounts of insurance previously ceded to fill up its new retention.

Reinsurer

An insurance entity to which another insurance entity can transfer, through the mechanism of reinsurance, part or all of its risk under a policy or policies it has issued or reinsured. If the transfer of risk is secured through indemnity reinsurance, the reinsurer becomes liable to the ceding entity for the reinsured benefits while the original entity, the ceding entity, remains fully liable to its insured policyholders. If the transfer of risk is secured through assumption reinsurance, the original entity steps out of the picture and transfers all of its liabilities and responsibilities to the reinsurer, who then is henceforth directly responsible to the original policyholders.

Retention

The portion of a policy which the ceding entity retains for its own liability on life insurance. It is normally expressed in terms of face amount of insurance, especially if more than the mortality risk is reinsured. It is sometimes expressed in terms of risk amount, particularly with single premium products.

An entity's retention is often graded by age and/or underwriting classification. Less frequently, special reduced retentions apply to specified risks, such as those engaging in aviation activities or with histories of coronary artery disease.

Retrocession

A form of reinsurance under which a reinsurer cedes to another insurer (the retrocessionaire) part or all of the reinsurance it has assumed from another entity. The original ceding entity has no relationship or recourse to the retrocessionaire and the original reinsurer remains fully liable to its client, the original ceding entity.

Retrocession provides a reinsurer with a method of accommodating its clients with respect to larger risks while still managing its own risk exposure.

Stop Loss Reinsurance

A form of non-proportional reinsurance under which the reinsurer pays some or all of a ceding entity's aggregate retained losses in excess of a predetermined dollar amount or in excess of a percentage of premium. Stop loss coverage provides protection against an excessive number or amount of claims in any given contract period.

Unauthorized Reinsurer

A reinsurer that is neither authorized, certified nor accredited (see "Authorized Reinsurer" and "Certified Reinsurer"). The ceding entity still may be able to take credit in its financial statements for reinsurance ceded to an unauthorized reinsurer if the reinsurer provides sufficient security for amounts due under the reinsurance treaty. This can usually be accomplished by permitting the ceding entity to withhold funds due the reinsurer (funds withheld approach) or by the reinsurer providing the ceding entity with a letter of credit, in a form acceptable to the state in question, or by the reinsurer establishing a trust agreement for the benefit of the ceding entity.

Yearly Renewable Term (YRT)

A form of life reinsurance under which the mortality or morbidity risks, but not the permanent plan reserves, are transferred to the reinsurer for a premium that varies each year with the amount at risk and the ages of the insureds. The amount of reinsurance, which may change annually, is generally the amount of insurance provided by the policy in excess of the primary insurer's reserve.

Statement of Statutory Accounting Principles No. 62 - Revised

Property and Casualty Reinsurance

STATUS

Type of Issue:	Common Area
Issued:	Finalized March 13, 2000; substantively revised December 5, 2009, and December 18, 2012
Effective Date:	January 1, 2001; substantive revisions in paragraphs 31.e., 80-83 and 98 (detailed in Issue Paper No. 137) are effective January 1, 2010; certified reinsurer changes effective December 31, 2012
Affects:	Supersedes SSAP No. 75 with guidance incorporated August 2011 Nullifies and incorporates INT 02-06, INT 02-09
Affected by:	No other pronouncements
Interpreted by:	INT 02-22, INT 03-02

STATUS **1**

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Property and Casualty Reinsurance

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for property and casualty reinsurance. A wide range of methods for structuring reinsurance arrangements can be employed depending on the requirements of individual companies. This statement deals with the more commonly employed methods.

SUMMARY CONCLUSION

General

2. Reinsurance is the assumption by an insurer of all or part of a risk undertaken originally by another insurer. The transaction whereby a reinsurer cedes all or part of the reinsurance it has assumed to another reinsurer is known as a retrocession.

3. Reinsurance has many beneficial purposes. Among them are that it enables an insurance entity to (a) expand its capacity, (b) share large risks with other insurers, (c) spread the risk of potential catastrophes and stabilize its underwriting results, (d) finance expanding volume by sharing the financial burden of reserves, (e) withdraw from a line or class of business, and (f) reduce its net liability to amounts appropriate to its financial resources.

4. Reinsurance agreements are generally classified as treaty or facultative. Treaty reinsurance refers to an arrangement involving a class or type of business written, while facultative reinsurance involves individual risks offered and accepted.

5. Reinsurance coverage can be pro rata (i.e., proportional reinsurance) where the reinsurer shares a pro rata portion of the losses and premium of the ceding entity or excess of loss (i.e., non-proportional) where the reinsurer, subject to a specified limit, indemnifies the ceding entity against the amount of loss in excess of a specified retention. Most reinsurance agreements fall into one of the following categories:

I. Treaty Reinsurance Contracts—Pro Rata:

A. Quota Share Reinsurance—The ceding entity is indemnified against a fixed percentage of loss on each risk covered in the agreement;

B. Surplus Share Reinsurance—The ceding entity establishes a retention or "line" on the risks to be covered and cedes a fraction or a multiple of that line on each policy subject to a specified maximum cession;

II. Treaty Reinsurance Contracts—Excess of Loss:

A. Excess Per Risk Reinsurance—The ceding entity is indemnified, subject to a specified limit, against the amount of loss in excess of a specified retention with respect to each risk covered by a treaty;

B. Aggregate Excess of Loss Reinsurance—The ceding entity is indemnified against the amount by which the ceding entity's net retained losses incurred during a specific period exceed either a predetermined dollar amount or a percentage of the entity's subject premiums for the specific period subject to a specified limit;

III. Treaty Reinsurance Contracts—Catastrophe: The ceding entity is indemnified, subject to a specified limit, against the amount of loss in excess of a specified retention with respect to an accumulation of losses resulting from a catastrophic event or series of events;

IV. Facultative Reinsurance Contracts—Pro Rata: The ceding entity is indemnified for a specified percentage of losses and loss expenses arising under a specific insurance policy in exchange for that percentage of the policy's premium;

V. Facultative Reinsurance Contracts—Excess of Loss: The ceding entity is indemnified, subject to a specified limit, for losses in excess of its retention with respect to a particular risk.

Characteristics of Reinsurance Agreements

6. Common contract provisions that may affect accounting practices include:

a. Reporting responsibility of the ceding entity—Details required and time schedules shall be established;

b. Payment terms—Time schedules, currencies intended, and the rights of the parties to withhold funds shall be established;

c. Payment of premium taxes—Customarily the responsibility of the ceding entity, a recital of nonliability of the reinsurer may be found;

d. Termination—May be on a cut-off or run-off basis. A cut-off provision stipulates that the reinsurer shall not be liable for loss as a result of occurrences taking place after the date of termination. A run-off provision stipulates that the reinsurer shall remain liable for loss under reinsured policies in force at the date of termination as a result of occurrences taking place after the date of termination until such time as the policies expire or are canceled; and

e. Insolvency clause—Provides for the survival of the reinsurer's obligations in the event of insolvency of the ceding entity, without diminution because of the insolvency.

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

Required Terms for Reinsurance Agreements

8. In addition to credit for reinsurance requirements applicable to reinsurance transactions generally, no credit or deduction from liabilities shall be allowed by the ceding entity for reinsurance recoverable where the agreement was entered into after the effective date of these requirements (see paragraphs 107 and 108) unless each of the following conditions is satisfied:

a. The agreement must contain an acceptable insolvency clause;

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

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

d. The agreement must provide for reports of premiums and losses, and payment of losses, no less frequently than on a quarterly basis, unless there is no activity during the period. The report of premiums and losses shall set forth the ceding entity's total loss and loss expense reserves on the policy obligations subject to the agreement, so that the respective obligations of the ceding entity and reinsurer will be recorded and reported on a basis consistent with this statement;

e. The agreement must include a proper reinsurance intermediary clause, if applicable, which stipulates that the credit risk for the intermediary is carried by the assuming insurance entity;

f. With respect to reinsurance contracts involving a certified reinsurer, the agreement must include a proper funding clause, which requires the certified reinsurer to provide and maintain security in an amount sufficient to avoid the imposition of any financial statement penalty on the ceding insurance entity for reinsurance ceded to the certified reinsurer. However, this does not preclude negotiation for higher contractual collateral amounts; and

g. With respect to retroactive reinsurance agreements, the following additional conditions apply:

i. The consideration to be paid by the ceding entity for the retroactive reinsurance must be a sum certain stated in the agreement;

ii. Direct or indirect compensation to the ceding entity or reinsurer is prohibited;

iii. Any provision for subsequent adjustment on the basis of actual experience in regard to policy obligations transferred, or on the basis of any other formula, is prohibited in connection with a retroactive reinsurance transaction, except that provision may be made for the ceding entity's participation in the reinsurer's ultimate profit, if any, under the agreement;

iv. A retroactive reinsurance agreement shall not be canceled or rescinded without the approval of the commissioner of the domiciliary state of the ceding entity.

Reinsurance Agreements with Multiple Cedents

9. Reinsurance agreements with multiple cedents require allocation agreements. The allocation agreement can be part of the reinsurance agreement or a separate agreement. If the agreement has multiple cedents:

a. The allocation must be in writing and

b. The terms of the allocation agreement must be fair and equitable.

Reinsurance Contracts Must Include Transfer of Risk

10. The essential ingredient of a reinsurance contract is the transfer of risk. The essential element of every true reinsurance agreement is the undertaking by the reinsurer to indemnify the ceding entity, i.e., reinsured entity, not only in form but in fact, against loss or liability by reason of the original insurance. Unless the agreement contains this essential element of risk transfer, no credit shall be recorded.(INT 02-22)

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

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

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

a. The reinsurer assumes significant insurance risk under the reinsured portions of the underlying insurance agreements; and

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

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

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

16. Significance of loss shall be evaluated by comparing the present value of all cash flows, determined as described in paragraph 15, with the present value of the amounts paid or deemed to have been paid to the reinsurer. If, based on this comparison, the reinsurer is not exposed to the reasonable possibility of significant loss, the ceding entity shall be considered indemnified against loss or liability relating to insurance risk only if substantially all of the insurance risk relating to the reinsured portions of the underlying insurance agreements has been assumed by the reinsurer. In this narrow circumstance, the reinsurer's economic position is virtually equivalent to having written the insurance contract directly. This condition is met only if insignificant insurance risk is retained by the ceding entity on the retained portions of the underlying insurance contracts, so that the reinsurer's exposure to loss is essentially the same as the reporting entity's.

17. Payment schedules and accumulating retentions from multiple years are contractual features inherently designed to delay the timing of reimbursement to the ceding entity. Regardless of what a particular feature might be called, any feature that can delay timely reimbursement violates the conditions

for reinsurance accounting. Transfer of insurance risk requires that the reinsurer's payment to the ceding entity depend on and directly vary with the amount and timing of claims settled under the reinsured contracts. Contractual features that can delay timely reimbursement prevent this condition from being met. Therefore, any feature that may affect the timing of the reinsurer's reimbursement to the ceding entity shall be closely scrutinized.

Accounting for Reinsurance

18. Reinsurance recoverables shall be recognized in a manner consistent with the liabilities (including estimated amounts for claims incurred but not reported) relating to the underlying reinsured contracts. Assumptions used in estimating reinsurance recoverables shall be consistent with those used in estimating the related liabilities. Certain assets and liabilities are created by entities when they engage in reinsurance contracts. Reinsurance assets meet the definition of assets as defined by *SSAP No. 4—Assets and Nonadmitted Assets* and are admitted to the extent they conform to the requirements of this statement.

19. Accounting for members of a reinsurance pool shall follow the accounting for the pool member which issued the underlying policy.[INT 03-02] Specific accounting rules for underwriting pools and associations are addressed in *SSAP No. 63—Underwriting Pools and Associations Including Intercompany Pools* (SSAP No. 63).

20. Reinsurance recoverable on loss payments is an admitted asset. Notwithstanding the fact that reinsurance recoverables on paid losses may meet the criteria for offsetting under the provisions of *SSAP No. 64—Offsetting and Netting of Assets and Liabilities* (SSAP No. 64), reinsurance recoverables on paid losses shall be reported as an asset without any available offset. Unauthorized reinsurance and reinsurance ceded to certified reinsurers is included in this asset and reflected separately as a liability to the extent required. Penalty for overdue authorized reinsurance shall be reflected as a liability.

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

22. Prospective reinsurance is defined as reinsurance in which a reinsurer agrees to reimburse a ceding entity for losses that may be incurred as a result of future insurable events covered under contracts subject to the reinsurance. Retroactive reinsurance is defined as reinsurance in which a reinsurer agrees to reimburse a ceding entity for liabilities incurred as a result of past insurable events covered under contracts subject to the reinsurance. A reinsurance agreement may include both prospective and retroactive reinsurance provisions.

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

24. It is not uncommon for a reinsurance arrangement to be initiated before the beginning of a policy period but not finalized until after the policy period begins. Whether there was agreement in principle at the beginning of the policy period and, therefore, the agreement is substantively prospective shall be determined based on the facts and circumstances. However, except as respects business assumed by a

U.S. reinsurer from ceding companies domiciled outside the U.S. and not affiliated with such reinsurer, or business assumed by a U.S. reinsurer where either the lead reinsurer or a majority of the capacity on the agreement is domiciled outside the U.S. and is not affiliated with such reinsurer, if an agreement entered into, renewed or amended on or after January 1, 1994 has not been finalized, reduced to a written form and signed by the parties within nine months after the commencement of the policy period covered by the reinsurance arrangement, then the arrangement is presumed to be retroactive and shall be accounted for as a retroactive reinsurance agreement. This presumption shall not apply to: (a) facultative reinsurance contracts, nor to (b) reinsurance agreements with more than one reinsurer which are signed by the lead reinsurer (i.e., the reinsurer setting the terms of the agreement for the reinsurers) within nine months after the commencement of the policy period covered by the reinsurance agreement, nor to (c) reinsurance agreements with more than one reinsurer (whether signed by the lead reinsurer or not) which were entered into, renewed or amended on or before December 31, 1996, (and which were not renewed or amended after that date) if reinsurers representing more than 50% of the capacity on the agreement have signed cover notes, placement slips or similar documents describing the essential terms of coverage and exclusions within nine months after the commencement of the policy period covered by the reinsurance arrangement. Also exempt from this presumption are reinsurance agreements where one of the parties is in conservation, rehabilitation, receivership or liquidation proceedings.

25. Prospective and retroactive provisions included within a single agreement shall be accounted for separately. If separate accounting for prospective and retroactive provisions included within a single agreement is impracticable, the agreement shall be accounted for as a retroactive agreement provided the conditions for reinsurance accounting are met.

Accounting for Prospective Reinsurance Agreements

26. Amounts paid for prospective reinsurance that meet the conditions for reinsurance accounting shall be reported as a reduction of written and earned premiums by the ceding entity and shall be earned over the remaining contract period in proportion to the amount of reinsurance protection provided or, if applicable, until the reinsurer’s maximum liability under the agreement has been exhausted. If the amounts paid are subject to adjustment and can be reasonably estimated, the basis for amortization shall be the estimated ultimate amount to be paid. Reinstatement premium, if any, shall be earned over the period from the reinstatement of the limit to the expiration of the agreement.

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

Accounting for Retroactive Reinsurance Agreements

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

29. All retroactive reinsurance agreements entered into, renewed or amended on or after January 1, 1994 (including subsequent development of such transactions) shall be accounted for and reported in the following manner:

a. The ceding entity shall record, without recognition of the retroactive reinsurance, loss and loss expense reserves on a gross basis on the balance sheet and in all schedules and exhibits;

b. The assuming entity shall exclude the retroactive reinsurance from loss and loss expense reserves and from all schedules and exhibits;

c. The ceding entity and the assuming entity shall report by write-in item on the balance sheet, the total amount of all retroactive reinsurance, identified as retroactive reinsurance reserve ceded or assumed, recorded as a contra-liability by the ceding entity and as a liability by the assuming entity;

d. The ceding entity shall, by write-in item on the balance sheet, restrict surplus resulting from any retroactive reinsurance as a special surplus fund, designated as special surplus from retroactive reinsurance account;

e. The surplus gain from any retroactive reinsurance shall not be classified as unassigned funds (surplus) until the actual retroactive reinsurance recovered exceeds the consideration paid;

f. The special surplus from retroactive reinsurance account for each respective retroactive reinsurance agreement shall be reduced at the time the ceding entity begins to recover funds from the assuming entity in amounts exceeding the consideration paid by the ceding entity under such agreement, or adjusted as provided in paragraph 29.j.;

g. For each agreement, the reduction in the special surplus from retroactive reinsurance account shall be limited to the lesser of (i) the actual amount recovered in excess of consideration paid or (ii) the initial surplus gain resulting from the respective retroactive reinsurance agreement. Any remaining balance in the special surplus from retroactive reinsurance account derived from any such agreement shall be returned to unassigned funds (surplus) upon elimination of all policy obligations subject to the retroactive reinsurance agreement;

h. The ceding entity shall report the initial gain arising from a retroactive reinsurance transaction (i.e., the difference between the consideration paid to the reinsurer and the total reserves ceded to the reinsurer) as a write-in item on the statement of income, to be identified as Retroactive Reinsurance Gain and included under Other Income;

i. The assuming entity shall report the initial loss arising from a retroactive reinsurance transaction, as defined in the preceding paragraph 29.g., as a write-in item on the statement of income, to be identified as Retroactive Reinsurance Loss and included under Other Income;

j. Any subsequent increase or reduction in the total reserves ceded under a retroactive reinsurance agreement shall be reported in the manner described in the preceding paragraphs 29.h. and 29.i., in order to recognize the gain or loss arising from such increase or reduction in reserves ceded. The Special Surplus from Retroactive Reinsurance Account write-in entry on the balance sheet shall be adjusted, upward or downward, to reflect such increase or reduction in reserves ceded. The Special Surplus from Retroactive Reinsurance Account write-in entry shall be equal to or less than the total ceded reserves under all retroactive reinsurance agreements in-force as of the date of the financial statement. Special surplus arising from a retroactive reinsurance transaction shall be considered to be earned surplus (i.e., transferred to unassigned funds (surplus)) only when cash recoveries from the assuming entity exceed the consideration paid by the ceding entity as respects such retroactive reinsurance transaction; and

k. The consideration paid for a retroactive reinsurance agreement shall be reported as a decrease in ledger assets by the ceding entity and as an increase in ledger assets by the assuming entity.

(For an illustration of ceding entity accounting entries see Question 33 in Exhibit A.)

30. Portfolio reinsurance is the transfer of an insurer's entire liability for in force policies or outstanding losses, or both, of a segment of the insurer's business. Loss portfolio transactions are to be accounted for as retroactive reinsurance.

31. The accounting principles for retroactive reinsurance agreements in paragraph 29 shall not apply to the following types of agreements (which shall be accounted for as prospective reinsurance agreements unless otherwise provided in this statement):

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

b. Novations, (i.e., (i) transactions in which the original direct insurer's obligations are completely extinguished, resulting in no further exposure to loss arising on the business novated or (ii) transactions in which the original assuming entity's obligations are completely extinguished) resulting in no further exposure to loss arising on the business novated, provided that (1) the parties to the transaction are not affiliates (or if affiliates, that the transaction has the prior approval of the domiciliary regulators of the parties) and (2) the accounting for the original reinsurance agreement will not be altered from retroactive to prospective;

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

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

e. Reinsurance/retrocession agreements that meet the criteria of property/casualty run-off agreements described in paragraphs 80-83.

32. Retroactive reinsurance agreements resulting in surplus gain to the ceding entity (with or without risk transfer) entered into between affiliates or between insurers under common control (as those terms are defined in Appendix A-440) shall be reported as follows:

a. The consideration paid by the ceding entity shall be recorded as a deposit and reported as a nonadmitted asset; and

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

33. The accounting and reporting provisions applicable to retroactive reinsurance apply to all transactions transferring liabilities in connection with a court-ordered rehabilitation, liquidation, or receivership. The requirement to include stipulated contract provisions in the reinsurance agreements

shall not apply to these transactions, with written approval of the ceding entity's domiciliary commissioner.

34. Novations meeting the requirements of paragraph 31.b. shall be accounted for as prospective reinsurance agreements. The original direct insurer, or the original assuming insurer, shall report amounts paid as a reduction of written and earned premiums, and unearned premiums to the extent that premiums have not been earned. Novated balances (e.g., loss and loss adjustment expense reserves) shall be written off through the accounts, exhibits, and schedules in which they were originally recorded. The assuming insurer shall report amounts received as written and earned premiums, and obligations assumed as incurred losses in the statement of income.

Deposit Accounting

35. To the extent that a reinsurance agreement does not, despite its form, transfer both components of insurance risk, all or part of the agreement shall be accounted for and reported as deposits in the following manner:

a. At the outset of the reinsurance agreement, the net consideration paid by the ceding entity (premiums less commissions or other allowances) shall be recorded as a deposit by the ceding company and as a liability by the assuming entity. The deposit shall be reported as an admitted asset by the ceding company if (i) the assuming company is licensed, accredited or otherwise qualified in the ceding company's state of domicile as described in Appendix A-785 or (ii) there are funds held by or on behalf of the ceding company which meet the requirements of paragraph 18 of Appendix A-785;

b. At subsequent reporting dates, the amount of the deposit/liability shall be adjusted by calculating the effective yield on the deposit agreement to reflect actual payments to date (receipts and disbursements shall be recorded through the deposit/liability accounts) and expected future payments (as discussed below), with a corresponding credit or charge to interest income or interest expense;

c. The calculation of the effective yield shall use the estimated amount and timing of cash flows. If a change in the actual or estimated timing or amount of cash flows occurs, the effective yield shall be recalculated to reflect the revised actual or estimated cash flows. The deposit shall be adjusted to the amount that would have existed at the reporting date had the new effective yield been applied since the inception of the reinsurance agreement. Changes in the carrying amount of the deposit asset/liability resulting from changes in the effective yield shall be recorded as interest income or interest expense;

d. It shall be assumed that any cash transactions for the settlement of losses will reduce the asset/liability accounts by the amount of the cash transferred. When the remaining losses are revalued upward, an increase in the deposit liability shall be recorded as interest expense – by the assuming company. Conversely, the ceding company shall increase its deposit (asset) with an offsetting credit to interest income; and increase its outstanding loss liability with an offsetting charge to incurred losses;

e. No deduction shall be made from the loss and loss adjustment expense reserves on the ceding company's Statement of Financial Position, schedules, and exhibits;

f. The assuming company shall record net consideration to be returned to the ceding company as a liability.

(For an illustration of the provisions of paragraph 35, see Exhibit C)

Assumed Reinsurance

36. Reinsurance premiums receivable at the end of the accounting period are combined with direct business receivables and reported as agents' balances or uncollected premiums. Where the ceding entity withholds premium funds pursuant to the terms of the reinsurance agreement, such assets shall be shown by the assuming entity as funds held by or deposited with reinsured companies. Reporting entities shall record any interest earned or receivable on the funds withheld as a component of aggregate write-ins for miscellaneous income.

37. If the assuming entity receives reinsurance premium prior to the effective date of the reinsurance contract, consistent with *SSAP No. 53—Property Casualty Contracts-Premiums*, paragraph 15, advance premiums shall be reported as a liability in the statutory financial statement and not considered income until the effective date of the coverage. Such amounts are not included in written premium or the unearned premium reserve. If the assuming entity receives reinsurance premium after the effective date of the reinsurance contract but prior to the due date, the amount received shall be reported as a reduction of the asset for deferred but not yet due (earned but unbilled premiums).

38. Reinsurance premiums more than 90 days overdue shall be nonadmitted except (a) to the extent the assuming entity maintains unearned premium and loss reserves as to the ceding entity, under principles of offset accounting as discussed in SSAP No. 64, or (b) where the ceding entity is licensed and in good standing in assuming entity's state of domicile. Reinsurance premiums are due pursuant to the original contract terms (as the agreement stood on the date of execution). In the absence of a specific contract date, reinsurance premiums will be deemed due thirty (30) days after the date on which (i) notice or demand of premium due is provided to the ceding entity or (ii) the assuming entity books the premium (see *SSAP No. 6—Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due From Agents and Brokers*).

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

40. Proportional reinsurance (i.e., first dollar pro rata reinsurance) premiums shall be allocated to the appropriate annual statement lines of business in the Underwriting and Investment exhibits. Non-proportional assumed reinsurance premiums shall be classified as reinsurance under the appropriate subcategories.

41. Assumed retroactive reinsurance premiums shall be excluded from all schedules and exhibits as addressed in paragraph 29.

42. Amounts payable by reinsurers on losses shall be classified as unpaid losses. Assumed reinsurance payable on paid losses shall be classified as a separate liability item on the balance sheet. IBNR losses on assumed reinsurance business shall be netted with ceded losses on the balance sheet and listed separately by annual statement line of business in the Underwriting and Investment exhibits.

Ceded Reinsurance

43. Ceded reinsurance premiums payable (net of ceding commission) shall be classified as a liability. Consistent with SSAP No. 64, ceded reinsurance premiums payable may be deducted from amounts due from the reinsurer, such as amounts due on assumed reinsurance, when a legal right of offset exists.

44. With regard to reinsurance premium paid prior to the effective date of the contract, the ceding entity shall reflect the prepaid item as a write-in admitted asset and it should not be recognized in the income statement until the effective date of the coverage. Such amounts are not included in ceded written premiums or ceded unearned premium but should be subject to impairment analysis. With regard to reinsurance premium paid by ceding entity after the reinsurance contract is in effect but prior to the due date, the ceding entity shall treat this item as a reduction to the liability for ceded reinsurance premiums payable. That liability reflects not only premiums unpaid but also amounts booked but deferred and not yet due.

45. Amounts withheld by the ceding entity that would otherwise be payable under the reinsurance agreement shall be reported as funds held by entity under reinsurance treaties. Reporting entities shall record any interest due or payable on the amounts withheld as a component of aggregate write-ins for miscellaneous income.

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

47. Ceded retroactive reinsurance premiums shall be excluded from all schedules and exhibits as addressed in paragraph 29.

48. Reinsurance accounting shall not be allowed for modeled trigger securitizations. Modeled trigger securitization transactions do not result in the kind of indemnification (in form and in fact) required by this SSAP, and are therefore not eligible for reinsurance accounting. Modeled trigger transactions should be evaluated as securitization transactions rather than as reinsurance transactions and should receive the accounting treatment recommended for securitization transactions.

Adjustable Features/Retrospective Rating

49. Reinsurance treaties may provide for adjustment of commission, premium, or amount of coverage, based on loss experience. The accounting for common examples is outlined in the following paragraphs:

Commission Adjustments

50. An accrual shall be maintained for the following adjustable features based upon the experience recorded for the accounting period:

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

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

Premium Adjustments

51. If the reinsurance agreement incorporates an obligation on the part of the ceding entity to pay additional premium to the assuming entity based upon loss experience under the agreement, a liability in the amount of such additional premium shall be recognized by the ceding entity during the accounting period in which the loss event(s) giving rise to the obligation to pay such additional premium occur(s). The assuming entity shall recognize an asset in a consistent manner. If the reinsurance agreement

incorporates an obligation on the part of the assuming entity to refund to the ceding entity any portion of the consideration received by the assuming entity based upon loss experience under the agreement, an asset in the amount of any such refund shall be recognized by the ceding entity during the accounting period in which the loss event(s) giving rise to the obligation to make such refund occur(s). The initial provisional or deposit premium is recalculated retrospectively, based on loss experience under the agreement during a specified period of time; the calculation is often based on an average over a period of years. The assuming entity shall recognize a liability in a consistent manner.

Adjustments in the Amount of Coverage

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

Impairment

53. Include as a nonadmitted asset, amounts accrued for premium adjustments on retrospectively rated reinsurance agreements with respect to which all uncollected balances due from the ceding company have been classified as nonadmitted.

Commissions

54. Commissions payable on reinsurance assumed business shall be included as an offset to Agents’ Balances or Uncollected Premiums. Commissions receivable on reinsurance ceded business shall be included as an offset to Ceded Reinsurance Balances Payable.

55. If the ceding commission paid under a reinsurance agreement exceeds the anticipated acquisition cost of the business ceded, the ceding entity shall establish a liability, equal to the difference between the anticipated acquisition cost and the reinsurance commissions received, to be amortized pro rata over the effective period of the reinsurance agreement in proportion to the amount of coverage provided under the reinsurance contract.

Unauthorized Reinsurance

56. If the assuming reinsurer is not authorized, otherwise approved or certified to do business in the ceding entity’s domiciliary state, the assumed reinsurance is considered to be unauthorized. A provision is established to offset credit taken in various balance sheet accounts for reinsurance ceded to unauthorized reinsurers. Credit for reinsurance with unauthorized reinsurers shall be permitted to the extent the ceding entity holds collateral in accordance with appendix A-785. If the assuming reinsurer is not licensed or is not an authorized reinsurer in the domiciliary state of the ceding entity or if the reinsurance does not meet required standards, the ceding entity must set up a provision for reinsurance liability in accordance with the NAIC Annual Statement Instructions for Property and Casualty Insurance Companies Schedule F.

57. The provision defined in paragraph 56 shall never be less than zero for any particular reinsurer. The change in liability for unauthorized reinsurance is a direct charge or credit to surplus.

Reinsurance Ceded to a Certified Reinsurer

58. The term certified reinsurer shall have the same meaning as set forth in the Appendix A-785.

59. Credit for reinsurance ceded to a certified reinsurer is permitted if security is held by or on behalf of the ceding entity in accordance with the certified reinsurer's rating assigned by the domestic state of the ceding insurance entity, and in accordance with Appendix A-785 of this manual. However, nothing in this guidance would prohibit the parties to a reinsurance agreement from agreeing to provisions establishing security requirements that exceed the minimum security requirements established for certified reinsurers.

60. An upgrade in a certified reinsurer's assigned rating applies on a prospective basis, i.e., the revised collateral requirement applies only to contracts entered into or renewed on or after the effective date of the new rating (see A-785). A downgrade in a certified reinsurer's rating applies on a retroactive basis, i.e., the revised collateral requirement applies to all reinsurance obligations incurred by the assuming insurer under its certified reinsurer status. Notwithstanding a change in a certified reinsurer's rating or revocation of its certification, a reporting entity that has ceded reinsurance to such certified reinsurer is allowed a three (3)-month grace period before recording a provision for reinsurance due to collateral deficiency associated with such rating downgrade and increased collateral requirement for all reinsurance ceded to such assuming insurer under its certified reinsurer status, unless the reinsurance is found by the commissioner of the reporting entity's domestic state to be at high risk of uncollectibility.

61. A provision is established by the ceding entity to offset credit taken in various balance sheet accounts for reinsurance ceded to a certified reinsurer in an amount proportionate to any deficiency in the amount of acceptable security that is provided by the certified reinsurer as compared to the amount of security that is required to be provided in accordance with the certified reinsurer's rating. The calculation of the provision for a collateral shortfall is separate from the calculation of the provision for overdue reinsurance ceded to certified reinsurers and shall be calculated in accordance with the NAIC Annual Statement Instructions for Property and Casualty Insurance Companies.

62. The provision defined in paragraph 61 shall never be less than zero for any particular certified reinsurer. The change in liability for reinsurance with certified reinsurers is a direct charge or credit to surplus.

Funds Held Under Reinsurance Treaties

63. This liability is established for funds deposited by or contractually withheld from reinsurers or reinsurers.

Provision for Reinsurance

64. The NAIC Annual Statement Instructions for Property and Casualty Companies for Schedule F—Provision for Overdue Reinsurance, provide for a minimum reserve for uncollectible reinsurance with an additional reserve required if an entity's experience indicates that a higher amount should be provided. The minimum reserve Provision for Reinsurance is recorded as a liability and the change between years is recorded as a gain or loss directly to unassigned funds (surplus). Any reserve over the minimum amount shall be recorded on the statement of income by reversing the accounts previously utilized to establish the reinsurance recoverable.

65. The provision for reinsurance is calculated separately for unauthorized, authorized and certified reinsurers. An authorized reinsurer is licensed, accredited or approved by the ceding entity's state of domicile; a certified reinsurer is certified by the ceding entity's state of domicile; an unauthorized reinsurer is not so licensed, accredited, approved or certified.

Asbestos and Pollution Contracts – Counterparty Reporting Exception

66. Upon approval by the domiciliary regulator(s) of the ceding entity (either the original direct insurer in the case of a reinsurance agreement or the original assuming reinsurer in the case of a retrocession agreement), an exception may be allowed with respect to a retroactive reinsurance agreement providing substantially duplicate coverage as prior reinsurance agreements on asbestos and/or pollution exposures. Under this exception, a reporting entity may aggregate reinsurers into one line item in Schedule F reflecting the counterparty under the retroactive agreement for the purposes of determining the Provision for Reinsurance. This exception would allow the Provision for Reinsurance to reflect that amounts have been recovered by the reporting entity under the duplicate coverage provided by the retroactive contract, and that inuring balances from the original contract(s) are payable to the retroactive counterparty. An agreement must meet all of the requirements in paragraphs 66.a. through 66.e. in order to be considered for this exception.

a. The underlying agreement clearly indicates the credit risk associated with the collection of the reporting entity's inuring reinsurance recoverables and losses related to the credit risk will be covered by the retroactive reinsurance counterparty.

b. The retroactive reinsurance agreement must transfer significant risk of loss.

c. The assuming retroactive reinsurance counterparty must have a financial strength rating from at least two nationally recognized statistical rating organizations (NRSRO), the lowest of which is higher than or equal to the NRSRO ratings of the underlying third-party reinsurers.

d. The transaction is limited to reinsurance recoverables attributable to asbestos, and/or pollution.

e. The recoverables from the inuring reinsurers remain subject to credit analysis and contingent liability analysis.

67. The reporting entity will continue to detail the reporting of original reinsurers that were aggregated for one line reporting per paragraph 66 as provided in the Annual Statement Instructions. The aggregation reporting in schedule F is only to the extent that inuring balances from original reinsurance contracts are also payable to the retroactive reinsurance counterparty. This guidance is not intended to allow credit for reinsurance with respect to any amounts that do not meet the requirements of Appendix A-785. This guidance is not intended to otherwise change the application of retroactive accounting guidance for the retroactive portions of the contract that are not duplicative of the original reinsurance. Other portions of the retroactive contracts should continue to follow guidance applicable to retroactive accounting and reporting.

Syndicated Letters of Credit

68. With a Syndicated Letter of Credit (Syndicated LC), the reinsurer enters into an agreement with a group of banks (the "Issuing Banks") and an agent bank (the "Agent"). Each Issuing Bank and the Agent is an NAIC-approved bank and a "qualified bank". This agreement requires the Agent to issue, on behalf of the each of the Issuing Banks, letters of credit in favor of the ceding insurer. The credit is issued (as an administrative matter) only through the Agent's letter of credit department. Each issuing bank signs the

Syndicated LC through the Agent, as its attorney-in-fact. Syndicated LCs are consistent with A-785, in that the Syndicated LC is the legal equivalent of multiple letters of credit separately issued by each of the issuing banks. Reporting entities shall take a reduction in the liability on account of reinsurance recoverables secured by the Syndicated LC if all of the following conditions are met:

a. All listed banks on the letter of credit are qualified and meet the criteria of the NAIC SVO approved bank listing;

b. Banks are severally and not jointly liable; and

c. Specific percentages for each assuming bank are listed in the letter of credit.

Disputed Items

69. Occasionally a reinsurer will question whether an individual claim is covered under a reinsurance agreement or may even attempt to nullify an entire agreement. A ceding entity, depending upon the individual facts, may or may not choose to continue to take credit for such disputed balances. A ceding entity shall take no credit whatsoever for reinsurance recoverables in dispute with an affiliate.

70. Items in dispute are those claims with respect to which the ceding entity has received formal written communication from the reinsurer denying the validity of coverage.

Uncollectible Reinsurance

71. Uncollectible reinsurance balances shall be written off through the accounts, exhibits, and schedules in which they were originally recorded.

Commutations

72. A commutation of a reinsurance agreement, or any portion thereof, is a transaction which results in the complete and final settlement and discharge of all, or the commuted portion thereof, present and future obligations between the parties arising out of the reinsurance agreement.

73. In commutation agreements, an agreed upon amount determined by the parties is paid by the reinsurer to the ceding entity. The ceding entity immediately eliminates the reinsurance recoverable recorded against the ultimate loss reserve and records the cash received as a negative paid loss. Any net gain or loss shall be reported in underwriting income in the statement of income.

74. The reinsurer eliminates a loss reserve carried at ultimate cost for a cash payout calculated at present value. Any net gain or loss shall be reported in underwriting income in the statement of income.

75. Commuted balances shall be written off through the accounts, exhibits, and schedules in which they were originally recorded.

National Flood Insurance Program

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

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

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

79. Policies written by the reporting entity under the National Flood Insurance Program are considered insurance policies issued by the reporting entity, with reinsurance ceded to FEMA. (Such policies are not considered uninsured plans under *SSAP No. 47—Uninsured Plans* (SSAP No. 47.) Balances due from or to FEMA shall be reported as ceded reinsurance balances receivable or payable. The commission and fee allowances received from FEMA shall be reported consistent with reinsurance ceding commission.

Accounting for the Transfer of Property and Casualty Run-Off Agreements

80. Property and casualty run-off agreements are reinsurance or retrocession agreements that are intended to transfer essentially all of the risks and benefits of a specific line of business or market segment that is no longer actively marketed by the transferring insurer or reinsurer. A property and casualty run-off agreement is not a novation as the transferring insurer or reinsurer remains primarily liable to the policyholder or ceding entity under the original contracts of insurance or reinsurance. Reinsurance agreements between affiliates or between insurers under common control (as those terms are defined in Appendix A-440) are not eligible for the exception for property and casualty run-off agreements in paragraph 31.e.

Criteria

81. The accounting treatment for property and casualty run-off agreements must be approved by the domiciliary regulators of the transferring entity (either the original direct insurer in the case of a reinsurance agreement or the original assuming reinsurer in the case of a retrocession agreement) and the assuming entity. If the transferring entity and assuming entity are domiciled in the same state, then the regulator of the state where the majority of the transferred liabilities is located shall be asked to approve the accounting treatment. In determining whether to approve an agreement for this accounting treatment, the regulators shall require the following:

a. Assuming Entity Properly Licensed – The entity assuming the run-off agreement must have the appropriate authority or license to write the business being assumed.

b. Limits and Coverages – The reinsurance or retrocession agreement shall provide the same limits and coverages that were afforded in the original insurance or reinsurance agreement.

c. Non-recourse – The reinsurance or retrocession agreement shall not contain any adjustable features or profit share or retrospective rating, and there shall be no recourse (other than normal representations and warranties that would be associated with a purchase and sale agreement) directly or indirectly against the transferring entity.

d. Risk Transfer – The reinsurance or retrocession agreement must meet the requirements of risk transfer as described in this statement.

e. Financial Strength of Reinsurer – The assuming reinsurer shall have a financial strength rating from at least two independent rating agencies (from NAIC credit rating providers (CRP)) which is equal to or greater than the current ratings of the transferring entity. The lowest financial strength rating received from an NAIC acceptable rating organization rating agency will be used to compare the financial strength ratings of the transferring and assuming entities.

f. Assessments – The assuming reinsurer or retrocessionaire (if required in the original reinsurance contract) shall be financially responsible for any and all assessments, including guaranty fund assessments, that are assessed against the transferring entity related to the insurance business being assumed.

g. Applicable Only to "Run-off" Business – The reinsurance or retrocession agreement shall only cover liabilities relating to a line(s) of business or specific market segments no longer actively marketed by the transferring entity.

h. Non-cancelable Reinsurance – The reinsurance or retrocession agreement shall provide that the reinsurance or retrocessional coverage provided by the proposed agreement cannot be cancelable by either party for any reason. (However, this provision will not override standard contracts law and principles and will not prevent any remedies, including rescission or termination that might be available for breach, misrepresentation, etc.)

Statutory Schedules and Exhibits

82. At the inception of the transaction, the transferring entity shall record the consideration paid to the assuming entity as a paid loss. If the consideration paid by the transferring entity is less than the loss reserves transferred, the difference shall be recorded by the ceding entity as a decrease in losses incurred. The assuming entity shall record the consideration received as a negative paid loss. In addition, the transferring entity shall record an increase to ceded reinsurance recoverable for the amount of the transferred reserve. Journal entries illustrating these transactions, including situations in which the transaction includes an unearned premium reserve, are included in Exhibit B of this Statement.

83. The assuming entity will report the business in the same line of business as reported by the original insurer or reinsurer. The assuming entity will report the business at the same level of detail using the appropriate statutory schedules and exhibits.

Disclosures

84. Unsecured Reinsurance Recoverables:

a. If the entity has with any individual reinsurers, authorized, unauthorized, or certified an unsecured aggregate recoverable for losses, paid and unpaid including IBNR, loss adjustment expenses, and unearned premium, that exceeds 3% of the entity's policyholder surplus, list each individual reinsurer and the unsecured aggregate recoverable pertaining to that reinsurer; and

b. If the individual reinsurer is part of a group, list the individual reinsurers, each of its related group members having reinsurance with the reporting entity, and the total unsecured aggregate recoverables for the entire group.

85. Reinsurance Recoverables in Dispute—Reinsurance recoverable on paid and unpaid (including IBNR) losses in dispute by reason of notification, arbitration or litigation shall be identified if the

amounts in dispute from any entity (and/or affiliate) exceed 5% of the ceding entity's policyholders surplus or if the aggregate of all disputed items exceeds 10% of the ceding entity's policyholders surplus. Notification means a formal written communication from a reinsurer denying the validity of coverage.

86. Uncollectible Reinsurance—Describe uncollectible reinsurance written off during the year reported in the following annual statement classifications, including the name(s) of the reinsurer(s):

a. Losses incurred;

b. Loss adjustment expenses incurred;

c. Premiums earned; and

d. Other.

87. Commutation of Ceded Reinsurance—Describe commutation of ceded reinsurance during the year reported in the following annual statement classifications, including the name(s) of the reinsurer(s):

a. Losses incurred;

b. Loss adjustment expenses incurred;

c. Premiums earned; and

d. Other.

88. Retroactive Reinsurance—The table illustrated in the NAIC Annual Statement Instructions for Property and Casualty Companies under Retroactive Reinsurance in the Notes to Financial Statements section shall be completed for all retroactive reinsurance agreements that transfer liabilities for losses that have already occurred and that will generate special surplus transactions. The insurer (assuming or ceding) shall assign a unique number to each retroactive reinsurance agreement and shall utilize this number for as long as the agreement exists. Transactions utilizing deposit accounting shall not be reported in this note.

89. Reinsurance Assumed and Ceded—The tables illustrated in the NAIC Annual Statement Instructions for Property and Casualty Companies under "Reinsurance Assumed and Ceded in the Notes to Financial Statements" section shall be completed as follows:

a. The financial statements shall disclose the maximum amount of return commission which would have been due reinsurers if all reinsurance were canceled with the return of the unearned premium reserve; and

b. The financial statements shall disclose the accrual of additional or return commission, predicated on loss experience or on any other form of profit sharing arrangements as a result of existing contractual arrangements.

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

91. Disclosures for paragraphs 92-97 represent annual statement interrogatories, which are required to be included with the annual audit report beginning with audit reports on financial statements as of and for the period ended December 31, 2006. The disclosures required within paragraphs 92-97 shall be included in accompanying supplemental schedules of the annual audit report beginning in year-end 2006.

These disclosures shall be limited to reinsurance contracts entered into, renewed or amended on or after January 1, 1994. This limitation applies to the annual audit report only and does not apply to the statutory annual statement interrogatories and the reinsurance summary supplemental filing.

92. Disclose if any risks are reinsured under a quota share reinsurance contract with any other entity that includes a provision that would limit the reinsurer's losses below the stated quota share percentage (e.g. a deductible, a loss ratio corridor, a loss cap, an aggregate limit or any similar provisions)? If yes, indicate the number of reinsurance contracts containing such provisions and if the amount of reinsurance credit taken reflects the reduction in quota share coverage caused by any applicable limiting provision(s).

93. Disclose if the reporting entity ceded any risk under any reinsurance contract (or under multiple contracts with the same reinsurer or its affiliates) for which during the period covered by the statement: (i) it recorded a positive or negative underwriting result greater than 5% of prior year-end surplus as regards policyholders or it reported calendar year written premium ceded or year-end loss and loss expense reserves ceded greater than 5% of prior year-end surplus as regards policyholders; (ii) it accounted for that contract as reinsurance and not as a deposit; and (iii) the contract(s) contain one or more of the following features or other features that would have similar results:

a. A contract term longer than two years and the contract is noncancellable by the reporting entity during the contract term;

b. A limited or conditional cancellation provision under which cancellation triggers an obligation by the reporting entity, or an affiliate of the reporting entity, to enter into a new reinsurance contract with the reinsurer, or an affiliate of the reinsurer;

c. Aggregate stop loss reinsurance coverage;

d. A unilateral right by either party (or both parties) to commute the reinsurance contract, whether conditional or not, except for such provisions which are only triggered by a decline in the credit status of the other party;

e. A provision permitting reporting of losses, or payment of losses, less frequently than on a quarterly basis (unless there is no activity during the period); or

f. Payment schedule, accumulating retentions from multiple years or any features inherently designed to delay timing of the reimbursement to the ceding entity.

94. Disclose if the reporting entity during the period covered by the statement ceded any risk under any reinsurance contract (or under multiple contracts with the same reinsurer or its affiliates) for which during the period covered by the statement it recorded a positive or negative underwriting result greater than 5% of prior year-end surplus as regards policyholders or it reported calendar year written premium ceded or year-end loss and loss expense reserves ceded greater than 5% of prior year-end surplus as regards policyholders; excluding cessions to approved pooling arrangements or to captive insurance companies that are directly or indirectly controlling, controlled by, or under common control with (i) one or more unaffiliated policyholders of the reporting entity, or (ii) an association of which one or more unaffiliated policyholders of the reporting entity is a member, where:

a. The written premium ceded to the reinsurer by the reporting entity or its affiliates represents fifty percent (50%) or more of the entire direct and assumed premium written by the reinsurer based on its most recently available financial statement; or

b. Twenty–five percent (25%) or more of the written premium ceded to the reinsurer has been retroceded back to the reporting entity or its affiliates in separate reinsurance contract.

95. If affirmative disclosure is required for paragraph 93 or 94, provide the following information:

a. A summary of the reinsurance contract terms and indicate whether it applies to the contracts meeting paragraph 93 or 94;

b. A brief discussion of management's principal objectives in entering into the reinsurance contract including the economic purpose to be achieved; and

c. The aggregate financial statement impact gross of all such ceded reinsurance contracts on the balance sheet and statement of income.

96. Except for transactions meeting the requirements of paragraph 31, disclose if the reporting entity ceded any risk under any reinsurance contract (or multiple contracts with the same reinsurer or its affiliates) during the period covered by the financial statement, and either:

a. Accounted for that contract as reinsurance (either prospective or retroactive) under statutory accounting principles (SAP) and as a deposit under generally accepted accounting principles (GAAP); or

b. Accounted for that contract as reinsurance under GAAP and as a deposit under SAP.

97. If affirmative disclosure is required for paragraph 96, explain in a supplemental filing why the contract(s) is treated differently for GAAP and SAP.

98. Disclosures for the Transfer of Property and Casualty Run-off Agreements

a. Disclose if the reporting entity has entered into any agreements which have been approved by their domiciliary regulator and have qualified pursuant to paragraph 31.e. (also see paragraphs 80-83).

b. If affirmative, provide a description of the agreement and the amount of consideration paid and liabilities transferred.

99. The financial statements shall disclose the following with respect to reinsurance agreements which qualify for reinsurer aggregation in accordance with paragraphs 66-67:

a. A description of the significant terms of the reinsurance agreement, including established limits and collateral, and

b. The amount of unexhausted limit as of the reporting date.

100. The financial statements shall disclose the following with respect to reinsurance agreements that have been accounted for as deposits:

a. A description of the reinsurance agreements.

b. Any adjustment of the amounts initially recognized for expected recoveries. The individual components of the adjustment (e.g., interest accrual, change due to a change in estimated or actual cash flow) shall be disclosed separately.

101. The financial statements shall disclose the impact on any reporting period in which a certified reinsurer's rating has been downgraded or its certified reinsurer status is subject to revocation and additional collateral has not been received as of the filing date. The disclosure should include the following:

a. Name of certified reinsurer downgraded or subject to revocation of certified reinsurer status and relationship to the reporting entity;

b. Date of downgrade or revocation and jurisdiction of action;

c. Collateral percentage requirements pre and post downgrade or revocation;

d. Net ceded recoverable subject to collateral;

e. As of the end of the current quarter, the estimated impact of the collateral deficiency to the reporting entity as a result of the assuming entity's downgrade or revocation of certified reinsurer status. (At year-end the actual impact of the collateral deficiency on the provision for reinsurance shall be disclosed.)

102. U.S. domiciled reinsurers are eligible for certified reinsurer status. If the reporting entity is a certified reinsurer, the financial statements shall disclose the impact on any reporting period in which its certified reinsurer rating is downgraded or status as a certified reinsurer is subject to revocation. Such disclosure shall include information similar to paragraphs 101.b., 101.c. and 101.d. and the expectation of its certified reinsurer's ability to meet the increased requirements.

103. Refer to the preamble for further discussion regarding disclosure requirements.

Relevant Literature

104. This statement adopts with modification *FASB Statement No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts* (FAS 113) and FASB *Emerging Issues Task Force No. 93-6, Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises* for the following:

a. Reinsurance recoverables on unpaid case-basis and incurred but not reported losses and loss adjustment expenses shall be reported as a contra-liability netted against the liability for gross losses and loss adjustment expenses;

b. Amounts paid for prospective reinsurance that meet the conditions for reinsurance accounting shall be reported as a reduction of unearned premiums;

c. The gain created by a retroactive reinsurance agreement because the amount paid to the reinsurer is less than the gross liabilities for losses and loss adjustment expenses ceded to the reinsurer is reported in the statement of income as a write-in gain in other income by the ceding entity and a write-in loss by the assuming entity. The gain created by a retroactive reinsurance agreement is restricted as a special surplus account until the actual retroactive reinsurance recovered is in excess of the consideration paid;

d. This statement requires that a liability (provision for reinsurance) be established through a provision reducing unassigned funds (surplus) for unsecured reinsurance recoverables from unauthorized or certified reinsurers and for certain overdue balances due from authorized reinsurers;

e. Some reinsurance agreements contain adjustable features that provide for adjustment of commission, premium or amount of coverage, based on loss experience. This statement requires that the asset or liability arising from the adjustable feature be computed based on experience to date under the agreement, and the impact of early termination may only be considered at the time the agreement has actually been terminated;

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

g. This statement requires that reinsurance recoverables on unpaid losses and loss adjustment expenses be presented as a contra-liability. Requirements for offsetting and netting are addressed in SSAP No. 64.

105. This statement adopts American Institute of Certified Public Accountants (AICPA*) Statement of Position 98-7, Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That Do Not Transfer Insurance Risk* (SOP 98-7) paragraphs 10-12 and 19 (subsection b only). This statement rejects AICPA SOP 98-7 paragraphs 13-17 and 19 (subsections a and c).

106. This statement rejects AICPA *Statement of Position No. 92-5, Accounting for Foreign Property and Liability Reinsurance*. This statement incorporates Appendix A-785 as applicable.

Effective Date and Transition

107. This statement shall apply to:

a. Reinsurance agreements entered into, renewed, or amended on or after January 1, 1994. An amendment is any revision or adjustment of contractual terms. The payment of premiums or reimbursement of losses recoverable under the agreement shall not constitute an amendment; and

b. Reinsurance agreements in force on January 1, 1995, which cover losses occurring or claims made on or after that date on policies reinsured under such agreements.

108. The guidance shall not apply to:

a. Reinsurance agreements which cover only losses occurring or claims made before January 1, 1994, and which were entered into before January 1, 1994, and were not subsequently renewed or amended; and

b. Reinsurance agreements that expired before and were not renewed or amended after January 1, 1995.

109. The guidance in paragraphs 49-53 shall be effective for all accounting periods beginning on or after January 1, 1996, and shall apply to reinsurance agreements entered into, renewed or amended on or after January 1, 1994.

110. This statement, including the guidance in paragraph 35 incorporated from SSAP No. 75, is effective for years beginning January 1, 2001. Changes resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors.*

a. Revisions to paragraph 31.e., related to paragraphs 80-83, and disclosures in paragraph 98 documented in *Issue Paper No. 137—Transfer of Property and Casualty Reinsurance Run-off Agreements* are effective for contracts entered on or after January 1, 2010.

b. The guidance in paragraphs 35, 100 and 105 was previously included within *SSAP No. 75—Reinsurance Deposit Accounting—An Amendment to SSAP No. 62R, Property and Casualty Reinsurance* (SSAP No. 75) and was also effective for years beginning January. 1, 2001. In 2011, the guidance from SSAP No. 75 was incorporated within this statement, with SSAP No. 75 nullified. The original guidance included in this statement for deposit accounting, as well as the original guidance adopted in SSAP No. 75, are retained for historical purposes in Issue Paper No. 104. The guidance in paragraph 48 was originally contained within *INT 02-06: Indemnification in Modeled Trigger Transactions* and was effective June 9, 2002. The guidance in paragraph 68 was originally contained within *INT 02-09: A-785 and Syndicated Letters of Credit* and was effective September 12, 2004.

c. The guidance related to certified reinsurers is applicable only to cedants domiciled in states that have enacted/promulgated the new collateral framework and only for their cessions to reinsurers certified under that domestic law/rule. The requirements applicable to contracts with certified reinsurers shall be effective for all reporting periods beginning on or after December 31, 2012.

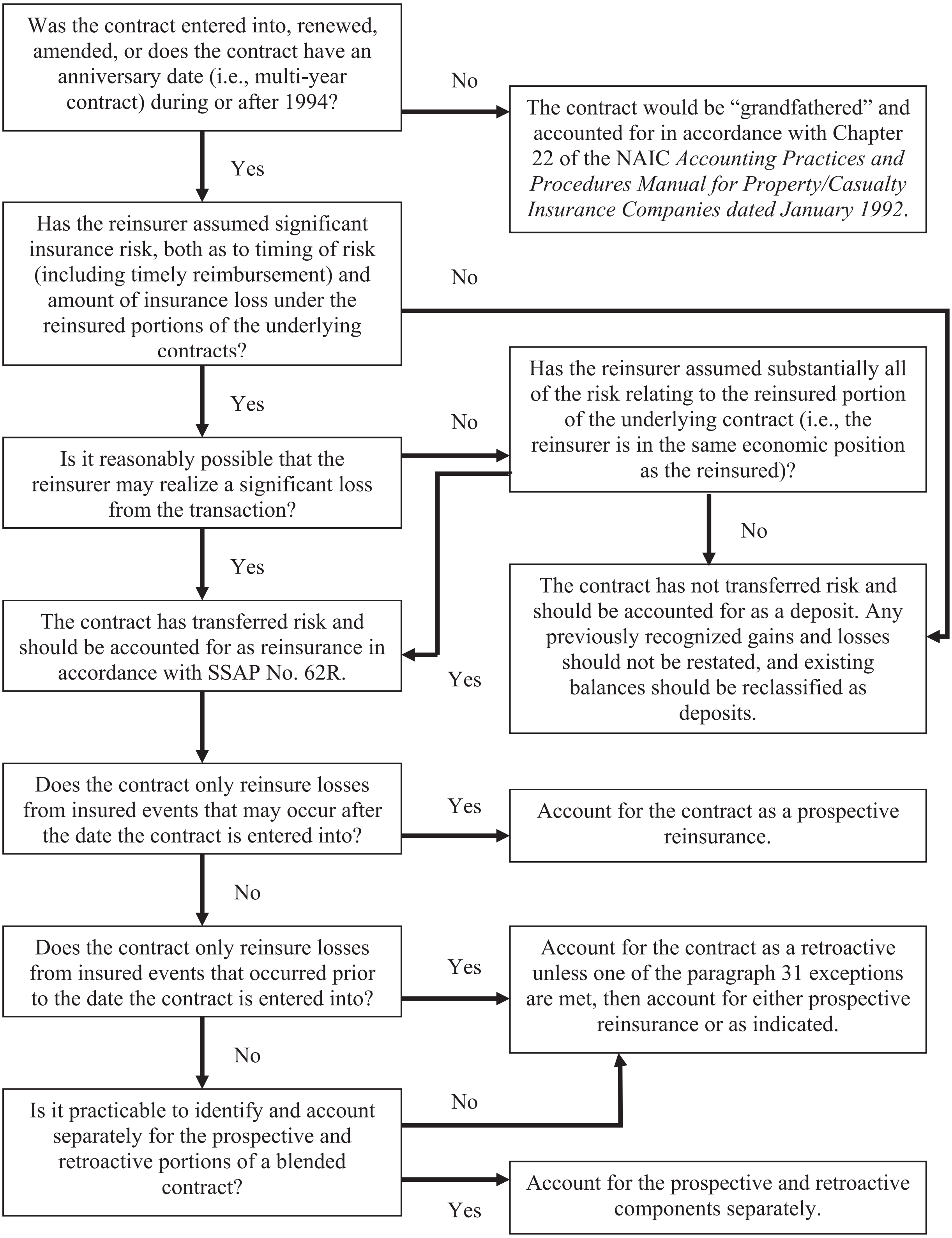
111. The guidance in paragraphs 66-67 and 99 allowing retroactive reinsurance exceptions for asbestos and pollution contracts is effective for all accounting periods beginning on or after January 1, 2014.

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 75—Property and Casualty Reinsurance*
- *Issue Paper No. 104—Reinsurance Deposit Accounting – An Amendment to SSAP No. 62R—Property and Casualty Reinsurance*
- *Issue Paper No. 137—Transfer of Property and Casualty Reinsurance Run-off Agreements*

CLASSIFYING REINSURANCE CONTRACTS



Was the contract entered into, renewed, amended, or does the contract have an anniversary date (i.e., multi-year contract) during or after 1994?

The contract would be "grandfathered" and accounted for in accordance with Chapter 22 of the NAIC *Accounting Practices and Procedures Manual for Property/Casualty Insurance Companies dated January 1992*.

Has the reinsurer assumed significant insurance risk, both as to timing of risk (including timely reimbursement) and amount of insurance loss under the reinsured portions of the underlying contracts?

Has the reinsurer assumed substantially all of the risk relating to the reinsured portion of the underlying contract (i.e., the reinsurer is in the same economic position as the reinsured)?

Is it reasonably possible that the reinsurer may realize a significant loss from the transaction?

The contract has not transferred risk and should be accounted for as a deposit. Any previously recognized gains and losses should not be restated, and existing balances should be reclassified as deposits.

The contract has transferred risk and should be accounted for as reinsurance in accordance with SSAP No. 62R.

Does the contract only reinsure losses from insured events that may occur after the date the contract is entered into?

Account for the contract as a prospective reinsurance.

Does the contract only reinsure losses from insured events that occurred prior to the date the contract is entered into?

Account for the contract as a retroactive unless one of the paragraph 31 exceptions are met, then account for either prospective reinsurance or as indicated.

Is it practicable to identify and account separately for the prospective and retroactive portions of a blended contract?

Account for the prospective and retroactive components separately.

EXHIBIT A – IMPLEMENTATION QUESTIONS AND ANSWERS

Applicability

1. Q: The accounting practices in SSAP No. 62R specify the accounting and reporting for reinsurance contracts. What contracts are considered reinsurance contracts for purposes of applying these accounting practices?

   A: Any transaction that indemnifies an insurer against loss or liability relating to insurance risk shall be accounted for in accordance with the accounting practices included in SSAP No. 62R. Therefore, all contracts, including contracts that may not be structured or described as reinsurance, shall be accounted for as reinsurance when those conditions are met.

2. Q: The provisions of this statement will apply to (a) reinsurance contracts entered into, renewed or amended on or after January 1, 1994, and (b) any other reinsurance contracts that are in force on January 1, 1995 and cover insurable events on the underlying insurance policies that occur on or after that date. What contracts would be exempt from the new accounting rules included in SSAP No. 62R?

   A: The only exempt contracts are:

   1) Purely retroactive reinsurance contracts that cover only insured events occurring before January 1, 1994, provided those contracts were entered into before that date and are not subsequently amended and

   2) Contracts that expired before January 1, 1995 and are not amended after that date.

3. Q: This statement is to be applied to contracts which are amended on or after January 1, 1994. What if the change in terms is not significant, or the terms changed have no financial effect on the contract?

   A: In general, the term amendment should be viewed broadly to include all but the most trivial changes. Examples of amendments include, but are not limited to, replacing one assuming entity with another (including an affiliated entity), or modifying the contract's limit, coverage, premiums, commissions, or experience-related adjustable features. No distinction is made between financial and non-financial terms.

4. Q: Must the accounting provisions of SSAP No. 62R be applied to an *otherwise exempt* contract if the ceding entity pays additional premiums under the contract on or after January 1, 1994?

   A: The answer depends on why the additional premiums are paid. If the additional premiums are the result of a renegotiation, adjustment, or extension of terms, the contract is subject to the accounting provisions of SSAP No. 62R. However, additional premiums paid without renegotiation, adjustment, or extension of terms would not make an otherwise exempt contract subject to those provisions.

5. Q: Prospective and retroactive portions of a reinsurance contract are allowed to be accounted for separately, if practicable. Can the retroactive portion of an existing contract be segregated and, therefore, exempted with other retroactive contracts covering insured events occurring prior to January 1, 1994?

   A: No. The transition provisions apply to an entire contract, which is either subject to or exempt from the revised provisions of SSAP No. 62R. A ceding entity may bifurcate a contract already subject to the new accounting rules in SSAP No. 62R and then account for both the prospective and retroactive portions in accordance with the new accounting standard.

Risk Transfer

6. Q: Do the new risk transfer provisions apply to existing contracts?

A: Yes, the new risk transfer provisions apply to some existing contracts. SSAP No. 62R applies in its entirety only to existing contracts which were renewed or amended on or after January 1, 1994, or which cover losses occurring or claims made after that date. Therefore, those contracts must be evaluated to determine whether they transfer risk and qualify for reinsurance accounting. For accounting periods commencing on or after January 1, 1995, balances relating to such contracts which do not transfer insurance risk shall be reclassified as deposits and shall be accounted for and reported in the manner described under the caption Reinsurance Contracts Must Include Transfer of Risk.

SSAP No. 62R does not apply to existing contracts which were entered into before, and were not renewed or amended on or after, January 1, 1994, and which cover only losses occurring or claims made before that date, nor to contracts which expired before, and were not renewed or amended on or after, January 1, 1995. Those contracts will continue to be accounted for in the manner provided by SSAP No. 62R before these revisions.

7. Q: How does the effective date affect the assessment of whether a significant loss to the reinsurer was reasonably possible?

A: The risk transfer assessment is made at contract inception, based on facts and circumstances known at the time. Because that point in time has passed for existing contracts, some have suggested that the risk transfer provisions be applied as of the effective date. However, that approach to the risk transfer assessment would violate the requirement to consider all cash flows from the contract. Therefore, the test must be applied from contract inception, considering the effect of any subsequent contract amendments. Careful evaluation and considered judgment will be required to determine whether a significant loss to the reinsurer was reasonably possible at inception.

8. Q: Should risk transfer be reassessed if contractual terms are subsequently amended?

A: Yes. When contractual terms are amended, risk transfer should be reassessed. For example, a contract that upon inception met the conditions for reinsurance accounting could later be amended so that it no longer meets those conditions. The contract should then be reclassified and accounted for as a deposit.

9. Q: How should the risk transfer assessment be made when a contract has been amended?

A: No particular method is prescribed for assessing risk transfer in light of a contract amendment. Whether an amended contract in substance transfers risk must be determined considering all of the facts and circumstances in light of the risk transfer requirements. Judgment also will be required to determine whether an amendment in effect creates a new contract.

10. Q: For purposes of evaluating whether a contract with a reinsurer transfers risk, what constitutes a contract?

A: A contract is not defined, but is essentially a question of substance. It may be difficult in some circumstances to determine the boundaries of a contract. For example, the profit-sharing provisions of one contract may refer to experience on other contracts and, therefore, raise the question of whether, in substance, one contract rather than several contracts exist.

The inconsistency that could result from varying interpretations of the term *contract* is limited by requiring that features of the contract or other contracts or agreements that directly or indirectly compensate the reinsurer or related reinsurers for losses be considered in evaluating whether a particular contract transfers risk. Therefore, if agreements with the reinsurer or related reinsurers, in the aggregate, do not transfer risk, the individual contracts that make up those agreements also would not be considered to transfer risk, regardless of how they are structured.

11. Q: If the assessment of risk transfer changes after the initial assessment at contract inception, how should the ceding entity account for the change?

A: The status of a contract should be determinable at inception and, absent amendment, subsequent changes should be very rare. If the risk of significant loss was not deemed reasonably possible at inception, and a significant loss subsequently occurred, the initial assessment was not necessarily wrong, because remote events do occur. Likewise, once a reasonable possibility of significant loss has been established, such loss need not occur in order to maintain the contract's status as reinsurance.

12. Q: SSAP No. 62R requires that reasonably possible outcomes be evaluated to determine the reinsurer's exposure to significant loss. What factors should be considered in determining whether a scenario being evaluated is reasonably possible?

A: The term *reasonably possible* means that the probability is more than remote. The test is applied to a particular scenario, not to the individual assumptions used in the scenario. Therefore, a scenario is not reasonably possible unless the likelihood of the entire set of assumptions used in the scenario occurring together is reasonably possible.

13. Q: In determining the amount of the reinsurer's loss under reasonably possible outcomes, may cash flows directly related to the contract other than those between the ceding and assuming companies, such as taxes and operating expenses of the reinsurer, be considered in the calculation?

A: No. The evaluation is based on the present value of all cash flows *between the ceding and assuming enterprises* under reasonably possible outcomes and, therefore, precludes considering other expenses of the reinsurer in the calculation.

14. Q: In evaluating the significance of a reasonably possible loss, should the reasonably possible loss be compared to gross or net premiums?

A: Gross premiums should be used.

15. Q: How does a commutation clause affect the period of time over which cash flows are evaluated for reasonable possibility of significant loss to the reinsurer?

A: All cash flows are to be assessed under reasonably possible outcomes. Therefore, unless commutation is expected in the scenario being evaluated, it should not be assumed in the calculation. Further, the assumptions used in a scenario must be internally consistent and economically rational in order for that scenario's outcome to be considered reasonably possible.

16. Q: What interest rate should be used in each evaluated scenario to make the present value calculation?

A: A reasonable and appropriate rate is required, which generally would reflect the expected timing of payments to the reinsurer and the duration over which those cash flows are expected to be invested by the reinsurer.

17. Q: SSAP No. 62R refers to payment schedules and accumulating retentions from multiple years as features that delay timely reimbursement of claims. Does the presence of those features generally prevent a contract from meeting the conditions for reinsurance accounting?

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

18. Q: What if a contract contains a feature such as a payment schedule or accumulating retention but could still result in the reasonable possibility of significant loss to the reinsurer?

A: Both of the following conditions are required for reinsurance accounting:

a. Transfer of significant risk arising from uncertainties about both (i) the ultimate amount of net cash flows from premiums, commission, claims, and claim settlement expenses paid under a contract (underwriting risk) and (ii) the timing of the receipt and payment of those cash flows (timing risk); and

b. Reasonable possibility of significant loss to the reinsurer.

Because both condition (a) and condition (b) must be met, failure to transfer significant timing and underwriting risk is not overcome by the possibility of significant loss to the reinsurer.

19. Q: Is it permissible to evaluate timely reimbursement on a present value basis?

A: No. The word timely is used in the ordinary temporal sense to refer to the length of time between payment of the underlying reinsured claims and reimbursement by the reinsurer.

While the test for reasonable possibility of significant loss to the reinsurer provides for a present value-based assessment of the economic characteristics of the reinsurance contract, the concept of timely reimbursement relates to the transfer of insurance risk (condition a. above), not the reasonable possibility of significant loss (condition b. above). Accordingly, timely reimbursement should be evaluated based solely on the length of time between payment of the underlying reinsured losses and reimbursement by the reinsurer.

20. Q: Are there any circumstances under which the conditions for risk transfer need not be met?

A: Yes. An extremely narrow and limited exemption is provided for contracts that reinsure either an individual risk or an underlying book of business that is inherently profitable. When substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts has been assumed by the reinsurer, the contract meets the conditions for reinsurance accounting. To qualify under this exception, no more than trivial insurance risk on the reinsured portions of the underlying insurance contracts may be retained by the ceding entity. The reinsurer's economic position must be virtually equivalent to having written the relevant portions of the reinsured contracts directly.

21. Q: In determining whether a reinsurance contract qualifies under the exception referred to in the preceding question, how should the economic position of the reinsurer be assessed in relation to that of the ceding entity?

A: The assessment should be made by comparing the net cash flows of the reinsurer under the reinsurance contract with the net cash flows of ceding entity on the reinsured portions of the underlying insurance contracts. This may be relatively easy for reinsurance of individual risks or for unlimited-risk quota-share reinsurance, because the premiums and losses on these types of reinsurance generally are the same as the premiums and losses on the reinsured portions of the underlying insurance policies.

In other types of reinsurance, determining the reinsurer's net cash flows relative to the insurer is likely to be substantially more difficult. For example, it generally would be difficult to demonstrate that the ceding entity's premiums and losses for a particular layer of insurance are the same as the reinsurer's premiums and losses related to that layer. If the economic position of the reinsurer relative to the insurer cannot be determined, the contract would not qualify under the exception.

Accounting Provisions

22. Q: An existing contract that was accounted for as reinsurance no longer qualifies for reinsurance accounting under the new accounting rules included in SSAP No. 62R. How should the ceding and assuming companies account for the contract in future periods?

A: Because the statement of income cannot be restated, previously recognized gains and losses are not revised. If the contract was entered into before, and not renewed or amended on or after, January 1, 1994 and covers only losses occurring or claims made before that date, or the contract expired before January 1, 1995 and was not renewed or amended on or after that date, it would continue to be accounted for in the manner provided before these revisions.

For accounting periods commencing on or after January 1, 1995, existing balances relating to contracts which do not transfer insurance risk and which were entered into on or after January 1, 1994 (covering losses occurring or claims made after that date) would be reclassified as deposits.

Premium payments to a reinsurer would be recorded as deposits. Likewise, losses recoverable from a reinsurer would not be recognized as receivables. Rather, any reimbursement for losses would be accounted for upon receipt as a refund of a deposit.

23. Q: What is the definition of past insurable events that governs whether reinsurance coverage is prospective or retroactive? For example, could a reinsurance contract that covers losses from asbestos and pollution claims on occurrence-based insurance policies effective during previous periods be considered prospective if the reinsurance coverage is triggered by a court interpretation that a loss is covered within the terms of the underlying insurance policies?

A: The distinction between prospective and retroactive reinsurance is based on whether a contract reinsures future or past insured events covered by the underlying reinsurance contracts. In the example above, the insured event is the occurrence of loss within the coverage of the underlying insurance contracts, not the finding of a court. Therefore, the fact that the asbestos exposure or pollution is covered under insurance policies effective during prior periods makes the reinsurance coverage in this example retroactive.

24. Q: Would the answer to the above question change if the reinsurance were written on a claims-made basis?

A: No. The form of the reinsurance—whether claims-made or occurrence-based—does not determine whether the reinsurance is prospective or retroactive. A claims-made reinsurance contract that reinsures claims asserted to the reinsurer in a future period as a result of insured events that occurred prior to entering into the reinsurance contract is a retroactive contract.

25. Q: What is the effect of adjustments to future premiums or coverage in determining whether reinsurance is prospective or retroactive?

A: Adjustments to future premiums or coverage may affect the accounting for a reinsurance contract. Whenever an adjustment results in a reinsurer providing new or additional coverage for past insurable events, that coverage is retroactive. For example, if subsequent years' premiums under a multiple accident year contract create additional coverage for previous accident years, the additional coverage is retroactive, even if the original coverage provided in the contract for those accident years was prospective. Likewise, if current losses under a multiple-year contract eliminate coverage in future periods, some or all of the premiums to be paid in those future periods should be charged to the current period.

26. Q: A reinsurance contract is entered into after the contract's effective date. Is the coverage between the contract's effective date and the date the contract was entered into prospective or retroactive?

A: The portion of the contract related to the period of time between the effective date of the contract and the date the contract was entered into is retroactive because it covers insured events that occurred prior to entering into the reinsurance contract.

27. Q: How is the date the reinsurance contract was entered into determined?

A: It is not uncommon for a reinsurance arrangement to be initiated before the beginning of a policy period but not finalized until after the policy period begins. Whether there was agreement in principle at the beginning of the policy period and, therefore, the contract is substantively prospective must be determined based on the facts and circumstances. For example, a contract may be considered to have been substantively entered into even though regulatory approval of that contract has not taken place.

The absence of agreement on significant terms, or the intention to establish or amend those terms at a later date based on experience or other factors, generally indicates that the parties to the contract have not entered into a reinsurance contact, but rather have agreed to enter into a reinsurance contract at a future date. If contractual provisions under a contract substantively entered into at a future date covered insurable events prior to that date, that coverage is retroactive.

In any event, SSAP No. 62R provides that if a contract (except facultative contracts and contracts signed by the lead reinsurer and certain cover notes or similar documents signed by reinsurers representing more than 50% of the capacity on the contract) has not been finalized, reduced to written form and signed by the parties within 9 months after its effective date, it is presumed to be retroactive.

28. Q: Are contracts to reinsure calendar-year incurred losses considered blended contracts that have both prospective and retroactive elements?

A: Yes. Most reinsurance contracts covering calendar-year incurred losses combine coverage for insured events that occurred prior to entering into the reinsurance contract with coverage for future insured events and, therefore, include both prospective and retroactive elements.

In any event, SSAP No. 62R provides that if a contract (except facultative contracts, contracts signed by the lead reinsurer and certain cover notes or similar documents signed by reinsurers representing more than 50% of the capacity on the contract) has not been finalized, reduced to written form and signed by the parties within 9 months after its effective date it is presumed retroactive.

29. Q: When the prospective and retroactive portions of a contract are being accounted for separately, how should premiums be allocated to each portion of the contract?

A: No specific method for allocating the reinsurance premiums to the risks covered by the prospective and retroactive portions of a contract is required. However, separate accounting for the prospective and retroactive portions of a contract may take place only when an allocation is practicable.

Practicability requires a reasonable basis for allocating the reinsurance premiums to the risks covered by the prospective and retroactive portions of the contract, considering all amounts paid or deemed to have been paid regardless of the timing of payment. If a reasonable basis for allocating the premiums between the prospective and retroactive coverage does not exist, the entire contract must be accounted for as a retroactive contract.

30. Q: A retroactive reinsurance contract contains a cut-through provision that provides the ceding entity's policyholders and claimants with the right to recover their claims directly from the reinsurer. May the ceding entity immediately recognize earned surplus associated with this type of contract?

A: No. SSAP No. 62R states that earned surplus may not be recognized "until the actual retroactive reinsurance recovered exceeds the consideration paid."

31. Q: A ceding entity enters into a retroactive reinsurance agreement that gives rise to segregated surplus. If the reinsurer prepays its obligation under the contract, may the ceding entity recognize earned surplus at the time the prepayment is received?

A: Segregated surplus arising from retroactive reinsurance transactions is earned as actual liabilities that have been transferred are recovered or terminated. Therefore, earned surplus is based on when the reinsurer settles its obligations to the ceding entity, and it may be appropriate to recognize earned surplus at the time the prepayment is received.

However, all of the facts and circumstances must be considered to determine whether the ceding entity has substantively recovered the liabilities transferred to the reinsurer. For example, if the ceding entity agrees to compensate the reinsurer for the prepayment, such as by crediting the reinsurer with investment income on prepaid amounts or balances held, the ceding entity has not, in substance, recovered its transferred liabilities but rather has received a deposit from the reinsurer that should be accounted for accordingly.

32. Q: If the ceding entity does not expect to receive any recoveries because the reinsurer has agreed to reimburse claimants under the reinsured contracts directly, would the ceding entity be considered to have recovered or terminated its transferred liabilities?

A: No. In the example given, the reinsurer is substantively acting as disbursing agent for the ceding entity. Therefore, the ceding entity cannot be said to have recovered amounts due from the reinsurer before payment is made to the claimant.

33. Q: What accounting entries would a ceding entity make to report a retroactive reinsurance contract?

A: Accounting Entries for a Ceding Entity to Report a Retroactive Reinsurance Contract:

Entry 1

Retroactive Reinsurance Reserves Ceded or Assumed (B/S)	10,000	
Retroactive Reinsurance Gain (I/S)		2,000
Cash		8,000

To record initial portfolio transfer see items #3 and #8. The ceding entity must establish the segregated surplus per item #4.

Entry 1A

Retro. Reins. Gain	2,000	
Profit/Loss Account		2,000

To close gain from retroactive transaction.

Entry 1B

Profit/Loss Account	2,000	
Special Surplus from Retro. Reins.		2,000

To close profit from retroactive reinsurance to special surplus.

Entry 2

Cash	2,000	
Retroactive Reinsurance Reserves Ceded or Assumed (B/S)		2,000

To record recovery of paid losses from the reinsurer. Outstanding ceded reserves after this recovery equals $8,000, and special surplus from retroactive reinsurance account equals $2,000; therefore, segregated surplus account is not changed per item #10.

Entry 3

Retroactive Reinsurance Reserves Ceded or Assumed (B/S)	3,000	
Retroactive Reinsurance Gain (I/S)		3,000

To record subsequent revision of the initial reserves ceded per item #10. The segregated surplus account is increased to $5,000 as a result of this upward development.

Entry 3A

Retro. Reinsurance Gain	3,000	
Profit/Loss Account		3,000

To close profit from retroactive reinsurance.

Entry 3B

Profit/Loss (I/S)	3,000	
Special Surplus from Retro. Reins.		3,000

To close profit and loss account to special surplus. (Retroactive reinsurance reserves ceded or assumed account balance equals $11,000. Special Surplus from retroactive reinsurance balance equals $5,000.)

Entry 4

Cash	4,000	
Retroactive Reinsurance Reserves Ceded or Assumed (B/S)		4,000

To record recovery of paid losses from the reinsurer. Outstanding ceded reserves after this recovery equals $7,000, therefore segregated surplus account is not changed per item #10.

Entry 5

Cash	3,000	
Retroactive Reinsurance Reserves Ceded or Assumed (B/S)		3,000

To record recovery of paid losses from reinsurer. Outstanding ceded reserves after recovery equals $4,000, therefore the following entry is needed per items #6 and #10.

Entry 5A

Special Surplus—Retro. Reins.	1,000	
Unassigned Funds		1,000

Retroactive Reinsurance reserves ceded or assumed after this entry equals $4,000.

Entry 6

Retroactive Reinsurance Loss (I/S)	1,000	
Retroactive Reinsurance Reserves Ceded or Assumed (B/S)		1,000

To record subsequent revision of the initial reserves ceded per item #10. The segregated surplus account is decreased as a result of this downward development to $3,000. The following entry is needed per items #6 and #10.

Entry 6A

Profit/Loss Account	1,000	
Retro. Reins. Loss		1,000

To close loss to profit and loss account.

Entry 6B

Special Surplus from Retro. Reins.	1,000	
Profit/Loss Account		1,000

To close profit and loss account to special surplus. (Remaining balance of retroactive reinsurance reserve ceded or assumed account equals $3,000.) (Special surplus from retro. reins. account balance equals $3,000.)

Entry 7

Cash	2,500	
Retroactive Reinsurance Gain (I/S)	500	
Retroactive Reinsurance Reserves Ceded or Assumed (B/S)		3,000

Entry 7A

Profit and Loss Account	500	
Retro. Reins. Gain		500

To close other income to profit and loss account.

Entry 7B

Special Surplus from Retro. Reins.	500	
Profit/Loss Account		500

To close profit and loss account to special surplus. (Remaining balance of special surplus from retro. reins. account equals $2,500.) (Remaining balance of retroactive reinsurance reserve ceded or assumed account -0-.)

Entry 7C

Special Surplus from Retro. Reins.	2,500	
Unassigned Funds		2,500

To close remaining special surplus account to unassigned surplus.

34. Q: How should the parties account for an adverse loss development reinsurance contract where, as of the statement date, the attachment level of the contract exceeds the ceding company's current case and IBNR reserves for the covered accident years (i.e. no surplus gain and no reinsurance recoverable as of the statement date), and the ceding company transferred cash to the reinsurer at the inception of the contract?

A: An adverse loss development reinsurance contract covering prior accident years meets the definition of "retroactive reinsurance" set forth in paragraph 22 of SSAP No. 62R:

> ….reinsurance in which a reinsurer agrees to reimburse a ceding entity for liabilities incurred as a result of past insurable events covered under contracts subject to the reinsurance….

Paragraph 29.k. of SSAP No. 62R specifically provides that the consideration paid for a retroactive reinsurance contract is to be recorded as a decrease in ledger assets by the ceding entity and an increase in ledger assets by the assuming entity.

Question 33 illustrates the accounting entries for retroactive reinsurance contracts.

If the retroactive reinsurance contract transfers both components of insurance risk then, pursuant to paragraph 29 of SSAP No. 62R, the ceding company would record the consideration paid as a decrease in ledger assets, recognize an expense for the reinsurance ceded through Other Income or Loss accounts as a write-in item identified as "Retroactive Reinsurance Ceded", and record the recoverable from the reinsurer as a contra liability.

No contra liability is established until and unless (and then only to the extent that) the ceding company establishes reserves which exceed the attachment point.

For the contract described, at inception no contra liability is recorded to offset current liability for the business ceded, since the ceded retroactive reinsurance premium relates to coverage in excess of the current liabilities recorded by the ceding company.

Once the ceding company's recorded liabilities exceed the attachment point of the adverse loss development reinsurance contract and triggers reinsurance recoverable from the reinsurer, a contra liability is established by the ceding company for the amount of the reinsurance recoverable. Any surplus resulting from the retroactive reinsurance is carried as a write-in item on the balance sheet designated as "Special Surplus from Retroactive Reinsurance Account." The surplus gain may not be classified as unassigned funds (surplus) until the actual retroactive reinsurance recovered exceeds the consideration paid.

If any portion of a retroactive reinsurance contract does not transfer insurance risk, then the portion which does not transfer risk is accounted for as a deposit pursuant to paragraph 35. The deposit is reported as an admitted asset of the ceding company if the reinsurer is licensed, accredited, certified or otherwise qualified in the ceding company's state of domicile as described in Appendix A-785, or if there are funds held by or on behalf of the ceding company as described in that appendix. Receipts and disbursements under the contract are recorded through the deposit/liability accounts. Amounts received in excess of the deposit made are recognized as a gain in the Other Income or Loss account.

Accounting entries for a ceding entity to report a retroactive reinsurance contract at the inception of which the cedent's reserves are lower than the attachment point of the reinsurance coverage:

Assume the company pays $16m to purchase adverse development coverage of $50m, above an attachment point.

Entry 1: Payment of Retrospective Reinsurance Premium

Retrospective Reinsurance Expense*	$16m	
Cash		$16m

The company pays $16m premium for the retrospective reinsurance contract.
*This is an Other Expense item, it does not flow through Schedule F or Schedule P.

Entry 2: Adverse Development Reaches the Attachment Point

Losses Incurred	$25m	
Gross Loss Reserve		$25m
Recoverable on Retro Reinsurance Contract**	$25m	
Other Income*		$9m
Contra – Retro Reinsurance Expense*		$16m
Surplus***	$9m	
Segregated Surplus***		$9m

The company incurs $25m development on reserves related to the contract.
*These are Other Income/Expense items do not flow through Schedule F or Schedule P.
**A contra-liability write-in item, not netted against loss reserves.
***Surplus is segregated in the amount of [$25m - $16m = $9m] recoverables less consideration paid.

Entry 3: Cash is Recovered on Paid Losses

Cash	$20m	
Recoverable on Retrospective Reinsurance Contract		$20m
Segregated Surplus	$4m	
Surplus		$4m

The company recovers $20m cash from reinsurer on this retro contract. Segregated Surplus decreases in the amount of [$20m - $16m = $4m] (decreases for amount recovered in excess of consideration paid).

35. Q: How should a ceding company account for payment of the premium for a retroactive reinsurance contract by the ceding company's parent company or some other person not a party to the reinsurance contract (for example, adverse loss development reinsurance contracts purchased by the parent company in the context of the purchase or sale of the ceding company)?

A: If the reinsurance premium is not paid directly by the ceding company but is instead paid on behalf of the ceding company by the ceding company's parent company or some other entity not a party to the reinsurance contract, then the ceding company should (1) record an increase in gross paid in and contributed surplus in the amount of the reinsurance premium to reflect the contribution to surplus by the parent or third party payor, and (2) record an expense in the amount of the reinsurance premium and account for the contract as provided in Questions 33 and 34.

EXHIBIT B – P&C RUNOFF REINSURANCE TRANSACTIONS

The following provides illustrative journal entries for P&C Runoff Reinsurance Transactions.

Example 1: Transfer of existing block of runoff business **with no residual UPR** on books of Transferor

Cedent/Transferor		**DR**	**CR**
Day 1 – Cedent transfers 50,000 in reserves for 50,000			
Ceded Reinsurance Recoverable (U&I Part 2A & Sch. F)	Contra Liab ↑	50,000	
Cash	Asset ↓		50,000
Losses Paid (U/W Part 2 & Sch. P)	I/S ↓	50,000	
Change in Reserves - Incurred Losses (U&I Part 2)	I/S ↑		50,000
Unlike novation, gross reserves stay on books of transferor			
Day 360 – Negative Development on Transferred Business - 3,000			
Reinsurance Recoverable on Unpaid Losses (Sch. F)	Contra Liab ↑	3,000	
Reserves for Unpaid Losses (U&I Part 2A & Sch. P)	Liab ↑		3,000
Day 540 – Reinsurer Pays the Loss @ Reported Reserve			
Reserves for Unpaid Losses (U&I Part 2A & Sch. P)	Liab ↓	53,000	
Ceded Reinsurance Recoverable (U&I Part 2A & Sch. F)	Contra Liab ↓		53,000
Reinsurer/ Transferee			
Day 1 – Cedent transfers 50,000 in reserves for 50,000			
Cash	Asset ↑	50,000	
Reported Losses on Reins. Assumed (U&I Part 2A & Sch. P)	Liab ↑		50,000
Change In Reserves – Incurred Losses (U&I Part 2)	I/S ↓	50,000	
Losses Paid or Incurred (negative) (U&I Part 2 & Sch. P)	I/S ↑		50,000
Day 360 – Negative Development on Transferred Business - 3,000:			
Change in Reserves – Incurred Losses (U&I Part 2)	I/S↓	3,000	
Reserves for Unpaid Losses (U&I Part 2A & Sch. P)	Liab ↑		3,000
Day 540 – Reinsurer Pays the Loss			
Reserves for Unpaid Losses (U&I Part 2A & Sch. P)	Liab ↓	53,000	
Cash	Asset ↓		53,000

Comments:
Since the Transferor is ceding incurred losses neither party should have premium impacted. To do that would distort many financial ratios.

Example 2: Transfer of existing block of runoff business **with some residual UPR** of 10,000 on books of Transferor (this should be less common).

Cedent/Transferor		**DR**	**CR**
Day 1 – Cedent transfers 50k in reserves & 10k UPR for 60,000			
Ceded Reinsurance Recoverable (U&I Part 2A & Sch. F)	Contra Liab ↑	50,000	
Unearned Premium Reserve (U&I Part 1 & 1A)	Liab ↓	10,000	
Cash	Asset ↓		60,000
Ceded Premium Written (U&I Part 1B)	I/S ↓	10,000	
Losses Paid (U&I Part 2 & Sch. P)	I/S ↓	50,000	
Change in Reserves - Incurred Losses (U&I Part 2)	I/S ↑		50,000
Change in UPR (U&I Part 1 & 1A)	I/S ↑		10,000
Unlike novation, gross reserves stay on books of transferor			
Day 180 – Premium is Fully Earned (Assumes 80% Loss Ratio)			
Ceded Reinsurance Recoverable (U&I Part 2A & Sch. F)	Contra Liab ↑	8,000	
Reserves for Unpaid Losses (U&I Part 2A & Sch. P)	Liab ↑		8,000
To mirror the increase in unpaid losses by the transferee			
Day 360 – Negative Development on Transferred Business - 3,000:			
Reinsurance Recoverable on Unpaid Losses (Sch. F)	Contra Liab ↑	3,000	
Reserves for Unpaid Losses (U&I Part 2A & Sch. P)	Liab ↑		3,000
Day 540 – Reinsurer Pays the Loss @ Reported Reserves (50+8+3)			
Reserves for Unpaid Losses (U&I Part 2A & Sch. P)	Liab ↓	61,000	
Ceded Reinsurance Recoverable (U&I Part 2A & Sch. F)	Contra Liab ↓		61,000

Reinsurer/Transferee			
Day 1 – Cedent transfers 50k in reserves & 10k UPR for 60,000			
Cash	Asset ↑	60,000	
Reported Losses on Reins. Assumed (U&I Part 2A & Sch. P)	Liab ↑		50,000
Unearned Premium Reserve (U&I Part 1 & 1A)	Liab ↑		10,000
Assumed Premium Written (U&I Part 1B)	I/S ↑		10,000
Change In Reserves – Incurred Losses (U&I Part 2)	I/S ↓	50,000	
Change in UPR (U&I Part 1 & 1A)	I/S ↓	10,000	
Losses Paid or Incurred (negative) (U&I Part 2 & Sch. P)	I/S ↑		50,000
Day 180 – Premium is Fully Earned (Assumes 80% Loss Ratio)			
Unearned Premium Reserve (U&I Part 1 & 1A)	Liab ↓	10,000	
Reserves for Unpaid Losses (U&I Part 2A & Sch. P)	Liab ↑		8,000
Change In Reserves – Incurred Losses (U&I Part 2)	I/S↓	8,000	
Change in UPR (U&I Part 1 & 1A)	I/S ↑		10,000
To record the increase in unpaid losses by the transferee			
Day 360 – Negative Development on Transferred Business -3,000:			
Change In Reserves – Incurred Losses (U&I Part 2)	I/S↓	3,000	
Reserves for Unpaid Losses (U&I Part 2A & Sch. P)	Liab ↑		3,000
Day 540 – Reinsurer Pays the Loss @ Reported Reserves (50+8+3)			
Reserves for Unpaid Losses (U&I Part 2A & Sch. P)	Liab ↓	61,000	
Cash	Asset ↓		61,000

Comments:
In this second example, the portion of the runoff business that has an UPR associated with it is essentially booked as prospective reinsurance. Other elements of the example are the same except that we assumed an 80% loss ratio on the unearned portion of the business.

EXHIBIT C – ILLUSTRATION OF A REINSURANCE CONTRACT THAT IS ACCOUNTED FOR AS A DEPOSIT USING THE INTEREST METHOD

Assumptions:

Premium = $1,000 (assumes no commissions or allowances)
Coverage Period = 1 year
Initial expected recoveries = $225 per year (at end of year) for five years
Initial Implicit rate = 4 percent*

*present value of $225 per year for five years at 4 percent = $1,000

At the end of Year 2, the timing of anticipated recoveries under the reinsurance contract changes. A reevaluation of the implicit interest rate produces a rate of 3.63 percent and an asset of $640 at the end of the year.

Description	Interest Income	Cash Recoveries	Deposit Balance
Initial payment			$1,000
Year 1 (4%)	$ 40		$1,040
End of Year 1		$ (225)	$ 815
Year 2 (4%)	$ 33		$ 848
End of Year 2		$ (200)	$ 648
Yield Adjustment	$ (8)		$ 640
Year 3 (3.63%)	$ 23		$ 663
End of Year 3		$ (175)	$ 488
Year 4 (3.63%)	$ 18		$ 506
End of Year 4		$ (175)	$ 331
Year 5 (3.63%)	$ 12		$ 343
End of Year 5		$ (175)	$ 168
Year 6 (3.63%)	$ 7		$ 175
End of Year 6		$ (175)	$ 0

At the inception of the contract, the ceding insurer records a deposit asset of $ 1,000 and the assuming company, a $1,000 deposit liability. The asset is admitted providing the conditions for credit for reinsurance are met.

At subsequent reporting dates, the deposit asset is adjusted by calculating the effective yield on the reinsurance agreement to reflect actual payments to date and expected future payments with a corresponding credit to interest income by the ceding company and interest expense by the assuming company.

At the end of year two, it is determined that the expected cash flows will differ from previous estimates, resulting in a lower effective yield on the deposit asset. The deposit asset is adjusted to the amount that would have existed at the reporting date had the new effective yield been applied from the inception of the reinsurance agreement. The adjustment is charged to interest income, i.e., as a reduction of interest income. Interest income during the remaining term of the agreement is reduced accordingly (i.e., the yield is reduced from 4.0% to 3.63%).

Statement of Statutory Accounting Principles No. 63

Underwriting Pools and Associations Including Intercompany Pools

STATUS

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Underwriting Pools and Associations Including Intercompany Pools

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for underwriting pools and associations.

SUMMARY CONCLUSION

2. Underwriting pools and associations can be categorized as follows: (a) involuntary, (b) voluntary, and (c) intercompany.

3. Involuntary pools represent a mechanism employed by states to provide insurance coverage to those with higher than average probability of loss who otherwise would be excluded from obtaining coverage. Reporting entities are generally required to participate in the underwriting results, including premiums, losses, expenses, and other operations of involuntary pools, based on their proportionate share of similar business written in the state. Involuntary plans are also referred to as residual market plans, involuntary risk pools, and mandatory pools.

4. Voluntary pools are similar to involuntary pools except they are not state mandated and a reporting entity participates in the pool voluntarily. In addition, voluntary pools are not limited to the provision of insurance coverage to those with higher than average probability of loss, but often are used to provide greater capacity for risks with exceptionally high levels of insurable values (e.g., aircraft, nuclear power plants, refineries, and offshore drilling platforms).

5. Intercompany pooling relates to business which is pooled among affiliated entities who are party to a pooling arrangement.(INT 03-02)

6. Participation in a pool may be on a joint and several basis, i.e., in addition to a proportional share of losses and expenses incurred by the pool, participants will be responsible for their share of any otherwise unrecoverable obligations of other pool participants. In certain instances, one or more entities may be designated as servicing carriers for purposes of policy issuance, claims handling, and general administration of the pooled business, while in other cases a pool manager or administrator performs all of these functions and simply bills pool participants for their respective shares of all losses and expenses incurred by the pool. In either case, liabilities arising from pooled business are generally incurred on a basis similar to those associated with non-pooled business, and should therefore be treated in a manner consistent with the guidelines set forth in *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets* (SSAP No. 5R).

7. Intercompany pooling arrangements involve establishment of a conventional quota share reinsurance agreement under which all of the pooled business is ceded to the lead entity and then retroceded back to the pool participants in accordance with their stipulated shares. Arrangements whereby there is one lead company that retains 100% of the pooled business and all or some of the affiliated companies have a 0% net share of the pool may qualify as intercompany pooling. In these arrangements, only the policy issuing entity has direct liability to its policyholders or claimants; other pool participants are liable as reinsurers for their share of the issuing entity's obligations. Although participants may use different assumptions (e.g., discount rates) in recording transactions, the timing of recording transactions shall be consistently applied by all participants.

8. Underwriting results relating to voluntary and involuntary pools shall be accounted for on a gross basis whereby the participant's portion of premiums, losses, expenses, and other operations of the pools are recorded separately in the financial statements rather than netted against each other. Premiums and losses shall be recorded as direct, assumed, and/or ceded as applicable. If the reporting entity is a direct writer of the business, premiums shall be recorded as directly written and accounted for in the same

manner as other business which is directly written by the entity. To the extent that premium is ceded to a pool, premiums and losses shall be recorded in the same manner as any other reinsurance arrangement. A reporting entity who is a member of a pool shall record its participation in the pool as assumed business as in any other reinsurance arrangement.

9. Underwriting results relating to intercompany pools shall be accounted for and reported as described in paragraph 8. While it is acceptable that intercompany pooling transactions be settled through intercompany arrangements and accounts, intercompany pooling transactions shall be reported on a gross basis in the appropriate reinsurance accounts consistent with other direct, assumed and ceded business.

10. Equity interests in, or deposits receivable from, a pool represent cash advances to provide funding for operations of the pool. These are admitted assets and shall be recorded separately from receivables and payables related to a pool's underwriting results. Receivables and payables related to underwriting results shall be accounted for in accordance with the guidance in paragraphs 6-8. If it is probable that these receivables are uncollectible, any uncollectible amounts shall be written off against operations in the period such determination is made. If it is reasonably possible a portion of the balance is uncollectible but is not written off, disclosure requirements outlined in SSAP No. 5R shall be followed.

Disclosures

11. If a reporting entity is part of a group of affiliated entities which utilizes a pooling arrangement under which the pool participants cede substantially all of their direct and assumed business to the pool, the financial statements shall include:

a. A description of the basic terms of the arrangement and the related accounting;

b. Identification of the lead entity and of all affiliated entities participating in the intercompany pool (include NAIC Company Codes) and indication of their respective percentage shares of the pooled business;

c. Description of the lines and types of business subject to the pooling agreement;

d. Description of cessions to non-affiliated reinsurers of business subject to the pooling agreement, and indication of whether such cessions were prior to or subsequent to the cession of pooled business from the affiliated pool members to the lead entity;

e. Identification of all pool members which are parties to reinsurance agreements with non-affiliated reinsurers covering business subject to the pooling agreement and which have a contractual right of direct recovery from the non-affiliated reinsurer per the terms of such reinsurance agreements;

f. Explanation of any discrepancies between entries regarding pooled business on the assumed and ceded reinsurance schedules of the lead entity and corresponding entries on the assumed and ceded reinsurance schedules of other pool participants;

g. Description of intercompany sharing, if other than in accordance with the pool participation percentage, of the Provision for Overdue Reinsurance (Schedule F, Part ~~7~~8) and the write–off of uncollectible reinsurance;

h. Amounts due to/from the lead entity and all affiliated entities participating in the intercompany pool as of the balance sheet date.

12. Refer to the preamble for further discussion regarding disclosure requirements.

Effective Date and Transition

13. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*.

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 97—Underwriting Pools and Associations Including Intercompany Pools*

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Statement of Statutory Accounting Principles No. 64

Offsetting and Netting of Assets and Liabilities

STATUS

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Offsetting and Netting of Assets and Liabilities

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for offsetting and netting of assets and liabilities.

SUMMARY CONCLUSION

2. Assets and liabilities shall be offset and reported net only when a valid right of setoff exists except as provided for in paragraphs 3 and 4. A right of setoff is a reporting entity's legal right, by contract or otherwise, to discharge all or a portion of the debt owed to another party by applying an amount that the other party owes to the reporting entity against the debt$^{(\text{INT 09-08})}$. A valid right of setoff exists only when all the following conditions are met:

a. Each of the two parties owes the other determinable amounts. An amount shall be considered determinable for purposes of this provision when it is reliably estimable by both parties to the agreement;

b. The reporting party has the right to set off the amount owed with the amount owed by the other party;

c. The reporting party intends to setoff; and

d. The right of setoff is enforceable at law.

3. Assets and liabilities that meet the criteria for offset shall not be netted when prohibited by specific statements of statutory accounting principles. An example of such is in the case of reinsurance recoverables on paid losses and ceded premiums payable as provided for in *SSAP No. 62R—Property and Casualty Reinsurance*.

4. Netting of assets and liabilities for reporting purposes when no valid right of setoff exists shall be allowed only when provided for by specific statements of statutory accounting principles. An example of such is in the case of real estate investments required to be shown net of encumbrances as provided for in *SSAP No. 40R—Real Estate Investments.*

5. Amounts due to or from affiliates shall be offset and reported net only when the provisions of paragraph 2 are met.

Disclosures

6. The following quantitative information shall be disclosed (separately for assets and liabilities) at the end of each reporting period (interim and annual) when derivative, repurchase and reverse repurchase, and securities borrowing and securities lending assets and liabilities are offset and reported net in accordance with paragraph 2 (valid right to offset):

a. The gross amounts of recognized assets and recognized liabilities

b. The amounts offset in accordance with paragraph 2 (valid right to offset)

c. The net amounts presented in the statement of financial positions.

7. Assets and liabilities that have a valid right to offset under paragraph 2, but are not netted as they are prohibited under paragraph 3, are not required to be captured in the disclosures in paragraph 6.

Relevant Literature

8. This statement adopts paragraphs 1, 7 and 13 of *APB Opinion No. 10, Omnibus Opinion—1966* and *FASB Interpretation No. 39, Offsetting of Amounts Related to Certain Contracts* with modifications (1) to prohibit offsetting as provided in specific statements and require netting when provided in specific statements, and (2) to reject guidance in paragraphs 10, 10A, and 10B of FIN 39, as amended by FSP FIN 39-1, that permits a reporting entity election to offset fair value amounts recognized for derivative instruments and fair value amounts recognized for the right to reclaim cash collateral or the obligation to return cash collateral arising from the derivative instruments with the same counterparty under a master netting agreement. Offsetting for statutory accounting purposes is limited to situations meeting the conditions in paragraph 2 and 4 of this SSAP. This statement adopts *FASB Emerging Issues Task Force No. 86-25, Offsetting Foreign Currency Swaps.*

9. This statement rejects *FSP FIN 39-1, Amendment of FASB Interpretation 39*. This statement rejects *FASB Interpretation No. 41, Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements.* FIN 41 has an offsetting exception for repurchase and reverse repurchase agreements and permits offsetting when the reporting parties do not intend to set off. This guidance is rejected for statutory accounting, and payables under repurchase agreements may only be offset against amounts recognized as receivables under reverse repurchase agreements if there is a valid right to offset meeting all the conditions, including the intent to offset, detailed in paragraph 2. This statement rejects *ASU 2011-11, Disclosures about Offsetting Assets and Liabilities* and *ASU 2013-01, Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities*. Statutory disclosure requirements for assets and liabilities reported net under a valid right to offset are detailed in paragraph 6.

Effective Date and Transition

10. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*. The revisions to paragraphs 8-9 are effective January 1, 2013. The revisions to paragraph 9 rejecting FIN 41 reflects a reversal of a prior decision to adopt FIN 41.

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 76—Offsetting and Netting of Assets and Liabilities*

Statement of Statutory Accounting Principles No. 65

Property and Casualty Contracts

STATUS

Type of Issue:	Property and Casualty
Issued:	Initial Draft
Effective Date:	January 1, 2001
Affects:	Nullifies and incorporates INT 02-10
Affected by:	No other pronouncements
Interpreted by:	No other pronouncements

STATUS **1**

SCOPE OF STATEMENT **3**

SUMMARY CONCLUSION **3**

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EXHIBIT A – GUIDELINES FOR STATES WHO PRESCRIBE OR PERMIT DISCOUNTING ON A NON-TABULAR BASIS **11**

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Property and Casualty Contracts

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for property and casualty insurance contracts. Topics not covered by this statement shall comply with the more general statutory accounting guidance.

2. Topics specific to title insurance, mortgage guaranty insurance, and financial guaranty insurance are not within the scope of this statement. These topics are addressed in *SSAP No. 57—Title Insurance*, *SSAP No. 58—Mortgage Guaranty Insurance*, and *SSAP No. 60—Financial Guaranty Insurance*.

SUMMARY CONCLUSION

3. Property and casualty insurance contracts can be written to cover insured events on the following reporting bases:

a. Occurrence—These policies cover insured events that occur within the effective dates of the policy regardless of when they are reported to the reporting entity. Liabilities for losses on these policies shall be recorded when the insured event occurs;

b. Claims made—These policies cover insured events that are reported (as defined in the policy) within the effective dates of the policy, subject to retroactive dates when applicable. Liabilities for losses on these policies shall be recorded when the event is reported to the reporting entity; and

c. Extended reporting—Endorsements to claims made policies covering insured events reported after the termination of a claims made contract but subject to the same retroactive dates where applicable. See paragraphs 7 and 8 for guidance for when premium shall be earned and losses shall be recorded.

Claims Made Policies

4. Normally, when claims made coverage is obtained, existing coverage is being replaced. The existing coverage may have been a claims made policy or an occurrence policy. In either case, in an effort to reduce premium costs, the insured may request that the claims made coverage cover only claims reported within the effective dates of the policy that occur after a specified date. This specified date is referred to as the retroactive date of the claims made policy and eliminates duplicate coverage when converting from occurrence coverage to claims made coverage.

5. The liability for an insured event shall be determined in accordance with *SSAP No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses* (SSAP No. 55).

6. Extended reporting endorsements, commonly referred to as tail coverage, allow extended reporting of insured events after the termination of a claims made contract. Extended reporting endorsements modify the exposure period of the underlying contract and can be for a defined period (e.g., six months, one year, five years) or can be for an indefinite period.

7. When a reporting entity issues an extended reporting endorsement or contract and the preceding claims made policy terminates, the reporting entity assumes liability for unreported claims and expense. This extended reporting coverage can be issued for an indefinite period or a fixed period. For indefinite reporting periods, premium shall be fully earned and loss and expense liability associated with unreported claims shall be recognized immediately. For coverage for a fixed period, premium shall be earned over the term of the fixed period, the reporting entity shall establish an unearned premium reserve for the unexpired portion of the premium and shall record losses as reported.

8. Some claims made policies provide extended reporting coverage at no additional charge in the event of death, disability, or retirement of a natural person insured. In such instance, a policy reserve is required to assure that premiums are not earned prematurely. The amount of the reserve should be adequate to pay for all future claims arising from these coverage features, after recognition of future premiums to be paid by current insureds for these benefits. The reserve, entitled "extended reporting endorsement policy reserve" shall be classified as a component part of the unearned premium reserve considered to run more than one year from the date of the policy.

9. When the anticipated losses, loss adjustment expenses, and maintenance costs anticipated to be reported during the extended reporting period exceed the recorded unearned premium reserve for a claims made policy, a premium deficiency reserve shall be recognized in accordance with *SSAP No. 53—Property Casualty Contracts—Premiums*.

Discounting

10. With the exception of fixed and reasonably determinable payments such as those emanating from workers' compensation tabular indemnity reserves and long-term disability claims, property and casualty loss reserves shall not be discounted. No loss adjustment expense reserves shall be discounted.

11. Tabular reserves are indemnity reserves that are calculated using discounts determined with reference to actuarial tables which incorporate interest and contingencies such as mortality, remarriage, inflation, or recovery from disability applied to a reasonably determinable payment stream. Tabular reserves shall not include medical loss reserves or loss adjustment expense reserves.

12. Due to several instances in which states have prescribed or permitted practices to allow discounting on a non-tabular basis, recommended guidelines for discounting non-tabular unpaid loss and LAE are provided within Exhibit A. If a state has a prescribed or permitted practice allowing the use of discounts, or if discounting is utilized in accordance with this SSAP, financial statement disclosures are required in accordance with paragraphs 13-16.

13. In accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors* (SSAP No. 3), a change in the discount rate used in discounting loss reserves shall be accounted for as a change in estimate. SSAP No. 3 requires changes in estimates to be included in the statement of income in the period the change becomes known.

14. The financial statements shall disclose whether or not any of the liabilities for unpaid losses or unpaid loss adjustment expenses are discounted, including liabilities for workers' compensation. The following disclosures, for each line of business, shall be made separately:

a. Table(s) used;

b. Rate(s) used;

c. The amount of discounted liability reported in the financial statement; and

d. The amount of tabular discount, by the line of business and reserve category (i.e., case and Incurred But Not Reported (IBNR)).

15. If the rate(s) used to discount prior accident years' liabilities have changed from the previous financial statement or if there have been changes in other key discount assumptions such as payout patterns, the financial statements shall disclose:

a. Amount of discounted current liabilities at current rate(s) and assumption(s) (exclude the current accident year);

b. Amount of discounted current liabilities at previous rate(s) and assumption(s) (exclude the current accident year);

c. Change in discounted liability due to change in interest rate(s) and assumption(s); and

d. Amount of non-tabular discount, by line of business and reserve category (i.e., case, defense and cost containment, adjusting and other).

16. Refer to the preamble for further discussion regarding disclosure requirements.

Structured Settlements

17. Structured settlements are periodic fixed payments to a claimant for a determinable period, or for life, for the settlement of a claim. Frequently a reporting entity will purchase an annuity to fund the future payments. Reporting entities may purchase an annuity in which the entity is the owner and payee, or an annuity in which the claimant is the payee. When annuities are purchased to fund periodic fixed payments, they shall be accounted for as follows:

a. When the reporting entity is the owner and payee, no reduction shall be made to loss reserves. The annuity shall be recorded at its present value and reported as an other-than-invested asset. Income from the annuities shall be recorded as miscellaneous income. The present value of the annuity and the related amortization schedule shall be obtained from the issuing life insurance company at the time the annuity is purchased; and

b. When the claimant is the payee, loss reserves shall be reduced to the extent that the annuity provides for funding of future payments. The cost of the annuities shall be recorded as paid losses.

18. Statutory accounting and Generally Accepted Accounting Principles (GAAP) are consistent for the accounting of structured settlement annuities where the reporting entity is the owner and payee, and where the claimant is the owner and payee and the reporting entity has been released from its obligation. GAAP distinguishes structured settlement annuities where the owner is the claimant and a legally enforceable release from the reporting entity’s liability is obtained from those where the claimant is the owner and payee but the reporting entity has not been released from its obligation. GAAP requires the deferral of any gain resulting from the purchase of a structured settlement annuity where the claimant is the owner and payee yet the reporting entity has not been released from its obligation. Statutory accounting treats these settlements as completed transactions and considers the earnings process complete, thereby allowing for immediate gain recognition.

19. The following information regarding structured settlements shall be disclosed in the financial statements:

a. The amount of reserves no longer carried by the reporting entity because it has purchased annuities with the claimant as payee, and the extent to which the reporting entity is contingently liable for such amounts should the issuers of the annuities fail to perform under the terms of the annuities; and

b. The name, location, and aggregate statement value of annuities due from any life insurer to the extent that the aggregate value of those annuities equal or exceed 1% of policyholders’ surplus. This disclosure shall only include those annuities for which the reporting entity has not obtained a release of liability from the claimant as a result of the purchase of an annuity. The reporting entity shall also disclose whether the life insurers are licensed in the reporting entity’s state of domicile.

20. Refer to the preamble for further discussion regarding disclosure requirements.

Policies with Coverage Periods Equal to or in Excess of Thirteen Months

21. Some property and casualty insurance contracts are written for coverage periods that equal or exceed thirteen months. These contracts may be single premium or fixed premium policies, and generally are not subject to cancellation or premium modification by the reporting entity. The most common policies with such coverage periods are home warranty and mechanical breakdown policies. Accordingly, this guidance is primarily focused on home warranty and mechanical breakdown policies and does not apply to multiple-year contracts comprised of single-year policies, each of which have separate premiums and annual aggregate deductibles.

22. Revenues are generally not received in proportion to the level of exposure or period of exposure. In order to recognize the economic results of the contract over the contract period, a liability shall be established for the estimated future policy benefits while taking into account estimated future premiums to be received. Unearned premiums shall be recorded in accordance with paragraphs 23-33 of this statement.

23. Paragraphs 24-33 shall apply to all direct and assumed contracts or policies ("contracts"), excluding financial guaranty contracts, mortgage guaranty contracts, and surety contracts, that fulfill both of the following conditions:

a. The policy or contract term is greater than or equal to 13 months; and

b. The reporting entity can neither cancel the contract, nor increase the premium during the policy or contract term.

24. At any reporting date prior to the expiration of the contracts, the reporting entity is required to establish an adequate unearned premium reserve, to be reported as the unearned premium reserve. For each of the three most recent policy years, the gross (i.e., direct plus assumed) unearned premium reserve shall be no less than the largest result of the three tests described in paragraphs 27-29. For years prior to the three most recent policy years, the gross unearned premium reserve shall be no less than the larger of the aggregate result of Test 1 or the aggregate result of Test 2 or the aggregate result of Test 3 taken over all of those policy years.

25. Any reserve credit applicable for reinsurance ceded shall be appropriately reflected in the financial statements with the resulting net unearned premium reserve being established by the reporting entity.

26. The projected losses and expenses may be reduced for expected salvage and subrogation recoveries, but may not be reduced for anticipated deductible recoveries, unless the deductibles are secured by a letter of credit (LOC) or like security. Projected salvage and subrogation recoveries (net of associated expenses) shall be established based on reporting entity experience, if credible; otherwise, based on industry experience.

27. Test 1 is management's best estimate of the amounts refundable to the contractholders at the reporting date.

28. Test 2 is the gross premium multiplied by the ratio of paragraph 28.a. to paragraph 28.b.:

a. Projected future gross losses and expenses to be incurred during the unexpired term of the contracts; and

b. Projected total gross losses and expenses under the contracts.

29. Test 3 is the projected future gross losses and expenses to be incurred during the unexpired term of the contracts as adjusted below, reduced by the present value of the future guaranteed gross premiums, if any.

a. A provision for investment income is permitted in the unearned premium reserve only with respect to the projected future losses and expenses used to determine the unearned premium reserve, and not with respect to incurred but unpaid losses and expenses;

b. A provision for investment income on projected future losses and expenses may be calculated to the expected date the loss or expense is incurred, not from the expected date of payment;

c. The rate of interest used to calculate the provision for investment income shall be reviewed and changed as necessary at each reporting date and shall not exceed the lesser of the following two standards:

i. The reporting entity's future net yield to maturity on statutory invested assets as shown in Schedule D, less a 1.5% actuarial provision for adverse deviations; or

ii. The current yield to maturity on a United States Treasury debt instrument maturing in five (5) years as of the reporting date.

d. The reporting entity's statutory invested assets shall be reduced by the loss and loss adjustment expense reserves on unpaid losses and expenses to calculate "available invested assets." If the available invested assets are less than the result of Test 3, as calculated above, an "invested asset shortfall" exists. In this event, the Test 3 reserve shall be recalculated with the provision for investment income based on the restricted amount of available invested assets.

30. For the purposes of Tests 2 and 3 above, "expenses" shall include all incurred and anticipated expenses related to the issuance and maintenance of the policy, including loss adjustment expenses, policy issuance and maintenance expenses, commissions, and premium taxes.

31. The projected future losses and expenses are to be re-estimated for each reporting date, and the most recent estimate of these projected losses and expenses is to be used in these Tests. If a range is selected and no single point in the range is identified as being the most likely, then the midpoint of management's estimate of the range shall be used. For purposes of this statement, it is assumed that management can quantify the high end of the range. If management determines that the high end of the range cannot be quantified, then a range does not exist, and management's best estimate shall be accrued.

32. The reporting entity shall provide an Actuarial Opinion and Report in conformity with the NAIC *Annual Statement Instructions for Property and Casualty Insurers*. Exhibit A of the actuarial opinion shall include the following three items:the Reserve for Direct and Assumed Unearned Premiums, the Reserve for Net Unearned Premiums (as reported on Page 3), and any other premium reserve items on which an opinion is being expressed. If any of these three items are material, the material item(s) must also be covered in the opinion and relevant comments paragraphs of the actuarial opinion.

33. The actuarial report shall include a description of the manner in which the adequacy of the amount of security for deductibles and self-insured retentions is determined. The actuarial report need not assess the credit-worthiness of the specific securities (e.g. LOC's), but the actuarial opinion must report collectibility problems if known to the actuary.

High Deductible Policies

34. Certain policies, particularly workers' compensation coverage, are available under high deductible plans. High deductible plans differ from self insurance coupled with an excess of loss policy because state laws generally require the reporting entity to fund the deductible and to periodically review the financial viability of the insured and make an assessment of the suitability of the deductible plan to the insured.

35. The liability for loss reserves shall be determined in accordance with SSAP No. 55. Because the risk of loss is present from the inception date, the reporting entity shall reserve losses throughout the policy period, not over the period after the deductible has been reached. Reserves for claims arising under high deductible plans shall be established net of the deductible, however, no reserve credit shall be permitted for any claim where any amount due from the insured has been determined to be uncollectible.

36. If the policy form requires the reporting entity to fund all claims including those under the deductible limit, the reporting entity is subject to credit risk, not underwriting risk. Reimbursement of the deductible shall be accrued and recorded as a reduction of paid losses simultaneously with the recording of the paid loss by the reporting entity.

37. If the reporting entity does not hold specific collateral for the policy, amounts accrued for reimbursement of the deductible shall be billed in accordance with the provisions of the policy or the contractual agreement and shall be aged according to the contractual due date. In the absence of a contractual due date, billing date shall be utilized for the aging requirement. Deductible recoverables that are greater than ninety days old shall be nonadmitted. However, if the reporting entity holds specific collateral for the high deductible policy, ten percent of deductible recoverable in excess of collateral specifically held and identifiable on a per policy basis, shall be reported as a nonadmitted asset in lieu of applying the aging requirement; however, to the extent that amounts in excess of the 10% are not anticipated to be collected they shall also be nonadmitted. The collateral requirements of this paragraph may be satisfied when an insured provides one collateral instrument to secure amounts owed under multiple policies, provided that the reporting entity has the contractual right to apply the collateral to the high deductible policy. Collateral obtained at a group level that is not supported by an existing pooling agreement requires a written allocation agreement among all collateral beneficiaries. The terms of such agreement must be fair and equitable. Documentation supporting any allocation of collateral among reporting entities must be maintained to allow proper calculation of the nonadmitted amounts and prohibit double counting of collateral.

38. The financial statements shall disclose the amount of reserve credit that has been recorded for high deductibles on unpaid claims and the amounts that have been billed and are recoverable on paid claims.

39. Refer to the preamble for further discussion regarding disclosure requirements.

Asbestos and Environmental Exposures

40. Asbestos exposures are defined as any loss or potential loss (including both first party and third party claims) related directly or indirectly to the manufacture, distribution, installation, use, and abatement of asbestos-containing material, excluding policies specifically written to cover these exposures. Environmental exposures are defined as any loss or potential loss, including third party claims, related directly or indirectly to the remediation of a site arising from past operations or waste disposal. Examples of environmental exposures include but are not limited to chemical waste, hazardous waste treatment, storage and disposal facilities, industrial waste disposal facilities, landfills, superfund sites, toxic waste pits, and underground storage tanks.

41. Reporting entities that are potentially exposed to asbestos and/or environmental claims shall record reserves consistently with SSAP No. 55.

42. The financial statements shall disclose the following if the reporting entity is potentially exposed to asbestos and/or environmental claims:

a. The reserving methodology for both case and IBNR reserves;

b. The amount paid and reserved for losses and loss adjustment expenses for asbestos and/or environmental claims, on a direct, assumed and net of reinsurance basis. Each company should report only its share of a group amount (after applying its respective pooling percentage) if the company is a member of an intercompany pooling agreement;

c. Description of the lines of business written for which there is potential exposure of a liability due to asbestos and/or environmental claims, and the nature of the exposure(s);

d. The following for each of the five most current calendar years[1] on both a gross and net of reinsurance basis, separately for asbestos and environmental losses (including coverage dispute costs):

Beginning reserves $______

Incurred losses and loss adjustment expenses ______

Calendar year payments for losses and loss adjustment expenses ______

Ending reserves $______

43. Refer to the preamble for further discussion regarding disclosure requirements.

Excess Statutory Reserve

44. This statement eliminates the requirement to record excess statutory reserves. Excess statutory reserves do not meet the definition of a liability established in *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets.*

Policyholder Dividends

45. Dividends to policyholders immediately become liabilities of the reporting entity when they are declared by the board of directors and shall be recorded as a liability. Incurred policyholder dividends are reported in the statement of income.

46. The financial statements shall disclose the terms of dividend restrictions, if any. Refer to the preamble for further discussion regarding disclosure requirements.

Relevant Literature

47. Structured settlements are addressed in *FASB Statement No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts* (FAS 113). FAS 113 is addressed in *SSAP*

[1] The requirement for five years of data is only applicable to the annual statement blank. The audited statutory financial report is only required to report two years. Additionally, the audited statutory financial statement shall include items not included in the notes to the annual statement blank where the blank's schedules and exhibits satisfy disclosure requirements that are not included in the audited statutory financial statement (i.e., Since the audited financial statements do not include Schedule P, all of the SSAP No. 55 disclosures shall be included in the audited notes to financial statements).

No. 62R—Property and Casualty Reinsurance. This statement rejects the AICPA *Audit and Accounting Guide—Audits of Property and Liability Insurance Companies.*

Effective Date and Transition

48. This statement is effective for years beginning January 1, 2001. To the extent that the requirements of paragraphs 23-33 produce a higher reserve than the reporting entity would have established through the use of their previous methodology, the reporting entity may phase in the additional reserve over a period not to exceed three years. Such a phase in period shall only be permitted if the reporting entity is able to demonstrate that it would not be operating in a hazardous financial condition and that there is not adverse risk to its insureds. The phase in shall be at least 60% of the difference between the reserve required by this statement and the reserve determined by the previous methodology during the first year, 80% in the second year, and 100% in the third year. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with SSAP No. 3. The guidance in the footnote of paragraph 42.d. was originally contained within *INT 02-10: Statutory Audit Report Notes and the Reporting Requirements Related to Discosures Containing Multiple Year Information* and was effective June 9, 2002.

REFERENCES

Other

- *Actuarial Standard of Practice No. 20, Discounting of Property and Casualty Loss and Loss Adjustment Expense*

- NAIC *Annual Statement Instructions for Property and Casualty Insurers*

Relevant Issue Papers

- *Issue Paper No. 65—Property and Casualty Contracts*

EXHIBIT A – GUIDELINES FOR STATES WHO PRESCRIBE OR PERMIT DISCOUNTING ON A NON-TABULAR BASIS

As discussed in paragraph 10 of this statement, with the exception of fixed and reasonably determinable payments such as those emanating from workers' compensation tabular indemnity reserves and long-term disability claims, property and casualty loss reserves shall not be discounted. However, one of the most common prescribed or permitted state practices is to allow discounting of unpaid losses and unpaid loss adjustment expenses on a non-tabular basis. The recommendations in this exhibit are not requirements and therefore should only be viewed as a recommendation to those states that prescribe or permit non-tabular discounting.

Recommended Prescribed or Permitted Practice Guidelines

The state of XYZ office will permit [insert domestic companies if prescribed or insert insurance company name if prescribed] to discount its December 20XX unpaid loss (i.e., reported losses and incurred but not reported losses) and unpaid loss adjustment expense (LAE) reserves on an non-tabular basis subject to the following conditions:

1. The unpaid loss and LAE reserves shall be determined in accordance with *Actuarial Standard of Practice No. 20, Discounting of Property and Casualty Loss and Loss Adjustment Expense* (and as agreed to by an actuary) but in no event shall the rate used exceed the lesser of the following two standards:

   a. If the reporting entity's statutory invested assets are at least equal to the total of all policyholder reserves, the reporting entity's net rate of return on statutory invested assets, less 1.5%, otherwise, the reporting entity's average net portfolio yield rate less 1.5% as indicated by dividing the net investment income earned by the average of the reporting entity's current and prior year total assets; or

   b. The current yield to maturity on a United States Treasury debt instrument with maturities consistent with the expected payout of the liabilities.

2. Disclosure of the [insert either prescribed or permitted practice] in compliance with the requirements of the *NAIC Accounting Practices and Procedures Manual* and the *NAIC Annual Statement Instructions – Property and Casualty*, including but not limited to:

   Note 1 – Summary of Significant Accounting Policies

   A. Disclosure of permitted practice

      a. Disclose that the reporting entity employs a prescribed or permitted accounting practice that departs from the NAIC Accounting Practices and Procedures; and

      b. Disclose the monetary effect on net income and statutory surplus of using the practice of discounting on a non-tabular basis rather than the NAIC statutory accounting practice of discounting fixed and reasonably determinable payments such as those emanating from workers' compensation tabular indemnity reserves and long-term disability claims.

   Note 32 – Discounting of Liabilities for Unpaid Losses or Unpaid Loss Adjustment Expenses
   XX. Non-tabular discounting

      a. Disclosure of whether the reporting entity is applying non-tabular discounting based upon a state prescribed or permitted practice. If permitted, provide further disclosure as to the date domiciliary state issued permitted practice and the expiration date of such practice;

b. Rate(s) used and the basis for the rate(s) used;

c. Amount of non-tabular discount disclosed by line of business and reserve category (i.e., unpaid loss, incurred but not reported, defense and cost containment expense, and adjusting and other expense); and

d. The amount of non-tabular discount reported in the statement.

Non-tabular discounting illustration:

	(1) Case	(2) IBNR	(3) Defense & Cost Containment Expense	(4) Adjusting & Other Expense
1. Homeowners/Farmowners				
2. Private Passenger Auto Liability/Medical				
3. Commercial Auto/Truck Liability/Medical				
4. Workers' Compensation				
5. Commercial Multiple Peril				
6. Medical Malpractice – Occurrence				
7. Medical Malpractice – Claims-Made				
8. Special Liability				
9. Other Liability – Occurrence				
10. Other Liability – Claims-Made				
11. Special Property				
12. Auto Physical Damage				
13. Fidelity, Surety				
14. Other (including Credit, Accident & Health)				
15. International				
16. Reinsurance Nonproportional Assumed Property				
17. Reinsurance Nonproportional Assumed Liability				
18. Reinsurance Nonproportional Assumed Financial Lines				
19. Products Liability – Occurrence				
20. Products Liability – Claims-Made				
21. Financial Guaranty/Mortgage Guaranty				
22. Total				

The rates used to discount Medical Malpractice unpaid losses at December 31, 20X2 have changed from the rates used at December 31, 20X1. At December 31, 20X2, the amount of discounted Medical Malpractice unpaid losses, excluding the current accident year, is $_______________. Had these unpaid losses been discounted at the rates used at December 31, 20X1 the amount of discounted liabilities would be $_______________. The reduction in the discounted liability due to the change in rates is $_______________.

This illustration neither regulates, permits, nor prohibits the practice of discounting liabilities for unpaid losses or unpaid loss adjustment expenses.

Statement of Statutory Accounting Principles No. 66

Retrospectively Rated Contracts

STATUS

Type of Issue:	Common Area
Issued:	Initial Draft
Effective Date:	January 1, 2001
Affects:	No other pronouncements
Affected by:	No other pronouncements
Interpreted by:	INT 05-05

STATUS **1**

SCOPE OF STATEMENT **3**

SUMMARY CONCLUSION **3**

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REFERENCES **7**

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Retrospectively Rated Contracts

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for retrospectively rated contracts. This statement applies to property and casualty contracts, life insurance contracts, and accident and health contracts.

2. Retrospective reinsurance contracts are not within the scope of this statement. They are addressed in *SSAP No. 62R—Property and Casualty Reinsurance* (SSAP No. 62R).

SUMMARY CONCLUSION

3. A retrospectively rated contract is one which has the final policy premium calculated based on the loss experience of the insured during the term of the policy (including loss development after the term of the policy) and the stipulated formula set forth in the policy or a formula required by law. The periodic adjustments may involve either the payment of return premium to the insured or payment of an additional premium by the insured, or both, depending on experience. Retrospective rating features are common in certain property and casualty contracts, group life, and group accident and health contracts. Some contracts have retrospective features required by law. Contracts with retrospective rating features are referred to as loss sensitive contracts.

4. Amounts due from insureds and amounts due to insureds under retrospectively rated contracts meet the definitions of assets and liabilities as set forth in *SSAP No. 4—Assets and Nonadmitted Assets* and *SSAP No. 5R—Liabilities, Contingencies and Impairment of Assets* (SSAP No. 5R), respectively. Amounts due from insureds and amounts due to insureds under retrospectively rated contracts are admitted assets to the extent they conform to the requirements of this statement.

5. Initial premiums shall be recognized in accordance with *SSAP No. 51—Life Contracts, SSAP No. 53—Property Casualty Contracts—Premiums,* and *SSAP No. 54 —Individual and Group Accident and Health Contracts*.

6. Specific funds received by the prescription drug plan sponsor from either the Medicare Part D enrollee or the government as payment for standard coverage that will be subject to retrospective premium adjustments should be accounted for under this statement. These funds include 'Direct Subsidy', 'Low Income Subsidy (premium portion)', 'Beneficiary Premium (standard coverage portion)', 'Part D Payment Demonstration' and 'Risk Corridor Payment Adjustment'. The funds noted above have a final policy amount that is calculated based on the loss experience of the insured during the term of the policy, therefore should be treated as such. Refer to *INT 05-05: Accounting for Revenues Under Medicare Part D Coverage* for additional information and definitions of terms specifically related to Medicare Part D business.

7. Because policy periods do not always correspond to reporting periods and because an insured's loss experience may not be known with certainty until sometime after the policy period expires, retrospective premium adjustments shall be estimated based on the experience to date using one of the following methods:

a. Property and Casualty Contracts:

i. Use of actuarially accepted methods in accordance with filed and approved retrospective rating plans. This includes but is not limited to the application of historical ratios of retrospective rated developments to earned standard premium to develop a ratio which is then applied to those policies for which no retrospective calculation has been recorded or for which no modification to the recorded calculation is needed. This method results in the calculation of one amount which is either a net asset or a net liability;

ii. Reviewing each individual retrospectively rated risk, comparing known loss development (including IBNR) with that anticipated in the policy contract to arrive at the best estimate of return or additional premium earned at that point in time. This method results in the calculation of an asset or a liability for each risk. The total of all receivables shall be recorded as an asset and the total of all return premiums shall be recorded as a liability.

b. Life and Accident & Health Contracts: Reporting entities offering group coverage have extensive underwriting procedures and complex individually negotiated benefits and contracts. Due to cost and reporting deadlines, these factors make it difficult to establish an exact valuation of retrospective premium adjustments. The method used to estimate the liability shall be reasonable based on the reporting entity's procedures and consistent among reporting periods. Common methods include a mathematical approach using a complex algorithm of the reporting entity's underwriting rules and experience rating practices, and an aggregate or group approach.

8. Assumptions used in estimating retrospective premium adjustments shall be consistent with the assumptions made in recording other assets and liabilities necessary to reflect the underwriting results of the reporting entity such as claim and loss reserves (including IBNR) and contingent commissions. Contingent commissions and other related expenses shall be adjusted in the same period the additional or return retrospective premiums are recorded.

9. Retrospective premium adjustments are estimated for the portion of the policy period that has expired and shall be considered an immediate adjustment to premium. Additional retrospective premiums and return retrospective premiums shall be recorded as follows:

a. Property and Casualty Reporting Entities:

i. Accrued additional retrospective premiums shall be recorded as a receivable with a corresponding entry made either to written premiums or as an adjustment to earned premiums. Premiums not recorded through written premium when accrued shall be recorded through written premium when billed;

ii. Accrued return retrospective premiums shall be recorded as part of the change in unearned premium (detailed in the underwriting and investment exhibit) liability with a corresponding entry made either to written premiums or as an adjustment to earned premiums. Premiums not recorded through written premium when accrued shall be recorded through written premium when billed;

iii. Ceded retrospective premium balances payable shall be recorded as liabilities, consistent with SSAP No. 62R. Ceded retrospective premiums recoverable shall be recorded as an asset. Consistent with *SSAP No. 64—Offsetting and Netting of Assets and Liabilities* (SSAP No. 64), ceded retrospective premium balances payable may be deducted from ceded retrospective premiums recoverable when a legal right of setoff exists.

b. Life and Accident and Health Reporting Entities:

i. Accrued additional retrospective premiums shall be recorded as an asset, accrued retrospective premiums, with a corresponding entry to premiums;

ii. Accrued return retrospective premiums shall be recorded as a liability, provision for experience rating refunds, with a corresponding entry to premiums.

c. Managed Care/Accident and Health Reporting Entities

i. Accrued additional retrospective premiums shall be recorded as an asset, accrued retrospective premiums with a corresponding entry to premiums;

ii. Accrued return retrospective premiums shall be recorded as a liability, as part of Accident and Health Reserves (reserve for rate credits or experience rating refunds), with a corresponding entry to premiums.

10. The amount of accrued estimated retrospective premiums to be recorded as a nonadmitted asset for property and casualty insurers shall be determined as follows:

a. 100% of the amount recoverable from any person for whom any agents' balances or uncollected premiums are classified as nonadmitted, and item (b), plus item (c) or (d) below. Once an insurer has elected either (c) or (d) below, a change from one to the other requires approval from the insurer's domiciliary state and such change must be disclosed in the financial statements.

b. Retrospective premium adjustments shall be determined and billed or refunded in accordance with the policy provisions or contract provisions. If accrued additional retrospective premiums are not billed in accordance with the policy provisions or contract provisions, the accrual shall be nonadmitted.

c. 10% of any accrued retrospective premiums not offset by retrospective return premiums, other liabilities to the same party (other than loss and loss adjustment expense reserves), or collateral, not otherwise used. Collateral shall be of the same types and quality permitted for use in connection with reinsurance (types of acceptable collateral vary from state to state) or by financial guaranty coverage issued by an insurer having an "A" or better rating from a nationally recognized rating agency. The financial guaranty coverage must allow the insured under the financial guaranty policy the same degree of access to payments under that policy as a beneficiary has under a qualified letter of credit as described in Appendix A-785. Accrued retrospectively rated premiums relating to bulk IBNR must be allocated to individual policyholder accounts prior to applying collateral by account. If the insurer is unable to allocate amounts by account, no credit may be taken for collateral.

d. An amount calculated using the factors below for accrued retrospective premiums not offset by retrospective return premiums, other liabilities to the same party (other than loss and loss expense reserves), or collateral, not otherwise used. Collateral shall be of the same types and quality permitted for use in connection with reinsurance (types of acceptable collateral vary from state to state) or by financial guaranty coverage issued by an insurer having an "A" or better rating from a nationally recognized rating agency. The financial guaranty coverage must allow the insured under the financial guaranty policy the same degree of access to payments under that policy as a beneficiary has under a qualified letter of credit as described in Appendix A-785.

Accrued retrospectively rated premiums relating to bulk IBNR must be allocated to individual policyholder accounts prior to categorizing by Quality Rating.

Insured's Current Quality Rating*	Insured's Corporate Debt Equivalent to (S&P/Moody's)**	Percentage of Retro Premium to be Nonadmitted***
1	AAA, AA, A/Aaa, Aa, A	1%
2	BBB/Baa	2%
3	BB/Ba	5%
4	B/B	10%
5	CCC, CC, C/Caa, Ca	20%
6	CI, D/C, or insured in default on debt service payments, or insured's debt service payments are jeopardized upon filing of a bankruptcy petition	100%

* The Percentage of Retro Premium to be Nonadmitted is based upon the Insured's Current Quality Rating (i.e., if an insured's quality rating drops, the percentage relating to the lower quality rating is used in calculating the amount to be nonadmitted and vice versa).

** Insureds that do not have a debt rating issued by a publicly recognized rating agency are required to be rated by the NAIC's Securities Valuation Office (SVO).

*** In the event the insured has no debt rating (either from a publicly recognized rating agency or from the SVO) the insured's quality rating will be considered category 5 for purposes of this calculation (i.e., a factor of 20% shall be applied), unless the insurer is aware of conditions of the insured that would warrant a category 6 classification (i.e., a factor of 100%).

11. Once accrued retrospective premium is billed, the due date is governed by *SSAP No. 6—Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due From Agents and Brokers*. Life and accident and health reporting entities shall nonadmit any accrued retrospective premium that is more than 90 days due. If a reporting entity has issued more than one policy to the same insured, retrospective balances shall be netted in accordance with SSAP No. 64.

12. If, in accordance with SSAP No. 5R, it is probable that the additional retrospective premium is uncollectible, any uncollectible additional retrospective premium shall be written off against operations in the period the determination is made. If it is reasonably possible a portion of the balance in excess of the nonadmitted portion determined in accordance with paragraph 10 is not anticipated to be collected, the disclosure requirements outlined in SSAP No. 5R shall be made.

Disclosures

13. The financial statements shall disclose the method used by the reporting entity to estimate retrospective premium adjustments. The amount of net premiums written that are subject to retrospective rating features, as well as the corresponding percentage to total net premiums written, shall be disclosed. In addition, disclose whether accrued retrospective premiums are recorded through written premium or as an adjustment to earned premium.

14. The financial statements shall disclose the calculation of nonadmitted retrospective premium. If a reporting entity chooses treatment described in paragraph 10.c. or 10.d., the appropriate exhibit must be

included in the notes to financial statements in the Annual Statement. Once a reporting entity has elected either 10.c. or 10.d., a change from one to the other requires approval from the reporting entity's domiciliary state and such change must be disclosed in the financial statements.

15. The financial statements shall disclose the following amounts for medical loss ratio rebates required pursuant to the Public Health Service Act for the current reporting period year-to-date and prior reporting period year: incurred rebates, amounts paid and unpaid liabilities segregated into the following categories: individual, small group employer, large group employer and other. In addition, the impact of reinsurance assumed, ceded and net on the total medical loss ratio rebate shall be disclosed.

16. Refer to the preamble for further discussion of the disclosure requirements.

Relevant Literature

17. This statement rejects *FASB Emerging Issues Task Force No. 93-14, Accounting for Multiple Year Retrospectively Rated Insurance Contracts* (EITF 93-14) since it applies only to multiple-year retrospectively rated contracts. The statutory principles outlined in the conclusion above are consistent with the guidance provided for accounting and retrospectively rated contracts in *FASB Statement No. 60, Accounting and Reporting by Insurance Companies* (FAS 60) and EITF 93-14, with the exception of the requirement to record certain amounts as nonadmitted. Although FAS 60 is rejected in *SSAP No. 50—Classifications and Definitions of Insurance or Managed Care Contracts In Force* and EITF 93-14 is rejected in this statement, it is considered appropriate that the accounting for retrospectively rated contracts be consistent with those provisions of both FAS 60 and EITF 93-14 as they are consistent with the Statement of Concepts.

Effective Date and Transition

18. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*.

REFERENCES

Other

- NAIC *Annual Statement Instructions for Property and Casualty Insurance Companies*

Relevant Issue Papers

- *Issue Paper No. 66—Accounting for Retrospectively Rated Contracts*

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Statement of Statutory Accounting Principles No. 67

Other Liabilities

STATUS

Type of Issue:	Common Area
Issued:	Initial Draft
Effective Date:	January 1, 2001
Affects:	No other pronouncements
Affected by:	No other pronouncements
Interpreted by:	No other pronouncements

STATUS 1

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Other Liabilities

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for other liabilities.

SUMMARY CONCLUSION

2. For purposes of identifying other liabilities, the guidance outlined in *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets* (SSAP No. 5R) must be considered. This statement is not an all-inclusive list of other liabilities. Certain other liabilities are covered in other statements. All other liabilities, whether or not specifically identified in this statement, shall be recorded and disclosed in accordance with SSAP No. 5R, which states that "Liabilities shall be recorded on a reporting entity's financial statements when incurred."

Self-Insurance

3. Self-insurance occurs when an entity retains insurance risks associated with the entity's day-to-day operations that are commonly transferred to an insurer through an insurance contract.

4. The fact that a decision is made not to insure against losses that can reasonably be expected sometime in the future does not necessitate accrual by the entity if it is not probable that an asset has been impaired or a liability incurred at the date of the financial statements.

5. If an uninsured (self-insured) event occurs, which either creates a liability or impairs an asset, the entity shall either establish a liability or write-down the impaired asset. The liability shall be established using the same estimation methodology an insurance company uses when an insurance contract is issued for the type of insurance risk which is self-insured. *SSAP No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses* describes the specific reserving guidance which shall be followed.

6. The related costs shall be recorded based on the nature of the underlying expenses, and allocated in accordance with *SSAP No. 70—Allocation of Expenses*. Related costs shall be recorded based on the nature of the underlying expenses.

Amounts Withheld or Retained by Company as Agent or Trustee

7. A reporting entity may, in the normal course of its business, withhold funds as an agent or trustee which will ultimately be paid to others.

8. Amounts withheld or retained by an entity as trustee or agent shall be recorded as a liability when the salaries or other compensation are expensed (paragraphs 8.a. and 8.b.) or the funds are received (paragraphs 8.c. through 8.e.). Examples of such occurrences are:

   a. As an employer, the reporting entity deducts and withholds federal and state income taxes, social security taxes, charitable contributions, savings plan deductions, garnishments, employee contributions to pension plans, employee share of group life and health insurance premiums, and other employee salary withholdings or deductions;

   b. Amounts due under deferred compensation arrangements shall be accrued in accordance with the provisions of *SSAP No. 92—Accounting for Postretirement Benefits Other Than Pensions, A Replacement of SSAP No. 14* (SSAP No. 92). Segregated funds (i.e., Rabbi trusts and similar arrangements) shall not be netted against the accrued liability unless the requirements of *SSAP No. 64—Offsetting and Netting of Assets and Liabilities* (SSAP No. 64) are met.

c. For a reporting entity that invests in commercial and residential mortgages, the entity may require the mortgagor to prepay real estate taxes and property insurance premiums which the entity will hold in escrow and pay when due;

d. The reporting entity holds deposits in connection with leases of investment property; and

e. The reporting entity may receive and hold other funds in a fiduciary capacity.

Remittances and Items Not Allocated

9. Cash receipts cannot always be identified for a specific purpose or, for other reasons, applied to a specific account when received. The reporting entity shall record a liability for these cash receipts when the funds are received. These liability accounts are generally referred to as suspense accounts. Examples include:

a. Premium payments received with the application for policies which have not yet been issued;

b. Premium payments in an amount different than the amount billed by the reporting entity; and

c. Unidentified cash receipts.

Interest Payable

10. Interest payable includes interest on debt, interest on real estate obligations, and approved interest on surplus notes. It also includes interest on funds held as a deposit or security, such as those held by a ceding company against a reinsurer. The amount to be reported is the amount which has accrued and is unpaid at the balance sheet date.

Payable to Parent, Subsidiaries and Affiliates

11. A liability shall be recognized and identified as due to affiliates for expenditures incurred on behalf of the reporting entity by a parent, affiliates, or subsidiaries or for amounts owed through other intercompany transactions. Amounts due to or from affiliates shall be offset and reported net only when the provisions of SSAP No. 64 are met. Examples of these expenses are executive salaries, workers' compensation insurance premiums, and pension contributions.

12. Reinsurance transactions are not considered liabilities of this nature and are covered in *SSAP No. 61R—Life, Deposit-Type and Accident and Health Reinsurance* and *SSAP No. 62R—Property and Casualty Reinsurance.*

Relevant Literature

13. This statement adopts *FASB Statement No. 116, Accounting for Contributions Received and Contributions Made* and AICPA *Statement of Position 96-1, Environmental Remediation Liabilities*. This statement is consistent with *FASB Statement No. 5, Accounting for Contingencies* as discussed in SSAP No. 5R.

Effective Date and Transition

14. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*.

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 96—Other Liabilities*

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Statement of Statutory Accounting Principles No. 68

Business Combinations and Goodwill

STATUS

Type of Issue:	Common Area
Issued:	Initial Draft
Effective Date:	January 1, 2001
Affects:	Nullifies and incorporates INT 99-10, INT 03-16
Affected by:	No other pronouncements
Interpreted by:	INT 00-28, INT 01-18, INT 06-07

STATUS **1**

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Business Combinations and Goodwill

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for business combinations. It addresses: (a) accounting for purchases of subsidiary, controlled and affiliated (SCA) investments (defined in *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities, A Replacement of SSAP No. 88* (SSAP No. 97)); (b) accounting for purchases of partnerships, joint ventures, and limited liability companies (defined in *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies*); (c) accounting for goodwill; and (d) accounting for mergers. This statement does not include guidance for stock of an affiliated company received as a capital contribution, rather than through a purchase. Stock received as a capital contribution is addressed by *SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties* (SSAP No. 25), *SSAP No. 95—Exchange of Nonmonetary Assets, A Replacement of SSAP No. 28—Nonmonetary Transactions* (SSAP No. 95), or SSAP No. 97*,* based on the details of each transaction. The statutory purchase method within *SSAP No. 68—Business Combinations* (SSAP No. 68) is not applicable for stock received as a capital contribution.

SUMMARY CONCLUSION

Business Combinations

2. A business combination shall be accounted for as either a statutory purchase or a statutory merger. Business combinations that create a parent-subsidiary relationship shall be accounted for as a statutory purchase. Business combinations where equity of one entity is issued in exchange for the equity of another entity, which is then canceled, and prospectively only one entity exists, shall be accounted for as a statutory merger.

Statutory Purchases of SCA Investments

3. The statutory purchase method of accounting is defined as accounting for a business combination as the acquisition of one entity by another. It shall be used for all purchases of SCA entities including partnerships, joint ventures, and limited liability companies. The acquiring reporting entity shall record its investment at cost. Cost is defined as the sum of: (a) any cash payment, (b) the fair value of other assets distributed, (c) the fair value of any liabilities assumed, and (d) any direct costs of the acquisition.$^{\text{(INT 00-28)}}$ Contingent consideration issued in a purchase business combination that is embedded in a security or that is in the form of a separate financial instrument shall be recorded by the issuer at fair value at the acquisition date.

4. For those acquired SCA entities accounted for in accordance with paragraphs 8.b.i., 8.b.ii., 8.b.iii. or 8.b.iv. of SSAP No. 97, and joint venture, partnership or limited liability company entities accounted for in accordance with paragraph 8 of SSAP No. 48, goodwill is defined as the difference between the cost of acquiring the entity and the reporting entity's share of the book value of the acquired entity. When the cost of the acquired entity is greater than the reporting entity's share of the book value, positive goodwill exists. When the cost of the acquired entity is less than the reporting entity's share of the book value, negative goodwill exists. Goodwill resulting from assumption reinsurance shall be recorded as a separate write-in for other-than-invested assets. All other goodwill shall be reported in the carrying value of the investment.

5. A business combination accounted for under the statutory purchase method and in which the acquired entity is valued in accordance with paragraphs 8.b.ii., 8.b.iii. or, 8.b.iv. of SSAP No. 97 shall determine the amount of positive goodwill or negative goodwill created by the combination using the reporting entity's share of the GAAP net book value of the acquired entity, adjusted to a statutory basis of accounting in accordance with paragraph 9 of SSAP No. 97 in the case of acquired entities valued in accordance paragraphs 8.b.ii. or 8.b.iv. of SSAP No. 97. Business combinations accounted for under the

statutory purchase method and in which the acquired entity is valued in accordance with, paragraph 8.b.i. of SSAP No. 97 shall determine the amount of positive or negative goodwill created by the business combination using the insurer's share of the statutory book value of the acquired entity.

6. For those acquired SCA entities accounted for in accordance with paragraph 8.b.i. of SSAP No. 97 under the statutory purchase method, the historical bases of the acquired entity shall continue to be used in preparing its statutory financial statements. Therefore, pushdown accounting is not permitted.

7. Positive goodwill recorded under the statutory purchase method of accounting shall be admitted subject to the following limitation: Positive goodwill from all sources, including life, accident and health, and deposit-type assumption reinsurance, is limited in the aggregate to 10% of the acquiring entity's capital and surplus as required to be shown on the statutory balance sheet of the reporting entity for its most recently filed statement with the domiciliary state commissioner adjusted to exclude any net positive goodwill, EDP equipment and operating system software, and net deferred tax assets. When negative goodwill exists, it shall be recorded as a contra-asset. Positive or negative goodwill resulting from the purchase of an SCA, joint venture, partnership or limited liability company shall be amortized to unrealized capital gains and losses on investments over the period in which the acquiring entity benefits economically, not to exceed 10 years. Positive or negative goodwill resulting from life, accident and health, and deposit-type assumption reinsurance shall be amortized to operations as a component of general insurance expenses over the period in which the assuming entity benefits economically, not to exceed 10 years. Goodwill shall be evaluated separately for each transaction.(INT 01-18)

Impairment

8. For any decline in the fair value of an entity, acquired through a purchase, that is other than temporary (INT 06-07), the investment shall be written down to fair value as the new cost basis and the amount of the write down shall be accounted for as a realized loss. The write down shall first be considered as an adjustment to any portion of the investment that is nonadmitted (e.g., nonadmitted goodwill). The new cost basis shall not be changed for subsequent recoveries in fair value. Future declines in fair value, which are determined to be other than temporary, shall be recorded as realized losses.

9. An impairment shall be considered to have occurred if it is probable that the reporting entity will be unable to recover the carrying amount of the investment or there is evidence indicating inability of the investee to sustain earnings which would justify the carrying amount of the investment. A fair value of an investment that is below the carrying amount based on the statutory equity method or the existence of investee operating losses may indicate a loss in value; however, they are not necessarily indicative of a loss in value that is other than temporary.

Statutory Mergers

10. The statutory merger method of accounting is defined as accounting for a business combination in which the original investors in the investee receive equity of the reporting entity for their interest in the investee and only one entity survives. It shall be used for all business combinations accomplished by (a) issuing equity of a newly formed entity for the equity of the merging entities, (b) one entity issuing equity in exchange for the equity of another entity and immediately canceling the equity of that entity, or (c) the exchange of membership interest.

11. Under the statutory merger method, no acquisition shall be recognized because the combination is accomplished without disbursing resources of the constituents. Ownership interest continues and the former statutory bases of accounting shall be retained. However, if one of the merged entities did not employ the statutory basis of accounting, the accounts shall be adjusted to the statutory bases with an offsetting adjustment to beginning surplus of the earliest period presented. The recorded assets, liabilities, and related surplus accounts of the constituents shall be carried forward to the combined corporation at

their recorded statutory amounts. The capital accounts of the entities shall be adjusted as necessary to reflect the appropriate par values of the capital stock of the new entity. Adjustments to the capital stock account shall be made to gross paid-in and contributed surplus, to the extent there is a balance in the account.

12. Income of the combined reporting entity shall include income of the constituents for the entire fiscal period in which the combination occurs and the balance sheet and the statement of operations for the two years presented shall be restated, as required by *SSAP No. 3—Accounting Changes and Corrections of Errors*. A reporting entity that merges with an entity which effectively is a shell company[1] (i.e., the reporting entity has no outstanding underwriting liabilities) shall be exempt from prior year restatement.

Treatment of Goodwill When Previously Purchased or Merged Entity Ceases to Exist

13. Goodwill carried by an entity related to a previous business combination shall be charged or credited to surplus immediately in the event that the investee or previous investor that the goodwill relates to ceases to exist (e.g., by merger or dissolution). This guidance is intended to prevent recognition of goodwill when the acquisition, merger or dissolution of the investor or investee would result with the remaining entity reporting goodwill in itself. Internally generated goodwill, or amounts that reflect the goodwill of the reporting entity are not permitted under statutory accounting principles.

Disclosures

14. For business combinations accounted for under the statutory purchase method, the financial statements shall disclose the following for as long as unamortized goodwill is reported as a component of the investment:

a. The name and brief description of the acquired entity;

b. Method of accounting, that is the statutory purchase method;

c. Cost of the acquired entity and the amount of goodwill; and

d. The amount of amortization of goodwill recorded for the period.

15. For business combinations taking the form of a statutory merger, the financial statements shall disclose:

a. The names and brief description of the combined entities;

b. Method of accounting, that is the statutory merger method;

c. Description of the shares of stock issued in the transaction;

d. Details of the results of operations of the previously separate entities for the period before the combination is consummated that are included in the current combined net income, including revenue, net income, and other changes in surplus; and

e. A description of any adjustments recorded directly to surplus for any entity that previously did not prepare statutory statements.

[1] When one of the entities is a "shell company," the prior year amounts shall only consist of the "non-shell company." The merger with a shell entity shall be reflected as of January 1 of the current year.

16. The financial statements shall disclose the following information regarding goodwill resulting from assumption reinsurance:

a. The name of the ceding entity;

b. The type of business assumed;

c. The cost of the acquired business and the amount of goodwill; and

d. The amount of amortization of goodwill recorded for the period.

17. A reporting entity that recognizes an impairment loss shall disclose the following in the financial statements that include the period of the impairment write-down:

a. A description of the impaired assets and the facts and circumstances leading to the impairment; and

b. The amount of the impairment charged to realized capital gains and losses and how fair value was determined.

Relevant Literature

18. This statement adopts paragraph 12 of *FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (FAS 121) to the extent that it addresses impairment of goodwill. Paragraphs 14.a. and 14.b. of FAS 121 are also adopted. Paragraphs 13, 14.c. and 14.d. of FAS 121 are rejected. *FASB Statement No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets* (FAS 144) supersedes FAS 121, but specifically scopes out the concept of goodwill. Given the applicability of the guidance found in paragraph 12 of FAS 121 to statutory accounting principles, the impairment guidance found in FAS 121, paragraph 12 is retained.

19. This statement adopts *FASB Emerging Issues Task Force No. 95-19, Determination of the Measurement Date for the Market Price of Securities Issued in a Purchase Business Combination* and *FASB Emerging Issues Task Force No. 97-8: Accounting for Contingent Consideration Issued in a Purchase Business Combination.*

20. This statement rejects *Accounting Principles Board Opinion No. 16, Business Combinations*, *FASB Statement No. 38, Accounting for Preacquisition Contingencies of Purchased Enterprises, an amendment of APB Opinion No. 16*, *Accounting Principles Board Opinion No. 17*, *Intangible Assets*, *FASB Statement No. 79, Elimination of Certain Disclosures for Business Combinations by Nonpublic Enterprises, FASB Statement No. 141, Business Combinations* and *FASB Statement No. 142, Goodwill and Other Intangible Assets.* The following related interpretative pronouncements are also rejected*:*

a. *AICPA Accounting Interpretations, Business Combinations: Accounting Interpretations of APB Opinion No. 16*;

b. *FASB Statement No. 10, Extension of "Grandfather" Provisions for Business Combinations*;

c. *AICPA Accounting Interpretations, Intangible Assets: Unofficial Accounting Interpretations of APB Opinion No. 17*;

d. *FASB Emerging Issues Task Force No. 85-14, Securities That Can Be Acquired for Cash in a Pooling of Interests*;

e. *FASB Emerging Issues Task Force No. 86-9, IRC Section 338 and Push-Down Accounting*;

f. *FASB Emerging Issues Task Force No. 86-10, Pooling with 10 Percent Cash Payout Determined by Lottery*;

g. *FASB Emerging Issues Task Force No. 87-11, Allocation of Purchase Price to Assets to Be Sold*;

h. *FASB Emerging Issues Task Force No. 87-15, Effect of a Standstill Agreement on Pooling-of-Interests Accounting*;

i. *FASB Emerging Issues Task Force No. 87-16, Whether the 90 Percent Test for a Pooling of Interests Is Applied Separately to Each Company or on a Combined Basis*;

j. *FASB Emerging Issues Task Force No. 87-27, Poolings of Companies that Do Not Have a Controlling Class of Common Stock*;

k. *FASB Emerging Issues Task Force No. 88-26, Controlling Preferred Stock in a Pooling of Interests*;

l. *FASB Emerging Issues Task Force No. 88-27, Effect of Unallocated Shares in an Employee Stock Ownership Plan on Accounting for Business Combinations*;

m. *FASB Emerging Issues Task Force No. 89-7, Exchange of Assets or Interest in a Subsidiary for a Noncontrolling Equity Interest in a New Entity*;

n. *FASB Emerging Issues Task Force No. 90-5, Exchanges of Ownership Interest between Entities under Common Control*;

o. *FASB Emerging Issues Task Force No. 90-6, Accounting for Certain Events Not Addressed in Issue No. 87-11 Relating to an Acquired Operating Unit to Be Sold*;

p. *FASB Emerging Issues Task Force No. 90-12, Allocating Basis to Individual Assets and Liabilities for Transactions within the Scope of Issue No. 88-16*;

q. *FASB Emerging Issues Task Force No. 90-13, Accounting for Simultaneous Common Control Mergers*;

r. *FASB Emerging Issues Task Force No. 91-5, Nonmonetary Exchange of Cost-Method Investments*;

s. *FASB Emerging Issues Task Force No. 92-9, Accounting for the Present Value of Future Profits Resulting from the Acquisition of a Life Insurance Company*;

t. *FASB Emerging Issues Task Force No. 93-7, Uncertainties Related to Income Taxes in a Purchase Business Combination*;

u. *FASB Emerging Issues Task Force No. 95-3, Recognition of Liabilities in Connection with a Purchase Business Combination*;

v. *FASB Emerging Issues Task Force No. 95-8, Accounting for Contingent Consideration Paid to the Shareholders of an Acquired Enterprise in a Purchase Business Combination*;

w. *FASB Emerging Issues Task Force No. 95-12, Pooling of Interests with a Common Interest in a Joint Venture*;

x. *FASB Emerging Issues Task Force No. 95-14, Recognition of Liabilities in Anticipation of a Business Combination*;

y. *FASB Emerging Issues Task Force No. 96-8, Accounting for a Business Combination When the Issuing Company Has Targeted Stock*;

z. *FASB Technical Bulletin 85-5, Issues Related to Accounting for Business Combinations*;

aa. *FASB Interpretations No. 4, Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method, an interpretation of FASB Statement No. 2*.

bb. *FASB Staff Position FAS 141/142-1: Interaction of FASB Statements No. 141 and No. 142 and EITF Issue No. 04-2.*

cc. *FASB Staff Position FAS 142-3, Determination of the Useful Life of Intangible Assets*

Effective Date and Transition

21. This statement is effective for years beginning January 1, 2001. The provisions of this statement shall be applied to all business combinations entered into on or after January 1, 2001. Goodwill that had been written off prior to the effective date of this statement is prohibited from being restored for purposes of applying the provisions of this statement. The guidance in paragraphs 4-6 was previously included within *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities, A Replacement of SSAP No. 88* and was effective for reporting periods ending on and after December 31, 2007. In 2011, the guidance related to goodwill included in SSAP No. 97 was incorporated into this statement. The original guidance included in this standard, and the substantive revisions reflected in SSAP No. 97 are retained for historical purposes within Issue Paper No. 118. Guidance reflected in paragraph 1, incorporated from *INT 03-16: Contribution of Stock*, was effective December 7, 2003.

REFERENCES

Other

- *Purposes and Procedures Manual of the NAIC ~~Securities Valuation~~Investment Analysis Office*

Relevant Issue Papers

- *Issue Paper No. 68—Business Combinations and Goodwill*
- *Issue Paper No. 118—Investments in Subsidiary, Controlled and Affiliated Entities, A Replacement of SSAP No. 46*

Statement of Statutory Accounting Principles No. 69

Statement of Cash Flow

STATUS

Type of Issue:	Common Area
Issued:	Initial Draft
Effective Date:	January 1, 2001
Affects:	No other pronouncements
Affected by:	No other pronouncements
Interpreted by:	No other pronouncements

STATUS 1

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Statement of Cash Flow

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for the Statement of Cash Flow.

SUMMARY CONCLUSION

2. The Statement of Cash Flow shall be prepared using the direct method. Cash from operations shall be reported consistent with the Statement of Income, excluding the effect of current and prior year accruals. For purposes of the Statement of Cash Flow, cash shall include cash, cash equivalents and short-term investments. Specific instructions for the classification of items are provided in the Annual Statement Instructions.

Disclosures

3. The financial statements shall disclose the following:

   a. Transactions considered to be investing and financing activities (consistent with the classifications in the Annual Statement) that affect recognized assets or liabilities but do not result in cash receipts or cash payments in the period (in narrative or schedule form); and

   b. The cash and noncash aspects of the above transactions identified as investing or financing consistent with the classifications provided by the Annual Statement Instructions. Examples of noncash investing and financing transactions include:

      i. Converting debt to equity;

      ii. Acquiring assets by assuming directly related liabilities, such as purchasing a building by incurring a mortgage to the seller; and

      iii. Exchanging noncash assets or liabilities for other noncash assets or liabilities.

4. Refer to the preamble for further discussion regarding disclosure requirements.

Relevant Literature

5. This statement adopts *FASB Emerging Issues Task Force Issue No. 95-13*, *Classification of Debt Issue Costs in the Statement of Cash Flows* which requires that cash payments for debt issue costs shall be classified as a financing activity in the Statement of Cash Flow. This statement adopts with modification *ASU 2012-05, Not-For-Profit Entities: Classification of the Sale Proceeds of Donated Financial Assets in the Statement of Cash Flows* for all reporting entities. Donated assets with donor-restrictions as to the sale or use of the contributed financial assets, or cash receipts from the sale of donated assets that are restricted as to use are not considered available to meet policyholder obligations and are nonadmitted in accordance with *SSAP No. 4—Assets and Nonadmitted Assets*.

6. *FASB Statement No. 95, Statement of Cash Flows, FASB Statement No. 102, Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale, an amendment of FASB Statement No. 95*, and *FASB Statement No. 104, Statement of Cash Flows—Net Reporting of Certain Cash Receipts and Cash Payments and Classification of Cash Flows from Hedging Transactions, an amendment of FASB Statement No. 95*, are rejected in this statement.

Effective Date and Transition

7. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors.*

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 92—Statement of Cash Flow*

Statement of Statutory Accounting Principles No. 70

Allocation of Expenses

STATUS

Type of Issue:	Common Area
Issued:	Initial Draft
Effective Date:	January 1, 2001
Affects:	No other pronouncements
Affected by:	No other pronouncements
Interpreted by:	No other pronouncements

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Allocation of Expenses

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for presentation and allocation of certain expenses of reporting entities into general categories and the apportionment of shared expenses between members of a group of entities.

SUMMARY CONCLUSION

2. This statement establishes uniform expense allocation rules to classify expenses within prescribed principal groupings. It is necessary to allocate those expenses which may contain characteristics of more than one classification, which this statement will refer to as allocable expenses.

3. Allocable expenses for property and casualty insurance companies shall be classified into one of three categories on the Underwriting and Investment Exhibit as follows:

a. Loss adjustment expenses—Expenses incurred in the adjusting, recording and paying of claims (including expenses associated with commutations);

b. Investment expenses—Expenses incurred in the investing of funds and pursuit of investment income. Such expenses include those specifically identifiable and allocated costs related to activities such as initiating and handling orders, researching and recommending investments (i.e., investment strategy), appraising, valuing, disbursing funds and collecting income, securities safekeeping, real estate taxes, records maintenance, data processing, support personnel, postage and supplies, office overhead, management and executive duties and all other functions reasonably associated with the investment of funds; or

c. Other underwriting expenses—Allocable expenses other than loss adjustment expenses and investment related expenses.

4. Similarly for life and accident and health insurers allocable expenses shall be categorized as general insurance expenses; insurance taxes, licenses and fees; or investment expenses which are netted against investment income on the Summary of Operations.

5. Allocable expenses for health insurers shall be classified as claim adjustment expenses; general administrative expenses; or investment expenses which are netted against investment income on the Statement of Revenue and Expenses.

6. Allocation to the above categories should be based on a method that yields the most accurate results. Specific identification of an expense with an activity that is represented by one of the categories above will generally be the most accurate method. Where specific identification is not feasible allocation of expenses should be based upon pertinent factors or ratios such as studies of employee activities, salary ratios or similar analyses.

7. Allocation may be entirely to one expense category based upon the type of expense incurred, for example, premium taxes would be 100% allocated to Other Underwriting Expenses for property and casualty companies. Other expenses may be allocated across several categories, such as salaries, which may be allocated to both general insurance expenses and net investment income of a life and accident and health company.

8. Many entities operate within a group where personnel and facilities are shared. Shared expenses, including expenses under the terms of a management contract, shall be apportioned to the entities incurring the expense as if the expense had been paid solely by the incurring entity. The apportionment

shall be completed based upon specific identification to the entity incurring the expense. Where specific identification is not feasible apportionment shall be based upon pertinent factors or ratios.

9. Any basis adopted to apportion expenses shall be that which yields the most accurate results and may result from special studies of employee activities, salary ratios, premium ratios or similar analyses. Expenses that relate solely to the operations of a reporting entity, such as personnel costs associated with the adjusting and paying of claims, must be borne solely by the reporting entity and are not to be apportioned to other entities within a group.

10. Apportioned expenses are subject to presentation and allocation as provided in paragraphs 3-6.

11. Any material individual component of the reported expense categories shall be presented either on the face of the Summary of Operations or within the footnotes or related Exhibits to the financial statements of the Life and Accident and Health annual statement, the Property and Casualty annual statement or the Health annual statement.

12. Refer to the preamble for further discussion regarding disclosure requirements.

Effective Date and Transition

13. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*.

REFERENCES

Other

- NAIC *Annual Statement Instructions for Property and Casualty Insurance Companies, "Underwriting and Investment Exhibit"*

- NAIC *Annual Statement Instructions for Life and Accident and Health Insurance Companies*

Relevant Issue Papers

- *Issue Paper No. 94—Allocation of Expenses*

Statement of Statutory Accounting Principles No. 71

Policy Acquisition Costs and Commissions

STATUS

Type of Issue:	Common Area
Issued:	Initial Draft
Effective Date:	January 1, 2001
Affects:	No other pronouncements
Affected by:	No other pronouncements
Interpreted by:	No other pronouncements

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Policy Acquisition Costs and Commissions

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for policy acquisition costs and commissions.

SUMMARY CONCLUSION

2. Acquisition costs are those costs that are incurred in the acquisition of new and renewal insurance contracts and include those costs that vary with and are primarily related to the acquisition of insurance contracts (e.g., agent and broker commissions, certain underwriting and policy issue costs, and medical and inspection fees). Acquisition costs and commissions shall be expensed as incurred. Determination of when acquisition costs and commissions have been incurred shall be made in accordance with *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets*.

3. Contingent commission liabilities shall be determined in accordance with the terms of each individual commission agreement. Commission liabilities determined on the basis of a formula that relates to loss experience shall be established for the earned portion. Assumptions used to calculate the contingent commission liability shall be consistent with the terms of the policy contract and with the assumptions made in recording other assets and liabilities necessary to reflect underwriting results of the reporting entity such as retrospective premium adjustments and loss reserves, including incurred but not reported.

4. Levelized commissions occur in situations where agents receive normal (non-level) commissions with payments made by a third party. It is intended, but not necessarily guaranteed, that the amounts paid to the agents by the third party would ultimately be repaid (with interest explicit or implied) to the third party by levelized payments (which are less than the normal first year commissions but exceed the normal renewal commissions) from the reporting entity. These transactions are, in fact, funding agreements between a reporting entity and a third party. The continuance of the stream of payments specified in the levelized commission contract is a mechanism to bypass recognition of those expenses which are ordinarily charged to expense in the first year of the contract. Consequently, the normal link between the persistency of the policy, the continuance of the premium payment or the maintenance of the agent's license with the reporting entity is not maintained with respect to the payment stream.

5. The use of an arrangement where commission payments are not linked to traditional elements such as premium payments and policy persistency, but rather are linked to the repayment of an advance amount requires the establishment of a liability for the full amount of the unpaid principal and accrued interest which is payable to a third party related to levelized commissions.

Relevant Literature

6. This statement rejects *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises, FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, *Statement of Position 05-1, Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection with Modifications or Exchanges of Insurance Contracts* and *ASU 2010-26, Financial Services – Insurance (Topic 944).*

Effective Date and Transition

7. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*.

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 71—Policy Acquisition Costs and Commissions*

Statement of Statutory Accounting Principles No. 72

Surplus and Quasi-Reorganizations

STATUS

Type of Issue:	Common Area
Issued:	Initial Draft
Effective Date:	January 1, 2001
Affects:	Nullifies and incorporates INT 99-01 and INT 00-12
Affected by:	No other pronouncements
Interpreted by:	No other pronouncements

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Surplus and Quasi-Reorganizations

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for statutory surplus and quasi-reorganizations.

SUMMARY CONCLUSION

2. Statutory surplus of a reporting entity consists of the following:

a. Capital stock;

b. Treasury stock;

c. Gross paid-in and contributed surplus;

d. Surplus notes;

e. Unassigned funds (surplus);

f. Special surplus funds; and

g. Other-than-special surplus funds.

Capital Stock

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

4. Notes or other receivables received for the issuance of capital stock which have been approved by the domiciliary commissioner and have been satisfied by receipt of cash or readily marketable securities prior to the filing of the statutory financial statement shall be treated as a Type I subsequent event in accordance with *SSAP No. 9—Subsequent Events* (SSAP No. 9) and as such shall be considered an admitted asset. To the extent that the notes or other receivables are not satisfied, they shall be nonadmitted.

5. Stock splits, similar to stock dividends, have no impact on the overall surplus of a reporting entity. The distinction between a stock split and a stock dividend shall be made in accordance with *Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research* Bulletins, "Chapter 7, Capital Accounts, Section B-Stock Dividends and Split-ups*"* (ARB 43). Stock splits shall be recorded by adjusting the capital stock account to reflect the par value of the outstanding number of shares after the split. An offsetting entry shall be made to paid-in or contributed surplus. Stock dividends shall be recorded in a manner consistent with paragraph 12.i.

Treasury Stock

6. Treasury stock is capital stock that has been issued and subsequently reacquired by the reporting entity. It is held for either reissuance or cancellation in the future. When a reporting entity's stock is acquired for purposes other than retirement, or when ultimate disposition has not yet been decided, the cost of acquired stock shall be reported as treasury stock which reduces statutory surplus. The acquisition

of treasury stock has no effect on either the number of shares issued or the amount of paid up capital shown in the capital stock account. Cancellation of treasury stock shall reduce the capital stock account by the par value and reduce paid-in or contributed surplus by the excess of cost over par value or stated value.

Gross Paid-in and Contributed Surplus

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

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

9. Real estate or other assets received as additional capital contributions are nonreciprocal transfers as defined in SSAP *No. 95—Exchanges of Nonmonetary Assets, A Replacement of SSAP No. 28—Nonmonetary Transactions* (SSAP No. 95).

10. Stock purchase warrants issued in return for cash shall be credited to gross paid-in and contributed surplus. When debt instruments are issued with conversion features, no value shall be assigned to the conversion features unless the conversion feature is clearly separable from the debt obligation in the form of a detachable stock purchase warrant. In such instances the relative fair value of the detachable stock purchase warrant at time of issue shall be credited to gross paid-in and contributed surplus. For instances in which a reporting entity has issued puttable warrants or mandatorily redeemable warrants, such items shall be reflected as liabilities as the warrants obligate the reporting entity to ultimately transfer cash or other assets to the holder in order to repurchase the shares.

Surplus Notes

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

Unassigned Funds (Surplus)

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

a. Net Income

Net income resulting from insurance and other operating activities of the reporting entity since its inception is a component of unassigned funds (surplus);

b. Unrealized Capital Gains and Losses on Investments

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

c. Effect of Exchange Rate Fluctuations

The cumulative gain or loss due to translating foreign operations to U.S. dollars and changes in balance sheet asset and liability values due to foreign currency translation is recorded as an unrealized capital gain or and loss and therefore is a component of unassigned funds (surplus). This component changes as the exchange rates fluctuate;

d. Nonadmitted Assets

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

e. Provision for Reinsurance

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

f. Asset Valuation Reserves

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

g. Separate Accounts

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

h. Subscribers Savings Accounts

Subscribers Savings Accounts (SSAs) are unique to reciprocals. SSAs represent a portion of a reciprocal insurance company's surplus that has been identified as subscribers (policyholders) accounts. When the source of amounts credited to the subscriber accounts is from the reciprocal's operations, the amounts are reported as unassigned funds (surplus);

i. Dividends to Stockholders

Dividends declared are charged directly to unassigned funds (surplus) on the declaration date and are carried as a liability until paid. The amount of the dividend is the cash paid if it is a cash dividend, the fair value of the assets distributed if it is property dividend, or the par value of the company's stock if it is a stock dividend. A stock dividend is recorded as a transfer from unassigned funds (surplus) to capital stock. Stock dividends have no effect on total capital and surplus while other forms of dividends reduce surplus. Forgiveness by a reporting entity of any debt, surplus note or other obligation of its parent or other stockholders shall be accounted for as a dividend. Dividends paid to related parties are subject to the requirements of *SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties*;

j. Change in Accounting Principles

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

k. Correction of an Error

Corrections of errors in previously issued financial statements are charged or credited directly to unassigned funds (surplus). The effect of corrections of errors shall not be included in the determination of net income or loss;

l. Stock Issuance Expenses

Expenses relating to the issuance of capital stock, for example underwriting commissions and filing fees are charged to unassigned funds (surplus);

m. Change in Surplus as a Result of Reinsurance

Life and accident and health insurers report increases in surplus that result from certain types of reinsurance transactions on a net of tax basis. As profits emerge from the ceded business the increase in surplus is amortized to income as provided for in Appendix A-791;

n. Changes in Deferred Tax Assets and Deferred Tax Liabilities

Consistent with the conclusions reached in *SSAP No. 101—Income Taxes, A Replacement of SSAP No. 10R and SSAP No. 10*, changes in deferred tax assets and deferred tax liabilities, including changes attributable to changes in tax rates and changes in tax status, if any, shall be recognized as a separate component of unassigned funds (surplus);

o. Other

This category includes other gains and losses in surplus not specifically identified elsewhere in this statement including but not limited to net proceeds from life insurance on employees, changes in the additional minimum pension liability as discussed in *SSAP No. 102—Accounting for Pensions, A Replacement of SSAP No. 89* and unearned compensation relating to stock issuances made under compensatory Employee Stock Ownership Plans, Stock Option Plans and Stock Purchase Plans.

Special Surplus Funds

13. A company may establish a segregated surplus account to provide for contingencies. Surplus thus appropriated is called appropriated surplus or special surplus funds. Surplus resulting from any retroactive reinsurance transaction entered by a property and casualty insurer must be recorded as an appropriation of surplus by the ceding company (special surplus from retroactive reinsurance account). Voluntary and

general contingency reserves which are not actual liabilities of the company are shown as appropriated surplus or special surplus funds.

Other-Than-Special Surplus Funds

14. Amounts provided to reporting entities, other than stock companies, in the organization stage to defray the expenses and meet initial minimum surplus requirements required to obtain a license to do the business of insurance or for the ongoing operations shall be reported as Other-Than-Special Surplus Funds. Examples of these types of deposits include but are not limited to: guaranty fund notes and subscriber accounts that represent individual subscriber contributions.

Quasi-Reorganizations

15. Restatement of gross paid-in and contributed surplus and unassigned funds (surplus) under a quasi-reorganization shall be permitted only if the criteria in both paragraphs 15.a. and 15.b. and either paragraph 15.c. or 15.d. are met:

a. The restatement is approved in writing by the domiciliary commissioner;

b. An 80% or greater change in the ultimate ownership of the reporting entity has occurred within six months prior to approval of the restatement;

c. A new business plan has been adopted that results in a substantive change in the operations and business mix of the reporting entity and the situation or circumstances that gave rise to the negative unassigned funds (surplus) will not be part of the ongoing operations;

d. The reporting entity is a shell company with no existing operations, in force policies or outstanding claims.

16. Restatement shall not result in the unassigned funds (surplus) account being greater than zero or the gross paid-in and contributed surplus account being less than zero immediately following the restatement. Total surplus as regards policyholders shall remain unchanged following restatement. The following components of unassigned funds (surplus) shall be considered in determining the amount available for restatement:

a. Net Income;

b. Effect of Exchange Rate Fluctuations;

c. Dividends to Stockholders;

d. Change in Accounting Principles;

e. Correction of an Error and

f. Stock Issuance Expenses.

17. The assets and liabilities of the reporting entity shall continue to be carried at historical cost or other value required by statutory accounting principles. No adjustments to assets or liabilities shall be made to reflect the effect of a quasi-reorganization.

18. The tax benefits of operating losses or tax credits existing at the date of a quasi-reorganization and subsequently recognized after the quasi-reorganization shall be recognized as an adjustment to gross paid-in and contributed surplus.

Demutualizations

19. Mutual insurance companies may undergo demutualization transactions and convert to stock enterprises. In order to effect a demutualization, a company may be required to issue consideration, often in the form of stock, to existing participating policyholders in exchange for their current membership interests. The receipt of such stock has no direct effect on the policyholders' contractual interests of their insurance policies (for example, it does not alter the cash surrender value of their life insurance policies). However, the governance of the mutual insurance company and, in particular, the participating policyholders' interest in that governance are modified. Stock received from a demutualization shall be accounted for at fair value with a gain recognized in income from continuing operations.

Changes in Statutory Surplus

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

Disclosures

21. The financial statements shall disclose the following:

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

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

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

d. The dates and amounts of dividends, or distributions paid. Note for each payment whether the dividend or distribution was ordinary or extraordinary.

e. The portion of the reporting entity profits that may be paid as ordinary dividends to stockholders;

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

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

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

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

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

i. unrealized gains and losses;

ii. nonadmitted asset values;

iii. separate account business;

iv. asset valuation reserves;

v. provision for reinsurance.

k. For reciprocal insurance companies only:

i. the amount of surplus identified as subscriber savings accounts;

ii. the source of the funds (either from the reciprocal's operations or contributed by the individual subscriber) and, the reporting location in surplus;

iii. the conditions upon which the balances are paid to the subscribers.

l. Disclosures required by SSAP No. 41;

m. Disclosures required by SSAP No. 9;

n. The impact of the restatement in a quasi-reorganization as long as financial statements for the period of the reorganization are presented; and

o. The effective date of a quasi-reorganization for a period of ten years following the reorganization.

22. Refer to the preamble for further discussion regarding disclosure requirements.

Relevant Literature

23. Paragraphs 9 and 10 of *Accounting Principles Board Opinion No. 12, Omnibus Opinion—1967,* are adopted with modification to eliminate the option of disclosing changes in the notes to the financial statements rather than in the Statement of Capital and Surplus. This statement originally adopted paragraphs 10 and 11 of *Accounting Principles Board Opinion No. 10, Omnibus Opinion—1966* (APB 10). However, for reporting periods ending after December 15, 1997, paragraphs 10 and 11 of APB 10 were deleted by paragraph 9, and replaced by paragraphs 6 and 7 of *FASB Statement No. 129, Disclosure of Information About Capital Structure* (FAS 129). As such, this statement adopts paragraphs 6, 7 and 9 of FAS 129. All other paragraphs of FAS 129 are rejected. This statement also adopts with modification paragraph 12 of *Accounting Principles Board Opinion No. 6* (APB 6), *Status of Accounting Research Bulletins,* to eliminate the option of recording treasury stock as an asset.

24. Paragraph 15 of *FASB Statement No. 5, Accounting For Contingencies*, is adopted by this statement. Paragraphs 1-4 and 10-16 of *Accounting Research Bulletin No. 43, Restatement and Revision of Accounting* Research *Bulletins,* "Chapter 7, Capital Accounts, Section B—Stock Dividends and Stock Split-ups" are adopted by this statement*.*

25. This statement adopts with modification *Accounting Research Bulletin No. 43, Restatement and Revision of Accounting* Research *Bulletins,* "Chapter 7, Capital Accounts, Section A—Quasi-Reorganization or Corporate Readjustment*,*" to permit restatement of gross paid-in and contributed surplus and unassigned funds (surplus) only in certain limited circumstances. This statement adopts *FASB Emerging Issues Task Force 99-4, Accounting for Stock Received from the Demutualization of a Mutual Insurance Company*.

26. This statement adopts with modification *Accounting Research Bulletin No. 46, Discontinuance of Dating Earned Surplus,* to require disclosure of the impact of the restatement in the financial statements as long as financial statements for the period of reorganization are presented and paragraph 28 of *Accounting Principles Board Opinion No. 9, Reporting the Results of Operations.* This statement rejects *FASB Emerging Issues Task Force No. 88-9, Put Warrants, FAS 150, Accounting for Certain Financial*

Instruments with Characteristics of both Liabilities and Equity (FAS 150), *FSP FAS 150-3, Effective Date, Disclosures and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests Under FASB Statement No. 150* (FSP FAS 150-3) and *FSP FAS 150-5, Issuer's Accounting Under FASB Statement No. 150 for Freestanding Warrants and Other Similar Instruments on Shares That Are Redeemable* (FSP FAS 150-5). FAS 150, and the corresponding FSPs are rejected as insurers do not prevalently issue financial instruments within the confines of these standards. However, guidance has been incorporated within this SSAP to ensure that puttable warrants and mandatorily redeemable warrants are reflected as liabilities, and not equity, within the financial statements.

27. This statement rejects paragraphs 1-11 and 13-24 of APB 6*, FASB Emerging Issue Task Force No. 85-1, Classifying Notes Received for Capital Stock,* and *FASB Emerging Issue Task Force No. 85-2, Classification of Costs Incurred in a Takeover Defense*.

28. This statement also rejects *Accounting Research Bulletin No. 43*, *Restatement and Revision of* Accounting Research *Bulletins,* "Chapter 1, Prior Opinions," paragraph 12 of APB 10*,* and *FASB Technical Bulletin No. 85-6, Accounting for a Purchase of Treasury Shares at a Price Significantly in Excess of the Current Market Price of the Shares and the Income Statement Classification of Costs Incurred in Defending against a Takeover Attempt.*

Effective Date and Transition

29. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*. The guidance in paragraph 19 was originally contained within *INT 00-12: EITF 99-4, Accounting for Stock Received from the Demutualization of a Mutual Insurance Company* and was effective June 12, 2000.

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 72—Statutory Surplus*
- *Issue Paper No. 84—Quasi-Reorganizations*

Statement of Statutory Accounting Principles No. 73

Health Care Delivery Assets - Supplies, Pharmaceuticals and Surgical Supplies, Durable Medical Equipment, Furniture, Medical Equipment and Fixtures, and Leasehold Improvements in Health Care Facilities

STATUS

Type of Issue:	Health Entities
Issued:	Initial Draft
Effective Date:	January 1, 2001
Affects:	Supersedes SSAP No. 87 with guidance incorporated August 2011
Affected by:	No other pronouncements
Interpreted by:	No other pronouncements

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Health Care Delivery Assets - Supplies, Pharmaceuticals and Surgical Supplies, Durable Medical Equipment, Furniture, Medical Equipment and Fixtures, and Leasehold Improvements in Health Care Facilities

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for health care delivery assets - supplies, pharmaceuticals and surgical supplies, durable medical equipment, furniture, medical equipment and fixtures and leasehold improvements.

SUMMARY CONCLUSION

2. This statement applies only to reporting entities which directly provide health care services to subscribers, members or policyholders. Such providers acquire and retain assets commonly referred to as "health care delivery assets" used in connection with the direct delivery of health care services in facilities owned or operated by the reporting entity and include supplies, pharmaceuticals and surgical supplies, durable medical equipment, furniture, medical equipment and fixtures and leasehold improvements in health care facilities.

3. Furniture, medical equipment and fixtures used in connection with the direct provision of health care services include diagnostic equipment, laboratory equipment, patient monitoring equipment, hospital beds, examining tables, and operating room equipment.

4. Supplies, pharmaceuticals and surgical supplies, durable medical equipment, furniture, medical equipment and fixtures, and leasehold improvements in health care facilities owned or operated by the reporting entity meet the definition of assets established in *SSAP No. 4—Assets and Nonadmitted Assets* (SSAP No. 4). Pharmaceuticals and surgical supplies, and durable medical equipment held by reporting entities and used for the direct delivery of health care services are assets which are used to fulfill policyholder obligations within the meaning of SSAP No. 4 and are admitted assets to the extent that they conform to the requirements of this statement. Furniture, medical equipment and fixtures, and leasehold improvements held by health reporting entities and used for the direct delivery of health care services are admitted assets to the extent that they conform to the requirements of this statement. Furniture, fixtures and equipment, and leasehold improvements which are not used in the direct delivery of health care (e.g., for administrative activities including claims processing, billing, and maintenance of medical records) are nonadmitted assets and are addressed in *SSAP No. 19—Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements* (SSAP No. 19).

5. The reporting entity shall maintain a control system that provides for identification of quantities on hand and appropriate valuation (lower of cost or fair value) of supplies, pharmaceuticals and surgical supplies, and durable medical equipment.

6. Supplies except for pharmaceuticals and surgical supplies discussed in paragraph 7 (e.g., linens, uniforms and garments, food and other commodities, and housekeeping, maintenance, and office supplies) shall be nonadmitted assets.

7. Pharmaceutical and surgical supplies (e.g. drugs, surgical items (such as implants), and medical dressings) used directly in the treatment of medical conditions shall be admitted assets.

8. Durable medical equipment includes consumable or salable equipment such as wheelchairs, crutches, braces, that is generally classified as inventory, and is of a nature that it may be reused. Subscribers, members or policyholders may utilize durable medical equipment on a temporary basis and

later return the equipment to the provider. The provider shall recognize the diminution in value, if any, as a result of use of such equipment.

9. Furniture, medical equipment and fixtures, and leasehold improvements shall be depreciated over their estimated useful lives but for a period not to exceed three years, except for a leasehold improvement which shall be amortized against net income over the shorter of its estimated useful life or the remaining life of the original lease excluding renewal or option periods, using methods detailed in SSAP No. 19.

10. In accordance with the reporting entity's written capitalization policy, amounts less than a predefined threshold of medical supplies, pharmaceuticals and surgical supplies, durable medical equipment, furniture, medical equipment and fixtures, and leasehold improvements shall be expensed when purchased. The reporting entity shall maintain a capitalization policy containing the predefined thresholds for each asset class to be made available for the department(s) of insurance.

Disclosures

11. The financial statements shall disclose if the written capitalization policy and the resultant predefined thresholds changed from the prior period and the reason(s) for such change.

Relevant Literature

12. This statement rejects the AICPA *Audit and Accounting Guide: Health Care Organizations*.

Effective Date and Transition

13. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*. Guidance reflected in paragraphs 10 and 11, incorporated from SSAP No. 87, was originally effective for years beginning on and after January 1, 2004.

14. Medical supplies, pharmaceuticals and surgical supplies, durable medical equipment, furniture, medical equipment and fixtures, and leasehold improvements capitalized prior to January 1, 2001 shall be depreciated over the shorter of its remaining useful life or three years.

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 100—Health Care Delivery Assets—Supplies, Pharmaceuticals and Surgical Supplies, and Durable Medical Equipment*

- *Issue Paper No. 101—Health Care Delivery Assets—Furniture, Medical Equipment and Fixtures, and Leasehold Improvements in Health Care Facilities*

- *Issue Paper No. 119—Capitalization Policy, An Amendment to SSAP Nos. 4, 19, 29, 73, 79 and 82*

Statement of Statutory Accounting Principles No. 74

Accounting for the Issuance of Insurance-Linked Securities Issued by a Property and Casualty Insurer through a Protected Cell

STATUS

Type of Issue:	Property and Casualty
Issued:	Finalized September 12, 2000
Effective Date:	January 1, 2001
Affects:	No other pronouncements
Affected by:	No other pronouncements
Interpreted by:	No other pronouncements

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Accounting for the Issuance of Insurance-Linked Securities Issued by a Property and Casualty Insurer through a Protected Cell

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for the issuance of insurance-linked securities issued by a property and casualty insurer through a protected cell. This statement applies to property and casualty contracts as defined in *SSAP No. 50—Classifications and Definitions of Insurance or Managed Care Contracts In Force* (SSAP No. 50).

SUMMARY CONCLUSION

2. An insurance-linked security can be issued by the insurer through a protected cell for purchase by investors. A protected cell is retained within the insurance or reinsurance company and is used to insulate the proceeds of the securities offering from the general business risks of the insurer, granting an additional comfort level for investors of the securitized instrument. The insurance exposures that have been securitized by the insurance-linked security are attributed to the protected cell.

3. Under the terms of the security, the principal may be paid to the investor on a specified maturity date, with interest, unless a trigger event occurs. The proceeds of the security offering will collateralize (i) the issuer's obligation under an insurance or reinsurance agreement if a trigger event occurs and (ii) the issuer's obligation to repay the security if a trigger event does not occur.

4. If the trigger event takes place before a specified date, the issuer is relieved of some or its entire obligation to repay the securityholders, and the investor incurs a loss of some or all of its investment. The security must be issued with an indemnity trigger.

5. In an insurance-linked security, the insurer that originated the transaction has hedged its portfolio of insurance risks by transferring certain of those risks to the securityholders. Should the triggering event occur, the issuer would incur a loss that would be partly offset by the amount of liability to securityholders from which it is relieved. This statement provides statutory accounting guidance solely for indemnity triggered insurance securitization transactions conducted through a protected cell.

Accounting for Prefunded Insurance-Linked Securities for Business Attributed to the Protected Cell from the General Account

General Account Reporting

6. Activities such as sales, underwriting and contract administration, premium collection and payment of premium taxes, and claims processing are activities of the insurance company distinct from the protected cell and shall be accounted for as transactions of the general account.

7. Amounts paid to the protected cell for underwriting risks, which ultimately will be securitized by the protected cell, shall be reported separately as a reduction of written and earned premiums in the current period general account's statement of income. This premium is earned by the general account in accordance with *SSAP No. 53—Property Casualty Contracts–Premiums* (SSAP No. 53).

8. At the maturity of the protected cell all assets and liabilities of the protected cell are distributed based on the contractual agreement with the securityholders. If after this distribution assets still reside in the protected cell, these assets shall be attributed to the general account and recognized as an adjustment to surplus.

9. Insurance claim liabilities arising from past insurable events attributed to the protected cell account from the general account shall be accounted for as retroactive reinsurance as prescribed in *SSAP No. 62R—Property and Casualty Reinsurance* (SSAP No. 62R).

10. General account recoverables from the protected cell as a result of an indemnity based securitized event, shall be recognized separately as a reduction of gross losses and loss expenses incurred in the current period general account's statement of income. General account recoverables from the protected cell on unpaid reported and incurred but not reported losses and loss adjustment expenses shall be netted against the liability for gross losses and loss adjustment expenses in the general account's balance sheet. Recoverables from the protected cell shall not exceed the assets carried at fair value in the protected cell.

11. The general account shall include an aggregate write-in for the total assets and an aggregate write-in for liabilities of any protected cell which it maintains. Transfers to the general account due or accrued shall be reported on a net basis so that the asset and the liability totals of the general account are not overstated.

Protected Cell Reporting

12. The protected cell annual statement is concerned with the investment activities and obligations relating to insurance-linked securities attributed to that protected cell. As a result, the protected cell statement shall report only the financial activities of the protected cell and shall not include general account expenses related to insurance activities which are recorded for in the general account.

13. The protected cell shall record premium income for transactions attributed to it by the general account as income reported in the protected cell's statement of income. This premium attribution is earned by the protected cell in accordance with SSAP No. 53.

14. The obligation from the issuance of the insurance-linked security is recorded as Funds Held Under Securitization Agreement, a liability on the protected cell balance sheet which is reported at its contractual value which will be the lower of the scheduled amount to be repaid to investors or the fair value of the investments in the protected cell. All protected cell assets shall be reported at fair value. Interest expenses payable to securityholders associated with the protected cell investment operations shall be deducted in the determination of net operating income of the cell. Net investment income and realized capital gains and losses relating to the investment operations of the protected cell are recorded as net investment income. Payables to the general account shall not exceed the assets carried at fair value in the protected cell.

15. Changes in both (i) the fair value of the protected cell invested assets and (ii) the protected cell contractual value of liabilities to investors shall be reported as an unrealized gain/loss in the equity section of the protected cell balance sheet.

16. If the trigger event occurs with respect to the underlying exposures attributed to the protected cell, the protected cell shall record the appropriate incurred losses in its current period statement of income. Correspondingly, the Funds Held Under Securitization Agreement shall be reduced and offset by gross losses incurred in the current period Statement of Income. The applicable funds to cover the subject exposure are then attributed to the general account via a balance sheet account, "Due to/from the General Account."

17. If the trigger event does not take place on or before the contractual maturity date, the protected cell repays the security as prescribed in the debt contract by reducing Funds Held Under Securitization Agreement.

Disclosures

General Account

18. The general account shall reflect all activities with its protected cells as an aggregate write-in in its statutory balance sheet and income statement. The general account shall also disclose in its notes to the financial statements the types and amounts of exposures /risks attributed to each of its protected cells.

Protected Cells

19. Each protected cell of a protected cell company shall prepare and submit to all states where the protected cell company is licensed and the NAIC the following supplemental financial information:

a. Balance Sheet

b. Income Statement

c. Statement of Cash Flows

d. Investment Schedules as typically required for a property/casualty insurer

e. Schedule P

20. Refer to the preamble for further discussion regarding disclosure requirements.

Relevant Literature

21. This statement only contemplates transactions with an indemnity-based trigger, as such they would be excluded from *FAS No. 133, Accounting for Derivative Instruments and Hedging Activities*.

Effective Date and Transition

22. This statement is effective for years beginning January 1, 2001. Changes resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors* (SSAP No. 3).

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 103—Accounting for the Issuance of Insurance-Linked Securities Issued by a Property and Casualty Insurer through a Protected Cell*

GLOSSARY [1]

Fair Value – See *SSAP No. 100—Fair Value Measurements*

Fully Funded – With respect to any exposure attributed to a protected cell, the fair value of the protected cell assets, on the date on which the insurance securitization is effected, equals or exceeds the maximum possible exposure attributable to the protected cell with respect to such exposures.

General Account – The assets and liabilities of a protected cell company other than protected cell assets and protected cell liabilities.

Indemnity Trigger – A transaction term by which relief of the issuer's obligation to repay investors is triggered by its incurring a specified level of losses under its insurance or reinsurance contracts.

Protected Cell – An identified pool of assets and liabilities of a protected cell company segregated and insulated by means of this Act from the remainder of the protected cell company's assets and liabilities.

Protected Cell Account – A specifically identified bank or custodial account established by a protected cell company for the purpose of segregating the protected cell assets of one protected cell from the protected cell assets of other protected cells and from the assets of the protected cell company's general account.

Protected Cell Assets – All assets, contract rights and general intangibles, identified with and attributable to a specific protected cell of a protected cell company.

Protected Cell Company – A domestic insurer that has one or more protected cells.

Protected Cell Company Insurance Securitization – The issuance of debt instruments, the proceeds from which support the exposures attributed to the protected cell, by a protected cell company where repayment of principal or interest, or both, to investors pursuant to the transaction terms is contingent upon the occurrence or nonoccurrence of an event with respect to which the protected cell company is exposed to loss under insurance or reinsurance contracts it has issued.

Protected Cell Liabilities – All liabilities and other obligations identified with and attributable to a specific protected cell of a protected cell company.

[1] Definitions in this glossary were adapted from the Protected Cell Company Model Act as adopted by the Insurance Securitization Working Group of the Financial Condition (E) Committee in 1999. These definitions are not intended to change the meaning of any terms used elsewhere in the *Accounting Practices and Procedures Manual*, and should only be used in the context of SSAP No. 74.

Statement of Statutory Accounting Principles No. 76

Reporting on the Costs of Start-Up Activities

STATUS

Type of Issue:	Common Area
Issued:	Finalized December 4, 2000
Effective Date:	January 1, 2002
Affects:	No other pronouncements
Affected by:	No other pronouncements
Interpreted by:	No other pronouncements

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Reporting on the Costs of Start-Up Activities

SCOPE OF STATEMENT

1. This statement addresses start-up costs. In practice, various terms are used to refer to start-up costs, such as pre-opening, pre-operating, and organization costs. For purpose of this statement, these costs are referred to as start-up costs.

SUMMARY CONCLUSION

2. Costs of start-up activities, including activities related to organizing a new entity (commonly referred to as organization costs), shall be expensed as incurred. Start-up activities are defined broadly as those one-time activities related to: (1) opening a new facility; (2) introducing a new product or service; (3) conducting business in a new territory; (4) conducting business with a new class of customer or beneficiary; (5) initiating a new process in an existing facility; or (6) commencing some new operation.

Disclosures

3. Cost of start-up activities incurred in an accounting period shall be disclosed in the annual audited statutory financial report only.

4. Refer to the preamble for further discussion regarding disclosure requirements.

Relevant Literature

5. This statement adopts American Institute of Certified Public Accountants (AICPA) *Statement of Position SOP 98-5, Reporting on the Costs of Start-Up Activities* (SOP 98-5), which requires costs of start-up activities and organization costs to be expensed as incurred. This statement is consistent with *SSAP No. 17—Preoperating and Research and Development Costs* (SSAP No. 17).

Effective Date and Transition

6. This statement is effective for years beginning January 1, 2002. Adoption as of January 1, 2001 is encouraged but not required. Changes resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors* (SSAP No. 3).

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 105—Reporting on the Costs of Start-Up Activities*

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Statement of Statutory Accounting Principles No. 78

Multiple Peril Crop Insurance

STATUS

Type of Issue:	Property and Casualty
Issued:	Finalized December 4, 2000
Effective Date:	January 1, 2001
Affects:	No other pronouncements
Affected by:	No other pronouncements
Interpreted by:	No other pronouncements

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EXHIBIT A - ILLUSTRATION OF CEDED PREMIUMS AND LOSSES **6**

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Multiple Peril Crop Insurance

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for Multiple Peril Crop Insurance (MPCI). This statement also establishes statutory accounting principles for the Aquatic Crop Reinsurance Agreement (hereinafter included in the term MPCI).

SUMMARY CONCLUSION

Introduction

2. Farming has always been an inherently risky enterprise because farmers operate at the mercy of nature and frequently are subjected to weather-related perils such as droughts, floods, hurricanes, and other natural disasters. Since the 1930s, many farmers have been able to transfer part of the risk of loss in production to the federal government through the subsidized MPCI program administered by the Federal Crop Insurance Corporation (FCIC), an agency of the United States Department of Agriculture. Major legislation enacted in 1980 and 1994 restructured the MPCI program. The 1980 legislation enlisted, for the first time, private insurance companies to sell, service, and share the risk of MPCI insurance policies. Subsequently, in 1994, the Federal Crop Insurance Reform and Department of Agriculture Reorganization Act revised the program to offer farmers two primary levels of insurance coverage, catastrophic and buy-up.

3. Catastrophic insurance is designed to provide farmers with protection against extreme crop losses for a small processing fee. Buy-up insurance provides protection against more typical and smaller crop losses in exchange for a policyholder-paid premium. The government subsidizes the total premium for catastrophic insurance and a portion of the premium for buy-up insurance. Farmers who purchase buy-up crop insurance must choose both the coverage level (the proportion of the crop to be insured) and the unit price (such as, per bushel) at which any loss is calculated. With respect to the coverage level of production, farmers can choose to insure as much as 85 percent of normal production or as little as 50 percent of normal production at different price levels. With respect to the unit price, farmers choose whether to value their insured production at FCICs full estimated market price or at a percentage of the full price.

4. In recent years, FCIC has introduced a new risk management tool called revenue insurance. Unlike traditional crop insurance, which insures against losses in the level of crop production, revenue insurance plans insure against losses in revenue. The plans protect the farmer from the effects of declines in crop prices or declines in crop yields, or both. Like traditional buy-up insurance, the government subsidizes a portion of the premiums. One of the plans, called Crop Revenue Coverage, is available in many states for major crops. Two other plans, called Income Protection and Revenue Assurance, are available to farmers in only limited areas.

5. Companies participate in the MPCI program with FCIC through the Standard Reinsurance Agreement (SRA) per the terms of which the insurance companies share in the underwriting results of each policy. The SRA reinsurance terms provide a company the flexibility to limit its exposure on a state by state basis. MPCI premium is not expense loaded, therefore FCIC pays the insurance companies, on behalf of the policyholder, a percent of premium for administrative expenses associated with selling and servicing crop insurance policies, including the expenses associated with adjusting claims.

6. The FCIC utilizes an escrow account to distribute or collect additional funds. Premium (collected from the policyholders and the federal government subsidy) is deposited in the escrow account and is available to pay the claims arising under the program.

Premium Recognition

7. MPCI gross premium is defined as the contractually determined amount specified by FCIC to the policyholder for the effective period of the contract based on the actuarially determined expectation of risk and policy benefits associated with the coverage provided by the terms of the insurance contract. In addition, gross premium shall also include the government premium subsidy paid on behalf of the policyholder.

8. MPCI ceded premium and losses are defined as the amount calculated by applying the proportional and non-proportional factors as stated in the SRA. An example of this application is shown in Exhibit A to this statement.

9. MPCI written premium shall be recorded as soon as an estimate can be made, but no later than the processing date. Upon recording written premium, a liability for the unearned premium reserve shall be established to reflect the amount of premium for the portion of the insurance coverage that has not yet expired. Premiums shall be recognized as revenue over the period of risk in proportion to the amount of insurance protection provided.

10. The company shall disclose the method used to compute the unearned premium reserve in the financial statements.

Amounts Receivable or Payable

11. The company shares underwriting risk with FCIC and can earn or lose money according to the claims it must pay farmers for crop losses. The company earns underwriting profits when the net retained premiums exceed the net crop loss claims paid. The company incurs underwriting losses when the net claims paid for crop losses exceed the net retained premiums. These definitions do not consider underwriting expenses, which would be included for traditional statutory accounting underwriting gains and losses. The use of the terms underwriting gains and losses in this issue paper are unique to the MPCI program. As the premiums of the program are held by FCIC in escrow, the company shall recognize as a write-in asset a receivable from FCIC for the amount of the underwriting gain (as defined in this paragraph). Whereas, when the company is in an underwriting loss position, the company shall recognize a write-in liability to the FCIC for the amount of the underwriting loss (as defined in this paragraph), as the monies held in the escrow account are not sufficient to cover the company's claims. In accordance with the SRA, funds that remain in escrow will be distributed to the company at the conclusion of the contract period if the contract results in a gain to the company. If the company owes additional funds to the escrow (i.e., it is in a loss position), those funds are remitted on a periodic basis until the contract expires. These amounts shall be recorded net as the program meets the requirements of offsetting as defined in *SSAP No. 64—Offsetting and Netting of Assets and Liabilities* (SSAP No. 64). In accordance with *SSAP No. 21—Other Admitted Assets* (SSAP No. 21), the amount receivable under the Federal Crop Insurance program shall be reported as an admitted asset.

12. Amounts receivable from policyholders meet the definition of an admitted asset as set forth in *SSAP No. 4—Assets and Nonadmitted Assets* (SSAP No. 4) and should be accounted for in accordance with *SSAP No. 6—Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due From Agents and Brokers* (SSAP No. 6). The due date shall be governed by contractual due date of the premium billing, and not the effective date of the contract.

Unpaid Losses and Loss Adjustment Expenses

13. In accordance with *SSAP No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses* (SSAP No. 55), losses and loss adjustment expenses shall be recognized as expense when a covered or insured event occurs.

14. The covered or insured event is the occurrence of an incident which gives rise to a claim or the incurring of costs. Claim payments and related expense payments are made subsequent to the occurrence of a covered or insured event and, in order to recognize the expense of a covered or insured event, it is necessary to establish a liability. The following are the types of future costs relating to the MPCI program:

a. Reported Losses: Expected payments for losses relating to insured events that have occurred and have been reported to, but not paid by, the insurer as of the statement date;

b. Incurred But Not Reported Losses, (IBNR): Expected payments for losses relating to insured events that have occurred but have not been reported to the insurer as of the statement date;

c. Loss Adjustment Expenses: Costs expected to be incurred in connection with the adjustment and recording of losses defined in paragraphs 14.a. and 14.b. of this statement.

Administrative Expense Payment

15. FCIC pays the insurance companies a percent of premium for administrative expenses associated with selling and servicing crop insurance policies, including the expenses associated with adjusting claims. The expense payment associated with the catastrophic coverage shall be recorded as a reduction of loss expenses whereas the expense payment for the buy-up coverage shall be recorded as a reduction of other underwriting expenses. The company shall disclose the total amounts received for each type of coverage.

Escrow Account

16. The escrow account shall not be recorded on the financial statements of the insurance company. This account is considered an FCIC account and as such is not owned by the insurance company, however, the company’s underwriting gain is reflected as a receivable in accordance with paragraph 11.

Effective Date

17. This statement is effective for SRA contracts entered into on or after January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Correction of Errors* (SSAP No. 3).

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 108—Multiple Peril Crop Insurance*

EXHIBIT A - ILLUSTRATION OF CEDED PREMIUMS AND LOSSES

NOTES TO THE ILLUSTRATION

Fund	The reinsurance fund specified in the Standard Reinsurance Agreement (SRA).
Column 1	Reinsured Company proportional reinsurance retention percentage.
Column 2	Gross Written Premium equals the insured paid premium amount plus premium subsidy provided by FCIC.
Column 3	Net Retained Premium is the Reinsured Company retained premium after proportional reinsurance. Gross Written Premium (Column 2) times the Reinsured Company retention percentage (Column 1).
Column 4	Proportional Ceded Premium is the premium retained by FCIC after proportional reinsurance. Gross Written Premium (Column 2) minus the Reinsured Company Net Retained Premium (Column 3).
Column 5	Reinsured Company proportional reinsurance retention percentage (Column 1).
Column 6	Gross Losses equals total claim payments to insured.
Column 7	Net Retained Losses are the Reinsured Company retained losses after proportional reinsurance. Gross Losses (Column 6) times the Reinsured Company retention percentage (Column 5).
Column 8	Proportional Ceded Losses are the losses retained by FCIC after proportional reinsurance. Gross Losses (Column 6) minus the Reinsured Company Net Retained Losses (Column 7).
Column 9	Retained Loss Ratio is the Reinsured Company's Net Retained Losses (Column 7) divided by the Reinsured Company's Net Retained Premium (Column 3).
Column 10	Underwriting (Gain)/Loss is the Reinsured Company share of the MPCI program gain or loss after calculating the non-proportional reinsurance provided in the SRA.
Column 11	Non-Proportional Ceded Premium is equal to the Reinsured Company Net Retained Premium (Column 3) minus Net Retained Losses (Column 7) minus an Underwriting (Gain) (Column 10) if one exists. This is FCIC's share of the underwriting gain after proportional reinsurance, based on the non-proportional reinsurance gain sharing factors specified in the SRA.
Column 12	Non-Proportional Ceded Losses is equal to the Reinsured Company Net Retained Premium (Column 3) minus Net Retained Losses (Column 7) minus an Underwriting Loss (Column 10) if one exists. This is FCIC's share of the underwriting loss after proportional reinsurance, based on the non-proportional reinsurance loss sharing factors specified in the SRA.
Column 13	Final Retained Premium is equal to the Reinsured Company Net Retained Premium (Column 3) minus the Non-Proportional Ceded Premium (Column 11). The Reinsured Company Net Retained Premium after proportional reinsurance is reduced by the amount of FCIC's underwriting gain share after non-proportional reinsurance.

Column 14 Final Retained Losses is equal to the Reinsured Company Net Retained Premium (Column 3) minus the Non-Proportional Ceded Losses (Column 12). The Reinsured Company Net Retained Losses after proportional reinsurance are reduced by the amount of FCIC's underwriting loss share after non-proportional reinsurance.

Column 15 Final Retained Loss Ratio is equal to Final Retained Losses divided by Final Retained Premium.

(a) Calculated based on the loss ratios for each fund by state. Net Retained Premium (Col 3) is applied to the percentages of Section II. C. and D. of the Standard Reinsurance Agreement.

(b) If the fund is in a GAIN position then there would be Non-proportional ceded premium. If the fund is in a LOSS position then there would be Non-proportional ceded losses.

Since each fund and state stands alone in the calculations, there is a possibility of Non-proportional ceded premium AND ceded losses within the same reinsurance year. There is also the possibility of this within the same fund (some states with a Gain and some states with a Loss).

EXHIBIT A - ILLUSTRATION OF CEDED PREMIUMS AND LOSSES

Fund	(1) Retention %	(2) Gross Written Premium	(3) Net Retained Premium (Col 2 x Col 1)	(4) Proportional Ceded Premium (Col 2 - Col 3)
Assigned Risk	20%	20,000,000	4,000,000	16,000,000
Developmental	35%	10,000,000	3,500,000	6,500,000
Dev - CRC	35%	5,000,000	1,750,000	3,250,000
Dev - CAT	35%	5,000,000	1,750,000	3,250,000
Commercial	100%	100,000,000	100,000,000	0
Comm - CRC	100%	20,000,000	20,000,000	0
Comm - CAT	100%	40,000,000	40,000,000	0
Total Premium		200,000,000	171,000,000	29,000,000

Fund	(5) Retention %	(6) Gross Losses	(7) Net Retained Losses (Col 6 x Col 5)	(8) Proportional Ceded Losses (Col 6 - Col 7)	(9) Retained Loss Ratio (Col 7/Col 3)	(10) Underwriting (Gain)Loss (a)
Assigned Risk	20%	40,000,000	8,000,000	32,000,000	200.0%	184,000
Developmental	35%	16,000,000	5,600,000	10,400,000	160.0%	525,000
Dev - CRC	35%	7,000,000	2,450,000	4,550,000	140.0%	210,000
Dev - CAT	35%	4,000,000	1,400,000	2,600,000	80.0%	(157,500)
Commercial	100%	80,000,000	80,000,000	0	80.0%	(18,800,000)
Comm - CRC	100%	18,000,000	18,000,000	0	90.0%	(1,880,000)
Comm - CAT	100%	22,000,000	22,000,000	0	55.0%	(12,500,000)
Total Losses		187,000,000	137,450,000	49,550,000	80.4%	(32,418,500)

Fund	(11) Non-Proportional Ceded Premium (b) (Col 3 - Col 7 - Col 10 "Gain")	(12) Non-Proportional Ceded Losses (b) (Col 3 - Col 7 + Col 10 "Loss")	(13) Final Retained Premium (Col 3 - Col 11)	(14) Final Retained Losses (Col 7 - Col 12)	(15) Final Retained Loss Ratio (Col 14/Col 13)
Assigned Risk	0	3,816,000	4,000,000	4,184,000	104.6%
Developmental	0	1,575,000	3,500,000	4,025,000	115.0%
Dev - CRC	0	490,000	1,750,000	1,960,000	112.0%
Dev - CAT	192,500	0	1,557,500	1,400,000	89.9%
Commercial	1,200,000	0	98,800,000	80,000,000	81.0%
Comm - CRC	120,000	0	19,880,000	18,000,000	90.5%
Comm - CAT	5,500,000	0	34,500,000	22,000,000	63.8%
Total	7,012,500	5,881,000	163,987,500	131,569,000	80.2%

Statement of Statutory Accounting Principles No. 83

Mezzanine Real Estate Loans

STATUS

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Interpreted by:	No other pronouncements

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Mezzanine Real Estate Loans

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for Mezzanine Real Estate Loans (MREL). An MREL is a loan secured by a pledge of direct or indirect equity interests in an entity that owns real estate (the "real estate owner"). The real estate owner is typically the borrower under a mortgage loan secured by the same real estate. The MREL borrower ("mezz borrower") may be the real estate owner or one or more of the holder(s) of the direct or indirect equity interest(s) in the real estate owner. As used herein, "direct equity interests" means the then issued and outstanding shares or units of partnership, membership or other beneficial interests in the real estate owner, and "indirect equity interests" means the then issued and outstanding shares or units of partnership, membership or other beneficial interests in a member, partner, shareholder or other holder of direct equity interests in the real estate owner.

SUMMARY CONCLUSION

2. For statutory accounting purposes, a MREL shall be defined as a debt obligation, that is not a security, which is secured by a pledge of equity interest in an entity that owns real estate. (A security is a share, participation, or other interest in property or in an enterprise of the issuer or an obligation of the issuer that:

a. Either is represented by an instrument issued in bearer or registered form, or if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer;

b. Is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment; and

c. Either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations).

3. MREL's meet the definition of assets as specified in *SSAP No. 4—Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this statement.

4. Reporting entities holding MREL's shall follow the accounting, reporting and disclosure requirements defined within *SSAP No. 37—Mortgage Loans* (SSAP No. 37).

5. In order for a MREL to qualify as an admitted asset, the MREL agreement (the agreement) shall:

a. Require that each pledgor abstain from granting additional security interests in the equity interest pledged; and

b. In addition to satisfaction of the requirements set forth in paragraphs 5.c. and 5.d., the MREL lender shall employ techniques to minimize the likelihood or impact of a bankruptcy filing on the part of the real estate owner and, if different, on the part of the mezz borrower. These techniques may include (by way of example and not limitation) one or more of the following: (i) separateness covenants, (ii) cash management techniques, (iii) exceptions to the non-recourse provisions for damages arising out of the mezz borrower's failure to comply with covenants prohibiting additional debt, transfers of the real estate, transfers of pledged interests, and violation of the single asset/single purpose covenants, (iv) full recourse liability in the event of a bankruptcy filing on the part of the real estate owner and, if different, on the part of the mezz borrower, and (v) loan guaranties; and

The selection of techniques that are applied in the instance of any particular MREL to achieve said purposes requires an exercise of judgement by the MREL lender. The reasonableness of the techniques utilized in any particular MREL will be assessed in light of the credit characteristics of the MREL borrower, any guarantors and the underlying real estate at the time of origination. Utilizing this standard provides flexibility to the MREL lender and provides a basis for the regulator and auditor in analyzing the reasonableness of the judgement of the MREL lender; and

c. The real estate owner and, if different, the mezz borrower shall:

i. Hold no assets other than, in the case of the real estate owner, the real property, and in the case of the mezz borrower (if different), the equity interest in the real estate owner;

ii. Not engage in any business other than, in the case of the real estate owner, the ownership and operation of the real estate, and in the case of the mezz borrower (if different), holding an ownership interest in the real estate owner; and

iii. Not incur additional debt, other than limited trade payables, a first mortgage loan (in the case of the real estate owner), and the MREL (in the case of the mezz borrower, if different).

d. At the time of the initial investment, the MREL lender shall corroborate that the sum of the first mortgage and the MREL does not exceed 100% of the value of the real estate as evidenced by a current appraisal. Acceptable appraisal methods are described in paragraph ~~12~~13 of *SSAP No. 40R—Real Estate Investments*.

Disclosures

6. The financial statements shall disclose, as applicable, the requirements of SSAP No. 37 paragraphs 20, 21 and 22. The MREL lender shall report in Appendix A-001 to its annual statement the amount and percentages of its total admitted assets held in MREL and the largest three investments held in MREL except that such detail shall not be required for assets held in MREL totaling less than 2.5% of its total admitted assets.

Effective Date and Transition

7. This statement is effective for years ending on and after December 31, 2001. Any change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*.

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 113—Mezzanine Real Estate Loans*

Statement of Statutory Accounting Principles No. 84

Certain Health Care Receivables and Receivables Under Government Insured Plans

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Certain Health Care Receivables and Receivables Under Government Insured Plans

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for pharmaceutical rebate receivables, claim overpayment receivables, loans and advances to providers who do not meet the definition of related parties, capitation arrangement receivables, risk-sharing receivables, and amounts receivable under government insured plans.

SUMMARY CONCLUSION

Overview

2. Pharmaceutical rebates are arrangements between pharmaceutical companies and reporting entities in which the reporting entities receive rebates based upon the drug utilization of its subscribers at participating pharmacies. These rebates are sometimes recorded as receivables by reporting entities using estimates based upon historical trends which should be adjusted to reflect significant variables involved in the calculation, such as number of prescriptions written/filled, type of drugs prescribed, use of generic vs. brand-name drugs, etc. In other cases, the reporting entity determines the amount of the rebate due based on the actual use of various prescription drugs during the accumulation period and then bills the pharmaceutical company. Oftentimes, a pharmacy benefits management company may determine the amount of the rebate based on a listing (of prescription drugs filled) prepared for the reporting entity's review. The reporting entity will confirm the listing and the pharmaceutical rebate receivable.

3. Claim overpayments may occur as a result of several events, including but not limited to claim payments made in error to a provider. Reporting entities often establish receivables for claim overpayments.

4. A health entity may make loans or advances to large hospitals or other providers. Such loans or advances are supported by legally enforceable contracts and are generally entered into at the request of the provider. In many cases, loans or advances are paid monthly and are intended to represent one month of fee-for-service claims activity with the respective provider.

5. A capitation arrangement is a compensation plan used in connection with some managed care contracts in which a physician or other medical provider is paid a flat amount, usually on a monthly basis, for each subscriber who has elected to use that physician or medical provider. In some instances, advances are made to a provider under a capitation arrangement in anticipation of future services.

6. Risk-sharing agreements are contracts between reporting entities and providers with a risk-sharing element based upon utilization. The compensation payments for risk-sharing agreements are typically estimated monthly and settled annually. These agreements can result in receivables due from the providers if annual utilization is different than that used in estimating the monthly compensation.

7. The definition and accounting treatment for nonadmitted assets is outlined in paragraph 3 of *SSAP No. 4—Assets and Nonadmitted Assets* (SSAP No. 4) as follows:

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

a. Specifically identified within the *Accounting Practices and Procedures Manual* as a nonadmitted asset; or

b. Not specifically identified as an admitted asset within the *Accounting Practices and Procedures Manual*.

If an asset meets one of these criteria, the asset shall be reported as a nonadmitted asset and charged against surplus unless otherwise specifically addressed within the *Accounting Practices and Procedures Manual*. The asset shall be depreciated or amortized against net income as the estimated economic benefit expires. In accordance with the reporting entity's written capitalization policy, amounts less than a predefined threshold of furniture, fixtures, equipment, or supplies, shall be expensed when purchased.

8. Pharmaceutical rebate receivables, claim overpayment receivables, loans and advances to providers, capitation arrangement receivables, risk-sharing receivables, and amounts receivable under government insured plans meet the definition of assets as set forth in SSAP No. 4, and are admitted assets to the extent that the requirements for admission defined in this statement are met.

9. This statement shall not be considered an all-inclusive list of health care receivables. Certain health care receivables are addressed in other statements. Health care receivable assets not addressed in other statements or this statement are nonadmitted assets.

Pharmaceutical Rebate Receivables

10. Pharmaceutical rebates receivables consist of reasonably estimated amounts and billed amounts. Both the billed amount and the estimated amount shall be admitted assets subject to the conditions specified below:

a. Estimated amounts shall be related solely to actual prescriptions filled during the 3 months immediately preceding the reporting date;

b. Billed amounts represent pharmaceutical rebate receivables that have been invoiced or confirmed in writing but not collected as of the reporting date. Billed amounts for an estimated amount under paragraph 10.a. shall be admitted only if the determination of the rebate, based on actual prescriptions filled, occurs and is invoiced or confirmed in writing within the 2 months following the reporting date of the estimated amount. Adjustments to previously billed amounts related to prior periods shall be nonadmitted until invoiced or confirmed in writing. Pharmaceutical rebates that have not been collected within 90 days of the invoice date or confirmation date shall be nonadmitted. Furthermore, if accrued pharmaceutical rebate receivables are not invoiced or confirmed in writing in accordance with the contract provisions, the accrual shall be nonadmitted; and

c. Evaluation of the collectibility of pharmaceutical rebate receivables shall be made periodically. If in accordance with *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets* (SSAP No. 5R), it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made.

11. The method used to reasonably estimate the receivable shall be consistent from period to period and shall be adjusted periodically for any changes in the underlying pharmaceutical rebate contract provisions. The financial statements shall disclose information regarding the reporting entity's pharmaceutical rebates in accordance with paragraph 24 of this statement.

12. Income from pharmaceutical rebates of insured plans shall be reported as a reduction to claims expense on the summary of operations.

13. Receivable and payable balances related to uncollected pharmaceutical rebates of uninsured plans shall be recorded on the financial statements of the reporting entity. Any pharmaceutical rebates earned by the reporting entity that are in excess of the amounts to be remitted to the uninsured plan pursuant to an administrative services agreement shall be determined consistent with the requirements of paragraphs 10 and 11 and shall be reported on the balance sheet as an amount receivable relating to uninsured accident and health plans, and as a reduction to general expenses on the statement of operations.

Claim Overpayment Receivables

14. A claim overpayment shall not be recorded as a receivable until invoiced. To the extent that the claim overpayment meets the setoff conditions in *SSAP No. 64—Offsetting and Netting of Assets and Liabilities* (SSAP No. 64) and the overpayment is a specific identifiable payment and not an estimate, the receivable may be admitted up to the amount of the payable to the provider for reported claims (i.e., excluding incurred but not reported claims). The receivable and payable shall be reported gross rather than netted on the balance sheet. Evaluation of the collectibility of claim overpayment receivables shall be made periodically. If in accordance with SSAP No. 5R, it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made. Amounts in excess of that written off that do not meet the right of offset conditions shall be nonadmitted as they are not available to satisfy policyholder obligations.

Loans and Advances to Providers

15. Loans or advances to providers who meet the definition of related parties in *SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties* shall follow the guidance in that statement. To the extent a loan or advance to a non-related party provider meets the setoff conditions in SSAP No. 64, the loan or advance may be admitted up to the amount of the payable to the provider for reported claims (i.e., excluding incurred but not reported claims).

16. In addition, a loan or advance to a non-related party hospital shall be admitted up to the amount of claims incurred and payable to the hospital if all of the following conditions are met:

a. The loan or advance meets the setoff conditions in SSAP No. 64;

b. The loan or advance is supported by a legally enforceable contract;

c. The loan or advance is administered pursuant to contractual terms;

d. The contractual terms of the agreement provide for separate quarterly reconciliations;

e. Each quarterly reconciliation shall be completed within nine months of the end of such quarter; and

f. A quarterly reconciled difference shall be settled within 90 days of the date the reconciliation is completed.

17. If a quarterly reconciliation is not performed or settled in accordance with paragraphs 16.e. and 16.f., all assets for loans or advances to that hospital shall be nonadmitted.

18. The receivable and payable shall be reported gross rather than netted on the balance sheet. Evaluation of the collectibility of loans and advances to providers shall be made periodically. If in accordance with SSAP No. 5R, it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made. Amounts in excess of that written off that do not meet the right of offset conditions shall be nonadmitted as they are not available to satisfy policyholder obligations.

Capitation Arrangement Receivables

19. Advances to providers under capitation arrangements that are made under the terms of an approved provider services contract in anticipation of future services shall be admitted to the extent that the advanced amount does not exceed one month of average capitation payments for the subject provider during the preceding twelve months, and provided that the contract cannot be terminated before the end of the month for which the advanced amount was paid. Evaluation of the collectibility of capitation arrangement receivables shall be made periodically. If in accordance with SSAP No. 5R, it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made.

Risk-Sharing Receivables

20. Risk-sharing receivables may consist of reasonably estimated amounts and billed amounts. Both the billed amount and the estimated amount shall be admitted assets subject to the conditions specified below:

a. Risk-sharing receivables and payables shall only be recorded when reasonably estimated. Estimates of risk-sharing receivables may be admitted if based on at least six months of actual claims experience for each risk-sharing contract. The contractual terms of any risk-sharing agreement shall provide for evaluation of the experience under the contract at least annually. The determination of the risk-sharing balance shall commence no later than 6 months following the close of such annual period, and the balance shall be invoiced no later than 8 months following close of the annual period;

b. Billed amounts represent risk-sharing receivables that have been invoiced but not collected as of the reporting date. Risk-sharing receivables and payables shall be invoiced or refunded in accordance with the contractual provisions of the risk-sharing agreement. Adjustments resulting in increases to previously billed amounts related to prior periods shall be nonadmitted until invoiced. Adjustments resulting in decreases to previously billed amounts shall be recognized immediately. Risk-sharing receivables that have not been collected within 90 days of the date of billing shall be nonadmitted;

c. Risk-sharing receivables and payables shall be reported gross rather than netted on the balance sheet. However, if a reporting entity has both a receivable and payable balance with the same provider and the balances meet the setoff conditions in SSAP No. 64, those balances shall be netted in accordance with SSAP No. 64; and

d. Evaluation of the collectibility of risk-sharing receivables shall be made quarterly. If in accordance with SSAP No. 5R, it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made.

21. The method used to reasonably estimate the receivable shall be consistent from period to period and shall be adjusted periodically for any changes in the underlying risk-sharing contract. The financial statements shall disclose information regarding the reporting entity's risk-sharing receivables in accordance with paragraph 25 of this statement.

22. Income/expense from risk-sharing contracts shall be reported as a component of claims expense on the summary of operations.

Amounts Receivable Under Government Insured Plans

23. Amounts receivable under government insured plans, including amounts over 90 days due, that qualify as accident and health contracts in accordance with *SSAP No. 50—Classifications and Definitions of Insurance or Managed Care Contracts in Force* shall be admitted assets. Amounts receivable under government insured plans include but are not limited to receivables under Medicare, Medicaid and similarly funded government insured plans. Evaluation of the collectibility of amounts receivable under government insured plans shall be made periodically. If in accordance with SSAP No. 5R, it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made. The collectibility and any nonadmission of amounts receivable from the government insured or uninsured plans are addressed here and in *SSAP No. 47—Uninsured Plans*, paragraph 11.c. Refer to *INT 05-05: Accounting for Revenues Under Medicare Part D Coverage* for additional information and definitions of terms specifically related to Medicare Part D business.

Disclosures

24. The financial statements shall disclose the method used by the reporting entity to estimate pharmaceutical rebate receivables. Furthermore, for the most recent three years and for each quarter therein, the reporting entity shall also disclose the following:

a. Estimated balance of pharmacy rebate receivable as reported on the financial statements;

b. Pharmacy rebates as invoiced or confirmed in writing; and

c. Pharmacy rebates collected.

An example of this disclosure is shown in Exhibit A to this statement.

25. The financial statements shall disclose the method used by the reporting entity to estimate its risk-sharing receivables. If any receivable and payable balances with the same provider are netted, the reporting entity shall disclose the gross receivable and payable balances in the notes to the financial statements. Furthermore, for the most recent three years, the reporting entity shall also disclose the following:

a. Risk-sharing receivables as estimated and reported on the prior year financial statements for annual periods ending in the current year;

b. Risk-sharing receivables as estimated and reported on the financial statements for annual periods ending in the current year and the following year;

c. Risk-sharing receivables invoiced as determined after the annual period;

d. Risk-sharing receivables not yet invoiced; and

e. Amounts collected from providers as payments under risk-sharing contracts.

An example of this disclosure is shown in Exhibit B to this statement.

Effective Date and Transition

26. This statement is effective for years ending on and after December 31, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*.

27. Prior to January 1, 2003, reporting entities may transition the invoicing provision outlined in paragraph 10 and shall invoice pharmaceutical rebates on no less than a semi-annual basis. Furthermore, prior to January 1, 2003, reporting entities may transition the 90 day admissibility provision outlined in paragraph 10 and shall nonadmit pharmaceutical rebates if such rebates have not been collected within 180 days of the billing date.

28. Prior to January 1, 2003, reporting entities may transition the invoicing provision outlined in paragraph 20 and shall invoice the risk-sharing balance no later than 11 months following the close of the annual period.

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 107—Certain Health Care Receivables and Receivables Under Government Insured Plans*

EXHIBIT A – ILLUSTRATION OF PHARMACEUTICAL REBATE RECEIVABLES

(000 omitted)

Quarter	Estimated Pharmacy Rebates as Reported on Financial Statements	Pharmacy Rebates as Invoiced/ Confirmed	Actual Rebates Collected Within 90 Days of Invoicing/ Confirmation	Actual Rebates Collected Within 91 to 180 Days of Invoicing/ Confirmation	Actual Rebates Collected More Than 180 Days After Invoicing/ Confirmation
12/31/2003	$150	$147			
9/30/2003	130	133	$62		
6/30/2003	142	143	70	$55	
3/30/2003	157	152	65	42	$20
12/31/2002	125	132	70	27	20
9/30/2002	123	129	62	31	14
6/30/2002	112	120	54	20	16
3/31/2002	110	118	57	39	20
12/31/2001	68	75	34	20	10
9/30/2001	60	59	27	17	10
6/30/2001	57	60	31	15	10
3/31/2001	45	50	25	18	7

EXHIBIT B – ILLUSTRATION OF RISK-SHARING RECEIVABLES

(000 omitted)

Calendar Year	Evaluation Period Year Ending	Risk-Sharing Receivable as Estimated and Reported in the Prior Year	Risk-Sharing Receivable as Estimated and Reported in the Current Year	Risk-Sharing Receivable Invoiced	Risk-Sharing Receivable Not Invoiced	Actual Risk-Sharing Amounts Collected in Year Invoiced	Actual Risk-Sharing Amounts Collected First Year Subsequent	Actual Risk-Sharing Amounts Collected Second Year Subsequent	Actual Risk-Sharing Amounts Collected – All Other
2003	2003	$245	$232	$155	$77	$0			
	2004	XXX	$189	XXX	$189	XXX	XXX		
2002	2002	$223	$225	$203	$22	$0	$200		
	2003	XXX	$245	XXX	$245	XXX	XXX	XXX	XXX
2001	2001	$190	$178	$174	$4	$0	$170	$5	
	2002	XXX	$223	XXX	$223	$XXX	XXX	XXX	XXX

If there were only one contract or if all contracts have the same experience period, then there would only be an entry in either the “Invoiced” or “Not Invoiced” column for the current year. This example assumes varying dates on experience periods for multiple contracts. Assumptions: Two risk-sharing contracts are in place, one with an experience period that ends 3/31/03 and one with an experience period that ends 10/31/03.

The $155,000 receivable for the contract period that ends 3/31/03 would be invoiced no later than 11/30/03 (or 8 months following close of the contract period) and could be collected no later than 2/28/04. Therefore, the $155,000 would appear in the “Invoiced” column in 2003 but not shown as collected in 2003. Further, the $189,000 estimate for the experience period that ends 3/31/04 could be recorded on the December 31, 2003 financial statement, since there is more than six months of experience under the contract.

The contract with the experience period that ends 10/31/03 with an estimated $77,000 receivable would be invoiced by 6/30/04 and collected by 09/30/04. Therefore, it would appear in the “Not Invoiced” column and not shown as collected in 2003. However, no estimate could be reported on the December 31, 2003 financial statement for the experience period that ends 10/31/04, because there is less than six months of experience under the contract.

EXHIBIT C – IMPLEMENTATION GUIDE

The purpose of this guide is to assist regulators as well as reporting entities in the practical application of SSAP No. 84.

Pharmaceutical Rebate Receivables

1. Q: What is a reasonable method of determining receivables for estimated amounts?

A: At any one reporting date, a reporting entity's receivable for pharmaceutical rebates can consist of two distinct amounts: 1) an estimated amount, and 2) a billed amount (that can include adjustments to previously billed amounts). The estimated amount represents the reporting entity's best estimate of the rebates it expects to receive for those prescriptions drugs filled during the most recent quarter, i.e. at 12/31/20X1, the estimate would relate to those prescriptions filled during the fourth quarter of 20X1. Estimated rebate amounts for prescription drugs filled in any other quarter must be nonadmitted.

When determining its estimate, the reporting entity should use the most accurate methods possible that utilize historical information relative to pharmaceutical rebates received. The reporting entity should use methods that consider contractual changes in rebate amounts, seasonality differences, changes in membership or premium revenue, changes in utilization of drugs with varying rebate levels, etc.

2. Q: Paragraph 10.b. states, "Billed amounts for an estimated amount under paragraph 10.a. shall be admitted only if the determination of the rebate, based on actual prescriptions filled, occurs and is invoiced or confirmed in writing within the 2 months following the reporting date of the estimated amount." What is meant by the phrase "within 2 months following the reporting date of the estimated amount?" Why does the SSAP make a distinction between those rebates that are invoiced and those that are confirmed in writing?

A: This sentence is worded in this fashion in order to show the relationship between an estimated amount and the related billed amount. At any reporting date, a billed amount will qualify as an admitted asset only if it was invoiced or confirmed in writing within the two months following the most previously filed financial statement, or the financial statement in which the related estimate was reported. E.g., using the example in Q&A 1, the reporting entity could admit billed amounts for rebates attributable to prescriptions drugs filled in *third quarter* of 20X1, only if the rebates were invoiced or confirmed in writing no later than 11/30/20X1. Further, the billed amount must be collected by 2/28/20X2 or it will become a nonadmitted asset.

Secondly, reporting entities typically administer their pharmaceutical benefit programs in one of two fashions, either directly or though a pharmaceutical benefit manager (PBM). The SSAP makes a distinction for these two instances. Entities that contract directly with the pharmaceutical company will invoice the pharmaceutical company for its rebates. However, for those entities that use a PBM, the SSAP requires that to admit billed amounts the reporting entity must receive reports from the PBM on a quarterly basis; the reports should provide fairly detailed information as to the number of each prescription drug filled, the rebate for each individual drug, the total amount of rebates to be received, any rebates to be received that relate to prior periods, etc. The reporting entity must then accept or "confirm" the report, and then communicate formal acceptance of the report to the PBM. Only after this occurs is the amount considered confirmed as required by the SSAP.

3. Q: What is a reasonable method of confirming a report received from our PBM?

A: The reporting entity should perform whatever verification procedures it deems necessary to provide adequate assurance that the report is accurate. These procedures might include, but are not limited to, reviewing the information required from the PBM as discussed in Q&A 2, verification of payments for prescription drug charges, trend testing, etc.

4. Q: Rebates relating to uninsured plans have been included in the gross receivable for pharmaceutical rebates. However, much of the amount was nonadmitted because of the requirement to bill within two months was not met. Is it still necessary to record the payable to the uninsured plan, even though the liability is essentially a pass-through?

A: Yes, the liability must still be recorded, regardless of the fact that the related asset may be nonadmitted.

5. Q: Should the disclosure in Exhibit A include rebates for both insured and uninsured business?

A: Yes, the disclosure to be included in the Notes to Financial Statements for pharmaceutical rebate receivables should include pharmaceutical rebates of insured and uninsured business. However, ultimately the reporting entity must have the ability to separately identify rebates for insured and uninsured business, given the distinct difference in treatment on the Statement of Revenue and Expenses.

6. Q: Please explain the transition period related to the invoicing of pharmaceutical rebate receivables.

A: The transition applies to all reporting periods preceding January 1, 2003, and allows transition for the invoicing and collection provisions found in paragraph 10.b. Throughout the transition period, the reporting entity may invoice (or confirm in writing) its pharmaceutical rebates semi-annually, i.e. the receivable for the estimated or billed amount may include two quarters, depending upon the invoice dates elected. However, reporting entities must still invoice or confirm in writing their rebates within 2 months of the end of each semi-annual period for the billed amount to be admitted.

For example, during the transition period B&P HMO elected to invoice its pharmaceutical rebates with semi-annual periods ending 12/31/2001 and 6/30/2002. B&Ps admitted asset for pharmaceutical rebate receivables for reporting periods ending 12/31/2001 through 3/31/2003 would be comprised of the following:

Transition period:

12/31/2001 Estimated amounts: third and fourth quarters of 2001
Billed amounts: none

3/31/2002 Estimated amounts: first quarter of 2002
Billed amounts: third and fourth quarters of 2001 if billed by 2/28/2002 (note that these billed amounts must be collected by 8/31/2002)

6/30/2002 Estimated amounts: first and second quarters of 2002
Billed amounts: third and fourth quarters of 2001 if billed by 2/28/2002 (note that these billed amounts must be collected by 8/31/2002)

9/30/2002 Estimated amounts: third quarter of 2002
Billed amounts: first and second quarters of 2002 if billed by 8/31/2002 (these billed amounts must be collected by 1/1/2003, the date of full implementation of SSAP No. 84)

12/31/2002 Estimated amounts: third and fourth quarters of 2002
Billed amounts: first and second quarters of 2002 if billed by 8/31/2002 (take note that these billed amounts must be collected by 1/1/2003, the date of full implementation of SSAP No. 84)

Full implementation of SSAP No. 84

3/31/2003 Estimated amounts: first quarter of 2003
Billed amounts: fourth quarter of 2002 if billed by 2/28/2003

Note that this situation will result in no admitted asset allowed for the billed amount related to the third quarter of 2002, given that the requirements of the SSAP are fully effective on 1/1/2003. B&P should consider invoicing its rebates as required by the SSAP prior to the close of the transition period to avoid this situation.

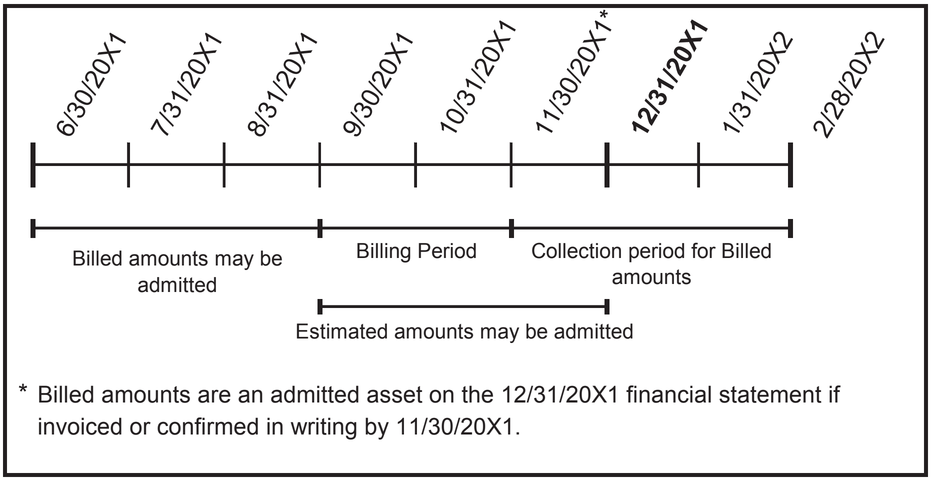
7. Q: How much historical data is required in the pharmaceutical rebates disclosure in 2001 and 2002?

A: Reporting entities should include as much information as possible when completing this disclosure in 2001 and 2002. Be aware that in 2001 and 2002, this disclosure will be included under Note 20, Other Items. In 2003, this disclosure will be a separate note.

8. Q: Should the disclosure include rebates invoiced or confirmed in writing that relate to prior periods?

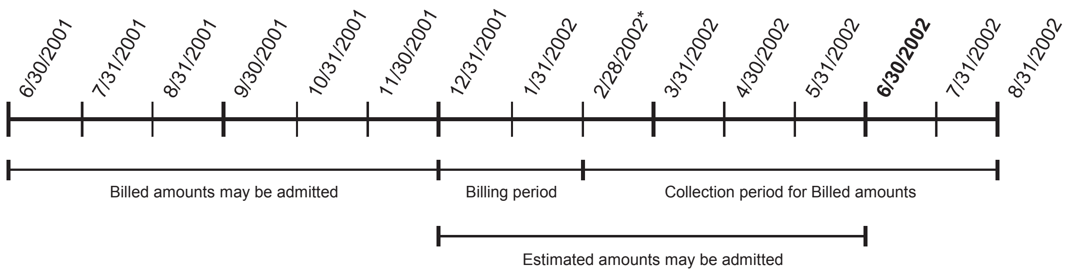
A: Yes. The disclosure should include all rebates invoiced or confirmed in writing during the respective quarter, whether such rebates relate to the most recently invoiced quarter or any quarter preceding that.

Illustrative timeline of SSAP No. 84 requirements relative to pharmaceutical rebate receivables, assuming a financial statement date of 12/31/20X1:


6/30/20X1
7/31/20X1
8/31/20X1
9/30/20X1
10/31/20X1
11/30/20X1*
12/31/20X1
1/31/20X2
2/28/20X2
Billed amounts may be admitted
Billing Period
Collection period for Billed amounts
Estimated amounts may be admitted

* Billed amounts are an admitted asset on the 12/31/20X1 financial statement if invoiced or confirmed in writing by 11/30/20X1.

Illustrative timeline of SSAP No. 84 transition guidance as related to pharmaceutical rebate receivables, assuming a financial statement date of 6/30/2002 and that the reporting entity has elected to invoice/confirm in writing its rebates at 12/31/2001 and 6/30/2002:


6/30/2001
7/31/2001
8/31/2001
9/30/2001
10/31/2001
11/30/2001
12/31/2001
1/31/2002
2/28/2002*
3/31/2002
4/30/2002
5/31/2002
6/30/2002
7/31/2002
8/31/2002
Billed amounts may be admitted
Billing period
Collection period for Billed amounts
Estimated amounts may be admitted

* Billed amounts for the third and fourth quarters of 2001 can be classified as an admitted asset on the 6/30/2002 financial statement if invoiced or confirmed in writing by 2/28/2002.

Loans and Advances to Providers

9. Q: Why was a distinction made between loans and advances to providers and loans and advances to hospitals?

A: This distinction was made to recognize the unique nature of certain arrangements between reporting entities and hospitals, whereby the participating hospitals are loaned and advanced amounts monthly or quarterly. Such arrangements oftentimes result in lower charges to the reporting entity and work to the benefit of the reporting entity.

10. Q: With regard to the phrase "a loan or advance to a non-related party hospital shall be admitted up to the amount of claims incurred and payable to the hospital," what does this mean? Does this require that the IBNR valuation be performed for each hospital in which funds are loaned or advanced?

A: In a situation in which amounts are loaned/advanced to a hospital, as the hospital provides services and reports such to the reporting entity, the costs of such services are applied against the outstanding loan. Also applied against the loan is the reporting entity's estimate of the amount of services provided but not yet reported, i.e. IBNR. The remaining portion of the loan represents the receivable subject to the requirements of the SSAP.

In determining the amount of claims incurred and payable to a particular hospital, the reporting entity should use the most accurate method available. In most instances an IBNR calculation would be the most accurate method of determining this amount.

11. Q: Please explain the reconciliation requirements in paragraph 16.d. and 16.e. related to loans and advances to hospitals.

A: While loans and advances to hospitals are typically paid monthly, the SSAP requires that such balances be reconciled at least quarterly on a per-hospital basis. The SSAP further requires that each quarter's account be reconciled within nine months of the end of that quarter, i.e. the reconciliation for the quarter ending 3/31/20X1 must be completed by 12/31/20X1.

Therefore, at 12/31/20X1, a reporting entity can have four quarters of loans and advances in its receivable: three quarters worth of unreconciled amounts and one quarter that has been reconciled but not settled.

12. Q: If amounts are loaned or advanced to a hospital but the reconciliation requirements of paragraph 16 are not met, must these amounts be nonadmitted?

A: Not necessarily. In this event, the guidance in paragraph 15 can be followed to determine admissibility, in that the loan or advance may be admitted up to the amount of the payable to the provider for reported claims.

Risk-Sharing Receivables

13. Q: The SSAP allows for the classification of certain estimates of risk-sharing receivables as admitted assets. In what instances may estimates be admitted, and what is a reasonable method of determining receivables for estimated amounts?

A: At any reporting date, a reporting entity's receivable for any one risk-sharing arrangement can consist of two amounts: 1) an estimated amount, and 2) a billed amount (that can include adjustments to previously billed amounts). An estimate can be admitted only if at least six months have passed since the commencement of the annual experience period. The estimated amount represents the reporting entity's best estimate of the receivable related to the contract period from inception to the reporting date.

When determining its estimate, the reporting entity should use the most accurate methods possible that utilize inception-to-date encounter data relative to outpatient surgery encounters, hospital days, etc. If the reporting entity cannot reasonably estimate its risk-sharing receivables, then such amounts must be nonadmitted.

14. Q: The SSAP requires that the determination of the risk share balance begin within six months from the end of the annual experience period, and further requires that the final amount must be invoiced no later than eight months following the close of such period. Must data accumulation stop with month six? Can the reporting entity utilize experience data from months seven and eight in its calculation?

A: The reporting entity should use as much experience data as possible within the 8-month invoicing requirement of paragraph 20.a. This requirement was included to ensure that reporting entities are being proactive when determining risk share balances but was in no way intended to limit the amount of experience data considered.

15. Q: Describe a situation when a receivable and payable would exist with the same provider under a risk-sharing arrangement?

A: This could happen 1) if the risk-share arrangement requires separate risk sharing for each line of business, for certain large groups, etc. or 2) where two contract/evaluation periods under a risk-sharing arrangement are involved.

16. Q: Please explain the transition period related to the invoicing of risk-sharing receivables.

A: The transition applies to all reporting periods preceding January 1, 2003, and allows transition for the invoicing provision found in paragraph 20. Throughout the transition period, the reporting entity may invoice its risk-sharing receivables within 11 months of the end of the contract period, i.e. 11/30/20X2 for a risk-sharing contract with an annual period ending 12/31/20X1. Therefore, during the transition period estimated amounts may be admitted for an additional three-month time period, i.e. from 7/1/20X1 through 11/30/20X2.

17. Q: The disclosure for risk-sharing receivables seems confusing. Please explain what should be included in columns three through six that address estimated and billed/invoiced balances.

A: The third column from the left contains the heading “Risk-Sharing Receivable as Estimated and Reported in the Prior Year.” This column should reflect the amount of risk-sharing receivables as determined in the prior year and reported as admitted assets on the prior year’s financial statement. Therefore, there will never be information reported for the year subsequent to the year in question, as contracts with evaluation periods ending in the following year cannot have risk-sharing receivables recorded in the previous year.

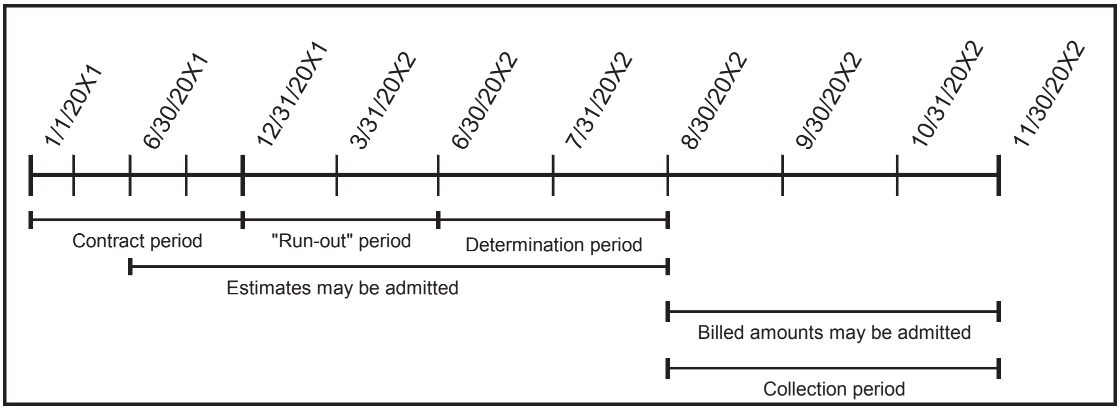
The fourth column, “Risk-Sharing Receivable as Estimated and Reported in the Current Year,” should contain the admitted amounts of risk-sharing receivables on the current year’s financial statement. These amounts should be segregated between those agreements with contract periods ending in the current year and those ending in the following year.

The fifth column from the left contains the heading “Risk-Sharing Receivable Invoiced” and will contain the amount of risk-sharing receivables invoiced during the designated year, regardless of whether such are outstanding as of the financial statement date.

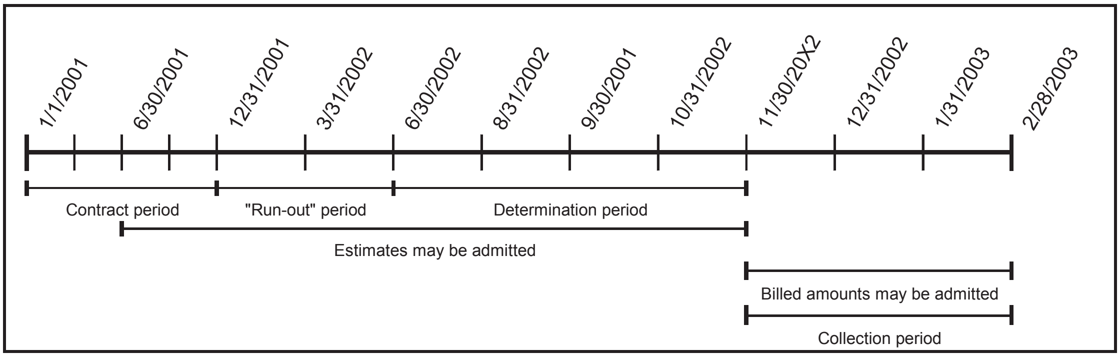
The sixth column, reflecting the heading “Risk-Sharing Receivable Not Invoiced,” should contain the current year-end receivable balance for agreements which qualify for estimation under paragraph 20.b., i.e. the contract has been in effect for at least six months but no amounts have been invoiced. Note that a particular reporting entity might not have any estimated receivables, if that entity’s risk-sharing contracts have not been in effect for at least six months.

Be aware that in 2001 and 2002, this disclosure will be included under Note 20, Other Items. In 2003, this disclosure will be a separate note.

Illustrative timeline of SSAP No. 84 requirements relative to risk-sharing receivables, assuming the reporting entity has one risk-sharing agreement in place with an effective date of 1/1/20X1:


1/1/20X1
6/30/20X1
12/31/20X1
3/31/20X2
6/30/20X2
7/31/20X2
8/30/20X2
9/30/20X2
10/31/20X2
11/30/20X2
Contract period
"Run-out" period
Determination period
Estimates may be admitted
Billed amounts may be admitted
Collection period

Illustrative timeline of SSAP No. 84 transition guidance as related to risk-sharing receivables, assuming the reporting entity has one risk-sharing agreement in place with an effective date of 1/1/2001:


1/1/2001
6/30/2001
12/31/2001
3/31/2002
6/30/2002
8/31/2002
9/30/2001
10/31/2002
11/30/20X2
12/31/2002
1/31/2003
2/28/2003
Contract period
"Run-out" period
Determination period
Estimates may be admitted
Billed amounts may be admitted
Collection period

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Statement of Statutory Accounting Principles No. 86

Accounting for Derivative Instruments and Hedging, Income Generation, and Replication (Synthetic Asset) Transactions

STATUS

Type of Issue:	Common Area
Issued:	Finalized May 14, 2002
Effective Date:	January 1, 2003
Affects:	Supersedes SSAP No. 31
Affected by:	No other pronouncements
Interpreted by:	No other pronouncements

STATUS **1**

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Accounting for Derivative Instruments and Hedging Activities

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for derivative instruments and hedging, income generation, and replication (synthetic asset) transactions using selected concepts outlined in *FASB Statement No. 133*, *Accounting for Derivative Instruments and Hedging Activities* (FAS 133).

2. This statement supersedes the provisions of *SSAP No. 31— Derivative Instruments*.

SUMMARY CONCLUSION

3. This statement addresses the recognition of derivatives and measurement of derivatives used in:

a. Hedging transactions;

b. Income generation transactions; and

c. Replication (synthetic asset) transactions

Definitions (for purposes of this statement)

4. “Derivative instrument” means an agreement, option, instrument or a series or combination thereof:

a. To make or take delivery of, or assume or relinquish, a specified amount of one or more underlying interests, or to make a cash settlement in lieu thereof; or

b. That has a price, performance, value or cash flow based primarily upon the actual or expected price, level, performance, value or cash flow of one or more underlying interests.

5. Derivative instruments include, but are not limited to; options, warrants used in a hedging transaction and not attached to another financial instrument, caps, floors, collars, swaps, forwards, futures and any other agreements or instruments substantially similar thereto or any series or combination thereof.

a. “Caps” are option contracts in which the cap writer (seller), in return for a premium, agrees to limit, or cap, the cap holder’s (purchaser) risk associated with an increase in a reference rate or index. For example, in an interest rate cap, if rates go above a specified interest rate level (the strike price or the cap rate), the cap holder is entitled to receive cash payments equal to the excess of the market rate over the strike price multiplied by the notional principal amount. Because a cap is an option-based contract, the cap holder has the right but not the obligation to exercise the option. If rates move down, the cap holder has lost only the premium paid. A cap writer has virtually unlimited risk resulting from increases in interest rates above the cap rate;

b. “Collar” means an agreement to receive payments as the buyer of an option, cap or floor and to make payments as the seller of a different option, cap or floor;

c. “Floors” are option contracts in which the floor writer (seller), in return for a premium, agrees to limit the risk associated with a decline in a reference rate or index. For example, in an interest rate floor, if rates fall below an agreed rate, the floor holder (purchaser) will receive cash payments from the floor writer equal to the difference between the market rate and an agreed rate multiplied by the notional principal amount;

d. "Forwards" are agreements (other than futures) between two parties that commit one party to purchase and the other to sell the instrument or commodity underlying the contract at a specified future date. Forward contracts fix the price, quantity, quality, and date of the purchase and sale. Some forward contracts involve the initial payment of cash and may be settled in cash instead of by physical delivery of the underlying instrument;

e. "Futures" are standardized forward contracts traded on organized exchanges. Each exchange specifies the standard terms of futures contracts it sponsors. Futures contracts are available for a wide variety of underlying instruments, including insurance, agricultural commodities, minerals, debt instruments (such as U.S. Treasury bonds and bills), composite stock indices, and foreign currencies;

f. "Options" are contracts that give the option holder (purchaser of the option rights) the right, but not the obligation, to enter into a transaction with the option writer (seller of the option rights) on terms specified in the contract. A call option allows the holder to buy the underlying instrument, while a put option allows the holder to sell the underlying instrument. Options are traded on exchanges and over the counter;

g. "Swaps" are contracts to exchange, for a period of time, the investment performance of one underlying instrument for the investment performance of another underlying instrument, typically, but not always, without exchanging the instruments themselves. Swaps can be viewed as a series of forward contracts that settle in cash and, in some instances, physical delivery. Swaps generally are negotiated over-the-counter directly between the dealer and the end user. Interest rate swaps are the most common form of swap contract. However, foreign currency, commodity, and credit default swaps also are common;

h. "Warrants" are instruments that give the holder the right to purchase an underlying financial instrument at a given price and time or at a series of prices and times outlined in the warrant agreement. Warrants may be issued alone or in connection with the sale of other securities, for example, as part of a merger or recapitalization agreement, or to facilitate divestiture of the securities of another business entity.

6. "Firm commitment" is an agreement with an unrelated party, binding on both parties and expected to be legally enforceable, with the following characteristics:

a. The agreement specifies all significant terms, including the quantity to be exchanged, the fixed price, and the timing of the transaction. The fixed price may be expressed as a specified amount of an entity's functional currency or of a foreign currency. It may also be expressed as a specified interest rate or specified effective yield;

b. The agreement includes a disincentive for nonperformance that is sufficiently large to make performance probable; and

c. For investments in subsidiary, controlled, and affiliated entities (as defined by *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities, A Replacement of SSAP No. 88* (SSAP No. 97)) and investments in limited liability companies (as defined by *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies*) it must be probable that acquisition will occur within a reasonable period of time.

7. A hedging transaction is defined as a derivative(s) transaction which is entered into and maintained to reduce:

a. The risk of a change in the fair value or cash flow of assets and liabilities which the reporting entity has acquired or incurred or has a firm commitment to acquire or incur or for which the entity has forecasted acquisition or incurrence; or

b. The currency exchange rate risk or the degree of foreign currency exposure in assets and liabilities which a reporting entity has acquired or incurred or has a firm commitment to acquire or incur or for which the entity has forecasted acquisition or incurrence.

8. "Income generation transaction" is defined as derivatives written or sold to generate additional income or return to the reporting entity. They include covered options, caps, and floors (e.g., a reporting entity writes an equity call option on stock that it already owns).

9. "Replication (Synthetic Asset) transaction" is a derivative transaction entered into in conjunction with other investments in order to reproduce the investment characteristics of otherwise permissible investments. A derivative transaction entered into by an insurer as a hedging or income generation transaction shall not be considered a replication (synthetic asset) transaction.

10. "Forecasted transaction" is a transaction that is expected to occur for which there is no firm commitment. Because no transaction or event has yet occurred and the transaction or event when it occurs will be at the prevailing market price, a forecasted transaction does not give an entity any present rights to future benefits or a present obligation for future sacrifices.

11. An "underlying" is a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable (including the occurrence or nonoccurrence of a specified event such as a scheduled payment under contract). An underlying may be a price or rate of an asset or liability but is not the asset or liability itself.

12. "Benchmark Interest Rate" is a widely recognized and quoted rate in an active financial market that is broadly indicative of the overall level of interest rates attributable to high-credit-quality obligors in that market. It is a rate that is widely used in a given financial market as an underlying basis for determining the interest rates of individual financial instruments and commonly referenced in interest-rate-related transactions. In theory, the benchmark interest rate should be a risk-free rate (that is, has no risk of default). In some markets, government borrowing rates may serve as a benchmark. In other markets, the benchmark interest rate may be an interbank offered rate. In the United States, currently only the interest rates on direct Treasury obligations of the U.S. government and, for practical reasons, the London Interbank Offered Rate (LIBOR) swap rate and the Fed Funds Effective Swap Rate (also referred to as the Overnight Index Swap Rate) are considered to be benchmark interest rates.

Embedded Derivative Instruments

~~12.~~13. Contracts that do not in their entirety meet the definition of a derivative instrument, such as bonds, insurance policies, and leases, may contain "embedded" derivative instruments—implicit or explicit terms that affect some or all of the cash flows or the value of other exchanges required by the contract in a manner similar to a derivative instrument. The effect of embedding a derivative instrument in another type of contract ("the host contract") is that some or all of the cash flows or other exchanges that otherwise would be required by the contract, whether unconditional or contingent upon the occurrence of a specified event, will be modified based on one or more underlyings. An embedded derivative instrument shall not be separated from the host contract and accounted for separately as a derivative instrument.

Impairment

~~13.~~14. This statement adopts the impairment guidelines established by *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets* (SSAP No. 5R) for the underlying financial assets or liabilities.

Recognition and Measurement of Derivatives Used in Hedging Transactions

~~14.~~15. Derivative instruments represent rights or obligations that meet the definitions of assets (*SSAP No. 4—Assets and Nonadmitted Assets*) or liabilities (SSAP No. 5R) and shall be reported in financial statements. In addition, derivative instruments also meet the definition of financial instruments as defined in *SSAP No. 27—Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* (SSAP No. 27). Should the cost basis of the derivative instrument be undefined (i.e., no premium is paid), the instrument shall be disclosed in accordance with paragraphs 44-47 of *SSAP No. 100—Fair Value Measurements* (SSAP No. 100). Derivative instruments are admitted assets to the extent they conform to the requirements of this statement.

~~15.~~16. Derivative instruments used in hedging transactions that meet the criteria of a highly effective hedge shall be considered an effective hedge and are permitted to be valued and reported in a manner that is consistent with the hedged asset or liability (referred to as hedge accounting). For instance, assume an entity has a financial instrument on which it is currently receiving income at a variable rate but wishes to receive income at a fixed rate and thus enters into a swap agreement to exchange the cash flows. If the transaction qualifies as an effective hedge and a financial instrument on a statutory basis is valued and reported at amortized cost, then the swap would also be valued and reported at amortized cost. Derivative instruments used in hedging transactions that do not meet or no longer meet the criteria of an effective hedge, or that meet the required criteria but the entity has chosen not to apply hedge accounting, shall be accounted for at fair value and the changes in the fair value shall be recorded as unrealized gains or unrealized losses (referred to as fair value accounting).

~~16.~~17. Entities shall not bifurcate the effectiveness of derivatives. A derivative instrument is either classified as an effective hedge or an ineffective hedge. Entities must account for the derivative using fair value accounting if it is deemed to be ineffective or becomes ineffective. Entities may redesignate a derivative in a hedging relationship even though the derivative was used in a previous hedging relationship that proved to be ineffective. An entity shall prospectively discontinue hedge accounting for an existing hedge if any one of the following occurs:

a. Any criterion in paragraphs 20-32~~19-31~~ is no longer met;

b. The derivative expires or is sold, terminated, or exercised (the effect is recorded as realized gains or losses or, for effective hedges of firm commitments or forecasted transactions, in a manner that is consistent with the hedged transaction – see paragraph 18~~17~~);

c. The entity removes the designation of the hedge; or

d. The derivative is deemed to be impaired in accordance with paragraph 14~~13~~. A permanent decline in a counterparty's credit quality/rating is one example of impairment required by paragraph 14~~13~~, for derivatives used in hedging transactions.

~~17.~~18. For those derivatives which qualify for hedge accounting, the change in the carrying value or cash flow of the derivative shall be recorded consistently with how the changes in the carrying value or cash flow of the hedged asset, liability, firm commitment or forecasted transaction are recorded. Upon termination of a derivative that qualified for hedge accounting, the gain or loss shall adjust the basis of the hedged item and be recognized in income in a manner that is consistent with the hedged item (alternatively, if the item being hedged is subject to IMR, the gain or loss on the hedging derivative may be realized and shall be subject to IMR upon termination.) Entities who choose the alternative method shall apply it consistently thereafter.

Hedge Designations

~~18.~~19. An entity may designate a derivative instrument as hedging the exposure to:

a. Changes in the fair value of an asset or a liability or an identified portion thereof that is attributable to a particular risk. This type of hedge can be utilized regardless of whether the hedged asset or liability is recorded in the financial statements at fair value;

b. Variability in expected future cash flows that are attributable to a particular risk. That exposure may be associated with an existing recognized asset or liability (such as all or certain future interest payments on variable-rate debt) or a forecasted transaction; or

c. Foreign currency exposure. Specific examples include a fair value or cash flow hedge of a foreign-currency-denominated firm commitment or financial instrument.

Fair Value Hedges

~~19.~~20. Fair value hedges qualify for hedge accounting if all of the following criteria are met:

a. At inception of the hedge, the formal documentation requirements of paragraph 35~~34~~ are met;

b. Both at inception of the hedge and on an ongoing basis, the hedging relationship must be highly effective in achieving offsetting changes in fair value attributable to the hedged risk during the period that the hedge is designated. An assessment of effectiveness is required whenever financial statements or earnings are reported, and at least every three months. All assessments of effectiveness shall be consistent with the risk management strategy documented for that particular hedging relationship;

c. The term highly effective describes a cash flow hedging relationship where the change in fair value of the derivative hedging instrument is within 80 to 125 percent of the opposite change in the fair value of the hedged item attributable to the hedged risk. It shall also apply when an R-squared of .80 or higher is achieved when using a regression analysis technique. Further guidance on determining effectiveness can be found within Exhibits A and B;

d. The hedged item is specifically identified as either all or a specific portion of a recognized asset or liability or of an unrecognized firm commitment. The hedged item is a single asset or liability (or a specific portion thereof) or is a portfolio of similar assets or a portfolio of similar liabilities (or a specific portion thereof);

e. If similar assets or similar liabilities are aggregated and hedged as a portfolio, the individual assets or individual liabilities must share the risk exposure for which they are designated as being hedged. The change in fair value attributable to the hedged risk for each individual item in a hedged portfolio must be expected to respond in a generally proportionate manner to the overall change in fair value of the aggregate portfolio attributable to the hedged risk; and

f. If the hedged item is a financial asset or liability, a recognized loan servicing right, or a nonfinancial firm commitment with financial components, the designated risk being hedged is:

i. the risk of changes in the overall fair value of the entire hedged item,

ii. the risk of changes in its fair value attributable to changes in benchmark interest rate,

iii. the risk of changes in its fair value attributable to changes in the related foreign currency exchange rates, or

iv. the risk of changes in its fair value attributable to both changes in the obligor's creditworthiness and changes in the spread over the benchmark interest rate with respect to the related financial asset's or liability's credit sector at inception of the hedge (referred to as credit risk).

If the risk designated as being hedged is not the risk in paragraph ~~19~~20.f.i., two or more of the other risks (benchmark interest rate risk, foreign currency exchange risk, and credit risk) may simultaneously be designated as being hedged.

The benchmark interest rate being hedged in a hedge of interest rate risk must be specifically identified as part of the designation and documentation at the inception of the hedging relationship. ~~Ordinarily, an entity should designate the same benchmark interest rate as the risk being hedged for similar hedges; the use of different benchmark interest rates for similar hedges should be rare and must be justified.~~ In calculating the change in the hedged item's fair value attributable to changes in the benchmark interest rate, the estimated cash flows used in calculating fair value must be based on all of the contractual cash flows of the entire hedged item. Excluding some of the hedged item's contractual cash flows (for example, the portion of the interest coupon in excess of the benchmark interest rate) from the calculation is not permitted.[1] An entity may not simply designate prepayment risk as the risk being hedged for a financial asset. However, it can designate the option component of a prepayable instrument as the hedged item in a fair value hedge of the entity's exposure to changes in the fair value of that "prepayment" option, perhaps thereby achieving the objective of its desire to hedge prepayment risk. The effect of an embedded derivative of the same risk class must be considered in designating a hedge of an individual risk. For example, the effect of an embedded prepayment option must be considered in designating a hedge of benchmark interest rate risk.

Cash Flow Hedges

~~20.~~21. Cash flow hedges qualify for hedge accounting if all of the following criteria are met:

a. At inception of the hedge, the formal documentation requirements of paragraph 35~~34~~ are met;

b. Both at inception of the hedge and on an ongoing basis, the hedging relationship shall be highly effective in achieving offsetting cash flows attributable to the hedged risk during the term of the hedge. An assessment of effectiveness is required whenever financial statements or earnings are reported, and at least every three months. All assessments of effectiveness shall be consistent with the originally documented risk management strategy for that particular hedging relationship; and

c. The term highly effective describes a cash flow hedging relationship where the change in cash flows or present value of cash flows of the derivative hedging instrument is within 80 to 125 percent of the opposite change in the cash flows or present value of the cash flows of the hedged item attributable to the hedged risk. It shall also apply when an R-

[1] The first sentence of paragraph ~~19~~20.d. that specifically permits the hedged item to be identified as either all or a specific portion of a recognized asset or liability or of an unrecognized firm commitment is not affected by the provisions in this subparagraph.

squared of .80 or higher is achieved when using a regression analysis technique. Further guidance on determining effectiveness can be found within Exhibits A and B.

Hedging Forecasted Transactions

~~21.~~22. A forecasted transaction is eligible for designation as a hedged transaction in a cash flow hedge if all of the following additional criteria are met:

a. The forecasted transaction is specifically identified as a single transaction or a group of individual transactions. If the hedged transaction is a group of individual transactions, those individual transactions must share the same risk exposure for which they are designated as being hedged. Thus, a forecasted purchase and a forecasted sale cannot both be included in the same group of individual transactions that constitute the hedged transaction.

b. The occurrence of the forecasted transaction is probable. An assessment of the likelihood that a forecasted transaction will take place should not be based solely on management's intent because intent is not verifiable. The transaction's probability should be supported by observable facts and the attendant circumstances. Consideration should be given to the following circumstances in assessing the likelihood that a transaction will occur:

i. The frequency of similar past transactions;

ii. The financial and operational ability of the entity to carry out the transaction;

iii. Substantial commitments of resources to a particular activity (for example, a manufacturing facility that can be used in the short run only to process a particular type of commodity);

iv. The extent of loss or disruption of operations that could result if the transaction does not occur; and

v. The likelihood that transactions with substantially different characteristics might be used to achieve the same business purpose (for example, an entity that intends to raise cash may have several ways of doing so, ranging from a short-term bank loan to a common stock offering).

The term probable requires a significantly greater likelihood of occurrence than the phrase more likely than not. In addition, both the length of time until a forecasted transaction is projected to occur and the quantity of the forecasted transaction are considerations in determining probability. Other factors being equal, the more distant a forecasted transaction is, the less likely it is that the transaction would be considered probable and the stronger the evidence that would be needed to support an assertion that it is probable. For example, a transaction forecasted to occur in five years may be less likely than a transaction forecasted to occur in one year. However, forecasted interest payments for the next 20 years on variable-rate debt typically would be probable if supported by an existing contract. Additionally, other factors being equal, the greater the physical quantity or future value of a forecasted transaction, the less likely it is that the transaction would be considered probable and the stronger the evidence that would be required to support an assertion that it is probable. For example, less evidence generally would be needed to support forecasted investments of $100,000 in a particular month than would be needed to support forecasted investments of $950,000 in that month by an entity, even if its investments have averaged $950,000 per month for the past 3 months.

A forecasted transaction that is expected to occur within 2 months of the original forecasted date (or time frame) may still be considered probable. If the transaction will not occur until greater than 2 months after the original forecasted date, it is no longer probable and will be accounted for as per the following paragraph.

If a forecasted transaction is determined to no longer be probable per the standards above, hedge accounting shall cease immediately and any deferred gains or losses on the derivative must be recognized in unrealized gains or losses. If an entity demonstrates a pattern of determining that hedged forecasted transactions probably will not occur, such action would call into question both the entity's ability to accurately predict forecasted transactions and the propriety of using hedge accounting in the future for similar forecasted transactions. Accordingly, hedge accounting for transactions forecasted by that entity will no longer be permitted.

c. If the hedged transaction is the forecasted purchase or sale of a nonfinancial asset, the designated risk being hedged is (1) the risk of changes in the functional-currency-equivalent cash flows attributable to changes in the related foreign currency exchange rates or (2) the risk of changes in the cash flows relating to all changes in the purchase price or sales price of the asset (reflecting its actual location if a physical asset), not the risk of changes in the cash flows relating to the purchase or sale of a similar asset in a different location or of a major ingredient.

d. If the hedged transaction is the forecasted purchase or sale of a financial asset or liability or the variable cash inflow or outflow of an existing financial asset or liability, the designated risk being hedged is (1) the risk of changes in the cash flows of the entire asset or liability, such as those relating to all changes in the purchase price or sales price (regardless of whether that price and the related cash flows are stated in the entity's functional currency or a foreign currency), (2) the risk of changes in its cash flows attributable to changes in the designated benchmark interest rate, (3) the risk of changes in the functional-currency-equivalent cash flows attributable to changes in the related foreign currency exchange rates, or (4) the risk of changes in its cash flows attributable to default or changes in the obligor's creditworthiness, and changes in the spread over the benchmark interest rate with respect to the hedged item's credit sector at inception of the hedge. Two or more of the above risks may be designated simultaneously as being hedged. The benchmark interest rate being hedged in a hedge of interest rate risk must specifically be identified as part of the designation and documentation at the inception of the hedging relationship. An entity may not designate prepayment risk as the risk being hedged.

Foreign Currency Hedges

~~22.~~23. If the hedged item is denominated in a foreign currency, an entity may designate the following types of hedges of foreign currency exposure, as specified in paragraphs 20-22~~19-21~~:

a. A fair value hedge of an unrecognized firm commitment or a recognized asset or liability;

b. A cash flow hedge of a forecasted transaction, an unrecognized firm commitment, the forecasted functional-currency-equivalent cash flows associated with a recognized asset or liability, or a forecasted intercompany transaction; or

c. A hedge of a net investment in a foreign operation.

~~23.~~24. The recognition in earnings of the foreign currency transaction gain or loss on a foreign-currency-denominated asset or liability based on changes in the foreign currency spot rate is not considered to be the remeasurement of that asset or liability with changes in fair value attributable to foreign exchange risk recognized in earnings. Thus, those criteria are not impediments to either a foreign currency fair value or cash flow hedge of such a foreign-currency-denominated asset or liability or a foreign currency cash flow hedge of the forecasted acquisition or incurrence of a foreign-currency-denominated asset or liability whose carrying amount will be remeasured at spot exchange rates. A foreign currency derivative instrument that has been entered into with another member of a holding company can be a hedging instrument in a fair value hedge or in a cash flow hedge of a recognized foreign-currency-denominated asset or liability or in a net investment hedge only if that other member has entered into an offsetting contract with an unrelated third party to hedge the exposure it acquired from issuing the derivative instrument to the affiliate that initiated the hedge.

~~24.~~25. The provisions in paragraph 24~~23~~ that permit a recognized foreign-currency-denominated asset or liability to be the hedged item in a fair value or cash flow hedge of foreign currency exposure also pertain to a recognized foreign-currency-denominated receivable or payable that results from a hedged forecasted foreign-currency-denominated sale or purchase on credit. An entity may choose to designate a single cash flow hedge that encompasses the variability of functional currency cash flows attributable to foreign exchange risk related to the settlement of a foreign-currency-denominated receivable or payable resulting from a forecasted sale or purchase on credit. Alternatively, an entity may choose to designate a cash flow hedge of the variability of functional currency cash flows attributable to foreign exchange risk related to a forecasted foreign-currency-denominated sale or purchase on credit and then separately designate a foreign currency fair value hedge of the resulting recognized foreign-currency-denominated receivable or payable. In that case, the cash flow hedge would terminate (be dedesignated) when the hedged sale or purchase occurs and the foreign-currency-denominated receivable or payable is recognized. Although the use of the same foreign currency derivative instrument for both the cash flow hedge and the fair value hedge is not prohibited, some ineffectiveness may result.

Foreign Currency Fair Value Hedges

~~25.~~26. *Unrecognized firm commitment*. A derivative instrument or a nonderivative financial instrument that may give rise to a foreign currency transaction gain or loss can be designated as hedging changes in the fair value of an unrecognized firm commitment, or a specific portion thereof, attributable to foreign currency exchange rates. The designated hedging relationship qualifies for hedge accounting if all the fair value hedge criteria in paragraph 20~~19~~ are met.

~~26.~~27. *Recognized asset or liability*. A nonderivative financial instrument shall not be designated as the hedging instrument in a fair value hedge of the foreign currency exposure of a recognized asset or liability. A derivative instrument can be designated as hedging the changes in the fair value of a recognized foreign-currency-denominated asset or liability (or a specific portion thereof) for which a foreign currency transaction gain or loss is recognized in earnings. All recognized foreign-currency-denominated assets or liabilities for which a foreign currency transaction gain or loss is recorded in earnings may qualify for hedge accounting if all the fair value hedge criteria in paragraph 20~~19~~ are met.

~~27.~~28. *Securities carried at fair value*. A nonderivative financial instrument shall not be designated as the hedging instrument in a fair value hedge of the foreign currency exposure of security carried at fair value. A derivative instrument can be designated as hedging the changes in the fair values of an debt security carried at fair value (or a specific portion thereof) attributable to changes in foreign currency exchange rates. The designated hedging relationship qualifies for hedge accounting if all the fair value hedge criteria in paragraph 20~~19~~ are met. An equity security carried at fair value can be hedged for changes in the fair value attributable to changes in foreign currency exchange rates and qualify for hedge accounting if all the fair value hedge criteria in paragraph 20~~19~~ are met and the following two conditions are satisfied.

a. The security is not traded on an exchange (or other established marketplace) on which trades are denominated in the investor's functional currency; and

b. Dividends or other cash flows to holders of the security are all denominated in the same foreign currency as the currency expected to be received upon sale of the security.

~~28.~~29. Gain and losses on a qualifying foreign currency fair value hedge shall be accounted for as specified in paragraphs 16-18~~15-17~~ and Exhibit C. The gain or loss on a nonderivative hedging instrument attributable to foreign currency risk is the foreign currency transaction gain or loss as determined under *SSAP No. 23— Foreign Currency Transactions and Translations* (SSAP No. 23).

Foreign Currency Cash Flow Hedges

~~29.~~30. A nonderivative financial instrument shall not be designated as a hedging instrument in a foreign currency cash flow hedge. A derivative instrument designated as hedging the foreign currency exposure to variability in the functional-currency-equivalent cash flows associated with a forecasted transaction (for example, a forecasted sale to an unaffiliated entity with the price to be denominated in a foreign currency), a recognized asset or liability, an unrecognized firm commitment, or a forecasted intercompany transaction (for example, a forecasted sale to a foreign subsidiary or a forecasted royalty from a foreign subsidiary) qualifies for hedge accounting if all the following criteria are met:

a. The hedged transaction is denominated in a currency other than the hedging unit's functional currency.

b. All of the criteria in paragraph 21~~20~~ are met.

c. If the hedged transaction is a group of individual forecasted foreign-currency-denominated transactions, a forecasted inflow of a foreign currency and a forecasted outflow of the foreign currency cannot both be included in the same group.

d. If the hedged item is a recognized foreign-currency-denominated asset or liability, all the variability in the hedged item's functional-currency-equivalent cash flows must be eliminated by the effect of the hedge. (For example, with a variable-rate foreign-currency-denominated asset or liability a cash flow hedge cannot be used to hedge changes in exchange rates alone because the derivative would not eliminate all the variability in the functional currency cash flows.)

e. If the hedged transaction is the forecasted purchase or sale of a financial asset or liability or the interest payments on that financial asset or liability or the variable cash inflow or outflow of an existing financial asset or liability, the designated risk being hedged is (1) the risk of overall change in the hedged cash flows related to the asset or liability, such as those relating to all changes in the purchase price or sales price (regardless of whether that price and the related cash flows are stated in the entity's functional currency or a foreign currency), (2) the risk of changes in its cash flows attributable to changes in the designated benchmark interest rate (referred to as interest rate risk), (3) the risk of changes in the functional-currency-equivalent cash flows attributable to changes in the related foreign currency exchange rates, or (4) the risk of changes in its cash flows attributable to default, changes in the obligor's creditworthiness, and changes in the spread over the benchmark interest rate with respect to the hedged item's credit sector at inception of the hedge (referred to as credit risk). Two or more of the above risks may be designated simultaneously as being hedged. An entity may not designate prepayment risk as the risk being hedged.

The benchmark interest rate being hedged in a hedge of interest rate risk must be specifically identified as part of the designation and documentation at the inception of the hedging relationship. ~~Ordinarily, an entity should designate the same benchmark interest rate as the risk being hedged for similar hedges, consistent with FAS 133 paragraph 62; the use of different benchmark interest rates for similar hedges should be rare and must be justified.~~ In a cash flow hedge of a variable-rate financial asset or liability, either existing or forecasted, the designated risk being hedged cannot be the risk of changes in its cash flows attributable to changes in the specifically identified benchmark interest rate if the cash flows of the hedged transaction are explicitly based on a different index, for example, based on a specific bank's prime rate, which cannot qualify as the benchmark rate. However, the risk designated as being hedged could potentially be the risk of overall changes in the hedged cash flows related to the asset or liability, provided that the other criteria for a cash flow hedge have been met.

~~30.~~31. A qualifying foreign currency cash flow hedge shall be accounted for in accordance with paragraphs 16-18~~15-17~~ and Exhibit C.

Hedges of the Foreign Currency Exposure of a Net Investment in a Foreign Operation

~~31.~~32. A derivative instrument or a nonderivative financial instrument that may give rise to a foreign currency transaction gain or loss under SSAP No. 23 can be designated as hedging the foreign currency exposure of a net investment in a foreign operation. The gain or loss on a hedging derivative instrument (or the foreign currency transaction gain or loss on the nonderivative instrument) that is designated as, and is effective as, an economic hedge of the net investment in a foreign operation shall be reported in the same manner as a translation adjustment to the extent it is effective as a hedge. The hedged net investment shall be accounted for consistent with SSAP No. 23; the provisions of this statement for recognizing the gain or loss on assets designated as being hedged in a fair value hedge do not apply to the hedge of a net investment in a foreign operation.

Hedge Effectiveness

~~32.~~33. The measurement of hedge effectiveness for a particular hedging relationship shall be consistent with the entity's risk management strategy and the method of assessing hedge effectiveness that was documented at the inception of the hedging relationship, as discussed in paragraph 35~~34~~.

~~33.~~34. The gain or loss on a derivative designated as a hedge and assessed to be effective is reported consistently with the hedged item. If an entity's defined risk management strategy for a particular hedging relationship excludes a specific component of the gain or loss, or related cash flows, on the hedging derivative from the assessment of hedge effectiveness (as discussed in Exhibit B), that excluded component of the gain or loss shall be recognized as an unrealized gain or loss. For example, if the effectiveness of a hedge with an option contract is assessed based on changes in the option's intrinsic value, the changes in the option's time value would be recognized in unrealized gains or losses. Time value is equal to the fair value of the option less its intrinsic value.

Documentation Guidance

~~34.~~35. At inception of the hedge, documentation must include:

a. A formal documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge, including identification of the hedging instrument, the hedged item, the nature of the risk being hedged, and how the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value or variability in cash flows attributable to the hedged risk will be assessed. There must be a reasonable basis for how the entity plans to assess the hedging instrument's effectiveness;

b. An entity's defined risk management strategy for a particular hedging relationship may exclude certain components of a specific hedging derivative's change in fair value, such as time value, from the assessment of hedge effectiveness, as discussed in paragraph 34~~33~~ and Exhibit B;

c. Signature of approval, for each instrument, by person(s) authorized, either by the entity's board of directors or a committee authorized by the board, to approve such transactions; and

d. A description of the reporting entity's methodology used to verify that opening transactions do not exceed limitations promulgated by the state of domicile.

~~35.~~36. For all derivatives terminated, expired, or exercised during the year:

a. Signature of approval, for each instrument, by person(s) authorized, either by the entity's board of directors or a committee authorized by the board, to approve such transactions;

b. A description, for each instrument, of the nature of the transaction, including:

i. The date of the transaction;

ii. A complete and accurate description of the specific derivative, including description of the underlying securities, currencies, rates, indices, commodities, derivatives, or other financial market instruments;

iii. Number of contracts or notional amount;

iv. Date of maturity, expiry or settlement;

v. Strike price, rate or index (termination price for futures contracts);

vi. Counterparty, or exchange on which the transaction was traded; and

vii. Consideration paid or received, if any, on termination.

c. Description of the reporting entity's methodology to verify that derivatives were effective hedges; and

d. Identification of any derivatives that ceased to be effective as hedges.

~~36.~~37. For derivatives open at quarter-end:

a. A description of the methodology used to verify the continued effectiveness of hedges;

b. An identification of any derivatives that have ceased to be effective as hedges;

c. A description of the reporting entity's methodology to determine fair values of derivatives;

d. Copy of Master Agreements, if any, where indicated on Schedule DB Part D.

Recognition and Measurement of Derivatives Used in Income Generation Transactions

General

~~37.~~38. Income generation transactions are defined as derivatives written or sold to generate additional income or return to the reporting entity. They include covered options, caps, and floors (e.g., a reporting entity writes an equity call option on stock that it already owns).

~~38.~~39. Because these transactions require writing derivatives, they expose the reporting entity to potential future liabilities for which the reporting entity receives a premium up front. Because of this risk, dollar limitations and additional constraints are imposed requiring that the transactions be "covered" (i.e., offsetting assets can be used to fulfill potential obligations). To this extent, the combination of the derivative and the covering asset works like a reverse hedge where an asset owned by the reporting entity in essence hedges the derivative risk.

~~39.~~40. As with derivatives in general, these instruments include a wide variety of terms regarding maturities, range of exercise periods and prices, counterparties, underlying instruments, etc.

~~40.~~41. The principal features of income generation transactions are:

a. Premium received is initially recorded as a deferred liability;

b. The accounting of the covering asset or underlying interest controls the accounting of the derivative. The covering asset/underlying interest is accounted at either fair value (e.g., common stocks) or (amortized) cost (e.g., bonds);

c. The gain/loss on termination of the derivative is a capital item. For life insurance companies, it shall be subject to IMR treatment if interest rate related;

d. For options that are exercised, the remaining premium shall adjust the proceeds (cost) associated with the exercise resulting in no explicit gain or loss reported for the derivative itself.

Written Fixed Income Covered Call Options

~~41.~~42. The principal features of written fixed income covered call options are:

a. The general approach is to value at cost (i.e., consideration received) without amortization over the life of the contract if the original duration is less than one year, otherwise carry at amortized cost;

b. An alternative to the general approach combines the accounting of the written option with the covering asset and then uses standard accounting for callable bonds (yield to worst amortization) on the adjusted asset. This method prevents the possibility of future loss recognition upon exercise while at the same time providing recognition of the income feature of the option over time. This approach would appear most relevant for longer-lived covered European call options, which are in substance like callable bonds;

c. For life insurance companies, the gain or loss flows through the IMR if the covering asset or underlying interest is subject to the IMR using callable bond rules to determine the remaining life;

d. Reporting entities are responsible for timely recognition of any probable losses that may occur as a result of the strategy. If the exercise price is below the covering asset's book value, the asset shall be evaluated for write down or disclosure treatment in accordance with SSAP No. 5R. All relevant factors such as whether the option is currently exercisable, the fair value of the bond relative to its exercise price, to what extent the statement value of the option premium offsets any loss on the asset, or how any IMR transaction on exercise would affect unassigned funds (surplus) and income shall be considered.

~~42.~~43. Written fixed income covered call options shall be accounted for as follows:

STATUS OF OPTION	COVERING ASSET VALUED AT AMORTIZED COST	COVERING ASSET VALUED AT FAIR VALUE
Open	Record premium as deferred liability. Carry at amortized value. (Alternatively carry at consideration received if original duration is less than 1 year to maturity.) Alternatively, attach premium to covering asset and amortize (under yield to worse scenario) using standard callable bond accounting.	Record premium as deferred liability. Changes in fair value recorded as unrealized adjustments to unassigned funds (surplus) – gain/loss.
Closed – Expired	Premium received recognized as realized capital gain. Gain from expiration to flow through IMR, if applicable. (1)	Premium received recognized as realized capital gain.
Closed – Exercised	Adjust disposition proceeds. (Include in capital gain/loss of disposed asset.) Gain or loss from disposition to flow through IMR, if applicable. (1)	Adjust disposition proceeds. (Include in capital gain/loss of disposed asset.)
Closed – Terminated	Recognize net amount as realized capital gain/loss. Gain or loss from disposition to flow through IMR, if applicable. (1)	Recognize net amount as realized capital gain/loss.

NOTE (1) If premium is attached to covering asset, the accounting treatment for the covering asset applies.

Written Covered Put Options

~~43.~~44. The principal features of written covered put options are:

a. The accounting for the underlying interest instead of the covering asset governs the accounting of the written put while it is open. For example, if a reporting entity wrote a put requiring it to purchase a certain common stock (underlying interest) at a specific price, the reporting entity might cover that option by holding cash or cash equivalents (covering asset). The accounting for the common stock would govern the accounting of the option in this case;

b. As with covered call writing for life insurance companies, gain/loss on termination may be subject to IMR over the remaining life of the underlying interest;

c. As with covered call writing, entities writing put options for income generation purposes are responsible for timely recognition of any probable losses that may occur as a result of the strategy.

~~44.~~45. Written covered put options shall be accounted for as follows:

STATUS OF OPTION	UNDERLYING INTEREST VALUED AT AMORTIZED COST	UNDERLYING INTEREST VALUED AT FAIR VALUE
Open	Record premium as deferred liability. Carry at amortized value. (Alternatively carry at consideration received if original duration is less than 1 year to maturity.)	Record premium as deferred liability. Changes in fair value recorded as unrealized adjustments to unassigned funds (surplus) – gain/loss.
Closed – Expired	Premium received recognized as realized capital gain. Gain from expiration to flow through IMR, if applicable.	Premium received recognized as realized capital gain.
Closed – Exercised	Adjust acquisition cost by premium received.	Adjust acquisition cost by premium received.
Closed – Terminated	Recognize net amount as realized capital gain/loss. Gain or loss from disposition to flow through IMR, if applicable.	Recognize net amount as realized capital gain/loss.

Written Fixed Income Caps and Floors

~~45.~~46. The principal features of written fixed income caps and floors are:

a. The value of the premium received shall be amortized into income over the life of the contract. For caps and floors, where the entity is selling off possible excess interest/income, the value of the covering asset is not relevant;

b. Gain/loss may be subject to IMR. The expected maturity would be the derivative contract's maturity.

~~46.~~47. Written fixed income caps and floors shall be accounted for as follows:

STATUS OF OPTION	COVERING ASSET VALUED AT AMORTIZED COST	COVERING ASSET VALUED AT FAIR VALUE
Open	Record premium as deferred liability. Carry at amortized value. (Alternatively carry at consideration received if original duration is less than 1 year to maturity.) Amortize over life of contract to produce constant yield. Record any interest expense as "Other Investment Income" – negative value.	Record premium as deferred liability. Changes in fair value recorded as unrealized adjustments to unassigned funds (surplus) – gain/loss.
Closed – Matured	Would usually mature at zero amortized value. Any remaining unamortized value recognized as ordinary income through a final amortization adjustment.	Premium received recognized as realized capital gain.
Closed – Exercised	Not applicable.	Not applicable.
Closed – Terminated	Recognize net amount as realized capital gain/loss. Gain/loss on termination to flow through IMR, if applicable.	Recognize net amount as realized capital gain/loss.

Recognition and Measurement of Derivatives Used in Replication (Synthetic Asset) Transactions

~~47.~~48. Replication (Synthetic Asset) transaction means a derivative transaction entered into in conjunction with other investments in order to reproduce the investment characteristics of otherwise permissible investments. A derivative transaction entered into by an insurer as a hedging or income generation transaction shall not be considered a replication (synthetic asset) transaction.

~~48.~~49. Any premium paid or received shall be carried as an asset or liability on the balance sheet (Derivative line on the Assets (or) Liabilities pages). Premiums paid or received on the replication (synthetic asset) derivative should be amortized into investment income or expense until the exercise, termination or maturity date of the derivative.

~~49.~~50. If the replication (synthetic asset) transaction would be carried at amortized cost and the cash instrument used is carried at amortized cost, then the derivative used should be carried at amortized cost. The derivative may be valued at fair value when both the replication (synthetic asset) and the cash instrument are valued at amortized cost. This is consistent with the alternative valuation methods available for hedges. If the replication (synthetic asset) transaction would be carried at fair value and/or the cash instrument used is carried at fair value, then the derivative used should be carried at fair value.

	(a)	(b)	(c)	(d)
	If the Replication (Synthetic Asset) is Valued at:	And Cash Instrument(s) Used is (are) Valued at:	The Derivative is Valued at:	Alternative Derivative Value Basis:
1.	Amortized Cost	Amortized Cost	Amortized Cost	Fair value
2.	Fair value	Fair value	Fair value	N/A
3.	Amortized Cost	Fair value	Fair value	N/A
4.	Fair value	Amortized Cost	Fair value	N/A

~~50.~~51. In the case of No. 3 in the chart above, the fair values for the cash instrument and derivative, when added together, shall not exceed the replication (synthetic asset) statement value. If this does occur, the excess shall reduce the fair value of the derivative and shall be recorded as an unrealized gain separate from the AVR.

~~51.~~52. If the replication (synthetic asset) transaction involves the exchange of interest related cash flows (default free assets), then the cash flows should be accrued as investment income. If the replication (synthetic asset) transaction involves the exchange of total return or change in index cash flows, then the cash flows should be segregated between interest income and fair value (equity) changes. The interest income portion should be accrued as investment income.

~~52.~~53. If the derivative is carried at fair value, the periodic change in the fair value should be recorded as an unrealized gain or loss adjustment to surplus until the transaction is terminated. If the replication (synthetic asset) transaction involves the exchange of total return or change in index cash flows, then the cash flows should be segregated between interest income and fair value (equity) changes. The fair value (equity) change should be recognized as a deferred asset/liability until the termination of the contract. Gains or losses on the derivative at termination or sale should be recognized as realized.

Disclosure Requirements

~~53.~~54. Reporting entities shall disclose the following for all derivative contracts used:

a. General disclosures:

i. A description of the reporting entity's objectives for using derivatives, i.e., hedging, income generation or replication;

ii. A description of the context needed to understand those objectives and its strategies for achieving those objectives;

iii. The description for hedging objectives shall identify the category, e.g., fair value hedges, cash flow hedges, or foreign currency hedges, and for all objectives, the type of instrument(s) used;

iv. A description of the accounting policies for derivatives including the policies for recognizing (or reasons for not recognizing) and measuring the derivatives used, and when recognized, where those instruments and related gains and losses are reported;

v. The net gain or loss recognized in unrealized gains or losses during the reporting period representing the component of the derivative instruments' gain or loss, if any, excluded from the assessment of hedge effectiveness; and

vi. The net gain or loss recognized in unrealized gains or losses during the reporting period resulting from derivatives that no longer qualify for hedge accounting.

b. Disclosures by type of instrument outstanding, e.g., call options, floors, etc.:

i. Notional or contract amounts;

ii. Carrying and fair values; and

iii. A discussion of the market risk, credit risk, and cash requirements of the derivatives.

c. For derivatives held for other-than-hedging purposes in addition to a and b above:

i. Average fair value of the derivatives during the reporting period together with the related end-of-period fair value distinguishing between assets and liabilities;

ii. Net gains or losses detailed by class, business activity or other category that is consistent with the management of those activities and where the net gains or losses are reported.

d. The financial statements shall disclose details of covered items and/or written transactions to allow evaluation of cash flow implications for all written covered options used for income generation.

e. A seller[2] of credit derivatives[3] shall disclose information[4] about its credit derivatives and hybrid instruments[5] that have embedded credit derivatives to enable users of financial

[2] The term "seller" refers to the party that assumes credit risk, which could be a guarantor in a guarantee-type contract, and any party that provides the credit protection in an option-type contract, a credit default swap, or any other credit derivative contract. A seller is also sometimes referred to as a writer of the contract.

[3] A credit derivative instrument is (1) in which one or more of its underlyings are related to the credit risk of a specified entity (or a group of entities) or an index based on the credit risk of a group of entities and (2) that exposes the seller to potential loss from credit-risk-related events specified in the contract. Examples of credit derivatives within the scope of this paragraph include, but are not limited to, credit default swaps, credit spread options, and credit index products. This also includes a hybrid instrument that has an embedded credit derivative (e.g., a credit-linked note). The disclosures required by this paragraph do not apply to an embedded derivative feature related to the transfer of credit risk that is only in the form of subordination of one financial instrument to another.

[4] One way to present the information for groups of similar credit derivatives would be first to segregate the disclosures by major types of contracts (single-name credit default swaps, traded indexes, other portfolio products and swaptions) and then, for each major type, provide additional subgroups for major types of referenced/underlying asset classes (e.g., corporate debt, sovereign debt, and structured finance).

[5] A hybrid instrument is considered a contract that includes the host contract and an embedded derivative. Unlike FAS 133, statutory accounting guidance in *SSAP No. 86—Accounting for Derivative Instruments and Hedging Activities* (SSAP No. 86) does not permit embedded derivatives to be separated from the host contract and accounted for separately as a derivative instrument. As noted in paragraph ~~53~~54.e., the seller of the hybrid instrument shall disclose the required information for the entire hybrid instrument, not just the embedded credit derivative.

statements to assess their potential effect on its financial position, income and cash flows. The seller of a credit derivative shall disclose the following information for each credit derivative, or each group of credit derivatives, even if the likelihood of the seller's having to make any payments under the credit derivative is remote. With respect to hybrid instruments that have embedded credit derivatives, the seller of the embedded credit derivative shall disclose the required information for the entire hybrid instrument, not just the embedded credit derivative.

i. The nature of the credit derivative, including the approximate term of the credit derivative, the reason(s) for entering into the credit derivative, the events or circumstances that would require the seller to perform under the credit derivative, and the current status (that is, as of the date of the statement of financial position) of the payment/performance risk of the credit derivative. For example, the current status of the payment/performance risk of a credit derivative could be based on either recently issued external credit ratings or current internal groupings used by the seller to manage its risk. An entity that uses internal groupings shall disclose how those groupings are determined and used for managing risk.

ii. The maximum potential amount of future payments (undiscounted) the seller could be required to make under the credit derivative. That maximum potential amount of future payments shall not be reduced by the effect of any amounts that may possibly be recovered under recourse or collateralization provisions in the credit derivative (which are addressed under ~~53~~54.e.iv. below). If the terms of the credit derivative provide for no limitation to the maximum potential future payments under the contract, that fact shall be disclosed. If the seller is unable to develop an estimate of the maximum potential amount of future payments under the credit derivative, the seller shall disclose the reasons why it cannot estimate the maximum potential amount.

iii. The fair value of the credit derivative as of the date of the statement of financial position.

iv. The nature of (1) any recourse provisions that would enable the seller to recover from third parties any of the amounts paid under the credit derivative and (2) any assets held either as collateral or by third parties that, upon the occurrence of any specified triggering event or condition under the credit derivative, the seller can obtain and liquidate to recover all or a portion of the amounts paid under the credit derivative. The seller shall indicate, if estimable, the approximate extent to which the proceeds from liquidation of those assets would be expected to cover the maximum potential amount of future payments under the credit derivative. In its estimate of potential recoveries, the seller of credit protection shall consider the effect of any purchased credit protection with identical underlying(s).

f. A holder of a financial instrument with an embedded credit derivative[6] that exposes the holder to the possibility (however remote) of being required to make future payments (not merely receive reduced cash inflows) because the possibility of those future payments is not caused by subordination (such as the subordination of one beneficial interest to another tranche of a securitization, thereby redistributing credit risk) shall

[6] This disclosure is required even though the embedded credit derivative is not separated under statutory accounting and recognized as a derivative. These requirements are also applicable to hybrid instruments that are beneficial interests in securitized financial assets.

provide the following disclosures for the entire hybrid instrument, not just the embedded credit derivative:

i. The nature of the embedded credit derivative, including the approximate term of the embedded credit derivative, the events or circumstances that would require the holder to perform under the embedded credit derivative, and the current status (that is, as of the date of the statement of financial position) of the payment/performance risk of the embedded credit derivative.

ii. The maximum potential amount of future payments (undiscounted) the holder could be required to make under the embedded credit derivative. That maximum potential amount of future payments shall not be reduced by the effect of any amounts that may possibly be recovered under recourse or collateralization provisions in the embedded credit derivative (which are addressed under paragraph ~~53~~54.f.iv.). If the terms of the embedded credit derivative provide for no limitation to the maximum potential future payments under the contract, that fact shall be disclosed. If the holder is unable to develop an estimate of the maximum potential amount of future payments under the embedded credit derivative, the holder shall disclose the reasons why it cannot estimate the maximum potential amount.

iii. The fair value of the hybrid instrument containing the embedded credit derivative as of the date of the statement of financial position.

iv. The nature of (1) any recourse provisions that would enable the holder to recover from third parties any of the amounts paid under the embedded credit derivative and (2) any assets held either as collateral or by third parties that, upon the occurrence of any specified triggering event or condition under the embedded credit derivative, the holder can obtain and liquidate to recover all or a portion of the amounts paid under the credit derivative. The holder shall indicate, if estimable, the approximate extent to which the proceeds from liquidation of those assets would be expected to cover the maximum potential amount of future payments under the embedded credit derivative. In its estimate of potential recoveries, the holder of credit protection shall consider the effect of any purchased credit protection with identical underlying(s).

g. For derivatives accounted for as cash flow hedges of a forecasted transaction, disclose:

i. The maximum length of time over which the entity is hedging its exposure to the variability in future cash flows for forecasted transactions excluding those forecasted transactions related to the payment of variable interest on existing financial instruments; and

ii. The amount of gains and losses classified in unrealized gains/losses related to cash flow hedges that have been discontinued because it was no longer probable that the original forecasted transactions would occur by the end of the originally specified time period or within 2 months of that date.

h. All derivatives are required to be shown gross on Schedule DB. However, derivatives may be reported net in the financial statements (pages 2 and 3 of the statutory financial statements) in accordance with *SSAP No. 64—Offsetting and Netting of Assets and Liabilities* (SSAP No. 64) when a valid right to offset exists. Derivatives offset in accordance with SSAP No. 64 and reported net in the financial statement shall follow the disclosure requirements in SSAP No. 64, paragraph 6. (Derivative Assets and Derivative

Liabilities reported on the balance sheet shall agree to columns 5 and 6, respectively, after netting, on Schedule DB – Part D – Section 1.)

i. The disclosure requirements of paragraphs ~~53~~54.a., ~~53~~54.b., and ~~53~~54.g. shall be included in the Annual Statement. Refer to the preamble for further discussion regarding interim disclosure requirements. The disclosure requirements of paragraphs ~~53~~54.a. through ~~53~~54.g. shall be included in the annual audited statutory financial reports. Paragraph 59 of the Preamble states that disclosures made within specific schedules or exhibits to the Annual Statement need not be duplicated in a separate note.

~~54.~~55. Refer to the preamble for further discussion regarding disclosure requirements.

Relevant Literature

~~55.~~56. This statement adopts the framework established by FAS 133, *FASB Statement No. 137, Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133, An amendment of FASB Statement No. 133* (FAS 137) and *FASB Statement No. 138, Accounting for Certain Derivative Instruments and Certain Hedging Activities, An amendment of FASB Statement No. 133* (FAS 138), for fair value and cash flow hedges, including its technical guidance to the extent such guidance is consistent with the statutory accounting approach to derivatives utilized in this statement. This statement adopts the provisions of FAS 133 and 138 related to foreign currency hedges. With the exception of guidance specific to foreign currency hedges and amendments specific to refining the hedging of interest rate risk (under FAS 138, the risk of changes in the benchmark interest rate would be a hedged risk), this statement rejects FAS No. 137 and 138 as well as the various related Emerging Issues Task Force interpretations. This statement adopts paragraphs 4 and 25 of *FASB Statement No. 149: Amendment of Statement 133 on Derivative Instruments and Hedging Activities* (FAS 149) regarding the definition of an underlying and guidance for assessing hedge effectiveness. All other paragraphs in FAS 149 are rejected as not applicable for statutory accounting. This statement adopts FSP FAS 133-1 and FIN 45-5*: Disclosures about Credit Derivatives and Certain Guarantees, An Amendment of FASB Statement No. 133 and FASB Interpretation No.45 and Clarification of the Effective Date of FASB Statement No. 161 (*FSP FAS 133-1 and FIN 45-4) and requires disclosures by sellers of credit derivatives. This statement rejects *FSP FIN 39-1, Amendments of FASB Interpretation No. 39*, and *ASU 2014-03, Derivatives and Hedging – Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps – Simplified Hedge Accounting Approach*.

~~56.~~57. This statement adopts revisions to ASC 815-20-25-15 as reflected within *ASU 2010-08, Technical Corrections to Various Topics*. This statement adopts revisions to ASC 815-10-50-4K as reflected within *ASU 2010-11, Derivatives and Hedging (Topic 815), Scope Exception Related to Embedded Credit Derivatives*, but rejects all other GAAP revisions from ASU 2010-11. These GAAP revisions are rejected as embedded derivatives are not separated from the host contract and recognized as derivatives under SSAP No. 86. Revisions are also incorporated to SSAP No. 86 to require disclosures on embedded credit derivatives that expose the holder of a financial instrument to the possibility of being required to make future payments. This disclosure is a modification to the GAAP disclosures specific to statutory accounting as embedded credit derivatives are not separately recognized under statutory accounting. It should be noted that the conclusions reached in this statement are not intended to usurp the rules and regulations put forth by states in their respective investment laws. The contents of this statement are intended to provide accounting guidance on the use of derivatives as allowed by an insurer's state of domicile. It is not intended to imply that insurers may use derivatives or cash instruments that the insurer's state of domicile does not allow under the state's insurance regulatory requirements, e.g., in replication transactions.

58. This statement adopts revisions to ASC 815-20 as reflected within *ASU 2013-10, Derivatives and Hedging, Inclusion of the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) as a*

benchmark interest rate for Hedge Accounting Purposes. These revisions define a benchmark interest rate, clarify what can be used in the U.S. for a benchmark interest rate, and eliminate the prior restriction on using different benchmark rates for similar hedges.

Effective Date and Transition

~~57.~~59. This statement is effective for derivative transaction entered into or modified on or after January 1, 2003. A modification is any revision or change in contractual terms of the derivative. SSAP No. 31 applies to derivative transaction prior to January 1, 2003. Alternatively, an insurer may choose to apply this statement to all derivatives to which the insurer is a party as of January 1, 2003. In either case, the insurer is to disclose the transition approach that is being used. Revisions adopted to paragraph 56~~55~~ to reject FSP FIN 39-1 is effective January 1, 2013, for companies that have previously reported a position in the balance sheet that was net of counterparty agreements. (Companies that have previously reported derivative instruments and/or related collateral gross shall not be impacted by these revisions.)

REFERENCES

Other

- *SSAP No. 31—Derivative Instruments*
- *Purposes and Procedures Manual of the NAIC ~~Securities Valuation~~Investment Analysis Office*–Part 13

Relevant Issue Papers

- *Issue Paper No. 114—Accounting for Derivative Instruments and Hedging Activities*

EXHIBIT A – DISCUSSION OF HEDGING EFFECTIVENESS

The Financial Accounting Standards Board established the Derivatives Implementation Group in 1999 to address execution of FAS 133. The Derivatives Implementation Group addressed two issues related to effectiveness that are applicable to this statement. The issues have been authored by the FASB staff and represents the staff's views, although FASB has discussed the responses at a public meeting and chosen not to object to dissemination of those responses. Official positions of the FASB are determined only after extensive due process and deliberation.

E7: Hedging—General: Methodologies to Assess Effectiveness of Fair Value and Cash Flow Hedges

Paragraph references: 20.b., 22, 28.b., 62, 86, 87

Date cleared by FASB Board: May 17, 2000

QUESTION

1. Since Statement 133 provides an entity with flexibility in choosing the method it will use in assessing hedge effectiveness, must an entity use a dollar-offset approach in assessing effectiveness?

BACKGROUND

2. Paragraph 20.b. of Statement 133 states, in part:

> Both at inception of the [fair value] hedge and on an ongoing basis, the hedging relationship is expected to be highly effective in achieving offsetting changes in fair value attributable to the hedged risk during the period that the hedge is designated. An assessment of effectiveness is required whenever financial statements or earnings are reported, and at least every three months.

3. Paragraph 28.b. indicates a similar requirement that the hedging relationship be expected to be highly effective in achieving offsetting changes in cash flows attributable to the hedged risk during the period that the hedge is designated.

4. Paragraph 22 of Statement 133 states, in part:

> The measurement of hedge ineffectiveness for a particular hedging relationship shall be consistent with the entity's risk management strategy and the method of assessing hedge effectiveness that was documented at the inception of the hedging relationship, as discussed in paragraph 20.a.

5. Paragraph 62 emphasizes that each entity must "define at the time it designates a hedging relationship the method it will use to assess the hedge's effectiveness in achieving offsetting changes in fair value or offsetting cash flows attributable to the risk being hedged." It also states, "This Statement does not specify a single method for either assessing whether a hedge is expected to be highly effective or measuring hedge ineffectiveness."

RESPONSE

6. No. Statement 133 requires an entity to consider hedge effectiveness in two different ways—in prospective considerations and in retrospective evaluations.

a. Prospective considerations.

Upon designation of a hedging relationship (as well as on an ongoing basis), the entity must be able to justify an expectation that the relationship will be highly effective over future periods in achieving offsetting changes in fair value or cash flows. That expectation, which is forward-looking, can be based upon regression or other statistical analysis of past changes in fair values or cash flows as well as on other relevant information.

b. Retrospective evaluations.

At least quarterly, the hedging entity must determine whether the hedging relationship has been highly effective in having achieved offsetting changes in fair value or cash flows through the date of the periodic assessment. That assessment can be based upon regression or other statistical analysis of past changes in fair values or cash flows as well as on other relevant information. If an entity elects at the inception of a hedging relationship to utilize the same regression analysis approach for both prospective considerations and retrospective evaluations of assessing effectiveness, then during the term of that hedging relationship those regression analysis calculations should generally incorporate the same number of data points. Electing to utilize a regression or other statistical analysis approach instead of a dollar-offset approach to perform retrospective evaluations of assessing hedge effectiveness may affect whether an entity can apply hedge accounting for the current assessment period as discussed below.

7. Paragraph 62 requires that at the time an entity designates a hedging relationship, it must define and document the method it will use to assess the hedge's effectiveness. That paragraph also states that ordinarily "an entity should assess effectiveness for similar hedges in a similar manner; use of different methods for similar hedges should be justified." Furthermore, it requires that an entity use that defined and documented methodology consistently throughout the period of the hedge. If an entity elects at the inception of a hedging relationship to utilize a regression analysis approach for prospective considerations of assessing effectiveness and the dollar-offset method to perform retrospective evaluations of assessing effectiveness, then that entity must abide by the results of that methodology as long as that hedging relationship remains designated. Thus, in its retrospective evaluation, an entity might conclude that, under a dollar-offset approach, a designated hedging relationship does not qualify for hedge accounting for the period just ended, but that the hedging relationship may continue and hedge accounting may be applied without interruption because, under a regression analysis approach, there is an expectation that the relationship will be highly effective in achieving offsetting changes in fair value or cash flows in future periods. In its next period's retrospective evaluation, covering the entire period for which the hedge has been designated, if that entity concludes that, under a dollar-offset approach, the hedging relationship has not been highly effective in having achieved offsetting changes in fair value or cash flows, hedge accounting may not be applied.

8. If an entity elects at the inception of a hedging relationship to utilize a regression analysis (or other statistical analysis) approach for either prospective considerations or retrospective evaluations of assessing effectiveness, then that entity must periodically update its regression analysis (or other statistical analysis). For example, if there is significant ineffectiveness measured and recognized in earnings for a hedging relationship, which is calculated each assessment period, the regression analysis should be rerun to determine whether the expectation of high effectiveness is still valid. As long as an entity reruns its regression analysis and determines that the hedging relationship is still expected to be highly effective, then it can continue to apply hedge accounting without interruption.

9. The application of a regression or other statistical analysis approach to assessing effectiveness is complex. Those methodologies require appropriate interpretation and understanding of the statistical inferences.

E8: Hedging–General: Assessing Hedge Effectiveness of Fair Value and Cash Flow Hedges Period-by-Period or Cumulatively under a Dollar-Offset Approach

Paragraph references: 20.b., 28.b., 30, 62, 64, 67

Date cleared by FASB Board: June 28, 2000

QUESTION

1. In periodically assessing retrospectively the effectiveness of a fair value hedge (or a cash flow hedge) in having achieved offsetting changes in fair values (or cash flows), an entity compares the change in the hedging instrument's fair value (or cash flows) to the change in the hedged item's fair value (or hedged transaction's cash flows) attributable to the hedged risk. If an entity elects at inception of a hedging relationship to utilize the dollar-offset approach for retrospective evaluations of assessing effectiveness, then should that entity base that comparison on (a) the fair value (or cash flow) changes that have occurred during the period being assessed (that is, on a period-by-period basis) or (b) the cumulative fair value (or cash flow) changes to date from the inception of the hedge? Is that entity permitted to use either a period-by-period approach or a cumulative approach on individual fair value hedges (or cash flow hedges) under a dollar-offset approach?

BACKGROUND

2. Paragraph 20.b. of Statement 133 states, in part:

> Both at inception of the [fair value] hedge and on an ongoing basis, the hedging relationship is expected to be highly effective in achieving offsetting changes in fair value attributable to the hedged risk during the period that the hedge is designated. An assessment of effectiveness is required whenever financial statements or earnings are reported, and at least every three months.…All assessments of effectiveness shall be consistent with the risk management strategy documented for that particular hedging relationship.

3. Paragraph 28.b. states, in part:

> Both at inception of the [cash flow] hedge and on an ongoing basis, the hedging relationship is expected to be highly effective in achieving offsetting cash flows attributable to the hedged risk during the term of the hedge, except as indicated in paragraph 28.d. An assessment of effectiveness is required whenever financial statements or earnings are reported, and at least every three months.…All assessments of effectiveness shall be consistent with the originally documented risk management strategy for that particular hedging relationship.

4. Paragraph 30.b. specifies how effectiveness (on a derivative designated as a cash flow hedge) should be calculated. The calculation of effectiveness is, in part, based on "cumulative gain or loss on the derivative from inception of the hedge."

5. Paragraph 67 of the Statement states, in part:

> If the hedge initially qualifies for hedge accounting, the entity would continue to assess whether the hedge meets the effectiveness test and also would measure any ineffectiveness during the hedge period. If the hedge fails the effectiveness test at any time (that is, if the entity does not expect the hedge to be highly effective at achieving offsetting changes in fair values or cash flows), the hedge ceases to qualify for hedge accounting.

RESPONSE

6. In periodically (that is, at least quarterly) assessing retrospectively the effectiveness of a fair value hedge (or a cash flow hedge) in having achieved offsetting changes in fair values (or cash flows) under a dollar-offset approach, Statement 133 permits an entity to use either a period-by-period approach or a cumulative approach on individual fair value hedges (or cash flow hedges). The period-by-period approach involves comparing the changes in the hedging instrument's fair values (or cash flows) that have occurred during the period being assessed to the changes in the hedged item's fair value (or hedged transaction's cash flows) attributable to the risk hedged that have occurred during the same period. The cumulative approach involves comparing the cumulative changes (to date from inception of the hedge) in the hedging instrument's fair values (or cash flows) to the cumulative changes in the hedged item's fair value (or hedged transaction's cash flows) attributable to the risk hedged. At inception of the hedge, an entity may choose either approach in designating how effectiveness will be assessed, depending on the nature of the hedge documented in accordance with paragraphs 20.a. and 28.a. For example, an entity may decide that the cumulative approach is generally preferred, yet may wish to use the period-by-period approach in certain circumstances.

7. Paragraph 62 requires that at the time an entity designates a hedging relationship, it must define and document the method it will use to assess the hedge's effectiveness. That paragraph also states that ordinarily "an entity should assess effectiveness for similar hedges in a similar manner; use of different methods for similar hedges should be justified." Furthermore, it requires that an entity use that defined and documented methodology consistently throughout the period of the hedge. If an entity elects at inception of a hedging relationship to base its comparison of changes in fair value (or cash flows) on a cumulative approach, then that entity must abide by the results of that methodology as long as that hedging relationship remains designated. Electing to utilize a period-by-period approach instead of a cumulative approach (or vice versa) to perform retrospective evaluations of assessing hedge effectiveness under the dollar-offset method may affect whether an entity can apply hedge accounting for the current assessment period.

8. If an entity elects to base its comparison of changes in fair value (or cash flows) on a period-by-period approach, the period cannot exceed three months. Fair value (or cash flow) patterns of the hedging instrument or the hedged item (or hedged transaction) in periods prior to the period being assessed are not relevant.

9. The foregoing guidance relates to an entity's periodic retrospective assessment and determining whether a hedging relationship continues to qualify for hedge accounting.

10. The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

EXHIBIT B – ASSESSMENT OF HEDGING EFFECTIVENESS

The following is based on paragraphs 62-70 of FAS 133 to offer additional guidance on assessing hedging effectiveness. The intent of such is to remain consistent with FAS 133 with respect to assessing hedge effectiveness.

1. This statement requires that an entity define at the time it designates a hedging relationship the method it will use to assess the hedge's effectiveness in achieving offsetting changes in fair value or offsetting cash flows attributable to the risk being hedged. It also requires that an entity use that defined method consistently throughout the hedge period to assess at inception of the hedge and on an ongoing basis whether it expects the hedging relationship to be highly effective in achieving offset. If the entity identifies an improved method and wants to apply that method prospectively, it must discontinue the existing hedging relationship and designate the relationship anew using the improved method. Although this statement suggests a method for assessing whether a hedge is expected to be highly effective or measuring hedge ineffectiveness, the appropriateness of a given method of assessing hedge effectiveness can depend on the nature of the risk being hedged and the type of hedging instrument used. Ordinarily, however, an entity should assess effectiveness for similar hedges in a similar manner; use of different methods for similar hedges should be justified.

2. In defining how hedge effectiveness will be assessed, an entity must specify whether it will include in that assessment all of the gain or loss on a hedging instrument. As discussed in paragraph 33, this statement permits (but does not require) an entity to exclude all or a part of the hedging instrument's time value from the assessment of hedge effectiveness, as follows:

a. If the effectiveness of a hedge with an option contract is assessed based on changes in the option's intrinsic value, the change in the time value of the contract would be excluded from the assessment of hedge effectiveness.

b. If the effectiveness of a hedge with an option contract is assessed based on changes in the option's minimum value, that is, its intrinsic value plus the effect of discounting, the change in the volatility value of the contract would be excluded from the assessment of hedge effectiveness.

c. If the effectiveness of a hedge with a forward or futures contract is assessed based on changes in fair value attributable to changes in spot prices, the change in the fair value of the contract related to the changes in the difference between the spot price and the forward or futures price would be excluded from the assessment of hedge effectiveness.

In each circumstance above, changes in the excluded component would be included in unrealized gains or losses. As noted in paragraph 1 of this Exhibit, the effectiveness of similar hedges generally should be assessed similarly; that includes whether a component of the gain or loss on a derivative is excluded in assessing effectiveness. No other components of a gain or loss on the designated hedging instrument may be excluded from the assessment of hedge effectiveness.

3. In assessing the effectiveness of a cash flow hedge, an entity generally will need to consider the time value of money if significant in the circumstances. Considering the effect of the time value of money is especially important if the hedging instrument involves periodic cash settlements. An example of a situation in which an entity likely would reflect the time value of money is a tailing strategy with futures contracts. When using a tailing strategy, an entity adjusts the size or contract amount of futures contracts used in a hedge so that earnings (or expense) from reinvestment (or funding) of daily settlement

gains (or losses) on the futures do not distort the results of the hedge. To assess offset of expected cash flows when a tailing strategy has been used, an entity could reflect the time value of money, perhaps by comparing the present value of the hedged forecasted cash flow with the results of the hedging instrument.

4. Whether a hedging relationship qualifies as highly effective sometimes will be easy to assess. If the critical terms of the hedging instrument and of the entire hedged asset or liability (as opposed to selected cash flows) or hedged forecasted transaction are the same, the entity could conclude that changes in fair value or cash flows attributable to the risk being hedged are expected to completely offset at inception and on an ongoing basis. For example, an entity may assume that a hedge of a forecasted purchase of a commodity with a forward contract will be highly effective if:

a. The forward contract is for purchase of the same quantity of the same commodity at the same time and location as the hedged forecasted purchase.

b. The fair value of the forward contract at inception is zero.

c. Either the change in the discount or premium on the forward contract is excluded from the assessment of effectiveness and included directly in unrealized gains and losses pursuant to paragraph 22B or the change in expected cash flows on the forecasted transaction is based on the forward price for the commodity.

5. However, assessing hedge effectiveness can be more complex. For example, hedge effectiveness would be reduced by the following circumstances, among others:

a. A difference between the basis of the hedging instrument and the hedged item or hedged transaction (such as a Deutsche mark-based hedging instrument and Dutch guilder-based hedged item), to the extent that those bases do not move in tandem

b. Differences in critical terms of the hedging instrument and hedged item or hedged transaction, such as differences in notional amounts, maturities, quantity, location, or delivery dates.

Hedge effectiveness also would be reduced if part of the change in the fair value of a derivative is attributable to a change in the counterparty's creditworthiness.

6. A hedge that meets the effectiveness test specified in paragraphs 19.b. and 20.b. (that is, both at inception and on an ongoing basis, the entity expects the hedge to be highly effective at achieving offsetting changes in fair values or cash flows) also must meet the other hedge accounting criteria to qualify for hedge accounting. If the hedge initially qualifies for hedge accounting, the entity would continue to assess whether the hedge meets the effectiveness test. If the hedge fails the effectiveness test at any time (that is, if the entity does not expect the hedge to be highly effective at achieving offsetting changes in fair values or cash flows), the hedge ceases to qualify for hedge accounting. The discussions of measuring hedge effectiveness in the examples in the remainder of this Exhibit assume that the hedge satisfied all of the criteria for hedge accounting at inception.

Assuming Effectiveness in a Hedge with an Interest Rate Swap

7. An entity may assume effectiveness in a hedging relationship of interest rate risk involving an interest-bearing asset or liability and an interest rate swap (or a compound hedging instrument composed of an interest rate swap and a mirror-image call or put option as discussed in paragraph 7.d.) if all of the applicable conditions in the following list are met:

Conditions applicable to both fair value hedges and cash flow hedges

a. The notional amount of the swap matches the principal amount of the interest-bearing asset or liability being hedged.

b. If the hedging instrument is solely an interest rate swap, the fair value of that swap at the inception of the hedging relationship is zero. If the hedging instrument is a compound derivative composed of an interest rate swap and mirror-image call or put option as discussed in paragraph 7.d., the premium for the mirror-image call or put option must be paid or received in the same manner as the premium on the call or put option embedded in the hedged item. That is, the reporting entity must determine whether the implicit premium for the purchased call or written put option embedded in the hedged item was principally paid at inception-acquisition (through an original issue discount or premium) or is being paid over the life of the hedged item (through an adjustment of the interest rate). If the implicit premium for the call or put option embedded in the hedged item was principally paid at inception-acquisition, the fair value of the hedging instrument at the inception of the hedging relationship must be equal to the fair value of the mirror-image call or put option. In contract, if the implicit premium for the call or put option embedded in the hedged item is principally being paid over the life of the hedged item, fair value of the hedging instrument at the inception of the hedging relationship must be zero.

c. The formula for computing net settlements under the interest rate swap is the same for each net settlement. (That is, the fixed rate is the same throughout the term, and the variable rate is based on the same index and includes the same constant adjustment or no adjustment.)

d. The interest-bearing asset or liability is not prepayable (that is, able to be settled by either party prior to its scheduled maturity), except as indicated in the following sentences. This criterion does not apply to an interest-bearing asset or liability that is prepayable solely due to a call option provided that the hedging instrument is a compound derivative composed of an interest rate swap and a mirror-image call option. The call option is considered a mirror-image of the call option contained in the hedged item if (1) the terms of the two call options exactly match (see Statement 133 Implementation Issue No. E6: Hedging–General: The Shortcut Method and the Provisions That Permit the Debtor or Creditor to Require Prepayment) and (2) the entity is the writer of one call option and the holder (or purchaser) of the other call option. Similarly, this criterion does not apply to the interest-bearing asset or liability that is prepayable solely due to a put option provided that the hedging instrument is a compound derivative composed of an interest rate swap and a mirror-image put option.

e. Any other terms in the interest-bearing financial instruments or interest rate swaps are typical of those instruments and do not invalidate the assumption of no ineffectiveness.

Conditions applicable to fair value hedges only

f. The expiration date of the swap matches the maturity date of the interest-bearing asset or liability.

g. There is no floor or cap on the variable interest rate of the swap.

h. The interval between repricings of the variable interest rate in the swap is frequent enough to justify an assumption that the variable payment or receipt is at a market rate (generally three to six months or less).

Conditions applicable to cash flow hedges only

i. All interest receipts or payments on the variable-rate asset or liability during the term of the swap are designated as hedged, and no interest payments beyond the term of the swap are designated as hedged.

j. There is no floor or cap on the variable interest rate of the swap unless the variable-rate asset or liability has a floor or cap. In that case, the swap must have a floor or cap on the variable interest rate that is comparable to the floor or cap on the variable-rate asset or liability. (For this purpose, comparable does not necessarily mean equal. For example, if a swap's variable rate is LIBOR and an asset's variable rate is LIBOR plus 2 percent, a 10 percent cap on the swap would be comparable to a 12 percent cap on the asset.)

k. The repricing dates match those of the variable-rate asset or liability.

l. The index on which the variable rate is based matches the index on which the asset or liability’s variable rate is based.

8. The fixed rate on a hedged item need not exactly match the fixed rate on a swap designated as a fair value hedge. Nor does the variable rate on an interest-bearing asset or liability need to be the same as the variable rate on a swap designated as a cash flow hedge. A swap’s fair value comes from its net settlements. The fixed and variable rates on a swap can be changed without affecting the net settlement if both are changed by the same amount. That is, a swap with a payment based on LIBOR and a receipt based on a fixed rate of 5 percent has the same net settlements and fair value as a swap with a payment based on LIBOR plus 1 percent and a receipt based on a fixed rate of 6 percent.

9. Comparable credit risk at inception is not a condition for assuming effectiveness even though actually achieving perfect offset would require that the same discount rate be used to determine the fair value of the swap and of the hedged item or hedged transaction. To justify using the same discount rate, the credit risk related to both parties to the swap as well as to the debtor on the hedged interest-bearing asset (in a fair value hedge) or the variable-rate asset on which the interest payments are hedged (in a cash flow hedge) would have to be the same. However, because that complication is caused by the interaction of interest rate risk and credit risk, which are not easily separable, comparable creditworthiness is not considered a necessary condition to assume effectiveness in a hedge of interest rate risk.

EXHIBIT C – SPECIFIC HEDGE ACCOUNTING PROCEDURES FOR DERIVATIVES

Synopsis: Derivatives may be designated as hedges of changes in the fair value or variability in expected cash flows of assets, liabilities, forecasted transactions or firm commitments due to one or more of the following risks: interest rate, security price, commodity price, foreign exchange rate, index of prices or rates or other variables (excluding risks of identifiable insurable events such as death, disability, accident, illness, damage to property or damage or injury to an insured or third party). Derivatives used in hedging transactions that meet the criteria of a highly effective hedge shall be considered an effective hedge and valued and reported in a manner that is consistent with the hedged asset or liability (referred to as hedge accounting). Under hedge accounting the valuation method used for the derivative shall be consistent with the valuation method used for the hedged item: e.g., amortized cost or fair value. Changes in the carrying value (i.e., amortization or fair value changes) or cash flow of the derivative shall be recognized in the same period and in the same category of income or surplus as the amortization or fair value changes of the hedged item: e.g. net gain from operations, realized capital gains and losses on investments, unrealized capital gains and losses on investments, or unrealized foreign exchange capital gain or loss.

The effects of hedge accounting are reflected in a manner that does not change the reporting of the item being hedged, consistent with the financial statement category that would normally be required under statutory accounting principles. Generally, if the change in the item being hedged is reported as a component of net gain from operations, the change in the derivative shall be reported in its appropriate component of net gain from operations. For example, a change in the aggregate reserve liabilities is reflected in its appropriate annual statement line change in aggregate reserves. A change in the related derivatives that are hedging that item is reflected through other income.

In the case where a portion of the item being hedged is reported as a component of net gain from operations, with the remainder reported as an other change to surplus, then the change in the hedging derivative is bifurcated; a portion is reported as a component of net gain from operations, in the appropriate category and included in the net gain from operations with the remainder reported as an other change to surplus.

For example, in the hedge of a foreign currency denominated asset the change in the value of the asset due to fluctuations in foreign exchange rates is recorded as unrealized capital gains or losses until the asset is sold. A derivative instrument that is in an effective hedging relationship of that item, shall have its change in value associated with fluctuations in foreign currency exchange rates bifurcated and recorded in unrealized capital gains and losses with the remaining change in value recorded consistent with the item being hedged (amortized cost or fair value).

A common purpose of entering into derivatives such as interest rate swaps and forwards as hedges is to change the interest rate characteristics of hedged items. Consistent with this purpose and the hedge accounting concept of matched accounting between the hedging and hedged item, hedged items may be viewed as bearing the changed interest rate characteristics and the cost of the derivatives may therefore be combined with the hedged items. All derivatives shall be reported on Schedule DB. When one or more derivatives hedge more than one asset, liability, forecasted transaction or firm commitment (or a portfolio of hedged items), a company may allocate the total derivative(s) to hedged items individually or in the aggregate. If derivatives are allocated to hedged items, indicate on Schedule DB the nature of the items hedged and the schedule or exhibit where they are presented.

An open derivative hedging a forecasted transaction or firm commitment shall be recorded at cost until the hedged transaction occurs. When the hedged forecasted transaction or firm commitment occurs, an open derivative shall be accounted for in a manner consistent with the hedged item (i.e., amortized cost or fair value).

Upon termination of a derivative that qualified for hedge accounting of an existing asset or liability or a forecasted transaction or firm commitment, the resulting gain or loss shall be recognized in income in a manner that is consistent with the hedged item. If the hedged item is recorded at amortized cost, the gain or loss shall adjust, individually or in the aggregate, the basis of the hedged item subject to amortization. Alternatively, if the item being hedged is subject to IMR, the gain or loss on the terminated hedging derivative may be realized and shall be subject to IMR upon termination. For terminated derivatives, indicate on Schedule DB, Section 2, Parts A and B the nature of the assets or liabilities so adjusted and the schedule or exhibit where they are presented.

Derivative instruments used in hedging transactions that (i) do not meet or no longer meet the criteria of an effective hedge or (ii) meet the required hedge criteria but the entity has chosen not to apply hedge accounting shall be accounted for at fair value and the changes in the fair value shall be recorded in surplus as unrealized gains or unrealized losses (referred to as fair value accounting). Hedge accounting may not be applied upon inception, redesignation or termination of a derivative designated in a hedging relationship if documentation is not maintained in accordance with SSAP No. 86 paragraphs 34-36.

Specific hedge accounting procedures for derivative instruments are outlined below.

1. Call and Put Options, Warrants, Caps, and Floors:

   a. Accounting at Date of Acquisition (purchase) or Issuance (written): The premium paid or received for purchasing or writing a call option, put option, warrant, cap or floor shall either be (i) recorded as an asset (purchase) or liability (written) on the Derivative line on the Assets (or) Liabilities pages or (ii) combined with the hedged item(s) individually or in the aggregate;

   b. Statement Value:

      i. Open derivatives hedging items recorded at amortized cost:

         (a) Options, warrants, caps, and floors purchased or written shall be valued at amortized cost in a manner consistent with the hedged item;

         (b) The amortization period and methods used shall result in a constant effective yield over the life of the hedged item or program. (For floating rate hedged items, the estimated effective yield shall be based on the current rate so the changes in yields attributable to changes in interest rates will be recognized in the period of change). Specific treatment includes:

            (1) Holdings in derivatives purchased or written within a year of maturity or expiry need not be amortized;

            (2) For hedges of forecasted transactions or firm commitments, the derivative may be recorded at cost until the hedged transaction occurs or it is determined that the hedge was not effective (see (d) in this section 1.b.i.);

            (3) For other derivatives, the amortization period is usually from date of acquisition (issuance) of the derivative to maturity of the hedged item or program.

         (c) For hedges where the cost of the derivative is combined with the hedged item, the statement value is zero. The fair value of the derivative and hedged item shall be determined and reported separately, either individually or in the aggregate;

(d) For hedges of forecasted transactions or firm commitments, the derivative shall be recorded at cost until (1) the hedged transaction occurs or (2) it is determined that the hedge was not effective (when the derivative is valued in accordance with (e) in this section);

(e) If during the life of the derivative it or a designated portion of the derivative is no longer effective as a hedge, valuation at amortized cost ceases and the derivative or the designated portion of the derivative shall be valued at its current fair value with gains and losses recognized in unrealized gains or unrealized losses to the extent it ceased to be an effective hedge.

ii. Open derivatives hedging items recorded at fair value (where gains and losses on the hedged item are recognized as adjustments to unassigned funds (surplus)):

(a) Options, warrants, caps, or floors purchased or written shall be valued at current fair value with changes in fair value recognized currently consistent with the hedged item; this will result in unrealized gain/loss treatment with adjustment to unassigned funds (surplus).

(b) For hedges where the cost of the derivative is combined with the hedged item, the fair value of the derivative and hedged item will be determined and reported separately, either individually or in the aggregate. The cost (book value) basis used to figure unrealized gain/loss on the derivative on Schedule DB is zero.

(c) For hedges of forecasted transactions or firm commitments, the derivative shall be recorded at cost until the hedged transaction occurs or it is determined that the hedge was not effective (when fair value accounting is applied as described in the Introduction above).

iii. Open derivatives hedging items recorded at fair value, where gains and losses on the hedged item are recognized currently in earnings: options, warrants, caps, or floors purchased or written shall be valued at current fair value with changes in fair value recognized currently in earnings together with the gains and losses on the hedged item.

(a) For hedges of forecasted transactions or firm commitments, the derivative shall be recorded at cost until (1) the hedged transaction occurs or (2) it is determined that the hedge was not effective (when fair value accounting is applied as described in (b) of this section).

(b) If during the life of the derivative it or a designated portion of the derivative is no longer effective as a hedge, recognition of changes in fair value through earnings ceases. The derivative or the designated portion of the derivative shall continue to be valued at its current fair value, but thereafter gains or losses shall be recognized in unrealized gains or unrealized losses to the extent it ceased to be an effective hedge.

c. Cash Flows and Income

i. Where the cost of the derivative is not combined with the hedged item:

(a) Amortization of premium or discount on derivatives is an adjustment to net investment income or another appropriate caption within operating income consistent with the reporting of the hedged item;

(b) Periodic cash flows and accruals of income/expense shall be reported in a manner consistent with the hedged item, such as net investment income or interest and adjustments on policy or deposit-type contract funds (operating income) or net realized capital gains.

ii. Where the cost of the derivative is combined with the hedged item, the cash flows and income of the derivative on Schedule DB will be zero. All related amortization and cash flow accounting shall be reported with the hedged item instead of with the derivative.

d. Gain/Loss on Termination of an option, warrant, cap or floor accounted for under hedge accounting (includes closing, exercise, maturity, and expiry):

i. Exercise of an Option: The remaining book value of the derivative shall become an adjustment to the cost or proceeds of the hedged item(s) received or disposed of individually or in aggregate;

ii. Sale, maturity, expiry, or other closing transaction of a derivative which is an effective hedge—Any gain or loss on the transaction will adjust the basis (or proceeds) of the hedged item(s) individually or in aggregate. Alternatively, if the item being hedged is subject to IMR, the gain or loss on the terminated hedging derivative may be realized and shall be subject to IMR upon termination;

iii. Gain/loss on termination of derivatives will be recognized currently in net income (realized gain/loss) to the extent they ceased to be effective hedges.

iv. Upon the redesignation of a derivative from a currently effective hedging relationship-

(a) with an item(s) carried at amortized cost to another effective hedging relationship with an item(s) carried at amortized cost, the derivative shall continue to be recorded at amortized cost and no gain or loss on the derivative shall be recognized.

(b) with an item(s) carried at amortized cost or fair value to an effective relationship with an item(s) carried at fair value, the accounting for the derivative shall be consistent with (ii) above.

(c) with an item(s) carried at fair value to an effective relationship with an item(s) carried at amortized cost, the accounting for the derivative shall be consistent with (ii) above.

2. Swaps, Collars, and Forwards (see also discussion in Introduction above):

a. Accounting at Date of Opening Position:

i. Any premium paid or received at date of opening shall either be (a) recorded on the Derivative line on the Assets (or) Liabilities pages or (b) combined with the hedged item(s), individually or in the aggregate;

b. Statement Value:

i. Open derivatives hedging items recorded at amortized cost:

(a) Swaps, collars, and forwards shall be valued at amortized cost in a manner consistent with hedged item;

(b) The amortization period and methods used shall result in a constant effective yield over the life of the hedged item or program. (For floating rate hedged items the estimated effective yield shall be based on the current rate so the changes in yields attributable to changes in interest rates will be recognized in the period of change.) Specific treatment includes:

(1) Holdings in derivatives purchased or written within a year of maturity or expiry need not be amortized;

(2) For hedges of forecasted transactions or firm commitments, the derivative shall be recorded at cost until (a) the hedged transaction occurs or (b) it is determined that the hedge was not effective (see (5) in this section 2.b.i.);

(3) For other derivatives the amortization period is usually from date of acquisition (issuance) of the derivative to maturity of the hedged item or program;

(4) For hedges where the cost of the derivative is combined with the hedged item, the statement value is zero. The fair value of the derivative and hedged item shall be determined and reported separately, either individually or in the aggregate;

(5) If during the life of the derivative it or a designated portion of the derivative is no longer effective as a hedge, valuation at amortized cost ceases and the derivative or a designated portion of the derivative shall be valued at its current fair value with gains and losses recorded in unrealized gains or unrealized losses to the extent that it ceased to be an effective hedge. Upon redesignation into an effective hedging relationship, the derivative’s mark to fair value through unrealized gain or loss shall be reversed.

ii. Open derivatives hedging items recorded at fair value (where gains and losses on the hedged item are recognized as adjustments to unassigned funds (surplus)):

(a) Swaps, collars, or forwards shall be valued at current fair value with changes in fair value recognized currently consistent with the hedged item; this will result in unrealized gain/loss treatment with adjustment to unassigned funds (surplus);

(b) For hedges where the derivative is combined with the hedged item, the fair value of the derivative and hedge item shall be determined and reported separately, either individually or in the aggregate. The cost (book value) basis used to figure gain/loss on the derivative is zero.

iii. Open foreign currency swap and forward contracts hedging foreign currency exposure on items denominated in a foreign currency and translated into U.S. dollars where fair value accounting is not being used:

(a) The foreign exchange premium (discount) on the currency contract shall be amortized into income over the life of the contract or hedge program. The foreign exchange premium (discount) is defined as the foreign currency (notional) amount to be received (paid) times the net of the forward rate minus the spot rate at the time the contract was opened.

Amortization is not required if the contract was entered into within a year of maturity;

(b) A foreign currency translation adjustment shall be reflected as an unrealized gain/loss (unassigned funds (surplus) adjustment) using the same procedures as done to translate the hedged item;

(c) The unrealized gain/loss for the period equals the foreign currency (notional) amount to be received (paid) times the net of the current spot rate minus the prior period end spot rate;

(d) The statement value of the derivative equals the amortized (premium) discount plus the cumulative unrealized gain/(loss) on the contract. The cumulative unrealized gain/(loss) equals the foreign currency (notional) amount to be received (paid) times the net of the current spot rate minus the spot rate at the time the contract was opened;

(e) Recognition of unrealized gains/losses and amortization of foreign exchange premium/discount on derivatives hedging forecasted transactions or firm commitments shall be deferred until the hedged transaction occurs. These deferred gains/losses will adjust the basis or proceeds of the hedged transaction when it occurs;

(f) For hedges where the cost of the foreign currency contract is combined with the hedged item, the statement value on Schedule DB is zero. The fair value of the derivative and hedged item shall be determined and reported separately, either individually or in the aggregate;

(g) If during the life of the currency contract it or a designated portion of the currency contract is not effective as a hedge, valuation at amortized cost shall cease. To the extent it ceased to be an effective hedge, a cumulative unrealized gain/loss (surplus adjustment) will be recognized equal to the notional amount or designated notional amount times the difference between the forward rate available for the remaining maturity of the contract (i.e., the forward rate as of the balance sheet date) and the forward rate at the time it ceased to be an effective hedge.

iv. Open derivatives hedging items recorded at fair value, where gains and losses on the hedged item are recognized currently in earnings: swaps, collars and forwards shall be valued at current fair value with changes in fair value recognized currently in earnings together with the gains and losses on the hedged item.

(a) If during the life of the derivative it or a designated portion of the derivative is no longer effective as a hedge, recognition of changes in fair value through earnings ceases. The derivative shall continue to be valued at its current fair value, but thereafter gains or losses shall be recognized in unrealized gains or unrealized losses to the extent it ceased to be an effective hedge.

c. Cash Flows and Income:

i. Where the cost of the derivative is not combined with the hedged item:

(a) Amortization of premium paid or received on derivatives is an adjustment to net investment income or another appropriate caption within operating income consistent with the reporting of the hedged item;

(b) Periodic cash flows and accruals of income/expense are to be reported in a manner consistent with the hedged item, usually as net investment income or another appropriate caption within operating income.

ii. Where the cost of the derivative is combined with the hedged item, the cash flows and income of the derivative on Schedule DB is zero. All related amortization and cash flow accounting shall be reported with the hedged item instead of with the derivative.

d. Gain/Loss on Termination of a swap, collar or forward accounted for under hedge accounting (includes closing, exercise, maturity, and expiry):

i. Exercise—The remaining book value of the derivative shall become an adjustment to the cost or proceeds of the hedged item(s) received or disposed of individually or in aggregate;

ii. Sale, maturity, expiry, or other closing transaction of a derivative which is an effective hedge—Any gain or loss on the transaction will adjust the basis (or proceeds) of the hedged item(s) individually or in aggregate. Alternatively, if the item being hedged is subject to IMR, the gain or loss on the terminated hedging derivative may be realized and shall be subject to IMR upon termination;

iii. Gain/loss on termination of derivatives will be recognized currently in net income (realized gain/loss) to the extent they ceased to be effective hedges.

iv. Upon the redesignation of a derivative from a currently effective hedging relationship-

(a) with an item(s) carried at amortized cost to another effective hedging relationship with an item(s) carried at amortized cost, the derivative shall continue to be recorded at amortized cost and no gain or loss on the derivative shall be recognized.

(b) with an item(s) carried at amortized cost or fair value to an effective relationship with an item(s) carried at fair value, the accounting for the derivative shall be consistent with (ii) above.

(c) with an item(s) carried at fair value to an effective relationship with an item(s) carried at amortized cost, the accounting for the derivative shall be consistent with (ii) above.

3. Futures (see also discussion in Introduction above):

a. Accounting at Date of Acquisition:

i. Positions in futures contracts shall be initially valued at the amount of cash deposits (i.e., basis or book value of the contract), if any, placed with a broker and either be (a) recorded as an asset (paid) or liability (received) on the Derivative line on the Assets (or) Liabilities pages or (b) combined with the hedged item. Subsequent additions (reductions) in cash deposits plus changes in contract value from date of contract opening (i.e., variation margin) paid (received) will increase (decrease) the book value of the futures contract (hedge accounting).

b. Statement Value:

i. Hedges of Items Recorded at Amortized Cost:

(a) Futures shall be valued at book value;

(b) Book value of open futures contracts need not be amortized;

(c) For hedges where the variation margin portion of the cost of the futures contract is combined with the hedged item, the statement value of the futures contract would be equal to cash deposits outstanding, if any. The fair value of the futures contract and the hedged item will be determined and reported separately, either individually or in the aggregate. Fair value on futures contracts is limited to the value of the cash deposits outstanding;

(d) For hedges of forecasted transactions or firm commitments, the derivative shall be recorded at cost (with the variation margin deferred) until (1) the hedged transaction occurs or (2) it is determined that the hedge was not effective (see (e) in this section);

(e) If during the life of the futures contract it or a designated portion of the futures contract is no longer effective as a hedge, hedge accounting for the variation margin ceases. A gain/(loss) equal to the variation margin received (paid) shall be recognized in unrealized gains or unrealized losses (surplus adjustment) to the extent it or a designated portion of the variation margin ceased to be an effective hedge. Statement value will be limited to the cash deposits outstanding, if any, and subsequent changes in the variation margin will be recognized in unrealized gains or unrealized losses (surplus adjustment).

ii. Hedges of Items Recorded at Fair Value (where gains and losses on the hedged item are recognized as adjustments to unassigned funds (surplus)):

(a) Changes in futures contract value from date of contract opening (i.e., variation margin) shall be recognized currently consistent with the hedged item. Statement value will be limited to the cash deposits outstanding, if any;

(b) This will result in unrealized gain/loss treatment with adjustment to unassigned funds (surplus);

(c) For hedges where the variation margin of the futures contract is combined with the hedged item, the fair value of the futures contract and the hedged item will be determined and reported separately, either individually or in the aggregate.

iii. Open foreign currency futures contracts hedging foreign currency exposure on item(s) denominated in a foreign currency and translated into U.S. dollars (where fair value accounting is not being used):

(a) The foreign exchange premium (discount) on the currency contract will be amortized into net investment income over the life of the contract or hedge program. The foreign exchange premium (discount) is defined as the foreign currency (notional) amount to be received (paid) times the net of the forward rate minus the spot rate at the time the contract was opened.

Amortization is not required if the contract was entered into within a year of maturity;

(b) A foreign currency translation adjustment shall be reflected as an unrealized gain/loss (unassigned funds (surplus) adjustment) using the same procedures as is done to translate the hedged item. The cumulative unrealized gain/(loss) which equals the foreign currency (notional) amount to be received (paid) times the net of the current spot rate minus the spot rate at the time the contract was opened shall be reported as recognized variation margin;

(c) The statement value of the currency futures contract is book value, including any cash deposits outstanding and increase (decrease) for amortization of foreign exchange (premium) discount plus the foreign exchange translation gain/(loss), which is reported as deferred variation margin;

(d) Recognition of unrealized gains/losses and amortization of foreign exchange premium/discount on derivatives hedging forecasted transactions or firm commitments shall be deferred until the hedged transaction occurs. These deferred gains/losses will adjust the basis or proceeds of the hedged transaction when it occurs;

(e) For hedges where the variation margin of the foreign currency contract is combined with the hedged item, the statement value of the foreign currency contract would equal the cash deposits outstanding, if any. The fair value of the derivative and the hedged item will be determined and reported separately, either individually or in the aggregate. Fair value on futures contracts is limited to the value of the cash deposits outstanding;

(f) If during the life of the currency contract it or a designated portion of the currency contract is not effective as a hedge, valuation at amortized cost ceases. To the extent it ceases to be an effective hedge, an unrealized gain/loss will be recognized equal to the notional amount or a designated portion of the notional amount times the difference between the forward rate available for the remaining maturity of the contract (i.e., the forward rate as of the balance sheet date) and the forward rate at the time it ceased to be an effective hedge.

iv. Open futures hedging items recorded at fair value, where gains and losses on the hedging item are recognized currently in earnings shall be valued at current fair value with changes in fair value recognized currently in earnings.

(a) If during the life of the futures contract it or a designated portion of the futures contract is no longer effective as a hedge, current recognition in earnings of changes in fair value ceases. Prospective changes in the variation margin shall be recognized in unrealized gains or unrealized losses (surplus adjustment) to the extent it or a designated portion of the variation margin ceased to be an effective hedge. Statement value of the derivative will thereafter be limited to the cash deposits outstanding, if any.

c. Gain/Loss on Termination of a futures contract accounted for under hedge accounting:

i. Settlement at maturity of a futures contract—The remaining variation margin of the futures contract shall become an adjustment to the cost or proceeds of the hedged item(s) received, disposed of or held, individually or in aggregate;

ii. Sale, or other closing transaction of a futures contract which is an effective hedge—Any gain or loss on the transaction will adjust the basis (or proceeds) of the hedged item(s) individually or in aggregate. Alternatively, if the item being hedged is subject to IMR, the gain or loss on the terminated hedging derivative may be realized and shall be subject to IMR upon termination;

iii Gain/loss on termination of futures contracts will be recognized currently in net income (realized gain/loss) to the extent they ceased to be effective hedges.

iv. Upon the redesignation of a derivative from a currently effective hedging relationship-

(a) with an item(s) carried at amortized cost to another effective hedging relationship with an item(s) carried at amortized cost, the derivative shall continue to be recorded at amortized cost and no gain or loss on the derivative shall be recognized.

(b) with an item(s) carried at amortized cost or fair value to an effective relationship with an item(s) carried at fair value, the accounting for the derivative shall be consistent with (ii) above.

(c) with an item(s) carried at fair value to an effective relationship with an item(s) carried at amortized cost, the accounting for the derivative shall be consistent with (ii) above.

Statement of Statutory Accounting Principles No. 90

Accounting for the Impairment or Disposal of Real Estate Investments

STATUS

Type of Issue:	Common Area
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STATUS **1**

SCOPE OF STATEMENT **3**

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Accounting for the Impairment or Disposal of Real Estate Investments

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for the impairment or disposal of real estate investments and the treatment of long-lived assets associated with discontinued operations including nonadmitted intangible assets other than goodwill, such as trade names (referred to collectively as long-lived assets). This statement is not intended to conflict with guidance concerning operating results associated with discontinued operations, which is contained in *SSAP No. 24—Discontinued Operations and Extraordinary Items* (SSAP No. 24).

2. This statement supersedes *SSAP No. 40R—Real Estate Investments* (SSAP No. 40R), paragraphs ~~10~~11, ~~11~~12 and ~~24~~25.

3. This statement does not apply to (a) goodwill, (b) servicing assets, (c) financial instruments, including investments in equity securities accounted for under the cost or equity method, (d) deferred policy acquisition costs, and (e) deferred tax assets. This statement also does not apply to long-lived assets for which the accounting is prescribed by *FASB Codification 985-20 – Costs of Software to be Sold, Leased or Marketed* (ASC 985-20) as adopted with modification to preclude the capitalization of software development costs in *SSAP No. 16R—Electronic Data Processing Equipment and Accounting for Software (SSAP No. 16R)*. For a discussion on software development costs, see the guidance also in *SSAP No. 16R*. Statutory guidance on goodwill is in *SSAP No. 68—Business Combinations and Goodwill* (SSAP No. 68).

SUMMARY CONCLUSION

Recognition and Measurement of an Impairment Loss

4. An impairment loss shall be recognized only if the carrying amount of a long-lived asset is not recoverable and exceeds its fair value. The carrying amount of a long-lived asset is not recoverable if it exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset. That assessment shall be based on the carrying amount of the asset at the date it is tested for recoverability, whether in use or under development. An impairment loss shall be measured as the amount by which the carrying amount of a long-lived asset exceeds its fair value as discussed in paragraph 16.

When to Test a Long-Lived Asset for Recoverability

5. A long-lived asset shall be tested for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable. The following are examples of such events or changes in circumstances:

a. A significant decrease in the fair value of a long-lived asset

b. A significant adverse change in the extent or manner in which a long-lived asset is being used or in its physical condition

c. A significant adverse change in legal factors or in the business climate that could affect the value of a long-lived asset, including an adverse action or assessment by a regulator

d. An accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of a long-lived asset

e. A current-period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with the use of a long-lived asset

f. A current expectation that, more likely than not, a long-lived asset will be sold or otherwise disposed of significantly before the end of its previously estimated useful life.

6. Real estate investment properties occupied by the company (per SSAP No. 40R) shall not be subject to recoverability testing under paragraphs 4 and 5 of this statement. However, if any of the following conditions are present, the reporting entity's property occupied by the company on a property by property basis shall be subject to immediate recoverability testing, by determining the fair value of the property using the criteria in SSAP No. 40R, paragraph ~~12~~13:

a. The financial condition of the reporting entity is in question as described in paragraph 7 of this statement.

b. The property occupied by the company is held for sale as defined in paragraph 21 of this statement.

c. A significant adverse change in the physical condition of the property occupied by the company has occurred.

d. The management of the reporting entity has voluntarily determined a need for recoverability testing.

7. The following, while not meant to be an all-inclusive listing, are factors, which would indicate that the financial condition of the reporting entity is in question:

a. Entity is subject to regulatory action such as administrative supervision, corrective order based on hazard to policyholders, or substantially similar proceeding, whether voluntary or involuntary;

b. Entity is at any action or control level under Risk Based Capital;

c. Grounds exist for conservation, receivership, rehabilitation or liquidation;

d. Independent certified public accounting report issues a going concern opinion, adverse opinion or disclaimer of opinion.

8. When a long-lived asset is tested for recoverability, it also may be necessary to review depreciation estimates and methods as required by *SSAP No. 3—Accounting Changes and Corrections of Errors* (SSAP No. 3). Any revision to the remaining useful life of a long-lived asset resulting from that review also shall be considered in developing estimates of future cash flows used to test the asset for recoverability. However, any change in the accounting method for the asset resulting from that review shall be made only after applying this statement.

New Cost Basis

9. If an impairment loss is recognized, the adjusted carrying amount of a long-lived asset shall be its new cost basis. For a depreciable long-lived asset, the new cost basis shall be depreciated (amortized) over the remaining useful life of that asset. Restoration of a previously recognized impairment loss is prohibited.

Estimates of Future Cash Flows Used to Test a Long-Lived Asset for Recoverability

10. Estimates of future cash flows used to test the recoverability of a long-lived asset shall include only the future cash flows (cash inflows less associated cash outflows) that are directly associated with, and that are expected to arise as a direct result of, the use and eventual disposition of the asset, however properties occupied by company are exempt from this requirement and should follow the guidance in paragraphs 6 and 7 of this statement. Those estimates shall exclude interest charges that will be recognized as an expense when incurred.

11. Estimates of future cash flows used to test the recoverability of a long-lived asset shall incorporate the entity's own assumptions about its use of the asset and shall consider all available evidence. The assumptions used in developing those estimates shall be reasonable in relation to the assumptions used in developing other information used by the entity for comparable periods, such as internal budgets and projections, accruals related to incentive compensation plans, or information communicated to others. However, if alternative courses of action to recover the carrying amount of a long-lived asset are under consideration or if a range is estimated for the amount of possible future cash flows associated with the likely course of action, reporting entities shall use their best estimate in testing the recoverability of a long-lived asset.

12. Estimates of future cash flows used to test the recoverability of a long-lived asset shall be made for the remaining useful life of the asset to the entity.

13. Estimates of future cash flows used to test the recoverability of a long-lived asset that is in use, including a long-lived asset for which development is substantially complete, shall be based on the existing service potential of the asset at the date it is tested. The service potential of a long-lived asset encompasses its remaining useful life, cash-flow-generating capacity, and for tangible assets, physical output capacity. Those estimates shall include cash flows associated with future expenditures necessary to maintain the existing service potential of a long-lived asset, including those that replace the service potential of component parts of a long-lived asset (for example, the roof of a building). Those estimates shall exclude cash flows associated with future capital expenditures that would increase the service potential of a long-lived asset.

14. Estimates of future cash flows used to test the recoverability of a long-lived asset that is under development shall be based on the expected service potential of the asset when development is substantially complete. Those estimates shall include cash flows associated with all future expenditures necessary to develop a long-lived asset, including interest payments that will be capitalized as part of the cost of the asset.

15. If a long-lived asset that is under development is in use, estimates of future cash flows used to test the recoverability of that asset shall include the cash flows associated with future expenditures necessary to maintain the existing service potential of the asset as well as the cash flows associated with all future expenditures necessary to substantially complete the asset that is under development.

Fair Value

16. A discussion of fair value is contained in *SSAP No. 100—Fair Value Measurements*. This statement requires real estate investment properties occupied by the company (per SSAP No. 40R), that are determined to be subject to recoverability testing as discussed in paragraphs 6 and 7, to follow the guidance in SSAP No. 40R, paragraph ~~12~~13.

Long-Lived Assets Categories for Real Estate Investments

17. SSAP No. 40R states that real estate investments shall be reported in the balance sheet categories of properties occupied by the company, properties held for the production of income, and properties held for sale. Accounting guidance in *FASB Statement No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets* (FAS 144) distinguishes between long-lived assets to be held and used and long-lived assets to be disposed of. For statutory accounting purposes, long-lived assets to be held and used encompass real estate investments classified under SSAP No. 40R as properties occupied by the company and properties held for the production of income. Further, FAS 144 bifurcates the category of long-lived assets to be disposed of into long-lived assets to be disposed of other than by sale and long-lived assets to be disposed of by sale. Long-lived real estate investments to be disposed of other than by sale shall be classified either as properties occupied by the company or as properties held for the production of income. Long-lived real estate investments to be disposed of by sale shall be classified as properties held for sale.

Long-Lived Assets to Be Disposed of Other Than By Sale

18. A long-lived asset to be disposed of other than by sale (for example, by abandonment, in an exchange measured based on the recorded amount of the nonmonetary asset relinquished, or in a distribution to owners in a spinoff) shall continue to be classified as held and used until disposal. Paragraphs 4-17, and 31-35 shall apply while the asset is classified as held and used. If a long-lived asset is to be abandoned or distributed to owners in a spinoff together with other assets (and liabilities) as a group and that disposal group is a segment, paragraphs 31-35 shall apply to the disposal group at the date of disposal.

Long-Lived Assets to Be Abandoned

19. For purposes of this statement, a long-lived asset to be abandoned is disposed of when it ceases to be used. If an entity commits to a plan to abandon a long-lived asset before the end of its previously estimated useful life, depreciation estimates shall be revised in accordance with SSAP No. 3 to reflect the use of the asset over its shortened useful life. A long-lived asset that has been temporarily idled shall not be accounted for as if abandoned.

Long-Lived Assets to Be Exchanged or to Be Distributed to Owners in a Spinoff

20. For purposes of this statement, a long-lived asset to be disposed of in an exchange measured based on the recorded amount of the nonmonetary asset relinquished or to be distributed to owners in a spinoff is disposed of when it is exchanged or distributed. If the asset is tested for recoverability while it is classified as held and used, the estimates of future cash flows used in that test shall be based on the use of the asset for its remaining useful life, assuming that the disposal transaction will not occur. In addition to any impairment losses required to be recognized while the asset is classified as held and used, an impairment loss, if any, shall be recognized when the asset is disposed of if the carrying amount of the asset exceeds its fair value[1].

[1] The provisions of this paragraph apply to nonmonetary exchanges that are not recorded at fair value under the provisions of *SSAP No. 95—Exchanges of Nonmonetary Assets, A Replacement of SSAP No. 28—Nonmonetary Transactions.*

Long-Lived Assets to Be Disposed Of By Sale

Recognition

21. Real estate investment properties classified as held for sale or a long-lived asset to be sold shall be classified as held for sale in the period in which all of the following criteria are met:

a. Management, having the authority to approve the action, commits to a plan to sell the asset.

b. The asset is available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets.

c. An active program to locate a buyer and other actions required to complete the plan to sell the asset have been initiated.

d. The sale of the asset is probable, and transfer of the asset is expected to qualify for recognition as a completed sale, within one year, except as permitted by paragraph 22.

e. The asset is being actively marketed for sale at a price that is reasonable in relation to its current fair value.

f. Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

If at any time the criteria in this paragraph are no longer met (except as permitted by paragraph 22), a long-lived asset classified as held for sale shall be reclassified as held and used in accordance with paragraphs 29 and 30.

22. Events or circumstances beyond an entity's control may extend the period required to complete the sale of a long-lived asset beyond one year. An exception to the one-year requirement in paragraph 21.d. shall apply in the following situations in which such events or circumstances arise:

a. If at the date an entity commits to a plan to sell a long-lived asset the entity reasonably expects that others (not a buyer) will impose conditions on the transfer of the asset that will extend the period required to complete the sale and (1) actions necessary to respond to those conditions cannot be initiated until after a firm purchase commitment is obtained and (2) a firm purchase commitment is probable within one year.

b. If an entity obtains a firm purchase commitment and, as a result, a buyer or others unexpectedly impose conditions on the transfer of a long-lived asset previously classified as held for sale that will extend the period required to complete the sale and (1) actions necessary to respond to the conditions have been or will be initiated in a timely manner and (2) a favorable resolution of the delaying factors is expected.

c. If during the initial one-year period, circumstances arise that previously were considered unlikely and, as a result, a long-lived asset previously classified as held for sale is not sold by the end of that period and (1) during the initial one-year period the entity initiated actions necessary to respond to the change in circumstances, (2) the asset is being actively marketed at a price that is reasonable given the change in circumstances, and (3) the criteria in paragraph 21 are met.

23. A long-lived asset that is newly acquired and that will be sold rather than held and used shall be classified as held for sale at the acquisition date only if the one-year requirement in paragraph 21.d. is met (except as permitted by paragraph 22) and any other criteria in paragraph 21 that are not met at that date are probable of being met within a short period following the acquisition (usually within three months).

24. If the criteria in paragraph 21 are met after the balance sheet date but before issuance of the financial statements, a long-lived asset shall continue to be classified as held and used in those financial statements when issued. The information required by paragraph 37 shall be disclosed in the notes to the financial statements. If the asset is tested for recoverability (on a held-and-used basis) as of the balance sheet date, the estimates of future cash flows used in that test shall consider the likelihood of possible outcomes that existed at the balance sheet date, including the assessment of the likelihood of the future sale of the asset. That assessment made as of the balance sheet date shall not be revised for a decision to sell the asset after the balance sheet date. An impairment loss, if any, to be recognized shall be measured as the amount by which the carrying amount of the asset exceeds its fair value at the balance sheet date.

Measurement

25. Real estate investment properties classified as held for sale or a long-lived asset to be sold shall be measured at the lower of its carrying amount or fair value less encumbrances and estimated costs to sell the property. If the asset is newly acquired, the carrying amount of the asset shall be established based on its fair value less encumbrances and estimated costs to sell the property at the acquisition date. A long-lived asset shall not be depreciated (amortized) while it is classified as held for sale. Interest and other expenses attributable to the liabilities of a disposal classified as held for sale shall continue to be accrued.

26. Costs to sell are the incremental direct costs to transact a sale, that is, the costs that result directly from and are essential to a sale transaction and that would not have been incurred by the entity had the decision to sell not been made. Those costs include broker commissions, legal and title transfer fees, and closing costs that must be incurred before legal title can be transferred.

27. The carrying amounts of any assets that are not covered by this statement that are included in a disposal classified as held for sale shall be adjusted in accordance with other applicable statements of statutory accounting principles prior to measurement.

28. A realized loss shall be recognized in the summary of operations for any initial or subsequent write-down to fair value less cost to sell. A gain shall not be recognized for any subsequent increase in fair value less cost to sell until the asset is sold. The loss shall adjust only the carrying amount of a long-lived asset, whether classified as held for sale individually or as part of a disposal group. A gain or loss not previously recognized that results from the sale of a long-lived asset shall be recognized at the date of sale.

Changes to a Plan of Sale

29. If circumstances arise that previously were considered unlikely and, as a result, an entity decides not to sell a long-lived asset previously classified as held for sale, the asset shall be reclassified as held and used. A long-lived asset that is reclassified shall be measured individually at the lower of its (a) carrying amount before the asset was classified as held for sale, adjusted for any depreciation (amortization) expense that would have been recognized had the asset been continuously classified as held and used, or (b) fair value at the date of the subsequent decision not to sell.

30. Any required adjustment to the carrying amount of a long-lived asset that is reclassified as held and used shall be included in income from continuing operations in the period of the subsequent decision not to sell. That adjustment shall be reported in the same income statement caption used to report a loss, if any, recognized in accordance with paragraph 32.

Reporting Long-Lived Assets and Disposal Groups to Be Disposed Of

Reporting Discontinued Operations

31. For purposes of reporting income and losses related to discontinued operations; any reference to the phrase "component of an entity" is replaced with "segment" as defined in SSAP No. 24.

Reporting Disposal Gains or Losses in Operations

32. Any disposal gain or loss recognized for long-lived assets shall be included as a net realized gain or loss in the summary of operations.

Reporting a Long-Lived Asset or Disposal Group Classified as Held for Sale

33. The results of operations of a segment that either has been disposed of or is classified as held for sale shall be reported consistently with the entity's reporting of continuing operations.

34. A long-lived asset classified as held for sale shall be presented separately in the balance sheet. The assets and liabilities of a disposal classified as held for sale shall be presented separately in the asset and liability sections, respectively, of the balance sheet. Those assets and liabilities shall not be offset and presented as a single amount. The major classes of assets and liabilities classified as held for sale, in the case of real estate shall be separately disclosed either on the face of the balance sheet or in the notes to financial statements (paragraph 37).

Reporting Impairment Losses

35. Any impairment loss recognized on long-lived assets shall be recorded in the summary of operations as a realized loss.

Disclosures

36. The following information shall be disclosed in the notes to the financial statements that include the period in which an impairment loss is recognized:

a. A description of the impaired assets and the facts and circumstances leading to the impairment;

b. The amount of the impairment loss and how fair value was determined; and

c. The caption in the summary of operations which includes the impairment loss.

37. The following information shall be disclosed in the notes to the financial statements that cover the period in which a long-lived asset either has been sold or is classified as held for sale:

a. A description of the facts and circumstances leading to the expected disposal, the expected manner and timing of that disposal.

b. If applicable, the gain or loss recognized and if not separately presented on the face of the summary of operations, the caption in the summary of operations that includes that gain or loss.

38. If paragraph 29 applies, a description of the facts and circumstances leading to the decision to change the plan to sell the asset; and its effect on the results of operations for the period and any prior

periods presented shall be disclosed in the notes to financial statements that include the period of that decision.

Relevant Literature

39. FAS 144 supersedes *FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (FAS 121) and in part *Accounting Principles Board Opinion No. 30, Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*. FAS 144 retains the requirements of FAS 121 to (a) recognize an impairment loss only if the carrying amount of a long-lived asset is not recoverable from its undiscounted cash flows and (b) measure an impairment loss as the difference between the carrying amount and fair value of the asset. FAS 144 requires that a long-lived asset to be abandoned, exchanged for a similar productive asset, or distributed to owners in a spinoff be considered held and used until it is disposed of. FAS 144 also sets forth that the accounting model for long-lived assets to be disposed of by sale is used for all long-lived assets, whether previously held and used or newly acquired. FAS 144 also resolves implementation issues that came about in the application of existing guidance. This statement adopts with modification *FAS 153, Exchanges of Nonmonetary Assets, An Amendment of APB Opinion No. 29* (FAS 153) for the accounting guidance of long-lived assets to be disposed of other than by sale addressed in paragraphs 18-20.

40. This statement adopts FAS 144 with modification to paragraphs 9, 17, 18, 19, 21, 25, 28, 35, 36, 37, 41, 42, 44, 45 and 47. Further, this statement rejects paragraphs 10-14, paragraphs 22-24, 26.d., and 43 of FAS 144. Refer to paragraph 41 of this statement for additional information with regard to these paragraphs.

41. The modifications to FAS 144 were made in order to maintain consistency with current statutory accounting principles and the Statement of Concepts:

a. Paragraph 9 is amended to require that changes in depreciation estimates and methods and amortization periods found as a result of a test for recoverability should be accounted for in accordance with SSAP No. 3;

b. Paragraphs 10-14, which address the grouping of assets, are rejected, as reporting entities should apply the guidance in this statement to each of its assets on an individual basis;

c. Paragraphs 17, 18, 19 and 21 discuss estimates of future cash flows used to test the recoverability of a long-lived asset, and states that a probability-weighted approach may be useful in considering the likelihood of those possible outcomes. For statutory accounting purposes, reporting entities shall use their best estimate in testing the recoverability of a long-lived asset;

d. Paragraphs 22-24, which discuss fair value, are rejected. The definition of fair value is in *SSAP No. 100—Fair Value Measurements*.

e. Paragraph 25 is amended to require that an impairment loss on properties occupied by the company and properties held for the production of income shall be recorded in the summary of operations as a realized loss;

f. Paragraph 28 is amended to require that changes in depreciation estimates shall be accounted for in accordance with SSAP No. 3;

g. If the sale is expected to occur beyond one year, paragraph 35 allows the cost to sell to be discounted. For statutory accounting purposes, the cost to sell shall not be discounted;

h. Paragraph 35 allows for expected future losses associated with the operations of a long-lived asset (disposal group) while it is held for sale to be excluded from the costs to sell. For statutory accounting purposes, the cost to sell should include expected future losses in accordance with SSAP No. 24, paragraph 4.

i. Paragraph 36 is amended to remove the reference to goodwill, as FAS 144 does not include goodwill within its scope unless such goodwill is included in an asset group that is or includes a reporting unit; paragraph 41.o. of this statement does not recognize a reporting unit. Paragraph 36 is further amended to require reporting entities to adjust all assets in accordance with other applicable statements of statutory accounting principles prior to measurement;

j. Paragraph 37 is amended to clarify that losses recognized as a result of adjustments to fair value less cost to sell shall be recorded in the summary of operations as a realized gain/loss. Paragraph 37 is also modified to disallow the recognition of any gain for subsequent increases in fair value less cost to sell until the asset is sold. This is consistent with the concept of conservatism found in the Statement of Concepts;

k. Within paragraphs 41, 42 and 44 of FAS 144 addressing discontinued operations; any reference to the phrase “component of an entity” is replaced with “segment” as defined in SSAP No. 24;

l. Paragraph 42 is amended to state that the results of operations of a discontinued operation shall be reported consistently with the entity’s reporting of continuing operations. This is consistent with the guidance found in paragraph 5 of SSAP No. 24;

m. Paragraph 44 is amended to state that adjustments to amounts previously reported related to continuing operations shall be reported consistently with the entity’s reporting of continuing operations. This is consistent with the guidance found in paragraph 5 of SSAP No. 24. In addition, paragraphs 44.a. through 44.c. are adopted into paragraph 5 of SSAP No. 24;

n. Paragraph 45 is amended to state that a gain or loss on an asset classified as held for sale that has been disposed of shall be included in the summary of operations as a realized gain or loss;

o. The disclosures in paragraphs 47.a. and 47.b. are adopted with respect to properties held for sale, except for the disclosures related to major classes of assets, as grouping has been rejected in this statement. Paragraphs 47.c. and 47.d. are rejected as such paragraphs relate to discontinued operations and segment reporting. The disclosures included in paragraphs 6 and 7 of SSAP No. 24 are more appropriate given the differences between statutory and generally accepted accounting principles reporting of discontinued operations;

p. Paragraph 26.d. requires the disclosure of the segment in which an impaired asset is reported. This paragraph is rejected, as statutory accounting requires accounting and reporting at the legal entity level. Further, any additional references to segments, reporting units, or disposal groups found in FAS 144 are also rejected, except with regard to a segment within the context of discontinued operations; and

q. Paragraph 43 is rejected and the guidance related to the recognition of losses/income expected between the measurement date and the expected disposal date included in paragraph 4 of SSAP No. 24 is retained, as such guidance is consistent with the concept of conservatism in the Statement of Concepts.

42. *FASB Statement No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets* (FAS 144) supersedes FAS 121, but specifically scopes out the concept of goodwill. Paragraphs 12-14 of FAS 121 address the impairment of goodwill and paragraphs 12, 14.a. and 14.b. of FAS 121 were adopted in SSAP No. 68. However, paragraph 12 of FAS 121 was superseded by *FASB Statement No. 142, Goodwill and Other Intangible Assets* (FAS 142), which was rejected in SSAP No. 68. Given the applicability of the guidance found in paragraph 12 of FAS 121 to statutory accounting principles, the impairment guidance found in FAS 121, paragraph 12 is retained. Paragraph 12 of FAS 121 has been excerpted in *Issue Paper No. 68—Business Combinations and Goodwill*, paragraph 31.

Effective Date and Transition

43. The provisions of this statement shall be applied to all assets on the books of the reporting entity within the scope of this statement for reporting periods beginning on and after January 1, 2006. The guidance within paragraphs 18-20 was originally amended with the adoption of SSAP No. 95, included in that statement, and effective for fiscal periods beginning after January 1, 2007. The original guidance included in this SSAP with tracked changes showing the amendments from SSAP No. 95 are retained for historical purposes within Issue Paper No. 127.

REFERENCES

Other

- *Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy*
- *SSAP No. 3—Accounting Changes and Corrections of Errors*
- *SSAP No. 24—Discontinued Operations and Extraordinary Items*
- *SSAP No. 40R—Real Estate Investments*

Relevant Issue Papers

- *Issue Paper No. 121—Accounting for the Impairment or Disposal of Real Estate Investments*
- *Issue Paper No. 127—Exchanges of Nonmonetary Assets, A Replacement of SSAP No. 28—Nonmonetary Transactions*

Statement of Statutory Accounting Principles No. 92

Accounting for Postretirement Benefits Other Than Pensions, A Replacement of SSAP No. 14

STATUS

Type of Issue:	Common Area
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STATUS **1**

SCOPE OF STATEMENT **3**

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Accounting for Postretirement Benefits Other Than Pensions, A Replacement of SSAP No. 14

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles and related reporting for employers' postretirement plans other than pensions.

2. This statement applies to all postretirement benefits expected to be provided by an employer to current and former employees (including retirees, disabled employees, and other former employees who are expected to receive postretirement benefits), their beneficiaries, and covered dependents, pursuant to the terms of an employer's undertaking to provide those benefits. Other postretirement benefits include, but are not limited to, postretirement health care; life insurance provided outside a pension plan to retirees; and other welfare benefits such as tuition assistance, day care, legal services, and housing subsidies provided after retirement. Often those benefits are in the form of a reimbursement to plan participants or direct payment to providers for the cost of specified services as the need for those services arises, but they may also include benefits payable as a lump sum, such as death benefits. Much of the guidance in this statement focuses on postretirement health care plans. Nevertheless, this statement applies equally to all postretirement benefits other than pensions. A postretirement benefit plan may be part of a larger plan or arrangement that provides benefits currently to active employees as well as to retirees. In those circumstances, the promise to provide benefits to present and future retirees under the plan shall be segregated from the promise to provide benefits currently to active employees and shall be accounted for in accordance with the provisions of this statement. Absent evidence to the contrary, it shall be presumed that an employer that has provided postretirement benefits in the past or is currently promising those benefits to employees will continue to provide those future benefits. This statement supersedes the guidance in *SSAP No. 14—Postretirement Plans Other Than Pensions* (SSAP No. 14), nullifies and incorporates the guidance in *INT 99-26: Offsetting Pension Assets and Liabilities* (INT 99-26) and nullifies *INT 01-16: Measurement Date for SSAP No. 8 Actuarial Valuations* (INT 01-16).

SUMMARY CONCLUSION

Single-Employer Defined Benefit Postretirement Plans

3. A defined benefit postretirement plan is one that defines the postretirement benefits in terms of (a) monetary amounts) or (b) benefit coverage to be provided. In some cases, an employer may limit its obligation through an individual or an aggregate "cap" on the employer's cost or benefit obligation. Plans of that nature are considered to be defined benefit postretirement plans. (Hybrid postretirement plans or ”cash-balance” plans are considered defined benefit plans for purposes of applying this statement.) For defined benefit plans, reporting entities shall adopt *FAS 158: Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106 and 132 (R)* (FAS 158) and *FASB Staff Position FAS 136(R)-1, Employers' Disclosures about Postretirement Benefit Plan Assets* (FSP FAS 136(R)-1) with modifications as discussed in paragraph ~~99~~100.

4. A postretirement benefit is part of the compensation paid to an employee for services rendered. In a defined benefit plan, the employer promises to provide, in addition to current wages and benefits, future benefits during retirement. Generally, the amount of those benefits depends on the benefit formula (which may include factors such as the number of years of service rendered or the employee's compensation before retirement or termination), the longevity of the retiree and any beneficiaries and covered dependents, and the incidence of events requiring benefit payments (for example, illnesses affecting the amount of health care required). In most cases, services are rendered over a number of years before an employee retires and begins to receive benefits or is entitled to receive benefits as a need arises. Even though the services rendered by the employee are complete and the employee has retired, the total amount of benefits the employer has promised and the cost to the employer of the services rendered are not precisely determinable but can be estimated using the plan's benefit formula and estimates of the effects of relevant future events.

Elements of Accounting for Postretirement Benefits

5. Any method of accounting that recognizes the cost of postretirement benefits over employee service periods (before the payment of benefits to retirees) must deal with two factors that stem from the nature of the arrangement. First, estimates or assumptions must be made about the future events that will determine the amount and timing of the benefit payments. Second, an attribution approach that assigns benefits and the cost of those benefits to individual years of service must be selected.

6. The expected postretirement benefit obligation for an employee is the actuarial present value as of a particular date of the postretirement benefits expected to be paid by the employer's plan to or for the employee, the employee's beneficiaries, and any covered dependents pursuant to the terms of the plan. Measurement of the expected postretirement benefit obligation is based on the expected amount and timing of future benefits, taking into consideration the expected future cost of providing the benefits and the extent to which those costs are shared by the employer, the employee (including consideration of contributions required during the employee's active service period and following retirement, deductibles, coinsurance provisions, and so forth), or others (such as through governmental programs).

7. The accumulated postretirement benefit obligation as of a particular date is the actuarial present value of all future benefits attributed to an employee's service rendered to that date pursuant to paragraphs 30-31 and 42-45, assuming the plan continues in effect and that all assumptions about future events are fulfilled. Prior to the date on which an employee attains full eligibility for the benefits that employee is expected to earn under the terms of the postretirement benefit plan (the full eligibility date), the accumulated postretirement benefit obligation for an employee is a portion of the expected postretirement benefit obligation. On and after the full eligibility date, the accumulated postretirement benefit obligation and the expected postretirement benefit obligation for an employee are the same. Determination of the full eligibility date is affected by plan terms that provide incremental benefits expected to be received by or on behalf of an employee for additional years of service, unless those incremental benefits are trivial. Determination of the full eligibility date is not affected by plan terms that define when benefit payments commence or by an employee's current dependency status.

8. Net periodic postretirement benefit cost comprises several components that reflect different aspects of the employer's financial arrangements. The service cost component of net periodic postretirement benefit cost is the actuarial present value of benefits attributed to services rendered by employees during the period (the portion of the expected postretirement benefit obligation attributed to service in the period). The service cost component is the same for an unfunded plan, a plan with minimal funding, and a well-funded plan. The other components of net periodic postretirement benefit cost are interest cost (interest on the accumulated postretirement benefit obligation, which is a discounted amount), actual return on plan assets[1], amortization of any prior service cost or credit included in unassigned funds (surplus), amortization of the transition obligation or transition asset, and the gain or loss component which includes, to the extent recognized, amortization of the net gain or loss included in unassigned funds (surplus) (refer to paragraph 49).

[1] To address a question on how the expected return on plan assets affects the determination of net periodic benefit cost if the actual return on plan assets for a period is a component of net periodic benefit cost, it is noted that the expected return on plan assets generally will be different from the actual return on plan assets for the year. This statement provides for recognition of that difference (a net gain or loss) in unassigned funds in the period it arises. The amount recognized in unassigned funds is also a component of net periodic benefit cost for the current period. Thus, the amount recognized in unassigned funds and the actual return on plan assets, when aggregated, equal the expected return on plan assets. The amount recognized in unassigned funds affects future net periodic benefit cost through subsequent amortization, if any, of the net gain or loss. (This footnote reflects guidance included in E12 of FSP FAS 158-1.)

Measurement of Cost and Obligations

Accounting for the Substantive Plan

9. An objective of this statement is that the accounting reflects the terms of the exchange transaction that takes place between an employer that provides postretirement benefits and the employees who render services in exchange for those benefits, as those terms are understood by both parties to the transaction. Generally, the extant written plan provides the best evidence of the terms of that exchange transaction. However, in some situations, an employer's cost-sharing policy, as evidenced by past practice or by communication of intended changes to a plan's cost-sharing provisions, or a past practice of regular increases in certain monetary benefits may indicate that the substantive plan—the plan as understood by the parties to the exchange transaction—differs from the extant written plan. The substantive plan shall be the basis for the accounting.

10. Except as provided in paragraph 11, an employer's cost-sharing policy, as evidenced by the following past practice or communication, shall constitute the cost-sharing provisions of the substantive plan if either of the following conditions exist. Otherwise, the extant written plan shall be considered to be the substantive plan.

a. The employer has a past practice of (1) maintaining a consistent level of cost sharing between the employer and its retirees through changes in deductibles, coinsurance provisions, retiree contributions, or some combination of those changes or (2) consistently increasing or reducing the employer's share of the cost of the covered benefits through changes in retired or active plan participants' contributions toward their retiree health care benefits, deductibles, coinsurance provisions, out-of-pocket limitations, and so forth, in accordance with the employer's established cost-sharing policy.

b. The employer has the ability, and has communicated to affected plan participants its intent, to institute different cost-sharing provisions at a specified time or when certain conditions exist (for example, when health care cost increases exceed a certain level).

11. An employer's past practice of maintaining a consistent level of cost sharing with its retirees or consistently increasing or reducing its share of the cost of providing the covered benefits shall not constitute provisions of the substantive plan if accompanied by identifiable offsetting changes in other benefits or compensation or if the employer incurred significant costs, such as work stoppages, to effect that cost-sharing policy. Similarly, an employer's communication of its intent to institute cost-sharing provisions that differ from the extant written plan or the past cost-sharing practice shall not constitute provisions of the substantive plan (a) if the plan participants would be unwilling to accept the change without adverse consequences to the employer's operations or (b) if other modifications of the plan, such as the level of benefit coverage, or providing offsetting changes in other benefits, such as pension benefits, would be required to gain plan participants' acceptance of the change to the cost-sharing arrangement.

12. A past practice of regular increases in postretirement benefits defined in terms of monetary amounts may indicate that the employer has a present commitment to make future improvements to the plan and that the plan will provide monetary benefits attributable to prior service that are greater than the monetary benefits defined by the extant written plan. In those situations, the substantive commitment to increase those benefits shall be the basis for the accounting. Changes in the benefits, other than benefits defined in terms of monetary amounts, covered by a postretirement health care plan or by other postretirement benefit plans shall not be anticipated.

13. Contributions expected to be received from active employees toward the cost of their postretirement benefits and from retired plan participants are treated similarly for purposes of measuring

an employer's expected postretirement benefit obligation. That obligation is measured as the actuarial present value of the benefits expected to be provided under the plan, reduced by the actuarial present value of contributions expected to be received from the plan participants during their remaining active service and postretirement periods. In determining the amount of the contributions expected to be received from those participants toward the cost of their postretirement benefits, consideration is given to any related substantive plan provisions, such as an employer's past practice of consistently increasing or reducing the contribution rates as described in paragraphs 10-11. An obligation to return contributions received from employees who do not attain eligibility for postretirement benefits and, if applicable, any interest accrued on those contributions shall be recognized as a component of an employer's postretirement benefit obligation.

14. Automatic benefit changes specified by the plan that are expected to occur shall be included in measurements of the expected and accumulated postretirement benefit obligations and the service cost component of net periodic postretirement benefit cost. Also, plan amendments shall be included in the computation of the expected and accumulated postretirement benefit obligations once they have been contractually agreed to, even if some provisions take effect only in future periods. For example, if a plan amendment grants a different benefit level for employees retiring after a future date, that increased or reduced benefit level shall be included in current-period measurements for employees expected to retire after that date.

15. Measuring the net periodic postretirement benefit cost and accumulated postretirement benefit obligation based on best estimates is superior to implying, by a failure to accrue, that no cost or obligation exists prior to the payment of benefits. This statement requires the use of explicit assumptions, each of which individually represents the best estimate of a particular future event, to measure the expected postretirement benefit obligation. A portion of that expected postretirement benefit obligation is attributed to each period of an employee's service associated with earning the postretirement benefits, and that amount is accrued as service cost for that period.

16. The service cost component of postretirement benefit cost, any prior service cost, and the accumulated postretirement benefit obligation are measured using actuarial assumptions and present value techniques to calculate the actuarial present value of the expected future benefits attributed to periods of employee service. Each assumption used shall reflect the best estimate solely with respect to that individual assumption. All assumptions shall presume that the plan will continue in effect in the absence of evidence that it will not continue. Principal actuarial assumptions include the time value of money (discount rates); participation rates (for contributory plans); retirement age; factors affecting the amount and timing of future benefit payments, which for postretirement health care benefits consider past and present per capita claims cost by age, health care cost trend rates, Medicare reimbursement rates, and so forth; salary progression (for pay-related plans); and the probability of payment (turnover, dependency status, mortality, and so forth).

17. Assumed discount rates shall reflect the time value of money as of the measurement date in determining the present value of future cash outflows currently expected to be required to satisfy the postretirement benefit obligation. In making that assumption, employers shall look to rates of return on high-quality fixed-income investments currently available whose cash flows match the timing and amount of expected benefit payments. If settlement of the obligation with third-party insurers is possible (for example, the purchase of nonparticipating life insurance contracts to provide death benefits), the interest rates inherent in the amount at which the postretirement benefit obligation could be settled are relevant in determining the assumed discount rates. Assumed discount rates are used in measurements of the expected and accumulated postretirement benefit obligations and the service cost and interest cost components of net periodic postretirement benefit cost.

18. Pursuant to paragraph 17, an employer shall look to rates of return on high-quality fixed-income investments in determining assumed discount rates. The objective of selecting assumed discount rates

using that method is to measure the single amount that, if invested at the measurement date in a portfolio of high-quality debt instruments, would provide the necessary future cash flows to pay the postretirement benefits when due. Notionally, that single amount, the accumulated postretirement benefit obligation, would equal the current fair value of a portfolio of high-quality zero coupon bonds whose maturity dates and amounts would be the same as the timing and amount of the expected future benefit payments. Because cash inflows would equal cash outflows in timing and amount, there would be no reinvestment risk in the yields to maturity of the portfolio. However, in other than a zero coupon portfolio, such as a portfolio of long-term debt instruments that pay semiannual interest payments or whose maturities do not extend far enough into the future to meet expected benefit payments, the assumed discount rates (the yield to maturity) need to incorporate expected reinvestment rates available in the future. Those rates shall be extrapolated from the existing yield curve at the measurement date. The determination of the assumed discount rate is separate from the determination of the expected rate of return on plan assets whenever the actual portfolio differs from the hypothetical portfolio described above. Assumed discount rates shall be reevaluated at each measurement date. If the general level of interest rates rises or declines, the assumed discount rates shall change in a similar manner.

19. The expected long-term rate of return on plan assets shall reflect the average rate of earnings expected on the existing assets that qualify as plan assets and contributions to the plan expected to be made during the period. In estimating that rate, appropriate consideration should be given to the returns being earned on the plan assets currently invested and the rates of return expected to be available for reinvestment. If the return on plan assets is taxable to the trust or other fund under the plan, the expected long-term rate of return shall be reduced to reflect the related income taxes expected to be paid under existing law. There is no assumption of an expected long-term rate of return on plan assets for plans that are unfunded or that have no assets that qualify as plan assets pursuant to this statement.

20. The service cost component of net periodic postretirement benefit cost and the expected and accumulated postretirement benefit obligations shall reflect future compensation levels to the extent the postretirement benefit formula defines the benefits wholly or partially as a function of future compensation levels. For pay-related plans, assumed compensation levels shall reflect the best estimate of the actual future compensation levels of the individual employees involved, including future changes attributed to general price levels, productivity, seniority, promotion, and other factors. All assumptions shall be consistent to the extent that each reflects expectations about the same future economic conditions, such as future rates of inflation. Measuring service cost and the expected and accumulated postretirement benefit obligations based on estimated future compensation levels entails considering any indirect effects, such as benefit limitations, that would affect benefits provided by the plan.

Assumptions Unique to the Postretirement Health Care Benefits

21. Measurement of an employer's postretirement health care obligation requires the use of several assumptions unique to health care benefits. Most significantly, it includes several assumptions about factors that will affect the amount and timing of future benefit payments for postretirement health care. Those factors include consideration of historical per capita claims cost by age, health care cost trend rates (for plans that provide a benefit in kind), and medical coverage to be paid by governmental authorities and other providers of health care benefits.

22. In principle, an employer's share of the expected future postretirement health care cost for a plan participant is developed by reducing the assumed per capita claims cost at each age at which the plan participant is expected to receive benefits under the plan by (a) the effects of coverage by Medicare [(INT 04-17)] and other providers of health care benefits, and (b) the effects of the cost-sharing provisions of the plan (deductibles, copayment provisions, out-of-pocket limitations, caps on the limits of the employer-provided payments, and retiree contributions). The resulting amount represents the assumed net incurred claims cost at each age at which the plan participant is expected to receive benefits under the plan. If contributions are required to be paid by active plan participants toward their postretirement health

care benefits, the actuarial present value of the plan participants' future contributions reduces the actuarial present value of the aggregate assumed net incurred claims costs.

23. The assumed per capita claims cost by age is the annual per capita cost, for periods after the measurement date, of providing the postretirement health care benefits covered by the plan from the earliest age at which an individual could begin to receive benefits under the plan through the remainder of the individual's life or the covered period, if shorter. The assumed per capita claims cost shall be the best estimate of the expected future cost of the benefits covered by the plan. It may be appropriate to consider other factors in addition to age, such as sex and geographical location, in developing the assumed per capita claims cost.

24. Past and present claims data for the plan, such as a historical pattern of gross claims by age (claims curve), should be used in developing the current per capita claims cost to the extent that those data are considered to be indicative of the current cost of providing the benefits covered by the plan. Those current claims data shall be adjusted by the assumed health care cost trend rate. The resulting assumed per capita claims cost by age, together with the plan demographics, determines the amount and timing of expected future gross eligible charges.

25. In the absence of sufficiently reliable plan data about the current cost of the benefits covered by the plan, the current per capita claims cost should be based, entirely or in part, on the claims information of other employers to the extent those costs are indicative of the current cost of providing the benefits covered by the plan. For example, the current per capita claims cost may be based on the claims experience of other employers derived from information in data files developed by insurance companies, actuarial firms, or employee benefits consulting firms. The current per capita claims cost developed on those bases shall be adjusted to best reflect the terms of the employer's plan and the plan demographics. For example, the information should be adjusted, as necessary, for differing demographics, such as the age and sex of plan participants, health care utilization patterns by men and women at various ages, and the expected geographical location of retirees and their dependents, and for significant differences between the nature and types of benefits covered by the employer's plan and those encompassed by the underlying data.

26. The assumption about health care cost trend rates represents the expected annual rates of change in the cost of health care benefits currently provided by the postretirement benefit plan, due to factors other than changes in the demographics of the plan participants, for each year from the measurement date until the end of the period in which benefits are expected to be paid. Past and current health care cost trends shall be used in developing an employer's assumed health care cost trend rates, which implicitly consider estimates of health care inflation, changes in health care utilization or delivery patterns, technological advances, and changes in the health status of plan participants. Differing services, such as hospital care and dental care, may require the use of different health care cost trend rates. It is appropriate for that assumption to reflect changes in health care cost trend rates over time. For example, the health care cost trend rates may be assumed to continue at the present level for the near term, or increase for a period of time, and then grade down over time to an estimated health care cost trend rate ultimately expected to prevail.

27. Certain medical claims may be covered by governmental programs under existing law or by other providers of health care benefits. Benefit coverage by those governmental programs shall be assumed to continue as provided by the present law and by other providers pursuant to their present plans. Presently enacted changes in the law or amendments of the plans of other health care providers that take effect in future periods and that will affect the future level of their benefit coverage shall be considered in current-period measurements for benefits expected to be provided in those future periods. Future changes in laws concerning medical costs covered by governmental programs and future changes in the plans of other providers shall not be anticipated.

28. In some cases, determining the assumed per capita claims cost by age as described in paragraphs 23-25 may not be practical because credible historical information about the gross per capita cost of covered benefits may not be available or determinable to satisfy the stated measurement approach. However, credible historical information about incurred claims costs may be available. In those cases, an alternative method of developing the assumed per capita claims cost may be used provided the method results in a measure that is the best estimate of the expected future cost of the benefits covered by the plan. For example, the assumed health care cost trend rates may be determined by adjusting the expected change in the employer's share of per capita incurred claims cost by age by a factor that reflects the effects of the plan's cost-sharing provisions. However, an approach that projects net incurred claims costs using unadjusted assumed health care cost trend rates would implicitly assume changes in the plan's cost-sharing provisions at those assumed rates and, therefore, is not acceptable unless the plan's cost-sharing provisions are indexed in that manner or the substantive plan operates in that manner.

29. Assumed discount rates include an inflationary element that reflects the expected general rate of inflation. Assumed compensation levels include consideration of future changes attributable to general price levels. Similarly, assumed health care cost trend rates include an element that reflects expected general rates of inflation for the economy overall and an element that reflects price changes of health care costs in particular. To the extent that those assumptions consider similar inflationary effects, the assumptions about those effects shall be consistent.

Attribution

30. An equal amount of the expected postretirement benefit obligation for an employee generally shall be attributed to each year of service in the attribution period (a benefit/years-of-service approach). However, some plans may have benefit formulas that attribute a disproportionate share of the expected postretirement benefit obligation to employees' early years of service. For that type of plan, the expected postretirement benefit obligation shall be attributed in accordance with the plan's benefit formula.

31. The beginning of the attribution period generally shall be the date of hire. However, if the plan's benefit formula grants credit only for service from a later date and that credited service period is not nominal in relation to employees' total years of service prior to their full eligibility dates, the expected postretirement benefit obligation shall be attributed from the beginning of that credited service period. In all cases, the end of the attribution period shall be the full eligibility date.

Recognition of Liabilities and Assets

32. An employer that sponsors one or more single-employer defined benefit postretirement plans other than pensions shall recognize in its statement of financial position the funded statuses of those plans. The status for each plan shall be measured as the difference between the fair value of plan assets and the accumulated postretirement benefit obligation (considering both vested and nonvested employees) as it is defined in this statement.

33. The employer shall aggregate the statuses of all overfunded plans and recognize that amount as a nonadmitted asset in its statement of financial position. It also shall aggregate the statuses of all underfunded plans and recognize that amount as a liability in its statement of financial position. It is not acceptable statutory accounting practice to offset pension or postretirement benefits other than pensions liability generated by one plan against the prepaid assets of another plan.

Recognition of Net Periodic Postretirement Benefit Cost

34. As with other forms of deferred compensation, the cost of providing postretirement benefits shall be attributed to the periods of employee service rendered in exchange for those future benefits pursuant to the terms of the plan. That cost notionally represents the change in the unfunded accumulated postretirement benefit obligation for the period, ignoring employer contributions to the plan, plan

settlements, and payments made by the employer directly to retirees. However, changes in that unfunded obligation that arise from experience gains and losses and the effects of changes in assumptions may be recognized as a component of net periodic postretirement benefit cost on a delayed basis. In addition, the effects of a plan initiation or amendment generally are recognized on a delayed basis.

35. The following components shall be included in the net postretirement benefit cost recognized for a period by an employer sponsoring a defined benefit postretirement plan: a) Service cost; b) Interest cost; c) Actual return on plan assets, if any; d) Amortization of any prior service cost or credit included in unassigned funds (surplus) to the extent required by paragraphs 40-45; e) Gain or loss (including the effects of changes in assumptions) to the extent recognized; and f) Amortization of any obligation or asset existing at the date of initial application of this statement, hereinafter referred to as the transition obligation or transition asset remaining in unassigned funds (surplus).

Service Cost

36. The service cost component recognized in a period shall be determined as the portion of the expected postretirement benefit obligation attributed to employee service during that period. The measurement of the service cost component requires identification of the substantive plan and the use of assumptions and an attribution method, which are discussed in paragraphs 9-31.

37. The prior service cost for nonvested employees not previously recognized[2] is not required to be included in net postretirement benefit cost entirely in the year this standard is adopted. Unrecognized prior service cost for nonvested employees shall be amortized as a component of the net postretirement benefit cost by assigning an equal amount to each expected future period of service before vesting occurs for nonvested employees active at the date of the amendment. Unassigned funds (surplus) is adjusted each period as prior service cost is amortized (refer to paragraphs ~~100-103~~101-104 for transition guidance related to the recognition of the prior service cost for nonvested employees through unassigned surplus).

Interest Cost

38. The interest cost component recognized in a period shall be determined as the increase in the accumulated postretirement benefit obligation to recognize the effects of the passage of time. Measuring the accumulated postretirement benefit obligation as a present value requires accrual of an interest cost at rates equal to the assumed discount rates.

Actual Return on Plan Assets

39. For a funded plan, the actual return on plan assets shall be determined based on the fair value of plan assets at the beginning and end of the period, adjusted for contributions and benefit payments. If the fund holding the plan assets is a taxable entity, the actual return on plan assets shall reflect the tax expense or benefit for the period determined in accordance with generally accepted accounting principles. Otherwise, no provision for taxes shall be included in the actual return on plan assets.

Prior Service Cost

40. Plan amendments (including initiation of a plan) may include provisions that attribute the increase or reduction in benefits to employee service rendered in prior periods or only to employee service to be rendered in future periods. For purposes of measuring the accumulated postretirement benefit obligation, the effect of a plan amendment on a plan participant's expected postretirement benefit

[2] The previous statutory accounting guidance in *SSAP No. 14—Postretirement Benefits Other Than Pensions* excluded nonvested employees from the service cost calculation. This exclusion has been eliminated with the issuance of this SSAP.

obligation shall be attributed to each year of service in that plan participant's attribution period, including years of service already rendered by that plan participant, in accordance with the attribution of the expected postretirement benefit obligation to years of service as discussed in paragraphs 30-31. If a plan is initiated that grants benefits solely in exchange for employee service after the date of the plan initiation or a future date, no portion of the expected postretirement benefit obligation is attributed to prior service periods because, in that case, the credited service period for the current employees who are expected to receive benefits under the plan begins at the date of the plan initiation or the future date.

41. Plan amendments that improve benefits are granted with the expectation that the employer will realize economic benefits in future periods. Consequently, except as discussed in paragraph 44, this statement does not permit the cost of benefit improvements (that is, prior service cost) to be included in net periodic postretirement benefit cost entirely in the year of the amendment. Rather, paragraph 42 provides for recognition of prior service cost arising from benefit improvements during the remaining years of service to the full eligibility dates of those plan participants active at the date of the plan amendment.

42. A plan amendment that retroactively increases benefits (including benefits that are granted to fully eligible plan participants) increases the accumulated postretirement benefit obligation. The cost of the benefit improvement shall be recognized as a charge to unassigned funds (surplus) at the date of the amendment. Except as specified in the next sentence and in paragraphs 43-44, that prior service cost shall be amortized as a component of net periodic postretirement benefit cost by assigning an equal amount to each remaining year of service to the full eligibility date of each plan participant active at the date of the amendment who was not yet fully eligible for benefits at that date. If all or almost all of a plan's participants are fully eligible for benefits, the prior service cost shall be amortized based on the remaining life expectancy of those plan participants rather than on the remaining years of service to the full eligibility dates of the active plan participants. Unassigned funds (surplus) is adjusted as a result of amortizing prior service cost.

43. To reduce the complexity and detail of the computations required, consistent use of an alternative approach that more rapidly amortizes the prior service cost recognized in unassigned funds (surplus) is permitted. For example, a straight-line amortization of the cost over the average remaining years of service to full eligibility for benefits of the active plan participants is acceptable.

44. In some situations, a history of regular plan amendments and other evidence may indicate that the period during which the employer expects to realize economic benefits from an amendment that grants increased benefits is shorter than the remaining years of service to full eligibility for benefits of the active plan participants. Identification of those situations requires an assessment of the individual circumstances of the particular plan. In those circumstances, the amortization of prior service cost shall be accelerated to reflect the more rapid expiration of the employer's economic benefits and to recognize the cost in the periods benefited.

45. A plan amendment that retroactively reduces, rather than increases, benefits decreases the accumulated postretirement benefit obligation. The reduction in benefits shall be recognized as a corresponding credit (prior service credit) to unassigned funds (surplus) that shall be used first to reduce any remaining prior service cost included in unassigned funds (surplus), then to reduce any transition obligation remaining in unassigned funds (surplus). The excess, if any, shall be amortized as a component of net periodic postretirement benefit cost on the same basis as specified in paragraph 42 for prior service cost. Immediate recognition of the excess is not permitted.

Gains and Losses

46. Gains and losses are changes in the amount of either the accumulated postretirement benefit obligation or plan assets resulting from experience different from that assumed or from changes in assumptions. This statement generally does not distinguish between those sources of gains and losses. Gains and losses include amounts that have been realized as well as amounts that are unrealized. Because gains and losses may reflect refinements in estimates as well as real changes in economic values and because some gains in one period may be offset by losses in another or vice versa, this statement does not require recognition of gains and losses as components of net postretirement benefit cost in the period in which they arise, except as described in paragraph 51. Gains and losses that are not recognized immediately as a component of net periodic postretirement benefit cost shall be recognized as increases or decreases in unassigned funds (surplus) as they arise.

47. The expected return on plan assets shall be determined based on the expected long-term rate of return on plan assets and the fair value of plan assets.

48. Plan asset gains and losses are differences between the actual return on plan assets during a period and the expected return on plan assets for that period. Plan asset gains and losses include changes reflected in the fair value of plan assets.

49. As a minimum, amortization of a net gain or loss included in unassigned funds (surplus) shall be included as a component of net periodic postretirement benefit cost for a year if, as of the beginning of the year, that net gain or loss exceeds 10 percent of the greater of the accumulated postretirement benefit obligation or the fair value of plan assets. If amortization is required, the minimum amortization shall be that excess divided by the average remaining service period of active plan participants. If all or almost all of a plan's participants are inactive, the average remaining life expectancy of the inactive participants shall be used instead of the average remaining service period.

50. Any systematic method of amortizing gains and losses included in unassigned funds (surplus) may be used in place of the minimum amortization specified in paragraph 49 provided that (a) the minimum amortization is recognized in any period in which it is greater (reduces the net gain or loss balance by more) than the amount that would be recognized under the method used, (b) the method is applied consistently, (c) the method is applied similarly to both gains and losses, and (d) the method used is disclosed. If an enterprise uses a method of consistently recognizing gains and losses immediately, any gain that does not offset a loss previously recognized in income pursuant to this paragraph shall first offset any transition obligation remaining in unassigned funds (surplus); any loss that does not offset a gain previously recognized in income pursuant to this paragraph shall first offset any transition asset remaining in unassigned funds (surplus).

51. In some situations, an employer may forgive a retrospective adjustment of the current or past years' cost-sharing provisions of the plan as they relate to benefit costs already incurred by retirees or may otherwise deviate from the provisions of the substantive plan to increase or decrease the employer's share of the benefit costs incurred in the current or past periods. The effect of a decision to temporarily deviate from the substantive plan shall be immediately recognized as a loss or gain.

52. The gain or loss component of net periodic postretirement benefit cost shall consist of (a) the difference between the actual return on plan assets and the expected return on plan assets, (b) any gain or loss immediately recognized or the amortization of the net gain or loss included in unassigned funds (surplus), and (c) any amount immediately recognized as a gain or loss pursuant to paragraph 51.

Measurement of Plan Assets

53. Plan assets are assets—usually stocks, bonds, and other investments (except certain insurance contracts as noted in paragraph 57)—that have been segregated and restricted (usually in a trust) to be used for postretirement benefits. The amount of plan assets includes amounts contributed by the employer, and by plan participants for a contributory plan, and amounts earned from investing the contributions, less benefits, income taxes, and other expenses incurred. Plan assets ordinarily cannot be withdrawn by the employer except under certain circumstances when a plan has assets in excess of obligations and the employer has taken certain steps to satisfy existing obligations. Securities of the employer held by the plan are includable in plan assets provided they are transferable.

54. Assets not segregated in a trust, or otherwise effectively restricted, so that they cannot be used by the employer for other purposes are not plan assets for purposes of this statement, even though the employer may intend that those assets be used to provide postretirement benefits. Those assets shall be accounted for in the same manner as other employer assets of a similar nature and with similar restrictions. Amounts accrued by the employer but not yet paid to the plan are not plan assets for purposes of this statement.

55. Plan investments, whether equity or debt securities, real estate, or other, shall be measured at their fair value as of the measurement date.

56. Plan assets used in plan operations (for example, buildings, equipment, furniture and fixtures, and leasehold improvements) shall be measured at cost less accumulated depreciation or amortization for all purposes.

Insurance Contracts

57. For purposes of this statement, an insurance contract is defined as a contract in which an insurance company unconditionally undertakes a legal obligation to provide specified benefits to specific individuals in return for a fixed consideration or premium; an insurance contract is irrevocable and involves the transfer of significant risk from the employer (or the plan) to the insurance company. Benefits covered by insurance contracts shall be excluded from the accumulated postretirement benefit obligation. Insurance contracts shall be excluded from plan assets.

58. Some insurance contracts (participating insurance contracts) provide that the purchaser (either the plan or the employer) may participate in the experience of the insurance company. Under those contracts, the insurance company ordinarily pays dividends to the purchaser, the effect of which is to reduce the cost of the plan. If the participating insurance contract causes the employer to remain subject to all or most of the risks and rewards associated with the benefit obligation covered or the assets transferred to the insurance company, that contract is not an insurance contract for purposes of this statement, and the purchase of that contract does not constitute a settlement pursuant to paragraphs ~~80 through 85~~81-86. Endorsement split-dollar life insurance contracts[3] do not settle a liability for a postretirement benefit obligation. For these contracts and other insurance contracts that do not constitute settlement, reporting

[3] An endorsement split-dollar life insurance arrangement is a split-dollar life insurance arrangement in which the entity owns and controls the insurance policy. The employer enters into a separate agreement that splits the policy benefits between the employer and the employee. The employer owns the policy, controls all rights of ownership, and may terminate the insurance policy (and, in turn, the policy benefits promised to the employee). To effect the split-dollar arrangement, the employer endorses a portion of the death benefits to the employee (the employee designates a beneficiary for this portion of the death benefits). Upon the death of the employee, the employee's beneficiary typically receives the designated portion of the death benefits directly from the insurance entity and the employer receives the remainder of the death benefits. SSAP No. 21, paragraph 6 provides guidance for amounts reporting entities can realize when they are owner and beneficiary, or otherwise have obtained rights to control insurance policies.

entities shall accrue a liability for the postretirement benefit arrangement in accordance with this statement.

59. The purchase price of a participating insurance contract ordinarily is higher than the price of an equivalent contract without a participation right. The difference is the cost of the participation right. The cost of the participation right shall be recognized at the date of purchase as a nonadmitted asset. In subsequent periods, the participation right shall be nonadmitted and measured at its fair value if the contract is such that fair value is reasonably estimable. Otherwise the participation right shall be measured at its amortized cost (not in excess of its net realizable value), and the cost shall be amortized systematically over the expected dividend period under the contract.

60. To the extent that insurance contracts are purchased during the period to cover postretirement benefits attributed to service in the current period (such as life insurance benefits), the cost of those benefits shall be the cost of purchasing the coverage under the contracts, except as provided in paragraph 59 for the cost of a participation right. If all the postretirement benefits attributed to service in the current period are covered by nonparticipating insurance contracts purchased during that period, the cost of the contracts determines the service cost component of net postretirement benefit cost for that period. Benefits attributed to current service in excess of benefits provided by nonparticipating insurance contracts purchased during the current period shall be accounted for according to the provisions of this statement applicable to plans not involving insurance contracts.

61. Other contracts with insurance companies may not meet the definition of an insurance contract because the insurance company does not unconditionally undertake a legal obligation to provide specified benefits to specified individuals. Those contracts shall be accounted for as investments and measured at fair value. If a contract has a determinable cash surrender value or conversion value, that is presumed to be its fair value. For some contracts, the best available estimate of fair value may be contract value.

Measurement Date

62. The measurements of plan assets and benefit obligations required by this statement shall be as of the date of the employer's fiscal year-end statement of financial position. Even though the postretirement benefit measurements are required as of a particular date, all procedures are not required to be performed after that date. As with other financial statement items requiring estimates, much of the information can be prepared as of an earlier date and projected forward to account for subsequent events (for example, employee service).

63. Measurements of net periodic postretirement benefit cost for both interim and annual financial statements generally shall be based on the assumptions at the beginning of the year (assumptions used for the previous year-end measurements of plan assets and obligations) unless more recent measurements of both plan assets and the accumulated postretirement benefit obligation are available. For example, if a significant event occurs, such as a plan amendment, settlement, or curtailment, that ordinarily would call for remeasurement, the assumptions used for those later measurements shall be used to remeasure net periodic postretirement benefit cost from the date of the event to the year-end measurement date. Unless an employer remeasures both its plan assets and benefit obligations during the fiscal year, the funded status it reports in its interim-period statement of financial position shall be the same asset or liability recognized in the previous year-end statement of financial position adjusted for (a) subsequent accruals of net periodic postretirement benefit cost that exclude the amortization of amounts previously recognized in unassigned funds (surplus) (for example, subsequent accruals of service cost, interest cost, and return on plan assets) and (b) contributions to a funded plan, or benefit payments. Upon remeasurement, a business entity shall adjust its statement of financial position in a subsequent interim period to reflect the overfunded or underfunded status of the plan consistent with that measurement date.

Disclosures - Single-Employer Defined Postretirement Plans

64. An employer that sponsors one or more other defined benefit postretirement plans shall provide the following information for postretirement benefit plans other than pensions. Amounts related to the employer's results of operations shall be disclosed for each period for which a statement of income is presented. Amounts related to the employer's statement of financial position, shall be disclosed as of the date of each statement of financial position presented.

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

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

c. The funded status of the plans and the amounts recognized in the statement of financial position, showing separately the assets (nonadmitted) and liabilities recognized.

d. The objectives of the disclosures about postretirement benefit plan assets are to provide users of financial statements with an understanding of:

i. How investment allocation decisions are made, including the factors that are pertinent to an understanding of investment policies and strategies

ii. The classes of plan assets

iii. The inputs and valuation techniques used to measure the fair value of plan assets

iv. The effect of fair value measurements using significant unobservable inputs (Level 3) on changes in plan assets for the period

v. Significant concentrations of risk within plan assets.

An employer shall consider those overall objectives in providing the following information about plan assets:

(a) A narrative description of investment policies and strategies, including target allocation percentages or range of percentages considering the classes of plan assets disclosed pursuant to (b) below, as of the latest statement of financial position presented (on a weighted-average basis for employers with more than one plan), and other factors that are pertinent to an understanding of those policies and strategies such as investment goals, risk management practices, permitted and prohibited investments including the use of derivatives, diversification, and the relationship between plan assets and benefit obligations. For investment funds disclosed as classes as described in (b) below, a description of the significant investment strategies of those funds shall be provided.

(b) The fair value of each class of plan assets as of each date for which a statement of financial position is presented. Asset classes shall be based on the nature and risks of assets in an employer's plan(s). Examples of classes of assets include, but are not limited to, the following: cash and cash equivalents; equity securities, (segregated by industry type, company size, or investment objective); debt securities, issued by national, state, and local governments; corporate debt securities; asset-backed securities; structured debt; derivatives on a gross basis (segregated by type of underlying risk in the contract, for example, interest rate contracts, foreign exchange contracts, equity contracts, commodity contracts, credit contracts, and other contracts); investment funds (segregated by type of fund); and real estate. Those examples are not meant to be all inclusive. An employer should consider the overall objectives in paragraph 64.d. in determining whether additional classes of plan assets or further disaggregation of classes should be disclosed.

(c) A narrative description of the basis used to determine the overall expected long-term rate-of-return-on-assets assumption, such as the general approach used, the extent to which the overall rate-of-return-on-assets assumption was based on historical returns, the extent to which adjustments were made to those historical returns in order to reflect expectations of future returns, and how those adjustments were determined. The description should consider the classes of assets described in (b) above, as appropriate.

(d) Information that enables users of financial statements to assess the inputs and valuation techniques used to develop fair value measurements of plan assets at the reporting date. For fair value measurements using significant unobservable inputs, an employer shall disclose the effect of the measurements on changes in plan assets for the period. To meet those objectives, the employer shall disclose the following information for each class of plan assets disclosed pursuant to (b) above for each annual period:

(1) The level within the fair value hierarchy in which the fair value measurements in their entirety fall,[4] segregating fair value measurements using quoted prices in active markets for identical assets or liabilities (Level 1), significant other observable inputs (Level 2), and significant unobservable inputs (Level 3)

(2) For fair value measurements of plan assets using significant unobservable inputs (Level 3), a reconciliation of the beginning and ending balances, separately presenting changes during the period attributable to the following:

[4] In some cases, the inputs used to measure fair value might fall in different levels of the fair value hierarchy. The level in the fair value hierarchy within which the fair value measurement in its entirety falls shall be determined based on the lowest level input that is significant to the fair value measurement in its entirety. Assessing the significance of a particular input to the fair value measurement in its entirety requires judgment, considering factors specific to the asset or liability.

(i) Actual return on plan assets, separately identifying the amount related to assets still held at the reporting date and the amount related to assets sold during the period

(ii) Purchases, sales, and settlements, net

(iii) Transfers in and/or out of Level 3 (for example, transfers due to changes in the observability of significant inputs)

(3) Information about the valuation technique(s) and inputs used to measure fair value and a discussion of changes in valuation techniques and inputs, if any, during the period.

e. The benefits (as of the date of the latest statement of financial position presented) expected to be paid in each of the next five fiscal years, and in the aggregate for the five fiscal years thereafter. The expected benefits should be estimated based on the same assumptions used to measure the company’s benefit obligation at the end of the year and should include benefits attributable to estimated future employee service.

f. The employer’s best estimate, as soon as it can reasonably be determined, of contributions expected to be paid to the plan during the next fiscal year beginning after the date of the latest statement of financial position presented. Estimated contributions may be presented in the aggregate combining (1) contributions required by funding regulations or laws, (2) discretionary contributions, and (3) noncash contributions.

g. The amount of net periodic benefit cost recognized, showing separately the service cost component, the interest cost component, the expected return on plan assets for the period, the gain or loss component, the prior service cost or credit component, the transition asset or obligation component, and the gain or loss recognized due to settlements or curtailments.

h. Separately the net gain or loss and net prior service cost or credit recognized in unassigned funds (surplus) for the period pursuant to paragraphs 42 and 46, and reclassification adjustments of unassigned funds (surplus) for the period, as those amounts, including amortization of the net transition asset or obligation, are recognized as components of net periodic benefit cost.

i. The amounts in unassigned funds (surplus) that have not yet been recognized as components of net periodic benefit cost, showing separately the net gain or loss, net prior service cost or credit, and net transition asset or obligation.

j. On a weighted-average basis, the following assumptions used in the accounting for the plans: assumed discount rates, rates of compensation increase (for pay-related plans), and expected long-term rates of return on plan assets specifying, in a tabular format, the assumptions used to determine the benefit obligation and the assumptions used to determine net benefit cost.

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

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

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

n. If applicable, any alternative method used to amortize prior service amounts or net gains and losses pursuant to paragraphs 43 and 50.

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

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

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

r. The amounts in unassigned funds (surplus) expected to be recognized as components of net periodic benefit cost over the fiscal year that follows the most recent annual statement of financial position presented, showing separately the net gain or loss, net prior service cost or credit, and net transition asset or obligation.

s. The amount and timing of any plan assets expected to be returned to the employer during the 12-month period, or operating cycle if longer, that follows the most recent annual statement of financial position presented.

Employers with Two or More Plans

65. Postretirement benefits offered by an employer may vary in nature and may be provided to different groups of employees. As discussed in paragraph 66, in some cases an employer may aggregate data from unfunded plans for measurement purposes in lieu of performing separate measurements for each unfunded plan (including plans whose designated assets are not appropriately segregated and restricted and thus have no plan assets as that term is used in this statement). Net periodic postretirement benefit cost, the accumulated postretirement benefit obligation, and plan assets shall be determined for each separately measured plan or aggregation of plans by applying the provisions of this statement to each such plan or aggregation of plans.

66. The data from all unfunded postretirement health care plans may be aggregated for measurement purposes if (a) those plans provide different benefits to the same group of employees or (b) those plans provide the same benefits to different groups of employees. Data from other unfunded postretirement welfare benefit plans may be aggregated for measurement purposes in similar circumstances, such as when an employer has a variety of welfare benefit plans that provide benefits to the same group of employees. However, a plan that has plan assets (as defined herein) shall not be aggregated with other plans but shall be measured separately.

Disclosures – Employers with Two or More Defined Benefit Plans

67. The disclosures required by this statement shall be aggregated for all of an employer's other defined benefit postretirement plans unless disaggregating in groups is considered to provide useful information or is otherwise required by this paragraph and paragraph 68 of this statement. Disclosures shall be as of the date of each statement of financial position presented. If aggregate disclosures are presented, an employer shall disclose:

a. The aggregate benefit obligation and aggregate fair value of plan assets for plans with benefit obligations in excess of plan assets as of the measurement date of each statement of financial position presented.

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

Interim Financial Disclosures – Defined Benefit Plans

69. The following shall be disclosed within interim financial statements that include a statement of income:

a. The amount of net periodic benefit cost recognized, for each period for which a statement of income is presented, showing separately the service cost component, the interest cost component, the expected return on plan assets for the period, the gain or loss component, the amount prior service cost or credit component, the transition asset or obligation component, and the gain or loss recognized due to a settlement or curtailment.

b. The total amount of the employer's contributions paid, and expected to be paid, during the current fiscal year, if significantly different from amounts previously disclosed pursuant to paragraph 64.f. of this statement. Estimated contributions may be presented in the aggregate combining (1) contributions required by funding regulations or laws, (2) discretionary contributions, and (3) noncash contributions.

Multiemployer Plans

70. For purposes of this statement, a multiemployer plan is a postretirement benefit plan to which two or more unrelated employers contribute, usually pursuant to one or more collective-bargaining agreements. A characteristic of multiemployer plans is that assets contributed by one participating employer may be used to provide benefits to employees of other participating employers since assets contributed by an employer are not segregated in a separate account or restricted to provide benefits only to employees of that employer.

71. An employer participating in a multiemployer plan shall recognize as net postretirement benefit cost the required contribution for the period, which shall include both cash and the fair value of noncash contributions, and shall recognize as a liability any unpaid contributions required for the period.

72. In some situations, withdrawal from a multiemployer plan may result in an employer having an obligation to the plan for a portion of the plan's unfunded accumulated postretirement benefit obligation. If it is either probable or reasonably possible that (a) an employer would withdraw from the plan under circumstances that would give rise to an obligation or (b) an employer's contribution to the fund would be increased during the remainder of the contract period to make up a shortfall in the funds necessary to maintain the negotiated level of benefit coverage (a "maintenance of benefits" clause), the employer shall

apply the provisions *SSAP No. 5R—Liabilities, Contingencies, and Impairments of Assets* (SSAP No. 5R).

Disclosures - Multiemployer Plans

73. An employer shall disclose the amount of contributions to multiemployer plans for each annual period for which a statement of income is presented. An employer may disclose total contributions to multiemployer plans without disaggregating the amounts attributable to pension plans and other postretirement benefit plans. The disclosures shall include a description of the nature and effect of any changes affecting comparability, such as a change in the rate of employer contributions, a business combination, or a divestiture. This disclosure shall identify whether the contributions represent more than 5 percent of total contributions to the plan as indicated in the plan's most recently available annual report.

74. In addition to the requirements of paragraph 73, the following information shall be disclosed:

a. Whether a funding improvement plan or rehabilitation plan had been implemented or is pending.

b. Whether the reporting entity paid a surcharge to the plan.

c. A description of minimum contributions required for future periods, if applicable.

d. A qualitative description of the extent to which the employer could be responsible for the obligations of the plan, including benefits earned by employees during employment with another employer.

~~74.~~75. Pursuant to paragraph 72, if withdrawal under circumstances that would give rise to an obligation is either probable or reasonably possible, the provisions and disclosures of SSAP No. 5R, shall apply.

Multiple-Employer Plans

~~75.~~76. Some postretirement benefit plans to which two or more unrelated employers contribute are not multiemployer plans. Rather, those multiple-employer plans are in substance aggregations of single-employer plans, combined to allow participating employers to pool plan assets for investment purposes or to reduce the costs of plan administration. Those plans ordinarily do not involve collective-bargaining agreements. They may also have features that allow participating employers to have different benefit formulas, with the employer's contributions to the plan based on the benefit formula selected by the employer. Those plans shall be considered single-employer plans rather than multiemployer plans for purposes of this statement, and each employer's accounting shall be based on its respective interest in the plan.

Postretirement Benefit Plans Outside the United States

~~76.~~77. This statement includes no special provisions applicable to postretirement benefit arrangements outside the United States. Those arrangements are subject to the provisions of this statement. The applicability of this statement to those arrangements is determined by the nature of the obligation and by the terms or conditions that define the amount of benefits to be paid, not by whether or how a plan is funded, whether benefits are payable at intervals or as a single amount, or whether the benefits are required by law or custom or are provided under a plan the employer has elected to sponsor.

Business Combinations

~~77.~~78. When an employer is acquired in a business combination and that employer sponsors a single-employer defined benefit postretirement plan, the assignment of the purchase price to individual assets acquired and liabilities assumed shall include a liability for the accumulated postretirement benefit obligation in excess of the fair value of the plan assets or an asset for the fair value of the plan assets in excess of the accumulated postretirement benefit obligation. The accumulated postretirement benefit obligation assumed shall be measured based on the benefits attributed by the acquired entity to employee service prior to the date the business combination is consummated, adjusted to reflect (a) any changes in assumptions based on the purchaser's assessment of relevant future events (as discussed in paragraphs 9-29) and (b) the terms of the substantive plan (as discussed in paragraphs 9-14) to be provided by the purchaser to the extent they differ from the terms of the acquired entity's substantive plan.

~~78.~~79. If the postretirement benefit plan of the acquired entity is amended as a condition of the business combination (for example, if the change is required by the seller as part of the consummation of the acquisition), the effects of any improvements attributed to services rendered by the participants of the acquired entity's plan prior to the date of the business combination shall be accounted for as part of the accumulated postretirement benefit obligation of the acquired entity. Otherwise, if improvements to the postretirement benefit plan of the acquired entity are not a condition of the business combination, credit granted for prior service shall be recognized as a plan amendment as discussed in paragraphs 40-45. If it is expected that the plan will be terminated or curtailed, the effects of those actions shall be considered in measuring the accumulated postretirement benefit obligation. Otherwise, no future changes to the plan shall be anticipated.

~~79.~~80. As a result of applying the provisions of paragraphs ~~77-78~~78-79, any previously existing net gain or loss, prior service cost or credit, or transition obligation or transition asset remaining in unassigned funds (surplus) is eliminated for the acquired employer's plan.

Accounting for Settlement of a Postretirement Benefit Obligation

~~80.~~81. For purposes of this statement, a settlement is defined as a transaction that (a) is an irrevocable action, (b) relieves the employer (or the plan) of primary responsibility for a postretirement benefit obligation, and (c) eliminates significant risks related to the obligation and the assets used to effect the settlement. Examples of transactions that constitute a settlement include making lump-sum cash payments to plan participants in exchange for their rights to receive specified postretirement benefits and purchasing long-term nonparticipating insurance contracts for the accumulated postretirement benefit obligation for some or all of the plan participants.

~~81.~~82. A transaction that does not meet the three criteria of paragraph ~~80~~81 does not constitute a settlement for purposes of this statement. For example, investing in a portfolio of high-quality fixed-income securities with principal and interest payment dates similar to the estimated payment dates of benefits may avoid or minimize certain risks. However, that investment decision does not constitute a settlement because that decision can be reversed, and investing in that portfolio does not relieve the employer (or the plan) of primary responsibility for a postretirement benefit obligation nor does it eliminate significant risks related to that obligation.

~~82.~~83. For purposes of this statement, the maximum gain or loss subject to recognition in income when a postretirement benefit obligation is settled is the net gain or loss included in unassigned funds (surplus) defined in paragraphs 46-50 plus any transition asset remaining in unassigned funds (surplus). That maximum gain or loss includes any gain or loss resulting from remeasurements of plan assets and the accumulated postretirement benefit obligation at the time of settlement.

~~83.~~84. If the entire accumulated postretirement benefit obligation is settled and the maximum amount subject to recognition is a gain, the settlement gain shall first reduce any transition obligation remaining in unassigned funds (surplus); any excess gain shall be recognized in income. If the entire accumulated postretirement benefit obligation is settled and the maximum amount subject to recognition is a loss, the maximum settlement loss shall be recognized in income. If only part of the accumulated postretirement benefit obligation is settled, the employer shall recognize in income the excess of the pro rata portion (equal to the percentage reduction in the accumulated postretirement benefit obligation) of the maximum settlement gain over any remaining transition obligation or a pro rata portion of the maximum settlement loss.

~~84.~~85. If the purchase of a participating insurance contract constitutes a settlement, the maximum gain (but not the maximum loss) shall be reduced by the cost of the participation right before determining the amount to be recognized in income. As detailed in paragraph 58, the purchase of an endorsement split-dollar life insurance contract does not settle a liability for a postretirement benefit obligation.

~~85.~~86. If the cost of all settlements in a year is less than or equal to the sum of the service cost and interest cost components of net postretirement benefit cost for the plan for the year, gain or loss recognition is permitted but not required for those settlements. However, the accounting policy adopted shall be applied consistently from year to year.

Accounting for a Plan Curtailment

~~86.~~87. For purposes of this statement, a curtailment is an event that significantly reduces the expected years of future service of active plan participants or eliminates the accrual of defined benefits for some or all of the future services of a significant number of active plan participants. Curtailments include:

a. Termination of employees' services earlier than expected, which may or may not involve closing a facility or discontinuing a component of an entity.

b. Termination or suspension of a plan so that employees do not earn additional benefits for future service. In the latter situation, future service may be counted toward eligibility for benefits accumulated based on past service.

~~87.~~88. The prior service cost included in unassigned funds (surplus) associated with the portion of the future years of service that had been expected to be rendered, but as a result of a curtailment are no longer expected to be rendered, is a loss. For purposes of measuring the effect of a curtailment, prior service cost includes the cost of plan amendments and any remaining transition obligation. For example, a curtailment may result from the termination of a significant number of employees who were plan participants at the date of a prior plan amendment. The loss associated with that curtailment is measured as the portion of the remaining prior service cost included in unassigned funds (surplus) related to that (and any prior) plan amendment attributable to the previously expected remaining future years of service of the employees who were terminated and the portion of the remaining transition obligation attributable to the previously expected remaining future years of service of the terminated employees who were plan participants at the date of transition.

~~88.~~89. The accumulated postretirement benefit obligation may be decreased (a gain) or increased (a loss) by a curtailment. That (gain) loss shall reduce any net loss (gain) included in unassigned funds (surplus).

a. To the extent that such a gain exceeds any net loss included in unassigned funds (surplus) (or the entire gain, if a net gain exists), it is a curtailment gain.

b. To the extent that such a loss exceeds any net gain included in unassigned funds (surplus) (or the entire loss, if a net loss exists), it is a curtailment loss.

For purposes of applying the provisions of this paragraph, any transition asset remaining in unassigned funds (surplus) shall be treated as a net gain and shall be combined with the unrecognized net gain or loss arising subsequent to transition to this statement.

~~89.~~90. If the sum of the effects identified in paragraphs ~~87-88~~88-89 is a net loss, it shall be recognized in income when it is probable that a curtailment will occur and the net effect is reasonably estimable. If the sum of those effects is a net gain, it shall be recognized in income when the related employees terminate or the plan suspension or amendment is adopted.

~~90.~~91. A settlement and a curtailment may occur separately or together. If benefits expected to be paid in future periods are eliminated for some plan participants (for example, because a significant portion of the work force is dismissed or a plant is closed) but the plan remains in existence and continues to pay benefits, to invest assets, and to receive contributions, a curtailment has occurred but not a settlement. If an employer purchases nonparticipating insurance contracts for the accumulated postretirement benefit obligation and continues to provide defined benefits for future service, either in the same plan or in a successor plan, a settlement has occurred but not a curtailment. If a plan termination occurs (that is, the obligation is settled and the plan ceases to exist) and the plan is not replaced by a successor defined benefit plan, both a settlement and a curtailment have occurred (whether or not the employees continue to work for the employer).

Measurement of the Effects of Termination Benefits

~~91.~~92. An employer that offers special or contractual termination benefits to employees shall recognize a liability and a loss when the employees accept the offer and the amount can be reasonably estimated. An employer that provides contractual termination benefits shall recognize a liability and a loss when it is probable that employees will be entitled to benefits and the amount can be reasonably estimated. A situation involving special or contractual termination benefits may also result in a curtailment to be accounted for under paragraphs ~~86-89~~87-90.

~~92.~~93. The liability and loss recognized for employees who accept an offer of special termination benefits to be provided by a postretirement benefit plan shall be the difference between (a) the accumulated postretirement benefit obligation for those employees, assuming that those employees (active plan participants) not yet fully eligible for benefits would terminate at their full eligibility date and that fully eligible plan participants would retire immediately, without considering any special termination benefits and (b) the accumulated postretirement benefit obligation as measured in (a) adjusted to reflect the special termination benefits.

Defined Contribution Plans

~~93.~~94. For purposes of this statement, a defined contribution postretirement plan is a plan that provides postretirement benefits in return for services rendered, provides an individual account for each participant, and has terms that specify how contributions to the individual's account are to be determined rather than the amount of postretirement benefits the individual is to receive. Under a defined contribution plan, the postretirement benefits a plan participant will receive are limited to the amount contributed to the plan participant's account, the returns earned on investments of those contributions, and forfeitures of other plan participants' benefits that may be allocated to the plan participant's account.

~~94.~~95. To the extent a plan's defined contributions to an individual's account are to be made for periods in which that individual renders services, the net postretirement benefit cost for a period shall be the contribution called for in that period. If a plan calls for contributions for periods after an individual retires or terminates, the estimated cost shall be accrued during the employee's service period.

~~95.~~96. A postretirement benefit plan having characteristics of both a defined benefit plan and a defined contribution plan requires careful analysis. If the substance of the plan is to provide a defined benefit, as may be the case with some "target benefit" plans, the accounting requirements shall be determined in accordance with the provisions of this statement applicable to a defined benefit plan and the disclosure requirements within paragraph 64 shall be followed.

Disclosures - Defined Contribution Plans

~~96.~~97. An employer shall disclose the amount of cost recognized for defined contribution postretirement benefit plans for all periods presented separately from the amount of cost recognized for defined benefit plans. The disclosures shall include a description of the nature and effect of any significant changes during the period affecting comparability, such as a change in the rate of employer contributions, a business combination, or a divestiture.

Consolidated/Holding Company Plans

~~97.~~98. The employees of many reporting entities are eligible for certain postretirement benefits other than pensions provided by a parent company or holding company. A reporting entity with employees who are eligible for those benefits and is not directly liable for those related obligations shall recognize an expense equal to its allocation of the benefits earned during the period. A liability shall be established for any such amounts due but not yet paid.

~~98.~~99. The reporting entity shall disclose in the financial statements that its employees participate in a plan sponsored by the holding company for which the reporting entity has no legal obligation. The amount of the postretirement benefit expense incurred and the allocation methodology utilized by the provider of such benefits shall also be disclosed. If the reporting entity is directly liable for postretirement benefits other than pensions, then the requirements outlined in paragraphs 1-~~96~~97 and paragraphs ~~99-108~~100-109 of this statement shall be applied.

Relevant Literature

~~99.~~100. This statement adopts with modification paragraphs 1-7 and 16-18 as well as Appendix D – Amendments to Statement 106 and Appendix E – Amendments to Statement 132(R) of *FASB Statement No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106 and 132(R)* (FAS 158). Paragraphs 8-10 and D2.u providing specific guidance for not-for-profit organizations are rejected. Paragraphs 11-15 regarding the effective dates for FAS 158 are rejected and paragraph 19 providing an alternative method for remeasuring plan assets and benefits obligations as of the fiscal year the measurement date provisions are applied is also rejected. The disclosure included within FAS 132 (R), as amended by FAS 158, pertaining specifically to pensions (paragraph 5.e.) has been rejected for inclusion within this standard. This Statement adopts the revisions to paragraph 5.d. of FAS 132(R) as amended by *FASB Staff Position FAS 132(R)-1, Employers' Disclosures about Postretirement Benefit Plan Assets* (FSP FAS 132(R)-1) and *ASU 2010-06, Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements* (ASU 2010-06). Other revisions to disclosure requirements as amended by FSP FAS 132(R)-1 relate to nonpublic entities and are rejected. This statement adopts *EITF 06-4, Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements*. This statement adopts by reference revisions to ASC 715-80 as detailed in *ASU 2011-09, Compensation – Retirement Benefits – Multiemployer Plans* with limited additional disclosures required within statutory financial statements. This statement adopts by reference *FSP FASB 158-1, Conforming Amendments to the Illustrations in FASB Statements No. 87, No. 88, and No. 106 and to the Related Staff Implementation Guides* (FSP FAS 158-1) to the extent that the examples and related implementation guides comply with the adopted GAAP guidance previously identified within this statement, as modified for statutory accounting. The following modifications from the adopted paragraphs of FAS 158 and FAS 106 have been incorporated within this standard:

a. All references to "other comprehensive income" or "accumulated other comprehensive income" within FAS 158 have been revised to reflect "unassigned funds (surplus)."

b. Any prepaid asset resulting from the excess of the fair value of plan assets over the accumulated postretirement benefit obligation shall be nonadmitted. Furthermore, any asset recognized from the cost of a "participation right" of an annuity contract per paragraph 59 shall also be nonadmitted.

c. Provisions within paragraph 57 and 58 of FAS 106, as amended by FAS 158, permitting a calculated market-related value of plan assets has been eliminated with only the fair value measurement method for plan assets retained.

d. The reduced disclosure requirements for nonpublic entities described in paragraph 8 of FAS 132(R), as amended by FAS 158, are rejected. All reporting entities shall follow the disclosure requirements within this statement which have been adopted from paragraph 5 of FAS 132(R), as amended by FAS 158.

e. Clarification has been included within this standard to ensure both vested and nonvested employees are included within the recognition of net postretirement benefit cost and in the accumulated postretirement benefit obligation. Although this is consistent with GAAP, this is a change from previous statutory accounting. As nonvested employees were excluded from statutory accounting under SSAP No. 14, guidance has been included to indicate that the unrecognized prior service cost attributed to nonvested individuals is not required to be included in net postretirement benefit cost entirely in the year this standard is adopted. The unrecognized prior service cost for nonvested employees shall be amortized as a component of net postretirement benefit cost by assigning an equal amount to each expected future period of service before vesting occurs for nonvested employees active at the date of the amendment. Unassigned funds (surplus) is then adjusted each period as prior service cost is amortized. (Guidance is included within the transition related to the recognition of the prior service cost for nonvested employees through unassigned surplus.)

f. Conclusion of *Interpretation 99-26: Offsetting Pension Assets and Liabilities* (INT 99-26) prohibiting the offset of defined benefit liabilities of one plan with prepaid assets of another plan has been incorporated within paragraph 33 of this statement.

g. Provisions within paragraph 44B of FAS 106, as amended by FAS 158, regarding the classification of underfunded liabilities as current or noncurrent liabilities and the classification of assets from overfunded plans as noncurrent assets has been rejected as inconsistent with statutory accounting.

h. Provisions within paragraph 65 of FAS 106, as amended by FAS 158, defining the fair value of investments have been rejected. Fair value definitions and measurement for investments shall be determined in accordance with statutory accounting guidance.

i. Provisions within paragraph 72 of FAS 106, as amended by FAS 158, regarding the plan assets measurement date for consolidating subsidiaries or entities utilizing the equity method under APB Opinion No. 18 has been rejected. For statutory accounting, all entities shall follow the measurement date guidance within paragraph 62 of this statement.

j. The disclosure requirement included within paragraph 5.e. of FAS 132(R) has been rejected for this statement as it specifically pertains to pensions.

k. Transition under FAS 158 is different from the requirements of this statement. FAS 158 requires publicly traded equity securities to initially apply the requirement to recognize the funded status of a postretirement benefit plan; the gains/losses, prior service costs/credits and transition obligations/assets that have not yet been included in net periodic benefit cost; and the disclosure requirements as of the end of the fiscal year ending after December 15, 2006. Transition guidelines for statutory accounting are defined in paragraphs ~~100-108~~101-109.

l. FAS 158 provided two approaches for an employer to transition to a fiscal year-end measurement date. For purposes of statutory accounting, the second approach permitting reporting entities to use earlier measurements determined for year-end reporting as of the fiscal year immediately preceding the year that the measurement date provisions is rejected. For consistency purposes, all reporting entities shall follow the first approach and remeasure plan assets and benefit obligations as of the beginning of the fiscal year that the measurement date provisions are applied.

Effective Date and Transition

~~100.~~101.Reporting entities are required to disclose the accumulated postretirement benefit obligation and the fair value of plan assets for defined postretirement benefit plans in the first reporting period after the effective date of this standard and in each subsequent reporting period. This disclosure shall specifically note the funded/underfunded status of the postretirement benefit plan. Reporting entities shall also specifically note the surplus impact necessary, at each reporting date, to reflect the full benefit obligation within the financial statements.

~~101.~~102.This statement is effective for quarterly and annual reporting periods beginning on or after January 1, 2013 (transition date) with early adoption permitted. Any unfunded defined benefit amounts, as determined when the accumulated benefit obligation exceeds the fair value of plan assets, is a liability under SSAP No. 5R and shall be reported in the first quarter statutory financial statements after the transition date with a corresponding entry to unassigned funds (surplus). If the fair value of plan assets exceeds the accumulated benefit obligation, the asset shall be considered a nonadmitted asset. Net periodic benefit cost shall include a component for unrecognized prior service cost for nonvested employees beginning in 2013.

~~102.~~103.Gains or losses, prior service costs or credits (including prior service costs for non-vested participants pursuant to paragraph 37), and remaining transition assets or obligations (collectively referred to as “unrecognized items”) from prior application of SSAP No. 14 that have not yet been included in net periodic benefit cost as of December 31, 2012[5] shall be recognized as components of the ending balance of unassigned funds (surplus), net of tax, as of January 1, 2013 (provided that alternative transition is not elected per paragraph ~~103~~104.b.). The offset to unassigned funds is reported separately as an “Aggregate Write-In for Other Than Invested Assets” or as an “Aggregate Write-In for Other Liabilities.” After recognition, the full unfunded or overfunded status or the plan shall be reflected within the financial statements. Any prepaid asset resulting from an overfunded plan shall be nonadmitted.

~~103.~~104.Due to the potential impact to surplus as a result of immediately applying the accounting guidance in paragraph ~~102~~103, reporting entities may elect one of the following two methods, on an individual plan basis, to recognize the transition surplus impact:

a. Reporting entities may elect to recognize the entire transition surplus impact calculated from applying paragraph ~~102~~103, on an individual plan basis, as of January 1, 2013.

[5] The intent of the guidance is to recognize the unrecognized amounts as of December 31, 2012, annual statements, even if new actuarial projections (expected postretirement benefit obligations) are calculated as of January 1, 2013. (These projections would be considered in the recognition of the 2013 pension cost.)

b. Alternatively, reporting entities may elect to recognize the entire surplus impact from applying paragraph ~~102~~103, on an individual plan basis, over a period not to exceed ten (10) years. The surplus impact initially recognized as of January 1, 2013, under this transition option, and subsequently over the transition period, shall be the greater of:

i. Ten percent of the calculated surplus impact as of the transition date; and

ii. Amortization[6] of the "unrecognized items" (defined in paragraph ~~102~~103) into net periodic benefit cost, including any accelerated amortization of these items from curtailments or settlements that occur after the transition date. (If the amortization cannot be determined at transition, at a minimum, the amount amortized for "unrecognized items" during the prior year shall be utilized for this component of the calculation. If the amount recognized for transition (greater of both components in paragraph ~~103~~104.b.) is subsequently determined to be less than what is amortized for the year (~~103~~104.b.ii.), the difference between what was recognized for transition, and what is amortized must immediately be recognized as an adjustment to the transition impact to unassigned funds – surplus.);

If the surplus deferral is elected at the transition date, subsequently, starting with the 2014 year-end financial statement, the reporting entity shall annually recognize the remaining surplus impact (collectively referred to as the "transition liability"[7]) on a systematic basis over a period not to exceed nine years. The minimum amount recognized each subsequent year shall be an amount that reflects the conditions within paragraph ~~103~~104.b. Additionally, reporting entities must recognize any remaining transition liability to the extent that the plan reflects a prepaid benefit cost. (For example, if changes in circumstances have resulted with the plan reflecting an overfunded status, the remaining transition liability must be recognized to the extent that the plan is overfunded.) Furthermore, if circumstances result with a subsequent gain attributed to the plan that will be recognized in earnings, the entity must recognize an additional amount of the remaining transition liability to offset the recognized gain.(INT 13-03) Reporting entities are permitted to recognize the remaining transition liability, or an amount in excess of the minimum requirement, at any time after the transition date. This transition guidance is specific to the transition surplus impact from initially applying this statement on January 1, 2013. Thus, this transition guidance does not apply to additional liability calculated from subsequent comparison of the fair value of plan assets to the accumulated benefit obligation, or the impact of subsequent plan amendments.

~~104.~~105.Reporting entities electing to apply the transition guidance in paragraph ~~103~~104.b. must disclose the full transition surplus impact calculated from applying paragraph ~~102~~103 in the first quarter statutory financial statements after the transition date and each reporting period thereafter. This disclosure shall include the initial "transition liability" calculated under paragraph ~~102~~103 and the annual amortization amount of the "unrecognized items" into net periodic benefit cost. This disclosure shall include a schedule of the entity's anticipated recognition of the remaining surplus impact over the transition period.

[6] Unless otherwise impacted from the provisions within this statement or in accordance with changes to the benefit plan, the amortization of the unrecognized items into net periodic benefit cost shall continue to follow the existing amortization schedules in effect on the transition date.

[7] If the surplus deferral from paragraph ~~103~~104.b. is elected, the deferred liability, although comprised of the previous "unrecognized items" shall be collectively referred to as the "transition liability." Although reporting entities will need to continue to track the unrecognized items for amortization into net periodic cost (offset through unassigned funds), reporting entities shall not allocate the recognized surplus impact from transition to these categories. As noted in paragraph ~~103~~104.b.ii., the minimum amount of liability recognized under the deferral option must cover the annual amortization of the "unrecognized items" into net periodic benefit cost to prevent a surplus benefit.

~~105.~~106.The requirement to measure plan assets and benefit obligations as of the date of the reporting entity's financial statement year-end is effective for financial statement years beginning January 1, 2014. (The measurement date change will be initially reflected in the December 31, 2014, financial statements.)

~~106.~~107.In order to transition to a fiscal year-end measurement date, the reporting entity shall remeasure plan assets and benefit obligations as of the beginning of the fiscal year that the measurement date provisions are applied. The reporting entity shall use those new measurements to determine the effects of the measurement date change as of the beginning of the fiscal year that the measurement date provisions are applied.

~~107.~~108.The reporting entity shall measure plan assets and benefit obligations as of the beginning of the fiscal year that the measurement date provisions are applied. This would result with the following:

a. Net periodic benefit cost for the period between the measurement date that is used for the immediately preceding fiscal year-end and the beginning of the fiscal year that the measurement date provisions are applied, exclusive of any curtailment or settlement gain or loss, shall be recognized, net of tax, as a separate adjustment of the opening balance of unassigned funds (surplus). That is, the pretax amount recognized as an adjustment to unassigned funds (surplus) is the net periodic benefit cost that without a change in measurement date otherwise would have been recognized on a delayed basis during the first interim period for the fiscal year that the measurement date provisions are applied.

b. Any gain or loss arising from a curtailment or settlement between the measurement date that is used for the immediately preceding fiscal year-end and the beginning of the fiscal year that the measurement date provisions are applied shall be recognized in earnings in that period and not as an adjustment to unassigned funds (surplus). This provision prohibits a reporting entity from early application of the measurement date provisions when the reporting entity has issued financial statements for the prior year without recognition of such a settlement or curtailment.

c. Other changes in the fair value of plan assets and the benefit obligations (for example, gains or losses) for the period between the measurement date that is used for the immediately preceding fiscal year-end and the beginning of the fiscal year that the measurement date provisions are applied shall be recognized, net of tax, as a separate adjustment of the opening balance of unassigned funds (surplus) for the fiscal year that the measurement date provisions are applied.

~~108.~~109.Earlier application of the recognition or measurement date provisions is encouraged, however, early applications must be for all of the reporting entity's benefit plans. If early application is elected, the transition date shall reflect the January 1st of the year in which this standard is initially applied. Retrospective application is not permitted.

REFERENCES

Other

- *Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy*

- *SSAP No. 14—Employers' Accounting for Postretirement Benefits Other Than Pensions*

Relevant Issue Papers

- *Issue Paper No. 133—Accounting for Postretirement Benefits Other Than Pensions, A Replacement of SSAP No. 14*

Statements of Statutory Accounting Principles No. 93

Accounting for Low Income Housing Tax Credit Property Investments

STATUS

Type of Issue:	Common Area
Issued:	June 13, 2005
Effective Date:	January 1, 2006
Affects:	Modifies Issue Paper No. 99, paragraph 2 to remove EITF 94-1 reference
Affected by:	No other current pronouncements
Interpreted by:	INT 06-07

STATUS **1**

SCOPE OF STATEMENT **3**

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Accounting for Low Income Housing Tax Credit Property Investments

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for investments in federal and certain state sponsored Low Income Housing Tax Credit (LIHTC) properties. State sponsored LIHTC programs that have the following characteristics are within the scope of and shall be accounted for in accordance with this statement:

a. The program is based upon Internal Revenue Code (IRC) section 42.

b. The investment requires an ongoing interest in a partnership, limited liability company, or similar pass thru type entity and cannot be transferred apart from this interest.

c. Resale value of the investment is not based upon the fair value of the underlying real estate.

d. Fair value of the investment is directly tied to the remaining stream of tax credits and deductible losses available to investors.

e. The critical element of value is known with a high degree of certainty before being marketed to investors.

f. The proportional amortized cost method is more indicative of liquidation value than the equity method.

State sponsored LIHTC programs requiring ownership in a partnership or limited liability company that do not have the foregoing characteristics shall continue to be accounted for in accordance with the requirements of *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies* (SSAP No. 48).

2. Some states have enacted laws that create programs by which transferable state tax credits are granted to entities under certain specified conditions (e.g., an entity makes an investment in a particular industry). Investments in transferable state tax credits are not within the scope of this statement.

SUMMARY CONCLUSION

3. *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies* (SSAP No. 48) prescribes accounting treatment for the valuation of partnerships and limited liability companies. Investments in certain state Low Income Housing Credits Investments that do not fall within the scope of this statement (SSAP No. 93) are covered by the requirements of SSAP No. 48.

4. LIHTC investments held by reporting entities meet the definition of an asset as specified in *SSAP No. 4—Assets and Nonadmitted Assets* and are admissible assets to the extent that they comply with the requirements of this statement.

5. Resale valuation of these investments is based on the present value of the future stream of tax credits and deductible losses, and not the fair value of the underlying real estate.

6. Generally accepted accounting principles (GAAP) guidance for LIHTC investments is addressed in *Emerging Issues Task Force No. 94-1: Accounting for Tax Benefits Resulting from Investments in Affordable Housing Projects* (EITF 94-1). EITF 94-1 is listed as not applicable to statutory accounting in *Issue Paper No. 99—Nonapplicable GAAP Pronouncements* (Issue Paper No. 99). This statement modifies Issue Paper No. 99 to remove the reference to EITF 94-1 and adopts EITF 94-1 with modifications described in paragraph 8.

7. Structurally, these investments are typically owned by multiple investors with varying interests in a top tier limited partnership, which holds direct interests in the operating limited partnerships within a single LIHTC investment fund. In other words, a single investor may hold a 15% interest in the "fund" level partnership, which owns 99% interests in 10 operating level limited partnerships. Although, not technically guaranteed as contemplated in EITF 94-1, the risks related to LIHTC investments have proven to be historically low.

8. The modifications to EITF 94-1 are as follows:

a. State Low Income Housing Tax Credit property investments, which comply with the requirements of paragraph 1 of this statement are included and will receive the accounting treatment prescribed by this statement.

b. LIHTC investments (regardless of whether they are guaranteed) shall be initially recorded at cost and carried at amortized cost unless considered impaired as discussed in paragraphs 12-15 of this statement. The amortized cost method utilized shall be similar to the amortized cost method discussed in EITF 94-1 with a modification to include tax benefits during the holding period because the primary value of the LIHTC is derived during the property holding period (typically 15 years or less). An illustration has been provided in Appendix A to this statement. A reporting entity investor using the cost method shall amortize any excess of the carrying amount of the investment over its estimated residual value during the periods in which tax benefits are allocated to the investor. The estimated residual value used in determining the amount to be amortized is the estimated residual value at the end of the last period in which tax benefits are allocated to the investor and should not reflect anticipated inflation. Annual amortization should be based on the proportion of tax benefits received in the current year to total estimated tax benefits to be allocated to the investor.

c. Federal tax credits shall be recognized in the income statement as an offset to federal taxes in the tax reporting year in which the tax credit is utilized in accordance with *SSAP No. 101—Income Taxes, A Replacement of SSAP No. 10R and SSAP No. 10* (SSAP No. 101). State tax credits shall be recognized in the income statement as an offset to state premium tax or state income tax, whichever is applicable, in the tax reporting year in which the credit is utilized.

d. Tax benefits received, other than tax credits, shall be accounted for pursuant to SSAP No. 101. Amortization shall be reported as a component of net investment income.

e. *AICPA Statement of Position 78-9, Accounting for Investments in Real Estate Ventures* (SOP 78-9) is rejected for purposes of statutory accounting in SSAP No. 48. This statement does not intend to establish SOP 78-9 as applicable to statutory accounting.

f. *FASB Interpretation No. 46, Consolidation of Variable Interest Entities* is (FIN 46) rejected for purposes of statutory accounting in *SSAP No. 3—Accounting Changes and Corrections of Errors* (SSAP No. 3). This statement does not intend to establish FIN 46 as applicable to statutory accounting.

g. Many LIHTC investments require future equity contributions by the investor (equity contributions), that may be contingent on a variety of conditions, such as receiving representations, contract performance, meeting occupancy requirements, etc. If the commitment by the investor to provide equity contributions meets the definition of a liability as defined in *SSAP No. 5R—Liabilities Contingencies and Impairments of Assets* a liability shall be recorded. If the commitment to provide equity contributions does not meet the definition of a liability, the contingent commitment shall be disclosed in the notes to the financial statements with other contingent commitments.

h. *EITF 85-16: Leveraged Leases* (EITF 85-16) is adopted for purposes of statutory accounting in *SSAP No. 22—Leases* (SSAP No. 22). This statement does not intend to readdress the conclusions reached in SSAP No. 22.

i. *SSAP No. 97—Investments in Subsidiary, Controlled, and Affiliated Entities, a Replacement of SSAP No. 88* (SSAP No. 97) should be utilized to account for investments that qualify as subsidiary, controlled or affiliated entities.

j. The impairment guidance contained in this statement shall be followed.

k. For statutory accounting purposes, deferred taxes are not reported as a component of income from continuing operations in the income statement; rather deferred taxes are recognized as a separate component of gains and losses in unassigned funds (surplus).

9. Additional funding that does not result in additional tax credits for the reporting entity (investor) shall be expensed as a component of net investment income. In the event a reporting entity obtains additional tax credits for a LIHTC investment, the following shall be applied:

a. If additional tax credits are allocated without additional funding, the additional tax credits shall not be afforded any value; rather, the tax benefit is only recognized when realized.

b. If additional funding directly related to the additional tax credits is required, the provisions of this statement shall be followed as if the additional funding were a new investment in LIHTC property.

10. An investment amortized to residual value in accordance with paragraph 8.b. of this statement shall not be revalued under any other method during or subsequent to the amortization period, other than as discussed in this statement.

11. Changes in estimated losses shall be accounted for in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors* as a change in estimate and included as a component of net investment income.

Impairment

12. Reporting entities with investments in LIHTC properties shall complete and document an impairment analysis at each reporting period. If it is determined that an impairment exists, the book value of the LIHTC investment shall be compared to the present value of future tax benefits discounted at a risk free rate of return, i.e., the rate on U.S. Treasury obligations of a similar duration, and the investment shall be written-down if the book value is higher. This will result in a new cost basis and the amount of the write-down shall be accounted for as a realized loss. The new cost basis shall not be changed for subsequent recoveries in fair value.

13. Among other things, an other-than-temporary impairment (INT 06-07) shall be considered to have occurred if it is probable that future tax benefits will not be received as expected. For example, for LIHTC properties based on state tax credits, if the reporting entity intends to decrease premium volume in that state, it may affect whether or not the tax credits in that state are realizable. The best available information about market share or premiums by state and premiums by line of business generally should be used to estimate the amount of future tax credits that are realizable. For purposes of determining impairment, future tax benefits consist of both estimated tax losses and anticipated tax credits. Loan default or a reasonable probability of credit recapture would signify that tax benefits would not be received as expected.

14. In a multi-tiered partnership, whereby one limited partnership exists only to hold interests in other limited partnerships that are each invested in different developments, the impairment should be determined at the lowest tier. The partnership that holds the assets in which the impairment is determined to exist will be adjusted to a new cost basis representing the lower of book value or the present value of future tax benefits discounted at a risk free rate of interest. This new cost basis and related realized loss shall be recognized by the holder of a LIHTC investment.

15. It should be noted that a foreclosure of a single property within an LIHTC investment fund only affects the loss of tax credits on a proportional basis. For example, a foreclosure of one property in a six property fund generating equal levels of credits would only eliminate 1/6 of the credits, thereby, only affecting 1/6 of the LIHTC investment fund value to the individual investors.

Audited Financial Statements

16. The reporting entity's return and book value of an LIHTC investment is reliant upon maintaining tax credit eligibility and not its share of the equity as reported on a financial statement. As such, a reporting entity shall monitor the tax credit eligibility of an LIHTC investment through requiring either audited GAAP or audited tax basis financial statements. In the event an audited GAAP or audited tax basis financial statement is not obtained, the asset shall be nonadmitted.

Disclosures

17. Disclose the number of remaining years of unexpired tax credits and the required holding period for the LIHTC investments.

18. Disclose if the LIHTC property is currently subject to any regulatory reviews and the status of such review. (Example investigations by the housing authority.)

19. Any commitment or contingent commitment (e.g., guarantees or commitments to provide additional capital contributions) including the amount of equity contributions that are contingent commitments related to LIHTC properties investments and the year(s) that contingent commitments are expected to be paid shall be disclosed.

20. The significance of an investment to the reporting entity's financial position and results of operations shall be considered in evaluating the extent of disclosures of the financial position and results of operations of an investment in a LIHTC. If in the aggregate the LIHTC investments exceed 10% of the total admitted assets of the reporting entity the following disclosures shall be made:

a. (i) The name of each partnership or limited liability company and percentage of ownership, (ii) the accounting policies of the reporting entity with respect to investments in partnerships and limited liability companies (iii) the difference, if any, between the amount at which the investment is carried and the amount of underlying equity in net assets (i.e., nonadmitted goodwill or other nonadmitted assets) and (iv) the accounting treatment of the difference;

b. For partnerships, and limited liability companies for which a quoted fair value is available, the aggregate value of each partnership, or limited liability company investment based on the quoted fair value; and

c. Summarized information as to assets, liabilities, and results of operations for partnerships, and limited liability companies either individually or in groups.

21. A reporting entity that recognizes an impairment loss shall disclose the following in the financial statements that include the period of the impairment write-down:

a. A description of the impaired assets and the facts and circumstances leading to the impairment; and

b. The amount of the impairment and how fair value was determined.

22. Disclose the amount and nature of the write-downs or reclassifications made during the year due to the forfeiture or ineligibility of tax credits, etc. These write-downs may be based on actual property level foreclosure, loss of qualification due to occupancy levels, compliance issues with tax code provisions within an LIHTC investment or other issues.

23. Refer to the preamble for further discussion regarding disclosure requirements.

Relevant Literature

24. This statement reinstates *EITF 94-1: Accounting for Tax Benefits from Investments in Affordable Housing Projects* as applicable to Statutory Accounting by removing it from *Issue Paper No. 99—Nonapplicable GAAP Pronouncements* (Issue Paper No. 99). This statement modifies Issue Paper No. 99 to remove the reference to EITF 94-1 and adopts EITF 94-1 with modifications described in paragraph 8 of this statement.

25. *AICPA Statement of Position 78-9, Accounting for Investments in Real Estate Ventures* (SOP 78-9) is rejected for purposes of statutory accounting in SSAP No. 48. This statement does not intend to establish SOP 78-9 as applicable to statutory accounting.

26. *FASB Interpretation No. 46, Consolidation of Variable Interest Entities* (FIN 46) is rejected for purposes of statutory accounting in SSAP No. 3. This statement does not intend to establish FIN 46 as applicable to statutory accounting.

27. *EITF 85-16: Leveraged Leases* (EITF 85-16) is adopted for purposes of statutory accounting in SSAP No. 22. This statement does not intend to readdress the conclusions reached in SSAP No. 22.

Effective Date and Transition

28. This statement is effective for reporting periods beginning on or after January 1, 2006. Early adoption is permitted. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with SSAP No. 3. The guidance previously in paragraph 3 of this SSAP superseded paragraph 1 of SSAP No. 48. In 2011, this guidance was moved to *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies* and deleted from this SSAP. The original guidance included in this standard is retained for historical purposes in Issue Paper No. 125.

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 125—Accounting for Low Income Housing Tax Credit Property Investments*

APPENDIX A – LOW INCOME HOUSING TAX CREDIT PROPERTY INVESTMENTS

A Limited Partnership Investment in an Affordable Housing Project Accounted for Using the Amortized Cost Method (modified to include tax benefits):

This appendix is based on EITF 94-1 "Schedule 3 Cost Method with Amortization" with modifications to include tax benefits.

Terms:
Date of Investment: January 1, 20X1
Purchase Price of Investment: $100,000

Assumptions:

1. All cash flows (except initial investment) occur at the end of each year.

2. Depreciation expense is computed, for book and tax purposes, using the straight-line method with a 27.5 year life (the same method is used for simplicity).

3. The investor made a $100,000 investment for a 5 percent limited partnership interest in the project at the beginning of the first year of eligibility for the tax credit.

4. The partnership finances the project cost of $4,000,000 with 50 percent equity and 50 percent debt.

5. The annual tax credit allocation (equal to 8 percent of the project's original cost) will be received for a period of 10 years.

6. The investor's tax rate is 35 percent.

7. For simplicity, the project will operate with break-even pretax cash flows including debt service during the first 15 years of operations.

8. The project's taxable and book loss will be equal to depreciation expense.

9. The investor will maintain the investment for 15 years (so there will be no recapture of tax credits).

10. The investor expects that the estimated residual value of the investment will be zero.

	Beginning Investment Balance	Tax Credits	Tax Depreciation	Tax Loss Benefit	Total Tax Benefits	Amortization	Ending Investment Balance
Year	1	2	3	4	5	6	7
0							100,000
1	100,000	16,000	7,273	2,546	18,546	9,358	90,642
2	90,642	16,000	7,273	2,546	18,546	9,358	81,285
3	81,285	16,000	7,273	2,546	18,546	9,358	71,927
4	71,927	16,000	7,273	2,546	18,546	9,358	62,569
5	62,569	16,000	7,273	2,546	18,546	9,358	53,212
6	53,212	16,000	7,273	2,546	18,546	9,358	43,854
7	43,854	16,000	7,273	2,546	18,546	9,358	34,496
8	34,496	16,000	7,273	2,546	18,546	9,358	25,139
9	25,139	16,000	7,273	2,546	18,546	9,358	15,781
10	15,781	16,000	7,273	2,546	18,546	9,358	6,423
11	6,423		7,273	2,546	2,546	1,285	5,139
12	5,139		7,273	2,546	2,546	1,285	3,854
13	3,854		7,273	2,546	2,546	1,285	2,569
14	2,569		7,273	2,546	2,546	1,285	1,285
15	1,285		7,273	2,546	2,546	1,285	-
Total		160,000	109,095	38,190	198,190	100,000	

1. Beginning-of-year investment for a 5 percent limited partnership interest in the project.

2. Eight percent tax credit on $200,000 tax basis of the underlying assets.

3. Tax Loss = Tax Depreciation (assumption 7) - $200,000 tax basis of the underlying assets using the straight-line method over 27.5 years.

4. Column (3) × 35% tax rate).

5. Column (2) + column (4)

6. Proportional amortization - $100,000 x column 5 / column 5 total

7. Beginning-of-year investment for a 5 percent limited partnership interest in the project (column 1) net of amortization in column 6.

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Statements of Statutory Accounting Principles No. 94 - Revised

Accounting for Transferable and Non-Transferable State Tax Credits

STATUS

Type of Issue:	Common Area
Issued:	June 12, 2006; substantively revised December 7, 2011
Effective Date:	December 31, 2006; substantive revisions detailed in Issue Paper No. 145 are effective December 31, 2011
Affects:	No other pronouncements
Affected by:	No other pronouncements
Interpreted by:	No other pronouncements

STATUS **1**

SCOPE OF STATEMENT **3**

SUMMARY CONCLUSION **3**

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APPENDIX B – ACCOUNTING FOR NON-TRANSFERABLE STATE TAX CREDITS **7**

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Accounting for Transferable and Non-Transferable State Tax Credits

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for transferable and non-transferable state tax credits that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

2. Investments in Low Income Housing Tax Credits as discussed in *SSAP No. 93—Accounting for Low Income Housing Tax Credit Property Investments*, which involve an investment by a reporting entity in a limited liability company or similar entity that earns tax credits as a consequence of its operating activities involving low income housing developments and passes those tax credits to its investors, are not within the scope of this statement.

3. Investments in a CAPCO (Certified Capital Company), organized as a partnership or an LLC, which is a company, authorized by state statute that borrows from investors (insurance companies), in order to make venture capital investments in "qualified" businesses, are not within the scope of this statement. Although associated with tax credits, the insurance company is paid principal and interest on its investment with the CAPCO. Depending upon the terms of the CAPCO offering, principal and interest payments to the insurance company will come from the CAPCO and/or the state. The CAPCO will make cash payments directly to the insurance company while the state will make payments in the form of premium or income tax credits.

SUMMARY CONCLUSION

4. The criteria in paragraphs 5 and 6 are for transferable state tax credits (i.e., credits which may be sold or assigned). The criteria in paragraphs 7 and 8 are for non-transferable state tax credits (i.e., those which cannot be sold or assigned to other parties).

Transferable State Tax Credits

5. Some states have enacted laws that create programs by which transferable state tax credits are granted to entities under certain specified conditions (e.g., an entity makes an investment in a particular industry). The terms of these state tax credits vary from state to state and, within a state, from program to program. However, many of these transferable state tax credit programs share the following four characteristics:

a. The tax credit is nonrefundable;

b. The holder of the transferable state tax credit may sell or otherwise transfer the transferable state tax credit to another entity, which can likewise resell or transfer the credit;

c. The transferable state tax credit will expire if not used by a predetermined date; and

d. The transferable state tax credit can be applied against either state income tax or state premium tax.

6. For purposes of this statement, such programs will be referred to as "transferable state tax credits." The criteria in paragraphs 5.b., 5.c. and 5.d. must be present in order for the transferable state tax credit to receive the accounting treatment described in this statement. When a reporting entity purchases a transferable state tax credit from another entity, the transaction does not result in a continuing investment in a business entity (i.e. limited partnership).

Non-Transferable State Tax Credits

7. If the original or subsequent holder of the transferable tax credit is not able to transfer the tax credit, then the admissibility criteria in paragraph 8 for non-transferable tax credits apply. These non-transferable state tax credits share the following characteristics:

a. The tax credit is nonrefundable;

b. The successive holder of a state tax credit must redeem the credit by April 15 of the subsequent year to the entity's acquisition of the state tax credit and is not permitted to carry-over, carry-back, obtain a refund, sell or assign the credit;

c. The non-transferable state tax credit will expire if not used by the predetermined date; and

d. The non-transferable state tax credit can be applied against either state income tax or state premium tax.

8. The criteria in paragraphs 7.b., 7.c. and 7.d. must be present in order for the non-transferable state tax credit to receive the accounting treatment described in this statement.

9. Transferable and non-transferable state tax credits as defined within this SSAP held by reporting entities meet the definition of assets as specified in *SSAP No. 4—Assets and Nonadmitted Assets* and are admissible assets to the extent that they comply with the requirements of this statement. If the criteria in paragraphs 6 or 8 are not met, the tax credits are nonadmitted.

Acquisition

10. Transferable and non-transferable state tax credits are recorded at cost at the date of acquisition.

Balance Sheet Treatment

11. Transferable and non-transferable state tax credits expected to be realized are initially recorded at cost.

12. Transferable and non-transferable state tax credits shall be established gross of any related state tax liabilities and reported in the category of other-than-invested assets (not reported net).

13. As transferable and non-transferable state tax credits are redeemed, the carrying value of the tax credits is reduced dollar for dollar by the amount of state tax credits applied toward the reporting entity's applicable state tax liability.

Income Statement Treatment

14. Gains on transferable and non-transferable state tax credits are deferred until the value of the state tax credits utilized exceeds the cost of the state tax credits or until the state tax credits are sold to other entities and the payment received is greater than the book value.

15. Losses on transferable and non-transferable state tax credits are recognized when known.

16. Gains and losses on transferable and non-transferable state tax credits are reflected in other income.

Impairment

17. An impairment shall be considered to have occurred if it is probable that the reporting entity will be unable to recover the carrying amount of the transferable or non-transferable state tax credits. State tax credits should be evaluated for impairment at each reporting date.

18. When there is a decline in the realizability of a transferable or non-transferable state tax credit owned by the reporting entity that is other than temporary, the asset shall be written down to the expected realizable amount and the amount of the write down shall be accounted for as a realized loss. The expected realizable value is the new cost basis.

19. The new cost basis shall not be changed for subsequent recoveries in realizability.

Disclosures

20. The following disclosures shall be made in the financial statements. For purposes of this disclosure, total unused transferable and non-transferable state tax credits represent the entire transferable and non-transferable state tax credits available:

a. Carrying value of transferable and non-transferable state tax credits gross of any related state tax liabilities by state and in total,

b. Total unused transferable and non-transferable state tax credits by state;

c. Method of estimating utilization of remaining transferable and non-transferable state tax credits or other projected recovery of the current carrying value.

d. Impairment amount recognized in the reporting period, if any.

e. Identify state tax credits by transferable and non-transferable classifications, and identify the admitted and Nonadmitted portions of each classification.

Effective Date and Transition

21. This statement is effective for reporting periods ending on or after December 31, 2006. Early adoption is permitted. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with SSAP No. 3. Substantive revisions to 1) revising the title; 2) incorporating the criteria for non-transferable state tax credits as described in paragraphs 7 and 8; 3) adding a disclosure; and 4) updating terminology throughout the document as appropriate, are effective for reporting periods ending on or after December 31, 2011.

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 126—Accounting for Transferable State Tax Credits*
- *Issue Paper No. 145—Accounting for Transferable and Non-Transferable State Tax Credits*

APPENDIX A – ACCOUNTING FOR TRANSFERABLE STATE TAX CREDITS

On 1/1/X1 SAM Insurance Company purchased transferable state tax credits for a cost of $100,000. The transferable state tax credits are redeemable for $160,000 and expire at the end of 12/31/X4. SAM initially expects to utilize the tax credits before expiration in their state of domicile in the amount of $40,000 per year. In year X4, SAM sells the remaining $30,000 in transferable state tax credits for $20,000

1/1/x1	Transferable state tax credits	100,000	
	Cash		100,000
	To record the purchase of the tax credits		
6/30/x1	Premium tax expense	40,000	
	Premium taxes payable to domiciliary state		40,000
	To record premium tax expense and accrue the liability in Year 1.		
10/1/x1	Premium tax payable	40,000	
	Transferable state tax credits		40,000
	To record the use of tax credits in Year 1. The reporting entity expects to be able to utilize remaining tax credits before expiration.		
6/30/x2	Premium tax expense	60,000	
	Premium taxes payable to domiciliary state		60,000
	To record premium tax expense and accrue the liability in Year 2.		
9/30/x2	Premium tax payable	60,000	
	Transferable state tax credits		60,000
	To record the use of taxes credits in Year 2. The reporting entity expects to be able to utilize remaining tax credits before expiration.		
6/30/x3	Premium tax expense	30,000	
	Premium taxes payable to domiciliary state		30,000
	To record premium tax expense and accrue the liability in Year 3.		
9/30/x3	Premium tax payable	30,000	
	Other income		30,000
	To record the use of premium tax credits in excess of cost and recognize a gain on premium tax credits in other income. The Company intends to sell the remaining tax credits in year 4.		
6/30/x4	Cash	20,000	
	Other income		20,000
	To record the sale of the remaining tax credits.		

APPENDIX B – ACCOUNTING FOR NON-TRANSFERABLE STATE TAX CREDITS

On 7/1/X1 LJW Insurance Company purchased non-transferable state tax credits for a cost of $100,000. The state tax credits are redeemable for $110,000, are not transferable and expire on, April 15, 20x2. LJW expects to utilize the tax credits before expiration in their state of domicile in the amount of $110,000.

7/1/x1	State tax credits	100,000	
	Cash		100,000
	To record the purchase of the tax credits		
9/30/x1	Premium tax expense	200,000	
	Premium taxes payable to domiciliary state		200,000
	To record premium tax expense and accrue the liability.		
3/15/x2	Premium tax payable	110,000	
	Other Income		10,000
	State tax credits		100,000
	To record the use of premium tax credits in excess of cost and recognize a gain on premium tax credits in other income. (The additional $90,000 of premium taxes payable would still be due.)		

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Statements of Statutory Accounting Principles No. 95

Exchanges of Nonmonetary Assets, A Replacement of SSAP No. 28—Nonmonetary Transactions

STATUS

Type of Issue:	Common Area
Issued:	September 11, 2006
Effective Date:	January 1, 2007
Affects:	Supersedes SSAP No. 28 Nullifies and incorporates INT 00-29, INT 02-19, INT 03-16 Nullifies INT 99-21
Affected by:	No other pronouncements
Interpreted by:	INT 00-26, INT 06-13, INT 08-05

STATUS **1**

SCOPE OF STATEMENT **3**

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Exchange of Nonmonetary Assets, A Replacement of SSAP No. 28—Nonmonetary Transactions

SCOPE OF STATEMENT

1. The statement establishes statutory accounting principles for nonmonetary transactions. Specific statutory requirements for certain types of nonmonetary transactions are addressed in other statements.

2. This statement supersedes the conclusions reached in *SSAP No. 28—Nonmonetary Transactions* (SSAP No. 28) by updating conclusions reached in SSAP No. 28 related to APB 29 with those included in FAS 153. Consequently, this statement adopts with modification FAS 153 to change GAAP references to those applicable to statutory accounting. In addition, references made to APB 29 within SSAP No. 28 will be replaced with the actual amended guidance resulting from FAS 153.

SUMMARY CONCLUSION

Definitions

3. The definitions of certain terms used in this statement are:

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

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

   c. Exchange (or exchange transaction) is a reciprocal transfer between a reporting entity and another entity that results in the reporting entity acquiring assets or services or satisfying liabilities by surrendering other assets or services or incurring other obligations. A reciprocal transfer of a nonmonetary asset shall be deemed an exchange only if the transferor has no substantial continuing involvement in the transferred asset such that the usual risks and rewards of ownership of the asset are transferred.

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

4. Nonmonetary transactions shall be accounted for in accordance with this statement, except as addressed by other statements or interpretations including but not limited to *SSAP No. 12—Employee Stock Ownership Plans* (SSAP No. 12), *SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties* (SSAP No. 25), *SSAP No. 68—Business Combinations and Goodwill* (SSAP No. 68), *SSAP No. 72—Surplus and Quasi-Reorganizations* (SSAP No. 72), *SSAP No. 103—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (SSAP No. 103), *SSAP No. 104R—Share-Based Payments* (SSAP No. 104R), and *INT 00-26: EITF 98-3: Determining Whether a Nonmonetary Transactions Involves Receipt of Productive Assets or of a Business* (INT 00-26).

Basic Principle

5. Accounting for nonmonetary transactions shall generally be based on the fair values of the assets (or services) involved, as defined in paragraph 13, which is the same basis as that used in monetary transactions. Thus, the cost of a nonmonetary asset acquired in exchange for another nonmonetary asset (reciprocal transactions) is the fair value of the asset surrendered to obtain it, and a gain or loss should be recognized on the exchange. The fair value of the asset received should be used to measure the cost if it is more clearly evident than the fair value of the asset surrendered. Similarly, a nonmonetary asset received in a nonreciprocal transfer should be recorded at the fair value of the asset received as defined in paragraph 6. A transfer of a nonmonetary asset to a stockholder or to another entity in a nonreciprocal transfer should be recorded at the fair value of the asset transferred, and a gain or loss should be recognized on the disposition of the asset. The fair value of a reporting entity's own stock reacquired may be a more clearly evident measure of the fair value of the asset distributed in a nonreciprocal transfer if the transaction involves distribution of a nonmonetary asset to eliminate a disproportionate part of owners' interests (that is, to acquire stock for the treasury or for retirement).

6. Fair value of assets received or transferred in a nonreciprocal transfer shall be measured based on statutory accounting principles for the type of asset transferred. Accordingly, the value shall be determined in accordance with *SSAP No. 26—Bonds, Excluding Loan-Backed and Structured Securities* (SSAP No. 26), *SSAP No. 30—Investments in Common Stock (excluding investments in common stock of subsidiary, controlled, or affiliated entities)* (SSAP No. 30), *SSAP No. 32—Investments in Preferred Stock (including investments in preferred stock of subsidiary, controlled, or affiliated entities)* (SSAP No. 32), SSAP No. 37*—Mortgage Loans* (SSAP No. 37), *SSAP No. 39—Reverse Mortgages* (SSAP No. 39), *SSAP No. 40R—Real Estate Investments* (SSAP No. 40R), *SSAP No. 43R—Loan-Backed and Structured Securities* (SSAP No. 43R), *SSAP No. 90—Accounting for the impairment or Disposal or Real Estate Investments* (SSAP No. 90) or other applicable statements. The guidance provided in SSAP No. 25 shall be followed in accounting for nonreciprocal transactions with affiliates and other related parties as defined in that statement.

Modifications of the Basic Principle

7. A nonmonetary exchange shall be measured based on the recorded amount (after reduction, if appropriate, for an indicated impairment of value) of the nonmonetary asset(s) relinquished, and not on the fair values of the exchanged assets, if any of the following conditions apply:

a. *Fair Value Not Determinable*. The fair value of neither the asset(s) received nor the asset(s) relinquished is determinable within reasonable limits (paragraph 14)

b. *Exchange Transaction to Facilitate Sales to Customers*. The transaction is an exchange of a product or property held for sale in the ordinary course of business for a product or property to be sold in the same line of business to facilitate sales to customers other than the parties to the exchange.

c. *Exchange Transaction That Lacks Commercial Substance*. The transaction lacks commercial substance (paragraph 8)

Commercial Substance

8. A nonmonetary exchange has commercial substance if the entity's future cash flows are expected to significantly change as a result of the exchange. The entity's future cash flows are expected to significantly change if either of the following criteria is met:

a. The configuration (risk, timing, and amount)[1] of the future cash flows of the asset(s) received differs significantly from the configuration of the future cash flows of the asset(s) transferred.

b. The entity-specific value[2] of the asset(s) received differs from the entity-specific value of the asset(s) transferred, and the difference is significant in relation to the fair values of the assets exchanged.

A qualitative assessment will, in some cases, be conclusive in determining that the estimated cash flows of the entity are expected to significantly change as a result of the exchange.

9. In the United States and some other tax jurisdictions, a transaction is not given effect for tax purposes unless it serves a legitimate business purpose other than tax avoidance. In assessing the commercial substance of an exchange, tax cash flows that arise solely because the tax business purpose is based on achieving a specified financial reporting result shall not be considered.

Additional Guidance

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

11. The exchanges of nonmonetary assets that would otherwise be based on recorded amounts (paragraphs 7 and 8) may include an amount of monetary consideration. The recipient of the monetary consideration has realized gain on the exchange to the extent that the amount of the monetary receipt exceeds a proportionate share of the recorded amount of the asset surrendered. The portion of the cost applicable to the realized amount should be based on the ratio of the monetary consideration to the total consideration received (monetary consideration plus the estimated fair value of the nonmonetary asset received) or, if more clearly evident, the fair value of the nonmonetary asset transferred. However, the entity paying the monetary consideration should not recognize any gain on a transaction covered in paragraphs 7 and 8, but should record the asset received at the amount of the monetary consideration paid plus the recorded amount of the nonmonetary asset surrendered. If a loss is indicated by the terms of a transaction described in this paragraph or in paragraphs 7 and 8, the entire indicated loss on the exchange should be recognized.

12. *Nonreciprocal Transfers to Owners*. Accounting for the distribution of nonmonetary assets to owners of an enterprise in a spin-off (INT 06-13 and INT 08-05) or other form of reorganization or liquidation or in a plan that is in substance the rescission of a prior business combination should be based on the recorded amount (after reduction, if appropriate, for an indicated impairment of value) (An indicated impairment of value of a long-lived asset covered by SSAP No. 90 shall be determined in accordance with paragraph 4 of SSAP No. 90) of the nonmonetary assets distributed. A pro rata distribution to owners of an enterprise of shares of a subsidiary or other investee company that has been or is being controlled or that has been or is being accounted for under the equity method is to be considered to be equivalent to a spin-off. Other nonreciprocal transfers of nonmonetary assets to owners should be accounted for at fair value if the fair

[1] The configuration of future cash flows is composed of the risk, timing, and amount of the cash flows. A change in any one of those elements would be a change in configuration.

[2] An entity-specific value (referred to as an entity-specific measurement in Concepts Statement 7) is different from a fair value measurement. As described in paragraph 24.b. of Concepts Statement 7, an entity-specific value attempts to capture the value of an asset or liability in the context of a particular entity. For example, an entity computing an entity-specific value of an asset would use its expectations about its use of that asset rather than the use assumed by marketplace participants. If it is determined that the transaction has commercial substance, the exchange would be measured at fair value, rather than at the entity-specific value.

value of the nonmonetary asset distributed is objectively measurable and would be clearly realizable to the distributing entity in an outright sale at or near the time of the distribution

Applying the Basic Principle

13. Fair value of a nonmonetary asset transferred to or from a reporting entity in a nonmonetary transaction should be determined in accordance with *SSAP No. 100—Fair Value Measurements*. If one of the parties in a nonmonetary transaction could have elected to receive cash instead of the nonmonetary asset, the amount of cash that could have been received may be evidence of the fair value of the nonmonetary assets exchanged.

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

15. A difference between the amount of gain or loss recognized for tax purposes and that recognized for accounting purposes may constitute a temporary difference to be accounted for according to *SSAP No. 101—Income Taxes, A Replacement of SSAP No. 10R and SSAP No. 10*.

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

Accounting for a Convertible Instrument Granted or Issued to a Nonemployee for Goods or Services or a Combination of Goods or Services and Cash

17. If a convertible instrument is issued in exchange for goods or services, the measurement date should be used both to measure the fair value of the convertible instrument and to measure the intrinsic value, if any, of the conversion option. The measurement date is the earlier of either of the following:

a. The date at which a commitment for performance by the counter party to earn the convertible instrument is reached (a “performance commitment”)

b. The date at which the counter party’s performance is complete

18. If a convertible instrument is issued in exchange for goods or services (or a combination of goods or services and cash), the following guidelines shall be used to measure the fair value of that instrument:

a. Consistent with this SSAP, the fair value of an equity instrument shall be determined based on either the fair value of the consideration received or the fair value of the equity instruments issued, whichever is more reliably measurable. Accordingly, if the fair value of the goods or services received is reliably determinable, and the issuer has not recently issued similar convertible instruments, the fair value of the goods or services should be used to measure the transaction.

b. Recent issuances of similar convertible instruments for cash to parties that only have an investor relationship with the issuer may provide the best evidence of fair value of the convertible instrument.

c. If reliable information about (a) or (b), above, is not available, the fair value of the convertible instrument should be deemed to be no less than the fair value of the equity shares into which it can be converted.

19. Whether distributions paid or payable on a convertible instrument issued or granted in exchange for goods or services (or a combination of goods or services and cash) should be recognized as a financing cost (that is, interest expense or dividends) or as a cost of the goods or services received or receivable from the counterparty.

20. Once an instrument is considered "issued" for accounting purposes, distributions paid or payable should be characterized as financing costs. Prior to that time, distributions paid or payable under the instrument should be characterized as a cost of the underlying goods or services. the accretion of a discount on a convertible instrument resulting from a beneficial conversion option does not begin until the instrument is issued for accounting purposes.

21. In cases where a company issues a convertible instrument for cash proceeds that indicate that the instrument includes a beneficial conversion option, and the purchaser of the instrument provides (receives) goods or services to (from) the issuer that are the subject of a separate contract, the terms of both the agreement for goods or services and the convertible instrument should be evaluated to determine whether their separately stated pricing is equal to the fair value of the goods or services and convertible instrument. If that is not the case, the terms of the respective transactions should be adjusted. The convertible instrument should be recognized at its fair value with a corresponding increase or decrease in the purchase or sales price of the goods or services. If an instrument issued to a goods or services provider (or purchaser) is part of a larger issuance, a substantive investment in the issuance by unrelated investors (who are not also providers or purchasers of goods or services) may provide evidence that the price charged to the goods or services provider represents the fair value of the convertible instrument.

Disclosures

22. A reporting entity that engages in a nonmonetary transaction during a period shall disclose the following in the financial statements:

a. The nature of the transaction;

b. The basis of accounting for the assets transferred; and

c. Gains or losses recognized on transfers.

23. Refer to the preamble for further discussion regarding disclosure requirements. The disclosure in paragraph 22 shall be included in the annual audited statutory financial reports only.

24. Entities shall disclose the amount of revenue and expense recognized from advertising barter transactions for each income statement period presented. In addition, if an entity engages in advertising barter transactions for which the fair value is not determinable within the limits of this Issue, information regarding the volume and type of advertising surrendered and received (such as the number of equivalent

pages, the number of minutes, or the overall percentage of advertising volume) shall be disclosed for each income statement period presented.

Relevant Literature

25. Although not meant to be all inclusive, accounting for specific nonmonetary transactions and unique circumstances is addressed in the following statements of statutory accounting principles:

- *SSAP No. 12—Employee Stock Ownership Plans* (SSAP No. 12),
- *SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties* (SSAP No. 25),
- *SSAP No. 68—Business Combinations and Goodwill* (SSAP No. 68),
- *SSAP No. 72—Surplus and Quasi-Reorganizations* (SSAP No. 72),
- *SSAP No. 103—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (SSAP No. 103),
- *SSAP No. 104R—Share-Based Payments* (SSAP No. 104R),
- *INT 00-26: EITF 98-3: Determining Whether a Nonmonetary Transactions Involves Receipt of Productive Assets or of a Business (INT 00-26),*

26. This statement updates general statutory guidance for accounting for nonmonetary transactions not specifically addressed in the statements of statutory accounting principles noted above and carries forward current statutory guidance for stock dividends and stock splits received, other types of nonmonetary transactions and involuntary conversions of nonmonetary assets to monetary assets. The guidance in this statement remains consistent with the guidance provided in SSAP No. 30, which addresses cash dividends and requires that dividends on common stock be recorded as investment income when declared with a corresponding receivable to be extinguished upon receipt of cash. This statement carries forward the disclosure requirements related to nonmonetary transactions from SSAP No. 28.

27. This statement adopts *Accounting Principles Board Opinion No. 29, Accounting for Nonmonetary Transactions* (APB 29) as modified by *FASB No. 153: Exchanges of Nonmonetary Assets, an amendment of APB Opinion No. 29* (FAS 153).

28. This statement adopts FAS 153 with modifications for references to statements of statutory accounting principles.

29. This statement continues the adoption of *Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins* (ARB 43), Chapter 7, Section B, *Stock Dividends and Stock Split-ups* paragraphs 1-9 as such relates to the receipt of stock in the form of a stock in the form of a stock dividend or stock split. This conclusion is consistent with the recognition concept included in the Statement of Concepts, which states, “Revenue should be recognized only as the earnings process of the underlying underwriting or investment business is completed”.

30. This statement continues the adoption of *FASB Interpretation No. 30, Accounting for Involuntary Conversions of Nonmonetary Assets to Monetary Assets* (FIN 30) with modification to provide that gain or loss contingencies be recognized in accordance with the conclusion in SSAP No. 5R and that gain or loss resulting from an involuntary conversion of nonmonetary assets to monetary assets be accounted for in continuing operations and disclosed in accordance with SSAP No. 24.

31. This statement continues the adoption of *FASB Emerging Issues Task Force Issue No. 86-29: Nonmonetary Transactions: Magnitude of Boot and the Exceptions to the Use of Fair Value* (EITF 86-29) and *FASB Emerging Issues Task Force Issue No. 93-11: Accounting for Barter Transactions Involving Barter Credits* (EITF 93-11) consistent with the general rule discussed in paragraph 26. This statement also adopts with modification *FASB Emerging Issues Task Force Issue No. 99-17, Accounting for Advertising Barter Transactions*.

32. This statement continues the rejection of paragraph 16 of *Accounting Principles Board Opinion No. 6, Status of Accounting Research Bulletins* and *Emerging Issues Task Force No. 96-4, Accounting for Reorganizations Involving a Non-Pro Rata Split-off of Certain Nonmonetary Assets to Owners*.

Effective Date and Transition

33. The provisions of this statement shall be effective for nonmonetary asset exchanges occurring in fiscal periods beginning after January 1, 2007. Earlier application is permitted for nonmonetary asset exchanges occurring in fiscal periods beginning after the date this statement is issued. The provisions of this statement shall be applied prospectively. The guidance in paragraphs 18, 19 and 20 related to long-lived assets to be disposed of other than by sale was previously included within *SSAP No. 90—Accounting for the Impairment or Disposal of Real Estate Investments* (SSAP No. 90). In 2012, the guidance from SSAP No. 95 was incorporated within SSAP No. 90, with those paragraphs in SSAP No. 95 being nullified. The original guidance included in this statement, as well as the original guidance adopted in SSAP No. 90 for long-lived assets to be disposed of other than by sale, are retained for historical purposes in Issue Paper No. 127.

34. This statement adopts the consensus positions of *EITF 01-1: Accounting for a Convertible Instrument Granted or Issued to a Nonemployee for Goods or Services or a Combination of Goods or Services and Cash* with certain modifications to incorporate guidance in EITF 96-18 regarding the measurement date. EITF 96-18 was previously rejected by the working group in *INT 99-13: EITF 96-18: Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services* in the context of *SSAP No. 13—Stock Options and Stock Purchase Plans*; however, the measurement guidance included in Issue 1 of EITF 96-18 is adopted in this statement. The reference in paragraph 4 to *INT 03-16: Contribution of Stock*, was deleted as guidance was incorporated into SSAP No. 25 and SSAP No. 68. The guidance in paragraph 24 was originally contained within *INT 00-29: EITF 99-17: Accounting for Advertising Barter Transactions* and was effective June 12, 2000. The guidance in paragraphs 17-21 was originally contained within *INT 02-19: EITF 01-1: Accounting for a Convertible Instrument Granted or Issued to a Nonemployee for Goods or Services or a Combination of Goods or Services and Cash* and was effective December 8, 2002.

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 127—Exchanges of Nonmonetary Assets, A Replacement of SSAP No. 28—Nonmonetary Transactions*

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Statement of Statutory Accounting Principles No. 97

Investments in Subsidiary, Controlled and Affiliated Entities, A Replacement of SSAP No. 88

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SCOPE OF STATEMENT **3**

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Investments in Subsidiary, Controlled and Affiliated Entities, A Replacement of SSAP No. 88

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for investments in subsidiaries, controlled and affiliated entities, hereinafter referred to as SCA entities.

2. This statement supersedes the conclusions reached in *SSAP No. 88—Investments in Subsidiary, Controlled, and Affiliated Entities* (SSAP No. 88).

SUMMARY CONCLUSION

Definitions

3. Parent and subsidiary are defined as follows:

a. Parent—An entity that directly or indirectly owns and controls the reporting entity;

b. Subsidiary—An entity that is, directly or indirectly, owned and controlled by the reporting entity.

4. An affiliate is defined as an entity that is within the holding company system or a party that, directly or indirectly, through one or more intermediaries, controls, is controlled by, or is under common control with the reporting entity. An affiliate includes a parent or subsidiary and may also include partnerships, joint ventures, and limited liability companies as defined in *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies* (SSAP No. 48). Those entities are accounted for under the guidance provided in SSAP No. 48, which requires an equity method for all such investments.

5. Control is defined as the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of the investee, whether through the (a) ownership of voting securities, (b) by contract other than a commercial contract for goods or nonmanagement services, (c) by common management, or (d) otherwise. Control shall be presumed to exist if a reporting entity and its affiliates directly or indirectly, own, control, hold with the power to vote, or hold proxies representing 10% or more of the voting interests of the entity.

6. Control as defined in paragraph 5 shall be measured at the holding company level. For example, if one member of an affiliated group has a 5% interest in an entity and a second member of the group has an 8% interest in the same entity, the total interest is 13% and therefore each member of the affiliated group shall be presumed to have control. This presumption will stand until rebutted by an evaluation of all the facts and circumstances relating to the investment based on the criteria in *FASB Interpretation No. 35, Criteria for Applying the Equity Method of Accounting for Investments in Common Stock, an Interpretation of APB Opinion No. 18.* The corollary is required to demonstrate control when a reporting entity owns less than 10% of the voting securities of an investee. The insurer shall maintain documents substantiating its determination for review by the domiciliary commissioner. Examples of situations where the presumption of control may be in doubt include the following:

a. Any limited partner investment in a limited partnership, unless the limited partner is affiliated with the general partner.

b. An entity where the insurer owns less than 50% of an entity and there is an unaffiliated individual or group of investors who own a controlling interest.

c. An entity where the insurer has given up participating rights[1] as a shareholder to the investee.

7. Investments in SCA entities meet the definition of assets as defined in *SSAP No. 4—Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this statement.

Applying the Market Valuation, Audited Statutory Equity and Audited GAAP Equity Methods

8. The admitted investments in SCA entities shall be valued using either the market valuation approach (as described in paragraph 8.a.), or one of the equity methods (as described in paragraph 8.b.).

a. In order to use the market valuation approach for SCA entities, the following requirements apply:

i. The subsidiary must be traded on one of the following major exchanges: (1) the New York Stock Exchange, (2) the American Stock Exchange, (3) the NASDAQ National exchange, or (4) the Tokyo Stock Exchange;

ii. The reporting entity must submit subsidiary information to the Securities Valuation Office (SVO) for its calculation of the subsidiary's market value. Such calculation could result in further discounts in market value above the established base discounts based on ownership percentages detailed below;

iii. Ownership percentages for determining the discount rate shall be measured at the holding company level;

iv. If an investment in a SCA results in an ownership percentage between 10% and 50%, a base discount percentage between 0% and 20% on a sliding scale basis is required;

v. If an investment in a SCA results in an ownership percentage greater than 50% up to and including 80%, a base discount percentage between 20% and 30% on a sliding scale basis is required;

vi. If an investment in a SCA results in an ownership percentage greater than 80% up to and including 85%, a minimum base discount percentage of 30% is required.

vii. Further, the SCA must have at least two million shares outstanding, with a total market value of at least $50 million in the public's control; and

viii. Any ownership percentages exceeding 85% will result in the SCA being recorded on an equity method.

b. If a SCA investment does not meet the requirements for the market valuation approach in paragraph 8.a. or, if the requirements are met, but a reporting entity elects not to use that

[1] The term "participating rights" refers to the type of rights that allows an investor to effectively participate in significant decisions related to an investee's ordinary course of business and is distinguished from the more limited type of rights referred to as "protective rights". Refer to the sections entitled: "Protective Rights" and "Substantive Participating Rights" in EITF 96-16, *Investor's Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights*. The term "participating rights" shall be used consistent with the discussion of substantive participating rights in this EITF.

approach, the reporting entity's proportionate share of its investments in SCAs shall be recorded as follows:

i. Investments in U.S. insurance SCA entities shall be recorded based on the underlying audited statutory equity of the respective entity's financial statements, adjusted for any unamortized goodwill as provided for in *SSAP No. 68—Business Combinations and Goodwill* (SSAP No. 68). Reporting entities shall record investments in U.S. insurance SCA entities on at least a quarterly basis, and shall base the investment value on the most recent quarterly information available from the SCA. Entities may recognize their investment in U.S. insurance SCA entities based on the unaudited statutory equity in the SCAs year-end Annual Statement if the annual SCA audited financial statements are not complete as of the filing deadline. The recorded statutory equity shall be adjusted for audit adjustments, if any, as soon as the annual audited financial statements have been completed. Annual consolidated or combined audits are allowed if completed in accordance with the Model Regulation Requiring Annual Audited Financial Reports as adopted by the SCA's domiciliary state;

ii. Investments in both U.S. and foreign noninsurance SCA entities that are engaged in the following transactions or activities:

(a) Collection of balances as described in *SSAP No. 6—Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due From Agents and Brokers*

(b) Sale/lease or rental of EDP Equipment and Software as described in *SSAP No. 16R—Electronic Data Processing Equipment and Accounting for Software*

(c) Sale/lease or rental of furniture, fixtures, equipment or leasehold improvements as described in *SSAP No. 19—Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements*

(d) Loans to employees, agents, brokers, representatives of the reporting entity or SCA as described in *SSAP No. 20—Nonadmitted Assets*

(e) Sale/lease or rental of automobiles, airplanes and other vehicles as described in *SSAP No. 20—Nonadmitted Assets*

(f) Providing insurance services on behalf of the reporting entity including but not limited to accounting, actuarial, auditing, data processing, underwriting, collection of premiums, payment of claims and benefits, policyowner services

(g) Acting as an insurance or administrative agent or an agent for a government instrumentality performing an insurance function (e.g. processing of state workers compensations plans, managing assigned risk plans, Medicaid processing etc).

(h) Purchase or securitization of acquisition costs and if 20% or more of the SCA's revenue is generated from the reporting entity and its affiliates, then the underlying equity of the respective entity's audited U.S. Generally Accepted Accounting Principles (GAAP) financial statements shall be adjusted to a statutory basis of accounting in accordance with paragraph 9. For purposes of this section, revenue means GAAP revenue reported in the audited U.S. GAAP financial statements excluding realized and unrealized capital gains/losses. Foreign SCA entities are defined as those entities incorporated or otherwise legally formed under the laws of a foreign country. Paragraphs 21-26 provide guidance for investments in holding companies;

iii. Investments in both U.S. and foreign noninsurance SCA entities that do not qualify under paragraph 8.b.ii., shall be recorded based on the audited U.S. GAAP equity of the investee. Foreign SCA entities are defined as those entities incorporated or otherwise legally formed under the laws of a foreign country. Additional guidance on investments in downstream holding companies is included in paragraphs 21-26. Additional guidance on the use of audited foreign GAAP basis financial statements for the U.S. GAAP equity valuation amount is included in paragraph 22.b.

iv. Investments in foreign insurance SCA entities shall be recorded based on the underlying U.S. GAAP equity from the audited U.S. GAAP basis financial statements, if available, or the audited foreign statutory basis financial statements of the respective entity adjusted to a statutory basis of accounting in accordance with paragraph 9 and adjusted for reserves of the foreign insurance SCA with respect to the business it assumes directly and indirectly from a U.S. insurer using the statutory accounting principles promulgated by the NAIC in the *Accounting Practices and Procedures Manual*. The audited foreign statutory basis financial statements must include an audited footnote that reconciles net income and equity on the foreign statutory basis of accounting to the U.S. GAAP basis. Foreign insurance SCA entities are defined as alien insurers formed according to the legal requirements of a foreign country.

c. The following provides guidance regarding the audits for entities covered under paragraph 8.b.:

i. The recorded GAAP equity shall be adjusted for any audit adjustments resulting from either the annual audited GAAP financial statements of the respective entity or, if the entity is a member of a consolidated or combined group of insurers, the annual audited GAAP financial statements of the consolidated or combined group of companies, as soon as determined. GAAP is defined as those pronouncements included in the FASB codification.

ii. Annual consolidated or combined audits are allowed for the valuation of U.S. insurance entities if completed in accordance with the Model Regulation Requiring Annual Audited Reports as adopted by the SCA's domiciliary state.

iii. Consolidated or combined financial statements are allowed for the valuation of downstream SCA entities, including downstream SCA entities, that directly or indirectly own U.S. insurance entities, provided that the statutory financial statements of such U.S. insurance entities are audited. The audited financial statements of the downstream SCA entities shall include, as other financial information, consolidating or combining balance sheet schedule(s) showing the equity of all relevant SCA entities, non SCA SSAP No. 48 entities, and any required intercompany eliminations. The consolidating or combining balance sheet of the downstream SCA entities shall then be adjusted for GAAP to SAP differences of the insurance entities and paragraph 8.b.ii. and 8.b.iv. entities owned directly and indirectly by the downstream SCA entities.

iv. Investments in foreign SCA entities shall follow the guidance in paragraphs 8.b.ii., 8.b.iii. and 8.b.iv. based upon the nature of the SCA as described in the respective paragraphs. To fulfill the requirement for audited U.S. GAAP basis financial statements, the value of foreign SCA investments may be based on the GAAP equity from audited financial statements prepared on a foreign GAAP basis. The audited foreign GAAP basis financial statements must include an audited footnote that reconciles net income and equity on the foreign GAAP basis of accounting to the U.S. GAAP basis. The statutory carrying value of foreign insurance SCA entities (i.e., 8.b.iv. entities) and foreign noninsurance 8.b.ii. SCA entities shall include the additional adjustments as described in paragraph 9.

9. The statutory basis of accounting for investments in noninsurance SCA entities, subject to paragraph 8.b.ii. and foreign insurance SCA entities, subject to paragraph 8.b.iv., shall be based on the underlying audited U.S. GAAP equity of the respective entity with the following adjustments:

a. Nonadmit assets pursuant to the following statutory accounting principles as promulgated by the NAIC in the *Accounting Practices and Procedures Manual*;

i. *SSAP No. 6—Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due From Agents and Brokers*

ii. *SSAP No. 16R—Electronic Data Processing Equipment and Accounting for Software*

iii. *SSAP No. 19—Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements*

iv. *SSAP No. 20—Nonadmitted Assets*

v. *SSAP No. 29—Prepaid Expenses*

b. Expense costs that are capitalized in accordance with GAAP but are expensed pursuant to statutory accounting as promulgated by the NAIC in the *Accounting Practices and Procedures Manual* (e.g., deferred policy acquisition costs);

c. Adjust depreciation for certain assets in accordance with the following statutory accounting principles:

i. *SSAP No. 16R—Electronic Data Processing Equipment and Accounting for Software*

ii. *SSAP No. 19—Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements*

d. Nonadmit the amount of goodwill of the SCA in excess of 10% of the audited U.S. GAAP equity of the SCA's last audited financial statements.

e. Nonadmit amount of the net deferred tax assets (DTAs) of the SCA in excess of 10% of the audited U.S. GAAP equity of the SCA's last audited financial statements.

f. Adjust the U.S. GAAP annuity account value reserves of a foreign insurance SCA, with respect to the business it wrote directly, using the commissioners' annuity reserve valuation method (CARVM) as defined in paragraphs 12 and 13 of Appendix A-820 (including the reserving provisions in the various Actuarial Guidelines which support CARVM). The valuation interest rate and mortality tables to be used in applying CARVM should be that prescribed by the foreign insurance SCA's country of domicile. If the Foreign SCA's country of domicile does not prescribe the necessary tables and/or rates, no reserve adjustment shall be made.

Note that the outcome of these adjustments, as well as guarantees or commitments of the parent entity to provide additional funding, can result in a negative equity valuation of the investment.

10. The audited statutory equity method as described in paragraph 8.b.i. and 8.b.ii. shall be applied by recording an initial and subsequent investment in an investee at cost (excluding any investment in an investee's preferred stock and/or surplus notes), which is defined in SSAP No. 68 as the sum of (a) any cash payment, (b) the fair value of other assets distributed, (c) the fair value of any liabilities assumed, and (d) any direct costs of the acquisition. Investments in an SCA's preferred stock and /or surplus notes are addressed in paragraphs 27-31. After the date of acquisition, the investment amount shall be adjusted for the amortization of goodwill and the reporting entity's share of the change in special surplus funds, other than special surplus funds and unassigned funds (surplus), as defined in *SSAP No. 72—Surplus and Quasi-Reorganizations*, and as adjusted appropriately for the items in paragraph 9. This represents the carrying amount of the investment.

11. If the reporting entity is using an equity method (as described in paragraphs 8.b.i. through 8.b.iv.), the reporting entity's share of undistributed earnings and losses of the investee shall be included in unrealized gains and losses of the reporting entity. The reporting entity's share of other changes in the investee's surplus (e.g., the change in the investee's nonadmitted assets) shall be recorded by the investor as a component of unrealized capital gains and losses on investments. If the reporting entity uses the market valuation approach outlined in paragraph 8.a., changes in that valuation shall be included in unrealized gains and losses. Dividends or distributions received from an investee shall be recognized in investment income when declared to the extent that they are not in excess of the undistributed accumulated earnings attributable to the investee. Dividends or distributions declared in excess of the undistributed accumulated earnings attributable to the investee shall reduce the carrying amount of the investment.

12. For investments in entities recorded based on the underlying audited GAAP equity of the investee, the amount to be recorded shall be defined as the initial investment in an investee at cost (excluding any investments in an investee's preferred stock), which is defined in SSAP No. 68. Investments in an SCA's preferred stock are addressed in paragraphs 27-31. The carrying amount of the investment shall be adjusted for the amortization of goodwill, as well as to recognize the reporting entity's share of the audited GAAP basis earnings or losses of the investee after the date of acquisition, adjusted for any dividends received. A reporting entity's share of adjustments that are recorded directly to the investee's stockholder's equity under GAAP shall also be recorded as adjustments to the carrying value of the investment with a corresponding amount recorded directly to unrealized capital gains and losses on investments. For entities subject to paragraphs 8.b.ii. or 8.b.iv. additional adjustments are required in accordance with paragraph 9.

13. On at least a quarterly basis, the procedures set forth below shall be followed by a reporting entity in applying an equity method of accounting (as described in paragraphs 8.b.i. through 8.b.iv.), as applicable, to investments in SCA entities:

a. A difference between the cost of an investment and the underlying equity in the statutory or GAAP book value, as applicable, of the acquired company at the date of acquisition shall be accounted for in accordance with SSAP No. 68 however, positive goodwill for noninsurance SCA entities subject to paragraph 8.b.ii. and foreign insurance SCA entities subject to paragraph 8.b.iv. shall be subject to the admissibility criteria in paragraph 9.d. rather than the admissibility criteria of paragraph 7 of SSAP No. 68.

b. A transaction of an investee of a capital nature that affects the reporting entity's share of stockholders' equity of the investee shall be reflected as an unrealized gain or loss (e.g., where the investee issues additional stock or a new class of stock that impacts the reporting entity's equity ownership in the investee, the reporting entity's recorded investment shall be adjusted to reflect the transaction);

c. Realized gains or losses on the sale of an investment in a SCA entity shall be recorded in an amount equal to the difference at the time of sale between the selling price and carrying amount of the investment plus any previously recorded unrealized gain or loss;

d. If financial statements of an investee are not sufficiently timely for the reporting entity to apply an equity method to the investee's current results of operations, the reporting entity shall record its share of the earnings or losses of an investee from the most recent available financial statements. A lag in reporting shall be consistent from period to period. This paragraph does not apply to a SCA valued under paragraph 8.b.i.;

e. For entities subject to 8.b.i., 8.b.iii. and 8.b.iv. a reporting entity's share of losses of an investee may equal or exceed the carrying amount of an investment accounted for by an equity method plus advances made by the investor. The reporting entity shall discontinue applying an equity method when the investment (including advances) is reduced to zero[2] and shall not provide for additional losses unless the reporting entity has guaranteed obligations of the investee or is otherwise committed to provide further financial support for the investee (guaranteed obligations meeting the definition of liabilities in *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets* shall be recorded as liabilities). If the investee subsequently reports net income, the reporting entity shall resume applying an equity method only after its share of that net income equals the share of net losses not recognized during the period that an equity method was suspended;

f. When an investee has outstanding cumulative preferred stock, the reporting entity shall compute its share of earnings (losses) after deducting the investee's preferred dividends, whether or not such dividends are declared;

g. An investment in a SCA entity may fall below the level of ownership described in paragraph 5 from the sale of a portion of an investment by the reporting entity, the sale of additional interests by an investee, or other transactions. The reporting entity shall discontinue accruing its share of the earnings or losses of the investee for an investment that no longer qualifies for an equity method. The earnings or losses that relate to the investment interests retained by the reporting entity and that were previously accrued shall remain as a part of the carrying amount of the investment. The investment account shall not be adjusted retroactively under the conditions described in this subparagraph. However, dividends received by the investor in subsequent periods which exceed the

[2] Refer to the additional guidance related to discontinuance of an equity method in paragraphs 15-17 and *INT 00-24: EITF 98-13: Accounting by an Equity Method Investor for Investee Losses When the Investor Has Loans to and Investments in Other Securities of the Investee and EITF 99-10: Percentage Used to Determine the Amount of Equity Method Losses.*

reporting entity's share of earnings for such periods shall be applied as a reduction of the carrying amount of the investment.

14. Once the reporting entity elects to use a valuation approach for a particular subsidiary, the reporting entity may not change the valuation method to another method without the approval of the domiciliary commissioner. For instance, if an entity selects the market valuation method, it may not change to an equity method or vice versa without approval from the domiciliary commissioner. Further, in order for an entity to transfer from a paragraph 8.a., or 8.b.ii. valuation to a paragraph 8.b.iii. valuation, the SCA shall not exceed the 20% threshold (as defined in paragraphs 8.b.ii.) for three consecutive years prior to making the change. When an investment qualifies for use of another method of accounting, the reporting entity shall adopt the new method of accounting and the investment shall be adjusted to reflect the reporting entity's equity interest in the SCA entity under the new method. A corresponding amount shall be recorded as an unrealized gain or loss.

15. If an additional investment, in whole or in part, represents, in substance, the funding of prior losses, the entity should recognize previously suspended losses only up to the amount of the additional investment determined to represent the funding of prior losses. Whether the investment represents the funding of prior losses depends on the facts and circumstances.

16. Judgment is required in determining whether prior losses are being funded and that all available information should be considered in performing the related analysis. The following are certain factors to consider in that regard. However, no one factor should be considered presumptive or determinative.

a. Whether the additional investment is acquired from a third party or directly from the investee. When the additional investment is purchased from a third party and the investee does not obtain additional funds either from the investor or the third party, it is unlikely that, in the absence of other factors, prior losses are being funded.

b. The fair value of the consideration received in relation to the value of the consideration paid for the additional investment. For example, if the fair value of the consideration received is less than the fair value of the consideration paid, it may indicate that prior losses are being funded to the extent that there is disparity in the value of the exchange.

c. Whether the additional investment results in an increase in ownership percentage of the investee. In instances in which the investment is made directly with the investee, the investor should consider the form of the investment and whether other investors are making simultaneous investments proportionate to their interests. Investments made without a corresponding increase in ownership or other interests, or a pro rata equity investment made by all existing investors, may indicate that prior losses are being funded.

d. The seniority of the additional investment relative to existing equity of the investee. An investment in an instrument that is subordinate to other equity of the investee may indicate that prior losses are being funded.

17. Upon making the additional investment, the investor should evaluate whether it has become otherwise committed to provide financial support to the investee.

18. A reporting entity that owns an interest in itself via direct ownership of shares of an upstream intermediate or ultimate parent shall reduce the value of such shares for the reciprocal ownership. If the shares of the parent are owned indirectly by a reporting entity, via a downstream SCA entity, the directly held entity, which owns the parent's shares, shall have its value reduced for the reciprocal ownership.

19. Any parent reporting entity that owns an interest in itself via either direct or indirect ownership of a down-stream affiliate, which in turn owns shares of the parent reporting entity, shall eliminate its interest in these shares from the valuation of such affiliate.

Qualified Versus Unqualified Opinions

20. Various opinions can be issued in which an entity can record certain investments under the GAAP Equity method of accounting. The reporting entity shall record investments that require audited GAAP equity in the manner described below when the audit opinion on the GAAP financial statements contains the following language:

a. The investment shall be nonadmitted if the audit opinion contains a disclaimer of opinion for the most recent statement of financial position presented in the financial statements.

b. The investment shall be nonadmitted if the audit opinion contains a qualified opinion due to a scope limitation that impacts the most recent statement of financial position presented in the financial statements and the impact of the scope limitation cannot be quantified. However, if the impact of the scope limitation is quantified in the audited financial statements or the audit opinion, the investment shall be admitted and the reporting entity's valuation of the investment shall be determined based on the GAAP equity of the investee, adjusted to exclude the impact of the quantified scope limitation.

c. The investment shall be nonadmitted if the audit opinion contains a qualified opinion due to a departure from GAAP that impacts the most recent statement of financial position presented in the financial statements and the impact of such departure is not quantified in either the auditor's report or the footnotes to the financial statements (see quantification exception related to the valuation of a U.S. insurance entity on the basis of U.S. statutory accounting principles discussed below). However, if the impact of the departure from GAAP is quantified in the audited financial statements or the audit opinion, the investment shall be admitted and the reporting entity's valuation of the investment shall be determined based on the GAAP equity of the investee, adjusted to exclude the impact of the quantified departure from GAAP. EXCEPTION: There is no need to quantify the impact of a departure from GAAP in either the auditor's report or the footnotes to the financial statements if a qualified audit opinion is issued due to a departure from GAAP and the departure is related to the valuation of an U.S. insurance entity on the basis of U.S. statutory accounting principles. In such cases, the investment shall be admitted without quantifying the departure.

d. The investment shall be nonadmitted if the audit opinion contains an adverse opinion due to a departure from GAAP that impacts the most recent statement of financial position presented in the financial statements and the impact of such departure is not quantified in either the auditor's report or the footnotes to the financial statements (see quantification exception related to the valuation of a U.S. insurance entity on the basis of U.S. statutory accounting principles discussed below). However, if the impact of the departure from GAAP is quantified in the audited financial statements or the audit opinion, the investment shall be admitted and the reporting entity's valuation of the investment shall be determined based on the GAAP equity of the investee, adjusted to exclude the impact of the quantified departure from GAAP. EXCEPTION: There is no need to quantify the impact of a departure from GAAP in either the auditor's report or the footnotes to the financial statements if an adverse audit opinion is issued due to a departure from GAAP and the departure is related to the valuation of an U.S. insurance entity on the basis of U.S. statutory accounting principles. In such cases, the investment shall be admitted without quantifying the departure.

e. The investment shall be nonadmitted if the audit opinion contains explanatory language indicating that there is substantial doubt about the investee's ability to continue as a going concern.

Valuation of Investments in Downstream Holding Companies

21. SSAP No. 48 requires the financial statements of joint ventures, partnerships, and/or limited liability companies in which the downstream noninsurance holding company has a minor ownership interest or otherwise lacks control, i.e., ownership interest is less than 10% (hereinafter referred to as "non SCA SSAP No. 48 entities"), to be valued using U.S. GAAP basis financial statements. Valuation of a downstream holding company, including its investments in SCA entities, depends upon the nature of the SCA entities and non SCA SSAP No. 48 entities it holds in accordance with paragraph 8 of this statement. All liabilities, commitments, contingencies, guarantees or obligations of the downstream noninsurance holding company, which are required to be recorded under applicable statutory accounting guidance, shall be reflected in the parent insurance reporting entity's determination of the carrying value of the investment in the downstream noninsurance holding company, if not already recorded in the financial statements of the downstream noninsurance holding company. If an SCA investment of the downstream holding company does not meet the provisions of paragraph 8.a. or if it elects not to use the guidance in paragraph 8.a., and instead uses the guidance in paragraph 8.b., the downstream holding company would be valued as the sum of the following (if applicable):

a. Investments by a downstream holding company in U.S. insurance SCA entities are recorded based upon the guidance in paragraph 8.b.i.;

b. Investments by a downstream holding company in noninsurance SCA entities that are engaged in transactions or activities described in paragraph 8.b.ii., are recorded based upon the guidance in paragraph 8.b.ii.;

c. Investments by a downstream holding company in noninsurance SCA entities that do not qualify under paragraph 21.b. shall be recorded based upon the guidance in paragraph 8.b.iii.;

d. Investments by a downstream holding company in foreign insurance SCA entities shall be recorded based upon the guidance in paragraph 8.b.iv.; and

e. Any other assets and/or liabilities of the downstream holding company (not addressed in paragraphs 21.a. through 21.d.) shall be valued in accordance with the applicable SSAP.

For purposes of applying paragraphs 21-26 of this statement, a downstream holding company shall be considered to be the parent reporting entity's investment in a SCA entity. See paragraphs 25 and 26 for a limited exception to the audited financial statements requirement for downstream noninsurance holding companies which meet specified conditions.

Admissibility Requirements of Investments in Downstream Holding Companies

22. To meet the admissibility requirements of this statement, unless the limited exception to the audited financial statements requirement discussed in paragraphs 25 and 26 applies, an annual audit of the financial statements of SCA entities, including the downstream holding company valued under paragraphs 8.b.i through 8.b.iv. must be obtained. The requirement for audited financial statements may be met by utilizing any one of the following methods:

a. Audited US GAAP financial statements of the downstream SCA holding company. (Consolidated or combined financial statements are allowed encompassing one or more downstream holding companies, including such holding companies that directly own U.S.

insurance entities, provided that the statutory financial statements of such U.S. insurance entities are audited. Annual consolidated or combined audits are allowed for insurance entities if completed in accordance with the Model Regulation Requiring Annual Audited Reports as adopted by the SCA's domiciliary state.) The audited financial statements of the downstream holding company shall include as other financial information, consolidating or combining balance sheet schedule(s) showing the equity of all relevant SCA entities and non-SCA SSAP No. 48 entities, and any required intercompany eliminations. The consolidating or combining balance sheet schedule shall separately present those entities owned directly by the downstream holding company. The consolidating or combining balance sheet shall then be adjusted for GAAP to SAP differences for paragraph 8.b.i., 8. b. ii. and 8.b.iv. entities owned directly or indirectly by the downstream holding company. The adjusted amount would then be the reported value of the investment in the downstream holding company at the higher-level reporting entity; or

b. Audited foreign GAAP-basis financial statements of the downstream SCA holding company. (Consolidated or combined financial statements are allowed encompassing one or more downstream holding companies, including such holding companies that directly own U.S. insurance entities, provided that the statutory financial statements of such U.S. insurance entities are audited. Annual consolidated or combined audits are allowed for insurance entities if completed in accordance with the Model Regulation Requiring Annual Audited Reports as adopted by the SCA's domiciliary state.) The audited foreign GAAP basis financial statements shall include an audited footnote disclosure within the financial statements that reconciles each consolidated entity's net income and equity on a foreign basis of accounting to a U.S. GAAP basis. The audited financial statements of the downstream holding company shall include as other financial information, consolidating or combining balance sheet schedule(s) showing the equity of all relevant SCA entities non SCA SSAP No. 48 entities, and any required intercompany eliminations. The consolidating or combining balance sheet schedule shall separately present those entities owned directly by the downstream holding company. The consolidating or combining balance sheet shall then be adjusted for GAAP to SAP differences of the insurance entities and paragraph 8.b.ii., and 8.b.iv. entities owned directly or indirectly by the downstream holding company. The adjusted amount would then be the reported value of the investment in the downstream holding company at the higher-level reporting entity; or

c. Individual audits of the downstream holding company and the downstream holding company's investments in individual SCA entities.

23. If the downstream noninsurance holding company does not meet the requirements of paragraph 25, audited GAAP financial statements, as described in paragraph 22, are required for the downstream noninsurance holding company and its SCA and non SCA investments in order for the investment in the downstream noninsurance holding company to be classified as an admitted asset.

24. A purchased downstream holding company is valued in accordance with the provisions of paragraphs 21-24 and the provisions of SSAP No. 68.

Limited Exceptions to the Audit Requirements for Downstream Noninsurance Holding Companies

25. This statement requires that investments in SCA entities be recorded using one of the valuation methods described in paragraph 8 in order to be admitted assets. Each of the paragraph 8.b. valuation methods require the financial statements of SCA entities, including downstream noninsurance holding companies, to be audited in order for the investments in SCA entities to be admitted assets. Likewise,

SSAP No. 48 requires the financial statements of joint ventures, partnerships, and/or limited liability companies in which the downstream noninsurance holding company has a minor ownership interest or otherwise lacks control, i.e., ownership interest is less than 10% to be audited (U.S. GAAP) in order to be admitted assets. There is a limited exception to the requirement to have audited financial statements of a downstream noninsurance holding company, provided that the entities owned by the downstream noninsurance holding company (8.b.iii. entity) have audited financial statements as described in paragraphs 25 and 26.

26. The process of admitting audited investments in entities owned by an unaudited downstream noninsurance holding company SCA entity will be known as a “look through.” In order to admit the investments in audited SCAs or the audited non SCA SSAP No. 48 entities owned by an unaudited downstream noninsurance holding company, a reporting entity may apply the look through approach, provided all of the following conditions are met:

a. The downstream noninsurance holding company is an 8.b.iii entity, and

b. The downstream noninsurance holding company does not own any other assets which are material to the downstream holding company other than the audited SCA entities and/or audited non SCA SSAP No. 48 entities, and

c. The downstream noninsurance holding company is not subject to liabilities, commitments, contingencies, guarantees or obligations which are material to the downstream noninsurance holding company.

If an investment in a downstream noninsurance holding company meets the requirements set forth above, the reporting entity can admit the individual audited SCA entities and/or audited non SCA SSAP No. 48 entities; however, unaudited immaterial assets of the downstream noninsurance holding company are to be carried at the lesser of the paragraph 8 valuation or nonadmitted (e.g. some equity method investments are required to be carried at a negative value due to either statutory adjustments or to parental obligations to keep funding the subsidiary).

Investment in Preferred Stock or Surplus Notes of a Subsidiary, Controlled and Affiliated Entity

27. Investments in common stock, preferred stock and surplus notes are reported separately. Care should be taken to avoid double counting of the separate investments. When the SCA investee has issued multiple equity components such as common stock, preferred stock and/or surplus note(s) the total reported equity of the SCA investee must be separated into the respective components in order to determine the equity attributable to each class.

28. In order to establish the equity value of the common stock investment in an SCA, the reporting entity reduces the total equity of the SCA by the SCA's (issuer’s) value of the preferred stock and/or surplus notes on the issuer’s balance sheet (not the reporting entity's book/adjusted carrying value for the SCA’s preferred stock and/or surplus notes held).

29. Investments in the preferred stock of an SCA shall be accounted for and reported in accordance with the provisions of *SSAP No. 32—Investments in Preferred Stock (including investments in common stock of subsidiary, controlled or affiliated entities)* (SSAP No. 32).

30. Investments in the surplus notes of an SCA shall be accounted for and reported in accordance with the provisions of *SSAP No. 41—Surplus Notes.*

31. The following example is provided to illustrate the accounting and reporting. The reporting entity holds 100% of the preferred stock. The SCA issued the preferred stock for $50,000. The investment in the SCA, measured in accordance with this SSAP is $250,000 including the preferred stock of the SCA. The

investment in the SCA is $200,000 ($250,000-50,000) and the preferred stock is measured and reported in accordance with SSAP No. 32.

Impairment

32. For any decline in the fair value of an investment in a SCA entity that is other than temporary(INT 06-07), the investment shall be written down to fair value as the new cost basis and the amount of the write down shall be accounted for as a realized loss. The write down shall first be considered as an adjustment to any portion of the investment that is nonadmitted (e.g., goodwill). The new cost basis shall not be changed for subsequent recoveries in fair value. Future declines in fair value, which are determined to be other than temporary shall be recorded as realized losses. An impairment shall be considered to have occurred if it is probable that the reporting entity will be unable to recover the carrying amount of the investment or there is evidence indicating inability of the investee to sustain earnings, which would justify the carrying amount of the investment. A fair value of an investment that is below the carrying amount based on the statutory equity method or the existence of investee operating losses may indicate a loss in value, however, they are not necessarily indicative of a loss in value that is other than temporary.

Consolidation

33. Majority-owned subsidiaries shall not be consolidated for individual entity statutory reporting. This does not exempt certain reporting entities that are members of an affiliated group from the requirement to issue consolidated or combined annual statements as supplemental information in accordance with NAIC guidelines.

Disclosures

34. The significance of an investment to the reporting entity's financial position and results of operations shall be considered in evaluating the extent of disclosures of the financial position and results of operations of an investee. The following disclosures shall be made for all investments in SCA entities that exceed 10% of the total admitted assets of the reporting entity:

a. Financial statements of a reporting entity shall disclose (i) the name of each SCA entity and percentage of ownership of common stock, (ii) the accounting policies of the reporting entity with respect to investments in SCA entities, and (iii) the difference, if any, between the amount at which the investment is carried and the amount of underlying equity in net assets (i.e., goodwill, other nonadmitted assets, fair value or discounted fair value adjustments) and the accounting treatment of the difference;

b. For those SCA entities for which a quoted market price is available, the aggregate value of each SCA investment based on the quoted price and the difference, if any, between the amount at which the investment is carried and the quoted price shall be disclosed;

c. Summarized information as to assets, liabilities and results of operations shall be presented for SCA entities, either individually or in groups;

d. Conversion of outstanding convertible securities, exercise of outstanding options and warrants and other contingent issuances of an investee may have a significant effect on an investor's share of reported earnings or losses. Accordingly, material effects of possible conversions, exercises or contingent issuances shall be disclosed in notes to the financial statements of the reporting entity; and

e. For those SCA entities in which the reporting entity elected, or was required, to change its valuation method as described in paragraph 14, a description of the reason for the change and the amount of adjustment recorded as unrealized gains or losses shall be disclosed. The entity shall also disclose whether commissioner approval was obtained in accordance with paragraph 14.

35. A reporting entity that calculates its investment in a foreign insurance subsidiary by adjusting annuity GAAP account value reserves using CARVM and the related Actuarial Guidelines shall disclose the interest rates and mortality assumptions used in the calculation as prescribed by the insurance department of the foreign country.

36. Any commitment or contingent commitment to a SCA entity shall be disclosed (e.g., guarantees or commitments to provide additional capital contributions).

37. A reporting entity that recognizes an impairment loss shall disclose the following in the financial statements that include the period of the impairment write down:

a. A description of the impaired assets and the facts and circumstances leading to the impairment; and

b. The amount of the impairment and how fair value was determined.

38. If a reporting entity holds an investment in a downstream noninsurance holding company, the reporting entity may look-through the downstream noninsurance holding company to the value of (i) SCA entities having audited financial statements and/or (ii) joint ventures, partnerships, and/or limited liability companies having audited financial statements in which the downstream noninsurance holding company has a minor ownership interest or otherwise lacks control, i.e., ownership interest is less than 10% in lieu of obtaining an audit of the financial statements of the downstream noninsurance holding company (provided the limited exception to the audited financial statements requirement contained in paragraphs 25-26 applies).

39. If a reporting entity utilizes the look-through approach for the valuation of the downstream noninsurance holding company instead of obtaining audited financial statements of the downstream noninsurance holding company, the financial statements of the reporting entity shall include the following disclosures:

a. The name of the downstream noninsurance holding company;

b. The carrying value of the investment in the downstream non insurance holding company;

c. The fact that the financial statements of the downstream noninsurance company are not audited;

d. The fact that the reporting entity has limited the value of its investment in the downstream noninsurance holding company to the value contained in the audited financial statements, including adjustments required by this statement, of SCA entities and/or non-SCA SSAP No. 48 entities owned by the downstream noninsurance holding company and valued in accordance with paragraphs 21-24;

e. The fact that all liabilities, commitments, contingencies, guarantees or obligations of the downstream noninsurance holding company, which are required to be recorded as liabilities, commitments, contingencies, guarantees or obligations under applicable accounting guidance, are reflected in the reporting entity's determination of the carrying value of the investment in the downstream noninsurance holding company, if not already recorded in the financial statements of the downstream noninsurance holding company.

40. Investments reported using an equity method from paragraph 8.b.ii. through 8.b.iv. may have fiscal year ends, not calendar year ends. To recognize a change to the reporting year-end of an equity method investee, including changes in, or the elimination of, previously existing differences (lag period) due to the reporting entity's ability to obtain financial results from a reporting period that is more consistent with, or the same as, that of the reporting entity, the guidance included in *FASB Emerging Issues Task Force 06-9: Reporting a Change in (or the elimination of) a Previously Existing Difference between the fiscal Year-End of a Parent Company and That of a Consolidated Entity or between the Reporting Period of an Investor and That of an Equity Method Investee* that defines such reporting period changes as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors* (SSAP No. 3) shall be followed. For instances in which this change in accounting principle occurs, disclosure requirements of SSAP No. 3 shall be followed.

41. Refer to the preamble for further discussion regarding disclosure requirements. The disclosures in paragraph 34.d. shall be included in the annual audited statutory financial reports only.

Relevant Literature

42. This statement adopts the *Purposes and Procedures Manual of the NAIC ~~Securities Valuation~~Investment Analysis Office*.

43. This statement adopts *FASB Interpretation No. 35, Criteria for Applying the Equity Method of Accounting for Investments in Common Stock, an Interpretation of APB Opinion No. 18* as guidance to be considered in determining the existence of control.

44. This statement adopts with modification EITF 06-9 to include:

a. Adopt the guidance that defines such reporting period changes as a change in accounting principle in accordance with SSAP No. 3, modified to apply only to equity method investments. For instances in which this change in accounting principle occurs, disclosure requirements of SSAP No. 3 shall be followed.

b. The consolidation guidance in EITF 06-9 is rejected.

c. Changes affecting companies reporting investments in SCA entities using the equity method: Investments in paragraph 8.b.i. entities are required to be calendar year-end. Investments in paragraphs 8.b.ii. through 8.b.iv. entities may have other fiscal year ends, thus this issue could apply to equity method investments under 8.b.ii. through 8.b.iv. or under equity method valued investments that fall within the scope of SSAP No. 48.

45. This statement rejects *APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock, AICPA Accounting Interpretations APB 18, The Equity Method of Accounting for Investments in Common Stock:* Accounting Interpretations of *APB Opinion No. 18, FASB Technical Bulletin No. 79-19, Investor's Accounting for Unrealized Losses on Marketable Securities Owned by an Equity Method Investee, FASB Emerging Issues Task Force No. 87-21, Change of Accounting Basis in Master Limited Partnership Transactions, FASB Emerging Issues Task Force No. 96-16, Investor's Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights*, *FASB Emerging Issues Task Force No. 98-2: Accounting by a Subsidiary or Joint Venture for an Investment in the stock of Its Parent Company or Joint Venture Partner* and *FASB Staff Position No. APB 18-1*, *Accounting by an Investor for Its Proportionate Share of Accumulated Other Comprehensive Income of an Investee Accounted for under the Equity Method in Accordance with APB Opinion No. 18 upon a Loss of Significant Influence.*

Effective Date and Transition

46. This statement is effective for reporting periods ending on and after December 31, 2007. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*. The guidance previously in paragraph 29 of this SSAP amended the title and paragraphs 2 and 3 *of SSAP No. 32—Investments in Preferred Stock (including investments in preferred stock of subsidiary, controlled, or affiliated entities*) (SSAP No. 32). In 2011, this guidance was moved to SSAP No. 32 and deleted from this SSAP. The original guidance included in this standard is retained for historical purposes in Issue Paper No. 118. The guidance previously in paragraph 34 of this SSAP amended paragraphs 4-6 of *SSAP No. 68—Business Combinations and Goodwill* (SSAP No. 68). In 2011, this guidance was moved to SSAP No. 68 and deleted from this SSAP. The original guidance included in this standard is retained for historical purposes in *SSAP No. 88—Investments in Subsidiary, Controlled and Affiliated Entities, A Replacement of SSAP No. 46*. Guidance reflected in paragraph 20, incorporated from *INT 03-03: Admissibility of Investments Recorded Based on the Audited GAAP Equity of the Investee when a Qualified Opinion is Provided* was originally effective December 7, 2003. Guidance reflected in paragraphs 15-17 incorporated from *INT 04-10: Accounting for Subsequent Investments in an Investee after Suspension of Equity Method Loss Recognition* was originally effective December 5, 2004. Guidance in paragraph 40 was previously included within *INT 08-03: EITF 06-9: Reporting a Change in (or the elimination of) a Previously Existing Difference between the fiscal Year-End of a Parent Company and That of a Consolidated Entity or between the Reporting Period of an Investor and That of an Equity Method Investee* and was effective for periods beginning May 31, 2008.

REFERENCES

Other

- *Purposes and Procedures Manual of the NAIC ~~Securities Valuation~~Investment Analysis Office*

Relevant Issue Papers

- *Issue Paper No. 118—Investments in Subsidiary, Controlled and Affiliated Entities, A Replacement of SSAP No. 88*

ILLUSTRATION OF ACCOUNTING FOR SCAS

This illustration, accompanying this Statement, is intended to provide an example of the application of paragraphs 8.b.ii. and 8.b.iii. Where an SCA meets the criteria of 8.b.ii., the illustration further demonstrates the necessary adjustments described in paragraph 9. While not all inclusive, the illustration is representative of the process and adjustments necessary to comply with this Statement. That is, the reporting entity must, first, determine which sub-section of paragraph 8 applies with respect to each SCA. Secondly, where the reporting entity has determined that an SCA meets the criteria of section 8.b.ii. or 8.b.iv., then the carrying amount is adjusted in accordance with the sub-section, which includes adjustments contained in the provisions of paragraph 9.

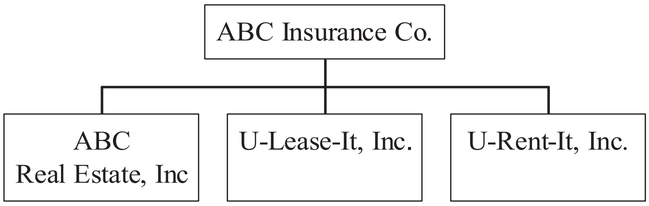
The ABC Insurance Company owns 100% of three subsidiaries:

1. ABC Real Estate, Inc. – owns and manages real estate properties and has no inter-company transactions

2. U-Lease-It, Inc. – leases furniture and equipment to local businesses including the insurance company. Lease fees received from ABC were $10 million each in 20x2 and 20x1.

3. U-Rent-It, Inc. – leases EDP equipment to local businesses including the insurance company. Lease fees received from ABC were $2 million each in 20x2 and 20x1.

ABC Insurance Company



Determination and application of adjustments to audited GAAP equity methods (paragraph 8.b. of SSAP No. 97)

ABC Real Estate, Inc.-the company is not engaged in any activities described in 8b.ii. No adjustments are made and ABC Insurance Company records its investment based upon audited GAAP equity in accordance with 8b.iii.

U-Lease-It, Inc.-the company is engaged in activities described in 8b.ii., leasing furniture and equipment. The fees paid by ABC and reflected in income of U-Lease-It, Inc. exceed 20% of GAAP revenue calculated as follows:

U-Lease-It, Inc.	(Millions)	
	20x1	**20x2**
GAAP revenue	46.5	46.4
Less:		
Realized capital gains/(losses)	6	(.2)
Adjusted GAAP revenue	45.9	46.6
Lease fees from ABC	10.0	10.0
Fees/adjusted GAAP revenue	21.8%	21.5%

U-Rent-It, Inc.-the company is engaged in activities described in 8b.ii., leasing EDP equipment. The fees paid by ABC and reflected in income of U-Rent-It, Inc. do not exceed 20% of GAAP revenue. No adjustments are made and ABC Insurance Company records its investment based upon audited GAAP equity in accordance with 8b.iii. The calculation test is as follows:

U-Rent-It, Inc.	(Millions)	
	20x2	**20x1**
GAAP revenue	32.6	30.5
Lease fees from ABC	2.0	2.0
Fees/GAAP revenue	6.1%	6.6%

Adjustments to audited GAAP equity for U-Lease-It, Inc.

	(Millions)	
	20x2	**20x1**
Audited GAAP equity	129	130
Nonadmit furniture & equipment	(250)	(260)
Nonadmit excess goodwill *	(2)	(2)
Adjusted GAAP equity	(123)	(132)

*Goodwill adjustment - 20x2=$15- (10% x $130[20x1GAAP equity] and 20x1=$15-(10% x $129.9 [20x0 GAAP equity])

Note: No DTA adjustment since the amount is less that 10% of GAAP equity

Schedule D affiliated common stocks for ABC Insurance Company

	(Millions)	
	20x2	**20x1**
ABC Real Estate Inc.	223	219
U-Lease-It, Inc.	(123)	(132)
U-Rent-It, Inc.	30	27
Total	130	114

Note: The change in carrying value between years of $16 million is reported as an unrealized gain in 20x2

ILLUSTRATED BALANCE SHEETS

ABC Insurance Company

	20x2	20x1		20x2	20x1
Net Admitted Assets			Liabilities		
Bonds	11,210	11,150	Policy reserves	12,516	12,394
Common stock (unaffiliated)	325	315	Contract claims	30	29
Common Stock (affiliated)	130	114			
Real estate	120	125	Expenses due and accrued	14	13
Mortgage loans	1,685	1,640	Misc. liabilities	250	245
Cash	10	7	Total liabilities	12,810	12,681
Sub-total	13,480	13,351	Common stock	100	100
Other assets	20	14	Unassigned funds	590	584
Total	13,500	13,365	Total equity	690	684
			Total	13,500	13,365

ABC Real Estate, Inc.

	20x2	20x1		20x2	20x1
Assets			Liabilities		
Cash	10	7	Notes payable	260	220
Bonds (available for sale)	110	103	Misc. liabilities	17	11
Real estate investments	330	280	Total liabilities	277	231
Other assets	50	60			
Total	500	450	Common stock	15	15
			Retained earnings	208	204
			Total equity	223	219
			Total	500	450

U-Lease-It, Inc.

	20x2	20x1		20x2	20x1
Assets			Liabilities		
Cash	5	7	Accounts payable	15	12
Bonds (available for sale)	20	18	Notes payable	183	190
Furniture & equipment	250	260	Total liabilities	198	202
Investments in subs (15.0 mil. Goodwill)	45	42	Common stock	15	15
Federal tax recoverable (DTA)	7	5	Retained earnings	114	115
Total	327	332	Total equity	129	130
			Total	327	332

Summary of Operations

	20x2	20x1
Revenues:		
Interest income	8.1	9.0
Realized capital gains/(losses)	0.6	(0.2)
Investment in sub	3.0	2.6
Lease fees	34.8	35.0
Total	46.5	46.4
Expenses:		
General Administration	6.4	6.2
Depreciation	42.4	41.0
Total	48.8	47.2
Net income before taxes	(2.3)	(0.8)
Federal income tax benefit	0.8	0.3
Net income	(1.5)	(0.5)
Unrealized capital gains/losses	0.4	0.6

U-Rent-It, Inc.

	20x2	20x1		20x2	20x1
Assets			Liabilities		
Cash	6	6	Accounts payable	3	4
Bonds (available for sale)	5	4	Notes payable	202	199
EDP equipment	220	216	Total liabilities	205	203
Other assets	4	4			
Total	235	230	Common stock	10	10
			Retained earnings	20	17
			Total equity	30	27
			Total	235	230

Summary of Operations

	20x2	20x1
Revenues:		
Interest income	0.5	0.4
Lease fees	32.1	30.1
Total	32.6	30.5
Expenses:		
General Administration	3.0	3.0
Depreciation	25.7	24.5
Total	28.7	27.5
Net income before taxes	3.9	3.0
Federal income tax	(1.3)	(1.0)
Net income	2.6	2.0
Unrealized capital gains/losses	0.4	0.6

APPENDIX A – IMPLEMENTATION QUESTIONS AND ANSWERS

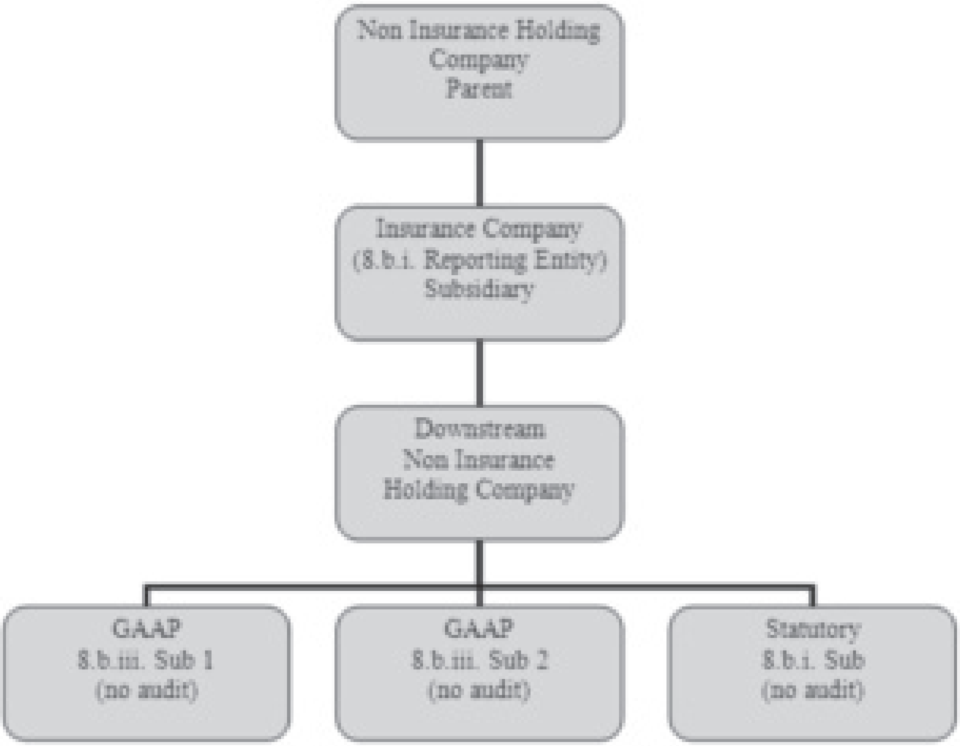
1. **Q – Is the list of activities listed in paragraph 8.b.ii. (f) meant to be all-inclusive? The guidance is as follows:**

> 8.b.ii. (f) Providing insurance services on behalf of the reporting entity including but not limited to accounting, actuarial, auditing, data processing, underwriting, collection of premiums, payment of claims and benefits, policyowner services

1.1 **A –** No, the Working Group did not intend for this list to be all-inclusive, but rather to be used as examples of the types of functions that can be performed by non-insurance companies. The purpose of the list is to set forth examples of activities that are often performed by an insurer directly that can result in less conservative values if performed by an entity that is not required to utilize statutory accounting as defined within the NAIC *Accounting Practices and Procedures Manual*. Therefore, the reporting entity, the auditor, and the regulator should consider whether the purpose of having the subsidiary is to avoid statutory accounting principles as discussed in *SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties*, paragraph 16.d., which reads as follows:

> 16.d. Transactions which are designed to avoid statutory accounting practices shall be reported as if the reporting entity continued to own the assets or to be obligated for a liability directly instead of through a subsidiary.

2. **Q – As illustrated below, would an audit of the upstream holding company with consolidating balance sheets of the insurance company meet the requirements for auditing the subsidiaries under SSAP No. 97?**


Non Insurance Holding Company Parent
Insurance Company (8.b.i. Reporting Entity) Subsidiary
Downstream Non Insurance Holding Company
GAAP 8.b.iii. Sub 1 (no audit)
GAAP 8.b.iii. Sub 2 (no audit)
Statutory 8.b.i. Sub (no audit)

2.1 **A -** No, SSAP No. 97 is specific in that it only allows audited GAAP financial statements of the downstream holding company level (See paragraph 22).

2.2 So, in the example provided above, the reporting entity cannot use an audit of the upstream holding company as the basis for complying with the audit requirements of SSAP No. 97. The primary purpose of the audit is to provide assurance that the valuation of the entity being considered is not materially misstated. Although assurance of this type would be provided for within an unqualified opinion of an upstream holding company, it would only be provided for in the context of the entity being audited. Since the materiality level for an upstream holding company is likely to be set at a higher level, the potential for material misstatement for the reporting entity's subsidiary(ies) could still exist within that unqualified opinion. It should also be noted, however, that individual state insurance holding company laws would still require an audit of the ultimate controlling entity.

3. **Q - Are consolidated, consolidating or combined audited financial statements allowed to meet the requirements for SSAP No. 97? Definitions of these types of audited financial statements are presented below:**

- Consolidated Audited Financial Statements (*ARB 51: Consolidated Financial Statements*, paragraph 1)

> 1. The purpose of consolidated statements is to present, primarily for the benefit of the shareholders and creditors of the parent company, the results of operations and the financial position of a parent company and its subsidiaries essentially as if the group were a single company with one or more branches or divisions. There is a presumption that consolidated statements are more meaningful than separate statements and that they are usually necessary for a fair presentation when one of the companies in the group directly or indirectly has a controlling financial interest in the other companies.

- Consolidating Audited Financial Statements (*ARB 51: Consolidated Financial Statements*, paragraph 24)

> 24. In some cases parent-company statements may be needed, in addition to consolidated statements, to indicate adequately the position of bondholders and other creditors or preferred stockholders of the parent. Consolidating statements, in which one column is used for the parent company and other columns for particular subsidiaries or groups of subsidiaries, often are an effective means of presenting the pertinent information.

- Combined Audited Financial Statements (*ARB 51: Consolidated Financial Statements*, paragraphs 22 and 23)

> 23. To justify the preparation of consolidated statements, the controlling financial interest should rest directly or indirectly in one of the companies included in the consolidation. There are circumstances, however, where combined financial statements (as distinguished from consolidated statements) of commonly controlled companies are likely to be more meaningful than their separate statements. For example, combined financial statements would be useful where one individual owns a controlling interest in several corporations which are related in their operations. Combined statements would also be used to present the financial position and the results of operations of a group of unconsolidated subsidiaries. They might also be used to combine the financial statements of companies under common management.
>
> 24. Where combined statements are prepared for a group of related companies, such as a group of unconsolidated subsidiaries or a group of commonly controlled companies, intercompany transactions and profits or losses should be eliminated, and if there are problems in connection with such matters as minority interests, foreign operations, different fiscal periods, or income taxes, they should be treated in the same manner as in consolidated statements.

3.1 **A -** In this example, only consolidating and combined financial statements are allowed under SSAP No. 97. Combined audited financial statements are used to present the financial position and results of operations of a group of unconsolidated commonly controlled enterprises. Although U.S. Generally Accepted Auditing Standards requirements for combined statements are similar to those required for consolidated financial statements, combined statements are allowed for purposes of meeting the requirements of this statement. (Consolidated or combined financial statements are allowed encompassing one or more downstream SCA entities, including downstream SCA entities that directly or indirectly own U.S. insurance entities provided that the statutory financial statements of such U.S. insurance entities are audited. Annual consolidated or combined audits are allowed for insurance entities if completed in accordance with the Model Regulation Requiring Annual Audited Reports as adopted by the SCA's domiciliary state.)

4. **Q - Does a balance sheet audit meet the admissibility test within SSAP No. 97, or would a full audit be required?**

4.1 **A -** The Working Group intended for a full financial statement audit to be performed, rather than a limited reporting engagement, in accordance with AU Section 508, paragraph 33 which states:

> ***Limited reporting engagements.*** The auditor may be asked to report on one basic financial statement and not on the others. For example, he or she may be asked to report on the balance sheet and not on the statements of income, retained earnings or cash flows. These engagements do not involve scope limitations if the auditor's access to information underlying the basic financial statements is not limited and if the auditor applies all the procedures he considers necessary in the circumstances; rather, such engagements involve limited reporting objectives. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

4.2 In addition, within SSAP No. 97, paragraph 8.c.i. (line 1) there is a reference to the "annual GAAP audit," which indicates a full audit. A limited engagement audit was not the intent when SSAP No. 97 or its predecessors, were developed.

4.3 Therefore, SSAP No. 97 requires the presentation of the balance sheet, income statement, statement of surplus and cash flows of each admitted entity to be presented, along with the corresponding notes to the financial statements (which can be accomplished as a whole).

5. **Q - Does the audit opinion provided on the subsidiaries financial statements have to be clean or unqualified in order for the SCA investment to be admitted?**

5.1 **A –** Paragraph 20 addresses various opinions that can be issued in which an entity can record certain investments under the GAAP Equity method of accounting. In certain cases, such as when the audit opinion is a disclaimer of opinion or there is indication that there is substantial doubt about the entity's ability to continue as a going concern, the guidance states the investment shall be nonadmitted. In addition, if there is a qualified opinion due to a departure from GAAP (or an adverse opinion) or due to a scope limitation, the investment shall be nonadmitted unless the impact of the departure is quantified within the audit **opinion** (see quantification exception related to the valuation of a U.S. insurance entity on the basis of U.S. statutory accounting principles discussed below). In cases where the departure is quantified, the reporting entity would admit the amount after adjusting for the quantified departure from GAAP. An audit report that contains a qualified or adverse opinion for any other reason than for what is stated within paragraph 20 would result in the nonadmissibility of the investment within that subsidiary. There is no need to quantify the impact of a departure from GAAP in either the auditor's report or the footnotes to the financial statements if a qualified audit opinion is issued due to a departure from GAAP and the departure is related to the valuation of an U.S. insurance entity on the basis of U.S. statutory accounting principles. In such cases, the investment shall be admitted without quantifying the departure.

6. **Q - Do GAAP audits for non-insurance entities need to be completed before the annual statement or audited financial statements are filed? They are required to be completed annually, but should there be clarification on when the audits are due?**

6.1 **A -** Paragraph 13.d. allows for a lag time if the audits of the investees are not completed as of the reporting date, as long as the lag is on a consistent annual basis and the SCA is not valued under paragraph 8.b.i. The following is an excerpt from paragraph 13.d. (bolded for emphasis). The SCA entity is still required to be audited annually.

> 13.d. If financial statements of an investee are not sufficiently timely for the reporting entity to apply an equity method to the investee's current results of operations, the reporting entity shall record its share of the earnings or losses of an investee from the **most recent available financial statements. A lag in reporting shall be consistent from period to period.** This paragraph does not apply to a SCA valued under paragraph 8.b.i.

7. **Q - Is it possible for an SCA investment valued using an equity method to be reported as a negative value?**

7.1 **A -** Yes, the equity method noninsurance SCA could have a negative equity. SSAP No. 97 paragraph 8.b.ii. relating to noninsurance SCA entities requires some assets to be reported as a negative value (nonadmitted) in paragraph 9. For example an 8.b.ii. SCA subsidiary that is only holding furniture, which is nonadmitted, would be reflected with negative equity to the extent the value of the nonadmitted asset(s) exceed(s) reported equity. It should be noted that although SSAP No. 97, paragraph 13.e. discusses some situations in which the equity method should be discontinued, this does not apply to SCA entities, which meet the requirements of paragraph 8.b.ii. In addition, SSAP No. 97, paragraph 13.e. lists some situations where the equity method would result in a valuation that is less than zero; examples are if reporting entity has guaranteed obligations of the investee or is otherwise committed to provide further financial support for the investee, in these cases, the valuation of the investment in subsidiary could be a negative value.

8. **Q - Paragraph 13.e. of SSAP No. 97, lists some situations where the equity method should be discontinued. If the equity method is discontinued, does the reporting entity cease tracking equity losses?**

8.1 **A -** No, the reporting entity does not cease tracking losses related to the investment in the SCA if an equity method is discontinued. If the equity method is discontinued, follow the guidance in paragraphs 15-17 and *INT 00-24: EITF 98-13: Accounting by an Equity Method Investor for Investee Losses When the Investor Has Loans to and Investments in Other Securities of the Investee and EITF 99-10: Percentage Used to Determine the Amount of Equity Method Losses* (INT 00-24).

8.2 INT 00-24 lists situations that might require the reporting entity to write down other investments in the SCA subsidiary, such as loans, because of continuing losses in the SCA investment. Paragraphs 15-17 provides guidance to assist in determining whether prior losses are being funded if the reporting entity purchases additional stock, etc. after suspending the equity method. Paragraphs 15-17 in INT 00-24 note that even if the equity method is not being applied, the investment should be tracked to determine if additional losses have to be applied to other items and to determine if the investment in the SCA has a future recovery.

9. **Q - SSAP No. 97, paragraphs 27-31 provide guidance on segregating the equity from common stock from the equity in the form of preferred stock and surplus notes. This guidance is required for reporting reasons and to prevent double counting of these items in the SCA equity. This section indicates that preferred stock is deducted from the total equity. The guidance notes that reporting entities report their investments in preferred stock in accordance with *SSAP No. 32—Investments in Preferred Stock (including investments in preferred stock of subsidiary, controlled, or affiliated entities*), which requires reporting at book value, fair value, or the lower of book value or fair value. When deducting the preferred stock from the equity of the SCA, which measure of**

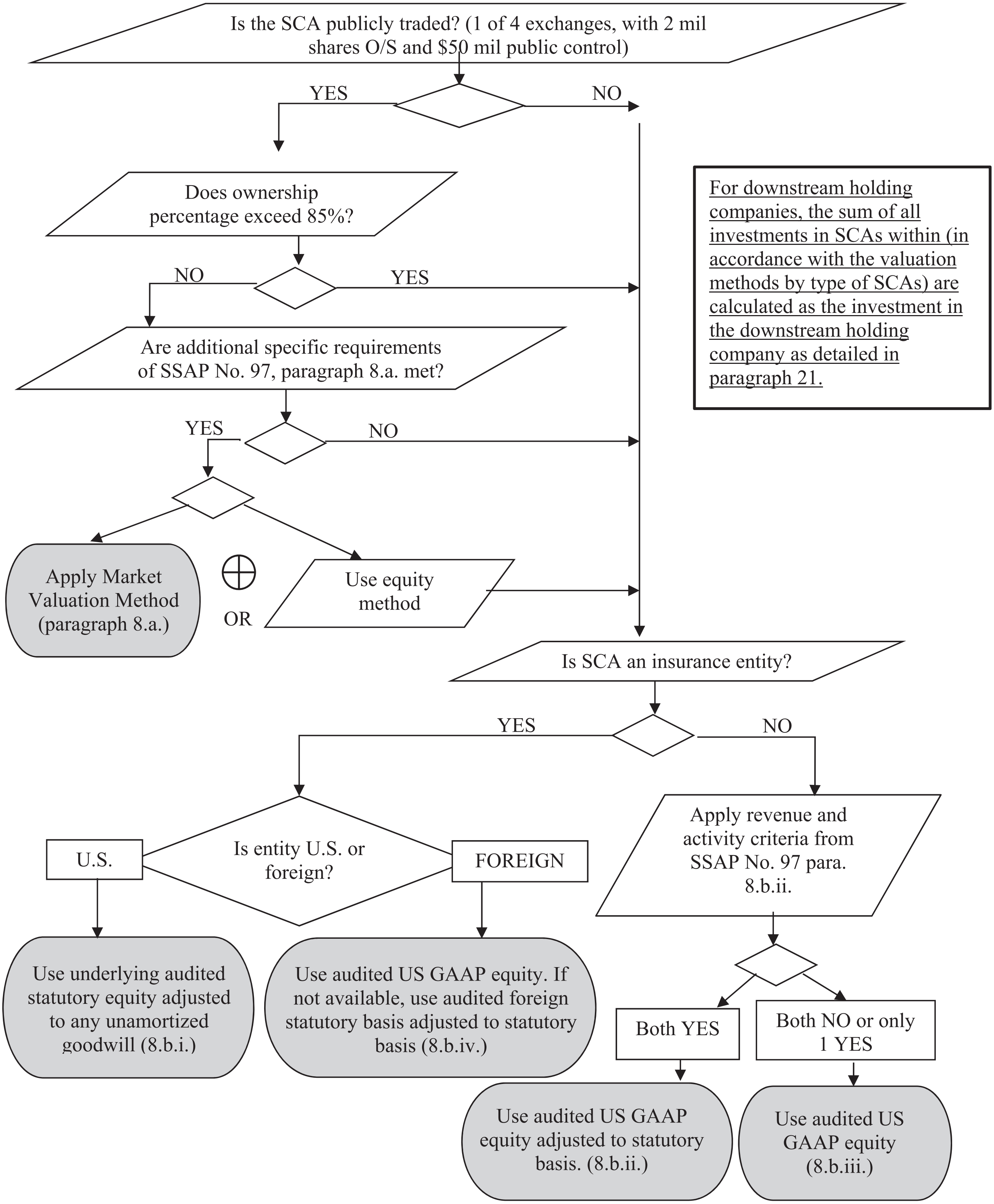
preferred stock is to be utilized; the investor's reporting valuation or the Issuer's value in the equity section of their balance sheet?

9.1 **A -** In order to establish the equity value of the common stock investment in an SCA, the reporting entity reduces the total equity of the SCA by the SCA's (Issuer's) value of the preferred stock on the issuer's balance sheet (not the reporting entity's Book/Adjusted Carrying Value for the SCA's preferred stock held). Continuing from the example in paragraph 31, if the reporting entity's Book/Adjusted Carrying Value for the SCA preferred stock is currently $40,000, the SCA's issuing value of the preferred stock ($50,000) would still be used to calculate the total equity of the SCA ($250,000 - $50,000 = $200,000). It should be noted this calculation does not affect the preferred stock valuation of $40,000 on the books of the investor.

10. **Q - If a parent reporting entity owns another insurance company that has obtained a permitted practice, or exemption or waiver from its state of domicile from the annual statutory audit requirement, would the parent be automatically allowed to admit the investment in the unaudited subsidiary?**

10.1 **A -** No, the parent would need to obtain a permitted practice allowing the parent reporting entity to admit the non-audited insurance company due to the admissibility requirements of SSAP No. 97.

APPENDIX B – DETERMINING THE VALUATION METHOD UNDER SSAP NO. 97


Is the SCA publicly traded? (1 of 4 exchanges, with 2 mil shares O/S and $50 mil public control)
YES
NO
Does ownership percentage exceed 85%?
NO
YES
Are additional specific requirements of SSAP No. 97, paragraph 8.a. met?
YES
NO
Apply Market Valuation Method (paragraph 8.a.)
OR
Use equity method
Is SCA an insurance entity?
YES
NO
Is entity U.S. or foreign?
U.S.
FOREIGN
Use underlying audited statutory equity adjusted to any unamortized goodwill (8.b.i.)
Use audited US GAAP equity. If not available, use audited foreign statutory basis adjusted to statutory basis (8.b.iv.)
Apply revenue and activity criteria from SSAP No. 97 para. 8.b.ii.
Both YES
Both NO or only 1 YES
Use audited US GAAP equity adjusted to statutory basis. (8.b.ii.)
Use audited US GAAP equity (8.b.iii.)

For downstream holding companies, the sum of all investments in SCAs within (in accordance with the valuation methods by type of SCAs) are calculated as the investment in the downstream holding company as detailed in paragraph 21.

APPENDIX C – SLIDING SCALE DISCOUNTING OF SCA ENTITIES USING THE MARKET VALUATION APPROACH

This chart illustrates the sliding scale discounting by ownership percentage that is described in paragraphs 8.a.iv., 8.a.v. and 8.a.vi. for investments in subsidiary controlled or affiliated entities which are carried using the market valuation approach.

Ownership Percentage	Discount Percentage	Ownership Percentage	Discount Percentage
10%	0.00%	48%	19.00%
11%	0.50%	49%	19.50%
12%	1.00%	50%	20.00%
13%	1.50%	51%	20.33%
14%	2.00%	52%	20.67%
15%	2.50%	53%	21.00%
16%	3.00%	54%	21.33%
17%	3.50%	55%	21.67%
18%	4.00%	56%	22.00%
19%	4.50%	57%	22.33%
20%	5.00%	58%	22.67%
21%	5.50%	59%	23.00%
22%	6.00%	60%	23.33%
23%	6.50%	61%	23.67%
24%	7.00%	62%	24.00%
25%	7.50%	63%	24.33%
26%	8.00%	64%	24.67%
27%	8.50%	65%	25.00%
28%	9.00%	66%	25.33%
29%	9.50%	67%	25.67%
30%	10.00%	68%	26.00%
31%	10.50%	69%	26.33%
32%	11.00%	70%	26.67%
33%	11.50%	71%	27.00%
34%	12.00%	72%	27.33%
35%	12.50%	73%	27.67%
36%	13.00%	74%	28.00%
37%	13.50%	75%	28.33%
38%	14.00%	76%	28.67%
39%	14.50%	77%	29.00%
40%	15.00%	78%	29.33%
41%	15.50%	79%	29.67%
42%	16.00%	80%	30.00%
43%	16.50%	81%	30.00%
44%	17.00%	82%	30.00%
45%	17.50%	83%	30.00%
46%	18.00%	84%	30.00%
47%	18.50%	85%	30.00%

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Statement of Statutory Accounting Principles No. 100

Fair Value Measurements

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SCOPE OF STATEMENT **3**

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Fair Value Measurements

SCOPE OF STATEMENT

1. This statement defines fair value, establishes a framework for measuring fair value and establishes disclosure requirements about fair value.

SUMMARY CONCLUSION

2. This standard applies under other accounting pronouncements that require or permit fair value measurements, but this standard does not require any new fair value amendments. However, the application of this standard may change current practice. This standard does not eliminate the practicability exceptions to fair value measurements in accounting pronouncements within the scope of this standard.

Scope

3. This standard applies under other statutory accounting pronouncements that require or permit fair value measurements, except as follows:

a. This standard does not eliminate the practicality exceptions to fair value measurements in accounting pronouncements within the scope of this standard.

b. This standard does not apply under *SSAP No. 22—Leases* (SSAP No. 22) and other accounting pronouncements that address fair value measurements for purposes of lease classification to measurement under SSAP No. 22. This scope exception does not apply to assets acquired or liabilities assumed in a business combination that are required to be measured at fair value under *SSAP No. 68—Business Combinations and Goodwill* (SSAP No. 68), regardless of whether those assets and liabilities are related to leases. This standard does not apply to share-based payment transactions captured within *SSAP No. 104R—Share-Based Payments* (SSAP No. 104R).

Definition of Fair Value

4. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Components of the Fair Value Definition

5. Asset/Liability - A fair value measurement is for a particular asset or liability. Therefore, the measurement should consider attributes specific to the asset or liability, for example, the condition and/or location of the asset or liability and restrictions, if any, on the sale or use of the asset at the measurement date. The asset or liability might be a standalone asset or liability (for example, a financial instrument or an operating asset) or a group of assets and/or liabilities (for example, an asset group, a reporting unit, or a business).

6. Price - A fair value measurement assumes that the asset or liability is exchanged in an orderly transaction between market participants to sell the asset or transfer the liability at the measurement date. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale). The transaction to sell the asset or transfer the liability is a hypothetical transaction at the measurement date, considered from the perspective of a market participant that holds the asset or owes the liability. Therefore, the objective of a fair value measurement is to determine the price that would be received to sell the asset or paid to transfer the liability at the measurement date (an exit price).

7. Principal (or Most Advantageous) Market - A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. The principal market is the market in which the reporting entity would sell the asset or transfer the liability with the greatest volume and level of activity for the asset or liability. The most advantageous market is the market in which the reporting entity would sell the asset or transfer the liability with the price that maximizes the amount that would be received for the asset or minimizes the amount that would be paid to transfer the liability, considering transaction costs in the respective market(s). In either case, the principal (or most advantageous) market (and thus, market participants) should be considered from the perspective of the reporting entity, thereby allowing for differences between and among entities with different activities. If there is a principal market for the asset or liability, the fair value measurement shall represent the price in that market (whether that price is directly observable or otherwise determined using a valuation technique), even if the price in a different market is potentially more advantageous at the measurement date.

8. The price in the principal (or most advantageous) market used to measure the fair value of the asset or liability shall not be adjusted for transaction costs. Transaction costs represent the incremental direct costs to sell the asset or transfer the liability in the principal (or most advantageous) market for the asset or liability. Transaction costs are not an attribute of the asset or liability; rather, they are specific to the transaction and will differ depending on how the reporting entity transacts. However, transaction costs do not include the costs that would be incurred to transport the asset or liability to (or from) its principal (or most advantageous) market. If location is an attribute of the asset or liability (as might be the case for a commodity), the price in the principal (or most advantageous) market used to measure the fair value of the asset or liability shall be adjusted for the costs, if any, that would be incurred to transport the asset or liability to (or from) its principal (or most advantageous) market.

9. Market Participants - Market participants are buyers and sellers in the principal (or most advantageous) market for the asset or liability that are:

a. Independent of the reporting entity; that is, they are not related parties;

b. Knowledgeable, having a reasonable understanding about the asset or liability and the transaction based on all available information, including information that might be obtained through due diligence efforts that are usual and customary;

c. Able to transact for the asset or liability; and

d. Willing to transact for the asset or liability; that is, they are motivated but not forced or otherwise compelled to do so.

10. The fair value of the asset or liability shall be determined based on the assumptions that market participants would use in pricing the asset or liability. In developing those assumptions, the reporting entity need not identify specific market participants. Rather, the reporting entity should identify characteristics that distinguish market participants generally, considering factors specific to (a) the asset or liability, (b) the principal (or most advantageous) market for the asset or liability, and (c) market participants with whom the reporting entity would transact in that market.

11. *Application to Assets* - A fair value measurement assumes the highest and best use of the asset by market participants, considering the use of the asset that is physically possible, legally permissible, and financially feasible at the measurement date. In broad terms, highest and best use refers to the use of an asset by market participants that would maximize the value of the asset or the group of assets within which the asset would be used. Highest and best use is determined based on the use of the asset by market participants, even if the intended use of the asset by the reporting entity is different.

12. The highest and best use of the asset establishes the valuation premise used to measure the fair value of the asset. Specifically:

a. In-use – The highest and best use of the asset is in-use if the asset would provide maximum value to market participants principally through its use in combination with other assets as a group (as installed or otherwise configured for use). For example, that might be the case for certain nonfinancial assets. If the highest and best use of the asset is in-use, the fair value of the asset shall be measured using an in-use valuation premise. When using an in-use valuation premise, the fair value of the asset is determined based on the price that would be received in a current transaction to sell the asset assuming that the asset would be used with other assets as a group and that those assets would be available to market participants. Generally, assumptions about the highest and best use of the asset should be consistent for all of the assets of the group within which it would be used.

b. In-exchange – The highest and best use of the asset is in-exchange if the asset would provide maximum value to market participants principally on a standalone basis. For example, that might be the case for a financial asset. If the highest and best use of the asset is in-exchange, the fair value of the asset shall be measured using an in-exchange valuation premise. When using an in-exchange valuation premise, the fair value of the asset is determined based on the price that would be received in a current transaction to sell the asset standalone.

13. Because the highest and best use of the asset is determined based on its use by market participants, the fair value measurement considers the assumptions that market participants would use in pricing the asset, whether using an in-use or an in-exchange valuation premise.

14. *Application to Liabilities* - Consideration of non-performance risk (own credit-risk) should not be reflected in the fair value calculation for liabilities (including derivative liabilities) at subsequent measurement. At initial recognition, it is perceived that the consideration of own-credit risk may be inherent in the contractual negotiations resulting in the liability. The consideration of non-performance risk for subsequent measurement is inconsistent with the conservatism and recognition concepts as well as the assessment of financial solvency for insurers, as a decrease in credit standing would effectively decrease reported liabilities and thus seemingly increase the appearance of solvency. Furthermore, liabilities reported or disclosed at “fair value” shall not reflect any third-party credit guarantee of debt.

Fair Value at Initial Recognition

15. When an asset is acquired or a liability is assumed in an exchange transaction for that asset or liability, the transaction price represents the price paid to acquire the asset or received to assume the liability (an entry price). In contrast, the fair value of the asset or liability represents the price that would be received to sell the asset or paid to transfer the liability (an exit price). Conceptually, entry prices and exit prices are different. Entities do not necessarily sell assets at the prices paid to acquire them. Similarly, entities do not necessarily transfer liabilities at the prices received to assume them.

16. In many cases, the transaction price will equal the exit price and, therefore, represent the fair value of the asset or liability at initial recognition. In determining whether a transaction price represents the fair value of the asset or liability at initial recognition, the reporting entity shall consider factors specific to the transaction and the asset or liability. For example, a transaction price might not represent the fair value of an asset or liability at initial recognition if:

a. The transaction is between related parties.

b. The transaction occurs under duress or the seller is forced to accept the price in the transaction. For example, that might be the case if the seller is experiencing financial difficulty.

c. The market in which the transaction occurs is different from the market in which the reporting entity would sell the asset or transfer the liability, that is, the principal or most advantageous market. For example, those markets might be different if the reporting entity is a securities dealer that transacts in different markets, depending on whether the counterparty is a retail customer (retail market) or another securities dealer (inter-dealer market).

d. For liabilities, differences may exist as non-performance risk (own credit risk) is not reflected in the fair value (i.e., exit price) determination of all liabilities (including derivatives).

Valuation Techniques

17. Valuation techniques consistent with the market approach, income approach, and/or cost approach shall be used to measure fair value. Key aspects of those approaches are summarized below:

a. Market approach. The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities (including a business). For example, valuation techniques consistent with the market approach often use market multiples derived from a set of comparables. Multiples might lie in ranges with a different multiple for each comparable. The selection of where within the range the appropriate multiple falls requires judgment, considering factors specific to the measurement (qualitative and quantitative). Valuation techniques consistent with the market approach include matrix pricing. Matrix pricing is a mathematical technique used principally to value debt securities without relying exclusively on quoted prices for the specific securities, but rather by relying on the securities' relationship to other benchmark quoted securities.

b. Income approach. The income approach uses valuation techniques to convert future amounts (for example, cash flows or earnings) to a single present amount (discounted). The measurement is based on the value indicated by current market expectations about those future amounts. Those valuation techniques include present value techniques; option-pricing models, such as the Black-Scholes-Merton formula (a closed-form model) and a binomial model (a lattice model), which incorporate present value techniques; and the multiperiod excess earnings method, which is used to measure the fair value of certain intangible assets.

c. Cost approach. The cost approach is based on the amount that currently would be required to replace the service capacity of an asset (often referred to as current replacement cost). From the perspective of a market participant (seller), the price that would be received for the asset is determined based on the cost to a market participant (buyer) to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence. Obsolescence encompasses physical deterioration, functional (technological) obsolescence, and economic (external) obsolescence and is broader than depreciation for financial reporting purposes (an allocation of historical cost) or tax purposes (based on specified service lives).

18. Valuation techniques that are appropriate in the circumstances and for which sufficient data are available shall be used to measure fair value. In some cases, a single valuation technique will be appropriate (for example, when valuing an asset or liability using quoted prices in an active market for

identical assets or liabilities). In other cases, multiple valuation techniques will be appropriate (for example, as might be the case when valuing a reporting unit). If multiple valuation techniques are used to measure fair value, the results (respective indications of fair value) shall be evaluated and weighted, as appropriate, considering the reasonableness of the range indicated by those results. A fair value measurement is the point within that range that is most representative of fair value in the circumstances.

19. Valuation techniques used to measure fair value shall be consistently applied. However, a change in a valuation technique or its application (for example, a change in its weighting when multiple valuation techniques are used) is appropriate if the change results in a measurement that is equally or more representative of fair value in the circumstances. That might be the case if, for example, new markets develop, new information becomes available, information previously used is no longer available, or valuation techniques improve. Revisions resulting from a change in the valuation technique or its application shall be accounted for as a change in accounting estimate pursuant to *SSAP No. 3—Accounting Changes and Corrections of Errors* (SSAP No. 3). The disclosure provisions of SSAP No. 3 for a change in accounting estimate are not required for revisions resulting from a change in a valuation technique or its application.

Inputs to Valuation Techniques

20. In this standard, inputs refer broadly to the assumptions that market participants would use in pricing the asset or liability, including assumptions about risk, for example, the risk inherent in a particular valuation technique used to measure fair value (such as a pricing model) and/or the risk inherent in the inputs to the valuation technique. Inputs may be observable or unobservable:

a. Observable inputs are inputs that reflect the assumptions market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the reporting entity.

b. Unobservable inputs are inputs that reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances.

Valuation techniques used to measure fair value shall maximize the use of observable inputs and minimize the use of unobservable inputs.

Fair Value Hierarchy

21. To increase consistency and comparability in fair value measurements and related disclosures, the fair value hierarchy prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. The fair value hierarchy gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). In some cases, the inputs used to measure fair value might fall in different levels of the fair value hierarchy. The level in the fair value hierarchy within which the fair value measurement in its entirety falls shall be determined based on the lowest level input that is significant to the fair value measurement in its entirety. Assessing the significance of a particular input to the fair value measurement in its entirety requires judgment, considering factors specific to the asset or liability.

22. The availability of inputs relevant to the asset or liability and the relative reliability of the inputs might affect the selection of appropriate valuation techniques. However, the fair value hierarchy prioritizes the inputs to valuation techniques, not the valuation techniques. For example, a fair value measurement using a present value technique might fall within Level 2 or Level 3, depending on the inputs that are significant to the measurement in its entirety and the level in the fair value hierarchy within which those inputs fall.

Level 1 Inputs

23. Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. An active market for the asset or liability is a market in which transactions for the asset or liability occur with sufficient frequency and volume to provide pricing information on an ongoing basis. A quoted price in an active market provides the most reliable evidence of fair value and shall be used to measure fair value whenever available, except as discussed in paragraphs 24 and 25.

24. If the reporting entity holds a large number of similar assets or liabilities (for example, debt securities) that are required to be measured at fair value, a quoted price in an active market might be available but not readily accessible for each of those assets or liabilities individually. In that case, fair value may be measured using an alternative pricing method that does not rely exclusively on quoted prices (for example, matrix pricing) as a practical expedient. However, the use of an alternative pricing method renders the fair value measurement a lower level measurement.

25. In some situations, a quoted price in an active market might not represent fair value at the measurement date. That might be the case if, for example, significant events (principal-to-principal transactions, brokered trades, or announcements) occur after the close of a market but before the measurement date. The reporting entity should establish and consistently apply a policy for identifying those events that might affect fair value measurements. However, if the quoted price is adjusted for new information, the adjustment renders the fair value measurement a lower level measurement.

26. If the reporting entity holds a position in a single financial instrument (including a block) and the instrument is traded in an active market, the fair value of the position shall be measured within Level 1 as the product of the quoted price for the individual instrument times the quantity held. The quoted price shall not be adjusted because of the size of the position relative to trading volume (blockage factor). The use of a blockage factor is prohibited, even if a market's normal daily trading volume is not sufficient to absorb the quantity held and placing orders to sell the position in a single transaction might affect the quoted price.

Level 2 Inputs

27. Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. If the asset or liability has a specified (contractual) term, a Level 2 input must be observable for substantially the full term of the asset or liability. Level 2 inputs include the following:

a. Quoted prices for similar assets or liabilities in active markets

b. Quoted prices for identical or similar assets or liabilities in markets that are not active, that is, markets in which there are few transactions for the asset or liability, the prices are not current, or price quotations vary substantially either over time or among market makers (for example, some brokered markets), or in which little information is released publicly (for example, a principal-to-principal market)

c. Inputs other than quoted prices that are observable for the asset or liability (for example, interest rates and yield curves observable at commonly quoted intervals, volatilities, prepayment speeds, loss severities, credit risks, and default rates)

d. Inputs that are derived principally from or corroborated by observable market data by correlation or other means (market-corroborated inputs).

28. Adjustments to Level 2 inputs will vary depending on factors specific to the asset or liability. Those factors include the condition and/or location of the asset or liability, the extent to which the inputs relate to items that are comparable to the asset or liability, and the volume and level of activity in the markets within which the inputs are observed. An adjustment that is significant to the fair value measurement in its entirety might render the measurement a Level 3 measurement, depending on the level in the fair value hierarchy within which the inputs used to determine the adjustment fall.

29. The reporting entity should evaluate the following factors to determine whether there has been a significant decrease in the volume and level of activity for the asset or liability when compared with normal market activity for the asset or liability (or similar assets or liabilities). The factors include, but are not limited to:

a. There are few recent transactions.

b. Price quotations are not based on current information.

c. Price quotations vary substantially either over time or among market makers (for example, some brokered markets).

d. Indexes that previously were highly correlated with the fair values of the asset or liability are demonstrably uncorrelated with recent indications of fair value for that asset or liability.

e. There is a significant increase in implied liquidity risk premiums, yields, or performance indicators (such as delinquency rates or loss severities) for observed transactions or quoted prices when compared with the reporting entity's estimate of expected cash flows, considering all available market data about credit and other nonperformance risk for the asset or liability.

f. There is a wide bid-ask spread or significant increase in the bid-ask spread.

g. There is a significant decline or absence of a market for new issuances (that is, a primary market) for the asset or liability or similar assets or liabilities.

h. Little information is released publicly (for example, a principal-to-principal market).

The reporting entity shall evaluate the significance and relevance of the factors to determine whether, based on the weight of the evidence, there has been a significant decrease in the volume and level of activity for the asset or liability.

30. If the reporting entity concludes there has been a significant decrease in the volume and level of activity for the asset or liability in relation to normal market activity for the asset or liability (or similar assets or liabilities), transactions or quoted prices may not be determinative of fair value (for example, there may be increased instances of transactions that are not orderly). Further analysis of the transactions or quoted prices is needed, and a significant adjustment to the transactions or quoted prices may be necessary to estimate fair value in accordance with this standard. Significant adjustments also may be necessary in other circumstances (for example, when a price for a similar asset requires significant adjustment to make it more comparable to the asset being measured or when the price is stale).

31. This standard does not prescribe a methodology for making significant adjustments to transactions or quoted prices when estimating fair value. Paragraphs 17-19 discuss the use of valuation techniques in estimating fair value. If there has been a significant decrease in the volume and level of activity for the asset or liability, a change in valuation technique or the use of multiple valuation techniques may be appropriate (for example, the use of a market approach and a present value technique). When weighting indications of fair value resulting from the use of multiple valuation techniques, the

reporting entity shall consider the reasonableness of the range of fair value estimates. The objective is to determine the point within that range that is most representative of fair value under current market conditions. A wide range of fair value estimates may be an indication that further analysis is needed.

32. Even in circumstances where there has been a significant decrease in the volume and level of activity for the asset or liability and regardless of the valuation technique(s) used, the objective of a fair value measurement remains the same. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. Determining the price at which willing market participants would transact at the measurement date under current market conditions if there has been a significant decrease in the volume and level of activity for the asset or liability depends on the facts and circumstances and requires the use of significant judgment. However, the reporting entity's intention to hold the asset or liability is not relevant in estimating fair value. Fair value is a market-based measurement, not an entity-specific measurement.

33. Even if there has been a significant decrease in the volume and level of activity for the asset or liability, it is not appropriate to conclude that all transactions are not orderly (that is, distressed or forced). Circumstances that may indicate that a transaction is not orderly include, but are not limited to:

a. There was not adequate exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities under current market conditions.

b. There was a usual and customary marketing period, but the seller marketed the asset or liability to a single market participant.

c. The seller is in or near bankruptcy or receivership (that is, distressed), or the seller was required to sell to meet regulatory or legal requirements (that is, forced).

d. The transaction price is an outlier when compared with other recent transactions for the same or similar asset or liability.

The reporting entity shall evaluate the circumstances to determine whether the transaction is orderly based on the weight of the evidence.

34. The determination of whether a transaction is orderly (or not orderly) is more difficult if there has been a significant decrease in the volume and level of activity for the asset or liability. Accordingly, the reporting entity shall consider the following guidance:

a. If the weight of the evidence indicates the transaction is not orderly, the reporting entity shall place little, if any, weight (compared with other indications of fair value) on that transaction price when estimating fair value or market risk premiums.

b. If the weight of the evidence indicates the transaction is orderly, the reporting entity shall consider that transaction price when estimating fair value or market risk premiums. The amount of weight placed on that transaction price when compared with other indications of fair value will depend on the facts and circumstances such as the volume of the transaction, the comparability of the transaction to the asset or liability being measured at fair value, and the proximity of the transaction to the measurement date.

c. If the reporting entity does not have sufficient information to conclude that the transaction is orderly or that the transaction is not orderly, it shall consider that transaction price when estimating fair value or market risk premiums. However, that transaction price may not be determinative of fair value (that is, that transaction price may not be the sole or primary basis for estimating fair value or market risk premiums). The reporting entity shall place less weight on transactions on which the reporting entity does not have sufficient information to conclude whether the transaction is orderly when compared with other transactions that are known to be orderly.

In its determinations, the reporting entity need not undertake all possible efforts, but shall not ignore information that is available without undue cost and effort. The reporting entity would be expected to have sufficient information to conclude whether a transaction is orderly when it is party to the transaction.

35. Regardless of the valuation technique(s) used, the reporting entity shall include appropriate risk adjustments. Risk-averse market participants generally seek compensation for bearing the uncertainty inherent in the cash flows of an asset or liability (risk premium). A fair value measurement should include a risk premium reflecting the amount market participants would demand because of the risk (uncertainty) in the cash flows. Otherwise, the measurement would not faithfully represent fair value. In some cases, determining the appropriate risk premium might be difficult. However, the degree of difficulty alone is not a sufficient basis on which to exclude a risk adjustment. Risk premiums should be reflective of an orderly transaction (that is, not a forced or distressed sale) between market participants at the measurement date under current market conditions.

36. When estimating fair value, this standard does not preclude the use of quoted prices provided by third parties, such as pricing services or brokers, when the reporting entity has determined that the quoted prices provided by those parties are determined in accordance with this standard. However, when there has been a significant decrease in the Volume or level of activity for the asset or liability, the reporting entity should evaluate whether those quoted prices are based on current information that reflects orderly transactions or a valuation technique that reflects market participant assumptions (including assumptions about risks). In weighting a quoted price as an input to a fair value measurement, the reporting entity should place less weight (when compared with other indications of fair value that are based on transactions) on quotes that do not reflect the result of transactions. Furthermore, the nature of the quote (for example, whether the quote is an indicative price or a binding offer) should be considered when weighting the available evidence, with more weight given to quotes based on binding offers.

Level 3 Inputs

37. Level 3 inputs are unobservable inputs for the asset or liability. Unobservable inputs shall be used to measure fair value to the extent that relevant observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. However, the fair value measurement objective remains the same, that is, an exit price from the perspective of a market participant that holds the asset or owes the liability. Therefore, unobservable inputs shall reflect the reporting entity's own assumptions about the assumptions that market participants would use in pricing the asset or liability (including assumptions about risk). Unobservable inputs shall be developed based on the best information available in the circumstances, which might include the reporting entity's own data. In developing unobservable inputs, the reporting entity need not undertake all possible efforts to obtain information about market participant assumptions. However, the reporting entity shall not ignore information about market participant assumptions that is reasonably available without undue cost and effort. Therefore, the reporting entity's own data used to develop unobservable inputs shall be adjusted if information is reasonably available without undue cost and effort that indicates that market participants would use different assumptions.

Inputs Based on Bid and Ask Prices

38. If an input used to measure fair value is based on bid and ask prices (for example, in a dealer market), the price within the bid-ask spread that is most representative of fair value in the circumstances shall be used to measure fair value, regardless of where in the fair value hierarchy the input falls (Level 1,

2, or 3). This standard does not preclude the use of mid-market pricing or other pricing conventions as a practical expedient for fair value measurements within a bid-ask spread.

Disclosures

39. A reporting entity shall disclose information that helps users of the financial statements to assess both of the following: (1) For assets and liabilities that are measured and reported[1] at fair value in the statement of financial position after initial recognition, the valuation techniques and inputs used to develop those measurements; (2) For fair value measurements in the statement of financial position determined using significant unobservable inputs (Level 3), the effect of the measurements on earnings (or changes in net assets) for the period. To meet these objectives, the reporting entity shall disclose the information in paragraphs 39.a. through 39.f. for each class of assets and liabilities measured and reported[2] at fair value in the statement of financial position after initial recognition. The reporting entity shall determine appropriate classes of assets and liabilities in accordance with the annual statement instructions.

a. The fair value measurements at the reporting date.

b. The level of the fair value hierarchy within which the fair value measurements are categorized in their entirety (Level 1, 2 or 3).

c. For assets and liabilities held at the reporting date, the amounts of any transfers between Level 1 and Level 2 of the fair value hierarchy, the reasons for the transfers, and the reporting entity's policy for determining when transfers between levels are recognized. Transfers into each level shall be disclosed and discussed separately from transfers out of each level.

d. For fair value measurements categorized within Level 2 and Level 3 of the fair value hierarchy, a description of the valuation technique(s) and the inputs used in the fair value measurement. If there has been a change in the valuation technique (for example, changing from a market approach to an income approach or the use of an additional valuation technique), the reporting entity shall disclose that change and the reason(s) for making it.

e. For fair value measurements categorized within Level 3 of the fair value hierarchy a reconciliation from the opening balances to the closing balances disclosing separately changes during the period attributable to the following:

i. Total gains or losses for the period recognized in income or surplus.

ii. Purchases, sales, issues, and settlements (each type disclosed separately)

iii. The amounts of any transfers into or out of Level 3, the reasons for those transfers, and the reporting entity's policy for determining when transfers between levels are recognized. Transfers into Level 3 shall be disclosed and discussed separately from transfers out of Level 3.

[1] The term "reported" is intended to reflect the measurement basis for which the asset or liability is classified within its underlying SSAP. For example, a bond with an NAIC designation of 2 is considered an amortized cost measurement and is not included within this disclosure even if the amortized cost and fair value measurement are the same. An example of when such a situation may occur includes a bond that is written down as other-then-temporarily impaired as of the date of financial position. The amortized cost of the bond after the recognition of the other-than-temporary impairment may agree to fair value, but under SSAP No. 26 this security is considered to still be reported at amortized cost.

[2] See footnote 1

f. A reporting entity shall disclose and consistently follow its policy for determining when transfers between levels are recognized. The policy about the timing of recognizing transfers shall be the same for transfers into Level 3 as that for transfers out of Level 3. Examples of policies for when to recognize the transfers are as follows:

i. The actual date of the event or change in circumstances that caused the transfer

ii. The beginning of the reporting period

iii. The end of the reporting period.

40. For derivative assets and liabilities, the reporting entity shall present both of the following:

a. The fair value disclosures required by paragraph 39.a., 39.b. and 39.c. on a gross basis

b. The reconciliation disclosures required by paragraph 39.d., 39.e. and 39.f. on either a gross or net basis

41. The quantitative disclosures required in paragraphs 39-40 of this standard shall be presented using a tabular format. (See Exhibit A.)

42. The reporting entity shall disclose the fair value hierarchy and the method used to obtain the fair value measurement for all items in which fair value is disclosed within the annual statement investment schedules. This disclosure is satisfied by the completion of the investment schedules in the Annual statement and is not required quarterly.

43. The reporting entity is encouraged, but not required, to combine the fair value information disclosed under this standard with the fair value information disclosed under other accounting pronouncements (for example, disclosures about fair value of financial instruments) in the periods in which those disclosures are required, if practicable. The reporting entity also is encouraged, but not required, to disclose information about other similar measurements, if practicable.

Disclosures about Fair Value of Financial Instruments

44. A reporting entity shall disclose in the notes to the financial statements, as of each date for which a statement of financial position is presented in the quarterly or annual financial statements, the aggregate fair value for all financial instruments and the level within the fair value hierarchy in which the fair value measurements in their entirety fall. This disclosure shall be summarized by type of financial instrument, for which it is practicable to estimate fair value, except for certain financial instruments identified in paragraph 45. Fair value disclosed in the notes shall be presented together with the related admitted values in a form that makes it clear whether the fair values and admitted values represent assets or liabilities and to which line items in the Statement of Assets, Liabilities, Surplus and Other Funds they relate. Unless specified otherwise in another SSAP, the disclosures may be made net of encumbrances, if the asset or liability is so reported. A reporting entity shall also disclose the method(s) and significant assumptions used to estimate the fair value of financial instruments.

	Aggregate Fair Value	Admitted Assets	Level 1	Level 2	Level 3	Not Practicable (Carrying Value)
Type of Financial Instrument:						
Bonds						
Common Stock						
Perpetual Preferred Stock						
Mortgage Loans						
Etc.						

If it is not practicable for an entity to estimate the fair value of the financial instrument or a class of financial instruments, the aggregate carrying amount for those items shall be reported in the "not practicable" column with additional disclosure as required in paragraph 46 of SSAP No. 100.

Not Practicable to Estimate FV	Carrying Value	Effective Interest Rate	Maturity	Explanation
Individual Security Reporting by Type or Class of Financial Instrument:				
Mortgage Loans:				
Description 1				A
Description 2				A
Etc.				

A – It was not practicable to determine the fair value of these financial instruments as a quoted market price was not available and the cost of obtaining an independent appraisal appears excessive considering the materiality of the instruments to the reporting entity.

45. The disclosures about fair value prescribed in paragraph 44 are not required for the following:

a. Employers' and plans' obligations for pension benefits, other postretirement benefits including health care and life insurance benefits, postemployment benefits, employee stock option and stock purchase plans, and other forms of deferred compensation arrangements, as defined in *SSAP No. 12—Employee Stock Ownership Plans* (SSAP No. 12), *SSAP No. 92—Accounting for Postretirement Benefits Other Than Pensions, A Replacement of SSAP No. 14* (SSAP No. 92), *SSAP No. 102—Accounting for Pensions, A Replacement of SSAP No. 89* (SSAP No. 102) and *SSAP No. 104R—Share-Based Payments* (SSAP No. 104R).

b. Substantively extinguished debt subject to the disclosure requirements of *SSAP No. 103—Accounting for Transfer and Servicing of Financial Assets and Extinguishments of Liabilities* (SSAP No. 103)

c. Insurance contracts, other than financial guarantees and deposit-type contracts

d. Lease contracts as defined in *SSAP No. 22—Leases* (SSAP No. 22)

e. Warranty obligations and rights

f. Investments accounted for under the equity method

g. Equity instruments issued by the entity

46. If it is not practicable for an entity to estimate the fair value of a financial instrument or a class of financial instruments, the following shall be disclosed:

a. Information pertinent to estimating the fair value of that financial instrument or class of financial instruments, such as the carrying amount, effective interest rate, and maturity; and

b. The reasons why it is not practicable to estimate fair value.

47. In the context of this standard, practicable means that an estimate of fair value can be made without incurring excessive costs. It is a dynamic concept: what is practicable for one entity might not be for another; what is not practicable in one year might be in another. For example, it might not be practicable for an entity to estimate the fair value of a class of financial instruments for which a quoted market price is not available because it has not yet obtained or developed the valuation model necessary to make the estimate, and the cost of obtaining an independent valuation appears excessive considering the materiality of the instruments to the entity. Practicability, that is, cost considerations, also may affect the required precision of the estimate; for example, while in many cases it might seem impracticable to estimate fair value on an individual instrument basis, it may be practicable for a class of financial instruments in a portfolio or on a portfolio basis. In those cases, the fair value of that class or of the portfolio should be disclosed. Finally, it might be practicable for an entity to estimate the fair value only of a subset of a class of financial instruments; the fair value of that subset should be disclosed.

Relevant Literature

48. This standard adopts with modification *FAS 157, Fair Value Measurements*; (FAS 157) *FSP FAS 157-1, Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting* Pronouncements *That Address Fair Value Measurements for Purposes of Lease Classification or Measurement Under Statement 13*, (FSP FAS 157-1) and *FSP FAS 157-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly* (FSP FAS 157-4). Modifications from FAS 157, FSP FAS 157-1 and FSP FAS 157-4 include:

a. See revision to paragraph 3.b. from adoption of *SSAP No. 104R—Share-Based Payments* (SSAP No. 104R).

b. This standard does not adopt the scope exclusions within paragraph 3 of FAS 157 for accounting pronouncements that require or permit measurements that are similar to fair value but that are not intended to measure fair value, including (a) accounting pronouncements that permit measurements that are based on, or otherwise use, vendor-specific objective evidence of fair value and (b) inventory pricing. These items are excluded as they are not prevalent within statutory accounting.

c. This standard does not adopt guidance from FAS 157 regarding the consideration of non-performance risk (own credit risk) in determining the fair value measurement of liabilities. The consideration of own credit-risk in the measurement of fair value liabilities is inconsistent with the statutory accounting concept of conservatism and the assessment of financial solvency for insurers. The fair value determination for liabilities should follow the guidance adopted from FAS 157, with the exception of the consideration of own-performance risk.

d. This standard includes revisions to reference statutory standards or terms instead of GAAP standards or terms.

e. This standard incorporates the guidance from SSAP No. 27 regarding disclosures about fair value of financial instruments. This incorporated SSAP No. 27 guidance was adopted from *FAS 107, Disclosures about Fair Value of Financial Instruments* (FAS 107) and was revised to adopt *FSP FAS 107-1 and APB-1, Interim Disclosures about Fair Value of Financial Instruments* (FSP FAS 107-1 and APB-1). For statutory purposes, the incorporation of this guidance within one standard results in having one comprehensive standard addressing fair value measurements and disclosures.

49. In August 2010, this statement adopted with modification the new and revised disclosure requirements within *ASU 2010-06, Fair Value Measurements and Disclosures – (Topic 820) – Improving Disclosures about Fair Value Measurements* (ASU 2010-06). GAAP revisions within ASU 2010-06 that modify the FASB Codification on aspects originally added by *ASU 2009-05, Fair Value Measurements and Disclosures, Measuring Liabilities at Fair Value* (ASU 2009-05) and *ASU 2009-12, Fair Value Measurements and Disclosures, Investment in Certain Entities that Calculate Net Asset Value per Share (or its equivalent)* (ASU 2009-12) are not adopted, as the underlying GAAP guidance within ASU 2009-05 and ASU 2009-12 has not been considered for statutory accounting. When ASU 2009-05 and ASU 2009-12 are reviewed for statutory accounting, the GAAP guidance considered will reflect the revisions from ASU 2010-06. Subsequent nonsubstantive revisions to the guidance adopted from ASU 2010-06 were incorporated within this Statement in November 2010 to clarify the disclosure requirements for statutory accounting. These revisions removed the distinction between recurring and non-recurring fair value measurements and clarified disclosure requirements for assets and liabilities measured and reported at fair value in the statement of financial position.

50. Paragraphs 44-47 adopt FAS 107 as amended by *FASB Statement No. 119, Disclosure about Derivative* Financial *Instruments and Fair Value of Financial Instruments* (FAS 119), except that paragraph 15(c) of FAS 119 relating to disclosure of financial instruments held or issued for trading is rejected and *FASB Emerging Issues Task Force No. 85-20, Recognition of Fees for Guaranteeing a Loan*. Financial instruments named within paragraph 8 of FAS 107 that are exempt from disclosure are adopted to the extent applicable for statutory accounting and are reflected in paragraph 45. This standard also adopts revisions to FAS 107 reflected in *FSP FAS 107-1 and APB-1, Interim Disclosures about Fair Value of Financial Instruments* (FSP FAS 107-1 and APB-1), and thus requires disclosure in both annual and quarterly financial statements. In addition, this standard rejects FASB Statement No. 126, Exemptions from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities, an amendment of FAS 107. FAS 119 is addressed in SSAP No. 31.

51. This standard rejects *ASU 2013-03, Financial Instruments – Clarifying the Scope and Applicability of a Particular Disclosure to Nonpublic Entities* (ASU 2013-03), *FSP FAS 157-2: Effective Date of FASB Statement No. 157* (FSP FAS 157-2) and *FSP FAS 157-3: Determining the Fair Value of a Financial Asset When the Market for That Asset is Not Active* (FSP FAS 157-3).

Effective Date and Transition

52. This standard shall be effective for December 31, 2010, annual financial statements, with interim and annual financial statement reporting thereafter. Early adoption is permitted for December 31, 2009, annual financial statements, with interim and annual reporting thereafter. Nonsubstantive disclosure revisions adopted in August and November 2010 to paragraphs 39-40 and the corresponding disclosure illustrations are initially effective for year-end 2010 financial statements, with interim and annual reporting thereafter. Nonsubstantive revisions adopted March 2011 to paragraphs 39.a., 39.e.ii., 42 and 44 are effective January 1, 2012, with interim and annual reporting thereafter as required in the SSAP. (Paragraph 42 is satisfied by the annual statement investment schedules and is not required quarterly.)

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 138—Fair Value Measurements*

EXHIBIT A - IMPLEMENTATION GUIDANCE AND DISCLOSURE ILLUSTRATIONS

53. For fair value measurements categorized within Level 2 and Level 3 of the fair value hierarchy, this Standard requires a reporting entity to disclose a description of the valuation techniques(s) and the inputs used in the fair value measurement. A reporting entity might disclose the following to comply with the input disclosure requirement of paragraph 39.d.:

a. Quantitative information about the input, for example, for certain debt securities or derivatives, information such as, but not limited to, prepayment rates, rates of estimated credit losses, interest rates (for example the LIBOR swap rate) or discount rates and volatilities.

b. The nature of the item being measured at fair value, including the characteristics of the item being measured that are considered in the determination of relevant inputs. For example, for residential mortgage-backed securities, a reporting entity might disclose the following:

i. The types of underlying loans (for example, prime loans or subprime loans)

ii. Collateral

iii. Guarantees or other credit enhancements

iv. Seniority level of the tranches of securities

v. The year of issue

vi. The weighted-average coupon rate of the underlying loans and the securities

vii. The weighted-average maturity of the underlying loans and the securities

viii. The geographical concentration of the underlying loans

ix. Information about the credit ratings of the securities

c. How third-party information such as broker quotes, pricing services, net asset values and relevant market data was considered in measuring fair value.

54. In addition, a reporting entity should provide any other information that will help users of its financial statements to evaluate the qualitative information disclosed. For example, a reporting entity might disclose the following with respect to its investment in a class of residential-mortgage backed securities:

> As of December 31, 20X1, the reported fair value of the reporting entity’s investments in Level 3, NAIC rated 6, residential mortgage-backed securities was $XXXX. These securities are senior tranches in a securitization trust and have a weighted-average coupon rate of XX percent and a weighted-average maturity of XX years. The underlying loans for these securities are residential subprime mortgages that originated in California in 2006. The underlying loans have a weighted-average coupon rate of XX percent and a weighted-average maturity of XX years. These securities are currently rated below investment grade. To measure their fair value, the reporting entity used an industry standard pricing model, which uses an income approach. The significant inputs for the pricing model include the following weighted averages:

a. Yield: XX percent

b. Probability of default; XX percent constant default rate

c. Loss severity; XX percent

d. Prepayment: XX percent constant prepayment rate

55. **Fair Value Measurements at Reporting Date:** For assets and liabilities measured and reported[3] at fair value at the reporting date, this Statement requires quantitative disclosures about the fair value measurements for each class of assets and liabilities. For assets, that information might be presented as follows. (This chart is an example, and the categories utilized by a reporting entity shall reflect the investments held by the reporting entity.)

(Paragraph 39.c. also requires that the reporting entity also disclose any significant transfers to or from Levels 1 and 2 and the reasons for those transfers. This disclosure requirement is not satisfied by the disclosure below and shall be reflected separately within the notes to financial statements.)

(In millions)	Level 1	Level 2	Level 3	Total
Description for each class of asset or liability:				
Perpetual Preferred Stock				
Industrial and Misc.				
Parent, Subsidiaries and Affiliates				
Total Perpetual Preferred	$	$	$	$
Redeemable Preferred Stock				
Industrial and Misc.				
Parent, Subsidiaries and Affiliates				
Total Redeemable Preferred	$	$	$	$
Bonds				
U.S. Governments				
Industrial and Misc.				
Hybrid Securities				
Parent, Subsidiaries and Affiliates				
Total Bonds	$	$	$	$
Common Stock				
Industrial and Misc.				
Parent, Subsidiaries and Affiliates				
Total Common Stock	$	$	$	$
Derivatives				
Interest Rate Contracts				
Foreign Exchange Contracts				
Credit Contracts				

[3] See footnote 1

(In millions)	Level 1	Level 2	Level 3	Total
Commodity Futures Contracts				
Commodity Forward Contracts				
Total Derivatives	$	$	$	$
Separate Account Assets				
Total	$	$	$	$

56. **Fair Value Measurements in Level 3 of the Fair Value Hierarchy:** For assets and liabilities measured and reported[4] at fair value categorized within Level 3 of the fair value hierarchy, this Statement requires a reconciliation from the opening balances to the closing balances for each class of assets and liabilities, except for derivative assets and liabilities, which may be presented net. For assets, the reconciliation may be presented as follows: (This chart is an example, and the categories provided will be revised in accordance with the investments held by the reporting entity.)

(Paragraph 39.e.iii. requires disclosures on the transfers in and/or out of Level 3. This disclosure requirement is satisfied by the following table.)

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
	Balance 01/01/20XX	Transfers into Level 3	Transfers out of Level 3	Total gains and (losses) included in Net Income	Total gains and (losses) included in Surplus	Purchases	Issues	Sales	Settlement s	Balance at 12/31/20XX
RMBS		(a)								
CMBS		(b)	(c)							
Derivative Assets										
Derivatives Liabilities										
………….										
………….										
………….										
Total										

Example Footnotes:

(a) Transferred from Level 2 to Level 3 because of lack of observable market data due to decrease in market activity for these securities.

(b) The reporting entity's policy is to recognize transfers in and transfers out as of the actual date of the event or change in circumstances that caused the transfer.

(c) Transferred from Level 3 to Level 2 because of observable market data became available for these securities.

[4] See footnote 1

Statement of Statutory Accounting Principles No. 101

Income Taxes, A Replacement of SSAP No. 10R and SSAP No. 10

STATUS

Type of Issue:	Common Area
Issued:	August 31, 2011
Effective Date:	January 1, 2012
Affects:	Supersedes SSAP No. 10R and SSAP No. 10
	Nullifies INT 00-21, INT 00-22, INT 01-19, INT 01-20
Affected by:	No other pronouncements
Interpreted by:	INT 01-18, INT 06-12

STATUS **1**

SCOPE OF STATEMENT **3**

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Income Taxes

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for current and deferred federal and foreign income taxes and current state income taxes. This statement supersedes conclusions reached in *SSAP No. 10—Income Taxes* and *SSAP No. 10R—Income Taxes, A Temporary Replacement of SSAP No. 10*.

SUMMARY CONCLUSION

2. For purposes of accounting for federal and foreign income taxes, reporting entities shall adopt *FASB Statement No. 109, Accounting for Income Taxes* (FAS 109) with modifications for state income taxes, the realization criteria for deferred tax assets, and the recording of the impact of changes in deferred tax balances. One objective of accounting for income taxes is to recognize the estimated amount of taxes payable or refundable for the current year as a tax liability or asset. A second objective is to recognize deferred tax liabilities and assets for the future tax consequences of events that have been recognized in a reporting entity's statutory financial statements or tax returns. However, the second objective is realistically constrained because (a) the tax payment or refund that results from a particular tax return is a joint result of all the items included in that return, (b) taxes that will be paid or refunded in future years are the joint result of events of the current or prior years and events of future years, and (c) information available about the future is limited. As a result, financial statements will recognize current and deferred income tax assets and liabilities in accordance with the provisions of this statement based upon estimates and approximations. For purposes of this statement, only adjusted gross deferred tax assets that are more likely than not (a likelihood of more than 50 percent) to be realized shall be considered in determining admitted adjusted gross deferred tax assets.

Current Income Taxes

3. "Income taxes incurred" shall include current income taxes, the amount of federal and foreign income taxes paid (recovered) or payable (recoverable) for the current year. Current income taxes are defined as:

a. Current year estimates (including quarterly estimates) of federal and foreign income taxes payable or refundable, based on tax returns for the current and prior years, except as addressed in paragraph 3.b., and tax loss contingencies (including related interest and penalties) for current and all prior years, computed in accordance with *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets* (SSAP No. 5R) with the following modifications:

i. The term "probable" as used in SSAP No. 5R shall be replaced by the term "more likely than not (a likelihood of more than 50 percent)" for federal and foreign income tax loss contingencies only.

ii. For purposes of the determination of a federal and foreign income tax loss contingency, it shall be presumed that the reporting entity will be examined by the relevant taxing authority that has full knowledge of all relevant information.

iii. If the estimated tax loss contingency is greater than 50% of the tax benefit originally recognized, the tax loss contingency recorded shall be equal to 100% of the original tax benefit recognized.

b. Amounts incurred or received during the current year relating to prior periods, to the extent not previously provided, as such amounts are deemed to be changes in accounting estimates as defined in *SSAP No. 3—Accounting Changes and Corrections of Errors* (SSAP No. 3).

c. In determining when tax loss contingencies associated with temporary differences should be included in current income taxes under paragraph 3.a., and therefore included in deferred taxes under paragraph 7, a reporting entity is not required to "gross-up" its current and deferred taxes until such time as an event has occurred that would cause a re-evaluation of the contingency and its probability of assessment, e.g., the IRS has identified the item as one which may be adjusted upon audit. Such an event could be the reporting entity's (or its affiliate or parent in a consolidated income tax return) receipt of a Form 5701, Proposed Audit Adjustment, or could occur earlier upon receipt of an Information Document Request. At such time, the company must reassess the probability of an adjustment, reasonably re-estimate the amount of tax contingency as determined in accordance with paragraph 3.a., make any necessary adjustment to deferred taxes, and re-determine the admissibility of any adjusted gross deferred tax asset as provided in paragraph 11.

4. State taxes (including premium, income and franchise taxes) shall be computed in accordance with SSAP No. 5R and shall be limited to (a) taxes due as a result of the current year's taxable basis calculated in accordance with state laws and regulations and (b) amounts incurred or received during the current year relating to prior periods, to the extent not previously provided as such amounts are deemed to be changes in accounting estimates. Property and casualty insurance companies shall report state taxes as other underwriting expenses under the caption "Taxes, licenses, and fees." Life and accident and health insurance companies shall report such amounts as general expenses under the caption "Insurance taxes, licenses, and fees, excluding federal income taxes." Other health entities shall report such amounts as general administration expenses under the caption "Taxes, licenses, and fees." State tax recoverables that are reasonably expected to be recovered in a subsequent accounting period are admitted assets. State taxes are reasonably expected to be recovered if the refund is attributable to overpayment of estimated tax payments, errors, carrybacks, or items for which the reporting entity has authority to recover under a state regulation or statute.

Deferred Income Taxes

5. Because tax laws and statutory accounting principles differ in their recognition and measurement of assets, liabilities, equity, revenues, expenses, gains, and losses, differences arise between:

a. The amount of taxable income and pretax statutory financial income for a year, and

b. The tax bases of assets or liabilities and their reported amounts in statutory financial statements.

6. A reporting entity's balance sheet shall include deferred income tax assets (DTAs) and liabilities (DTLs) related to the estimated future tax consequences of temporary differences and carryforwards, generated by statutory accounting, as defined in paragraph 11 of FAS 109.

7. A reporting entity's deferred tax assets and liabilities are computed as follows:

a. Temporary differences are identified and measured using a "balance sheet" approach whereby statutory and tax basis balance sheets are compared;

b. Temporary differences include unrealized gains and losses and nonadmitted assets but do not include asset valuation reserve (AVR), interest maintenance reserve (IMR), Schedule F penalties and, in the case of a mortgage guaranty insurer, amounts attributable to its statutory contingency reserve to the extent that "tax and loss" bonds have been purchased;

c. Total DTAs and DTLs are computed using enacted tax rates;

d. A DTL is not recognized for amounts described in paragraph 31 of FAS 109; and

e. Gross DTAs are reduced by a statutory valuation allowance adjustment if, based on the weight of available evidence, it is more likely than not (a likelihood of more than 50 percent) that some portion or all of the gross DTAs will not be realized. The statutory valuation allowance adjustment[1], determined in a manner consistent with paragraphs 20-25 of FAS 109[2], shall reduce the gross DTAs to the amount that is more likely than not to be realized (the adjusted gross deferred tax assets).

8. Changes in DTAs and DTLs, including changes attributable to changes in tax rates and changes in tax status, if any, shall be recognized as a separate component of gains and losses in unassigned funds (surplus). Admitted adjusted gross DTAs and DTLs shall be offset and presented as a single amount on the statement of financial position.

Admissibility of Income Tax Assets

9. Current income tax recoverables shall include all current income taxes, including interest, reasonably expected to be recovered in a subsequent accounting period, whether or not a return or claim has been filed with the taxing authorities. Current income tax recoverables are reasonably expected to be recovered if the refund is attributable to overpayment of estimated tax payments, errors, carrybacks, as defined in paragraph 289 of FAS 109, or items for which the reporting entity has substantial authority, as that term is defined in Federal Income Tax Regulations.$^{(\text{INT 06-12})}$

10. Current income tax recoverables meet the definition of assets as specified in *SSAP No. 4—Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this statement.

[1] The statutory valuation allowance adjustment is utilized strictly to calculate the "adjusted gross DTA". (Admittance criteria in paragraph 11 are applied to the "adjusted gross DTA".) In determining the amount of adjusted gross DTA, the reporting entity shall consider reversal patterns of temporary differences to the extent necessary to support establishing or not establishing a valuation allowance adjustment, determined in accordance with paragraphs 228 and 229 of FAS 109. For purposes of this accounting statement, consideration of reversal patterns does not require scheduling beyond that necessary to support establishing or not establishing a valuation allowance adjustment. The application of the statutory valuation allowance adjustment in this statement shall not result in a statutory valuation allowance reserve within the statutory financial statements, but rather should result in a reduction of the gross DTA.

[2] For purposes of determining the amount of adjusted gross DTA and the amount admitted under paragraph 11, the admission calculation shall be made on a separate company, reporting entity basis. A reporting entity that files a consolidated federal income tax return with its parent should look to the amount of taxes it paid (or were allocated to it) as a separate legal entity in determining the admitted DTA under paragraph 11.a. Furthermore, the DTA under this paragraph may not exceed the amount that the reporting entity could reasonably expect to have refunded by its parent. The taxes paid by the reporting entity represent the maximum DTA that may be admitted under paragraph 11.a., although the amount could be reduced pursuant to the group's tax allocation agreement. The amount of admitted adjusted gross DTA under paragraph 11.b.i. is limited to the amount that the reporting entity expects to realize within the applicable realization period, on a separate company basis. The reporting entity must estimate its separate company taxable income and the tax benefit that it expects to receive from reversing deductible temporary differences in the form of lower tax payments to its parent. A reporting entity that projects a tax loss in the applicable realization period cannot admit a DTA related to the loss under paragraph 11.b., even if the loss could offset taxable income of other members in the consolidated group and the reporting entity could expect to be paid for the tax benefit pursuant to its tax allocation agreement.

11. The net admitted DTA shall not exceed the excess of the adjusted gross DTA, as determined under paragraph 7.e., over gross DTL. Adjusted gross DTAs shall be admitted based upon the three-component admission calculation at an amount equal to the sum of paragraphs 11.a., 11.b., and 11.c.:

a. Federal income taxes paid in prior years that can be recovered through loss carrybacks for existing temporary differences that reverse during a timeframe corresponding with IRS tax loss carryback provisions, not to exceed three years, including any amounts established in accordance with the provision of SSAP No. 5R as described in paragraph 3.a. of this statement related to those periods.

b. If the reporting entity is subject to risk-based capital requirements or is required to file a Risk-Based Capital Report with the domiciliary state, the reporting entity shall use the *Realization Threshold Limitation Table – RBC Reporting Entities* (RBC Reporting Entity Table) in this component of the admission calculation. The RBC Reporting Entity Table's threshold limitations are contingent upon the ExDTA ACL RBC ~~ACL~~ Ratio[3].

If the reporting entity is either a mortgage guaranty insurer or financial guaranty insurer that is not subject to risk-based capital requirements and is not required to file a Risk-Based Capital Report with the domiciliary state and the reporting entity meets the minimum capital and reserve requirements for the state of domicile, then the reporting entity shall use the *Realization Threshold Limitation Table – Financial Guaranty or Mortgage Guaranty Non-RBC Reporting Entities* (Financial Guaranty or Mortgage Guaranty Non-RBC Reporting Entity Table) in this component of the admission calculation. The Financial Guaranty or Mortgage Guaranty Non-RBC Reporting Entity Table's threshold limitations are contingent upon the following ratio: the numerator is equal to the sum of 1) surplus to policyholders, 2) less the amount of the admitted DTA in paragraph 11.a. (ExDTA Surplus) plus, 3) contingency reserves. The denominator is equal to the required amount of minimum aggregate capital required to be maintained under the applicable NAIC model law or state variation thereof based on the risk characteristics and the amount of insurance in force (Required Aggregate Risk Capital)[4].

If the reporting entity (1) is not subject to risk-based capital requirements, (2) is not required to file a Risk-Based Capital Report with the domiciliary state, (3) is not a mortgage guaranty or financial guaranty insurer, and (4) meets the minimum capital and reserve requirements, then the reporting entity shall use the *Realization Threshold Limitation Table – Other Non-RBC Reporting Entities* (Other Non-RBC Reporting Entity Table). The Other Non-RBC Reporting Entity Table's threshold limitations are

[3] The December 31 Risk-Based Capital ratio is calculated based on the Authorized Control Level RBC for the current reporting period, which is in the process of being filed with the state of domicile, and computed without net deferred tax assets (ExDTA ACL RBC). The interim period (March 31, June 30, and September 30) ExDTA ACL RBC ratio numerator shall use the Total Adjusted Capital (TAC) with current quarter surplus ExDTA and current quarter TAC adjustments. The interim period denominator shall use the Authorized Control Level RBC as filed for the most recent calendar year.

[4] If the reporting entity is a mortgage guaranty insurer, this ratio is based on the requirements of Section 12 of the NAIC Mortgage Guaranty Insurance Model Law and state laws that, based on the risk characteristics and amount of insurance in force, require aggregate capital to be maintained in a risk-to-capital ratio of not less than 25 to 1. If the reporting entity is a financial guaranty insurer, this ratio is based on the requirements of Section 4C of the NAIC Financial Guaranty Insurance Model Guideline 1626 and state laws that require aggregate capital to be maintained based on the risk characteristics and amount of insurance in force.

contingent upon the ratio of adjusted gross DTA (Adjusted gross DTA less the amount of DTA admitted in paragraph 11.a.) to adjusted capital and surplus[5].

Realization Threshold Limitation Table – RBC Reporting Entities

ExDTA ACL RBC (%)	11.b.i.	11.b.ii.
Greater than 300%	3 years	15%
200 – 300%	1 year	10%
Less than 200%	0 years	0%

Realization Threshold Limitation Table – Financial Guaranty or Mortgage Guaranty Non-RBC Reporting Entities

(See paragraph 11.b.) Ex DTA Surplus plus Contingency Reserves/Required Aggregate Risk Capital (%)	11.b.i.	11.b.ii.
Greater than 115%	3 years	15%
100% to 115%	1 year	10%
Less than 100%	0 years	0%

Realization Threshold Limitation Table – Other Non-RBC Reporting Entities

Adjusted Gross DTA / Adjusted Capital & Surplus (%)	11.b.i.	11.b.ii.
Less than 50%	3 years	15%
50% to 75%	1 year	10%
Greater than 75%	0 years	0%

The reporting entity shall admit:

[5] Consistent with the requirements of paragraph 11.b.ii., adjusted statutory capital and surplus used in this calculation component is based on statutory capital and surplus for the current reporting period excluding any net DTA, EDP equipment and operating system software and any net positive goodwill.

i. The amount of adjusted gross DTAs, after the application of paragraph 11.a., expected to be realized within the applicable period (refer to the 11.b.i. column of the applicable Realization Threshold Limitation Table above; the RBC Reporting Entity Table, the Financial Guaranty or Mortgage Guaranty Non-RBC Reporting Entity Table, or the Other Non-RBC Reporting Entity Table) following the balance sheet date limited to the amount determined in paragraph 11.b.ii.

ii. An amount that is no greater than the applicable percentage (refer to the 11.b.ii. column of the applicable Realization Threshold Limitation Table above: the RBC Reporting Entity Table, the Financial Guaranty or Mortgage Guaranty Non-RBC Reporting Entity Table, or the Other Non-RBC Reporting Entity Table) of statutory capital and surplus as required to be shown on the statutory balance sheet of the reporting entity for the current reporting period's statement filed with the domiciliary state commissioner adjusted to exclude any net DTAs, EDP equipment and operating system software and any net positive goodwill.(INT 01-18) For financial guaranty or mortgage guaranty non-RBC reporting entities, the amount of statutory capital and surplus utilized for this part of the calculation does not include contingency reserves.

c. The amount of adjusted gross DTAs, after application of paragraphs 11.a. and 11.b. that can be offset against existing gross DTLs. The reporting entity shall consider the character (i.e., ordinary versus capital) of the DTAs and DTLs such that offsetting would be permitted in the tax return under existing enacted federal income tax laws and regulations. Additionally, for purposes of this component, the reporting entity shall consider the reversal patterns of temporary differences; however, this consideration does not require scheduling beyond that required in paragraph 7.e.

12. In computing a reporting entity's admitted adjusted gross DTA pursuant to paragraph 11;

a. For purposes of paragraph 11.a., existing temporary differences that reverse during a timeframe corresponding with IRS tax loss carryback provisions, not to exceed three years, shall be determined in accordance with paragraphs 228 and 229 of FAS 109;

b. In determining the amount of federal income taxes that can be recovered through loss carrybacks, the amount and character (i.e., ordinary versus capital) of the loss carrybacks and the impact, if any, of the Alternative Minimum Tax shall be determined in accordance with the provisions of the Internal Revenue Code, and regulations thereunder;

c. The amount of carryback potential that may be considered in calculating the admitted adjusted gross DTAs of a reporting entity in paragraph 11.a. that files a consolidated income tax return with one or more affiliates, may not exceed the amount that the reporting entity could reasonably expect to have refunded by its parent; and

d. The phrases "reverse during a timeframe corresponding with IRS tax loss carryback provisions, not to exceed three years," "realized within one year of the balance sheet date" and "realized within three years of the balance sheet date" are intended to accommodate interim reporting dates and reporting entities that file on an other than calendar year basis for federal income tax purposes.

Realization of Tax Benefits and Tax-Planning Strategies

13. Future realization of the tax benefit of an existing deductible temporary difference or carryforward ultimately depends on the existence of sufficient taxable income of the appropriate character (for example, ordinary income or capital gain) within the carryback, carryforward period available under

the tax law. The following four possible sources of taxable income may be available under the tax law to realize a tax benefit for deductible temporary differences and carryforwards:

a. Future reversals of existing taxable temporary differences

b. Future taxable income exclusive of reversing temporary differences and carryforwards

c. Taxable income in prior carryback year(s) if carryback is permitted under the tax law

d. Tax-planning strategies in paragraph 14 that would, if necessary, be implemented to, for example:

  i. Accelerate taxable amounts to utilize expiring carryforwards

  ii. Change the character of taxable or deductible amounts from ordinary income or loss to capital gain or loss

  iii. Switch from tax-exempt to taxable investments.

Evidence available about each of those possible sources of taxable income will vary for different tax jurisdictions and, and possibly, from year to year. To the extent evidence about one or more sources of taxable income is sufficient to support a conclusion that the reporting entity will realize the full or a partial amount of its adjusted gross deferred tax assets, other sources need not be considered. Consideration of each source is required, however, to determine the amount of the statutory valuation allowance adjustment that is recognized for gross deferred tax assets under paragraph 7.e.

14. In some circumstances, there are tax-planning strategies (including elections for tax purposes) that (a) are prudent and feasible, (b) a reporting entity ordinarily might not take, but would take to prevent an operating loss or tax credit carryforward from expiring unused, and (c) would result in realization of deferred tax assets. A reporting entity shall consider tax-planning strategies in determining the amount of the statutory valuation allowance adjustment necessary under paragraph 7.e. Consideration of tax planning strategies for the realization of deferred tax assets when determining admission under paragraph 11 is not required; however, such strategies shall not conflict with the tax planning strategies used when computing the statutory valuation allowance. Any significant potential expenses to implement a tax-planning strategy or any significant losses that would be recognized if that strategy were implemented (net of any recognizable tax benefits associated with those expenses or losses) shall reduce the amount of admission under paragraph 11.

15. When a prudent and feasible tax-planning strategy is contemplated, and management determines this strategy would more likely than not enable the reporting entity to realize the full or a partial amount of its adjusted gross deferred tax assets, paragraph 3 of this statement related to tax loss contingencies shall be applied in determining admissibility of deferred tax assets under paragraph 11 of this statement.

Intercompany Income Tax Transactions

16. In the case of a reporting entity that files a consolidated income tax return with one or more affiliates, income tax transactions (including payment of tax contingencies to its parent) between the affiliated parties shall be recognized if:

a. Such transactions are economic transactions as defined in *SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties* (SSAP No. 25);

b. Are pursuant to a written income tax allocation agreement; and

c. Income taxes incurred are accounted for in a manner consistent with the principles of FAS 109, as modified by this statement.

17. Amounts owed to a reporting entity pursuant to a recognized transaction shall be treated as a loan or advance, and nonadmitted, pursuant to SSAP No. 25, to the extent that the recoverable is not settled within 90 days of the filing of a consolidated income tax return, or where a refund is due the reporting entity's parent, within 90 days of the receipt of such refund.

Intraperiod Tax Allocation

18. In accordance with paragraph 35 of FAS 109, a reporting entity's unrealized gains and losses shall be recorded net of any allocated DTA or DTL. The amount allocated shall be computed in a manner consistent with paragraph 38 of FAS 109.

19. Income taxes incurred shall be allocated to net income and realized capital gains or losses in a manner consistent with paragraph 38 of FAS 109. Furthermore, income taxes incurred or received during the current year attributable to prior years shall be allocated, to the extent not previously provided, to net income in accordance with SSAP No. 3 unless attributable, in whole or in part, to realized capital gains or losses, in which case, such amounts shall be apportioned between net income and realized capital gains and losses, as appropriate.

Interim Periods

20. Income taxes incurred in interim periods shall be computed using an estimated annual effective current tax rate for the annual period in accordance with the methodology described in paragraphs 19 and 20 of *Accounting Principles Board Opinion No. 28, Interim Financial Reporting*. Estimates of the annual effective tax rate at the end of interim periods are, of necessity, based on estimates and are subject to subsequent refinement or revision. If a reliable estimate cannot be made, the actual effective tax rate for the year-to-date may be the best estimate of the annual effective tax rate. If a reporting entity is unable to estimate a part of its "ordinary" income (or loss) or the related tax (or benefit) but is otherwise able to make a reliable estimate, the tax (or benefit) applicable to the item that cannot be estimated shall be reported in the interim period in which the item is reported.

Disclosures

21. Statutory financial statement disclosures shall be made in a manner consistent with the provisions of paragraphs 43-45 and 48 of FAS 109. However, required disclosures with regard to a reporting entity's GAAP valuation allowance shall be replaced with disclosures relating to the statutory valuation allowance adjustment and the nonadmittance of some portion or all of a reporting entity's DTAs. The financial statements shall include the disclosures required by paragraph 47 of FAS 109 for non-public companies. Paragraphs 22-28 describe the disclosure requirements as modified for the difference between the requirements of FAS 109 and those prescribed by this statement.

22. The components of the net DTA or DTL recognized in a reporting entity's financial statements shall be disclosed as follows:

a. The total of all DTAs (gross, adjusted gross, admitted and nonadmitted) by tax character;

b. The total of all DTLs by tax character;

c. The total DTAs nonadmitted as the result of the application of paragraph 11;

d. The net change during the year in the total DTAs nonadmitted;

e. The amount of each result or component of the calculation, by tax character of paragraphs 11.a., 11.b.i., 11.b.ii., and 11.c., and the ExDTA ACL RBC Ratio, the ExDTA Surplus plus Contingency Reserves/Required Aggregate Risk Capital Ratio, or the Adjusted Gross DTA/Adjusted Capital and Surplus Ratio used in the applicable *Realization Threshold Limitation Table* (the RBC Reporting Entity Table, the Financial Guaranty or Mortgage Guaranty Non-RBC Reporting Entity Table, or the Other Non-RBC Reporting Entity Table) in paragraph 11.b., as applicable; and

f. The impact of tax-planning strategies on the determination of adjusted gross DTAs and the determination of net admitted DTAs, by percentage and by tax character, and whether the tax-planning strategies include the use of reinsurance-related tax planning strategies.

23. To the extent that DTLs are not recognized for amounts described in paragraph 31 of FAS 109, the following shall be disclosed:

a. A description of the types of temporary differences for which a DTL has not been recognized and the types of events that would cause those temporary differences to become taxable;

b. The cumulative amount of each type of temporary difference;

c. The amount of the unrecognized DTL for temporary differences related to investments in foreign subsidiaries and foreign corporate joint ventures that are essentially permanent in duration if determination of that liability is practicable or a statement that determination is not practicable; and

d. The amount of the DTL for temporary differences other than those in paragraph 23.c. that is not recognized in accordance with the provisions of paragraphs 31 of FAS 109.

24. The significant components of income taxes incurred (i.e., current income tax expense) and the changes in DTAs and DTLs shall be disclosed. Those components would include, for example:

a. Current tax expense or benefit;

b. The change in DTAs and DTLs (exclusive of the effects of other components listed below);

c. Investment tax credits;

d. The benefits of operating loss carryforwards;

e. Adjustments of a DTA or DTL for enacted changes in tax laws or rates or a change in the tax status of the reporting entity; and

f. Adjustments to gross deferred tax assets because of a change in circumstances that causes a change in judgment about the realizability of the related deferred tax asset, and the reason for the adjustment and change in judgment.

25. Additionally, to the extent that the sum of a reporting entity's income taxes incurred and the change in its DTAs and DTLs is different from the result obtained by applying the federal statutory rate to its pretax net income, a reporting entity shall disclose the nature of the significant reconciling items.

26. A reporting entity shall also disclose the following:

a. The amounts, origination dates and expiration dates of operating loss and tax credit carryforwards available for tax purposes;

b. The amount of federal income taxes incurred in the current year and each preceding year, which are available for recoupment in the event of future net losses; and

c. The aggregate amount of deposits admitted under Section 6603 of the Internal Revenue Service Code.

27. For any federal or foreign income tax loss contingencies as determined in accordance with paragraph 3.a. for which it is reasonably possible that the total liability will significantly increase within 12 months of the reporting date, the reporting entity shall disclose an estimate of the range of the reasonably possible increase or a statement that an estimate of the range cannot be made.

28. If a reporting entity's federal income tax return is consolidated with those of any other entity or entities, the following shall be disclosed:

a. A list of names of the entities with whom the reporting entity's federal income tax return is consolidated for the current year; and

b. The substance of the written agreement, approved by the reporting entity's Board of Directors, which sets forth the manner in which the total combined federal income tax for all entities is allocated to each entity which is a party to the consolidation. (If no written agreement has been executed, give an explanation of why such an agreement has not been executed.) Additionally, the disclosure shall include the manner in which the entity has an enforceable right to recoup federal income taxes in the event of future net losses which it may incur or to recoup its net losses carried forward as an offset to future net income subject to federal income taxes.

29. Refer to the preamble for further discussion regarding disclosure requirements.

Relevant Literature

30. This statement adopts the provisions of FAS 109 except as modified in paragraph 2 of this statement which results in paragraphs 29-30, 36-37, 39, 41-42, 46, and 49-59 of FAS 109 being rejected, inasmuch as they are not applicable to reporting entities subject to this statement or are inconsistent with other statutory accounting principles. Paragraph 47 of FAS 109 is adopted with modification to provide for the disclosures required for non public reporting entities.

31. This statement rejects *FASB Interpretation No. 18, Accounting for Income Taxes in Interim Periods…an interpretation of APB Opinion No. 28 and FIN 48: Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109.*

32. The following lists FASB Staff Positions that are adopted or rejected by this statement:

a. *FASB Staff Position FAS 109-1, Application of FASB Statement No. 109, Accounting for Income Taxes, to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004* is adopted in its entirety.

b. FASB *Staff Position FAS 109-2, Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004* is rejected in its entirety.

c. *FASB Staff Position FIN 48-2, Effective Date of FIN 48 for Certain Nonpublic Enterprises* is rejected in its entirety.

d. *FASB Staff Position FIN 48-3, Effective Date of FIN 48 for Certain Nonpublic Enterprises* is rejected in its entirety.

33. The following lists Accounting Principles Board Opinions that are adopted or rejected by this statement:

a. *Accounting Principles Board Opinion No. 2, Accounting for the "Investment Credit,"* paragraphs 9-15 are adopted with modification to utilize the cost reduction method only and rejects all other paragraphs;

b. *Accounting Principles Board Opinion No. 4 (Amending No. 2), Accounting for the "Investment Credit,"* is rejected in its entirety;

c. *Accounting Principles Board Opinion No. 10, Omnibus Opinion—1966,* paragraph 6 is adopted;

d. *Accounting Principles Board Opinion No. 23, Accounting for Income Taxes—Special Areas,* paragraphs 1-3, 5-9, 12-13, and 15-18 are adopted, and paragraphs 19-25, and 31-33 are rejected;

e. *Accounting Principles Board Opinion No. 28, Interim Financial Reporting,* paragraphs 19 and 20 are adopted and all other paragraphs rejected.

34. The following lists FASB Technical Bulletins that are adopted or rejected by this statement:

a. *FASB Technical Bulletin No. 79-9, Accounting in Interim Periods for Changes in Income Tax Rates* is rejected in its entirety;

b. *FASB Technical Bulletin No. 82-1, Disclosure of the Sale or Purchase of Tax Benefits through Tax Leases* is adopted in its entirety.

35. The following lists FASB Emerging Issues Task Force Issues that are adopted or rejected by this statement:

a. *FASB Emerging Issues Task Force No. 91-8, Application of FASB Statement No. 96 to a State Tax Based on the Greater of a Franchise Tax or an Income Tax,* is rejected in its entirety;

b. *FASB Emerging Issues Task Force No. 92-8, Accounting for the Income Tax Effects under FASB Statement No. 109 of a Change in Functional Currency When an Economy Ceases to Be Considered Highly Inflationary*, is adopted in its entirety;

c. *FASB Emerging Issues Task Force No. 93-13, Effect of a Retroactive Change in Enacted Tax Rates That Is Included in Income from Continuing Operations*, is rejected in its entirety;

d. *FASB Emerging Issues Task Force No. 93-16, Application of FASB Statement No. 109 to Basis Differences within Foreign Subsidiaries That Meet the Indefinite Reversal Criterion of APB Opinion No. 23*, is rejected in its entirety;

e. *FASB Emerging Issues Task Force No. 93-17, Recognition of Deferred Tax Assets for a Parent Company's Excess Tax Basis in the Stock of a Subsidiary That Is Accounted for as a Discontinued Operation*, is adopted in its entirety;

f. *FASB Emerging Issues Task Force No. 94-10, Accounting by a Company for the Income Tax Effects of Transactions among or with Its Shareholders under FASB Statement No. 109*, is rejected in its entirety;

g. *FASB Emerging Issues Task Force No. 95-9, Accounting for Tax Effects of Dividends in France in Accordance with FASB Statement No. 109*, is rejected in its entirety;

h. *FASB Emerging Issues Task Force No. 95-10, Accounting for Tax Credits Related to Dividend Payments in Accordance with FASB Statement No. 109*, is rejected in its entirety;

i. *FASB Emerging Issues Task Force No. 95-20, Measurement in the Consolidated Financial Statements of a Parent of the Tax Effects Related to the Operations of a Foreign Subsidiary That Receives Tax Credits Related to Dividend Payments*, is rejected in its entirety.

36. This statement rejects *AICPA Accounting Interpretations, Accounting for the Investment Credit: Accounting Interpretations of APB Opinion No. 4* in its entirety.

Effective Date and Transition

37. This statement shall be effective for years beginning January 1, 2012. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*.

REFERENCES

Relevant Issue Papers

- Issue Paper No. 83—Accounting for Income Taxes

EXHIBIT A – IMPLEMENTATION QUESTIONS AND ANSWERS

The National Association of Insurance Commissioners issued *SSAP No. 101—Income Taxes* (SSAP No. 101) with an effective date of January 1, 2012.

This Q&A is effective for reporting periods ending on or after January 1, 2012.

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1. Q – What are the primary differences between the accounting for income taxes pursuant to FAS 109 and SSAP No. 101? [No specific paragraph reference]

1.1 A – SSAP No. 101 establishes statutory accounting principles for current and deferred federal and foreign income taxes and current state income taxes. In general, SSAP No. 101 adopts the concepts of FAS 109, with modifications. The primary differences and modifications are summarized below:

1.2 State Income Tax

- FAS 109 – State income taxes should be included as "income taxes incurred." Deferred state income taxes are recognized.

- SSAP No. 101 – State income taxes should be included as "Taxes, Licenses, and Fees" by property and casualty insurers and as "Insurance taxes, licenses, and fees, excluding federal income taxes" by life and accident and health insurers. No deferred state income taxes are recognized.

1.3 Valuation Allowance

- FAS 109 – Gross deferred tax assets (DTAs) are reduced by a valuation allowance if it is more likely than not that some portion or all of the DTAs will not be realized. The valuation allowance should be sufficient to reduce the DTA to the amount that is more likely than not to be realized.

- SSAP No. 101 – Gross DTAs are reduced by a statutory valuation allowance adjustment that is determined on a separate company, reporting entity basis. Pursuant to paragraphs 2 and 7.e. of SSAP No. 101, gross DTAs are adjusted to an amount that is more likely than not to be realized (a likelihood of more than 50 percent). Only adjusted gross DTAs shall be considered in determining admitted adjusted gross DTAs. See Question 2 for further discussion of the statutory valuation allowance adjustment. See Question 4 for a further discussion of the admissibility test. See Question 12 for further discussion of presentation and disclosure of the statutory valuation allowance adjustment.

1.4 Unique Statutory Accounting Items

- FAS 109 – In general, the effects of all temporary differences must be reflected with limited exceptions provided in FAS 109 paragraphs 31-34 (relating to items specified in Accounting Principles Board Opinion No. 23) and for temporary differences related to goodwill for which amortization is not deductible for tax purposes.

- SSAP No. 101 – In addition to the exceptions provided in FAS 109, temporary differences do not include asset valuation reserve (AVR), interest maintenance reserve (IMR), Schedule F penalties and, in the case of a mortgage guaranty insurer, amounts attributable to its statutory contingency reserve to the extent that "tax and loss" bonds have been purchased.

1.5 Changes in Deferred Tax Assets and Liabilities

- FAS 109 – Changes in DTAs and deferred tax liabilities (DTLs) are included in income tax expense or benefit and are allocated to continuing operations, discontinued operations, extraordinary items and items charged directly to shareholders' equity.

- SSAP No. 101 – Changes in DTAs and DTLs are recognized as a separate component of gains and losses in surplus, except to the extent allocated to changes in unrealized gains and losses.

1.6 Regulated Enterprises

- FAS 109 – Regulated enterprises that meet the criteria for application of FAS 71, *Accounting for* the *Effects of Certain Types of Regulation*, are not exempt from the requirements of FAS 109. However, assets are reported on a net-of-tax basis (see paragraphs 29, 57, 58 and 59 of FAS 109).

- SSAP No. 101 – These special paragraphs do not apply pursuant to paragraph 30 of SSAP No. 101.

1.7 Business Combinations

- FAS 109 – Paragraphs 30 and 53-56 of FAS 109 provide certain guidance regarding the treatment of business combinations. In general, a deferred tax asset or liability is recognized for the differences between the assigned values and the tax bases of the assets and liabilities recognized in a purchased business combination. If financial statements for prior years are restated, all purchase business combinations that were consummated in those prior years shall be remeasured in accordance with FAS 109.

- SSAP No. 101 – These special paragraphs do not apply pursuant to paragraph 30 of SSAP No. 101.

1.8 Intraperiod Tax Allocation

- FAS 109 – Income tax expense or benefit is allocated among continuing operations, discontinued operations, extraordinary items, and items charged or credited directly to shareholders' equity pursuant to paragraphs 36 and 37 of FAS 109.

- SSAP No. 101 – These paragraphs of FAS 109 do not apply pursuant to paragraph 30 of SSAP No. 101. Instead, paragraphs 18 and 19 of SSAP No. 101 provide special rules for statutory accounting. See Question 10 for a further discussion of these rules.

1.9 Certain Quasi-Reorganizations

- FAS 109 – Paragraph 39 provides special rules relating to the treatment of deductible temporary differences and carryforwards as of the date of a quasi-reorganization.

- SSAP No. 101 – Paragraph 39 of FAS 109 does not apply pursuant to paragraph 30 of SSAP No. 101.

1.10 Financial Statement Classification of DTAs and DTLs

- FAS 109 – Pursuant to paragraphs 41 and 42 of FAS 109, DTAs and DTLs are to be classified separately as either current or noncurrent, depending on the classification of the related asset or liability. Furthermore, current DTAs and DTLs and noncurrent DTAs and DTLs are netted within the classification and with the net amount reported.

- SSAP No. 101 – These paragraphs do not apply to statutory accounting pursuant to paragraph 30 of SSAP No. 101. The net admitted DTA, or the net DTL, should be reported in the statutory financial statements.

1.11 Accounting for Uncertainty in Income Taxes

- FAS 109 – Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109 (FIN 48) provides accounting and reporting guidance for uncertain tax positions under GAAP.

- SSAP No. 101 – FIN 48 is rejected for statutory accounting pursuant to paragraph 31 of SSAP No. 101. *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets* (SSAP No. 5R) provides guidance in determining the amount of federal and foreign income tax loss contingencies with the following modifications. The term "probable" as used in SSAP No. 5R is replaced by the term "more likely than not (a likelihood of more than 50 percent)". In determining the amount of a federal or foreign income tax loss contingency, it shall be assumed that the reporting entity will be examined by the tax authority that has full knowledge of all relevant information. If the estimated tax loss contingency is greater than 50% of the tax benefit originally recognized, the tax loss contingency recorded shall be equal to 100% of the original tax benefit recognized. See Question 9 for further discussion of income tax loss contingencies.

1.12 Classification of Interest and Penalties

- FAS 109 – FIN 48 allows interest on tax assessments to be reported as either income taxes or interest expense and penalties to be reported as either income taxes or another expense classification, based on the accounting policy election of the enterprise.

- SSAP No. 101 – Interest and penalties related to foreign or federal income tax are included in income taxes pursuant to paragraph 3.a. of SSAP No. 101.

1.13 Financial Statement Disclosures

- FAS 109 – Paragraphs 43-45 and 47-48 of FAS 109 provide various requirements for providing information in the financial statements regarding the income taxes of the reporting entity. In general, the reporting entity is to provide certain information regarding the components of its DTAs and DTLs, the amount of and changes in its valuation allowance, significant components of income tax expense, differences between the expected amount of income tax expense using current tax rates and the amount of reported income tax expense, and tax attributes being carried over. In addition, FIN 48 includes specific disclosures related to uncertain tax positions.

- SSAP No. 101 – In general, paragraphs 21-29 of SSAP No. 101 follow the disclosure requirements provided by FAS 109, but with the following modifications and additions:

  - The disclosures regarding valuation allowance are replaced with disclosures relating to the statutory valuation allowance adjustment and the nonadmitted portion of the DTA.

  - The amount of the gross DTA, adjusted gross DTA, DTL, admitted and nonadmitted DTA is required to be separately disclosed, by tax character (ordinary or capital).

  - Disclose the amount of each result or component of the admission calculation, by tax character, for paragraphs 11.a, 11.b.i, 11.b.ii, and 11.c. In addition, disclose the ExDTA Authorized Control Level (ACL) RBC Ratio, the ExDTA Surplus plus Contingency Reserves/Required Aggregate Risk Capital Ratio (see paragraph 11.b.), or the Adjusted Gross DTA/Adjusted Capital and Surplus Ratio used in the applicable Realization Threshold Limitation Table (the RBC Reporting Entity Table, the Financial Guaranty or Mortgage Guaranty Non-RBC Reporting Entity Table, or the Other Non-RBC Reporting Entity Table) in paragraph 11.b., as applicable.

- The impact of tax-planning strategies on the determination of adjusted gross DTAs and the determination of net admitted adjusted gross DTAs, by percentage and by tax character, must be disclosed. In addition, disclose whether tax-planning strategies include the use of reinsurance-related tax planning strategies.

- FIN 48 and the associated disclosure requirements are rejected for statutory accounting purposes and replaced with the following disclosure. For any federal or foreign income tax loss contingencies for which it is reasonably possible that the total liability will significantly increase within 12 months of the reporting date, a disclosure of an estimate of the range of the reasonably possible increase is required. If determination of a reasonable range of the significant increase is not possible, the reporting entity is to provide a statement that an estimate cannot be made.

- The disclosures relating to deferred income tax expense or benefit are replaced with certain disclosures relating to the reporting entity's "change in DTAs and DTLs."

- Only the nature of significant reconciling items between the reported amount and "expected" amount of income tax expense and change in DTAs and DTLs are to be disclosed. This generally follows the disclosure requirements of FAS 109 for nonpublic entities.

- See Question 12 for a more detailed discussion of the disclosure requirements of SSAP No. 101.

2. Q – How should an entity measure its adjusted gross deferred tax assets and its gross deferred tax liabilities? [Paragraph 7]

2.1 A – An enterprise shall record a gross deferred tax liability or asset for all temporary differences and operating loss, capital loss and tax credit carryforwards. Temporary differences include unrealized gains and losses and nonadmitted assets but do not include AVR, IMR, Schedule F penalties and, in the case of a mortgage guaranty insurer, amounts attributable to its statutory contingency reserve to the extent that "tax and loss" bonds have been purchased. In general, temporary differences produce taxable income or result in tax deductions when the related asset is recovered or the related liability is settled. A deferred tax asset or liability represents the increase or decrease in taxes payable or refundable in future years as a result of temporary differences and carryforwards at the end of the current year. Additionally, gross DTAs are reduced by a statutory valuation allowance adjustment if, based on the weight of available evidence, it is more likely than not (a likelihood of more than 50 percent) that some portion or all of the gross DTAs will not be realized. The statutory valuation allowance adjustment, determined in a manner consistent with paragraphs 20-25 of FAS 109, shall reduce gross DTAs to the amount that is more likely than not to be realized (the adjusted gross deferred tax assets).[6] This answer only addresses the recognition of adjusted gross DTAs and gross DTLs and does not address the admissibility of such amounts. See Question 4 for a discussion of the admissibility criteria of SSAP No. 101.

2.2 Paragraph 7 of SSAP No. 101 states that temporary differences are identified and measured using a "balance sheet" approach whereby the statutory balance sheet and the tax basis balance sheet are compared. Operating loss, capital loss and tax credit carryforwards are computed in accordance with the applicable Internal Revenue Code.

2.3 The following illustrates the recognition and measurement of a typical book to tax difference for an insurance company:

[6] SSAP No. 101 requires the statutory valuation allowance adjustment to be presented in the annual statement as a direct reduction in the gross DTA. It is not included in non-admitted DTA.

Illustration

Assumptions:

1/1/X2	Purchase 100 shares of Darby/Allyn Corp. stock for $25 a share
3/31/X2	Fair Value of Darby/Allyn Corp. stock has increased to $35 a share
3/31/X2	Tax basis reserves are computed and determined to be 80% of the statutory basis reserves

Balance Sheet at 3/31/X2:

				Tax Effect
			Basis	DTA (DTL)
	Statutory Basis	**Tax Basis**	**Difference**	**(35%)**[7]
Common Stock	$3,500	$2,500	($1,000) [8]	($350)
Reserves	$100,000	$80,000	$20,000 [9]	$7,000

Journal Entries:

1/1/X2	DR	Common stock	$2,500
	CR	Cash	($2,500)
		Acquisition of common stock at $25 per share	

3/31/X2	DR	Common stock	$1,000
	CR	Change in unrealized capital gains and losses	($1,000)
		Adjust carrying value to FV of $35 per share at end of quarter	

3/31/X2	DR	Change in reserves or unpaid losses	$100,000
	CR	Reserves or Unpaid losses	($100,000)
		Recognition of reserves computed on a statutory basis	
3/31/X2	DR	Deferred tax asset	$7,000
	CR	Change in deferred income taxes	($6,650)
	CR	Deferred tax liability	($350)
		Recognition of deferred taxes	

NOTE: Presentation of deferred tax amounts and unrealized gain or losses net of tax is addressed in Question 12.

2.4 As depicted in the Illustration, the deferred tax assets and liabilities are tracked gross in the entity's ledger and not netted until after consideration of the statutory valuation allowance adjustment, if any (see below), and the admissibility of deferred tax assets.

[7] See Question 3 for a discussion of "enacted rates."

[8] The carrying value of the stock on the statutory balance sheet reflects the fair value of the common stock per SSAP No. 30—*Investments in Common Stock (excluding investments in common stock of subsidiary, controlled, or affiliated entities)* whereas the carrying value of the stock for tax purposes is its original cost. This difference is defined as temporary in that the $1,000 appreciation in value will be recognized in the tax return when the stock is disposed of. The difference is a deferred tax liability in that the reversal of this temporary difference will increase future taxable income.

[9] The reserve difference is due to the fact that statutory reserves are computed on a more conservative set of assumptions than for tax (life and health entities) or the tax reserves are discounted (property and casualty and other health entities). This amount is a temporary difference in that the entity will recognize the difference between statutory and tax carrying values over the life of the reserve or upon settlement of the claim or payment of the reserve. The difference is a deferred tax asset in that the reversal of this temporary difference will decrease future taxable income.

Statutory Valuation Allowance Adjustment

2.5 SSAP No. 101 paragraph 7.e. provides that gross DTAs are reduced by a statutory valuation allowance *adjustment* if, based on the weight of available evidence, it is more likely than not that some portion or all of the gross DTAs will not be realized. The statutory valuation allowance adjustment is determined on a separate company, reporting entity basis. The determination of whether gross DTAs will be realized is based on the existence of sufficient taxable income of the appropriate character (ordinary income or capital gain) within the carryback, carryover period available under the tax law. Paragraph 13.a. through 13.d. of SSAP No. 101 identifies four sources of taxable income to be considered in evaluating the existence of sufficient taxable income. These sources are identical to those to be considered under FAS 109 paragraph 21. FAS 109 paragraph 20 provides that "all available evidence, both positive and negative, should be considered to determine whether, based on the weight of that evidence, a valuation allowance is needed. Information about an enterprise's current financial position and its results of operations for the current and preceding years ordinarily is readily available. That historical information is supplemented by all currently available information about future years. Sometimes, however, historical information may not be available (for example, start-up operations) or it may not be as relevant (for example, if there has been a significant, recent change in circumstances) and special attention is required." A reporting entity is not required to consider all four sources of taxable income in determining the need for a statutory valuation allowance adjustment if one or more sources are alone sufficient to support the conclusion that the entity will realize the tax benefits of its gross deferred tax assets (i.e., a conclusion that no valuation allowance is necessary). However, the reporting entity is required to consider all of the potential sources of taxable income to determine the amount of the adjustment if a conclusion is reached that a statutory valuation allowance adjustment is necessary. Historical and/or currently available information may exist that is also significant and relevant in determining the amount of the DTAs admitted under paragraph 11 of SSAP No. 101. This historical and/or currently available information must also be considered when determining the amount of DTAs admitted under paragraph 11 of SSAP No. 101, irrespective of the conclusion reached in establishing or not establishing a statutory valuation allowance adjustment. See Question 4.13 for specific guidance on the admissibility of DTAs under paragraph 11.c. of SSAP No. 101.

2.6 Footnote 1 to paragraph 7.e. of SSAP No. 101 indicates that a reporting entity shall consider reversal *patterns* of temporary differences, and might be required to schedule such differences:

> …to the extent necessary to support establishing or not establishing a valuation allowance adjustment, determined in accordance with paragraphs 228 and 229 of FAS 109. For purposes of this accounting statement, consideration of reversal patterns does not require scheduling beyond that necessary to support establishing or not establishing a valuation allowance adjustment.

Paragraph 228 of FAS 109 generally holds that a company may need to schedule its temporary *differences* to determine the particular years in which the reversal of temporary differences is expected to occur. As discussed in Question 5b, paragraph 229 of FAS 109 indicates that future originating temporary differences and their subsequent reversal should be considered in determining the existence of future taxable income.

2.7 Although a reporting entity may need to consider the reversal pattern of temporary differences in evaluating the need for a statutory valuation allowance adjustment, scheduling the reversal pattern of such differences is not required in every instance. Under SSAP No. 101 and consistent with FAS 109, a general understanding of reversal patterns is, in many cases, relevant in assessing the need for a valuation allowance. Judgment is crucial in making this assessment. The amount of scheduling, if any, that will be required will depend on the facts and circumstances of each situation. For example, a reporting entity which relies upon future taxable income exclusive of reversing temporary differences and carryforwards[10] for realization of DTAs is not required to schedule the reversal pattern of its existing temporary differences. This is consistent with guidance provided by the Financial Accounting Standards Board (FASB) in its answer to question 2 of *A Guide to Implementation of Statement 109 on Accounting for Income Taxes: Question and Answers* (Special Report on Statement 109) which states that scheduling of existing temporary differences is unnecessary for purposes of determining the need for a valuation allowance "where it can be easily demonstrated that future taxable income will more likely than not be adequate to realize future tax benefits of existing deferred tax assets." In contrast, a reporting entity which relies upon the future reversal of existing taxable temporary differences to realize the tax benefits of its deductible temporary differences and carryforwards may be required to consider the reversal patterns of its taxable temporary differences.[11] The degree of scheduling required, however, depends on the facts and circumstances of each situation and the relative magnitude of the taxable and deductible temporary differences. In certain situations, the ability to reasonably conclude that reversing taxable temporary differences will more likely than not create sufficient taxable income to realize reversing deductible temporary differences can be done without detailed scheduling.[12]

2.8 If scheduling is considered necessary, the amount of scheduling required will depend on the particular facts and circumstances and be subject to judgment. There may be more than one acceptable approach. The FASB's answer to question 1 of the Special Report on Statement 109 indicates that the following concepts underlie the determination of reversal patterns under Statement 109:

a. The particular years in which temporary differences result in taxable or deductible amounts generally are determined by the timing of the recovery of the related asset or settlement of the related liability' (paragraph 228).

b. The tax law determines whether future reversals of temporary differences will result in taxable and deductible amounts that offset each other in future years' (paragraph 227).

In addition, the FASB noted that "minimizing complexity is an appropriate consideration in selecting a method for determining reversal patterns"[13], but that the methods used must be systematic and logical and should be consistently applied for all similarly categorized temporary differences and from year to year. Furthermore, the same method should be utilized in determining the reversal patterns in every taxing jurisdiction for which the temporary difference exists.

Grouping of Assets and Liabilities for Measurement

2.9 The manner in which an entity groups its assets and liabilities for measurement shall be conducted in a reasonable and consistent manner. For instance, an entity may group its invested assets into Annual Statement classifications (stocks, bonds, preferred stocks, etc.) or other reasonable groupings (lines of business for grouping its reserves). Entities have the option of recognizing the DTA and DTL

[10] One of the four possible sources of taxable income that can be used to realize a tax benefit. See paragraph 13.b. of SSAP No. 101.

[11] For example, due to the relatively short loss carryback periods under existing tax law, such consideration may be appropriate when taxable temporary differences are expected to reverse in a short number of future years while the deductible temporary differences are expected to reverse over a long number of future years. In addition, for "indefinite-lived" intangible assets (i.e., intangible assets like those discussed in paragraph 11 of FAS 142 for which no legal, regulatory, contractual, competitive, economic, or other factors limit their useful lives), predicting reversal of temporary differences related to such assets would be inconsistent with financial reporting assertions that the assets are indefinite-lived. In such a case, the reversal of taxable temporary differences with respect to such indefinite-lived intangible assets should not be considered a source of future taxable income when determining the statutory valuation allowance adjustment.

[12] Q&A 2 from the Special Report on Statement 109 published by the FASB.

[13] Q&A 1 from the Special Report on Statement 109 published by the FASB.

within each grouping on a net or gross basis. For instance, a portfolio of common stocks will have both unrealized gain and unrealized losses associated with them. The reporting entity may elect to combine the unrealized gains and losses and compute a single DTA or DTL or it may elect to segregate the unrealized gains from the unrealized losses and compute separate DTAs and DTLs. This option might also arise with respect to depreciable assets. Regardless of which method an entity elects, it is crucial that consistency is maintained to and within each grouping from period to period. An entity shall retain internal documentation to support its grouping in addition to the methodologies employed to arrive at such. An entity is permitted to modify its groupings should events or circumstances change from a previous period. Examples include a change in materiality of underlying assets and liabilities, administrative costs associated with detailing groupings increases or changes in the computer systems that allow more specificity. Entities that modify their groupings should be prepared to rationalize these changes. These entities should also disclose that a modification was made and general reason for such in the notes to the financial statements.

Measurement of Nonadmitted Assets

2.10 As noted in paragraph 7.b. of SSAP No. 101, temporary differences include nonadmitted assets. The measurement of these types of assets is not addressed in FAS 109 in that the concept of nonadmission is unique to statutory accounting. For assets that are nonadmitted for statutory accounting purposes, DTAs and DTLs should be measured after nonadmission.

Illustration:

	Statutory Before Nonadmit (Info Purpose)	**Statutory After Nonadmit**	**Tax**	**Basis Difference**[14]	**Tax Effect DTA (DTL) (35%)**
Furniture Fixtures and Equipment	$1,000	0	$1,000		
Accumulated Depreciation	200	0	400		
Basis	$800	0	$600	$600	$210

2.11 The effect of this illustration is a reduction of surplus by $590 ($800 decrease for nonadmitted asset and $210 increase for DTA), provided the resulting DTA meets the admissibility test in paragraph 11 of SSAP No. 101.

3. Q – A reporting entity's deferred tax assets and liabilities are computed using "enacted tax rates." What is the meaning of the term "enacted tax rates"? [Paragraph 7.c.]

3.1 A – Paragraph 7.c. of SSAP No.101 provides that total DTAs and DTLs are computed using enacted tax rates.

3.2 Consistent with FAS 109, SSAP No. 101 further requires that deferred tax assets and liabilities be measured using the enacted tax rate that is expected to apply to taxable income in the periods in which the deferred tax asset or liability is expected to be settled or realized. The effects of future changes in tax rates are not anticipated in the measurement of deferred tax assets and liabilities. Deferred tax assets and liabilities are adjusted for changes in tax rates and other changes in the tax law, and the effects of those changes are recognized at the time the change is enacted.

[14] Difference is computed from the "Statutory After Nonadmit" balance.

3.3 Tax laws may apply different tax rates to ordinary income and capital gains. In instances where the enacted tax law provides for different rates on income of different character, deferred tax assets and liabilities should be measured by applying the appropriate enacted tax rate based on the type of taxable or deductible amounts expected to be realized from the reversal of existing temporary differences.

3.4 Currently, under U.S. federal tax law, if taxable income (both ordinary and capital gain) exceeds a specified amount, all taxable income is taxed at a single flat tax rate, 35%. Unless graduated tax rates are a significant factor, (i.e., unless the company's taxable income frequently falls below the specified amount), the enacted tax rate is 35% for both ordinary income and capital gain. Alternative minimum tax and the effect of special deductions, such as the small life deduction, are ignored, except to the extent necessary to estimate future taxable income and therefore the enacted rate applicable to that level of taxable income is used.

3.5 If graduated tax rates are expected to be a significant factor in the determination of taxes payable or refundable in future years, deferred tax assets and liabilities should be measured using the average tax rate (based on currently enacted graduated rates) that is expected to apply to estimated average annual taxable income in the period in which the deferred tax asset or liability is expected to be settled or realized. For example, assume a property and casualty insurance company consistently has taxable income less than $10 million, but in excess of $1 million. The enacted graduated rate applicable to that level of taxable income is 34%. Therefore, the reporting entity should use 34% for the determination of its taxes payable or refundable.

3.6 As a reference, FAS 109 paragraphs 18 and 236 provide the following:

> 18. The objective is to measure a deferred tax liability or asset using the enacted tax rate(s) expected to apply to taxable income in the periods in which the deferred tax liability or asset is expected to be settled or realized. Under current U.S. federal tax law, if taxable income exceeds a specified amount, all taxable income is taxed, in substance, at a single flat tax rate. That tax rate shall be used for measurement of a deferred tax liability or asset by enterprises for which graduated tax rates are not a significant factor. Enterprises for which graduated tax rates are a significant factor shall measure a deferred tax liability or asset using the average graduated tax rate applicable to the amount of estimated annual taxable income in the periods in which the deferred tax liability or asset is estimated to be settled or realized (paragraph 236). Other provisions of enacted tax laws should be considered when determining the tax rate to apply to certain types of temporary differences and carryforwards (for example, the tax law may provide for different tax rates on ordinary income and capital gains). If there is a phased-in change in tax rates, determination of the applicable tax rate requires knowledge about when deferred tax liabilities and assets will be settled and realized.
>
> 236. The following example illustrates determination of the average graduated tax rate for measurement of deferred tax liabilities and assets by an enterprise for which graduated tax rates ordinarily are a significant factor. At the end of year 3 (the current year), an enterprise has $1,500 of taxable temporary differences and $900 of deductible temporary differences, which are expected to result in net taxable amounts of approximately $200 on the future tax returns for each of years 4-6. Enacted tax rates are 15 percent for the first $500 of taxable income, 25 percent for the next $500, and 40 percent for taxable income over $1,000. This example assumes that there is no income (for example, capital gains) subject to special tax rates.
>
> The deferred tax liability and asset for those reversing taxable and deductible temporary differences in years 4-6 are measured using the average graduated tax rate for the estimated amount of annual taxable income in future years. Thus, the average graduated tax rate will differ depending on the expected level of annual taxable income (including reversing temporary differences) in years 4-6. The average tax rate will be:
>
> a. 15 percent if the estimated annual level of taxable income in years 4-6 is $500 or less
>
> b. 20 percent if the estimated annual level of taxable income in years 4-6 is $1,000

c. 30 percent if the estimated annual level of taxable income in years 4-6 is $2,000.

Temporary differences usually do not reverse in equal annual amounts as in the example above, and a different average graduated tax rate might apply to reversals in different future years. However, a detailed analysis to determine the net reversals of temporary differences in each future year usually is not warranted. It is not warranted because the other variable (that is, taxable income or losses exclusive of reversing temporary differences in each of those future years) for determination of the average graduated tax rate in each future year is no more than an estimate. For that reason, an aggregate calculation using a single estimated average graduated tax rate based on estimated average annual taxable income in future years is sufficient. Judgment is permitted, however, to deal with unusual situations, for example, an abnormally large temporary difference that will reverse in a single future year, or an abnormal level of taxable income that is expected for a single future year. The lowest graduated tax rate should be used whenever the estimated average graduated tax rate otherwise would be zero.

4a. Q – How should a reporting entity calculate the amount of its admitted adjusted gross DTAs? [Paragraph 11]

4.1 A – After a reporting entity has calculated the amount of its adjusted gross DTAs and gross DTLs pursuant to paragraph 7, it must determine the amount of its adjusted gross DTAs that can be admitted under paragraph 11. The amount of adjusted gross DTAs is not recalculated under paragraph 11; rather, some or all of the adjusted gross DTA may not be currently admitted.

4.2 Paragraphs 11.a., 11.b. and 11.c. require three interdependent calculations or components that when added together equals the amount of the reporting entity's admitted adjusted gross DTAs. Each of the calculations starts with the total of the reporting entity's adjusted gross DTAs, and determines the amount of such adjusted gross DTAs that can be admitted under that part. For example, the consideration of existing temporary differences in the calculation of admitted adjusted gross DTAs under paragraph 11.a., does not prevent the reconsideration of the same temporary differences in the paragraph 11.b.i. calculation. However, to avoid duplication of admitted adjusted gross DTAs when adding the three parts together, the amount of admitted adjusted gross DTAs under paragraph 11.a. must be subtracted from the amount of adjusted gross DTAs in the paragraph 11.b.i. calculation. Similarly, the amount of admitted adjusted gross DTAs under paragraphs 11.a. and 11.b. must be subtracted from the total adjusted gross DTAs in the paragraph 11.c. calculation.

First Component – Admission Based On Previously Paid Taxes [Paragraph 11.a.]

4.3 Under paragraphs 11.a. and 12.b., a reporting entity can admit adjusted gross DTAs to the extent that it would be able to recover federal income taxes paid in the carryback period, by treating existing temporary differences that reverse during a timeframe corresponding with Internal Revenue Code tax loss carryback provisions[15], not to exceed three years as ordinary or capital losses that originated in each such subsequent year. The reversing temporary differences are specific to each year in which they reverse, and in turn, to the specific year(s) to which they can be carried back corresponding with tax loss carryback provisions. Reversing temporary differences for unrealized losses and nonadmitted assets are treated as capital or ordinary losses depending on their character for tax purposes. The entity is not required to project an actual net operating loss in future periods. This first component of admission is available to all entities, regardless of whether they meet any of the threshold limitations in paragraph 11.b. for reversals expected to be realized against future taxable income.

[15] For example, Federal Internal Revenue Code tax loss carryback provisions in effect as of January 1, 2012, ordinary losses can be carried back two years for nonlife insurance companies and three years for life insurance companies, while capital losses for both nonlife and life companies can be carried back three years.

4.4 Paragraph 12.b. limits the amount of federal income taxes recoverable under paragraph 11.a. to the amount that would be refunded to the reporting entity if a carryback claim was filed with the Internal Revenue Service (IRS). If some amount of taxes paid in the carryback period is not recovered because of limitations imposed by the Alternative Minimum Tax system, the resulting AMT credit is not treated as a newly created DTA. Paragraph 12.c. further limits the amount of federal income taxes recoverable under paragraph 11.a. for a reporting entity that files a consolidated income tax return with one or more affiliates, to the amount that the reporting entity could reasonably expect to have refunded by its parent. See Question 8 for a further discussion of the impact of filing a consolidated federal income tax return.

Second Component – Admission Based On Projected Future Tax Savings [Paragraph 11.b.]

4.5 The amount of a reporting entity's adjusted gross DTAs that can be admitted pursuant to paragraph 11.b. is in part, dependent on the amount of the reporting entity's adjusted capital and surplus. Accordingly, a reporting entity must determine which Realization Threshold Limitation Table set forth in paragraph 11.b. is applicable to the reporting entity and then, based on its respective facts, determine what applicable period to apply under paragraph 11.b.i. and applicable percentage to use under paragraph 11.b.ii.

4.6 If the reporting entity is subject to risk-based capital requirements or is required to file a Risk-Based Capital Report with the domiciliary state, it should use the RBC Reporting Entity Table set forth in paragraph 11.b. Threshold limitations for this table are contingent upon the ExDTA ACL RBC ratio. See Question 4b for a discussion on the ExDTA ACL RBC ratio.

4.7 If the reporting entity is (1) either a mortgage guaranty insurer or financial guaranty insurer that is not subject to risk-based capital requirements, (2) is not required to file a Risk-Based Capital Report with the domiciliary state, and (3) the reporting entity meets the minimum capital and reserve requirements[16] for the state of domicile, then it should use the Financial Guaranty or Mortgage Guaranty Non-RBC Reporting Entity Table set forth in paragraph 11.b. Threshold limitations for this table are contingent upon the ratio of ExDTA Surplus plus contingency reserves divided by the minimum aggregate capital required (see further detail in paragraph 11.b.).

4.8 If the reporting entity (1) is not subject to risk-based capital requirements, (2) is not required to file a Risk-Based Capital Report with the domiciliary state, (3) is not a mortgage guaranty or financial guaranty insurer, and (4) meets the minimum capital and reserve requirements[17], it should use the Other Non-RBC Reporting Entity Table set forth in paragraph 11.b. Threshold limitations for this table are contingent upon the ratio of adjusted gross DTA less the amount of adjusted gross DTA admitted in paragraph 11.a. to adjusted capital and surplus.

4.9 The amount of admitted adjusted gross DTAs under paragraph 11.b.i., is limited to the amount that the reporting entity expects to realize within the applicable period as determined using the applicable *Realization Threshold Limitation Table* following the balance sheet date. See Question 6 for a further discussion of the meaning of "expected to be realized." The amount of admitted adjusted gross DTAs under the paragraph 11.a. calculation is subtracted from the amount of adjusted gross DTAs under paragraph 11.b.i., to prevent the counting of the same admitted adjusted gross DTAs more than once. If the reporting entity expects to realize an amount of adjusted gross DTAs under paragraph 11.b.i. that is equal to or less than the admitted adjusted gross DTAs calculated under paragraph 11.a., then the resulting admitted adjusted gross DTAs under paragraph 11.b.i. will be zero.

[16] If a reporting entity is not at the minimum capital and reserve requirements, the admitted adjusted gross DTA for this component is zero.

[17] See Footnote 16

4.10 The reference to applicable period following the balance sheet date in 4.9 refers to the paragraph 11.b.i. column of the applicable Realization Threshold Limitation Table, the RBC Reporting Entity Table, the Financial Guaranty or Mortgage Guaranty Non-RBC Reporting Entity Table or the Other Non-RBC Reporting Entity Table.

4.11 The amount of admitted adjusted gross DTAs under paragraph 11.b.i. is also limited to an amount that is no greater than the applicable percentage of adjusted statutory capital and surplus specified in paragraph 11.b.ii. See Question 4c for a discussion of the meaning of "an amount that is no greater than".

4.12 The reference to an amount no greater than the applicable percentage of statutory capital and surplus in 4.11 refers to the 11.b.ii. column of the applicable Realization Threshold Limitation Table; the RBC Reporting Entity Table, the Financial Guaranty or Mortgage Guaranty Non-RBC Reporting Entity Table or the Other Non-RBC Reporting Entity Table.

Third Component – Admission Based On Offset Against DTL [Paragraph 11.c.]

4.13 Under paragraph 11.c., a reporting entity can admit adjusted gross DTAs as an offset against gross DTLs in an amount equal to the lesser of: (1) its adjusted gross DTAs, after subtracting the amount of admitted adjusted gross DTAs under paragraphs 11.a. and 11.b., or (2) its gross DTLs. In determining the amount of adjusted gross DTAs that can be offset against existing gross DTLs in the paragraph 11.c. calculation, the character (i.e., ordinary versus capital) of the DTAs and DTLs must be taken into consideration such that offsetting would be permitted in the tax return under existing enacted federal income tax laws and regulations. For example, an adjusted gross DTA related to unrealized capital losses could not be offset against an ordinary income DTL. Ordinary DTAs can be admitted by offset with ordinary DTLs and/or capital DTLs. However, capital DTAs can only be admitted by offset with capital DTLs. In addition to consideration of the character of the DTAs and DTLs, significant and relevant historical and/or currently available information may exist specific to the remaining adjusted gross DTAs and gross DTLs. This information must also be taken into consideration when determining admission by offset with gross DTLs. As stated in paragraph 11.c., "for purposes of this component, the reporting entity shall consider the reversal patterns of temporary differences; however, this consideration does not require scheduling beyond that required in paragraph 7.e." This consideration requires a scheduling exercise if scheduling is needed for determination of the statutory valuation allowance adjustment and, as a result, should be consistent with the determination of any statutory valuation allowance adjustment, which occurs prior to performing the admissibility calculations.[18] As noted in Question 2.7, scheduling reversal patterns of temporary differences in evaluating the need for a statutory valuation allowance adjustment where a reporting entity relies on sources of future taxable income, exclusive of reversals of temporary differences, is not required. In such case, that reporting entity is not required to schedule reversal patterns of temporary differences for purposes of paragraph 11.c. of SSAP No. 101. However, the significant and relevant historical and/or currently available information noted above must be considered and be consistent with the conclusion to admit or nonadmit adjusted gross DTAs under paragraph 11.c. without additional detailed scheduling. See Question 2.5 through 2.8 for further discussion of scheduling for purposes of determining the reporting entity's statutory valuation allowance adjustment.

Other Considerations

4.14 In certain situations, a reporting entity's expected federal income tax rate on its reversing temporary differences will be less than the enacted tax rate used in the determination of its gross DTAs and DTLs. Examples of such entities include: property/casualty insurance companies with large municipal bond portfolios that are AMT taxpayers, Blue Cross-Blue Shield Organizations with section 833(b) deductions, small life insurance companies, reporting entities projecting a tax loss, and entities that

[18] Footnote 1 of SSAP No. 101 provides that a reporting entity "shall consider reversal patterns of temporary differences *to the extent necessary* to support establishing or not establishing a valuation allowance adjustment." (Emphasis added).

file in a consolidated federal income tax return that cannot realize the full amount of their adjusted gross DTAs under the existing intercompany tax sharing or tax allocation agreement. Pursuant to paragraphs 231, 232 and 238 of FAS 109, such entities are required to report their gross DTLs at the enacted tax rate, and cannot take into consideration the impact of the AMT, section 833(b) deduction, or the small life insurance company deduction to reduce their gross DTLs.

4.15 For those entities, the amount of admitted adjusted gross DTAs calculated under paragraphs 11.a. and 11.b. will reflect the actual tax rate in the carryback period under paragraph 11.a. and the expected tax rate in the applicable period as discussed in 4.10 above under paragraph 11.b., which takes into consideration the impact of the AMT, special deductions, and the provisions of the intercompany tax sharing or allocation agreement. See Question 6 for further discussion of this issue. As such, the entity's admitted adjusted gross DTAs under paragraphs 11.a. and 11.b. may be less than its adjusted gross DTAs on temporary differences at the enacted rate. Any unused amount of DTAs resulting from a rate differential under paragraphs 11.a. and 11.b. can be used under paragraph 11.c. to offset existing DTLs.

4.16 The above principles can be illustrated by the following examples:

4.17 Facts:

RBC Reporting Entity Example

1. Life Insurance Company ABC[19] has $12,500,000 of deductible temporary differences at 12-31-20X2 that generate $4,375,000 of gross DTAs ($2,100,000 Ordinary, $2,275,000 Capital), at the enacted federal income tax rate of 35%. Management has concluded that ABC will more likely than not realize gross DTAs of $4,100,000 ($2,100,000 Ordinary, $2,000,000 Capital) related to its $12.5 million of deductible temporary differences. Based on management's conclusion, a statutory valuation allowance adjustment was recognized for $275,000 reducing capital DTAs from $2,275,000 to $2,000,000. ABC also has $4,000,000 of taxable temporary differences resulting in $1,400,000 ($1,000,000 Ordinary, $400,000 Capital) of gross DTLs.

2. ABC has determined that $2,000,000 of its $6,000,000 existing deductible ordinary temporary differences will reverse in 12-31-20X3, another $1,500,000 will reverse in 12-31-20X4, and another $2,000,000 will reverse in 12-31-20X5. The remaining $500,000 of ABC's existing deductible ordinary temporary differences will reverse in years 20X6 or later. None of ABC's deductible capital temporary differences are expected to reverse within the applicable period.

3. ABC reported $400,000 and $600,000 of taxable income in 20X0 and 20X1, respectively. ABC reported $140,000 and $210,000 of tax expense on its 20X0 and 20X1 federal income tax returns, respectively. It has also projected taxable income of $1,200,000 and $420,000 of federal income taxes for 20X2 that have been reflected in its current statutory income tax provision calculation. There are no differences between its regular and alternative minimum taxable income during 20X0 through 20X2.

4. ABC is projecting an income tax rate of 35% in 20X3, as well as in years 20X4 and 20X5 based on its estimated taxable income and federal income tax liability. ABC expects to realize[20] a federal income tax benefit of 35% from 20X3 through 20X5 related to reversing ordinary temporary differences. ABC does not anticipate any capital gain income in 20X3 through 20X5.

[19] ABC does not qualify for the small life insurance company deduction. Please note the results in this example may be different due to differences in the applicable carryback periods if ABC was a P&C company.

[20] See Question 6 for discussion on the admittance calculation under paragraph 11.b.i. and what is meant by the phrase: "expected to be realized."

5. ABC has an ExDTA ACL RBC Ratio at 12-31-20X2 of 600%. Adjusted statutory capital and surplus under paragraph 11.b.ii. is $7,000,000 at 12-31-20X2, and was computed by subtracting the admitted balances of net DTA's, goodwill and EDP from the current period statutory surplus. Statutory surplus is defined in paragraph 2 of SSAP No. 72.

4.18 Calculation of ABC's Admitted Adjusted Gross DTAs:

1. ABC can admit $726,000 ($132,000 + $198,000 + $396,000) of adjusted gross DTAs under paragraph 11.a., all of which are ordinary in tax character.

a. ABC first carries $400,000 of the hypothetical net operating loss[21] of $2,000,000 from 20X3 back to 20X0 recovering $132,000 in taxes paid. The difference between the total 20X0 taxes paid at 35% ($140,000) and the amount recoverable ($132,000) through carryback of the $400,000 represents an $8,000 AMT credit generated as a result of the 90% AMT net operating loss[22] limitation. This AMT credit is not treated as a new DTA as of 12-31-20X2. The remaining $1,600,000 of the hypothetical net operating loss ($2,000,000 – $400,000) is available for utilization in years 20X1 and 20X2.

b. ABC would carry an additional $600,000 of the remaining hypothetical net operating loss of $1,600,000 from 20X3 back to 20X1 recovering $198,000 in taxes paid.[23] The difference between the total taxes paid at 35% ($210,000) and the amount recoverable ($198,000) through carryback of the $600,000 represents a $12,000 AMT credit generated as a result of the 90% AMT NOL limitation. Again, this AMT credit is not treated as a new DTA as of 12-31-20X2. The remaining $1,000,000 of hypothetical net operating loss ($1,600,000 – $600,000) is available for utilization in 20X2.

c. ABC would carry the remaining $1,000,000 of the hypothetical net operating loss from 20X3 plus an additional $200,000 of the hypothetical net operating loss from 20X4 back to 20X2, recovering $396,000 in taxes projected to be paid.[24] The difference between the total taxes projected to be paid at 35% ($420,000) and the amount recoverable ($396,000) through carryback of the $1,200,000 represents a $24,000 AMT credit generated as a result of the 90% AMT NOL limitation. As noted previously, this AMT credit is not treated as a new DTA as of 12-31-20X2.

[21] It should be noted that if ABC's hypothetical 20X3 carryback was insufficient to fully offset all positive taxable income in 20X0, the company would not be allowed to carryback any of the hypothetical loss from 20X4 or 20X5 to 20X0 per paragraph 11.a., as 20X0 is outside of the timeframe corresponding with tax loss carryback provisions for a life insurance company.

[22] A life insurance company incurs an "operating loss deduction" rather than a "net operating loss". The term "net operating loss" or "NOL" will be used generically throughout this document to refer to any operating loss incurred or expected to be incurred by the reporting entity.

[23] If ABC would not have had sufficient hypothetical NOL from 20X3 to carryback to 20X1, the company would have been able to carryback its hypothetical NOL of $1,500,000 from 20X4 back to 20X1 pursuant to the applicable tax loss carryback provisions.

[24] If ABC would not have had sufficient hypothetical NOL from 20X4 to carryback to 20X2, the company would have been able to carryback is hypothetical NOL of $2,000,000 from 20X5 back to 20X2 pursuant to the applicable tax loss carryback provisions.

The fact that the full $5,500,000 of reversing deductible ordinary temporary differences available for carryback were not used in the paragraph 11.a. calculation does not prevent their inclusion in the paragraph 11.b. and 11.c. calculations.

2. ABC can admit $1,050,000 of adjusted gross DTAs under paragraph 11.b. Since ABC has an ExDTA ACL RBC ratio of 600%, the Realization Threshold Limitation Table provides that the company can use the thresholds of 3 years for projected realization and 15% of adjusted capital and surplus. The company expects to realize a federal income tax benefit of $1,925,000 ($5,500,000 X 35%) in 20X3 through 20X5 related to its reversing deductible temporary differences. The $1,925,000 amount must be reduced by the $726,000 of admitted adjusted gross DTAs under paragraph 11.a. to prevent double counting of the same income tax benefit. As a result, ABC has projected adjusted gross DTAs available for admission under this component of $1,199,000 ($1,925,000 – $726,000), all of which is ordinary in tax character. However, 15% of adjusted capital and surplus is a limiting factor in this example. As such, admission of reversing deductible temporary differences that are projected to be realized during 20X3 through 20X5 is limited to $1,050,000 ($7,000,000 X 15%).

3. ABC can admit $724,000 ($324,000 Ordinary, $400,000 Capital) of adjusted gross DTAs under paragraph 11.c. Even though ABC has $2,324,000 of adjusted gross DTAs available for admission under this component ($4,100,000 – $726,000 – $1,050,000) and only $1,400,000 DTLs, these DTAs are made up of $324,000 Ordinary DTAs ($2,100,000 – $726,000 – $1,050,000) and $2,000,000 of Capital DTAs. Thus, the tax character of the DTAs and DTLs becomes the limiting factor for this component. There is $1,000,000 of Ordinary DTLs available to offset against the $324,000 of Ordinary DTAs. There is $400,000 of Capital DTLs to offset against the $2,000,000 Capital DTAs. While ordinary DTAs can be offset against both ordinary and capital DTLs, the reverse is not allowed in the tax return (see Question 4.13). In this situation, ABC can admit $324,000 and $400,000 of its Ordinary and Capital DTAs, respectively.

4.19 Summary of ABC's Admitted Gross DTA Calculation:

Gross DTAs at Enacted Tax Rate		$4,375,000
Less: Statutory Valuation Allowance Adjustment		275,000
Adjusted Gross DTAs at Enacted Tax Rate		4,100,000
Admitted Gross DTAs (paragraph 11.a.)	$ 726,000	
Admitted Gross DTAs (paragraph 11.b.)	1,050,000	
Admitted Gross DTAs (paragraph 11.c.)	724,000	
Total Admitted Adjusted Gross DTAs(sum of 11.a., 11.b., and 11.c.)	2,500,000	(2,500,000)
Nonadmitted Adjusted Gross DTAs		1,600,000
Admitted DTA		2,500,000
Gross DTL		(1,400,000)
Net Admitted DTA/DTL		$1,100,000

4.20 Facts:

Financial Guaranty or Mortgage Guaranty Non-RBC Reporting Entity Example

1. Financial Guaranty Insurance Company DEF has the same facts as Life Insurance Company ABC except:

a. DEF is not an RBC reporting entity and therefore does not calculate an RBC percentage. DEF is a financial guaranty insurer and has an ExDTA Surplus plus Contingency Reserve/Required Aggregate Risk Capital ratio of 105%. This ratio represents the sum of surplus to policyholders (excluding any admitted DTA from 11.a.) plus contingency reserves divided by the minimum aggregate capital required.

b. DEF reported $1,000,000 of taxable income and $350,000 of tax expense on its 20X1 federal income tax return. It has also projected taxable income of $1,200,000 and $420,000 of federal income taxes for 20X2 that have been reflected in its current statutory income tax provision calculation. There are no differences between its regular and alternative minimum taxable income in 20X1 or 20X2.

4.21 Calculation of DEF's Admitted Adjusted Gross DTAs:

1. DEF can admit $726,000 ($330,000 + $396,000) of adjusted gross DTAs under paragraph 11.a, all of which are ordinary in tax character.

a. DEF first carries $1,000,000 of the hypothetical net operating loss[25] of $2,000,000 from 20X3 back to 20X1 recovering $330,000 in taxes paid. The difference between the total 20X1 taxes paid at 35% ($350,000) and the amount recoverable ($330,000) through carryback of the $1,000,000 represents a $20,000 AMT credit generated as a result of the 90% AMT net operating loss limitation. This AMT credit is not treated as a new DTA as of 12-31-20X2. The remaining $1,000,000 of the hypothetical net operating loss ($2,000,000 – $1,000,000) is available for utilization in 20X2.

b. DEF would carry the remaining $1,000,000 of the hypothetical net operating loss from 20X3 plus an additional $200,000 of the hypothetical net operating loss from 20X4 back to 20X2 recovering $396,000 in taxes projected to be paid.[26] The difference between the total taxes projected to be paid at 35% ($420,000) and the amount recoverable ($396,000) through carryback of the $1,200,000 represents a $24,000 AMT credit generated as a result of the 90% AMT net operating loss limitation. As noted previously, this AMT credit is not treated as a new DTA as of 12-31-20X2.

The fact that the full $3,500,000 of reversing deductible ordinary temporary differences available for carryback were not used in the paragraph 11.a. calculation does not prevent their inclusion in the paragraph 11.b. and 11.c. calculations.

2. DEF cannot admit any additional adjusted gross DTAs under paragraph 11.b. Since DEF has an ExDTA Surplus plus Contingency Reserves/Required Aggregate Risk Capital ratio of 105%, the Realization Threshold Limitation Table provides that the company can use the thresholds of 1 year for projected realization and 10% of adjusted capital and surplus. The company expects to realize a federal income tax benefit of $700,000 ($2,000,000 X 35%) in 20X3 related to its reversing deductible temporary differences. The $700,000 amount must be reduced by the $726,000 of admitted adjusted gross DTAs under paragraph 11.a. to prevent double counting of the same income tax benefit. DEF admitted $26,000 more adjusted gross DTAs based on carryback of the hypothetical net operating loss under paragraph 11.a. than is

[25] It should be noted that if DEF's hypothetical 20X3 carryback was insufficient to fully offset all positive taxable income in 20X1, the company would not be allowed to carryback any of the hypothetical loss from 20X4 or 20X5 to 20X1 per paragraph 11.a., as 20X1 is outside of the timeframe corresponding with tax loss carryback provisions for a non-life insurance company.

[26] If DEF would not have had sufficient hypothetical NOL from 20X3 to carryback to 20X2, the company would have been able to carryback is hypothetical NOL of $1,500,000 from 20X4 back to 20X2 pursuant to the applicable tax loss carryback provisions.

projected to be realized within the 1-year applicable threshold limitation. As a result, there is $0 of expected additional reversing deductible differences available for admission under paragraph 11.b.

3. DEF can admit $1,400,000 ($1,000,000 Ordinary, $400,000 Capital) of adjusted gross DTAs under paragraph 11.c. Even though DEF has $3,374,000 of adjusted gross DTAs available for admission under this component ($4,100,000 – $726,000), these DTAs are made up of $1,374,000 Ordinary DTAs ($2,000,000 – $726,000) and $2,000,000 of Capital DTAs. Thus, the tax character of the DTAs and DTLs must be considered as a potential limiting factor for this component. There is $1,000,000 of Ordinary DTLs to offset against the $1,374,000 of Ordinary DTAs. There is $400,000 of Capital DTLs to offset against the $2,000,000 Capital DTAs. While Ordinary DTAs can be offset against both Ordinary and Capital DTLs, the reverse is not allowed in the tax return (see Question 4.13). In this situation, DEF can admit $1,000,000 and $400,000 of its Ordinary and Capital DTAs, respectively. If DEF's adjusted gross DTAs, after reduction for the amount of adjusted gross DTAs admitted under paragraphs 11.a. and 11.b., were less than $1,400,000 in this example, DEF would be limited to the balance of its adjusted gross DTAs in the paragraph 11.c. calculation, subject to the rules of offset under existing enacted federal income tax laws and regulations.

4.22 Summary of DEF's Admitted Gross DTA Calculation:

Gross DTAs at Enacted Tax Rate		$4,375,000
Less: Statutory Valuation Allowance Adjustment		275,000
Adjusted Gross DTAs at Enacted Tax Rate		4,100,000
Admitted Gross DTAs (paragraph 11.a.)	$ 726,000	
Admitted Gross DTAs (paragraph 11.b.)	0	
Admitted Gross DTAs (paragraph 11.c.)	1,400,000	
Total Admitted Adjusted Gross DTAs (sum of 11.a., 11.b. and 11.c.)	2,126,000	(2,126,000)
Nonadmitted Adjusted Gross DTAs		1,974,000
Admitted DTA		2,126,000
Gross DTL		(1,400,000)
Net Admitted DTA/DTL		$726,000

4.23 Facts:

Other Non-RBC Reporting Entity Example

1. Title Insurance Company GHI has the same facts as Life Insurance Company ABC except:

a. GHI is not a RBC reporting entity and therefore does not calculate a RBC percentage. GHI is also not a financial guaranty or mortgage guaranty insurer. As such, GHI must use the Other Non-RBC Reporting Entity Threshold Limitation Table under paragraph 11.b.

b. GHI reported $1,000,000 of taxable income and $350,000 of tax expense on its 20X1 federal income tax return. It has also projected taxable income of $1,200,000 and $420,000 of federal income taxes for 20X2 that have been reflected in its current statutory income tax provision calculation. There are no differences between its regular and alternative minimum taxable income in 20X1 or 20X2.

4.24 Calculation of GHI's Admitted Adjusted Gross DTAs:

1. GHI can admit $726,000 ($330,000 + $396,000) of adjusted gross DTAs under paragraph 11.a, all of which are ordinary in tax character.

a. GHI first carries $1,000,000 of the hypothetical net operating loss[27] of $2,000,000 from 20X3 back to 20X1 recovering $330,000 in taxes paid. The difference between the total 20X1 taxes paid at 35% ($350,000) and the amount recoverable ($330,000) through carryback of the $1,000,000 represents a $20,000 AMT credit generated as a result of the 90% AMT net operating loss limitation. This AMT credit is not treated as a new DTA as of 12-31-20X2. The remaining $1,000,000 of the hypothetical net operating loss ($2,000,000 – $1,000,000) is available for utilization in 20X2.

b. GHI would carry the remaining $1,000,000 of the hypothetical net operating loss from 20X3 plus an additional $200,000 of the hypothetical net operating loss from 20X4 back to 20X2 recovering $396,000 in taxes projected to be paid.[28] The difference between the total taxes projected to be paid at 35% ($420,000) and the amount recoverable ($396,000) through carryback of the $1,200,000 represents a $24,000 AMT credit generated as a result of the 90% AMT net operating loss limitation. As noted previously, this AMT credit is not treated as a new DTA as of 12-31-20X2.

The fact that the full $3,500,000 of reversing deductible ordinary temporary differences available for carryback were not used in the paragraph 11.a. calculation does not prevent their inclusion in the paragraph 11.b. and 11.c. calculations.

2. GHI can admit $1,050,000 of adjusted gross DTAs under paragraph 11.b. Since GHI has an Adjusted Gross DTA to Adjusted Capital and Surplus ratio of 48% ($3,374,000/$7,000,000), the Realization Threshold Limitation Table provides that the company can use the thresholds of 3 years for projected realization and 15% of adjusted capital and surplus. The company expects to realize a federal income tax benefit of $1,925,000 ($5,500,000 X 35%) in 20X3 through 20X5 related to its reversing deductible temporary differences. The $1,925,000 amount must be reduced by the $726,000 of admitted adjusted gross DTAs under paragraph 11.a. to prevent double counting of the same income tax benefit. As a result, GHI has projected adjusted gross DTAs available for admission under this component of $1,199,000 ($1,925,000 – 726,000), all of which is ordinary in tax character. However, 15% of adjusted capital and surplus is a limiting factor in this example. As such, admission of reversing deductible temporary differences that are projected to be realized during 20X3 through 20X5 is limited to $1,050,000 ($7,000,000 X 15%).

3. GHI can admit $724,000 ($324,000 Ordinary, $400,000 Capital) of adjusted gross DTAs under paragraph 11.c. Even though GHI has $2,324,000 of adjusted gross DTAs available for admission under this component ($4,100,000 – $726,000 – $1,050,000), these DTAs are made up of $324,000 Ordinary DTAs ($2,000,000 – $726,000 – $1,050,000) and $2,000,000 of Capital DTAs. Thus, the tax character of the DTAs and DTLs becomes the limiting factor for this component. There is $1,000,000 of Ordinary DTLs available to offset against the $324,000 of

[27] It should be noted that if GHI's hypothetical 20X3 carryback was insufficient to fully offset all positive taxable income in 20X1, the company would not be allowed to carryback any of the hypothetical loss from 20X4 or 20X5 to 20X1 per paragraph 11.a., as 20X1 is outside of the timeframe corresponding with tax loss carryback provisions for a non-life insurance company.

[28] If GHI would not have had sufficient hypothetical NOL from 20X3 to carryback to 20X2, the company would have been able to carryback is hypothetical NOL of $1,500,000 from 20X4 back to 20X2 pursuant to the applicable tax loss carryback provisions.

Ordinary DTAs. There is $400,000 of Capital DTLs to offset against the $2,000,000 Capital DTAs. While ordinary DTAs can be offset against both ordinary and capital DTLs, the reverse is not allowed in the tax return (see Question 4.13). In this situation, GHI can admit $324,000 and $400,000 of its Ordinary and Capital DTAs, respectively.

4.25 Summary of GHI's Admitted Gross DTA Calculation:

Gross DTAs at Enacted Tax Rate		$4,375,000
Less: Statutory Valuation Allowance Adjustment		275,000
Adjusted Gross DTAs at Enacted Tax Rate		4,100,000
Admitted Gross DTAs (paragraph 11.a.)	$ 726,000	
Admitted Gross DTAs (paragraph 11.b.)	1,050,000	
Admitted Gross DTAs (paragraph 11.c.)	724,000	
Total Admitted Adjusted Gross DTAs (sum of 11.a., 11.b. and 11.c.)	2,500,000	(2,500,000)
Nonadmitted Adjusted Gross DTAs		1,600,000
Admitted DTA		2,500,000
Gross DTL		(1,400,000)
Net Admitted DTA/DTL		$1,100,000

4b. Q – How is the ExDTA ACL RBC ratio calculated? [Paragraph 11.b.i.]

4.26 A – The December 31 ExDTA ACL RBC ratio is calculated in the same manner as in the ACL RBC Ratio computed in the Annual RBC Report, where Total Adjusted Capital (TAC) is divided by ACL RBC. However, for purposes of paragraph 11.b.i., TAC does not include any DTAs of the reporting entity. The ACL RBC would be the amount calculated in the Annual RBC Report.

4.27 The interim period (March 31, June 30, and September 30) ExDTA ACL RBC ratio calculation is discussed in 4.29-4.33.

4.28 For all companies, the TAC will include current period capital and surplus, excluding any DTAs of the reporting entity. Other TAC adjustments are dependent on whether the company is a Life, P&C or Health insurer.

4.29 For life companies, the AVR adjustment is calculated as a required part of the development of capital and surplus each quarter, and is one of the major adjustments to TAC (added back to surplus). As noted on the illustrative interim TAC calculation in 4.33 for life companies, there are other TAC adjustments such as subsidiaries' dividend liabilities, etc., that are drawn from the Quarterly Statement.

4.30 For P&C and Health companies, except for the AVR and life subsidiaries' dividend liability amounts (both of which are only applicable to P&C companies with life subsidiaries), which are readily available on the quarter, the prior year's annual TAC adjustments should be used in the current quarter's TAC calculation. The P&C and Health interim TAC illustrations in 4.33 provide example details of various interim RBC TAC adjustments.

4.31 The ACL RBC used for the interim RBC calculation is the ACL RBC from the most recently filed Annual Statement for the most recent calendar year. For example, for June 30, 20X3, the ACL for the interim RBC calculation is taken from the 20X2 RBC Report based on the 20X2 Annual Statement.

4.32 In most instances, the prior year's annual ACL RBC will suffice. A company should only revise its interim ACL RBC for a material change in its risk profile when requested to do so by its domiciliary state or subject to domiciliary state approval.

4.33 The above principles are illustrated below:

Interim Life RBC Example					
Based on the 2011 Life RBC Report page LR033					
		Reported		Interim Period	
	SOURCE OF THE DATA	12/31/20X2		3/31/20X3	
Capital and Surplus	P3, L38	$1,800,000,000		$1,700,000,000	
Adjustments:					
AVR	P3, L24.01	60,000,000		65,000,000	
Dividend Liability	P3, L6.1, L6.2 in part	0		0	
Sub AVR	P3, L24.01 of subs	5,000,000		4,500,000	
Sub Dividend Liability	P3, L6.1, L6.2 in part of subs	0		0	
P&C Non-Tabular Discounts and/or Alien Insurance Subsidiary: Other	P&C Subs P3, L1 & L3 in part	0		0	
Hedging Fair Value Adjustment	Company Records	0		0	
Credit for Capital Notes	P3, L24.11	0		0	
Total Adjusted Capital (TAC)	5-Year Historical Data	1,865,000,000		1,769,500,000	
Less: Deferred Tax Asset	P2, C3, L18.2	190,000,000		200,000,000	
TAC ExDTA		$1,675,000,000		$1,569,500,000	
Authorized Control Level RBC	5-Year Historical Data	$175,000,000		$175,000,000	*
Total Adjusted Capital ExDTA/Authorized Control Level Risk-Based Capital		957%		897%	
* ACL RBC amount for interim period is the 12/31/20X2 amount					

Interim P&C RBC Example					
(Based on the 2011 P&C RBC Report page PR026					
		Reported		Interim Period	
	SOURCE OF THE DATA	12/31/20X2		3/31/20X3	
Capital and Surplus	P3, C1, L37 (Ann. & Qtrly. Stmt.)	$850,000,000		$765,000,000	
Adjustments:					
Non-Tabular Discount-Losses	SCHEDULE P P1-SUM C32, L12 (Ann. Stmt. Only)	(800,000)		(800,000)	
Non-Tabular Discount-Expense	SCHEDULE P P1-SUM C33. L12 (Ann. Stmt. Only)	(60,000)		(60,000)	
Discount on Medical Loss Reserves Reported as Tabular in Schedule P	Company Records	0		0	

Discount on Medical Expense Reserves Reported as Tabular In Schedule P	Company Records	0		0	
P&C Subs Non-Tabular Discount-Losses	SCHEDULE P P1-SUM C32, L12 (Ann. Stmt. Only)	0		0	
P&C Subs Non-Tabular Discount-Expenses	SCHEDULE P P1-SUM C33, L12 (Ann. Stmt. Only)	0		0	
P&C Subs Discount on Medical Loss Reserves Reported as Tabular in Schedule P	Subs' Company Records	0		0	
P&C Subs Discount on Medical Expense Reserves Reported as Tabular In Schedule P	Subs' Company Records	0		0	
AVR - Life Subs	Subs P3, C1, L24.01 (Ann. & Qtrly. Stmt.)	5,000,000		6,000,000	
Dividend Liability - Life Subs	Subs P3 C1 L6.1 + L6.2 (Ann. & Qtrly. Stmt.)	0		0	
Total Adjusted Capital	5-Year Historical Data P17, C1, L28	854,140,000		770,140,000	
	(Annual/Current calc. on Qtr.)				
Less: Deferred Tax Asset	P2, C3, L18.2 (Ann. & Qtrly. Stmt.)	82,000,000		72,000,000	
Total Adjusted Capital ExDTA	PR026 (Annual RBC Report/Current Calc. on Qtr.)	772,140,000		698,140,000	
Authorized Control Level Risk-Based Capital	5-Year Historical Data P17, C1, L29 (Annual)	171,000,000		171,000,000	*
Total Adjusted Capital ExDTA/ Authorized Control Level Risk-Based Capital		452%		408%	
* ACL RBC amount for interim period is the 12/31/20X2 amount					

Interim Health RBC Example					
(Based on the 2011 Health RBC Report page XR024					
		Reported		Interim Period	
	SOURCE OF THE DATA	12/31/20X2		3/31/20X3	
Capital and Surplus	P3, C3, L33 (Ann. & Qtrly. Stmt.)	$850,000,000		$765,000,000	
Adjustments:					
AVR – Life Subs	Subs' Company Records	0		0	
Dividend Liability – Life Subs	Subs' Company Records	0		0	
Tabular Discounts – P&C subs	Subs' Company Records	0		0	

Non-Tabular Discounts – P&C Subs	Subs' Company Records	0		0	
Total Adjusted Capital	5-Year Historical Data P28, C1, L14 (Annual/ Current calc. on Qtr.)	850,000,000		765,000,000	
Less: Deferred Tax Asset	P2, C3, L18.2 (Ann. & Qtrly. Stmt.)	82,000,000		72,000,000	
Total Adjusted Capital ExDTA	XR 24 (Annual RBC Report/Current Calc. on Qtr.)	768,000,000		693,000,000	
Authorized Control Level Risk-Based Capital	5-Year Historical Data P28, C1, L15 (Annual)	171,000,000		171,000,000	*
Total Adjusted Capital ExDTA/ Authorized Control Level Risk-Based Capital		449%		405%	
* ACL RBC amount for interim period is the 12/31/20X2 amount					

4c. Q – What is meant by the phrase "an amount that is no greater than"? [Paragraph 11.b.ii.]

4.34 A – As discussed in 4.11 the amount of admitted adjusted gross DTAs under paragraph 11.b.i. is also limited to an amount that is no greater than the applicable percentage of statutory capital and surplus test specified in paragraph 11.b.ii. For purposes of this test, statutory capital and surplus as shown on the statutory balance sheet of the reporting entity for the current period's statement filed with the domiciliary state commissioner is adjusted to exclude any net DTAs, EDP equipment and operating system software and any net positive goodwill.

4.35 The phrase "an amount that is no greater than" in paragraph 11.b.ii. allows an entity to utilize an amount lower (e.g., from the reporting entity's most recently filed statement) than what would be allowed if it utilized the amount of statutory capital and surplus adjusted to exclude any net DTAs, EDP equipment and operating system software and any net positive goodwill as required to be shown on the statutory balance sheet of the reporting entity for the current period's statement filed with the domiciliary state commissioner. This ability to utilize a lower amount is for administrative ease if a reporting entity's surplus is increasing.

4.36 For example, at 12/31/20X2 if adjusted capital and surplus is $100M and at 9/30/20X2 it was $80M, the entity may utilize the $80M amount from the prior quarter.

4.37 If instead 12/31/20X2 adjusted capital and surplus were $60M, the entity may not utilize the $80M amount from the prior quarter as that would overstate the limitation under paragraph 11.b.ii.

4.38 If at 12/31/20X2 an entity's adjusted capital and surplus was initially determined to be $150M, the entity can still utilize that amount under paragraph 11.b.ii., if there is a late accounting adjustment that increases that amount to $160M.

5a. Q – How is the timing of reversals of temporary differences and carryforwards determined for SSAP No. 101 purposes? [Paragraphs 7, 11.a., 11.b.i. and 12.a.]

5.1 A – The timing of temporary difference reversals is critical in determining the amount of admitted adjusted gross DTAs. Determining the reversal of temporary differences impacts the adjusted gross DTA admitted pursuant to paragraphs 11.a., 11.b.i. and potentially 11.c. of SSAP No. 101.

5.2 Paragraph 12.a. of SSAP No. 101 states that "For purposes of paragraph 11.a., existing temporary differences that reverse during a timeframe corresponding with IRS tax loss carryback provisions, not to exceed three years, shall be determined in accordance with paragraphs 228 and 229 of FAS 109." The timing of reversals of temporary differences and carryforwards for purposes of paragraph 11.b. of SSAP No. 101 shall be determined under similar principles.

5.3 Paragraph 228 of FAS 109 states, in pertinent part, that "[t]he particular years in which temporary differences result in taxable or deductible amounts generally are determined by the timing of the recovery of the related asset or settlement of the related liability." Question 1 of the FASB's Special Report on Statement 109 provides additional guidance on scheduling. It defines "scheduling" as the analysis performed to determine the pattern and timing of the reversal of temporary differences. It also provides certain guidelines to be followed, including the need for the method employed to be systematic and logical, that a consistent method be used for each category of temporary differences, and that a change in the method used be considered a change in accounting principle.

5.4 Assume Company A purchases its only asset for $1,000, an asset that is admissible for statutory accounting purposes and depreciated over five years on a straight-line basis. Assume also that the asset is depreciated over seven years for tax purposes using the Modified Accelerated Cost Recovery System (MACRS). The following table summarizes the statutory and tax basis of the asset at the end of each year.

Year	Cost	Statutory Depreciation	Statutory Basis	Tax Depreciation	Tax Basis	Deductible/ (Taxable) Temporary Difference
1	$1,000	$200	$800	$143	$857	$57
2	-	200	600	245	612	12
3	-	200	400	175	437	37
4	-	200	200	125	312	112
5	-	200	-	89	223	223
6	-	-	-	89	134	134
7	-	-	-	89	45	45
8	-	-	-	45[29]	-	-

5.5 At the end of year one, the Company would conclude that $45 ($57 - $12) of the $57 outstanding deductible temporary difference would reverse within one year, leaving a temporary difference of $12 at the end of year two. However, for computing a two or three year reversal, the Company would not project a reversal of the temporary difference by the end of year three or four as the deductible temporary difference is scheduled to increase (from $12 to $37 and from $37 to $112, respectively). If the Company had decided to sell the asset in year two, it may be appropriate to conclude that the outstanding deductible temporary difference of $57 would reverse in year two.

5.6 A similar rationale would apply in the instance of a nonadmitted asset. Assume the same facts as aforementioned, except that the asset is nonadmitted for statutory accounting purposes. The results are summarized in tabular form below.

[29] Due to the mid-year convention applicable to most asset acquisitions for tax purposes, the asset is treated as acquired in mid-year, meaning that a seven (7) year asset is depreciated over eight (8) tax years.

Year	Cost	Statutory Charge to Surplus	Statutory Basis	Tax Depreciation	Tax Basis	Deductible/ (Taxable) Temporary Difference
1	$1,000	$1,000	-	$143	$857	$857
2	-	-	-	245	612	612
3	-	-	-	175	437	437
4	-	-	-	125	312	312
5	-	-	-	89	223	223
6	-	-	-	89	134	134
7	-	-	-	89	45	45
8	-	-	-	45	-	-

5.7 In this example, the Company has a steady decline in the deductible temporary difference that is not complicated by competing depreciation regimes. This is due to the fact that the Company took the large surplus charge when the asset was nonadmitted, thereby creating a significant deductible temporary difference. The Company would project a $245 temporary difference reversal in year two (from $857 to $612), a $175 temporary difference reversal in year three (from $612 to $437), and a $125 temporary difference reversal in year four (from $437 to $312). Although the Company will take income statement charges for depreciation on the nonadmitted asset, the statutory basis is nonetheless zero from the moment the asset was nonadmitted. Future statutory depreciation deductions will not impact the statutory basis and have no impact on the analysis.

5.8 The above examples assume a single asset. However, the analysis becomes more complicated when the Company has hundreds or thousands of assets within its fixed asset pool. In this instance, it is expected that management will make its best estimate of the expected reversal pattern determined in a manner consistent with the grouping for measurement (see question 2 for more discussion about grouping).

5.9 As indicated above, the timing of the reversal of a particular balance sheet item will depend on the expected recovery of the related asset and liability. For example, the temporary difference associated with property & casualty loss reserves would be expected to reverse in a manner consistent with the payout pattern ("development") of the underlying loss reserves. Historical loss development triangles may be useful in substantiating a reversal pattern. For instance, assume Company A writes two types of property and casualty policies: auto liability and workers' compensation. The following table details the components of the statutory and tax reserves for Company A as of December 31, 20X2.

Private Passenger Auto Liability	Statutory Reserves	Tax Reserves	Temporary Difference
AY + 0	$1,000	$900	$100
AY + 1	850	690	160
AY + 2	700	580	120
AY + 3	550	490	60
AY + 4	400	385	15
AY + 5	300	275	25
AY + 6	200	175	25

AY + 7	100	90	10
AY + 8	80	75	5
AY + 9	70	65	5
Prior	50	45	5
Total	$4,300	$3,770	$530

Workers' Compensation	**Statutory Reserves**	**Tax Reserves**	**Temporary Difference**
AY + 0	$1,000	$825	$175
AY + 1	900	800	100
AY + 2	850	770	80
AY + 3	790	695	95
AY + 4	725	610	115
AY + 5	695	600	95
AY + 6	655	575	80
AY + 7	605	545	60
AY + 8	575	505	70
AY + 9	550	495	55
Prior	505	450	55
Total	$7,850	$6,870	$980

5.10 One option in analyzing the reversal of the temporary difference would be to calculate the historical loss development patterns for the two lines of business by accident year for each year in the applicable reversal period. By applying these development patterns to the individual temporary differences, the Company could estimate the expected reversal of the temporary difference as a whole for each year in the applicable reversal period.

5.11 Another option would be to apply the average development factor by line of business to each reserve for each year in the applicable reversal period. If the average one-year development factor for all accident years for auto liability and workers' compensation were 70% and 35%, respectively, the one-year temporary difference reversal would be $371 ($530 x 70%) for auto liability and $343 ($980 x 35%) for workers' compensation. The same approach could be used in determining the reversal for any other year in the applicable reversal period.

5.12 The temporary difference related to property and casualty unearned premiums is typically twenty percent (20%) of the outstanding statutory unearned premium reserve. If a company issues only one-year policies, it is reasonable to assume that the entire temporary difference will reverse in one year. If a company writes multi-year contracts, management will be required to estimate the percentage of the unearned premium that will be earned within each year of the applicable reversal period and apply these percentages to the outstanding temporary difference.

5.13 The reversal of the temporary difference related to life insurance reserves may require actuarial assistance, normally involving anticipated development of the statutory and tax reserves for policies issued prior to the end of the current reporting year. In computing the anticipated development, it would be expected that reasonable assumptions be used, which may include cash-flow modeling of the entity's reserves. Deferred acquisition costs on life insurance policies are amortized over prescribed periods pursuant to federal tax law. The amortization schedules should provide management with the ability to estimate the reversal for each year in the applicable reversal period with reasonable accuracy.

5.14 For those temporary differences that do not have a defined reversal period, such as unrealized losses on common stock or deferred compensation liabilities, management will need to determine when the temporary difference is "expected" to reverse. For instance, assume a company has an unrealized loss of $200 in its equity portfolio and that, on average, the portfolio turns over twenty-percent (20%) per year. It would be appropriate for the company to conclude that $40 of the temporary difference will reverse in each year in the applicable reversal period. When determining when the temporary difference would be "expected" to reverse, management should normally take into account events that are likely to occur using information, facts and circumstances in existence as of the reporting date. The estimates used in this circumstance should not be extended to other tests of impairment. For instance, when the entity assumed a 20% turnover in its equity portfolio, it is not involuntarily required to record an impairment in accordance with paragraph 9 of SSAP No. 30—*Investments in Common Stock (excluding investments in common stock of subsidiary, controlled, or affiliated entities)*.

5.15 In summary, the methodology used to develop the reversal pattern should be consistent, systematic, and rational. Although consistency is encouraged, business conditions may dictate that certain factors be given more or less weight than in previous periods. Factors to be considered include historical patterns, recent trends, and the likely impact of future initiatives (without regard to future originating temporary differences). For instance, if a company has migrated to a more efficient claims management system, outstanding reserves may be settled more quickly than historical payment patterns may indicate. A company that expects to enter into a loss portfolio transfer reinsurance transaction should consider the implications of that treaty in determining the reversal of the loss reserve temporary difference.

5b. Q – How **should future originating differences impact the scheduling of temporary difference reversals during the applicable period? [Paragraphs 11.a., 11.b.i., 11.c. and 12.a]**

5.16 A – Future originating differences, and their subsequent reversals, are considered in assessing the existence of future taxable income. However, they should not impact the scheduling of existing temporary difference reversals during the applicable period. Paragraph 229 of FAS 109 provides the following:

> 229. For some assets or liabilities, temporary differences may accumulate over several years and then reverse over several years. That pattern is common for depreciable assets. Future originating differences for existing depreciable assets and their subsequent reversals are a factor to be considered when assessing the likelihood of future taxable income (paragraph 21(b)) for realization of a tax benefit for existing deductible temporary differences and carryforwards.

6. Q – What is meant by the phrase "expected to be realized"? [Paragraph 11.b.i.]

6.1 A – A reporting entity calculates the amount of its adjusted gross DTAs and gross DTLs under paragraph 7 using the enacted tax rate. The amount of adjusted gross DTAs and gross DTLs is not recalculated under paragraph 11. The purpose of paragraph 11 is to determine the amount of adjusted gross DTAs that can be admitted in the reporting period.

6.2 An excerpt of SSAP No. 4 – *Assets and Nonadmitted Assets* indicates:

> 2. For purposes of statutory accounting, an asset shall be defined as: probable[30] future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.

6.3 The phrase "expected to be realized" encompasses a reasonable expectation as to the value of the DTAs consistent with SSAP No. 4. This means that if a reporting entity's management expects that deductible temporary differences that reverse in the applicable period will produce a federal income tax benefit at a rate that is lower than the enacted rate, the expected rate should be taken into consideration in

[30] *FASB Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements* (CON 6) states, "Probable is used with its usual general meaning, rather than in a specific accounting or technical sense (such as that in FASB Statement No. 5, Accounting for Contingencies, par. 3), and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved."

the determination of the amount of admitted adjusted gross DTAs under paragraph 11.b.i. In other words, available evidence causes the reporting entity to expect the asset to be realized at less than the enacted rate. In such cases, it would not be appropriate to calculate the amount of admitted adjusted gross DTAs under paragraph 11.b.i. on the basis of reversing deductible temporary differences at the enacted tax rate.

6.4 The following examples illustrate situations where the amount of admitted adjusted gross DTAs under paragraph 11.b.i. would be less than the adjusted gross DTAs calculated using deductible temporary differences reversing in the applicable period at the enacted income tax rate. The approach in these examples is to determine the tax savings that the company would expect to realize from its reversing deductible temporary differences. This is accomplished through a calculation of the company's income tax liability "with and without" these temporary differences. It is assumed that in these examples there are no prudent and feasible tax-planning strategies that would cause the entity to expect the asset to be realized at a rate different than that presented in the examples.

Example 1:

6.5 P&C has a significant portion of its investment portfolio in municipal bonds. It is estimating regular taxable income to be $6,000,000 in 20X3, $4,000,000 in 20X4, and $5,000,000 in 20X5. Included in these amounts are $10,000,000 ($8,500,000 net of 15% "proration") of excluded tax-exempt interest per year and $2,000,000 of reversing deductible temporary differences per year that were included in P&C's deferred inventory at 12/31/X2. The Company's ExDTA ACL RBC percentage is 700% and therefore required to use the three-year applicable period under paragraph 11.b.i.

20X3	**Without Reversing Temporary Differences**		**With Reversing Temporary Differences**	
	Regular Tax	AMT	Regular Tax	AMT
Regular Taxable Income	$8,000,000	$8,000,000	$8,000,000	$8,000,000
AMT/ACE Adjustment		6,375,000[31]		6,375,000
Reversing Temporary Differences			(2,000,000)	(2,000,000)
Taxable Income	8,000,000	14,375,000	6,000,000	12,375,000
Tax (35% regular/20% AMT)	2,800,000	2,875,000	2,100,000	2,475,000
Tax Liability	$2,800,000	75,000	$2,100,000	375,000
Total Tax		$2,875,000		$2,475,000

20X4	**Without Reversing Temporary Differences**		**With Reversing Temporary Differences**	
	Regular Tax	AMT	Regular Tax	AMT
Regular Taxable Income	$6,000,000	$6,000,000	$6,000,000	$6,000,000
AMT/ACE Adjustment		6,375,000		6,375,000
Reversing Temporary Differences			(2,000,000)	(2,000,000)
Taxable Income	6,000,000	12,375,000	4,000,000	10,375,000
Tax (35% regular/20% AMT)	2,100,000	2,475,000	1,400,000	2,075,000
Tax Liability	$2,100,000	375,000	$1,400,000	675,000
Total Tax		$2,475,000		$2,075,000

[31] $10,000,000 x 85% x 75%

20X5	Without Reversing Temporary Differences		With Reversing Temporary Differences	
	Regular Tax	AMT	Regular Tax	AMT
Regular Taxable Income	$7,000,000	$7,000,000	$7,000,000	$7,000,000
AMT/ACE Adjustment		6,375,000		6,375,000
Reversing Temporary Differences			(2,000,000)	(2,000,000)
Taxable Income	7,000,000	13,375,000	5,000,000	11,375,000
Tax (35% regular/20% AMT)	2,450,000	2,675,000	1,750,000	2,275,000
Tax Liability	$2,450,000	225,000	$1,750,000	525,000
Total Tax		$2,675,000		$2,275,000

Total[32]	Without Reversing Temporary Differences		With Reversing Temporary Differences	
	Regular Tax	AMT	Regular Tax	AMT
Regular Taxable Income	$21,000,000	$21,000,000	$21,000,000	$21,000,000
AMT/ACE Adjustment		19,125,000		19,125,000
Reversing Temporary Differences			(6,000,000)	(6,000,000)
Taxable Income	21,000,000	40,125,000	15,000,000	34,125,000
Tax (35% regular/20% AMT)	7,350,000	8,025,000	5,250,000	6,825,000
Tax Liability	$7,350,000	675,000	$5,250,000	1,575,000
Total Tax		$8,025,000		$6,825,000

6.6 Over the three-year applicable period, the reversing deductible temporary differences of $6,000,000 are expected to save P&C income taxes at a rate of 20% or $1,200,000 ($8,025,000 – $6,825,000). The remaining 15% tax benefit represents an additional AMT credit carryover of $900,000 ($1,575,000 – $675,000). Therefore, P&C's admitted adjusted gross DTAs under paragraph 11.b.i., before reduction for any admitted adjusted gross DTAs under paragraph 11.a. would be $1,200,000, which is less than the amount of its adjusted gross DTAs of $2,100,000 ($6,000,000 x 35%) on reversing deductible temporary differences at the enacted rate. However, the $900,000 difference generated by the 15% (35% - 20%) rate differential under paragraph 11.b.i. would be taken into account in the paragraph 11.c. calculation as part of the amount of adjusted gross DTAs, after application of paragraphs 11.a. and 11.b., that can be offset against existing gross DTLs.

6.7 In the above example, if P&C were to be in a regular tax liability during 20X5 (i.e. a year in the applicable period subsequent to the creation of the 20X3 and 20X4 AMT credit carryovers), these credit carryovers may be utilized in determining the 20X5 with and without calculation. This utilization must be within the applicable period and would be limited to the amount allowed under tax law. In Example 1, assuming full utilization of the 20X3 and 20X4 carryovers, in 20X5 the admitted adjusted gross DTAs under paragraph 11.b.i. (before reduction for any admitted adjusted gross DTAs under paragraph 11.a.) would then be equal to the $2,100,000 adjusted gross DTAs on the $6,000,000 of reversing deductible temporary differences because the AMT credit is both generated and fully utilized in the applicable period.

Example 2:

6.8 SL is a small life insurance company with projected assets of less than $500 million at the end of 20X3. SL also estimates that its 20X3 taxable income before the small life insurance company deduction (SLICD) will be $1,300,000. Included in this amount is $400,000 of reversing deductible temporary items

[32] The totals are provided for illustration purposes only. The calculations are required to be performed individually each year.

that were part of SL's deferred inventory at 12/31/X2. The Company's ExDTA ACL RBC percentage is 250% and therefore it is required to use the one-year applicable period under paragraph 11.b.i.

20X3	**Without Reversing Temporary Differences**		**With Reversing Temporary Differences**	
	Regular Tax	AMT	Regular Tax	AMT
Regular Taxable Income before SLICD	$1,700,000	$1,700,000	$1,700,000	$1,700,000
Reversing Temporary Differences			(400,000)	(400,000)
Net	1,700,000	1,700,000	1,300,000	1,300,000
Small Life Insurance Company Deduction (60%)	(1,020,000)	(1,020,000)	(780,000)	(780,000)
AMT/ACE Adjustment (75% of SLICD)		765,000		585,000
Taxable Income	680,000	1,445,000	520,000	1,105,000
Tax (35% regular/20% AMT)	238,000	289,000	182,000	221,000
Tax Liability	$238,000	51,000	$182,000	39,000
Total Tax		$289,000		$221,000

6.9 Since SL is a small life insurance company with less than $3 million of taxable income before the small life insurance company deduction, it is taxed at an effective federal income tax rate of 17%. The $400,000 of reversing deductible temporary differences in 20X3 is expected to save SL $68,000 ($289,000 - $221,000) in federal income taxes at the 17% rate. The tax savings represents a reduction in regular taxes of $56,000 and AMT taxes of $12,000. Under paragraph 11.b.i., SL would admit adjusted gross DTAs of $68,000, before reduction for any adjusted gross DTAs admitted under paragraph 11.a. Any unused amount of adjusted gross DTAs related to the 18% (35% - 17%) rate differential under paragraph 11.b.i. would be taken into account under paragraph 11.c. as part of the amount of adjusted gross DTAs, after reduction for adjusted gross DTAs admitted under paragraphs 11.a. and 11.b., that can be offset against existing gross DTLs. This same approach would be used in 20X4 and 20X5, if the Company instead qualified for the three-year applicable period under paragraph 11.b.i.

Example 3:

6.10 BCBS is a Blue Cross/Blue Shield Organization that expects to fully offset its regular taxable income with available section 833 (b) deductions in 20X2. Prior to considering the section 833 (b) deduction, BCBS projects $8,000,000 of taxable income in 20X3, which includes $3,000,000 of reversing deductible temporary differences that were part of its deferred inventory at 12/31/X2. The Company's ExDTA ACL RBC percentage is 250% and therefore it is required to use the one-year applicable period under paragraph 11.b.i.

20X3	**Without Reversing Temporary Differences**		**With Reversing Temporary Differences**	
	Regular Tax	AMT	Regular Tax	AMT
Regular Taxable Income Before 833(b)	$11,000,000	$11,000,000	$11,000,000	$11,000,000
Reversing Temporary Differences			(3,000,000)	(3,000,000)
Net	11,000,000	11,000,000	8,000,000	8,000,000
Section 833 (b) Deduction	(11,000,000)		(8,000,000)	
Taxable Income	0	11,000,000	0	8,000,000
Tax (35% regular/20% AMT)	0	2,200,000	0	1,600,000
Tax Liability	$0	2,200,000	$0	1,600,000
		$2,200,000		$1,600,000

6.11 BCBS has a 0% effective tax rate on regular taxable income in 20X3 and is taxed at 20% for AMT. Its regular taxable income is $0, both "with and without" the $3,000,000 reversing deductible temporary differences since the section 833 (b) deduction changes by an equal amount. The $600,000 reduction in AMT tax liability related to the $3,000,000 reversing deduction temporary differences is expected to generate a 20% tax savings in 20X3. Therefore, BCBS would admit $600,000 of adjusted gross DTAs under paragraph 11.b.i., before reduction for any adjusted gross DTAs admitted under paragraph 11.a. Any unused amount of adjusted gross DTAs related to the 15% (35% - 20%) rate differential under paragraph 11.b.i. would be taken into account under paragraph 11.c. as part of the amount of adjusted gross DTAs, after reduction for adjusted gross DTAs admitted under paragraphs 11.a. and 11.b., that can be offset against existing gross DTLs. The same approach would be used in 20X4 and 20X5 if the Company instead qualified for the three-year applicable period under paragraph 11.b.i.

Example 4:

6.12 ABC insurance company is projecting an income tax loss in 20X3 of $20,000,000, which includes $5,000,000 of reversing deductible temporary differences that were part of its deferred inventory at 12/31/X2. ABC expects to pay $0 federal income taxes in 20X3 for both regular and AMT tax purposes as a result of its tax loss. The Company's ExDTA ACL RBC percentage is 250% and therefore, it is required to use the one-year applicable period under paragraph 11.b.i.

20X3	**Without Reversing Temporary Differences**		**With Reversing Temporary Differences**	
	Regular Tax	AMT	Regular Tax	AMT
Regular Taxable Income (Loss)	($15,000,000)	($15,000,000)	($15,000,000)	($15,000,000)
Reversing Temporary Differences			(5,000,000)	(5,000,000)
Taxable Income (Loss)	(15,000,000)	(15,000,000)	(20,000,000)	(20,000,000)
Tax (35% regular/20% AMT)	$0	$0	$0	$0

6.13 In 20X3, ABC expects to realize no tax benefit related to the $5,000,000 of reversing deductible temporary differences since they simply increase the amount of an NOL. Its expected income tax rate for 20X3 would be 0% and ABC would have $0 admitted adjusted gross DTAs under paragraph 11.b.i. However, if some or all of the reversing temporary differences could be absorbed in the carryback period, ABC would have an admitted adjusted gross DTA under paragraph 11.a.[33] The adjusted gross DTAs of $1,750,000 ($5,000,000 x 35%), related to ABC's reversing temporary differences, would also be available as part of its total adjusted gross DTAs, after reduction for adjusted gross DTAs admitted under paragraphs 11.a. and 11.b., that can be offset against gross DTLs in the paragraph 11.c. calculation.

6.14 If a company qualified to utilize the three-year applicable period under paragraph 11.b.i. and within that applicable period forecasted a taxable loss in one or more of the years and taxable income in the other years, the loss may be utilized in determining the with and without calculation. This loss utilization must be within the applicable period and would be limited to the amount allowed to be carried back or carried forward under applicable tax law.

7. Q – SSAP No. 101 provides that a reporting entity may admit deferred tax assets in an amount equal to federal income taxes paid in prior years that can be recovered through loss carrybacks for existing temporary differences that reverse during a timeframe corresponding with IRS tax loss carryback provisions, not to exceed three years, including any amounts established in

[33] For purposes of determining the amount of admitted adjusted gross DTAs under paragraph 11.a., ABC would look to the amount of existing temporary differences that reverse during a timeframe corresponding with the tax loss carryback provisions allowed by the applicable tax law, not to exceed three years, notwithstanding that it is limited to a one-year applicable period for purposes of paragraph 11.b.i.

accordance with the provisions of SSAP No. 5R as described in paragraph 3.a. of this statement related to those periods. What is the meaning of the term "taxes paid"? [Paragraph 11.a.]

7.1 A – Under paragraph 11.a. of SSAP No. 101, the term "taxes paid" means the total tax (both regular and AMT, but not including interest and penalties), that was or will be reported on the reporting entity's federal income tax returns for the periods included in the carryback period including any amounts established in accordance with the provision of SSAP No. 5R as described in paragraph 3.a. of SSAP No. 101 related to those periods. If a federal income tax return in the carryback period has been amended, or adjusted by the IRS, "taxes paid" would reflect the impact of the amended tax return, or settlement with the IRS.

7.2 In applying the term "taxes paid" to a reporting entity that is party to a consolidated federal income tax return, the term "taxes paid" means the total federal income tax (both regular and AMT) that was paid, or is expected to be paid to the common parent of the reporting entity's affiliated group, in accordance with the intercompany tax sharing agreement, with respect to the income tax years included in the carryback period. "Taxes paid" includes amounts established in accordance with the provision of SSAP No. 5R as described in paragraph 3.a. of SSAP No. 101 related to those periods, including current federal income taxes payable (i.e., accrued in the entity's financial statements) related to the carryback period. The ability of the reporting entity to recover (through loss carrybacks) taxes that were paid to its common parent is generally governed by the terms and provisions of the affiliated group's intercompany tax sharing or tax allocation agreement.

8. Q – How is a company's computation of adjusted gross and admitted adjusted gross deferred tax assets impacted if it joins in the filing of a consolidated federal income tax return? [paragraphs 7, 11, 12 and 16]

8.1 A – For purposes of determining the amount of DTAs and the amount admitted under paragraph 11, the calculation should be made on a separate company, reporting entity basis. Under paragraph 7, a reporting entity's gross deferred tax assets and liabilities are determined by identifying its temporary differences. These temporary differences are measured using a "balance sheet" approach by comparing statutory and tax basis balance sheets for that entity. Once a reporting entity determines its gross DTAs, they are reduced for any statutory valuation allowance adjustment that may be necessary to determine the adjusted gross DTAs. The amount of adjusted gross DTAs that are admitted is determined in accordance with paragraph 11.

8.2 Under paragraph 11.a., an entity shall determine the amount of "federal income taxes paid in prior years that can be recovered through loss carrybacks for existing temporary differences that reverse during a timeframe corresponding with IRS tax loss carryback provisions, not to exceed three years." Such amount shall include any amounts established for tax loss contingencies in accordance with paragraph 3.a. Consistent with guidance promulgated in other EAIWG interpretations, a reporting entity that files a consolidated federal income tax return with its parent should look to the amount of taxes it paid (or were allocable to it) as a separate legal entity in determining the admitted adjusted gross DTAs under paragraph 11.a. Furthermore, the admitted adjusted gross DTAs under paragraph 11.a. may not exceed the amount that the entity could reasonably expect to have refunded by its parent (paragraph 12.c.). The taxes paid by the reporting entity represent the maximum DTAs that may be admitted under paragraph 11.a., although the amount could be reduced pursuant to the group's tax allocation agreement.

8.3 The amount of admitted adjusted gross DTAs under paragraph 11.b.i. is limited to the amount that the reporting entity expects to realize within the applicable period (refer to the 11.b.i. column of the applicable Realization Threshold Limitation Table in paragraph 11.b.) following the balance sheet date on a separate company basis. The entity must estimate its separate company taxable income and the tax benefit that it expects to receive from reversing deductible temporary differences in the form of lower tax payments to its parent. If the reporting entity has reversing adjusted gross DTAs during the applicable period for which it does not expect to realize a benefit under paragraph 11.b. on a separate company basis, the reporting entity cannot admit an amount related to such DTAs under paragraph 11,b., even though the reporting entity may be paid a tax benefit for such items pursuant to its tax allocation agreement.

8.4 The following examples reflect this analysis and assume that the surplus limitation of paragraph 11.b.ii. is not applicable:

Example 1:

8.5 Assume Company A, a life insurance company, joins in the filing of a consolidated federal income tax return. Consolidated taxes paid in prior carryback years total $150, of which Company A paid $100. Company A has existing temporary differences that reverse by the end of the third calendar year following the balance sheet date[34] that, on a separate company reporting entity basis and following the applicable carryback provisions of the Internal Revenue Code for each year in which temporary differences reverse, would give rise to a tax recovery of $125.

8.6 Under paragraph 11.a., Company A could record an admitted DTA of $100, equal to the taxes it paid. Additionally, under paragraph 11.b.i., Company A could admit an additional $25, assuming it expects to realize such tax benefit based on its separate company analysis. Due to the consolidated return filing, the $100 admitted under paragraph 11.a. could only be admitted provided this amount could reasonably be expected to be refunded by the parent [paragraph 12.c.] and would be available pursuant to a written income tax allocation agreement [paragraph 16.b.].

Example 2:

8.7 Assume the same facts as in Example 1, except consolidated taxes paid in prior carryback years that could be recovered are $70 and, pursuant to a written income tax allocation agreement, taxes recoverable through loss carrybacks may not exceed consolidated taxes paid in prior carryback years.

8.8 In this situation, Company A would admit a DTA of $70 under paragraph 11.a. (recoverable taxes limited to consolidated taxes paid which could be refunded by the parent). In addition, $55 ($125-$70) of DTA may be admitted under paragraph 11.b.i., if Company A expected to realize this tax benefit on the basis of its separate company estimated taxable income and temporary differences that are expected to be realized within the applicable period following the balance sheet date.

Example 3:

8.9 Parent Company P files a consolidated federal income tax return with its insurance subsidiaries, R, S and T. Assume consolidated taxes that could be recovered through loss carryback total $450. However, in the prior carryback years $200 was paid by each of the subsidiaries, R, S and T. The difference between the amount paid by the subsidiaries ($600) and the amount available through loss carryback ($150) is attributable to interest expense incurred by Company P. Pursuant to the group's written income tax allocation agreement, in the case of loss carrybacks, taxes recoverable are limited to the consolidated taxes paid in the carryback years.

8.10 Because the adjusted gross DTA admitted under paragraph 11.a. for each reporting entity cannot exceed what each entity paid and could reasonably be expected to be refunded by P, no more than $450 in total may be admitted by the subsidiaries (under paragraph 11.a.). If the adjusted gross DTA associated with the subsidiaries' temporary differences that reverse in the 11.a. period exceed the $450 of taxes recoverable through loss carryback on a consolidated basis, the adjusted gross DTA admitted by the insurance subsidiaries under paragraph 11.a. should be allocated among the subsidiaries, consistent with

[34] Corresponds to the timeframe permitted by the Internal Revenue Code for carrybacks of tax losses for a life insurance company. Please note that the applicable carryback period for a non-life insurance company may be different.

the principles of its written income tax allocation agreement. This allocation would, in most instances, be based on each subsidiary's share of reversing temporary differences.

8.11 Under paragraph 11.c., an entity may admit its adjusted gross DTAs, after application of paragraphs 11.a. and 11.b., based upon offset against its own existing gross DTLs and not against gross DTLs of other members of the affiliated or consolidated group.

9a. Q – Current income taxes are defined by paragraph 3.a. to include tax loss contingencies for current and all prior years, computed in accordance with SSAP No. 5R, including the modifications in paragraphs 3.a.i, 3.a.ii. and 3.a.iii. How does the modification provided in paragraph 3.a.iii. impact the calculation of the tax contingencies recorded?

9.1 A – Paragraph 3.a.iii. provides the following rule: If the estimated tax loss contingency is greater than 50% of the tax benefit originally recognized, the tax loss contingency recorded shall be equal to 100% of the original tax benefit recognized.

9.2 For example, assume that a company claimed a deduction in its current year federal income tax return that resulted in a $100 permanent tax benefit[35]. Management must assume that the tax position will be examined by a taxing authority that has full knowledge of all relevant information (paragraph 3.a.ii.). In addition, management has determined that the probability of a liability is more likely than not (a likelihood of more than 50% pursuant to paragraph 3.a.i.) and that the liability can be reasonably estimated. Management's best estimate of the loss of the tax benefit is $40 (an amount not greater than 50% of the tax benefit originally recognized). Under these facts, the company would establish a current tax liability in the amount of $40, increasing its current income tax expense by $40.

DR	Current income tax expense	$40	
CR	Liability for current income tax		$40

9.3 Assume the same facts as 9.2, except that management determines the best estimate of the liability to be $60 (an amount greater than 50% of the tax benefit originally recorded). Under paragraph 3.a.iii., the company would be required to record a tax contingency of $100 offsetting the entire original tax benefit recorded. Under these facts, the company would establish a current tax liability in the amount of $100, increasing its current income tax expense by $100.

DR	Current income tax expense	$100	
CR	Liability for current income tax		$100

9b. Q – What impact, if any, does the inclusion of tax contingencies as a component of current income taxes have on the determination of deferred income taxes? [Paragraph 3.c.]

9.4 A – The purpose of this interpretation is to address when such contingencies should be "grossed-up" and reflected in the calculation of both statutory current and deferred federal income taxes.

9.5 Gross deferred tax assets and liabilities are determined in accordance with paragraph 7 of SSAP No. 101, and reflect the changes in temporary differences taken into account in estimating taxes currently payable and are manifested in the enterprise's tax basis balance sheet. If gross tax loss contingencies associated with temporary differences have been included in taxes currently payable, a corresponding adjustment must be made to the tax basis balance sheet used in the determination of gross deferred tax

[35] The treatment of tax contingencies related to temporary differences is discussed in Question 9b.

assets and liabilities. Deferred tax assets and liabilities are not adjusted for tax contingencies not associated with temporary differences (i.e. permanent differences).

9.6 For example, assume that a company determines, in accordance with SSAP No. 5R, including the modifications in paragraph 3.a. of SSAP No. 101, a tax loss contingency is required to be established for a $100 deduction claimed in a prior year federal income tax return. Assuming a 35% tax rate, the company would establish a current tax liability in the amount of $35, increasing its current income tax expense by $35.

DR	Current income tax expense	$35	
CR	Liability for current income tax		$35

9.7 If the $100 deduction was associated with a temporary difference such as reserves, the company would make a corresponding adjustment to deferred taxes. The company would increase its gross deferred tax asset for reserves by $35 to reflect the future tax benefit associated with that reserve deduction. Any gross deferred tax asset recorded would still be subject to the admissibility requirements of paragraph 11.

DR	Gross deferred tax asset	$35	
CR	Change in net deferred tax (surplus)		$35

9.8 If the $100 deduction was associated with a permanent item such as meals and entertainment expenses, the company would make no corresponding adjustment to the deferred tax assets.

9.9 In determining the timing of when a tax loss contingency for a temporary item should be grossed up, paragraph 3.c. of SSAP No. 101 provides the following guidance:

> 3.c. In determining when tax loss contingencies associated with temporary differences should be included in current income taxes under Paragraph 3.a., and therefore included in deferred taxes under paragraph 7, a reporting entity is not required to "gross-up" its current and deferred taxes until such time as an event has occurred that would cause a re-evaluation of the contingency and its probability of assessment, e.g., the IRS has identified the item as one which may be adjusted upon audit. Such an event could be the reporting entity's (or its affiliate or parent in a consolidated income tax return) receipt of a Form 5701, Proposed Audit Adjustment, or could occur earlier upon receipt of an Information Document Request. At such time, the company must reassess the probability of an adjustment, reasonably re-estimate the amount of tax contingency as determined in accordance with paragraph 3.a., make any necessary adjustment to deferred taxes, and re-determine the admissibility of any adjusted gross deferred tax asset as provided in paragraph 11.

10a. Q – If the reporting entity adjusts the amount of regular taxable income and capital gains reported on a prior year income tax return from the amount originally determined for financial reporting purposes, how is the effect of the change reported in the current year? [Paragraph 19]

10.1 A – Paragraph 19 of SSAP No. 101 indicates that "income taxes incurred or received during the current year attributable to prior years shall be allocated, to the extent not previously provided, to net income in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors* (SSAP No. 3) unless attributable, in whole or in part, to realized capital gains or losses, in which case, such amounts shall be apportioned between net income and realized capital gains and losses, as appropriate". Paragraph 19 also indicates that income taxes incurred are to be allocated to ordinary income and realized capital gains consistent with paragraph 38 of FAS 109. Paragraph 38 of FAS 109 provides, in general, that the portion of the total income tax expense remaining after allocation to ordinary income would be allocated to realized capital gains or losses.

10.2 In accordance with paragraph 19, the amount of additional federal income taxes incurred in the current year with respect to the prior year would be allocated between ordinary income and realized capital gain items. The amount of additional federal income tax expense allocated to ordinary income should be determined by comparing the amount of additional tax expense actually incurred to the amount of tax expense that would have been incurred had the adjustment to ordinary income been zero (a "with and without" computation). The remaining amount of additional federal income tax expense would then be allocated to realized capital gains. The amounts of additional federal income tax expense allocated to ordinary income and realized capital gains would be included in the current period's federal income tax expense and not as a direct adjustment to surplus.

10.3 As an example, assume Company X files its 20X1 federal income tax return and reports $1,000,000 of taxable income comprised of $800,000 of ordinary income and $200,000 of capital gain income. Since the company is subject to taxation at a 34 percent tax rate on all its income, it incurred federal income tax expense of $340,000. In preparing its 20X1 statutory income tax provision, the company estimated that its liability for 20X1 federal income tax would be $238,000 based on $600,000 of ordinary income and $100,000 realized capital gains.

10.4 In determining the amount of "income taxes incurred" for its 20X2 financial statement, Company X must include the additional $102,000 of income tax expense incurred on its 20X1 federal income tax return ($340,000 actual tax incurred less $238,000 originally reported) in net income for 20X2 pursuant to paragraph 19 of SSAP No. 101 and not as a surplus adjustment. The $102,000 additional expense would be allocated to federal income taxes on net income and realized capital gains and losses as follows:

Total additional income tax expense	$102,000
Tax expense allocated to operations ($200,000 additional income x 34%)	68,000
Tax expense allocated to realized gains	$ 34,000

The tax expense allocated to operations was determined as follows:

Total recomputed tax expense	$340,000
Tax expense with only capital gain changes	272,000 [36]
Tax expense allocated to operations	$ 68,000

10.5 For all purposes of computing and allocating federal income taxes between operations and capital gains and losses, the character of the income or loss item as determined for statutory accounting purposes should be followed. Thus, if an income item is treated as a capital gain for statutory accounting purposes but as ordinary income for tax purposes, the federal income tax allocable to such income would be considered tax expense attributable to capital gains.

10b. Q – What is meant by the phrase in paragraph 18 "a reporting entity's unrealized gains and losses shall be recorded net of any allocated DTA or DTL"? [Paragraph 18]

10.6 A – Pursuant to Paragraph 18 of SSAP No. 101, a reporting entity's unrealized gains and losses shall be recorded net of any allocated DTA or DTL in accordance with paragraph 35 of FAS 109. Paragraph 35 of FAS 109 indicates that income taxes incurred are to be allocated between various items, including gains from operations and items charged or credited directly to shareholders' equity, such as the change in unrealized gains and losses.

[36] This is a company with less than $10 million of taxable income therefore $600,000 of original ordinary income plus $200,000 recomputed capital gains equals $800,000 taxable income times 34 percent applicable tax rate equals $272,000.

10.7 To the extent a reporting entity's admitted DTA or its DTL changes during the year, the portion of such change allocable to changes in unrealized gains and losses during the year should be determined. The portion so allocable would be reported with, and netted against, the related change in unrealized gains and losses reported as a component of changes in surplus. The remaining portion of the change in DTA or DTL allocable to other temporary differences should be reported as a separate component of changes in surplus and/or change in nonadmitted assets.

10.8 For example, assume the reporting entity has DTAs of $1,000 relating to temporary differences other than unrealized losses, and a $100 DTL relating to unrealized gains as of the beginning of the year. Since the entity is subject to tax at 35 percent and all of its DTAs are expected to reverse within one year, the entity recorded a $900 net admitted DTA as of the beginning of the year.

10.9 During the current year, the DTAs relating to temporary differences other than unrealized losses did not change, but the DTL relating to the entity's unrealized gains increased by $100 (unrealized gains increased by $285 during the year). As a result, the amount of the entity's net admitted DTAs decreased by $100.

10.10 Pursuant to paragraph 18 of SSAP No. 101, the $100 decrease in the DTA during the year is to be allocated between changes attributable to temporary differences other than unrealized gains and losses and those attributable to unrealized gains and losses. Since the DTA relating to temporary differences other than unrealized gains and losses did not change during the year, the entire decrease is allocable to the change in unrealized gains. Therefore, the $100 decrease is to be allocated and netted against the $285 change in unrealized gains reported in change in surplus, resulting in a $185 net increase in surplus relating to its unrealized gains. If a portion of the unrealized loss DTA is determined to be nonadmitted, that amount is not recorded separately from the operating differences DTA. The change in the total nonadmitted DTA from period to period is recorded in surplus as a Change in Nonadmitted Assets.

11. Q – How are current and deferred income taxes to be accounted for in interim periods? [Paragraphs 12.d. and 20]

11.1 A – In setting forth the methodology for the computation of current income taxes (income taxes incurred) in interim periods, paragraph 20 states:

> 20. Income taxes incurred in interim periods shall be computed using an estimated annual effective current tax rate for the annual period in accordance with the methodology described in paragraphs 19 and 20 of *Accounting Principles Board Opinion No. 28, Interim Financial Reporting*. Estimates of the annual effective tax rate at the end of interim periods are, of necessity, based on estimates and are subject to subsequent refinement or revision. If a reliable estimate cannot be made, the actual effective tax rate for the year-to-date may be the best estimate of the annual effective tax rate. If an insurer is unable to estimate a part of its "ordinary" income (or loss) or the related tax (or benefit) but is otherwise able to make a reliable estimate, the tax (or benefit) applicable to the item that cannot be estimated shall be reported in the interim period in which the item is reported.

11.2 As a result, to the extent a reliable estimate can be made of an expected annual effective tax rate, reporting entities should apply this rate to net income before federal and foreign income taxes, in the case of property and casualty insurers and health insurers, and net income and realized capital gains before federal and foreign income taxes in the case of life insurers. If a reliable estimate of the expected annual effective tax rate cannot be made, reporting entities should compute current and deferred taxes at interim reporting dates using the most reliable information that is available.

11.3 The following examples illustrate the estimation process for income taxes incurred using the estimated annual effective rate:

Projected statutory net income[37] for current year		$10,000,000
Estimated annual permanent differences		(2,800,000)
Estimated annual temporary differences:		2,000,000
Projected taxable income for current year		$9,200,000
Projected federal tax for current year (at 35%)		$3,220,000
Estimated annual effective tax rate		32.2%

11.4 As a result, assuming that during the calendar year the reporting entity's expectations as to its statutory and taxable income do not change, income tax incurred will be recorded on a quarterly basis as follows:

Quarter	Statutory Income (Loss)	Income Taxes Incurred
1	$(2,000,000)	$(644,000)
2	4,000,000	1,288,000
3	6,000,000	1,932,000
4	2,000,000	644,000
Total	$10,000,000	$3,220,000

11.5 If the reporting entity's expectations as to its statutory and taxable income change in the second quarter so that it expects that its annual effective rate will increase from 32.2% to 34%, it will record income taxes incurred in the second quarter of $1,324,000 (cumulative statutory income at end of the second quarter of $2,000,000 at 34% or $680,000 less $644,000 tax benefit recorded in first quarter).

11.6 As noted above, life insurers must estimate their annual effective tax rate and record income taxes incurred based on net income and realized capital gains before federal and foreign income taxes. With regard to intraperiod tax allocation, paragraph 19 states in relevant part:

> 19. Income taxes incurred shall be allocated to net income and realized capital gains or losses in a manner consistent with paragraph 38 of FAS 109.

11.7 As a result of the above and where the reporting entity expects realized capital gains or losses for the annual period, income taxes incurred must be allocated using a "with and without" methodology to net income before taxes and realized capital gains (see Question 10.4 for further discussion).

11.8 An example of this "with and without" methodology is as follows:

Projected statutory net income for current year		$10,000,000
Realized gains included above		(1,000,000)
		9,000,000
Estimated annual permanent differences:		(2,800,000)
Estimated annual temporary differences:		2,000,000
Projected ordinary taxable income for current year		$8,200,000
Projected ordinary federal tax for current year (at 35%)		$2,870,000
Projected capital gain federal tax for current year (at 35%)		350,000
Projected total federal tax for current year		$3,220,000
Estimated ordinary annual effective tax rate ($2,870,000 / $9,000,000)		31.9%
Estimated capital gain annual effective tax rate ($350,000 / $1,000,000)		35.0%
Estimated total annual effective tax rate ($3,220,000 / $10,000,000)		32.2%

[37] For all examples in Question 11, statutory net income represents operating and capital gain income before federal and foreign income taxes.

11.9 As a result, assuming that during the calendar year the reporting entity's expectations as to its statutory and taxable income (including the amounts of ordinary and capital income) do not change, income tax incurred will be recorded on a quarterly basis as follows:

Quarter	Ordinary Income (Loss)	Capital Income (Loss)	Ordinary Taxes Incurred	Capital Taxes Incurred
1	$(1,000,000)	$(1,000,000)	$(319,000)	$(350,000)
2	3,000,000	1,000,000	956,000	350,000
3	5,000,000	1,000,000	1,595,000	350,000
4	2,000,000	0	638,000	0
Total	$9,000,000	$1,000,000	$2,870,000	$350,000

11.10 With respect to the recording of deferred taxes on an interim basis paragraph 12.d. states:

> 12.d. The phrases "reverse during a timeframe corresponding with IRS tax loss carryback provisions, not to exceed three years," "realized within one year of the balance sheet date" and "realized within three years of the balance sheet date" are intended to accommodate interim reporting dates and reporting entities that file on an other than calendar year basis for federal income tax purposes.

11.11 When considered in the context of paragraph 20, this paragraph requires the use of the annual effective rate when determining deferred taxes at an interim reporting date. As such, a reporting entity's admitted adjusted gross DTAs are determined in accordance with paragraph 11 by reference to the adjusted gross DTAs that will reverse each year in the applicable period. Note however, that due to the inherent unpredictability, and general inability to project changes in capital gains and losses on a quarter by quarter basis, the deferred tax implications of the changes in unrealized gains and losses should be recorded on a discrete period basis (i.e., based on the change in the amounts on a quarter by quarter basis). For example in determining its admitted adjusted gross DTAs at March 31, 20X2, the reversal period referred to above is calendar years 20X3, 20X4 and 20X5 (i.e., expected adjusted gross DTAs at December 31, 20X2 that are expected to reverse in 20X3, 20X4 and 20X5).

11.12 This methodology is illustrated by the following example:

In this example, XYZ Co. is a life insurance company[38] that has a three-year carryback potential and also has an ExDTA ACL RBC percentage of 700%.

Projected statutory net income for 20X3			$10,000,000
Estimated annual permanent differences:			(2,800,000)
Estimated annual temporary differences:			2,000,000
Projected ordinary taxable income for current year			$9,200,000
Temporary differences at December 31, 20X2:			$5,000,000
Estimated temporary differences at December 31, 20X3:			$7,000,000
Taxable income in carryback period (taxes paid at 35%):			
	Year ended December 31, 20X0	$800,000	($280,000)
	Year ended December 31, 20X1	2,000,000	(700,000)

[38] XYZ Co. does not qualify for the small life insurance company deduction. Please note the results in this example may be different due to differences in the applicable carryback periods if XYZ Co. was a P&C insurance company.

	Year ended December 31, 20X2	3,000,000	(1,050,000)
	Year ended December 31, 20X3	$9,200,000	($3,220,000)

Note: Year ended December 31, 20X3 taxable income and taxes paid considered in the calculation of its interim tax accruals are based on the reporting entity's estimate of its annual taxable income and taxes to be paid. This amount may differ from the quarterly federal income tax estimates it expects to make during the year.

	Reversing Period		
	20X3	20X4	20X5
December 31, 20X2 Temporary difference reversals:	$2,000,000	$1,500,000	$1,500,000
	20X4	20X5	20X6
December 31, 20X3 Temporary difference reversals:	$3,000,000	$2,000,000	$2,000,000

Admitted deferred tax assets at December 31, 20X2:				
	Paragraph 11.a.			
		20X0	$800,000	
		20X1	2,000,000	
		20X2	2,200,000	
			5,000,000	
		Taxes paid at 35%		$1,750,000
	Paragraph 11.b.			0
	Paragraph 11.c.			0
	Total admitted			$1,750,000

Note: The recovery of federal income taxes paid in prior years under paragraph 11.a. is calculated in this example by carrying back 20X3's temporary difference reversals to offset 20X0's taxable income of $800,000 and $1,200,000 of 20X1's taxable income; then carrying back 20X4's temporary difference reversals to offset 20X1's remaining taxable income of $800,000 and $700,000 of 20X2's taxable income; finally, carrying back 20X5's temporary difference reversals to offset $1,500,000 of 20X2's taxable income. Since all gross DTAs were admitted under paragraph 11.a., paragraphs 11.b. and 11.c. need not be considered.

Admitted deferred tax assets at December 31, 20X3:				
	Paragraph 11.a.			
		20X1	$2,000,000	
		20X2	3,000,000	
		20X3	2,000,000	
			7,000,000	
		Taxes paid at 35%		$2,450,000
	Paragraph 11.b.			0
	Paragraph 11.c.			0
	Total admitted			$2,450,000

Note: The recovery of federal income taxes paid in prior years under paragraph 11.a. is calculated in this example by carrying back 20X4's temporary difference reversals to offset 20X1's taxable income of $2,000,000 and $1,000,000 of 20X2's taxable income; then carrying back 20X5's temporary difference reversals to offset 20X2's remaining taxable income of $2,000,000; finally, carrying back 20X6's temporary difference reversals to offset $2,000,000 of 20X3's taxable income. Since all gross DTAs were admitted under paragraph 11.a., paragraphs 11.b. and 11.c. need not be considered.	
Total estimated federal taxes for 20X3:	
Income taxes incurred (current tax) ($9,200,000 X 35%)	$3,220,000
Change in deferred tax ($1,750,000 – $2,450,000)	(700,000)
	$2,520,000

11.13 As a result of the above, the annual effective tax rate for current and deferred income taxes is as follows:

Current ($3,220,000/$10,000,000)	32.2%
Deferred (($700,000)/$10,000,000)	(7.0)%
Total annual effective rate	25.2%

Quarter	Statutory Income (Loss)	Income Taxes Incurred	Deferred Taxes
1	$(2,000,000)	$(644,000)	$140,000
2	4,000,000	1,288,000	(280,000)
3	6,000,000	1,932,000	(420,000)
4	2,000,000	644,000	(140,000)
Total	$10,000,000	$3,220,000	$(700,000)

11.14 To the extent that a reporting entity's estimated year end[39] admitted adjusted gross deferred tax assets are limited by its surplus pursuant to paragraph 11.b.ii., the annual effective deferred tax rate must be adjusted to consider the impact of this limitation on a quarterly basis.

12. Q – How do you present deferred taxes in the Annual Statement? [Paragraphs 8, 18, 21-28 and 36]

12.1 A – This answer is divided into four different parts.

Change in Accounting Principle

12.2 As required by paragraph 37 of SSAP No. 101, balances of current and deferred federal and foreign income taxes resulting from the adoption of SSAP No. 101 effective January 1, 2012 shall be presented in the Annual Statement as a Cumulative Effect of Changes in Accounting Principles. SSAP No. 3 provides the following:

> 3. A change in accounting principle results from the adoption of an accepted accounting principle, or method of applying the principle, which differs from the principles or methods previously used for reporting purposes. A change in the method of applying an accounting principle shall be considered a change in accounting principle.
>
> 4. A characteristic of a change in accounting principle is that it concerns a choice from among two or more statutory accounting principles. However, a change in accounting principle is

[39] In the previous example, year end is December 31, 20X3.

> neither (a) the initial adoption of an accounting principle in recognition of events or transactions occurring for the first time or previously immaterial in their effect, nor (b) the adoption or modification of an accounting principle necessitated by transactions or events that are clearly different in substance from those previously occurring.
>
> 5. The cumulative effect of changes in accounting principles shall be reported as adjustments to unassigned funds (surplus) in the period of the change in accounting principle. The cumulative effect is the difference between the amount of capital and surplus at the beginning of the year and the amount of capital and surplus that would have been reported at that date if the new accounting principle had been applied retroactively for all prior periods.

12.3 In accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors* (SSAP No. 3), adjustments to amounts recorded as of January 1, 2012, would be recorded as a modification to the changes in accounting principle account rather than corrections of an error through the period of 2012.

Illustration A Assumptions:

12.4 On January 1, 2012, as a result of applying paragraph 11.b. requirements to use current period statutory capital and surplus rather than prior quarter statutory capital and surplus as required by previous guidance, the AlphaBeta P/C Company computed the following balances related to deferred taxes:

	1/1/12	**12/31/11**
Gross DTA	$200,000	$200,000
Statutory Valuation Allowance Adjustment	0	0
Adjusted Gross DTA	200,000	200,000
Deferred Tax Assets Nonadmitted	25,000	10,000
Admitted Adjusted Gross DTA	175,000	190,000
Gross DTL	100,000	100,000
Net Admitted Adjusted Gross DTA	$75,000	$90,000

There was no change in the amount of the current tax liability recorded by AlphaBeta as a result of the adoption of SSAP No. 101.

12.5 The Cumulative Effect of Changes in Accounting Principles line shown in the surplus section of the Annual Statement would show a decrease of $15,000 ($90,000 – $75,000) on 1/1/2012. In addition, during the second quarter of 2012, the Company determined that it incorrectly computed its Net Admitted Adjusted Gross DTA as of 1/1/2012 under SSAP No. 101 and modified its opening balance as follows (note that modifications were not a result of changes in circumstances or events which occurred during 2012):

	Revised 1/1/12
Gross DTA	$200,000
Statutory Valuation Allowance Adjustment	0
Adjusted Gross DTA	200,000
DTA Nonadmitted	35,000
Admitted Adjusted Gross DTA	165,000
Gross DTL	100,000
Net Admitted Adjusted Gross DTA	$65,000

12.6 The Company would record the following balances in its 3/31/12 financial statements:

	1/1/12	**Revised 1/1/12**	**Increase (Decrease)**

Gross DTA	$200,000	$200,000	$0
Statutory Valuation Allowance Adjustment	0	0	0
Adjusted Gross DTA	200,000	200,000	0
DTA Nonadmitted	25,000	35,000	10,000
Admitted Adjusted Gross DTA	175,000	165,000	(10,000)
Gross DTL	100,000	100,000	0
Net Admitted Adjusted Gross DTA	$75,000	$65,000	($10,000)

12.7 The additional $10,000 decrease in net admitted adjusted gross DTA would also be recorded through the Cumulative Effect of Changes in Accounting Principles line shown in the surplus section of the Annual Statement.

Unrealized Capital Gains and Losses

12.8 SSAP No. 101 paragraph 18 states:

> 14. In accordance with paragraph 35 of FAS 109, a reporting entity's unrealized gains and losses shall be recorded net of any allocated DTA or DTL. The amount allocated shall be computed in a manner consistent with paragraph 38 of FAS 109.

12.9 The following illustrates the presentation of such requirement in the Annual Statement:

Illustration *B Assumptions:*

12.10 Entity grouped its investments in a reasonable and consistent manner and calculated the following gross amounts attributable to appreciation and depreciation in the fair value of its common stocks during 20X2 (see question 2 regarding grouping of assets and liabilities for measurement):

	Gross	**Carrying Value**	**Rate**	**Tax Effected DTA (DTL)**
Common stock carrying value 1/1/X2		$800,000		
Unrealized (loss)	($428,571)		35%	$150,000
Unrealized gain	342,857		35%	(120,000)
Net (loss) gain		(85,714)		$30,000
Common stock carrying value 12/31/X2		$714,286		

12.11 The journal entries need to present unrealized losses and gains net of tax are:

12/31/X2	DR	Change in unrealized capital gains and losses	$85,714
	CR	Common stock	($85,714)
	Recognition of net depreciation in FV of common stock		

12/31/X2	DR	Deferred tax asset	$150,000
	CR	Deferred tax liability	($120,000)
	CR	Change in deferred income taxes	($30,000)
	Recognition of gross deferred tax amounts		

12/31/X2	DR	Change in deferred income taxes	$30,000
	CR	Change in unrealized capital gains and losses	($30,000)
	Reclass tax effect of net unrealized loss per paragraph 18 of SSAP No. 101		

12.12 Condensed 12/31/X2 Balance Sheet:

ASSETS	20X2	20X1		LIABILITIES, SURPLUS AND OTHER FUNDS	20X2	20X1
Common Stock	$714,286	$800,000		Surplus:		
Net deferred tax asset	30,000			Beginning of year	$800,000	
				Change in UNL	(55,714)[40]	
Total Assets	$744,286	$800,000		**Liabilities & Surplus**	$744,286	$800,000

Annual Statement Presentation

12.13 In accordance with SSAP No. 101, DTAs and DTLs shall be offset and presented as a single amount on the statement of financial position. The following illustrates this requirement:

Illustration C Assumptions:

12.14 The entity had the following balances (1/1/X2 balances carried forward from Illustration A):

	1/1/X2	**12/31/X2**	**Change**
Gross DTA	$200,000	$510,000	$310,000
Statutory Valuation Allowance Adjustment	0	10,000	10,000
Adjusted Gross DTA	200,000	500,000	300,000[41]
DTA Nonadmitted	25,000	150,000	125,000
Admitted Adjusted Gross DTA	175,000	350,000	175,000
Gross DTL	100,000	200,000	100,000
Net Admitted Adjusted Gross DTA	$75,000	$150,000	$75,000
Current FIT Recoverable	**$18,000**	**$20,000**	**$2,000**

12.15 Illustrative 12/31/X2 Balance Sheet for Illustration C:

ASSETS	Current Year			Prior Year
	1 Assets	2 Nonadmitted Assets	3 Net Admitted Assets (Cols. 1 - 2)	4 Net Admitted Assets
Current Federal and foreign income tax recoverable and interest thereon	$20,000	$0	$20,000	$18,000
Net deferred tax asset	$300,000	$150,000	$150,000	$75,000

[40] Computed at $85,714 (total change in UNG/UNL) - $30,000 tax effect

[41] Includes $30,000 resulting from net unrealized losses as shown in Illustration B. As such the change in net deferred income taxes at 12/31/X2 is $170,000 ($300,000 (gross change in DTA) – $100,000 (gross change in DTL) – $30,000 reclass to net unrealized capital gains (losses)).

12.16 Illustrative 12/31/X2 Income Statement for Illustration C:

STATEMENT OF INCOME (P/C) SUMMARY OF OPERATIONS (Life & Health) STATEMENT OF REVENUES AND EXPENSES (Health)	1 Current Year	2 Prior Year
Gains and (losses) in surplus		
Change in net unrealized capital gains (losses) less capital gains tax of $	($55,714)	0
Change in net deferred income tax	$170,000	0
Change in nonadmitted assets	($125,000)	0

12.17 Illustrative 12/31/X2 Exhibit of Nonadmitted Assets for Illustration C:

	1 End of Current Year	2 End of Prior Year	3 Changes for Year (Increase) Decrease
Net deferred tax asset	$150,000	$25,000	($125,000)
Total	$150,000	$25,000	($125,000)

Illustration D Assumptions:

12.18 The entity had the following balances (1/1/20X2 balances carried forward from Illustration A):

	1/1/X2	**12/31/X2**	**Change**
Gross DTA	$200,000	$510,000	$310,000
Statutory Valuation Allowance Adjustment	0	10,000	10,000
Adjusted Gross DTA	200,000	500,000	300,000[42]
DTA Nonadmitted	25,000	150,000	125,000
Net Admitted Adjusted Gross DTA	175,000	350,000	175,000
Gross DTL	100,000	200,000	100,000
Net Admitted Adjusted Gross DTA	$75,000	$150,000	$75,000
Current FIT Liability	**$7,000**	**$12,000**	**$5,000**

12.19 Illustrative 12/31/X2 Balance Sheet for Illustration D:

ASSETS	Current Year			Prior Year
	1 Assets	2 Nonadmitted Assets	3 Net Admitted Assets (Cols. 1 - 2)	4 Net Admitted Assets
Net deferred tax asset	$300,000	$150,000	$150,000	75,000

[42] Includes $30,000 resulting from net unrealized losses as shown in Illustration B. As such the change in net deferred income taxes at 12/31/X2 is $170,000 ($300,000 (gross change in DTA) – $100,000 (gross change in DTL) – $30,000 reclass to net unrealized capital gains (losses)).

LIABILITIES, SURPLUS AND OTHER FUNDS	1 Current Year	2 Prior Year
Current Federal and foreign income taxes (including $0 on realized capital gains (Losses))	$12,000	$7,000

12.20 Illustrative 12/31/X2 Income Statement for Illustration D:

STATEMENT OF INCOME (P/C) **SUMMARY OF OPERATIONS (Life & Health)** **STATEMENT OF REVENUES AND EXPENSES (Health)**	1 Current Year	2 Prior Year
Gains and (losses) in surplus		
Change in net unrealized capital gains (losses) less capital gains tax of $	($55,714)	0
Change in net deferred income tax	$170,000	0
Change in nonadmitted assets	($125,000)	0

12.21 Illustrative 12/31/X2 Exhibit of Nonadmitted Assets for Illustration D:

	1 End of Current Year	2 End of Prior Year	3 Changes for Year (Increase) Decrease
Net deferred tax asset	$150,000	$25,000	($125,000)
Total	$150,000	$25,000	($125,000)

Notes to the Financial Statements Disclosures:

12.22 SSAP No. 101 paragraphs 21-28 include extensive disclosure requirements. Although some of these amounts are presented on the face of the financial statements or in schedules or exhibits to the Annual Statement, they will be included in the Notes to the Financial Statements both in the Annual Statement and in the Annual Audited Financial Statements.

12.23 This section provides specific examples that illustrate the disclosures required in SSAP No. 101. The formats in the illustrations are not requirements. Some of the disclosure paragraphs of SSAP No. 101 are not specific as to whether the entity should disclose the nature of certain items or whether the entity should disclose specific amounts. The illustrations included herein use a combination of each method. The NAIC encourages a format that provides the information in the most understandable manner in the specific circumstances. The following illustrations are for a single hypothetical insurance enterprise, referred to as AlphaBeta Property & Casualty Insurance Company.[43]

12.24 All of the disclosures would be completed in the year-end Annual Statement and audited statutory financial statements. The disclosures of paragraphs 22-24 and 25 (on a prospective basis) and 26-28 should be presented in accordance with paragraph 61 of the Preamble on the initial adoption of SSAP No. 10, a predecessor of SSAP No. 101, therefore these notes would only be presented in the first, second and third Quarterly Statements if the underlying data changed significantly.

12.25 Selected AlphaBeta P/C Company Financial Data at December 31, 20X2 (Balance Sheet information carried forward from Illustration C):

[43] In applying the illustrative examples to the 2012 calendar year, prior year balances would include any adjustments required from the cumulative change in accounting principle required as a result of the adoption of SSAP No. 101.

ASSETS	Current Year			Prior Year
	1 Assets	2 Nonadmitted Assets	3 Net Admitted Assets (Cols. 1 - 2)	4 Net Admitted Assets
Current federal and foreign income tax recoverable and interest thereon	$20,000	$0	$20,000	$18,000
Net deferred tax asset	$300,000	$150,000	$150,000	$75,000

CAPITAL AND SURPLUS ACCOUNT	1 Current Year	2 Prior Year
Change in net unrealized capital gains (losses)less capital gains tax of $30,000	($55,714)	0
Change in net deferred income tax	$170,000	0
Change in nonadmitted assets	($125,000)	0

EXHIBIT OF NONADMITTED ASSETS	1 End of Current Year	2 End of Prior Year	3 Changes for Year (Increase) Decrease
Net deferred tax asset	$150,000	$25,000	($125,000)

STATEMENT OF INCOME	20X2
UNDERWRITING INCOME	
Premiums earned	$5,250,000
DEDUCTIONS:	
Losses incurred	3,550,000
Loss adjustment expenses incurred	1,750,000
Other underwriting expenses incurred	525,000
Net underwriting gain (loss)	(575,000)
INVESTMENT INCOME	
Net investment gain (loss)	1,350,000
OTHER INCOME	
Total other income	125,000
Net income before dividends to policyholders, after capital gains tax and before all other federal and foreign income taxes	900,000
Dividends to policyholders	200,000
Net income, after dividends to policyholders, after capital gains tax and before all other federal and foreign income taxes	700,000
Federal and foreign income taxes incurred	220,000
Net income	$480,000

Paragraph 22 Illustration:

12.26 The components of the net DTA recognized in the Company’s Assets, Liabilities, Surplus and Other Funds are as follows:

	12/31/20X2			12/31/20X1			Change		
	Ordinary	Capital	Total	Ordinary	Capital	Total	Ordinary	Capital	Total
Gross Deferred Tax Assets	$375,000	$135,000	$510,000	$93,000	$107,000	$200,000	$282,000	$28,000	$310,000
Statutory Valuation Allowance Adjustments	0	10,000	10,000	0	0	0	0	10,000	10,000
Adjusted Gross Deferred Tax Assets	375,000	125,000	500,000	93,000	107,000	200,000	282,000	18,000	300,000
Deferred Tax Assets Nonadmitted	150,000	0	150,000	20,000	5,000	25,000	130,000	(5,000)	125,000
Subtotal Net Admitted Deferred Tax Asset	225,000	125,000	350,000	73,000	102,000	175,000	152,000	23,000	175,000
Deferred Tax Liabilities	21,000	179,000	200,000	15,000	85,000	100,000	6,000	94,000	100,000
Net Admitted Deferred Tax Asset/(Net Deferred Tax Liability)	$204,000	($54,000)	$150,000	$58,000	$17,000	$75,000	$146,000	($71,000)	$75,000
Admission Calculation Components SSAP No. 101 (Paragraph 11)									
a. Federal Income Taxes Paid In Prior Years Recoverable Through Loss Carrybacks.	$85,000	$5,000	$90,000	$45,000	$5,000	$50,000	$40,000	0	$40,000
b. Adjusted Gross Deferred Tax Assets Expected To Be Realized (Excluding The Amount Of Deferred Tax Assets From a, above) After Application of the Threshold Limitation. (The Lesser of b.i. and b.ii. Below)	50,000	10,000	60,000	13,000	12,000	25,000	37,000	(2,000)	35,000
i. Adjusted Gross Deferred Tax Assets Expected to be Realized Following the Balance Sheet Date.	**NA**	**NA**	**60,000**	**NA**	**NA**	**25,000**	**NA**	**NA**	**35,000**
ii. Adjusted Gross Deferred Tax Assets Allowed per Limitation Threshold.	**NA**	**NA**	**900,000**	**NA**	**NA**	**750,000**	**NA**	**NA**	**150,000**
c. Adjusted Gross Deferred Tax Assets (Excluding The Amount Of Deferred Tax Assets From a. and b. above) Offset by Gross Deferred Tax Liabilities.	90,000	110,000	200,000	15,000	85,000	100,000	75,000	25,000	100,000
Deferred Tax Assets Admitted as the result of application of SSAP No. 101.Total (a. + b. + c.)	$225,000	$125,000	$350,000	$73,000	$102,000	$175,000	$152,000	$23,000	$175,000
	20X2 Percentage	20X1 Percentage							
Ratio Percentage Used To Determine Recovery Period And Threshold Limitation Amount[44]	600%	500%							
Amount Of Adjusted Capital And Surplus Used To Determine Recovery Period And Threshold Limitation[45]	$6,000,000	$5,000,000							
The Company's tax-planning strategies include the use of reinsurance-related tax-planning strategies.									

[44] Disclose the ratio used by the reporting entity from the applicable Realization Threshold Limitation Table in paragraph 11.b. of SSAP No. 101 to determine the appropriate limitations of paragraph 11.b. In the event that late immaterial modifications to a reporting entity's statutory financial statements occur subsequent to initial completion of the statutory financial statements but prior to filing or similar deadline, these immaterial changes do not need to be reflected in this ratio if such modifications do not cause the reporting entity to change the threshold limitation from the applicable Realization Threshold Limitation Table.

[45] Provide the amount of adjusted capital and surplus used to calculate the limitation under paragraph 11.b.ii.

	12/31/20X2			12/31/20X1			Change		
	Ordinary	Capital	Total	Ordinary	Capital	Total	Ordinary	Capital	Total
Impact of Tax Planning Strategies	12/31/20X2			12/31/20X1			Change		
	Ordinary Percent	Capital Percent	Total Percent[46]	Ordinary Percent	Capital Percent	Total Percent	Ordinary Percent	Capital Percent	Total Percent
Adjusted Gross DTAs (% of Total Adjusted Gross DTAs)	6%	7%	13%	7%	7%	14%	-1%	0%	-1%
Net Admitted Adjusted Gross DTAs (% of Total Net Admitted Adjusted Gross DTAs)	14%	15%	29%	15%	15%	30%	-1%	0%	-1%

Paragraph 23 Illustration:

12.27 The Company has not recognized a deferred tax liability of approximately $30,000 for the undistributed earnings of its 100 percent owned foreign subsidiaries that arose in 20X2 and prior years because the Company does not expect those unremitted earnings to reverse and become taxable to the Company in the foreseeable future. A deferred tax liability will be recognized when the Company expects that it will recover those undistributed earnings in a taxable manner, such as through receipt of dividends or sale of the investments. As of December 31, 20X2, the undistributed earnings of these subsidiaries were approximately $88,000.

Paragraph 24 Illustration:

12.28 The provisions for incurred taxes on earnings for the years ended December 31 are:

	20X2	**20X1**
Federal	$180,000	$135,000
Foreign	40,000	15,000
	220,000	150,000
Federal income tax on net capital gains	52,000	36,000
Utilization of capital loss carry-forwards	(52,000)	(36,000)
Federal and foreign income taxes incurred	$220,000	$150,000

12.29 The tax effects of temporary differences that give rise to significant[47] portions of the deferred tax assets and deferred tax liabilities are as follows:

Deferred Tax Assets:	12/31/20X2	12/31/20X1	Change
Ordinary			
Discounting of unpaid losses	30,000	10,000	20,000
Unearned premium reserve	235,000	50,000	185,000
Investments	25,000	15,000	10,000
Pension accrual	65,000	15,000	50,000
Other (including items <5% of total ordinary tax assets)	20,000	3,000	17,000
Subtotal	375,000	93,000	282,000
Statutory valuation allowance adjustment	0	0	0
Nonadmitted	150,000	20,000	130,000
Admitted ordinary deferred tax assets	225,000	73,000	152,000
Capital			

[46] The total percentage should be separately calculated and is not intended to be a summation of the percentages by tax character.

[47] Significant is defined as any amount in excess of 5% of the total applicable DTAs or DTLs.

Investments	125,000	45,000	80,000
Net capital loss carry-forward	10,000	62,000	(52,000)
Other (including items <5% of total capital tax assets)	0	0	0
Subtotal	135,000	107,000	28,000
Statutory valuation allowance adjustment	10,000	0	10,000
Nonadmitted	0	5,000	(5,000)
Admitted capital deferred tax assets	125,000	102,000	23,000
Admitted deferred tax assets	350,000	175,000	175,000
Deferred Tax Liabilities:			
Ordinary			
Investments	10,000	5,000	5,000
Fixed assets	6,000	5,000	1,000
Other (including items <5% of total ordinary tax liabilities)	5,000	5,000	0
Subtotal	21,000	15,000	6,000
Capital:			
Investments	110,000	55,000	55,000
Real estate	64,000	25,000	39,000
Other (including items <5% of total capital tax liabilities)	5,000	5,000	
Subtotal	179,000	85,000	94,000
Deferred tax liabilities	200,000	100,000	100,000
Net deferred tax assets/liabilities	150,000	75,000	75,000

12.30 The change in net deferred income taxes is comprised of the following (this analysis is exclusive of nonadmitted assets as the Change in Nonadmitted Assets is reported separately from the Change in Net Deferred Income Taxes in the surplus section of the Annual Statement):

	Dec. 31, 20X2	**Dec. 31, 20X1**	**Change**
Adjusted gross deferred tax assets	$500,000	$200,000	$300,000
Total deferred tax liabilities	200,000	100,000	100,000
Net deferred tax assets (liabilities)	$300,000	$100,000	200,000
Tax effect of unrealized gains (losses)			(30,000)
Change in net deferred income tax			$170,000

Paragraph 25 Illustration[48]:

12.31 The provision for federal and foreign income taxes incurred is different from that which would be obtained by applying the statutory Federal income tax rate to income before income taxes. The significant items causing this difference are as follows:

	Dec. 31, 20X2	**Effective Tax Rate**
Provision computed at statutory rate	$245,000	35.0%
Tax exempt income deduction	(102,000)	(14.6)
Dividends received deduction	(84,000)	(12.0)

[48] This illustration includes both the rate reconciliation and the tax effected amounts although only one of these is required to be disclosed under SSAP No. 101.

Tax differentials on foreign earnings	(34,000)	(4.8)
Change in statutory valuation allowance adjustment	10,000	1.4
Nondeductible goodwill	8,000	1.1
Other	7,000	1.0
Total	$50,000	7.1%
Federal and foreign income taxes incurred	$220,000	31.4%
Change in net deferred income taxes[49]	(170,000)	(24.3)
Total statutory income taxes	$50,000	7.1%

Paragraph 26 Illustration:

12.32 The Company has net capital loss carryforwards which expire as follows: 20X5, $9,000; 20X6; $1,000.

Paragraph 27 Illustration:

12.33 The Company believes it is reasonably possible that the liability related to any federal or foreign tax loss contingencies may significantly increase within the next 12 months. However, an estimate of the reasonably possible increase cannot be made at this time.

Paragraph 28 Illustration:

12.34 The Company is included in a consolidated federal income tax return with its parent company, Alpha Corporation. The Company has a written agreement, approved by the Company's Board of Directors, which sets forth the manner in which the total combined federal income tax is allocated to each entity which is a party to the consolidation. Pursuant to this agreement, the Company has the enforceable right to recoup federal income taxes paid in prior years in the event of future net losses, which it may incur, or to recoup its net losses carried forward as an offset to future net income subject to federal income taxes.

13. Q – How are tax-planning strategies to be considered in determining adjusted gross DTAs [Paragraph 7.e.] and admitted adjusted gross DTAs [Paragraphs 11.a., 11.b.i., 14 and 15]?

Overview:

13.1 A – Paragraph 14 of SSAP No. 101 states:

> In some circumstances, there are tax-planning strategies (including elections for tax purposes) that (a) are prudent and feasible, (b) a reporting entity ordinarily might not take, but would take to prevent an operating loss or tax credit carryforward from expiring unused, and (c) would result in realization of deferred tax assets. A reporting entity shall consider tax-planning strategies in (1) determining the amount of the statutory valuation allowance adjustment necessary under paragraph 7.e. and (2) the realization of deferred tax assets when determining admission under paragraph 11…

13.2 Paragraph 248 of FAS 109 additionally states that:

> Tax-planning strategies also may shift the estimated pattern and timing of future reversals of temporary differences…. A tax-planning strategy to accelerate the reversal of deductible

[49] As reported in the surplus section of the Annual Statement. The change in net deferred income taxes is before nonadmission of any DTA. The change in nonadmitted DTA is reported together with the total change in nonadmitted assets and presented as a separate component of surplus.

> temporary differences in time to offset taxable income that is expected in an early future year might be the only means to realize a tax benefit for those deductible temporary differences if they otherwise would reverse and provide no tax benefit in some later future year(s).

13.3 As also provided in paragraph 14 of SSAP No. 101, if a tax-planning strategy is used to accelerate the reversal or realization of an item, any significant net-of-tax potential costs or losses associated with the implementation of the strategy should reduce the adjusted gross or admitted DTA.

13.4 When considering a prudent and feasible tax-planning strategy that is more likely than not to enable realization of all or part of an adjusted gross DTA or admitted DTA, paragraph 15 of SSAP No. 101 states that "paragraph 3 of this statement related to tax loss contingencies shall be applied in determining admissibility of deferred tax assets under paragraph 11 of this statement." Accordingly, a reporting entity must evaluate the likelihood, if a tax-planning strategy were implemented, of whether a tax loss contingency would be required to be recorded under paragraph 3.a. If so, the admitted tax benefit of a tax-planning strategy must be reduced by the amount of tax loss contingency so required. For example, if a tax-planning strategy provided a $100 admitted DTA, but the reporting entity estimated that a tax loss contingency reserve of $40 would be required if the strategy was implemented, the admitted DTA resulting from the tax-planning strategy would be reduced by $40. Since the admitted DTA would be net of any applicable tax loss contingencies, no separate tax loss contingencies would actually be recorded for these items.

Statutory Valuation Allowance Adjustment:

13.5 As discussed in Question 2.5, future realization of gross DTAs ultimately depends on the existence of sufficient taxable income of the appropriate character within the carryback or carryforward period available under the tax law. In determining adjusted gross DTAs, a reporting entity shall consider the four sources of taxable income that may be available under the tax law, one of which is tax-planning strategies[50]. As noted in paragraph 13 of SSAP No. 101, a reporting entity is not required to consider all four sources of taxable income if one or more sources are alone sufficient to support the conclusion that the entity will realize the tax benefits of its adjusted gross DTAs (i.e., a conclusion that no statutory valuation allowance is necessary). Accordingly, tax-planning strategies need not be considered if the other sources of taxable income are sufficient to realize the benefits of reversing existing DTAs. However, the reporting entity is required to consider the impact of tax planning strategies to determine the amount of the adjustment if a conclusion is reached that a statutory valuation allowance adjustment is necessary.

Tax-Planning Strategies for Admission of DTAs:

13.6 In order for a tax-planning strategy to support admission of adjusted gross DTAs under paragraph 11, the reporting entity must demonstrate that (1) the admitted DTAs would be realized either within a period that would give rise to a carryback of tax losses under the Internal Revenue Code, not to exceed three years (for admission under paragraph 11.a.), or within the applicable period (refer to the 11.b.i. column of the applicable Realization Threshold Limitation Table in paragraph 11) and (2) it would have the ability to implement the strategy. In such circumstances an entity may recognize, as admitted assets, the related DTAs that are realizable as a result of the available tax-planning strategy in accordance with paragraphs 11.a., 11.b.i. and 11.c. of SSAP No. 101. Using tax-planning strategies in determining the admissible DTA is analogous to the use of tax-planning strategies in determining the amount of the statutory valuation allowance adjustment required under paragraph 7.e. of SSAP No. 101 and paragraph

[50] See paragraph 13 of SSAP No. 101 and paragraph 21 of FAS 109. Examples of tax-planning strategies as provided in paragraph 13.d. are (1) accelerate taxable amounts to utilize expiring carryforward, (2) change the character of taxable or deductible amounts from ordinary income or loss to capital gain or loss, and (3) switch from tax-exempt to taxable investments.

22 of FAS 109. Although a reporting entity may use tax-planning strategies in determining the portion of its adjusted gross DTAs that are admissible, it is not required to do so.

13.7 The requirement in paragraph 11.a. and 11.b.i. of SSAP No. 101 to consider only those DTAs that reverse or are realized within a period that would give rise to a carryback of losses under the Internal Revenue Code not to exceed three years (paragraph 11.a.) or within the applicable period following the balance sheet date (paragraph 11.b.i.) causes those DTAs which would otherwise reverse beyond such period to potentially provide no tax benefit (unless admitted under paragraph 11.c.). The potential reversal beyond the appropriate period is comparable to an expiring net operating loss, in that the deduction would not provide a tax benefit under SSAP No. 101. Thus, to the extent prudent and feasible tax-planning strategies exist to accelerate the reversal or realization of these DTAs, these strategies are comparable to those contemplated in paragraph 248 of FAS 109 above.

13.8 An example of a prudent and feasible tax-planning strategy is as follows:

13.9 Company A, a property/casualty insurance company for federal income tax purposes, has paid federal income taxes of $500,000 in each of calendar years 20X1 and 20X2. The company has an ExDTA ACL RBC percentage of 250% and therefore is required to use the one-year applicable period under paragraph 11.b.i. of SSAP No. 101. It has capital and surplus for purposes of paragraph 11.b.ii. of SSAP No. 101 of $20,000,000. Company A has an obligation to provide post-retirement health benefits to its employees. At December 31, 20X2, Company A has included a liability for $1,000,000 on its statutory-basis financial statements for post-retirement health benefits. This liability is not currently deductible for federal income tax purposes, and only $25,000 reverses within each of the next two calendar years. This is Company A's only DTA under SSAP No. 101, and there are no DTLs. Company A, absent any tax-planning strategies, would compute a DTA of $350,000 ($1,000,000 X 35%), and would admit $17,500 ($50,000 X 35%) under paragraph 11.a., and has no additional admitted DTA under paragraph 11.b.

13.10 Company A could implement a welfare benefit fund for tax purposes, and contribute assets to the fund to cover qualifying welfare benefits. The contribution, subject to limitations, would be deductible for federal income tax purposes, and would have the effect of accelerating the deduction for Company A's post-retirement health benefits. Company A has computed that $300,000 could be contributed during 20X3 to the welfare benefit fund, and to implement this strategy, it would cost $15,000 on an after-tax basis. Company A management believe that this strategy is prudent and feasible, and the Company would be able to implement this strategy if necessary. Company A would be able to admit an additional $90,000 of DTAs ($300,000 X 35%, or $105,000, less $15,000 in costs) under paragraph 11.a., with no additional admitted DTA under paragraph 11.b.

13.11 A tax-planning strategy would not be considered prudent or feasible if use of the strategy would be inconsistent with assumptions inherent in statutory or other accounting basis financial statements. For instance, a tax-planning strategy to sell securities identified as "held to maturity" for GAAP-basis financial statements at a loss would not be prudent or feasible. Additionally, if a potential tax planning strategy were to involve selling debt securities at a loss, it would not be prudent or feasible if the securities had not been identified as impaired and the loss recognized for statutory-basis financial statements. Additionally, a tax-planning strategy that could not be implemented to realize a tax benefit within the requisite period following the balance sheet date or is inconsistent with management's business plan objectives would not be prudent and/or feasible.

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Statement of Statutory Accounting Principles No. 102

Accounting for Pensions, A Replacement of SSAP No. 89

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Accounting for Pensions, A Replacement of SSAP No. 89

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles and related reporting for employers' pension obligations.

2. This statement establishes financial accounting and reporting standards for an insurer that offers pension benefits to its employees. Ordinarily, such benefits are periodic pension payments to retired employees or their survivors, but they may also include benefits payable as a single lump sum and other types of benefits, such as death benefits provided through a pension plan. (This statement does not apply to life insurance benefits provided outside a pension plan or postretirement health and welfare benefits.) Arrangements to provide pension benefits may take a variety of forms and may be financed in different ways. This statement applies to any arrangement that is similar in substance to a pension plan regardless of form or financing. This statement applies to a written plan and to a plan whose existence may be implied from a well-defined, although perhaps unwritten, practice of paying postretirement benefits. This statement supersedes the guidance in *SSAP No. 89—Accounting for Pensions, A Replacement of SSAP No. 8* (SSAP No. 89), nullifies and incorporates the guidance in *INT 99-26: Offsetting Pension Assets and Liabilities* (INT 99-26)*,* and *INT 04-12: Determining the Classification and Benefit Attribution Method for a "Cash Balance" Pension Plan* (INT 04-12), and nullifies *INT 01-16: Measurement Date for SSAP No. 8 Actuarial Valuations* (INT 01-16), *INT 03-18: Accounting for a Change in the Additional Minimum Liability in SSAP No. 8—Pensions (SSAP No. 8)* (INT 03-18) and *INT 04-03: Clarification for Calculating the Additional Minimum Pension Liability under SSAP No. 89—Accounting for Pensions, A Replacement of SSAP No. 8, paragraph 16.f.* (INT 04-03). This statement also modifies *INT 04-17: Impact of Medicare Modernization on Postretirement Benefits* (INT 04-17) to remove reference to pensions as this interpretation only addresses postretirement benefits other than pensions.

SUMMARY CONCLUSION

Defined Benefit Plans

Single-Employer Defined Benefit Pension Plans

3. A defined benefit pension plan is one that defines an amount of pension benefit to be provided, usually as a function of one or more factors such as age, years of service, or compensation. (Hybrid pension plans that refer to an account balance, rather than a monthly annuity at retirement (also known as cash balance plans) are considered defined benefit plans for purposes of applying this statement.) For defined benefit plans, reporting entities shall adopt *FAS 158: Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106, and 132(R)* (FAS 158) and *FASB Staff Position FAS 136(R)-1, Employers' Disclosures about Postretirement Benefit Plan Assets* (FSP FAS 136(R)-1) with modifications as discussed within paragraph ~~81~~82.

4. A pension benefit is part of the compensation paid to an employee for services. In a defined benefit pension plan, the employer promises to provide, in addition to current wages, retirement income payments in future years after the employee retires or terminates service. Generally, the amount of benefit to be paid depends on a number of future events that are incorporated in the plan's benefit formula, often including how long the employee and any survivors live, how many years of service the employee renders, and the employee's compensation in the years immediately before retirement or termination. In most cases, services are rendered over a number of years before an employee retires and begins collecting the pension. Even though the services rendered by an employee are complete and the employee has retired, the total amount of benefit that the employer has promised and the cost to the employer of the services rendered are not precisely determinable but can only be estimated using the benefit formula and estimates of the relevant future events, many of which the employer cannot control.

Elements of Pension Accounting

5. Net periodic pension cost is made up of several components that reflect different aspects of the employer's financial arrangements as well as the cost of benefits earned by employees. The cost of a benefit can be determined without regard to how the employer decides to finance the plan. The service cost component of net periodic pension cost is the actuarial present value of benefits attributed by the plan's benefit formula to services rendered by employees during the period. The service cost component is conceptually the same for an unfunded plan, a plan with minimal funding, and a well-funded plan. The other components of net periodic pension cost are interest cost (interest on the projected benefit obligation, which is a discounted amount), actual[1] return on plan assets, amortization of any prior service cost or credit included in unassigned funds (surplus), and gain or loss, which includes, to the extent recognized, amortization of the net gain or loss included in unassigned funds (surplus) (refer to paragraph 24).

6. The projected benefit obligation is the actuarial present value of all benefits attributed by the plan's benefit formula to employee service rendered prior to that date. The projected benefit obligation is measured using an assumption as to future compensation levels if the pension benefit formula is based on those future compensation levels. The projected benefit obligation is a measure of benefits attributed to service to date assuming that the plan continues in effect and that estimated future events (including compensation increases, turnover, and mortality) occur.

7. The accumulated benefit obligation is the actuarial present value of benefits attributed by the pension benefit formula to employee service rendered prior to that date and based on current and past compensation levels. The accumulated benefit obligation differs from the projected benefit obligation in that it includes no assumption about future compensation levels. For plans with flat-benefit or non-pay-related pension benefit formulas, the accumulated benefit obligation and the projected benefit obligation are the same.

8. Plan assets are assets that have been segregated and restricted to provide for pension benefits. The amount of plan assets includes amounts contributed by the employer and amounts earned from investing the contributions, less benefits paid. Assets not segregated in a trust or otherwise effectively restricted so that they cannot be used by the employer for other purposes are not considered plan assets even though it may be intended that such assets be used to provide for pension benefits. Amounts accrued by the employer but not yet paid to the plan are also not considered plan assets. Securities of the employer held by the plan are includable in plan assets provided they are transferable.

Recognition of Net Periodic Pension Cost

9. The following components shall be included in the net pension cost for a period by an employer sponsoring a defined benefit pension plan: a) Service cost; b) Interest cost; c) Actual return on plan assets; d) Amortization of any prior service cost or credit included in unassigned funds (surplus); e) Gain or loss (including the effects of changes in assumptions) to the extent recognized; and f) Amortization of any net transition asset or obligation existing at the date of initial application of this statement and remaining in unassigned funds (surplus).

[1] To address a question on how the expected return on plan assets affects the determination of net periodic pension cost if the actual return on plan assets for a period is a component of net periodic pension cost, it is noted that the expected return on plan assets generally will be different from the actual return on plan assets for the year. This statement provides for recognition of that difference (a net gain or loss) in unassigned funds in the period it arises. The amount recognized in unassigned funds is also a component of net periodic pension cost for the current period. Thus, the amount recognized in unassigned funds and the actual return on plan assets, when aggregated, equal the expected return on plan assets. The amount recognized in unassigned funds affects future net periodic pension cost through subsequent amortization, if any, of the net gain or loss. (This footnote reflects guidance included in E12 of FSP FAS 158-1.)

Service Cost

10. The service cost component recognized in a period shall be determined as the actuarial present value of benefits attributed by the pension benefit formula to employee service (including both vested and nonvested employees) during that period.

11. The prior service cost for nonvested employees not previously recognized[2] is not required to be included in net periodic pension cost entirely in the year this standard is adopted. Unrecognized prior service cost for nonvested employees shall be amortized as a component of net periodic pension cost by assigning an equal amount to each expected future period of service before vesting occurs for nonvested employees active at the date of the amendment. Unassigned funds (surplus) is adjusted each period as prior service cost is amortized (refer to paragraphs ~~83-85~~84-86 for transition guidance related to the recognition of the prior service cost for nonvested employees though unassigned surplus).

Interest Cost

12. The interest cost component recognized in a period shall be determined as the increase in the projected benefit obligation due to the passage of time. Measuring the projected benefit obligation as a present value requires accrual of an interest cost at rates equal to the assumed discount rates.

Actual Return on Plan Assets

13. For a funded plan, the actual return on plan assets shall be determined based on the fair value of plan assets at the beginning and the end of the period, adjusted for contributions and benefit payments.

Prior Service Cost

14. Plan amendments (including initiation of a plan) often include provisions that grant increased benefits based on services rendered in prior periods. Because plan amendments are granted with the expectation that the employer will realize economic benefits in future periods, the cost of providing such retroactive benefits (prior service cost) is not required to be included in net periodic pension cost entirely in the year of the amendment but provides for recognition during the future service periods of those employees active at the date of the amendment who are expected to receive benefits under the plan.

15. A plan amendment that retroactively increases benefits (including benefits that are granted to retirees) increases the projected benefit obligation. The cost of the benefit improvement shall be recognized as a charge to unassigned funds (surplus) at the date of the amendment. Except as specified in paragraphs 16-17, that prior service cost shall be amortized as a component of net periodic pension cost by assigning an equal amount to each future period of service of each employee active at the date of the amendment who is expected to receive benefits under the plan. If all or almost all of a plan's participants are inactive, the cost of retroactive plan amendments affecting benefits of inactive participants shall be amortized based on the remaining life expectancy of those participants instead of based on the remaining service period. Unassigned funds (surplus) is adjusted each period as prior service cost is amortized.

16. Consistent use of an alternative approach that more rapidly amortizes the cost of retroactive amendments is acceptable. For example, a straight-line amortization of the cost over the average remaining service period of employees expected to receive benefits under the plan is acceptable. The alternative method used shall be disclosed.

[2] The previous statutory accounting guidance in *SSAP No. 89—Accounting for Pensions, A Replacement of SSAP No. 8* excluded nonvested employees from the service cost calculation. This exclusion has been eliminated with the issuance of this SSAP.

17. In some situations a history of regular plan amendments and other evidence may indicate that the period during which the employer expects to realize economic benefits from an amendment granting retroactive benefits is shorter than the entire remaining service period of the active employees. Identification of such situations requires an assessment of the individual circumstances and the substance of the particular plan situation. In those circumstances, the amortization of prior service cost shall be accelerated to reflect the more rapid expiration of the employer's economic benefits and to recognize the cost in the periods benefited.

18. A plan amendment that retroactively reduces, rather than increases, benefits decreases the projected benefit obligation. The reduction in benefits shall be recognized as a credit (prior service credit) to unassigned funds (surplus) that shall be used first to reduce any remaining prior service cost included in unassigned funds (surplus). Any remaining prior service credit shall be amortized as a component of net periodic pension cost on the same basis as the cost of a benefit increase.

Gains and Losses

19. Gains and losses are changes in the amount of either the projected benefit obligation or plan assets resulting from experience different from that assumed and from changes in assumptions. This statement does not distinguish between those sources of gains and losses. Gains and losses include amounts that have been realized, as well as amounts that are unrealized. Because gains and losses may reflect refinements in estimates as well as real changes in economic values and because some gains in one period may be offset by losses in another or vice versa, recognition of gains and losses as components of net pension cost of the period in which they arise is not required. Gains and losses that are not recognized immediately as a component of net periodic pension cost shall be recognized as increases or decreases in unassigned funds (surplus) as they arise.

20. The expected return on plan assets shall be determined based on the expected long-term rate of return on plan assets and the fair value of plan assets.

21. Asset gains and losses are differences between the actual return on assets during a period and the expected return on assets for that period. Asset gains and losses include changes reflected in the fair value of assets.

22. As a minimum, amortization of a net gain or loss included in unassigned funds (surplus) shall be included as a component of net pension cost for a year if, as of the beginning of the year, that net gain or loss exceeds 10 percent of the greater of the projected benefit obligation or the fair value of plan assets. If amortization is required, the minimum amortization shall be that excess divided by the average remaining service period of active employees expected to receive benefits under the plan. If all or almost all of a plan's participants are inactive, the average remaining life expectancy of the inactive participants shall be used instead of average remaining service.

23. Any systematic method of amortizing gains or losses may be used in lieu of the minimum specified in the previous paragraph provided that (a) the minimum is used in any period in which the minimum amortization is greater (reduces the net balance included in unassigned funds (surplus) by more), (b) the method is applied consistently, (c) the method is applied similarly to both gains and losses, and (d) the method used is disclosed.

24. The gain or loss component of net periodic pension cost shall consist of (a) the difference between the actual return on plan assets and the expected return on plan assets and (b) amortization of the net gain or loss included in unassigned funds (surplus).

Recognition of Liabilities and Assets

25. If the projected benefit obligation (considering both vested and nonvested participants) exceeds the fair value of plan assets, the employer shall recognize in its statement of financial position a liability that equals the unfunded projected benefit obligation. If the fair value of plan assets exceeds the projected benefit obligation, the employer shall recognize in its statement of financial position an asset that equals the overfunded projected benefit obligation. This prepaid asset resulting from the excess of the fair value of plan assets over the projected benefit obligation shall be nonadmitted.

26. If multiple single-employer plans exist, the employer shall aggregate the statuses of all overfunded plans and recognize that amount as an asset in its statement of financial position. It also shall aggregate the statuses of all underfunded plans and recognize that amount as a liability in its statement of financial position. It is not acceptable statutory accounting practice to offset pension or postretirement benefits other than pensions liability generated by one plan against the prepaid assets of another plan.

27. The asset or liability that is recognized pursuant to paragraph 25 may result in a temporary difference, as defined in *SSAP No. 101—Income Taxes—A Replacement of SSAP No. 10R and SSAP No. 10* (SSAP No. 101). The deferred tax effects of any temporary differences shall be recognized in income tax expense or benefit for the year and shall be allocated pursuant to SSAP No. 101.

28. If a new determination of the funded status of a plan to be recognized as an asset or a liability in the employer's statement of financial position is made, or when net gains or losses, prior service costs or credits, or the net transition asset or obligation existing at the date of initial application of this statement are amortized as components of net periodic pension cost, the related balances for those net gains or losses, prior service costs or credits, and transition asset or obligation in unassigned funds (surplus) shall be adjusted as necessary and reported in unassigned funds (surplus).

Measurement of Cost and Obligations

29. The service component of net periodic pension cost, the projected benefit obligation, and the accumulated benefit obligation are based on an attribution of pension benefits to periods of employee service and on the use of actuarial assumptions to calculate the actuarial present value of those benefits. Actuarial assumptions reflect the time value of money (discount rate) and the probability of payment (assumptions as to mortality, turnover, early retirement, and so forth).

Attribution

30. Pension benefits ordinarily shall be attributed to periods of employee service based on the plan's benefit formula to the extent that the formula states or implies an attribution. In some situations a history of regular increases and other evidence may indicate that an employer has a present commitment to make future amendments and that the substance of the plan is to provide benefits attributable to prior service that are greater than the benefits defined by the written terms of the plan. In those situations, the substantive commitment shall be the basis for the accounting, and the existence and nature of the commitment to make future amendments shall be disclosed.

31. In some situations a history of regular increases in non-pay-related benefits or benefits under a career-average-pay plan and other evidence may indicate that an employer has a present commitment to make future amendments and that the substance of the plan is to provide benefits attributable to prior service that are greater than the benefits defined by the written terms of the plan. In those situations, the substantive commitment shall be the basis for the accounting, and the existence and nature of the commitment to make future amendments shall be disclosed.

32. Some plans may have benefit formulas that attribute all or a disproportionate share of the total benefits provided to later years of service, thereby achieving in substance a delayed vesting of benefits. For such plans the total projected benefit shall be considered to accumulate in proportion to the ratio of the number of completed years of service to the number that will have been completed when the benefit is first fully vested. If a plan's benefit formula does not specify how a particular benefit relates to services rendered, the benefit shall be considered to accumulate as follows:

a. For benefits of a type includable in vested benefits, in proportion to the ratio of the number of completed years of service to the number that will have been completed when the benefit is first fully vested.

b. For benefits of a type not includable in vested benefits, in proportion to the ratio of completed years of service to total projected years of service.

Assumptions

33. Each significant actuarial assumption used shall reflect the best estimate solely with respect to that individual assumption. All assumptions shall presume that the plan will continue in effect in the absence of evidence that it will not continue.

34. Assumed discount rates shall reflect the rates at which the pension benefits could be effectively settled. It is appropriate in estimating those rates to look to available information about rates implicit in current prices of annuity contracts that could be used to effect settlement of the obligation. In making those estimates, employers may also look to rates of return on high-quality fixed-income investments currently available and expected to be available during the period to maturity of the pension benefits. Assumed discount rates are used in measurements of the projected, accumulated, and vested benefit obligations and the service and interest cost components of net periodic pension cost.

35. The objective of selecting assumed discount rates using the method noted in paragraph 34 is to measure the single amount that, if invested at the measurement date in a portfolio of high-quality debt instruments, would provide the necessary future cash flows to pay the pension benefits when due. Notionally, that single amount, the projected benefit obligation, would equal the fair value of a portfolio of high-quality zero coupon bonds whose maturity dates and amounts would be the same as the timing and amount of the expected future benefit payments. Because cash inflows would equal cash outflows in timing and amount, there would be no reinvestment risk in the yields to maturity of the portfolio. However, in other than a zero coupon portfolio, such as a portfolio of long-term debt instruments that pay semiannual interest payments or whose maturities do not extend far enough into the future to meet expected benefit payments, the assumed discount rates (the yield to maturity) need to incorporate expected reinvestment rates available in the future. Those rates shall be extrapolated from the existing yield curve at the measurement date. The determination of the assumed discount rate is separate from the determination of the expected rate of return on plan assets whenever the actual portfolio differs from the hypothetical portfolio above. Assumed discount rates shall be reevaluated at each measurement date. If the general level of interest rates rises or declines, the assumed discount rates shall change in a similar manner.

36. The expected long-term rate of return on plan assets shall reflect the average rate of earnings expected on the funds invested or to be invested to provide for the benefits included in the projected benefit obligation. In estimating that rate, appropriate consideration should be given to the returns being earned by the plan assets in the fund and the rates of return expected to be available for reinvestment. The expected long-term rate of return on plan assets is used to compute the expected return on assets.

37. The service cost component of net periodic pension cost and the projected benefit obligation shall reflect future compensation levels to the extent that the pension benefit formula defines pension benefits

wholly or partially as a function of future compensation levels. Future increases for which a present commitment exists shall be similarly considered. Assumed compensation levels shall reflect an estimate of the actual future compensation levels of the individual employees involved, including future changes attributed to general price levels, productivity, seniority, promotion, and other factors. All assumptions shall be consistent to the extent that each reflects expectations of the same future economic conditions, such as future rates of inflation. Measuring service cost and the projected benefit obligation based on estimated future compensation levels entails considering indirect effects, such as changes under existing law in social security benefits or benefit limitations that would affect benefits provided by the plan.

38. The accumulated benefit obligation shall be measured based on employees' history of service and compensation without an estimate of future compensation levels. Excluding estimated future compensation levels also means excluding indirect effects of future changes such as increases in the social security wage base. In measuring the accumulated benefit obligation, projected years of service shall be a factor only in determining employees' expected eligibility for particular benefits, such as:

a. Increased benefits that are granted provided a specified number of years of service are rendered

b. Early retirement benefits

c. Death benefits

d. Disability benefits

39. Automatic benefit increases specified by the plan (for example, automatic cost-of-living increases) that are expected to occur shall be included in measurements of the projected, accumulated, and vested benefit obligations, and the service cost component. Also, retroactive plan amendments shall be included in the computation of the projected and accumulated benefit obligations once they have been contractually agreed to, even if some provisions take effect only in future periods.

Measurement of Plan Assets

40. Plan investments, whether equity or debt securities, real estate, or other, shall be measured at their fair value as of the measurement date. The fair value of an investment shall be reduced by brokerage commissions and other costs normally incurred in a sale, if those costs are significant (similar to fair value less costs to sell).

41. Plan assets used in plan operations (for example, buildings, equipment, furniture and fixtures, and leasehold improvements) shall be measured at cost less accumulated depreciation or amortization for all purposes.

42. The measurements of plan assets and benefit obligations shall be as of the date of the employer’s fiscal year-end statement of financial position. Requiring that the pension measurements be as of a particular date is not intended to require that all procedures be performed after that date. As with other financial statement items requiring estimates, much of the information can be prepared as of an earlier date and projected forward to account for subsequent events (for example, employee service). Unless a business entity remeasures both its plan assets and benefit obligations during the fiscal year, the funded status it reports in its interim-period statement of financial position shall be the same asset or liability recognized in the previous year-end statement of financial position adjusted for (1) subsequent accruals of net periodic pension cost that exclude the amortization of amounts previously recognized in other unassigned funds (surplus) (for example, subsequent accruals of service cost, interest cost, and return on plan assets) and (2) contributions to a funded plan, or benefit payments. Sometimes, a business entity remeasures both plan assets and benefit obligations during the fiscal year. That is the case, for example,

when a significant event such as a plan amendment, settlement, or curtailment occurs that calls for a remeasurement. Upon remeasurement, a business entity shall adjust its statement of financial position in a subsequent interim period to reflect the overfunded or underfunded status of the plan consistent with that measurement date.

43. Measurements of net periodic pension cost for both interim and annual financial statements shall be based on the assumptions used for the previous year-end measurements unless more recent measurements of both plan assets and obligations are available or a significant event occurs, such as a plan amendment, that would ordinarily call for such measurements.

Employers with Two or More Plans

44. An employer that sponsors two or more separate defined benefit pension plans shall determine net periodic pension cost, liabilities, and assets by separately applying the provisions of this statement to each plan. In particular, unless an employer clearly has a right to use the assets of one plan to pay benefits of another, a liability required to be recognized for one plan shall not be reduced or eliminated because the employer has recognized an asset for another plan that has assets in excess of its projected benefit obligation. (As noted within paragraph 26, overfunded plans shall be aggregated for asset reporting (nonadmitted) and underfunded plans shall be aggregated for liability reporting.)

Annuity Contracts

45. An annuity contract is a contract in which an insurance company unconditionally undertakes a legal obligation to provide specified benefits to specific individuals in return for a fixed consideration or premium. An annuity contract is irrevocable and involves the transfer of significant risk from the employer to the insurance company. Some annuity contracts (participating annuity contracts) provide that the purchaser (either the plan or the employer) may participate in the experience of the insurance company. Under those contracts, the insurance company ordinarily pays dividends to the purchaser. If the substance of a participating contract is such that the employer remains subject to all or most of the risks and rewards associated with the benefit obligation covered and the assets transferred to the insurance company, that contract is not an annuity contract for purposes of this statement.

46. To the extent that benefits currently earned are covered by annuity contracts, the cost of those benefits shall be the cost of purchasing the contracts, except as provided in paragraph 49. That is, if all the benefits attributed by the plan's benefit formula to service in the current period are covered by nonparticipating annuity contracts, the cost of the contracts determines the service cost component of net pension cost for that period.

47. Benefits provided by the pension benefit formula beyond benefits provided by annuity contracts (for example, benefits related to future compensation levels) shall be accounted for according to the provisions of this statement applicable to plans not involving insurance contracts.

48. Benefits covered by annuity contracts shall be excluded from the projected benefit obligation and the accumulated benefit obligation. Except as provided in paragraph 49, annuity contracts shall be excluded from plan assets.

49. Some annuity contracts provide that the purchaser (either the plan or the employer) may participate in the experience of the insurance company. Under those contracts, the insurance company ordinarily pays dividends to the purchaser, the effect of which is to reduce the cost of the plan. The purchase price of a participating annuity contract ordinarily is higher than the price of an equivalent contract without participation rights. The difference is the cost of the participation right. The cost of the participation right shall be recognized at the date of purchase as a nonadmitted asset. In subsequent periods, the participation right shall be nonadmitted and measured at its fair value if the contract is such

that fair value is reasonably estimable. Otherwise, the participation right shall be measured at its amortized cost (not in excess of its net realizable value), and the cost shall be amortized systematically over the expected dividend period under the contract.

Other Contracts with Insurance Companies

50. Insurance contracts that are in substance equivalent to the purchase of annuities shall be accounted for as such. Other contracts with insurance companies shall be accounted for as investments and measured at fair value. For some contracts, the best available evidence of fair value may be contract value. If a contract has a determinable cash surrender value or conversion value, that is presumed to be its fair value.

Defined Benefit Plans – Settlements and Curtailments

51. A settlement is defined as a transaction that (a) is an irrevocable action, (b) relieves the employer (or the plan) of primary responsibility for a pension benefit obligation, and (c) eliminates significant risks related to the obligation and the assets used to effect the settlement. Examples of transactions that constitute a settlement include (a) making lump-sum cash payments to plan participants in exchange for their rights to receive specified pension benefits and (b) purchasing nonparticipating annuity contracts to cover vested benefits.

52. A transaction that does not meet all of the above three criteria does not constitute a settlement for purposes of this statement. For example, investing in a portfolio of high-quality fixed-income securities with principal and interest payment dates similar to the estimated payment dates of benefits may avoid or minimize certain risks. However, that does not constitute a settlement because the investment decision can be reversed and such a strategy does not relieve the employer (or the plan) of primary responsibility for a pension obligation nor does it eliminate significant risks related to the obligation.

Annuity Contracts

53. The definition of an annuity contract is included in paragraph 45. If the substance of a participating annuity contract is such that the employer remains subject to all or most of the risks and rewards associated with the benefit obligation covered or the assets transferred to the insurance company, the purchase of the contract does not constitute a settlement.

Curtailment

54. A curtailment is an event that significantly reduces the expected years of future service of present employees or eliminates for a significant number of employees the accrual of defined benefits for some or all of their future services. Curtailments include:

a. Termination of employees' services earlier than expected, which may or may not involve closing a facility or discontinuing a component of an entity.

b. Termination or suspension of a plan so that employees do not earn additional defined benefits for future services. In the latter situation, future service may be counted toward vesting of benefits accumulated based on past service.

Relationship of Settlements and Curtailments to Other Events

55. A settlement and a curtailment may occur separately or together. If benefits to be accumulated in future periods are reduced but the plan remains in existence and continues to pay benefits, to invest assets, and to receive contributions, a curtailment has occurred but not a settlement. If an employer purchases nonparticipating annuity contracts for vested benefits and continues to provide defined benefits for future

service, either in the same plan or in a successor plan, a settlement has occurred but not a curtailment. If a plan is terminated (that is, the obligation is settled and the plan ceases to exist) and not replaced by a successor defined benefit plan, both a settlement and a curtailment have occurred (whether or not the employees continue to work for the employer).

Accounting for Settlement of the Pension Obligation

56. The maximum gain or loss subject to recognition in earnings when a pension obligation is settled is the net gain or loss remaining in unassigned funds (surplus) plus any transition asset remaining in unassigned funds (surplus) from initial application of SSAP No. 89. That maximum amount includes any gain or loss first measured at the time of settlement. The maximum amount shall be recognized in earnings if the entire projected benefit obligation is settled. If only part of the projected benefit obligation is settled, the employer shall recognize in earnings a pro rata portion of the maximum amount equal to the percentage reduction in the projected benefit obligation.

57. If the purchase of a participating annuity contract constitutes a settlement, the maximum gain (but not the maximum loss) shall be reduced by the cost of the participation right before determining the amount to be recognized in earnings.

58. If the cost of all settlements in a year is less than or equal to the sum of the service cost and interest cost components of net periodic pension cost for the plan for the year, gain or loss recognition is permitted but not required for those settlements. However, the accounting policy adopted shall be applied consistently from year to year.

Accounting for a Plan Curtailment

59. The prior service cost included in unassigned funds (surplus) associated with years of service no longer expected to be rendered as the result of a curtailment is a loss. For example, if a curtailment eliminates half of the estimated remaining future years of service of those who were employed at the date of a prior plan amendment and were expected to receive benefits under the plan, then the loss associated with the curtailment is half of the prior service cost included in unassigned funds (surplus) related to that amendment that has not been amortized as a component of net periodic pension cost. For purposes of applying the provisions of this paragraph, prior service cost includes the cost of retroactive plan amendments and any transition obligation remaining in unassigned funds (surplus) from initial application of SSAP No. 89.

60. The projected benefit obligation may be decreased (a gain) or increased (a loss) by a curtailment.

a. To the extent that such a gain exceeds any net loss included in unassigned funds (surplus) (or the entire gain, if a net gain exists), it is a curtailment gain.

b. To the extent that such a loss exceeds any net gain included in unassigned funds (surplus) (or the entire loss, if a net loss exists), it is a curtailment loss.

For purposes of applying the provisions of this paragraph, any transition asset remaining in unassigned funds (surplus) from initial application of SSAP No. 89 shall be treated as a net gain and shall be combined with the net gain or loss arising subsequent to transition to SSAP No. 89.

61. If the sum of the effects identified in paragraphs 59 and 60 is a net loss, it shall be recognized in earnings when it is probable that a curtailment will occur and the effects described are reasonably estimable. If the sum of those effects is a net gain, it shall be recognized in earnings when the related employees terminate or the plan suspension or amendment is adopted.

Termination Benefits

62. An employer may provide benefits to employees in connection with their termination of employment. They may be either special termination benefits offered only for a short period of time or contractual termination benefits required by the terms of a plan only if a specified event, such as a plant closing, occurs. An employer that offers special termination benefits to employees shall recognize a liability and a loss when the employees accept the offer and the amount can be reasonably estimated. An employer that provides contractual termination benefits shall recognize a liability and a loss when it is probable that employees will be entitled to benefits and the amount can be reasonably estimated. Termination benefits may take various forms including lump-sum payments, periodic future payments, or both. They may be paid directly from an employer's assets, an existing pension plan, a new employee benefit plan, or a combination of those means. The cost of termination benefits recognized as a liability and a loss shall include the amount of any lump-sum payments and the present value of any expected future payments. A situation involving termination benefits may also involve a curtailment to be accounted for under paragraphs 59-61.

Disclosures – Single-Employer Defined Benefit Plans

63. An employer that sponsors one or more defined benefit pension plans or one or more other defined benefit postretirement plans shall provide the following information, separately for pension plans and other postretirement benefit plans. Amounts related to the employer’s results of operations shall be disclosed for each period for which a statement of income is presented. Amounts related to the employer’s statement of financial position, shall be disclosed as of the date of each statement of financial position presented.

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

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

c. The funded status of the plans and the amounts recognized in the statement of financial position, showing separately the assets and liabilities recognized.

d. The objectives of the disclosures about postretirement benefit plan assets are to provide users of financial statements with an understanding of:

   i. How investment allocation decisions are made, including the factors that are pertinent to an understanding of investment policies and strategies

   ii. The classes of plan assets

   iii. The inputs and valuation techniques used to measure the fair value of plan assets

   iv. The effect of fair value measurements using significant unobservable inputs (Level 3) on changes in plan assets for the period

v. Significant concentrations of risk within plan assets.

An employer shall consider those overall objectives in providing the following information about plan assets:

(a) A narrative description of investment policies and strategies, including target allocation percentages or range of percentages considering the classes of plan assets disclosed pursuant to (b) below, as of the latest statement of financial position presented (on a weighted-average basis for employers with more than one plan), and other factors that are pertinent to an understanding of those policies and strategies such as investment goals, risk management practices, permitted and prohibited investments including the use of derivatives, diversification, and the relationship between plan assets and benefit obligations. For investment funds disclosed as classes as described in (b) below, a description of the significant investment strategies of those funds shall be provided.

(b) The fair value of each class of plan assets as of each date for which a statement of financial position is presented. Asset classes shall be based on the nature and risks of assets in an employer's plan(s). Examples of classes of assets could include, but are not limited to, the following: cash and cash equivalents; equity securities, (segregated by industry type, company size, or investment objective); debt securities, issued by national, state, and local governments; corporate debt securities; asset-backed securities; structured debt; derivatives on a gross basis (segregated by type of underlying risk in the contract, for example, interest rate contracts, foreign exchange contracts, equity contracts, commodity contracts, credit contracts, and other contracts); investment funds (segregated by type of fund); and real estate. Those examples are not meant to be all inclusive. An employer should consider the overall objectives in paragraph 63.d. in determining whether additional classes of plan assets or further disaggregation of classes should be disclosed.

(c) A narrative description of the basis used to determine the overall expected long-term rate-of-return-on-assets assumption, such as the general approach used, the extent to which the overall rate-of-return-on-assets assumption was based on historical returns, the extent to which adjustments were made to those historical returns in order to reflect expectations of future returns, and how those adjustments were determined. The description should consider the classes of assets described in (b) above, as appropriate.

(d) Information that enables users of financial statements to assess the inputs and valuation techniques used to develop fair value measurements of plan assets at the reporting date. For fair value measurements using significant unobservable inputs, an employer shall disclose the effect of the measurements on changes in plan assets for the period. To meet those objectives, the employer shall disclose the following information for each class of plan assets disclosed pursuant to (b) above for each annual period:

(1) The level within the fair value hierarchy in which the fair value measurements in their entirety fall,[3] segregating fair value measurements using quoted prices in active markets for identical assets or liabilities (Level 1), significant other observable inputs (Level 2), and significant unobservable inputs (Level 3)

(2) For fair value measurements of plan assets using significant unobservable inputs (Level 3), a reconciliation of the beginning and ending balances, separately presenting changes during the period attributable to the following:

(i) Actual return on plan assets, separately identifying the amount related to assets still held at the reporting date and the amount related to assets sold during the period

(ii) Purchases, sales, and settlements, net

(iii) Transfers in and/or out of Level 3 (for example, transfers due to changes in the observability of significant inputs)

(3) Information about the valuation technique(s) and inputs used to measure fair value and a discussion of changes in valuation techniques and inputs, if any, during the period.

e. For defined benefit pension plans, the accumulated benefit obligation.

f. The benefits (as of the date of the latest statement of financial position presented) expected to be paid in each of the next five fiscal years, and in the aggregate for the five fiscal years thereafter. The expected benefits should be estimated based on the same assumptions used to measure the company's benefit obligation at the end of the year and should include benefits attributable to estimated future employee service.

g. The employer's best estimate, as soon as it can reasonably be determined, of contributions expected to be paid to the plan during the next fiscal year beginning after the date of the latest statement of financial position presented. Estimated contributions may be presented in the aggregate combining (1) contributions required by funding regulations or laws, (2) discretionary contributions, and (3) noncash contributions.

h. The amount of net benefit cost recognized, showing separately the service cost component, the interest cost component, the expected return on plan assets for the period, the gain or loss component, the prior service cost or credit component, the transition asset or obligation component, and the gain or loss recognized due to settlements or curtailments.

i. Separately the net gain or loss and net prior service cost or credit recognized in unassigned funds (surplus) for the period pursuant to paragraphs 15 and 19 and reclassification adjustments of unassigned funds (surplus) for the period, as those

[3] In some cases, the inputs used to measure fair value might fall in different levels of the fair value hierarchy. The level in the fair value hierarchy within which the fair value measurement in its entirety falls shall be determined based on the lowest level input that is significant to the fair value measurement in its entirety. Assessing the significance of a particular input to the fair value measurement in its entirety requires judgment, considering factors specific to the asset or liability.

amounts, including amortization of the net transition asset or obligation, are recognized as components of net periodic benefit cost.

j. The amounts in unassigned funds (surplus) that have not yet been recognized as components of net periodic benefit cost, showing separately the net gain or loss, net prior service cost or credit, and net transition asset or obligation.

k. On a weighted-average basis, the following assumptions used in the accounting for the plans: assumed discount rates, rates of compensation increase (for pay-related plans), and expected long-term rates of return on plan assets specifying, in a tabular format, the assumptions used to determine the benefit obligation and the assumptions used to determine net benefit cost.

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

m. If applicable, any alternative method used to amortize prior service amounts or net gains and losses pursuant to paragraphs 16 and 23.

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

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

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

q. The amounts in unassigned funds (surplus) expected to be recognized as components of net periodic benefit cost over the fiscal year that follows the most recent annual statement of financial position presented, showing separately the net gain or loss, net prior service cost or credit, and net transition asset or obligation.

r. The amount and timing of any plan assets expected to be returned to the employer during the 12-month period, or operating cycle if longer, that follows the most recent annual statement of financial position presented.

Disclosures – Employers with Two or More Defined Benefit Plans

64. The disclosures required by this statement shall be aggregated for all of an employer’s defined benefit pension plans and for all of an employer’s other defined benefit postretirement plans unless disaggregating in groups is considered to provide useful information or is otherwise required by this paragraph and paragraph 65. Disclosures shall be as of the date of each statement of financial position presented. Disclosures about pension plans with assets in excess of the accumulated benefit obligation generally may be aggregated with disclosures about pension plans with accumulated benefit obligations in excess of assets. The same aggregation is permitted for other postretirement benefit plans. If aggregate disclosures are presented, an employer shall disclose:

a. The aggregate benefit obligation and aggregate fair value of plan assets for plans with benefit obligations in excess of plan assets as of the measurement date of each statement of financial position presented.

b. The aggregate pension accumulated benefit obligation and aggregate fair value of plan assets for pension plans with accumulated benefit obligations in excess of plan assets.

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

Interim Financial Disclosures –Defined Benefit Plans

66. The following shall be disclosed within interim financial statements that include a statement of income:

a. The amount of net periodic benefit cost recognized, for each period for which a statement of income is presented, showing separately the service cost component, the interest cost component, the expected return on plan assets for the period, the gain or loss component, the amount of prior service cost or credit component, the transition asset or obligation component, and the gain or loss recognized due to a settlement or curtailment.

b. The total amount of the employer’s contributions paid, and expected to be paid, during the current fiscal year, if significantly different from amounts previously disclosed pursuant to paragraph 63.g. Estimated contributions may be presented in the aggregate combining (1) contributions required by funding regulations or laws, (2) discretionary contributions, and (3) noncash contributions.

Defined Contribution Plans

67. A defined contribution pension plan is a plan that provides pension benefits in return for services rendered, provides an individual account for each participant, and has terms that specify how contributions to the individual's account are to be determined rather than the amount of pension benefits the individual is to receive. Under a defined contribution plan, the pension benefits a participant will receive depend only on the amount contributed to the participant's account, the returns earned on investments of those contributions, and forfeitures of other participants' benefits that may be allocated to the participant's account.

68. To the extent that a plan's defined contributions to an individual's account are to be made for periods in which that individual renders services, the net pension cost for a period shall be the contribution called for in that period. If a plan calls for contributions for periods after an individual retires or terminates, the estimated cost shall be accrued during the employee's service period.

69. A pension plan having characteristics of both a defined benefit plan and a defined contribution plan requires careful analysis. If the substance of the plan is to provide a defined benefit, as may be the case with some "target benefit" plans, the accounting requirements shall be determined in accordance with the provisions applicable to a defined benefit plan and the disclosure requirements within paragraph 63 shall be followed.

Disclosures - Defined Contribution Plans

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

Multiemployer Plans

71. A multiemployer plan is a pension plan to which two or more unrelated employers contribute, usually pursuant to one or more collective-bargaining agreements. A characteristic of multiemployer plans is that assets contributed by one participating employer may be used to provide benefits to employees of other participating employers since assets contributed by an employer are not segregated in a separate account or restricted to provide benefits only to employees of that employer.

72. A reporting entity participating in a multiemployer plan shall recognize as net pension cost the required contribution for the period and shall recognize as a liability any contributions due and unpaid.

73. In some situations, withdrawal from a multiemployer plan may result in a reporting entity having an obligation to the plan for a portion of its unfunded benefit obligations. If withdrawal under circumstances that would give rise to an obligation is either probable or reasonably possible, the provisions of *SSAP No. 5R—Liabilities, Contingencies and Impairment of Assets* (SSAP No. 5R) shall apply.

Disclosures - Multiemployer Plans

74. A reporting entity shall disclose the amount of contributions to multiemployer plans for each annual period for which a statement of income is presented. A reporting entity may disclose total contributions to multiemployer plans without disaggregating the amounts attributable to pension plans and other postretirement benefit plans. The disclosures shall include a description of the nature and effect of any changes affecting comparability, such as a change in the rate of employer contributions, a business combination, or a divestiture. This disclosure shall identify whether the contributions represent more than 5 percent of total contributions to the plan as indicated in the plan's most recently available annual report.

75. In addition to the requirements of paragraph 74, the following information shall be disclosed:

a. Whether a funding improvement plan or rehabilitation plan had been implemented or is pending.

b. Whether the reporting entity paid a surcharge to the plan.

c. A description of minimum contributions required for future periods, if applicable.

d. A qualitative description of the extent to which the employer could be responsible for the obligations of the plan, including benefits earned by employees during employment with another employer.

~~75.~~76. In some situations, withdrawal from a multiemployer plan may result in a reporting entity having an obligation to the plan for a portion of the unfunded benefit obligation of the pension plans and other postretirement benefit plans. If withdrawal under circumstances that would give rise to an obligation is either probable or reasonably possible, the provisions of SSAP No. 5R shall apply. If it is either probable or reasonably possible that (a) an employer would withdraw from the plan under circumstances that would give rise to an obligation or (b) an employer's contribution to the fund would be increased during the remainder of the contract period to make up a shortfall in the funds necessary to maintain the negotiated level of benefit coverage (a "maintenance of benefits" clause), the employer shall apply the provisions and disclosures of SSAP No. 5R.

Multiple-Employer Plans

~~76.~~77. Some pension plans to which two or more unrelated employers contribute are not multiemployer plans. Rather, they are in substance aggregations of single-employer plans combined to allow participating employers to pool their assets for investment purposes and to reduce the costs of plan administration. Those plans ordinarily do not involve collective-bargaining agreements. They may also have features that allow participating employers to have different benefit formulas, with the employer's contributions to the plan based on the benefit formula selected by the employer. Such plans shall be considered single-employer plans rather than multiemployer plans, and each reporting entity's accounting shall be based on its respective interest in the plan.

Non-U.S. Pension Plans

~~77.~~78. Except for its effective date, this statement includes no special provisions applicable to pension arrangements outside the United States. To the extent that those arrangements are in substance similar to pension plans in the United States, they are subject to the provisions of this statement. The substance of an arrangement is determined by the nature of the obligation and by the terms or conditions that define the amount of benefits to be paid, not by whether (or how) a plan is funded, whether benefits are payable at intervals or as a single amount, or whether the benefits are required by law or custom or are provided under a plan the employer has elected to sponsor.

~~78.~~79. It is customary or required in some countries to provide benefits in the event of a voluntary or involuntary severance of employment (also called termination indemnities). If such an arrangement is in substance a pension plan (for example, if the benefits are paid for virtually all terminations), it is subject to the provisions of this statement.

Business Combinations

~~79.~~80. When an employer is acquired in a business combination and that employer sponsors a single-employer defined benefit pension plan, the assignment of the purchase price to individual assets acquired and liabilities assumed shall include a liability for the projected benefit obligation in excess of plan assets or an asset for plan assets in excess of the projected benefit obligation, thereby eliminating any previously existing net gain or loss, prior service cost or credit, or transition asset or obligation recognized in unassigned funds (surplus). If it is expected that the plan will be terminated or curtailed, the effects of those actions shall be considered in measuring the projected benefit obligation.

Consolidated/Holding Company Plans

~~80.~~81. The employees of many reporting entities are members of a plan sponsored by a parent company or holding company. A reporting entity who participates in these plans and is not directly liable for obligations under the plan shall recognize pension expense equal to its allocation from the holding company or parent company of the required contribution to the plan for the period. A liability shall be established for any such contributions due and unpaid. Furthermore, the reporting entity shall disclose in the notes to the financial statements that its employees participate in a plan sponsored by the holding company for which the reporting entity has no legal obligation. The amount of expense incurred and the allocation methodology utilized by the provider of such benefits shall also be disclosed. If the reporting entity is directly liable for obligations under the plan, then the requirements outlined above in paragraphs 1-80~~79~~ and ~~82-90~~83-91 of this statement shall be applied.

Relevant Literature

~~81.~~82. This statement adopts with modification paragraphs 1-7 and 16-17 as well as Appendix C – Amendments to Statements 87 and 88 and Appendix E – Amendments to Statement 132(R) of *FASB Statement No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106 and 132(R)* (FAS 158). Paragraphs 8-10 providing specific guidance for not-for-profit organizations is rejected. Paragraphs 11-15 regarding the effective dates for FAS 158 is rejected and paragraph 19 providing an alternative method for remeasuring plan assets and benefits obligations as of the fiscal year the measurement date provisions are applied is also rejected. Appendix D – Amendments to Statement 106 has not been incorporated within this statutory statement as it will be considered in accordance with revisions to *SSAP No. 14—Postretirement Benefits Other Than Pensions* (SSAP No. 14). Disclosures included within FAS 132(R), as amended by FAS 158, pertaining to health care (paragraphs 5.l. and 5.m.) have been rejected for inclusion within this standard, but will also be considered in accordance with revisions to SSAP No. 14. This statement adopts the revisions to paragraph 5.d. of FAS 132(R) as amended by *FASB Staff Position FAS 132(R)-1, Employers' Disclosures about Postretirement Benefit Plan Assets* (FSP FAS 132(R)-1) and *ASU 2010-06, Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements* (ASU 2010-06). Other revisions to disclosures requirements as amended by FSP FAS 132(R)-1 relate to nonpublic entities and are rejected. This statement adopts by reference revisions to ASC 715-80 as detailed in *ASU 2011-09, Compensation – Retirement Benefits – Multiemployer Plans* with limited additional disclosures required within statutory financial statements. This statement adopts by reference *FSP FASB 158-1, Conforming Amendments to the Illustrations in FASB Statements No. 87, No. 88, and No. 106 and to the Related Staff Implementation Guides* (FSP FAS 158-1) to the extent that the examples and related implementation guides comply with the adopted GAAP guidance previously identified within this statement, as modified for statutory accounting. The following modifications from the adopted paragraphs of FAS 158 have been incorporated within this standard:

a. All references to 'other comprehensive income' or 'accumulated other comprehensive income' within FAS 158 have been revised to reflect unassigned funds (surplus).

b. Any prepaid asset resulting from the excess of the fair value of plan assets over the projected benefit obligation shall be nonadmitted. Furthermore, any asset recognized from the cost of a 'participation right' of an annuity contract per paragraph 49 shall also be nonadmitted.

c. Provisions within paragraph 30 of FAS 87, as amended by FAS 158, permitting a market-related value of plan assets have been eliminated with only the fair value measurement method for plan assets being retained.

d. The reduced disclosure requirements for nonpublic entities described in paragraph 8 of FAS 132(R), as amended by FAS 158, are rejected. All reporting entities shall follow the disclosure requirements included in paragraph 5 of FAS 132(R) as amended by FAS 158.

e. Clarification has been included within this standard to ensure both vested and nonvested employees are included within the recognition of net periodic pension cost and in the pension benefit obligation. Although this is consistent with GAAP, this is a change from previous statutory accounting. As nonvested employees were excluded from statutory accounting under SSAP No. 89, guidance has been included to indicate that the unrecognized prior service cost attributed to nonvested individuals is not required to be included in net periodic pension cost entirely in the year this standard is adopted. The unrecognized prior service cost for nonvested employees shall be amortized as a component of net periodic pension cost by assigning an equal amount to each expected future period of service before vesting occurs for nonvested employees active at the date of the amendment. Unassigned funds (surplus) is then adjusted each period as prior service cost is amortized. (Guidance is included within the transition related to the recognition of the prior service cost for nonvested employees through unassigned funds (surplus).)

f. Conclusion of *Interpretation 04-12: EITF 03-4: Determining the Classification and Benefit Attribution Method for a "Cash Balance" Pension Plan* (INT 04-12) indicating that 'cash balance' plans are considered defined benefit plans has been incorporated within paragraph 3 of this statement.

g. Conclusion of *Interpretation 99-26: Offsetting Pension Assets and Liabilities* (INT 99-26) prohibiting the offset of defined benefit liabilities of one plan with prepaid assets of another plan has been incorporated within paragraph 26 of this statement.

h. Provisions within paragraph 36 of FAS 87, as amended by FAS 158, regarding the classification of underfunded liabilities as current or noncurrent liabilities and the classification of assets from overfunded plans as noncurrent assets has been rejected as inconsistent with statutory accounting.

i. Provisions within paragraph 49 of FAS 87, as amended by FAS 158, defining the fair value of investments have been rejected. Fair value definitions and measurement for investments shall be determined in accordance with statutory accounting guidance.

j. Provisions within paragraph 52 of FAS 87, as amended by FAS 158, regarding the plan assets measurement date for consolidating subsidiaries or entities utilizing the equity method under APB Opinion No. 18 has been rejected. For statutory accounting, all entities shall follow the measurement date guidance within paragraph 42 of this statement.

k. Transition under FAS 158 is different from this statement. FAS 158 requires entities with publicly traded equity securities to initially apply the requirement to recognize the funded status of a benefit plan; the gains/losses, prior service costs/credits and transition obligations/assets that have not yet been included in net periodic benefit cost; and the disclosure requirements as of the end of the fiscal year ending after December 15, 2006. Transition guidelines for statutory accounting are defined in paragraphs ~~82-90~~83-91.

l. FAS 158 provided two approaches for an employer to transition to a fiscal year-end measurement date. For purposes of statutory accounting, the second approach permitting reporting entities to use earlier measurements determined for year-end reporting as of the fiscal year immediately preceding the year that the measurement date provisions is rejected. For consistency purposes, all reporting entities shall follow the first approach and remeasure plan assets and benefit obligations as of the beginning of the fiscal year that the measurement date provisions are applied.

Effective Date and Transition

~~82.~~83. Reporting entities are required to disclose the projected benefit obligation, the accumulated benefit obligation and the fair value of plan assets for defined benefit pension plans in the first reporting period after the effective date of this standard and in each subsequent reporting period. This disclosure shall specifically note the funded/underfunded status of the pension plan based on the projected benefit obligation. Reporting entities shall also specifically note the surplus impact necessary, at each reporting date, to reflect the full projected benefit obligation within the financial statements.

~~83.~~84. This statement is effective for quarterly and annual reporting periods beginning on or after January 1, 2013 (transition date) with early adoption permitted. Any unfunded defined benefit pension amounts, as determined when the projected benefit obligation exceeds the fair value of plan assets, is a liability under SSAP No. 5R and shall be reported in the first quarter statutory financial statements after the transition date with a corresponding entry to unassigned funds (surplus). If the fair value of plan assets exceeds the projected benefit obligation, the asset shall be considered a nonadmitted asset. Net periodic pension cost shall include a component for unrecognized prior service cost for nonvested employees beginning in 2013.

~~84.~~85. Gains or losses, prior service costs or credits (including prior service costs for non-vested participants pursuant to paragraph 11), and remaining transition assets or obligations from prior application of SSAP No. 89 (collectively referred to as "unrecognized items") that have not yet been included in net periodic benefit cost as of December 31, 2012[4] shall be recognized as components of the balance of unassigned funds (surplus), net of tax, as of January 1, 2013 (provided that alternative transition is not elected per paragraph ~~85~~86.b.). The offset to unassigned funds is reported separately as an "Aggregate Write-In for Other-Than-Invested Assets" or as an "Aggregate Write-In for Other Liabilities." After recognition, the full unfunded or overfunded status of the plan shall be reflected within the financial statements.[5] Any prepaid asset resulting from an overfunded plan shall be nonadmitted.

~~85.~~86. Due to the potential impact to surplus as a result of immediately applying the accounting guidance in paragraph ~~84~~85, reporting entities may elect one of the following two methods, on an individual plan basis, to recognize the transition surplus impact:

a. Reporting entities may elect to recognize the entire transition surplus impact calculated from applying paragraph ~~84~~85, on an individual plan basis, as of January 1, 2013.

b. Alternatively, reporting entities may elect to recognize the entire surplus impact from applying paragraph ~~84~~85, on an individual plan basis, over a period not to exceed ten (10) years. The surplus impact initially recognized as of January 1, 2013, under this transition option, and subsequently over the transition period, shall be the greater of:

i. Ten percent of the calculated surplus impact as of the transition date;

ii. Amortization[6] of the "unrecognized items" (defined in paragraph ~~84~~85) into net periodic pension cost, including any accelerated amortization of these items from curtailments or settlements that occur after the transition date. (If the amortization cannot be determined at transition, at a minimum, the amount amortized for "unrecognized items" during the prior year shall be utilized for this component of the calculation. If the amount recognized for transition (greater of

[4] The intent of the guidance is to recognize the unrecognized amounts as of December 31, 2012, annual statements, even if new actuarial projections (accumulated benefit obligation/projected benefit obligation amounts) are calculated as of January 1, 2013. (These projections would be considered in the recognition of the 2013 pension cost.)

[5] Upon the effective date of this statement, reporting entities are required to reflect the full unfunded or overfunded status of their defined benefit pension plans. As such, the concept of an "additional minimum liability" previously reflected in *SSAP No. 89—Pensions* is not incorporated within this statement. If an additional minimum liability (and a corresponding intangible asset) had been recognized under SSAP No. 89, such items shall be eliminated with the implementation of this statement, and the guidance in paragraph ~~85~~86 shall be followed. The elimination of any additional minimum liability and corresponding intangible asset shall also occur if the entity elects the transition option reflected in paragraph ~~85~~86.b.

[6] Unless otherwise impacted from the provisions within this statement or in accordance with changes to the pension plan, the amortization of the unrecognized items into net periodic pension cost shall continue to follow the existing amortization schedules in effect on the transition date.

all three components in paragraph ~~85~~86.b.) is subsequently determined to be less than what is amortized for the year (~~85~~86.b.ii.), the difference between what was recognized for transition, and what is amortized must immediately be recognized as an adjustment to the transition impact to unassigned funds (surplus);

iii. Amount necessary to establish a total liability that is equal to any unfunded accumulated benefit obligation (the accumulated benefit obligation less the fair value of plan assets).[7]

If the surplus deferral is elected at the transition date, subsequently, starting with the 2014 year-end financial statement, the reporting entity shall annually recognize the remaining surplus impact (collectively referred to as the "transition liability"[8]) on a systematic basis over a period not to exceed nine years. The minimum amount recognized each subsequent year shall be an amount that reflects the conditions within paragraph ~~85~~86.b. Additionally, reporting entities must recognize any remaining transition liability to the extent that the plan reflects a prepaid benefit cost. (For example, if changes in circumstances have resulted with the plan reflecting an overfunded status, the remaining transition liability must be recognized to the extent that the plan is overfunded.) Furthermore, if circumstances result with a subsequent gain attributed to the plan that will be recognized in earnings, the entity must recognize an additional amount of the remaining transition liability to offset the recognized gain.[INT 13-03] Reporting entities are permitted to recognize the remaining transition liability, or an amount in excess of the minimum requirement, at any time after the transition date. This transition guidance is specific to the transition surplus impact from initially applying this statement on January 1, 2013. Thus, this transition guidance does not apply to additional liability calculated from subsequent comparison of the fair value of plan assets to the projected benefit obligation, or the impact of subsequent plan amendments.

~~86.~~87. Reporting entities electing to apply the transition guidance in paragraph ~~85~~86.b. must disclose the full transition surplus impact calculated from applying paragraph ~~84~~85 in the first quarter statutory financial statements after the transition date and each reporting period thereafter. This disclosure shall include the initial "transition liability" calculated under paragraph ~~84~~85, the annual amortization amount of the "unrecognized items" into net periodic pension cost, the amount of the unfunded accumulated benefit obligation, and the remaining unrecognized transition impact. This disclosure shall include a schedule of the entity's anticipated recognition of the remaining surplus impact over the transition period.

~~87.~~88. The requirement to measure plan assets and benefit obligations as of the date of the reporting entity's financial statement year-end is effective for financial statement years beginning January 1, 2014. (The measurement date change will be initially reflected in the December 31, 2014 financial statements.)

~~88.~~89. In order to transition to a fiscal year-end measurement date, the reporting entity shall remeasure plan assets and benefit obligations as of the beginning of the fiscal year that the measurement date

[7] The intent of this standard is to ensure that under the deferral option the liability initially recognized for an unfunded plan reflects the minimum liability previously recognized under SSAP No. 89. For any instances in which an additional minimum liability recognized under SSAP No. 89 is greater than the unfunded ABO at transition, an amount equal to the previously recognized additional minimum liability shall be used in determining this component of ~~85~~86.b.iii. The deferral option under this standard is not intended to allow a surplus benefit to be recognized at initial transition for an unfunded plan.

[8] If the surplus deferral from paragraph ~~85~~86.b. is elected, the deferred liability, although comprised of the previous "unrecognized items" shall be collectively referred to as the "transition liability." Although reporting entities will need to continue to track the unrecognized items for amortization into net periodic cost (offset through unassigned funds), reporting entities shall not allocate the recognized surplus impact from transition to these categories. As noted in paragraph ~~85~~86.b.ii., the minimum amount of liability recognized under the deferral option must cover the annual amortization of the "unrecognized items" into net periodic pension cost to prevent a surplus benefit.

provisions are applied. The reporting entity shall use those new measurements to determine the effects of the measurement date change as of the beginning of the fiscal year that the measurement date provisions are applied.

~~89.~~90. The reporting entity shall measure plan assets and benefit obligations as of the beginning of the fiscal year that the measurement date provisions are applied. This would result with the following:

a. Net periodic benefit cost for the period between the measurement date that is used for the immediately preceding fiscal year-end and the beginning of the fiscal year that the measurement date provisions are applied, exclusive of any curtailment or settlement gain or loss, shall be recognized, net of tax, as a separate adjustment of the opening balance unassigned funds (surplus). That is, the pretax amount recognized as an adjustment to unassigned funds (surplus) is the net periodic benefit cost that without a change in measurement date otherwise would have been recognized on a delayed basis during the first interim period for the fiscal year that the measurement date provisions are applied.

b. Any gain or loss arising from a curtailment or settlement between the measurement date that is used for the immediately preceding fiscal year-end and the beginning of the fiscal year that the measurement date provisions are applied shall be recognized in earnings in that period and not as an adjustment to unassigned funds (surplus). This provision prohibits a reporting entity from early application of the measurement date provisions when the reporting entity has issued financial statements for the prior year without recognition of such a settlement or curtailment.

c. Other changes in the fair value of plan assets and the benefit obligations (for example, gains or losses) for the period between the measurement date that is used for the immediately preceding fiscal year-end and the beginning of the fiscal year that the measurement date provisions are applied shall be recognized, net of tax, as a separate adjustment of the opening balance of unassigned funds (surplus) for the fiscal year that the measurement date provisions are applied.

~~90.~~91. Earlier application of the recognition or measurement date provisions is encouraged, however, early applications must be for all of the reporting entity's benefit plans. If early application is elected, the transition date shall reflect the January 1st of the year in which this standard is initially applied. Retrospective application is not permitted.

REFERENCES

Other

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *SSAP No. 89—Accounting for Pensions, A Replacement of SSAP No. 8*

Relevant Issue Papers

- *Issue Paper No. 8—Accounting for Pensions*
- *Issue Paper No. 123—Accounting for Pensions, A Replacement of SSAP No. 8*
- *Issue Paper No. 132—Accounting for Pensions, A Replacement of SSAP No. 89*

EXHIBIT A - IMPLEMENTATION GUIDE

Note: After transition, new "unrecognized" amounts will be reflected in the year-end funded status, but not yet reflected in unassigned funds. Therefore additional entries will be needed at the end of each year to recognize these new "unrecognized" amounts in unassigned funds. (An example includes gains and losses that will be included in unassigned funds (surplus), but not recognized in net periodic pension cost if they do not exceed 10% of the greater of the projected benefit obligation or the fair value of plan assets.) The entries in the implementation guide focus on the transition impact, and subsequent entries for "unrecognized" items have not been included within the illustrations.

Transition Implementation

1. Overfunded Plan with Prepaid Benefit Cost

Consideration of contributions or tax effects are not reflected in this example.

Example 1	**Dec. 31, 2012**	**Jan. 1, 2013**
Accumulated Benefit Obligation	$(6,240)	$(6,240)
Plus: Non-Vested Liability	(100)*	(100)
Total Accumulated Benefit Obligation	$(6,340)	$(6,340)
Projected Benefit Obligation	$(6,437)	$(6,437)
Plus: Non-Vested Liability	(100)	(100)
Total PBO	$(6,537)	$(6,537)
Plan Assets at Fair Value	$9,268	$9,268
Funded Status	$2,731	$2,731
Transition Obligation / (Asset)	$36	
Prior Service Cost	214	
Prior Service Cost (Non-Vested)	100	
Unrecognized Losses / (Gains)	2,465	
Total Unrecognized Items	$2,815	-
Net Overfunded Plan Asset / (Liability for Benefits)	$5,546	$2,731

*The amount shown for December 31, 2012 reflects the non-vested liability, which must be considered at transition under SSAP No. 102. However, the non-vested liability is not a factor in the December 31, 2012, financial statements under SSAP No. 89.

Overfunded Plan Asset and Liability for Benefits are terms to reflect the overfunded and unfunded status of the plan. For the amounts shown as of December 31, 2012, immediately prior to the effective date of the new standard, these terms reflect the balance sheet position. As overfunded plan assets are not admitted, these prepaids shall be reflected within Aggregate Write-Ins for Other-Than-Invested Assets. Transition liabilities recognized that have not been reflected through expense shall be reflected within Aggregate Write-Ins for Liabilities.

1a. January 1, 2013 – Transition Date - Recognize "Unrecognized Items"

1.	Unassigned Funds – Transition Obligation	36
	Unassigned Funds – Prior Service Cost	214
	Unassigned Funds – Prior Service Cost (Nonvested)	100

Unassigned Funds – Unrecognized Losses 2,465
Overfunded Plan Asset 2,815
(Aggregate Write-Ins for Other-Than-Invested Assets)

For this plan, which is overfunded by more than the unrecognized liabilities, the entry at transition will be netted against the existing prepaid with an offset to unassigned funds.

2. Change in Nonadmitted - Overfunded Plan Asset 2,815
(Aggregate Write-Ins for Other-Than-Invested Assets)
Unassigned Funds 2,815

This entry illustrates the impact to the "change in nonadmitted" as a result of the decline in overfunded plan assets. For this particular example, with the transition entry to unassigned funds and the impact to nonadmitted assets, there is no surplus impact at transition.

1b. December 31, 2013 – Recognition of Periodic Pension Cost

After transition, recognition of net periodic pension cost includes 1) service cost, 2) interest cost, 3) expected return on plan assets, 4) amortization of prior service cost included in unassigned funds, 5) amortization of gains and losses and f) amortization of any transition asset or obligation remaining in unassigned funds.

(Per paragraph ~~85~~86, if surplus deferral is elected at transition, beginning with 2014 annual financials, the entity shall recognize the remaining surplus impact on a systematic basis over a period not to exceed the remaining nine years. As, this illustration is in an overfunded status, there is no surplus deferral. Recognition of net periodic cost, including amortization of the "unrecognized items" will occur each year regardless if surplus deferral is elected.)

Components of Net Periodic Cost	**Dec. 31, 2013**
Service Cost	550
Interest Cost	150
Expected Return on Plan Assets	(250)
Total	*450*
Amortization of:	
o Transition Obligation	7.2
o Prior Service Cost	42.8
o Prior Service Cost (nonvested)	20
o Unrecognized Losses	493
Total	*563*
Total Net Periodic Pension Cost	**1,013**

1. Net Periodic Pension Cost 1,013
Prepaid Benefit Cost 1,013
(Aggregate Write-Ins for Other-Than-Invested Assets)

This entry recognizes the periodic pension cost with an offset to the prepaid pension asset. (A prepaid benefit cost is created when cumulative contributions to a pension plan exceed cumulative net periodic pension costs. Thus, a prepaid benefit cost can only be reduced through the recognition of pension cost.)

2. Overfunded Plan Asset	563	
(Aggregate Write-Ins for Other-Than-Invested Assets)		
Unassigned Funds – Transition Obligation		7.2
Unassigned Funds – Prior Service Cost		42.8
Unassigned Funds – Prior Service Cost (Nonvested)		20
Unassigned Funds – Unrecognized Losses		493

This entry recognizes the transition amounts amortized through net periodic pension cost. The offset is to unassigned funds (as unassigned funds was used for the initial recognition of the unrecognized items). As this plan continues to be overfunded, these amounts are offset to overfunded plan assets.

3. Change in Nonadmitted - Prepaid Benefit Cost	1,013	
(Aggregate Write-Ins for Other-Than-Invested Assets)		
Unassigned Funds		1,013

This entry illustrates the impact of the change in nonadmitted prepaid benefit cost to unassigned funds.

4. Unassigned Funds	563	
Change in Nonadmitted – Overfunded Plan Asset		563
(Aggregate Write-Ins for Othe- Than-Invested Assets)		

This entry illustrates the impact of the change in nonadmitted overfunded plan asset to unassigned funds.

1c. December 31, 2014 – Recognition of Periodic Pension Cost

Components of Net Periodic Cost	**Dec. 31, 2014**
Service Cost	2500
Interest Cost	1000
Expected Return on Plan Assets	(500)
Total	*3000*
Amortization of:	
o Transition Obligation	7.2
o Prior Service Cost	42.8
o Prior Service Cost (nonvested)	20
o Unrecognized Losses	493
Total	*563*
Total Net Periodic Pension Cost	**3,563**

Note – This example was purposely completed to show a significant amount of periodic pension cost to create an underfunded plan status. This was done strictly for illustration purposes and is not intended to indicate that such significant changes would be expected, although they could occur.

1. Net Periodic Pension Cost	3,563	
Prepaid Benefit Cost		3,563
(*Aggregate Write-In for Othe- Than-Invested Assets)*		

2. Overfunded Plan Asset	1,282	
Unassigned Funds – Transition Obligation		7.2
Unassigned Funds – Prior Service Cost		42.8
Unassigned Funds – Prior Service Cost (Nonvested)		20

Unassigned Funds – Unrecognized Losses		493
Liability for Pension Benefits		719
(Aggregate Write-In for Other Liabilities)		

This entry recognizes the transition amounts that have been recognized through net periodic pension cost, with an offset to unassigned funds. The overfunded plan asset is initially offset, until the plan reaches an unfunded status, which is then reflected through a liability for pension benefits (aggregate write-in for other liabilities).

3. Change in Nonadmitted - Prepaid Benefit Cost	3,563	
Unassigned Funds		3,563
4. Unassigned Funds	1,282	
Change in Nonadmitted - Overfunded Plan Asset		1,282

These entries illustrate the impact of the change in nonadmitted to unassigned funds.

Illustration 1 – Example Paragraph ~~85~~86 Note Disclosure:

SSAP No. 102 became effective January 1, 2013. This SSAP requires that any underfunded defined benefit pension amounts, as determined when the projected benefit obligation exceeds the fair value of plan assets, to be recognized as a liability under SSAP No. 5R. Such liability is required to be reported in the first quarter statutory financial statement after the transition date with a corresponding entry to unassigned funds. The adoption of SSAP No. 102 did not have a surplus impact on ABC entity as the pension plan was overfunded by more than the transition liabilities. At transition, ABC entity recognized $2,815 in unrecognized transition obligations, prior service costs, and unrecognized losses as components of the ending balance of unassigned funds as of January 1, 2013. This recognition resulted in a financial presentation which reflects the actual $2,731 overfunded status of the plan (fair value of plan assets exceeds the projected benefit obligation) as of January 1, 2013. As required under SSAP No. 102, overfunded plan assets are nonadmitted.

***For purposes of this example, tax effects are not reflected. However, the amount recognized at transition as components of the unassigned funds shall be net of tax.*

The following provides the status of the pension plan as of December 31, 2012, and the transition date (January 1, 2013):

Example 1	**Dec. 31, 2012**	**Jan. 1, 2013**
Accumulated Benefit Obligation	$(6,240)	$(6,240)
Plus: Non-Vested Liability	(100)	(100)
Total Accumulated Benefit Obligation	$(6,340)	$(6,340)
Projected Benefit Obligation	$(6,437)	$(6,437)
Plus: Non-Vested liability	(100)	(100)
Total PBO	$(6,537)	$(6,537)
Plan Assets at Fair Value	$9,268	$9,268
Funded Status	$2,731	$2,731
Transition Obligation / (Asset)	$36	
Prior Service Cost	214	
Prior Service Cost (Non-Vested)	100	
Unrecognized Losses / (Gains)	2,465	
Total Unrecognized Items	$2,815	-
Net Overfunded Plan Asset / (Liability for Benefits)	$5,546	$2,731

In the March 31, 2013, financial statements, the $2,731 overfunded plan assets was reflected as follows:

• Prepaid Benefit Cost	$5,546 (nonadmitted)
• Overfunded Plan Asset	$(2,815) (nonadmitted)

These amounts are reported net in Aggregate Write-Ins for Other-Than-Invested Assets: $2,731

Illustration of Example 1 – Overfunded Plan with Prepaid Benefit Cost

	Aggregate Write-In for Other-Than-Invested Assets		**Nonadmitted Assets**	**Unassigned Funds**	**Periodic Pension Cost**	**Aggregate Write-In for Other Liabilities**
	Prepaid Benefit Cost	**Overfunded Plan Asset**				
Existing Balances 12/31/2012	5,546DR		5,546CR			
Transition Entries – 1/1/2013						
A		2,815CR		2,815DR		
B			2,815DR	2,815CR		
After Transition	**5,546DR**	**2,815CR**	**2,731CR**	-		
After Transition-Net	**2,731DR**		**2,731CR**	-		
A – Recognize "unrecognized items" existing at 1/1/13 transition date (gains or losses, prior service costs or credits, and transition assets or obligations). For this plan, which is overfunded by more than the unrecognized liabilities, the entry at transition will be netted against the existing overfunded plan asset with an offset to unassigned funds. B – Illustrates the impact to the "change in nonadmitted" as a result of the decline in overfunded plan assets. For this particular example, with the transition entry to unassigned funds and the impact to nonadmitted assets, there is no surplus impact at transition. At transition, the net balance in aggregate write-ins reflects the overfunded state of the plan.						
Recognition of Net Periodic Pension Cost – 12/31/2013						
C	1,013CR				1,013DR	
D		563DR		563CR		
E			1,013DR	1,013CR		
F			563CR	563DR		
Net Impact	450CR		450DR	1,013CR	1,013DR	
Ending Balances	**4,533 DR**	**2,252CR**	**2,281CR**	**1,013CR**	**1,013DR**	
Ending Balances-Net	**2,281DR**		**2,281CR**	**–**		
C – Reflects the periodic pension cost with an offset to the prepaid pension asset. D – Recognizes the transition amounts amortized through net periodic pension cost. The offset it to unassigned funds (as that was how the "unrecognized items" were recognized at transition). E/F – Reflects the change in nonadmitted assets to unassigned funds.						
Recognition of Net Periodic Pension Cost – 12/31/2014						
G	3,563CR				3,563DR	
H		1,282DR		563CR		719CR
I			3,563DR	3,563CR		
J			1,282CR	1,282DR		
Net Impact	2,281CR		2,281DR	2,844CR	3,563DR	719CR
Ending Balances	**970 DR**	**970 CR**	-	**2,844CR**	**3,563DR**	
Ending Balances - Net	-		-	**719DR**		**719CR**
G/H – Reflects the periodic pension cost with an offset to the prepaid pension asset. As no contributions have been made, the 2014 pension cost moves the plan from an overfunded to underfunded state. The overfunded plan asset credit is reduced to equally offset the remaining prepaid benefit cost of $970. The underfunded status is then reflected through a liability for pension benefits (aggregate write-in for other liabilities). I/J – Reflects the change in nonadmitted assets to unassigned funds.						

2. Underfunded Plan with Accrued Benefit Cost

Consideration of contributions or tax effects are not reflected in this example.

Example 2	**Dec. 31, 2012**	**Jan. 1, 2013**
Accumulated Benefit Obligation	$(2,015)	$(2,015)
Plus: Non-Vested Liability	(60)*	(60)
Total Accumulated Benefit Obligation	$(2,075)	$(2,075)
Projected Benefit Obligation	$(2,268)	$(2,268)
Plus: Non-Vested Liability	(60)	(60)
Total PBO	$(2,328)	$(2,328)
Plan Assets at Fair Value	$1,992	$1,992
Funded Status	$(336)	$(336)
Transition Obligation / (Asset)	$(544)	
Prior Service Cost / (Credit)	(494)	
Prior Service Cost (Non-Vested)	60	
Unrecognized Losses / (Gains)	926	
Total Unrecognized Items	$(52)	-
Net Overfunded Plan Asset / (Liability for Benefits)	$(388)	$(336)

*The amount shown for December 31, 2012, reflects the non-vested liability, which must be considered at transition under SSAP No. 102. However, the non-vested liability is not a factor in the December 31, 2012, financial statements under SSAP No. 89.

Overfunded Plan Asset and Liability for Benefits are terms to reflect the overfunded and underfunded status of the plan. For the amounts shown as of December 31, 2012, immediately prior to the effective date of the new standard, these terms reflect the balance sheet position. As overfunded plan assets are not admitted, these prepaids shall be reported within Aggregate Write-Ins for Other-Than-Invested Assets. Transition liabilities recognized that have not been reflected through expense shall be reported within Aggregate Write-Ins for Liabilities.

2a. January 1, 2013 – Transition Date - Recognize "Unrecognized Items"

1.	Liability for Pension Benefits *(Aggregate Write-In for Liabilities)*	52	
	Unassigned Funds – Prior Service Cost (Nonvested)	60	
	Unassigned Funds – Unrecognized Losses	926	
	Unassigned Funds – Transition Asset		544
	Unassigned Funds – Prior Service Credit		494

For this plan, which is underfunded but has a net unrecognized asset, at transition the entity will improve their surplus presentation by $52 through a contra-liability. Use of the contra-liability is necessary, as if the item were recorded as an asset, it would be nonadmitted and result in a surplus reduction. Although there is a net unrecognized asset, this plan is in an underfunded state.

2b. December 31, 2013 – Recognition of Net Periodic Pension Cost

Components of Net Periodic Cost	**Dec. 31, 2012**
Service Cost	250
Interest Cost	100
Expected Return on Plan Assets	(50)
Total	*300*
Amortization of:	
o Transition Obligation (Asset)	(272)
o Prior Service Cost / (Credit)	(247)
o Prior Service Cost (nonvested)	30
o Unrecognized Losses	463
Total	*(26)*
Total Net Periodic Pension Cost	**274**

1. Unassigned Funds – Transition Asset	272	
Unassigned Funds – Prior Service Credit	247	
Unassigned Funds – Prior Service Cost (Nonvested)		30
Unassigned Funds – Unrecognized Losses		463
Liability for Pension Benefits *(Aggregate Write-In for Liabilities)*		26

This entry occurs to amortize the transition items. Due to the nature of the unrecognized items (net asset – recorded as a contra-liability), this entry reverses the original entry to remove the portion that will be amortized into periodic pension cost for the current period.

2. Net Periodic Pension Cost	274	
Accrued Benefit Cost		274

This entry recognizes the net periodic pension cost for the service cost, interest cost, expected return on plan assets and the amortization of the unrecognized items.

Note: All references to "accrued benefit cost" represent an unpaid expense liability, these amounts wills be reflected within general expenses due and accrued (life) or LAE/Other Underwriting expenses (p/c).

Note: This example uses a 2-year amortization period of the "unrecognized items." In actuality, amortization periods of each item will vary. Disclosures shall continue to separately present these items.

2c. December 31, 2014 – Recognition of Net Periodic Pension Cost

Components of Net Periodic Cost	**Dec. 31, 2014**
Service Cost	2500
Interest Cost	1000
Expected Return on Plan Assets	(500)
Total	*3,000*
Amortization of:	
o Transition Obligation / (Asset)	(272)
o Prior Service Cost / (Credit)	(247)
o Prior Service Cost (nonvested)	30
o Unrecognized Losses	463
Total	*(26)*
Total Net Periodic Pension Cost	**2,974**

1. Unassigned Funds – Transition Asset	272	
Unassigned Funds – Prior Service Credit	247	
Unassigned Funds – Prior Service Cost (Nonvested)		30
Unassigned Funds – Unrecognized Losses		463
Liability for Pension Benefits *(Aggregate Write-In for Liabilities)*		26

This entry occurs to amortize the transition items. Due to the nature of the unrecognized items (net asset – recorded as a contra-liability), this entry reverses the original entry to remove the portion that will be amortized into periodic pension cost for the current period.

2. Net Periodic Pension Cost	2,974	
Accrued Benefit Cost		2,974

This entry recognizes the net periodic pension cost for the service cost, interest cost, expected return on plan assets and the amortization of the unrecognized items.

Illustration 2 – Paragraph ~~85~~86 Example Note Disclosure:

SSAP No. 102 became effective January 1, 2013. This SSAP requires that any underfunded defined benefit pension amounts, as determined when the projected benefit obligation exceeds the fair value of plan assets, to be recognized as a liability under SSAP No. 5R. Such liability is required to be reported in the first quarter statutory financial statement after the transition date with a corresponding entry to unassigned funds. At transition, ABC entity recognized a net $52 asset from unrecognized transition obligations/assets, prior service costs/credits, and unrecognized gains/losses as a component of the ending balance of unassigned funds as of January 1, 2013. This net impact was reflected as a contra-liability as the plan is in an underfunded state.

***For purposes of this example, tax effects are not reflected. However, the amount recognized at transition as components of the unassigned funds shall be net of tax.*

The following provides the status of the pension plan as of December 31, 2012, and the transition date (January 1, 2013):

Example 2	**Dec. 31, 2012**	**Jan. 1, 2013**
Accumulated Benefit Obligation	$(2,015)	$(2,015)
Plus: Non-Vested Liability	(60)	(60)
Total Accumulated Benefit Obligation	$(2,075)	$(2,075)
Projected Benefit Obligation	$(2,268)	$(2,268)
Plus: Non-Vested Liability	(60)	(60)
Total PBO	$(2,328)	$(2,328)
Plan Assets at Fair Value	$1,992	$1,992
Funded Status	$(336)	$(336)
Transition Obligation / (Asset)	$(544)	
Prior Service Cost / (Credit)	(494)	
Prior Service Cost (Non-Vested)	60	
Unrecognized Losses / (Gains)	926	
Total Unrecognized Items	$(52)	-
Net Overfunded Plan Asset / (Liability for Benefits)	$(388)	$(336)

In the March 31, 2013, financial statements, underfunded pension obligations were reflected as follows:

- Accrued Benefit Cost - $388
- Liability for Pension Benefits (Aggregate Write-In for Liabilities) - ($52)

Illustration of Example 2 – Underfunded Plan with Accrued Benefit Cost

	Net Periodic Cost (Expense Recognition)	**Unassigned Funds**	**Aggregate Write-In for Liabilities**	**Accrued Benefit Cost**
Existing Balance – 12/31/2012		388DR		388CR
Transition Entries – 1/1/2013				
A		52CR	52DR	
After Transition		**336DR**	**52DR**	**388CR**
A. Recognize "unrecognized" items at transition. The above entry reflects the "net" impact, resulting with an unrecognized net asset (contra-liability) and an increase to the surplus presentation. (This unrecognized net asset is reflected as a contra-liability as it does not reflect a prepaid for the overfunding of plan assets. If this was reflected as an asset, it would be nonadmitted.)				
Recognition of Net Periodic Pension Cost – 12/31/2013				
B		26 DR	26 CR	
C	274 DR			274 CR
B. Entry amortizes the transition items (entry is shown net.) Due to the nature of the unrecognized items, (net asset, recorded as a contra-liability), this entry reverses the original entry to remove the portion that will be amortized into net periodic pension cost for the current period. C. Entry recognizes the net periodic pension cost, interest cost, expected return on plan assets, and the amortization of the unrecognized items.				
Recognition of Net Periodic Pension Cost – 12/31/2014				
D		26 DR	26 CR	
E	2,974 DR			2,974 CR
D. Entry occurs to amortize the transition items (entry is shown net). Due to the nature of the unrecognized items, (net asset, recorded as a contra-liability), this entry reverses the original entry to remove the portion that will be amortized into net periodic pension cost for the current period. E. Entry recognizes net periodic pension cost the service cost, interest cost, expected return on plan assets and the amortization of the unrecognized items.				

3. Underfunded Plan with Accrued Benefit Cost with Surplus Deferral Elected

Consideration of contributions or tax effects are not reflected in this example.

Example 3	Dec. 31, 2012	Jan. 1, 2013
Accumulated Benefit Obligation	$(1,819)	$(1,819)
Plus: Non-Vested Liability	(103)*	(103)
Total Accumulated Benefit Obligation	$(1,922)	$(1,922)
Projected Benefit Obligation	$(2,099)	$(2,099)
Plus: Non-Vested Liability	(103)	(103)
Total PBO as of January 1, 2012	$(2,202)	$(2,202)
Plan Assets at Fair Value	$0	$0
Funded Status	$(2,202)	$(2,202)
Transition Obligation / (Asset)	$0	
Prior Service Cost	0	
Prior Service Cost (Non-Vested)	103	
Unrecognized Losses / (Gains)	440	
Total Unrecognized Items	543	-
Net Overfunded Plan Asset / (Liability for Benefits)	$(1,659)	$(1,922)

* The amount shown for December 31, 2012, reflects the non-vested liability, which must be considered at transition under SSAP No. 102. However, the non-vested liability is not a factor in the December 31, 2012, financial statements under SSAP No. 89.

Overfunded Plan Asset and Liability for Benefits are terms to reflect the overfunded and underfunded status of the plan. For the amounts shown as of December 31, 2012, immediately prior to the effective date of the new standard, these terms reflect the balance sheet position. As overfunded plan assets are not admitted, these prepaids shall be reflected within Aggregate Write-Ins for Other-Than-Invested Assets. Transition liabilities recognized that have not been reflected through expense shall be reflected within Aggregate Write-Ins for Liabilities.

As illustrated above, the liability for pension benefits as of January 1, 2013, does not equal the underfunded plan status as the entity elected the transition deferral. Rather, the liability for pension benefits equals, at a minimum, the accumulated benefit obligation (ABO) less the plan asset at fair value. (Minimum transition liability that equals the ABO is required in accordance with paragraph ~~85~~86.) After the transition period, the net overfunded plan asset / (liability for benefits) should equal the funded status of the plan.

3a. January 1, 2013 – Transition Date - Recognize "Unrecognized Items"

In accordance with paragraph ~~85~~86, the surplus impact initially recognized as of January 1, 2013 under the transition option, and subsequently over the transition period, shall be the greater of:

	Minimum Transition Liability	
~~85~~86.b.i.	10% of Calculated Surplus Impact	54.3
~~85~~86.b.ii.	Anticipated Annual Amortization of "Unrecognized Items" (Assumes 5-year Uniform Amortization)	108.6
~~85~~86.b.iii.	Difference Between ABO and Accrued Benefit Cost	263
	Transition Liability	**263**

Note: Amortization of the unrecognized items (paragraph ~~85~~86.b.ii.) may not be determinable at transition. If the amortization amount that will be recognized year-end 2013 is unknown at the transition date, at a minimum, the amount amortized for "unrecognized items" during the prior year shall be utilized for component ~~85~~86.b.ii. of the minimum transition liability. If the amount recognized for transition (greater of all three components in paragraph ~~85~~86.b.) is subsequently determined to be less than what is amortized for the year (~~85~~86.b.ii.), the difference between what was recognized for transition, and what is amortized must immediately be recognized as an adjustment to the transition impact to unassigned funds – surplus.)

January 1, 2013 – Transition Date:

Reversal of Additional Minimum Liabilities/Intangible Plan Assets: As this plan has an unfunded ABO, following the guidance under SSAP No. 89, the entity had recognized an additional minimum liability and corresponding admitted intangible asset. As the concept of an additional minimum liability has been eliminated from SSAP No. 102, at transition these amounts are eliminated, with the determination of the overfunded/unfunded projected benefit obligation calculated subsequent to the elimination.

Balances as of 12/31/2012 under SSAP No. 89:

Accumulated Benefit Obligation:	$1,819
Accrued Liability:	$1,659
SSAP No. 89 Additional Minimum Liability:	$160
SSAP No. 89 Admitted Intangible Asset:	$160

Unassigned Funds	160	
Intangible Asset		160
Additional Minimum Liability	160	
Unassigned Funds		160

Application of SSAP No. 102 – Recognition of Unfunded Status with Surplus Deferral:

1. Unassigned Funds – Transition Liability	263	
Liability for Pension Benefits *(Aggregate Write-In for Liabilities)*		263

This entry represents the minimum transition liability required to be recognized at the transition date. As noted within the transition guidance, an entity may elect to transition the surplus impact over a period not to exceed 10 years. Paragraph ~~85~~86 provides the specifications on the minimum liability recognized at transition. As this transition liability amount has yet to be recognized through expense (periodic cost), the liability is reflected through "aggregate write-ins for liabilities."

3b. December 31, 2013 – Recognition of Net Periodic Pension Cost

Components of Net Periodic Cost	**Dec. 31, 2013**
Service Cost	250
Interest Cost	100
Expected Return on Plan Assets	(50)
Total	*300*
Amortization of:	
o Prior Service Cost (nonvested)	20.6
o Unrecognized Losses	88
Total	*108.6*
Total Net Periodic Pension Cost	**408.6**

1. Liability for Pension Benefits *(Aggregate Write-In for Liabilities)*	108.6	
Unassigned Funds – Prior Service Cost (Nonvested)		20.6
Unassigned Funds – Unrecognized Losses		88

This entry occurs prior to amortization of the transition items. This entry reverses a portion of the original transition entry for the amount that will be amortized into periodic pension cost for the current period.

2. Net Periodic Pension Cost	408.6	
Accrued Benefit Cost		408.6

This entry recognizes net periodic pension cost for the service cost, interest cost, expected return on plan assets and amortization of the unrecognized items.

Note: Although the entity elected the transition option for surplus deferral, and the guidance allows up to 10 years for deferral, an entity must continue to recognize a minimum amount of the transition liability as determined in accordance with paragraph ~~85~~86.b. This requires the entity to recognize an amount that is at the greater of either 10% of the initial surplus impact or the amortization of the unrecognized items in effect at transition.

In this example, the entity will only receive a 3-year deferral – This illustration assumes 5-year uniform amortization of the transition amounts into expense for illustration purposes only. In practice, the minimum transition liability amounts may not be determinable until the expense is calculated in each future year:

Surplus Impact at Transition		**Prior Service Cost**	**Unrealized Losses**	
Transition Liability:	543	103	440	
Amount Recognized Jan. 1, 2013	(263)			
Remaining Transition Liability	**280**			
				Remaining Transition Liability
Minimum Transition Liability:		Anticipated Amortization:		
2014	**108.6**	20.6	88	171.4
2015	**108.6**	20.6	88	62.8
2016	**62.8**	12	50.8	-

3c. December 31, 2014 – Recognition of Transition Liability:

1.	Unassigned Funds – Transition Liability	108.6	
	Liability for Pension Benefits *(Aggregate Write-In for Liabilities)*		108.6

This entry represents the minimum transition liability required to be recognized at the subsequent date.

3d. December 31, 2014 – Recognition of Net Periodic Benefit Cost

Components of Net Periodic Cost	**Dec. 31, 2014**
Service Cost	50
Interest Cost	30
Expected Return on Plan Assets	(35)
Total	*45*
Amortization of:	
o Prior Service Cost (nonvested)	20.6
o Unrecognized Losses	88
Total	*108.6*
Total Net Periodic Pension Cost	**153.6**

1.	Liability for Pension Benefits *(Aggregate Write-In for Liabilities)*	108.6	
	Unassigned Funds – Prior Service Cost (Nonvested)		20.6
	Unassigned Funds – Unrecognized Losses		88
2.	Net Periodic Pension Cost	153.6	
	Accrued Benefit Cost		153.6

This entry illustrates the December 2014 entries. The first removes the liability recognized for transition so that it could be recycled through expense, with the second recognizing net periodic cost (including the amortization of the unrecognized items.)

3e. December 31, 2015 – Activity within the pension plan has resulted with an overfunded plan.

As required under paragraph ~~85~~86, if the fair value of plan assets had changed so that the plan was in an overfunded status, the transition liability would also be impacted with accelerated recognition to the extent the plan is in an overfunded status:

Components of Net Periodic Cost	**Dec. 31, 2015**
Service Cost	100
Interest Cost	75
Expected Return on Plan Assets	(50)
Total	*125*
Amortization of:	
o Prior Service Cost (nonvested)	20.6
o Unrecognized Losses	88
Total	*108.6*
Total Net Periodic Pension Cost	**233.6**

Recognition of Remaining Transition Liability and Net Periodic Pension Cost:

1. Unassigned Funds – Transition Liability	171.40	
Liability for Pension Benefits		171.40
(Aggregate Write-In for Liabilities)		

This entry illustrates the immediate recognition of the remaining transition liability

2. Liability for Pension Benefits	108.6	
(Aggregate Write-In for Liabilities)		
Unassigned Funds – Prior Service Cost (Nonvested)		20.6
Unassigned Funds – Unrecognized Losses		88

This entry reflects the amortization into net periodic pension cost of the "unrecognized items" within unassigned funds. Amortization has not changed with the recognition of the remaining transition liability.

3. Net Periodic Pension Cost	233.60	
Accrued Benefit Cost		233.60

Recognizes net periodic pension cost for the service cost, interest cost, expected return on plan assets, and the amortization of unrecognized items.

4. Accrued Benefit Cost	2,456	
Prepaid Benefit Cost	844	
(Aggregate Write-In – Assets)		
Cash – Contribution		3,300

This entry recognizes the cash contribution, the elimination of the accrued benefit cost and the establishment of the prepaid benefit cost from the contribution.

5. Liability for Pension Benefits	217	
Overfunded Plan Asset		217

Since the plan is now in a net overfunded status, the liability for pension benefits is reduced to zero, and offset to the overfunded pension asset (contra-asset).

6. Unassigned Funds (Change in Nonadmitted)	844	
Prepaid Benefit Cost (Nonadmitted)		844

This entry recognizes the prepaid benefit cost that is nonadmitted and the underlying impact on unassigned funds.

7. Overfunded Plan Asset (Nonadmitted)	217	
Unassigned Funds (Change in Nonadmitted)		217

This entry illustrates the impact of the change in nonadmitted overfunded plan asset to unassigned funds.

Example 3 - Comprehensive Illustration

Consideration of contributions or tax effects are not reflected in the example.

Underfunded Plan With Accrued Benefit Cost - Surplus Deferral Elected

		12/31/2012	1/1/2013	12/31/2013	12/31/2014	12/31/2015
ABO		(1,819)	(1,819)	(2,019)	(2,049)	(2,079)
Non-Vested Liability		(103)	(103)	(103)	(103)	(103)
Total ABO	A	(1,922)	(1,922)	(2,122)	(2,152)	(2,182)
PBO	B	(2,099)	(2,099)	(2,399)	(2,444)	(2,569)
Non-Vested Liability	C	(103)	(103)	(103)	(103)	(103)
Total PBO	D	(2,202)	(2,202)	(2,502)	(2,547)	(2,672)
Plan Assets at Fair Value	E	-	-	-	-	3,300
Funded Status	F	(2,202)	(2,202)	(2,502)	(2,547)	628
Items Not Recognized in Unassigned Funds						
Transition Obligation (Asset)		-	-	-	-	-
Prior Service Cost		-	-	-	-	-
Prior Service Cost Non-Vested	G	103	-	-	-	-
Unrecognized Losses (Gains)	H	440	-	-	-	-
Total Unrecognized Items	I	543	-	-	-	-
Transition Items - Aggregate WI	J		(263)		(109)	(171)
Unassigned Funds - Transition	K			109	109	109
Periodic Pension Cost	L			(300)	(45)	(125)
Periodic Pension Cost - Amort.	M			(109)	(109)	(109)
Contribution	N		-	-	-	3,300
Overfunded Plan Asset	O	(1,659)	(1,922)	(2,222)	(2,376)	628
(Liability for Benefits)						
Unrecognized Transition Items	P		(280)	(280)	(171)	-
Funded Status	Q		(2,202)	(2,502)	(2,547)	628
Liability Reported Beg of Year	R		(1,659)	(1,922)	(2,222)	(2,375)
Recognized Transition Items	S		(263)		(109)	(171)
Unassigned Funds	T			109	109	109
Net Periodic Pension Cost	U		-	(409)	(154)	(235)
Contribution	V		-	-		3,300
Accrued/Prepaid End of Year	W	(1,659)	(1,922)	(2,222)	(2,375)	628
Unrecognized Items	X		(280)	(280)	(171)	0
Funded Status	Y		(2,202)	(2,502)	(2,547)	628
Reporting Lines:						
Accrued Benefit Cost	Z	1,659	1,659	2,068	2,221	0
Aggregate WI – Net Asset	AA					628
Aggregate WI - Liability	BB		263	154	154	0
Total Liability/(Asset) Reported	CC	1,659	1,922	2,222	2,376	(628)
Unfunded/(Overfunded) Status	DD		2,202	2,502	2,547	(628)
Liability Not Reported	EE		280	280	171	0

Underfunded Plan with Accrued Benefit Cost - Surplus Deferral Elected

Jan. 1, 2013 - Transition

Entry A *- Recognize Minimum Transition Liability*

Unassigned Funds	263	
Liability for Pension Benefits *(Aggregate Write-In for Liabilities)*		263

Dec. 31, 2013 - Recognize Periodic Pension Cost

Entry A *- Reverses portion of transition entry for the amount that will be amortized into periodic cost for the period.*

Liability for Pension Benefits *(Aggregate Write-In for Liabilities)*	109	
Unassigned Funds		109

Entry B *- Recognize net periodic cost*

Net Periodic Cost	409	
Accrued Benefit Cost		409

Dec. 31, 2014 - Recognize Transition and Periodic Pension Cost

Entry A *- Recognize transition liability*

Unassigned Funds	109	
Liability for Pension Benefits *(Aggregate Write-In for Liabilities)*		109

Entry B *- Reverses portion of transition entry for the amount that will be amortized into periodic cost for the period.*

Liability for Pension Benefits *(Aggregate Write-In for Liabilities)*	109	
Unassigned Funds		109

Entry C *- Recognize net periodic cost*

Net Periodic Cost	154	
Accrued Benefit Cost		154

Dec. 31, 2015 - Recognize Transition and Periodic Pension Cost

Entry A *- Recognize transition liability*

Unassigned Funds	171	
Liability for Pension Benefits *(Aggregate Write-In for Liabilities)*		171

Entry B *- Reverses portion of transition entry for the amount that will be amortized into periodic cost for the period.*

Liability for Pension Benefits	109	
(Aggregate Write-In for Liabilities)		
Unassigned Funds		109

Entry C *- Recognize net periodic cost*

Net Periodic Cost	234	
Accrued Benefit Cost		234

Entry D *- Recognize Cash Contribution*

Accrued Benefit Cost	2,456	
Prepaid Benefit Cost	844	
(Aggregate Write-In Assets)		
Cash Contribution		3,300

Entry E *– Reduce Liability to Zero and Record Overfunded Plan Asset*

Liability for Pension Benefits	217	
Overfunded Plan Asset		217

Entry F ***–*** *Recognize Nonadmitted Asset – Prepaid Benefit Cost*

Unassigned Funds	844	
(Change in Nonadmitted)		
Prepaid Benefit Cost (Nonadmitted)		844

Entry G ***–*** *Recognize Nonadmitted Asset – Overfunded Plan Asset*

Overfunded Plan Asset (Nonadmitted)	217	
Unassigned Funds (Change in Nonadmitted)		217

Illustration 3 – Paragraph ~~85~~86 Example Note Disclosure – March 31, 2013:

SSAP No. 102 became effective January 1, 2013. This SSAP requires that any underfunded defined benefit pension amounts, as determined when the projected benefit obligation exceeds the fair value of plan assets, to be recognized as a liability under SSAP No. 5R. Such liability is required to be reported in the first quarter statutory financial statement after the transition date with a corresponding entry to unassigned funds. ABC entity elected to utilize the minimum transition option reflected in paragraph ~~85~~86 of SSAP No. 102. The SSAP requires initial transition liability to be the greater of paragraphs ~~85~~86.b.i, ~~85~~86.b.ii., and ~~85~~86.b.iii.:

	Minimum Transition Liability	
~~85~~86.b.i.	10% of Calculated Surplus Impact	54.3
~~85~~86.b.ii.	Annual Amortization of "Unrecognized Items" (Assumes 5-year Uniform Amortization)	108.6
~~85~~86.b.iii.	Difference Between ABO and Accrued Benefit Cost	263
	Minimum Transition Liability	**263**

Note - Amortization of the unrecognized items (paragraph ~~85~~86.b.ii.) may not be determinable at transition. If the amortization amount that will be recognized year-end 2013 is unknown at the transition date, at a minimum, the amount amortized for "unrecognized items" during the prior year shall be utilized for component ~~85~~86.b.ii. of the minimum transition liability. If the amount recognized for transition (greater of all three components in paragraph ~~85~~86.b.) is subsequently determined to be less than what is amortized for the year (~~85~~86.b.ii.), the difference between what was recognized for transition, and what is amortized must immediately be recognized as an adjustment to the transition impact to unassigned funds – surplus.

Although the entity elected the transition option for surplus deferral, and SSAP No. 102 allows up to 10 years for deferral, an entity must continue to recognize a minimum amount of the transition liability as determined in accordance with paragraph ~~85~~86.b. This requires the entity to recognize each year an amount that is at least equal to the amortization of the unrecognized items in effect at transition. Although the amortization of the transition items into future expenses (paragraph ~~85~~86.b.ii.) may not be fully determinable at the time of transition (as they are dependent on the future expense calculations), the reporting entity anticipates that the remaining $280 surplus impact from the election of the transition deferral in SSAP No. 102 will be recognized over a 3-year* period.

* This is a reporting entity projection and may be revised based on future expenses and activity.

Recognized Surplus Impact at Transition & Remaining Transition Liability		**Prior Service Cost**	**Unrealized Losses**
Transition Liability:	543	103	440
Amount Recognized Jan. 1, 2013	(263)		
Remaining Transition Liability	**280**		

The following provides the status of the pension plan as of December 31, 2012, and the transition date (January 1, 2013):

Example 3	**Dec. 31, 2012**	**Jan. 1, 2013**
Accumulated Benefit Obligation	$(1,922)	$(1,922)
Projected Benefit Obligation	$(2,099)	$(2,099)
Plus: Non-Vested Liability	(103)	(103)
Total PBO	$(2,202)	$(2,202)
Plan Assets at Fair Value	0	0
Funded Status	($2,202)	($2,202)

Transition Obligation / (Asset)	0	
Prior Service Cost	0	
Prior Service Cost (Non-Vested)	103	
Unrecognized Losses / (Gains)	440	
Total Unrecognized Items	543	-
Overfunded Plan Asset / (Liability for Benefits)	(1,659)	(1,922)

In the March 31, 2013, financial statements, the $1,922 liability for pension benefits was reflected in the financial statements as follows:

- Aggregate Write-Ins for Liabilities: $263
- Accrued Benefit Cost: $1,659
- Surplus Deferral - Unrecognized Transition Liability - $280

(Note – This disclosure shall be completed on a quarterly and annual basis, with updated financial information reflecting the current and prior reporting periods, until the plan is fully funded without any transition liability remaining.)

Illustration 3 – Paragraph ~~85~~86 Example Note Disclosure – December 31, 2015 – After Overfunded Contribution:

At December 31, 2015, ABC entity contributed $3,300 towards the pension plan. This contribution resulted in the plan being in an overfunded status. Pursuant to the requirements of SSAP No. 102, ABC immediately recognized the remaining transition liability ($171.40). Although the transition liability has been fully-recognized to unassigned funds, the amortization of the liability into net periodic pension cost has not changed.

Although the entity elected the transition option for surplus deferral, and SSAP No. 102 allows up to 10 years for deferral, with the contribution resulting in an overfunded-plan status, ABC entity was restricted to a 3-year transition schedule as follows:

January 1, 2013 (Transition):	$263.00
December 31, 2014:	$108.60
December 31, 2015	$171.40
Total Transition Liability	$543.00

In the December 31, 2015, annual financial statements, pension obligations were reflected as follows:

- Prepaid Benefit Cost - $844 (Nonadmitted)
- Overfunded Plan Asset - $(217) (Nonadmitted)

These amounts are both reported as Aggregate Write-Ins for Other-Than-Invested Assets resulting in a net $628.

4. Underfunded Plan with Prepaid Benefit Cost – No Surplus Deferral Elected

Consideration of contributions or tax effects are not reflected in this example.

Example 4	**Dec. 31, 2012**[9]	**Jan. 1, 2013**	**Dec. 31, 2013**	**Jan. 1, 2014**	**Dec. 31, 2014**
Accumulated Benefit Obligation	(1,532)	(1,532)	(1,732)	(1,732)	(1,957)
Plus: Non-Vested Liability	(100)	(100)	(100)	(100)	(100)
Total Accumulated Benefit Obligation	$ (1,632)	$ (1,632)	(1,832)	(1,832)	(2,057)
Projected Benefit Obligation	$(1,752)	$(1,752)	(2,052)	(2,052)	(2,277)
Plus: Non-Vested liability	(100)	(100)	(100)	(100)	(100)
Total PBO	$(1,852)	$(1,852)	(2,152)	(2,152)	(2,377)
Plan Assets at Fair Value	1,600	1,600	1,600	2,500	2,500
Funded Status	($252)	($252)	(552)	348	123
Transition Obligation / (Asset)	0	**0**	**0**	**0**	**0**
Prior Service Cost	48	**0**	**0**	**0**	**0**
Prior Service Cost (Non-Vested)	100	**0**	**0**	**0**	**0**
Unrecognized Losses / (Gains)	600	**0**	**0**	**0**	**0**
Total Unrecognized Items	748	**0**	**0**	**0**	**0**
Net Overfunded Plan Asset / (Liability for Benefits)	**496**	**(252)**	**(552)**	**348**	**123**

Overfunded Plan Asset and Liability for Benefits are terms to reflect the overfunded and unfunded status of the plan. For the amounts shown as of December 31, 2012 immediately prior to the effective date of the new standard, these terms reflect the balance sheet position. As overfunded plan assets are not admitted, these prepaids shall be reflected within Aggregate Write-Ins for Other-Than-Invested Assets. Transition liabilities recognized that have not been reflected through expense shall be reflected within Aggregate Write-Ins for Liabilities.

January 1, 2013 – Transition Date, Recognize "Unrecognized Items"

A.	Unassigned Funds – Prior Service Cost	48	
	Unassigned Funds – Prior Service Cost (Non-vested)	100	
	Unassigned Funds – Unrecognized Losses	600	
	Liability for Plan Benefits *(Aggregate Write-In for Liabilities)*		252
	Overfunded Plan Asset *(Aggregate Write-In for Other-Than-Invested Assets)*		496
B.	Change in Nonadmitted – Overfunded Plan Asset	496	
	Unassigned Funds		496

[9] The amount shown for December 31, 2012, reflects the non-vested liability, which must be considered at transition under SSAP No. 102. However, the non-vested liability is not a factor in the December 31, 2012, financial statements under SSAP No. 89.

Prepaid Benefit Cost and Overfunded Plan Assets are both reflected as Aggregate Write-Ins for Other-Than-Invested Assets. However, Prepaid Benefit Cost can only be reduced with a corresponding income statement impact. Entry A, which uses a contra-asset, effectively results with a net elimination of the assets reported for the plan and establishes the appropriate liability to reflect the unfunded status. (Reporting entities will need to continue to track these categories separately.)

December 31, 2013 – Recognition of Net Periodic Pension Cost
After transition, recognition of net periodic pension cost includes: 1) service cost, 2) interest cost, 3) expected return on plan assets, 4) amortization of prior service cost included in unassigned funds, 5) amortization of gains and losses and 6) amortization of any transition asset or obligation remaining in unassigned funds.

Components of Net Periodic Cost	**Dec. 31, 2013**
Service Cost	250
Interest Cost	100
Expected Return on Plan Assets	(50)
Total	300
Amortization of:	
o Prior Service Cost	1.20
o Prior Service Cost (nonvested)	2.50
o Unrecognized Losses	15.00
Total	18.70
Total Net Periodic Pension Cost	**318.70**

C. Liability for Pension Benefits *(Aggregate Write-In for Liabilities)*	18.70	
Unassigned Funds – Transition Liability		18.70

This entry occurs prior to amortization of the items recognized at transition. This entry reverses a portion of the original transition entry for the amount that will be amortized into periodic pension cost for the current period.

D. Net Periodic Pension Cost	318.70	
Prepaid Benefit Cost *(Aggregate Write-In for Other-Than-Invested Assets)*		318.70

This entry recognizes net periodic pension cost for the service cost, interest cost, expected return on plan assets and amortization of the noted items. As the plan has a prepaid benefit cost, the prepaid benefit cost will be reduced with the recognition of periodic cost.

E. Overfunded Plan Asset *(Aggregate Write-In for Other-Than-Invested Assets)*	318.70	
Unassigned Funds		318.70

Entry reflects a reduction in the contra-asset recognized at transition at an amount equal to the reduction of prepaid benefit cost.

F. Change in Nonadmitted – Prepaid Benefit Cost	318.70	
Unassigned Funds		318.70

G. Unassigned Funds	318.70	
Change in Nonadmitted – Overfunded Plan Asset		318.70

Entries to reflect the change in nonadmitted assets for both entries "D" and "E." These entries offset.

H. Unassigned Funds	318.70	
Liability for Pension Benefits *(Aggregate Write-In for Liabilities)*		318.70

Entry recognizes the unfunded liability from the 2013 net periodic costs. This entry assumes no additional changes in the PBO or Fair Value of Plan Assets at year-end. In practice, there will always be changes in the year-end PBO due to changes in the discount rate used to calculate the PBO, actuarial demographics different than expected, etc. An additional variation is actual return on plan assets different from expected return on plan assets. All of these factors will impact the year-end funded status, and will also need to be recorded as part of entry "H" at year-end.

January 1, 2014 – Contribution

	Jan. 1, 2014
Contribution	$900

I. Prepaid Benefit Cost *(Aggregate Write-In for Other-Than-Invested Assets)*	900	
Cash		900

J. Liability for Pension Benefits *(Aggregate Write-In for Liabilities)*	552	
Overfunded Plan Asset		552

With the cash contribution, the plan becomes overfunded with a prepaid benefit cost. The contribution directly increases the Prepaid Benefit Cost. The liability for pension benefits is eliminated, with an offset to the Overfunded Plan asset. The plan now has a NET overfunded plan asset of $348.

K. Unassigned Funds	900	
Change in Nonadmitted - Prepaid Benefit Cost		900

L. Change in Nonadmitted- Overfunded Plan Asset	552	
Unassigned Funds		552

Entries recognize the impact as a result of the nonadmitted overfunded plan asset from entry "I" and "J."

December 31, 2014 – Recognition of Net Periodic Pension Cost

After transition, recognition of net periodic pension cost includes: 1) service cost, 2) interest cost, 3) expected return on plan assets, 4) amortization of prior service cost included in unassigned funds, 5) amortization of gains and losses and 6) amortization of any transition asset or obligation remaining in unassigned funds.

Components of Net Periodic Cost	**Dec. 31, 2014**
Service Cost	200
Interest Cost	75
Expected Return on Plan Assets	(50)
Total	225
Amortization of:	
o Prior Service Cost	1.20
o Prior Service Cost (nonvested)	2.50
o Unrecognized Losses	15.00
Total	18.70
Total Net Periodic Pension Cost	**243.70**

This example assumes no changes in the amortization timeframe. As noted in footnote 6 of SSAP No. 102, unless otherwise impacted from SSAP No. 102, or in accordance with changes to the pension plan, the amortization of the unrecognized items into net periodic pension cost shall continue to follow the existing amortization schedules in effect on the transition date.

Although the amortization of Prior Service Cost (assuming no additional changes) and non-vested Prior Service Cost will typically follow a straight-line amortization into Net Periodic Pension Cost, this is not the case for the Unrecognized Gains/Losses. The total amount of unrecognized gains/losses subject to amortization will continuously change due to changes in the discount rates, actuarial assumptions, differences between expected and actual return on assets, etc. In addition, unrecognized gains/losses are amortized into expense only to the extent that they exceed the 10% corridor (SSAP 102, paragraph 22). The 10% corridor is based on the greater of the PBO or the Fair Value of Plan assets, and these amounts are also continuously changing. Therefore, the amortization of the gain/loss will never occur on a straight-line basis using the corridor method described in paragraph 22. There is no "amortization schedule" in effect at transition date for the unrecognized gains/losses.

M. Overfunded Plan Assets	18.70	
(Aggregate Write-In for Other-Than-Invested Assets)		
Unassigned Funds – Transition Liability		18.70

This entry occurs prior to amortization of the transition items. This entry reverses a portion of the original transition entry made to unassigned funds for the amount that will be amortized into periodic pension cost for the current period. Since the plan is currently overfunded, this is offset by overfunded plan asset.

N. Unassigned Funds	18.70	
Change in Nonadmitted - Overfunded Plan Asset		18.70

This entry reflects the change in nonadmitted from entry "M."

O. Net Periodic Pension Cost	243.70	
Prepaid Benefit Cost		243.70
(Aggregate Write-In for Other-Than-Invested Assets)		

This entry recognizes net periodic pension cost for the service cost, interest cost, expected return on plan assets and amortization of the noted items. As the plan has a prepaid benefit cost, this will be reduced with the recognition of periodic cost. Once that amount is exhausted, an accrued liability would be recorded.

P. Change in Nonadmitted - Prepaid Benefit Cost	243.70	
Unassigned Funds		243.70

Entries to reflect the change in nonadmitted assets for entry "O."

Example 4 - Underfunded Plan with Prepaid Benefit Cost – No Surplus Deferral Elected:

	Aggregate Write-In For Other-Than-Invested Assets		Change in Nonadmitted Assets	Net Periodic Cost	Unassigned Funds	Liability for Pension Benefits	Cash
	Overfunded Plan Asset	Prepaid Benefit Cost					
Existing Balance 12/31/2012		496 DR	496 CR[10]	-	496 CR 496 DR	-	
Transition Entries 1/1/2013							
A	496 CR				748 DR	252 CR	
B			496 DR		496 CR		
Jan. 1, 2013	**496 CR**	**496 DR**	**-**	**-**	**252 DR**	**252 CR**	
Jan. 1, 2013 - Net	**-**		**-**	**-**	**252 DR**	**252 CR**	**-**
Dec. 31, 2013:							
C					18.70 CR	18.70 DR	
D		318.70 CR		318.70 DR[11]			
E	318.70 DR				318.70 CR		
F			318.70 DR		318.70 CR		
G			318.70 CR		318.70 DR		
H					318.70 DR	318.70 CR	
Dec. 31, 2013	**177.30 CR**	**177.30 DR**	**-**		**552 DR**	**552 CR**	
Dec. 31, 2013 - Net	**-**		**-**	**-**	**552 DR**	**552 CR**	
Jan. 1, 2014 Contribution							
I		900 DR					900 CR
J	552 CR					552 DR	
K			900 CR		900 DR		
L			552 DR		552 CR		
After Contribution	**729.30 CR**	**1077.30 DR**	**348 CR**		**900 DR**	**-**	**900 CR**
Jan. 1, 2014 - Net	**348 DR**		**348 CR**		**900 DR**	**-**	**900 CR**
Dec. 31, 2014:							
M	18.70 DR				18.70 CR		
N			18.70 CR		18.70 DR		
O		243.70 CR		243.70 DR[11]			
P			243.70 DR		243.70 CR		
Dec. 31, 2014	**710.60 CR**	**833.60 DR**	**123 CR**		**900 DR**	**-**	**900 CR**
Dec. 31, 2014 - Net	**123 DR**		**123 CR**		**900 DR**		**900 CR**

[10] This reflects the change reported in prior years.

[11] Since Net Periodic Cost closes to unassigned funds at the end of each year, the balance does not carry forward.

5. Underfunded Plan with Prepaid Benefit Cost – Surplus Deferral, Funded ABO

Consideration of contributions or tax effects are not reflected in this example.

Example 5	**Dec. 31, 2012**[12]	**Jan. 1, 2013**	**Dec. 31, 2013**	**Dec. 31, 2014**	**Jan, 1, 2015**	**Dec. 31, 2015**
Accumulated Benefit Obligation	$ (1,032)	$(1,032)	$ (1,232)	$ (1,457)	$ (1,457)	$ (1,657)
Plus: Non-Vested Liability	(100)	(100)	(100)	(100)	(100)	(100)
Total Accumulated Benefit Obligation	$((1,132)	$ (1,132)	(1,332)	(1,557)	(1,557)	(1,757)
Projected Benefit Obligation	$(1,752)	$(1,752)	(2,052)	(2,177)	(2,177)	(2,377)
Plus: Non-Vested liability	(100)	(100)	(100)	(100)	(100)	100
Total PBO	$(1,852)	$(1,852)	(2,152)	(2,277)	(2,277)	(2,477)
Plan Assets at Fair Value	1,600	1,600	1,600	1,600	2,500	2,500
Funded Status	($252)	($252)	(552)	(677)	223	23
Transition Obligation/(Asset)	0	**0**	**0**	**0**	**0**	
Prior Service Cost	48	**0**	**0**	**0**	**0**	
Prior Service Cost (Non-Vested)	100	**0**	**0**	**0**	**0**	
Unrecognized Losses/(Gains)	600	**0**	**0**	**0**	**0**	
Total Unrecognized Items	748	**0**	**0**	**0**	**0**	
Net Overfunded Plan Asset/ (Liability for Benefits)	**496**	**(25.20)**	**(325.20)**	**(475.40)**	**223**	**23**
Surplus Impact Deferred		**(226.80)**	**(226.80)**	**(201.60)**	**-**	**-**

Surplus Impact – The transition guidance in SSAP No. 92 and SSAP No. 102 requires a minimum of 10% of the surplus impact on the transition date. If a systematic 10-year allocation was applied to the total "unrecognized items" rather than the surplus impact, there would be a number of years in which a prepaid asset would still be reflected without any impact to surplus even though the plan is underfunded. This is because a reduction in overfunded plan assets alone has a corresponding change to nonadmitted assets, resulting in a net zero surplus impact.

Determine the initial transition surplus impact under the deferral election:

In accordance with paragraph ~~85~~86.b. of SSAP No. 102, the surplus impact initially recognized as of January 1, 2013 under the transition option, and subsequently over the transition period, shall be the **greater of**:

[12] The amount shown for December 31, 2012, reflects the non-vested liability, which must be considered at transition under SSAP No. 102. However, the non-vested liability is not a factor in the December 31, 2012, financial statements under SSAP No. 89.

	Minimum Transition Liability	
~~85~~86.b.i.	10% of Calculated Surplus Impact	25.20
~~85~~86.b.ii.	Anticipated Annual Amortization of "Unrecognized Items" (Assume 40-year Uniform Amortization)	18.70
~~85~~86.b.iii.	Difference Between unfunded ABO and Accrued Benefit Cost. (In this example, ABO is fully funded.)	-
	Transition Liability	**25.20**

~~85~~86.b.ii. Note: If the amortization cannot be determined at transition, at a minimum, the amount amortized for unrecognized items during the prior year shall be utilized for this calculation. If the amount recognized for transition (greater of all three components) is subsequently determined to be less than what was amortized for the year, the difference between what was recognized for transition and what is amortized must immediately be recognized as an adjustment to the transition impact to unassigned funds – surplus.

January 1, 2013 – Transition Date

2.	Unassigned Funds	496	
	Overfunded Plan Asset *(Aggregate Write-In for Other-Than-Invested Assets)*		496
3.	Change in Nonadmitted – Overfunded Plan Asset	496	
	Unassigned Funds		496
4.	Unassigned Funds – Transition Liability	25.20	
	Liability for Plan Benefits *(Aggregate for Write-In Liability)*		25.20

Prepaid Benefit Cost and Overfunded Plan Assets are both reflected as Aggregate Write-Ins for Other-Than-Invested Assets. However, Prepaid Benefit Cost can only be reduced with a corresponding income statement impact. Entry A, which uses a contra-asset, effectively results with a net elimination of the assets reported for the plan. (Reporting entities will need to continue to track these categories separately.) The first two entries (Entry A & B) have a **ZERO surplus impact** and the third entry recognizes a liability for 10% of the surplus impact calculated at transition as that is the greatest element from paragraph ~~85~~86.b.

December 31, 2013 – Recognition of Net Periodic Pension Cost
After transition, recognition of net periodic pension cost includes: 1) service cost, 2) interest cost, 3) expected return on plan assets, 4) amortization of prior service cost included in unassigned funds, 5) amortization of gains and losses and 6) amortization of any transition asset or obligation remaining in unassigned funds.

As noted in paragraph ~~85~~86.b., if surplus deferral is elected at the transition date, subsequently, starting with the 2014 year-end financial statement, the reporting entity shall annually recognize the remaining surplus impact. As such, unless the entity elects to recognize the remaining surplus impact early (which is permitted under SSAP No. 102), there is no additional surplus impact from transition recognized as of December 31, 2013.

Components of Net Periodic Cost	Dec. 31, 2013
Service Cost	250
Interest Cost	100
Expected Return on Plan Assets	(50)
Total	300
Amortization of:	
o Prior Service Cost	1.20
o Prior Service Cost (nonvested)	2.50
o Unrecognized Losses	15.00
Total	18.70
Total Net Periodic Pension Cost	**318.70**

Note – This example assumes no changes in the amortization timeframe. As noted in footnote 5 of SSAP No. 102, unless otherwise impacted from SSAP No. 102, or in accordance with changes to the pension plan, the amortization of the unrecognized items into net periodic pension cost shall continue to follow the existing amortization schedules in effect on the transition date. Although the amortization of Prior Service Cost (assuming no additional changes) and non-vested Prior Service Cost will typically follow a straight-line amortization into Net Periodic Pension Cost, this is not the case for the Unrecognized Gains/Losses. The total amount of unrecognized gains/losses subject to amortization will continuously change due to changes in the discount rates, actuarial assumptions, differences between expected and actual return on assets, etc. In addition, unrecognized gains/losses are amortized into expense only to the extent that they exceed the 10% corridor (SSAP No. 102, paragraph 22). The 10% corridor is based on the greater of the PBO or the Fair Value of Plan assets, and these amounts are also continuously changing. Therefore, the amortization of the gain/loss will never occur on a straight-line basis using the corridor method described in paragraph 22. There is no "amortization schedule" in effect at transition date for the unrecognized gains/losses.

D. Liability for Pension Benefits 18.70
(Aggregate Write-In for Liabilities)
Unassigned Funds – Transition Liability 18.70

This entry occurs prior to amortization of the transition items. This entry reverses a portion of the original transition entry for the amount that will be amortized into periodic pension cost for the current period.

E. Net Periodic Pension Cost 318.70
Prepaid Benefit Cost 318.70
(Aggregate Write-In for Other-Than-Invested Assets)

This entry recognizes net periodic pension cost for the service cost, interest cost, expected return on plan assets and amortization of the unrecognized items. (As the plan has a prepaid benefit cost, this will be reduced with the recognition of periodic cost.)

F. Overfunded Plan Asset 318.70
(Aggregate Write-In for Other-Than-Invested Assets)
Unassigned Funds 318.70

Entry reflects a reduction in the contra-asset recognized at transition at an amount equal to the reduction of prepaid benefit cost.

G. Change in Nonadmitted – Prepaid Benefit Cost	318.70	
Unassigned Funds		318.70

H. Unassigned Funds	318.70	
Change in Nonadmitted – Overfunded Plan Asset		318.70

Entries to reflect the change in nonadmitted assets for both entries "E" and "F." These entries offset.

I. Unassigned Funds	318.70	
Liability for Pension Benefits *(Aggregate Write-In for Liabilities)*		318.70

Entry reflects the unfunded liability from the 2013 plan-related costs. This entry assumes no additional changes in the PBO or Fair Value of Plan Assets at year-end. In practice, there will always be changes in the year-end PBO due to changes in the discount rate used to calculate the PBO, actuarial demographics different than expected, etc. An additional variation is **actual** return on plan assets different from **expected** return on plan assets. All of these factors will impact the year-end funded status, and will also need to be recorded as part of entry "I" at year-end.

December 31, 2014 – Recognition of Deferred Transition Impact

J. Unassigned Funds – Transition Liability	25.20	
Liability for Pension Benefits *(Aggregate Write-In for Liabilities)*		25.20

Per paragraph ~~85~~86, if surplus deferral is elected at transition, beginning with 2014 annual financials, the entity shall recognize the remaining surplus impact on a systematic basis over a period not to exceed the remaining nine years. This entry represents the minimum transition liability to be recognized subsequent to transition. Since it is assumed that there is no change in the amortization expectations, and ABO is still funded, this entry reflects 10% of the transition surplus impact.

December 31, 2014 – Recognition of Net Periodic Pension Cost

Components of Net Periodic Cost	**Dec. 31, 2014**
Service Cost	100
Interest Cost	75
Expected Return on Plan Assets	(50)
Total	125
Amortization of:	
o Prior Service Cost	1.20
o Prior Service Cost (nonvested)	2.50
o Unrecognized Losses	15.00
Total	18.70
Total Net Periodic Pension Cost	**143.70**

Note – This example assumes no changes in the amortization timeframe. As noted in footnote 5 of SSAP No. 102, unless otherwise impacted from SSAP No. 102, or in accordance with changes to the pension plan, the amortization of the unrecognized items into net periodic pension cost shall continue to follow the existing amortization schedules in effect on the transition date. Although the amortization of Prior Service Cost (assuming no additional changes) and non-vested Prior Service Cost will typically follow a straight-line amortization into Net Periodic Pension Cost, this is not the case for the Unrecognized Gains/Losses. The total amount of unrecognized gains/losses subject to amortization will continuously change due to changes in the discount rates, actuarial assumptions, differences between expected and actual return on assets, etc. In addition, unrecognized gains/losses are amortized into expense only to the extent that they exceed the 10% corridor (SSAP No. 102, paragraph 22). The 10% corridor is based on the greater of the PBO or the Fair Value of Plan assets, and these amounts are also continuously changing. Therefore, the amortization of the gain/loss will never occur on a straight-line basis using the corridor method described in paragraph 22. There is no "amortization schedule" in effect at transition date for the unrecognized gains/losses.

K.	Liability for Pension Benefits *(Aggregate Write-In for Liabilities)*	18.70	
	Unassigned Funds – Transition Liability		18.70

This entry occurs prior to amortization of the transition items. This entry reverses a portion of the original transition entry for the amount that will be amortized into periodic pension cost for the current period.

L.	Net Periodic Pension Cost	143.70	
	Prepaid Benefit Cost *(Aggregate Write-In for Other-Than-Invested Assets)*		143.70

This entry recognizes net periodic pension cost for the service cost, interest cost, expected return on plan assets and amortization of the noted items. (As the plan has a prepaid benefit cost, this will be reduced with the recognition of periodic cost.)

M.	Overfunded Plan Asset *(Aggregate Write-In for Other-Than-Invested Assets)*	143.70	
	Unassigned Funds		143.70

Entry reflects the change in overfunded plan assets as a reduction in the contra-asset from initial transition.

N.	Change in Nonadmitted – Prepaid Benefit Cost	143.70	
	Unassigned Funds		143.70

O.	Unassigned Funds	143.70	
	Change in Nonadmitted – Overfunded Plan Asset		143.70

Entries reflect the change in nonadmitted assets for both entries "L" and "M." These entries offset.

P.	Unassigned Funds	143.70	
	Liability for Pension Benefits *(Aggregate Write-In for Liabilities)*		143.70

Entry reflects the unfunded liability from the 2014 plan-related costs. This entry assumes no additional changes in the PBO or Fair Value of Plan Assets at year-end. In practice, there will always be changes in the year-end PBO due to changes in the discount rate used to calculate the PBO, actuarial demographics different than expected, etc. An additional variation is **actual** return on plan assets different from **expected** return on plan assets. All of these factors will impact the year-end funded status, and will also need to be recorded as part of entry "P" at year-end.

January 1, 2015 – Recognition of Cash Contribution

	Jan. 1, 2015
Contribution	$900

Q.	Prepaid Benefit Cost *(Aggregate Write-In for Other-Than-Invested Assets)*	900.00	
	Cash		900.00

R.	Liability for Pension Benefits *(Aggregate Write-In for Liabilities)*	475.40	
	Overfunded Plan Asset *(Aggregate Write-In for Other-Than-Invested Assets)*		475.40

S.	Unassigned Funds	900.00	
	Change in Nonadmitted – Prepaid Benefit Cost		900.00

T.	Change in Nonadmitted – Overfunded Plan Asset	475.40	
	Unassigned Funds		475.40

With the cash contribution, the plan becomes overfunded with a prepaid benefit cost. The contribution directly increases the Prepaid Benefit Cost. The liability for pension benefits is eliminated, with an offset to the Overfunded Plan asset. The plan now has a NET overfunded plan asset of $223.

U.	Unassigned Funds	201.60	
	Overfunded Plan Asset		201.60

Since the plan is in an overfunded status, per paragraph ~~85~~86.b. of SSAP No. 102, the entity is required to recognize the deferred surplus impact from initial transition to the extent that the plan is overfunded. As the plan is overfunded by more than the remaining transition surplus impact, this entry recognizes the full remaining surplus impact deferred at transition.

V.	Change in Nonadmitted – Overfunded Plan Assets	201.60	
	Unassigned Funds		201.60

Entry reflects the change in nonadmitted assets from entry "U."

December 31, 2015 – Recognition of Net Periodic Pension Cost

Components of Net Periodic Cost	**Dec. 31, 2015**
Service Cost	100
Interest Cost	175
Expected Return on Plan Assets	(75)
Total	200

Amortization of:	
o Prior Service Cost	1.20
o Prior Service Cost (nonvested)	2.50
o Unrecognized Losses	15.00
Total	18.70
Total Net Periodic Pension Cost	**218.70**

(Previous notes on amortization continue to apply.)

W.	Overfunded Plan Asset *(Aggregate Write-In for Other-Than-Invested Assets)*	18.70	
	Unassigned Funds		18.70

This entry occurs prior to amortization of the transition items. This entry reverses a portion of the unrecognized items recognized to unassigned funds as part of the transition guidance (even if recognized subsequent to initial recognition under the deferral option) for the amount that will be amortized into periodic pension cost for the current period.

X.	Unassigned Funds	18.70	
	Change in Nonadmitted – Overfunded Plan Asset		18.70

Entry reflects the change in nonadmitted assets from entry "W."

Y.	Net Periodic Pension Cost	218.70	
	Prepaid Benefit Cost *(Aggregate Write-In for Other-Than-Invested Assets)*		218.70

This entry recognizes net periodic pension cost for the service cost, interest cost, expected return on plan assets and amortization of the noted items. As the plan has a prepaid benefit cost, this will be reduced with the recognition of periodic cost.

Z.	Change in Nonadmitted – Prepaid Benefit Cost	218.70	
	Unassigned Funds		218.70

Entry reflects the change in nonadmitted assets from entry "Y." This example assumes no additional changes in the PBO or Fair Value of Plan Assets at year-end. In practice, there will always be changes in the year-end PBO due to changes in the discount rate used to calculate the PBO, actuarial demographics different than expected, etc. An additional variation is **actual** return on plan assets different from **expected** return on plan assets. All of these factors will impact the year-end funded status, and will also need to be recorded at year-end in an **additional entry** impacting the Overfunded Plan Asset. If the plan became underfunded due to these changes, then the amount of the underfunding would then be recorded as a Liability for Pension Benefits.

Example: Assume the PBO increased by $100 at year-end due to discount rate changes, etc. This would cause the plan to be underfunded by $77.00.

1.	*Unassigned Funds*	*100.00*	
	Overfunded Plan Asset		*23.00*
	Liability for Pension Benefits		*77.00*

2.	*Change in Nonadmitted – Overfunded Plan Asset*	*23.00*	
	Unassigned Funds		*23.00*

Example 5 - Underfunded Plan with Prepaid Benefit Cost – Surplus Deferral, Funded ABO:

	Aggregate Write-In For Other-Than-Invested Assets		Change in Nonadmitted Assets	Net Periodic Cost	Unassigned Funds	Liability for Pension Benefits	Cash
	Overfunded Plan Asset	Prepaid Benefit Cost					
Existing Balance 12/31/2012 (This reflects pre-2012 Entries)		**496 DR**	**496 CR**[13]	**-**	**496 CR** **496 DR**	**-**	
Transition Entries – 1/1/2013							
A	496 CR				496 DR		
B			496 DR		496 CR		
C					25.20 DR	25.20 CR	
Jan 1, 2013	**496 CR**	**496 DR**	**-**	**-**	**25.20 DR**	**25.20 CR**	
Jan 1, 2013 - Net	**-**		**-**	**-**	**25.20 DR**	**25.20 CR**	
Dec. 31, 2013:							
D					18.70 CR	18.70 DR	
E		318.70 CR		318.70 DR[14]			
F	318.70 DR				318.70 CR		
G			318.70 DR		318.70 CR		
H			318.70 CR		318.70 DR		
I					318.70 DR	318.70 CR	
Dec. 31, 2013:	**177.30 CR**	**177.30 DR**	**-**		**325.20 DR**	**325.20 CR**	
Dec. 31, 2013 - Net	**-**		**-**	**-**	**325.20 DR**	**325.20 CR**	
Dec. 31, 2014:							
J					25.20 DR	25.20 CR	
K					18.70 CR	18.70 DR	
L		143.70 CR		143.70 DR[14]			
M	143.70 DR				143.70 CR		
N			143.70 DR		143.70 CR		
O			143.70 CR		143.70 DR		
P					143.70 DR	143.70 CR	
Dec. 31, 2014	**33.60 CR**	**33.60 DR**	**-**		**475.40 DR**	**475.40 CR**	
Dec. 31, 2014 – Net	**-**		**-**	**-**	**475.40 DR**	**475.40 CR**	
Jan. 1, 2015 – Contribution							
Q		900.00 DR					900.00 CR
R	475.40 CR					475.40 DR	
S			900.00 CR		900.00 DR		
T			475.40 DR		475.40 CR		
U	201.60 CR				201.60 DR		
V			201.60 DR		201.60 CR		
Jan. 1, 2015 – After Contribution	**710.60 CR**	**933.60 DR**	**223.00 CR**		**900 DR**	**-**	**900 CR**
Jan 1, 2015 - Net	**223.00 DR**		**223.00 CR**	**-**	**900 DR**	**-**	**900 CR**

[13] This reflects the change reported in prior years.

[14] Since Net Periodic Cost closes to unassigned funds at the end of each year, the balance does not carry forward.

Dec. 31, 2015:							
W	18.70 DR				18.70 CR		
X			18.70 CR		18.70 DR		
Y		218.70 CR		218.70 DR[14]			
Z			218.70 DR		218.70 CR		
Dec. 31, 2015:	**691.90 CR**	**714.90 DR**	**23.00 CR**		**900.00 DR**		**900.00 CR**
Dec. 31, 2015 - Net	**23.00 DR**		**23.00 CR**		**900.00 DR**		**900.00 CR**

6. Underfunded Plan with Prepaid Benefit Cost – Surplus Deferral, Unfunded ABO

Consideration of contributions or tax effects are not reflected in this example.

Example 6	**Dec. 31, 2012**[15]	**Jan. 1, 2013**	**Dec. 31, 2013**	**Dec. 31, 2014**	**Jan, 1, 2015**	**Dec. 31, 2015**
Accumulated Benefit Obligation	$ (1,632)	$ (1,632)	$ (1,932)	$ (2,057)	$ (2,457)	$ (2,457)
Plus: Non-Vested Liability	(100)	(100)	(100)	(100)	(100)	(100)
Total Accumulated Benefit Obligation	$(1,732)	$(1,732)	(2,032)	(2,157)	(2,557)	(2,557)
Projected Benefit Obligation	$(1,752)	$(1,752)	(2,052)	(2,177)	(2,177)	(2,377)
Plus: Non-Vested liability	(100)	(100)	(100)	(100)	(100)	100
Total PBO	$(1,852)	$(1,852)	(2,152)	(2,277)	(2,277)	(2,477)
Plan Assets at Fair Value	1,600	1,600	1,600	1,600	2,500	2,500
Funded Status	($252)	($252)	(552)	(677)	223	23
Transition Obligation / (Asset)	0	**0**	**0**	**0**	**0**	
Prior Service Cost	48	**0**	**0**	**0**	**0**	
Prior Service Cost (Non-Vested)	100	**0**	**0**	**0**	**0**	
Unrecognized Losses / (Gains)	600	**0**	**0**	**0**	**0**	
Total Unrecognized Items	748	**0**	**0**	**0**	**0**	
Net Overfunded Plan Asset / (Liability for Benefits)	**496**	**(132)**	**(432)**	**(582.20)**	**223**	**23**
Additional Minimum Liability (Unfunded ABO)	(32)	0	The concept of an additional minimum liability and related intangible asset for plans with an unfunded ABO is eliminated in SSAP No. 102.			
Intangible Asset	32	0				
Surplus Impact Deferred		**(120)**	**(120)**	**(94.80)**	**-**	**-**

Surplus Impact – The transition guidance in SSAP No. 92 and SSAP No. 102 requires a minimum of 10% of the surplus impact on the transition date. If a systematic 10-year allocation was applied to the total "unrecognized items" rather than the surplus impact, there would be a number of years in which a prepaid asset would still be reflected, without any impact to surplus, even though the plan is underfunded. This is because a reduced in overfunded plan assets alone has a corresponding change to nonadmitted assets, resulting in a net zero surplus impact.

[15] The amount shown for December 31, 2012, reflects the non-vested liability, which must be considered at transition under SSAP No. 102. However, the non-vested liability is not a factor in the December 31, 2012, financial statements under SSAP No. 89.

Determine the initial transition surplus impact under the deferral election:

In accordance with paragraph ~~85~~86.b. of SSAP No. 102, the surplus impact initially recognized as of January 1, 2013 under the transition option, and subsequently over the transition period, shall be the **greater of**:

	Minimum Transition Liability	
~~85~~86.b.i	10% of Calculated Surplus Impact at Transition	25.20
~~85~~86.b.ii	Anticipated Annual Amortization of "Unrecognized Items" (Assume 40-year Uniform Amortization)	18.70
~~85~~86.b.iii	Difference Between unfunded ABO and Accrued Benefit Cost.	132.00
	Transition Liability	**132.00**

~~85~~86*.b.ii. Note: If the amortization cannot be determined at transition, at a minimum, the amount amortized for unrecognized items during the prior year shall be utilized for this calculation. If the amount recognized for transition (greater of all three components) is subsequently determined to be less than what was amortized for the year, the difference between what was recognized for transition and what is amortized must immediately be recognized as an adjustment to the transition impact to unassigned funds – surplus.*

January 1, 2013 – Transition Date

Reversal of Additional Minimum Liabilities/Intangible Plan Assets: As this plan has an unfunded ABO, following the guidance under SSAP No. 89, the entity had recognized an additional minimum liability and corresponding admitted intangible asset. As the concept of an additional minimum liability has been eliminated from SSAP No. 102, at transition these amounts are eliminated, with the determination of the overfunded/unfunded projected benefit obligation calculated subsequent to the elimination.

Unassigned Funds	32	
Intangible Asset		32
Additional Minimum Liability	32	
Unassigned Funds		32

Application of SSAP No. 102 – Recognition of Unfunded Status with Surplus Deferral:

A. Unassigned Funds	496	
Overfunded Plan Asset *(Aggregate Write-In for Other-Than-Invested Assets)*		496
B. Change in Nonadmitted – Overfunded Plan Asset	496	
Unassigned Funds		496
C. Unassigned Funds – Transition Liability	132	
Liability for Pension Benefits		132

Prepaid Benefit Cost and Overfunded Plan Assets are both reflected as Aggregate Write-Ins for Other-Than-Invested Assets. However, Prepaid Benefit Cost can only be reduced with a corresponding income statement impact. Entry A, which uses a contra-asset, effectively results with a net elimination of the assets reported for the plan. (Reporting entities will need to continue to track these categories separately.)

Entries A & B have a **ZERO surplus impact** and the third entry recognizes a liability for the unfunded ABO per the requirements of paragraph ~~85~~86.b.

December 31, 2013 – Recognition of Net Periodic Pension Cost

After transition, recognition of net periodic pension cost includes: 1) service cost, 2) interest cost, 3) expected return on plan assets, 4) amortization of prior service cost included in unassigned funds, 5) amortization of gains and losses and 6) amortization of any transition asset or obligation remaining in unassigned funds.

As noted in paragraph ~~85~~86.b., if surplus deferral is elected at the transition date, subsequently, starting with the 2014 year-end financial statement, the reporting entity shall annually recognize the remaining surplus impact. As such, unless the entity elects to recognize the remaining surplus impact early (which is permitted under SSAP No. 102), there is no additional surplus impact from transition recognized as of December 31, 2013.

Components of Net Periodic Cost	**Dec. 31, 2013**
Service Cost	250
Interest Cost	100
Expected Return on Plan Assets	(50)
Total	300
Amortization of:	
o Prior Service Cost	1.20
o Prior Service Cost (nonvested)	2.50
o Unrecognized Losses	15.00
Total	18.70
Total Net Periodic Pension Cost	**318.70**

Note – This example assumes no changes in the amortization timeframe. As noted in footnote 5 of SSAP No. 102, unless otherwise impacted from SSAP No. 102, or in accordance with changes to the pension plan, the amortization of the unrecognized items into net periodic pension cost shall continue to follow the existing amortization schedules in effect on the transition date. Although the amortization of Prior Service Cost (assuming no additional changes) and non-vested Prior Service Cost will typically follow a straight-line amortization into Net Periodic Pension Cost, this is not the case for the Unrecognized Gains/Losses. The total amount of unrecognized gains/losses subject to amortization will continuously change due to changes in the discount rates, actuarial assumptions, differences between expected and actual return on assets, etc. In addition, unrecognized gains/losses are amortized into expense only to the extent that they exceed the 10% corridor (SSAP 102, paragraph 22). The 10% corridor is based on the greater of the PBO or the Fair Value of Plan assets, and these amounts are also continuously changing. Therefore, the amortization of the gain/loss will never occur on a straight-line basis using the corridor method described in paragraph 22. There is no "amortization schedule" in effect at transition date for the unrecognized gains/losses.

D. Liability for Pension Benefits *(Aggregate Write-In for Liabilities)*	18.70	
Unassigned Funds – Transition Liability		18.70

This entry occurs prior to amortization of the transition items. This entry reverses a portion of the original transition entry for the amount that will be amortized into periodic pension cost for the current period.

E. Net Periodic Pension Cost	318.70	
Prepaid Benefit Cost *(Aggregate Write-In for Other-Than-Invested Assets)*		318.70

This entry recognizes net periodic pension cost for the service cost, interest cost, expected return on plan assets and amortization of the unrecognized items. (As the plan has a prepaid benefit cost, this will be reduced with the recognition of periodic cost.)

F. Overfunded Plan Asset *(Aggregate Write-In for Other-Than-Invested Assets)*	318.70	
Unassigned Funds		318.70

Entry reflects a reduction in the contra-asset recognized at transition at an amount equal to the reduction of prepaid benefit cost.

G. Change in Nonadmitted – Prepaid Benefit Cost	318.70	
Unassigned Funds		318.70

H. Unassigned Funds	318.70	
Change in Nonadmitted – Overfunded Plan Asset		318.70

Entries to reflect the change in nonadmitted assets for both entries "E" and "F." These entries offset.

I. Unassigned Funds	318.70	
Liability for Pension Benefits *(Aggregate Write-In for Liabilities)*		318.70

Entry reflects the unfunded liability from the 2013 plan-related costs. This entry assumes no additional changes in the PBO or Fair Value of Plan Assets at year-end. In practice, there will always be changes in the year-end PBO due to changes in the discount rate used to calculate the PBO, actuarial demographics different than expected, etc. An additional variation is **actual** return on plan assets different from **expected** return on plan assets. All of these factors will impact the year-end funded status, and will also need to be recorded as part of entry "I" at year-end.

December 31, 2014 – Recognition of Deferred Transition Impact

In accordance with paragraph ~~85~~86 of SSAP No. 102, the minimum amount recognized each subsequent year shall be an amount that reflects the conditions of paragraph ~~85~~86.b. As such, the surplus recognized shall be the **greater of:**

	Minimum Transition Liability	
~~85~~86.b.i.	10% of Calculated Surplus Impact at Transition	25.20
~~85~~86.b.ii.	Anticipated Annual Amortization of "Unrecognized Items" (Assume 40-year Uniform Amortization)	18.70
~~85~~86.b.iii.	Difference Between unfunded ABO and Accrued Benefit Cost/Fair Value of Plan Assets. (Dec. 31, 2014 - Fair value of plan assets together with the Liability for Pension Benefits exceed the ABO.)	-
	Transition Liability	**25.20**

(Previous note on amortization continues to apply.)

J. Unassigned Funds – Transition Liability	25.20	
Liability for Pension Benefits *(Aggregate Write-In for Liabilities)*		25.20

Entry represents the minimum transition liability to be recognized subsequent to transition. (10% of the transition surplus impact is the greatest component of paragraph ~~85~~86.b. as of Dec. 31, 2014.)

December 31, 2014 – Recognition of Net Periodic Pension Cost

Components of Net Periodic Cost	**Dec. 31, 2014**
Service Cost	100
Interest Cost	75
Expected Return on Plan Assets	(50)
Total	125
Amortization of:	
o Prior Service Cost	1.20
o Prior Service Cost (nonvested)	2.50
o Unrecognized Losses	15.00
Total	18.70
Total Net Periodic Pension Cost	**143.70**

(Previous note on amortization continues to apply.)

K. Liability for Pension Benefits *(Aggregate Write-In for Liabilities)*	18.70	
Unassigned Funds – Transition Liability		18.70

This entry occurs prior to amortization of the transition items. This entry reverses a portion of the unrecognized items recognized to unassigned funds as part of the transition guidance (even if recognized subsequent to initial recognition under the deferral option) for the amount that will be amortized into periodic pension cost for the current period.

L. Net Periodic Pension Cost	143.70	
Prepaid Benefit Cost *(Aggregate Write-In for Other-Than-Invested Assets)*		143.70

This entry recognizes net periodic pension cost for the service cost, interest cost, expected return on plan assets and amortization of the unrecognized items. (As the plan has a prepaid benefit cost, this will be reduced with the recognition of periodic cost.)

M. Overfunded Plan Asset *(Aggregate Write-In for Other-Than-Invested Assets)*	143.70	
Unassigned Funds		143.70

Entry reflects the change in overfunded plan assets as a reduction in the contra-asset to correspond with the change in net periodic pension cost. With this entry, the Prepaid Benefit Cost and Overfunded Plan Assets net to zero. This is appropriate as the plan is underfunded and a liability is reflected.

N. Change in Nonadmitted – Prepaid Benefit Cost	143.70	
Unassigned Funds		143.70

O. Unassigned Funds	143.70	
Change in Nonadmitted – Overfunded Plan Asset		143.70

Entries to reflect the change in nonadmitted assets for both entries "L" and "M." These entries offset.

P. Unassigned Funds	143.70	
Liability for Pension Benefits *(Aggregate Write-In for Liabilities)*		143.70

Entry reflects the full unfunded liability, including impact from the 2014 plan-related costs.

Note - This entry assumes no additional changes in the PBO or Fair Value of Plan Assets at year-end. In practice, there will always be changes in the year-end PBO due to changes in the discount rate used to calculate the PBO, actuarial demographics different than expected, etc. An additional variation is **actual** return on plan assets different from **expected** return on plan assets. All of these factors will impact the year-end funded status, and will also need to be recorded as part of entry "P" at year-end.

January 1, 2015 – Recognition of Cash Contribution

	Jan. 1, 2015
Contribution	$900

Q. Prepaid Benefit Costs *(Aggregate Write-In for Other-Than-Invested Assets)*	900.00	
Cash		900.00

R. Liability for Pension Benefits *(Aggregate Write-In for Liabilities)*	582.20	
Overfunded Plan Asset *(Aggregate Write-In for Other-Than-Invested Assets)*		582.20

S. Unassigned Funds	900.00	
Change in Nonadmitted – Prepaid Benefit Cost		900.00

T. Change in Nonadmitted – Overfunded Plan Asset	582.20	
Unassigned Funds		582.20

With the cash contribution, the plan becomes overfunded with a prepaid benefit cost. The contribution directly increases the Prepaid Benefit Cost. The liability for pension benefits is eliminated, with an offset to the Overfunded Plan asset. The plan now has a NET overfunded plan asset of $223.

U. Unassigned Funds	94.80	
Overfunded Plan Assets		94.80

As the surplus deferral was elected, with the overfunded status, per paragraph ~~85~~86.b. of SSAP No. 102, the entity is required to recognize the deferred surplus impact from initial transition to the extent that the plan is overfunded. As the plan is overfunded by more than the remaining transition surplus impact, this entry recognizes the full remaining surplus impact deferred at transition.

V. Change in Nonadmitted – Overfunded Plan Assets	94.80	
Unassigned Funds		94.80

Entry reflects the change in nonadmitted assets from entry U.

December 31, 2015 – Recognition of Net Periodic Pension Cost

Components of Net Periodic Cost	Dec. 31, 2015
Service Cost	100
Interest Cost	175
Expected Return on Plan Assets	(75)
Total	200
Amortization of:	
o Prior Service Cost	1.20
o Prior Service Cost (nonvested)	2.50
o Unrecognized Losses	15.00
Total	18.70
Total Net Periodic Pension Cost	**218.70**

(Prior amortization note continues to apply.)

W. Overfunded Plan Asset *(Aggregate Write-In for Other-Than-Invested Assets)*	18.70	
Unassigned Funds		18.70

This entry occurs prior to amortization of the transition items. This entry reverses a portion of the original transition entry for the amount that will be amortized into periodic pension cost for the current period.

X. Unassigned Funds	18.70	
Change in Nonadmitted – Overfunded Plan Asset		18.70

Entry reflects the change in nonadmitted assets from entry “W.”

Y. Net Periodic Pension Cost	218.70	
Prepaid Benefit Cost *(Aggregate Write-In for Other-Than-Invested Assets)*		218.70

This entry recognizes net periodic pension cost for the service cost, interest cost, expected return on plan assets and amortization of the unrecognized items. As the plan has a prepaid benefit cost, this will be reduced with the recognition of periodic cost.

Z. Change in Nonadmitted – Prepaid Benefit Cost	218.70	
Unassigned Funds		218.70

Entry reflects the change in nonadmitted assets from entry “Y.”

Example 6 - Underfunded Plan with Prepaid Benefit Cost – Surplus Deferral, Unfunded ABO:

	Aggregate Write-In For Other-Than-Invested Assets		Change in Nonadmitted Assets	Net Periodic Cost	Unassigned Funds	Liability for Pension Benefits	Cash
	Overfunded Plan Asset	Prepaid Benefit Cost					
Existing Balance 12/31/2012 (This reflects pre-2012 Entries)		496 DR	496 CR[16]	-	496 CR 496 DR	-	
Transition Entries – 1/1/2013							
A	496 CR				496 DR		
B			496 DR		496 CR		
C					132 DR	132 CR	
Jan 1, 2013	**496 CR**	**496 DR**	-	-	**132 DR**	**132 CR**	
Jan. 1, 2013 – Net	-		-	-	**132 DR**	**132 CR**	-
Dec. 31, 2013:							
D					18.70 CR	18.70 DR	
E		318.70 CR		318.70 DR[17]			
F	318.70 DR				318.70 CR		
G			318.70 DR		318.70 CR		
H			318.70 CR		318.70 DR		
I					318.70 DR	318.70 CR	
Dec. 31, 2013:	**177.30 CR**	**177.30 DR**	-		**432.00 DR**	**432.00 CR**	
Dec. 31, 2013 – Net	-		-	-	**432.00 DR**	**432.00 CR**	-
Dec. 31, 2014:							
J					25.20 DR	25.20 CR	
K					18.70 CR	18.70 DR	
L		143.70 CR		143.70 DR[17]			
M	143.70 DR				143.70 CR		
N			143.70 DR		143.70 CR		
O			143.70 CR		143.70 DR		
P					143.70 DR	143.70 CR	
Dec. 31, 2014	**33.60 CR**	**33.60 DR**	-		**582.20 DR**	**582.20 CR**	
Dec. 31, 2014 – Net	- -		-	-	**582.20 DR**	**582.20 CR**	-
Jan. 1, 2015 – Contribution							
Q		900 DR					900 CR
R	582.20 CR					582.20 DR	
S			900 CR		900 DR		
T			582.20 DR		582.20 CR		
U	94.80 CR				94.80 DR		
V			94.80 DR		94.80 CR		

[16] This reflects the change reported in prior years.

[17] Since Net Periodic Cost closes to unassigned funds at the end of each year, the balance does not carry forward.

Jan. 1, 2015 – After Contribution	**710.60 CR**	**933.60 DR**	**223.00 CR**		**900 DR**	**-**	**900 CR**
Jan. 1, 2015 – Net	**223.00 DR**		**223.00 CR**	**-**	**900 DR**	**-**	**900 CR**
Dec. 31, 2015:							
W	18.70 DR				18.70 CR		
X			18.70 CR		18.70 DR		
Y		218.70 CR		218.70 DR[17]			
Z			218.70 DR		218.70 CR		
Dec. 31, 2015	**691.90 CR**	**714.90 DR**	**23 CR**		**900 DR**		**900 CR**
Dec. 31, 2015 - Net	**23 DR**		**23 CR**	**-**	**900 DR**	**-**	**900 CR**

EXHIBIT B - CHANGES IN THE MEASUREMENT DATE AND PLAN SETTLEMENT

Note: Footnote references in this section link numbers together for ease of reference.

The reporting entity adopted this SSAP as of the transition date (January 1, 2013.) In accordance with this SSAP, Company B is changing the measurement date for its defined benefit pension plan from September 30 to December 31 for its December 31, 2014, financial statements. In accordance with this SSAP, statutory accounting principles require that change to be implemented by remeasuring plan assets and obligations as of December 31, 2013. Company B has a plan settlement on November 30, 2013, and remeasures its plan assets and benefit obligations as of November 30, 2013, resulting in a settlement loss before taxes of $60,000[6], which is a portion of the net loss in unassigned funds (surplus). However, the effects of remeasuring plan assets and obligations as of November 30, 2013, on the funded status reported in Company B's statement of financial position are not recognized until the following fiscal year because the change in measurement date has not been adopted at November 30, 2013. In recognizing the effects of the plan settlement and change in measurement date:

a. Recognize the settlement loss in net income in the fourth quarter of 2013 and a corresponding decrease in the cumulative net loss in unassigned funds (surplus).

b. Recognize the net periodic pension cost incurred from October 1, 2013, to December 31, 2013, net of tax, as an adjustment to beginning unassigned funds (surplus) for 2014.

c. Recognize any gains or losses arising during the period from October 1, 2013, to December 31, 2013, net of tax, as an adjustment to unassigned funds (surplus) for 2014.

d. Recognize corresponding changes in pension liability and deferred tax amounts for the above items.

The funded status of Company B's Plan assets as of September 30, 2013, November 30, 2013, December 31, 2013 and December 31, 2014, and amounts included in unassigned funds (surplus) to be recognized as a component of net periodic pension cost are shown below. Company B has no remaining transition asset or obligation. Company B is not required to amortize the cumulative net loss because it is less than 10% of the greater of the fair value of plan assets or the projected benefit obligation for all years presented. The applicable tax rate for 2013 and 2014 is 40%.

	9/30/13	**11/30/13**	**12/31/13**	**12/31/14**
Projected Benefit Obligation	(3,660)	(3,200)	(3,210)	(3,700)
Plan Asset – Fair Value	2,600	2,200	2,225	2,200
Funded Status	**(1,060)**	**(1,000)**	**(985)**	**(1,500)**
Items not yet recognized as a component of net periodic cost:	380	360	350	230
Prior Service Cost	265[5]	220	315[4]	365
Net Loss	**645**	**580**	**665**	**595**

Based on actuarial valuations performed as of September 30, 2013, and November 30, 2013, the reporting entity determines its net periodic pension cost for the two-month period from October 1, 2013, to November 30, 2013, and for the one-month period from December 1, 2013, to December 31, 2013, as follows:

Net Periodic Pension Cost	**2 Months**	**1 Month**	**Total**
Service Cost	25	15	40
Interest Cost	30	15	45
Expected Return on Plan Assets	(30)	(15)	(45)
Total service cost, interest cost, and expected return on plan assets	**25**	**15**	**40**[2]
Amortization of prior service cost	20	10	30[3]
Amortization of net loss	0	0	0
Total Amortization	20	10	30
Net Periodic Benefit Cost	**45**	**25**	**70**[1]

a. In the fourth quarter of 2013, the reporting entity makes the following journal entry to recognize the $60,000[6] settlement loss: (40% tax rate - $24,000)

Net Periodic Pension Cost (settlement loss)	60	
Deferred Tax Asset	24	
Unassigned Funds (Surplus)		84

b. In 2014, the reporting entity makes the following net journal entry to apply the measurement date provisions and adjust the beginning balances of unassigned funds (surplus), pension liability and deferred tax accounts for the amortization of prior service cost and the service cost, interest cost, and expected return on plan assets.

Unassigned Funds (Surplus)	24	
Deferred Tax Asset	16	
Accrued Benefit Cost		40

This journal entry reflects the following considerations:

- Debit to unassigned funds (surplus) for the $70[1] net periodic benefit cost
- Debit to deferred tax asset for $16 calculated as 40% of the $40[2] total service cost, interest cost, and expected return on plan assets
- Debit to unassigned funds (surplus) for $12 for the tax impact calculated as 40% of the $30[3] amortization of the prior service cost
- Credit to Unassigned funds (surplus) for $28 for the tax impact calculated as 40% of the $70[1] net periodic benefit cost
- Credit to Unassigned funds (surplus) for $30[3] for the amortization of the prior service cost.
- Credit to liability for pension benefits for the $40[2] total service cost, interest cost, and expected return on plan assets

c. The following entry adjusts the beginning balances of unassigned funds (surplus), pension liability and deferred tax accounts for the net loss arising during the period. (Net loss is calculated as follows: Net loss at December 31, 2013 of $315[4], less net loss at November 30, 2013 of $265[5], plus settlement loss of $60[6] to equal $110.)

Unassigned Funds (Surplus)	66	
Deferred Tax Asset	44	
Accrued Benefit Cost		110

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Statement of Statutory Accounting Principles No. 103

Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities

STATUS

Type of Issue:	Common Area
Issued:	March 3, 2012
Effective Date:	January 1, 2013
Affects:	Supersedes SSAP No. 91R Nullifies and incorporates INT 99-22; INT 03-05
Affected by:	No other pronouncements
Interpreted by:	INT 01-31, INT 04-21, INT 09-08

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Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities

SCOPE OF STATEMENT

1. Transfers of financial assets take many forms. Accounting for transfers in which the transferor has no continuing involvement with the transferred financial assets or with the transferee are generally straightforward. However, transfers of financial assets often occur in which the transferor has some continuing involvement either with the assets transferred or with the transferee. Examples of continuing involvement include, but are not limited to, servicing arrangements, recourse or guarantee arrangements, agreements to purchase or redeem transferred financial assets, options written or held, derivative financial instruments that are entered into contemporaneously with, or in contemplation of the transfer, arrangements to provide financial support, pledges of collateral, and the transferor's beneficial interests in the transferred financial assets. Transfers of financial assets with continuing involvement raise issues about the circumstances under which the transfers should be considered as sales of all or part of the assets or as secured borrowings. An objective in accounting for transfers of financial assets is for each reporting entity that is a party to the transaction to recognize only assets it controls and liabilities it has incurred, to derecognize assets only when control has been surrendered, and to derecognize liabilities only when they have been extinguished. Sales and other transfers may frequently result in a disaggregation of financial assets and liabilities into components, which become separate assets and liabilities.

2. This statement focuses on the issues of accounting for transfers[1] and servicing of financial assets and extinguishments of liabilities. This statement establishes statutory accounting principles for transfers and servicing of financial assets, including asset securitizations and securitizations of policy acquisition costs, extinguishments of liabilities, repurchase agreements, repurchase financing and reverse repurchase agreements, including dollar repurchase and dollar reverse repurchase agreements that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts). This statement discusses generalized situations. Facts and circumstances and specific contracts need to be considered carefully in applying this statement. Securitizations of nonfinancial assets are outside the scope of this statement. Transfers of financial assets that are in substance real estate shall be accounted for in accordance with *SSAP No. 40R—Real Estate Investments*. Additionally, retained beneficial interests from the sale of loan-backed or structured securities are to be accounted for in accordance with SSAP No. 43R—Loan-Backed and Structured Securities, Revised.

3. *SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties* (SSAP No. 25) shall be followed for accounting and disclosure requirements for all related party transactions.

4. *SSAP No. 91R—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (SSAP No. 91R) has been superseded by this statement.

5. This statement does not address the securitization of mortality or morbidity risk. The National Association of Insurance Commissioners' (NAIC's) Insurance Securitization Working Group of the Financial Condition (E) Committee is charged with the development of model laws, model regulations and proposed accounting guidance for the securitization of mortality and morbidity risk. When such proposed accounting guidance is finalized the development of a statement will be considered.

[1] Terms defined in the glossary to this statement (Exhibit A) are set in boldface type.

SUMMARY CONCLUSION

Accounting for Transfers and Servicing of Financial Assets

6. The objective of paragraph 8 and related implementation guidance is to determine whether a transferor has surrendered control over transferred financial assets. This determination must consider the transferor's continuing involvement in the transferred financial assets and requires the use of judgment that must consider all arrangements or agreements made contemporaneously with, or in contemplation of, the transfer, even if they were not entered into at the time of the transfer.

7. The requirements of paragraph 8 apply to transfers of an entire financial asset, transfers of a group of entire financial assets, and transfers of a participating interest in an entire financial asset (all of which are referred to collectively in this statement as transferred financial assets). A participating interest has all of the following characteristics:

a. From the date of the transfer, it represents a proportionate (pro rata) ownership interest in an entire financial asset. The percentage of ownership interests held by the transferor in the entire financial asset may vary over time, while the entire financial asset remains outstanding as long as the resulting portions held by the transferor (including any participating interest retained by the transferor or its agents) and the transferee(s) meet the other characteristics of a participating interest. For example, if the transferor's interest in an entire financial asset changes because it subsequently sells another interest in the entire financial asset, the interest held initially and subsequently by the transferor must meet the definition of a participating interest.

b. From the date of the transfer, all cash flows received from the entire financial asset are divided proportionately among the participating interest holders in an amount equal to their share of ownership. Cash flows allocated as compensation for services performed, if any, shall not be included in that determination provided those cash flows are not subordinate to the proportionate cash flows of the participating interest and are not significantly above an amount that would fairly compensate a substitute service provider, should one be required, which includes the profit that would be demanded in the marketplace. In addition, any cash flows received by the transferor as proceeds of the transfer of the participating interest shall be excluded from the determination of proportionate cash flows provided that the transfer does not result in the transferor receiving an ownership interest in the financial asset that permits it to receive disproportionate cash flows.

c. The rights of each participating interest holder (including the transferor in its role as a participating interest holder) have the same priority, and no participating interest holder's interest is subordinated to the interest of another participating interest holder. That priority does not change in the event of bankruptcy or other receivership of the transferor, the original debtor, or any other participating interest holder. Participating interest holders have no recourse to the transferor, its agents or to each other, other than standard representations and warranties, ongoing contractual obligations to service the entire financial asset and administer the transfer contract, and contractual obligations to share in any set-off benefits received by any participating interest holder. That is, no participating interest holder is entitled to receive cash before any other participating interest holder under its contractual rights as a participating interest holder. For example, if a participating interest holder also is the servicer of the entire financial asset and receives cash in its role as servicer, that arrangement would not violate this requirement.

d. No party has the right to pledge or exchange the entire financial asset unless all participating interest holders agree to pledge or exchange the entire financial asset.

If a transfer of a portion of an entire financial asset meets the definition of a participating interest, the transferor shall apply the guidance in paragraph 8. If a transfer of a portion of a financial asset does not meet the definition of a participating interest, the transferor and transferee shall account for the transfer in accordance with the guidance in paragraph 14 as a secured borrowing. However, if the transferor transfers an entire financial asset in portions that do not individually meet the participating interest definition, paragraph 8 shall be applied to the entire financial asset once all portions have been transferred.

8. A transfer of an entire financial asset, a group of entire financial assets, or a participating interest in an entire financial asset in which the transferor surrenders control over those financial assets shall be accounted for as a sale if, and only if, all of the following conditions are met:

a. The transferred financial assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership. Transferred financial assets are isolated in bankruptcy or other receivership only if the transferred financial assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor.

b. Each transferee (or, if the transferee is an entity whose sole purpose is to engage in securitization or asset-backed financing activities and that entity is constrained from pledging or exchanging the assets it receives, each third-party holder of its beneficial interests) has the right to pledge or exchange the assets (or beneficial interests) it received, and no condition both constrains the transferee (or third-party holder of its beneficial interests) from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor (paragraphs 43-46).

c. The transferor or its agents do not maintain effective control over the transferred financial assets or third-party beneficial interests related to those transferred assets (paragraph 50). Examples of a transferor’s effective control over the transferred financial assets include, but are not limited to (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (paragraphs 51-52), (2) an agreement that provides the transferor with both the unilateral ability to cause the holder to return specific financial assets and a more-than-trivial benefit attributable to that ability, other than through a cleanup call (paragraphs 53-57), or (3) an agreement that permits the transferee to require the transferor to repurchase the transferred financial assets at a price that is so favorable to the transferee that it is probable that the transferee will require the transferor to repurchase them (paragraph 58).

Accounting for Transfers of Participating Interests

9. Upon completion of a transfer of a participating interest that satisfies the conditions to be accounted for as a sale (paragraph 8), the transferor (seller) shall:

a. Allocate the previous carrying amount of the entire financial asset between the participating interests sold and the participating interest that continues to be held by the transferor on the basis of their relative fair values at the date of the transfer (paragraph 61).

b. Derecognize the participating interest(s) sold.

c. Recognize and initially measure at fair value servicing assets, servicing liabilities, and any other assets obtained and liabilities incurred in the sale (such as cash) (paragraphs 62-66).

d. Recognize in earnings any gain or loss on the sale.

e. Report any participating interest or interests that continue to be held by the transferor as the difference between the previous carrying amount of the entire financial asset and the amount derecognized.

The transferee shall recognize the participating interest(s) obtained, other assets obtained, and any liabilities incurred and initially measure them at fair value.

10. Upon completion of a transfer of participating interests that does not satisfy the conditions to be accounted for as a sale, the guidance in paragraph 14 shall be applied.

Accounting for Transfers of an Entire Financial Asset or Group of Entire Financial Assets

11. Upon completion of a transfer of an entire financial assets or a group of entire financial assets that satisfies the conditions to be accounted for as a sale (see paragraph 8), the transferor (seller) shall:

a. Derecognize the transferred financial assets;

b. Recognize and initially measure at fair value servicing assets, servicing liabilities, and any other assets obtained (including a transferor's beneficial interest in the transferred financial assets) and liabilities incurred[2] in the sale (paragraphs 60 and 62-66).

c. For reporting entities required to maintain an Interest Maintenance Reserve (IMR), the accounting for realized and unrealized capital gains and losses shall be determined per the guidance in the SSAP for the specific type of investment (e.g., SSAP No. 43R for loan-backed and structured securities), or if not specifically stated in the related SSAP, in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*. For reporting entities not required to maintain an IMR, realized capital gains and losses shall be reported as net realized capital gains or losses in the statement of income, and unrealized capital gains and losses shall be reported as net unrealized gains and losses in unassigned funds (surplus).

The transferee shall recognize all assets obtained and any liabilities incurred, and initially measure them at fair value.

12. Repurchase agreements, reverse repurchase agreements, repurchase financing, collateral requirements and dollar repurchase agreements are described in paragraphs 93-109. When an asset is sold and the proceeds are reinvested within 30 days in the same or substantially the same security, such transfers shall be considered to be wash sales and shall be accounted for as sales as discussed in paragraphs 87-92 and disclosed as required by paragraph 28. Unless there is a concurrent contract to repurchase or redeem the transferred financial assets from the transferee, the transferor does not maintain effective control over the transferred financial assets.

13. Upon completion of a transfer of an entire financial asset or a group of entire financial assets that does not satisfy the conditions to be accounted for as a sale in its entirety, the guidance in paragraph 14 shall be applied.

[2] Some assets that might be obtained and liabilities that might be incurred include cash, put or call options that are held or written (for example, guarantee or recourse obligations), forward commitments (for example, commitments to deliver additional receivables during the revolving periods of some securitizations) and swaps (for example, provisions that convert interest rates from fixed to variable).

Secured Borrowing

14. If a transfer of an entire financial asset, a group of entire financial assets, or a participating interest in an entire financial asset does not meet the conditions for a sale in paragraph 8, or if a transfer of a portion of an entire financial asset does not meet the definition of a participating interest (paragraph 7), the transferor and transferee shall account for the transfer as a secured borrowing with pledge of collateral (paragraph 19). The transferor shall continue to report the transferred financial assets in its statement of financial position with no change in their measurement (that is, basis of accounting).

Recognition and Measurement of Servicing Assets and Liabilities

15. An entity shall recognize and initially measure at fair value, a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract in either of the following situations:

a. A servicer's transfer of an entire financial asset, a group of entire financial assets, or a participating interest in an entire financial asset that meets the requirements for sale accounting; or

b. An acquisition or assumption of a servicing obligation that does not relate to financial assets of the servicer.

An entity that transfers its financial assets to an entity in a transfer that qualifies as a sale in which the transferor obtains the resulting securities and classifies them as debt securities shall separately recognize its servicing assets or servicing liabilities.

16. A servicer that transfers or securitizes financial assets in a transaction that does not meet the requirements for sale accounting and is accounted for as a secured borrowing with the underlying assets remaining on the transferor's balance sheet shall not be recognized as a servicing asset or servicing liability.

17. If distinct servicing rights exist in accordance with the above guidelines, the reporting entity shall recognize a servicing asset or liability. When the servicing fees to be received exceed the cost of servicing the transferred assets, a servicing asset is recognized and nonadmitted. When the cost of servicing the transferred assets is greater than the servicing fees to be received, a liability shall be recorded for the excess to recognize this obligation. A corresponding loss shall be recorded through the Summary of Operations in other income. Servicing assets or liabilities shall be measured subsequently at fair value at each reporting date with fluctuations in fair value reported as unrealized gains and losses. Declines in fair value which are determined to be other than temporary shall be recorded as realized losses.

Financial Assets Subject to Prepayment

18. Financial assets, except for instruments that are within the scope of SSAP No. 86, that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment shall be subsequently measured like investments in debt securities and loan-backed and structured securities in accordance with SSAP No. 43R. Examples of such financial assets include, but are not limited to, **interest-only strips**, other beneficial interests, loans, or other receivables.

Secured Borrowings and Collateral

19. A debtor may grant a **security interest** in certain assets to a lender (the secured party) to serve as collateral for its obligation under a borrowing, with or without recourse to other assets of the debtor. An obligor under other kinds of current or potential obligations, for example, interest rate swaps, also may grant a security interest in certain assets to a secured party. If collateral is transferred to the secured party, the custodial arrangement is commonly referred to as a pledge. Secured parties sometimes are permitted

to sell or repledge (or otherwise transfer) collateral held under a pledge. The same relationships occur, under different names, in transfers documented as sales that are accounted for as secured borrowings (paragraph 14). The accounting for noncash[3] collateral by the debtor (or obligor) and the secured party depends on whether the secured party or its agent has the right to sell or repledge the collateral and on whether the debtor has defaulted.

a. If the secured party (transferee) or its agent has the right by contract or custom to sell or repledge the collateral, then the debtor (transferor) shall report that asset in its balance sheet.

b. If the secured party (transferee) sells collateral pledged to it, it shall recognize the proceeds from the sale and its obligation to return the collateral. The sale of the collateral is a transfer subject to the provisions of this statement.

c. If the debtor (transferor) defaults under the terms of the secured contract and is no longer entitled to redeem the pledged asset, it shall derecognize the pledged asset, and the secured party (transferee) shall recognize the collateral as its asset initially measured at fair value or, if it has already sold the collateral, derecognize its obligation to return the collateral.

d. Except as provided in paragraph 19.c., the debtor (transferor) shall continue to carry the collateral as its asset, and the secured party (transferee) shall not recognize the pledged asset.

20. Reporting entities may enter into certain transactions that require the granting of a security interest in certain assets to another party to serve as collateral[(INT 09-08)] for their performance under a contract. If the assets pledged are recorded as admitted assets under *SSAP No. 4—Assets and Nonadmitted Assets* (SSAP No. 4) and *INT 01-31: Assets Pledged as Collateral* (INT 01-31) and are not impaired under the provisions of *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets* (SSAP No. 5R), the pledging entity records the collateral as an admitted asset until committing a contract default that has not been cured in accordance with the contract provisions. At the time of an uncured default, the provisions of paragraph 19 shall be used to determine the appropriate accounting treatment for the collateral. If the secured party utilizes collateral to offset all or a portion of the liability owed by the pledging entity as a result of the default, then the collateral amount utilized to offset the liability shall be removed from the balance sheet. At the same time, the amount of the liability that was offset shall be removed from the balance sheet since that obligation has been satisfied through the secured party's utilization of that collateral. To the extent that an uncured default remains without the secured party utilizing the collateral to offset the obligation, the pledging insurer shall only record an admitted asset for the amount of collateral that it can redeem.

Extinguishments of Liabilities

21. A debtor shall derecognize a liability if and only if it has been extinguished (see *SSAP No. 15—Debt and Holding Company Obligations* (SSAP No. 15)). A liability has been extinguished if either of the following conditions is met:

a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes delivery of cash, other financial assets, goods, or services or reacquisition by the debtor of its outstanding debt securities whether the securities are canceled or held as so-called treasury bonds; or

[3] Cash "collateral," sometimes used, for example, in securities lending transactions, shall be derecognized by the payer and recognized by the recipient, not as collateral, but rather as proceeds of either a sale or a borrowing.

b. The debtor is legally released[4] from being the primary obligor under the liability, either judicially or by the creditor.

22. An exchange of debt instruments with substantially different terms is also considered a debt extinguishment and shall be accounted for in accordance with paragraph 21. A debtor's exchange of debt instruments (in a nontroubled debt situation) is accomplished with debt instruments that are substantially different if the present value of the cash flows under the terms of the new debt instrument is at least 10 percent different from the present value of the remaining cash flows under the terms of the original instrument. If the difference between the present value of the cash flows under the terms of the new debt instrument and the present value of the remaining cash flows under the terms of the original debt instrument is less than 10 percent, a creditor should evaluate whether the modification is more than minor based on the specific facts and circumstances (and other relevant considerations) surrounding the modification.

Disclosures

23. The principal objectives of the disclosures required by this statement are to provide users of the financial statements with an understanding of all of the following:

a. A transferor's continuing involvement (as defined in the glossary of this statement), if any, with transferred financial assets.

b. The nature of any restrictions on assets reported by an entity in its statement of financial position that relate to a transferred financial asset, including the carrying amounts of those assets.

c. How servicing assets and servicing liabilities are reported under this statement.

d. For transfers accounted for as sales when a transferor has continuing involvement with the transferred financial assets and for transfers of financial assets accounted for as secured borrowings, how the transfer of financial assets affects a transferor's financial position, financial performance, and cash flows.

Those objectives apply regardless of whether this statement requires specific disclosures. The specific disclosures required by this statement are minimum requirements and an entity may need to supplement the required disclosures specified in paragraph 28 depending on the facts and circumstances of a transfer, the nature of an entity's continuing involvement with the transferred financial assets, and the effect of an entity's continuing involvement on the transferor's financial position, financial performance, and cash flows. Disclosures required by other Statement of Statutory Accounting Principles (SSAPs) for a particular form of continuing involvement shall be considered when determining whether the disclosure objectives of this statement have been met.

24. Disclosures required by this statement may be reported in the aggregate for similar transfers if separate reporting of each transfer would not provide more useful information to financial statement users. A transferor shall disclose how similar transfers are aggregated. A transferor shall distinguish transfers that are accounted for as sales from transfers that are accounted for as secured borrowings. In determining whether to aggregate the disclosures for multiple transfers, the reporting entity shall consider quantitative and qualitative information about the characteristics of the transferred financial assets. For example, consideration should be given, but not limited, to the following:

[4] If nonrecourse debt (such as certain mortgage loans) is assumed by a third party in conjunction with the sale of an asset that serves as sole collateral for that debt, the sale and related assumption effectively accomplish a legal release of the seller-debtor for purposes of applying this Statement.

a. The nature of the transferor's continuing involvement.

b. The types of financial assets transferred.

c. Risks related to the transferred financial assets to which the transferor continues to be exposed after the transfer and the change in the transferor's risk profile as a result of the transfer.

25. The disclosures shall be presented in a manner that clearly and fully explains to financial statement users the transferor's risk exposure related to the transferred financial assets and any restrictions on the assets of the entity. An entity shall determine, in light of the facts and circumstances, how much detail it must provide to satisfy the disclosure requirements of this statement and how it aggregates information for assets with different risk characteristics. The entity must strike a balance between obscuring important information as a result of too much aggregation and excessive detail that may not assist financial statement users to understand the entity's financial position. For example, an entity shall not obscure important information by including it with a large amount of insignificant detail. Similarly, an entity shall not disclose information that is so aggregated that it obscures important differences between the different types of involvement or associated risks.

26. The disclosures in paragraph 28.f. of this statement apply to transfers accounted for as sales when the transferor has continuing involvement with transferred financial assets as a result of a securitization, asset-backed financing arrangement, or a similar transfer. If specific disclosures are required for a particular form of the transferor's continuing involvement by other SSAPs, the transferor shall provide the information required in paragraphs 28.f.i.(a) and 28.f.ii.(a) of this statement with a cross-reference to the separate notes to financial statements so a financial statement user can understand the risks retained in the transfer. The entity need not provide each specific disclosure required in paragraphs 28.f.i.(b), 28.f.ii.(a)(1)–(4), and 28.f.ii.(b)–(e) if the disclosure is not required by other SSAPs and the objectives of paragraph 23 are met. For example, if the transferor's only form of continuing involvement is a derivative, the entity shall provide the disclosures required in paragraphs 28.f.i.(a) and 28.f.ii.(a) of this statement and the disclosures about derivatives required by applicable SSAPs. In addition, the entity would evaluate whether the other disclosures in paragraph 28.f. are necessary for the entity to meet the objectives in paragraph 23.

27. To apply the disclosures in paragraph 28, an entity shall consider all involvements by the transferor or its agents to be involvements by the transferor.

28. A reporting entity shall disclose the following:

a. For collateral:

i. If the entity has entered into repurchase agreements or securities lending transactions, its policy for requiring collateral or other security and the fair value of the loaned security;

ii. If the entity has pledged any of its assets as collateral that are not reclassified and separately reported in the statement of financial position pursuant to paragraph 19.a., the carrying amounts and classifications of both those assets and associated liabilities as of the date of the latest statement of financial position presented, including qualitative information about the relationship(s) between those assets and associated liabilities. For example, if assets are restricted solely to satisfy a specific obligation, the carrying amounts of those assets and associated liabilities, including a description of the nature of restrictions placed on the assets, shall be disclosed.

iii. If the entity or its agent has accepted collateral that it is permitted by contract or custom to sell or repledge, the fair value as of the date of each statement of financial position presented of that collateral and of the portion of that collateral that it has sold or repledged, and information about the sources and uses of that collateral. Additionally, the reporting entity shall disclose the aggregate amount of contractually obligated open collateral positions (aggregate amount of securities at current fair value or cash received for which the borrower may request the return of on demand) and the aggregate amount of contractually obligated collateral positions under 30-day, 60-day, 90-day, and greater than 90-day terms.

iv. If the entity has accepted collateral that it is not permitted by contract or custom to sell or repledge, provide detail on these transactions, including the terms of the contract, and the current fair value of the collateral.

v. For all securities lending transactions, disclose collateral for transactions that extend beyond one year from the reporting date; and

vi. For securities lending transactions administered by an affiliated agent in which "one-line" reporting (paragraph 83.a.) of the reinvested collateral per paragraph 83.c. is optional, at the discretion of the reporting entity, disclose the aggregate value of the reinvested collateral which is "one line" reported and the aggregate value of items which are reported in the investment schedules (paragraph 83.b.). Identify the rationale between the items which are one line reported and those that are investment schedule reported and if the treatment has changed from the prior period and

vii. For securities lending transactions, include separately, the amount of any loaned securities within the separate account and if the policy and procedures for the separate account differ from the general account.

b. The reporting entity shall provide the following information by type of program (repurchase agreement, securities lending or dollar repurchase agreement) with respect to the reinvestment of the cash collateral and any securities which it or its agent receives as collateral that can be sold or repledged.

i. The aggregate amount of the reinvested cash collateral (amortized cost and fair value). Reinvested cash collateral shall be broken down by the maturity date of the invested asset – under 30-day, 60-day, 90-day, 120-day, 180-day, less than 1 year, 1-2 years, 2-3 years and greater than 3 years.

ii. To the extent that the maturity dates of the liability (collateral to be returned) does not match the invested assets, the reporting entity shall explain the additional sources of liquidity to manage those mismatches.

c. For in-substance defeasance of debt

i. If debt was considered to be extinguished by in-substance defeasance, a general description of the transaction and the amount of debt that is considered extinguished at the end of each the period so long as that debt remains outstanding.

d. For all servicing assets and servicing liabilities:

i. A description of the risks inherent in servicing assets and servicing liabilities and, if applicable, the instruments used to mitigate the income statement effect of changes in fair value to the servicing assets and servicing liabilities. (Disclosure of quantitative information about the instruments used to manage the risks inherent in servicing assets and servicing liabilities is encouraged but not required.)

ii. The amount of contractually specified servicing fees, late fees and ancillary fees earned for each period for which results of operations are presented, including a description of where each amount is reported in the statement of income.

iii. Quantitative and qualitative information about the assumptions used to estimate the fair value (for example, discount rates, anticipated credit losses, and prepayment speeds). (An entity that provides quantitative information about the instruments used to manage the risks inherent in the servicing assets and servicing liabilities, as encouraged by paragraph 28.d.i., also is encouraged, but not required to disclose the quantitative and qualitative information about the assumptions used to estimate the fair value of those instruments.

e. When servicing assets and servicing liabilities are subsequently measured at fair value:

i. For each class of servicing assets and servicing liabilities, the activity in the balance of servicing assets and the activity in the balance of servicing liabilities (including a description of where changes in fair value are reported in the statement of income for each period for which results of operations are presented), including, but not limited to, the following:

(a) The beginning and ending balances

(b) Additions (through purchases of servicing assets, assumptions of servicing obligations, and recognition of servicing obligations that result from transfers of financial assets)

(c) Disposals

(d) Changes in fair value during the period resulting from (i) changes in valuation inputs or assumptions used in the valuation model and (ii) other changes in fair value and a description of those changes

(e) Other changes that affect the balance and a description of those changes.

f. For securitizations, asset-backed financing arrangements, and similar transfers accounted for as sales when the transferor has continuing involvement (as defined in the glossary) with the transferred financial assets:

i. For each income statement presented:

(a) The characteristics of the transfer (including a description of the transferor's continuing involvement with the transferred financial assets, the nature and initial fair value of the assets obtained as proceeds and the liabilities incurred in the transfer, and the gain or loss from sale of transferred financial assets. For initial fair value measurements of assets obtained and liabilities incurred in the transfer, the following information:

(1) The level within the fair value hierarchy in which the fair value measurements in their entirety fall, segregating fair value measurements using quoted prices in active markets for identical assets or liabilities (Level 1), significant other observable inputs (Level 2), and significant unobservable inputs (Level 3)

(2) The key inputs and assumptions[5] used in measuring the fair value of assets obtained and liabilities incurred as a result of the sale that relate to the transferor's continuing involvement (including, at a minimum, but not limited to, and if applicable, quantitative information about discount rates, expected prepayments including the expected weighted-average life of prepayable[6] financial assets, and anticipated credit losses, including expected static pool losses[7])[8]

(b) Cash flows between a transferor and transferee, including proceeds from new transfers, proceeds from collections reinvested in revolving-period transfers, purchases of previously transferred financial assets, servicing fees, and cash flows received from a transferor's beneficial interests.

ii. For each statement of financial position presented, regardless of when the transfer occurred:

(a) Qualitative and quantitative information about the transferor's continuing involvement with transferred financial assets that provides financial statement users with sufficient information to assess the reasons for the continuing involvement and the risks related to the transferred financial assets to which the transferor continues to be exposed after the transfer and the extent that the transferor's risk profile has changed as a result of the transfer (including, but not limited to, credit risk, interest rate risk, and other risks), including:

(1) The total principal amount outstanding, the amount that has been derecognized, and the amount that continues to be recognized in the statement of financial position.

(2) The terms of any arrangements that could require the transferor to provide financial support (for example, liquidity arrangements

[5] If an entity has aggregated multiple transfers during a period in accordance with paragraphs 24 and 25, it may disclose the range of assumptions.

[6] The weighted-average life of prepayable assets in periods (for example, months or years) can be calculated by multiplying the principal collections expected in each future period by the number of periods until that future period, summing those products, and dividing the sum by the initial principal balance.

[7] Expected static pool losses can be calculated by summing the actual and projected future credit losses and dividing the sum by the original balance of the pool of assets.

[8] The timing and amount of future cash flows for transferor's interests in transferred financial assets are commonly uncertain, especially if those interests are subordinate to more senior beneficial interests. Thus, estimates of future cash flows used for a fair value measurement depend heavily on assumptions about default and prepayment of all the financial assets transferred, because of the implicit credit or prepayment risk enhancement arising from the subordination.

and obligations to purchase assets) to the transferee or its beneficial interest holders, including a description of any events or circumstances that could expose the transferor to loss and the amount of the maximum exposure to loss.

(3) Whether the transferor has provided financial or other support during the periods presented that it was not previously contractually required to provide to the transferee or its beneficial interest holders, including when the transferor assisted the transferee or its beneficial interest holders in obtaining support, including:

(i.) The type and amount of support

(ii.) The primary reasons for providing the support

(4) Information is encouraged about any liquidity arrangements, guarantees, and/or other commitments provided by third parties related to the transferred financial assets that may affect the transferor's exposure to loss or risk of the related transferor's interest.

(b) The entity's accounting policies for subsequently measuring assets and liabilities that relate to the continuing involvement with the transferred financial assets;

(c) The key inputs and assumptions used in measuring the fair value of assets or liabilities that relate to the transferor's continuing involvement (including, at a minimum, but not limited to, and if applicable, quantitative information about discount rates, expected prepayments including the expected weighted-average life of prepayable financial assets, and anticipated credit losses, including expected static pool losses);

(d) For the transferor's interests in the transferred financial assets, a sensitivity analysis or stress test showing the hypothetical effect on the fair value of those interests (including any servicing assets or servicing liabilities) of two or more unfavorable variations from the expected levels for each key assumption that is reported under paragraph 28.f.ii.(c) independently from any change in another key assumption, and a description of the objectives, methodology, and limitations of the sensitivity analysis or stress test

(e) Information about the asset quality of transferred financial assets and any other assets that it manages together with them. This information shall be separated between assets that have been derecognized and assets that continue to be recognized in the statement of financial position. This information is intended to provide financial statement users with an understanding of the risks inherent in the transferred financial assets as well as in other assets and liabilities that it manages together with transferred financial assets. For example, information for receivables shall include, but is not limited to:

(i.) Delinquencies at the end of the period; and (ii.) Credit losses, net of recoveries, during the period.

g. Disclosure requirements for transfers of financial assets accounted for as secured borrowing:

i. The carrying amounts and classifications of both assets and associated liabilities recognized in the transferor's statement of financial position at the end of each period presented, including qualitative information about the relationship(s) between those assets and associated liabilities. For example, if assets are restricted solely to satisfy a specific obligation, the carrying amounts of those assets and associated liabilities, including a description of the nature of restrictions placed on the assets.

h. Description of any loaned securities, including the amount, a description of, and the policy for, requiring collateral, and whether or not the collateral is restricted;

i. A description of the securities underlying repurchase and reverse repurchase agreements, dollar repurchase and dollar reverse repurchase agreements, including book values and fair values, and maturities for the following categories: (i) securities subject to reverse repurchase agreements; (ii) securities subject to repurchase agreements; (iii) securities subject to dollar repurchase agreements; and (iv) securities subject to dollar reverse repurchase agreements; and

j. A description of the terms of reverse repurchase agreements whose amounts are included in borrowed money.

k. Disclose any transfers of receivables with recourse.

l. A reporting entity shall disclose the following information for wash sales, as defined in paragraph 12, involving transactions for securities with a NAIC designation of 3 or below, or that do not have an NAIC designation:

i. A description of the reporting entity's objectives regarding these transactions;

ii. An aggregation of transactions by NAIC designation 3 or below, or that do not have an NAIC designation;

iii. The number of transactions involved during the reporting period;

iv. The book value of securities sold;

v. The cost of securities repurchased; and

vi. The realized gains/losses associated with the securities involved.

m. All repurchase and reverse repurchase transactions and securities borrowing and securities lending transactions shall be shown gross when detailed on the respective investment schedules. However, repurchase and reverse repurchase transactions and securities borrowing and securities lending transactions may be reported net in the financial statements (pages 2 and 3 of the statutory financial statements) in accordance with *SSAP No. 64—Offsetting and Netting of Assets and Liabilities* (SSAP No. 64) when a valid right to offset exists. When these transactions are offset in accordance with SSAP No. 64 and reported net in the financial statements, the disclosure requirements in SSAP No. 64, paragraph 6, shall be followed.

29. Refer to the preamble for further discussion regarding disclosure requirements. The disclosures required by paragraph 28 shall be made for the current quarter in the quarterly statement and for the year in the annual statement.

Application Guidance

30. This application guidance describes certain provisions of this statement in more detail and describes how they apply to certain types of transactions. It also discusses generalized situations. Facts and circumstances and specific contracts need to be considered carefully in applying this statement. This application guidance is an integral part of the standards provided in this statement.

31. Paragraph 6 of this statement states that the objective of paragraph 8 and related implementation guidance is to determine whether a transferor has surrendered control over transferred financial assets.

Unit of Account

32. Paragraph 7 establishes the unit of account to which the sale accounting conditions in paragraph 8 shall be applied. Paragraph 7 states that paragraph 8 shall be applied to transfers of an entire financial asset, transfers of a group of entire financial assets, and transfers of a participating interest in an entire financial asset. Inherent in that principle is that to be eligible for sale accounting an entire financial asset cannot be divided into components before a transfer unless all of the components meet the definition of a participating interest.

33. The legal form of the asset and what the asset conveys to its holders shall be considered in determining what constitutes an entire financial asset. The following examples illustrate the application of what constitutes an entire financial asset:

a. A loan to one borrower in accordance with a single contract that is transferred to a securitization entity before securitization shall be considered an entire financial asset. Similarly, a beneficial interest in securitized financial assets after the securitization process has been completed shall be considered an entire financial asset. In contrast, a transferred interest in an individual loan shall not be considered an entire financial asset; however, if the transferred interest meets the definition of a participating interest, the participating interest would be eligible for sale accounting.

b. In a transaction in which the transferor creates an interest-only strip from a loan and transfers the interest-only strip, the interest-only strip does not meet the definition of an entire financial asset (and an interest-only strip does not meet the definition of a participating interest; therefore, sale accounting would be precluded). In contrast, if an entire financial asset is transferred to a securitization entity and the transfer meets the conditions for sale accounting, the transferor may obtain an interest-only strip as proceeds from the sale. An interest-only strip received as proceeds of a sale is an entire financial asset for purposes of evaluating any future transfers that could then be eligible for sale accounting.

c. If multiple advances are made to one borrower in accordance with a single contract (such as a line of credit, credit card loan, or a construction loan), an advance on that contract would be a separate unit of account if the advance retains its identity, does not become part of a larger loan balance, and is transferred in its entirety. However, if the transferor transfers an advance in its entirety and the advance loses its identity and becomes part of a larger loan balance, the transfer would be eligible for sale accounting only if the transfer of the advance does not result in the transferor retaining any interest in the larger balance or if the transfer results in the transferor's interest in the larger balance meeting the definition of a participating interest. Similarly, if the transferor transfers an interest in an advance that has lost its identity, the interest must be a participating interest in the larger balance to be eligible for sale accounting.

Participating Interests in an Entire Financial Asset

34. Paragraph 7.b. requires that all cash flows received from the entire financial asset be divided among the participating interest holders (including any interest retained by the transferor or its agents) in proportion to their share of ownership. That is, the participating interest definition does not allow for the allocation of specified cash flows unless each cash flow is proportionately allocated to the participating interest holders. For example, in the case of an individual loan in which the borrower is required to make a contractual payment that consists of a principal amount and interest amount on the loan, the transferor and transferee shall share in the principal and interest payments on the basis of their proportionate ownership interest in the loan. In contrast, if the transferor is entitled to receive an amount that represents the principal payments and the transferee is entitled to receive an amount that represents the interest payments on the loan, that arrangement would not be consistent with the participating interest definition because the transferor and transferee do not share proportionately in the cash flows received from the loan. In other cases, a transferor may transfer a portion of an individual loan that represents either a senior interest or a junior interest in an individual loan. In both of those cases, the transferor would account for the transfer as a secured borrowing because the senior interest or junior interest in the loan does not meet the requirements to be participating interests (see paragraph 38).

35. Paragraph 7.b. states that cash flows allocated as compensation for services performed, if any, shall not be included in that determination provided that those cash flows are not subordinate to the proportionate cash flows of the participating interest and are not significantly above an amount that would fairly compensate a substitute service provider, should one be required, including any profit that would be demanded in the marketplace. Cash flows allocated as compensation for services performed that are significantly above an amount that would fairly compensate a substitute service provider would result in a disproportionate division of cash flows of the entire financial asset among the participating interest holders and, therefore, would preclude the portion of a transferred financial asset from meeting the definition of a participating interest. Examples of cash flows that are compensation for services performed include loan origination fees paid by the borrower to the transferor, fees necessary to arrange and complete the transfer paid by the transferee to the transferor, and fees for servicing the financial asset.

36. The transfer of a portion of an entire financial asset may result in a gain or loss on the transfer when the contractual interest rate on the entire financial asset differs from the market rate at the time of transfer. Paragraph 7.b. states that any cash flows received by the transferor as proceeds of a transfer of a participating interest shall be excluded from the determination of whether the cash flows of the participating interest are proportionate provided that the transfer does not result in the transferor receiving an ownership interest in the financial asset that permits it to receive disproportionate cash flows. For example, if the transferor transfers an interest in an entire financial asset and the transferee agrees to incorporate the excess interest (between the contractual interest rate on the financial asset and the market interest rate at the date of transfer) into the contractually specified servicing fee, the excess interest would likely result in the conveyance of an interest-only strip to the transferor from the transferee. An interest-only strip would result in a disproportionate division of cash flows of the financial asset among the participating interest holders and would preclude the portion from meeting the definition of a participating interest.

37. Paragraph 7.c. requires that the rights of each participating interest holder (including the transferor in its role as participating interest holder) have the same priority and that no participating interest holder's interest is subordinated to the interest of another participating interest holder. In certain transfers, recourse is provided to the transferee that requires the transferor to reimburse any premium paid by the transferee if the underlying financial asset is prepaid within a defined timeframe of the transfer date. Such recourse would preclude the transferred portion from meeting the definition of a participating

interest. However, once the recourse provision expires, the transferred portion shall be reevaluated to determine if it meets the participating interest definition.

38. Paragraph 7.c. also requires that participating interest holders have no recourse to the transferor (or its agents) or to each other, other than standard representations and warranties, ongoing contractual obligations to service the entire financial asset and administer the transfer contract, and contractual obligations to share in any set-off benefits. Recourse in the form of an independent third-party guarantee shall be excluded from the evaluation of whether the participating interest definition is met. Similarly, cash flows allocated to a third-party guarantor for the guarantee fee shall be excluded from the determination of whether the cash flows are divided proportionately among the participating interest holders.

Isolation Beyond the Reach of the Transferor and Its Creditors

39. The nature and extent of supporting evidence required for an assertion in financial statements that an entire financial asset, a group of entire financial assets, or a participating interest in an entire financial asset (which are referred to collectively in this statement as transferred financial assets) have been isolated—put presumptively beyond the reach of the transferor and its creditors, either by a single transaction or a series of transactions taken as a whole—depend on the facts and circumstances. All available evidence that either supports or questions an assertion shall be considered, including whether the contract or circumstances permit the transferor to revoke the transfer. It also may include consideration of the legal consequences of the transfer in the jurisdiction in which bankruptcy or other receivership would take place, whether a transfer of financial assets would likely be deemed a true sale at law (as described in paragraph 40.a.) or otherwise isolated (as described in paragraph 40.b.), whether the transferor is affiliated with the transferee, and other factors pertinent under applicable law. Derecognition of transferred financial assets is appropriate only if the available evidence provides reasonable assurance that the transferred financial assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor and its creditors (paragraph 74.c.). Transactions between related parties or affiliates are accounted for in accordance with SSAP No. 25.

40. In the context of U.S. bankruptcy laws, a true sale opinion from an attorney is often required to support a conclusion that transferred financial assets are isolated from the transferor, and its creditors. In addition, a nonconsolidation opinion is often required if the transfer is to an affiliated entity. In the context of U.S. bankruptcy laws:

a. A true sale opinion is an attorney's conclusion that the transferred financial assets have been sold and are beyond the reach of the transferor's creditors and that a court would conclude that the transferred financial assets would not be included in the transferor's bankruptcy estate.

b. A nonconsolidation opinion is an attorney's conclusion that a court would recognize that an entity holding the transferred financial assets exists separately from the transferor. Additionally, a nonconsolidation opinion is an attorney's conclusion that a court would not order the substantive consolidation of the assets and liabilities of the entity holding the transferred financial assets and the assets and liabilities of the transferor in the event of the transferor's bankruptcy or receivership.

A legal opinion may not be required if a transferor has a reasonable basis to conclude that the appropriate legal opinion(s) would be given if requested. For example, the transferor might reach a conclusion without consulting an attorney if (1) the transfer is a routine transfer of financial assets that does not result in any continuing involvement by the transferor or (2) the transferor had experience with other transfers with similar facts and circumstances under the same applicable laws and regulations.

41. For insurers that are subject to conservatorship, or other receivership procedures, judgments about whether transferred financial assets have been isolated need to be made in relation to the powers of conservators or receivers in those jurisdictions.

42. Whether securitizations isolate transferred financial assets may depend on such factors as whether the securitization is accomplished in one step or multiple step transfers (paragraphs 71-76). Some common financial transactions, for example, typical repurchase agreements and securities lending transactions, may isolate transferred financial assets from the transferor, although they may not meet the other conditions for surrender of control (paragraph 8).

Conditions That Constrain a Transferee

43. Sale accounting is allowed under paragraph 8.b. only if each transferee (or, if the transferee is an entity whose sole purpose is to engage in securitization or asset-backed financing arrangements and that entity is constrained from pledging or exchanging the assets it receives, each third-party holder of its beneficial interests) has the right to pledge or exchange the assets or beneficial interests it received, and no condition both constrains the transferee (or third-party holder of its beneficial interests) from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor. Many transferor-imposed or other conditions on a transferee's right to pledge or exchange both constrain a transferee from pledging or exchanging and, through that constraint, provide more than a trivial benefit to the transferor. Judgment is required to assess whether a particular condition results in a constraint. Judgment also is required to assess whether a constraint provides a more-than-trivial benefit to the transferor. If the transferee is an entity whose sole purpose is to engage in securitization or asset-backed financing activities, that entity may be constrained from pledging or exchanging the transferred financial assets to protect the rights of beneficial interest holders in the financial assets of the entity. Paragraph 8.b. requires that the transferor look through the constrained entity to determine whether each third-party holder of its beneficial interests has the right to pledge or exchange the beneficial interests that it holds. The considerations in paragraphs 47-49 apply to the transferee or the third-party holders of its beneficial interests in an entity that is constrained from pledging or exchanging the assets it receives and whose sole purpose is to engage in securitization or asset-backed financing activities

44. Some conditions may constrain a transferee from pledging or exchanging the financial asset and may provide the transferor with more than a trivial benefit. For example, a provision that prohibits selling or pledging a transferred loan receivable not only constrains the transferee but also provides the transferor with the more-than-trivial benefit of knowing who holds the financial asset (a prerequisite to repurchasing the financial asset) and of being able to block the financial asset from being transferred to a competitor for the loan customer's business. Transferor-imposed contractual constraints that narrowly limit timing or terms, for example, allowing a transferee to pledge only on the day assets are obtained or only on terms agreed to with the transferor, also constrain the transferee and presumptively provide the transferor with more-than-trivial benefits. In some circumstances in which the transferor has no continuing involvement with the transferred financial assets, some conditions may constrain a transferee from pledging or exchanging the financial assets. If the transferor and its agents have no continuing involvement with the transferred financial assets, the condition under paragraph 8.b. is met. For example, if a transferor receives only cash in return for the transferred financial assets and the transferor and its agents have no continuing involvement with the transferred financial assets, sale accounting is allowed under paragraph 8.b. even if the transferee entity is significantly limited in its ability to pledge or exchange the transferred assets.

45. However, some conditions may not constrain a transferee from pledging or exchanging the transferred financial asset. For example, a transferor's right of first refusal on the occurrence of a bona fide offer to the transferee from a third party presumptively would not constrain a transferee. This is because the right in itself does not enable the transferor to compel the transferee to sell the financial asset and the transferee would be in a position to receive the sum offered by exchanging the financial asset, albeit possibly from the transferor rather than the third party. Further examples of conditions that

presumptively would not constrain a transferee for purposes of this statement include (a) a requirement to obtain the transferor's permission to sell or pledge that is not to be unreasonably withheld, (b) a prohibition on sale to the transferor's competitor if other potential willing buyers exist, (c) a regulatory limitation such as on the number or nature of eligible transferees (as in the case of securities issued under Securities Act Rule 144A or debt placed privately), and (d) illiquidity, for example, the absence of an active market. However, judgment is required to assess the significance of some conditions. For example, a prohibition on sale to the transferor's competitor would be a constraint if that competitor were the only potential willing buyer other than the transferor.

46. A condition imposed by a transferor that constrains the transferee presumptively provides more than a trivial benefit to the transferor. A condition not imposed by the transferor that constrains the transferee may or may not provide more than a trivial benefit to the transferor. For example, if the transferor refrains from imposing its usual contractual constraint on a specific transfer because it knows an equivalent constraint is already imposed on the transferee by a third party, it presumptively benefits more than trivially from that constraint. However, the transferor cannot benefit from a constraint if it is unaware at the time of the transfer that the transferee is constrained.

Transferor's Rights or Obligations to Reacquire Transferred Assets or Beneficial Interests

47. Some rights or obligations to reacquire transferred financial assets or beneficial interests both constrain the transferee and provide more than a trivial benefit to the transferor, thus precluding sale accounting under paragraph 8.b. A freestanding call option written by a transferee to the transferor may benefit the transferor and, if the transferred financial assets are not readily obtainable in the marketplace, is likely to constrain a transferee because the transferee might have to default if the call was exercised and the transferee had pledged or exchanged the financial assets. For example, if a transferor in a securitization transaction has a call option to repurchase third-party beneficial interests at the price paid plus a stated return, that arrangement conveys more than a trivial benefit to the transferor (paragraphs 53 and 54). If the third-party holders of its beneficial interests are constrained from pledging or exchanging their beneficial interests due to that call option, the transferor would be precluded from accounting for the transfer of financial assets to the securitization entity as a sale. Similarly, a freestanding forward purchase-sale contract between the transferor and the transferee on transferred financial assets not readily obtainable in the marketplace would benefit the transferor and is likely to constrain a transferee in much the same manner. Alternatively, freestanding rights to reacquire transferred assets that are readily obtainable presumptively do not constrain the transferee from pledging or exchanging them and thus do not preclude sale accounting under paragraph 8.b.

48. Other rights or obligations to reacquire transferred financial assets, regardless of whether they constrain the transferee, may result in the transferor's maintaining effective control over the transferred financial assets, as discussed in paragraphs 50-58, thus precluding sale accounting under paragraph 8.c. For example, an attached call in itself would not constrain a transferee who is able, by exchanging or pledging the asset subject to that call, to obtain substantially all of its economic benefits. However, an attached call could result in the transferor's maintaining effective control over the transferred asset(s) because the attached call gives the transferor the unilateral ability to cause whoever holds that specific asset to return it.

49. The concept of qualified special-purpose entities (QSPEs) was previously included within SSAP No. 91R. With the issuance of this Statement, this concept is no longer included within statutory accounting guidance. Although this concept has been eliminated and is no longer a factor in determining whether a transfer of assets qualifies for sale accounting, reporting entities may continue to form, conduct transfers between, or have investments in trusts or other such legal vehicles that may have previously met the conditions to be considered a QSPE. Accounting for transfers of assets between the insurer and such trusts or other legal vehicles, including whether such transfers qualify for sale accounting, are subject to the provisions of this Statement. As noted within paragraph 3, SSAP No. 25 shall be followed for accounting and disclosure requirements for all related party transactions.

Effective Control Over Transferred Financial Assets or Beneficial Interests

50. Judgment is required to assess whether the transferor maintains effective control over transferred financial assets or third-party beneficial interests. The transferor must evaluate whether a combination of multiple arrangements maintains effective control of transferred financial assets. When the transferee issues beneficial interests in the transferred financial assets, the evaluation of whether the transferor maintains effective control over the transferred financial assets also shall consider whether the transferor maintains effective control over the transferred financial assets through its control over the third-party beneficial interests. To assess whether the transferor maintains effective control over the transferred financial assets, all continuing involvement by the transferor or its agents shall be considered continuing involvement by the transferor. When assessing effective control, the transferor only considers the involvements of an agent when the agent acts for and on behalf of the transferor. In other words, if the transferor and transferee have the same agent, the agent's activities on behalf of the transferee would not be considered in the transferor's evaluation of whether it has effective control over a transferred financial asset. For example, an investment manager may act as a fiduciary (agent) for both the transferor and the transferee; therefore, the transferor need only consider the involvements of the investment manager when it is acting on its behalf.

Agreement to Repurchase or Redeem Transferred Financial Assets

51. An agreement that both entitles and obligates the transferor to repurchase or redeem transferred financial assets from the transferee maintains the transferor's effective control over those assets as described in paragraph 8.c.(1) when all of the following conditions are met:

a. The financial assets to be repurchased or redeemed are the same or substantially the same as those transferred (paragraph 52).

b. The agreement is to repurchase or redeem them before maturity, at a fixed or determinable price.

c. The agreement is entered into contemporaneously with, or in contemplation of, the transfer.

52. To be substantially the same, the financial asset that was transferred and the financial asset that is to be repurchased or redeemed need to have all of the following characteristics:

a. The same primary obligor (except for debt guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and the terms of the guarantee must be the same);

b. Identical form and type so as to provide the same risks and rights;

c. The same maturity (or in the case of mortgage-backed pass-through and pay-through securities similar remaining weighted-average maturities that result in approximately the same market yield);

d. Identical contractual interest rates;

e. Similar assets as collateral; and

f. The same aggregate unpaid principal amount or principal amounts within accepted "good delivery" standards for the type of security involved.

Unilateral Ability to Cause the Return of Specific Transferred Financial Assets

53. A transferor maintains effective control over transferred financial assets when the transferor has the unilateral ability to cause the holder to return specific financial assets and that ability provides more than a trivial benefit to the transferor. A cleanup call, however, is permitted as an exception to that general principle. A call on a transferred financial asset provides the transferor with effective control over that financial asset if, under its price and other terms, the call provides the transferor with the unilateral ability to reclaim the transferred financial asset and conveys more than a trivial benefit to the transferor. A call or other right conveys more than a trivial benefit if the price to be paid is fixed, determinable, or otherwise potentially advantageous, unless because that price is so far out of the money or for other reasons it is probable when the option is written that the transferor will not exercise it. A transferor's unilateral ability to cause a securitization entity to return to the transferor or otherwise dispose of specific transferred financial assets, for example, in response to its decision to exit a market or a particular activity, would provide the transferor with effective control over the transferred financial assets if it provides more than a trivial benefit to the transferor. However, a call on readily obtainable assets at fair value may not provide the transferor with more than a trivial benefit. (Paragraph 56 provides an example in which, due to the combination of arrangements, the transferor would maintain effective control.).

54. Effective control over transferred financial assets can be present even if the right to reclaim is indirect. For example, if a call allows a transferor to buy back the beneficial interests at a fixed price, the transferor may maintain effective control of the financial assets underlying those beneficial interests. If the transferee is an entity whose sole purpose is to engage in securitization or asset-backed financing activities, that entity may be constrained from choosing to pledge or exchange the transferred financial assets. In that circumstance, any call held by the transferor on third-party beneficial interests is effectively an attached call on the transferred financial assets. Depending on the price and other terms of the call, the transferor may maintain effective control over the transferred financial assets.

55. An embedded call would not result in the transferor's maintaining effective control because it is the issuer rather than the transferor who holds the call and the call does not provide more than a trivial benefit to the transferor. For example, a call embedded by the issuer of a callable bond or the borrower of a prepayable mortgage loan would not provide the transferor with effective control over the transferred financial asset.

56. A right to reclaim specific transferred financial assets by paying their fair value when reclaimed generally does not maintain effective control when it does not convey a more than trivial benefit to the transferor. However, a transferor has maintained effective control if it has such a right and also holds the residual interest in the transferred financial assets. For example, if a transferor holds the residual interest in securitized financial assets and can reclaim the transferred financial assets at termination of the securitization entity by purchasing them in an auction, and thus at what might appear to be fair value, then sale accounting for the transfer of those financial assets it can reclaim would be precluded. Such circumstances provide the transferor with a more than trivial benefit and effective control over the financial assets, because it can pay any price it chooses in the auction and recover any excess paid over fair value through its residual interest in the transferred financial assets.

57. Removal-of-account provisions do not result in the transferor's maintaining effective control, and are thus precluded from being accounted for as sales under statutory accounting as discussed in paragraph 78.

Arrangements to Reacquire Transferred Financial Assets

58. A transferor maintains effective control over the transferred financial asset as described in paragraph 8.c.(3) through an agreement that permits the transferee to require the transferor to repurchase the transferred financial asset at a price that is so favorable to the transferee at the date of the transfer that it is probable that the transferee will require the transferor to repurchase the transferred financial asset.

For example, a put option written to the transferee generally does not provide the transferor with effective control over the transferred financial asset. However, a put option that is sufficiently deep in the money when it is written would provide the transferor effective control over the transferred financial asset because it is probable that the transferee will exercise the option and the transferor will be required to repurchase the transferred financial asset. In contrast, a sufficiently out-of-the-money put option held by the transferee would not provide the transferor with effective control over the transferred financial asset if it is probable when the option is written that the option will not be exercised. Likewise, a put option held by the transferee at fair value would not provide the transferor with effective control over the transferred financial asset.

Changes That Result in the Transferor's Regaining Control of Financial Assets Sold

59. A change in law or other circumstance may result in a transferred portion of an entire financial asset no longer meeting the conditions of a participating interest (paragraph 7) or the transferor's regaining control of transferred financial assets after a transfer that was previously accounted for as a sale, because one or more of the conditions in paragraph 8 are no longer met. Such changes, unless they arise solely from the initial application of this statement or from a change in market prices (for example, an increase in price that moves into-the-money a freestanding call on a non-readily-obtainable transferred financial asset that was originally sufficiently out-of-the-money that it was judged not to constrain the transferee), are accounted for in the same manner as a purchase of the transferred financial assets from the former transferee(s) in exchange for liabilities assumed (paragraph 9 or 11). (This "re-purchase" premise is consistent with *INT 04-21: EITF 02-09: Accounting for Changes that Result in a Transferor Regaining Control of Financial Assets Sold*.) After that change, the transferor recognizes in its financial statements those transferred financial assets together with liabilities to the former transferee(s) or beneficial interest holders of the former transferee(s). The transferor initially measures those transferred financial assets and liabilities at fair value on the date of the change, as if the transferor purchased the transferred financial assets and assumed the liabilities on that date. The former transferee would derecognize the transferred financial assets on that date, as if it had sold the transferred financial assets in exchange for a receivable from the transferor.

Measurement of Interests Held after a Transfer of Financial Assets

Assets Obtained and Liabilities Incurred as Proceeds

60. The proceeds from a sale of financial assets consist of the cash and any other assets obtained, including beneficial interests and separately recognized servicing assets, in the transfer less any liabilities incurred, including separately recognized servicing liabilities. Any asset obtained is part of the proceeds from the sale. Any liability incurred, even if it is related to the transferred financial assets, is a reduction of the proceeds. Any derivative financial instrument entered into concurrently with a transfer of financial assets is either an asset obtained or a liability incurred and part of the proceeds received in the transfer. All proceeds and reductions of proceeds from a sale shall be initially measured at fair value.

Participating Interests in Financial Assets That Continue to be Held by a Transferor

61. Participating interests in financial assets that continue to be held by a transferor are not part of the proceeds of the transfer, and the carrying amount of those participating interests shall be measured at the date of the transfer by allocating the previous carrying amount between the participating interests transferred and sold, and the participating interests that are not transferred and continue to be held by a transferor, based on their relative fair values.

Servicing Assets and Liabilities

62. Servicing of mortgage loans, credit card receivables, or other financial assets commonly includes, but is not limited to, collecting principal, interest, and escrow payments from borrowers; paying taxes and

insurance from escrowed funds; monitoring delinquencies; executing foreclosure if necessary; temporarily investing funds pending distribution; remitting fees to guarantors, trustees, and others providing services; and accounting for and remitting principal and interest payments to the holders of beneficial interests or participating interests in the financial assets. Servicing is inherent in all financial assets; it becomes a distinct asset or liability for accounting purposes only in the circumstances described in paragraph 63. If a transferor sells a participating interest in an entire financial asset, it would recognize a servicing asset or a servicing liability only related to the participating interest sold.

63. An entity that undertakes a contract to service financial assets shall recognize either a servicing asset or a servicing liability, each time it undertakes an obligation to service a financial asset that (a) results from a servicer's transfer of an entire financial asset, a group of entire financial assets, or a participating interest in an entire financial asset that meets the requirements for sale accounting, or (b) is acquired or assumed and the servicing obligation does not relate to financial assets of the servicer. However, if the transferor transfers the assets to an entity in a transfer that qualifies as a sale in which the transferor obtains the resulting securities, and classifies them as debt securities, the servicing asset or servicing liability may be reported together with the asset being serviced and not recognized separately. A servicer of financial assets commonly receives the benefits of servicing—revenues from contractually specified servicing fees, a portion of the interest from the financial assets, late charges, and other ancillary sources, including "float," all of which it is entitled to receive only if it performs the servicing—and incurs the costs of servicing the financial assets. Typically, the benefits of servicing are expected to be more than adequate compensation to a servicer for performing the servicing, and the contract results in a servicing asset. However, if the benefits of servicing are not expected to adequately compensate a servicer for performing the servicing, the contract results in a servicing liability. (A servicing asset may become a servicing liability, or vice versa, if circumstances change, and the initial measure for servicing may be zero if the benefits of servicing are just adequate to compensate the servicer for its servicing responsibilities.) A servicer would account for its servicing contract that qualifies for separate recognition as a servicing asset or a servicing liability initially measured at its fair value regardless of whether explicit consideration was exchanged.

64. A servicer that transfers or securitizes financial assets in a transaction that does not meet the requirements for sale accounting and is accounted for as a secured borrowing with the underlying financial assets remaining on the transferor's balance sheet shall not recognize a servicing asset or a servicing liability.

65. A servicer that recognizes a servicing asset or servicing liability shall account for the contract to service financial assets separately from those financial assets, as follows:

a. Report servicing assets separately from servicing liabilities as a nonadmitted asset in the statement of financial position.

b. Initially measure servicing assets and servicing liabilities at fair value, (paragraph 15).

c. Account separately for rights to future interest income from the serviced assets that exceed contractually specified servicing fees. Those rights are not servicing assets; they are financial assets, effectively interest-only strips to be accounted for in accordance with paragraph 18 of this statement. (Interest-only strips preclude a portion of a financial asset from meeting the definition of a participating interest; see paragraph 36.)

d. Identify classes of servicing assets and servicing liabilities based on (1) the availability of market inputs used in determining the fair value of servicing assets and servicing liabilities, (2) an entity's method for managing the risks of its servicing assets and servicing liabilities, or (3) both.

e. Subsequently measure each class of separately recognized servicing assets and servicing liabilities at fair value. Changes in fair value should be reported as unrealized gains and losses (paragraph 17). Declines in fair value which are determined to be other-than-temporary shall be recorded as realized losses.

66. As indicated above, transferors sometimes agree to take on servicing responsibilities when the future benefits of servicing are not expected to adequately compensate them for performing that servicing. In that circumstance, the result is a servicing liability rather than a servicing asset. For example, if in the transaction illustrated in Exhibit B – Illustration 3 the transferor had agreed to service the loans without explicit compensation and it estimated the fair value of that servicing obligation at $50, net proceeds would be reduced to $980, gain on sale would become a loss on sale of $20, and the transferor would report a servicing liability of $50.

Securitizations

67. Financial assets, such as mortgage loans, are commonly transferred in securitizations. Securitizations of mortgage loans may include pools of single-family residential mortgages or other types of real estate mortgage loans, for example, multifamily residential mortgages and commercial property mortgages. Both financial and nonfinancial assets can be securitized; life insurance policy loans, patent and copyright royalties, and even taxi medallions also have been securitized. But securitizations of nonfinancial assets are outside the scope of this statement.

68. An originator of a typical securitization (the transferor) transfers a portfolio of financial assets to a securitization entity, commonly a trust. In “pass-through” and “pay-through” securitizations, receivables are transferred to the entity at the inception of the securitization, and no further transfers are made; all cash collections are paid to the holders of beneficial interests in the entity.

69. Beneficial interests in the securitization entity are sold to investors and the proceeds are used to pay the transferor for the assets transferred financial assets. Those beneficial interests may comprise either a single class having equity characteristics or multiple classes of interests, some having debt characteristics and others having equity characteristics. The cash collected from the portfolio is distributed to the investors and others as specified by the legal documents that established the entity.

70. Pass-through and pay-through securitizations that meet the conditions in paragraph 8 qualify for sale accounting under this statement. All financial assets obtained and liabilities incurred by the transferor of a securitization that qualifies as a sale shall be recognized and measured as provided in paragraphs 9 and 11; that includes the implicit forward contract to sell additional financial assets during a revolving period, which may become valuable or onerous to the transferor as interest rates and other market conditions change.

Isolation of Transferred Financial Assets in Securitizations

71. A securitization carried out in one transfer or a series of transfers may or may not isolate the transferred financial assets beyond the reach of the transferor and its creditors. Whether it does depends on the structure of the securitization transaction taken as a whole, considering such factors as the type and extent of further involvement in arrangements to protect investors from credit, and interest rate, and other risks, the availability of other financial assets, and the powers of bankruptcy courts or other receivers. The discussion in paragraphs 72-74 relates only to the isolation condition in paragraph 8.a. The conditions in paragraphs 8.b. and 8.c. also must be considered to determine whether a transferor has surrendered control over the transferred financial assets.

72. In certain securitizations, a corporation that, if it failed, would be subject to the U.S. Bankruptcy Code transfers financial assets to a securitization entity exchange for cash. The entity raises that cash by issuing to investors beneficial interests that pass through all cash received from the financial assets, and

the transferor has no further involvement with the trust or the transferred financial assets. The Board understands that those securitizations generally would be judged as having isolated the assets, because, in the absence of any continuing involvement, there would be reasonable assurance that the transfer would be found to be a true sale at law that places the assets beyond the reach of the transferor, and its creditors, even in bankruptcy or other receivership.

73. In other securitizations, a similar corporation transfers financial assets to a securitization entity in exchange for cash and beneficial interests in the transferred financial assets. That entity raises the cash by issuing to investors commercial paper that gives them a senior beneficial interest in cash received from the financial assets. The beneficial interests obtained by the transferring corporation represent a junior interest to be reduced by any credit losses on the financial assets in the entity. The senior beneficial interests (commercial paper) are highly rated by credit rating agencies only if both (a) the credit enhancement from the junior interest is sufficient and (b) the transferor is highly rated. Depending on facts and circumstances, the Board understands that those "single-step" securitizations often would be judged in the United States as not having isolated the financial assets, because the nature of the continuing involvement may make it difficult to obtain reasonable assurance that the transfer would be found to be a true sale at law that places the financial assets beyond the reach of the transferor and its creditors in U.S. bankruptcy (paragraph 39). If the transferor fell into bankruptcy and the transfer was found not to be a true sale at law, investors in the transferred financial assets might be subjected to an automatic stay that would delay payments due them, and they might have to share in bankruptcy expenses and suffer further losses if the transfer was recharacterized as a secured loan.

74. Still other securitizations use multiple transfers intended to isolate transferred financial assets beyond the reach of the transferor and its creditors, even in bankruptcy. For example, in "two-step" structures:

a. First, the corporation transfers a group of financial assets to a special-purpose corporation that, although wholly owned, is so designed that the possibility is remote that the transferor or its creditors could reclaim the financial assets. This first transfer is designed to be judged to be a true sale at law, in part because the transferor does not provide "excessive" credit or yield protection to the special-purpose corporation, and the Board understands that transferred financial assets are likely to be judged beyond the reach of the transferor or the transferor's creditors even in bankruptcy or other receivership.

b. Second, the special-purpose corporation transfers a group of financial assets to a trust or other legal vehicle with a sufficient increase in the credit or yield protection on the second transfer (provided by a transferor's junior beneficial interest or other means) to merit the high credit rating sought by third-party investors who buy senior beneficial interests in the trust. Because of that aspect of its design, that second transfer might not be judged to be a true sale at law and, thus, the transferred financial assets could at least in theory be reached by a bankruptcy trustee for the special-purpose corporation.

c. However, the special-purpose corporation is designed to make remote the possibility that it would enter bankruptcy. For example, its charter forbids it from undertaking any other business or incurring any liabilities, so that there can be no creditors to petition to place it in bankruptcy. Furthermore, its dedication to a single purpose is intended to make it extremely unlikely, even if it somehow entered bankruptcy, that a receiver under the U.S. Bankruptcy Code could reclaim the transferred financial assets because it has no other assets to substitute for the transferred financial assets.

75. The Board understands that the "two-step" securitizations described above, taken as a whole, generally would be judged under present U.S. law as having isolated the financial assets beyond the reach of the transferorand its creditors, even in bankruptcy or other receivership. However, each entity involved in a transfer must be evaluated under the applicable accounting guidance.

76. The powers of receivers vary considerably by state of domicile, and therefore some receivers may be able to reach financial assets transferred under a particular arrangement and others may not. A securitization may isolate transferred financial assets from a transferor subject to such a receiver and its creditors even though it is accomplished by only one transfer directly to a securitization entity that issues beneficial interests to investors and the transferor provides credit or yield protection.

Sales of Future Revenues

77. In addition to securitization of assets, some reporting entities have entered into transactions characterized as a sale of future revenues. These transactions are sometimes referred to as securitizations and are sometimes characterized as selling deferred acquisition costs. A sale of future revenues by a reporting entity shall not result in the immediate recognition of income or surplus. The proceeds of any such sale shall be established as a liability and shall be reduced as the proceeds are repaid.

Removal-of-Accounts Provisions

78. Many transfers of financial assets that involve transfers of a group of entire financial assets to an entity whose sole purpose is to engage in securitization or asset-backed financing activities empower the transferor to reclaim assets subject to certain restrictions. Such a power is sometimes called a removal-of-accounts provision (ROAP). Transfers of assets that include ROAP provisions are precluded from being accounted for as sales under statutory accounting and shall follow the guidance in paragraph 14 for secured borrowing.

Securities Lending Transactions

79. Securities lending transactions are generally initiated by broker-dealers and other financial institutions that need specific securities to cover a short sale or a customer's failure to deliver securities sold. Securities lending transactions typically extend less than one year. Transferees (borrowers) of securities generally are required to provide collateral to the transferor (lender) of securities, commonly cash but sometimes other securities or standby letters of credit, with a value slightly higher than that of the securities borrowed. If the collateral is cash, the transferor typically earns a return by investing that cash at rates higher than the rate paid or rebated to the transferee. If the collateral is other than cash, the transferor typically receives a fee. Securities custodians or other agents commonly carry out securities lending activities on behalf of clients. Because of the protection of collateral (typically valued daily and adjusted frequently for changes in the market price of the securities transferred) and the short terms of the transactions, most securities lending transactions in themselves do not impose significant credit risks on either party. Other risks arise from what the parties to the transaction do with the assets they receive. For example, investments made with cash collateral impose market and credit risks on the transferor.

80. If the criteria conditions in paragraph 8 (sales criteria) are met, securities lending transactions shall be accounted for:

a. By the transferor as a sale of the "loaned" securities for proceeds consisting of the cash collateral"[9] and a forward repurchase commitment.

b. By the transferee as a purchase of the "borrowed" securities in exchange for the collateral and a forward resale commitment. During the term of that agreement, the transferor has surrendered control over the securities transferred and the transferee has obtained control

[9] If the "collateral" in a transaction that meets the criteria in paragraph 8 is a financial asset that the holder or its agent is permitted by contract or custom to sell or repledge, that financial asset is proceeds of the sale of the "loaned" securities. To the extent that the "collateral" consists of letters of credit or other financial instruments that the holder or its agent is not permitted by contract or custom to sell or repledge, a securities lending transaction does not satisfy the sale criteria and is accounted for as a loan of securities by the transferor to the transferee.

over those securities with the ability to sell or transfer them at will. In that case, creditors of the transferor have a claim only to the "collateral" and the forward repurchase commitment.

81. Many securities lending transactions are accompanied by an agreement that entitles and obligates the transferor to repurchase or redeem the transferred financial assets before their maturity under which the transferor maintains effective control over those financial assets (paragraphs 51-52). Those transactions shall be accounted for as secured borrowings, in which cash (or securities that the holder or its agent is permitted by contract or custom to sell or repledge) received as collateral is considered the amount borrowed, the securities loaned are considered pledged as collateral against the cash or securities borrowed and reclassified as set forth in paragraph 19.a., and any rebate paid to the transferee of securities is interest on the cash or securities the transferor is considered to have borrowed.

82. The transferor of securities being "loaned" accounts for cash received in the same way whether the transfer is accounted for as a sale or a secured borrowing. The cash received shall be recognized as the transferor's asset – as shall investments made with that cash, even if made by agents or in pools with other securities lenders – along with the obligation to return the cash. If securities that may be sold or repledged are received, the transferor of the securities being "loaned" accounts for those securities in the same way as it would account for cash received.

83. The transferor of securities being "loaned" accounts for collateral received in the same way whether the transfer is accounted for as a sale or a secured borrowing. The collateral received shall be recognized as the transferor's asset – as shall investments made with that collateral, even if made by agents or in pools with other securities lenders – along with the obligation to return the collateral. If securities that may be sold or repledged are received by the transferor or its agent, the transferor of the securities being "loaned" accounts for those securities in the same way as it would account for collateral received. Collateral which may be sold or repledged by the transferor or its agent is reflected on balance sheet, along with the obligation to return the asset[10]. Collateral received which may not be sold or repledged by the transferor or its agent is off balance sheet[11]. For collateral on the balance sheet, the reporting is determined by the administration of the program.

a. Securities lending programs where the collateral received by the reporting entity's unaffiliated agent that can be sold or repledged is reported on the balance sheet. The collateral received and reinvestment of that collateral by the reporting entity's unaffiliated agent shall be reflected as a one-line entry on the balance sheet (Securities Lending Collateral) and a detailed schedule will be required each quarter and at year-end to list the description of the collateral asset. This description shall include the NAIC designation, fair value; book adjusted carrying value and maturity date. A separate liability shall also be established to record the obligation to return the collateral (Collateral from Securities Lending Activities)

b. Securities lending programs where the collateral received by the reporting entity that can be sold or repledged is reported on the balance sheet. If the reporting entity is the administrator of the program, then, the collateral received and any reinvestment of that collateral is reported with the invested assets of the reporting entity based on the type of investment (i.e. bond, common stock, etc). A separate liability shall also be established to

[10] If cash is received by the transferor or its agent and reinvested or repledged it is reported on balance sheet. It is explicitly intended that when the lender bears reinvestment risk, that collateral is on balance sheet.

[11] An example of collateral which is off balance sheet is when securities are received by the transferor or its agent in which the collateral must be held and returned, without the ability to transfer or repledge the collateral. This would involve limited situations in which the transferor or agent is prohibited from reinvesting the collateral.

record the obligation to return the collateral (Collateral from Securities Lending Activities)

c. Securities lending programs where the collateral received by the reporting entity's affiliated agent can report using either one line reporting (paragraph 83.a.) or investment schedule reporting (paragraph 83.b.).

84. Reinvestment of the collateral by the reporting entity or its agent shall follow the same impairment guidance as other similar invested assets reported on the balance sheet. Any fees received by the transferor for loaning the securities shall be recorded as miscellaneous investment income.

Securities Lending Transactions – Collateral Requirements[12]

85. The reporting entity shall receive collateral having a fair value as of the transaction date at least equal to 102 percent of the fair value of the loaned securities at that date. If at any time the fair value of the collateral received from the counterparty is less than 100 percent of the fair value of the loaned securities, the counterparty shall be obligated to deliver additional collateral by the end of the next business day, the fair value of which, together with the fair value of all collateral then held in connection with the transaction at least equals 102 percent of the fair value of the loaned securities. If the collateral received from the counterparty is less than 100 percent at the reporting date, the difference between the actual collateral and 100 percent will be nonadmitted. Collateral value is measured and compared to the loaned securities in aggregate by counterparty.

86. In the event that foreign securities are loaned and the denomination of the currency of the collateral is other than the denomination of the currency of the loaned foreign securities, the amount of collateral shall be at least equal to 105 percent of the fair value of the loaned securities at that date. If at any time the fair value of the collateral received from the counterparty is less than 102 percent of the fair value of the loaned securities, the reporting entity must obtain additional collateral by the end of the next business day, the fair value of which together with the fair value of all collateral then held in connection with the transaction at least equals 105 percent of the fair value of the loaned securities. If the collateral received from the counterparty is less than 100 percent at the reporting date, the difference between the actual collateral and 100 percent will be nonadmitted. Collateral value is measured and compared to the loaned securities in aggregate by counterparty.

Repurchase Agreements and "Wash Sales"

87. Government securities dealers, banks, other financial institutions, and corporate investors commonly use repurchase agreements to obtain or use short-term funds. Under those agreements, the transferor ("repo party") transfers a security to a transferee ("repo counterparty" or "reverse party") in exchange for cash[13] and concurrently agrees to reacquire that security at a future date for an amount equal to the cash exchanged plus a stipulated "interest" factor. Repurchase agreements, reverse repurchase agreements and dollar repurchase agreements meet the definition of assets as defined in *SSAP No. 4—Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this statement.

88. Repurchase agreements can be effected in a variety of ways. Some repurchase agreements are similar to securities lending transactions in that the transferee or its agent has the right to sell or repledge

[12] The collateral requirements are required for determining admitted assets under statutory accounting, but the receipt of collateral is not a factor in determining whether the transferor has effective control over the loaned assets in accordance with paragraph 51.

[13] Instead of cash, other securities or letters of credit sometimes are exchanged. Those transactions are accounted for in the same manner as securities lending transactions (paragraphs 79-86).

the securities to a third party during the term of the repurchase agreement. In other repurchase agreements, the transferee does not have the right to sell or repledge the securities during the term of the repurchase agreement. For example, in a tri-party repurchase agreement, the transferor transfers securities to an independent third-party custodian that holds the securities during the term of the repurchase agreement. Also, many repurchase agreements are for short terms, often overnight, or have indefinite terms that allow either party to terminate the arrangement on short notice. However, other repurchase agreements are for longer terms, sometimes until the maturity of the transferred financial asset. Some repurchase agreements call for repurchase of securities that need not be identical to the securities transferred.

89. If the conditions in paragraph 8 are met, the transferor shall account for the repurchase agreement as a sale of financial assets and a forward repurchase commitment, and the transferee shall account for the agreement as a purchase of financial assets and a forward resale commitment. Other transfers that are accompanied by an agreement to repurchase the transferred financial assets that may be accounted for as sales include transfers with agreements to repurchase at maturity. (Repurchase financing is addressed in paragraphs 96-101.)

90. Furthermore, "wash sales" that previously were not recognized if the same financial asset was purchased within 30 days before or after the sale shall be accounted for as sales under this statement. Unless there is a concurrent contract to repurchase or redeem the transferred financial assets from the transferee, the transferor does not maintain effective control over the transferred financial assets.

91. As with securities lending transactions, under many agreements to repurchase transferred financial assets before their maturity the transferor maintains effective control over those financial assets. Repurchase agreements that do not meet all the conditions in paragraph 8 shall be treated as secured borrowings. Fixed-coupon and dollar-roll repurchase agreements, and other contracts under which the securities to be repurchased need not be the same as the securities sold, qualify as borrowings if the return of substantially the same (paragraph 52) securities as those concurrently transferred is assured. Therefore, those transactions shall be accounted for as secured borrowings by both parties to the transfer.

92. If a transferor has transferred securities to an independent third-party custodian, or to a transferee, under conditions that preclude the transferee from selling or repledging the assets during the term of the repurchase agreement (as in most tri-party repurchase agreements), the transferor has not surrendered control over those assets.

Repurchase Agreements

93. Repurchase agreements are defined as agreements under which a reporting entity sells securities and simultaneously agrees to repurchase the same or substantially the same securities at a stated price on a specified date. For securities to be substantially the same, the criteria defined in paragraph 52 must be met, and for mortgage-backed securities excluding mortgage pass-through securities, the projected cash flows of the securities must be substantially the same under multiple scenario prepayment assumptions.

94. For repurchase agreements that are accounted for as collateralized borrowings in accordance with paragraph 91 of this statement, the underlying securities shall continue to be accounted for as an investment owned by the reporting entity. The proceeds from the sale of the securities shall be recorded as a liability, and the difference between the proceeds and the amount at which the securities will be subsequently reacquired shall be reported as interest expense, calculated on the straight-line method or the scientific interest (constant yield) method, over the term of the agreement.

95. Reporting entities generally take possession of the underlying collateral under repurchase agreements and in many cases may obtain additional collateral when the estimated fair value of such securities falls below their current contract value. However, to the extent that the current fair value of the

collateral is less than the recorded amount, the shortfall shall reduce the admitted asset value of the repurchase agreement.

Repurchase Financing

96. Repurchase financing is a repurchase agreement that relates to a previously transferred financial asset between the same counterparties (or affiliates of either counterparty) that is entered into contemporaneously with, or in contemplation of, the initial transfer.

97. A repurchase financing involves the transfer of a previously transferred financial asset back to the initial transferor as collateral for a financing between the initial transferee (the borrower) and the initial transferor (the lender). A repurchase financing also typically involves the initial transferor returning the transferred financial asset (or substantially the same asset) to the initial transferee when the financing is repaid on a stated date. A repurchase financing is entered into in contemplation of the initial transfer if both transactions are considered together at the execution of the initial transfer.

98. When the transferor transfers a financial asset and also enters into a repurchase financing with the transferee, there are typically three transfers of the financial assets:

a. Initial transfer – An initial transferor transfers a financial asset to an initial transferee.

b. Repurchase financing – The initial transferee (the borrower) transfer the previously transferred financial asset back to the initial transferor (the lender) as collateral for a financing between the initial transferor and initial transferee.

c. Settlement – The initial transferor (the lender) returns the financial asset (or substantially the same asset) to the initial transferee (the borrower) upon receipt of payment from the initial transferee.

99. Repurchase financing that is entered into contemporaneously with, or in contemplation of, an initial transfer of financial asset between the same counterparties (or affiliates of either counterparty) shall not be separately accounted for as a transfer of a financial asset and a related repurchase financing unless (a) the two transactions have a valid and distinct business or economic purpose for being entered into separately and (b) the repurchase financing does not result in the initial transferor regaining control over the financial asset. Unless the provisions in paragraph 100 are met, the initial transfer and repurchase financing shall be evaluated as a linked transaction. The linked transaction shall be evaluated to determine whether it meets the requirements for sale accounting per paragraph 8. If the linked transaction does not meet the requirements for sale accounting, the linked transaction shall be accounted for based on the economies of the combined transactions, which generally represent a forward contract. *SSAP No. 86—Accounting for Derivative Instruments and Hedging, Income Generation, and Replication (Synthetic Asset) Transactions* shall be used to evaluate whether the linked transaction shall be accounted for as a derivative.

100. An initial transfer of a financial asset and repurchase financing that are entered into contemporaneously with, or in contemplation of, one another shall be considered linked unless all of the following criteria are met at the inception of the transaction:

a. The initial transfer and the repurchase financing are not contractually contingent on one another. Even if no contractual relationship exists, the pricing and performance of either the initial transfer or the repurchase financing must not be dependent on the terms and execution of the other transaction.

b. The repurchase financing provides the initial transferor with recourse to the initial transferee upon default. That recourse must expose the initial transferor to the credit risk of the initial transferee, or its affiliates, and not solely to the market risk of the transferred financial asset. The initial transferee's agreement to repurchase the previously transferred financial asset (or substantially the same asset) for a fixed price and not fair value.

c. The financial asset subject to the initial transfer and repurchase financing is readily obtainable in the marketplace. In addition, the initial transfer of a financial asset and the repurchase financing are executed at market rates. This criterion may not be circumvented by embedding off-market terms in a separate transaction contemplated with the initial transfer or the repurchase financing.

d. The financial asset and repurchase agreement are not coterminous (the maturity of the repurchase financing must be before the maturity of the financial asset.)

101. In accordance with paragraph 99, an initial transfer of assets and a repurchase financing shall not be considered separate transactions unless the provisions of paragraph 100 are met. If the provisions of paragraph 100 are met, the initial transfer shall be evaluated to determine whether it meets the requirements for sale accounting without taking into consideration the repurchase financing. In such situations, the repurchase financing shall then be separately analyzed as a repurchase agreement.

Reverse Repurchase Agreements

102. Reverse repurchase agreements are defined as agreements under which a reporting entity purchases securities and simultaneously agrees to resell the same or substantially the same securities at a stated price on a specified date. For securities to be substantially the same, the criteria defined in paragraph 52 must be met, and for mortgage-backed securities excluding mortgage pass-through securities, the projected cash flows of the securities must be substantially the same under multiple scenario prepayment assumptions.

103. For reverse repurchase agreements that are accounted for as collateralized lendings in accordance with paragraph 91 of this statement, the underlying securities shall not be accounted for as investments owned by the reporting entity. The amount paid for the securities shall be reported as a short-term investment, and the difference between the amount paid and the amount at which the securities will be subsequently resold shall be reported as interest income, calculated on the straight-line method or the scientific interest (constant yield) method, over the term of the agreement.

Collateral Requirements – Repurchase and Reverse Repurchase Agreements[14]

104. The collateral requirements for repurchase and reverse repurchase agreements are as follows:

Repurchase Transaction

a. The reporting entity shall receive collateral having a fair value as of the transaction date at least equal to 95 percent of the fair value of the securities transferred by the reporting entity in the transaction as of that date. If at any time the fair value of the collateral received from the counterparty is less than 95 percent of the fair value of the securities so transferred, the counterparty shall be obligated to deliver additional collateral by the end of the next business day the fair value of which, together with the fair value of all collateral then held in connection with the transaction, at least equals 95 percent of the fair value of the transferred securities. If the collateral is less than 95 percent at the reporting date, the difference between the actual collateral and 95 percent will be nonadmitted.

[14] The collateral requirements are required for determining admitted assets under statutory accounting, but the receipt of collateral is not a factor in determining whether the transferor has effective control over the loaned assets in accordance with paragraph 50.

Reverse Repurchase Transaction

b. The reporting entity shall receive as collateral transferred securities having a fair value at least equal to 102 percent of the purchase price paid by the reporting entity for the securities. If at any time the fair value of the collateral is less than 100 percent of the purchase price paid by the reporting entity, the counterparty shall be obligated to provide additional collateral, the fair value of which, together with fair value of all collateral then held in connection with the transaction, at least equals 102 percent of the purchase price.

Dollar Repurchase Agreements

105. Dollar repurchase and dollar reverse repurchase agreements are defined as repurchase and reverse repurchase agreements involving debt instruments that are pay-through securities collateralized with Government National Mortgage Association (GNMA), Federal Home Loan Mortgage Corporation (FHLMC) and Federal National Mortgage Association (FNMA) collateral, and pass-through certificates sponsored by GNMA, mortgage participation certificates issued by the FHLMC or similar securities issued by the FNMA. Dollar repurchase agreements are also commonly referred to as dollar roll transactions. To meet the definition of dollar repurchase and dollar reverse repurchase agreements, the securities underlying the agreements must meet the criteria defined in paragraph 52, and for mortgage-backed securities excluding mortgage pass-through securities, the projected cash flows of the securities must be substantially the same under multiple scenario prepayment assumptions.

106. For the seller in a dollar repurchase agreement accounted for as collateralized borrowing in accordance with paragraph 91 of this statement, a liability is recorded for the amount of proceeds of the sale and the sold mortgage-backed securities are not removed from the accounting records. During the period of the agreement, interest income is recorded as if the mortgage-backed security had been held during the term of the agreement. This is offset by an equal amount of interest expense related to the proceeds received from the sale. Additional interest expense is recorded representing the difference between the sales price and the repurchase price of the mortgage-backed securities sold.

107. When the mortgage-backed securities are repurchased under the agreement, the original mortgage-backed securities sold are removed from the accounting records and the purchased mortgage-backed securities are recorded. The principal amount of the mortgage-backed securities repurchased must be in good delivery form consistent with paragraph 52.

108. If the principal amount repurchased is greater than the amount sold, the cash paid is recorded as an additional investment in the newly acquired certificates. If the principal amount repurchased is less than the amount sold, a gain or loss relating to the original certificates held is recorded.

109. For the purchaser in a dollar reverse repurchase agreement accounted for as collateralized lending in accordance with paragraph 91 of this statement, an asset is recorded for the amount of the purchase. Upon completion of the reverse repurchase agreement, cash is received in exchange for a “substantially the same” security. The difference between the purchase and reselling price represents interest income for the lending of short-term funds.

Separate Transactions

110. Agreements to repurchase and resell securities that do not meet the definitions in paragraphs 79-92 of this statement shall be accounted for as two separate transactions, that is, as a sale and purchase or as a purchase and sale, in accordance with the relevant statutory accounting guidance. For example, sales of bonds would result in recognition of realized gains or losses.

Offsetting

111. Reporting entities may operate on both sides of the repurchase agreement market resulting in recording of liabilities and assets representing repurchase and reverse repurchase agreements, respectively.

112. Reporting entities shall offset such liabilities and assets only to the extent that a legal right to offset exists as defined in SSAP No. 64, paragraph 2. Otherwise, separate assets and liabilities shall be recognized.

Loan Syndications

113. Borrowers often borrow amounts greater than any one lender is willing to lend. Therefore, it is common for groups of lenders to jointly fund those loans. That may be accomplished by a syndication under which several lenders share in lending to a single borrower, but each lender loans a specific amount to the borrower and has the right to repayment from the borrower.

114. A loan syndication is not a transfer of financial assets. Each lender in the syndication shall account for the amounts it is owed by the borrower. Repayments by the borrower may be made to a lead lender who then distributes the collections to the other lenders of the syndicate. In those circumstances, the lead lender is also functioning as a servicer and, therefore, shall only recognize its portion of the loan as a financial asset.

Loan Participations

115. Groups of banks or other entities also may jointly fund large borrowings through loan participations in which a single lender makes a large loan to a borrower and subsequently transfers interests in the loan to other entities.

116. Transfers by the originating lender may take the legal form of either assignments or participations. The transfers are usually on a nonrecourse basis, and the transferor (originating lender) continues to service the loan. The transferee (participating entity) may or may not have the right to sell or transfer its participation during the term of the loan, depending upon the terms of the participation agreement.

117. If the loan participation agreement transfers a participating interest in an entire financial asset (as described in paragraph 7 of this statement) and the conditions in paragraph 8 are met, the transfer shall be accounted for by the transferor as a sale of a participating interest. A transferor's right of first refusal on a bona fide offer from a third party, a requirement to obtain the transferor's permission that shall not be unreasonably withheld, or a prohibition on sale to the transferor's competitor is a limitation on the transferee's rights but presumptively does not constrain a transferee from exercising its right to pledge or exchange. However, if the loan participation agreement constrains the transferees from pledging or exchanging its participating interest and that constraint provides a more-than-trivial benefit to the transferor, the transferor has not relinquished control and shall account for the transfer as a secured borrowing.

Factoring Arrangements

118. Factoring arrangements are a means of discounting accounts receivable on a nonrecourse, notification basis. Accounts receivable in their entireties are sold outright, usually to a transferee (the factor) that assumes the full risk of collection, without recourse to the transferor in the event of a loss. Debtors are directed to send payments to the transferee. Factoring arrangements that meet the conditions in paragraph 8 shall be accounted for as sales of financial assets because the transferor surrenders control over the receivables to the factor.

Transfers of Receivables with Recourse

119. In a transfer of an entire receivable, a group of entire receivables, or a portion of an entire receivable with recourse, the transferor provides the transferee with full or limited recourse. The transferor is obligated under the terms of the recourse provision to make payments to the transferee or to repurchase receivables sold under certain circumstances, typically for defaults up to a specified percentage. A transfer of receivables with recourse shall not be recognized as a sale, but rather as secured borrowing. (This provision is applied regardless if the transfer was comprised of the entire receivable, a group of the entire receivable, or a portion of the entire receivable.) A transfer of receivables without recourse shall only be recognized if the transferor receives cash for the receivables. The sale shall be recognized when cash is received. Sales of premium receivables are addressed in *SSAP No. 42—Sale of Premium Receivables*.

Extinguishments of Liabilities

120. If a creditor releases a debtor from primary obligation on the condition that a third party assumes the obligation and that the original debtor becomes secondarily liable, that release extinguishes the original debtor's liability. However, in those circumstances, whether or not explicit consideration was paid for that guarantee, the original debtor becomes a guarantor. As a guarantor, it shall recognize a guarantee obligation in the same manner as would a guarantor that had never been primarily liable to that creditor, with due regard for the likelihood that the third party will carry out its obligations. The guarantee obligation shall be initially measured at fair value, and that amount reduces the gain or increases the loss recognized on extinguishment.

121. Exchanges of debt instruments or debt instrument modifications are considered extinguishments if the exchange or modification results with substantially different terms or is considered more than minor. If the cash flows under the terms of the new debt instrument are at least 10 percent different from the present value of the remaining cash flows under the terms of the original instrument, then the exchange of, or modification to, debt instruments is consider substantially different and/or more than minor.

Relevant Literature

122. The accounting guidance in this statement adopts with modification *FAS 166, Accounting for the Transfers of Financial Assets, an Amendment to FAS 140* (FAS 166), *FAS 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 140), as amended by FAS 166, and FAS 156, *Accounting for Servicing of Financial Assets, an amendment of FASB Statement No. 140*, as amended by FAS 166. Statutory modifications from these adoptions include:

a. Rejects the GAAP consideration for "consolidated affiliates" as the concept of consolidation has not been adopted for statutory accounting.

b. Rejects reference to GAAP standards and GAAP methods not adopted for statutory as well as concepts that are not pertinent for insurers. For example, references to investments "held-to-maturity", "available for sale" or "trading" and reference to FASB standards are replaced with statutory terms and references to statutory standards.

c. Rejects GAAP reference and guidance regarding "Revolving-Period Securitizations" as this GAAP guidance is not applicable to statutory accounting. This concept was also deemed not applicable to statutory accounting under SSAP No. 91R.

d. Rejects GAAP guidance for "Sale-Type and Direct-Financing Lease Receivables" as leases shall be accounted for in accordance with *SSAP No. 22—Leases* (SSAP No. 22). This conclusion is consistent with SSAP No. 91R.

e. Rejects GAAP guidance for “Banker’s Acceptances and Risk Participations in Them,” as not applicable for statutory accounting. This GAAP guidance was also deemed not applicable to statutory accounting under SSAP No. 91R.

f. Rejects GAAP guidance for “Removal of Account Provisions” that allows recognition of sale accounting. For statutory, transfers that would empower the transferor to reclaim assets under certain conditions (considered “removal-of-accounts provisions”) are precluded from being accounted for as sales. This conclusion is consistent with SSAP No. 91R.

g. Rejects GAAP guidance for “Transfers of Receivables with Recourse” that allows transfers of receivables in their entirety with recourse to be accounted for as sales. For statutory, a transfer of receivables with recourse shall be accounted for as a secured borrowing. This conclusion is consistent with SSAP No. 91R.

h. Rejects illustrations for transactions involving transfers of lease financing receivables with residual values and banker’s acceptances with a risk participation as the GAAP guidance in FAS 166 related to these topics has been rejected for statutory accounting.

i. Rejects the optionality provided within FAS 156 for subsequent measurement of servicing assets and servicing liabilities using either fair value or an amortization method. This statement requires application of a fair value method for subsequent measurement.

j. Incorporates guidance previously included in SSAP No. 91R specific to insurance entities, and guidance that was adopted from GAAP guidance not revised through the issuance of FAS 166. Items incorporated include:

   i. Clarification that transfers of financial assets that are in substance real estate shall be accounted for in accordance with *SSAP No. 40R—Real Estate Investments* (paragraph 2).

   ii. Clarification that transactions between related parties or affiliates are accounted for in accordance with *SSAP No. 25—Accounting For and Disclosures About Transactions with Affiliates and Other Related Parties* (paragraph 3).

   iii. Clarification that the guidance does not address the securitization of mortality or morbidity risk (paragraph 5).

   iv. Guidance on the accounting of sale transactions for entities required to maintain an interest maintenance reserve (IMR). This guidance requires such entities to account for realized and unrealized capital gains and losses per the guidance in the SSAP for the specific type of investment, or if not specifically stated in the related SSAP, in accordance with SSAP No. 7 (paragraph 11.c.).

   v. Clarification of when servicing assets and servicing liabilities shall be recognized as well as measurement of these items. Continues prior statutory decision that servicing rights assets shall be nonadmitted (paragraphs 15-17).

   vi. Guidance on the accounting for transactions that require the granting of a security interest in certain assets to another party to serve as collateral for their performance under a contract (paragraph 20).

   vii. Disclosures on security lending transactions, loaned securities; securities underlying repurchase and reverse repurchase agreements, dollar repurchase and dollar reverse repurchase agreements; receivables with recourse; and wash sales (paragraphs 28.a., 28.b., and 28.h.-28.l.).

viii. Guidance on the sales of future revenues (paragraph 77).

ix. Guidance on collateral requirements for securities lending transactions (paragraph 85).

x. Clarification that repurchase agreements, reverse repurchase agreements and dollar repurchase agreements meet the definition of assets as defined in *SSAP No. 4—Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this guidance (paragraph 87).

xi. Guidance on Repurchase Agreements (paragraphs 93-101).

xii. Guidance on Reverse Repurchase Agreements (paragraphs 102-103).

xiii. Guidance on Collateral for Reverse and Repurchase Agreements (paragraph 104).

xiv. Guidance on Dollar Repurchase Agreements (paragraph 105-109).

xv. Guidance for Separate Transactions (paragraph 110).

xvi. Guidance for Offsetting (paragraph 112). (This guidance was revised in November 2012 to only allow offsetting when a valid right to offset exists in accordance with SSAP No. 64. This is different from previous guidance reflected in SSAP No. 91R.)

xvii. Guidance for Transfers of Receivables with Recourse (paragraph 120).

123. This statement also adopts *FASB Staff Position 140-3, Accounting for Transfers of Financial Assets and Repurchase Financing Transactions* (FSP FAS 140-3), *ASU 2011-03, Transfers and Servicing (Topic 860), Reconsideration of Effective Control for Repurchase Agreements* and *AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as used In Certain Audit Guides and a Statement of Position.* This statement adopts *FASB Emerging Issues Task Force (EITF) No. 87-34, Sale of Mortgage Servicing Rights with a Subservicing Agreement, FASB EITF No. 88-11, Allocation of Recorded Investment When a Loan as Part of a Loan is Sold, FASB EITF No. 88-18, Sales of Future Revenues, FASB EITF No. 88-22, Securitization of Credit Card and Other Receivable Portfolios, FASB EITF No. 90-21, Balance Sheet Treatment of a Sale of Mortgage Servicing Rights with a Subservicing Agreement, FASB EITF No. 95-5, Determination of What Risks and Rewards, If Any, Can Be Retained and Whether Any Unresolved Contingencies May Exist in a Sale of Mortgage Loan Servicing Rights, FASB EITF No. 96-19, Debtor's Accounting for a Modification or Exchange of Debt Instruments*, as amended by FAS 166, and *FASB EITF No. 01-7, Creditor's Accounting for a Modification or Exchange of Debt Instruments*.

124. This statement rejects FASB *EITF No. 84-5, Sale of Marketable Securities with a Put Option*, and FASB *EITF No. 92-2, Measuring Loss Accruals by Transferors of Receivables with Recourse* and *FTB 01-1: Effective Date for Certain Financial Institutions of Certain Provisions of Statement 140 related to Isolation of Transferred Financial Assets*. This statement rejects *FIN 41, Offsetting Amounts Related to Certain Repurchase and Reverse Repurchase Agreements*. This rejection, as it is a reversal of the prior adoption of this guidance in SSAP No. 45, and the revisions to paragraphs 112-113 adopted November 2012, are effective January 1, 2013. This guidance has been rejected as it permits optionality as to whether offsetting and net reporting occurs for repurchase and reverse purchase agreements under master

netting agreements. The provisions of SSAP No. 64 shall be used in determining whether assets and liabilities shall be offset and reported net.

Effective Date and Transition

125. This standard shall be effective for years beginning on and after January 1, 2013 (effective date) and shall be applied prospectively. This statement must be applied as of the beginning of the reporting entity's first annual reporting period after the effective date, for interim periods within that first annual reporting period, and for interim and annual reporting periods thereafter. Earlier application is prohibited. This statement must be applied to transfers occurring on or after the effective date. On and after the effective date, the concept of a qualifying special purpose entity is no longer relevant for statutory accounting purposes. The disclosure provisions of this statement shall be applied to transfers that occurred both before and after the effective date of this statement. Guidance reflected in paragraph 22 added from *INT 03-05, EITF 01-7: Creditor's Accounting for a Modification or Exchange of Debt Instruments* has been in effect since June 22, 2003.

REFERENCES

Other

- *SSAP No. 18—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
- *SSAP No. 33—Securitization*
- *SSAP No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements*
- *SSAP No. 91R—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
- *Purposes and Procedures Manual of the NAIC ~~Securities Valuation~~Investment Analysis Office*

Relevant Issue Papers

- *Issue Paper No. 122—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
- *Issue Paper No. 134—Servicing Assets/Liabilities, An Amendment of SSAP No. 91*
- *Issue Paper No. 141—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
- *Issue Paper No. 144—Substantive Revisions to SSAP No. 91R—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities - Revised*

EXHIBIT A – GLOSSARY

Adequate Compensation

The amount of benefits of servicing that would fairly compensate a substitute servicer should one be required, which includes the profit that would be demanded in the marketplace.

Agent

A party that acts for and on behalf of another party. For example, a third-party intermediary is an agent of the transferor if it acts on behalf of the transferor.

Attached Call

A call option held by the transferor of a financial asset that becomes part of and is traded with the underlying instrument. Rather than being an obligation of the transferee, an attached call is traded with and diminishes the value of the underlying instrument transferred subject to that call.

Beneficial Interests

Rights to receive all or portions of specified cash inflows received by a trust or other entity, including, but not limited to, senior and subordinated shares of interest, principal, or other cash inflows to be "passed-through" or "paid-through," premiums due to guarantors, commercial paper obligations, and residual interests, whether in the form of debt or equity.

Benefits of Servicing

Revenues from contractually specified servicing fees, late charges, and other ancillary sources, including "float."

Cleanup Call

An option held by the servicer or its affiliate, which may be the transferor, to purchase the remaining transferred financial assets, or the remaining beneficial interests not held by the transferor, its affiliates, or its agents in an entity (or in a series of beneficial interests in transferred financial assets within an entity), if the amount of outstanding financial assets or beneficial interests falls to a level at which the cost of servicing those assets or beneficial interests becomes burdensome in relation to the benefits of servicing.

Collateral

Personal or real property in which a security interest has been given.

Continuing Involvement

Any involvement with the transferred financial assets that permits the transferor to receive cash flows or other benefits that arise from the transferred financial assets or that obligates the transferor to provide additional cash flows or other assets to any party related to the transfer. All available evidence shall be considered, including, but not limited to, explicit written arrangements, communications between the transferor and the transferee or its beneficial interest holders, and unwritten arrangements customary to similar transfers. Examples of continuing involvement with the transferred financial assets include, but are not limited to, servicing arrangements, recourse or guarantee arrangements, agreements to purchase or redeem transferred financial assets, options written or held, derivative financial instruments that are entered into contemporaneously with, or in contemplation of, the transfer, arrangements to provide financial support, pledges of collateral, and the transferor's beneficial interests in the transferred financial assets.

Contractually Specified Servicing Fees

All amounts that, per contract, are due to the servicer in exchange for servicing the financial asset and would no longer be received by a servicer if the beneficial owners of the serviced assets (or their trustees or agents) were to exercise their actual or potential authority under the contract to shift the servicing to another servicer. Depending on the servicing contract, those fees may include some or all of the difference between the interest rate collectible on the financial asset being serviced and the rate to be paid to the beneficial owners of those financial assets.

Derecognize

Remove previously recognized assets or liabilities from the statement of financial position.

Derivative Financial Instrument

A derivative instrument (as defined in *SSAP No. 86—Accounting for Derivative Instruments and Hedging, Income Generation, and Replication (Synthetic Asset) Transactions*) that is a financial instrument (refer to *SSAP No. 27—Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk, Financial Instruments with Concentrations of Credit Risk and Disclosures about Fair Value of Financial Instruments*, paragraph 2).

Embedded Call

A call option held by the issuer of a financial instrument that is part of and trades with the underlying instrument. For example, a bond may allow the issuer to call it by posting a public notice well before its stated maturity that asks the current holder to submit it for early redemption and provides that interest ceases to accrue on the bond after the early redemption date. Rather than being an obligation of the initial purchaser of the bond, an embedded call trades with and diminishes the value of the underlying bond.

Financial Asset

Cash, evidence of an ownership interest in an entity, or a contract that conveys to a one entity a right (a) to receive cash or another financial instrument from a second entity or (b) to exchange other financial instruments on potentially favorable terms with the second entity.

Financial Liability

A contract that imposes on one entity an obligation (a) to deliver cash or another financial instrument to a second entity or (b) to exchange other financial instruments on potentially unfavorable terms with the second entity.

Freestanding Call

A call that is neither embedded in nor attached to an asset subject to that call.

Interest-Only Strip

A contractual right to receive some or all of the interest due on a bond, mortgage loan, collateralized mortgage obligation, or other interest-bearing financial asset.

Participating Interest

A participating interest has the following characteristics:

a. From the date of the transfer, it represents a proportionate (pro rata) ownership interest in an entire financial asset. The percentage of ownership interests held by the transferor in the entire financial asset may vary over time, while the entire financial asset remains outstanding as long as the resulting portions held by the transferor or its agents) and the transferee(s) meet the other characteristics of a participating interest. For example, if the transferor's interest in an entire financial asset changes because it subsequently sells another interest in the entire financial asset, the interest held initially and subsequently by the transferor must meet the definition of a participating interest.

b. From the date of the transfer, all cash flows received from the entire financial asset are divided proportionately among the participating interest holders in an amount equal to their share of ownership. Cash flows allocated as compensation for services performed, if any, shall not be included in that determination provided those cash flows are not subordinate to the proportionate cash flows of the participating interest and are not significantly above an amount that would fairly compensate a substitute service provider, should one be required, which includes the profit that would be demanded in the marketplace. In addition, any cash flows received by the transferor as proceeds of the transfer of the participating interest shall be excluded from the determination of proportionate cash flows provided that the transfer does not result in the transferor receiving an ownership interest in the financial asset that permits it to receive disproportionate cash flows.

c. The rights of each participating interest holder (including the transferor in its role as a participating interest holder) have the same priority, and no participating interest holder's interest is subordinated to the interest of another participating interest holder. That priority does not change in the event of bankruptcy or other receivership of the transferor, the original debtor, or any other participating interest holder. Participating interest holders have no recourse to the transferor, its agents or to each other, other than standard representations and warranties, ongoing contractual obligations to service the entire financial asset and administer the transfer contract, and contractual obligations to share in any set-off benefits received by any participating interest holder. That is, no participating interest holder is entitled to receive cash before any other participating interest holder under its contractual rights as a participating interest holder. For example, if a participating interest holder also is the servicer of the entire financial asset and receives cash in its role as servicer, that arrangement would not violate this requirement.

d. No party has the right to pledge or exchange the entire financial asset unless all participating interest holders agree to pledge or exchange the entire financial asset.

Proceeds

Cash, beneficial interests, servicing assets, derivatives, or other assets that are obtained in a transfer of financial assets, less any liabilities incurred.

Recourse

The right of a transferee of receivables to receive payment from the transferor of those receivables for (a) failure of debtors to pay when due, (b) the effects of prepayments, or (c) adjustments resulting from defects in the eligibility of the transferred receivables.

Securitization

The process by which financial assets are transformed into securities.

Security Interest

A form of interest in property that provides that upon default of the obligation for which the security interest is given, the property may be sold in order to satisfy that obligation.

Seller

A transferor that relinquishes control over financial assets by transferring them to a transferee in exchange for consideration.

Servicing Asset

A contract to service financial assets under which the estimated future revenues from contractually specified servicing fees, late charges, and other ancillary revenues are expected to more than adequately compensate the servicer for performing the servicing. A servicing contract is either (a) undertaken in conjunction with selling or securitizing the financial assets being serviced or (b) purchased or assumed separately.

Servicing Liability

A contract to service financial assets under which the estimated future revenues from contractually specified servicing fees, late charges, and other ancillary revenues are not expected to adequately compensate the servicer for performing the servicing.

Standard Representations and Warranties

Representations and warranties that assert the financial asset being transferred is what it is purported to be at the transfer date. Examples include representations and warranties about (a) the characteristics, nature, and quality of the underlying financial asset, including characteristics of the underlying borrower and the type and nature of the collateral securing the underlying financial asset, (b) the quality, accuracy, and delivery of documentation relating to the transfer and the underlying financial asset, and (c) the accuracy of the transferor's representations in relation to the underlying financial asset.

Transfer

The conveyance of a noncash financial asset by and to someone other than the issuer of that financial asset. Thus, a transfer includes selling a receivable, putting it into a securitization trust, or posting it as collateral but excludes the origination of that receivable, the settlement of that receivable, or the restructuring of that receivable into a security in a troubled debt restructuring.

Transferee

An entity that receives a financial asset, an interest in a financial asset, or a group of financial assets from a transferor.

Transferor

An entity that transfers a financial asset, an interest in a financial asset, or a group of financial assets that it controls to another entity.

Unilateral Ability (See paragraphs 53 and 54)

A capacity for action not dependent on the actions (or failure to act) of any other party.

EXHIBIT B – ILLUSTRATIONS

Illustration—Recording Transfers with Proceeds of Cash, Derivatives, and Other Liabilities

1. Company A transfers entire loans with a carrying amount of $1,000 to a subsidiary and receives proceeds with a fair value of $1,030 and the transfer is accounted for as a sale. Company A undertakes no servicing responsibilities and assumes a limited recourse obligation to repurchase delinquent loans.

Company A agrees to provide the transferee a return at a floating rate of interest even though the contractual terms of the loan are fixed rate in nature (that provision is effectively an interest rate swap).

Fair Values	
Cash proceeds	$1,050
Interest rate swap asset	40
Recourse obligation	60

Net Proceeds	
Cash received	$1,050
Plus: Interest rate swap asset	40
Less: Recourse obligation	(60)
Net proceeds	$1,030

Gain on Sale	$1,030
Net proceeds	1,000
Carrying amount of loans sold	$ 30
Gain on sale	

Journal Entry		
Cash	1,050	
Interest rate swap asset	40	
Loans		1,000
Recourse obligation		60
Gain on sale		30
To record transfer		

Illustration—Recording Transfers of Participating Interests

2. Company B transfers a nine-tenths participating interest in a loan with a fair value of $1,100 and a carrying amount of $1,000, and the transfer is accounted for as a sale. The servicing contract has a fair value of zero because Company B estimates that the benefits of servicing are just adequate to compensate it for its servicing responsibilities.

Fair values	
Cash proceeds for nine-tenths sold ($1,100 x 9/10)	$990
One-tenth interest continued to be held by the transferor ($1,100 x 1/10)	110

Allocated Carrying Amount Based on Relative Fair Values

	Fair Value	Percentage Of Total Fair Value	Allocated Carrying Amount
Nine-tenths participating interest sold ($1,100 x 9/10)	$990	90	$900
One-tenth participating interest continued to be held by the transferor ($1,100 x 1/10)	110	10	100
Total	$ 1,100	100	$1,000

Gain on Sale	
Net proceeds	$ 990
Less: Carrying amount of loans sold	(900)
Gain on sale	$90

Journal Entry		
Cash	990	
Loans		900
Gain on sale		90
To record transfer		

Illustration—Sale of Receivables with Servicing Obtained

3. Company C originates $1,000 of loans that yield 10 percent interest income for their estimated lives of 9 years. Company C transfers the entire loans to an entity and the transfer is accounted for as a sale. Company C receives as proceeds $1,000 cash, a beneficial interest to receive 1 percent on the contractual interest on the loans (an interest-only strip receivable), and an additional 1 percent of the contractual interest as compensation for servicing the loans. The fair values of the servicing asset and the interest-only strip receivable are $40 and $60, respectively.

Fair Values	
Cash proceeds	$1,000
Servicing asset	40
Interest-only strip receivable	60

Net Proceeds		
Cash proceeds		$1,000
Servicing Asset		40
Interest-only strip receivable		60
	Net Proceeds	$1,100

Gain on Sale	
Net proceeds	$1,100
Less: Carrying amount of loans sold	(1,000)
Gain on sale	$ 100

Journal Entries		
Cash	1,000	
Interest-only strip receivable	60	
Servicing Asset	40	
Loans		1,000
Gain on sale		100
To record transfer and to recognize interest-only strip receivable and servicing asset		

Illustration—Securities Lending Transaction Treated as a Secured Borrowing

4. The following example illustrates the accounting for a securities lending transaction treated as a secured borrowing, in which the securities borrower sells the securities upon receipt and later buys similar securities to return to the securities lender:

Facts

Transferor's carrying amount and fair value of security loaned	$1,000
Cash "collateral"	1,020
Transferor's return from investing cash collateral at a 5 percent annual rate	5
Transferor's rebate to the securities borrower at a 4 percent annual rate	4

For simplicity, the fair value of the security is assumed not to change during the 35-day term of the transaction.

Journal Entries for the Transferor

At inception:		
Cash	1,020	
Payable under securities loan agreements		1,020
To record the receipt of cash collateral		
Securities pledged to creditors	1,000	
Securities		1,000
To reclassify loaned securities that the secured party has the right to sell or repledge		
Money market instrument	1,020	
Cash		1,020
To record investment of cash collateral		
At conclusion:		
Cash	1,025	
Interest		5
Money market instrument		1,020
To record results of investment		
Securities	1,000	
Securities pledged to creditors		1,000
To record return of security		
Payable under securities loan agreements	1,020	
Interest ("rebate")	4	
Cash		1,024
To record repayment of cash collateral plus interest		

Journal Entries for the Transferee

At inception:		
Receivable under securities loan agreements	1,020	
Cash		1,020
To record transfer of cash collateral		

Cash	1,000	
Obligation to return borrowed securities		1,000

To record sale of borrowed securities to a third party and the resulting obligation to return securities that it no longer holds

At conclusion:

Obligation to return borrowed securities	1,000	
Cash		1,000

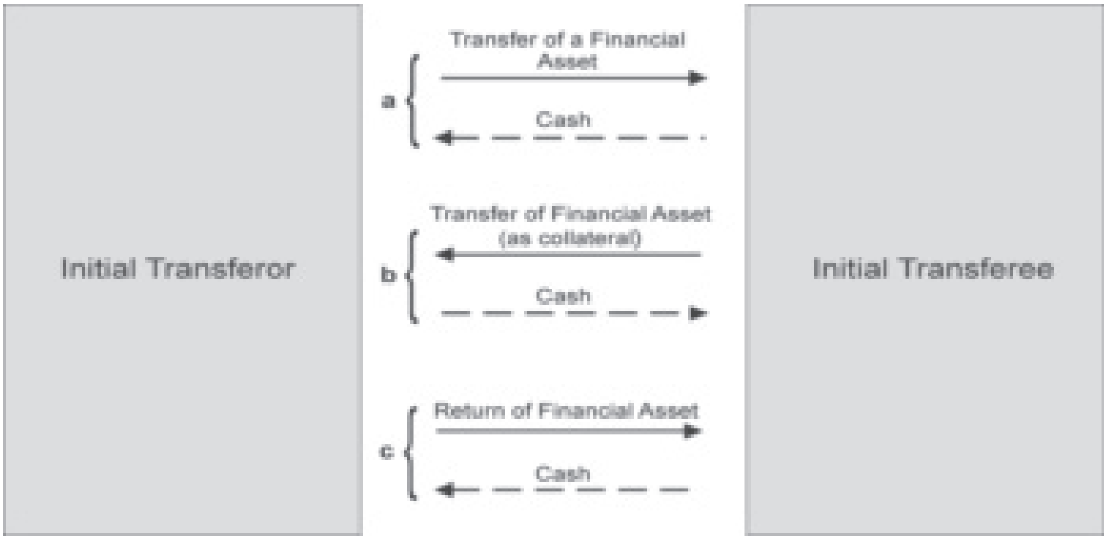
To record the repurchase of securities borrowed

Cash	1,024	
Receivable under securities loan agreements		1,020
Interest revenue ("rebate")		4

To record the receipt of cash collateral and rebate interest

Illustration—Initial Transfer and Repurchase Financing

5. The following diagram is an example of an initial transfer of a financial asset and a subsequent repurchase financing, as described in paragraphs 96-101.


Initial Transferor
Transfer of a Financial Asset
a
Cash
Transfer of Financial Asset (as collateral)
b
Cash
Return of Financial Asset
c
Cash
Initial Transferee

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Statement of Statutory Accounting Principles No. 104 - Revised

Share-Based Payments

STATUS

Type of Issue:	Common Area
Issued:	August 11, 2012; substantively revised – December 15, 2013
Effective Date:	January 1, 2013; substantive revisions detailed in Issue Paper No. 146 are effective December 31, 2014
Affects:	Supersedes SSAP No. 13 Nullifies and incorporates INT 99-17, INT 00-06, INT 00-32, INT 01-14
Affected by:	No other pronouncements
Interpreted by:	No other pronouncements

STATUS 1

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SCOPE OF STATEMENT

1. This statement provides statutory accounting principles for transactions in which an entity exchanges its equity instruments to employees and non-employees in share-based payment transactions. This statement does not provide statutory accounting principles for employee share ownership plans; those transactions are addressed in *SSAP No. 12—Employee Stock Ownership Plans*.

SUMMARY OF ISSUE

2. The objective of accounting for transactions under share-based payment arrangements with employees is to recognize in the financial statements the employee services received in exchange for equity instruments issued or liabilities incurred and the related cost to the entity as those services are consumed. The objective of accounting for share-based payment transactions with non-employees is to recognize in the financial statements the most reliably measurable fair values of such transactions. This statement uses the terms compensation and payment in their broadest senses to refer to the consideration paid for employee services and goods and services regardless of whether the supplier is an employee.

3. The accounting for all share-based payment transactions shall reflect the rights conveyed to the holder of the instruments and the obligations imposed on the issuer of the instruments, regardless of how those transactions are structured. This statement requires that the cost resulting from all share-based payment transactions be recognized in the financial statements. This statement establishes fair value as the measurement objective in accounting for share-based payment arrangements and requires all entities to apply a fair-value-based measurement method[1] in accounting for share-based payment transactions with employees except for equity instruments held by employee stock ownership plans.

Scope and Scope Exceptions

4. Employees - This statement applies to all share-based payment transactions in which an entity acquires employee services by issuing (or offering to issue) its shares, share options, or other equity instruments or by incurring liabilities to an employee that meet either of the following conditions:

a. The amounts are based, at least in part[2], on the price of the entity's shares or other equity instruments.

b. The awards require or may require settlement by issuing the entity's equity shares or other equity instruments.

5. Share-based payments awarded to an employee of the reporting entity by a related party or other holder of an economic interest in the entity as compensation for services provided to the entity are share-based payment transactions to be accounted for under this statement unless the transfer is clearly for a purpose other than compensation for services to the reporting entity. The substance of such a transaction

[1] Accounting pronouncements that require fair value measurements but that are excluded from *SSAP No. 100—Fair Value Measurements* is limited to this statement addressing share-based payment transactions. The fair value measurement objective in this statement is generally consistent with the fair value measurement objective in SSAP No. 100. However, for certain share-based payment transactions with employees, the measurements at the grant date are fair-value-based measurements, not fair value measurements. Although some measurements in this statement are fair value measurements, for practical reasons this statement is excluded in its entirety from SSAP No. 100. To be consistent with GAAP guidance on share-based payment transactions, the definition of fair value for use in this statement is: "the amount at which the asset (or liability) could be bought (or incurred) or sold (settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale." Observable market prices of identical or similar equity or liability instruments in active markets are the best estimate of fair value and, if available, should be used as the basis for the measurement of equity and liability instruments awarded in a share-based payment transaction with employees.

[2] The phrase "at least in part" is used because an award of share-based compensation may be indexed to both the price of an entity's shares and something else that is neither the price of the entity's shares nor a market, performance, or service condition.

is that the economic interest holder makes a capital contribution to the reporting entity, and that entity makes a share-based payment to its employee in exchange for services rendered. An example of a situation in which such a transfer is not compensation is a transfer to settle an obligation of the economic interest holder to the employee that is unrelated to employment by the entity.

6. Non-Employees - This statement applies to all share-based payment transactions in which an entity acquires goods or services by issuing (or offering to issue) its shares, share-options, or other equity instruments or by incurring liabilities to a goods or service provider that is not an employee in amounts based, at least in part[3], on the price of the entity's shares or other equity instruments or that require or may require settlement by issuing the entity's equity shares or other equity instrument.

7. The guidance in this statement does not apply to equity instruments held by an employee stock ownership plan. Such equity instruments shall follow the guidance in *SSAP No. 12—Employee Stock Ownership Plans* (SSAP No. 12). The guidance in this statement does not apply to transactions involving equity instruments either issued to a lender or investor that provides financing to the issuer or issued in a business combination.

8. The guidance for share-based payments to employees is contained in paragraphs 9-1154, and the guidance for share-based payments to non-employees is contained in paragraphs 116-143~~115-142~~. The guidance for employees is further divided as follows:

a. Compensatory Share-Based Payment Plans: Paragraphs 9-1054.

b. Noncompensatory Share-Based Payment Plans: Paragraphs 106-112~~105-111~~.

c. Consolidated/Holding Company Share-Based Payment Plans: Paragraphs 113-115~~112-114~~.

Employee Share-Based Payments - Compensatory

Recognition Principle for Share-Based Payment Transactions

9. Stock purchase and stock option plans that do not meet the criteria of a non-compensatory plan (paragraphs 106-112~~105-111~~) and are not otherwise excluded from the scope of this statement shall be classified as compensatory and follow the recognition, measurement and disclosure guidance in paragraphs 10-1054.

10. An entity shall recognize the services received in a share-based payment transaction with an employee as services are received. Employee services themselves are not recognized before they are received. The entity shall recognize either a corresponding increase in equity or a liability, depending on whether the instruments granted satisfy the equity or liability classification criteria (see paragraphs 14-27). As the services are consumed, the entity shall recognize the related cost.

11. The accounting for all share-based payment transactions shall reflect the rights conveyed to the holder of the instruments and the obligations imposed on the issuer of the instruments, regardless of how those transactions are structured. For example, the rights and obligations embodied in a transfer of equity shares to an employee for a note that provides no recourse to other assets of the employee (that is, other than the shares) are substantially the same as those embodied in a grant of equity share options. Thus, that transaction shall be accounted for as a substantive grant of equity share options.

[3] See Footnote 2

12. Assessment of both the rights and obligations in a share-based payment award and any related arrangement and how those rights and obligations affect the fair value of an award requires the exercise of judgment in considering the relevant facts and circumstances.

Determining the Grant Date

13. As a practical accommodation, in determining the grant date of an award subject to this statement, assuming all other criteria in the grant date definition have been met, a mutual understanding of the key terms and conditions of an award to an individual employee shall be presumed to exist at the date the award is approved in accordance with the relevant corporate governance requirements (that is, by the Board or management with the relevant authority) if both of the following conditions are met:

a. The award is a unilateral grant and, therefore, the recipient does not have the ability to negotiate the key terms and conditions of the award with the employer.

b. The key terms and conditions of the award are expected to be communicated to an individual recipient within a relatively short time period from the date of approval. A relatively short time period is that period in which an entity could reasonably complete all actions necessary to communicate the awards to the recipients in accordance with the entity's customary human resource practices.

Determining Whether to Classify a Financial Instrument as a Liability or As Equity

14. Paragraphs 14-27, provide guidance for determining whether certain financial instruments awarded in share-based payment transactions are liabilities. In determining whether an instrument not specifically discussed in those paragraphs shall be classified as a liability or as equity, an entity shall apply statutory accounting principles applicable to financial instruments issued in transactions not involving share-based payment.

15. Unless paragraphs 16-27 require otherwise, an entity shall apply the classification criteria in Appendix A, as they are effective at the reporting date, in determining whether to classify as a liability a freestanding financial instrument given to an employee in a share-based payment transaction. Paragraphs 65-69~~64-68~~ provide criteria for determining when instruments subject to this statement subsequently become subject to other applicable statutory accounting principles.

16. In determining the classification of an instrument, an entity shall take into account the classification requirements that are effective for that specific entity at the reporting date as established by Appendix A. In addition, a call option written on an instrument that is not classified as a liability under those classification requirements also shall be classified as equity so long as those equity classification requirements for the entity continue to be met, unless liability classification is required under the provisions of paragraphs 19 and 20.

17. Appendix A does not apply to outstanding shares embodying a conditional obligation to transfer assets, for example, shares that give the employee the right to require the employer to repurchase them for cash equal to their fair value (puttable shares). A put right may be granted to the employee in a transaction that is related to a share-based compensation arrangement. If exercise of such a put right would require the entity to repurchase shares issued under the share-based compensation arrangement, the shares shall be accounted for as puttable shares. A puttable (or callable) share awarded to an employee as compensation shall be classified as a liability if either of the following conditions is met:

a. The repurchase feature permits the employee to avoid bearing the risks and rewards normally associated with equity share ownership for a reasonable period of time from the date the requisite service is rendered and the share is issued. An employee begins to bear the risks and rewards normally associated with equity share ownership when all the requisite service has been rendered. A repurchase feature that can be exercised only upon the occurrence of a contingent event that is outside the employee's control (such as an initial public offering) would not meet this condition until it becomes probable that the event will occur within the reasonable period of time.

b. It is probable that the employer would prevent the employee from bearing those risks and rewards for a reasonable period of time from the date the share is issued.

For this purpose, a period of six months or more is a reasonable period of time.

18. A puttable (or callable) share that does not meet either of those conditions shall be classified as equity.

19. Options or similar instruments on shares shall be classified as liabilities if either of the following conditions is met:

a. The underlying shares are classified as liabilities.

b. The entity can be required under any circumstances to settle the option or similar instrument by transferring cash or other assets. A cash settlement feature that can be exercised only upon the occurrence of a contingent event that is outside the employee's control (such as an initial public offering) would not meet this condition until it becomes probable that event will occur.

20. For example, a reporting entity that is a Securities and Exchange Commission (SEC) registrant may grant an option to an employee that, upon exercise, would be settled by issuing a mandatorily redeemable share. Because the mandatorily redeemable share would be classified as a liability under Appendix A (as well as under *SSAP No. 72—Surplus and Quasi-Reorganizations*), the option also would be classified as a liability.

21. An award may be indexed to a factor in addition to the entity's share price. If that additional factor is not a market, performance, or service condition, the award shall be classified as a liability for purposes of this statement, and the additional factor shall be reflected in estimating the fair value of the award.

22. For this purpose, an award of equity share options granted to an employee of an entity's foreign operation that provides for a fixed exercise price denominated either in the foreign operation's functional currency or in the currency in which the employee's pay is denominated shall not be considered to contain a condition that is not a market, performance, or service condition. Therefore, such an award is not required to be classified as a liability if it otherwise qualifies as equity. For example, equity share options with an exercise price denominated in euros granted to employees of a U.S. entity's foreign operation whose functional currency is the euro are not required to be classified as liabilities if those options otherwise qualify as equity. In addition, such options are not required to be classified as liabilities even if the functional currency of the foreign operation is the U.S. dollar, provided that the employees to whom the options are granted are paid in euros.

23. The accounting for an award of a share-based payment shall reflect the substantive terms of the award and any related arrangement. Generally, the written terms provide the best evidence of the substantive terms of an award. However, an entity's past practice may indicate that the substantive terms of an award differ from its written terms. For example, an entity that grants a tandem award under which an employee receives either a stock option or a cash-settled stock appreciation right is obligated to pay cash on demand if the choice is the employee's, and the entity thus incurs a liability to the employee. In contrast, if the choice is the entities, it can avoid transferring its assets by choosing to settle in stock, and the award qualifies as an equity instrument. However, if an entity that nominally has the choice of settling

awards by issuing stock predominately settles in cash or if the entity usually settles in cash whenever an employee asks for cash settlement, the entity is settling a substantive liability rather than repurchasing an equity instrument. In determining whether an entity that has the choice of settling an award by issuing equity shares has a substantive liability, the entity also shall consider whether:

a. It has the ability to deliver the shares. (Federal securities law generally requires that transactions involving offerings of shares under employee share option arrangements be registered, unless there is an available exemption. For purposes of this statement, such requirements do not, by themselves, imply that an entity does not have the ability to deliver shares and thus do not require an award that otherwise qualifies as equity to be classified as a liability.)

b. It is required to pay cash if a contingent event occurs (see paragraphs 19-20).

24. A provision that permits employees to effect a broker-assisted cashless exercise of part or all of an award of share options through a broker does not result in liability classification for instruments that otherwise would be classified as equity if both of the following criteria are satisfied:

a. The cashless exercise requires a valid exercise of the share options.

b. The employee is the legal owner of the shares subject to the option (even though the employee has not paid the exercise price before the sale of the shares subject to the option).

25. A broker that is a related party of the entity must sell the shares in the open market within a normal settlement period, which generally is three days, for the award to qualify as equity.

26. Similarly, a provision for either direct or indirect (through a net-settlement feature) repurchase of shares issued upon exercise of options (or the vesting of nonvested shares), with any payment due employees withheld to meet the employer's minimum statutory withholding requirements resulting from the exercise, does not, by itself, result in liability classification of instruments that otherwise would be classified as equity. However, if an amount in excess of the minimum statutory requirement is withheld, or may be withheld at the employee's discretion, the entire award shall be classified and accounted for as a liability.

27. Minimum statutory withholding requirements are to be based on the applicable minimum statutory withholding rates required by the relevant tax authority (or authorities, for example, federal, state, and local), including the employee's share of payroll taxes that are applicable to such supplemental taxable income.

Market, Performance, and Service Conditions

28. Accruals of compensation cost for an award with a performance condition shall be based on the probable outcome of that performance condition—compensation cost shall be accrued if it is probable that the performance condition will be achieved and shall not be accrued if it is not probable that the performance condition will be achieved. If an award has multiple performance conditions (for example, if the number of options or shares an employee earns varies depending on which, if any, of two or more performance conditions is satisfied), compensation cost shall be accrued if it is probable that a performance condition will be satisfied. In making that assessment, it may be necessary to take into account the interrelationship of those performance conditions.

29. If an award requires satisfaction of one or more market, performance, or service conditions (or any combination thereof), compensation cost shall be recognized if the requisite service is rendered, and no compensation cost shall be recognized if the requisite service is not rendered.

Payroll Taxes

30. A liability for employee payroll taxes on employee stock compensation shall be recognized on the date of the event triggering the measurement and payment of the tax to the taxing authority (for a nonqualified option in the United States, generally the exercise date). Payroll taxes, even though directly related to the appreciation on stock options, are operating expenses and shall be reflected as such in the statement of operations.

Initial Measurement

31. While some of the material in paragraphs 31-34 was written in terms of awards classified as equity, it applies equally to awards classified as liabilities. The subparagraphs of paragraph 36 provide specific guidance for awards classified as liabilities.

32. A share-based payment transaction with employees shall be measured based on the fair value (or in certain situations specified in this statement, a calculated value or intrinsic value) of the equity instruments issued.

33. An entity shall account for the compensation cost from share-based payment transactions with employees in accordance with the fair-value-based method set forth in this statement. That is, the cost of services received from employees in exchange for awards of share-based compensation generally shall be measured based on the grant-date fair value of the equity instruments issued or on the fair value of the liabilities incurred. The cost of services received by an entity as consideration for equity instruments issued or liabilities incurred in share-based compensation transactions with employees shall be measured based on the fair value of the equity instruments issued or the liabilities settled. The portion of the fair value of an instrument attributed to employee service is net of any amount that an employee pays (or becomes obligated to pay) for that instrument when it is granted. For example, if an employee pays $5 at the grant date for an option with a grant-date fair value of $50, the amount attributed to employee service is $45.

34. However, this statement provides certain exceptions (paragraph 49) to that measurement method if it is not possible to reasonably estimate the fair value of an award at the grant date. A reporting entity that is not able to reasonably estimate the fair value of its equity options and similar instruments may measure its liabilities under share-based payment arrangements at intrinsic value (see paragraphs 36.b. and 48).

Terms of the Award Affect Fair Value

35. The terms of a share-based payment award and any related arrangement affect its value and, except for certain explicitly excluded features, such as a reload feature, shall be reflected in determining the fair value of the equity or liability instruments granted. For example, the fair value of a substantive option structured as the exchange of equity shares for a nonrecourse note will differ depending on whether the employee is required to pay nonrefundable interest on the note.

Measurement Objective – Fair Value at Grant Date

36. The measurement objective for equity instruments awarded to employees is to estimate the fair value at the grant date of the equity instruments that the entity is obligated to issue when employees have rendered the requisite service and satisfied any other conditions necessary to earn the right to benefit from the instruments (for example, to exercise share options). That estimate is based on the share price and other pertinent factors, such as expected volatility, at the grant date. The following subparagraphs provide guidance regarding the measurement objective and measurement date for liability instruments:

a. Measurement Objective and Measurement Date for Liabilities: At the grant date, the measurement objective for liabilities incurred under share-based compensation arrangements is the same as the measurement objective for equity instruments awarded to employees as described in paragraph 36. However, the measurement date for liability instruments is the date of settlement.

b. Measurement Objective and Measurement Date for Liabilities of Entities Subject to Paragraph 48: An entity subject to paragraph 48 shall make a policy decision of whether to measure all of its liabilities incurred under share-based payment arrangements at fair value or to measure all such liabilities at intrinsic value. Consistent with the guidance in paragraph 48, an entity that is not able to reasonably estimate the fair value of its equity share options and similar instruments because it is not practicable for it to estimate the expected volatility of its share price shall make a policy choice of whether to measure its liabilities under share-based payment arrangements at calculated value or at intrinsic value.

37. The fair value of an equity share option or similar instrument shall be measured based on the observable market price of an option with the same or similar terms and conditions.

38. Such market prices for equity share options and similar instruments granted to employees are frequently not available; however, they may become so in the future. As such, the fair value of an equity share option or similar instrument shall be estimated using a valuation technique such as an option-pricing model. For this purpose, a similar instrument is one whose fair value differs from its intrinsic value, that is, an instrument that has time value. For example, a share appreciation right that requires net settlement in equity shares has time value; an equity share does not.

Factors or Restrictions that Impact the Determination of Fair Value at Grant Date

Vesting Versus Nontransferability

39. To satisfy the measurement objective in paragraph 36, the restrictions and conditions inherent in equity instruments awarded to employees are treated differently depending on whether they continue in effect after the requisite service period. A restriction that continues in effect after an entity has issued instruments to employees, such as the inability to transfer vested equity share options to third parties or the inability to sell vested shares for a period of time, is considered in estimating the fair value of the instruments at the grant date. For equity share options and similar instruments, the effect of nontransferability (and nonhedgeability, which has a similar effect) is taken into account by reflecting the effects of employees' expected exercise and postvesting employment termination behavior in estimating fair value (referred to as an option's expected term).

Forfeitability

40. A restriction that stems from the forfeitability of instruments to which employees have not yet earned the right, such as the inability either to exercise a nonvested equity share option or to sell nonvested shares, is not reflected in estimating the fair value of the related instruments at the grant date. Instead, those restrictions are taken into account by recognizing compensation cost only for awards for which employees render the requisite service.

Performance of Service Conditions

41. Awards of share-based employee compensation ordinarily specify a performance condition or a service condition (or both) that must be satisfied for an employee to earn the right to benefit from the award. No compensation cost is recognized for instruments that employees forfeit because a service condition or a performance condition is not satisfied (that is, instruments for which the requisite service is not rendered).

42. The fair-value-based method described in paragraphs 36 and 39-43 uses fair value measurement techniques, and the grant-date share price and other pertinent factors are used in applying those techniques. However, the effects on the grant-date fair value of service and performance conditions that apply only during the requisite service period are reflected based on the outcomes of those conditions. This statement refers to the required measure as fair value.

Market Conditions

43. Some awards contain a market condition. The effect of a market condition is reflected in the grant-date fair value of an award. (Valuation techniques have been developed to value path-dependent options as well as other options with complex terms. Awards with market conditions, as defined in this statement, are path-dependent options.) Compensation cost thus is recognized for an award with a market condition provided that the requisite service is rendered, regardless of when, if ever, the market condition is satisfied.

Market, Performance, and Service Conditions That Affect Conditions Other than Vesting or Exercisability

44. Market, performance, and service conditions (or any combination thereof) may affect an award's exercise price, contractual term, quantity, conversion ratio, or other factors that are considered in measuring an award's grant-date fair value. A grant-date fair value shall be estimated for each possible outcome of such a performance or service condition, and the final measure of compensation cost shall be based on the amount estimated at the grant date for the condition or outcome that is actually satisfied.

Nonvested or Restricted Shares

45. A nonvested equity share or nonvested equity share unit awarded to an employee shall be measured at its fair value as if it were vested and issued on the grant date.

46. Nonvested shares granted to employees usually are referred to as restricted shares, but this statement reserves that term for fully vested and outstanding shares whose sale is contractually or governmentally prohibited for a specified period of time.

47. A restricted share awarded to an employee, that is, a share that will be restricted after the employee has a vested right to it, shall be measured at its fair value, which is the same amount for which a similarly restricted share would be issued to third parties.

Calculated Value for Entities Not Reasonably Able to Estimate Fair Value

48. An entity may not be able to reasonably estimate the fair value of its equity share options and similar instruments because it is not practicable for it to estimate the expected volatility of its share price. In that situation, the entity shall account for its equity share options and similar instruments based on a value calculated using the historical volatility of an appropriate industry sector index instead of the expected volatility of the entity's share price (the calculated value). Throughout the remainder of this statement, provisions that apply to accounting for share options and similar instruments at fair value also apply to calculated value.

Difficulty of Estimation

49. It should be possible to reasonably estimate the fair value of most equity share options and other equity instruments at the date they are granted. However, in rare circumstances, it may not be possible to reasonably estimate the fair value of an equity share option or other equity instrument at the grant date because of the complexity of its terms.

50. An equity instrument for which it is not possible to reasonably estimate fair value at the grant date shall be accounted for based on its intrinsic value (paragraph 71~~70~~) for measurement after issue date.

Reload and Contingent Features

51. The fair value of each award of equity instruments, including an award of options with a reload feature (reload options), shall be measured separately based on its terms and the share price and other pertinent factors at the grant date. The effect of a reload feature in the terms of an award shall not be included in estimating the grant-date fair value of the award. Rather, a subsequent grant of reload options pursuant to that provision shall be accounted for as a separate award when the reload options are granted.

52. A contingent feature of an award that might cause an employee to return to the entity either equity instruments earned or realized gains from the sale of equity instruments earned for consideration that is less than fair value on the date of transfer (including no consideration), such as a clawback feature shall not be reflected in estimating the grant-date fair value of an equity instrument.

Requisite Service Period

53. An entity shall make its initial best estimate of the requisite service period at the grant date (or at the service inception date, if that date precedes the grant date) and shall base accruals of compensation cost on that period.

54. The initial best estimate and any subsequent adjustment to that estimate of the requisite service period for an award with a combination of market, performance, or service conditions shall be based on an analysis of all of the following:

a. All vesting and exercisability conditions

b. All explicit, implicit, and derived service periods

c. The probability that performance or service conditions will be satisfied.

Market, Performance, and Service Conditions

55. Performance or service conditions that affect vesting are not reflected in estimating the fair value of an award at the grant date because those conditions are restrictions that stem from the forfeitability of instruments to which employees have not yet earned the right. However, the effect of a market condition is reflected in estimating the fair value of an award at the grant date (paragraph 43). For purposes of this statement, a market condition is not considered to be a vesting condition, and an award is not deemed to be forfeited solely because a market condition is not satisfied.

56. In some cases, the terms of an award may provide that a performance target that affects vesting could be achieved after an employee completes the requisite service period. That is, the employee would be eligible to vest in the award regardless of whether the employee is rendering service on the date the performance target is achieved. A performance target that affects vesting and that could be achieved after an employee's requisite service period shall be accounted for as a performance condition. As such, the performance target shall not be reflected in estimating the fair value of the award at the grant date. Compensation cost shall be recognized in the period in which it becomes probable that the performance target will be achieved and should represent the compensation cost attributable to the period(s) for which the requisite service already has been rendered. If the performance target becomes probable of being achieved before the end of the requisite service period, the remaining unrecognized compensation cost for which requisite service has not yet been rendered shall be recognized prospectively over the remaining requisite service period. The total amount of compensation cost recognized during and after the requisite service period shall reflect the number of awards that are expected to vest and shall be adjusted to reflect those awards that ultimately vest. The requisite service period ends when the employee can cease

rendering service and still be eligible to vest in the award if the performance target is achieved. The stated vesting period (which includes the period in which the performance target could be achieved) may differ from the requisite service period.

Subsequent Measurement

~~56.~~57. Guidance that equally applies to both liabilities and equity is generally found in paragraphs 58-70~~57-69~~. Paragraphs 71-79~~70-78~~ provide additional subsequent measurement guidance for awards classified as equity and paragraphs 80-83~~79-82~~ provide additional subsequent measurement guidance for awards classified as liabilities.

Recognition of Compensation Costs Over the Requisite Service

~~57.~~58. The compensation cost for an award of share-based employee compensation classified as equity shall be recognized over the requisite service period, with a corresponding credit to equity (generally, paid-in capital). The requisite service period is the period during which an employee is required to provide service in exchange for an award, which often is the vesting period. The requisite service period is estimated based on an analysis of the terms of the share-based payment award.

~~58.~~59. The total amount of compensation cost recognized at the end of the requisite service period for an award of share-based compensation shall be based on the number of instruments for which the requisite service has been rendered (that is, for which the requisite service period has been completed). An entity shall base initial accruals of compensation cost on the estimated number of instruments for which the requisite service is expected to be rendered. That estimate shall be revised if subsequent information indicates that the actual number of instruments is likely to differ from previous estimates. The cumulative effect on current and prior periods of a change in the estimated number of instruments for which the requisite service is expected to be or has been rendered shall be recognized in compensation cost in the period of the change. Previously recognized compensation cost shall not be reversed if an employee share option (or share unit) for which the requisite service has been rendered expires unexercised (or unconverted).

~~59.~~60. An entity shall reverse previously recognized compensation cost for an award with a market condition only if the requisite service is not rendered.

Estimating the Requisite Service Period

~~60.~~61. The requisite service period may be explicit or it may be implicit, being inferred from an analysis of other terms in the award, including other explicit service or performance conditions. The requisite service period for an award that contains a market condition can be derived from certain valuation techniques that may be used to estimate grant-date fair value. An award may have one or more explicit, implicit, or derived service periods; however, an award may have only one requisite service period for accounting purposes unless it is accounted for as in-substance multiple awards. An award with a graded vesting schedule that is accounted for as in-substance multiple awards is an example of an award that has more than one requisite service period (paragraph 64~~63~~).

~~61.~~62. The service inception date is the beginning of the requisite service period. If the service inception date precedes the grant date, accrual of compensation cost for periods before the grant date shall be based on the fair value of the award at the reporting date. In the period in which the grant date occurs, cumulative compensation cost shall be adjusted to reflect the cumulative effect of measuring compensation cost based on fair value at the grant date rather than the fair value previously used at the service inception date (or any subsequent reporting date).

~~62.~~63. An entity shall adjust that initial best estimate in light of changes in facts and circumstances. Whether and how the initial best estimate of the requisite service period is adjusted depends on both the nature of the conditions identified in paragraph 54 and the manner in which they are combined, for example, whether an award vests or becomes exercisable when either a market or a performance condition is satisfied or whether both conditions must be satisfied.

Graded Vesting Awards

~~63.~~64. An entity shall make a policy decision about whether to recognize compensation cost for an award with only service conditions that has a graded vesting schedule in either of the following ways:

a. On a straight-line basis over the requisite service period for each separately vesting portion of the award as if the award was, in-substance, multiple awards.

b. On a straight-line basis over the requisite service period for the entire award (that is, over the requisite service period of the last separately vesting portion of the award).

However, the amount of compensation cost recognized at any date must at least equal the portion of the grant-date value of the award that is vested at that date.

Awards May Become Subject to Other Guidance

~~64.~~65. Paragraphs 66-69~~65-68~~ are intended to apply to those instruments issued in share-based payment transactions with employees accounted for under this statement, and to instruments exchanged in a business combination for share-based payment awards of the acquired business that were originally granted to employees of the acquired business and are outstanding as of the date of the business combination. Instruments issued, in whole or in part, as consideration for goods or services other than employee service shall not be considered to have been issued in exchange for employee service when applying the guidance in those paragraphs, irrespective of the employment status of the recipient of the award on the grant date.

~~65.~~66. A freestanding financial instrument issued to an employee in exchange for past or future employee services that is subject to initial recognition and measurement guidance within this statement shall continue to be subject to the recognition and measurement provisions of this statement throughout the life of the instrument, unless its terms are modified when the holder is no longer an employee. Only for purposes of this paragraph, a modification does not include a change to the terms of an award if that change is made solely to reflect an equity restructuring provided that both of the following conditions are met:

a. There is no increase in fair value of the award (or the ratio of intrinsic value to the exercise price of the award is preserved, that is, the holder is made whole) or the antidilution provision is not added to the terms of the award in contemplation of an equity restructuring.

b. All holders of the same class of equity instruments (for example, stock options) are treated in the same manner.

~~66.~~67. Other modifications of that instrument that take place when the holder is no longer an employee shall be subject to the modification guidance in paragraph 69~~68~~. Following modification, recognition and measurement of the instrument should be determined through reference to other applicable statutory accounting principles.

~~67.~~68. Once the classification of an instrument is determined, the recognition and measurement provisions of this statement shall be applied until the instrument ceases to be subject to the requirements discussed in paragraph 66~~65~~. Other applicable statutory accounting principles apply to a freestanding financial instrument that was issued under a share-based payment arrangement but that is no longer subject to this statement.

~~68.~~69. An entity may modify (including cancel and replace) or settle a fully vested, freestanding financial instrument after it becomes subject to other applicable statutory accounting principles. Such a modification or settlement shall be accounted for under the provisions of this statement unless it applies equally to all financial instruments of the same class regardless of whether the holder is (or was) an employee (or an employee's beneficiary). Following the modification, the instrument continues to be accounted for under other applicable statutory accounting principles. A modification or settlement of a class of financial instrument that is designed exclusively for and held only by current or former employees (or their beneficiaries) may stem from the employment relationship depending on the terms of the modification or settlement. Thus, such a modification or settlement may be subject to the requirements of this statement. See paragraph 66~~65~~ for a discussion of changes to awards made solely to reflect an equity restructuring.

Change in Classification Due to Change in Probable Settlement Outcome

~~69.~~70. An option or similar instrument that is classified as equity, but subsequently becomes a liability because the contingent cash settlement event is probable of occurring, shall be accounted for similar to a modification from an equity to liability award. That is, on the date the contingent event becomes probable of occurring (and therefore the award must be recognized as a liability), the entity recognizes a share-based liability equal to the portion of the award attributed to past service (which reflects any provision for acceleration of vesting) multiplied by the award's fair value on that date. To the extent the liability equals or is less than the amount previously recognized in equity, the offsetting debit is a charge to equity. To the extent that the liability exceeds the amount previously recognized in equity, the excess is recognized as compensation cost. The total recognized compensation cost for an award with a contingent cash settlement feature shall at least equal the fair value of the award at the grant date. The guidance in this paragraph is applicable only for options or similar instruments issued as part of employee compensation arrangements. That is, the guidance included in this paragraph is not applicable, by analogy or otherwise, to instruments outside employee share-based payment arrangements.

Subsequent Measurement - Awards Classified as Equity

Fair Value Not Reasonably Estimable

~~70.~~71. An equity instrument for which it is not possible to reasonably estimate fair value at the grant date shall be remeasured at each reporting date through the date of exercise or other settlement. The final measure of compensation cost shall be the intrinsic value of the instrument at the date it is settled. Compensation cost for each period until settlement shall be based on the change (or a portion of the change, depending on the percentage of the requisite service that has been rendered at the reporting date) in the intrinsic value of the instrument in each reporting period. The entity shall continue to use the intrinsic value method for those instruments even if it subsequently concludes that it is possible to reasonably estimate their fair value.

Contingent Features

~~71.~~72. A contingent feature of an award that might cause an employee to return to the entity either equity instruments earned or realized gains from the sale of equity instruments earned for consideration that is less than fair value on the date of transfer (including no consideration), such as a clawback feature, shall be accounted for if and when the contingent event occurs.

Modification of An Award

~~72.~~73. A modification of the terms or conditions of an equity award shall be treated as an exchange of the original award for a new award. In substance, the entity repurchases the original instrument by issuing a new instrument of equal or greater value, incurring additional compensation cost for any incremental value. The effects of a modification shall be measured as follows:

a. Incremental compensation cost shall be measured as the excess, if any, of the fair value of the modified award determined in accordance with the provisions of this statement over the fair value of the original award immediately before its terms are modified, measured based on the share price and other pertinent factors at that date. As indicated in paragraph 48, references to fair value throughout this statement shall be read also to encompass calculated value. The effect of the modification on the number of instruments expected to vest also shall be reflected in determining incremental compensation cost. The estimate at the modification date of the portion of the award expected to vest shall be subsequently adjusted, if necessary, in accordance with paragraph 59~~58~~.

b. Total recognized compensation cost for an equity award shall at least equal the fair value of the award at the grant date unless at the date of the modification the performance or service conditions of the original award are not expected to be satisfied. Thus, the total compensation cost measured at the date of a modification shall be the sum of the following:

   i. The portion of the grant-date fair value of the original award for which the requisite service is expected to be rendered (or has already been rendered) at that date, and

   ii. The incremental cost resulting from the modification.

   Compensation cost shall be subsequently adjusted, if necessary, in accordance with paragraph 59~~58~~.

c. A change in compensation cost for an equity award measured at intrinsic value in accordance with paragraph 71~~70~~ shall be measured by comparing the intrinsic value of the modified award, if any, with the intrinsic value of the original award, if any, immediately before the modification.

~~73.~~74. Paragraphs 65-69~~64-68~~ provide additional guidance on accounting for modifications of certain freestanding financial instruments that initially were subject to this statement but subsequently became subject to other applicable statutory accounting principles.

Short-Term Inducements

~~74.~~75. A short-term inducement shall be accounted for as a modification of the terms of only the awards of employees who accept the inducement. Other inducements are modifications of the terms of all awards subject to them and shall be accounted for as such.

Equity Restructuring or Business Combination

~~75.~~76. Exchanges of share options or other equity instruments or changes to their terms in conjunction with an equity restructuring or a business combination are modifications for purposes of this statement. Except for a modification to add an antidilution provision that is not made in contemplation of an equity restructuring, accounting for a modification in conjunction with an equity restructuring requires a comparison of the fair value of the modified award with the fair value of the original award immediately before the modification in accordance with paragraph 73~~72~~. If those amounts are the same, for instance, because the modification is designed to equalize the fair value of an award before and after an equity restructuring, no incremental compensation cost is recognized. See paragraph 66~~65~~ for an additional exception.

Repurchase or Cancellation

~~76.~~77. The amount of cash or other assets transferred (or liabilities incurred) to repurchase an equity award shall be charged to equity, to the extent that the amount paid does not exceed the fair value of the equity instruments repurchased at the repurchase date. Any excess of the repurchase price over the fair value of the instruments repurchased shall be recognized as additional compensation cost. An entity that repurchases an award for which the requisite service has not been rendered has, in effect, modified the requisite service period to the period for which service already has been rendered, and thus the amount of compensation cost measured at the grant date but not yet recognized shall be recognized at the repurchase date.

Cancellation and Replacement

~~77.~~78. Cancellation of an award accompanied by the concurrent grant of (or offer to grant) a replacement award or other valuable consideration shall be accounted for as a modification of the terms of the cancelled award. (The phrase *offer to grant* is intended to cover situations in which the service inception date precedes the grant date.) Therefore, incremental compensation cost shall be measured as the excess of the fair value of the replacement award or other valuable consideration over the fair value of the cancelled award at the cancellation date in accordance with paragraph 73~~72~~. Thus, the total compensation cost measured at the date of a cancellation and replacement shall be the portion of the grant-date fair value of the original award for which the requisite service is expected to be rendered (or has already been rendered) at that date plus the incremental cost resulting from the cancellation and replacement.

~~78.~~79. A cancellation of an award that is not accompanied by the concurrent grant of (or offer to grant) a replacement award or other valuable consideration shall be accounted for as a repurchase for no consideration. Accordingly, any previously unrecognized compensation cost shall be recognized at the cancellation date.

Subsequent Measurement - Awards Classified as Liabilities

Measurement

~~79.~~80. The fair value of liabilities incurred in share-based payment transactions with employees shall be remeasured at the end of each reporting period through settlement.

~~80.~~81. Changes in the fair value (or intrinsic value for an entity that elects that method) of a liability incurred under a share-based payment arrangement that occur during the requisite service period shall be recognized as compensation cost over that period. The percentage of the fair value (or intrinsic value) that is accrued as compensation cost at the end of each period shall equal the percentage of the requisite service that has been rendered at that date. Changes in the fair value (or intrinsic value) of a liability that occur after the end of the requisite service period are compensation costs of the period in which the changes occur. Any difference between the amount for which a liability award is settled and its fair value at the settlement date as estimated in accordance with the provisions of this statement is an adjustment of compensation cost in the period of settlement.

~~81.~~82. Reporting entities shall measure a liability award under a share-based payment arrangement based on the award's fair value (or calculated value in accordance with paragraph 48) remeasured at each reporting date until the date of settlement. Compensation costs for each period until settlement shall be based on the change (or a portion of the change, depending on the percentage of the requisite service that has been rendered at the reporting date) in the fair value of the instrument for each reporting period.

Modification of an Award

~~82.~~83. A modification of a liability award is accounted for as the exchange of the original award for a new award. However, because liability awards are remeasured at their fair value (or calculated value for an entity subject to paragraph 48) at each reporting date, no special guidance is necessary in accounting for a modification of a liability award that remains a liability after the modification.

Look-Back Plans

~~83.~~84. The accounting guidance in this section addresses the accounting for certain employee stock purchase plans with a look-back option. An example of a look-back option is a provision that establishes the purchase price as an amount based on the lesser of the stock's market price at the grant date or its market price at the exercise date (or purchase date).

~~84.~~85. As with all employee share purchase plans, the objective of the measurement process for employee share purchase plans with a look-back option is to reasonably measure fair value of the award at the grant date. Paragraph 71~~70~~ provides guidance on the measurement requirements if it is not possible to reasonably estimate fair value at the grant date.

Accounting for Tax Effects of Share-Based Compensation Awards

~~85.~~86. Income tax regulations specify allowable tax deductions for instruments issued under share-based payment arrangements in determining an entity's income tax liability. For example, under tax law, allowable tax deductions may be measured as the intrinsic value of an instrument on a specified date. The time value component, if any, of the fair value of an instrument generally may not be tax deductible. Therefore, tax deductions may arise in different amounts and in different periods from compensation costs recognized in financial statements. Similarly, the amount of expense reported for an employee stock ownership plan during a period may differ from the amount of the related income tax deduction prescribed by income tax rules and regulations.

~~86.~~87. This guidance addresses how temporary differences are recognized for share-based payment arrangement awards that are classified either as equity or as liabilities under the requirements of paragraphs 14-27. Incremental guidance is also provided for issues related to employee stock ownership plans.

Tax Effects for Instruments Classified as Equity

~~87.~~88. The cumulative amount of compensation cost recognized for instruments classified as equity that ordinarily would result in a future tax deduction under existing tax law shall be considered to be a deductible temporary difference in applying the requirements of *SSAP No. 101—Income Taxes, a Replacement of SSAP No. 10R and SSAP No. 10* (SSAP No. 101). The deductible temporary difference shall be based on the compensation cost recognized for financial reporting purposes. Compensation cost that is capitalized as part of the cost of an asset, such as inventory, shall be considered to be part of the tax basis of that asset for financial reporting purposes.

~~88.~~89. Recognition of compensation cost for instruments that ordinarily do not result in tax deductions under existing tax law shall not be considered to result in a deductible temporary difference. A future event can give rise to a tax deduction for instruments that ordinarily do not result in a tax deduction. The tax effects of such an event shall be recognized only when it occurs. An example of a future event that would be recognized only when it occurs is an employee's sale of shares obtained from an award before meeting a tax law's holding period requirement, sometimes referred to as a disqualifying disposition, which results in a tax deduction not ordinarily available for such an award.

Tax Effects for Instruments Classified as Liability

~~89.~~90. The cumulative amount of compensation cost recognized for instruments classified as liabilities that ordinarily would result in a future tax deduction under existing tax law also shall be considered to be a deductible temporary difference. The deductible temporary difference shall be based on the compensation costs recognized for financial reporting purposes.

Accounting for Tax Effects – Initial Measurement

~~90.~~91. SSAP No. 101 requires a deferred tax asset to be evaluated for future realization and to be reduced by a statutory valuation allowance to the amount that is more likely than not to be realized. Differences between the deductible temporary difference computed pursuant to paragraphs 88-89~~87-88~~ and the tax deduction that would result based on the current fair value of the entity's shares shall not be considered in measuring the gross deferred tax asset or determining the need for a valuation allowance for a deferred tax asset recognized under these requirements.

Accounting for Tax Effects – Subsequent Measurement

~~91.~~92. If a deduction reported on a tax return for an award of equity instruments exceeds the cumulative compensation cost for those instruments recognized for financial reporting, any resulting realized tax benefit that exceeds the previously recognized deferred tax asset for those instruments is the excess tax benefit. If only a portion of an award is exercised, determination of the excess tax benefits shall be based on the portion of the award that is exercised.

~~92.~~93. The amount deductible for an award of equity instruments on the employer's tax return may be less than the cumulative compensation costs recognized for financial reporting purposes. The write-off of a deferred tax asset related to that deficiency, net of the related statutory valuation allowance, if any, shall first be offset to the extent of any remaining gross paid-in and contributed surplus from excess tax benefits arising from previous awards granted, modified, or settled in cash and measured in accordance with a fair value based method of accounting. An entity shall exclude from that amount excess tax benefits from share-based payment arrangements that are outside the scope of this statement, excess tax benefits from employee stock ownership plans, and excess tax benefits that have not been realized pursuant to the requirements established in SSAP No. 101.

~~93.~~94. An excess tax benefit determined pursuant to paragraph 92~~91~~ shall be recognized as gross paid-in and contributed surplus, except that an excess of a realized tax benefit for an award over the deferred tax asset for that award shall be recognized in the income statement to the extent that the excess stems from a reason other than changes in the fair value of an entity's shares between the measurement date for accounting purposes and a later measurement date for tax purposes.

~~94.~~95. Paragraph 93~~92~~ contains measurement guidance on how much, if any, of the write-off of a deferred tax asset from a tax deficiency shall be offset against additional paid-in capital. The remaining balance, if any, of the write-off of a deferred tax asset related to a tax deficiency shall be recognized in the income statement.

Tax Benefits of Dividends on Share-Based Payment Awards to Employees

~~95.~~96. A realized income tax benefit from dividends or dividend equivalents that are charged to unassigned-funds (surplus) and are paid to employees for any of the following equity classified awards shall be recognized as an increase to gross paid-in and contributed surplus:

a. Nonvested equity shares

b. Nonvested equity share units

c. Outstanding equity share options.

~~96.~~97. The amount recognized in gross paid-in and contributed surplus for the realized income tax benefit from dividends on the awards identified in the preceding paragraph shall be included in the pool of excess tax benefits available to absorb tax deficiencies on share-based payment awards.

~~97.~~98. Dividends or dividend equivalents paid to employees for the awards identified in paragraph 96~~95~~ may result in a tax deduction prior to the actual realization of the related tax benefit because the employer, for example, has a net operating loss carryforward. The income tax benefit of those dividends shall not be recognized until the deduction reduces income taxes payable. Unrealized income tax benefits from dividends on equity-classified employee share-based payment awards shall be excluded from the pool of excess tax benefits available to absorb potential future tax deficiencies on share-based payment awards.

~~98.~~99. Dividends or dividend equivalents paid to employees on the portion of an award of equity shares or other equity instruments that vests shall be charged to unassigned funds (surplus). If the related award is not expected to vest, dividends or dividend equivalents shall be recognized as compensation costs. Dividends and dividend equivalents shall be reclassified between unassigned funds (surplus) and compensation costs in a subsequent period if the entity changes its forfeiture estimates (or actual forfeitures differ from previous estimates).

~~99.~~100. Adjustments to gross paid-in and contributed surplus for reclassifications of the tax benefits from dividends on the awards discussed in the preceding paragraph in subsequent periods increase or decrease the entity's pool of excess tax benefits available to absorb tax deficiencies by a corresponding amount. Additionally, the tax benefits from dividends that are reclassified from gross paid-in and contributed surplus to the income statement (that is, as a reduction of income tax expense or an increase of income tax benefit) if an entity's estimate of forfeitures increases (or actual forfeitures exceed the entity's estimates) shall be limited to the entity's pool of excess tax benefits available to absorb tax deficiencies on the date of the reclassification.

Accounting for Rabbi Trusts

~~100.~~101. Rabbi trusts are grantor trusts generally set up to fund compensation for a select group of management or highly paid executives. To qualify as a rabbi trust for income tax purposes, the terms of the trust agreement must explicitly state that the assets of the trust are available to satisfy the claims of general creditors in the event of bankruptcy of the employer.

~~101.~~102. There are four potential scenarios for deferred compensation arrangements where amounts earned by an employee are invested in the stock of the employer and placed in a “rabbi trust.”

Plan A: The plan does not permit diversification and must be settled by the delivery of a fixed number of shares of employer stock.

Plan B: The plan does not permit diversification and may be settled by the delivery of cash or shares of employer stock.

Plan C: The plan permits diversification; however, the employee has not diversified (the plan may be settled in cash, shares of employer stock, or diversified assets).

Plan D: The plan permits diversification and the employee has diversified (the plan may be settled in cash, shares of employer stock, or diversified assets).

~~102.~~103. The accounts of the rabbi trust should be consolidated with the accounts of the employer in the financial statements of the employer.

a. For Plan A, employer stock held by the rabbi trust should be classified in equity in a manner similar to the manner in which treasury stock is accounted for. Subsequent changes in the fair value of the employer's stock should not be recognized. The deferred compensation obligation should be classified as an equity instrument and changes in the fair value of the amount owed to the employee should not be recognized.

b. For Plans B and C, employer stock held by the rabbi trust should be classified in equity in a manner similar to the manner in which treasury stock is accounted for. Subsequent changes in the fair value of the employer's stock should not be recognized. The deferred compensation obligation should be classified as a liability and adjusted with a corresponding charge (or credit) to compensation cost, to reflect the changes in the fair value of the amount owed to the employee.

c. For Plan D, assets held by the rabbi trust should be accounted for in accordance with statutory accounting principles for the particular asset (for example, if the diversified asset is a marketable equity security, that security would be accounted for in accordance with SSAP No. 30). The deferred compensation obligation should be classified as a liability and adjusted, with a corresponding charge (or credit) to compensation cost, to reflect changes in the fair value of the amount owed to the employee. Changes in the fair value of the deferred compensation obligation should not be recorded in unrealized gains or losses, even if changes in the fair value of the assets held by the rabbi trust are recorded in surplus pursuant to *SSAP No. 30—Investments in Common Stock (excluding investments in common stock of subsidiary, controlled or affiliated entities)*..

Disclosures – Employee Share-Based Payments

~~103.~~104. An entity with one or more share-based payment arrangements shall disclose information that enables users of the financial statements to understand all of the following:

a. The nature and terms of such arrangements that existed during the period and the potential effects of those arrangements on shareholders;

b. The effect of compensation costs arising from share-based payment arrangements on the income statement;

c. The method of estimating the fair value of the goods or services received, or the fair value of the equity instruments granted (or offered to grant), during the period; and

d. The cash flow effects resulting from share-based payment arrangements.

~~104.~~105. The disclosures in paragraph 104~~103~~ are for annual audited statutory financial statements only. Appendix B illustrates the information needed to achieve the objectives in this paragraph.

Employee Share-Based Payments - Noncompensatory Plans

Overview and Background

~~105.~~106. This section provides guidance to all entities that use employee share purchase plans. The entity must first determine whether the plan is compensatory or noncompensatory. This is determined by the terms of the plan (paragraphs 107-108~~106-107~~). A plan with an option feature, for example a look-back feature, is considered compensatory.

Recognition

~~106.~~107. An employee share purchase plan that satisfies all of the following criteria does not give rise to recognizable compensation costs (that is, the plan is noncompensatory):

a. The plan satisfies either of the following conditions:

i. The terms of the plan are no more favorable than those available to all holders of the same class of shares. Note that a transaction subject to an employee share purchase plan that involves a class of equity shares designed exclusively for and held only by current or former employees or their beneficiaries may be compensatory depending on the terms of the arrangement.

ii. Any purchase discount from the market price does not exceed the per-share amount of share issuance costs that would have been incurred to raise a significant amount of capital by a public offering. A purchase discount of 5 percent or less from the market price shall be considered to comply with this condition without further justification. A purchase discount greater than 5 percent that cannot be justified under this condition results in compensation cost for the entire amount of the discount. Note that an entity that justifies a purchase discount in excess of 5 percent shall reassess at least annually, and no later than the first share purchase offer during the fiscal year, whether it can continue to justify that discount pursuant to this paragraph.

b. Substantially all employees that meet limited employment qualifications may participate on an equitable basis.

c. The plan incorporates no option features, other than the following:

i. Employees are permitted a short period of time—not exceeding 31 days—after the purchase price has been fixed to enroll in the plan.

ii. The purchase price is based solely on the market price of the shares at the date of purchase, and employees are permitted to cancel participation before the purchase date and obtain a refund of amounts previously paid (such as those paid by payroll withholdings).

~~107.~~108. A plan provision that establishes the purchase price as an amount based on the lesser of the equity share's market price at date of grant or its market price at date of purchase, commonly called a look-back plan, is an example of an option feature that causes the plan to be compensatory. Similarly, a plan in which the purchase price is based on the share's market price at date of grant and that permits a participating employee to cancel participation before the purchase date and obtain a refund of amounts previously paid contains an option feature that causes the plan to be compensatory.

~~108.~~109. The requisite service period for any compensation cost resulting from an employee share purchase plan is the period over which the employee participates in the plan and pays for the shares.

Initial Measurement

~~109.~~110. The objective in paragraph 36 also applies to the fair value measurements associated with grants under a compensatory employee share purchase plan. The objective in this paragraph states that the fair value measurement method is to estimate the fair value of the equity instruments, based on the share price and other measurement assumptions at the grant date, that are issued in exchange for employee services.

Subsequent Measurement

~~110.~~111. Changes in total employee withholdings during a purchase period that occur solely as a result of salary increases, commissions, or bonus payments are not plan modifications if they do not represent changes to the terms of the award that was offered by the employer and initially agreed to by the employee at the grant (or measurement) date. Under those circumstances, the only incremental compensation cost is that which results from the additional shares that may be purchased with the additional amounts withheld (using the fair value calculated at the grant date). For example, an employee may elect to participate in the plan on the grant date by requesting that 5 percent of the employee's annual salary be withheld for future purchases of stock. If the employee receives an increase in salary during the term of the award, the base salary on which the 5 percent withholding amount is applied will increase, thus increasing the total amount withheld for future share purchases. That increase in withholdings as a result of the salary increase is not considered a plan modification and thus only increases the total compensation cost associated with the award by the grant date fair value associated with the incremental number of shares that may be purchased with the additional withholdings during the period. The incremental number of shares that may be purchased is calculated by dividing the incremental amount withheld by the exercise price as of the grant date (for example, 85 percent of the grant date stock price).

~~111.~~112. Any decreases in the withholding amounts (or percentages) shall be disregarded for purposes of recognizing compensation cost unless the employee services that were valued at the grant date will no longer be provided to the employer due to a termination. However, no compensation cost shall be recognized for awards that an employee forfeits because of failure to satisfy a service requirement for vesting. The accounting for decreases in withholdings is consistent with the requirement in paragraph 58 that the total amount of compensation cost that must be recognized for an award be based on the number of instruments for which the requisite service has been rendered (that is, for which the requisite service period has been completed).

Employee Share-Based Payments - Consolidated / Holding Company Plans

~~112.~~113. Except for the disclosure requirement in paragraph 114~~113~~, the provisions of this statement do not apply to a reporting entity, as long as:

a. The reporting entity is not directly liable for obligations under the share-based payment plan.

b. Compensation costs associated with share-based payments provided by a related party or holder of an economic interest in the reporting entity, equal to the required contribution to the plan for the period, are included in allocated expenses to the reporting entity. A liability shall be established for any such contributions due and unpaid.

~~113.~~114. The reporting entity shall disclose in the financial statements that its employees participate in a plan sponsored by the holding company for which the reporting entity has no legal obligation. The amount of the expense incurred and the allocation methodology utilized by the provider of such benefits shall also be disclosed.

~~114.~~115. If the reporting entity is directly liable for the share-based payment plan, then the other provisions of this statement apply.

Non-Employee Share-Based Payments

~~115.~~116. Reporting entities that grant share-based payments to non-employees shall recognize the goods acquired or services received as part of the transaction when it obtains the goods or as services are received. A grantor may need to recognize a nonadmitted prepaid asset before it actually receives goods or services if it first exchanges share-based payment for an enforceable right to receive those goods or services. Nonetheless, the goods or services shall not be recognized before they are received. (The nonadmitted asset recognized prior to the goods and services would be eliminated upon receipt of the goods and services that are recognized.)

~~116.~~117. If fully vested, nonforfeitable equity instruments are issued at the date the grantor and grantee enter into an agreement for goods or services (no specific performance is required by the grantee to retain those equity instruments), then, because of the elimination of any obligation on the part of the counterparty to earn the equity instruments, a measurement date has been reached. A grantor shall recognize the equity instruments when they are issued (in most cases, when the agreement is entered into). Whether the corresponding cost is an immediate expense or a nonadmitted prepaid asset depends on the specific facts and circumstances. A grantor may conclude that an asset (other than a note or a receivable) has been received in return for fully-vested, nonforfeitable equity instruments that are issued at the date the grantor and grantee enter into an agreement for goods or services (and no specific performance is required by the grantee in order to retain those equity instruments). Such an asset shall not be displayed as contra-equity by the grantor of the equity instrument. The transferability (or lack thereof) of the equity instruments shall not affect the balance sheet display of this nonadmitted prepaid asset. This guidance is limited to transactions in which equity instruments are transferred to other than employees in exchange for goods or services.

~~117.~~118. An entity may grant fully vested, nonforfeitable equity instruments that are exercisable by the grantee only after a specified period of time if the terms of the agreement provide for earlier exercisability if the grantee achieves specified performance conditions. Any measured cost of the transaction shall be recognized in the same period(s) and in the same manner as if the entity had paid cash for the goods or services or used cash rebates as a sales discount instead of paying with, or using, the equity instruments.

~~118.~~119. A recognized nonadmitted prepaid asset, expense, or sales discount shall not be reversed if a stock option that the counterparty has the right to exercise expires unexercised. As noted in paragraph 116~~115~~, the goods and services shall not be recognized before they are received.

~~119.~~120. A grantor shall recognize either a corresponding increase in equity or a liability, depending on whether the instruments granted satisfy the equity or liability classification criteria established in paragraphs 14-27 for employee share-based payments. As the goods or services are disposed of or consumed, the grantor shall recognize the related cost, unless other statutory accounting principles require costs to be expensed when incurred. In these instances, when the goods or services are received, the grantor shall recognize the related cost.

Initial Measurement – Reporting Entity Grantor/Issuer

~~120.~~121. Share-based payment transactions with non-employees shall be measured at the fair value of the consideration received or the fair value of the equity instruments issued, whichever is more reliably measurable.

~~121.~~122. The accounting for all share-based payment transactions shall reflect the rights conveyed to the holder of the instruments and the obligations imposed on the issuer of the instruments, regardless of how those transactions are structured. The terms of a share-based payment award and any related arrangement affect its value and, except for certain explicitly excluded features, such as a reload feature, shall be reflected in determining the fair value of the equity or liability instruments granted. Assessment of both the rights and obligations in a share-based payment award and any related arrangement and how those rights and obligations affect the fair value of an award requires the exercise of judgment in considering the relevant facts and circumstances. The minimum value method (a method that reflects the time value of an option but ignores the volatility value) is not an acceptable method for determining the fair value of non-employee awards.

~~122.~~123. If the fair value of goods or services received in a share-based payment transaction with non-employees is more reliably measurable than the fair value of the equity instruments issued, the fair value of the goods or services received shall be used to measure the transaction. In contrast, if the fair value of the equity instruments issued in a share-based payment transaction with non-employees is more reliably measurable than the fair value of the consideration received, the transaction shall be measured based on the fair value of the equity instruments issued.

~~123.~~124. Sales incentives in the form of equity instruments shall be measured at the fair value of the sales incentive or the fair value of the equity instruments issued, whichever is more reliably measurable.

~~124.~~125. The issuer/grantor shall measure the fair value of the equity instruments provided in share-based payment transactions using the stock price and other measurement assumptions as of the earlier of the following dates, referred to as the measurement date:

a. The date at which a commitment for performance by the counterparty to earn the equity instruments is reached (a performance commitment[4])

b. The date at which the counterparty's performance is complete.

~~125.~~126. The counterparty's performance is complete when the counterparty has delivered or, in the case of sales incentives, purchased the goods or services, despite the fact that at that date the quantity or all the terms of the equity instruments may yet depend on other events (this would occur, for example, if a target stock price requirement has not been met when the counterparty has delivered the goods or services).

~~126.~~127. Situations may arise in which counterparty performance may be required over a period of time but the equity award granted to the party performing the services is fully vested and nonforfeitable on the date the parties enter into the contract. While this type of arrangement may be rare, because, typically, vesting provisions do exist, the measurement date for an award that is nonforfeitable and that vests immediately could be the date the parties enter into the contract, even though services have not yet been performed.

~~127.~~128. If fully vested, nonforfeitable equity instruments are issued at the date the grantor and grantee enter into an agreement for goods or services (no specific performance is required by the grantee to retain those equity instruments), then, because of the elimination of any obligation on the part of the counterparty to earn the equity instruments, a measurement date has been reached.

~~128.~~129. If an entity grants fully vested, nonforfeitable equity instruments that are exercisable by the grantee only after a specified period of time and the terms of the agreement provide for earlier exercisability if the grantee achieves specified performance conditions, the grantor shall measure the fair value of the equity instruments at the date of grant and shall recognize that measured cost in the same period(s) and in the same manner as if the grantor had paid cash.

[4] A performance commitment is a commitment under which performance by the grantee to earn the equity instruments is probable because of sufficiently large disincentives for nonperformance. The disincentives must result from the relationship between the grantor and the grantee. Forfeiture of the equity instruments as the sole remedy in the event of the grantee's nonperformance is not considered a sufficiently large disincentive for purposes of applying the guidance. In addition, the ability to sue for nonperformance, in and of itself, does not represent a sufficiently large disincentive to ensure that performance is probable. (A granting entity may always be able to sue for nonperformance but it is not always clear whether any significant damages would result.)

Initial Measurement – Reporting Entity Grantee/Provider

~~129.~~130. An entity (the grantee or provider) may enter into transactions to provide goods or services in exchange for equity instruments. The grantee shall measure the fair value of the equity instruments in these transactions using the stock price and other measurement assumptions as of the earlier of either of the following dates referred to as the measurement date:

a. The date the parties come to a mutual understanding of the terms of the equity-based compensation arrangement and a commitment for performance by the grantee to earn the equity instruments (a performance commitment[5]) is reached, or

b. The date at which the grantee's performance necessary to earn the equity instruments is complete (that is, the vesting date).

Measurement Before the Measurement Date

~~130.~~131. In accordance with other accounting guidance, it may be appropriate for an issuer to recognize costs related to share-based payment transactions with non-employees before a measurement date has occurred:

a. If the quantity and terms of the equity instruments are known up front, the equity instruments shall be measured at their then-current fair values at each interim financial reporting date.

b. If the quantity and terms of the equity instruments are not known up front, and the transaction is only impacted by market conditions, the equity instruments shall be measured at their then-current fair values at each interim financial reporting date.

c. If the quantity and terms of the equity instruments are not known up front, and the transaction is only impacted by counterparty performance conditions or both market conditions and counterparty performance conditions, the equity instruments shall be measured at their then-current best estimate of the possible outcomes. When no amount within a range can be deemed a better estimate, then the midpoint of the range shall be used.

Measurement at the Measurement Date – Transactions Involve Only Market Conditions

~~131.~~132. The quantity or terms of an equity instrument may be dependent only on market conditions. If, on the measurement date, the quantity or any of the terms of the equity instruments are dependent on the achievement of market conditions, then the issuer shall use the fair value of the equity instruments for recognition purposes. That fair value shall be calculated as the fair value of the equity instruments without regard to the market condition plus the fair value of the issuer's commitment to change the quantity or terms of the equity instruments based on whether the market condition is met.

~~132.~~133. As it relates to a grantee, if on the measurement date the quantity or any of the terms of the equity instrument are dependent on the achievement of a market condition, then the grantee shall measure revenue based on the fair value of the equity instruments inclusive of the adjustment provisions. That fair value would be calculated as the fair value of the equity instruments without regard to the market condition plus the fair value of the commitment to change the quantity or terms of the equity instruments if the market condition is met. That is, the existence of a market condition that, if achieved, results in an adjustment to an equity instrument generally affects the value of the instrument. Pricing models have been adapted to value many of those path-dependent equity instruments.

[5] See Footnote 4.

~~133.~~134. The quantity or terms of an equity instrument may be dependent on counterparty performance conditions. If, on the measurement date, the quantity or any of the terms of the equity instruments are dependent on the achievement of counterparty performance conditions that, based on the different possible outcomes, result in a range of aggregate fair values for the equity instruments as of that date, then the issuer should utilize the best estimate (that is, the variable terms times the applicable number of equity instruments) amount within that range for recognition purposes. When no amount within the range can be deemed a better estimate, then the midpoint of the range shall be used. The amount may be zero only if zero is determined to be the best estimate. This guidance also applies if the quantity or terms of an equity instrument is dependent on both market conditions and counterparty performance conditions.

Subsequent Measurement

~~134.~~135. After the issuer measures the then-current fair value of the issuer's commitment related to the market condition as described in paragraph 132~~131~~, the issuer shall, to the extent necessary, recognize and classify future changes in the fair value of this commitment in accordance with any relevant accounting guidance on financial instruments.

~~135.~~136. Paragraph 134~~133~~ provides measurement date guidance on the measurement of transactions that involve counterparty performance conditions. As each quantity and term become known and until all the quantities and terms that stem from the counterparty's performance become known, the best estimate or midpoint aggregate fair value measured pursuant to the guidance in that paragraph shall be adjusted, to reflect additional cost of the transaction, using the modification accounting methodology described in paragraphs 73-74~~72-73~~. That is, the adjustment shall be measured at the date of the revision of the quantity or terms of the equity instruments as the difference between the then-current fair value of the revised instruments utilizing the then-known quantity or term and the then-current fair value of the old equity instruments immediately before the quantity or term becomes known. The then-current fair value is calculated using the assumptions that result in the best estimate or midpoint aggregate fair value (in accordance with paragraph 134~~133~~) if the quantity or any other terms remain unknown.

~~136.~~137. Paragraph 134~~133~~ also provides measurement date guidance on the measurement of transactions that involve both market conditions and counterparty performance conditions. Through the date the last performance-related condition is resolved, the issuer shall apply modification accounting (paragraphs 73-74~~72-73~~) for the resolution of both counterparty performance conditions and market conditions. If, at the time the last counterparty performance-related condition is resolved, any market conditions remain, then the issuer shall measure the then-current fair value of the issuer's commitment to issue additional equity instruments or change the terms of the equity instruments based on whether the market condition is met. This measured amount is an additional cost of the transaction. After the issuer measures the then-current fair value of the issuer's commitment related to the market condition, the issuer shall, to the extent necessary, recognize and classify future changes in the fair value of this commitment in accordance with any relevant accounting literature on financial instruments.

~~137.~~138. Paragraph 129~~128~~ addresses the situation in which an entity grants fully vested, nonforfeitable equity instruments with terms that provide for potential acceleration of exercisability and establishes that the grantor shall measure the fair value of the equity instruments at the date of grant and shall recognize that measured cost in the same period(s) and in the same manner as if the grantor had paid cash. For these situations, if, after the arrangement date, the grantee performs as specified and exercisability is accelerated, the grantor shall record incremental cost measured at the date of the revision of the terms of the equity instruments (that is, the acceleration date) as the difference between the then-current fair value of the revised instruments utilizing the accelerated exercisability date and the then-current fair value of the old equity instruments immediately before exercisability is accelerated. If the only change in the terms of the equity instruments is the acceleration of exercisability, the application of this methodology will only result in a significant additional charge if the expected dividend on the underlying instrument exceeds the sum of the effect of discounting the exercise price and the loss of time value (exclusive of the effect of discounting the exercise price) resulting from the early exercise of the equity instrument.

Subsequent Measurement – Grantee Accounting

~~138.~~139. A grantee may be party to an arrangement in which the terms of the equity instruments are subject to adjustment after the measurement date. Paragraphs 140-141~~139-140~~ address transactions in which any of the terms of the equity instruments are subject to adjustment after the measurement date (that is, the terms of the equity instrument are subject to adjustment based on performance above the level committed to in a performance commitment, performance after the instrument is earned, or market conditions) and how the grantee shall account for an increase in fair value as a result of an adjustment (upon resolution of the contingency after the measurement date) as revenue.

~~139.~~140. If, on the measurement date, the quantity or any of the terms of the equity instruments are dependent on the achievement of grantee performance conditions (beyond those conditions for which a performance commitment exists), then changes in fair value of the equity instrument that result from an adjustment to the instrument upon the achievement of a performance condition shall be measured as additional revenue from the transaction using a methodology consistent with modification accounting described in paragraphs 73-74~~72-73~~. That is, the adjustment shall be measured at the date of the revision of the quantity or terms of the equity instrument as the difference between the then-current fair value of the revised instruments utilizing the then-known quantity and terms and the then-current fair value of the old equity instruments immediately before the adjustment.

~~140.~~141. Changes in fair value of the equity instruments after the measurement date unrelated to the achievement of performance conditions shall be accounted for in accordance with any relevant guidance on the accounting and reporting for investments in equity instruments.

Disclosures - Non-Employee Share Based Payment

~~141.~~142. An entity (grantor) that acquires goods or services other than employee services in share-based payment transactions shall provide disclosures similar to those required by paragraphs 104-105~~103-104~~ to the extent that those disclosures are important to an understanding of the effects of those transactions on the financial statements. These disclosures, if applicable, are for annual audited statutory financial statements only.

~~142.~~143. An entity (grantee) shall disclose, in each period's financial statements, the amount of gross operating revenue recognized as a result of nonmonetary transactions addressed within this statement. These disclosures, if applicable, are for annual audited statutory financial statements only.

Relevant Literature

144. This statement adopts *ASU 2014-12, Compensation – Stock Compensation, Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period* (ASU 2014-12) with an effective date of January 1, 2016, with early adoption permitted. ASU 2014-12 allows prospective or retrospective adoption based on the election of the reporting entity. This election is adopted for statutory financial statements; however, reporting entities shall follow the approach used when completing their GAAP financials (if applicable). The disclosures in *SSAP No. 3—Accounting Changes and Corrections of Errors* shall be completed in the first interim and annual reporting period of adoption.

~~143.~~145. This statement adopts with modification GAAP guidance regarding stock options and stock purchase plans reflected in *Topic 718: Compensation – Stock Compensation, as amended by ASU 2010-13, Compensation – Stock Compensation (Topic 18): Effect of Denominating the Exercise Price of a Share-Based Payment Award in the Current of the Market in Which the Underlying Equity Security*

Trades, with the exception of FASB Codification *Subtopic 718-40: Employee Stock Ownership Plans*. Statutory guidance on employee stock ownership plans is provided in *SSAP No. 12—Employee Stock Ownership Plans*. This adoption with modification includes the related implementation guidance reflected within the FASB Codification Topic 718, not reflected within this standard. Modifications to the adopted GAAP guidance are as follows:

a. GAAP references are revised to reference applicable statutory accounting guidance.

b. GAAP reporting line items (either explicitly provided in the statement or adopted by reference – such as the GAAP implementation guidance) shall be replaced to reference applicable statutory annual statement line items. (For example, GAAP references to "other comprehensive income" shall be reflected within "Surplus - Unassigned Funds").

c. GAAP guidance to calculate earnings per share is not applicable to statutory accounting and has not been included within the statement.

d. GAAP effective date and transition, and transition disclosures have not been incorporated. Reporting entities shall follow the effective date and transition elements provided within this statement.

e. Inclusion of guidance specific to statutory for consolidated/holding company plans.

~~144.~~146. This statement adopts with modification GAAP guidance regarding the exchange of equity instruments for goods or services with non-employees as reflected *in Subtopic 505-50 – Equity, Equity-Payments to Non-Employees*. Modifications to this adopted GAAP guidance are as follows:

a. Prepaid assets are nonadmitted.

b. Costs for goods and services shall be recognized when the goods or services are received consistent with other statutory accounting principles.

c. Minimum value method for determining fair value is rejected for all entities.

d. Estimates of expected costs for the exchange of equity instruments dependent on market conditions or performance obligations shall be determined based on the best estimate of fair values. If a better estimate cannot be determined, then the midpoint (rather than the lowest amount) of aggregate fair values within the range shall be used.

e. GAAP references are revised to reference applicable statutory accounting guidance.

~~145.~~147. The adoption with modification of FASB Codification Topic 718 and Subtopic 505-50 detailed in paragraphs 145-146~~143-144~~ also reflects adoption with modification of the following pre-codification GAAP standards:

a. *FAS 123R, Share-Based Payment* (FAS 123R);

b. *FAS 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity* (FAS 150) – (Adopted only to the extent referenced in FAS 123R for classifying instruments as equity or liability for application in this statement. Adopted guidance is reflected in Appendix A);

c. *FASB Staff Position FAS 123(R)-1: Classification and Measurement of Freestanding Financial Instruments Originally issued in Exchange for Employee Services under FASB Statement No. 123(R)* (FAS 123R-1);

d. *FASB Staff Position (FSP) FAS 123(R)-2: Practical Accommodation to the Application of Grant Date as Defined in FASB Statement No. 123(R)* (FSP FAS 123R-2);

e. *FASB Staff Position (FSP) FAS123(R)-4: Classification of Options and Similar Instruments Issued as Employee Compensation That Allow for Cash Settlement upon the Occurrence of a Contingent Event* (FSP FAS 123R-4);

f. *FASB Staff Position (FSP) FAS 123(R)-5: Amendment of FASB Staff Position FAS 123R-1* (FSP FAS 123R-5);

g. *FASB Staff Position (FSP) FAS 123(R)-6: Technical Corrections of FASB Statement No. 123(R)* (FSP FAS 123R-6);

h. *FASB Emerging Issues Task Force 96-18: Accounting for Equity Instruments That are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling Goods or Services;*

i. *FASB Emerging Issues Task Force 97-14: Accounting for Deferred Compensation Arrangements Where Amounts Earned Are Held in a Rabbi Trust and Invested* (EITF 97-14);

j. *FASB Emerging Issues Task Force 00-08: Accounting by a Grantee for an Equity Instrument to Be Received in Conjunction with Providing Goods or Services;*

k. *FASB Emerging Issues Task Force 00-16: Recognition and Measurement of Employer Payroll Taxes on Employee Stock-Based Compensation* (EITF 00-16);

l. *FASB Emerging Issues Task Force 00-18: Accounting Recognition for Certain Transactions Involving Equity Instruments Granted to Other Than Employees*; and

m. *FASB Technical Bulletin 97-01, Accounting under Statement 123 for Certain Employee Stock Purchase Plans with a Look-Back Option* (TB 97-01)

~~146.~~148. The adoption with modification of FASB Codification Topic 718 in this statement reflects rejection of the following pre-codification GAAP standards:

a. *FASB Staff Position (FSP) FAS 123(R)-3: Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards* (FSP FAS 123R-3); and

b. *FASB Staff Position (FSP) EITF 03-6-1; Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities* (FSP EITF 03-6-1),.

Effective Date and Transition

~~147.~~149. This statement shall be effective prospectively (paragraph 120~~119~~) for years beginning January 1, 2013, with interim and annual financial reporting thereafter. The cumulative effect of initially applying this statement, if any, shall be recognized as of the required effective date as a change in accounting principle under SSAP No. 3. Early adoption is permitted for December 31, 2012, financial statements, with interim and annual reporting thereafter.

~~148.~~150. Reporting entities with existing share-based payment instruments that applied the guidance contained in *SSAP No. 13—Stock Options and Stock Purchase Plans* (SSAP No. 13) shall apply the requirements of the adopted SSAP No. 104 prospectively to new awards and to awards modified, repurchased, or cancelled after the required effective date. Those reporting entities shall continue to account for any portion of awards outstanding at the date of initial application using the accounting principles originally applied to those awards (SSAP No. 13).

~~149.~~151. The substantive revisions to this statement to incorporate guidance for share-based payment transactions for non-employees, reflected predominantly in paragraphs 116-143~~115-142~~, are effective prospectively initially for years ending December 31, 2014. The cumulative effect of initially applying this statement, if any, shall be recognized as of the required effective date as a change in accounting principle under *SSAP No. 3—Accounting Changes and Corrections of Errors* (SSAP No. 3).

152. The guidance in paragraph 56 is effective as of January 1, 2016, with early adoption permitted.

REFERENCES

Other

- *SSAP No. 12—Employee Stock Ownership Plans*

Relevant Issue Papers

- *Issue Paper No. 129—Share-Based Payment, A Replacement of SSAP No. 13*

- *Issue Paper No. 146— Share-Based Payments With Non-Employees*

APPENDIX A – Classification Criteria: Liability or Equity

Classification Criteria

1. As detailed in paragraph 14 of the statement, an entity shall apply the classification criteria detailed in paragraphs 14-27 in the statement, as they are effective at the reporting date, in determining whether to classify as a liability a freestanding financial instrument given to an employee in a share-based payment transaction.

2. The guidance in this Section shall be applied to a freestanding financial instrument in its entirety. Any nonsubstantive or minimal features shall be disregarded in applying the classification provisions of this Section. Judgment, based on consideration of all the terms of an instrument and other relevant facts and circumstances, is necessary to distinguish substantive, nonminimal features from nonsubstantive or minimal features.

Mandatorily Redeemable Financial Instruments

3. A mandatorily redeemable financial instrument shall be classified as a liability unless the redemption is required to occur only upon the liquidation or termination of the reporting entity.

4. A financial instrument that embodies a conditional obligation to redeem the instrument by transferring assets upon an event not certain to occur becomes mandatorily redeemable if that event occurs, the condition is resolved, or the event becomes certain to occur.

5. In determining if an instrument is mandatorily redeemable, all terms within a redeemable instrument shall be considered. The following items do not affect the classification of a mandatorily redeemable financial instrument as a liability:

a. A term extension option

b. A provision that defers redemption until a specified liquidity level is reached

c. A similar provision that may delay or accelerate the timing of a mandatory redemption.

6. If a financial instrument will be redeemed only upon the occurrence of a conditional event, redemption of that instrument is conditional and, therefore, the instrument does not meet the definition of mandatorily redeemable financial instrument in this statement. However, that financial instrument would be assessed at each reporting period to determine whether circumstances have changed such that the instrument now meets the definition of a mandatorily redeemable instrument (that is, the event is no longer conditional). If the event has occurred, the condition is resolved, or the event has become certain to occur, the financial instrument is reclassified as a liability.

Obligations to Repurchase Issuer's Equity Shares by Transferring Assets

7. An entity shall classify as a liability (or an asset in some circumstances) any financial instrument, other than an outstanding share, that, at inception, has both of the following characteristics:

a. It embodies an obligation to repurchase the issuer's equity shares, or is indexed to such an obligation, and

b. It requires or may require the issuer to settle the obligation by transferring assets.

8. In this statement, "indexed to" is used interchangeably with "based on variations in the fair value of." The phrase "requires or may require" encompasses instruments that either conditionally or

unconditionally obligate the issuer to transfer assets. If the obligation is conditional, the number of conditions leading up to the transfer of assets is irrelevant.

9. Examples of financial instruments that meet the criteria in paragraph 7 of Appendix A include forward purchase contracts or written put options on the issuer's equity shares that are to be physically settled or net cash settled.

10. All obligations that permit the holder to require the issuer to transfer assets result in liabilities, regardless of whether the settlement alternatives have the potential to differ.

11. Certain financial instruments that embody obligations that are liabilities within the scope of this statement also may contain characteristics of assets but be reported as single items. Some examples include the following:

a. Net-cash-settled or net-share-settled forward purchase contracts.

b. Certain combined options to repurchase the issuer's shares.

Those instruments are classified as assets or liabilities initially or subsequently depending on the instrument's fair value on the reporting date.

12. An instrument that requires the issuer to settle its obligation by issuing another instrument (for example, a note payable in cash) ultimately requires settlement by a transfer of assets, accordingly:

a. When applying paragraphs 7-11 of Appendix A, this also would apply for an instrument settled with another instrument that ultimately may require settlement by a transfer of assets (warrants for puttable shares).

b. It is clear that a warrant for mandatorily redeemable shares would be a liability under this statement.

Certain Obligations to Issue a Variable Number of Shares

13. A financial instrument that embodies an unconditional obligation, or a financial instrument other than an outstanding share that embodies a conditional obligation, that the issuer must or may settle by issuing a variable number of its equity shares shall be classified as a liability (or an asset in some circumstances) if, at inception, the monetary value of the obligation is based solely or predominantly on any one of the following:

a. A fixed monetary amount known at inception (for example, a payable settleable with a variable number of the issuer's equity shares),

b. Variations in something other than the fair value of the issuer's equity shares (for example, a financial instrument indexed to the Standard and Poor's S&P 500 Index and settleable with a variable number of the issuer's equity shares), or

c. Variations inversely related to changes in the fair value of the issuer's equity shares (for example, a written put option that could be net share settled).

Prohibition on Combining Freestanding Financial Instruments

14. A freestanding financial instrument that is within the scope of this statement shall not be combined with another freestanding financial instrument in applying paragraphs 3-13 of Appendix A. For example, a freestanding written put option that is classified as a liability under this statement shall not be combined with an outstanding equity share.

Distinguishing Liability from Equity – Scope and Scope Exclusions

15. The guidance in paragraphs 14-27 of this statement applies to any freestanding financial instrument, including one that has any of the following attributes:

a. Comprises more than one option or forward contract, or

b. Has characteristics of both a liability and equity and, in some circumstances, also has characteristics of an asset (for example, a forward contract to purchase the issuer's equity shares that is to be net cash settled). Accordingly, this statement does not address an instrument that has only characteristics of an asset.

For example, an instrument that consists of a written put option for an issuer's equity shares and a purchased call option and nothing else is a freestanding financial instrument. That freestanding financial instrument embodies an obligation to repurchase the issuer's equity shares and is subject to the requirements of this statement.

APPENDIX B – Disclosure Information

1. The following list indicates the minimum information needed to achieve the objectives in paragraphs 104~~103~~ and 142~~141~~ illustrate how the disclosure requirements might be satisfied. In some circumstances, an entity may need to disclose information beyond the following to achieve the disclosure objectives:

a. A description of the share-based payment arrangement(s), including the general terms of awards under the arrangement(s), such as:

i. The requisite service period(s) and any other substantive conditions (including those related to vesting)

ii. The maximum contractual term of equity (or liability) share options or similar instruments

iii. The number of shares authorized for awards of equity share options or other equity instruments.

b. The method it uses for measuring compensation cost from share-based payment arrangements with employees.

c. For the most recent year for which an income statement is provided, both of the following:

i. The number and weighted-average exercise prices (or conversion ratios) for each of the following groups of share options (or share units):

(a) Those outstanding at the beginning of the year

(b) Those outstanding at the end of the year

(c) Those exercisable or convertible at the end of the year

(d) Those that during the year were:

(1) Granted

(2) Exercised or converted

(3) Forfeited

(4) Expired

ii. The number and weighted-average grant-date fair value (or calculated value for an entity that uses that method or intrinsic value for awards measured pursuant to paragraph 49) of equity instruments not specified in (c)(1), for all of the following groups of equity instruments:

(a) Those nonvested at the beginning of the year

(b) Those nonvested at the end of the year

(c) Those that during the year were:

(1) Granted

(2) Vested

(3) Forfeited

d. For each year for which an income statement is provided, both of the following:

i. The weighted-average grant-date fair value (or calculated value for an entity that uses that method or intrinsic value for awards measured at that value pursuant to paragraphs 49-50) of equity options or other equity instruments granted during the year, and

ii. The total intrinsic value of options exercised (or share units converted), share-based liabilities paid, and the total fair value of shares vested during the year.

e. For fully vested share options (or share units) and share options expected to vest at the date of the latest statement of financial position, both of the following:

i. The number, weighted-average exercise price (or conversion ratio), aggregate intrinsic value, and weighted-average remaining contractual term of options (or share units) outstanding, and

ii. The number, weighted-average exercise price (or conversion ratio), aggregate intrinsic value, and weighted-average remaining contractual term of options (or share units) currently exercisable (or convertible).

f. For each year for which an income statement is presented, both of the following (An entity that uses the intrinsic value method pursuant to paragraphs 49-50 is not required to disclose the following information for awards accounted for under that method):

i. A description of the method used during the year to estimate the fair value (or calculated value) of awards under share-based payment arrangements, and

ii. A description of the significant assumptions used during the year to estimate the fair value (or calculated value) of share-based compensation awards, including (if applicable):

(a) Expected term of share options and similar instruments, including a discussion of the method used to incorporate the contractual term of the instruments and employees' expected exercise and postvesting employment termination behavior into the fair value (or calculated value) of the instrument.

(b) Expected volatility of the entity's shares and the method used to estimate it. An entity that uses a method that employs different volatilities during the contractual term shall disclose the range of expected volatilities used and the weighted-average expected volatility. An entity that uses the calculated value method shall disclose the reasons why it is not practicable for it to estimate the expected volatility of its share price, the appropriate industry sector index that it has selected, the reasons for selecting that particular index, and how it has calculated historical volatility using that index.

(c) Expected dividends. An entity that uses a method that employs different dividend rates during the contractual term shall disclose the range of expected dividends used and the weighted-average expected dividends.

(d) Risk-free rate(s). An entity that uses a method that employs different risk-free rates shall disclose the range of risk-free rates used.

(e) Discount for post-vesting restrictions and the method for estimating it.

g. An entity that grants equity or liability instruments under multiple share-based payment arrangements with employees shall provide the information specified in paragraph (a) through (f) separately for different types of awards to the extent that the differences in the characteristics of the awards make separate disclosure important to an understanding of the entity's use of share-based compensation. For example, separate disclosure of weighted-average exercise prices (or conversion ratios) at the end of the year for options (or share units) with a fixed exercise price (or conversion ratio) and those with an indexed exercise price (or conversion ratio) could be important. It also could be important to segregate the number of options (or share units) not yet exercisable into those that will become exercisable (or convertible) based solely on fulfilling a service condition and those for which a performance condition must be met for the options (share units) to become exercisable (convertible). It could be equally important to provide separate disclosures for awards that are classified as equity and those classified as liabilities. In addition, an entity that has multiple share-based payment arrangements with employees shall disclose information separately for different types of awards under those arrangements to the extent that differences in the characteristics of the awards make separate disclosure important to an understanding of the entity's use of share-based compensation.

h. For each year for which an income statement is presented, both of the following:

i. Total compensation cost for share-based payment arrangements

(a) Recognized in income as well as the total recognized tax benefit related thereto

(b) Capitalized as part of the cost of an asset.

ii. A description of significant modifications, including:

(a) The terms of the modifications,

(b) The number of employees affected,

(c) The total incremental compensation cost resulting from the modifications.

i. As of the latest balance sheet date presented, the total compensation cost related to nonvested awards not yet recognized and the weighted-average period over which it is expected to be recognized.

j. If not separately disclosed elsewhere, the amount of cash received from exercise of share options and similar instruments granted under share-based payment arrangements and the tax benefit realized from stock options exercised during the annual period.

k. If not separately disclosed elsewhere, the amount of cash used to settle equity instruments granted under share-based payment arrangements.

l. A description of the entity’s policy, if any, for issuing shares upon share option exercise (or share unit conversion), including the source of those shares (that is, new shares or treasury shares). If as a result of its policy, an entity expects to repurchase shares in the following annual period, the entity shall disclose an estimate of the amount (or a range, if more appropriate) of shares to be repurchased during that period.

2. In addition to the information required by this statement, an entity may disclose supplemental information that it believes would be useful to investors and creditors, such as a range of values calculated on the basis of different assumptions, provided that the supplemental information is reasonable and does not lessen the prominence and credibility of the information required by this statement. The alternative assumptions shall be described to enable users of the financial statements to understand the basis for the supplemental information.

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Statement of Statutory Accounting Principles No. 105

Working Capital Finance Investments

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Working Capital Finance Investments

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for working capital finance investments held by reporting entities. This statement amends *SSAP No. 20—Nonadmitted Assets* (SSAP No. 20) to allow working capital finance investments as admitted assets to the extent they conform to the requirements of this statement.

SUMMARY CONCLUSION

2. Working capital finance investments represent a confirmed short-term obligation[1] to pay a specified amount owed by one party (the obligor) to another (typically a supplier of goods), generated as a part of a working capital finance investment program currently designated by the NAIC Securities Valuation Office. Pursuant to the working capital finance investment program, this short-term obligation has been transferred by the entity entitled to payment (typically a supplier of goods) to a third party investor.

3. Working capital finance investments held by a reporting entity represent a right of the reporting entity to receive future payment. This Statement provides accounting and reporting guidelines for the right to receive payment under working capital finance programs that meet particular criteria.

Working Capital Finance Program - Definitions and Conditions

4. A “working capital finance program” is an open account program under which an investor may purchase interests, or evidence thereof, in commercial non-insurance receivables. A working capital finance program is created for the benefit of a commercial investment-grade obligor and its suppliers of goods or services, and facilitated by a finance agent.

5. A working capital finance program transfers a right to payment to an investor from a short term obligation and arises from transactions among:

a. a buyer of goods or services that becomes an obligor to the supplier of goods or services,

b. the supplier(s) of those goods or services,

c. a finance agent, and

d. an investor.

6. A “working capital finance investment” is an interest in payment(s) from a confirmed supplier receivable issued pursuant to a working capital finance program. The payment (maturity) date must not exceed one year from the date of invoice from the supplier to the obligor. This investment is created when the investor purchases from a working capital finance program that is currently designated as NAIC “1” or “2” by the NAIC Securities Valuation Office, any of the following:

a. One or more confirmed supplier receivables;

b. in case of a participation, a participation interest in one or more confirmed supplier receivables issued by the finance agent or lead lender holding confirmed supplier receivables; or

[1] All references to short-term obligations in this statement to refer to obligations not exceeding one year.

c. a certificate, note or other interest manifestation, documented in a way that is verifiable by regulators, representing a legally enforceable interest in a right to payment from a trust, other special purpose entity or pool holding confirmed supplier receivables.

7. "Obligor" is the party that purchases the goods or services that generates the original supplier receivable (and payable for the Obligor). The obligor must be a single entity, which has an NAIC designation of "1" or "2" or a Credit Rating Provider equivalent. The obligor must confirm the supplier receivable described in paragraph 11 as described in the confirmation process in paragraphs 12-14.

8. "Supplier" is the party that sells the goods or services to the obligor. The supplier sells the confirmed supplier receivable in accordance with the terms of the working capital finance program designated by the NAIC Securities Valuation Office at a price agreed to by the finance agent and/or investor.

9. "Investor" is the party purchasing a working capital finance investment in accordance with the terms of the working capital finance program designated by the NAIC Securities Valuation Office.

10. The "finance agent" is a bank, financial institution, other financial intermediary, or service provider that facilitates the working capital finance program, arranges the sale, assignment or transfer of the confirmed supplier receivable to the investor for a fee and administers the payment mechanism. In the case of participation, the finance agent must inform the reporting entity investor of a default or event of default as soon as it becomes aware of such default or event of default. For the working capital finance program to qualify under this SSAP, the finance agent must meet the requirements of either paragraph 10.a. or 10.b.:

a. The finance agent is directly regulated by, or falls under the supervision of, a financial regulator of its domiciliary country provided that such country appears on the *Purposes and Procedures Manual of the NAIC ~~Securities Valuation~~Investment Analysis Office* List of Jurisdictions Eligible for Netting and that the Securities Valuation Office determines that the regulator is the functional equivalent of the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, or the Federal Deposit Insurance Corporation; or

b. Payments from the obligor must 1) be paid directly to the reporting entity (investor) and cannot flow through the finance agent and 2) there can be no commingling of payments or assets with those of the obligor, supplier, servicer or trust administrator or other investors.

11. A "confirmed supplier receivable" is a first priority perfected security interest or right to payment of a monetary obligation from the obligor arising from the sale of goods or services from the supplier to the obligor the payment of which has been confirmed by the obligor committing and stating that the obligations under the agreement and any payment shall not be affected by the invalidity, unenforceability, existence, performance or non-performance of the underlying commercial trade transaction or any related contract or undertaking nor that it will not protest, delay, or deny, nor offer nor assert any defenses, personal or otherwise, against payment to the supplier or any party taking claims, interests, or rights to payments made by the supplier.

a. The confirmed supplier receivable must be sold, assigned or otherwise transferred in a manner that results in an absolute, irrevocable and legally enforceable obligation that has been confirmed by the Obligor.

b. In the case of a participation, the certificates or other evidence of participation provide an absolute, irrevocable, and legally enforceable obligation of the finance agent or holder of the confirmed supplier receivable to pay to the reporting entity investor all of the amounts due to it under the confirmed supplier receivable, without reduction or delay arising from any claims that the finance agent may have against the reporting entity investor. The reporting entity investor's ability to exercise its rights as creditor, or to direct the finance agent to exercise the rights of a creditor on its behalf, shall not be subject to the discretion of the finance agent or other lenders or investors. The reporting entity investor's ability to exercise its rights as creditor, or to direct the finance agent to exercise the rights of a creditor on its behalf, shall not be subject to, other than during a cure period not to exceed thirty days, the discretion of the finance agent or other lenders or investors.

Confirmation Process

12. In the case of a purchase, the investor shall verify, prior to the sale that the obligor has confirmed the respective amounts, payment dates and related invoice numbers' specified dates and has waived all defenses to payment. In the case of a participation, the finance agent must verify that the obligor has confirmed the respective amounts, payment dates and related invoice numbers' specified due dates, and has waived all defenses to payment in accordance with the confirmation process.

13. The obligor must commit and state that upon confirmation of a supplier receivable it is obligated to pay to the investor, the finance agent, or any third party acting as agent or trustee for the investor, a sum equal to the full amount of that confirmed supplier receivable(s) on a date certain stated in the confirmation and that it waives any right of setoff or other defenses to avoid or delay the full and timely payment of that Confirmed Supplier Receivable. The documents establishing the working capital finance program or the confirmation must state and confirm that the obligation to pay must be independent of any other contracts or claims that might be raised in defense arising from any transaction financed in connection with the WCFP, the confirmed supplier receivable, or any other courses of performance or courses of dealing with the supplier.

14. In the case of participation, the investor must certify that it has a commercially reasonable belief that its participation interest meets the Uniform Commercial Code's standards for creating and preserving first priority security interests in the payments due and in the confirmed supplier receivables. Commercially reasonable belief shall mean the SVO deems the investor's belief reasonable in light of the systems, policies, or practices commonly recognized in the field of investing in participations. The investor must be able to demonstrate to a regulator or to the SVO, upon either's request, the basis for its commercially reasonable belief that the WCFP creates and preserves the investor's ability to enforce a first priority perfected security interest in the confirmed supplier receivables.

15. In the case of a certificate, note, or other manifestation, capable of verification, representing a right to payment from a trust, other special purpose entity, or special purpose pool holding confirmed supplier receivables, the investor must certify that it has a commercially reasonable belief that the documents establishing and governing the working capital finance program create and preserve interests in the confirmed supplier receivables capable of being enforced by the trustee or other entity holding confirmed supplier receivables as first priority perfected security interests under the Uniform Commercial Code. The investor must be able to demonstrate the basis for such belief to a regulator or to the SVO upon either's request. Commercially reasonable belief shall mean the SVO deems the investor's belief reasonable in light of the systems, policies, and practices commonly recognized in the field of investing in securitizations, loan-backed, structured, or trust-issued securities.

Program Requirements

16. The working capital finance program investor must provide in its annual filing with the Securities Valuation Office an annual audit of the consolidated financial statements of which the finance agent is part, which does not report any qualifications related to servicing, and one of the following:

a. An annual independent report according to Statement on Standards for Attestation Engagements (SSAE) No. 16, reporting on controls at a service organization related to the administration of the investment; or

b. An annual audit of the internal controls of the consolidated group of which the finance agent is part, which does not note any material weaknesses related to servicing.

The NAIC Securities Valuation Office would review the materiality of the report findings in making their determination of the assignment of a designation.

17. If the credit rating of the working capital finance program or obligor falls to non-investment grade (below the equivalent of NAIC designation "1" or "2"), the reporting entity shall nonadmit, the working capital finance investments obtained under the related working capital finance program and/or the related obligor. Due to the short-term nature of these investments, once an investment is nonadmitted due to the credit rating of the working capital finance program or the obligor, those investments will continue to be nonadmitted.

18. Reporting entity investors must have the ability to monitor the working capital finance program and the credit-related activities of the obligor. Reporting entity investors must provide information as requested to the state of domicile indicating that they have the ability to monitor on an ongoing basis the activities of the working capital finance program. Initial permission to invest in Working Capital Finance Investment Programs may be required by the domiciliary commissioner.

19. All contracts or agreements that are a part of or that together constitute a working capital finance program must provide that if a dispute arises among any of the parties under any of the contracts or agreements that are a part of or that together constitute the working capital finance program, each party agrees that the dispute will be submitted to a court of competent jurisdiction in the United States or a constituent state thereof or of an alternative dispute resolution process recognized thereby. All contracts or agreements that are a part of or that together constitute a working capital finance program must provide that any dispute arising under any of the contracts or agreements that are a part of or that together constitute the working capital finance program must be resolved pursuant to the laws of the United States or a constituent state thereof that address the substance of the dispute but excluding those laws addressing conflicts of law.

Exclusions

20. A working capital finance investment excludes any receivables financed through:

a. Factoring: the purchase of receivables in bulk from a supplier where the receivables represent the payment obligations of potentially thousands of buyers to a single supplier, in which the buyers have no relationship with or contractual obligation to pay the factor and retain all legal defenses to payment they may have against the supplier;

b. Forfaiting: the purchase of one or a series of receivables from exporters by a forfaiter to enable the exporter (seller) to finance a commercial transaction with a buyer in which the Obligor has no relationship with or contractual obligation to pay the forfaiter and retains all legal defenses to pay it may have against the seller; or

c. Invoice discounting: the advancement of funds by a finance company to a business entity with the funds advanced limited to a defined percentage of the business entity's eligible and outstanding receivables.

21. Eligible Confirmed Supplier Receivables must not:

a. Include insurance or insurance related assets;

b. Be impaired or in default at the time of purchase;

c. Have a payment (maturity) date longer than one year from the date of the invoice from the Supplier to the Obligor giving rise to the confirmed supplier receivable, and the maturity date must not be subject to change or rolling; nor

d. Include any receivable of any parent or affiliate of the reporting entity investor, and neither the Obligor nor any Supplier may be affiliated with the reporting entity investor. Working Capital Finance Investments that have obligors or vendors that are affiliated with the investor are ineligible, and therefore, nonadmitted assets.

Accounting and Reporting

22. The right to receive payment generated by a working capital finance investment issued under a working capital finance program is considered to meet the definition of an asset as defined in *SSAP No. 4—Assets and Nonadmitted Assets*, and is an admitted asset to the extent the investment conforms to the requirements set forth in this Statement and the *Purposes and Procedures Manual of the NAIC ~~Securities Valuation~~Investment Analysis Office*. For programs that comply with all of these elements, working capital finance investments shall be valued and reported in accordance with this Statement, the *Purposes and Procedures Manual of the NAIC ~~Securities Valuation~~Investment Analysis Office*, and the designation assigned in the NAIC Valuations of Securities product. Programs that do not comply with the elements set forth in this Statement, or the provisions set forth in the *Purposes and Procedures Manual of the NAIC ~~Securities Valuation~~Investment Analysis Office* are nonadmitted. Working capital finance investments are reported as other invested assets in the financial statements.

23. A working capital finance investment shall be recorded on the trade date. At acquisition, the Working Capital Finance Investment shall be initially reported at cost, excluding brokerage and other related fees, and all other costs (internal costs, or costs paid for origination, purchase or commitment to purchase such investments), which shall be expensed as incurred.

24. After initial acquisition, the Working Capital Finance Investment shall be reported at amortized cost until the specified maturity date, unless the investment, or a portion thereof, is deemed uncollectible or when an other-than-temporary impairment has occurred. In the event that a working capital finance investment is purchased by a reporting entity investor at a premium (amount to be received by the entity under the confirmed supplier receivable is less than the price paid for the investment), the excess paid by the reporting entity investor in comparison to the amount receivable under the confirmed supplier receivable must be immediately expensed.

25. For reporting entities required to maintain an Interest Maintenance Reserve (IMR), the accounting for realized capital gains and losses from working capital finance investments shall be in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve* (SSAP No. 7). For reporting entities not required to maintain an IMR, realized gains and losses from working capital finance investments shall be reported as net realized capital gains or losses in the statement of income. For reporting entities not required to maintain an AVR, unrealized gains and losses shall be recorded as a direct credit or charge to unassigned funds (surplus).

26. A Working Capital Finance Investment may provide for a prepayment penalty or acceleration fee in the event the working capital finance investment is liquidated prior to its scheduled termination date. Such fees shall be reported as investment income when received.

27. *SSAP No. 34—Investment Income Due and Accrued* shall be followed for determining and recording investment income earned on working capital finance investments acquired at a discount. In accordance with *SSAP No. 34—Investment Income Due and Accrued*, investment income shall be reduced

for amounts that have been determined to be uncollectible, however amounts more than 15 days overdue are nonadmitted.

Default

28. A working capital finance investment payment that is uncollected by the reporting entity within fifteen days after the due date shall be considered in default and nonadmitted. If the reporting entity has any other working capital finance investment assets from the same defaulting counterparty, all other working capital finance investments from that counterparty shall be nonadmitted. All working capital finance investments from a counterparty identified in default shall be evaluated for impairment.

Impairment

29. An other-than-temporary impairment(INT 06-07) shall be considered to have occurred if it is probable that the reporting entity will be unable to collect all amounts due according to the contractual terms of a confirmed supplier receivable including the payment on the established due date. Pursuant to this guidance, assessment of other-than-temporary impairment shall include an evaluation of the financial condition and short-term prospects of the obligor. If it is determined that a decline in the fair value of a working capital finance investment below book/adjusted carrying value is due to an other-than-temporary impairment, an impairment loss shall be recognized as a realized loss equal to the entire difference between the working capital finance investment's carrying value and fair value as of the reporting period for which the assessment is made. Fair value shall be determined in accordance with *SSAP No. 100—Fair Value Measurements*, and reflect the price to sell the asset in an orderly market between market participants. As such, the fair value shall reflect the assumptions market participants will use in pricing the asset, including assumptions about risk.

30. For reporting entities required to maintain an AVR/IMR, the entire amount of the realized loss from the other-than temporary impairment shall be recorded through the AVR, in accordance with SSAP No. 7.

31. Upon recognition of an other-than-temporary impairment, the fair value of the working capital finance investment on the measurement date shall become the new cost basis of the working capital finance investment and the new cost basis shall not be adjusted for subsequent recoveries in fair value. Once an investment is determined to be other-than-temporarily impaired, until all expected payments are received, the reporting entity must re-evaluate the investment quarterly and reassess fair value, with recognized realized losses for the difference between the book/adjusted carrying value and the current fair value. This process shall continue until either all expected payments are received, or the entity has recognized a realized loss for the entire uncollected carrying value.

Disclosures

32. The financial statements shall include the following disclosures:

a. Fair value in accordance with *SSAP No. 100—Fair Value Measurements*

b. Concentrations of credit risk in accordance with SSAP No. 27—*Disclosure of Information* a*bout Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* (SSAP No. 27) in the annual audited statutory financial reports only.

c. Information regarding the aggregate book/adjusted carrying value of working capital finance investment by designation including gross assets with nonadmitted and net admitted amounts annually. (Note that programs designated 3-6 are nonadmitted.)

	Gross Asset CY	Non-Admitted Asset CY	Net Admitted Asset CY
WCFI Designation 1			
WCFI Designation 2			
WCFI Designation 3			
WCFI Designation 4			
WCFI Designation 5			
WCFI Designation 6			
Total			

d. Annual and quarterly information regarding the aggregate book/adjusted carrying value maturity distribution on the underlying working capital finance investments by the categories of maturities up to 180 days and 181 to 365 days.

e. Any events of default of working capital finance investments during the reporting period.

33. Refer to the preamble for further discussion regarding disclosure requirements.

Effective Date and Transition

34. This statement is effective for years on or after January 1, 2014. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors.*

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 147—Working Capital Finance Investments*

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Statement of Statutory Accounting Principles No. 106

Affordable Care Act Section 9010 Assessment

STATUS

Type of Issue:	Common Area
Issued:	June 12, 2014
Effective Date:	January 1, 2014
Affects:	SSAP No. 35R
Affected by:	No other pronouncements
Interpreted by:	No other pronouncements

STATUS **1**

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Affordable Care Act Section 9010 Assessment

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for the Affordable Care Act Section 9010 assessment and disclosures related to the risk sharing provisions of the Affordable Care Act.

SUMMARY CONCLUSION

2. This statement adopts *ASU 2011-06: Other Expenses – Fees Paid to the Federal Government by Health Insurers* (ASU 2011-06) with modifications identified in paragraph 11. ASU 2011-06 provides specific guidance related to the assessment in Section 9010 of the Affordable Care Act.

Affordable Care Act Section 9010 Assessment

3. The Affordable Care Act (ACA) imposes an assessment on entities that issue health insurance for each calendar year beginning on or after January 1, 2014. Pursuant to Section 9010 of the ACA, a reporting entity's portion of the assessment is paid no later than September 30 of the applicable calendar year (the fee year) beginning in 2014 and is not tax deductible. The amount of the assessment for the reporting entity is based on the ratio of the amount of an entity's subject net health premiums written for any U.S. health risk during the preceding calendar year (data year) to the aggregate amount of subject net health premiums written by all subject U.S. health insurance providers during the preceding calendar year. The ACA includes some significant exclusions regarding which entities are required to pay the assessment. The guidance in this statement applies to all reporting entities that are subject to the fee. The guidance in this statement applies to the unique facts and circumstances in the ACA; accordingly, an entity should apply judgment when evaluating the facts and circumstances of other assessments arrangements before analogizing the guidance for Section 9010 of the ACA.

4. Throughout this discussion of the Section 9010 assessment of the ACA, the following terms apply:

   a. The term "data year" means the calendar year immediately before the fee year. For example, 2014 is the data year for fee year 2015.

   b. The term "fee year" means the calendar year in which the assessment must be paid to the U.S. Treasury.

5. A reporting entity's portion of the annual assessment becomes payable to the U.S. Treasury once the reporting entity provides health insurance (in the fee year) for any subject U.S. health risk for each calendar year beginning on or after January 1, 2014.

6. The liability related to the Section 9010 ACA assessment shall be estimated and recorded in full once the entity provides qualifying health insurance (typically January 1) in the applicable calendar year in which the assessment is paid (fee year) with a corresponding entry to expense. The Section 9010 ACA assessment shall be recognized in full on January 1 of the fee year, in the operating expense category of Taxes, Licenses and Fees.

7. Liability recognition of the Section 9010 fee is not required in the data year. In the data year, the reporting entity is required to reclassify from unassigned surplus to special surplus an amount equal to its estimated subsequent fee year assessment. This segregation in special surplus is accrued monthly throughout the data year. The reclassification from unassigned surplus to special surplus does not reduce total surplus. On January 1 of the fee year, the prior year segregation in special surplus is reversed and the full current fee year assessment liability shall be accrued.

8. The Section 9010 ACA annual assessment does not represent a cost related to the acquisition of policies that is consistent with the definition of acquisition costs in *SSAP No. 71—Policy Acquisition Costs and Commissions*.

Disclosures

9. For the Section 9010 ACA assessment:

a. For the annual reporting period ending December 31, 2013, and thereafter, a reporting entity subject to the assessment under section 9010 of the Affordable Care Act, shall provide a disclosure of the assessment payable in the upcoming year consistent with the guidance provided under *SSAP No. 9—Subsequent Events* (SSAP No. 9) for a Type II subsequent event. The disclosure shall provide information regarding the nature of the assessment and an estimate of its financial impact, including the impact on its risk-based capital position as if it had occurred on the balance sheet date. In accordance with SSAP No. 9, paragraph 9, the reporting entity shall also consider whether there is a need to present pro forma financial statements regarding the impact of the assessment, based on its judgment of the materiality of the assessment.

b. Additionally, for annual reporting periods ending on or after December 31, 2014, the disclosure in paragraph 9.a. is expanded to include information on the amounts reflected in special surplus in the data year.

i. The reporting entity shall disclose the amount of premium written for the current year that is the basis for the determination of the section 9010 fee assessment to be paid in the subsequent year (net assessable premium). Prior year amounts shall also be included for comparative purposes;

ii. Reporting entities shall provide information regarding the nature of the assessment, the estimated amount of the assessment payable in the upcoming year (current and prior year) and the amount of assessment paid (current and prior year), and;

iii. The disclosure shall also provide the Total Adjusted Capital and Authorized Control Level (in dollars) before and after adjustment (as reported in its estimate of special surplus applicable to the 9010 fee) to reflect the fee as of the annual reporting date as if it had been reported on the balance sheet date. The disclosure shall also provide a statement as to whether an RBC action level would have been triggered had the fee been reported as of the balance sheet date.

10. Refer to the preamble for further discussion regarding disclosure requirements.

Relevant Literature

11. *ASU 2011-06: Other Expenses – Fees Paid to the Federal Government by Health Insurers* is adopted with the following modifications: 1) to require full expense recognition on January 1 of the fee year, 2) to require the reclassification from unassigned surplus to special surplus in the data year for the estimated amount payable, and 3) other modifications for statutory accounting terminology as reflected in this statement.

Effective Date and Transition

12. This statement is effective for years beginning January 1, 2014. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with

SSAP No. 3—Accounting Changes and Corrections of Errors. The Section 9010 ACA fee specific guidance in paragraphs 2-8 and paragraph 9.b. was adopted December 2013 with a January 1, 2014, effective date. This guidance was originally reflected in *SSAP No. 35—Guaranty Fund and Other Assessments – Revised* (SSAP No. 35R). The disclosure language in paragraph 9.a. was also moved from SSAP No. 35R, but was originally effective December 31, 2013. The guidance from SSAP No. 35R was moved into this statement in June 2014. This movement was a placement change and did not result in revisions to the accounting guidance previously included in SSAP No. 35R.

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 148—Affordable Care Act Section 9010 Assessment*

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Statement of Statutory Accounting Principles No. 107

Accounting for the Risk-Sharing Provisions of the Affordable Care Act

STATUS

Type of Issue:	Common Area
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Effective Date:	December 15, 2014
Affects:	Nullifies INT 13-04
Affected by:	No other pronouncements
Interpreted by:	No other pronouncements

STATUS 1

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Accounting for the Risk-Sharing Provisions of the Affordable Care Act

SCOPE OF STATEMENT

1. The Affordable Care Act (ACA) imposes fees and premium stabilization provisions on health insurance issuers offering commercial health insurance. This statement provides accounting for three programs known as risk adjustment, reinsurance and risk corridors that take effect in 2014. Risk adjustment is a permanent risk-spreading program (ACA Section 1343). The temporary transitional reinsurance program (ACA Section 1341) and temporary risk corridors program (ACA Section 1342) are for years 2014 through 2016.

SUMMARY CONCLUSION

2. Specific terms included in Appendix A are unique to these programs and should not be applied to other aspects of statutory accounting. The required payments to the programs by reporting entities are described as "contributions" in the program literature but are referred to in this guidance as assessments for clarity. Amounts redistributed by the programs back to reporting entities are termed "payments" by the programs. These "payments" are recoverables / receivables for the reporting entity and are termed program distributions or receivables (to the reporting entity) in this guidance. The reporting of payable or receivable amounts in this guidance is from the perspective of the reporting entity. The statement based on this statement will nullify *INT 13-04: Accounting for the Risk-Sharing Provisions of the Affordable Care Act.*

3. This statement establishes statutory accounting principles for the risk-sharing provisions of the ACA. The manner in which these provisions are applied in the determination of the medical loss ratios (MLR) and rebates may be different from these as the MLR calculations are based on the ACA Section 2718(b).

Risk Adjustment Program – Description and Overview

4. The risk adjustment program based on Section 1343 of the ACA is effective beginning in the 2014 benefit year and continues as a permanent program.

5. The risk adjustment program includes health plans (except certain exempt and grandfathered plans) in the individual or small group markets both on and off the exchange. All covered risk adjustment plans are required to participate in the risk adjustment program.

6. The purpose of the risk adjustment program is to transfer funds from lower risk plans to higher risk plans within similar plans in the same state in order to adjust premiums for adverse selection among carriers caused by membership shifts due to guarantee issue and community rating mandates. States may set up their own risk adjustment programs, or they may permit Health and Human Services (HHS) to develop and manage the program in the state. In addition to the risk adjustment amount, HHS determines the user fee. In states operating their own risk adjustment program, the state will determine the fee.

7. Risk adjustment assessments and distributions will be computed based on the reporting entity's risk score versus the overall market risk score after applying adjustments. Risk adjustment assessments will be made if the plan average actuarial risk of all of their enrollees in a market and state is lower than the plan average risk of all enrollees in fully insured plans in that market and state risk pool. Risk adjustment distributions will be made to health plan issuers whose plans have an average actuarial risk that is greater than the plan average actuarial risk scores in that market and state risk pool. The reinsurance program is not considered in the computation.

8. HHS will collect a user fee to support the administration of the HHS-operated risk adjustment program. This fee applies to issuers of risk adjustment covered plans in states in which HHS is operating

the risk adjustment program. For example, HHS projects that the per capita risk adjustment user fee for 2014 is approximately $1 per enrollee per year. Similar terms will apply for the user fees of state operated programs.

9. All risk adjustment distributions made to issuers are completely funded through the amounts assessed to other issuers within the same market in the same state to ensure equality between program distributions and assessments. Consequently, risk adjustment assessments will be invoiced prior to processing program distributions to issuers. Once applicable risk adjustment assessments by issuers are received by HHS or the state, funds will be redistributed to the higher risk plans. Each issuer that offers a risk adjustment covered plan will be notified of risk adjustment distributions or assessments by June 30 of the year following the benefit year to align with the program distributions and assessment processing. Risk adjustment assessments owed by an issuer to HHS or the state are required to be remitted within 30 days of notification of the assessment. Once applicable assessments are received by HHS or the state, funds will be redistributed to the higher risk plans.

Risk Adjustment Program – Accounting Treatment

10. The accounting elements of the ACA permanent risk adjustment program, which are considered separately, include the user fee and the risk adjustment assessments and distributions.

11. The user fee is paid to HHS in states where the risk adjustment program is being operated by HHS and to the state program if operated by the state. Risk adjustment user fees shall be treated as government assessments. These fees are treated the same as other non-income-based governmental taxes and fees in that they are recognized as an expense and liability when the premium subject to the assessment is written.

12. Premium adjustments pursuant to the risk adjustment program will be based upon the risk scores (health status) of enrollees, participating in risk adjustment covered plans rather than the actual loss experience of the insured. This program bears some similarities to the Medicare Advantage risk adjustment program[1] under which the plan receives additional funding (or pays additional amounts) based on adjustments to risk scores of enrollees (see *INT 05-05: Accounting for Revenues Under Medicare Part D Coverage*).

13. The risk adjustment payables and receivables shall be accounted for as premium adjustments subject to redetermination as specified in this statement.

a. Risk adjustment payables meet the definition of liabilities as set forth in *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets* (SSAP No. 5R). Risk adjustment receivables meet the definition of an asset and are admissible to the extent that they meet all of the criteria in this statement.

b. Risk adjustment payables and receivables shall be estimated based on experience to date. The method used to estimate the payables and receivables shall be reasonable and consistent between reporting periods. Reporting entities shall be aware of the significant uncertainties involved in preparing estimates and be both diligent and conservative in their estimations. In exercising the judgment required to prepare reasonable estimates for the financial reporting of risk adjustment program payables and receivables, the statutory accounting concept of conservatism shall be followed. In addition, reporting entities are required to have sufficient data to determine a reasonable estimate. Ensuring sufficient data requires that the reporting entity's estimate is based on demonstrated knowledge of the marketplace and annual information which includes patient encounter and diagnosis

[1] The ACA program also has significant differences from the Medicare Advantage risk adjustment program, which is retrospective, administered as a single national program, with most enrollees administered by the federal government. By contrast, the ACA risk adjustment is not retrospective, and is administered by each entity by state and by plan.

code data to determine the differences in the actuarial risk profile of the reporting entity's insureds versus the market participants in the particular market and state risk pool. Sufficient data shall incorporate patient default scores, if applicable, under the terms of the risk adjustment program. In addition, the estimates shall be consistent with other financial statement assertions and the pricing scenarios used by the reporting entity.

c. Premium revenue adjustments for the risk adjustment program are estimated for the portion of the policy period that has expired and shall be reported as an immediate adjustment to premium. Accrued risk adjustment receivables shall be recorded as a write-in for other-than-invested assets, with a corresponding entry to premiums; accrued risk adjustment payables shall be recorded as a liability with a corresponding entry to premiums. Reporting entities shall record additions or reductions to revenue resulting from the risk adjustment program in the period in which the changes in risk scores of enrollees result in reasonably estimable additions or reductions. The risk adjustment program receivables shall be reported gross of payables.

d. The risk adjustment receivables are administered through a federal governmental program. Once amounts are collected by the governmental entity, there is an obligation to distribute the funds. Amounts over 90 days due shall not cause the receivable to be treated as a nonadmitted asset based solely on aging.

e. Provided that the risk adjustment receivables due the reporting entity are determined in a manner that is consistent with the requirements of this statement, the receivables are admitted assets until determination of impairment or payment denial is received from the governmental entity or government-sponsored entity administering the program. Upon notification that payments to be paid to the reporting entity will be less than the recorded receivables, any amount in excess of the confirmed amount shall be written off and charged to income, except for amounts that are under appeal. Any receivable for risk adjustment amounts under appeal shall be reflected as a nonadmitted asset.

f. Evaluation of the collectibility of all amounts receivable from the risk adjustment program shall be made for each reporting period. If, in accordance with SSAP No. 5R, it is probable that the risk adjustment receivables are uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made. If it is reasonably possible that a portion of the balance determined in accordance with this paragraph is not anticipated to be collected and is therefore not written off, the disclosure requirements outlined in SSAP No. 5R shall be followed.

Transitional Reinsurance Program – Description and Overview

14. The transitional reinsurance program based on Section 1341 of the ACA is effective for plan years 2014 through 2016. Reinsurance assessments will be collected and distributions will be issued during the three-year term.

15. All issuers of major medical commercial products and third party administrators (TPAs) on behalf of uninsured group health plans are required to contribute funding at the national contribution rate to HHS. States establishing reinsurance programs may collect additional funding. Non-grandfathered individual plans are eligible to receive benefit program distributions via an excess-of-loss reinsurance system. Grandfathered plans are ineligible. Group plans are required to contribute funding, but are not eligible to receive reinsurance program distributions.

16. In general, this transitional reinsurance program provides funding to issuers in the individual market that incur high claims costs for enrollees. The program requires assessments from all issuers and TPAs on behalf of group health plans based on a per member annual fee established by HHS. The

reinsurance assessment will fund reinsurance program distributions plus disbursements to the U.S. Treasury, in addition to covering administrative expenses of the program.

17. Consequently, the term "reinsurance" does not represent actual reinsurance between licensed insurers as defined by *SSAP No. 61—Revised—Life, Deposit-Type and Accident and Health Reinsurance* (SSAP No. 61R). This program is similar to an involuntary pool in *SSAP No. 63—Underwriting Pools and Associations Including Intercompany Pools* (SSAP No. 63) for the individual insured health products subject to the 2014 ACA market reforms. For the group plans, which are required to contribute funding but are not eligible to receive program distributions, the program is an assessment payable by the reporting entity and not a pool.

18. The national transitional reinsurance program assessment rate for all issuers and TPAs will be established by HHS and will be designed to collect more than $12 billion in 2014 to cover the required $10 billion for the reinsurance program, the $2 billion contribution to the U.S. Treasury, and additional amounts to cover the administrative costs of the federal government entity and applicable reinsurance entities. States electing to operate their own reinsurance program have the option to increase the reinsurance assessment rate to provide additional funding for the reinsurance program or to fund the administrative expenses of the applicable reinsurance entity. Assessments for the reinsurance program must fund the reinsurance program of $10 billion in 2014, $6 billion in 2015 and $4 billion in 2016, plus disbursements to the U.S. Treasury of $2 billion, $2 billion and $1 billion for years 2014 through 2016, in addition to covering administrative expenses of the applicable reinsurance entity or HHS.

19. Reinsurance program distributions will be processed either by the applicable reinsurance entity or by HHS and will be made to issuers of non-grandfathered individual market plans for high claim costs of enrollees. Distributions from the applicable reinsurance entity to insurers providing individual coverage will be calculated as a coinsurance rate multiplied by the eligible claims submitted for an individual enrollee's covered benefits between an attachment point and the reinsurance cap for each benefit year. The coinsurance rate, attachment point and reinsurance cap are initially determined by HHS, but may be modified by the state, if the state chooses to establish its own reinsurance program.

20. Each state is eligible to establish a reinsurance program, regardless of whether the state establishes a Marketplace Exchange. If a state establishes a reinsurance program, the state must enter into a contract with an applicable reinsurance entity or entities or establish a reinsurance entity to carry out the program. If a state does not elect to establish its own reinsurance program, HHS will administer the reinsurance program on behalf of that state. HHS establishes the annual administrative portion for the fee. (For example, the 2014 fee will be $0.11 per-member per-year resulting in $20.3 million of administrative expense funding).

21. Reinsurance assessments to fund the program are made on an annual basis with billing beginning December 15, 2014. An insurer may submit claims for reimbursement when an enrollee of the reinsurance-eligible plan has met the applicable criteria as determined by either the state or HHS. Claims may be submitted through April 30 of the year following the benefit year. HHS will distribute reinsurance program funds among issuers nationally based on submitted claims. Issuers will be notified of pending reinsurance distributions by June 30 following the benefit year. If the requests for distributions exceed the actual assessments collected, HHS will reduce reinsurance distributions on a pro-rata basis. If the requests for distributions are less than actual assessments collected, HHS will increase reinsurance distributions on a pro-rata basis.

Transitional Reinsurance Program – Accounting Treatment

22. Due to the diverse elements of the transitional reinsurance program, which includes characteristics of traditional reinsurance, involuntary pools and governmental assessments, a hybrid accounting approach is required. The accounting treatment for the transitional reinsurance program

outlined below is discussed in terms of the payables and receivables and the impact to the health insurance products subject to the program.

23. The following are the broad groupings of the health insurance products subject to the transitional reinsurance program:

a. Individual insured health products subject to the 2014 ACA market reforms. This excludes grandfathered and non-grandfathered 2013 products (referred to as subject individual insured products);

b. Other insured health products. This encompasses products which are not subject to the ACA market reforms including individual grandfathered and non-grandfathered (referred to as other insured health products);

c. Self-insured health products.

24. The guidance in this section will provide treatment for each of the assessments payable and program distribution receivable elements of the program listed below for the health insurance products listed in paragraph 23.

a. Assessments for reinsurance

b. Administrative costs assessments

c. Additional U.S. Treasury assessment

d. Reinsurance distributions

Subject Individual Insured Health Products

Subject Individual Insured Issuers - Assessments Payable for Reinsurance

25. Transitional reinsurance assessments attributable to enrollees in individual plans are treated as ceded reinsurance premium. This applies both to assessments made at the national assessment rate and to any state-elected additional assessments that will fund reinsurance program distributions. Ceded premiums would be reported as a reinsurance cession and follow reinsurance accounting in accordance with SSAP No. 61R, paragraph 17 and paragraphs 25-27:

26. For the individual coverage issuers, this is an involuntary pool and under the terms of the transitional reinsurance program, the transfer of risk and timely reimbursement requirements of SSAP No. 61R are deemed to be met.

27. With regard to individual coverage issuers, the transitional reinsurance program is more similar to traditional reinsurance than it is to an assessment, because program assessments are made to and program distributions are received from the government or government-sponsored entity. Accordingly, the program is accounted for as reinsurance for individual insured products subject to the transitional reinsurance program.

28. The provisions of SSAP No. 63, paragraph 3, define involuntary pools.

29. The transitional reinsurance program differs from an involuntary pool, in that there is not a proportionate sharing of the entire results of a pool. However, the purpose is very similar: to address the additional costs associated with high-risk individuals. Furthermore, HHS has noted, *"the Affordable Care Act ... requires that states eliminate or modify high-risk pools to the extent necessary to carry out the reinsurance program,"* which likewise highlights the similar purposes of the two mechanisms. Therefore,

SSAP No. 63, paragraph 8, provides additional relevant guidance. As the transitional reinsurance program is a mechanism for sharing the additional costs associated with high-risk individuals, it is accounted for as traditional reinsurance.

Subject Individual Insured Issuers - Reinsurance Administrative Expense Assessments

30. The assessment payable by the reporting entity for administrative expenses attributable to individual coverage is reflected as ceded premium. This applies both to assessments made at the national assessment rate and to any state-required assessments that will provide additional funding for administrative expenses.

31. Normally reinsurance premiums are set at a level intended to cover anticipated claim costs and include an administrative charge component. Therefore, as a matter of consistency, it is appropriate to include the administrative charge component for the transitional reinsurance program in ceded premium for individual insured products.

Subject Individual Insured Issuers - U.S. Treasury Assessment

32. Because this portion of the assessment is earmarked for the U.S. Treasury and not for the reimbursement of claims or to cover the operating costs of the reinsurance program, it is a federal assessment not based on income. This portion of the assessment is not treated as ceded premium, but as an assessment under SSAP No. 35R and is reflected in the same expense category as taxes, licenses and fees. This is also consistent with annual statement expense reporting categories.

Subject Individual Insured Issuers - Reinsurance Program Distributions

33. Program distributions received from the ACA transitional reinsurance program for individual insurance is reflected as ceded claim benefit recoveries. This applies both to distributions received pursuant to the uniform federal reinsurance parameters and to any state distribution received.

34. In keeping with the rationale for reinsurance assessments above, distributions receivable from the transitional reinsurance program for individual insurance products is reflected the same as traditional reinsurance recoveries as described in SSAP No. 61R, paragraph 27.

35. Therefore, recoveries received are reported in the summary of operations and will reduce the ceding entity's reported benefits paid.

36. HHS and all applicable reinsurance entities shall be reported consistent with providers to an involuntary pool and will be treated as authorized reinsurers for the purposes of financial reporting for subject individual health products.

37. All receivables from the transitional reinsurance program are subject to the 90-day nonadmission rule beginning from when program receivables are due to be disbursed by the government or a government-sponsored entity. That is, the 90-day rule begins when governmental receivables are due, not from the date of initial accrual. The announced governmental or government-sponsored entity distribution date shall be the contractual due date similar to Appendix A-791, paragraph 2h, which requires that payments due from the reinsurer are made in cash within ninety (90) days of the settlement date. The receivable is also subject to impairment analysis.

Other Insured Health Products

Other Insured Health Products – Assessments Payable for Reinsurance

38. Transitional reinsurance program reinsurance assessments made for enrollees in fully insured plans other than individual plans are treated as an assessment payable by the reporting entity and charged

to taxes, licenses and fees. This applies both to assessments made at the national assessment rate and to any state assessments that will fund reinsurance program distributions. In this case, for fully insured non-individual plans, the entity cannot, under the terms of the program, be deemed to be "participating," as funds for claim recoveries will not be re-distributed back to the issuer for the coverage that is being assessed. Therefore, issuers of other insured health products that are not for individuals are paying an involuntary fee but are not participating in an involuntary pool.

39. The treatment of the transitional reinsurance program reinsurance assessments for non-individual fully insured plans differs from the treatment for individual plans. Since the non-individual plans are not eligible for reimbursement, they are not participating in a reinsurance arrangement, and thus, the assessments are not treated as ceded premium. As an involuntary assessment, the transitional reinsurance program reinsurance assessments, consistent with SSAP No. 35R are treated as an assessment payable by the reporting entity and charged to taxes, licenses and fees expense. The expense is accrued in proportion to the other insured health enrollees base that will be used to determine the assessments payable as the premium subject to the assessment is written.

Other Insured Health Products - Reinsurance Administrative Expense Assessments

40. The reinsurance program administrative costs for other insured health products are an assessment payable by the reporting entity. This applies both to assessments made at the national assessment rate and to any state assessment that will fund administrative expenses and is reflected in the same expense category as taxes, licenses and fees.

Other Insured Health Products - U.S. Treasury Assessment

41. The additional U.S. Treasury assessment for other insured health products is a federal assessment payable by the reporting entity which is not based on income and is reflected in the same expense category as taxes, licenses and fees.

Other Insured Health Products - Reinsurance Program Distributions (not applicable)

42. Reinsurance recoveries will not occur for insured health products other than individual. Other insured health products will pay the transitional reinsurance program assessments payable but not receive program distributions for claims.

Self-Insured Health Products

Self-Insured Health Products - Assessments Payable for Reinsurance

43. Assessments made on behalf of self-insured plans which are administered by the reporting entity are uninsured plans and are excluded from the reporting entity's statement of operations, with respect to both monies received from the plans and assessments disbursed by the reporting entity. Any resulting liabilities or receivables shall be reported as liabilities and receivables held in connection with uninsured plans. This treatment is consistent with *SSAP No. 47—Uninsured Plans* (SSAP No. 47)*,* paragraphs 5 and 8-11.

44. The self-insured plan, not the reporting entity, is legally liable for assessments for the transitional reinsurance program. The funds are a bona fide pass-through by the reporting entity, which is merely providing a service for the self-insured (uninsured) plan. Therefore, the reporting entity will not report revenues or expenses for the assessments for the transitional reinsurance program.

45. The reporting entity may have received funds from the self-insured plans in advance of making disbursements. In that event, a liability is established for funds held in connection with self-insured plans.

46. The reporting entity, depending on its arrangement with the (uninsured) plan, may make a disbursement before receiving full funding from the plan. In that event, an asset is established for amounts receivable in connection with uninsured plans. The asset would be subject to the rules for admissibility and impairment as prescribed in SSAP No. 47, paragraphs 9-10.

Self-Insured Health Products - Reinsurance Administrative Expense Assessments Payable and U.S. Treasury Assessment

47. A reporting entity providing a service for a self-insured plan that is uninsured shall apply the pass-through treatment for the transitional reinsurance program's administrative cost assessments and additional U.S. Treasury contribution amounts. The uninsured plan, not the reporting entity, is legally liable. Therefore, the reporting entity will not report revenues or expenses with respect to the transitional reinsurance program's administrative cost assessments and additional U.S. Treasury contribution amounts.

Self-Insured Health Products - Reinsurance Payments (not applicable)

48. Reinsurance recoveries will not occur for self-insured health products, as these products will pay fees but not receive claims reimbursements.

Risk Corridors – Description and Overview

49. The risk corridors program based on Section 1342 of the ACA is effective for benefit years beginning in 2014 through 2016. The risk corridors program applies to Qualified Health Plans (QHPs) in the individual and small group markets whether sold on or outside of an exchange.

50. The purpose of the risk corridors program is to provide limitations on issuer losses and gains for QHPs through additional protection against initial pricing risk. The program creates a mechanism for sharing the risk for allowable costs between the federal government and the QHP issuers. The program is applied at the QHP level, not the issuer or market segment level. Although the risk-corridor program provides protection against extreme bounds of experience, there is a substantial corridor in which all variance in experience directly affects the financial return of the reporting entity.

51. To determine whether an issuer pays into (contributes), or receives distributions from, the risk corridors program, HHS will compare Allowable Costs[2] and the Target Amount[3] based on a formula that compares allowable costs. Below is an example (before transition requirements) for a QHP.

a. When a QHP's Allowable Costs for any benefit year are more than 103% but not more than 108% of the Target Amount, HHS will pay the QHP issuer an amount equal to 50% of the Allowable Costs in excess of 103% of the target amount.

b. When a QHP's Allowable Costs for any benefit year are more than 108% of the Target Amount, HHS will pay the QHP issuer an amount equal to 2.5% of the Target Amount plus 80% of the Allowable Costs in excess of 108% of the target Amount.

c. If a QHP's Allowable Costs for any benefit year are less than 97% but not less than 92% of the Target Amount, the QHP issuer must remit assessments payable to HHS in an amount equal to 50% of the difference between 97% of the Target Amount and the Allowable Costs.

[2] With respect to a QHP, Allowable Costs is an amount equal to the sum of incurred claims of the QHP issuer, adjusted to include qualifying expenditures by the QHP for activities that improve health care quality, expenditures for health information technology and meaningful use requirements and other required adjustments.

[3] With respect to a QHP, the Target Amount is an amount equal to the total premiums earned with respect to a QHP, including any premium tax credit under any governmental program, reduced by the allowable administrative costs of the plan.

d. When a QHP's Allowable Costs for any benefit year are less than 92% of the Target Amount, the QHP issuer must remit assessments payable to HHS in an amount equal to the sum of 2.5% of the Target Amount plus 80% of the difference between 92% of the Target Amount and the Allowable Costs.

52. The risk corridors program creates a mechanism for sharing risk for allowable costs between the federal government and QHP issuers. The ACA establishes the risk corridors program as a federal program; consequently, HHS will operate the risk corridors program under federal rules without state variations. The risk corridors program is intended to protect against inaccurate rate setting in the early years of the exchanges by limiting the extent of issuer losses and gains. In the event that risk corridors programs collections are not sufficient to cover all the required distributions, the ACA requires the use of other sources of federal funding for the required distributions, subject to the availability of appropriations.

53. The final risk corridors settlement calculation will be communicated by HHS after the end of the benefit year and after premium and loss adjustments related to the reinsurance and risk adjustment programs have been determined.

Risk Corridors – Accounting Treatment

54. This program is similar to the risk corridors program established for the Medicare Part D prescription drug coverage[4]. However, due to the asymmetrical nature of the risk-corridor calculation, an overstatement of expense in one cell, which is theoretically offset by the understatement of expense in another cell, does not necessarily result in zero financial impact.

55. Payables and receivables pursuant to the temporary risk corridors program shall be accounted for as specified in this statement.

56. Risk corridor assessments meet the definition of liabilities as set forth in SSAP No. 5R. Risk corridor receivables due to the reporting entity meet the definition of an asset and are admissible to the extent that they meet all of the criteria in this statement.

a. Assumptions used in estimating retrospective premium adjustments shall be consistent with the assumptions made in recording other assets and liabilities necessary to reflect the underwriting results of the reporting entity such as claim and loss reserves (including IBNR) and contingent commissions. Contingent commissions and other related expenses shall be adjusted in the same period the additional or return retrospective premiums are recorded.

b. The additions or reductions to premium revenue resulting from the risk corridors program are recognized over the contractual period of coverage, to the extent that such additions or reductions are reasonably estimable. Reporting entities shall be aware of the significant uncertainties involved in preparing estimates and be both diligent and conservative in their estimations. Risk corridors payables and receivables shall be estimated based on experience to date. The method used to estimate the payables and receivables shall be reasonable and consistent between reporting periods. In exercising the judgment required to prepare reasonable estimates for the financial reporting of risk corridors program payables and receivables, the statutory accounting concept of conservatism shall be followed. In addition, reporting entities are required to have sufficient information to determine a reasonable estimate. Part of ensuring sufficient information requires that the reporting entity's estimate is based on demonstrated knowledge of the impacts of the other risk-sharing programs on the risk corridors

[4] The ACA risk corridors program also has significant differences between the Medicare risk corridors program. The ACA risk corridors program is performed at a significantly more granular plan specific level with a pro-rata allocation of the issuer's overall claim costs for the plan's state/market cell.

program and the terms of the risk corridors program. In addition, the estimates shall be consistent with other financial statement assertions and the pricing scenarios used by the reporting entity.

c. The risk corridors receivables are from a federal governmental program. Amounts over 90 days due shall not cause the receivable to be treated as a nonadmitted asset based solely on aging.

d. Provided that the risk corridors receivables due the reporting entity are determined in a manner that is consistent with the requirements of this statement, the receivables are admitted assets until determination of impairment or payment denial is received from the governmental entity or government-sponsored entity administering the program. Upon notification that payments to be paid to the reporting entity will be less than the recorded receivables, any amount in excess of the confirmed amount shall be written off and charged to income, except for amounts that are under appeal. Any receivable for risk adjustment amounts under appeal shall be reflected as a nonadmitted asset.

e. Evaluation of the collectibility of all amounts receivable from the risk corridors program shall be made for each reporting period. If, in accordance with SSAP No. 5R, it is probable that the risk corridors receivables are uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made. If it is reasonably possible, that a portion of the balance determined in accordance with this paragraph is not anticipated to be collected and is therefore not written off, the disclosure requirements outlined in SSAP No. 5R shall be followed.

f. Reporting shall be consistent with *SSAP No. 66—Retrospectively Rated Contracts* (SSAP No. 66), paragraph 9 guidance on reporting for retrospective premium.

Disclosures

57. The financial statements shall disclose on an annual and quarterly basis beginning in the first quarter of 2014, the assets, liabilities and revenue elements by program regarding the risk-sharing provisions of the Affordable Care Act for the reporting periods which are impacted by the programs including the listing in paragraphs 57.a. through 57.c. Reporting entities shall also indicate if they wrote any accident and health insurance premium, which is subject to the Affordable Care Act risk-sharing provisions. In the event that the balances are zero, the reporting entity should provide context to explain the reasons for the zero balances, including insufficient data to make an estimate, no balances or premium was excluded from the program, etc. Asset balances shall reflect admitted asset balances. The disclosure shall include the following:

a. ACA Permanent Risk Adjustment Program

i. Premium adjustments receivable due to ACA Risk Adjustment
ii. Risk adjustment user fees payable for ACA Risk Adjustment
iii. Premium adjustments payable due to ACA Risk Adjustment
iv. Reported as revenue in premium for accident and health contracts (written/collected) due to ACA Risk Adjustment
v. Reported in expenses as ACA risk adjustment user fees (incurred/paid)

b. ACA Transitional Reinsurance Program

i. Amounts recoverable for claims paid due to ACA Reinsurance
ii. Amounts recoverable for claims unpaid due to ACA Reinsurance (contra-liability)

iii. Amounts receivable relating to uninsured plans for contributions for ACA Reinsurance
iv. Liabilities for contributions payable due to ACA Reinsurance - not reported as ceded premium
v. Ceded reinsurance premiums payable due to ACA Reinsurance
vi. Liability for amounts held under uninsured plans contributions for ACA Reinsurance
vii. Ceded reinsurance premiums due to ACA Reinsurance
viii. Reinsurance recoveries (income statement) due to ACA Reinsurance payments or expected payments
ix. ACA Reinsurance Contributions – not reported as ceded premium

c. ACA Temporary Risk Corridors Program

i. Accrued retrospective premium due from ACA Risk Corridors
ii. Reserve for rate credits or policy experience rating refunds due to ACA Risk Corridors
iii. Effect of ACA Risk Corridors on net premium income (paid/received)
iv. Effect of ACA Risk Corridors on change in reserves for rate credits

58. In addition, beginning in annual 2014 and both quarterly and annual thereafter, a roll forward of prior year ACA risk-sharing provisions specified asset and liability balances shall be disclosed in the annual statutory Notes to Financial Statements, as illustrated in Appendix B. Note for the roll forward illustration, assets shall be reflected gross of any nonadmission. The reasons for adjustments to prior year balances (i.e. federal audits, revised participant counts, information which impacted risk score projections, etc.) shall also be disclosed. For year-end 2014, all columns and rows are expected to be zero since 2014 is the first year that a receivable or liability will be recorded.

RELEVANT LITERATURE

Generally Accepted Accounting Principles

59. GAAP did not issue additional guidance to address the risk-sharing provisions of the ACA.

Effective Date and Transition

60. This statement is effective for years ending on or after December 15, 2014. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*. Risk-sharing provisions guidance was previously reflected within *INT 13-04: Accounting for the Risk-Sharing Provisions of the Affordable Care Act* and was effective January 1, 2014. Upon adoption of this SSAP, INT 13-04 was nullified. Disclosures in paragraphs 57 and 58 were adopted in *SSAP No. 35R—Guaranty Fund and Other Assessments,* but were moved to this SSAP prior to publication.

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 150—Accounting for the Risk-Sharing Provisions of the Affordable Care Act*

APPENDIX A – GLOSSARY

The terms included in this appendix are specific to the risk-sharing provisions of the ACA; accordingly, they are not intended to be applied to other topics.

Affordable Care Act (ACA) – The Patient Protection and Affordable Care Act (PPACA), commonly called the Affordable Care Act (ACA), is a United States federal statute signed into law on March 23, 2010.

Applicable Reinsurance Entity – A tax-exempt not-for-profit organization, the duties of which shall be to carry out the transitional reinsurance program by coordinating the funding and operation of the risk-spreading mechanisms designed to stabilize the individual markets during the implementation of health reform.

Cell – The risk corridor calculation is done at the QHP (Qualified Health Plan) level – the cell is state, market (individual or small group), QHP.

Assessment – Required payments into the applicable reinsurance entity by all issuers of major medical commercial products and third-party administrators to fund the transitional reinsurance program.

Exchange – Health insurance marketplaces, also called Health Exchanges, are organizations set up to facilitate the purchase of health insurance in every state of the United States in accordance with the Patient Protection and Affordable Care Act. The exchanges are regulated, online marketplaces, administered by either federal or state government, where individuals, families and small businesses can purchase qualified health insurance plans starting October 1, 2013, with coverage beginning January 1, 2014. Exchanges will also determine who qualifies for subsidies and make subsidy payments to insurers on behalf of individuals receiving them. They will also accept applications for other health coverage programs such as Medicaid and Children's Health Insurance Program (CHIP).

Exempt Plans – Certain health plans that are determined not to be a risk adjustment covered plan in the applicable federally certified risk adjustment methodology (45 C.F.R. § 153.20), grandfathered health plans, group health insurance coverage benefits that are not an integral part of a group health plan, are limited scope, or supplemental benefits (45 C.F.R. § 146.145(c)), and individual health insurance coverage excepted benefits (45 C.F.R. § 148.220).

Grandfathered Plans – A group health plan that was created or an individual health insurance policy that was purchased on or before March 23, 2010. Grandfathered plans are exempted from many changes required under the ACA. Plans or policies may lose their "grandfathered" status if they make certain significant changes that reduce benefits or increase costs to consumers. New employees and new family members may be added to grandfathered group plans after March 23, 2010.

Health and Human Services (HHS) – The Department of Health and Human Services (HHS) is the United States government's principal agency that oversees CMS, which administers programs for protecting the health of all Americans and providing essential human services.

Market Segment – Subset of consumers with its own set of demographic and other assumptions such as individual, state/federal, small group, group, Medicaid or Medicare.

Program Distribution– Amounts payable to or redistributed by the applicable reinsurance entity or the HHS to issuers of non-grandfathered individual market plans that incur high claims costs for enrollees and are eligible to receive benefit payments (recoveries).

Qualified Health Plan (QHP) – Under the Affordable Care Act, starting in 2014, an insurance plan that is certified by the Health Insurance Marketplace, provides essential health benefits and follows established limits on cost-sharing (such as deductibles, copayments, and out-of-pocket maximum amounts).

Risk Score – Individual risk score means a relative measure of predicted health care costs for a particular enrollee that is the result of a risk adjustment model. Claims-based risk-assessment models use data, typically from a 12-month period, to identify underlying conditions and assign a risk score for each individual based on an algorithm.

APPENDIX B – ACA RISK-SHARING PROVISIONS ROLL-FORWARD ILLUSTRATION

Receivables are reflected gross of any nonadmission for this illustration.

	Accrued During the Prior Year on Business Written Before December 31 of the Prior Year		Received or Paid as of the Current Year on Business Written Before December 31 of the Prior Year		Differences		Adjustments			Unsettled Balances as of the Reporting Date	
					Prior Year Accrued Less Payments (Col 1 - 3)	Prior Year Accrued Less Payments (Col 2 - 4)	To Prior Year Balances	To Prior Year Balances		Cumulative Balance from Prior Years (Col 1 – 3 +7)	Cumulative Balance from Prior Years (Col 2 – 4 +8)
	1	2	3	4	5	6	7	8	9	10	11
	Receivable	(Payable)	Receivable	(Payable)	Receivable	(Payable)	Receivable	(Payable)	Ref	Receivable	(Payable)
a. Permanent ACA Risk Adjustment Program											
1. Premium adjustments receivable	4,000,000		3,000,000		1,000,000		-800,000		A	200,000	0
2. Premium adjustments (payable)		8,000,000		9,000,000		-1,000,000		1,000,000	B		0
3. Subtotal ACA Permanent Risk Adjustment Program	**4,000,000**	**8,000,000**	**3,000,000**	**9,000,000**	**1,000,000**	**-1,000,000**	**-800,000**	**1,000,000**		**200,000**	**0**
b. Transitional ACA Reinsurance Program											
1. Amounts recoverable for claims paid	22,000,000		15,000,000		7,000,000		-7,000,000		C	0	
2. Amounts recoverable for claims unpaid (contra liability)	8,000,000		9,000,000		-1,000,000		990,000		D	-10,000	
3. Amounts receivable relating to uninsured plans	3,000,000		2,800,000		200,000		-100,000		E	100,000	
61.											
4. Liabilities for contributions payable due to ACA Reinsurance – not reported as ceded premium		90,000		75,000		15,000		-14,000	G		1,000
5. Ceded reinsurance premiums payable		100		200		-100		100	I		0
6. Liability for amounts held under uninsured plans		125,000		15,000		110,000		90,000	J		200,000
7. Subtotal ACA Transitional Reinsurance Program	**33,000,000**	**215,100**	**26,800,000**	**90,200**	**6,200,000**	**124,900**	**- 6,110,000-**	**76,100**		**90,000**	**201,000**
c. Temporary ACA Risk Corridors Program											
1. Accrued retrospective premium	12,000,000		14,000,000		-2,000,000		1,750,000		K	-250,000	
2. Reserve for rate credits or policy experience rating refunds		150,000		250,000		-100,000		100,000	L		0
3. Subtotal ACA Risk Corridors Program	**12,000,000**	**150,000**	**14,000,000**	**250,000**	**-2,000,000**	**-100,000**	**1,750,000**	**100,000**	**M**	**-250,000**	**0**
d. Total for ACA Risk-Sharing Provisions	**49,000,000**	**8,365,100**	**43,800,000**	**9,340,200**	**5,200,000**	**-975,100**	**-5,160,000**	**1,176,100**		**40,000**	**201,000**

Explanation of Adjustments

a. Adjusted due to federal audit

b. Adjusted because of revised participant count

c. Adjusted due to poor experience of other participants in the reinsurance pool.

d. Revised risk score information in the state of substantially impacted risk scores

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GLOSSARY to the Statements of Statutory Accounting Principles[1]

Adjusted Carrying Value – Carrying value amount adjusted to remove any accrued interest and to add back any of the following amounts: individual nonadmitted amounts, individual valuation allowances (if applicable), and aggregate valuation allowance (if applicable). In effect, this is equivalent to the SAP Book Value. (Not to be confused with the old "book value" reported in the annual statement blanks for data years 2000 and prior.)

Amortized Cost – See SAP Book Value.

Call Provision – Option to buy an asset at a specified price within a specified period. (Also applicable to Call and Call Option.)

Capitation Arrangement – A compensation plan used in connection with some managed care contracts in which a physician or other medical provider is paid a flat amount, usually on a monthly basis, for each subscriber who has elected to use that physician or medical provider.

Credit Rating Provider – CRP stands for Credit Rating Provider and refers to the NRSROs on the NAIC Credit Rating Provider List discussed in the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*.

Deferred Tax Asset – The deferred tax consequences attributable to deductible temporary differences and carryforwards. A deferred tax asset is measured using the applicable enacted tax rate and provisions of the enacted tax law. Deferred tax assets are subject to the admissibility criteria as outlined in *SSAP No. 101—Income Taxes, A Replacement of SSAP No. 10R and SSAP No. 10*, paragraph 11.

Deferred Tax Liability – The deferred tax consequences attributable to taxable temporary differences. A deferred tax liability is measured using the applicable enacted tax rate and provisions of the enacted tax law.

Equity Method – Accounting valuation approach used in which the initial investment is adjusted in accordance with the ownership of another entity. Guidance for using the equity method, and for determining adjustments to the investment under the equity method is detailed in *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies* (SSAP No. 48) and *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities, A Replacement of SSAP No. 88* (SSAP No. 97).

Fair Value – Fair value is defined in *SSAP No. 100—Fair Value Measurements.*

Guaranteed Investment Contract or Guaranteed Interest Contract (GIC) – An insurer-issued funding vehicle, typically issued to retirement plans, under which the insurer accepts a deposit (or, less frequently, a series of deposits) from the purchaser and guarantees to pay a specified interest rate of return on the funds deposited during a specified period of time.

Morbidity Risk – The potential for a person to experience illness, injury, or other physical or psychological impairment, whether temporary or permanent. Morbidity risk excludes the potential for an individual's death, but includes the potential for an illness or injury that results in death.

Mortality Risk – The potential for loss of life, with respect to a specified person or group of people. For reverse mortgages (SSAP No. 39), mortality risk is defined as the risk of loan payments extending beyond the borrower's original projected life expectancy.

[1] Note that some SSAPs may have terminology that is specific to that topic. Refer to the SSAP for clarification. Accordingly, they are not intended to be applied to other topics.

Nonforfeiture – The principle that some types of insurance contract have an economic value to which the contract owner is entitled even upon lapsation or surrender of the contract. A *nonforfeiture value* is the economic value that must be provided to the contract owner upon lapsation or surrender; it can take various forms, such as a lump-sum cash payment, an amount of paid-up insurance, an amount of term insurance, etc.

Nonoperating System Software – Application systems software such as language processors, library routines and debugging aides and other computer software are not considered operating system software.

Operating System Software – The operating system is a program or a series of programs controlling the data job and task management operations of a computer or a computer network through executive scheduling and monitoring. It increases the productivity of a computer installation by managing the allocation of all available computer resources including the control processing unit, main storage and input/output devices.

Original Cost – See SAP Book Value.

Par Value – The nominal (or face value) of a stock or bond.

Recorded Investment – The SAP Book Value (Adjusted Carrying Value) plus Accrued Interest.

SAP Book Value – Original cost, including capitalized acquisition costs and accumulated depreciation, unamortized premium and discount, deferred origination and commitment fees, direct write-downs, and increase/decrease by adjustment.

SAP Carrying Value (Amount) – The SAP book value plus accrued interest and reduced by any valuation allowance (if applicable) and any nonadmitted adjustment applied to the individual investment. Carrying value is used in the determination of impairment.

Statement Value – The SAP book value reduced by any valuation allowance and nonadmitted adjustment applied to an individual investment or a similar group of investments, e.g., bonds, mortgage loans, common stock.

Appendix A
Excerpts of NAIC Model Laws

Introduction

The following appendices are an integral part of the NAIC *Accounting Practices and Procedures Manual*. The guidance herein is referred to by specific statements of statutory accounting principles (SSAPs).

Some appendices define certain terms. Such definitions are not intended to change the meaning of any terms used elsewhere in the NAIC *Accounting Practices and Procedures Manual* and should only be used in the context of the appendix in which it appears and the SSAP that refers to that appendix.

Certain appendices contain requirements regarding reserves, which are effective with new business written after the effective date of the related SSAP. Transition guidance is provided in the related SSAPs.

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Appendix A-001

Investments of Reporting Entities

Introduction

Section 1. Reporting Requirements
Section 2. Investment Risk Interrogatories
Section 3. Summary Investment Schedule

Introduction

A reporting entity may acquire, hold or invest in investments or engage in investment practices as set forth in the laws and regulations of its domiciliary state. The disclosure required by this appendix is not intended to preempt such state authority. The financial information disclosed herein is intended solely for the use of state regulators for solvency analysis and should not be used for any other purpose.

Section 1. Reporting Requirements

The following reporting requirements apply to the provisions of this appendix:

1. Annual Statement – Section 3
2. Supplement to Annual Statement filed by April 1 – Section 2
3. Audited Statutory Financial Statements – Sections 2 and 3

Section 2. Investment Risks Interrogatories

Of The.. Insurance Company
Address (City, State, Zip Code) ....
NAIC Group Code... NAIC Company Code............................. Employer's ID Number..

The Investment Risks Interrogatories are to be filed by April 1. They are also to be included with the Audited Statutory Financial Statements.

Answer the following interrogatories by reporting the applicable U.S. dollar amounts and percentages of the reporting entity's total admitted assets held in that category of investments.

1. Reporting entity's total admitted assets as reported on Page 2 of this annual statement: $____________

2. Ten largest exposures to a single issuer/borrower/investment:

	1 Issuer	2 Description of Exposure	3 Amount	4 Percentage of Total Admitted Assets
2.01	....	a.	$...........................	.... %
2.02	....	b.	$...........................	.... %
2.03	....	c.	$...........................	.... %
2.04	....	d.	$...........................	.... %
2.05	....	e.	$...........................	.... %
2.06	....	f.	$...........................	.... %
2.07	....	g.	$...........................	.... %
2.08	....	h.	$...........................	.... %
2.09	....	i.	$...........................	.... %
2.10	....	j.	$...........................	.... %

3. Amounts and percentages of the reporting entity's total admitted assets held in bonds and preferred stocks by NAIC designation:

	Bonds	1	2		Preferred Stocks	3	4
3.01	NAIC – 1	$....................	.... %	3.07	P/RP – 1	$..................	................%
3.02	NAIC – 2	$....................	.... %	3.08	P/RP – 2	$..................	................%
3.03	NAIC – 3	$....................	.... %	3.09	P/RP – 3	$..................	................%
3.04	NAIC – 4	$....................	.... %	3.10	P/RP – 4	$..................	................%
3.05	NAIC – 5	$....................	.... %	3.11	P/RP – 5	$..................	................%
3.06	NAIC – 6	$....................	.... %	3.12	P/RP – 6	$..................	................%

4. Assets held in foreign investments:

4.01 Are assets held in foreign investments less than 2.5% of the reporting entity's total admitted assets? Yes [ ] No [ ]

If response, to 4.01 above is yes, responses are not required for interrogatories 5 – 10.

4.02	Total admitted assets held in foreign investments	$	............%
4.03	Foreign-currency-denominated investments	$	............%
4.04	Insurance liabilities denominated in that same foreign currency	$	............%

5. Aggregate foreign investment exposure categorized by NAIC sovereign designation:

		1	2
5.01	Countries designated NAIC – 1	$	.... %
5.02	Countries designated NAIC – 2	$	.... %
5.03	Countries designated NAIC – 3 or below	$	.... %

6. Two largest foreign investment exposures to a single country, categorized by the country's NAIC sovereigndesignation:

		1	2
	Countries designated NAIC – 1:		
6.01	Country:	$	.... %
6.02	Country:	$	.... %
	Countries designated NAIC – 2:		
6.03	Country:	$	.... %
6.04	Country:	$	.... %
	Countries designated NAIC – 3 or below:		
6.05	Country:	$	.... %
6.06	Country:	$	.... %

7. Aggregate unhedged foreign currency exposure: $ ....%

8. Aggregate unhedged foreign currency exposure categorized by NAIC sovereign designation:

		1	2
8.01	Countries designated NAIC – 1	$	.... %
8.02	Countries designated NAIC – 2	$	.... %
8.03	Countries designated NAIC – 3 or below	$	.... %

9. Two largest unhedged foreign currency exposures to a single country, categorized by the country's NAIC sovereign designation:

		1	2
	Countries designated NAIC – 1:		
9.01	Country:	$	.... %
9.02	Country:	$	.... %
	Countries designated NAIC – 2:		
9.03	Country:	$	.... %
9.04	Country:	$	.... %
	Countries designated NAIC – 3 or below:		
9.05	Country:	$	.... %
9.06	Country:	$	.... %

10. Ten largest non-sovereign (i.e. non-governmental) foreign issues:

	1 Issuer	2 NAIC Designation	3	4
10.01	....	....	$	.... %
10.02	....	....	$	.... %
10.03	....	....	$	.... %
10.04	....	....	$	.... %
10.05	....	....	$	.... %
10.06	....	....	$	.... %
10.07	....	....	$	.... %
10.08	....	....	$	.... %
10.09	....	....	$	.... %
10.10	....	....	$	.... %

11. Amounts and percentages of the reporting entity's total admitted assets held in Canadian investments and unhedged Canadian currency exposure:

11.01 Are assets held in Canadian investments less than 2.5% of the reporting entity's total admitted assets? Yes [ ] No [ ]

If response to 11.01 is yes, detail is not required for the remainder of Interrogatory 11.

		1	2
11.02	Total admitted assets held in Canadian Investments	$............................	.... %
11.03	Canadian-currency-denominated investments	$............................	.... %
11.04	Canadian-denominated insurance liabilities	$............................	.... %
11.05	Unhedged Canadian currency exposure	$............................	.... %

12. Report aggregate amounts and percentages of the reporting entity's total admitted assets held in investments with contractual sales restrictions:

12.01 Are assets held in investments with contractual sales restrictions less than 2.5% of the Reporting entity's total admitted assets. Yes [ ] No [ ]

If response to 12.01 is yes, responses are not required for the remainder of Interrogatory 12.

	1	2	3
12.02	Aggregate statement value of investments with contractual sales restrictions:	$	............................%
	Largest 3 investments with contractual sales restrictions:		
12.03	....	$	............................%
12.04	....	$	............................%
12.05	....	$	............................%

13. Amounts and percentages of admitted assets held in the ten largest equity interests:

13.01 Are assets held in equity interest less than 2.5% of the reporting entity's total admitted assets? Yes [ ] No [ ]

If response to 13.01 is yes, responses are not required for the remainder of Interrogatory 13.

	1 Issuer	2	3
13.02	....	$	............................%
13.03	....	$	............................%
13.04	....	$	............................%
13.05	....	$	............................%
13.06	....	$	............................%
13.07	....	$	............................%
13.08	....	$	............................%
13.09	....	$............................	............................%
13.10	....	$............................	............................%
13.11	....	$	............................%

14. Amounts and percentages of the reporting entity's total admitted assets held in nonaffiliated, privately placed equities:

14.01 Are assets held in nonaffiliated, privately placed equities less than 2.5% of the reporting entity's total admitted assets? Yes [ ] No [ ]

If response to 14.01 above is yes, responses are not required for the remainder of Interrogatory 14.

	1	2	3
14.02	Aggregate statement value of investments held in nonaffiliated, privately placed equities:	$	.... %
	Largest 3 investments held in nonaffiliated, privately placed equities:		
14.03	....	$	.... %
14.04	....	$	.... %
14.05	....	$	.... %

15. Amounts and percentages of the reporting entity's total admitted assets held in general partnership interests:

15.01 Are assets held in general partnership interests less than 2.5% of the reporting entity's total admitted assets? Yes [ ] No [ ]

If response to 15.01 above is yes, responses are not required for the remainder of Interrogatory 15.

	1	2	3
15.02	Aggregate statement value of investments held in general partnership interests:	$	.... %
	Largest 3 investments in general partnership interests:		
15.03	....	$	.... %
15.04	....	$	.... %
15.05	....	$	.... %

16. Amounts and percentages of the reporting entity's total admitted assets held in mortgage loans:

16.01 Are mortgage loans reported in Schedule B less than 2.5% of the reporting entity's total admitted assets? Yes [ ] No [ ]

If response to 16.01 above is yes, responses are not required for the remainder of Interrogatory 16 and Interrogatory 17.

	1 (Type (Residential, Commercial, Agricultural)	2	3
16.02	....	$	.... %
16.03	....	$	.... %
16.04	....	$	.... %
16.05	....	$	.... %
16.06	....	$	.... %
16.07	....	$	.... %
16.08	....	$	.... %
16.09	....	$	.... %
16.10	....	$	.... %
16.11	....	$	.... %

Amount and percentage of the reporting entity's total admitted assets held in the following categories of mortgage loans:

		Loans	
16.12	Construction loans	$	..............................%
16.13	Mortgage loans over 90 days past due	$	..............................%
16.14	Mortgage loans in the process of foreclosure	$	..............................%
16.15	Mortgage loans foreclosed	$	..............................%
16.16	Restructured mortgage loans	$	..............................%

17. Aggregate mortgage loans having the following loan-to-value ratios as determined from the most current appraisal as of the annual statement date:

	Loan-to-Value	Residential		Commercial		Agricultural	
		1	2	3	4	5	6
17.01	above 95%	$	..............%	$....................	.... %	$	.............%
17.02	91% to 95%	$	..............%	$....................	.... %	$	.............%
17.03	81% to 90%	$	..............%	$....................	.... %	$	.............%
17.04	71% to 80%	$	..............%	$....................	.... %	$	.............%
17.05	below 70%	$	..............%	$....................	.... %	$	.............%

18. Amounts and percentages of the reporting entity's total admitted assets held in each of the five largest investments in real estate:

18.01 Are assets held in real estate reported in less than 2.5% of the reporting entity's total admitted assets? Yes [ ] No [ ]

If response to 18.01 above is yes, responses are not required for the remainder of Interrogatory 18.

Largest five investments in any one parcel or group of contiguous parcels of real estate:

	Description 1	2	3
18.02	....	$	....%
18.03	....	$	....%
18.04	....	$	....%
18.05	....	$	....%
18.06	....	$	....%

19. Report aggregate amounts and percentages of the reporting entity's total admitted assets held in investments held in mezzanine real estate loans:

19.01 Are assets held in investments held in mezzanine real estate loans less than 2.5% of the Reporting entity's total admitted assets. Yes [ ] No [ ]

If response to 19.01 is yes, responses are not required for the remainder of Interrogatory 19.

	1	2	3
19.02	Aggregate statement value of investments held in mezzanine real estate loans:	$	............................%
	Largest 3 investments held in mezzanine real estate loans:		
19.03	....	$	............................%
19.04	....	$	............................%
19.05	....	$	............................%

20. Amounts and percentages of the reporting entity's total admitted assets subject to the following types of agreements:

		At Year-end		At End of Each Quarter		
				1st Qtr	2nd Qtr	3rd Qtr
		1	2	3	4	5
20.01	Securities lending agreements (do not include assets held as collateral for such transactions)	$	...............%	$...............	$	$ ....
20.02	Repurchase agreements	$	...............%	$...............	$	$ ....
20.03	Reverse repurchase agreements	$	...............%	$...............	$	$ ....
20.04	Dollar repurchase agreements	$	...............%	$...............	$	$ ....
20.05	Dollar reverse repurchase agreements	$	...............%	$...............	$	$ ....

21. Amounts and percentages of the reporting entity's total admitted assets for warrants not attached to other financial instruments, options, caps, and floors:

		Owned		Written	
		1	2	3	4
21.01	Hedging	$	......................%	$	.............................%
21.02	Income generation	$	......................%	$	.............................%
21.03	Other	$	......................%	$	.............................%

22. Amounts and percentages of the reporting entity's total admitted assets of potential exposure for collars, swaps, and forwards:

		At Year-end		At End of Each Quarter		
				1st Qtr	2nd Qtr	3rd Qtr
		1	2	3	4	5
22.01	Hedging	$	......................%	$	$	$ ....
22.02	Income generation	$	......................%	$	$	$ ....
22.03	Replications	$	......................%	$	$	$ ....
22.04	Other	$	......................%	$	$	$ ....

23. Amounts and percentages of the reporting entity's total admitted assets of potential exposure for futures contracts:

		At Year-end		At End of Each Quarter		
				1st Qtr	2nd Qtr	3rd Qtr
		1	2	3	4	5
23.01	Hedging	$	......................%	$	$	$ ....
23.02	Income generation	$	......................%	$	$	$ ....
23.03	Replications	$	......................%	$	$	$ ....
23.04	Other	$	......................%	$	$	$ ....

Section 3. Summary Investment Schedule

	Gross Investment Holdings*		Admitted Assets as Reported in the Annual Statement			
	1	2	3	4	5	6
Investment Categories	**Amount**	**Percentage**	**Amount**	**Securities Lending Reinvested Collateral Amount**	**Total (Col. 3+4) Amount**	**Percentage**
1. Bonds	....	....	....	....	....	....
1.1 US Treasury Securities	....	....	....	....	....	....
1.2 U.S. government agency and corporate obligations (excluding mortgage-backed securities)						
1.21 Issued by US Government Agencies	....	....	....	....	....	....
1.22 Issued by US Government-sponsored agencies	....	....	....	....	....	....
1.3 Non-U.S. Government (including Canada, excluding mortgage-backed securities)	....	....	....	....	....	....
1.4 Securities issued by states, territories and possessions and political subdivisions in the US						
1.41 States, territories and possessions general obligations	....	....	....	....	....	....
1.42 Political subdivisions of states, territories and possessions and political subdivisions general obligations	....	....	....	....	....	....
1.43 Revenue and assessment obligations	....	....	....	....	....	....
1.44 Industrial development bonds and similar obligations	....	....	....	....	....	....
1.5 Mortgage-backed securities (includes residential and commercial MBS)	....	....	....	....	....	....
1.51 Pass-through securities						
1.511 Issued or guaranteed by GNMA	....	....	....	....	....	....
1.512 Issued or guaranteed by FNMA and FHLMC	....	....	....	....	....	....
1.513 All other	....	....	....	....	....	....
1.52 CMOs and REMICs:						
1.521 Issued or guaranteed by GNMA, FNMA, FHLMC or VA	....	....	....	....	....	....
1.522 Issued by non-U.S. Government issuers and collateralized by mortgage-backed securities issued or guaranteed by agencies shown in Line 1.521	....	....	....	....	....	....
1.523 All other	....	....	....	....	....	....
2. Other debt and other fixed income securities (excluding short term)						
2.1 Unaffiliated domestic securities (includes credit tenant loans and hybrid securities)	....	....	....	....	....	....

Investment Categories	Gross Investment Holdings*		Admitted Assets as Reported in the Annual Statement			
2.2 Unaffiliated Non-U.S. securities (including Canada)	....	....	....	....	....	....
2.3 Affiliated securities	....	....	....	....	....	....
3. Equity interests						
3.1 Investments in mutual funds	....	....	....	....	....	....
3.2 Preferred stocks						
3.21 Affiliated	....	....	....	....	....	....
3.22 Unaffiliated	....	....	....	....	....	....
3.3 Publicly traded equity securities (excluding preferred stocks)						
3.31 Affiliated	....	....	....	....	....	....
3.32 Unaffiliated	....	....	....	....	....	....
3.4 Other equity securities						
3.41 Affiliated	....	....	....	....	....	....
3.42 Unaffiliated	....	....	....	....	....	....
3.5 Other equity interests including tangible personal property under leases						
3.51 Affiliated	....	....	....	....	....	....
3.52 Unaffiliated	....	....	....	....	....	....
4. Mortgage loans						
4.1 Construction and land development	....	....	....	....	....	....
4.2 Agricultural	....	....	....	....	....	....
4.3 Single family residential properties	....	....	....	....	....	....
4.4 Multifamily residential properties	....	....	....	....	....	....
4.5 Commercial loans	....	....	....	....	....	....
4.6 Mezzanine real estate loans	....	....	....	....	....	....
5. Real Estate Investments						
5.1 Property occupied by company	....	....	....	....	....	....
5.2 Property held for production of income (including $ .... of property acquired in satisfaction of debt)	....	....	....	....	....	....
5.3 Property held for sale (including $………… property acquired in satisfaction of debt)	....	....	....	....	....	....
6. Contract Loans	....	....	....	....	....	....
7. Derivatives	....	....	....	....	....	....
8. Receivables for securities	....	....	....	....	....	....
9. Securities Lending (Line 10, Asset Page reinvested collateral)	....	....	....	....	....	....
10. Cash, cash equivalents and short-term investments	....	....	....	....	....	....
11. Other Invested Assets	....	....	....	....	....	....
12. **Total Invested Assets**						

* Gross Investment Holdings as valued in compliance with NAIC Accounting Practices & Procedures Manual

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Appendix A-010

Minimum Reserve Standards For Individual And Group Health Insurance Contracts

Definitions

1. “Annual claim cost” is the net annual cost per unit of benefit before the addition of expenses, including claim settlement expenses, and a margin for profit or contingencies. For example, the annual claim cost for a $100 monthly disability benefit, for a maximum disability benefit period of one year, with an elimination period of one week, with respect to a male at age 35, in a certain occupation might be $12, while the gross premium for this benefit might be $18. The additional $6 would cover expenses and profit or contingencies.

2. “Claims accrued” is that portion of claims incurred on or prior to the valuation date that result in liability of the insurer for the payment of benefits for medical services that have been rendered on or prior to the valuation date, and for the payment of benefits for days of hospitalization and days of disability that have occurred on or prior to the valuation date, that the insurer has not paid as of the valuation date, but for which it is liable and will have to pay after the valuation date. This liability is sometimes referred to as a liability for “accrued” benefits. A claim reserve, which represents an estimate of this accrued claim liability, must be established. *SSAP No. 55 defines this as a Claim Liability and not a Claim Reserve.*

3. “Claims reported” are considered as a reported claim for annual statement purposes when an insurer has been informed that a claim has been incurred, if the date reported is on or prior to the valuation date.

4. “Claims unaccrued” represent that portion of claims incurred on or prior to the valuation date which result in liability of the insurer for the payment of benefits for medical services expected to be rendered after the valuation date, and for benefits expected to be payable for days of hospitalization and days of disability occurring after the valuation date. This liability is sometimes referred to as a liability for unaccrued benefits. A claim reserve, which represents an estimate of the unaccrued claim payments expected to be made (which may or may not be discounted with interest), must be established. *SSAP No. 54 defines this as a Claim Reserve differentiated from the Claim Liability in paragraph 2 above.*

5. When an insurer has not been informed, on or before the valuation date, concerning a claim that has been incurred on or prior to the valuation date, the claim is considered an “unreported claim” for annual statement purposes.

6. “Date of disablement” is the earliest date the insured is considered as being disabled under the definition of disability in the contract, based on a doctor’s evaluation or other evidence. Normally this date will coincide with the start of any elimination period.

7. “Elimination period” is a specified number of days, weeks, or months starting at the beginning of each period of loss, during which no benefits are payable.

8. “Gross premium” is the amount of premium charged by the insurer. It includes the net premium (based on claim-cost) for the risk, together with any loading for expenses, profit or contingencies.

9. The term “group long-term disability income” includes group contracts providing group disability income coverage with a maximum benefit duration longer than two years. Group long-term disability income contracts are based on a group pricing structure. The term “group long-term disability” does not

include group short-term disability (coverage with benefit periods of two years or less in maximum duration). It also does not include voluntary group disability income coverage that is priced on an individual risk structure and generally sold in the workplace.

~~9.~~10. The term “group insurance” includes blanket insurance and franchise insurance and any other forms of group insurance.

~~10.~~11. “Level premium” is a premium calculated to remain unchanged throughout either the lifetime of the policy or for some shorter projected period of years. The premium need not be guaranteed; in which case, although it is calculated to remain level, it may be changed if any of the assumptions on which it was based are revised at a later time. Generally, the annual claim costs are expected to increase each year and the insurer, instead of charging premiums that correspondingly increase each year, charges a premium calculated to remain level for a period of years or for the lifetime of the contract. In this case the benefit portion of the premium is more than needed to provide for the cost of benefits during the earlier years of the policy and less than the actual cost in the later years. The building of a prospective contract reserve is a natural result of level premiums.

~~11.~~12. “Long-term care insurance” is any insurance policy or rider advertised, marketed, offered or designed to provide coverage for not less than twelve (12) consecutive months for each covered person on an expense incurred, indemnity, prepaid or other basis; for one or more necessary or medically necessary diagnostic, preventive, therapeutic, rehabilitative, maintenance or personal care services, provided in a setting other than an acute care unit of a hospital. Such term also includes a policy or rider which provides for payment of benefits based upon cognitive impairment or the loss of functional capacity. Long-term care insurance may be issued by insurers; fraternal benefit societies; nonprofit health, hospital, and medical service corporations; prepaid health plans; health maintenance organizations or any similar organization to the extent they are otherwise authorized to issue life or health insurance. Long-term care insurance shall not include any insurance policy which is offered primarily to provide basic Medicare supplement coverage, basic hospital expense coverage, basic medical-surgical expense coverage, hospital confinement indemnity coverage, major medical expense coverage, disability income or related asset-protection coverage, accident only coverage, specified disease or specified accident coverage, or limited benefit health coverage.

~~12.~~13. “Modal Premium” refers to the premium paid on a contract based on a premium term which could be annual, semi-annual, quarterly, monthly, or weekly. Thus if the annual premium is $100 and if, instead, monthly premiums of $9 are paid then the modal premium is $9.

~~13.~~14. Normally the terminal reserve is a positive value. However, if the values of the benefits are decreasing with advancing age or duration it could be a negative value, called a “negative reserve.”

~~14.~~15. “Preliminary Term Reserve Method” is a method of valuation whereby the valuation net premium for each year falling within the preliminary term period is exactly sufficient to cover the expected incurred claims of that year, so that the terminal reserves will be zero at the end of the year. As of the end of the preliminary term period, a new constant valuation net premium (or stream of changing valuation premiums) becomes applicable such that the present value of all such premiums is equal to the present value of all claims expected to be incurred following the end of the preliminary term period.

~~15.~~16. “Present value of amounts not yet due on claims” represents the reserve for “claims unaccrued” (see definition), which may be discounted at interest.

~~16.~~17. “Rating block” means a grouping of contracts determined by the valuation actuary based on common characteristics, such as a policy form or forms having similar benefit designs.

~~17.~~18. The term “reserve” is used to include all items of benefit liability, whether in the nature of incurred claim liability or in the nature of contract liability relating to future periods of coverage, and whether the liability is accrued or unaccrued. An insurer under its contracts promises benefits which result in:

a. Claims that have been incurred, that is, for which the insurer has become obligated to make payment, on or prior to the valuation date. On these claims, payments expected to be made after the valuation date for accrued and unaccrued benefits are liabilities of the insurer which shall be provided for by establishing claim reserves; or

b. Claims that are expected to be incurred after the valuation date. Any present liability of the insurer for these future claims shall be provided for by the establishment of contract reserves and unearned premium reserves.

~~18.~~19. “Terminal reserve” is the reserve at the end of a contract year and is defined as the present value of benefits expected to be incurred after that contract year minus the present value of future valuation net premiums.

~~19.~~20. “Unearned premium reserve” values that portion of the premium paid or due to the insurer which is applicable to the period of coverage extending beyond the valuation date. Thus if an annual premium of $120 was paid on November 1, $20 would be earned as of December 31 and the remaining $100 would be unearned. The unearned premium reserve could be on a gross basis as in this example or on a valuation net premium basis.

~~20.~~21. “Valuation net modal premium” is the modal fraction of the valuation net annual premium that corresponds to the gross modal premium in effect on any contract to which contract reserves apply. Thus if the mode of payment in effect is quarterly, the valuation net modal premium is the quarterly equivalent of the valuation net annual premium.

Scope

~~21.~~22. These standards apply to all individual and group health and accident and sickness insurance coverages, including single premium credit disability insurance. All other credit insurance is not subject to Appendix A-010.

~~22.~~23. When an insurer determines that adequacy of its health insurance reserves requires reserves in excess of the minimum standards specified herein, such increased reserves shall be held and shall be considered the minimum reserves for that insurer.

~~23.~~24. With respect to any block of contracts, or with respect to an insurer’s health business as a whole, a prospective gross premium valuation is the ultimate test of reserve adequacy as of a given valuation date. Such a gross premium valuation will take into account, for contracts in force, in a claims status, or in a continuation of benefits status on the valuation date, the present value as of the valuation date of: all expected benefits unpaid, all expected expenses unpaid, and all unearned or expected premiums, adjusted for future premium increases reasonably expected to be put into effect.

~~24.~~25. Such a gross premium valuation is to be performed whenever a significant doubt exists as to reserve adequacy with respect to any major block of contracts, or with respect to the insurer’s health business as a whole. In the event inadequacy is found to exist, immediate loss recognition shall be made and the reserves restored to adequacy. Adequate reserves (inclusive of claim, premium and contract reserves, if any) shall be held with respect to all contracts, regardless of whether contract reserves are required for such contracts under these standards.

~~25.~~26. Whenever minimum reserves, as defined in this Appendix, exceed reserve requirements as determined by a prospective gross premium valuation, such minimum reserves remain the minimum requirement under these standards.

~~26.~~27. The following paragraphs set forth minimum standards for three categories of health insurance reserves:

a. Claim Reserves;

b. Premium Reserves;

c. Contract Reserves.

~~27.~~28. Adequacy of an insurer's health insurance reserves is to be determined on the basis of all three categories combined. However, these standards emphasize the importance of determining appropriate reserves for each of the three categories separately.

Claim Reserves

~~28.~~29. General:

a. Claim reserves are required for all incurred but unpaid claims on all health insurance policies.

b. Appropriate claim expense reserves are required with respect to the estimated expense of settlement of all incurred but unpaid claims.

c. All such reserves for prior valuation years are to be tested for adequacy and reasonableness along the lines of claim runoff schedules in accordance with the statutory financial statement including consideration of any residual unpaid liability.

~~29.~~30. Minimum Standards for Claim Reserves:

a. Disability Income

i. Interest. The maximum interest rate for claim reserves is specified in Exhibit 1.

ii. Morbidity. Minimum standards with respect to morbidity are those specified in Exhibit 1, except that at the option of the insurer:

(a) For individual disability income claims incurred January 1, 2001, to January 1, 2007, each insurer may elect which of the following to use as the minimum morbidity standard for claim reserves.

(1) The minimum morbidity standard in effect for claim reserves as of the date the claim was incurred, or

(2) The standards as defined in paragraph 30.a.ii.(c) applied to all open claims. Once an insurer elects to calculate reserves for all open claims on the standard defined in paragraph 30.a.ii.(c), all future valuations must be on that basis.

(b~~a~~) For group and individual claims incurred from January 1, 2001, through December 31, 2006, with a duration from date of disablement of less than two years, reserves may be based on the insurer's experience, if such experience is considered credible, or upon other assumptions designed to place a sound value on the liabilities.

(c~~b~~) For individual disability income claims incurred on or after January 1, 2007, the minimum standards with respect to morbidity are those specified in Exhibit 1, except that, at the option of the insurer, assumptions regarding claim termination rates for the period less than two (2) years from the date of disablement may be based on the insurer's experience, if such experience is considered credible, or upon other assumptions designed to place a sound value on the liabilities.

(d~~c~~) For group disability income claims incurred from January 1, 2001, through December 31, 2006, with a duration from date of disablement of more than two (2) years but less than five (5) years, reserves may be based on the insurer's experience if such experience is considered credible and for which the insurer maintains underwriting and claim administration control.

(e~~d~~) For group disability income claims incurred on or after January 1, 2007;

(1) Assumptions regarding claim termination rates for the period less than two (2) years from the date of disablement may be based on the insurer's experience, if the experience is considered credible, or upon other assumptions designed to place a sound value on the liabilities.

(2) Assumptions regarding claim termination rates for the period two (2) or more years but less than five (5) years from the date of disablement may be based on the insurer's experience if such experience is considered credible and for which the insurer maintains underwriting and claim administration control.

(f~~e~~) With respect to claims termination standards (d~~c~~) and (e~~d~~)(2) above, for experience to be considered credible for purposes of this appendix, the company should be able to provide claim termination patterns over no more than six (6) years reflecting at least 5,000 claims terminations during the third through fifth claims durations on reasonably similar applicable policy forms.

A plan of modification to the reserve basis must be in writing and must include:

(1) An analysis of the credibility of the experience;

(2) A description of how all of the insurer's experience is proposed to be used in setting reserves;

(3) A description and quantification of the margins to be included; and

(4) A summary of the financial impact that the proposed plan of modification would have had on the insurer's last filed annual statement.

(g~~f~~) For claim reserves to reflect "sound values" and/or reasonable margins, reserve tables based on credible experience should be adjusted regularly to maintain reasonable margins.

(h~~g~~) For disability income claims incurred prior to January 1, 2007, each insurer may elect to use as the minimum morbidity standard for claim reserves:

(1) The individual and group disability income claims minimum morbidity standard in effect for claim reserves as of the date the claim was incurred; or

(2) The individual and group disability income claims termination standards as defined in Items (c~~b~~) and (e~~d~~), applied to all open claims. Once an insurer elects to calculate reserves for all open claims on the standards defined in Items (c~~b~~) and (e~~d~~), all future valuations must be on that basis.

(3) After the effective date selected by the company in paragraph 30.a.ii.(i), the standards as defined in paragraph 30.a.ii.(i) applied to all open group long-term disability income claims, or

(4) The standards as defined in paragraph 30.b. applied to all open group disability income claims.

Once an insurer elects to calculate reserves for all open claims on a more recent standard, then all future valuations must be on that basis.

(i) For group long-term disability income claims incurred on or after October 1, 2014, or the subsequent date that is chosen for optional early adoption, and before the date specified in paragraph 30.b., the minimum standards with respect to morbidity may be based on the 2012 GLTD termination table or subsequent table with considerations of:

(1) The insurer's own experience computed in accordance with Actuarial Guideline XLVII, as included in the most current version of the NAIC *Accounting Practices and Procedures Manual*, and

(2) An adjustment to include an own experience measurement margin derived in accordance with Actuarial Guideline XLVII, as included in the most current version of the NAIC *Accounting Practices and Procedures Manual*, and

(3) A credibility factor derived in accordance with Actuarial Guideline XLVII, as included in the most current version of the NAIC *Accounting Practices and Procedures Manual*.

b. Subject to the conditions in this Section, the 2012 GLTD or subsequent table with considerations outlined in paragraph 30.a. shall be used in determining minimum standards with respect to morbidity for group long-term disability claims incurred on or after January 1, 2017.

i. For group long-term disability income claims incurred on or after January 1, 2007, but before the effective date selected by the company in paragraph 30.a. ii.(i), and group disability income claims incurred on or after January 1, 2007, that are not group long-term disability income, the minimum standards with respect to morbidity are those specified in Exhibit 1 except that, at the option of the insurer:

(a) Assumptions regarding claim termination rates for the period less than two (2) years from the date of disablement may be based on the insurer's experience, if the experience is considered credible, or upon other assumptions designed to place a sound value on the liabilities.

(b) Assumptions regarding claim termination rates for the period two (2) or more years but less than five (5) years from the date of disablement may, with the approval of the commissioner, be based on the insurer's experience for which the insurer maintains underwriting and claim administration control. The request for such approval of a plan of modification to the reserve basis must include:

(1) An analysis of the credibility of the experience;

(2) A description of how all of the insurer's experience is proposed to be used in setting reserves;

(3) A description and quantification of the margins to be included;

(4) A summary of the financial impact that the proposed plan of modification would have had on the insurer's last filed annual statement;

(5) A copy of the approval of the proposed plan of modification by the commissioner of the state of domicile; and

(6) Any other information deemed necessary by the commissioner.

(c) Each insurer may elect which of the following to use as the minimum morbidity standard for group long-term disability income claim reserves:

(1) The minimum morbidity standard in effect for claim reserves as of the date the claim was incurred, or

(2) The standards as defined in paragraph 30.a.ii.(i) applied to all open claims.

Once an insurer elects to calculate reserves for all open claims on a more recent standard, then all future valuations must be on that basis.

iii. Duration of Disablement. For contracts with an elimination period, the duration of disablement shall be measured as dating from the time that benefits would have begun to accrue had there been no elimination period.

c~~b~~. All Other Benefits

i. Interest. The maximum interest rate for claim reserves is specified in Exhibit 1.

ii. Morbidity or other Contingency. The reserve shall be based on the insurer's experience, if such experience is considered credible, or upon other assumptions designed to place a sound value on the liabilities.

~~30.~~31. Claim Reserve Methods Generally - A generally accepted actuarial reserving method or other reasonable method or a combination of methods may be used to estimate all claim liabilities. The methods used for estimating liabilities generally may be aggregate methods, or various reserve items may be separately valued. Approximations based on groupings and averages may also be employed. Adequacy of the claim reserves, however, shall be determined in the aggregate.

Premium Reserves

~~31.~~32. General

a. Except as noted in 31.b below, unearned premium reserves are required for all contracts with respect to the period of coverage for which premiums, other than premiums paid in advance, have been paid beyond the date of valuation.

b. Single premium credit disability insurance individual policies and group certificates are excluded from unearned premium reserve requirements of paragraphs 32-34~~31-33~~.

c. If premiums due and unpaid are carried as an asset, such premiums must be treated as premiums in force, subject to unearned premium reserve determination. The value of unpaid commissions, premium taxes, and the cost of collection associated with due and unpaid premiums must be carried as an offsetting liability.

d. The gross premiums paid in advance for a period of coverage commencing after the next premium due date which follows the date of valuation may be appropriately discounted to the valuation date and shall be held as a separate liability .

~~32.~~33. Minimum Standards for Unearned Premium Reserves

a. The minimum unearned premium reserve with respect to any contract is the pro rata unearned modal premium that applies to the premium period beyond the valuation date, with such premium determined on the basis of:

i. The valuation net modal premium on the contract reserve basis applying to the contract; or;

ii. The gross modal premium for the contract if no contract reserve applies.

b. However, in no event may the sum of the unearned premium and contract reserves for all contracts of the insurer subject to contract reserve requirements be less than the gross modal unearned premium reserve on all such contracts, as of the date of valuation. Such reserve shall never be less than the expected claims for the period beyond the valuation date represented by such unearned premium reserve, to the extent not provided for elsewhere.

~~33.~~34. Premium Reserve Methods Generally - The insurer may employ suitable approximations and estimates; including, but not limited to groupings, averages and aggregate estimation; in computing premium reserves. Such approximations or estimates shall be tested periodically to determine their continuing adequacy and reliability.

Contract Reserves

~~34.~~35. General:

a. Contract reserves are required, unless otherwise specified in 34 b. below for:

i. All individual and group contracts with which level premiums are used; or

ii. All individual and group contracts with respect to which, due to the gross premium pricing structure at issue, the value of the future benefits at any time exceeds the value of any appropriate future valuation net premiums at that time. This evaluation may be applied on a rating block basis if the total premiums for the block were developed to support the total risk assumed and expected expenses for the block each year, and a qualified actuary certifies the premium development. The actuary should state in the certification that premiums for the rating block were developed such that each year's premium was intended to cover that year's costs without any prefunding. If the premium is also intended to recover costs for any prior years, the actuary should also disclose the reasons for and magnitude of such recovery. The values specified in this paragraph shall be determined on the basis specified in paragraph 36~~35~~ below.

iii. If rates are determined such that each year's premium is intended to cover that year's cost, the rating block approach results in no contract reserves unless required by paragraph 38~~37~~. If rates are designed to prefund future years' costs, contract reserves will be required.

b. Contracts not requiring a contract reserve are contracts which cannot be continued after one year from issue and contracts already in force on January 1, 2001 for which no contract reserve was required under SSAP No. 54 paragraph 40.

c. The contract reserve is in addition to claim reserves and premium reserves.

d. The methods and procedures for contract reserves shall be consistent with those for claim reserves for any contract, or else appropriate adjustment must be made when necessary to assure provision for the aggregate liability. The definition of the date of incurral must be the same in both determinations.

e. The total contract reserve established shall incorporate provisions for moderately adverse deviations.

~~35.~~36. Minimum Standards for Contract Reserves:

a. Basis:

i. Morbidity or other Contingency. Minimum standards with respect to morbidity are those set forth in Exhibit 1.

(a) Valuation net premiums used under each contract must have a structure consistent with the gross premium structure at issue of the contract as this relates to advancing age of insured, contract duration and period for which gross premiums have been calculated.

(b) Except as provided in paragraph 34~~33~~.a.ii., if for a policy form there is no gross premium variation by age, the valuation net premiums will nonetheless vary based on age at issue for each contract since at issue the present value of valuation net premiums for a contract must equal the present value of tabular claim costs.

(c) Contracts for which tabular morbidity standards are not specified in Exhibit 1 shall be valued using tables established for reserve purposes by a qualified actuary. The morbidity tables shall contain a pattern of incurred claims cost that reflects the underlying morbidity and shall not be constructed for the primary purpose of minimizing reserves.

(d) Effective January 1, 2007, when determining the morbidity assumptions, the actuary shall use assumptions that represent the best estimate of anticipated future experience, but shall not incorporate any expectation of future morbidity improvement. Morbidity improvement is a change, in the combined effect of claim frequency and the present value of future expected claim payments given that a claim has occurred, from the current morbidity tables or experience that will result in a reduction to reserves. It is not the intent of this provision to restrict the ability of the actuary to reflect the morbidity impact for a specific known event that has occurred and that is able to be evaluated and quantified.

(e) Business in force prior to January 1, 2007 may be permitted to retain the original reserve basis, which may not meet the provisions of (d) above.

ii. Interest. The maximum interest rate is specified in Exhibit 1.

iii. Termination rates. Termination rates used in the computation of reserves shall be on the basis of a mortality table as specified in Exhibit 1 except as noted in the following paragraphs.

(a) Under contracts for which premium rates are not guaranteed, and where the effects of insurer underwriting are specifically used by policy duration in the valuation morbidity standard or for return of premium or other deferred cash benefits, total termination rates may be used at ages and durations where these exceed specified mortality table rates, but not in excess of the lesser of:

(1) Eighty percent of the total termination rate used in the calculation of the gross premiums, or

(2) Eight percent.

(b) For long-term care individual policies or group certificates, issued within the period January 1, 2001, to December 31, 2006, the contract reserve may be established on a basis of separate:

(1) Mortality (as specified in Exhibit 1) and

(2) Terminations other than mortality, where the terminations are not to exceed:

a. For policy years one through four (4), the lesser of eighty percent (80%) of the voluntary lapse rate used in the calculation of gross premiums and eight percent (8%);

b. For policy years five (5) and later, the lesser of one hundred percent (100%) of the voluntary lapse rate used in the calculation of gross premiums and four percent (4%).

(c) For long-term care individual policies or group certificates issued on or after January 1, 2007, the contract reserve shall be established on the basis of:

(1) Mortality (as specified in Exhibit 1); and

(2) Terminations other than mortality, where the terminations are not to exceed:

a. For policy year one, the lesser of eighty percent (80%) of the voluntary lapse rate used in the calculation of gross premiums and six percent (6%).

b. For policy years two (2) through four (4), the lesser of eighty percent (80%) of the voluntary lapse rate used in the calculation of gross premiums and four percent (4%).

c. For policy years five (5) and later, the lesser of one hundred percent (100%) of the voluntary lapse rate used in the calculation of gross premiums and two percent (2%), except certificates under policies issued to one or more employers or labor organizations, or to a trust or to the trustees of a fund established by one or more employers or labor organizations, or a combination thereof, for employees or former employees or a combination thereof, or for members or former members or a combination thereof, of a labor organization where the 2% shall be three percent (3%).

(d) Where a morbidity standard specified in Exhibit 1 is on an aggregate basis, such morbidity standard may be adjusted to reflect the effect of insurer underwriting by policy duration. The adjustments must be appropriate to the underwriting.

b. Reserve Method:

i. For insurance except long-term care and return of premium or other deferred cash benefits, the minimum reserve is the reserve calculated on the two-year full preliminary term method; that is, under which the terminal reserve is zero at the first and also the second contract anniversary.

ii. For long-term care insurance, the minimum reserve is the reserve calculated on the one-year full preliminary term method.

iii. (a) For return of premium or other deferred cash benefits, the minimum reserve is the reserve calculated as follows:

(1) On the one year preliminary term method if the benefits are provided at any time before the twentieth anniversary;

(2) On the two year preliminary term method if the benefits are only provided on or after the twentieth anniversary.

(b) The preliminary term method may be applied only in relation to the date of issue of a contract. Reserve adjustments introduced later, as a result of rate increases, revisions in assumptions (e.g., projected inflation rates) or for other reasons, are to be applied immediately as of the effective date of adoption of the adjusted basis.

c. Negative Reserves. Negative reserves on any benefit may be offset against positive reserves for other benefits in the same contract, but the total contract reserve with respect to all benefits combined may not be less than zero.

d. Nonforfeiture Benefits for Long-Term Care Insurance. The contract reserve on a policy basis shall not be less than the net single premium for the nonforfeiture benefits at the appropriate policy duration, where the net single premium is computed according to the above specifications.

~~36.~~37. Alternative Valuation Methods and Assumptions Generally – Provided the contract reserve on all contracts to which an alternative method or basis is applied is not less in the aggregate than the amount determined according to the applicable standards specified above; an insurer may use any reasonable assumptions as to interest rates, termination and/or mortality rates, and rates of morbidity or other contingency. Also, subject to the preceding condition, the insurer may employ methods other than the methods stated above in determining a sound value of its liabilities under such contracts, including but not limited to the following: the net level premium method; the one-year full preliminary term method; prospective valuation on the basis of actual gross premiums with reasonable allowance for future expenses; the use of approximations such as those involving age groupings, groupings of several years of issue, average amounts of indemnity, grouping of similar contract forms; the computation of the reserve for one contract benefit as a percentage of, or by other relation to, the aggregate contract reserves exclusive of the benefit or benefits so valued; and the use of a composite annual claim cost for all or any combination of the benefits included in the contracts valued.

~~37.~~38. Tests For Adequacy and Reasonableness of Contract Reserves:

a. Annually, an appropriate review shall be made of the insurer’s prospective contract liabilities on contracts valued by tabular reserves, to determine the continuing adequacy and reasonableness of the tabular reserves giving consideration to future gross premiums. The insurer shall make appropriate increments to such tabular reserves if such tests indicate that the basis of such reserves is no longer adequate subject, however, to the minimum standards in paragraph 36~~33~~ above.

b. In the event a company has a contract or a group of related similar contracts, for which future gross premiums will be restricted by contract, insurance department regulations, or for other reasons, such that the future gross premiums reduced by expenses for administration, commissions, and taxes will be insufficient to cover future claims, the company shall establish contract reserves for such shortfall in the aggregate.

Reinsurance

~~38.~~39. Increases to, or credits against reserves carried, arising because of reinsurance assumed or reinsurance ceded, must be determined in a manner consistent with these minimum reserve standards and with all applicable provisions of the reinsurance contracts which affect the insurer’s liabilities.

Exhibit 1. Specific Standards For Morbidity, Interest And Mortality

Morbidity

1. Minimum morbidity standards for valuation of specified individual contract health insurance benefits are as follows:

a. Disability Income Benefits Due to Accident or Sickness

i. Contract Reserves:

(a) The 1985 Commissioners Individual Disability Tables A (85CIDA); or

(b) The 1985 Commissioners Individual Disability Tables B (85CIDB).

(c) Each insurer shall elect, with respect to all individual contracts issued in any one statement year, whether it will use Tables A or Tables B as the minimum standard.

ii. Claim Reserves:

(a) For claims incurred on or after January 1, 2002:

The 1985 Commissioners Individual Disability Table A (85CIDA) with claim termination rates multiplied by the following adjustment factors:

Duration	Adjustment Factor	Adjusted Termination Rates*
Week 1	0.366	0.04831
2	0.366	0.04172
3	0.366	0.04063
4	0.366	0.04355
5	0.365	0.04088
6	0.365	0.04271
7	0.365	0.04380
8	0.365	0.04344
9	0.370	0.04292
10	0.370	0.04107
11	0.370	0.03848
12	0.370	0.03478
13	0.370	0.03034
Month 4	0.391	0.08758
5	0.371	0.07346
6	0.435	0.07531
7	0.500	0.07245
8	0.564	0.06655
9	0.613	0.05520
10	0.663	0.04705

Duration	Adjustment Factor	Adjusted Termination Rates*
11	0.712	0.04486
12	0.756	0.04309
13	0.800	0.04080
14	0.844	0.03882
15	0.888	0.03730
16	0.932	0.03448
17	0.976	0.03026
18	1.020	0.02856
19	1.049	0.02518
20	1.078	0.02264
21	1.107	0.02104
22	1.136	0.01932
23	1.165	0.01865
24	1.195	0.01792
Year 3	1.369	0.16839
4	1.204	0.10114
5	1.199	0.07434
6 and later	1.000	**

* The adjusted termination rates derived from the application of the adjustment factors to the DTS Valuation Table termination rates shown in exhibits 3a, 3b, 3c, 4, and 5 (*Transactions of the Society of Actuaries* (TSA) XXXVII, pp. 457-463) is displayed. The adjustment factors for age, elimination period, class, sex, and cause displayed in exhibits 3a, 3b, 3c, and 4 should be applied to the adjusted termination rates shown in this table.

** Applicable DTS Valuation Table duration rate from exhibits 3c and 4 (TSA XXXVII, pp. 462-463).

The 85CIDA table so adjusted for the computation of claim reserves shall be known as 85CIDC (The 1985 Commissioners Individual Disability Table C).

(b) For claims incurred from January 1, 2001, through December 31, 2001:

Each insurer may elect which of the following to use as the minimum standard for claims incurred prior to January 1, 2002:

(i) The minimum morbidity standard in effect for contract reserves on currently issued contracts, as of the date the claim is incurred, or

(ii) The standard as defined in Item (i), applied to all open claims.

(iii) Once an insurer elects to calculate reserves for all open claims on the standard defined in Item (i), all future valuations.

b. Hospital Benefits, Surgical Benefits and Maternity Benefits (Scheduled benefits or fixed time period benefits only)

i. Contract Reserves:

The 1974 Medical Expense Tables, Table A, Transactions of the Society of Actuaries, Volume XXX, pg. 63. Refer to the paper (in the same volume, pg. 9) to which this table is appended, including its discussions, for methods of adjustment for benefits not directly valued in Table A: "Development of the 1974 Medical Expense Benefits," Houghton and Wolf.

ii. Claim Reserves:

No specific standard. See 1.f.

c. Cancer Expense Benefits (Scheduled benefits or fixed time period benefits only)

i. Contract Reserves:

The 1985 NAIC Cancer Claim Cost Tables.

ii. Claim Reserves:

No specific standard. See 1.f.

d. Accidental Death Benefits

i. Contract Reserves:

The 1959 Accidental Death Benefits Table.

ii. Claim Reserves:

Actual amount incurred.

e. Single Premium Credit Disability

i. Contract Reserves:

(a) For contracts issued on or after January 1, 2002:

(i) For plans having less than a thirty-day elimination period, the 1985 Commissioners Individual Disability Table A (85CIDA) with claim incidence rates increased by twelve percent (12%).

(ii) For plans having a thirty-day and greater elimination period, the 85CIDA for a fourteen-day elimination period with the adjustment in Item (i).

(b) For contracts issued prior to January 1, 2002, each insurer may elect either Item (i) or (ii) to use as the minimum standard. Once an insurer elects to calculate reserves for all contracts on the standard defined in Item (a), all future valuations must be on that basis.

(i) The minimum morbidity standard in effect for contract reserves on currently issued contracts, as of the date the contract was issued, or

(ii) The standard as defined in Item (a), applied to all contracts.

ii. Claim Reserves:

Claim reserves are to be determined as provided in paragraph ~~30~~31.

f. Other Individual Contract Benefits

i. Contract Reserves:

For all other individual contract benefits, morbidity assumptions are to be determined as provided in the reserve standards.

ii. Claim Reserves:

For all benefits other than disability, claim reserves are to be determined as provided in the standards.

2. Minimum morbidity standards for valuation of specified group contract health insurance benefits are as follows:

a. Disability Income Benefits Due to Accident or Sickness where the Model references this Exhibit; otherwise, Actuarial Guideline XLVII, as included in the most current version of the NAIC *Accounting Practices and Procedures Manual.*

i. Contract Reserves:

The 1987 Commissioners Group Disability Income Table (87CGDT).

ii. Claim Reserves:

The 1987 Commissioners Group Disability Income Table (87CGDT);

b. Single Premium Credit Disability

i. Contract Reserves:

(a) For contracts issued on or after January 1, 2002:

(i) For plans having less than a thirty-day elimination period, the 1985 Commissioners Individual Disability Table A (85CIDA) with claim incidence rates increased by twelve percent (12%).

(ii) For plans having a thirty-day and greater elimination period, the 85CIDA for a fourteen-day elimination period with the adjustment in item (i).

ii. For contracts issued prior to January 1, 2002, each insurer may elect either Item (a) or (b) to use as the minimum standard. Once an insurer elects to calculate reserves for all contracts on the standard defined in Item (a), all future valuations must be on that basis.

(a) The minimum morbidity standard in effect for contract reserves on currently issued contracts, as of the date the contract was issued, or

(b) The standard as defined in Item (a), applied to all contracts.

iii. Claim Reserves:

Claim reserves are to be determined as provided in paragraph 31~~30~~.

c. Other Group Contract Benefits

i. Contract Reserves:

For all other group contract benefits, morbidity assumptions are to be determined as provided in the reserve standards.

ii. Claim Reserves:

For all benefits other than disability, claim reserves are to be determined as provided in the standards.

Interest

3. For contract reserves the maximum interest rate is the maximum rate allowed by Appendix A-820 in the valuation of whole life insurance issued on the same date as the health insurance contract.

4. For claim reserves on policies that require contract reserves, the maximum interest rate is the maximum rate allowed by Appendix A-820 in the valuation of whole life insurance issued on the same date as the claim incurral date.

5. For claim reserves on policies not requiring contract reserves, the maximum interest rate is the maximum rate allowed by Appendix A-820 in the valuation of single premium immediate annuities issued on the same date as the claim incurral date, reduced by 100 basis points.

Mortality

6. (a) Unless paragraph 7 or 8 applies, the mortality basis used for all policies except long-term care individual policies and group certificates issued before January 1, 2001 shall be according to a table (but without use of selection factors) permitted by law for the valuation of whole life insurance issued on the same date as the health insurance contract.

(b) For long-term care insurance individual policies or group certificates issued from January 1, 2001 through December 31, 2006 the mortality basis used shall be the 1983 Group Annuity Mortality Table without projection. For long-term care insurance individual policies or group certificates issued on or after January 1, 2007 the mortality basis used shall be the 1994 Group Annuity Mortality Static Table.

7. Other mortality tables adopted by the NAIC and promulgated by the commissioner may be used in the calculation of the minimum reserves if appropriate for the type of benefits and if approved by the commissioner. The request for approval shall include the proposed mortality table and the reason that the standard specified in paragraph 6 Subsection A is inappropriate.

8. For single premium credit insurance using the 85 CIDA table, no separate mortality shall be assumed.

Exhibit 2. Reserves for Waiver of Premium (Supplementary explanatory material)

1. Waiver of premium reserves involve several special considerations. First, the disability valuation tables promulgated by the NAIC are based on exposures that include contracts on premium waiver as in-force contracts. Hence, contract reserves based on these tables are NOT reserves on "active lives" but rather reserves on contracts "in force." This is true for the 1964 CDT and for both the 1985 CIDA and CIDB tables.

2. Accordingly, tabular reserves using any of these tables should value reserves on the following basis:

   a. Claim reserves should include reserves for premiums expected to be waived, valuing as a minimum the valuation net premium being waived.

   b. Premium reserves should include contracts on premium waiver as in-force contracts, valuing as a minimum the unearned modal valuation net premium being waived.

   c. Contract reserves should include recognition of the waiver of premium benefit in addition to other contract benefits provided for, valuing as a minimum the valuation net premium to be waived.

If an insurer is, instead, valuing reserves on what is truly an active life table, or if a specific valuation table is not being used but the insurer's gross premiums are calculated on a basis that includes in the projected exposure only those contracts for which premiums are being paid, then it may not be necessary to provide specifically for waiver of premium reserves. Any insurer using such a true "active life" basis should carefully consider, however, whether or not additional liability should be recognized on account of premiums waived during periods of disability or during claim continuation.

Appendix A-200

Separate Accounts Funding Guaranteed Minimum Benefits Under Group Contracts

Scope

1. This appendix applies to a group life insurance contract providing survivor income benefits, a group annuity contract, or a funding agreement if the contract is a group contract that utilizes a separate account and provides guaranteed minimum benefits. This appendix shall not apply to modified guaranteed annuities or modified guaranteed life insurance or variable annuity or variable life insurance subject to appendices A-255, A-588, A-250, and A-270 or equity index products but this appendix shall apply to index contracts as defined in paragraph 18.

Definitions

2. "Account assets" means separate account assets plus any assets held in the general account or a supplemental account to meet the asset maintenance requirements.

3. "Account contracts" means the contracts providing guaranteed minimum benefits or other benefits and funded by a separate account and, if applicable, funded in part by the general account or a supplemental account to meet the asset maintenance requirements.

4. "Actuarial opinion" means the valuation actuary's opinion covering reserves for contract liabilities under account contracts that is required to be submitted to the commissioner.

5. "Actuarial memorandum" means the memorandum of the valuation actuary that supports the actuarial opinion covering reserves for contract liabilities under account contracts.

6. "Appointed actuary" means the qualified actuary appointed or retained either directly by or by the authority of the board of directors through an executive officer of the company to prepare the annual statement of actuarial opinion for the company as a whole.

7. "Asset maintenance requirements" means the requirement to maintain assets to fund contract benefits in accordance with paragraphs 29-39.

8. "Book value contract" means a fixed accumulation contract (GIC), purchased under a retirement plan or plan of deferred compensation, established or maintained by an employer, that does not participate in the investment experience of a separate account, with a fixed interest rate guarantee, including a guarantee based on an external index, and that is supported by a separate account, the plan of operations of which provides that the separate account's assets are valued as if the assets were held in the insurance company's general account.

9. "Class of contracts" means the set of all contracts to which a given plan of operations pertains.

10. "Contract" means a group life insurance policy, group annuity contract, or funding agreement that is within the scope of this appendix as set forth in paragraph 1.

11. "Contract benefits" means the amounts obligated to be paid by the insurance company under an account contract.

12. "Contract liabilities" means the liabilities of the insurance company under account contracts, including liabilities with respect to which guarantees as to amount are provided by the insurance company and liabilities with respect to which guarantees as to amount are not provided by the insurance company.

13. a. "Derivative instrument" means an agreement, option, instrument or a series or combination of them:

i. To make or take delivery of, or assume or relinquish, a specified amount of one or more underlying interests, or to make a cash settlement in lieu thereof; or

ii. That has a price, performance, value or cash flow based primarily upon the actual or expected price, level, performance, value or cash flow of one or more underlying interests.

b. Derivative instruments include options, warrants used in a hedging transaction and not attached to another financial instrument, caps, floors, collars, swaps, forwards, futures and any other agreements, options or substantially similar instruments or any series or combination of them.

14. "Duration" means, with respect to separate account or supplemental account assets or guaranteed contract liabilities, a measure of the price sensitivity of a stream of cash flows to interest rate movements, including, but not limited to, modified duration or option adjusted duration.

15. "General account" means the assets of the insurance company other than separate account and supplemental account assets, and associated reserves.

16. "Guaranteed minimum benefits" means benefits payable under the terms of the contract that are based on either (1) the greater of subparagraph a. or b., or (2) subparagraph c. of this paragraph where:

a. Is that part of the market value of account assets that determines the contractholder's benefits, i.e., to the extent the assets are beneficially "client" assets; provided, that if asset performance does not determine the contractholder's benefit, this subparagraph equals zero;

b. Is a fixed minimum guarantee related to all or part of the considerations received under the contract; and

c. Is an amount based upon a publicly available interest rates series or an index of the aggregate market value of a group of publicly traded financial instruments, either of which is specified in the contract.

17. "Hedging transaction" means a derivative transaction, involving use of one or more derivative instruments, that is entered into and maintained to reduce:

a. The risk of a change in the value, yield, price, cash flow or quantity of assets or liabilities that the insurer has acquired or incurred or anticipates acquiring or incurring; or

b. The currency exchange risk or the degree of exposure as to assets or liabilities that an insurer has acquired or incurred or anticipates acquiring or incurring.

18. "Index contract" means a contract under which contract benefits shall be based upon a publicly available interest rate series or an index of the aggregate market value of a group of publicly traded financial instruments, either of which is specified in the contract, and that does not provide a guarantee of some or all of the consideration received plus earnings at a fixed rate specified in advance and that does not provide any secondary guarantees on elective benefits or maturity values.

19. "Market value separate account" means a separate account in which the separate account assets are valued at their market value.

20. "Nationally Recognized Statistical Rating Organization (NRSRO)" means a rating organization so designated by the Securities and Exchange Commission of the United States of America (SEC) which has applied to, and whose NRSRO status has been confirmed by, the NAIC Securities Valuation Office.

21. "Plan of operations" means a written plan meeting the requirements of paragraph 27.

22. "Qualified actuary" means an individual who is qualified to sign statements of actuarial opinion in accordance with the qualification standards set forth in Appendix A-820.

23. "Spot rate" corresponding to a given time of benefit payment means the yield on a zero-coupon non-callable and non-prepayable United States government obligation maturing at that time, or the zero-coupon yield implied by the price of a representative sampling of coupon-bearing non-callable and non-prepayable United States government obligations in accordance with a formula set forth in the plan of operations. To the extent that guaranteed contract liabilities are denominated in the currency of a foreign country rated in one of the two highest rating categories by an NRSRO and are supported by investments denominated in the currency of the foreign country, the spot rate may be determined by reference to substantially similar obligations of the government of the foreign country.

24. "Supplemental account" means a separate account to which assets may be contributed by the insurance company for the purpose of complying, in whole or in part, with the asset maintenance requirement and with respect to which neither the account contracts nor applicable law shall provide that the assets of the supplemental account are not chargeable with liabilities arising out of any other business of the insurance company.

25. "United States government obligation" means a direct obligation issued, assumed, guaranteed or insured by the United States of America or by an agency or instrumentality of the United States.

26. "Valuation actuary" means the appointed actuary or, alternatively, a qualified actuary designated by the appointed actuary to render the actuarial opinion. Written documentation of any such designation shall be on file at the company and available for review upon request.

Plan of Operations

27. The plan of operations for a class of contracts shall describe the financial implications for the insurer of the issuance of contracts in the class, and shall include at least the following:

a. A description of the class of contracts to which the plan of operations pertains. This should include a description of the products, the markets to which the products will be sold, the benefits that are being offered (including whether those benefits will be paid on a market or book value basis);

b. A statement of the investment policy for the separate account and any supplemental account, including requirements for diversification, maturity, type and quality of assets, and as applicable, target duration for matching guaranteed contract liabilities or the degree to which the investment policy is likely to match the performance of an interest rate series or index on which contract benefits are based;

c. A description of how the value of the separate account assets and any supplemental account is to be determined, including but not limited to, a statement of procedures and rules for valuing securities and other assets that are not publicly traded;

d. A description of how the guaranteed contract liabilities are to be valued, including, if applicable, with respect to guaranteed minimum benefits or other benefits, a description of the methodology for calculating spot rates and the rates proposed to be used to discount guaranteed contract liabilities if higher than the applicable spot rates, but the rate or rates used shall not exceed 105 percent of the spot rate, except that if the expected time of payment of a contract benefit is more than thirty (30) years, it shall be discounted from the expected time of payment to year thirty (30) at a rate of no more than eighty percent (80%) of the thirty-year spot rate and from year thirty (30) to the date of valuation at a rate not greater than 105 percent of the thirty-year spot rate, and shall conservatively reflect expected investment returns (taking into account foreign exchange risks);

e. A statement of how the separate account's operations are designed to provide for payment of contract benefits as they become due, including but not limited to:

  i. A description of the method for estimating the amount and timing of benefit payments;

  ii. The arrangements necessary to provide liquidity to cover contingencies;

  iii. The method to be used to comply with the asset maintenance requirement;

  iv. The manner in which account assets will be allocated between the separate account, any supplemental account, and the general account;

  v. If applicable, the deductions to be used in determining the market value of an asset when determining the asset maintenance requirement when the investment policy of the separate account and any supplemental accounts is not likely to match the performance of an interest rate series or index on which contract benefits are based; and

  vi. For index contracts, the deductions to be used for replicated (synthetic) asset transactions in determining the market value of the separate account.

f. If hedging transactions are to be utilized in managing separate account or any supplemental account assets, a description of the instruments and techniques and an explanation of how they are intended to reduce risk of loss;

g. If the amount of the asset maintenance requirement depends on the separate account, any supplemental account or a subportfolio of either being duration matched, a description of the method used to determine the durations of separate account and any supplemental account assets and guaranteed contract liabilities;

h. If a part of the asset maintenance requirement is to be met by maintaining a reserve liability in the general account, a description of:

  i. The circumstances under which increases and decreases in the general account portion of the reserve liability will be made;

  ii. The circumstances under which transfers will be made between the separate account and the general account; and

  iii. Any arrangements needed to provide sufficient liquidity in the general account to enable the insurance company to make transfers to the separate account when due.

i. A statement as to the extent to which the contracts in the class will provide or applicable law does provide that the separate account assets shall not be chargeable with liabilities arising out of any other business of the insurance company; and

j. If any person other than the insurance company may authorize, approve or review the acquisition and disposition of investments for the separate account or any supplemental account, a statement of the safeguards adopted by the insurance company to assure that the actions to be taken by these persons are appropriate, including a description of the criteria used by the insurance company in selecting the person.

28. Notwithstanding the descriptions in the plan of operations, the insurance company may change the rate used pursuant to paragraph 34 to discount guaranteed contract liabilities and other items applicable to the separate account or any supplemental accounts, such as if the investment portfolio is different from that anticipated by the plan of operations, provided that the rates used shall not exceed the maximum multiples of the spot rates as prescribed in paragraph 27.d.

Asset Maintenance Requirements for Market Value Separate Accounts Supporting Contracts other than Index Contracts

29. At all times an insurer shall hold sufficient assets as a reserve in the general account, the separate account or supplemental accounts, as appropriate, such that the:

a. Market value of the assets held in the separate account, plus

b. The market value of any supplemental account, plus

c. Any assets held in the general account as a reserve for guaranteed contract liabilities, less

d. The deductions provided for in paragraph 30, equals or exceeds the value of guaranteed contract liabilities determined in accordance with paragraph 34.

30. In determining compliance with the asset maintenance requirement and the reserve for guaranteed contract liabilities in accordance with paragraph 29, the insurance company shall deduct a percentage of the market value of the separate account or supplemental account asset or an amount attributable to a replicated (synthetic) asset transaction as follows:

a. For debt instruments, the percentage shall be the NAIC asset valuation reserve "reserve objective factor," but the factor shall be increased fifty percent (50%) for the purpose of this calculation if the difference in durations of the assets and liabilities is more than one-half year;

b. For assets that are not debt instruments, the percentage shall be the NAIC asset valuation reserve "maximum reserve factor"; and

c. For replicated (synthetic) asset transactions, the market value of the separate account or supplemental account assets shall be decreased by an amount equal to the asset valuation reserve for the transaction as if the transaction were occurring in the general account, determined in accordance with SSAP No. 7; but to the extent that the NAIC asset valuation reserve maximum reserve factor was not used in determining the amount of the deduction, the amount of the deduction shall be increased fifty percent (50%) for purposes of this calculation.

31. To the extent that guaranteed contract liabilities are denominated in the currency of a foreign country and are supported by separate account or supplemental account assets denominated in the currency of the foreign country, the percentage deduction for these assets under paragraph 30 shall be that for a substantially similar investment denominated in the currency of the United States.

32. To the extent that guaranteed contract liabilities are denominated in the currency of the United States and are supported by separate account or supplemental account assets denominated in the currency

of a foreign country, and to the extent that guaranteed contract liabilities are denominated in the currency of a foreign country and are supported by separate account or supplemental account assets denominated in the currency of the United States, the deduction for debt instruments and replicated (synthetic) assets transactions under paragraph 30 shall be increased by fifteen percent (15%) of its market value unless the currency exchange risk has been adequately hedged, in which case the percentage deduction under paragraph 30 shall be increased by one-half percent (0.5%). No guaranteed contract liabilities denominated in the currency of a foreign country shall be supported by separate account or supplemental account assets denominated in the currency of another foreign country. For purposes of this paragraph, the currency exchange rate on an asset is deemed to be adequately hedged if:

a. It is an obligation of a jurisdiction that is rated in one of two (2) highest rating categories by an NRSRO or a political subdivision or other governmental unit of the jurisdiction, or is organized under the laws of the jurisdiction; and

b. At all times the principal amount and scheduled interest payments on the principal are hedged against the United States dollar pursuant to contracts or agreements that are:

   i. Issued by or traded on a securities exchange or board of trade regulated under the laws of the United States or Canada or a province of Canada;

   ii. Entered into with a United States banking institution that has assets in excess of $5 billion and that has obligations outstanding, or has a parent corporation that has obligations, that are rated in one of the two (2) highest rating categories by an NRSRO, or with a broker-dealer registered with the Securities and Exchange Commission that has net capital in excess of $250 million; or

   iii. Entered into with any other banking institution that has assets in excess of $5 billion and that has obligations outstanding, or has a parent corporation that has obligations outstanding, that are rated in one of the two (2) highest rating categories by an NRSRO and that is organized under the laws of a jurisdiction that is rated in one of the two (2) highest rating categories by an NRSRO.

33. All or a portion of the amount needed to comply with the asset maintenance requirement may be allocated to one or more supplemental accounts. If the account contract or applicable law provides that the assets in the separate account shall not be chargeable with liabilities arising out of any other business of the insurance company, the insurance company shall maintain in a supplemental account or the general account the amount of any account assets in excess of the sum of (i) the amounts contributed (net of withdrawals) by the contractholder, and (ii) the earnings attributable to the amounts contributed (net of withdrawals) by the contractholder.

34. For purposes of paragraphs 29-34, the minimum value of guaranteed contract liabilities is defined to be the sum of the expected guaranteed contract benefits, each discounted at a rate corresponding to the expected time of payment of the contract benefit that is not greater than the maximum multiple of the spot rate supportable by the expected return from the separate account and any supplemental account assets provided that the rate used shall not exceed the maximum multiples of the spot rates as prescribed in paragraph 27.d. or as described in the actuarial opinion. In calculating the minimum value of contract benefits, all guaranteed contract benefits potentially available to the contractholder shall be considered in the valuation process and analysis, and the reserve held shall be sufficient to fund the greatest present value of each independent guaranteed benefit stream, including guaranteed annuitization options available. To the extent that future cash flows are dependent upon the benefit responsiveness features of an employer-sponsored plan, a best estimate or an estimate based on the insurance company's experience shall be used in the projections of the future cash flows. In addition, the valuation actuary shall periodically review the actual experience under the contract to validate the

assumptions used. In projecting cash flows for contingent benefits involving mortality, the mortality tables for these benefits prescribed in Appendix A-820 shall be used.

Asset Maintenance Requirements for Market Value Separate Accounts Supporting Index Contracts

35. At all times an insurance company shall hold sufficient assets as a reserve in the general account, the separate account or supplemental accounts, as appropriate, such that the:

a. Market value of the assets held in the separate account, plus

b. The market value of any supplemental account, plus

c. Any assets held in the general account as a reserve for guaranteed contract liabilities, less

d. Any deduction provided for in paragraph 36, equals or exceeds the value of guaranteed contract liabilities determined in the manner set forth in the plan of operations.

36. In determining compliance with the asset maintenance requirement and the reserves for guaranteed contract liabilities in accordance with paragraph 35, the insurance company shall deduct a percentage of the market value of a separate account or supplemental account asset as set forth in the plan of operations, and for replication (synthetic asset) transactions, the value of the separate account or supplemental account assets shall be decreased in the manner set forth in the plan of operations.

37. All or a portion of the amount needed to comply with the asset maintenance requirement may be allocated to one or more supplemental accounts. If the account contract or applicable law provides that the assets in the separate account shall not be chargeable with liabilities arising out of any other business of the insurance company, the insurance company shall maintain in a supplemental account or the general account the amount of any account assets in excess of the sum of (i) the amounts contributed (net of withdrawals) by the contractholder, and (ii) the earnings attributable to the amounts contributed (net of withdrawals) by the contractholder.

Asset Maintenance Requirements for Separate Accounts Supporting Book Value Contracts

38. At all times an insurance company shall hold sufficient assets in the general account, the separate account or supplemental accounts, as appropriate, such that the value of the account assets, valued as if the assets were held in the insurance company's general account, equals or exceeds the reserve required for contracts supported by the separate account, determined as if the contracts were held in the general account.

39. All or any portion of the amount needed to comply with the asset maintenance requirement may be allocated to one or more supplemental accounts. If the account contract or applicable law provides that the assets in the separate account shall not be chargeable with liabilities arising out of any other business of the insurance company, the insurance company shall maintain in a supplemental account or the general account the amount of any account assets in excess of the sum of (i) the amounts contributed (net of withdrawals) by the contractholder, and (ii) the earnings attributable to the amounts contributed (net of withdrawals) by the contractholder.

Asset Valuation Reserve

40. When the insurance company values separate account or supplemental account assets at market and complies with the asset maintenance requirements of the section entitled Asset Maintenance Requirements for Market Value Separate Accounts Supporting Contracts other than Index Contracts or the section entitled Asset Maintenance Requirements for Market Value Separate Accounts Supporting Index Contracts, it need not maintain an asset valuation reserve with respect to these assets.

Reserve Valuation and Documentation

41. Reserves for contracts funded by a market value separate account supporting contracts other than index contracts shall be an amount equal to the following:

a. The total reserve required to be maintained on the valuation date under paragraphs 29-34;

b. Plus the excess, if any, of the market value of separate account assets (to the extent that the market value of the assets determines the contractholder's benefits, i.e., to the extent the assets are beneficially "client" assets) over the amount determined in accordance with subparagraph a. above;

c. Plus any additional amount determined by the valuation actuary as necessary to make adequate provision for all of the contract liabilities.

42. Reserves for index contracts funded by a market value separate account shall be an amount equal to the following:

a. The total reserve required to be maintained on the valuation date under paragraphs 35-37;

b. Plus the excess, if any, of the market value of separate account assets (to the extent that the market value of the assets determines the contractholder's benefits, i.e., to the extent the assets are beneficially "client" assets) over the amount determined in accordance with subparagraph a. above;

c. Plus any additional amounts determined by the valuation actuary as necessary to make adequate provision for all of the contract liabilities.

43. Reserves for book value contracts shall be determined as if the contracts were held in the general account.

44. The amount of any reserves required by paragraph 41.c. or paragraph 42.c. may be established by either:

a. Allocating sufficient assets to the separate account or a supplemental account to satisfy the requirement; or

b. Setting up the additional reserves in the general account.

45. Account assets shall make adequate provision for contract liabilities, taking into account any risk charge payable from the separate account assets and the amount of any reserve liability of the general account and amounts held in any supplemental account with respect to the asset maintenance requirement.

46. The level of risk charges, if any, payable to the general account shall be appropriate in view of such factors as the nature of the guaranteed contract liabilities and losses experienced in connection with account contracts and other pricing factors.

47. The fixed-income asset portfolio shall conform to and justify the rates used to discount contract liabilities for valuation pursuant to paragraph 34 if applicable.

48. The company shall document whether any rates used pursuant to paragraph 34 to discount guaranteed contract liabilities and other items applicable to the separate account or any supplemental account were modified from the rate or rates described in the plan of operations.

49. The company shall substantially conform with Appendix A-822 and maintain internal documentation to either:

a. Demonstrate the adequacy of account assets based upon cash flow analysis; or

b. Explain why cash flow analysis is not appropriate, describe the alternative methodology of asset adequacy testing used, and demonstrate the adequacy of account assets under such methodology.

50. The company's internal documentation pertaining to reserves for contract liabilities under account contracts shall also:

a. Clearly describe the assumptions used in projecting cash flows under each class of assets, and any dynamic portfolio hedging techniques utilized and the tests performed on the utilization of the techniques;

b. Clearly describe how the company reflected the risk of default on obligations and mortgage loans, including obligations and mortgage loans that are not investment grade;

c. Clearly describe how the company has reflected withdrawal risks, if applicable, including a discussion of the positioning of the contracts within the benefit withdrawal priority order pertaining to the contracts;

d. If the plan of operations provides for investments in separate account or supplemental account assets other than United States government obligations, demonstrate that the rates used to discount contract liabilities pursuant to paragraph 34 conservatively reflect expected investment returns (taking into account any foreign exchange risks);

e. If the contracts provide that in certain circumstances they would cease to be funded by a separate account and, instead, would become contracts funded by the general account, clearly describe how any increased reserves would be provided for if and to the extent these circumstances occurred;

f. Document the amount of separate account assets that are not chargeable with liabilities arising out of any other business of the insurance company;

g. Document the amount of reserves and supporting assets as of December 31 and where the reserves and assets are shown in the annual statement;

h. Document the amount of any contingency reserve carried as part of surplus;

i. For book value contracts, document the market value of supporting assets; and

j. Where separate account assets are not chargeable with liabilities arising out of any other business of the insurance company, describe how the level of risk charges payable to the general account provider are appropriate compensation for the risk taken by the general account.

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Appendix A-205

Illustrative Disclosure Of Differences Between NAIC Statutory Accounting Practices And Procedures And Accounting Practices Prescribed Or Permitted By The State Of Domicile

XYZ Insurance Company
Footnotes to Financial Statements
December 31, 2002 and 2001

Note 1–Organization

The XYZ Company is a mutual life insurance company domiciled in the state of ABC and licensed to do business in all 50 states. The company markets traditional whole life, term and disability income insurance policies to individuals through its career agency force.

Notes 2–Basis of Presentation

The financial statements of XYZ Company are presented on the basis of accounting practices prescribed or permitted by the ABC Insurance Department.

The ABC Insurance Department recognizes only statutory accounting practices prescribed or permitted by the state of ABC for determining and reporting the financial condition and results of operations of an insurance company, for determining its solvency under the ABC Insurance Law. The National Association of Insurance Commissioners' (the "NAIC") *Accounting Practices and Procedures Manual* version effective January 1, 2001 ("NAIC SAP") has been adopted as a component of prescribed or permitted practices by the state of ABC. The state has adopted certain prescribed accounting practices which differ from those found in NAIC SAP. Specifically, 1) goodwill arising from the purchase of a subsidiary, controlled or affiliated entity is written off directly to surplus in the year it originates by ABC domiciled companies; in NAIC SAP, goodwill in amounts not to exceed 10% of an insurer's capital and surplus may be capitalized and all amounts of goodwill are amortized to unrealized gains and losses on investments over periods not to exceed 10 years, and 2) 100% of all fixed assets may be admitted by ABC domiciled companies; in NAIC SAP, fixed assets are not admitted. The Commissioner of Insurance has the right to permit other specific practices which deviate from prescribed practices.

The Company, with the explicit permission of the Commissioner of Insurance of the state of ABC, records the value of its home office building at fair market value instead of at the depreciated cost method required by NAIC SAP. If the home office building were carried at depreciated cost, home office property and statutory surplus would be decreased by $2,500,000 and $2,300,000 as of December 31, 2002 and 2001, respectively. Additionally, net income would be increased by $120,000 and $103,000 respectively, for the years then ended.

Illustration to use if prescribed or permitted statutory accounting practices (individually or in the aggregate), which differ from the NAIC basis of accounting, prevent the triggering of a regulatory event:

> If the reporting entity had not used the above prescribed and permitted practices that differ from the NAIC basis of accounting a risk based capital regulatory event would have been triggered. The company would have moved to a risk based capital company action level and the total adjusted capital would have been decreased by $300,000.

Illustration to use if prescribed or permitted practices statutory accounting practices, which differ from the NAIC basis of accounting, have no impact on regulatory events:

If the reporting entity has not used the above prescribed and permitted practices that differ from the NAIC basis of accounting a risk based capital regulatory event would not have been triggered. The impact on net income and capital is shown in the following paragraphs.

A reconciliation of the Company's net income and capital and surplus between NAIC SAP and practices prescribed and permitted by the state of ABC is shown below.

	2002	**2001**
Net Income, ABC state basis	$3,200,000	$2,900,000
State Prescribed Practices:		
Depreciation of fixed assets	100,000	110,000
State Permitted Practices:		
Depreciation, home office property	120,000	103,000
Net Income, NAIC SAP	$3,420,000	$3,113,000
Statutory Surplus, ABC state basis	$30,000,000	$27,900,000
State Prescribed Practices:		
Goodwill, net	3,000,000	2,700,000
Fixed Assets, net	(850,000)	(950,000)
State Permitted Practices:		
Home Office Property	(2,500,000)	(2,300,000)
Statutory Surplus, NAIC SAP	$29,650,000	$27,350,000

Appendix A-225

Managing General Agents

Definitions

1. “Managing General Agent” (MGA) means any person, firm, association or corporation who:

   a. Manages all or part of the insurance business of an insurer (including the management of a separate division, department or underwriting office); and

   b. Acts as an agent for such insurer whether known as a Managing General Agent, manager or other similar term, who, with or without the authority, either separately or together with affiliates, produces, directly or indirectly, and underwrites an amount of gross direct written premium equal to or more than five percent (5%) of the policyholder surplus as reported in the last annual statement of the insurer in any one quarter or year together with one or more of the following activities related to the business produced:

      i. Adjusts or pays claims in a material amount;

      ii. Negotiates reinsurance on behalf of the insurer.

   c. Notwithstanding the above, the following persons shall not be considered MGA’s for the purposes of this Appendix:

      i. An employee of the insurer;

      ii. A U.S. Manager of the United States branch of an alien insurer;

      iii. An underwriting manager which, pursuant to contract, manages all or part of the insurance operations of the insurer, is under common control with the insurer, subject to a regulatory holding company act, if any, and whose compensation is not based on the volume of premiums written;

      iv. The attorney-in-fact authorized by and acting for the subscribers of a reciprocal insurer or inter-insurance exchange under powers of attorney.

2. “Underwrite” means the authority to accept or reject risk on behalf of the insurer.

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Appendix A-235

Interest-Indexed Annuity Contracts

Definition

1. “Interest-indexed annuity contract” means any annuity contract where the interest credits are linked to an external reference.

Valuation Requirements

2. In developing life insurance reserves for interest-indexed annuity contracts, the insurer must be in compliance with the minimum requirements of Appendix A-820.

3. In the calculation of reserves for interest-indexed annuity contracts, future guarantees will be determined by assuming that future interest crediting rates will be equal to the statutory valuation interest rate for such contracts as defined in Appendix A-820.

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Appendix A-250

Variable Annuities

Definitions

1. “Variable annuity” means a policy or contract, individual or group, that provides for annuity benefits that vary according to the investment experience of a separate account or accounts maintained by the insurer as to the policy or contract.

2. The company shall maintain in each such separate account assets with a value at least equal to the reserves and other contract liabilities with respect to the account.

3. The reserve liability for variable annuities shall be established pursuant to the requirements of Appendix A-820 in accordance with actuarial procedures that recognize the variable nature of the benefits provided and any mortality guarantees.

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Appendix A-255

Modified Guaranteed Annuities

Definitions

1. A "Modified Guaranteed Annuity" is a deferred annuity contract, individual or group, the underlying assets of which are held in a separate account, and the values of which are guaranteed if held for specified periods. The contract contains nonforfeiture values that are based upon a market-value adjustment formula if held for shorter periods. This formula may or may not reflect the value of assets held in the separate account. The assets underlying the contract must be in a separate account during the period or periods when the contract holder can surrender the contract.

2. "Interest credits" means all interest that is credited to the contract.

3. "Separate account" means a separate account established pursuant to the insurance laws pertaining to the insurer.

Valuation Requirements

4. Reserve liabilities for modified guaranteed annuities shall be established as provided in Appendix A-820 in accordance with actuarial procedures that recognize:

    a. That assets of the separate account are based on market values;

    b. The variable nature of benefits provided; and

    c. Any mortality guarantees.

5. As a minimum, the separate account liability will equal the surrender value based upon the market-value adjustment formula contained in the contract. If that liability is greater than the market value of the assets, a transfer of assets will be made into the separate account so that the market value of the assets at least equals that of the liabilities. Any additional reserve that is needed to cover future guaranteed benefits shall be established.

6. The market-value adjustment formula, the interest guarantees, and the degree to which projected cash flow of assets and liabilities are matched must also be considered. The company shall determine whether the assets in the separate account are adequate to provide all future benefits that are guaranteed.

Separate Accounts

7. The insurer shall maintain in each separate account assets with a value at least equal to the valuation reserves and other contract liabilities respecting such account.

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Appendix A-270

Variable Life Insurance

Definitions

1. “Variable life insurance policy” means an individual or group policy that provides for life insurance the amount or duration of which varies according to the investment experience of any separate account or accounts established and maintained by the insurer as to the policy.

2. “Affiliate” of an insurer means a person, directly or indirectly, controlling, controlled by, or under common control with the insurer; a person who regularly furnishes investment advice to the insurer with respect to its separate accounts for which a specific fee or commission is charged; or any director, officer, partner or employee of the insurer, controlling or controlled person, or person providing investment advice or any member of the immediate family of such person.

3. “Assumed investment rate” means the rate of investment return that would be required to be credited to a variable life insurance policy, after deduction of charges for taxes, investment expenses and mortality and expense guarantees to maintain the variable death benefit equal at all times to the amount of death benefit, other than incidental insurance benefits, which would be payable under the plan of insurance if the death benefit did not vary according to the investment experience of the separate account.

4. “Benefit base” means the amount to which the net investment return is applied.

5. “Control” (including the terms “controlling,” “controlled by” and “under common control with”) means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract other than a commercial contract for goods or non-management services, or otherwise, unless the power is the result of an official position with or corporate office held by the person. Control shall be presumed to exist if a person, directly or indirectly, owns, controls, holds with the power to vote, or holds proxies representing more than ten percent (10%) of the voting securities of any other person. This presumption can be overcome by predominant evidence to the contrary, however, it shall stand until overcome by such predominant contradictory evidence.

6. “Flexible premium policy” means any variable life insurance policy other than a “scheduled premium policy” as defined in paragraph 13.

7. “General account” means all assets of the insurer other than assets in separate accounts.

8. “Incidental insurance benefit” means all insurance benefits in a variable life insurance policy, other than the variable death benefit and the minimum death benefit, including but not limited to, accidental death and dismemberment benefits, disability benefits, guaranteed insurability options, family income or term riders.

9. “Minimum death benefit” means the amount of the guaranteed death benefit, other than incidental insurance benefits, payable under a variable life insurance policy regardless of the investment performance of the separate account.

10. “Net investment return” means the rate of investment return in a separate account to be applied to the benefit base.

11. “Person” means an individual, corporation, partnership, association, trust or fund.

12. “Policy processing day” means the day on which charges authorized in the policy are deducted from the policy’s cash value.

13. “Scheduled premium policy” means a variable life insurance policy under which both the amount and timing of premium payments are fixed by the insurer.

14. “Variable death benefit” means the amount of the death benefit, other than incidental insurance benefits, payable under a variable life insurance policy dependent on the investment performance of the separate account, which the insurer would have to pay in the absence of any minimum death benefit.

Valuation Requirements

15. Reserve liabilities for variable life insurance policies shall be established as provided in Appendix A-820 in accordance with actuarial procedures that recognize the variable nature of the benefits provided and any mortality guarantees.

16. Reserve liabilities for the guaranteed minimum death benefit shall be the reserve needed to provide for the contingency of death occurring when the guaranteed minimum death benefit exceeds the death benefit that would be paid in the absence of the guarantee, and shall be maintained in the general account of the insurer and shall not be less than the greater of the following minimum reserves:

a. The aggregate total of the term costs, if any, covering a period of one full year from the valuation date or, if less, covering the period provided for in the guarantee not otherwise provided for by the reserves held in the separate account, on each variable life insurance contract, assuming an immediate one-third depreciation in the current value of the assets in the separate account followed by a net investment return equal to the assumed investment rate; or

b. The aggregate total of the “attained age level” reserves on each variable life insurance contract. The “attained age level” reserve on each variable life insurance contract shall not be less than zero and shall equal the “residue,” as described in paragraph 16.b.i. below, of the prior year’s “attained age level” reserve on the contract, with any such “residue,” increased or decreased by a payment computed on an attained age basis as described in paragraph 16.b.ii. below.

i. The “residue” of the prior year’s “attained age level” reserve on each variable life insurance contract shall not be less than zero and shall be determined by adding interest at the valuation interest rate to the prior year’s reserve, deducting the tabular claims based on the “excess,” if any, of the guaranteed minimum death benefit over the death benefit that would be payable in the absence of a guarantee, and dividing the net result by the tabular probability of survival. The “excess” referred to in the preceding sentence shall be based on the actual level of death benefits that would have been in effect during the preceding year in the absence of the guarantee, taking appropriate account of the reserve assumptions regarding the distribution of death claim payments over the year.

ii. The payment referred to in this paragraph shall be computed so that the present value of a level payment of that amount each year over the future period for which charges for this risk will be collected under the contract, is equal to (A) minus (B) minus (C), where (A) is the present value of the future guaranteed minimum death benefits, (B) is the present value of the future death benefits that would be payable in the absence of such guarantee, and (C) is any “residue,” as described in paragraph 16.b.i. of the prior year’s “attained age level” reserve on such variable life insurance contract. This result shall be divided by the present value, at the valuation date, of a temporary life annuity of one per annum at the current attained age payable over the period in which future charges for this risk will be collected under the contract. If no future charges for this risk will be collected under the contract, the payment shall equal (A) minus (B) minus (C). The amounts of the future death benefits referred to in (B) shall be computed assuming a net investment return of the separate account which may differ from the assumed investment rate or the valuation interest but in no event may exceed the maximum interest rate permitted for the valuation of life contracts.

c. The valuation interest rate and mortality table used in computing the two minimum reserves described in 16 a. and 16 b. above shall conform to acceptable standards for the valuation of life insurance contracts. In determining the minimum reserves, the company may employ suitable approximations and estimates, including but not limited to groupings and averages.

17. Incidental Insurance Benefit. Reserve liabilities for all fixed incidental insurance benefits and any guarantees associated with variable accidental insurance benefits shall be maintained in the general account and reserve liabilities for all variable aspects of the variable incidental insurance benefits shall be maintained in a separate account, in amounts determined in accordance with the actuarial procedures appropriate to the benefit.

Separate Accounts

18. The assets of separate accounts shall be valued at least as often as variable benefits are determined but in any event at least monthly.

19. The insurer shall maintain in each separate account assets with a value at least equal to the valuation reserves and other contract liabilities respecting such account.

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Appendix A-440

Insurance Holding Companies

Definitions

1. “Affiliate.” An “affiliate” of, or person “affiliated” with, a specific person, is a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified.

2. “Control.” The term “control” (including the terms “controlling,” “controlled by” and “under common control with”) means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract other than a commercial contract for goods or nonmanagement services, or otherwise, unless the power is the result of an official position with or corporate office held by the person. Control shall be presumed to exist if any person, directly or indirectly, owns, controls, holds with the power to vote, or holds proxies representing, ten percent (10%) or more of the voting securities of any other person. This presumption can be overcome by predominant evidence to the contrary, however, it shall stand until overcome by such predominant contradictory evidence.

3. “Insurance Holding Company System.” An “insurance holding company system” consists of two (2) or more affiliated persons, one or more of which is an insurer.

4. “Person.” A “person” is an individual, a corporation, a limited liability company, a partnership, an association, a joint stock company, a trust, an unincorporated organization, any similar entity or any combination of the foregoing acting in concert, but shall not include any joint venture partnership exclusively engaged in owning, managing, leasing or developing real or tangible personal property.

5. “Securityholder.” A “securityholder” of a specified person is one who owns any security of such person, including common stock, preferred stock, debt obligations and any other security convertible into or evidencing the right to acquire any of the foregoing.

6. “Subsidiary.” A “subsidiary” of a specified person is an affiliate controlled by such person directly or indirectly through one or more intermediaries.

7. “Voting Security.” The term “voting security” shall include any security convertible into or evidencing a right to acquire a voting security.

Standards and Management of an Insurer Within a Holding Company System

8. Transactions Within a Holding Company System

9. Transactions within a holding company system to which an insurer subject to registration is a party shall be subject to the following standards:

   a. The terms shall be fair and reasonable;

   b. Charges or fees for services performed shall be reasonable;

   c. Expenses incurred and payment received shall be allocated to the insurer in conformity with statutory accounting practices consistently applied;

   d. The books, accounts and records of each party to all such transactions shall be so maintained as to clearly and accurately disclose the nature and details of the transactions including such accounting information as is necessary to support the reasonableness of the charges or fees to the respective parties; and

e. The insurer's surplus as regards policyholders following any dividends or distributions to shareholder affiliates shall be reasonable in relation to the insurer's outstanding liabilities and adequate to meet its financial needs. In determining whether an insurer's surplus as regards policyholders is reasonable in relation to the insurer's outstanding liabilities and adequate to meet its financial needs, the following factors, among others, shall be considered:

i. The size of the insurer as measured by its assets, capital and surplus, reserves, premium writings, insurance in force and other appropriate criteria;

ii. The extent to which the insurer's business is diversified among several lines of insurance;

iii. The number and size of risks insured in each line of business;

iv. The extent of the geographical dispersion of the insurer's insured risks;

v. The nature and extent of the insurer's reinsurance program;

vi. The quality, diversification and liquidity of the insurer's investment portfolio;

vii. The recent past and projected future trend in the size of the insurer's investment portfolio;

viii. The surplus as regards policyholders maintained by other comparable insurers;

ix. The adequacy of the insurer's reserves; and

x. The quality and liquidity of investments in affiliates.

Appendix A-585

Universal Life Insurance

Definitions

1. “Cash surrender value” means the net cash surrender value plus any amounts outstanding as policy loans.

2. “Fixed premium universal life insurance policy” means a universal life insurance policy other than a flexible premium universal life insurance policy.

3. “Flexible premium universal life insurance policy” means a universal life insurance policy which permits the policyowner to vary, independently of each other, the amount or timing of one or more premium payments or the amount of insurance.

4. “Interest-indexed universal life insurance policy” means any universal life insurance policy where the interest credits are linked to an external referent.

5. “Net cash surrender value” means the maximum amount payable to the policyowner upon surrender.

6. “Policy value” means the amount to which separately identified interest credits and mortality, expense, or other charges are made under a universal life insurance policy.

7. “Universal life insurance policy” means a life insurance policy where separately identified interest credits (other than in connection with dividend accumulations, premium deposit funds, or other supplementary accounts) and mortality and expense charges are made to the policy. A universal life insurance policy may provide for other credits and charges, such as charges for the cost of benefits provided by rider.

Valuation Requirements

8. The minimum valuation standard for universal life insurance policies shall be the Commissioners Reserve Valuation Method, as described below for such policies, and the tables and interest rates specified below. The terminal reserve for the basic policy and any benefits and/or riders for which premiums are not paid separately as of any policy anniversary shall be equal to the net level premium reserves less (C) and less (D), where:

a. Reserves by the net level premium method shall be equal to ((A)-(B))r where (A), (B) and “r” are as defined below:

i. (A) is the present value of all future guaranteed benefits at the date of valuation.

ii. (B) is the quantity $\frac{\text{PVFB}}{\ddot{a}x}$ äx+t where PVFB is the present value of all benefits guaranteed at issue assuming future guaranteed maturity premiums are paid by the policyowner and taking into account all guarantees contained in the policy or declared by the insurer.

b. äx and äx+t are present values of an annuity of one per year payable on policy anniversaries beginning at ages x and x+t, respectively, and continuing until the highest attained age at which a premium may be paid under the policy. The letter "x" is defined as the issue age and the letter "t" is defined as the duration of the policy.

c. The guaranteed maturity premium for flexible premium universal life insurance policies shall be that level gross premium, paid at issue and periodically thereafter over the period during which premiums are allowed to be paid, which will mature the policy on the latest maturity date, if any, permitted under the policy (otherwise at the highest age in the valuation mortality table), for an amount which is in accordance with the policy structure.[1] The guaranteed maturity premium is calculated at issue based on all policy guarantees at issue (excluding guarantees linked to an external referent). The guaranteed maturity premium for fixed premium universal life insurance policies shall be the premium defined in the policy which at issue provides the minimum policy guarantees.[2]

d. The letter "r" is equal to one, unless the policy is a flexible premium policy and the policy value is less than the guaranteed maturity fund, in which case "r" is the ratio of the policy value to the guaranteed maturity fund.

e. The guaranteed maturity fund at any duration is that amount which, together with future guaranteed maturity premiums, will mature the policy based on all policy guarantees at issue.

f. (C) is the quantity $((a)-(b))\frac{\ddot{a}_{x+t}}{\ddot{a}_{x}}\,r$ where (a)-(b) is as described in paragraph 9 of

Appendix A-820 for the plan of insurance defined at issue by the guaranteed maturity premiums and all guarantees contained in the policy or declared by the insurer.

g. (D) is the sum of any additional quantities analogous to (C) which arise because of structural changes[3] in the policy, with each such quantity being determined on a basis consistent with that of (C) using the maturity date in effect at the time of the change.

h. The guaranteed maturity premium, the guaranteed maturity fund and (B) above shall be recalculated to reflect any structural changes in the policy. This recalculation shall be done in a manner consistent with the descriptions above.

i. Future guaranteed benefits are determined by (1) projecting the greater of the guaranteed maturity fund and the policy value, taking into account future guaranteed maturity premiums, if any, and using all guarantees of interest, mortality, expense deductions, etc., contained in the policy or declared by the insurer; and (2) taking into account any benefits guaranteed in the policy or by declaration which do not depend on the policy value.

j. All present values shall be determined using (i) an interest rate (or rates) specified by Appendix A-820 for policies issued in the same year; (ii) the mortality rates specified by Appendix A-820 for policies issued in the same year; and (iii) any other tables needed to value supplementary benefits provided by a rider which is being valued together with the policy.

9. To the extent that the insurer declares guarantees more favorable than those in the policy (contractual guarantees), such declared guarantees shall be applicable to the determination of future guaranteed benefits.

10. The mortality and interest bases for calculating present values are the minimum standards in Appendix A-820.

11. In effecting structural changes, consistent methods are prescribed when calculating reserves. Several such methods are possible, but perhaps the simplest such method would be that of maintaining proportionality between the Guaranteed Maturity Fund and Guaranteed Maturity Premium values and the current face amount. In applying this method, Guaranteed Maturity Fund and Guaranteed Maturity Premium values could be calculated per dollar of face amount and simply multiplied by the new face amount. This would eliminate much of the complexity involved in other methods.

Alternative Minimum Reserves

12. If, in any policy year, the guaranteed maturity premium on any universal life insurance policy is less than the valuation net premium for such policy, calculated by the valuation method actually used in calculating the reserve thereon but using the minimum valuation standards of mortality and rate of interest, the minimum reserve required for such contract shall be the greater of a. or b.

a. The reserve calculated according to the method, the mortality table, and the rate of interest actually used.

b. The reserve calculated according to the method actually used but using the minimum valuation standards of mortality and rate of interest and replacing the valuation net premium by the Guaranteed Maturity Premium in each policy year for which the valuation net premium exceeds the Guaranteed Maturity Premium.

13. For universal life insurance reserves on a net level premium basis, the valuation net premium is:

$$\frac{\text{PVFB}}{\ddot{a}x}$$

and for reserves on a Commissioners Reserve Valuation Method, the valuation net premium is:

$$\frac{\text{PVFB}}{\ddot{a}x} + \frac{\text{(a)-(b)}}{\ddot{a}x}$$

Footnotes:

1. The maturity amount shall be the initial death benefit where the death benefit is level over the lifetime of the policy except for the existence of a minimum-death-benefit corridor, or shall be the specified amount where the death benefit equals a specified amount plus the policy value or cash surrender value except for the existence of a minimum-death-benefit corridor.

2. The Guaranteed Maturity Premium for both flexible and fixed premium policies shall be adjusted for death benefit corridors provided by the policy. The Guaranteed Maturity Premium may be less than the premium necessary to pay all charges. This can especially happen in the first year for policies with large first year expense charges.

3. Structural changes are those changes which are separate from the automatic workings of the policy. Such changes usually would be initiated by the policyholder and include changes in the guaranteed benefits, changes in latest maturity date, or changes in allowable premium payment period. For fixed premium universal life policies with redetermination of all credits and charges no more frequently than annually, on policy anniversaries, structural changes also include changes in guaranteed benefits, or in fixed premiums, unanticipated by the guaranteed maturity premium for such policies at the date of issue, even if such changes arise from automatic workings of the policy. The recomputation of (B) in paragraph 8.a.ii. above, for fixed premium universal life structural changes, shall exclude from PVFB, the present value of future guaranteed benefits, those guaranteed benefits which are funded by the excess of the insurer's declared guarantees of interest, mortality and expenses, over the guarantees contained in the policy at the date of issue.

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Appendix A-588

Modified Guaranteed Life Insurance

The NAIC no longer maintains Model Law 588 as an NAIC sponsored model law; however, as this appendix is referenced in *SSAP No. 56—Separate Accounts,* the Statutory Accounting Principles (E) Working Group has chosen to retain this appendix as a valid NAIC standard.

Definitions

1. “Interest Credits” means all interest that is credited to the policy.

2. “Modified Guaranteed Life Insurance Policy” means an individual or group policy of life insurance, the underlying assets which are held in a separate account, and the values of which are guaranteed if held for specified periods. It contains cash-surrender values that are based upon a market value adjustment formula if held for shorter periods. The formula may, or may not, reflect the value of assets held in the separate account. The assets underlying the policy must be in a separate account during the period or periods when the policyholder can surrender the policy.

3. “Policy processing day” means the day on which charges authorized in the policy are deducted from the policy’s cash value.

4. “Separate account” means a separate account established pursuant to the insurance laws pertaining to the insurer.

Valuation Requirements

5. Reserve liabilities for modified guaranteed life insurance policies shall be established pursuant to the requirements of Appendix A-820 in accordance with actuarial procedures that recognize:

   a. That assets of the separate account are based on market value;

   b. The variable nature of the benefits provided; and

   c. Any mortality guarantees.

6. As a minimum, the separate account liability will equal the surrender value based upon the market value adjustment formula contained in the policy. If that liability is greater than the market value of the assets, a transfer of assets will be made into the separate account so that the market value of the assets at least equals that of the liabilities. Any additional reserve that is needed to cover future guaranteed benefits shall be established.

7. The market value adjustment formula, the interest guarantees and the degree to which projected cash flow of assets and liabilities are matched must also be considered. The company shall determine whether the assets in the separate account are adequate to provide all future guaranteed benefits.

8. Reserve liabilities for all fixed incidental insurance benefits and any guarantees associated with variable incidental insurance benefits shall be maintained in the general account.

Separate Accounts

9. The insurer shall maintain in each separate account assets with a value at least equal to the valuation reserves and other contract liabilities respecting such account.

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Appendix A-620

Accelerated Benefits

Purpose

The purpose of this Appendix is to provide guidance with respect to accelerated benefit related to individual and group life insurance policies. This Appendix shall apply to all accelerated benefits provisions of individual and group life insurance policies except those subject to Appendix A-641.

Definitions

1. “Accelerated benefits” covered under this Appendix are benefits payable under a life insurance contract:

   a. To a policyowner or certificateholder, during the lifetime of the insured, in anticipation of death or upon the occurrence of specified life-threatening or catastrophic conditions as defined by the policy or rider; and

   b. Which reduce the death benefit otherwise payable under the life insurance contract; and

   c. Which are payable upon the occurrence of a single qualifying event which results in the payment of a benefit amount fixed at the time of acceleration.

2. “Qualifying event” shall mean one or more of the following:

   d. A medical condition which would result in a drastically limited life span as specified in the contract, for example, twenty-four (24) months or less; or

   e. A medical condition which has required or requires extraordinary medical intervention, such as, but not limited to, major organ transplant or continuous artificial life support, without which the insured would die; or

   f. Any condition which usually requires continuous confinement in an eligible institution as defined in the contract if the insured is expected to remain there for the rest of his or her life; or

   g. A medical condition which would, in the absence of extensive or extraordinary medical treatment, result in a drastically limited life span. Such conditions may include, but are not limited to, one or more of the following:

      i. Coronary artery disease resulting in an acute infarction or requiring surgery;

      ii. Permanent neurological deficit resulting from cerebral vascular accident;

      iii. End stage renal failure; or

      iv. Acquired Immune Deficiency Syndrome.

Valuation Requirements

3. When benefits are provided through the acceleration of benefits under group or individual life policies or riders to such policies, policy reserves shall be determined in accordance with Appendix A-820. Mortality tables and interest for life insurance reserves as specified in Appendix A-820

shall be used as well as appropriate assumptions for the other provisions incorporated in the policy form. Reserves in the aggregate should be sufficient to cover:

a. Policies upon which no claim has yet arisen.

b. Policies upon which an accelerated claim has arisen.

4. For policies and certificates which provide actuarially equivalent benefits, no additional reserves need to be established.

5. Policy liens and policy loans, including accrued interest, represent assets of the company for statutory reporting purposes. For any policy on which the policy lien exceeds the policy's statutory reserve liability such excess must be held as a nonadmitted asset.

Appendix A-628

Title Insurance

Definitions

1. “Abstract of title” or “abstract” means a written history, synopsis or summary of the recorded instruments affecting the title to real property.

2. “Affiliate” means a specific person that directly, or indirectly through one or more intermediaries, controls, or is controlled by or is under common control with the person specified.

3. “Bona fide employee” of the title insurer or title insurance agent means an individual who devotes substantially all of his or her time to performing services on behalf of a title insurer or title insurance agent and whose compensation for those services is in the form of salary or its equivalent paid by the title insurer or title insurance agent.

4. “Control” (including the terms “controlling,” “controlled by” and “under common control with”) means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract other than a commercial contract for goods or nonmanagement services, or otherwise, unless the power is the result of an official position or corporate office held by the person. Control shall be presumed to exist if a person, directly or indirectly, owns, controls, holds with the power to vote, or holds proxies representing, ten percent (10%) or more of the voting securities of another person. This presumption can be overcome by predominant evidence to the contrary; however, it shall stand until overcome by such predominant contradictory evidence.

5. “Escrow” means written instruments, money or other items deposited by one party with a depository, escrow agent or escrowee for delivery to another party upon the performance of a specified condition or the happening of a certain event.

6. “Escrow, settlement or closing fee” means the consideration for supervising or handling the actual execution, delivery or recording of transfer and lien documents and for disbursing funds.

7. “Net retained liability” means the total liability retained by a title insurer for a single risk, after taking into account any ceded liability and collateral, acceptable to the commissioner, maintained by the insurer.

8. “Person” means any natural person, partnership, association, cooperative, corporation, trust or other legal entity.

9. “Security” or “security deposit” means funds or other property received by the title insurer as collateral to secure an indemnitor’s obligation under an indemnity agreement pursuant to which the insurer is granted a perfected security interest in the collateral in exchange for agreeing to provide coverage in a title insurance policy for a specific title exception to coverage.

10. “Title insurance agent” or “agent” means an authorized person, other than a bona fide employee of the title insurer who, on behalf of the title insurer, performs the following acts, in conjunction with the issuance of a title insurance report or policy:

   a. Determines insurability and issues title insurance reports or policies, or both, based upon the performance or review of a search or abstract of title; and

   b. Performs one or more of the following functions:

i. Collects or disburses premiums, escrow or security deposits or other funds;

ii. Handles escrows, settlements or closings;

iii. Solicits or negotiates title insurance business; or

iv. Records closing documents.

11. "Title insurance business" or "business of title insurance" means:

a. Issuing as insurer or offering to issue as insurer a title insurance policy;

b. Transacting or proposing to transact by a title insurer any of the following activities when conducted or performed in contemplation of or in conjunction with the issuance of a title insurance policy:

i. Soliciting or negotiating the issuance of a title insurance policy;

ii. Guaranteeing, warranting or otherwise insuring the correctness of title searches for all instruments affecting titles to real property, any interest in real property, cooperative units and proprietary leases and for all liens or charges affecting the same;

iii. Handling of escrows, settlements or closings;

iv. Executing title insurance policies;

v. Effecting contracts of reinsurance; or

vi. Abstracting, searching or examining titles;

c. Guaranteeing, warranting or insuring searches or examinations of title to real property or any interest in real property; or

d. Guaranteeing or warranting the status of title as to ownership of or liens on real property and personal property by any person other than the principals to the transaction; or

e. Doing or proposing to do any business substantially equivalent to any of the activities listed in this paragraph in a manner designed to evade the provisions of this Appendix.

12. "Title insurance policy" or "policy" means a contract insuring or indemnifying owners of, or other persons lawfully interested in, real or personal property or any interest in real property, against loss or damage arising from any or all of the following conditions existing on or before the policy date and not excepted or excluded:

a. Defects in or liens or encumbrances on the insured title;

b. Unmarketability of the insured title;

c. Invalidity, lack of priority or unenforceability of liens or encumbrances on the stated property;

d. Lack of legal right of access to the land; or

e. Unenforceability of rights in title to the land.

13. "Title insurance report" or "report" means a preliminary report, commitment or binder issued prior to the issuance of a title insurance policy containing the terms, conditions, exceptions and any other matters incorporated by reference under which the title insurer is willing to issue its title insurance policy.

14. "Title insurer" or "insurer" means a company organized for the purpose of transacting the business of title insurance.

15. "Title plant" means a set of records consisting of documents, maps, surveys or entries affecting title to real property or any interest in or encumbrance on the property, which have been filed or recorded in the jurisdiction for which the title plant is established or maintained.

Admitted Asset Standards

16. An investment in a title plant or plants in an amount equal to the actual cost shall be allowed as an admitted asset for title insurers. The aggregate amount of the investment shall not exceed the lesser of twenty percent (20%) of admitted assets or forty percent (40%) of surplus to policyholders, both as required to be shown on the statutory balance sheet of the insurer for its most recently filed statement with the domiciliary state commissioner; if the amount of the investment exceeds the above limits, the excess amount shall be recorded as a nonadmitted asset.

Reserves

17. A title insurer shall establish and maintain:

a. A known claim reserve in an amount estimated to be sufficient to cover all unpaid losses, claims and allocated loss adjustment expenses arising under title insurance policies, guaranteed certificates of title, guaranteed searches and guaranteed abstracts of title, and all unpaid losses, claims and allocated loss adjustment expenses for which the title insurer may be liable, and for which the insurer has received notice by or on behalf of the insured, holder of a guarantee or escrow or security depositor.

b. A Statutory or Unearned Premium Reserve consisting of:

i. The amount of the statutory or unearned premium or reinsurance reserve legally held at December 31, 2000. The balance of this reserve shall be released in accordance with the state laws in effect prior to January 1, 2001; and

ii. For those title insurance policies and guarantees written after January 1, 2001, reserves shall be established that are equal to the sum of the following items, as set forth in the title insurer's most recent annual statement:

(a) For each title insurance policy on a single risk written or assumed, an amount, as determined by the insurer's state of domicile, per $1,000 of net retained liability for policies under $500,000 and for policies of $500,000 or greater, or any other reasonable method as required by the insurer's state of domicile; and

(b) An amount as determined by the insurer's state of domicile for the escrow, settlement and closing fees collected in contemplation of the issuance of title insurance policies or guarantees.

iii. The aggregate of the amounts set aside in this reserve in any calendar year pursuant to subparagraph b.ii. shall be released from the reserve and restored to net profits over a period of twenty (20) years pursuant to the following formula: thirty-five percent (35%) of the aggregate sum on July 1 of the year next succeeding the year of addition; fifteen percent (15%) of the aggregate sum on July 1 of each of the succeeding two (2) years; ten percent (10%) of the aggregate sum on July 1 of the next succeeding year; three percent (3%) of the aggregate sum on July 1 of each of the next three (3) succeeding years; two percent (2%) of the aggregate sum on July 1 of each of the next three (3) succeeding years; and one percent (1%) of the aggregate sum on July 1 of each of the next succeeding ten (10) years.

iv. The insurer shall calculate a retroactive adjusted statutory or unearned premium reserve on an aggregate basis at January 1, 2001. The adjusted aggregate reserve shall be calculated as if Subsection b. ii. had been in effect for all years beginning twenty (20) years prior to January 1, 2001. If the adjusted aggregate reserve exceeds the aggregate amount set aside for statutory or unearned premiums in the insurer's December 31, 2000 annual statement, the insurer shall–increase its statutory or unearned premium reserve by an amount equal to one-sixth of that excess in each of the succeeding six years, commencing with the 2001 calendar year.

v. The aggregate of the amounts set aside in this reserve in any calendar year as adjustments to the insurer's statutory or unearned premium reserve pursuant to Subsection b. iv. shall be released from the reserve and restored to net profits, or equity if the additions required by subparagraph b.iv. of this section reduced equity directly, over a period not exceeding ten (10) years pursuant to the following table:

Year of Addition	Release
2001	Equally over 10 years
2002	Equally over 9 years
2003	Equally over 8 years
2004	Equally over 7 years
2005	Equally over 6 years
2006	Equally over 5 years

c. A supplemental reserve shall be established consisting of any other reserves necessary, when taken in combination with the reserves required by Subsections a. and b. of this paragraph, to cover the company's liabilities with respect to all losses, claims and loss adjustment expenses.

Appendix A-630

Mortgage Guaranty Insurance

Definitions

1. “Mortgage guaranty insurance” is:

   a. Insurance against financial loss by reason of nonpayment of principal, interest or other sums agreed to be paid under the terms of any note or bond or other evidence of indebtedness secured by a mortgage, deed of trust, or other instrument constituting a lien or charge on real estate, provided the improvement on such real estate is a residential building or a condominium unit or buildings designed for occupancy by not more than four families.

   b. Insurance against financial loss by reason of nonpayment of principal, interest or other sums agreed to be paid under the terms of any note or bond or other evidence of indebtedness secured by a mortgage, deed of trust, or other instrument constituting a lien or charge on real estate, providing the improvement on such real estate is a building or buildings designed for occupancy by five (5) or more families or designed to be occupied for industrial or commercial purposes.

   c. Insurance against financial loss by reason of nonpayment of rent or other sums agreed to be paid under the terms of a written lease for the possession, use or occupancy of real estate, provided the improvement on such real estate is a building or buildings designed to be occupied for industrial or commercial purposes.

2. “Authorized real estate security” for the purpose of this Appendix means an amortized note, bond or other evidence of indebtedness, not exceeding ninety-five percent (95%) of the fair market value of the real estate, secured by a mortgage, deed of trust, or other instrument which constitutes, or is equivalent to, a first lien or charge on real estate; provided:

   a. The real estate loan secured in such manner is one of a type which a bank, savings and loan association, or an insurance company, which is supervised and regulated by a state department or the federal government, is authorized to make, or would be authorized to make, disregarding any requirement applicable to such an institution that the amount of the loan not exceed a certain percentage of the value of the real estate.

   b. The improvement on such real estate is a building or buildings designed for occupancy as specified by paragraphs 1.a. and 1.b. of this Appendix.

   c. The lien on such real estate may be subject to and subordinate to the following:

      i. The lien of any public bond, assessment or tax, when no installment, call or payment of or under such bond, assessment or tax is delinquent.

      ii. Outstanding mineral, oil, water or timber rights, rights-of-way, easements or rights-of-way of support, sewer rights, building restrictions or other restrictions or covenants, conditions or regulations of use, or outstanding leases upon such real property under which rents or profits are reserved to the owner thereof.

3. “Contingency reserve” means an additional premium reserve established to protect policyholders against the effect of adverse economic cycles.

Investment Limitation

4. A mortgage guaranty insurance company shall not report as an admitted asset notes or other evidences of indebtedness secured by mortgage or other lien upon real property. This provision shall not apply to obligations secured by real property, or contracts for the sale of real property, which obligations or contracts of sale are acquired in the course of the good faith settlement of claims under policies of insurance issued by the mortgage guaranty insurance company, or in the good faith disposition of real property so acquired.

Reserves

5. Unearned Premium Reserves - A mortgage guaranty insurance company shall compute and maintain an unearned premium reserve.

6. Loss Reserve - A mortgage guaranty insurance company shall compute and maintain adequate case basis and other loss reserves which accurately reflect loss frequency and loss severity and shall include components for claims reported and for claims incurred but not reported, including estimated losses on:

a. Insured loans which have resulted in the conveyance of property which remains unsold;

b. Insured loans in the process of foreclosure;

c. Insured loans in default for four (4) months or for any lesser period which is defined as default for such purposes in the policy provisions; and

d. Insured leases in default for four (4) months or for any lesser period which is defined as default for such purposes in policy provisions.

7. Contingency Reserve

Each mortgage guaranty insurance company shall compute and maintain a contingency reserve.

8. Reinsurance

Whenever a mortgage guaranty insurance company obtains reinsurance from an insurance company which is properly licensed to provide such reinsurance or from an appropriate governmental agency, the mortgage guaranty insurer and the reinsurer shall establish and maintain the reserves required in this Appendix in appropriate proportions in relation to the risk retained by the original insurer and ceded to the assuming reinsurer so that the total reserves established shall not be less than the reserves required by this Appendix.

Appendix A-641

Long-Term Care Insurance

Definitions

1. “Long-term care insurance” means any insurance policy or rider advertised, marketed, offered or designed to provide coverage for not less than twelve (12) consecutive months for each covered person on an expense incurred, indemnity, prepaid or other basis; for one or more necessary or medically necessary diagnostic, preventive, therapeutic, rehabilitative, maintenance or personal care services, provided in a setting other than an acute care unit of a hospital. Such term includes group and individual annuities and life insurance policies or riders which provide directly or which supplement long-term care insurance. Such term also includes a policy or rider which provides for payment of benefits based upon cognitive impairment or the loss of functional capacity. The term shall also include qualified long-term care insurance contracts. Long-term care insurance may be issued by insurers; fraternal benefit societies; nonprofit health, hospital, and medical service corporations; prepaid health plans; health maintenance organizations or any similar organization to the extent they are otherwise authorized to issue life or health insurance. Long-term care insurance shall not include any insurance policy which is offered primarily to provide basic Medicare supplement coverage, basic hospital expense coverage, basic medical-surgical expense coverage, hospital confinement indemnity coverage, major medical expense coverage, disability income or related asset-protection coverage, accident only coverage, specified disease or specified accident coverage, or limited benefit health coverage. With regard to life insurance, this term does not include life insurance policies which accelerate the death benefit specifically for one or more of the qualifying events of terminal illness, medical conditions requiring extraordinary medical intervention, or permanent institutional confinement, and which provide the option of a lump-sum payment for those benefits and in which neither the benefits nor the eligibility for the benefits is conditioned upon the receipt of long-term care. Notwithstanding any other provision contained herein, any product advertised, marketed or offered as long-term care insurance shall be subject to the provisions of this Appendix.

2. “Applicant” means:

   a. In the case of an individual long-term care insurance policy, the person who seeks to contract for benefits, and

   b. In the case of a group long-term care insurance policy, the proposed certificate holder.

3. “Certificate” means, for the purposes of this Appendix, any certificate issued under a group long-term care insurance policy, which policy has been delivered or issued for delivery.

4. “Group long-term care insurance” means a long-term care insurance policy which is delivered or issued for delivery to:

   a. One or more employers or labor organizations, or to a trust or to the trustees of a fund established by one or more employers or labor organizations, or a combination thereof, for employees or former employees or a combination thereof or for members or former members or a combination thereof, of the labor organizations; or

   b. Any professional, trade or occupational association for its members or former or retired members, or combination thereof, if such association:

      i. Is composed of individuals all of whom are or were actively engaged in the same profession, trade or occupation; and

      ii. Has been maintained in good faith for purposes other than obtaining insurance; or

c. An association or a trust or the trustee(s) of a fund established, created or maintained for the benefit of members of one or more associations. Prior to advertising, marketing or offering such policy, the association or associations, or the insurer of the association or associations, shall evidence that the association or associations have at the outset a minimum of 100 persons and have been organized and maintained in good faith for purposes other than that of obtaining insurance; have been in active existence for at least one year; and have a constitution and bylaws which provide that:

i. The association or associations hold regular meetings not less than annually to further purposes of the members;

ii. Except for credit unions, the association or associations collect dues or solicit contributions from members; and

iii. The members have voting privileges and representation on the governing board and committees.

5. "Policy" means, for the purposes of this Appendix, any policy, contract, subscriber agreement, rider or endorsement delivered or issued for delivery by an insurer; fraternal benefit society; nonprofit health, hospital, or medical service corporation; prepaid health plan; health maintenance organization or any similar organization.

6. a. "Qualified long-term care insurance contract" or "federally tax-qualified long-term care insurance contract" means an individual or group insurance contract that meets the requirements of Section 7702B(b) of the Internal Revenue Code of 1986, as amended, as follows:

i. The only insurance protection provided under the contract is coverage of qualified long-term care services. A contract shall not fail to satisfy the requirements of this subparagraph by reason of payments being made on a per diem or other periodic basis without regard to the expenses incurred during the period to which the payments relate;

ii. The contract does not pay or reimburse expenses incurred for services or items to the extent that the expenses are reimbursable under Title XVIII of the Social Security Act, as amended, or would be so reimbursable but for the application of a deductible or coinsurance amount. The requirements of this subparagraph do not apply to expenses that are reimbursable under Title XVIII of the Social Security Act only as a secondary payor. A contract shall not fail to satisfy the requirements of this subparagraph by reason of payments being made on a per diem or other periodic basis without regard to the expenses incurred during the period to which the payments relate;

iii. The contract is guaranteed renewable, within the meaning of section 7702B(b)(1)(C) of the Internal Revenue Code of 1986, as amended;

iv. The contract does not provide for a cash surrender value or other money that can be paid, assigned, pledged as collateral for a loan, or borrowed except as provided in subparagraph 6.a.v. below;

v. All refunds of premiums, and all policyholder dividends or similar amounts, under the contract are to be applied as a reduction in future premiums or to increase future benefits, except that a refund on the event of death of the insured or a complete surrender or cancellation of the contract cannot exceed the aggregate premiums paid under the contract; and

vi. The contract meets the consumer protection provisions set forth in Section 7702B(g) of the Internal Revenue Code of 1986, as amended.

b. "Qualified long-term care insurance contract" or "federally tax-qualified long term care insurance contract" also means the portion of a life insurance contract that provides long-term care insurance coverage by rider or as part of the contract and that satisfies the requirements of Sections 7702B(b) and (e) of the Internal Revenue Code of 1986, as amended.

Valuation Requirements

7. When long-term care benefits are provided through the acceleration of benefits under group or individual life policies or riders to such policies, policy reserves for the benefits shall be determined in accordance with Appendix A-820. Claim reserves shall also be established in the case when the policy or rider is in claim status.

8. Reserves for policies and riders subject to this Appendix should be based on the multiple decrement model utilizing all relevant decrements except for voluntary termination rates. Single decrement approximations are acceptable if the calculation produces essentially similar reserves, if the reserve is clearly more conservative, or if the reserve is immaterial. The calculations may take into account the reduction in life insurance benefits due to the payment of long-term care benefits. However, in no event shall the reserves for the long-term care benefit and the life insurance benefit be less than the reserves for the life insurance benefit assuming no long-term care benefit.

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

a. Definition of insured events;

b. Covered long-term care facilities;

c. Existence of home convalescence care coverage;

d. Definition of facilities;

e. Existence or absence of barriers to eligibility;

f. Premium waiver provision;

g. Renewability;

h. Ability to raise premiums;

i. Marketing method;

j. Underwriting procedures;

k. Claims adjustment procedures;

l. Waiting period;

m. Maximum benefit;

n. Availability of eligible facilities;

o. Margins in claim costs;

p. Optional nature of benefit;

q. Delay in eligibility for benefit;

r. Inflation protection provisions; and

s. Guaranteed insurability option.

10. When long-term care benefits are provided other than as in the above, reserves shall be determined in accordance with Appendix A-010.

Appendix A-695

Synthetic Guaranteed Investment Contracts

Scope and Application

1. This appendix applies to that portion of a group annuity contract or other agreement defined in paragraph 23 and issued by a life insurer that functions as an accounting record for an accumulation fund and has benefit guarantees relating to a principal amount and levels of interest at a fixed rate of return specified in advance. The fixed rates of return will be constant over the applicable rate periods, and may reflect prior and current market conditions with respect to the segregated portfolio but may not reference future changes in market conditions.

Definitions

2. "Account assets" means the assets in the segregated portfolio plus any assets held in the general account or a separate account to meet the asset maintenance requirements.

3. "Actuarial opinion and memorandum" means the valuation actuary's opinion and memorandum covering synthetic guaranteed investment contract liabilities that is required to be submitted to the commissioner.

4. "Appointed actuary" means the qualified actuary appointed or retained either directly by or by the authority of the board of directors through an executive officer of the company to prepare the annual statement of actuarial opinion for the company as a whole.

5. "Asset maintenance requirement" means the requirement to maintain assets to fund contract benefits in accordance with paragraph 27 of this appendix.

6. "Class of contracts" means the set of all contracts to which a given plan of operation pertains.

7. "Contract value record" means an accounting record, provided by the contract in relation to a segregated portfolio of assets, that is credited with a fixed rate of return over regular periods, and that is used to measure the extent of the insurer's obligation to the contractholder. The fixed rate of return credited to the contract value record is determined by means of a crediting rate formula or declared at the inception of the contract and valid for the entire term of the contract.

8. "Crediting rate formula" means a mathematical formula used to calculate the fixed rate of return credited to the contract value record during any rate period and based in part upon the difference between the contract value record and the market value record amortized over an appropriate period. The fixed rate of return calculated by means of this formula may reflect prior and current market conditions with respect to the segregated portfolio, but may not reference future changes in market conditions.

9. "Duration" means, with respect to the segregated portfolio assets or guaranteed contract liabilities, a measure of price sensitivity to changes in interest rates, such as the Macaulay duration or option-adjusted duration.

10. "Fair market value" means a reasonable estimate of the amount that a knowledgeable buyer of an asset would be willing to pay, and a knowledgeable seller of an asset would be willing to accept, for the asset without duress in an arm's length transaction. In the case of a publicly traded security, the fair market value is the price at which the security is traded or, if no price is available, a price that appropriately reflects the latest bid and asked prices for the security. In the case of a debt instrument that is not publicly traded, the fair market value is the discounted present value of the asset calculated at a

reasonable discount rate. For all other non-publicly traded assets, fair market value will be determined in accordance with valuation practices customarily used within the financial industry.

11. "Guaranteed minimum benefits" means contract benefits on a specified date that may be either:

a. A principal guarantee, with or without a fixed minimum interest rate guarantee, related to the segregated portfolio;

b. An assurance as to the future investment return or performance of the segregated portfolio; or

c. The fair market value of the segregated portfolio, to the extent that the fair market value of the assets determines the contractholder's benefits.

12. a. "Hedging instrument" means:

i. An interest rate futures agreement or foreign currency futures agreement, an option to purchase or sell an interest rate futures agreement or foreign currency futures agreement, or any option to purchase or sell a security or foreign currency, used in a bona fide hedging transaction; or

ii. A financial agreement or arrangement entered into with a broker, dealer or bank, qualified under applicable federal and state securities or banking law and regulation, in connection with investment in one or more securities in order to reduce the risk of changes in market valuation or to create a synthetic investment that, when added to the portfolio, reduces the risk of changes in market valuation.

b. An instrument shall not be considered a hedging instrument or a part of a bona fide hedging transaction if it is purchased in conjunction with another instrument where the effect of the combined transaction is an increase in the portfolio's exposure to market risk.

13. "Investment guidelines" means a set of written guidelines, established in advance by the person with investment authority over the segregated portfolio, to be followed by the investment manager. The guidelines shall include a description of:

a. The segregated portfolio's investment objectives and limitations;

b. The investment manager's degree of discretion;

c. The duration, asset class, quality, diversification, and other requirements of the segregated portfolio; and

d. The manner in which derivative instruments may be used, if at all, in the segregated portfolio.

14. "Investment manager" means the person (including the contractholder) responsible for managing the assets in the segregated portfolio in accordance with the investment guidelines in a fiduciary capacity to the owner of the assets.

15. "Market value record" means an accounting record provided by the contract to reflect the fair market value of the segregated portfolio.

16. “Nationally Recognized Statistical Rating Organization (NRSRO)” means a rating organization so designated by the Securities and Exchange Commission of the United States of America (SEC) which has applied to, and whose NRSRO status has been confirmed by, the NAIC Securities Valuation Office.

17. “Permitted custodial institution” means a bank, trust company or other licensed fiduciary services provider.

18. “Plan of operation” means a written plan meeting the requirements of paragraph 26 of this appendix.

19. “Qualified actuary” means an individual who meets the qualification standards set forth in Appendix A-820.

20. “Rate period” means the period of time during which the fixed rate of return credited to the contract value record is applicable between crediting rate formula adjustments.

21. “Segregated portfolio” means:

a. A portfolio or sub-portfolio of assets to which the contract pertains that is held in a custody or trust account by the permitted custodial institution and identified on the records of the permitted custodial institution as special custody assets held for the exclusive benefit of the retirement plans or other entities on whose behalf the contractholder holds the contract; and

b. Any related cash or currency received by the permitted custodial institution for the account of the contractholder and held in a deposit account for the exclusive benefit of the retirement plans or other entities on whose behalf the contractholder holds the contract.

22. “Spot rate” corresponding to a given time of benefit payment means the yield on a zero-coupon non-callable and non-prepayable United States government obligation maturing at that time, or the zero-coupon yield implied by the price of a representative sampling of coupon-bearing, non-callable and non-prepayable United States government obligations in accordance with a formula set forth in the plan of operation. To the extent that guaranteed contract liabilities are denominated in the currency of a foreign country rated in one of the two (2) highest rating categories by an NRSRO and are supported by investments denominated in the currency of the foreign country, the spot rate may be determined by reference to substantially similar obligations of the government of the foreign country.

23. “Synthetic guaranteed investment contract” or “contract” means a group annuity contract or other agreement that in whole or in part establishes the insurer’s obligations by reference to a segregated portfolio of assets that is not owned by the insurer.

24. “United States government obligation” means a direct obligation issued, assumed, guaranteed or insured by the United States of America or by an agency or instrumentality of the United States government.

25. “Valuation actuary” means the appointed actuary or, alternatively, a qualified actuary designated by the appointed actuary to render the actuarial opinion. Written documentation of any such designation shall be on file at the company and available for review upon request.

Plan of Operation

26. The plan of operation for a class of contracts shall describe the financial implications for the insurer of the issuance of contracts in the class, and shall include at least the following:

a. A statement describing the methods and procedures used to value statutory liabilities for purposes of paragraph 27;

b. A description of the allowable investment parameters (such as objectives, asset classes, quality, duration and diversification requirements applied to the assets held within the segregated portfolio) to be reflected in the investment guidelines applicable to each contract issued in the class to which the submitted plan of operation applies; and a description of the procedures that will be followed by the insurer in evaluating the appropriateness of any specific investment guidelines submitted by the contractholder.

Reserves and Documentation

27. Asset maintenance requirements for segregated portfolios covered by this appendix.

a. At all times an insurer shall hold minimum reserves in the general account or one or more separate accounts, as appropriate, equal to the excess, if any, of the value of the guaranteed contract liabilities, determined in accordance with paragraphs 27.f. and 27.g., over the market value of the assets in the segregated portfolio less the deductions provided for in paragraph 27.b. These reserve requirements shall be applied on a contract-by-contract basis.

b. In determining compliance with the asset maintenance requirement and the reserve for guaranteed contract liabilities specified in paragraph 27.a., the insurer shall deduct a percentage of the market value of an asset as follows:

i. For debt instruments, the percentage shall be the NAIC asset valuation reserve "reserve objective factor," but the factor shall be increased by fifty percent (50%) for the purpose of this calculation if the difference in durations of the assets and liabilities is more than one-half year.

ii. For assets that are not debt instruments, the percentage shall be the NAIC asset valuation reserve “maximum reserve factor.”

c. To the extent that guaranteed contract liabilities are denominated in the currency of a foreign country and are supported by segregated portfolio assets denominated in the currency of the foreign country, the percentage deduction for these assets under paragraph 27.b. shall be that for a substantially similar investment denominated in the currency of the United States.

d. To the extent that guaranteed contract liabilities are denominated in the currency of the United States and are supported by segregated portfolio assets denominated in the currency of a foreign country, and to the extent that guaranteed contract liabilities are denominated in the currency of a foreign country and are supported by segregated portfolio assets denominated in the currency of the United States, the deduction for debt instruments under paragraph 27.b. shall be increased by fifteen percent (15%) of the market value of the assets unless the currency exchange risk on the assets has been adequately hedged, in which case the percentage deduction under paragraph 27.b. shall be increased by one-half percent (.5%). No guaranteed contract liabilities denominated in the currency of a foreign country shall be supported by segregated portfolio assets denominated in the currency of another foreign country. For purposes of this paragraph, the currency exchange risk on an asset is deemed to be adequately hedged if:

i. It is an obligation of

(a) A jurisdiction that is rated in one of the two (2) highest rating categories by an NRSRO;

(b) Any political subdivision or other governmental unit of such a jurisdiction, or any agency or instrumentality of jurisdiction, political subdivision or other governmental unit; or

(c) An institution that is organized under the laws of any such jurisdiction; and

ii. At all times the principal amount of the obligation and scheduled interest payments on the obligation are hedged against the United States dollar pursuant to contracts or agreements that are:

(a) Issued by or traded on a securities exchange or board of trade regulated under the laws of the United States or Canada or a province of Canada;

(b) Entered into with a United States banking institution that has assets in excess of $5 billion and that has obligations outstanding, or has a parent corporation that has obligations outstanding, that are rated in one of the two (2) highest rating categories by an NRSRO, or with a broker-dealer registered with the Securities and Exchange Commission that has net capital in excess of $250 million; or

(c) Entered into with any other banking institution that has assets in excess of $5 billion and that has obligations outstanding, or has a parent corporation that has obligations outstanding, that are rated in one of the two (2) highest rating categories by an NRSRO and that is organized under the laws of a jurisdiction that is rated in one of the two (2) highest rating categories by an NRSRO.

e. These contracts may provide for the allocation to one or more separate accounts of all or any portion of the amount needed to meet the asset maintenance requirement. If the contract provides that the assets in the separate account shall not be chargeable with liabilities arising out of any other business of the insurer, the insurer shall maintain in a distinct separate account that is so chargeable:

i. That portion of the amount needed to meet the asset maintenance requirement that has been allocated to separate accounts; less

ii. The amounts contributed to separate accounts by the contractholder in accordance with the contract and the earnings on the contract.

f. For purposes of this paragraph, the minimum value of guaranteed contract liabilities is defined to be the sum of the expected guaranteed contract benefits, each discounted at a rate corresponding to the expected time of payment of the contract benefit that is not greater than the maximum multiple of the spot rate supportable by the expected return from the segregated portfolio assets, and in no event greater than 105 percent of the spot rate as described in the plan of operation or the actuary's opinion and memorandum, except that if the expected time of payment of a contract benefit is more than thirty (30) years, it shall be discounted from the expected date of payment to year thirty (30) at a rate of no more than eighty percent (80%) of the thirty-year spot rate and from year thirty (30) to the date of valuation at a rate not greater than 105 percent of the thirty-year spot rate.

g. In calculating the minimum value of guaranteed contract benefits:

i. All guaranteed benefits potentially available to the contractholder on an ongoing basis shall be considered in the valuation process and analysis, and the reserve held must be sufficient to fund the greatest present value of each independent guaranteed contract benefit. For purposes of this subparagraph, the right granted to the contractholder to exit the contract by discharging the insurer of its guarantee obligation under the contract and taking control of the assets in the segregated portfolio shall not be considered a guaranteed benefit.

ii. To the extent that future guaranteed cash flows are dependent upon the benefit responsiveness of an employer-sponsored plan, a best estimate based on company experience, or other reasonable criteria if company experience is not available, shall be used in the projections of future cash flows.

28. Account assets shall make adequate provision for contract liabilities, taking into account any risk charge payable, the segregated portfolio assets, and the amount of any reserve liability with respect to the asset maintenance requirement.

29. The fixed-income segregated portfolio shall conform to and justify the rates used to discount contract liabilities for valuation pursuant to paragraph 27.f.

30. The company shall document whether any rates used pursuant to paragraph 27.f. to discount guaranteed contract liabilities and other items applicable to the segregated portfolio were modified from the rate or rates described in the plan of operation.

31. The level of risk charges, if any, retained in the general account shall be appropriate in view of such factors as the nature of the guaranteed contract liabilities and losses experienced in connection with account contracts and other pricing factors.

32. The company shall substantially conform with Appendix A-822 and maintain internal documentation to either:

a. Demonstrate the adequacy of account assets based upon cash flow analysis, or

b. Explain why cash flow testing analysis is not appropriate, describe the alternative methodology of asset adequacy testing used, and demonstrate the adequacy of account assets under that methodology;

33. The company's internal documentation pertaining to reserves for synthetic guaranteed investment contract liabilities shall also:

a. Clearly describe the assumptions used in projecting cash flows under each class of assets, and any dynamic portfolio hedging techniques utilized and the tests performed on the utilization of the techniques;

b. Clearly describe how the company has reflected the cost of capital;

c. Clearly describe how the company has reflected the risk of default on obligations and mortgage loans, including obligations and mortgage loans that are not investment grade;

d. Clearly describe how the company has reflected withdrawal risks, if applicable, including a discussion of the positioning of the contracts within the benefit withdrawal priority order pertaining to the contracts;

e. If the plan of operation provides for investments in segregated portfolio assets other than United States government obligations, demonstrate that the rates used to discount contract liabilities pursuant to paragraph 27.f. conservatively reflect expected investment returns, taking into account any foreign exchange risks;

f. If the contracts provide that in certain circumstances they would cease to be funded by a segregated portfolio and, instead would become contracts funded by the general account, clearly describe how any increased reserves would be provided for if and to the extent these circumstances occurred;

g. Document the amount of account assets maintained in a separate account that are not chargeable with liabilities arising out of any other business of the insurance company;

h. Document the amount of reserves and supporting assets as of December 31 and where the reserves are shown in the annual statement;

i. Document the amount of any contingency reserve carried as part of surplus;

j. Document the market value of the segregated asset portfolio; and

k. Where separate account assets are not chargeable with liabilities arising out of any other business of the insurance company, describe how the level of risk charges payable to the general account provides an appropriate compensation for the risk taken by the general account.

34. When the insurer issues a synthetic guaranteed investment contract and complies with the asset maintenance requirements of paragraph 27, it need not maintain an asset valuation reserve with respect to those account assets.

35. This paragraph describes the reserve valuation requirements for contracts subject to this appendix.

a. Reserves for synthetic investment contracts subject to this appendix shall be an amount equal to the sum of the following:

i. The amounts determined as the minimum reserve as required under paragraph 27; and

ii. Any additional amount determined by the insurer's valuation actuary as necessary to make adequate provision for all contract liabilities.

b. The amount of any reserves required by paragraph 35.a. may be established by either:

i. Allocating sufficient assets to one or more separate accounts; or

ii. Setting up the additional reserves in the general account.

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Appendix A-785

Credit For Reinsurance

Definitions

1. “Commissioner” refers to the commissioner of insurance in the state where credit or a reduction from liability is taken.

2. “Jurisdiction” refers to any state, district or territory of the United States and also to territories, provinces or jurisdictions other than the United States.

3. “Liabilities” shall mean the assuming insurer’s gross liabilities attributable to reinsurance ceded by U. S. domiciled insurers that are not otherwise secured by acceptable means.

4. “Beneficiary” means the entity for whose sole benefit the trust has been established and any successor of the beneficiary by operation of law. If a court of law appoints a successor in interest to the named beneficiary, then the named beneficiary includes and is limited to the court appointed domiciliary receiver (including conservator, rehabilitator or liquidator).

5. “Grantor” means the entity that has established a trust for the sole benefit of the beneficiary. When established in conjunction with a reinsurance agreement, the grantor is the unlicensed, unaccredited assuming insurer.

6. “Obligations,” as used in paragraph 29 of this appendix means:

   a. Reinsured losses and allocated loss expenses paid by the ceding company, but not recovered from the assuming insurer;

   b. Reserves for reinsured losses reported and outstanding;

   c. Reserves for reinsured losses incurred but not reported; and

   d. Reserves for allocated reinsured loss expenses and unearned premiums.

Credit Allowed a Domestic Ceding Insurer

7. Credit for reinsurance shall be allowed a domestic ceding insurer as either an asset or a reduction from liability on account of reinsurance ceded only when the reinsurer meets the requirements of paragraphs 8, 9, 10, 11, 12 or 13 of this appendix. Credit shall be allowed under paragraphs 8, 9, or 10 of this appendix only as respects cessions of those kinds or classes of business which the assuming insurer is licensed or otherwise allowed to write or assume in its state of domicile or, in the case of a U.S. branch of an alien assuming insurer, in the state through which it is entered and licensed to transact insurance or reinsurance. Credit shall be allowed under paragraphs 10 or 11 of this appendix only if the applicable requirements of paragraph 14 have been satisfied.

8. Credit shall be allowed when the reinsurance is ceded to an assuming insurer that is licensed to transact insurance or reinsurance in the domiciliary state of the ceding insurer.

9. Credit shall be allowed when the reinsurance is ceded to an assuming insurer that is accredited as a reinsurer by the domiciliary state of the ceding insurer. In order to be eligible for accreditation, a reinsurer must:

a. File with the commissioner evidence of its submission to the domiciliary state's jurisdiction;

b. Submit to the domiciliary state's authority to examine its books and records;

c. Be licensed to transact insurance or reinsurance in at least one state, or in the case of a U.S. branch of an alien assuming insurer, is entered through and licensed to transact insurance or reinsurance in at least one state;

d. File annually with the commissioner a copy of its annual statement filed with the insurance department of its state of domicile and a copy of its most recent audited financial statement; and

e. Demonstrate to the satisfaction of the commissioner that it has adequate financial capacity to meet its reinsurance obligations and is otherwise qualified to assume reinsurance from domestic insurers. An assuming insurer is deemed to meet this requirement as of the time of its application if it maintains a surplus as regards policyholders in an amount not less than $20,000,000 and its accreditation has not been denied by the commissioner within ninety (90) days after submission of its application.

10. a. Credit shall be allowed when the reinsurance is ceded to an assuming insurer that is domiciled in, or in the case of a U.S. branch of an alien assuming insurer is entered through, a state that employs standards regarding credit for reinsurance substantially similar to those of the domiciliary state of the ceding insurer and the assuming insurer or U.S. branch of an alien assuming insurer:

i. Maintains a surplus as regards policyholders in an amount not less than $20,000,000; and

ii. Submits to the authority of the domiciliary state to examine its books and records.

b. The requirement of paragraph 10.a.i. does not apply to reinsurance ceded and assumed pursuant to pooling arrangements among insurers in the same holding company system.

11. a. Credit shall be allowed when the reinsurance is ceded to an assuming insurer that maintains a trust fund in a qualified U.S. financial institution, as defined in paragraph 53, for the payment of the valid claims of its U.S. ceding insurers, their assigns and successors in interest. The assuming insurer shall report annually information substantially the same as that required to be reported on the NAIC Annual Statement form by licensed insurers. The assuming insurer shall submit to examination of its books and records by the commissioner and bear the expense of examination.

b. i. Credit for reinsurance shall not be granted under this paragraph 11 unless the form of the trust and any amendments to the trust have been approved by:

(a) The commissioner of the state where the trust is domiciled; or

(b) The commissioner of another state who, pursuant to the terms of the trust instrument, has accepted principal regulatory oversight of the trust.

ii. The trust instrument shall provide that:

(a) Contested claims shall be valid and enforceable out of funds in trust to the extent remaining unsatisfied thirty (30) days after entry of the final order of any court of competent jurisdiction in the United States;

(b) Legal title to the assets of the trust shall be vested in the trustee for the benefit of the grantor's U.S. ceding insurers, their assigns and successors in interest;

(c) The trust shall be subject to examination as determined by the commissioner;

(d) The trust shall remain in effect for as long as the assuming insurer, or any member or former member of a group of insurers, shall have outstanding obligations under reinsurance agreements subject to the trust; and

(e) No later than February 28 of each year the trustee of the trust shall report to the commissioner in writing setting forth the balance in the trust and listing the trust's investments at the preceding year-end, and shall certify the date of termination of the trust, if so planned, or certify that the trust shall not expire prior to the following December 31.

c. The following requirements apply to the following categories of assuming insurer:

i. The trust fund for a single assuming insurer shall consist of funds in trust in an amount not less than the assuming insurer's liabilities attributable to reinsurance ceded by U.S. ceding insurers, and, in addition, the assuming insurer shall maintain a trusteed surplus of not less than $20,000,000, except as provided in paragraph 11.c.ii. of this appendix.

ii. At any time after the assuming insurer has permanently discontinued underwriting new business secured by the trust for at least three full years, the commissioner with principal regulatory oversight of the trust may authorize a reduction in the required trusteed surplus, but only after a finding, based on an assessment of the risk, that the new required surplus level is adequate for the protection of U.S. ceding insurers, policyholders and claimants in light of reasonably foreseeable adverse loss development. The risk assessment may involve an actuarial review, including an independent analysis of reserves and cash flows, and shall consider all material risk factors, including when applicable the lines of business involved, the stability of the incurred loss estimates and the effect of the surplus requirements on the assuming insurer's liquidity or solvency. The minimum required trusteed surplus may not be reduced to an amount less than thirty percent (30%) of the assuming insurer's liabilities attributable to reinsurance ceded by U.S. ceding insurers covered by the trust.

iii. (a) In the case of a group including incorporated and individual unincorporated underwriters:

(1) For reinsurance ceded under reinsurance agreements with an inception, amendment or renewal date on or after January 1, 1993, the trust shall consist of a trusteed account in an amount

not less than the respective underwriters' several liabilities attributable to business ceded by U.S. domiciled ceding insurers to any underwriter of the group;

(2) For reinsurance ceded under reinsurance agreements with an inception date on or before December 31, 1992, and not amended or renewed after that date, not-withstanding the other provisions contained herein, the trust shall consist of a trusteed account in an amount not less than the respective underwriters' several insurance and reinsurance liabilities attributable to business written in the United States; and

(3) In addition to these trusts, the group shall maintain in trust a trusteed surplus of which $100,000,000 shall be held jointly for the benefit of the U.S. domiciled ceding insurers of any member of the group for all years of account; and

(b) The incorporated members of the group shall not be engaged in any business other than underwriting as a member of the group and shall be subject to the same level of regulation and solvency control by the group's domiciliary regulator as are the unincorporated members.

(c) Within ninety (90) days after its financial statements are due to be filed with the group's domiciliary regulator, the group shall provide to the commissioner an annual certification by the group's domiciliary regulator of the solvency of each underwriter member; or if a certification is unavailable, financial statements, prepared by independent public accountants, of each underwriter member of the group.

iv. In the case of a group of incorporated underwriters under common administration, the group shall:

(a) Have continuously transacted an insurance business outside the United States for at least three (3) years immediately prior to making application for accreditation;

(b) Maintain aggregate policyholders' surplus of at least $10,000,000,000;

(c) Maintain a trust fund in an amount not less than the group's several liabilities attributable to business ceded by U.S. domiciled ceding insurers to any member of the group pursuant to reinsurance contracts issued in the name of the group;

(d) In addition, maintain a joint trusteed surplus of which $100,000,000 shall be held jointly for the benefit of U.S. domiciled ceding insurers of any member of the group as additional security for these liabilities; and

(e) Within ninety (90) days after its financial statements are due to be filed with the group's domiciliary regulator, make available to the commissioner an annual certification of each underwriter member's solvency by the member's domiciliary regulator and financial statements of each underwriter member of the group prepared by its independent public accountant.

d. For the purposes of this paragraph 11., the term "liabilities" shall mean the assuming insurer's gross liabilities attributable to reinsurance ceded by U.S. domiciled insurers excluding liabilities that are otherwise secured by acceptable means, and shall include:

i. For business ceded by domestic insurers authorized to write accident and health, and property and casualty insurance:

(a) Losses and allocated loss expenses paid by the ceding insurer, recoverable from the assuming insurer;

(b) Reserves for losses reported and outstanding;

(c) Reserves for losses incurred but not reported;

(d) Reserves for allocated loss expenses; and

(e) Unearned premiums.

ii. For business ceded by domestic insurers authorized to write life, health and annuity insurance:

(a) Aggregate reserves for life policies and contracts net of policy loans and net due and deferred premiums;

(b) Aggregate reserves for accident and health policies;

(c) Deposit funds and other liabilities without life or disability contingencies; and

(d) Liabilities for policy and contract claims.

12. Credit shall be allowed when the reinsurance is ceded to an assuming insurer that has been certified as a reinsurer in the domestic state of the ceding insurer and secures its obligations in accordance with the requirements of this paragraph 12.

a. In order to be eligible for certification, the assuming insurer shall meet the following requirements:

i. The assuming insurer must be domiciled and licensed to transact insurance or reinsurance in a qualified jurisdiction, as determined by the domestic state of the ceding insurer pursuant to paragraphs 12.c. and 12.k. of this subsection;

ii. The assuming insurer must maintain minimum capital and surplus, or its equivalent, in an amount as provided in paragraph 12.i.iii.(b) of this appendix;

iii. The assuming insurer must maintain financial strength ratings from two or more rating agencies deemed acceptable by the domestic state of the ceding insurer, as provided in paragraph 12.i.iii.(c) of this appendix;

iv. The assuming insurer must agree to submit to the jurisdiction of the domestic state of the ceding insurer, appoint the commissioner of the domestic state of the ceding insurer as its agent for service of process in that state, and agree to provide security for 100 percent of the assuming insurer's liabilities attributable to reinsurance ceded by U.S. ceding insurers if it resists enforcement of a final U.S. judgment;

v. The assuming insurer must agree to meet applicable information filing requirements as determined by the domestic state of the ceding insurer, both with respect to an initial application for certification and on an ongoing basis; and

vi. The assuming insurer must satisfy any other requirements for certification deemed relevant by the domestic state of the ceding insurer.

b. An association including incorporated and individual unincorporated underwriters may be a certified reinsurer. In order to be eligible for certification, in addition to satisfying requirements of paragraph 12.a. of this appendix:

i. The association shall satisfy its minimum capital and surplus requirements through the capital and surplus equivalents (net of liabilities) of the association and its members, which shall include a joint central fund that may be applied to any unsatisfied obligation of the association or any of its members, in an amount determined by the domestic state of the ceding insurer to provide adequate protection;

ii. The incorporated members of the association shall not be engaged in any business other than underwriting as a member of the association and shall be subject to the same level of regulation and solvency control by the association's domiciliary regulator as are the unincorporated members; and

iii. Within ninety (90) days after its financial statements are due to be filed with the association's domiciliary regulator, the association shall provide to the domestic state of the ceding insurer an annual certification by the association's domiciliary regulator of the solvency of each underwriter member; or if a certification is unavailable, financial statements, prepared by independent public accountants, of each underwriter member of the association.

c. The domestic state of the ceding insurer shall create and publish a list of qualified jurisdictions, under which an assuming insurer licensed and domiciled in such jurisdiction is eligible to be considered for certification by the domestic state of the ceding insurer as a certified reinsurer.

i. In order to determine whether the domiciliary jurisdiction of a non-U.S. assuming insurer is eligible to be recognized as a qualified jurisdiction, the domestic state of the ceding insurer shall evaluate the appropriateness and effectiveness of the reinsurance supervisory system of the jurisdiction, both initially and on an ongoing basis, and consider the rights, benefits and the extent of reciprocal recognition afforded by the non-U.S. jurisdiction to reinsurers licensed and domiciled in the U.S. A qualified jurisdiction must agree to share information and cooperate with the domestic state of the ceding insurer with respect to all certified reinsurers domiciled within that jurisdiction. A jurisdiction may not be recognized as a qualified jurisdiction if the domestic state of the ceding insurer has determined that the jurisdiction does not adequately and promptly enforce final U.S. judgments and arbitration awards. Additional factors may be considered in the discretion of the domestic state of the ceding insurer.

ii. A list of qualified jurisdictions shall be published through the NAIC Committee Process. The domestic state of the ceding insurer shall consider this list in determining qualified jurisdictions. If the domestic state of the ceding insurer approves a jurisdiction as qualified that does not appear on the list of qualified jurisdictions, the state shall provide thoroughly documented justification in accordance with criteria to be developed under regulations.

iii. U.S. jurisdictions that meet the requirement for accreditation under the NAIC financial standards and accreditation program shall be recognized as qualified jurisdictions.

iv. If a certified reinsurer's domiciliary jurisdiction ceases to be a qualified jurisdiction, the domestic state of the ceding insurer has the discretion to suspend the reinsurer's certification indefinitely, in lieu of revocation.

d. The domestic state of the ceding insurer shall assign a rating to each certified reinsurer, giving due consideration to the financial strength ratings that have been assigned by rating agencies deemed acceptable to the commissioner pursuant to regulation. The domestic state of the ceding insurer shall publish a list of all certified reinsurers and their ratings.

e. A certified reinsurer shall secure obligations assumed from U.S. ceding insurers under this subsection at a level consistent with its rating, as specified in paragraph 12.h.i. of this appendix.

i. In order for a domestic ceding insurer to qualify for full financial statement credit for reinsurance ceded to a certified reinsurer, the certified reinsurer shall maintain security in a form acceptable to the domestic state of the ceding insurer and consistent with the provisions of paragraph 18 of this appendix, or in a multibeneficiary trust in accordance with paragraph 11 of this appendix, except as otherwise provided in paragraph 12.e.ii. through 12.e.v. of this appendix.

ii. If a certified reinsurer maintains a trust to fully secure its obligations subject to paragraph 11 of this appendix, and chooses to secure its obligations incurred as a certified reinsurer in the form of a multibeneficiary trust, the certified reinsurer shall maintain separate trust accounts for its obligations incurred under reinsurance agreements issued or renewed as a certified reinsurer with reduced security as permitted by paragraph 12, or comparable laws of other U.S. jurisdictions, and for its obligations subject to paragraph 11 of this appendix. It shall be a condition to the grant of certification under paragraph 12 of this appendix that the certified reinsurer shall have bound itself, by the language of the trust and agreement with the commissioner with principal regulatory oversight of each such trust account, to fund, upon termination of any such trust account, out of the remaining surplus of such trust any deficiency of any other such trust account.

iii. The minimum trusteed surplus requirements provided in paragraph 11 of this appendix are not applicable with respect to a multibeneficiary trust maintained by a certified reinsurer for the purpose of securing obligations incurred under this subsection, except that such trust shall maintain a minimum trusteed surplus of $10,000,000.

iv. With respect to obligations incurred by a certified reinsurer under paragraph 12 of this appendix, if the security is insufficient, the allowable reinsurance credit shall be reduced by an amount proportionate to the deficiency, and the domestic state of the ceding insurer has the discretion to impose further reductions in allowable credit upon finding that there is a material risk that the certified reinsurer's obligations will not be paid in full when due.

v. For purposes of paragraph 12, a certified reinsurer whose certification has been terminated for any reason shall be treated as a certified reinsurer required to secure 100 percent of its obligations.

(a) As used in paragraph 12.e.v., the term "terminated" refers to revocation, suspension, voluntary surrender and inactive status.

(b) If the domestic state of the ceding insurer continues to assign a higher rating as permitted by other provisions of paragraph 12, this requirement does not apply to a certified reinsurer in inactive status or to a reinsurer whose certification has been suspended.

f. If an applicant for certification has been certified as a reinsurer in an NAIC accredited jurisdiction, the domestic state of the ceding insurer has the discretion to defer to that jurisdiction's certification, and has the discretion to defer to the rating assigned by that jurisdiction, and such assuming insurer shall be considered to be a certified reinsurer in the domestic state of the ceding insurer.

g. A certified reinsurer that ceases to assume new business in this state may request to maintain its certification in inactive status in order to continue to qualify for a reduction in security for its in-force business. An inactive certified reinsurer shall continue to comply with all applicable requirements of paragraph 12, and the domestic state of the ceding insurer shall assign a rating that takes into account, if relevant, the reasons why the reinsurer is not assuming new business.

h. The credit allowed under paragraph 12 shall be based upon the security held by or on behalf of the ceding insurer in accordance with a rating assigned to the certified reinsurer by the commissioner. The security shall be in a form consistent with the provisions of paragraph 12 and paragraph 18 of this appendix, and paragraphs 19-50 of this appendix, as applicable. The amount of security required in order for full credit to be allowed shall correspond with the following requirements:

i.

Ratings	**Security Required**
Secure – 1	0%
Secure – 2	10%
Secure – 3	20%
Secure – 4	50%
Secure – 5	75%
Vulnerable – 6	100%

ii. Affiliated reinsurance transactions shall receive the same opportunity for reduced security requirements as all other reinsurance transactions.

iii. The commissioner shall require the certified reinsurer to post one hundred percent (100%), for the benefit of the ceding insurer or its estate, security upon the entry of an order of rehabilitation, liquidation or conservation against the ceding insurer.

iv. In order to facilitate the prompt payment of claims, a certified reinsurer shall not be required to post security for catastrophe recoverables for a period of one year from the date of the first instance of a liability reserve entry by the ceding company as a result of a loss from a catastrophic occurrence as recognized by the commissioner. The one year deferral period is contingent upon the certified reinsurer continuing to pay claims in a timely manner. Reinsurance recoverables for only the following lines of business as reported on the NAIC annual financial statement related specifically to the catastrophic occurrence will be included in the deferral:

(a) Line 1: Fire

(b) Line 2: Allied Lines

(c) Line 3: Farmowners multiple peril

(d) Line 4: Homeowners multiple peril

(e) Line 5: Commercial multiple peril

(f) Line 9: Inland Marine

(g) Line 12: Earthquake

(h) Line 21: Auto physical damage

v. Credit for reinsurance under paragraph 12 of this appendix shall apply only to reinsurance contracts entered into or renewed on or after the effective date of the certification of the assuming insurer. Any reinsurance contract entered into prior to the effective date of the certification of the assuming insurer that is subsequently amended after the effective date of the certification of the assuming insurer, or a new reinsurance contract, covering any risk for which collateral was provided previously, shall only be subject to this section with respect to losses incurred and reserves reported from and after the effective date of the amendment or new contract.

vi. Nothing in paragraph 12 of this appendix shall prohibit the parties to a reinsurance agreement from agreeing to provisions establishing security requirements that exceed the minimum security requirements established for certified reinsurers under this section.

i. Certification Procedure

i. The commissioner of the domestic state of the ceding insurer shall post notice on the insurance department’s website promptly upon receipt of any application for certification, including instructions on how members of the public may respond to the application. The commissioner may not take final action on the application until at least thirty (30) days after posting the notice required by this paragraph.

ii. The commissioner of the domestic state of the ceding insurer shall issue written notice to an assuming insurer that has made application and been approved as a certified reinsurer. Included in such notice shall be the rating assigned the certified reinsurer in accordance with paragraph 12.h. of this appendix. The commissioner shall publish a list of all certified reinsurers and their ratings.

iii. In order to be eligible for certification, the assuming insurer shall meet the following requirements:

(a) The assuming insurer must be domiciled and licensed to transact insurance or reinsurance in a Qualified Jurisdiction, as determined by the commissioner pursuant to paragraph 12.c. and 12.k. of this appendix.

(b) The assuming insurer must maintain capital and surplus, or its equivalent, of no less than $250,000,000 calculated in accordance with paragraph 12.i.iv.(h) of this appendix. This requirement may also be satisfied by an association including incorporated and individual unincorporated underwriters having minimum capital and surplus equivalents (net of liabilities) of at least $250,000,000 and a central fund containing a balance of at least $250,000,000.

(c) The assuming insurer must maintain financial strength ratings from two or more rating agencies deemed acceptable by the commissioner. These ratings shall be based on interactive communication between the rating agency and the assuming insurer and shall not be based solely on publicly available information. These financial strength ratings will be one factor used by the commissioner in determining the rating that is assigned to the assuming insurer. Acceptable rating agencies include the following:

(1) Standard & Poor's;

(2) Moody's Investors Service;

(3) Fitch Ratings;

(4) A.M. Best Company; or

(5) Any other Nationally Recognized Statistical Rating Organization.

(d) The certified reinsurer must comply with any other requirements reasonably imposed by the commissioner of the domestic state of the ceding insurer.

iv. Each certified reinsurer shall be rated on a legal entity basis, with due consideration being given to the group rating where appropriate, except that an association including incorporated and individual unincorporated underwriters that has been approved to do business as a single certified reinsurer may be evaluated on the basis of its group rating. Factors that may be considered as part of the evaluation process include, but are not limited to, the following:

(a) The certified reinsurer's financial strength rating from an acceptable rating agency. The maximum rating that a certified reinsurer may be assigned will correspond to its financial strength rating as outlined in the table below. The commissioner shall use the lowest financial strength rating received from an approved rating agency in establishing the maximum rating of a certified reinsurer. A failure to obtain or maintain at least two financial strength ratings from acceptable rating agencies will result in loss of eligibility for certification:

Ratings	Best	S&P	Moody's	Fitch
Secure – 1	A++	AAA	Aaa	AAA
Secure – 2	A+	AA+, AA, AA-	Aa1, Aa2, Aa3	AA+, AA, AA-
Secure – 3	A	A+, A	A1, A2	A+, A
Secure – 4	A-	A-	A3	A-
Secure – 5	B++, B+	BBB+, BBB, BBB-	Baa1, Baa2, Baa3	BBB+, BBB, BBB-
Vulnerable – 6	B, B-C++, C+, C, C-, D, E, F	BB+, BB, BB-, B+, B, B-, CCC, CC, C, D, R	Ba1, Ba2, Ba3, B1, B2, B3, Caa, Ca, C	BB+, BB, BB-, B+, B, B-, CCC+, CC, CCC-, DD

(b) The business practices of the certified reinsurer in dealing with its ceding insurers, including its record of compliance with reinsurance contractual terms and obligations;

(c) For certified reinsurers domiciled in the U.S., a review of the most recent applicable NAIC Annual Statement Blank, either Schedule F (for property/casualty reinsurers) or Schedule S (for life and health reinsurers);

(d) For certified reinsurers not domiciled in the U.S., a review annually of Form CR-F (for property/casualty reinsurers) or Form CR-S (for life and health reinsurers);

(e) The reputation of the certified reinsurer for prompt payment of claims under reinsurance agreements, based on an analysis of ceding insurers' Schedule F reporting of overdue reinsurance recoverables, including the proportion of obligations that are more than ninety (90) days past due or are in dispute, with specific attention given to obligations payable to companies that are in administrative supervision or receivership;

(f) Regulatory actions against the certified reinsurer;

(g) The report of the independent auditor on the financial statements of the insurance enterprise, on the basis described in paragraph (h) below;

(h) For certified reinsurers not domiciled in the U.S., audited financial statements (audited U.S. GAAP basis if available, audited IFRS basis statements are allowed but must include an audited footnote reconciling equity and net income to a U.S. GAAP basis, or, with the permission of the state insurance commissioner, audited IFRS statements with reconciliation to U.S. GAAP certified by an officer of the company), regulatory filings, and actuarial opinion (as filed with the non-U.S. jurisdiction supervisor). Upon the initial application for certification, the commissioner will consider audited financial statements for the last three (3) years filed with its non-U.S. jurisdiction supervisor;

(i) The liquidation priority of obligations to a ceding insurer in the certified reinsurer's domiciliary jurisdiction in the context of an insolvency proceeding;

(j) A certified reinsurer's participation in any solvent scheme of arrangement, or similar procedure, which involves U.S. ceding insurers. The commissioner shall receive prior notice from a certified reinsurer that proposes participation by the certified reinsurer in a solvent scheme of arrangement; and

(k) Any other information deemed relevant by the commissioner.

v. Based on the analysis conducted under paragraph 12.i.iv.(e) of a certified reinsurer's reputation for prompt payment of claims, the commissioner may make appropriate adjustments in the security the certified reinsurer is required to post to protect its liabilities to U.S. ceding insurers, provided that the commissioner shall, at a minimum, increase the security the certified reinsurer is required to post by one rating level under paragraph 12.h. if the commissioner finds that:

(a) more than fifteen percent (15%) of the certified reinsurer's ceding insurance clients have overdue reinsurance recoverables on paid losses of ninety (90) days or more which are not in dispute and which exceed $100,000 for each cedent; or

(b) the aggregate amount of reinsurance recoverables on paid losses which are not in dispute that are overdue by ninety (90) days or more exceeds $50,000,000.

vi. The assuming insurer must submit a properly executed Form CR-1 as evidence of its submission to the jurisdiction of this state, appointment of the commissioner as an agent for service of process in this state, and agreement to provide security for one hundred percent (100%) of the assuming insurer's liabilities attributable to reinsurance ceded by U.S. ceding insurers if it resists enforcement of a final U.S. judgment. The commissioner shall not certify any assuming insurer that is domiciled in a jurisdiction that the commissioner has determined does not adequately and promptly enforce final U.S. judgments or arbitration awards.

vii. The certified reinsurer must agree to meet applicable information filing requirements as determined by the commissioner, both with respect to an initial application for certification and on an ongoing basis. All information submitted by certified reinsurers which are not otherwise public information subject to disclosure shall be exempted from disclosure under [cite state law equivalent of Freedom of Information Act] and shall be withheld from public disclosure. The applicable information filing requirements are, as follows:

(a) Notification within ten (10) days of any regulatory actions taken against the certified reinsurer, any change in the provisions of its domiciliary license or any change in rating by an approved rating agency, including a statement describing such changes and the reasons therefore;

(b) Annually, Form CR-F or CR-S, as applicable;

(c) Annually, the report of the independent auditor on the financial statements of the insurance enterprise, on the basis described in paragraph 12.i.vii.(d) below;

(d) Annually, audited financial statements (audited U.S. GAAP basis if available, audited IFRS basis statements are allowed but must include an audited footnote reconciling equity and net income to a U.S. GAAP basis, or, with the permission of the state insurance commissioner, audited IFRS statements with reconciliation to U.S. GAAP certified by an officer of the company), regulatory filings, and actuarial opinion (as filed with the certified reinsurer's supervisor). Upon the initial certification, audited financial statements for the last three (3) years filed with the certified reinsurer's supervisor;

(e) At least annually, an updated list of all disputed and overdue reinsurance claims regarding reinsurance assumed from U.S. domestic ceding insurers;

(f) A certification from the certified reinsurer's domestic regulator that the certified reinsurer is in good standing and maintains capital in excess of the jurisdiction's highest regulatory action level; and

(g) Any other information that the commissioner may reasonably require.

j. Change in Rating or Revocation of Certification

i. In the case of a downgrade by a rating agency or other disqualifying circumstance, the commissioner shall upon written notice assign a new rating to the certified reinsurer in accordance with the requirements of paragraph 12.i.

ii. The commissioner shall have the authority to suspend, revoke, or otherwise modify a certified reinsurer's certification at any time if the certified reinsurer fails to meet its obligations or security requirements under this section, or if other financial or operating results of the certified reinsurer, or documented significant delays in payment by the certified reinsurer, lead the commissioner to reconsider the certified reinsurer's ability or willingness to meet its contractual obligations.

iii. If the rating of a certified reinsurer is upgraded by the commissioner, the certified reinsurer may meet the security requirements applicable to its new rating on a prospective basis, but the commissioner shall require the certified reinsurer to post security under the previously applicable security requirements as to all contracts in force on or before the effective date of the upgraded rating. If the rating of a certified reinsurer is downgraded by the commissioner, the commissioner shall require the certified reinsurer to meet the security requirements applicable to its new rating for all business it has assumed as a certified reinsurer.

iv. Upon revocation of the certification of a certified reinsurer by the commissioner, the assuming insurer shall be required to post security in accordance with paragraph 18 in order for the ceding insurer to continue to take credit for reinsurance ceded to the assuming insurer. If funds continue to be held in trust in accordance with paragraph 11, the commissioner may allow additional credit equal to the ceding insurer's *pro rata* share of such funds, discounted to reflect the risk of uncollectibility and anticipated expenses of trust administration. Notwithstanding the change of a certified reinsurer's rating or revocation of its certification, a domestic insurer that has ceded reinsurance to that certified reinsurer may not be denied credit for reinsurance for a period of three (3) months for all reinsurance ceded to that certified reinsurer, unless the reinsurance is found by the commissioner to be at high risk of uncollectibility.

k. Qualified Jurisdictions

i. If, upon conducting an evaluation with respect to the reinsurance supervisory system of any non-U.S. assuming insurer, the commissioner of the domestic state of the ceding insurer determines that the jurisdiction qualifies to be recognized as a qualified jurisdiction, the commissioner shall publish notice and evidence of such recognition in an appropriate manner. The commissioner may establish a procedure to withdraw recognition of those jurisdictions that are no longer qualified.

ii. In order to determine whether the domiciliary jurisdiction of a non-U.S. assuming insurer is eligible to be recognized as a qualified jurisdiction, the commissioner shall evaluate the reinsurance supervisory system of the non-U.S. jurisdiction, both initially and on an ongoing basis, and consider the rights, benefits and the extent of reciprocal recognition afforded by the non-U.S. jurisdiction to reinsurers licensed and domiciled in the U.S. The commissioner shall determine the appropriate approach for evaluating the qualifications of such jurisdictions, and create and publish a list of jurisdictions whose reinsurers may be approved by the commissioner as eligible for certification. A qualified jurisdiction must agree to share information and cooperate with the commissioner with respect to all certified reinsurers domiciled within that jurisdiction. Additional factors to be considered in determining whether to recognize a qualified jurisdiction, in the discretion of the commissioner, include but are not limited to the following:

(a) The framework under which the assuming insurer is regulated.

(b) The structure and authority of the domiciliary regulator with regard to solvency regulation requirements and financial surveillance.

(c) The substance of financial and operating standards for assuming insurers in the domiciliary jurisdiction.

(d) The form and substance of financial reports required to be filed or made publicly available by reinsurers in the domiciliary jurisdiction and the accounting principles used.

(e) The domiciliary regulator's willingness to cooperate with U.S. regulators in general and the commissioner in particular.

(f) The history of performance by assuming insurers in the domiciliary jurisdiction.

(g) Any documented evidence of substantial problems with the enforcement of final U.S. judgments in the domiciliary jurisdiction. A jurisdiction will not be considered to be a qualified jurisdiction if the commissioner has determined that it does not adequately and promptly enforce final U.S. judgments or arbitration awards.

(h) Any relevant international standards or guidance with respect to mutual recognition of reinsurance supervision adopted by the International Association of Insurance Supervisors or successor organization.

(i) Any other matters deemed relevant by the commissioner.

iii. A list of qualified jurisdictions shall be published through the NAIC Committee Process. The commissioner shall consider this list in determining qualified jurisdictions. If the commissioner approves a jurisdiction as qualified that does not appear on the list of qualified jurisdictions, the commissioner shall provide thoroughly documented justification with respect to the criteria provided under paragraphs 12.k.ii.(a) to (i).

iv. U.S. jurisdictions that meet the requirements for accreditation under the NAIC financial standards and accreditation program shall be recognized as qualified jurisdictions.

l. Recognition of Certification Issued by an NAIC Accredited Jurisdiction

i. If an applicant for certification has been certified as a reinsurer in an NAIC accredited jurisdiction, the commissioner has the discretion to defer to that jurisdiction's certification, and to defer to the rating assigned by that jurisdiction, if the assuming insurer submits a properly executed Form CR-1 and such additional information as the commissioner requires. The assuming insurer shall be considered to be a certified reinsurer in this State.

ii. Any change in the certified reinsurer's status or rating in the other jurisdiction shall apply automatically in this State as of the date it takes effect in the other jurisdiction. The certified reinsurer shall notify the commissioner of any change in its status or rating within 10 days after receiving notice of the change.

iii. The commissioner may withdraw recognition of the other jurisdiction's rating at any time and assign a new rating in accordance with paragraph 12.j. of this appendix.

iv. The commissioner may withdraw recognition of the other jurisdiction's certification at any time, with written notice to the certified reinsurer. Unless the commissioner suspends or revokes the certified reinsurer's certification in accordance with paragraph 12.j. of this appendix, the certified reinsurer's certification shall remain in good standing in the domestic state of the ceding insurer for a period of three (3) months, which shall be extended if additional time is necessary to consider the assuming insurer's application for certification in this State.

m. Mandatory Funding Clause. In addition to the clauses required under *SSAP No. 61R—Life, Deposit-Type and Accident and Health Reinsurance* and *SSAP No. 62R—Property and Casualty Reinsurance*, reinsurance contracts entered into or renewed under paragraph 12 of this appendix shall include a proper funding clause, which requires the certified reinsurer to provide and maintain security in an amount sufficient to avoid the imposition of any financial statement penalty on the ceding insurer under this section for reinsurance ceded to the certified reinsurer.

n. The commissioner shall comply with all reporting and notification requirements that may be established by the NAIC with respect to certified reinsurers and qualified jurisdictions.

13. Credit shall be allowed when the reinsurance is ceded to an assuming insurer not meeting the requirements of paragraphs 8, 9, 10, 11 or 12 of this appendix, but only as to the insurance of risks located in jurisdictions where the reinsurance is required by applicable law or regulation of that jurisdiction.

14. If the assuming insurer is not licensed, accredited or certified to transact insurance or reinsurance in the domiciliary state of the ceding insurer, the credit allowed by paragraphs 10 and 11 of this appendix shall not be allowed unless the assuming insurer agrees in the reinsurance agreements:

a. i. That in the event of the failure of the assuming insurer to perform its obligations under the terms of the reinsurance agreement, the assuming insurer, at the request of the ceding insurer, shall submit to the jurisdiction of any court of competent jurisdiction in any state of the United States, will comply with all requirements necessary to give the court jurisdiction, and will abide by the final decision of the court or of any appellate court in the event of an appeal.

ii. To designate the commissioner or a designated attorney as its true and lawful attorney upon whom may be served any lawful process in any action, suit or proceeding instituted by or on behalf of the ceding insurer.

b. This paragraph 14 is not intended to conflict with or override the obligation of the parties to a reinsurance agreement to arbitrate their disputes, if this obligation is created in the agreement.

15. If the assuming insurer does not meet the requirements of paragraphs 8, 9 or 10, the credit allowed by paragraph 11 or 12 of this appendix shall not be allowed unless the assuming insurer agrees in the trust agreements to the following conditions:

a. Notwithstanding any other provisions in the trust instrument, if the trust fund is inadequate because it contains an amount less than the amount required by paragraph 11 c. of this appendix, or if the grantor of the trust has been declared insolvent or placed into receivership, rehabilitation, liquidation or similar proceedings under the laws of its state or country of domicile, the trustee shall comply with an order of the commissioner with regulatory oversight over the trust or with an order of a court of competent jurisdiction directing the trustee to transfer to the commissioner with regulatory oversight all of the assets of the trust fund.

b. The assets shall be distributed by and claims shall be filed with and valued by the commissioner with regulatory oversight in accordance with the laws of the state in which the trust is domiciled that are applicable to the liquidation of domestic insurance companies.

c. If the commissioner with regulatory oversight determines that the assets of the trust fund or any part thereof are not necessary to satisfy the claims of the U.S. ceding insurers of the grantor of the trust, the assets or part thereof shall be returned by the commissioner with regulatory oversight to the trustee for distribution in accordance with the trust agreement.

d. The grantor shall waive any right otherwise available to it under U.S. law that is inconsistent with this provision.

16. If an accredited or certified reinsurer ceases to meet the requirements for accreditation or certification, the domestic state of the ceding insurer may suspend or revoke the reinsurer's accreditation or certification.

a. The domestic state of the ceding insurer must give the reinsurer notice an opportunity for hearing. The suspension or revocation may not take effect until after the state's order on hearing, unless:

i. The reinsurer waives its right to hearing;

ii. The state's order is based on regulatory action by the reinsurer's domiciliary jurisdiction or the voluntary surrender or termination of the reinsurer's eligibility to transact insurance or reinsurance business in its domiciliary jurisdiction or in the primary certifying state of the reinsurer under paragraph 12.f. of this appendix; or

iii. The domestic state of the ceding insurer finds that an emergency requires immediate action and a court of competent jurisdiction has not stayed the state's action.

b. While a reinsurer's accreditation or certification is suspended, no reinsurance contract issued or renewed after the effective date of the suspension qualifies for credit except to the extent that the reinsurer's obligations under the contract are secured in accordance with paragraph 18. If a reinsurer's accreditation or certification is revoked, no credit for reinsurance may be granted after the effective date of the revocation except to the extent that the reinsurer's obligations under the contract are secured in accordance with paragraph 12.e. or paragraph 18.

Valuation of and Requirements for Trust Assets

17. Assets deposited in the trust shall be valued according to their current fair market value and shall consist only of cash in U.S. dollars, certificates of deposit issued by a U.S. financial institution as defined in paragraph 52, clean, irrevocable, unconditional and "evergreen" letters of credit issued or confirmed by a qualified U.S. financial institution, as defined in paragraph 52, and investments of the type specified in this paragraph, but investments in or issued by an entity controlling, controlled by or under common control with either the grantor or beneficiary of the trust shall not exceed five percent (5%) of total investments. No more than twenty percent (20%) of the total of the investments in the trust may be foreign investments authorized under paragraphs 17.a.v., c., f.ii. or g. of this paragraph, and no more than ten percent (10%) of the total of the investments in the trust may be securities denominated in foreign currencies. For purposes of applying the preceding sentence, a depository receipt denominated in U.S. dollars and representing rights conferred by a foreign security shall be classified as a foreign investment denominated in a foreign currency. The assets of a trust shall be invested only as follows:

a. Government obligations that are not in default as to principal or interest, that are valid and legally authorized and that are issued, assumed or guaranteed by:

i. The United States or by any agency or instrumentality of the United States;

ii. A state of the United States;

iii. A territory, possession or other governmental unit of the United States;

iv. An agency or instrumentality of a governmental unit referred to in paragraphs 17.a.i. and 17.a.ii. if the obligations shall be by law (statutory of otherwise) payable, as to both principal and interest, from taxes levied or by law required to be levied or from adequate special revenues pledged or otherwise appropriated or by law required to be provided for making these payments, but shall not be obligations eligible for investment under this paragraph if payable solely out of special assessments on properties benefited by local improvements; or

v. The government of any other country that is a member of the Organization for Economic Cooperation and Development and whose government obligations are rated A or higher, or the equivalent, by a rating agency recognized by the Securities Valuation Office of the NAIC;

b. Obligations that are issued in the United States, or that are dollar denominated and issued in a non-U.S. market, by a solvent U.S. institution (other than an insurance company) or that are assumed or guaranteed by a solvent U.S. institution (other than an insurance company) and that are not in default as to principal or interest if the obligations:

i. Are rated A or higher (or the equivalent) by a securities rating agency recognized by the Securities Valuation Office of the NAIC, or if not so rated, are similar in structure and other material respects to other obligations of the same institution that are so rated;

ii. Are insured by at least one authorized insurer (other than the investing insurer or a parent, subsidiary or affiliate of the investing insurer) licensed to insure obligations in this state and, after considering the insurance, are rated AAA (or the equivalent) by a securities rating agency recognized by the Securities Valuation Office of the NAIC; or

iii. Have been designated as Class One or Class Two by the Securities Valuation Office of the NAIC;

c. Obligations issued, assumed or guaranteed by a solvent non U.S. institution chartered in a country that is a member of the Organization for Economic Cooperation and Development or obligations of U.S. corporations issued in a non-U.S. currency, provided that in either case the obligations are rated A or higher, or the equivalent, by a rating agency recognized by the Securities Valuation Office of the NAIC;

d. An investment made pursuant to the provisions of paragraph 17.a., b. or c. shall be subject to the following additional limitations:

i. An investment in or loan upon the obligations of an institution other than an institution that issues mortgage-related securities shall not exceed five percent (5%) of the assets of the trust;

ii. An investment in any one mortgage-related security shall not exceed five percent (5%) of the assets of the trust;

iii. The aggregate total investment in mortgage-related securities shall not exceed twenty-five percent (25%) of the assets of the trust; and

iv. Preferred or guaranteed shares issued or guaranteed by a solvent U.S. institution are permissible investments if all of the institution's obligations are eligible as investments under paragraphs 17.b.i. and b.iii. of this paragraph, but shall not exceed two percent (2%) of the assets of the trust.

e. As used in this appendix:

i. "Mortgage-related security" means an obligation that is rated AA or higher (or the equivalent) by a securities rating agency recognized by the Securities Valuation Office of the NAIC and that either:

(a) Represents ownership of one or more promissory notes or certificates of interest or participation in the notes (including any rights designed to assure servicing of, or the receipt or timeliness of receipt by the holders of the notes, certificates, or participation of amounts payable under, the notes, certificates or participation), that:

(1) Are directly secured by a first lien on a single parcel of real estate, including stock allocated to a dwelling unit in a residential cooperative housing corporation, upon which is located a dwelling or mixed residential and commercial structure, or on a residential manufactured home as defined in 42 U.S.C.A. Section 5402(6), whether the manufactured home is considered real or personal property under the laws of the state in which it is located; and

(2) Were originated by a savings and loan association, savings bank, commercial bank, credit union, insurance company, or similar institution that is supervised and examined by a federal or state housing authority, or by a mortgagee approved by the Secretary of Housing and Urban Development pursuant to 12 U.S.C.A. Sections 1709 and 1715-b, or, where the notes involve a lien on the manufactured home, by an institution or by a financial institution approved for insurance by the Secretary of Housing and Urban Development pursuant to 12 U.S.C.A. Section 1703; or

(b) Is secured by one or more promissory notes or certificates of deposit or participations in the notes (with or without recourse to the insurer of the notes) and, by its terms, provides for payments of principal in relation to payments, or reasonable projections of payments, or notes meeting the requirements of paragraphs 17.e.i.(a)(1) and 17.e.i.(a)(2);

ii. "Promissory note," when used in connection with a manufactured home, shall also include a loan, advance or credit sale as evidenced by a retail installment sales contract or other instrument.

f. Equity interests

i. Investments in common shares or partnership interests of a solvent U.S. institution are permissible if:

(a) Its obligations and preferred shares, if any, are eligible as investments under this paragraph; and

(b) The equity interests of the institution (except an insurance company) are registered on a national securities exchange as provided in the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a to 78kk or otherwise registered pursuant to that Act, and if otherwise registered, price quotations for them are furnished through a nationwide automated quotations system approved by the Financial Industry Regulatory Authority, or successor organization. A trust shall not invest in equity interests under this paragraph an amount exceeding one percent (1%) of the assets of the trust even though the equity interests are not so registered and are not issued by an insurance company.

ii. Investments in common shares of a solvent institution organized under the laws of a country that is a member of the Organization for Economic Cooperation and Development, if:

(a) All its obligations are rated A or higher, or the equivalent, by a rating agency recognized by the Securities Valuation Office of the NAIC; and

(b) The equity interests of the institution are registered on a securities exchange regulated by the government of a country that is a member of the Organization for Economic Cooperation and Development.

iii. An investment in or loan upon any one institution's outstanding equity interests shall not exceed one percent (1%) of the assets of the trust. The cost of an investment in equity interests made pursuant to this paragraph, when added to the aggregate cost of other investments in equity interests then held pursuant to this paragraph, shall not exceed ten percent (10%) of the assets in the trust;

g. Obligations issued, assumed or guaranteed by a multinational development bank, provided the obligations are rated A or higher, or the equivalent, by a rating agency recognized by the Securities Valuation Office of the NAIC.

h. Investment companies:

i. Securities of an investment company registered pursuant to the Investment Company Act of 1940, 15 U.S.C. § 802, are allowable investments if the investment company:

(a) Invests at least ninety percent (90%) of its assets in the types of securities that qualify as an investment under paragraphs 17.a., 17.b., or 17.c., or invests in securities that are determined to be substantively similar to the types of securities set forth in paragraphs 17.a., 17.b., or 17.c.; or

(b) Invests at least ninety percent (90%) of its assets in the types of equity interests that qualify as an investment under paragraph 17.f.i.;

ii. Investments made by a trust in investment companies under this paragraph shall not exceed the following limitations:

(a) An investment in an investment company qualifying under paragraph 17.h.i. (a) shall not exceed ten percent (10%) of the assets in the trust and the aggregate amount of investment in qualifying investment companies shall not exceed twenty-five percent (25%) of the assets in the trust; and

(b) Investments in an investment company qualifying under paragraph 17.h.i. (b) of this paragraph shall not exceed five percent (5%) of the assets in the trust and the aggregate amount of investment in qualifying investment companies shall be included when calculating the permissible aggregate value of equity interests pursuant to paragraph 17.f.i.

i. Letters of Credit

i. In order for a letter of credit to qualify as an asset of the trust, the trustee shall have the right and the obligation pursuant to the deed of trust or some other binding agreement (as duly approved by the commissioner), to immediately draw down the full amount of the letter of credit and hold the proceeds in trust for the beneficiaries of the trust if the letter of credit will otherwise expire without being renewed or replaced.

ii. The trust agreement shall provide that the trustee shall be liable for its negligence, willful misconduct or lack of good faith. The failure of the trustee to draw against the letter of credit in circumstances where such draw would be required shall be deemed to be negligence and/or willful misconduct.

Asset or Reduction from Liability for Reinsurance Ceded by a Domestic Insurer to an Assuming Insurer not Meeting the Requirements detailed above under "Credit Allowed a Domestic Ceding Insurer" (paragraphs 7-17)

18. An asset or a reduction from liability for the reinsurance ceded by a domestic insurer to an assuming insurer not meeting the requirements under "Credit Allowed a Domestic Ceding Insurer" (paragraphs 7-17) shall be allowed in an amount not exceeding the liabilities carried by the ceding insurer. The reduction shall be in the amount of funds held by or on behalf of the ceding insurer, including funds held in trust for the ceding insurer, under a reinsurance contract with the assuming insurer as security for the payment of obligations thereunder, if the security is held in the United States subject to withdrawal solely by, and under the exclusive control of, the ceding insurer; or, in the case of a trust, held in a qualified U.S. financial institution, as defined under "Qualified U.S. Financial Institutions" at paragraph 53. This security may be in the form of:

a. Cash;

b. Securities listed by the Securities Valuation Office of the National Association of Insurance Commissioners, including those deemed exempt from filing as defined by the *Purposes and Procedures Manual of the NAIC Securities Valuation Office*, and qualifying as admitted assets;

Drafting Note: The *Purposes and Procedures Manual of the NAIC Securities Valuation Office* has been renamed the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*, however, the Model law refers to the previous name.

c. i. Clean, irrevocable, unconditional and evergreen letters of credit, issued or confirmed by a qualified U.S. financial institution, as defined in paragraph 52, effective no later than December 31 of the year for which the filing is being made, and in the possession of, or in trust for, the ceding insurer on or before the filing date of its annual statement;

ii. Letters of credit meeting applicable standards of issuer acceptability as of the dates of their issuance (or confirmation) shall, notwithstanding the issuing (or confirming) institution's subsequent failure to meet applicable standards of issuer acceptability, continue to be acceptable as security until their expiration, extension, renewal, modification or amendment, whichever first occurs.

d. An admitted asset or a reduction from liability for reinsurance ceded to an unauthorized assuming insurer pursuant to this appendix shall be allowed only when the requirements of paragraph 14 and the applicable portions under the sections below titled "Trust Agreements Qualified under Paragraph 18", "Letters of Credit Qualified under Paragraph 18", and "Other Security" at paragraph 50.

Trust Agreements Qualified under Paragraph 18

19. The trust agreement shall be entered into between the beneficiary, the grantor and a trustee, which shall be a qualified U.S. financial institution as defined in paragraph 53.

20. The trust agreement shall create a trust account into which assets shall be deposited.

21. All assets in the trust account shall be held by the trustee at the trustee's office in the United States.

22. The trust agreement shall provide that:

a. The beneficiary shall have the right to withdraw assets from the trust account at any time, without notice to the grantor, subject only to written notice from the beneficiary to the trustee;

b. No other statement or document is required to be presented to withdraw assets, except that the beneficiary may be required to acknowledge receipt of withdrawn assets;

c. It is not subject to any conditions or qualifications outside of the trust agreement; and

d. It shall not contain references to any other agreements or documents except as provided for in paragraph 29.

23. The trust agreement shall be established for the sole benefit of the beneficiary.

24. The trust agreement shall require the trustee to:

a. Receive assets and hold all assets in a safe place;

b. Determine that all assets are in such form that the beneficiary, or the trustee upon direction by the beneficiary, may whenever necessary negotiate any such assets, without consent or signature from the grantor or any other person or entity;

c. Furnish to the grantor and the beneficiary a statement of all assets in the trust account upon its inception and at intervals no less frequent than the end of each calendar quarter;

d. Notify the grantor and the beneficiary within ten (10) days, of any deposits to or withdrawals from the trust account;

e. Upon written demand of the beneficiary, immediately take any and all steps necessary to transfer absolutely and unequivocally all right, title and interest in the assets held in the trust account to the beneficiary and deliver physical custody of the assets to the beneficiary; and

f. Allow no substitutions or withdrawals of assets from the trust account, except on written instructions from the beneficiary, except that the trustee may, without the consent of but with notice to the beneficiary, upon call or maturity of any trust asset, withdraw such asset upon condition that the proceeds are paid into the trust account.

25. The trust agreement shall provide that at least thirty (30) days, but not more than forty-five (45) days, prior to termination of the trust account, written notification of termination shall be delivered by the trustee to the beneficiary.

26. The trust agreement shall be made subject to and governed by the laws of the state in which the trust is domiciled.

27. The trust agreement shall prohibit invasion of the trust corpus for the purpose of paying compensation to, or reimbursing the expenses of, the trustee. In order for a letter of credit to qualify as an asset of the trust, the trustee shall have the right and the obligation pursuant to the deed of trust or some other binding agreement, as duly approved by the commissioner, to immediately draw down the full amount of the letter of credit and hold the proceeds in trust for the beneficiaries of the trust if the letter of credit will otherwise expire without being renewed or replaced.

28. The trust agreement shall provide that the trustee shall be liable for its negligence, willful misconduct or lack of good faith. The failure of the trustee to draw against the letter of credit in circumstances where such draw would be required shall be deemed to be negligence and/or willful misconduct.

29. Notwithstanding other provisions of this appendix, when a trust agreement is established in conjunction with a reinsurance agreement covering risks other than life, annuities and accident and health, where it is customary practice to provide a trust agreement for a specific purpose, the trust agreement may provide that the ceding insurer shall undertake to use and apply amounts drawn upon the trust account, without diminution because of the insolvency of the ceding insurer or the assuming insurer, only for the following purposes:

a. To pay or reimburse the ceding insurer for the assuming insurer's share under the specific reinsurance agreement regarding any losses and allocated loss expenses paid by the ceding insurer, but not recovered from the assuming insurer, or for unearned premiums due to the ceding insurer if not otherwise paid by the assuming insurer;

b. To make payment to the assuming insurer of any amounts held in the trust account that exceed 102 percent of the actual amount required to fund the assuming insurer's obligations under the specific reinsurance agreement; or

c. Where the ceding insurer has received notification of termination of the trust account and where the assuming insurer's entire obligations under the specific reinsurance agreement remain unliquidated and undischarged ten (10) days prior to the termination date, to withdraw amounts equal to the obligations and deposit those amounts in a separate account, in the name of the ceding insurer in any qualified U.S. financial institution as defined in paragraph 53 apart from its general assets, in trust for such uses and purposes specified in paragraphs 29.a.

and b. above as may remain executory after such withdrawal and for any period after the termination date.

30. Notwithstanding other provisions of this appendix, when a trust agreement is established to meet the requirements of paragraph 18 in conjunction with a reinsurance agreement covering life, annuities or accident and health risks, where it is customary to provide a trust agreement for a specific purpose, the trust agreement may provide that the ceding insurer shall undertake to use and apply amounts drawn upon the trust account, without diminution because of the insolvency of the ceding insurer or the assuming insurer, only for the following purposes:

a. To pay or reimburse the ceding insurer for:

i. The assuming insurer's share under the specific reinsurance agreement of premiums returned, but not yet recovered from the assuming insurer, to the owners of policies reinsured under the reinsurance agreement on account of cancellations of the policies; and

ii. The assuming insurer's share under the specific reinsurance agreement of surrenders and benefits or losses paid by the ceding insurer, but not yet recovered from the assuming insurer, under the terms and provisions of the policies reinsured under the reinsurance agreement;

b. To pay to the assuming insurer amounts held in the trust account in excess of the amount necessary to secure the credit or reduction from liability for reinsurance taken by the ceding insurer; or

c. Where the ceding insurer has received notification of termination of the trust and where the assuming insurer's entire obligations under the specific reinsurance agreement remain unliquidated and undischarged ten (10) days prior to the termination date, to withdraw amounts equal to the assuming insurer's share of liabilities, to the extent that the liabilities have not yet been funded by the assuming insurer, and deposit those amounts in a separate account, in the name of the ceding insurer in any qualified U. S. financial institution apart from its general assets, in trust for the uses and purposes specified in paragraphs 30.a. and b. as may remain executory after withdrawal and for any period after the termination date.

31. Either the reinsurance agreement or the trust agreement must stipulate that assets deposited in the trust account shall be valued according to their current fair market value and shall consist only of cash in United States dollars, certificates of deposit issued by a United States bank and payable in United States dollars, and investments permitted by the Insurance Code or any combination of the above, provided investments in or issued by an entity controlling, controlled by or under common control with either the grantor or the beneficiary of the trust shall not exceed five percent (5%) of total investments. The agreement may further specify the types of investments to be deposited. If the reinsurance agreement covers life, annuities or accident and health risks, then the provisions required by this paragraph must be included in the reinsurance agreement.

32. Notwithstanding any other provisions in the trust instrument, if the grantor of the trust has been declared insolvent or placed into receivership, rehabilitation, liquidation or similar proceedings under the laws of its state or country of domicile, the trustee shall comply with an order of the commissioner with regulatory oversight over the trust or court of competent jurisdiction directing the trustee to transfer to the commissioner with regulatory oversight or other designated receiver all of the assets of the trust fund. The assets shall be applied in accordance with the priority statutes and laws of the state in which the trust is domiciled applicable to the assets of insurance companies in liquidation. If the commissioner with

regulatory oversight determines that the assets of the trust fund or any part thereof are not necessary to satisfy claims of the U.S. beneficiaries of the trust, the assets or any part of them shall be returned to the trustee for distribution in accordance with the trust agreement.

33. The trust agreement may provide that the trustee may resign upon delivery of a written notice of resignation, effective not less than ninety (90) days after the beneficiary and grantor receive the notice and that the trustee may be removed by the grantor by delivery to the trustee and the beneficiary of a written notice of removal, effective not less than ninety (90) days after the trustee and the beneficiary receive the notice, provided that no such resignation or removal shall be effective until a successor trustee has been duly appointed and approved by the beneficiary and the grantor and all assets in the trust have been duly transferred to the new trustee.

34. The grantor may have the full and unqualified right to vote any shares of stock in the trust account and to receive from time to time payments of any dividends or interest upon any shares of stock or obligations included in the trust account. Any interest or dividends shall be either forwarded promptly upon receipt to the grantor or deposited in a separate account established in the grantor’s name.

35. The trustee may be given authority to invest, and accept substitutions of, any funds in the account, provided that no investment or substitution shall be made without prior approval of the beneficiary, unless the trust agreement specifies categories of investments acceptable to the beneficiary and authorizes the trustee to invest funds and to accept substitutions that the trustee determines are at least equal in market value to the assets withdrawn and that are consistent with the restrictions in paragraph 38.b.

36. The trust agreement may provide that the beneficiary may at any time designate a party to which all or part of the trust assets are to be transferred. Transfer may be conditioned upon the trustee receiving, prior to or simultaneously, other specified assets.

37. The trust agreement may provide that, upon termination of the trust account, all assets not previously withdrawn by the beneficiary shall, with written approval by the beneficiary, be delivered over to the grantor.

38. A reinsurance agreement may contain provisions that:

a. Require the assuming insurer to enter into a trust agreement and to establish a trust account for the benefit of the ceding insurer, and specifying what the agreement is to cover;

b. Require the assuming insurer, prior to depositing assets with the trustee, to execute assignments or endorsements in blank, or to transfer legal title to the trustee of all shares, obligations or any other assets requiring assignments, in order that the ceding insurer, or the trustee upon the direction of the ceding insurer, may whenever necessary negotiate these assets without consent or signature from the assuming insurer or any other entity;

c. Require that all settlements of account between the ceding insurer and the assuming insurer be made in cash or its equivalent; and

d. Stipulate that the assuming insurer and the ceding insurer agree that the assets in the trust account, established pursuant to the provisions of the reinsurance agreement, may be withdrawn by the ceding insurer at any time, notwithstanding any other provisions in the reinsurance agreement, and shall be utilized and applied by the ceding insurer or its successors in interest by operation of law, including without limitation any liquidator, rehabilitator, receiver or conservator of such company, without diminution because of insolvency on the part of the ceding insurer or the assuming insurer, only for the following purposes:

i. To pay or reimburse the ceding insurer for:

(a) The assuming insurer's share under the specific reinsurance agreement of premiums returned, but not yet recovered from the assuming insurer, to the owners of policies reinsured under the reinsurance agreement because of cancellations of such policies;

(b) The assuming insurer's share of surrenders and benefits or losses paid by the ceding insurer pursuant to the provisions of the policies reinsured under the reinsurance agreement; and

(c) Any other amounts necessary to secure the credit or reduction from liability for reinsurance taken by the ceding insurer;

ii. To make payment to the assuming insurer of amounts held in the trust account in excess of the amount necessary to secure the credit or reduction from liability for reinsurance taken by the ceding insurer.

39. The reinsurance agreement also may contain provisions that:

a. Give the assuming insurer the right to seek approval from the ceding insurer, which shall not be unreasonably or arbitrarily withheld, to withdraw from the trust account all or any part of the trust assets and transfer those assets to the assuming insurer, provided:

i. The assuming insurer shall, at the time of withdrawal, replace the withdrawn assets with other qualified assets having a current fair market value equal to the market value of the assets withdrawn so as to maintain at all times the deposit in the required amount; or

ii. After withdrawal and transfer, the current fair market value of the trust account is no less than 102 percent of the required amount.

b. Provide for the return of any amount withdrawn in excess of the actual amounts required for paragraph 38.d., and for interest payments at a rate not in excess of the prime rate of interest on such amounts;

c. Allow the award by any arbitration panel or court of competent jurisdiction of:

i. Interest at a rate different from that provided in paragraph 39.b.;

ii. Court or arbitration costs;

iii. Attorney's fees; and

iv. Any other reasonable expenses.

40. Financial Reporting - A trust agreement may be used to reduce any liability for reinsurance ceded to an unauthorized assuming insurer in statutory financial statements when established on or before the date of filing of the statutory financial statement of the ceding insurer. Further, the reduction for the existence of an acceptable trust account may be up to the current fair market value of acceptable assets

available to be withdrawn from the trust account at that time, but such reduction shall be no greater than the specific obligations under the reinsurance agreement that the trust account was established to secure.

41. The failure of any trust agreement to specifically identify the beneficiary as defined in paragraph 4 shall not be construed to affect any actions or rights that the commissioner may take or possess pursuant to the provisions of the laws of the domiciliary state.

Letters of Credit Qualified under Paragraph 18

42. The letter of credit must be clean, irrevocable, unconditional and issued or confirmed by a qualified U.S. financial institution as defined in paragraph 52. The letter of credit shall contain an issue date and expiration date and shall stipulate that the beneficiary need only draw a sight draft under the letter of credit and present it to obtain funds and that no other document need be presented. The letter of credit also shall indicate that it is not subject to any condition or qualifications outside of the letter of credit. In addition, the letter of credit itself shall not contain reference to any other agreements, documents or entities, except as provided in paragraph 49.a. If a court of law appoints a successor in interest to the named beneficiary, then the named beneficiary includes and is limited to the court appointed domiciliary receiver (including conservator, rehabilitator or liquidator).

43. The heading of the letter of credit may include a boxed section containing the name of the applicant and other appropriate notations to provide a reference for the letter of credit. The boxed section shall be clearly marked to indicate that such information is for internal identification purposes only.

44. The letter of credit shall contain a statement to the effect that the obligation of the qualified U.S. financial institution under the letter of credit is in no way contingent upon reimbursement with respect thereto.

45. The term of the letter of credit shall be for at least one year and shall contain an “evergreen clause” that prevents the expiration of the letter of credit without due notice from the issuer. The “evergreen clause” shall provide for a period of no less than thirty (30) days notice prior to expiration date or nonrenewal.

46. The letter of credit shall state whether it is subject to and governed by the laws of the ceding insurers state or the Uniform Customs and Practice for Documentary Credits of the International Chamber of Commerce (Publication 600) or International Standby Practices of the International Chamber of Commerce Publication 590 (ISP98), or any successor publication, and all drafts drawn thereunder shall be presentable at an office in the United States of a qualified U.S. financial institution.

47. If the letter of credit is made subject to the Uniform Customs and Practice for Documentary Credits of the International Chamber of Commerce Publication 600 (UCP 600) or International Standby Practices of the International Chamber of Commerce Publication 590 (ISP98), or any successor publication, then the letter of credit shall specifically address and provide for an extension of time to draw against the letter of credit in the event that one or more of the occurrences specified in Article 36 of Publication 600 or any other successor publication, occur.

48. If the letter of credit is issued by a financial institution authorized to issue letters of credit, other than a qualified U.S. financial institution as described in paragraph 42, then the following additional requirements shall be met:

a. The issuing financial institution shall formally designate the confirming qualified U.S. financial institution as its agent for the receipt and payment of the drafts; and

b. The “evergreen clause” shall provide for thirty (30) days notice prior to expiration date for nonrenewal.

49. Reinsurance agreement provisions:

a. The reinsurance agreement in conjunction with which the letter of credit is obtained may contain provisions that:

i. Require the assuming insurer to provide letters of credit to the ceding insurer and specify what they are to cover;

ii. Stipulate that the assuming insurer and ceding insurer agree that the letter of credit provided by the assuming insurer pursuant to the provisions of the reinsurance agreement may be drawn upon at any time, notwithstanding any other provisions in the agreement, and shall be utilized by the ceding insurer or its successors in interest only for one or more of the following reasons:

(a) To pay or reimburse the ceding insurer for:

(1) The assuming insurer's share under the specific reinsurance agreement of premiums returned, but not yet recovered from the assuming insurers, to the owners of policies reinsured under the reinsurance agreement on account of cancellations of such policies;

(2) The assuming insurer's share, under the specific reinsurance agreement, of surrenders and benefits or losses paid by the ceding insurer, but not yet recovered from the assuming insurers, under the terms and provisions of the policies reinsured under the reinsurance agreement; and

(3) Any other amounts necessary to secure the credit or reduction from liability for reinsurance taken by the ceding insurer;

(b) Where the letter of credit will expire without renewal or be reduced or replaced by a letter of credit for a reduced amount and where the assuming insurer's entire obligations under the reinsurance agreement remain unliquidated and undischarged ten (10) days prior to the termination date, to withdraw amounts equal to the assuming insurer's share of the liabilities, to the extent that the liabilities have not yet been funded by the assuming insurer and exceed the amount of any reduced or replacement letter of credit, and deposit those amounts in a separate account in the name of the ceding insurer in a qualified U.S. financial institution apart from its general assets, in trust for such uses and purposes specified in paragraph 49.a.ii.(a) as may remain after withdrawal and for any period after the termination date.

iii. All of the provisions of paragraph 49.a. shall be applied without diminution because of insolvency on the part of the ceding insurer or assuming insurer.

b. Nothing contained in paragraph 49.a. shall preclude the ceding insurer and assuming insurer from providing for:

i. An interest payment, at a rate not in excess of the prime rate of interest, on the amounts held pursuant to paragraph 49.a.ii.; or

ii. The return of any amounts drawn down on the letters of credit in excess of the actual amounts required for the above or any amounts that are subsequently determined not to be due.

Other Security

50. A ceding insurer may take credit for unencumbered funds withheld by the ceding insurer in the United States subject to withdrawal solely by the ceding insurer and under its exclusive control.

51. Credit will not be granted, nor an asset or reduction from liability allowed, to a ceding insurer for reinsurance effected with assuming insurers meeting the requirements of this appendix or otherwise in compliance with this appendix unless the reinsurance agreement:

a. Includes a proper insolvency clause, which stipulates that reinsurance is payable directly to the liquidator or successor without diminution regardless of the status of the ceding company;

b. Includes a provision pursuant to Section [cite state law equivalent to Section 2 of the Credit for Reinsurance Model Law] whereby the assuming insurer, if an unauthorized assuming insurer, has submitted to the jurisdiction of an alternative dispute resolution panel or court of competent jurisdiction within the United States, has agreed to comply with all requirements necessary to give the court or panel jurisdiction, has designated an agent upon whom service of process may be effected, and has agreed to abide by the final decision of the court or panel; and

c. Includes a proper reinsurance intermediary clause, if applicable, which stipulates that the credit risk for the intermediary is carried by the assuming insurer.

Qualified U.S. Financial Institutions

52. For purposes of paragraphs 17, 18.c., 42 and 48, a “qualified U.S. financial institution” means an institution that:

a. Is organized or (in the case of a U.S. office of a foreign banking organization) licensed, under the laws of the United States or any state thereof;

b. Is regulated, supervised and examined by U.S. federal or state authorities having regulatory authority over banks and trust companies; and

c. Has been determined by either the commissioner or the Securities Valuation Office of the National Association of Insurance Commissioners to meet such standards of financial condition and standing as are considered necessary and appropriate to regulate the quality of financial institutions whose letters of credit will be acceptable to the commissioner.

53. A “qualified U.S. financial institution” means, for purposes of those provisions of this appendix specifying those institutions that are eligible to act as a fiduciary of a trust, an institution that:

a. Is organized, or in the case of a U.S. branch or agency office of a foreign banking organization, licensed, under the laws of the United States or any state thereof and has been granted authority to operate with fiduciary powers; and

b. Is regulated, supervised and examined by federal or state authorities having regulatory authority over banks and trust companies.

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Appendix A-791

Life And Health Reinsurance Agreements

Accounting Requirements

1. This Appendix shall not apply to assumption reinsurance, yearly renewable term reinsurance or certain nonproportional reinsurance such as stop loss or catastrophe reinsurance.

Q *– Aside from assumption reinsurance, what other types of reinsurance are exempt from the accounting requirements?*

A *– Yearly renewable term (YRT) and certain nonproportional reinsurance arrangements, such as stop loss and catastrophe reinsurance are exempt because these do not normally provide significant surplus relief and therefore are outside the scope of this Appendix. If a catastrophe arrangement takes a reserve credit for actual losses beyond the attachment point or the unearned premium reserve (UPR) of the current year's premium, there will most likely be no regulatory concern.*

Similarly, if a YRT treaty provides incidental reserve credits for the ceding insurer's net amount at risk for the year with no other allowance to enhance surplus, there will most likely be no regulatory concern. For purposes of this exemption, a treaty labeled as YRT does not meet the intended definition of YRT if the surplus relief in the first year is greater than that provided by a YRT treaty with zero first year reinsurance premium and no additional allowance from the reinsurer.

Additional pertinent information applicable to all YRT treaties and to non-proportional reinsurance arrangements is contained in paragraphs 19 and 20 of SSAP No. 61R.

2. No insurer shall, for reinsurance ceded, reduce any liability or establish any asset in any statutory financial statement if, by the terms of the reinsurance agreement, in substance or effect, any of the following conditions exist:

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

Q *– What should be included in the renewal expense allowances with regard to direct expenses? An allocation of salaries? Computer usage? Or just marginal expenses directly related to the business reinsured such as claim payment expenses, postage, etc.?*

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

Paragraph 2.a. implements that purpose by prohibiting credit for reinsurance in certain instances where the ceding insurer is afforded a large ceding commission at the inception of the agreement resulting in a significant increase in surplus only to have such surplus increase be drained away in subsequent periods because renewal expense allowances provided under the agreement are insufficient to cover the direct *allocable costs estimated at the time the business is reinsured, which are anticipated to be incurred by the ceding insurer in maintaining the business reinsured.*

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

In determining what the ceding insurer should include in the renewal expenses with regard to direct expenses, there should be an allocation of all renewal expenses anticipated at the time the business is reinsured including salaries, computer usage, postage, etc. This comprehensive calculation should recognize that the anticipated expense levels may be estimated; a comparison with pricing assumptions may be considered in determining the reasonableness of such assumptions.

When an agreement does not comply with paragraph 2.a., this area of non-compliance should be addressed by the posting of a reserve for the present value of the deficiency rather than denial for credit for reinsurance, assuming that no other area of non-compliance is encountered with the agreement and that the assets received corresponding to the ceding commission are in compliance with the Codification, including Appendix A-785. For example, the assets received corresponding to the ceding commission must be admissible and not subject to repayment to the reinsurer.

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

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

A *– Under a combination coinsurance/modified coinsurance (co/modco) arrangement the ceding company and the reinsurer both establish reserves for future claim payments. Treaty provisions which adjust the reserves each party holds in lieu of transferring funds owed to the reinsurer are acceptable. However, adjustment of reserves in lieu of payment when funds are due to the ceding company is a violation of the accounting requirements since it is a depletion of the ceding company's assets. In other words, statutory gains can be used to increase the modified coinsurance reserve but statutory losses cannot be used to reduce the modified coinsurance reserve. This is the case even if the agreement provides for this adjustment at inception and never requires a payment to be owed by the reinsurer.*

Under a coinsurance with funds withheld treaty the reinsurer establishes the entire amount of reserve liability on its share of reinsured policies, but the ceding company withholds a portion of the reinsurer’s assets typically in an amount less than the reserves, to offset future obligations. Provided the withheld assets are not withheld for any purpose other than the payment of future claims, it is not a violation of the accounting requirements for the reinsurer to require full use of such withheld assets for the payment of claims prior to using any other assets owned by the reinsurer.

Paragraph 2.b. disallows reinsurance credit if the ceding company can be deprived of assets at the reinsurer's option or automatically upon the occurrence of some event. Thus, a provision in a coinsurance with funds withheld or modified coinsurance treaty which unilaterally or automatically allows the reinsurer to convert the treaty to coinsurance at some later date would be of concern. Although the parties could have entered a coinsurance agreement at inception, regulators are concerned that the reinsurer would take invested assets from the ceding company at a time which would be to the detriment of the ceding company's policyholders. Therefore, a conversion provision will not violate paragraph 2.b. only if all of the following are met:

i) *the triggers for conversion are limited to ceding company violations of treaty provisions, including complying representations and warranties; the occurrence of a violation has been determined; and the ceding company has been given an opportunity and refuses to promptly remedy the violation;*

ii) *the conversion is structured so that the surplus of the ceding company will remain unchanged immediately following the conversion;*

iii) *the invested assets to be transferred upon conversion are less than or equal to the modco reserve, in the case of modco or co/modco, or to the Funds Withheld, in the case of coinsurance funds withheld, and have been maintained in a Trust or Escrow Account since inception of the agreement; and*

iv) *the reinsurance complies with Credit for Reinsurance requirements (see Appendix A-785) immediately upon conversion.*

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

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

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

Q *– Should a reinsurer have a unilateral right to establish underlying cost of insurance rates or credited interest rates for policies which are wholly or partially reinsured?*

A *– No, only the ceding company has the right to set the cost of insurance rates charged policyholders and to set the rates of interest credited to them. However, a representation (but not a warranty) that the ceding company shall vary nonguaranteed elements reinsured in a manner consistent with the ceding company's documented procedures, in effect at the time the agreement was entered into, does not violate the accounting requirements.*

***Q –** May a reinsurance contract allow the reinsurer to change the cost of insurance that the ceding company must pay under the treaty?*

***A –** So long as the aggregate amounts payable by the ceding company in any settlement period do not exceed the income of the reinsured policies during that period, the treaty's structure would not be in violation of paragraph 2.e. There is not compliance if any changes could cause payments made by the ceding company to exceed income from the reinsured business, unless the change is necessary to conform to the documented procedures represented to the reinsurer at the time the treaty was entered into and as long as the ceding company has the ability to change the insurance rates it charges policyholders by at least as much as was included in the original representation.*

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

***A –** So long as the aggregate amounts payable by the ceding company in any settlement period do not exceed the income of the reinsured policies during that period, the treaty's structure would not be in violation of paragraph 2.e. There is not compliance if any changes could cause payments made by the ceding company to exceed income from the reinsured business, unless the limited participation reflects a change in declared interest rates which is necessary to conform to the documented procedures represented to the reinsurer at the time the treaty was entered into and as long as the ceding company has the ability to change the declared interest rates to be credited to policyholders by at least as much as was included in the original representation.*

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

Risk categories:

i. Morbidity

ii. Mortality

iii. Lapse

This is the risk that a policy will voluntarily terminate prior to the recoupment of a statutory surplus strain experienced at issue of the policy.

iv. Credit Quality

This is the risk that invested assets supporting the reinsured business will decrease in value. The main hazards are that assets will default or that there will be a decrease in earning power. It excludes market value declines due to changes in interest rate.

v. Reinvestment

This is the risk that interest rates will fall and funds reinvested (coupon payments or monies received upon asset maturity or call) will therefore earn less than expected. If asset durations are less than liability durations, the mismatch will increase.

vi. Disintermediation

This is the risk that interest rates rise and policy loans and surrenders increase or maturing contracts do not renew at anticipated rates of renewal. If asset durations are greater than the liability durations, the mismatch will increase. Policyholders will move their funds into new products offering higher rates. The company may have to sell assets at a loss to provide for these withdrawals.

+ - Significant 0 - Insignificant

RISK CATEGORY

	i.	ii.	iii.	iv.	v.	vi.
Health Insurance - other than LTC/LTD*	+	0	+	0	0	0
Health Insurance - LTC/LTD*	+	0	+	+	+	0
Immediate Annuities	0	+	0	+	+	0
Single Premium Deferred Annuities	0	0	+	+	+	+
Flexible Premium Deferred Annuities	0	0	+	+	+	+
Guaranteed Interest Contracts	0	0	0	+	+	+
Other Annuity Deposit Business	0	0	+	+	+	+
Single Premium Whole Life	0	+	+	+	+	+
Traditional Non-Par Permanent	0	+	+	+	+	+
Traditional Non-Par Term	0	+	+	0	0	0
Traditional Par Permanent	0	+	+	+	+	+
Traditional Par Term	0	+	+	0	0	0
Adjustable Premium Permanent	0	+	+	+	+	+
Indeterminate Premium Permanent	0	+	+	+	+	+
Universal Life Flexible Premium	0	+	+	+	+	+

Universal Life Fixed Premium	0	+	+	+	+	+
Universal Life Fixed Premium dump-in premiums allowed	0	+	+	+	+	+

*LTC = Long Term Care Insurance

LTD = Long Term Disability Insurance

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

***Q** – Is asset segmentation an acceptable mechanism for legal segregation of assets?*

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

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

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

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

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

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

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

***A** – The ceding company does not need to segregate assets separately for each reinsurer if the treaties are virtually identical.*

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

A *– The assets should be valued at their statutory admitted value.*

Q *– When the assets are legally segregated, how are the funds withheld payables and receivables reported?*

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

ii. Notwithstanding the requirements of paragraph g.i., the assets supporting the reserves for the following classes of business and any classes of business which do not have a significant credit quality, reinvestment or disintermediation risk may be held by the ceding company without segregation of such assets:

(a) Health Insurance - LTC/LTD

(b) Traditional Non-Par Permanent

(c) Traditional Par Permanent

(d) Adjustable Premium Permanent

(e) Indeterminate Premium Permanent

(f) Universal Life Fixed Premium

(no dump-in premiums allowed)

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

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

Where:
I is the net investment income
CG is capital gains less capital losses
X is the current year cash and invested assets plus investment income due and accrued less borrowed money
Y is the same as X but for the prior year

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

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

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

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

3. Any increase in surplus net of federal income tax resulting from reinsurance agreements entered into or amended after the effective date of the Codification which involve the reinsurance of business issued prior to the effective date of the agreements shall be identified separately on the insurer's statutory financial statement as a surplus item and recognition of the surplus increase as income shall be reflected on a net of tax basis as earnings emerge from the business reinsured.

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

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

Written Agreements

4. No reinsurance agreement or amendment to any agreement may be used to reduce any liability or to establish any asset in any financial statement, unless the agreement, amendment or a binding letter of intent has been duly executed by both parties no later than the "as of date" of the financial statement.

5. In the case of a letter of intent, a reinsurance agreement or an amendment to a reinsurance agreement must be executed within a reasonable period of time, not exceeding ninety (90) days from the execution date of the letter of intent, in order for credit to be granted for the reinsurance ceded.

Appendix A-812

Smoker/Nonsmoker Mortality Tables for Use in Determining Minimum Reserve Liabilities

Purpose

1. The purpose of this Appendix is to permit the use of mortality tables that reflect differences in mortality between smokers and nonsmokers in determining minimum reserve liabilities for plans of insurance with separate premium rates for smokers and nonsmokers.

Definitions

2. As used in this Appendix, “1980 CSO Table, with or without Ten-Year Select Mortality Factor” means that mortality table, consisting of separate rates of mortality for male and female lives, developed by the Society of Actuaries Committee to Recommend New Mortality Tables for Valuation of Standard Individual Ordinary Life Insurance, referred to as the Commissioners 1980 Standard Ordinary Mortality Table. The same select factors will be used for both smokers and nonsmokers tables.

3. As used in this Appendix, “1980 CET Table” means that mortality table consisting of separate rates of mortality for male and female lives, developed by the Society of Actuaries Committee to Recommend New Mortality Tables for Valuation of Standard Individual Ordinary Life Insurance, and referred to as the Commissioners 1980 Extended Term Insurance Table.

4. As used in this Appendix, the phrase “smoker and nonsmoker mortality tables” refers to the mortality tables with separate rates of mortality for smokers and nonsmokers derived from the tables defined in paragraphs 2-3 which were developed by the Society of Actuaries Task Force on Smoker/Nonsmoker Mortality and the California Insurance Department staff and recommended by the NAIC Technical Staff Actuarial Group.

5. As used in this Appendix, the phrase “composite mortality tables” refers to the mortality tables defined in paragraphs 2-3 as they were originally published with rates of mortality that do not distinguish between smokers and nonsmokers.

Alternate Tables

6. For any policy of insurance delivered or issued for delivery after the effective date of Codification, at the option of the company and subject to the conditions stated in paragraph 7 of this Appendix;

   a. The 1980 CSO Smoker and Nonsmoker Mortality Tables, with or without Ten-Year Select Mortality Factors, may be substituted for the 1980 CSO Table, with or without Ten-Year Select Mortality Factors, and

   b. The 1980 CET Smoker and Nonsmoker Mortality Tables may be substituted for the 1980 CET Table for use in determining minimum reserve liabilities.

Conditions

7. For each plan of insurance with separate rates for smokers and nonsmokers an insurer may

   a. Use composite mortality tables to determine minimum reserve liabilities,

b. Use smoker and nonsmoker mortality tables to determine the valuation net premiums and additional minimum reserves, if any, required by Appendix A-820 and use composite mortality tables to determine the basic minimum reserves, or

c. Use smoker and nonsmoker mortality to determine minimum reserve liabilities.

Appendix A-815

Model Regulation Permitting the Recognition of Preferred Mortality Rates For Use in Determining Minimum Reserve Liabilities

Purpose

1. The purpose of this regulation is to recognize, permit and prescribe the use of mortality tables that reflect differences in mortality between preferred and standard lives in determining minimum reserve liabilities in accordance with paragraph 3.a.iii. of Appendix A-820 Standard Valuation Law and paragraphs 16 and 17 of Appendix A-830 Valuation of Life Insurance Model Regulation.

2. **Definitions**

a. "2001 CSO Mortality Table" means that mortality table, consisting of separate rates of mortality for male and female lives, developed by the American Academy of Actuaries CSO Task Force from the Valuation Basic Mortality Table developed by the Society of Actuaries Individual Life Insurance Valuation Mortality Task Force, and adopted by the NAIC in December 2002. The 2001 CSO Mortality Table is included in the *Proceedings of the NAIC (2nd Quarter 2002)* and supplemented by the 2001 CSO Preferred Class Structure Mortality Table defined below in Subsection B. Unless the context indicates otherwise, the "2001 CSO Mortality Table" includes both the ultimate form of that table and the select and ultimate form of that table and includes both the smoker and nonsmoker mortality tables and the composite mortality tables. It also includes both the age-nearest-birthday and age-last-birthday bases of the mortality tables. Mortality tables in the 2001 CSO Mortality Table include the following:

i. "2001 CSO Mortality Table (F)" means that mortality table consisting of the rates of mortality for female lives from the 2001 CSO Mortality Table.

ii. "2001 CSO Mortality Table (M)" means that mortality table consisting of the rates of mortality for male lives from the 2001 CSO Mortality Table.

iii. "Composite mortality tables" means mortality tables with rates of mortality that do not distinguish between smokers and nonsmokers.

iv. "Smoker and nonsmoker mortality tables" means mortality tables with separate rates of mortality for smokers and nonsmokers.

b. "2001 CSO Preferred Class Structure Mortality Table" means mortality tables with separate rates of mortality for super preferred nonsmokers, preferred nonsmokers, residual standard nonsmokers, preferred smokers, and residual standard smoker splits of the 2001 CSO Nonsmoker and Smoker Tables, as adopted by the NAIC at the September, 2006 national meeting and published in the *NAIC Proceedings {3rd Quarter 2006}*. Unless the context indicates otherwise, the "2001 CSO Preferred Class Structure Mortality Table" includes both the ultimate form of that table and the select and ultimate form of that table. It includes both the smoker and nonsmoker mortality tables. It includes both the male and female mortality tables and the gender composite mortality tables. It also includes both the age-nearest-birthday and age-last-birthday bases of the mortality table.

c. "Statistical agent" means an entity with proven systems for protecting the confidentiality of individual insured and insurer information; demonstrated resources for and history of ongoing electronic communications and data transfer ensuring data integrity with insurers, which are its members or subscribers; and a history of and means for aggregation of data and accurate promulgation of the experience modifications in a timely manner.

2001 CSO Preferred Class Structure Table

3. At the election of the company, for each calendar year of issue, for any one or more specified plans of insurance and subject to satisfying the conditions stated in this regulation, the 2001 CSO Preferred Class Structure Mortality Table may be substituted in place of the 2001 CSO Smoker or Nonsmoker Mortality Table as the minimum valuation standard for policies issued on or after January 1, 2007. For policies issued on or after January 1, 2004 (effective date of adoption of the 2001 CSO Mortality Table for Use in Determining Minimum Reserve Liabilities and Nonforfeiture Benefits), and prior to January 1, 2007, these tables may be substituted with the consent of the commissioner and subject to the conditions of paragraph 4. In determining such consent, the commissioner may rely on the consent of the commissioner of the company's state of domicile. No such election shall be made until the company demonstrates at least 20% of the business to be valued on this table is in one or more of the preferred classes. A table from the 2001 CSO Preferred Class Structure Mortality Table used in place of a 2001 CSO Mortality Table, pursuant to the requirements of this rule, will be treated as part of the 2001 CSO Mortality Table only for purposes of reserve valuation pursuant to the requirements of the NAIC model regulation, "Recognition of the 2001 CSO Mortality Table For Use In Determining Minimum Reserve Liabilities And Nonforfeiture Benefits Model Regulation."

4. **Conditions**

a. For each plan of insurance with separate rates for preferred and standard nonsmoker lives, an insurer may use the super preferred nonsmoker, preferred nonsmoker, and residual standard nonsmoker tables to substitute for the nonsmoker mortality table found in the 2001 CSO Mortality Table to determine minimum reserves. At the time of election and annually thereafter, except for business valued under the residual standard nonsmoker table, the appointed actuary shall certify that:

i. The present value of death benefits over the next ten years after the valuation date, using the anticipated mortality experience without recognition of mortality improvement beyond the valuation date for each class, is less than the present value of death benefits using the valuation basic table corresponding to the valuation table being used for that class.

ii. The present value of death benefits over the future life of the contracts, using anticipated mortality experience without recognition of mortality improvement beyond the valuation date for each class, is less than the present value of death benefits using the valuation basic table corresponding to the valuation table being used for that class.

b. For each plan of insurance with separate rates for preferred and standard smoker lives, an insurer may use the preferred smoker and residual standard smoker tables to substitute for the smoker mortality table found in the 2001 CSO Mortality Table to determine minimum reserves. At the time of election and annually thereafter, for business valued under the preferred smoker table, the appointed actuary shall certify that:

i. The present value of death benefits over the next ten years after the valuation date, using the anticipated mortality experience without recognition of mortality improvement beyond the valuation date for each class, is less than the present value of death benefits using the preferred smoker valuation basic table corresponding to the valuation table being used for that class.

ii. The present value of death benefits over the future life of the contracts, using anticipated mortality experience without recognition of mortality improvement beyond the valuation date for each class, is less than the present value of death benefits using the preferred smoker valuation basic table.

c. Unless exempted by the commissioner, every authorized insurer using the 2001 CSO Preferred Class Structure Table shall annually file with the commissioner, with the NAIC, or with a statistical agent designated by the NAIC and acceptable to the commissioner, statistical reports showing mortality and such other information as the commissioner may deem necessary or expedient for the administration of the provisions of this regulation. The form of the reports shall be established by the commissioner or the commissioner may require the use of a form established by the NAIC or by a statistical agent designated by the NAIC and acceptable to the commissioner.

d. The use of the 2001 CSO Preferred Class Structure Table for the valuation of policies issued prior to January 1, 2007 shall not be permitted in any statutory financial statement in which a company reports, with respect to any policy or portion of a policy coinsured, either of the following:

i. In cases where the mode of payment of the reinsurance premium is less frequent than the mode of payment of the policy premium, a reserve credit that exceeds, by more than the amount specified in this paragraph as Y, the gross reserve calculated before reinsurance. Y is the amount of the gross reinsurance premium that (a) provides coverage for the period from the next policy premium due date to the earlier of the end of the policy year and the next reinsurance premium due date, and (b) would be refunded to the ceding entity upon the termination of the policy.

ii. In cases where the mode of payment of the reinsurance premium is more frequent than the mode of payment of the policy premium, a reserve credit that is less than the gross reserve, calculated before reinsurance, by an amount that is less than the amount specified in this paragraph as Z. Z is the amount of the gross reinsurance premium that the ceding entity would need to pay the assuming company to provide reinsurance coverage from the period of the next reinsurance premium due date to the next policy premium due date minus any liability established for the proportionate amount not remitted to the reinsurer.

For purposes of this condition, both the reserve credit and the gross reserve before reinsurance (i) for the mean reserve method shall be defined as the mean reserve minus the deferred premium asset, and (ii) for the mid-terminal reserve method shall include the unearned premium reserve. A company may estimate and adjust its accounting on an aggregate basis in order to meet the conditions to use the 2001 CSO Preferred Class Structure Table.

Effective Date

5. The effective date of this regulation is after January 1, 2007.

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Appendix A-817

Preneed Life Insurance Minimum Standards for Determining Reserve Liabilities and Nonforfeiture Values

Scope

1. This rule applies to preneed insurance contracts, as defined in paragraph 5 and to similar policies and certificates.

Purpose

2. The purpose of this appendix is to establish for preneed insurance products minimum mortality standards for reserves and nonforfeiture values, and to require the use of the 1980 Commissioners Standard Ordinary (CSO) Life Valuation Mortality Table for use in determining the minimum standard of valuation of reserves and the minimum standard nonforfeiture values for preneed insurance products.

Definitions

3. The term "**2001 CSO Mortality Table**" means that mortality table, consisting of separate rates of mortality for male and female lives, developed by the American Academy of Actuaries CSO Task Force from the Valuation Basic Mortality Table developed by the Society of Actuaries Individual Life Insurance Valuation Mortality Task Force, and adopted by the NAIC in December 2002. The 2001 CSO Mortality Table is included in the *Proceedings of the NAIC (2nd Quarter 2002)*. Unless the context indicates otherwise, the "2001 CSO Mortality Table" includes both the ultimate form of that table and the select and ultimate form of that table and includes both the smoker and nonsmoker mortality tables and the composite mortality tables. It also includes both the age-nearest-birthday and age-last-birthday bases of the mortality tables.

4. The term "**Ultimate 1980 CSO**" means the Commissioners' 1980 Standard Ordinary Life Valuation Mortality Tables (1980 CSO) without ten-year (10-year) selection factors, incorporated into the 1980 amendments to the NAIC Standard Valuation Law approved in December 1983.

5. For the purposes of this guidance, preneed insurance is any life insurance policy or certificate that is issued in combination with, in support of, with an assignment to, or as a guarantee for a prearrangement agreement for goods and services to be provided at the time of and immediately following the death of the insured. Goods and services may include, but are not limited to embalming, cremation, body preparation, viewing or visitation, coffin or urn, memorial stone, and transportation of the deceased. The status of the policy or contract as preneed insurance is determined at the time of issue in accordance with the policy form filing.

Minimum Valuation Mortality Standards

6. For preneed insurance contracts, as defined in paragraph 5, and similar policies and contracts, the minimum mortality standard for determining reserve liabilities and nonforfeiture values for both male and female insureds shall be the Ultimate 1980 CSO.

Minimum Valuation Interest Rate Standards

7. The interest rates used in determining the minimum standard for valuation of preneed insurance shall be the calendar year statutory valuation interest rates as defined in Appendix *A-820 Minimum Life and Annuity Reserve Standards*, paragraphs 5-8.

8. The interest rates used in determining the minimum standard for nonforfeiture values for preneed insurance shall be the calendar year statutory nonforfeiture interest rates.

Minimum Valuation Method Standards

9. The method used in determining the standard for the minimum valuation of reserves of preneed insurance shall be the method defined in Appendix *A-820 Minimum Life and Annuity Reserve Standards*, paragraphs 9-11.

Transition Rules

10. For preneed insurance policies issued on or after the effective date of this appendix and before January 1, 2012, the 2001 CSO may be used as the minimum standard for reserves and minimum standard for nonforfeiture benefits for both male and female insureds.

11. If an insurer elects to use the 2001 CSO as a minimum standard for any policy issued on or after the effective date of this appendix and before January 1, 2012, the insurer shall provide, as a part of the actuarial opinion memorandum submitted in support of the company's asset adequacy testing, an annual written notification to the domiciliary commissioner. The notification shall include:

a. A complete list of all preneed policy forms that use the 2001 CSO as a minimum standard;

b. A certification signed by the appointed actuary stating that the reserve methodology employed by the company in determining reserves for the preneed policies issued after the effective date and using the 2001 CSO as a minimum standard, develops adequate reserves (For the purposes of this certification, the preneed insurance policies using the 2001 CSO as a minimum standard cannot be aggregated with any other policies.); and

c. Supporting information regarding the adequacy of reserves for preneed insurance policies issued after the effective date of this guidance and using the 2001 CSO as a minimum standard for reserves.

12. Preneed insurance policies issued on or after January 1, 2012, must use the Ultimate 1980 CSO in the calculation of minimum nonforfeiture values and minimum reserves.

Effective Date

13. This rule is applicable to preneed insurance policies and certificates and similar contracts and certificates, as specified in paragraph 5, issued on or after January 1, 2011.

Appendix A-818

Determining Reserve Liabilities for Credit Life Insurance Model Regulation

Definitions

1. "2001 CSO Mortality Table" means that mortality table, consisting of separate rates of mortality for male and female lives, developed by the American Academy of Actuaries CSO Task Force from the Valuation Basic Mortality Table developed by the Society of Actuaries Individual Life Insurance Valuation Mortality Task Force, and adopted by the NAIC in December 2002. The 2001 CSO Mortality Table is included in the *Proceedings of the NAIC (2nd Quarter 2002)*. Unless the context indicates otherwise, the "2001 CSO Mortality Table" includes both the ultimate form of that table and the select and ultimate form of that table and includes both the smoker and nonsmoker mortality tables and the composite mortality tables. It also includes both the age-nearest-birthday and age-last-birthday bases of the mortality tables.

2. "Composite mortality tables" means mortality tables with rates of mortality that do not distinguish between smokers and nonsmokers.

3. "Credit life insurance" means insurance on a debtor or debtors, pursuant to or in connection with a specific loan or other credit transaction, to provide for satisfaction of a debt, in whole or in part, upon the death of an insured debtor.

4. Credit life insurance does NOT include:

   a. Insurance written in connection with a credit transaction that is:

      i. Secured by a first mortgage or deed of trust; and

      ii. Made to finance the purchase of real property or the construction of a dwelling thereon, or to refinance a prior credit transaction made for such a purpose;

   b. Insurance sold as an isolated transaction on the part of the insurer and not related to an agreement or a plan for insuring debtors of the creditor.

   c. Insurance for which no identifiable charge is made to the debtor.

   d. Insurance on accounts receivable.

5. This rule applies to credit life insurance policies and certificates, and those similar policies and certificates where there is no identifiable charge made to the debtor.

2001 CSO Male Composite Ultimate Mortality Table

6. The minimum standard for both male and female insureds shall be 2001 CSO Male Composite Ultimate Mortality Table.

7. Where the credit life insurance policy or certificate insures two lives, the minimum standard shall be twice the mortality in the 2001 CSO Male Composite Ultimate Mortality Table based on the age of the older insured.

Minimum Standards

8. Appendix A-830 shall not apply to credit life insurance.

9. The interest rates used in determining the minimum standard for valuation shall be the calendar year statutory valuation interest rates as defined in Appendix A-820, paragraphs 5-8.

10. The method used in determining the minimum standard for valuation shall be the commissioners reserve valuation method as defined in Appendix A-820, paragraphs 9-11.

Appendix A-820

Minimum Life and Annuity Reserve Standards

Definitions

1. A "qualified actuary" is an individual who:

   a. Is a member in good standing of the American Academy of Actuaries;

   b. Is qualified to sign statements of actuarial opinion for life and health insurance company annual statements in accordance with the American Academy of Actuaries qualification standards for actuaries signing such statements;

   c. Is familiar with the valuation requirements applicable to life and health insurance companies;

   d. Has not been found by the Commissioner (or if so found has subsequently been reinstated as a qualified actuary), following appropriate notice and hearing to have:

      i. Violated any provision of, or any obligation imposed by, the Insurance Law or other law in the course of his or her dealings as a qualified actuary;

      ii. Been found guilty of fraudulent or dishonest practices;

      iii. Demonstrated his or her incompetence, lack of cooperation, or untrustworthiness to act as a qualified actuary;

      iv. Submitted to the Commissioner during the past five (5) years, pursuant to this regulation, an actuarial opinion or memorandum that the Commissioner rejected because it did not meet the provisions of this regulation including standards set by the Actuarial Standards Board; or

      v. Resigned or been removed as an actuary within the past five (5) years as a result of acts or omissions indicated in any adverse report on examination or as a result of failure to adhere to generally acceptable actuarial standards; and

   e. Has not failed to notify the Commissioner of any action taken by any Commissioner of any other state similar to that under subparagraph d. above.

Valuation Requirements

2. Reserves reported in the financial statements shall:

   a. Be computed in accordance with presently accepted actuarial standards,

   b. Be based on actuarial assumptions that produce reserves at least as great as those called for in any contract provision as to reserve basis and method, and are in accordance with all other contract provisions,

   c. Be computed on the basis of assumptions consistent with those used in computing the corresponding items in the annual statement of the preceding year-end with any exceptions disclosed in the notes to the financial statements, and

d. Include provision for all actuarial reserves and related statement items which ought to be established.

Computation of Minimum Standard for Life Insurance and Endowment Benefits

3. The minimum standard for the valuation of all life insurance and endowment policies and contracts shall be the commissioners reserve valuation methods defined in paragraphs 9-11, valuation interest rates provided in paragraphs 5-8, and the following tables:

a. For all ordinary policies of life insurance issued on the standard basis on or after January 1, 2004, excluding preneed policies (which follow Appendix A-817) any disability and accidental death benefits in the policies:

i. The Commissioners 2001 Standard Ordinary Mortality Table;

ii. At the election of the company for any one or more specified plans of life insurance, the Commissioners 2001 Standard Ordinary Mortality Table with 25-Year Select Mortality Factors; or

iii. Any ordinary mortality table adopted subsequently by the National Association of Insurance Commissioners for use in determining the minimum standard for valuation for such policies;

b. For all ordinary policies of life insurance issued on the standard basis, prior to January 1, 2004, excluding any disability and accidental death benefits in the policies and including preneed policies issued on or after January 1, 2012 (see A-817):

i. The Commissioners 1980 Standard Ordinary Mortality Table;

ii. At the election of the company for any one or more specified plans of life insurance, the Commissioners 1980 Standard Ordinary Mortality Table with Ten-Year Select Mortality Factors;

c. For all industrial life insurance policies issued on the standard basis, excluding any disability and accidental death benefits in the policies, the Commissioners 1961 Standard Industrial Mortality Table or any industrial mortality table adopted after 1980 by the National Association of Insurance Commissioners for use in determining the minimum standard of valuation for the policies;

d. For total and permanent disability benefits in or supplementary to ordinary policies or contracts, the tables of Period 2 disablement rates and the 1930 to 1950 termination rates of the 1952 Disability Study of the Society of Actuaries, with due regard to the type of benefit or any tables of disablement rates and termination rates adopted after 1980 by the National Association of Insurance Commissioners, for use in determining the minimum standard of valuation for those policies. Any such table shall, for active lives, be combined with a mortality table permitted for calculating the reserves for life insurance policies;

e. For accidental death benefits in or supplementary to policies, the 1959 Accidental Death Benefits Table or any accidental death benefits table adopted after 1980 by the National Association of Insurance Commissioners for use in determining the minimum standard of valuation for those policies. The table shall be combined with a mortality table for calculating the reserves for life insurance policies; and

f. For group life insurance, life insurance issued on the substandard basis and other special benefits: tables which provide for an adequate reserve.

Computation of Minimum Standard for Annuities

4. The minimum standard for the valuation of all individual annuity and pure endowment contracts and for all annuities and pure endowments purchased under group annuity and pure endowment contracts, shall be the commissioners annuity reserve valuation methods defined in paragraphs 12 and 13, valuation interest rates provided in paragraphs 5-8, and the tables defined in Appendix A-821.

Computation of Minimum Standard Valuation Interest Rates by Calendar Year of Issue - All Business

5. The interest rates used in determining the minimum standard for the valuation of policies issued on or after the effective date of the Codification shall be the calendar year statutory valuation interest rates as defined below:

a. Calendar Year Statutory Valuation Interest Rates

i. The calendar year statutory valuation interest rates, I, shall be determined as follows and the results rounded to the nearer one-quarter of one percent:

(a) For life insurance:

$$I = .03 + W(R_1 - .03) + \frac{W}{2}(R_2 - .09);$$

(b) For single premium immediate annuities and for annuity benefits involving life contingencies arising from other annuities with cash settlement options and from guaranteed interest contracts with cash settlement options:

$$I = .03 + W(R - .03)$$

where R_1 is the lesser of R and .09,

R_2 is the greater of R and .09,

R is the reference interest rate defined in paragraph 7,

and W is the weighting factor defined in paragraph 6;

(c) For other annuities with cash settlement options and guaranteed interest contracts with cash settlement options, valued on an issue year basis, except as stated in subparagraph (b) above, the formula for life insurance stated in subparagraph (a) above shall apply to annuities and guaranteed interest contracts with guarantee durations in excess of ten (10) years and the formula for single premium immediate annuities stated in subparagraph (b) above shall apply to annuities and guaranteed interest contracts with guarantee duration of ten (10) years or less;

(d) For other annuities with no cash settlement options and for guaranteed interest contracts with no cash settlement options, the formula for single premium immediate annuities stated in subparagraph (b) above shall apply.

(e) For other annuities with cash settlement options and guaranteed interest contracts with cash settlement options, valued on a change in fund basis, the formula for single premium immediate annuities stated in subparagraph (b) above shall apply.

ii. However, if the calendar year statutory valuation interest rate for a life insurance policy issued in any calendar year determined without reference to this sentence differs from the corresponding actual rate for similar policies issued in the immediately preceding calendar year by less than one-half of one percent (1/2 of 1%), the calendar year statutory valuation interest rate for the life insurance policies shall be equal to the corresponding actual rate for the immediately preceding calendar year.

6. The weighting factors referred to in the formulas stated above are given in the following tables:

a. Weighting Factors for Life Insurance:

Guarantee Duration (Years)	Weighting Factors
10 or less	.50
More than 10, but not more than 20	.45
More than 20	.35

For life insurance, the guarantee duration is the maximum number of years the life insurance can remain in force on a basis guaranteed in the policy or under options to convert to plans of life insurance with premium rates or nonforfeiture values or both which are guaranteed in the original policy;

b. Weighting factor for single premium immediate annuities and for annuity benefits involving life contingencies arising from other annuities with cash settlement options and guaranteed interest contracts with cash settlement options:

.80

c. Weighting factors for other annuities and for guaranteed interest contracts, except as stated in subparagraph (b) above, shall be as specified in Items i., ii. and iii. below, according to the rules and definitions in items iv., v. and vi. below:

i. For annuities and guaranteed interest contracts valued on an issue year basis:

Guarantee Duration (Years)	Weighting Factor for Plan Type A	B	C
5 or less:	.80	.60	.50
More than 5, but not more than 10:	.75	.60	.50
More than 10, but not more than 20:	.65	.50	.45
More than 20:	.45	.35	.35

		Plan Type		
		A	B	C
ii.	For annuities and guaranteed interest contracts valued on a change in fund basis, the factors shown in Item i. above increased by:	.15	.25	.05

		Plan Type		
		A	B	C
iii.	For annuities and guaranteed interest contracts valued on an issue year basis (other than those with no cash settlement options) that do not guarantee interest on considerations received more than one year after issue or purchase and for annuities and guaranteed interest contracts valued on a change in fund basis that do not guarantee interest rates on considerations received more than twelve (12) months beyond the valuation date, the factors shown in Item i. or derived in Item ii. increased by:	.05	.05	.05

iv. For other annuities with cash settlement options and guaranteed interest contracts with cash settlement options, the guarantee duration is the number of years for which the contract guarantees interest rates in excess of the calendar year statutory valuation interest rate for life insurance policies with guarantee duration in excess of twenty (20) years. For other annuities with no cash settlement options and for guaranteed interest contracts with no cash settlement options, the guaranteed duration is the number of years from the date of issue or date of purchase to the date annuity benefits are scheduled to commence.

v. Plan type as used in the above tables is defined as follows:

(a) Plan Type A: At any time policyholder may withdraw funds only (l) with an adjustment to reflect changes in interest rates or asset values since receipt of the funds by the insurance company, or (2) without an adjustment but installments over five years or more, or (3) as an immediate life annuity, or (4) no withdrawal permitted.

(b) Plan Type B: Before expiration of the interest rate guarantee, policyholder may withdraw funds only (1) with an adjustment to reflect changes in interest rates or asset values since receipt of the funds by the insurance company, or (2) without an adjustment but in installments over five years or more, or (3) no withdrawal permitted. At the end of interest rate guarantee, funds may be withdrawn without an adjustment in a single sum or installments over less than five years.

(c) Plan Type C: Policyholder may withdraw funds before expiration of interest rate guarantee in a single sum or installments over less than five years either (1) without adjustment to reflect changes in interest rates or asset values since receipt of the funds by the insurance company, or (2) subject only to a fixed surrender charge stipulated in the contract as a percentage of the fund.

vi. A company may elect to value guaranteed interest contracts with cash settlement options and annuities with cash settlement options on either an issue year basis or on a change in fund basis. Guaranteed interest contracts with no cash settlement options and other annuities with no cash settlement options must be valued on an issue year basis. An issue year basis of valuation refers to a valuation basis under which the interest rate used to determine the minimum valuation standard for the entire duration of the annuity or guaranteed interest contract is the calendar year valuation interest rate for the year of issue or year of purchase of the annuity or guaranteed interest contract, and the change in fund basis of valuation refers to a valuation basis under which the interest rate used to determine the minimum valuation standard applicable to each change in the fund held under the annuity or guaranteed interest contract is the calendar year valuation interest rate for the year of the change in the fund.

7. The reference interest rate referred to in paragraph 5 of this Appendix shall be defined as follows:

a. For all life insurance, the lesser of the average over a period of thirty-six (36) months and the average over a period of twelve (l2) months, ending on June 30 of the calendar year preceding the year of issue, of the monthly average of the composite yield on seasoned corporate bonds, as published by Moody’s Investors Service, Inc.;

b. For single premium immediate annuities and for annuity benefits involving life contingencies arising from other annuities with cash settlement options and guaranteed interest contracts with cash settlement options, the average over a period of twelve (12) months, ending on June 30 of the calendar year of issue or year of purchase, of the monthly average of the composite yield on seasoned corporate bonds, as published by Moody’s Investors Service, Inc.;

c. For other annuities with cash settlement options and guaranteed interest contracts with cash settlement options, valued on a year of issue basis, except as stated in subparagraph (b) above, with guarantee duration in excess of ten (10) years, the lesser of the average over a period of thirty-six (36) months and the average over a period of twelve (12) months, ending on June 30 of the calendar year of issue or purchase, of the monthly average of the composite yield on seasoned corporate bonds, as published by Moody’s Investors Service, Inc.;

d. For other annuities with cash settlement options and guaranteed interest contracts with cash settlement options, valued on a year of issue basis, except as stated in subparagraph (b) above, with guarantee duration of ten (10) years or less, the average over a period of twelve (12) months, ending on June 30 of the calendar year of issue or purchase, of the monthly average of the composite yield on seasoned corporate bonds, as published by Moody’s Investors Service, Inc.;

e. For other annuities with no cash settlement options and for guaranteed interest contracts with no cash settlement options, the average over a period of twelve (12) months, ending on June 30 of the calendar year of issue or purchase, of the monthly average of the composite yield on seasoned corporate bonds, as published by Moody's Investors Service, Inc.;

f. For other annuities with cash settlement options and guaranteed interest contracts with cash settlement options, valued on a change in fund basis, except as stated in subparagraph b. above, the average over a period of twelve (12) months, ending on June 30 of the calendar year of the change in the fund, of the monthly average of the composite yield on seasoned corporate bonds, as published by Moody's Investors Service, Inc.

8. In the event that the monthly average of the composite yield on seasoned corporate bonds is no longer published by Moody's Investors Service, Inc. or in the event that the National Association of Insurance Commissioners determines that the monthly average of the composite yield on seasoned corporate bonds as published by Moody's Investors Service, Inc. is no longer appropriate for the determination of the reference interest rate, then an alternative method for determination of the reference interest rate adopted by the National Association of Insurance Commissioners may be substituted.

Reserve Valuation Method—Life Insurance and Endowment Benefits

9. Except as otherwise provided in this Appendix, reserves according to the commissioners reserve valuation method, for the life insurance and endowment benefits of policies providing for a uniform amount of insurance and requiring the payment of uniform premiums shall be the excess, if any, of the present value, at the date of valuation, of the future guaranteed benefits provided for by those policies, over the then present value of any future modified net premiums therefore. The modified net premiums for a policy shall be the uniform percentage of the respective contract the premiums for the benefits that the present value, at the date of issue of the policy, of all modified net premiums shall be equal to the sum of the then present value of the benefits provided for by the policy and the excess of a. over b., as follows:

a. A net level annual premium equal to the present value, at the date of issue, of the benefits provided for after the first policy year, divided by the present value, at the date of issue, of an annuity of one per annum payable on the first and each subsequent anniversary of the policy on which a premium falls due. However, the net level annual premium shall not exceed the net level annual premium on the nineteen-year premium whole life plan for insurance of the same amount at an age one year higher than the age at issue of the policy.

b. A net one-year term premium for the benefits provided for in the first policy year.

10. For a life insurance policy for which the contract premium in the first policy year exceeds that of the second year and for which no comparable additional benefit is provided in the first year for the excess and which provides an endowment benefit or a cash surrender value or a combination in an amount greater than the excess premium, the reserve according to the commissioners reserve valuation method as of any policy anniversary occurring on or before the assumed ending date defined herein as the first policy anniversary on which the sum of any endowment benefit and any cash surrender value then available is greater than the excess premium shall, except as otherwise provided in paragraphs 17 and 18, be the greater of the reserve as of the policy anniversary calculated as described in the preceding paragraph and the reserve as of the policy anniversary calculated as described in those paragraphs, but with (i) the value defined in that paragraph being reduced by fifteen percent (15%) of the amount of such excess first year premium, (ii) all present values of benefits and premiums being determined without reference to premiums or benefits provided for by the policy after the assumed ending date, (iii) the policy being assumed to mature on that date as an endowment, and (iv) the cash surrender value provided on that

date being considered as an endowment benefit. In making the above comparison the mortality stated in paragraph 3 and interest bases stated in paragraphs 5-8 shall be used.

11. Reserves according to the commissioners reserve valuation method shall be calculated by a method consistent with the principles of paragraphs 9 and 10 for:

a. Life insurance policies providing for a varying amount of insurance or requiring the payment of varying premiums;

b. Group annuity and pure endowment contracts purchased under a retirement plan or plan of deferred compensation, established or maintained by an employer (including a partnership or sole proprietorship) or by an employee organization, or by both, other than a plan providing individual retirement accounts or individual retirement annuities under Section 408 of the Internal Revenue Code, as now or hereafter amended;

c. Disability and accidental death benefits in all policies and contracts; and

d. All other benefits, except life insurance and endowment benefits in life insurance policies and benefits provided by all other annuity and pure endowment contracts.

Reserve Valuation Method—Annuity and Pure Endowment Benefits

12. Paragraph 13 shall apply to all annuity and pure endowment contracts other than group annuity and pure endowment contracts purchased under a retirement plan or plan of deferred compensation, established or maintained by an employer (including a partnership or sole proprietorship) or by an employee organization, or by both, other than a plan providing individual retirement accounts or individual retirement annuities under Section 408 of the Internal Revenue Code, as now or hereafter amended.

13. Reserves according to the commissioners annuity reserve method for benefits under annuity or pure endowment contracts, excluding any disability and accidental death benefits in the contracts, shall be the greatest of the respective excesses of the present values, at the date of valuation, of the future guaranteed benefits, including guaranteed nonforfeiture benefits, provided for by the contracts at the end of each respective contract year, over the present value, at the date of valuation, of any future valuation considerations derived from future gross considerations, required by the terms of the contract, that become payable prior to the end of the respective contract year. The future guaranteed benefits shall be determined by using the mortality table, if any, and the interest rate, or rates, specified in the contracts for determining guaranteed benefits. The valuation considerations are the portions of the respective gross considerations applied under the terms of the contracts to determine nonforfeiture values.

Minimum Reserves

14. In no event shall a company’s aggregate reserves for all life insurance policies, excluding disability and accidental death benefits be less than the aggregate reserves calculated in accordance with the methods set forth in paragraphs 9-11, 12-13, 17-18 and 19 and the mortality table or tables and rate or rates of interest used in calculating nonforfeiture benefits for the policies.

Optional Reserve Calculation

15. Reserves for any category of policies, contracts or benefits, may be calculated, at the option of the company, according to any standards that produce greater aggregate reserves for the category than those calculated according to the minimum standard provided here, but the rate or rates of interest used for policies and contracts, other than annuity and pure endowment contracts, shall not be higher than the corresponding rate or rates of interest used in calculating any nonforfeiture benefits provided there.

16. A company that shall have adopted at any time a standard of valuation producing greater aggregate reserves than those calculated according to the minimum standard provided here may, adopt a lower standard of valuation, but not lower than the minimum provided here; provided that the holding of additional reserves previously determined by a qualified actuary shall not be deemed to be the adoption of a higher standard of valuation.

Reserve Calculation—Valuation Net Premium Exceeding the Gross Premium Charged

17. If in any contract year the gross premium charged by a life insurance company on a policy or contract is less than the valuation net premium for the policy or contract calculated by the method used in calculating the reserve but using the minimum valuation standards of mortality and rate of interest, the minimum reserve required for the policy or contract shall be the greater of either the reserve calculated according to the mortality table, rate of interest, and method actually used for the policy or contract, or the reserve calculated by the method actually used for the policy or contract but using the minimum valuation standards of mortality and rate of interest and replacing the valuation net premium by the actual gross premium in each contract year for which the valuation net premium exceeds the actual gross premium. The minimum valuation standards of mortality and rate of interest to be used are those standards stated in paragraph 3 and paragraphs 5-8 of this Appendix.

18. For a life insurance policy for which the gross premium in the first policy year exceeds that of the second year and for which no comparable additional benefit is provided in the first year for the excess and which provides an endowment benefit or a cash surrender value or a combination in an amount greater than the excess premium, the provisions of paragraphs 17 and 18 shall be applied as if the method actually used in calculating the reserve for the policy were the method described in paragraph 9. The minimum reserve at each policy anniversary of such a policy shall be the greater of the minimum reserve calculated in accordance with paragraphs 9 and 10 and the minimum reserve calculated in accordance with paragraphs 17 and 18.

Reserve Calculation—Indeterminate Premium Plans

19. In the case of a plan of life insurance that provides for future premium determination, the amounts of which are to be determined by the insurance company based on then estimates of future experience, or in the case of a plan of life insurance or annuity that is of such a nature that the minimum reserves cannot be determined by the methods described above, the reserves that are held under the plan shall:

a. Be appropriate in relation to the benefits and the pattern of premiums for that plan; and

b. Be computed by a method that is consistent with the principles of this Appendix and which produce a good and sufficient reserve.

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Appendix A-821

Annuity Mortality Table for Use in Determining Reserve Liabilities for Annuities

Purpose

1. The purpose of this Appendix is to recognize the following mortality tables for use in determining the minimum standard of valuation for annuity and pure endowment contracts: the 1983 Table “a,” the Annuity 2000 Mortality Table, and the 1994 Group Annuity Reserving (1994 GAR) Table.

Definitions

2. As used in this Appendix “1983 Table ‘a’” means that mortality table developed by the Society of Actuaries Committee to Recommend a New Mortality Basis for Individual Annuity Valuation and adopted as a recognized mortality table for annuities in June 1982 by the National Association of Insurance Commissioners.

3. As used in this Appendix “1994 GAR Table” means that mortality table developed by the Society of Actuaries Group Annuity Valuation Table Task Force and shown in the *Proceedings of the NAIC*.

4. As used in this Appendix “Annuity 2000 Mortality Table” means that mortality table developed by the Society of Actuaries Committee on Life Insurance Research and shown in the Proceedings of the NAIC.

Individual Annuity or Pure Endowment Contracts

5. Except as provided in paragraph 6 of this Appendix, the Annuity 2000 Mortality Table shall be used for determining the minimum standard of valuation for any individual annuity or pure endowment contract.

6. The 1983 Table “a” without projection is to be used for determining the minimum standards of valuation for an individual annuity or pure endowment contract solely when the contract is based on life contingencies and is issued to fund periodic benefits arising from:

a. Settlements of various forms of claims pertaining to court settlements or out of court settlements from tort actions;

b. Settlements involving similar actions such as workers’ compensation claims; or

c. Settlements of long term disability claims where a temporary or life annuity has been used in lieu of continuing disability payments.

Group Annuity or Pure Endowment Contracts

7. The 1994 GAR Table shall be used for determining the minimum standard of valuation for any annuity or pure endowment purchased under a group annuity or pure endowment contract.

Application of the 1994 GAR Table

8. In using the 1994 GAR Table, the mortality rate for a person age x in year (1994 + n) is calculated as follows:

$$q_x^{1994+n} = q_x^{1994} (1 - AA_x)^n$$

where the q_x^{1994} and AA_xs are as specified in the 1994 GAR Table.

Appendix A-822

Asset Adequacy Analysis Requirements

Definitions

1. “Asset adequacy analysis” means an analysis of the adequacy of reserves and related actuarial items, in light of the assets supporting such reserves and related items, to meet the obligations of an insurer.

Asset Adequacy Analysis

2. The reserves and related items, when considered in light of the assets held by the company with respect to such reserves and related actuarial items including, but not limited to, the investment earnings on the assets, and the considerations anticipated to be received and retained under the policies and contracts, shall make adequate provision, according to presently accepted actuarial standards of practice, for the anticipated cash flows required by the contractual obligations and related expenses of the company.

3. If the company determines as the result of asset adequacy analysis that a reserve should be held in addition to the aggregate reserve held and calculated in accordance with methods set forth in Appendix A-820, the company shall establish the additional reserve.

4. Additional reserves established above and deemed not necessary in subsequent years may be released. The release of such reserves would not be deemed an adoption of a lower standard of valuation.

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Appendix A-830

Valuation of Life Insurance Policies (Including the Introduction and Use of New Select Mortality Factors)

Purpose

1. The purpose of this appendix is to provide:

   a. Tables of select mortality factors and rules for their use;

   b. Rules concerning a minimum standard for the valuation of plans with nonlevel premiums or benefits; and

   c. Rules concerning a minimum standard for the valuation of plans with secondary guarantees.

2. The method for calculating basic reserves defined in this appendix will constitute the Commissioners' Reserve Valuation Method for policies to which this appendix is applicable.

Applicability

3. This appendix shall apply to all life insurance policies, with or without nonforfeiture values, issued on or after the effective date of this appendix, subject to the following exceptions and conditions. Nothing in this section shall be construed to expand the applicability of the Valuation of Life Insurance Policies Model Regulation to include life insurance policies exempted under this section.

   a. Exceptions

      i. This appendix shall not apply to any individual life insurance policy issued on or after the effective date of this appendix if the policy is issued in accordance with and as a result of the exercise of a reentry provision contained in the original life insurance policy of the same or greater face amount, issued before the effective date of this appendix, that guarantees the premium rates of the new policy. This appendix also shall not apply to subsequent policies issued as a result of the exercise of such a provision, or a derivation of the provision, in the new policy.

      ii. This appendix shall not apply to any universal life policy that meets all the following requirements:

         (a) Secondary guarantee period, if any, is five (5) years or less;

         (b) Specified premium for the secondary guarantee period is not less than the net level reserve premium for the secondary guarantee period based on the CSO valuation tables as defined in paragraph 9 and the applicable valuation interest rate. For contracts issued beginning January 1, 2004, the net level reserve premium is based on the ultimate mortality rates in the 2001 CSO Mortality Table; and

         (c) The initial surrender charge is not less than 100 percent of the first year annualized specified premium for the secondary guarantee period.

Drafting Note: Policies with a secondary guarantee are described in paragraph 29.

iii. This appendix shall not apply to any variable life insurance policy that provides for life insurance, the amount or duration of which varies according to the investment experience of any separate account or accounts.

iv. This appendix shall not apply to any variable universal life insurance policy that provides for life insurance, the amount or duration of which varies according to the investment experience of any separate account or accounts.

v. This appendix shall not apply to a group life insurance certificate unless the certificate provides for a stated or implied schedule of maximum gross premiums required in order to continue coverage in force for a period in excess of one year.

vi. This appendix shall not apply to preneed policies, which follow the requirements of A-817.

b. Conditions

i. Calculation of the minimum valuation standard for policies with guaranteed nonlevel gross premiums or guaranteed nonlevel benefits (other than universal life policies), or both, shall be in accordance with the provisions of paragraphs 21-28.

ii. Calculation of the minimum valuation standard for flexible premium and fixed premium universal life insurance policies, that contain provisions resulting in the ability of a policyholder to keep a policy in force over a secondary guarantee period shall be in accordance with the provisions of paragraphs 29-32.

Definitions

4. “Basic reserves” means reserves calculated in accordance with Appendix A-820, paragraphs 9-11.

5. “Contract segmentation method” means the method of dividing the period from issue to mandatory expiration of a policy into successive segments, with the length of each segment being defined as the period from the end of the prior segment (from policy inception, for the first segment) to the end of the latest policy year as determined below. For contracts beginning January 1, 2004, all calculations are made using the 2001 CSO Mortality Rate, and, if elected, the optional minimum mortality standard for deficiency reserves stipulated in paragraph 17. (or any other valuation mortality table adopted by the National Association of Insurance Commissioners (NAIC) after the effective date of this appendix for this purpose), and, if elected, the optional minimum mortality standard for deficiency reserves stipulated in paragraph 17 of this appendix. The length of a particular contract segment shall be set equal to the minimum of the value *t* for which G_t is greater than R_t (if G_t never exceeds R_t the segment length is deemed to be the number of years from the beginning of the segment to the mandatory expiration date of the policy), where G_t and R_t are defined as follows:

$$G_t = \frac{GPx+k+t}{GP_{x+k+t-1}}$$

where: x = original issue age;

k = the number of years from the date of issue to the beginning of the segment;

t = 1, 2, ...; *t* is reset to 1 at the beginning of each segment;

$GP_{x+k+t-1}$ = Guaranteed gross premium per thousand of face amount for year *t* of the segment, ignoring policy fees only if level for the premium paying period of the policy.

$$R_t = \frac{q_{x+k+t}}{q_{x+k+t-1}}$$

However, R_t may be increased or decreased by one percent in any policy year, at the company's option, but R_t shall not be less than one;

where: x, k and t are as defined above, and

The value of "$q_{x+k+t-1}$" is the valuation mortality rate for deficiency reserves in policy year k+t, but using the unmodified select mortality rates if modified select mortality rates are used in the computation of deficiency reserves.

However, if GP_{x+k+t} is greater than 0 and $GP_{x+k+t-1}$ is equal to 0, G_t shall be deemed to be 1000. If GP_{x+k+t} and $GP_{x+k+t-1}$ are both equal to 0, G_t shall be deemed to be 0.

Drafting Note: The purpose of the one percent tolerance in the R factor is to prevent irrational segment lengths due to such things as premium rounding. For example, consider a plan in which gross premiums are designed at some point to be a ratio times the underlying ultimate mortality rates, where the ratio varies by issue age. The resulting segments may be greater than one year, because the guaranteed gross premiums are not expressed in fractional cents. The tolerance factor allows the creation of one year segments for a plan in which premiums parallel the underlying valuation mortality table.

6. "Deficiency reserves" means the excess, if greater than zero, of

a. Minimum reserves calculated in accordance with Appendix A-820, paragraphs 17 and 18, over

b. Basic reserves.

7. "Guaranteed gross premiums" means the premiums under a policy of life insurance that are guaranteed and determined at issue.

8. "Maximum valuation interest rates" means the interest rates defined in Appendix A-820, paragraphs 5-8 (Computation of Minimum Standard by Calendar Year of Issue – All Business) that are to be used in determining the minimum standard for the valuation of life insurance policies.

9. "1980 CSO valuation tables" means the Commissioners' 1980 Standard Ordinary Mortality Table (1980 CSO Table) without ten-year selection factors, referenced in Appendix A-820, and variations of the 1980 CSO Table approved by the NAIC, such as the smoker and nonsmoker versions approved in December 1983.

Drafting Note: This appendix defines the 1980 CSO Tables without the existing ten -year select mortality factors to assure that, if select mortality factors are elected, only one set of factors may be applied to the base valuation mortality table.

10. "Scheduled gross premium" means the smallest illustrated gross premium at issue for other than universal life insurance policies. For universal life insurance policies, scheduled gross premium means the smallest specified premium described in paragraph 29.c., if any, or else the minimum premium described in paragraph 29.d.

11. a. "Segmented reserves" means reserves, calculated using segments produced by the contract segmentation method, equal to the present value of all future guaranteed benefits

less the present value of all future net premiums to the mandatory expiration of a policy, where the net premiums within each segment are a uniform percentage of the respective guaranteed gross premiums within the segment. The uniform percentage for each segment is such that, at the beginning of the segment, the present value of the net premiums within the segment equals:

i. The present value of the death benefits within the segment, plus

ii. The present value of any unusual guaranteed cash value (see paragraph 24) occurring at the end of the segment, less

iii. Any unusual guaranteed cash value occurring at the start of the segment, plus

iv. For the first segment only, the excess of the Item (a) over Item (b), as follows:

(a) A net level annual premium equal to the present value, at the date of issue, of the benefits provided for in the first segment after the first policy year, divided by the present value, at the date of issue, of an annuity of one per year payable on the first and each subsequent anniversary within the first segment on which a premium falls due. However, the net level annual premium shall not exceed the net level annual premium on the nineteen-year premium whole life plan of insurance of the same renewal year equivalent level amount at an age one year higher than the age at issue of the policy.

(b) A net one year term premium for the benefits provided for in the first policy year.

b. The length of each segment is determined by the "contract segmentation method," as defined in paragraph 5.

c. The interest rates used in the present value calculations for any policy may not exceed the maximum valuation interest rate, determined with a guarantee duration equal to the sum of the lengths of all segments of the policy.

d. For both basic reserves and deficiency reserves computed by the segmented method, present values shall include future benefits and net premiums in the current segment and in all subsequent segments.

Drafting Note: The segmentation requirement should not be limited to plans with no cash surrender values; otherwise companies could avoid segmentation entirely by designing policies with minimal (positive) cash values. Segmentation for plans with cash surrender values should be based solely upon gross premium levels. Basing segmentation upon the level of cash surrender values introduces complications because of the inter-relationship between minimum cash surrender values and gross premium patterns. The requirements of this appendix relating to reserves for plans with unusual cash values and to reserves if cash values exceed calculated reserves serve to link required reserves and cash surrender values. The calculation of segmented reserves shall not be linked to the occurrence of a positive unitary terminal reserve at the end of a segment. The requirement of this appendix to hold the greater of the segmented reserve or the unitary reserve eliminates the need for any linkage.

12. "Tabular cost of insurance" means the net single premium at the beginning of a policy year for one-year term insurance in the amount of the guaranteed death benefit in that policy year.

13. "Ten-year select factors" means the select factors referenced in Appendix A-820.

14. a. "Unitary reserves" means the present value of all future guaranteed benefits less the present value of all future modified net premiums, where:

i. Guaranteed benefits and modified net premiums are considered to the mandatory expiration of the policy; and

ii. Modified net premiums are a uniform percentage of the respective guaranteed gross premiums, where the uniform percentage is such that, at issue, the present value of the net premiums equals the present value of all death benefits and pure endowments, plus the excess of Item (a) over Item (b), as follows:

(a) A net level annual premium equal to the present value, at the date of issue, of the benefits provided for after the first policy year, divided by the present value, at the date of issue, of an annuity of one per year payable on the first and each subsequent anniversary of the policy on which a premium falls due. However, the net level annual premium shall not exceed the net level annual premium on the nineteen-year premium whole life plan of insurance of the same renewal year equivalent level amount at an age one year higher than the age at issue of the policy.

(b) A net one year term premium for the benefits provided for in the first policy year.

b. The interest rates used in the present value calculations for any policy may not exceed the maximum valuation interest rate, determined with a guarantee duration equal to the length from issue to the mandatory expiration of the policy.

Drafting Note: The purpose of this paragraph is to define as specifically as possible what has become commonly called the unitary method. Appendix A-820 does not define the term "unitary" for policies with nonlevel premiums or benefits; its requirement for reserves "computed by a method that is consistent with the principles of Appendix A-820" has not been uniformly interpreted.

15. "Universal life insurance policy" means any individual life insurance policy under the provisions of which separately identified interest credits (other than in connection with dividend accumulations, premium deposit funds, or other supplementary accounts) and mortality or expense charges are made to the policy.

General Calculation Requirements for Basic Reserves and Premium Deficiency Reserves

16. Prior to January 1, 2004, at the election of the company for any one or more specified plans of life insurance, the minimum mortality standard for basic reserves may be calculated using the 1980 CSO valuation tables with select mortality factors. Effective January 1, 2004, the 2001 CSO Mortality Table is the minimum standard for basic reserves (or any other valuation mortality table adopted by the NAIC after the effective date of the 2001 CSO table for this purpose). Prior to January 1, 2004 if select mortality factors are elected, they may be:

a. The ten-year select mortality factors referenced in Appendix A-820;

b. The select mortality factors in Attachment 1 of this appendix; or

Drafting Note: The select mortality factors for duration 1 through 15 in Attachment 1 of this appendix reflect the Society of Actuaries' data for the years 1983 through 1986, split by sex and smoking status, with fifteen years of mortality improvement, based on Society of Actuaries' Projection Scale A applied. A 50% margin was added. The factors were then graded to the 1980 CSO Tables over the next five durations. A 50% margin was deemed appropriate to provide a reasonable margin, with little likelihood that actual experience for significant blocks of business would exceed it.

c. Any other table of select mortality factors adopted by the NAIC after the effective date of this appendix for the purpose of calculating basic reserves.

17. Deficiency reserves, if any, are calculated for each policy as the excess, if greater than zero, of the quantity A over the basic reserve. The quantity A is obtained by recalculating the basic reserve for the policy using guaranteed gross premiums instead of net premiums when the guaranteed gross premiums are less than the corresponding net premiums. At the election of the company for any one or more specified plans of insurance, the quantity A and prior to January 1, 2004 the corresponding net premiums used in the determination of quantity A may be based upon the 1980 CSO valuation tables with select mortality factors (or any other valuation mortality table adopted by the NAIC after the effective date of this appendix). If select mortality factors are elected, they may be:

a. The ten-year select mortality factors referenced in Appendix A-820;

b. The select mortality factors in Attachment 1 of this appendix;

Effective January 1, 2004, the 2001 CSO Mortality Table is the minimum standard for deficiency reserves. If select mortality rates are used, they may be multiplied by X percent for durations in the first segment, subject to the conditions specified in Sections 17c. to iv. (a). In demonstrating compliance with those conditions, the demonstrations may not combine the results of tests that utilize the 1980 CSO Mortality Table with those tests that utilize the 2001 CSO Mortality Table, unless the combination is explicitly required by regulation or necessary to be in compliance with relevant Actuarial Standards of Practice.

Drafting Note: The select mortality factors in Attachment 1 of this appendix do not reflect the underwriting risk classes that have evolved since the period of the underlying experience. In light of this consideration and the recent recognition of the regulatory value of actuarial opinions, this appendix allows actuarial judgment to be used for deficiency reserves.

c. For durations in the first segment, X percent of the select mortality factors in Attachment 1 of this appendix, subject to the following:

i. X may vary by policy year, policy form, underwriting classification, issue age, or any other policy factor expected to affect mortality experience;

ii. X is such that, when using the valuation interest rate used for basic reserves, Item (a) is greater than or equal to Item (b);

(a) The actuarial present value of future death benefits, calculated using the mortality rates resulting from the application of X;

(b) The actuarial present value of future death benefits calculated using anticipated mortality experience without recognition of mortality improvement beyond the valuation date;

iii. X is such that the mortality rates resulting from the application of X are at least as great as the anticipated mortality experience, without recognition of mortality improvement beyond the valuation date, in each of the first five (5) years after the valuation date;

iv. The appointed actuary shall increase X at any valuation date where it is necessary to continue to meet all the requirements of paragraph 17.c.;

v. The appointed actuary may decrease X at any valuation date as long as X continues to meet all the requirements of paragraph 17.c.; and

vi. The appointed actuary shall specifically take into account the adverse effect on expected mortality and lapsation of any anticipated or actual increase in gross premiums.

(a) If X is less than 100 percent at any duration for any policy, the following requirements shall be met:

(i) The appointed actuary shall annually prepare an actuarial opinion and memorandum for the company in conformance with the asset adequacy analysis requirements as outlined in Appendix A-822;

(ii) The appointed actuary shall disclose, in the Regulatory Asset Adequacy Issues Summary, the impact of the insufficiency of assets to support the payment of benefits and expenses and the establishment of statutory reserves during one or more interim periods; and

(iii) The appointed actuary shall annually opine for all policies subject to this appendix as to whether the mortality rates resulting from the application of X meet the requirements of paragraph 17.c. This opinion shall be supported by an actuarial report, subject to appropriate Actuarial Standards of Practice promulgated by the Actuarial Standards Board of the American Academy of Actuaries. The X factors shall reflect anticipated future mortality, without recognition of mortality improvement beyond the valuation date, taking into account relevant emerging experience.

d. Any other table of select mortality factors adopted by the NAIC after the effective date of this appendix for the purpose of calculating deficiency reserves.

18. This paragraph applies to both basic reserves and deficiency reserves. Any set of select mortality factors may be used only for the first segment. However, if the first segment is less than ten (10) years, the appropriate ten-year select mortality factors referenced in Appendix A-820 may be used thereafter through the tenth policy year from the date of issue.

Drafting Note: This appendix does not allow the use of select mortality factors beyond the first segment. The rationale is that the result of a premium increase that is sufficient to require a new segment will be increased lapsation, leading to mortality deterioration after the increase. Also, for policies that have reentry provisions, select mortality factors shall not be used in segments beginning after reentry unless a new policy is actually issued. However, this appendix allows the use of the ten-year select mortality factors referenced in Appendix A-820 beyond the first segment (but in no case beyond the tenth policy year) in recognition that the mortality deterioration is unlikely to occur to a significant degree within the first ten (10) years.

19. In determining basic reserves or deficiency reserves, guaranteed gross premiums without policy fees may be used where the calculation involves the guaranteed gross premium but only if the policy fee is a level dollar amount after the first policy year. In determining deficiency reserves, policy fees may be included in guaranteed gross premiums, even if not included in the actual calculation of basic reserves.

20. Reserves for policies that have changes to guaranteed gross premiums, guaranteed benefits, guaranteed charges, or guaranteed credits that are unilaterally made by the insurer after issue and that are effective for more than one year after the date of the change shall be the greatest of the following: (1) reserves calculated ignoring the guarantee, (2) reserves assuming the guarantee was made at issue, and (3) reserves assuming that the policy was issued on the date of the guarantee.

Calculation of Minimum Valuation Standard for Policies with Guaranteed Nonlevel Gross Premiums or Guaranteed Nonlevel Benefits (Other than Universal Life Policies)

21. Basic Reserves

a. Basic reserves shall be calculated as the greater of the segmented reserves and the unitary reserves. Both the segmented reserves and the unitary reserves for any policy shall use the same valuation mortality table and selection factors. At the option of the insurer, in calculating segmented reserves and net premiums, either of the adjustments described in subparagraph i. or ii. below may be made:

i. Treat the unitary reserve, if greater than zero, applicable at the end of each segment as a pure endowment and subtract the unitary reserve, if greater than zero, applicable at the beginning of each segment from the present value of guaranteed life insurance and endowment benefits for each segment.

ii. Treat the guaranteed cash surrender value, if greater than zero, applicable at the end of each segment as a pure endowment; and subtract the guaranteed cash surrender value, if greater than zero, applicable at the beginning of each segment from the present value of guaranteed life insurance and endowment benefits for each segment.

22. Deficiency Reserves

a. The deficiency reserve at any duration shall be calculated:

i. On a unitary basis if the corresponding basic reserve determined by paragraph 21 is unitary;

ii. On a segmented basis if the corresponding basic reserve determined by paragraph 21 is segmented; or

iii. On the segmented basis if the corresponding basic reserve determined by paragraph 21 is equal to both the segmented reserve and the unitary reserve.

b. Paragraph 22 shall apply to any policy for which the guaranteed gross premium at any duration is less than the corresponding modified net premium calculated by the method used in determining the basic reserves, but using the minimum valuation standards of mortality (specified in paragraph 17) and rate of interest.

c. Deficiency reserves, if any, shall be calculated for each policy as the excess if greater than zero, for the current and all remaining periods, of the quantity A over the basic reserve, where A is obtained as indicated in paragraph 17.

d. For deficiency reserves determined on a segmented basis, the quantity A is determined using segment lengths equal to those determined for segmented basic reserves.

23. Minimum Value

a. Basic reserves may not be less than the tabular cost of insurance for the balance of the policy year, if mean reserves are used. Basic reserves may not be less than the tabular cost of insurance for the balance of the current modal period or to the paid-to-date, if later, but not beyond the next policy anniversary, if mid-terminal reserves are used. The tabular cost of insurance shall use the same valuation mortality table and interest rates as that used for the calculation of the segmented reserves. However, if select mortality factors are used, they shall be the ten-year select factors referenced in Appendix A-820. In no case may total reserves (including basic reserves, deficiency reserves and any reserves held for supplemental benefits that would expire upon contract termination) be less than the amount that the policyowner would receive (including the cash surrender value of the supplemental benefits, if any, referred to above), exclusive of any deduction for policy loans, upon termination of the policy. Effective January 1, 2004, the valuation mortality table used in determining the tabular cost of insurance shall be the ultimate mortality rates in the 2001 CSO Mortality Table.

24. Unusual Pattern of Guaranteed Cash Surrender Values

Drafting Note: This requirement is independent of both the segmentation process and the unitary process. After the greater of the segmented or the unitary reserve has been determined, then this paragraph imposes an additional floor on the ultimate reserve. The purpose of this paragraph is to assure adequate funding of significant increases in guaranteed cash surrender values.

a. For any policy with an unusual pattern of guaranteed cash surrender values, the reserves actually held prior to the first unusual guaranteed cash surrender value shall not be less than the reserves calculated by treating the first unusual guaranteed cash surrender value as a pure endowment and treating the policy as an *n* year policy providing term insurance plus a pure endowment equal to the unusual cash surrender value, where *n* is the number of years from the date of issue to the date the unusual cash surrender value is scheduled.

b. The reserves actually held subsequent to any unusual guaranteed cash surrender value shall not be less than the reserves calculated by treating the policy as an *n* year policy providing term insurance plus a pure endowment equal to the next unusual guaranteed cash surrender value, and treating any unusual guaranteed cash surrender value at the end of the prior segment as a net single premium, where

i. *n* is the number of years from the date of the last unusual guaranteed cash surrender value prior to the valuation date to the earlier of:

(a) The date of the next unusual guaranteed cash surrender value, if any, that is scheduled after the valuation date; or

(b) The mandatory expiration date of the policy; and

ii. The net premium for a given year during the *n* year period is equal to the product of the net to gross ratio and the respective gross premium; and

iii. The net to gross ratio is equal to Item (a) divided by Item (b) as follows:

(a) The present value, at the beginning of the *n* year period, of death benefits payable during the *n* year period plus the present value, at the beginning of the n year period, of the next unusual guaranteed cash surrender value, if any, minus the amount of the last unusual guaranteed cash surrender value, if any, scheduled at the beginning of the *n* year period.

(b) The present value, at the beginning of the *n* year period, of the scheduled gross premiums payable during the *n* year period.

c. For purposes of this paragraph, a policy is considered to have an unusual pattern of guaranteed cash surrender values if any future guaranteed cash surrender value exceeds the prior year's guaranteed cash surrender value by more than the sum of:

i. One hundred ten percent (110%) of the scheduled gross premium for that year;

ii. One hundred ten percent (110%) of one year's accrued interest on the sum of the prior year's guaranteed cash surrender value and the scheduled gross premium using the nonforfeiture interest rate used for calculating policy guaranteed cash surrender values; and

iii. Five percent (5%) of the first policy year surrender charge, if any.

25. Optional Exemption for Yearly Renewable Term Reinsurance. At the option of the company, the following approach for reserves on YRT reinsurance may be used:

Drafting Note: Traditional reserves for yearly renewable term (YRT) reinsurance, the calculations of which this section describes, are already adequate and sufficient. However, without this option in the appendix, YRT reinsurance would be subject to the more complex segmentation calculations.

a. Calculate the valuation net premium for each future policy year as the tabular cost of insurance for that future year.

b. Basic reserves shall never be less than the tabular cost of insurance for the appropriate period, as defined in paragraph 23.

c. Deficiency reserves.

i. For each policy year, calculate the excess, if greater than zero, of the valuation net premium over the respective maximum guaranteed gross premium.

ii. Deficiency reserves shall never be less than the sum of the present values, at the date of valuation, of the excesses determined in accordance with subparagraph i. above.

d. Prior to January 1, 2004, for purposes of this paragraph, the calculations use the maximum valuation interest rate and the 1980 CSO mortality tables with or without ten-year select mortality factors, or any other table adopted after the effective date of this appendix by the NAIC for this purpose. Effective January 1, 2004, the calculations specified in this paragraph (25) shall use the ultimate mortality rates in the 2001 CSO Mortality Table.

e. A reinsurance agreement shall be considered YRT reinsurance for purposes of this paragraph if only the mortality risk is reinsured.

f. If the assuming company chooses this optional exemption, the ceding company's reinsurance reserve credit shall be limited to the amount of reserve held by the assuming company for the affected policies.

26. Optional Exemption for Attained-Age-Based Yearly Renewable Term Life Insurance Policies. At the option of the company, the following approach for reserves for attained-age-based YRT life insurance policies may be used:

Drafting Note: Traditional reserves for attained-age-based YRT policies, the calculations of which this subsection describes, are already adequate and sufficient. However, without this option in the appendix, these policies would be subject to the more complex segmentation calculations.

a. Calculate the valuation net premium for each future policy year as the tabular cost of insurance for that future year.

b. Basic reserves shall never be less than the tabular cost of insurance for the appropriate period, as defined in paragraph 23.

c. Deficiency reserves.

i. For each policy year, calculate the excess, if greater than zero, of the valuation net premium over the respective maximum guaranteed gross premium.

ii. Deficiency reserves shall never be less than the sum of the present values, at the date of valuation, of the excesses determined in accordance with subparagraph i. above.

d. Prior to January 1, 2004, for purposes of this paragraph, the calculations use the maximum valuation interest rate and the 1980 CSO valuation tables with or without ten-year select mortality factors, or any other table adopted after the effective date of this appendix by the NAIC for this purpose. Effective January 1, 2004, the calculations specified in this paragraph shall use the ultimate mortality rates in the 2001 CSO Mortality Table.

e. A policy shall be considered an attained-age-based YRT life insurance policy for purposes of this subsection if:

i. The premium rates (on both the initial current premium scale and the guaranteed maximum premium scale) are based upon the attained age of the insured such that the rate for any given policy at a given attained age of the insured is independent of the year the policy was issued; and

ii. The premium rates (on both the initial current premium scale and the guaranteed maximum premium scale) are the same as the premium rates for policies covering all insureds of the same sex, risk class, plan of insurance and attained age.

f. For policies that become attained-age-based YRT policies after an initial period of coverage, the approach of this subsection may be used after the initial period if:

i. The initial period is constant for all insureds of the same sex, risk class and plan of insurance; or

ii. The initial period runs to a common attained age for all insureds of the same sex, risk class and plan of insurance; and

iii. After the initial period of coverage, the policy meets the conditions of paragraph 26.e. above.

g. If this election is made, this approach shall be applied in determining reserves for all attained-age-based YRT life insurance policies issued on or after the effective date of this appendix.

27. Exemption from Unitary Reserves for Certain *n*-Year Renewable Term Life Insurance Polices. Unitary basic reserves and unitary deficiency reserves need not be calculated for a policy if the following conditions are met:

Drafting Note: Without this exemption, companies issuing certain *n*-year renewable term policies could be forced to hold reserves higher than *n*-year term reserves, even though in many cases gross premiums are well above valuation mortality rates.

a. The policy consists of a series of *n*-year periods, including the first period and all renewal periods, where *n* is the same for each period, except that for the final renewal period, n may be truncated or extended to reach the expiry age, provided that this final renewal period is less than 10 years and less than twice the size of the earlier n-year periods, and for each period, the premium rates on both the initial current premium scale and the guaranteed maximum premium scale are level;

b. Prior to January 1, 2004, the guaranteed gross premiums in all *n*-year periods are not less than the corresponding net premiums based upon the 1980 CSO Table with or without the ten-year select mortality factors. Effective January 1, 2004, the calculations specified in this paragraph shall use the ultimate mortality rates in the 2001 CSO Mortality Table; and

c. There are no cash surrender values in any policy year.

28. Exemption from Unitary Reserves for Certain Juvenile Policies. Unitary basic reserves and unitary deficiency reserves need not be calculated for a policy if the following conditions are met, based upon the initial current premium scale at issue:

a. At issue, the insured is age twenty-four (24) or younger;

b. Until the insured reaches the end of the juvenile period, which shall occur at or before age twenty-five (25), the gross premiums and death benefits are level, and there are no cash surrender values; and

c. After the end of the juvenile period, gross premiums are level for the remainder of the premium paying period, and death benefits are level for the remainder of the life of the policy.

Drafting Note: The jumping juvenile policy described has traditionally been valued in two segments. This exemption will allow that practice to continue without requiring the calculation of reserves on a unitary basis. However, within each segment, both basic and deficiency reserves shall comply with the segmented reserve requirements.

Calculation of Minimum Valuation Standard for Flexible Premium and Fixed Premium Universal Life Insurance Policies That Contain Provisions Resulting in the Ability of a Policyowner to Keep a Policy in Force Over a Secondary Guarantee Period

29. General

a. Policies with a secondary guarantee include:

i. A policy with a guarantee that the policy will remain in force at the original schedule of benefits, subject only to the payment of specified premiums;

ii. Prior to January 1, 2004 a policy in which the minimum premium at any duration is less than the corresponding one year valuation premium, calculated using the maximum valuation interest rate and the 1980 CSO valuation tables with or without ten-year select mortality factors, or any other table adopted after the effective date of this appendix by the NAIC for this purpose. Effective January 1, 2004, the one-year valuation premium shall be calculated using the ultimate mortality rates in the 2001 CSO Mortality Table; or

iii. A policy with any combination of subparagraph i. and ii.

Drafting Note: Universal life and variable universal life policies with secondary guarantees that meet the requirements of paragraph 3.a.ii. are not subject to this appendix.

b. A secondary guarantee period is the period for which the policy is guaranteed to remain in force subject only to a secondary guarantee. When a policy contains more than one secondary guarantee, the minimum reserve shall be the greatest of the respective minimum reserves at that valuation date of each unexpired secondary guarantee, ignoring all other secondary guarantees. Secondary guarantees that are unilaterally changed by the insurer after issue shall be considered to have been made at issue. Reserves described in paragraphs 30 and 31 below shall be recalculated from issue to reflect these changes.

c. Specified premiums mean the premiums specified in the policy, the payment of which guarantees that the policy will remain in force at the original schedule of benefits, but which otherwise would be insufficient to keep the policy in force in the absence of the guarantee if maximum mortality and expense charges and minimum interest credits were made and any applicable surrender charges were assessed.

d. For purposes of this paragraph, the minimum premium for any policy year is the premium that, when paid into a policy with a zero account value at the beginning of the policy year, produces a zero account value at the end of the policy year. The minimum premium calculation shall use the policy cost factors (including mortality charges, loads and expense charges) and the interest crediting rate, which are all guaranteed at issue.

e. The one-year valuation premium means the net one-year premium based upon the original schedule of benefits for a given policy year. The one-year valuation premiums for all policy years are calculated at issue. The select mortality factors defined in paragraphs 17.b., 17.c. and 17.d. may not be used to calculate the one-year valuation premiums.

f. The one-year valuation premium should reflect the frequency of fund processing, as well as the distribution of deaths assumption employed in the calculation of the monthly mortality charges to the fund.

30. Basic Reserves for the Secondary Guarantees. Basic reserves for the secondary guarantees shall be the segmented reserves for the secondary guarantee period. In calculating the segments and the segmented reserves, the gross premiums shall be set equal to the specified premiums, if any, or otherwise to the minimum premiums, that keep the policy in force and the segments will be determined according to the contract segmentation method as defined in paragraph 5.

31. Deficiency Reserves for the Secondary Guarantees. Deficiency reserves, if any, for the secondary guarantees shall be calculated for the secondary guarantee period in the same manner as described in paragraph 22 with gross premiums set equal to the specified premiums, if any, or otherwise to the minimum premiums that keep the policy in force.

32. Minimum Reserves. The minimum reserves during the secondary guarantee period are the greater of:

a. The basic reserves for the secondary guarantee plus the deficiency reserve, if any, for the secondary guarantees; or

b. The minimum reserves required by other appendices governing universal life plans.

Attachment 1

SELECT MORTALITY FACTORS

This Attachment contains tables of select mortality factors that are the bases to which the respective percentage of paragraphs 16.b., 17.b. and 17.c. are applied.

The six tables of select mortality factors contained herein include: (1) male aggregate, (2) male nonsmoker, (3) male smoker, (4) female aggregate, (5) female nonsmoker, and (6) female smoker.

These tables apply to both age last birthday and age nearest birthday mortality tables.

For sex-blended mortality tables, compute select mortality factors in the same proportion as the underlying mortality. For example, for the 1980 CSO-B Table, the calculated select mortality factors are eighty percent (80%) of the appropriate male table in this Attachment, plus twenty percent (20%) of the appropriate female table in this Attachment.

Attachment 1

SELECT MORTALITY FACTORS

Male, Aggregate

Issue	Duration																			
Age	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**11**	**12**	**13**	**14**	**15**	**16**	**17**	**18**	**19**	**20+**
0-15	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
16	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
17	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
18	96	98	98	99	99	100	100	90	92	92	92	92	93	93	96	97	98	98	99	100
19	83	84	84	87	87	87	79	79	79	81	81	82	82	82	85	88	91	94	97	100
20	69	71	71	74	74	69	69	67	69	70	71	71	71	71	74	79	84	90	95	100
21	66	68	69	71	66	66	67	66	67	70	70	70	70	71	71	77	83	88	94	100
22	65	66	66	63	63	64	64	64	65	68	68	68	68	69	71	77	83	88	94	100
23	62	63	59	60	62	62	63	63	64	65	65	67	67	69	70	76	82	88	94	100
24	60	56	56	59	59	60	61	61	61	64	64	64	66	67	70	76	82	88	94	100
25	52	53	55	56	58	58	60	60	60	63	62	63	64	67	69	75	81	88	94	100
26	51	52	55	56	58	58	57	61	61	62	63	64	66	69	66	73	80	86	93	100
27	51	52	55	57	58	60	61	61	60	63	63	64	67	66	67	74	80	87	93	100
28	49	51	56	58	60	60	61	62	62	63	64	66	65	66	68	74	81	87	94	100
29	49	51	56	58	60	61	62	62	62	64	64	62	66	67	70	76	82	88	94	100
30	49	50	56	58	60	60	62	63	63	64	62	63	67	68	71	77	83	88	94	100
31	47	50	56	58	60	62	63	64	64	62	63	66	68	70	72	78	83	89	94	100
32	46	49	56	59	60	62	63	66	62	63	66	67	70	72	73	78	84	89	95	100
33	43	49	56	59	62	63	64	62	65	66	67	70	72	73	75	80	85	90	95	100
34	42	47	56	60	62	63	61	63	66	67	70	71	73	75	76	81	86	90	95	100
35	40	47	56	60	63	61	62	65	67	68	71	73	74	76	76	81	86	90	95	100
36	38	42	56	60	59	61	63	65	67	68	70	72	74	76	77	82	86	91	95	100
37	38	45	56	57	61	62	63	65	67	68	70	72	74	76	76	81	86	90	95	100
38	37	44	53	58	61	62	65	66	67	69	69	73	75	76	77	82	86	91	95	100
39	37	41	53	58	62	63	65	65	66	68	69	72	74	76	76	81	86	90	95	100
40	34	40	53	58	62	63	65	65	66	68	68	71	75	76	77	82	86	91	95	100

Male, Aggregate

Issue	Duration																			
Age	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**11**	**12**	**13**	**14**	**15**	**16**	**17**	**18**	**19**	**20+**
41	34	41	53	58	62	63	65	64	64	66	68	70	74	76	77	82	86	91	95	100
42	34	43	53	58	61	62	63	63	63	64	66	69	72	75	77	82	86	91	95	100
43	34	43	54	59	60	61	63	62	62	64	66	67	72	74	77	82	86	91	95	100
44	34	44	54	58	59	60	61	60	61	62	64	67	71	74	77	82	86	91	95	100
45	34	45	53	58	59	60	60	60	59	60	63	66	71	74	77	82	86	91	95	100
46	31	43	52	56	57	58	59	59	59	60	63	67	71	74	75	80	85	90	95	100
47	32	42	50	53	55	56	57	58	59	60	65	68	71	74	75	80	85	90	95	100
48	32	41	47	52	54	56	57	57	57	61	65	68	72	73	74	79	84	90	95	100
49	30	40	46	49	52	54	55	56	57	61	66	69	72	73	74	79	84	90	95	100
50	30	38	44	47	51	53	54	56	57	61	66	71	72	73	75	80	85	90	95	100
51	28	37	42	46	49	53	54	56	57	61	66	71	72	73	75	80	85	90	95	100
52	28	35	41	45	49	51	54	56	57	61	66	71	72	74	75	80	85	90	100	100
53	27	35	39	44	48	51	53	55	57	61	67	71	74	75	76	81	86	100	100	100
54	27	33	38	44	48	50	53	55	57	61	67	72	74	75	76	81	100	100	100	100
55	25	32	37	43	47	50	53	55	57	61	68	72	74	75	78	100	100	100	100	100
56	25	32	37	43	47	49	51	54	56	61	67	70	73	74	100	100	100	100	100	100
57	24	31	38	43	47	49	51	54	56	59	66	69	72	100	100	100	100	100	100	100
58	24	31	38	43	48	48	50	53	56	59	64	67	100	100	100	100	100	100	100	100
59	23	30	39	43	48	48	51	53	55	58	63	100	100	100	100	100	100	100	100	100
60	23	30	39	43	48	47	50	52	53	57	100	100	100	100	100	100	100	100	100	100
61	23	30	39	43	49	49	50	52	53	75	100	100	100	100	100	100	100	100	100	100
62	23	30	39	44	49	49	51	52	75	75	100	100	100	100	100	100	100	100	100	100
63	22	30	39	45	50	50	52	75	75	75	100	100	100	100	100	100	100	100	100	100
64	22	30	39	45	50	51	75	75	75	75	100	100	100	100	100	100	100	100	100	100
65	22	30	39	45	50	65	70	70	70	70	100	100	100	100	100	100	100	100	100	100

Male, Aggregate

Issue	Duration																			
Age	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**11**	**12**	**13**	**14**	**15**	**16**	**17**	**18**	**19**	**20+**
66	22	30	39	45	60	65	70	70	70	70	100	100	100	100	100	100	100	100	100	100
67	22	30	39	60	60	65	70	70	70	70	100	100	100	100	100	100	100	100	100	100
68	23	32	55	60	60	65	70	70	70	70	100	100	100	100	100	100	100	100	100	100
69	23	52	55	60	60	65	70	70	70	70	100	100	100	100	100	100	100	100	100	100
70	48	52	55	60	60	65	70	70	70	70	100	100	100	100	100	100	100	100	100	100
71	48	52	55	60	60	65	70	70	70	70	100	100	100	100	100	100	100	100	100	100
72	48	52	55	60	60	65	70	70	70	70	100	100	100	100	100	100	100	100	100	100
73	48	52	55	60	60	65	70	70	70	70	100	100	100	100	100	100	100	100	100	100
74	48	52	55	60	60	65	70	70	70	70	100	100	100	100	100	100	100	100	100	100
75	48	52	55	60	60	65	70	70	70	70	100	100	100	100	100	100	100	100	100	100
76	48	52	55	60	60	65	70	70	70	100	100	100	100	100	100	100	100	100	100	100
77	48	52	55	60	60	65	70	70	100	100	100	100	100	100	100	100	100	100	100	100
78	48	52	55	60	60	65	70	100	100	100	100	100	100	100	100	100	100	100	100	100
79	48	52	55	60	60	65	100	100	100	100	100	100	100	100	100	100	100	100	100	100
80	48	52	55	60	60	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
81	48	52	55	60	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
82	48	52	55	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
83	48	52	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
84	48	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
85+	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100

Male, Non-Smoker

Issue										Duration										
Age	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**11**	**12**	**13**	**14**	**15**	**16**	**17**	**18**	**19**	**20+**
0-15	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
16	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
17	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
18	93	95	96	98	99	100	100	90	92	92	92	92	95	95	96	97	98	98	99	100
19	80	81	83	86	87	87	79	79	79	81	81	82	83	83	86	89	92	94	97	100
20	65	68	69	72	74	69	69	67	69	70	71	71	72	72	75	80	85	90	95	100
21	63	66	68	71	66	66	67	66	67	70	70	70	71	71	73	78	84	89	95	100
22	62	65	66	62	63	64	64	64	67	68	68	68	70	70	73	78	84	89	95	100
23	60	62	58	60	62	62	63	63	64	67	68	68	67	69	71	77	83	88	94	100
24	59	55	56	58	59	60	61	61	63	65	67	66	66	69	71	77	83	88	94	100
25	52	53	55	56	58	58	60	60	61	64	64	64	64	67	70	76	82	88	94	100
26	51	53	55	56	58	60	61	61	61	63	64	64	66	69	67	74	80	87	93	100
27	51	52	55	58	60	60	61	61	62	63	64	66	67	66	67	74	80	87	93	100
28	49	52	57	58	60	61	63	62	62	64	66	66	63	66	68	74	81	87	94	100
29	49	51	57	60	61	61	62	62	63	64	66	63	65	67	68	74	81	87	94	100
30	49	51	57	60	61	62	63	63	63	64	62	63	66	68	70	76	82	88	94	100
31	47	50	57	60	60	62	63	64	64	62	63	65	67	70	71	77	83	88	94	100
32	46	50	57	60	62	63	64	64	62	63	65	66	68	71	72	78	83	89	94	100
33	45	49	56	60	62	63	64	62	63	65	66	68	71	73	74	79	84	90	95	100
34	43	48	56	62	63	64	62	62	65	66	67	70	72	74	74	79	84	90	95	100
35	41	47	56	62	63	61	62	63	66	67	68	70	72	74	75	80	85	90	95	100
36	40	47	56	62	59	61	62	63	66	67	68	70	72	74	75	80	85	90	95	100
37	38	45	56	58	59	61	62	63	66	67	67	69	71	73	74	79	84	90	95	100
38	38	45	53	58	61	62	63	65	65	67	68	70	72	74	73	78	84	89	95	100
39	37	41	53	58	61	62	63	64	65	67	68	70	71	73	73	78	84	89	95	100
40	34	41	53	58	61	62	63	64	64	66	67	69	71	73	72	78	83	89	94	100

Male, Non-Smoker

Issue	Duration																			
Age	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**11**	**12**	**13**	**14**	**15**	**16**	**17**	**18**	**19**	**20+**
41	34	41	53	58	61	61	62	62	63	65	65	67	69	71	71	77	83	88	94	100
42	34	43	53	58	60	61	62	61	61	63	64	66	67	69	71	77	83	88	94	100
43	32	43	53	58	60	61	60	60	60	60	62	64	66	68	69	75	81	88	94	100
44	32	44	52	57	59	60	60	59	59	58	60	62	65	67	69	75	81	88	94	100
45	32	44	52	57	59	60	59	57	57	57	59	61	63	66	68	74	81	87	94	100
46	32	42	50	54	56	57	57	56	55	56	59	61	63	65	67	74	80	87	93	100
47	30	40	48	52	54	55	55	54	54	55	59	61	62	63	66	73	80	86	93	100
48	30	40	46	49	51	52	53	53	54	55	57	61	62	63	63	70	78	85	93	100
49	29	39	43	48	50	51	50	51	53	54	57	61	61	62	62	70	77	85	92	100
50	29	37	42	45	47	48	49	50	51	54	57	61	61	61	61	69	77	84	92	100
51	27	35	40	43	45	47	48	50	51	53	57	60	61	61	62	70	77	85	92	100
52	27	34	39	42	44	45	48	49	50	53	56	60	60	62	62	70	77	85	100	100
53	25	31	37	41	44	45	47	49	50	51	56	59	61	61	62	70	77	100	100	100
54	25	30	36	39	43	44	47	48	49	51	55	59	59	61	62	70	100	100	100	100
55	24	29	35	38	42	43	45	48	49	50	56	58	59	61	62	100	100	100	100	100
56	23	29	35	38	42	42	44	47	48	50	55	57	58	59	100	100	100	100	100	100
57	23	28	35	38	42	42	43	45	47	49	53	55	56	100	100	100	100	100	100	100
58	22	28	33	37	41	41	43	45	45	47	51	53	100	100	100	100	100	100	100	100
59	22	26	33	37	41	41	42	44	44	46	50	100	100	100	100	100	100	100	100	100
60	20	26	33	37	41	40	41	42	42	45	100	100	100	100	100	100	100	100	100	100
61	20	26	33	37	41	40	41	42	42	75	100	100	100	100	100	100	100	100	100	100
62	19	25	32	38	40	40	41	42	75	75	100	100	100	100	100	100	100	100	100	100
63	19	25	33	36	40	40	41	75	75	75	100	100	100	100	100	100	100	100	100	100
64	18	24	32	36	39	40	75	75	75	75	100	100	100	100	100	100	100	100	100	100
65	18	24	32	36	39	65	70	70	70	70	100	100	100	100	100	100	100	100	100	100
66	18	24	32	36	60	65	70	70	70	70	100	100	100	100	100	100	100	100	100	100
67	18	24	32	60	60	65	70	70	70	70	100	100	100	100	100	100	100	100	100	100
68	18	24	55	60	60	65	70	70	70	70	100	100	100	100	100	100	100	100	100	100
69	18	52	55	60	60	65	70	70	70	70	100	100	100	100	100	100	100	100	100	100
70	48	52	55	60	60	65	70	70	70	70	100	100	100	100	100	100	100	100	100	100

Male, Non-Smoker

Issue									Duration										
Age	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**11**	**12**	**13**	**14**	**15**	**16**	**17**	**18**	**19**	**20+**
71	48	52	55	60	60	65	70	70	70	70	100	100	100	100	100	100	100	100	100	100
72	48	52	55	60	60	65	70	70	70	70	100	100	100	100	100	100	100	100	100	100
73	48	52	55	60	60	65	70	70	70	70	100	100	100	100	100	100	100	100	100	100
74	48	52	55	60	60	65	70	70	70	70	100	100	100	100	100	100	100	100	100	100
75	48	52	55	60	60	65	70	70	70	70	100	100	100	100	100	100	100	100	100	100
76	48	52	55	60	60	65	70	70	70	100	100	100	100	100	100	100	100	100	100	100
77	48	52	55	60	60	65	70	70	100	100	100	100	100	100	100	100	100	100	100	100
78	48	52	55	60	60	65	70	100	100	100	100	100	100	100	100	100	100	100	100	100
79	48	52	55	60	60	65	100	100	100	100	100	100	100	100	100	100	100	100	100	100
80	48	52	55	60	60	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
81	48	52	55	60	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
82	48	52	55	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
83	48	52	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
84	48	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
85+	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100

Male, Smoker

Issue	Duration																			
Age	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**11**	**12**	**13**	**14**	**15**	**16**	**17**	**18**	**19**	**20+**
0-15	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
16	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
17	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
18	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
19	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
20	98	100	100	100	100	100	100	99	99	99	100	99	99	99	100	100	100	100	100	100
21	95	98	99	100	95	96	96	95	96	97	97	96	96	96	96	97	98	98	99	100
22	92	95	96	90	90	93	93	92	93	95	95	93	93	92	93	94	96	97	99	100
23	90	92	85	88	88	89	89	89	90	90	90	90	89	90	92	94	95	97	98	100
24	87	81	82	85	84	86	88	86	86	88	88	86	86	88	89	91	93	96	98	100
25	77	78	79	82	81	83	83	82	83	85	84	84	84	85	86	89	92	94	97	100
26	75	77	79	82	82	83	83	82	83	84	84	84	84	85	81	85	89	92	96	100
27	73	75	78	82	82	83	83	82	82	82	82	84	84	80	81	85	89	92	96	100
28	71	73	79	82	81	82	83	81	81	82	82	82	80	80	81	85	89	92	96	100
29	69	72	78	81	81	82	82	81	81	81	81	77	80	80	81	85	89	92	96	100
30	68	71	78	81	81	81	82	81	81	81	76	77	80	80	81	85	89	92	96	100
31	65	70	77	81	79	81	82	81	81	76	77	79	81	81	83	86	90	93	97	100
32	63	67	77	78	79	81	81	81	76	77	77	80	83	83	85	88	91	94	97	100
33	60	65	74	78	79	79	81	76	77	77	79	80	83	85	85	88	91	94	97	100
34	57	62	74	77	79	79	75	76	77	79	79	81	83	85	87	90	92	95	97	100
35	53	60	73	77	79	75	75	76	77	79	80	82	84	86	88	90	93	95	98	100
36	52	59	71	75	74	75	75	76	77	79	79	81	83	85	87	90	92	95	97	100
37	49	58	70	71	74	74	75	76	77	78	79	81	84	86	86	89	92	94	97	100
38	48	55	66	70	72	74	74	75	76	78	79	81	83	85	87	90	92	95	97	100
39	45	50	65	70	72	72	74	74	75	77	79	81	84	86	86	89	92	94	97	100
40	41	49	63	68	71	72	73	74	74	76	78	80	83	85	86	89	92	94	97	100

Male, Smoker

Issue									Duration											
Age	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**11**	**12**	**13**	**14**	**15**	**16**	**17**	**18**	**19**	**20+**
41	40	49	63	68	71	72	72	72	73	75	76	78	81	84	85	88	91	94	97	100
42	40	49	62	68	70	71	71	71	71	73	75	76	81	83	85	88	91	94	97	100
43	39	50	62	67	69	69	70	70	70	71	73	76	79	83	85	88	91	94	97	100
44	39	50	60	66	68	69	68	69	69	69	71	74	79	81	85	88	91	94	97	100
45	37	50	60	66	68	68	68	67	67	67	69	73	78	81	85	88	91	94	97	100
46	37	48	58	63	65	67	66	66	66	67	71	74	78	81	84	87	90	94	97	100
47	36	47	55	61	63	64	64	64	65	67	71	75	79	81	84	87	90	94	97	100
48	35	46	53	58	60	62	63	63	65	67	72	75	79	81	83	86	90	93	97	100
49	34	45	51	56	58	59	61	62	63	67	72	77	80	81	83	86	90	93	97	100
50	34	43	49	53	55	57	60	61	63	67	73	78	80	81	81	85	89	92	96	100
51	32	42	47	52	55	57	60	61	63	67	73	78	80	83	84	87	90	94	97	100
52	32	40	46	50	54	56	60	61	63	67	73	78	81	84	85	88	91	94	100	100
53	30	37	44	49	54	56	59	61	65	67	74	79	83	85	87	90	92	100	100	100
54	30	36	43	48	53	55	59	61	65	67	74	80	84	85	89	91	100	100	100	100
55	29	35	42	47	53	55	59	61	65	67	75	80	84	86	90	100	100	100	100	100
56	28	35	42	47	53	55	57	60	63	68	74	79	83	85	100	100	100	100	100	100
57	28	35	42	47	53	54	57	60	64	67	74	78	81	100	100	100	100	100	100	100
58	26	33	43	48	54	54	56	59	63	67	73	78	100	100	100	100	100	100	100	100
59	26	33	43	48	54	53	57	59	63	66	73	100	100	100	100	100	100	100	100	100
60	25	33	43	48	54	53	56	58	62	66	100	100	100	100	100	100	100	100	100	100
61	25	33	43	49	55	55	57	59	63	75	100	100	100	100	100	100	100	100	100	100
62	25	33	43	50	56	56	58	61	75	75	100	100	100	100	100	100	100	100	100	100
63	24	33	45	51	56	56	59	75	75	75	100	100	100	100	100	100	100	100	100	100
64	24	34	45	51	57	57	75	75	75	75	100	100	100	100	100	100	100	100	100	100
65	24	34	45	52	57	65	70	70	70	70	100	100	100	100	100	100	100	100	100	100

Male, Smoker

Duration

Issue Age	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20+
66	24	35	45	53	60	65	70	70	70	70	100	100	100	100	100	100	100	100	100	100
67	25	35	45	60	60	65	70	70	70	70	100	100	100	100	100	100	100	100	100	100
68	25	36	55	60	60	65	70	70	70	70	100	100	100	100	100	100	100	100	100	100
69	27	52	55	60	60	65	70	70	70	70	100	100	100	100	100	100	100	100	100	100
70	48	52	55	60	60	65	70	70	70	70	100	100	100	100	100	100	100	100	100	100
71	48	52	55	60	60	65	70	70	70	70	100	100	100	100	100	100	100	100	100	100
72	48	52	55	60	60	65	70	70	70	70	100	100	100	100	100	100	100	100	100	100
73	48	52	55	60	60	65	70	70	70	70	100	100	100	100	100	100	100	100	100	100
74	48	52	55	60	60	65	70	70	70	70	100	100	100	100	100	100	100	100	100	100
75	48	52	55	60	60	65	70	70	70	70	100	100	100	100	100	100	100	100	100	100
76	48	52	55	60	60	65	70	70	70	100	100	100	100	100	100	100	100	100	100	100
77	48	52	55	60	60	65	70	70	100	100	100	100	100	100	100	100	100	100	100	100
78	48	52	55	60	60	65	70	100	100	100	100	100	100	100	100	100	100	100	100	100
79	48	52	55	60	60	65	100	100	100	100	100	100	100	100	100	100	100	100	100	100
80	48	52	55	60	60	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
81	48	52	55	60	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
82	48	52	55	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
83	48	52	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
84	48	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
85+	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100

Female, Aggregate

Issue										Duration										
Age	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20+
0-15	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
16	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
17	99	100	100	100	100	100	100	100	93	95	96	97	97	100	100	100	100	100	100	100
18	83	83	84	84	84	84	86	78	78	79	82	84	85	88	88	90	93	95	98	100
19	65	66	68	68	68	68	63	63	64	66	69	71	72	74	75	80	85	90	95	100
20	48	50	51	51	51	47	48	48	49	51	56	57	58	61	63	70	78	85	93	100
21	47	48	50	51	47	47	48	49	51	53	57	60	61	64	64	71	78	86	93	100
22	44	47	48	45	47	47	48	49	53	54	60	61	63	64	66	73	80	86	93	100
23	42	45	44	45	47	47	49	51	53	54	61	64	64	67	69	75	81	88	94	100
24	39	40	42	44	47	47	50	51	54	56	64	64	66	69	70	76	82	88	94	100
25	34	38	41	44	47	47	50	53	56	57	64	67	69	71	73	78	84	89	95	100
26	34	38	41	45	49	49	51	56	58	59	66	69	70	73	70	76	82	88	94	100
27	34	38	41	47	50	51	54	57	59	60	69	70	73	70	71	77	83	88	94	100
28	34	37	43	47	53	53	56	59	62	63	70	73	70	72	74	79	84	90	95	100
29	34	38	43	49	54	56	58	60	63	64	73	70	72	74	75	80	85	90	95	100
30	35	38	43	50	56	56	59	63	66	67	70	71	74	75	76	81	86	90	95	100
31	35	38	43	51	56	58	60	64	67	65	71	72	74	75	76	81	86	90	95	100
32	35	39	45	51	56	59	63	66	65	66	72	72	75	76	76	81	86	90	95	100
33	36	39	44	52	58	62	64	65	66	67	72	74	75	76	76	81	86	90	95	100
34	36	40	45	52	58	63	63	66	67	68	74	74	76	76	76	81	86	90	95	100
35	36	40	45	53	59	61	65	67	68	70	75	74	75	76	75	80	85	90	95	100
36	36	40	45	53	55	62	65	67	68	70	74	74	74	75	75	80	85	90	95	100
37	36	41	47	52	57	62	65	67	68	69	72	72	73	75	74	79	84	90	95	100
38	34	41	44	52	57	63	66	68	69	70	72	71	72	74	75	80	85	90	95	100
39	34	40	45	53	58	63	66	68	69	69	70	70	70	73	74	79	84	90	95	100
40	32	40	45	53	58	65	65	67	68	69	70	69	70	73	73	78	84	89	95	100

Female, Aggregate

Issue	Duration																			
Age	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**11**	**12**	**13**	**14**	**15**	**16**	**17**	**18**	**19**	**20+**
41	32	40	45	53	57	63	64	67	68	68	69	69	69	73	74	79	84	90	95	100
42	32	40	45	52	56	61	63	65	66	68	69	68	70	74	75	80	85	90	95	100
43	31	39	45	51	55	59	61	65	65	66	68	69	69	74	77	82	86	91	95	100
44	31	39	45	50	54	58	61	63	64	66	67	68	71	75	78	82	87	91	96	100
45	31	38	44	49	53	56	59	62	63	65	67	68	71	77	79	83	87	92	96	100
46	29	37	43	48	51	54	59	62	63	65	67	69	71	77	78	82	87	91	96	100
47	28	35	41	46	49	54	57	61	62	66	68	69	71	77	77	82	86	91	95	100
48	28	35	41	44	49	52	57	61	63	66	68	71	72	75	77	82	86	91	95	100
49	26	34	39	43	47	52	55	61	63	67	69	71	72	75	75	80	85	90	95	100
50	25	32	38	41	46	50	55	61	63	67	69	72	72	75	74	79	84	90	95	100
51	25	32	38	41	45	50	55	61	63	66	68	69	71	74	74	79	84	90	95	100
52	23	30	36	41	45	51	56	61	62	65	66	68	68	73	73	78	84	89	100	100
53	23	30	36	41	47	51	56	61	62	63	65	66	68	72	72	78	83	100	100	100
54	22	29	35	41	47	53	57	61	61	62	62	66	66	69	70	76	100	100	100	100
55	22	29	35	41	47	53	57	61	61	61	62	63	64	68	69	100	100	100	100	100
56	22	29	35	41	45	51	56	59	60	61	62	63	64	67	100	100	100	100	100	100
57	22	29	35	41	45	50	54	56	58	59	61	62	63	100	100	100	100	100	100	100
58	22	30	36	41	44	49	53	56	57	57	61	62	100	100	100	100	100	100	100	100
59	22	30	36	41	44	48	51	53	55	56	59	100	100	100	100	100	100	100	100	100
60	22	30	36	41	43	47	50	51	53	55	100	100	100	100	100	100	100	100	100	100
61	22	29	35	39	42	46	49	50	52	80	100	100	100	100	100	100	100	100	100	100
62	20	28	33	39	41	45	47	49	80	80	100	100	100	100	100	100	100	100	100	100
63	20	28	33	38	41	44	46	80	80	80	100	100	100	100	100	100	100	100	100	100
64	19	27	32	36	40	42	80	80	80	80	100	100	100	100	100	100	100	100	100	100
65	19	25	30	35	39	72	75	75	80	80	100	100	100	100	100	100	100	100	100	100
66	19	25	30	35	72	72	75	75	80	80	100	100	100	100	100	100	100	100	100	100
67	19	25	30	72	72	72	75	75	80	80	100	100	100	100	100	100	100	100	100	100
68	19	25	68	72	72	72	75	75	80	80	100	100	100	100	100	100	100	100	100	100
69	19	64	68	72	72	72	75	75	80	80	100	100	100	100	100	100	100	100	100	100
70	60	60	64	68	68	72	75	75	80	80	100	100	100	100	100	100	100	100	100	100

Female, Aggregate

Issue	Duration																			
Age	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**11**	**12**	**13**	**14**	**15**	**16**	**17**	**18**	**19**	**20+**
71	60	60	64	68	68	72	75	75	80	80	100	100	100	100	100	100	100	100	100	100
72	60	60	64	68	68	72	75	75	80	80	100	100	100	100	100	100	100	100	100	100
73	60	60	64	68	68	72	75	75	80	80	100	100	100	100	100	100	100	100	100	100
74	60	60	64	68	68	72	75	75	80	80	100	100	100	100	100	100	100	100	100	100
75	60	60	64	68	68	72	75	75	80	80	100	100	100	100	100	100	100	100	100	100
76	60	60	64	68	68	72	75	75	80	100	100	100	100	100	100	100	100	100	100	100
77	60	60	64	68	68	72	75	75	100	100	100	100	100	100	100	100	100	100	100	100
78	60	60	64	68	68	72	75	100	100	100	100	100	100	100	100	100	100	100	100	100
79	60	60	64	68	68	72	100	100	100	100	100	100	100	100	100	100	100	100	100	100
80	60	60	64	68	68	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
81	60	60	64	68	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
82	60	60	64	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
83	60	60	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
84	60	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
85+	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100

Female, Non-Smoker

Issue										Duration										
Age	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**11**	**12**	**13**	**14**	**15**	**16**	**17**	**18**	**19**	**20+**
0-15	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
16	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
17	96	98	98	98	98	99	99	99	92	92	93	95	95	97	99	99	99	100	100	100
18	78	80	80	80	80	81	81	74	75	75	78	79	82	83	85	88	91	94	97	100
19	60	62	63	63	63	65	59	59	60	60	64	67	67	70	72	78	83	89	94	100
20	42	44	45	45	45	42	42	42	45	45	50	51	53	56	58	66	75	83	92	100
21	41	42	44	45	41	42	42	44	47	47	51	53	54	57	59	67	75	84	92	100
22	39	41	44	41	41	42	44	45	49	49	54	56	57	58	60	68	76	84	92	100
23	38	41	38	40	41	42	44	46	49	50	56	57	58	60	62	70	77	85	92	100
24	36	36	38	40	41	42	46	47	50	51	58	59	60	62	63	70	78	85	93	100
25	32	34	37	40	41	43	46	49	51	53	59	60	62	63	64	71	78	86	93	100
26	32	34	37	41	43	45	47	50	53	53	60	62	63	64	62	70	77	85	92	100
27	32	34	38	43	46	47	49	51	53	55	62	63	64	62	62	70	77	85	92	100
28	30	34	39	43	47	49	51	53	56	58	63	63	61	62	63	70	78	85	93	100
29	30	35	40	45	50	51	52	55	58	59	64	61	62	63	63	70	78	85	93	100
30	31	35	40	46	51	52	53	56	59	60	62	62	63	65	65	72	79	86	93	100
31	31	35	40	46	51	53	55	58	60	58	62	62	63	65	65	72	79	86	93	100
32	32	35	40	45	51	53	56	59	57	58	62	63	63	65	64	71	78	86	93	100
33	32	36	41	47	52	55	58	55	58	59	63	63	65	65	65	72	79	86	93	100
34	33	36	41	47	52	55	55	57	58	59	63	65	64	65	64	71	78	86	93	100
35	33	36	41	47	52	53	57	58	59	61	63	64	64	64	64	71	78	86	93	100
36	33	36	41	47	49	53	57	58	59	61	63	64	63	64	63	70	78	85	93	100
37	32	36	41	44	49	53	57	58	59	60	62	62	61	62	63	70	78	85	93	100
38	32	37	39	45	50	54	57	58	60	60	61	61	61	62	61	69	77	84	92	100
39	30	35	39	45	50	54	57	58	60	59	60	60	59	60	61	69	77	84	92	100
40	28	35	39	45	50	54	56	57	59	59	60	59	59	59	60	68	76	84	92	100

Female, Non-Smoker

Issue Age	Duration 1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20+
41	28	35	39	45	49	52	55	55	58	57	58	59	58	59	60	68	76	84	92	100
42	27	35	39	44	49	52	54	55	56	57	57	57	58	60	61	69	77	84	92	100
43	27	34	39	44	47	50	53	53	55	55	56	57	56	60	61	69	77	84	92	100
44	26	34	38	42	47	50	52	53	54	55	55	55	56	61	62	70	77	85	92	100
45	26	33	38	42	45	48	51	51	52	53	54	55	56	61	62	70	77	85	92	100
46	24	32	37	40	43	47	49	51	52	53	54	55	56	60	61	69	77	84	92	100
47	24	30	35	39	42	45	47	49	51	53	54	55	56	59	60	68	76	84	92	100
48	23	30	35	37	40	44	47	49	50	53	54	55	55	59	57	66	74	83	91	100
49	23	29	33	35	39	42	45	48	50	53	54	55	55	57	56	65	74	82	91	100
50	21	27	32	34	37	41	44	48	50	53	54	55	55	56	55	64	73	82	91	100
51	21	26	30	34	37	41	44	48	49	51	53	53	54	55	55	64	73	82	91	100
52	20	25	30	33	37	41	44	47	48	50	50	51	51	55	53	62	72	81	100	100
53	19	24	29	32	37	41	43	47	48	48	49	49	51	52	52	62	71	100	100	100
54	18	24	29	32	37	41	43	45	47	47	47	49	49	51	51	61	100	100	100	100
55	18	23	28	32	37	41	43	45	45	45	46	46	47	50	50	100	100	100	100	100
56	18	23	28	32	36	39	42	44	44	45	46	46	46	49	100	100	100	100	100	100
57	18	23	28	31	35	38	41	42	44	44	45	45	46	100	100	100	100	100	100	100
58	17	23	26	31	35	36	38	41	41	42	45	45	100	100	100	100	100	100	100	100
59	17	23	26	30	33	35	38	39	40	41	44	100	100	100	100	100	100	100	100	100
60	17	23	26	30	32	34	36	38	39	40	100	100	100	100	100	100	100	100	100	100
61	17	22	25	29	32	33	35	36	38	80	100	100	100	100	100	100	100	100	100	100
62	16	22	25	28	30	32	34	35	80	80	100	100	100	100	100	100	100	100	100	100
63	16	20	24	28	30	32	34	80	80	80	100	100	100	100	100	100	100	100	100	100
64	14	21	24	27	29	30	80	80	80	80	100	100	100	100	100	100	100	100	100	100
65	15	19	23	25	28	72	75	75	80	80	100	100	100	100	100	100	100	100	100	100

Female, Non-Smoker

Issue	Duration																			
Age	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20+
66	15	19	23	25	72	72	75	75	80	80	100	100	100	100	100	100	100	100	100	100
67	15	19	22	72	72	72	75	75	80	80	100	100	100	100	100	100	100	100	100	100
68	13	18	68	72	72	72	75	75	80	80	100	100	100	100	100	100	100	100	100	100
69	13	64	68	72	72	72	75	75	80	80	100	100	100	100	100	100	100	100	100	100
70	60	60	64	68	68	72	75	75	80	80	100	100	100	100	100	100	100	100	100	100
71	60	60	64	68	68	72	75	75	80	80	100	100	100	100	100	100	100	100	100	100
72	60	60	64	68	68	72	75	75	80	80	100	100	100	100	100	100	100	100	100	100
73	60	60	64	68	68	72	75	75	80	80	100	100	100	100	100	100	100	100	100	100
74	60	60	64	68	68	72	75	75	80	80	100	100	100	100	100	100	100	100	100	100
75	60	60	64	68	68	72	75	75	80	80	100	100	100	100	100	100	100	100	100	100
76	60	60	64	68	68	72	75	75	80	100	100	100	100	100	100	100	100	100	100	100
77	60	60	64	68	68	72	75	75	100	100	100	100	100	100	100	100	100	100	100	100
78	60	60	64	68	68	72	75	100	100	100	100	100	100	100	100	100	100	100	100	100
79	60	60	64	68	68	72	100	100	100	100	100	100	100	100	100	100	100	100	100	100
80	60	60	64	68	68	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
81	60	60	64	68	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
82	60	60	64	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
83	60	60	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
84	60	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
85+	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100

Female, Smoker

Issue	Duration																			
Age	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**11**	**12**	**13**	**14**	**15**	**16**	**17**	**18**	**19**	**20+**
0-15	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
16	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
17	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
18	99	100	100	100	100	100	100	95	96	97	100	100	100	100	100	100	100	100	100	100
19	87	89	92	92	92	92	84	84	86	86	92	93	95	96	99	99	99	100	100	100
20	74	77	80	80	80	73	73	73	75	77	83	83	86	88	90	92	94	96	98	100
21	71	74	78	78	71	71	73	74	77	79	85	86	88	89	90	92	94	96	98	100
22	68	71	75	70	71	71	73	74	78	79	88	90	89	89	92	94	95	97	98	100
23	65	69	67	70	70	70	73	77	79	81	89	90	90	92	92	94	95	97	98	100
24	62	60	64	69	70	70	74	77	79	81	92	90	92	93	93	94	96	97	99	100
25	53	58	63	67	69	70	74	78	81	82	92	93	93	95	95	96	97	98	99	100
26	53	58	63	69	71	72	75	79	82	82	93	93	95	96	90	92	94	96	98	100
27	52	56	63	70	74	74	78	81	82	84	93	95	95	90	90	92	94	96	98	100
28	52	56	64	71	75	77	79	82	85	86	95	95	90	92	92	94	95	97	98	100
29	51	56	64	71	78	78	81	84	86	88	95	90	90	92	92	94	95	97	98	100
30	51	56	64	72	79	79	82	85	88	89	90	90	92	93	93	94	96	97	99	100
31	51	56	64	72	78	81	84	84	88	84	90	90	92	93	93	94	96	97	99	100
32	51	56	64	71	78	81	85	86	84	85	90	90	92	94	93	94	96	97	99	100
33	51	57	62	71	78	82	85	83	84	85	90	92	93	93	93	94	96	97	99	100
34	51	56	62	71	78	82	81	83	85	86	90	92	92	94	93	94	96	97	99	100
35	51	56	62	71	78	79	83	84	85	86	90	91	91	93	93	94	96	97	99	100
36	49	56	62	71	74	79	83	84	85	86	90	90	91	93	92	94	95	97	98	100
37	48	55	62	67	74	79	83	84	85	86	89	90	89	92	91	93	95	96	98	100
38	47	55	57	66	72	77	81	84	86	86	87	88	88	90	91	93	95	96	98	100
39	45	50	57	66	72	77	81	83	85	86	86	87	86	89	90	92	94	96	98	100
40	41	50	57	66	72	77	81	83	84	85	86	86	86	89	89	91	93	96	98	100

Female, Smoker

Issue Age	Duration 1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20+
41	40	50	57	65	71	76	79	81	83	84	85	86	85	89	90	92	94	96	98	100
42	40	49	57	65	69	74	77	80	82	83	84	85	86	90	92	94	95	97	98	100
43	39	49	55	63	69	73	76	78	80	82	83	84	85	92	93	94	96	97	99	100
44	39	48	55	62	67	71	75	78	80	80	82	84	86	93	96	97	98	98	99	100
45	37	47	55	61	65	70	73	76	78	80	81	84	86	94	97	98	98	99	99	100
46	36	46	53	59	63	68	71	75	77	79	83	85	86	93	96	97	98	98	99	100
47	34	44	51	57	62	66	70	75	77	80	83	85	86	93	94	95	96	98	99	100
48	34	44	50	54	60	64	69	74	77	80	84	86	87	92	92	94	95	97	98	100
49	33	42	48	53	58	63	68	74	77	81	84	86	87	92	91	93	95	96	98	100
50	31	41	46	51	57	61	67	74	77	81	85	87	87	91	90	92	94	96	98	100
51	30	39	45	51	56	61	67	74	75	80	83	85	85	90	90	92	94	96	98	100
52	29	38	45	50	56	62	68	74	75	79	81	83	84	90	90	92	94	96	100	100
53	28	37	43	49	57	62	68	73	74	77	79	81	83	89	89	91	93	100	100	100
54	28	36	43	49	57	63	69	73	74	75	78	80	81	87	89	91	100	100	100	100
55	26	35	42	49	57	63	69	73	73	74	76	78	79	86	87	100	100	100	100	100
56	26	35	42	49	56	62	67	71	72	74	76	78	79	85	100	100	100	100	100	100
57	26	35	42	49	55	61	66	69	72	73	76	78	79	100	100	100	100	100	100	100
58	28	36	43	49	55	59	63	68	69	72	76	78	100	100	100	100	100	100	100	100
59	28	36	43	49	54	57	63	67	68	70	76	100	100	100	100	100	100	100	100	100
60	28	36	43	49	53	57	61	64	67	69	100	100	100	100	100	100	100	100	100	100
61	26	35	42	48	52	56	59	63	66	80	100	100	100	100	100	100	100	100	100	100
62	26	33	41	47	51	55	58	62	80	80	100	100	100	100	100	100	100	100	100	100
63	25	33	41	46	51	55	57	80	80	80	100	100	100	100	100	100	100	100	100	100
64	25	33	40	45	50	53	80	80	80	80	100	100	100	100	100	100	100	100	100	100
65	24	32	39	44	49	72	75	75	80	80	100	100	100	100	100	100	100	100	100	100

Female, Smoker

Issue	Duration																		
Age	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**11**	**12**	**13**	**14**	**15**	**16**	**17**	**18**	**19**	**20+**
66	24	32	39	44	72	72	75	75	80	80	100	100	100	100	100	100	100	100	100	100
67	24	32	39	72	72	72	75	75	80	80	100	100	100	100	100	100	100	100	100	100
68	24	32	68	72	72	72	75	75	80	80	100	100	100	100	100	100	100	100	100	100
69	24	64	68	72	72	72	75	75	80	80	100	100	100	100	100	100	100	100	100	100
70	60	60	64	68	68	72	75	75	80	80	100	100	100	100	100	100	100	100	100	100
71	60	60	64	68	68	72	75	75	80	80	100	100	100	100	100	100	100	100	100	100
72	60	60	64	68	68	72	75	75	80	80	100	100	100	100	100	100	100	100	100	100
73	60	60	64	68	68	72	75	75	80	80	100	100	100	100	100	100	100	100	100	100
74	60	60	64	68	68	72	75	75	80	80	100	100	100	100	100	100	100	100	100	100
75	60	60	64	68	68	72	75	75	80	80	100	100	100	100	100	100	100	100	100	100
76	60	60	64	68	68	72	75	75	80	100	100	100	100	100	100	100	100	100	100	100
77	60	60	64	68	68	72	75	75	100	100	100	100	100	100	100	100	100	100	100	100
78	60	60	64	68	68	72	75	100	100	100	100	100	100	100	100	100	100	100	100	100
79	60	60	64	68	68	72	100	100	100	100	100	100	100	100	100	100	100	100	100	100
80	60	60	64	68	68	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
81	60	60	64	68	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
82	60	60	64	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
83	60	60	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
84	60	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
85+	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100

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Appendix B
Interpretations of the Emerging Accounting Issues (E) Working Group

Introduction

The NAIC Emerging Accounting Issues (E) Working Group (EAIWG) is responsible for responding to Statutory Accounting Principle (SAP) questions that generally relate to application, interpretation and clarification.

The NAIC Statutory Accounting Principles (E) Working Group (SAPWG) addressed all generally accepted accounting principles (GAAP) pronouncements included in categories a, b and c of the Statutory Hierarchy issued through 1996 during the initial drafting of the SSAPs. As documented in the Policy Statement on the Maintenance of Statutory Accounting Principles (included in Appendix F), the SAPWG will continue to review new GAAP guidance for applicability to SAP. Beginning January 1, 1999, the EAIWG has addressed the EITF opinions issued subsequent to 1996.

Appendix B includes the final interpretations of the EAIWG through December 2014.

Reporting entities should note that the interpretations are generally effective when finalized by the EAIWG. This Manual may not include all of the interpretations currently in effect due to the fact that it is printed annually. As items are adopted, updates to the Manual are posted to the following password-protected Web site:

www.naic.org/committees_e_app_manual_updates.htm

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

In 2009, the Emerging Accounting Issues (E) Working Group reached a consensus to incorporate "rejected" and "non-applicable" FASB EITFs that do not provide additional statutory accounting guidance in a listing within a designated interpretation. This interpretation (INT 99-00) included reference of all FASB EITFs, including those previously included in Appendix B as a statutory accounting interpretation, that were 1) rejected as not applicable to statutory accounting; 2) rejected without providing additional statutory guidance; or 3) rejected on the basis of issues rejected in an SSAP. In 2014, the Statutory Accounting Principles (E) Working Group adopted a proposal to move all references to rejected GAAP material from INT 99-00 into *Issue Paper No. 99—Nonapplicable GAAP Pronouncements*.

In 2013, the Statutory Accounting Principles (E) Working Group adopted a proposal to remove completely superseded SSAPs and nullified interpretations (INTs) from the printed Manual and include these items on the Statutory Accounting Principles (E) Working Group "Updates to the Accounting Practices and Procedures Manual" webpage (www.naic.org/committees_e_app_manual_updates.htm). By including on this password-protected updates page, annual subscribers to the printed *Accounting Practices and Procedures Manual* will continue to have access to the superseded and nullified guidance for historical purposes. The completely superseded SSAPs and nullified INTs are still included in Appendix H – Superseded SSAPs and Nullified Interpretations within the AP&P Folio View CD-ROM. References on the face of the INTs are classified as current or superseded.

No.	Title	Page
INT 00-03	Illustration of the Accounting/Reporting of Deposit-Type Contracts in Accordance with SSAPs No. 51, 52 and 56	00-03-1
INT 00-20	Application of SEC SAB No. 99, Materiality to the Preamble of the AP&P Manual	00-20-1
INT 00-24	EITF 98-13: Accounting by an Equity Method Investor for Investee Losses When the Investor Has Loans to and Investments in Other Securities of the Investee and EITF 99-10: Percentage Used to Determine the Amount of Equity Method Losses	00-24-1
INT 00-26	EITF 98-3: Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business	00-26-1
INT 00-28	EITF 99-12: Determination of the Measurement Date for the Market Price of Acquirer Securities Issued in a Purchase Business Combination	00-28-1
INT 01-18	Consolidated or Legal Entity Level – Limitations on EDP Equipment, Goodwill and Deferred Tax Assets Admissibility	01-18-1
INT 01-25	Accounting for U.S. Treasury Inflation-Indexed Securities	01-25-1
INT 01-31	Assets Pledged as Collateral	01-31-1
INT 02-22	Accounting for the U.S. Terrorism Risk Insurance Program	02-22-1
INT 03-02	Modification to an Existing Intercompany Pooling Arrangement	03-02-1
INT 04-17	Impact of Medicare Modernization Act on Postretirement Benefits	04-17-1
INT 04-21	EITF 02-09: Accounting for Changes that Result in a Transferor Regaining Control of Financial Assets Sold	04-21-1
INT 05-05	Accounting for Revenues Under Medicare Part D Coverage	05-05-1
INT 06-02	Accounting and Reporting for Investments in a Certified Capital Company (CAPCO)	06-02-1
INT 06-07	Definition of Phrase “Other Than Temporary”	06-07-1
INT 06-12	Tax Deposits Submitted in Accordance with Section 6603 of the Internal Revenue Service (IRS) Code	06-12-1
INT 06-13	EITF 01-2: Interpretations of APB Opinion No. 29	06-13-1
INT 07-01	Application of the Scientific (constant yield) Method in Situations of Reverse Amortization	07-01-1
INT 08-05	EITF 02-11: Accounting for Reverse Spinoffs	08-05-1
INT 09-08	Accounting for Loans Received under the Federal TALF Program	09-08-1
INT 13-03	Clarification of Surplus Deferral in SSAP No. 92 & SSAP No. 102	13-03-1

Interpretation of the Emerging Accounting Issues (E) Working Group

INT 00-03: Illustration of the Accounting/Reporting of Deposit-Type Contracts in Accordance with SSAPs No. 51, 52 and 56

INT 00-03 Dates Discussed

December 6, 1999, March 13, 2000

INT 00-03 References

Current:
SSAP No. 51—Life Contracts (SSAP No. 51)
SSAP No. 52—Deposit-Type Contracts (SSAP No. 52)
SSAP No. 56—Separate Accounts (SSAP No. 56)

INT 00-03 Issue

1. Deposit-type contracts, as defined in SSAP No. 52 may be maintained in the general account or transferred to the separate account of an insurance company. During the process of preparing Blanks proposals to conform the reporting requirements to the SSAPs, the Impact of Codification on NAIC Publications Working Group noted an inconsistency in the reporting of deposit-type contracts between SSAP No. 52 and SSAP No. 56. At the 1999 NAIC Fall National Meeting, SSAP No. 56 was amended to clarify that the requirements of SSAP No. 52 are applicable to separate account deposit-type contracts.

2. Exhibit A is included as an illustration of accounting/reporting of separate account deposit-type contracts in accordance with SSAP Nos. 51, 52 and 56. Is this illustration consistent with the intent of the Codification of Statutory Accounting Principles (E) Working Group?

INT 00-03 Discussion

3. The Working Group reached a consensus that Exhibit A is consistent with the intent of the SSAPs.

INT 00-03 Status

4. No further discussion is planned.

Illustrative Example of the Accounting/Reporting of Deposit-Type Contracts in Accordance with SSAPs 51/52

NOTE: Entries presented in this illustration may not reflect all accounting entries associated with the activity, e.g., some "due from" or "due to" entries are eliminated to simplify the example.

1. Contractholder surrendered an ordinary life insurance policy and elected to place the proceeds ($100,000) under a supplementary contract without life contingencies (SCWOLC).

General Account Statement

a.	Surrender Benefits & Withdrawals	$100,000	
	Liability for Deposit –Type Contracts		$100,000
b.	Aggregate Reserves for Life Policies	$100,000	
	Increase in Aggregate Reserves for Life Policies		$100,000

2. Insurer transfers, pursuant to contract provisions, $95,000 to separate account fund for SCWOLC contracts from general account fund for SCWOLC contracts; $5,000 is retained in the general account.

General Account Statement

a.	Liability for Deposit –Type Contracts	$95,000	
	Transfers to Separate Accounts		$95,000
b.	Transfers to Separate Account	$95,000	
	Cash		$95,000

Separate Accounts Statement

c.	Other transfers from General Account (net)	$95,000	
	Transfers on account of deposit-type contracts		$95,000
d.	Cash	$95,000	
	Other Transfers from General Account		$95,000
e.	Increase in liability for deposit-type contracts	$95,000	
	Liability for Deposit-Type Contracts		$95,000

3. Insurer establishes a $4,000 CARVM valuation allowance for this contract in the separate account fund.

Separate Accounts Statement

a.	Liability for Deposit-Type Contracts	$4,000	
	Increase in liability for deposit-type contracts		$4,000
b.	Change in expense allowances recognized in reserves	$4,000	
	Other transfers from General Account (net)		$4,000

General Account Statement

c.	Transfers to Separate Accounts (net)	$4,000	
	Transfer to/or (from) Separate Accounts		$4,000

4. Insurer’s separate account fund for SCWOLC contracts assets earns $2,000 investment income that is immediately credited to the separate account fund for SCWOLC contracts.

Separate Accounts Statement

a.	Cash	$2,000	
	Net investment income		$2,000
b.	Increase in liability for deposit-type contracts	$2,000	
	Liability for Deposit-Type Contracts		$2,000

5. Contractholder is paid a $1,000 SCWOLC contract benefit from the separate account fund. The example has been simplified to show the cash flows from the Separate Account to the General Account and the payment to the contractholder from the General Account.

General Account Statement

a.	Cash	$1,000	
	Liability for Deposit-Type Contracts		$1,000
b.	Liability for Deposit-Type Contracts	$1,000	
	Cash		$1,000

Separate Accounts Statement

c.	Transfers on account of deposit-type contracts	$1,000	
	Cash		$1,000
d.	Liability for Deposit-type Contracts	$1,000	
	Increase in liability for deposit-type contracts		$1,000

6. Contractholder requests the insurer to purchase a variable annuity contract (insurance product) with $25,000 drawn from the separate account fund supporting the SCWOLC contract (deposit-type contract) and transfer it to a separate fund supporting variable annuities. This example has been simplified and ignores the internal cash exchange.

General Account Statement

a.	Transfers to Separate Accounts	$25,000	
	Premiums and Annuity Considerations		$25,000

Separate Accounts Statement

b.	Liability for Deposit-Type Contracts	$25,000	
	Increase in liability for deposit-type contracts		$25,000
c.	Transfers on account of deposit-type contracts	$25,000	
	Other transfers to general account (net)		$25,000
d.	Other transfers to general account (net)	$25,000	
	Net Premiums and Annuity Considerations		$25,000
e.	Increase in aggregate reserve for life, annuity	$25,000	
	Aggregate Reserve for life, annuity		$25,000

7. Contractholder in accordance with a Group GIC contract requests that $15,000 be withdrawn from the Group GIC Separate Account fund maintained by the insurer and transferred to the contractholder's Separate Account fund supporting the SCWOLC contract.

Separate Accounts Statement

a.	Liability for Deposit-Type Contracts (GIC)	$15,000	
	Increase in liability for deposit-type contracts		$15,000
b.	Transfers on account of deposit-type contracts	$15,000	
	Cash		$15,000
c.	Cash	$15,000	
	Transfers on account of deposit-type contracts		$15,000
d.	Increase in liability for deposit-type contracts	$15,000	
	Liability for Deposit-Type Contracts (SCWOLC)		$15,000

General Accounts Statement

e.	Other transfers to separate account (net)	$15,000	
	Liability for Deposit-Type Contracts (SCWOLC)		$15,000
f.	Liability for Deposit-Type Contracts (SCWOLC)	$15,000	
	Other transfers to separate account (net)		$15,000

8. Contractholder is assessed the annual administration fee of $100 for the SCWOLC contract.

Separate Accounts Statement

a.	Administration fees	$100	
	Cash		$100
b.	Liability for Deposit-type contracts	$100	
	Increase in liability for deposit-type contracts		$100

General Account Statement

c.	Cash	$100	
	Management fees		$100

"T" Accounts

General Account Statement

Balance Sheet

Cash

Xaction Ref.	Debit	Credit
Begin Bal.	100,000	
2b		95,000
5a	1,000	
5b		1,000
8c	100	
Total	101,100	96,000
Net	5,100	

Aggregate Reserves for Life Policies etc.

Xaction Ref.	Debit	Credit
Begin Bal.		100,000
1b	100,000	

Liab for Deposit-Type Contracts

Xaction Ref.	Debit	Credit
1a		100,000
2a	95,000	
5a		1,000
5b	1,000	
7e		15,000
7f	15,000	
Total	111,000	116,000
Net		5,000

Transfers to Sep Accts Pybl

Xaction Ref.	Debit	Credit
2a		95,000
2b	95,000	
3c	4,000	
7e	15,000	
7f		15,000
Total	114,000	110,000
Net	4,000	

Summary of Operations

Premiums & Considerations

Xaction Ref.	Debit	Credit
6a		25,000

Income from Fees . . From Sep Accts

Xaction Ref.	Debit	Credit
8c		100

Surrender Benefits

Xaction Ref.	Debit	Credit
1a	100,000	

Increase in Agg Res for Life Pol etc.

Xaction Ref.	Debit	Credit
1b		100,000

Transfers to Sep Accts

Xaction Ref.	Debit	Credit
3c		4,000
6a	25,000	
Total	25,000	4,000
Net	21,000	

Separate Accounts Statement

Balance Sheet

Cash

Xaction Ref.	Debit	Credit
Begin Bal.	15,000	
2d	95,000	
4a	2,000	
5c		1,000
7b		15,000
7c	15,000	
8a		100
Total	127,000	16,100
Net	110,900	

Aggregate Reserves for Life Policies etc.

Xaction Ref.	Debit	Credit
6e		25,000

Liab for Deposit-Type Contracts

Xaction Ref.	Debit	Credit
Begin Bal.		15,000
2e		95,000
3a	4,000	
4b		2,000
5d	1,000	
6b	25,000	
7a	15,000	
7d		15,000
8b	100	
Total	45,100	127,000
Net		81,900

Transfers to Gen Acct Pybl

Xaction Ref.	Debit	Credit
2c	95,000	
2d		95,000
3b		4,000
6c		25,000
6d	25,000	
Total	120,000	124,000
Net		4,000

Summary of Operations

Premiums & Considerations

Xaction Ref.	Debit	Credit
6d		25,000

Deposits Acct of Deposit-Type Contracts

Xaction Ref.	Debit	Credit
2c		95,000
5c	1,000	
6c	25,000	
7b	15,000	
7c		15,000
Total	41,000	110,000
Net		69,000

Net Invest Inc & Cap Gains

Xaction Ref.	Debit	Credit
4a		2,000

Change in Expense Allow

Xaction Ref.	Debit	Credit
3b	4,000	

Fees Assoc with Charges for Inv Mgmt etc.

Xaction Ref.	Debit	Credit
8a	100	

Increase in Agg Res for Life Cont etc.

Xaction Ref.	Debit	Credit
6e	25,000	

Increase in Liab for Deposit-Type Contracts

Xaction Ref.	Debit	Credit
2e	95,000	
3a		4,000
4b	2,000	
5d		1,000
6b		25,000
7a		15,000
7d	15,000	
8b		100
Total	112,000	45,100
Net	66,900	

General Account Instructions

NOTES to FINANCIAL STATEMENTS

19. Separate Accounts

Illustration B:

Reconciliation of Net Transfers To or (From) Separate Accounts

1. Transfers as reported in the Summary of Operations of the Separate Accounts Statement:

a.	Transfers to Separate Accounts	$ 25,000
b.	Transfers from Separate Accounts	$ 4,000
c.	Net transfers to or (From) Separate Accounts (a) – (b)	$ 21,000

2. Reconciling Adjustments:

a. ______________________________ $__________

b. ______________________________ $__________

c. ______________________________ $__________

3. Transfers as Reported in the Summary of Operations of the Life, Accident & Health Annual Statement

(1c) + (2) = $ 21,000

Note: This illustration reflects 2001 financial statements and will not be subsequently updated.

ANNUAL STATEMENT FOR THE YEAR 2001 OF THE SEPARATE ACCOUNTS OF THE

ASSETS	Current Year			Prior Year
	1 General Account Basis	2 Fair Value Basis	3 Total (Cols. 1 + 2)	4 Total
1. Bonds (Schedule D)				
2. Stocks (Schedule D):				
2.1 Preferred stocks				
2.2 Common stocks				
3. Mortgage loans on real estate (Schedule B)				
4. Real estate (Schedule A):				
4.1 Properties held for the production of income (less $…………encumbrances)				
4.2 Properties held for sale (less $………………………………encumbrances)				
5. Policy loans				
6. Cash (Schedule E-Part 1)		110,900	110,900	
7. Short-term investments (Schedule DA)				
8. Other invested assets (Schedule BA)				
9. Aggregate write-ins for invested assets				
10. Subtotals—Cash and invested assets (Lines 1 to 9)		110,900	110,900	
11. Investment income due and accrued				
12. Receivable for securities				
13. Net adjustment in assets and liabilities due to foreign exchange rates				
14. Aggregate write-ins for other-than-invested assets				
15. Lines 10 to 14		110,900	110,900	
DETAILS OF WRITE-INS				
0901.				
0902.				
0903.				
0998. Summary of remaining write-ins Line 9 from overflow page				
0999. Totals (Lines 0901 through 0903 + 0998) (Line 9 above)				
1401.				
1402.				
1403.				
1498. Summary of remaining write-ins for Line 14 from overflow page				
1499. Totals (Lines 1401 through 1403 plus 1498) (Line 14 above)				

Note: This illustration reflects 2001 financial statements and will not be subsequently updated.

ANNUAL STATEMENT FOR THE YEAR 2001 OF THE SEPARATE ACCOUNTS OF THE

LIABILITIES AND SURPLUS	Current Year			Prior Year
	1 General Account Basis	2 Fair Value Basis	3 Total (Cols. 1 +2)	4 Total
1. Aggregate reserve for life, annuity and accident and health policies and contracts (Exhibit 6, Line 9999999, Col. 2)		25,000	25,000	
2. Liability for deposit-type contracts (Exhibit 7, Line 9, Col. 1)		81,900	81,900	
3. Interest Maintenance Reserve				
4. Charges for investment management, administration and contract guarantees due or accrued				
5. Investment expenses due or accrued (Exhibit 4, Line 24)				
6. Investment taxes, licenses and fees due or accrued, excluding federal income taxes (Exhibit 5, Line 8)				
7. Federal and foreign income taxes due or accrued (excluding deferred taxes)				
8. Reserve for future federal income taxes				
9. Unearned investment income (Exhibit 2, Line 14, Col. 2)				
10. Other transfers to general account due or accrued (net) (including $....... accrued expense allowances recognized in reserves)		4,000	4,000	
11. Remittances and items not allocated				
12. Payable for securities				
13. Net adjustment in assets and liabilities due to foreign exchange rates				
14. Aggregate write-ins for liabilities				
15. Total Liabilities (including $..due or accrued net transfers to or (from) the general account)		110,900	110,900	
16. Contributed surplus				
17. Aggregate write-ins for special surplus funds				
18. Unassigned funds				
19. Surplus (Lines 16 through 18)				
20. Totals		110,900	110,900	
DETAILS OF WRITE-INS				
1401.				
1402.				
1403.				
1498. Summary of remaining write-ins for Line 14 from overflow page				
1499. Totals (Lines 1401 through 1403 plus 1498) (Line 14 above)				
1701.				
1702.				
1703.				
1798. Summary of remaining write-ins for Line 17 from overflow page				
1799. Totals (Lines 1701 through 1703 plus 1798) (Line 17 above)				

Note: This illustration reflects 2001 financial statements and will not be subsequently updated.

ANNUAL STATEMENT FOR THE YEAR 2001 OF THE SEPARATE ACCOUNTS OF THE

SUMMARY OF OPERATIONS	1 Current Year	2 Prior Year
1. Transfers to Separate Accounts:		
1.1 Net premiums and annuity considerations for life and accident and health policies and contracts		
1.2 Considerations for supplementary contracts with life contingencies	25,000	
1.3 Aggregate write-ins for other transfers to Separate Accounts		
1.4 Totals (Lines 1.1 to 1.3)		
2. Transfers on account of deposit-type contracts (including $110,000 deposits less $41,000 withdrawals)	25,000	
3. Net investment income and capital gains and losses (Exhibit 1, Line 9)		
4. Aggregate write-ins for other income	69,000	
	2,000	
5. Totals (Lines 1.4 to 4)		
	96,000	
DEDUCT:		
6. Transfers from the Separate Account on account of contract benefits:		
6.1 Death benefits		
6.2 Matured endowments		
6.3 Annuity benefits		
6.4 Payments on supplementary contracts with life contingencies		
6.5 Accident and health benefits		
6.6 Surrender benefits and withdrawals for life contracts		
6.7 Aggregate write-ins for other transfers from Separate Accounts on account of contract benefits		
7. Transfers on account of policy loans		
8. Net transfer of reserves from or (to) Separate Accounts		
9. Other transfers from the Separate Accounts:		
9.1 Federal and foreign income taxes incurred		
9.2 Change in expense allowances recognized in reserves		
9.3 Aggregate write-ins for other transfers from Separate Accounts	4,000	
10. Subtotals (Lines 6.1 to 9.3)		
11. Fees associated with charges for investment management, administration and contract guarantees	4,000	
12. Increase in aggregate reserve for life and accident and health policies and contracts	100	
13. Increase in reserve for variable dividend accumulations	25,000	
14. Increase in liability for deposit-type contracts		
15. Increase in reserve for future federal income taxes	66,900	
16. Aggregate write-ins for reserves and funds		
17. Totals (Lines 10 to 16)		
	96,000	
18. Net gain from operations (including $……………unrealized capital gains) (Line 5 minus Line 17)	0	
SURPLUS ACCOUNT		
19. Surplus, December 31, prior year		
20. Net gain from operations (Line 18)		
21. Surplus contributed or (withdrawn) during year		
22. Change in reserve on account of change in valuation basis, (increase) or decrease		
23. Transfer from Separate Accounts of the change in expense allowances charged or credited to surplus		
24. Aggregate write-ins for gains and losses in surplus		
25. Surplus, December 31, current year (Page 3, Line 19)		
DETAILS OF WRITE-INS		
01.301.		
01.302.		
01.303.		
01.398. Summary of remaining write-ins for Line 1.3 from overflow page		
01.399. Totals (Lines 01.301 through 01.303 plus 01.398) (Line 1.3 above)		
0401.		
0402.		
0403.		
0498. Summary of remaining write-ins for Line 4 from overflow page		
0499. Totals (Lines 0401 through 0403 plus 0498) (Line 4 above)		
06.701.		
06.702.		
06.703.		
06.798. Summary of remaining write-ins for Line 6.7 from overflow page		
06.799. Totals (Lines 06.701 through 06.703 plus 06.798) (Line 6.7 above)		
09.301.		
09.302.		
09.303.		
09.398. Summary of remaining write-ins for Line 9.3 from overflow page		
09.399. Totals (Lines 09.301 through 09.303 plus 09.398) (Line 9.3 above)		
1601.		
1602.		
1603.		
1698. Summary of remaining write-ins for Line 16 from overflow page		
1699. Totals (Lines 1601 through 1603 plus 1698) (Line 16 above)		
2401.		
2402.		
2403.		
2498. Summary of remaining write-ins for Line 24 from overflow page		
2499. Totals (Lines 2401 through 2403 plus 2498) (Line 24 above)		

Note: This illustration reflects 2001 financial statements and will not be subsequently updated.

GENERAL ACCOUNT
ANNUAL STATEMENT FOR THE YEAR 2001 OF THE

ASSETS	Current Year			Prior Year
	1	2	3	4
	Assets	Nonadmitted Assets	Net Admitted Assets (Cols. 1 - 2)	Net Admitted Assets
1. Bonds				
2. Stocks:				
2.1 Preferred stocks (Schedule D, Part 2, Section 1)				
2.2 Common stocks (Schedule D, Part 2, Section 2)				
3. Mortgage loans on real estate (Schedule B, Part 1):				
3.1 First liens				
3.2 Other than first liens				
4. Real estate (Schedule A):				
4.1 Properties occupied by the company (less $.......... encumbrances)				
4.2 Properties held for the production of income (less $.......... encumbrances)				
4.3 Properties held for sale (less $.......... encumbrances)				
5. Policy loans				
6. Premium notes, including $.......... for first year premiums				
7. Cash ($....…………………., Schedule E, Part 1) and short-term investments ($....……….….., Schedule DA, Part 2)	5,100		5,100	
8. Other invested assets (Schedule BA, Part 1)				
9. Receivable for securities				
10. Aggregate write-ins for invested assets				
11. Subtotals, cash and invested assets (Lines 1 to 10)	5,100		5,100	
12. Reinsurance ceded:				
12.1 Amounts recoverable from reinsurers (Schedule S, Part 2)				
12.2 Commissions and expense allowances due				
12.3 Experience rating and other refunds due				
12.4 Other amounts receivable under reinsurance contracts				
13. Electronic data processing equipment and software				
14. Federal and foreign income tax recoverable and interest thereon (including $………… net deferred tax asset)				
15. Guaranty funds receivable or on deposit				
16. Life insurance premiums and annuity considerations deferred and uncollected on in force business (less premiums on reinsurance ceded and less $........loading)				
17. Accident and health premiums due and unpaid				
18. Investment income due and accrued (Exhibit 2)				
19. Net adjustment in assets and liabilities due to foreign exchange rates				
20. Receivable from parent, subsidiaries and affiliates				
21. Amounts receivable relating to uninsured accident and health plans				
22. Amounts due from agents				
23. Other assets nonadmitted (Exhibit 12)				
24. Aggregate write-ins for other-than-invested assets				
25. Total assets excluding Separate Accounts business (Lines 11 to 24)	5,100		5,100	
26. From Separate Accounts Statement	110,900		110,900	
27. Total (Lines 25 and 26)	116,000		116,000	
DETAILS OF WRITE-INS				
1001.				
1002.				
1003.				
1098. Summary of remaining write-ins for Line 10 from overflow page				
1099. Totals (Lines 1001 through 1003 + 1098) (Line 10 above)				
2401.				
2402.				
2403.				
2498. Summary of remaining write-ins for Line 24 from overflow page				
2499. Totals (Lines 2401 through 2403 + 2498) (Line 24 above)				

Note: This illustration reflects 2001 financial statements and will not be subsequently updated.

GENERAL ACCOUNT
ANNUAL STATEMENT FOR THE YEAR 2001 OF THE

LIABILITIES, SURPLUS AND OTHER FUNDS

		1 Current Year	2 Prior Year
1.	Aggregate reserve for life policies and contracts $...............(Exhibit 8, Line 9999999) less $ .included in Line 6.3 (including $ Modco Reserve	....	....
2.	Aggregate reserve for accident and health policies (Exhibit 9, Line 17, Col. 1) (including $.........Modco Reserve)	....	....
3.	Liability for deposit-type contracts (Exhibit 10, Line 14, Col. 1) (including $........Modco Reserve)	5,000	....
4.	Policy and contract claims:		
4.1	Life (Exhibit 11, Part 1, Line 4.4, Col. 1 less sum of Cols. 9, 10 and 11)	....	....
4.2	Accident and health (Exhibit 11, Part 1, Line 4.4, sum of Cols. 9, 10 and 11)	....	....
5.	Policyholders' dividends $..and coupons $...due and unpaid (Exhibit 7, Line 10)	....	....
6.	Provision for policyholders' dividends and coupons payable in following calendar year—estimated amounts:		
6.1	Dividends apportioned for payment to ...., 20 .... (including $ .... Modco Reserve)	....	....
6.2	Dividends not yet apportioned (including $ .... Modco Reserve)	....	....
6.3.	Coupons and similar benefits (including $ .... Modco Reserve)	....	....
7.	Amount provisionally held for deferred dividend policies not included in Line 6	....	....
8.	Premiums and annuity considerations for life and accident and health policies and contracts received in advance less $...................discount; .. including $................accident and health premiums (Exhibit 1, Part 1, Col. 1, sum of Lines 4 and 14)	....	....
9.	Policy and contract liabilities not included elsewhere:		
9.1	Surrender values on canceled policies	....	....
9.2	Provision for experience rating refunds, including $... accident and health experience rating refunds	....	....
9.3	Other amounts payable on reinsurance, including $......................................assumed and $.........................ceded	....	....
9.4	Interest Maintenance Reserve (Page 33, Line 6)	....	....
10.	Commissions to agents due or accrued-life and annuity contracts $........... accident and health $……. and deposit-type contract funds $	....	....
11.	Commissions and expense allowances payable on reinsurance assumed	....	....
12.	General expenses due or accrued (Exhibit 5, Line 12, Col. 5)	....	....
13.	Transfers to Separate Accounts due or accrued (net) (including ($ 4,000) accrued for expense allowances recognized in reserves)	(4,000)	....
14.	Taxes, licenses and fees due or accrued, excluding federal income taxes (Exhibit 6, Line 9, Col. 5)	....	....
15.	Federal and foreign income taxes, including $.......................................on realized capital gains (losses) (including $.. .... net-deferred tax liability)	....	....
16.	Unearned investment income (Exhibit 2, Line 9, Col. 2)	....	....
17.	Amounts withheld or retained by company as agent or trustee	....	....
18.	Amounts held for agents' account, including $.. agents' credit balances	....	....
19.	Remittances and items not allocated	....	....
20.	Net adjustment in assets and liabilities due to foreign exchange rates	....	....
21.	Liability for benefits for employees and agents if not included above	....	....
22.	Borrowed money $..and interest thereon $	....	....
23.	Dividends to stockholders declared and unpaid	....	....
24.	Miscellaneous liabilities:		
24.1	Asset valuation reserve (Page 34, Line 15, Col. 7)	....	....
24.2	Reinsurance in unauthorized companies	....	....
24.3	Funds held under reinsurance treaties with unauthorized reinsurers	....	....
24.4	Payable to parent, subsidiaries and affiliates	....	....
24.5	Drafts outstanding	....	....
24.6	Liability for amounts held under uninsured accident and health plans	....	....
24.7	Funds held under coinsurance	....	....
24.8	Payable for securities	....	....
24.9	Capital notes $……… and interest thereon $………	....	....
25.	Aggregate write-ins for liabilities		
26.	Total liabilities excluding Separate Accounts business (Lines 1 to 25)	1,000	
27.	From Separate Accounts statement	110,900	....
28.	Total liabilities (Lines 26 and 27)	111,900	
29.	Common capital stock	....	....
30.	Preferred capital stock	....	....
31.	Aggregate write-ins for other than special surplus funds	....	....
32.	Surplus notes	....	....
33.	Gross paid in and contributed surplus (Page 3, Line 33, Col. 2 plus Page 4, Line 51.1, Col. 1)	....	....
34.	Aggregate write-ins for special surplus funds	....	....
35.	Unassigned funds (surplus)	....	
36.	Less treasury stock, at cost:		....
36.1	.... shares common (value included in Line 29 $ ....)	....	....
36.2	.... shares preferred (value included in Line 30 $ ....)	....	....
37.	Surplus (total Lines 31 + 32 + 33 + 34 + 35 - 36) (Including $.............in Separate Accounts Statement)		
38.	Totals of Lines 29, 30 and 37 (Page 4, Line 55)		
39.	Totals of Lines 28 and 38 (Page 2, Line 27, Col. 3)		
	DETAILS OF WRITE-INS		
2501.		....	....
2502.		....	
2503.		....	
2598.	Summary of remaining write-ins for Line 25 from overflow page	....	
2599.	Totals (Lines 2501 through 2503 plus 2598) (Line 25 above)		
3101.		....	....
3102.		....	
3103.		....	
3198.	Summary of remaining write-ins for Line 31 from overflow page	....	
3199.	Totals (Lines 3101 through 3103 plus 3198) (Line 31 above)		
3401.		....	....
3402.		....	
3403.		....	
3498.	Summary of remaining write-ins for Line 34 from overflow page	....	
3499.	Totals (Lines 3401 through 3403 plus 3498) (Line 34 above)		

Note: This illustration reflects 2001 financial statements and will not be subsequently updated.

GENERAL ACCOUNT
ANNUAL STATEMENT FOR THE YEAR 2001 OF THE

SUMMARY OF OPERATIONS
(Excluding Unrealized Capital Gains and Losses)

		1 Current Year	2 Prior Year
1.	Premiums and annuity considerations for life and accident and health policies and contracts (Exhibit 1, Part 1, Line 20.4, Col. 1, less Col. 11)	25,000	
2.	Considerations for supplementary contracts with life contingencies		
3.	Net investment income (Exhibit 2, Line 16)		
4.	Amortization of Interest Maintenance Reserve (IMR) (Page 33, Line 5)		
5.	Separate Accounts net gain from operations excluding unrealized gains or losses		
6.	Commissions and expense allowances on reinsurance ceded (Exhibit 1, Part 2, Line 26.1, Col. 1)		
7.	Reserve adjustments on reinsurance ceded		
8.	Miscellaneous Income:		
	8.1 Income from fees associated with investment management, administration and contract guarantees from Separate Accounts	100	
	8.2 Charges and fees for deposit-type contracts		
	8.3 Aggregate write-ins for miscellaneous income		
9.	Totals (Lines 1 to 8.3)	25,100	
10.	Death benefits		
11.	Matured endowments (excluding guaranteed annual pure endowments)		
12.	Annuity benefits (Exhibit 11, Part 2, Line 6.4, Cols. 4 + 8)		
13.	Disability benefits and benefits under accident and health policies		
14.	Coupons, guaranteed annual pure endowments and similar benefits		
15.	Surrender benefits and withdrawals for life contracts	100,000	
16.	Group conversions		
17.	Interest and adjustments on policy or deposit-type contract funds		
18.	Payments on supplementary contracts with life contingencies		
19.	Increase in aggregate reserves for life and accident and health policies and contracts	(100,000)	
20.	Totals (Lines 10 to 19)	0	
21.	Commissions on premiums, annuity considerations and deposit-type contract funds (direct business only) (Exhibit 1, Part 2, Line 31, Col. 1, less Col. 11)		
22.	Commissions and expense allowances on reinsurance assumed (Exhibit 1, Part 2, Line 26.2, Col. 1, less Col. 11)		
23.	General insurance expenses (Exhibit 5, Line 10, Cols. 1 + 2 + 3)		
24.	Insurance taxes, licenses and fees, excluding federal income taxes (Exhibit 6, Line 7, Cols. 1 + 2 + 3)		
25.	Increase in loading on deferred and uncollected premiums		
26.	Net transfers to or (from) Separate Accounts	21,000	
27.	Aggregate write-ins for deductions		
28.	Totals (Lines 20 to 27)	21,000	
29.	Net gain from operations before dividends to policyholders and federal income taxes (Line 9 minus Line 28)	4,100	
30.	Dividends to policyholders		
31.	Net gain from operations after dividends to policyholders and before federal income taxes (Line 29 minus Line 30)		
32.	Federal and foreign income taxes incurred (excluding tax on capital gains)		
33.	Net gain from operations after dividends to policyholders and federal income taxes and before realized capital gains or (losses) (Line 31 minus Line 32)		
34.	Net realized capital gains or (losses) less capital gains tax and transferred to the IMR (Exhibit 3, Footnote (a), Line 3C)		
35.	Net income (Line 33 plus Line 34)		
	CAPITAL AND SURPLUS ACCOUNT		
36.	Capital and surplus, December 31, prior year (Page 3, Line 38, Col. 2)		
37.	Net income (Line 35)		
38.	Change in net unrealized capital gains (losses)		
39.	Change in net unrealized foreign exchange capital gain (loss)		
40.	Change in net deferred income tax		
41.	Change in nonadmitted assets and related items (Exhibit 12, Line 6, Col. 3)		
42.	Change in liability for reinsurance in unauthorized companies		
43.	Change in reserve on account of change in valuation basis, (increase) or decrease (Exhibit 8A, Line 9999999, Col. 4)		
44.	Change in asset valuation reserve (Page 34, Lines 2 through 4 plus 8, 11 and 12, Col. 7)		
45.	Change in treasury stock (Page 3, Lines 36.1 and 36.2 Col. 2 minus Col. 1)		
46.	Surplus (contributed to) withdrawn from Separate Accounts during period		
47.	Other changes in surplus in Separate Accounts statement		
48.	Change in surplus notes		
49.	Cumulative effect of changes in accounting principles		
50.	Capital changes:		
	50.1 Paid in		
	50.2 Transferred from surplus (Stock Dividend)		
	50.3 Transferred to surplus		
51.	Surplus adjustment:		
	51.1 Paid in		
	51.2 Transferred to capital (Stock Dividend)		
	51.3 Transferred from capital		
	51.4 Change in surplus as a result of reinsurance		
52.	Dividends to stockholders		
53.	Aggregate write-ins for gains and losses in surplus		
54.	Net change in capital and surplus for the year (Lines 37 through 53)		
55.	Capital and surplus, December 31, current year (Lines 36 + 54) (Page 3, Line 38)		
	DETAILS OF WRITE-INS		
08.301.			
08.302.			
08.303.			
08.398.	Summary of remaining write-ins for Line 8.3 from overflow page		
08.399.	Totals (Lines 08.301 through 08.303 plus 08.398) (Line 8.3 above)		
2701.			
2702.			
2703.			
2798.	Summary of remaining write-ins for Line 27 from overflow page		
2799.	Totals (Lines 2701 through 2703 plus 2798) (Line 27 above)		
5301.			
5302.			
5303.			
5398.	Summary of remaining write-ins for Line 53 from overflow page		
5399.	Totals (Lines 5301 through 5303 plus 5398) (Line 53 above)		

Note: This illustration reflects 2001 financial statements and will not be subsequently updated.

GENERAL ACCOUNT
ANNUAL STATEMENT FOR THE YEAR 2001 OF THE

CASH FLOW

		1	2
	Cash from Operations	Current Year	Prior Year
1.	Premiums and annuity considerations for life and accident and health policies and contracts	25,000	
2.	Charges and fees for deposit-type contracts		
3.	Considerations for supplementary contracts with life contingencies		
4.	Net investment income		
5.	Commissions and expense allowances on reinsurance ceded		
6.	Fees associated with investment management, administration and contract guarantees from Separate Accounts	100	
7.	Aggregate write-ins for miscellaneous income		
8.	Total (Lines 1 to 7)	25,100	
9.	Death benefits		
10.	Matured endowments		
11.	Annuity benefits		
12.	Disability benefits and benefits under accident and health policies		
13.	Coupons, guaranteed annual pure endowments and similar benefits		
14.	Surrender benefits and withdrawals for life contracts	100,000	
15.	Group conversions		
16.	Interest and adjustments on policy or deposit-type contract funds		
17.	Payments on supplementary contracts with life contingencies		
18.	Total (Lines 9 to 17)	100,000	
19.	Commissions on premiums, annuity considerations and deposit-type contract funds		
20.	Commissions and expense allowances on reinsurance assumed		
21.	General insurance expenses		
22.	Insurance taxes, licenses and fees, excluding federal income taxes		
23.	Net transfers to or (from) Separate Accounts	25,000	
24.	Aggregate write-ins for deductions		
25.	Total (Lines 18 to 24)	125,000	
26.	Dividends paid to policyholders		
27.	Federal income taxes (excluding tax on capital gains)		
28.	Total (Lines 25 to 27)	125,000	
29.	Net cash from operations (Line 8 minus Line 28)	(99,900)	
	Cash from Investments		
30.	Proceeds from investments sold, matured or repaid:		
30.1	Bonds		
30.2	Stocks		
30.3	Mortgage loans		
30.4	Real estate		
30.5	Other invested assets		
30.6	Net gains (losses) on cash and short-term investments		
30.7	Miscellaneous proceeds		
30.8	Total investment proceeds (Lines 30.1 to 30.7)		
31.	Net tax on capital gains (losses)		
32.	Total (Line 30.8 minus Line 31)		
33.	Cost of investments acquired (long-term only):		
33.1	Bonds		
33.2	Stocks		
33.3	Mortgage loans		
33.4	Real estate		
33.5	Other invested assets		
33.6	Miscellaneous applications		
33.7	Total investments acquired (Lines 33.1 to 33.6)		
34.	Net increase (or decrease) in policy loans and premium notes		
35.	Net cash from investments (Line 32 minus Line 33.7 minus Line 34)		
	Cash from Financing and Miscellaneous Sources		
36.	Cash provided:		
36.1	Surplus notes, capital and surplus paid in		
36.2	Borrowed money $............................less amounts repaid $		
36.3	Capital notes $.............. less amounts repaid $...........		
36.4	Deposits on deposit-type contract funds and other liabilities without life or disability contingencies	115,000	
36.5	Other cash provided		
36.6	Total (Lines 36.1 to 36.5)	115,000	
37.	Cash applied:		
37.1	Dividends to stockholders paid		
37.2	Interest on indebtedness		
37.3	Withdrawals on deposit-type contract funds and other liabilities without life or disability contingencies	110,000	
37.4	Other applications (net)		
37.5	Total (Lines 37.1 to 37.4)	110,000	
38.	Net cash from financing and miscellaneous sources (Line 36.6 minus Line 37.5)	5,000	
	RECONCILIATION OF CASH AND SHORT-TERM INVESTMENTS		
39.	Net change in cash and short-term investments (Line 29, plus Line 35, plus Line 38)	(94,900)	
40.	Cash and short-term investments:		
40.1	Beginning of year	100,000	
40.2	End of year (Line 39 plus Line 40.1)	5,100	
	DETAILS OF WRITE-INS		
0701.			
0702.			
0703.			
0798.	Summary of remaining write-ins for Line 7 from overflow page		
0799.	Totals (Lines 0701 through 0703 plus 0798) (Line 7 above)		
2401.			
2402.			
2403.			
2498.	Summary of remaining write-ins for Line 24 from overflow page		
2499.	Totals (Lines 2401 through 2403 plus 2498) (Line 24 above)		

Note: This illustration reflects 2001 financial statements and will not be subsequently updated.

ANNUAL STATEMENT FOR THE YEAR 2001 OF THE SEPARATE ACCOUNTS OF THE

EXHIBIT 7—DEPOSIT TYPE CONTRACTS

	1	2	3	4	5	6
	Total	Guaranteed Interest Contracts	Supplemental Contracts and Annuities Certain	Dividend Accumulations or Refunds	Premium and Other Deposit Funds	Other
1. Balance at the beginning of the year	15,000	15,000				
2. Deposits received during the year	110,000		110,000			
3. Investment earnings credited to the account	2,000		2,000			
4. Other net change in reserves	(4,000)		(4,000)			
5. Fees and other charges assessed	100		100			
6. Surrender charges						
7. Net surrender or withdrawal payments	41,000	15,000	26,000			
8. Other net transfers to or (from) General Accounts						
9. Balance at the end of current year(Lines 1+2+3+4-5-6-7-8)	81,900	0	81,900			

Reconciliation of Exh. 7 to Summary of Operations:

Exh. 7, Column 1, Line 9	81,900
Exh. 7, Column 1, Line 1	15,000
Summary of Operations, Column 1, Line 14	66,900

Exh. 7, Column 1, Line 2	110,000
Exh. 7, Column 1, Line 7	41,000
Summary of Operations, Column 1, Line 2	69,000

Note: This illustration reflects 2001 financial statements and will not be subsequently updated.

GENERAL ACCOUNT
ANNUAL STATEMENT FOR THE YEAR 2001 OF THE

EXHIBIT 10—DEPOSIT TYPE CONTRACTS

		1	2	3	4	5	6
		Total	Guaranteed Interest Contracts	Supplemental Contracts and Annuities Certain	Dividend Accumulations or Refunds	Premium and Other Deposit Funds	Other
1.	Balance at the beginning of the year before reinsurance						
2.	Deposits received during the year	115,000		115,000			
3.	Investment earnings credited to the account						
4.	Other net change in reserves						
5.	Fees and other charges assessed						
6.	Surrender charges						
7.	Net surrender or withdrawal payments	41,000	15,000	26,000			
8.	Other net transfers to or (from) Separate Accounts	69,000	(15,000)	84,000			
9.	Balance at the end of current year before reinsurance (Lines 1+2+3+4-5-6-7-8)	5,000	0	5,000			
10.	Reinsurance balance at the beginning of the year						
11.	Net change in reinsurance assumed						
12.	Net change in reinsurance ceded						
13.	Reinsurance balance at the end of the year (Lines 10+11-12)						
14.	Net balance at the end of current year after reinsurance (Lines 9-13).						

Interpretation of the Emerging Accounting Issues (E) Working Group

INT 00-20: Application of SEC SAB No. 99, *Materiality* to the Preamble of the AP&P Manual

INT 00-20 Dates Discussed

June 12, 2000; September 20, 2000; June 11, 2001; October 16, 2001

INT 00-20 References

Current:
Preamble to the NAIC *Accounting Practices and Procedures Manual* (Preamble)

INT 00-20 Issue

1. In summary, SEC Staff Accounting Bulletin No. 99, *Materiality* (SAB No. 99) addresses two issues; 1) may a company or auditor assume the immateriality of items that fall below a percentage threshold set by management or its auditors to determine whether amounts and items are material to the financial statements? and 2) may a company make intentional immaterial misstatements in its financial statements? The SEC staff answers each question as NO and gives numerous references to FASB guidelines to support their opinion.

2. The issue is whether the responses outlined in SAB No. 99 can be applied to statutory accounting and the concept of materiality as defined in paragraphs 44-49 of the Preamble?

INT 00-20 Discussion

3. At the 2000 Spring National Meeting, the Statutory Accounting Principles (E) Working Group (SAPWG) reviewed SAB No. 99 for incorporation into the *Accounting Practices and Procedures Manual* (AP&P Manual or Manual). The SAPWG determined that no modifications to the Preamble were warranted and referred the issue to the NAIC/AICPA Working Group for their consideration. The SAPWG felt the SAB had applicability to management of reporting entities, independent auditors and State Examiners. The NAIC/AICPA WG reviewed the SAB and determined that an interpretation of the Preamble was a more effective way to adopt the SAB for statutory accounting. The NAIC/AICPA WG felt that the AP&P Manual reached a larger audience than the A/S Instructions or Examiner's Handbook.

4. The Working Group reached a consensus to adopt an interpretation of the concept of materiality based on certain matters outlined in SAB No. 99. The Working Group believes the responses below provide additional support for the concepts delineated in Section VI of the Preamble. The SAB contains numerous references to SEC guidelines and GAAP pronouncements that are not reflected in this interpretation as such matters are not necessarily applicable or appropriate for statutory financial reporting. The interpretative responses (as modified by this interpretation) are as follows:

> **QUESTION:** Paragraph 49 of the Preamble states "The provisions of this Manual need not be applied to immaterial items." May a reporting entity's management, state examiner or independent auditor of the entity's financial statements assume the immateriality of items that fall below a percentage threshold set by management, state examiner or independent auditor to determine whether amounts and items are material to the financial statements?

INTERPRETIVE RESPONSE No. Over time, the NAIC is aware that reporting entities have developed quantitative thresholds as "rules of thumb" to assist in the preparation of their financial statements, and that state examiners and independent auditors also have used these thresholds in their evaluation of whether items might be considered material to users of a reporting entity's financial statements. One rule of thumb in particular suggests that the misstatement or omission of an item that falls under a 5% of surplus threshold is not material in the absence of particularly egregious circumstances, such as self-dealing or misappropriation by senior management. Exclusive reliance on this or any percentage or numerical threshold has no basis in the accounting literature or the law.

The use of a percentage as a numerical threshold, such as 5% of surplus, may provide the basis for a preliminary assumption that - without considering all relevant circumstances - a deviation of less than the specified percentage with respect to a particular item on the reporting entity's financial statements is unlikely to be material. The NAIC has no objection to such a "rule of thumb" as an initial step in assessing materiality. But quantifying, in percentage terms, the magnitude of a misstatement is only the beginning of an analysis of materiality; it cannot appropriately be used as a substitute for a full analysis of all relevant considerations. Materiality concerns the significance of an item to users of the reporting entity's financial statements. A matter is "material" if there is a substantial likelihood that a reasonable person would consider it important.

QUESTION: May a reporting entity make intentional immaterial misstatements in its financial statements?

INTERPRETIVE RESPONSE No. In certain circumstances, intentional immaterial misstatements are unlawful.

Each reporting entity must make and keep books, records, and accounts, that, in reasonable detail, accurately and fairly reflect the acquisitions and dispositions of assets of the reporting entity and must maintain internal control that is sufficient to provide reasonable, but not absolute, assurances that, among other things, transactions are recorded as necessary to permit the preparation of financial statements in conformity with the revised *Accounting Practices and Procedures Manual*. In this context, determinations of what constitutes "reasonable assurance" and "reasonable detail" are based not on a "materiality" analysis but on the level of detail and degree of assurance that would satisfy prudent individuals in the conduct of their own affairs. It is unlikely that it is ever "reasonable" for a reporting entity to record misstatements or not to correct known misstatements as part of an ongoing effort directed by or known to senior management for the purpose of "managing" reported results or financial position.

The National Commission on Fraudulent Financial Reporting, also known as the Treadway Commission, in its 1987 report,

> The tone set by top management - the corporate environment or culture within which financial reporting occurs - is the most important factor contributing to the integrity of the financial reporting process. Notwithstanding an impressive set of written rules and procedures, if the tone set by management is lax, fraudulent financial reporting is more likely to occur.

Statement on Auditing Standards No. ("SAS") 54, "Illegal Acts by Clients," and SAS No. 82, "Consideration of Fraud in a Financial Statement Audit" provide guidance to the independent auditor. Pursuant to paragraph 38 of SAS 82, if the independent auditor determines there is evidence that fraud may exist, the independent auditor must discuss the matter with the appropriate level of management. The auditor must report directly to the audit committee fraud involving senior management and fraud that causes a material misstatement of the financial statements. Paragraph 4 of SAS No. 82 states that "misstatements arising from fraudulent financial reporting are intentional misstatements or omissions of amounts or disclosures in financial statements to deceive financial statement users." SAS No. 82 further states that fraudulent financial reporting may involve falsification or alteration of accounting records; misrepresenting or omitting events, transactions or other information in the financial statements; and the intentional misapplication of accounting principles relating to amounts, classifications, the manner of presentation, or disclosures in the financial statements. The clear implication of SAS No. 82 is that immaterial misstatements may be fraudulent financial reporting.

Independent auditors that learn of intentional misstatements may also be required to (1) re-evaluate the degree of audit risk involved in the audit engagement, (2) determine whether to revise the nature, timing, and extent of audit procedures accordingly, and (3) consider whether to resign.

Intentional misstatements also may signal the existence of reportable conditions or material weaknesses in the reporting entity’s system of internal accounting control designed to detect and deter improper accounting and financial reporting.

An auditor is required to report to the audit committee any reportable conditions or material weaknesses in a reporting entity’s system of internal accounting control that the auditor discovers in the course of the examination of the registrant's financial statements.

INT 00-20 Status

5. No further discussion planned.

Interpretation of the Emerging Accounting Issues (E) Working Group

INT 00-24: EITF 98-13: Accounting by an Equity Method Investor for Investee Losses When the Investor Has Loans to and Investments in Other Securities of the Investee and EITF 99-10: Percentage Used to Determine the Amount of Equity Method Losses

INT 00-24 Dates Discussed

June 12, 2000; September 11, 2000

INT 00-24 References

Current:
SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities, A Replacement of SSAP No. 88 (SSAP No. 97)

Superseded:
SSAP No. 46—Investments in Subsidiary, Controlled, and Affiliated Entities (SSAP No. 46)
SSAP No. 88—Investments in Subsidiary, Controlled and Affiliated Entities, A Replacement of SSAP No. 46 (SSAP No. 88)

INT 00-24 Issue

1. EITF 98-13 and Topic No. D-68, *Accounting by an Equity Method Investor for Investee Losses When the Investor Has Loans to and Investments in Other Securities of an Investee* (EITF 98-13 or Topic D-68) provides the FASB staff position that Accounting Principles Board Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock* (APB No. 18) requires an investor that owns common (or other voting) stock and also (a) owns debt securities (including mandatorily redeemable preferred stock), (b) owns preferred stock, or (c) has extended loans to the investee to continue to report losses. Paragraph 13 of FASB Statement 114, *Accounting by Creditors for Impairment of a Loan* (FAS 114) as amended by FASB Statement 118, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures* (FAS 118) provides that when a loan is impaired, a creditor shall measure impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate. Paragraph 12 of FASB Statement 115, *Accounting for Certain Investments in Debt and Equity Securities* (FAS 115) provides that investments in both debt securities not held to maturity and equity securities that have readily determinable fair values shall be carried at fair value.

2. EITF 99-10, *Accounting by an Equity Method Investor for Investee Losses When the Investor Has Loans to and Investments in Other Securities of an Investee* (EITF 99-10) and Topic No. D-68 provides the FASB staff position on an investor's accounting when more than one type of interest is held. Specifically, the FASB staff announced that APB No. 18 requires that when an investor owns common stock and also (a) owns debt securities (including mandatorily redeemable preferred stock), (b) owns preferred stock, or (c) has extended loans to the investee (collectively referred to as "other investments”), the equity method investor should continue to report losses up to the investor's investment carrying value, including any additional financial support made or committed to by the investor. EITF 98-13 provides guidance on the interaction between the applicable literature for those instruments and APB No. 18 for situations in which an investee is incurring losses and (a) an investor is not required to advance additional funds to the investee and (b) previous losses have reduced the common stock investment account to zero. However, neither

Topic D-68 nor EITF 98-13 provides guidance on how an investor should calculate the amount of equity method losses or subsequent income in that circumstance.

3. The issue is, when an investor is required to account for a common stock investment using the equity method, how the equity method loss pickup from the application of APB No. 18 (when the carrying amount of the common stock has been reduced to zero) interacts with the applicable literature relating to investments in the other securities of the investee (either FAS 114 or FAS 115), and if an investor owns common stock and "other investments" in an investee and is not required to advance additional funds to the investee and if previous losses have reduced the common stock investment account to zero, how additional equity method losses should be measured and recognized by the investor.

INT 00-24 Discussion

4. The Working Group reached a consensus to adopt the final conclusions reached in EITF 98-13 and 99-10 with modification as follows:

5. The EITF reached a consensus that in situations where (a) an investor is not required to advance additional funds to the investee and (b) previous losses have reduced the common stock investment account to zero, the investor should continue to report its share of equity method losses in its statement of operations to the extent of and as an adjustment to the adjusted basis of the other investments in the investee. The order in which those equity method losses should be applied to the other investments should follow the seniority of the other investments (that is, priority in liquidation). For each period, the adjusted basis of the other investments should be adjusted for the equity method losses, then the investor should apply SSAP No. 97 to the other investments, as applicable.

6. For purposes of this consensus, other investments in the investee include, but are not limited to, preferred stock, debt securities, and loans to the investee (collectively referred to as loans and securities). The cost basis of the other investments is the original cost of those investments adjusted for the effects of other-than-temporary write-downs, unrealized gains and losses, and amortization of any discount or premium on debt securities or loans. The adjusted basis is the cost basis adjusted for the valuation allowance account for an investee loan and the cumulative equity method losses applied to the other investments. Equity method income subsequently recorded should be applied to the adjusted basis of the other investments in reverse order of the application of the equity method losses (that is, equity method income is applied to the more senior securities first).

7. When the investor has loans and securities of the investee that are within the scopes of SSAP No. 97, the investor should perform the following in order to determine the amount of equity method loss to report at the end of a period:

a. Apply SSAP No. 97 to determine the maximum amount of equity method losses.

b. Determine whether the adjusted basis of the other investment(s) in the investee is positive.

i. When the adjusted basis is positive, the adjusted basis of the other investments should be adjusted for the amount of the equity method loss based on its seniority. For investments accounted for in accordance with SSAP No. 30, this adjusted basis becomes the security's basis from which subsequent changes in fair value are measured.

ii. When the adjusted basis reaches zero, equity method losses should cease being reported; however, the investor should continue to track the amount of unreported equity method losses for purposes of applying SSAP No. 97. (If one of the other investments is sold at a time when its carrying value exceeds its adjusted basis, the difference between the cost basis of that other investment and its adjusted basis at the time of sale represents equity method losses that were originally applied to that other investment but effectively reversed upon its sale. Accordingly, that excess represents unreported equity method losses that should continue to be tracked before future equity method income can be reported.

c. After applying SSAP No. 97, apply *SSAP No. 30—Investments in Common Stock (excluding investments in common stock of subsidiary, controlled, or affiliated entities)* (SSAP No. 30) to the adjusted basis of the other investments in the investee, as applicable. Apply appropriate statutory accounting principles to other investments that are not within the scope of SSAP No. 30.

8. The EITF reached a consensus that an investor should not recognize equity method losses based solely on the percentage of investee common stock held by the investor.

9. The EITF observed that an entity should utilize a single entity-wide approach to determine the amount of its equity method losses when previous losses have reduced the common stock investment account to zero and that the selected policy should be disclosed in the footnotes to the financial statements.

10. The provisions of these consensuses are effective for interim or annual periods beginning after January 1, 2001.

11. Refer to Exhibit 00-24A for an example that illustrates application of these consensuses.

INT 00-24 Status

12. No further discussion is planned.

Exhibit 00-24A
ILLUSTRATION OF THE APPLICATION OF THE INT 00-24 CONSENSUS'S

XYZ Investment in ABC Company

1. ABC Company is a life insurance company, formed January 2, 20X1 to sell health insurance in the state of New York. On January 2, 20X1, XYZ Insurance Company invested $500,000 in ABC, and purchased 100,000 shares of common stock at par, and 40,000 shares of preferred stock at par. ABC Preferred stock is non-voting, 5% cumulative.

2. XYZ determined it has obtained a controlling interest in ABC as XYZ owns 50% of the voting interests of ABC. XYZ accounted for its investment in ABC Insurance Company under the statutory equity method of accounting. The following table is selected information from the financial statements of ABC Insurance Company.

	1/2/20X1	12/31/20X1	12/31/20X2	12/31/20X3	12/31/20X4
Capital and Surplus:					
Common stock, $1 par, 200,000 shares issued and outstanding	$ 200,000	$ 200,000	$ 200,000	$ 200,000	$ 200,000
Preferred stock, $10 par, 100,000 shares issued and outstanding	$1,000,000	$1,000,000	$1,000,000	$1,000,000	$1,000,000
Surplus Notes			$ 500,000	$ 500,000	$ 500,000
Unassigned Funds (Surplus)		$ 130,000	($ 180,000)	($ 630,000)	($1,430,000)
Total Capital and Surplus	$1,200,000	$1,330,000	$1,520,000	$ 1,070,000	$ 270,000

	12/31/20X5	12/31/20X6	12/31/20X7	12/31/20X8	12/31/20X9
Capital and Surplus:					
Common stock, $1 par, 200,000 shares issued and outstanding	$ 200,000	$ 200,000	$ 200,000	$ 200,000	$ 200,000
Preferred stock, $10 par, 100,000 shares issued and outstanding	$1,000,000	$1,000,000	$1,000,000	$1,000,000	$1,000,000
Surplus Notes	$ 500,000	$1,000,000	$1,000,000	$1,000,000	$1,000,000
Unassigned Funds (Surplus)	($1,980,000)	($1,830,000)	($1,280,000)	($ 430,000)	$ 820,000
Total Capital and Surplus	($280,000)	$ 370,000	$ 920,000	$1,770,000	$3,020,000

3. At 1/2/20X1, XYZ recorded the following entry to record its investment in ABC:

Investment in ABC Common stock	$ 100,000	
Investment in ABC Preferred stock	$ 400,000	
Cash		$ 500,000

To record initial investment in ABC Insurance Company.

4. During the year ended 12/31/20X1, ABC had statutory net income before dividends of $200,000. At 12/31/20X1, ABC declared and paid a 5% preferred dividend, and a common stock dividend of $.10 per share. XYZ recorded the following entries:

Cash	$ 20,000	
Dividend Income		$ 20,000

To record preferred dividend income from ABC Insurance Company for 20X1.

Investment in ABC Common stock	$ 75,000	
Unrealized Gain/Loss		$ 75,000

To record 20X1 unrealized gain on investment in ABC Common. (($200,000 - $50,000) * 50%)

Cash	$ 10,000	
Unrealized Gain/Loss	$ 10,000	
Dividend Income		$ 10,000
Investment in ABC Common stock		$ 10,000

To record 20X1 dividend on ABC Common. (100,000 shares * $.10)

5. During the year ended 12/31/20X2, ABC issued an 8% surplus note of $500,000. XYZ purchased 100% of the surplus note. During that same year, ABC incurred a statutory net loss before dividends of $250,000. At 12/31/20X2, ABC declared and paid a 5% preferred dividend, and a common stock dividend of $.05 per share. No interest or principal repayments of the surplus note were approved. XYZ recorded the following entries:

Investment in ABC Surplus Notes	$ 500,000	
Cash		$ 500,000

To record investment in ABC Insurance Company surplus notes.

Cash	$ 20,000	
Dividend Income		$ 20,000

To record preferred dividend income from ABC Insurance Company for 20X2.

Unrealized Gain/Loss	$ 150,000	
Investment in ABC Common stock		$ 150,000

To record 20X2 unrealized loss on investment in ABC Common. (($-250,000 - $50,000) * 50%)

Cash	$ 5,000	
Unrealized Gain/Loss	$ 5,000	
Dividend Income		$ 5,000
Investment in ABC Common stock		$ 5,000

To record 20X2 dividend on ABC Common. (100,000 shares * $.05)

6. During the year ended 12/31/20X3, ABC Insurance Company incurred a statutory net loss before dividends of $400,000. ABC Insurance Company did not declare any dividends, and no interest or principal repayments of the surplus note were approved. XYZ recorded the following entries:

Dividends Receivable	$ 20,000	
Dividend Income		$ 20,000

To record preferred dividend income from ABC Insurance Company for 20X3.

Unrealized Gain/Loss	$ 182,000	
Investment in ABC Preferred stock		$ 172,000
Investment in ABC Common stock		$ 10,000

To record 20X3 unrealized loss on investment in ABC Common and Preferred.

Total net loss and preferred stock dividend ($450,000).

Common stock component reduces the Investment in ABC Common stock component to $0. (20,000 * 50%)

Total net loss and preferred dividend (-$400,000 - $50,000)	$450,000
Less amount used to reduce common stock investment to $0	20,000
Amount remaining to be allocated to investment in preferred	430,000
XYZ ownership % of preferred	40%
XYZ reduction in investment in preferred	$172,000

7. During the year ended 12/31/20X4, ABC Insurance Company incurred a statutory net loss before dividends of $750,000. ABC Insurance Company did not declare any dividends, and no interest or principal repayments of the surplus note were approved. XYZ recorded the following entries:

Dividends Receivable	$ 20,000	
Dividend Income		$ 20,000

To record preferred dividend income from ABC Insurance Company for 20X4.

Unrealized Gain/Loss	$ 458,000	
Investment in ABC Preferred stock		$ 228,000
Investment in ABC Surplus note		$ 230,000

To record 20X4 unrealized loss on investment in ABC Preferred and Surplus Notes.

Total net loss and preferred stock dividend ($800,000).

Common stock component reduces the Investment in ABC Preferred stock component to $0. (570,000 * 40%)

Preferred stock component calculated as:

Total net loss and preferred dividend (-$750,000 - $50,000)	$800,000
Less amount used to reduce preferred stock investment to $0	570,000
Amount remaining to be allocated to investment in surplus note	230,000
XYZ ownership % of surplus note	100%
XYZ reduction in investment in ABC Surplus Notes	$230,000

8. During the year ended 12/31/20X5, ABC Insurance Company incurred a statutory net loss before dividends of $500,000. ABC Insurance Company did not declare any dividends, and no interest or principal repayments of the surplus note were approved. XYZ recorded the following entries:

Dividends Receivable	$ 20,000	
Dividend Income		$ 20,000

To record preferred dividend income from ABC Insurance Company for 20X5.

Unrealized Gain/Loss	$ 270,000	
Investment in ABC Surplus note		$ 270,000

To record 20X5 unrealized loss on investment in ABC Surplus Notes.

Total ABC net loss and preferred stock dividend (-$500,000 - $50,000).

Surplus Note component calculated as:

Total net loss and preferred dividend (-$500,000 - $50,000)	$550,000
XYZ ownership % of ABC Surplus Note	100%
	$550,000
Amount of unrealized loss recognized in 20X5	$270,000
Amount of unrealized loss suspended	$280,000

9. Since XYZ has not guaranteed any liabilities of ABC, the reduction they would recognize is limited to their remaining investment in ABC Surplus Notes. Therefore, they would only recognize a 20X5 unrealized loss on their investment in ABC of $270,000.

10. During the year ended 12/31/20X6, ABC Insurance Company realigned their marketing efforts and modified the products they were selling. ABC also issued an additional 8% surplus note of $500,000. This surplus note was purchased by an unaffiliated third party. During the year ended 12/31/X6, ABC Insurance Company had statutory net income before dividends of $200,000. ABC Insurance Company did not declare any dividends on common stock, but declared and paid current and dividends in arrears on preferred. XYZ recorded the following entries:

Cash	$ 80,000	
Dividends Receivable		$ 60,000
Dividend Income		$ 20,000

To record preferred dividend income from ABC Insurance Company for 20X6, and receipt of preferred dividends receivable for 20X3, 20X4 and 20X5.

11. XYZ did not record any change in their investment in ABC Surplus Notes, ABC Preferred or ABC Common, since ABCs' net income after preferred dividends did not exceed the losses accumulated during the period that XYZ suspended recording unrealized losses.

12. The following amounts were tracked:

Total ABC net income and preferred stock dividend ($200,000 - $50,000).

Surplus Note component calculated as:

Total net income and preferred dividend ($200,000 - $50,000)	$150,000
XYZ ownership % of ABC Surplus Note	50%
Amount of unrealized loss suspended in 20X5	$ 75,000
Remaining amount of unrealized loss suspended	$280,000
	$205,000

13. During the year ended 12/31/20X7, ABC Insurance Company had statutory net income before dividends of $600,000. At 12/31/20X7, ABC declared and paid a 5% preferred dividend. No interest or principal repayments of the surplus note were approved. XYZ recorded the following entries:

Cash	$ 20,000	
Dividend Income		$ 20,000

To record preferred dividend income from ABC Insurance Company for 20X7.

Investment in ABC Surplus Notes	$ 70,000	
Unrealized Gain/Loss		$ 70,000

To record 20X7 unrealized gain on investment in ABC Surplus Notes.

Total ABC net income and preferred stock dividend ($600,000 - $50,000).
Surplus Note component calculated as:

Total net income and preferred dividend ($600,000 - $50,000)	$550,000
XYZ ownership % of ABC Surplus Note	50%
	$275,000
Remaining amount of unrealized loss suspended in 20X5	$205,000
20X7 amount of unrealized gain on investment in ABC Surplus Note	$ 70,000

14. During the year ended 12/31/20X8, ABC Insurance Company had statutory net income before dividends of $900,000. At 12/31/20X8, ABC declared and paid a 5% preferred dividend. No interest or principal repayments of the surplus note were approved. XYZ recorded the following entries:

Cash	$ 20,000	
Dividend Income		$ 20,000

To record preferred dividend income from ABC Insurance Company for 20X8.

Total ABC net income and preferred stock dividend ($900,000 - $50,000).
Surplus Note component calculated as:

Total net income and preferred dividend ($900,000 - $50,000)	$850,000
XYZ ownership % of ABC Surplus Note	50%
20X8 amount of unrealized gain on investment in ABC Surplus Note	$425,000

Investment in ABC Surplus Notes	$ 425,000	
Unrealized Gain/Loss		$ 425,000

To record 20X8unrealized gain on investment in ABC Surplus Notes.

15. During the year ended 12/31/20X9, ABC Insurance Company had statutory net income, before interest on surplus notes and dividends, of $1,400,000. The Commissioner approved one year's interest payment on the surplus notes. At 12/31/20X9, ABC declared and paid a 5% preferred dividend, and a $.10 dividend per share on Common stock. XYZ recorded the following entries:

Cash	$ 20,000	
Dividend Income		$ 20,000

To record preferred dividend income from ABC Insurance Company for 20X9.

Cash	$ 40,000	
Interest Income		$ 40,000

To record surplus notes interest income from ABC Insurance Company for 20X9. ($500,000 * 8%)

Investment in ABC Surplus Notes	$ 5,000	
Investment in ABC Preferred Stock	$ 400,000	
Investment in ABC Common Stock	$ 130,000	
Unrealized Gain/Loss		$ 535,000

To record 20X9 unrealized gain on investment in ABC Common, Preferred and Surplus Notes.

Components computed as follows:

Total Net Income net of preferred stock dividend and interest on surplus notes ($1,400,000 - $50,000 - $80,000)	$ 1,270,000
Less amount needed to restore investment in surplus notes	($ 10,000)
Amount available for preferred stock and common stock investment restoration	$ 1,260,000
Amount needed to restore preferred stock component	($ 1,000,000)
Amount available to restore common stock component	$ 260,000

Surplus Notes component ($10,000 * 50%)	$ 5,000
Preferred Stock component ($1,000,000 * 40%)	$ 400,000
Common stock component ($260,000 * 50%)	$ 130,000

Cash	$ 10,000	
Unrealized Gain/Loss	$ 10,000	
Dividend Income		$ 10,000
Investment in ABC Common stock		$ 10,000

To record 20X9 dividend on ABC Common. (100,000 shares * $.10)

Interpretation of the Emerging Accounting Issues (E) Working Group

INT 00-26: EITF 98-3: Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business

INT 00-26 Dates Discussed

June 12, 2000; September 11, 2000; March 5, 2006; June 11, 2006; December 10, 2006; March 10, 2007

INT 00-26 References

Current:
SSAP No. 95—Exchange of Nonmonetary Assets, A replacement of SSAP No. 28—Nonmonetary Transactions (SSAP No. 95)

Superseded:
SSAP No. 28—Nonmonetary Transactions (SSAP No. 28)

INT 00-26 Issue

1. The basic principle contained in APB Opinion No. 29, *Accounting for Nonmonetary Transactions* (APB No. 29) is that an exchange of nonmonetary assets should be recorded at fair value. Certain modifications to that basic principle are contained in paragraphs 20-23 of APB No. 29. Paragraph 21.b. provides that accounting for an exchange of productive assets for similar productive assets should be based on the recorded amount of the nonmonetary assets relinquished. Paragraph 4 of APB No. 29 states that Opinion is not applicable to business combinations.

2. APB Opinion No. 16, *Business Combinations* (APB No. 16) provides accounting guidance for business combinations. Paragraph 1 of APB No. 16 states that "a business combination occurs when a corporation and one or more incorporated or unincorporated businesses are brought together into one accounting entity. The single entity carries on the activities of the previously separate, independent enterprises."

3. It is not clear whether exchanges of certain types of assets, for example, radio stations, cable systems, and hotels, are considered exchanges of productive assets or business combinations.

4. The issues are whether the exchange of assets or groups of assets involving the receipt of a consolidated business can be considered an exchange of similar productive assets accounted for at historical cost pursuant to paragraph 21 of APB No. 29 and how a "business" should be defined.

5. In December of 2004, the Financial Accounting Standards Board (FASB) issued *FAS 153: Exchanges of Nonmonetary Assets, an amendment of APB Opinion No. 29* (FAS 153), which addresses the measurement of exchanges of nonmonetary assets. It eliminates the exception from fair value measurement for nonmonetary exchanges of similar productive assets in paragraph 21.b. of APB No. 29, and replaces it with an exception for exchanges that do not have commercial substance. This statement specifies that a nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of

the exchange. While the guidance referred to above has been amended, the statutory accounting guidance included in the following discussion is not impacted and remains in effect.

INT 00-26 Discussion

6. The Working Group reached a consensus to update the description of the issue by adding an explanatory paragraph 5, which discusses amendments to APB No. 29 resulting from FAS 153.

7. The Working Group reached a consensus to adopt the conclusions reached in EITF 98-3 with modification. APB No. 29 is adopted with SSAP No. 95. Although APB No. 16 is rejected in SSAP No. 68, the issues raised in EITF 98-3 are applicable to statutory accounting and SSAP No. 95. The modified conclusions of EITF 98-3 are outlined in paragraphs 8-15.

8. The EITF reached a consensus that the guidance below should be used to evaluate whether a business has been received in a nonmonetary exchange transaction.

9. A business is a self-sustaining integrated set of activities and assets conducted and managed for the purpose of providing a return to investors. A business consists of (a) inputs, (b) processes applied to those inputs, and (c) resulting outputs that are used to generate revenues. For a transferred set of activities and assets to be a business, it must contain all of the inputs and processes necessary for it to continue to conduct normal operations after the transferred set is separated from the transferor, which includes the ability to sustain a revenue stream by providing its outputs to customers.

10. The elements necessary for a transferred set to continue to conduct normal operations will vary by industry and by the operating strategies of the transferred set. An evaluation of the necessary elements should consider:

Inputs

a. Long-lived assets, including intangible assets, or rights to the use of long-lived assets.

b. Intellectual property.

c. The ability to obtain access to necessary materials or rights.

d. Employees.

Processes

e. The existence of systems, standards, protocols, conventions, and rules that act to define the processes necessary for normal, self-sustaining operations, such as (i) strategic management processes, (ii) operational processes, and (iii) resource management processes.

Outputs

f. The ability to obtain access to the customers that purchase the outputs of the transferred set.

11. A transferred set of activities and assets fails the definition of a business if it excludes one or more of the above items such that it is not possible for the set to continue normal operations and sustain a revenue stream by providing its products and/or services to customers. However, if the excluded item or items are only minor (based on the degree of difficulty and the level of investment necessary to obtain access to or to acquire the missing item(s)), then the transferred set is capable of continuing normal operations and is a business. The assessment of whether

excluded items are only minor should be made without regard to the attributes of the transferee and should consider such factors as the uniqueness or scarcity of the missing element, the time frame, the level of effort, and the cost required to obtain the missing element. If goodwill is present in a transferred set of activities and assets, it should be presumed that the excluded items are minor and that the transferred set is a business.

12. The assessment of whether a transferred set is a business should be made without regard to how the transferee intends to use the transferred set. In other words, it is not relevant to the evaluation of whether the transferred set is a business whether the transferee will actually operate the set on a stand-alone basis or intends to continue using the transferred set in the same manner as the transferor.

13. If all but a de minimis amount of the fair value of the transferred set of activities and assets is represented by a single tangible or identifiable intangible asset, the concentration of value in the single asset is an indicator that an asset rather than a business is being received.

14. The level of working capital or the adequacy of financing necessary to conduct normal operations in the transferred set is not an indicator either way as to whether the set meets the definition of a business. Likewise, if the planned principal operations of the transferred set have commenced, the presence and/or expectation of continued operating losses while the set seeks to achieve the level of market share necessary to attain profitability is not an indicator of whether or not the set is a business. However, if the transferred set is in the development stage and has not commenced planned principal operations, the set is presumed not to be a business.

15. The determination of whether a transferred set of assets and activities is or is not a business is a three-step process. First, one must identify the elements included in the transferred set. Second, one must compare the identified elements in the transferred set to the complete set of elements necessary for the transferred set to conduct normal operations in order to identify any missing elements. Third, if there are missing elements, one must make an assessment as to whether the missing elements cause one to conclude that the transferred set is not a business. That assessment is based on the degree of difficulty or the level of investment (relative to the fair value of the transferred set) necessary to obtain access to or to acquire the missing elements. If the degree of difficulty and level of investment necessary to obtain access to or to acquire the missing elements are not significant, then the missing elements are considered minor and their absence would not cause one to conclude that the transferred set is not a business. The determination of the degree of difficulty or level of investment necessary to obtain access to or to acquire the missing elements requires significant judgment and is dependent on the particular facts and circumstances.

INT 00-26 Status

16. On March 10, 2007, the Working Group reached a consensus to remove SSAP No. 68 from the references section of this interpretation; as it should not be used to interpret SSAP No. 68. No further discussion is planned.

Interpretation of the Emerging Accounting Issues (E) Working Group

INT 00-28: EITF 99-12: Determination of the Measurement Date for the Market Price of Acquirer Securities Issued in a Purchase Business Combination

INT 00-28 Dates Discussed

June 12, 2000; September 11, 2000

INT 00-28 References

Current:
SSAP No. 68—Business Combinations and Goodwill (SSAP No. 68)

INT 00-28 Issue

1. APB No. 16, *Business Combinations* (APB No. 16) appears to include contradictory guidance about the date that should be used to value equity securities issued to effect a business combination accounted for using the purchase method. Paragraph 74 of APB No. 16 states that "the market price for a reasonable period before and after the date the terms of the acquisition are agreed to and announced should be considered in determining the fair value of securities issued." However, paragraph 94 of APB No. 16 refers to determining the cost of an acquired company as of the date of acquisition, which is defined in paragraph 93 as, "ordinarily . . . the date assets are received and other assets are given or securities are issued." This Issue addresses that apparent contradiction.

2. The interval between initiating and completing a business combination may involve an extended period of time. Although management of the companies involved may agree to and announce the terms of a business combination at the initiation date, internal or external contingencies, such as the need to obtain shareholder or regulatory approvals, may exist and prevent concurrent consummation of the combination. Because of the length of time that may be required to resolve those contingencies, the market price of the securities that are expected to be issued to effect a purchase business combination may fluctuate. As a result, the total cost of the acquired company assigned by the acquirer may vary significantly depending on the date that is used to value the securities that are issued.

3. The issues are:

a. The date that should be used to value marketable equity securities of the acquirer issued to effect a business combination accounted for using the purchase method when the number of the acquirer's shares or amount of other consideration is not subject to change pursuant to the existing terms of the acquisition agreement

b. The date that should be used as the measurement date to value equity securities of the acquirer issued in a purchase business combination if the number of the acquirer's shares or amount of other consideration to be issued could change pursuant to a formula in the initial acquisition agreement.

INT 00-28 Discussion

4. The Working Group reached a consensus to adopt the final conclusions reached in EITF 99-12, *Determination of the Measurement Date for the Market Price of Acquirer Securities*

Issued in a Purchase Business Combination (EITF 99-12) with modification. Although APB 16 is rejected in SSAP No. 68, the issues identified in EITF 99-12 are applicable to paragraph 3 of SSAP No. 68. The issue of cost is defined as:

> 3. The statutory purchase method of accounting is defined as accounting for a business combination as the acquisition of one entity by another. It shall be used for all purchases of SCA entities including partnerships, joint ventures, and limited liability companies. The acquiring reporting entity shall record its investment at cost. Cost is defined as the sum of: (a) any cash payment, (b) the fair value of other assets distributed, (c) the fair value of any liabilities assumed, and (d) any direct costs of the acquisition. Contingent consideration issued in a purchase business combination that is embedded in a security or that is in the form of a separate financial instrument shall be recorded by the issuer at fair value at the acquisition date.

5. As shown in subsection b of the excerpted paragraph above, SSAP No. 68 does not address the timing issues raised in EITF 99-12 of "other assets distributed".

6. The modifications to the conclusions reached in EITF 99-12 are as follows:

7. The EITF reached a consensus on Issue 1 that the value of the acquirer's marketable equity securities issued to effect a purchase business combination should be determined, pursuant to the guidance in paragraph 74 of APB No. 16, based on the market price of the securities over a reasonable period of time before and after the terms of the acquisition are agreed to and announced. In other words, the date of measurement of the value of the acquirer's marketable equity securities should not be influenced by the need to obtain shareholder or regulatory approvals. EITF members observed that the reasonable period of time referred to in paragraph 74 of APB No. 16 is intended to be very short, such as a few days before and after the acquisition is agreed to and announced. EITF members also observed that in transactions involving a hostile tender offer, the measurement date for the value of the acquirer's marketable equity securities occurs when the proposed transaction is announced and sufficient shares have been tendered to make the offer binding or when the proposed acquisition becomes nonhostile, as evidenced by the target company's agreement to the purchase price.

8. The EITF also reached a consensus that if the purchase price (the number of shares or the amount of other consideration) is subsequently changed as a result of further negotiations or a revised acquisition agreement, a new measurement date for valuing the acquirer's marketable equity securities that will be issued to effect the combination is established as of the date of the change. The Working Group clarified that if the change in the number of shares or other consideration is not substantive, a new measurement date does not result from the change.

9. The EITF addressed the accounting for contingent consideration issued to effect a purchase business combination in Issue No. 97-8, *Accounting for Contingent Consideration Issued in a Purchase Business Combination* (EITF 97-8). The measurement guidance in this Issue is to be applied to the acquirer's equity securities issued to effect a business combination accounted for using the purchase method, including those instruments that meet the criteria in EITF 97-8 for recording as part of the cost of the business acquired. (EITF 97-8 was adopted by the Working Group in SSAP No. 68.)

10. The EITF reached a consensus on Issue 2 that if the application of the formula results in a change to the number of shares or the amount of other consideration to be issued in the purchase business combination, then the first date on which the number of acquirer shares and the amount of other consideration become fixed without subsequent revision is the measurement date. That is, the measurement date is the earliest date, from the date the terms of the acquisition are agreed to and announced to the date of final application of the formula pursuant to the acquisition

agreement, on which subsequent applications of the formula do not result in a change in the number of shares or the amount of other consideration. For example, assume the terms of a purchase business combination are agreed to and announced on March 1, 1999. Also assume that the purchase agreement includes a formula arrangement that specifies that an adjustment will be made to the number of shares issued in the business combination if the average closing security price for the 10 days ending June 30, 1999, is less than $16. If the 10-day average closing security price drops below $16 for the first time on June 1, 1999, and does not subsequently recover to an amount equal to or greater than $16 from June 1, 1999 through June 30, 1999, June 1, 1999 is the measurement date. However, if the originally announced number of shares or amount of other consideration does not change as a result of final application of the formula, then the initial date that the terms were agreed to and announced is the measurement date. The EITF noted that a new measurement date does not occur as a result of the application of a nonsubstantive formula in the original agreement.

11. As another example, assume that the terms of the acquisition are agreed to and announced on March 31, 1999. The number of shares to be issued in the business combination is equal to $20 million divided by the June 30, 1999 closing market price of the acquirer's common stock; however, if the June 30, 1999 closing market price of the acquirer’s common stock is less than $16 or greater than $24, the exchange ratio is adjusted as follows: (a) if the closing market price is less than $16, the acquirer will issue 1,250,000 shares of its common stock for the outstanding common shares of the target company, and (b) if the closing market price is greater than $24, the acquirer will issue 833,000 shares of its common stock for the outstanding common shares of the target company. The variable exchange ratio represents a formula and, as a result, if the stock price changes during the period from March 31, 1999 through June 30, 1999, but remains within the $16-$24 range, the measurement date is June 30, 1999. However, if the acquirer’s closing common stock price exceeds $24 on June 1, 1999, and remains above $24 through June 30, 1999, the number of shares to be issued in the transaction becomes fixed on June 1, 1999, and that date is the measurement date.

12. The EITF also reached a consensus that the securities should be valued based on market prices a few days before and after the measurement date determined in Issue 2 but that the measurement period would not include any dates after the date the business combination is consummated.

13. The EITF reached a consensus that the consensus reached on Issue 1 should only be applied prospectively to purchase business combinations consummated on or after January 1, 2001. The EITF reached a consensus that the consensuses reached on Issue 2 should be applied prospectively to purchase business combinations initiated on or after January 1, 2001. An entity should apply its existing policy prior to the effective date of the consensus on Issue 2.

INT 00-28 Status

14. No further discussion is planned.

Interpretation of the Emerging Accounting Issues (E) Working Group

INT 01-18: Consolidated or Legal Entity Level – Limitations on EDP Equipment, Goodwill and Deferred Tax Assets Admissibility

INT 01-18 Dates Discussed

March 26, 2001; June 11, 2001

INT 01-18 References

Current:
SSAP No. 16R—Electronic Data Processing Equipment and Accounting for Software (SSAP No. 16R)
SSAP No. 19—Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements (SSAP No. 19)
SSAP No. 68—Business Combinations and Goodwill (SSAP No. 68)
SSAP No. 101—Income Taxes, A Replacement of SSAP No. 10R and SSAP No. 10 (SSAP No. 101)

Superseded:
SSAP No. 79—Depreciation of Nonoperating System Software – An Amendment to SSAP No. 16—Electronic Data Processing Equipment and Software (SSAP No. 79)
SSAP No. 10R—Income Taxes—A Temporary Replacement of SSAP No. 10 (SSAP No. 10R)

INT 01-18 Issue

1. Case Number 1: The reporting entity has several wholly-owned insurance company subsidiaries. The reporting entity will account for its investment in these subsidiaries at their underlying statutory equity in accordance with *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities, A Replacement of SSAP No. 88* (SSAP No. 97).

2. Case Number 2: A reporting entity has deferred tax assets (DTAs) in excess of those that are allowed to be admitted in accordance with the guidance in SSAP No. 101 paragraph 11. The reporting entity files a consolidated tax return with one or more affiliates. Those affiliates have deferred tax liabilities (DTLs) that exceed the remaining DTAs available for admission after application of paragraphs 11.a. and 11.b. of SSAP No. 101 at the affiliates' legal entity level.

3. The accounting issues are:

Case Number 1:

When applying the limitations described in paragraph 11 of SSAP No. 101, paragraph 4 of SSAP No. 16R, and paragraph 7 of SSAP No. 68 to the parent reporting entity's adjusted capital and surplus, is the reporting entity required to exclude any net deferred tax assets, EDP equipment and operating system software, and net positive goodwill included in its insurance subsidiaries' valuation? Or, is the limitation calculated solely based on the legal entity's adjusted capital and surplus?

The effect of looking solely at the legal entity is to allow for the "stacking" of intangibles, so that the parent reporting entity may effectively have more than the defined limitations “invested” in deferred tax assets, EDP equipment and operating system software and goodwill. These assets are limited at each subsidiary legal entity level.

Case Number 2:

Can the reporting entity offset its DTAs against existing gross DTLs of an affiliated entity? This offset would be pursuant to the allowance of an offset against existing DTLs under SSAP No. 101 paragraph 11.c. This offset would occur only after application of paragraphs 11.a. and 11.b. for both the reporting entity and the affiliate. The premise for the offset is that both entities file a consolidated federal income tax return and that future deductible items of the reporting entity are, by current tax law, able to offset future income items of the affiliate. The affiliates for this purpose would have to have a tax sharing agreement that required payment from one affiliate to another for loss usage.

INT 01-18 Discussion

4. The Working Group reached a consensus as follows:

Case Number 1:

The Working Group reached a consensus that in applying the limitations described in paragraph 11.b.ii. of SSAP No. 101, paragraph 4 of SSAP No. 16R, and paragraph 7 of SSAP No. 68 to the parent reporting entity's adjusted capital and surplus, the reporting entity shall not exclude any net deferred tax assets, EDP equipment, operating system software, and net positive goodwill included in its insurance subsidiaries valuation.

Case Number 2:

The Working Group reached a consensus that the reporting entity shall not offset it's DTAs against existing gross DTLs of an affiliated entity.

INT 01-18 Status

5. No further discussion planned.

Interpretation of the Emerging Accounting Issues (E) Working Group

INT 01-25: Accounting for U.S. Treasury Inflation-Indexed Securities

INT 01-25 Dates Discussed

June 11, 2001; October 16, 2001; September 10, 2002; December 8, 2002

INT 01-25 References

Current:
SSAP No. 26—Bonds, excluding Loan-backed and Structured Securities (SSAP No. 26)

INT 01-25 Issue

1. Treasury inflation-indexed securities are direct obligations of the United States government, and are backed by the full faith and credit of the government. The principal is protected against inflation. Since the principal is indexed to the Consumer Price Index and grows with inflation, the investor is guaranteed that the real purchasing power of the principal will keep pace with the rate of inflation (Based on the Reference CPI-U, which has a three-month lag). Although deflation could cause the principal to decline, Treasury will pay at maturity an amount that is no less than the par amount as of the date the security was first issued.

2. Interest is also protected from inflation. The investor will receive semiannual interest payments, based on a fixed semiannual interest rate applied to the inflation-adjusted principal, so that the investor is guaranteed a real rate of return above inflation.

> Summary of the Structure and Index:
>
> Principal amount. The principal amount of Treasury inflation-indexed securities will be adjusted for changes in the level of inflation. The inflation-adjusted principal amount of the securities can be calculated daily. However, the inflation adjustment will not be payable by Treasury until maturity, when the securities will be redeemed at the greater of their inflation-adjusted principal amount or the principal amount of the securities on the date of original issuance (i.e., par).
>
> Index. The index for measuring the inflation rate will be the nonseasonally adjusted CPI-U (U.S. City Average All Items Consumer Price Index for All Urban Consumers). CPI-U was selected by Treasury because it is the best known and most widely accepted measure of inflation.
>
> Interest payments. Every six months Treasury will pay interest based on a fixed rate of interest determined at auction. Semiannual interest payments are determined by multiplying the inflation-adjusted principal amount by one-half the stated rate of interest on each interest payment date.
>
> Payment at maturity. If at maturity the inflation-adjusted principal is less than the par amount of the security (due to deflation), the final payment of principal of the security by Treasury will not be less than the par amount of the security at issuance. In such a circumstance, Treasury will pay an additional amount at maturity so that the additional amount plus the inflation-adjusted principal amount will equal the par amount of the securities on the date of original issuance. Initially, the securities will be issued with a 10-year maturity; however, Treasury expects to issue other maturities over time.
>
> Stripping. The securities will be eligible for the STRIPS program (Separate Trading of Registered Interest and Principal of Securities) as of the first issue date. Unlike the

conventional STRIPS program, however, interest components stripped from different inflation-indexed securities, at least initially, will not be interchangeable or fungible with interest components from other securities, even if they have the same payment or maturity date.

3. The accounting issue is how should changes to inflation-adjusted principal be recorded?

4. At the September 10, 2002 and December 8, 2002 the Working Group expanded this interpretation to address specific questions regarding U.S. Treasury Inflation-Indexed Securities purchased at either a premium or discount and how the inflation adjustment interacts with any such premium or discount, as well as the calculation of each of these amounts.

5. The following example will be used to highlight issues concerning the amortization of premium and inflation adjustment for a typical security:

Assume:	
Par value of TIP security	$500,000
Inflation factor at date of purchase	1.12075
Price at date of purchase	102.96875
Original issue date 6/30/X0	
Purchase date 06/30/X6	
Maturity date 06/30/X10	
Amount of inflation adjustment at date of purchase	
($500,000 * .12075)	$60,375
Total purchase price	
($500,000*1.12075*1.0296875)	$577,011
Premium at date of purchase	
($577,011 - $500,000 - $60,375)	$16,636

6. The issues are:

Issue a. – If accretion or amortization should be recognized over the period of time the security is owned.

Issue b. – Assuming that at the end of the accounting period, 12/31/X6, the inflation factor is 1.13000, what the correct book value of the security would be.

Issue c. – Assuming that at the end of the accounting period, 12/31/X6, the inflation factor is 1.12000, what the correct value of the security would be.

Issue d. – How changes in accounting treatment would be handled.

INT 01-25 Discussion

7. At its October 16, 2001 meeting, the Working Group reached a consensus that the inflation adjustment be recognized as an unrealized gain until such time as it is paid, at which time it should be recognized as a realized gain. If there is a deflation adjustment, such amounts should only be recognized to the extent of any previously recognized inflation adjustment for that particular security, (reduce any unrealized gain on that security to zero) as the investor is guaranteed at maturity to receive at least the par amount of the security. (See paragraph 8.c. below for amendments to this paragraph adopted at the December 8, 2002 meeting.)

8. At its December 8, 2002 meeting, the Working Group reached a consensus on the following issues related to the purchase of a treasury inflation-indexed security at either a premium or a discount, how the inflation adjustment interacts with any such premium or discount, as well as the calculation of each of these amounts.

> Issue a. – The $16,636 premium paid for the security should be amortized over the remaining life of the security. Therefore, if the inflation adjustment factor never changed from the 1.12075 at date of purchase, the security would have a book value at maturity of $560,375, the amount the reporting entity would receive at maturity date ($500,000*1.12075).
>
> Issue b. – The reporting entity should record the unrealized gain/loss based on the difference in the inflation factor times the par amount, and amortize the premium over the remaining life of the security.
>
> Issue c. – In the case where the inflation factor is reduced to a factor not less than 1.0000, the reporting entity should reflect the change in the inflation adjustment as well as amortization of premium. Paragraph 7 of this interpretation is amended as follows:
>
> > 7. The Working Group reached a consensus that the inflation adjustment be recognized as an unrealized gain until such time as it is paid, at which time it should be recognized as a realized gain. If there is a deflation adjustment, such amounts should only be recognized to the extent the inflation factor is not reduced to an amount less than 1.0000 as the investor is guaranteed at maturity to receive at least the par amount of the security.
>
> Issue d. - A change in accounting principle should be recorded per the requirements of *SSAP No. 3—Accounting Changes and Corrections of Errors*, paragraph 5:
>
> > 5. The cumulative effect of changes in accounting principles shall be reported as adjustments to unassigned funds (surplus) in the period of the change in accounting principle. The cumulative effect is the difference between the amount of capital and surplus at the beginning of the year and the amount of capital and surplus that would have been reported at that date if the new accounting principle had been applied retroactively for all prior periods.
>
> In the specific question noted, if the reporting entity is currently recognizing both amortization of premium as well as the change in the inflation adjustment factor as amortization of premium, there should not be a cumulative effect on surplus to record.

INT 01-25 Status

9. No further discussion planned.

Interpretation of the Emerging Accounting Issues (E) Working Group

INT 01-31: Assets Pledged as Collateral

INT 01-31 Dates Discussed

October 16, 2001; December 10, 2001; March 18, 2002; September 12, 2004; December 5, 2004; March 3, 2012; August 31, 2012

INT 01-31 References

Current:
SSAP No. 4—Assets and Nonadmitted Assets (SSAP No. 4)
SSAP No. 103—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (SSAP No. 103)

Superseded/Nullified:
SSAP No. 18—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (SSAP No. 18)
SSAP No. 33—Securitization (SSAP No. 33)
SSAP No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements (SSAP No. 45)
SSAP No. 91R—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (SSAP No. 91R)
INT 99-02: Accounting for Collateral in Excess of Debt Principal (INT 99-02)

INT 01-31 Issue

1. Insurers may enter into certain transactions that require the granting of a security interest in certain assets to another party to serve as collateral for their performance under a contract. The arrangement is commonly referred to as a pledge, typically accomplished by delivery of assets to the secured party or to an independent custodian. In these transactions, the pledging insurer typically (1) continues to receive the income on the pledged collateral and (2) can remove and substitute other securities with little or no advance notice to the secured party as long as they comply with related investment quality and market value agreement provisions. Examples include collateral pledged under investment, derivative, debt obligations and policyholder transactions.

2. Specific examples of collateral pledged for derivative and investment transactions include but are not limited to: (1) securities posted with a broker as margin for futures and options transactions, (2) securities pledged to secure credit exposure with swap counterparties, (3) securities pledged under reverse repurchase agreements or securitizations that are accounted for as secured borrowing transactions and (4) securities pledged under securities lending transactions.

3. Specific examples of collateral pledged for debt obligations and policyholder transactions include but are not limited to assets pledged to secure (1) debt borrowings from or insurance contracts issued to banking entities and (2) insurance contracts issued to governmental entities such as municipalities.

4. Under these transactions, the fair value of the securities pledged as collateral may exceed the contract balance (swap fair value, advance balance, policyholder account balance, etc). For this interpretation, this excess carrying value of securities pledged over the corresponding asset or contract balance is called the "overcollateralization" amount.

5. The accounting issue is whether the assets pledged as collateral under the various transactions mentioned above should be considered admitted assets.

INT 01-31 Discussion

6. The Working Group reached a consensus that if the collateral had not been pledged in the examples described above, it is assumed the underlying asset would be recorded as an admitted asset under SSAP No. 4 (e.g. they are readily marketable assets available to meet both current and future policyholder obligations). In addition, it is assumed that the asset would not be considered impaired under SSAP No. 5R due to a default, fair value decline, or other loss contingency.

7. Therefore, for the examples described above, the pledging insurer would record the collateral (including the overcollateralization amount) as an admitted asset until they have committed a contract default that has not been cured in accordance with the contract provisions. This accounting is in accordance with the provisions of SSAP No. 103. This consensus of reporting collateral as an admitted asset is further supported by SSAP Nos. 4 and 5 since generally, the insurer can readily substitute pledged assets. Additionally, an insurer may typically unwind the transaction allowing the assets to be available to the pledging insurer to meet policyholder obligations. Furthermore, no event has occurred to indicate an impairment or potential loss contingency with respect to such pledged assets. The fact that some pledged assets may constitute an overcollaterlization amount does not change this analysis. Accordingly, all assets pledged in support of these type transactions should also be admitted.

8. At the time of an uncured default, the provisions of paragraph 20 of SSAP No. 103 shall be used to determine the appropriate accounting treatment for the collateral. If the secured party utilizes collateral to offset all or a portion of the liability owed by the pledging insurer as a result of the default, then the collateral amount utilized to offset the liability shall be removed from the balance sheet. At the same time, the amount of the liability that was offset should be removed from the balance sheet since that obligation has been satisfied through the secured party's utilization of that collateral. To the extent that an uncured default remains without the secured party utilizing the collateral to offset the obligation, the pledging insurer should only record an admitted asset for the amount of collateral that it can redeem.

INT 01-31 Status

9. As of March 18, 2002, the consensus position of this interpretation is consistent with the position of the NAIC Invested Asset (E) Working Group. This interpretation will be reviewed by the FAS 140 Subgroup of the NAIC Statutory Accounting Principles (E) Working Group in conjunction of its consideration of incorporating GAAP pronouncement *FAS 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, a replacement of FASB Statement 125* into the statutory accounting model. As such, this interpretation is subject to amendment pending disposition of the FAS 140 Subgroup's review of collateral and FAS 140 in its entirety.

10. On September 12, 2004, the Working Group noted that the review of FAS 140 was complete and INT 01-31 was listed as an interpretation of SSAP No. 91R. On March 3, 2012, the Working Group adopted with modification *FAS 166—Accounting for Transfers of Financial Assets, an Amendment of FAS 140* (FAS 166). With this adoption, there was no change to the consensus opinion within this interpretation, and this INT was listed as an interpretation of SSAP No. 103.

11. No further discussion is planned.

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Interpretation of the Emerging Accounting Issues (E) Working Group

INT 02-22: Accounting for the U.S. Terrorism Risk Insurance Program

INT 02-22 Dates Discussed

December 8, 2002, March 9, 2003

INT 02-22 References

Current:
SSAP No. 35R—Guaranty Fund and Other Assessments (SSAP No. 35R)
SSAP No. 62R—Property and Casualty Reinsurance (SSAP No. 62R)

INT 02-22 Issue

1. The Terrorism Risk Insurance Act of 2002 establishes a temporary Federal program in the Department of the Treasury that provides for a system of shared public and private compensation for insured losses resulting from acts of terrorism, i.e., subject losses. The Terrorism Insurance Program (or the "Program") requires that all entities that meet the definition of an insurer under the act (generally, commercial property/casualty insurers that are licensed in the U.S.) participate in the Program. The Program becomes effective upon enactment and runs through December 31, 2005. (For purposes of the act, there is a "Transition Period" that runs from enactment through December 31, 2002, and three "Program Years" that run from January 1st through December 31st of 2003, 2004, and 2005, respectively.) The amount of compensation paid to participating insurers under the Program is 90% of subject losses, after an insurer deductible, and subject to an annual cap. The deductible under the Program is 1% for the Transition Period, 7% for Program Year 1, 10% for Program Year 2, and 15% for Program Year 3. In each case, the deductible percentage is multiplied times the insurer's direct earned premiums from the calendar year immediately preceding the respective Transition or Program year. The annual cap limits the amount of terrorism losses paid by insurers and the amount of Federal reimbursement and is $100 billion for Program Year 1 (combined with the Transition Period), Program Year 2, and Program Year 3

2. The Program provides for the establishment of a mandatory surcharge on all covered policyholders to provide for recoupment of defined losses paid by the Department of Treasury. To the extent that the amount of Federal financial assistance exceeds the amount recovered through the mandatory surcharge, the Department of Treasury may impose a second surcharge. The two surcharges combined may not exceed 3% of the annual premium charged for the insured policy. The Program provides that the Department of the Treasury shall collect the surcharges and further provides that insurers shall collect the surcharges and remit such amounts collected to the Department of Treasury.

3. The issues are:

Issue 1: Does the Program result in a transfer of underwriting risk for terrorism losses to the Department of Treasury and, if so, how should the recovery from the Department of Treasury for terrorism losses be accounted for by insurers?

Issue 2: How should the imposition of the surcharges on policyholders by the Department of Treasury be accounted for by insurers?

INT 02-22 Discussion

4. The Working Group reached a consensus as follows:

> Issue 1: Because the Program results in losses from acts of terrorism (above the defined insurer deductibles) being paid by the Department of Treasury, there is a transfer of insurance risk and accordingly, the recovery of such losses should be reported as reinsured losses.
>
> Issue 2: Because the terrorism loss risk-spreading premium is imposed on policyholders as a surcharge and the Department of Treasury provides for insurers to collect the surcharge "and remit amounts collected to the Secretary," the surcharge generally meets the requirements of paragraph 13 of SSAP No. 35R and should be accounted for as such.

INT 02-22 Status

5. No further discussion is planned.

6. The Act has been extended through December 31, 2014, with the enactment of the Reauthorization Act.

Interpretation of the Emerging Accounting Issues (E) Working Group

INT 03-02: Modification to an Existing Intercompany Pooling Arrangement

INT 03-02 Dates Discussed

March 9, 2003; June 22, 2003

INT 03-02 References

Current:
SSAP No. 61R—Life, Deposit-Type and Accident and Health Reinsurance (SSAP No. 61R)
SSAP No. 62R—Property and Casualty Reinsurance (SSAP No. 62R)
SSAP No. 63—Underwriting Pools and Associations Including Intercompany Pools (SSAP No. 63)

INT 03-02 Issue

1. Insurance groups that utilize intercompany pooling arrangements often modify these arrangements from time to time for various business reasons. These business reasons commonly include mergers, acquisitions, dispositions or a restructuring of the group's legal entity structure. As an insurance group's business objectives and strategies evolve, it may be necessary for the insurance group's legal entity structure to similarly evolve in order to address the insurance group's business needs.

2. SSAP No. 63, paragraphs 5 and 7, defines and describes intercompany pooling as an arrangement among affiliated entities whereby "all of the pooled business is ceded to the lead entity and then retroceded back to the pool participants in accordance with their stipulated shares." This arrangement is established through "a conventional quota share reinsurance agreement…" Arrangements whereby there is one lead company that retains 100% of the pooled business and all or some of the affiliated companies have a 0% net share of the pool may qualify as intercompany pooling."

3. Therefore, in order to effectuate a modification to the existing intercompany pooling arrangement, companies must either 1) amend the existing reinsurance agreement, or 2) execute new agreements. The latter scenario may entail executing at least two agreements: a commutation of the existing agreement, and a new quota share agreement(s) that covers both past and future periods.

4. To illustrate, in order to effectuate a relatively simple modification, such as changing pooling participation percentages without changing the pool participants, companies often simply amend the existing pooling agreement. Alternatively, in order to effectuate a more complex modification, such as changing (by adding or removing) the number of pool participants, a company must commute the existing pooling agreement and execute a new quota share agreement(s). In conjunction with executing the appropriate reinsurance agreements, a transfer of assets and liabilities amongst the impacted affiliates is also required in order to implement the new reinsurance agreement(s). At issue is the appropriate valuation basis to be used for assets and liabilities that are transferred pursuant to the new reinsurance agreement(s).

5. Since SSAP No. 63 does not specifically address modifications to intercompany pooling arrangements, insurance groups that modify their intercompany pooling arrangements must refer elsewhere in Statutory Accounting Principles (SAP) for relevant guidance. The obvious guidance

for such transactions is SSAP No. 62R since an intercompany pooling arrangement is, by definition, affiliated reinsurance. There is, however, a minority opinion that *SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties* (SSAP No. 25) appears to apply due to the affiliated nature of these transactions. Since the guidance and intent of SSAP No. 62R and SSAP No. 25 provide for different valuation bases, this interpretation serves to provide definitive guidance as to which SSAP is relevant for these transactions and, therefore, clarify the appropriate valuation basis to be used for assets and liabilities transferred pursuant to a modification to an intercompany pooling arrangement.

SSAP No. 62R Approach:

6. This approach refers to the guidance and statutory accounting intent from SSAP No. 62R since intercompany pooling arrangements are defined and established through reinsurance. Further, since modifications to intercompany pooling agreements typically involve the transfer of net liabilities incurred since the inception of the existing pooling agreement (i.e., prior to the effective date of the new agreement), the retroactive reinsurance accounting guidance in paragraphs 28-34 of SSAP No. 62R is applicable. Paragraph 28 states that this special accounting treatment is warranted "due to the potential abuses involving the creation of surplus to policyholders and the distortion of underwriting results…" However, paragraph 31.d. specifically applies to intercompany reinsurance arrangements, and amendments to intercompany reinsurance agreements, since the reinsurance agreement is among companies 100% owned by a common parent. This paragraph allows prospective accounting treatment for intercompany reinsurance agreements that do not result in a gain in surplus as a result of the transaction.

7. To provide historical perspective, prior to the adoption (with modification) of FASB *Statement No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts* (FAS 113) as SAP, paragraph 31.d. was added as one of the SAP modifications. The intent of adding paragraph 31.d. was to specifically exclude intercompany reinsurance agreements among entities 100% owned by a common parent from retroactive reinsurance accounting requirements as a result of amending or modifying these agreements, provided there is no surplus gain. The presumption in this intent was that there would be no gains to the ceding entity resulting from implementing amendments or modifications to these types of reinsurance agreements.

8. Therefore, based on the foregoing guidance and background, the statutory accounting intent is to avoid surplus gains for the ceding entity as a result of implementing a modification to an intercompany pooling arrangement. On that basis, such a modification does not represent an economic transaction to the insurance group or to the impacted companies. As such, the transfer of both the assets and the liabilities valued at statutory book value ensures that there is no impact to surplus as a result of implementing a modification to an existing pooling arrangement.

SSAP No. 25 Approach:

9. An approach different from that which refers to reinsurance accounting guidance is to refer to the guidance in SSAP No. 25 since some may view a modification to an intercompany pooling agreement as a related party transaction involving the exchange of assets or liabilities. In this case, paragraphs 12-16 of SSAP No. 25 would appear applicable. This guidance specifies differing valuation bases, depending on whether the transaction is considered an economic or a non-economic transaction. Paragraph 12 states that "…The appearance of permanence is also an important criterion is assessing the economic substance of a transaction. In order for a transaction to have economic substance and thus warrant revenue (loss) recognition, it must appear unlikely to be reversed…" Since insurance groups often modify intercompany pooling arrangements, this type of transaction is not permanent, and may be construed as a non-economic transaction.

Paragraph 16.b. states that "non-economic transactions . . . shall be recorded at the lower of existing book value or fair value at the date of the transaction."

10. It appears that this guidance is intended to address matters involving discrete or isolated transfers of assets and/or liabilities between affiliates rather than transfers of assets and liabilities effected in relation to executing reinsurance transactions (the guidance for which is SSAP No. 62R). Additionally, application of this guidance would result in a change to the surplus of the insurance group as a result of implementing a modification to an existing intercompany pooling arrangement. As previously stated, the statutory accounting intent is to avoid surplus gains for the insurance group as a result of implementing a modification to an intercompany pooling arrangement.

11. The accounting issues are:

a. What is the relevant guidance for modifications to intercompany pooling arrangements?

b. What is the appropriate valuation basis to be used for assets and liabilities that are transferred among affiliates in conjunction with the execution of a new reinsurance agreement(s) that serves to substantively modify an existing intercompany pooling arrangement?

INT 03-02 Discussion

The Working Group reached a consensus as follows:

12. SSAP No. 62R provides accounting for property and casualty reinsurance agreements including specific guidance on intercompany pooling agreements. SSAP No. 62R provides two methods of accounting for changes in intercompany pooling agreements, depending on whether or not the pooling results in a gain in surplus.

13. The appropriate valuation basis to be used for assets and liabilities that are transferred among affiliates in conjunction with the execution of a new reinsurance agreement(s) that serves to substantively modify an existing intercompany pooling arrangement is statutory book value for assets and statutory value for liabilities. Book value is defined in the glossary of the *Accounting Practices and Procedure Manual*.

INT 03-02 Status

14. No further discussion is planned.

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Interpretation of the Emerging Accounting Issues (E) Working Group

INT 04-17: Impact of Medicare Modernization Act on Postretirement Benefits

INT 04-17 Dates Discussed

September 14, 2004; December 5, 2004

INT 04-17 References

Current:
SSAP No. 92—Accounting for Postretirement Benefits Other Than Pensions, A Replacement of SSAP No. 14 (SSAP No. 92)

Superseded:
SSAP No. 10R—Income Taxes (SSAP No. 10R)
SSAP No. 14—Postretirement Benefits Other Than Pensions (SSAP No. 14)
SSAP No. 89—Accounting for Pensions, A Replacement of SSAP No. 8 (SSAP No. 89)

INT 04-17 Issue

1. In December 2003, the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the Act) became law. Under the Act, starting in 2006, retirees will have the ability to obtain prescription drug benefits through a new Medicare Part D program and companies that continue to provide postretirement prescription drug benefits to their retirees may be eligible to receive a new federal subsidy.

2. In May 2004, FASB adopted the Board directed FASB Staff Position (FSP) *FAS 106-2, Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003* (FSP FAS 106-2). The guidance found in FSP FAS 106-2 superseded the earlier guidance in *FSP FAS 106-1, Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003* and was intended as being the final guidance on this subject.

3. Questions have arisen regarding whether an employer that provides postretirement prescription drug coverage should recognize the effects of the Act on the plan's accumulated postretirement benefit obligation (APBO) and the employer's postretirement benefit costs and, if so, when and how to account for those effects.

INT 04-17 Discussion

4. The Working Group reached a consensus to adopt the final conclusions reached in FSP FAS 106-2 with the following modifications:

a. Postretirement benefits should be accounted for in accordance with SSAP No. 92.

b. Income Taxes should be accounted for in accordance with SSAP No. 101.

c. Calculations shall not exclude non-vested employees.

d. Any references to *FSP FAS 106-1, Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003* are removed as this guidance was superseded by FSP FAS 106-2.

e. The effective date is universal for both public and non-public entities.

5. Per FSP FAS 106-2:

> 3. The guidance in this FSP related to accounting for the subsidy applies only to the sponsor of a single-employer defined benefit postretirement health care plan for which (a) the employer has concluded that prescription drug benefits available under the plan to some or all participants for some or all future years are "actuarially equivalent" to Medicare Part D and thus qualify for the subsidy under the Act and (b) the expected subsidy will offset or reduce the employer's share of the cost of the underlying postretirement prescription drug coverage on which the subsidy is based. This Interpretation also provides guidance for the disclosures about the effects of the subsidy for an employer that sponsors a postretirement health care benefit plan that provides prescription drug coverage but for which the employer has not yet been able to determine actuarial equivalency.
>
> 4. Although this FSP provides limited guidance on certain other related aspects of accounting and disclosure necessitated by the Act (for example, changes in assumed participation rates and health care cost trend rates, as well as income tax accounting) that guidance is not intended to supersede or in any way limit the application of other relevant authoritative literature. This FSP does not address the accounting for the subsidy in situations that may arise in which the expected subsidy exceeds the employer's share of the cost of the underlying postretirement prescription drug coverage on which the subsidy is based. It also does not address accounting for the subsidy by multiemployer health and welfare benefit plans or by the sponsors or participating employers of those plans.

6. The Act introduces two new features to Medicare that an employer needs to consider in determining those measurements: (a) a subsidy that is based on 28 percent of an individual beneficiary's annual prescription drug costs between $250 and $5,000 (subject to indexation and the provisions of the Act as to "allowable retiree costs") and (b) the opportunity for a retiree to obtain a prescription drug benefit under Medicare.

7. Per FSP FAS 106-2:

> 9. An employer's eligibility for the 28 percent subsidy depends on whether the prescription drug benefit available under its plan is at least "actuarially equivalent" to the Medicare Part D benefit. At present, detailed regulations necessary to implement the Act have not been issued, including those that would specify the manner in which actuarial equivalency must be determined, the evidence required to demonstrate actuarial equivalency, and the documentation requirements necessary to be entitled to the subsidy.[1] In addition, the magnitude of the subsidy for an employer depends on how many of the employer's Medicare-eligible retired Plan participants choose not to enroll in the *voluntary* Medicare Part D plan. Further, specific regulations regarding the payment/reimbursement mechanism for the subsidy are yet to be defined by the appropriate administrative agency. Accordingly, questions have been raised regarding whether the subsidy is substantively similar to other Medicare benefits that existed when Statement 106 was issued and therefore should be accounted for as a reduction of the APBO and net periodic postretirement benefit cost, or whether the subsidy represents a

[1] Section 1860D-11(c) of the Social Security Act, as amended by the Act, states that "the Secretary [of Health and Human Services] shall establish processes and methods for determining the actuarial valuation of prescription drug coverage."

payment to the employer that is determined by reference to its plan's benefit payments but is not, in and of itself, a direct reduction of postretirement benefit costs. Under either view, there is also a question as to when the subsidy should be given accounting recognition.

Effect on Per Capita Claims Cost

10. Regardless of the impact of the subsidy, the existence of prescription drug coverage under Medicare Part D may have an effect on an employer's per capita claims cost for a plan that currently provides a prescription drug benefit. That effect depends on (a) whether current and future retirees (or their beneficiaries under the employer-sponsored plan) enroll in the voluntary Medicare Part D plan and (b) the Act's macro-socioeconomic effects on health care cost trends and consumers' behavior.

Plan Amendments

11. In response to the Act, or for other reasons, an employer may amend an existing plan (or establish a new one). To the extent that an employer amends a plan (positively or negatively), the APBO will be affected by the direct effects of the change in benefits attributed to employee services already rendered. If an amendment changes the determination as to the actuarial equivalency of benefits available under the plan, the expected subsidy to the employer also will change.

Income Tax Accounting

12. The Act excludes receipt of the subsidy from the taxable income of the employer for federal income tax purposes.[2] Accordingly, this Interpretation addresses how that provision affects the accounting for the temporary difference related to the employer's accrued postretirement benefit cost under Statement 109, *Accounting for Income Taxes.*

FASB Staff Position

13. Paragraph 35 of Statement 106 specifies that health care coverage provided by Medicare shall be taken into account in measuring the employer's postretirement health care benefit obligation. Paragraph 40 of Statement 106 requires presently enacted changes in relevant laws to be considered in current period measurements of net periodic postretirement benefit cost and the APBO. Therefore, under that guidance, measures of the APBO and net periodic postretirement benefit cost on or after the date of enactment shall reflect the effects of the Act.

Effect of the Subsidy on Benefits Attributable to Past Service

14. When an employer initially accounts for the subsidy pursuant to the effective date and transition guidance in paragraphs 23–32, its effect on the APBO shall be accounted for as an actuarial experience gain pursuant to paragraphs 56 and 59 or 60 of Statement 106.

Effect of the Subsidy on Current Measures of Net Periodic Postretirement Benefit Cost

15. Because the subsidy affects the employer's share of its plan's costs, the subsidy is included in measuring the costs of benefits attributable to current service. Therefore, the subsidy reduces service cost (as defined in paragraph 47 of Statement 106) when it is recognized as a component of net periodic postretirement benefit cost.

[2] New Section 139A of the Internal Revenue Code established by Section 1202 of the Act.

Changes in Estimates

16. If an estimate of the expected subsidy subsequently changes—as a result of changes in regulations or legislation, changes in the underlying estimates of postretirement prescription drug costs, or for reasons other than a plan amendment—the effect of the change in estimate is an actuarial experience gain or loss pursuant to paragraph 56 of Statement 106.

Plan Amendments

17. If prescription drug benefits currently available under an existing plan are deemed not actuarially equivalent as of the date of enactment of the Act, but the plan is subsequently amended to provide actuarially equivalent benefits, the direct effect of the plan amendment on the APBO (that is, the effect of only the change in prescription drug coverage) and the effect on the APBO from any resulting subsidy to which the employer is expected to be entitled as a result of the amendment shall be combined. If that combined effect reduces the APBO, it is deemed to be an actuarial experience gain pursuant to paragraph 56 of Statement 106. If the combined effect increases the APBO, it is deemed to be prior service cost that shall be accounted for pursuant to paragraphs 50-54 of Statement 106.

18. A plan that provides prescription drug benefits that previously were deemed actuarially equivalent under the Act may be subsequently amended to reduce its prescription drug coverage and that reduced coverage may not be considered actuarially equivalent. In that circumstance, any actuarial experience gain related to the subsidy previously recognized is unaffected. However, the combined net effect on the APBO of (a) the subsequent plan amendment that reduces benefits under the plan and thus disqualifies the benefits as actuarially equivalent and (b) the elimination of the subsidy shall be accounted for as prior service cost (credit) as of the date the amendment is adopted.

Income Tax Accounting

19. In the periods in which the subsidy affects the employer's accounting for the plan, it shall have no effect on any plan-related temporary difference accounted for under Statement 109 because the subsidy is exempt from federal taxation. That is, the measure of any temporary difference shall continue to be determined as if the subsidy did not exist. To illustrate, consider the following simple example.

> Prior to the adoption of this FSP, an employer's carrying amount of accrued postretirement benefit cost (the amount recognized in the statement of financial position) is $100 for a noncontributory, unfunded prescription drug benefit plan with only inactive participants who are not yet eligible to collect benefits. Assuming a tax rate of 35 percent and no corresponding tax basis for the accrued postretirement benefit cost, the employer would report a $35 deferred tax asset related to that $100 deductible temporary difference. Because the employer has a policy of amortizing gains and losses under paragraph 59 of Statement 106, upon adoption of the FSP and recognition of a $28 actuarial gain resulting from the subsidy, neither the carrying amount of accrued postretirement benefit cost nor the deferred tax asset would change. Subsequently, ignoring interest on the APBO (which includes interest on the subsidy), as the actuarial gain related to the subsidy is amortized as a component of net periodic postretirement benefit cost, the carrying amount of accrued postretirement cost would be reduced. However, the associated temporary difference and deferred tax asset would remain unchanged. That is, after the gain related to the subsidy is amortized in its entirety, the carrying amount of accrued postretirement benefit cost would be $72, and the deferred tax asset would remain at $35.

> For purposes of simplicity, this example ignores complexities regarding the amount and timing of the subsidies reflected in the carrying amount of accrued postretirement benefit cost arising from any of the following: (a) netting gains and losses and application of the corridor amortization approach described in paragraph 59 of Statement 106, (b) recognition of additional subsidies through amortization of prior service costs that include effects of the subsidy, or (c) reduction in future service and interest costs. Those complexities must be considered in determining the temporary difference on which the deferred tax effects under Statement 109 will be based. However, providing detailed guidance on the application of Statement 109 to postretirement benefits other than pensions is beyond the scope of this FSP.

INT 04-17 Disclosures

8. Per FSP FAS 106-2:

> 20. Until an employer is able to determine whether benefits provided by its plan are actuarially equivalent, it shall disclose the following in financial statements for interim or annual periods:
>
> a. The existence of the Act
>
> b. The fact that measures of the APBO or net periodic postretirement benefit cost do not reflect any amount associated with the subsidy because the employer is unable to conclude whether the benefits provided by the plan are actuarially equivalent to Medicare Part D under the Act.

9. In interim and annual financial statements for the first period in which an employer includes the effects of the subsidy in measuring the net postretirement benefit cost and the first period in which an employer includes the effects of the subsidy in measuring net periodic postretirement benefit cost, it shall disclose the following:

a. The reduction in the net postretirement benefit cost for the subsidy related to benefits attributed to former employees.

b. The effect of the subsidy on the measurement of net periodic postretirement benefit cost for the current period. That effect includes (1) any amortization of the actuarial experience gain in (a) as a component of the net amortization called for by paragraph 49 of SSAP No. 92, (2) the reduction in current period service cost due to the subsidy, and (3) the resulting reduction in interest cost on the net postretirement benefit cost as a result of the subsidy.

c. Any other disclosures required by paragraph 64.q. of SSAP No. 92 which requires disclosure of "An explanation of any significant change in the benefit obligation or plan assets not otherwise apparent in the other disclosures required by this statement."

10. For purposes of the disclosures required by paragraphs 64.a. of SSAP No. 92, an employer shall disclose gross benefit payments (paid and expected, respectively), including prescription drug benefits, and separately the gross amount of the subsidy receipts (received and expected, respectively).

INT 04-17 Effective Date and Transition

11. This interpretation is effective for reporting years beginning on or after January 1, 2005 with early adoption allowed. A change resulting from adoption of this interpretation should be accounted for as detailed in paragraphs 12 and 13. A change resulting from the adoption of this

Interpretation shall be accounted for as a change in accounting principle in accordance with SSAP No. 3.

12. Per FSP FAS 106-2:

> 24. … If the effects of the Act—including the subsidy, if any, changes in participation rates, and changes in estimated health care costs—cause the employer to conclude that enactment of the Act was not a "significant event" pursuant to paragraph 73 of Statement 106, the effects of the Act shall be incorporated in the next measurement of plan assets and obligations otherwise required by Statement 106 following the effective date of this FSP. If an employer concludes that enactment of the Act was a significant event, but either (a) benefits available under its plan are not actuarially equivalent to Medicare Part D or (b) the employer is unable to conclude (refer to paragraph 33) whether any benefits are actuarially equivalent, it shall measure any effects of the Act other than the subsidy (for example, changes in estimated participation rates or health care costs) at the next measurement date for plan assets and obligations required by paragraphs 28–32 of this FSP.

13. Per FSP FAS 106-2:

> 27. For a plan (a) that provides benefits that are considered actuarially equivalent as of the date of enactment, based on information that is available as of the date of adoption of this interpretation, and (b) for which enactment of the Act was a significant event, this interpretation provides two alternative methods of transition—retroactive application to the date of enactment (paragraphs 28–29) or prospective application from the date of adoption (paragraph 30).
>
> Retroactive application to date of enactment
>
> 28. When this FSP is initially adopted, a remeasurement of the plan's assets and APBO, including the effects of the subsidy, if applicable, as well as the other effects of the Act, shall be made as of the earlier of (a) the plan's measurement date that normally would have followed enactment of the Act or (b) the end of the employer's interim or annual period that includes the date of the Act's enactment. As an alternative, employers are permitted, but not required, to perform that remeasurement as of the date of enactment. The measurement of the APBO shall be based on the plan provisions in place on the measurement date. Plan amendments occurring after the measurement date pursuant to (a) or (b) above shall not be anticipated in performing that measurement. However, if prior to the effective date of this FSP, a plan is amended so as to not be considered actuarially equivalent, the employer shall not reflect any effects of the subsidy in the transitional measurements required by this FSP. If the prescription drug coverage provided by a plan was amended after December 8, 2003, but before January 31, 2004 (the date before which plan amendments would not cause the deferral provided by FSP FAS 106-1 to expire), the effects of the prescription drug plan amendment and the consequential effects of the subsidy shall be accounted for pursuant to the applicable guidance in either paragraph 17 or 18 of this FSP.
>
> 29. The effects of measuring plan assets and obligations under paragraph 28 generally will not affect the accrued or prepaid postretirement benefit cost reported in the employer's statement of financial position as of the measurement date.[3] However, those measurements will affect net periodic postretirement benefit cost for periods subsequent to the date of the re-measurement.[4] To the extent that previously issued financial reports

[3] The paragraph 28 measurement would affect the statement of financial position if, pursuant to paragraph 60 of Statement 106, the employer has a policy of immediately recognizing gains and losses.

[4] Depending on the measurement date selected for the plan pursuant to paragraph 72 of Statement 106, the net periodic postretirement benefit cost may not be affected by the Act in the employer's reporting period immediately following the measurement required by paragraph 28. For example, for a public company with a December 31 fiscal year-end, the

for periods prior to the effective date of this FSP would have been affected by the remeasurement of plan assets and obligations under paragraph 28, the requirements in paragraph 20 of APB Opinion No. 20, Accounting Changes, and paragraph 10 of FASB Statement No. 3, Reporting Accounting Changes in Interim Financial Statements, as applicable, shall be followed.[5] In calculating the effects on prior periods, the guidance in paragraphs 17 and 18 of this FSP applies to plan amendments adopted subsequent to the measurement date described in paragraph 28 but before the effective date of this FSP. The effects of any such amendment shall be determined as of the date the plan amendment is adopted. The following examples illustrate the application of the provisions in this paragraph.

> Example A—Calendar Year-End, September 30 Measurement Date
>
> Calendar Company, a public company, sponsors a postretirement health care benefit plan that provides prescription drug coverage. It has a December 31 year-end for financial reporting purposes and uses a September 30 measurement date pursuant to paragraph 72 of Statement 106. Calendar Company elected to defer any accounting for the effects of the Act pursuant to FSP FAS 106-1 and made that election in the quarter ending March 31, 2004, the first period in which the plan's accounting for the effects of the Act normally would have been reflected in Calendar Company's financial statements.
>
> Calendar Company adopts the guidance in this FSP as of July 1, 2004, the beginning of its third quarter. Calendar Company and its actuarial advisors determine that benefits provided by the plan as of the date of enactment were at least actuarially equivalent to Medicare Part D, and, accordingly, Calendar Company will be entitled to the subsidy. Calendar Company performs an interim measurement of the effects of the Act on the APBO as of December 31, 2003, the end of its interim (and annual) period that includes the date of the Act's enactment and determines that the aggregate effect on service cost, interest cost, and amortization of gains and losses results in a reduction of $500 in annual net periodic postretirement benefit cost compared to that amount calculated without considering the effects of the Act.
>
> The effect of applying this FSP has no cumulative effect on Calendar Company's retained earnings as of December 31, 2003. Because Calendar Company uses a September 30 measurement date, the accounting for the plan is reflected in Calendar Company's financial statements on a one-quarter lag. Therefore, the Act had no effect on net periodic postretirement benefit cost for the first quarter. Accordingly, in applying the guidance in Statement 3, Calendar Company reports net periodic postretirement benefit cost for the nine-month period ending September 30, 2004, reflecting $250 (the second and third quarter amounts) of the $500 annual reduction. Net periodic postretirement benefit cost included in third quarter results of operations reflects only that quarter's $125 reduction due to the Act. When presented for comparative purposes, for example in summary quarterly financial information in the annual report or for comparative purposes in the 2005 second quarter financial report, the results of operations for the second quarter of 2004 will be restated to reflect a $125 reduction in net periodic postretirement benefit cost due to the Act.

end of the employer's interim period that includes the date of enactment would be December 31, 2003. If that employer uses a September 30 measurement date pursuant to paragraph 72 of Statement 106, the effects of the Act on the plan would first affect net periodic postretirement benefit cost in the employer's interim period that begins April 1, 2004.

[5] Paragraph 10 of Statement 3 states that no cumulative effect of a change in accounting principle shall be included in net income of the interim period, other than the first interim period, in which the change is adopted. However, financial information for the pre-change interim periods of the fiscal year in which the change is made shall be restated on the basis of the new accounting principle whenever those pre-change interim periods are subsequently presented.

Example B—April 30 Year-End, April 30 Measurement Date

Spring Company, a public company, sponsors a postretirement health care benefit plan that provides prescription drug coverage. It has an April 30 year-end for financial reporting purposes and uses April 30 as the measurement date for plan assets and obligations under Statement 106. Spring Company elected to defer any accounting for the effects of the Act pursuant to FSP FAS 106-1 and made that election in the quarter ending January 31, 2004, the first period in which the plan's accounting for the effects of the Act normally would have been reflected in Spring Company's financial statements.

Spring Company adopts the guidance in this FSP as of August 1, 2004, the beginning of its second quarter. Spring Company and its actuarial advisors determine that benefits provided by the plan as of the date of enactment were at least actuarially equivalent to Medicare Part D, and, accordingly, Spring Company will be entitled to the subsidy. Spring Company measures the effects of the Act on the APBO as of January 31, 2004, the end of its interim period that includes the date of the Act's enactment and determines that the aggregate effect on service cost, interest cost, and amortization of gains and losses results in a reduction of $500 in annual net periodic postretirement benefit cost compared to that amount calculated without considering the effects of the Act.

Because the date for remeasuring the plan's assets and obligations required by this FSP—for an employer that elects retroactive application—occurs in Spring Company's prior fiscal year, the cumulative effect of applying the guidance in this FSP on Spring Company's retained earnings as of April 30, 2004, is $125 (the fourth quarter effect on net periodic postretirement cost, ignoring any deferred income tax effects, which may be none). That cumulative effect of a change in accounting principle is recognized in Spring Company's net income for the six months ending October 31, 2004. Assuming no other changes in assumptions or other gains and losses arise in the regularly scheduled April 30, 2004 measurement of the plan, pursuant to the guidance in Statement 3, Spring Company reports net periodic postretirement benefit cost for the six-month period ending October 31, 2004, reflecting $250 (the first and second quarter amounts) of the $500 annual reduction. Net periodic postretirement benefit cost included in second quarter results of operations reflects only that quarter's $125 reduction due to the Act. When presented for comparative purposes, for example in summary quarterly financial information in the annual report or for comparative purposes in the next fiscal year's first quarter financial report, the results of operations for the quarter ended July 31, 2004, will be restated to reflect the $125 reduction in net periodic postretirement benefit cost due to the Act and the $125 cumulative effect of the change in accounting principle.

Prospective application as of date of adoption

30. When this FSP is initially adopted, a remeasurement of the plan's assets and APBO, including the effects of the subsidy, if applicable, as well as the other effects of the Act, shall be made as of the beginning of the period of adoption pursuant to the guidance in paragraph 73 of Statement 106. The measurement of the APBO shall be based on the plan provisions in place on the measurement date and shall incorporate the best available current information regarding actuarial assumptions and discount rates. The results of that measurement shall be used to determine net periodic postretirement benefit cost in interim periods following the date of adoption until the next measurement date otherwise required by Statement 106. The following example illustrates the application of the provisions of this paragraph.

Example C—Calendar Year-End, September 30 Measurement Date

Calendar Company, a public company, sponsors a postretirement health care benefit plan that provides prescription drug coverage. It has a December 31 year-end for financial reporting purposes and uses a September 30 measurement date pursuant to paragraph 72 of Statement 106. Calendar Company elected to defer any accounting for the effects of the Act pursuant to FSP FAS 106-1 and made that election in the quarter ending March 31, 2004, the first period in which the plan's accounting for the effects of the Act normally would have been reflected in Calendar Company's financial statements.

Calendar Company adopts the guidance in this FSP as of July 1, 2004, the beginning of its third quarter. Calendar Company and its actuarial advisors determine that benefits provided by the plan as of the date of enactment were at least actuarially equivalent to Medicare Part D, and, accordingly, Calendar Company will be entitled to the subsidy. Calendar Company measures the effects of the Act on the APBO as of April 1, 2004, the beginning of the plan's interim period that corresponds to the plan sponsor's first reporting period beginning after June 15, 2004, and determines that the aggregate effect on service cost, interest cost, and amortization of gains and losses results in a reduction of $500 in annual net periodic postretirement benefit cost compared to that amount calculated without considering the effects of the Act.

Net periodic postretirement benefit cost for the quarters ending September 30 and December 31, 2004, reflecting the activity in the plan for the quarters ending June 30 and September 30, 2004, will include a $125 per quarter reduction in net periodic postretirement benefit cost due to the effects of the Act.

Nonpublic entity with only small plans

31. If enactment of the Act constitutes a significant event for a plan, a nonpublic entity that meets the criteria in paragraph 23 may follow the guidance in paragraph 28, including the related transition guidance described in paragraph 29, or may incorporate the effects of the Act prospectively in measures of net periodic postretirement benefit cost and plan assets and obligations for fiscal years beginning after December 15, 2004.

Employer That Did Not Elect Deferral

32. For an employer that did not elect the deferral option provided under FSP FAS 106-1 and whose previous accounting for the effects of the Act differs from the guidance in this FSP, the adoption of this FSP constitutes a change in accounting principle under Opinion 20. Accordingly, the cumulative effect of retroactive application of this FSP to the date of the Act's enactment shall be reflected in the financial statements following the provisions of paragraph 20 of Opinion 20 and paragraphs 9 and 10 of Statement 3, as applicable.

Subsequent Determination of Actuarial Equivalence Absent a Plan Amendment

33. When adopting this FSP, an employer and its actuarial consultants may be unable to determine the extent to which the benefits provided by a plan are actuarially equivalent as of the date of the initial measurement applying the guidance in this FSP. If clarifying regulations related to the Act or new information about the interpretation or determination of *actuarial equivalency* under the Act becomes available, the employer shall reconsider whether the benefits provided under its plan, as presently constructed, are actuarially equivalent.[6] If that reconsideration results in a conclusion that benefits provided by the plan are actuarially equivalent (or that additional benefits provided by the

[6] The guidance in this paragraph does not apply if a plan amendment is the event that gives rise to the employer's reconsideration of actuarial equivalency. The guidance in paragraphs 17 and 18 of this FSP apply to plan amendments.

plan are actuarially equivalent in the case of a plan under which an employer previously had determined that some benefits were actuarially equivalent), that conclusion could be a significant event pursuant to paragraph 73 of Statement 106.[7] If the effects of the subsidy on the plan are significant, a measurement of plan assets and obligations shall be performed as of the date that actuarial equivalency is determined. Any effect on the APBO due to the subsidy shall be reflected as an actuarial gain consistent with the guidance in paragraph 14 of this FSP. Measures of net periodic postretirement benefit cost for subsequent periods would reflect the effects of those measurements (reported on a lag basis, if appropriate; refer to footnote 6). Prior financial statements shall not be retroactively adjusted nor shall a cumulative effect for prior periods be recognized in income.

INT 04-17 Status

14. No further discussion is planned.

[7] To the extent that some benefits under a plan are determined to be actuarially equivalent at the date of adoption of the FSP, the provisions of paragraphs 24–32 apply.

Interpretation of the Emerging Accounting Issues (E) Working Group

INT 04-21: EITF 02-9: Accounting for Changes That Result in a Transferor Regaining Control of Financial Assets Sold

INT 04-21 Dates Discussed

December 5, 2004; March 13, 2005; March 3, 2012; August 31, 2012

INT 04-21 References

Current:
SSAP No. 103—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (SSAP No. 103)

Superseded:
SSAP No. 91R—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (SSAP No. 91R)

INT 04-21 Issue

1. EITF No. 02-9, *Accounting for Changes That Result in a Transferor Regaining Control of Financial Assets Sold* (EITF 02-9) expands on a key concept presented in FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 140), paragraph 55. This key concept requires a transferred financial asset that has been accounted for as sold to be accounted for as "re-purchased" if the basis for that sale accounting subsequently becomes invalid.

2. The following is excerpted from EITF 02-9:

> 1. …One circumstance that has raised questions about the application of paragraph 55 occurs when the provisions of paragraph 55 are triggered because the transferor holds a contingent right such as a contingent call option on the transferred financial assets (for example, a removal of accounts provision or "ROAP") and the contingency has been met. This issue assumes that the transferee is not consolidated by the transferor.
>
> 2. Under Statement 140, rights held by the transferor (typically in the form of purchased options or forward purchase contracts) only preclude sale accounting under paragraph 9.c.(2) if they provide the transferor with (a) the unilateral right to cause the holder to return specific transferred financial assets, and (b) more than a trivial benefit. One class of contingent rights (including certain ROAPs 1) does not preclude sale accounting because it does not include unilateral rights. The most common type of ROAP is a default ROAP, which gives the holder the right but not the obligation to purchase (call) a loan that is in default (the meaning of default typically is specifically defined in each transaction). Such rights are common in credit card securitizations and in securitizations sponsored by the Government National Mortgage Association (GNMA) 2 and other governmental or quasi-governmental agencies. Once the contingency is met (in this case, when a given loan goes into default), the call option on that asset (loan) is no longer contingent. At that point, the transfer fails the criterion in paragraph 9.c.(2) of Statement 140 because the transferor has the unilateral right to purchase a specific transferred financial asset and obtains more than a trivial benefit. Under the requirements of paragraph 55, when a contingency related to a transferor's contingent right has been met, the transferor generally must account for the "re-purchase" of a specific subset of the financial assets transferred to and held by the qualifying entity. The transferor must do so regardless of whether it intends to exercise its call option.

3. Per EITF 02-9, the issues are:

Issue 1—How the transferor should account for the transferor's beneficial interests when the underlying assets are re-recognized under the provisions of paragraph 55 because the transferor's contingent right (for example, a ROAP or other contingent call option on the transferred financial assets) becomes exercisable, including whether any gain or loss should be recognized by the transferor when paragraph 55 is applied.

Issue 2—Whether under any circumstances a loan loss allowance should initially be recorded for loans that do not meet the definition of a security when they are re-recognized under the provisions of paragraph 55

Issue 3—How re-recognition under paragraph 55 of assets sold affects the accounting for the related servicing asset.

Issue 4—After a paragraph 55 event, how the transferor should account for the transferor's interests (other than the servicing asset).

INT 04-21 Discussion

4. EITF 02-9 consensus on each issue is as follows:

5. The Task Force reached a consensus on Issue 1 that upon application of paragraph 55, no gain or loss should be recognized in earnings with respect to any of the transferor's beneficial interests. Beneficial interests should be evaluated periodically for possible impairment, including at the time paragraph 55 is applied. A gain or loss may be recognized upon the exercise of a ROAP or similar contingent right with respect to the "re-purchased" transferred financial assets that were sold if the ROAP or similar contingent right held by the transferor is not accounted for as a derivative under Statement 133 and is not at-the-money, resulting in the fair value of those repurchased assets being greater or less than the related obligation to the transferee.

6. The Task Force reached a consensus on Issue 3 that under no circumstances should a loan loss allowance be initially recorded for loans that do not meet the definition of a security when they are re-recognized pursuant to paragraph 55.

7. The Task Force reached a consensus on Issue 4 that when a paragraph 55 event occurs, the accounting for the servicing asset related to the previously sold financial assets does not change as a result of the application of paragraph 55. That is, even though the transferor has regained control over the previously sold assets, the cash flows from those assets will contractually be paid to the SPE, which will then distribute the proceeds to satisfy its contractual obligations (including obligations to the beneficial interest holders). Because the transferor, as servicer, is still contractually required to collect the asset's cash flows for the benefit of the SPE and otherwise service the assets, it should continue to recognize the servicing asset and assess the asset for impairment as required by Statement 140.

8. The Task Force reached a consensus on Issue 5 that when a paragraph 55 event occurs, the transferor should continue to account for the transferor's interests in those underlying financial assets apart from any re-recognized financial assets. That is, the transferor's interests should not be combined with and accounted for with the re-recognized financial assets. However, a subsequent event that results in the transferor reclaiming those financial assets from the transferee—for example, the exercise of a ROAP or the consolidation by the transferor of the securitization entity in accordance with applicable generally accepted accounting principles, including Interpretation 46R—would result in a recombination of the transferor's interests with the underlying financial assets.

5. The Working Group reached a consensus to adopt EITF 02-9 as an interpretation of SSAP No. 103, with modification as follows:

a. Change references to FAS 140 to SSAP No. 103 including paragraph-specific references. Modify FAS 140, paragraph 55 references to refer to SSAP No. 103, paragraph 59.

b. Change references to FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* to SSAP No. 86 as an interpretation of SSAP No. 91R.

c. Remove reference to Interpretation 46R as FASB Interpretation No. 46, *Consolidation of Variable Interest Entities,* is pending review for statutory accounting. (The prior GAAP guidance in FASB Interpretation FIN 46 was rejected for statutory accounting in *SSAP No. 3—Accounting Changes and Corrections of Errors*.)

d. Limit the applicability of EITF 02-9, Issue 3 to only valuation allowances applicable to statutory accounting for mortgage loans and real estate under development as provided in *SSAP No. 37—Mortgage Loans* and real estate under development as discussed in *SSAP No. 38—Acquisition, Development and Construction Arrangements*.

6. This interpretation was originally effective for years beginning January 1, 2005, to be consistent with the original effective date of SSAP No. 91R. Revisions adopted to this interpretation on March 3, 2012, are in accordance with the adoption with modification of FAS 166 in a new SSAP to superseded SSAP No. 91R.

INT 04-21 Status

7. In 2009, *FAS 166, Accounting for Transfers of Financial Assets, an Amendment of FAS 140*, was issued. In addition to amending FAS 140, it also amended FASB EITF 02-9. FAS 166 was adopted for statutory accounting in SSAP No. 103 to supersede SSAP No. 91R. On March 3, 2012, corresponding revisions to INT 04-21 were also adopted to reflect the updated GAAP guidance adopted for statutory accounting interpreting SSAP No. 103. These changes will not be tracked in subsequent editions of the Manual.

8. No further discussion is planned.

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Interpretation of the Emerging Accounting Issues (E) Working Group

INT 05-05: Accounting for Revenues Under Medicare Part D Coverage

INT 05-05 Dates Discussed

September 28, 2005; December 3, 2005

INT 05-05 References

Current:
SSAP No. 47—Uninsured Plans (SSAP No. 47)
SSAP No. 54—Individual and Group Accident and Health Contracts (SSAP No. 54)
SSAP No. 66—Retrospectively Rated Contracts (SSAP No. 66)
SSAP No. 84—Health Care Receivables and Receivables Under Government Insured Plans (SSAP No. 84)

INT 05-05 Issue

1. The Medicare Modernization Act of 2003 (MMA) created a new program, commonly known as Medicare Part D, whereby Medicare recipients may obtain prescription coverage offered by insurers who have been approved by the Centers for Medicare and Medicaid Services (CMS). Insurers who offer Medicare Part D coverage will, starting in January 2006, receive several different types of funds relating to the program. Some of these funds relate to portions of the coverage that require an annual reconciliation, resulting in the return of any excess funds received. Other funds may be received (or may be required to be returned) to offset experience that is especially unfavorable (or, respectively, favorable).

2. How should the various components of the funds received or receivable by an insurer from Medicare Part D coverage be accounted for?

INT 05-05 Discussion

3. The attached appendix provides a listing of terms to which CMS ascribes a specific meaning. This list has been enhanced to include other terms in order to facilitate consistent application for accounting and the NAIC's Risk Based Capital formula. It should be noted that the terms included in the attached appendix are for the most part defined by CMS. Consequently, the term 'reinsurance payment' does not represent actual reinsurance as defined by *SSAP No. 61R—Life, Deposit-Type and Accident and Health Reinsurance* (SSAP No. 61R).

4. The Working Group reached a consensus to adopt the following guidance as it applies to the various funds to be received under the Medicare Part D program. The funds should be accounted for in accordance with one of the three SSAP's outlined below:

a. Specific funds received as reimbursements (or advance payments) for uninsured claims under a partially uninsured plan should be accounted for under SSAP No. 47. These funds include 'Reinsurance Payments' and 'Low Income Subsidy (cost-sharing portion)'. These funds are paid by the Government for a portion of claims above the out-of-pocket threshold or relate to PDP payments for all or a portion of the deductible, the coinsurance and the co-payment amounts for low-income beneficiaries.

b. Specific funds received by the PDP Sponsor from either the Medicare Part D enrollee or the government as payment for Standard Coverage that will be subject to retrospective premium adjustments should be accounted for under SSAP No. 66. These funds include 'Direct Subsidy', 'Low Income Subsidy (premium portion)', 'Beneficiary Premium (standard coverage portion)', 'Part D Payment Demonstration' and 'Risk Corridor Payment Adjustment'. The funds noted above have a final policy amount that is calculated based on the loss experience of the insured during the term of the policy, therefore should be treated as such.

c. Specific funds received as premiums for coverage that is not retrospectively rated should be accounted for under SSAP No. 54. These funds include 'Beneficiary Premium (supplemental benefit portion)', as these payments are considered to be standard premium payments that do not meet the definitions under SSAP No. 47 or SSAP No. 66 as defined in 4.a. and 4.b.

5. The collectibility and any nonadmission of amounts receivable from the government insured or uninsured plans are addressed in SSAP No. 84, paragraph 23 and SSAP No. 47, paragraph 11.c., respectively.

INT 05-05 Status

6. No further discussion is planned.

Appendix – Commonly Used Terms for Medicare Part D Coverage

The federal Centers for Medicare and Medicaid Services (CMS) oversees the Medicare Part D prescription drug coverage, including both coverage provided through a stand-alone Prescription Drug Plan (PDP) and coverage provided as part of a Medicare Advantage plan. CMS ascribed specific meaning to most of the following terms. Other terms have been defined below in order to facilitate consistent application.

Beneficiary Premium (Standard Coverage Portion) – The amount received from the Part D enrollee (directly, or from CMS after being withheld from Social Security benefits) as payment for the Standard Coverage. This includes any late enrollment penalties that the PDP Sponsor receives for an enrollee. The Beneficiary Premium is accounted for as health premium.

Beneficiary Premium (Supplemental Benefit Portion) – The amount received from the Part D enrollee (directly, or from CMS after being withheld from Social Security benefits) as payment for Supplemental Benefits. The Beneficiary Premium is accounted for as health premium.

Coverage Year Reconciliation – A reconciliation made after the close of each calendar year, to determine the amounts that a PDP Sponsor is entitled to for the Low-Income Subsidy (Cost-Sharing Portion), the Reinsurance Payment, and the Risk Corridor Payment Adjustment. To the extent that interim payments (if any) from CMS exceeded the amounts determined by the reconciliation, the PDP Sponsor must return the excess to the government; to the extent that interim payments (if any) from CMS fell short of the amounts determined by the reconciliation, the government will make an additional payment to the PDP Sponsor. The Coverage Year Reconciliation results in the Low-Income Subsidy (Cost-Sharing Portion) and the Reinsurance Payment being essentially a self-insured (by the government) component of the Part D coverage, subject to SSAP No. 47. The Coverage Year Reconciliation also results in the treatment of the Risk Corridor Payment Adjustment as a retrospective premium adjustment, subject to SSAP No. 66.

Direct Subsidy – The amount the government pays to the PDP Sponsor for the Standard Coverage. These payments are accounted for as health premium.

Low-Income Subsidy (Cost-Sharing Portion) – The amount the government pays to the PDP Sponsor for additional benefits provided to low-income enrollees. The additional benefits may include payment for some or all of the deductible, the coinsurance, and the co-payment above the out-of-pocket threshold. These payments are accounted for as payments made under a self-insured plan.

Low-Income Subsidy (Premium Portion) – The amount the government pays to the PDP Sponsor for low-income enrollees in lieu of part or all of the Beneficiary Premium (Standard Coverage Portion). These payments are accounted for as health premium.

PDP Sponsor – The entity that provides stand-alone Part D coverage (as opposed to Part D coverage provided through a Medicare Advantage plan).

Reinsurance Payment – An amount paid by the government for benefit costs above the out-of-pocket threshold (see "Standard Coverage"). Generally, when costs exceed the out-of-pocket threshold, the government pays 80% of the costs, the enrollee pays 5% (or the specified co-payments of either $2 for generic and $5 for brand name prescriptions), and the PDP Sponsor pays the remainder (typically, 15% of the costs). The amount paid by the government is treated as a claim payment made by a self-insured benefit plan rather than as revenue to the PDP Sponsor, and the claims do not flow through the PDP sponsor's income statement. In cases where the government prepays the Reinsurance Payment on an estimated basis, the prepayment is treated as a deposit, which again does not pass through the PDP Sponsor's income statement.

The amount paid by the enrollee is paid directly to the pharmacy; therefore there is no required accounting for this amount by the PDP sponsor.

Part D Payment Demonstration – A payment from the government to a PDP Sponsor participating in CMS's Part D Payment Demonstration. The Payment Demonstration is a special arrangement in which the PDP sponsor receives a predetermined per-enrollee capitation payment and the government no longer provides reinsurance for the 80% of costs in excess of the out-of-pocket threshold. Rather, the PDP sponsor assumes the risk for this 80% of costs, in addition to its normal 15% share of costs in excess of this threshold. However, risk corridor protection does still apply to this 80% share of costs. These payments are accounted for as health premium.

Reinsurance Coverage – The Medicare Part D provision under which the PDP Sponsor may receive a Reinsurance Payment. This does not include payments under the Part D Payment Demonstration.

Risk Corridor Payment Adjustment – An amount, by which the government adjusts its payments to the PDP Sponsor, based on how actual benefit costs vary from the costs anticipated in the PDP Sponsor's bid for the Part D contract (the "target amount" of costs). The government establishes thresholds for symmetric risk corridors around the target amount, using percentages of the target amount. If actual costs exceed the target amount but are less than the first threshold upper limit, then no adjustment is made. If actual costs exceed the first threshold upper limit, the government will make an additional payment equal to 50% (75% in 2006 and 2007, or 90% under some circumstances) of the excess that falls between the first and second thresholds, and 80% of the excess that falls above the second threshold. However, if actual costs are less than the target amount, then the PDP Sponsor must make a comparable payment to the government. For 2006 and 2007, the first and second thresholds are 2.5% and 5%, respectively; for 2008-2011, they are 5% and 10%; and for 2012 and later, the thresholds have not yet been established, but will be no less than the 2008-2011 values. Risk corridor payment adjustments are accounted for as retrospective premium adjustments on retrospectively rated contracts.

Risk Corridor Protection – The Medicare Part D provision under which the PDP sponsor may receive (or pay) a Risk Corridor Payment Adjustment. Most employer plans providing Medicare Part D are not eligible for Risk Corridor Protection.

Standard Coverage – The Part D benefit design that conforms to certain standards prescribed by the government. The standard coverage comprises: no coverage for an annual initial deductible; coverage net of a coinsurance provision (25% of costs are payable by the insured) for costs up to an initial coverage limit; a range beyond the initial coverage limit, in which the insured pays all of the prescription drug costs –i.e. no coverage by the PDP; and an annual out-of-pocket threshold, above which the insured pays the greater of a specified co-payment or 5% of the drug cost. The various limits and thresholds are set at specified dollar amounts for 2006, which will be increased in later years based on the growth in drug expenditures. Wherever the term "Standard Coverage" is used as part of these instructions, the same treatment would be applied to coverage that has been approved as actuarially equivalent coverage. With respect to amounts above the out-of-pocket threshold, see the definitions of "Reinsurance Payment" and "Part D Payment Demonstration."

Supplemental Benefits – Benefits in excess of the Standard Coverage. These benefits typically will cover some portion of the deductible, the co-payments, or the "coverage gap" between the initial coverage limit and the out-of-pocket threshold. Supplemental Benefits are part of an enrollee's Part D coverage, so they are not placed in the "Other" category in the RBC formula. However, they are not subject to either the Reinsurance Payment or the Risk Corridor Payment Adjustment, so they receive less favorable RBC treatment than the Standard Coverage.

Interpretation of the Emerging Accounting Issues (E) Working Group

INT 06-02: Accounting and Reporting for Investments in a Certified Capital Company (CAPCO)

INT 06-02 Dates Discussed

March 5, 2006; June 11, 2006; September 10, 2006

INT 06-02 References

Current:
SSAP No. 26—Bonds, excluding Loan-Backed and Structured Securities (SSAP No. 26)
SSAP No. 30—Investments in Common Stock (excluding investments in common stock of subsidiary, controlled, or affiliated entities) (SSAP No. 30)
SSAP No. 32—Investments in Preferred Stock (including investments in preferred stock of subsidiary, controlled, or affiliated entities) (SSAP No. 32)
SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies (SSAP No. 48)

INT 06-02 Issue

1. A certified capital company (CAPCO) is a state legislated venture capital firm that can be a partnership, corporation, trust or limited liability company, profit or not-for-profit, for which investors who invest cash to acquire an equity interest or qualified debt instrument receive state premium or income tax credit. Although these investments are sometimes termed by different acronyms, they will be referred to as a CAPCO for purposes of this issue.

2. A reporting entity that qualifies as a certified investor typically earns, in the year the investment is made, a vested credit against state premium or income taxes equal to greater than 100% of the investor's investment of certified capital, of which a certain percent (varies by state; example: 10%, 25%) may be taken in any taxable year. The credit to be applied in any one year may not exceed the entity's state premium or income tax liability for the taxable year. Any unused tax credit may be carried forward until the premium or income tax credit is used (varies by state; some indefinitely, in other instances there is a specified expiration date, such as 2010; 2020). In some cases, a certified investor may transfer or assign unused premium or income tax credits. In addition to tax credits, the CAPCO often pays a nominal amount of interest and has a specified principal repayment date. The CAPCO often provides for a mechanism that guarantees the principal repayment.

3. Depending on the terms of the agreement, a CAPCO may make prepayments of principal and interest on its indebtedness.

4. The accounting issues are:

Issue 1: How should investments in a CAPCO be accounted for?

Issue 2: If the CAPCO agreement provides for the majority of interest to be paid in advance, how should it be earned?

INT 06-02 Discussion

5. For Issue 1, the Working Group came to a consensus that reporting entities should account and report for investments in CAPCO's consistent with the agreement structure within the guidance provided below:

a. Investment in a debt instrument of a CAPCO shall be reported as a bond in accordance with the *Purposes and Procedures Manual of the NAIC ~~Securities Valuation~~Investment Analysis Office* and the designation assigned in the *NAIC Valuations of Securities* product prepared by the NAIC Securities Valuation Office (Valuations of Securities manual) as stated in SSAP No. 26, paragraph 7.

b. Investment in an equity interest of a CAPCO shall be reported as common stock and reported at fair value as stated in SSAP No. 30, paragraph 7.

c. Investment in preferred stock interest of a CAPCO shall be reported as preferred stock in accordance with the *Purposes and Procedures Manual of the NAIC ~~Securities Valuation~~Investment Analysis Office* and the designation assigned in the *NAIC Valuations of Securities* product prepared by the NAIC Securities Valuation Office (Valuations of Securities manual) as stated in SSAP No. 32, paragraphs 15-18.

d. Investment in a Joint Venture, Partnership and Limited Liability Company (LLC) shall be reported in accordance with SSAP No. 48, paragraphs 5-6. The reported value of the investment shall be decreased in proportion to the premium tax credits utilized.

e. The tax credits shall be recognized as a reduction of the tax liabilities as they are utilized. Tax credits received are not to be included in investment income.

6. For Issue 2, the Working Group came to a consensus that reporting entities should account for any prepaid interest received by the insurer to be recorded as an unearned interest liability and should be amortized over the life of the security. This is consistent with the treatment of prepaid interest in SSAP's No. 37 and 49. This is also consistent with SSAP No. 34, which states that gross investment income should be reported as earned, and includes a change in unearned investment income.

INT 06-02 Status

7. No further discussion is planned.

Interpretation of the Emerging Accounting Issues (E) Working Group

INT 06-07: Definition of Phrase "Other Than Temporary"

INT 06-07 Dates Discussed

September 10, 2006; December 10, 2006

INT 06-07 References

Current:
SSAP No. 26—Bonds, Excluding Loan-Backed and Structured Securities (SSAP No. 26)
SSAP No. 30—Investments in Common Stock (excluding investments in common stock of subsidiary, controlled or affiliated entities) (SSAP No. 30)
SSAP No. 32—Investments in Preferred Stock (including investments in common stock of subsidiary, controlled or affiliated entities) (SSAP No. 32)
SSAP No. 37—Mortgage Loans (SSAP No. 37)
SSAP No. 39—Reverse Mortgages (SSAP No. 39)
SSAP No. 43R—Loan-Backed and Structured Securities (SSAP No. 43R)
SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies (SSAP No. 48)
SSAP No. 68—Business Combinations and Goodwill (SSAP No. 68*)*
SSAP No. 93—Accounting for Low Income Housing Tax Credit Property Investments (SSAP No. 93*)*
SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities, A Replacement of SSAP No. 88 (SSAP No. 97)
SSAP No. 105—Working Capital Investments (SSAP No. 105*)*

Superseded:
SSAP No. 88—Investments in Subsidiary, Controlled, and Affiliated Entities, A Replacement of SSAP No. 46 (SSAP No. 88)
SSAP No. 98—Treatment of Cash Flows When Quantifying Changes in Valuation and Impairments, an Amendment of SSAP No. 43—Loan-Backed and Structured Securities (SSAP No. 98)
SSAP No. 99—Accounting for Certain Securities Subsequent to an Other-Than-Temporary Impairment (SSAP No. 99)

Affects:
Nullifies the prior interpretation on this topic, *INT 02-07 Definition of Phrase "Other Than Temporary"*

INT 06-07 Issue

1. The *Accounting Practices and Procedures Manual* contains guidance for determining when an investment is considered impaired within each of the above identified statements. Those statements should also be used to determine the measurement of an impairment loss. Each of the above statements also makes reference to an "other than temporary" decline in fair value. This interpretation is designed to address questions related to that phrase, as well as summarize the statutory accounting process for determining when an investment is considered impaired.

Step 1: Determine Whether an Investment Is Impaired

2. The decision for determining when an investment is considered impaired is dictated by the applicable SSAP and the respective impairment indicators included in each of the SSAPs. If an impairment indicator is present, the determination of an impairment shall be assessed at the

individual security or investment level as reported in the annual statement and supporting schedules. For those SSAPs that require the reporting entity to use the fair value to determine if an impairment has occurred, the determination of that value shall be consistent with how the term fair value is defined within *SSAP No. 100—Fair Value Measurements*. Once a reporting entity has determined that an impairment indicator is present, the reporting entity shall continue to evaluate whether the investment is impaired each subsequent reporting period until either (a) the investment experiences a recovery of the fair value up to (or beyond) its carrying value or (b) the investor recognizes an other-than-temporary impairment loss.

Step 2: Evaluate Whether an Impairment Is Other Than Temporary

3. There are numerous factors to be considered when determining whether an impairment is other than temporary and their relative significance will vary from case to case. The Emerging Accounting Issues (E) Working Group (Working Group) has been asked if the phrase "other than temporary" should be interpreted to mean "permanent." The Working Group[1] believes the Statutory Accounting Principles (E) Working Group consciously chose the phrase "other than temporary" as the analysis was not intended to determine whether an individual security or investment was "permanently impaired." The fair value of assets may decline for various reasons. The market price may be affected by general market conditions, which reflect prospects for the economy as a whole, or by specific information pertaining to an industry or an individual company. Such declines require further investigation by management. Acting upon the premise that a write-down may be required, management should consider all available evidence to evaluate the fair value of its investment.

4. The Working Group believes that the following items are only a few examples of the factors, which, individually or in combination, indicate that a security's decline in value is specific to an issuer's fundamental credit difficulties, or that a non-interest related decline is other than temporary and that a write-down of the carrying value is required:

a. The length of time and the extent to which the fair value has been less than cost;

b. The financial condition and short-term prospects of the issuer, including any specific events that may influence the operations of the issuer, such as changes in technology, that may impair the earnings potential of the asset or the discontinuance of a segment of the business that may affect the future earnings potential; or

c. The intent and ability of the holder to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in value.

5. An interest related impairment should be deemed other-than-temporary when an investor has the intent to sell an investment, at the reporting date, before recovery of the cost of the investment. The investor should consider whether its cash or working capital requirements and contractual or regulatory obligations indicate that the investment may need to be sold before the forecasted recovery occurs. The term "interest related" includes a declining value due to both increases in the risk free interest rate and general credit spread widening. Credit spreads can widen or contract for a variety of reasons, including supply/demand imbalances in the marketplace or perceived higher/lower risk of an entire sector. If the declining value is caused, in whole or in part, due to credit spreads widening, but not due to fundamental credit problems of the issuer, the change in credit spreads is deemed to be interest related. Fundamental credit

[1] The recommendations provided by the Working Group were developed in part from SEC Staff Accounting Bulletin No. 59–*Noncurrent Marketable Equity Securities* (SAB 59). As such, readers of this Interpretation should understand that SAB 59 has not been adopted as part of Statutory Accounting Principles as SAB's are not part of the Statutory Hierarchy (see Preamble).

problems exist with the issuer when there is evidence of financial difficulty that may result in the issuer being unable to pay principal or interest when due.

6. Unless evidence exists to support the assertion that the decline in fair value below carrying value is temporary, a write-down, accounted for as a realized loss, should be recorded. In accordance with the guidance of the SSAPs, such loss should be recognized in income for the period in which other than temporary impairment is determined to have occurred. The adjusted carrying value reflecting the impairment loss of the individual security or investment shall be the new cost basis of the individual security or investment.

7. The Working Group has also been asked if it is appropriate for reporting entities, independent auditors or state examiners to apply predefined thresholds to the phrase “other than temporary”? The Working Group is aware that certain insurers, independent auditors and state examiners, over time, have developed quantitative thresholds as “rules of thumb” to assist in the evaluation of asset impairment. One rule of thumb in particular suggests that if the fair value is less than its carrying value by 20 percent or more, then it is considered to be other than temporarily impaired. Another suggests that an asset is other than temporarily impaired if the fair value has been less than cost for more than 6 months. The use of a numerical threshold may provide the basis for a preliminary assumption that – without considering all relevant circumstances – an impairment may have occurred. Identifying the impairment is only the beginning of the analysis; it cannot appropriately be used as a substitute for a full analysis of all relevant qualitative considerations. Exclusive reliance on such thresholds removes the ability of management to apply its judgment, a concept inherent to the impairment model.

Step 3: If the Impairment is Other Than Temporary, the Cost Basis of the Individual Asset Shall Be Written Down to a New Cost Basis and the Amount of the Write-Down Is Accounted for as a Realized Loss

8. If an impairment is considered other than temporary, the cost or carrying value of the asset should be written down to reflect its value in accordance with the relevant SSAP. A company's management should follow the impairment guidance in the SSAP pertaining to that particular asset class while considering various factors on a case-by-case basis in determining the amount of the realized loss that should be recorded.

INT 06-07 Discussion

9. The Working Group reached a consensus to adopt with modification paragraph 6, 7 and 11 of *FSP FAS115-1/124-1: The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments* (FSP FAS 115-1/124-1). This INT rejects paragraphs 1-5, 8-10, 12-15, and 19 of FSP FAS 115-1/124-1. This INT does not address paragraphs 16-18 and footnote 1 to paragraph 7 of FSP FAS115-1/124-1.

10. Paragraphs 3-8 of this interpretation incorporate the guidance that was in *INT 02-07: Definition of Phrase “Other Than Temporary”* (INT 02-07), paragraphs 3-9, with an addition to clarify the general credit spread widening that was discussed in INT 02-07, paragraph 6. On final adoption of this Interpretation, INT 02-07 is nullified.

11. FSP FAS 115-1/124-1 nullified the requirements of paragraphs 10-18 of EITF 03-01: *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments* (EITF 03-1) and carried forward the requirements of paragraphs 8, 9, 21 and 22 of the EITF to the FSP. The Working Group notes that the remaining paragraphs of EITF 03-01 either primarily related to the EITF process or are inconsistent with the current statutory model for impairment and are

rejected. The Statutory Accounting Principles (E) Working Group is separately considering the disclosures related to the FSP.

12. FSP EITF 03-1-1: Effective Date of Paragraphs 10-20 of EITF Issue No. 03-1 (FSP EITF 03-1-1) was issued by the EITF on September 30, 2004, and delayed the effective date for the measurement and recognition guidance contained in paragraphs 10-20 of EITF 03-1. The delay of the effective date for paragraphs 10-20 of Issue 03-1 was superseded concurrent with the final issuance of FSP FAS 115-1/124-1 and as such, is rejected.

INT 06-07 Status

13. INT 06-07 nullifies *INT 02-07: Definition of Phrase "Other Than Temporary."*

14. No further discussion is planned.

Interpretation of the Emerging Accounting Issues (E) Working Group

INT 06-12: Tax Deposits Submitted in Accordance with Section 6603 of the Internal Revenue Service (IRS) Code

INT 06-12 Dates Discussed

September 10, 2006; December 10, 2006

INT 06-12 References

Current:
SSAP No. 101—Income Taxes, A Replacement of SSAP No. 10R and SSAP No. 10 (SSAP No. 101)

Superseded:
SSAP No. 10R—Income Taxes – A Temporary Replacement of SSAP No. 10 (SSAP No. 10R)

INT 06-12 Issue

1. The American Jobs Creation Act of 2004 enacted on October 22, 2004, added new section 6603 to the Internal Revenue Service Code (the Code) to permit a taxpayer to make a deposit with the Internal Revenue Service to suspend the running of interest under section 6601 on a potential underpayment of tax. A deposit may be made with respect to certain underpayments of tax that have not been assessed at the time of the deposit.

2. Section 6603(a) provides that a taxpayer may make a deposit with the Service that may be used by the Secretary to pay any income, gift, estate, or generation-skipping taxes imposed on the taxpayer under the Code, or certain excise taxes imposed on the taxpayer under the Code. Section 6603(b) provides that, to the extent that a deposit is used by the Service to pay tax, the tax shall be treated as paid on the date the deposit is made for purposes of computing interest on underpayments under section 6601.

3. Section 6603(c) provides that the Service will return to the taxpayer any amount of a deposit that the taxpayer requests in writing be returned unless the amount has previously been used to pay tax or the Service determines that collection of tax is in jeopardy.

4. The accounting issue is whether protective tax deposits meet the definition of current income tax recoverable as that term is used in SSAP No. 101, paragraph 9.

INT 06-12 Discussion

5. The Working Group reached a consensus that deposits made with the Internal Revenue Service, as described in paragraphs 1-3 of this interpretation, meet the definition of a current income tax recoverable as defined in SSAP No. 101, paragraph 9, as the reporting entity has made the deposit under its substantial authority and the deposit can be recovered upon written request.

6. Section 6603 tax deposits are admitted assets to the extent the section 6603 tax deposit complies with SSAP No. 101 and this guidance. The reporting entity shall report section 6603 tax deposits as assets within the caption "Current Federal and Foreign Income Tax Recoverable and Interest thereon." The section 6603 tax deposit asset and any related tax liability shall be presented on a gross basis for statutory reporting purposes.

Calculating Nonadmission

7. The reporting entity shall expense amounts previously used to pay tax.

8. The reporting entity shall nonadmit:

a. amounts the Service has determined, or the reporting entity estimates it is probable the Service will determine, that collection of the tax from the reporting entity is in jeopardy for section 6603 tax deposit amounts in excess of the specifically established tax liability, or

b. any portion of the deposit that the reporting entity does not reasonably expect to be recovered in a subsequent accounting period for section 6603 tax deposit amounts in excess of specifically established tax liability.

9. The term “specifically established tax liability” is a liability, that for financial reporting purposes, the reporting entity has recognized relating to the IRS Section 6603 tax deposit. The reporting entity intends this “specifically established tax liability” to be settled by applying the section 6603 tax deposit. In calculating nonadmission discussed in the paragraph 8, the reporting entity shall deduct the specifically accrued tax liability prior to the determination of whether the remaining amounts should be nonadmitted.

10. To illustrate the nonadmission criteria, consider the following two situations:

a. IAOA insurer has a 6603 tax deposit of $100,000 and a federal income tax liability of $30,000 that IAOA intends to pay in the normal course of business. IAOA would not consider the tax liability when determining nonadmission of the section 6603 tax deposit. IAOA is not aware of any situations which would indicate that use of the deposit is in question and would admit the entire $100,000 tax deposit.

b. TAI insurer has a $110,000 section 6603 tax deposit and has been notified by its tax department that an adverse tax finding of $45,000 was probable, and may result in significant interest penalties. TAI recorded a “specifically established tax liability” of $45,000 and **intends** to use the section 6603 tax deposit to settle the $45,000 adverse tax finding. In determining the amount of the 6603 tax deposit to nonadmit, TAI would determine the amount in excess of the “specifically established tax liability, which is $65,000 ($110,000 – $45,000). This net amount of $65,000 is then evaluated for nonadmission, based on other relevant factors, if any. To continue the illustration, TAI became aware of an additional situation at the reporting date, which indicated that $10,000 of the section 6603 tax deposit is not reasonably expected to be recovered in a subsequent accounting period . As a result, TAI would nonadmit $10,000 of the tax deposit.

INT 06-12 Status

11. No further discussion is planned. The Working Group noted that *FIN 48: Accounting for Uncertainty in Income Tax, an interpretation of FASB Statement No. 109* (FIN 48) is pending review by the Statutory Accounting Principles (E) Working Group has the potential to impact the consensus in this Interpretation. The Working Group will consider if the interpretation requires updating after the review of FIN 48 is complete.

Interpretation of the Emerging Accounting Issues (E) Working Group

INT 06-13: EITF 01-2: Interpretations of APB Opinion No. 29

INT 06-13 Dates Discussed

September 10, 2006; December 10, 2006

INT 06-13 References

Current:
SSAP No. 40R—Real Estate Investments (SSAP No. 40R)
SSAP No. 95—Exchanges of Nonmonetary Assets, A Replacement of SSAP No. 28—Nonmonetary Transactions (SSAP No. 95)

Superseded:
SSAP No. 77—Real Estate Sales – An Amendment to SSAP No. 40, Real Estate Investments (SSAP No. 77)

INT 06-13 Issue

1. The introduction to issues as described in *EITF 01-2: Interpretations of APB Opinion No. 29* is as follows:

> 1. The basic principle in Opinion 29 is that the accounting for nonmonetary transactions should be based on the fair values of the assets (or services) exchanged. The cost of a nonmonetary asset acquired in exchange for another nonmonetary asset is the fair value of the asset surrendered to obtain it, and a gain or loss for the difference between the carrying amount of the surrendered asset and its fair value should be recognized on the exchange. The fair value of the asset received should be used to measure the fair value of the asset surrendered (and the cost of the asset received) if it is more clearly evident than the fair value of the asset surrendered. Opinion 29 includes several modifications to that principle in circumstances in which (a) fair values of the assets exchanged are not readily determinable (paragraph 20.a. of Opinion 29), (b) the assets exchanged are products or properties held for sale in the same line of business to facilitate sales to customers other than the parties to the exchange (paragraph 20.b. of Opinion 29), (c) the assets exchanged are similar productive assets not held for sale in the ordinary course of business, [Note: See paragraph 44 of the STATUS section.] (d) the exchange involves an amount of monetary consideration (paragraph 22 of Opinion 29), and (e) the transaction represents a nonreciprocal transfer to owners (paragraph 23 of Opinion 29). Over the years, the Task Force has addressed several issues relating to the guidance in Opinion 29. The purpose of this Issue is to codify and reconcile the following Issues:
>
> *Issue No. 86-29, "Nonmonetary Transactions: Magnitude of Boot and the Exceptions to the Use of Fair Value"* (paragraphs 4-6, and 18-19)
>
> *Issue No. 87-17, "Spinoffs or Other Distributions of Loans Receivable to Shareholders"* (paragraphs 28-29)
>
> *Issue No. 87-29, "Exchange of Real Estate Involving Boot"* (paragraphs 25-27)
>
> *Issue No. 89-7, "Exchange of Assets or Interest in a Subsidiary for a Noncontrolling Equity Interest in a New Entity"* (paragraphs 21-24)

Issue No. 96-2, "Impairment Recognition When a Nonmonetary Asset Is Exchanged or Is Distributed to Owners and Is Accounted for at the Asset's Recorded Amount" (paragraphs 33-39)

Issue No. 96-4, "Accounting for Reorganizations Involving a Non–Pro Rata Split-off of Certain Nonmonetary Assets to Owners" (paragraphs 30-32)

Issue No. 98-7, "Accounting for Exchanges of Similar Equity Method Investments" (paragraph 11)

Issue No. 00-5, "Determining Whether a Nonmonetary Transaction Is an Exchange of Similar Productive Assets" (paragraphs 2-3, 9-10, and 12-17).

The Task Force observed that the transition guidance for the above Issues is governed by the original consensuses on those Issues.

2. As described in paragraph 44 in the STATUS section of *EITF 01-2, FAS 153: Exchanges of Nonmonetary Assets, an amendment of APB Opinion No. 29* (FAS 153), was issued in December 2004 and eliminated the fair value measurement exception for nonmonetary exchanges of similar productive assets provided in APB 29 and replaces it with an exception from fair value measurement for nonmonetary exchanges that lack commercial substance. As a result, FAS 153 nullifies Issues 1(b), 1(c), 2-5, and 7 since those issues interpret the exception to fair value measurement for similar productive assets that was eliminated by FAS 153. FAS 153 was adopted with modification in *SSAP No. 95—Exchanges of Nonmonetary Assets, A Replacement of SSAP No. 28—Nonmonetary Transactions* (SSAP No. 95). *FAS 144: Accounting for the Impairment or Disposal of Long-Lived Assets*, also amended APB 29 and resolved issues 13(a) and 13(b) of EITF 01-2. FAS 144 was adopted with modification in *SSAP No. 90—Accounting for the Impairment or Disposal of Real Estate Investments* (SSAP No. 90). This Interpretation addresses the remaining issues of EITF 01-2.

3. The following EITF issues listed above were adopted, rejected or determined to be not applicable to statutory accounting principles in their entirety, as follows:

- *EITF Issue No. 86-29, "Nonmonetary Transactions: Magnitude of Boot and the Exceptions to the Use of Fair Value*" – adopted in *SSAP No. 95—Exchanges of Nonmonetary Assets, A Replacement of SSAP No. 28—Nonmonetary Transactions*

- *EITF Issue No. 87-17, "Spinoffs or Other Distributions of Loans Receivable to Shareholders"* – determined to be not applicable to statutory accounting principles

- *EITF Issue No. 87-29, "Exchange of Real Estate Involving Boot*" – adopted in *SSAP No. 40R—Real Estate Investments*

- *EITF Issue No. 89-7, "Exchange of Assets or Interest in a Subsidiary for a Noncontrolling Equity Interest in a New Entity"* – rejected in *SSAP No. 68—Business Combinations and Goodwill*

- *EITF Issue No. 96-4, "Accounting for Reorganizations Involving a Non-Pro Rata Split-off of Certain Nonmonetary Assets to Owners"* – rejected in *SSAP No. 95—Exchanges of Nonmonetary Assets, A Replacement of SSAP No. 28—Nonmonetary Transactions*

4. As EITF 01-2 was adopted to codify or reconcile the issues included in paragraph 1 of this interpretation, each issue will be described and discussed in paragraphs 5-18 of this interpretation.

INT 06-13 Discussion

5. Issue 6 and guidance per EITF 01-2:

> *Issue 6—If a nonmonetary exchange is required to be accounted for at fair value, whether full or partial gain recognition is appropriate in a circumstance in which one entity (Entity A) transfers its ownership of either a controlled productive asset or assets or a controlled business to another entity (Entity B) in exchange for a noncontrolling ownership interest in that entity (Entity B).*
>
> 16. The Task Force reached a consensus on Issue 6 that if the fair value of the asset(s) given up (or of the ownership interest received if the fair value of that asset is more readily determinable) is less than its carrying value, that difference should be recognized as a loss. [Note: See STATUS section.] If the fair value of the asset(s) given up (or of the ownership interest received if that asset's fair value is more readily determinable) is greater than its carrying value, then (a) a gain in the amount of that difference should be recognized if the entity accounts for the ownership interest received using the cost method, or (b) a partial gain should be recognized if the entity accounts for the ownership interest received using the equity method. The partial gain should be calculated as the amount described in (a), above, less the portion of that gain represented by the economic interest (which may be different from the voting interest) retained. For example, if Entity A exchanges an asset with a carrying value of $1,000 and a fair value of $2,000 for a 30 percent economic interest in Entity B, Entity A should recognize a gain of $700 [($2,000 - $1,000) × 70%]. Thus, the amount recorded for the ownership interest received is partially based on its fair value at the exchange date and partially based on the carryover amount of the asset(s) surrendered.
>
> 17. The Task Force observed that paragraph 20 of Opinion 29 requires that the accounting for a nonmonetary transaction subject to Opinion 29 should not be based on the fair values of the assets transferred unless those fair values are determinable within reasonable limits.

6. The STATUS section of EITF 01-2 states the following relative to Issue 6:

> 45. Issue 6 addresses whether full or partial gain recognition is appropriate in circumstances in which an entity transfers its ownership of either a controlled productive asset (or assets) or a controlled business to another entity in exchange for a noncontrolling ownership interest in that entity. Statement 153 amends the scope of Opinion 29 to exclude a transfer of assets to an entity in exchange for an equity interest in that entity. Statement 153 also amends Statement 140 to remove the scope exception in Statement 140 for exchanges of equity method investments for similar productive assets. Accordingly, transfers of equity method investments in exchange for other assets should be accounted for in accordance with Statement 140. However, Opinion 29 (as amended by Statement 153) and Statement 140 do not provide guidance on the accounting for transfers of nonfinancial assets in exchange for other assets. Therefore, the guidance in Issue 6 should continue to be applied in circumstances in which an entity transfers a nonfinancial asset (or assets) to another entity in exchange for a noncontrolling ownership interest in that entity and the exchange is required to be accounted for at fair value.

7. The Working Group reached a consensus to adopt the EITF 01-2 for Issue 6 guidance believing the economic interest relates to the ownership interest of Entity B in the above issue. This may or may not be different from the voting interest or controlling interest of Entity B.

However, the GAAP guidance above for Issue 6 determines the proper accounting for the transactions between unrelated parties relative to the gain or loss on the nonmonetary transaction. This guidance establishes the cost basis for the ownership interest in Entity B to be recorded by Entity A. Subsequent to the transactions, existing guidance should apply for the ownership interest. For statutory purposes, the valuation of this ownership interest would then follow existing statutory guidance (e.g., *SSAP No. 30—Investments in Common Stock (excluding investments in common stock of subsidiary, controlled, or affiliated entities)* for Common Stock, *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies* for Joint Ventures, *SSAP No. 97—Investments in Subsidiary, Controlled, and Affiliated Entities, A Replacement of SSAP No. 88* for investments in SCA entities, etc.)

8. Issue 8 and guidance per EITF 01-2:

> **Exchanges Involving Monetary Consideration (Paragraph 22 of Opinion 29)**
>
> *Issue 8(a)—What level of monetary consideration in a nonmonetary exchange causes the transaction to be considered monetary in its entirety and, therefore, outside the scope of Opinion 29.*
>
> 19. The Task Force discussed an exchange of nonmonetary assets that would otherwise be based on recorded amounts but that also involves monetary consideration (boot). The Task Force reached a consensus that that transaction should be considered monetary (rather than nonmonetary) if the boot is significant, and agreed that "significant" should be defined as at least 25 percent of the fair value of the exchange. As a monetary transaction, both parties would record the exchange at fair value[1] (as discussed in Issue 8(b), below). If the boot in a transaction is less than 25 percent, the pro rata gain recognition guidance in paragraph 22 of Opinion 29 should be applied by the receiver of boot, and the payer of boot would not recognize a gain. The Task Force acknowledged that the ability to satisfactorily measure fair value is a prerequisite to the use of fair value.
>
> [1] For real estate transactions, see Issue 10.
>
> *Issue 8(b)—In a monetary exchange (required to be accounted for at fair value), whether "full or partial" gain recognition is appropriate if an entity transfers its ownership of a controlled asset, group of assets, or business to another entity in exchange for a noncontrolling ownership interest in the other entity.*
>
> 20. The Task Force reached a consensus on Issue 8(b) that the gain should be computed in a manner consistent with the consensus reached in Issue 6. The Task Force reached a consensus that application of the consensus on Issue 8(b) is required for exchange transactions committed to after April 19, 2001. A transaction is committed to if the parties to the transaction have signed a binding, written agreement that specifically sets forth the principal provisions of the transaction. If any of the principal provisions are yet to be negotiated, or are subsequently changed, such a preliminary agreement does not qualify as a commitment for purposes of this consensus.

9. The Working Group reached a consensus to adopt the EITF 01-2 guidance for Issues 8(a) and 8(b) without modification.

10. Issue 9 and guidance per EITF 01-2:

Issue 9—In the monetary exchange described below, whether the amount of gain recognized should exceed the amount that would be computed pursuant to the guidance for Issue 8(b).

21. An enterprise transfers its ownership of an individual asset (or assets) or its ownership interest in a subsidiary to a newly created entity in exchange for an ownership interest in that entity that will be accounted for by the equity method and monetary consideration. The monetary consideration received exceeds the fair value of the portion of the surrendered asset that has been sold in the exchange. The excess monetary consideration is funded by proceeds from nonrecourse financing within the newly created entity. Subsequent to the transfer, the enterprise does not control the entity. The specifics of the transaction are as follows:

- Company A owns equipment with a book basis of $100 and an appraised value of $400.
- Company B, previously unrelated to Company A, creates a new subsidiary, Company X, and transfers cash of $60 to Company X.
- Company A transfers the equipment to Company X in exchange for shares of Company X stock that represent a 40 percent ownership interest in Company X. Simultaneously, Company X borrows $300 with recourse to only the equipment and pays Company A $360 cash.

22. The Task Force reached a consensus that if the enterprise has no actual or implied commitment, financial or otherwise, to support the operations of the new entity in any manner, a gain of $260 should be recognized. The investor's basis in the new entity should be no less than zero. The gain calculation is illustrated as follows:

Fair value of interest in equipment sold ($400 × 60%)	$ 240
Less: Cost of interest in equipment sold ($100 × 60%)	(60)
	$ 180
Plus: Additional gain to the extent of the negative investment	80*
Total gain recognized	$ 260

* The additional gain is calculated as follows:

Cost of equipment	$100
Less: Cost of interest in equipment sold	(60)
Remaining cost	40
Less: Cash received in excess of 60% of the equipment's fair value	(120)
Negative investment	$ (80)

23. Task Force members noted that specific facts and circumstances may affect gain recognition and that it would be impractical for the Task Force to consider all possible variations of the basic transaction described above.

24. The SEC Observer emphasized that any gain recognition is heavily dependent on a careful analysis of specific facts and circumstances. Gain recognition would not be appropriate if a significant uncertainty exists regarding realization or the enterprise has an actual or implied commitment to support the operations of the new entity in any manner (see, for example, SAB 81).

11. The Working Group reached a consensus to adopt the EITF 01-2 guidance for Issue 9 without modification. The Working Group also noted the following facts are important to this consensus:

- The monetary consideration in the example is considered significant under the consensus of Issue 8(b), and as such, Issue 9 is considered a ***monetary* exchange**.
- The monetary consideration received by Entity A in the transaction **exceeds the fair value of the portion of the surrendered asset**.
- The excess monetary consideration is funded by proceeds from nonrecourse financing within Company X. The $300 borrowing with recourse described in the example explicitly states **the recourse is only to the equipment and is not related to Entity A**.
- Prior to the transaction, Entity A and Entity B are unrelated parties. In exchange for the equipment, **Entity A receives shares of Company X stock representing a 40 percent ownership interest**.

In the example above, the monetary consideration received exceeds the fair value of the portion of the surrendered asset that has been sold in the exchange. When this occurs, additional gain should be recognized to ensure the basis in the ownership interest is not less than zero.

12. Issue 10 and guidance per EITF 01-2:

> Exchanges of Real Estate Involving Monetary Consideration (Paragraph 22 of Opinion 29)
>
> 25. Statement 66 indicates that the accounting for exchanges of real estate is covered by Opinion 29 and not by Statement 66. However, as discussed above in Issue 8(a), the Task Force reached a consensus that an exchange of nonmonetary assets that would otherwise be based on recorded amounts under paragraph 21 of Opinion 29 but that involves boot should be considered a monetary (rather than nonmonetary) transaction if the boot is at least 25 percent of the fair value of the exchange. As a result, the Task Force reached a different consensus for exchanges of either (a) real estate held for sale in the ordinary course of business for real estate to be sold in the same line of business or (b) real estate not held for sale in the ordinary course of business for similar real estate when the boot is at least 25 percent of the fair value of the exchange. (Those types of exchanges are referred to in Issues 10(a) and 10(b) as exchanges of similar real estate.)
>
> *Issue 10(a)—Whether Statement 66 applies to an exchange of similar real estate that is not subject to Opinion 29 because the transaction involves enough boot for the exchange to be considered monetary under the consensus for Issue 8(a).*
>
> 26. The Task Force reached a consensus that a transaction involving an exchange of similar real estate that is considered a monetary transaction under Issue 8(a) because boot is at least 25 percent of the fair value of the exchange would be allocated between two components: a monetary portion and a nonmonetary portion. [Note: See STATUS section.] The allocation between the monetary and nonmonetary portions of the transaction should be based on their relative fair values at the time of the transaction. A Task Force member noted that Interpretation 43 provides guidance on when an asset is considered real estate.
>
> *Issue 10(b)—If applicable, how Statement 66 should be applied.*

27. The Task Force reached a consensus that for the receiver of boot, the monetary portion would be accounted for under Statement 66 as the equivalent of a sale of an interest in the underlying real estate, and the nonmonetary portion would be accounted for based on the recorded amount (after reduction, if appropriate, for an indicated impairment in value) of the nonmonetary asset relinquished pursuant to paragraph 21 of Opinion 29. [Note: See STATUS section.] For the payer of boot, the monetary portion would be accounted for as an acquisition of real estate, and the nonmonetary portion would be accounted for pursuant to paragraph 21 of Opinion 29. Following is an example of the application of this consensus:

Assumptions

- Party A transfers real estate with a fair value of $2,000,000 (Party A's net book value of $1,500,000) to Party B and receives $400,000 cash, a $400,000 note from Party B payable to Party A, and real estate with a fair value of $1,200,000 (Party B's net book value of $800,000).
- The initial investment requirement for full accrual profit recognition under Statement 66 is 20 percent.
- The terms of the note from Party B to Party A would satisfy the continuing investment provisions necessary for application of the full accrual method. The interest rate on the note from Party B is a market rate, and the note is considered fully collectible.
- The values of the real estate transferred by both parties are readily determinable and clearly realizable at the exchange date.
- Neither party has any continuing involvement with the real estate transferred to the other.

Computation of Allocation by Both Party A and Party B

Monetary Portion of Transaction:

Total monetary consideration divided by total fair value of exchange	$800,000 ÷ $2,000,000 = 40%

For this example, the monetary portion of the transaction is the exchange of $400,000 cash and a $400,000 note for real estate with a fair value of $800,000 ($2,000,000 x 40%).

Nonmonetary Portion of Transaction:

Fair value of real estate exchanged divided by total fair value of exchange	$1,200,000 ÷ $2,000,000 = 60%

For this example, the nonmonetary portion of the transaction is the exchange of real estate with a fair value of $1,200,000 for similar real estate with a fair value of $1,200,000 ($2,000,000 x 60%).

Accounting by Party A (the Receiver of Monetary Consideration)

The monetary portion of the transaction qualifies for full accrual profit recognition because the cash down payment of $400,000 and the $400,000 note meet the criteria in paragraphs 9-12 of Statement 66 for a buyer's initial and continuing investment when applied to the monetary portion of the transaction. Accordingly, a gain of $200,000

($800,000 total monetary consideration less $600,000 [$1,500,000 total net book value x 40%] pro rata portion of net book value) would be recorded at the date of sale.

The nonmonetary portion of the transaction does not qualify for gain recognition because the exchange involves similar real estate. The accounting basis of the new property equals $900,000 ($1,500,000 total net book value of the real estate exchanged less the $600,000 pro rata portion of net book value sold).

Accounting by Party B (the Payer of Monetary Consideration)

The monetary portion of the transaction represents an acquisition of real estate for the monetary consideration paid of $800,000.

The nonmonetary portion of the transaction does not qualify for gain recognition because the exchange involves similar real estate. The accounting basis of the new property equals $1,600,000 ($800,000 net book value of the real estate exchanged plus $800,000 total monetary consideration paid).

13. The STATUS section of EITF 01-2 states the following relative to Issues 10(a) and 10(b):

46. Issues 10(a) and 10(b) previously addressed circumstances in which an entity is involved in a real estate exchange that meet the following conditions: (1) the exchange includes boot that is at least 25 percent of the fair value of the exchange and (2) the exchange is either (a) real estate held for sale in the ordinary course of business for real estate to be sold in the same line of business or (b) real estate not held for sale in the ordinary course of business for similar real estate. Statement 153, however, eliminates the fair value measurement exception for nonmonetary exchanges of similar productive assets provided in Opinion 29 and replaces it with an exception from fair value measurement for nonmonetary exchanges that lack commercial substance. Therefore, Issues 10(a) and 10(b) address circumstances in which an entity is involved in a real estate exchange that meets the following conditions: (1) the exchange includes boot that is at least 25 percent of the fair value of the exchange and (2) the exchange meets one of the conditions set forth in paragraph 20 of Opinion 29.

14. The Working Group reached a consensus to adopt the EITF 01-2 guidance for Issues 10(a) and 10(b) with the modification to replace references to FAS 66: *Accounting for Sales of Real Estate* with references to *SSAP No. 40R—Real Estate Investments*. In addition, reporting entities should note that as a result of the issuance of FAS 153, Issues 10(a) and 10(b) address circumstances in which an entity is involved in a real estate exchange that meets the following conditions: (1) the exchange includes boot that is at least 25 percent of the fair value of the exchange and (2) the exchange meets one of the conditions set forth in paragraph 20 of Opinion 29.

15. Issue 11 and guidance per EITF 01-2:

Nonreciprocal Transfers to Owners (Paragraph 23 of Opinion 29)

Spinoffs or Other Distributions of Loans Receivable to Shareholders

28. An enterprise distributes loans receivable to its owners by forming a subsidiary, transferring those loans receivable to the subsidiary, and then distributing the stock of that subsidiary to shareholders of the parent.

Issue 11—Whether the enterprise should report the distribution at book value as a spinoff or at fair value as a dividend-in-kind if the book value of the loans receivable, which may be either the "recorded investment in the receivable" or the "carrying amount of the *receivable," is in excess of their fair value, and how the recipient should record the transaction.*

29. The Task Force reached a consensus that the distribution should be reported at fair value by the enterprise and the recipient. Task Force members noted that the transaction is not a spinoff because the subsidiary does not constitute a business.[4] Rather, the transaction should be considered a dividend-in-kind. Under paragraph 23 of Opinion 29, dividends-in-kind are nonreciprocal transfers of nonmonetary assets to owners that should be accounted for at fair value if the fair value of the nonmonetary asset distributed is objectively measurable and would be clearly realizable to the distributing entity in an outright sale at or near the time of distribution. On July 5, 1989, subsequent to the date of the consensus, the SEC staff issued SAB 82, which discusses accounting for transfers of nonperforming assets by financial institutions and disclosure of the impact of financial assistance from regulators. In discussing the value at which a transfer of nonperforming assets should be recorded by the transferor financial institution, SAB 82 makes reference to the Task Force consensus on Issue 10, that an enterprise that distributes loans to its owners should report such distribution at fair value.

[4] Issue 98-3 provides guidance on determining whether an asset group constitutes a business.

16. The Working Group reached a consensus to adopt the EITF 01-2 guidance with the modification to replace the reference to paragraph 23 of APB Opinion 29 with paragraph 12 of SSAP No. 95, the reference in footnote 4 to EITF Issue 98-3 shall be replaced with INT 00-26: *EITF 98-3: Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business*.

17. Issue 12 and guidance per EITF 01-2:

Accounting for Reorganizations Involving a Non–Pro Rata Split-off of Certain Nonmonetary Assets to Owners

30. Some believe that paragraph 23 of Opinion 29 requires that nonreciprocal transfers of nonmonetary assets to owners on a non-pro rata basis be accounted for at fair value, without regard to the nature of the nonmonetary assets distributed. Others believe that Opinion 29 requires historical cost accounting for corporate liquidations or reorganizations involving the distribution to owners of all or a significant segment of the business, whether in a spinoff, split-off, or split-up and whether or not the distribution is on a pro rata basis.

31. Although Opinion 29 does not define the term split-off, federal income tax law states that a split-off is a transaction in which a parent company exchanges its stock in a subsidiary for parent company stock held by its shareholders. For federal income tax purposes, the exchange of shares need not be pro rata to all shareholders, or even include all shareholders, in order to be considered a tax-free split-off.

Issue 12—Whether a non-pro rata split-off of all or a significant segment of a business in a corporate plan of reorganization should be accounted for at historical cost or at fair value.

32. The Task Force reached a consensus that a non-pro rata split-off of a segment of a business in a corporate plan of reorganization should be accounted for at fair value. The Task Force also reached a consensus that a split-off of a targeted business, distributed on a pro rata basis to the holders of the related targeted stock, should be accounted for at historical cost. The Task Force observed that if the targeted stock was created in contemplation of the subsequent split-off, the two steps (creation of the targeted stock

and the split-off) cannot be separated and should be viewed as one transaction with the split-off being accounted for at fair value.

18. The Working Group reached a consensus to adopt the EITF 01-2 guidance for Issue 12 with the modification to replace references to paragraph 23 of APB Opinion 29 with paragraph 12 of SSAP No. 95.

INT 06-13 Status

No further discussion is planned.

Interpretation of the Emerging Accounting Issues (E) Working Group

INT 07-01: Application of the Scientific (Constant Yield) Method in Situations of Reverse Amortization

INT 07-01 Dates Discussed

March 10, 2007; June 2, 2007

INT 07-01 References

Current:
SSAP No. 26—Bonds, excluding Loan-Backed and Structured Securities (SSAP No. 26)
SSAP No. 43R—Loan-Backed and Structured Securities (SSAP No. 43R)

Superseded:
SSAP No. 98—Treatment of Cash Flows When Quantifying Changes in Valuation and Impairments, an Amendment of SSAP No. 43—Loan-Backed and Structured Securities (SSAP No. 98)

INT 07-01 Issue

1. SSAP No. 26 and SSAP No. 43R both reference the use of the scientific or constant yield method of amortization of a premium or a discount. *SSAP No. 26—Bonds, Excluding Loan-Backed and Structured Securities* (SSAP No. 26) provides the following (bolding added for emphasis):

> **Amortized Cost**
>
> 6. **Amortization of bond premium or discount shall be calculated using the scientific (constant yield) interest method taking into consideration specified interest and principal provisions over the life of the bond.** Bonds containing call provisions (where the issue can be called away from the reporting entity at the issuer's discretion) shall be amortized to the call or maturity value/date which produces the lowest asset value (yield to worst).

SSAP No. 43R—Loan-Backed and Structured Securities (SSAP No. 43R) provides the following (bolding added for emphasis):

> **Amortization**
>
> 8. **Amortization of premium or discount shall be calculated using the scientific (constant yield) interest method** and shall be recorded as an adjustment to investment income. The interest method results in a constant effective yield equal to the prevailing rate at the time of purchase or at the time of subsequent adjustments to book value. The amortization period shall reflect estimates of the period over which repayment of principal of the loan-backed securities is expected to occur, not the stated maturity period.
>
> **Collection of All Contractual Cashflows is Probable**
>
> 12. The following guidance applies to loan-backed and structured securities for which it is probable that the investor will be able to collect all contractually required payments receivable. (Paragraphs 17-19 provide guidance for securities in which collection of all

contractual cash flows is not probable and paragraphs 20-24 provide guidance for beneficial interests.) Prepayments are a significant variable element in the cash flow of loan-backed securities because they affect the yield and determine the expected maturity against which the yield is evaluated. Falling interest rates generate faster prepayment of the mortgages underlying the security, shortening its duration. This causes the reporting entity to reinvest assets sooner than expected at potentially less advantageous rates. This is called prepayment risk. Extension risk is created by rising interest rates which slow repayment and can significantly lengthen the duration of the security. Differences in cash flows can also result from other changes in the cash flows from the underlying assets. If assets are delinquent or otherwise not generating cash flow, which should be reflected in the cash flow analysis through diminishing security cash flows, even if assets have not been liquidated and gain/losses have not been booked.

13. Changes in currently estimated cash flows, including the effect of prepayment assumptions, on loan-backed securities shall be reviewed periodically, at least quarterly. The prepayment rates of the underlying loans shall be used to determine prepayment assumptions. Prepayment assumptions shall be applied consistently across portfolios to all securities backed by similar collateral (similar with respect to coupon, issuer, and age of collateral). Reporting entities shall use consistent assumptions across portfolios for similar collateral within controlled affiliated groups. Since each reporting entity may have a unique method for determining the prepayment assumptions, it is impractical to set standard assumptions for the industry. Relevant sources and rationale used to determine each prepayment assumption shall be documented by the reporting entity.

14. Loan-backed securities shall be revalued using the currently estimated cash flows, including new prepayment assumptions, using either the prospective or retrospective adjustment methodologies, consistently applied by type of securities. However, if at any time during the holding period, the reporting entity determines it is no longer probable that they will collect all contractual cashflows, the reporting entity shall apply the accounting requirements in paragraphs 17-19.

15. The prospective approach recognizes, through the recalculation of the **effective yield** to be applied to future periods, the effects of all cash flows whose amounts differ from those estimated earlier and the effects and changes in projected cash flows. Under the prospective method, the recalculated effective yield will equate the carrying amount of the investment to the present value of the anticipated future cash flows. The recalculated yield is then used to accrue income on the investment balance for subsequent accounting periods. There are no accounting changes in the current period unless the security is determined to be other than temporarily impaired.

16. The retrospective methodology changes both the yield and the asset balance so that expected future cash flows produce a return on the investment equal to the return now expected over the life of the investment as measured from the date of acquisition. Under the retrospective method, the recalculated **effective yield** will equate the present value of the actual and anticipated cash flows with the original cost of the investment. The current balance is then increased or decreased to the amount that would have resulted had the revised yield been applied since inception, and investment income is correspondingly decreased or increased.

2. The following identifies three situations where, using a constant yield methodology for determining amortization or accretion, changes in amortized value move in the opposite direction of what is expected. That is, if a security is purchased at a premium, the constant yield methodology will, in certain cases, cause the amortized value to move to a discount during the life of the security. Conversely, if the security were purchased at a discount, the constant yield methodology will, in certain cases, cause the amortized value to move to a premium during the life of the security.

Accounting Issues:

3. The fundamental accounting questions are

Issue 1: When applying the constant yield method to loan-backed or structured securities, can amortized value be interpreted to represent the discounted cash flows?

Issue 2: Should a security purchased at a premium be allowed to move to a discount, or should a discount be allowed to move to a premium, if this occurs as a result of applying the scientific (constant yield) interest method."

Issue 3: On the subject of Parity (described in example 3), is it appropriate under statutory accounting guideline to "assume away" day delay and subsequently eliminate amortizing to a value less than par? If so, should a payment date assumption or a record date assumption be used?

4. Following are practical situations where a security purchased at a premium will have increases in amortized value, and where a security purchased at a discount will have decreases in amortized value. The question is should the scientific (constant yield) method be interpreted to allow these securities to be amortized as illustrated below.

Example 1

5. This first example examines a stepped coupon bond purchased at a discount. At time of acquisition the future interest rate adjustments are known, and so are taken into account in the yield calculation. This example illustrates how a (theoretical) stepped coupon bond, without a call schedule, could result in the amortized value changing from a discount to a premium.

Description: FEDERAL HOME LN MTG CORP MTN
Maturity: 03-18-2019
Int Type: Stepped Coupon not callable
03/18/2004 4.000%
03/18/2007 6.000%
03/18/2013 8.000%
Purchase Date: 3/18/2004
Purchase Price: 97.125
Based on this information, the effective annual yield at acquisition is: 6.3246%

6. The following illustrates the semiannual amortization schedule determined at time of acquisition. The amortized values represent the sum of the discounted future cash flows at each payment date. Based on the purchase price and cash flow assumptions, the semiannual yield is 3.1623%.

		Interest					
		Rate	Interest	Total			
Pay Date	Par Value	Annual	Payment	Payment	Income	Accr Disc	Amort Value
3/18/2004	1,000,000.00			(971,250.00)			971,250.00
9/18/2004	1,000,000.00	4.0000%	20,000.00	20,000.00	30,713.97	10,713.97	981,963.97
3/18/2005	**1,000,000.00**	**4.0000%**	**20,000.00**	**20,000.00**	**31,052.78**	**11,052.78**	**993,016.75**
9/18/2005	**1,000,000.00**	**4.0000%**	**20,000.00**	**20,000.00**	**31,402.30**	**11,402.30**	**1,004,419.05**
3/18/2006	1,000,000.00	4.0000%	20,000.00	20,000.00	31,762.88	11,762.88	1,016,181.92
9/18/2006	1,000,000.00	4.0000%	20,000.00	20,000.00	32,134.86	12,134.86	1,028,316.78
3/18/2007	1,000,000.00	4.0000%	20,000.00	20,000.00	32,518.60	12,518.60	1,040,835.38
9/18/2007	1,000,000.00	6.0000%	30,000.00	30,000.00	32,914.48	2,914.48	1,043,749.86
3/18/2008	1,000,000.00	6.0000%	30,000.00	30,000.00	33,006.64	3,006.64	1,046,756.50
9/18/2008	1,000,000.00	6.0000%	30,000.00	30,000.00	33,101.72	3,101.72	1,049,858.22
3/18/2009	1,000,000.00	6.0000%	30,000.00	30,000.00	33,199.81	3,199.81	1,053,058.02
9/18/2009	1,000,000.00	6.0000%	30,000.00	30,000.00	33,300.99	3,300.99	1,056,359.02
3/18/2010	1,000,000.00	6.0000%	30,000.00	30,000.00	33,405.38	3,405.38	1,059,764.40
9/18/2010	1,000,000.00	6.0000%	30,000.00	30,000.00	33,513.07	3,513.07	1,063,277.47
3/18/2011	1,000,000.00	6.0000%	30,000.00	30,000.00	33,624.17	3,624.17	1,066,901.64
9/18/2011	1,000,000.00	6.0000%	30,000.00	30,000.00	33,738.77	3,738.77	1,070,640.41
3/18/2012	1,000,000.00	6.0000%	30,000.00	30,000.00	33,857.00	3,857.00	1,074,497.41
9/18/2012	1,000,000.00	6.0000%	30,000.00	30,000.00	33,978.98	3,978.98	1,078,476.39
3/18/2013	1,000,000.00	6.0000%	30,000.00	30,000.00	34,104.80	4,104.80	1,082,581.19
9/18/2013	1,000,000.00	8.0000%	40,000.00	40,000.00	34,234.61	(5,765.39)	1,076,815.80
3/18/2014	1,000,000.00	8.0000%	40,000.00	40,000.00	34,052.29	(5,947.71)	1,070,868.09
9/18/2014	1,000,000.00	8.0000%	40,000.00	40,000.00	33,864.20	(6,135.80)	1,064,732.30
3/18/2015	1,000,000.00	8.0000%	40,000.00	40,000.00	33,670.17	(6,329.83)	1,058,402.47
9/18/2015	1,000,000.00	8.0000%	40,000.00	40,000.00	33,470.00	(6,530.00)	1,051,872.47
3/18/2016	1,000,000.00	8.0000%	40,000.00	40,000.00	33,263.50	(6,736.50)	1,045,135.97
9/18/2016	1,000,000.00	8.0000%	40,000.00	40,000.00	33,050.47	(6,949.53)	1,038,186.45
3/18/2017	1,000,000.00	8.0000%	40,000.00	40,000.00	32,830.71	(7,169.29)	1,031,017.16
9/18/2017	1,000,000.00	8.0000%	40,000.00	40,000.00	32,603.99	(7,396.01)	1,023,621.15
3/18/2018	1,000,000.00	8.0000%	40,000.00	40,000.00	32,370.11	(7,629.89)	1,015,991.26
9/18/2018	1,000,000.00	8.0000%	40,000.00	40,000.00	32,128.83	(7,871.17)	1,008,120.08
3/18/2019	1,000,000.00	8.0000%	40,000.00	1,040,000.00	31,879.92	(8,120.08)	1,000,000.00
Subtotal						28,750.00	

7. As can be seen from this schedule, the amortized value quickly changes from a discount situation to a premium situation. The question is should the accretion of the discount end when the discount is fully amortized, i.e. when Amortized Value = Par Value. In the above, this would occur somewhere between 3/18/05 and 9/18/05. Or, is it proper to report the amortized value as the sum of the discounted cash flows at a given point in time using the effective yield at acquisition? (Note: A prospective method is not applicable for this situation since the cash flows are known at time of acquisition, and those assumptions will not change over time.)

Example 2

8. The second situation explores a variable rate security using the Retrospective Method of Amortization. This example exemplifies the issue identified as "**Drift**." As variable interest rates are not known in advance, adjustments to yields must be made whenever a new interest rate becomes effective. Using the retrospective method, the effective yield is calculated based upon the purchase price, and the actual received and the projected future cash flows. For simplicity's

sake, a bond with a single principal payment at maturity is used, but similar results would occur if the security were any type of variable rate instrument.

9. The situation presented below shows the cash flow assumptions at purchase when there is only one known interest rate. Immediately following, are the effects of using a retrospective adjustment, once the second interest rate is known and applied.

Original Purchase Assumptions:	
Par value:	1,000,000.00
Price:	98.000
Cost:	980,000.00
Acq Date:	01/022006
Maturity Date:	12/15/2009
Interest rate:	2.000%
Pays:	Quarterly
Effective Annual Yield:	2.53326%
Qrtrly Yield:	.63332%

							Accretion	Amortized
Pay Date	Par Value	Int Rate	Int Recvd	Prin Recd	Total Cash	Income	Discount	Value
1/2/2006	1,000,000	2.00%	(944.44)		(980,944.44)			980,000.00
3/15/2006	1,000,000	2.00%	5,000.00	0.00	5,000.00	5,034.16	978.60	980,978.60
6/15/2006	1,000,000	2.00%	5,000.00	0.00	5,000.00	6,212.69	1,212.69	982,191.29
9/15/2006	1,000,000	2.00%	5,000.00	0.00	5,000.00	6,220.37	1,220.37	983,411.67
12/15/2006	1,000,000	2.00%	5,000.00	0.00	5,000.00	6,228.10	1,228.10	984,639.77
3/15/2007	1,000,000	2.00%	5,000.00	0.00	5,000.00	6,235.88	1,235.88	985,875.65
6/15/2007	1,000,000	2.00%	5,000.00	0.00	5,000.00	6,243.71	1,243.71	987,119.36
9/15/2007	1,000,000	2.00%	5,000.00	0.00	5,000.00	6,251.58	1,251.58	988,370.94
12/15/2007	1,000,000	2.00%	5,000.00	0.00	5,000.00	6,259.51	1,259.51	989,630.45
3/15/2008	1,000,000	2.00%	5,000.00	0.00	5,000.00	6,267.49	1,267.49	990,897.94
6/15/2008	1,000,000	2.00%	5,000.00	0.00	5,000.00	6,275.51	1,275.51	992,173.45
9/15/2008	1,000,000	2.00%	5,000.00	0.00	5,000.00	6,283.59	1,283.59	993,457.04
12/15/2008	1,000,000	2.00%	5,000.00	0.00	5,000.00	6,291.72	1,291.72	994,748.76
3/15/2009	1,000,000	2.00%	5,000.00	0.00	5,000.00	6,299.90	1,299.90	996,048.66
6/15/2009	1,000,000	2.00%	5,000.00	0.00	5,000.00	6,308.13	1,308.13	997,356.80
9/15/2009	1,000,000	2.00%	5,000.00	0.00	5,000.00	6,316.42	1,316.42	998,673.22
12/15/2009	1,000,000	2.00%	5,000.00	1,000,000.00	1,000,000.00	6,324.76	1,326.78	-

10. Based on the purchase assumptions, the amortization schedule for this security is normal. The accretion of discount is a smooth curve, and the amortized value approaches par value at maturity. As previously indicated, the following shows the interest rate adjusted for the accrual period ending 3/15/08. The original purchase assumptions are as stated above. The interest payments from 3/15/06 through 12/15/07 are paid based on the 2.000% annual interest rate effective from issue date (12/15/05) through 12/14/07. For accrual period beginning 12/15/07, however, the interest rate adjusts to 3.500%. Using a retrospective methodology, the following amortization schedule results:

							Accretion	Amortized
Pay Date	Par Value	Int Rate	Int Recvd	Prin Recd	Total Cash	Income	Discount	Value
1/2/2006	1,000,000	2.00%	(944.44)		(980,944.44)			980,000.00
3/15/2006	1,000,000	2.00%	5,000.00	0.00	5,000.00	6,510.55	2,455.00	982,455.00
6/15/2006	1,000,000	2.00%	5,000.00	0.00	5,000.00	8,046.82	3,046.82	985,501.81
9/15/2006	1,000,000	2.00%	5,000.00	0.00	5,000.00	8,071.77	3,071.77	988,573.58
12/15/2006	1,000,000	2.00%	5,000.00	0.00	5,000.00	8,096.93	3,096.93	991,670.51
3/15/2007	1,000,000	2.00%	5,000.00	0.00	5,000.00	8,122.30	3,122.30	994,792.81
6/15/2007	1,000,000	2.00%	5,000.00	0.00	5,000.00	8,147.87	3,147.87	997,940.67
9/15/2007	1,000,000	2.00%	5,000.00	0.00	5,000.00	8,173.65	3,173.65	1,001,114.33
12/15/2007	1,000,000	**2.00%**	**5,000.00**	**0.00**	**5,000.00**	**8,199.64**	**3,199.64**	**1,004,313.97**
3/15/2008	1,000,000	**3.50%**	**8,750.00**	**0.00**	**8,750.00**	**8,225.85**	**(524.15)**	**1,003,789.82**
6/15/2008	1,000,000	3.50%	8,750.00	0.00	8,750.00	8,221.56	(528.44)	1,003,261.38
9/15/2008	1,000,000	3.50%	8,750.00	0.00	8,750.00	8,217.23	(532.77)	1,002,728.61
12/15/2008	1,000,000	3.50%	8,750.00	0.00	8,750.00	8,212.87	(537.13)	1,002,191.48
3/15/2009	1,000,000	3.50%	8,750.00	0.00	8,750.00	8,208.47	(541.53)	1,001,649.94
6/15/2009	1,000,000	3.50%	8,750.00	0.00	8,750.00	8,204.03	(545.97)	1,001,103.98
9/15/2009	1,000,000	3.50%	8,750.00	0.00	8,750.00	8,199.56	(550.44)	1,000,553.54
12/15/2009	1,000,000	3.50%	8,750.00	1,000,000.00	1,008,750.00	8,195.05	(553.54)	-

11. From this, it is apparent that the amortized value quickly breaks out of the cost / par range and becomes a premium situation. The book value for the periods prior to 12/15/07 would have been reported at the original amortized values as determined in the prior spreadsheet. On the 12/31/07 annual statement there would be a retrospective catch-up adjustment.

12. Because of the variability of cash flows, recalculating a yield based on the retrospective method and applying that yield to calculate an amortized value can cause a security to bust out of the cost / par range, and the amortization (accretion) to move in the "wrong direction." For variable rate, interest only, and principal only asset backed securities, the additional complication caused by day delay would also come into play.

Example 3

13. The third example represents a mortgage backed security purchased at a slight premium. This situation illustrates what is described as **"Parity."** American Banker Online describes parity as "The parity price at which the yield of a mortgage-backed bond equals its net coupon rate. Securities with parity amortize to a value less than 100.

14. Parity occurs because the accrual date, usually the last day of the month, is many days prior to the payment date, typically 15, or 25 days for a mortgage backed security, and up to 45, or 55 days (or longer) for a collateralized mortgage obligation. The following is a simplified example using a mortgage backed security. The assumption is that the security is purchased at a slight premium (price = 100.1000). Because of day delay, however, the parity price is not 100, but is approximately 99.90.

CUSIP: 123456-AB-1 (Made up)
Description: Sample Mortgage Backed Security
Final payment date: 01/15/2006
Int Rate: 5.50%

Day Delay: 44
CPR: 6%

Purchase Date:	2/15/2004
Purchase Price:	100.1000
Par Purchased:	1,000,000.00
Annual Yield (SIA)	5.16841%
Periodic (monthly) Yield	0.43070%
Interest Rate	5.500%

	Prin Red	Principal	Book	Total Incm	Int Incm	Amort	Amort Fctr
2/15/2004		1,000,000.00	1,001,000.00	-	(2,138.89)	-	1.00100
3/15/2004	46,066.11	953,933.89	954,767.44	4,311.32	4,477.77	(166.45)	1.00087
4/15/2004	45,822.29	908,111.60	908,790.15	4,112.19	4,267.19	(155.00)	1.00075
5/15/2004	45,579.72	862,531.88	863,066.88	3,914.17	4,057.72	(143.56)	1.00062
6/15/2004	45,338.40	817,193.48	817,596.34	3,717.24	3,849.37	(132.13)	1.00049
7/15/2004	45,098.32	772,095.16	772,377.29	3,521.39	3,642.12	(120.73)	1.00037
8/15/2004	44,859.48	727,235.68	727,408.48	3,326.64	3,435.97	(109.33)	1.00024
9/15/2004	44,621.87	682,613.81	682,688.66	3,132.95	3,230.91	(97.95)	1.00011
10/15/2004	44,385.48	638,228.33	638,216.60	2,940.35	3,026.93	(86.58)	0.99998
11/15/2004	44,150.31	594,078.02	593,991.06	2,748.80	2,824.04	(75.23)	0.99985
12/15/2004	43,916.35	550,161.67	550,010.81	2,558.32	2,622.22	(63.89)	0.99973
1/15/2005	43,683.59	506,478.08	506,274.66	2,368.90	2,421.47	(52.57)	0.99960
2/15/2005	43,452.03	463,026.05	462,781.38	2,180.53	2,221.78	(41.25)	0.99947
3/15/2005	43,221.66	419,804.39	419,529.77	1,993.20	2,023.15	(29.95)	0.99935
4/15/2005	42,992.48	376,811.91	376,518.63	1,806.92	1,825.58	(18.66)	0.99922
5/15/2005	**42,764.48**	**334,047.43**	**333,746.76**	**1,621.67**	**1,629.05**	**(7.38)**	**0.99910**
6/15/2005	**42,537.66**	**291,509.77**	**291,212.98**	**1,437.45**	**1,433.57**	**3.88**	**0.99898**
7/15/2005	42,312.00	249,197.77	248,916.12	1,254.26	1,239.12	15.14	0.99887
8/15/2005	42,087.50	207,110.27	206,855.00	1,072.08	1,045.71	26.38	0.99877
9/15/2005	41,864.16	165,246.11	165,028.45	890.93	853.32	37.61	0.99868
10/15/2005	41,641.97	123,604.14	123,435.31	710.78	661.95	48.83	0.99863
11/15/2005	41,420.92	82,183.22	82,074.43	531.64	471.60	60.04	0.99868
12/15/2005	41,201.01	40,982.21	40,944.66	353.50	282.25	71.24	0.99908
1/15/2006	40,982.21	-	-	176.35	93.92	37.55	*

* The last amortization calculation is an adjustment to bring book value to 0.

15. By looking at the amortization factors, which represent amortized value / remaining principal, it is evident that the security quickly goes from a premium situation to a discount situation between 5/15/2005 and 6/15/2005. Due to Parity, the security does not amortize to a value of 100, but to a slight discount.

16. In addressing the issue of parity for REMICs, the tax code allows for accruing interest and calculating Original Issue Discount (OID) on a payment date to payment date basis, thereby eliminating the discrepancy between the accrual periods and the payment dates. Another method of eliminating parity would be to use the accrual end date (record date) plus one as the assumed payment date. Both methods sync up the accrual period and the payment date, essentially eliminating day delay.

17. Is it appropriate under statutory accounting guideline to "assume away" day delay and subsequently eliminate amortizing to a value less than par? If so, should a payment date assumption or a record date assumption be used?

INT 07-01 Discussion

18. The Working Group came to the following consensuses:

Issue 1: When applying the constant yield method to loan-backed or structured securities, can amortized value be interpreted to represent the discounted cash flows?

19. The Working Group noted that in the case of loan-backed or asset-backed securities; the unamortized balance of an issue at any point in time will represent the present value of all future cash flows discounted to the present using the constant yield.

Issue 2: Should a security purchased at a premium be allowed to move to a discount, or should a discount be allowed to move to a premium, if this occurs as a result of applying the scientific (constant yield) interest method."

20. It has been noted that certain anomalies will exist with certain types of bonds, loan-backed and structured securities when applying the constant yield method. These anomalies can cause a premium to move to a discount, or a discount to move to a premium.

21. Some think that the value should be frozen once this occurs. However, both SSAP No. 26 and SSAP No. 43R are clear that the scientific (constant yield) interest method is required to be used when accreting/amortizing the discount/premium on a bond, loan-backed or structured security.

22. The Working Group noted that recording a discount or a premium and accreting/amortizing to par is consistent with a held to maturity approach that results in no gain or loss at maturity. Although it could be argued that freezing a discount or premium, or stopping at par at a particular point in time, would achieve the same result, this approach appears to ignore the fundamentals of the issue that have led to the anomalies. The Working Group noted that ignoring the facts of the issue in order to prevent the original premium or original discount from reversing is inappropriate, and that the above examples demonstrate that fact. Therefore, a security purchased at a premium is allowed to move to a discount, and that a discount is allowed to move to a premium, if this occurs as a result of applying a constant yield method.

Issue 3: On the subject of Parity (described in example 3), is it appropriate under statutory accounting guideline to "assume away" day delay and subsequently eliminate amortizing to a value less than par? If so, should a payment date assumption or a record date assumption be used?

23. It has been noted for mortgage backed securities; interest is often "earned" as of the end of the month but not paid until a later date. This delay known as the "day delay" is often 10-25 days depending on the contract. The yields as provided by "Bloomberg," are Security Industry Association (SIA) compliant yields, which do not "assume away 'day delay'", but produce amortization to a value of less than 100, as seen in the example. After discussion, the Working Group determined that the difference between amortizing to the earned record date or to the payment date for the securities described in issue 3 is typically immaterial. Therefore, the Working Group determined to continue to allow flexibility in amortization for the day delay.

24. The user of this interpretation should also note that amortization continues to apply the effective yield method in the above situations **provided that doing so does not conflict with other statutory requirements** in the SSAPs. For example, yield to worst is still a continuing requirement and other SVO requirements are still in effect, etc.

INT 07-01 Status

25. No further discussion is planned.

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Interpretation of the Emerging Accounting Issues (E) Working Group

INT 08-05: EITF 02-11: Accounting for Reverse Spinoffs

INT 08-05 Dates Discussed

March 29, 2008; May 31, 2008

INT 08-05 References

Current:
SSAP No. 24—Discontinued Operations and Extraordinary Items (SSAP No. 24)
SSAP No. 95—Exchanges of Nonmonetary Assets, A Replacement of SSAP No. 28—Nonmonetary Transactions (SSAP No. 95)

INT 08-05 Issue

1. *EITF 02-11: Accounting for Reverse Spinoffs* (EITF 02-11) was issued in September 2002 to address whether to account for spinoffs as reverse spinoffs based on the substance, instead of the legal form, of such transactions. In a reverse spinoff, the legal spinnee should be treated as though it were the spinnor for accounting purposes. *(In spinoff transactions, the 'spinnor' is the entity transferring assets, whereas the term 'spinnee' refers to the new entity.)*

2. As noted within EITF 02-11:

> 1. An entity may desire to reorganize its operations in response to its business needs. For example, an entity (the "spinnor") may transfer assets into a new legal spun-off entity (the "spinnee") and distribute the shares of the spinnee to its shareholders, without the surrender by the shareholders of any stock of the spinnor. Such a transaction is commonly referred to as a "spinoff." Consider the following example:
>
>> Big Company owns and operates a mall and a retail store that occupies the anchor store position in that mall. The mall and the store are managed by two separate divisions. The shareholders of Big Company would like to split Big Company into two companies so that each can focus on its own operations. To achieve this, Big Company transfers the mall's assets and operations into a newly created subsidiary, Mall Company, and distributes the shares of Mall Company to its shareholders on a pro rata basis in a spinoff.
>
> 2. A spinoff allows an entity to be reorganized in a manner that allows it to meet the needs of its owners. However, there may be other benefits as well. If the spinoff qualifies as a nontaxable reorganization, the distribution results in no taxable gain being recognized by either the spinnor or its shareholders. Additionally, if the spinnee is subsequently sold by the shareholders, the double taxation that would have occurred if a company sold its subsidiary directly and distributed the proceeds to its shareholders is avoided.
>
> 3. The accounting guidance for spinoffs is provided in Opinion 29. Although the basic principle underlying Opinion 29 is that the accounting for nonmonetary transactions should be based on the fair values of the assets (or services) involved, it provides a modification to that basic principle for nonreciprocal transfers to owners (such as spinoffs). Opinion 29, paragraph 23 (as amended by Statement 144), states:
>
>> Accounting for the distribution of nonmonetary assets to owners of an enterprise in a spin-off or other form of reorganization or liquidation or in a plan that is in substance the rescission of a prior business combination should be based on the

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

> 4. Accordingly, under Opinion 29, an entity's distribution of the shares of a wholly owned or consolidated subsidiary to its shareholders should be recorded based on the carrying value of the subsidiary. Regardless of whether the spun-off operations will be sold immediately after the spinoff, the transaction should not be accounted for as a sale of the accounting spinnee followed by a distribution of the proceeds.
>
> 5. In certain cases, the spinoff of a subsidiary to its shareholders is such that the legal form of the transaction does not match its substance. That is, in certain circumstances, the spinnee will be the continuing entity. The issue is whether to account for a spinoff as a reverse spinoff based on the substance instead of the legal form of the transaction. In a reverse spinoff, the legal spinnee should be treated as though it were the spinnor for accounting purposes (accounting spinnor).
>
> 6. Consider the following example:
>
> > Snack Food Company owns two subsidiaries—Ice Cream Subsidiary and Snack Subsidiary. Ice Cream Subsidiary is significantly larger and more profitable than Snack Subsidiary. The shareholders of Snack Food Company would like to continue the ice cream operations and dispose of the snack food operations. To facilitate this, Snack Food Company distributes the shares of Ice Cream Subsidiary to the shareholders thereby creating Ice Cream Company. The shareholders are then able to dispose of the operations of Snack Food Company (now solely comprising Snack Subsidiary operations) by selling the shares directly to a third party and, at the same time, retain ownership of the Ice Cream Company.
>
> Accounting for the above transaction based upon its legal form would present Snack Food Company as the spinnor with Ice Cream Company as the spinnee. However, in substance, Snack Food Company has disposed of Snack Subsidiary and continued its ice cream operations. The legal form of the spinoff may have been driven primarily by tax planning strategies. Accounting for the transaction based on its substance depicts Ice Cream Company as the accounting spinnor and Snack Food Company as the accounting spinnee.

3. Per EITF 02-11, paragraph 5, the issue is whether to account for a spinoff as a reverse spinoff based on the substance instead of the legal form of the transaction. In a reverse spinoff, the legal spinnee should be treated as though it were the spinnor for accounting purposes (accounting spinnor).

4. The FASB Emerging Issues Task Force reached the following consensus in paragraphs 7-8 of EITF 02-11:

> 7. The Task Force reached a consensus that reverse spinoff accounting is appropriate when treatment of the legal spinnee as the accounting spinnor results in the most accurate depiction of the substance of the transaction for shareholders and other users of the financial statements. The Task Force observed that the determination of

whether reverse spinoff accounting is appropriate is a matter of judgment that depends on an evaluation of all relevant facts and circumstances.
8. The Task Force reached a consensus that in determining whether reverse spinoff accounting is appropriate, a presumption should exist that a spinoff should be accounted for based on its legal form, in other words, that the legal spinnor is also the accounting spinnor. However, that presumption may be overcome. An evaluation of the following indicators should be considered in that regard. Nevertheless, no one indicator should be considered presumptive or determinative.

5. The FASB Emerging Issues Task Force identified the following indicators that a spinoff should be accounted for as a reverse spinoff in paragraph 8 of EITF 02-11:

- The size of the legal spinnor and the legal spinnee—All else being equal, in a reverse spinoff, the accounting spinnor (legal spinnee) is larger than the accounting spinnee (legal spinnor). The determination of which entity is larger is based on a comparison of the assets, revenues, and earnings of the two entities. There are no established "bright lines" that should be used to determine which entity is the larger of the two.

- The fair value of the legal spinnor and the legal spinnee—All else being equal, in a reverse spinoff, the fair value of the accounting spinnor (legal spinnee) is greater than that of the accounting spinnee (legal spinnor).

- Senior management—All else being equal, in a reverse spinoff, the accounting spinnor (legal spinnee) retains the senior management of the formerly combined entity. Senior management generally consists of the chairman of the board, chief executive officer, chief operating officer, chief financial officer, and those divisional heads reporting directly to them, or the executive committee if one exists.

- Length of time to be held—All else being equal, in a reverse spinoff, the accounting spinnor (legal spinnee) is held for a longer period than the accounting spinnee (legal spinnor). A proposed or approved plan of sale for one of the separate entities concurrent with the spinoff may identify that entity as the accounting spinnee.

INT 08-05 Discussion

6. The EITF consensus is that reverse spinoff accounting is appropriate when treatment of a legal spinnee as the accounting spinnor results in the most accurate depiction of the substance of the transaction for shareholders and other users of the financial statements. The Task Force observed that the determination of whether reverse spinoff accounting is appropriate is a matter of judgment that depends on an evaluation of all relevant facts and circumstances.

7. The Task Force consensus indicated that a presumption should exist that a spinoff should be accounted for based on its legal form (legal spinnor is the accounting spinnor); however that presumption can be overcome based on an evaluation of indicators that may suggest when a reverse spinoff exists (legal spinnee would be accounting spinnor).

8. In various instances within the statutory accounting guidelines, guidance is incorporated to promote accounting in accordance with the substance of transactions instead of their legal form. The Working Group reached a consensus to adopt EITF 02-11, indicating that reverse spinoff accounting is appropriate when treatment of a legal spinnee as the accounting spinnor results in the most accurate depiction of the substance of the transaction. In situations in which reverse spinoff accounting is judged to be most appropriate, this will result with the carrying value of the spinnee, instead of the spinnor, being utilized in determining the spinoff distribution to shareholders.

9. The following examples have been incorporated from EITF 02-11 to illustrate situations in which a spinoff should be accounted for in accordance with the legal form or as a reverse spinoff:

Example 1 - Retail Company, a retail store chain, has a wholly owned restaurant subsidiary. The retail and restaurant operations are operated independently with a small executive management team overseeing both. Since the two have unrelated operations, the shareholders believe that the two operations should be separated by way of a spinoff. They believe that this will allow those separate companies to pursue opportunities in their respective industries and maximize their individual value. In order to accomplish the spinoff, Retail Company creates a new legal entity, Restaurant Company, into which the assets and operations of the restaurant subsidiary are transferred. The shares of Restaurant Company are then distributed to the shareholders of Retail Company on a pro rata basis.

The executive management team of Retail Company will be divided between the two entities. A comparison of the two companies is presented below:

(In 000s)	Assets	Revenues	Net Income	Fair Value
Retail	$500	$410	$150	$675
Restaurant	$100	$ 75	$21	$170

Evaluation: Based on an analysis of the indicators in this example, the spinoff should be accounted for in accordance with its legal form. That is, the transaction should not be accounted for as a reverse spinoff. Retail Company should be designated as the accounting spinnor based on the first two indicators listed below.

- Retail Company has substantially larger operations than Restaurant Company.
- The fair value of Retail Company is greater than Restaurant Company.
- The management team is allocated between the two operations.
- There are no planned or likely disposals of either Retail Company or Restaurant Company.

The designation of Retail Company as the accounting spinnor will provide the most accurate depiction of the transaction to shareholders and other users of the financial statements because, in substance, Retail Company has spun off its Restaurant Company into a separate company.

Example 2 - Retail Company, a retail store chain, has a wholly owned restaurant subsidiary. The retail and restaurant operations are operated independently, with a small executive management team overseeing both. While the restaurant subsidiary has grown rapidly, the retail operations have deteriorated steadily due to increased competition. The shareholders believe that the two operations should be separated by way of a spinoff. Management intends to dispose of the retail operations. In order to accomplish the spinoff, Retail Company creates a new legal entity, Restaurant Company, into which the assets and operations of the restaurant subsidiary are transferred. The shares of Restaurant Company are then distributed to the shareholders of Retail Company on a pro rata basis.

The executive management team of the combined entity will be assigned primarily to Restaurant Company, as the intent is to dispose of Retail Company (now solely comprising the retail operations). A comparison of certain statistics of the two companies is presented below:

(In 000s)	Assets	Revenues	Net Income	Fair Value
Retail	$300	$210	$ 35	$375
Restaurant	$600	$450	$150	$700

Evaluation: Based on an analysis of the indicators in this example, the spinoff should be accounted for as a reverse spinoff. Restaurant Company, although the legal spinnee, should be designated as the accounting spinnor based on the following:

- Restaurant Company has substantially larger operations than Retail Company.
- The fair value of Restaurant Company is greater than that of Retail Company.
- The management team is primarily assigned to Restaurant Company.
- Management intends to dispose of Retail Company upon finalizing the spinoff.

The designation of Restaurant Company as the accounting spinnor will provide the most accurate depiction of the transaction to shareholders and other users of the financial statements, as, in substance, Retail Company has disposed of its retail operations and continued its restaurant operations.

INT 08-05 Status

10. No further discussion is planned.

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Interpretation of the Emerging Accounting Issues (E) Working Group

INT 09-08: Accounting for Loans Received Under the Federal TALF Program

INT 09-08 Dates Discussed

September 21, 2009; December 5, 2009; March 3, 2012; August 31, 2012

INT 09-08 References

Current:
SSAP No. 64—Offsetting and Netting of Assets and Liabilities
SSAP No. 103—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (SSAP No. 103)

Superseded:
SSAP No. 91R—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities – Revised

INT 09-08 Issue

1. In November 2008, the Federal Reserve announced the "Term Asset-Backed Securities Lending Facility" (TALF) Program as a means to make credit available to consumers and small businesses on more favorable terms by facilitating the issuance of asset-backed securities (ABS) and improving the market conditions for eligible ABS. (Newly issued ABS backed by commercial mortgage loans (CMBS) are TALF eligible as of June 2009. Legacy CMBS, or securities created prior to January 2009 are eligible as of July 2009.)

2. Under the TALF program, loan proceeds will be disbursed to the borrower, contingent on receipt by the New York Federal Reserve's custodian bank (custodian) of the eligible collateral, an administrative fee, and margin, if applicable. As the loan is non-recourse, if the borrower does not repay the loan, the New York Federal Reserve Bank will enforce its rights in the collateral and sell the collateral to a special purpose vehicle (SPV) established specifically for the purpose of managing such assets.

3. Unless further extended, issuance of new TALF loans will cease in March 2010, except for CMBS which end in June 2010. (This is an extension from the original end date of December 31, 2009.)

4. The accounting issue is whether TALF loans received and the corresponding collateral provided by the reporting entity shall be reported net within the statutory financial statements.

INT 09-08 Discussion

5. Guidance is included within *SSAP No. 64—Offsetting and Netting Assets and Liabilities* (SSAP No. 64). This guidance indicates that assets and liabilities shall be reported net only when a valid right of setoff exists. Under paragraph 2 of SSAP No. 64, a valid right of setoff exists only when all of the following conditions are met:

a. Each of the two parties owes the other determinable amounts. An amount shall be considered determinable for purposes of this provision when it is reliably estimable by both parties to the agreement;

b. The reporting party has the right to setoff the amount owed with the amount owed by the other party;

c. The reporting party intends to setoff; and

d. The right of setoff is enforceable by law.

6. Guidance in SSAP No. 64, paragraph 3 indicates that assets and liabilities that meet the criteria for offset shall not be netted when prohibited by specific statements of statutory accounting principles. Paragraph 4 of SSAP No. 64 specifies that the netting of assets and liability for reporting purposes when no valid right of setoff exists shall be allowed only when provided for by specific statements of statutory accounting principles.

7. In reviewing the criteria for setoff within SSAP No. 64, it would appear that the criteria within paragraph 2.a. of SSAP No. 64 is clearly met, as after the receipt of a TALF loan, the borrower and the New York Federal Reserve Bank would owe the other determinable amounts. Further, it would seem that the criteria in paragraph 2.d. of SSSAP No. 64 is also met, as if the reporting entity did not repay the loan, the New York Federal Reserve Bank has the ability to enforce its rights in the collateral and sell the collateral to a special purpose vehicle (SPV) established specifically for the purpose of managing such assets.

8. However, the conditions in paragraphs 2.b. and 2.c. of SSAP No. 64 are not considered to be met, and prohibit a net presentation. Paragraph 2.b. requires the reporting entity to have a right to setoff the amount owed. Although a default on the loan repayment will trigger an eventual setoff of the collateral and TALF loan, the ability to default on the loan is not considered a "right to setoff" by the reporting entity. Additionally, it is presumed that a reporting entity enters into these loans with the intention of repaying the loan and recapturing collateral. Thus, the provision of paragraph 2.c., which requires an intent of the reporting party to setoff, is also not met.

9. In considering whether a provision should be incorporated within a specific statutory accounting principle to permit netting, although no valid right of setoff exists, it is noted that guidance for collateral is included within *SSAP No. 103—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (SSAP No. 103). Pursuant to guidance within this SSAP, unless the transferor defaults on the secured contract, the transferor shall continue to carry the collateral as an asset. It is only after default that the reporting entity would remove the collateral as an asset, with a corresponding reduction to the liability. It is noted that a specific provision for TALF loans would be inconsistent with existing SSAP No. 103 guidance for the reporting of loans and collateral.

10. Pursuant to the existing statutory accounting guidance for offsetting and the reporting of collateral, the Working Group reached a consensus that loans received, and collateral provided, under the TALF program do not meet the SSAP No. 64 criteria for offset. Furthermore, no specific provision shall be established within statutory accounting principles that permit a net reporting presentation for transactions under the TALF program. Loans received and collateral provided under the TALF program shall be reported separately, on a gross basis, until time of default on the received loan. At time of default, the collateral claimed by the New York Federal Reserve Bank shall be removed from the reporting entity's balance sheet, with a corresponding reduction of the liability established for the TALF loan. For annual statement reporting, asset-backed securities provided as collateral under the TALF program shall continue to be reported in the same category as previously reported and would not be moved to the U.S. Government category. For example, Industrial and Misc. securities would continue to be reported in the industrial and miscellaneous category and not as government securities.

INT 09-08 Status

11. No further discussion planned.

Interpretation of the Emerging Accounting Issues (E) Working Group

INT 13-03: Clarification of Surplus Deferral in SSAP No. 92 & SSAP No. 102

INT 13-03 Dates Discussed
November 20, 2013, and December 15, 2013

INT 13-03 References

Current:
SSAP No. 92—Accounting for Postretirement Benefits Other Than Pensions
SSAP No. 102—Accounting for Pensions

INT 13-03 Issue

1. In March 2012, the Statutory Accounting Principles (E) Working Group finalized SSAP No. 92 and SSAP No. 102 to adopt with modification GAAP guidance pertaining to pensions and postretirement benefit obligations other than pensions. As a result of the accounting guidance, and potential impact to surplus reflected in both SSAPs, the Working Group adopted transition guidance that allowed a surplus deferral for a period not to exceed ten years.

2. Per the surplus deferral provisions within the SSAPs, the deferral option was not intended to allow a surplus benefit to be recognized at initial transition for an unfunded plan. Additionally, the SSAPs required a minimum amount of the deferred liability to be subsequently recognized under the deferral option to cover the annual amortization of the "unrecognized items" into net periodic cost and prevent a surplus benefit.

3. The SSAPs also incorporated guidance to indicate that the reporting entities must recognize remaining transition liability to the extent that the plan reflects a prepaid benefit cost, with an example that if changes in circumstances resulted with the plan reflecting an overfunded status; the remaining transition liability must be recognized to the extent the plan is overfunded. Furthermore, the guidance indicated that if circumstances resulted with a subsequent gain attributed to the plan that would be recognized in earnings, the entity must recognize an additional amount of the remaining transition liability to offset the recognized gain.

4. Due to the current market environment resulting with increases in the fair value of plan assets and/or changes in discount rates that have reduced the projected obligations for pension and OPEB plans, questions have been received as to whether the reduction in pension or OPEB liabilities on the balance sheet, resulting in more favorable surplus positions related to the pension/OPEB plans, should be permitted when there are remaining unrecognized liabilities from the surplus deferral elected at transition of SSAP No. 92 and SSAP No. 102. These questions often refer to the current guidance in the SSAPs, which provide the example of a plan being in an overfunded state, or that the gain is recognized in earnings, as criteria for when an additional amount of the remaining transition liability is needed to offset the recognized gain. As the changes in fair value or discount rates (and other changes such as curtailments or settlements) may not result in an overfunded plan, and may not be recognized in earnings, there is uncertainty with regards to the application of the guidance.

5. The accounting issue is whether a surplus benefit was intended to result from pension/OPEB changes or activities when an unrecognized pension/OPEB transition liability continues to exist.

INT 13-03 Discussion

6. The Working Group reached a consensus that the existing explicit guidance highlighting the intent to prevent a surplus benefit reflects the original objective of the surplus deferral guidance in SSAP No. 92 and SSAP No. 102. As such, the guidance in SSAP No. 92 and SSAP No. 102 was not intended (on a net basis for each plan) to result in more favorable, subsequent surplus pension/OPEB positions when there are remaining unrecognized liabilities as a result of the reporting entity's initial election for surplus deferral.

7. In accordance with this consensus, if there is a plan curtailment, settlement, or other plan amendment resulting in a reduction of benefit obligations, or net benefit obligation gains due to revisions in assumptions (e.g., discount rates) or plan experience differing from assumptions, or plan asset gains due to the actual return on plan assets exceeding the expected return on plan assets, a corresponding amount of unrecognized liability from the surplus deferral shall be recognized. For this purpose, net gains, if any, are the net aggregation of all gains and losses (excluding plan amendments that increase benefit obligations) from factors such as those listed above, determined as of a measurement or remeasurement date. This shall occur regardless if the impact from the change results with the plan being in an overfunded state, or whether the gain is recognized in earnings. The Working Group agrees that the intent of the original guidance was to provide surplus relief from the immediate surplus impact from adopting SSAP No. 92 and SSAP No. 102, but that in no instances should changes (on a net basis for each plan) attributed to pension or OPEB plans result in more favorable, subsequent surplus positions when there are unrecognized liabilities remaining as a result of the reporting entity's initial election for surplus deferral.

INT 13-03 Status

8. No further discussion anticipated.

NAIC

National Association of Insurance Commissioners

Accounting Practices and Procedures Manual

As of March 2015

Volume II

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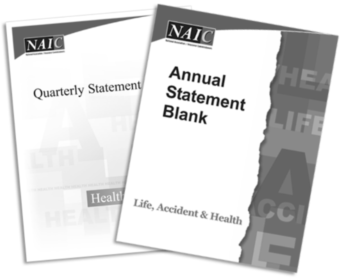

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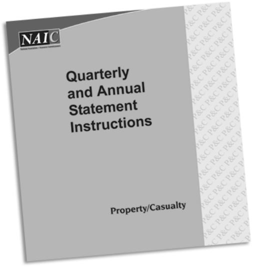

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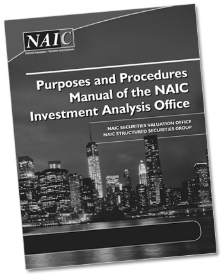

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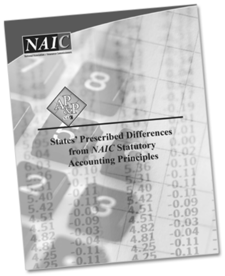

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DEDICATION

The *Accounting Practices and Procedures Manual* is dedicated to Norris Clark, California Department of Insurance (retired), Chair of the Codification of Statutory Accounting Principles Working Group, and its successors, the Statutory Accounting Principles and Emerging Accounting Issues (E) Working Groups from September 1994 through July 2004, and to Joseph Fritsch, New York Department of Financial Services (retired), Chair of the Statutory Accounting Principles (E) Working Group from 2004 through December 2012.

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

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Completely superseded SSAPs and nullified interpretations (INTs) are removed from the printed *Accounting Practices and Procedures Manual* and posted on the "Updates to the Accounting Practices and Procedures Manual" password-protected webpage (www.naic.org/committees_e_app_manual_updates.htm). These items are also included in Appendix H – Superseded SSAPs and Nullified Interpretations within the *Accounting Practices and Procedures Manual* Folio View CD-ROM.

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How to Use This Manual

The contents of this manual are arranged as follows:

Volume I:

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- Appendix E – Issue Papers 76-150
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- Appendix G – Implementation Guide for the Model Audit Rule
- Appendix H – Superseded SSAPs and Nullified Interpretations (This appendix is no longer included within the printed Manual but is still accessible within the AP&P Folio View CD-ROM and on the "Updates to the Accounting Practices and Procedures (AP&P) Manual" webpage, www.naic.org/committees_e_app_manual_updates.htm).

The arrangement of material as indicated above is included in the Table of Contents at the front of each Volume. A detailed Table of Contents also proceeds each section covering the material within.

Summary of Changes:

This section provides a summary of the changes that were made to the As of March 2014 version of the *Accounting Practices and Procedures Manual* to create the As of March 2015 version. This is divided into substantive revisions to statutory accounting principles, nonsubstantive revisions to statutory accounting principles, and revisions to the appendices included in the Manual. This is a key resource for users who are looking to identify changes from the prior edition.

Preamble:

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

Statements of Statutory Accounting Principles:

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

changes to the SSAPs. Completely superseded SSAPs are no longer authoritative and have been removed from the printed Manual but are available for reference on the "Updates to the Accounting Practices and Procedures (AP&P) Manual" webpage (www.naic.org/committees_e_app_manual_updates.htm). The completely superseded SSAPs have been retained in Appendix H – Superseded SSAPs and Nullified Interpretations within the AP&P Folio View CD-ROM.

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

> TYPE OF ISSUE – SSAPs designated as Common Area apply to all insurers. Although the nomenclature or terms provided in the prescribed annual statement forms may vary among different types of insurers, only one set of nomenclature or terms may have been used in the SSAP. For example, the Statement of Income found in the Property and Casualty Annual Statement shall be considered as synonymous with the Summary of Operations found in the Life and Health Annual Statement.
>
> ISSUED – Date when the SSAP was adopted by the NAIC. SSAPs designated with Initial Draft were adopted by the NAIC Plenary in March 1998 as part of the Codification Project (SSAP Nos. 1-73). The date included for SSAP No. 74, and subsequent SSAPs, denotes when the Statutory Accounting Principles (E) Working Group adopted the SSAP.
>
> EFFECTIVE DATE – Date representing when the SSAP is effective. Many times there are additional details relative to the transition provided within the SSAP.
>
> AFFECTS/AFFECTED BY – A useful tool for tracking relationships between statements and interpretations is contained within these sections. The "affects" section is used when a SSAP substantively amends or supersedes previously issued SSAPs. Nullified INTs are also noted in this section. Readers are referenced to another SSAP in the "affected by" section if the SSAP has been substantively amended or superseded. Text within paragraphs substantively amended or superseded may also be "shaded" to notify readers that revised guidance is available.
>
> INTERPRETED BY – This section includes a reference to the applicable Interpretation (INT) of the Emerging Accounting Issues (E) Working Group contained within Appendix B of the Manual which provides interpretative guidance as a result of issues raised by users of the Manual or related GAAP guidance. INTs are generally effective when adopted. Readers should note that the Manual only contains the INTs finalized through December 2014 due to the fact that the Manual is published annually. Readers may use the NAIC website, as indicated on the inside front cover of the Manual, to keep abreast of recently issued INTs.

Refer to the Relevant Literature and Effective Date and Transition sections of the SSAP for details of substantive and nonsubstantive changes.

Appendix A – Excerpts of NAIC Model Laws:

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

Appendix B – Interpretations of the Emerging Accounting Issues (E) Working Group:

The Emerging Accounting Issues (E) Working Group (EAIWG) is responsible for responding to SAP questions that generally relate to application, interpretation and clarification. Appendix B includes the final interpretations of the EAIWG through December 2014. Once an INT is

finalized, the related SSAP will contain reference to the applicable INT. Interpretations that have been nullified are removed from the printed Manual and posted for reference on the "Updates to the Accounting Practices and Procedures (AP&P) Manual" webpage (www.naic.org/committees_e_app_manual_updates.htm). The nullified INTs are retained in Appendix H – Superseded SSAPs and Nullified Interpretations within the AP&P Folio View CD-ROM.

Appendix C – Actuarial Guidelines:

The NAIC Life Actuarial (A) Task Force and Health Actuarial (B) Task Force have been asked on many occasions to assist a particular state insurance department in interpreting a statute dealing with an actuarial topic relative to an unusual policy form or situation not contemplated at the time of original drafting of a particular statute. The Life Actuarial (A) Task Force and Health Actuarial (B) Task Force, in developing interpretations or guidelines, must often consider the intent of the statute, the reasons for initially adopting the statute and the current situation. The Life Actuarial (A) Task Force and Health Actuarial (B) Task Force feel that for those situations which are sufficiently common to all states, the publishing of actuarial guidelines on these topics would be beneficial to the regulatory officials in each state and would promote uniformity in regulation which is beneficial to everyone. To this end, the Life Actuarial (A) Task Force and Health Actuarial (B) Task Force have developed certain actuarial guidelines and will continue to do so as the need arises. The guidelines are not intended to be viewed as statutory revisions but merely a guide to be used in applying a statute to a specific circumstance.

Appendix D – GAAP Cross-Reference to SAP:

As expressed in the Statement of Concepts, SAP utilizes the framework established by Generally Accepted Accounting Principles (GAAP). Appendix D includes GAAP pronouncements that have been considered in the development of SAP. This listing includes GAAP pronouncements issued through December 2014. This Appendix is a valuable and efficient tool for readers who are interested in the status of a particular GAAP pronouncement in the SAP model.

Appendix E – Issue Papers:

This section includes all of the issue papers associated with SSAPs adopted by the Statutory Accounting Principles (E) Working Group through December 2014. The issue papers are used as the first step in developing new SSAPs and contain a recommended conclusion, discussion and relevant literature section. Issue papers **DO NOT** constitute an authoritative level of statutory accounting, as supported by the statutory hierarchy, and should only be used as reference material. Nevertheless, issue papers are an important part of the Manual because they reference the history and discussion of the related SSAP. The "Relevant Statutory Accounting and GAAP Guidance" section of the issue paper contains excerpts of accounting guidance in place at the time the Statutory Accounting Principles (E) Working Group considered (but not necessarily adopted) when forming the conclusions reached in the resultant SSAP.

Appendix F – Policy Statements:

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

Appendix G – Implementation Guide for Model Audit Rule:

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

Appendix H – Completely Superseded SSAPs and Nullified Interpretations

In 2013, the Statutory Accounting Principles (E) Working Group adopted a proposal to remove completely superseded SSAPs and nullified interpretations (INTs) from the printed Manual and

include these items on the "Updates to the Accounting Practices and Procedures (AP&P) Manual" webpage (www.naic.org/committees_e_app_manual_updates.htm). By including on this password-protected updates page, all who annually subscribe to the printed *Accounting Practices and Procedures Manual* will continue to have access to the superseded and nullified guidance for historical purposes. The completely superseded SSAPs and nullified INTs have been retained in Appendix H – Superseded SSAPs and Nullified Interpretations within the AP&P Folio View CD-ROM.

How to Use this Manual …

... to account for a certain item under NAIC SAP

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

... to compare SAP to GAAP for a particular issue

Appendix D is an excellent reference for users who are interested in determining how SAP addresses an issue that has been adopted by GAAP. Appendix D provides a reference to the SSAP or INT that addresses a particular GAAP pronouncement. As indicated in the Preamble, users should not utilize GAAP until and unless adopted by the NAIC. Within the body of the applicable SSAP or INT, readers will find documentation as to the reason for adoption, rejection, or adoption with modification of a particular GAAP pronouncement.

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

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

... to obtain updates to the latest published Manual

The Manual contains information as of December 2014. Please note that there will be modifications to the accounting pronouncements included in the Manual from year to year, as such guidance is subject to the maintenance process. To address this, the NAIC has a website dedicated to providing updates on the latest information impacting statutory accounting. A user must pre-order the As of March 2016 Manual in order to obtain access to the changes occurring during 2015 that are maintained within this password-protected website. Once access is granted, a user may enter the website and download an issue paper, statement of statutory accounting principles, appendix or interpretation that affects the Manual. This website also includes the latest minutes of the Statutory Accounting Principles (E) Working Group and Emerging Accounting Issues (E) Working Group. To learn more about how to obtain updates to the latest published Manual, refer to the Maintenance Process page, which precedes the Table of Contents.

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

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

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

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

Name	**Title**	**Issue**	**Phone**	**Email**
Julie Gann	Sr. Manager Accounting and Reporting	Statutory Accounting and Reporting	(816) 783-8966	jgann@naic.org
Robin Marcotte	Sr. Manager Accounting and RBC	Statutory Accounting and Reporting	(816) 783-8124	rmarcotte@naic.org
Josh Arpin	Accounting and Reinsurance Policy Advisor	Statutory Accounting Reinsurance	(816) 783-8481	jarpin@naic.org
SVO		SVO P&P Manual	(212) 398-9000	SVOinquirydesk@naic.org
Statutory Accounting & Reporting Help Line		Annual Statement Reporting & Statutory Accounting	(816) 783-8400	

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Summary of Changes to the *As of March 2014 Version* of the *Accounting Practices and Procedures Manual* included in the *As of March 2015 Version*

The following represents a summary of the changes that were made to the *As of March 2014* version of the *Accounting Practices and Procedures Manual* (Manual) to create the *As of March 2015* version.

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

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

The third section summarizes any revisions to the appendices in the Manual.

1. Substantive Revisions – Statutory Accounting Principles		
Section	**Reference**	**Description**
SSAP No. 40R SSAP No. 48	2013-17	Revisions related to wholly-owned single real estate held in an LLC, which meets specific conditions, with an effective date of Jan. 1, 2015.
SSAP No. 106 SSAP No. 35R	2014-01 2014-13	New SSAP moves guidance on the Affordable Care Act Section 9010 from SSAP No. 35R and includes nonsubstantive edits to the disclosures.
SSAP No. 107 SSAP No. 35R	2014-12 2013-28	New SSAP addresses the risk-sharing provisions of the Affordable Care Act known as risk adjustment, reinsurance and risk corridors. With this adoption, the disclosures previously located within SSAP No. 35R are moved to this SSAP and INT 13-04 is nullified.
2. Nonsubstantive Revisions – Statutory Accounting Principles		
Section	**Reference**	**Description**
Preamble	2013-35	Revisions clarify that as of Sept. 15, 2009, AICPA SOPs will no longer be reviewed for statutory accounting.
SSAP No. 1 SSAP No. 4	2014-16	Revisions clarify the guidance for restricted assets.
SSAP No. 3 SSAP No. 68	2013-29	Revisions clarify that the disclosure exemption for mergers with shell entities does not change the Jan. 1 date to determine the cumulative effect in accounting principle.
SSAP No. 11	2014-07	Revisions identify the adoption of specific paragraphs from *Accounting Principles Board Opinion (APB) 12, Omnibus Opinion – 1967* and add guidance to reflect previously adopted GAAP, with minor technical edits.
SSAP No. 16R	2014-04	Revisions make the capitalization policy disclosure consistent with other SSAPs.

SSAP No. 19 SSAP No. 22	2014-05	Revisions adopt with modification *ASU 2014-05–Service Concession Arrangements* to clarify that service concession arrangements are not within the scope of SSAP No. 22 and shall not be recognized as property, plant or equipment in SSAP No. 19.
SSAP No. 26 SSAP No. 43R	2014-02	Revisions incorporate a new “structured note” disclosure and clarify that the guidance in SSAP No. 43R pertains to structured securities, not structured notes.
SSAP No. 35R	2013-28	Revisions include disclosures pertaining to the risk-sharing provisions of the Affordable Care Act programs (risk adjustment, reinsurance and risk corridors). These disclosures were subsequently moved to SSAP No. 107.
SSAP No. 55	2014-19	Revisions clarify that claims-related losses for extra contractual obligations and bad faith lawsuits are to be included in losses. Also, technical revisions related to prepaid adjustment expenses.
SSAP No. 56	2014-18	Revisions clarify the reporting of separate accounts disclosures.
SSAP No. 57	2014-06	Revisions to the disclosure requirements, with corresponding terminology revisions.
SSAP No. 86	2013-32	Revisions adopt *ASU 2013-10–Inclusion of the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) as a Benchmark Interest Rate for Hedge Accounting Purposes.* This ASU defines a benchmark interest rate and eliminates the restriction on different rates for similar hedges.
	2014-09	Revisions reject *ASU 2014-03–Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps—Simplified Hedge Accounting Approach (PCC)* as not applicable.
	2014-11	Revisions clarify the reporting of derivatives between Schedule DB and the balance sheet.
SSAP No. 92 SSAP No. 102	2013-37	Revisions adopt by reference *ASU 2011-09–Disclosures about an Employer’s Participation in a Multiemployer Plan* and incorporate limited additional disclosures for multiemployer plans.
SSAP No. 97	2013-31	Revisions add reference in Appendix B – Determining the Valuation Method, to the SSAP’s downstream holding company guidance.
SSAP No. 101	2014-20	Revisions clarify the RBC authorized control level used in the DTA calculation.
SSAP No. 104R	2014-17	Revisions adopt *ASU 2014-12–Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period* with an effective date of Jan. 1, 2016, with early adoption permitted.

3. Revisions to the Appendices

Section	Reference	Description
Appendix A	2014-21	Revisions incorporate changes to *Appendix A-010: Minimum Reserve Standards for Individual and Group Health Insurance Contracts* to allow the 2012 Group Long-Term Disability Table adopted by the Health Actuarial (B) Task Force with a Jan. 1, 2017, effective date and early adoption permitted.

Appendix B	2013-04 (EAIWG) 2014-12 (SAPWG) 2014-26 (SAPWG)	*INT 13-04: Accounting for the Risk-Sharing Provisions of the Affordable Care Act* was adopted to provide temporary guidance on the risk-sharing provisions. This INT was subsequently nullified by SSAP No. 107 and moved to Appendix H. Placement revisions move GAAP guidance identified as rejected from INT 99-00 into Issue Paper No. 99. INT 99-00 was nullified and moved to Appendix H.
Appendix C	2014-22	*Actuarial Guideline XLVII: Application of Company Experience in the Calculation of Claim Reserves Under the 2012 Group Long-Term Disability Valuation Table* has been added. *Actuarial Guideline XLVIII: Actuarial Opinion and Memorandum Requirements for the Reinsurance of Policies Required to be Valued Under Sections 6 and 7 of the NAIC Valuation of Life Insurance Policies Model Regulation* (Model 830) has been added. Actuarial Interpretations 38 through 41 have been added to Appendix C2.
Appendix D	2013-35	Revisions update the appendix based on the consideration of GAAP through the statutory review process. These revisions are not tracked as changes. Additionally, revisions clarify that as of Sept. 15, 2009, AICPA SOPs will no longer be reviewed for statutory accounting.
Appendix E	2013-34 2014-03 2014-14 2013-35 2014-26 2014-08 2014-01 2014-13 2013-17 2014-12	Revisions reflect the rejection of the following GAAP guidance as not applicable to statutory accounting in *Issue Paper No. 99—Nonapplicable GAAP Pronouncements* (Issue Paper No. 99): • *ASU 2012-04–Technical Corrections and Improvements* • *ASU 2013-12–Definition of a Public Business Entity, An Addition to the Master Glossary* • *ASU 2014-10–Development Stage Entities* • *SOP 09-1–Performing Agreed-Upon Procedures Engagements That Address the Completeness, Accuracy, or Consistency of XBRL-Tagged Data* Placement revisions move GAAP guidance identified as rejected from INT 99-00 into Issue Paper No. 99. Additionally, revisions add reference of the original SSAP that corresponds with each issue paper, as well as the current authoritative SSAP guidance. The following issue papers were adopted or amended: • *Issue Paper No. 148—Affordable Care Act Section 9010 Assessment* • *Issue Paper No. 149—Wholly-Owned Single Real Estate Property in an LLC* • *Issue Paper No. 150—Accounting for the Risk-Sharing Provisions of the Affordable Care Act*
Appendix F	N/A	No revisions have been made to this appendix.
Appendix G	N/A	No revisions have been made to this appendix.
Appendix H	2014-26 2013-04 (EAIWG) 2014-12 (SAPWG)	Revisions add nullified INTs: • *INT 99-00: Compilation of Rejected EITFs* • *INT 13-04: Accounting for the Risk-Sharing Provisions of the Affordable Care Act*

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Appendix C
Actuarial Guidelines

Introduction

The NAIC Life Actuarial (A) Task Force and the Health Actuarial (B) Task Force, formerly known as the Life and Health Actuarial Task Force, have been asked on many occasions to assist a particular state insurance department in interpreting a statute dealing with an actuarial topic relative to an unusual policy form or situation not contemplated at the time of original drafting of a particular statute. The Life Actuarial (A) Task Force and the Health Actuarial (B) Task Force, in developing an interpretation or guideline, must often consider the intent of the statute, the reasons for initially adopting the statute and the current situation. The Life Actuarial (A) Task Force and the Health Actuarial (B) Task Force feel that for those situations which are sufficiently common to all states, that the publishing of actuarial guidelines on these topics would be beneficial to the regulatory officials in each state and would promote uniformity in regulation which is beneficial to everyone. To this end, the Life Actuarial (A) Task Force and the Health Actuarial (B) Task Force have developed certain actuarial guidelines and will continue to do so as the need arises. The guidelines are not intended to be viewed as statutory revisions but merely a guide to be used in applying a statute to a specific circumstance.

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Appendix C

Actuarial Guidelines

Guideline No.	Description	Date Adopted By NAIC	Interpretation of	Revision of Earlier Guideline
I	Valuation of Policies in Which the Net Premium Exceeds Gross Premium	Dec. 1978	Standard Valuation Law	No
II	Valuation of active life Funds Held Relative to Group Annuity Contracts	Dec. 1978	Standard Valuation Law	No
III	Definition of the term "Maturity Value" in the Standard Nonforfeiture Law for Individual Deferred Annuities	Dec. 1978	Standard Nonforfeiture Law for Individual Deferred Annuities	No
IV	Minimum Reserves for Certain Forms of Term Insurance	Dec. 1984	Standard Valuation Law	Yes
V	Acceptable Approximations For Continuous Functions	Dec. 1979	Standard Valuation and Nonforfeiture Laws	No
VI	Interpretation Regarding Use of Single or Joint Life Mortality Tables	Dec. 1979	Standard Valuation and Standard Nonforfeiture Law for Life Insurance	Yes
VII	Calculation of Equivalent Level Amounts	Dec. 1979	Standard Valuation and Nonforfeiture Laws	No
VIII	The Valuation of Individual Single Premium Deferred Annuities	Dec. 1980	Standard Valuation Law	No
IX	Form Classification of Individual Single Premium Annuities for Application of the Valuation and Nonforfeiture Laws	June 1981	Standard Valuation Law and Standard Nonforfeiture Law for Individual Deferred Annuities	No
IX-A	Use of Substandard Annuity Mortality Tables in Valuing Impaired Lives Under Structured Settlements	June 1989	Standard Valuation Law	No
IX-B	Clarification of methods for immediate and deferred annuities and structured settlement contracts	Dec. 1988	Standard Valuation Law	No
IX-C	Use of Substandard Annuity Mortality Tables in Valuing Impaired Lives Under Individual Single Premium Immediate Annuities	March 2001	Standard Valuation Law	No
X	Guideline for Interpretation of NAIC Standard Nonforfeiture Law for Individual Deferred Annuities	Dec. 1981	Standard Nonforfeiture Law for Individual Deferred Annuities	No

Actuarial Guidelines

Guideline No.	Description	Date Adopted By NAIC	Interpretation of	Revision of Earlier Guideline
XI	Effect of an Early Election by an Insurance Company of an Operative Date under Section 5-C of the Standard Nonforfeiture Law for Life Insurance	Dec. 1982	Standard Nonforfeiture Law for Life Insurance	No
XII	Interpretation Regarding Valuation and Nonforfeiture Interest Rates	June 1983 Withdrawn March 1993	Standard Valuation Law and Standard Nonforfeiture Law for Life Insurance	No
XIII	Guideline Concerning the Commissioners' Annuity Reserve Valuation Method	March 1985	Standard Valuation Law	No
XIV	Surveillance Procedure Regarding the Actuarial Opinion for Life and Health Insurers	Dec. 1985	Instructions for Financial Examiners	No
XV	Illustrations Guideline for Variable Life Insurance Model Regulation	June 1986	Variable Life Insurance Model Regulation	No
XVI	Guideline for Calculation of Commissioners' Reserve Valuation Method on Select Mortality and/or Split Interest	Dec. 1986	Standard Valuation Law	No
XVII	Guideline for Calculation of Commissioners' Reserve Valuation Method Reserves When Death Benefits are Not Level	Dec. 1986	Standard Nonforfeiture Law for Life Insurance	No
XVIII	Guideline for Calculation of Commissioners' Reserve Valuation Method Reserves on Semi-Continuous, Fully Continuous or Discounted Continuous Basis	Dec. 1986	Standard Valuation Law	No
XIX	Guideline Concerning 1980 Commissioners' Standard Ordinary Mortality Table With 10-Year Select Mortality Factors	Dec. 1986	NAIC Procedure for Permitting Same Minimum Nonforfeiture Standards for Men and Women Insured Under 1980 CSO and 1980 CET Mortality Tables Model Regulation	No
XX	Guideline Concerning Joint Life Functions for 1980 Commissioners' Standard Ordinary Mortality Table	Dec. 1986	Standard Valuation Law	No

Actuarial Guidelines

Guideline No.	Description	Date Adopted By NAIC	Interpretation of	Revision of Earlier Guideline
XXI	Guideline Calculation of CRVM Reserves When (b) is Greater Than (a)	June 1987	Standard Valuation Law	No
XXII	Interpretation Regarding Nonforfeiture Values for Policies With Indeterminate Premiums	June 1987	Standard Nonforfeiture Law for Life Insurance	No
XXIII	Guideline Concerning Variable Life Insurance Separate Account Investments	June 1987	Variable Life Insurance Model Regulation	No
XXIV	Guideline for Variable Life Nonforfeiture Values	June 1987	Standard Nonforfeiture Law For Life Insurance and Variable Life Insurance Model Regulation	No
XXV	Guidelines for Calculation of Minimum Reserves and Minimum Nonforfeiture Values for Policies with Guaranteed Increasing Death Benefits Based on an Index	Oct. 2010	Standard Valuation Law	Yes
XXVI	Guideline for Election of Operative Dates under Standard Valuation Law and Standard Nonforfeiture Law	Dec. 1989	Standard Valuation Law Standard Nonforfeiture Law	No
XXVII	Actuarial Guidelines for Accelerated Benefits	June 1991	Standard Valuation Law Standard Nonforfeiture Law	No
XXVIII	Statutory Reserves for Group Long-Term Disability Contracts Within a Survivor Income Benefit Provision	Dec. 1991	Standard Valuation Law Minimum Reserve Standards for Individual and Group Health Insurance Contracts	No
XXIX	Guidelines Concerning Reserves of Companies in Rehabilitation	Dec. 1992	Standard Valuation Law	No
XXX	Guidelines for Application of Plan Type to Guaranteed Interest Contracts (GICs) with Benefit Responsive Payment Provisions Used to Fund Employee Benefit Plans	Dec. 1992	Standard Valuation Law	No
XXXI	Valuation Issues vs. Policy Form Approval	Dec. 1992	Standard Valuation Law	No
XXXII	Reserve for Immediate Payment of Claims	Dec. 1993	Standard Valuation Law	No

Actuarial Guidelines

Guideline No.	Description	Date Adopted By NAIC	Interpretation of	Revision of Earlier Guideline
XXXIII	Determining CARVM Reserves for Annuity Contracts with Elective Benefits	Dec. 2009	Standard Valuation Law	Yes
XXXIV	Variable Annuity Minimum Guaranteed Death Benefit Reserves	Dec. 2003 (repealed effective Dec. 30, 2009)	Standard Valuation Law	Yes
XXXV	The Application of the Commissioners Annuity Reserve Method to Equity Indexed Annuities	Dec. 1998	Standard Valuation Law	No
XXXVI	The Application of the Commissioners Reserve Valuation Method to Equity Indexed Life Insurance Policies	June 2000	Standard Valuation Law	No
XXXVII	Variable Life Insurance Reserves for Guaranteed Minimum Death Benefits	Oct. 2001	Standard Valuation Law	No
XXXVIII	The Application of the Valuation of Life Insurance Policies Model Regulation (“Model”)	Sept. 2012	The Valuation of Life Insurance Policies Model Regulation	Yes
XXXIX	Reserves for Variable Annuities with Guaranteed Living Benefits	Sept. 2008 (effective until Dec. 30, 2009)	Standard Valuation Law	Yes
XL	Guideline for Valuation Rate of Interest for Funding Agreements and Guaranteed Interest Contracts (GICs) with Bail-Out Provisions	Sept. 2003	Standard Valuation Law	No
XLI	Projection of Guaranteed Nonforfeiture Benefits under CARVM	June 2006	Standard Valuation Law and Standard Nonforfeiture Law for Individual Deferred Annuities	No
XLII	The Application of the Model Regulation Permitting the Recognition of Preferred Mortality Tables for Use in Determining Minimum Reserve Liabilities	Sept. 2007	Model Regulation Permitting the Recognition of Preferred Mortality Tables for Use in Determining Minimum Reserve Liabilities	No
XLIII	CARVM for Variable Annuities	March 2010	Standard Valuation Law	Yes
XLIV	Group Term Life Waiver of Premium Disabled Life Reserves	Dec. 2008	Standard Valuation Law	No

Actuarial Guidelines

Guideline No.	Description	Date Adopted By NAIC	Interpretation of	Revision of Earlier Guideline
XLV	The Application of the Standard Nonforfeiture Law for Life Insurance to Certain Policies Having Intermediate Cash Benefits	Dec. 2008	Standard Nonforfeiture Law	No
XLVI	Interpretation of the Calculation of the Segment Length with Respect to the Life Insurance Policies Model Regulation upon a Change in the Valuation Mortality Rates Subsequent to Issue	Sept. 2009	The Valuation of Life Insurance Policies Model Regulation	No
XLVII	The Application of Company Experience in the Calculation of Claim Reserves Under the 2012 Group Long-Term Disability Valuation Table	Nov. 2014	The Health Insurance Reserves Model Regulation	No
XLVIII	Actuarial Opinion and Memorandum Requirements for the Reinsurance of Policies Required to be Valued under Sections 6 and 7 of the NAIC Valuation of Life Insurance Policies Model Regulation (Model 830)	Dec. 2014	The Valuation of Life Insurance Policies Model Regulation	No

Actuarial Guideline I

INTERPRETATION OF THE STANDARD VALUATION LAW RESPECT TO THE VALUATION OF POLICIES WHOSE VALUATION NET PREMIUMS EXCEED THE ACTUAL GROSS PREMIUM COLLECTED

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

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

3. For policies so valued the maximum permissible valuation interest rate and the applicable mortality basis specified is that in effect at the date of issue of such policies.

Actuarial Guideline II

RESERVE REQUIREMENTS WITH RESPECT TO INTEREST RATE GUIDELINES ON ACTIVE LIFE FUNDS HELD RELATIVE TO GROUP ANNUITY CONTRACTS

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

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

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

For funds receive:

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

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

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

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

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

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

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

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

i_{py} = Lowest of:

(1) The net new money rate credited by the company on group annuity funds attributable to contributions received in calendar year y less .005; or

(2) i_{gy}; or

(3) i_{my}; where

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

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

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

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

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

Table of Values of i_{my}

(Effective for the December 31, 1977 Valuation)

Calendar Year y in Which Contributions Were Received	Value of i_{my} for Calendar Years y + 1 Through y + 10
1976	.089
1977	.087
1978	.081
1979	.084
1980	.100
1981	.124
1982	.145

Actuarial Guideline III

INTERPRETATION OF MINIMUM CASH SURRENDER BENEFIT UNDER STANDARD NONFORFEITURE LAW FOR INDIVIDUAL DEFERRED ANNUITIES

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

For contracts providing cash surrender values, the cash surrender value at maturity shall be at least equal to the minimum nonforfeiture amount at maturity as defined in Section 4. For purposes of calculating cash surrender values prior to maturity, the term “maturity value” in the Standard Nonforfeiture Law for Individual Deferred Annuities shall mean the cash surrender value at maturity.

Actuarial Guideline IV

ACTUARIAL INTERPRETATION REGARDING MINIMUM RESERVES FOR CERTAIN FORMS OF TERM LIFE INSURANCE

Scope

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

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

Background Information

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

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

and

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

Acceptable Approaches

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

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

> The question was raised whether a policy providing term insurance for several years, automatically followed by permanent insurance, should be considered as two separate policies for the purpose of the Act. In the Committee's opinion, the respective portions may be treated separately if the portion providing permanent insurance takes the Company's regular rate at the then attained age. The rated age provision in the law appears to cover this point. However, the Committee draws a distinction between policies providing purely term insurance followed by permanent insurance at the company's published rate at the attained age of conversion, and the policies providing for an initial premium such that the increased premium at a subsequent duration differs from that for a new policy at the attained age. The latter case obviously constitutes a single policy to which the formula should be applied at the outset[3]

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

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

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

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

Reinsured Business

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

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

Adequacy of Reserves

Although the above alternative is acceptable as meeting the intent of the Standard Valuation Law, this does not in any way relieve the certifying actuary of the insurance company from exercising his own best judgment with respect to the appropriate reserves. In particular, the actuary should consider term contracts of this nature when he states his opinion that aggregate reserves "make a good and sufficient provision for all unmatured obligations of the company guaranteed under the terms of its policies" and "include provision for all actuarial reserves and related statement items which ought to be established."[4]

References

1. The Record, American Institute of Actuaries, Vol. XXXV, 1946, p. 270.

2. Ibid., p. 300.

3. 1947 NAIC Proceedings, 257.

4. Instructions for Completing NAIC Life and Health Annual Statement Blank, 1976, p. 1.

Actuarial Guideline V

INTERPRETATION REGARDING ACCEPTABLE APPROXIMATIONS FOR CONTINUOUS FUNCTIONS

Text

For reserves and values using continuous functions:

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

By assuming that D_{x+t} is linear for $0<t<1$

$\overline{D}_x = (D_x + D_{x+1})/2$.

By assuming that the deaths in the year of age x to x+1 are uniformly distributed over that year of age,

$\overline{D}_x = [(\delta\text{-}d)/\delta^2]D_x+[(i\text{-}\delta)/\delta^2]D_{x+1}$

where: $d = iv = i/(1+i)$

δ = force of interest

i = interest rate

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

By assuming that deaths in the year of age x to x+1 are uniformly distributed over that year of age,

$\overline{C}_x = (i/\delta)C_x$.

By assuming that the total deaths are concentrated at the middle of the year of age,

$\overline{C}_x = (1+i)^{1/2}C_x$ or $(1+i/2)C_x$.

Background Material

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

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

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

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

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

Actuarial Guideline VI

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

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

Background Material

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

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

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

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

Insurance companies are allowed to select "expense allowances" for use in computing their reserves and nonforfeiture values up to the level of the "expense allowances" defined in these model laws. A higher "expense allowance" would produce reserves or nonforfeiture values which are less than the minimum defined in the model laws, and therefore state insurance departments cannot permit companies to use a higher amount as an "expense allowance."

The wording of these model laws is generally clear and precise in defining the "expense allowances" which are permitted for policies which provide single life benefits. However, the proper level of the "expense allowances" for policies providing joint life insurance benefits is not so clear. The "expense allowance" defined in the Standard Valuation Law depends on the modified net premium for a policy on the 20-payment whole life insurance plan, and the "expense allowance" defined in the Standard Nonforfeiture Law depends on the adjusted premium for a policy on the ordinary life plan.

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

Actuarial Guideline VII

INTERPRETATION REGARDING CALCULATION OF EQUIVALENT LEVEL AMOUNTS

Text

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

Background Material

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

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

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

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

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

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

The Standard Valuation Law is not nearly so clear on this point. It contains wording as follows:

> Reserves according to the Commissioners Reserve Valuation Method for (1) life insurance policies providing for a varying amount of insurance----shall be calculated by a method consistent with the principles of the preceding paragraph-----.

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

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

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

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

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

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

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

Actuarial Guideline VIII

THE VALUATION OF INDIVIDUAL SINGLE PREMIUM DEFERRED ANNUITIES

Text

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

Actuarial Guideline IX

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

Text

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

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

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

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

Actuarial Guideline IX-A

USE OF SUBSTANDARD ANNUITY MORTALITY TABLES IN VALUING IMPAIRED LIVES UNDER STRUCTURED SETTLEMENTS

Text

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

1. Periodic benefits arising from settlements of various forms of claims pertaining to court settlements or out of court settlements from tort actions, such as arising from accidents or medical malpractice;

2. Settlements involving similar action such as workers' compensation; or

3. Settlements of long term disability claims where a temporary or life annuity has been used in lieu of continuing disability payments.

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

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

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

Minimum Reserves

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

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

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

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

Background

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

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

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

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

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

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

It is recognized that at issue the vast bulk of the liability normally pertains to payments that are certain and not contingent upon survival, since the vast majority of substandard contracts contain a certain period and most of the benefits either fall within that certain period or are guaranteed to be paid. It is also noted that the interest discount factor in the early durations is far more important than the mortality element. The selection of the interest discount factor is the subject of Guideline IX-B.

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

Effective Date

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

Actuarial Guideline IX-B

CLARIFICATION OF METHODS UNDER STANDARD VALUATION LAW FOR INDIVIDUAL SINGLE PREMIUM IMMEDIATE ANNUITIES, ANY DEFERRED PAYMENTS ASSOCIATED THEREWITH, SOME DEFERRED ANNUITIES, AND STRUCTURED SETTLEMENTS CONTRACTS

Text

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

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

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

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

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

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

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

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

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

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

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

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

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

(iii) For each valuation year calculate "graded interest rate reserves" based on the assumption that the valuation interest rate during the first twenty contract years is "X percent" as calculated in step two and thereafter is the Plan Type A interest rate for contracts without cash settlement options for guarantee durations of more than twenty years.

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

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

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

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

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

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

Background

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

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

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

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

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

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

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

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

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

It is recognized that these procedures for determining statutory formulae reserves are only temporary while the Special Committee on Valuation is developing a new statutory formula to go along with a valuation of liabilities based on the supporting assets and the actuary's best judgment to account for reasonable deviations.

Actuarial Guideline IX-C

USE OF SUBSTANDARD ANNUITY MORTALITY TABLES IN VALUING IMPAIRED LIVES UNDER INDIVIDUAL SINGLE PREMIUM IMMEDIATE ANNUITIES

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

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

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

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

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

Minimum Reserves

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

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

2) Solve for the constant addition to the true age mortality rates such that the present value of future benefits at issue is equal to or greater than the present value obtained in 1). The base mortality table and the valuation interest rate shall be the same as used in 1).

The constant addition to the mortality table herein described shall be made as of the issue date and, once determined, held constant for the period of time that the contract remains in force. The addition of a constant to the valuation mortality rate produces a gradually declining percentage extra mortality such that reserves will grade into standard reserves at the end of the standard valuation mortality table thereby making the reserve more conservative (closer to standard) each year that the annuitant or measuring life lives.

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

Background

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

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

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

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

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

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

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

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

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

Effective Date

This Guideline will be effective for contracts issued on or after January 1, 2001.

Actuarial Guideline X

GUIDELINE FOR INTERPRETATION OF NAIC STANDARD NONFORFEITURE LAW FOR INDIVIDUAL DEFERRED ANNUITIES

Text

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

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

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

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

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

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

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

II. Treatment of Dividends Credited to Deferred Annuity Contracts

No single rule can be given for the treatment of dividends credited to deferred annuity contracts. The contractual wording of the applicable dividend option must be taken into account together with the appropriate provisions of the NAIC Standard Nonforfeiture Law for Individual Deferred Annuities.

If the dividend option in effect provides that dividends be left on deposit at interest, without any further qualification, then the cash surrender value should be increased by the full accumulated amount. In this case, the phrase “increased by any additional amounts credited by the company to the contract” applies and no surrender charge may be made.

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

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

Actuarial Guideline XI

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

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

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

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

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

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

"Generic form," as mentioned in Section C, refers to generic groups, such as ordinary vs. group, term vs. permanent, flexible cash value vs. fixed cash value, separate account vs. fixed account.

Actuarial Guideline XII

INTERPRETATION REGARDING VALUATION AND NONFORFEITURE INTEREST RATES

ACTUARIAL GUIDELINE XII WAS WITHDRAWN ON MARCH 7, 1993

Actuarial Guideline XIII

GUIDELINE CONCERNING THE COMMISSIONERS' ANNUITY RESERVE VALUATION METHOD

Preamble

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

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

Guideline

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

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

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

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

For contracts issued on and after January 1, 1985, contingent surrender charges with bail-out rates less than or equal to the calendar year statutory valuation interest rate for life insurance policies with guarantee duration in excess of twenty years issued in the same year may be treated as available. For contracts issued prior to January 1, 1985, contingent surrender charges with bail-out rates less than or equal to 6.00% (the calendar year statutory valuation interest rate for life insurance policies with guarantee duration in excess of twenty years issued in 1984) may be treated as available.

There are some contracts with contingent surrender charges with bail-out rates which are a function of an external index whose future values are not known. Judgment is required to determine whether or not such surrender charges may be treated as available. Comparison to the calendar year statutory valuation interest rate for life insurance policies with guarantee duration in excess of twenty years may be useful.

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

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

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

Actuarial Guideline XIV

SURVEILLANCE PROCEDURE FOR REVIEW OF THE ACTUARIAL OPINION FOR LIFE AND HEALTH INSURERS

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

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

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

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

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

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

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

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

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

9. In the Actuarial Report, the actuary providing the opinion should make specific reference as to whether the good and sufficient analysis considered the inter-relationships of assumptions with respect to guaranteed benefit payments, future expenses, policyowner dividends, and post-issue premium or benefit adjustments, especially among persistency, mortality, morbidity, inflation, and interest rates, and, if so, what those consideration were.

10. In the Actuarial Report, the actuary providing the opinion should document the extent to which the opinion is influenced by a continuing business assumption, and, if the impact is material, comment on the company's plan of operations with regard to this assumption as it affects assumed expenses and interest rates, and future reserve requirements.

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

    a. Be done by a qualified reviewer;

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

12. If at any time during the review, the regulator requires more information deemed to be material to the development of the opinion, the company would be expected to comply with requests for such information.

Actuarial Guideline XV

ILLUSTRATIONS GUIDELINE FOR VARIABLE LIFE INSURANCE MODEL REGULATION

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

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

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

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

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

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

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

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

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

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

   a. An illustration of the variable funding option must comply with these guidelines;

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

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

10. Nothing herein shall prohibit the distribution to the prospective policyholder of illustrations in addition to those required by Article VII of the NAIC Model Variable Life Insurance Regulation provided that, except for Item 3 which shall only apply to required illustrations under Article VII, such additional illustrations comply with the standards set forth herein.

Actuarial Guideline XVI

CALCULATION OF CRVM RESERVES ON SELECT MORTALITY AND/OR SPLIT INTEREST

Text

When CRVM reserves are being calculated, it is necessary to determine the value of ${}_{19}P_{x+1}$. The Standard Valuation Law permits the use of Select Mortality Factors with the 1980 CSO Table. While the maximum valuation interest rate for any policy is level for all durations, the law permits the use of other interest rates as long as the resulting reserves are not less than those according to the minimum standard. Thus, it is possible to calculate reserves by the CRVM method using split interest rates, i.e., interest rates that are not the same at all durations.

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

Background Information:

The Report of the Society of Actuaries Committee on Specifications for Monetary Values - 1980 CSO Tables recommended this approach. This Report was accepted by the Board of Governors of the Society and forwarded to the NAIC early in 1984. This approach is logical because it is consistent with the calculation of the “net level annual premium equal to the present value, at the date of issue, of such benefits provided for after the first policy year, divided by the present value, at the date of issue, of an annuity of one per annum payable on the first and each subsequent anniversary of such policy on which a premium falls due.....” (See Section 4 of the Standard Valuation Law, emphasis added.)

Actuarial Guideline XVII

CALCULATION OF CRVM RESERVES WHEN DEATH BENEFITS ARE NOT LEVEL

Text

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

Background Information

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

Actuarial Guideline XVIII

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

Text

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

Background Information

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

Actuarial Guideline XIX

1980 CSO MORTALITY TABLE WITH TEN-YEAR SELECT MORTALITY FACTORS

Text

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

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

Background Information

The published report of a committee of the Society of Actuaries contains two sets of alternative select mortality factors. While that committee recommended that the alternative factors not be adopted, their publication has caused some confusion.

Actuarial Guideline XX

JOINT LIFE FUNCTIONS FOR 1980 CSO MORTALITY TABLE

Text

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

Other methods of calculating joint life functions may also be acceptable. In particular, it is acceptable to calculate "exact" joint life functions using published 1980 CSO mortality rates for the actual ages and genders of the lives to be insured.

1980 CSO and 1980 CET TABLES

A5-1

Tables showing the deduction to be made from the age of the older of two lives in order to obtain the equivalent equal ages. The equivalent equal ages are then used to enter tables of functions derived from tables based on one male and one female of the same age.

MALE/MALE

Difference in Ages	Deduct from Older Age
0-1 Years	-2
2-3	-1
4-6	0
7-9	1
10-13	2
14-19	3
20-32	4
33-55	5
56 & Over	6

FEMALE/FEMALE

Difference in Ages	Deduct from Older Age
0-1 Years	3
2-3	4
4-6	5
7-9	6
10-13	7
14-20	8
21-48	9
49-70	8
71 & Over	7

OLDER MALE/YOUNGER FEMALE

Difference in Ages	Deduct from Older Age
0-1 Years	0
2-4	1
5-8	2
9-14	3
15-27	4
28-54	5
55 & Over	6

OLDER FEMALE/YOUNGER MALE

Difference in Ages	Deduct from Older Age
0 Years	0
1-2	1
3-4	2
5-6	3
7-8	4
9-11	5
12-14	6
15-18	7
19-25	8
26-47	9
48-70	8
71 & Over	7

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

1980 CSO AND 1980 CET TABLES

ULTIMATE 1_{XX} TABLES

A5-6

MALE/FEMALE - JOINT EQUAL AGES

Age	1980 CSO ANB	1980 CET ANB	Age	1980 CSO ANB	1980 CET ANB
0	60,560,928	16,765,573,343	50	50,059,381	12,731,016,815
1	60,133,368	16,611,833,035	51	49,476,690	12,538,651,151
2	60,016,709	16,554,688,329	52	48,854,768	12,334,020,364
3	59,908,679	16,500,057,858	53	48,189,855	12,115,954,884
4	59,802,641	16,446,102,669	54	47,476,163	11,882,965,072
5	59,699,780	16,393,146,218	55	46,711,322	11,634,492,272
6	59,600,678	16,341,343,876	56	45,894,341	11,370,389,297
7	59,505,913	16,290,849,123	57	45,025,102	11,090,791,424
8	59,415,464	16,241,650,759	58	44,105,689	10,796,774,543
9	59,328,717	16,193,575,473	59	43,138,010	10,489,174,436
10	59,243,877	16,146,128,297	60	42,120,816	10,168,205,698
11	59,160,343	16,099,143,064	61	41,050,947	9,833,163,320
12	59,073,969	16,051,489,601	62	39,922,456	9,482,414,384
13	58,981,223	16,002,211,528	63	38,727,178	9,114,117,409
14	58,878,596	15,950,364,363	64	37,455,765	8,726,038,290
15	58,763,783	15,895,335,606	65	36,104,361	8,317,746,958
16	58,635,678	15,836,840,771	66	34,673,184	7,890,297,942
17	58,494,366	15,774,918,724	67	33,168,368	7,446,389,780
18	58,341,111	15,709,926,059	68	31,598,177	6,989,702,695
19	58,180,090	15,643,001,774	69	29,974,031	6,524,328,290
20	58,012,531	15,574,485,426	70	28,301,780	6,052,945,571
21	57,841,394	15,505,178,968	71	26,582,447	5,577,062,990
22	57,669,027	15,435,715,764	72	24,815,246	5,097,324,032
23	57,497,173	15,366,563,757	73	22,997,777	4,614,505,500
24	57,326,406	15,297,875,217	74	21,131,047	4,130,490,018
25	57,156,720	15,229,646,694	75	19,226,083	3,649,618,370
26	56,989,251	15,162,179,359	76	17,303,859	3,178,781,104
27	56,822,842	15,095,162,526	77	15,392,302	2,726,027,311
28	56,656,351	15,028,290,956	78	13,522,753	2,299,540,338
29	56,488,648	14,961,264,778	79	11,725,985	1,906,364,931
30	56,318,617	14,893,789,474	80	10,025,717	1,551,018,508
31	56,145,156	14,825,724,856	81	8,438,546	1,235,758,486
32	55,966,614	14,756,488,721	82	6,977,243	961,383,029

ULTIMATE 1_{XX} TABLES (CONT’D)

Age	1980 CSO ANB	1980 CET ANB	Age	1980 CSO ANB	1980 CET ANB
33	55,783,044	14,686,100,270	83	5,651,637	727,555,449
34	55,592,824	14,614,138,379	84	4,470,897	533,319,971
35	55,393,802	14,540,044,697	85	3,444,826	377,233,215
36	55,185,521	14,463,709,462	86	2,579,176	256,609,122
37	54,964,779	14,384,303,697	87	1,872,714	167,383,564
38	54,728,980	14,301,162,422	88	1,316,256	104,405,498
39	54,476,679	14,213,496,296	89	893,896	62,098,302
40	54,204,296	14,119,829,355	90	585,350	35,106,033
41	53,909,967	14,019,719,765	91	368,642	18,789,100
42	53,590,820	13,911,767,923	92	222,531	9,470,646
43	53,246,767	13,795,743,779	93	128,118	4,461,337
44	52,876,702	13,671,168,213	94	69,801	1,940,503
45	52,480,127	13,537,874,323	95	35,420	760,483
46	52,055,563	13,395,455,885	96	16,202	255,127
47	51,602,680	13,243,953,279	97	6,225	65,264
48	51,120,195	13,083,039,247	98	1,699	9,381
49	50,606,437	12,912,305,585	99	200	200

ULTIMATE 1_{XX} TABLES

A5-7

MALE/FEMALE - JOINT EQUAL AGES

Age	1980 CSO ALB	1980 CET ALB	Age	1980 CSO ALB	1980 CET ALB
0	60,347,148	16,688,703,189	50	49,768,036	12,634,833,983
1	60,075,038	16,583,260,682	51	49,165,729	12,436,335,758
2	59,962,694	16,527,373,094	52	48,522,312	12,224,987,624
3	59,855,660	16,473,080,264	53	47,833,009	11,999,459,978
4	59,751,210	16,419,624,444	54	47,093,742	11,758,728,672
5	59,650,229	16,367,245,047	55	46,302,832	11,502,440,784
6	59,553,296	16,316,096,500	56	45,459,722	11,230,590,360
7	59,460,688	16,266,249,941	57	44,565,396	10,943,782,984
8	59,372,090	16,217,613,116	58	43,621,850	10,642,974,490
9	59,286,297	16,169,851,885	59	42,629,413	10,328,690,067
10	59,202,110	16,122,635,680	60	41,585,882	10,000,684,509
11	59,117,156	16,075,316,332	61	40,486,702	9,657,788,852
12	59,027,596	16,026,850,564	62	39,324,817	9,298,265,896
13	58,929,910	15,976,287,946	63	38,091,472	8,920,077,850
14	58,821,190	15,922,849,984	64	36,780,063	8,521,892,624
15	58,699,730	15,866,088,188	65	35,388,772	8,104,022,450
16	58,565,022	15,805,879,748	66	33,920,776	7,668,343,861
17	58,417,738	15,742,422,392	67	32,383,272	7,218,046,238
18	58,260,600	15,676,463,916	68	30,786,104	6,757,015,492
19	58,096,310	15,608,743,600	69	29,137,906	6,288,636,930
20	57,926,962	15,539,832,196	70	27,442,114	5,815,004,280
21	57,755,210	15,470,447,365	71	25,698,846	5,337,193,511
22	57,583,100	15,401,139,760	72	23,906,512	4,855,914,766
23	57,411,790	15,332,219,487	73	22,064,412	4,372,497,759
24	57,241,563	15,263,760,956	74	20,178,565	3,890,054,194
25	57,072,986	15,195,913,026	75	18,264,971	3,414,199,737
26	56,906,046	15,128,670,942	76	16,348,080	2,952,404,208
27	56,739,596	15,061,726,741	77	14,457,528	2,512,783,824
28	56,572,500	14,994,777,867	78	12,624,369	2,102,952,634
29	56,403,632	14,927,527,126	79	10,875,851	1,728,691,720
30	56,231,886	14,859,757,165	80	9,232,132	1,393,388,497
31	56,055,885	14,791,106,788	81	7,707,894	1,098,570,758
32	55,874,829	14,721,294,496	82	6,314,440	844,469,239
33	55,687,934	14,650,119,324	83	5,061,267	630,437,710
34	55,493,313	14,577,091,538	84	3,957,862	455,276,593

ULTIMATE 1_{XX} TABLES (CONT'D)

Age	1980 CSO ALB	1980 CET ALB	Age	1980 CSO ALB	1980 CET ALB
35	55,289,662	14,501,877,080	85	3,012,001	316,921,168
36	55,075,150	14,424,006,580	86	2,225,945	211,996,343
37	54,846,880	14,342,733,060	87	1,594,485	135,894,531
38	54,602,830	14,257,329,359	88	1,105,076	83,251,900
39	54,340,488	14,166,662,826	89	739,623	48,602,168
40	54,057,132	14,069,774,560	90	476,996	26,947,566
41	53,750,394	13,965,743,844	91	295,586	14,129,873
42	53,418,794	13,853,755,851	92	175,324	6,965,992
43	53,061,734	13,733,455,996	93	98,960	3,200,920
44	52,678,414	13,604,521,268	94	52,610	1,350,493
45	52,267,845	13,466,665,104	95	25,811	507,805
46	51,829,122	13,319,704,582	96	11,214	160,196
47	51,361,438	13,163,496,263	97	3,962	37,322
48	50,863,316	12,997,672,416	98	950	4,790
49	50,332,909	12,821,661,200	99	100	100

Actuarial Guideline XXI

CALCULATION OF CRVM RESERVES WHEN (B) IS GREATER THAN (A) AND SOME RULES FOR DETERMINATION OF (A)

Text

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

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

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

Background Information

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

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

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

Actuarial Guideline XXII

INTERPRETATION REGARDING NONFORFEITURE VALUES FOR POLICIES WITH INDETERMINATE PREMIUMS

Text

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

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

Background Information

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

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

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

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

This guideline was written with policies other than universal life insurance in mind. However, it is possible to design a fixed premium universal life insurance policy to which this guideline would be applicable.

Actuarial Guideline XXIII

GUIDELINE CONCERNING VARIABLE LIFE INSURANCE SEPARATE ACCOUNT INVESTMENTS

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

If a variable life insurance separate account is divided into separate series, portfolios or other investment subdivisions, each series, portfolio or investment subdivision shall comply with this subsection.

Actuarial Guideline XXIV

GUIDELINES FOR VARIABLE LIFE NONFORFEITURE VALUES

Minimum cash surrender values for variable life insurance policies shall be determined separately for the basic policy and any benefits and riders for which premiums are paid separately. The methods pertain to a basic policy and any benefits and riders for which premiums are not paid separately.

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

A. Definitions

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

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

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

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

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

B. Retrospective Method

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

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

The benefit charges shall include the charges made for mortality and any charges made for riders or supplementary benefits for which premiums are not paid separately. If benefit charges are substantially level by duration and develop low or no cash values, then the Commissioner shall have the right to require higher cash values unless the insurer provides adequate justification that the cash values are appropriate in relation to the policy's other characteristics.

The administrative expense charges shall include charges per premium payment, charges per dollar of premium paid, periodic charges per thousand dollars of insurance, periodic per policy charges, and any other charges permitted by the policy to be imposed without regard to the policyowner's request for services. The averaged administrative expense charges for any year shall be those which would have been imposed in the year if the charge rate or rates for each transaction or period within the year had been equal to the arithmetic average of the corresponding charge rates which the policy states will be imposed in policy years through twenty in determining the policy value.

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

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

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

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

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

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

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

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

C. Prospective Method

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

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

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

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

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

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

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

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

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

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

D. Maximum Charge Method

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(2) 10% of all other premiums received.

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

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

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

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

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

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

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

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

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

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

E. Minimum Paid-Up Nonforfeiture Benefits

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

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

Ever since the adoption of the original Standard Nonforfeiture Law (SNFL) in 1942, provision has been made for nonforfeiture calculations on the basis of substandard mortality. (See Sections 5.5a. and 5c, Paragraph 8(e) of SNFL.)

While this provision has been used infrequently in the past, it is anticipated the substandard mortality will be more frequently utilized in variable life insurance, given its flexible nature, to reflect the mortality classification assigned to the policy by the insurer.

A charge may be made at the surrender of the policy provided that the result after the deduction of the charge is not less than the minimum cash surrender value required by this guideline.)

Actuarial Guideline XXV

CALCULATION OF MINIMUM RESERVES AND MINIMUM NONFORFEITURE VALUES FOR POLICIES WITH GUARANTEED INCREASING DEATH BENEFITS BASED ON AN INDEX

A. Valuation - Text

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

1. 2.0% If the annual increase is limited to an annual and non-cumulative maximum of 0% through 5.0%

2. 1.5% If the annual increase is limited to an annual and cumulative maximum of 0% through 5.0%.

3. 1.5% If the annual increase is limited to an annual and non-cumulative maximum of 5.01% through 10.0%.

4. 1.25% If the annual increase is limited to an annual and cumulative maximum of 5.01% through 10.0%.

5. 1.0% For all other plans.

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

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

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

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

B. Nonforfeiture – Text

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

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

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

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

1. 2.0% If the annual increase is limited to an annual and non-cumulative maximum of 0% through 5.0%.

2. 1.5% If the annual increase is limited to an annual and cumulative maximum of 0% through 5.0%.

3. 1.5% If the annual increase is limited to an annual and non-cumulative maximum of 5.01% through 10.0%.

4. 1.25% If the annual increase is limited to an annual and cumulative maximum of 5.01% through 10.0%.

5. 1.0% For all other plans.

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

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

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

II. FOR POLICIES WHERE ANY DEATH BENEFIT FOR ANY POLICY YEAR WOULD NOT EXCEED THE THRESHOLD AMOUNT IN ABSENCE OF ANY ANNUAL INCREASES BASED ON THE INDEX

For a policy where premiums are fixed in amount at issue which provides for whole life insurance with the amount of death benefit adjusted periodically with the Consumer Price Index or another cost of living index, the unadjusted value of the minimum nonforfeiture benefit at any time shall be based on a level death benefit, an acceptable mortality table for life insurance nonforfeiture and a nonforfeiture interest rate equal to:

1. 4.5% If the annual increase based on the index is limited to a maximum of 0% through 5.0%.

2. 4.25% If the annual increase based on the index is limited to a maximum of 5.01% through 10.0%.

3. 4.0% For all other plans.

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

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

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

BACKGROUND

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

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

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

[1] In 2010, the actuarial guideline was modified to substitute a threshold amount for 10,000, such threshold being increased by the change in the CPI-U, the CPI for All Urban Consumers.

7702. The cash value accumulation test to qualify thereunder requires a minimum interest rate of 4% and an assumed level amount of death benefits.

In the case of policies for an initial amount of insurance of $5,000 or less, the IRS rules provide an exception to the prohibition of assuming increasing death benefits. However, since many of the policies for very low amounts of initial face amount of insurance would require relatively high expenses if underwritten, many of the policies are issued with simplified underwriting or on a guaranteed issue basis with lower amounts of death benefits in the early policy years, some of the resulting annual increases are such as would disqualify many of the policies for the exception. Therefore it is recommended that policies for low amounts of insurance be allowed to qualify under the cash value accumulation test by permitting the nonforfeiture values to be based on a level death benefit and 4% or higher interest and requiring such values to be updated as increases based on the index take place. The amount in this guideline is set at $10,000 (or the threshold amount[1] after December 31, 2009), to allow for future adjustments and for different patterns of benefits for low amounts.

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

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

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

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

Actuarial Guideline XXVI

June 3, 1989

ELECTION OF OPERATIVE DATES UNDER STANDARD VALUATION LAW AND STANDARD NONFORFEITURE LAW

Preamble

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

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

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

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

Text

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

Background Material

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

Historically, insurance companies have been allowed to elect early operative dates so as to pass along the benefits of improved mortality rates and current interest rates to policyholders who purchase new life insurance policies. These new policies would typically have lower nonforfeiture values and would require lower reserves, and net premiums would be lower also. The expectation is that the lower net premiums might allow the company to reconsider its gross premium rates for these new policies issued after the operative date, and in many cases to lower the new gross premium rates.

A second reason for allowing the election of an early operative date would be to allow insurance companies and state insurance departments more time to prepare and review new life insurance policies, which are to be introduced into them marketplace. If every life insurance policy had to be changed over on the same mandatory operative date, it would be a great burden on the resources of all the parties involved.

Actuarial Guideline XXVII

ACCELERATED BENEFITS

PURPOSE

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

I) non-discounted acceleration of benefits

II) actuarially discounted acceleration of benefits

III) interest accrual approach to financing acceleration of benefits

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

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

I. NON-DISCOUNTED ACCELERATION OF BENEFITS

A. Description

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

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

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

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

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

B. Reserves

1. Reserving Approach

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

2. General Consideration

A reserve formula should consider all relevant factors.

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

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

a. Definition of acceleration events,

b. Premium waiver provision,

c. Marketing method,

d. Underwriting procedures,

e. Delay in eligibility for benefit,

f. Maximum benefit,

g. Optional nature of benefit, and/or

h. Guaranteed insurability options.

II. ACTUARIALLY DISCOUNTED ACCELERATION OF BENEFIT

A. Description

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

B. Reserves

The application of standard valuation law and CRVM reserves is appropriate for these policies. No additional reserves need be held as long as the actuary is convinced that the method used to discount the death benefit reflects sound actuarial principles.

If the actuary is convinced that the discounting procedure does not appropriately reflect these conditions, he or she should determine a reserve such that reserves are adequate for the life insurance benefits based on aggregates. There is nothing in this benefit design that changes that equation.

III. INTEREST ACCRUAL APPROACH TO FINANCING ACCELERATION OF BENEFITS

A. Description

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

1. Alternative methods of including an interest accrual option:

   a. A benefit of this type may be provided either as an integral part of a life insurance policy or as a rider to a life insurance policy.

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

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

B. Interest Accrual Rate

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

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

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

C. Reserves

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

2. Following the occurrence of a qualifying event, accrued interest is an asset of the company for statutory reporting purposes. However, the valuation actuary should make certain that reserves in the aggregate are adequate to assure that such aggregate accrued interest is provided for. This will assure that such accrued

interest assets can be held as admitted assets. The insurer's valuation actuary may voluntarily increase the statutory reserve liability on each such policy in order to eliminate the need to non-admit a portion of the accrued interest policy lien or policy loan.

IV. BENEFIT PAYMENT LIENS

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

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

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

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

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

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

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

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

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

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

V. GENERAL CONSIDERATIONS

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

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

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

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

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

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

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

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

Actuarial Guideline XXVIII

STATUTORY CLAIM RESERVES FOR GROUP LONG-TERM DISABILITY CONTRACTS WITH A SURVIVOR INCOME BENEFIT PROVISION

Background

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

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

Drafting Note: Please see the 1990 “Proceedings,” Vol. 2, Pages 995-999, and the 1991 “Proceedings,” Vol. 1B, Pages 1321-1328.

Text

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

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

Actuarial Guideline XXIX

GUIDELINE CONCERNING RESERVES OF COMPANIES IN REHABILITATION

Preamble

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

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

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

Guideline

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

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

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

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

A method consistent with CRVM adopted for purposes of a rehabilitation program should consider the valuation bases and expense allowance prior to restructuring as well as after restructuring. Depending upon the types of changes to the restructured contract, it may or may not be appropriate to take into account the guaranteed benefits and premium structure prior to restructuring.

The issue date for purposes of determining the applicable mortality tables and interest rates also depends on the circumstances. For example, it may be appropriate to treat annuity contracts as newly issued so that reserves are required to be recomputed using more current discount rates. However, in the same rehabilitation plan it may be inappropriate to treat a restructured level premium whole life contract as newly issued. Accordingly, whether a contract is treated as having a new issue date after contract restructuring depends upon the terms of the rehabilitation plan and the restructured contracts. In general, contracts are not treated as newly issued unless the rehabilitation plan or state filing for the restructured contracts so provides.

Similarly, the appropriate CRVM expense allowance will depend upon the terms and the intent of the restructuring and rehabilitation plan. Depending upon the types of changes to the restructured contract, it may be appropriate to carry forward an unamortized expense allowance based on original policy date. In other cases, a new unamortized expense allowance would be calculated as of the restructure date. In general, a new unamortized expense allowance is not calculated unless the rehabilitation plan or the state filing for the restructured contract so provides.

Actuarial Guideline XXX

GUIDELINE FOR THE APPLICATION OF PLAN TYPE TO GUARANTEED INTEREST CONTRACTS (GICS) WITH BENEFIT RESPONSIVE PAYMENT PROVISIONS USED TO FUND EMPLOYEE BENEFIT PLANS.

Background Material

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

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

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

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

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

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

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

3. Plan Type C is a plan under which the policyholder may withdraw funds before expiration of the interest rate guarantee in a single sum or installments over less than five years either (a) without adjustment to reflect changes in interest rates or asset values since receipt of the funds by the insurance company, or (b) subject only to a fixed surrender charge stipulated in the contract as a percentage of the funds.

Text

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

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

   and

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

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

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

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

Actuarial Guideline XXXI

VALUATION ISSUES VS. POLICY FORM APPROVAL

Background

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

Text

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

Actuarial Guideline XXXII

RESERVE FOR IMMEDIATE PAYMENT OF CLAIMS

Background Material

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

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

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

Text

RESERVES FOR IMMEDIATE PAYMENT OF CLAIMS

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

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

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

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

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

III. Where an insurer pays interest on death proceeds at an earlier point than as required by contract, it is appropriate that the statutory formula reflect such practice.

IV. Where the actual formula reserves are more conservative than minimum statutory formula reserves, an insurer using curtate functions without provision for immediate payment of claims must demonstrate compliance with minimum statutory formula reserves adjusted in accordance with II above.

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

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

1. First year 20%
2. Second year 40%
3. Third year 60%
4. Fourth year 80%
5. Fifth and later years 100%

Actuarial Guideline XXXIII

DETERMINING CARVM RESERVES FOR ANNUITY CONTRACTS WITH ELECTIVE BENEFITS

Background Information

1. Introduction

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

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

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

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

2. Annuitization Benefits

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

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

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

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

3. Application of Incidence Rates in CARVM

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

4. Integrated Benefit Stream Approach

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

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

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

5. Valuation Interest Rates

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

Purpose

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

Definitions

1. Elective and Non-Elective Benefits in CARVM

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

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

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

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

2. Elective and Non-Elective Incidence Rates in CARVM

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

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

3. Integrated Benefit Stream

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

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

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

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

Text

1. Greatest Present Value

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

2. Examples of Integrated Benefit Streams That Must Be Considered

   A. Cash Value Streams

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

   B. Annuitization Streams

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

C. Other Elective Benefit Streams

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

3. Determination of Valuation Interest Rates

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

A. The basis of valuation (issue year or change in fund);

B. Whether or not the annuity provides for cash settlement options;

C. Whether interest is guaranteed on premiums received more than 12 months following issue (or the valuation date for change in fund basis);

D. The guarantee duration; and

E. The Plan Type.

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

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

4. Determination of Guarantee Duration and Plan Type

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

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

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

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

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

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

> The first portion consists of the series of defined payments to the extent that the payments, or any fraction thereof, are withdrawals that reduce or deplete the annuity's defined values. Applying paragraph 4(A) to this portion would result in Plan Type A, Plan Type B, or Plan Type C, by following the definitions of such contained within the Standard Valuation Law and reflecting the specific contract provisions, especially with regard to withdrawal. Paragraph 4(A) would also apply to any residual withdrawals that can be made following election of the GLIB benefit.
>
> The second portion is a life annuity without option to take or receive additional amounts under the contract, and consists of the payments not included in the above portion. Applying paragraph 4(B), Plan Type A would generally apply to this segment with the guarantee duration determined using the period from contract issue to commencement of payments in this second portion.

5. Change in Fund Basis

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

6. Purchase Rates

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

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

7. Practical Considerations

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

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

Effective Date

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

Actuarial Guideline XXXIV

VARIABLE ANNUITY MINIMUM GUARANTEED DEATH BENEFIT RESERVES

This Actuarial Guideline was repealed effective Dec. 30, 2009.

I. Background

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

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

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

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

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

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

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

II. Scope

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

III. Definitions

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

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

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

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

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

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

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

IV. Text

A. General Methodology

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

B. Separate Account Reserve Calculation

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

C. Integrated Reserve Calculation

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

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

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

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

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

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

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

D. Immediate Drops and Assumed Returns

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

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

To determine the immediate drop and net assumed return, the Separate Account funds supporting the variable annuity contracts on the valuation date should be allocated to the five asset classes as follows:

- Equity Class
- Bond Class
- Balanced Class
- Money Market Class
- Specialty Class

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

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

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

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

E. Valuation Mortality and Interest

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

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

F. Reinsurance Reserve

1. Reinsurance Ceded

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

Similar to the formula demonstrated in Section IV.C., the determination of future Integrated Benefit Streams including the impact of reinsurance is accomplished by combining four separate benefit streams: A^r, B^r, C and D, described below. These future Integrated Benefit Streams are determined over all Calculation Periods, and are discounted at the valuation interest rate.

- A^r is the stream of Projected Net Amounts at Risk paid to those expected to die during the Calculation Period, based on valuation mortality. It is equal to benefit stream A defined in Section IV.C., reduced by future Projected Net Amounts at Risk reinsurance recoveries.

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

- C is as defined in Section IV.C.

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

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

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

2. Reinsurance Assumed

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

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

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

G. Asset Adequacy Analysis Requirement

The Projected Reduced Account Value, and consequently, the Projected Net Amount at Risk need not reflect future partial withdrawals. There is also the possibility that other risks may not be reflected in the reserve calculations described above. Therefore, the appointed actuary shall perform a standalone asset adequacy analysis of the total reserve held for all of the contracts falling within the scope of this

Guideline. Such analysis shall be performed reflecting the assets supporting the total reserve held for the contracts and all benefits and guarantees associated with the variable annuity contracts, as well as all expenses and charges associated with the variable annuity contracts. The analysis shall be performed on an aggregate basis, consistent with the requirements of Section 6 of the NAIC Model Actuarial Opinion and Memorandum Regulation, including the requirement that the analysis conform to the Actuarial Standards of Practice as promulgated from time to time by the Actuarial Standards Board. However, no separate actuarial opinion is required by this Guideline. If such analysis reveals a reserve shortfall, the total reserves held for the contracts must be increased accordingly.

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

H. Effective Date

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

APPENDIX I

Immediate Drop Percentages and Gross Assumed Returns

ASSET CLASS	IMMEDIATE DROP PERCENTAGE	GROSS ASSUMED RETURN
Equity	14.00%	14.00%
Bond	6.50%	9.50%
Balanced	9.00%	11.50%
Money Market	2.50%	6.50%
Specialty	9.00%	9.50%

APPENDIX II

1994 Variable Annuity MGDB Mortality Table
FEMALE Age Last Birthday

AGE	1000q_x	AGE	1000q_x	AGE	1000q_x	AGE	1000q_x	AGE	1000q_x
1	0.519	24	0.344	47	1.371	70	16.957	93	192.270
2	0.358	25	0.346	48	1.488	71	18.597	94	210.032
3	0.268	26	0.352	49	1.619	72	20.599	95	228.712
4	0.218	27	0.364	50	1.772	73	22.888	96	248.306
5	0.201	28	0.382	51	1.952	74	25.453	97	268.892
6	0.188	29	0.403	52	2.153	75	28.372	98	290.564
7	0.172	30	0.428	53	2.360	76	31.725	99	313.211
8	0.158	31	0.455	54	2.589	77	35.505	100	336.569
9	0.154	32	0.484	55	2.871	78	39.635	101	360.379
10	0.159	33	0.514	56	3.241	79	44.161	102	385.051
11	0.169	34	0.547	57	3.713	80	49.227	103	411.515
12	0.185	35	0.585	58	4.270	81	54.980	104	439.065
13	0.209	36	0.628	59	4.909	82	61.410	105	465.584
14	0.239	37	0.679	60	5.636	83	68.384	106	488.958
15	0.271	38	0.739	61	6.460	84	75.973	107	507.867
16	0.298	39	0.805	62	7.396	85	84.432	108	522.924
17	0.315	40	0.874	63	8.453	86	94.012	109	534.964
18	0.326	41	0.943	64	9.611	87	104.874	110	543.622
19	0.333	42	1.007	65	10.837	88	116.968	111	548.526
20	0.337	43	1.064	66	12.094	89	130.161	112	550.000
21	0.340	44	1.121	67	13.318	90	144.357	113	550.000
22	0.343	45	1.186	68	14.469	91	159.461	114	550.000
23	0.344	46	1.269	69	15.631	92	175.424	115	1000.000

APPENDIX II

1994 Variable Annuity MGDB Mortality Table
MALE Age Last Birthday

AGE	$1000q_x$	AGE	$1000q_x$	AGE	$1000q_x$	AGE	$1000q_x$	AGE	$1000q_x$
1	0.587	24	0.760	47	2.366	70	29.363	93	243.533
2	0.433	25	0.803	48	2.618	71	32.169	94	264.171
3	0.350	26	0.842	49	2.900	72	35.268	95	285.199
4	0.293	27	0.876	50	3.223	73	38.558	96	305.931
5	0.274	28	0.907	51	3.598	74	42.106	97	325.849
6	0.263	29	0.935	52	4.019	75	46.121	98	344.977
7	0.248	30	0.959	53	4.472	76	50.813	99	363.757
8	0.234	31	0.981	54	4.969	77	56.327	100	382.606
9	0.231	32	0.997	55	5.543	78	62.629	101	401.942
10	0.239	33	1.003	56	6.226	79	69.595	102	422.569
11	0.256	34	1.005	57	7.025	80	77.114	103	445.282
12	0.284	35	1.013	58	7.916	81	85.075	104	469.115
13	0.327	36	1.037	59	8.907	82	93.273	105	491.923
14	0.380	37	1.082	60	10.029	83	101.578	106	511.560
15	0.435	38	1.146	61	11.312	84	110.252	107	526.441
16	0.486	39	1.225	62	12.781	85	119.764	108	536.732
17	0.526	40	1.317	63	14.431	86	130.583	109	543.602
18	0.558	41	1.424	64	16.241	87	143.012	110	547.664
19	0.586	42	1.540	65	18.191	88	156.969	111	549.540
20	0.613	43	1.662	66	20.259	89	172.199	112	550.000
21	0.642	44	1.796	67	22.398	90	188.517	113	550.000
22	0.677	45	1.952	68	24.581	91	205.742	114	550.000
23	0.717	46	2.141	69	26.869	92	223.978	115	1000.000

APPENDIX II

1994 Variable Annuity MGDB Mortality Table
FEMALE Age Nearest Birthday

AGE	$1000q_x$	AGE	$1000q_x$	AGE	$1000q_x$	AGE	$1000q_x$	AGE	$1000q_x$
1	0.628	24	0.344	47	1.316	70	16.239	93	184.435
2	0.409	25	0.344	48	1.427	71	17.687	94	201.876
3	0.306	26	0.348	49	1.549	72	19.523	95	220.252
4	0.229	27	0.356	50	1.690	73	21.696	96	239.561
5	0.207	28	0.372	51	1.855	74	24.107	97	259.807
6	0.194	29	0.392	52	2.050	75	26.832	98	281.166
7	0.181	30	0.415	53	2.256	76	29.954	99	303.639
8	0.162	31	0.441	54	2.465	77	33.551	100	326.956
9	0.154	32	0.470	55	2.713	78	37.527	101	350.852
10	0.155	33	0.499	56	3.030	79	41.826	102	375.056
11	0.163	34	0.530	57	3.453	80	46.597	103	401.045
12	0.175	35	0.565	58	3.973	81	51.986	104	428.996
13	0.195	36	0.605	59	4.569	82	58.138	105	456.698
14	0.223	37	0.652	60	5.250	83	64.885	106	481.939
15	0.256	38	0.707	61	6.024	84	72.126	107	502.506
16	0.287	39	0.771	62	6.898	85	80.120	108	518.642
17	0.309	40	0.839	63	7.897	86	89.120	109	531.820
18	0.322	41	0.909	64	9.013	87	99.383	110	541.680
19	0.331	42	0.977	65	10.215	88	110.970	111	547.859
20	0.335	43	1.037	66	11.465	89	123.714	112	550.000
21	0.339	44	1.091	67	12.731	90	137.518	113	550.000
22	0.342	45	1.151	68	13.913	91	152.286	114	550.000
23	0.344	46	1.222	69	15.032	92	167.926	115	1000.000

APPENDIX II

1994 Variable Annuity MGDB Mortality Table
MALE Age Nearest Birthday

AGE	1000q_x	AGE	1000q_x	AGE	1000q_x	AGE	1000q_x	AGE	1000q_x
1	0.701	24	0.738	47	2.246	70	28.068	93	234.658
2	0.473	25	0.782	48	2.486	71	30.696	94	255.130
3	0.393	26	0.824	49	2.751	72	33.688	95	276.308
4	0.306	27	0.860	50	3.050	73	36.904	96	297.485
5	0.280	28	0.892	51	3.397	74	40.275	97	317.953
6	0.268	29	0.922	52	3.800	75	44.013	98	337.425
7	0.257	30	0.948	53	4.239	76	48.326	99	356.374
8	0.238	31	0.971	54	4.706	77	53.427	100	375.228
9	0.230	32	0.992	55	5.234	78	59.390	101	394.416
10	0.233	33	1.003	56	5.854	79	66.073	102	414.369
11	0.245	34	1.004	57	6.601	80	73.366	103	436.572
12	0.267	35	1.006	58	7.451	81	81.158	104	460.741
13	0.302	36	1.020	59	8.385	82	89.339	105	484.644
14	0.352	37	1.054	60	9.434	83	97.593	106	506.047
15	0.408	38	1.111	61	10.629	84	105.994	107	522.720
16	0.463	39	1.182	62	12.002	85	115.015	108	534.237
17	0.509	40	1.268	63	13.569	86	125.131	109	542.088
18	0.544	41	1.367	64	15.305	87	136.815	110	546.908
19	0.573	42	1.481	65	17.192	88	150.191	111	549.333
20	0.599	43	1.599	66	19.208	89	164.944	112	550.000
21	0.627	44	1.725	67	21.330	90	180.886	113	550.000
22	0.658	45	1.867	68	23.489	91	197.834	114	550.000
23	0.696	46	2.037	69	25.700	92	215.601	115	1000.000

APPENDIX III

Description of Asset Classes

Equity Class

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

Bond Class

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

Balanced Class

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

Money Market Class

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

Specialty Class

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

Actuarial Guideline XXXV

THE APPLICATION OF THE COMMISSIONERS ANNUITY RESERVE METHOD TO EQUITY INDEXED ANNUITIES

Background

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

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

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

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

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

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

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

Scope

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

Computational Methods

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

General Requirements on the Use of Certain Computational Methods

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

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

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

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

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

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

Type 1 Methods

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

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

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

Type 2 Methods

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

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

Required Change in Method

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

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

Optional Change in Method

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

Plan Type

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

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

Other Regulatory Requirements

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

Asset Adequacy Testing of Reserves

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

ATTACHMENT 1
Description of Computational Methods

CARVM-UMV

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

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

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

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

MVRM

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

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

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

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

MVRM Using Black-Scholes Projection Method

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

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

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

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

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

EDIM

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

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

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

Step 4: The reserve is the sum of a Fixed Component and an Equity Component.

ATTACHMENT 2
Hedged as Required Criteria

In order to use a Type 1 computational method, the appointed actuary needs to certify quarterly that it meets either the “Basic” or “Option Replication” criteria.

Basic

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

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

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

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

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

Option Replication

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

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

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

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

5. The Company must have a stated maximum tolerance for differences between the expected performance of the hedge and the actual results of the hedge. The maximum tolerance test and compliance evaluation test must meet the following minimum requirements. The compliance evaluation criteria will be a retrospective correlation test performed at least on a weekly basis.

The Company will compare the change in the market value, from the beginning of the calendar quarter, of the hedge portfolio with the change in the market value of the options embedded in the liability portfolio. The maximum dollar amount of difference permitted between these two changes is10% of the beginning of period market value of the options embedded in the liabilities. If the difference exceeds this limit, the following steps must be taken:

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

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

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

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

ATTACHMENT 3
Reasonableness of Assumptions Certification

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

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

____

(Name of actuary)

____

(Signature of actuary)

____

(Date of certification)

ATTACHMENT 4
Reasonableness and Consistency of Assumptions Certification

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

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

1. reasonable in light of current relevant economic conditions as of the date of valuation, and

2. are consistent with the comparable assumptions used to determine the statement value of any derivative instruments used to hedge the equity indexed based obligations embedded in the equity indexed annuities subject to this certification

____

(Name of actuary)

____

(Signature of actuary)

____

(Date of certification)

Actuarial Guideline XXXVI

THE APPLICATION OF THE COMMISSIONERS RESERVE VALUATION METHOD TO EQUITY INDEXED LIFE INSURANCE POLICIES

Background

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

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

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

Scope

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

Definitions

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

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

Term. An index-based benefit crediting period.

Computational Methods

Computational methods deemed to be consistent with CRVM can be classified into three groups, Type 1 methods, Type 2a methods and Type 2 methods. The following computational method is considered a Type 1 method: the Implied Guarantee Rate Method (IGRM). Type 1 computational methods are deemed to be consistent with CRVM only if the "Hedged as Required" criteria are met. The following is considered a Type 2a method: the Commissioners Reserve Valuation Method with Updated Average Market Value (CRVM with UAMV). The following is considered a Type 2 method: the Commissioners Reserve Valuation Method with Updated Market Value (CRVM with UMV). For a complete description of these methods, consult Attachment 1.

The minimum reserve for equity indexed life insurance policies is the statutory reserve calculated under the Universal Life Insurance Model Regulation for an identical policy with no guaranteed index-based benefits. If the reserve produced by Type 1, Type 2a or Type 2, as appropriate, is greater than the minimum reserve, then that Type 1, Type 2a or Type 2 reserve is the minimum reserve.

Type 1 Methods

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

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

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

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

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

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

Type 2a Methods

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

Type 2a Prerequisite Criteria are as follows:

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

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

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

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

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

Type 2 Methods

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

Required Change in Method

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

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

Optional Change in Method

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

Asset Adequacy Testing of Reserves

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

Attachment 1
Description of Computational Methods

Implied Guaranteed Rate Method (IGRM)

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

The following describes how the IGRM works:

1. Issue date calculations:

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

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

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

2. Valuation date calculations:

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

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

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

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

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

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

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

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

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

The following describes how the CRVM with UAMV works:

1. Issue date calculations:

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

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

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

2. Valuation date calculations:

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

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

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

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

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

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

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

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

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

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

CRVM with Updated Market Value (UMV) Method

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

1. Issue date calculations:

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

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

2. Valuation date calculations:

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

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

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

At the time of calculation, fund values projected to the end of the current term should be further projected to the end of the next term at the guaranteed interest rate. This should be added to the accumulated option cost for that term. This should be done successively for each subsequent term, using the appropriate option cost for each term. The option for each term should provide for the index-based benefit in excess of any other interest rate guarantee for the term. The cost for each option should recognize the current relevant economic condition on the calculation date and be priced as if the term began on that date. The option cost for each future term should be accumulated to the end of the term at the appropriate maximum valuation rate in accordance with the SVL.

Attachment 2
Hedged as Required Criteria - Life Products

In order to use a Type 1 computational method, the appointed actuary needs to certify quarterly that it meets either the "Basic" or "Option Replication" criteria.

Basic

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

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

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

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

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

Option Replication

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

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

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

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

5. The company must have a stated maximum tolerance for differences between the expected performance of the hedge and the actual results of the hedge. The maximum tolerance test and compliance evaluation test must meet the following minimum requirements. The compliance evaluation criterion will be a retrospective correlation test performed at least on a weekly basis. The company will compare the change in the market value, from the beginning of the calendar quarter, of the hedge portfolio with the change in the market value of the target of the option replication strategy. The maximum dollar amount of difference permitted between these two changes is10% of the beginning of period market value of the target of the option replication strategy. If the difference exceeds this limit, the following steps must be taken:

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

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

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

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

Attachment 3
Reasonableness of Assumptions Certification
for Implied Guaranteed Rate Method

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

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

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

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

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

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

   b. ________________(to be described by appointed actuary)

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

____

(Name of actuary)

____

(Signature of actuary)

____

(Date of certification)

Attachment 4
Reasonableness and Consistency of Assumptions Certification for Commissioners Reserve Valuation Method with Updated Average Market Value

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

> I, (state name and professional designation) am the appointed actuary for (company name). I have reviewed the assumptions underlying the values assigned to all equity index options used in the determination of statutory reserves using a Type 2a computational method for all equity indexed universal life insurance policies issued or reinsured by (company name) insurance company and reported in the statutory financial statement as of (the date of valuation).
>
> The assumptions used to determine such option values for the current term are:
>
> 1. Reasonable in light of current relevant economic conditions as of the date of valuation; and
> 2. Consistent with the comparable assumptions used to determine the statement of value of any derivative instruments as of the valuation date used to hedge the equity index-based obligations embedded in the equity indexed life policies subject to this certification.
>
> The assumptions used to determine equity index option values for terms subsequent to the current term are:
>
> 1. Determined in accordance with the Commissioners Reserve Valuation Method with Updated Average Market Value
> 2. Based on quantitative data for the base case option (1-year European At-The-Money) of 3% plus ___._% 60 -month moving average annualized daily actual volatility
> 3. Reasonably adjusted to reflect the following variances from the base case due to benefit design and capital market reasons (all material adjustments should be listed)
>   a. skew adjustments
>
>   b. _______________(to be described by appointed actuary)
> 4. Reliant on the following source(s) for assumptions not prescribed by this Actuarial Guideline:
>   a. _______________(to be described by appointed actuary)

____

(Name of actuary)

____

(Signature of actuary)

____

(Date of certification)

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

The following certification must be filed in conjunction with each quarterly and annual statutory financial statement filed with the appropriate regulatory official in each state in which the insurer does business. The appointed actuary must sign the certification.

> I, (state name and professional designation) am the appointed actuary for (company name). I have reviewed the assumptions underlying the values assigned to all equity index options used in the determination of statutory reserves using a Type 2 computational method for all equity indexed universal life insurance policies issued or reinsured by (company name) insurance company and reported in the statutory financial statement as of (the date of valuation). The assumptions used to determine such option values are:
>
> 1. Reasonable in light of current relevant economic conditions as of the date of valuation; and
> 2. Consistent with the comparable assumptions used to determine the statement of value of any derivative instruments as of the valuation date used to hedge the equity index-based obligations embedded in the equity indexed life policies subject to this certification.

____

(Name of actuary)

____

(Signature of actuary)

____

(Date of certification)

Actuarial Guideline XXXVII

VARIABLE LIFE INSURANCE RESERVES FOR GUARANTEED MINIMUM DEATH BENEFITS

Background

This guideline's primary focus is to clarify the appropriate projection assumptions and methodologies used to determine statutory reserve liabilities for Guaranteed Minimum Death Benefits (GMDBs) offered with variable life insurance products.

For many years, insurance companies have not applied uniform reserve standards to variable life insurance policies in general, and to GMDBs in particular. Four regulatory sources are often looked to for guidance. First, the Standard Valuation Law (SVL) requires that CRVM be based on the present value of future guaranteed benefits. Second, the Variable Life Insurance Model Regulation as revised in 1983 and again in 1989 states "Reserve liabilities for variable life insurance policies shall be established under [SVL] in accordance with actuarial procedures that recognize the variable nature of the benefits provided and any mortality guarantees." Third is the Universal Life Insurance Model Regulation and most recently the Valuation of Life Insurance Policies Model Regulation.

GMDBs are common features of variable life products. Recently, reserve methods for universal life secondary guarantees have been clarified in the Valuation of Life Insurance Policies Model Regulation. These secondary guarantees are similar to GMDBs offered with variable life policies. A Guaranteed Minimum Death Benefit is any guarantee which provides death benefit protection which would not otherwise be provided in the absence of such a guaranteed benefit or provision. An example of a GMDB is a policy in which death benefits continue in-force even if the policy value is zero. This benefit may be contingent on additional qualifications being met, such as cumulative premiums meeting some limit.

Additional examples of GMDBs are provided below. This list is not intended to include all types of GMDBs.

- A Minimum Death Benefit Provision or No Lapse provision where death benefits are guaranteed to remain in-force for a period of time even if the policy value is not greater than zero subject only to certain conditions being met such as cumulative premiums meeting a minimum amount, or if a theoretical policy value is sufficient to meet a minimum amount.

- Death Benefits that are guaranteed to be at least as large as the original face amount, regardless of investment performance which might generate negative Paid Up Additions on a traditional fixed premium variable life insurance policy.

The Variable Life Insurance Model Regulation defines the reserve methodology for variable life policies. However, currently two versions of the model regulation exist and this results in inconsistent treatment by state. These two versions include the 1983 revisions and the 1989 revisions to the model regulation. Many states have not passed either revision and therefore require direct interpretation of SVL. In practice, companies have interpreted these regulations inconsistently with regard to assumptions and/or application to current products available today. The 1983 version of the regulation treats flexible premium policies differently than scheduled premium policies. The 1983 version of the regulation did not anticipate the types of GMDBs available today which require contingent conditions to be met to maintain a death benefit guarantee, for instance specified premiums must be paid. Thus, confusion exists with regard to which valuation method is appropriate. The 1989 version makes no distinction between the scheduled premium and flexible premium policies.

This Guideline codifies the basic interpretation of reserve liabilities for variable life GMDBs by clarifying the projection assumptions and methodologies that comply with the SVL. Minimum valuation standards that may be used to determine this reserve and are not specifically addressed in this guideline are defined by SVL and other applicable state regulations. This guideline focuses on the methodology of the 1989 revisions to interpret SVL, as we believe the 1989 revision more appropriately considers the types of products and GMDBs available today.

Interpretations of both the 1983 and 1989 versions reflect the comments made in the December 1972 report which concluded that an acceptable GMDB reserve system should have the following characteristics:

1. The GMDB reserve should be held in the general account of the company so that it will be backed by the general assets of the company, most of which are debt obligations valued at amortized cost and, therefore, are of a fixed dollar nature. It would not be proper to hold the GMDB reserve in the separate account, assuming the reserve is not supported by fixed dollar assets but by assets that are moving in the opposite direction from the risk, i.e. value moving downward while the risk increases and vice versa.

2. The GMDB reserve should be adequate to cover the GMDB death claims for the next year in all but the most extreme circumstances so that the regulatory authorities can be assured the company will not run into financial trouble from this source before the next annual statement is filed.

3. The GMDB reserve should react slowly but steadily through an extended period of poor investment experience of the separate account.

4. The GMDB reserve should not cause unnecessary fluctuations in surplus by increasing too rapidly in a sharp market downswing. Also, the reserve should not decrease too rapidly in a sharp market upswing after a period of poor market performance.

This guideline maintains the four principles above in interpreting the Standard Valuation Law as it relates to variable life business and the methods defined in both the 1983 and 1989 versions of the Variable Life Insurance Model Regulation.

Reserve methodologies which recognize the variable nature of GMDB are defined in the Variable Life Insurance Model Regulation and include a One-Year Term reserve recognizing a 1/3 drop in separate account assets, the Attained Age Level Reserve (AALR) methodology and in the 1983 version, a methodology for flexible premium policies. Reserves for GMDBs are held in the general account.

This guideline recognizes the following principles when determining appropriate reserves for GMDB.

- Determine the guaranteed death benefits which are not valued in the basic policy reserves.

- Establish a reserve for these benefits over the period of time in which revenue is collected to pay for such benefits; however, no greater than the period of time these guaranteed benefits are provided.

- Collected revenue should not be de-minimus in order to reduce the reserve.

- The reserve established is in addition to basic reserves

This guideline interprets the standards for applying these methodologies. This guideline also interprets the projection assumptions to be applied to determine excess guaranteed death benefits. The guideline clarifies the use of the AALR methodology for flexible premium variable life policies with contingent

GMDB benefit structures similar to specified premium contracts. This guideline is based on the belief that the 1983 revisions did not anticipate these types of GMDB benefits on flexible premium contracts. Thus, it makes sense to interpret the 1983 revisions for these types of GMDB benefits by applying the AALR methodology when there is a contingent GMDB structure. For flexible premium plans with other types of GMDBs, the flexible premium language of the 1983 revision is used where applicable.

The AALR methodology, along with the one-year term reserve is generally consistent with the principles above in that additional reserves are established in recognition of all death benefit guarantees not reflected in basic reserves. If multiple guarantees exist all guarantees must be valued and the greatest additional reserve is held. Consecutive GMDBs are treated as a single guarantee. These reserves are funded over the period of time GMDB Revenue will be collected through either policy charges or premiums, however, not to exceed the GMDB benefit period. The AALR methodology funds any GMDB Revenue deficiency over the period of time the Revenue is collected, however, no longer than the end of the guarantee period.

GMDB reserves are held in addition to basic reserves unless the appointed actuary provides satisfactory documentation to the state of domicile insurance department stating why such reserves are redundant. For example, for traditional variable life product designs where reserves are generally determined on a tabular basis and use an assumed interest rate (AIR), if basic reserves are determined based on at least the guaranteed face amount, (i.e. ignoring any negative additions) then the guaranteed death benefit is fully reflected in the basic reserves; therefore, an additional GMDB reserve is redundant. Neither this guideline nor the 1989 amendments specifically address traditional variable life product designs, nor does this guideline specifically exclude these designs from its scope.

An additional purpose of this guideline is to emphasize the impact of Sections 3A(3) and 3A(4) in the Valuation of Life Insurance Policies Model Regulation (“XXX”) relative to reserving for variable life and variable universal life products.

Scope

The guideline applies to all variable life insurance contracts to which the Standard Valuation Law applies and which provide Guaranteed Minimum Death Benefits (GMDBs) either explicitly or implicitly.

Definitions

Attained age level reserve (AALR): The AALR is a methodology described in the 1983 and 1989 revisions to the Variable Life Insurance Model Regulation.

Catch-up provision: A Catch-up provision is a provision in the policy that gives the policyholder the right to catch up on any contingent requirements in order to maintain the GMDB.

Guaranteed Period: The guaranteed period is the period of time over which a GMDB is guaranteed regardless of the basic guarantees in the policy. A policy may have multiple guaranteed periods and GMDBs.

Guaranteed Minimum Death Benefit (GMDB): A Guaranteed Minimum Death Benefit (GMDB) is any guarantee which provides continued death benefit protection which would not otherwise be provided in the absence of such a guaranteed benefit or provision. A policy may have multiple GMDBs.

One-Year Term (OYT) reserve: The OYT reserve covers a period of no more than one year following a 1/3–asset drop. This reserve is fully described in the 1989 revision to the Variable Life Insurance Model Regulation. This guideline clarifies the methodology and the assumptions used to determine OYT reserves.

Policy Value: Policy value means, as of the valuation date, the greater of (a) zero and (b) the amount to which separately identified interest credits and/or investment return and mortality, expense, or other charges are made under a variable life insurance policy. Subsequent to the valuation date, "policy value" means the amount determined in accordance with the procedures specified in this guideline.

Projection Assumptions: The Projection Assumptions are used to determine guaranteed death benefits. This projection of policy values uses the following assumptions:

1. Cost of insurance rates are equal to the minimum valuation mortality.

2. The GMDB is assumed to be in effect for the maximum period of the GMDB. All minimum requirements necessary to maintain the GMDB in force subsequent to the valuation date are assumed to be met at the latest point in time sufficient to maintain the GMDB through its maximum period. Contingent requirements, if any, required to reinstate or catch-up as of the valuation date are assumed to occur on the valuation date. If the GMDB would continue in effect subsequent to the valuation date with no additional actions required, contingent requirements are assumed not to resume until the latest point in time which would prevent the termination of the GMDB.

3. The general account policy values and separate account policy values are projected at the valuation interest rate. The assumed investment rate, if any, is used when determining the OYT reserve.

4. The guaranteed period covered is determined assuming all contingent requirements are met.

5. Policy options and benefits are assumed to continue unchanged as of the valuation date. Examples include fixed and variable account allocation and the death benefit option.

6. The projection of policy values is made for the entire guarantee period, regardless of whether projected policy values are positive or negative at any point in the projection. Any negative policy value would be set to zero.

The policy value is projected forward from the valuation date with valuation interest rate credits, any payments required to maintain the guarantee and valuation mortality charges (and no other credits or charges). The Guideline stipulates that "A death benefit in the absence of the guarantee is assumed to be provided as long as the projected policy value is greater than zero," and "Any negative policy value would be set to zero." An AALR need not be established for a VUL policy to provide for any period during which there would be a death benefit in the absence of the guarantee, since this benefit would be provided for by the policy's basic reserve. This means that for an AALR to develop, the mortality charges must exceed the required payments plus interest credits by enough to reduce the policy value to zero during the guarantee period. Surrender charges are not relevant to this determination.

GMDB Revenue: GMDB Revenue is policy charges or premium, either implicit or explicit. These charges or premiums may or may not be explicitly stated to cover GMDB benefits. An example of an implicit premium is a positive premium necessary to maintain a target policy value in order to maintain benefits.

Term cost: Term costs are based on the guaranteed minimum death benefits in excess of the death benefits that would be provided in absence of such guarantee based on a projection of policy values using the Projection Assumptions defined above. These costs are then discounted to the valuation date. The term costs are based on minimum valuation mortality standards and a discount rate not to exceed the maximum valuation interest rate.

1/3-Asset Drop: A 1/3 reduction in separate account assets that is used in the calculation of the one-year term reserve. This 1/3 drop is not applied to fixed account assets.

Text

1. Basic Reserves:

Basic Reserves include the reserve held for death benefits provided in the absence of a GMDB. Reserve liabilities for variable life insurance policies shall be established consistent with the methodologies described in the Standard Valuation Law and in accordance with actuarial procedures that recognize the variable nature of the benefits provided and any mortality guarantees. Reserve methods described in the Variable Life Insurance Model Regulation and the Universal Life Insurance Model Regulation may be appropriately utilized to determine reserve liabilities such that application of these methods is consistent with the principles of the Standard Valuation Law.

2. Guaranteed Minimum Death Benefit Reserves:

Additional reserves are required to provide for liabilities of GMDB provisions which provide benefits that would not be provided in the absence of the guarantee. In measuring these liabilities, the basic reserve provides for death benefits which occur in the absence of the guarantee. GMDB reserves provide for the contingency of death occurring when the guaranteed minimum death benefit exceeds the death benefit that would be paid in absence of the guarantee. A consistent reserve methodology should be used regardless of whether a contract has scheduled premiums or flexible premiums.

When a contract provides multiple GMDBs and/or multiple guarantee periods, a reserve is established based on the guaranteed period which produces the greatest reserve as of the valuation date. Consecutive GMDBs are treated as a single guarantee period. The reserve methodology reflects all potential guarantee periods assuming that contingent requirements are met such as: contingent premiums paid, Catch-up Provisions or any pre-funding of contingent requirements.

For a policy under the 1989 revisions or a flexible premium policy with contingent GMDBs similar to a specified premium contract under the 1983 revision, the GMDB reserve equals the greater of (1) and (2) where (1) equals "the aggregate total of term costs" (OYT) which covers a period of no more than one year following a 1/3-Asset Drop, and (2) equals the AALR as described below.

For a flexible premium policy under the 1983 revisions not covered above, (where the GMDB guarantee is not contingent on any policyholder requirement), reserve liabilities for any guaranteed minimum death benefit shall be maintained in the general account of the insurer and shall be not less than the aggregate total of the term costs, if any, covering the period provided for in the guarantee not otherwise provided for by the reserves held in the separate account assuming a 1/3-asset drop, projected at the valuation interest rate.

a) One Year Term Reserves (OYT):

This reserve component equals the "aggregate total of term costs", if any, covering a period of one full year from the valuation date, or, if less, covering the period of time death benefits are provided which are not otherwise provided for by the basic reserves. This reserve assumes any contingent requirements to maintain the GMDB are met by reflecting any Catch-up Provisions or any pre-funding of contingent requirements.

"Aggregate total term costs" equals the present value of guaranteed minimum death benefits in excess of death benefits that would be provided in absence of such guarantee, if any, prior to the end of one full year or the end of the guaranteed period if sooner. A death benefit in the absence of the guarantee is assumed to be provided as long as the projected policy value is greater than zero. Death benefits are determined by projecting the policy value following a 1/3 -Asset Drop and using the Projection Assumptions defined above. Present values are determined using valuation mortality rates and the maximum valuation interest rate.

b) Attained Age Level Reserves (AALR):

This reserve component allows for funding GMDBs over no longer than the guaranteed period. This reserve assumes contingent requirements are met to maintain the GMDB and reflect any prepaid contingent requirements or Catch-up provisions. A death benefit in the absence of the guarantee is assumed to be provided as long as the projected policy value is greater than zero. This reserve component exists until no later than the end of the guarantee period if, on any prior valuation date, projected policy values resulted in guaranteed minimum death benefits in excess of death benefits that would be provided in absence of such guarantee. To the extent long term favorable investment performance results in redundant reserves, the valuation actuary may request permission from the state of domicile insurance department to release all or a portion of the redundant GMDB reserves. This projection of policy value is based on the Projection Assumptions defined above and does not incorporate a 1/3-Asset Drop.

The AALR reserve component shall not be less than zero and shall equal the "residue," as described in paragraph (1) below, of the prior year's AALR on the contract, with any such "residue," increased or decreased by a "payment" computed on an attained age basis as described in paragraph (2) below.

(1) The "residue" of the prior year's AALR on each variable life insurance contract shall not be less than zero and shall be determined by adding interest at the maximum valuation interest rate to such prior year's reserve, deducting the tabular claims based on the "excess", if any, of the guaranteed minimum death benefit over the death benefit that would be payable in absence of such guarantee, and dividing the result by the tabular probability of survival. Hence, tabular costs are only deducted for years where, in the absence of the guarantee, coverage would be less than the guaranteed coverage.

(2) The "payment" used to increase or decrease the "residue" above shall be computed so that the present value of a level payment of that amount each year over the future period for which GMDB Revenue will be collected under the contract is equal to (A) minus (B) minus (C), where, (A) is the present value of future guaranteed minimum death benefits. The future guaranteed minimum death benefits are the projected future death benefits including the GMDB. (B) is the present value of the projected future death benefits that would be payable in the absence of the GMDB. The guaranteed benefit for (A) and (B) should be calculated for the life of the policy. Both (A) and (B) are calculated based on the Projection Assumptions. (C) is any "residue," as described in paragraph (1) above, of the prior year's AALR on such variable contract. Minimum standards of valuation mortality assumptions and maximum valuation interest rates are used to determine present values and net level payments. The period of time in which GMDB Revenue will be collected is limited to the period of time policy values are sufficient to collect policy charges or the period of time contingent requirements will be paid to maintain the GMDB. In no event will the time period be greater than the time to the end of the guarantee period. It should also be noted that the "payment" may be negative resulting in the reserve running off over the remaining guarantee period.

c) Other Flexible Premium Policies under the 1983 revisions not included above:

The present value of potential guaranteed minimum death benefits in excess of death benefits that would be provided in absence of such guarantee is determined by using minimum standards of valuation mortality assumptions and maximum valuation interest rates.

3. Issues:

Sections 3A(3) and 3A(4) of "XXX" state the following:

3A(3): This regulation shall not apply to any variable life insurance policy that provides for life insurance, the amount or duration of which varies according to the investment experience of any separate account or accounts.

3A(4): This regulation shall not apply to any variable universal life insurance policy that provides for life insurance, the amount or duration of which varies according to the investment experience of any separate account or accounts.

The language of these sections is clear. The reserving for variable life and variable universal life is in no way affected by the provisions of "XXX." In particular, the 19-year select factors and the "X" factor are not applicable to the calculation of reserves for variable life and variable universal life products.

Effective Date

This guideline affects all variable life insurance contracts issued. Where the application of this Guideline produces higher reserves than the company had otherwise established by their previously used interpretation, such company must comply with this guideline effective December 31, 2001. However, such company may request a grade in period, not to exceed three (3) years, from the domiciliary Commissioner upon satisfactory demonstration of the previous interpretation and that such delay of implementation will not cause a hazardous financial condition or potential harm to its policyholders.

Retroactive application of the guideline to in-force policies to develop the current residue portion of the AALR will generally not be feasible. Therefore, the residue as of 12/31/2000 should be set equal to the greater of the amount established by the company under its current method or $0 if the company did not previously calculate an AALR.

Actuarial Guideline XXXVIII

THE APPLICATION OF THE VALUATION OF LIFE INSURANCE POLICIES MODEL REGULATION

Introduction

The revised version of the *Valuation of Life Insurance Policies Model Regulation* (Model #830) was adopted by the NAIC in March 1999. Since that date, some questions have been raised regarding whether and how Model #830 applies to various product designs. The purpose of this guideline is to provide direction as to the application of Model #830 to such products. Specifically, this guideline provides examples of various policy features that constitute "guarantees" and gives directions on how to reserve for these guarantees in accordance with Model #830.

Obviously, new policy designs will emerge subsequent to the development of this document. No statute, regulation, or guideline can anticipate every future product design, and common sense and professional responsibility are needed to assure compliance with both the letter and the spirit of the law. While Model #830 is a complex regulation, its intent is clear: reserves need to be established for the guarantees provided by a policy. Policy designs which are created to simply disguise those guarantees or exploit a perceived loophole must be reserved in a manner similar to more typical designs with similar guarantees.

Text

The following product designs have been brought to the attention of the NAIC Life Actuarial (A) Task Force. The list below specifies reserving approaches which the Task Force regards as being most consistent with the letter and spirit of Model #830. However, the specified reserving approaches should be modified as needed to comply with the intent of this guideline that similar reserves be established for policy designs that contain similar guarantees.

1. An initial level premium rate is guaranteed for 10 years followed by increased guaranteed premiums for an additional 20 years. However, the company cannot increase premiums after year 10 (i.e., the initial premium continues to be charged) unless some specified event occurs.

   The initial reserve segment is 30 years. Since the contract contains provisions that limit the company's ability to increase premiums, then the initial premium should be treated as guaranteed for the entire 30-year period. It would be contrary to the conservative nature of statutory accounting to treat this policy the same as one in which the ability to raise premiums is unrestricted.

2. A term policy has an illustrated level premium for 30 years, the first 10 of which are guaranteed. Additionally, there is a refund option which provides that a specified refund will be paid if the premium ever increases. The refund must be requested within a limited time (e.g., 30 days) of receiving notice of the increase. Coverage terminates if the option is exercised.

   This example differs from the one above in that there is no specified event that has to occur in order for the company to impose a premium increase; however, the company must provide an additional benefit to the policyholder if it exercises this right. Thus the company does not have an unrestricted right to impose an increase after 10 years. If the contract contains provisions that require that additional benefits be provided to the policyholder in the event of a premium increase, even if these benefits are lost if not claimed within a stated time frame, then the initial premiums should be treated as guaranteed for the entire 30 year period. It would be contrary to the conservative nature of statutory accounting to treat this policy the same as one in which the ability to raise premiums does not require that additional benefits be provided. Therefore, the initial segment for this policy is 30 years.

3. An initial level premium rate is guaranteed for 10 years followed by increased guaranteed premiums for an additional 20 years. However, after year 10 the policyholder is protected against premiums being increased above the initial level, with the protection provided by a second company through either reinsurance, a second policy issued to the consumer, or an agreement between the companies.

   The combined reserves of the direct writer and the second company should be no less than the amount which the direct writer would hold if (a) there were no second company and (b) the initial reserve segment were 30 years. If this condition is not met, reserve credits for the direct writer should be disallowed. The reserve held by the direct writer should be based on the initial level premium being guaranteed for 30 years.

4. A product has relatively high gross premiums but with a guaranteed dividend or guaranteed refund schedule, or by some other means guarantees a low net cost to the policyholder.

   The net amount of premium (i.e., gross premium less dividends or refunds) should be used in the reserve calculation. That represents the amount the insured actually pays for coverage.

   For products reinsured on either a coinsurance or modified coinsurance basis, the reinsurer's reserve calculation should also be based on the net premium (i.e., gross premiums less dividends or refunds guaranteed to be paid to the policyholder).

5. a) A re-entry term product has an initial rate guarantee for 10 years, with loose or non-existent re-entry underwriting, allowing the policyholder to re-enter for an additional 20 years at specified favorable rates.

   b) A universal life policy has provisions such that, if the UL policy lapses prior to the 10th policy anniversary because the actual accumulation value (or cash value, depending on design) falls below zero but stipulated premiums have been paid, a substitute policy is guaranteed to be issued providing the same amount of insurance coverage at the same stipulated premium for the remainder of the 10-year period plus an additional 20 years.

   The reentry periods and premiums should be treated as a continuation of the initial guarantees for reserve calculation purposes. The initial reserve segment applicable to the original policy should be 30 years if the stipulated premium for the substitute policy is not high enough to trigger a new reserve segment. When the substitute policy is issued, reserves should be determined as if the coverage had been issued at the issue age and issue date of the original policy. Effectively, the company has guaranteed coverage for 30 years at the time the initial policy is issued, and the reserves established should reflect that guarantee.

6. A reinsurance treaty provides for 30 years of level premiums on a current scale but directly guarantees those premiums for only the first 10 years. However, if the reinsurer increases the premiums after 10 years, the reinsurer agrees to increase the expense allowance such that the net payments (premium minus allowance) by the direct writer remains unchanged.

   Relative to the reinsurer's reserve calculation, the initial reserve segment should be 30 years and the valuation premium should be level over that period. In this instance, the additional "expense allowance" has no relationship to the expenses actually incurred by the direct writer in administering the reinsured policies. Although a bona fide expense allowance would typically not be considered in determining the valuation premiums and reserve segments, in this instance the additional "expense allowance" has no relationship to the expenses actually incurred by the direct writer in administering the reinsured policies."

7. A universal life policy has a cumulative "premium catch-up provision" in which the coverage is guaranteed to remain in force as long as a stipulated premium is paid each year, and if the insured is paying less than is required to maintain the guarantee, there is an unlimited right to make up past premium deficiencies.

Model #830 requires that "when a policy contains more than one secondary guarantee, the minimum reserve shall be the greatest of the respective minimum reserves at that valuation date of each unexpired secondary guarantee, ignoring all other secondary guarantees." Since secondary guarantees with "catch-up" provisions are capable of being reinstated up to the end of the secondary guarantee period, they constitute "unexpired secondary guarantees" which must be incorporated into the calculation of "the greatest of the respective minimum reserves at that valuation date of each unexpired secondary guarantee, ignoring all other secondary guarantees."

The basic and deficiency reserves for a secondary guarantee with a catch-up provision should be computed as if the stipulated premium requirement had been met. The basic reserve shall be reduced by the product of (a) the "catch-up amount," if any, which would be required on the valuation date and (b) the ratio of the "initial" (i.e., before adjustment) basic reserve to the sum of the "initial" basic and deficiency reserves. In no event shall the "reduced" basic reserve be reduced below zero. The deficiency reserve shall be reduced by the product of (a) the "catch-up amount," if any, which would be required on the valuation date and (b) the ratio of the "initial" deficiency reserve to the sum of the "initial" basic and deficiency reserves. In no event shall the "reduced" deficiency reserve be reduced below zero.

If a universal life policy with a "premium catch up provision" has a shadow account below the level necessary to maintain the secondary guarantee, then the reserve for the secondary guarantee shall be valued according to this example. The basic and deficiency reserves, before deduction for the catch-up amount, shall be calculated as specified in Section 8A, Section 8B, Section 8C or Section 8E, as applicable.

8A. For policies and certificates issued prior to July 1, 2005: A universal life policy guarantees the coverage to remain in force as long as the accumulation of premiums paid satisfies the secondary guarantee requirement.

First, the minimum gross premiums (determined at issue) that will satisfy the secondary guarantee requirement must be derived.

Second, for purposes of applying Sections 7B and 7C of Model #830, the "specified premiums" are the minimum gross premiums derived in "Step One."

Third, a determination should be made of the amount of actual premium payments in excess of the minimum gross premiums. For policies utilizing shadow accounts, this will be the amount of the shadow account. For policies with no shadow accounts but which specify cumulative premium requirements, this excess will be the amount of the cumulative premiums paid in excess of the cumulative premium requirements; the cumulative premium payments and requirements should include any interest credited under the secondary guarantee (with interest credited at the rate specified under the secondary guarantee).

Fourth, a determination should be made of the single payment necessary at the valuation date to fully fund the remaining secondary guarantee assuming that the minimum gross premiums have been paid, up through the valuation date, during the secondary guarantee period. The result from "Step Three" should be divided by this number.

Fifth, compute the net single premium on the valuation date for the coverage provided by the secondary guarantee for the remainder of the secondary guarantee period, using any valuation table and select factors authorized in Section 5A of Model #830.

Sixth, the "net amount of additional premiums" is determined by multiplying the ratio from "Step Four" by the difference between the net single premium from "Step Five" and the basic and deficiency reserve, if any, computed in "Step Two."

Seventh, a "reduced deficiency reserve" should be computed by multiplying the deficiency reserve, if any, by the one minus the ratio from "Step Four," but not less than zero. This "reduced deficiency reserve" is the deficiency reserve to be used for purposes of Section 7D(1) of Model #830.

Eighth, the actual reserve used for purposes of Section 7D(1) of Model #830 is the lesser of: (1) the net single premium from "Step Five," and (2) the amount of the excess from "Step Six" plus the basic reserve and the deficiency reserve, if any, computed in "Step Two." Reduce this result by the applicable policy surrender charges, i.e., the account value less the cash surrender value. If the resulting amount is less than the sum of the basic and deficiency reserve from Step Two, then the basic and deficiency reserves to be used for the purposes of Section 7D(1) are those calculated in Step Two, and no further calculation is required.

Ninth, an "increased basic reserve" should be computed by subtracting the "reduced deficiency reserve" in "Step Seven" from the reserve computed in "Step Eight." This "increased basic reserve" is the basic reserve to be used for purposes of Section 7D(1) of Model #830.

8B. For policies and certificates issued on or after July 1, 2005 and on or prior to December 31, 2006: A universal life policy guarantees the coverage to remain in force as long as the accumulation of premiums paid satisfies the secondary guarantee requirement.

First, the minimum gross premiums (determined at issue) that will satisfy the secondary guarantee requirement must be derived.

Second, for purposes of applying Sections 7B and 7C of Model #830, the "specified premiums" are the minimum gross premiums derived in "Step One." Consistent with Model #830, the remaining steps in this guideline should be calculated on a segmented basis, using the segments that Model #830 defines for the product. Therefore, in the remaining steps, the term "fully fund the guarantee" should be interpreted to mean fully funding the guarantee to the end of each possible segment. The term "remainder of the secondary guarantee period" should be interpreted to mean the remainder of each possible segment. The total reserve should equal the greatest of all possible segmented reserves.

Third, a determination should be made of the amount of actual premium payments in excess of the minimum gross premiums. For policies utilizing shadow accounts, this will be the amount of the shadow account. For policies with no shadow accounts but which specify cumulative premium requirements, this excess will be the amount of the cumulative premiums paid in excess of the cumulative premium requirements; the cumulative premium payments and requirements should include any interest credited under the secondary guarantee (with interest credited at the rate specified under the secondary guarantee).

Fourth, as of the valuation date for the policy being valued, for policies utilizing shadow accounts, determine the minimum amount of shadow account required to fully fund the guarantee. For policies with no shadow accounts but which specify cumulative premium requirements, determine the amount of the cumulative premiums paid in excess of the cumulative premium requirements that would result in no future premium requirements to fully fund the guarantee; the cumulative premium payments and requirements should include any interest credited under the secondary guarantee (with interest credited at the rate specified under the secondary guarantee). For any policy for which the secondary guarantee can not be fully funded in advance, solve for the minimum sum of any possible excess funding (either the amount in the shadow account or excess cumulative premium payments depending on the product design) and the present value of future premiums (using the maximum allowable valuation interest rate and the minimum mortality standards allowable for calculating basic reserves) that would fully fund the guarantee. The amount determined above for this step is to then be divided by one minus a 7% premium load allowance (0.93). The result from "Step Three" should be divided by this number, with the resulting ratio capped at 1. The ratio is intended to measure the level of prefunding for a secondary guarantee which is used to establish reserves. Assumptions within the numerator and denominator of the ratio therefore must be consistent in order to appropriately reflect the level of prefunding. The denominator is allowed to be inconsistent only by the amount of the premium load allowance as defined in this step. As used here, "assumptions" include any factor or value, whether assumed or known, which is used to calculate the numerator or denominator of the ratio.

[DRAFTING NOTE: The 7% premium load allowance approximates an average premium load level as evidenced by policies currently sold in the market. Rather than have the funding ratio vary according to the actual policy loads (which can fluctuate greatly by company and product), all companies will use an identical premium load allowance at a level approximately equal to the current industry average.]

Fifth, compute the net single premium on the valuation date for the coverage provided by the secondary guarantee for the remainder of the secondary guarantee period, using any valuation table and select factors authorized in Section 5A of Model #830.

Sixth, the "net amount of additional premiums" is determined by multiplying the ratio from "Step Four" by the difference between the net single premium from "Step Five" and the basic and deficiency reserve, if any, computed in "Step Two."

Seventh, a "reduced deficiency reserve" should be computed by multiplying the deficiency reserve, if any, by the one minus the ratio from "Step Four," but not less than zero. This "reduced deficiency reserve" is the deficiency reserve to be used for purposes of Section 7D(1) of Model #830.

Eighth, the actual reserve used for purposes of Section 7D(1) of Model #830 is the lesser of: (1) the net single premium from "Step Five," and (2) the amount of the excess from "Step Six" plus the basic reserve and the deficiency reserve, if any, computed in "Step Two." Reduce this result by the applicable policy surrender charges, i.e., the account value less the cash surrender value. Multiply this surrender charge by the ratio of the net level premium for the secondary guarantee period divided by the net level premium for whole life insurance. Calculate both net premiums using the maximum allowable valuation interest rate and the minimum mortality standards allowable for calculating basic reserves. However, if no future premiums are required to support the guarantee period being valued, there is no reduction for surrender charges. If the resulting amount is less than the sum of the basic and deficiency reserve from Step Two, then the basic and deficiency reserves to be used for the purposes of Section 7D(1) of Model #830 are those calculated in Step Two, and no further calculation is required.

Ninth, an "increased basic reserve" should be computed by subtracting the "reduced deficiency reserve" in "Step Seven" from the reserve computed in "Step Eight." This "increased basic reserve" is the basic reserve to be used for purposes of Section 7D(1) of Model #830.

8C. For all policies and certificates issued on or after January 1, 2007 and on or prior to December 31, 2012: A universal life policy guarantees the coverage to remain in force as long as the accumulation of premiums paid satisfies the secondary guarantee requirement.

First, the minimum gross premiums (determined at issue) that will satisfy the secondary guarantee requirement must be derived.

Second, for purposes of applying Sections 7B and 7C of Model #830, the "specified premiums" are the minimum gross premiums derived in "Step One." Consistent with Model #830, the remaining steps in this guideline should be calculated on a segmented basis, using the segments that Model #830 defines for the product. Therefore, in the remaining steps, the term "fully fund the guarantee" should be interpreted to mean fully funding the guarantee to the end of each possible segment. The term "remainder of the secondary guarantee period" should be interpreted to mean the remainder of each possible segment. The total reserve should equal the greatest of all possible segmented reserves. Additionally, for purposes of applying Sections 7B and 7C of Model #830, a lapse rate of no more than 2% per year for the first 5 years, followed by no more than 1% per year to the policy anniversary specified in the following table based on issue age, and 0% per year thereafter may be used. If the duration in the table is less than 5, then a lapse rate of no more than 2% per year may be used through that duration, and 0% per year thereafter.

Issue Age	Duration
0-50	30th policy anniversary
51-60	Policy anniversary age 80
61-70	20th policy anniversary
71-89	Policy anniversary age 90
90 and over	No lapse

Third, a determination should be made of the amount of actual premium payments in excess of the minimum gross premiums. For policies utilizing shadow accounts, this will be the amount of the shadow account. For policies with no shadow accounts but which specify cumulative premium requirements, this excess will be the amount of the cumulative premiums paid in excess of the cumulative premium requirements; the cumulative premium payments and requirements should include any interest credited under the secondary guarantee (with interest credited at the rate specified under the secondary guarantee).

Fourth, as of the valuation date for the policy being valued, for policies utilizing shadow accounts, determine the minimum amount of shadow account required to fully fund the guarantee. For policies with no shadow accounts but which specify cumulative premium requirements, determine the amount of the cumulative premiums paid in excess of the cumulative premium requirements that would result in no future premium requirements to fully fund the guarantee; the cumulative premium payments and requirements should include any interest credited under the secondary guarantee (with interest credited at the rate specified under the secondary guarantee). For any policy for which the secondary guarantee can not be fully funded in advance, solve for the minimum sum of any possible excess funding (either the amount in the shadow account or excess cumulative premium payments depending on the product design) and the present value of future premiums (using the maximum allowable valuation interest rate and the minimum mortality standards allowable for calculating basic reserves) that would fully fund the guarantee. The amount determined above for this step is to then be divided by one minus a 7% premium load allowance (0.93). The result from "Step Three" should be divided by this number, with the resulting ratio capped at 1. The ratio is intended to measure the level of prefunding for a secondary guarantee which is used to establish reserves. Assumptions within the numerator and denominator of the ratio therefore must be consistent in order to appropriately reflect the level of prefunding. The denominator is allowed to be inconsistent only by the amount of the premium load allowance as defined in this step. As used here, "assumptions" include any factor or value, whether assumed or known, which is used to calculate the numerator or denominator of the ratio.

[DRAFTING NOTE: The 7% premium load allowance approximates an average premium load level as evidenced by policies currently sold in the market. Rather than have the funding ratio vary according to the actual policy loads (which can fluctuate greatly by company and product), all companies will use an identical premium load allowance at a level approximately equal to the current industry average.]

Fifth, compute the net single premium on the valuation date for the coverage provided by the secondary guarantee for the remainder of the secondary guarantee period, using any valuation table and select factors authorized in Section 5A of Model #830. For purposes of calculating the net single premium, a lapse rate subject to the same criteria as the lapse rate used in applying Step 2 of 8C above may be used.

Sixth, the "net amount of additional premiums" is determined by multiplying the ratio from "Step Four" by the difference between the net single premium from "Step Five" and the basic and deficiency reserve, if any, computed in "Step Two."

Seventh, a "reduced deficiency reserve" should be computed by multiplying the deficiency reserve, if any, by the one minus the ratio from "Step Four," but not less than zero. This "reduced deficiency reserve" is the deficiency reserve to be used for purposes of Section 7D(1) of Model #830.

Eighth, the actual reserve used for purposes of Section 7D(1) of Model #830 is the lesser of: (1) the net single premium from "Step Five," and (2) the amount of the excess from "Step Six" plus the basic reserve and the deficiency reserve, if any, computed in "Step Two." Reduce this result by the applicable policy surrender charges, i.e., the account value less the cash surrender value. Multiply this surrender charge by the ratio of the net level premium for the secondary guarantee period divided by the net level premium for whole life insurance. Calculate both net premiums using the maximum allowable valuation interest rate and the minimum mortality standards allowable for calculating basic reserves. If the resulting amount is less than the sum of the basic and deficiency reserve from Step Two, then the basic and deficiency reserves to be used for the purposes of Section 7D(1) of Model #830 are those calculated in Step Two, and no further calculation is required.

Ninth, an "increased basic reserve" should be computed by subtracting the "reduced deficiency reserve" in "Step Seven" from the reserve computed in "Step Eight." This "increased basic reserve" is the basic reserve to be used for purposes of Section 7D(1) of Model #830.

Business reserved pursuant to Section 8C must be supported by an asset adequacy analysis specific to this business. This asset adequacy analysis must be performed pursuant to the requirements of Section 3 of the Standard Valuation Law. Reserves required by Section 8C shall be increased by any additional reserves required by the asset adequacy analysis.

8D. This Section 8D applies to policies and certificates (1) issued on and after July 1, 2005, (2) issued prior to January 1, 2013, and (3) in force on December 31, 2012, or on any valuation date thereafter: Under a universal life policy with a secondary guarantee, the coverage is guaranteed to remain in force as long as the accumulation of premiums paid satisfies the secondary guarantee requirement.

Notwithstanding the requirements of any of the other sections of this Actuarial Guideline (and in addition to any testing that may be required under Section 8C), this Section 8D describes the reserving requirements with respect to universal life with secondary guarantee products, with or without a shadow account, with multiple sets of interest rate or other credits, or multiple sets of cost of insurance, expense, or other charges that may become applicable to the calculation of the secondary guarantee measures in any one policy year. This Section 8D does not apply if the minimum gross premiums for the policies are determined by applying the set of charges and credits that produces the lowest premiums, regardless of the imposition of constraints, contingencies, or conditions that would otherwise limit the application of those credits and charges. The requirements of this Section 8D apply to a company on December 31, 2012, and on any subsequent valuation date if (1) on the applicable date, the in force face amount (direct plus assumed) of universal life insurance to which this Section 8D would otherwise apply exceeds 2% of the company's face amount of individual permanent life insurance in force, or (2) on the applicable date, the company's face amount of insurance in force subject to this Section 8D exceeds $1,000,000,000 (one billion dollars). Any company otherwise meeting these criteria may seek an exemption to the requirements under this Section 8D by filing an exemption request with its state of domicile, which will provide a copy of the request to the NAIC Financial Analysis (E) Working Group (FAWG). If the state of domicile agrees with the exemption request, then the requirements of this Section 8D do not apply to such company, provided FAWG does not conclude that the exemption would allow the company to use a reserving methodology that is not appropriate in relation to the benefits and the pattern of premiums for the plans covered.

a. Primary Reserve Methodology

The company's aggregate gross reserve before reinsurance for the business subject to this Section 8D to be reported in the December 31, 2012, and subsequent annual statutory financial statements of the company will be the aggregate reserve under 1 below, plus any excess of the aggregate reserve determined as defined in 2 below, over 1:

1. The basic and deficiency reserve as of the valuation date determined by the company according to the reserve methodology and assumptions used by the company for the statutorily-reported reserve for the business subject to this Section 8D as of December 31, 2011.

2. The reserve amount as of the valuation date determined according to the same requirements for determining the deterministic reserve in the version of the valuation manual specified under Section 11 of the *Standard Valuation Law* (Model #820) and adopted by NAIC Life Insurance and Annuities (A) Committee on August 17, 2012, or in any version subsequently adopted by the NAIC as of the July 1 preceding the valuation date (Valuation Manual), but with the two modifications identified below, determined as follows:

   a) First, future year-by-year cash flows for the block of business subject to this Section 8D are projected as of the valuation date. In making this projection:

      (I) the projected net investment earnings from the starting assets shall be the lesser of (i) the actual portfolio net investment returns and (ii) net investment returns based on a portfolio of A-rated corporate bonds purchased in the year of issue of the policies based on yields available in the year of issue for those bonds.

      (II) the projected net investment rate for the reinvestment assets shall be the lesser of (i) the average over a period of 12 months, ending on the June 30 prior to the valuation date, of the monthly average of the composite yield on seasoned corporate bonds, as published by Moody's Investor Services, Inc. and (ii) 7% per annum.

b) Second, future year-by-year net investment returns are determined from the cash flows generated in Section 8D(a)(2)(a).

c) Third, the reserve for the policies is computed using the year-by-year net investment returns determined in Section 8D(a)(2)(b) to discount the cash flows applicable to those policies.

The company may calculate the reserves as of any December 31 as of a date no earlier than three months before that December 31 valuation date, using relevant company data, provided an appropriate method is used to adjust those reserves to the valuation date.

If the aggregate reserve determined pursuant to the second calculation above exceeds the aggregate reserve determined pursuant to the first calculation, the additional reserve to be held is deemed to be required pursuant to Model #820, Section 3 and Section 6, which provide for an analysis of reserves pursuant to an asset adequacy analysis with margins for moderately adverse assumptions. Any such excess shall be allocated to each policy in proportion to the Step 1 reserve for that policy.

b. Alternative Reserve Methodology

The requirements of subsection a. above shall not apply to a company that holds a total gross reserve amount, before reinsurance, for the business subject to this Section 8D at least equal to the total reserve determined in accordance with the November 1, 2011 Life Actuarial (A) Task Force Statement on Actuarial Guideline XXXVIII, except that for purposes of determining any deficiency reserves under Model #830, using mortality and lapse assumptions according to the same requirements for determining the deterministic reserve in the Valuation Manual.

c. Documentation and Reporting

Under the direction of one or more qualified actuaries, the company shall prepare a stand-alone Actuarial Memorandum covering the reserve analysis performed on the business described in this Section 8D in compliance with Section 7 of the *Actuarial Opinion and Memorandum Regulation* (Model #822) to document the assumptions, analyses and results of the reserve calculations described above. The Actuarial Memorandum shall be prepared regardless of whether the company used the Primary Reserve Methodology described in Section 8D(a) or the Alternative Reserve Methodology described in Section 8D(b). Documentation in the submitted Actuarial Memorandum must be sufficient for another actuary qualified in the same practice area to evaluate the assumptions, analyses and results, and to enable regulatory review and verification that the assumptions, analyses and results satisfy the requirements described above, as they relate to the company. In the event that the Valuation Manual is incomplete or unclear as to any matter, the actuary preparing the Actuarial Memorandum shall use his or her best judgment in applying the requirements of the Valuation Manual and shall document his or her decisions in the Actuarial Memorandum. For any business subject to this Section 8D that has been ceded by the company, the Actuarial Memorandum shall provide a listing of the assuming companies with face amount, reserve credit taken, and form of reinsurance for such business. The Actuarial Memorandum shall be submitted to the state of domicile of the company by the April 30 following the valuation date. The state of domicile shall provide a copy of the Actuarial Memorandum to FAWG and, upon request, to any other state in which the company is licensed.

For those companies that used the Primary Reserve Methodology described above, the Actuarial Memorandum shall also provide with respect to the business subject to this Section 8D a description of the simplifications, approximations and modeling efficiency (aggregation) techniques used to calculate the reserve amount set forth in Subsection 2 of the Primary Reserve Methodology (i.e., Section 8D(a)(2)) and a clear indication that, upon request, information may be obtained that is adequate to permit the audit of any subgroup of the aggregated reserve amounts to ensure that the total of the seriatim (policy-by-policy) reserve calculations produces a reserve not materially different than the aggregated reserve amount determined pursuant to Subsection 2 of the Primary Reserve Methodology (i.e., Section 8D(a)(2)).

Along with the filing of the Actuarial Memorandum pertaining to the December 31, 2012 valuation date, those companies using the Primary Reserve Methodology above shall also submit a report to its state of domicile indicating what the gross reserve before reinsurance for the business subject to this Section 8D would be as of December 31, 2012 if the reserve had been determined pursuant to the methodology and experience assumptions used to determine the reserve set forth in Subsection 2 of the Primary Reserve Methodology (i.e., Section 8D(a)(2)), except using a net reinvestment return rate assumption not greater than the maximum valuation interest rate for the year of issue of each policy set forth in Model #820. The company shall include in this report what its (i) total adjusted capital and (ii) company action level risk based capital would be if the company held the reserve calculated pursuant to this methodology rather than the reserve actually reported for the applicable business in the annual statement submitted by the company to the NAIC. The report described in this paragraph will be provided by the company to the state of domicile, which will forward a copy to FAWG. Upon request, the state of domicile will also forward a copy of this report to any other state in which the company is licensed. The state of domicile, FAWG, and any other state receiving the report will treat it as containing confidential information. The report is to be provided for informational purposes only, and it is to be considered and used as one additional piece of information to be evaluated in the context of the company's overall financial position.

The domestic state will perform a review of the Actuarial Memorandum in consultation with FAWG to ensure the company's reserve calculations have been performed according to the requirements of this Section 8D.

If:

- the company reports in its financial statements the reserve level required above, adjusted for any phase-in period approved by the company's state of domicile, and
- the company complies with any applicable phase-in period made by the state of domicile with respect to such additional reserves, and
- FAWG agrees with the state of domicile's decisions,

FAWG shall issue a confidential report to non-domiciliary states indicating that the company's reserving methodology is appropriate in relation to the benefits and the pattern of premiums for the plans covered. If FAWG does not agree with the state of domicile's decisions, FAWG shall issue a confidential report to non-domiciliary states indicating that the company's reserving methodology is not appropriate in relation to the benefits and the pattern of premiums for the plans covered.

8E. For policies and certificates issued on or after January 1, 2013: For a universal life policy that guarantees the coverage to remain in force as long as the accumulation of premiums paid satisfies the secondary guarantee requirement.

Step 1: The first step is to derive the minimum gross premiums for the policy or certificate (to be determined at issue). Except as indicated for policies and certificates described in Method I Policy Design #3 (described below), the minimum premiums so derived must satisfy the secondary guarantee requirement. Model #830, Section 7A(4) does not apply in determining the minimum gross premiums for policies and certificates described in this Section 8E.

I) Methodology for determining the minimum gross premiums for certain designs ("Method I").

1. Policy Design #1: For a policy containing a secondary guarantee that uses a shadow account with a single set of charges and credits, the minimum gross premium for any policy year is the premium that, when paid into a policy with a zero shadow account value at the beginning of the policy year, produces a zero shadow account value at the end of the policy year, using the guaranteed shadow account charges and credits (e.g., interest credited rate, mortality charges, premium loads and expense charges) specified under the secondary guarantee.

2. Policy Design #2: For a policy that compares paid accumulated premiums to minimum required accumulated premiums (cumulative premium policy), with both accumulations based on a single set of charges and credits specified under the secondary guarantee, the minimum gross premium for any policy year is the premium that, when paid into a policy for which the accumulated premiums equals the minimum required accumulated premiums at the beginning of the policy year, results in the paid accumulated premiums being equal to the minimum required accumulated premiums at the end of the policy year.

3. Policy Design #3: If, for any policy year, a shadow account secondary guarantee, a cumulative premium secondary guarantee design, or other secondary guarantee design, provides for multiple sets of charges and/or credits, then the minimum gross premiums shall be determined by applying the set of charges and credits in that policy year that produces the lowest premiums, ignoring the constraint that such minimum premiums satisfy the secondary guarantee requirement and ignoring any contingencies or conditions that would otherwise limit the application of those charges and credits.

Notwithstanding the language in the approaches described above, the guaranteed (including conditionally guaranteed) policy credits for each year shall be limited as to magnitude in order for minimum gross premiums to be determined consistent with any of the policy designs above. The limitations must be met at the time of each product filing and also when guaranteed credits or charges for each such product are revised. For this purpose, policy credits based on the interest or accumulation rates in the policy shall not exceed the "Index" (defined in the next sentence) plus 3% per annum. The Index used to establish the limitation as to magnitude shall be either (i) the monthly average of the composite yield on seasoned corporate bonds as published by Moody's Investors Service, Inc., for the month immediately preceding the date of the Actuarial Opinion required under this Section 8E and described below, or (ii) the monthly average over a period of twelve months, ending on the June 30 preceding the date of the Actuarial Opinion required below, of the composite yield on seasoned corporate bonds, as published by Moody's Investors Service, Inc. The averaging period chosen by the company must be elected at time of product filing and consistently used for that product thereafter even if guaranteed credits or charges are subsequently revised for that product.

II) Methodology for determining the minimum gross premiums for other designs ("Method II").

Unless otherwise provided in this Section 8E, the minimum gross premiums shall be the lowest schedule of premiums that keep the policy in force over the life of the secondary guarantee period and that produce the greatest deficiency reserve at issue. If deficiency reserves produced at issue are all zero, then the smallest absolute value of the difference between "quantity A" set forth in Model #830, Section 5B, over the basic reserve shall be considered the greatest deficiency reserve. For purposes of this Step 1, in deriving the deficiency reserve associated with a particular schedule of gross premiums, the X factors used shall be set equal to 1 for all durations, issue ages, and risk classes.

For policies that use a shadow account, and for cumulative premium policies, the schedule of premiums that keep the policy in force over the life of the secondary guarantee period and that produce the greatest deficiency reserve at issue shall be determined assuming the following premium-paying patterns for premiums actually paid under the policy:

- Level premiums for the life of the secondary guarantee but not beyond the duration that premiums may be paid under the policy, and
- Increasing premiums over the life of the secondary guarantee (including any resulting reserve segments created), but not beyond the durations that premiums may be paid under the policy, and
- Combinations of the above premium patterns including higher initial premiums for funding levels to have access to better charges and credits with combinations of level and increasing premium patterns thereafter.

For all policies and certificates subject to this Step 1 of Method II of this Section 8E, the company shall also perform a good faith high-level analytical review of the product design with respect to the premium payment patterns to be expected with respect to that design. The review should consider whether there are situations whereby the product design is likely to elicit a pattern of premium payments that, if paid, would provide the insured with access to lower charges and/or higher credits than those that would apply assuming the premium paying patterns required to be tested under this Section 8E and thereby result in the need for a deficiency reserve significantly in excess of that determined using the schedules of minimum gross premiums determined pursuant to the premium payment patterns required to be tested under this Section 8E. To the extent identified, the company shall use such other premium payment patterns it determines are likely to result in the need for a greater deficiency reserve than implied by the premium payment patterns required to be tested under this Section 8E in determining the schedule of minimum gross premiums and related deficiency reserve. In performing this analytic review, the company shall consider payment patterns which keep the policy in force over the lifetime of the secondary guarantee.

Step 2: For purposes of applying Section 7B and Section 7C of Model #830, the “specified premiums” are the minimum gross premiums derived in Step 1. Consistent with Model #830, the remaining steps in this guideline should be calculated on a segmented basis, using the segments that Model #830 defines for the product. Therefore, in the remaining steps, the term “fully fund the guarantee” should be interpreted to mean fully funding the guarantee to the end of each possible segment. The term “remainder of the secondary guarantee period” should be interpreted to mean the remainder of each possible segment. The total reserve should equal the greatest of all possible segmented reserves. Additionally, for purposes of applying Section 7B and Section 7C of Model #830, the lapse rate used shall be no more than 2% per year for the first 5 years, followed by no more than 1% per year to the policy anniversary specified in the following table based on issue age, and 0% per year thereafter. If the duration in the table is less than 5, then a lapse rate of no more than 2% per year may be used through that duration, and 0% per year thereafter.

Issue Age	Duration
0-50	30th policy anniversary
51-60	Policy anniversary age 80
61-70	20th policy anniversary
71-89	Policy anniversary age 90
90 and over	No lapse

Step 3: A determination should be made of the amount of actual premium payments greater than or less than the minimum gross premiums. For policies using shadow accounts and qualifying under one of the Policy Designs of Method I, this will be the amount of the shadow account. For policies using shadow accounts whose minimum gross premium is determined under Method II, this will be the amount of the shadow account minus the amount that would be in the shadow account if the minimum gross premiums used to calculate basic and deficiency reserves in Step 2 were paid. This result may be negative. For cumulative premium policies whose minimum gross premiums are determined under Method I, this excess will be the amount of cumulative premiums paid over the cumulative premium requirements. For cumulative premium policies whose minimum gross premiums are determined under Method II, this excess will be the amount of the cumulative premiums paid minus the cumulative premium using the minimum gross premiums used to calculate basic and deficiency reserves in Step 2. This result may be negative. The cumulative premium payments and requirements should include any interest credited under the secondary guarantee (with interest credited at the rate specified under the secondary guarantee).

Step 4: As of the valuation date for the policy being valued, for policies using shadow accounts, determine the minimum amount of shadow account required to fully fund the guarantee. For cumulative premium policies, determine the minimum amount of the cumulative premiums required to fully fund the guarantee less the cumulative premium requirements. For any policy for which the secondary guarantee cannot be fully funded in advance, solve for the minimum sum of any possible excess funding (either the amount in the shadow account or excess cumulative premium payments depending on the product design) and the present value of future premiums (using the maximum allowable valuation interest rate and the minimum mortality standards allowable for calculating basic reserves) that would fully fund the guarantee. For shadow account policies, if the minimum gross premium is determined according to Method II and the Step 3 amount is positive then the amount determined above for this step is reduced by any positive shadow account based on minimum gross premiums. For cumulative premium policies, if the minimum gross premium is determined according to Method II and the Step 3 amount is positive then the amount determined above for this step is reduced by the excess of cumulative premiums, assuming minimum gross premiums are paid, over the cumulative premium requirements. For shadow account policies, if the minimum gross premium is determined according to Method II and the Step 3 amount is negative then the amount determined above for this step is replaced by the amount of the shadow account based on the minimum gross premiums. For cumulative premium policies, if the minimum gross premiums are determined by Method II and the Step 3 amount is negative then the amount determined above for this step is replaced by the excess of cumulative premiums, assuming minimum gross premiums are paid, over the cumulative premium requirements.

The amount determined above for this step is then divided by one minus a 7% premium load allowance (0.93).

The result from Step 3 should be divided by the number above, with the resulting ratio capped at 1 and no less than (-1). The ratio is intended to measure the level of prefunding for a secondary guarantee and is used to establish reserves. Assumptions within the numerator and denominator of the ratio therefore must be consistent in order to appropriately reflect the level of prefunding. The denominator is allowed to be inconsistent only by the amount of the premium load allowance as defined in this step. As used here, “assumptions” include any factor or value, whether assumed or known, that is used to calculate the numerator or denominator of the ratio.

[DRAFTING NOTE: The 7% premium load allowance approximates an average premium load level as evidenced by policies currently sold in the market. Rather than have the funding ratio vary according to the actual policy loads (which can fluctuate greatly by company and product), all companies will use an identical premium load allowance at this 7% level, which is approximately equal to the current industry average.]

Step 5: Compute the net single premium on the valuation date for the coverage provided by the secondary guarantee for the remainder of the secondary guarantee period, using any valuation table and select factors authorized in Section 5A of Model #830. For purposes of calculating the net single premium, a lapse rate subject to the same criteria as the lapse rate used in applying Step 2 may be used.

Step 6: If the amount in Step 3 is positive the “net amount of additional premiums” is determined by multiplying the ratio from Step 4 by the difference between the net single premium from Step 5 and the basic and deficiency reserve, if any, computed in Step 2.

If the amount in Step 3 is negative, the “net amount of additional premiums” is determined by multiplying the ratio from Step 4 by the basic reserves, if any, computed in Step 2. This result will be negative or zero. Subtract the deficiency reserve calculated in Step 2 from this result and then add the following amount, depending on whether the policy is a shadow account policy or a cumulative premium policy:

a) If a shadow account policy add the following:
The deficiency reserve at issue calculated using X factors associated with the premium paying pattern used in determining the greatest deficiency reserve in Method II, Step 1, multiplied by one minus the ratio of the amount of the shadow account divided by minimum amount in the shadow account that would fully fund the guarantee. This amount in Step 6(a) is not to be less than zero.

b) If a cumulative premium policy add the following:
The deficiency reserve at issue calculated using X factors associated with the premium paying pattern used in determining the greatest deficiency reserve in Method II, Step 1, multiplied by one minus the ratio of the amount of cumulative premiums paid divided by the minimum amount of cumulative premiums required to fully fund the guarantee. This amount in Step 6(b) is not to be less than zero.

Step 7: A “reduced deficiency reserve” shall be computed by multiplying the deficiency reserve, if any, by one minus the ratio (such ratio not to be set less than zero) from Step 4; this final amount also not to be set less than zero. This “reduced deficiency reserve” is the deficiency reserve to be used for purposes of Section 7D(1) of Model #830.

Step 8: The reserve used for purposes of Model #830, Section 7D(1), is as follows.

a) Take the lesser of:
1) the “net amount of additional premiums” from Step 6 plus the basic reserve and the deficiency reserve, if any, computed in Step 2, and
2) the net single premium from Step 5.

b) Reduce the result in Step 8(a) by the applicable policy surrender charges (i.e., the account value less the cash surrender value). Multiply this surrender charge by the ratio of the net level premium for the secondary guarantee period divided by the net level premium for whole life insurance. Calculate both net premiums using the maximum allowable valuation interest rate and the minimum mortality standards allowable for calculating basic reserves.

c) Calculate the reserve floor:
1) If the result in Step 3 is negative, then the reserve floor shall equal the sum of the Step 2 basic and deficiency reserves and the amount from Step 6.
2) If the result in Step 3 is not negative, then the reserve floor shall equal the sum of the Step 2 basic and deficiency reserves without any adjustment.

The reserve to be used for purposes of Model #830, Section 7D(1) is the greater of the resulting amount from Step 8(b) above and the reserve floor.

Step 9: An "increased basic reserve" shall be computed by subtracting the "reduced deficiency reserve" in Step 7 from the reserve computed in Step 8. This "increased basic reserve" is the basic reserve to be used for purposes of Model #830, Section 7D(1).

Actuarial Opinion and Company Representation Requirements

If a company uses one of the Policy Design methodologies described above in Method I of this Section 8E to determine the minimum gross premiums in Step 1, the company shall submit to its state of domicile at the time of filing/approval of a new product, or by December 31, 2012, for current products that will be issued in 2013 or thereafter, and at any time when rates and/or charges are changed, an Actuarial Opinion signed by the Appointed Actuary and a Representation of the Company signed by a Senior Officer of the company regarding the applicable policy form(s) that states:

Actuarial Opinion

"I, (name and professional designation), am the appointed actuary for (company name). I have examined the actuarial assumptions and actuarial methods used in determining the reserves described herein, and, in my opinion: (1) the product referenced herein meets the definition of Policy Design # ___ described in Method I in Section 8E of Actuarial Guideline XXXVIII (AG 38); (2) notwithstanding the language in Policy Design # ___, the guaranteed (including conditionally guaranteed) policy credits in the product available for any year do not exceed the "Index" defined in Method I in Section 8E of AG 38 plus 3% per annum; and (3) the minimum gross premiums determined under Policy Design # ___ are not inconsistent with the minimum premiums, charges and credits that are expected to apply under the policy."

(Name of actuary, printed or typed)
(Signature of actuary)
(Date signed)

Company Representation

"(company name) hereby represents: (1) that the product referenced herein meets the definition of Policy Design # ___ described in Method I in Section 8E of Actuarial Guideline XXXVIII (AG 38); (2) notwithstanding the language in Policy Design # ___, the guaranteed (including conditionally guaranteed) policy credits in the product available for any year do not exceed the "Index" defined in Method I in Section 8E of AG 38 plus 3% per annum; and (3) the minimum gross premiums determined under Policy Design # ___ are not inconsistent with the minimum premiums, charges and credits that are expected to apply under the policy."

(Name of company Officer, printed or typed)
(Signature of company Officer)
(Date signed)

The state of domicile shall provide a copy of the Actuarial Opinion and the Company Representation to FAWG and, upon request, to any state in which the company plans to issue the policy that is the subject of the Actuarial Opinion and Company Representation.

Policy Design

If a company develops reserves based on Method II of this Section 8E, the company shall submit a report from its Appointed Actuary prior to issuing policies on that form to its state of domicile, which will provide a copy to FAWG and (upon request) to any state in which the company plans to issue the product, that briefly describes the analytical review performed, the company's conclusions following the analytical review, and whether any additional premium payment patterns other than those required by this Section 8E were tested as a result of the review. If FAWG agrees with the state of domicile's decisions with respect to the company's Method II reserving methodology, FAWG shall issue a confidential report to non-domiciliary states indicating that the company's reserving methodology is appropriate in relation to the benefits and the pattern of premiums for the plans covered. If FAWG does not agree with the state of domicile's decisions with respect to the company's Method II reserving methodology, FAWG shall issue a confidential report to non-domiciliary states indicating that the company's reserving methodology is not appropriate in relation to the benefits and the pattern of premiums for the plans covered.

Effective Date

With the exception of Steps 3 through Step 9 of Section 8A and all of Section 8B, Section 8C, Section 8D and Section 8E, the scope of this guideline shall be inclusive of policies issued on and after the earlier of a state's adoption of the revised Model #830 (adopted by the NAIC in March 1999) or the statutory accounting practices and procedures as set forth in the NAIC *Accounting Practices and Procedures Manual*. All of Section 8A, Section 8B, Section 8C, Section 8D and Section 8E shall be applicable to policies and certificates issued on or after the later of the date of a state's adoption of the revised Model #830 and January 1, 2003, subject to the dates and/or applicable scope specified in Section 8A, Section 8B, Section 8C, Section 8D and Section 8E.

Actuarial Guideline XXXIX

RESERVES FOR VARIABLE ANNUITIES WITH GUARANTEED LIVING BENEFITS

I. Background

The purpose of this Actuarial Guideline (Guideline) is to interpret the standards for the valuation of reserves for guaranteed living benefits included in variable deferred and immediate annuity contracts (VAGLBs). This Guideline provides an interpretation of the National Association of Insurance Commissioners' (NAIC) Model Standard Valuation Law (SVL) for VAGLBs and is intended to be temporary.

The methodology does not specifically address how "base variable annuity reserves" (i.e., reserves for variable annuity contracts calculated by ignoring VAGLBs) should be calculated. Rather, it only addresses the calculation of reserves for VAGLBs to be held in the General Account.

In addition, this Guideline interprets the standards for the valuation of reserves when the VAGLB risk is reinsured.

II. Scope

This Guideline applies to variable deferred and immediate annuity contracts that provide one or more guaranteed living benefits. This Guideline does not apply to those group annuity contracts that are not subject to the Commissioners' Annuities Reserve Valuation Method (CARVM).

VAGLB designs falling under the scope of this Guideline include, but are not limited to, currently offered provisions commonly referred to as Guaranteed Minimum Accumulation Benefits (GMABs), Guaranteed Minimum Income Benefits (GMIBs), Guaranteed Minimum Withdrawal Benefits (GMWBs), and Guaranteed Payout Annuity Floors (GPAFs).

III. Text

A. Aggregate Reserves for Contracts with VAGLBs

The Aggregate Reserves for Contracts with VAGLBs are the total reserves held by the company in support of the variable annuity contracts with VAGLBs, and equals the sum of 1 and 2, where:

1. equals the aggregate reserves for the variable annuity contracts ignoring both the future revenues and benefits from the VAGLBs and after comparison to the cash value of the contracts. For the purpose of determining future revenues and benefits for VAGLBs, a charge should be imputed in the event that there are no explicit VAGLB charges.

   and

2. equals the VAGLB reserve, determined as the sum of the aggregate VAGLB charges from the date of issue to the valuation date for VAGLB benefits in-force (i.e., contracts still in-force and still eligible for the VAGLB), the sum reduced by 2.5% each calendar quarter beginning January 1, 2008 and subject to the asset adequacy analysis requirement in subsection C (i.e., each quarter the prior quarter VAGLB result is multiplied by 0.975 then the VAGLB charges from the quarter are added to the product). In the event that there are no explicit VAGLB charges, a charge should be imputed.

The VAGLB reserve must be held in the General Account. (This is in addition to any amounts in item 1 that are required to be held in the General Account).

B. Reserve for Ceded and Assumed Reinsurance

If all or a portion of the VAGLB risk is reinsured on a proportional basis, the ceding company is entitled to a corresponding proportional reinsurance reserve credit based on the VAGLB reserve held before consideration of reinsurance.

Adjustments may need to be made to the reserve credit taken by ceding companies where the underlying reinsurance treaty contains non-proportional elements.

For companies where VAGLB risk is assumed, the aggregate VAGLB reserves for contracts with VAGLBs will be the sum of a) the aggregate direct VAGLB charges in proportion to the amount of reinsurance from the issue date of the contract to the effective date of the reinsurance contract and b) gross reinsurance premiums from the effective date of the reinsurance contract to the valuation date for VAGLB benefits in force (i.e. contracts still in force and eligible for the VAGLB) and subject to the asset adequacy analysis requirement in subsection C.

C. Asset Adequacy Analysis Requirement

The appointed actuary must perform a standalone asset adequacy analysis of the VAGLB reserve. If such analysis reveals a reserve shortfall, VAGLB reserves must be increased. Such analysis shall be performed reflecting the following:

1. all VAGLB benefits and expenses,

2. all VAGLB charges, and

3. the assets supporting the VAGLB reserves.

The analysis shall be performed on an aggregate basis for all contracts with VAGLBs, consistent with the requirements of the NAIC Model Actuarial Opinion and Memorandum Regulation, including the requirement that the analysis conform to the Actuarial Standards of Practice as promulgated from time to time by the Actuarial Standards Board. However, no separate actuarial opinion is required by this Actuarial Guideline.

Where the VAGLB is reinsured, the asset adequacy analysis may reflect the reinsurance. However, if the inclusion of reinsurance in the asset adequacy analysis would increase the VAGLB reserve, then reinsurance must be reflected in the analysis.

IV. Applicability

This Guideline is effective December 31, 2002 and affects all contracts issued on or after January 1, 1981.

Since the requirements of this Guideline are intended to be temporary, this Guideline is in effect until no later than December 30, 2009.

Actuarial Guideline XL

GUIDELINE FOR VALUATION RATE OF INTEREST FOR FUNDING AGREEMENTS AND GUARANTEED INTEREST CONTRACTS (GICS) WITH BAIL-OUT PROVISIONS

PURPOSE

The purpose of this Guideline is to interpret the Standard Valuation Law (SVL) for assignment of appropriate valuation interest rates to risks embedded in bail-out provisions under Funding Agreements and Guaranteed Interest Contracts.

BACKGROUND

Funding Agreements (FAs) and other types of Guaranteed Interest Contracts (GICs) typically issued to tax-exempt municipal bonds, money market funds and securities lending funds, often contain bail-out provisions that allow the contractholders to get their money back at full book value. Such provisions may be triggered by the credit rating downgrade of the issuer below a given level or may be at a given period’s notice to the contractholder, e.g. 7, 30, 90 or 180 days’ notice. The contract language for these provisions may be as follows:

1. In the event that the investment provider (i.e. the insurance company) is downgraded below *A-/A3* by S & P and/or Moody’s respectively, the contract holder has the right to terminate the contract and receive the remaining principal and accrued interest without penalty. [In most cases the issuer has the alternate option to provide a replacement contract or post collateral or do a credit wrap.]

2. Each party has the right to terminate the contract before maturity by giving the other at least *7/30/90 or 180-days* notice in writing. At such termination the principal and accrued interest is payable with no penalty.

Contracts with downgrade provision

The bulk of the contracts issued with a downgrade provision are fixed rate FAs or GICs issued in connection with tax-exempt municipal bonds. These contracts can be short-term or long-term. Short-term contracts typically have an average life of around one-year, and are intended for municipal bond funds for construction, acquisition, housing, tax revenue anticipation notes (TRANS), etc. In these types of funds the cash-flow projections are provided when the case is underwritten, but there may be variability in the actual withdrawals. Any outstanding principal and interest is payable at maturity.

Long-term contracts are issued in connection with the debt service reserve (DSR) or the float fund of the bond issue, and mature at the same time as the bonds, which can be as long as 30 years. The float fund takes in deposits, and pays out the half-yearly interest and principal (if any is due) on the bonds. It runs to near zero about twice a year, after each half-yearly coupon payment. The DSR is a contingent fund for a rainy day to prevent a missed coupon or principal payment on the bond. The DSR has a single deposit that is typically 10% of the bond issue.

Contracts with put provision

FAs or GICs with put provisions are generally issued to money market funds subject to Rule 2a-7 of the Investment Company Act. Rule 2a-7 provides guidelines on liquidity, requiring funds available at book value subject to certain notification periods. Additionally, these contracts usually have downgrade provisions. Even if the downgrade provision is not in the contract, it can be assumed that the put will be exercised on downgrade, since a certain level of credit is also a Rule 2a-7 requirement.

Typically, these FAs or GICs guarantee a floating rate of interest linked to an index like LIBOR, which is paid out and reset periodically. Most contracts have fixed maturity dates when the principal is returned. Generally the FAs or GICs are the higher yielding assets of the money market funds, and therefore puts are not expected to be exercised.

Risks

Both the downgrade and the put provisions present liquidity or concentration type of risks to the issuer, i.e. if a critical event occurs, a substantial part of the whole block of business is likely to be liquidated. Sufficient asset liquidity, prudent A/L management, cash flow testing, hedging strategies, etc. can mitigate these risks. Also, companies generally have contractual provisions providing alternative options.

Downgrade provision:
The main risk here is that, upon downgrade to the trigger level, a company may have to realize its assets at a market loss in order to pay out at book. If the downgrade happens in a falling interest rate environment there is no risk of a market loss as the underlying assets are likely to be at a higher market value. On the other hand if the downgrade occurs in a rising interest rate environment, market value losses would occur when the company sells assets to pay out liabilities at book value.

Companies have written provisions in their contracts that provide alternate options to paying at book value in a rising interest rate environment:

“Novation/Assignment” option: The novation/assignment option allows the company to transfer its liabilities to another funding agreement provider that meets the credit rating requirements of the contractholder. In a rising interest rate environment, the new provider should be willing to pay a “premium” to assume a liability crediting a below market interest rate. In a perfectly efficient market this “premium” should precisely offset the market value loss upon the sale of the asset. In practice, however, it is less likely that the “premium” would fully offset the market value loss since:

- The new provider may view the liability risk somewhat differently
- The new provider may try and take advantage of the situation of the downgraded company
- There may be a large volume of these types of contracts in the market, etc.

However, the “premium” payable by the new provider could provide a substantial offset against the market value loss incurred by the downgraded company.

“Collateralization” option: This option allows the company to post assets as collateral for the benefit of the contractholder, as an alternative to payment at book value. The collateral posted would have to meet the credit requirements of the contractholder, which could be government or agency securities. Usually the collateral posted is required to have a cushion, typically ranging from 102% to 105%.

Upon trigger of the downgrade provision, the company would need to have suitable assets in its portfolio that are available for use as collateral, and also acceptable to the contractholder. In addition, there will be administrative and custodial expenses/fees of establishing and monitoring collateral levels. In some states there may also be legal restrictions on encumbering assets that back policyholder claims.

If the downgraded company can overcome the above constraints, then collateralization is another alternative of maintaining the contract and not having to pay out at book value.

“Credit Wrap” option: Under this arrangement the contract is issued out of a separate account which is guaranteed by a financial guarantee insurer. Effectively, the credit rating of the guarantor passes through to meet the credit requirement of the FA or GIC. [A number of FAs or GICs requiring a higher credit rating are currently being written in this way.]

The contract being wrapped has to meet certain criteria before the financial guarantee insurers are willing to wrap. Generally, the guarantor would also require higher credit rated securities in the separate account, which could be government or agency, and would require these in the 102% to 105% range. There will also be administrative and custodial expenses of establishing and monitoring the separate account in addition to the wrap fee payable to the mono-line insurer.

Although at significant cost, this option does provide the downgraded company a viable alternative to paying out at book value.

Put provision:
The put provision is not tied to a particular event but can contractually be exercised by giving the required days' notice. It has been argued that this provision is there to meet the Rule 2a-7 liquidity requirements and in practice is unlikely to be exercised, particularly since the FAs or GICs are one of the higher yielding assets of the money market portfolio. However, it is a contractual option and if, for example, the issuer were in financial difficulties, it will be exercised. Past experience suggests this is the case.

The put provision therefore presents a liquidity or concentration risk similar to that of downgrade——it is likely to be exercised in bulk upon happening of a critical event. Similar considerations apply, i.e. in a rising interest rate environment market value losses would occur when the company sells assets to pay out liabilities at book value.

Reserves

For reserving the Standard Valuation Law applies. However, when the SVL was enacted, these types of bail-out provisions did not exist, and were therefore not addressed explicitly. The purpose of this Guideline is to interpret the SVL for assignment of appropriate valuation interest rates to risks embedded in these bail-out provisions.

Other Actuarial Guidelines have provided similar interpretations. For example, Guideline XIII addresses interest bailout provisions under annuity contracts, Guideline XXX provides for participant directed withdrawal provisions under GICs, and Guideline XXXIII covers the elective and non-elective benefits under individual annuity contracts.

Plan Types

The SVL utilizes a concept known as Plan Type, which was designed to distinguish between the various levels of disintermediation risks—the greater the disintermediation risk for a company, the more conservative is the resulting valuation rate. Plan Types designated in the model SVL are defined as follows:

Plan Type A: At any time policyholder may withdraw funds only (l) with an adjustment to reflect changes in interest rates or asset values since receipt of the funds by the insurance company, or (2) without such adjustment but in installments over five years or more, or (3) as an immediate life annuity, or (4) no withdrawal permitted.

Plan Type B: Before expiration of the interest rate guarantee, policyholder may withdraw funds only (1) with an adjustment to reflect changes in interest rates or asset values since receipt of the funds by the insurance company, or (2) without such adjustment but in installments over five years or more, or (3) no withdrawal permitted. At the end of interest rate guarantee, funds may be withdrawn without an adjustment in a single sum or installments over less than five years.

Plan Type C: Policyholder may withdraw funds before expiration of interest rate guarantee in a single sum or installments over less than five years either (1) without adjustment to reflect changes in interest rates or asset values since receipt of the funds by the insurance company, or (2) subject only to a fixed surrender charge stipulated in the contract as a percentage of the fund.

TEXT

For the purpose of the application of the Standard Valuation Law to FAs and GICs, the annuities and GIC valuation interest rates are to be used. The bailout provisions described above shall be treated as a withdrawal by the policyholder at book value, and the underlying contracts shall be classified as Plan Type C.

However, for contracts containing written provisions that allow the insurance company alternate options to paying out at book value, the valuation actuary may use a valuation rate of interest higher than Type C. In no event may the valuation interest rate be greater than that applicable to similar contracts with no put or bailout provisions. If a provision requires over-collateralization and/or use of high credit quality assets, this should be adequately reflected in the reserves.

If a higher interest rate than Type C is used, the valuation actuary must be satisfied and be able to demonstrate that the written provisions substantially reduce the liquidity risk. In addition, the valuation actuary must be satisfied, and should periodically review, that there are other risk management measures in place to reduce the liquidity or concentration risk, taking into consideration at least the following:

Readily liquidated assets at nil or minimal market-value loss
Cash-flow testing results
Standby lines of credit available and other liquidity facilities established
Hedges in place with liquidity options
High credit quality assets available for use as collateral.

Actuarial Guideline XLI

PROJECTION OF GUARANTEED NONFORFEITURE BENEFITS UNDER CARVM

I. Background

The following is an excerpt from the October 21, 2003, Report of the American Academy of Actuaries' Life Valuation Subcommittee:

> Annuity SNFL Impact on Reserves
>
> Per the Standard Valuation Law, Commissioner's Annuity Reserve Valuation Method (CARVM) is:
>
> "the greatest of the respective excesses of the present values, at the date of valuation, of the future guaranteed benefits, *including guaranteed nonforfeiture benefits*, provided for by the contracts at the end of each respective contract year, over the present value, at the date of valuation, of any future valuation considerations derived from future gross considerations, required by the terms of the contract, that become payable prior to the end of the respective contract year."
>
> Historically the guaranteed nonforfeiture benefit calculation has been determined at issue (e.g. 90 percent of premiums accumulated at three percent interest). The recent change to the Standard Nonforfeiture Law for Individual Deferred Annuities has changed this.
>
> Nonforfeiture Rate
>
> The new Standard Nonforfeiture Law for Individual Deferred Annuities has changed the nonforfeiture rate from being static to being dynamic. Under the old law, the nonforfeiture interest rate was three percent. The revised law bases the nonforfeiture rate on the five-year Constant Maturity Treasury Rate less 125 basis points (bps). The nonforfeiture rate is subject to a minimum of one percent and a maximum of three percent. Additional enhancements include the ability to reset the nonforfeiture rate at a date predetermined in the contract and allowing an additional reduction (offset) for Equity Indexed Annuities.
>
> The nonforfeiture rate can be reset at a date predetermined in the contract (e.g. five years from issue) and based on a formula specified in the contract. The same requirements applicable to the initial rate apply to the re-determined rate.
>
> The revised law allows an additional offset to the nonforfeiture rate for contracts that provide substantive participation in an equity indexed benefit. This offset ranges from 0 bps to 100 bps.
>
> The ability to re-determine the nonforfeiture rate and that the EIA offset may be reevaluated in the future raises some issues with the CARVM calculation.
>
> In doing a CARVM projection, what should be the assumed interest rate? Should the option depend on whether there are re-determination provisions? Should the option depend on whether the product relies on an equity indexed offset?

The Report further states:

> The minimum guaranteed interest rate in the contract might be different than the minimum nonforfeiture rate. To the extent that the guaranteed values in the contract are always greater than the minimum nonforfeiture benefits, then the nonforfeiture values do not come into play.

This Guideline specifies how to determine the nonforfeiture interest rate used in determining the minimum nonforfeiture benefits guaranteed under the contract. As noted in the Report, the minimum nonforfeiture benefits may be less the guaranteed values otherwise provided by the contract. Where this is the case, the higher guaranteed values are used in the CARVM calculation, and "the nonforfeiture values do not come into play."

It should also be noted that requirements for projecting guarantees exist in other regulations and guidelines, such as the specifications in Actuarial Guideline XXXV ("The Application of the Commissioners Annuity Reserve Method to Equity Indexed Annuities") for projecting equity-indexed guarantees. The specifications of this Guideline are in addition to any other requirements.

II. Scope

This Guideline applies to contracts subject to CARVM and the Standard Nonforfeiture Law for Individual Deferred Annuities ("SNLIDA").

III. Text

The following assumptions shall be made on the valuation date for purposes of determining the future nonforfeiture interest rate when this rate is not known in advance. For purposes of (B) below, "NI" shall refer to the nonforfeiture interest rate, "VI" shall refer to the valuation interest rate, and "CNI" shall refer to the current nonforfeiture interest rate which will be adjusted for any future durations pursuant to "A" below.

A. For the period of time during which the additional EIA offset is not known, the additional offset shall be zero.

B. For the period of time during which the nonforfeiture interest rate is not known,
NI = min [max {VI, CNI}, 3%]

If the redetermination of the nonforfeiture interest rate is based on changes to the value of the underlying index (this will be the five-year Constant Maturity Treasure Rate in the case of the nonforfeiture interest rate), then for purposes of this Guideline it shall be assumed that such rate is not known as of the first date on which the rate may be subject to redetermination.

IV. Applicability

This Guideline is effective December 31, 2006 and affects all contracts issued on or after January 1, 1981.

Actuarial Guideline XLII

THE APPLICATION OF THE MODEL REGULATION PERMITTING THE RECOGNITION OF PREFERRED MORTALITY TABLES FOR USE IN DETERMINING MINIMUM RESERVE LIABILITIES

1. Purpose

The purpose of this Guideline is to provide rules and guidance to appointed actuaries in the selection of the proper set of mortality rates when a company chooses to use the 2001 CSO Preferred Class Structure Mortality Table authorized under the Model Regulation Permitting The Recognition of Preferred Mortality Tables for use in Determining Minimum Reserve Liabilities (herein after called the "Model"). All terms in this guideline specifically defined in the regulation will have the same definition as specified by the regulation.

2. Effective Date and Scope

The 2001 CSO Preferred Class Structure Mortality Table is available for valuation purposes for individual life policy forms (and certain group life products sold to individuals by certificate with premium rates guaranteed from issue for at least two years), issued on or after 1/1/2007, or, if later, the effective date of the state's actual regulation based on the Model.

3. Definitions

A. "Anticipated mortality" means the appointed actuary's assumption about the mortality to be experienced in the future on a group of insured lives.

B. "Appointed actuary" means any individual who is appointed or retained in accordance with the requirements set forth in the Actuarial Opinion and Memorandum Regulation.

C. "Basic reserves" means reserves calculated in accordance with Section 5 of the Standard Valuation Law.

D. "Class" means a group of policies under one or more plans of insurance that has similar anticipated mortality, as grouped together by the insurer.

E. "Credibility" means a measure of the predictive value in a given application that the appointed actuary attaches to a particular body of data (predictive is used here in the statistical sense and not in the sense of predicting the future).

F. "Deficiency reserves" means the excess over basic reserves, if any, of minimum reserves established in accordance with Section 8 of the Standard Valuation Law.

G. "Full credibility" means the level at which a particular body of data is assigned full predictive value based on a selected confidence interval.

H. "Preferred class certification" means the certification required by Section 5 of the Model.

I. "Underwriting-based justification" means the incorporation of underwriting criteria for use in setting the anticipated mortality assumption.

J. "Underwriting class" means the insurer's designation of insureds into a particular premium rate structure, e.g. super preferred, preferred, or standard

4. Selection of Table within the 2001 CSO Preferred Class Structure Mortality Table

Section 5 of the Model contains the requirements governing the set of mortality rates to be used for the purpose of calculating reserves based on the 2001 CSO Preferred Class Structure Mortality Table. The election of the 2001 CSO Preferred Class Structure Mortality Table is on a policy form and calendar year of issue basis, although once a calendar year cohort of policy forms is placed on the 2001 CSO Preferred Class Mortality Structure Table basis, it may not subsequently revert back to the standard 2001 CSO basis without the approval of the commissioner. This would be considered a basis change for annual statement reporting purposes. For those calendar years of issue in which a company opts to use the 2001 CSO Preferred Class Structure Mortality Table, it must use the entire 2001 CSO Preferred Class Structure Mortality Table for the chosen policy forms, i.e. a company may not use the preferred classes from the 2001 CSO Preferred Class Structure Mortality Table and use the Standard 2001 CSO Mortality Table for the non-preferred class(es). Additionally, if the company sells two similar policy forms in the same market the appointed actuary must use the same version of the table for both forms and may not use the 2001 CSO Preferred Class Structure Mortality Table on one and the Standard 2001 CSO Mortality Table on the other. A characteristic of this two-form scenario is that preferred lives would be attracted to one form and non-preferred lives would be attracted to the other.

The Model contains a requirement that at the time of election and annually thereafter, except for business valued under the Residual Standard Nonsmoker Table or the Residual Standard Smoker Table, the appointed actuary shall certify that the following tests of sufficiency were passed:

a. For each class, the present value of death benefits over the next ten years after the valuation date using the anticipated mortality experience without recognition of mortality improvement beyond the valuation date for each class is less than the present value of death benefits using the valuation basic table corresponding to the valuation table being used for that class.

b. For each class, the present value of death benefits over the future life of the contracts using anticipated mortality experience without recognition of mortality improvement beyond the valuation date for each class is less than the present value of death benefits using the valuation basic table corresponding to the valuation table being used for that class.

In the event that the class does not contain any policies with expiry dates ten or more years into the future, the sufficiency test based on the present value over the future life of the contracts shall be the only test required.

In order to choose the proper set of mortality rates within the 2001 CSO Preferred Class Structure Mortality Table and to develop the preferred class certification, the following considerations shall be made:

A. Creation of Classes

The appointed actuary should consider the composition and characteristics of the policies issued under a plan of insurance in determining the appropriate classes that will be applicable under that plan. The policies that comprise classes generally have similar underwriting or mortality experience characteristics. When classes are similar across various plans of insurance, these classes may be combined into a single aggregate class. The appointed actuary shall not combine classes that are expected to have dissimilar anticipated mortality as a means to produce reserves that are materially lower than those developed if the classes were not combined.

The appointed actuary should consider the presence of reinsurance in creating classes. Anticipated mortality should be assessed and classes should be created on a gross basis. To the extent that anticipated mortality on reinsurance ceded or assumed is materially different from that on direct business, the appointed actuary should consider creating separate classes to properly reflect the anticipated mortality.

If, due to differences in actual experience by policy form and underwriting class, groupings of classes are changed from those used in the prior actuarial certifications, the change and the effect of the change shall be disclosed to the commissioner in the actuarial certification.

Separate classes may be established for a single policy form if there are significant anticipated mortality differences for different cohorts of insured lives, such as age groups or policy sizes. For instance, if a company has different underwriting thresholds for policies with face amounts of $1 million or more, it may be appropriate to have a class for policies with face amounts of less than $1 million and a separate class for policies of $1 million or more.

B. Deriving Anticipated Mortality

i. If relevant company experience for a particular class is available and has full credibility, the appointed actuary shall use that experience as the basis for deriving anticipated mortality.

ii. In situations where relevant company experience for a particular class is available but does not have full credibility, the appointed actuary shall derive the anticipated mortality by blending the relevant company experience for the class with actual relevant, credible experience and past trends in experience of other similar types of business, either in the same company, in other companies (including reinsurance companies), or from other sources, generally in that order of preference provided that the appointed actuary supplies underwriting-based justification. The blending process shall be based on a credibility methodology that is recognized by the actuarial profession as acceptable practice as provided for in published transactions and scientific journals.

iii. In situations where relevant company experience for a particular class is not available (e.g. a new product), the appointed actuary may derive the anticipated mortality using actual relevant credible experience and past trends in experience of other similar types of business either in the same company, in other companies (including reinsurance companies), or from other sources, generally in that order of preference, provided that the appointed actuary supplies underwriting-based justification.

iv. Underwriting-based justification shall include an analysis of the relationship between the underwriting-based criteria for the class where no experience data is available or does not have full credibility and the underwriting-based criteria that underlie the actual relevant credible experience data.

v. If no sufficient underwriting-based or experienced-based justification is made to derive anticipated mortality for a class, the company shall not use the 2001 CSO Preferred Class Structure Mortality Table for valuation.

C. Periodic Assessment of Anticipated Mortality

The appointed actuary shall annually review relevant emerging experience and underwriting methods for the purpose of assessing the appropriateness of anticipated mortality for each class and, in aggregate, for all classes combined. If the results of statistical or other testing indicate that previously anticipated mortality for a given class is inappropriate, then the appointed actuary shall set a new anticipated mortality assumption for the class. After analyzing the appropriateness of the anticipated mortality for each class, the appointed actuary shall analyze the appropriateness of the anticipated mortality assumptions at the aggregate level. If the analysis at the aggregate level indicates that aggregate anticipated mortality is inadequate, then the appointed actuary shall adjust the anticipated mortality assumption for one or more of the classes until the appointed actuary is satisfied that the anticipated mortality assumptions are adequate at the aggregate level.

D. Tests of Sufficiency

After the anticipated mortality is established, each class must be tested for sufficiency. If a class fails any required sufficiency test, the class must be re-valued using a different set of mortality rates from the 2001 CSO Preferred Class Structure Mortality Table. A company must choose a set of mortality rates under which all required tests of sufficiency can be passed.

E. Calculation of Present Value

When a class is tested for sufficiency, the calculation of the present value of death benefits shall be based on a projection of death benefits, without the effect of lapse, at the valuation interest rate used to determine basic reserves for the class. If the class contains policies with several valuation interest rates, the lowest valuation interest rate used to determine the base reserves for any policy within the class shall be used for that class.

F. Right of Commissioner to Change the Table Used by the Company

The commissioner may require a company to change the mortality table if it is determined by the commissioner that inadequate justification of anticipated mortality is provided by the company.

5. Communications and Disclosures

The appointed actuary shall provide to the commissioner an annual certification that, as of the valuation date, the anticipated mortality experience of each Class of business (other than Residual Standard Class) meets the criteria of 4(a) and 4(b) above. Additionally, the appointed actuary shall prepare an annual report in support of the certification. The report shall include the following items:

A. The certification that the report supports;

B. The specified plans of insurance for which the company has elected to use the Preferred Class Structure Table, briefly describing each plan and the amount of in force business (count, face amount, and reserves) on each plan on the valuation date;

C. Compliance with the certification criteria;

D. Description of sources of information used as a basis for determining anticipated mortality;

E. Analysis performed to evaluate the credibility of relevant historical company experience when establishing anticipated mortality for each Class;

F. Analysis performed to evaluate the relationship between the underwriting-based criteria and the anticipated mortality established in each class.

G. Statistical or other quantitative analyses performed in assessing the continued appropriateness of the anticipated mortality assumption for each Class and for all Classes in aggregate, and a summary of changes made as a result of the analyses;

H. Anticipated Mortality, without recognition of mortality improvement beyond the date of valuation, for each Class and for all Classes in aggregate;

I. For each Class, the ratio of Anticipated Mortality to the mortality rates in the Valuation Basic Table corresponding to the set of valuation mortality rates being used for that Class;

J. Any changes made in the approach or parameters applied to the statistical analyses or tests performed compared to those performed at the last annual valuation; and,

K. Disclosure of the financial impact of any change in the chosen set of valuation mortality rates

Drafting Note: Annual actuarial opinions, certifications and reports for the use of "X" factors have been required since the implementation of the NAIC's Valuation of Life Insurance Model Regulation. The work and analysis to be performed for Preferred Class Certification is very similar to the requirements for the use of the "X" factors and the appointed actuary may combine the selection and analysis of "X" factors and the selection and analysis of 2001 CSO Preferred Class Structure Mortality Table into one actuarial opinion, certification and annual experience report, if the appointed actuary wishes to do so.

6. Other Items of Note

A. If a class of business is assigned to a different set of mortality rates within the 2001 CSO Preferred Class Structure Mortality Table (either a higher or lower level of mortality rates) from that used in the prior valuation, the change is not considered a basis change, and the reserve change must be accounted for in the calculation of gain from operations.

B. Multiple underwriting classes on a policy form can be mapped into the same set of mortality rates within the 2001 CSO Preferred Class Structure Mortality Table, if, in aggregate, the underwriting classes can be shown to have anticipated mortality no greater than the valuation basic table underlying the set of mortality rates selected.

C. If a company chooses to use the 2001 CSO Preferred Class Structure Mortality Table for basic reserves, the same table must be the basis for the calculation of deficiency reserves.

Actuarial Guideline XLIII

CARVM FOR VARIABLE ANNUITIES

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Section I) Background

The purpose of this Actuarial Guideline (Guideline) is to interpret the standards for the valuation of reserves for variable annuity and other contracts involving certain guaranteed benefits similar to those offered with variable annuities. The Guideline codifies the basic interpretation of the Commissioners Annuity Reserve Valuation Method (CARVM) by clarifying the assumptions and methodologies that will comply with the intent of the Standard Valuation Law (SVL). It also applies similar assumptions and methodologies to contracts that contain characteristics similar to those described in the scope, but that are not directly subject to CARVM.

For many years regulators and the industry have struggled with the issue of applying a uniform reserve standard to these contracts and in particular some of the guaranteed benefits referenced above. Current approaches make assumptions about product design, contractholder behavior and economic relationships and conditions. The economic volatility seen over the last few decades, combined with an increase in the complexity of these products, have made attempts to use these approaches for measuring economic-related risk less successful.

The Guideline addresses these issues by including an approach that applies principles of asset adequacy analysis directly to the risks associated with these products and guarantees.

The NAIC is currently using a similar approach to calculate risk-based capital (RBC) for similar contracts (i.e., the C-3 Phase II project). The methodology in the Guideline is based on that approach, and the intent of the Guideline is to, where possible, facilitate a framework whereby companies may determine both reserve and RBC in a consistent calculation.

In developing the Guideline, two regulatory sources were looked to for guidance. First, the SVL requires that CARVM be based on the greatest present value of future guaranteed benefits. Second, the NAIC Model Variable Annuity Regulation (VAR) states that the “reserve liability for variable annuities shall be established pursuant to the requirements of the Standard Valuation Law in accordance with actuarial procedures that recognize the variable nature of the benefits provided and any mortality guarantees.”

The Guideline requires that reserves for contracts falling within its scope be based on a minimum floor determined using a standard scenario (referred to as the Standard Scenario Amount) plus the excess over this minimum floor, if any, of a reserve calculated using a projection of the assets and estimated liabilities supporting these contracts over a broad range of stochastically generated projection scenarios and using prudent estimate assumptions (referred to as the Conditional Tail Expectation Amount). Within each of these scenarios, the greatest of the present values of accumulated losses ignoring Federal Income Tax is determined. The assumed fund performance for these scenarios must meet the mandated calibration standards contained in the Guideline. The reserve calculated using projections is based on a Conditional Tail Expectation measure of the results for each scenario.

Conditional Tail Expectation (CTE) is a statistical risk measure that provides enhanced information about the tail of a distribution above that provided by the traditional use of percentiles. Instead of only identifying a value at a particular percentile and thus ignoring the possibility of extremely large values in the tail, CTE recognizes a portion of the tail by providing the average over all values in the tail beyond the CTE percentile. Thus where the tail of the distribution of losses approximates that of a standard normal distribution, CTE (70) will approximate the 88th percentile; where the tail is "fatter" than that of a standard normal distribution, CTE (70) will exceed the 88th percentile; and where the tail is not as "fat" as a standard normal distribution, CTE (70) will be lower than the 88th percentile. Therefore, for distributions with "fat tails" from low probability, high impact events, such as those covered by the Guideline, the use of CTE will provide a more revealing measure than use of a single percentile requirement.

For certain products (e.g., variable annuities with Guaranteed Minimum Death Benefits only), a company can use an Alternative Methodology in place of the modeling approach outlined above to determine the Conditional Tail Expectation Amount.

The projection methodology used to calculate the Conditional Tail Expectation Amount, as well as the approach used to develop the Alternative Methodology, is based on the following set of principles. These principles should be followed when applying the methodology in the Guideline and analyzing the resulting reserves.[1]

> **Principle 1.** The objective of the approach used to determine the Conditional Tail Expectation Amount is to quantify the amount of statutory reserves needed by the company to be able to meet contractual obligations in light of the risks to which the company is exposed.
>
> **Principle 2.** The calculation of the Conditional Tail Expectation Amount is based on the results derived from an analysis of asset and liability cash flows produced by the application of a stochastic cash flow model to equity return and interest rate scenarios. For each scenario the greatest present value of accumulated surplus deficiency is calculated. The analysis reflects Prudent Estimate (see the definition of Prudent Estimate in Section III) assumptions for deterministic variables and is performed in aggregate (subject to limitations related to contractual provisions)[2] to allow the natural offset of risks within a given scenario. The methodology utilizes a projected total statutory balance sheet approach by including all projected income, benefit and expense items related to the business in the model and sets the Conditional Tail Expectation Amount at a degree of confidence using the conditional tail expectation measure applied to the set

[1] Note the following when considering these principles:
  a. The principles should be considered in their entirety.
  b. The Guideline requires companies to meet these principles with respect to only those contracts that fall within the scope of the Guideline and are inforce as of the valuation date to which the requirements are applied.

[2] Examples where full aggregation between contracts may not be possible include experience rated group contracts and the operation of reinsurance treaties.

of scenario specific greatest present values of accumulated statutory deficiencies that is deemed to be reasonably conservative over the span of economic cycles.

Principle 3. The implementation of a model involves decisions about the experience assumptions and the modeling techniques to be used in measuring the risks to which the company is exposed. Generally, assumptions are to be based on the conservative end of the actuary's confidence interval. The choice of a conservative estimate for each assumption may result in a distorted measure of the total risk. Conceptually,[3] the choice of assumptions and the modeling decisions should be made so that the final result approximates what would be obtained for the Conditional Tail Expectation Amount at the required CTE level if it were possible to calculate results over the joint distribution of all future outcomes. In applying this concept to the actual calculation of the Conditional Tail Expectation Amount, the actuary should be guided by evolving practice and expanding knowledge base in the measurement and management of risk.

Principle 4. While a stochastic cash flow model attempts to include all real world risks relevant to the objective of the stochastic cash flow model and relationships among the risks, it will still contain limitations because it is only a model. The calculation of the Conditional Tail Expectation Amount is based on the results derived from the application of the stochastic cash flow model to scenarios while the actual statutory reserve needs of the company arise from the risks to which the company is (or will be) exposed in reality. Any disconnect between the model and reality should be reflected in setting Prudent Estimate assumptions to the extent not addressed by other means.

Principle 5. Neither a cash flow scenario model, nor a method based on factors calibrated to the results of a cash flow scenario model, can completely quantify a company's exposure to risk. A model attempts to represent reality, but will always remain an approximation thereto and hence uncertainty in future experience is an important consideration when determining the Conditional Tail Expectation Amount. Therefore, the use of assumptions, methods, models, risk management strategies (e.g., hedging), derivative instruments, structured investments or any other risk transfer arrangements (such as reinsurance) that serve solely to reduce the calculated Conditional Tail Expectation Amount without also reducing risk on scenarios similar to those used in the actual cash flow modeling are inconsistent with these principles. The use of assumptions and risk management strategies should be appropriate to the business and not merely constructed to exploit 'foreknowledge' of the components of the required methodology.

The methodology prescribed in the Guideline is applied to a company's entire portfolio of variable annuities (whether or not they contain guaranteed benefits), as well as other affected products that contain guaranteed benefits. Current guaranteed benefits include Guaranteed Minimum Death Benefits, Guaranteed Minimum Accumulation Benefits, Guaranteed Minimum Income Benefits, Guaranteed Minimum Withdrawal Benefits, Guaranteed Lifetime Withdrawal Benefits, and Guaranteed Payout Annuity Floors. It is also expected that the methodology in the Guideline will be applied to future variations on these designs and to new guarantee designs.

Since statutory reporting requires companies to report reserves prior to reinsurance, the Guideline clarifies standards for adjusting the various components of the reserve so that the reserve may be reported both prior to and net of reinsurance.

The Guideline also requires an allocation of the total reported reserve between the General and Separate Accounts and prescribes a method for doing this allocation.

[3] The intent of Principle 3 is to describe the conceptual framework for setting assumptions. Appendix 9 provides the requirements and guidance for setting contractholder behavior and includes alternatives to this framework if the actuary is unable to fully apply this principle.

Actuarial certification of the work done to calculate reserves is required by the Guideline. A qualified actuary (referred to throughout the Guideline as "the actuary") shall certify that the work has been done in a way that meets all applicable Actuarial Standards of Practice.

For more details on the development of these requirements, including the development of the calibration criteria, see the American Academy of Actuaries recommendation on C-3 Phase II risk-based capital.

This Guideline and its Appendices require the actuary to make various determinations, verifications and certifications. The company shall provide the actuary with the necessary information sufficient to permit the actuary to fulfill the responsibilities set forth in this Guideline and its Appendices and responsibilities arising from applicable Actuarial Standards of Practice, including ASOP No. 23, *Data Quality*.

The risks reflected in the calculation of reserves under this Guideline arise from actual or potential events or activities which are both:

a) Directly related to the contracts falling under the scope of this Guideline or their supporting assets; and
b) Capable of materially affecting the reserve.

Categories and examples of risks reflected in the reserve calculations include but are not necessarily limited to:

a) Asset Risks
   (i) Separate Account fund performance;
   (ii) Credit risks (e.g., default or rating downgrades);
   (iii) Commercial mortgage loan rollover rates (roll-over of bullet loans);
   (iv) Uncertainty in the timing or duration of asset cash flows (e.g., shortening (prepayment risk) and lengthening (extension risk));
   (v) Performance of equities, real estate, and Schedule BA assets;
   (vi) Call risk on callable assets;
   (vii) Risk associated with hedge instrument (includes basis, gap, price, parameter estimation risks, and variation in assumptions); and
   (viii) Currency risk.
b) Liability Risks
   (i) Reinsurer default, impairment or rating downgrade known to have occurred before or on the valuation date;
   (ii) Mortality/longevity, persistency/lapse, partial withdrawal and premium payment risks;
   (iii) Utilization risk associated with guaranteed living benefits;
   (iv) Anticipated mortality trends based on observed patterns of mortality improvement or deterioration, where permitted;
   (v) Annuitization risks; and
   (vi) Additional premium dump-ins (high interest rate guarantees in low interest rate environments);
c) Combination Risks
   (i) Risks modeled in the company's risk assessment processes that are related to the contracts, as described above;
   (ii) Disintermediation risk (including such risk related to payment of surrender or partial withdrawal benefits); and
   (iii) Risks associated with Revenue Sharing Income.

The risks not necessarily reflected in the calculation of reserves under this Guideline are:

a) Those not reflected in the determination of Risk-Based Capital; and

b) Those reflected in the determination of Risk-Based Capital but arising from obligations of the company not directly related to the contracts falling under the scope of this Guideline, or their supporting assets, as described above.

Categories and examples of risks not reflected in the reserve calculations include but are not necessarily limited to:

a) Asset Risks
   Liquidity risks associated with a "run on the bank."

b) Liability Risks
   (i) Reinsurer default, impairment or rating downgrade occurring after the valuation date;
   (ii) Catastrophic events (e.g., epidemics or terrorist events);
   (iii) Major breakthroughs in life extension technology that have not yet fundamentally altered recently observed mortality experience; and
   (iv) Significant future reserve increases as an unfavorable scenario is realized.

c) General Business Risks
   (i) Deterioration of reputation;
   (ii) Future changes in anticipated experience (reparameterization in the case of stochastic processes) which would be triggered if and when adverse modeled outcomes were to actually occur;
   (iii) Poor management performance;
   (iv) The expense risks associated with fluctuating amounts of new business;
   (v) Risks associated with future economic viability of the company;
   (vi) Moral hazards; and
   (vii) Fraud and theft.

Section II) Scope

A) The Guideline applies to contracts, whether directly written or assumed through reinsurance, falling into any of the following categories:

1) Variable deferred annuity contracts subject to the Commissioner's Annuity Reserve Valuation Method (CARVM), whether or not such contracts contain Guaranteed Minimum Death Benefits (GMDBs), or Variable Annuity Guaranteed Living Benefits (VAGLBs);

2) Variable immediate annuity contracts, whether or not such contracts contain GMDBs or VAGLBs;

3) Group annuity contracts that are not subject to CARVM, but contain guarantees similar in nature[4] to GMDBs, VAGLBs, or any combination thereof; and

4) All other products that contain guarantees similar in nature to GMDBs or VAGLBs, even if the insurer does not offer the mutual funds or variable funds to which these guarantees relate, where there is no other explicit reserve requirement.[5]

[4] The term "similar in nature," as used in sections II)A)3) and II)A)4) is intended to capture both current products and benefits as well as product and benefit designs that may emerge in the future. Examples of the currently known designs are listed in footnote #5 below. Any product or benefit design that does not clearly fit the Scope should be evaluated on a case-by-case basis taking into consideration factors that include, but are not limited to, the nature of the guarantees, the definitions of GMDB and VAGLB in sections III)A)1) and III)A)2) and whether the contractual amounts paid in the absence of the guarantee are based on the investment performance of a market-value fund or market-value index (whether or not part of the company's separate account).

If such a benefit is offered as part of a contract that has an explicit reserve requirement and that benefit does not currently have an explicit reserve requirement:

a) The Guideline shall be applied to the benefit on a standalone basis (i.e., for purposes of the reserve calculation, the benefit shall be treated as a separate contract);

b) The reserve for the underlying contract is determined according to the explicit reserve requirement; and

c) The reserve held for the contract shall be the sum of a) and b).

B) The Guideline does not apply to contracts falling under the scope of the NAIC Model Modified Guaranteed Annuity Regulation (MGAs); however, it does apply to contracts listed above that include one or more subaccounts containing features similar in nature to those contained in MGAs (e.g., market value adjustments).

C) Separate account products that guarantee an index and do not offer GMDBs or VAGLBs are excluded from the scope of the Guideline.

Section III) Definitions

A) Definitions of Benefit Guarantees

1) Guaranteed Minimum Death Benefit (GMDB). A GMDB is a guaranteed benefit providing, or resulting in the provision that, an amount payable on the death of a contractholder, annuitant, participant, or insured will be increased and/or will be at least a minimum amount. Only such guarantees having the potential to produce a contractual total amount payable on death that exceeds the account value, or in the case of an annuity providing income payments, an amount payable on death other than continuation of any guaranteed income payments, are included in this definition. GMDBs that are based on a portion of the excess of the account value over the net of premiums paid less partial withdrawals made (e.g., an Earnings Enhanced Death Benefit) are also included in this definition.

2) Variable Annuity Guaranteed Living Benefit (VAGLB). A VAGLB is a guaranteed benefit providing, or resulting in the provision that, one or more guaranteed benefit amounts payable or accruing to a living contractholder or living annuitant, under contractually specified conditions (e.g., at the end of a specified waiting period, upon annuitization, or upon withdrawal of premium over a period of time), will increase contractual benefits should the contract value referenced by the guarantee (e.g., account value) fall below a given level or fail to achieve certain performance levels. Only such guarantees having the potential to provide benefits with a present value as of the benefit commencement date that exceeds the contract value referenced by the guarantee are included in this definition. Payout annuities without minimum payout or performance guarantees are neither considered to contain nor to be VAGLBs.

3) Guaranteed Minimum Income Benefit (GMIB). A GMIB is a VAGLB design for which the benefit is contingent on annuitization of a variable deferred annuity or similar contract. The benefit is typically expressed as a contractholder option, on one or more

[5] For example, a group life contract that wraps a GMDB around a mutual fund would generally fall under the scope of the Guideline since there is not an explicit reserve requirement for this type of group life contract. However, for an individual variable life contract with a GMDB and a benefit similar in nature to a VAGLB, the Guideline would generally apply only to the VAGLB-type benefit, since there is an explicit reserve requirement that applies to the variable life contract and the GMDB.

option dates, to have a minimum amount applied to provide periodic income using a specified purchase basis.

4) Guaranteed Payout Annuity Floor (GPAF). A GPAF is a VAGLB design guaranteeing that one or more of the periodic payments under a variable immediate annuity will not be less than a minimum amount.

B) Definitions of Reserve Methodology Terminology

1) Scenario. A scenario consists of a set of asset growth rates and investment returns from which assets and liabilities supporting a set of contracts may be determined for each year of a projection.

2) Cash Surrender Value. For purposes of the Guideline, the Cash Surrender Value for a contract is the amount available to the contractholder upon surrender of the contract. Generally, it is equal to the account value less any applicable surrender charges, where the surrender charge reflects the availability of any free partial surrender options. For contracts where all or a portion of the amount available to the contractholder upon surrender is subject to a market value adjustment, however, the Cash Surrender Value shall reflect the market value adjustment consistent with the required treatment of the underlying assets. That is, the Cash Surrender Value shall reflect any market value adjustments where the underlying assets are reported at market value, but shall not reflect any market value adjustments where the underlying assets are reported at book value.

3) Scenario Greatest Present Value. For a given scenario, the Scenario Greatest Present Value is the sum of:

a) The greatest of the present values, as of the projection start date, of the projected Accumulated Deficiencies for the scenario; and

b) The Starting Asset Amount, as defined below.

4) Conditional Tail Expectation Amount. The Conditional Tail Expectation Amount is equal to the numerical average of the 30 percent largest values of the Scenario Greatest Present Values.

5) Working Reserve. The Working Reserve is the assumed reserve used in the projections of Accumulated Deficiencies supporting the calculation of the Scenario Greatest Present Values. At any point in the projections, including at the start of the projection, the Working Reserve shall equal the projected Cash Surrender Value.

For a variable payout annuity without a Cash Surrender Value, the Working Reserve shall equal the present value, at the valuation interest rate and the valuation mortality table specified for such a product by the Standard Valuation Law of future income payments projected using a return based on the valuation interest rate less appropriate asset based charges. For annuitizations that occur during the projection, the valuation interest rate as of the current valuation date may be used in determining the Working Reserve. Alternatively, if an integrated model of equity returns and interest rates is used, a future estimate of valuation interest rates may be incorporated into the Working Reserve.

For contracts not covered above, the actuary shall determine the Working Reserve in a manner that is consistent with the above requirements.

6) Accumulated Deficiency. Accumulated Deficiency is an amount measured as of the end of a projection year and equals the projected Working Reserve less the amount of projected assets, both as of the end of the projection year. Accumulated Deficiencies may be positive or negative.[6]

7) Starting Asset Amount. The Starting Asset Amount equals the value of the assets at the start of the projection, as defined in section A1.4)A) of Appendix 1.

8) Prudent Estimate. The deterministic assumptions to be used for projections are to be the actuary's Prudent Estimate. This means that they are to be set at the conservative end of the actuary's confidence interval as to the true underlying probabilities for the parameter(s) in question, based on the availability of relevant experience and its degree of credibility.

A Prudent Estimate assumption is developed by applying a margin for uncertainty to the "Anticipated Experience" assumption. The margin for uncertainty shall provide for estimation error and margins for adverse deviation. The resulting Prudent Estimate assumption shall be reasonably conservative over the span of economic cycles and over a plausible range of expected experience, in recognition of the Principles described in Section I. "Anticipated Experience" would typically be the actuary's reasonable estimate of future experience for a risk factor given all available, relevant information pertaining to the contingencies being valued. Recognizing that assumptions are simply assertions of future unknown experience, the margin should be directly related to uncertainty in the underlying risk factor. The greater the uncertainty, the larger the margin. Each margin should serve to increase the Aggregate Reserve that would otherwise be held in its absence (i.e., using only the Anticipated Experience assumption).

For example, assumptions for circumstances that have never been observed require more margins for error than those for which abundant and relevant experience data are available.

This means that valuation assumptions not stochastically modeled are to be consistent with the stated Principles in Section I, be based on any relevant and credible experience that is available, and should be set to produce, in concert with other Prudent Estimate assumptions, a Conditional Tail Expectation Amount that is consistent with the stated CTE level.

The actuary shall follow the principles discussed in Appendices 9 and 10 in determining Prudent Estimate assumptions.

9) Gross Wealth Ratio. The Gross Wealth Ratio is the cumulative return for the indicated time period and percentile (e.g., 1.0 indicates that the index is at its original level).

10) Clearly Defined Hedging Strategy. The designation of Clearly Defined Hedging Strategy applies to strategies undertaken by a company to manage risks through the future purchase or sale of hedging instruments and the opening and closing of hedging positions. In order to qualify as a Clearly Defined Hedging Strategy, the strategy must meet the principles outlined in the Background section of the Guideline (particularly Principle 5) and shall, at a minimum, identify:

a) The specific risks being hedged (e.g., delta, rho, vega, etc.),

[6] Note that a positive Accumulated Deficiency means that there is a cumulative loss and a negative Accumulated Deficiency means that there is a cumulative gain.

b) The hedge objectives,
c) The risks not being hedged (e.g., variation from expected mortality, withdrawal, and other utilization or decrement rates assumed in the hedging strategy, etc.),
d) The financial instruments that will be used to hedge the risks,
e) The hedge trading rules including the permitted tolerances from hedging objectives,
f) The metric(s) for measuring hedging effectiveness,
g) The criteria that will be used to measure effectiveness,
h) The frequency of measuring hedging effectiveness,
i) The conditions under which hedging will not take place, and
j) The person or persons responsible for implementing the hedging strategy.

The hedge strategy may be dynamic, static, or a combination thereof.

It is important to note that strategies involving the offsetting of the risks associated with variable annuity guarantees with other products outside of the scope of the Guideline (e.g., equity-indexed annuities) do not currently qualify as a Clearly Defined Hedging Strategy under the Guideline.

11) Revenue Sharing. Revenue Sharing, for purposes of the Guideline, means any arrangement or understanding by which an entity responsible for providing investment or other types of services makes payments to the company (or to one of its affiliates). Such payments are typically in exchange for administrative services provided by the company (or its affiliate), such as marketing, distribution and recordkeeping. Only payments that are attributable to charges or fees taken from the underlying variable funds or mutual funds supporting the contracts that fall under the scope of the Guideline shall be included in the definition of Revenue Sharing.

12) Domiciliary Commissioner. For purposes of the Guideline, this term refers to the chief insurance regulatory official of the state of domicile of the company.

13) Aggregate Reserve. The minimum reserve requirement as of the valuation date for the contracts falling within the scope of the Guideline.

14) 1994 Variable Annuity MGDB Mortality Table. This mortality table is shown in Appendix 11.

Section IV) Definition of General Reserve Methodology

A) General Description. The Aggregate Reserve for contracts falling within the scope of the Guideline shall equal the Conditional Tail Expectation Amount but not less than the Standard Scenario Amount, where the Aggregate Reserve is calculated as the Standard Scenario Amount plus the excess, if any, of the Conditional Tail Expectation Amount over the Standard Scenario Amount.

B) Impact of Reinsurance Ceded. Where reinsurance is ceded for all or a portion of the contracts, both components in the above general description (and thus the Aggregate Reserve) shall be determined net of any reinsurance treaties that meet the statutory requirements that would allow the treaty to be accounted for as reinsurance.

An Aggregate Reserve before reinsurance shall also be calculated if needed for regulatory reporting or other purposes, using methods described in Appendix 2.

C) The Standard Scenario Amount. The Standard Scenario Amount is the aggregate of the reserves determined by applying the Standard Scenario method to each of the contracts falling within the scope of the Guideline. The Standard Scenario method is outlined in Appendix 3.

D) The Conditional Tail Expectation Amount. The Conditional Tail Expectation Amount shall be determined based on a projection of the contracts falling within the scope of the Guideline, and the assets supporting these contracts, over a broad range of stochastically generated projection scenarios and using Prudent Estimate assumptions.

The stochastically generated projection scenarios shall meet the Scenario Calibration Criteria described in Appendix 5.

The Conditional Tail Expectation Amount may be determined in aggregate for all contracts falling within the scope of the Guideline (i.e., a single grouping). At the option of the company, it may be determined by applying the methodology outlined below to sub-groupings of contracts, in which case, the Conditional Tail Expectation Amount shall equal the sum of the amounts computed for each such sub-grouping.

The Conditional Tail Expectation Amount shall be determined using the following steps:

1) For each scenario, projected aggregate Accumulated Deficiencies are determined at the start of the projection (i.e., "time 0") and at the end of each projection year as the sum of the Accumulated Deficiencies for each contract grouping.

2) The Scenario Greatest Present Value is determined for each scenario based on the sum of the aggregate Accumulated Deficiencies[7] and aggregate Starting Asset Amounts for the contracts for which the Aggregate Reserve is being computed.

3) The Scenario Greatest Present Values for all scenarios are then ranked from smallest to largest and the Conditional Tail Expectation Amount is the average of the largest 30 percent of these ranked values.

The projections shall be performed in accordance with Appendix 1. The actuary shall document the assumptions and procedures used for the projections and summarize the results obtained as described in Appendix 2 and Appendix 8.

E) Alternative Methodology. For variable deferred annuity contracts that contain either no guaranteed benefits or only GMDBs (i.e., no VAGLBs), the Conditional Tail Expectation Amount may be determined using the Alternative Methodology described in Appendix 4 rather than using the approach described in subsection D) above. However, in the event the approach described in subsection D) has been used in prior valuations the Alternative Methodology may not be used without approval from the Domiciliary Commissioner.

The Conditional Tail Expectation Amount for the group of contracts to which the Alternative Methodology is applied shall not be less than the aggregate Cash Surrender Value of those contracts.

The actuary shall document the assumptions and procedures used for the Alternative Methodology and summarize the results obtained as described in Appendix 2 and Appendix 8.

[7] The Scenario Greatest Present Value is therefore based on the greatest projected Accumulated Deficiency, in aggregate, for all contracts for which the Aggregate Reserve is computed hereunder, rather than based on the sum of the greatest projected Accumulated Deficiency for each grouping of contracts.

F) Allocation of Results to Contracts. The Aggregate Reserve shall be allocated to the contracts falling within the scope of the Guideline using the method outlined in Appendix 6.

G) Reserve as of January 1, 2009. The reserve as of January 1, 2009 shall be the sum of the reserves from the asset adequacy analysis requirements in Actuarial Guideline XXXIV and Actuarial Guideline XXXIX.

Section V) Effective Date

The Guideline affects all contracts issued on or after January 1, 1981, effective December 31, 2009. Where the application of the Guideline produces higher reserves than the company had otherwise established by their previously used interpretation, such company may request a grade-in period, not to exceed three (3) years, from the Domiciliary Commissioner upon satisfactory demonstration of the previous interpretation and that such delay of implementation will not cause a hazardous financial condition or potential harm to its policyholders. The grading shall be done only on the reserves on the contracts in-force as of December 31, 2009. The reserves under the old basis and new basis shall be compared each year - 2/3 of the difference shall be subtracted from the reserve under the new basis in 2009 and 1/3 of the difference shall be subtracted from the reserve under the new basis in 2010.

APPENDIX 1 - Determination of Conditional Tail Expectation Amount Based on Projections

A1.1) Projection of Accumulated Deficiencies

A) General Description of Projection. The projection of Accumulated Deficiencies shall be made ignoring Federal Income Tax and reflect the dynamics of the expected cash flows for the entire group of contracts, reflecting all product features, including the guarantees provided under the contracts. Insurance company expenses (including overhead and investment expense), fund expenses, contractual fees and charges, revenue sharing income received by the company (net of applicable expenses) and cash flows associated with any reinsurance or hedging instruments are to be reflected on a basis consistent with the requirements herein. Cash flows from any fixed account options shall also be included. Any market value adjustment assessed on projected withdrawals or surrenders shall also be included (whether or not the Cash Surrender Value reflects market value adjustments). Throughout the projection, where estimates are used, such estimates shall be on a Prudent Estimate basis.

Federal Income Tax shall not be included in the projection of Accumulated Deficiencies.

B) Grouping of Variable Funds and Subaccounts. The portion of the Starting Asset Amount held in the Separate Account represented by the variable funds and the corresponding account values may be grouped for modeling using an approach that recognizes the investment guidelines and objectives of the funds. In assigning each variable fund and the variable subaccounts to a grouping for projection purposes, the fundamental characteristics of the fund shall be reflected and the parameters shall have the appropriate relationship to the required calibration points of the S&P 500. The grouping shall reflect characteristics of the efficient frontier (i.e., returns generally cannot be increased without assuming additional risk).

An appropriate proxy for each variable subaccount shall be designed in order to develop the investment return paths. The development of the scenarios for the proxy funds is a fundamental step in the modeling and can have a significant impact on results. As such, the actuary must map each variable account to an appropriately crafted proxy fund normally expressed as a linear combination of recognized market indices (or sub-indices).

C) Grouping of Contracts. Projections may be performed for each contract inforce on the date of valuation or by grouping contracts into representative cells of model plans using all characteristics and criteria having a material impact on the size of the reserve. Grouping shall be the responsibility of the actuary but may not be done in a manner that intentionally understates the resulting reserve.

D) Modeling of Hedges. The appropriate costs and benefits of hedging instruments that are currently held by the company in support of the contracts falling under the scope of the Guideline shall be included in the projections. If the company is following a Clearly Defined Hedging Strategy and the hedging strategy meets the requirements of Appendix 7, the projections shall take into account the appropriate costs and benefits of hedge positions expected to be held in the future through the execution of that strategy.

To the degree either the currently held hedge positions or the hedge positions expected to be held in the future introduce basis, gap, price, or assumption risk, a suitable reduction for effectiveness of hedges shall be made. The actuary is responsible for verifying compliance with a Clearly Defined Hedging Strategy and the requirements in Appendix 7 for all hedge instruments included in the projections.

While hedging strategies may change over time, any change in hedging strategy shall be documented and include an effective date of the change in strategy.

The use of products not falling under the scope of the Guideline (e.g., equity-indexed annuities) as a hedge shall not be recognized in the determination of Accumulated Deficiencies.

These requirements do not supersede any statutes, laws, or regulations of any state or jurisdiction related to the use of derivative instruments for hedging purposes and should not be used in determining whether a company is permitted to use such instruments in any state or jurisdiction.

Upon request of the company's domiciliary commissioner and for information purposes to show the effect of including future hedge positions in the projections, the company shall show the results of performing an additional set of projections reflecting only the hedges currently held by the company in support of the contracts falling under the scope of the Guideline. Because this additional set of projections excludes some or all of the derivative instruments, the investment strategy used may not be the same as that used in the determination of the Conditional Tail Expectation Amount.

E) Revenue Sharing.

1) Projections of Accumulated Deficiencies may include income from projected future Revenue Sharing, as defined in Section III) net of applicable projected expenses ("Net Revenue Sharing Income") if the following requirements are met:

a) The Net Revenue Sharing Income is received[8] by the company,[9]

b) Signed contractual agreement or agreements are in place as of the valuation date and support the current payment of the Net Revenue Sharing Income; and

c) The Net Revenue Sharing Income is not already accounted for directly or indirectly as a company asset.

2) The amount of Net Revenue Sharing Income to be used shall reflect the actuary's assessment of factors that include but are not limited to the following (not all of these factors will necessarily be present in all situations):

a) The terms and limitations of the agreement(s), including anticipated revenue, associated expenses and any contingent payments incurred or made by either the company or the entity providing the Net Revenue Sharing as part of the agreement(s);

b) The relationship between the company and the entity providing the Net Revenue Sharing Income that might affect the likelihood of payment and the level of expenses;

c) The benefits and risks to both the company and the entity paying the Net Revenue Sharing Income of continuing the arrangement.

[8] For purposes of this section, Net Revenue Sharing Income is considered to be received by the company if it is paid directly to the company through a contractual agreement with either the entity providing the Net Revenue Sharing Income or an affiliated company that receives the Net Revenue Sharing Income. Net Revenue Sharing Income would also be considered to be received, if it is paid to a subsidiary that is owned by the company and if 100% of the statutory income from that subsidiary is reported as statutory income of the company. In this case the actuary needs to assess the likelihood that future Net Revenue Sharing Income is reduced due to the reported statutory income of the subsidiary being less than future Net Revenue Sharing Income received.

[9] As in other sections of the Guideline, the term "the company" is used exclusively as a reference to the insurance company writing the business falling under the scope of the Guideline. The term "entity providing the Net Revenue Sharing Income" is self-explanatory and is used consistently in this subsection.

d) The likelihood that the company will collect the Net Revenue Sharing Income during the term(s) of the agreement(s) and the likelihood of continuing to receive future revenue after the agreement(s) has ended;

e) The ability of the company to replace the services provided to it by the entity providing the Net Revenue Sharing Income or to provide the services itself, along with the likelihood that the replaced or provided services will cost more to provide; and

f) The ability of the entity providing the Net Revenue Sharing Income to replace the services provided to it by the company or to provide the services itself, along with the likelihood that the replaced or provided services will cost more to provide.

3) The amount of projected Net Revenue Sharing Income shall also reflect a margin (which decreases the assumed Net Revenue Sharing Income) directly related to the uncertainty of the revenue. The greater the uncertainty, the larger the margin. Such uncertainty is driven by many factors including the potential for changes in the securities laws and regulations, mutual fund board responsibilities and actions, and industry trends. Since it is prudent to assume that uncertainty increases over time, a larger margin shall be applied as time that has elapsed in the projection increases.

4) All expenses required or assumed to be incurred by the company in conjunction with the arrangement providing the Net Revenue Sharing Income, as well as any expenses assumed to be incurred by the company in conjunction with the assumed replacement of the services provided to it (as discussed in subsection 2)e) above) shall be included in the projections as a company expense under the requirements of section A1.1)A). In addition, expenses incurred by either the entity providing the Net Revenue Sharing Income or an affiliate of the company shall be included in the applicable expenses discussed in section A1.1)A) and A1.1)E)1) that reduce the Net Revenue Sharing Income.

5) The actuary is responsible for reviewing the revenue sharing agreements, verifying compliance with these requirements, and documenting the rationale for any source of Net Revenue Sharing Income used in the projections.

6) The amount of Net Revenue Sharing Income assumed in a given scenario shall not exceed the sum of a) and b), where:

a) Is the contractually guaranteed Net Revenue Sharing Income projected under the scenario, and

b) Is the actuary's estimate of non-contractually guaranteed Net Revenue Sharing Income before reflecting any margins for uncertainty multiplied by the following factors:

(i) 1.0 in the first projection year;
(ii) 0.9 in the second projection year;
(iii) 0.8 in the third projection year;
(iv) 0.7 in the fourth projection year;
(v) 0.6 in the fifth projection year;
(vi) 0.5 in the sixth and all subsequent projection years. The resulting amount of non-contractually guaranteed Net Revenue Sharing Income after application of this factor shall not exceed 0.25% per year on separate account assets in the sixth and all subsequent projection years.

F) Length of Projections. Projections of Accumulated Deficiencies shall be run for as many future years as needed so that no materially greater reserve value would result from longer projection periods.

G) AVR/IMR. The AVR and the IMR shall be handled consistently with the treatment in the company's cash flow testing.

A1.2) Determination of Scenario Greatest Present Values

A) Scenario Greatest Present Values. For a given scenario, the Scenario Greatest Present Value is the sum of:

1) The greatest present value, as of the projection start date, of the projected Accumulated Deficiencies defined in Section III)B)6); and

2) The Starting Asset Amount.

B) Discount Rates. In determining the Scenario Greatest Present Values, Accumulated Deficiencies shall be discounted using the same interest rates at which positive cash flows are invested, as determined in section A1.4)D). Such interest rates shall be reduced to reflect expected credit losses. Note that the interest rates used do not include a reduction for Federal Income Taxes.

A1.3) Projection Scenarios

A) Minimum Required Scenarios. The number of scenarios for which projected greatest present values of Accumulated Deficiencies shall be computed shall be the responsibility of the actuary and shall be considered to be sufficient if any resulting understatement in total reserves, as compared with that resulting from running additional scenarios, is not material.

B) Scenario Calibration Criteria. Returns for the groupings of variable funds shall be determined on a stochastic basis such that the resulting distribution of the Gross Wealth Ratios of the scenarios meets the Scenario Calibration Criteria specified in Appendix 5.

A1.4) Projection Assets

A) Starting Asset Amount. For the projections of Accumulated Deficiencies, the value of assets at the start of the projection shall be set equal to the approximate value of statutory reserves at the start of the projection. Assets shall be valued consistently with their annual statement values. The amount of such asset values shall equal the sum of the following items, all as of the start of the projection:

1) All of the Separate Account assets supporting the contracts;

2) An amount of assets held in the General Account equal to the approximate value of statutory reserves as of the start of the projections less the amount in 1), above.

In many instances the initial General Account assets may be negative, resulting in a projected interest expense. General Account assets chosen for use as described above shall be selected on a consistent basis from one reserve valuation hereunder to the next.

Any hedge assets meeting the requirements described in section A1.1)D) shall be reflected in the projections and included with other General Account assets under item 2) above. To the extent the sum of the value of such hedge assets and the value of assets in item 1) above is greater than the approximate value of statutory reserves as of the start of the projections, then item 2) above may include enough negative General Account assets or cash such that the sum of items 1) and 2) above equals the approximate value of statutory reserves as of the start of the projections.[10]

The actuary shall document which assets were used as of the start of the projection, the approach used to determine which assets were chosen and shall verify that the value of the assets equals the approximate value of statutory reserves at the start of the projection.

B) Valuation of Projected Assets. For purposes of determining the projected Accumulated Deficiencies, the value of projected assets shall be determined in a manner consistent with their value at the start of the projection. For assets assumed to be purchased during a projection, the value shall be determined in a manner consistent with the value of assets at the start of the projection that have similar investment characteristics.

C) Separate Account Assets. For purposes of determining the Starting Asset Amounts in subsection A) and the valuation of projected assets in subsection B), assets held in a Separate Account shall be summarized into asset categories determined by the actuary as discussed in section A1.1)B).

D) General Account Assets. General Account assets shall be projected, net of projected defaults, using assumed investment returns consistent with their book value and expected to be realized in future periods as of the date of valuation. Initial assets that mature during the projection and positive cash flows projected for future periods shall be invested at interest rates, which, at the option of the actuary, are one of the following:

1) The forward interest rates implied by the swap curve[11] in effect as of the valuation date,

2) The 200 interest rate scenarios available as prescribed for Phase I, C-3 Risk Based Capital calculation, coupled with the Separate Account return scenarios by mating them up with the first 200 such scenarios and repeating this process until all Separate Account return scenarios have been mated with a Phase I scenario, or

3) Interest rates developed for this purpose from a stochastic model that integrates the development of interest rates and the Separate Account returns.

When the option described in 1) above (the forward interest rates implied by the swap curve) is used, an amount shall be subtracted from the interest rates to reflect the current market expectations about future interest rates using the process described in section A1.5)A).

The actuary may switch from 1) to 2), from 1) to 3) or from 2) to 3) from one valuation date to the next, but may not switch in the other direction without approval from the Domiciliary Commissioner.

A1.5) Projection of Annuitization Benefits (including GMIBs)

A) Assumed Annuitization Purchase Rates at Election. For purposes of projecting annuitization benefits (including annuitizations stemming from the election of a GMIB), the projected annuitization purchase rates shall be determined assuming that market interest rates available at the time of election are the interest rates used to project General Account Assets, as determined in

[10] Further elaboration on potential practices with regard to this issue may be included in a practice note.

[11] The swap curve is based on the Federal Reserve H.15 interest swap rates. The rates are for a Fixed Rate Payer in return for receiving three month LIBOR. One place where these rates can be found is http://www.federalreserve.gov/releases/h15/default.htm.

A1.4)D). However, where the interest rates used to project General Account Assets are based upon the forward interest rates implied by the swap curve in effect as of the valuation date (i.e., the option described in section A1.4)D)1) is used, herein referred to as a point estimate), the margin between the cost to purchase an annuity using the guaranteed purchase basis and the cost using the interest rates prevailing at the time of annuitization shall be adjusted as discussed below.

If a point estimate is being used, it is important that the margin assumed reflects the current market expectations about future interest rates at the time of annuitization, as described more fully below, and a downward adjustment to the interest rate assumed in the purchase rate basis. The latter adjustment is necessary since a greater proportion of contractholders will select an annuitization benefit when it is worth more than the cash surrender value then when it is not. As a practical matter, this effect can be approximated by using an interest rate assumption in the purchase rate basis that is 0.30 percent below that implied by the forward swap curve, as described below.

To calculate market expectations of future interest rates, the par or current coupon swap curve is used (documented daily in Federal Reserve H.15 with some interpolation needed). Deriving the expected rate curve from this swap curve at a future date involves the following steps:

1) Calculate the implied zero-coupon rates. This is a well documented “bootstrap” process. For this process we use the equation $100=C^n * (v + v^2 + \ldots +v^n) + 100v^n$ where the “v^t” terms are used to stand for the discount factors applicable to cash flows 1,2,…n years hence and C^n is the n-year swap rate. Each of these discount factors are based on the forward curve and therefore are based on different rates, however (i.e. “v^2” does not equal v times v). Given the one year swap rate, one can solve for v. Given v and the two year swap rate one can then back into v^2, and so on.

2) Convert the zero coupon rates to one year forward rates by calculating the discount factor needed to get from v^{t-1} to v^t.

3) Develop the expected rate curve.

This recognizes that, for example, the five-year forward one-year rate is not the rate the market expects on one year instruments five years from now. The reason is that as the bond gets shorter the “risk premium” in the rate diminishes. This is sometimes characterized as “rolling down” the yield curve. Table A shows the historic average risk premium at various durations. From this table, one can see that to get the rate the market expects a 1 year swap to have five years from now; one must subtract the risk premium associated with six year rates (.95%) and add back that associated with 1 year rates (.50%). This results in a net reduction of .45%.

Table A: Risk Premium by Duration

Duration	Risk Premium	Duration	Risk Premium
1	0.500%	6	0.950%
2	0.750%	7	1.000%
3	0.750%	8	1.100%
4	0.850%	9+	1.150%
5	0.900%		

The Exhibit below combines the three steps. Columns A through D convert the swap curve to the implied forward rate for each future payment date. Columns E through H remove the current risk premium, add the risk premium t years in the future (the Exhibit shows the rate curve five years in the future), and uses that to get the discount factors to apply to the 1 year, 2 year,…5 year cash flows 5 years from now.

Exhibit: Derivation of discount rates expected in the future

	A	B	C	D	E	F	G	H
1 2 3	Projection Years	Swap Curve Rate	PV of Zero Coupon	Forward 1 Year Rate	Risk Premium	Risk Premium 5 Years Out	Expected Forward Rate In Five Years	PV of Zero Coupon In 5 Years
4	1	2.57%	0.97494	2.5700%	0.50000%			
5	2	3.07%	0.94118	3.5879%	0.75000%			
6	3	3.44%	0.90302	4.2251%	0.75000%			
7	4	3.74%	0.86231	4.7208%	0.85000%			
8	5	3.97%	0.82124	5.0010%	0.90000%			
9	6	4.17%	0.77972	5.3249%	0.95000%	0.50000%	4.8749%	0.95352
10	7	4.34%	0.73868	5.5557%	1.00000%	0.75000%	5.3057%	0.90547
11	8	4.48%	0.69894	5.6860%	1.10000%	0.75000%	5.3360%	0.85961
12	9	4.60%	0.66050	5.8209%	1.15000%	0.85000%	5.5209%	0.81463
13	10	4.71%	0.62303	6.0131%	1.15000%	0.90000%	5.7631%	0.77024
14	Cell formulas for Projection Year 10:		=(1-B13*SUM(C4:C12))/(1+B13)	=C12/C13-1		=E8	=D13-E13+F13	=H12/(1+G13)

Where interest rates are projected stochastically using an integrated model, although one would "expect" the interest rate n years hence to be that implied for an appropriate duration asset by the forward swap curve as described above, there is a steadily widening confidence interval about that point estimate with increasing time until the annuitization date. The "expected margin" in the purchase rate is less than that produced by the point estimate based on the expected rate, since a greater proportion of contractholders will have an annuitization benefit whose worth is in excess of cash surrender value when margins are low than when margins are high. As a practical matter, this effect can be approximated by using a purchase rate margin based on an earnings rate .30 percent below that implied by the forward swap curve. If a stochastic model of interest rates is used instead of a point estimate then no such adjustment is needed.

B) Projected Election of Guaranteed Minimum Income Benefit and other Annuitization Options. For contracts projected to elect annuitization options (including annuitizations stemming from the election of a GMIB), the projections may assume one of the following at the actuary's option:

1) The contract is treated as if surrendered at an amount equal to the statutory reserve that would be required at such time for the payout annuity benefits, or

2) The contract is assumed to stay inforce, the projected periodic payments are paid, and the Working Reserve is equal to one of the following:
   a) The statutory reserve required for the payout annuity, if it is a fixed payout annuity, or
   b) If it is a variable payout annuity, the Working Reserve for a variable payout annuity as defined in Section III)B)5).

If the projected payout annuity is a variable payout annuity containing a floor guarantee (such as a GPAF) under a specified contractual option, only option 2) above shall be used.

Where mortality improvement is used to project future annuitization purchase rates, as discussed in A) above, mortality improvement shall also be reflected on a consistent basis in either the determination of the reserve in 1) above or the projection of the periodic payments in 2) above.

A1.6) Relationship to Risk Based Capital Requirements

A) The Guideline anticipates that the projections described herein may be used for the determination of Risk Based Capital (the "RBC requirements") for some or all of the contracts falling within the scope of the Guideline. There are several differences between the requirements of the Guideline and the RBC requirements, and among them are two major differences. First, the Conditional Tail Expectation level is different (CTE (70) for the Guideline and CTE (90) for the RBC requirements). Second, the projections described in the Guideline are performed on a basis that ignores Federal Income Tax. That is, under the Guideline, the Accumulated Deficiencies do not include projected Federal Income Tax and the interest rates used to discount the Scenario Greatest Present Value (i.e., the interest rates determined in section A1.4)D)) contain no reduction for Federal Income Tax. Under the RBC requirements, the projections do include projected Federal Income Tax and the discount interest rates used in the RBC requirement do contain a reduction for Federal Income Tax.

B) To further aid the understanding of the Guideline and any instructions relating to the RBC requirement, it is important to note the equivalence in meaning between the following terms, subject to the differences noted above:

1) The amount that is added to the Starting Asset Amount in Section III)B)6) of the Guideline is similar to the Additional Asset Requirement referenced in the RBC requirement.

2) The Conditional Tail Expectation Amount referenced in the Guideline is similar to the Total Asset Requirement referenced in the RBC requirement.

A1.7) Compliance with Actuarial Standards of Practice (ASOPs)

When determining the Conditional Tail Expectation Amount using projections, the analysis shall conform to the Actuarial Standards of Practice as promulgated from time to time by the Actuarial Standards Board.

A1.8) Compliance with Principles

When determining the Conditional Tail Expectation Amount using projections, any interpretation and application of the requirements of the Guideline shall follow the principles discussed in the Section I) Background.

APPENDIX 2 - Reinsurance and Statutory Reporting Issues

A2.1) Treatment of Reinsurance Ceded in the Aggregate Reserve

A) Aggregate Reserve Net of and Prior to Reinsurance Ceded. As noted in Section IV)B), the Aggregate Reserve is determined net of reinsurance ceded. Therefore, it is necessary to determine the components needed to determine the Aggregate Reserve (i.e., the Standard Scenario Amount, and either the Conditional Tail Expectation Amount determined using projections or the Conditional Tail Expectation Amount determined using the Alternative Methodology) on a net of reinsurance basis. In addition, as noted in Section IV)B), it may be necessary to determine the Aggregate Reserve determined on a "direct" basis, or prior to reflection of reinsurance ceded. Where this is needed, each of these components shall be determined prior to reinsurance. Sections B) through D) below discuss methods necessary to determine these components on both a "net of reinsurance" and a "prior to reinsurance" basis. Note that due allowance for reasonable approximations may be used where appropriate.

B) Conditional Tail Expectation Amount Determined using Projections. In order to determine the Aggregate Reserve net of reinsurance ceded, Accumulated Deficiencies, Scenario Greatest Present Values, and the resulting Conditional Tail Expectation Amount shall be determined reflecting the effects of reinsurance treaties that meet the statutory requirements that would allow the treaty to be accounted for as reinsurance within the projections. This involves including, where appropriate, all anticipated reinsurance premiums or other costs and all reinsurance recoveries, where both premiums and recoveries are determined by recognizing any limitations in the reinsurance treaties, such as caps on recoveries or floors on premiums.

In order to determine the Conditional Tail Expectation Amount prior to reinsurance ceded, Accumulated Deficiencies, Scenario Greatest Present Values, and the resulting Conditional Tail Expectation Amount shall be determined ignoring the effects of reinsurance within the projections. One acceptable approach involves a projection based on the same Starting Asset Amount as for the Aggregate Reserve net of reinsurance and by ignoring, where appropriate, all anticipated reinsurance premiums or other costs and all reinsurance recoveries in the projections.

C) Conditional Tail Expectation Amount Determined using the Alternative Methodology. If a company chooses to use the Alternative Methodology, as allowed in Section IV)E), it is important to note that the methodology produces reserves on a prior to reinsurance ceded basis. Therefore, where reinsurance is ceded, the Alternative Methodology must be modified to reflect the reinsurance costs and reinsurance recoveries under the reinsurance treaties in the determination of the Aggregate Reserve net of reinsurance. In addition, the Alternative Methodology, unadjusted for reinsurance, shall be applied to the contracts falling under the scope of the Guideline to determine the Aggregate Reserve prior to reinsurance.

D) Standard Scenario Amount. Where reinsurance is ceded, the Standard Scenario Amount shall be calculated as described in Appendix 3 to reflect the reinsurance costs and reinsurance recoveries under the reinsurance treaties. If it is necessary, the Standard Scenario Amount shall be calculated prior to reinsurance ceded using the methods described in Appendix 3, but ignoring the effects of the reinsurance ceded.

A.2.2) Aggregate Reserve to be held in the General Account

The amount of the reserve held in the General Account shall not be less than the excess of the Aggregate Reserve over the sum of the Basic Reserve, as defined in section A3.2), attributable to the variable portion of all such contracts.

A.2.3) Actuarial Certification and Memorandum

A) Actuarial Certification. Actuarial Certification of the work done to determine the Aggregate Reserve shall be required. The actuary shall certify that the work performed has been done in a way that substantially complies with all applicable Actuarial Standards of Practice. The scope of this certification does not include an opinion on the adequacy of the Aggregate Reserve,[12] the company's surplus or the company's future financial condition. The actuary shall also note any material change in the model or assumptions from that used previously and the estimated impact of such changes.

Appendix 8 contains more information on the contents of the required Actuarial Certification.

B) Required Memorandum. An actuarial memorandum shall be constructed documenting the methodology and assumptions upon which the Aggregate Reserve is determined. The memorandum shall also include sensitivity tests that the actuary feels appropriate, given the composition of the company's block of business (i.e., identifying the key assumptions that, if changed, produce the largest changes in the Aggregate Reserve). This memorandum shall have the same confidential status as the actuarial memorandum supporting the actuarial opinion[13] and shall be available to regulators upon request.

Appendix 8 contains more information on the contents of the required memorandum.

C) Conditional Tail Expectation Amount Determined using the Alternative Methodology. Where the Alternative Methodology is used, there is no need to discuss the underlying assumptions and model in the required memorandum. Certification that expense, revenue, fund mapping, and product parameters have been properly reflected, however, shall be required.

Appendix 8 contains more information on the contents of the required Actuarial Certification and memorandum.

D) Material Changes. If there is a material change in results due to a change in assumptions from the previous year, the memorandum shall include a discussion of such change in assumptions and an estimate of the impact it has on the results.

[12] The adequacy of total company reserves, which includes the Aggregate Reserve, is addressed in the company's Actuarial Opinion as required by the NAIC Model Actuarial Opinion and Memorandum Regulation.

[13] This is consistent with Section 3D(8) of the Standard Valuation Law, which states: "Except as provided in Paragraphs (12), (13) and (14), documents, materials or other information in the possession or control of the Department of Insurance that are a memorandum in support of the opinion, and any other material provided by the company to the commissioner in connection with the memorandum, shall be confidential by law and privileged, shall not be subject to [insert open records, freedom of information, sunshine or other appropriate phrase], shall not be subject to subpoena, and shall not be subject to discovery or admissible in evidence in any private civil action. However, the commissioner is authorized to use the documents, materials or other information in the furtherance of any regulatory or legal action brought as a part of the commissioner's official duties."

APPENDIX 3 - Standard Scenario Requirements

A3.1) Overview

A) Application to Determine Reserves. A Standard Scenario Reserve shall be determined for each of the contracts falling under the scope of the Guideline by applying section A3.3). This includes those contracts to which the Alternative Methodology is applied.

The Standard Scenario Reserve for a contract with guaranteed living benefits or guaranteed death benefits is based on a projection of the account value based on specified returns for supporting assets equal to the account value. An initial drop is applied to the supporting assets and account value on the valuation date. Subsequently, account values are projected at specified rates earned by the supporting assets less contract and fund charges. The assumptions for the projection of account values and margins are prescribed in section A3.3)C). For any contract with guarantees the Standard Scenario Reserve includes the greatest present value of the benefit payments in excess of account values applied over the present value of revenue produced by the margins.

B) The Standard Scenario Amount

1) The Standard Scenario Amount is defined in Section IV)C) of this Guideline as the aggregate of the reserves determined by applying the Standard Scenario Method to each of the contracts falling under the scope of the Guideline. Except as provided in subsection A3.3)B)1), the Standard Scenario Amount equals the sum over all contracts of the Standard Scenario Reserve determined for each contract as of the statement date as described in A3.1)B)2).

2) The Standard Scenario Method requires the Standard Scenario Amount to not be less than the sum over all contracts of the Standard Scenario Reserve determined for the contract as of the statement date as described in section A3.3), where the Discount Rate is equal to *DR*, which is defined as the valuation interest rate specified by the Standard Valuation Law for annuities valued on an issue year basis, using Plan Type A and a Guarantee Duration greater than 10 years but not more than 20 years. The presence of guarantees of interest on future premiums and/or cash settlement options is to be determined using the terms of the contracts.

C) Illustrative Application of the Standard Scenario to a Projection or Model Office. If the Conditional Tail Expectation Amount is determined based on a projection of an inforce prior to the statement date and/or by the use of a model office, which is a grouping of contracts into representative cells, then additional determinations of A3.1)B)2) shall be performed on the prior inforce and/or model office. The calculations are for illustrative purposes to assist in validating the reasonableness of the projection and/or the model office.

The following table identifies the illustrative additional determinations required by this section using the Discount Rate, *DR*, as defined in A3.1)B)2). The additional determinations required are based on how the Conditional Tail Expectation projection or Alternative Methodology is applied. For completeness, the table also includes the determinations required by section A3.1)B)2).

1) Run A in the table is required for all companies by section A3.1)B)2). No additional determinations are required if a company's stochastic or alternative methodology result is calculated on individual contracts as of the statement date.

2) A company that uses a model office as of the statement date to determine its stochastic or alternative methodology result must provide an additional determination for the model office based on the Discount Rate *DR*, run B.

3) A company that uses a contract by contract listing of a prior inforce to determine its stochastic or alternative methodology with result PS and then projects requirements to the statement date with result S must provide an additional determination for the prior inforce based on the Discount Rate *DR*, run C.

4) A company that uses a model office of a prior inforce to determine its stochastic or alternative methodology requirements with result PM and then projects requirements to the statement date with result S must provide an additional determination for the prior model office based on the Discount Rate *DR*, run D.

Standard Scenario Run	Guideline Variations	Validation Measures	
		Model Office Projection	Projection of Prior Inforce
A. Valuation on the statement date on inforce contracts with discount rate *DR*	None	None	None
B. Valuation on the statement date on the model office with discount rate *DR*	If not material to model office validation	A/B compare to 1.00	None
C. Valuation on a prior inforce date on prior inforce contracts with discount rate *DR*	If not material to projection validation	None	A/C - S/PS compare to 0
D. Valuation on a prior inforce date on a model office with discount rate *DR*	If not material to model office or projection validation.	(A/D – S/PM) compare to 0	

Modification of the requirements in section A3.3) when applied to a prior inforce or a model office is permitted if such modification facilitates validating the projection of inforce or the model office. All such modifications should be documented.

A3.2) Basic and Basic Adjusted Reserve - Application of Actuarial Guideline XXXIII

A) The Basic Reserve for a given contract shall be determined by applying statutory statement valuation requirements applicable immediately prior to adoption of the Guideline to the contract ignoring any guaranteed death benefits in excess of account values or guaranteed living benefits applying proceeds in excess of account values.

B) The calculation of the Basic Reserve shall assume a return on separate account assets based on the year of issue statutory valuation rate less appropriate asset based charges, including charges for any guaranteed death benefits or guaranteed living benefits. It shall also assume a return for any fixed separate account and general account options equal to the rates guaranteed under the contract.

C) The Basic Reserve shall be no less than the Cash Surrender Value on the valuation date, as defined in Section III)B) of the Guideline.

D) The Basic Adjusted Reserve shall be that determined based on A3.2)A) and A3.2)B) except in A3.2)A) free partial withdrawal provisions shall be disregarded when determining surrender charges in applying the statutory statement valuation requirement prior to adoption of the Guideline. Section A3.2)C) shall not apply to the Basic Adjusted Reserve.

A3.3) Standard Scenario Reserve - Application of the Standard Scenario Method

A) General. Where not inconsistent with the guidance given here, the process and methods used to determine the Standard Scenario Reserve under the Standard Scenario Method shall be the same as required in the calculation of the Conditional Tail Expectation Amount as described in Section IV) of the Guideline. Any additional assumptions needed to determine the Standard Scenario Reserve shall be explicitly documented.

B) Results for the Standard Scenario Method. For each contract, the Standard Scenario Reserve is the reserve based on 1) or 2) where:

1) For contracts without any guaranteed benefits, as defined in Section III)A) of the Guideline and where not subsequently disapproved by the Domiciliary Commissioner, the Standard Scenario Reserve is the Basic Reserve described in section A3.2)A), A3.2)B) and A3.2)C).

2) For all other contracts the Standard Scenario Reserve is equal to the greater of Cash Surrender Value on the valuation date, as defined in Section III)B) of the Guideline, and the quantity a) + b) - c), where:

a) Is the Basic Adjusted Reserve calculated for the contract, as described in section A3.2)D);

b) Is the greater of zero and the greatest present value at the Discount Rate measured as of the end of each projection year of the negative of the Accumulated Net Revenue described below using the assumptions described in A3.3)C). The Accumulated Net Revenue at the end of a projection year is equal to (i) + (ii) - (iii), where:

(i) Is the Accumulated Net Revenue at the end of the prior projection year accumulated at the Discount Rate to the end of the current projection year; the Accumulated Net Revenue at the beginning of the projection (i.e., time 0) is zero;

(ii) Are the margins generated during the projection year on account values accumulated at the Discount Rate to the end of the projection year (the factors and assumptions to be used in calculating the margins and account values are in A3.3)C)); and

(iii) Are the contract benefits in excess of account values applied, Individual reinsurance premiums and Individual reinsurance benefits payable or receivable during the projection year accumulated at the Discount Rate to the end of the projection year. Individual reinsurance is defined in A3.3)C)2).

c) Is the contract's allocation of the value of hedges and Aggregate reinsurance as described in section A3.3)D). Aggregate reinsurance is defined in section A3.3)C)2).

No reinsurance shall be considered in the Standard Scenario Amount if such reinsurance does not meet the statutory requirements that would allow the treaty to be accounted for as reinsurance. The actuary shall determine the projected reinsurance premiums and benefits reflecting all treaty limitations and assuming any options in the treaty to the other party are exercised to decrease the value of reinsurance to the reporting company (e.g., options to increase premiums or terminate coverage). The positive value of any reinsurance treaty that is not guaranteed to the insurer or its successor shall be excluded from the value of reinsurance. The commissioner may require the exclusion of a reinsurance treaty or any portion of a reinsurance treaty if the terms of the reinsurance) treaty or the portion required to be excluded serves solely to reduce the calculated

Standard Scenario Reserve without also reducing risk on scenarios similar to those used to determine the Conditional Tail Expectation Reserve. Any reinsurance reflected in the Standard Scenario Reserve shall be appropriate to the business and not merely constructed to exploit 'foreknowledge' of the components of the Standard Scenario Method.

C) Assumptions for use in paragraph A3.3)B)2)b) for Accumulated Net Revenue and Account Values.

1) Account Value Return Assumptions. The bases for return assumptions on assets supporting the Account Value are shown in Table I. The "Initial" returns shall be applied to the account value supported by each asset class on the valuation date as immediate drops, resulting in the Account Value at time 0. The "Year 1," "Years 2 – 5," and "Year 6+" returns for the equity, bond and balanced classes are gross annual effective rates of return and are used (along with other decrements and/or increases) to produce the Account Value as of the end of each projection interval. For purposes of this section, money market funds supporting Account Value shall be considered part of the Bond class.

The Fixed Fund rate is the greater of the minimum rate guaranteed in the contract or 4% but not greater than the current rates being credited to Fixed Funds on the valuation date.

Account Values shall be projected using the appropriate gross rates from Table I for equity, bond and balanced classes applied to the supporting assets less all fund and contract charges according to the provisions of the funds and contract and applying the Fixed funds rate from Table I as if it were the resulting net rate after deduction for fund or contract charges.

The annual margins on Account Value are defined as follows:

a) During the Surrender Charge Amortization Period, as determined following the step outlined in section A3.3)E) below:
   (i) 0.20% of Account Value; plus
   (ii) Any Net Revenue Sharing Income, as defined in section A1.1)E), that is contractually guaranteed to the insurer and its liquidator, receiver, and statutory successor; plus
   (iii) For all of the guaranteed living benefits of a given contract combined,[14] the greater of:
      - 0.20% of Account Value; or
      - Explicit and optional contract charges for guaranteed living benefits; plus
   (iv) For all guaranteed death benefits of a given contract combined,[15] the greater of:
      - 0.20% of Account Value; or
      - Explicit and optional contract charges for guaranteed death benefits.

b) After the Surrender Charge Amortization Period:

[14] This excludes any guaranteed living benefit that is added to the contract simply for the purpose of increasing the revenue allowed under this section.

[15] This excludes any guaranteed death benefit that is added to the contract simply for the purpose of increasing the revenue allowed under this section.

The amount determined in a) above; plus 50% of the excess, if any, of all contract charges (excluding Net Revenue Sharing Income) over the sum of a)(i) , a)(iii) and a)(iv) above.

However, on fixed funds after the surrender charge period, a margin of up to the amount in a) above plus .4% may be used.

Table I

	Initial	Year 1	Years 2 – 5	Year 6+
Equity Class	-13.5%	0%	4.0%	5.50%
Bond Class	0%	0%	4.85%	4.85%
Balanced Class	-8.1%	0%	4.34%	5.24%
Fixed Separate Accounts and General Account (net)	0%	Fixed Fund Rate	Fixed Fund Rate	Fixed Fund Rate

2) Reinsurance Credit. Individual reinsurance is defined as reinsurance where the total premiums for and benefits of the reinsurance can be determined by applying the terms of the reinsurance to each contract covered without reference to the premiums or benefits of any other contract covered and summing the results over all contracts covered. Reinsurance that is not Individual is Aggregate.

Individual reinsurance premiums projected to be payable on ceded risk and receivable on assumed risk shall be included in the Projected Net Revenue. Similarly, Individual reinsurance benefits projected to be receivable on ceded risk and payable on assumed risk shall be included in the Projected Net Revenue. No Aggregate reinsurance shall be included in Projected Net Revenue.

3) Lapses, Partial Withdrawals, and In-The-Moneyness. Partial withdrawals elected as guaranteed living benefits, see A3.3)C)7), or required contractually (e.g., a contract operating under an automatic withdrawal provision on the valuation date) are to be deducted from the Account Value in each projection interval consistent with the projection frequency used, as described in A3.3)C)6), and according to the terms of the contract. No other partial withdrawals, including free partial withdrawals, are to be deducted from Account Value. All lapse rates should be applied as full contract surrenders.

For purposes of determining the dynamic lapse assumptions shown in Table II below, a guaranteed living benefit is in the money (ITM) for any projection interval if the Account Value at the beginning of the projection interval is less than the Current Value of the guaranteed living benefit (as defined below) also at the beginning of that projection interval.

The Current Value of the guaranteed living benefit at the beginning of any projection interval is either the amount of the current lump sum payment (if exercisable) or the present value of future lump sum or income payments. More specific guidance is provided below. For the purpose of determining the present value, the discount rate shall be equal *DR* as defined in A3.1)B)2). If future living benefit payments are life contingent (i.e., either the right of future exercise or the right to future income benefits expires with the death of the annuitant or the owner), then the company shall determine the present value of such payments using the mortality table specified in A3.3)C)5).

If a guaranteed living benefit is exercisable (withdrawal can start or, in the case of a GMWB, has begun) at the beginning of the projection interval, then the Current Value of the guaranteed living benefit shall be determined assuming immediate or continued exercise of that benefit.

If a guaranteed living benefit is not exercisable (e.g., due to minimum age or duration requirements) at the beginning of that projection interval, then the Current Value of the guaranteed living benefit shall be determined assuming exercise of the guaranteed living benefit at the earliest possible future projection interval. If the right to exercise the guaranteed living benefit is contingent on the survival of the annuitant or the owner, then the Current Value of the guaranteed living benefit shall assume survival to the date of exercise using the mortality table specified in A3.3)C)5).

Determination of the Current Value of a guaranteed living benefit that is exercisable or payable at a future projection interval shall take account of any guaranteed growth in the basis for the guarantee (e.g., where the basis grows according to an index or an interest rate).

For a GMWB, the Current Value shall be determined assuming the earliest penalty-free withdrawal of guaranteed benefits after withdrawals begin and by applying the constraints of any applicable maximum or minimum withdrawal provisions. If the GMWB is currently exercisable and the right to future GMWB payments is contingent upon the survival of the annuitant or owner, then the Current Value shall assume survival using the mortality table specified in A3.3)C)5). After a GMWB that has payments that are contingent upon the survival of the annuitant or owner has commenced, then the Current Value shall assume survival using the Annuity 2000 Mortality Table.

For an unexercised GMIB, the Current Value shall be determined assuming the option with a reserve closest to the reserve for a 10 year certain and life option. The reserve values and the value of the GMIB on the assumed date of exercise shall be determined using the discount rate *DR* specified in A3.1)B)2) and for life contingent payments, the Annuity 2000 Mortality Table. The Current Value of an unexercised GMIB, however, shall be set equal to the Account Value if the contractholder can receive higher income payments on the assumed date of exercise by electing the same option under the normal settlement option provisions of the contract.

For the purpose of applying the lapse assumptions specified in Table II below or contractholder elections rates specified in A3.3)C)7), the contract shall be considered "out of the money" (OTM) for a projection interval if the Current Value of the guaranteed living benefit at the beginning of the projection interval is less than or equal to the Account Value at the beginning of the same projection interval. If the Current Value of the guaranteed living benefit at the beginning of the projection interval is greater than the Account Value also at the beginning of the projection interval, the contract shall be considered 'in the money' (ITM) and the percent ITM shall equal:

100 * ((Current Value of the guaranteed living benefit /Account Value) - 1)

If a contract has multiple living benefit guarantees then the guarantee having the largest Current Value shall be used to determine the percent in the money.

Table II - Lapse Assumptions

	During Surrender Charge Period	After Surrender Charge Period		
Death Benefit Only Contracts	5%	10%		
All Guaranteed Living Benefits OTM	5%	10%		
		ITM < 10%	10%<=ITM< 20%	20%<=ITM
Any Guaranteed Minimum Accumulation Benefit ITM	2%	2%	0%	0%
Any Other Guaranteed Living Benefits ITM	3%	7%	5%	2%

4) Account Transfers and Future Deposits. No transfers between funds shall be assumed in the projection used to the determine the greatest present value amount required under section A3.3)B)2)b) unless required by the contract (e.g., transfers from a dollar cost averaging fund or contractual rights given to the insurer to implement a contractually specified portfolio insurance management strategy or a contract operating under an automatic re-balancing option). When transfers must be modeled, to the extent not inconsistent with contract language, the allocation of transfers to funds must be in proportion to the contract's current allocation to funds.

Margins generated during a projection interval on funds supporting account value are transferred to the Accumulation of Net Revenue and are subsequently accumulated at the Discount Rate. Assets for each class supporting account values are to be reduced in proportion to the amount held in each asset classes at the time of transfer of margins or any portion of Account Value applied to the payment of benefits.

No future deposits to Account Value shall be assumed unless required by the terms of the contract to prevent contract or guaranteed benefit lapse, in which case they must be modeled. When future deposits must be modeled, to the extent not inconsistent with contract language, the allocation of the deposit to funds must be in proportion to the contract's current allocation to such funds.

5) Mortality. Mortality at 70% of the 1994 Variable Annuity MGDB Mortality Tables (1994 MGDB tables) through age 85 increasing by 1% each year to 100% of the 1994 MGDB tables at age 115 shall be assumed in the projection used to the determine the greatest present value amount required under section A3.3)B)2)b).

6) Projection Frequency. The projection used to determine the greatest present value amount required under section A3.3)B)2)b) shall be calculated using an annual or more frequent time step, such as quarterly. For time steps more frequent than annual, assets supporting Account Values at the start of a year may be retained in such funds until year-end (i.e., margin earned during the year will earn the fund rates instead of the Discount Rate until year end) or removed after each time step. However, the same approach shall be applied for all years. Similarly, projected benefits, lapses, elections and other contractholder activity can be assumed to occur annually or at the end of each time step, but the approach shall be consistent for all years.

7) Contractholder Election Rates. Contractholder election rates for exercisable ITM guaranteed living benefits other than GMWBs shall be 5% per annum in every projection interval where the living benefit is less than 10% ITM, 15% per annum in every projection interval where the living benefit is 10% or more ITM and less than 20% ITM, and 25% per annum in every projection interval where the living benefit is more than 20% ITM. In addition, the election rate for an exercisable ITM guaranteed living benefit shall be 100% at the last model duration to elect such benefit. This 100% election rate shall be used when a Guaranteed Minimum Accumulation Benefit is at the earliest date that the benefit is exercisable and in-the-money. However, the contractholder election rate for any exercisable ITM guaranteed living benefit shall be zero if exercise would cause the extinction of a guaranteed living benefit having a larger Current Value. For this purpose, GMDBs are not benefits subject to election.

For guaranteed minimum withdrawal benefits, a partial withdrawal, if allowed by contract provisions, equal to the applicable percentage in Table III applied to the contract's maximum allowable partial withdrawal shall be assumed. However, if the contract's minimum allowable partial withdrawal exceeds the partial withdrawal from applying the rate in Table III to the contract's maximum allowable partial withdrawal, then the contract's minimum allowable partial withdrawal shall be assumed.

Table III - Guaranteed Withdrawal Assumptions

	Attained Age less than 50	Attained Age 50 to 59	Attained Age 60 or Greater
Withdrawals do not reduce other elective Guarantees that are in the money	50%	75%	100%
Withdrawals reduce elective Guarantees that are in the money	25%	50%	75%

8) Indices. If an interest index is required to determine projected benefits or reinsurance obligations, the index must assume interest rates have not changed since the last reported rates before the valuation date. If an equity index is required the index shall be consistent with the last reported index before the valuation date, the initial drop in equity returns and the subsequent equity returns in the standard scenario projection. The sources of information and how they are used to determine the indexes shall be documented and, to the extent possible, consistent from year to year.

D) Assumptions for use in Section A3.3)B)2)c).

1) The Value of Aggregate Reinsurance. The value of Aggregate reinsurance shall be calculated separately from the Accumulated Net Revenue. The value of Aggregate reinsurance is the discounted value, using the statutory valuation rate described in the following paragraph, of the excess of (a) the projected benefit payments from the reinsurance; over (b) the projected gross reinsurance premiums, where (a) and (b) are determined under the assumptions described in section A3.3)C) for all applicable contracts in aggregate.

In order for the value of the Aggregate reinsurance to be consistent with the underlying Standard Scenario reserve, the discount rate shall be a weighted average of the valuation rates (*DR*) of the contracts that are supported by the Aggregate reinsurance treaty. The weights used to determine this discount rate shall be reasonably related to the risks that are being covered by the Aggregate reinsurance (e.g., account value or values of guaranteed benefits) and shall be applied consistently from year to year. If an appropriate method to determine this discount rate does not exist, the value of the Aggregate reinsurance shall be determined using the statutory valuation rate in effect on the valuation date for annuities valued on an issue year basis using Plan Type A and a Guarantee Duration greater than 10 years but not more than 20 years, determined assuming there are cash settlement options but no interest guarantees on future premiums.

2) The Value of Approved Hedges. The value of approved hedges shall be calculated separately from the Accumulated Net Revenue. The value of approved hedges is the difference between: a) the discounted value at the 1-year CMT[16] as of the valuation date of the pre-tax cash flows from the approved hedges; less b) their statement values on the valuation date.

To be an approved hedge for purposes of the Standard Scenario Reserve, a derivative or other investment has to be an actual asset held by the company on the valuation date, be used as a hedge supporting the contracts falling under the scope of the Guideline, and comply with any statutes, laws, or regulations (including applicable documentation requirements) of the domiciliary state or jurisdiction related to the use of derivative instruments.

The Domiciliary Commissioner may require the exclusion of any portion of the value of approved hedges upon a finding that the company's documentation, controls, measurement, execution of strategy or historical results are not adequate to support a future expectation of risk reduction commensurate with the value of approved hedges.

The cash flow projection for approved hedges that expire in less than one year from the valuation date should be based on holding the hedges to their expiration. For hedges with an expiration of more than 1 year, the value of hedges should be based on liquidation of the hedges one year from the valuation date. Where applicable, the liquidation value of hedges shall be consistent with the assumed returns in the Standard Scenario from the start of the projection to the date of liquidation, Black-Scholes pricing, a risk free rate equal to the 5-year CMT as of the valuation date and the annual volatility implicit as of the valuation date in the statement value of the hedges when the statement value of hedges are valued with Black-Scholes pricing and a risk-free rate equal to the 5-year CMT as of the valuation date.[17]

There is no credit in the Standard Scenario for dynamic hedging beyond the credit that results from hedges actually held on the valuation date.

3) Allocation of the Value of Hedges and the Value of Aggregate Reinsurance. The value of approved hedges and Aggregate reinsurance shall be allocated to the contracts which are supported by the applicable Aggregate reinsurance agreements and approved hedges. A

[16] For purposes of this Appendix, the term CMT refers to the nominal yields on actively traded non-inflation-indexed issues adjusted to constant maturities, as released daily by the Federal Reserve Board. As of this writing, the current and historical one-year rates may be found at http://www.federalreserve.gov/releases/h15/data/Business_day/H15_TCMNOM_Y1.txt and the current and historical five-year rates may be found at http://www.federalreserve.gov/releases/h15/data/Business_day/H15_TCMNOM_Y5.txt.

[17] Conceptually, the item being hedged, the contract guarantees, and the approved hedges are accounted for at the average present value of the worst 30% of all scenarios, the tail scenarios for a CTE (70) measure. However, the statement value of approved hedges is at market. Therefore, the standard scenario value of approved hedges is a proxy of the adjustment needed to move approved hedges from a market value to a tail value.

contract's allocation shall be the lesser of the amount in A3.3)B)2)b) for the contract or the product of a) and b) where:

a) Is the sum of the value of the applicable approved hedges plus the value of the applicable Aggregate reinsurance for all contracts supported by the same hedges and/or the Aggregate reinsurance agreement; and

b) Is the ratio of the amount in A3.3)B)2)b) for the contract to the sum of the amount in A3.3)B)2)b) for all contracts supported by the same hedges and/or the Aggregate reinsurance agreement.

4) Retention of components. For the seriatim Standard Scenario Reserve on the statement date under each of Sections A3.1)B)1) and A3.1)B)2), the actuary should have available to the Commissioner the following values for each contract:

a) The Standard Scenario Reserve prior to adjustment under paragraph A3.3)D)3)

b) The Standard Scenario Reserve net of the adjustment in A3.3)D)3).

E) Determination of the Surrender Charge Amortization Period to be used in section A3.3)C)1)a) and b).

The purpose of the Surrender Charge Amortization Period is to help determine how much of the surrender charge is amortized in the Basic Adjusted Reserve portion of the Standard Scenario Amount and how much needs to be amortized in the Accumulated Net Revenue portion. Once determined, the Surrender Charge Amortization Period determines the duration over which the lower level of margins, as described in A3.3)C)1)a), is used. After that duration, the higher level of margins, as described in A3.3)C)1)b), is used.

A separate Surrender Charge Amortization Period is determined for each contract and is based on amounts determined in the calculation of the Basic Adjusted Reserve for that contract. A key component of the calculation is the amount of the surrender charge that is not amortized in the Basic Adjusted Reserve calculation for that contract. This is represented by the difference between the account value and the cash surrender value projected within the Basic Adjusted Reserve calculation for the contract.

The Surrender Charge Amortization Period for a given contract is determined by following the steps:

1) Measure the duration of the greatest present value used in the Basic Adjusted Reserve. The Basic Adjusted Reserve is determined for a contract by taking the greatest present value of a stream of projected benefits. The benefit stream that determines the greatest present value typically includes an "ultimate" event (e.g., 100% surrender, 100% annuitization, or maturity). The "BAR Duration" is the length of time between the valuation date and the projected "ultimate" event.

2) Determine the amount of the surrender charge not amortized in the Basic Adjusted Reserve. The surrender charge not amortized in the Basic Adjusted Reserve is the difference between the projected account value and the projected cash surrender value at the BAR Duration (i.e., at the time of that projected "ultimate" event). This value for a given contract shall not be less than zero.

3) Determine the Surrender Charge Amortization Period before rounding. This equals a) time b) plus c), where:

a) Equals the ratio of the amount determined in step 2 to the Account Value on the valuation date;
b) Equals 100; and
c) Equals the BAR Duration determined in step 1.

4) Determine the Surrender Charge Amortization Period for the contract. This is the amount determined in step 3, rounded to the nearest number that represents a projection duration, taking into account the projection frequency described in A3.3)C)6). For example, step 3 produces a value of 2.15 and the projection frequency is quarterly, the Surrender Charge Amortization Period for the contract is 2.25.

APPENDIX 4 - Alternative Methodology

A4.1) General Methodology

A) General Methodology Description. For variable deferred annuity contracts that either contain no guaranteed benefits or only GMDBs[18] (i.e., no VAGLBs), the Conditional Tail Expectation Amount may be determined by using the method outlined below rather than by using the approach described in Section IV)D) (i.e., based on projections), provided the approach described in Section IV)D) has not been used in prior valuations or else approval has been obtained from the Domiciliary Commissioner.

The Conditional Tail Expectation Amount determined using the Alternative Methodology for a group of contracts with GMDBs shall be determined as the sum of amounts obtained by applying factors to each contract inforce as of a valuation date and adding this to the contract's Cash Surrender Value.[19] The resulting Conditional Tail Expectation Amount shall not be less than the Cash Surrender Value in aggregate for the group of contracts to which the Alternative Methodology is applied.

The Conditional Tail Expectation Amount determined using the Alternative Methodology for a group of contracts that contain no guaranteed benefits[20] shall be determined using an application of Actuarial Guideline XXXIII, as described below.

For purposes of performing the Alternative Methodology, materially similar contracts within the group may be combined together into subgroups to facilitate application of the factors. Specifically, all contracts comprising a "subgroup" must display substantially similar characteristics for those attributes expected to affect reserves (e.g., definition of guaranteed benefits, attained age, contract duration, years-to-maturity, market-to-guaranteed value, asset mix, etc.). Grouping shall be the responsibility of the actuary but may not be done in a manner that intentionally understates the resulting reserve.

B) Definitions of Terms Used in this Appendix.

1) Annualized Account Charge Differential. This term is the charge as percentage account value (revenue for the company) minus the expense as percentage of account value.

2) Asset Exposure. Asset Exposure refers to the greatest possible loss to the insurance company from the value of assets underlying general or separate account contracts falling to zero.

3) Benchmark. Benchmarks have similar risk characteristics to the entity (e.g., asset class, index, or fund) to be modeled.

4) Deterministic Calculations. In a Deterministic Calculation, a given event (e.g., asset returns going up by 7% then down by 5%) is assumed to occur with certainty. In a stochastic calculation, events are assigned probabilities.

5) Foreign Securities. Securities issued by entities outside the United States and Canada.

[18] This includes "earnings enhanced death benefits," as discussed in Section III)A)1).

[19] The amount that is added to a contract's Cash Surrender Value may be negative, zero or positive, thus resulting in a reserve for a given contract that could be less than, equal to, or greater than, the Cash Surrender Value.

[20] The term "contracts that contain no guaranteed benefits" means that there are no guaranteed benefits at any time during the life of the contract (past, present or future).

6) Grouped Fund Holdings. Grouped Fund Holdings relate to guarantees that apply across multiple deposits or for an entire contract instead of on a deposit-by-deposit basis.

7) Guaranteed Value. The Guaranteed Value is the benefit base or a substitute for the account value (if greater than the account value) in the calculation of living benefits or death benefits. The methodology for setting the Guaranteed Value is defined in the variable annuity contract.

8) High-Yield Bonds. High-Yield Bonds are below investment grade, with NAIC designations (if assigned) of 3, 4, 5, or 6. Compared to investment grade bonds, these bonds have higher risk of loss due to credit events. Funds containing securities predominately containing securities that are not NAIC designated as 1 or 2 (or similar agency ratings) are considered to be High-Yield.

9) Investment Grade Fixed Income Securities. Securities with NAIC designations of 1 or 2 are Investment Grade. Funds containing securities predominately with NAIC designations of 1 or 2 or with similar agency ratings are considered to be Investment Grade.

10) Liquid Securities. These securities can be sold and converted into cash at a price close to its true value in a short period of time.

11) Margin Offset. Margin Offset is the portion of charges plus any Revenue Sharing allowed under section A1.1)E) available to fund claims and amortization of the unamortized surrender charges allowance.

12) Multi-Point Linear Interpolation. This methodology is documented in mathematical literature and calculates factors based on multiple attributes categorized with discrete values where the attributes' actual values may be between the discrete values.

13) Model Office. A Model Office converts many contracts with similar features into one contract with specific features for modeling purposes.

14) Pre-Packaged Scenarios. The Pre-Packaged Scenarios are the year-by-year asset returns that may be used (but are not mandated) in projections related to the alternative methodology. These scenarios are available on an American Academy of Actuaries website.

15) Quota-Share Reinsurance. In this type of reinsurance treaty, the same proportion is ceded on all cessions. The reinsurer assumes a set percentage of risk for the same percentage of the premium, minus an allowance for the ceding company's expenses.

16) Resets. A Reset benefit results in a future minimum guaranteed benefit being set equal to the contract's account value at previous set date(s) after contract inception.

17) Risk Mitigation Strategy. A Risk Mitigation Strategy is a device to reduce the probability and/or impact of a risk below an acceptable threshold.

18) Risk Profile. Risk Profile in the Guideline relates to the prescribed asset class categorized by the volatility of returns associated with that class.

19) Risk Transfer Arrangements. A Risk Transfer Arrangement shifts risk exposures (e.g., the responsibility to pay at least a portion of future contingent claims) away from the original insurer.

20) Roll-Up. A Roll-Up benefit results in the guaranteed value associated with a minimum contractual guarantee increasing at a contractually defined interest rate.

21) Volatility. Volatility refers to the annualized standard deviation of asset returns.

C) Contract-by-Contract Application for Contracts that Contain No Guaranteed Living or Death Benefits. The Alternative Methodology reserve for each contract that contains no guaranteed living or death benefits shall be determined by applying Actuarial Guideline XXXIII. The application shall assume a return on separate account assets equal to the year of issue valuation interest rate less appropriate asset based charges. It shall also assume a return for any fixed separate account and general account options equal to the rates guaranteed under the contract.

The reserve for such contracts shall be no less than the Cash Surrender Value on the valuation date, as defined in Section III)B).

D) Contract-by-Contract Application for Contracts that Contain GMDBs only. For each contract, factors are used to determine a dollar amount, equal to $R\times\left(CA+FE\right)+GC$ (as described below), that is to be added to that contract's Cash Surrender Value as of the valuation date. The dollar amount to be added for any given contract may be negative, zero, or positive. The factors that are applied to each contract shall reflect the following attributes as of the valuation date:

1) The contractual features of the variable annuity product,

2) The actual issue age, period since issue, attained age, years-to-maturity, and gender applicable to the contract,

3) The account value and composition by type of underlying variable or fixed fund,

4) Any surrender charges,

5) The GMDB and the type of adjustment made to the GMDB for partial withdrawals (e.g., proportional or dollar-for-dollar adjustment), and

6) Expenses to be incurred and revenues to be received by the company as estimated on a Prudent Estimate basis as described in Section III)B)8) and complying with the requirements for Revenue Sharing as described in section A1.1)E).

E) Factor Components. Factors shall be applied to determine each of the following components.[21]

CA = Provision for amortization of the unamortized surrender charges calculated by the insurer based on each contract's surrender charge schedule, using prescribed assumptions, except that lapse rates shall be based on the insurer's Prudent Estimate, but with no provision for Federal Income Taxes or mortality;

FE = Provision for fixed dollar expenses less fixed dollar revenue calculated using prescribed assumptions, the contract's actual expense charges, the insurer's anticipated

[21] Material to assist in the calculation of the components is available on the American Academy of Actuaries' website, at http://www.actuary.org/life/phase2.asp.

actual expenses and lapse rates, both estimated on a Prudent Estimate basis, and with no provision for Federal Income Taxes or mortality;

GC = Provision for the costs of providing the GMDB less net available spread-based charges determined by the formula $F \times GV - G \times AV \times R$, where GV and AV are as defined in section A4.3)A);

R = A scaling factor that is a linear function of the ratio of the margin offset to Total Account Charges (*W*) and takes the form $R(\beta_0, \beta_1) = \beta_0 + \beta_1 \times W$. The intercept and slope factors for this linear function vary according to:

a) Product type,
b) Pro-rata or dollar-for-dollar reductions in guaranteed value following partial withdrawals,
c) Fund class,
d) Attained age,
e) Contract duration,
f) Asset-based charges, and
g) 90% of the ratio of account value to guaranteed value, determined in the aggregate for all contracts sharing the same product characteristics.

Tables of factors for *F*, *G*, β_0, and β_1 values, reflecting a 65% confidence level and ignoring Federal Income Tax, are available from the National Association of Insurance Commissioners. In calculating $R(\beta_0, \beta_1)$ directly from the linear function provided above, the margin ratio *W* must be constrained to values greater than or equal to 0.2 and less than or equal to 0.6.

Interpolated values of F, *G* and *R* (calculated using the linear function described above) for all contracts having the same product characteristics and asset class shall be derived from the pre-calculated values using multi-point linear interpolation over the following four contract-level attributes:

1) Attained age,

2) Contract duration,

3) Ratio of account value to GMDB, and

4) The total of all asset based charges, including any fund management fees or allowances based on the underlying variable annuity funds received by the insurer.

The gross asset-based charges for a product shall equal the sum of all contractual asset-based charges plus fund management fees or allowances based on the underlying variable annuity funds received by the insurer determined by complying with the requirements for Prudent Estimate described in Section III)B)8) and Revenue Sharing described in section A1.1)E). Net asset-based charges equal gross asset-based charges less any company expenses assumed to be incurred expressed as a percentage of account value. All expenses that would be assumed if the Conditional Tail Expectation Amount were being computed as described in section A1.1)A) should be reflected either in the calculation of the net asset based charges or in the expenses reflected in the calculation of the amount *FE*.

No adjustment is made for Federal Income Taxes in any of the components listed above.

For purposes of determining the Conditional Tail Expectation Amount using the Alternative Methodology, any interpretation and application of the requirements of the Guideline shall follow the principles discussed in the Section I) Background.

A4.2) Calculation of *CA* and *FE*

A) General Description. Components *CA* and *FE* shall be calculated for each contract, thus reflecting the actual account value and GMDB, as of the valuation date, which is unique to each contract.

Components *CA* and *FE* are defined by deterministic "single-scenario" calculations that account for asset growth, interest and inflation at prescribed rates. Mortality is ignored for these two components. Lapse rates shall be determined on a Prudent Estimate basis as described in Section III)B)8). Lapse rates shall be adjusted by the formula shown below (the Dynamic Lapse Multiplier, λ), which bases the relationship of the GMDB (denoted as GV in the formula) to the account value (denoted as AV in the formula) on the valuation date. Thus, projected lapse rates are smaller when the GMDB is greater than the account value and larger when the GMDB is less than the account value.

$$\lambda = MIN\left[U, MAX\left[L, 1 - M \times \left(\frac{GV}{AV} - D\right)\right]\right],$$

where U=1, L=0.5, M=1.25, and D=1.1.

Present values shall be computed over the period from the valuation date to contract maturity at a discount rate of 5.75%.

Projected fund performance underlying the account values is as shown in the table below. Unlike the *GC* component, which requires the entire account value to be mapped, using the Fund Categorization Rules set forth in section A4.4, to a single "equivalent" asset class (as described in A4.4)C)), the *CA* and *FE* calculation separately projects each variable subaccount (as mapped to the 8 prescribed categories shown in section A4.4)) using the net asset returns shown in the following table. If surrender charges are based wholly on deposits or premiums as opposed to account value, use of this table may not be necessary.

Asset Class / Fund	Net Annualized Return
Fixed Account	Guaranteed Rate
Money Market	0%
Fixed Income (Bond)	0%
Balanced	–1%
Diversified Equity	–2%
Diversified International Equity	–3%
Intermediate Risk Equity	–5%
Aggressive or Exotic Equity	–8%

B) Component *CA*. Component *CA* is computed as the present value of the projected change in surrender charges plus the present value of an implied borrowing cost of 25 basis points at the beginning of each future period applied to the surrender charge at such time.

This component can be interpreted as the "amount needed to amortize the unamortized surrender charge allowance for the *persisting* policies plus the implied borrowing cost." By definition, the amortization for non-persisting lives in each time period is exactly offset by the collected surrender charge revenue (ignoring timing differences and any waiver upon death). The unamortized balance must be projected to the end of the surrender charge period using the net asset returns and Dynamic Lapse Multiplier, λ, both as described above and the year-by-year amortization discounted also as described above. For simplicity, mortality is ignored in the calculations. Surrender charges and free partial withdrawal provisions are as specified in the contract. Lapse and withdrawal rates are determined on a Prudent Estimate basis, and may vary according to the attributes of the business being valued, including, but not limited to, attained age, contract duration, etc.

C) Component *FE*. Component *FE* establishes a provision for fixed dollar expenses (e.g., allocated costs, including overhead expressed as "per contract" *and* those expenses defined on a "per contract" basis) less any fixed dollar revenue (e.g., annual administrative charges or contract fees) through the earlier of contract maturity or 30 years. *FE* is computed as the present value of the company's assumed fixed expenses projected at an assumed annual rate of inflation starting in the second projection year. This rate grades uniformly from the current inflation rate ("CIR") into an ultimate inflation rate of 3% per annum in the 8th year after the valuation date. The CIR is the greater of 3% and the inflation rate assumed for expenses in the company's most recent asset adequacy analysis for similar business.

A4.3) Calculation of the *GC* Component

A) *GC* Factors. *GC* is calculated as $F \times GV - G \times AV \times R$, where GV is the amount of GMDB and AV is the contract account value, both as of the valuation date. *F*, *G* and the slope and intercept for the linear function used to determine *R* (identified symbolically as β_0 and β_1) are pre-calculated factors available from the National Association of Insurance Commissioners and known herein as the "Pre-Calculated Factors." These factors shall be interpolated as described in subsection F), below, and modified as necessary as described in sections A4.3)G) and A4.3)H).

B) Five Steps. There are five major steps in determining the *GC* component for a given contract:

1) Classifying the asset exposure (as specified in subparagraph C), below);

2) Determining the risk attributes (as specified in subparagraphs D) and E), below);

3) Retrieving the appropriate nodal factors from the factor grid (as described in subparagraph F) below;

4) Interpolating the nodal factors, where applicable (optional) also as described in subparagraph F), below; and

5) Applying the factors to the contract values.

C) Classifying Asset Exposure. For purposes of calculating *GC* (unlike what is done for components *CA* and *FE*), the entire account value for each contract must be assigned to one of the eight prescribed fund classes shown in section A4.4), using the Fund Categorization rules in section A4.4).

D) Product Designs. Factors *F*, *G* and $R(\beta_1, \beta_2)$ are available within the Pre-Calculated Factors for the following GMDB product designs:

1) Return of Premium ("ROP"),

2) Premiums less withdrawals accumulated at 3% per annum, capped at 2.5 times premiums less withdrawals, with no further increase beyond age 80 ("ROLL3"),

3) Premiums less withdrawals accumulated at 5% per annum, capped at 2.5 times premiums less withdrawals, with no further increase beyond age 80 ("ROLL5"),

4) An annual ratchet design (maximum anniversary value), for which the guaranteed benefit never decreases and is increased to equal the previous contract anniversary account value, if larger, with no further increases beyond age 80 ("MAV"),

5) A design having a guaranteed benefit equal to the larger of the benefits in designs 3 and 4, above ("HIGH"),

6) An enhanced death benefit ("EDB") equal to 40% of the net earnings on the account (i.e., 40% of account value less total premiums paid plus withdrawals made) with this latter benefit capped at 40% of premiums less withdrawals ("EDB"),

E) Other Attributes. Factors F, G and $R(\beta_1, \beta_2)$ are available within the Pre-Calculated Factors for the following set of attributes:

1) Two Partial Withdrawal Rules – one for contracts having a pro-rata reduction in the GMDB and another for contracts having a dollar-for-dollar reduction,

2) The eight asset classes described in section A4.4)B),

3) Eight attained ages, with a 5-year age setback for females,

4) Five contract durations,

5) Seven values of GV/AV, and

6) Three levels of asset-based income.

F) Interpolation of F, G and $R(\beta_1, \beta_2)$.

1) Values of F, G and $R(\beta_1, \beta_2)$ apply to a contract having the product characteristics listed in section A4.5)A) and shall be determined by selecting values for the appropriate partial withdrawal rule and asset class and then using multi-point linear interpolation among published values for the last four attributes shown in section A4.3)E).

2) Interpolation over all four dimensions is not required, but if not performed over one or more dimensions, the factor used must result in a conservative (higher) value of GC. However, simple linear interpolation using the $AV \div GV$ ratio is mandatory. In this case, the company must choose nodes for the other three dimensions according to the following rules: next highest attained age, nearest duration, and nearest Annualized Account Charge Differential, as listed in A4.5)C) (i.e., capped at +100 and floored at –100 bps).

3) For $R(\beta_1, \beta_2)$, the interpolation should be performed on the Scaling Factors R calculated using β_1, β_2, using the ratio of Margin Offset to Total Asset Charges (W), not on the factors β_1 and β_2 themselves.

4) An Excel® workbook, Excel® add-in and companion dynamic link library (.dll) program is available from the National Association of Insurance Commissioners that can be used to determine the correct values and perform the multi-point linear interpolation.

5) Alternatively, published documentation can be referenced on performing multi-point linear interpolation and the required sixteen values determined using a key that is documented in the table "*Components of Key Used for GC Factor Look-Up*" located in section A4.5)C).

G) Adjustments to *GC* for Product Variations & Risk Mitigation/Transfer. In some cases, it may be necessary to make adjustments to the published factors due to:

1) A variation in product form wherein the definition of the guaranteed benefit is materially different from those for which factors are available (see section A4.3)H)); and/or

2) A risk mitigation or other management strategy, other than a hedging strategy, that cannot be accommodated through a straightforward and direct adjustment to the published values.

Adjustments may not be made to *GC* for hedging strategies.

Any adjustments to the published factors must be fully documented and supported through stochastic analysis. Such analysis may require stochastic simulations, but would not ordinarily be based on full inforce projections. Instead, a representative "model office" should be sufficient. Use of these adjusted factors must be supported by a periodic review of the appropriateness of the assumptions and methods used to perform the adjustments, with changes made to the adjustments when deemed necessary by such review.

Note that minor variations in product design do not necessarily require additional effort. In some cases, it may be reasonable to use the factors/formulas for a different product form (e.g., for a roll-up GMDB near or beyond the maximum reset age or amount, the ROP GMDB factors/formulas shall be used, possibly adjusting the guaranteed value to reflect further resets, if any). In other cases, the reserves may be based on two different guarantee definitions and the results interpolated to obtain an appropriate value for the given contract/cell. Likewise, it may be possible to adjust the Alternative Methodology results for certain risk transfer arrangements without significant additional work (e.g., quota-share reinsurance without caps, floors or sliding scales would normally be reflected by a simple pro-rata adjustment to the "gross" *GC* results).

However, if the contract design is sufficiently different from those provided and/or the risk mitigation strategy is non-linear in its impact on the Conditional Tail Expectation Amount, and there is no practical or obvious way to obtain a good result from the prescribed factors/formulas, any adjustments or approximations must be supported using stochastic modeling. Notably this modeling need not be performed on the whole portfolio, but can be undertaken on an appropriate set of representative policies.

H) Adjusting *F* and *G* for Product Design Variations. This subsection describes the typical process for adjusting *F* and *G* factors due to a variation in product design. Note that *R* (as determined by the slope and intercept terms in the factor table) would not be adjusted.

1) Select a contract design among those described in section A4.3)D) that is similar to the product being valued. Execute cash flow projections using the documented assumptions (see table of *Liability Modeling Assumptions & Product Characteristics* in section A4.5)A) and table of *Asset Based Fund Charges* in section A4.5)B)) and the pre-packaged scenarios for a set of representative cells (combinations of attained age, contract duration, asset class, AV/GMDB ratio and asset-based charges). These cells should correspond to nodes in the table of pre-calculated factors. Rank (order) the sample distribution of results for the present value of net cost.[22] Determine those scenarios that comprise CTE (65).

2) Using the results from step 1, average the present value of cost for the CTE (65) scenarios and divide by the current guaranteed value. For the J^{th} cell, denote this value by F_J. Similarly, average the present value of margin offset revenue for the same subset of scenarios and divide by account value. For the J^{th} cell, denote this value by G_J.

3) Extract the corresponding pre-calculated factors. For each cell, calibrate to the published tables by defining a "model adjustment factor" (denoted by asterisk) separately for the "cost" and "margin offset" components:

$$F_J^* = \frac{f\left(\tilde{\theta}\right)}{F_J} \text{ and } G_J^* = \frac{\hat{g}\left(\tilde{\theta}\right)}{G_J}$$

4) Execute "product specific" cash flow projections using the documented assumptions and pre-packaged scenarios for the same set of representative cells. Here, the company should model the actual product design. Rank (order) the sample distribution of results for the present value of net cost. Determine those scenarios that comprise CTE (65).

5) Using the results from step 4, average the present value of cost for the CTE (65) scenarios and divide by the current guaranteed value. For the J^{th} cell, denote this value by $\overline{F}_J$. Similarly, average the present value of margin offset revenue for the same subset of scenarios and divide by account value. For the J^{th} cell, denote this value by $\overline{G}_J$.

6) To calculate the Conditional Tail Expectation Amount for the specific product in question, the company should implement the Alternative Methodology as documented, but use $\overline{F}_J \times F_J^*$ in place of F and $\overline{G}_J \times G_J^*$ instead of G. The same R factors as appropriate for the product evaluated in step 1 shall be used for this step (i.e., the product used to calibrate the cash flow model).

I) Adjusting *GC* for Mortality Experience. The factors that have been developed for use in determining *GC* assume male mortality at 100% of the 1994 Variable Annuity MGDB ALB Mortality Table. Companies electing to use the Alternative Methodology that have not conducted an evaluation of their mortality experience shall use these factors. Other companies should use the procedure described below to adjust for the actuary's Prudent Estimate of mortality. The development of Prudent Estimate mortality shall follow the requirements and guidance of Appendix 10. Once a company uses the modified method for a block of business, the option to use the unadjusted factors is no longer available for that part of its business. In applying the factors to actual inforce business, a 5-year age setback should be used for female annuitants.

[22] Present value of net cost = PV[guaranteed benefit claims in excess of account value] – PV[margin offset]. The discounting includes cash flows in all future years (i.e., to the earlier of contract maturity and the end of the horizon).

1) Develop a set of mortality assumptions based on Prudent Estimate. In setting these assumptions, the actuary shall be guided by the definition of Prudent Estimate and the principles discussed in Appendices 9 and 10 of the Guideline.

2) Calculate two sets of net single premiums (NSP) at each attained age: one valued using 100% of the 1994 Variable Annuity MGDB ALB Mortality Table (with the aforementioned 5-year age setback for females) and the other using Prudent Estimate mortality. These calculations shall assume an interest rate of 3.75% and a lapse rate of 7% per year.

3) The *GC* factor is multiplied by the ratio, for the specific attained age being valued, of the NSP calculated using the Prudent Estimate mortality to the NSP calculated using the 1994 Variable Annuity MGDB ALB Mortality Table (with the aforementioned 5-year age setback for females).

A4.4) Fund Categorization

A) Criteria. The following criteria should be used to select the appropriate factors, parameters and formulas for the exposure represented by a specified guaranteed benefit. When available, the volatility of the long-term annualized total return for the fund(s) – or an appropriate benchmark – should conform to the limits presented. For this purpose, “long-term” is defined as twice the average projection period that would be applied to test the product in a stochastic model (generally, at least 30 years).

Where data for the fund or benchmark are too sparse or unreliable, the fund exposure should be moved to the next higher volatility class than otherwise indicated. In reviewing the asset classifications, care should be taken to reflect any additional volatility of returns added by the presence of currency risk, liquidity (bid-ask) effects, short selling and speculative positions.

B) Asset Classes. Variable subaccounts must be categorized into one of the following eight (8) asset classes. For purposes of calculating *CA* or *FE*, each contract will have one or more of the following asset classes represented, whereas for component *GC*, all subaccounts will be mapped into a single asset class.

1) Fixed Account. This class is credited interest at guaranteed rates for a specified term or according to a ‘portfolio rate’ or ‘benchmark’ index. This class offers a minimum positive guaranteed rate that is periodically adjusted according to company policy and market conditions.

2) Money Market/Short-Term. This class is invested in money market instruments with an average remaining term-to-maturity of less than 365 days.

3) Fixed Income. This class is invested primarily in investment grade fixed income securities. Up to 25% of the funds within this class may be invested in diversified equities or high-yield bonds. The expected volatility of the returns for this class will be lower than the Balanced fund class.

4) Balanced. This class is a combination of fixed income securities with a larger equity component. The fixed income component should exceed 25% of the portfolio. Additionally, any aggressive or ‘specialized’ equity component should not exceed one-third (33.3%) of the total equities held. Should the fund violate either of these constraints, it should be categorized as an equity fund. This class usually has a long-term volatility in the range of 8% – 13%.

5) Diversified Equity. This class is invested in a broad-based mix of U.S. and foreign equities. The foreign equity component (maximum 25% of total holdings) must be comprised of liquid securities in well-developed markets. Funds in this class would exhibit long-term volatility comparable to that of the S&P500. These funds should usually have a long-term volatility in the range of 13% – 18%.

6) Diversified International Equity. This class is similar to the Diversified Equity class, except that the majority of fund holdings are in foreign securities. This class should usually have a long-term volatility in the range of 14% – 19%.

7) Intermediate Risk Equity. This class has a mix of characteristics from both the Diversified and Aggressive Equity Classes. This class has a long-term volatility in the range of 19% – 25%.

8) Aggressive or Exotic Equity. This class comprises more volatile funds where risk can arise from: underdeveloped markets, uncertain markets, high volatility of returns, narrow focus (e.g., specific market sector), etc. This class (or market benchmark) either does not have sufficient history to allow for the calculation of a long-term expected volatility, or the volatility is very high. This class would be used whenever the long-term expected annualized volatility is indeterminable or exceeds 25%.

C) Selecting Appropriate Investment Classes. The selection of an appropriate investment type should be done at the level for which the guarantee applies. For guarantees applying on a deposit-by-deposit basis, the fund selection is straightforward. However, where the guarantee applies across deposits or for an entire contract, the approach can be more complicated. In such instances, the approach is to identify for each contract where the "grouped holdings" fit within the categories listed and to classify the associated assets on this basis.

A seriatim process is used to identify the "grouped" fund holdings, to assess the risk profile of the current fund holdings (possibly calculating the expected long-term volatility of the funds held with reference to the indicated market proxies), and to classify the entire 'asset exposure' into one of the specified choices. Here, 'asset exposure' refers to the underlying assets (separate and/or general account investment options) on which the guarantee will be determined. For example, if the guarantee applies separately for each deposit year within the contract, then the classification process would be applied separately for the exposure of each deposit year.

In summary, mapping the benefit exposure (i.e., the asset exposure that applies to the calculation of the guaranteed minimum death benefits) to one of the prescribed asset classes is a multi-step process:

1) Map each separate and/or general account investment option to one of the prescribed asset classes. For some funds, this mapping will be obvious, but for others it will involve a review of the fund's investment policy, performance benchmarks, composition and expected long-term volatility.

2) Combine the mapped exposure to determine the expected long-term "volatility of current fund holdings." This will require a calculation based on the expected long-term volatility for each fund and the correlations between the prescribed asset classes as given in the table "*Correlation Matrix for Prescribed Asset Classes*," in section A4.4)D).

3) Evaluate the asset composition and expected volatility (as calculated in step 2) of current holdings to determine the single asset class that best represents the exposure, with due consideration to the constraints and guidelines presented earlier in this section.

In step 1, the company should use the fund's actual experience (i.e., historical performance, inclusive of reinvestment) only as a guide in determining the expected long-term volatility. Due to limited data and changes in investment objectives, style and/or management (e.g., fund mergers, revised investment policy, different fund managers, etc.); the company may need to give more weight to the expected long-term volatility of the fund's benchmarks. In general, the company should exercise caution and not be overly optimistic in assuming that future returns will consistently be less volatile than the underlying markets.

In step 2, the company should calculate the "volatility of current fund holdings" (for the exposure being categorized) by the following formula

$$\sigma = \sqrt{\sum_{i=1}^{n}\sum_{j=1}^{n} w_i w_j \rho_{ij} \sigma_i \sigma_j}$$

using the volatilities and correlations in the following table where $w_i = \frac{AV_i}{\sum_k AV_k}$ is the relative value of fund i expressed as a proportion of total contract value, ρ_{ij} is the correlation between asset classes i and j and σ_i is the volatility of asset class i. An example is provided after the table.

D) Correlation Matrix for Prescribed Asset Classes.

ANNUAL VOLATILITY		FIXED ACCOUNT	MONEY MARKET	FIXED INCOME	BALANCED	DIVERSE EQUITY	INTL EQUITY	INTERM EQUITY	AGGR EQUITY
1.0%	FIXED ACCOUNT	**1**	0.50	0.15	0	0	0	0	0
1.5%	MONEY MARKET	0.50	**1**	0.20	0	0	0	0	0
5.0%	FIXED INCOME	0.15	0.20	**1**	0.30	0.10	0.10	0.10	0.05
10.0%	BALANCED	0	0	0.30	**1**	0.95	0.60	0.75	0.60
15.5%	DIVERSE EQUITY	0	0	0.10	0.95	**1**	0.60	0.80	0.70
17.5%	INTL EQUITY	0	0	0.10	0.60	0.60	**1**	0.50	0.60
21.5%	INTERM EQUITY	0	0	0.10	0.75	0.80	0.50	**1**	0.70
26.0%	AGGR EQUITY	0	0	0.05	0.60	0.70	0.60	0.70	**1**

E) Fund Categorization Example. As an example, suppose three funds (Fixed Income, diversified U.S. Equity and Aggressive Equity) are offered to clients on a product with a contract level guarantee (i.e., across all funds held within the contract). The current fund holdings (in dollars) for five sample contracts are shown in the following table.

	1	**2**	**3**	**4**	**5**
MV Fund X (Fixed Income):	5,000	4,000	8,000	-	5,000
MV Fund Y (Diversified Equity):	9,000	7,000	2,000	6,000	-
MV Fund Z (Aggressive Equity):	1,000	4,000	-	4,000	5,000
Total Market Value:	15,000	15,000	10,000	10,000	10,000
Total Equity Market Value:	10,000	11,000	2,000	10,000	5,000
Fixed Income % (*A*):	33%	27%	80%	0%	50%
Fixed Income Test (*A*>75%):	No	No	Yes	No	No
Aggressive % of Equity (B):	10%	36%	n/a	40%	100%
Balanced Test (*A*>25% & *B*<33.3%):	Yes	No	n/a	No	No
Volatility of Current Fund Holdings:	10.9%	13.2%	5.3%	19.2%	13.4%
Fund Classification:	**Balanced**	**Diversified***[23]	**Fixed Income**	**Intermediate**	**Diversified**

[23] Although the volatility suggests "Balanced Fund," the Balanced Fund criteria were not met. Therefore, this 'exposure' is moved "up" to Diversified Equity. For those funds classified as Diversified Equity, additional analysis would be required to assess whether they should be instead designated as "Diversified International Equity."

As an example, the "Volatility of Current Fund Holdings" for contract #1 is calculated as $\sqrt{A+B}$ where:

$$A = \left(\frac{5}{15}\times 0.05\right)^2 + \left(\frac{9}{15}\times 0.155\right)^2 + \left(\frac{1}{15}\times 0.26\right)^2$$

$$B = 2\cdot\left(\frac{5}{15}\cdot\frac{9}{15}\right)(0.1\times 0.05\times 0.155) + 2\cdot\left(\frac{5}{15}\cdot\frac{1}{15}\right)(0.05\times 0.05\times 0.26) + 2\cdot\left(\frac{9}{15}\cdot\frac{1}{15}\right)(0.7\times 0.155\times 0.26)$$

So the volatility for contract #1 = $\sqrt{0.0092+0.0026}$ = 0.109 or 10.9%.

A4.5) Tables

A) Liability Modeling Assumptions & Product Characteristics used for *GC* Factors.

Asset Based Charges (MER)	Vary by fund class. See section A4.5)B).
Base Margin Offset	100 basis points per annum.
GMDB Description	1. ROP = return of premium ROP. 2. ROLL3 = 3% roll-up, capped at 2.5 × premium, frozen at age 80. 3. ROLL5 = 5% roll-up, capped at 2.5 × premium, frozen at age 80. 4. MAV = annual ratchet (maximum anniversary value), frozen at age 80. 5. HIGH = Higher of 5% roll-up and annual ratchet. 6. EDB = 40% Enhanced Death Benefit (capped at 40% of deposit). Note that the Pre-Calculated Factors were originally calculated with a combined ROP benefit, but they have been adjusted to remove the effect of the ROP. Thus, the factors for this benefit 5 are solely for the Enhanced Death Benefit.
Adjustment to GMDB Upon Partial Withdrawal	Separate factors for "Pro-Rata by Market Value" and "Dollar-for-Dollar."
Surrender Charges	Ignored (i.e., zero). Included in the *CA* component.
Single Premium / Deposit	$100,000. No future deposits; no intra-contract fund rebalancing.
Base Contract Lapse Rate (Total Surrenders)	• Pro-rata by MV: 10% p.a. at all contact durations (before dynamics) • Dollar-for-dollar: 2% p.a. at all contract durations (no dynamics)
Partial Withdrawals	• Pro-rata by MV: None (i.e., zero) • Dollar-for-dollar: Flat 8% p.a. at all contract durations (as a % of AV). No dynamics or anti-selective behavior.
Mortality	100% of the 1994 Variable Annuity MGDB Mortality Table (MGDB 94 ALB). For reference, 1000 × q_x rates at ages 65 and 70 for 100% of MGDB 94 ALB Male are 18.191 and 29.363 respectively. Note that section A4.3)I) allows modification to this assumption.
Gender /Age Distribution	100% male. Methodology accommodates different attained ages. A 5-year age setback will be used for female annuitants.
Max. Annuitization Age	All policies terminate at age 95.
Fixed Expenses	Ignored (i.e., zero). Included in the *FE* component.
Annual Fee and Waiver	Ignored (i.e., zero). Included in the *FE* component.

Discount Rate	5.75% pre-tax.
Dynamic Lapse Multiplier (Applies only to policies where GMDB is adjusted "pro-rata by MV" upon withdrawal)	$\lambda = MIN\left[U, MAX\left[L, 1 - M \times \left(\frac{GV}{AV} - D\right)\right]\right]$ U=1, L=0.5, M=1.25, D=1.1 ▪ Applied to the 'Base Contract Lapse Rate' ▪ Does not apply to partial withdrawals.

B) Asset-Based Fund Charges (bps per annum).

Asset Class / Fund	**Account Value Charge**
Fixed Account	0
Money Market	110
Fixed Income (Bond)	200
Balanced	250
Diversified Equity	250
Diversified International Equity	250
Intermediate Risk Equity	265
Aggressive or Exotic Equity	275

C) Components of Key Used for *GC* Factor Look-Up.

(First Digit Always "1")

Contract Attribute	Key : Possible Values & Description	
Product Definition, P	0 : 0	Return-of-premium.
	1 : 1	Roll-up (3% per annum).
	2 : 2	Roll-up (5% per annum).
	3 : 3	Maximum Anniversary Value (MAV).
	4 : 4	High of MAV and 5% Roll-up.
	5 : 5	Enhanced Death Benefit (excludes the ROP GMDB, which would have to be added separately if the contract in question has an ROP benefit.)
GV Adjustment Upon Partial Withdrawal, A	0 : 0	Pro-rata by market value.
	1 : 1	Dollar-for-dollar.
Fund Class, F	0 : 0	Fixed Account.
	1 : 1	Money Market.
	2 : 2	Fixed Income (Bond).
	3 : 3	Balanced Asset Allocation.
	4 : 4	Diversified Equity.
	5 : 5	International Equity.
	6 : 6	Intermediate Risk Equity.
	7 : 7	Aggressive / Exotic Equity.

Attained Age (Last Birthday), X	0 : 35 1 : 45 2 : 55 3 : 60 4 : 65 5 : 70 6 : 75 7 : 80
Contract Duration (years-since-issue), D	0 : 0.5 1 : 3.5 2 : 6.5 3 : 9.5 4 : 12.5
Account Value-to-Guaranteed Value Ratio, ϕ	0 : 0.25 1 : 0.50 2 : 0.75 3 : 1.00 4 : 1.25 5 : 1.50 6 : 2.00
Annualized Account Charge Differential from A4.5)B) Assumptions	0 : −100 bps 1 : +0 2 : +100

APPENDIX 5 - Scenario Calibration Criteria

A5.1) General

This Appendix outlines the requirements for the stochastic models used to simulate fund performance.[24] Specifically, it sets certain standards that must be satisfied and offers guidance to the actuary in the development and validation of the scenario models. Background material and analysis are presented to support the recommendation. The Appendix focuses on the S&P 500 as a proxy for returns on a broadly diversified U.S. equity fund, but there is also advice on how the techniques and requirements would apply to other types of funds. General modeling considerations such as the number of scenarios and projection frequency are also discussed.

The calibration points given in this Appendix are applicable to gross returns (before the deduction of any fees or charges). To determine the net returns appropriate for the projections required by the Guideline, the actuary shall reflect applicable fees and contractholder charges in the development of projected account values. The projections shall also include the costs of managing the investments and converting the assets into cash when necessary.

As a general rule, funds with higher expected returns should have higher expected volatilities and in the absence of well-documented mitigating factors (e.g., a highly reliable and favorable correlation to other fund returns), should lead to higher reserve requirements.[25]

State or path dependent models are not prohibited, but must be justified by the historic data and meet the calibration criteria. To the degree that the model uses mean-reversion or path-dependent dynamics, this must be well supported by research and clearly documented in the Memorandum supporting the required actuarial certification.

The equity scenarios used to determine reserves must be available in an electronic format to facilitate any regulatory review.

A5.2) Gross Wealth Ratios

Gross Wealth Ratios derived from the stochastic return scenarios for use with a Separate Account variable fund category for diversified U.S. equities must satisfy calibration criteria consistent with that for the S&P 500 shown in the following table. Under these calibration criteria, Gross Wealth Ratios for quantiles less than 50 percent may not exceed the value from the table corresponding to the quantile, while at quantiles greater than 50 percent; Gross Wealth Ratios may not be less than the corresponding value for the quantile from the table. Gross Wealth Ratios must be tested for holding period 1, 5, 10 and 20 years throughout the projections, except as noted in section A5.3).

The “wealth factors” are defined as gross accumulated values (i.e., before the deduction of fees and charges) with complete reinvestment of income and maturities, starting with a unit investment. These can be less than 1, with “1” meaning a zero return over the holding period.

[24] For more details on the development of these requirements, including the development of the calibration points, see the American Academy of Actuaries recommendation on C-3 Phase II risk-based capital.

[25] While the model need not strictly adhere to ‘mean-variance efficiency,’ prudence dictates some form of consistent risk/return relationship between the proxy investment funds. In general, it would be inappropriate to assume consistently ‘superior’ expected returns (i.e., risk/return point above the frontier).

S&P 500 Total Return Gross Wealth Ratios at the Calibration Points

Calibration Point	One Year	Five Year	Ten Year	Twenty Year
2.5%	0.78	0.72	0.79	▨
5.0%	0.84	0.81	0.94	1.51
10.0%	0.90	0.94	1.16	2.10
90.0%	1.28	2.17	3.63	9.02
95.0%	1.35	2.45	4.36	11.70
97.5%	1.42	2.72	5.12	▨

The scenarios need not strictly satisfy all calibration points, but the actuary should be satisfied that any differences do not materially reduce the resulting reserves.[26] In particular, the actuary should be mindful of which tail most affects the business being valued. If reserves are less dependent on the right (left) tail for all products under consideration (e.g., a return of premium guarantee would primarily depend on the left tail, an enhanced death benefit equal to a percentage of the gain would be most sensitive to the right tail, etc.), it is not necessary to meet the right (left) calibration points.

For models that require starting values for certain state variables,[27] long-term ('average' or 'neutral') values should be used for calibration. The same values should normally be used to initialize the models for generating the actual projection scenarios unless an alternative assumption can be clearly justified.[28] It should be noted that a different set of initialization parameters might produce scenarios that do not satisfy all the calibration points shown in the above table. However, the S&P 500 scenarios used to determine reserves must meet the calibration criteria.

A5.3) Calibration Requirements Beyond Twenty Years

It is possible to parameterize some path and/or state dependent models to produce higher volatility (and/or lower expected returns) in the first 20 years in order to meet the calibration criteria, but with lower volatility (and/or higher expected returns) for other periods during the forecast horizon. While this property may occur for certain scenarios (e.g., the state variables would evolve over the course of the projection and thereby affect future returns), it would be inappropriate and unacceptable for a company to alter the model parameters and/or its characteristics for periods beyond year 20 in a fashion not contemplated at the start of the projection and primarily for the purpose(s) of reducing the volatility and/or severity of ultimate returns.[29]

A5.4) Other Funds

Calibration of other markets (funds) is left to the judgment of the actuary, but the scenarios so generated must be consistent with the calibration points in the table in section A5.2). This does not imply a strict functional relationship between the model parameters for various markets/funds, but it would generally be inappropriate to assume that a market or fund consistently "outperforms" (lower risk, higher expected return relative to the efficient frontier) over the long term.

[26] See the Preamble to the Accounting Practices and Procedures Manual for an explanation of materiality.

[27] For example, a stochastic log volatility ("SLV") model requires the starting volatility. Also, the regime-switching lognormal model requires an assumption about the starting regime.

[28] A clear justification exists when state variables are observable or "known" to a high degree of certainty and not merely estimated or inferred based on a "balance of probabilities."

[29] Such adjustments must be clearly documented and justified by the historic data.

The actuary shall document the actual 1-, 5-, 10- and 20-year wealth factors of the scenarios at the same frequencies as in the "S&P 500 Total Return Gross Wealth Ratios at the Calibration Points" table in section A5.2). The annualized mean and standard deviation of the wealth factors for the 1-, 5-, 10- and 20-year holding periods must also be provided. For equity funds, the actuary shall explain the reasonableness of any significant differences from the S&P500 calibration points.

When parameters are fit to historic data without consideration of the economic setting in which the historic data emerged, the market price of risk may not be consistent with a reasonable long-term model of market equilibrium. One possibility for establishing 'consistent' parameters (or scenarios) across all funds would be to assume that the market price of risk is constant (or nearly constant) and governed by some functional (e.g., linear) relationship. That is, higher expected returns can only be garnered by assuming greater risk.[30]

Specifically, two return distributions *X* and *Y* would satisfy the following relationship:

$$\text{Market Price of Risk} = \left(\frac{\mathrm{E}[\mathrm{R}_X] - \mathrm{r}}{\sigma_X} \right) = \left(\frac{E[R_Y] - \mathrm{r}}{\sigma_Y} \right)$$

where $E[R]$ and σ are respectively the (unconditional) expected returns and volatilities and *r* is the expected risk-free rate over a suitably long holding period commensurate with the projection horizon. One approach to establish consistent scenarios would set the model parameters to maintain a near-constant market price of risk.

A closely related method would assume some form of 'mean-variance' efficiency to establish consistent model parameters. Using the historic data, the mean-variance (alternatively, 'drift-volatility') frontier could be a constructed from a plot of (mean, variance) pairs from a collection of world market indices. The frontier could be assumed to follow some functional form,[31] with the coefficients determined by standard curve fitting or regression techniques. Recognizing the uncertainty in the data, a 'corridor' could be established for the frontier. Model parameters would then be adjusted to move the proxy market (fund) inside the corridor.

Clearly, there are many other techniques that could be used to establishing consistency between the scenarios. While appealing, the above approaches do have drawbacks[32] and the actuary should not be overly optimistic in constructing the model parameters or the scenarios.

Funds can be grouped and projected as a single fund if such grouping is not anticipated to materially reduce reserves. However, care should be taken to avoid exaggerating the benefits of diversification. The actuary must document the development of the investment return scenarios and be able to justify the mapping of the company's variable accounts to the proxy funds used in the modeling.

[30] As an example, the standard deviation of log returns is often used as a measure of risk.

[31] Quadratic polynomials and logarithmic functions tend to work well.

[32] For example, mean-variance measures ignore the asymmetric and fat-tailed profile of most equity market returns.

A5.5) Correlation of Fund Returns

In constructing the scenarios for the proxy funds, the company may require parameter estimates for a number of different market indices. When more than one index is projected, it is generally necessary to allow for correlations in the simulations. It is not necessary to assume that all markets are perfectly positively correlated, but an assumption of independence (zero correlation) between the equity markets would inappropriately exaggerate the benefits of diversification. An examination of the historic data suggests that correlations are not stationary and that they tend to increase during times of high volatility or negative returns. As such, the actuary should take care not to underestimate the correlations in those scenarios used for the reserve calculations.

If the projections include the simulation of interest rates (other than for discounting surplus strain) as well as equity returns, the processes may be independent provided that the actuary can demonstrate that this assumption (i.e., zero correlation) does not materially underestimate the resulting reserves.

A5.6) Number of Scenarios and Efficiency in Estimation

For straight Monte Carlo simulation (with equally probable "paths" of fund returns), the number of scenarios should typically equal or exceed 1000. The appropriate number will depend on how the scenarios will be used and the materiality of the results. The actuary should use a number of scenarios that will provide an acceptable level of precision.

Fewer than 1000 scenarios may be used provided that the actuary has determined through prior testing (perhaps on a subset of the portfolio) that the CTE values so obtained materially reproduce the results from running a larger scenario set.

Variance reduction and other sampling techniques are intended to improve the accuracy of an estimate more efficiently than simply increasing the number of simulations. Such methods can be used provided the actuary can demonstrate that they do not lead to a material understatement of results. Many of the techniques are specifically designed for estimating means, not tail measures, and could in fact reduce accuracy (and efficiency) relative to straight Monte Carlo simulation.[33]

The above requirements and warnings are not meant to preclude or discourage the use of valid and appropriate sampling methods, such as Quasi Random Monte Carlo (QRMC), importance sampling or other techniques designed to improve the efficiency of the simulations (relative to pseudo-random Monte Carlo methods). However, the actuary should maintain documentation that adequately describes any such techniques used in the projections. Specifically, the documentation should include the reasons why such methods can be expected not to result in systematic or material under-statement of the resulting reserves compared to using pseudo-random Monte Carlo numbers.

A5.7) Frequency of Projection and Time Horizon

Use of an annual cashflow frequency ("timestep") is generally acceptable for benefits/features that are not sensitive to projection frequency. The lack of sensitivity to projection frequency should be validated by testing wherein the actuary should determine that the use of a more frequent (i.e., shorter) time step does not materially increase reserves. A more frequent time increment should always be used when the product features are sensitive to projection period frequency.

[33] However, with careful implementation, many variance reduction techniques can work well for CTE estimators. For example, see Manistre, B.J. and Hancock, G. (2003), "Variance of the CTE Estimator," 2003 Stochastic Modeling Symposium, Toronto, ON, September 2003.

Care must be taken in simulating fee income and expenses when using an annual time step. For example, recognizing fee income at the end of each period after market movements, but prior to persistency decrements, would normally be an inappropriate assumption. It is also important that the frequency of the investment return model be linked appropriately to the projection horizon in the liability model. In particular, the horizon should be sufficiently long so as to capture the vast majority of costs (on a present value basis) from the scenarios.[34]

A5.8) Pre-Packaged Scenarios

The American Academy of Actuaries has provided 10,000 scenarios on its website[35] for the following nineteen asset classes.[36]

1) 3-month U.S. Treasury yields

2) 6-month U.S. Treasury yields

3) 1-year U.S. Treasury yields

4) 2-year U.S. Treasury yields

5) 3-year U.S. Treasury yields

6) 5-year U.S. Treasury yields

7) 7-year U.S. Treasury yields

8) 10-year U.S. Treasury yields

9) 20-year U.S. Treasury yields

10) 30-year U.S. Treasury yields

11) Money Market / Short-Term

12) U.S. Intermediate Term Government Bonds

13) U.S. Long Term Corporate Bonds

14) Diversified Fixed Income

15) Diversified Balanced Allocation

16) Diversified Large Capitalized U.S. Equity

[34] As a general guide, the forecast horizon should not be less than 20 years.

[35] The pre-packaged scenarios can be found at http://www.actuary.org/life/phase2.asp and are fully documented at http://www.actuary.org/pdf/life/c3supp_march05.pdf.

[36] Because the reserves calculated using projections involve cash flow projections, the pre-packaged scenarios were developed under the "real world" probability measure (as opposed to a "risk-neutral" basis). Therefore, the pre-packaged scenarios may not be appropriate for purposes of projecting the market value of future hedge instruments within a projection (to the extent such instruments are used in the projections). For this purpose, it may be more appropriate to use risk neutral scenarios to determine the market value of hedge instruments in the cash flow projections that are based on real world scenarios.

17) Diversified International Equity

18) Intermediate Risk Equity

19) Aggressive or Specialized Equity

The scenarios are available as gross monthly accumulation factors (or U.S. Treasury yields) over a 30-year horizon in comma-separated value format (*.*csv*). These scenarios have been appropriately correlated so that the K^{th} scenario for each asset class must be used together and considered one 'future investment return scenario.'[37] Hence, the scenarios can be combined (by blending the accumulation factors[38]) to create additional 'proxy' scenarios for the company's funds.

For example, suppose the actuary wanted to construct scenarios for a 'balanced fund' that targets a 60/40 allocation between bonds and U.S. equities. If we denote [AF^{X}] as the matrix of accumulation factors for asset class X, then the balanced scenarios would be defined by [AF^{BAL}] = 0.60 × [AF^{BOND}] + 0.40 × [$\text{AF}^{S\&P500}$]. Care should be taken to avoid exaggerating the benefits of diversification. The actuary shall document the development of the investment return scenarios and be able to justify the mapping of the company's variable accounts to the proxy funds used in the modeling.

The U.S. Treasury yields are expressed as nominal semi-annual bond equivalent yields in decimal format. All other returns are expressed as periodic (not cumulative) market accumulation factors (i.e., monthly "gross wealth ratios"). Interest rates are assumed to change at the start of each month, hence the value in column T applies for month T-1. The market accumulation factor in column T represents the growth in month T-1.

If all or a portion of these scenarios are used, then the actuary shall verify that the scenario calibration criteria are met.

[37] It is inappropriate to misalign the ordering of scenarios (e.g., scenario J for "Diversified U.S. Equity" cannot be combined with scenario K for "Diversified International Equity," where J ≠ K).

[38] It is important to blend the accumulation factors (not the returns) in order to achieve the desired asset mix.

APPENDIX 6 - Allocation of the Aggregate Reserves to the Contract Level

Section IV states that the Aggregate Reserve shall be allocated to the contracts falling within the scope of the Guideline. When the Conditional Tail Expectation Amount is greater that the Standard Scenario Amount, this allocation requires that the excess be allocated to the contracts falling within the scope of the Guideline.

A6.1) Allocation when the Aggregate Reserve equals the Conditional Tail Expectation Amount

A) Single sub-grouping. When the Aggregate Reserve is equal to the Conditional Tail Expectation Amount and the Conditional Tail Expectation Amount is determined in aggregate for all contracts falling within the scope of the Guideline (i.e., a single grouping), as described in Section IV)D), the excess of the Conditional Tail Expectation Amount over the Standard Scenario Amount shall be allocated to each contract on the basis of the difference between the Standard Scenario Reserve and the Cash Surrender Value[39] on the valuation date for the contract. If the cash surrender value is not defined or not available, the Standard Scenario Amount will be the basis of allocation.

B) Multiple sub-groupings. When the Aggregate Reserve is equal to the Conditional Tail Expectation Amount and the Conditional Tail Expectation Amount is determined using more than one sub-grouping, as described in Section IV)D), the allocation of the excess of the Conditional Tail Expectation Amount over the Standard Scenario Amount and shall reflect that sub-grouping of contracts used to determine the Conditional Tail Expectation Amount, as described in Section IV)D).

For example, when the Conditional Tail Expectation Amount is determined using sub-grouping, the excess of the aggregate (i.e., the total for all contracts within the scope of the Guideline) Conditional Tail Expectation Amount over the aggregate Standard Scenario Amount shall be allocated only to those contracts that are part of sub-groupings whose contributions to the Conditional Tail Expectation Amount exceed their contribution to the Standard Scenario Amount.

In the case of such sub-groupings, the excess of the aggregate Conditional Tail Expectation Amount over the aggregate Standard Scenario Amount shall be allocated to each sub-grouping in proportion to the difference between the Conditional Tail Expectation and the Standard Scenario Reserve for each sub-grouping for which that excess is positive.

Once the allocation to each sub-grouping is determined, the excess of the reserve allocated to such sub-grouping over the Standard Scenario Amount determined for that sub-grouping shall be allocated to each contract within that sub-grouping on the basis of the difference between the Standard Scenario Reserve and the Cash Surrender Value on the valuation date for the contracts. If the cash surrender value is not defined or not available, the Standard Scenario Amount will be the basis of allocation.

[39] Note that since the Standard Scenario Reserve for a contract is, by definition, greater than or equal to the Cash Surrender Value, it is understood that the difference between the Standard Scenario Reserve and the Cash Surrender Value for each contract will never be less than zero.

As an example, consider a company with the results of the following three sub-groupings:

Sub-grouping	A	B	C	Total
Conditional Tail Expectation Amount	28	40	52	120
Standard Scenario Amount	20	45	30	95
Aggregate Reserve				**120**
(1) – (2)	8	-5	22	25
Allocation	6.67	0	18.33	25

In this example, the excess of the Conditional Tail Expectation Amount over the Standard Scenario Amount, in aggregate, equals 25 (i.e., the "Total" column of row 1 less row 2, or 120 – 95). This excess of 25 would be allocated only to those contracts that are part of sub-groupings whose contributions to the Conditional Tail Expectation Amount exceed their contributions to the Standard Scenario Amount. In this example, that would be contracts in sub-groupings A and C (since in sub-grouping B, the contribution to the Standard Scenario Amount exceeds the contribution to the Conditional Tail Expectation Amount). Therefore, the excess of 25 would be allocated to the contracts in sub-groupings A and C in proportion to the difference between the Conditional Tail Expectation Amount and the Standard Scenario Reserve for those sub-groupings (i.e. row 4). In this example, the total difference between the Conditional Tail Expectation Amount and the Standard Scenario Reserve for the contracts in sub-groupings A and C equals 8 + 22, or 30. This would result in 8/30 of the excess of the Conditional Tail Expectation Amount over the Standard Scenario Amount (or 6.67) to be allocated to the contracts in sub-groupings A and 22/30 of the excess of the Conditional Tail Expectation Amount over the Standard Scenario Amount (or 18.33) to be allocated to the contracts in sub-groupings C as shown on line (5) above.

In this example, the allocation of the Aggregate Reserve to contracts within sub-grouping B would equal the Standard Scenario Reserve for those contracts (as described in section A6.2) below). For sub-groupings A and C, the difference between the allocation of the Aggregate Reserve to each of those sub-grouping and the Standard Scenario Amount determined for each of those sub-grouping would be allocated to each contract within each of those sub-groupings based on the difference between the Standard Scenario Reserve and the Cash Surrender Value for each of the contracts within the relevant sub-group. The result would be an allocated Aggregate Reserve for a given contract that would be equal to the Standard Scenario Reserve for that contract plus the amount of the difference between 1) and 2) below that is allocated to that contract, where:

1) Equals the allocation of the Aggregate Reserve to that contract's sub-grouping; and

2) Equals the Standard Scenario Amount determined for that contract's sub-grouping.

A6.2) Allocation when the Aggregate Reserve equals the Standard Scenario Amount

The Standard Scenario Amount, as required by Section IV)C), is calculated on a contract-by-contract basis, as described in Appendix 3. Therefore, when the Aggregate Reserve is equal to the Standard Scenario Amount, the reserve allocated to each contract shall be the reserve calculated for each contract under the Standard Scenario method.

APPENDIX 7 – Modeling of Hedges

A7.1) Initial Considerations

The appropriate costs and benefits of hedging instruments that are currently held by the company in support of the contracts falling under the scope of the Guideline (excluding those that involve the offsetting of the risks associated with variable annuity guarantees with other products outside of the scope of the Guideline, such as equity-indexed annuities) shall be included in the calculation of the Conditional Tail Expectation Amount, determined in accordance with Section IV)D) and section A1.4) of the Guideline (i.e., Conditional Tail Expectation Amount using projections). If the company is following a Clearly Defined Hedging Strategy ("hedging strategy"), as defined in Section III, in accordance with an investment policy adopted by the Board of Directors, or a committee of Board members, the company is eligible to reduce the amount of the Conditional Tail Expectation Amount using projections otherwise calculated. The investment policy must clearly articulate the company's hedging objectives, including the metrics that drive rebalancing/trading. This specification could include maximum tolerable values for investment losses, earnings, volatility, exposure, etc. in either absolute or relative terms over one or more investment horizons vis-à-vis the chance of occurrence. Company management is responsible for developing, documenting, executing and evaluating the investment strategy, including the hedging strategy, used to implement the investment policy.

For this purpose, the investment assets refer to all the assets including derivatives supporting covered products and guarantees. This is also referred to as the investment portfolio. The investment strategy is the set of all asset holdings at all points in time in all scenarios. The hedging portfolio, which is also referred to as the hedging assets, is a subset of the investment assets. The hedging strategy is the hedging asset holdings at all points in time in all scenarios. There is no attempt to distinguish what is the hedging portfolio and what is the investment portfolio in this Appendix. Nor is the distinction between investment strategy and hedging strategy formally made here. Where necessary to give effect to the intent of this Appendix, the requirements applicable to the hedging portfolio or the hedging strategy are to apply to the overall investment portfolio and investment strategy.

This particularly applies to restrictions on the reasonableness or acceptability of the models that make up the stochastic cash flow model used to perform the projections, since these restrictions are inherently restrictions on the joint modeling of the hedging and non-hedging portfolio. To give effect to these requirements, they must apply to the overall investment strategy and investment portfolio.

The cost and benefits of hedging instruments that are currently held by the company in support of the contracts falling under the scope of the Guideline shall be included in the stochastic cash flow model used to calculate the Conditional Tail Expectation Amount in accordance with Section IV)D) (the "model"). If the company is following a Clearly Defined Hedging Strategy, the model shall take into account the cost and benefits of hedge positions expected to be held by the company in the future based on the operation of the hedging strategy.

Before either a new or revised hedging strategy can be used to reduce the amount of the Conditional Tail Expectation Amount otherwise calculated, the hedging strategy should be in place (i.e., effectively implemented by the company) for at least three months. The company may meet the time requirement by having evaluated the effective implementation of the hedging strategy for at least three months without actually having executed the trades indicated by the hedging strategy (e.g., mock testing or by having effectively implemented the strategy with similar annuity products for at least three months).

These requirements do not supersede any statutes, laws, or regulations of any state or jurisdiction related to the use of derivative instruments for hedging purposes and should not be used in determining whether a company is permitted to use such instruments in any state or jurisdiction.

A7.2) Background

The analysis of the impact of the hedging strategy on cash flows is typically performed using either one of two methods as described below. Although a hedging strategy would normally be expected to reduce risk provisions, the nature of the hedging strategy and the costs to implement the strategy may result in an increase in the amount of the Conditional Tail Expectation Amount otherwise calculated.

The fundamental characteristic of the first method is that all hedging positions, both the currently held positions and those expected to be held in the future, are included in the stochastic cash flow model used to determine the Scenario Greatest Present Value, as discussed in Section IV)D), for each scenario.

The fundamental characteristic of the second method is that the effectiveness of the current hedging strategy (including currently held hedge positions) on future cash flows is evaluated, in part or in whole, outside of the stochastic cash flow model. In this case, the reduction to the Conditional Tail Expectation Amount otherwise calculated should be commensurate with the degree of effectiveness of the hedging strategy in reducing accumulated deficiencies otherwise calculated.

Regardless of the methodology used by the company, the ultimate effect of the current hedging strategy (including currently held hedge positions), on the Conditional Tail Expectation Amount needs to recognize all risks, associated costs, imperfections in the hedges and hedging mismatch tolerances associated with the hedging strategy. The risks include, but are not limited to: basis, gap, price, parameter estimation, and variation in assumptions (mortality, persistency, withdrawal, annuitization, etc.). Costs include, but are not limited to: transaction, margin (opportunity costs associated with margin requirements) and administration. In addition, the reduction to the Conditional Tail Expectation Amount attributable to the hedging strategy may need to be limited due to the uncertainty associated with the company's ability to implement the hedging strategy in a timely and effective manner. The level of operational uncertainty varies indirectly with the amount of time that the new or revised strategy has been in effect or mock tested.

No hedging strategy is perfect. A given hedging strategy may eliminate or reduce some but not all risks, transforms some risks into others, introduces new risks or has other imperfections. For example, a delta-only hedging strategy does not adequately hedge the risks measured by the "Greeks" other than delta. Another example is that financial indices underlying typical hedging instruments typically do not perform exactly like the separate account funds, and hence the use of hedging instruments has the potential for introducing basis risk.

A7.3) Calculation of CTE Amount (reported)

The company should begin by calculating "CTE Amount(best efforts)" – the results obtained when the Conditional Tail Expectation Amount (or "CTE Amount") is based on incorporating the hedging strategy (including currently held hedge positions) into the stochastic cash flow model, including all of the factors and assumptions needed to execute the hedging strategy (e.g., stochastic implied volatility).

Because most models will include at least some approximations or idealistic assumptions, CTE Amount(best efforts) may overstate the impact of the hedging strategy. To compensate for potential overstatement of the impact of the hedging strategy, the company shall recalculate the Conditional Tail Expectation Amount assuming the company has no dynamic hedging strategy (i.e., reflect only hedge positions held by the company on the valuation date. The result so obtained is called "CTE Amount(adjusted)." In some situations the determination of CTE Amount(adjusted) may include both direct and indirect techniques.

Finally, the reported value for the Conditional Tail Expectation Amount is given by:
CTE Amount(reported) = E x CTE Amount(best efforts) +
(1 – E) × CTE Amount(adjusted)

The value for E (an "effectiveness factor") reflects the actuary's view as to the level of sophistication of the stochastic cash flow model and its ability to properly reflect the parameters of the hedging strategy (i.e., the "Greeks" being covered by the strategy) as well as the associated costs, risks, and benefits E will be no greater than 0.70. As the sophistication of the stochastic cash flow model increases, the value for E increases (i.e., the greater the ability of the CTE Amount(best efforts) model to capture all risks and uncertainties, the higher the value of E). If the model used to determine the "CTE Amount(best efforts)" effectively reflects all of the parameters used in the hedging strategy, the value of E may be up to 0.70. If certain economic risks are not hedged, yet the model does not generate scenarios that sufficiently capture those risks, E must be in the lower end of the range. If hedge cash flows are not modeled directly, E will be no greater than 0.30. Simplistic hedge cash flow models will have a value of E in the low range between 0.00 and 0.70.

Additionally, the company shall demonstrate that, based on an analysis of at least the most recent 12 months, the model is able to replicate the hedging strategy in a way that justifies the value used for E. A company that does not have 12 months of experience to date shall set E to a value no greater than 0.30.

A7.4) Specific Considerations and Requirements

As part of the process of choosing a methodology and assumptions for estimating the future effectiveness of the current hedging strategy (including currently held hedge positions) for purposes of reducing the Conditional Tail Expectation Amount, the actuary should review actual historical hedging effectiveness. The actuary shall evaluate the appropriateness of the assumptions on future trading, transaction costs, and other elements of the model, the strategy, the mix of business, and other items that are likely to result in materially adverse results. This includes an analysis of model assumptions that, when combined with the reliance on the hedging strategy, are likely to result in adverse results relative to those modeled. The parameters and assumptions shall be adjusted (based on testing contingent on the strategy used and other assumptions) to levels that fully reflect the risk based on historical ranges and foreseeable future ranges of the assumptions and parameters. If this is not possible by parameter adjustment, the model shall be modified to reflect them at either Anticipated Experience or adverse estimates of the parameters.

A discontinuous hedging strategy is a hedging strategy where the relationships between the sensitivities to equity markets and interest rates (commonly referred to as the Greeks) associated with the guaranteed contractholder options embedded in the variable annuities and other in-scope products and these same sensitivities associated with the hedging assets are subject to material discontinuities. This includes, but is not limited to, a hedging strategy where material hedging assets will be obtained when the variable annuity account balances reach a predetermined level in relationship to the guarantees. Any hedging strategy, including a delta hedging strategy, can be a discontinuous hedging strategy if implementation of the strategy permits material discontinuities between the sensitivities to equity markets and interest rates associated with the guaranteed contractholder options embedded in the variable annuities and other in-scope products and these same sensitivities associated with the hedging assets. There may be scenarios that are particularly costly to discontinuous hedging strategies, especially where those result in large discontinuous changes in sensitivities (Greeks) associated with the hedging assets. Where discontinuous hedging strategies contribute materially to a reduction in the Conditional Tail Expectation Amount, the actuary must evaluate the interaction of future trigger definitions and the discontinuous hedging strategy, in addition to the items mentioned in the previous paragraph. This includes an analysis of model assumptions that, when combined with the reliance on the discontinuous hedging strategy, may result in adverse results relative to those modeled.

Implementing a strategy that has a strong dependence on acquiring hedging assets at specific times that depend on specific values of an index or other market indicators may not be implemented as precisely as planned.

The combination of elements of the stochastic cash flow model, including the initial actual market asset prices, prices for trading at future dates, transaction costs, and other assumptions should be analyzed by the actuary as to whether the stochastic cash flow model permits hedging strategies that make money in some scenarios without losing a reasonable amount in some other scenarios. This includes, but is not limited to:

A) Hedging strategies with no initial investment that never lose money in any scenario and in some scenarios make money; or

B) Hedging strategies that with a given amount of initial money never make less than accumulation at the one-period risk free rates in any scenario but make more than this in one or more scenarios.

If the stochastic cash flow model allows for such situations, the actuary should be satisfied that the results do not materially rely directly or indirectly on the use of such strategies. In addition, the actuary should disclose the situations and provide supporting documentation as to why the actuary believes the situations are not material for determining the Conditional Tail Expectation Amount. If the results do materially rely directly or indirectly on the use of such strategies, the strategies may not be used to reduce the Conditional Tail Expectation Amount otherwise calculated.

In addition to the above, the method used to determine prices of financial instruments for trading in scenarios should be compared to actual initial market prices. If there are substantial discrepancies, the actuary should disclose the substantial discrepancies and provide supporting documentation as to why the model-based prices are appropriate for determining the Conditional Tail Expectation Amount. In addition to comparisons to initial market prices, there should be testing of the pricing models that are used to determine subsequent prices when scenarios involve trading financial instruments. This testing should consider historical relationships. For example, if a method is used where recent volatility in the scenario is one of the determinants of prices for trading in that scenario, then that model should approximate actual historic prices in similar circumstances in history.

A7.5) Certification and Documentation

The actuary must provide a certification that the values for E, CTE Amount(adjusted) and CTE Amount(best efforts) were calculated using the process discussed above and the assumptions used in the calculations were reasonable for the purpose of determining the Conditional Tail Expectation Amount. The actuary shall document the method(s) and assumptions (including data) used to determine CTE Amount(adjusted) and CTE Amount(best efforts) and maintain adequate documentation as to the methods, procedures and assumptions used to determine the value of E.

The actuary must provide a certification as to whether the Clearly Defined Hedging Strategy is fully incorporated into the stochastic cash flow model and any supplementary analysis of the impact of the hedging strategy on the Conditional Tail Expectation Amount. The actuary must document the extent to which elements of the hedging strategy (e.g., time between portfolio rebalancing) are not fully incorporated into the stochastic cash flow model and any supplementary analysis to determine the impact, if any. In addition, the actuary must provide a certification and maintain documentation to support the certification that the hedging strategy designated as the Clearly Defined Hedging Strategy meets the requirements of a Clearly Defined Hedging Strategy including that the implementation of the hedging strategy in the stochastic cash flow model and any supplementary analysis does not include knowledge of events that occur after any action dictated by the hedging strategy (i.e. the model cannot use information about the future that would not be known in actual practice).

A financial officer of the company (e.g., Chief Financial Officer, Treasurer or Chief Investment Officer) or a person designated by them who has direct or indirect supervisory authority over the actual trading of assets and derivatives must certify that the hedging strategy meets the definition of a Clearly Defined Hedging Strategy and that the Clearly Defined Hedging Strategy is the hedging strategy being used by the company in its actual day to day risk mitigation efforts.

APPENDIX 8 – Certification Requirements

A8.1) Management Certification

Management must provide signed and dated written representations as part of the valuation documentation that the valuation appropriately reflects management's intent and ability to carry out specific courses of actions on behalf of the entity where such is relevant to the valuation. This certification will be submitted no later than March 1. Upon written request by the company, the commissioner may grant an extension of the date for submission of the certification.

A8.2) Actuarial Certification

A) General Description. The certification shall be provided by a qualified actuary and consist of at least the following:

1) A paragraph identifying the actuary and his or her qualifications;

2) A scope paragraph identifying the reserves as of the valuation date for contracts included in the certification categorized by the approaches used to determine the reserves (e.g., Alternative Methodology, Projections, Standard Scenario);

3) A reliance paragraph describing those areas, if any, where the certifying actuary has relied on other experts;
   a) A reliance statement from each of those relied on should accompany the certification.
   b) The reliance statements should note the information being provided and a statement as to the accuracy, completeness or reasonableness, as applicable, of the information.

4) A paragraph certifying that the reserve was calculated in accordance with the principles and requirements of the Guideline;

5) A paragraph certifying that the assumptions used for these calculations are Prudent Estimate assumptions for the products, scenarios, and purpose being tested; and

6) A paragraph stating that the qualified actuary is not opining on the adequacy of the company's surplus or its future financial condition.

7) This certification will be submitted no later than March 1. Upon written request by the company, the commissioner may grant an extension of the date for submission of the certification.

A8.3) Supporting Memorandum

A) General Description. A supporting memorandum shall be created to document the methodology and assumptions used to determine the Aggregate Reserve. The information shall include the comparison of the Standard Scenario Amount to the Conditional Tail Expectation Amount required by Section IV)A) in the determination of the Aggregate Reserve.

B) Alternative Methodology using Published Factors.

1) If a seriatim approach was not used, disclose how contracts were grouped.

2) Disclosure of assumptions to include:
   a) Component CA
      (i) Mapping to prescribed asset categories
      (ii) Lapse and withdrawal rates
   b) Component FE
      (i) Determination of fixed dollar costs and revenues
      (ii) Lapse and withdrawal rates
      (iii) Inflation rates
   c) Component GC
      (i) Disclosure of contract features and how the company mapped the contract form to those forms covered by the Alternative Methodology factors
         - Product Definition - If not conservatively assigned to a published factor, company specific factors or stochastic modeling is required.
         - Partial Withdrawal Provision
         - Fund Class - Disclose the process used to determine the single asset class that best represents the exposure for a contract. If individual funds are mapped into prescribed categories, the process used to map the individual funds should be disclosed.
         - Attained Age
         - Contract Duration
         - Ratio of Account Value to Guaranteed Value
         - Annualized Account Charge Differential from Base Assumption
      (ii) Derivation of Equivalent Account Charges
      (iii) Derivation of margin offset
      (iv) Disclosure of interpolation procedures and confirmation of node determination

3) Disclosure, if applicable, of reinsurance that exists and how it was handled in applying published factors (For some reinsurance, creation of company-specific factors or stochastic modeling may be required.).
   a) Discuss how reserves before reinsurance were determined.

C) Alternative Factors based on Company-Specific Factors.

1) Disclosure of requirements consistent with Published Factors, as noted in subsection B) above.

2) Stochastic analysis supporting adjustments to published factors should be fully documented. This analysis needs to be submitted when initially used and be available upon request in subsequent years. Adjustments may include:
   a) Contract design;
   b) Risk mitigation strategy (excluding hedging); and
   c) Reinsurance.

D) Stochastic Modeling.

1) Assets
   a) Description including type and quality
   b) Investment & disinvestment assumptions
   c) Describe assets used at the start of the projection
   d) Source of asset data

e) Asset valuation basis

f) Documentation of assumptions
   (i) Default costs
   (ii) Prepayment functions
   (iii) Market value determination
   (iv) Yield on assets acquired
   (v) Mapping and grouping of funds to modeled asset classes

g) Hedging Strategy
   (i) Documentation of strategy
   (ii) Identification of current positions
   (iii) Description on how strategy was incorporated into modeling
      - Basis risk, gap risk, price risk, assumption risk
      - Document the methods and criterion used to estimate the a priori effectiveness of the hedging strategy
   (iv) Documentation required for specific consideration raised in section A7.4).
   (v) Documentation and certification required by section A7.5).

2) Liabilities

a) Product descriptions

b) Source of Liabilities

c) Grouping of contracts

d) Reserve method and modeling (e.g., Working Reserves were set to CSV)

e) Investment Reserves

f) Describe how reinsurance was handled in the models, including how reserves gross of reinsurance were modeled.

g) Documentation of assumptions (i.e., list assumptions, discuss the sources and the rationale for using the assumptions).
   (i) Premiums and subsequent deposits
   (ii) Withdrawal, Lapse and Termination Rates
      - Partial Withdrawal (including treatment of dollar-for-dollar offsets on GMDBs and VAGLBs, and Required Minimum Distributions
      - Lapses / Surrenders
   (iii) Crediting Strategy
   (iv) Mortality
   (v) Annuitization rates
   (vi) Income Purchase rates
   (vii) GMIB and GMWB Utilization rates
   (viii) Commissions
   (ix) Expenses
   (x) Persistency Bonuses
   (xi) Investment / Fund Choice
   (xii) Revenue Sharing
   (xiii) Asset Allocation, Rebalancing and Transfer Assumptions
      - Dollar Cost Averaging

h) The section showing the assumptions used for lapse and utilization assumptions for contracts with guaranteed living benefits in the development of the Conditional Tail Expectation Amount, as described in section A9.7).

3) Scenarios

a) Description of scenario generation for interest rates and equity returns

(i) Disclose the number "n" of scenarios used and the methods used to determine the sampling error of the CTE(70) statistic when using "n" scenarios.

(ii) Time step of model (e.g., monthly, quarterly, annual)

(iii) Correlation of fund returns

b) Calibration

(i) Gross Wealth Ratios for equity funds

- Disclosure of adjustments to model parameters, if any.
- Disclosure of 1-year, 5-year and 10-year wealth factors, as well as mean and standard deviation.

(ii) Consistency of other funds to equity funds

(iii) Correlation between all funds

(iv) Estimate of market return volatility assumptions underlying the generated scenarios compared to actual observed volatility underlying market values.

c) Extent of use of pre-packaged scenarios and support for mapping variable accounts to proxy funds

4) Description and results of sensitivity tests performed. At the request of the domiciliary commissioner, the company shall provide a sensitivity test showing an estimate of the impact of the market return volatility assumption when market volatility is materially higher than assumed in the generated scenarios.

5) Documentation of all material changes in the model or assumptions from that used previously and the estimated impact of such changes. This documentation, or a summary of this documentation, shall be included in an executive summary or some other prominent place in the memorandum.

6) A description of the methods used to validate the model and a summary of the results of the validation testing.

E) Standard Scenario.

1) For the amounts in 2), 3) and 4) below report the Basic Reserve in A3.3)B)2)a), the projection requirements in A3.3)B)2)b), the value of Aggregate reinsurance in A3.3)D)1), the value of hedges in A3.3)D)2), the total allocation of the value of hedges and Aggregate reinsurance in A3.3)B)2)c) and the Standard Scenario Reserve.

2) Report the Standard Scenario Amount as of the valuation date.

3) If applicable, report the Standard Scenario Amount on the inforce prior to the valuation date that was used to project the reserve requirements to the valuation date.

4) If applicable, report the Standard Scenario Amount on the model office used to represent the inforce.

5) Discuss modifications, if any, in the application of the standard scenario requirements to produce the amounts in 2), 3) and 4) above.

6) Document any assumptions, judgments or procedures not prescribed in the Standard Scenario Method or in the Guideline that are used to produce the Standard Scenario Amount.

7) If applicable, documentation of approval by the commissioner to use the Basic Reserve as the Standard Scenario Amount.

8) Document the company's calculation of DR.

9) Document the allocation of funds to Equity, Bond, Balanced and Fixed classes.

10) A statement by the actuary that none of the reinsurance treaties included in the Standard Scenario serve solely to reduce the calculated Standard Scenario Reserve without also reducing risk on scenarios similar to those used to determine the Conditional Tail Expectation Reserve. This should be accompanied by a description of any reinsurance treaties that have been excluded from the Standard Scenario along with an explanation of why the treaty was excluded.

F) The memorandum shall be made available for examination by the commissioner upon his or her request but shall be returned to the company after such examination and shall not be considered a record of the insurance department or subject to automatic filing with the commissioner.

APPENDIX 9 – Contractholder Behavior

A9.1) General

Contractholder behavior assumptions encompass actions such as lapses, withdrawals, transfers, recurring deposits, benefit utilization, option election, etc. Contractholder behavior is difficult to predict and behavior assumptions can significantly impact the results. In the absence of relevant and fully credible empirical data, the actuary should set behavior assumptions on the conservative end of the plausible spectrum (consistent with the definition of Prudent Estimate).

In setting behavior assumptions, the actuary should examine, but not be limited by, the following considerations:

1) Behavior can vary by product, market, distribution channel, fund performance, time/product duration, etc.

2) Options embedded in the product may impact behavior.

3) Options may be elective or non-elective in nature. Living benefits are often elective and death benefit options are generally non-elective.

4) Elective contractholder options may be more driven by economic conditions than non-elective options.

5) As the value of a product option increases, there is an increased likelihood that contractholders will behave in a manner that maximizes their financial interest (e.g., lower lapses, higher benefit utilization, etc.).

6) Behavior formulas may have both rational and irrational components (irrational behavior is defined as situations where some contractholders may not always act in their best financial interest). The rational component should be dynamic but the concept of rationality need not be interpreted in strict financial terms and might change over time in response to observed trends in contractholder behavior based on increased or decreased financial efficiency in exercising their contractual options.

7) Options that are ancillary to the primary product features may not be significant drivers of behavior. Whether an option is ancillary to the primary product features depends on many things such as:
    a) For what purpose was the product purchased?
    b) Is the option elective or non-elective?
    c) Is the value of the option well known?

8) External influences, including emergence of viatical / life settlement companies, may impact behavior.

A9.2) Aggregate vs. Individual Margins

As noted in Section III)B)8), Prudent Estimate assumptions are developed by applying a margin for uncertainty to the Anticipated Experience assumption. The issue of whether the level of the margin applied to the Anticipated Experience assumption is determined in aggregate or independently for each and every behavior assumption is discussed in Principle 3 in Section II) of this Guideline, which states:

> The choice of a conservative estimate for each assumption may result in a distorted measure of the total risk. Conceptually, the choice of assumptions and the modeling decisions should be made so that the final result approximates what would be obtained for the Conditional Tail Expectation Amount at the required CTE level if it were possible to calculate results over the joint distribution of all future outcomes. In applying this concept to the actual calculation of the Conditional Tail Expectation Amount, the actuary should be guided by evolving practice and expanding knowledge base in the measurement and management of risk.

Although this Principle discusses the concept of determining the level of margins in aggregate, it notes that the application of this concept shall be guided by evolving practice and expanding knowledge. From a practical standpoint, it may not always be possible to completely apply this concept to determine the level of margins in aggregate for all behavior assumptions.

Therefore, the actuary shall determine Prudent Estimate assumptions independently for each behavior (e.g., mortality lapses, and benefit utilization), using the requirements and guidance in this Appendix and throughout the guideline, unless the actuary can demonstrate that an appropriate method was used to determine the level of margin in aggregate for two or more behaviors.

A9.3) Sensitivity Testing

The impact of behavior can vary by product, time period, etc. Sensitivity testing of assumptions is required and shall be more complex than e.g., base lapse assumption minus 1% across all contracts. A more appropriate sensitivity test in this example might be to devise parameters in a dynamic lapse formula to reflect more out-of-the-money contracts lapsing and/or more holders of in-the-money contracts persisting and eventually utilizing the guarantee. The actuary should apply more caution in setting assumptions for behaviors where testing suggests that stochastic modeling results are sensitive to small changes in such assumptions. For such sensitive behaviors, the actuary shall use higher margins when the underlying experience is less than fully relevant and credible.

A9.4) Specific Considerations and Requirements

Within materiality considerations, the actuary should consider all relevant forms of contractholder behavior and persistency, including but not limited to the following:

1) Mortality (additional guidance and requirements regarding mortality is contained in Appendix 10)

2) Surrenders

3) Partial Withdrawals (Systematic and Elective)

4) Fund Transfers (Switching/Exchanges)

5) Resets/Ratchets of the Guaranteed Amounts (Automatic and Elective)

6) Future Deposits

It may be acceptable to ignore certain items that might otherwise be explicitly modeled in an ideal world, particularly if the inclusion of such items reduces the calculated provisions. For example:

1) The impact of fund transfers (intra-contract fund "switching") might be ignored, unless required under the terms of the contract (e.g., automatic asset re-allocation/rebalancing, dollar cost averaging accounts, etc.)

2) Future deposits might be excluded from the model, unless required by the terms of the contracts under consideration and then only in such cases where future premiums can reasonably be anticipated (e.g., with respect to timing and amount).

However, the actuary should exercise caution in assuming that current behavior will be indefinitely maintained. For example, it might be appropriate to test the impact of a shifting asset mix and/or consider future deposits to the extent they can reasonably be anticipated and increase the calculated amounts.

Normally, the underlying model assumptions would differ according to the attributes of the contract being valued. This would typically mean that contractholder behavior and persistency may be expected to vary according to such characteristics as (this is not an exhaustive list):

1) Gender

2) Attained age

3) Issue age

4) Contract duration

5) Time to maturity

6) Tax status

7) Fund value

8) Investment option

9) Guaranteed benefit amounts

10) Surrender charges, transaction fees or other contract charges

11) Distribution channel

Unless there is clear evidence to the contrary, behavior assumptions should be no less conservative than past experience. Margins for contractholder behavior assumptions shall assume, without relevant and credible experience or clear evidence to the contrary, that contractholders' efficiency will increase over time.

In determining contractholder behavior assumptions, the company shall use actual experience data directly applicable to the business segment (i.e., direct data) if it is available. In the absence of direct data, the company should then look to use data from a segment that are similar to the business segment (i.e., other than direct experience), whether or not the segment is directly written by the company. If data from a similar business segment are used, the assumption shall be adjusted to reflect differences between the two segments. Margins shall reflect the data uncertainty associated with using data from a similar but not identical business segment. The actuary shall document any significant similarities or differences between the two business segments, the data quality of the similar business segment and the adjustments and the margins applied.

Where relevant and fully credible empirical data do not exist for a given contractholder behavior assumption, the actuary shall set the contractholder behavior assumption to reflect the increased uncertainty such that the contractholder behavior assumption is shifted towards the conservative end of the plausible range of expected experience that serves to increase the Aggregate Reserve. If there are no relevant data, the actuary shall set the contractholder behavior assumption to reflect the increased uncertainty such that the contractholder behavior assumption is at the conservative end of the range. Such adjustments shall be consistent with the definition of Prudent Estimate, with the Principles described in Section I, and with the guidance and requirements in this Appendix.

Ideally, contractholder behavior would be modeled dynamically according to the simulated economic environment and/or other conditions. It is important to note, however, that contractholder behavior should neither assume that all contractholders act with 100% efficiency in a financially rational manner nor assume that contractholders will always act irrationally.

A9.5) Dynamic Assumptions

Consistent with the concept of Prudent Estimate assumptions described earlier, the liability model should incorporate margins for uncertainty for all risk factors which are not dynamic (i.e., the non-scenario tested assumptions) and are assumed not to vary according to the financial interest of the contractholder.

The actuary should exercise care in using static assumptions when it would be more natural and reasonable to use a dynamic model or other scenario-dependent formulation for behavior. With due regard to considerations of materiality and practicality, the use of dynamic models is encouraged, but not mandatory. Risk factors which are not scenario tested, but could reasonably be expected to vary according to a stochastic process, or future states of the world (especially in response to economic drivers) may require higher margins and/or signal a need for higher margins for certain other assumptions.

Risk factors that are modeled dynamically should encompass the plausible range of behavior consistent with the economic scenarios and other variables in the model, including the non-scenario tested assumptions. The actuary shall test the sensitivity of results to understand the materiality of making alternate assumptions and follow the guidance discussed above on setting assumptions for sensitive behaviors.

A9.6) Consistency with the CTE Level

All behaviors (i.e., dynamic, formulaic and non-scenario tested) should be consistent with the scenarios used in the CTE calculations (generally, the approximately top 1/3 of the loss distribution). To maintain such consistency, it is not necessary to iterate (i.e., successive runs of the model) in order to determine exactly which scenario results are included in the CTE measure. Rather, in light of the products being valued, the actuary should be mindful of the general characteristics of those scenarios likely to represent the tail of the loss distribution and consequently use Prudent Estimate assumptions for behavior that are reasonable and appropriate in such scenarios. For variable annuities, these "valuation" scenarios would typically display one or more of the following attributes:

1) Declining and/or volatile separate account asset values;

2) Market index volatility, price gaps and/or liquidity constraints;

3) Rapidly changing interest rates.

The behavior assumptions should be logical and consistent both individually and in aggregate, especially in the scenarios that govern the results. In other words, the actuary should not set behavior assumptions in isolation, but give due consideration to other elements of the model. The interdependence of assumptions (particularly those governing customer behaviors) makes this task difficult and by definition requires professional judgment, but it is important that the model risk factors and assumptions:

1) Remain logically and internally consistent across the scenarios tested;

2) Represent plausible outcomes; and

3) Lead to appropriate, but not excessive, asset requirements.

The actuary should remember that the continuum of "plausibility" should not be confined or constrained to the outcomes and events exhibited by historic experience.

Companies should attempt to track experience for all assumptions that materially affect their risk profiles by collecting and maintaining the data required to conduct credible and meaningful studies of contractholder behavior.

A9.7) Additional Considerations and Requirements for Assumptions Applicable to Guaranteed Living Benefits

Experience for contracts without guaranteed living benefits may be of limited use in setting a lapse assumption for contracts with in-the-money or at-the-money guaranteed living benefits. Such experience may only be used if it is appropriate (e.g., lapse experience on contracts without a living benefit may have relevance to the early durations of contracts with living benefits) and relevant to the business and is accompanied by documentation that clearly demonstrates the relevance of the experience, as discussed in the following paragraph.

The supporting memorandum required by Appendix 8 of this Guideline, shall include a separately identifiable section showing the assumptions used for lapse and utilization assumptions for contracts with guaranteed living benefits in the development of the Conditional Tail Expectation Amount. This section shall be considered part of the supporting memorandum and shall show the formulas used to set the assumptions and describe the key parameters affecting the level of the assumption (e.g., age, duration, in-the-moneyness, during and after the surrender charge period). The section shall include a summary that shows the lapse and utilization rates that result from various combinations of the key parameters. The section shall show any experience data used to develop the assumptions and describe the source, relevance and credibility of that data. If relevant and credible data were not available, the section should discuss how the assumption is consistent with the requirement that the assumption is to be on the conservative end of the plausible range of expected experience. The section shall also discuss the sensitivity tests performed to support the assumption. This separately identifiable section shall be made available on a standalone basis if requested by the Domiciliary Commissioner. If it is requested, the section shall have the same confidential status as the supporting memorandum and the actuarial memorandum supporting the actuarial opinion, as discussed in section A2.3)B).

Regarding lapse assumptions for contracts with guaranteed living benefits, the section shall include, at a minimum, the following:

1) Actual to expected lapses on two bases, where "expected" equals one of the following:
   a) Prudent estimate assumptions used in the development of the Conditional Tail Expectation Amount;
   b) The assumptions used in the Standard Scenario;

2) The lapse assumptions used in the development of Conditional Tail Expectation Amount and corresponding actual experience separated by:

a) Logical blocks of business (based on company's assessment);
b) Duration (at a minimum this should show during the surrender charge period vs. after the surrender charge period);
c) In-the-moneyness (consistent with how dynamic assumptions are determined); and
d) Age (to the extent age impacts the election of benefits lapse).

This data shall be separated by experience incurred in the following periods:
a) In the past year;
b) In the past three years; and
c) All years.

APPENDIX 10 – Specific Guidance and Requirements for Setting Prudent Estimate Mortality Assumptions

A10.1) Overview

A) Intent. The guidance and requirements in this Appendix apply for setting Prudent Estimate mortality assumptions when determining the Conditional Tail Expectation Amount (whether using projections or the Alternative Methodology). The intent is for Prudent Estimate mortality assumptions to be based on facts, circumstances and appropriate actuarial practice (where more than one approach to appropriate actuarial practice exists, the actuary should select the practice that the actuary deems most appropriate under the circumstances) with only a limited role for unsupported actuarial judgment.

B) Description. Prudent Estimate mortality assumptions are determined by first developing expected mortality curves based on either available experience or published tables. Where necessary, margins are applied to the experience to reflect data uncertainty. The expected mortality curves are then adjusted based on the credibility of the experience used to determine the expected mortality curve. Section A10.2) addresses guidance and requirements for determining expected mortality curves and section A10.3) addresses guidance and requirements for adjusting the expected mortality curves to determine Prudent Estimate mortality.

Finally, the credibility-adjusted tables shall be adjusted for mortality improvement (where such adjustment is permitted or required) using the guidance and requirements in section A10.4).

C) Business Segments. For purposes of setting Prudent Estimate mortality assumptions, the products falling under the scope of the Guideline shall be grouped into business segments with different mortality assumptions. The grouping should generally follow the pricing, marketing, management and/or reinsurance programs of the company. Where less refined segments are used for setting the mortality assumption than is used in business management the documentation should address the impact, if material, of the less refined segmentation on the resulting reserves.

D) Margin for Data Uncertainty. The expected mortality curves that are determined in section A10.2) may need to include a margin for data uncertainty. The margin could be in the form of an increase or a decrease in mortality, depending on the business segment under consideration. The margin shall be applied in a direction (i.e., increase or decrease in mortality) that results in a higher reserve. A sensitivity test may be needed to determine the appropriate direction of the provision for uncertainty to mortality. The test could be a prior year mortality sensitivity analysis of the business segment or an examination of current representative cells of the segment.

For purposes of this Appendix, if mortality must be increased (decreased) to provide for uncertainty the business segment is referred to as a plus (minus) segment.

It may be necessary, because of a change in the mortality risk profile of the segment, to reclassify a business segment from a plus (minus) segment to a minus (plus) segment to the extent compliance with this subsection requires such a reclassification.

A10.2) Determination of Expected Mortality Curves

A) Experience Data. In determining expected mortality curves the company shall use actual experience data directly applicable to the business segment (i.e., direct data) if it is available. In the absence of direct data, the company should then look to use data from a segment that is similar to the business segment (i.e., other than direct experience). See section B) below for additional considerations. Finally, if there is no data, the company shall use the applicable table, as required in subsection C) below.

B) Data Other than Direct Experience. If expected mortality curves for a segment are being determined using data from a similar business segment (whether or not directly written by the company), the actuary shall document any similarities or differences between the two business segments (e.g., type of underwriting, marketing channel, average policy size, etc.). The actuary shall also document the data quality of the mortality experience of the similar business. Adjustments shall be applied to the data to reflect differences between the business segments and margins shall be applied to the adjusted expected mortality curves to reflect the data uncertainty associated with using data from a similar but not identical business segment. The actuary shall document the adjustments and the margins applied.

To the extent the mortality of a business segment is reinsured, any mortality charges that are consistent with the company's own pricing and applicable to a substantial portion of the mortality risk may also be a reasonable starting point for the determination of the company's expected mortality curves. The actuary shall document the application of such reinsurance charges and how they were used to set the company's expected mortality curves for the segment.

C) No Data Requirements. When little or no experience or information is available on a business segment, the company shall use expected mortality curves that would produce expected deaths no less than using 100% of the 1994 Variable Annuity MGDB mortality table for a plus segment and expected deaths no greater than 100% of the Annuity 2000 table for a minus segment. If mortality experience on the business segment is expected to be atypical (e.g., demographics of target markets are known to have higher (lower) mortality than typical), these "no data" mortality requirements may not be adequate.

D) Additional Considerations Involving Data. The following considerations shall apply to mortality data specific to the business segment for which assumptions are being determined (i.e., direct data discussed in subsection A) above or other than direct data discussed in subsection B) above).

1) Underreporting of deaths. Mortality data shall be examined for possible underreporting of deaths. Adjustments shall be made to the data if there is any evidence of underreporting. Alternatively, exposure by lives or amounts on contracts for which death benefits were in the money may be used to determine expected mortality curves. Underreporting on such exposures should be minimal; however, this reduced subset of data will have less credibility.

2) Experience by contract duration. Experience of a plus segment shall be examined to determine if mortality by contract duration increases materially due to selection at issue. In the absence of information, the actuary shall assume that expected mortality will increase by contract duration for an appropriate select period. As an alternative, if the actuary determines that mortality is impacted by selection, the actuary could apply margins to the expected mortality in such a way that the actual mortality modeled does not depend on contract duration.

3) Modification and Relevance of data. Even for a large company the quantity of life exposures and deaths are such that a significant amount of smoothing may be required to determine expected mortality curves from mortality experience. Expected mortality curves, when applied to the recent historic exposures (e.g., 3 to 7 years), should not result in an estimate of aggregate number of deaths less (greater) than the actual number deaths during the exposure period for plus (minus) segments. If this condition is not satisfied,

the actuary must document the rationale in support of using expected mortality that differs from recent mortality experience.

In determining expected mortality curves (and the credibility of the underlying data), older data may no longer be relevant. The "age" of the experience data used to determine expected mortality curves should be documented. There should be commentary in the documentation on the relevance of the data (e.g., any actual and expected changes in markets, products and economic conditions over the historic and projected experience).

4) Other considerations. In determining expected mortality curves, consideration should be given to factors that include, but are not limited to, trends in mortality experience, trends in exposure, volatility in year-to-year A/E mortality ratios, mortality by lives relative to mortality by amounts, changes in the mix of business and product features that could lead to mortality selection.

E) Documentation Requirements.

1) All Segments. The documentation should include any material considerations necessary to understand the development of mortality assumptions for the statutory valuation even if such considerations are not explicitly mentioned in this section. The documentation should be explicit when material judgments were required and such judgments had to be made without supporting historic experience.

The documentation shall:

a) Explain the rationale for the grouping of contracts into different segments for the determination of mortality assumptions and characterize the type and quantity of business that constitute each segment.

b) Describe how each segment was determined to be a plus or minus segment.

c) Summarize any mortality studies used to support mortality assumptions, quantify the exposures and corresponding deaths, describe the important characteristics of the exposures and comment on unusual data points or trends.

d) Document the age of the experience data used to determine expected mortality curves and comment on the relevance of the data.

e) Document the mathematics used to adjust mortality based on credibility and summarize the result of applying credibility to the mortality segments.

f) Discuss any assumptions made on mortality improvements, the support for such assumptions and how such assumptions adjusted the modeled mortality.

g) Describe how the expected mortality curves compare to recent historic experience and comment on any differences.

h) Discuss how the mortality assumptions are consistent with the goal of achieving the required CTE level over the joint distribution of all future outcomes, in keeping with Principle #3 and Appendix 9.

If the study was done on a similar business segment, identify the differences in the business segment on which the data were gathered and the business segment on which the data were used to determine mortality assumptions for the statutory valuation. Describe how these differences were reflected in the mortality used in modeling.

If mortality assumptions for the statutory valuation were based in part on reinsurance rates, document how the rates were used to set expected mortality (e.g., assumptions made on loadings in the rates and/or whether the assuming company provided their expected mortality and the rationale for their assumptions).

2) Plus Segments. For a plus segment, the documentation shall also discuss the examination of the mortality data for the underreporting of deaths and experience by duration, and describe any adjustments that were made as a result of the examination.

3) Minus Segments. For a minus segment the documentation shall also discuss how the mortality deviations on minus segments compare to those on any plus segments. To the extent the overall margin is reduced, the documentation should include support for this assumption.

A10.3) Adjustment for Credibility to Determine Prudent Estimate Mortality

A) Adjustment for Credibility. The expected mortality curves determined in section A10.2) shall be adjusted based on the credibility of the experience used to determine the curves in order to arrive at Prudent Estimate mortality. The adjustment for credibility shall result in blending the expected mortality curves with a mortality table consistent with a statutory valuation mortality table. For a plus segment, the table shall be consistent with 100% of the 1994 Variable Annuity MGDB table (or a more recent mortality table adopted by the NAIC to replace this table). For a minus segment, the table shall be consistent with 100% of the 2000 Annuity table (or a more recent mortality table adopted by the NAIC to replace that table). The approach used to adjust the curves shall suitably account for credibility.[40]

B) Adjustment of Statutory Valuation Mortality for Improvement. For purposes of the adjustment for credibility, the statutory valuation mortality table for a plus segment may be and the statutory valuation mortality table for a minus segment must be adjusted for mortality improvement. Such adjustment shall reflect applicable published industrywide experience from the effective date of the respective statutory valuation mortality table to the experience weighted average date underlying the data used to develop the expected mortality curves (discussed in section A10.2)).

C) Credibility Procedure. The credibility procedure used shall:

1) Produce results that are reasonable in the professional judgment of the actuary,

2) Not tend to bias the results in any material way,

3) Be practical to implement,

4) Give consideration to the need to balance responsiveness and stability,

5) Take into account not only the level of aggregate claims but the shape of the mortality curve, and

6) Contain criteria for full credibility and partial credibility that have a sound statistical basis and be appropriately applied.

Documentation of the credibility procedure used shall include a description of the procedure, the statistical basis for the specific elements of the credibility procedure, and any material changes from prior credibility procedures.

D) Further Adjustment of the Credibility-adjusted Table for Mortality Improvement. The credibility-adjusted table used for plus segments may be and the credibility adjusted date used for minus

[40] For example, when credibility is zero, an appropriate approach should result in a mortality assumption consistent with 100% of the statutory valuation mortality table used in the blending.

segments must be adjusted for applicable published industrywide experience from the experience weighted average date underlying the company experience used in the credibility process to the valuation date.

Any adjustment for mortality improvement beyond the valuation date is discussed in section A10.4).

A10.4) Future Mortality Improvement

The mortality assumption resulting from the requirements of section A10.3) shall be adjusted for mortality improvements beyond the valuation date if such an adjustment would serve to increase the resulting Conditional Tail Expectation Amount. If such an adjustment would reduce the Conditional Tail Expectation Amount, such assumptions are permitted, but not required. In either case, the assumption must be based on current relevant data with a margin for uncertainty (increasing assumed rates of improvement if that results in a higher reserve, reducing them otherwise).

APPENDIX 11 - 1994 Variable Annuity MGDB Mortality Table

FEMALE Age Last Birthday

AGE	$1000q_x$	AGE	$1000q_x$	AGE	$1000q_x$	AGE	$1000q_x$	AGE	$1000q_x$
1	0.519	24	0.344	47	1.371	70	16.957	93	192.270
2	0.358	25	0.346	48	1.488	71	18.597	94	210.032
3	0.268	26	0.352	49	1.619	72	20.599	95	228.712
4	0.218	27	0.364	50	1.772	73	22.888	96	248.306
5	0.201	28	0.382	51	1.952	74	25.453	97	268.892
6	0.188	29	0.403	52	2.153	75	28.372	98	290.564
7	0.172	30	0.428	53	2.360	76	31.725	99	313.211
8	0.158	31	0.455	54	2.589	77	35.505	100	336.569
9	0.154	32	0.484	55	2.871	78	39.635	101	360.379
10	0.159	33	0.514	56	3.241	79	44.161	102	385.051
11	0.169	34	0.547	57	3.713	80	49.227	103	411.515
12	0.185	35	0.585	58	4.270	81	54.980	104	439.065
13	0.209	36	0.628	59	4.909	82	61.410	105	465.584
14	0.239	37	0.679	60	5.636	83	68.384	106	488.958
15	0.271	38	0.739	61	6.460	84	75.973	107	507.867
16	0.298	39	0.805	62	7.396	85	84.432	108	522.924
17	0.315	40	0.874	63	8.453	86	94.012	109	534.964
18	0.326	41	0.943	64	9.611	87	104.874	110	543.622
19	0.333	42	1.007	65	10.837	88	116.968	111	548.526
20	0.337	43	1.064	66	12.094	89	130.161	112	550.000
21	0.340	44	1.121	67	13.318	90	144.357	113	550.000
22	0.343	45	1.186	68	14.469	91	159.461	114	550.000
23	0.344	46	1.269	69	15.631	92	175.424	115	1000.000

APPENDIX 11 - 1994 Variable Annuity MGDB Mortality Table

MALE Age Last Birthday

AGE	$1000q_x$	AGE	$1000q_x$	AGE	$1000q_x$	AGE	$1000q_x$	AGE	$1000q_x$
1	0.587	24	0.760	47	2.366	70	29.363	93	243.533
2	0.433	25	0.803	48	2.618	71	32.169	94	264.171
3	0.350	26	0.842	49	2.900	72	35.268	95	285.199
4	0.293	27	0.876	50	3.223	73	38.558	96	305.931
5	0.274	28	0.907	51	3.598	74	42.106	97	325.849
6	0.263	29	0.935	52	4.019	75	46.121	98	344.977
7	0.248	30	0.959	53	4.472	76	50.813	99	363.757
8	0.234	31	0.981	54	4.969	77	56.327	100	382.606
9	0.231	32	0.997	55	5.543	78	62.629	101	401.942
10	0.239	33	1.003	56	6.226	79	69.595	102	422.569
11	0.256	34	1.005	57	7.025	80	77.114	103	445.282
12	0.284	35	1.013	58	7.916	81	85.075	104	469.115
13	0.327	36	1.037	59	8.907	82	93.273	105	491.923
14	0.380	37	1.082	60	10.029	83	101.578	106	511.560
15	0.435	38	1.146	61	11.312	84	110.252	107	526.441
16	0.486	39	1.225	62	12.781	85	119.764	108	536.732
17	0.526	40	1.317	63	14.431	86	130.583	109	543.602
18	0.558	41	1.424	64	16.241	87	143.012	110	547.664
19	0.586	42	1.540	65	18.191	88	156.969	111	549.540
20	0.613	43	1.662	66	20.259	89	172.199	112	550.000
21	0.642	44	1.796	67	22.398	90	188.517	113	550.000
22	0.677	45	1.952	68	24.581	91	205.742	114	550.000
23	0.717	46	2.141	69	26.869	92	223.978	115	1000.000

APPENDIX 11 - 1994 Variable Annuity MGDB Mortality Table

FEMALE Age Nearest Birthday

AGE	1000q_x	AGE	1000q_x	AGE	1000q_x	AGE	1000q_x	AGE	1000q_x
1	0.628	24	0.344	47	1.316	70	16.239	93	184.435
2	0.409	25	0.344	48	1.427	71	17.687	94	201.876
3	0.306	26	0.348	49	1.549	72	19.523	95	220.252
4	0.229	27	0.356	50	1.690	73	21.696	96	239.561
5	0.207	28	0.372	51	1.855	74	24.107	97	259.807
6	0.194	29	0.392	52	2.050	75	26.832	98	281.166
7	0.181	30	0.415	53	2.256	76	29.954	99	303.639
8	0.162	31	0.441	54	2.465	77	33.551	100	326.956
9	0.154	32	0.470	55	2.713	78	37.527	101	350.852
10	0.155	33	0.499	56	3.030	79	41.826	102	375.056
11	0.163	34	0.530	57	3.453	80	46.597	103	401.045
12	0.175	35	0.565	58	3.973	81	51.986	104	428.996
13	0.195	36	0.605	59	4.569	82	58.138	105	456.698
14	0.223	37	0.652	60	5.250	83	64.885	106	481.939
15	0.256	38	0.707	61	6.024	84	72.126	107	502.506
16	0.287	39	0.771	62	6.898	85	80.120	108	518.642
17	0.309	40	0.839	63	7.897	86	89.120	109	531.820
18	0.322	41	0.909	64	9.013	87	99.383	110	541.680
19	0.331	42	0.977	65	10.215	88	110.970	111	547.859
20	0.335	43	1.037	66	11.465	89	123.714	112	550.000
21	0.339	44	1.091	67	12.731	90	137.518	113	550.000
22	0.342	45	1.151	68	13.913	91	152.286	114	550.000
23	0.344	46	1.222	69	15.032	92	167.926	115	1000.000

APPENDIX 11 - 1994 Variable Annuity MGDB Mortality Table

MALE Age Nearest Birthday

AGE	1000q_x	AGE	1000q_x	AGE	1000q_x	AGE	1000q_x	AGE	1000q_x
1	0.701	24	0.738	47	2.246	70	28.068	93	234.658
2	0.473	25	0.782	48	2.486	71	30.696	94	255.130
3	0.393	26	0.824	49	2.751	72	33.688	95	276.308
4	0.306	27	0.860	50	3.050	73	36.904	96	297.485
5	0.280	28	0.892	51	3.397	74	40.275	97	317.953
6	0.268	29	0.922	52	3.800	75	44.013	98	337.425
7	0.257	30	0.948	53	4.239	76	48.326	99	356.374
8	0.238	31	0.971	54	4.706	77	53.427	100	375.228
9	0.230	32	0.992	55	5.234	78	59.390	101	394.416
10	0.233	33	1.003	56	5.854	79	66.073	102	414.369
11	0.245	34	1.004	57	6.601	80	73.366	103	436.572
12	0.267	35	1.006	58	7.451	81	81.158	104	460.741
13	0.302	36	1.020	59	8.385	82	89.339	105	484.644
14	0.352	37	1.054	60	9.434	83	97.593	106	506.047
15	0.408	38	1.111	61	10.629	84	105.994	107	522.720
16	0.463	39	1.182	62	12.002	85	115.015	108	534.237
17	0.509	40	1.268	63	13.569	86	125.131	109	542.088
18	0.544	41	1.367	64	15.305	87	136.815	110	546.908
19	0.573	42	1.481	65	17.192	88	150.191	111	549.333
20	0.599	43	1.599	66	19.208	89	164.944	112	550.000
21	0.627	44	1.725	67	21.330	90	180.886	113	550.000
22	0.658	45	1.867	68	23.489	91	197.834	114	550.000
23	0.696	46	2.037	69	25.700	92	215.601	115	1000.000

Actuarial Guideline XLIV

GROUP TERM LIFE WAIVER OF PREMIUM DISABLED LIFE RESERVES

I. Background

Section 4.G. of the Standard Valuation Law establishes tables approved by the commissioner as the minimum standard for computing reserves for group life insurance and special benefits. The purpose of this Actuarial Guideline (Guideline) is to determine the minimum standard of valuation for group term life waiver of premium disabled life benefits and to recognize the 2005 Group Term Life Waiver (GTLW) Mortality and Recovery Tables.

Group term life policies do not maintain contract reserves beyond the duration of the policy issued to the group policyholder. However, some policies guarantee an extended death benefit to an individual insured who is disabled according to the terms of the policy. Thus, to the extent such guarantees are made, a disabled life reserve must be maintained for each individual that is so disabled. However, prior to the creation of this guideline, there has been no formal guidance regarding the calculation of these disabled life reserves.

II. Scope

This guideline applies to group term life certificates on individuals who become disabled on or after January 1, 2009. Based on the provisions of Section 4.G. of the Standard Valuation Law, companies may apply this to group term life certificates on individuals who became disabled prior to January 1, 2009, provided they obtain permission from the commissioner.

III. Definitions

"2005 GTLW Mortality Tables" means the mortality rate tables shown in Attachments A and B.

"2005 GTLW Recovery Tables" means the recovery rate tables shown in Attachments C and D.

IV. Text

A. Group Waiver of Premium Reserve Calculation

1. The minimum standard of valuation for group term life waiver of premium disabled life benefits shall be the present value of the death benefit payable discounted for interest and recovery. Since there is not a contract reserve based upon an aggregate table, the discounted value of waived premiums is inadequate to support this liability.

2. Except as provided in Section B, the 2005 GTLW Mortality and Recovery Tables shall be used for determining the minimum standard of valuation for any group term life waiver of premium disabled life benefit incurred on or after the effective date of this guideline. The valuation tables were derived from employer-employee group life experience. Other forms of group term life insurance are also subject to the same requirements if they contain similar extended death benefit provisions. Section B offers ways to modify the underlying rates of mortality or recovery if they differ from those associated with the underlying experience in the valuation table.

3. The maximum interest rate shall be the maximum rate permitted by law in the valuation of life insurance of the same guaranteed duration issued on the same date as the claim incurral date of disability. This maximum interest rate shall be used for determining the minimum standard of valuation for any group term life waiver of premium disabled life benefit incurred on or after the effective date of this guideline. The guaranteed duration used to determine the life insurance rate of interest is equal to the largest term in years between the point at which any individual in the group may become disabled and the point at which no death benefit is available. Thus, if a person could become disabled at age 20, and remain disabled, and receive a benefit upon death before age 65, the guaranteed duration would be 45 years. For most groups and companies this would mean the maximum interest rate shall be the rate for life insurance with duration greater than 20 years.

B. Use of Company Experience

1. The Appointed Actuary shall review company experience at least once every five years. The review of company experience can range from a detailed experience study to a high level analysis. The extent of the review must be sufficient to enable the Appointed Actuary to defend any conclusion reached. Company experience shall:

i. Be segmented into policies with similar benefits, on individuals of each gender;

ii. Be experience-specific to the company;

iii. Include all relevant experience in the past three most recent years;

iv. Exclude experience that is not in the past six most recent years;

v. Otherwise be relevant, in accordance with the professional judgment of the Appointed Actuary; and

vi. Not be deemed irrelevant by the commissioner.

2. The commissioner may require a company to use its experience based upon the most recent review referenced in Section B.1 to establish its specific valuation tables if:

i. Actual mortality experience is reasonably expected to be greater than 90% of the 2005 GTLW Mortality Tables; or

ii. Actual recovery experience is reasonably expected to be less than 125% of the 2005 GTLW Recovery Tables.

Under these circumstances, the commissioner may require a company to use the process set out in Section B.4 and establish for the company a minimum value for Z.

3. A company may use its experience exclusively without reference to the standard tabular mortality expected experience or to the standard tabular recovery expected experience to create its specific valuation tables if:

i. The Appointed Actuary can demonstrate and certify the following:

a) The company-specific valuation tables are based on company experience with allowances for graduation and margins for adverse experience;

b) The company-specific mortality valuation tables used for computing minimum reserves for group term life waiver of premium benefits are such that there is at least an 85% statistical confidence that the actual annual aggregate mortality will be less than the mortality in the company-specific-mortality valuation tables; and

c) The company-specific recovery valuation tables used for computing minimum reserves for group term life waiver of premium benefits are such that there is at least an 85% statistical confidence that the actual annual aggregate recoveries will be greater than the recoveries in the company-specific recovery valuation tables.

ii. The company has written permission from the domiciliary commissioner to use the company-specific valuation tables.

iii. Unless otherwise exempted or required, the specific valuation tables shall apply to the computation of minimum reserves for group term life waiver of premium disabled life benefits for claims incurred during or after the calendar year in which the study was performed.

iv. The company shall not use mortality and recovery tables with rates that produce reserves less than the reserves produced by using 75% of the 2005 GTLW Mortality Tables and 160% of the 2005 GTLW Recovery Tables for all durations of disability combined.

4. If not invoking Section B.3, a company may use a credibility-weighted combination of company mortality experience with the 2005 GTLW Mortality Tables and/or of company recovery experience with the 2005 GTLW Recovery Tables to create its specific valuation tables.

i. The blended tables for each gender and type of experience (mortality and recovery) shall be computed using the formula Blended Table = T x S, where:

a) Z shall be a credibility weighting factor, between 0 and 1, developed by the Appointed Actuary using credibility theory methods not unacceptable to the commissioner;

b) F shall be the ratio of the company's actual experience to the expected experience for the 2005 GTLW Mortality and Recovery Tables for each gender and type of experience (mortality and recovery);

c) M shall be 1.12 for mortality tables and 0.80 for recovery tables. The values provide a smooth transition between the 2005 tables and company experience when Z = 1;

d) S shall be the 2005 GTLW Mortality and Recovery Tables; and

e) T shall be computed using the following steps:

Step 1: Compute the raw value of T = [Z x (F x M) + (1 – Z)].

Step 2: Round T to the nearest 5%.

Step 3: If the absolute difference between the T produced in step 2 and the value of T utilized immediately prior to the study is less than 10%, then set T equal to the value of T utilized immediately prior to the study.

Step 4: For all durations of disability, combined for each gender, set the value of T to the greater of 75% and the T resulting from step 3 for mortality and set the value of T to the lesser of 160% and the T resulting from step 3 for recovery.

ii. The company has written permission from the domiciliary commissioner to use the blended valuation tables.

iii. Unless otherwise exempted or required, the specific valuation tables shall apply to the computation of minimum reserves for group term life waiver of premium disabled life benefits for claims incurred during or after the calendar year in which the study was performed.

ATTACHMENT A
2005 GTLW Mortality and Recovery Tables
Graduated Death Rates (1,000Q[X])
Select Period (duration 9 months to 10 years)

MALES

PROBABILITY OF DEATH (1,000Q[X]+T) - SELECT PERIOD

Central Age => Duration of Disability	17	22	27	32	37	42	47	52	57	62	67	72
1 (4th qtr.)	21.3	25.0	25.0	28.8	35.0	35.0	35.0	37.5	38.8	46.3	42.5	38.8
2 (1st qtr.)	26.3	28.8	30.0	36.3	37.5	37.5	37.5	37.5	37.5	37.5	33.8	30.0
2 (2nd qtr.)	27.5	30.0	30.0	37.5	35.0	35.0	33.8	33.8	33.8	33.8	32.5	28.8
2 (3rd qtr.)	31.3	33.8	33.8	33.8	26.3	26.3	27.5	27.5	28.8	28.8	28.8	25.0
2 (4th qtr.)	33.8	38.8	37.5	32.5	22.5	22.5	22.5	22.5	21.3	21.3	21.3	21.3
2 (annual)	107.2	117.9	119.2	128.2	112.6	113.6	114.0	114.7	114.9	115.2	110.7	100.5
3	37.5	56.3	68.8	70.0	71.3	72.5	73.8	75.0	81.3	83.8	86.3	91.3
4	22.5	32.5	60.0	60.0	61.3	62.5	62.5	62.5	68.8	71.3	73.8	77.5
5	15.0	22.5	41.3	48.8	50.0	51.3	52.5	52.5	56.3	58.8	65.0	68.8
6	15.0	22.5	37.5	41.3	42.5	43.8	45.0	46.3	52.5	53.8	68.8	76.3
7	15.0	22.5	27.5	31.3	32.5	33.8	35.0	37.5	48.8	52.5	71.3	78.8
8	15.0	22.5	25.0	28.8	31.3	32.5	33.8	36.3	55.0	57.5	77.5	85.0
9	15.0	22.5	22.5	23.8	28.8	31.3	33.8	40.0	56.3	60.0	81.3	93.8
10	15.0	22.5	18.8	21.3	23.8	27.5	33.8	42.5	56.3	62.5	87.5	101.3

FEMALES

PROBABILITY OF DEATH (1,000Q[X]+T) - SELECT PERIOD

Central Age => Duration of Disability	17	22	27	32	37	42	47	52	57	62	67	72
1 (4th qtr.)	12.5	15.0	20.0	21.3	22.5	26.3	31.3	33.8	36.3	40.0	37.5	35.0
2 (1st qtr.)	11.3	13.8	17.5	20.0	20.0	23.8	30.0	32.5	33.8	36.3	32.5	28.8
2 (2nd qtr.)	11.3	13.8	17.5	20.0	20.0	21.3	28.8	31.3	31.3	32.5	31.3	27.5
2 (3rd qtr.)	10.0	12.5	16.3	18.8	18.8	21.3	25.0	26.3	27.5	27.5	27.5	23.8
2 (4th qtr.)	10.0	11.3	15.0	16.3	16.3	17.5	20.0	21.3	20.0	20.0	20.0	20.0
2 (annual)	39.4	47.4	61.5	70.0	70.3	78.9	97.8	104.8	106.4	110.3	105.8	95.7
3	18.8	28.8	36.3	37.5	40.0	43.8	52.5	65.0	66.3	67.5	76.3	80.0
4	15.0	21.3	25.0	26.3	28.8	31.3	40.0	48.8	55.0	56.3	63.8	67.5
5	10.0	18.8	23.8	25.0	26.3	28.8	31.3	37.5	45.0	51.3	56.3	58.8
6	10.0	16.3	17.5	17.5	20.0	23.8	30.0	35.0	45.0	48.8	60.0	62.5
7	10.0	13.8	15.0	16.3	17.5	23.8	30.0	35.0	43.8	50.0	63.8	66.3
8	10.0	13.8	15.0	16.3	17.5	22.5	28.8	33.8	43.8	51.3	68.8	71.3
9	10.0	12.5	15.0	16.3	17.5	20.0	28.8	33.8	41.3	52.5	73.8	77.5
10	10.0	11.3	13.8	15.0	17.5	20.0	28.8	33.8	40.0	52.5	78.8	83.8

ATTACHMENT B
2005 GTLW Mortality and Recovery Tables
Graduated Death Rates (1,000Q[X])
Ultimate Period (11+ years)

Attained Age	Male	Female
27	12.5	10.0
28	12.5	10.0
29	12.5	10.0
30	13.8	11.3
31	13.8	11.3
32	13.8	11.3
33	13.8	11.3
34	13.8	11.3
35	15.0	12.5
36	15.0	12.5
37	15.0	12.5
38	15.0	12.5
39	16.3	13.8
40	17.5	13.8
41	18.8	15.0
42	18.8	15.0
43	18.8	15.0
44	20.0	16.3
45	20.0	17.5
46	21.3	17.5
47	21.3	18.8
48	22.5	18.8
49	23.8	18.8
50	25.0	20.0
51	26.3	20.0
52	27.5	20.0
53	30.0	22.5
54	31.3	23.8
55	32.5	25.0
56	35.0	27.5
57	36.3	28.8
58	38.8	30.0
59	41.3	31.3
60	42.5	31.3
61	43.8	32.5
62	46.3	33.8
63	48.8	35.0
64	50.0	37.5
65	52.5	38.8
66	55.0	40.0
67	56.3	40.0
68	58.8	42.5
69	60.0	45.0
70	63.8	47.5
71	65.0	50.0
72	66.3	52.5
73	72.5	57.5
74	77.5	62.5
75	82.5	67.5
76	87.5	73.8
77	92.5	78.8
78	95.0	80.0
79	98.8	81.3
80	100.0	82.5
81	103.8	83.8
82	107.5	83.8
83	113.8	88.8
84	121.3	93.8
85	128.8	98.8
86	136.3	105.0
87	143.8	111.3
88	152.5	117.5
89	161.3	123.8
90	171.3	131.3
91	182.5	140.0
92	195.0	150.0
93	210.0	161.3
94	227.5	175.0
95	248.8	191.3
96	280.0	215.0
97	335.0	257.5
98	448.8	345.0
99	1000.0	1000.0

ATTACHMENT C
2005 GTLW Mortality and Recovery Tables
Graduated Recovery Rates (1,000Q[X])
Select Period (duration 9 months to 10 years)

MALES

PROBABILITY OF RECOVERY (1,000Q[X]+T) - SELECT PERIOD

Central Age => Duration of Disability	17	22	27	32	37	42	47	52	57	62	67	72
1 (4th qtr.)	39.7	39.7	32.5	26.7	25.4	19.5	15.0	9.8	7.8	5.2	3.9	3.3
2 (1st qtr.)	37.7	37.7	31.2	26.0	23.4	16.3	13.7	8.5	7.2	5.2	4.6	3.3
2 (2nd qtr.)	34.5	34.5	28.0	22.8	22.1	15.6	12.4	7.8	6.5	4.6	3.9	3.3
2 (3rd qtr.)	31.9	31.9	26.0	21.5	20.8	15.0	9.8	7.2	5.9	3.9	3.3	2.6
2 (4th qtr.)	28.0	28.0	23.4	19.5	18.9	14.3	8.5	6.5	4.6	3.3	2.6	2.0
2 (annual)	120.9	120.5	99.9	82.5	78.5	56.8	41.6	28.2	22.8	16.0	13.6	10.6
3	111.2	111.2	90.4	73.5	54.0	46.2	37.7	23.4	15.0	10.4	7.8	7.2
4	100.1	100.1	75.4	56.6	43.6	35.8	26.0	17.6	11.1	9.1	5.9	5.2
5	81.3	81.3	59.8	43.6	36.4	29.3	17.6	13.7	8.5	7.2	5.2	4.6
6	49.4	49.4	42.3	35.8	31.2	24.1	13.7	9.1	6.5	6.5	4.6	3.9
7	39.0	39.0	35.1	31.2	28.0	20.8	11.1	7.8	5.2	5.2	3.3	2.6
8	34.5	34.5	31.2	28.0	23.4	16.3	10.4	6.5	5.2	3.9	2.0	1.3
9	28.0	28.0	26.7	24.7	20.2	13.7	8.5	5.2	4.6	3.3	1.3	0.7
10	24.7	24.7	22.8	20.8	15.0	11.1	6.5	4.6	3.9	2.6	1.3	0.0

FEMALES

PROBABILITY OF RECOVERY (1,000Q[X]+T) - SELECT PERIOD

Central Age => Duration of Disability	17	22	27	32	37	42	47	52	57	62	67	72
1 (4th qtr.)	61.1	61.1	50.1	41.0	28.6	24.7	16.9	16.3	13.0	8.5	6.5	5.2
2 (1st qtr.)	46.2	46.2	38.4	31.9	26.7	22.1	16.3	15.0	11.7	8.5	7.2	5.9
2 (2nd qtr.)	38.4	38.4	31.2	25.4	24.7	19.5	14.3	13.7	9.8	7.2	5.9	4.6
2 (3rd qtr.)	34.5	34.5	28.6	23.4	22.8	16.9	11.7	11.1	7.8	5.9	4.6	3.9
2 (4th qtr.)	29.9	29.9	24.7	20.8	20.2	15.0	9.1	8.5	5.9	3.9	3.3	2.6
2 (annual)	138.8	138.3	114.7	95.1	88.5	69.3	48.6	45.4	33.3	24.1	19.9	16.2
3	129.4	129.4	105.3	85.8	70.2	59.2	42.3	31.9	20.2	14.3	11.1	9.8
4	125.5	125.5	94.3	70.9	55.3	44.2	29.3	22.8	13.7	11.7	7.2	5.9
5	106.6	106.6	78.0	57.2	43.6	34.5	21.5	15.0	11.7	10.4	7.8	6.5
6	65.7	65.7	55.9	47.5	35.8	26.7	17.6	11.1	9.8	9.8	6.5	5.2
7	48.8	48.8	43.6	39.0	30.6	22.1	16.3	9.1	7.8	7.8	5.2	3.9
8	40.3	40.3	36.4	32.5	26.0	18.2	15.0	8.5	7.2	5.9	3.3	2.0
9	31.9	31.9	29.9	28.0	22.8	15.6	12.4	7.2	5.9	4.6	2.0	0.7
10	27.3	27.3	24.7	22.8	18.9	11.7	7.2	5.2	5.2	3.3	2.0	0.0

ATTACHMENT D
2005 GTLW Mortality and Recovery Tables
Graduated Recovery Rates (1,000Q[X])
Ultimate Period (11+ years)

Attained Age	Male	Female
27	16.3	16.3
28	16.3	16.3
29	16.3	16.3
30	16.3	16.3
31	16.3	16.3
32	16.3	16.3
33	16.3	16.9
34	16.3	17.6
35	16.3	18.9
36	16.3	20.2
37	16.3	21.5
38	15.6	20.8
39	15.0	20.2
40	15.0	19.5
41	14.3	18.2
42	14.3	17.6
43	13.7	17.6
44	13.0	17.6
45	12.4	16.9
46	11.7	16.9
47	11.1	16.9
48	11.1	15.6
49	11.1	14.3
50	10.4	13.0
51	10.4	11.7
52	10.4	11.1
53	9.8	10.4
54	9.1	9.8
55	7.8	9.1
56	7.2	7.8
57	6.5	7.2
58	5.9	6.5
59	5.2	6.5
60	4.6	5.9
61	3.9	5.9
62	3.3	5.2
63	3.3	5.2
64	3.3	5.2
65	3.3	4.6
66	3.3	4.6
67	3.3	4.6
68	2.6	3.9
69	2.0	2.6
70	2.0	2.0
71	1.3	1.3
72	0.7	0.7
73	0.7	0.7
74	0.7	0.7
75	0.7	0.7
76	0.7	0.7
77	0.7	0.7
78	0.7	0.7
79	0.7	0.7
80	0.0	0.0
81	0.0	0.0
82	0.0	0.0
83	0.0	0.0
84	0.0	0.0
85	0.0	0.0
86	0.0	0.0
87	0.0	0.0
88	0.0	0.0
89	0.0	0.0
90	0.0	0.0
91	0.0	0.0
92	0.0	0.0
93	0.0	0.0
94	0.0	0.0
95	0.0	0.0
96	0.0	0.0
97	0.0	0.0
98	0.0	0.0
99	0.0	0.0

Actuarial Guideline XLV

THE APPLICATION OF THE STANDARD NONFORFEITURE LAW FOR LIFE INSURANCE TO CERTAIN POLICIES HAVING INTERMEDIATE CASH BENEFITS

Scope

This Guideline applies to individual life insurance policies, other than variable and non-variable adjustable life policies and current assumption whole life policies, that provide for an endowment benefit, materially less than the policy face amount, at a specified intermediate duration during a longer period of life insurance protection. The payment of such endowment benefit does not alter or eliminate any premiums or benefits scheduled for the period subsequent to the endowment date, nor does the policy automatically terminate upon payment of the endowment benefit. Policies that offer a return of premium endowment benefit may be considered a special case of the policies subject to this Guideline.

Background

In recent years a new category of life insurance products has emerged in the life insurance marketplace. These products offer a cash benefit at a specified time, typically many years prior to the coverage expiry date of the policy, conditioned on the insured being alive and the policy being in force at that time. The cash benefit has often taken the form of an intermediate period endowment that is either built into the policy or is provided through a rider or an endorsement. When the amount of the cash benefit is based upon the premiums paid into the policy, the benefit is often referred to as a return of premium benefit.

The straightforward application of Sections 3 and 5c of the Standard Nonforfeiture Law For Life Insurance (the Law), considering guaranteed benefits and premiums (whether guaranteed or indeterminate) during the entire period death benefits are guaranteed available under the policy, subject only to the payment of required premiums, can result in negative or very low cash values at all durations for these products. This is caused by high premiums assumed applicable in the later durations. This application of the Law produces unacceptable results, as it fails to recognize that the cash benefit should be prefunded with the premiums that fall due prior to the time the benefit becomes available.

The intent of this Guideline is to provide guidance with respect to the required minimum cash values for some of the products described in the Scope section. However, other products within the scope designed to provide similar benefits, and having similar premium structures (for example products having a cash value at the end of an initial level premium period equal to the total premiums paid) would be expected to provide minimum cash values that are determined in a manner consistent with this Guideline. For products with multiple endowment benefits, the minimum cash values should be determined in accordance with the principles of this Guideline.

Text

A. The following methodology shall be used in the determination of minimum cash surrender values for policies subject to this Guideline in accordance with the requirements of the Law.

   1. The endowment period shall be that period of time measured from the issue date of the policy to the date when the endowment benefit becomes payable (the endowment date) under the terms of the policy.

   2. If the endowment benefit is added by rider to a policy, then for minimum cash value determination purposes the base policy and the endowment benefit are to be treated as integrated.

3. Premiums under the policy may be provided through a scale of guaranteed rates for the term of the policy or through a scale of current rates that are subject to a scale of guaranteed maximum premiums; if rates are subject to a scale of guaranteed maximum premiums, the minimum cash values shall be the greater of those produced under this Guideline using the guaranteed maximum rates and current rate scale applicable at issue of the policy.

4. Any cash surrender value available under the policy in the event of default in a premium payment due on any policy anniversary during the endowment period shall be an amount not less than the excess, if any, of the present value, on the anniversary, of the endowment benefit and any future incremental death benefits during the endowment period which would have been provided for by the policy if there had been no default, over the sum of:

   (i) The then present value of the adjusted premiums as defined below corresponding to premiums which would have fallen due on and after the anniversary during the endowment period; and

   (ii) The amount of any indebtedness to the company on the policy.

5. Incremental death benefits are death benefits during the endowment period in excess of the lowest death benefit provided under the policy during the endowment period.

6. The adjusted premiums for the policy shall be calculated on an annual basis and shall be such uniform percentage of the respective premiums specified in the policy for each policy year during the endowment period, excluding amounts payable as extra premiums to cover impairments or special hazards and also excluding any uniform annual contract charge or policy fee specified in the policy in a statement of the method to be used in calculating the cash surrender value and paid-up nonforfeiture benefits, that the present value, at the date of issue of the policy, of all adjusted premiums shall be equal to the sum of:

   (i) The present value of the endowment benefit and any incremental death benefits provided for by the policy during the endowment period;

   (ii) One percent (1%) of the average amount of insurance (total death benefit under the policy, including any incremental death benefits) at the beginning of each of the first ten policy years; and

   (iii) One hundred twenty-five percent (125%) of the nonforfeiture net level premium as defined below, provided however, that no nonforfeiture net level premium shall be considered to exceed 4% of the average amount of insurance (total death benefit under the policy, including any incremental death benefits) at the beginning of each of the first ten policy years.

7. The nonforfeiture net level premium for the policy shall be equal to the present value, at the date of issue of the policy, of the endowment benefit and any incremental death benefits provided for by the policy during the endowment period, divided by the present value, at the date of issue of the policy, of an annuity of one per annum payable on the date of issue of the policy and on each anniversary of such policy on which a premium falls due prior to the endowment date.

8. The mortality rates and interest rate used in the determination of the minimum cash values for the policy shall be those applicable under the Law considering during the entire period death benefits are guaranteed available under the policy, subject only to the payment of required premiums.

B. In no event can the cash surrender value under the policy at any duration be less than the greater of:

1. The minimum cash value calculated according to Section A of this Guideline; and

2. The minimum cash value at the same duration resulting from the application of the methods described in Sections 3 and 5c of the Law considering guaranteed benefits and premiums (whether guaranteed or indeterminate) during the entire period death benefits are guaranteed available under the policy, subject only to the payment of required premiums. In performing this calculation, no annual premium at any duration after the endowment period shall exceed the difference between the death benefit and the cash value at that duration.

C. The cash surrender values for the policy must also satisfy the consistency of progression of cash values test contained in Section 8 of the Law, considering guaranteed benefits and premiums (whether guaranteed or indeterminate) during the entire period death benefits are guaranteed available under the policy, subject only to the payment of required premiums.

D. For policies where the benefit is defined in more general terms as providing for a return of premiums paid or a portion of premiums paid, the procedures of Subsection 5c C of the Law and the requirements of Section A above shall be applied in the determination of a revised set of minimum cash values in the event the value of the endowment benefit of the policy changes due to a change made to the premium schedule provided at issue.

Applicability

This Guideline is effective for all policy forms filed on or after January 1, 2009, and affects all contracts issued on or after January 1, 2010.

Actuarial Guideline XLVI

INTERPRETATION OF THE CALCULATION OF THE SEGMENT LENGTH WITH RESPECT TO THE LIFE INSURANCE POLICIES MODEL REGULATION UPON A CHANGE IN THE VALUATION MORTALITY RATES SUBSEQUENT TO ISSUE

I. Background

Some states have revised their regulation permitting the use of the 2001 CSO Preferred Class Structure Mortality Table so that at the company's option it might be used to value a policy on a plan which was previously approved for issue based on valuation using the 2001 CSO Mortality Table. A company making this election would be changing the valuation mortality rates. It is also the case that use of the 2001 CSO Preferred Class Structure Mortality Table is predicated upon the block of policies initially, and annually thereafter, satisfying certain requirements with respect to the present value of death benefits over certain future periods. If these requirements are not satisfied at some point in the future, the company must change to a table for which the requirements are satisfied. For example, this could mean changing from the super preferred nonsmoker table to the preferred nonsmoker table or maybe from the preferred smoker table to the smoker table. Although a non-elective change, this is also a change in the valuation mortality rates.

Section 4B of the Valuation of Life Insurance Policies Model Regulation defines the "Contract Segmentation Method" in which segments are to be calculated using the valuation mortality rates for deficiency reserves. Thus, potentially either of the two examples given above could trigger a recalculation of the valuation segments at the time the valuation mortality rates are changed. The purpose of this guideline is to prescribe which circumstances involving a change to the valuation mortality rates, require a recalculation of the segments and which do not.

The Valuation of Life Insurance Policies Model Regulation was adopted, in part, to stop the use of high net premiums late in the policy's life from unduly influencing the level of reserves early in the policy's life ("postfunding"). The contract segmentation method was the answer devised to control this. After the adoption of this regulation, companies incorporated the establishment of the segment lengths into the policy design process based on the valuation mortality expected to be used. Now it is seen that there are circumstances in which it may be necessary or desirable to change valuation mortality after issue. But if it triggers a segment recalculation then there could be unintended, undesirable results.

This guideline classifies the circumstances involved in changes to valuation mortality rates into two categories: those where deliberately designed postfunding is less likely so no segment recalculation is prescribed, and those where such postfunding is more possible so segment recalculation is required. In general, non-elective valuation mortality changes require no segment recalculation, while elective valuation mortality changes are divided into those on plans filed for approval before the adoption of this guideline and those filed after adoption. To preclude enhancing postfunding by changing valuation mortality after a plan is approved, recalculation of segments is required if the change is elected on plans filed after adoption of this guideline, but is not required for plans filed before.

II. Scope

This guideline is effective December 31, 2008.

III. Text

A. For policies subject to a non-elective change in valuation mortality rates:

For policies which were the subject of a non-elective change in valuation mortality rates because the requirements for continued use of the prior rates were no longer satisfied, Section 4B of the Valuation of Life Insurance Policies Model Regulation shall be interpreted so that the segments need not be recalculated.

B. For policies subject to a company election to substitute the 2001 Preferred Class Structure Table for the 2001 CSO Mortality Table:

1. For policies issued on a policy form filed for approval prior to January 1, 2009, Section 4B of the Valuation of Life Insurance Policies Model Regulation shall be interpreted so that the segments need not be recalculated.

2. For policies issued on a policy form filed for approval after January 1, 2009, Section 4B of the Valuation of Life Insurance Policies Model Regulation shall be interpreted to require that the segments be recalculated using the new valuation mortality rates.

Actuarial Guideline XLVII

THE APPLICATION OF COMPANY EXPERIENCE IN THE CALCULATION OF CLAIM RESERVES UNDER THE 2012 GROUP LONG-TERM DISABILITY VALUATION TABLE

I. Background

The 2012 Group Long-Term Disability (GLTD) Valuation Table, as included in the *Health Insurance Reserves Model Regulation* (#10), is the valuation standard to replace the Commissioner's Group Disability Table 1987 (CGDT87 Table) with a new one based on the GLTD 2008 Table. This table is referred to as the GLTD 2012 Valuation Table and can be found at the following location:

http://www.naic.org/documents/01_naic_2012_group_long-term_disability_valuation_table.xls

An actuarial guideline is more appropriate to handle the multiple segments of the 2012 GLTD Valuation Table, the computations of own experience and the application of credibility which are not normally found in model regulations.

II. Purpose

The purpose of this Actuarial Guideline is to provide an instruction for the use of the 2012 GLTD Valuation Table that is referenced in the *Health Insurance Reserves Model Regulation* (#10). This guideline pertains to Group Long-Term Disability claims consistent with the conditions defined in the model regulation, and governs the selection of claim termination rates for the purpose of calculating GLTD claim reserves. This guideline does not address reserve adequacy, which remains the concern of the insurer according to the terms expressed in the model regulation.

Although the various detailed formulas in this guideline do not directly address or define reserve adequacy, it is assumed that appropriate adequacy tests will be made periodically. Such adequacy testing is considered to be an additional tool for the actuary to make appropriate choices where leeway from any prescription made herein is allowed (A/E calculation, margin, etc.) so that the calculation of the reserve will generally be adequate and the actuary does not need to continually rely on other measures to achieve adequacy. In addition to the few times that leeway from prescription is mentioned below, nothing in this guideline should be assumed to prohibit the actuary from building a case and requesting permission from the state insurance commissioner for other appropriate variations. Many such situations, because they would apply to fully credible blocks of business and are intended for continual use, should be considered for approval by the commissioner for a period tied to the updates required by Section C.vi and not approved on an annual basis.

III. Text

A. When the insurer follows the instructions provided in this guideline, the selected claim termination rates automatically meet the minimum valuation standard defined in the model regulation.

B. Valuation Table Modifications

If not invoking the small company exception specified in Section D, a company must use a credibility-weighted combination of its own claim termination experience with the 2012 GLTD Valuation Table to create its specific valuation table.

i. For claims in Duration Group 1 (duration ≤ 3 months), termination rates may be developed as below consistent with other Duration Groups or in any other manner deemed appropriate by the actuary. With respect to credibility, any value between 0 and 1.0 that the actuary deems appropriate for the block may be used.

ii. For claims beyond 3 months, the valuation termination rates shall be computed using the termination rates from the 2012 GLTD Valuation Table (S) multiplied by experience adjustment factors (T) that are calculated separately for four different duration groups.

Valuation Termination Rate = $T \times S$

The duration groups are defined as follows:
Group 2: duration > 3 months and duration ≤ 24 months
Group 3 duration > 24 months and duration ≤ 60 months
Group 4: duration > 60 months and duration ≤ 120 months
Group 5: duration > 120 months

a) S shall be the sum of recovery and death rates from the 2012 GLTD Valuation Table.

b) T shall be computed as $T = [Z \times F * (1 - M) + (1 - Z)]$.

1) Z shall be a credibility weighting factor, between 0 and 1, developed for each duration group according to the following specifications:
Groups 2–5: $Z = Min\left(\sqrt{N/_K}, 1\right)$ N is the number of expected recovery and death counts from the 2012 GLTD Valuation Table.

2) K is a set of constants defined by duration group as follows:

Group 2: K = 3,300	Group 4: K = 2,100
Group 3: K = 2,500	Group 5: K = 1,700

3) F shall be the ratio of the company's actual total of recovery and death counts to the expected recovery and death counts for the 2012 GLTD Valuation Table for each duration group specified above.

If the actuary has reserve adequacy or other significant analysis that demonstrates in the development and use of Company Specific Experience (see Section C below) that an alternative measurement is deemed appropriate, such as:

I. Use of some other weighting of claims (gross benefit, net benefit, etc.) that is not only appropriate for measuring A/E, but also is expected to generally produce reserves not less than those produced by using a claim count measurement.

II. Use of an increased credibility factor Z if F is less than 1 to give the company experience more weight.

Then, a basis other than claim count may be used.

4) *M* is the company experience margin, determined for each duration group according to the following formula:

$$M = Min\left(15\%, Max\left(5\%, 3\% + 1.65 * \sqrt{A/C}\right)\right)$$

This is the minimum value for the definition of *M* prior to any reserve adequacy analysis. Adequacy tests and analysis of experience (sharpness of fluctuations, trends over the period of the termination rate study, changing claims practices, etc.) may indicate that a larger value of *M* may be more appropriate. If so, such a value is deemed appropriate.

5) *A* is a set of constants defined by duration group as follows:

Group 2: $A = 4.0$	Group 4: $A = 2.5$
Group 3: $A = 3.0$	Group 5: $A = 2.0$

6) *C* shall be the company's actual number of total recovery and death counts by duration group.

iii. The company shall not use termination rates that produce total reserves for claims disabled for more than two years that are less than the reserves produced for these claims by computing *T* as $\underline{T} = 1.30$. If the Company Specific Experience, determined in Section C below, for Duration Group 3 includes at least 5,000 claim terminations, the value of *T* for that Duration Group shall not be limited to ≤ 1.30

C. Company Specific Experience—Own Experience Measurement
In computing values *F* and *S* to comply with Section B above, the appointed actuary shall:

i. Segment the company claim termination experience into any major subgroups that may produce significantly different results (e.g., market niches, claims operations, unique benefit designs, etc.).

ii. Combine affiliated statutory entities and assumed reinsurance, where claim management is under a common structure, when considering company experience. It is also appropriate to evaluate experience separately when specific blocks of company business have distinct claim management practices or significantly different risk characteristics.

iii. Include all relevant experience the company is capable of providing for as many of the last five years as possible (not including the lag period described below). However, there are two situations where using other than a five-year period may be more appropriate. The first is when a company's experience in a longer period not only increases credibility but is still relevant and appropriate for the company's products and claim management practices. The second is for a company that has had significant changes in product and/or claim management practices within the past five years that has diminished the relevance of the company's experience early in the five-year period. In this second situation, less than five years of experience may be used for any duration band for which there is compelling logic and when either the company's experience to be used is at least 90% credible, or the shorter experience period produces higher reserves than using five years.

iv. Recognize a suitable lag period to allow for a full resolution of claim status. The lag period used in the 2008 GLTD Study was 12 months. However, the appointed actuary may use a different lag period based on his or her company experience. For example, company experience indicates that all changes after the selected lag period are negligible.

v. Measure actual (A) to expected (E) terminations based on claim count (unless another weighting is deemed more appropriate, as mentioned in Section B(ii)(b)4), where the E is based on monthly expected recoveries and deaths from the 2012 GLTD Valuation Table. Claim count is also used in the measurement of credibility.

vi. Update the minimum valuation basis in accordance with Section B above at least once every five years. In addition, the valuation basis also must be updated whenever the company's annual own experience study produces, in accordance with Section B, a value *T* that changes by more than 10% from the one used in the current valuation basis for any of the five duration groups.

vii. Recognize where appropriate any flexibility built into the 2012 GLTD Valuation Table, such as not utilizing diagnosis-specific termination rates when the information is deemed unreliable.

viii. Do not count as terminations those claims that are closed due to settlement (i.e., a lump sum replacing a series of potential future payments), or that have reached the end of the maximum benefit duration, or that are closed due to a contractual limit, such as a mental and nervous limit. For this purpose, a closure due to a change in definition of disability should be considered an actual termination and not a termination due to reaching the maximum benefit duration.

ix. Use experience that is otherwise relevant in accordance with the professional judgment of the appointed actuary.

x. Do not use experience that the commissioner has deemed inappropriate or likely to produce significantly inadequate reserves.

In the above paragraphs, the expression term "company" refers to a single company or a group of legally related companies subject to the same claim management.

D. Own Experience Measurement Exemption

If, at the time of valuation, a company has fewer than 50 open claims disabled within two years of the effective date of the valuation, and fewer than 200 open claims disabled more than two years prior to the effective date of the valuation, the carrier is exempt from the requirement that the 2012 GLTD Valuation Table be modified by the company's own experience. Said company will use 100% of the 2012 Valuation Table for calculating claims termination rates in order to comply with the minimum valuation standard.

Actuarial Guideline XLVIII

ACTUARIAL OPINION AND MEMORANDUM REQUIREMENTS FOR THE REINSURANCE OF POLICIES REQUIRED TO BE VALUED UNDER SECTIONS 6 AND 7 OF THE NAIC VALUATION OF LIFE INSURANCE POLICIES MODEL REGULATION (MODEL 830)

Background

The NAIC Principle-Based Reserving Implementation (EX) Task Force ("PBRI Task Force") serves as the coordinating body for all NAIC technical groups involved with projects related to the Principle-Based Reserves (PBR) initiative for life and health policies. The PBRI Task Force was also charged with further assessing, and making recommendations regarding, the solvency implications of life insurance reserve financing mechanisms addressed in the June 6, 2013 NAIC White Paper of the Captives and Special Purpose Vehicle Use (E) Subgroup of the Financial Condition (E) Committee. Some of these reinsurance arrangements have been referred to as "XXX / AXXX Captive arrangements," although not all such arrangements actually involve reinsurers organized as captives. On June 30, 2014, the PBRI Task Force adopted a framework as found in Exhibits 1 and 2 of the June 4, 2014 report from Rector & Associates, Inc. (the "June 2014 Rector Report"). Exhibit 2 of the report included a charge to the Life Actuarial (A) Task Force (LATF) to develop a level of reserves (the "Required Level of Primary Security") that must be supported by certain defined assets ("Primary Security"). The level of reserves is to be calculated by a method referred to as the "Actuarial Method." Another charge to LATF is to promulgate an actuarial guideline specifying that, in order to comply with the Actuarial Opinion Memorandum Regulation as it relates to XXX/AXXX reinsurance arrangements, the opining actuary must issue a qualified opinion as to the ceding insurer's reserves if the ceding insurer or any insurer in its holding company system has engaged in a XXX/AXXX reserve financing arrangement that does not adhere to the Actuarial Method and Primary Security forms adopted by the NAIC. This Actuarial Guideline is responsive to that charge.

The requirements in this Actuarial Guideline derive authority from Section 3 of the NAIC *Actuarial Opinion and Memorandum Regulation*, Model 822 "(AOMR"). Section 3 provides, the commissioner "shall have the authority to specify specific methods of actuarial analysis and actuarial assumptions when, in the commissioner's judgment, these specifications are necessary for an acceptable opinion to be rendered relative to the adequacy of reserves and related items." This Actuarial Guideline defines new terms, such as Primary Security and Required Level of Primary Security, specifies the Actuarial Method used to calculate the Required Level of Primary Security, and specifies other requirements that must be followed when reinsurance is involved in order for the appointed actuary to render an actuarial opinion that is not qualified.

No statute, regulation or guideline can anticipate every potential XXX/AXXX captive arrangement. Common sense and professional responsibility are needed to assure not only that the text of this Actuarial Guideline is strictly observed, but also that its purpose and intent are honored scrupulously. To that end, and to provide documentation to the appointed actuary as to the arrangements that are subject to review under this Actuarial Guideline, the appointed actuary may request from each ceding insurer, and may rely upon, the certification by the Chief Financial Officer or other responsible officer of each ceding insurer filed with the insurer's domiciliary regulator that the insurer has not engaged in any arrangement or series of arrangements involving XXX or AXXX reserves that are designed to exploit a perceived ambiguity in, or to violate the purpose and intent of, this Actuarial Guideline.

The purpose and intent of this Actuarial Guideline are to establish uniform, national standards governing XXX or AXXX reserve financing arrangements[1] and, in connection with such arrangements, to ensure that Primary Security, in an amount at least equal to the Required Level of Primary Security, is held by or on behalf of the ceding insurer. As described further in Section 4.B., the provisions of this Actuarial Guideline are not intended to apply to policies that were issued prior to 1/1/2015 if those policies were included in a captive reserve financing arrangement as of 12/31/2014. Further, the requirements of this Actuarial Guideline should be viewed as minimum standards and are not a substitute for the diligent analysis of reserve financing arrangements by regulators. A regulator should impose requirements in addition to those set out in this Actuarial Guideline if the facts and circumstances warrant such action.

Text

1. Authority

Pursuant to Section 3 of the NAIC *Actuarial Opinion and Memorandum Regulation*, Model 822 ("AOMR"), the commissioner shall have the authority to specify specific methods of actuarial analysis and actuarial assumptions when, in the commissioner's judgment, these specifications are necessary for an acceptable opinion to be rendered relative to the adequacy of reserves and related items.

2. Scope

This Actuarial Guideline applies to Covered Policies as that term is defined in Section 4.

3. Exemptions

This Actuarial Guideline does not apply to:

A. Risks ceded to an assuming insurer for policies eligible for exemption under Section 6.F or Section 6.G. of Model 830 or the portion of the reserve pursuant to Yearly Renewable Term ("YRT") Reinsurance under Section 6.E. of Model 830; or

B. Risks ceded to an assuming insurer that meets the applicable requirements of (1) Section 2.E. of the NAIC *Credit for Reinsurance Model Act*, Model 785 ("Model 785") and has been certified in the ceding insurer's domiciliary state or, if that state has not adopted a provision equivalent to Section 2.E., in a minimum of five states, or (2) Section 2.D. of Model 785; or

C. Risks ceded to an assuming insurer that meets the applicable requirements of Sections 2.A., 2.B. or 2.C., of Model 785, and that, in addition:

1. prepares its statutory financial statements in compliance with the NAIC *Accounting Practices and Procedures Manual*, without any departures from NAIC statutory accounting practices and procedures pertaining to the

[1] In general, reserve financing arrangements are those where the security/assets backing part or all of the reserves have one or more of the following characteristics: such security/assets (1) are issued by the ceding insurer or its affiliates; and/or (2) are not unconditionally available to satisfy the general account obligations of the ceding insurer; and/or (3) create a reimbursement, indemnification or other similar obligation on the part of the ceding insurer or any if its affiliates (other than a payment obligation under a derivative contract acquired in the normal course and used to support and hedge liabilities pertaining to the actual risks in the policies ceded pursuant to the reinsurance arrangement).

admissibility or valuation of assets or liabilities that increase the assuming insurer's reported surplus and are material enough that they would need to be disclosed in the financial statement of the assuming insurer pursuant to Statement of Statutory Accounting Principles No. 1 ("SSAP 1"), paragraph 7, if the assuming insurer were required to comply with SSAP 1; and

2. is not in a Company Action Level Event, Regulatory Action Level Event, Authorized Control Level Event, or Mandatory Control Level Event as those terms are defined in the NAIC *Risk-Based Capital (RBC) for Insurers Model Act*, Model 312 when its RBC is calculated in accordance with the life risk-based capital report including overview and instructions for companies, as the same may be amended by the NAIC from time to time, without deviation.

D. Risks ceded to an assuming insurer if the ceding insurer's domiciliary regulator, after consulting with the NAIC Financial Analysis (E) Working Group (FAWG) or other group of regulators designated by the NAIC, as applicable, determines that all of the following apply: (1) such risks are clearly outside of the intent and purpose of this Actuarial Guideline (as described in the Background section above); (2) such risks are included within the scope of this Actuarial Guideline only as a technicality; and (3) the application of this Actuarial Guideline to such risks is not necessary to provide appropriate protection to policyholders under all the facts and circumstances. The domiciliary regulator shall publicly disclose any decision made pursuant to this Section 3.D. to exempt a reinsurance arrangement from this Actuarial Guideline, as well as the general basis therefor (including a summary description of the arrangement), although the domiciliary regulator may choose not to disclose the names of the parties to the arrangement.

4. Definitions

A. Actuarial Method: The methodology used to determine the Required Level of Primary Security, as described in Section 5 of this Actuarial Guideline.

B. Covered Policies: Subject to the exemptions described in Section 3 of this Actuarial Guideline, Covered Policies are those policies that are required to be valued under Sections 6 or 7 of the NAIC Valuation of Life Insurance Policies Model Regulation Model 830 ("Model 830") and that have risk ceded to an assuming insurer; provided, however, that Covered Policies shall not include policies that were both (1) issued prior to 1/1/2015 and (2) ceded so that they were part of a reinsurance arrangement, as of 12/31/2014, that would not qualify for exemption as described in Section 3 of this Actuarial Guideline.

C. Required Level of Primary Security: The dollar amount determined by applying the Actuarial Method to the risks ceded with respect to Covered Policies.

D. Primary Security: The following forms of security:

1. Cash meeting the requirements of Section 3.A. of Model 785;

2. SVO-listed securities meeting the requirements of Section 3.B. of Model 785, but excluding any synthetic letter of credit, contingent note, credit-linked note or other similar security that operates in a manner similar to a letter of credit; and

3. For security held in connection with funds-withheld and modified coinsurance reinsurance arrangements:

   a. Commercial loans in good standing of CM3 quality and higher;

   b. Policy Loans; and

   c. Derivatives acquired in the normal course and used to support and hedge liabilities pertaining to the actual risks in the policies ceded pursuant to the reinsurance arrangement.

E. Other Security: Any asset, including any asset meeting the definition of Primary Security, acceptable to the Commissioner of the ceding insurer's domiciliary state.

NOTE: The Capital Adequacy Task Force has been charged with the development of RBC asset risk charges for assets that may be held as "Other Security."

F. Section 8 Effective Date: The operative date of the Valuation Manual under the Standard Valuation Law.

G. Trust: A reinsurance credit trust as defined by Section 11 of the Credit for Reinsurance Model Regulation (Model 786); provided, that notwithstanding Section 11(B)(13) of Model 786, (i) funds consisting of Primary Security or Other Security held in trust, shall for the purposes identified in Section 5.C. hereof, be valued according to the valuation rules set forth in Section 5.C., as applicable; and (ii) there are no affiliate investment limitations with respect to funds consisting of Other Security held in such trust.

5. Required Actuarial Analysis

As to each reinsurance arrangement in which Covered Policies have been ceded, the appointed actuary must perform an analysis, on a treaty by treaty basis, of such Covered Policies to determine whether:

(i) funds consisting of Primary Security, in an amount at least equal to the Required Level of Primary Security, are held by or on behalf of the ceding insurer, as security under the reinsurance contract within the meaning of Section 3 of Model 785, on a funds withheld, Trust, or modified coinsurance basis; and

(ii) funds consisting of Other Security, in an amount at least equal to any portion of the statutory reserves as to which Primary Security is not held pursuant to subsection (i) above, are held by or on behalf of the ceding insurer as security under the reinsurance contract within the meaning of Section 3 of Model 785.

A. Actuarial Method

The Actuarial Method to establish the amount of the Required Level of Primary Security shall be "Requirements for Principle-Based Reserves for Life Products," including all relevant definitions, from the NAIC Valuation Manual ("VM-20") with the modifications as provided below:

1. For Covered Policies required to be valued under section 6 of Model 830, the Actuarial Method is the greater of the Deterministic Reserve or the applicable

percentage of the Net Premium Reserve (NPR) from Table 1 below based on the issue age range, sex and smoking status, subject to any additional modifications below. No exemption testing is allowed.

2. For Covered Policies required to be valued under section 7 of Model 830, the Actuarial Method is the greater of the Deterministic Reserve, the Stochastic Reserve, or the applicable percentage of the NPR from Table 2 below based on the issue age range, sex and smoking status, subject to any additional modifications below. No exemption testing is allowed.

3. Except as provided in paragraph 4 below, the Actuarial Method is to be applied on a gross basis to all risks with respect to the Covered Policies as originally issued or assumed by the ceding insurer.

4. If the ceding insurer cedes less than 100% of its risk with respect to Covered Policies in a reinsurance arrangement that is subject to this Actuarial Guideline, and (x) retains a portion of the risk for its own account or (y) cedes a portion of the risk in an arrangement that qualifies for exemption pursuant to Section 3 of this Actuarial Guideline, then the Actuarial Method will be applied in the following manner:

   a. Prior to the Section 8 Effective Date, the Actuarial Method will be applied to all risks with respect to the Covered Policies as originally issued or assumed by the ceding insurer and the resulting Required Level of Primary Security will be adjusted using the following methodology:

      (i) For a quota share retained by the ceding insurer for its own account, the Required Level of Primary Security will be reduced by at most a percentage equal to the excess of 100% over the quota share ceded in the non-exempt reinsurance arrangement;

      (ii) For a non-exempt reinsurance arrangement in which only a secondary guarantee rider is ceded:

         (a) the Required Level of Primary Security will be calculated as the excess of (1) over (2), where (1) is the Required Level of Primary Security using the Actuarial Method applied to all risks under the Covered Policies including the ceded secondary guarantee rider (reduced by the amount specified pursuant to subsection (iv) below in the event any risk is ceded on a yearly renewable term basis in an exempt arrangement) and (2) is the statutory reserve retained by the ceding insurer on the Covered Policies (reduced by the amount specified pursuant to subsection (iv) below in the event any risk is ceded on a yearly renewable term basis in an exempt arrangement);

(b) if the ceding insurer cedes risks with respect to Covered Policies in more than one non-exempt reinsurance arrangement, in no event will the aggregate amount of Primary Security held with respect to the Covered Policies including all riders be less than the Required Level of Primary Security calculated using the Actuarial Method as if all risks ceded in non-exempt reinsurance arrangements were ceded in a single non-exempt reinsurance arrangement.

(iii) For risks ceded on a coinsurance basis in an exempt arrangement, the Required Level of Primary Security will be reduced by at most a percentage equal to the quota share ceded in the exempt coinsurance arrangement;

(iv) For risks ceded on a yearly renewable term basis in an exempt arrangement, the Required Level of Primary Security will be reduced by at most [(1 / (2 * number of reinsurance premiums per year)) * cx], calculated using the mortality defined in the NPR; and

(v) For all other exempt arrangements, including but not limited to stop loss, excess of loss and other non-proportional reinsurance arrangements, there will be no reduction in the Required Level of Primary Security.

NOTE: It is possible for any combination of (i), (ii), (iii), (iv) and (v) above to apply.

The adjustments outlined in (ii), (iii) and (iv) above will be made only with respect to exempt arrangements entered into directly by the ceding insurer. The ceding insurer will make no adjustments as a result of retrocession arrangements entered into by any of its assuming insurers.

Section 8 of VM-20 (Reinsurance) in the Valuation Manual shall not be used in applying the Actuarial Method, except that Section 8.C.11. shall apply when some of the assets supporting the gross reserve are held by the counterparty or by another party. In no event will the Required Level of Primary Security resulting from application of the Actuarial Method exceed the amount of statutory reserves ceded.

b. On and after the Section 8 Effective Date, in lieu of the methodologies set forth in subsections 4.a(iii) and (iv), Section 8 of VM-20 (Reinsurance) in the Valuation Manual will be used to apply the Actuarial Method to risks ceded in an exempt arrangement to an assuming insurer, including risks written prior to the Section 8 Effective Date. The methodologies set forth in subsections 4.a(i), (ii) and (v) above will continue to apply.

Percentages Applicable to the NPR in Determination of the Actuarial Method

Table 1

(Derived From 2014 VBT / 2001 VBT Term Net Level Premium Mortality Ratios)

Issue Age	Male Non-Smoker	Female Non-Smoker	Male Smoker	Female Smoker
< 25	55%	60%	65%	70%
25 – 34	55%	60%	65%	70%
35 – 44	55%	60%	65%	70%
45 – 54	55%	60%	70%	70%
55 – 64	60%	60%	85%	80%
65 – 74	70%	70%	90%	100%
75 - 84	75%	80%	90%	100%
85 +	75%	80%	75%	100%

Table 2

(Derived From 2014 VBT / 2001 VBT Whole Life Net Level Premium Mortality Ratios)

Issue Age	Male Non-Smoker	Female Non-Smoker	Male Smoker	Female Smoker
< 25	80%	80%	85%	85%
25 - 34	80%	80%	85%	85%
35 – 44	80%	80%	85%	85%
45 – 54	80%	80%	85%	90%
55 – 64	80%	85%	90%	90%
65 – 74	85%	90%	90%	100%
75 - 84	85%	95%	95%	100%
85 +	85%	95%	85%	100%

B. Additional Modifications to Actuarial Method

Prior to implementation of PBR, the Actuarial Method shall include any amendments to VM-20 adopted by the Life Actuarial (A) Task Force (LATF) no later than the September 30th immediately preceding the year-end analysis required by this Actuarial Guideline. Notwithstanding, the asset spread tables and asset default cost tables required by VM-20 shall be included in the Actuarial Method if adopted by LATF no later than the December 31st of such year. The rules for incorporating the tables of asset spreads and asset default costs into the Actuarial Method should follow the same rules for incorporating those tables as set forth in VM-20.

After implementation of PBR, the Actuarial Method shall be the version of VM-20 included in the Valuation Manual applicable to such year, without modification.

NOTE: As provided in Section 5.A. above, a percentage of NPR is incorporated into the Actuarial Method initially to allow time for necessary calibrations to NPR to be made. From and after January 1, 2016, it is anticipated that this Actuarial Guideline will be amended to use 100% of the "recalibrated" NPR for the purposes of the Actuarial Method (including, for the avoidance of doubt, any reserves in-force as of such date pertaining to Covered Policies written in 2015 and certain policies written prior to 1/1/2015, as noted in Section 4.B).

C. Valuations Used for Purposes of the Required Actuarial Analysis

For the purposes of both (a) calculating the Required Level of Primary Security pursuant to the Actuarial Method and (b) determining the amount of Primary Security and Other Security, as applicable, held by or on behalf of the ceding insurer, the following shall apply: (i) for assets, including any such assets held in Trust, that would be admitted under the NAIC *Accounting Practices and Procedures Manual* if they were held by the ceding insurer, the valuations are to be determined according to statutory accounting procedures as if such assets were held in the ceding insurer's general account and without taking into consideration the effect of any prescribed or permitted practices; and (ii) for all other assets, the valuations are to be those that were assigned to the assets for the purpose of determining the amount of reserve credit taken.

6. Actuarial Opinion and Memorandum Requirements

A. Qualified Actuarial Opinion

The appointed actuary must render a qualified actuarial opinion as described in Section 6.D. of the AOMR if:

1. As of the valuation date, and as to any reinsurance arrangement as to which the actuarial analysis required by Section 5 must be made:

(i) funds consisting of Primary Security, in an amount at least equal to the Required Level of Primary Security, are not held by or on behalf of the ceding insurer, as security under the reinsurance contract within the meaning of Section 3 of Model 785, on a funds withheld, Trust, or modified coinsurance basis, unless the ceding insurer complies with one of the Remediation Options listed below; or

(ii) funds consisting of Other Security, in an amount at least equal to any portion of the statutory reserves as to which Primary Security is not held pursuant to subsection (i) above, are not held by or on behalf of the ceding insurer as security under the reinsurance arrangement within the meaning of Section 3 of Model 785, unless the ceding insurer complies with one of the Remediation Options listed below; or

2. The appointed actuary for any affiliated reinsurer of the ceding insurer issues a qualified actuarial opinion with respect to such an affiliated reinsurer where (i) the affiliate reinsures Covered Policies of the ceding insurer and (ii) the qualified actuarial opinion pertaining to the affiliated reinsurer results, in whole or in part, from the analysis required by this Actuarial Guideline.

3. Remediation Options:

(i) In the case of Section 6.A.1.(i):

(1) Add additional Primary Security on or before March 1 of the year in which the actuarial opinion is being filed in an amount that would have caused the Primary Security held by or on behalf of the ceding insurer, as security under the reinsurance contract, on a funds withheld, Trust, or modified coinsurance basis, to equal or exceed the Required Level of Primary Security on the valuation date; or

(2) Establish a liability equal to the difference between the Primary Security held pursuant to Section 6.A.1(i) and the Required Level of Primary Security.

(ii) In the case of Section 6.A.1.(ii):

(1) Add additional Other Security on or before March 1 of the year in which the actuarial opinion is being filed in an amount that would have caused Other Security held by or on behalf of the ceding insurer, as security under the reinsurance contract, to be at least equal to the portion of the statutory reserve as to which Primary Security is not held pursuant to Section 6.A.(1)(i) (including any funds added pursuant to Section 6.A.3.(i)), on the valuation date.

(2) Establish a liability equal to the difference between (a) the portion of the statutory reserves that exceed the Primary Security held pursuant to Section 6.A.1.(i) (including any funds added pursuant to Section 6.A.3.(i)); and (b) Other Security held by or on behalf of the ceding insurer as security under the reinsurance contract.

B. Additional Requirements for the Actuarial Opinion and Memorandum for Companies that have Covered Policies Requiring the Analysis Pursuant to this Actuarial Guideline

1. In the statement of actuarial opinion, the appointed actuary must state whether (i) the appointed actuary has performed an analysis, as to each reinsurance arrangement under which Covered Policies have been ceded, of the security supporting the Covered Policies and whether funds consisting of Primary Security in an amount at least equal to the Required Level of Primary Security are held by or on behalf of the ceding insurer, as security under the reinsurance contract, on a funds withheld, Trust, or modified coinsurance basis and (ii) funds consisting of Primary Security or Other Security in an amount equal to the statutory reserves are held by or on behalf of the ceding insurer as security under the reinsurance arrangement.

2. In the actuarial memorandum as described by Section 7 of the AOMR, the appointed actuary must document the analysis and requirements applied by this Actuarial Guideline as to each reinsurance arrangement under which Covered Policies are ceded.

7. Effective Date

This Actuarial Guideline shall become effective as of January 1, 2015 to all Covered Policies.

8. Sunset Provision

This Actuarial Guideline shall cease to apply as to ceding insurers domiciled in a jurisdiction that has in effect, as of January 1st of the calendar year immediately preceding the year in which the actuarial opinion is to be filed, a law and regulation substantially similar to the amendment to the Credit for Reinsurance Model Law and new Model Regulation adopted by the NAIC pursuant to Recommendation #5 of the June 2014 Rector Report.

ACTUARIAL GUIDELINES – APPENDICES

Appendix C-1

Provides maximum reserve valuation and maximum life policy nonforfeiture interest rates for new issues, new purchases or changes in fund (as defined) under Section 4217, 4218, and 4221(k) of the New York Insurance Law as amended in 1982, 1983, 1985, 1986, 1987, 1988, 1990 and 1994. This information is provided for informational purposes and to aid compliance with the New York law.

Appendix C-2

Includes interpretations from the Emerging Actuarial Issues (E) Working Group adopted by the Financial Condition (E) Committee. The Financial Analysis (E) Working Group follows these interpretations in performing its reviews of the reserving methodologies under AG 38.

Appendix C-1

APPENDIX TO GUIDELINES

This information can be found at the New York State Department of Financial Services Web site:
http://www.dfs.ny.gov/insurance/life/ilifemax.htm

NEW YORK STATE DEPARTMENT OF FINANCIAL SERVICES
Maximum Reserve Valuation and Maximum Life Policy
Nonforfeiture Interest Rates

The maximum reserve valuation and nonforfeiture interest rates, prescribed by Sections 4217 and 4221(k) of the New York Insurance Law, are specified in "Table A through Table H Rates" noted below. Such rates vary from year to year based on Moody's corporate bond yield averages for 12 and 36 months ending on June 30, and weighting factors prescribed by Section 4217. The Moody's averages are provided for years 1981 to present in the attached Appendix.

Clarification on Fixed Annuity Reserves Interest Rates

We note that there has been some concern over the appropriate maximum valuation interest rate for flexible premium deferred annuities (FPDA). Section 4217(c)(4)(D)(iii) of the New York Insurance Law does not allow the use of the additional .05 weighting factor for annuities that guarantee interest rates on future considerations received more than twelve months beyond the valuation date. Accordingly, for flexible premium deferred annuities the weighting factors shown in Section 4217(c)(4)(D)(iii)(I) or 4217(c)(4)(D)(iii)(II) should be used. For convenience, maximum valuation interest rates for such FPDAs are shown in Table D (issue year basis) and Table G (change in fund basis). The rates shown in Table E and Table H are not appropriate for FPDAs.

- **General Information**
- **Table A through Table H Rates**
- **Appendix (Moody's Averages)**

Regulation 128 and Discontinued 30-year US Treasury Bond

To the extent Regulation 128 references the 30-year spot rate, the spot rate associated with the longest available Treasury bond (e.g., that maturing 2/15/31) should be used.

NEW YORK STATE
DEPARTMENT of
FINANCIAL SERVICES

Andrew M. Cuomo
Governor

Benjamin M. Lawsky
Superintendent

August 15, 2014

TO: ALL AUTHORIZED LIFE INSURANCE COMPANIES, ACCREDITED LIFE REINSURERS, FRATERNAL BENEFIT SOCIETIES AND CHARITABLE ANNUITY SOCIETIES

SUBJECT: MAXIMUM RESERVE VALUATION AND MAXIMUM LIFE POLICY NONFORFEITURE INTEREST RATES

Attached hereto is an outline providing maximum reserve valuation and maximum life policy non-forfeiture interest rates for new issues, new purchases or changes in fund (as defined) for years 1982 through 2013 (and other years where shown), under Sections 4217, 4218 and 4221(k) of the New York Insurance Law, as amended in 1982, 1983, 1985, 1986, 1987, 1988, 1990, and 1994.

The maximum valuation and non-forfeiture interest rates, prescribed by Sections 4217 and 4221(k) of the New York Insurance Law for future years, will vary from year to year depending on Moody's corporate bond yield averages.

The maximum valuation interest rates for issues, purchases and changes-in-fund of years 1982 through 2014 (and other years where shown) are outlined below. The maximum valuation and non-forfeiture interest rates for Ordinary Life Insurance are shown in Category A of page 1, except for Single Premium Life Insurance, as defined in Section 4217(c)(4)(B)(vi), the maximum valuation interest rates for which are shown in Category B on pages 2-3.

Please refer to Sections 4217 and 4221 of NY Insurance Law, Regulation 147 and Regulation 151 for definitions and explanations of valuation interest rate, guarantee duration, plan type and product category. Regulation 151 has been effective since February 28, 2001 and is available on our web site.

This notice is to be used for informational purposes, as an aid in complying with the law.

Should any person have any question or comment in regard to this information, please contact Mr. John Karwatowski of the Life Bureau at (518) 474-7929.

A. ORDINARY LIFE INSURANCE (Except as covered in B.)

Issue Year	Guarantee Duration	Maximum Reserve Valuation Interest Rate	Maximum NonForfeiture Interest Rate
1979-1981	10 Years or less	4.50%	5.50%
	More than 10 years, up to 20	4.50	5.50
	More than 20 years	4.50	5.50
1982	10 Years or less	6.75%	8.50%
	More than 10 years, up to 20	6.25	7.75
	More than 20 years	5.50	7.00
1983-1986	10 Years or less	7.25%	9.00%
	More than 10 years, up to 20	6.75	8.50
	More than 20 years	6.00	7.50
1987	10 Years or less	6.50%	8.25%
	More than 10 years, up to 20	6.00	7.50
	More than 20 years	5.50	7.00
1988-1992	10 Years or less	6.00%	7.50%
	More than 10 years, up to 20	6.00	7.50
	More than 20 years	5.50	7.00
1993	10 Years or less	6.00%	7.50%
	More than 10 years, up to 20	6.00	7.50
	More than 20 years	5.00	6.25
1994	10 Years or less	5.50%	7.00%
	More than 10 years, up to 20	5.25	6.50
	More than 20 years	5.00	6.25
1995-1998	10 Years or less	5.50%	7.00%
	More than 10 years, up to 20	5.25	6.50
	More than 20 years	4.50	5.75
1999-2005	10 Years or less	5.00%	6.25%
	More than 10 years, up to 20	4.75	6.00
	More than 20 years	4.50	5.75
2006-2012	10 Years or less	4.50%	5.75%
	More than 10 years, up to 20	4.25	5.25
	More than 20 years	4.00	5.00
2013	10 Years or less	3.75%	4.75%
	More than 10 years, up to 20	3.75	4.75
	More than 20 years	3.50	4.50
2014	10 Years or less	3.75%	4.75%
	More than 10 years, up to 20	3.75	4.75
	More than 20 years	3.50	4.50
2015	10 Years or less	3.75%	4.75%
	More than 10 years, up to 20	3.75	4.75
	More than 20 years	3.50	4.50

B. Single Premium Life Insurance of the kind referred to in Section 4217(c)(4)(B)(vi) of the New York Insurance Laws (as amended by Chapter 302 of the laws of 1987).

		Maximum Reserve Valuation Interest Rate	
Issue Year	Guarantee Duration	Issue Year Basis	Change-In-Fund Basis
1982	10 Years or less	10.00%	10.50%
	More than 10 yrs, up to 20	7.25	10.00
	More than 20 years	6.25	8.75
1983	10 Years or less	8.75%	9.25%
	More than 10 yrs, up to 20	7.00	8.75
	More than 20 years	6.25	7.75
1984	10 Years or less	8.50%	9.25%
	More than 10 yrs, up to 20	7.00	8.50
	More than 20 years	6.25	7.50
1985	10 Years or less	8.50%	9.00%
	More than 10 yrs, up to 20	7.00	8.50
	More than 20 years	6.25	7.50
1986	10 Years or less	7.25%	7.75%
	More than 10 yrs, up to 20	6.50	7.25
	More than 20 years	5.75	6.50
1987	10 Years or less	6.50%	6.75%
	More than 10 yrs, up to 20	6.00	6.50
	More than 20 years	5.50	6.00
1988	10 Years or less	7.00%	7.50%
	More than 10 yrs, up to 20	6.25	7.00
	More than 20 years	5.75	6.25
1989	10 Years or less	7.00%	7.25%
	More than 10 yrs, up to 20	6.25	7.00
	More than 20 years	5.50	6.25
1990	10 Years or less	6.50%	7.00%
	More than 10 yrs, up to 20	6.25	6.50
	More than 20 years	5.50	6.00
1991	10 Years or less	6.75%	7.00%
	More than 10 yrs, up to 20	6.25	6.75
	More than 20 years	5.50	6.00
1992	10 Years or less	6.25%	6.50%
	More than 10 yrs, up to 20	6.00	6.25
	More than 20 years	5.25	5.75
1993	10 Years or less	5.75%	6.00%
	More than 10 yrs, up to 20	5.50	5.75
	More than 20 years	5.00	5.25
1994	10 Years or less	5.50%	5.75%
	More than 10 yrs, up to 20	5.25	5.50
	More than 20 years	4.75	5.00

B (cont.). Single Premium Life Insurance of the kind referred to in Section 4217(c)(4)(B)(vi) of the New York Insurance Laws (as amended by Chapter 302 of the laws of 1987).

		Maximum Reserve Valuation Interest Rate	
Issue Year	Guarantee Duration	Issue Year Basis	Change-In-Fund Basis
1995	10 Years or less	6.00%	6.25%
	More than 10 yrs, up to 20	5.50	6.00
	More than 20 years	5.00	5.50
1996	10 Years or less	5.50%	5.75%
	More than 10 yrs, up to 20	5.25	5.50
	More than 20 years	4.75	5.00
1997	10 Years or less	5.50%	5.75%
	More than 10 yrs, up to 20	5.25	5.50
	More than 20 years	5.00	5.25
1998	10 Years or less	5.25%	5.50%
	More than 10 yrs, up to 20	5.00	5.25
	More than 20 years	4.75	4.75
1999	10 Years or less	5.25%	5.50%
	More than 10 yrs, up to 20	5.00	5.25
	More than 20 years	4.50	4.75
2000	10 Years or less	5.75%	6.00%
	More than 10 yrs, up to 20	5.25	5.75
	More than 20 years	4.75	5.25
2001	10 Years or less	5.50%	5.75%
	More than 10 yrs, up to 20	5.25	5.50
	More than 20 years	4.75	5.00
2002	10 Years or less	5.50%	5.75%
	More than 10 yrs, up to 20	5.25	5.50
	More than 20 years	4.75	5.00
2003	10 Years or less	5.00%	5.25%
	More than 10 yrs, up to 20	4.75	5.00
	More than 20 years	4.50	4.75
2004	10 Years or less	4.75%	5.00%
	More than 10 yrs, up to 20	4.75	4.75
	More than 20 years	4.25	4.50
2005	10 Years or less	4.50%	4.75%
	More than 10 yrs, up to 20	4.50	4.50
	More than 20 years	4.00	4.25
2006	10 Years or less	4.50%	4.75%
	More than 10 yrs, up to 20	4.50	4.50
	More than 20 years	4.25	4.25

B (cont.). Single Premium Life Insurance of the kind referred to in Section 4217(c)(4)(B)(vi) of the New York Insurance Laws (as amended by Chapter 302 of the laws of 1987).

		Maximum Reserve Valuation Interest Rate	
Issue Year	Guarantee Duration	Issue Year Basis	Change-In-Fund Basis
2007	10 Years or less	4.75%	4.75%
	More than 10 yrs, up to 20	4.50	4.75
	More than 20 years	4.25	4.25
2008	10 Years or less	4.75%	5.00%
	More than 10 yrs, up to 20	4.50	4.75
	More than 20 years	4.25	4.50
2009	10 Years or less	5.00%	5.25%
	More than 10 yrs, up to 20	4.75	5.00
	More than 20 years	4.25	4.75
2010	10 Years or less	4.50%	4.75%
	More than 10 yrs, up to 20	4.50	4.50
	More than 20 years	4.00	4.25
2011	10 Years or less	4.25%	4.50%
	More than 10 yrs, up to 20	4.25	4.25
	More than 20 years	4.00	4.00
2012	10 Years or less	3.75%	4.00%
	More than 10 yrs, up to 20	3.75	3.75
	More than 20 years	3.50	3.75
2013	10 Years or less	3.75%	3.75%
	More than 10 yrs, up to 20	3.50	3.75
	More than 20 years	3.50	3.50
2014	10 Years or less	4.00%	4.00%
	More than 10 yrs, up to 20	3.75	4.00
	More than 20 years	3.50	3.75

C. Single Premium Immediate Annuities and annuity benefits arising from life insurance policies and annuity and guaranteed interest contracts with cash settlement options.

Issues of or Purchases During	Maximum Reserve Valuation Interest Rate
1982	13.25%
1983 - 1984	11.25
1985	11.00
1986	9.25
1987	8.00
1988 - 1989	8.75
1990	8.25
1991	8.25
1992	7.75
1993	7.00
1994	6.50
1995	7.25
1996 - 1997	6.75
1998 - 1999	6.25
2000	7.00
2001	6.75
2002	6.50
2003	6.00
2004	5.50
2005 - 2006	5.25
2007-2008	5.50
2009	6.00
2010	5.25
2011	5.00

C. (cont.) Single Premium Immediate Annuities and annuity benefits arising from life insurance policies and annuity and guaranteed interest contracts with cash settlement options.

Issues of or Purchases During	Maximum Reserve Valuation Interest Rate
2012	4.25
2013	4.00
2014	4.50

D. Other Annuities and Guaranteed Interest Contracts, with cash settlement options and with interest rate guarantees on future considerations, valued on the "Issue Year" basis.

		Maximum Reserve Valuation Interest Rate		
		Plan Type		
Issue Year	Guarantee Duration	A	B	C
1982	5 Years or less	13.25%	10.50%	9.25%
	More than 5 yrs, up to 10	12.50	10.50	9.25
	More than 10 yrs, up to 20	8.50	7.25	6.75
	More than 20 years	6.75	6.00	6.00
1983	5 Years or less	11.25%	9.25%	8.25%
	More than 5 yrs, up to 10	10.75	9.25	8.25
	More than 10 yrs, up to 20	8.25	7.00	6.75
	More than 20 years	6.75	5.75	5.75
1984	5 Years or less	11.25%	9.25%	8.00%
	More than 5 yrs, up to 10	10.75	9.25	8.00
	More than 10 yrs, up to 20	8.25	7.00	6.75
	More than 20 years	6.75	5.75	5.75
1985	5 Years or less	11.00%	9.00%	8.00%
	More than 5 yrs, up to 10	10.50	9.00	8.00
	More than 10 yrs, up to 20	8.25	7.00	6.50
	More than 20 years	6.50	5.75	5.75
1986	5 Years or less	9.25%	7.75%	6.75%
	More than 5 yrs, up to 10	8.75	7.75	6.75
	More than 10 yrs, up to 20	7.50	6.50	6.00
	More than 20 years	6.00	5.50	5.50
1987	5 Years or less	8.00%	6.75%	6.25%
	More than 5 yrs, up to 10	7.75	6.75	6.25
	More than 10 yrs, up to 20	7.00	6.00	5.75
	More than 20 years	5.75	5.25	5.25
1988	5 Years or less	8.75%	7.50%	6.75%
	More than 5 yrs, up to 10	8.50	7.50	6.75
	More than 10 yrs, up to 20	7.25	6.25	6.00
	More than 20 years	6.00	5.25	5.25
1989	5 Years or less	8.75%	7.25%	6.50%
	More than 5 yrs, up to 10	8.25	7.25	6.50
	More than 10 yrs, up to 20	7.25	6.25	6.00
	More than 20 years	6.00	5.25	5.25
1990	5 Years or less	8.25%	7.00%	6.25%
	More than 5 yrs, up to 10	8.00	7.00	6.25
	More than 10 yrs, up to 20	7.00	6.25	5.75
	More than 20 years	5.75	5.25	5.25
1991	5 Years or less	8.25%	7.00%	6.25%
	More than 5 yrs, up to 10	8.00	7.00	6.25
	More than 10 yrs, up to 20	7.00	6.25	5.75
	More than 20 years	5.75	5.25	5.25

D. (cont.) Other Annuities and Guaranteed Interest Contracts, with cash settlement options and with interest rate guarantees on future considerations, valued on the "Issue Year" basis.

		Maximum Reserve Valuation Interest Rate		
			Plan Type	
Issue Year	Guarantee Duration	A	B	C
1992	5 Years or less	7.75%	6.50%	6.00%
	More than 5 yrs, up to 10	7.50	6.50	6.00
	More than 10 yrs, up to 20	6.75	6.00	5.75
	More than 20 years	5.75	5.00	5.00
1993	5 Years or less	7.00%	6.00%	5.50%
	More than 5 yrs, up to 10	6.75	6.00	5.50
	More than 10 yrs, up to 20	6.25	5.50	5.25
	More than 20 years	5.25	4.75	4.75
1994	5 Years or less	6.50%	5.75%	5.25%
	More than 5 yrs, up to 10	6.50	5.75	5.25
	More than 10 yrs, up to 20	6.00	5.25	5.00
	More than 20 years	5.00	4.50	4.50
1995	5 Years or less	7.25%	6.25%	5.75%
	More than 5 yrs, up to 10	7.00	6.25	5.75
	More than 10 yrs, up to 20	6.25	5.50	5.25
	More than 20 years	5.25	4.75	4.75
1996	5 Years or less	6.75%	5.75%	5.25%
	More than 5 yrs, up to 10	6.50	5.75	5.25
	More than 10 yrs, up to 20	6.00	5.25	5.00
	More than 20 years	5.00	4.50	4.50
1997	5 Years or less	6.75%	5.75%	5.25%
	More than 5 yrs, up to 10	6.50	5.75	5.25
	More than 10 yrs, up to 20	6.00	5.25	5.25
	More than 20 years	5.25	4.75	4.75
1998	5 Years or less	6.25%	5.50%	5.00%
	More than 5 yrs, up to 10	6.00	5.50	5.00
	More than 10 yrs, up to 20	5.75	5.00	4.75
	More than 20 years	4.75	4.50	4.50
1999	5 Years or less	6.25%	5.50%	5.00%
	More than 5 yrs, up to 10	6.00	5.50	5.00
	More than 10 yrs, up to 20	5.50	5.00	4.75
	More than 20 years	4.75	4.50	4.50
2000	5 Years or less	7.00%	6.00%	5.50%
	More than 5 yrs, up to 10	6.75	6.00	5.50
	More than 10 yrs, up to 20	5.75	5.25	5.00
	More than 20 years	5.00	4.50	4.50
2001	5 Years or less	6.75%	5.75%	5.25%
	More than 5 yrs, up to 10	6.50	5.75	5.25
	More than 10 yrs, up to 20	6.00	5.25	5.00
	More than 20 years	5.00	4.50	4.50

D. (cont.) Other Annuities and Guaranteed Interest Contracts, with cash settlement options and with interest rate guarantees on future considerations, valued on the "Issue Year" basis.

Issue Year	Guarantee Duration	Maximum Reserve Valuation Interest Rate Plan Type A	B	C
2002	5 Years or less	6.50%	5.75%	5.25%
	More than 5 yrs, up to 10	6.25	5.75	5.25
	More than 10 yrs, up to 20	6.00	5.25	5.00
	More than 20 years	5.00	4.50	4.50
2003	5 Years or less	6.00%	5.25%	4.75%
	More than 5 yrs, up to 10	5.75	5.25	4.75
	More than 10 yrs, up to 20	5.50	4.75	4.75
	More than 20 years	4.75	4.25	4.25
2004	5 Years or less	5.50%	5.00%	4.75%
	More than 5 yrs, up to 10	5.50	5.00	4.75
	More than 10 yrs, up to 20	5.00	4.75	4.50
	More than 20 years	4.50	4.25	4.25
2005	5 Years or less	5.25%	4.75%	4.50%
	More than 5 yrs, up to 10	5.00	4.75	4.50
	More than 10 yrs, up to 20	4.75	4.50	4.25
	More than 20 years	4.25	4.00	4.00
2006	5 Years or less	5.25%	4.75%	4.50%
	More than 5 yrs, up to 10	5.25	4.75	4.50
	More than 10 yrs, up to 20	4.75	4.50	4.25
	More than 20 years	4.25	4.00	4.00
2007	5 Years or less	5.50%	4.75%	4.50%
	More than 5 yrs, up to 10	5.25	4.75	4.50
	More than 10 yrs, up to 20	4.75	4.50	4.25
	More than 20 years	4.25	4.00	4.00
2008	5 Years or less	5.50%	5.00%	4.50%
	More than 5 yrs, up to 10	5.50	5.00	4.50
	More than 10 yrs, up to 20	5.00	4.50	4.25
	More than 20 years	4.25	4.00	4.00
2009	5 Years or less	6.00%	5.25%	5.00%
	More than 5 yrs, up to 10	5.75	5.25	5.00
	More than 10 yrs, up to 20	5.25	4.75	4.50
	More than 20 years	4.50	4.25	4.25
2010	5 Years or less	5.25%	4.75%	4.25%
	More than 5 yrs, up to 10	5.00	4.75	4.25
	More than 10 yrs, up to 20	4.75	4.25	4.25
	More than 20 years	4.25	4.00	4.00

D. (cont.) Other Annuities and Guaranteed Interest Contracts, with cash settlement options and with interest rate guarantees on future considerations, valued on the "Issue Year" basis.

		Maximum Reserve Valuation Interest Rate		
		Plan Type		
Issue Year	Guarantee Duration	A	B	C
2011	5 Years or less	5.00%	4.50%	4.25%
	More than 5 yrs, up to 10	4.75	4.50	4.25
	More than 10 yrs, up to 20	4.50	4.25	4.00
	More than 20 years	4.00	3.75	3.75
2012	5 Years or less	4.25%	4.00%	3.75%
	More than 5 yrs, up to 10	4.25	4.00	3.75
	More than 10 yrs, up to 20	4.00	3.75	3.75
	More than 20 years	3.75	3.50	3.50
2013	5 Years or less	4.00%	3.75%	3.50%
	More than 5 yrs, up to 10	3.75	3.75	3.50
	More than 10 yrs, up to 20	3.75	3.50	3.50
	More than 20 years	3.50	3.50	3.50
2014	5 Years or less	4.50%	4.00%	3.75%
	More than 5 yrs, up to 10	4.25	4.00	3.75
	More than 10 yrs, up to 20	4.00	3.75	3.75
	More than 20 years	3.75	3.50	3.50

E. Other Annuities and Guaranteed Interest Contracts, with cash settlement options but without interest rate guarantees on future considerations, valued on the "Issue Year" basis.

		Maximum Reserve Valuation Interest Rate		
		Plan Type		
Issue Year	Guarantee Duration	A	B	C
1982	5 Years or less	13.75%	11.25%	10.00%
	More than 5 yrs, up to 10	13.25	11.25	10.00
	More than 10 yrs, up to 20	8.75	7.50	7.25
	More than 20 years	7.25	6.25	6.25
1983	5 Years or less	11.75%	9.75%	8.75%
	More than 5 yrs, up to 10	11.25	9.75	8.75
	More than 10 yrs, up to 20	8.75	7.50	7.00
	More than 20 years	7.00	6.25	6.25
1984	5 Years or less	11.75%	9.75%	8.50%
	More than 5 yrs, up to 10	11.25	9.75	8.50
	More than 10 yrs, up to 20	8.75	7.50	7.00
	More than 20 years	7.00	6.25	6.25
1985	5 Years or less	11.50%	9.50%	8.50%
	More than 5 yrs, up to 10	11.00	9.50	8.50
	More than 10 yrs, up to 20	8.50	7.50	7.00
	More than 20 years	7.00	6.25	6.25
1986	5 Years or less	9.50%	8.00%	7.25%
	More than 5 yrs, up to 10	9.25	8.00	7.25
	More than 10 yrs, up to 20	7.75	6.75	6.50
	More than 20 years	6.50	5.75	5.75
1987	5 Years or less	8.50%	7.25%	6.50%
	More than 5 yrs, up to 10	8.00	7.25	6.50
	More than 10 yrs, up to 20	7.25	6.50	6.00
	More than 20 years	6.00	5.50	5.50
1988	5 Years or less	9.25%	7.75%	7.00%
	More than 5 yrs, up to 10	8.75	7.75	7.00
	More than 10 yrs, up to 20	7.50	6.50	6.25
	More than 20 years	6.25	5.75	5.75
1989	5 Years or less	9.00%	7.50%	7.00%
	More than 5 yrs, up to 10	8.75	7.50	7.00
	More than 10 yrs, up to 20	7.50	6.50	6.25
	More than 20 years	6.25	5.50	5.50
1990	5 Years or less	8.50%	7.25%	6.50%
	More than 5 yrs, up to 10	8.25	7.25	6.50
	More than 10 yrs, up to 20	7.50	6.50	6.25
	More than 20 years	6.25	5.50	5.50
1991	5 Years or less	8.75%	7.25%	6.75%
	More than 5 yrs, up to 10	8.25	7.25	6.75
	More than 10 yrs, up to 20	7.50	6.50	6.25
	More than 20 years	6.25	5.50	5.50

E. (cont.) Other Annuities and Guaranteed Interest Contracts, with cash settlement options but without interest rate guarantees on future considerations, valued on the "Issue Year" basis.

		Maximum Reserve Valuation Interest Rate		
		Plan Type		
Issue Year	Guarantee Duration	A	B	C
1992	5 Years or less	8.00%	6.75%	6.25%
	More than 5 yrs, up to 10	7.75	6.75	6.25
	More than 10 yrs, up to 20	7.00	6.25	6.00
	More than 20 years	6.00	5.25	5.25
1993	5 Years or less	7.25%	6.25%	5.75%
	More than 5 yrs, up to 10	7.00	6.25	5.75
	More than 10 yrs, up to 20	6.50	5.75	5.50
	More than 20 years	5.50	5.00	5.00
1994	5 Years or less	6.75%	6.00%	5.50%
	More than 5 yrs, up to 10	6.50	6.00	5.50
	More than 10 yrs, up to 20	6.25	5.50	5.25
	More than 20 years	5.25	4.75	4.75
1995	5 Years or less	7.50%	6.50%	6.00%
	More than 5 yrs, up to 10	7.25	6.50	6.00
	More than 10 yrs, up to 20	6.50	5.75	5.50
	More than 20 years	5.50	5.00	5.00
1996	5 Years or less	6.75%	6.00%	5.50%
	More than 5 yrs, up to 10	6.75	6.00	5.50
	More than 10 yrs, up to 20	6.25	5.50	5.25
	More than 20 years	5.25	4.75	4.75
1997	5 Years or less	7.00%	6.00%	5.50%
	More than 5 yrs, up to 10	6.75	6.00	5.50
	More than 10 yrs, up to 20	6.25	5.50	5.25
	More than 20 years	5.25	5.00	5.00
1998	5 Years or less	6.50%	5.75%	5.25%
	More than 5 yrs, up to 10	6.25	5.75	5.25
	More than 10 yrs, up to 20	6.00	5.25	5.00
	More than 20 years	5.00	4.75	4.75
1999	5 Years or less	6.25%	5.50%	5.25%
	More than 5 yrs, up to 10	6.25	5.50	5.25
	More than 10 yrs, up to 20	5.75	5.25	5.00
	More than 20 years	5.00	4.50	4.50
2000	5 Years or less	7.25%	6.25%	5.75%
	More than 5 yrs, up to 10	7.00	6.25	5.75
	More than 10 yrs, up to 20	6.00	5.50	5.25
	More than 20 years	5.25	4.75	4.75
2001	5 Years or less	7.00%	6.00%	5.50%
	More than 5 yrs, up to 10	6.75	6.00	5.50
	More than 10 yrs, up to 20	6.25	5.50	5.25
	More than 20 years	5.25	4.75	4.75

E. (cont.) Other Annuities and Guaranteed Interest Contracts, with cash settlement options but without interest rate guarantees on future considerations, valued on the "Issue Year" basis.

		Maximum Reserve Valuation Interest Rate		
		Plan Type		
Issue Year	Guarantee Duration	A	B	C
2002	5 Years or less	6.75%	6.00%	5.50%
	More than 5 yrs, up to 10	6.50	6.00	5.50
	More than 10 yrs, up to 20	6.00	5.50	5.25
	More than 20 years	5.25	4.75	4.75
2003	5 Years or less	6.25%	5.50%	5.00%
	More than 5 yrs, up to 10	6.00	5.50	5.00
	More than 10 yrs, up to 20	5.50	5.00	4.75
	More than 20 years	4.75	4.50	4.50
2004	5 Years or less	5.75%	5.00%	4.75%
	More than 5 yrs, up to 10	5.50	5.00	4.75
	More than 10 yrs, up to 20	5.25	4.75	4.75
	More than 20 years	4.75	4.25	4.25
2005	5 Years or less	5.25%	4.75%	4.50%
	More than 5 yrs, up to 10	5.25	4.75	4.50
	More than 10 yrs, up to 20	5.00	4.50	4.50
	More than 20 years	4.50	4.00	4.00
2006	5 Years or less	5.50%	4.75%	4.50%
	More than 5 yrs, up to 10	5.25	4.75	4.50
	More than 10 yrs, up to 20	5.00	4.50	4.50
	More than 20 years	4.50	4.25	4.25
2007	5 Years or less	5.50%	5.00%	4.75%
	More than 5 yrs, up to 10	5.50	5.00	4.75
	More than 10 yrs, up to 20	5.00	4.50	4.50
	More than 20 years	4.50	4.25	4.25
2008	5 Years or less	5.75%	5.00%	4.75%
	More than 5 yrs, up to 10	5.50	5.00	4.75
	More than 10 yrs, up to 20	5.00	4.75	4.50
	More than 20 years	4.50	4.25	4.25
2009	5 Years or less	6.25%	5.50%	5.00%
	More than 5 yrs, up to 10	6.00	5.50	5.00
	More than 10 yrs, up to 20	5.25	4.75	4.75
	More than 20 years	4.75	4.25	4.25
2010	5 Years or less	5.25%	4.75%	4.50%
	More than 5 yrs, up to 10	5.25	4.75	4.50
	More than 10 yrs, up to 20	5.00	4.50	4.25
	More than 20 years	4.25	4.00	4.00
2011	5 Years or less	5.00%	4.50%	4.25%
	More than 5 yrs, up to 10	5.00	4.50	4.25
	More than 10 yrs, up to 20	4.75	4.25	4.25
	More than 20 years	4.25	4.00	4.00

E. (cont.) Other Annuities and Guaranteed Interest Contracts, with cash settlement options but without interest rate guarantees on future considerations, valued on the "Issue Year" basis.

		Maximum Reserve Valuation Interest Rate		
		Plan Type		
Issue Year	Guarantee Duration	A	B	C
2012	5 Years or less	4.25%	4.00%	3.75%
	More than 5 yrs, up to 10	4.25	4.00	3.75
	More than 10 yrs, up to 20	4.00	3.75	3.75
	More than 20 years	3.75	3.50	3.50
2013	5 Years or less	4.00%	3.75%	3.75%
	More than 5 yrs, up to 10	4.00	3.75	3.75
	More than 10 yrs, up to 20	3.75	3.75	3.50
	More than 20 years	3.50	3.50	3.50
2014	5 Years or less	4.50%	4.00%	4.00%
	More than 5 yrs, up to 10	4.50	4.00	4.00
	More than 10 yrs, up to 20	4.00	3.75	3.75
	More than 20 years	3.75	3.50	3.50

F. Other Annuities and Guaranteed Interest Contracts, without cash settlement options, valued on the "Issue Year" basis.

Issue Year	Guarantee Duration	Maximum Reserve Valuation Interest Rate Plan Type A
1982	5 Years or less	13.25%
	More than 5 yrs, up to 10	12.50
	More than 10 yrs, up to 20	11.25
	More than 20 years	8.75
1983	5 Years or less	11.25%
	More than 5 yrs, up to 10	10.75
	More than 10 yrs, up to 20	9.75
	More than 20 years	7.75
1984	5 Years or less	11.25%
	More than 5 yrs, up to 10	10.75
	More than 10 yrs, up to 20	9.75
	More than 20 years	7.50
1985	5 Years or less	11.00%
	More than 5 yrs, up to 10	10.50
	More than 10 yrs, up to 20	9.50
	More than 20 years	7.50
1986	5 Years or less	9.25%
	More than 5 yrs, up to 10	8.75
	More than 10 yrs, up to 20	8.00
	More than 20 years	6.50
1987	5 Years or less	8.00%
	More than 5 yrs, up to 10	7.75
	More than 10 yrs, up to 20	7.25
	More than 20 years	6.00
1988	5 Years or less	8.75%
	More than 5 yrs, up to 10	8.50
	More than 10 yrs, up to 20	7.75
	More than 20 years	6.25
1989	5 Years or less	8.75%
	More than 5 yrs, up to 10	8.25
	More than 10 yrs, up to 20	7.50
	More than 20 years	6.25
1990	5 Years or less	8.25%
	More than 5 yrs, up to 10	8.00
	More than 10 yrs, up to 20	7.25
	More than 20 years	6.00
1991	5 Years or less	8.25%
	More than 5 yrs, up to 10	8.00
	More than 10 yrs, up to 20	7.25
	More than 20 years	6.00

F. (cont.) Other Annuities and Guaranteed Interest Contracts, without cash settlement options, valued on the "Issue Year" basis.

		Maximum Reserve Valuation Interest Rate
Issue Year	Guarantee Duration	Plan Type A
1992	5 Years or less	7.75%
	More than 5 yrs, up to 10	7.50
	More than 10 yrs, up to 20	6.75
	More than 20 years	5.75
1993	5 Years or less	7.00%
	More than 5 yrs, up to 10	6.75
	More than 10 yrs, up to 20	6.25
	More than 20 years	5.25
1994	5 Years or less	6.50%
	More than 5 yrs, up to 10	6.50
	More than 10 yrs, up to 20	6.00
	More than 20 years	5.00
1995	5 Years or less	7.25%
	More than 5 yrs, up to 10	7.00
	More than 10 yrs, up to 20	6.50
	More than 20 years	5.50
1996	5 Years or less	6.75%
	More than 5 yrs, up to 10	6.50
	More than 10 yrs, up to 20	6.00
	More than 20 years	5.00
1997	5 Years or less	6.75%
	More than 5 yrs, up to 10	6.50
	More than 10 yrs, up to 20	6.00
	More than 20 years	5.25
1998	5 Years or less	6.25%
	More than 5 yrs, up to 10	6.00
	More than 10 yrs, up to 20	5.75
	More than 20 years	4.75
1999	5 Years or less	6.25%
	More than 5 yrs, up to 10	6.00
	More than 10 yrs, up to 20	5.50
	More than 20 years	4.75
2000	5 Years or less	7.00%
	More than 5 yrs, up to 10	6.75
	More than 10 yrs, up to 20	6.25
	More than 20 years	5.25
2001	5 Years or less	6.75%
	More than 5 yrs, up to 10	6.50
	More than 10 yrs, up to 20	6.00
	More than 20 years	5.00

F. (cont.) Other Annuities and Guaranteed Interest Contracts, without cash settlement options, valued on the "Issue Year" basis.

		Maximum Reserve Valuation Interest Rate
Issue Year	Guarantee Duration	Plan Type A
2002	5 Years or less	6.50%
	More than 5 yrs, up to 10	6.25
	More than 10 yrs, up to 20	6.00
	More than 20 years	5.00
2003	5 Years or less	6.00%
	More than 5 yrs, up to 10	5.75
	More than 10 yrs, up to 20	5.50
	More than 20 years	4.75
2004	5 Years or less	5.50%
	More than 5 yrs, up to 10	5.50
	More than 10 yrs, up to 20	5.00
	More than 20 years	4.50
2005	5 Years or less	5.25%
	More than 5 yrs, up to 10	5.00
	More than 10 yrs, up to 20	4.75
	More than 20 years	4.25
2006	5 Years or less	5.25%
	More than 5 yrs, up to 10	5.25
	More than 10 yrs, up to 20	4.75
	More than 20 years	4.25
2007	5 Years or less	5.50%
	More than 5 yrs, up to 10	5.25
	More than 10 yrs, up to 20	5.00
	More than 20 years	4.25
2008	5 Years or less	5.50%
	More than 5 yrs, up to 10	5.50
	More than 10 yrs, up to 20	5.00
	More than 20 years	4.50
2009	5 Years or less	6.00%
	More than 5 yrs, up to 10	5.75
	More than 10 yrs, up to 20	5.50
	More than 20 years	4.75
2010	5 Years or less	5.25%
	More than 5 yrs, up to 10	5.00
	More than 10 yrs, up to 20	4.75
	More than 20 years	4.25

F. (cont.) Other Annuities and Guaranteed Interest Contracts, without cash settlement options, valued on the "Issue Year" basis.

Issue Year	Guarantee Duration	Maximum Reserve Valuation Interest Rate Plan Type A
2011	5 Years or less	5.00%
	More than 5 yrs, up to 10	4.75
	More than 10 yrs, up to 20	4.50
	More than 20 years	4.00
2012	5 Years or less	4.25%
	More than 5 yrs, up to 10	4.25
	More than 10 yrs, up to 20	4.00
	More than 20 years	3.75
2013	5 Years or less	4.00%
	More than 5 yrs, up to 10	3.75
	More than 10 yrs, up to 20	3.75
	More than 20 years	3.50
2014	5 Years or less	4.50%
	More than 5 yrs, up to 10	4.25
	More than 10 yrs, up to 20	4.00
	More than 20 years	3.75

G. Other Annuities and Guaranteed Interest Contracts, with cash settlement options and with interest rate guarantees on future considerations, valued on the "Change-in-Fund" basis.

		Maximum Reserve Valuation Interest Rate		
		Plan Type		
Change in Fund During Year	Guarantee Duration	A	B	C
1982	5 Years or less	15.00%	13.75%	10.00%
	More than 5 yrs, up to 10	14.50	13.75	10.00
	More than 10 yrs, up to 20	13.25	12.50	9.25
	More than 20 years	10.50	10.50	8.00
1983	5 Years or less	12.75%	11.75%	8.75%
	More than 5 yrs, up to 10	12.25	11.75	8.75
	More than 10 yrs, up to 20	11.25	10.75	8.25
	More than 20 years	9.25	9.25	7.25
1984	5 Years or less	12.75%	11.75%	8.50%
	More than 5 yrs, up to 10	12.25	11.75	8.50
	More than 10 yrs, up to 20	11.25	10.75	8.00
	More than 20 years	9.25	9.25	7.00
1985	5 Years or less	12.50%	11.50%	8.50%
	More than 5 yrs, up to 10	12.00	11.50	8.50
	More than 10 yrs, up to 20	11.00	10.50	8.00
	More than 20 years	9.00	9.00	7.00
1986	5 Years or less	10.25%	9.50%	7.25%
	More than 5 yrs, up to 10	10.00	9.50	7.25
	More than 10 yrs, up to 20	9.25	8.75	6.75
	More than 20 years	7.75	7.75	6.00
1987	5 Years or less	9.00%	8.50%	6.50%
	More than 5 yrs, up to 10	8.75	8.50	6.50
	More than 10 yrs, up to 20	8.00	7.75	6.25
	More than 20 years	6.75	6.75	5.50
1988	5 Years or less	10.00%	9.25%	7.00%
	More than 5 yrs, up to 10	9.50	9.25	7.00
	More than 10 yrs, up to 20	8.75	8.50	6.75
	More than 20 years	7.50	7.50	6.00
1989	5 Years or less	9.75%	9.00%	7.00%
	More than 5 yrs, up to 10	9.50	9.00	7.00
	More than 10 yrs, up to 20	8.75	8.25	6.50
	More than 20 years	7.25	7.25	5.75
1990	5 Years or less	9.25%	8.50%	6.50%
	More than 5 yrs, up to 10	8.75	8.50	6.50
	More than 10 yrs, up to 20	8.25	8.00	6.25
	More than 20 years	7.00	7.00	5.50

G. (cont.) Other Annuities and Guaranteed Interest Contracts, with cash settlement options and with interest rate guarantees on future considerations, valued on the "Change-in-Fund" basis.

		Maximum Reserve Valuation Interest Rate		
		Plan Type		
Change in Fund During Year	Guarantee Duration	A	B	C
1991	5 Years or less	7.25%	6.75%	5.50%
	More than 5 yrs, up to 10	7.00	6.75	5.50
	More than 10 yrs, up to 20	6.50	6.50	5.25
	More than 20 years	5.75	5.75	4.75
1995	5 Years or less	8.25%	7.50%	6.00%
	More than 5 yrs, up to 10	8.00	7.50	6.00
	More than 10 yrs, up to 20	7.25	7.00	5.75
	More than 20 years	6.25	6.25	5.25
1996	5 Years or less	7.25%	6.75%	5.50%
	More than 5 yrs, up to 10	7.00	6.75	5.50
	More than 10 yrs, up to 20	6.75	6.50	5.25
	More than 20 years	5.75	5.75	4.75
1997	5 Years or less	7.50%	7.00%	5.50%
	More than 5 yrs, up to 10	7.25	7.00	5.50
	More than 10 yrs, up to 20	6.75	6.50	5.25
	More than 20 years	5.75	5.75	5.00
1998	5 Years or less	7.00%	6.50%	5.25%
	More than 5 yrs, up to 10	6.75	6.50	5.25
	More than 10 yrs, up to 20	6.25	6.00	5.00
	More than 20 years	5.50	5.50	4.75
1999	5 Years or less	6.75%	6.25%	5.25%
	More than 5 yrs, up to 10	6.50	6.25	5.25
	More than 10 yrs, up to 20	6.25	6.00	5.00
	More than 20 years	5.50	5.50	4.50
2000	5 Years or less	7.75%	7.25%	5.75%
	More than 5 yrs, up to 10	7.50	7.25	5.75
	More than 10 yrs, up to 20	7.00	6.75	5.50
	More than 20 years	6.00	6.00	5.00
2001	5 Years or less	7.50%	7.00%	5.50%
	More than 5 yrs, up to 10	7.25	7.00	5.50
	More than 10 yrs, up to 20	6.75	6.50	5.25
	More than 20 years	5.75	5.75	5.00
2002	5 Years or less	7.25%	6.75%	5.50%
	More than 5 yrs, up to 10	7.00	6.75	5.50
	More than 10 yrs, up to 20	6.50	6.25	5.25
	More than 20 years	5.75	5.75	4.75

G. (cont.) Other Annuities and Guaranteed Interest Contracts, with cash settlement options and with interest rate guarantees on future considerations, valued on the "Change-in-Fund" basis.

		Maximum Reserve Valuation Interest Rate		
		Plan Type		
Change in Fund During Year	Guarantee Duration	A	B	C
2003	5 Years or less	6.50%	6.25%	5.00%
	More than 5 yrs, up to 10	6.25	6.25	5.00
	More than 10 yrs, up to 20	6.00	5.75	4.75
	More than 20 years	5.25	5.25	4.50
2004	5 Years or less	6.00%	5.75%	4.75%
	More than 5 yrs, up to 10	6.00	5.75	4.75
	More than 10 yrs, up to 20	5.50	5.50	4.75
	More than 20 years	5.00	5.00	4.25
2005	5 Years or less	5.75%	5.25%	4.50%
	More than 5 yrs, up to 10	5.50	5.25	4.50
	More than 10 yrs, up to 20	5.25	5.00	4.50
	More than 20 years	4.75	4.75	4.00
2006	5 Years or less	5.75%	5.50%	4.50%
	More than 5 yrs, up to 10	5.50	5.50	4.50
	More than 10 yrs, up to 20	5.25	5.25	4.50
	More than 20 years	4.75	4.75	4.25
2007	5 Years or less	5.75%	5.50%	4.75%
	More than 5 yrs, up to 10	5.75	5.50	4.75
	More than 10 yrs, up to 20	5.50	5.25	4.50
	More than 20 years	4.75	4.75	4.25
2008	5 Years or less	6.00%	5.75%	4.75%
	More than 5 yrs, up to 10	6.00	5.75	4.75
	More than 10 yrs, up to 20	5.50	5.50	4.50
	More than 20 years	5.00	5.00	4.25
2009	5 Years or less	6.50%	6.25%	5.00%
	More than 5 yrs, up to 10	6.50	6.25	5.00
	More than 10 yrs, up to 20	6.00	5.75	5.00
	More than 20 years	5.25	5.25	4.50
2010	5 Years or less	5.50%	5.25%	4.50%
	More than 5 yrs, up to 10	5.50	5.25	4.50
	More than 10 yrs, up to 20	5.25	5.00	4.25
	More than 20 years	4.75	4.75	4.00
2011	5 Years or less	5.25%	5.00%	4.25%
	More than 5 yrs, up to 10	5.25	5.00	4.25
	More than 10 yrs, up to 20	5.00	4.75	4.25
	More than 20 years	4.50	4.50	4.00

G. (cont.) Other Annuities and Guaranteed Interest Contracts, with cash settlement options and with interest rate guarantees on future considerations, valued on the "Change-in-Fund" basis.

		Maximum Reserve Valuation Interest Rate		
		Plan Type		
Change in Fund During Year	Guarantee Duration	A	B	C
2012	5 Years or less	4.50%	4.25%	3.75%
	More than 5 yrs, up to 10	4.50	4.25	3.75
	More than 10 yrs, up to 20	4.25	4.25	3.75
	More than 20 years	4.00	4.00	3.50
2013	5 Years or less	4.00%	4.00%	3.75%
	More than 5 yrs, up to 10	4.00	4.00	3.75
	More than 10 yrs, up to 20	4.00	3.75	3.50
	More than 20 years	3.75	3.75	3.50
2014	5 Years or less	4.75%	4.50%	4.00%
	More than 5 yrs, up to 10	4.50	4.50	4.00
	More than 10 yrs, up to 20	4.50	4.25	3.75
	More than 20 years	4.00	4.00	3.75

H. Other Annuities and Guaranteed Interest Contracts, with cash settlement options and without interest rate guarantees on future considerations, valued on the "Change-in-Fund" basis.

		Maximum Reserve Valuation Interest Rate		
		Plan Type		
Change In Fund During Year	Guarantee Duration	A	B	C
1982	5 Years or less	15.75%	14.50%	10.50%
	More than 5 yrs, up to 10	15.00	14.50	10.50
	More than 10 yrs, up to 20	13.75	13.25	10.00
	More than 20 years	11.25	11.25	8.75
1983	5 Years or less	13.50%	12.25%	9.25%
	More than 5 yrs, up to 10	12.75	12.25	9.25
	More than 10 yrs, up to 20	11.75	11.25	8.75
	More than 20 years	9.75	9.75	7.75
1984	5 Years or less	13.25%	12.25%	9.25%
	More than 5 yrs, up to 10	12.75	12.25	9.25
	More than 10 yrs, up to 20	11.75	11.25	8.50
	More than 20 years	9.75	9.75	7.50
1985	5 Years or less	13.00%	12.00%	9.00%
	More than 5 yrs, up to 10	12.50	12.00	9.00
	More than 10 yrs, up to 20	11.50	11.00	8.50
	More than 20 years	9.50	9.50	7.50
1986	5 Years or less	10.75%	10.00%	7.75%
	More than 5 yrs, up to 10	10.25	10.00	7.75
	More than 10 yrs, up to 20	9.50	9.25	7.25
	More than 20 years	8.00	8.00	6.50
1987	5 Years or less	9.50%	8.75%	6.75%
	More than 5 yrs, up to 10	9.00	8.75	6.75
	More than 10 yrs, up to 20	8.50	8.00	6.50
	More than 20 years	7.25	7.25	6.00
1988	5 Years or less	10.25%	9.50%	7.50%
	More than 5 yrs, up to 10	10.00	9.50	7.50
	More than 10 yrs, up to 20	9.25	8.75	7.00
	More than 20 years	7.75	7.75	6.25
1989	5 Years or less	10.00%	9.50%	7.25%
	More than 5 yrs, up to 10	9.75	9.50	7.25
	More than 10 yrs, up to 20	9.00	8.75	7.00
	More than 20 years	7.50	7.50	6.25
1990	5 Years or less	9.50%	8.75%	7.00%
	More than 5 yrs, up to 10	9.25	8.75	7.00
	More than 10 yrs, up to 20	8.50	8.25	6.50
	More than 20 years	7.25	7.25	6.00
1991	5 Years or less	9.75%	9.00%	7.00%
	More than 5 yrs, up to 10	9.25	9.00	7.00
	More than 10 yrs, up to 20	8.75	8.25	6.75
	More than 20 years	7.25	7.25	6.00

H. (cont.) Annuities and Guaranteed Interest Contracts, with cash settlement options and without interest rate guarantees on future considerations, valued on the “Change-in-Fund” basis.

		Maximum Reserve Valuation Interest Rate		
		Plan Type		
Change in Fund During Year	Guarantee Duration	A	B	C
1992	5 Years or less	9.00%	8.25%	6.50%
	More than 5 yrs, up to 10	8.50	8.25	6.50
	More than 10 yrs, up to 20	8.00	7.75	6.25
	More than 20 years	6.75	6.75	5.75
1993	5 Years or less	8.25%	7.50%	6.00%
	More than 5 yrs, up to 10	7.75	7.50	6.00
	More than 10 yrs, up to 20	7.25	7.00	5.75
	More than 20 years	6.25	6.25	5.25
1994	5 Years or less	7.50%	7.00%	5.75%
	More than 5 yrs, up to 10	7.25	7.00	5.75
	More than 10 yrs, up to 20	6.75	6.50	5.50
	More than 20 years	6.00	6.00	5.00
1995	5 Years or less	8.50%	8.00%	6.25%
	More than 5 yrs, up to 10	8.25	8.00	6.25
	More than 10 yrs, up to 20	7.50	7.25	6.00
	More than 20 years	6.50	6.50	5.50
1996	5 Years or less	7.50%	7.00%	5.75%
	More than 5 yrs, up to 10	7.25	7.00	5.75
	More than 10 yrs, up to 20	6.75	6.75	5.50
	More than 20 years	6.00	6.00	5.00
1997	5 Years or less	7.75%	7.25%	5.75%
	More than 5 yrs, up to 10	7.50	7.25	5.75
	More than 10 yrs, up to 20	7.00	6.75	5.50
	More than 20 years	6.00	6.00	5.25
1998	5 Years or less	7.00%	6.75%	5.50%
	More than 5 yrs, up to 10	7.00	6.75	5.50
	More than 10 yrs, up to 20	6.50	6.25	5.25
	More than 20 years	5.75	5.75	4.75
1999	5 Years or less	7.00%	6.50%	5.50%
	More than 5 yrs, up to 10	6.75	6.50	5.50
	More than 10 yrs, up to 20	6.25	6.25	5.25
	More than 20 years	5.50	5.50	4.75
2000	5 Years or less	8.00%	7.50%	6.00%
	More than 5 yrs, up to 10	7.75	7.50	6.00
	More than 10 yrs, up to 20	7.25	7.00	5.75
	More than 20 years	6.25	6.25	5.25

H. (cont.) Annuities and Guaranteed Interest Contracts, with cash settlement options and without interest rate guarantees on future considerations, valued on the "Change-in-Fund" basis.

		Maximum Reserve Valuation Interest Rate		
		Plan Type		
Change in Fund During Year	Guarantee Duration	A	B	C
2001	5 Years or less	7.75%	7.25%	5.75%
	More than 5 yrs, up to 10	7.50	7.25	5.75
	More than 10 yrs, up to 20	7.00	6.75	5.50
	More than 20 years	6.00	6.00	5.00
2002	5 Years or less	7.50%	7.00%	5.75%
	More than 5 yrs, up to 10	7.25	7.00	5.75
	More than 10 yrs, up to 20	6.75	6.50	5.50
	More than 20 years	6.00	6.00	5.00
2003	5 Years or less	6.75%	6.25%	5.25%
	More than 5 yrs, up to 10	6.50	6.25	5.25
	More than 10 yrs, up to 20	6.25	6.00	5.00
	More than 20 years	5.50	5.50	4.75
2004	5 Years or less	6.25%	6.00%	5.00%
	More than 5 yrs, up to 10	6.00	6.00	5.00
	More than 10 yrs, up to 20	5.75	5.50	4.75
	More than 20 years	5.00	5.00	4.50
2005	5 Years or less	5.75%	5.50%	4.75%
	More than 5 yrs, up to 10	5.75	5.50	4.75
	More than 10 yrs, up to 20	5.25	5.25	4.50
	More than 20 years	4.75	4.75	4.25
2006	5 Years or less	5.75%	5.50%	4.75%
	More than 5 yrs, up to 10	5.75	5.50	4.75
	More than 10 yrs, up to 20	5.50	5.25	4.50
	More than 20 years	4.75	4.75	4.25
2007	5 Years or less	6.00%	5.75%	4.75%
	More than 5 yrs, up to 10	5.75	5.75	4.75
	More than 10 yrs, up to 20	5.50	5.50	4.75
	More than 20 years	5.00	5.00	4.25
2008	5 Years or less	6.25%	6.00%	5.00%
	More than 5 yrs, up to 10	6.00	6.00	5.00
	More than 10 yrs, up to 20	5.75	5.50	4.75
	More than 20 years	5.00	5.00	4.50
2009	5 Years or less	6.75%	6.50%	5.25%
	More than 5 yrs, up to 10	6.50	6.50	5.25
	More than 10 yrs, up to 20	6.25	6.00	5.00
	More than 20 years	5.50	5.50	4.75

H. (cont.) Annuities and Guaranteed Interest Contracts, with cash settlement options and without interest rate guarantees on future considerations, valued on the "Change-in-Fund" basis.

		Maximum Reserve Valuation Interest Rate		
			Plan Type	
Change in Fund During Year	Guarantee Duration	A	B	C
2010	5 Years or less	5.75%	5.50%	4.75%
	More than 5 yrs, up to 10	5.50	5.50	4.75
	More than 10 yrs, up to 20	5.25	5.25	4.50
	More than 20 years	4.75	4.75	4.25
2011	5 Years or less	5.25%	5.25%	4.50%
	More than 5 yrs, up to 10	5.25	5.25	4.50
	More than 10 yrs, up to 20	5.00	5.00	4.25
	More than 20 years	4.50	4.50	4.00
2012	5 Years or less	4.50%	4.50%	4.00%
	More than 5 yrs, up to 10	4.50	4.50	4.00
	More than 10 yrs, up to 20	4.25	4.25	3.75
	More than 20 years	4.00	4.00	3.75
2013	5 Years or less	4.25%	4.00%	3.75%
	More than 5 yrs, up to 10	4.00	4.00	3.75
	More than 10 yrs, up to 20	4.00	4.00	3.75
	More than 20 years	3.75	3.75	3.50
2014	5 Years or less	4.75%	4.50%	4.00%
	More than 5 yrs, up to 10	4.75	4.50	4.00
	More than 10 yrs, up to 20	4.50	4.50	4.00
	More than 20 years	4.00	4.00	3.75

APPENDIX

The maximum reserve valuation interest rates are based on reference interest rates, which are averages of corporate bond earnings published by Moody’s Investors Service, Inc., and weighting factors prescribed by Section 4217, which defines running averages of the published monthly yield rates for 12-month and 36-month periods.

The following table shows the 12-month and 36-month yield averages for recent years:

TABLE 1

	12-Month	36-Month	
For Period Ending	Running	Running	Lesser of
June 30 of Year	Average	Average	Two Averages
	(1)	(2)	(3)
1981	13.71%	11.57%	11.57%
1982	15.70	13.64	13.64
1983	13.39%	14.26%	13.39%
1984	13.22	14.10	13.22
1985	13.01%	13.21%	13.01%
1986	10.75	12.33	10.75
1987	9.40%	11.05%	9.40%
1988	10.32	10.15	10.15
1989	10.09%	9.93%	9.93%
1990	9.52	9.97	9.52
1991	9.63%	9.74%	9.63%
1992	8.88	9.34	8.88
1993	8.13%	8.88%	8.13%
1994	7.52	8.18	7.52
1995	8.42%	8.03%	8.03%
1996	7.55	7.83	7.55
1997	7.74%	7.90%	7.74%
1998	7.11	7.47	7.11
1999	6.96%	7.27%	6.96%
2000	7.93	7.33	7.33
2001	7.72%	7.54%	7.54%
2002	7.44	7.70	7.44
2003	6.71%	7.29%	6.71%
2004	6.26	6.80	6.26
2005	5.78%	6.25%	5.78%
2006	5.87	5.97	5.87
2007	6.00%	5.88%	5.88%
2008	6.21	6.02	6.02
2009	6.79%	6.33%	6.33%
2010	5.75%	6.25%	5.75%
2011	5.37%	5.97%	5.37%
2012	4.55%	5.22%	4.55%
2013	4.15 %	4.69 %	4.15 %
2014	4.72 %	4.48 %	4.48 %

The maximum nonforfeiture interest rate for Life Insurance, under Section 4221(k), for a particular issue year, is equal to 125% of the maximum reserve valuation interest rate for the same issue year, rounded to the nearer 1/4%.

Should the computed maximum reserve valuation interest rate for Life Insurance (other than Single Premium Life Insurance covered in Category B on pages 2-3) for a particular issue year be different from the actual maximum reserve valuation interest rate for the next previous issue year by less than 1/2%, then the maximum reserve valuation interest rate for such particular issue year will be the same as that for such next previous issue year.

Appendix C-2

Interpretations of the Emerging Actuarial Issues (E) Working Group

Introduction

The Emerging Actuarial Issues (E) Working Group responds to questions of application, interpretation and clarification with respect to *Actuarial Guideline XXXVIII—The Application of the Valuation of Life Insurance Policies Model Regulation* (AG 38). Following an abbreviated public comment and review period of no less than 7 days, the Working Group will adopt by consensus formal interpretations on issues presented before it. These interpretations will then be reported to the Financial Condition (E) Committee, which, after adopting, will direct the Financial Analysis (E) Working Group to follow the interpretations in performing its reviews of the reserving methodologies under AG 38. These interpretations will not become effective until formally adopted by the Financial Condition (E) Committee. In no event shall a consensus opinion of the Working Group supersede or otherwise conflict with AG 38.

Interpretation of the Emerging Actuarial Issues (E) Working Group

Actuarial INT 01

Date Adopted by Emerging Actuarial Issues (E) Working Group

November 20, 2012

Date Adopted by Financial Condition (E) Committee

December 1, 2012

Reference

Actuarial Guideline 38- The Application of the Valuation of Life Insurance Policies Model Regulation, Section *8D(b)*

Issue / Question

1. The Guideline does not seem to preclude a company from using the Alternative Reserve Methodology for yearend 2012, thus avoiding the Primary Reserve Methodology calculations, even if in prior valuations their total reserve held was not at least as great as the total reserve determined in accordance with the November 1, 2011 Life Actuarial (A) Task Force (LATF) statement. In other words, at yearend 2012 a company can switch to any alternative reserve methodology as long as the total reserve held is at least as great as the total reserve determined in accordance with the November 1, 2011 LATF statement using the required lapses and mortality. Is that a correct interpretation?

Interpretation of Emerging Actuarial Issues (E) Working Group

2. Yes. The requirements as written provide for use of either 8D(a) or 8D(b) for the 12/31/12 valuation.

Interpretation of the Emerging Actuarial Issues (E) Working Group

Actuarial INT 02

Date Adopted by Emerging Actuarial Issues (E) Working Group

December 19, 2012

Date Adopted by Financial Condition (E) Committee

December 20, 2012

Reference

Actuarial Guideline 38- The Application of the Valuation of Life Insurance Policies Model Regulation Section 8D(b)

Issue / Question

1. If a company uses the Alternative Reserve Methodology for yearend 2012, can they switch to the Primary Reserve Methodology for future valuations? What, if anything, should be reported in Exhibit 5A-Changes in Basis of Valuation for yearend 2012 or in future years as a result of these AG 38 revisions and any switch to the Primary Reserve Methodology or to the Alternative Reserve Methodology?

Interpretation of Emerging Actuarial Issues (E) Working Group

2. A company, pursuant to the requirements of AG 38, 8D, may switch between the Primary Reserve Methodology and the Alternative Reserve Methodology.

3. For 12/31/12 or subsequent reserve valuations any change to or from the Primary or Alternative reserve methodologies should be reported in Exhibit 5A.

4. The company should check with their domestic state whether approval is required for any subsequent change to or from the Primary or Alternative reserve methodologies for reserves after 12/31/12.

Interpretation of the Emerging Actuarial Issues (E) Working Group

Actuarial INT 03

Date Adopted by Emerging Actuarial Issues (E) Working Group

November 20, 2012

Date Adopted by Financial Condition (E) Committee

December 1, 2012

Reference

Actuarial Guideline 38- The Application of the Valuation of Life Insurance Policies Model Regulation, Section 8D(b)

Issue / Question

1. The Alternative Reserve Methodology calls for deficiency reserve mortality to be based on the VM-20 deterministic reserve mortality. Since XXX calls for segments to be based on deficiency reserve mortality this could affect segment lengths. However, at least the spirit of AG46, which came out when the 2001 CSO Preferred Risk tables came out, seems to allow for segments to continue to be based on the mortality table in use when the policy was issued. Does AG46 apply here and thus the original mortality basis for the segment lengths can continue to be used?

Interpretation of Emerging Actuarial Issues (E) Working Group

2. The original mortality basis for determining the segment length can continue to be used. 8D is not intended to be more restrictive in determination of segments.

Interpretation of the Emerging Actuarial Issues (E) Working Group

Actuarial INT 04

Date Adopted by Emerging Actuarial Issues (E) Working Group

November 20, 2012

Date Adopted by Financial Condition (E) Committee

December 1, 2012

Reference

Actuarial Guideline 38-The Application of the Valuation of Life Insurance Policies Model Regulation, Section 8D

Issue / Question

1. The Guideline states "The requirements of this Section 8D apply to a company on December 31, 2012, and on any subsequent valuation date if (1) on the applicable date, the in force face amount (direct plus assumed) of universal life insurance to which this Section 8D would otherwise apply exceeds 2% of the company's face amount of individual permanent life insurance in force…". Does the referenced individual permanent life insurance exclude term insurance?

Interpretation of Emerging Actuarial Issues (E) Working Group

2. Yes. Term is excluded.

Interpretation of the Emerging Actuarial Issues (E) Working Group

Actuarial INT 05

Date Adopted by Emerging Actuarial Issues (E) Working Group

December 19, 2012

Date Adopted by Financial Condition (E) Committee

December 20, 2012

Reference

Actuarial Guideline 38- The Application of the Valuation of Life Insurance Policies Model Regulation Section 8D

Issue / Question

1. Subsection 8Da states that the Primary Reserve is determined by adding any excess of (2) over (1), where (1) is the reserve according to the methodology and assumptions used to calculate the reserves reported as of December 31, 2011. In the following three scenarios, what is the basis for the determination of (1)? Assume that scenarios 1 and 2 involve universal life with secondary guarantees (ULSG) policies issued between July 1, 2005 and December 31, 2006, with a higher set of cost of insurance (COI) charges being triggered if the shadow account value ever becomes 0 after issue:

a. Issue 1) Reserves have always been calculated using the wrong methodology for determining the ratio in the fourth step of Section 8B. In applying Section 8D, would the reserves for 8Da1 be based on the correct methodology or on the methodology actually used by the company for year-end 2011?

b. Issue 2) A policy has a negative account value but has not lapsed due to the secondary guarantee. The shadow account value eventually drops to 0 and then becomes negative, and the policyholder pays a premium during the grace period intended on keeping the policy in force. The company invokes the higher secondary guarantee charges to calculate the shadow account value, but the policyholder argues that the lower shadow account COI charges apply due to the premium being paid during the state required grace period; i.e. that during the grace period the policyholder has the opportunity to pay a premium based on the lower COI charges rather than based on the much higher set of COI charges. This is litigated, and a ruling is made that the higher COI rates cannot be charged unless the shadow account value has not been positive for a period of time greater than the grace period. Based on this ruling, the assumption in the AG38 calculation that the higher set of COI charges would be triggered at the end of the first policy year would not be valid. Would the reserves for 8Da1 continue to be based on the assumption that the higher COI charges would be triggered after the first policy year, or would they be modified to reflect the lower COI charges?

c. Issue 3) Policies with multiple sets of COI charges have only been issued in 2012. What is the basis for the value of (1)?

Interpretation of Emerging Actuarial Issues (E) Working Group

2. Issue 1) The reserves determined by the company under 8D(a)(1) are intended to be consistent with the methodology used by the company for the 12/31/2011 valuation. If a calculation error has been made in applying the 2011 methodology, this error should not be repeated in applying this methodology for the 2012 year-end valuation.

3. Issue 2) Where a valid court decision has interpreted the provisions of a policy, those interpretations should be reflected in future reserve calculations. In effect, the court ruled that the company made a mistake in applying certain policy provisions. Therefore, the 2012 reserve calculations should incorporate the correct view of the affected policies' provisions as determined by the court. As in 1) above, any error in the 2011 reserve calculations due to this company mistake should not be perpetuated in the 2012 reserve calculations.

4. Issue 3) In this case, the value of (1) would be based on the company's methodology for reserving these policies for 2012 quarterly reporting.

Interpretation of the Emerging Actuarial Issues (E) Working Group

Actuarial INT 06

Date Adopted by Emerging Actuarial Issues (E) Working Group

November 20, 2012

Date Adopted by Financial Condition (E) Committee

December 1, 2012

Reference

Actuarial Guideline 38- The Application of the Valuation of Life Insurance Policies Model Regulation, Section 8D(b)

Issue / Question

1. Is the report documenting the special 2012 sensitivity test described at the end of Section 8D required to be a stand-alone document or can it be included in the required Section 8D Actuarial Memorandum?

Interpretation of Emerging Actuarial Issues (E) Working Group

2. Considering the special nature of the 2012 sensitivity test, the documentation should be contained either in a stand-alone document or included as a separate appendix in the Actuarial Memorandum

Interpretation of the Emerging Actuarial Issues (E) Working Group

Actuarial INT 07

Date Adopted by Emerging Actuarial Issues (E) Working Group

November 20, 2012

Date Adopted by Financial Condition (E) Committee

December 1, 2012

Reference

Actuarial Guideline 38- The Application of the Valuation of Life Insurance Policies Model Regulation, Section 8D(b)

Issue / Question

1. If all of a company's universal life with secondary guarantees (ULSG) policies subject to Section 8D are the same identical policies that are subject to Section 8C, are they still required to perform the separate Section 8C stand-alone asset adequacy analysis or does the Section 8D Primary Reserve Methodology calculation suffice?

Interpretation of Emerging Actuarial Issues (E) Working Group

2. Such policies are still required to perform the separate Section 8C stand-alone asset adequacy analysis. Section 8D, second paragraph, clarifies that Section 8D is "in addition to any testing that may be required under Section 8C."

Interpretation of the Emerging Actuarial Issues (E) Working Group

Actuarial INT 08

Date Adopted by Emerging Actuarial Issues (E) Working Group

November 20, 2012

Date Adopted by Financial Condition (E) Committee

December 1, 2012

Reference

Actuarial Guideline 38- The Application of the Valuation of Life Insurance Policies Model Regulation, Section 8D(a)

Issue / Question

1. For companies using the Primary Reserve Methodology, is it expected that the full deterministic reserve calculations will be performed every quarter or just annually?

Interpretation of Emerging Actuarial Issues (E) Working Group

2. This methodology would be used at least annually, with appropriate approximations used as permitted pursuant to quarterly statutory reporting requirements.

Interpretation of the Emerging Actuarial Issues (E) Working Group

Actuarial INT 09

Date Adopted by Emerging Actuarial Issues (E) Working Group

November 20, 2012

Date Adopted by Financial Condition (E) Committee

December 1, 2012

Reference

Actuarial Guideline 38- The Application of the Valuation of Life Insurance Policies Model Regulation, Section 8D(a)

Issue / Question

1. If the deterministic reserve "wins" for the Primary Reserve Methodology calculation, what impact should that have on tax reserves?

Interpretation of Emerging Actuarial Issues (E) Working Group

2. This question involves determination of values under the requirements of the Internal Revenue Code. The NAIC has no comment on how those values should be determined.

Interpretation of the Emerging Actuarial Issues (E) Working Group

Actuarial INT 10

Date Adopted by Emerging Actuarial Issues (E) Working Group

November 20, 2012

Date Adopted by Financial Condition (E) Committee

December 1, 2012

Reference

Actuarial Guideline 38- The Application of the Valuation of Life Insurance Policies Model Regulation, Section 8D(a)(2)

Issue / Question

1. In relation to the Valuation Manual, Item 2. under the Primary Reserve Methodology section references "…or in any version subsequently adopted by the NAIC…." Please clarify exactly what constitutes "adopted by the NAIC." Does it have to be adopted by Executive/Plenary or just the A Committee or just Life Actuarial (A) Task Force (LATF)? "version" includes amendments that have been adopted, correct?

Interpretation of Emerging Actuarial Issues (E) Working Group

2. Adopted by the NAIC means the Valuation Manual and any amendments adopted through Executive & Plenary as of the 7/1 preceding the year-end valuation date.

Interpretation of the Emerging Actuarial Issues (E) Working Group

Actuarial INT 11

Date Adopted by Emerging Actuarial Issues (E) Working Group

December 19, 2012

Date Adopted by Financial Condition (E) Committee

December 20, 2012

Reference

Actuarial Guideline 38- The Application of the Valuation of Life Insurance Policies Model Regulation

Issue / Question

1. My question is on section 8E, regarding when a product would fall under method 1 or method 2. If you have a shadow account product that has either a single set of charges, or multiple sets of charges, and the product meets the crediting rate limitations defined in method 1, is there anything that could cause the product to be deemed to be subject to method 2? To put it another way, when I read section 8E, it seems that any shadow account product meeting the interest crediting limits would fall under method 1. This is because all shadow accounts have either a single set of charges or multiple sets of charges, so all shadow account products that meet the interest crediting limitation would fall under policy design 1 or policy design 3. Is this a correct interpretation, or if not, why?

Interpretation of Emerging Actuarial Issues (E) Working Group

2. This interpretation is not completely correct. In drafting the revisions to AG 38, regulators were aware of the possibility that all existing and future product designs might not fit the three generic product designs noted in AG 38, independent of the crediting rate limitation. Method II was intended to provide a default reserve methodology for these other product designs, together with the more generic product designs containing interest crediting guarantees higher than the company-selected interest index plus 3 percent. The considerations in satisfying the actuarial opinion requirements contained in Section 8E should enable the opining actuary to determine the appropriate reserving methodology for a particular universal life with secondary guarantees (ULSG) product design.

Interpretation of the Emerging Actuarial Issues (E) Working Group

Actuarial INT 12

Date Adopted by Emerging Actuarial Issues (E) Working Group

November 20, 2012

Date Adopted by Financial Condition (E) Committee

December 1, 2012

Reference

Actuarial Guideline 38- The Application of the Valuation of Life Insurance Policies Model Regulation Section 8D(b)

Issue / Question

1. Section 8D(b), Alternate Methodology, requires the company to determine its deficiency reserve under Model 830 using mortality and lapse assumptions according to the same requirements for determining the deterministic reserve in the Valuation Manual. Does this require the company to determine its Triple-X segments (under the segmentation method) using the qx and lapse rates of the VM, or simply use these qx and lapse rates in calculating the deficiency reserve once the segments are determined using the company's current approach for determining such segments?

Interpretation of Emerging Actuarial Issues (E) Working Group

2. The original mortality basis for determining the segment length can continue to be used. 8D is not intended to be more restrictive in determination of segments.

Note: This response is similar to that for question Actuarial INT 03.

Interpretation of the Emerging Actuarial Issues (E) Working Group

Actuarial INT 13

Date Adopted by Emerging Actuarial Issues (E) Working Group

December 19, 2012

Date Adopted by Financial Condition (E) Committee

December 20, 2012

Reference

Actuarial Guideline 38- The Application of the Valuation of Life Insurance Policies Model Regulation

Issue / Question

1. Given all of the focus that the Guideline places on what premiums to use for these universal life with secondary guarantees (ULSG) reserve calculations, we are having unexpected difficulty finding published guidance on what premiums to assume in the deterministic reserve calculations for the Primary Reserve Methodology. Does such guidance exist and if so, where can we find it?

2. This question specifically asks for published guidance, but if none exists perhaps, the Working Group could provide such guidance or at least common practices/approaches they are aware of. Guidance is needed to create consistency amongst how companies are approaching this step of the calculation.

Interpretation of Emerging Actuarial Issues (E) Working Group

3. For 8D(a)(2) reserve calculations, the company should use the expected premium to be paid by the policyholder, determined either policy by policy or by appropriate policy groupings. The Valuation Manual adopted by the A Committee on 8/17/12 provides requirements regarding premiums for the deterministic reserve calculation. Such requirements include those in Section 4(A), Section 7(B), and Sections 9(A) and 9(D).

Interpretation of the Emerging Actuarial Issues (E) Working Group

Actuarial INT 14

Date Adopted by Emerging Actuarial Issues (E) Working Group

November 20, 2012

Date Adopted by Financial Condition (E) Committee

December 1, 2012

Reference

Actuarial Guideline 38- The Application of the Valuation of Life Insurance Policies Model Regulation, Section 8E

Issue / Question

1. In the case of a Method I type product that is currently being sold and will continue to be sold unmodified after 12/31/12, the company would have to do a standalone asset adequacy analysis under Section 8C for issues 1/1/07 through 12/31/12 but they would not have to do a standalone asset adequacy analysis for issues after 12/31/12 even though it is the same product. Correct?

Interpretation of Emerging Actuarial Issues (E) Working Group

2. Yes. It is a correct interpretation that the stand-alone asset adequacy analysis in 8C does not include policies issued after 12/31/12.

Interpretation of the Emerging Actuarial Issues (E) Working Group

Actuarial INT 15

Date Adopted by Emerging Actuarial Issues (E) Working Group

November 20, 2012

Date Adopted by Financial Condition (E) Committee

December 1, 2012

Reference

Actuarial Guideline 38- The Application of the Valuation of Life Insurance Policies Model Regulation, Section 8E(II)

Issue / Question

1. The minimum schedule of premiums required to be identified/tested for in Method II is something that is expected to be needed to be done separately for every age/sex cell, correct?

Interpretation of Emerging Actuarial Issues (E) Working Group

2. Yes. The schedule of minimum gross premiums should be based on all appropriate attributes unique to the policy being valued.

Interpretation of the Emerging Actuarial Issues (E) Working Group

Actuarial INT 16

Date Adopted by Emerging Actuarial Issues (E) Working Group

November 20, 2012

Date Adopted by Financial Condition (E) Committee

December 1, 2012

Reference

Actuarial Guideline 38- The Application of the Valuation of Life Insurance Policies Model Regulation, Section 8E

Issue / Question

1. If all of a company's currently approved universal life with secondary guarantees (ULSG) policy forms fall under the same Method I policy design, pass the Index Test, and meet the minimum premium requirements, can a single Actuarial Opinion and a single Company Representation be submitted that lists each policy form or does a separate Actuarial Opinion and a separate Company Representation need to be submitted for each form?

Interpretation of Emerging Actuarial Issues (E) Working Group

2. This is up to the state of domicile. Some groupings may make sense but any special qualification or language needed should result in a separate opinion and representation.

Interpretation of the Emerging Actuarial Issues (E) Working Group

Actuarial INT 17

Date Adopted by Emerging Actuarial Issues (E) Working Group

November 20, 2012

Date Adopted by Financial Condition (E) Committee

December 1, 2012

Reference

Actuarial Guideline 38- The Application of the Valuation of Life Insurance Policies Model Regulation, Section 8E(II)

Issue / Question

1. Is the greatest deficiency reserve test to be performed on a seriatim or product level basis? What if we see mixed results (For example, 70% pattern 1 and 30% pattern 2)

Interpretation of Emerging Actuarial Issues (E) Working Group

2. The test should be performed on a seriatim basis, except to the extent it may be practical to group policies with identical attributes. It is possible that several combination premium patterns will be identified as having broad applicability. Regardless, each policy should assume a premium pattern that produces the greatest deficiency reserve as of the issue date consistent with good faith testing and review.

Interpretation of the Emerging Actuarial Issues (E) Working Group

Actuarial INT 18

Date Adopted by Emerging Actuarial Issues (E) Working Group

November 20, 2012

Date Adopted by Financial Condition (E) Committee

December 1, 2012

Reference

Actuarial Guideline 38- The Application of the Valuation of Life Insurance Policies Model Regulation, Section 8E(II)

Issue / Question

1. For the combination premium patterns, what does it mean "...to have access to better charges and credits...."? Can this be ignored it if the product only has one set of charges?

Interpretation of Emerging Actuarial Issues (E) Working Group

2. Better charges and credits can be understood as lower charges and/or higher credits that may be triggered based on the magnitude of the premium paid, the shadow account or other measures generally dependent on policyholder behavior. For example, a higher interest rate might apply to amounts above or below some defined premium dollar limit in particular policy years or based simply on the level of the shadow account. Higher or lower premium payments could lead directly to the most favorable interest rate (or weighted average interest rate) accessible within product design constraints. Better charges and credits would generally lead to lower minimum gross premiums and potentially greater deficiency reserves. For purposes of this question this requirement cannot be ignored, particularly if there are multiple sets of credits in addition to the assumed single set of charges.

Interpretation of the Emerging Actuarial Issues (E) Working Group

Actuarial INT 19

Date Adopted by Emerging Actuarial Issues (E) Working Group

November 20, 2012

Date Adopted by Financial Condition (E) Committee

December 1, 2012

Reference

Actuarial Guideline 38- The Application of the Valuation of Life Insurance Policies Model Regulation Section 8E(II)

Issue / Question

1. When testing combination premium patterns, do premium patterns that break segments need to be considered?

Interpretation of Emerging Actuarial Issues (E) Working Group

2. It is not necessary to reverse engineer premium patterns solely to create unfavorable segment breaks. However, segment breaks that result from premium patterns consistent with the applicability of favorable charges and credits must be considered.

Interpretation of the Emerging Actuarial Issues (E) Working Group

Actuarial INT 20

Date Adopted by Emerging Actuarial Issues (E) Working Group

November 20, 2012

Date Adopted by Financial Condition (E) Committee

December 1, 2012

Reference

Actuarial Guideline 38- The Application of the Valuation of Life Insurance Policies Model Regulation, Section 8E(II)

Issue / Question

1. Do patterns with dump-in premiums need to be tested? If so, how should the dump-in premium be reflected in the determination of the uniform percentage (i.e., do you include the dump-in premium in determining the k percentage).

Interpretation of Emerging Actuarial Issues (E) Working Group

2. Premium patterns that involve dump-in premiums must be considered, and testing may be appropriate. In the absence of more definitive guidance, the uniform percentage should be determined in accordance with Actuarial Guideline 21.

Interpretation of the Emerging Actuarial Issues (E) Working Group

Actuarial INT 21

Date Adopted by Emerging Actuarial Issues (E) Working Group

January 30, 2013

Date Adopted by Financial Condition (E) Committee

February 20, 2013

Reference

Actuarial Guideline 38- The Application of the Valuation of Life Insurance Policies Model Regulation, Section 8D (a)(2a)

Issue / Question

1. Should the VM-20 deterministic reserve starting asset requirement related to the 2% collar be applied before or after the Primary Reserve Methodology caps on starting and reinvestment assets are applied?

Interpretation of Emerging Actuarial Issues (E) Working Group

2. Subsection a.2.a) (I) of Section 8D requires the determination of one of two portfolios of existing assets to support the initial reserve estimate for the block. Once this initial asset portfolio is determined, the deterministic gross premium reserve is determined using as the discount rates the net investment returns generated by the future projected cash flows calculated using the selected initial portfolio and future net reinvestment rates established according to subsection a.2.a) (II) of Section 8D.

3. If the resulting reserve falls within the +/- 2% collar (referenced in VM-20) relative to the initial reserve estimate (and corresponding level of initial assets), the calculated reserve is the final reserve. If the calculated reserve breaches the +/- 2% collar, the actuary must either provide a detailed rationale as to why the calculated reserve is appropriate or redo the reserve calculation assuming revised initial reserve and asset levels.

4. In performing the additional reserve calculation(s), use the same asset portfolio (adjusted upward or downward as below based on the results of the deterministic reserve calculation), either that of subsection a.2.a) (I) (i) or a.2.a) (I) (ii), as chosen for the initial reserve calculation.

5. If the initial or subsequently determined reserve is greater than the prior reserve estimate and the asset portfolio used in the deterministic reserve calculation is:

a. as described in subsection a.2.a)(I)(i), then the prior asset portfolio shall be adjusted upward using assets as described in subsection a.2.a)(I)(i) to the extent such assets remain available in the company's portfolio after which such assets shall be adjusted upward as needed using assets as described in subsection a.2.a)(I)(ii). The recommended method for adjusting the prior asset portfolio upward is to do so in a pro rata fashion. Any other method proposed for adjusting the prior asset portfolio upward must be clearly documented in the Actuarial Memorandum and shall not involve changing the asset composition of the prior asset portfolio but shall constitute only additions to that portfolio.

b. as described in subsection a.2.a)(I)(ii), then the prior asset portfolio shall be adjusted upward as needed in a pro rata fashion using assets as described in subsection a.2.a)(I)(ii).

6. Regardless of which portfolio is chosen for the initial deterministic reserve calculation, if the initial or subsequently determined, reserve is less than the prior reserve estimate, then the prior asset portfolio shall be adjusted downward as needed in a pro rata fashion.

Interpretation of the Emerging Actuarial Issues (E) Working Group

Actuarial INT 22

Date Adopted by Emerging Actuarial Issues (E) Working Group

December 19, 2012

Date Adopted by Financial Condition (E) Committee

December 20, 2012

Reference

Actuarial Guideline 38- The Application of the Valuation of Life Insurance Policies Model Regulation Section 8E/8D

Issue / Question

1. Consider the following: A universal life policy with a secondary guarantee requires that a shadow account be maintained at a positive level for the secondary guarantee to remain in effect. Once the shadow account value goes down to zero, the secondary guarantee terminates and cannot be reactivated. There is only one set of charges and credits that apply to the shadow account. In determining reserves for this policy under section 8E, would the assumption be made that the secondary guarantee terminates at the end of the first policy year since, if only the minimum premium is paid, the shadow account value would be zero at the end of the first policy year?

2. If the policy was written before 2012, would it be subject to section 8D?

Interpretation of Emerging Actuarial Issues (E) Working Group

3. For issues in or after January 1, 2013, 8E would be applicable. But the policy, as described, would not fit into Method I because the minimum premium derived according to Method I would not satisfy the secondary guarantee requirements. Calculation of the reserve using Method I requires that the minimum premium keep the secondary guarantee in effect. Therefore, it must be reserved according to Method II.

4. For issues between July 1, 2005 and December 31, 2012 (inclusive), any regulatory response regarding applicability of Section 8D would require analysis of the policy form and dialog with the valuation actuary.

Interpretation of the Emerging Actuarial Issues (E) Working Group

Actuarial INT 23

Date Adopted by Emerging Actuarial Issues (E) Working Group

December 19, 2012

Date Adopted by Financial Condition (E) Committee

December 20, 2012

Reference

Actuarial Guideline 38- The Application of the Valuation of Life Insurance Policies Model Regulation Section 8E

Issue / Question

1. Under 8E, Method I, Policy Design #1 applies for policies containing a secondary guarantee that uses a shadow account with a single set of charges and credits. For those policies, the minimum gross premium for any policy year is the premium that, when paid into a policy with a zero shadow account value at the beginning of the policy year, produces a zero shadow account value at the end of the policy year, using the guaranteed shadow account charges and credits specified under the secondary guarantee. Presumably, this will result in a yearly renewable term (YRT)-like pattern for the minimum premium.

2. The actuarial opinion required by 8E includes the statement "the minimum gross premiums determined under Policy Design # ___ are not inconsistent with the minimum premiums, charges and credits that are expected to apply under the policy." What is meant by "expected to apply"?

3. Since it is not likely that the policyholder will fund the policy using the YRT-like pattern that is the minimum premium, it does not seem as if "expected to apply" means "expected to be paid." It appears that "expected to apply" should be interpreted to mean that the YRT-type pattern will either fund the secondary guarantee or it is less than the minimum amount necessary to fund the guarantee.

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4. The phrase "expected to apply" is intended to mean that the minimum premiums determined ($0-to-$0) are based on charges/credits generally consistent with those expected to apply to premium scales likely to be received from policyholders. For example, high premium loads at later durations would not be expected to apply for products with charges and credits that encourage a limited-pay or single-pay premium pattern. Other design features that should give the opining actuary pause, and could draw regulatory scrutiny, include negative charges and credits or unusual patterns of charges and credits. In addition, the actuary should not favorably opine on a product for Method I reserves with variables resulting in minimum gross premiums that would be inconsistent with the premiums a reasonable person would pay to limit advance funding. If the actuary is unable to opine favorably, the reserves should be calculated under Method II.

Interpretation of the Emerging Actuarial Issues (E) Working Group

Actuarial INT 24

Date Adopted by Emerging Actuarial Issues (E) Working Group

December 19, 2012

Date Adopted by Financial Condition (E) Committee

December 20, 2012

Reference

Actuarial Guideline 38- The Application of the Valuation of Life Insurance Policies Model Regulation

Issue / Question

1. A shadow account has a product design feature where the premium load is expressed as a fixed percentage of premium up to the target premium, and the target premium is reasonably consistent with level premium funding of the lifetime guarantee. In effect, there is a fixed dollar cap on the annual premium charge. The literal form of the charge is simply a specified percentage of premiums up the target premium and 0% thereafter. This will always mathematically produce the same result as the capped charge described above. Please clarify that a fixed dollar cap for the premium load, regardless of how the cap is expressed, does not make such a product incompatible with Policy Design # 1.

Interpretation of Emerging Actuarial Issues (E) Working Group

2. A flat percentage of premium charge, subject to an annual maximum, would be compatible with Policy Design (PD) #1 provided the actuary is able to issue an unqualified actuarial opinion. The specified percentage rate subject to an annual maximum may be construed as a single rate even though an alternative expression of this charge could be viewed as involving a second rate equal to zero. However, it should be noted that the actuary might be unable to opine favorably in the case of designs with credit/charge structures that encourage limited-pay premium schedules.

3. The above interpretation does not extend to designs using a flat percentage load for premiums up to a break point and a different (non 0%) load for premiums above that. Such a design should be considered as PD#3, as would any design with tiered interest rate credits or other tiered credits/charges.

Interpretation of the Emerging Actuarial Issues (E) Working Group

Actuarial INT 25

Date Adopted by Emerging Actuarial Issues (E) Working Group

January 30, 2013

Date Adopted by Financial Condition (E) Committee

February 20, 2013

Reference

Actuarial Guideline 38- The Application of the Valuation of Life Insurance Policies Model Regulation, Section 8E

Issue / Question

1. Does the exemption for UL policies with short guarantee periods (see below) still apply in Section 8E of AG38?

2. This language is from the XXX model reg (Model 830)

> 3.A.(2) This regulation shall not apply to any universal life policy that meets all the following requirements:
>
> (a) Secondary guarantee period, if any, is five (5) years or less;
>
> (b) Specified premium for the secondary guarantee period is not less than the net level reserve premium for the secondary guarantee period based on the CSO valuation tables as defined in Section 4F and the applicable valuation interest rate; and
>
> (c) The initial surrender charge is not less than 100 percent of the first year annualized specified premium for the secondary guarantee period.

Interpretation of Emerging Actuarial Issues (E) Working Group

3. Yes.

Interpretation of the Emerging Actuarial Issues (E) Working Group

Actuarial INT 26

Date Adopted by Emerging Actuarial Issues (E) Working Group

February 12, 2013

Date Adopted by Financial Condition (E) Committee

April 8, 2013

Reference

Actuarial Guideline 38- The Application of the Valuation of Life Insurance Policies Model Regulation, Section 8D

Issue / Question

1. Section 8D(a) references the deterministic reserve calculation in the VM20 valuation manual in the definition of the Primary Reserve Methodology. As part of the asset assumptions used in the deterministic reserve calculation, page 82 of the VM20 manual describes the derivation of the Illustrative Current Market Benchmark Spreads. We have reviewed the JP Morgan US Liquid Index data referenced, and the final published values appear to be derived from the underlying data for the index as opposed to referencing published table views. Does the Working Group agree that using an updated table would be preferred? Would the Working Group consider publishing an updated table as of 9/30 or providing additional details on how the table values (shown on page 89) were derived? The values for Table G (page 90) for the below investment grade bonds were taken directly from the source index so they are easy to replicate.

Interpretation of Emerging Actuarial Issues (E) Working Group

2. For the 12/31/12 AG 38, 8D valuation it may be assumed that the 9/30/09 Tables H & I approximate both Tables F & G and Tables H & I as of 12/31/12. This assumption is based on benchmarking with current spread information from other sources as of 12/31/12. It is understood that strict technical compliance for each and every asset may not be possible due to modeling limitations. Professional judgment should be used to produce results that comply with the spirit of this standard, i.e., no lessening of conservatism. For example, if a company has access to current data sources and can reconstruct Tables F and G as of 12/31/12 then this would be an acceptable approach. In any event, appropriate explanation and justification should be provided for the methodology that was employed and the results that were obtained. The NAIC intends to provide updated tables for future year end AG 38, 8D, valuations.

Interpretation of the Emerging Actuarial Issues (E) Working Group

Actuarial INT 27

Date Adopted by Emerging Actuarial Issues (E) Working Group

February 12, 2013

Date Adopted by Financial Condition (E) Committee

April 8, 2013

Reference

Actuarial Guideline 38- The Application of the Valuation of Life Insurance Policies Model Regulation, Section 8D

Issue / Question

1. If the modified VM-20 deterministic reserve ends up being the minimum reserve held in the AG 38 8D calculation, can a reinsurance reserve credit also be calculated under the guidance of VM-20 (in particular for YRT reinsurance)?

Interpretation of Emerging Actuarial Issues (E) Working Group

2. The Section 8D reserve methodology (VM-20 deterministic) applies for calculating the company's aggregate gross reserve before reinsurance. AG 38, 8D, does not address how the credit for reinsurance is determined. The approach to determine the credit for YRT reinsurance shall be documented in the stand-alone Actuarial Memorandum required by AG 38, Section 8D(c).

Interpretation of the Emerging Actuarial Issues (E) Working Group

Actuarial INT 28

Date Adopted by Emerging Actuarial Issues (E) Working Group

February 12, 2013

Date Adopted by Financial Condition (E) Committee

April 8, 2013

Reference

Actuarial Guideline 38- The Application of the Valuation of Life Insurance Policies Model Regulation

Issue / Question

1. A product has a shadow account product design feature where, in addition to the fixed charges and credits associated with the policy, there is a shadow account premium charge in the event that the policyholder underfunds the policy. This premium charge is expressed as a fixed percentage of the premium shortfall when compared to a given level premium.

2. Please clarify whether a shadow account charge expressed as a fixed percentage of the premium shortfall is regarded as "multiple sets of charges" or as a "single set of charges" and thus whether such a product is compatible with Policy Design # 1 or Policy Design # 3.

Interpretation of Emerging Actuarial Issues (E) Working Group

3. This charge and treatment as Policy Design 1 does not appear consistent with the type of charge and treatment addressed by adopted INT 24 (formerly referred to as Pending Submission 6 prior to its adoption).

4. INT 24 deals with a single charge that all policyholders will incur which stops after a certain level of premiums have been paid. The charge described here is not incurred by all policyholders and provides the potential for a reserve premium being subject to the full impact of this charge whereas the premiums actually expected to be paid would not incur this charge.

5. More information is needed to fully assess the applicable Policy Design but based on the information provided Policy Design 3 appears appropriate.

Interpretation of the Emerging Actuarial Issues (E) Working Group

Actuarial INT 29

Date Adopted by Emerging Actuarial Issues (E) Working Group

April 4, 2013

Date Adopted by Financial Condition (E) Committee

April 8, 2013

Reference

Actuarial Guideline 38- The Application of the Valuation of Life Insurance Policies Model Regulation

Section 8E I) 3 Actuarial Opinion and Company Representation section

Issue / Question

1. A company currently issues a ULSG product that is clearly a Policy Design #3. Two hypothetical examples of the charge/credit structure are shown in Tables 1 and 2 below. Under either structure, the policy form:

- Is clearly Policy Design #3
- Does not run afoul of the "Index plus 3%" of 8E

2. The purpose of the bifurcated cost of insurance charge structure in Table 1 or bifurcated premium charge structure in Table 2 is to optimize management of policyholder premium paying pattern behavior. The exact insurance charge for any given policy under the Table 1 design is either COI 1 or COI 2, where the rate is determined by comparing the actual fund value to a pre-defined fund value. If the actual fund value is in excess of the pre-defined fund value, COI 1 is used, otherwise COI 2 is used. Similarly, the exact premium charge amount for any given policy under the Table 2 design is PremPct1 for amounts paid up to a target amount plus PremPct2 for amounts paid in excess of the target amount.

3. The company's approach to establishing statutory reserves has always been to determine AG XXXVIII Step 1 minimum premiums based on the lowest charges from Table 1 (or Table 2). The actuary concludes that everything in the reserving practices of the company with respect to this policy form is in compliance with the letter and spirit of AG XXXVIII, and except for the third statement in the Actuarial Opinion (of Section E), the actuary feels s/he could sign such an attestation. The third statement declares "the minimum gross premiums determined under Policy Design #3 are not inconsistent with the minimum premiums, charges and credits that are expected to apply".

4. What is the actuary expected to do in such a situation?

TABLE 1

	COI_1	COI_2	Interest	Prem Load
45	0.000066	0.000231	3.75%	15%
46	0.000108	0.000378	3.75%	15%
47	0.000146	0.000511	3.75%	15%
48	0.000180	0.000630	3.75%	15%
49	0.000212	0.000742	3.75%	15%
50	0.000242	0.000847	3.75%	15%
51	0.000276	0.000966	3.75%	15%
52	0.000316	0.001106	3.75%	15%
53	0.000364	0.001274	3.75%	15%
54	0.000422	0.001477	3.75%	15%
55	0.000486	0.001701	3.75%	15%
56	0.000556	0.001946	3.75%	15%
57	0.000632	0.002212	3.75%	15%
58	0.000712	0.002492	3.75%	15%
59	0.000796	0.002786	3.75%	15%
60	0.000882	0.003087	3.75%	15%
61	0.000972	0.003402	3.75%	15%
62	0.001070	0.003745	3.75%	15%
63	0.001180	0.004130	3.75%	15%
64	0.001310	0.004585	3.75%	15%
65	0.001470	0.005145	3.75%	15%

TABLE 2

			Up to Target	In excess
	COI	Interest	PremPct1	PremPct2
45	0.000149	4.00%	15%	5%
46	0.000243	4.00%	15%	5%
47	0.000329	4.00%	15%	5%
48	0.000405	4.00%	15%	5%
49	0.000477	4.00%	15%	5%
50	0.000545	4.00%	15%	5%
51	0.000621	4.00%	15%	5%
52	0.000711	4.00%	15%	5%
53	0.000819	4.00%	15%	5%
54	0.000950	4.00%	15%	5%
55	0.001094	4.00%	15%	5%
56	0.001251	4.00%	15%	5%
57	0.001422	4.00%	15%	5%
58	0.001602	4.00%	15%	5%
59	0.001791	4.00%	15%	5%
60	0.001985	4.00%	15%	5%
61	0.002187	4.00%	15%	5%
62	0.002408	4.00%	15%	5%
63	0.002655	4.00%	15%	5%
64	0.002948	4.00%	15%	5%
65	0.003308	4.00%	15%	5%

Interpretation of Emerging Actuarial Issues (E) Working Group

5. As indicated in INT 23, the actuary who is unable to opine favorably would be required to calculate reserves in accordance with Method II.

Interpretation of the Emerging Actuarial Issues (E) Working Group

Actuarial INT 30

Date Adopted by Emerging Actuarial Issues (E) Working Group

June 6, 2013

Date Adopted by Financial Condition (E) Committee

July 17, 2013

Reference

Actuarial Guideline 38- The Application of the Valuation of Life Insurance Policies Model Regulation Section 8E

Issue / Question

1. Does Section 8E apply to the following.... (a) a 10 year secondary guarantee of the cumulative minimum premium variety where there is no interest credited to the premiums, and premiums are expected to be level (b) same question as above except the secondary guarantee period is 15 years.

Interpretation of Emerging Actuarial Issues (E) Working Group

2. Yes. Section 8E applies to both, for policies issued on or after 1/1/2013.

Interpretation of the Emerging Actuarial Issues (E) Working Group

Actuarial INT 31

Date Adopted by Emerging Actuarial Issues (E) Working Group

August 23, 2013

Date Adopted by Financial Condition (E) Committee

August 26, 2013

Reference

1. Subsection 8D states in the second paragraph that: "This section does not apply if the minimum gross premiums for the policies are determined by applying the set of charges and credits that produces the lowest premiums, …"

2. Interpretation ACT INT 02 states that a company may switch between the Primary Reserve Methodology and the Alternative Reserve Methodology.

Issue / Question

3. Can a company use the Alternative Reserve Methodology found in sub-section 8D of AG38 for a policy with multiple sets of interest credits or charges if the reserves have previously been calculated using the lowest minimum gross premiums?

Interpretation of Emerging Actuarial Issues (E) Working Group

4. The applicability language in the second paragraph of AG 38, Section 8D, should not be interpreted to preclude a company from using AG 38, Section 8D(b), "Alternative Reserve Methodology", pursuant to the requirements of 8D(b) and any applicable interpretations adopted by the NAIC.

Interpretation of the Emerging Actuarial Issues (E) Working Group

Actuarial INT 32

Date Adopted by Emerging Actuarial Issues (E) Working Group

August 23, 2013

Date Adopted by Financial Condition (E) Committee

August 26, 2013

Reference

Regulation XXX; Actuarial Guideline 38, 8D

Issue / Question

1. The company states that reserves equal to the deterministic reserve required in the valuation manual of the valuation law (model 820) are lower than produced under the above methodology, but states that it would hold reserves per the valuation manual if that produced greater reserves in aggregate for the block. If tested for each policy, the reserve required per the valuation manual would in some cases be higher than as calculated based on regulation XXX. Can the valuation manual floor be applied in aggregate rather than for each policy?

Interpretation of Emerging Actuarial Issues (E) Working Group

2. The deterministic reserve as required by Actuarial Guideline 38 8D(a) should be applied in the aggregate versus policy by policy.

Interpretation of the Emerging Actuarial Issues (E) Working Group

Actuarial INT 33

Date Adopted by Emerging Actuarial Issues (E) Working Group

August 23, 2013

Date Adopted by Financial Condition (E) Committee

August 26, 2013

Reference

Section 7 of AG38 and Steps 1, 2, and 8 of Section 8E of AG38

Issue / Question

1. Does the language "This result may be negative." occurring twice in Step 3 of Section 8E of Actuarial Guideline 38 (AG 38) apply only to the Method II reserve approach in AG 38 or to both Method I and Method II reserve approaches? Step 3 of Section 8E of AG 38 provides for the determination of the amount of actual premium payments (or shadow account) greater than or less than the minimum gross premiums (or shadow account based on minimum premiums), as defined in Section 8E.

2. The issue regarding the referenced language relates to the interpretation of Step 3 as it applies particularly to (i) cumulative premium secondary guarantee designs with a "premium catch-up provision" or (ii) shadow account secondary guarantee designs where, if the shadow account is below the level necessary to maintain the secondary guarantee, there is a "catch-up provision" where the shadow account may be reinstated prior to the end of the secondary guarantee period.

3. In addition to Section 8E of AG 38, it appears that Section 7 of AG 38 applies in this situation. For Section 8E Method I reserve calculations, the language of Section 7 appears to deal with any deficiency indicated in Step 3 of Section 8E satisfactorily since that deficiency is measured relative to the guarantees (cumulative premium or shadow account). In this case, the value of the numerator in Step 3 of Section 8E would be zero and the floor basic and deficiency reserve would be set at the minimums defined in Section 7.

4. However, for Section 8E Method II reserve calculations, for purposes of applying Section 8E, the deficiency in Step 3 is measured relative to the premium defined in Step 1 which is the schedule of minimum gross premiums that create the greatest deficiency reserve rather than the schedule of minimum gross premiums based on the policy guarantees. This is inconsistent with the requirements and intent of Section 7 and therefore would allow for the ratio in Step 4 of Section 8E to be negative.

Interpretation of Emerging Actuarial Issues (E) Working Group

5. The recommended response is essentially correct. The phrase, "This result may be negative" applies only to Method II policies in Section 8E, Step 3. This phrase does not apply to the Step 3 amount for Method I policies given the requirements of AG 38, Section 7. Method I policies that would otherwise have a negative Step 3 amount were it not for Section 7 are those policies that are underfunded but provide for a catch up provision as addressed by Section 7. The Step 2 basic and deficiency reserves for such policies, used to calculate the "reserve floor" in Step 8 (c), must be adjusted as provided by Section 7 prior to calculating the "reserve floor" in Step 8 (c).

Interpretation of the Emerging Actuarial Issues (E) Working Group

Actuarial INT 34

Date Adopted by Emerging Actuarial Issues (E) Working Group

November 22, 2013

Date Adopted by Financial Condition (E) Committee

December 17, 2013

Reference

Actuarial Guideline 38 Section 8D.a.2(a)

Issue / Question

1. Section 8D directs companies to use "…the same requirements for determining the deterministic reserve in the version of the valuation manual specified…but with two modifications…" In determining future Treasury yield rates used in calculating the sale price of any asset existing on the valuation date, this language in Section 8D of AG38 can be interpreted in one of two ways:

a. Assuming a level series of future Treasury yield curves for all future years of the model projection period. In this case, any gains or losses arising from the sale of existing assets during the projection period would be determined using a level Treasury yield curve scenario prospectively, and a spread applicable to the asset, as determined on the valuation date.

b. Assuming the series of future Treasury yield curves is that described under Scenario 12 from the prescribed set of interest rate scenarios used in the stochastic exclusion test in VM-20. To these Treasury rates is added a spread to determine the yield rate to be used on the sale of an existing asset during the model projection period.

Interpretation of Emerging Actuarial Issues (E) Working Group

2. It is recommended that the approach outlined in paragraph 1.a. be the interpretation of the relevant language of Actuarial Guideline 38 Section 8D.a.2(a).

Interpretation of the Emerging Actuarial Issues (E) Working Group

Actuarial INT 35

Date Adopted by Emerging Actuarial Issues (E) Working Group

December 13, 2013

Date Adopted by Financial Condition (E) Committee

December 17, 2013

Reference

Actuarial Guideline 38 Section 8D.A.2(a)(I)

Issue / Question

1. Section 8.D.A.2(a)(I) states, "net investment returns based on a portfolio of A-rated corporate bonds purchased in the year of issue of the policies based on yields available in the year of issue of those bonds" shall be calculated.

2. A possible interpretation of this language is that a company may be permitted to determine this hypothetical portfolio book yield for each year using their actual A-rated bonds purchased in that year, i.e. their own A-rated bonds. Is this approach acceptable?

Interpretation of Emerging Actuarial Issues (E) Working Group

3. It was the intent of this provision that a company use a hypothetical portfolio composed of A-rated corporate bonds with yields commensurate with the A-rated corporate bond yields available in the year of issue. If the yields associated with the company's actual A-rated bonds purchased in the year of issue are commensurate with A-rated corporate bond yields available in the year of issue, then the company's approach is acceptable. If the yields associated with the company's bonds are significantly higher than A-rated corporate bond yields available in the year of issue, then the approach is unacceptable.

4. If such an approach was used, the appointed actuary should address this question in the memorandum. Reasonable approaches for comparison to a company's assets include using a published index of A-rated corporate bond yields such as Moody's at an appropriate point in the year of issue or an average over the course of the year. Another reasonable approach would be to use a Treasury yield curve at an appropriate point in the year of issue or an average over the course of the year plus an appropriate published spread of A-rated corporate bond yields over Treasuries. An appropriate point in time would be June 30 of that year if the business was sold uniformly throughout the year. If the comparison does not show the yields from company's assets to be commensurate with the published index or adjusted yield curve rate, then (a) the sample size of the company's own A-rated portfolio relative to the total portfolio backing the liabilities, and (b) the year to year consistency of asset allocation become major items to be addressed in the memorandum.

Interpretation of the Emerging Actuarial Issues (E) Working Group

Actuarial INT 36

Date Adopted by Emerging Actuarial Issues (E) Working Group

December 13, 2013

Date Adopted by Financial Condition (E) Committee

December 17, 2013

Reference

Actuarial Guideline 38 Section 8D.a

Issue / Question

1. Section 8D.a. applies to a company's aggregate gross reserve before reinsurance. The reserve calculation requires a projection of future year-by-year cash flows, which includes such items as investment earnings and general insurance expenses. If a company has ceded 100% of the business to an authorized reinsurer by use of coinsurance, the assets and net liabilities are no longer on the ceding company's books. Additionally, the administration is also generally transferred to the reinsurer. In such circumstances, the projection of future cash flows is "hypothetical" in that one must assume a starting asset portfolio, future investment strategy, future general insurance expenses, and so on. Furthermore, the ceding company generally does not have the data or systems to determine the reserves and must rely on the assuming company.

2. Since the assuming company is required to calculate the reserves on both direct and assumed business, may the ceding company use the reserves as reported by the reinsurer in the reinsurer's annual statement?

Interpretation of Emerging Actuarial Issues (E) Working Group

3. Under 100% coinsurance agreements with an authorized reinsurer, the ceding company is permitted to report reserves equal to those calculated by the reinsurer in the reinsurer's Exhibit 5/Schedule S.

4. Note that this interpretation was not being requested for coinsurance with funds withheld, modified coinsurance, or agreements where the reinsurer is unauthorized.

5. The Working Group recommends the above interpretation as guidance for yearend 2013, provided there is no conflict with the accounting requirements in the Accounting Practices and Procedures Manual. The issue/question will be submitted to the Life Actuarial (A) Task Force for broader consideration and possible amendment to the valuation manual.

Interpretation of the Emerging Actuarial Issues (E) Working Group

Actuarial INT 37

Date Adopted by Emerging Actuarial Issues (E) Working Group

December 13, 2013

Date Adopted by Financial Condition (E) Committee

December 17, 2013

Reference

Actuarial Guideline 38 Sections 8B and 8C

Issue / Question

1. Step 4 of Section 8E says "…determine the minimum amount of shadow account required to fully fund the guarantee." Should this determination take into account actual history, or is this a purely theoretical value?

2. Consider a hypothetical policy valued on its 5th anniversary. It has a shadow fund value of $12,000. Premiums of $2,500 were paid on each anniversary. If the policyholder paid an additional $63,000 (net of premium loads) on the valuation date, the guarantee would be fully funded. However, due to the product design, if the $12,000 shadow fund value resulted from a single premium of $10,000 at issue, the guarantee would be fully funded by payment of an additional $60,000 (net) at the valuation date. Is the "minimum amount" $75,000 or $72,000?

Interpretation of Emerging Actuarial Issues (E) Working Group

3. Step 4 of Section 8E states that the determination is to be made as of "the valuation date for the policy being valued…", indicative of a seriatim calculation that considers the actual circumstances of the policy. If on the valuation date a specific set of charges and credits are applicable for future shadow account calculations, such charges and credits should be used in the determination regardless of any more favorable charges and credits that may have been available as of the issue date.

4. Given the information that the policyholder has no control over the future charges and credits to be applied in fully funding the guarantee, it is presumed that a single set of charges/credits (with no caps or floors) is operative as of the valuation date. While an unqualified response is not possible in the absence of a full understanding of the policy design, the minimum amount appears to be $75,000 rather than $72,000.

5. Also, per AG38, Section 8E, the actuary must ensure that the methodology is compatible with the intent that the funding ratio (Step 3 result divided by the Step 4 result) measures the level of prefunding.

Interpretation of the Emerging Actuarial Issues (E) Working Group

Actuarial INT 38

Date Adopted by Emerging Actuarial Issues (E) Working Group

August 14, 2014

Date Adopted by Financial Condition (E) Committee

August 18, 2014

Reference

Actuarial Guideline 38 Section 8D

Issue / Question

1. Actuarial INT 27 clarifies that AG38, Section 8D, addresses the gross reserve requirements and required documentation regarding reinsurance. In reviewing the AG 38, Section 8D Actuarial Memorandum and reinsurance information, it appears that guidance is needed to address situations where the YRT reinsurance agreement reserve credit taken may be significantly different than the reserve an assuming company has set up. Such a significant difference can be due to a larger credit being calculated under VM-20 assumptions versus that set up by an assuming company. Additionally, in some cases the higher gross reserve required under the AG 38, Section 8D modified deterministic reserve, was not reported in the statutory blank prior to the reinsurance credit being taken.

Interpretation of Emerging Actuarial Issues (E) Working Group

2. The reserve established pursuant to AG 38, Section 8D (AG38-8D), should be reported on a gross basis prior to any adjustment for reinsurance. In addition, the reserve credit for reinsurance on policies subject to AG38-8D should be calculated using current statutory requirements and mortality and interest applicable under the AG38-8D.a.1. calculation.

3. Since AG38-8D does not address credit for reinsurance and only addresses calculation of the gross reserve, any determination of such credit would be outside of AG38-8D and, therefore, based on current statutory requirements and accepted practices. For example, for the calculation of the ceding credit to be posted in the statutory statement, current accounting guidance (including SSAP No. 61R, paragraph 37) should be followed. And for asset adequacy analysis, both for general testing of aggregate reserves and for the standalone analysis required by AG38-8C, currently accepted actuarial practice should be followed. AG38-8D does not incorporate VM-20 directly into either of these.

Interpretation of the Emerging Actuarial Issues (E) Working Group

Actuarial INT 39

Date Adopted by Emerging Actuarial Issues (E) Working Group

November 14, 2014

Date Adopted by Financial Condition (E) Committee

November 18, 2014

Reference

Actuarial Guideline 38 Section 8D. a.2.a)(I), Section 7.D. of VM-20

Issue / Question

1. Subsection a.2. of Section 8D provides for two exceptions to the usual deterministic reserve requirements of VM-20 in calculating the gross premium reserve in Section 8D.a.2. One of these exceptions, in subsection a.2.a)(I), relates to net investment earnings on starting assets and limits those earnings to "…the lesser of (i) the actual portfolio net investment returns and (ii) the net investment returns based on a portfolio of A-rated corporate bonds…".

2. The language of Section 8D.a.2.a)(I) is not prescriptive as to the process for determining this net investment earnings comparison. One option is to compare actual portfolio yields to hypothetical portfolio yields as of a single point in time, most logically the valuation date. Another option is to develop both an actual and hypothetical portfolio as of the valuation date and project future asset cash flows and net investment returns prospectively and then use the lesser earning portfolio net investment return in each future year. Other prospective-type approaches to determining the Section 8D.a.2.a)(I) lesser net investment return portfolio are also possible. These lesser returns are then combined, in some fashion, with the net reinvestment return prescribed in Section 8D.a.2.a)(II) to develop the final path of discount rates used in the final Section 8D.a.2.c) reserve calculation.

3. In determining an appropriate interpretation of the language of Section 8D.a.2.a)(I) an important question to ask is: Is a prospective-type interpretation and approach illustrated above, or something similar, consistent with the determination of a single starting asset portfolio as described in Section 7.D. ofVM-20? The objective of the requirement in Section 8D.a.2.a)(I) is to impose a restriction on the determination of the starting asset portfolio required under VM-20 for the deterministic reserve calculation, not to anticipate the use of multiple portfolios prospectively. The use of future year-by-year net investment returns from multiple portfolios (actual and hypothetical) would appear to be inconsistent with the starting asset portfolio requirement of VM-20.

4. The issues at hand are twofold:

   a. Does a prospective future net investment return comparison interpretation of the language of Section 8D.a.2.a)(I) create an inconsistency with the language of Section 7.D. of VM-20 with respect to the requirements for utilizing a single starting asset portfolio in the deterministic reserve calculation?

   b. Given the multitude of possible approaches that might be used, does a prospective future net investment return comparison interpretation of the language of Section 8D.a.2.a)(I) lead to the creation of a non-level playing field beyond the range of approaches available in interpreting Section 8D.a.2.a)(I) in a manner that is consistent with VM-20?

Interpretation of Emerging Actuarial Issues (E) Working Group

5. For 12/31/2014 and later Section 8D submissions, for purposes of determining the starting asset portfolio, the language of Section 8D.a.2.a)(I) is interpreted such that the actual/hypothetical starting asset portfolio net investment return comparison is made as of the valuation date and not prospectively. Examples of how the comparison may be made include (i) a comparison of the weighted average hypothetical portfolio versus actual portfolio net investment returns as of the valuation date or (ii) a historical issue-year-by-issue-year hypothetical versus actual portfolio net investment return comparison, perhaps resulting in a starting asset portfolio as of the valuation date that is a hybrid of the company's actual portfolio assets for certain issue years and a hypothetical asset portfolio for other issue years.

Interpretation of the Emerging Actuarial Issues (E) Working Group

Actuarial INT 40

Date Adopted by Emerging Actuarial Issues (E) Working Group

November 14, 2014

Date Adopted by Financial Condition (E) Committee

November 18, 2014

Reference

Actuarial Guideline 38 Section 8D.a.2.c) and Section 7.C.4. of VM-20

Issue / Question

1. Subsection a.2.c) of Section 8D provides for the calculation of gross premium Primary Reserve to be performed using the path of net investment returns determined in Section 8D.a.2.b) "…to discount the cash flows applicable to those policies.", i.e. those policies subject to Section 8D. The cash flows referenced in Section 8D.a.2.c) are to include, as per Section 4.A.3. of VM-20, death and cash surrender benefits. For the ULSG policy types subject to the requirements of Section 8D, if the interest rate credited to the policy account value is a non-guaranteed element (NGE), the value of the benefits be directly impacted by the net investment earnings of the assets used to back the reserves held in support of the risks assumed under the policies. In addition, lapse rates for these ULSG policy types also may vary depending on the net investment earnings of the assets used to back the reserves held in support of the risks assumed under the policies.

2. Section 7.C. of VM-20, covering NGE cash flows, requires, in subsection 4. that:

   a. "Projected levels of NGE in the cash flow model must be consistent with the experience assumptions used in each scenario. Policyholder behavior assumptions in the model must be consistent with the NGE assumed in the model."

   b. There is only a single (level) interest rate scenario applicable for the Section 8D.a.2. reserve gross premium reserve calculation so the issue centers on whether the NGE and policyholder behavior assumptions are "consistent" with the experience assumptions and NGE respectively.

Interpretation of Emerging Actuarial Issues (E) Working Group

3. This interpretation permits the delinking of the liability cash flows used in the Section 8D.a.2.c) gross premium reserve calculation from the net investment returns determined as in Section 8D.a.2.b) provided the actuary can provide justification that the impact of such delinkage on the Section 8D.a.2. reserve calculation is consistent with the requirements of Section 7.C.4 and Section 2G of VM-20.

4. The information required to support the delinked approach would need to present reasonable justification and reflect the consistency of the assumptions used with the particular company's anticipated experience and ULSG product structures. The information provided should be adequate to support the assertion that the requirements of Section 2.G. and Section 7.C.4. of VM-20 have been achieved.

Interpretation of the Emerging Actuarial Issues (E) Working Group

Actuarial INT 41

Date Adopted by Emerging Actuarial Issues (E) Working Group

December 11, 2014

Date Adopted by Financial Condition (E) Committee

December 12, 2014

Reference

Actuarial Guideline 38 Section 8D. a.2.a)(I)

Issue / Question

1. Section 8D directs companies to test: "The company's aggregate gross reserve before reinsurance for the business subject to this Section 8D to be reported in the December 31, 2012, and subsequent annual statutory financial statements of the company will be the aggregate reserve under 1 below, plus any excess of the aggregate reserve determined as defined in 2 below, over 1".

2. Furthermore Section 8D requires that for existing assets: "The projected net investment earnings from the starting assets shall be the lesser of (i) the actual portfolio net investment returns and (ii) net investment returns based on a portfolio of A-rated corporate bonds purchased in the year of issue of the policies based on yields available in the year of issue for those bonds."

3. Is it required to test reinsurance assumed?

   a. Some companies only test at the direct writer level (using hypothetical portfolios) while other companies test the reinsurance assumed against actual assets.

4. Is it appropriate to use hypothetical portfolios for testing?

   a. Assuming a company where the reserves are 100% ceded (all but an insignificant amount was coinsurance) and no assets remain. May the company test on the basis of a hypothetical portfolio of A rated bonds described above? While this may be the only interpretation available, there is no connection between the assets and the liabilities or any company investment policy.

   b. When the existing asset yield is below that of the hypothetical portfolio, is it required to take a hair-cut on the yields of the existing assets or is it acceptable to use a hypothetical portfolio of just one bond per issue year instead?

Interpretation of Emerging Actuarial Issues (E) Working Group

5. Do the requirements of AG38-8D apply to applicable reinsurance assumed?

   a. Yes. It is required to apply the requirements of AG38-8D to include reinsurance assumed on risks that are within its scope. AG38-8D(a) includes the company's "aggregate gross reserve before reinsurance…". This is interpreted, for applicable business, to be the company's direct written business plus coinsurance reinsurance assumed and prior to any reinsurance ceded. Only this interpretation is consistent with the scope of AG38-8D and the reporting of reserves in Exhibit 5 of the annual statement.

6. Is it appropriate to use hypothetical portfolios for testing?

   a. There are two types of hypothetical portfolios possible for this question.

      i. The first type of hypothetical portfolio is required by AG-38, 8D(a)(2)(a)(I)(ii). This citation provides for a derivation of a hypothetical "portfolio of A rated corporate bonds purchased in the year of issue of the policies based on yields available in the year of issue for those bonds."

      ii. There may be a second type of hypothetical portfolio to use in place of the actual portfolio pursuant to AG38, 8D(a)(2)(a)(I)(i) if that actual portfolio is incomplete or unavailable for a company that has ceded some or all of the risk through coinsurance. In this case the company may coordinate with and make use of the reserve calculations of the assuming reinsurer, as provided in VM-20 Section 8.A.1. However, the ceding company, in calculating the pre-reinsurance ceded reserve or gross reserve required by AG-38 Section 8D, must assure that such modeling and assumptions are appropriate as provided by the first paragraph of VM-20 Section 8.D.2 and as provided by VM-20 Section 8.D.2.b.

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Appendix D
GAAP Cross-Reference to SAP
as of December 2014

Introduction

As expressed in the Statement of Concepts, Statutory Accounting Principles (SAP) utilizes the framework established by Generally Accepted Accounting Principles (GAAP). Appendix D includes GAAP pronouncements that have been considered or are pending consideration in the development of SAP.

The NAIC Codification of Statutory Accounting Principles by the Statutory Accounting Principles (E) Working Group (SAPWG) (Statutory Accounting Principles as of January 1, 2000) addressed all GAAP pronouncements included in categories a, b, and c issued through 1996, during the initial drafting of the SSAPs, as well as the AICPA Accounting Interpretations included in Category D:

- Category A - FASB Statements and Interpretations, APB Opinions, and AICPA Accounting Research Bulletins

- Category B - FASB Technical Bulletins, Board-Directed FASB Staff Positions, AICPA Industry Audit and Accounting Guides, and AICPA Statements of Position

- Category C - Consensus positions of the FASB Emerging Issues Task Force (EITF) and AICPA Practice Bulletins

- Category D - AICPA Accounting Interpretations

Subsequent to the NAIC codification of statutory accounting principles, as documented in the Policy Statement on the Maintenance of Statutory Accounting Principles (included in Appendix F), the SAPWG continued to review new GAAP guidance for applicability to SAP. Beginning January 1, 1999, the NAIC Emerging Accounting Issues (E) Working Group (EAIWG) was formed and began addressing FASB EITF opinions issued subsequent to 1996. The positions of the EAIWG are documented in an interpretation (INT) as indicated by reference in the applicable column of the GAAP Cross-Reference to SAP chart. Appendix B includes the full text of EAIWG INTs issued before December 31, 2014. In October 2010, the SAPWG undertook a project to incorporate authoritative guidance related to specific topics in one location. This means that guidance within INTs has been incorporated into the applicable SSAPs, where possible. Appendix D now references the applicable SSAP, not the nullified INT. Therefore, completely superseded SSAPs and nullified interpretations (INTs) are removed from the printed Manual and are included on the "Updates to the Accounting Practices and Procedures (AP&P) Manual" webpage. Under this approach, only current authoritative guidance is located in Volume I of this Manual, while preserving the historical reference of previous authoritative SSAPs and INTs for accounting purposes. Completely superseded SSAPs and nullified INTs are also included in Appendix H – Superseded SSAPs and Nullified Interpretations within the AP&P Folio View CD-ROM.

In June 2009, the FASB issued *FASB Statement 168, FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles (FAS 168)*, effective for interim and annual periods ending after Sept. 15, 2009. FAS 168 (Topic 105 of the FASB Codification) identified the sources of accounting principles and the framework for selecting the principles used in the preparation of the financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles (GAAP) in the United States. Pursuant to this standard:

- FASB Accounting Standards Codification was established as the source of authoritative accounting principles recognized by the FASB to be applied by nongovernmental entities. (SEC guidance included within the FASB Codification is provided for convenience and relates only to SEC entities.)

- Accounting Standards Updates issued after the effective date of FAS 168 are not considered authoritative in their own right. Such standards serve only to update the FASB Codification, provide background information, and provide the bases of conclusions on the changes to the FASB Codification.

- Effective September 15, 2009, all non-SEC accounting and reporting standards were superseded. Additionally, all nongrandfathered, non-SEC accounting literature not included in the Codification was deemed nonauthoritative. As of September 15, 2009, AICPA Statements of Position are no longer reviewed as part of the statutory maintenance process as they are no longer considered authoritative GAAP literature. If the AICPA were to address an issue that affects the FASB Codification, an accounting standard update (ASU) would be issued and reviewed for applicability to statutory accounting.

As a result of FAS 168, Appendix D – GAAP Cross Reference to SAP has been revised to include reference of FASB Accounting Standards Updates, as well as the Accounting Standards Codification Reference (Topic and Subtopic) for pre-codification GAAP guidance. Pre-codification GAAP guidance that has been superseded as a result of exclusion from the GAAP Codification has been identified within Appendix D. **Users of the NAIC *Accounting Practices and Procedures Manual* shall continue to refer to the FASB pre-codification standards, and the applicable references to such standards, to determine the GAAP guidance that has been adopted, adopted with modification, or rejected for statutory accounting.**

To assist users in tracing pre-codification GAAP standards to the FASB Codification, Appendix D – GAAP Cross-Reference to SAP includes the Topic and Subtopic for all pre-codification GAAP standards that have been included in the FASB Codification. **This FASB Codification reference does not reflect GAAP guidance adopted for statutory accounting.** Only the guidance detailed in specific SSAPs or Interpretations shall be utilized in determining the GAAP guidance adopted, adopted with modification, or rejected for statutory accounting. Items noted with "Not Explicitly Included in Codification" are no longer included in the FASB Cross Reference tool. The information may have been included in a subsequent revision or removed.

Information Provided in Appendix D – GAAP Cross-Reference to SSAP:

- Status - This column includes the SAPWG/EAIWG status of review. A "Pending" status indicates that the SAPWG or EAIWG has not completed deliberation of the GAAP pronouncement. Items noted as "Not Board-Directed or SEC Update" will not be reviewed by the Working Group unless specifically requested for review.

- Disposition - This column represents the general conclusion of the SAPWG/EAIWG for the stated GAAP pronouncement. This information is included in Appendix D as a reference tool, however, the guidance in the specific SSAP or Interpretation shall be the authoritative source in determining the GAAP guidance adopted, adopted with modification, or rejected for statutory accounting.

- SSAP or INT Number – This column provides the authoritative statutory accounting source addressing the GAAP pronouncement.

- Accounting Standards Codification Topic and Subtopic – This column provides a reference guide to trace pre-codification GAAP standards to the new FASB Codification.

In addition to the "GAAP Cross Reference to SSAP," Appendix D includes the "FASB Codification to Pre-Codification GAAP" supplement. This supplement serves as a reference tool in tracing the FASB Codification to pre-codification GAAP standards that have been reviewed, or are pending review as part of the current NAIC statutory accounting maintenance process. This supplement does not indicate which GAAP standards have been adopted, adopted with modification or rejected for statutory accounting. Pre-codification GAAP guidance not captured as part of the statutory accounting maintenance process, but that has been incorporated in the FASB Codification, has not been referenced within this Supplement. Future consideration will occur on whether this pre-codification GAAP guidance will be reviewed for statutory accounting. Pre-codification GAAP included in the FASB codification, but not referenced within this supplement includes: FASB Derivative Implementation Group Issues; EITF Appendix D Topics; FASB Statement No. 138 Examples; FASB Staff Implementation Guides; AICPA Technical Inquiry Service and Audit and Accounting Guides. (The Audit and Accounting Guides (AAG) related to insurance have been reviewed for statutory accounting and are referenced in this supplement – HCO: Health Care Organizations, LHI: Life and Health Insurance and PLI: Property and Liability Insurance Companies. This supplement also does not include reference to the SEC standards incorporated within the FASB Codification: SEC Financial Reporting Releases; SEC Interpretive Releases; SEC Staff Accounting Bulletins; and SEC Regulation S-X.

Appendix D - GAAP Cross-Reference to SAP Table of Contents Page

FASB Codification:

Accounting Standards Updates D-1

Pre-FASB Codification:

Category A - FASB Statements and Interpretations, APB Opinions, and AICPA Accounting Research Bulletins D-9

Category B - FASB Technical Bulletins, FASB Staff Positions, AICPA Industry Audit and Accounting Guides, and AICPA Statements of Position D-42

Category C - Consensus positions of the FASB Emerging Issues Task Force and AICPA Practice Bulletins D-66

Category D - AICPA Accounting Interpretations D-109

FASB Codification to Pre-Codification GAAP D-111

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STATUTORY ACCOUNTING PRINCIPLES
GAAP CROSS-REFERENCE TO STATUTORY ACCOUNTING PRINCIPLES

ACCOUNTING STANDARDS UPDATES

GAAP Pronounce-ment	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.[1]
2009-01	Topic 105—Generally Accepted Accounting Principles—Amendments based on—Statement of Financial Accounting Standards No. 168—The *FASB Accounting Standards Codification*™ and the Hierarchy of Generally Accepted Accounting Principles	Complete	Adopt (Adopted FAS 168)	Preamble	Not Explicitly Included in Codification.
2009-02	Omnibus Update—Amendments to Various Topics for Technical Corrections	Complete	N/A	IP 99	Not Explicitly Included in Codification.
2009-03	*SEC Update—Amendments to Various Topics Containing SEC Staff Accounting Bulletins (SEC Update)*	*SEC Update*			*Not Explicitly Included in Codification.*
2009-04	*Accounting for Redeemable Equity Instruments—Amendment to Section 480-10-S99 (SEC Update)*	*SEC Update*			*Not Explicitly Included in Codification.*
2009-05	Fair Value Measurements and Disclosures (Topic 820)—Measuring Liabilities at Fair Value	Pending			820 825
2009-06	Income Taxes (Topic 740)—Implementation Guidance on Accounting for Uncertainty in Income Taxes and Disclosure Amendments for Nonpublic Entities	Pending			740
2009-07	*Accounting for Various Topics—Technical Corrections to SEC Paragraphs (SEC Update)*	*SEC Update*			*Not Explicitly Included in Codification.*
2009-08	*Earnings per Share—Amendments to Section 260-10-S99 (SEC Update)*	*SEC Update*			*260*
2009-09	*Accounting for Investments—Equity Method and Joint Ventures and Accounting for Equity-Based Payments to Non-Employees—Amendments to Sections 323-10-S99 and 505-50-S99 (SEC Update)*	*SEC Update*			*Not Explicitly Included in Codification.*

[1] To assist users in tracing pre-codification GAAP standards to the FASB Codification, the FASB Codification Topic and Subtopic for all pre-codification GAAP standards has been included in this Appendix. This FASB Codification reference does not reflect GAAP guidance adopted for statutory accounting. The Accounting Practices and Procedures Manual (E) Subgroup was formed to assess changes necessary to reflect the new GAAP Codification within statutory accounting principles. Until this process is complete, or as otherwise noted in specific SSAPs or Interpretations, users of the *NAIC Accounting Practices and Procedures Manual* shall continue to refer to the FASB pre-codification standards, and the applicable references to such standards, to determine the GAAP guidance that has been adopted, adopted with modification, or rejected for statutory accounting.

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ACCOUNTING STANDARDS UPDATES

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.[1]
2009-10	*Financial Services—Broker and Dealers: Investments—Other—Amendment to Subtopic 940-325 (SEC Update)*	*SEC Update*			*Not Explicitly Included in Codification.*
2009-11	*Extractive Activities—Oil and Gas—Amendment to Section 932-10-S99 (SEC Update)*	*SEC Update*			*932*
2009-12	Fair Value Measurements and Disclosures (Topic 820): Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)	Pending			820
2009-13	Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements	Complete	N/A Nullifies INT 04-18	IP 99	605
2009-14	Software (Topic 985): Certain Revenue Arrangements That Include Software Elements	Complete	Adopt/M	16R	985
2009-15	Accounting for Own-Share Lending Arrangements in Contemplation of Convertible Debt Issuance or Other Financing	Complete	N/A	IP 99	470
2009-16	Transfers and Servicing (Topic 860): Accounting for Transfers of Financial Assets (FAS 166)	Complete	Adopt/M	103	Not Explicitly Included in Codification.
2009-17	Consolidations (Topic 810): Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities (FAS 167)	Pending			Not Explicitly Included in Codification.
2010-01	Equity (Topic 505): Accounting for Distributions to Shareholders with Components of Stock and Cash	Complete	N/A	IP 99	505
2010-02	Consolidation (Topic 810): Accounting and Reporting for Decreases in Ownership of a Subsidiary—A Scope Clarification	Pending			805 810 845
2010-03	Extractive Activities—Oil and Gas (Topic 932): Oil and Gas Reserve Estimation and Disclosures	Complete	N/A	IP 99	932
2010-04	*Accounting for Various Topics: Technical Corrections to SEC Paragraphs*	*SEC Update*			*Not Explicitly Included in Codification.*
2010-05	*Compensation—Stock Compensation (Topic 718): Escrowed Share Arrangements and the Presumption of Compensation (SEC Update)*	*SEC Update*			*Not Explicitly Included in Codification.*
2010-06	Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements	Complete	Adopt/M	92, 100, 102	715 820

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ACCOUNTING STANDARDS UPDATES

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.[1]
2010-07	Not-for-Profit Entities (Topic 958): Not-for-Profit Entities: Mergers and Acquisitions	Pending			Not Explicitly Included in Codification.
2010-08	Technical Corrections to Various Topics	Complete	Adopt para. 815-20-25-15 Reject all others	86	Various
2010-09	Subsequent Events (Topic 855): Amendments to Certain Recognition and Disclosure Requirements	Complete	Reject	9	855
2010-10	Consolidation (Topic 810): Amendments for Certain Investment Funds	Pending			810
2010-11	Derivatives and Hedging (Topic 815): Scope Exception Related to Embedded Credit Derivatives	Complete	Adopt/M Paragraph 815-10-50k Reject all others	27, 86	815
2010-12	*Income Taxes (Topic 740): Accounting for Certain Tax Effects of the 2010 Health Care Reform Acts*	*SEC Update*			*740*
2010-13	Compensation—Stock Compensation (Topic 718): Effect of Denominating the Exercise Price of a Share-Based Payment Award in the Currency of the Market in Which the Underlying Equity Security Trades	Complete	Adopt/M	104R	718
2010-14	*Accounting for Extractive Activities—Oil & Gas: Amendments to Paragraph 932-10-S99-1 (SEC Update)*	*SEC Update*			*932*
2010-15	Financial Services—Insurance (Topic 944): How Investments Held through Separate Accounts Affect an Insurer's Consolidation Analysis of Those Investments	Pending			944
2010-16	Entertainment—Casinos (Topic 924): Accruals for Casino Jackpot Liabilities	Complete	N/A	IP 99	924
2010-17	Revenue Recognition—Milestone Method (Topic 605): Milestone Method of Revenue Recognition	Complete	N/A	IP 99	605
2010-18	Receivables (Topic 310): Effect of a Loan Modification When the Loan Is Part of a Pool That Is Accounted for as a Single Asset	Pending			310
2010-19	*Foreign Currency (Topic 830): Foreign Currency Issues: Multiple Foreign Currency Exchange Rates*	*SEC Update*			*830*

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GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.[1]
2010-20	Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses	Complete	Adopt/M for mortgage loans Reject all others	36, 37	310
2010-21	*Accounting for Technical Amendments to Various SEC Rules and Schedules: Amendments to SEC Paragraphs Pursuant to Release No. 33-9026: Technical Amendments to Rules, Forms, Schedules and Codification of Financial Reporting Policies (SEC Update)*	*SEC Update*			*Various*
2010-22	*Accounting for Various Topics—Technical Corrections to SEC Paragraphs (SEC Update)*	*SEC Update*			*Various*
2010-23	Health Care Entities (Topic 954): Measuring Charity Care for Disclosure	Pending			954
2010-24	Health Care Entities (Topic 954): Presentation of Insurance Claims and Related Insurance Recoveries	Complete	N/A	IP 99	954
2010-25	Plan Accounting—Defined Contribution Pension Plans (Topic 962): Reporting Loans to Participants by Defined Contribution Pension Plans	Complete	N/A	IP 99	310 962
2010-26	Financial Services—Insurance (Topic 944): Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts	Complete	Reject	71	944
2010-27	Other Expenses (Topic 720): Fees Paid to the Federal Government by Pharmaceutical Manufacturers	Complete	N/A	IP 99	720
2010-28	Intangibles—Goodwill and Other (Topic 350): When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts	Pending			350
2010-29	Business Combinations (Topic 805): Disclosure of Supplementary Pro Forma Information for Business Combinations	Pending			805 958
2011-01	Receivables (Topic 310): Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20	Complete	See ASU 2011-02	36	310

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ACCOUNTING STANDARDS UPDATES

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.[1]
2011-02	Receivables (Topic 310): A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring	Complete	Adopt/M Paragraphs 310-40-15-13 through 18 and 310-40-15-20 Reject all others	36	310
2011-03	Transfers and Servicing (Topic 860): Reconsideration of Effective Control for Repurchase Agreements	Complete	Adopt	103	860
2011-04	Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs	Pending			715 805 820
2011-05	Comprehensive Income (Topic 220): Presentation of Comprehensive Income	Complete	N/A	IP 99	205 220
2011-06	Other Expenses (Topic 720): Fees Paid to the Federal Government by Health Insurers	Complete	Adopt/M	106	405 720
2011-07	Health Care Entities (Topic 954): Presentation and Disclosure of Patient Service Revenue, Provision for Bad Debts, and the Allowance for Doubtful Accounts for Certain Health Care Entities	Complete	N/A	IP 99	954
2011-08	Intangibles—Goodwill and Other (Topic 350): Testing Goodwill for Impairment	Pending			350
2011-09	Compensation—Retirement Benefits—Multiemployer Plans (Subtopic 715-80): Disclosures about an Employer's Participation in a Multiemployer Plan	Complete	Adopt	92, 102	715
2011-10	Property, Plant, and Equipment (Topic 360): Derecognition of in Substance Real Estate—A Scope Clarification	Pending			360
2011-11	Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities	Complete	Reject	64	210 270
2011-12	Comprehensive Income (Topic 220)–Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05	Complete	N/A	IP 99	220
2012-01	Health Care Entities (Topic 954)–Continuing Care Retirement Communities— Refundable Advance Fees	Complete	N/A	IP 99	954
2012-02	Intangibles—Goodwill and Other (Topic 350)–Testing Indefinite-Lived Intangible Assets for Impairment	Pending			350

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ACCOUNTING STANDARDS UPDATES

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.[1]
2012-03	*Technical Amendments and Corrections to SEC Sections–Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin No. 114, Technical Amendments Pursuant to SEC Release No. 33-9250, and Corrections Related to FASB Accounting Standards Update 2010-22*	*SEC Update*			*Not Explicitly Included in Codification.*
2012-04	Technical Corrections and Improvements	Complete	N/A	IP 99	Various
2012-05	Statement of Cash Flows (Topic 230)–Not-for-Profit Entities: Classification of the Sale Proceeds of Donated Financial Assets in the Statement of Cash Flows	Complete	Adopt/M	69	230 958
2012-06	Business Combinations (Topic 805)–Subsequent Accounting for an Indemnification Asset Recognized at the Acquisition Date as a Result of a Government-Assisted Acquisition of a Financial Institution	Pending			805
2012-07	Entertainment—Films (Topic 926)–Accounting for Fair Value Information That Arises after the Measurement Date and Its Inclusion in the Impairment Analysis of Unamortized Film Costs	Complete	N/A	IP 99	926
2013-01	Clarifying the Scope of Disclosures About Offsetting Assets and Liabilities	Complete	Reject	64	210
2013-02	Comprehensive Income – Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income	Complete	N/A	IP 99	220 270
2013-03	Financial Instruments: Clarifying the Scope and Applicability of a Particular Disclosure to Nonpublic Entities	Complete	Reject	100	825
2013-04	Liabilities: Obligations Resulting from Joint and Several Liability Arrangements for which the Total Amount is Fixed at the Reporting Date (Topic 405)	Complete	Adopt/M	5R	405
2013-05	Foreign Currency Matters: Parent's Accounting for the Cumulative Translation Adjustment upon Derecognition of Certain Subsidiaries or Groups of Assets within a Foreign Entity or of an Investment in a Foreign Entity (Topic 830)	Pending			805 810 830
2013-06	Not-for-Profit Entities: Services Received from Personnel of an Affiliate (Topic 958)	Pending			954 958
2013-07	Presentation of Financial Statements: Liquidation Basis of Accounting (Topic 205)	Complete	N/A	IP 99	205 960 962 965
2013-08	Investment Companies: Amendments to the Scope, Measurement, and Disclosure Requirements (Topic 946)	Pending			230 323 810 820 946

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GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.[1]
2013-09	Fair Value Measurements: Deferral of the Effective Date of Certain Disclosures for Nonpublic Employee Benefit Plans in Update No. 2011-04	Pending			820
2013-10	Derivatives and Hedging (Topic 815) Inclusion of the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) as a Benchmark Interest Rate for Hedge Accounting Purposes	Complete	Adopt	86	815
2013-11	Income Taxes (Topic 740) Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists	Pending			740
2013-12	Definition of a Public Business Entity, An Addition to the Master Glossary	Complete	N/A	IP 99	Glossary
2014-01	Investments—Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects	Pending			323
2014-02	Intangibles—Goodwill and Other (Topic 350): Accounting for Goodwill	Pending			350
2014-03	Derivatives and Hedging (Topic 815): Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps—Simplified Hedge Accounting Approach (PCC)	Complete	Reject	86	815 825
2014-04	Receivables—Troubled Debt Restructurings by Creditors (Subtopic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure	Pending			270 310
2014-05	Service Concession Arrangements (Topic 853)	Complete	Adopt/M	22	853
2014-06	Technical Corrections and Improvements Related to Glossary Terms	Pending			Glossary
2014-07	Consolidation (Topic 810): Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements (PCC)	Pending			810
2014-08	Presentation of Financial Statements (Topic 205) and Property, Plant, and Equipment (Topic 360): Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity	Pending			205 360
2014-09	Revenue from Contracts with Customers (Topic 606)	Pending			Various
2014-10	Development Stage Entities (Topic 915), Elimination of Certain Financial Reporting Requirements, Including an Amendment to Variable Interest Entities Guidance in Topic 810, Consolidation	Complete	N/A	IP 99	275 925
2014-11	Transfers and Servicing (Topic 860), Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures	Pending			860

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GAAP Pronounce-ment	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.[1]
2014-12	Compensation—Stock Compensation (Topic 718), Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period	Complete	Adopt	104R	718
2014-13	Consolidation (Topic 810)—Measuring the Financial Assets and the Financial Liabilities of a Consolidated Collateralized Financing Entity	Pending			805 810 820
2014-14	Receivables—Troubled Debt Restructurings by Creditors (Subtopic 310-40)—Classification of Certain Government-Guaranteed Mortgage Loans upon Foreclosure	Pending			310
2014-15	Presentation of Financial Statements—Going Concern (Subtopic 205-40)—Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern	Pending			205
2014-16	Derivatives and Hedging (Topic 815)—Determining Whether the Host Contract in a Hybrid Financial Instrument Issued in the Form of a Share Is More Akin to Debt or to Equity	Pending			815
2014-17	Business Combinations (Topic 805)—Pushdown Accounting	Pending			805
2014-18	Business Combinations (Topic 805): Accounting for Identifiable Intangible Assets in a Business Combination (a consensus of the Private Company Council)	Pending			805

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PRE-CODIFICATION STANDARDS - CATEGORY A GAAP
FASB STATEMENTS

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
FAS 01	*Disclosure of Foreign Currency Translation Information*	*Superseded by FAS 8 & FAS 52*			
FAS 02	Accounting for Research and Development Costs	Complete	Adopt	17	730-10
FAS 03	*Reporting Accounting Changes in Interim Financial Statements—An Amendment of APB Opinion No. 28*	*Superseded by FAS 154* *Complete*	*N/A*	*IP 99*	
FAS 04	*Reporting Gains and Losses from Extinguishment of Debt—An Amendment of APB Opinion No. 30*	*Superseded by FAS 145* *Complete*	*Reject*	*15*	
FAS 05	Accounting for Contingencies	Complete	Adopt Adopt paragraph 15	5R 72	310-10 360-10 440-10 450-10 450-20 450-30 460-10 505-10 720-20 730-20 944-20 944-40 944-60
FAS 06	Classification of Short-Term Obligations Expected to Be Refinanced—An Amendment of ARB No. 43, Chapter 3A	Complete	N/A	IP 99	210-10 470-10
FAS 07	Accounting and Reporting by Development Stage Enterprises	Complete	Reject	17	915-10 915-205 915-210 915-215 915-225 915-230 915-235 915-340 915-605 915-810 980-10
FAS 08	*Accounting for the Translation of Foreign Currency Transactions and Foreign Currency Financial Statements*	*Superseded by FAS 52*			
FAS 09	*Accounting for Income Taxes: Oil and Gas Producing Companies—An Amendment of APB Opinions 11 and 23*	*Superseded by FAS 19*			

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FASB STATEMENTS

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
FAS 10	*Extension of "Grandfather" Provisions for Business Combinations—An Amendment of APB Opinion No. 16*	*Superseded by FAS 141* *Complete*	*Reject*	*68*	
FAS 11	*Accounting for Contingencies: Transition Method—An Amendment of FASB Statement No. 5*	*Complete*	*N/A*	*IP 99*	*Not Explicitly Included in Codification. See FAS 5*
FAS 12	*Accounting for Certain Marketable Securities*	*Superseded by FAS 115*			
FAS 13	Accounting for Leases Reject except certain guidance on operating leases, leveraged leases, and sale leaseback transactions	Complete	Adopt paragraph 15, 16(b, c, d), 19 (a, b), 23(b, c), 36, 37, 39(c), 42-47 Reject all others	22	360-10 410-20 440-10 450-10 460-10 470-10 840-10 840-20 840-30 840-40 958-810 980-840
FAS 14	*Financial Reporting for Segments of a Business Enterprise*	*Superseded by FAS 131* *Complete*	*N/A*	*IP 99*	
FAS 15	Accounting by Debtors and Creditors for Troubled Debt Restructurings	Complete	Adopt/M	36	310-40 450-20 470-60
FAS 16	Prior Period Adjustments	Complete	Reject	3	250-10 270-10 450-20
FAS 17	*Accounting for Leases: Initial Direct Costs—An Amendment of FASB Statement No. 13*	*Superseded by FAS 91*			
FAS 18	*Financial Reporting for Segments of a Business Enterprise: Interim Financial Statements—An Amendment of FASB Statement No. 14*	*Superseded by FAS 131* *Complete*	*N/A*	*IP 99*	
FAS 19	Financial Accounting and Reporting by Oil and Gas Producing Companies	Complete	N/A	IP 99	932-10 932-235 932-270 932-360 932-470 932-720 932-740

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FASB STATEMENTS

GAAP Pronounce-ment	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
FAS 20	*Accounting for Forward Exchange Contracts—An Amendment of FASB Statement No. 8*	*Superseded by FAS 52*			
FAS 21	*Suspension of the Reporting of Earnings per Share and Segment Information by Nonpublic Enterprises—An Amendment of APB Opinion No. 15 and FASB Statement No. 14*	*Superseded by FAS 131* *Complete*	*N/A*	*IP 99*	
FAS 22	Changes In the Provisions of Lease Agreements Resulting from Refundings of Tax-Exempt Debt—An Amendment of FASB Statement No. 13	Complete	Reject	22	840-30
FAS 23	Inception of the Lease—An Amendment of FASB Statement No. 13	Complete	Adopt paragraph 10 - Reject all others	22	840-10
FAS 24	*Reporting Segment Information in Financial Statements That Are Presented in Another Enterprise's Financial Report—An Amendment of FASB Statement No. 14*	*Superseded by FAS 131* *Complete*	*N/A*	*IP 99*	
FAS 25	*Suspension of Certain Accounting Requirements for Oil and Gas Producing Companies—An Amendment of FASB Statement No. 19*	*Complete*	*N/A*	*IP 99*	*Not Explicitly Included in Codification See FAS 19*
FAS 26	*Profit Recognition on Sales-Type Leases of Real Estate—An Amendment of FASB Statement No. 13*	*Superseded by FAS 98*			
FAS 27	Classification of Renewals or Extensions of Existing Sales-Type or Direct Financing Leases—An Amendment of FASB Statement No. 13	Complete	Reject	22	Not Directly Included in Codification Included as amendments to FAS 13
FAS 28	Accounting for Sales with Leasebacks—An Amendment of FASB Statement No. 13	Complete	Adopt/M	22	840-40
FAS 29	Determining Contingent Rentals—An Amendment of FASB Statement No. 13	Complete	Adopt paragraphs 8 & 11 - Reject all others	22	840-10
FAS 30	*Disclosure of Information about Major Customers—An Amendment of FASB Statement No. 14*	*Superseded by FAS 131* *Complete*	*N/A*	*IP 99*	
FAS 31	*Accounting for Tax Benefits Related to U. K. Tax Legislation Concerning Stock Relief*	*Superseded by FAS 96 & FAS 109*			

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PRE-CODIFICATION STANDARDS - CATEGORY A GAAP
FASB STATEMENTS

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
FAS 32	*Specialized Accounting and Reporting Principles and Practices in AICPA Statements of Position and Guides on Accounting and Auditing Matters—An Amendment of APB Opinion No. 20*	*Superseded by FAS 111*			
FAS 33	*Financial Reporting and Changing Prices*	*Superseded by FAS 89*			
FAS 34	Capitalization of Interest Cost	Complete	Adopt	44	360-10 835-20
FAS 35	Accounting and Reporting by Defined Benefit Pension Plans	Complete	N/A	IP 99	460-10 960-10 960-20 960-30 960-205 960-310 960-325 960-360 962-10 965-10
FAS 36	*Disclosure of Pension Information—An Amendment of APB Opinion No. 8*	*Superseded by FAS 87*			
FAS 37	Balance Sheet Classification of Deferred Income Taxes—An Amendment of APB Opinion No. 11	Complete	N/A	IP 99	740-10
FAS 38	*Accounting for Preacquisition Contingencies of Purchased Enterprises—An Amendment of APB Opinion No. 16*	*Superseded by FAS 141* *Complete*	*Reject*	*68*	
FAS 39	*Financial Reporting and Changing Prices: Specialized Assets—Mining and Oil and Gas—A Supplement to FASB Statement No. 33*	*Superseded by FAS 89*			
FAS 40	*Financial Reporting and Changing Prices: Specialized Assets—Timberlands and Growing Timber—A Supplement to FASB Statement No. 33*	*Superseded by FAS 89*			
FAS 41	*Financial Reporting and Changing Prices: Specialized Assets—Income-Producing Real Estate—A Supplement to FASB Statement No. 33*	*Superseded by FAS 89*			
FAS 42	Determining Materiality for Capitalization of Interest Cost—An Amendment of FASB Statement No. 34	Complete	Adopt	44	835-20
FAS 43	Accounting for Compensated Absences	Complete	Adopt	11	420-10 710-10

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FASB STATEMENTS

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
FAS 44	*Accounting for Intangible Assets of Motor Carriers—An Amendment of Chapter 5 of ARB No. 43 and an Interpretation of APB Opinions 17 and 30*	*Superseded by FAS 145* *Complete*	*N/A*	*IP 99*	
FAS 45	Accounting for Franchise Fee Revenue	Complete	N/A	IP 99	850-10 952-10 952-340 952-440 952-605 952-720
FAS 46	*Financial Reporting and Changing Prices: Motion Picture Films*	*Superseded by FAS 89*			
FAS 47	Disclosure of Long-Term Obligations	Complete	N/A	IP 99	440-10 470-10
FAS 48	Revenue Recognition When Right of Return Exists	Complete	N/A	IP 99	450-10 460-10 605-15
FAS 49	Accounting for Product Financing Arrangements	Complete	N/A	IP 99	470-40
FAS 50	Financial Reporting in the Record and Music Industry	Complete	N/A	IP 99	928-10 928-340 928-405 928-430 928-440 928-605 928-720
FAS 51	Financial Reporting by Cable Television Companies	Complete	N/A	IP 99	922-10 922-350 922-360 922-430 922-605 922-720 922-835
FAS 52	Foreign Currency Translation	Complete	Reject	23, 31	205-10 440-10 815-20 830-10 830-20 830-30
FAS 53	*Financial Reporting by Producers and Distributors of Motion Picture Films*	*Superseded by FAS 139* *Complete*	*N/A*	*IP 99*	
FAS 54	*Financial Reporting and Changing Prices: Investment Companies—An Amendment of FASB Statement No. 33*	*Superseded by FAS 89*			

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FASB STATEMENTS

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
FAS 55	*Determining whether a Convertible Security is a Common Stock Equivalent—An Amendment of APB Opinion No. 15*	*Superseded by FAS 111*			
FAS 56	*Designation of AICPA Guide and Statement of Position (SOP) 81-1 on Contractor Accounting and SOP 81-2 Concerning Hospital-Related Organizations as Preferable for Purposes of Applying APB Opinion 20—An Aamendment of FASB Statement No. 32*	*Superseded by FAS 111*			
FAS 57	Related Party Disclosures	Complete	Adopt/M	25	850-10 958-20 958-810
FAS 58	Capitalization of Interest Cost in Financial Statements That Include Investments Accounted for by the Equity Method—An Amendment of FASB Statement No. 34	Complete	Adopt	44	835-20
FAS 59	*Deferral of the Effective Date of Certain Accounting Requirements for Pension Plans of State and Local Governmental Units—An Amendment of FASB Statement No. 35*	*Superseded by FAS 75*			
FAS 60	Accounting and Reporting by Insurance Enterprises	Complete	Reject paragraph 52 Reject	40R 50, 51, 52, 53, 54, 57, 59, 71	325-10 944-10 944-20 944-30 944-40 944-50 944-60 944-80 944-310 944-325 944-360 944-505 944-605 944-740 944-805
FAS 61	Accounting for Title Plant	Complete	Adopt/M	57	950-350
FAS 62	Capitalization of Interest Cost in Situations Involving Certain Tax-Exempt Borrowings and Certain Gifts and Grants—An Amendment of FASB Statement No. 34	Complete	Adopt/M	44	835-20
FAS 63	Financial Reporting by Broadcasters	Complete	N/A	IP 99	920-10 920-350 920-405 920-440 920-845

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GAAP Pronounce-ment	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
FAS 64	*Extinguishments of Debt Made to Satisfy Sinking-Fund Requirements—An Amendment of FASB Statement No. 4*	*Superseded by FAS 145* *Complete*	*Reject*	*15*	
FAS 65	Accounting for Certain Mortgage Banking Activities	Complete	N/A	IP 99	310-10 440-10 860-50 948-10 948-310 948-340 948-605 948-720 958-320
FAS 66	Accounting for Sales of Real Estate	Complete	Adopt/M	40R	360-20 440-10 460-10 605-10 840-10 976-10 976-310 976-330 976-605 976-705
FAS 67	Accounting for Costs and Initial Rental Operations of Real Estate Projects	Complete	Adopt	40R	970-10 970-340 970-360 970-605 970-720
FAS 68	Research and Development Arrangements	Complete	N/A	IP 99	440-10 730-20
FAS 69	Disclosures about Oil and Gas Producing Activities—An Amendment of FASB Statements 19, 25, 33, and 39	Complete	N/A	IP 99	932-235
FAS 70	*Financial Reporting and Changing Prices: Foreign Currency Translation—An Amendment of FASB Statement No. 33*	*Superseded by FAS 89*			

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GAAP Pronounce-ment	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
FAS 71	Accounting for the Effects of Certain Types of Regulation	Complete	N/A	IP 99	840-30 980-10 980-250 980-340 980-350 980-405 980-410 980-450 980-470 980-605 980-710 980-810 980-835 980-840
FAS 72	*Accounting for Certain Acquisitions of Banking or Thrift Institutions—An Amendment of APB Opinion No. 17, an Interpretation of APB Opinions 16 and 17, and an Amendment of FASB Interpretation No. 9*	*Superseded by FAS 141R* *Complete*	*N/A*	*IP 99*	
FAS 73	*Reporting a Change in Accounting for Railroad Track Structures—An Amendment of APB Opinion No. 20*	*Superseded by FAS 154* *Complete*	*N/A*	*IP 99*	
FAS 74	*Accounting for Special Termination Benefits Paid to Employees*	*Superseded by FAS 88*			
FAS 75	*Deferral of the Effective Date of Certain Accounting Requirements for Pension Plans of State and Local Governmental Units—An Amendment of FASB Statement No. 35*	*Superseded by FAS 135* *Complete*	*N/A*	*IP 99*	
FAS 76	*Extinguishment of Debt—An Amendment of APB Opinion No. 26*	*Superseded by FAS 125 & FAS 140*			
FAS 77	*Reporting by Transferors for Transfers of Receivables with Recourse*	*Superseded by FAS 125 & FAS 140*			
FAS 78	Classification of Obligations That Are Callable by the Creditor—An Amendment of ARB No. 43, Chapter 3A	Complete	N/A	IP 99	470-10
FAS 79	*Elimination of Certain Disclosures for Business Combinations by Nonpublic Enterprises—An Amendment of APB Opinion No. 16*	*Superseded by FAS 141* *Complete*	*Reject*	*68*	
FAS 80	*Accounting for Futures Contracts*	*Superseded by FAS 133* *Complete*	*Reject*	*31*	

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FASB STATEMENTS

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
FAS 81	*Disclosure of Postretirement Health Care and Life Insurance Benefits*	*Superseded by FAS 106*			
FAS 82	*Financial Reporting and Changing Prices: Elimination of Certain Disclosures—An Amendment of FASB Statement No. 33*	*Superseded by FAS 89*			
FAS 83	*Designation of AICPA Guides and Statement of Position on Accounting by Brokers and Dealers in Securities, by Employee Benefit Plans, and by Banks as Preferable for Purposes of Applying APB Opinion 20—An Amendment of FASB Statement No. 32 and APB Opinion No. 30 and a Rescission of FASB Interpretation No. 10*	*Superseded by FAS 111*			
FAS 84	Induced Conversions of Convertible Debt—An Amendment of APB Opinion No. 26	Complete	Adopt	15	470-20
FAS 85	*Yield Test for Determining whether a Convertible Security Is a Common Stock Equivalent—An Amendment of APB Opinion No. 15*	*Superseded by FAS 128* *Complete*	*N/A*	*IP 99*	
FAS 86	Accounting for the Costs of Computer Software to Be Sold, Leased or Otherwise Marketed	Complete	Adopt/M	17	730-10 985-20 985-330 985-705
FAS 87	Employers' Accounting for Pensions	Complete	Adopt/M	8, 89, 92, 102	420-10 715-10 715-20 715-30 715-80 805-20 835-20 958-715 960-10 962-10 965-10 980-715
FAS 88	Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits	Complete	Adopt/M Adopt paragraph 15	8, 89, 92, 102 11	710-10 712-10 715-30 715-60 958-10 958-715
FAS 89	Financial Reporting and Changing Prices	Complete	N/A	IP 99	255-10
FAS 90	Regulated Enterprises—Accounting for Abandonments and Disallowances of Plant Costs—an Amendment of FASB Statement No. 71	Complete	N/A	IP 99	980-360 980-835

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FASB STATEMENTS

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
FAS 91	Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases—An Amendment of FASB Statements No. 13, 60, and 65 and a Rescission of FASB Statement No. 17	Complete	Reject	26, 37, 43R	310-20 440-10 840-30
FAS 92	Regulated Enterprises—Accounting for Phase-In Plans—An Amendment of FASB Statement No. 71	Complete	N/A	IP 99	360-10 980-340
FAS 93	Recognition of Depreciation by Not-for-Profit Organizations	Complete	N/A	IP 99	958-360 958-720
FAS 94	Consolidation of All Majority-Owned Subsidiaries—An Amendment of ARB No. 51, with Related Amendments of APB Opinion No. 18 and ARB No. 43, Chapter 12	Complete	Reject	3	810-10 840-10
FAS 95	Statement of Cash Flows	Complete	Reject	69	230-10 310-10 815-10 815-20 830-230 942-230
FAS 96	*Accounting for Income Taxes*	*Superseded by FAS 109*			
FAS 97	Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments	Complete	Reject	50, 51, 52, 71	944-20 944-30 944-40 944-60 944-605 944-825
FAS 98	Accounting for Leases: Sale-Leaseback Transactions Involving Real Estate, Sales-Type Leases of Real Estate, Definition of the Lease Term, and Initial Direct Costs of Direct Financing Leases—An Amendment of FASB Statements No. 13, 66, and 91 and a Rescission of FASB Statement No. 26 and Technical Bulletin No. 79-11	Complete	Adopt paragraphs 1-13, 17-22 (a, b, d & e) Adopt/M paragraphs 22j, 27, 30, and 31 Reject all others	22	840-40 980-840
FAS 99	*Deferral of the Effective Date of Recognition of Depreciation by Not-for-Profit Organizations—An Amendment of FASB Statement No. 93*	*Complete*	*N/A*	*IP 99*	*Not Explicitly Included in Codification. See FAS 99*

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FASB STATEMENTS

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
FAS 100	*Accounting for Income Taxes—Deferral of the Effective Date of FASB Statement No. 96—An Amendment of FASB Statement No. 96*	*Superseded by FAS 103, FAS 108 & FAS 109*			
FAS 101	Regulated Enterprises—Accounting for the Discontinuation of Application of FASB Statement No. 71	Complete	N/A	IP 99	980-20
FAS 102	Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale—An Amendment of FASB Statement No. 95	Complete	Reject	69	230-10 310-10 960-205 962-205 970-230
FAS 103	*Accounting for Income Taxes—Deferral of the Effective Date of FASB Statement No. 96—An Amendment of FASB Statement No. 96*	*Superseded by FAS 108 & FAS 109*			
FAS 104	Statement of Cash Flows—Net Reporting of Certain Cash Receipts and Cash Payments and Classification of Cash Flows From Hedging Transactions—An Amendment of FASB Statement No. 95	Complete	Reject	69	Not Directly Included in Codification. Included as amendments to FAS 95
FAS 105	*Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*	*Superseded by FAS 133* *Complete*	*Adopt/M*	*27, 31*	
FAS 106	Employers' Accounting for Postretirement Benefits Other Than Pensions	Complete	Adopt/M	14, 92	420-10 710-10 715-10 715-20 715-30 715-60 715-70 715-80 805-20 958-715 980-715
FAS 107	Disclosures about Fair Value of Financial Instruments	Complete	Adopt	100	310-10 825-10 942-470 958-320
FAS 108	*Accounting for Income Taxes—Deferral of the Effective Date of FASB Statement No. 96*	*Superseded by FAS 109*			

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PRE-CODIFICATION STANDARDS - CATEGORY A GAAP
FASB STATEMENTS

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
FAS 109	Accounting for Income Taxes	Complete	Adopt paragraphs 256-258 Adopt/M	22 10, 10R, 101	225-20 272-10 450-10 718-740 740-10 740-20 740-30 805-740 830-20 830-740 840-30 852-740 942-740 944-740 946-740 958-720 980-740 995-740
FAS 110	Reporting by Defined Benefit Pension Plans of Investment Contracts—An Amendment of FASB Statement No. 35	Complete	N/A	IP 99	960-325
FAS 111	Rescission of FASB Statement No. 32 and Technical Corrections	Complete	N/A	IP 99	Not Directly Included in Codification. Technical Amendments to Various Standards
FAS 112	Employers' Accounting for Postemployment Benefits—An Amendment of FASB Statements No. 5 and 43	Complete	Adopt	11	420-10 712-10
FAS 113	Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts	Complete	Adopt/M	61R, 62R	450-10 944-20 944-30 944-40 944-210 944-310 944-340 944-405 944-605 944-825

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PRE-CODIFICATION STANDARDS - CATEGORY A GAAP
FASB STATEMENTS

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
FAS 114	Accounting by Creditors for Impairment of a Loan—An Amendment of FASB Statements No 5 and 15	Complete	Adopt FAS 5 amendments and paragraphs 35 and 36 of CON 6 Adopt paragraphs 9, 22, and 25 Reject paragraphs 6d, 13 & 21 Adopt/M	5R 36 37	310-10 310-30 310-40
FAS 115	Accounting for Certain Investments in Debt and Equity Securities	Complete	Reject	26, 30, 32, 43R	320-10 942-320
FAS 116	Accounting for Contributions Received and Contributions Made	Complete	Adopt	67	440-10 605-10 720-25 835-10 958-10 958-30 958-205 958-310 958-320 958-325 958-360 958-450 958-605
FAS 117	Statements of Not-for-Financial-Profit Organizations	Complete	N/A	IP 99	954-225 958-205 958-210 958-225 958-230 958-320 958-720
FAS 118	Accounting by Creditors for Impairment of a Loan-Income Recognition and Disclosures	Complete	Adopt for troubled debt restructuring Adopt/M	36 37	310-10 310-40
FAS 119	*Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments*	*Superseded by FAS 133* *Complete*	*Adopt/M*	*31, 100*	

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PRE-CODIFICATION STANDARDS - CATEGORY A GAAP
FASB STATEMENTS

GAAP Pronounce-ment	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
FAS 120	Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts	Complete	Reject	50, 51, 52	944-20
FAS 121	*Accounting for Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*	*Superseded by FAS 144* *Complete*	 *Adopt/M* *Adopt paragraphs 12,14a & 14b Reject, paragraphs 13,14c & d*	 *40R* *68*	
FAS 122	*Accounting for Mortgage Servicing Rights*	*Superseded by FAS 125 & FAS 140*			
FAS 123	*Accounting for Stock-Based Compensation*	*Superseded by FAS 123(R)* *Complete*	 *Reject*	 *13*	
FAS 123(R)	Share-Based Payment	Complete	Adopt/M	104R	260-10 505-50 505-60 718-10 718-20 718-30 718-50 718-740 815-10
FAS 124	Accounting for Certain Investments Held by Not-For-Profit Organizations	Complete	N/A	IP 99	954-320 958-205 958-320 958-325

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PRE-CODIFICATION STANDARDS - CATEGORY A GAAP
FASB STATEMENTS

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
FAS 125	*Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*	*Superseded by FAS 140*			
		Complete	*Reject paragraph 83*	*42*	
			Adopt 9-13 15-17,23-25 27-30,66-71 Reject paragraph 14	*45*	
			Adopt/M For Securitizations	*33*	
			Adopt/M	*18*	
FAS 126	Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities	Complete	Reject	100	825-10
FAS 127	*Deferral of the Effective Date of Certain Provisions of FASB Statement No. 125*	*Superseded by FAS 140*			
		Complete	*Reject*	*18*	
FAS 128	Earnings per Share	Complete	N/A	IP 99	205-20 250-10 260-10
FAS 129	Disclosure of Information about Capital Structure	Complete	Adopt paragraphs 6, 7 and 9, rejecting all others	72	470-10 505-10
FAS 130	Reporting Comprehensive Income	Complete	N/A	IP 99	205-10 220-10 323-10 505-10 715-30 965-205
FAS 131	Disclosures about Segments of an Enterprise and Related Information	Complete	N/A	IP 99	280-10

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PRE-CODIFICATION STANDARDS - CATEGORY A GAAP
FASB STATEMENTS

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
FAS 132	*Employers' Disclosures about Pensions and Other Postretirement Benefits an amendment of FASB Statements No. 87, 88 and 106*	*Superseded by FAS 132(R)* *Complete*	 *Adopt/M*	 *8, 11, 14, 89*	230-10
FAS 132(R)	Employers' Disclosures about Pensions and Other Postretirement Benefits—An Amendment of FASB Statements No. 87, 88 and 106	Complete	Adopt/M Adopt paragraphs 5(a), 5(b), 5(h), 5(q), and 8(m) as modified by FAS 158.	14, 89, 92, 102 11	450-20 715-20 715-70 715-80 958-715
FAS 133	Accounting for Derivative Instruments and Hedging Activities	Complete	Adopt/M	86	220-10 310-10 440-10 815-10 815-15 815-20 815-25 815-30 815-35 960-325
FAS 134	Accounting for Mortgage-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise an amendment of FASB Statement No. 65	Complete	N/A	IP 99	Not Directly Included in Codification. Included as amendments to FAS 65
FAS 135	Rescission of FASB Statement No. 75 and Technical Corrections	Complete	N/A	IP 99	Not Directly Included in Codification. Technical Amendments to Various Standards
FAS 136	Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others	Complete	N/A	IP 99	958-20 958-30 958-205 958-225 958-605

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PRE-CODIFICATION STANDARDS - CATEGORY A GAAP
FASB STATEMENTS

GAAP Pronounce-ment	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
FAS 137	Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133	Complete	Reject	86	*Not Explicitly Included in Codification. See FAS 133*
FAS 138	Accounting for Certain Derivative Instruments and Certain Hedging Activities—An Amendment of FASB Statement No. 133	Complete	Adopt/M	86	815-10 815-20 815-25 815-30
FAS 139	Rescission of FASB Statement No. 53 and amendments to FASB Statements No. 63, 89 and 121	Complete	N/A	IP 99	Not Directly Included in Codification. Included as amendments to FAS 63, FAS 89 and FAS 121
FAS 140	*Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, A Replacement of FASB Statement 125*	*Superseded by FAS 166* *Complete*	*Adopt/M*	*91R, 103*	*310-10* *320-10* *405-20* *460-10* *470-50* *815-20* *840-30* *860-10* *860-20* *860-30* *860-50*
FAS 141	*Business Combinations – June 2001*	*Superseded by FAS 141 revised in 12/07* *Complete*	*Reject*	*68*	
FAS 141 (Revised)	Business Combinations – December 2007	Pending			805-10 805-20 805-30 805-40 805-50 805-740 958-805
FAS 142	Goodwill and Other Intangible Assets	Complete	Reject	68	205-20 280-10 323-10 350-10 350-20 350-30

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FASB STATEMENTS

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
FAS 143	Accounting for Asset Retirement Obligations	Complete	N/A	IP 99	360-10 410-20 450-20 835-20 840-10 840-40 980-410
FAS 144	Accounting for the Impairment or Disposal of Long-Lived Assets	Complete	Adopt/M	24, 68, 90	205-10 205-20 225-20 360-10 840-20 840-30 855-10 958-225 958-360
FAS 145	Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13, and Technical Corrections	Complete	Adopt paragraph 9.c.c. Reject all others	22	470-50
FAS 146	Accounting for Costs Associated with Exit or Disposal Activities	Complete	Adopt paragraphs 420-10-25-11 through 13 and 420-10-30-8 All others rejected	22 24	280-10 420-10 450-20 712-10 715-30 840-10 912-275 958-225
FAS 147	*Acquisitions of Certain Financial Institutions—An Amendment of FASB Statements No. 72 and 144 and FASB Interpretation No. 9*	*Superseded by FAS 141(R)* *Complete*	*N/A*	*IP 99*	
FAS 148	*Accounting for Stock-Based Compensation—Transition and Disclosure—An Amendment of FASB Statement No. 123*	*Superseded by FAS 123(R)* *Complete*	*Reject*	*13*	
FAS 149	Amendment of Statement 133 on Derivative Instruments and Hedging Activities	Complete	Paragraphs 4 and 25 adopted. Reject all others.	86	815-10

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PRE-CODIFICATION STANDARDS - CATEGORY A GAAP
FASB STATEMENTS

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
FAS 150	Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity	Complete	Adopted as referenced in SSAP No. 104R only. All other rejected as not applicable.	104R	260-10 460-10 480-10 835-10
FAS 151	Inventory Costs—An Amendment of ARB No. 43, Chapter 4	Complete	N/A	IP 99	Not Directly Included in Codification. Included as amendments to ARB 43, Chp 4
FAS 152	Accounting for Real Estate Time-Sharing Transactions—An Amendment of FASB Statements No. 66 and 67	Complete	Adopt	40R	Not Directly Included in Codification. Included as amendments to FAS 66 and FAS 67
FAS 153	Exchanges of Nonmonetary Assets—An Amendment of APB Opinion No. 29	Complete	Adopt/M	90, INT 00-26	Not Directly Included in Codification. Included as amendments to APB 29
FAS 154	Accounting Changes and Error Corrections—A Replacement of APB Opinion No. 20 and FASB Statement No. 3	Complete	Reject	3	250-10 835-20
FAS 155	Accounting for Certain Hybrid Financial Instruments—An Amendment of FASB Statements No. 133 and 140	Pending			815-15
FAS 156	Accounting for Servicing of Financial Assets—An Amendment of FASB Statement No. 140	Complete	Adopt/M	91R, 103	860-50
FAS 157	Fair Value Measurements	Complete	Adopt/M	100	250-10 270-10 815-10 820-10

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PRE-CODIFICATION STANDARDS - CATEGORY A GAAP
FASB STATEMENTS

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
FAS 158	Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—An Amendment of FASB Statements No. 87, 88, 106 and 132(R)	Complete	Adopt/M Paragraphs 1-7, 16-17, Appendices D and E. Adopt/M Paragraphs 1-7, 16-17, Appendices C and E.	92 102	715-20 715-30 715-60 958-715
FAS 159	The Fair Value Option for Financial Assets and Financial Liabilities—Including an Amendment of FASB Statement No. 115	Pending			470-20 825-10 954-825
FAS 160	Noncontrolling Interests in Consolidated Financial Statements—An Amendment of ARB No. 51	Complete	N/A	IP 99	Not Explicitly Included in Codification.
FAS 161	Disclosures about Derivative Instruments and Hedging Activities—An Amendment of FASB Statement No. 133	Pending			815-10
FAS 162	*The Hierarchy of Generally Accepted Accounting Principles*	*Replaced by FAS 168* *Complete*	*Adopt/M*	*Preamble*	
FAS 163	Accounting for Financial Guarantee Insurance Contracts—An Interpretation of FASB Statement No. 60	Pending			944-20 944-40 944-310 944-605
FAS 164	Not-for-Profit Entities: Mergers and Acquisitions—Including an Amendment of FASB Statement No. 142	Pending			740-10 805-10 805-50 954-805 954-810 958-805 958-810
FAS 165	Subsequent Events	Complete	Adopt/M	9	855-10
FAS 166	Accounting for Transfers of Financial Assets—An Amendment of FASB Statement No. 140	Complete (ASU 2009-16)	Adopt/M	103	860-10
FAS 167	Amendments to FASB Interpretation No. 46(R)	Pending (ASU 2009-17)			810-10

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FASB STATEMENTS

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
FAS 168	The *FASB Accounting Standards Codification*^{TM} and the Hierarchy of Generally Accepted Accounting Principles—A Replacement of FASB Statement No. 162	Complete	Adopt	Preamble	105-10

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PRE-CODIFICATION STANDARDS - CATEGORY A GAAP
FASB INTERPRETATIONS

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
FIN 01 (APB 20)	Accounting Changes Related to the Cost of Inventory	Complete	N/A	IP 99	250-10 330-10
FIN 02 (APB 21)	*Imputing Interest on Debt Arrangements Made under the Federal Bankruptcy Act*	*Superseded by FAS 15*			
FIN 03 (APB 8)	*Accounting for the Cost of Pension Plans subject to the Employee Retirement Income Security Act of 1974*	*Superseded by FAS 87*			
FIN 04 (FASB 2)	*Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method*	*Superseded by FAS 141R* *Complete*	*Reject*	*68*	
FIN 05 (FASB 2)	*Applicability of FASB Statement No. 2 to Development Stage Enterprises*	*Superseded by FAS 7*			
FIN 06 (FASB 2)	Applicability of FASB Statement No. 2 to Computer Software	Complete	Adopt	17	730-10 985-20
FIN 07 (FASB 7)	Applying FASB Statement No. 7 in Financial Statements of Established Operating Enterprises	Complete	Reject	17	915-10 915-810
FIN 08 (FASB 6)	Classification of a Short-Term Obligation Repaid Prior to Being Replaced by a Long-Term Security	Complete	N/A	IP 99	470-10
FIN 09 (APB 16 & 17)	*Applying APB Opinions No. 16 and 17 When a Savings and Loan Association or a Similar Institution is Acquired in a Business Combination Accounted for by the Purchase Method*	*Superseded by FAS 141R* Complete	N/A	*IP 99*	
FIN 10 (FASB 12	*Application of FASB Statement No. 12 to Personal Financial Statements*	*Superseded by FAS 83*			
FIN 11 (FASB 12)	*Changes in Market Value after the Balance Sheet Date*	*Superseded by FAS 115*			
FIN 12 (FASB 12)	*Accounting for Previously Established Allowance Accounts*	*Superseded by FAS 115*			
FIN 13 (FASB 12)	*Consolidation of a Parent and Its Subsidiaries Having Different Balance Sheet Dates*	*Superseded by FAS 115*			
FIN 14 (FASB 5)	Reasonable Estimation of the Amount of a Loss	Complete	Adopt/M	5R	450-20
FIN 15 (FASB 8)	*Translation of Unamortized Policy Acquisition Costs by a Stock Life Insurance Company*	*Superseded by FAS 52*			
FIN 16 (FASB 12)	*Clarification of Definitions and Accounting for Marketable Equity Securities That Become Nonmarketable*	*Superseded by FAS 115*			
FIN 17 (FASB 8)	*Applying the Lower of Cost or Market Rule in Translated Financial Statements*	*Superseded by FAS 52*			
FIN 18 (APB 28)	Accounting for Income Taxes in Interim Periods	Complete	Reject	10, 10R, 101	225-20 740-270

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FASB INTERPRETATIONS

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
FIN 19 (FASB 13)	Lessee Guarantee of the Residual Value of Leased Property	Complete	Reject	22	460-10 840-10
FIN 20 (APB 20)	*Reporting Accounting Changes under AICPA Statements of Position*	*Superseded by FAS 154* *Complete*	*Reject*	*3*	
FIN 21 (FASB 13)	Accounting for Leases in a Business Combination	Complete	Reject	22	840-10 840-30 958-805
FIN 22 (APB 11 & 23)	*Applicability of Indefinite Reversal Criteria to Timing Differences*	*Superseded by FAS 96 & FAS 109*			
FIN 23 (FASB 13)	Leases of Certain Property Owned by a Governmental Unit or Authority	Complete	Reject	22	840-10
FIN 24 (FASB 13)	Leases Involving Only Part of a Building	Complete	Reject	22	840-10
FIN 25 (APB 2, 4, 11, & 16)	*Accounting for an Unused Investment Tax Credit*	*Superseded by FAS 96 & FAS 109*			
FIN 26 (FASB 13)	Accounting for Purchase of a Leased Asset by the Lessee during the Term of the Lease	Complete	Reject	22	840-30
FIN 27 (FASB 13 & APB 30)	Accounting for a Loss on a Sublease	Complete	Adopt	22	Glossary Term
FIN 28 (APB 15 & 25)	*Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans*	*Superseded by FAS 123(R)* *Complete*	*Adopt* *N/A*	*13* *104R*	
FIN 29 (APB 23 & 24)	*Reporting Tax Benefits Realized on Disposition of Investments in Certain Subsidiaries and Other Investees*	*Superseded by FAS 96 & FAS 109*			
FIN 30 (APB 29)	Accounting for Involuntary Conversions of Nonmonetary Assets to Monetary Assets	Complete	Adopt/M	28, 95	450-10 605-40 740-10
FIN 31 (APB 15 & FASB 28)	*Treatment of Stock Compensation Plans in EPS Computations*	*Superseded by FAS 128* *Complete*	*N/A*	*IP 99*	
FIN 32 (APB 2, 4 & 11)	*Application of Percentage Limitations in Recognizing Investment Tax Credit*	*Superseded by FAS 96 & FAS 109*			

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PRE-CODIFICATION STANDARDS - CATEGORY A GAAP
FASB INTERPRETATIONS

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
FIN 33 (FASB 34)	Applying FASB Statement No. 34 to Oil and Gas Producing Operations Accounted for by the Full Cost Method	Complete	N/A	IP 99	932-835
FIN 34 (FASB 5)	*Disclosure of Indirect Guarantees of Indebtedness of Others*	*Superseded by FIN 45* *Complete*	*Adopt*	*5R*	
FIN 35 (APB 18)	Criteria for Applying the Equity Method of Accounting for Investments in Common Stock	Complete	Adopt	46, 88, 97	323-10
FIN 36 (FASB 19)	Accounting for Exploratory Wells in Progress at the End of a Period	Complete	N/A	IP 99	932-360
FIN 37 (FASB 52)	Accounting for Translation Adjustments upon Sale of Part of an Investment in a Foreign Entity	Complete	Reject	23	830-30
FIN 38 (APB 25)	*Determining the Measurement Date for Stock Option, Purchase and Award Plans Involving Junior Stock*	*Superseded by FAS 123(R)* *Complete*	*Adopt* *N/A*	*13* *104R*	
FIN 39 (APB 10 & FASB 105)	Offsetting of Amounts Related to Certain Contracts	Complete	Adopt/M	64	210-20 450-30 815-10
FIN 40 (FASB 12, 60, 97 & 113)	Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance and Other Enterprises	Complete	Reject	51, 52	Not Directly Included in Codification. Issue Addressed in FAS 168 and APB 22
FIN 41 (APB 10 and FIN 39)	Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements	Complete	Reject	64, 103	210-20 860-30
FIN 42 (FASB 116)	*Accounting for Transfers of Assets in Which a Not-for-Profit Organization is Granted Variance Power*	*Superseded by FAS 136* *Complete*	*N/A*	*IP 99*	
FIN 43	Real Estate Sales	Complete	Adopt/M	40R, 77	360-20 978-10
FIN 44 (APB 25)	*Accounting for Certain Transactions involving Stock Compensation*	*Superseded by FAS 123(R)*	*N/A*	*104R*	
FIN 45 (FASB 5, 57 & 107)	Guarantor's Accounting and Disclosure requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others	Complete	Adopt/M	5R	460-10 840-10 850-10

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PRE-CODIFICATION STANDARDS - CATEGORY A GAAP
FASB INTERPRETATIONS

GAAP Pronounce-ment	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
FIN 46 (ARB 51)	*Consolidation of Variable Interest Entities*	*Superseded by FIN 46(R)*			
		Complete	*Reject*	*3*	
FIN 46(R)	Consolidation of Variable Interest Entities	Pending			323-10 712-10 715-30 715-60 810-10 860-10 954-810 958-810
FIN 47 (FASB 143)	Accounting for Conditional Asset Retirement Obligations	Complete	N/A	IP 99	410-20 450-20
FIN 48 (FASB 109)	Accounting for Uncertainty in Income Taxes	Complete	Reject	101	740-10 740-270 805-740 835-10

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PRE-CODIFICATION STANDARDS - CATEGORY A GAAP
APB OPINIONS

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
APB 1	*New Depreciation Guidelines and Rules*	*Superseded by FAS 96 and 109*			
APB 2	Accounting for the "Investment Credit"	Complete	Adopt/M paragraphs 9-15, Reject all others	10, 10R, 101	740-10
APB 3	*The Statement of Source and Application of Funds*	*Superseded by APB 19*			
APB 4	Accounting for the "Investment Credit" (Amending No. 2)	Complete	Reject	10, 10R, 101	740-10
APB 5	*Reporting of Leases in Financial Statements of Lessee*	*Superseded by FAS 13*			
APB 6	Status of Accounting Research Bulletins	Complete	Adopt /M Paragraph 12 Reject all others Reject paragraph 16	72 28, 95	Not Directly Included in Codification. Included as amendments to ARB 43
APB 7	*Accounting for Leases in Financial Statements of Lessors*	*Superseded by FAS 13*			
APB 8	*Accounting for the Cost of Pension Plans*	*Superseded by FAS 87*			
APB 9	Reporting the Results of Operations	Complete	Reject paragraphs 1-19 and 26-27 Adopt paragraph 28 *Paragraphs 20-25 and 29 superseded by APB 20 & 30 and FAS 16*	3 72	225-10 225-20 250-10 505-10

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PRE-CODIFICATION STANDARDS - CATEGORY A GAAP
APB OPINIONS

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
APB 10	Omnibus Opinion—1966	Complete	Adopt paragraphs 10 & 11 Reject paragraph 12	72	210-20 605-10 740-10
			Adopt/M paragraphs 1,7 &13	64	
			Adopt paragraph 6	10, 10R, 101	
			All other paragraphs rejected		
APB 11	*Accounting for Income Taxes*	*Superseded by FAS 96 & 109*			
APB 12	Omnibus Opinion—1967	Complete	Adopt paragraphs 4 & 5	19	210-10 310-10 360-10 505-10 710-10 715-20 835-30
			Adopt/M paragraphs 9 & 10	72	
			Adopt/M paragraphs 2 and 3	5R	
			Adopt paragraphs 6, 6A and 7	11	
			Adopt/M paragraphs 6 - 8	14	
			Adopt paragraphs 16 & 17	15	
			Paragraphs 11-15 superseded		

STATUTORY ACCOUNTING PRINCIPLES
GAAP CROSS-REFERENCE TO STATUTORY ACCOUNTING PRINCIPLES

PRE-CODIFICATION STANDARDS - CATEGORY A GAAP
APB OPINIONS

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
APB 13	Amending Paragraph 6 of APB Opinion No. 9, Application to Commercial Banks	Complete	N/A	IP 99	Not Directly Included in Codification. Included as amendments to APB 9
APB 14	Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants	Complete	Adopt	15	470-20 505-10
APB 15	*Earnings Per Share*	*Superseded by FAS 128* *Complete*	*N/A*	*IP 99*	
APB 16	*Business Combinations*	*Superseded by FAS 141* *Complete*	*Reject*	*68*	
APB 17	*Intangible Assets*	*Superseded by FAS 142* *Complete*	*Reject*	*68*	
APB 18	The Equity Method of Accounting for Investments in Common Stock	Complete	Reject	46, 88, 97	225-20 250-10 260-10 323-10 325-20 460-10 810-10 850-10 958-20 958-810 970-810
APB 19	*Reporting Changes in Financial Position*	*Superseded by FAS 95*			
APB 20	*Accounting Changes*	*Superseded by FAS 154* *Complete*	*Reject*	*3*	
APB 21	Interest on Receivables and Payables	Complete	Adopt/M	15	310-10 470-10 740-10 835-30
APB 22	Disclosure of Accounting Policies	Complete	Adopt	1	235-10

STATUTORY ACCOUNTING PRINCIPLES
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PRE-CODIFICATION STANDARDS - CATEGORY A GAAP
APB OPINIONS

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
APB 23	Accounting for Income Taxes—Special Areas	Complete	Adopt paragraphs 1-3, 5-9, 12-13, 15-18 Reject paragraphs 19-23, 25, 31-33	10R	
			Adopt paragraphs 1-3, 5-9, 12-13, 15-18 Reject paragraphs 19-25, 31-33	101	740-30 942-740
APB 24	*Accounting for Income Taxes—Investments in Common Stock Accounted for by the Equity Method (Other than Subsidiaries and Corporate Joint Ventures)*	*Superseded by FAS 96 & 109*			
APB 25	*Accounting for Stock Issued to Employees*	*Superseded by FAS 123(R)*			
		Complete	*Adopt/M*	*13*	
			N/A	*104R*	
APB 26	Early Extinguishment of Debt	Complete	Adopt/M	15	470-50 850-10
APB 27	*Accounting for Lease Transactions by Manufacturer or Dealer Lessors*	*Superseded by FAS 13*			
APB 28	Interim Financial Reporting	Complete	Adopt paragraphs 19 & 20 Reject all others	10, 10R, 101	225-20 250-10 270-10 450-10 740-270
APB 29	Accounting for Nonmonetary Transactions	Complete Amended by FAS 153	Adopt/M	28, 95	605-40 610-30 845-10

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PRE-CODIFICATION STANDARDS - CATEGORY A GAAP
APB OPINIONS

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
APB 30	Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions	Complete	Adopt paragraphs 13-18 and 20. Reject all others	24	225-20 830-10
APB 31	*Disclosure of Lease Commitments by Lessees*	*Superseded by FAS 13*			

STATUTORY ACCOUNTING PRINCIPLES
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PRE-CODIFICATION STANDARDS - CATEGORY A GAAP
ACCOUNTING RESEARCH BULLETINS

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
ARB 43	Restatement and Revision of Accounting Research Bulletins:				
	Chapter 1	Complete	Reject	72	310-10 505-10 605-10 850-10
	Chapter 2A	Complete	Adopt	1	205-10
	Chapter 2B	*Deleted by APB 9*			
	Chapter 3A	Complete	Reject	20	210-10 310-10 340-10 470-10 958-210
	Chapter 3B	*Replaced by APB 10*			
	Chapter 4	Complete	N/A	IP 99	330-10 440-10 450-20
	Chapter 5	*Deleted by FAS 142*			
	Chapter 6	*Deleted by FAS 5*			
	Chapter 7A	Complete	Adopt/M	72	852-20
	Chapter 7B	Complete	Adopt paragraphs 1-4 and paragraphs 10-16 Adopt paragraphs 1-9	72 28, 95	505-20
	Chapter 7C	*Deleted by ARB 48*			
	Chapter 8	*Deleted by APB 9*			
	Chapter 9A	Complete	Reject	19	Not Explicitly Included in Codification.
	Chapter 9B	*Replaced by APB 6*			
	Chapter 9C	Complete	Reject	19	360-10
	Chapter 10A	Complete	Reject	40R	720-30

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PRE-CODIFICATION STANDARDS - CATEGORY A GAAP
ACCOUNTING RESEARCH BULLETINS

GAAP Pronounce-ment	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
	Chapter 10B	*Deleted by APB 11*			
	Chapter 11	Complete	Reject	20	912-10 912-20 912-210 912-225 912-275 912-310 912-330 912-405 912-605
	Chapter 12	*Complete*	*Reject*	*23*	Not Directly Included in Codification. Issue Addressed in FAS 133
	Chapter 13A	*Deleted by APB 8*			
	Chapter 13B	*Deleted by FAS 123(R)*			
		Complete	*Adopt/M*	*13*	
			N/A	*104R*	
	Chapter 14	*Deleted by APB 5*			
	Chapter 15	*Deleted by APB 26*			
ARB 44	*Declining-Balance Depreciation*	*Superseded by ARB 44 (Rev.)*			
ARB 44 (Rev.)	*Declining-Balance Depreciation*	*Superseded by FAS 96 & 109*			
ARB 45	Long-Term Construction-Type Contracts	Complete	N/A	IP 99	440-10 605-35
ARB 46	Discontinuance of Dating Earned Surplus	Complete	Adopt/M	72	Not Directly Included in Codification. Included as amendments to ARB 43, Chapter 7a
ARB 47	*Accounting for Costs of Pension Plans*	*Superseded by APB 8*			
ARB 48	*Business Combinations*	*Superseded by APB 16*			

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PRE-CODIFICATION STANDARDS - CATEGORY A GAAP
ACCOUNTING RESEARCH BULLETINS

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
ARB 49	*Earnings per Share*	*Superseded by APB 9*			
ARB 50	*Contingencies*	*Superseded by FAS 5*			
ARB 51	Consolidated Financial Statements	Complete	Reject	3	505-10 810-10 850-10 860-10 958-810 970-810

STATUTORY ACCOUNTING PRINCIPLES
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PRE-CODIFICATION STANDARDS - CATEGORY B GAAP
FASB TECHNICAL BULLETINS

GAAP Pronounce-ment	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
TB79-1 (Revised)	*Purpose and Scope of FASB Technical Bulletins and Procedures for Issuance*	*Complete*	*N/A*	*IP 99*	*Not Included in Codification. No Longer Applicable or Relevant.*
TB79-2	*Computer Software Costs*	*Superseded by FAS 86*			
TB79-3	Subjective Acceleration Clauses in Long-Term Debt Agreements	Complete	N/A	IP 99	470-10
TB79-4	Segment Reporting of Puerto Rican Operations	Complete	N/A	IP 99	280-10
TB79-5	Meaning of the Term “Customer” as it Applies to Health Care Facilities under FASB Statement No. 14	Complete	N/A	IP 99	954-280
TB79-6	*Valuation Allowances Following Debt Restructuring*	*Superseded by FAS 114*			
TB79-7	*Recoveries of a Previous Writedown under a Troubled Debt Restructuring Involving a Modification of Terms*	*Superseded by FAS 114*			
TB79-8	*Applicability of FASB Statements 21 and 33 to Certain Brokers and Dealers in Securities*	*Superseded by FAS 131* *Complete*	*N/A*	*IP 99*	
TB79-9	Accounting in Interim Periods for Changes in Income Tax Rates	Complete	Reject	10, 10R, 101	740-270
TB79-10	Fiscal Funding Clauses in Lease Agreements	Complete	Reject	22	840-10
TB79-11	*Effect of a Penalty on the Term of a Lease*	*Superseded by FAS 98*			
TB79-12	Interest Rate used in Calculating the Present Value of Minimum Lease Payments	Complete	Reject	22	Glossary Terms
TB79-13	Applicability of FASB Statement No. 13 to Current Value Financial Statements	Complete	Reject	22	840-10
TB79-14	Upward Adjustment of Guaranteed Residual Values	Complete	Reject	22	840-30
TB79-15	Accounting for Loss on a Sublease Not Involving the Disposal of a Segment	Complete	Adopt	22	840-20 840-30
TB79-16 (Revised)	Effect of a Change in Income Tax Rate on the Accounting for Leveraged Leases	Complete	Adopt	22	840-30
TB79-17	*Reporting Cumulative Effect Adjustment from Retroactive Application of FASB Statement No. 13*	*Complete*	*Reject*	*22*	*Not Explicitly Included in Codification. See FAS 13*
TB79-18	*Transition Requirement of Certain FASB Amendments and Interpretations of FASB Statement No. 13*	*Complete*	*Reject*	*22*	*Not Explicitly Included in Codification. See FAS 13*

STATUTORY ACCOUNTING PRINCIPLES
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PRE-CODIFICATION STANDARDS - CATEGORY B GAAP
FASB TECHNICAL BULLETINS

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
TB79-19	Investor's Accounting for Unrealized Losses on Marketable Securities Owned by an Equity Method Investee	Complete	Reject	46, 88, 97	Not Directly Included in Codification. Included within FAS 115 and FAS 133
TB80-1	Early Extinguishment of Debt through Exchange for Common or Preferred Stock	Complete	Adopt/M	15	470-50
TB80-2	Classification of Debt Restructurings by Debtors and Creditors	Complete	Adopt	36	310-40 470-60
TB81-1	*Disclosure of Interest Rate Futures Contracts and Forward and Standby Contracts*	*Superseded by FAS 80*			
TB81-2	*Accounting for Unused Investment Tax Credits Acquired in a Business Combination Accounted for by the Purchase Method*	*Superseded by FAS 96 & FAS 109*			
TB81-3	*Multi-Employer Pension Plan Amendments Act of 1980*	*Superseded by FAS 111*			
TB81-4	*Classification as Monetary or Non-monetary Items*	*Superseded by FAS 89*			
TB81-5	*Offsetting Interest Cost to Be Capitalized with Interest Income*	*Superseded by FAS 62*			
TB81-6	Applicability of Statement 15 to Debtors in Bankruptcy Situations	Complete	Adopt	36	470-60
TB82-1	Disclosure of the Sale or Purchase of Tax Benefits through Tax Leases	Complete	Adopt	10, 10R, 101	Not Directly Included in Codification. Included within FAS 109, APB 22 and APB 30
TB82-2	*Accounting for the Conversion of Stock Options into Incentive Stock Options as a Result of the Economic Recovery Tax Act of 1981*	*Superseded by FAS 123 and 123(R)* *Complete*	*N/A*	*IP 99*	
TB83-1	*Accounting for the Reduction in the Tax Basis of an Asset Caused by the Investment Tax Credit*	*Superseded by FAS 96 & FAS 109*			
TB84-1	Accounting for Stock Issued to Acquire the Results of a Research and Development Arrangement	Complete	N/A	IP 99	Not Directly Included in Codification. Included within FAS 141R
TB84-2	*Accounting for the Effects of the Tax Reform Act of 1984 on Deferred Income Taxes Relating to Domestic International Sales Corporations*	*Superseded by FAS 96 & FAS 109*			

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PRE-CODIFICATION STANDARDS - CATEGORY B GAAP
FASB TECHNICAL BULLETINS

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
TB84-3	*Accounting for the Effects of the Tax Reform Act of 1984 on Deferred Income Taxes of Stock Life Insurance Enterprises*	*Superseded by FAS 96 & FAS 109*			
TB84-4	*In-Substance Defeasance of Debt*	*Superseded by FAS 125 & FAS 140*			
TB85-1	Accounting for the Receipt of Federal Home Loan Mortgage Corporation Participating Preferred Stock	Complete	N/A	*IP 99*	Not Directly Included in Codification. Included within APB 29
TB85-2	*Accounting for Collateralized Mortgage Obligations (CMOs)*	*Superseded by FAS 125 & FAS 140*			
TB85-3	Accounting for Operating Leases with Scheduled Rent Increases	Complete	Adopt	22	840-20
TB85-4	Accounting for Purchases of Life Insurance	Complete	Adopt/M	21	325-30
TB85-5	*Issues Relating to Accounting for Business Combinations, Including Costs of Closing Duplicate Facilities of an Acquirer, Stock Transactions between Companies under Common Control, Downstream Mergers, Identical Common Shares for a Pooling of Interests, and Pooling of Interests by Mutual and Cooperative Enterprises*	*Superseded by FAS 141R* *Complete*	*Reject*	*68*	
TB85-6	Accounting for a Purchase of Treasury Shares at a Price Significantly in Excess of the Current Market Price of the Shares and the Income Statement Classification of Costs Incurred in Defending Against a Takeover Attempt	Complete	Reject	72	225-20 505-30
TB86-1	*Accounting for Certain Effects of the Tax Reform Act of 1986*	*Superseded by FAS 96 & FAS 109*			
TB86-2	Accounting for an Interest in the Residual Value of a Leased Asset Acquired by a Third Party or Retained by a Lessor That Sells the Related Minimum Rental Payments	Complete	Adopt	22	360-10 840-30
TB87-1	*Accounting for a Change in Method of Accounting for Certain Postretirement Benefits*	*Superseded by FAS 106*			
TB87-2	Computation of a Loss on an Abandonment	Complete	N/A	IP 99	980-360 980-740
TB87-3	Accounting for Mortgage Servicing Fees and Rights	Complete	N/A	IP 99	860-50

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PRE-CODIFICATION STANDARDS - CATEGORY B GAAP
FASB TECHNICAL BULLETINS

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
TB88-1	Issues Relating to Accounting for Leases: Time Pattern of the Physical Use of the Property in an Operating Lease, Lease Incentives in an Operating Lease, Applicability of Leveraged Lease Accounting to Existing Assets of the Lessor, Money-Over-Money Lease Transactions, and Wrap Lease Transactions	Complete	Adopt paragraphs 1—12 Reject all others	22	840-10 840-20 840-30 840-40
TB88-2	*Definition of a Right of Setoff*	*Superseded by FIN 39*			
TB90-1	Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts	Complete	N/A	IP 99	460-10 605-20
TB94-1	Application of Statement 115 to Debt Securities Restructured in a Troubled Debt Restructuring	Complete	Reject	36	320-10
TB97-1	Accounting under Statement 123 for Certain Employee Stock Purchase Plans with a Look-Back Option *(Amended with FAS 123(R) - not superseded.)*	Complete	Adopt/M	104R	718-50
TB01-1	Effective Date for Certain Financial Institutions of Certain Provisions of Statement 140 Related to the Isolation of Transferred Financial Assets	Complete	Reject	91R, 103	Glossary Terms

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PRE-CODIFICATION STANDARDS - CATEGORY B GAAP
FASB STAFF POSITIONS[2]

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
FSP FAS 13-1	*Accounting for Rental Costs Incurred during a Construction Period*	*Not Board Directed*			*840-20*
FSP FAS 13-2	Accounting for a Change or Projected Change in the Timing of Cash Flows Relating to Income Taxes Generated by a Leveraged Lease Transaction	Complete	Adopt	22	Not Directly Included in Codification. Included within FAS 13
FSP FAS 19-1	Accounting for Suspended Well Costs	Complete	N/A	IP 99	932-360
FSP FAS 97-1	*FSP FAS 97-1—Situations in Which Paragraphs 17(b) and 20 of FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments, Permit or Require Accrual of an Unearned Revenue Liability*	*Not Board Directed*			*944-605*
FSP FAS 106-1	*Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003*	*Superseded by FSP FAS 106-2*			
FSP FAS 106-2	Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003	Complete	Adopt/M	INT 04-17	715-60 740-10
FSP FAS 107-1 and APB 28-1	Interim Disclosures about Fair Value of Financial Instruments	Complete	Adopt	100	Not Explicitly Included in Codification.
FSP FAS 109-1	Application of *FASB Statement No. 109, Accounting for Income Taxes*, to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004	Complete	Adopt	101	740-10

[2] On December 5, 2009, the Statutory Accounting Principles (E) Working Group adopted revisions to the NAIC *Accounting Practices and Procedures Manual* to refer to the FASB Accounting Standards Codification as prescribed in *FAS 168, FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles* (FAS 168). With the issuance of FAS 168, and the establishment of the FASB Codification, the previous GAAP hierarchy established in *FAS 162, The Hierarchy of Generally Accepted Accounting Principles* (FAS 162) has been eliminated. As a result of FAS 168, the FASB Accounting Standards Codification is the source of authoritative accounting principles recognized by the FASB. (SEC guidance included within the codification is provided for convenience and relates only to SEC entities.) Pursuant to previous decisions by the Statutory Accounting Principles (E) Working Group, FASB Staff Positions (FSPs) issued after May 9, 2008, will be reviewed as part of the statutory accounting maintenance review process. FSPs issued prior to May 9, 2008, will be reviewed as part of the maintenance process if considered to be "Board-directed". (Board-directed FSPs were issued to provide narrow and limited revisions to the FASB statements or FASB interpretations formerly provided in FASB Technical Bulletins.) FSPs that were not considered "Board-directed" were considered to provide application guidance similar to that found in FASB Staff Implementation Guides and Staff Announcements and were previously classified (pre-FAS 162) as NAIC Level 5 guidance. Due to this Level 5 classification, these FSPs were not reviewed as part of the statutory accounting maintenance review process.

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PRE-CODIFICATION STANDARDS - CATEGORY B GAAP
FASB STAFF POSITIONS[2]

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
FSP FAS 109-2	Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004	Complete	Reject	IP 99	Not Explicitly Included in Codification. See FAS 109
FSP FAS 115-1 and FAS 124-1	The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments	Complete	Adopt/M	26, 32, 34 INT 06-07	320-10 325-20 958-325
FSP FAS 115-2 and 124-2	Recognition and Presentation of Other-Than-Temporary Impairments	Pending			320-10
FSP FAS 117-1	Endowments of Not-for-Profit Organizations: Net Asset Classification of Funds Subject to an Enacted Version of the Uniform Prudent Management of Institutional Funds Act, and Enhanced Disclosures for All Endowment Funds	Complete	N/A	IP 99	958-205
FSP FAS 123(R)-1	Classification and Measurement of Freestanding Financial Instruments Originally Issued in Exchange for Employee Services under FASB Statement No. 123(R)	Complete	Adopt/M	104R	718-10
FSP FAS 123(R)-2	Practical Accommodation to the Application of Grant Date as Defined in FASB Statement No. 123(R)	Not Board Directed Complete	Adopt/M	104R	718-10
FSP FAS 123(R)–3	Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards	Not Board Directed Complete	Rejected	104R	Not Explicitly Included in Codification. See FAS 123R
FSP FAS 123(R)-4	Classification of Options and Similar Instruments Issued as Employee Compensation That Allow for Cash Settlement upon the Occurrence of a Contingent Event	Complete	Adopt/M	104R	718-10
FSP FAS 123(R)-5	Amendment of FASB Staff Position FAS 123(R)-1	Complete	Adopt/M	104R	Not Directly Included in Codification. Included within FAS 123R-1
FSP FAS 123(R)-6	Technical Corrections of FASB Statement No. 123(R)	Complete	Adopt/M	104R	Not Directly Included in Codification. Included within FAS 123R

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PRE-CODIFICATION STANDARDS - CATEGORY B GAAP
FASB STAFF POSITIONS[2]

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
FSP FAS 126-1	Applicability of Certain Disclosure and Interim Reporting Requirements for Obligors for Conduit Debt Securities	Complete	N/A	IP 99	Not Directly Included in Codification. Included within APB 28, FAS 69, FAS 109, FAS 126, FAS 131, FAS 132R and 141R
FSP FAS 129-1	*Disclosure Requirements under FASB Statement No. 129 Relating to Contingently Convertible Securities*	*Not Board Directed*			*470-10* *505-10* *815-10*
FSP FAS 132(R)-1	Employers' Disclosures about Postretirement Benefit Plan Assets	Complete	Revisions to paragraph 5d of FAS 132 adopted. Reject all others.	92, 102	Not Explicitly Included in Codification.
FSP FAS 133-1 and FIN 45-4	Disclosures about Credit Derivatives and Certain Guarantees: An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45; and Clarification of the Effective Date of FASB Statement No. 161	Complete	Adopt	86, 5R	Not Explicitly Included in Codification.
FSP FAS 140-1	*Accounting for Accrued Interest Receivable Related to Securitized and Sold Receivables under FASB Statement No. 140*	*Not Board Directed*			*860-20*
FSP FAS 140-2	*Clarification of the Application of Paragraphs 40(b) and 40(c) of FASB Statement No. 140*	*Not Board Directed*			*Not Explicitly Included in Codification.*
FSP FAS 140-3	Accounting for Transfers of Financial Assets and Repurchase Financing Transactions	Complete	Adopt	91R, 103	860-10
FSP FAS 140-4 and FIN 46(R)-8	*Disclosures by Public Entities (Enterprises) about Transfers of Financial Assets and Interests in Variable Interest Entities*	*Superseded by ASU 2009-17*			*810-10*
FSP FAS 141-1 & 142-1	*Interaction of FASB Statements No. 141, Business Combinations, and No. 142, Goodwill and Other Intangible Assets, and EITF Issue No. 04-2, Whether Mineral Rights Are Tangible or Intangible Assets*	*Superseded by FAS 141R* *Complete*	*Reject*	*68*	
FSP FAS 141R-1	Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies	Pending			805-10 805-20 805-30
FSP FAS 142-2	*Application of FASB Statement No. 142 to Oil- and Gas-Producing Entities*	*Not Board Directed*			*932-350*

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PRE-CODIFICATION STANDARDS - CATEGORY B GAAP
FASB STAFF POSITIONS[2]

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
FSP FAS 142-3	Determination of the Useful Life of Intangible Assets	Complete	Reject	68	275-10 350-30
FSP FAS 143-1	Accounting for Electronic Equipment Waste Obligations	Complete	N/A	IP 99	410-20 720-40
FSP FAS 144-1	*Determination of Cost Basis for Foreclosed Assets under FASB Statement No. 15 and the Measurement of Cumulative Losses Previously Recognized under Paragraph 37 of FASB Statement No. 144*	*Not Board Directed*			*310-40*
FSP FAS 146-1	*Determining Whether a One-Time Termination Benefit Offered in Connection with an Exit or Disposal Activity Is, in Substance, an Enhancement to an Ongoing Benefit Arrangement*	*Not Board Directed*			*420-10* *715-30*
FSP FAS 150-1	*Issuer's Accounting for Freestanding Financial Instruments Composed of More Than One Option or Forward Contract Embodying Obligations under FASB Statement No. 150*	*Not Board Directed*			*480-10*
FSP FAS 150-2	*Accounting for Mandatorily Redeemable Shares Requiring Redemption by Payment of an Amount that Differs from the Book Value of Those Shares under FASB Statement No. 150*	*Not Board Directed*			*480-10*
FSP FAS 150-3	Effective Date, Disclosures, and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests under *FASB Statement No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*	Complete	N/A	IP 99	480-10
FSP FAS 150-4	*Issuers' Accounting for Employee Stock Ownership Plans under FASB Statement No. 150*	*Not Board Directed*			*480-10*
FSP FAS 150-5	Issuer's Accounting under FASB Statement No. 150 for Freestanding Warrants and Other Similar Instruments on Shares that are Redeemable	Complete	N/A	IP 99	480-10
FSP FAS 157-1	Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13	Complete	Adopt/M	100	Not Directly Included in Codification. Included within FAS 157 and FAS 13

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PRE-CODIFICATION STANDARDS - CATEGORY B GAAP
FASB STAFF POSITIONS[2]

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
FSP FAS 157-2	Effective Date of FASB Statement No. 157	Complete	Reject	100	Not Explicitly Included in Codification.
FSP FAS 157-3	*Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active*	*Superseded by FSP FAS 157-4* *Complete*	*Reject*	*100*	*Not Explicitly Included in Codification.*
FSP FAS 157-4	Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly	Complete	Adopt/M	100	Not Explicitly Included in Codification.
FSP FAS 158-1	*Conforming Amendments to the Illustrations in FASB Statements No. 87, No. 88, and No. 106 and to the Related Staff Implementation Guides*	*Not Board Directed* *Complete*	*Adopt/M*	*92, 102*	*Not Directly Included in Codification. Included within FAS 87, FAS 88 and FAS 106*
FSP FIN 39-1	*Amendment of FASB Interpretation No. 39*	*Complete*	*Reject*	*64, 86*	*Not Directly Included in Codification. Included within FIN 39*
FSP FIN 45-1	*Accounting for Intellectual Property Infringement Indemnifications under FASB Interpretation No. 45*	*Not Board Directed*			*460-10*
FSP FIN 45-2	*Whether FASB Interpretation No. 45 Provides Support for Subsequently Accounting for a Guarantor's Liability at Fair Value*	*Not Board Directed*			*460-10*
FSP FIN 45-3	Application of FASB Interpretation No. 45 to Minimum Revenue Guarantees Granted to a Business or Its Owners	Complete	Adopt/M	5R	460-10 954-460
FSP FIN 46(R)-1	*Reporting Variable Interests in Specified Assets of Variable Interest Entities as Separate Variable Interest Entities under Paragraph 13 of FASB Interpretation No. 46 (revised December 2003)*	*Not Board Directed*			*810-10*
FSP FIN 46(R)-2	*Calculation of Expected Losses under FASB Interpretation No. 46 (revised December 2003)*	*Not Board Directed*			*810-10*

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GAAP Pronounce-ment	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
FSP FIN 46(R)-3	*Evaluating Whether, as a Group, the Holders of the Equity Investment at Risk Lack the Direct or Indirect Ability to Make Decisions about an Entity's Activities through Voting Rights or Similar Rights under FASB Interpretation No. 46 (revised December 2003)*	*Not Board Directed*			*810-10* *952-810*
FSP FIN 46(R)-4	Technical Correction of FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities,* Relating to Its Effects on Question No. 12 of EITF Issue No. 96-21, "Implementation Issues in Accounting for Leasing Transactions involving Special-Purpose Entities"	Pending			
FSP FIN 46(R)-5	Implicit Variable Interests under FASB Interpretation No. 46 (revised December 2003)	Pending			810-10
FSP FIN 46(R)-6	*Determining the Variability to Be Considered in Applying FASB Interpretation No. 46(R)*	*Not Board Directed*			810-10
FSP FIN 46(R)-7	Application of FASB Interpretation No. 46(R) to Investment Companies	Complete	N/A	IP 99	Not Directly Included in Codification. Included within FIN 46R
FSP FIN 48-1	Definition of Settlement in FASB Interpretation No. 48	Pending			740-10
FSP FIN 48-2	*Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises*	*Complete*	*Reject*	*101*	*Not Explicitly Included in Codification. See FIN 48*
FSP FIN 48-3	Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises	Complete	Reject	101	Not Explicitly Included in Codification.
FSP APB 14-1	Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)	Pending			470-20 815-15 825-10
FSP APB 18-1	Accounting by an Investor for Its Proportionate Share of Accumulated Other Comprehensive Income of an Investee Accounted for under the Equity Method in Accordance with APB Opinion No. 18 upon a Loss of Significant Influence	Complete	Reject	88, 97	323-10 323-30
FSP FTB 85-4-1	Accounting for Life Settlement Contracts by Third-Party Investors	Pending			325-30

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PRE-CODIFICATION STANDARDS - CATEGORY B GAAP
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GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
FSP EITF 85-24-1	Application of EITF Issue No. 85-24 When Cash for the Right to Future Distribution Fees for Shares Previously Sold is Received from Third Parties	Complete	N/A	IP 99	946-605
FSP EITF 99-20-1	Amendments to the Impairment Guidance of EITF Issue No. 99-20	Complete	Adopt	43R	Not Explicitly Included in Codification.
FSP EITF 00-19-1	*Application of EITF Issue No. 00-19 to Freestanding Financial Instruments Originally Issued as Employee Compensation*	*Superseded by FSP FAS 123(R)-1*			
FSP EITF 00-19-2	Accounting for Registration Payment Arrangements	Complete	Adopt/M	5R	470-20 815-10 815-40 825-20
FSP EITF 03-1-1	*Effective Date of Paragraphs 10–20 of EITF Issue No. 03-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*	*Superseded by FSP FAS 115-1/124-1* *Complete*	*Reject*	*INT 06-07*	
FSP EITF 03-6-1	Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities	Complete	Reject	104R	260-10
FSP AAG INV-1 and SOP 94-4-1	Reporting of Fully Benefit-Responsive Investment Contracts Held by Certain Investment Companies Subject to the AICPA Investment Company Guide and Defined-Contribution Health and Welfare and Pension Plans	Complete	N/A	IP 99	946-205 946-210
FSP AUG AIR-1	Accounting for Planned Major Maintenance Activities	Complete	N/A	IP 99	340-10 360-10 908-360
FSP SOP 78-9-1	Interaction of AICPA Statement of Position 78-9 and EITF Issue No. 04-5	Complete	N/A	IP 99	970-810
FSP SOP 90-7-1	An Amendment of AICPA Statement of Position 90-7	Complete	N/A	IP 99	Not Directly Included in Codification. Included within SOP 90-1
FSP SOP 94-3-1 and AAG HCO-1	Omnibus Changes to Consolidation and Equity Method Guidance for Not-for-Profit Organizations	Complete	N/A	IP 99	*958-810*
FSP SOP 94-6-1	Terms of Loan Products That May Give Rise to a Concentration of Credit Risk	*Not Board Directed*			*310-10* *825-10*

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PRE-CODIFICATION STANDARDS - CATEGORY B GAAP
FASB STAFF POSITIONS[2]

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
FSP SOP 07-1-1	*Effective Date of AICPA Statement of Position 07-1*	*Complete*	*N/A*	*IP 99*	*Not Directly Included in Codification. Included within SOP 07-1*

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PRE-CODIFICATION STANDARDS - CATEGORY B GAAP
AICPA INDUSTRY AUDIT & ACCOUNTING GUIDES

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
	Audits of Stock Life Insurance Companies	Complete	Reject	51, 52	944 – Financial Services - Insurance
	Audits of Property and Liability Insurance Companies	Complete	Reject	65	944 – Financial Services - Insurance
	Audits of Health Care Organizations	Complete	Reject	73	954 – Health Care Entities

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PRE-CODIFICATION STANDARDS - CATEGORY B GAAP
AICPA STATEMENTS OF POSITION[3]

GAAP Pronounce-ment	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
14,040	*Confirmation of Insurance Policies in Force*	*Withdrawn* *Complete*	*N/A*	*IP 99*	
14,060	*Auditing Property and Liability Reinsurance*	*Withdrawn* *Complete*	*N/A*	*IP 99*	
14,070	*Auditing Life Reinsurance*	*Withdrawn* *Complete*	*N/A*	*IP 99*	
74-6	*Withdrawn 1985*				
74-8	*Superseded 1996*	*Complete*	*N/A*	*IP 99*	
74-11	*Superseded 1987*				
74-12	*Withdrawn 1985*				
75-1	*Withdrawn 1981*				
75-2	Accounting Practices of Real Estate Investment Trusts	Complete	N/A	IP 99	974-10 974-605 974-835
75-3	*Superseded 1986*				
75-4	*Superseded 1986*				
75-5	*Withdrawn 1985*				
75-6	*Withdrawn 1985*				
76-1	*Withdrawn 1985*				
76-2	*Withdrawn 1985*				
76-3	Accounting Practices for Certain Employee Stock Ownership Plans	Complete	N/A	IP 99	Grandfathered 105-10-70-2c
77-1	*Superseded 1987*				
77-2	*Superseded 1986*				
78-1	*Superseded 1990*				
78-2	*Superseded 1993*				
78-3	*Withdrawn 1985*				
78-4	*Withdrawn 1985*				
78-5	*Withdrawn 1985*				
78-6	*Withdrawn 1985*				
78-7	*Superseded 1986*				
78-8	*Withdrawn 1981*				

[3] As of September 15, 2009, AICPA Statements of Position are no longer reviewed as part of the statutory maintenance process as they are no longer considered authoritative GAAP literature. If the AICPA were to address an issue that affects the FASB Codification, an accounting standard update (ASU) would be issued and reviewed for applicability to statutory accounting. Therefore, this table will no longer be updated after SOP 09-1.

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AICPA STATEMENTS OF POSITION[3]

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
78-9	Accounting for Investments in Real Estate Ventures	Complete	Reject	48	320-10 323-30 970-323 970-605 970-810 970-835
78-10	*Superseded 1996*	*Complete*	*N/A*	*IP 99*	
79-1	*Superseded 1987*				
79-2	*Withdrawn 1985*				
79-3	*Withdrawn 1985*				
79-4	*Withdrawn 1985*				
80-1	*Withdrawn 1985*				
80-2	*Superseded l986*				
80-3	*Withdrawn 1985*				
81-1	Accounting for Performance of Construction-Type and Certain Production-Type Contracts	Complete	N/A	IP 99	210-10 460-10 605-35 910-20 912-20
81-2	*Superseded 1990*				
82-1	Accounting and Financial Reporting for Personal Financial Statements	Complete	N/A	IP 99	274-10
83-1	*Reporting by Banks of Investment Securities Gains or Losses*	*Superseded* *Complete*	*N/A*	*IP 99*	
85-1	*Superseded 1990*				
85-2	*Superseded 1991*				
85-3	Accounting by Agricultural Producers and Agricultural Cooperatives	Complete	N/A	IP 99	905-10 905-205 905-310 905-325 905-330 905-360 905-405 905-605
86-1	*Superseded 1991*				
87-1	*Superseded 1990*				
87-2	*Accounting for Joint Costs of Informational Materials and Activities of Not-For-Profit Organizations That Include a Fund-Raising Appeal*	*Superseded* *Complete*	*N/A*	*IP 99*	
88-1	Accounting for Developmental and Preoperating Costs, Purchases and Exchanges of Take-off and Landing Slots, and Airframe Modifications	Complete	N/A	IP 99	908-350 908-360 908-720 908-845
88-2	*Superseded 1991*				

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PRE-CODIFICATION STANDARDS - CATEGORY B GAAP
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GAAP Pronounce-ment	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
89-1	*Superseded 1997*				
89-2	*Reports on Audited Financial Statements of Investment Companies*	*Withdrawn* *Complete*	*N/A*	*IP 99*	
89-3	*Questions Concerning Accountants' Services on Prospective Financial Statements*	*Withdrawn* *Complete*	*N/A*	*IP 99*	
89-4	*Superseded 1997*				
89-5	*Superseded 1996*				
89-6	*Superseded 1992*				
89-7	*Report on the Internal Control Structure in Audits of Investment Companies*	*Withdrawn* *Complete*	*N/A*	*IP 99*	
90-1	*Accountants' Services on Prospective Financial Statements for Internal Use Only and Partial Presentations*	*Withdrawn* *Complete*	*N/A*	*IP 99*	
90-2	*Report on Internal Control Structure in Audits of Futures Commission Merchants*	*Withdrawn* *Complete*	*N/A*	*IP 99*	
90-3	Definition of Term Substantially the Same for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position	Complete	Adopt	18, 45, 91R, 103	860-10
90-4	*Superseded 1992*				
90-5	*Superseded 1996*				
90-6	*Superseded 1996*				
90-7	Financial Reporting by Entities in Reorganization Under the Bankruptcy Code	Complete	N/A	IP 99	210-10 852-10 852-20 852-740
90-8	*Financial Accounting and Reporting by Continuing Care Retirement Communities*	*Superseded* *Complete*	*N/A*	*IP 99*	
90-9	*Superseded 1992*				
90-10	*Superseded 1995*				
90-11	*Disclosure of Certain Information by Financial Institutions About Debt Securities Held as Assets*	*Superseded* *Complete*	*Adopt*	*26*	
91-1	*Software Revenue Recognition*	*Superseded* *Complete*	*N/A*	*IP 99*	
92-1	Accounting for Real Estate Syndication Income	Complete	Adopt	40R	970-605
92-2	*Questions and Answers on the Term Reasonably Objective Basis and Other Issues Affecting Prospective Financial Statements*	*Withdrawn* *Complete*	*N/A*	*IP 99*	

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GAAP Pronounce-ment	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
92-3	*Accounting for Foreclosed Assets*	*Superseded* *Complete*	*Adopt*	*40R*	
92-4	*Auditing Insurance Entities Loss Reserves*	*Withdrawn* *Complete*	*Reject*	*55*	
92-5	Accounting for Foreign Property and Liability Reinsurance	Complete	Reject	62R	944-605
92-6	Accounting and Reporting by Health and Welfare Benefit Plans	Complete	N/A	IP 99	962-325 965-10 965-20 965-30 965-40 965-205 965-310 965-320 965-325 965-360
92-7	*Superseded 1994*				
92-8	*Auditing Property/Casualty Insurance Entities Statutory Financial Statements—Applying Certain Requirements of the NAIC Annual Statement Instructions*	*Complete*	*N/A*	*IP 99*	*Not Included in Codification. Auditing and Attestation SOP*
92-9	*Audits of Not-for-Profit Organizations Receiving Federal Awards*	*Superseded* *Complete*	*N/A*	*IP 99*	
93-1	Financial Accounting and Reporting for High-Yield Debt Securities by Investment Companies	Complete	N/A	IP 99	450-20 946-320
93-2	*Determination, Disclosure, and Financial Statement Presentation of Income, Capital Gain, and Return of Capital Distributions by Investment Companies*	*Superseded* *Complete*	*N/A*	*IP 99*	
93-3	Rescission of Accounting Principles Board Statements	Complete	N/A	IP 99	255-10
93-4	Foreign Currency Accounting and Financial Statement Presentation for Investment Companies	Complete	N/A	IP 99	946-830
93-5	*Reporting on Required Supplementary Information Accompanying Compiled or Reviewed Financial Statements of Common Interest Realty Associations*	*Withdrawn* *Complete*	*N/A*	*IP 99*	

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GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
93-6	Employers' Accounting for Employee Stock Ownership Plans	Complete	Adopt/M Reject paragraphs 28-34, 37, 44 & 53.b. Adopt/M paragraphs 13 & 25	12 15	460-10 718-40 718-740
93-7	Reporting on Advertising Costs	Complete	Reject	29	340-20 720-35 958-720
93-8	*The Auditor's Consideration of Regulatory Risk-Based Capital for Life Insurance Enterprises*	*Withdrawn* *Complete*	*N/A*	*IP 99*	
94-1	*Inquiries of State Insurance Regulators*	*Withdrawn* *Complete*	*N/A*	*IP 99*	
94-2	*The Application of the Requirements of Accounting Research Bulletins, Opinions of the Accounting Principles Board, and Statements and Interpretations of the Financial Accounting Standards Board to Not-for-Profit Organizations*	*Superseded* *Complete*	*N/A*	*IP 99*	
94-3	Reporting of Related Entities by Not-for-Profit Organizations	Complete	N/A	IP 99	954-810 958-810 958-840
94-4	Reporting of Investment Contracts Held by Health and Welfare Benefit Plans and Defined-Contribution Pension Plans	Complete	N/A	IP 99	962-10 962-205 962-325 965-325
94-5	Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises	Complete	Adopt	1	944-10 944-20 944-40 944-505
94-6	Disclosures of Certain Significant Risks and Uncertainties	Complete	Adopt	1	205-20 275-10 330-10 360-10 410-30 450-20 460-10 605-35 740-10 958-205 958-605 985-20

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GAAP Pronounce-ment	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
95-1	Accounting for Certain Insurance Activities of Mutual Life Insurance Enterprises	Complete	Reject	51, 52	944-20 944-30 944-40 944-50 944-605
95-2	Financial Reporting by Nonpublic Investment Partnerships	Complete	N/A	IP 99	946-20 946-210 946-225
95-3	Accounting for Certain Distribution Costs of Investment Companies	Complete	N/A	IP 99	946-20
95-4	*Letters for State Insurance Regulators to Comply with the NAIC Model Audit Rule*	*Withdrawn* *Complete*	*N/A*	*IP 99*	
95-5	*Auditor's Reporting on Statutory Financial Statements of Insurance Enterprises*	*Withdrawn* *Complete*	*N/A*	*IP 99*	
96-1	Environmental Remediation Liabilities	Complete	Adopt	67	410-30 440-10 450-20
97-1	Accounting by Participating Mortgage Loan Borrowers	Complete	Adopt	40R	310-30 470-30 835-20
97-2	Software Revenue Recognition	Complete	Adopt/M paragraphs 6-91	16R 81	450-10 605-35 730-10 730-20 985-20 985-605
97-3	Accounting by Insurance and Other Enterprises for Insurance-Related Assessments	Complete	Reject Adopt/M	35 35R	310-10 405-30 450-20
98-1	Accounting for the Costs of Computer Software Developed or Obtained for Internal Use	Complete	Adopt/M Paragraphs 11-42 & 93	16R	350-10 350-40 350-50 730-10 985-20
98-2	Accounting for Costs of Activities of Not-for-Profit Organizations and State and Governmental Entities that Include Fund Raising	Complete	N/A	IP 99	958-720
98-3	*Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*	*Superseded* *Complete*	*N/A*	*IP 99*	

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GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
98-4	Deferral of the Effective Date of a Provision of SOP 97-2, Software Revenue Recognition	Complete	Reject	16R	Not Directly Included in Codification. Included within SOP 97-2
98-5	Reporting on the Costs of Start-Up Activities	Complete	Adopt	76	720-15
98-6	*Reporting on Management's Assessment Pursuant to the Life Insurance Ethical Market Conduct Program of the Insurance Marketplace Standards Association*	*Withdrawn* *Complete*	*N/A*	*IP 99*	
98-7	Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That Do Not Transfer Insurance Risk	Complete	Adopt paragraphs 10-12 & 19b. Reject 13-17, 19a & 19c.	62R	340-30 450-10 835-10
98-8	*Engagements to Perform Year 2000 Agreed-Upon Procedures Attestation Engagements Pursuant to Rule 17a-5 of the Securities Exchange Act of 1934, Rule 17Ad-18 of the Securities Exchange Act of 1934, and Advisories No. 17-98 and No. 42-98 of the Commodity Futures Trading Commission*	*Withdrawn* *Complete*	*N/A*	*IP 99*	
98-9	Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions	Complete	Adopt/M paragraphs 6-8	16R	Not Directly Included in Codification. Included within SOP 97-2
99-1	*Guidance to Practitioners in Conducting and Reporting on an Agreed-Upon Procedures Engagement to Assist Management in Evaluating the Effectiveness of its Corporate Compliance Program*	*Complete*	*N/A*	*IP 99*	*Not Included in Codification. Auditing and Attestation SOP*
99-2	Accounting for and Reporting of Postretirement Medical Benefit (401(h)) Features of Defined Benefit Pension Plans	Complete	N/A	IP 99	960-20 960-30 960-205 965-10 965-205
99-3	Accounting for and Reporting of Certain Defined Contribution Plan Investments and Other Disclosure Matters	Complete	N/A	IP 99	962-10 962-325 965-325
00-1	*Auditing Health Care Third-Party Revenues and Related Receivables*	*Complete*	*N/A*	*IP 99*	*Not Included in Codification. Auditing and Attestation SOP*

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GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
00-2	Accounting by Producers or Distributors of Films	Complete	N/A	IP 99	210-10 430-10 460-10 855-10 926-10 926-20 926-230 926-330 926-405 926-430 926-605 926-705 926-720 926-835 926-845 926-855
00-3	Accounting by Insurance Enterprises for Demutualizations and Formations of Mutual Insurance Holding Companies and for Certain Long-Duration Participating Contracts	Pending			944-805
01-1	Amendment to Scope of Statement of Position 95-2, Financial Reporting by Nonpublic Investment Partnerships, to Include Commodity Pools	Complete	N/A	IP 99	Not Directly Included in Codification. Included within SOP 95-2
01-2	Accounting and Reporting by Health and Welfare Benefit Plans	Complete	N/A	IP 99	Not Directly Included in Codification. Included within EBP AAG and SOP 92-6
01-3	*Performing Agreed-Upon Procedures Engagements That Address Internal Control Over Derivative Transactions as Required by the New York State Insurance Law*	*Complete*	*N/A*	*IP 99*	*Not Included in Codification. Auditing and Attestation SOP*
01-4	*Reporting Pursuant to the Association for Investment Management and Research Performance Presentation Standards*	*Withdrawn* *Complete*	*N/A*	*IP 99*	
01-5	Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification	Complete	Adopt	1	Not Directly Included in Codification. Included within SOP 94-5

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GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
01-6	Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others	Complete	N/A	IP 99	310-10 310-20 460-10 605-20 825-10 835-30 860-20 860-50 942-10 942-210 942-305 942-310 942-320 942-325 942-360 942-405 942-470 942-505 942-825 944-320 948-10
02-1	*Performing Agreed-Upon Procedures Engagements That Address Annual Claims Payment Reports as Required by the New Jersey Administrative Code*	*Complete*	*N/A*	*IP 99*	*Not Included in Codification. Auditing and Attestation SOP*
02-2	Accounting for Derivative Instruments and Hedging Activities by Not-for-Profit Health Care Organizations, and Clarification of the Performance Indicator	Complete	N/A	IP 99	954-815
03-1	Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts	Complete	Rejected	56	944-20 944-30 944-40 944-80 944-320 944-605
03-2	*Attest Engagements on Greenhouse Gas Emissions Information*	*Complete*	*N/A*	*IP 99*	*Not Included in Codification. Auditing and Attestation SOP*
03-3	Accounting for Certain Loans or Debt Securities Acquired in a Transfer	Considered for 43R only Pending	Paragraphs 5, 7 and 9 adopted for 43R only.	43R	310-10 310-30 835-10

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AICPA STATEMENTS OF POSITION[3]

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
03-4	Reporting Financial Highlights and Schedule of Investments by Nonregistered Investment Partnerships: An Amendment to the Audit and Accounting Guide Audits of Investment Companies and *AICPA Statement of Position 95-2, Financial Reporting by Nonpublic Investment Partnerships*	Complete	N/A	IP 99	Not Directly Included in Codification. Included within SOP 95-2
03-5	Financial Highlights of Separate Accounts: An Amendment to the Audit and Accounting Guide Audits of Investment Companies	Complete	N/A	IP 99	Not Directly Included in Codification. Included within INV AAG
04-1	*Auditing the Statement of Social Insurance*	*Complete*	*N/A*	*IP 99*	*Not Included in Codification. Auditing and Attestation SOP*
04-2	Accounting for Real Estate Time-Sharing Transactions	Complete	N/A	IP 99	978-10 978-230 978-250 978-310 978-330 978-340 978-605 978-720 978-810 978-840
05-1	Statement of Position 05-1 Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection With Modifications or Exchanges of Insurance Contracts	Complete	Rejected	71	944-30
06-1	*Statement of Position 06-1 Reporting Pursuant to the Global Investment Performance Standards*	*Complete*	*N/A*	*IP 99*	*Not Included in Codification. Auditing and Attestation SOP*
07-1	Clarification of the Scope of the Audit and Accounting Guide Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies	Complete	N/A	IP 99	946-10 946-323 946-810
07-2	*Attestation Engagements That Address Specified Compliance of Control Objectives and Related Controls at Entities That Provide Services to Investment Companies, Investment Advisers, or Other Service Providers*	*Complete*	*N/A*	*IP 99*	*Not Included in Codification. Auditing and Attestation SOP*

STATUTORY ACCOUNTING PRINCIPLES
GAAP CROSS-REFERENCE TO STATUTORY ACCOUNTING PRINCIPLES

PRE-CODIFICATION STANDARDS - CATEGORY B GAAP
AICPA STATEMENTS OF POSITION[3]

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
09-1	*Performing Agreed-Upon Procedures Engagements That Address the Completeness, Accuracy, or Consistency of XBRL-Tagged Data*	*Complete*	*Reject*	*IP 99*	*Not Included in Codification. Auditing and Attestation SOP*

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PRE-CODIFICATION STANDARDS - CATEGORY C GAAP
CONSENSUS OPINIONS OF THE EMERGING ISSUES TASK FORCE

GAAP Pronounce-ment	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
84-1	*1984 Tax Reform Act: Deferred Income Taxes of Stock Life Insurance Companies*	*Resolved by FAS 109*			
84-2	*Tax Reform Act of 1984: Deferred Income Taxes Relating to Domestic International Sales Corporations*	*Resolved by FAS 109*			
84-3	*Convertible Debt "Sweeteners"*	*Nullified by FAS 84*			
84-4	*Acquisition, Development and Construction Loans*	*Resolved by PB 1*			*810-10* *815-15*
84-5	Sale of Marketable Securities with a Put Option	Complete	Reject	18, 91R, 103	460-10 860-20
84-6	*Termination of Defined Benefit Pension Plans*	*Nullified by FAS 88*			
84-7	*Termination of Interest Rate Swaps*	*Partially nullified and Partially resolved by FAS 133* *Complete*	*Adopt*	*31*	
84-8	*Variable Stock Purchase Warrants Given by Suppliers to Customers*	*Resolved by FAS 123(R)* *Complete*	*N/A*	*104R*	
84-9	*Deposit Float of Banks*	*Superseded by PB 1 and AAG BSI* *Complete*	*N/A*	*IP 99*	.
84-10	*LIFO Conformity of Companies Relying on Insilco Tax Court Decision*	*No EITF Consensus*			
84-11	*Offsetting Installment Note Receivables and Bank Debt ("Note Monetization")*	*Resolved by FIN 39*			
84-12	*Operating Leases with Scheduled Rent Increases*	*Nullified by FTB 85-3*			

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PRE-CODIFICATION STANDARDS - CATEGORY C GAAP
CONSENSUS OPINIONS OF THE EMERGING ISSUES TASK FORCE

GAAP Pronounce-ment	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
84-13	*Purchase of Stock Options and Stock Appreciation Rights in a Leveraged Buyout*	*Nullified by FAS 123(R) except for entities within the scope of paragraph 83 of FAS 123(R)* *Complete*	*Adopt* *Nullified*	*13* *104R*	
84-14	*Deferred Interest Rate Setting*	*Nullified by FAS 133* *Complete*	*Reject*	*31*	
84-15	*Grantor Trusts Consolidation*	*No EITF Consensus*			
84-16	*Earnings-per-Share Cash-Yield Test for Zero Coupon Bonds*	*Resolved by FAS 85*			
84-17	Profit Recognition on Sales of Real Estate with Graduated Payment Mortgages or Insured Mortgages	Complete	Adopt	40R	360-20
84-18	*Stock Option Pyramiding*	*Nullified by FAS 123(R) except for entities within the scope of paragraph 83 of FAS 123(R)* *Complete*	*Adopt* *Nullified*	*13* *104R*	
84-19	Mortgage Loan Payment Modifications	Complete	Adopt	37	310-20
84-20	GNMA Dollar Rolls	Complete	Adopt	45	815-10 860-10
84-21	*Sale of a Loan with a Partial Participation Retained*	*Resolved by FAS 125 & FAS 140*			
84-22	*Prior Years' Earnings per Share following a Savings and Loan Association Conversion and Pooling*	*Resolved by FAS 141*			

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CONSENSUS OPINIONS OF THE EMERGING ISSUES TASK FORCE

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
84-23	*Leveraged Buyout Holding Company Debt*	*No EITF Consensus*			
84-24	*LIFO Accounting Issues*	*No EITF Consensus*			
84-25	*Offsetting Nonrecourse Debt with Sales-Type of Direct Financing Lease Receivables*	*Resolved by FTB 86-2*			
84-26	*Defeasance of Special-Purpose Borrowings*	*Resolved by FAS 125 & FAS 140*			
84-27	*Deferred Taxes on Subsidiary Stock Sales*	*Resolved by FAS 109*			
84-28	*Impairment of Long-Lived Assets*	*Resolved by FAS 121 and FAS 144*			
84-29	*Gain and Loss Recognition on Exchanges of Productive Assets and the Effect of Boot*	*Resolved by EITF 86-29*			
84-30	*Sales of Loans to Special-Purpose Entities*	*Resolved by FIN 46 & FIN 46 (R)*			
84-31	*Equity Certificates of Deposit*	*Resolved by FAS 133*			
84-32	*(Not Used)*				
84-33	*Acquisition of a Tax Loss Carryforward—Temporary Parent-Subsidiary Relationship*	*Resolved by FAS 144*			
84-34	*Permanent Discount Restricted Stock Purchase Plans*	*Nullified by FAS 123(R) except for entities within the scope of paragraph 83 of FAS 123(R)* *Complete*	*N/A*	*104R*	
84-35	*Business Combinations: Sale of Duplicate Facilities and Accrual of Liabilities*	*No EITF Consensus*			
84-36	*Interest Rate Swap Transactions*	*Nullified by FAS 133* *Complete*	*Adopt*	*31*	
84-37	*Sale-Leaseback Transaction with Repurchase Option*	*No EITF Consensus*			840-40

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CONSENSUS OPINIONS OF THE EMERGING ISSUES TASK FORCE

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
84-38	*Identical Common Shares for a Pooling of Interests*	*Nullified by FTB 85-5*			
84-39	*Transfers of Monetary and Nonmonetary Assets among Individuals and Entities under Common Control*	*No longer technically helpful*			
84-40	*Long-Term Debt Repayable by a Capital Stock Transaction*	*Nullified by FIN 46, FIN 46 (R) & FAS 150* *Complete*	*Reject*	*15*	
84-41	*Consolidation of Subsidiary after Instantaneous In-Substance Defeasance*	*Resolved by FAS 94*			
84-42	*Push-Down of Parent Company Debt to a Subsidiary*	*No EITF Consensus*			
84-43	*Income Taxes Effects of Asset Revaluations in Certain Foreign Countries*	*Nullified by FAS 109*			
84-44	*Partial Termination of a Defined Benefit Pension Plan*	*Resolved by FAS 88*			
85-1	Classifying Notes Received for Capital Stock	Complete	Reject	72	310-10 505-10 850-10
85-2	*Classification of Costs Incurred in a Takeover Defense*	*Nullified by TB 85-6* *Complete*	*Reject*	*72*	
85-3	*Tax Benefits Relating to Asset Dispositions Following an Acquisition of a Financial Institution*	*Nullified by FAS 109*			
85-4	*Downstream Mergers and Other Stock Transactions between Companies under Common Control*	*Resolved by FTB 85-5*			
85-5	*Restoration of Deferred Taxes Previously Eliminated by Net Operating Loss Recognition*	*Resolved by FAS 109*			
85-6	*Futures Implementation Questions*	*Resolved by Q&A 80*			
85-7	*Federal Home Loan Mortgage Corporation Stock*	*Resolved by FTB 85-1*			
85-8	*Amortization of Thrift Intangibles*	*Nullified by FAS 141(R)* *Complete*	*N/A*	*IP 99*	
85-9	Revenue Recognition on Options to Purchase Stock of Another Entity	Complete	Adopt	15	470-20
85-10	*Employee Stock Ownership Plan Contribution Funded by a Pension Plan Termination*	*Nullified by FAS 88*			

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CONSENSUS OPINIONS OF THE EMERGING ISSUES TASK FORCE

GAAP Pronounce-ment	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
85-11	*Use of an Employee Stock Ownership Plan in a Leveraged Buyout*	*No longer technically helpful*			
85-12	Retention of Specialized Accounting for Investments in Consolidation	Complete	N/A	IP 99	810-10
85-13	Sale of Mortgage Service Rights on Mortgages Owned by Others	Complete	N/A	IP 99	860-50
85-14	*Securities That Can Be Acquired for Cash in a Pooling of Interests*	*Nullified by FAS 141* *Complete*	*Reject*	*68*	
85-15	*Recognizing Benefits of Purchased Net Operating Loss Carryforwards*	*Nullified by FAS 109*			
85-16	Leveraged Leases • Real Estate Leases and Sale-Leaseback Transactions • Delayed Equity Contributions by Lessors	Complete	Adopt	22	840-30
85-17	Accrued Interest upon Conversion of Convertible Debt	Complete	Adopt	15	470-20 835-10
85-18	Earnings-per-Share Effect of Equity Commitment Notes	Partially Nullified by FAS 128 Complete	N/A	IP 99	Not Directly Included in Codification. Included within FAS 128
85-19	*(Not Used)*				
85-20	Recognition of Fees for Guaranteeing a Loan	Complete *Partially nullified by FAS 163*	Adopt	27	310-10 460-10 605-20
85-21	Changes of Ownership Resulting in a New Basis of Accounting	No EITF Consensus			805-50
85-22	*Retroactive Application of FASB Technical Bulletins*	*No longer technically helpful*			
85-23	Effect of a Redemption Agreement on Carrying Value of a Security	Complete	N/A	IP 99	Not Directly Included in Codification. Issue Subject to FAS 133
85-24	Distribution Fees by Distributors of Mutual Funds That Do Not Have a Front-End Sales Charge	Complete	N/A	IP 99	946-605 946-720
85-25	*Sale of Preferred Stocks with a Put Option*	*Nullified by FAS 125, 133 & 140*			*860-20*

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GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
85-26	*Measurement of Servicing Fee Under FASB Statement No. 65 When a Loan is Sold with Servicing Retained*	*Resolved by FTB 87-3 & FAS 125 & FAS 140*			
85-27	Recognition of Receipts from Made-Up Rental Shortfalls	Complete	N/A	IP 99	970-360
85-28	*Consolidation Issues Relating to Collateralized Mortgage Obligations*	*Resolved by FAS 94*			
85-29	Convertible Bonds with a “Premium Put”	Complete Partially Nullified by FAS 133	Adopt	15	Not Directly Included in Codification. Issue Subject to FAS 133, FAS 155 and FIN 45
85-30	*Sale of Marketable Securities at a Gain with a Put Option*	*Resolved by FAS 125 & FAS 140*			
85-31	Comptroller of the Currency’s Rule on Deferred Tax Debits	Complete	N/A	IP 99	942-740
85-32	*Purchased Lease Residuals*	*Nullified by FTB 86-2*			
85-33	*Disallowance of Income Tax Deduction for Core Deposit Intangibles*	*Nullified by FAS 109*			
85-34	*Banker’s Acceptances and Risk Participations*	*Resolved by FAS 125 and FAS 140*			
85-35	*Transition and Implementation Issues for FASB Statement No. 86*	*No longer technically helpful*			
85-36	*Discontinued Operations with Expected Gain and Interim Operating Losses*	*Nullified by FAS 144* *Complete*	*Adopt*	*24*	
85-37	*Recognition of Note Received for Real Estate Syndication Activities*	*Resolved by SOP 92-1*			
85-38	*Negative Amortizing Loans*	*No longer technically helpful*			
85-39	*Implications of SEC Staff Accounting Bulletin No. 59 on Noncurrent Marketable Equity Securities*	*No EITF Consensus*			

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GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
85-40	*Comprehensive Review of Sales of Marketable Securities with Put Arrangements*	*Nullified by FAS 125 and partially nullified by FAS 140*			
85-41	Accounting for Savings and Loan Associations under FSLIC Management Consignment Program	Complete	N/A	IP 99	Not Directly Included in Codification. Issue Subject to FAS 109, FAS 142 and FAS 141R
85-42	*Amortization of Goodwill Resulting from Recording Time Savings Deposits at Fair Values*	*Nullified by FAS 141(R)* *Complete*	*N/A*	*IP 99*	
85-43	*Sale of Subsidiary for Equity Interest in Buyer*	*Resolved by EITF 86-29*			
85-44	*Differences between Loan Loss Allowances for GAAP and RAP*	*Complete*	*N/A*	*IP 99*	*Not Included in Codification As No Longer Applicable Or Relevant*
85-45	*Business Combinations: Settlement of Stock Options and Awards*	*Nullified by FAS 123(R) except for entities within the scope of paragraph 83 of FAS 123(R)* *Complete*	*Adopt* *Nullified*	*13* *104R*	
85-46	Partnership's Purchase of Withdrawing Partner's Equity	No EITF Consensus			
86-1	*Recognizing Net Operating Loss Carryforwards*	*Nullified by FAS 109*			
86-2	*Retroactive Wage Adjustments Affecting Medicare Payments*	*No longer technically helpful* *Complete*	*N/A*	*IP 99*	

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GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
86-3	*Retroactive Regulations regarding IRC Section 338 Purchase Price Allocations*	*No longer technically helpful* *Complete*	*N/A*	*IP 99*	
86-4	*Income Statement Treatment of Income Tax Benefit for Employee Stock Ownership Plan Dividends*	*Nullified by FAS 109*			
86-5	Classifying Demand Notes with Repayment Terms	Complete	N/A	IP 99	470-10
86-6	Antispeculation Clauses in Real Estate Sales Contracts	Complete	Adopt	40R	360-20
86-7	Recognition by Homebuilders of Profit from Sales of Land and Related Construction Contracts	Complete	N/A	IP 99	970-360
86-8	Sale of Bad-Debt Recovery Rights	Complete	Adopt	15	860-10
86-9	IRC Section 338 and Push-Down Accounting	Complete	Reject	68	805-50 805-740
86-10	*Pooling with 10 Percent Cash Payout Determined by Lottery*	*Nullified by FAS 141* *Complete*	*Reject*	*68*	
86-11	*Recognition of Possible 1986 Tax Law Changes*	*Resolved by FAS 109*			
86-12	*Accounting by Insureds for Claims-Made Insurance Policies*	*Codified in Issue 03-8* *Complete*	*N/A*	*IP 99*	
86-13	Recognition of Inventory Market Declines at Interim Reporting Dates	Complete	N/A	IP 99	330-10
86-14	*Purchased Research and Development Projects in a Business Combination*	*No EITF Consensus*			
86-15	Increasing-Rate Debt	Complete	Adopt	15	470-10 835-10
86-16	*Carryover of Predecessor Cost in Leveraged Buyout Transactions*	*Superseded by EITF 88-16*			
86-17	Deferred Profit on Sale-Leaseback Transaction with Lessee Guarantee of Residual Value	Complete	Reject	22	460-10 840-40
86-18	*Debtor's Accounting for a Modification of Debt Terms*	*Resolved by FIN 39 and Superseded by Issue 96-19* *Complete*	*Adopt*	*15*	

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GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
86-19	*Change in Accounting for Other Postemployment Benefits*	*Resolved by FAS 106*			
86-20	*Accounting for Other Postemployment Benefits of an Acquired Company*	*Nullified by FAS 106*			
86-21	Application of the AICPA Notice to Practitioners regarding Acquisition, Development, and Construction Arrangements to Acquisition of an Operating Property	Complete	Adopt	38	310-10 815-15
86-22	*Display of Business Restructuring Provisions in the Income Statement*	*No EITF Consensus*			
86-23	*(Not Used)*				
86-24	*Third-Party Establishment of Collateralized Mortgage Obligations*	*Nullified by FAS 125 and FAS 140* *Complete*	*N/A*	*IP 99*	
86-25	Offsetting Foreign Currency Swaps	Complete	Adopt	64	815-10
86-26	*Using Forward Commitments as a Surrogate for Deferred Rate Setting*	*Resolved by FAS 133*			
86-27	Measurement of Excess Contributions to a Defined Contribution Plan or Employee Stock Ownership Plan	Complete	N/A	IP 99	715-70
86-28	*Accounting Implications of Indexed Debt Instruments*	*Nullified by FAS 133* *Complete*	*Adopt*	*15*	*470-10*
86-29	*Nonmonetary Transactions: Magnitude of Boot and the Exceptions to the Use of Fair Value*	*Codified in EITF 01-2* *Complete*	*Adopt*	*28, 95*	
86-30	Classification of Obligations When a Violation is Waived by the Creditor	Complete	N/A	IP 99	470-10
86-31	*Reporting the Tax Implications of a Pooling of a Bank and a Savings and Loan Association*	*Nullified by FAS 141* *Complete*	*N/A*	*IP 99*	
86-32	Early Extinguishment of a Subsidiary's Mandatorily Redeemable Preferred Stock	Complete	Reject	32	505-10 810-10
86-33	Tax Indemnifications in Lease Agreements	Complete	Adopt	22	460-10 840-10
86-34	*Futures Contracts Used as Hedges of Anticipated Reverse Repurchase Transactions*	*Nullified by FAS 133* *Complete*	*Reject*	*31*	

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GAAP Pronounce-ment	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
86-35	*Debentures with Detachable Stock Purchase Warrants*	*Superseded by EITF No. 96-13*			
86-36	*Invasion of a Defeasance Trust*	*Complete*	*Adopt*	*15*	*Not Included in Codification As No Longer Applicable Or Relevant*
86-37	*Recognition of Tax Benefit of Discounting Loss Reserves of Insurance Companies*	*Nullified by FAS 109*			
86-38	*Implications of Mortgage Prepayments on Amortization of Servicing Rights*	*Section A - Nullified by FAS 122 & FAS 125* *Section B – Nullified by FAS 125* *Section C – Superseded by EITF No. 89-4*			
86-39	*Gains from the Sale of Mortgage Loans with Servicing Rights Retained*	*Nullified by FAS 122, FAS 125 & FAS 140*			
86-40	Investments in Open-End Mutual Funds That Invest in U.S. Government Securities	Complete	N/A	IP 99	320-10
86-41	*Carryforward of the Corporate Alternative Minimum Tax Credit*	*Nullified by FAS 109*			
86-42	*Effect of a Change in Tax Rates on Assets and Liabilities Recorded Net-of-Tax in a Purchase Business Combination*	*Nullified by FAS 109*			
86-43	Effect of a Change in Tax Law or Rates on Leveraged Leases	Complete	Adopt	22	840-30
86-44	*Effect of a Change in Tax Law on Investments in Safe Harbor Leases*	*Complete*	*N/A*	*IP 99*	*Not Included in Codification As No Longer Applicable Or Relevant*
86-45	*Imputation of Dividends on Preferred Stock Redeemable at the Issuer's Option with Initial Below-Market Dividend Rate*	*No EITF Consensus*			
86-46	Uniform Capitalization Rules for Inventory under the Tax Reform Act of 1986	Complete	N/A	IP 99	330-10
87-1	*Deferral Accounting for Cash Securities That Are Used to Hedge Rate or Price Risk*	*Resolved by FAS 133*			

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GAAP Pronounce-ment	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
87-2	*Net Present Value Method of Valuing Speculative Foreign Exchange Contracts*	*Nullified by FAS 133* *Complete*	*Reject*	*31*	
87-3	*(Not Used)*				
87-4	Restructuring of Operations: Implications of SEC Staff Accounting Bulletin No. 67	Complete	N/A	IP 99	Not Directly Included in Codification. Issue Subject to FAS 144 and EITF 94-3
87-5	*Troubled Debt Restructurings: Interrelationship between FASB Statement No. 15 and the AICPA Savings and Loan Guide*	*Nullified by FAS 114*			
87-6	*Adjustments Relating to Stock Compensation Plans*	*Nullified by FIN 44* *Complete*	*Adopt* *Nullified*	*13* *104R*	
87-7	Sale of an Asset Subject to a Lease and Nonrecourse Financing: "Wrap-Lease Transactions"	Complete	Reject	22	Not Directly included in Codification Issue Subject to EITF 88-1 and FAS 13
87-8	Tax Reform Act of 1986: Issues Related to the Alternative Minimum Tax	*Issues 1 – 9 and 11 nullified by FAS 96 & 109* Issue 10	Adopt	22	740-10 840-30
87-9	Profit Recognition on Sales of Real Estate with Insured Mortgages or Surety Bonds	Complete	Adopt	40R	360-20
87-10	Revenue Recognition by Television (Barter) Syndicators	Guidance revised by FAS 139 Complete	N/A	IP 99	Not Directly Included in Codification. Issue Subject to SOP 00-2
87-11	*Allocation of Purchase Price to Assets to Be Sold*	*Nullified by FAS 144* *Complete*	*Reject*	*68*	
87-12	Foreign Debt-for-Equity Swaps	Complete	Reject	23	830-20

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GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
87-13	*Amortization of Prior Service Cost for a Defined Benefit Plan When There Is a History of Plan Amendments*	*Resolved by Q&A 87, Question 20*			
87-14	*(Not Used)*				
87-15	*Effect of a Standstill Agreement on Pooling-of-Interests Accounting*	*Nullified by FAS 141* *Complete*	*Reject*	*68*	
87-16	*Whether the 90 Percent Test for a Pooling of Interests is Applied Separately to Each Company or on a Combined Basis*	*Nullified by FAS 141* *Complete*	*Reject*	*68*	
87-17	*Spinoffs or Other Distributions of Loans Receivable to Shareholders*	*Codified in EITF 01-2*			
87-18	Use of Zero Coupon Bonds in a Troubled Debt Restructuring	Complete *Partially resolved by FAS 125 & FAS 140*	Adopt/M	36	310-40
87-19	Substituted Debtors in a Troubled Debt Restructuring	Complete	Adopt/M	36	310-40
87-20	*Offsetting Certificates of Deposit against High-Coupon Debt*	*Partially resolved by FAS 125 and Superseded by EITF 96-19* *Complete*	*N/A*	*IP 99*	
87-21	Change of Accounting Basis in Master Limited Partnership Transactions	Complete	Reject	46, 88, 97	805-50
87-22	*Prepayments to the Secondary Reserve of the FSLIC*	*Issue Addressed in PB 3 and PB 3 was Withdrawn* *Complete*	*N/A*	*IP 99*	

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GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
87-23	*Book Value Stock Purchase Plans*	*Issues 1 and 2 nullified by FAS 123(R) except for entities within the scope of paragraph 83 of FAS 123(R) and Issue 3 nullified by SOP 93-6* *Complete*	*Adopt* *Nullified*	*13* *104R*	
87-24	Allocation of Interest to Discontinued Operations	Complete	N/A	IP 99	205-20
87-25	*Sale of Convertible, Adjustable-Rate Mortgages with Contingent Repayment Agreement*	*Resolved by FAS 125 & FAS 140*			
87-26	*Hedging of Foreign Currency Exposure with a Tandem Currency*	*Nullified by FAS 133* *Complete*	*Reject*	*23*	
87-27	*Poolings of Companies That Do Not Have a Controlling Class of Common Stock*	*Nullified by FAS 141* *Complete*	*Reject*	*68*	
87-28	*Provision for Deferred Taxes on Increases in Cash Surrender Value of Key-Person Life Insurance*	*Resolved by FAS 109*			
87-29	*Exchange of Real Estate Involving Boot*	*Codified in EITF 01-2* *Complete*	*Adopt*	*40R*	
87-30	Sale of a Short-Term Loan Made under a Long-Term Credit Commitment	Complete	N/A	IP 99	860-10
87-31	*Sale of Put Options on Issuer's Stock*	*Codified in EITF No. 96-13*			
87-32	*(Not Used)*				

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CONSENSUS OPINIONS OF THE EMERGING ISSUES TASK FORCE

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
87-33	*Stock Compensation Issues Related to Market Decline*	*Nullified by FIN 44* *Complete*	*Adopt* *Nullified*	*13* *104R*	
87-34	Sale of Mortgage Servicing Rights with a Subservicing Agreement	Complete	Adopt	18, 91R, 103	860-50
88-1	Determination of Vested Benefit Obligation for a Defined Benefit Pension Plan	Complete	Adopt	8, 89, 92, 102	715-20 715-30
88-2	*(Not Used)*				
88-3	*Rental Concessions Provided by Landlord*	*Resolved by FTB 88-1 and EITF 88-10 and 94-3*			
88-4	Classification of Payment Made to IRS to Retain Fiscal Year	Complete	N/A	IP 99	740-10
88-5	Recognition of Insurance Death Benefits	Complete	Adopt	21	325-30
88-6	*Book Value Stock Plans in an Initial Public Offering*	*Nullified by FAS 123(R) except for entities within the scope of paragraph 83 of FAS 123(R)* *Complete*	*Adopt* *Nullified*	*13* *104R*	
88-7	*(Not Used)*				
88-8	Mortgage Swaps	*Partially nullified and partially resolved by FAS 133* Complete	Reject	31	

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GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
88-9	*Put Warrants*	*Nullified by FAS 128, 133, and 150 or superseded by Issue No. 96-13* *Complete*	*Adopt/M*	*72*	
88-10	*Costs Associated with Lease Modification or Termination*	*Nullified and resolved by FAS 146* *Complete*	*Adopt (See FAS 146)*	*22*	
88-11	*Allocation of Recorded Investment When a Loan or Part of a Loan Is Sold*	*Nullified by Statement 125 and Statement 140, as amended by Statement 156* *Complete*	*Adopt*	*18, 91R, 103*	
88-12	Transfer of Ownership Interest as Part of Down Payment under FASB Statement No. 66	Complete	Adopt	40R	360-20
88-13	*(Not Used)*				
88-14	*Settlement of Fees with Extra Units to a General Partner in a Master Limited Partnership*	*No EITF Consensus*			*810-10*
88-15	*Classification of Subsidiary's Loan Payable in Consolidated Balance Sheet When Subsidiary's and Parent's Fiscal Years Differ*	*No EITF Consensus*			*470-10* *810-10*
88-16	*Basis in Leveraged Buyout Transactions*	*Nullified by FAS 141R* *Complete*	*N/A*	*IP 99*	

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GAAP Pronounce-ment	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
88-17	*Accounting for Fees and Costs Associated with Loan Syndications and Loan Participations*	*Partially nullified by FAS 125 & superseded by EITF 97-3* *Complete*	*Reject*	*37*	
88-18	Sales of Future Revenues	Complete	Adopt	18, 91R, 103	470-10
88-19	FSLIC-Assisted Acquisitions of Thrifts	Complete	N/A	IP 99	942-10
88-20	Difference between Initial Investment and Principal Amount of Loans in a Purchased Credit Card Portfolio	Complete	N/A	IP 99	310-10
88-21	Accounting for the Sale of Property Subject to the Seller's Preexisting Lease	Complete	Reject	22	840-40
88-22	Securitization of Credit Card and Other Receivable Portfolios	Complete	Adopt	18, 91R, 103	860-10 860-20
88-23	Lump-Sum Payments under Union Contracts	Complete	Reject	29	710-10
88-24	Effect of Various Forms of Financing under FASB Statement No. 66	Complete	Adopt	40R	360-20
88-25	Ongoing Accounting and Reporting for a Newly Created Liquidating Bank	Complete	N/A	IP 99	852-10 942-810
88-26	*Controlling Preferred Stock in a Pooling of Interests*	*Nullified by FAS 141* *Complete*	*Reject*	*68*	
88-27	*Effect of Unallocated Shares in an Employee Stock Ownership Plan on Accounting for Business Combinations*	*Nullified by FAS 141* *Complete*	*Reject*	*68*	
89-1	*Accounting by a Pension Plan for Bank Investment Contracts and Guaranteed Investment Contracts*	*Resolved by FAS 110 and SOP 94-4*			
89-2	*Maximum Maturity Guarantees on Transfers of Receivables with Recourse*	*Nullified by FAS 125 & partially nullified by FAS 140*			
89-3	Balance Sheet Presentation of Savings Accounts in Financial Statements of Credit Unions	Complete	N/A	IP 99	942-405
89-4	*Accounting for a Purchased Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate*	*Superseded by EITF 99-20* *Complete*	*Reject*	*43R*	

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GAAP Pronounce-ment	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
89-5	*Sale of Mortgage Loan Servicing Rights*	*Superseded by EITF 95-5*			
89-6	*(Not Used)*				
89-7	*Exchange of Assets or Interest in a Subsidiary for a Noncontrolling Equity Interest in a New Entity*	*Codified in EITF 01-2* *Complete*	*Reject*	*68*	
89-8	*Expense Recognition for Employee Stock Ownership Plans*	*Nullified by SOP 93-6*			
89-9	*Accounting for In-Substance Foreclosures*	*Nullified by FAS 114*			
89-10	*Sponsor's Recognition of Employee Stock Ownership Plan Debt*	*Superseded by SOP 93-6*			
89-11	Sponsor's Balance Sheet Classification of Capital Stock with a Put Option Held by an Employee Stock Ownership Plan	Complete	Reject	12	480-10
89-12	*Earnings-per-Share Issues Related to Convertible Preferred Stock Held by an Employee Stock Ownership Plan*	*Superseded by SOP 93-6*			
89-13	Accounting for the Cost of Asbestos Removal	Complete	Adopt	40R	410-20 410-30
89-14	Valuation of Repossessed Real Estate	Complete	Adopt	40R	310-40
89-15	*Accounting for a Modification of Debt Terms When the Debtor is Experiencing Financial Difficulties*	*Superseded by EITF 02-4* *Complete*	*Adopt/M*	*36*	
89-16	Consideration of Executory Costs in Sale-Leaseback Transactions	Complete	Adopt	22	840-40
89-17	*Accounting for the Retail Sale of an Extended Warranty Contract in Connection with the Sale of a Product*	*Nullified by FTB 90-1*			
89-18	*Divestitures of Certain Investment Securities to an Unregulated Commonly Controlled Entity under FIRREA*	*Nullified by FAS 115* *Complete*	*Reject*	*26*	
89-19	*Accounting for a Change in Goodwill Amortization for Business Combinations Initiated Prior to the Effective Date of FASB Statement No. 72*	*Nullified by FAS 141R* *Complete*	*N/A*	*IP 99*	
89-20	Accounting for Cross Border Tax Benefit Leases	Complete	N/A	IP 99	840-40
90-1	(Not Used)				

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GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
90-2	*Exchange of Interest-Only and Principal-Only Securities for a Mortgage-Backed Security*	*Nullified by FAS 125 and FAS 140* *Complete*	*Reject*	*43R*	
90-3	Accounting for Employers' Obligations for Future Contributions to a Multiemployer Pension Plan	Complete	Adopt	8, 89, 92, 102	715-80
90-4	Earnings-per-Share Treatment of Tax Benefits for Dividends on Stock Held by an Employee Stock Ownership Plan	Complete	N/A	IP 99	718-40
90-5	*Exchanges of Ownership Interests between Entities under Common Control*	*Nullified by FAS 141R and FAS 160* *Complete*	*Reject*	*68*	
90-6	*Accounting for Certain Events Not Addressed in Issue No. 87-11 Relating to an Acquired Operating Unit to Be Sold*	*Nullified by FAS 144* *Complete*	*Reject*	*68*	
90-7	*Accounting for a Reload Stock Option*	*Nullified by FAS 123(R) except for entities within the scope of paragraph 83 of FAS 123(R)* *Complete*	*Adopt* *Nullified*	*13* *104R*	
90-8	Capitalization of Costs to Treat Environmental Contamination	Complete	Adopt	40R	410-20 410-30
90-9	*Changes to Fixed Employee Stock Option Plans as a Result of Equity Restructuring*	*Nullified by FIN 44* *Complete*	*Adopt* *Nullified*	*13* *104R*	
90-10	*Accounting for a Business Combination Involving a Majority-Owned Investee of a Venture Capital Company*	*Resolved by FAS 141*			

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GAAP Pronounce-ment	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
90-11	*Accounting for Exit and Entrance Fees Incurred in a Conversion from the Savings Association Insurance Fund to the Bank Insurance Fund*	*No longer technically helpful*			
90-12	*Allocating Basis to Individual Assets and Liabilities for Transactions within the Scope of Issue No. 88-16*	*Nullified by FAS 141R* *Complete*	*Reject*	*68*	
90-13	*Accounting for Simultaneous Common Control Mergers*	*Nullified by FAS 141R and FAS 160* *Complete*	*Reject*	*68*	
90-14	Unsecured Guarantee by Parent of Subsidiary's Lease Payments in a Sale-Leaseback Transaction	Complete	Adopt	22	460-10 840-40
90-15	*Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions*	*Nullified by FIN 46 & FIN 46 (R)* *Complete*	*Reject*	*22*	*958-810* *958-840*
90-16	*Accounting for Discontinued Operations Subsequently Retained*	*Nullified by FAS 144* *Complete*	*N/A*	IP 99	
90-17	*Hedging Foreign Currency Risks with Purchased Options*	*Affirmed by FAS 133; therefore no longer necessary* *Complete*	*Reject*	*31*	
90-18	Effect of a "Removal of Accounts" Provision on the Accounting for a Credit Card Securitization	Complete	N/A	IP 99	Not Directly Included in Codification. Issue Subject to FAS 140 and FAS 156
90-19	*Convertible Bonds with Issuer Option to Settle for Cash upon Conversion*	*Nullified by FSP APB 14-1* *Complete*	*Adopt/M*	*15*	*Not Explicitly Included in Codification.*
90-20	Impact of an Uncollateralized Irrevocable Letter of Credit on a Real Estate Sale-Leaseback Transaction	Complete	Adopt	22	460-10 840-40

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GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
90-21	Balance Sheet Treatment of a Sale of Mortgage Servicing Rights with a Subservicing Agreement	Complete	Adopt	18, 91R, 103	460-10 860-10 860-50
90-22	Accounting for Gas-Balancing Arrangements	No EITF Consensus			932-10 932-815
91-1	*Hedging Intercompany Foreign Currency Risks*	*Nullified by FAS 133* *Complete*	 *Reject*	 *31*	
91-2	Debtor's Accounting for Forfeiture of Real Estate Subject to a Nonrecourse Mortgage	No EITF Consensus			
91-3	*Accounting for Income Tax Benefits from Bad Debts of a Savings and Loan Association*	*Resolved by FAS 109*			
91-4	*Hedging Foreign Currency Risks with Complex Options and Similar Transactions*	*Resolved by FAS 133* *Complete*	 *Reject*	 *31*	
91-5	Nonmonetary Exchange of Cost-Method Investments	Complete	Reject	68	325-20
91-6	Revenue Recognition of Long-Term Power Sales Contracts	Complete	N/A	IP 99	440-10 980-605
91-7	Accounting for Pension Benefits Paid by Employers after Insurance Companies Fail to Provide Annuity Benefits	Complete	Adopt	8, 89	715-30
91-8	Application of FASB Statement No. 96 to a State Tax Based on the Greater of a Franchise Tax or an Income Tax	Complete	Reject	10, 10R, 101	740-10
91-9	Revenue and Expense Recognition for Freight Services in Process	Complete	N/A	IP 99	605-20
91-10	Accounting for Special Assessments and Tax Increment Financing Entities (TIFEs)	Complete	N/A	IP 99	460-10 970-470
92-1	Allocation of Residual Value or First-Loss Guarantee to Minimum Lease Payments in Leases Involving Land and Building(s)	Complete	Reject	22	460-10 840-10
92-2	Measuring Loss Accruals by Transferors for Transfers of Receivables with Recourse	Complete	Reject	18, 91R, 103	Not Directly Included in Codification. Issue Subject to FAS 133, FAS 140, FAS 156 and FIN 45.
92-3	Earnings-per-Share Treatment of Tax Benefits for Dividends on Unallocated Stock Held by an Employee Stock Ownership Plan (Consideration of the Implications of FASB Statement No. 109 on Issue 2 of EITF Issue No. 90-4)	Complete	N/A	IP 99	Not Directly Included in Codification. Issue Subject to SOP 93-6

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GAAP Pronounce-ment	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
92-4	Accounting for a Change in Functional Currency When an Economy Ceases to Be Considered Highly Inflationary	Complete	Reject	23	830-10
92-5	Amortization Period for Net Deferred Credit Card Origination Costs	Complete	N/A	IP 99	310-20
92-6	*(Not Used)*				
92-7	Accounting by Rate-Regulated Utilities for the Effects of Certain Alternative Revenue Programs	Complete	N/A	IP 99	980-605
92-8	Accounting for the Income Tax Effects under FASB Statement No. 109 of a Change in Functional Currency When an Economy Ceases to Be Considered Highly Inflationary	Complete	Adopt	10, 10R, 101	830-740
92-9	Accounting for the Present Value of Future Profits Resulting from the Acquisition of a Life Insurance Company	Complete	Reject	68	944-20
92-10	*Loan Acquisitions Involving Table Funding Arrangements*	*Nullified by FAS 125*			
92-11	(Not Used)				
92-12	Accounting for OPEB Costs by Rate-Regulated Enterprises	Complete	N/A	IP 99	715-60 980-715
92-13	Accounting for Estimated Payments in Connection with the Coal Industry Retiree Health Benefit Act of 1992	Complete	N/A	IP 99	450-20 715-60 930-715
93-1	Accounting for Individual Credit Card Acquisitions	Complete	N/A	IP 99	310-20
93-2	*Effect of Acquisition of Employer Shares for/by an Employee Benefit Trust on Accounting for Business Combinations*	*Resolved by FAS 141*			
93-3	Plan Assets under FASB Statement No. 106	Complete	Adopt	14	710-10 715-60
93-4	*Accounting for Regulatory Assets*	*Nullified by FAS 121 & FAS 144*			*980-340* *980-715*
93-5	*Accounting for Environmental Liabilities*	*Nullified by SOP 96-1*			
93-6	Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises	Complete	Adopt/M	62R	944-20
93-7	*Uncertainties Related to Income Taxes in a Purchase Business Combination*	*Nullified by FAS 141R* *Complete*	 *Reject*	 *68*	
93-8	Accounting for the Sale and Leaseback of an Asset That is Leased to Another Party	Complete	Adopt	22	840-40

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GAAP Pronounce-ment	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
93-9	Application of FASB Statement No. 109 in Foreign Financial Statements Restated for General Price-Level Changes	Complete	N/A	IP 99	830-740
93-10	*Accounting for Dual Currency Bonds*	*Resolved by FAS 133*			
93-11	Accounting for Barter Transactions Involving Barter Credits	Complete	Adopt	28, 95	845-10
93-12	Recognition and Measurement of the Tax Benefit of Excess Tax Deductible Goodwill Resulting from a Retroactive Change in Tax Law	Complete	N/A	IP 99	Not Directly Included in Codification. Included in FAS 109
93-13	Effect of a Retroactive Change in Enacted Tax Rates That is Included in Income from Continuing Operations	Complete	Reject	10, 10R, 101	740-10
93-14	Accounting for Multiple-Year Retrospectively Rated Insurance Contracts by Insurance Enterprises and Other Enterprises	Complete	Reject	66	450-10 720-20 944-20
93-15	(Not Used)				
93-16	Application of FASB Statement No. 109 to Basis Differences within Foreign Subsidiaries That Meet the Indefinite Reversal Criterion of APB Opinion No. 23	Complete	Reject	10, 10R, 101	740-30 830-740
93-17	Recognition of Deferred Tax Assets for a Parent Company's Excess Tax Basis in the Stock of a Subsidiary That Is Accounted for as a Discontinued Operation	Complete	Adopt	10, 10R, 101	740-30
93-18	*Recognition of Impairment for an Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate*	*Superseded by EITF 99-20* *Complete*	*Reject*	*43R*	
94-1	Accounting for Tax Benefits Resulting from Investments in Affordable Housing Projects	Complete	Adopt/M	93	323-740 325-20
94-2	Treatment of Minority Interests in Certain Real Estate Investment	Complete	N/A	IP 99	Not Explicitly Included in Codification.
94-3	*Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*	*Nullified by FAS 146* *Complete*	*Reject*	*24*	
94-4	*Classification of an Investment in a Mortgage-Backed Interest-Only Certificate as Held-to-Maturity*	*Resolved by FAS 125 & FAS 140*			

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GAAP Pronounce-ment	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
94-5	*Determination of What Constitutes All Risks and Rewards and No Significant Unresolved Contingencies in a Sale of Mortgage Loan Servicing Rights under Issue 89-5*	*Superseded by EITF 95-5*			
94-6	*Accounting for the Buyout of Compensatory Stock Options*	*Nullified by FIN 44* *Complete*	*Adopt* *Nullified*	*13* *104R*	
94-7	*Accounting for Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock*	*Codified in EITF 96-13*			
94-8	Accounting for Conversion of a Loan into a Debt Security in a Debt Restructuring	Complete	Reject	36	310-40
94-9	*Determining a Normal Servicing Fee Rate for the Sale of an SBA Loan*	*Nullified by FAS 125*			
94-10	Accounting by a Company for the Income Tax Effects of Transactions among or with Its Shareholders under FASB Statement No. 109	Complete	Reject	10, 10R, 101	740-10 740-20
95-1	Revenue Recognition on Sales with a Guaranteed Minimum Resale Value	Complete	N/A	IP 99	460-10 605-50 840-10 840-30
95-2	*Determination of What Constitutes a Firm Commitment for Foreign Currency Transactions Not Involving a Third Party*	*Nullified by FAS 133* *Complete*	*Reject*	*23*	
95-3	*Recognition of Liabilities in Connection with a Purchase Business Combination*	*Nullified by FAS 141R* *Complete*	*Reject*	*68*	
95-4	Revenue Recognition on Equipment Sold and Subsequently Repurchased Subject to an Operating Lease	Complete	N/A	IP 99	605-15 840-10
95-5	Determination of What Risks and Rewards, If Any, Can Be Retained and Whether Any Unresolved Contingencies May Exist in a Sale of Mortgage Loan Servicing Rights	Complete	Adopt	18, 91R, 103	860-50
95-6	Accounting by a Real Estate Investment Trust for an Investment in a Service Corporation	Complete	N/A	IP 99	974-323 974-840
95-7	Implementation Issues Related to the Treatment of Minority Interests in Certain Real Estate Investment Trusts	Complete	N/A	IP 99	Not Explicitly Included in Codification.

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GAAP Pronounce-ment	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
95-8	*Accounting for Contingent Consideration Paid to the Shareholders of an Acquired Enterprise in a Purchase Business Combination*	*Nullified by FAS 141R* *Complete*	*Reject*	*68*	
95-9	Accounting for Tax Effects of Dividends in France in Accordance with FAS Statement No. 109	Complete	Reject	10, 10R, 101	740-10
95-10	Accounting for Tax Credits Related to Dividend Payments in Accordance with FASB Statement No. 109	Complete	Reject	10, 10R, 101	740-10
95-11	*Accounting for Derivative Instruments Containing Both a Written Option-Based Component and a Forward-Based Component*	*Resolved by FAS 133*			
95-12	*Pooling of Interests with a Common Interest in Joint Venture*	*Nullified by FAS 141* *Complete*	*Reject*	*68*	
95-13	Classification of Debt Issue Costs in the Statement of Cash Flows	Complete	Adopt	69	230-10
95-14	*Recognition of Liabilities in Anticipation of a Business Combination*	*Nullified by FAS 146* *Complete*	*Reject*	*68*	
95-15	*Recognition of Gain or Loss When a Binding Contract Requires a Debt Extinguishment to Occur at a Future Date for a Specified Amount*	*Superseded by EITF 96-19* *Complete*	*Adopt/M*	*15*	
95-16	*Accounting for Stock Compensation Arrangements with Employer Loan Features under APB Opinion No. 25*	*Nullified by FAS 123(R) except for entities within the scope of paragraph 83 of FAS 123(R)* *Complete*	*Adopt* *Nullified*	*13* *104R*	
95-17	Accounting for Modifications to an Operating Lease That Do Not Change the Lease Classification	Complete	Adopt	22	840-20

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GAAP Pronounce-ment	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
95-18	*Accounting and Reporting for a Discontinued Business Segment When the Measurement Date Occurs after the Balance Sheet Date but before the Issuance of Financial Statements.*	*Nullified by FAS 144* *Complete*	*Reject*	*24*	
95-19	*Determination of the Measurement Date for the Market Price of Securities Issued in a Purchase Business Combination*	*Codified in EITF 99-12* *Complete*	*Adopt*	*68*	
95-20	Measurement in the Consolidated Financial Statements of a Parent of the Tax Effects Related to the Operations of a Foreign Subsidiary That Receives Tax Credits Related to Dividend Payments	Complete	Reject	10, 10R, 101	740-10
95-21	*Accounting for Assets to Be Disposed Of Acquired in a Purchase Business Combination*	*Resolved by FAS 144*			
95-22	Balance Sheet Classification of Borrowings Outstanding under Revolving Credit Agreements That Include both a Subjective Acceleration Clause and a Lock-Box Arrangement	Complete	N/A	IP 99	470-10
95-23	The Treatment of Certain Site Restoration/ Environmental Exit Costs When Testing a Long-Lived Asset for Impairment	Complete	Adopt	40R	360-10 360-20
96-1	*Sale of Put Options on Issuer's Stock That Require or Permit Cash Settlement*	*Codified in EITF 96-13*			
96-2	*Impairment Recognition When a Nonmonetary Asset Is Exchanged or Is Distributed to Owners and Is Accounted for at the Asset's Recorded Amount*	*Codified in EITF 01-2*			
96-3	*Accounting for Equity Instruments That Are Issued for Consideration Other Than Employee Services under FASB Statement No. 123*	*Superseded by EITF 96-18* *Complete*	*Reject*	*13*	
96-4	*Accounting for Reorganizations Involving a Non-Pro Rata Split-off of Certain Nonmonetary Assets to Owners*	*Codified in EITF 01-2* *Complete*	*Reject*	*28, 95*	
96-5	Recognition of Liabilities for Contractual Termination Benefits or Changing Benefit Plan Assumptions in Anticipation of a Business Combination	Complete	Adopt	8, 89, 92, 102	420-10 450-10 710-10 712-10 715-60 718-10 805-20

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PRE-CODIFICATION STANDARDS - CATEGORY C GAAP
CONSENSUS OPINIONS OF THE EMERGING ISSUES TASK FORCE

GAAP Pronounce-ment	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
96-6	Accounting for the Film and Software Costs Associated with Developing Entertainment and Educational Software Products	No EITF Consensus			985-705
96-7	*Accounting for Deferred Taxes on In-Process Research and Development Activities Acquired in a Purchase Business Combination*	*Nullified by FAS 141R* *Complete*	*N/A*	*IP 99*	
96-8	*Accounting for a Business Combination When the Issuing Company Has Targeted Stock*	*Nullified by FAS 141* *Complete*	*Reject*	*68*	
96-9	*Classification of Inventory Markdowns and Other Costs Associated with a Restructuring*	*Removed from EITF Agenda*			*330-10* *420-10*
96-10	Impact of Certain Transactions on the Held-to-Maturity Classification under FASB Statement No. 115	Complete	Reject	26	320-10
96-11	Accounting for Forward Contracts and Purchased Options to Acquire Securities Covered by FASB Statement No. 115	Complete	Reject	31	320-10 815-10
96-12	Recognition of Interest Income and Balance Sheet Classification of Structured Notes	Complete	Reject	43R	320-10 835-10
96-13	*Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock*	*Codified in EITF 00-19*			
96-14	*Accounting for the Costs Associated with Modifying Computer Software for the Year 2000*	*No longer technically helpful* *Complete*	*Adopt*	*17*	
96-15	Accounting for the Effects of Changes in Foreign Currency Exchange Rates on Foreign-Currency-Denominated Available-for-Sale Debt Securities	Complete	Reject	23	320-10 830-20
96-16	Investor's Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights	Complete	Reject	IP 99	810-10
96-17	Revenue Recognition under Long-Term Power Sales Contracts That Contain both Fixed and Variable Pricing Terms	Complete	N/A	IP 99	980-350 980-605
96-18	Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services	Complete	Adopted/M	104R	440-10 505-50

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CONSENSUS OPINIONS OF THE EMERGING ISSUES TASK FORCE

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
96-19	Debtor's Accounting for a Modification or Exchange of Debt Instruments	Complete Amended by EITF Issue No. 06-6	Adopt	18, 91R, 103 103	470-50
96-20	*Impact of FASB Statement No. 125 on Consolidation of Special-Purpose Entities*	*Nullified by FAS 140* *Complete*	*Reject*	*103*	
96-21	Implementation Issues in Accounting for Leasing Transactions involving Special-Purpose Entities	Complete	Reject	22	460-10 840-10 840-20 840-40 958-810 958-840
96-22	Applicability of the Disclosures Required by FASB Statement No. 114 When a Loan Is Restructured in a Troubled Debt Restructuring into Two (or More) Loans	Complete	Adopt	36	310-40
96-23	*The Effects of Financial Instruments Indexed to, and Settled in, a Company's Own Stock on Pooling-of-Interests Accounting for a Subsequent Business Combination*	*Resolved by FAS 141*			
97-1	Implementation Issues in Accounting for Lease Transactions, including Those involving Special-Purpose Entities	Complete	N/A	IP 99	450-20 460-10 840-10 840-40 958-840
97-2	Application of FASB Statement No. 94 and APB Opinion No. 16 to Physician Practice Management Entities and Certain Other Entities with Contractual Management Arrangements	Complete	N/A	IP 99	718-10 810-10 954-810
97-3	Accounting for Fees and Costs Associated with Loan Syndications and Loan Participations after the Issuance of FASB Statement No. 125	Complete	Reject	IP 99	310-20 860-10
97-4	Deregulation of the Pricing of Electricity---Issues Related to the Application of FASB Statements No. 71 and 101	Complete	N/A	IP 99	980-20

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GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
97-5	*Accounting for the Delayed Receipt of Option Shares upon Exercise under APB Opinion No. 25*	*Nullified by FAS 123(R) except for entities within the scope of paragraph 83 of FAS 123(R)* *Complete*	*N/A*	*104R*	
97-6	*Application of Issue No. 96-20 to Qualifying Special-Purpose Entities Receiving Transferred Financial Assets Prior to the Effective Date of FASB Statement No. 125*	*Nullified by FAS 140* *Complete*	*N/A*	IP 99	
97-7	Accounting for Hedges of the Foreign Currency Risk Inherent in an Available-for-Sale Marketable Equity Security	Complete	N/A	IP 99	Not Directly Included in Codification. Issue Subject to FAS 130 and 133
97-8	*Accounting for Contingent Consideration Issued in a Purchase Business Combination*	*Nullified by FAS 141R* *Complete*	*Adopt*	*68*	
97-9	*Effect on Pooling-of-Interests Accounting of Certain Contingently Exercisable Options or Other Equity Instruments*	*Nullified by FAS 141* *Complete*	*N/A*	IP 99	
97-10	The Effect of Lessee Involvement in Asset Construction	Complete	Reject	IP 99	460-10 840-40
97-11	Accounting for Internal Costs Relating to Real Estate Property Acquisitions	Complete	Adopt	40R	970-340 970-720
97-12	*Accounting for Increased Share Authorizations in an IRS Section 423 Employee Stock Purchase Plan under APB Opinion No. 25*	*Nullified by FAS 123(R) except for entities within the scope of paragraph 83 of FAS 123(R)* *Complete*	*Adopt* *Nullified*	*INT 99-17* *104R*	

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GAAP Pronounce-ment	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
97-13	Accounting for Costs Incurred in Connection with a Consulting Contract or an Internal Project That Combines Business Process Reengineering and Information Technology Transformation	Complete	Adopt	17	720-45
97-14	Accounting for Deferred Compensation Arrangements Where Amounts Earned Are Held in a Rabbi Trust and Invested	Complete	Adopt/M	104R	260-10 710-10 810-10
97-15	*Accounting for Contingency Arrangements Based on Security Prices in a Purchase Business Combination*	*Nullified by FAS 141R* *Complete*	*N/A*	*IP 99*	
98-1	*Valuation of Debt Assumed in a Purchase Business Combination*	*Nullified by FAS 141R* *Complete*	*N/A*	*IP 99*	
98-2	Accounting by a Subsidiary or Joint Venture for an Investment in the Stock of Its Parent Company or Joint Venture Partner	Complete	Reject	97	Not Directly Included in Codification. Issue Subject to FIN 46R
98-3	*Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business*	*Nullified by FAS 141R* *Complete*	*Adopt/M*	*INT 00-26*	
98-4	*Accounting by a Joint Venture for Businesses Received at Its Formation*	*No EITF Consensus*			*805-10* *845-10*
98-5	Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios	Complete	Reject	15	470-20 505-10
98-6	*Investor's Accounting for an Investment in a Limited Partnership When the Investor Is the Sole General Partner and the Limited Partners Have Certain Approval or Veto Rights*	*Removed from EITF Agenda*			
98-7	*Accounting for Exchanges of Similar Equity Method Investments*	*Codified in EITF 01-2* *Complete*	*Adopt*	*Nullifed by SSAP No. 95*	
98-8	Accounting for Transfers of Investments That Are in Substance Real Estate	Complete	Adopt	40R, 77, 103	360-20
98-9	Accounting for Contingent Rent	Complete	Adopt/M	22	450-20 450-30 840-10

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GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
98-10	*Accounting for Contracts Involved in Energy Trading and Risk Management Activities*	*Superseded by EITF 02-3* *Complete*	*Adopt/M*	*86*	
98-11	Accounting for Acquired Temporary Differences in Certain Purchase Transactions That Are Not Accounted for as Business Combinations	Pending			740-10
98-12	Application of Issue No. 00-19 to Forward Equity Sales Transactions	*Nullified by FAS 150* *Complete*	*Adopt/M*	*86*	
98-13	Accounting by an Equity Method Investor for Investee Losses When the Investor Has Loans to and Investments in Other Securities of the Investee	Complete	Adopt/M	INT 00-24	320-10 323-10
98-14	Debtor's Accounting for Changes in Line-of-Credit or Revolving-Debt Arrangements	Complete	Reject	15	470-50
98-15	Structured Notes Acquired for a Specified Investment Strategy	Complete	Reject	43R	320-10
99-1	*Accounting for Debt Convertible into the Stock of a Consolidated Subsidiary*	*Superseded by EITF 08-8* *Complete*	*Adopt/M*	*86*	*Not Explicitly Included in Codification.*
99-2	Accounting for Weather Derivatives	Complete	Adopt/M	86	460-10 815-45
99-3	*Application of Issue No. 96-13 to Derivative Instruments with Multiple Settlement Alternatives*	*Codified in EITF 00-19* *Complete*	*Adopt/M*	*86*	
99-4	Accounting for Stock Received from the Demutualization of a Mutual Insurance Company	Complete	Adopt	72	325-30
99-5	Accounting for Pre-Production Costs Related to Long-Term Supply Arrangements	Complete	N/A	IP 99	340-10 460-10 730-10
99-6	*Impact of Acceleration Provisions in Grants Made between Initiation and Consummation of a Pooling-of-Interests Business Combination*	*Nullified by FAS 141* *Complete*	*N/A*	IP 99	
99-7	Accounting for an Accelerated Share Repurchase Program	Complete	N/A	IP 99	260-10 505-30
99-8	Accounting for Transfers of Assets that are Derivative Instruments but that are not Financial Assets	Complete	Adopt/M	86	815-10 860-10

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GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
99-9	Effect of Derivative Gains and Losses on the Capitalization of Interest	Complete	Adopt/M	86	815-25 815-30
99-10	Percentage used to Determine the Amount of Equity Method Losses	Complete	Adopt	INT 00-24	323-10
99-11	*Subsequent Events Caused by Year 2000*	*No longer technically helpful* *Complete*	*N/A*	IP 99	
99-12	*Determination of the Measurement Date for the Market Price of Acquirer Securities Issued in a Purchase Business Combination*	*Nullified by FAS 141R* *Complete*	*Adopt/M*	*INT 00-28*	
99-13	Application of Issue No. 97-10 and FASB Interpretation No. 23 to Entities that Enter into Leases with Governmental Entities	Complete	N/A	IP 99	840-40
99-14	*Recognition by a Purchaser of Losses on Firmly Committed Executory Contracts*	*No EITF Consensus*			
99-15	*Accounting for Decreases in Deferred Tax Asset Valuation Allowances Established in a Purchase Business Combination As a Result of a Change in Tax Regulations*	*Nullified by FAS 141R* *Complete*	*N/A*	*IP 99*	
99-16	Accounting for Transactions with Elements of Research and Development Arrangements	Complete	N/A	IP 99	810-30
99-17	Accounting for Advertising Barter Transactions	Complete	Adopt/M	95	605-20
99-18	*Effect on Pooling-of-Interests Accounting of Contracts Indexed to a Company's Own Stock*	*Resolved by FAS 141* *Complete*	*N/A*	*IP 99*	
99-19	Reporting Revenue Gross as a Principal versus Net as an Agent	Complete	N/A	IP 99	605-45
99-20	Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to be Held by the Transferor in Securitized Financial Assets	Complete	Adopt	43R	310-20 310-30 320-10 325-40 835-10
00-1	Investor Balance Sheet and Income Statement Display under the Equity Method for Investments in Certain Partnerships and Other Ventures	Complete	Reject	48	323-30 810-10 910-810 930-810 932-810
00-2	Accounting for Web Site Development Costs	Complete	Adopt	16R 82	350-10 350-50
00-3	Application of AICPA Statement of Position 97-2 to Arrangements That Include the Right to Use Software Stored on Another Entity's Hardware	Complete	Adopt/M	16R 81	985-20 985-605

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GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
00-4	*Majority Owner's Accounting for a Transaction in the Shares of a Consolidated Subsidiary and a Derivative Indexed to the Minority Interest in That Subsidiary*	*Nullified by FAS 150* *Complete*	*N/A*	*IP 99*	*460-10* *480-10*
00-5	*Determining Whether a Nonmonetary Transaction is an Exchange of Similar Productive Assets*	*Codified in EITF 01-2*			
00-6	*Accounting for Freestanding Derivative Financial Instruments Indexed to, and Potentially Settled in, the Stock of a Consolidated Subsidiary*	*Superseded by EITF 08-8* *Complete* *Partially Nullified by FAS 150*	*N/A*	*IP 99*	*815-10*
00-7	*Application of Issue No. 96-13 to Equity Derivative Instruments That Contain Certain Provisions That Require Net Cash Settlement If Certain Events outside the Control of the Issuer Occur*	*Codified in EITF 00-19* *Complete*	*Adopt/M*	*86*	
00-8	Accounting by a Grantee for an Equity Instrument to Be Received in Conjunction with Providing Goods or Services	Complete	Adopt/M	104R	505-50 845-10
00-9	Classification of a Gain or Loss from a Hedge of Debt That Is Extinguished	Complete	Adopt/M	86	815-30
00-10	Accounting for Shipping and Handling Fees and Costs	Complete	N/A	IP 99	605-45
00-11	Lessors' Evaluation of Whether Leases of Certain Integral Equipment Meet the Ownership Transfer Requirements of FASB Statement No. 13	Complete	Adopt/M	22	840-10
00-12	Accounting by an Investor for Stock-Based Compensation Granted to Employees of an Equity Method Investee	Pending			323-10 505-10 718-10
00-13	Determining Whether Equipment Is "Integral Equipment" Subject to FASB Statements No. 66 and No. 98	Complete	Adopt	40R, 77	360-20 978-10
00-14	*Accounting for Certain Sales Incentives*	*Codified in EITF 01-9* *Complete*	*N/A*	*IP 99*	

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GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
00-15	*Classification in the Statement of Cash Flows of the Income Tax Benefit Received by a Company upon Exercise of a Nonqualified Employee Stock Option*	*Nullified by FAS 123R except for entities within the scope of paragraph 83 of FAS 123(R)* *Complete*	*N/A*	*IP 99*	
00-16	Recognition and Measurement of Employer Payroll Taxes on Employee Stock-Based Compensation	Complete	Adopt/M	104R	718-10
00-17	*Measuring the Fair Value of Energy-Related Contracts in Applying Issue No. 98-10*	*Superseded by EITF 02-3* *Complete*	*N/A*	*IP 99*	
00-18	Accounting Recognition for Certain Transactions involving Equity Instruments Granted to Other Than Employees	Complete	Adopt/M	104R	505-50
00-19	Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock	Complete *Partially Nullified by FAS 150*	N/A	IP 99	480-10 505-10 815-10 815-15 815-40
00-20	*Accounting for Costs Incurred to Acquire or Originate Information for Database Content and Other Collections of Information*	*No longer technically helpful*			
00-21	*Revenue Arrangements with Multiple Deliverables*	*Complete* *Nullified by ASU 2009-13*	*Adopt/M* *ASU 2009-13 deemed not applicable, nullifying INT 04-18.*		*605-25*
00-22	*Accounting for "Points" and Certain Other Time-Based or Volume-Based Sales Incentive Offers, and Offers for Free Products or Services to Be Delivered in the Future*	*Codified in EITF 01-9* *Complete*	*N/A*	*IP 99*	

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GAAP Pronounce-ment	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
00-23	*Issues Related to the Accounting for Stock Compensation under APB Opinion No. 25 and FASB Interpretation No. 44*	*Nullified by FAS 123(R) except for entities within the scope of paragraph 83 of FAS 123(R)* *Complete*	*N/A*	*104R*	
00-24	*Revenue Recognition: Sales Arrangements That Include Specified-Price Trade-in Rights*	*No EITF Consensus*			
00-25	*Vendor Income Statement Characterization of Consideration Paid to a Reseller of the Vendor's Products*	*Codified in EITF 01-9*			
00-26	*Recognition by a Seller of Losses on Firmly Committed Executory Contracts*	*No EITF Consensus*			
00-27	Application of Issue No. 98-5 to Certain Convertible Instruments	Pending *Partially Nullified by FAS 150*			260-10 470-20 505-10
01-1	Accounting for a Convertible Instrument Granted or Issued to a Nonemployee for Goods or Services or a Combination of Goods or Services and Cash	Complete	Adopt/M	6	470-20
01-2	Interpretations of APB Opinion No. 29	*Partially Nullified by FAS 153* Complete	Adopt/M	INT 06-13	810-10 845-10
01-3	*Accounting in a Business Combination for Deferred Revenue of an Acquiree*	*Nullified by FAS 141R* *Complete*	*N/A*	*IP 99*	
01-4	*Accounting for Sales of Fractional Interests in Equipment*	*No EITF Consensus*			
01-5	Application of FASB Statement No. 52 to an Investment Being Evaluated for Impairment That Will Be Disposed Of	Complete	Reject	IP 99	830-30
01-6	The Meaning of "Indexed to a Company's Own Stock"	Complete	N/A	IP 99	Not Explicitly Included in Codification.
01-7	Creditor's Accounting for a Modification or Exchange of Debt Instruments	Complete	Adopt	103	310-20

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GAAP Pronounce-ment	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
01-8	Determining Whether an Arrangement Contains a Lease	Complete	Adopt/M	22	440-10 815-10 840-10 840-20 840-30
01-9	Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)	Complete	N/A	IP 99	330-10 605-50 908-360
01-10	*Accounting for the Impact of the Terrorist Attacks of September 11, 2001*	*Complete*	*Nullifed as no longer relevant, including INT 01-32.*		*Not included in codification. No longer applicable or relevant.*
01-11	*Application of Issue No. 00-19 to a Contemporaneous Forward Purchase Contract and Written Put Option*	*Resolved by FAS 150*			
01-12	The Impact of the Requirements of FASB Statement No. 133 on Residual Value Guarantees in Connection with a Lease	Complete	N/A	IP 99	460-10 815-10 840-10
01-13	Income Statement Display of Business Interruption Insurance Recoveries	Complete	Adopt	24	225-30 450-30
01-14	Income Statement Characterization of Reimbursements Received for "Out-of-Pocket" Expenses Incurred	Complete	N/A	IP 99	605-45
02-1	*(Not Used)*				
02-2	*When Separate Contracts That Meet the Definition of Financial Instruments Should Be Combined for Accounting Purposes*	*No EITF Consensus* *Partially resolved by FAS 150*			
02-3	Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities	Complete *Modified by FAS 157*	Reject	IP 99	815-10 932-330 940-325
02-4	Determining Whether a Debtor's Modification or Exchange of Debt Instruments in within the Scope of FASB Statement No. 15	Complete	Adopt	36	470-60
02-5	*Definition of "Common Control" in Relation to FASB Statement No. 141*	*No EITF Consensus*			
02-6	Classification in the Statement of Cash Flows of Payments Made to Settle an Asset Retirement Obligation within the Scope of FASB Statement No. 143	Complete	N/A	IP 99	230-10 410-20
02-7	Unit of Accounting for Testing Impairment of Indefinite-Lived Intangible Assets	Complete	Reject	IP 99	350-30

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GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
02-8	Accounting for Options Granted to Employees in Unrestricted, Publicly Traded Shares of an Unrelated Entity	Complete	N/A	IP 99	815-10
02-9	Accounting for Changes That Result in a Transferor Regaining Control of Financial Assets Sold	Complete	Adopt/M	INT 04-21	860-20 860-50
02-10	*Determining Whether a Debtor Is Legally Released as Primary Obligor When the Debtor Becomes Secondarily Liable under the Original Obligation*	*No longer technically helpful*			
02-11	Accounting for Reverse Spinoffs	Complete	Adopt	INT 08-05	505-60
02-12	*Permitted Activities of a Qualifying Special-Purpose Entity in Issuing Beneficial Interests under FASB Statement No. 140*	*Nullified by FAS 166*			
02-13	Deferred Income Tax Considerations in Applying the Goodwill Impairment Test in FASB Statement No. 142	Complete	Reject	IP 99	350-20
02-14	Whether the Equity Method of Accounting Applies When an Investor Does Not Have an Investment in Voting Stock of an Investee but Exercises Significant Influence through Other Means (The name of EITF 02-14 has been changed to – "Whether an Investor Should Apply the Equity Method of Accounting to Investments Other Than Common Stock".)	Complete	Reject	IP 99	323-10
02-15	Determining Whether Certain Conversions of Convertible Debt to Equity Securities Are within the Scope of FASB Statement No. 84	Complete	Adopt	15	470-20
02-16	Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor	Complete	N/A	IP 99	605-50 705-20
02-17	*Recognition of Customer Relationship Intangible Assets Acquired in a Business Combination*	*Nullified by FAS 141R* *Complete*	*Reject*	*IP 99*	
02-18	Accounting for Subsequent Investments in an Investee after Suspension of Equity Method Loss Recognition	Complete	Adopt/M	48, 97	323-10
03-1	*The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*	*Nullified by FSP FAS 115–1/ FAS124–1*			
03-2	Accounting for the Transfer to the Japanese Government of the Substitutional Portion of Employee Pension Fund Liabilities	Complete	N/A	IP 99	715-20 715-30

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GAAP Pronounce-ment	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
03-3	*Applicability of Topic No. D–79 to Claims-Made Insurance Policies*	*Codified in EITF 03-8*			
03-4	Determining the Classification and Benefit Attribution Method for a "Cash Balance" Pension Plan	Complete	Adopt/M	102	715-30
03-5	Applicability of AICPA Statement of Position 97-2 to Non-Software Deliverables in an Arrangement Containing More-Than-Incidental Software	Complete	Adopt	16R	985-605
03-6	Participating Securities and the Two-Class Method under FASB Statement No. 128	Complete	Reject	IP 99	260-10
03-7	*Accounting for the Settlement of the Equity-Settled Portion of a Convertible Debt Instrument That Permits or Requires the Conversion Spread to Be Settled in Stock (Instrument C of Issue No. 90-19)*	*Nullified by FSP APB 14-1* *Complete*	*Adopt*	*15*	*Not Explicitly Included in Codification.*
03-8	Accounting for Claims-Made Insurance and Retroactive Insurance Contracts by the Insured Entity	Pending			450-30 720-20 954-720
03-9	*Determination of the Useful Life of Renewable Intangible Assets Under FASB Statement No. 142*	*Removed from EITF agenda*			
03-10	Application of Issue No. 02-16 by Resellers to Sales Incentives Offered to Consumers by Manufacturers	Complete	N/A	IP 99	605-50 705-20
03-11	Reporting Realized Gains and Losses on Derivative Instruments That Are Subject to FASB Statement No. 133 and Not "Held for Trading Purposes" as Defined in Issue No. 02-3	Complete	Reject	IP 99	815-10
03-12	Impact of FASB Interpretation No. 45 on Issue No. 95-1	Complete	N/A	IP 99	460-10
03-13	Applying the Conditions in Paragraph 42 of FASB Statement No. 144 in Determining Whether to Report Discontinued Operations	Complete	N/A	IP 99	205-20
03-14	*Participants' Accounting for Emissions Allowances under a "Cap and Trade" Program*	*Removed from EITF agenda*			
03-15	*Interpretation of Constraining Conditions of a Transferee in a Collateralized Bond Obligation Structure*	*No EITF Consensus*			
03-16	Accounting for Investments in Limited Liability Companies	Complete	Reject	IP 99	272-10 323-30
03-17	*Subsequent Accounting for Executory Contracts That Have Been Recognized on an Entity's Balance Sheet*	*No EITF Consensus*			

STATUTORY ACCOUNTING PRINCIPLES
GAAP CROSS-REFERENCE TO STATUTORY ACCOUNTING PRINCIPLES

PRE-CODIFICATION STANDARDS - CATEGORY C GAAP
CONSENSUS OPINIONS OF THE EMERGING ISSUES TASK FORCE

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
04-1	*Accounting for Preexisting Relationships between the Parties to a Business Combination*	*Nullified by FAS 141R* *Complete*	*N/A*	*IP 99*	
04-2	*Whether Mineral Rights Are Tangible or Intangible Assets*	*Nullified by FAS 141R* *Complete*	*N/A*	*IP 99*	
04-3	Mining Assets: Impairment and Business Combinations	Complete	N/A	IP 99	930-360 930-805
04-4	*Allocation of Goodwill to Reporting Units for a Mining Enterprise*	*Removed from the EITF Agenda* *Complete*	*N/A*	*IP 99*	
04-5	Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights	Complete	N/A	IP 99	810-20
04-6	Accounting for Stripping Costs Incurred during Production in the Mining Industry	Complete	N/A	IP 99	930-10 930-330
04-7	*Determining Whether an Interest Is a Variable Interest in a Potential Variable Interest Entity*	*Removed From Agenda – Issue Addressed in FSP FIN 46R-6* *Complete*	*N/A*	*IP 99*	
04-8	The Effect of Contingently Convertible Instruments on Diluted Earnings per Share	Complete	N/A	IP 99	260-10
04-9	*Accounting for Suspended Well Costs*	*Resolved by FSP FAS 19-1*			
04-10	Determining Whether to Aggregate Operating Segments That Do Not Meet the Quantitative Thresholds	Complete	N/A	IP 99	280-10
04-11	*Accounting in a Business Combination for Deferred Postcontract Customer Support Revenue of a Software Vendor*	*No longer technically helpful*			
04-12	*Determining Whether Equity-Based Compensation Awards Are Participating Securities*	*Removed from EITF agenda*			
04-13	Accounting for Purchases and Sales of Inventory with the Same Counterparty	Complete	N/A	IP 99	845-10

STATUTORY ACCOUNTING PRINCIPLES
GAAP CROSS-REFERENCE TO STATUTORY ACCOUNTING PRINCIPLES

PRE-CODIFICATION STANDARDS - CATEGORY C GAAP
CONSENSUS OPINIONS OF THE EMERGING ISSUES TASK FORCE

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
05-1	Accounting for the Conversion of an Instrument That Became Convertible upon the Issuer's Exercise of a Call Option	Pending			470-20
05-2	The Meaning of "Conventional Convertible Debt Instrument" in Issue No. 00-19	Pending			815-40
05-3	*Accounting for Rental Costs Incurred during the Construction Period*	*Removed from EITF agenda*			
05-4	*The Effect of a Liquidated Damages Clause on a Freestanding Financial Instrument Subject to Issue No. 00-19*	*Removed from EITF agenda*			
05-5	Accounting for Early Retirement or Postemployment Programs with Specific Features (Such As Terms Specified in Altersteilzeit Early Retirement Arrangements)	Complete	N/A	IP 99	715-30
05-6	Determining the Amortization Period for Leasehold Improvements Purchased after Lease Inception or Acquired in a Business Combination	Complete	N/A INT 06-10 nullified.	IP 99	805-20 840-10
05-7	*Accounting for Modifications to Conversion Options Embedded in Debt Instruments and Related Issues*	*Superseded by EITF Issue No. 06-6*			
05-8	Income Tax Consequences of Issuing Convertible Debt with a Beneficial Conversion Feature	Complete	N/A	IP 99	740-10
06-1	Accounting for Consideration Given by a Service Provider to a Manufacturer or Reseller of Equipment Necessary for an End-Customer to Receive Service from the Service Provider	Complete	N/A	IP 99	605-50
06-2	Accounting for Sabbatical Leave and Other Similar Benefits Pursuant to FASB Statement No. 43	Complete	Adopt	11	710-10
06-3	How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation)	Complete	Adopt/M	35R	605-45
06-4	Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements	Complete	Adopt	92	715-60
06-5	Accounting for Purchases of Life Insurance—Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4	Complete	Adopt/M	21	325-30
06-6	Debtor's Accounting for a Modification (or Exchange) of Convertible Debt Instruments	Pending			470-50

STATUTORY ACCOUNTING PRINCIPLES
GAAP CROSS-REFERENCE TO STATUTORY ACCOUNTING PRINCIPLES

PRE-CODIFICATION STANDARDS - CATEGORY C GAAP
CONSENSUS OPINIONS OF THE EMERGING ISSUES TASK FORCE

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
06-7	Issuer's Accounting for a Previously Bifurcated Conversion Option in a Convertible Debt Instrument When the Conversion Option No Longer Meets the Bifurcation Criteria in FASB Statement No. 133	Complete	N/A	IP 99	470-20 815-15
06-8	Applicability of the Assessment of a Buyer's Continuing Investment under FASB Statement No. 66 for Sales of Condominiums	Complete	Adopt/M	40R	360-20
06-9	Reporting a Change in (or the Elimination of) a Previously Existing Difference between the Fiscal Year-End of a Parent Company and That of a Consolidated Entity or between the Reporting Period of an Investor and That of an Equity Method Investee	Complete	Adopt/M	48, 97	810-10
06-10	Accounting for Deferred Compensation and Postretirement Benefit Aspects of Collateral Assignment Split-Dollar Life Insurance Arrangements	Complete	N/A	IP 99	715-60
06-11	Accounting for Income Tax Benefits of Dividends on Share-Based Payment Awards	Pending			718-740
06-12	*Accounting for Physical Commodity Inventories for Entities within the Scope of the AICPA Audit and Accounting Guide, Brokers and Dealers in Securities*	*No EITF Consensus*			
07-1	Accounting for Collaborative Arrangements	Complete	N/A	IP 99	808-10
07-2	*Accounting for Convertible Debt Instruments That Are Not Subject to the Guidance in Paragraph 12 of APB Opinion No. 14*	*Removed from Agenda*			
07-3	Accounting for Nonrefundable Advance Payments for Goods or Services to Be Used in Future Research and Development Activities	Complete	N/A	17, 29	730-10 730-20
07-4	Application of the Two-Class Method under FASB Statement No. 128 to Master Limited Partnerships	Complete	N/A	IP 99	260-10
07-5	Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity's Own Stock	Complete	N/A	IP 99	718-10 815-40
07-6	Accounting for the Sale of Real Estate Subject to the Requirements of FASB Statement No. 66, When the Agreement Includes a Buy-Sell Clause	Complete	Adopt	40R	360-20
08-1	*Revenue Recognition for a Single Unit of Accounting* (The name of EITF 08-1 has be changed to "Revenue Arrangements with Multiple Deliverables.")	*Reflected in ASU 2009-13*			*Not Explicitly Included in Codification.*

STATUTORY ACCOUNTING PRINCIPLES
GAAP CROSS-REFERENCE TO STATUTORY ACCOUNTING PRINCIPLES

PRE-CODIFICATION STANDARDS - CATEGORY C GAAP
CONSENSUS OPINIONS OF THE EMERGING ISSUES TASK FORCE

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
08-2	*Lessor Revenue Recognition for Maintenance Services*	*Removed from Agenda*			
08-3	Accounting by Lessees for Maintenance Deposits	Complete	Adopt/M	19, 22	840-10
08-4	Transition Guidance for Conforming Changes to Issue No. 98-5	Pending			Not Explicitly Included in Codification.
08-5	Issuer's Accounting for Liabilities Measured at Fair Value with a Third-Party Credit Enhancement	Pending			820-10 825-10
08-6	Equity Method Investment Accounting Considerations	Pending			323-10
08-7	Accounting for Defensive Intangible Assets	Complete	Adopt/M	20	350-30
08-8	Accounting for an Instrument (or an Embedded Feature) with a Settlement Amount That Is Based on the Stock of an Entity's Consolidated Subsidiary	Complete	N/A	IP 99	810-10 815-10 815-40
08-9	*Milestone Method of Revenue Recognition*	*Reflected in ASU 2010-17*			*Not Explicitly Included in Codification.*
08-10	*Selected Statement 160 Implementation Questions*	*No EITF Consensus*			
09-1	*Accounting for Own-Share Lending Arrangements in Contemplation of Convertible Debt Issuance*	*Reflected in ASU 2009-15*			*Not Explicitly Included in Codification.*
09-2	*Research and Development Assets Acquired in an Asset Acquisition*	*Removed from Agenda*			
09-3	*Applicability of AICPA Statement of Position 97-2 to Certain Arrangements That Include Software Elements*	*Reflected in ASU 2009-14*			*Not Explicitly Included in Codification.*
09-4	*Seller Accounting for Contingent Consideration*	*No EITF Consensus*			

Note: “EITF Abstracts, Appendix D - Other Technical Matters” have been included in the FASB Codification, but have not previously been reviewed for statutory accounting. As such, these items have not been included in this Appendix D. Before the FASB Codification, these items were not considered to be in the top three levels of the FASB hierarchy and, thus, not reviewed as part of the statutory maintenance process.

STATUTORY ACCOUNTING PRINCIPLES
GAAP CROSS-REFERENCE TO STATUTORY ACCOUNTING PRINCIPLES

PRE-CODIFICATION STANDARDS - CATEGORY C GAAP
AICPA PRACTICE BULLETINS

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
PB 1	Purpose and Scope of AcSEC Practice Bulletins and Procedures for Their Issuance	Complete			
	Exhibit A	Complete	Adopt	19	310-10
	Exhibit B	Complete	N/A		360-10
	Exhibit C	Complete	N/A		
	Exhibit D	Complete	N/A		
	Exhibit E	Complete	N/A		
	Exhibit F	Complete	N/A		
	Exhibit G	Complete	N/A		
	Exhibit H	Complete	N/A		
	Exhibit I	Complete	Adopt	38	
PB 2	Elimination of Profits Resulting From Intercompany Transfers of LIFO Inventories	Complete	N/A	IP 99	810-10
PB 3	*Prepayments Into the Secondary Reserve of the FSLIC and Contingencies Related to Other Obligations of the FSLIC*	*Withdrawn 1990*			
PB 4	Accounting for Foreign Debt/Equity Swaps	Complete	Adopt	26	942-310
PB 5	Income Recognition on Loans to Financially Troubled Countries	Complete	N/A	IP 99	942-310
PB 6	*Amortization of Discounts on Certain Acquired Loans*	*Superseded by SOP 03-3*			
		Complete	*Reject*	*37*	
PB 7	*Criteria for Determining Whether Collateral for a Loan Has Been In-Substance Foreclosed*	*Withdrawn 1994*			
PB 8	Application of FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses From the Sale of Investments, to Insurance Enterprises	Complete	Reject	51, 52	944-20 944-30 944-60 944-605 944-825
PB 9	*Disclosures of Fronting Arrangements by Fronting Companies*	*Superseded by FAS 113*			
PB 10	*Amendment to Practice Bulletin 7, Criteria for Determining Whether Collateral for a Loan Has Been In-Substance Foreclosed*	*Withdrawn 1994*			
PB 11	Accounting for Preconfirmation Contingencies in Fresh-Start Reporting	Complete	N/A	IP 99	Not Explicitly Included in Codification.
PB12	*Reporting Separate Investment Fund Option Information of Defined Contribution Pension Plans*	*Superseded by SOP 99-3*			
		Complete	*N/A*	*IP 99*	

STATUTORY ACCOUNTING PRINCIPLES
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PRE-CODIFICATION STANDARDS - CATEGORY C GAAP
AICPA PRACTICE BULLETINS

GAAP Pronounce-ment	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
PB 13	Direct-Response Advertising and Probable Future Benefits	Complete	Reject	29	340-20 944-30
PB 14	Accounting and Reporting by Limiting Liability Companies and Limited Liability Partnerships	Complete	N/A	IP 99	272-10 850-10
PB 15	Accounting by the Issuer of Surplus Notes	Complete	Reject	41	944-470

STATUTORY ACCOUNTING PRINCIPLES
GAAP CROSS-REFERENCE TO STATUTORY ACCOUNTING PRINCIPLES

PRE-CODIFICATION STANDARDS - CATEGORY D GAAP
AICPA ACCOUNTING INTERPRETATIONS

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
AIN-ARB43 Chapter 13B	*Compensation Involved in Stock Option and Stock Purchase Plans: Unofficial Accounting Interpretations of Accounting Research Bulletin No. 43, Chapter 13B*	*Superseded by APB 25*			
AIN-Key Man Life	*Deferred Compensation Contracts: Unofficial Accounting Interpretations*	*Superseded by FTB 85-4*			
AIN-ARB51	*Consolidated Financial Statements: Accounting Interpretations of ARB No. 51*	*Superseded by FAS 111*			
AIN-APB4	*Accounting for the Investment Credit: Accounting Interpretations of APB Opinion No. 4*	*Complete* *Items 1, 2, & 3* *Items 4, 5, & 6 Superseded by FAS 96, 109 & 111*	*Reject*	*10, 10R, 101*	*Not Included in Codification As No Longer Applicable Or Relevant*
AIN-APB7	*Accounting for Leases in Financial Statements of Lessors: Accounting Interpretations of APB Opinion No. 7*	*Superseded by FAS 111*			
AIN-APB8	*Accounting for the Cost of Pension Plans: Accounting Interpretation of APB Opinion No. 8*	*Superseded by FAS 111*			
AIN-APB9	Reporting the Results of Operations: Unofficial Accounting Interpretations of APB Opinion No. 9	Complete Item 1 *Item 2 Superseded by FAS 111*	Reject	3	225-20
AIN-APB11	*Accounting for Income Taxes: Accounting Interpretations of APB Opinion No. 11*	*Deleted by FAS 96 & FAS 109*			
AIN-APB15	*Computing Earnings per Share: Accounting Interpretations of APB Opinion No. 15*	*Superseded by FAS 128* *Complete*	*N/A*	*IP 99*	
AIN-APB16	*Business Combinations: Accounting Interpretations of APB Opinion No. 16*	*Superseded by FAS 141* *Complete*	*Reject* *Reject # 39*	*68* *25*	

STATUTORY ACCOUNTING PRINCIPLES
GAAP CROSS-REFERENCE TO STATUTORY ACCOUNTING PRINCIPLES

PRE-CODIFICATION STANDARDS - CATEGORY D GAAP
AICPA ACCOUNTING INTERPRETATIONS

GAAP Pronouncement	Name	Status	Disposition	Stat. Ref.	Acctg. Stds. Codification Topic-Subt.
AIN-APB17	*Intangible Assets: Unofficial Accounting Interpretations of APB Opinion No. 17*	*Superseded by FAS 142* *Complete*	*Reject*	*68*	
AIN-APB18	The Equity Method of Accounting for Investments in Common Stock: Accounting Interpretations of APB Opinion No. 18	Complete	Reject	46, 88, 97	323-10 323-30 810-10
AIN-APB19	*Reporting Changes in Financial Position: Accounting Interpretations of APB Opinion No. 19*	*Superseded by FAS 95*			
AIN-APB20	*Accounting Changes: Accounting Interpretations of APB Opinion No. 20*	*Superseded by FAS 128* *Complete*	*Reject*	*3*	
AIN-APB21	Interest on Receivables and Payables: Accounting Interpretations of APB Opinion No. 21	Complete	Adopt	15	932-835
AIN-APB22	*Disclosure of Accounting Policies: Accounting Interpretations of APB Opinion No. 22*	*Superseded by FAS 111*			
AIN-APB23	*Accounting for Income Taxes: Special Areas: Accounting Interpretations of APB Opinion No. 23*	*Superseded by FAS 96 & FAS 109*			
AIN-APB25	*Accounting for Stock Issued to Employees: Accounting Interpretations of APB Opinion No. 25*	*Superseded by FAS 123(R)* *Complete*	*Adopt* *N/A*	*13* *104R*	
AIN-APB26	Early Extinguishment of Debt: Accounting Interpretations of APB Opinion No. 26	Complete	Adopt	15	470-20 470-50
AIN-APB30	Reporting the Result of Operations: Accounting Interpretations of APB Opinion No. 30	Complete	see Note	24	225-20

Note: SSAP No. 24 adopts guidance related to the definition of extraordinary items and terminology relevant to the disposal of a segment and the criteria for recording a related loss. It rejects all interpretations related to the accounting and reporting of discontinued operations, extraordinary items, and unusual or infrequently occurring events and transactions.

Appendix D
FASB Codification to Pre-Codification GAAP
as of December 2014

Information provided within this Appendix D supplement has been obtained from the FASB Cross-Reference Tool. This supplement serves as a reference tool in tracing the FASB Codification to pre-codification GAAP standards that have been reviewed, or are pending review as part of the current NAIC statutory accounting maintenance process. This supplement does not indicate which GAAP standards have been adopted, adopted with modification or rejected for statutory accounting. Pre-codification GAAP guidance not captured as part of the statutory accounting maintenance process, but that has been incorporated in the FASB Codification, has not been referenced within this Supplement. Future consideration will occur on whether this pre-codification GAAP guidance will be reviewed for statutory accounting. Pre-codification GAAP included in the FASB codification, but not referenced within this supplement includes: FASB Derivative Implementation Group Issues; EITF Appendix D Topics; FASB Statement No. 138 Examples; FASB Staff Implementation Guides; AICPA Technical Inquiry Service and Audit and Accounting Guides. The Audit and Accounting Guides (AAG) related to insurance have been reviewed for statutory accounting and are referenced in this supplement – HCO: Health Care Organizations, LHI: Life and Health Insurance and PLI: Property and Liability Insurance Companies. This supplement also does not include reference to the SEC standards incorporated within the FASB Codification: SEC Financial Reporting Releases; SEC Interpretive Releases; SEC Staff Accounting Bulletins; and SEC Regulation S-X.

***Indicates that the guidance that comprises this FASB Codification section was not previously part of the statutory maintenance process (i.e., below category "c" of the pre-codification GAAP hierarchy or SEC) or that no reference to previous GAAP guidance was reflected in the FASB Cross-Reference Tool.

GAAP Codification Topic and Subtopic	Codification Section	Pre-Codification GAAP Reference
105 – Generally Accepted Accounting Principles		
105-10	Overall	ASU 2012-04 FAS 168
205 – Presentation of Financial Statements		
205-10	Overall	ASU 2011-05 ASU 2013-07 ASU 2014-08 FAS 52 FAS 130 FAS 144 ARB 43
205-20	Discontinued Operations	ASU 2014-08 FAS 128 FAS 142 FAS 144 SOP 94-6 EITF 87-24 EITF 03-13
205-30	Liquidation Basis of Accounting	ASU 2013-07
205-40	Going Concern	ASU 2014-15
210 –Balance Sheet		
210-10	Overall	ASU 2010-21 FAS 6 APB 12 ARB 43 SOP 81-1

GAAP Codification Topic and Subtopic	Codification Section	Pre-Codification GAAP Reference
		SOP 90-7 SOP 00-2
210-20	Offsetting	ASU 2011-11 ASU 2012-04 ASU 2013-01 FIN 39 FIN 41 APB 10
215 – Statement of Shareholder Equity		
215-10	Overall	***
220 – Comprehensive Income		
220-10	Overall	ASU 2011-05 ASU 2011-12 ASU 2013-02 FAS 130 FAS 133
225 – Income Statement		
225-10	Overall	ASU 2010-21 APB 09
225-20	Extraordinary and Unusual Items	FAS 109 FAS 144 FIN 18 APB 09 APB 18 APB 28 APB 30 FTB 85-06 AIN-APB9 AIN-APB30
225-30	Business Interruption Insurance	EITF 01-13
230 – Statement of Cash Flows		
230-10	Overall	ASU 2010-08 ASU 2012-04 ASU 2012-05 ASU 2013-08 ASU 2014-08 FAS 95 FAS 102 FAS 132 EITF 95-13 EITF 02-06
230-830	Foreign Currency Matters	***
235 – Notes to Financial Statements		
235-10	Overall	ASU 2014-09 APB 22
250 – Accounting Changes and Error Corrections		
250-10	Overall	FAS 16 FAS 128 FAS 154 FAS 157 FIN 01 APB 9 APB 18 APB 28

GAAP Codification Topic and Subtopic	Codification Section	Pre-Codification GAAP Reference
255 – Changing Prices		
255-10	Overall	FAS 52 FAS 89 SOP 93-3 EITF 04-03
260 – Earnings per Share		
260-10	Overall	ASU 2009-08 ASU 2009-15 FAS 123(R) FAS 128 FAS 129 FAS 150 APB 18 FSP EITF 03-06-1 EITF 97-14 EITF 99-07 EITF 00-27 EITF 03-06 EITF 04-08 EITF 07-04
270 – Interim Reporting		
270-10	Overall	ASU 2010-20 ASU 2011-11 ASU 2013-02 ASU 2014-04 ASU 2014-08 ASU 2014-09 FAS 16 FAS 157 APB 28
270-740	Income Taxes	***
272 – Limited Liability Entities		
272-10	Overall	ASU 2010-08 FAS 109 EITF 03-16 PB 14
274 – Personal Financial Statements		
274-10	Overall	SOP 82-1
275 – Risks and Uncertainties		
275-10	Overall	ASU 2014-09 ASU 2014-10 FSP FAS 142-3 SOP 94-6
280 – Segment Reporting		
280-10	Overall	ASU 2014-08 FAS 131 FAS 142 FAS 146 TB 79-04 EITF 04-10

GAAP Codification Topic and Subtopic	Codification Section	Pre-Codification GAAP Reference
305 – Cash and Cash Equivalents		
305-10	Overall	***
310 – Receivables		
310-10	Overall	ASU 2010-20 ASU 2010-25 ASU 2011-01 ASU 2011-04 ASU 2012-04 ASU 2014-09 ASU 2014-14 FAS 5 FAS 65 FAS 95 FAS 102 FAS 107 FAS 114 FAS 118 FAS 133 FAS 140 APB 12 APB 21 ARB 43 FSP SOP 94-6-1 SOP 97-3 SOP 01-6 SOP 03-3 EITF 85-01 EITF 85-20 EITF 86-21 EITF 88-20 PB 01
310-20	Nonrefundable Fees and Other Costs	FAS 91 EITF 84-19 EITF 92-05 EITF 93-01 EITF 97-03 EITF 99-20 EITF 01-07 SOP 01-6
310-30	Loans and Debt Securities Acquired with Deteriorated Credit Quality	ASU 2010-18 FAS 114 EITF 99-20 SOP 97-1 SOP 03-3
310-40	Troubled Debt Restructurings by Creditors	ASU 2010-18 ASU 2010-20 ASU 2011-02 ASU 2014-04 ASU 2014-14 FAS 15 FAS 114 FAS 118 TB 80-02 FSP FAS 144-1 EITF 87-18

GAAP Codification Topic and Subtopic	Codification Section	Pre-Codification GAAP Reference
		EITF 87-19 EITF 89-14 EITF 94-08 EITF 96-22
320 – Investments–Debt and Equity Securities		
320-10	Overall	FAS 115 FAS 140 TB 94-01 FSP FAS 115-1/124-1 SOP 78-9 EITF 86-40 EITF 96-10 EITF 96-11 EITF 96-12 EITF 96-15 EITF 98-13 EITF 98-15 EITF 99-20
323 – Investments–Equity Method and Joint Ventures		
323-10	Overall	ASU 2010-02 ASU 2012-04 ASU 2013-08 FAS 128 FAS 130 FAS 142 FIN 35 FIN 46(R) APB 18 FSP APB 18-1 EITF 98-13 EITF 99-10 EITF 00-12 EITF 02-14 EITF 02-18 EITF 08-06 AIN-APB 18
323-30	Partnerships, Joint Ventures, and Limited Liability Entities	FSP APB 18-1 EITF 00-01 EITF 03-16 AIN-APB 18 SOP 78-9
323-740	Income Taxes	ASU 2014-01 EITF 94-01
325 – Investments–Other		
325-10	Overall	FAS 60
325-20	Cost Method Investments	APB 18 FSP FAS 115-1/124-1 EITF 91-05 EITF 94-01
325-30	Investments in Insurance Contracts	TB 85-04 FSP FTB 85-04-1 EITF 88-05 EITF 99-04 EITF 06-05

GAAP Codification Topic and Subtopic	Codification Section	Pre-Codification GAAP Reference
325-40	Beneficial Interests in Securitized Financial Assets	EITF 99-20
330 – Inventory		
330-10	Overall	ASU 2012-04 ASU 2014-09 FIN 01 ARB 43 EITF 86-13 EITF 86-46 EITF 96-09 EITF 01-09 SOP 94-6
340 – Other Assets and Deferred Costs		
340-10	Overall	ASU 2010-22 ASU 2014-09 ARB 43 Chapter 3a FSP AUG AIR-1 EITF 99-05
340-20	Capitalized Advertising Costs	SOP 93-7 PB 13
340-30	Insurance Contracts that Do Not Transfer Insurance Risk	SOP 98-7
340-40	Contracts with Customers	ASU 2014-09
350 – Intangibles–Goodwill and Other		
350-10	Overall	ASU 2014-09 FAS 142 SOP 98-1 EITF 00-02
350-20	Goodwill	ASU 2010-28 ASU 2011-08 ASU 2012-04 FAS 131 FAS 142 EITF 02-13
350-30	General Intangibles Other than Goodwill	ASU 2012-02 FAS 142 FSP FAS 142-3 EITF 02-07 EITF 08-07
350-40	Internal Use Software	SOP 98-1
350-50	Website Development Costs	SOP 98-1 EITF 00-02
360 – Property, Plant and Equipment		
360-10	Overall	ASU 2014-04 ASU 2014-08 ASU 2014-09 FAS 5 FAS 13 FAS 34 FAS 92 FAS 143 FAS 144 APB 12 ARB 43 TB 86-02 FSP AUG AIR-1

GAAP Codification Topic and Subtopic	Codification Section	Pre-Codification GAAP Reference
		SOP 94-6 EITF 95-23 PB 1
360-20	Real Estate Sales	ASU 2011-10 ASU 2014-09 FAS 66 FIN 43 EITF 84-17 EITF 86-06 EITF 87-09 EITF 88-12 EITF 88-24 EITF 95-23 EITF 98-08 EITF 00-13 EITF 06-08 EITF 07-06
405 – Liabilities		
405-10	Overall	***
405-20	Extinguishments of Liabilities	FAS 140
405-30	Insurance-Related Assessments	ASU 2011-06 SOP 97-3
405-40	Obligations Resulting from Joint and Several Liabilities	ASU 2013-04
410 – Asset Retirement and Environmental Obligations		
410-10	Overall	***
410-20	Asset Retirement Obligations	ASU 2012-04 ASU 2014-09 FAS 13 FAS 143 FIN 47 FSP FAS 143-1 EITF 89-13 EITF 90-08 EITF 02-06
410-30	Environmental Obligations	ASU 2012-04 SOP 94-6 SOP 96-1 EITF 89-13 EITF 90-08
420 – Exit or Disposal Cost Obligations		
420-10	Overall	FAS 43 FAS 87 FAS 106 FAS 112 FAS 146 FSP FAS 146-1 EITF 96-05 EITF 96-09
430 – Deferred Revenue		
430-10	Overall	ASU 2014-09 SOP 00-2

GAAP Codification Topic and Subtopic	Codification Section	Pre-Codification GAAP Reference
440 – Commitments		
440-10	Overall	ASU 2014-09 FAS 5 FAS 13 FAS 47 FAS 52 FAS 65 FAS 66 FAS 68 FAS 91 FAS 116 FAS 133 ARB 43 ARB 45 AAG-HCO SOP 96-1 EITF 91-06 EITF 96-18 EITF 01-08
450 – Contingencies		
450-10	Overall	ASU 2014-09 FAS 5 FAS 13 FAS 48 FAS 109 FAS 113 APB 28 FIN 30 SOP 97-2 SOP 98-7 EITF 93-14 EITF 96-05
450-20	Loss Contingencies	ASU 2010-20 FAS 5 FAS 15 FAS 16 FAS 132(R) FAS 143 FAS 146 FIN 14 FIN 47 ARB 43 AAG-HCO SOP 93-1 SOP 94-6 SOP 96-1 SOP 97-3 EITF 92-13 EITF 97-01 EITF 98-09

GAAP Codification Topic and Subtopic	Codification Section	Pre-Codification GAAP Reference
450-30	Gain Contingencies	FAS 5 FIN 39 EITF 98-09 EITF 01-13 EITF 03-08
460 – Guarantees		
460-10	Overall	ASU 2012-04 ASU 2014-09 FAS 5 FAS 13 FAS 35 FAS 48 FAS 66 FAS 140 FAS 150 FIN 19 FIN 45 FIN 46(R) APB 18 TB 90-01 FSP FIN 45-1 FSP FIN 45-2 FSP FIN 45-3 SOP 81-1 SOP 93-6 SOP 94-6 SOP 00-2 SOP 01-6 EITF 84-05 EITF 85-20 EITF 86-17 EITF 86-33 EITF 90-14 EITF 90-20 EITF 90-21 EITF 91-10 EITF 92-01 EITF 95-01 EITF 96-21 EITF 97-01 EITF 97-10 EITF 99-02 EITF 99-05 EITF 00-04 EITF 01-12 EITF 03-12
470 – Debt		
470-10	Overall	FAS 6 FAS 13 FAS 47 FAS 78 FAS 129 FIN 08 APB 21 ARB 43

GAAP Codification Topic and Subtopic	Codification Section	Pre-Codification GAAP Reference
		TB 79-03 FSP FAS 129-1 EITF 86-05 EITF 86-15 EITF 86-28 EITF 86-30 EITF 88-15 EITF 88-18 EITF 95-22
470-20	Debt with Conversion and Other Options	ASU 2009-15 FAS 5 FAS 15 FAS 84 FAS 133 FAS 159 APB 14 FSP APB 14-1 FSP EITF 00-19-2 EITF 85-09 EITF 85-17 EITF 98-05 EITF 00-27 EITF 01-01 EITF 02-15 EITF 05-01 EITF 06-07 AIN APB 26
470-30	Participating Mortgage Loans	SOP 97-1
470-40	Product Financing Arrangements	ASU 2014-09 FAS 49
470-50	Modifications and Extinguishments	FAS 140 FAS 145 APB 26 TB 80-01 EITF 96-19 EITF 98-14 EITF 06-06 AIN-APB 26
470-60	Troubled Debt Restructurings by Debtors	FAS 15 TB 80-02 TB 81-06 EITF 02-04
480 – Distinguishing Liabilities from Equity		
480-10	Overall	FAS 150 FSP FAS 150-1 FSP FAS 150-2 FSP FAS 150-3 FSP FAS 150-4 FSP FAS 150-5 EITF 89-11 EITF 00-04 EITF 00-19

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505 – Equity		
505-10	Overall	ASU 2010-21 FAS 5 FAS 129 FAS 130 APB 9 APB 12 APB 14 ARB 43 ARB 51 FSP FAS 129-1 EITF 85-01 EITF 86-32 EITF 98-05 EITF 00-12 EITF 00-19 EITF 00-27
505-20	Stock Dividends and Stock Splits	ASU 2010-01 ARB 43
505-30	Treasury Stock	ARB 43 TB 85-6 EITF 99-07
505-50	Equity-Based Payments to Non-Employees	ASU 2014-09 FAS 123(R) EITF 96-18 EITF 00-08 EITF 00-18
505-60	Spinoffs and Reverse Spinoffs	FAS 123(R) EITF 02-11
605 – Revenue Recognition		
605-10	Overall	ASU 2010-17 ASU 2014-09 FAS 66 FAS 116 APB 10 ARB 43
605-15	Products	FAS 5 FAS 48 FIN 45 EITF 95-04
605-20	Services	ASU 2014-09 TB 90-01 SOP 01-6 EITF 85-20 EITF 91-09 EITF 99-17
605-25	Multiple-Element Arrangements	ASU 2009-13 ASU 2010-17 EITF 00-21
605-28	Milestone Method	ASU 2010-17
605-30	Rights to Use	***

GAAP Codification Topic and Subtopic	Codification Section	Pre-Codification GAAP Reference
605-35	Construction-Type and Production-Type Contracts	ARB 45 SOP 81-1 SOP 94-6 SOP 97-2
605-40	Gains and Losses	FIN 30 APB 29
605-45	Principal Agent Considerations	EITF 99-19 EITF 00-10 EITF 01-14 EITF 06-03
605-50	Customer Payments and Incentives	EITF 95-01 EITF 01-09 EITF 02-16 EITF 03-10 EITF 06-01
606 – Revenue from Contracts with Customers		
606-10	Overall	ASU 2014-09
610 – Other Income		
610-10	Overall	ASU 2014-09
610-20	Gains and Losses from the Derecognition of Nonfinancial Assets	ASU 2014-09
610-30	Gains and Losses on Involuntary Conversions	ASU 2014-09 FIN 30 APB 29
705 – Cost of Sales and Services		
705-10	Overall	ASU 2014-09
705-20	Accounting for Consideration Received from a Vendor	ASU 2014-09 EITF 02-16 EITF 03-10
710 – Compensation-General		
710-10	Overall	FAS 43 FAS 88 FAS 106 APB 12 EITF 88-23 EITF 93-03 EITF 96-05 EITF 97-14 EITF 06-02
712 – Compensation-Nonretirement Postemployment Benefits		
712-10	Overall	FAS 88 FAS 106 FAS 112 FAS 146 FIN 46(R) EITF 96-05
715 – Compensation-Retirement Benefits		
715-10	Overall	FAS 87 FAS 106
715-20	Defined Benefit Plans—General	ASU 2010-06 ASU 2011-04 FAS 87 FAS 88 FAS 106

GAAP Codification Topic and Subtopic	Codification Section	Pre-Codification GAAP Reference
		FAS 132(R) FAS 158 APB 12 EITF 88-01 EITF 03-02
715-30	Defined Benefit Plans—Pension	ASU 2011-09 ASU 2012-04 FAS 87 FAS 88 FAS 106 FAS 130 FAS 146 FAS 158 FIN 46(R) FSP FAS 146-1 EITF 88-01 EITF 91-07 EITF 03-02 EITF 03-04 EITF 05-05
715-60	Defined Benefit Plans—Other Postretirement	ASU 2012-04 FAS 88 FAS 106 FAS 158 FIN 46(R) FSP FAS 106-2 EITF 92-12 EITF 92-13 EITF 93-03 EITF 96-05 EITF 06-04 EITF 06-10
715-70	Defined Contribution Plans	FAS 106 FAS 132(R) EITF 86-27
715-80	Multiemployer Plans	ASU 2011-09 FAS 87 FAS 106 FAS 132(R) EITF 90-03
718 – Compensation-Stock Compensation		
718-10	Overall	ASU 2010-13 ASU 2014-12 FAS 5 FAS 123(R) FAS 128 FSP FAS 123(R)-1 FSP FAS 123(R)-2 FSP FAS 123(R)-4 EITF 96-05 EITF 97-02 EITF 00-12 EITF 00-16 EITF 07-05
718-20	Awards Classified as Equity	FAS 123(R)

GAAP Codification Topic and Subtopic	Codification Section	Pre-Codification GAAP Reference
718-30	Awards Classified as Liabilities	FAS 123(R)
718-40	Employee Stock Ownership Plans	SOP 93-6 EITF 90-04
718-50	Employee Share Purchase Plans	FAS 123(R) TB 97-01
718-740	Income Taxes	FAS 109 FAS 123(R) SOP 93-6 EITF 06-11
720 – Other Expenses		
720-10	Overall	***
720-15	Start-Up Costs	ASU 2014-09 SOP 98-5
720-20	Insurance Costs	FAS 5 AAG-HCO EITF 93-14 EITF 03-08
720-25	Contributions Made	FAS 116
720-30	Real and Personal Property Taxes	ARB 43
720-35	Advertising Costs	SOP 93-7
720-40	Electronic Equipment Waste Obligations	FSP FAS 143-1
720-45	Business and Technology Reengineering	EITF 97-13
720-50	Fees Paid to the Federal Government by Pharmaceutical Manufacturers and Health Insurers	ASU 2010-27 ASU 2011-06
730 – Research and Development		
730-10	Overall	FAS 2 FAS 86 FIN 06 SOP 97-2 SOP 98-1 EITF 99-05 EITF 07-03
730-20	Research and Development Arrangements	ASU 2014-09 FAS 2 FAS 5 FAS 68 SOP 97-2 EITF 07-03
740 – Income Taxes		
740-10	Overall	ASU 2009-06 ASU 2010-12 ASU 2013-11 FAS 37 FAS 109 FAS 116 FAS 164 FIN 30 FIN 48 APB 2 APB 4 APB 10 APB 18 APB 21 FSP FAS 106-2

GAAP Codification Topic and Subtopic	Codification Section	Pre-Codification GAAP Reference
		FSP FAS 109-1 FSP FIN 48-1 SOP 94-6 EITF 87-08 EITF 88-04 EITF 91-08 EITF 93-13 EITF 94-10 EITF 95-09 EITF 95-10 EITF 95-20 EITF 98-11 EITF 05-08
740-20	Intraperiod Tax Allocation	FAS 109 EITF 94-10
740-30	Other Considerations or Special Areas	FAS 109 APB 23 EITF 93-16 EITF 93-17
740-270	Interim Reporting	FAS 109 FAS 144 FIN 18 APB 28 TB 79-09
740-323	Investments—Equity Method and Joint Ventures	***
740-718	Compensation—Stock Compensation	***
740-805	Business Combinations	***
740-830	Foreign Currency Matters	***
740-852	Reorganizations	***
805 – Business Combinations		
805-10	Overall	ASU 2010-02 ASU 2010-29 ASU 2013-05 ASU 2014-13 FAS 141(R) FAS 164 FSP FAS 141(R)-1 EITF 98-04
805-20	Identifiable Assets and Liabilities, and Any Noncontrolling Interest	ASU 2011-04 ASU 2012-06 ASU 2014-09 ASU 2014-18 FAS 5 FAS 13 FAS 87 FAS 106 FAS 141(R) FSP FAS 141(R)-1 EITF 96-05 EITF 05-06
805-30	Goodwill or Gain from Bargain Purchase, Including Consideration Transferred	FAS 141(R) FAS 142 FSP FAS 141(R)-1
805-40	Reverse Acquisitions	FAS 141(R)

GAAP Codification Topic and Subtopic	Codification Section	Pre-Codification GAAP Reference
805-50	Related Issues	ASU 2010-08 ASU 2010-22 ASU 2014-17 FAS 141(R) FAS 164 EITF 85-21 EITF 86-09 EITF 87-21
805-740	Income Taxes	FAS 109 FAS 141(R) FIN 48 EITF 86-09
808 – Collaborative Arrangements		
808-10	Overall	ASU 2014-09 EITF 07-01
810 –Consolidation		
810-10	Overall	ASU 2010-02 ASU 2010-10 ASU 2010-22 ASU 2011-10 ASU 2013-05 ASU 2013-08 ASU 2014-07 ASU 2014-09 ASU 2014-10 ASU 2014-13 FAS 94 FAS 167 FIN 46(R) APB 18 ARB 51 FSP FAS 140-4/FIN 46(R)-8 FSP FIN 46(R)-1 FSP FIN 46(R)-2 FSP FIN 46(R)-3 FSP FIN 46(R)-5 FSP FIN 46(R)-6 EITF 84-04 EITF 85-12 EITF 86-32 EITF 88-14 EITF 88-15 EITF 96-16 EITF 97-02 EITF 97-14 EITF 00-01 EITF 01-02 EITF 04-05 EITF 06-09 EITF 08-08 PB 01 PB 02 AIN APB 18

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810-20	Control of Partnerships and Similar Entities	EITF 04-05
810-30	Research and Development Arrangements	EITF 99-16
815 – Derivatives and Hedging		
815-10	Overall	ASU 2010-11 ASU 2013-01 FAS 95 FAS 123(R) FAS 133 FAS 138 FAS 149 FAS 157 FAS 161 FIN 39 FSP FAS 129-1 FSP EITF 00-19-2 EITF 84-20 EITF 86-25 EITF 96-11 EITF 99-08 EITF 00-06 EITF 00-19 EITF 01-08 EITF 01-12 EITF 02-03 EITF 02-08 EITF 03-11 EITF 08-08
815-15	Embedded Derivatives	ASU 2010-11 ASU 2014-16 FAS 107 FAS 133 FAS 155 FSP APB 14-1 EITF 84-04 EITF 86-21 EITF 00-19 EITF 06-07 PB 01
815-20	Hedging—General	ASU 2013-10 ASU 2014-03 FAS 52 FAS 95 FAS 133 FAS 138 FAS 140
815-25	Fair Value Hedges	FAS 133 FAS 138 EITF 99-09
815-30	Cash Flow Hedges	ASU 2010-08 FAS 133 FAS 138 EITF 99-09 EITF 00-09
815-35	Net Investment Hedges	FAS 133

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815-40	Contracts in Entity's Own Equity	FSP EITF 00-19-2 EITF 00-19 EITF 05-02 EITF 07-05 EITF 08-08
815-45	Weather Derivatives	EITF 99-02
820 – Fair Value Measurements and Disclosures		
820-10	Overall	ASU 2009-05 ASU 2009-12 ASU 2010-06 ASU 2011-04 ASU 2013-08 ASU 2013-09 ASU 2014-09 ASU 2014-13 FAS 157 EITF 08-05
825 – Financial Instruments		
825-10	Overall	ASU 2009-05 ASU 2011-04 ASU 2013-03 ASU 2014-03 FAS 107 FAS 126 FAS 159 FSP APB 14-1 FSP SOP 94-6-1 SOP 01-6 EITF 08-05
825-20	Registration Payment Arrangements	FSP EITF 00-19-2
830 – Foreign Currency Matters		
830-10	Overall	FAS 52 APB 30 EITF 92-04
830-20	Foreign Currency Transactions	FAS 52 FAS 109 EITF 87-12 EITF 96-15
830-30	Translation of Financial Statements	ASU 2010-19 ASU 2013-05 FAS 52 FIN 37 EITF 01-05
830-230	Statement of Cash Flows	FAS 95
830-740	Income Taxes	FAS 109 EITF 92-08 EITF 93-09 EITF 93-16

GAAP Codification Topic and Subtopic	Codification Section	Pre-Codification GAAP Reference
835 – Interest		
835-10	Overall	FAS 116 FAS 150 FIN 48 SOP 03-3 SOP 98-7 EITF 85-17 EITF 86-15 EITF 96-12 EITF 99-20
835-20	Capitalization of Interest	FAS 34 FAS 42 FAS 58 FAS 62 FAS 87 FAS 143 FAS 154 SOP 97-1
835-30	Imputation of Interest	ASU 2014-09 APB 12 APB 21 SOP 01-6
840 – Leases		
840-10	Overall	ASU 2014-05 ASU 2014-09 FAS 13 FAS 23 FAS 29 FAS 66 FAS 94 FAS 143 FAS 146 FIN 19 FIN 21 FIN 23 FIN 24 FIN 45 TB 79-10 TB 79-12 TB 79-13 TB 88-01 EITF 86-33 EITF 92-01 EITF 95-01 EITF 95-04 EITF 96-21 EITF 97-01 EITF 98-09 EITF 00-11 EITF 01-08 EITF 01-12 EITF 05-06 EITF 08-03

GAAP Codification Topic and Subtopic	Codification Section	Pre-Codification GAAP Reference
840-20	Operating Leases	ASU 2014-09 FAS 13 FAS 144 TB 79-15 TB 85-03 TB 88-01 FSP FAS 13-1 EITF 95-17 EITF 96-21 EITF 01-08
840-30	Capital Leases	ASU 2010-20 ASU 2014-09 FAS 13 FAS 22 FAS 71 FAS 91 FAS 98 FAS 109 FAS 140 FAS 144 FIN 21 FIN 26 FIN 27 APB 12 TB 79-14 TB 79-15 TB 79-16(R) TB 86-02 TB 88-01 EITF 85-16 EITF 86-43 EITF 87-08 EITF 95-01 EITF 01-08
840-40	Sale-Leaseback Transactions	FAS 13 FAS 28 FAS 98 FAS 143 TB 88-01 EITF 84-37 EITF 86-17 EITF 88-21 EITF 89-16 EITF 89-20 EITF 90-14 EITF 90-20 EITF 93-08 EITF 96-21 EITF 97-01 EITF 97-10 EITF 99-13

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845 – Nonmonetary Transactions		
845-10	Overall	ASU 2010-02 ASU 2014-09 APB 29 EITF 93-11 EITF 98-04 EITF 00-08 EITF 01-02 EITF 04-13
850 – Related Party Disclosures		
850-10	Overall	FAS 45 FAS 57 FIN 45 APB 18 APB 26 ARB 43 ARB 51 EITF 85-01 PB 14
852 – Reorganizations		
852-10	Overall	ASU 2012-04 SOP 90-7 EITF 88-25
852-20	Quasi-Reorganizations	ARB 43 SOP 90-7
852-740	Income Taxes	FAS 109 SOP 90-7
853 – Service Concession Arrangements		
853-10	Overall	ASU 2014-05
855 – Subsequent Events		
855-10	Overall	ASU 2010-09 FAS 144 FAS 165 SOP 00-2
860 – Transfers and Servicing		
860-10	Overall	ASU 2011-03 ASU 2014-11 FAS 5 FAS 57 FAS 91 FAS 140 FAS 159 FAS 166 FIN 46(R) ARB 51 TB 01-01 FSP FAS 140-3 SOP 90-3 SOP 04-2 EITF 84-20 EITF 86-08 EITF 87-30 EITF 88-22 EITF 90-21

GAAP Codification Topic and Subtopic	Codification Section	Pre-Codification GAAP Reference
		EITF 97-03 EITF 99-08
860-20	Sales of Financial Assets	ASU 2014-11 FAS 95 FAS 115 FAS 140 FSP FAS 140-1 SOP 01-6 EITF 84-05 EITF 85-25 EITF 88-22 EITF 02-09
860-30	Secured Borrowing and Collateral	ASU 2013-01 ASU 2014-11 FAS 140 FIN 41
860-40	Transfers to Qualifying Special Purpose Entities	***
860-50	Servicing Assets and Liabilities	FAS 65 FAS 140 FAS 156 TB 87-03 SOP 01-6 EITF 85-13 EITF 87-34 EITF 90-21 EITF 95-05 EITF 02-09
905 – Agriculture		
905-10	Overall	SOP 85-3
905-205	Presentation of Financial Statements	SOP 85-3
905-310	Receivables	SOP 85-3
905-325	Investments——Other	SOP 85-3
905-330	Inventory	SOP 85-3
905-360	Property, Plant, and Equipment	SOP 85-3
905-405	Liabilities	SOP 85-3
905-505	Equity	***
905-605	Revenue Recognition	SOP 85-3
905-705	Cost of Sales and Services	***
908 – Airlines		
908-10	Overall	***
908-280	Segment Reporting	***
908-330	Inventory	***
908-350	Intangibles—Takeoff and Landing Slots	SOP 88-1
908-360	Property, Plant, and Equipment	FSP AUG AIR-1 SOP 88-1 EITF 01-09
908-605	Revenue Recognition	***
908-710	Compensation—General	***
908-720	Other Expenses	SOP 88-1
908-845	Nonmonetary Transactions	SOP 88-1
910 – Contractors–Construction		
910-10	Overall	***
910-20	Contract Costs	SOP 81-1

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910-235	Notes to Financial Statements	***
910-310	Receivables	***
910-330	Inventory	***
910-340	Other Assets and Deferred Costs	***
910-360	Property, Plant, and Equipment	***
910-405	Liabilities	***
910-605	Revenue Recognition	***
910-810	Consolidation	EITF 00-01
912 – Contractors–Federal Government		
912-10	Overall	ARB 43
912-20	Contract Costs	ARB 43 SOP 81-1
912-210	Balance Sheet	ARB 43
912-225	Income Statement	ARB 43
912-235	Notes to Financial Statements	***
912-255	Changing Prices	***
912-275	Risks and Uncertainties	FAS 146 ARB 43
912-310	Receivables	ASU 2014-09 ARB 43
912-330	Inventory	ARB 43
912-405	Liabilities	ARB 43
912-450	Contingencies	***
912-605	Revenue Recognition	ARB 43
912-705	Cost of Sales and Services	***
912-715	Compensation—Retirement Benefits	***
912-730	Research and Development	***
912-835	Interest	ASU 2014-09
915 – Development Stage Entities		
915-10	Overall	ASU 2014-10 FAS 07 FIN 07
915-205	Presentation of Financial Statements	FAS 07
915-210	Balance Sheet	FAS 07
915-215	Statement of Shareholder Equity	FAS 07
915-225	Income Statement	FAS 07
915-230	Statement of Cash Flows	FAS 07
915-235	Notes to Financial Statements	FAS 07
915-340	Other Assets and Deferred Costs	FAS 07
915-605	Revenue Recognition	FAS 07
915-810	Consolidation	FAS 07 FIN 07
920 – Entertainment–Broadcasters		
920-10	Overall	FAS 63
920-310	Receivables	***
920-350	Intangibles—Goodwill and Other	FAS 63
920-405	Liabilities	FAS 63
920-440	Commitments	FAS 63
920-605	Revenue Recognition	***
920-845	Nonmonetary Transactions	FAS 63
922 – Entertainment–Cable Television		
922-10	Overall	FAS 51

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922-350	Intangibles—Goodwill and Other	FAS 51
922-360	Property, Plant, and Equipment	FAS 51
922-430	Deferred Revenue	FAS 51
922-605	Revenue Recognition	FAS 51
922-720	Other Expenses	FAS 51
922-835	Interest	FAS 51
924 – Entertainment–Casinos		
924-10	Overall	***
924-280	Segment Reporting	***
924-405	Liabilities	ASU 2010-16 ASU 2014-09
924-605	Revenue Recognition	ASU 2010-16
924-720	Other Expenses	***
924-740	Income Taxes	***
926 – Entertainment–Films		
926-10	Overall	SOP 00-2
926-20	Other Assets—Film Costs	ASU 2012-07 SOP 00-2
926-230	Statement of Cash Flows	SOP 00-2
926-330	Inventory	SOP 00-2
926-405	Liabilities	SOP 00-2
926-430	Deferred Revenue	SOP 00-2
926-605	Revenue Recognition	SOP 00-2
926-705	Cost of Sales and Services	SOP 00-2
926-720	Other Expenses	SOP 00-2
926-835	Interest	SOP 00-2
926-845	Nonmonetary Transactions	SOP 00-2
926-855	Subsequent Events	SOP 00-2
928 – Entertainment–Music		
928-10	Overall	FAS 50
928-340	Other Assets and Deferred Costs	FAS 50
928-405	Liabilities	FAS 50
928-430	Deferred Revenue	FAS 50
928-440	Commitments	FAS 50
928-605	Revenue Recognition	FAS 50
928-720	Other Expenses	FAS 50
930 – Extractive Activities–Mining		
930-10	Overall	EITF 04-06
930-330	Inventory	EITF 04-06
930-360	Property, Plant, and Equipment	EITF 04-03
930-715	Compensation—Retirement Benefits	EITF 92-13
930-805	Business Combinations	EITF 04-03
930-810	Consolidation	EITF 00-01
932 – Extractive Activities–Oil and Gas		
932-10	Overall	ASU 2009-11 ASU 2010-03 ASU 2010-14 ASU 2010-22 FAS 19 EITF 90-22
932-225	Income Statement	***

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932-235	Notes to Financial Statements	ASU 2010-03 ASU 2014-09 FAS 19 FAS 69
932-270	Interim Reporting	FAS 19
932-280	Segment Reporting	***
932-323	Investments—Equity Method and Joint Ventures	***
932-330	Inventory	EITF 02-03
932-350	Intangibles—Goodwill and Other	FSP FAS 142-2
932-360	Property, Plant, and Equipment	ASU 2012-04 FAS 19 FIN 36 FSP FAS 19-1
932-470	Debt	FAS 19
932-605	Revenue Recognition	***
932-720	Other Expenses	FAS 19
932-740	Income Taxes	FAS 19
932-810	Consolidation	EITF 00-01
932-815	Derivatives and Hedging	EITF 90-22
932-835	Interest	ASU 2014-09 FIN 33 AIN-APB21
940 – Financial Services–Broker and Dealers		
940-10	Overall	***
940-20	Broker-Dealer Activities	***
940-310	Receivables	***
940-320	Investments—Debt and Equity Securities	***
940-325	Investments—Other	EITF 02-03
940-340	Other Assets and Deferred Costs	***
940-405	Liabilities	***
940-605	Revenue Recognition	***
940-720	Other Expenses	ASU 2014-09
940-810	Consolidation	***
940-820	Fair Value Measurements and Disclosures	***
942 – Financial Services–Depository and Lending		
942-10	Overall	SOP 01-6 EITF 88-19
942-210	Balance Sheet	ASU 2010-21 SOP 01-6
942-225	Income Statement	ASU 2010-21
942-230	Statement of Cash Flows	FAS 95
942-235	Notes to Financial Statements	***
942-305	Cash and Cash Equivalents	SOP 01-6
942-310	Receivables	SOP 01-6 PB 4 PB 5
942-320	Investments—Debt and Equity Securities	FAS 115 SOP 01-6
942-325	Investments—Other	SOP 01-6
942-360	Property, Plant, and Equipment	SOP 01-6
942-405	Liabilities	SOP 01-6 EITF 89-03

GAAP Codification Topic and Subtopic	Codification Section	Pre-Codification GAAP Reference
942-470	Debt	FAS 107 SOP 01-6
942-505	Equity	SOP 01-6
942-605	Revenue Recognition	***
942-720	Other Expenses	***
942-740	Income Taxes	FAS 109 APB 23 EITF 85-31
942-805	Business Combinations	***
942-810	Consolidation	EITF 88-25
942-825	Financial Instruments	SOP 01-6 EITF 85-20
944 – Financial Services–Insurance		
944-10	Overall	ASU 2010-21 FAS 60 SOP 94-5
944-20	Insurance Activities	FAS 5 FAS 60 FAS 97 FAS 113 FAS 120 FAS 163 SOP 94-5 SOP 95-1 SOP 03-1 EITF 92-09 EITF 93-06 EITF 93-14 PB 8
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Appendix E
Statutory Issue Papers

Introduction

Appendix E includes all of the issue papers associated with SSAPs adopted through December 2014. The issue papers are used as the first step in developing new or substantively revised SSAPs and contain a recommended conclusion, discussion, and relevant literature section. While the issue papers do not constitute an authoritative level of statutory accounting guidance, as defined by the statutory hierarchy, they are an important part of this Manual because they reference the history and discussion of the related SSAP.

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Statutory Issue Paper No. 1

Consolidation of Majority-Owned Subsidiaries

STATUS
Finalized March 16, 1998

Current Authoritative Guidance for Consolidation of Majority-Owned Subsidiaries: SSAP No. 3 and SSAP No. 97

This issue paper may not be directly related to the current authoritative statement.

Original SSAP from Issue Paper: SSAP No. 3

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Currently, statutory reporting entities do not consolidate the financial statements of a majority-owned subsidiary in their annual statement filing. Investments in majority-owned subsidiaries are reported in Schedule D of the Annual Statement as other investments of a similar type (e.g., common stock and preferred stock) and are valued in accordance with the procedures outlined in the *Purposes and Procedures Manual of the NAIC Securities Valuation Office* (SVO Purposes and Procedures). Current GAAP guidance is not consistent with this position and requires consolidation of majority-owned subsidiaries.

SUMMARY CONCLUSION

2. The policy of not consolidating majority owned subsidiaries for individual entity statutory reporting is consistent with the recognition concept included in the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts), therefore formal codification of such practice is recommended. The current statutory practice for recording the investment in majority-owned subsidiaries is also an accepted statutory accounting practice by all states.

3. Certain reporting entities who are members of an affiliated group may be required to prepare and issue consolidated or combined annual statements as supplemental information. These statements shall be prepared in accordance with NAIC guidelines.

DISCUSSION

4. The policy of not consolidating majority-owned subsidiaries is consistent with the *Recognition* concept included in the Statement of Concepts. This concept states that one objective of statutory reporting is to reflect an entity's ability to meet its policyholder obligations with the existence of readily marketable assets available when both current and future obligations are due. With an investment in subsidiaries, the cash flow generated by the investee may not be available to satisfy policyholder obligations. Therefore the asset that is readily marketable is the shares of ownership (e.g., common or preferred stock).

5. Other issue papers address specific statutory accounting principles which will be used in recording a reporting entity's investment in insurance and non-insurance affiliates.

Drafting Notes/Comments

- Valuation of the investment in subsidiaries and the reporting of the related income or loss as described in Chapter 6 of the Life APP and Chapter 5b in the SVO Purposes and Procedures is addressed in another issues paper.
- Subsidiary is defined in *Issue Paper No. 46—Accounting for Investments in Subsidiary, Controlled and Affiliated Entities*.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

6. Statutory accounting guidance defines a subsidiary, controlled, or affiliated ("SCA") entity in terms of controlling ownership in an entity's voting capital stock. Ownership of more than 50% provides "undisputed control" and when 50% or less of the outstanding stock is owned, "control is dependent upon the influence that the owner of that block of stock may have on the other holders of outstanding capital stock." Relevant guidance states that *"Investments in SCA companies include debt security loans and preferred and common stock. In general, the accounting for each type of investment is the same as it would be for any other bond, preferred stock, or common stock investment except that there are some special valuation considerations.*" This precludes consolidation of subsidiaries for individual entity statutory reporting purposes.

Generally Accepted Accounting Principles

7. FAS 94 paragraph 13 (amending ARB 51 paragraphs 2 and 3), states:

> 2. The usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule ownership by one company, directly or indirectly, of over fifty percent of the outstanding voting shares of another company is a condition pointing toward consolidation. However, there are exceptions to this general rule. A majority-owned subsidiary shall not be consolidated if control is likely to be temporary or if it does not rest with the majority owner (as, for instance, if the subsidiary is in legal reorganization or in bankruptcy or operates under foreign exchange restrictions, controls, or other governmental imposed uncertainties so severe that they cast significant doubt on the parent's ability to control the subsidiary).
>
> 3. All majority-owned subsidiaries--all companies in which a parent has a controlling financial interest through direct or indirect ownership of a majority voting interest--shall be consolidated except those described in the last sentence of paragraph 2.

RELEVANT LITERATURE

Statutory Accounting

– Accounting Practices and Procedures Manuals for Life and Accident and Health Insurance Companies and Property/Casualty Insurance Companies - Chapter 6 Investments in Subsidiary, Controlled or Affiliated Companies

– *Purposes and Procedures Manual of the NAIC Securities Valuation Office* - Chapter 5b Common Stocks of Subsidiary, Controlled or Affiliated Companies

Generally Accepted Accounting Principles

– *FASB Statement No. 94 (FAS 94), Consolidation of All Majority-Owned Subsidiaries*

– *Accounting Research Bulletin No. 51 (as amended by FAS 94), Consolidated Financial Statements*

State Regulations

No accounting guidance was noted in the state regulations.

Statutory Issue Paper No. 2

Definition of Cash

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 2

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory guidance limits the classification of cash to include only *"a medium of exchange that a bank will accept for deposit and allow an immediate credit to the depositor's account."* The statutory guidance also allows *"temporary investments in the form of saving accounts and nonnegotiable certificates of deposit in qualified banks and trust companies"* to be classified as cash. Nonnegotiable certificates of deposit are instruments whose title may only be transferred upon the agreement of the affected parties to the terms and conditions of the transfer and not upon endorsement and delivery or delivery alone.

2. Additionally, current statutory practice allows reporting of negative cash as a negative asset. This treatment is consistent with the conservatism concept discussed in the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

Cash Definition

3. Cash constitutes a medium of exchange that a bank or other similar financial institution will accept for deposit and allow an immediate credit to the depositor's account. Also classified as cash for financial statement purposes, although not falling within the above definition of cash, are savings accounts and certificates of deposit in banks or other similar financial institutions with maturity dates in one year or less from the acquisition date and cash equivalents. Cash equivalents are short-term, highly liquid investments that are both (a) readily convertible to known amounts of cash, and (b) so near their maturity that they present insignificant risk of changes in value because of changes in interest rates. Only investments with original maturities of three months or less qualify under this definition.

Treatment of Negative Cash Balances

4. If a reporting entity has multiple cash accounts, the net amount of all such accounts shall be reported jointly. Cash accounts with positive balances shall not be reported separately from cash accounts with negative balances. If in the aggregate, the reporting entity has a net negative cash balance, this amount shall be reported as such in the annual statement and shall not be recorded as a liability.

DISCUSSION

5. As stated in the Statement of Concepts, *"the cornerstone of solvency measurement is financial reporting. Therefore, the regulator's ability to effectively determine relative financial condition using financial statements is of paramount importance to the protection of policyholders." Additionally, it states "the ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due."* The definition of cash is consistent with the Statement of Concepts. Those instruments not included in the definition of cash (e.g., commercial paper and overnight repurchase agreements in excess of 3 months) shall be shown separately as short-term investments.

6. Treating all certificates of deposit with maturity dates in one year or less from the financial statement date as cash is a change from current statutory accounting. This change was made to address inconsistencies in the guidance between the Accounting Practices and Procedures Manuals for Property and Casualty Insurance Companies and Life and Accident and Health Insurance Companies (P&C and Life/A&H Accounting Practices and Procedures Manuals) and the *Purposes and Procedures Manual of the NAIC Securities Valuation Office* (SVO Purposes and Procedures). The P&C and Life/A&H Accounting Practices and Procedures Manuals require all nonnegotiable certificates of deposit to be classified as cash and negotiable certificates of deposit to be classified as short-term investments or bonds depending on the length to maturity at acquisition. The SVO Purposes and Procedures requires both negotiable and nonnegotiable certificates of deposit to be submitted to the SVO and valued under the general provisions for valuing bonds.

7. The treatment of recording negative cash as a negative asset in the statutory balance sheet follows the concept of conservatism as many regulatory limitations are calculated based upon total admitted assets.

Drafting Notes/Comments

- Funds classified as cash which are not immediately available for the benefit of policyholders (i.e., restricted cash, trust accounts, etc.) is addressed in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*.
- Treatment of drafts issued and drafts honored will be addressed in a separate issue paper.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

8. Existing statutory accounting guidance specifically addresses assets qualifying for treatment and classification as cash. Statutory accounting classifies certain assets as being either cash, short-term or long-term investments. The P&C Accounting Practices and Procedures Manual defines cash as follows:

> The asset must be a medium of exchange that a bank will accept for deposit and allow an immediate credit to the depositor's account. Also classified for financial statement purposes, although not falling within the above description of cash, are temporary investments in the form of saving accounts and nonnegotiable certificates of deposit in qualified banks and trust companies.

There is a similar definition of cash in the Life/A&H Accounting Practices and Procedures Manual.

9. Section 2(C)(7) of the SVO Purposes and Procedures indicates the following requirements for certificates of deposit: "Certificates of Deposit (negotiable and non-negotiable) will be considered under the general provisions of Section 2(B)."

Generally Accepted Accounting Principles

10. GAAP adds a "cash equivalent" category for instruments classified as cash. GAAP literature defines a cash equivalent to be short-term, highly liquid investments that are readily convertible to known amounts of cash and are so near their maturity that they present insignificant risk of changes in value because of changes in interest rates.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manuals for Life and Accident and Health Insurance Companies, Chapter 5
- Accounting Practices and Procedures Manuals for Property and Casualty Insurance Companies, Chapter 5

- Accounting Practices and Procedures (EX4) Task Force Minutes
- *Purposes and Procedures Manual of the NAIC Securities Valuation Office*, Section 2
- NAIC Annual Statement Instructions

Generally Accepted Accounting Principles

- *FASB Statement No. 95, Statement of Cash Flows*

State Regulations

- North Carolina Insurance Department Directive 92-D-2

Other Sources of Information

- Draft discussion material from previous Property/Casualty codification projects, Chapter 5.

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Statutory Issue Paper No. 3

Accounting Changes

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 3

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Statutory accounting and GAAP differ in accounting for corrections of errors and certain changes in accounting. Statutory accounting and GAAP are similar in their treatment of mergers and changes in reporting entities. The purpose of this issue paper is to codify statutory guidance and to expand disclosure requirements for changes in accounting, which include changes in accounting principle, estimate, and reporting entity, and for correction of an error in previously issued financial statements in order to achieve the concept of consistency/comparability as defined in the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

2. The term accounting change means a change in an accounting principle, an accounting estimate or the reporting entity. The correction of an error in previously issued financial statements is not deemed to be an accounting change.

Accounting Principle

3. A change in accounting principle results from the adoption of an accepted accounting principle different from the one previously used for reporting purposes. An accounting principle includes not only accounting principles and practices but also the methods of applying them.

4. A characteristic of a change in accounting principle is that it concerns a choice from among two or more accounting principles. However, neither (a) initial adoption of an accounting principle in recognition of events or transactions occurring for the first time or that previously were immaterial in their effect nor (b) adoption or modification of an accounting principle necessitated by transactions or events that are clearly different in substance from those previously occurring is a change in accounting principle.

Accounting Estimate

5. Changes in estimates used in accounting are necessary consequences of periodic presentations of financial statements which require estimating the effects of future events. Examples of items for which estimates are necessary include service lives of depreciable assets and uncollectible receivables. Accounting estimates change as new events occur, as more experience is acquired, or as additional information is obtained.

Correction of an Error

6. Errors in financial statements result from mathematical mistakes, mistakes in the application of accounting principles or oversight or misuse of facts that existed at the time the financial statements were prepared. In contrast, a change in accounting estimate results from new information or subsequent developments and accordingly from better insight or improved judgment. Thus an error is distinguished from a change in estimate.

7. Current statutory treatment shall be retained as follows:

- Changes in accounting principles and corrections of errors in previously reported financial statements shall be reported as adjustments to surplus in the period of the change in accounting principle or the period an error is detected.
- A change in the method of applying an accounting principle shall be considered as a change in accounting principle for purposes of applying the accounting principles set forth in this paper.
- A change in accounting estimate shall be included in the statement of income in the period when the change becomes known.

8. If the effect of a change in accounting principle is inseparable from the effect of a change in accounting estimate, then the change shall be considered as a change in accounting estimate for purposes of applying the accounting principles set forth in this paper. The treatment of a change resulting from an insurance department examination will depend on whether the change resulted from a correction of an error, a change in accounting principle or a change in estimate.

9. Material changes which do not affect assets, liabilities, revenues, expenses or surplus but which do affect historical information in the financial statement supplemental schedules (e.g., Schedule P) shall be reflected in the current years' schedules with appropriate notations made directly to the affected schedules and in the notes to the financial statement.

10. For mergers, restatement of prior years' amounts in the Annual Statement shall be required. Additionally, restatement shall be required for the two most recent years' included in the Five Year Historical Summary. The Five Year Historical Summary shall include a footnote that the other three years have not been restated. A company that merges with an entity which effectively is a shell company (i.e., the other entity has no outstanding underwriting liabilities), shall be exempt from the above requirements.

Disclosures

11. Disclosure of material changes in accounting and correction of errors shall include:

- a brief description of the change, encompassing a general disclosure of the reason and justification for change or correction.
- the impact of the change or correction on net income, surplus, total assets and total liabilities for the two years presented in the financial statements (i.e., the balance sheet and statement of income and operations).
- the effect on net income of the current period shall be disclosed for a change in estimate that affects several future periods, such as a change in the service lives of depreciable assets or actuarial assumptions affecting pension costs. Disclosure of the effect on those income statement amounts is not necessary for estimates made each period in the ordinary course of accounting for items such as uncollectible accounts; however, disclosure is recommended if the effect of a change in the estimate is material.

DISCUSSION

12. *Accounting Principles Board Opinion No. 9*, *Reporting the Results of Operations* (APB 9) and *Accounting Principles Board Opinion No. 20*, *Accounting Changes* (APB 20) address GAAP accounting and reporting for accounting changes. Portions of these pronouncements are not applicable to statutory accounting and some of the guidance is not consistent with statutory objectives. Therefore, rejection of APB 20 in its entirety and the portions of APB 9 that address the treatment of extraordinary items and prior period adjustments is recommended.

13. The consistency concept within the Statement of Concepts is concerned with the regulator's need for meaningful, comparable financial information to determine an entity's financial condition through

consistency in the development and application of statutory accounting principles. In keeping with the Statement of Concepts, comparability of financial information would be best served by the restatement of prior year financial information for certain changes in accounting principle as well as the correction of an error in the previous year. However, existing statutory accounting guidance and practice requires such an item to be shown as an adjustment to surplus. In order to bridge the gap between current statutory accounting guidance and the achievement of comparability sought by the Statement of Concepts, additional disclosure as to the general description and the effect of such changes on income and surplus for all periods presented would provide the financial statement reader enough information to understand the effect of such change on consistency between periods.

14. The modification of existing statutory accounting for additional disclosure relating to changes between years and correction of prior errors bridges the gap between GAAP accounting as required by APB 20 and APB 9. More importantly, the added disclosure bridges the gap between current statutory procedures and the concept of consistency/ comparability required by the Statement of Concepts.

Drafting Notes/Comments

- Accounting for Consolidations of Majority-owned Subsidiaries is addressed in a separate issue paper (see Issue Paper No. 1).
- Accounting for mergers is addressed in a separate issue paper. This may include an expansion of the traditional definition of a merger to include all combinations or assumptions which, in substance, are mergers.
- Extraordinary items are discussed in a separate issue paper.
- Specific discussion regarding reserve changes including a change in valuation basis is addressed in a separate paper.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

15. Statutory accounting is specific as to the treatment of accounting changes. The primary statutory accounting guidance is the NAIC Annual Statement Instructions (Annual Statement Instructions). Summarized, the Annual Statement Instructions specify that a change in accounting principle or the correction of an error is to be reported as an adjustment to surplus. Changes in accounting estimates are to be included in the statement of income for the current period. The treatment for a merger requires that prior year's amounts be restated and reported on a merged basis consistent with the current year's post-merger reporting basis.

16. The issues of changes in accounting principles and estimates are not specifically addressed in the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies.

17. Chapter 10 of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, in a discussion on recoveries from salvage and subrogation, states that:

> Companies which have previously reported reserves gross of salvage and subrogation should report the change to the net method as a change in accounting principle. The cumulative effect on prior years of this change should be reported as a write-in item in the surplus section of the annual statement. The change in the reserve calculated using the net method should be included in net income for the year of the change and all future years.

18. The Annual Statement Instructions (which documents the conclusions reached by the Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force in meeting 92-1) addresses accounting changes. The instructions state that:

Amounts reported in prior years may need to be adjusted in the current year as a result of the following:

Changes in accounting principles or practices or changes in the methods of applying accounting principles or practices.

Changes in accounting estimates as a result of new events or new information.

Corrections of errors in previously filed information.

A merger.

If changes are required for amounts reported in prior years, such changes should be included in the amounts reported for the current year and the effects of such changes should be reported as follows, unless these Instructions or the NAIC Accounting Practices and Procedures manual specifically provide for a different treatment:

(1) The cumulative effect of a change in accounting principles or practices or a change in the method of applying accounting principles or practices should be reported with an appropriate identifying title as a write-in item for gains and losses in surplus. The cumulative effect of changing to a new accounting principle is the difference between the amount of capital and surplus at the beginning of the year and the amount of capital and surplus that would have been reported at that date if the new accounting principle had been applied retroactively for all prior periods. An example of a change in accounting principles would be a change in the method of accounting for pensions or other post-employment benefits.

(2) The effects of changes in accounting estimates are included in income and expenses in the Statement of Income for the current year. For example, a change in the estimate of loss reserves for losses related to prior years should be included in the Statement of Income in losses incurred for the current year.

(3) The effects of changes resulting from corrections of errors in previously filed information (for example, mathematical mistakes, misapplication of accounting principles, or oversight or misuse of facts) should be reported as an adjustment to surplus in the current year. Such adjustments to surplus should be reported with an appropriate identifying title as a write-in item for gains and losses in surplus.

(4) In the case of a merger, prior years' amounts reported for assets, liabilities, surplus, revenues and expenses, as well as those amounts reflected in supporting Annual Statement schedules, should be reported on a merged basis consistent with the current year's post-merger reporting basis. A footnote should be inserted on each page of the Annual Statement which contains such merged amounts clearly detailing the circumstances.

If one of the above described adjustments is required that does not affect assets, liabilities, revenues or expenses but which does adjust historical information, such as that found in Schedule P, the change may be made in the currently filed annual statements; however, appropriate notations of such adjustments should be made directly on the schedules affected and in the notes to the Financial Statements.

Generally Accepted Accounting Principles

19. Statutory accounting treatment is similar to GAAP except for the following:

- when reporting changes in accounting principles, GAAP accounting requires that the cumulative effect of a change be reported in the statement of income as a separate line item. Statutory accounting requires this to be shown as a separate component of surplus.
- GAAP accounting requires that corrections of errors be reported as prior period adjustments with adjustment to the prior year income and surplus.
- accounting for changes in a reporting entity includes several circumstances in which there may be a change in reporting entity. The only relevant area as it applies to Statutory Accounting is that of a merger. As such, this is the only area which Statutory Accounting specifically addresses.

20. The primary GAAP accounting guidance with respect to accounting changes comes from APB 20, paragraph 19, which states that changes in accounting principles are to be reported as follows:

a. Financial statements for prior periods included for comparative purposes should be presented as previously reported.

b. The cumulative effect of changing to a new accounting principle on the amount of retained earnings at the beginning of the period in which the change is made should be included in net income of the period of the change.

c. The effect of adopting the new accounting principle on income before extraordinary items and on net income of the period of the change should be disclosed.

d. Income before extraordinary items and net income computed on a pro forma basis should be shown on the face of the income statements for all periods presented as if the newly adopted accounting principle had been applied during all periods affected.

21. APB 20 also states that changes in accounting estimates are to be accounted for as follows:

> ...the effect of a change in accounting estimate should be accounted for in
> a. the period of change if the change affects that period only or
> b. the period of change and future periods if the change affects both.
>
> A change in an estimate should not be accounted for by restating amounts reported in financial statements of prior periods or by reporting pro forma amounts for prior periods.

22. For changes in the reporting entity (e.g., a merger), APB 20 states the following:

> ...accounting changes which result in financial statements that are in effect the statements of a different reporting entity should be reported by restating the financial statements of all prior periods presented in order to show financial information for the new reporting entity for all periods.

23. For changes in accounting principles inseparable from changes in accounting estimates, APB 20 states:

> Changes of this type are often related to the continuing process of obtaining additional information and revising estimates and are therefore considered as changes in estimates for purposes of applying this Opinion.

24. Lastly, according to APB 20, corrections of errors are to be accounted for as follows:

> Correction of an error in the financial statements of a prior period discovered subsequent to their issuance should be reported as a prior period adjustment.

25. GAAP accounting provides guidance with respect to the accounting for prior period adjustments in APB 9, paragraph 18. APB 9 states that *"When comparative statements are presented corresponding adjustments should be made of the amounts of net income (and the components thereof) and retained earnings balances (as well as of other affected balances) for all of the periods reported therein, to reflect the retroactive application of the prior period adjustments."* Additionally, APB 9 requires footnote disclosures regarding such changes.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 10, *Losses*
- Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force Minutes, 92-1, 91-4
- NAIC Annual Statement Instructions

Generally Accepted Accounting Principles

- *Accounting Principles Board Opinion No. 9, Reporting the Results of Operations*
- *Accounting Principles Board Opinion No. 20, Accounting Changes*
- *FASB Statement No. 16, Prior Period Adjustments*

State Regulations

- No additional guidance obtained from state statutes or regulations.

Other Sources of Information

- Draft discussion materials from previous Property/Casualty codification projects, *Prior Period Adjustments/Corrections of Errors*

Statutory Issue Paper No. 4

Definition of Assets and Nonadmitted Assets

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 4

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. One of the cornerstones of the statutory accounting model is the use of nonadmitted assets. This concept interjects a level of conservatism in the reporting of an insurance enterprise's statutory financial position and is consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts). Currently, statutory accounting does not address the general definition of assets as used in the statutory accounting model. Furthermore, statutory accounting is not explicit and is sometimes inconsistent with regard to the guidelines for accounting for nonadmitted assets. Current guidance allows the establishment of an asset. This asset is charged against surplus as a nonadmitted asset, and is also depreciated or amortized against net income as its estimated economic benefit expires. Current guidance also allows in limited circumstances for a nonadmitted asset to be charged through operations when acquired.

The purpose of this issue paper is to provide a definition of an "asset" for use in statutory accounting and establish consistent treatment of nonadmitted assets.

SUMMARY CONCLUSION

2. For purposes of statutory accounting, an asset shall be defined as: probable[1] future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. An asset has three essential characteristics: (a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (b) a particular entity can obtain the benefit and control others' access to it, and (c) the transaction or other event giving rise to the entity's right to or control of the benefit has already occurred. These assets shall then be evaluated to determine whether they are admitted. The criteria used is outlined in paragraph 3 below.

[1] *FASB Statement of Financial Accounting Concepts No. 6*, *Elements of Financial Statements* (CON 6), states:

Probable is used with its usual general meaning, rather than in a specific accounting or technical sense (such as that in FASB Statement No. 5, *Accounting for Contingencies*, par. 3), and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved...

3. As stated in the Statement of Concepts, *"The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which are unavailable due to encumbrances or other third party*

interests should not be recognized on the balance sheet", and are, therefore, considered nonadmitted. For purposes of the Codification, a nonadmitted asset shall be defined as an asset meeting the criteria in paragraph 2 above, which is accorded limited or no value in statutory reporting and is one which is:

a. Specifically identified within the Codification as a nonadmitted asset or

b. Not specifically identified within the Codification as an admitted asset.

If an asset meets one of these criteria, the asset shall be reported as a nonadmitted asset and charged against surplus unless otherwise specifically addressed within the Codification. The asset shall be depreciated or amortized against net income as the estimated economic benefit expires. In accordance with the reporting entity's capitalization policy, immaterial amounts of furniture, fixtures, and equipment, or supplies, can be expensed when purchased.

4. Transactions which do not give rise to assets as defined in paragraph 2 shall be charged to operations in the period the transactions occur. Those transactions which result in amounts which may meet the definition of an asset, but are specifically identified within the Codification as not giving rise to assets (e.g., policy acquisition cost), shall also be charged to operations in the period the transactions occur.

DISCUSSION

5. The Accounting Practices and Procedures Manuals for Property and Casualty and for Life and Accident and Health Insurance Companies define the term nonadmitted asset as an asset that has been *"accorded limited or no value in statutory reporting"*. Chapter 9 of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies further elaborates by saying, *"Some assets may be nonadmitted because they do not conform to the laws and regulations of the various states and other assets may be nonadmitted because they are not readily convertible to liquid assets."* Chapter 9 of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies includes a similar discussion.

6. The concept of nonadmitted assets can be traced back to the 1874 Association Blank, thus establishing general acceptance through universal use. Statutory accounting does not specifically address the general definition of an asset. CON 6, which was adopted as part of the framework to be utilized in the Codification, does provide a general definition of assets. This provides an appropriate measure for statutory assets.

7. The adoption of the above accounting principles will be consistent with the recognition concept within the Statement of Concepts (i.e., the ability to meet policyholder obligations as predicated on the existence of readily marketable assets available when both current and future obligations are due).

Drafting Notes/Comments

- Accounting Practices and Procedures manual states that non-admittance of accrued investment income is to be recorded as a reduction of investment income. This is specifically addressed in a separate issue paper.
- Deferred premiums is addressed in a separate issue paper.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

8. Statutory accounting in this area is general and somewhat inconsistent. The prefaces to the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies state:

> State statutes and accompanying regulations generally define what may be included as assets on a balance sheet, i.e., admitted assets. Because of the conservatism intrinsic to insurance accounting, certain assets may be accorded limited or no value in statutory reporting, i.e., nonadmitted assets. The investments a company is permitted to make and the limitations and methods of valuation for inclusion as admitted assets are usually specified. Also, because of the nature of the calculation of certain liabilities, offsetting of assets is permitted in order to maintain consistency. The discussion of assets in Part One includes certain nonadmitted as well as admitted assets.

9. Chapter 9 of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies discusses the accounting for periodic transactions for nonadmitted assets as follows:

> Some assets or portions thereof may be nonadmitted because they do not conform to the laws and regulations of the various states. As a result, certain assets which normally would be accorded value in noninsurance corporations are accorded no value and thus reduce the reported surplus of the insurance company. In addition, state regulations require that certain expenditures which could normally be capitalized by a non-insurance company be charged as an expense.
>
> Changes between years in nonadmitted assets are usually charged directly to surplus. The change between years in nonadmitted investment income due or accrued, though, is reported as a component of investment income in the summary of operations.
>
> Even though a state insurance code may prohibit or limit certain assets, these assets are generally carried in the company's general ledger. Depreciable assets are depreciated in a systematic and rational manner over their estimated useful lives.

10. Chapter 9 of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies states:

> Because, in many respects, the statutory balance sheet is presented on a conservative basis, certain assets (which may have a recognized value in noninsurance corporations) are accorded no value and thus reduce the reported surplus of the insurance company. Some assets may be nonadmitted because they do not conform to the laws and regulations of the various states and other assets may be nonadmitted because they are not readily convertible to liquid assets. Changes in the amount of nonadmitted assets are charged or credited directly to surplus.
>
> Each chapter in this book relating to investments discusses the limitations in amount and quality of investments that are treated as admitted. In general, authorized investments that are within the limitations of the laws and regulations of the various states are considered to be admitted assets. Investments exceeding the limitations, or those of questionable quality, may be nonadmitted.

11. Chapter 9 of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies also provides some general guidance on certain nonadmitted assets. A sample follows:

> Electronic Data Processing Equipment: Application systems software may be expensed when purchased or established as a nonadmitted asset and written off over a period of years not to exceed the software's expected useful life.
>
> Equipment, Furniture and Supplies: The company may record furniture and equipment as a ledger asset, depreciate it, and nonadmit it in the exhibit of assets in the statutory financial statements, or the company may expense the furniture and equipment when it is purchased. Supplies are normally expensed when purchased.

Generally Accepted Accounting Principles

12. Asset recognition is governed by *FASB Statement of Financial Accounting Concepts No. 6*, *Elements of Financial Statements* (CON 6), paragraphs 25-34. An asset is defined in paragraph 25 of CON 6 as follows:

> Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.

13. Paragraph 26 of CON 6, further defines the characteristics of an asset as follows:

> An asset has three essential characteristics: (a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (b) a particular entity can obtain the benefit and control others' access to it, and (c) the transaction or other event giving rise to the entity's right to or control of the benefit has already occurred.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, pg. v and Chapter 9
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, pg. v and Chapter 9

Generally Accepted Accounting Principles

- *FASB Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements*

State Regulations

- No additional guidance obtained from state statutes or regulations.

Other Sources of Information

- Draft discussion material from previous Property/Casualty codification projects
- Draft discussion material from previous Life codification projects

Statutory Issue Paper No. 5

Definition of Liabilities, Loss Contingencies and Impairments of Assets

STATUS
Finalized March 16, 1998

Original SSAP: SSAP No. 5; Current Authoritative Guidance: SSAP No. 5R

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Statutory accounting currently does not define the term liability for use in preparation of statutory financial statements. Statutory accounting does address the accounting for certain liabilities within the statutory framework. The current statutory accounting guidance results in some confusion about when the recording of a liability, loss contingency or impairment of an asset is required outside the specific guidance prescribed by statutory accounting. The purpose of this issue paper is to provide a definition of a "liability" for statutory accounting purposes and to provide the accounting principles to be followed when recording such a liability in statutory financial statements. This paper also establishes the criteria for recording loss contingencies and impairments of assets.

SUMMARY CONCLUSION

Liabilities

2. For purposes of statutory accounting, a "liability" shall be defined as certain or probable[1] future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or to provide services to other entities in the future as a result of past transaction(s) or event(s). A liability has three essential characteristics: (a) it embodies a present duty or responsibility to one or more other entities that entails settlement by probable[1] future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand, (b) the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice, and (c) the transaction or other event obligating the entity has already happened. This includes but is not limited to liabilities arising from policyholder obligations (e.g. policyholders benefits, reported claims and reserves for incurred but not reported claims). Liabilities shall be recorded on a Company's financial statements when incurred.

3. Estimates (e.g., loss reserves) are required in financial statements for many ongoing and recurring activities of a reporting entity. The mere fact that an estimate is involved does not of itself constitute a loss contingency. For example, estimates of losses utilizing appropriate actuarial methodologies meet the definition of liabilities as outlined above and are not loss contingencies.

[1] *FASB Statement of Financial Accounting Concepts No. 6*, *Elements of Financial Statements* (CON 6), states:

> Probable is used with its usual general meaning, rather than in a specific accounting or technical sense (such as that in *FASB Statement 5, Accounting for Contingencies,* par. 3), and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved...

Loss Contingencies or Impairments of Assets

4. For purposes of implementing the statutory accounting principles of loss contingency or impairment of an asset described below the following additional definitions shall apply:

> **Probable -** The future event or events are likely to occur.
>
> **Reasonably Possible -** The chance of the future event or events occurring is more than remote but less than probable.
>
> **Remote -** The chance of the future event or events occurring is slight.

5. A "loss contingency" or "impairment of an asset" is defined as an existing condition, situation, or set of circumstances involving uncertainty as to possible loss to an enterprise that will ultimately be resolved when one or more future event(s) occur or fail to occur (e.g., collection of receivables).

6. An estimated loss from a loss contingency or the impairment of an asset shall be recorded by a charge to operations if both of the following conditions are met:

a. Information available prior to issuance of the statutory financial statements indicates that it is probable that an asset has been impaired or a liability has been incurred at the date of the statutory financial statements. It is implicit in this condition that it is probable that one or more future events will occur confirming the fact of the loss or incurrence of a liability, and

b. The amount of loss can be reasonably estimated.

7. This accounting shall be followed even though the application of other prescribed statutory accounting principles or valuation criteria may not require, or does not address, the recording of a particular liability or impairment of an asset (e.g., known impairment of an invested asset even though published VOS manual has not recognized impairment).

8. Additionally, in instances where a judgment, assessment or fine has been rendered against a company, there is a presumption that the criteria in paragraph 6.a. and 6.b. have been met. The amount of the liability shall include the anticipated settlement amount, legal costs, insurance recoveries and other related amounts and shall take into account factors such as the nature of the litigation, progress of the case, opinions of legal counsel, and management's intended response to the litigation, claim, or assessment.

9. When condition 6 a. above is met with respect to a particular loss contingency, and the reasonable estimate of the loss is a range, which meets condition 6 b. above, an amount shall be accrued for the loss. When an amount within management's estimate of the range of a loss appears to be a better estimate than any other amount within the range, that amount shall be accrued. When no amount within the range is a better estimate than any other amount, however, the midpoint (mean) in the range shall be accrued. For purposes of this paragraph, it is assumed that management can quantify the high end of the range. If management determines that the high end of the range cannot be quantified, then a range does not exist, and management's best estimate shall be used.

Disclosure

10. If a loss contingency or impairment of an asset is not recorded because only one of the conditions 6 a. or 6 b. is met, or if exposure to a loss exists in excess of the amount accrued pursuant to the provisions described above, disclosure of the loss contingency or impairment of the asset shall be made in the notes to the financial statements when there is at least a reasonable possibility that a loss or an additional loss may have been incurred. The disclosure shall indicate the nature of the contingency and shall give an estimate of the possible loss or range of loss or state that such an estimate cannot be made.

11. Disclosure is not required of a loss contingency involving an unasserted claim or assessment when there has been no manifestation by a potential claimant of an awareness of a possible claim or assessment unless it is considered probable that a claim will be asserted and there is a reasonable possibility that the outcome will be unfavorable.

12. Certain loss contingencies, the common characteristic of each being a guarantee, shall be disclosed in financial statements even though the possibility of loss may be remote. Examples include (a) guarantees of indebtedness of others, and (b) guarantees to repurchase receivables (or, in some cases, to repurchase related properties) that have been sold or otherwise assigned. The disclosure of those loss contingencies, and others that in substance have the same characteristics, shall be applied to statutory financial statements. The disclosure shall include the nature and amount of the guarantee. Consideration shall be given to disclosing, if estimable, the value of any recovery that could be expected to result, such as from the guarantor's right to proceed against an outside party.

DISCUSSION

13. The Conclusion above adopts certain principles in *FASB Statement No. 5*, *Accounting for Contingencies* (FAS 5), *FASB Statement No. 114*, *Accounting by Creditors for Impairment of a Loan* (FAS 114) – only as it amends in part FAS 5, and paragraphs 35 and 36 of *FASB Statement of Concepts No. 6—Elements of Financial Statements. FASB Interpretation No. 14, Reasonable Estimation of Amounts of a Loss*, *An Interpretation of FASB Statement No.* 5 is adopted with the modification to accrue the loss amount as the midpoint of the range rather than the minimum. This issue paper also adopts *FASB Interpretation No. 34*, *Disclosure of Indirect Guarantees of Indebtedness of Others, An interpretation of FASB Statement No. 5,*and *Accounting Principles Board Opinion No. 12, Omnibus Opinion—1967, paragraphs 2 and 3.*

14. Although the above accounting principles are not specifically discussed in current statutory accounting literature, these principles are well established in the determination of policy reserves in the life insurance and property and casualty accounting models. Both models use actuarial methods to establish the accounting estimates recorded. Obligations incurred in the normal conduct of business (e.g., obligations to pay employees, obligations to pay for assets or services acquired, etc.) represent other examples of applying the accounting principles described above.

15. Consistent with the solvency and conservatism concepts in the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy, the statutory accounting model uses numerous accounting methods to accomplish the objective of reporting a company's statutory financial position to demonstrate solvency. These accounting methods (nonadmitted assets, Asset Valuation Reserves, etc.) normally do not meet the criteria required in applying the accounting principles described in the Conclusion above. Therefore, such accounting methods should be applied by direct charges to or appropriation of a Company's surplus. Notwithstanding the application of these statutory accounting methods, when an event, situation, transaction or other information comes to the financial statement preparer's attention that indicates a liability or loss has been incurred or that an asset has been impaired, the accounting principles described in the Conclusion above should be followed.

16. Paragraph 9 provides guidance on recording an estimate which lies within an estimated range. It is anticipated that using the midpoint in a range will be applicable only in the rare instance where there is a continuous range of possible values, and no amount within that range is any more probable than any other. This guidance is not applicable when there are several point estimates which have been determined as equally possible values, but those point estimates do not constitute a range. If there are several point estimates with equal probabilities, management should determine their best estimate of the liability.

17. Disclosure of the nature of accruals made in applying the above statutory accounting principle and in some circumstances the amount accrued may be necessary for the fair presentation of the statutory financial statements.

Drafting Notes/Comments

- Appropriation of retained earnings and gain contingencies (e.g., paragraphs 15 and 17 of FAS 5) are covered in separate issue papers.
- *FASB Statement No. 114*, *Accounting by Creditors for Impairment of a Loan*, is addressed in its entirety in a separate issue paper.
- Impairment of mortgage loans, real estate investments and other invested assets are addressed in separate issue papers.
- Policy, loss and claim reserves are addressed in separate issue papers.
- Surplus notes is addressed in a separate issue paper.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

18. As discussed above, current statutory accounting is limited to dealing with specific asset and liability captions included on a company's statement of financial position.

Generally Accepted Accounting Principles

19. Relevant sections of GAAP literature follow:

FASB Statement of Concepts No. 6*, *Elements of Financial Statements

> 35. Liabilities are probable[21] future sacrifices of economic benefits arising from obligations[22] of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.
>
> [21] Probable is used with its usual general meaning, rather than in a specific accounting or technical sense (such as that in Statement 5, par. 3), and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved (Webster's New World Dictionary, p. 1132). Its inclusion in the definition is intended to acknowledge that business and other economic activities occur in an environment characterized by uncertainty in which few outcomes are certain (pars. 44-48).
>
> [22] Obligations in the definition is broader than legal obligations. It is used with its usual general meaning to refer to duties imposed legally or socially; to that which one is bound to do by contract, promise, moral responsibility, and so forth (Webster's New World Dictionary, p. 981). It includes equitable and constructive obligations as well as legal obligations (pars. 37-40).
>
> 36. A liability has three essential characteristics: (a) it embodies a present duty or responsibility to one or more other entities that entails settlement by probable future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand, (b) the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice, and (c) the transaction or other event obligating the entity has already happened. Liabilities commonly have other features that help identify them - for example, most liabilities require the obligated entity to pay cash to one or more identified other entities and are legally enforceable. However, those features are not essential characteristics of liabilities. Their absence, by itself, is not sufficient to preclude an item's qualifying as a liability. That is, liabilities may not require an entity to pay cash but to convey other assets, to provide or stand ready to provide services, or to use assets. And the identity of the recipient need not be known to the obligated entity before the time of settlement. Similarly, although most liabilities rest generally on a foundation of legal rights and duties, existence of a legally enforceable claim is not a prerequisite for an obligation to qualify as a liability if for other reasons the entity has the duty or responsibility to pay cash, to transfer other assets, or to provide services to another entity.

FASB Statement No. 5, Loss Contingencies

1. For the purpose of this Statement, a contingency is defined as an existing condition, situation, or set of circumstances involving uncertainty as to possible gain (hereinafter a "gain contingency") or loss[1] (hereinafter a "loss contingency") to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the acquisition of an asset or the reduction of a liability or the loss or impairment of an asset or the incurrence of a liability.

[1] The term loss is used for convenience to include many charges against income that are commonly referred to as expenses and others that are commonly referred to as losses.

2. Not all uncertainties inherent in the accounting process give rise to contingencies as that term is used in this Statement. Estimates are required in financial statements for many on-going and recurring activities of an enterprises. The mere fact that an estimate is involved does not of itself constitute the type of uncertainty referred to in the definition in paragraph 1. For example, the fact that estimates are used to allocate the known cost of a depreciable asset over the period of use by an enterprise does not make depreciation a contingency; the eventual expiration of the utility of the asset is not uncertain. Thus, depreciation of assets is not a contingency as defined in paragraph 1, nor are such matters as recurring repairs, maintenance, and overhauls, which interrelate with depreciation. Also, amounts owed for services received, such as advertising and utilities, are not contingencies even though the accrued amounts may have been estimated; there is nothing uncertain about the fact that those obligations have been incurred.

3. When a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. This Statement uses the terms *probable, reasonably possible*, and *remote* to identify three areas within that range, as follows:

   a. *Probable*. The future event or events are likely to occur.

   b. *Reasonably possible*. The chance of the future event or events occurring is more than remote but less than likely.

   c. *Remote*. The chance of the future event or events occurring is slight.

Accrual of Loss Contingencies

8. An estimated loss from a loss contingency (as defined in paragraph 1) shall be accrued by a charge to income[3] if both of the following conditions are met:

   a) Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements.[4] It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.

[3] Paragraphs 23-24 of APB Opinion No. 9, "Reporting the Results of Operations," describe the "rare" circumstances in which a prior period adjustment is appropriate. Those paragraphs are not amended by this Statement.

[4] Date of the financial statements means the end of the most recent accounting period for which financial statements are being presented.

   b) The amount of loss can be reasonably estimated.

Disclosure of Loss Contingencies

9. Disclosure of the nature of an accrual[5] made pursuant to the provisions of paragraph 8, and in some circumstances the amount accrued, may be necessary for the financial statements not to be misleading.

10. If no accrual is made for a loss contingency because one or both of the conditions in paragraph 8 are not met, or if an exposure to loss exists in excess of the amount accrued pursuant to the provisions of paragraph 8, disclosure of the contingency shall be made when there is at least a reasonable possibility that a loss or an additional loss may have been incurred.[6] The disclosure shall indicate the nature of the contingency and shall give an estimate of the possible loss or range of loss or state that such an estimate cannot be made. Disclosure is not required of a loss contingency involving an unasserted claim or assessment when there has been no manifestation by a potential claimant of an awareness of a possible claim or assessment unless it is considered probable that a claim will be asserted and there is a reasonable possibility that the outcome will be unfavorable.

[5] Terminology used shall be descriptive of the nature of the accrual (see paragraphs 57-64 of Accounting Terminology Bulletin No. 1, “Review and Resume”).

[6] For example, disclosure shall be made of any loss contingency that meets the condition in paragraph 8.a. but that is not accrued because the amount of loss cannot be reasonably estimated (paragraph 8(b)). Disclosure is also required of some loss contingencies that do not meet the condition in paragraph 8.a. - namely, those contingencies for which there is a reasonable possibility that a loss may have been incurred even though information may not indicate that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements.

FASB Interpretation No. 14, Reasonable Estimation of the Amount of Loss, An Interpretation of FASB Statement No. 5

3. When condition (a) in paragraph 8 is met with respect to a particular loss contingency and the reasonable estimate of the loss is a range, condition (b) in paragraph 8 is met and an amount shall be accrued for the loss. When some amount within the range appears at the time to be a better estimate than any other amount within the range, that amount shall be accrued. When no amount within the range is a better estimate than any other amount, however, the minimum amount in the range shall be accrued.[1] In addition, paragraph 9 of the Statement may require disclosure of the nature and, in some circumstances, the amount accrued, and paragraph 10 requires disclosure of the nature of the contingency and the additional exposure to loss if there is at least a reasonable possibility of loss in excess of the amount accrued.

[1] Even though the minimum amount in the range is not necessarily the amount of loss that will be ultimately determined, it is not likely that the ultimate loss will be less than the minimum amount.

RELEVANT LITERATURE

Statutory Accounting Practices and Procedures

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy

Generally Accepted Accounting Principles

- *FASB Statement of Accounting Concepts No. 6, Elements of Financial Statements*
- *FASB Statement No. 5, Accounting for Contingencies*
- *FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan*
- *FASB Interpretation No. 14, Reasonable Estimation of the Amount of a Loss, An Interpretation of FASB Statement No. 5*
- *FASB Interpretation No. 34*, *Disclosure of Indirect Guarantees of Indebtedness of Others, An interpretation of FASB Statement No. 5*
- *Accounting Principles Board Opinion No. 12*, *Omnibus Opinion—1967, paragraphs 2 and 3*

State Regulations

- Oregon Insurance Statutes, Title 56, Chapter 733, *Accounting and Investments*

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Statutory Issue Paper No. 6

Amounts Due From Agents and Brokers

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 6

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Some reporting entities conduct a significant amount of their business through insurance agents and brokers. For purposes of this issue paper the term agent will be used as reference to both entities. In the ordinary course of business, amounts may be due from or payable to agents by a reporting entity. Business reasons for these transactions vary between each type of entity transacting business with the reporting entity. These variations may be the result of formal contractual requirements, the nature of the insurance products being sold or the services being performed. Statutory accounting for amounts due from agents is not addressed in sufficient detail in either the Accounting Practices and Procedures Manuals for Life and Accident and Health or for Property and Casualty Insurance Companies. Additionally, interpretation and application of accounting practices dealing with amounts due from agents are inconsistent among states. This issue paper establishes a framework for the accounting and reporting of amounts due from agents and brokers (collectively referred to as "agents") that is consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

2. Amounts due from agents can result from various insurance transactions ranging from premiums collected on behalf of the reporting entity to amounts advanced to the agent by the reporting entity to finance agency operations. Premiums owed by the agent shall be reflected net of commissions, if permitted by the contract. In almost all cases these transactions result in an amount due to the reporting entity that meets the definition of an asset as set forth in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*. First, an evaluation shall be made to determine nonadmitted amounts. Next, an evaluation shall be made of such assets in accordance with *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets* (Issue Paper No. 5), to determine whether there is an impairment. This two-step process is set forth below:

a. The uncollected agent's receivable which is over ninety days due shall be accounted for as a nonadmitted asset regardless of any offsetting amount (e.g., unearned premium).

b. Remaining amounts determined to be uncollectible shall be written off: If, in accordance with Issue Paper No. 5, it is probable the agent's receivable is uncollectible, any uncollectible agent's receivable shall be written off against operations in the period such determination is made. If it is reasonably possible a portion of the balance is uncollectible and is therefore not written off, disclosure requirements outlined in Issue Paper No. 5 shall be followed.

3. Advances to agents - All such balances, which are primarily encountered in the life insurance industry, are nonadmitted if a) the amounts are in the form of unsecured loans or advances, or b) the contractual terms for repayment are through application of future renewal commissions and/or other credits, or c) the terms of repayment do not provide readily available cash for the satisfaction of policyholder liabilities.

4. The following situations provide additional guidance in determining the nonadmitted portion of agent's balances as discussed above:

a. Amounts payable to agents under the same contractual agreement - If amounts are both payable to and receivable from an agent, and the contractual agreements between the agent and the reporting entity permit offsetting, then the nonadmitted portion of amounts due from that agent should be calculated on the net balance due.

b. Amounts due from agents (affiliated or nonaffiliated) paid prior to the date of the financial statements and repaid to the agent by the reporting entity or one of the reporting entity's affiliates subsequent to the date of the financial statements - Such amounts should be accounted for in accordance with the substance of the transaction (a "wash" transaction) and not its form. Accordingly, the amounts due should be reestablished as an asset and subjected to asset collectibility and nonadmitted asset calculations using the original due date of the receivable. Short-term financing by third parties should also be considered "wash" transactions if the substance of the transaction is to avoid the nonadmitted asset principle set forth above.

c. Amounts classified as nonadmitted assets collected subsequent to date of the statutory financial statements - Such amounts shall not be used to adjust the nonadmitted asset otherwise calculated.

d. Determination of the Due Date -

i. The due date for original and deposit premiums is governed by the effective date of the underlying insurance contract and not the agent/reporting entity contractual relationship.

ii. The due date for endorsement and installment premiums is governed by the effective date of the endorsement and the contractual due date of the installment.

iii. The due date for audit premiums and retrospective premiums is governed by policy or contract provisions. If the due date for receivables relating to these policies is not addressed by policy provisions or contract provisions, any uncollected premium (either accrued or billed) is nonadmitted.

iv. These provisions are to be applied to all balances due except those arising from force placed insurance obtained by a lender for collateral protection, certain policies, known as a Trustee Sales Guarantees (TSGs), issued by title insurance companies to lenders on defaulted real estate loans and crop/hail policies. For forced placed insurance, the due date for purposes of applying paragraph 2 shall be the date of billing. For TSG policies, the due date for purposes of applying paragraph 2 shall be at the expiration of the grace period given to the defaulted debtor, which is provided by statute. Crop/hail premiums are considered installment premiums in accordance with paragraph 4.d.ii. and accordingly, the due date for purposes of applying paragraph 2 shall be governed by the contractual due date of the installment.

e. Reconciling items between a Reporting Entity's Account and Agent's Account - If such amounts are over ninety days due, the amounts shall be nonadmitted.

DISCUSSION

5. The Statement of Concepts states:

> The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which may be unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet but rather should be charged against surplus when acquired or when availability otherwise becomes questionable.

6. Based upon the above concept, agents' balances should reflect only amounts that are available to meet both current and future policyholder obligations when the obligations are due. Therefore, amounts determined to be impaired, regardless of aging, should be charged to operations. The adoption of a write-off/allowance methodology will provide a more appropriate measure of those assets available to meet policyholder obligations.

7. Under the conservatism concept of statutory accounting, premiums and other amounts collected by the agents on behalf of the reporting entity, which are over 90 days due and advances made to an agent, should be treated as nonadmitted assets and charged to surplus. In keeping with the concept of conservatism, subsequent collection of nonadmitted assets should not be considered in the determining period-end nonadmitted assets. These recoveries should be accounted for in the period received.

8. The draft discussion materials from previous Property/Casualty codification projects suggested aging of all original or renewal premiums receivable to begin as of the effective date of the policy regardless of whether the reporting entity is using a direct bill or account current system. In addition, the proposed version requires endorsement premiums and installment premiums to begin aging from the effective date of the endorsement and from the due date of the installment. An exception is provided for force placed insurance and for certain title insurance policies known as TSGs. Force placed insurance is a type of collateral protection insurance typically offered to financial institutions and other lenders that make loans secured by collateral. Coverage is obtained by the lender when the collateral securing a loan becomes uninsured by the borrower. Due to the nature of this specific type of insurance most policies or certificates are not issued, and consequently not billed, until after the effective date of coverage. As a result, the due date for purposes of paragraph 2 is the date of billing. TSGs are title insurance policies issued to lending institutions during the foreclosure process on defaulted real estate loans. TSGs are requested by the lending institution, and premium is booked by the reporting entity at the notice of default date. There is, typically by law, a grace period given to the defaulted debtor to bring the loan current. Since the premium is remitted to the reporting entity from the proceeds of the foreclosed property this grace period results in a lag period before the premium could be collected. As a result, the due date for purposes of paragraph 2 is the date at which the grace period expires.

9. Current statutory accounting for life and accident and health companies generally requires agents' balances to be nonadmitted. This is not consistent with the treatment of such balances for property and casualty companies. The majority of agents' balances for life and accident and health companies consist of advances to agents under agents' contracts. This paper does not recommend a change for these types of balances. Advances to agents under agents' contracts would follow the treatment outlined in the Summary Conclusion above. To the extent the agents' balance consists of amounts other than advances to agents under agents' contracts, the recommended treatment outlined in this paper is theoretically different from existing practice. Adoption of the principles outlined in the Summary Conclusion above for life and accident and health and property and casualty companies will provide necessary consistency without having a significant impact on the conservatism of the statutory financial statements.

Drafting Notes/Comments

- This issue paper does not address nonadmitted assets for retrospective premiums on direct or assumed business as this issue was addressed and codified by the NAIC in 1993. Current guidance is included in Chapter 22 of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies. This is addressed in a separate issue paper.
- Reinsurance premiums payable, reinsurance commissions receivable, etc., which are currently reported on the same line in the Annual Statement, are addressed in a separate issue paper.
- In preparing this paper, the following issues were identified as future potential issue paper topics:
- Right of Offset - (agent commissions, reinsurance premiums payable and receivable, etc.)
- Aging/nonadmitting of reinsurance premiums due (governed by Chapter 22)
- Premiums sold with recourse (premium finance company)
- Accounting/aging of retrospective premiums currently reported on line 9.2 or line 9.3 is addressed in a separate issue paper.
- Accounting for uncollected premium balances is addressed in *Issue Paper No. 10—Uncollected Premium Balances.*
- Accounting for bills receivable is addressed in *Issue Paper No. 21—Bills Receivable for Premiums.*
- Sale of premium receivables will be addressed in *Issue Paper No. 42—Sale of Premium Receivables*.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE:

Statutory Accounting

10. The Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 7, *Agents' Balances or Uncollected Premiums*, page 2, paragraph 2, provides the following guidance:

> To satisfy the requirements of the annual statement blank, agents' balances or uncollected premiums over three months due are nonadmitted assets. (See Chapter 9 - Nonadmitted Assets, see excerpt below.)

11. Chapter 9, *Nonadmitted Assets*, page 1, point 3, reinforces Chapter 7 by stating the following:

> Agents' Balances or Uncollected Premiums Over Three Months Due: The statutes of most states require that agents' balances or uncollected premiums over three months due be nonadmitted because of the uncertainty of collection.

12. The Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies is silent with respect to when the aging of agents' balances and uncollected premiums is to commence, however, the Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force (Emerging Accounting Issues Working Group) reached a consensus in the 89-2 session which states the following:

> Aging of Agents' Balances
>
> The issues considered were:
>
> 1. In computing the non-admitted portion of agents' balances, should an agents' account current be aged from the dates of the account current statement or from the effective dates of the individual policies billed in the statements?
>
>   The consensus of the group was that accounts current should be aged from the dates of the statements.

2. How should balances be aged when the account current system is not used?

   The balance should be aged from the effective date of the policy.

13. Chapter 9 of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies discusses the nonadmitting of certain assets as follows:

> Some examples of assets which are nonadmitted due to either an uncertainty as to their collectibility or an insufficient basis for determining their valuation or other reasons are:
>
> 1. deposits in suspended depositories;
>
> 2. agents' debit balances;
>
> 3. bills receivable which are not properly secured by collateral;
>
> 4. loans on personal security (endorsed or not) which are not properly secured by collateral;
>
> 5. cash advanced to or in the hands of officers or agents;
>
> 6. travel advances.

Generally Accepted Accounting Principles

14. GAAP accounting for agent balances or uncollectible premiums/receivables is governed by *FASB Statement No. 5, Accounting for Contingencies* (FAS 5), paragraphs 1, 3 and 8:

> 1. For the purpose of this Statement, a contingency is defined as an existing condition, situation, or set of circumstances involving uncertainty as to possible gain (hereinafter a "gain contingency") or loss[1] (hereinafter a "loss contingency") to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the acquisition of an asset or the reduction of a liability or the loss or impairment of an asset or the incurrence of a liability.
>
> [1] The term loss is used for convenience to include many charges against income that are commonly referred to as expenses and others that are commonly referred to as losses.
>
> 3. When a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. This Statement uses the terms probable, reasonably possible, and remote to identify three areas within that range, as follows:
>
>   a) Probable. The future event or events are likely to occur.
>
>   b) Reasonably possible. The chance of the future event or events occurring is more than remote but less than likely.
>
>   c) Remote. The chance of the future event or events occurring is slight.
>
> 8. An estimated loss from a loss contingency (as defined in paragraph 1) shall be accrued by a charge to income[3] if both of the following conditions are met:
>
>   a) Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements.[4] It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.

b) The amount of loss can be reasonably estimated.

[3] Paragraphs 23-24 of *APB Opinion No. 9*, “Reporting the Results of Operations,” describe the “rare” circumstances in which a prior period adjustment is appropriate. Those paragraphs are not amended by this statement.

[4] Date of the financial statements means the end of the most recent accounting period for which financial statements are being presented.

15. The FAS 5 criteria above, is used in interpreting information such as historical trending and general information about the stability of the agents\insured in an effort to evaluate the adequacy of a premium receivable allowance. Accounting for contingencies is discussed in more detail in Issue Paper No. 5.

16. GAAP accounting requires the aging of agents’ balances or uncollected premiums to begin from the effective date of the policy. Aging for endorsement premiums should begin from the endorsement’s effective date and installment premiums should begin from the installment’s due date. Although not specifically stated, this guidance can be deduced through review of *FASB Statement of Financial Accounting Concepts No. 5*, *Recognition and Measurement in Financial Statements of Business Enterprises*, paragraph 83, as follows:

> 83. Further guidance for recognition of revenues and gains is intended to provide an acceptable level of assurance of the existence and amounts of revenues and gains before they are recognized. Revenues and gains of an enterprise during a period are generally measured by the exchange values of the assets (goods or services) or liabilities involved, and recognition involves consideration of two factors (a) being realized or realizable and (b) being earned, with sometimes one and sometimes the other being the more important consideration.
>
> a. Realized or realizable. Revenues and gains generally are not recognized until realized or realizable.[50]Revenues and gains are realized when products (goods or services), merchandise, or other assets are exchanged for cash or claims to cash. Revenues and gains are realizable when related assets received or held are readily convertible to known amounts of cash or claims to cash. Readily convertible assets have (i) interchangeable (fungible) units and (ii) quoted prices available in an active market that can rapidly absorb the quantity held by the entity without significantly affecting the price.
>
> b. Earned. Revenues are not recognized until earned. An entity's revenue earning activities involve delivering or producing goods, rendering services, or other activities that constitute its ongoing major or central operations,[51] and revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues. Gains commonly result from transactions and other events that involve no “earning process,” and for recognizing gains, being earned is generally less significant than being realized or realizable.

[50] The terms realized and realizable are used in the Boards conceptual framework in precise scenes, focusing on conversion or convertibility of noncash assets into cash or claims to cash (Concepts Statement 3, par. 83). Realized has sometimes been used in a different, broader sense: for example, some have used that term to include realizable or to include certain conversions of noncash assets into other assets that are also not cash or claims to cash. APB Statement 4, paragraphs 148-153, used the term realization even more broadly as a synonym for recognition.

[51]"Most types of revenue are the joint result of many profit-directed activities of an enterprise and revenue is often described as being 'earned' gradually and continuously by the whole of enterprise activities. Earning in this sense is a technical term that refers to the activities that give rise to the revenue-purchasing, manufacturing, selling, rendering service, delivering goods, allowing other entities to use enterprise assets, the occurrence of an event specified in a contract, and so forth. All of the profit-directed activities of an enterprise that comprise the process by which revenue is earned may be called the earning process" (APB Statement 4, par. 149). Concepts Statement 3, paragraph 64, footnote 31, contains the same concept.

17. The renewal or establishment of an insurance policy in exchange for a claim to cash (premium receivable) triggers the realization characteristic of revenue recognition, therefore, the aging of the agents' balance or uncollected premium should commence on the effective date of the new or renewed policy. Endorsement premiums will trigger the realization characteristic on the effective date of the endorsement, while installment premiums will trigger the realization characteristic on the due date of the installment.

18. Although the realization characteristic of revenue recognition may have been triggered, the more important characteristic of earned may not have been, hence, the recording of an unearned premium.

19. *FASB Statement No. 60*, *Accounting and Reporting by Insurance Enterprises* (FAS 60), also provides some indirect guidance. FAS 60, paragraph 13, requires revenue on short-duration contracts to be recognized over the period of the contract in proportion to the amount of insurance protection provided. The contract period starts with the policy effective date. Therefore, it is reasonable to begin aging from the policy effective date as this is the date when revenue recognition begins.

OTHER SOURCES OF INFORMATION

20. The draft discussion materials from previous Property/Casualty codification projects proposed extensive modifications to the accounting for agents' balances and uncollected premiums. The following represents a summary of those modifications:

> When the original or deposit premium are more than ninety days past due based on an aging referenced to effective date and therefore, not admitted, all premiums subsequently charged on the same policies or bonds are similarly not admitted, except that if the amount of such original or deposit premiums does not exceed 20% of the subsequently charged premiums in the same policies of bonds, such subsequently charged premiums, if otherwise not themselves more than ninety days overdue, shall be allowed as admitted assets.

21. The same basic concept was also discussed for endorsement premiums and installment premiums. In addition, this version discussed certain parameters where a greater than ninety day nonadmitted premium could be accounted for as an admitted asset. The modification was stated as follows:

> A premium which has been determined to be not admitted may be treated as admitted if it has been collected within forty-five days of the date of determination and not more than ninety days had elapsed from the billing date to the date of determination and further, that not more than one hundred thirty-five days had elapsed from the effective date of the premium to the date of determination.

22. The draft discussion materials from previous Property/Casualty codification projects contradicted the Emerging Accounting Issues Working Group's consensus by proposing the following:

> Original or deposit premiums
>
> > Aging is always based on the effective date of the policy or bond regardless of whether the insurer is using a direct billing system or an account current system.

Endorsement

Aging is always based on the effective dates of the endorsements.

Installments

Aging is always based on the due date of the installment.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapters 7 & 9
- NAIC Annual Statement Instructions for Property and Casualty Insurance Companies
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 9
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*

Generally Accepted Accounting Principles

- *FASB Statement No. 5, Accounting for Contingencies*
- *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises*
- *FASB Statement of Financial Accounting Concepts No. 5, Recognition and Measurement in Financial Statements of Business Enterprises*

State Regulations

- State regulations contain numerous references to amounts due from agents and brokers. Due to the volume, specific references to each state regulation has not been reproduced in this issue paper.

Other Sources of Information

- Draft discussion materials from previous Property/Casualty codification projects
- NAIC Technical Resource Group Proposed Draft Life Codification, Chapter 9

Statutory Issue Paper No. 7

Asset Valuation Reserve and Interest Maintenance Reserve

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 7

Type of Issue:
Life and Accident and Health Insurance Companies

SUMMARY OF ISSUE

1. Current statutory accounting guidance requires life and accident and health insurance companies to recognize liabilities for an asset valuation reserve (AVR) and an interest maintenance reserve (IMR). There is no such requirement for property and casualty insurance companies. The AVR is intended to establish a reserve to offset potential credit-related investment losses on all invested asset categories excluding cash, policy loans, premium notes, collateral notes and income receivable. The IMR captures the realized capital gains and losses resulting from changes in the general level of interest rates. These gains and losses are to be amortized into investment income over the expected remaining life of the investments sold. The IMR also applies to certain liability gains/losses related to changes in interest rates. These gains and losses are to be amortized into investment income over the expected remaining life of the liability released.

2. The purpose of this issue paper is to establish statutory accounting principles for AVR and IMR that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

3. The IMR and AVR shall be calculated and reported in accordance with Section 6. Interest Maintenance Reserve and Asset Valuation Reserve for Life Insurance Companies and Fraternal Benefit Societies of the Purposes and Procedures of the Securities Valuation Office of the NAIC (*Purposes and Procedures Manual of the NAIC Securities Valuation Office*).

DISCUSSION

4. This issue paper adopts current statutory guidance for AVR and IMR for Life and Accident and Health insurance companies.

5. This issue paper rejects paragraph 28 (subtitled, Reporting of Realized Investment Gains and Losses of Investments) of *FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments* (FAS 97), as amended by *FASB Statement No. 115*, *Accounting for Certain Investments in Debt and Equity Securities* (FAS 115), for Life and Accident and Health Insurance Companies.

6. As stated in the draft discussion material from previous Life Codification projects, Chapter 16B, *Asset Valuation Reserve, "The purpose of the AVR is to establish a provision for the volatile incidence of asset losses and recognize appropriately the long term return expectations for equity type investments. The AVR provides a mechanism to absorb unrealized and credit-related realized gains and losses on all invested asset categories excluding cash, policy loans, premium notes, collateral notes and income receivable."*

7. Chapter 16 A *Interest Maintenance Reserve*, in the draft discussion material from previous Life Codification projects states, “The purpose of the IMR is to protect surplus from investment transactions that are entered into as a reaction to interest rate movements. The IMR minimizes the effect that realized gains and losses attributable to interest rate movement have on current year operations by deferring and amortizing such capital gains and losses, net of tax, over the approximate remaining life of the investments sold.” These reserves serve to stabilize statutory surplus against fluctuations in the market value of securities and provide an extra layer of protection for policyholders. Furthermore, gains trading (i.e., selectively selling securities to include realized gains in earnings) opportunities are reduced by reporting an IMR. This is consistent with the Conservatism concept included in the Statement of Concepts, which states, “valuation procedures should, to the extent possible, prevent sharp fluctuations in surplus.”

8. The accounting policy to record AVR and IMR also is consistent with the “*ultimate objective of solvency regulations*” as stated in the Statement of Concepts. This states, “*the ultimate objective of solvency regulation is to ensure that policyholder, contract holder and other legal obligations are met when they come due and that companies maintain capital and surplus at all times and in such forms as required by statute to provide an adequate margin of safety.”*

9. Because AVR and IMR only pertain to life and accident and health insurance companies, there is a difference in how Life and Accident and Health Insurance Companies and how Property and Casualty Insurance Companies account for investments. Property and Casualty Insurance Companies are required to record bonds and preferred stock with a NAIC designation of 3 through 6 at the lower of amortized cost or market. This provides a conservative measure of such securities in accordance with the conservatism concept in the Statement of Concepts.

Drafting Notes/Comments

- Realized gains and losses for insurers not maintaining an IMR are addressed in specific invested asset issue papers.
- This issue paper references the *Purposes and Procedures Manual of the NAIC Securities Valuation Office*. The guidance for AVR/IMR was subsequently moved to the Annual Statement Instructions for Life and Accident and Health Insurance Companies. SSAP No. 7 references the Annual Statement Instructions.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

10. Chapter 16, *Asset Valuation Reserve and Interest Maintenance Reserve*, in the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies states the instructions for calculating the AVR and IMR are contained in the *Purposes and Procedures Manual of the NAIC Securities Valuation Office*.

11. Section 6. Interest Maintenance Reserve and Asset Valuation Reserve for Life Insurance Companies and Fraternal Benefit Societies of the Purposes and Procedures of the Securities Valuation Office of the NAIC contains the following excerpts (note that this is not quoted in its entirety):

> This Section applies to all life insurance companies and fraternal benefit societies. The Section describes in general terms, principles of the calculation for Interest Maintenance Reserve (IMR) for realized gains and losses from fixed income investments and the Asset Valuation Reserve (AVR) on all invested assets held by a company. [Refer to the NAIC’s Life and Health Annual Statement Instructions published July 28, 1994 for specific accounting and reporting guidance.] The IMR is a single component reserve. The AVR breaks down into two major components and each component has two subcomponents:

The Default Component--

(i) The Bond and Preferred Stock Subcomponent
(ii) The Mortgage Subcomponent

The Equity Component--

(i) The Common Stock Subcomponent
(ii) The Real Estate and Other Invested Assets Subcomponent

(A) **Interest Maintenance Reserve (IMR)**. This reserve applies to realized capital gains and losses net of tax on short-term and long-term fixed income investments. These gains and losses are from the disposal of investments as reported in Schedule D, Part 4 for long-term bonds and preferred stock; Schedule DA, short-term bonds; Schedule DB, interest rate hedges; Schedule B, mortgage loans; or Schedule BA for other fixed income investments. The reserve captures the realized capital gains and losses resulting from changes in the general level of interest rates. These gains and losses are to be amortized into investment income over the expected remaining life of the investments sold. The IMR also applies to certain liability gains/losses related to changes in interest rates. These gains and losses are to be amortized into investment income over the expected remaining life of the liability released.

The current year's IMR is equal to:

The beginning balance
plus (minus) the realized capital gains (losses) net of tax attributed to interest rate changes
plus (minus) realized liability gains (losses) net of tax attributed to interest rate changes
less an amortization amount

(a) Interest Related Realized Capital Gains and Losses:

The gains and losses are to be reported net of applicable capital gains taxes allocated in accordance with an insurers established policy.

A realized gain or loss on each debt security and mortgage backed security will be an interest related gain or loss if the debt security's beginning NAIC rating did not change by more than one classification at the end of the holding period. The holding period is defined as the period from the date of purchase to the date of sale. For debt securities acquired before January 1, 1991, the debt security's rating as of December 31, 1990 should be the beginning rating used for this purpose. A debt security's gain or loss should not be included in this reserve if the debt security rating was ever a "6" during the holding period.

Preferred stock that did not have an NAIC/SVO rating classification of "PSF-4", "PSF-5", "PSF-6" or "P-4", "P-5" or "P-6" at any time during the holding period should be reported as interest related gains and (losses) in the Interest Maintenance Reserve if the stock's beginning NAIC/SVO rating did not change by more than one classification at the end of the holding period.

For preferred stocks acquired before January 1, 1993, the holding period is assumed to have begun in December 31, 1992.

Losses recognized on loan-backed bonds and other structured securities that have a negative effective yield at the date of valuation should be treated as realized losses and included in the reserve as if the security had been sold and the loss considered an interest rate loss. If the security is valued using the prospective adjustment methodology, a negative effective yield occurs when the net undiscounted sum of anticipated future cash flows of the security is less than the current book value of the security at the date of valuation. If the security is valued using the retrospective adjustment methodology, a negative effective yield occurs when the net undiscounted sum of actual and anticipated cash flows is less than the original cost of the investment.

Capital gains and losses net of capital gains tax on mortgage loans, where interest is not more than 90 days past due, not in process of foreclosure, not in course of voluntary conveyance, or have not had restructured terms over the prior two years will be classified as an interest rate gain or loss. Prepayment penalties recorded as capital gains on mortgage securities are also considered to be due to interest rate changes.

Capital gains or (losses) due to interest rate changes on fixed income investments with less than one year to expected maturity should be captured in the IMR. Gains or (losses), net of capital gains tax, in the remaining categories are amortized according to the Group Amortization Schedule Section 6(B)(j) or the seriatim method.

Realized gains and losses on fixed income investments recorded on Schedule BA should be classified as an interest gain or loss if they are in the nature of those defined for bonds, preferred stocks and mortgages.

Realized gains and losses, net of capital gains tax, on derivative investments arising out of transactions entered into solely for the purpose of altering the interest rate characteristics of the company's assets and/or liabilities should be allocated to the IMR and amortized into income over the remaining life of the assets or liabilities associated with the derivative instruments.

(b) Liability gains/(losses) Subject to IMR Amortization

1) Reinsurance -

The interest rate related gain or loss (net of taxes) associated with the sale, transfer or reinsurance of a block of liabilities must be credited or charged to the IMR and then amortized into income provided:

1. the portion of the block reinsured represents more than 5% of a company's general account liabilities (Page 3, Line 26),

2. the transaction is irrevocable and is to a non-affiliate and

3. the transaction was completed in the current year.

The amount of the gain or loss that is interest rate related and its IMR amortization should be determined using the following procedure for the portion of the block sold, transferred or reinsured.

1. Identify the IMR balance and future amortization arising from the past and present dispositions of the assets associated with the block of liabilities.

2. Identify the IMR balance and future amortization that would result if the remaining assets associated with the block of liabilities were to be sold.

3. Define the interest rate related gain or (loss) net of taxes to be the negative of the sum of the IMR balances determined in steps 1 and 2. The future amortization of the gain or loss is the negative of the sum of the amortization determined in steps 1 and 2.

The associated assets are the assets allocable to the reinsured block of business for the purposes of investment income allocation. If the company has not been tracking the investment income of the block, it should retrospectively identify the assets using procedures consistent with its usual investment income allocation procedures. The associated assets are not necessarily the same as the assets transferred as part of the transaction.

2) Market Value Adjustments

Material gains or losses resulting from market value adjustments on policies and contracts backed by assets that are valued at book, including the marginal tax impact, should be captured by the IMR and amortized in the same manner as capital gains and losses on fixed income investments. A gain or loss is considered material if it is in excess of both .01% of liabilities and $1,000,000. The amortization schedules should be determined in a manner consistent with the determination of associated market value adjustment.

(d) Amortization into income:

There are two acceptable methods for accumulating and calculating the amortization schedule:

1. Seriatim Method— The amount of each capital gain or (loss), net of capital gains tax, amortized in a given year using the seriatim method is the excess of the amount of income that would have been reported in that year, had the asset not been disposed of, over the amount of income that would have been reported had the asset been repurchased at its sale price. The capital gains tax associated with or allocated to each gain or (loss) should be amortized in proportion to the amortization of the gain or (loss).

For loan-backed bonds and structured securities that are valued using currently anticipated prepayments use an amortization schedule developed using the anticipated future cash flows of the security sold consistent with the prepayment assumptions that would have been used to value the security had the security been purchased at its sale price.

For the year ending December 31, 1994, only loan-backed and structured securities that meet the following definition are required to be valued using currently anticipated prepayments:

Loan-backed and structured securities that have potential for loss of a significant portion of the original investment due to changes in interest rates or the prepayment rate of the underlying loans supporting the security. These securities should include, but are not limited to, interest-only structured securities and structured securities purchased at a significant premium over par value.

The seriatim calculation on an asset by asset basis is the desired approach, but since a seriatim approach may impose an administrative burden on some companies, each company may use the method employed by that company to amortize interest related capital gains and losses among lines of business and policyholders in accordance with the investment income allocation process as approved by the state insurance department.

2. Grouped Method— A company may use a standard “simplified method” by which the capital gains and (losses), net of capital gains tax, are grouped according to the number of calendar years to expected maturity.

The groupings are based on the years to expected maturity as of the date of sale.

a. less than 1 calendar year to expected maturity
b. 1 to 5 calendar years to expected maturity
c. 6 to 10 calendar years to expected maturity

d. 11 to 15 calendar years to expected maturity
e. 16 to 20 calendar years to expected maturity
f. 21 to 25 calendar years to expected maturity
g. over 25 calendar years to expected maturity.

The amortization schedule for the current year is the sum of the gains and losses by maturity groupings times the appropriate factor for the current and future years. The maturity groupings and factors are found in 6(B)(j).

The presence of sinking fund payments, amortization schedules, expected prepayments, and adjustable interest rates complicate the determination of the number of calendar years to expected maturity. The expected maturity date is:

For fixed income instruments with fixed contractual repayment dates and amounts (including bonds, preferred stock, callable or convertible bonds and preferreds), the expected maturity is defined as the contractual retirement date that produces the lowest amortization value for Annual Statement purposes (lowest internal rate of return or “yield to worst”). Potential retirement dates include all possible call dates, and the contractual maturity date. When the instrument’s contractual terms include scheduled sinking fund payments of fixed amounts, an additional calculation of yield to average life should be included in the analysis where average life is defined as the date at which the instrument is 50% repaid. For puttable instruments, where the exercise option rests with the investor, expected maturity is the put or maturity date that produces the highest internal rate of return. For perpetual instruments, the expected maturity is 30 years from the current date.

However, where a callable bond purchased at a premium is called or sold after the expected maturity date, there should be no amortization of the call premium or interest rate related gain or loss and the gain or loss should be taken into income immediately. Similarly there should be no amortization of any interest rate related gain or loss arising if a convertible bond or preferred stock is disposed of after the expected maturity date.

For liability gains and losses included in the IMR, amortization should be determined in a manner consistent with the determination of associated market value adjustment or assets transferred.

“Calendar years to expected maturity” means the calendar year of expected maturity minus the calendar year of sale date.

For purposes of the grouped method, the following additional assumptions are applicable:

- For fixed income investments, other than residential mortgages and residential mortgage pass-throughs, without a maturity date or sinking fund schedule, a maturity date 30 years from the current year should be used.

- For loan-backed bonds and other structured securities that are valued using currently anticipated prepayments use the remaining weighted average life of principal and interest payments consistent with the prepayment assumptions that would have been used to value the security had the security been repurchased at its sale price.

- For the year ending December 31, 1994, only loan-backed and structured securities that meet the following definition are required to be valued using currently anticipated prepayments:

  Loan-backed and structured securities that have potential for loss of a significant portion of the original investment due to changes in interest rates or the prepayment rate of the underlying loans supporting the security. These securities should include, but are not limited to, interest-only structured securities and structured securities purchased at a significant premium over pay value.

- For residential mortgages and residential mortgage pass-throughs other than Real Estate Mortgage Investment Conduits (REMICs), not valued using currently anticipated prepayments, the number of calendar years to expected maturity is defined to be one half of the number of calendar years to final maturity.

- For REMICs and other asset backed investments not valued using currently anticipated prepayments, purchased at the time of original issuance, the calendar year of expected maturity is the calendar year of issue plus the weighted average life (rounded to the nearest whole number) as stated in the Offering Circular, using the prepayment assumption stated in the Circular to be used for Federal Income Taxation.

- For REMICs and other asset-backed investments not valued using currently anticipated prepayments, purchased after the original issuance, it is permissible for the Company to re-compute the weighted average life of the investment based on the same prepayment assumptions used to compute the purchase price, provided that this re-computation is done in a consistent manner for all similar asset-backed investments.

(e) Separate Accounts

Interest Maintenance Reserve (IMR) requirements for investments reported in the separate accounts statement are applied on an account by account basis. If an IMR is required for a separate account, all of the investments in the separate account are subject to the requirement. If an IMR is not required for a separate account, none of the investments in that separate account are subject to the requirement.

An IMR is required for separate accounts valued at book, but is not required for separate accounts valued at market. For example, separate accounts for traditional variable annuities, or variable life insurance do not require an IMR because assets and liabilities are valued at market.

If an IMR is required for investments in the separate accounts statement, it is kept separate from the general accounts IMR and accounted for in the separate accounts statement. For further details see rules as explained in Sec (6) (A) (f).

(f) Negative IMR

A negative IMR balance may be recorded as a negative liability in either the general account or the separate accounts statements of a company only to the extent that it is covered or offset by a positive IMR liability in the other statement.

The following information is presented to assist in determining the proper accounting:

General Account IMR Balance	Separate Accounting IMR Balance	Net IMR Balance
Positive	Positive	Positive (See rule a)
Negative	Negative	Negative (See rule b)
Positive	Negative	Positive (See rule c)
Positive	Negative	Negative (See rule d)
Negative	Positive	Positive (See rule e)
Negative	Positive	Negative (See rule f)

Rules:

a) If both balances are positive, then report each as a liability in its respective statement.

b) If both balances are negative, then no portion of the negative balances is allowable as a negative liability in either statement. Report a zero for the IMR liability in each statement. If there is any disallowed negative IMR balance in the general account statement, record the disallowed portion as a positive amount for Disallowed IMR in a write-in line for assets not admitted in Exhibit 14. If there is any disallowed negative IMR balance in the separate accounts statement, determine the change in the disallowed portion and make a direct charge or credit to the surplus account for the Change in Disallowed IMR.

c) If the general account balance is positive, the separate accounts balance is negative and the combined net balance is positive, then all of the negative IMR balance is allowable as a negative liability in the separate accounts statement.

d) If the general account balance is positive, the separate account balance is negative, and the combined net balance is negative, then the negative amount not covered by the positive amount is not allowable. Report only the allowable portion as a negative liability in the separate accounts statement, and follow the instructions in b) above for handling the disallowed portion of negative IMR balances in the separate accounts statement.

e) If the general account balances is negative, the separate account balance is positive, and the combined net balance is positive, then all of the negative IMR balance is allowable as a negative liability in the general account statement.

f) If the general account balance is negative, the separate account balance is positive, and the combined net balance is negative, the negative amount not covered by the positive amount is not allowable. Report only the allowable portion as a negative liability in the general account statement, and follow the instructions in b) above for handling the disallowed portion of negative IMR balances in the general account statement.

(B) **Asset Valuation Reserve (AVR)**. This reserve shall apply to the specific risk characteristics of all the invested asset categories excluding cash, policy loans, premium notes, collateral loans and income receivables. The specific assets to be included in each subcomponent are:

The Default Component

The Bond and Preferred Stock Component shall include all fixed income investments that are corporate or governmental unit obligations, excepting those listed in subsection (g) as exempt from the AVR reserve, preferred stock and loan backed securities as reported in Schedule D, Part 1 and Part 2--Section 1 and Schedule DA, and counterparty exposure arising from derivative transactions as reported in Schedule DB, Part E, Section 1.

The Mortgage Subcomponent shall include all farm, commercial, residential mortgages as reported in Schedule B and Schedule DA.

The Equity Component

The Common Stock Subcomponent shall include all affiliated and unaffiliated common stock investments as reported in Schedule D, Part 2--Section 2.

The Real Estate and Other Invested Asset Subcomponent shall include all real estate reported on Schedule A and all Other Invested Assets as reported on Schedule BA and DA.

(a) Calculation of the AVR:

The current year’s AVR by subcomponent is equal to:

The beginning balance
plus (minus) the realized capital gains (losses) net of tax as allocated by the company on assets corresponding to the subcomponent
plus (minus) unrealized capital gains (losses) on assets corresponding to the subcomponent
plus (minus) transfers between components
plus an annual contribution
plus any voluntary contribution
plus (minus) an adjustment up to zero or down to maximum.

(b) Realized Capital Gains and Losses:

Report all realized credit-related (default) and equity capital gains and (losses), net of capital gains tax applicable to the assets in each component and subcomponent including those realized capital gains and (losses) that are incurred on Separate Accounts assets for which AVR treatment is required. Exclude all interest rate related capital gains and (losses) from the AVR.

A realized gain or loss on a debt security will be a credit related gain or loss if the debt security's beginning NAIC/SVO rating changed by more than one classification at the end of the holding period. The holding period is defined as the period from the date of purchase to the date of sale. For debt securities acquired before January 1, 1991 the debt securities rating as of December 31, 1990 should be the beginning rating used for this purpose. A debt security gain or loss should always be included in this reserve if the bond rating was ever a "6" during the holding period.

Preferred stock that had an NAIC/SVO rating classification of "PSF-4", "PSF-5", "PSF-6", "P-4", "P-5" or "P-6" at any time during the holding period shall be reported as credit related gains and (losses) in the Asset Valuation Reserve.

For preferred stocks acquired before January 1, 1993 the holding period is presumed to have begun on December 31, 1992.

In addition, all gains or losses, net of capital gains taxes, on mortgage loans, where interest is more than 90 days past due, in the process of foreclosure in course of voluntary conveyance, or have had restructured terms over the prior two years, would be classified as credit related gains or losses. Permanent impairment writedowns are also treated as credit losses.

Realized gains or losses net of capital gains tax on portfolio or general hedging instruments should be included with the hedged assets. Gains or losses net of capital gains tax on hedges used as specific hedges should be included only if the specific hedged asset is sold or disposed.

Realized gains or losses on derivative instruments not accounted for as specific (as opposed to general) hedge transactions should be allocated to the component and subcomponent of the assets associated with the derivative instruments used in the general hedge.

Realized gains or losses, net of capital gains resulting from the sale of U.S. Government Securities and the direct or guaranteed securities of agencies which are backed by the full faith and credit of the U.S. Government are exempt from the AVR. This category is detailed in Section 6(B)(g)(i).

The gains or (losses) are to be reported net of applicable capital gains taxes as allocated by the company.

(c) Unrealized Capital Gains and Losses:

Unrealized gains and losses should be summarized by subcomponent asset type and included in the reserve computation including those unrealized capital gains and (losses) that are incurred on Separate Account assets for which AVR treatment is required. The equity method of accounting is allowed in accounting for the operating results of subsidiary, controlled or affiliated companies. If the equity accounting method is used, the amount of the undistributed income or loss reported in Exhibit 2 of the Annual Statement less the amount of any dividends received is to be included as an unrealized capital gain or loss when computing the Common Stock Subcomponent. Unrealized gains and (losses) for Affiliated Life Insurance Companies which are maintaining their own AVR are excluded since the maximum reserve factor for such companies is 0%.

Unrealized gains or losses on derivative instruments not accounted for as hedging transactions should be allocated to the component and subcomponent of the assets associated with the derivative instruments.

(d) Transfers Between Components:

If the sum of a subcomponent’s beginning balance, realized gains and losses and unrealized gains and losses is greater than the ending maximum of the subcomponent, and the balance of its sister subcomponent is below its maximum reserve, the excess must be transferred to the other subcomponent of the Default or Equity components up to that subcomponent’s maximum.

If after the above transfers, the Equity or Default component is greater than total maximum for the component, the excess may be transferred to the other component or may be released to surplus.

If the balance before transfers of any of the four sub-components is negative, and the balance before transfers of its “sister” subcomponent within the same component is positive, the negative amount should be transferred to the “sister” sub-component to the extent that the transfer does not reduce the positive balance before transfers of the “sister” sub-component to less than 50% of its balance prior to the transfer.

No other transfers may be made without Commissioner approval.

(e) Annual Contribution:

The formula for the annual contribution to a subcomponent is as follows:

The amortization rate times the subcomponent maximum amount minus the accumulated balance. (Accumulated balance is shown on Page 49, Line 6 of the Annual Statement).

(f) Contribution Rate:

The contribution rate is 20% per year.

(h) Voluntary Contribution to the Reserves:

Companies may make voluntary contributions to the subcomponents. Voluntary contributions will become a permanent part of the AVR once they have been reported and may not be removed in subsequent years.

12. Most state regulations refer to the literature of the NAIC for guidance on the calculation of AVR and IMR. An example is the Texas Administration Code, Title 28 - Insurance, Chapter 7, *Corporate and Finance*, which states:

> (4) Asset valuation reserve (AVR) -- A reserve applied to the specific risk characteristics of all the invested asset categories except cash, policy loans, premium notes, collateral loans, and income receivables. Asset valuation reserves shall be calculated as prescribed by the NAIC and adopted from time to time by the State Board of Insurance under the Texas Administrative Code, Title 28, Chapter 7.
>
> (12) Interest maintenance reserve (IMR) -- A reserve applied to realized capital gains and losses on short-term and long-term fixed investments. These gains and losses are from the disposal of investments as reported in Schedule D, part 1 -- Bonds, or Schedule B -- Mortgage Loans of the current annual statement. The reserve captures the realized capital gains and losses resulting from changes in the general level of interest rates as prescribed by the NAIC and adopted from time to time by the State Board of Insurance under the Texas Administrative Code, Title 28, Chapter 7.

Generally Accepted Accounting Principles

13. AVR and IMR are not addressed in current GAAP literature.

14. Paragraph 28 of FAS 97, as amended by FAS 115, addresses the GAAP accounting for realized gains and losses. It states:

> Reporting of Realized Investment Gains and Losses of Investments
>
> 28. Statement 60 required that insurance enterprises report realized gains and losses in the statement of earnings below operating earnings and net of applicable income taxes. This Statement precludes that practice. Realized gains and losses shall be reported in the statement of earnings as a component of other income, on a pretax basis, and shall not be deferred to future periods either directly or indirectly. The first sentence of paragraph 50 of Statement 60 is superseded by the following: Realized gains and losses on all investments (except investments that are classified as trading securities and those that are accounted for as hedges as described in FASB Statements No. 52, Foreign Currency Translation, and No. 80, Accounting for Futures Contracts) shall be reported in the statement of earnings as a component of other income, on a pretax basis. Realized gains and losses shall be presented as a separate item in the statement of earnings or disclosed in the notes to the financial statements. Realized gains and losses shall not be deferred, either directly or indirectly.

OTHER SOURCES OF INFORMATION

15. The draft discussion material from previous Life Codification projects contains the following excerpts:

> Chapter 16A - Interest Maintenance Reserve
>
> All U.S. life insurance companies and fraternal benefit societies are required to establish an Interest Maintenance Reserve (IMR) for realized gains and losses resulting from changes in the overall level of interest rates on fixed income investments. The IMR is calculated in accordance with instructions promulgated by the Valuation of Securities (EX4) Task Force of the National Association of Insurance Commissioners and contained in the Life Accident and Health Annual Statement Instructions and the Valuation of Securities manual. Because the instructions for the calculation of the IMR are periodically revised, the current publications should be consulted.
>
> The purpose of the IMR is to protect surplus from investment transactions that are entered into as a reaction to interest rate movements. The IMR minimizes the effect that realized capital gains and losses attributable to interest rate movement have on current year operations by deferring and amortizing such capital gains and losses, net of tax, over the approximate remaining life of the investments sold. The IMR applies to realized capital gains and losses, net of tax, on short-term and long-term fixed income securities, including bonds, notes, preferred stock and mortgages.

Chapter 16B - Asset Valuation Reserve

All U.S. life insurance companies and fraternal benefit societies must include as a liability in their statutory financial statement an Asset Valuation Reserve (AVR) on fixed income and equity investments. The AVR is calculated in accordance with instructions promulgated by the Valuation of Securities (EX4) Task Force of the National Association of Insurance Commissioners and contained in the Life, Accident and Health Annual Statement Instructions and the Valuation of Securities manual. Because the instructions for the calculation of the AVR are periodically revised, the current publications should be consulted.

The purpose of the AVR is to establish a provision for the volatile incidence of asset losses and recognize appropriately the long term return expectations for equity type investments. The AVR provides a mechanism to absorb unrealized and credit-related realized gains and losses on all invested asset categories excluding cash, policy loans, premium notes, collateral notes and income receivable.

The AVR contains two components, default and equity, each designed to address specific asset risk areas. The default component is further divided into the bond and preferred stock subcomponent and the mortgage subcomponent; the equity component is comprised of the common stock subcomponent and the real estate and other invested asset subcomponent. Increases or decreases to the reserve are charged or credited directly to surplus. The AVR is limited to maximums by subcomponent, and no subcomponent of the AVR may be less than zero. Transfers between subcomponents or between components may be required or may be allowed without commissioner approval when negative or certain maximum subcomponent balances occur.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *Purposes and Procedures Manual of the NAIC Securities Valuation Office*, Section 6. Interest Maintenance Reserve and Asset Valuation Reserve for Life Insurance Companies and Fraternal Benefit Societies
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 16, *Asset Valuation Reserve and Interest Maintenance Reserve*

Generally Accepted Accounting Principles

- *FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*
- *FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities*

State Regulations

- Texas Administration Code, Title 28 - Insurance, Chapter 7, *Corporate and Finance*

Other Sources of Information

- Draft discussion material from previous Life Codification projects, Chapter 16A, *Interest Maintenance Reserve*, and Chapter 16B, *Asset Valuation Reserve*

Statutory Issue Paper No. 8

Accounting for Pensions

STATUS
Finalized December 6, 1999

Current Authoritative Guidance for Pensions: SSAP No. 102
This issue paper may not be directly related to the current authoritative statement.

Original SSAP from Issue Paper: SSAP No. 8

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. The current Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies do not address employers' accounting for pension plans. However, a position paper was prepared by the Study Group of EX4 on Accounting for Insurance Company-Funded Pensions and was adopted by the NAIC. The adopted position does not mandate a specific accounting method but calls for expanded disclosures with regard to pension accounting and is documented in the September 15, 1987 Accounting Practices and Procedures (EX4) Task Force minutes. Under this existing guidance, reporting entities have the option of continuing to recognize pension costs on the pay-as-you-go (Employee Retirement Income Security Act funding) method or adopting the provisions of *FASB Statement No. 87*, *Employers' Accounting for Pensions* (FAS 87), which requires recognition of pension costs over the period a participant renders service to the reporting entity and recognition of a liability for unfunded costs.

2. FAS 87 requires recognition of pension costs over the period a participant renders service to the reporting entity and recognition of a liability for unfunded costs. It also permits the recognition of an asset when the pension plan is over funded (i.e., plan assets exceed plan liabilities). *FASB Statement No. 88, Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits* (FAS 88), requires recognition of previously unrecognized amounts when a reporting entity settles or curtails a defined benefit plan or provides benefits in connection with the termination of an employee. *FASB Statement No. 132, Employers' Disclosures about Pensions and Other Postretirement Benefits* (FAS 132), specifies disclosure requirements for pension and other postretirement benefit plans.

3. The purpose of this issue paper is to establish statutory accounting principles for an employer's pension obligations that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

Defined Benefit Plans

4. A defined benefit plan defines the amount of the pension benefit that will be provided to the plan participant at retirement or termination. For such benefit plans, reporting entities shall adopt FAS 87 with a modification to exclude non-vested employees. Therefore, the cost related to services rendered prior to becoming eligible and vested in the plan are recognized as a component of the net periodic pension cost in the period the employee becomes vested. Any intangible asset or prepaid expense resulting from adoption of the provisions of this issue paper shall be considered a nonadmitted asset, as such an asset cannot be readily converted to cash to satisfy policyholder obligations. This is consistent with the

definition of assets and nonadmitted assets set forth in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*.

5. If a reporting entity settles or curtails a defined benefit plan, the reporting entity shall immediately recognize all previously unrecognized amounts as discussed below. A settlement is a transaction which is irrevocable and releases the employer from responsibility for the pension obligation by eliminating the risks relative to the obligation and the assets associated with the plan (e.g., making lump-sum cash payments to plan participants in exchange for their rights to receive specified pension benefits or purchasing nonparticipating annuity contracts to cover vested benefits). If a settlement occurs and the net result is a loss, such loss is recognized at the time of the settlement. If the net result is a gain, such gain is not recognized until the proceeds are received by the reporting entity. A curtailment is an event which significantly alters the make up of the pension plan (e.g., a reduction in the years of service required or the employees covered). If a curtailment occurs, there are generally two components to any gain or loss. Any unrecognized prior service cost shall be recognized as a loss. An increase or decrease in pension benefit obligations due to the curtailment will also result in a gain or loss, and is combined with the prior service cost loss. If the net result of the curtailment is a loss, such loss shall be recognized when it is probable that the curtailment will occur and that the effects can be reasonably estimated. If the net result is a gain, such gain shall not be recognized in earnings until the employees terminate or the plan suspension or amendment is adopted and the proceeds are received by the reporting entity. When such gains are recognized, any excess tax surcharges shall also be recognized.

Defined Contribution Plans

6. A defined contribution plan defines the amount of the employer's contributions to the plan and its allocation to plan participants. The pension benefit provided to the plan participant at retirement or termination depends on the amount of employer and employee contributions, earnings on plan investments and, in some plans, other participant forfeitures.

7. For defined contribution plans, the reporting entity shall expense contributions required by the plan over the period in which the employee vests in those contributions. Contributions to plan participants' accounts made prior to vesting shall be treated as prepaid expenses, and shall be nonadmitted. Contributions required after participants terminate or retire shall be accrued and an expense shall be recorded over the working lives of the participants beginning at the date the participant initially vests in plan contributions.

8. Certain defined contribution plans may define the employer’s contribution as a percentage of the plan participants’ individual compensation rather than as a specific dollar amount which is allocated among the plan participants. If an employer's contributions to a defined contribution plan are in excess of those required under the plan and required to be allocated to individual participants, such amounts are recorded as a prepaid expense and nonadmitted under statutory accounting principles.

Disclosures

9. The disclosures required by paragraph 5 of FAS 132 shall be included in the notes to the statutory financial statements considering the modification in this issue paper to include only vested employees. Paragraph 5 of FAS 132 is included in the Relevant GAAP Guidance section of this issue paper.

10. The disclosures required by paragraph 5 of FAS 132 shall be made when an employer recognizes a gain or loss related to a settlement or curtailment of a defined benefit plan or when providing termination benefits.

Transition

11. At the effective date of Codification, the transition obligation or asset shall be determined as the difference between the vested projected benefit obligation and the fair value of plan assets. If prior to the effective date of Codification, the reporting entity has adopted FAS 87 for statutory accounting purposes,

the transition obligation or asset calculated above shall be compared to those amounts previously recorded under FAS 87. The difference between these amounts represents an incremental asset or liability. If the reporting entity has not previously adopted FAS 87 for statutory accounting purposes, the entire transition asset or obligation represents the incremental asset or liability.

12. At the effective date of Codification, if the reporting entity calculates an incremental liability, this liability shall be recognized according to one of the two following methods:

a. The reporting entity may elect to record the entire incremental liability as a direct charge to surplus;

b. Alternatively, the reporting entity may elect to amortize the incremental liability as a component of net periodic pension cost over a period not to exceed 20 years.

13. At the effective date of Codification, if the reporting entity calculates an incremental asset, this asset shall be recognized according to one of the two following methods:

a. The reporting entity may elect to record the entire incremental asset as a direct credit to surplus;

b. Alternatively, the reporting entity may elect to accrue the incremental asset as a component of net periodic pension cost in an amount each period such that total net periodic pension cost may be reduced to an amount not less than zero (i.e., the accrual of the incremental asset may be used to offset current period net periodic pension cost).

An incremental asset resulting from a transition obligation that is less than an amount previously recorded under FAS 87 should first reduce the recorded liability. Any remaining incremental asset shall be recorded as nonadmitted.

Consolidated/Holding Company Plans

14. The employees of many reporting entities are members of a plan sponsored by a parent company or holding company. A reporting entity who participates in these plans and is not directly liable for obligations under the plan shall recognize pension expense equal to its allocation from the holding company or parent company of the required contribution to the plan for the period. A liability shall be established for any such contributions due and unpaid. Furthermore, the reporting entity shall disclose in the notes to the financial statements that its employees participate in a plan sponsored by the holding company for which the reporting entity has no legal obligation. The amount of expense incurred and the allocation methodology utilized by the provider of such benefits shall also be disclosed. If the reporting entity is directly liable for obligations under the plan, then the requirements outlined above in paragraphs 4 to 13 of this issue paper shall be applied.

DISCUSSION

15. The conclusions in paragraphs 4 to 13 above adopt FAS 87, FAS 88, and FAS 132 with the following modifications:

a. Calculation of the pension obligation shall exclude non-vested employees. Partially vested employees are included only to the extent of their vested amounts.

b. Any asset which results from an excess of the fair value of plan assets over the pension obligation shall be recorded as a nonadmitted asset.

c. At the date of adoption of this accounting principle, the pension obligation or asset not previously recognized related to vested employees may be recorded immediately or may be amortized over future periods.

d. A net gain (net of excess tax surcharge) resulting from the settlement or curtailment of a pension plan is not recognized until the proceeds are received by the reporting entity.

e. The reduced disclosure requirements for nonpublic entities described in paragraph 8 of FAS 132 are rejected. All reporting entities shall follow the disclosure requirements included in paragraph 5 of FAS 132.

f. Disclosures relating to other comprehensive income in paragraph 5 of FAS 132 shall be made for income on a statutory basis.

This is consistent with the definition of liabilities as defined in *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets.*

16. This issue paper also adopts *FASB Emerging Issues Task Force No. 88-1, Determination of Vested Benefit Obligation for a Defined Benefit Pension Plan*, *FASB Emerging Issues Task Force No. 90-3, Accounting for Employers' Obligations for Future Contributions to a Mutliemployer Pension Plan*, *FASB Emerging Issues Task Force No. 91-7*, *Accounting for Pension Benefits Paid by Employers after Insurance Companies Fail to Provide Annuity Benefits*, and *FASB Emerging Issues Task Force No 96-5*, *Recognition of Liabilities for Contractual Termination Benefits or Changing Benefit Plan Assumptions in Anticipation of a Business Combination*.

17. Accounting for any intangible asset or prepaid expense resulting from application of the provisions of this issue paper as a nonadmitted asset is consistent with the recognition concept in the Statement of Concepts which states that:

> The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which may be unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet but rather should be charged against surplus when acquired or when availability otherwise becomes questionable.

18. The transition rules have been modified from FAS 87. For an incremental asset or liability which is not recorded immediately upon adoption of the above provisions, an employer is permitted to amortize the incremental asset or liability as a component of net periodic pension cost over future periods in accordance with paragraphs 12 and 13. FAS 87 requires that any transition amount be amortized on a straight-line basis over the average remaining service period of employees expected to receive benefits (except for employers with all or nearly all inactive employees or those with an average remaining service period of less than 15 years).

19. The guidance as discussed in paragraph 1 above, requires expanded disclosures rather than mandating a specific accounting method. However, this adopted position is inconsistent with the concept of recognition outlined in the Statutory Statement of Concepts which states: *"Liabilities require recognition as they are incurred."* Therefore, adoption of FAS 87, with modifications, will be required for statutory accounting and reporting.

Drafting Notes/Comments

- Postemployment benefits are addressed in *Issue Paper No. 13—Employers' Accounting for Postemployment Benefits*.

- Postretirement benefits other than pensions are addressed in *Issue Paper No. 14—Employers' Accounting for Postretirement Benefits Other Than Pensions*.
- Other deferred compensation plans, such as Rabbi Trusts and ESOPs, are addressed in a separate issue paper.
- The tax attributes associated with the accounting principles discussed in this paper (i.e., deferred income taxes) are not currently recognized in existing statutory accounting guidance. Accounting principles for federal income taxes are addressed in a separate issue paper.
- Holding company obligations are addressed in a separate issue paper.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

20. The position adopted by the Accounting Practices and Procedures (EX4) Task Force is summarized in the minutes from its September 15, 1987 meeting. Key points are paraphrased below:

> For multi-company plans sponsored by a parent company, the pension expenses would be the amount contributed by the company to the parent company related to the pension plan. This is comparable to the treatment of multi-employer and similar plans under FAS 87.
>
> For plans sponsored by the reporting company, pension expense is the amount to be funded for the period. If the company chooses to adopt FAS 87 and 88, any resulting intangible or prepaid asset would be considered nonadmitted unless approved by the insurer's state of domicile as appropriate. For self-funded plans, i.e. where the company reflects the assets of the pension plan among its own assets, the amount of accrued pension costs and its location in the balance sheet should be disclosed. Accrued pension costs related to the pension plan would be determined in accordance with accepted actuarial methods.
>
> For companies which report on a GAAP basis, but choose to retain statutory accounting methods for state regulatory reporting, additional footnote disclosures supplementing those outlined below are encouraged but not required.

21. The following observations, among others, were made by the Study Group of EX4:

> One of the principal reasons that FAS 87 and 88 were adopted under GAAP was to improve income statement comparability. This comparability has a stronger emphasis on a GAAP income statement than is typical for statutory reporting which is balance sheet oriented.
>
> The liquidation priority of a pension plan liability appears to be behind policyholder liabilities. It appears that unless there is a perfected interest by the pension plan participants or the Pension Benefit Guaranty Corp., that the pension plan stands as a general creditor behind the policyholder. The FASB is less interested in this aspect since the thrust of its position was one of economic over legal substance. However, statutory accounting is on a modified going-concern basis. In addition, the interest of the policyholder is of utmost importance and is primarily responsible for the rationale used in statutory reporting. Nevertheless, the responsibility of the insurance company to live up to its pension plan obligations on an ongoing basis must be recognized.
>
> If FAS 87 were adopted for SAP, certain issues would need to be addressed such as whether the assets (prepaid pension cost and an intangible asset) and liabilities (accrued pension cost) that may arise should be permitted or required to be reported in the financial statements. It would appear that the prepaid and intangible assets would be considered nonadmitted assets since they represent assets, potential or otherwise, not available to satisfy policyholder obligations. Furthermore, companies with unfunded pension plans could be impaired or rendered insolvent by implementing GAAP basis accounting for pensions.

22. The NAIC Annual Statement Instructions for Life and Accident and Health and for Property and Casualty Insurance Companies specify the required disclosures developed by the Study Group of EX4 and adopted by EX4 which include:

a. a description of the plan's funding policy,
b. the method of determination and the amount of pension expense,
c. the amount of the accumulated benefit obligation, the amount of vested benefits and the fair value of the plan assets valued as of the most recent actuarial valuation date,
d. any funding waiver requested or obtained from the IRS,
e. for an unfunded plan, the method of funding the obligation and how the deficiency will be met,
f. significant matters affecting the year-to-year comparability of the pension information and
g. the location(s) and amount(s) of liabilities for benefits.

Illustrations of sample disclosures are also provided in the Annual Statement Instructions.

23. The Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 17, Other Liabilities, contains the following with respect to pension plans:

> Liabilities for Benefits for Employees and Agents
>
> A company may be required or desire to establish a liability for certain benefits to employees and agents which are not provided for in other accounts. Examples include: 1. It may be desirable to hold the liability for a nonqualified pension plan in this category in order to assist the tax department in adjusting their tax deductions.

Generally Accepted Accounting Principles

24. FAS 87 focuses primarily on single-employer defined benefit plans and requires:

a. a standardized method for measuring net periodic pension cost (unit credit actuarial method or projected unit credit actuarial method depending on the type of plan),
b. immediate recognition of a liability (the minimum liability) when the accumulated benefit obligation exceeds the fair value of plan assets with delayed recognition of the offsetting amount as an increase in net periodic pension cost, and
c. various disclosures about the plan including the components of net pension cost and of the projected benefit obligation in the financial statements. (Paraphrased from the "Fundamentals of Pension Accounting" section of the "Summary" section immediately preceding the FAS 87 statement.)

25. The following is a brief paraphrased summary of the key provisions under FAS 87:

> FAS 87 requires the recognition of a liability (unfunded accrued pension cost) if net periodic pension cost as determined under FAS 87 exceeds amounts the employer has contributed to the plan. An asset (prepaid pension cost) is recognized if net periodic pension cost is less than amounts the employer has contributed to the plan.
>
> For defined benefit pension plans, an additional pension liability (referred to as the minimum liability) must be recognized when the accumulated benefit obligation (defined in FAS 87) for plan participants exceeds the fair value of the plan assets plus or minus any accrued or prepaid pension expense. If an additional liability is recognized, an equal amount shall be recognized as an intangible asset, provided that the asset recognized shall not exceed the amount of unrecognized prior service cost (defined in FAS 87). If an additional liability required to be recognized exceeds unrecognized prior service cost, the excess (which would represent a net loss not yet recognized as net periodic pension cost) is reported as a reduction in equity, net of

any tax benefits that result from considering such losses as temporary differences for purposes of applying the provisions of FASB Statement No. 109, Accounting for Income Taxes.

The intangible asset representing the unrecognized prior service cost (which at the date of initial adoption would be the unrecognized net obligation) is amortized as a component of the net periodic pension cost on a straight-line basis over the average remaining service period of employees expected to receive benefits under the plan, except that, (a) if the average remaining service period is less than 15 years, the employer may elect to use a 15-year period, and (b) if all or almost all of a plan's participants are inactive, the employer shall use the inactive participants' average remaining life expectancy period.

26. FAS 88 prescribes a method for determining the amount to be recognized in earnings when a pension obligation is settled, a plan is curtailed or benefits are provided to employees in connection with their termination of employment. A settlement is a transaction which is irrevocable and releases the employer from responsibility for the pension obligation by eliminating the risks relative to the obligation and the assets associated with the plan. A curtailment is an event which significantly alters the make up of the pension plan (e.g., a reduction in the years of service required or the employees covered).

27. FAS 88 requires recognition of certain previously unrecognized amounts when certain transactions or events occur, the source and timing of the amount to be recognized in earnings will vary with the nature of the transaction. Generally, if a settlement occurs, a gain or loss is recognized related to previously unrecognized gains or losses from either changes in assumptions or actual results which were different from that assumed. In addition, any unamortized net asset from the implementation of FAS 87 is recognized as a gain. If a curtailment occurs, there are generally two components to any gain or loss. Any unrecognized prior service cost is recognized as a loss. An increase or decrease in pension benefit obligations due to the curtailment will also result in a gain or a loss, and is combined with the prior service cost loss. If the net result of the curtailment is a loss, it is recognized when it is probable that the curtailment will occur and that the effects are reasonably estimable. If the net result is a gain, it is not recognized in earnings until the employees terminate or the plan suspension or amendment is adopted.

28. FAS 132 requires the following disclosures:

Disclosures about Pensions and Other Postretirement Benefits

5. An employer that sponsors one or more defined benefit pension plans or one or more defined benefit postretirement plans shall provide the following information:

a. A reconciliation of beginning and ending balances of the benefit obligation[2] showing separately, if applicable, the effects during the period attributable to each of the following: service cost, interest cost, contributions by plan participants, actuarial gains and losses, foreign currency exchange rate changes[3], benefits paid, plan amendments, business combinations, divestitures, curtailments, settlements, and special termination benefits

[2] For defined benefit pension plans, the benefit obligation is the projected benefit obligation—the actuarial present value as of a date of all benefits attributed by the pension benefit formula to employee service rendered prior to that date. For defined benefit postretirement plans, the benefit obligation is the accumulated postretirement benefit obligation—the actuarial present value of benefits attributed to employee service rendered to a particular date.

[3] The effects of foreign currency exchange rate changes that are to be disclosed are those applicable to plans of a foreign operation whose functional currency is not the reporting currency pursuant to *FASB Statement No. 52*, *Foreign Currency Translation*.

b. A reconciliation of beginning and ending balances of the fair value of plan assets showing separately, if applicable, the effects during the period attributable to each of the following: actual return on plan assets, foreign currency exchange rate changes[4], contributions by the employer, contributions by plan participants, benefits paid, business combinations, divestitures, and settlements

[4] Refer to footnote 3.

c. The funded status of the plans, the amounts not recognized in the statement of financial position, and the amounts recognized in the statement of financial position, including:
   (1) The amount of any unamortized prior service cost
   (2) The amount of any unrecognized net gain or loss (including asset gains and losses not yet reflected in market-related value)
   (3) The amount of any remaining unamortized, unrecognized net obligation or net asset existing at the initial date of application of Statement 87 or 106
   (4) The net pension or other postretirement benefit prepaid assets or accrued liabilities
   (5) Any intangible asset and the amount of accumulated other comprehensive income recognized pursuant to paragraph 37 of Statement 87, as amended

d. The amount of net periodic benefit cost recognized, showing separately the service cost component, the interest cost component, the expected return on plan assets for the period, the amortization of the unrecognized transition obligation or transition asset, the amount of recognized gains and losses, the amount of prior service cost recognized, and the amount of gain or loss recognized due to a settlement or curtailment

e. The amount included within other comprehensive income for the period arising from a change in the additional minimum pension liability recognized pursuant to paragraph 37 of Statement 87, as amended

f. On a weighted-average basis, the following assumptions used in the accounting for the plans: assumed discount rate, rate of compensation increase (for pay-related plans), and expected long-term rate of return on plan assets

g. The assumed health care cost trend rate(s) for the next year used to measure the expected cost of benefits covered by the plan (gross eligible charges) and a general description of the direction and pattern of change in the assumed trend rates thereafter, together with the ultimate trend rate(s) and when that rate is expected to be achieved

h. The effect of a one-percentage-point increase and the effect of a one-percentage point decrease in the assumed health care cost trend rates on (1) the aggregate of the service and interest cost components of net periodic postretirement health care benefit cost and (2) the accumulated postretirement benefit obligation for health care benefits (For purposes of this disclosure, all other assumptions shall be held constant, and the effects shall be measured based on the substantive plan that is the basis for the accounting.)

i. If applicable, the amounts and types of securities of the employer and related parties included in plan assets, the approximate amount of future annual benefits of plan participants covered by insurance contracts issued by the employer or related parties, and any significant transactions between the employer or related parties and the plan during the period

j. If applicable, any alternative amortization method used to amortize prior service amounts or unrecognized net gains and losses pursuant to paragraphs 26 and 33 of Statement 87 or paragraphs 53 and 60 of Statement 106

k. If applicable, any substantive commitment, such as past practice or a history of regular benefit increases, used as the basis for accounting for the benefit obligation

l. If applicable, the cost of providing special or contractual termination benefits recognized during the period and a description of the nature of the event

m. An explanation of any significant change in the benefit obligation or plan assets not otherwise apparent in the other disclosures required by this Statement.

Amounts related to the employer's results of operations shall be disclosed for each period for which an income statement is presented. Amounts related to the employer's statement of financial position shall be disclosed for each balance sheet presented.

Employers with Two or More Plans

6. The disclosures required by this Statement may be aggregated for all of an employer's defined benefit pension plans and may be aggregated for all of an employer's defined benefit postretirement plans or may be disaggregated in groups if that is considered to provide the most useful information or is otherwise required by paragraph 7. Disclosures about pension plans with assets in excess of the accumulated benefit obligation generally may be aggregated with disclosures about pension plans with accumulated benefit obligations in excess of assets. The same aggregation is permitted for postretirement plans. However, if those disclosures are combined, an employer shall disclose the aggregate benefit obligation and aggregate fair value of plan assets for plans with benefit obligations in excess of plan assets. The aggregate pension accumulated benefit obligation and aggregate fair value of plan assets for pension plans with accumulated benefit obligations in excess of plan assets also shall be disclosed. Disclosure of amounts recognized in the statement of financial position shall present prepaid benefit costs and accrued benefit liabilities separately.

7. An employer may combine disclosures about pension or postretirement benefit plans outside the United States with those for U.S. plans unless the benefit obligations of the plans outside the United States are significant relative to the total benefit obligation and those plans use significantly different assumptions.

Reduced Disclosure Requirements for Nonpublic Entities

8. A nonpublic entity[5] may elect to disclose the following for its pension and other postretirement benefit plans in lieu of the disclosures required by paragraph 5 of this Statement:

a. The benefit obligation, fair value of plan assets, and funded status of the plan
b. Employer contributions, participant contributions, and benefits paid
c. The amounts recognized in the statement of financial position, including the net pension and other postretirement benefit prepaid assets or accrued liabilities and any intangible asset and the amount of accumulated other comprehensive income recognized pursuant to paragraph 37 of Statement 87, as amended
d. The amount of net periodic benefit cost recognized and the amount included within other comprehensive income arising from a change in the minimum pension liability recognized pursuant to paragraph 37 of Statement 87, as amended
e. On a weighted-average basis, the following assumptions used in the accounting for the plans: assumed discount rate, rate of compensation increase (for pay-related plans), and expected long-term rate of return on plan assets
f. The assumed health care cost trend rate(s) for the next year used to measure the expected cost of benefits covered by the plan (gross eligible charges) and a general description of the direction and pattern of change in the assumed trend rates thereafter, together with the ultimate trend rate(s) and when that rate is expected to be achieved

[5] A nonpublic entity is any entity other than one (a) whose debt or equity securities trade in a public market either on a stock exchange (domestic or foreign) or in the over-the-counter market, including securities quoted only locally or regionally, (b) that makes a filing with a regulatory agency in preparation for the sale of any class of debt or equity securities in a public market, or (c) that is controlled by an entity covered by (a) or (b).

g. If applicable, the amounts and types of securities of the employer and related parties included in plan assets, the approximate amount of future annual benefits of plan participants covered by insurance contracts issued by the employer or related parties, and any significant transactions between the employer or related parties and the plan during the period

h. The nature and effect of significant nonroutine events, such as amendments, combinations, divestitures, curtailments, and settlements.

Defined Contribution Plans

9. An employer shall disclose the amount of cost recognized for defined contribution pension or other postretirement benefit plans during the period separately from the amount of cost recognized for defined benefit plans. The disclosures shall include a description of the nature and effect of any significant changes during the period affecting comparability, such as a change in the rate of employer contributions, a business combination, or a divestiture.

Multiemployer Plans

10. An employer shall disclose the amount of contributions to multiemployer plans during the period. An employer may disclose total contributions to multiemployer plans without disaggregating the amounts attributable to pensions and other postretirement benefits. The disclosures shall include a description of the nature and effect of any changes affecting comparability, such as a change in the rate of employer contributions, a business combination, or a divestiture.

11. Paragraph 70 of Statement 87 and paragraph 83 of Statement 106 are carried forward without reconsideration. Paragraphs 70 and 83 read as follows:

> In some situations, withdrawal from a multiemployer plan may result in an employer's having an obligation to the plan for a portion of its unfunded benefit obligations. If withdrawal under circumstances that would give rise to an obligation is either probable or reasonably possible, the provisions of FASB Statement No. 5, *Accounting for Contingencies*, shall apply.
>
> In some situations, withdrawal from a multiemployer plan may result in an employer's having an obligation to the plan for a portion of the plan's unfunded accumulated postretirement benefit obligation. If it is either probable or reasonably possible that (a) an employer would withdraw from the plan under circumstances that would give rise to an obligation or (b) an employer's contribution to the fund would be increased during the remainder of the contract period to make up a shortfall in the funds necessary to maintain the negotiated level of benefit coverage (a "maintenance of benefits" clause), the employer shall apply the provisions of *FASB Statement No. 5*, *Accounting for Contingencies*.

OTHER SOURCES OF INFORMATION

29. The NAIC Technical Resource Group Proposed Draft Life Codification, Chapter 23, General Expenses and Taxes, Licenses and Fees, contains the following language:

> Pension Costs
>
> Many insurance companies offer their employees' pension plans as part of the compensation package for service rendered. Pension plans include defined contribution or defined benefit pension plans. The accounting for each of these types differs.
>
> For defined benefit pension plans, an insurance company is responsible for providing a specified benefit to the plan participants at retirement. The insurance company has the option of recognizing the benefit costs by adoption Financial Accounting Standards Board Statement of

> Financial Accounting Standard (FAS) No. 87, “Employers' Accounting for Pensions,” or based upon funding required under the Employee Retirement Income Security Act (ERISA).
>
> If FAS 87 is adopted, pension service costs must be recognized over the period a participant renders service to the company for qualified and non-qualified (e.g. Top Hat Plans) defined benefit pension plans.
>
> If the ERISA funding method is elected, an insurance company will record the pension service costs for defined benefit pension plans based upon requirements of ERISA for qualified pension plans. Pension service costs will then be recorded in conjunction with funding required by ERISA for such qualified plans on a pay-as-you-go basis. When ERISA dictates additional funding is required, the employer will recognize this funding as a corresponding expense.
>
> If the ERISA funding method is elected for qualified defined benefit pension plans, pension service costs associated with any non-qualified plans must be accrued as earned. Those service costs must be accrued over the working lives of the participants covered under the non-qualified plan.
>
> For defined contribution benefit plans, the insurance company is responsible for making specific contributions to a participant's pension plan account. The insurance company must accrue the contributions required by the plan in the period in which those contributions are earned. Contributions to plan participants' accounts required during the participants' working lives must be expensed over that period. The contributions required after participants terminate or retire require an expense be accrued and a liability established over the working lives of the participants.
>
> If a company makes contributions to the defined contribution plan in excess of those allocated to individual participants, the excess is recorded as a prepaid asset.
>
> Settlements and Curtailments of Pension Plans
>
> Companies that offer their employees defined benefit pension plans periodically settle or curtail the plan.
>
> A settlement is a transaction which is irrevocable, releases the employer from responsibility for the pension, and eliminates the risks relative to the obligation and the assets associated with the plan. For example, lump-sum cash payout to the employees in lieu of their pension rights.
>
> A curtailment is an event which significantly alters the make up of the pension plan. For example, the years of service required is reduced or the employees covered under the plan is decreased.
>
> Settlements and curtailments of pension plans should be accounted for using generally accepted accounting principles.

30. The chapter on Non-Claim Operating Expenses included in the draft discussion material from previous Property/Casualty codification projects contains the following language which contradicts some of the Life Codification language:

> Statement of the Financial Accounting Standards Board (“FASB”) No. 87, “Employers' Accounting for Pensions” was issued in December 1985 and superseded Accounting Principles Board (“APB”) Opinion 8 “Accounting for the Cost of Pension Plans”. FASB 87 should be followed in accounting for pension plans. FASB 87 requires that pension plans be accounted for on the accrual basis of accounting and any difference between “Net Period Pension Cost” incurred and the amount actually funded is accrued. GAAP permits the recognition of an asset for the excess of any pension funds over the plan's liabilities. SAP, however, does not permit the recognition of any prepaid pension expense. “Net Periodic Pension Cost” includes the following components:

1. Current service cost. (The present value of future benefits earned for the employee's current service.)

2. Amortization of unrecognized prior service or retroactive benefit costs over the future service periods of those employees active at the inception or plan amendment date. (The present value of future benefits credited for an employee's prior service at the inception or amendment of the plan should be ratably accrued over his remaining service life.)

3. “Gains and losses are changes in the amount of either the projected benefit obligation or plan assets resulting from experience different from that assumed and changes in assumptions.” “Because gains and losses may reflect refinements in estimates as well as real changes in economic values and because some gains in one period may be offset by losses in another or vice versa, ... ”such gains and losses are not recognized as part of “net pension cost in the period in which they arise”. FASB 87 sets forth the minimum and alternative methods of amortizing net gains and losses.

FASB 88 “Employers’ Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits” should be followed when such plans are terminated.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *Issue Paper No. 3—Accounting Changes*
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- Minutes from the June 23, 1987 meeting of the Accounting Practices and Procedures (EX4) Task Force
- Minutes from the September 15, 1987 meeting of the Accounting Practices and Procedures (EX4) Task Force
- Minutes from the June 12, 1986 meeting of the Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force
- Minutes from the September 8, 1986 meeting of the Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 17, *Other Liabilities*
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies
- NAIC Annual Statement Instructions for Life and Accident and Health Insurance Companies
- NAIC Annual Statement Instructions for Property and Casualty Insurance Companies
- Employers’ Accounting for Postretirement Benefits Other Than Pensions - Field Test of the Statutory Proposal - prepared by the Codification Advisory Group, September 20, 1992

Generally Accepted Accounting Principles

- *FASB Statement No. 87, Employers’ Accounting for Pensions*
- *FASB Statement No. 88, Employers’ Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*
- *FASB Statement No. 132, Employers’ Disclosures about Pensions and Other Postretirement Benefits*
- *FASB Emerging Issues Task Force No. 88-1, Determination of Vested Benefits Obligation for a Defined Benefit Pension Plan*
- *FASB Emerging Issues Task Force No. 90-3, Accounting for Employers’ Obligations for Future Contributions to a Mutliemployer Pension Plan*
- *FASB Emerging Issues Task Force No. 91-7, Accounting for Pension Benefits Paid by Employers after Insurance Companies Fail to Provide Annuity Benefits*

- *FASB Emerging Issues Task Force No. 96-5, Recognition of Liabilities for Contractual Termination Benefits or Changing Benefit Plan Assumptions in Anticipation of a Business Combination*

State Regulations

- No additional guidance obtained from state statutes or regulations.

Other Sources of Information

- NAIC Technical Resource Group Proposed Draft Life Codification, Chapter 22, *General Expenses and Taxes, Licenses and Fees*
- Draft discussion material from previous Property/Casualty codification projects - Chapter on Non-Claim Operating Expenses

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Statutory Issue Paper No. 9

Subsequent Events

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 9

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. The Accounting Practices and Procedures Manuals for Life and Accident and Health Insurance Companies and for Property and Casualty Insurance Companies do not address the accounting treatment for events occurring subsequent to the period covered by statutory financial statements but prior to their issuance. Although general guidance for disclosing material subsequent events is found in the NAIC Annual Statement Instructions (Annual Statement Instructions) and guidance for identifying and disclosing material subsequent events is found in the NAIC *Financial Condition Examiners Handbook*, specific criteria as to whether a material subsequent event should be recorded in the current financial statements or simply disclosed in the notes to the financial statements is not defined. The purpose of this issue paper is to define "subsequent events" for statutory accounting purposes and to establish the criteria for recording such events in the financial statements and/or disclosing them in the notes to the financial statements.

SUMMARY CONCLUSION

2. For purposes of statutory accounting, "subsequent events" shall be defined as events or transactions that occur subsequent to the balance sheet date, but prior to the issuance of the statutory financial statements. For purposes of this paper, the issuance of the statutory financial statements includes not only the submission of the Quarterly and Annual Statement but also the issuance of the audit opinion by the reporting entity's certified public accountant.

3. Material subsequent events shall be considered either:

   a. Type I. Events that provide additional evidence with respect to conditions that existed at the date of the balance sheet and affect the estimates inherent in the process of preparing financial statements.

   b. Type II. Events that provide evidence with respect to conditions that did not exist at the balance sheet date but arose subsequent to that date.

4. All information that becomes available prior to the issuance of the financial statements relating to a material Type I subsequent event shall be used by management to determine a related accounting estimate (see *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets* and *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*). Any changes in estimates resulting from the use of such evidence shall be recorded in the financial statements unless specifically prohibited (e.g., subsequent collection of agents balances over 90 days due when determining nonadmitted agents balances as prohibited by *Issue Paper No. 6—Amounts Due from Agents and Brokers*). For material Type I subsequent events, the nature and the amount of the adjustment shall be disclosed in the notes to the financial statements only if necessary to keep the financial statements from being misleading.

5. Information that becomes available prior to the issuance of the financial statements relating to a material Type II subsequent event shall not be recorded in the financial statements, but shall be disclosed in the notes to the financial statements. If an event is of such a nature that pro forma disclosures are necessary to keep the financial statements from being misleading, disclosure of supplemental pro forma financial data shall be made including the impact on net income, surplus, total assets and total liabilities giving effect to the event as if it had occurred on the date of the balance sheet.

6. The conclusions in this issue paper, including the disclosures in paragraph 5, shall also apply to quarterly statement filings.

DISCUSSION

7. The above conclusion expands and clarifies the guidance provided in the NAIC *Financial Condition Examiners Handbook* and the Annual Statement Instructions by requiring that Type I subsequent events be recorded in the financial statements.

8. The Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts) states that *"the cornerstone of solvency measurement is financial reporting. Therefore, the regulator's ability to effectively determine relative financial condition using financial statements is of paramount importance to the protection of policyholders."* The recording of Type I subsequent events provides the regulator relevant information to evaluate the financial condition of an entity. However, in some circumstances, the recording of Type I subsequent events is specifically prohibited within Codification (e.g., subsequent collection of agents balances over 90 days due when determining nonadmitted agents balances).

9. Identifying events that require adjustment of the financial statements under the criteria stated in the conclusion calls for the management of the entity to exercise judgment and accumulate knowledge of the facts and circumstances surrounding the event. For example, a loss on an uncollectible agent's balance as a result of an agent's deteriorating financial condition leading to bankruptcy subsequent to the balance sheet date would be indicative of conditions existing at the balance sheet date, thereby requiring the recording of such event to the financial statements before their issuance. On the other hand, a similar loss resulting from an agent's major casualty loss such as a fire or flood subsequent to the balance sheet date would not be indicative of conditions existing at the balance sheet date and recording of the event to the financial statements would not be appropriate. However, this is a Type II subsequent event which would require disclosure in the notes to the financial statements as described in paragraph 5 above.

10. Additionally, the Statement of Concepts states that *"Because these basic financial statements cannot be expected to provide all of the information necessary to evaluate an entity's short-term and long-term stability, management must supplement the financial statements with sufficient disclosures (e.g., notes to the financial statements, management's discussion and analysis, and supplementary schedules and exhibits) to assist financial statement users in evaluating the information provided."* Disclosure of Type II subsequent events meets this objective. Examples of Type II events that require disclosure to the financial statements (but should not result in adjustment) are: i) sale of a bond or capital stock issue, ii) purchase of a business, iii) settlement of litigation when the event giving rise to the claim took place subsequent to the balance sheet date and iv) casualty losses resulting from a hurricane or earthquake subsequent to the balance sheet date.

Drafting Notes/Comments
None

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

11. The Annual Statement Instructions for Life and Accident and Health Insurance Companies require disclosure of subsequent events in the notes to the financial statements as follows:

> Events Subsequent
> Instruction:
>
> Describe any events occurring subsequent to the close of the books or accounts for this statement which may have a material effect on the financial condition of the company.
>
> Illustration:
>
> On February 1, 19__, the Board of Directors adopted a plan for recapitalization subject to shareholder approval, which would effect an amendment to the Certificate of Incorporation to increase the authorized common shares from _________to_____________.

12. The Annual Statement Instructions for Property and Casualty Insurance Companies is similar to the Life and Accident and Health instructions above.

13. Part 1, Section 5, *Report on Full Scope Examination*, of the NAIC *Financial Condition Examiners Handbook* discusses reporting of transactions consummated subsequent to the effective date of the examination as follows:

> Any transaction consummated by a company subsequent to the effective date of an examination, which is for the purpose of adjusting the company's previously reported financial condition, shall not be recognized in the preparation of the examiner's financial statement in the report of examination.
>
> Such transaction may be described by a qualifying statement, or statements, when supported by a reference to the original minutes or document evidencing such subsequent transaction or transactions. Such supporting data shall be set forth in a clearly captioned appendix or appendices to the report.

14. Exhibit G to Part 1 (General) of the NAIC *Financial Condition Examiners Handbook* provides a list of procedures to assist in identifying subsequent events but does not provide guidance as to the treatment of the events once identified. A list of the procedures are as follows:

> EXHIBIT G--
> REVIEW OF EVENTS SUBSEQUENT TO THE BALANCE SHEET DATE
>
> Company ___________ Examination Date ___________ Approved By ___________
>
> Generally, the period of review of post-balance sheet events extends from the date of the balance sheet to the date of the examination report, which in most cases is the date of substantial completion of the fieldwork. It is usually not possible, however, to extend all procedures to the same date. If delivery of the examination report is unduly delayed, consideration should be given to extending the review to a later date.
>
> The workpaper should contain specific information as to the scope of investigation of subsequent events and the consideration given to each of them. Procedures related to subsequent events that extend into the subsequent period include, but are not necessarily limited to, the items described below.

1. Scan cash receipts records for evidence of proceeds of loans, significant sales of productive assets or other unusual items.

   Amounts over $ ____________Date through _______________

2. Scan cash disbursements records for unusual payments and payment of liabilities not recorded as of balance-sheet date.

   Amounts over $ ___________Date through _______________

3. Review general journal entries for entries that would have a material effect upon the financial statement as of balance sheet date.

   Amounts over $ ___________ Date through ________________

4. Read minutes of meetings to directors, stockholders and important committees up to the report date. If minutes have not been prepared, obtain a written representation from the secretary about matters dealt with at such meetings. Review draft (if any) or proxy statement to be issued to shareholders for matters that may affect the financial statements.

5. Read latest available interim financial statements. Compare them with the financial statements being reported on and obtain explanations for any unusual items noted as a result of the comparison.

   Amounts over $ _____________ Date through ______________

6. Inquire of officers and other executives having responsibility for financial and accounting matters as to whether the interim statements have been prepared on the same basis as that used for the statements under examination. (Indicate identity of statements and periods covered.)

   Amounts over $ _____________ Date through ____________

7. Inquire of officers and other executives having responsibility for financial and accounting matters (limited where appropriate to major locations) as to: (NOTE: Indicate persons with whom discussions were held and date and attach memoranda or comments regarding significant matters discussed. Corporate office inquiries should extend to the report date.)

   a. Whether any substantial contingent liabilities or commitments existed at the balance-sheet date or at the date of inquiry.

   b. Whether there was any significant change in the capital stock or debt to the date of inquiry.

   c. The current status of items in the financial statements being reported on that were accounted for on the basis of tentative, preliminary, or inconclusive data.

   d. Whether any other matters had occurred that would materially affect the financial statements or operations of the company. This includes appropriate inquiries as to subsequent events of material affiliates accounted for by the equity method.

      Amounts over $ __________________ Date through ____________

8. If the above procedures produce responses that significantly affect the financial statements, they should be confirmed in writing. This may be done in the letter of representations.

   Amounts over $ __________________ Date through _____________

Generally Accepted Accounting Principles

15. The primary source of GAAP authoritative guidance for the treatment of subsequent events is *AICPA Statement on Auditing Standards No. 1, Section 560*, *Subsequent Events*, which states the following:

> .01 An independent auditor's report ordinarily is issued in connection with historical financial statements that purport to present financial position at a stated date and results of operations and cash flows for a period ended on that date. However, events or transactions sometimes occur subsequent to the balance sheet date, but prior to the issuance of the financial statements and auditor's report, that have a material effect on the financial statements and therefore require adjustment or disclosure in the statements. These occurrences hereinafter are referred to as "subsequent events."
>
> .02 Two types of subsequent events require consideration by management and evaluation by the independent auditor.
>
> .03 The first type consists of those events that provide additional evidence with respect to conditions that existed at the date of the balance sheet and affect the estimates inherent in the process of preparing financial statements. All information that becomes available prior to the issuance of the financial statements should be used by management in its evaluation of the conditions on which the estimates were based. The financial statements should be adjusted for any changes in estimates resulting from the use of such evidence.
>
> .04 Identifying events that require adjustment of the financial statements under the criteria stated above calls for the exercise of judgment and knowledge of the facts and circumstances. For example, a loss on an uncollectible trade account receivable as a result of a customer's deteriorating financial condition leading to bankruptcy subsequent to the balance-sheet date would be indicative of conditions existing at the balance-sheet date, thereby calling for adjustment of the financial statements before their issuance. On the other hand, a similar loss resulting from a customer's major casualty such as a fire or flood subsequent to the balance-sheet date would not be indicative of conditions existing at the balance-sheet date and adjustment of the financial statements would not be appropriate. The settlement of litigation for an amount different from the liability recorded in the accounts would require adjustment of the financial statements if the events, such as personal injury or patent infringement, that gave rise to the litigation had taken place prior to the balance-sheet date.
>
> .05 The second type consists of those events that provide evidence with respect to conditions that did not exist at the date of the balance sheet being reported on but arose subsequent to that date. These events should not result in adjustment of the financial statements.[1] Some of these events, however, may be of such a nature that disclosure of them is required to keep the financial statements from being misleading. Occasionally such an event may be so significant that disclosure can best be made by supplementing the historical financial statements with pro forma financial data giving effect to the event as if it had occurred on the date of the balance sheet. It may be desirable to present pro forma statements, usually a balance sheet only, in columnar form on the face of the historical statements.

[1] This paragraph is not intended to preclude giving effect in the balance sheet, with appropriate disclosure, to stock dividends or stock splits or reverse splits consummated after the balance-sheet date but before issuance of the financial statements.

.06 Examples of events of the second type that require disclosure to the financial statements (but should not result in adjustment) are:

a. Sale of a bond or capital stock issue.

b. Purchase of a business.

c. Settlement of litigation when the event giving rise to the claim took place subsequent to the balance-sheet date.

d. Loss of plant or inventories as a result of fire or flood.

e. Losses on receivables resulting from conditions (such as a customer's major casualty) arising subsequent to the balance-sheet date.

.07 Subsequent events affecting the realization of assets such as receivables and inventories or the settlement of estimated liabilities ordinarily will require adjustment of the financial statements (see paragraph .03) because such events typically represent the culmination of conditions that existed over a relatively long period of time. Subsequent events such as changes in the quoted market prices of securities ordinarily should not result in adjustment of the financial statements (see paragraph .05) because such changes typically reflect a concurrent evaluation of new conditions.

.08 When financial statements are reissued, for example, in reports filed with the Securities and Exchange Commission or other regulatory agencies, events that require disclosure in the reissued financial statements to keep them from being misleading may have occurred subsequent to the original issuance of the financial statements. Events occurring between the time of original issuance and reissuance of financial statements should not result in adjustment of the financial statements[2] unless the adjustment meets the criteria for the correction of an error or the criteria for prior period adjustments set forth in Opinions of the Accounting Principles Board.* Similarly, financial statements reissued in comparative form with financial statements of subsequent periods should not be adjusted for events occurring subsequent to the original issuance unless the adjustment meets the criteria stated above.

[2] However, see paragraph .05 as to the desirability of presenting pro forma financial statements to supplement the historical financial statements in certain circumstances.

* See also Statement of Financial Accounting Standards No. 16, Prior Period Adjustments (AC section A35).

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- NAIC *Annual Statement Instructions for Life and Accident and Health Insurance Companies*
- NAIC *Annual Statement Instructions for Property and Casualty Insurance Companies*
- NAIC *Financial Condition Examiners Handbook*
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 6—Amounts Due from Agents and Brokers*

Generally Accepted Accounting Principles

- *AICPA Statement on Auditing Standards No. 1, Section 560, Subsequent Events*

State Regulations

- No additional guidance obtained from state statutes or regulations.

Statutory Issue Paper No. 10

Uncollected Premium Balances

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 6

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. This issue paper addresses direct and group billed uncollected premiums for Property and Casualty and Accident and Health policies. It does not address uncollected and deferred premiums for life considerations, which are addressed in a separate issue paper. The Accounting Practices and Procedures Manuals for Property and Casualty Insurance Companies and for Life and Accident and Health Insurance Companies (the Manuals) do not provide definitive guidance on when to begin aging premiums. This issue paper puts forth a framework for the accounting and reporting of uncollected premium balances that is consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

2. Premium transactions result in amounts due to the reporting entity that meet the definition of an asset as set forth in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets.* First, an evaluation shall be made to determine nonadmitted amounts. Next an evaluation shall be made of the remaining admitted assets in accordance with *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets* (Issue Paper No. 5), to determine whether there is an impairment. This two step process is set forth below:

a. To the extent that there is no related unearned premium, any uncollected premium balances which are over ninety days due shall be accounted for as a nonadmitted asset. If an installment premium is over ninety days due, the amount over ninety days due plus all future installments that have been recorded on that policy shall be accounted for as nonadmitted assets.

b. Amounts determined to be uncollectible shall be written off: If, in accordance with Issue Paper No. 5, it is probable the uncollected premium balance is uncollectible, any uncollectible premiums receivable shall be written off against operations in the period such determination is made. If it is reasonably possible a portion of the balance is uncollectible and is therefore not written off, disclosure requirements outlined in Issue Paper No. 5 shall be followed.

3. The following provides additional guidance in determining the nonadmitted portion of uncollected premiums:

a. Amounts classified as nonadmitted assets collected subsequent to date of the statutory financial statements - Such amounts should not be used to adjust the nonadmitted asset otherwise calculated.

b. Determination of the Due Date -

i. The due date for original and deposit premiums is governed by the effective date of the underlying insurance contract and not the agent/reporting entity contractual relationship.

ii. The due date for endorsement and installment premiums is governed by the effective date of the endorsement and the contractual due date of the installment.

iii. The due date for audit premiums and retrospective premiums is governed by policy provisions or contract provisions. If the due date for receivables relating to audits is not addressed by policy provisions or contract provisions, any uncollected premium (either accrued or billed) is nonadmitted.

iv. These provisions are to be applied to all premium receivables except those arising from force placed insurance obtained by a lender for collateral protection, certain policies, known as a Trustee Sales Guarantees (TSGs), issued by title insurance companies to lenders on defaulted real estate loans and crop/hail policies. For forced placed insurance, the due date for purposes of applying paragraph 2 shall be the date of billing. For TSG policies, the due date for purposes of applying paragraph 2 shall be at the expiration of the grace period given to the defaulted debtor, which is provided by statute. Crop/hail premiums are considered installment premiums in accordance with paragraph 3.b.ii. and accordingly, the due date for purposes of applying paragraph 2 shall be governed by the contractual due date of the installment.

DISCUSSION

4. The Statement of Concepts states:

> The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which may be unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet but rather should be charged against surplus when acquired or when availability otherwise becomes questionable.

5. Based upon the above concept, uncollected premium balances should reflect only amounts that are available to meet both current and future policyholder obligations when the obligations are due. Therefore, amounts determined to be impaired, regardless of aging, should be charged to income in the period such determination is made. Short-term policies shall also be subject to this collectibility analysis. The adoption of this methodology will more appropriately provide the statutory financial statement reader with an indication of those assets available to meet policyholder obligations. Under the conservatism concept of statutory accounting, uncollected premiums over ninety days due, even if they are determined to be collectible, should be nonadmitted and charged to surplus. Uncollected installment premiums over ninety days due, even if they are determined to be collectible, should be nonadmitted along with all future installments. Additionally, the conservatism concept of statutory accounting will not allow subsequent collection of amounts charged to surplus as nonadmitted assets to reduce the nonadmitted asset. These recoveries will be accounted for in the period received.

6. An exception to the due date guidance is provided for force placed insurance and for certain title insurance policies known as TSGs. Force placed insurance is a type of collateral protection insurance typically offered to financial institutions and other lenders that make loans secured by collateral. Coverage is obtained by the lender when the collateral securing a loan becomes uninsured by the borrower. Due to the nature of this specific type of insurance, most policies or certificates are not issued, and consequently not billed, until after the effective date of coverage. As a result, the due date for purposes of paragraph 2 is the date of billing. TSGs are title insurance policies issued to lending

institutions during the foreclosure process on defaulted real estate loans. TSGs are requested by the lending institution, and premium is booked by the reporting entity at the notice of default date. There is, typically by law, a grace period given to the defaulted debtor to bring the loan current. Since the premium is remitted to the reporting entity from the proceeds of the foreclosed property, this grace period results in a lag period before the premium could be collected. As a result, the due date for purposes of paragraph 2 is the date at which the grace period expires.

Drafting Notes/Comments

- A separate issue paper addresses deferred and uncollected life and annuity premiums.
- A separate issue paper addresses nonadmitted assets for retrospective premiums on direct or assumed business; this issue was addressed and codified by the NAIC in 1993. Guidance is included in Chapter 22 of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies.
- A separate issue paper addresses premiums sold with recourse (premium finance company).
- Reinsurance premiums payable, reinsurance commissions receivable, etc., which are currently reported on the same line item in the Annual Statement are addressed in a separate issue paper.
- Accounting for uncollected agents' balances is addressed in *Issue Paper No. 6—Amounts Due From Agents and Brokers*.
- Accounting for bills receivable is addressed in *Issue Paper No. 21—Bills Receivable For Premiums*.
- Accounting/aging of retrospective premiums currently reported on line 9.2 or 9.3 is addressed in a separate issue paper.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

7. The draft discussion material from previous Property/Casualty codification projects suggested aging of all original or renewal premiums receivable to begin as of the effective date of the policy. In addition, the proposed version suggests endorsement premiums begin aging from the effective date of the endorsement and installment premiums begin aging from the contractual due date of the installment. This presentation is consistent with GAAP and provides for a conservative aging process.

8. The Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 7, *Agents' Balances or Uncollected Premiums*, page 2, paragraph 2, provides the following guidance:

> To satisfy the requirements of the annual statement blank, agents' balances or uncollected premiums over three months due are nonadmitted assets. (See Chapter 9 – Nonadmitted Assets, see excerpt below.)

9. The Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 9, *Nonadmitted Assets*, page 1, point 3, reinforces Chapter 7 by stating the following:

> Agents Balances or Uncollected Premiums Over Three Months Due: The statutes of most states require that agents' balances or uncollected premiums over three months due be nonadmitted because of the uncertainty of collection.

10. The NAIC Annual Statement Instructions for Property and Casualty Insurance Companies, Exhibit 2 - Analysis of Nonadmitted Assets, Line 24.2 - Premiums, Agents' Balances and Installments Booked but Deferred and Not Yet Due, provides additional guidance for nonadmitting installment premiums as follows:

> This item should include all future installments on all policies for which one or more installments are over three months past due.

11. The Accounting Practices and Procedures Manuals for Property and Casualty and for Life and Accident and Health Insurance Companies do not address when the aging of uncollected premiums is to commence; however, the draft discussion material from previous Property/Casualty codification projects suggested the following:

> Original or deposit premiums
>
> Aging is always based on the effective date of the policy or bond regardless of whether the insurer is using a direct billing system or an account current system.
>
> Endorsement
>
> Aging is always based on the effective dates of the endorsements.
>
> Installments
>
> Aging is always based on the due date of the installment.

12. The Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 18, pages 3 and 4, discusses uncollected premiums as follows:

> Accident and Health Policies
>
> Accident and health insurance policies typically provide a grace period after the due date for the premium to be received before the policy is terminated. If the company is relatively assured of collecting the late premium, and has established an appropriate unearned premium reserve, it is permitted to record such due and uncollected premium as an admitted asset.
>
> On accident and health policies, other than group, with premiums payable more frequently than quarterly, all due and unpaid premiums are not admitted if more than one period premium is overdue. Group premiums more than 90 days overdue also are disallowed as an admitted asset.
>
> Because the policyholder can terminate the policy at any time simply by not paying the premium, the company should consider its lapse experience in determining the amount it records as uncollected premiums. Recording older due premiums (although not more than 90 days past due), which have little or no unearned premium reserve, may overstate the company's financial condition.

Generally Accepted Accounting Principles

13. GAAP accounting for uncollectible premiums/receivables is governed by *FASB Statement No. 5, Accounting for Contingencies* (FAS 5), paragraphs 1, 3 and 8:

> 1. For the purpose of this Statement, a contingency is defined as an existing condition, situation, or set of circumstances involving uncertainty as to possible gain (hereinafter a “gain contingency”) or loss[1] (hereinafter a “loss contingency”) to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the acquisition of an asset or the reduction of a liability or the loss or impairment of an asset or the incurrence of a liability.
>
> [1] The term loss is used for convenience to include many charges against income that are commonly referred to as expenses and others that are commonly referred to as losses.
>
> 3. When a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable

to remote. This Statement uses the terms probable, reasonably possible, and remote to identify three areas within that range, as follows:

a) Probable. The future event or events are likely to occur.

b) Reasonably possible. The chance of the future event or events occurring is more than remote but less than likely.

c) Remote. The chance of the future event or events occurring is slight.

8. An estimated loss from a loss contingency (as defined in paragraph 1) shall be accrued by a charge to income[3] if both of the following conditions are met:

a) Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements.[4] It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.

b) The amount of loss can be reasonably estimated.

[3] Paragraphs 23-24 of APB Opinion No. 9, Reporting the Results of Operations, describe the rare circumstances in which a prior period adjustment is appropriate. Those paragraphs are not amended by this Statement.

[4] Date of the financial statements means the end of the most recent accounting period for which financial statements are being presented.

14. The FAS 5 criteria above is used in interpreting information such as historical trending and general information about the stability of the insureds in an effort to evaluate the collectibility of the receivable balance. Accounting for contingencies is discussed in more detail in Issue Paper No. 5.

15. GAAP accounting requires the aging of direct billed premiums to begin from the effective date of the policy. Aging for endorsement premiums should begin from the endorsement's effective date and installment premiums should begin from the installment's contractual due date. Although not specifically stated, this guidance can be deduced through review of *FASB Statement of Concepts No. 5*, *Recognition and Measurement in Financial Statements of Business Enterprises*, paragraph 83, as follows:

83. Further guidance for recognition of revenues and gains is intended to provide an acceptable level of assurance of the existence and amounts of revenues and gains before they are recognized. Revenues and gains of an enterprise during a period are generally measured by the exchange values of the assets (goods or services) or liabilities involved, and recognition involves consideration of two factors (a) being realized or realizable and (b) being earned, with sometimes one and sometimes the other being the more important consideration.

a. Realized or realizable. Revenues and gains generally are not recognized until realized or realizable. Revenues and gains are realized when products (goods or services), merchandise, or other assets are exchanged for cash or claims to cash. Revenues and gains are realizable when related assets received or held are readily convertible to known amounts of cash or claims to cash. Readily convertible assets have (i) interchangeable (fungible) units and (ii) quoted prices available in an active market that can rapidly absorb the quantity held by the entity without significantly affecting the price.

> b. Earned. Revenues are not recognized until earned. An entity's revenue-earning activities involve delivering or producing goods, rendering services, or other activities that constitute its ongoing major or central operations, and revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues. Gains commonly result from transactions and other events that involve no "earning process," and for recognizing gains, being earned is generally less significant than being realized or realizable.

16. The renewal or establishment of an insurance policy in exchange for a claim to cash (premium receivable) triggers the realization characteristic of revenue recognition, therefore, the aging of the uncollected premium should commence on the effective date of the new or renewed policy. Endorsement premiums will trigger the realization characteristic on the effective date of the endorsement, while installment premiums will trigger the realization characteristic on the contractual due date of the installment.

17. *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises* (FAS 60), also provides some indirect guidance. FAS 60, paragraph 13, requires revenue on short-duration contracts to be recognized over the period of the contract in proportion to the amount of insurance protection provided. The contract period starts with the policy effective date. Therefore, it is reasonable to begin aging from the policy effective date, as this is the date when revenue recognition begins.

OTHER SOURCES OF INFORMATION

18. The draft discussion material from previous Property/Casualty codification projects proposed extensive modifications to the accounting for agents' balances and uncollected premiums. The following represents a summary of those modifications:

> When the original or deposit premium is more than ninety days past due based on an aging referenced to effective date and therefore, not admitted, all premiums subsequently charged on the same policies or bonds are similarly not admitted, except that if the amount of such original or deposit premiums does not exceed 20% of the subsequently charged premiums in the same policies or bonds, such subsequently charged premiums, if otherwise not themselves more than ninety days overdue, shall be allowed as admitted assets.

19. The same basic concept was also discussed for endorsement premiums and installment premiums. In addition, it discussed certain parameters where a greater than ninety day nonadmitted premium could be accounted for as an admitted asset. The modification was stated as follows:

> A premium which has been determined to be not admitted may be treated as admitted if it has been collected within forty-five days of the date of determination and not more than ninety days had elapsed from the billing date to the date of determination and further, that not more than one hundred thirty-five days had elapsed from the effective date of the premium to the date of determination.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapters 7 & 9
- NAIC Annual Statement Instructions
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 18

- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*

Generally Accepted Accounting Principles

- *FASB Statement No. 5, Accounting for Contingencies*
- *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises*
- *FASB Statement of Financial Accounting Concepts No. 5, Recognition and Measurement in Financial Statements of Business Enterprises*

State Regulations

- No additional guidance obtained from state statutes or regulations.

Other Sources of Information

- Draft discussion material from previous Property/Casualty codification projects

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Statutory Issue Paper No. 11

Compensated Absences

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 11
This issue paper may not be directly related to the current authoritative statement.

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory guidance does not specifically address the accounting for compensated absences (i.e., vested vacation benefits, vested sick pay benefits, and holidays) in either the Accounting Practices and Procedures manuals for Life and Accident and Health or for the Property and Casualty Insurance Companies. The purpose of this issue paper is to establish statutory accounting principles for compensated absences that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

2. A reporting entity shall accrue a liability for employees' compensation for future absences if all of the following conditions are met:

a. The reporting entity's obligation relating to employees' rights to receive compensation for future absences is attributable to employees' services already rendered,

b. The obligation relates to rights that vest[1] or accumulate[2],

c. Payment of the compensation is probable, and

d. The amount can be reasonably estimated.

3. In the unlikely situation in which a reporting entity does not accrue a liability in accordance with paragraph 2 only because the amount cannot be reasonably estimated (i.e., condition d. is not met), that fact and the reasons therefore shall be disclosed in a note to the financial statements. An employer is not required to accrue a liability for nonvesting accumulating rights for compensated absences as the right to receive these benefits is contingent upon future events and continued employment.

4. A reporting entity shall accrue a liability for employees' compensated absences or, for services reimbursable under service agreements with an affiliate, if all of the above conditions are met.

[1] In this issue paper, vested rights are those for which the reporting entity has an obligation to make payment even if an employee terminates; thus, they are not contingent on an employee's future service.

[2] For purposes of this issue paper, accumulate means that earned but unused rights to compensated absences may be carried forward to one or more periods subsequent to that in which they are earned, even though there may be a limit to the amount that can be carried forward.

5. Accounting changes adopted to conform to the provisions of this issue paper shall be accounted for in accordance with *Issue Paper No. 3—Accounting Changes*. In the year the principle is adopted, recognition of the liability for compensated absences at the time of adoption that has not previously been recorded shall be recognized through a direct charge to surplus.

Consolidated/Holding Company Plans

6. The employees of many reporting entities are eligible for certain compensated absence benefits granted by a parent company or holding company. An entity with employees who are eligible for those benefits and is not directly liable for those related obligations shall recognize an expense equal to its allocation from the parent company or holding company of the benefits earned during the period. A liability shall be established for any such amounts due, but not yet paid. Furthermore, the reporting entity shall disclose in the notes to the financial statements that its employees participate in a plan sponsored by the holding company for which the reporting entity has no legal obligation. The amount of expense incurred and the allocation methodology utilized by the provider of such benefits shall also be disclosed. If the reporting entity is directly liable for compensated absence benefits, then the requirements outlined above in paragraphs 2 - 5 shall be applied.

DISCUSSION

7. Paragraphs 2-5 of the Summary Conclusion above adopt *FASB Statement No. 43*, *Accounting for Compensated Absences* (FAS 43) with certain modifications to paragraphs 8 and 9. Paragraphs 8 and 9 discuss the effective date and the accounting for the retroactive adoption of FAS 43. This issue paper modifies these paragraphs by requiring the initial adoption of this accounting principle to be recorded as a change in accounting principle consistent with Issue Paper No. 3 (i.e., the cumulative effect of the change will be charged to surplus in the year of adoption).

8. Liability, as defined by *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets,* is a probable future sacrifice of economic benefit arising from the present obligation of a particular entity to transfer assets or to provide services to other entities in the future as a result of past transactions or events. Compensated absences, which meet the criteria discussed in the conclusion above, meet this definition of a liability. The recording of a liability for compensated absences is also consistent with presenting financial statements which support the Solvency and Conservatism concepts within the Statement of Concepts.

Drafting Notes/Comments

- Holding company obligations are addressed in a separate issue paper.
- Accounting for pensions is addressed in *Issue Paper No. 8—Accounting for Pensions*.
- Employers' accounting for postemployment benefits is addressed in *Issue Paper No. 13—Employers' Accounting for Postemployment Benefits*.
- Employers' accounting for postretirement benefits other than pensions is addressed in *Issue Paper No. 14—Employers' Accounting for Postretirement Benefits Other Than Pensions.*

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting Principles

9. Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 17, *Other Liabilities*, provides general guidance on the accrual of compensated absences as follows:

> Liabilities for Benefits for Employees and Agents
>
> A company may be required or desire to establish a liability for certain benefits to employees and agents which are not provided for in other accounts. Examples include:

The company may wish to set up a liability for the salary for accrued but unused vacation hours since vacation hours can legitimately be viewed as "earned" at the end of the work periods for which they are granted.

10. The Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies does not provide specific guidance on accounting for compensated absences.

Generally Accepted Accounting Principles

11. The accrual for compensated absences is governed by FAS 43, *Accounting for Compensated Absences*. Paragraphs 6, 7, 8 and 9 provide for the determination and treatment of compensated absences.

6. An employer shall accrue a liability for employees' compensation for future absences if all of the following conditions are met:

a. The employer's obligation relating to employees' rights to receive compensation for future absences is attributable to employees' services already rendered,

b. The obligation relates to rights that vest[1] or accumulate[2],

[1] In this Statement, vested rights are those for which the employer has an obligation to make payment even if an employee terminates; thus, they are not contingent on an employee's future service.

[2] For purposes of this Statement, accumulate means that earned but unused rights to compensated absences may be carried forward to one or more periods subsequent to that in which they are earned, even though there may be a limit to the amount that can be carried forward.

c. Payment of the compensation is probable, and

d. The amount can be reasonably estimated.

If an employer meets conditions (a), (b), and (c) and does not accrue a liability because condition (d) is not met, that fact shall be disclosed.

7. Notwithstanding the conditions specified in paragraph 6, an employer is not required to accrue a liability for nonvesting accumulating rights to receive sick pay benefits[3] (that is, compensation for an employee's absence due to illness) for the reasons stated in paragraph 15.

[3] In accounting for compensated absences, the form of an employer's policy for compensated absences should not prevail over actual practices. For example, if employees are customarily paid "sick pay" benefits even though their absences from work are not actually the result of illness or if employees are routinely allowed to take compensated "terminal leave" for accumulated unused sick pay benefits prior to retirement, such benefits shall not be considered sick pay benefits for purposes of applying the provisions of paragraph 7 but rather should be accounted for in accordance with paragraph 6.

Effective Date and Transition

8. This Statement shall be effective for fiscal years beginning after December 15, 1980, with earlier application encouraged. Accounting changes adopted to conform to the provisions of this Statement shall be applied retroactively. In the year that this Statement is first applied, the financial statements shall disclose the nature of any restatement and its effect on income before extraordinary items, net income, and related per share amounts for each year restated.

9. If retroactive restatement of all years presented is not practicable, the financial statements presented shall be restated for as many consecutive years as practicable and the cumulative effect of applying the Statement shall be included in determining net income of the earliest year restated (not necessarily the earliest year presented). If it is not practicable to restate any prior year, the cumulative effect shall be included in net income in the year in which the Statement is first applied. (See paragraph 20 of *APB Opinion No. 20, Accounting Changes*.) The effect on income before extraordinary items, net income, and related per share amounts of applying this Statement in a year in which the cumulative effect is included in determining that year's net income shall be disclosed for that year.

OTHER SOURCES OF INFORMATION

12. Chapter 22 of the NAIC Technical Resource Group Proposed Draft Life Codification suggested the recording of a compensated absence liability under the following circumstances:

> Compensated Absences
>
> Employers pay their employees for absences due to vacations, sick time and holidays. Compensated absences must be accrued if all of the following criteria are met:
>
> a. the employees have rendered services which obligate the employer to pay for future absences;
>
> b. the employees are entitled to compensation even if employment is terminated;
>
> c. payment of the compensation is probable; and
>
> d. the amount can be reasonably estimated.
>
> Salary advances to an employee can be used to reduce the liability for that employee's compensated absences.

RELEVANT LITERATURE

Statutory Accounting Practices and Procedures

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *Issue Paper No. 3—Accounting Changes*
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 17

Generally Accepted Accounting Principles

- *FASB Statement No. 43, Accounting for Compensated Absences*

State Regulations

- No additional guidance obtained from state statutes or regulations.

Other Sources of Information

- NAIC Technical Resource Group Proposed Draft Life Codification, Chapter 22

Statutory Issue Paper No. 12

Accounting for Drafts Issued and Outstanding

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 2

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory accounting, as documented in the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, provides guidance on the accounting for drafts but does not provide a definition of a draft. This issue paper will establish a definition for "draft" and will codify statutory accounting relating to drafts.

SUMMARY CONCLUSION

2. For purposes of statutory accounting, a "draft" is defined as an order to pay a sum certain in money, which is signed by the drawer (e.g., the insurance company or its agent), and payable to order or bearer (policyholder) by the drawee (bank) only upon approval by the insurance company once the draft has been presented to the drawee.

3. A reporting entity that utilizes instruments that meet the above definition of drafts shall elect one of the following accounting methods:

a. **Draft Issued Method** - When a draft is issued, an increase in paid losses and a related decrease in loss reserves is recorded. Drafts that have not been presented for payment and remain outstanding at the balance sheet date are reflected as a liability.

b. **Draft Honored Method** - An increase in paid losses and a related decrease in loss reserves is recorded when the draft is cashed and presented by the bank to the reporting entity for reimbursement. Consequently, under a draft honored method there is no liability for outstanding drafts.

The method elected by a reporting entity to account for drafts issued and outstanding shall remain consistent from year to year. Procedures for changes in the accounting method shall be governed by *Issue Paper No. 3—Accounting Changes*.

DISCUSSION

4. Statutory accounting does not address the characteristics of a draft, however, Chapter 13*, Other Liabilities*, of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies does provide specific guidance on how to account for drafts. This guidance is consistent with GAAP accounting procedures for outstanding drafts as discussed in *AICPA Statement of Position 92-4, Auditing Insurance Entities' Loss Reserves.*

5. Drafts and checks have different legal characteristics. A check is payable on demand, whereas a draft must be approved for payment by the issuer (the reporting entity) before it is honored by the bank. Because of these different characteristics, a draft meets the definition of a liability as defined by NAIC

Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets. Outstanding checks are accounted for as a reduction of cash.

Drafting Notes/Comments
None

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
6. The Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 13, *Other Liabilities*, discusses the accounting for drafts as follows:

> Companies may record loss and loss expense drafts written to claimants and policyholders on either a draft issued or a draft honored basis. On an issued system, paid losses and appropriate loss reserve releases are recorded when the draft is issued. Drafts that have not been presented for payment and remain outstanding at the balance sheet date are reflected as a liability under this caption.
>
> Companies on a draft honored system do not record paid losses or release loss reserves until the drafts are cashed and presented by the bank to the company for reimbursement. Consequently, under a draft honored system there is no liability for outstanding drafts.

Generally Accepted Accounting Principles
7. *AICPA Statement of Position 92-4, Auditing Insurance Entities' Loss Reserves* as incorporated through Appendix L of the AICPA Audit and Accounting Guide: Audits of Property and Liability Insurance Companies, discusses the accounting for drafts as follows:

> Drafts outstanding - Some insurance companies may elect to pay claims by draft rather than by check and may not record the drafts as cash disbursed until the drafts are presented to the insurer by the bank. A liability for drafts outstanding is required only if cash disbursements and claim statistical information are not recorded concurrently, thereby creating a timing difference. Because the claim statistical information is updated to reflect the payment, no loss reserve is recorded for the claim; however, because the draft has not been presented, a drafts outstanding liability is required.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 13

Generally Accepted Accounting Principles
- *AICPA Statement of Position 92-4, Auditing Insurance Entities' Loss Reserves*
- *AICPA Audit and Accounting Guide: Audits of Property and Casualty Insurance Companies*

State Regulations
- No additional guidance obtained from state statutes and regulations.

Statutory Issue Paper No. 13

Employers' Accounting for Postemployment Benefits

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 11

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory practices and procedures do not address accounting for the estimated cost of benefits provided by an employer to former or inactive employees or agents after employment but before retirement (referred to as "postemployment benefits"). Postemployment benefits are all types of benefits provided to former or inactive employees or agents, their beneficiaries, and covered dependents. Those benefits include, but are not limited to, salary continuation, supplemental unemployment benefits, severance benefits, disability-related benefits (including workers' compensation), job training and counseling, and continuation of benefits such as health care benefits and life insurance coverage.

2. The purpose of this issue paper is to establish statutory accounting principles for postemployment benefits that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

3. Employers shall accrue a liability for the reporting entity's obligation to provide postemployment benefits if all of the following conditions are met:

a. The obligation is attributable to employees' or agents' services already rendered,
b. The obligation relates to rights that vest or accumulate,
c. Payment of the benefits is probable, and
d. The amount of the benefits can be reasonably estimated.

4. If those four conditions are not met, the employer must account for postemployment benefits when it is probable that a liability has been incurred and the amount can be reasonably estimated. In the unlikely situation in which a reporting entity does not accrue a liability in accordance with paragraph 3 only because the amount cannot be reasonably estimated, that fact and the reasons therefore shall be disclosed in the notes to the financial statements.

5. Postemployment benefits provided to employees or agents in connection with their termination can include special termination benefits and contractual termination benefits. Special termination benefits are defined as those that are offered only for a short period of time; contractual termination benefits are defined as those required by the terms of a plan only if a specified event, such as a facility closing, occurs. An employer that offers special termination benefits to employees or agents shall recognize a liability and an expense when the employees or agents accept the offer and the amount can be reasonably estimated. An employer that provides contractual termination benefits shall recognize a liability and an expense when it is probable that employees or agents will be entitled to benefits and the amount can be reasonably estimated. The cost of such termination benefits shall include the amount of any lump-sum payments and the present value of any expected future payments.

6. Accounting changes adopted to conform to the provisions of this issue paper shall be accounted for in accordance with *Issue Paper No. 3—Accounting Changes*. In the year the principle is adopted, recognition of the liability for postemployment benefits at the time of adoption that has not previously been recorded shall be recognized through a direct charge to surplus.

Consolidated/Holding Company Plans

7. The employees of many reporting entities are eligible for certain postemployment benefits granted by a parent company or holding company. An entity with employees who are eligible for those benefits and is not directly liable for those related obligations shall recognize an expense equal to its allocation from the parent company or holding company of the benefits earned during the period. A liability shall be established for any such amounts due, but not yet paid. Furthermore, the reporting entity shall disclose in the notes to the financial statements that its employees participate in a plan sponsored by the holding company for which the reporting entity has no legal obligation. The amount of expense incurred and the allocation methodology utilized by the provider of such benefits shall also be disclosed. If the reporting entity is directly liable for postemployment benefit obligations, then the requirements outlined in paragraphs 3 to 6 above shall be applied.

DISCUSSION

8. Paragraphs 3 - 6 of the Summary Conclusion above adopt *FASB Statement No. 112*, *Employers' Accounting for Postemployment Benefits: an amendment of FASB Statements No. 5 and 43* (FAS 112), and the provisions of *FASB Statement No. 88*, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits* (FAS 88), that address termination benefits, both with a modification to adopt the principles in accordance with *Issue Paper No. 3—Accounting Changes.*

9. The Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts) states under the concept of recognition that *"Liabilities require recognition as they are incurred"* and *"Accounting treatments which tend to defer expense recognition do not generally represent acceptable SAP treatment"*. In addition, the Statement of Concepts states under the concept of conservatism that *"In order to provide a margin of protection for policyholders, the concept of conservatism should be followed when developing estimates as well as establishing accounting principles for statutory reporting"*. Requiring reporting entities to follow the guidance in FAS 112 and the termination benefit provisions of FAS 88 is consistent with the recognition and conservatism concepts in the Statement of Concepts.

10. Without guidance on accounting for the cost of postemployment benefits, reporting entities' accounting for such benefits can vary. FAS 112 notes in paragraph 2 that:

> Some employers accrued the estimated cost of those benefits over the related service periods of active employees. Other employers applied a terminal accrual approach and recognized the estimated cost of those benefits at the date of the event giving rise to the payment of the benefits (for example, the death of an active employee, the temporary or permanent disability of an active employee, or the layoff of an employee). Still other employers recognized the cost of postemployment benefits when they were paid (cash basis). Some employers may have used different methods of accounting for different types of benefits.

11. FAS 112 does not provide employers with an option to recognize the effect of adoption over future periods. Paragraph 25 of FAS 112 includes the following statements:

> The Board considered whether a provision for delayed recognition of the transition amount was needed. A major objective of transition is to minimize implementation costs and mitigate disruption without unduly compromising the ability of financial statements to provide useful information. An important factor considered by the Board was the potential magnitude of the unrecorded postemployment benefit obligation. Information made available to the Board indicated

> that postemployment benefits are generally not as significant as pension or other postretirement benefits. The Board concluded that a provision for delayed recognition was not needed to mitigate the financial statement impact of immediately recognizing the transition amount when this Statement is adopted. That provision would have added unnecessary complexity to the application of this Statement, reduced financial statement comparability, and been inconsistent with Statements 5 and 43, which do not provide for delayed recognition at transition.

This issue paper adopts this immediate recognition concept.

Drafting Notes/Comments

- Accounting for postemployment benefits incurred in connection with a restructuring is addressed in a separate issue paper addressing restructuring costs and EITF 94-3.
- Accounting for pensions is discussed in *Issue Paper No. 8—Accounting for Pensions*.
- Accounting for compensated absences is addressed in *Issue Paper No. 11—Compensated Absences*.
- Accounting for postretirement benefits other than pensions is addressed in *Issue Paper No. 14—Employers' Accounting for Postretirement Benefits Other Than Pensions.*
- Holding company obligations are addressed in a separate issue paper.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

12. The Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 17, *Other Liabilities*, contains the following with respect to liabilities for benefits for employees and agents:

> Liabilities for Benefits for Employees and Agents
>
> A company may be required or desire to establish a liability for certain benefits to employees and agents which are not provided for in other accounts. Examples include:
>
> 1. It may be desirable to hold the liability or a nonqualified pension plan in this category in order to assist the tax department in adjusting their tax deductions.
>
> 2. The company may wish to set up a liability for the salary for accrued but unused vacation hours since vacation hours can legitimately be viewed as "earned" at the end of the work periods for which they are granted.

Generally Accepted Accounting Principles

13. FAS 112, requires employers to recognize the obligation to provide postemployment benefits in accordance with *FASB Statement No. 43, Accounting for Compensated Absences* (FAS 43), if the obligation is attributable to employees' services already rendered, employees' rights to those benefits accumulate or vest, payment of the benefits is probable, and the amount of the benefits can be reasonably estimated. If those four conditions are not met, the employer should account for postemployment benefits when it is probable that a liability has been incurred and the amount can be reasonably estimated in accordance with *FASB Statement No. 5*, *Accounting for Contingencies* (FAS 5). If an obligation for postemployment benefits is not accrued in accordance with FAS 5 or FAS 43 only because the amount cannot be reasonably estimated, the financial statements shall disclose that fact.

14. FAS 88 has provisions that address accounting for benefits provided to employees in connection with their termination of employment. Special termination benefits are defined as those that are offered only for a short period of time and contractual termination benefits are defined as those required by the terms of a plan only if a specified event, such as a plant closing, occurs. FAS 88 requires an employer that offers special termination benefits to employees to recognize a liability and a loss when the employees accept the offer and the amount can be reasonably estimated. It also requires an employer that provides

contractual termination benefits to recognize a liability and loss when it is probable that employees will be entitled to benefits and the amount can be reasonably estimated. The cost of the termination benefits recognized shall include the amount of any lump-sum payments and the present value of any expected future payments.

OTHER SOURCES OF INFORMATION

15. The draft discussion material from previous Life codification projects, Chapter 17, *Other Liabilities*, modified the above language:

> Liabilities for Benefits for Employees and Agents
>
> A company must establish a liability for certain benefits to employees and agents which are not provided for in other accounts. Examples include deferred compensation and nonqualified benefit plans for employees and agents.

16. The NAIC Technical Resource Group proposed draft Life codification Chapter 22, *General Expenses and Taxes, Licenses and Fees*, contains the following guidance:

> Employee Termination Benefits
>
> For a variety of reasons, companies pay compensation to employees at termination. Such benefits include disability benefits, death benefits, severance payments, unemployment benefits, etc. These benefits are paid after an employee terminates but are typically based on service previously rendered.
>
> The cost of such post-employment benefits must be spread over the working lives of those expected to receive the benefit. These benefits include all benefits paid to or for former or inactive employees (including their beneficiaries and/or dependents) after employment.
>
> Such compensation must be accrued during an employee's working life if:
>
> a. the benefit to be paid is earned for service previously rendered;
> b. the right to those benefits accumulates, vests or;
> c. the payment of the benefits is probable; and
> d. the amount can be reasonably estimated.

17. The draft discussion material from previous Property/Casualty codification projects, Chapter 23, *Non-Claim Operating Expenses*, contains the following language:

> Salaries, and Employee Relations and Welfare (Including Post Employment Retirement and Other Benefits)
>
> Salaries and payroll related expenses are usually the second largest expense for most insurance companies. SAP requires that salaries and related expenses be accounted for under the accrual basis of accounting (i.e., expense recorded when incurred and not when paid). Pensions and other post retirement benefit plans for which there is no promulgated SAP should be accounted for in accordance with GAAP as promulgated by the Financial Accounting Standards Board (FASB). (The preceding may need revision based on final outcome of the FASB 106 Task Force.)
>
> Employee compensation and post retirement benefits include, among other things, the following:
>
> 1. Salaries and wages
> 2. Pension plans.
> 3. Post retirement benefits other than pensions.
> 4. Compensated absences.
> 5. Stock purchase and option plans.
> 6. Other deferred compensation

18. In addition, the draft discussion materials from previous Property/Casualty codification projects discusses deferred compensation and special termination benefits specifically and states the following:

> Other Deferred Compensation
>
> The accounting for other deferred compensation arrangements, which do not constitute pension plans is governed by APB Opinion No. 12, "Omnibus Opinion." APB 12 provides that deferred compensation contracts should be accounted separately for each employee on the accrual basis. The amount of each accrual cannot be less than the present value of the benefits to be provided (including benefits to beneficiaries) by the terms of the contract. The accruals should be made over the employee's employment period.
>
> Special Termination Benefits
>
> FASB 74 "Accounting for Special Termination Benefits Paid to Employees" [FAS 74] provides that,
>
>> ... an employer that offers for a short period of time special termination benefits to employees shall recognize a liability and an expense when the employees accept the offer and the amount can be reasonable estimated. The amount shall include any lump sum payments and the present value of any expected future payments.
>
> These arrangements may also effect the estimated costs of pension benefits.

19. It should be noted that although FAS 74 has been superseded by FAS 88, the conclusions reached in FAS 74 were incorporated into FAS 88 (i.e., the cost of special termination benefits should be recognized as a liability and a loss when the employees accept the offer and the amount can be reasonable estimated). See paraphrasing from FAS 88 in the Generally Accepted Accounting Principles section of this paper.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *Issue Paper No. 3—Accounting Changes*
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 17, *Other Liabilities*, subcaption—Liabilities for Benefits for Employees and Agents, page 17-1
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 17, *Other Liabilities*, subcaption—Postretirement Benefits Other Than Pensions, page 17-3
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 13, *Other Liabilities*, subcaption—Postretirement Benefits Other Than Pensions, page 13-3

Generally Accepted Accounting Principles

- *FASB Statement No. 112, Employers' Accounting for Postemployment Benefits an amendment of FASB Statements No. 5 and 43*
- *FASB Statement No. 5, Accounting for Contingencies*
- *FASB Statement No. 43, Accounting for Compensated Absences*
- *FASB Statement No. 88, Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*

State Regulations

- No additional guidance obtained from state statutes or regulations.

Other Sources of Information

- NAIC Technical Resource Group proposed draft Life codification, Chapter 22, *General Expenses and Taxes*, Licenses and Fees
- Draft discussion material from previous Property/Casualty codification projects, Chapter 23, *Non-Claim Operating Expenses*, subcaption - Pension Plans
- Draft discussion material from previous Life codification projects, Chapter 17, *Other Liabilities*, subcaption - Liabilities for Benefits for Employees and Agents, page 17.2

Statutory Issue Paper No. 14

Employers' Accounting for Postretirement Benefits Other Than Pensions

STATUS
Finalized December 6, 1999

Current Authoritative Guidance for Postretirement Benefits Other Than Pensions: SSAP No. 92
This issue paper may not be directly related to the current authoritative statement.

Original SSAP from Issue Paper: SSAP No. 14

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Postretirement benefits include all forms of benefits, other than retirement income, provided by an employer to retirees. Those benefits may be defined in terms of specified benefits that are provided to retirees as the need for those benefits arises, such as certain health care benefits, or they may be defined in terms of monetary amounts that become payable on the occurrence of a specified event, such as life insurance benefits. Current statutory accounting addresses employers' accounting for postretirement benefits other than pensions.

2. GAAP guidance has been established by *FASB Statement No. 106*, *Employers' Accounting for Postretirement Benefits Other Than Pensions* (FAS 106), and differs from the current statutory guidance. *FASB Statement No. 132*, *Employers' Disclosures about Pensions and Other Postretirement Benefits* (FAS 132), specifies disclosure requirements for pension and other postretirement benefit plans.

3. The purpose of this issue paper is to establish statutory accounting principles for postretirement benefits other than pensions that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. Employers' accounting for postretirement benefits other than pensions under statutory accounting shall be consistent with existing statutory guidance in the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies. The principles contained therein shall apply to postretirement benefits other than pensions for all eligible and vested employees and vested former employees including their beneficiaries and covered dependents, pursuant to the terms of an employer's undertaking to provide those benefits. Any asset resulting from an overfunding of the plan shall be recorded as a nonadmitted asset.

Disclosure

5. The disclosures required by paragraph 5 of FAS 132 shall be included in the notes to the statutory financial statements considering the modification in this issue paper to include only vested employees. Paragraph 5 of FAS 132 is included in the Relevant GAAP Guidance section of this issue paper. The disclosures required by paragraph 5 of FAS 132 shall be made when an employer recognizes a gain or loss related to a settlement or curtailment of a defined benefit plan or when providing termination benefits.

Consolidated/Holding Company Plans

6. The employees of many reporting entities are eligible for certain postretirement benefits other than pensions provided by a parent company or holding company. A reporting entity with employees who are eligible for those benefits and is not directly liable for those related obligations shall recognize an expense equal to its allocation of the benefits earned during the period. A liability shall be established for any such amounts due, but not yet paid. The reporting entity shall disclose in the notes to the financial statements that its employees participate in a plan sponsored by the holding company for which the reporting entity has no legal obligation. The amount of the postretirement benefit expense incurred and the allocation methodology shall also be disclosed in the financial statements. If the reporting entity is directly liable for certain postretirement benefits other than pensions, then the requirements outlined in paragraphs 4 and 5 of this issue paper shall be applied.

DISCUSSION

7. Current statutory accounting and the accounting codified within this issue paper adopt FAS 106, FAS 132 and *Accounting Principles Board Opinion No. 12*, *Omnibus Opinion–1967*, paragraphs 6 through 8 with the following modifications:

a. Any asset which results from an excess of the fair value of plan assets over the postretirement benefit obligation shall be recorded as a nonadmitted asset.

b. Calculation of the postretirement benefit obligation shall exclude non-vested employees. Partially vested employees are included only to the extent of their vested amounts.

c. The reduced disclosure requirements for nonpublic entities described in paragraph 8 of FAS 132 are rejected. All reporting entities shall follow the disclosure requirements included in paragraph 5 of FAS 132.

d. Disclosures relating to other comprehensive income in paragraph 5 of FAS 132 shall be made for income on a statutory basis.

8. This issue paper adopts *FASB Emerging Issues Task Force No. 93-3*, *Plan Assets under FASB Statement No. 106.*

9. The Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies address employers’ accounting for postretirement benefits other than pensions and require that the obligation for such benefits be recognized on an accrual basis for current retirees and fully eligible or vested employees. If the fair value of plan assets exceeds the postretirement obligation and a transition asset results, the asset is considered a nonadmitted asset. At transition, the employer may elect to recognize the unfunded postretirement benefit obligation as a charge to statutory surplus in the period of adoption or amortize it as a component of net periodic postretirement benefit cost over a period of up to twenty years.

10. GAAP guidance is established by FAS 106 and differs from the current statutory guidance in that it requires the accrual of expected postretirement benefits for all current and former employees (including retirees, disabled employees, and other former employees who are expected to receive postretirement benefits), their beneficiaries, and covered dependents, pursuant to the terms of an employer's undertaking to provide those benefits. Two options are provided for recognizing the transition obligation. An employer may choose to immediately recognize the transition obligation as the effect of a change in accounting principle, subject to certain limitations. Alternatively, an employer may choose to recognize the transition obligation on a delayed basis over the plan participants' future service periods, with disclosure of the unrecognized amount. However, that delayed recognition cannot result in less rapid recognition than accounting for the transition obligation on a pay-as-you-go basis.

11. The Statement of Concepts states under the recognition concept that *"Liabilities require recognition as they are incurred" and "Accounting treatments which tend to defer expense recognition do not generally represent acceptable SAP treatment."* In addition, the Statement of Concepts states under the concept of conservatism that *"In order to provide a margin of protection for policyholders, the concept of conservatism should be followed when developing estimates as well as establishing accounting principles for statutory reporting."* Requiring reporting entities to follow the existing statutory guidance relative to accounting for postretirement benefits other than pensions is consistent with the recognition and conservatism concepts in the Statement of Concepts.

Drafting Notes/Comments

- Federal income taxes are addressed in a separate issue paper.
- Holding company obligations are addressed in a separate issue paper.
- Accounting for pensions is addressed in *Issue Paper No. 8—Accounting for Pensions*.
- Accounting for postemployment benefits is addressed in *Issue Paper No. 13—Employers' Accounting for Postemployment Benefits*.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

12. The following is an excerpt from the Accounting Practices and Procedures Manuals for Life and Accident and Health [Chapter 17] and for Property and Casualty [Chapter 13] Insurance Companies:

> Postretirement Benefits Other Than Pensions
>
> Postretirement benefits are all forms of benefits, other than retirement income, provided by an employer to retirees. Those benefits may be defined in terms of specified benefits that are provided to retirees as the need for those benefits arises, such as certain health care benefits, or they may be defined in terms of monetary amounts that become payable on the occurrence of a specified event, such as life insurance benefits.
>
> An employer shall account for its postretirement benefits on an accrual basis. The postretirement benefit obligation for current retirees and fully eligible or vested employees at transition (initial adoption date*) is measured by estimating the actuarial present value of benefits expected to be received at retirement using explicit assumptions. A health care cost trend rate assumption is used in the estimation. A health care cost trend rate is an assumption about the annual rate(s) of change in the cost of health care benefits currently provided by the postretirement benefit plan, due to factors other than changes in the composition of the plan population by age and dependency status, for each year from the measurement date until the end of the period in which benefits are expected to be paid. The health care cost trend rates implicitly consider estimates of health care inflation, changes in health care utilization or status of the plan participants.
>
> * For most companies, the transition or initial adoption date is January 1, 1993. For companies whose plans are outside the United States and for defined benefits of employers with no more than 500 plan participants in the aggregate, the transition or initial adoption is January 1, 1995.
>
> Plan assets, if any, shall be segregated or restricted, and measured at fair value.
>
> At transition, an employer may elect to recognize the unfunded postretirement benefit obligation immediately in statutory surplus or amortize it as a component of net periodic postretirement benefit cost over a period of up to twenty years.
>
> In each period, estimated postretirement benefits for newly eligible or vested employees shall be accrued at eligibility date ("estimated eligibility cost"). Interest cost on the postretirement benefit obligation at the beginning of the period shall be recognized during the period. Actuarial gains

and losses (other than plan asset gains and losses) arising from differences between assumptions and actual experience upon subsequent remeasurement of the obligation may be recognized as a component of the net periodic postretirement benefit cost in the current period or amortized. The net actuarial gain or loss shall be included as a component of the net periodic postretirement benefit cost for a year, if, as of the beginning of the year, that unrecognized net gain or loss exceeds 10 percent of the greater of the postretirement benefit obligation or the fair value of plan assets. That gain or loss, if not recognized immediately, shall be amortized over the average life expectancy of the employer's fully vested and retiree group. The method elected must be consistently applied.

Gains or Losses On Plan Assets:

Plan asset gains and losses are differences between the actual return on plan assets (including changes in the fair values of plan assets) during a period and the expected return on plan assets for that period. Amortization of an unrecognized net asset gain or loss shall be included as a component of net postretirement benefit cost for a year if, as of the beginning of the year, that unrecognized net gain or loss exceeds 10 percent of the greater of the postretirement benefit obligation or the fair value of plan assets. That excess shall be amortized over the average life expectancy of the employer's fully vested and retiree group.

Plan amendments:

Plan amendments may include provisions that increase or reduce benefits to retirees and fully eligible employees. The cost of benefit improvements is the increase in the postretirement benefit obligation as a result of the plan amendment, measured at the date of the amendment. That increase shall be amortized over the average life expectancy of the employer's fully vested and retiree group.

A plan amendment can reduce, rather than increase, the postretirement benefit obligation. A reduction in that obligation shall first reduce any existing unrecognized plan amendment cost, and then, reduce any remaining unrecognized transition obligation. The excess, if any, shall be amortized on the same basis as plan amendments that increase benefits.

Financial Statement Presentation:

The net periodic postretirement benefit cost (i.e., the estimated eligibility cost, interest cost, actuarial gains or losses, and any amortization costs) shall be reflected in the income statement. If an employer elects immediate recognition of the initial transition obligation, it shall be accounted for as a change of accounting method (i.e., the initial transition obligation is recorded as an adjustment to statutory surplus).

Transition Asset:

If the fair value of plan assets exceeds the postretirement obligation and a transition asset results, the asset shall be considered a nonadmitted asset.

Defined Contribution Plans:

A defined contribution postretirement benefit plan is a plan that provides postretirement benefits by establishing an individual account for each participant and has terms that specify how contributions to the individual's account are to be determined rather than the amount of postretirement benefits the individual is to receive. Under a defined contribution plan, postretirement benefits a plan participant will receive are limited to the amount contributed to the plan participant's account, the returns earned on investments of these contributions, and forfeitures of other plan participants' benefits that may be allocated to the plan participant's account.

To the extent that an employer's defined contributions to an individual's account are vested or irrevocable, the net postretirement benefit cost for a period shall be the contribution called for in that period. If a plan calls for contributions for periods after an individual retires, the estimated costs shall be accrued at retirement date.

Effective Date:

This policy shall be effective for the first quarter financial statements dated March 31, 1993, except that plans outside the United States and for defined benefit plans of employees with no more than 500 plan participants in the aggregate, this policy shall be effective for 1st quarter financial statements dated March 31, 1995.

13. The NAIC Annual Statement Instructions (Annual Statement Instructions) for Life and Accident and Health Insurance Companies contain the following language related to Liabilities, Surplus and Other Funds:

Line 13 - General Expenses Due or Accrued

Include: Expenses not yet incurred but which it is anticipated will be incurred in connection with accident and health claims at the year-end.

Unfunded postretirement benefit obligation.

14. The Annual Statement Instructions also include the following language with respect to Capital and Surplus Account:

Details of Write-ins Aggregated at Line 46 for Gains and Losses in Surplus

Report separately any other changes to Capital and Surplus, not included above, including amounts received for subordinated surplus debentures.

Include: The initial transition obligation for unfunded postretirement benefit obligation if a company elects to immediately recognize such obligation.

(Charges) or credits for extraordinary amounts of taxes (including interest) paid or accrued in prior years.

(Charges) or credits for extraordinary amounts of expenses paid or accrued in prior years.

(See Item 7 on Page d of these instructions.)

15. In addition, the Annual Statement Instructions for Exhibit 5 - General Expenses state:

Line 3.31- Other Employee Welfare
Line 3.32- Other Agent Welfare

Expenses included in this line may be reported on a functional basis.

Include: The net periodic postretirement benefit cost.

Meals to employees. (Companies so desiring may exclude this item from Other Employee Welfare or Other Agent Welfare and include it under Details Aggregated on Line 9.3 for Expenses.)

Contributions to employee associations or clubs.

16. The Annual Statement Instructions also provide guidance on information to be included in the notes to the financial statements:

> 6. Retirement Plans, Deferred Compensation and Other Postretirement Benefit Plans Instruction:
>
> c. Postretirement Benefit Plans
> Include the following:
>
> A description of the plan(s).
>
> A description of the plan's policy.
>
> The method of determination and the amount of postretirement benefit expense.
>
> The amount of the postretirement benefit obligation for retirees and fully eligible or vested employees and the fair value of the plan assets valued as of the most recent actuarial valuation date.
>
> The amount of the postretirement benefit obligation included on Page 3, Line 13 [Life and Accident and Health] or Lines 2 and 4 [Property and Casualty].
>
> The amount of the postretirement obligation for non vested employees as of the most recent actuarial date.
>
> The discount and health care cost trend rate used in the estimations.
>
> The effect of a one-percentage-point increase in the assumed health care cost trend rates for each future year on (1) the aggregate of the estimated eligibility and interest cost components of net periodic postretirement benefit cost and (2) the postretirement benefit obligation for health care benefits (for purposes of this disclosure, all other assumptions shall be held constant and the effects shall be measured based upon the substantive plan that is the basis of accounting).
>
> Significant matters affecting the year-to-year comparability of the plan information.
>
> An employer who is a member of a multi-employer plan shall disclose a description of the plan(s), the method of determination and the amount of postretirement benefit expense for the employer/member and the unfunded postretirement benefit obligation.
>
> Postretirement Defined Contribution Plans
> Include the following:
>
> A description of the plans, including employee groups covered.
>
> The basis for determining contributions.
>
> The nature and effect of significant matters affecting comparability of information for all periods presented.
>
> The amount of cost recognized during the period.

Sample disclosure is also provided.

17. The NAIC Annual Statement Instructions for Property and Casualty Insurance Companies includes the following language with respect to Underwriting and Investment Exhibit - Part 4 - Expenses:

> The total management fees and the method(s) used for allocation shall be disclosed in the Notes to Financial Statements. The company shall use the same allocation method(s) on a consistent basis.
>
> Line 9 - Employee Relations and Welfare
>
> Include: The net periodic postretirement benefit cost.

Generally Accepted Accounting Principles

18. The following summary from FAS 106, describes the GAAP methodology and concepts:

> Summary
>
> This Statement establishes accounting standards for employers' accounting for postretirement benefits other than pensions (hereinafter referred to as postretirement benefits). Although it applies to all forms of postretirement benefits, this Statement focuses principally on postretirement health care benefits. It will significantly change the prevalent current practice of accounting for postretirement benefits on a pay-as-you-go (cash) basis by requiring accrual, during the years that the employee renders the necessary service, of the expected cost of providing those benefits to an employee and the employee's beneficiaries and covered dependents.
>
> The Board's conclusions in this Statement result from the view that a defined postretirement benefit plan sets forth the terms of an exchange between the employer and the employee. In exchange for the current services provided by the employee, the employer promises to provide, in addition to current wages and other benefits, health and other welfare benefits after the employee retires. It follows from that view that postretirement benefits are not gratuities but are part of an employee's compensation for services rendered. Since payment is deferred, the benefits are a type of deferred compensation. The employer's obligation for that compensation is incurred as employees render the services necessary to earn their postretirement benefits.
>
> The ability to measure the obligation for postretirement health care benefits and the recognition of that obligation have been the subject of controversy. The Board believes that measurement of the obligation and accrual of the cost based on best estimates are superior to implying, by a failure to accrue, that no obligation exists prior to the payment of benefits. The Board believes that failure to recognize an obligation prior to its payment impairs the usefulness and integrity of the employer's financial statements.
>
> The Board's objectives in issuing this Statement are to improve employers' financial reporting for postretirement benefits in the following manner:
>
> a. To enhance the relevance and representational faithfulness of the employer's reported results of operations by recognizing net periodic postretirement benefit cost as employees render the services necessary to earn their postretirement benefits
>
> b. To enhance the relevance and representational faithfulness of the employer's statement of financial position by including a measure of the obligation to provide postretirement benefits based on a mutual understanding between the employer and its employees of the terms of the underlying plan
>
> c. To enhance the ability of users of the employer's financial statements to understand the extent and effects of the employer's undertaking to provide postretirement benefits to its employees by disclosing relevant information about the obligation and cost of the postretirement benefit plan and how those amounts are measured

d. To improve the understandability and comparability of amounts reported by requiring employers with similar plans to use the same method to measure their accumulated postretirement benefit obligations and the related costs of the postretirement benefits.

Similarity to Pension Accounting

The provisions of this Statement are similar, in many respects, to those in *FASB Statements No. 87, Employers' Accounting for Pensions*, and *No. 88, Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*. To the extent the promise to provide pension benefits and the promise to provide postretirement benefits are similar, the provisions of this Statement are similar to those prescribed by Statements 87 and 88; different accounting treatment is prescribed only when the Board has concluded that there is a compelling reason for different treatment. Appendix B identifies the major similarities and differences between this Statement and employers' accounting for pensions.

Basic Tenets

This Statement relies on a basic premise of generally accepted accounting principles that accrual accounting provides more relevant and useful information than does cash basis accounting. The importance of information about cash flows or the funding of the postretirement benefit plan is not ignored. Amounts funded or paid are given accounting recognition as uses of cash, but the Board believes that information about cash flows alone is insufficient. Accrual accounting goes beyond cash transactions and attempts to recognize the financial effects of noncash transactions and events as they occur. Recognition and measurement of the accrued obligation to provide postretirement benefits will provide users of financial statements with the opportunity to assess the financial consequences of employers' compensation decisions.

In applying accrual accounting to postretirement benefits, this Statement adopts three fundamental aspects of pension accounting: delayed recognition of certain events, reporting net cost, and offsetting liabilities and related assets.

Delayed recognition means that certain changes in the obligation for postretirement benefits, including those changes arising as a result of a plan initiation or amendment, and certain changes in the value of plan assets set aside to meet that obligation are not recognized as they occur. Rather, those changes are recognized systematically over future periods. All changes in the obligation and plan assets ultimately are recognized unless they are first reduced by other changes. The changes that have been identified and quantified but not yet recognized in the employer's financial statements as components of net periodic postretirement benefit cost and as a liability or asset are disclosed.

Net cost means that the recognized consequences of events and transactions affecting a postretirement benefit plan are reported as a single amount in the employer's financial statements. That single amount includes at least three types of events or transactions that might otherwise be reported separately. Those events or transactions -- exchanging a promise of deferred compensation in the form of postretirement benefits for employee service, the interest cost arising from the passage of time until those benefits are paid, and the returns from the investment of plan assets -- are disclosed separately as components of net periodic postretirement benefit cost.

Offsetting means that plan assets restricted for the payment of postretirement benefits offset the accumulated postretirement benefit obligation in determining amounts recognized in the employer's statement of financial position and that the return on those plan assets offsets postretirement benefit cost in the employer's statement of income. That offsetting is reflected even though the obligation has not been settled, the investment of the plan assets may be largely controlled by the employer, and substantial risks and rewards associated with both the obligation and the plan assets are borne by the employer.

Recognition and Measurement

The Board is sensitive to concerns about the reliability of measurements of the postretirement health care benefit obligation. The Board recognizes that limited historical data about per capita claims costs are available and that actuarial practice in this area is still developing. The Board has taken those factors into consideration in its decisions to delay the effective date for this Statement, to emphasize disclosure, and to permit employers to phase in recognition of the transition obligation in their statements of financial position. However, the Board believes that those factors are insufficient reason not to use accrual accounting for postretirement benefits in financial reporting. With increased experience, the reliability of measures of the obligation and cost should improve.

An objective of this Statement is that the accounting reflect the terms of the exchange transaction that takes place between an employer that provides postretirement benefits and the employees who render services in exchange for those benefits. Generally the extant written plan provides the best evidence of that exchange transaction. However, in some situations, an employer's cost-sharing policy, as evidenced by past practice or by communication of intended changes to a plan's cost-sharing provisions, or a past practice of regular increases in certain monetary benefits may indicate that the substantive plan -- the plan as understood by the parties to the exchange transaction -- differs from the extant written plan. The substantive plan is the basis for the accounting.

This Statement requires that an employer's obligation for postretirement benefits expected to be provided to or for an employee be fully accrued by the date that employee attains full eligibility for all of the benefits expected to be received by that employee, any beneficiaries, and covered dependents (the full eligibility date), even if the employee is expected to render additional service beyond that date. That accounting reflects the fact that at the full eligibility date the employee has provided all of the service necessary to earn the right to receive all of the benefits that employee is expected to receive under the plan.

The beginning of the attribution (accrual) period is the employee's date of hire unless the plan only grants credit for service from a later date, in which case benefits are generally attributed from the beginning of that credited service period. An equal amount of the expected postretirement benefit obligation is attributed to each year of service in the attribution period unless the plan attributes a disproportionate share of the expected benefits to employees' early years of service. The Board concluded that, like accounting for other deferred compensation agreements, accounting for postretirement benefits should reflect the explicit or implicit contract between the employer and its employees.

Single Method

The Board believes that understandability, comparability, and usefulness of financial information are improved by narrowing the use of alternative accounting methods that do not reflect different facts and circumstances. The Board has been unable to identify circumstances that would make it appropriate for different employers to use fundamentally different accounting methods or measurement techniques for similar postretirement benefit plans or for a single employer to use fundamentally different methods or measurement techniques for different plans. As a result, a single method is prescribed for measuring and recognizing an employer's accumulated postretirement benefit obligation.

Amendment to Opinion 12

An employer's practice of providing postretirement benefits to selected employees under individual contracts, with specific terms determined on an individual-by-individual basis, does not constitute a postretirement benefit plan under this Statement. This Statement amends APB Opinion No. 12, Omnibus Opinion--1967, to explicitly require that an employer's obligation under deferred compensation contracts be accrued following the terms of the individual contract over the required service periods to the date the employee is fully eligible for the benefits.

Transition

Unlike the effects of most other accounting changes, a transition obligation for postretirement benefits generally reflects, to a considerable extent, the failure to accrue the accumulated postretirement benefit obligation in earlier periods as it arose rather than the effects of a change from one acceptable accrual method of accounting to another. The Board believes that accounting for transition from one method of accounting to another is a practical matter and that a major objective of that accounting is to minimize the cost and mitigate the disruption to the extent possible without unduly compromising the ability of financial statements to provide useful information.

This Statement measures the transition obligation as the unfunded and unrecognized accumulated postretirement benefit obligation for all plan participants. Two options are provided for recognizing that transition obligation. An employer can choose to immediately recognize the transition obligation as the effect of an accounting change, subject to certain limitations. Alternatively, an employer can choose to recognize the transition obligation in the statement of financial position and statement of income on a delayed basis over the plan participants' future service periods, with disclosure of the unrecognized amount. However, that delayed recognition cannot result in less rapid recognition than accounting for the transition obligation on a pay-as-you-go basis.

Effective Dates

This Statement generally is effective for fiscal years beginning after December 15, 1992, except that the application of this Statement to plans outside the United States and certain small, nonpublic employers is delayed to fiscal years beginning after December 15, 1994. The amendment of Opinion 12 is effective for fiscal years beginning after March 15, 1991.

19. FAS 132 sets forth disclosure requirements:

Disclosures about Pensions and Other Postretirement Benefits

5. An employer that sponsors one or more defined benefit pension plans or one or more defined benefit postretirement plans shall provide the following information:

a. A reconciliation of beginning and ending balances of the benefit obligation[2] showing separately, if applicable, the effects during the period attributable to each of the following: service cost, interest cost, contributions by plan participants, actuarial gains and losses, foreign currency exchange rate changes[3], benefits paid, plan amendments, business combinations, divestitures, curtailments, settlements, and special termination benefits

[2] For defined benefit pension plans, the benefit obligation is the projected benefit obligation—the actuarial present value as of a date of all benefits attributed by the pension benefit formula to employee service rendered prior to that date. For defined benefit postretirement plans, the benefit obligation is the accumulated postretirement benefit obligation—the actuarial present value of benefits attributed to employee service rendered to a particular date.

[3] The effects of foreign currency exchange rate changes that are to be disclosed are those applicable to plans of a foreign operation whose functional currency is not the reporting currency pursuant to *FASB Statement No. 52, Foreign Currency Translation*.

b. A reconciliation of beginning and ending balances of the fair value of plan assets showing separately, if applicable, the effects during the period attributable to each of the following: actual return on plan assets, foreign currency exchange rate changes[4], contributions by the employer, contributions by plan participants, benefits paid, business combinations, divestitures, and settlements

[4] Refer to footnote 3.

c. The funded status of the plans, the amounts not recognized in the statement of financial position, and the amounts recognized in the statement of financial position, including:
   (1) The amount of any unamortized prior service cost
   (2) The amount of any unrecognized net gain or loss (including asset gains and losses not yet reflected in market-related value)
   (3) The amount of any remaining unamortized, unrecognized net obligation or net asset existing at the initial date of application of Statement 87 or 106
   (4) The net pension or other postretirement benefit prepaid assets or accrued liabilities
   (5) Any intangible asset and the amount of accumulated other comprehensive income recognized pursuant to paragraph 37 of Statement 87, as amended

d. The amount of net periodic benefit cost recognized, showing separately the service cost component, the interest cost component, the expected return on plan assets for the period, the amortization of the unrecognized transition obligation or transition asset, the amount of recognized gains and losses, the amount of prior service cost recognized, and the amount of gain or loss recognized due to a settlement or curtailment
e. The amount included within other comprehensive income for the period arising from a change in the additional minimum pension liability recognized pursuant to paragraph 37 of Statement 87, as amended
f. On a weighted-average basis, the following assumptions used in the accounting for the plans: assumed discount rate, rate of compensation increase (for pay-related plans), and expected long-term rate of return on plan assets
g. The assumed health care cost trend rate(s) for the next year used to measure the expected cost of benefits covered by the plan (gross eligible charges) and a general description of the direction and pattern of change in the assumed trend rates thereafter, together with the ultimate trend rate(s) and when that rate is expected to be achieved
h. The effect of a one-percentage-point increase and the effect of a one-percentage- point decrease in the assumed health care cost trend rates on (1) the aggregate of the service and interest cost components of net periodic postretirement health care benefit cost and (2) the accumulated postretirement benefit obligation for health care benefits (For purposes of this disclosure, all other assumptions shall be held constant, and the effects shall be measured based on the substantive plan that is the basis for the accounting.)
i. If applicable, the amounts and types of securities of the employer and related parties included in plan assets, the approximate amount of future annual benefits of plan participants covered by insurance contracts issued by the employer or related parties, and any significant transactions between the employer or related parties and the plan during the period
j. If applicable, any alternative amortization method used to amortize prior service amounts or unrecognized net gains and losses pursuant to paragraphs 26 and 33 of Statement 87 or paragraphs 53 and 60 of Statement 106
k. If applicable, any substantive commitment, such as past practice or a history of regular benefit increases, used as the basis for accounting for the benefit obligation
l. If applicable, the cost of providing special or contractual termination benefits recognized during the period and a description of the nature of the event
m. An explanation of any significant change in the benefit obligation or plan assets not otherwise apparent in the other disclosures required by this Statement.

Amounts related to the employer's results of operations shall be disclosed for each period for which an income statement is presented. Amounts related to the employer's statement of financial position shall be disclosed for each balance sheet presented.

Employers with Two or More Plans

6. The disclosures required by this Statement may be aggregated for all of an employer's defined benefit pension plans and may be aggregated for all of an employer's defined benefit postretirement plans or may be disaggregated in groups if that is considered to provide the most useful information or is otherwise required by paragraph 7. Disclosures about pension plans with

assets in excess of the accumulated benefit obligation generally may be aggregated with disclosures about pension plans with accumulated benefit obligations in excess of assets. The same aggregation is permitted for postretirement plans. However, if those disclosures are combined, an employer shall disclose the aggregate benefit obligation and aggregate fair value of plan assets for plans with benefit obligations in excess of plan assets. The aggregate pension accumulated benefit obligation and aggregate fair value of plan assets for pension plans with accumulated benefit obligations in excess of plan assets also shall be disclosed. Disclosure of amounts recognized in the statement of financial position shall present prepaid benefit costs and accrued benefit liabilities separately.

7. An employer may combine disclosures about pension or postretirement benefit plans outside the United States with those for U.S. plans unless the benefit obligations of the plans outside the United States are significant relative to the total benefit obligation and those plans use significantly different assumptions.

Reduced Disclosure Requirements for Nonpublic Entities

8. A nonpublic entity[5] may elect to disclose the following for its pension and other postretirement benefit plans in lieu of the disclosures required by paragraph 5 of this Statement:

a. The benefit obligation, fair value of plan assets, and funded status of the plan
b. Employer contributions, participant contributions, and benefits paid
c. The amounts recognized in the statement of financial position, including the net pension and other postretirement benefit prepaid assets or accrued liabilities and any intangible asset and the amount of accumulated other comprehensive income recognized pursuant to paragraph 37 of Statement 87, as amended
d. The amount of net periodic benefit cost recognized and the amount included within other comprehensive income arising from a change in the minimum pension liability recognized pursuant to paragraph 37 of Statement 87, as amended
e. On a weighted-average basis, the following assumptions used in the accounting for the plans: assumed discount rate, rate of compensation increase (for pay-related plans), and expected long-term rate of return on plan assets
f. The assumed health care cost trend rate(s) for the next year used to measure the expected cost of benefits covered by the plan (gross eligible charges) and a general description of the direction and pattern of change in the assumed trend rates thereafter, together with the ultimate trend rate(s) and when that rate is expected to be achieved
g. If applicable, the amounts and types of securities of the employer and related parties included in plan assets, the approximate amount of future annual benefits of plan participants covered by insurance contracts issued by the employer or related parties, and any significant transactions between the employer or related parties and the plan during the period
h. The nature and effect of significant nonroutine events, such as amendments, combinations, divestitures, curtailments, and settlements.

Defined Contribution Plans

9. An employer shall disclose the amount of cost recognized for defined contribution pension or other postretirement benefit plans during the period separately from the amount of cost recognized for defined benefit plans. The disclosures shall include a description of the nature and effect of any significant changes during the period affecting comparability, such as a change in the rate of employer contributions, a business combination, or a divestiture.

[5] A nonpublic entity is any entity other than one (a) whose debt or equity securities trade in a public market either on a stock exchange (domestic or foreign) or in the over-the-counter market, including securities quoted only locally or regionally, (b) that makes a filing with a regulatory agency in preparation for the sale of any class of debt or equity securities in a public market, or (c) that is controlled by an entity covered by (a) or (b).

Multiemployer Plans

10. An employer shall disclose the amount of contributions to multiemployer plans during the period. An employer may disclose total contributions to multiemployer plans without disaggregating the amounts attributable to pensions and other postretirement benefits. The disclosures shall include a description of the nature and effect of any changes affecting comparability, such as a change in the rate of employer contributions, a business combination, or a divestiture.

11. Paragraph 70 of Statement 87 and paragraph 83 of Statement 106 are carried forward without reconsideration. Paragraphs 70 and 83 read as follows:

> In some situations, withdrawal from a multiemployer plan may result in an employer's having an obligation to the plan for a portion of its unfunded benefit obligations. If withdrawal under circumstances that would give rise to an obligation is either probable or reasonably possible, the provisions of FASB Statement No. 5, *Accounting for Contingencies*, shall apply.
>
> In some situations, withdrawal from a multiemployer plan may result in an employer's having an obligation to the plan for a portion of the plan's unfunded accumulated postretirement benefit obligation. If it is either probable or reasonably possible that (a) an employer would withdraw from the plan under circumstances that would give rise to an obligation or (b) an employer's contribution to the fund would be increased during the remainder of the contract period to make up a shortfall in the funds necessary to maintain the negotiated level of benefit coverage (a "maintenance of benefits" clause), the employer shall apply the provisions of *FASB Statement No. 5, Accounting for Contingencies*.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *Issue Paper No. 3—Accounting Changes*
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 13, Other Liabilities
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 17, Other Liabilities
- NAIC Annual Statement Instructions for Life and Accident and Health Insurance Companies
- NAIC Annual Statement Instructions for Property and Casualty Insurance Companies

Generally Accepted Accounting Principles

- *FASB Statement No. 106, Employers' Accounting for Postretirement Benefits Other Than Pensions*
- *FASB Statement No. 132, Employers' Disclosures about Pensions and Other Postretirement Benefits*
- *FASB Emerging Issues Task Force No. 93-3, Plan Assets under FASB Statement No. 106*
- *Accounting Principles Board Opinion No. 12, Omnibus Opinion–1967, paragraphs 6 through 8*
- *FASB Special Report, A Guide to Implementation of Statement 106 on Employers' Accounting for Postretirement Benefits Other Than Pensions: Questions and Answers*

State Regulations

- No additional guidance obtained from state statutes or regulations.

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Statutory Issue Paper No. 16

Electronic Data Processing Equipment and Software

STATUS
Finalized March 16, 1998

Original SSAP: SSAP No. 16; Current Authoritative Guidance: SSAP No. 16R

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. The current statutory guidance provides that some states permit recording electronic data processing (EDP) equipment and operating system software as admitted assets. This is subject to limitations such as a percentage of total assets, minimum purchase price, and period of depreciation. Application system software may be expensed when purchased, or established as a nonadmitted asset and written off over a period of years not to exceed the software's expected useful life.

2. GAAP requires purchases of EDP equipment and software to be capitalized and depreciated over the expected useful lives of the assets, except for software purchased or leased for research and development purposes, which is required to be expensed at acquisition. There is no authoritative literature in GAAP that addresses capitalization of software developed for internal use, and industry practice is mixed. This issue paper establishes a framework for the accounting and reporting of EDP equipment and software that is consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

3. EDP equipment and software generally meet the definition of an asset in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*. EDP equipment and operating system software are admitted assets to the extent they conform to the requirements of this issue paper. Nonoperating system software meet the criteria defining nonadmitted assets; accordingly, such assets shall be reported as nonadmitted assets and charged against surplus.

4. EDP equipment and software shall be depreciated for a period not to exceed three years using methods detailed in *Issue Paper No. 67—Depreciation of Property and Amortization of Leasehold Improvements*.

5. The aggregate amount of admitted EDP equipment and operating system software (net of accumulated depreciation) shall be limited to three percent of the reporting entity's capital and surplus, excluding from capital and surplus any EDP equipment and operating system software, net deferred tax assets and net positive goodwill, as of the financial statement date.

6. The following disclosures shall be made in the financial statements:

   a. Depreciation and amortization expense for the period;

   b. For EDP equipment and operating system software, balances of major classes of depreciable assets, by nature or function, at the balance sheet date;

c. For EDP equipment and operating system software, accumulated depreciation and amortization, either by major classes of depreciable assets or in total, at the balance sheet date; and

d. A general description of the method or methods used in computing depreciation with respect to major classes of depreciable assets.

DISCUSSION

7. *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets* states that an asset not readily available to satisfy policyholder obligations *"shall be recorded as a nonadmitted asset and charged against surplus."* This is consistent with the Statement of Concepts, which states that a reporting entity's *"ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due*."

8. EDP equipment and operating system software meet the criteria defining admitted assets because they generally have a resale value. The limitation of the depreciation period to three years is deemed appropriate due to the current evolutionary period for such equipment and software. Additionally, the limitation on the amount of EDP equipment and operating system software which may be admitted in an amount not to exceed three percent of capital and surplus (as adjusted by EDP equipment and operating system software, net deferred tax assets and net positive goodwill) is consistent with the conservatism concept of the Statement of Concepts.

9. Nonoperating system software is not considered readily available to satisfy policyholder obligations, particularly due to the nature of internally developed EDP software and the modifications made to purchased EDP software, that make it tailored for use only on the owner's computer system, thereby rendering it unable to be readily resold. Nonadmitting nonoperating software is also consistent with the conservatism concept of the Statement of Concepts.

Drafting Notes/Comments

- *FASB Statement No. 2*, *Accounting for Research and Development Costs* (FAS 2), FASB Interpretation No. 6, *Applicability of FASB Statement No. 2 to Computer Software* (FIN 6) and *FASB Statement No. 86, Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed* (FAS 86) are addressed in *Issue Paper No. 17—Preoperating and Research and Development Costs*.
- Furniture, fixtures & equipment are addressed in *Issue Paper No. 19—Furniture, Fixtures and Equipment*.
- Leases and sale-leaseback transactions are addressed in *Issue Paper No. 22—Leases*

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

10. The Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 8, *Other Admitted Assets,* differentiates between operating software and applications software as follows:

> 1. Various states permit showing the depreciated value of electronic data processing apparatus and related equipment constituting a data processing record keeping or accounting system as an asset. This is subject to limitations such as a percentage of total assets, minimum purchase price and period of depreciation. Operating system software may also qualify as an asset. The operating system is a program or series of programs controlling the data job and task management operations of a computer or a computer network through executive scheduling and monitoring. It increases the productivity of a computer installation by managing the allocation of all available computer resources including the control processing unit, main storage and input/output devices. Applications systems software such as language processors, library

routines and debugging aides and other computer software are not considered operating system software and may not be recognized as admitted assets.

11. Chapter 9, Nonadmitted Assets, states: *"application systems software may be expensed when purchased or established as a nonadmitted asset and written off over a period of years not to exceed the software's expected useful life."*

12. The Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies contains similar guidance.

13. In most states the depreciated value of EDP equipment and its related operating software is an admitted asset, generally subject to several restrictions. The restrictions could include the following: requiring permission from the insurance commissioner of the state of domicile, setting a minimum amount that can be capitalized as an asset, establishing a maximum depreciable life (such as 10 years for hardware and five years for software) and limiting the amount that may be admitted to a percentage of total admitted assets or capital and surplus. Applications software is typically nonadmitted.

Generally Accepted Accounting Principles

14. GAAP requires purchases of long-lived equipment to be capitalized at their historical cost and depreciated over the expected useful life of the assets by recording a monthly charge against current income, in accordance with *Accounting Research Bulletin No. 43*, *Restatement and Revision of Accounting Research Bulletins* (ARB 43), Chapter 9, *Depreciation*. This treatment is consistent with the matching concept of GAAP, which requires revenues and expenses to be recognized over the period in which they are earned or incurred.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manuals for Property and Casualty Insurance Companies, Chapters 8 and 9
- Accounting Practices and Procedures Manuals for Life and Accident and Health Insurance Companies, Chapters 8 and 9
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 67—Depreciation of Property and Amortization of Leasehold Improvements*

State Regulations

- California Statutes - Insurance Laws, Division 1, Part 2, Article 4, *Property Authorized for Excess Funds Investments*
- New York Statutes - Insurance Laws, Chapter 28, Article 13, *Assets and Deposits*
- Texas Statutes - Insurance Laws, Texas Insurance Code, Chapter 3*, Life, Health and Accident Insurance*, subchapter A. Terms Defined; Domestic Companies
- Texas Administrative Code, Title 28, Part I, Chapter 7, *Corporate and Financial*

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Statutory Issue Paper No. 17

Preoperating and Research and Development Costs

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 17

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. This issue paper addresses organizational costs, research and development costs and start-up costs for new and existing entities. Current statutory accounting guidance does not specifically address the treatment of such costs. Standard statutory practice is to expense these costs as incurred. GAAP specifically addresses the treatment of research and development costs and costs of development stage enterprises. GAAP provides limited guidance on the treatment of other organizational costs resulting in varied practices.

2. The purpose of this issue paper is to establish specific statutory accounting principles related to preoperating and research and development costs that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

3. Preoperating, including organization and start up costs, and research and development costs shall be expensed as incurred. Preoperating and research and development costs are incurred for such new projects as: (1) arranging operations for a new company (e.g., legal, actuarial and accounting costs associated with regulatory approval and licensing and issuance of stock); (2) establishing production, sales or service facilities at a new site; (3) changing operations or production significantly; or (4) developing and producing a new product, adopting a new process or offering a new service. Preoperating, including organization and start up costs, and research and development costs specifically exclude tangible assets acquired in connection with such activities.

DISCUSSION

4. This issue paper adopts *FASB Statement No. 2*, *Accounting for Research and Development Costs* (FAS 2) and the related *FASB Interpretation No. 6*, *Applicability of FASB Statement No. 2 To Computer Software* (FIN 6) and rejects *FASB Statement No. 7*, *Accounting and Reporting by Development Stage Enterprises* (FAS 7). This issue paper also adopts *FASB Statement No. 86*, *Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed* (FAS 86), with the exception of paragraphs 5 and 6 and paragraphs 8 through 11, which are rejected.

5. *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets* (Issue Paper No. 4) defines an asset as *"probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events*." Although in some instances preoperating and research and development costs may appear to comply with the definition of an asset established by Issue Paper No. 4, it is not consistent with the Conservatism concept included in the Statement of Concepts to estimate that it is "probable" that an entity in a preoperating phase or a new product still being developed will generate future economic benefits. Preoperating and research and development costs, therefore, do not meet the definition of an asset for statutory accounting purposes and as such should be expensed as incurred. This

is consistent with the Recognition concept included in the Statement of Concepts, which states that a reporting entity's *"ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due."*

6. FAS 2 requires research and development costs (e.g., costs related to the development of an insurance product providing a new form of coverage or modifications to an existing insurance product) to be expensed as incurred. FAS 7 specifies that the accounting of the cost of a development stage enterprise should be no different than the accounting for similar costs of a mature enterprise. FAS 7 requires that the recoverability of costs incurred by a development stage enterprise be assessed in order to identify which costs qualify for capitalization or deferral. It permits recognition of these costs as an asset if they meet the GAAP criteria for capitalization. Other organizational costs are not specifically addressed in GAAP literature resulting in varied practices. Companies which have capitalized these costs do so under the matching concept of relating costs to revenue. Under this theory, revenue will be realized through future operations and therefore the costs should be deferred and expensed in the future when the revenue is recognized. Because the future benefit is rarely certain or measurable and the future period over which deferred costs might be allocated is usually arbitrary, deferral is not consistent with the Conservatism and Recognition concepts included in the Statement of Concepts.

7. FAS 86 reaffirms the provisions of FAS 2 for the treatment of software developed to be sold, leased or otherwise marketed by requiring the related software development costs to be expensed as incurred, with the exception of software costs incurred subsequent to the research and development phase but prior to making the software available to the public. Paragraphs 5, 6 and 8 through 11 of FAS 86 allow these costs to be capitalized. For the purposes of this paper, these costs are not considered to be different from the other costs incurred during a preoperating or research and development period and are included in the conclusion to expense these costs as incurred.

Drafting Notes/Comments

- Accounting treatment of goodwill, real estate, EDP equipment and software and furniture and equipment are addressed in separate issue papers.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

8. The majority of states do not specifically address the admission of preoperating costs in their insurance regulations and statutes. Typically, a reference is made to the treatment of goodwill and all other intangible assets. An example of this type of state guidance is New York Statutes - Insurance Laws, Chapter 28 of the Consolidated Insurance Laws, Article 13, *Assets and Deposits*, which states:

> The following shall not be allowed as admitted assets of a domestic or foreign insurer or the United States branch of an alien insurer in any determination of its financial condition:
>
> (1) Goodwill, trade names, agency plants and other like intangible assets.

9. Several states do make specific reference to organization costs in their insurance regulations and statutes. For example, Maryland Insurance Statutes - Insurance Laws, Article 48A -- Insurance Code, Subtitle 5, *Assets and Liabilities,* explicitly requires the nonadmission of organization costs, as opposed to expensing them as incurred.

Generally Accepted Accounting Principles

10. FAS 2, paragraph 12, states that "*All research and development costs encompassed by this Statement shall be charged to expense when incurred.*"

11. FAS 2 contains the following definitions:

> 8. For purposes of this Statement, research and development is defined as follows:
>
> a) Research is planned search or critical investigation aimed at discovery of new knowledge with the hope that such knowledge will be useful in developing a new product or service (hereinafter "product") or a new process or technique (hereinafter "process") or in bringing about a significant improvement to an existing product or process.
>
> b) Development is the translation of research findings or other knowledge into a plan or design for a new product or process or for a significant improvement to an existing product or process whether intended for sale or use. It includes the conceptual formulation, design, and testing of product alternatives, construction of prototypes, and operation of pilot plants. It does not include routine or periodic alterations to existing products, production lines, manufacturing processes, and other on-going operations even though those alterations may represent improvements and it does not include market research or market testing activities.

12. FIN 6, paragraph 5, states:

> When software for use in research and development activities is purchased or leased, its cost shall be accounted for as specified by paragraphs 11(c) and 12 of *Statement No. 2.* That is, the cost shall be charged to expense as incurred unless the software has alternative future uses (in research and development or otherwise).

13. FAS 86 amends FAS 2 and FIN 6 to provide guidance on accounting for software developed internally for sale, lease or other marketing. FAS 86, paragraph 3, states:

> All costs incurred to establish the technological feasibility of a computer software product to be sold, leased, or otherwise marketed are research and development costs. These costs shall be charged to expense when incurred as required by FASB Statement No. 2, *Accounting for Research and Development Costs.*

14. FAS 86, paragraphs 5 and 6, addresses the treatment of the costs of internally developed software that has completed the research and development phase but has not been made available to the public. FAS 86, paragraph 5, states:

> Costs of producing product masters incurred subsequent to establishing technological feasibility shall be capitalized. Those costs include coding and testing performed subsequent to establishing technological feasibility. Software production costs for computer software that is to be used as an integral part of a product or process shall not be capitalized until both (a) technological feasibility of the product has been established for the software and (b) all research and development activities for the other components of the product or process have been completed.

15. FAS 86, paragraph 6, states:

> Capitalization of computer software costs shall cease when the product is available for general release to customers. Costs of maintenance and customer support shall be charged to expense when related revenue is recognized or when those costs are incurred, whichever occurs first.

16. Paragraphs 8 through 11 of FAS 86 address the accounting and disclosure requirements for software costs capitalized under the provisions of paragraph 5 above.

17. FAS 7 states:

> Generally accepted accounting principles that apply to established operating enterprises shall govern the recognition of revenue by a development stage enterprise and shall determine whether a cost incurred by a development stage enterprise is to be charged to expense when incurred or is to be capitalized or deferred. Accordingly, capitalization or deferral of costs shall be subject to the same assessment of recoverability that would be applicable in an established operating enterprise.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*

Generally Accepted Accounting Principles

- *FASB Statement No. 2, Accounting for Research and Development Costs*
- *FASB Statement No. 7, Accounting and Reporting by Development Stage Enterprises*
- *FASB Statement No. 86, Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed*
- *FASB Interpretation No. 6, Applicability of FASB Statement No. 2 to Computer Software*

State Regulations

- Maryland Insurance Statutes - Insurance Laws, Article 48A--Insurance Code,
  Subtitle 5, *Assets and Liabilities*
- New York Statutes - Insurance laws, Chapter 28 of the Consolidated Insurance Laws, Article 13, *Assets and Deposits*

Statutory Issue Paper No. 19

Furniture, Fixtures and Equipment

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 19

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. The current statutory accounting guidance allows reporting entities to record furniture and equipment as assets, depreciate those assets, and nonadmit the undepreciated balance in the statutory financial statements. Alternatively, reporting entities may expense furniture and equipment when purchased. Guidance found in state statutes varies widely on the treatment of furniture, fixtures and equipment. GAAP requires purchases of furniture, fixture and equipment to be capitalized and depreciated over the expected useful lives of the assets. This issue paper establishes a framework for the accounting and reporting of furniture and equipment that is consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

2. Furniture, fixtures and equipment generally meet the definition of assets established in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets* (Issue Paper No. 4). Within that definition, such items also meet the criteria defining nonadmitted assets. As such, the undepreciated portion of these assets shall be reported as nonadmitted assets and charged against surplus. These nonadmitted assets shall be depreciated against net income as the estimated economic benefit expires. This conclusion is a change from current statutory guidance because an acquisition which meets the definition of an asset established in Issue Paper No. 4 may no longer be expensed. This change will promote uniformity in the accounting for furniture, fixtures and equipment.

3. In accordance with the reporting entity's capitalization policy, immaterial amounts of furniture, fixtures, and equipment, or supplies, can be expensed when purchased.

DISCUSSION

4. Issue Paper No. 4 defines an asset as *"probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events."* Issue Paper No. 4 also states that an asset not readily available to satisfy policyholder obligations *"shall be recorded as a nonadmitted asset and charged against surplus."* This is consistent with the Statement of Concepts, which states that a reporting entity's *"ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due."* Furniture, fixtures and equipment meet the definition of an asset but are not considered readily available to satisfy policyholder obligations. Therefore, it is in conformity with the above guidance to nonadmit these assets. This is also consistent with the concept of conservatism included in the Statement of Concepts.

Drafting Notes/Comments

- EDP equipment is addressed in *Issue Paper No. 16—Electronic Data Processing Equipment and Software*

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

5. The Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies (Chapter 9, *Nonadmitted Assets*, in both manuals) require the nonadmission of furniture and equipment via one of two accounting methods:

1. The reporting entity may record furniture and equipment as an asset, depreciate it through the Summary of Operations and record the change in the nonadmitted amount through Exhibit 14 for Life and Accident and Health Insurance Companies or Exhibit 2 for Property and Casualty Insurance Companies, which directly affects surplus.

2. The reporting entity may expense furniture and equipment when purchased.

6. Guidance found in state statutes is not consistent on this issue. Some states allow the undepreciated balances of furniture and equipment over a specified cost threshold to be treated as admitted assets, in amounts up to stipulated percentages of the aggregate of all other assets. The threshold for capitalization and the percentage of admitted asset limits permitted vary widely. An example is the Texas Statutes - Insurance Laws, Texas Insurance Code, Chapter 3, *Life, Health and Accident Insurance*, subchapter A. Terms Defined; Domestic Companies*,* which allows furniture, fixtures and equipment, including a data processing system, used in connection with the business of an insurance company to be admitted if the total value of the property exceeds $2,000 and constitutes less than 10% of the aggregate other admitted assets of the company. Assets which do not meet the threshold for capitalization (i.e., supplies) are expensed when purchased. Other states place no capitalization threshold on furniture, fixtures and equipment but require the assets to be amortized over a period not to exceed a specified number of years. For example, Florida Administrative Code, Title 38, Chapter 38F-5, *Self-Insurers Funds*, allows all furniture, fixtures and equipment of self insurers to be admitted as long as the assets are depreciated over a five-year useful life. Some states waive both the threshold for capitalization and the useful life requirement and only place limits on the percentage of admitted assets that the undepreciated balance of furniture, fixtures and equipment may comprise. An example is the Idaho statutes, Insurance Laws, Title 41, *Insurance*, Chapter 6, *Assets and Liabilities,* which states, “ All office equipment, office furniture, private passenger automobiles, deemed necessary for conduct of insurance business, the aggregate amount of which shall not at any one time exceed one percent (1%) of the other assets of the insurer.”

Generally Accepted Accounting Principles

7. GAAP requires purchases of furniture, fixtures and equipment to be capitalized at their historical cost and depreciated over the expected useful life of the assets by recording a monthly charge against current income, in accordance with *Accounting Research Bulletin No. 43*, *Restatement on Revision of Accounting Research Bulletins*, Chapter 9, *Depreciation*. This treatment is consistent with the matching concept of GAAP, which requires revenues and expenses to be recognized in income over the period in which they are earned or incurred. Furniture, fixtures and equipment are reported in the balance sheet at their historical cost net of accumulated depreciation.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 9, *Nonadmitted Assets*
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 9, *Nonadmitted Assets*
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*

Generally Accepted Accounting Principles

- *Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins, Chapter 9, Depreciation*

State Regulations

- Texas Statutes - Insurance Laws, Texas Insurance Code, Chapter 3, *Life, Health and Accident Insurance*, subchapter A. Terms Defined; Domestic Companies
- Texas Administrative Code, Title 28, Part I, Chapter 7, *Corporate and Financial*
- Florida Administrative Code, Title 38, Chapter 38F-5, *Self-Insurers Funds*
- Idaho Statutes, Insurance Laws, Title 41, *Insurance*, Chapter 6, *Assets and Liabilities*

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Statutory Issue Paper No. 20

Gain Contingencies

STATUS
Finalized March 16, 1998

Original SSAP: SSAP No. 5; Current Authoritative Guidance: SSAP No. 5R

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory guidance does not address accounting for gain contingencies. GAAP requires contingencies that may result in gains to be disclosed but not recorded in current year income.

2. This issue paper establishes the statutory accounting for gain contingencies that is consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

3. For purposes of applying this statutory accounting principle, a "gain" shall be defined as an increase in surplus (net assets) which results from peripheral or incidental transactions of a reporting entity and from all other transactions and other events and circumstances affecting the reporting entity except those that result from revenues or investments by owners. If, on or before the balance sheet date, (a) the transaction or event has been fully completed, and (b) the amount of the gain is determinable, then the transaction or event is considered a gain, and is recognized in the financial statements. This definition excludes increases in surplus that result from activities that constitute a reporting entity's ongoing major or central operations or activities. Because investment activities are central to an insurer's operations, increases in surplus that result from such investment activities are excluded from the definition of gains. Revenues are inflows or other enhancements of assets of a reporting entity or settlements of its liabilities (or a combination of both) from providing products, rendering services, or other activities that constitute the reporting entity's ongoing major or central operations. Investments by owners include any type of capital infused into the surplus of the reporting entity.

4. A "gain contingency" shall be defined as an existing condition, situation, or set of circumstances involving uncertainty as to possible "gain" (as defined in the preceding paragraph) to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur (e.g., a plaintiff has filed suit for damages associated with an event occurring prior to the balance sheet, but the outcome of the suit is not known as of the balance sheet date). Gain contingencies shall not be recognized in a reporting entity's financial statements. However, if subsequent to the balance sheet date but prior to the issuance of the financial statements, the gain contingency is realized, the gain shall be disclosed in the notes to financial statements and the unissued financial statements should not be adjusted to record the gain. A gain is generally considered realizable when noncash resources or rights are readily convertible to known amounts of cash or claims to cash.

5. Gain contingencies shall not be recorded in a reporting entity's financial statements. The notes to the financial statements shall contain adequate disclosure about the nature of the gain contingency. However, care should be exercised to avoid misleading implications as to the likelihood of realization.

DISCUSSION

6. This issue paper adopts paragraph 17 of *FASB Statement No. 5*, *Accounting for Contingencies* (FAS 5), which provides guidance with respect to the accounting and reporting of gain contingencies.

7. The definition of a "gain," as stated in paragraph 3 above, is consistent with that of *FASB Statement of Financial Accounting Concepts No. 6*, *Elements of Financial Statements* (CON 6). This definition of gains excludes investment activities of insurance companies.

8. Disclosure in a note to the financial statements but not recording a gain contingency is consistent with the conservatism and recognition concepts included in the Statement of Concepts. In addition, it prevents the recognition of transactions before the earnings process is completed (as prescribed in the recognition concept in the Statement of Concepts).

Drafting Notes/Comments

- Accounting for loss contingencies is addressed in *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- Revenue recognition issues are addressed in separate issue papers
- Income taxes are addressed in a separate issue paper
- Reinsurance agreements are addressed in a separate issue paper

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

9. As noted above, current statutory guidance does not address gain contingencies. However, the conservatism and recognition concepts of the Statement of Concepts provide guidance which can be applied to the accounting treatment of gain contingencies. The conservatism concept of the Statement of Concepts states the following:

> To the extent that factors or events result in adverse variation from management's accounting estimates, the ability to meet policyholder obligations may be lessened. In order to provide a margin of protection for policyholders, the concept of conservatism should be followed when developing estimates as well as establishing accounting principles for statutory reporting. Conservative valuation procedures provide protection to policyholders against adverse fluctuations in financial condition or operating results.

10. The recognition concept of the Statement of Concepts states that "*Revenue should be recognized only as the earnings process of the underlying underwriting or investment business is completed*."

Generally Accepted Accounting Principles

11. *FASB Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements* (CON 6), paragraphs 78 and 82, defines revenues and gains as follows:

> Revenues are inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations.
>
> Gains are increases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity except those that result from revenues or investments by owners.

12. Additionally, paragraph 88 states the following:

> Items that are revenues for one kind of entity may be gains for another, and items that are expenses for one kind of entity may be losses for another. For example, investments in securities

> that may be sources of revenues and expenses for insurance or investment companies may be sources of gains and losses in manufacturing or merchandising companies.

13. GAAP literature addresses accounting for gain contingencies in both general terms and in the event of gain contingencies which result from specific accounting treatments required by GAAP. FAS 5 provides general guidance for the treatment of gain contingencies. FAS 5, paragraph 17, states the following:

> Contingencies that might result in gains usually are not reflected in the accounts since to do so might be to recognize revenue prior to its realization.
>
> Adequate disclosure shall be made of contingencies that might result in gains, but care shall be exercised to avoid misleading implications as to the likelihood of realization.

14. Examples of GAAP literature which require a conservative treatment of gain recognition in specific accounting situations include:

1. *FASB Statement No. 88, Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*, paragraph 14, which requires gains due to the curtailment of all or a portion of a defined benefit pension plan to be recognized in income only when the related employee terminations occur, as opposed to curtailment losses which must be recognized in income when it is probable that the curtailment will occur and the effects are reasonably estimable.

2. *Accounting Principles Board Opinion No. 30, Reporting the Results of Operations--Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*, paragraph 15, which requires gains from the disposal of a segment of a business to be recognized in income at the actual disposal date, as opposed to losses from the disposal of a segment of a business which must be recognized in income at the measurement date (i.e. the date at which management commits to a formal plan to dispose the segment).

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy

Generally Accepted Accounting Principles

- *FASB Statement No. 5, Accounting for Contingencies*
- *FASB Statement No. 88, Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*
- *FASB Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements*
- *Accounting Principles Board Opinion No. 30, Reporting the Results of Operations--Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*

State Regulations

- No additional guidance obtained from state statutes or regulations.

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Statutory Issue Paper No. 21

Bills Receivable For Premiums

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 6

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Bills receivable, which are generally interest bearing, are used by reporting entities as methods of financing premiums. The Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies provides guidance on the accounting for bills receivable taken for premiums. However, the guidance for bills receivable in the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies relates to non-premium loans (which will be addressed in a separate issue paper). This issue paper establishes statutory accounting for bills receivable for premiums that is consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

2. Bills receivable for premiums meet the definition of assets as set forth in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*. First, an evaluation shall be made to determine nonadmitted amounts. Next, an evaluation shall be made of such assets in accordance with *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets* (Issue Paper No. 5) to determine whether there is an impairment. This two step process is set forth below:

1. Bills receivable shall be accounted for as a nonadmitted asset if either of the following conditions are present:

    a. Past due installment: If any installment is past due, the entire bills receivable balance from that policy is nonadmitted; or

    b. Aggregate bills receivable balance due in excess of the unearned premium on the policy for which the note was accepted: If the aggregate bills receivable balance due exceeds the policy's unearned premium, the amount in excess of the unearned premium is nonadmitted.

3. Amounts determined to be uncollectible shall be written off: If, in accordance with Issue Paper No. 5, it is probable a portion of the bills receivable is uncollectible, any uncollectible bills receivable shall be written off against operations in the period such determination is made. If it is reasonably possible a portion of the balance is uncollectible, disclosure requirements outlined in Issue Paper No. 5 shall be followed.

4. The following shall provide additional guidance in determining the nonadmitted portion of bills receivable:

a. Amounts classified as nonadmitted assets collected subsequent to the date of the statutory financial statements - Such amounts shall not be used to decrease the nonadmitted asset otherwise calculated.

b. Determination of the Due Date - The due date is governed by the contractual due date of the installment.

DISCUSSION

5. The Statement of Concepts states:

> The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which may be unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet but rather should be charged against surplus when acquired or when availability otherwise becomes questionable.

6. Based upon the above concept, bills receivable should reflect only amounts that are available to meet both current and future policyholder obligations when the obligations are due. Therefore, amounts determined to be impaired (i.e., uncollectible), regardless of aging, should be charged to operations in the period such determination is made.

7. Under the conservatism concept of statutory accounting and consistent with current statutory accounting guidance, the entire bill receivable is nonadmitted if the related premium installment is past due. In addition, any excess of the aggregate bill receivable over the unearned premium amount on the policy of any performing bill receivable is nonadmitted. In accordance with the concept of conservatism, subsequent collection of nonadmitted assets should not be considered in the determining period-end nonadmitted assets. These recoveries should be accounted for in the period received.

Drafting Notes/Comments

- Accounting/aging of retrospective premiums currently reported on line 9.2 or line 9.3 is addressed in a separate issue paper.
- Accounting for uncollected agents' balances is addressed in *Issue Paper No 6—Amounts Due From Agents and Brokers.*
- A separate issue paper addresses unearned and unbilled premiums.
- Accounting for uncollected premium balances is addressed in *Issue Paper No. 10—Uncollected Premium Balances*.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

8. Chapter 8, *Other Admitted Assets*, of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies discusses bills receivable as follows:

> (g) Bills receivable taken for premiums are admitted assets provided that the current installment is not past due, and the balance due does not exceed the unearned premium on the policy for which the note was accepted.

9. Chapter 9, *Nonadmitted Assets,* of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies discusses bills receivable as follows:

> 6. Bills Receivable, Taken for Premiums: Bills or notes receivable are used as methods of financing premiums usually in states where installment premiums are not permitted or customary. If any portion of a bill or note receivable is unpaid past the due date of an installment, the entire bill or note is classified as nonadmitted. Also, on bills or notes not past due, the excess of the balance due over the unearned premium on the underlying policy or policies is classified as a nonadmitted asset. To the extent bills receivable are taken for premium for retrospectively rated policies, such bills must meet the same criteria required of accrued retrospective premiums to be reported as an admitted asset.

Generally Accepted Accounting Principles

10. GAAP addresses collectibility issues related to bills receivable in FASB Statement No. 5, *Accounting for Contingencies* (FAS 5), paragraphs 1, 3 and 8:

> 1. For the purpose of this Statement (FAS 5), a contingency is defined as an existing condition, situation, or set of circumstances involving uncertainty as to possible gain (hereinafter a "gain contingency") or loss[1] (hereinafter a "loss contingency") to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the acquisition of an asset or the reduction of a liability or the loss or impairment of an asset or the incurrence of a liability.
>
> [1] The term loss is used for convenience to include many charges against income that are commonly referred to as expenses and others that are commonly referred to as losses.
>
> 3. When a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. This Statement uses the terms probable, reasonably possible, and remote to identify three areas within that range, as follows:
>
> a) Probable. The future event or events are likely to occur.
>
> b) Reasonably possible. The chance of the future event or events occurring is more than remote but less than likely.
>
> c) Remote. The chance of the future event or events occurring is slight.
>
> 8. An estimated loss from a loss contingency (as defined in paragraph 1) shall be accrued by a charge to income[3] if both of the following conditions are met:
>
> a) Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements.[4] It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.
>
> b) The amount of loss can be reasonably estimated.
>
> [3] Paragraphs 23-24 of APB Opinion No. 9, Reporting the Results of Operations, describe the rare circumstances in which a prior period adjustment is appropriate. Those paragraphs are not amended by this Statement.
>
> [4] Date of the financial statements means the end of the most recent accounting period for which financial statements are being presented.

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11. The FAS 5 criteria above is used in interpreting information such as historical trending and general information about the financial condition of the insureds in an effort to evaluate the collectibility of a receivable balance. Accounting for contingencies is discussed in more detail in Issue Paper No. 5.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapters 8 and 9
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*

Generally Accepted Accounting Principles

- *FASB Statement No. 5, Accounting for Contingencies*

State Regulations

- No additional guidance obtained from state statutes or regulations.

Statutory Issue Paper No. 22

Leases

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 22

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory accounting guidance provides only limited guidance on the accounting for leases and does not clearly differentiate capital and financing leases from operating leases. The Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies state that the form of lease agreements should determine the accounting. However, the manuals also state that lease-purchase transactions should be accounted for in accordance with their substance. Both sections state that GAAP is commonly used as a guideline where not in conflict with statutory accounting principles. This guidance generally has been interpreted to prescribe operating lease treatment for all leases, but to allow sales-type lease treatment by lessors if the criteria established in GAAP are met.

2. The purpose of this issue paper is to establish statutory accounting principles for leases by lessors and lessees that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts). It addresses:

- Accounting and reporting by lessees
- Accounting and reporting by lessors
- Sale-leaseback transactions
- Leveraged leases for lessors
- Related party leases
- Disclosures

SUMMARY CONCLUSION

3. For purposes of statutory accounting principles, a lease is defined as an agreement conveying the right to use property, plant, or equipment (land and/or depreciable assets) usually for a stated period of time. This definition does not include agreements that are contracts for services that do not transfer the right to use property, plant, or equipment from one contracting party to the other (i.e., employee lease contracts). On the other hand, agreements that do transfer the right to use property, plant, or equipment meet the definition of a lease for purposes of statutory accounting principles even though substantial services by the contractor (lessor) may be called for in connection with the operation or maintenance of such assets.

Accounting and Reporting by Lessees

4. All leases shall be considered operating leases. Rent on an operating lease shall be charged to expense over the lease term as it becomes payable, except as provided in paragraphs 5 and 6.

5. As discussed in *FASB Technical Bulletin 85-3*, *Accounting for Operating Leases with Scheduled Rent Increases,* the effects of scheduled rent increases normally shall be recognized on a straight-line basis over the lease term.

6. Lease agreements may also include incentives for the lessee to sign the lease, such as an up-front cash payment to the lessee, payment of costs for the lessee (such as moving expenses), or the assumption by the lessor of the lessee's preexisting lease. As discussed in *FASB Technical Bulletin 88-1*, *Issues Relating to Accounting for Leases: Time Pattern of the Physical Use of the Property in an Operating Lease; Lease Incentives in an Operating Lease; Applicability of Leveraged Lease Accounting to Existing Assets of the Lessor; Money-Over-Money Lease Transactions; Wrap Lease Transactions,* incentives paid to or payments made on behalf of the lessee shall be considered reductions of minimum lease payments (i.e., the payments that the lessee is obligated to make or can be required to make in connection with the leased properties.) These incentives shall be recognized over the lease term on a straight-line basis unless the use of another systematic and rational allocation basis is more representative of the time pattern in which the leased property is physically employed. (The lessee's immediate recognition of expenses or losses (e.g., moving costs, losses on subleases, write-offs of leasehold improvements) shall not be changed by this guidance.)

Accounting and Reporting by Lessors

7. All leases, except leveraged leases as defined in paragraph 14, shall be considered operating leases and accounted for by the lessor as follows:

a. The leased property shall be included in the same balance sheet category it would be had the property not been leased. The property shall be depreciated following the lessor's normal depreciation policies for such assets.

b. Rental income shall be reported as investment income as it becomes receivable according to the provisions of the lease. However, as discussed in paragraphs 5 and 6 of this issue paper, rentals may be recognized before they become due, if rentals vary from the straight-line basis. The guidance in *Issue Paper No. 34—Investment Income Due and Accrued* shall be applied to the receivable balance.

c. Initial direct costs shall be charged to expense when incurred, and shall not be deferred and allocated over the lease term. Initial direct costs are those incremental costs that the lessor has incurred in directly evaluating, negotiating, administering, and closing a lease transaction.

8. The sale of property subject to an operating lease, or of property that is leased by or intended to be leased by the third-party purchaser to another party, shall not be treated as a sale if the seller or any party related to the seller (related party is defined in *Issue Paper No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties* (Issue Paper No. 25) retains substantial risks of ownership in the leased property.

Sale-Leaseback Transactions

9. Sale-leaseback transactions involve the sale of property, plant, or equipment by the owner and a lease of the asset back to the seller. Sale-leaseback accounting, whereby the seller-lessee records the sale, removes the assets and related liabilities from its balance sheet, and accounts for the lease in accordance with the guidance in paragraphs 4-6 of this issue paper, shall be used by the seller-lessee for sale-leaseback transactions only if the transaction includes all of the following:

a. A normal leaseback (see paragraph 11)

b. Payment terms and provisions that adequately demonstrate the buyer-lessor's initial and continuing investment in the property (see paragraph 12)

c. Payment terms and provisions that transfer all of the other risks and rewards of ownership as demonstrated by the absence of any other continuing involvement by the seller-lessee (see paragraph 12)

d. Admitted assets, if the buyer-lessor is a related party, or either admitted or nonadmitted assets if the buyer-lessor is not a related party. For purposes of this paragraph, related parties include those identified in Issue Paper No. 25 and entities created for the purpose of buying and leasing nonadmitted assets for the reporting entity and/or its affiliates.

When applying sale-leaseback accounting, the sale, and gains or losses thereon, shall be recognized in accordance with the relevant statutory guidance for the asset being sold. For example, sales of real estate shall be accounted for in accordance with *Issue Paper No. 40—Real Estate Investments* (Issue Paper No. 40), which adopts *FASB Statement No. 66*, *Accounting for Sales of Real Estate* (FAS 66).

10. If criteria a., b., or c. in paragraph 9 are not met the sale of the asset shall be accounted for as a financing or deposit in accordance with FAS 66, which was adopted in Issue Paper No. 40. If criteria 9 d. is not met, the deposit method shall be used. Under the deposit method, the seller recognizes no profit or loss on the sale, does not record notes receivable, continues to report in its financial statements the property and the related existing debt even if it has been assumed by the buyer. Lease payments decrease and collections on the buyer-lessors note, if any, increase the seller-lessees deposit account. The property and related debt continue to be in the seller-lessees balance sheet, and the seller-lessee continues to depreciate the property. Also, a loss shall be recognized by the seller-lessee, if, at any reporting date, the net admitted value of the leased asset exceeds the sum of the balance in the deposit account, the fair value of the unrecorded note receivable, and any debt assumed by the buyer. Under the financing method, the asset will continue to be carried as an admitted asset. The proceeds from the sale are recognized as a borrowing (liability) and equated to the present value of the leaseback rents to determine the interest rate to use to accrue interest on the debt. If there is a change in lease terms such that the sale-leaseback transaction subsequently qualifies for sale-leaseback accounting recognition, sale-leaseback accounting as described in paragraph 9 shall be applied as if the sale had been recognized at the inception of the lease. Otherwise at the end of the lease term any deferred profit shall be recognized.

11. A normal leaseback in the context of a real estate sale-leaseback shall be defined as a lessee-lessor relationship that involves the active use of the property by the seller-lessee in consideration for payment of rent, including contingent rentals that are based on the future operations of the seller-lessee, and excludes other continuing involvement provisions.

12. A continuing involvement provision shall be defined as involvement by the seller-lessee with the leased property that result in the seller-lessee not transferring the risks or rewards of ownership to the buyer-lessor. Examples of continuing involvement are as follows:

a. The seller-lessee has an obligation or an option to repurchase the property or the buyer-lessor can compel the seller-lessee to repurchase the property.

b. The seller-lessee guarantees the buyer-lessor’s investment or a return on that investment for a limited or extended period of time.

c. The seller-lessee is required to pay the buyer-lessor at the end of the lease term for a decline in the fair value of the property below the estimated residual value on some basis other than excess wear and tear of the property levied on inspection of the property at the termination of the lease.

d. The seller-lessee provides nonrecourse financing to the buyer-lessor for any portion of the sales proceeds or provides recourse financing in which the only recourse is to the leased asset.

e. The seller-lessee is not relieved of the obligation under any existing debt related to the property.

f. The seller-lessee provides collateral on behalf of the buyer-lessor other than the property directly involved in the sale-leaseback transaction, the seller-lessee or a related party to the seller-lessee guarantees the buyer-lessor's debt, or a related party to the seller-lessee guarantees a return of or on the buyer-lessor's investment.

g. The seller-lessee's rental payment is contingent on some predetermined or determinable level of future operations of the buyer-lessor.

h. The buyer-lessor is obligated to share with the seller-lessee any portion of the appreciation of the property.

13. The buyer-lessor shall account for the purchase in accordance with applicable statutory guidance for the asset acquired and lease in accordance with paragraphs 7-8 of this issue paper.

Leveraged Leases for Lessors

14. Generally, leveraged leases are those in which the lessor acquires, through the incurrence of debt (such that the lessor is substantially "leveraged" in the transaction), property, plant or equipment with the intentions to lease the asset(s) to the lessee. Leveraged leases shall be defined as those leases that meet the criteria set forth in paragraph 42.a. through 42.d. (and the related paragraphs to which 42 refers) of *FASB Statement No. 13*, *Accounting for Leases* (FAS 13) as amended and interpreted. Leases which meet the preceding definition shall be accounted for in accordance with paragraphs 43-47 (and the related paragraphs to which 43-47 refer) of FAS 13. The lessor shall record its investment net of the nonrecourse debt. In cases where the asset being leased is a nonadmitted asset, any net leveraged lease asset shall be nonadmitted.

Related-Party Leases

15. This issue paper applies to arms-length transactions. To the extent that leases between related parties are, in substance, arms-length transactions the guidance in this issue paper shall be applied. The determination of whether related party leases qualify as arms length transactions will be addressed in Issue Paper No. 25.

Disclosures

16. The following disclosures shall be made in the notes to the financial statements of lessees:

- A general description of the lessee's leasing arrangements including, but not limited to, the following:

(1) Rental expense for each period for which an income statement is presented, with separate amounts for minimum rentals, contingent rentals, and sublease rentals. Rental payments under leases with terms of a month or less that were not renewed need not be included.

(2) The basis on which contingent rental payments are determined.

(3) The existence and terms of renewal or purchase options and escalation clauses.

(4) Restrictions imposed by lease agreements, such as those concerning dividends, additional debt, and further leasing.

- Additionally, for leases having initial or remaining noncancelable lease terms in excess of one year:

(1) Future minimum rental payments required as of the date of the latest balance sheet presented, in the aggregate and for each of the five succeeding fiscal years.

(2) The total of minimum rentals to be received in the future under noncancelable subleases as of the date of the latest balance sheet presented.

- For sale-leaseback transactions:

(1) A description of the terms of the sale-leaseback transaction, including future commitments, obligations, provisions, or circumstances that require or result in the seller-lessee's continuing involvement.

(2) For those accounted for as deposits, (a) the obligation for future minimum lease payments as of the date of the latest balance sheet presented in the aggregate and for each of the five succeeding fiscal years and (b) the total of minimum sublease rentals, if any, to be received in the future under noncancelable subleases in the aggregate and for each of the five succeeding years.

When leasing is a significant part of the lessor's business activities in terms of revenue, net income, or assets, the following information with respect to leases shall be disclosed in the financial statements:

- For operating leases:

(1) The cost and carrying amount, if different, of property on lease or held for leasing by major classes of property according to nature or function, and the amount of accumulated depreciation in total as of the date of the latest balance sheet presented;

(2) Minimum future rentals on noncancelable leases as of the date of the latest balance sheet presented, in the aggregate and for each of the five succeeding years;

(3) Total contingent rentals included in income for each period for which an income statement is presented; and

(4) A general description of the lessor's leasing arrangements.

- For leveraged leases:

(1) a description of the terms including the pretax income from the leveraged leases shall be disclosed in the notes to the financial statements. For purposes of presenting the investment in a leveraged lease in the lessor's balance sheet, the amount of related deferred taxes shall be presented separately (from the remainder of the net investment).

(2) In the notes to the financial statements, separate presentation (from each other) shall be made of pretax income from the leveraged lease, the tax effect of pretax income, and the amount of investment tax credit recognized as income during the period.

(3) When leveraged leasing is a significant part of the lessor's business activities in terms of revenue, net income, or assets, the components of the net investment balance in leveraged leases shall be disclosed in the notes to the financial statements.

DISCUSSION

17. This issue paper provides more comprehensive guidance on accounting for leases than exists in the current statutory accounting literature. Nevertheless, the principles established are generally consistent with current statutory accounting principles.

18. This issue paper rejects FAS 13, as amended and interpreted, except for certain of the guidance on operating leases, sale-leaseback transactions and leveraged leases (i.e., paragraphs 15, 16.(b., c., d.), 19.(a., b.), 23.(b., c.), 36, 37, 38.b., 39.c. and, 42-47). A complete list of all FASB Statements, Interpretations and Technical Bulletins adopted and rejected by this issue paper is included in the Relevant GAAP Literature section of this paper. FAS 13 was rejected because this issue paper provides that all leases except for leveraged leases, are accounted for as operating leases, whereas the essence of FAS 13 is to classify and account for leases as either capital or operating.

19. The statutory accounting principles differ from GAAP as follows:

- All leases except for leveraged leases for lessors are accounted for as operating leases. Under GAAP, leases are treated as operating or capital by lessees and as operating, sales-type, direct financing or leveraged leases by lessors.

- No distinction is made between current and long term classifications on the balance sheet.

- Sale-leaseback transactions involving related parties and nonadmitted assets are accounted for by the seller-lessee as deposits.

20. In rejecting the FAS 13 guidance on capital and financing leases for all leases other than leveraged leases, the financial statement impact of classification and accounting for the different types of leases under GAAP was considered and is explained and described below for both lessees and lessors:

Lessee

Capital lease - A capital lease is reflected on the lessee's balance sheet as both an asset and a corresponding liability. A capital lease generally produces a declining income statement charge over the term of the lease, represented by the sum of amortization of the capitalized asset, usually straight-line, and a declining interest expense element on the lease obligation balance. The effect is similar to that which would result if the lessee borrowed money and purchased the asset outright instead of leasing it.

Operating lease - An operating lease does not result in an asset or liability being reflected on the lessee's balance sheet. An operating lease normally results in a level income statement charge over the term of the lease reflecting the rent payments required by the lease agreement.

Lessor

Direct financing lease - A direct financing lease is treated as in effect a loan, producing declining revenue similar to interest over the term of the lease. Under the accelerated pattern of revenue recognition provided by a direct financing lease, revenue declines relative to the lessor's declining investment and thus matches the pattern of the lessor's interest carrying costs, either explicit or implicit. The balance sheet effect of the accounting for a direct financing lease is that the lessor's asset is effectively converted from a property classification to a receivable (net investment in the lease).

Sales-type lease - In addition to the effects of the direct financing lease described above, in a sales-type lease the manufacturer or dealer records a sale and the related cost of sales and gross profit at the beginning of the lease. In the balance sheet the treatment converts leased property carried at manufacturing or wholesale cost to a receivable equal to the normal selling price (i.e., the price the asset would sell for in an arms-length transaction).

Leveraged Leases - Generally, leveraged leases are those in which the lessor acquires, through the incurrence of debt (such that the lessor is substantially "leveraged" in the transaction), property, plant or equipment with the intentions to lease the asset(s) to the lessee. Except for the exclusion of leveraged leases from the definition of a direct financing leases, it otherwise meets the definition of a direct financing lease. A leveraged lease involves at least three parties: the lessee, a long-term creditor, and a lessor. The long-term creditor provides financing, which is a significant percentage of the cost of the property, to the lessor which is nonrecourse as to the general credit of the lessor. The lessor's investment in the property declines after the original investment has been made, often turns negative, and then increases during later years of the lease before it finally is realized. The lessor records the investment in a leveraged lease net of the nonrecourse debt. Income is recognized only in periods in which the net investment is positive.

Operating lease - An operating lease generally produces a level income effect over the term of the lease, represented by the excess of the level rent payments called for by the lease agreement over straight-line depreciation of the leased asset. (This level income from the lease would compare to a generally declining pattern of either explicit or implicit interest carrying costs.) Depreciable life would extend beyond the initial lease term. The rental income and depreciation are shown broad in the income statement as revenue and expense, respectively. For balance sheet purposes, the leased asset is classified with or near property, plant and equipment.

21. Since (a) statutory accounting principles provide for offsetting of obligations against real estate assets, (b) certain assets would be considered nonadmitted assets if capitalized, (c) most leases are considered operating leases under GAAP and (d) leasing is not a significant part of insurance companies business the objectives of statutory accounting would not be appreciably enhanced by adopting the GAAP guidance.

22. In addition, the statutory accounting principles established in this issue paper provide for the deferral of any gains on sales of property with a leaseback, except if certain strict criteria are met. Such accounting meets the conservatism objective in the Statement of Concepts. Furthermore, the statutory accounting principles established for sale-leaseback transactions of nonadmitted assets with related parties meet the conservatism objective by eliminating the possibility of surplus enhancement through sale-leaseback transactions involving nonadmitted assets.

Drafting Notes/Comments

- Accounting for real estate, including sales of real estate, is addressed in *Issue Paper No. 40—Real Estate Investments.*
- Accounting for related party transactions is addressed in *Issue Paper No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties*.
- *Issue Paper No. 34—Investment Income Due and Accrued* allows investment income not yet due to be considered an admitted asset. Under this issue paper rental income may be recognized before it is due.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

23. Chapter 8 of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies discusses accounting for leases as follows:

> Investments in Real Estate, Equipment and Other Assets Involving Leases
>
> The statutory method of accounting for lease and sale leaseback arrangements is governed largely by the form of the agreement to which the insurance company is party. Life insurance companies are encouraged to account for lease purchase transactions with the same objectives in mind as in accounting for all transactions, conservatism and policyholder protection. Financial Accounting Standards Board Statements 13, 28, and 66 are commonly used as guidelines where not in conflict with statutory accounting principles.

24. The accounting treatment as stated in the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies is similar to the treatment stated in the preceding paragraph.

25. In the August 5, 1987 meeting of the Emerging Accounting Issues Working Group, a consensus was reached as to the accounting for free rent. The minutes read as follows:

> Accounting for Free Rent
>
> The recent soft real estate market has given rise to the unusual situation of new tenants receiving "free rent" during initial periods of tenancy. An insurer requested direction as to the appropriate statutory accounting treatment during the term of the lease.
>
> Two alternatives were considered by the working group:
>
> 1. A "cash basis" method reflecting no payments during the "free rent" period and then accounting for the monthly rentals as payments are made.
>
> 2. A method based on GAAP treatment which would require the spreading of the actual rent to be paid over the full lease period. The "free rent" period would reflect monthly rent expense on an accrual basis. The accrued rent liability would increase during the "free rent" period and be reduced monthly with the cash payment of rent after the initial period.
>
> The working group concluded that the second method was preferable.

26. The Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force discussed the issue of a sale and leaseback of home office buildings in their May 7, 1986 meeting. The minutes are as follows:

> Sale and Leaseback of Home Office Buildings
>
> The third area of discussion was the sale and leaseback of home office buildings where notes are taken back as part of the purchase price and the result is an increase to the insurers surplus through recognition of gain on the sale.
>
> The issues discussed and the consensus reached were:
>
> 1. Should FASB 66 be applicable for statutory purposes?
>
> 2. Is there a need for special statutory accounting direction or should each situation be treated individually?
>
> Present statutory accounting probably permits recognition of the gain. The group believes, however, that FASB 66 should be used for guidance by regulators, if not contrary to law, and, at a commissioners discretion.

27. The Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force discussed the issue of a sale and leaseback of furniture and equipment in their September 11, 1989, meeting. The minutes are as follows:

> Accounting for Sale and Leaseback of Furniture and Equipment
>
> Mr. Robert Solitro, Director of Examinations for the State of New Hampshire Insurance Department, had requested that this item be placed on the agenda of the working group. His request included an issue summary (Attachment A).
>
> In the situation described, an insurance company would enter into a sale and lease-back agreement with a third party, non-affiliate, in which nonadmitted furniture is sold and then leased-back. As described, the terms of the agreement would provide that future payments to be made

by the insurance company would be equal to or greater than the proceeds to be received from the original sale.

The issue identified and addressed by the working group at this meeting was as follows:

> Should the transaction be accounted for as an operating lease or a capital lease?
>
> > The working group reached the consensus that for sale and leaseback transactions involving furniture and non-EDP equipment guidance should be obtained form FASB No. 13 and related amendments. In a case where it is determined that the transaction results in a capital lease, no surplus enhancement should be recorded.

28. The Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force discussed the issue of capital gains and increased real estate valuation through sale-leaseback and repurchase transactions in their December 4, 1989, meeting. The minutes are as follows:

> Capital Gains and Increased Real Estate Valuation Through Sale-Leaseback and Repurchase Transactions
>
> This topic was raised by Hyrum Gentner, Chief Insurance Examiner of the Utah Insurance Department and John Kay, Senior Examiner in that department (Attachment G). The situation described involved the sale and lease-back of an insurers real estate with the insurer accepting a note for most of the proceeds of the sale. The lease-back was for 12 months with an option for an additional 19 years. The insurer paid for an option to repurchase the property. A significant gain was realized on the sale. The insurer repurchased the property and used the repurchase cost plus the cost of the repurchase option to determine the book value of the real estate. The result was an increased valuation, slightly less than the realized capital gain on the sale.
>
> Mr. Gentner and Mr. Kay had also indicated that the Utah Department had been faced with three alternatives: (1) to recognize the gain and increased asset valuation, (2) to not recognize the gain and increased asset valuation, and (3) to recognize both and make full disclosure including a comment expressing the Insurance Department concern regarding the nature of the transactions. In connection with the last option, regulations would then be implemented requiring prior written departmental approval for such transactions and specifying the Commissioners authority to establish investment valuation reserves.
>
> After a general discussion of the subject, Norris Clark, chair of the working group was authorized to respond to the Utah Insurance Department stating that the issue had been discussed at the January 22, 1986 (86-1) and May 7, 1986 (86-3) meetings of the working group and that the transactions discussed by Mr. Gentner and Mr. Kay appeared to be of the kind in which no gain should be recognized.

Generally Accepted Accounting Principles

29. Accounting for leases is governed by *FASB Statement No. 13, Accounting for Leases,* as amended and interpreted by incorporating FASB Statements, Interpretations, and Technical Bulletins. Some key paragraphs of the FASB Current Text, Section L10, Leases, follow (note that the Current Text is an integration of currently effective accounting and reporting standards and that the authority of the Current Text is derived from the underlying pronouncements, which remain in force):

> .102 For purposes of applying the accounting and reporting standards [herein], leases are classified as follows:
>
> a. Classifications from the standpoint of the lessee:
> (1) Capital leases. Leases that meet one or more of the criteria in paragraph .103.
> (2) Operating leases. All other leases.
> b. Classifications from the standpoint of the lessor: [FAS 13, ¶6]

(1) Sales-type leases. Leases that give rise to manufacturer's or dealer's profit (or loss) to the lessor (that is, the fair value of the leased property at the inception of the lease is greater or less than its cost or carrying amount, if different) and that meet one or more of the criteria in paragraph .103 and both of the criteria in paragraph .104, except as indicated in the following sentence. A lease involving real estate shall be classified as a sales-type lease only if it meets the criterion in paragraph .103(a), in which case the criteria in paragraph .104 do not apply. [FAS 98, ¶22c] Normally, sales-type leases will arise when manufacturers or dealers use leasing as a means of marketing their products. Leases involving lessors that are primarily engaged in financing operations normally will not be sales-type leases if they qualify under paragraphs .103 and .104, but will most often be direct financing leases, described in paragraph .102(b)(2) below. However, a lessor need not be a dealer to realize dealer's profit (or loss) on a transaction, for example, if a lessor, not a dealer, leases an asset that at the inception of the lease has a fair value that is greater or less than its cost or carrying amount, if different, such a transaction is a sales-type lease, assuming the criteria referred to are met. [FAS13, ¶6] Leases of a manufacturing company's equipment sold to a leasing subsidiary that are accounted for as direct financing leases on the subsidiary's financial statements normally would be sales-type capital leases in the consolidated financial statements. [FAS94, ¶52] A renewal or extension of an existing sales-type or direct financing lease that otherwise qualifies as a sales-type lease shall be classified as a direct financing lease unless the renewal or extension occurs at or near the end of the original term 3 specified in the existing lease, in which case it shall be classified as a sales-type lease (refer to paragraph .113(f)). [FAS27, ¶6]

(2) Direct financing leases. Leases other than leveraged leases that do not give rise to manufacturer's or dealer's profit (or loss) to the lessor but that meet one or more of the criteria in paragraph .103 and both of the criteria in paragraph .104. In such leases, the cost or carrying amount, if different, and fair value of the leased property are the same at the inception of the lease. [FAS13, ¶6] An exception arises when an existing sales-type or direct financing lease is renewed or extended during the term of the existing lease. [FAS27, ¶7] In such cases, the fact that the carrying amount of the property at the end of the original lease term is different from its fair value at that date shall not preclude the classification of the renewal or extension as a direct financing lease (refer to paragraph .113(f)).

(3) Leveraged leases. Leases that meet the criteria of paragraph .144. [FAS13, ¶6]

(4) Operating leases. All other leases, including leases that involve real estate and give rise to manufacturer's or dealer's profit (or loss) to the lessor but do not meet the criterion in paragraph .103(a). [FAS98, ¶22d]Criteria for Classifying Leases (Other Than Leveraged Leases)

.103 The criteria for classifying leases set forth in this paragraph and in paragraph .104 derive from the concept [FAS 13, paragraph 7] that a lease that transfers substantially all of the benefits and risks incident to the ownership of property should be accounted for as the acquisition of an asset and the incurrence of an obligation by the lessee and as a sale or financing by the lessor. All other leases should be accounted for as operating leases. In a lease that transfers substantially all of the benefits and risks of ownership, the economic effect on the parties is similar, in many respects, to that of an installment purchase. [FAS 13, paragraph 60] If at its inception a lease meets one or more of the following four criteria, the lease shall be classified as a capital lease by the lessee. Otherwise, it shall be classified as an operating lease. (Refer to paragraph .150 and Exhibit 150C for an illustration of the application of these criteria.)

a. The lease transfers ownership of the property to the lessee by the end of the lease term.[4a]

b. The lease contains a bargain purchase option.

c. The lease term is equal to 75 percent or more of the estimated economic life of the leased property. However, if the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property, including earlier years of use, this criterion shall not be used for purposes of classifying the lease.

d. The present value[5] at the beginning of the lease term of the minimum lease payments, excluding that portion of the payments representing executory costs, to be paid by the lessor, including any profit thereon, equals or exceeds 90 percent of the excess of the fair value of the leased property to the lessor at the inception of the lease over any related investment tax credit retained by the lessor and expected to be realized by him.[6] However, if the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property, including earlier years of use, this criterion shall not be used for purposes of classifying the lease. A lessor shall compute the present value of the minimum lease payments using the interest rate implicit in the lease. A lessee shall compute the present value of the minimum lease payments using its incremental borrowing rate unless (1) it is practicable for him to learn the implicit rate computed by the lessor and (2) the implicit rate computed by the lessor is less than the lessee's incremental borrowing rate. If both of those conditions are met, the lessee shall use the implicit rate. [FAS 13, paragraph 7]

[4a] This criterion is met in situations in which the lease agreement provides for the transfer of title at or shortly after the end of the lease term in exchange for the payment of a nominal fee, for example, the minimum required by statutory regulation to transfer title. [FAS 98, paragraph 22.e.]

[5] Refer to paragraphs .509 through .511 for supplemental guidance on the interest rate to be used in calculating the present value of minimum lease payments.

[6] The 90-percent test is stated as a lower limit rather than as a guideline. [FIN 19, paragraph 4]

.104 From the standpoint of the lessor, a lease involving real estate shall be classified as a sales-type lease only if it meets the criterion in paragraph .103(a) as appropriate under paragraph .102(b)(1). Otherwise, if the lease at inception meets any one of the four criteria in paragraph .103 and in addition meets both of the following criteria, it shall be classified as a sales-type lease, a direct financing lease, a leveraged lease, or an operating lease as appropriate under paragraph .102(b). If the lease does not meet any of the criteria of paragraph .103 or both of the following criteria, the lease shall be classified as an operating lease.

a. Collectibility of the minimum lease payments is reasonably predictable. A lessor shall not be precluded from classifying a lease as a sales-type lease, a direct financing lease, or a leveraged lease simply because the receivable is subject to an estimate of uncollectibility based on experience with groups of similar receivables. [FAS98, ¶22f]

b. No important uncertainties surround the amount of unreimbursable costs yet to be incurred by the lessor under the lease.[7] Important uncertainties might include commitments by the lessor to guarantee performance of the leased property in a manner more extensive than the typical product warranty or to effectively protect the lessee from obsolescence of the leased property. However, the necessity of estimating executory costs to be paid by the lessor (refer to paragraphs .113(a) and .114(a)) shall not by itself constitute an important uncertainty as referred to herein. [FAS13, ¶8]

[7] If the property covered by the lease is yet to be constructed or has not been acquired by the lessor at the inception of the lease, the classification criteria of paragraph .104(b) shall be applied at the date that construction of the property is completed or the property is acquired by the lessor. [FAS23, ¶ 7]

.105 If at any time the lessee and lessor agree to change the provisions of the lease, other than by renewing the lease or extending its term, in a manner that would have resulted in a different classification of the lease under the criteria in paragraphs .103 and .104 had the changed terms been in effect at the inception of the lease, the revised agreement shall be considered as a new agreement over its term, and the criteria in paragraphs .103 and .104 shall be applied for purposes of classifying the new lease. Likewise, except when a guarantee or penalty is rendered inoperative as described in paragraphs .108 and .113(e), any action that extends the lease beyond the expiration of the existing lease term, such as the exercise of a lease renewal option other than those already included in the lease term, shall be considered as a new agreement, which shall be classified according to the provisions of paragraphs .102 through .104. Changes in estimates (for example, changes in estimates of the economic life or of the residual value of the leased property) or changes in circumstances (for example, default by the lessee), however, shall not give rise to a new classification of a lease for accounting purposes. [FAS13, ¶9]

Accounting and Reporting by Lessees

Operating Leases

.111 Normally, rental on an operating lease shall be charged to expense over the lease term as it becomes payable. If rental payments are not made on a straight-line basis,[13a] rental expense nevertheless shall be recognized on a straight-line basis unless another systematic and rational basis is more representative of the time pattern in which use benefit is derived from the leased property, in which case that basis shall be used. [FAS 13, paragraph 15]

[13a] Refer to paragraphs .525 through .527F for supplemental guidance on accounting for operating leases with scheduled rent increases and lease incentives.

.112 The following information with respect to leases shall be disclosed in the lessees financial statements or the footnotes thereto. (Refer to paragraphs .151 and .152 for illustrations.)

b. For operating leases having initial or remaining noncancelable lease terms in excess of one year:

(1) Future minimum rental payments required as of the date of the latest balance sheet presented, in the aggregate and for each of the five succeeding fiscal years.

(2) The total of minimum rentals to be received in the future under noncancelable subleases as of the date of the latest balance sheet presented.

c. For all operating leases, rental expense for each period for which an income statement is presented, with separate amounts for minimum rentals, contingent rentals, and sublease rentals. Rental payments under leases with terms of a month or less that were not renewed need not be included.

d. A general description of the lessees leasing arrangements including, but not limited to, the following:

(1) The basis on which contingent rental payments are determined.

(2) The existence and terms of renewal or purchase options and escalation clauses.

(3) Restrictions imposed by lease agreements, such as those concerning dividends, additional debt, and further leasing. [FAS 13, paragraph 16]

Sales-Type Leases

.113 Sales-type leases shall be accounted for by the lessor as follows:

a. The minimum lease payments (net of amounts, if any, included therein with respect to executory costs to be paid by the lessor, together with any profit thereon) plus the unguaranteed residual value accruing to the benefit of the lessor shall be recorded as the gross investment in the lease.[13b] [FAS13, ¶17] The estimated residual value used to compute the unguaranteed residual value accruing to the benefit of the lessor shall not exceed the amount estimated at the inception of the lease.[14] [FAS23, ¶9] However, if the sales-type lease involves real estate, the lessor shall account for the transaction under the provisions of Section R10, "Real Estate," in the same manner as a seller of the same property. [FAS98, ¶22g]

[13b] Paragraphs .536 and .537 further discuss residual value retained by a lessor that sells rental payment.

[14] If the lease agreement or commitment, if earlier, includes a provision to escalate minimum lease payments for increases in construction or acquisition cost of the leased property or for increases in some other measure of cost or value, such as general price levels, during the construction or preacquisition period, the effect of any increases that have occurred shall be considered in the determination of "the estimated residual value of the leased property at the inception of the lease" for purposes of the paragraph. [FAS23, ¶9]

b. The difference between the gross investment in the lease in (a) above and the sum of the present values of the two components of the gross investment shall be recorded as unearned income. The discount rate to be used in determining the present values shall be the interest rate implicit in the lease. The net investment in the lease shall consist of the gross investment less the unearned income. The unearned income shall be amortized to income over the lease term so as to produce a constant periodic rate of return on the net investment in the lease.[15] However, other methods of income recognition may be used if the results obtained are not materially different from those which would result from the prescribed method. The net investment in the lease shall be subject to the same considerations as other assets in classification as current or noncurrent assets in a classified balance sheet. [FAS13, ¶17] Contingent rentals shall be included in the determination of income as accruable. [FAS29, ¶13] [(Refer to paragraph .165 for an illustration involving contingent rentals.)]

[15] This is the interest method described in Section 169, paragraph .108 and footnote 4. [FAS13, ¶12, fn 11]

c. The present value of the minimum lease payments (net of executory costs, including any profit thereon), computed at the interest rate implicit in the lease, shall be recorded as the sales price. The cost or carrying amount, if different, of the leased property, plus any initial direct costs, less the present value of the unguaranteed residual value accruing to the benefit of the lessor, computed at the interest rate implicit in the lease, shall be charged against income in the same period.

d. The estimated residual value shall be reviewed at least annually.[16] If the review results in a lower estimate than had been previously established, a determination must be made as to whether the decline in estimated residual value is other than temporary. If the decline in estimated residual value is judged to be other than temporary, the accounting for the transaction shall be revised using the changed estimate. The resulting reduction in the net investment shall be recognized as a loss in the period in which the estimate is changed. An upward adjustment of the estimated residual value shall not be made.

[16] Paragraphs .514 through .517 discuss upward adjustment of guaranteed residential values.

e. In leases containing a residual guarantee or a penalty for failure to renew the lease at the end of the lease term,[17] following the method of amortization described in (b) above will result in a balance of minimum lease payments receivable at the end of the lease term that will equal the amount of the guarantee or penalty at that date. In the event that a renewal or other extension of the lease term renders the guarantee or penalty inoperative, the existing balances of the minimum lease payments receivable and the estimated residual value shall be adjusted for the changes resulting from the revised agreement (subject to the limitation on the residual value imposed by subparagraph (d) above) and the net adjustment shall be charged or credited to unearned income. [FAS13, ¶17]

[17] Residual guarantees and termination penalties that serve to extend the lease term are excluded from minimum lease payments and are thus distinguished from those guarantees and penalties referred to in this paragraph. [FAS13, ¶17 fn 17]

f. Except for a change in the provisions of a lease that results from a refunding by the lessor of tax-exempt debt, including an advance refunding, in which the perceived economic advantages of the refunding are passed through to the lessee by a change in the provisions of the lease agreement and the revised agreement is classified as a direct financing lease (refer to paragraph .110), a change in the provisions of a lease, a renewal or extension of an existing lease, and a termination of a lease prior to the expiration of the lease term shall be accounted for as follows: [FAS22, 15]

(1) If the provisions of a lease are changed in a way that changes the amount of the remaining minimum lease payments and the change either (a) does not give rise to a new agreement under the provisions of paragraph .105 or (b) does give rise to a new agreement but such agreement is classified as a direct financing lease, the balance of the minimum lease payments receivable and the estimated residual value, if affected, shall be adjusted to reflect the change (subject to the limitation on the residual value imposed by subparagraph (d) above), and the net adjustment shall be charged or credited to unearned income. If the change in the lease provisions gives rise to a new agreement classified as an operating lease, the remaining net investment shall be removed from the accounts, the leased asset shall be recorded as an asset at the lower of its original cost, present fair value, or present carrying amount, and the net adjustment shall be charged to income of the period. The new lease shall thereafter be accounted for as any other operating lease.

(2) Except when a guarantee or penalty is rendered inoperative as described in subparagraph (e) above, a renewal or an extension of an existing lease shall be accounted for as follows:

(a) If the renewal or extension is classified as a direct financing lease, it shall be accounted for as described in subparagraph (f)(1) above.

(b) If the renewal or extension is classified as an operating lease, the existing lease shall continue to be accounted for as a sales-type lease to the end of its original term, and the renewal or extension shall be accounted for as any other operating lease. [FAS13, ¶17]

(c) If a renewal or extension that occurs at or near the end of the term[18] of the existing lease is classified as a sales-type lease, the renewal or extension shall be accounted for as a sales-type lease. [FAS27, ¶8]

[18] A renewal or extension that occurs in the last few months of an existing lease is considered to have occurred at or near the end of the existing lease term. [FAS27, ¶8]

(3) A termination of the lease shall be accounted for by removing the net investment from the accounts, recording the leased asset at the lower of its original cost, present fair value, or present carrying amount, and the net adjustment shall be charged to income of the period. [FAS13, ¶17]

g. If prior to the expiration of the lease term a change in the provisions of a lease results from a refunding by the lessor of tax-exempt debt, including an advance refunding,[19] in which the perceived economic advantages of the refunding are passed through to the lessee and the revised agreement is classified as a direct financing lease by the lessor, the change shall be accounted for as follows:[20]

(1) If a change in the provisions of a lease results from a refunding of tax-exempt debt, including an advance refunding that is accounted for as an early extinguishment of debt, the lessor shall adjust the balance of the minimum lease payments receivable and the estimated residual value, if affected (that is, the gross investment in the lease), in accordance with the requirements of paragraphs .114(c) and .113(f)(1). The adjustment of unearned income shall be the amount required to adjust the net investment in the lease to the sum of the present values of the two components of the gross investment based on the interest rate applicable to the revised lease agreement. The combined adjustment resulting from applying the two preceding sentences shall be recognized as a gain or loss in the current period. [Paragraphs .162 and .163 illustrate the accounting prescribed by this paragraph.]

(2) If a change in the provisions of the lease results from an advance refunding that is not accounted for as an early extinguishment of debt at the date of the advance refunding, the lessor shall systematically recognize, as revenue, any reimbursements to be received from the lessee for costs related to the debt to be refunded, such as unamortized discount or issue costs or a call premium, over the period from the date of the advance refunding to the call date of debt to be refunded. [FAS22, ¶12]

[19] An advance refunding involves the issuance of new debt to replace existing debt with the proceeds from the new debt placed in trust or otherwise restricted to retire the existing debt at a determinable future date or dates. [FAS22, ¶1, fn1] Section D14, "Debt: Extinguishments," provides criteria for determining whether the advance refunding should be recognized as an extinguishment of the existing debt at the date of the advance refunding. FAS76, ¶10]

[20] This paragraph prescribes the accounting for a direct financing lease by governmental units that classify and account for leases of that kind [FAS22, ¶12, fn4]

Accounting and Reporting by Lessors

Operating Leases

.115. Operating leases shall be accounted for by the lessor as follows:

a. The leased property shall be included with or near property, plant, and equipment in the balance sheet. The property shall be depreciated following the lessor's normal depreciation policy, and in the balance sheet the accumulated depreciation shall be deducted from the investment in the leased property.

b. Rent shall be reported as income over the lease term as it becomes receivable according to the provisions of the lease. However, if the rentals vary from a straight-line basis,[24a] the income shall be recognized on a straight-line basis unless another systematic and rational basis is more representative of the time pattern in which use benefit from the leased property is diminished, in which case that basis shall be used.

[24a] Refer to paragraphs .525 through .527F for supplemental guidance on accounting for operating leases with scheduled rent increases and lease incentives.

c. Initial direct costs shall be deferred and allocated over the lease term in proportion to the recognition of rental income. However, initial direct costs may be charged to expense as incurred if the effect is not materially different from that which would have resulted from the use of the method prescribed in the preceding sentence. [FAS 13, paragraph 19]

d. If, at the inception of the lease, the fair value of the property in an operating ease involving real estate that would have been classified as a sales-type lease except that it did not meet the criterion in paragraph .103(a) is less than its cost or carrying amount, if different, then a loss equal to that difference shall be recognized at the inception of the lease. [FAS 98, paragraph 22.j.]

Sale-Leaseback Transactions

.128 Sale-leaseback transactions involve the sale of property by the owner and a lease of the property back to the seller. A sale of property that is accompanied by a leaseback of all or any part of the property for all or part of its remaining economic life shall be accounted for by the seller-lessee in accordance with the provisions of paragraph .129 [except that a sale-leaseback involving real estate, property improvements, or integral equipment[27a] shall be accounted for in accordance with the provisions of paragraphs .130A through .130M]. A sale of property that is accompanied by a leaseback of all or any part of the property for all or part of its remaining economic life shall be accounted for by the [buyer-lessor] in accordance with the provisions of paragraph .130. [FAS28, paragraph 2] [See paragraphs .544 through .545 for supplemental guidance in accounting for sale-leaseback transactions when nonrecourse debt is obtained using the lease rentals or lease rentals and the leased asset as collateral and the nonrecourse debt is sold with the asset to a third party investor (a wrap lease transaction).]

[27a] The terms *property improvements* and *integral equipment* are discussed in paragraph .130A and footnote 32a.

.129 If the lease meets one of the criteria for treatment as a capital lease (refer to paragraph .103), the seller-lessee shall account for the lease as a capital lease; otherwise, as an operating lease. Any profit or loss on the sale[28] shall be deferred and amortized in proportion to the amortization of the lease asset[29], if a capital lease, or in proportion to the related gross rental charged to expense over the lease term, if an operating lease, unless:

a. The seller-lessee relinquishes the right to substantially all of the remaining use of the property sold (retaining only a minor portion of such use),[30] in which case the sale and the leaseback shall be accounted for as saeparate transactions based on their respective terms. However, if the amount of rentals called for by the lease is unreasonable under market conditions at the inception of the lease, an appropriate amount shall be deferred or accrued, by adjusting the profit or loss on the sale, and amortized as specified in the introduction of this paragraph to adjust those rentals to a reasonable amount.

[28] *Profit or loss on the sale* is used in this paragraph to refer to the profit or loss that would be recognized on the sale if there were no leaseback. For example, on a sale of real estate subject to Section R10, the profit on the sale to be deferred and amortized in proportion to the leaseback would be the profit that could otherwise be recognized in accordance with that section. [FAS28, ¶3]

[29] If the leased asset is land only, the amortization shall be on a straight-line basis over the lease term. [FAS13, ¶33, fn23]

[30] *Substantially all* and *minor* are used here in the context of the concepts underlying the classification criteria of this section. In that context, a test based on the 90-percent recovery criterion of paragraph .103(d) could be used as a guideline; that is, if the present value of a reasonable amount of rental for the leaseback represents 10 percent or less of the fair value of the asset sold, the seller-lessee could be presumed to have transferred to the [buyer-lessor] the right to substantially all of the remaining use of the property sold, and the seller-lessee could be presumed to have retained only a minor portion of such use. [FAS28, ¶3a]

b. The seller-lessee retains more than a minor part but less than substantially all[31] of the use of the property through the leaseback and realizes a profit on the sale[32] in excess of (1) the present value of the minimum lease payments over the lease term, if the leaseback is classified as an operating lease, or (2) the recorded amount of the leased asset, if the leaseback is classified as a capital lease. In that case, the profit on the sale in excess of either the present value of the minimum lease payments or the recorded amount of the leased asset, whichever is appropriate, shall be recognized at the date of the sale. For purposes of applying this provision, the present value of the minimum lease payments for an operating lease shall be computed using the interest rate that would be used to apply the 90 percent recovery criterion of paragraph .103(d).

c. If the lease meets the criteria in paragraphs .103 and .104, the [buyer-lessor] shall record the transaction as a purchase and a direct financing lease; otherwise, the [buyer-lessor] shall record the transaction as a purchase and an operating lease. [FAS 13, paragraph 34]

[31] *Substantially all* is used here in the context of the concepts underlying the classification criteria of this section. In that context, if a leaseback of *the entire property sold* meets the criteria of this section for classification as a capital lease, the seller-lessee would be presumed to have retained substantially all of the remaining use of the property sold. [FAS28, ¶3b]

[32] *Profit or loss on the sale* is used in this paragraph to refer to the profit or loss that would be recognized on the sale if there were no leaseback. For example, on a sale of real estate subject to Section R10, the profit on the sale to be deferred and amortized in proportion to the leaseback would be the profit that could otherwise be recognized in accordance with that section. [FAS28, ¶3]

Sale-Leaseback Transactions Involving Real Estate

.130A Paragraphs .130A through .130M [present] standards of financial accounting and reporting by a seller-lessee for sale-leaseback transactions involving real estate, including real estate with equipment, such as manufacturing facilities, power plants, and office buildings with furniture and fixtures. A sale-leaseback transaction involving real estate with equipment includes any sale-leaseback transaction in which the equipment and the real estate are sold and leased back as a package, irrespective of the relative value of the equipment and the real estate. Those paragraphs also address sale-leaseback transactions in which the seller-lessee sells property improvements or integral equipment[32a] to a buyer-lessor and leases them back while retaining the underlying land.[32b]

[32a] The terms *property improvements* or *integral equipment* as used in paragraphs .130A through .130M of this section refer to any physical structure or equipment attached to the real estate, or other parts thereof, that cannot be removed and used separately without incurring significant cost. Examples include an office building, a manufacturing facility, a power plant, and a refinery. [FAS98, ¶6, fn2]

[32b] Paragraphs .141 and .142 of Section R10 address transactions in which the seller sells property improvements to a buyer and leases the underlying land to the buyer of the improvements. Under certain circumstances, paragraph .141 of Section R10 precludes sales recognition for such transactions and requires that they be accounted for as leases of both the land and improvements. Paragraphs .130A through .130M of this section are not intended to modify paragraph .141 of Section R10; thus, they do not address a sale-leaseback transaction that does not qualify for sales recognition under the provisions of paragraph .141 of Section R10. However, those paragraphs do address a sale-leaseback transaction that qualifies for sales recognition under the provisions of paragraph .142 of Section R10. [FAS98, ¶6, fn3]

Sale-Leaseback Accounting

.130B Sale-leaseback accounting is a method of accounting for a sale-leaseback transaction in which the seller-lessee records the sale, removes all property and related liabilities from its balance sheet, recognizes gain or loss from the sale in accordance with [paragraphs .129 and .130A through .130M] and Section R10, and classifies the leaseback in accordance with this section. [FAS98, paragraph 70]

Criteria for Sale-Leaseback Accounting

.130C Sale-leaseback accounting shall be used by a seller-lessee only if a sale-leaseback transaction includes all of the following:

a. A normal leaseback as described in paragraph .130D
b. Payment terms and provisions that adequately demonstrate the buyer-lessor's initial and continuing investment in the property (refer to paragraphs .111 through .119 of Section R10)
c. Payment terms and provisions that transfer *all* of the other risks and rewards of ownership as demonstrated by the absence of *any* other continuing involvement by the seller-lessee described in paragraphs .130G through .130I of this section and paragraphs .128 through .142 and .144 through .146 of Section R10. [FAS98, paragraph 7]

.130D A *normal leaseback* is a lessee-lessor relationship that involves the active use of the property by the seller-lessee in consideration for payment of rent, including contingent rentals that are based on the future operations of the seller-lessee,[32c] and excludes other continuing involvement provisions or conditions described in paragraphs .130G through .130I of this section. The phrase *active use of the property by the seller-lessee* refers to the use of the property during the lease term in the seller-lessee's trade or business, provided that subleasing of the leased back property is minor.[32d] If the present value of a reasonable amount of rental for that portion of the leaseback that is subleased is not more than 10 percent of the fair value of the asset sold, the leased back property under sublease is considered minor. Active use of the property may involve the providing of services where the occupancy of the property is generally transient or short-term and is integral to the ancillary services being provided. Those ancillary services include, but are not limited to, housekeeping, inventory control, entertainment, bookkeeping, and food services. Thus, the use of property by a seller-lessee engaged in the hotel or bonded warehouse business or the operation of a golf course or a parking lot, for example, is considered active use. [FAS98, paragraph 8]

[32c] Paragraphs .130A through .130M distinguish between contingent rentals that are based on the future operations of the seller-lessee and those that are based on some predetermined or determinable level of future operations of the buyer-lessor. The latter type of contingent rental is addressed in paragraph .130H(e) of this section. [FAS98, ¶8, fn4]

[32d] The term] *minor* is used here in the context of the definition in footnote 30 to paragraph .129. [FAS98, ¶8, fn6]

Terms of the Sale-Leaseback Transaction

.130E Terms of the sale-leaseback transaction that are substantially different from terms that an independent third-party lessor or lessee would accept represent an exchange of some stated or unstated rights or privileges. Those rights or privileges shall be considered in evaluating the continuing involvement provisions in paragraphs .130G thorough .130I of this section. Those terms or conditions include, but are not limited to, the sales price, the interest rate, and other terms of any loan from the seller-lessee to the buyer-lessor. The fair value of the property used in making that evaluation shall be based on objective evidence, for example, an independent third-party appraisal or recent sales of comparable property. [FAS98, ¶9]

Continuing Involvement

.130F A sale-leaseback transaction that does not qualify for sale-leaseback accounting because of any form of continuing involvement by the seller-lessee other than a normal leaseback shall be accounted for by the deposit method or as a financing, whichever is appropriate under Section R10. The provisions or conditions described in paragraphs .130G through .130I of this section are examples of continuing involvement for the purpose of applying paragraphs .130A through .130M. [FAS98, ¶10]

.130G Paragraphs .128 thorough .142 and .144 thorough .146 of Section R10 describe forms of continuing involvement by the seller-lessee with the leased property that result in the seller-lessee not transferring the risks or rewards of ownership to the buyer-lessor. Two examples of continuing involvement specified in those paragraphs that are frequently found in sale-leaseback transactions are provisions or conditions in which:

a. The seller-lessee has an obligation or an option[32e] to repurchase the property or the buyer-lessor can compel the seller-lessee to repurchase the property.
b. The seller-lessee guarantees the buyer-lessor's investment or a return on that investment for a limited or extended period of time. [FAS98, ¶11]

[32e] A right of first refusal based on a bona fide offer by a third party ordinarily is not an obligation or an option to repurchase. An agreement that allows the seller-lessee to repurchase the asset in the event no third-party offer is made is an option to repurchase. [FAS98, ¶11, fn7]

.130H Other provisions or conditions that are guarantees and that do not transfer all of the risks of ownership shall constitute continuing involvement for the purpose of applying paragraphs .130A through .130M to sale-leaseback transactions and include, but are not limited to, the following:

a. The seller-lessee is required to pay the buyer-lessor at the end of the lease terms for a decline in the fair value of the property below the estimated residual value on some basis other than excess wear and tear of the property levied on inspection of the property at the termination of the lease.

b. The seller-lessee provides nonrecourse financing to the buyer-lessor for any portion of the sales proceeds or provides recourse financing in which the only recourse is to the leased asset.

c. The seller-lessee is not relieved of the obligation under any existing debt related to the property.

d. The seller-lessee provides collateral on behalf of the buyer-lessor other than the property directly involved in the sale-leaseback transaction, the seller-lessee or a related party to the seller-lessee guarantees the buyer-lessor's debt, or a related party to the seller-lessee guarantees a return of or on the buyer-lessor's investment.

e. The seller-lessee's rental payment is contingent on some predetermined or determinable level of future operations of the buyer-lessor.[32f] [FAS98, ¶12]

[32f] Paragraphs .130A through .130M distinguish between contingent rentals that are based on the future operations of the seller-lessee and those that are based on some predetermined or determinable level of future operations of the buyer-lessor. [FAS98, ¶8, fn4]

.130I The following provisions or conditions also shall be considered examples of continuing involvement for the purpose of applying paragraphs. 130A through .130M to sale-leaseback transactions:

a. The seller-lessee enters into a sale-leaseback transaction involving property improvements or integral equipment[32g] without leasing the underlying land to the buyer-lessor.[32h]

b. The buyer-lessor is obligated to share with the seller-lessee any portion of the appreciation of the property.

c. Any other provision or circumstance that allows the seller-lessee to participate in any future profits of the buyer-lessor or the appreciation of the leased property, for example, a situation in which the seller-lessee owns or has an option to acquire any interest in the buyer-lessor. [FAS98, ¶13]

[32g] The terms *property improvements* or *integral equipment* as used in paragraphs .130A through .130M refer to any physical structure or equipment attached to the real estate, or other parts thereof, that cannot be removed and used separately without incurring significant cost. Examples include an office building, a manufacturing facility, a power plant, and a refinery. [FAS98, ¶6, fn2]

[32h] Paragraphs .141 and .142 of Section R10 address transactions in which the seller sells property improvements to a buyer and leases the underlying land to the buyer of the improvements. Under certain circumstances, paragraph .141 of Section R10 precludes sales recognition for such transactions and requires that they be accounted for as leases of both the land and improvements. Paragraph .130A through .130M of this section are not intended to modify paragraph .141 of Section R10; thus, they do not address a sale-leaseback transaction that does not qualify for sales recognition under the provisions of paragraph .141 of Section R10. However, those paragraphs do address a sale-leaseback transaction that qualifies for sales recognition under the provisions of paragraph .142 of Section R10. [FAS98, ¶6, fn3]

Financial Statement Presentation and Disclosure

.130K In addition to the [other] disclosure requirements of this section and Section R10, the financial statements of a seller-lessee shall include a description of the terms of the sale-leaseback transaction, including future commitments, obligations, provisions, or circumstances that require or result in the seller-lessee's continuing involvement. [FAS98, ¶17]

.130L The financial statements of a seller-lessee that has accounted for a sale-leaseback transaction by the deposit method or as a financing according to the provisions of this section and Section R10 also shall disclose:

a. The obligation for future minimum lease payments as of the date of the latest balance sheet presented in the aggregate and for each of the five succeeding fiscal years.
b. The total of minimum sublease rentals, if any, to be received in the future under noncancelable subleases in the aggregate and for each of the five succeeding fiscal years. [FAS98, ¶18]

Accounting for and Reporting for Leveraged Leases

.143 From the standpoint of the lessee, leveraged leases shall be classified and accounted for in the same manner as nonleveraged leases. The balance of this section deals with leveraged leases from the standpoint of the lessor. [FAS13, paragraph 41]

.144 For the purposes of this section, a leveraged lease is defined as one having all the following characteristics:

a. Except for the exclusion of leveraged leases from the definition of a direct financing lease as set forth in paragraph .102(b)(2), it otherwise meets that definition. Leases that meet the definition of sales-type leases set forth in paragraph .102 (b)(1) shall not be accounted for as leveraged leases but shall be accounted for as prescribed in paragraph .113.
b. It involves at least three parties: a lessee, a long-term creditor, and a lessor (commonly called an equity participant).
c. The financing provided by the long-term creditor is nonrecourse as to the general credit of the lessor (although the creditor may have recourse to the specific property leased and the unremitted rentals relating to it). The amount of financing is sufficient to provide the lessor with substantial l*everage* in the transaction.
d. The lessor's net investment, as defined in paragraph .145, declines during the early years once the investment has been completed and rises during the later years of the lease before its final elimination. Such decreases and increases in the net investment balance may occur more than once.

A lease meeting the preceding definition shall be accounted for by the lessor using the method prescribed in paragraphs .145 through .149[36a]. An exception arises if the investment tax credit is accounted for other than stated in paragraphs .145 and .146,[37] in which case the lease shall be classified as a direct financing lease and accounted for in accordance with paragraph .114. A lease not meeting the definition of a leveraged lease shall be accounted for in accordance with its classification under paragraph .102(b). [FAS 13, ¶42]

[36a] Paragraphs .536 and .537 further discuss residual value retained by a lessor that sells rental payments.]

[37] It is recognized that the investment tax credit may be accounted for other than as prescribed here, as provided by Congress in the Revenue Act of 1971. [FAS13, ¶42, fn24]

.145 The lessor shall record its investment in a leveraged lease net of the nonrecourse debt. [37a]. The net of the balances of the following accounts shall represent the initial and continuing investment in leveraged leases:

a. Rentals receivable, net of that portion of the rental applicable to principal and interest on the nonrecourse debt.
b. A receivable for the amount of investment tax credit to be realized on the transaction.

c. The estimated residual value of the lease asset. The estimated residual value shall not exceed the amount estimated at the inception of the lease except as provided in footnote 38 [38][FAS23, ¶10]

d. Unearned and deferred income consisting of (1) the estimated pretax lease income (or loss), after deducting the initial direct costs, remaining to be allocated to income over the lease term and (2) the investment tax credit remaining to be allocated to income over the lease term.

[37a] Footnote 502 further discusses nonrecourse debt collateralized by a lease receivable

[38] If the lease agreement or commitment, if earlier, includes a provision to escalate minimum lease payments for increases in construction or acquisition cost of the leased property or for increases in some other measure of cost or value, such as general price levels, during the construction or preacquisition period, the effect of any increases that have occurred shall be considered in the determination of "the estimated residual value of the leased property at the inception of the lease" for purposes of this paragraph. [FAS23, ¶10]

The investment in leveraged leases less deferred taxes arising from differences between the pretax accounting income and taxable income shall represent the lessor's net investment in leveraged leases for purposes of computing periodic net income from the lease as described in paragraph .146. [FAS13, ¶43]

.146 Given the original investment and using the projected cash receipts and disbursements over the term of the lease, the rate of return on the net investment in the years[39] in which it is positive shall be computed. The rate is that rate which when applied to the net investment in the years in which the net investment is positive will distribute the net income to those years (refer to Exhibit 154C) and is distinct from the interest rate implicit in the lease. In each year whether positive or not, the difference between the net cash flow and the amount of income recognized, if any, shall serve to increase or reduce the net investment balance. The net income recognized shall be composed of three elements: two, pretax lease income (or loss) and investment tax credit, shall be allocated in proportionate amounts from the unearned and deferred income included in net investment, as described in paragraph .145; the third element is the tax effect of the pretax lease income (or loss) recognized, which shall be reflected in tax expense for the year. The tax effect of the difference between pretax accounting income (or loss) and taxable income (or loss) for the year shall be charged or credited to deferred taxes. The accounting prescribed in paragraph .145 and in this paragraph is illustrated in paragraph .154. [FAS13, ¶44]

[39] The use of the term *years* is not intended to preclude application of the accounting prescribed in this paragraph to shorter accounting periods. [FAS13, ¶44, fn 25]

.147 If the projected net cash receipts[40] over the term of the lease are less than the lessor's initial investment, the deficiency shall be recognized as a loss at the inception of the lease. Likewise, if at any time during the lease term the application of the method prescribed in paragraphs .145 and .146 would result in a loss being allocated to future years, that loss shall be recognized immediately. This situation might arise in cases in which one of the important assumptions affecting net income is revised (refer to paragraph .148). . [FAS13, ¶45]

[40] For purposes of this paragraph, net cash shall be gross cash receipts less gross cash disbursement s exclusive of the lessor's initial investment. [FAS13, ¶44, fn 26]

.148 Any estimated residual value and all other important assumptions affecting estimated total net income from the lease shall be reviewed at lease annually.[41] If during the lease term the estimate of the residual value is determined to be excessive and the decline in the residual value is judged to be other than temporary or if the revision of another important assumption changes the estimated total net income from the lease, the rate of return and the allocation of income to positive investment years shall be recalculated from the inception of the lease following the method described in paragraph .146 and using the revised assumption. The accounts constituting the net investment balance shall be adjusted to conform to the recalculated balances, and the change in the net investment shall be recognized as a gain or loss in the year in which the assumption is changed. An upward adjustment of the estimated residual value shall not be made.[41a] The accounting prescribed in this paragraph is illustrated in paragraph .154. [FAS13, ¶46]

[41] Refer to paragraphs .521 through .524 for supplemental guidance on the effect of a change in income tax rate on the accounting for leveraged leases.

[41a] Paragraphs .536 and .537 further discuss residual value retained by a lessor that sells rental payments.]

Accounting for Income Taxes

.148A Section I27, "Income Taxes," does not change (a) the pattern of recognition of after-tax income for leveraged leases as required by this section or (b) the allocation of the purchase price in a purchase business combination to acquired leveraged leases as required by paragraphs .140 through .142. Integration[41b] of the results of income tax accounting for leveraged leases with the other results of accounting for income taxes under Section I27 is required when deferred tax credits related to leveraged leases are the only source (refer to paragraph .120 of Section I27) for recognition of a tax benefit for deductible temporary differences and carryforwards not related to leveraged leases. A valuation allowance is not necessary if deductible temporary differences and carryforwards will offset taxable amounts from future recovery of the net investment in the leveraged lease. However, to the extent that the amount of deferred tax credits for a leveraged lease as determined under this section differs from the amount of the deferred tax liability related to the leveraged lease that would otherwise result from applying the requirements of Section I27, that difference is preserved and is not a source of taxable income for recognition of the tax benefit of deductible temporary differences and operating loss or tax credit carryforwards. [FAS109, ¶256]

[41b] Integration is an issue when all of the following exist:

a. The accounting for a leveraged lease requires recognition of deferred tax credits.
b. The requirements of Section 127 limit the recognition of a tax benefit for deductible temporary differences and carryforwards not related to the leveraged lease.
c. Unrecognized tax benefits could offset taxable amounts that result form future recovery of the net investment in the leveraged lease.

In those circumstances, integration shall be required. However, integration should not override any results that are unique to income tax accounting for leveraged leases, for example, the manner of recognizing the tax effect of an enacted change in tax rates. [FAS109, ¶126]

.148B Paragraph .141 requires that the tax effect of any difference between the assigned value and the tax basis of a leveraged lease at the date of a business combination not be accounted for as a deferred tax credit. Section I27 does not change that requirement. Any tax effects included in unearned and deferred income as required by this section are not offset by the deferred tax consequences of other temporary differences or by the tax benefit of operating loss or tax credit carryforwards. However, deferred tax credits that arise after the date of a business combination are accounted for in the same manner as described above for leveraged leases that were not acquired in a purchase business combination. [FAS109, ¶257] [Exhibit 185A in Section I27 presents an example that integrates the] accounting for leveraged leases [as required by this section] and the accounting for income taxes required by Section I27. [FAS109, ¶258]

Disclosures

.149 For purposes of presenting the investment in a leveraged lease in the lessor's balance sheet, the amount of related deferred taxes shall be presented separately (from the remainder of the net investment). In the income statement or the notes thereto, separate presentation (from each other) shall be made of pretax income from the leveraged lease, the tax effect of pretax income, and the amount of investment tax credit recognized as income during the period. When leveraged leasing is a significant part of the lessor's business activities in terms of revenue, net income, or assets, the components of the net investment balance in leveraged leases as set forth in paragraph .145 shall be disclosed in the footnotes to the financial statements. Paragraph .154 contains an illustration of the balance sheet, income statement and footnote presentation for a leveraged lease. [FAS13, ¶47]

.401 Bargain purchase option. A provision allowing the lessee, at his option, to purchase the leased property for a price that is sufficiently lower than the expected fair value of the property at the date the option becomes exercisable that exercise of the option appears, at the inception of the lease, to be reasonably assured. [FAS 13, paragraph 5.d.].

.402 Bargain renewal option. A provision allowing the lessee, at [the lessee's] option, to renew the lease for a rental[401] sufficiently lower than the fair rental of the property at the date the option becomes exercisable that exercise of the option appears, at the inception of the lease, to be reasonably assured. [FAS13, ¶5e]

[401] *Fair Rental* in this context shall mean the expected rental for equivalent property under similar terms and conditions. [FAS13, ¶5, fn 2]

.404 Contingent rentals. The increases or decreases in lease payments that result from changes occurring subsequent to the inception of the lease in the factors (other than the passage of time) on which lease payments are based, except as provided in the following sentence. Any escalation of minimum lease payments relating to increases in construction or acquisition cost of the leased property or for increases in some measure of cost or value during the construction or preconstruction period, as discussed in footnote 13, shall be excluded from contingent rentals. Lease payments that depend on a factor directly related to the future use of the leased property, such as machine hours of use or sales volume during the lease term, are contingent rentals and, accordingly, are excluded from minimum lease payments in their entirety. However, lease payments that depend on an existing index or rate, such as the consumer price index or the prime interest rate, shall be included in minimum lease payments based on the index or rate existing at the inception of the lease; any increases or decreases in lease payments that result from subsequent changes in the index or rate are contingent rentals and thus affect the determination of income as accruable. [FAS29, ¶11]

.406 Estimated economic life of leased property. The estimated remaining period during which the property is expected to be economically usable by one or more users, with normal repairs and maintenance, for the purpose for which it was intended at the inception of the lease, without limitation by the lease term. [FAS 13, paragraph 5.g.].

.409 Fair value of the leased property. The price for which the property could be sold in an arms-length transaction between unrelated parties. The following are examples of the determination of fair value:

a. When the lessor is a manufacturer or dealer, the fair value of the property at the inception of the lease will ordinarily be its normal selling price, reflecting any volume or trade discounts that may be applicable. However, the determination of fair value shall be made in light of market conditions prevailing at the time, which may indicate that the fair value of the property is less than the normal selling price and, in some instances, less than the cost of the property.

b. When the lessor is not a manufacturer or dealer, the fair value of the property at the inception of the lease will ordinarily be its cost, reflecting any volume or trade discounts that may be applicable. However, when there has been a significant lapse of time between the acquisition of the property by the lessor and the inception of the lease, the determination of fair value shall be made in light of market conditions prevailing at the inception of the lease, which may indicate that the fair value of the property is greater or less than its cost or carrying amount, if different, (refer to paragraph .102). [FAS 13, paragraph 5.c.].

.412 Interest rate implicit in the lease. The discount rate that, when applied to (a) the minimum lease payments, excluding that portion of the payments representing executory costs to be paid by the lessor, together with any profit thereon, and (b) the unguaranteed residual value accruing to the benefit of the lessor[403] causes the aggregate present value at the beginning of the lease term to be equal to the fair value of the leased property to the lessor at the inception of the lease, minus any investment tax credit retained by the lessor and expected to be realized by him. (This definition does not necessarily purport to include all factors that a lessor might recognize in determining his rate of return, for example, see paragraph .146.) [FAS 13, paragraph 5.k.]

[403] If the lessor is not entitled to any excess of the amount realized on disposition of the property over a guaranteed amount, no unguaranteed residual value would accrue to the lessors benefit. [FAS 13, paragraph 5.k., footnote 8]

.413 Lease. An agreement conveying the right to use property, plant, or equipment (land or depreciable assets or both) usually for a stated period of time. [FAS 13, paragraph 1].

.414 Lease term. The fixed noncancelable term of the lease plus (a) all periods, if any, covered by bargain renewal options (as defined paragraph .402), (b) all periods, if any, for which failure to renew the lease imposes a penalty (as defined in paragraph .418A) on the lessee in such amount that a renewal appears, at the inception of the lease, to be reasonably assured, (c) all periods, if any, covered by ordinary renewal options[405] during which a guarantee by the lessee of the lessors debt directly or indirectly related to the leased property[405a] is expected to be in effect or a loan from the lessee to the lessor directly or indirectly related to the leased property is expected to be outstanding, (d) all periods, if any, covered by ordinary renewal options preceding the date as of which a bargain purchase option (as defined in paragraph .401) is exercisable, and (e) all periods, if any, representing renewals or extensions of the lease at the lessors option; however, in no case shall the lease term be assumed to extend beyond the date a bargain purchase option becomes exercisable. A lease that is cancelable (1) only upon the occurrence of some remote contingency, (2) only with the permission of the lessor, (3) only if the lessee enters into a new lease with the same lessor, or (4) only if the lessee incurs a penalty in such amount that continuation of the lease appears, at inception, reasonably assured shall be noncancelable for purposes of this definition.[FAS 98, paragraph 22.a.]

[405] Paragraphs .501 through .505 address fiscal funding clauses in lease agreements.

[405a] The phrase indirectly related to the leased property is used in this paragraph to describe provisions or conditions that in substance are guarantees of the lessors debt or loans to the lessor by the lessee that are related to the leased property but are structured in such a manner that they do not represent a direct guarantee or loan. Examples include a party related to the lessee guaranteeing the lessors debt on behalf of the lessee, or the lessee financing the lessors purchase of the leased asset using collateral other than the leased property. [FAS 98, paragraph 22.a.]

.415 Lessees incremental borrowing rate. The rate that, at the inception of the lease, the lessee would have incurred to borrow over a similar term the funds necessary to purchase the leased asset.[406]

[406] Paragraphs .509 through .511 further discuss the interest rate used in calculating the present value of the minimum lease payments.

.417 Minimum lease payments.

(a) From the standpoint of the lessee: The payments that the lessee is obligated to make or can be required to make in connection with the leased property. [FAS 13, paragraph 5.j.], (Contingent rentals, as defined in paragraph .404, shall be excluded from minimum lease payments.) [FAS 29, paragraph 10] However, a guarantee by the lessee of the lessors debt and the lessees obligation to pay (apart from the rental payments) executory costs in connection with the leased property shall be excluded. If the lease contains a bargain purchase option, only the minimum rental payments over the lease term (as defined in paragraph .413) and the payment called for by the bargain purchase option shall be included in the minimum lease payments. Otherwise, minimum lease payments include the following:

(1) The minimum rental payments called for by the lease over the lease term.

(2) Any guarantee by the lessee or any party related to the lessee of the residual value at the expiration of the lease term, whether or not payment of the guarantee constitutes a purchase of the leased property.[407] When the lessor has the right to require the lessee to purchase the property at termination of the lease for a certain or determinable amount, that amount shall be considered a lessee guarantee. When the lessee agrees to make up any deficiency[408] below a stated amount in the lessors realization of the residual value, the guarantee to be included in the minimum lease payments shall be the stated amount,[409] rather than an estimate of the deficiency to be made up.

[407] A guarantee of the residual value obtained by the lessee from an unrelated third party for the benefit of the lessor shall not be used to reduce the amount of the lessees minimum lease payments except to the extent that the lessor explicitly releases the lessee from obligation, including secondary obligation if the guarantor defaults, to make up a residual value deficiency. Amounts paid in consideration for a guarantee by an unrelated third party are executory costs and are not included in the lessees minimum lease payments.

[408] A lease provision requiring the lessee to make up a residual value deficiency that is attributable to damage, extraordinary wear and tear, or excessive usage is similar to contingent rentals in that the amount is not determinable at the inception of the lease. Such a provision does not constitute a lessee guarantee of the residual value.

[409] If a lease limits the amount of the lessees obligation to make up a residual value deficiency to an amount less than the stipulated residual value of the leased property at the end of the lease term, the amount of the lessees guarantee to be included in minimum lease payments shall be limited to the specified maximum deficiency the lessee can be required to make up. The *stated amount* is the specified maximum deficiency that the lessee is obligated to make up. If that maximum deficiency clearly exceeds any reasonable estimate of a deficiency that might be expected to arise in normal circumstances, the lessors risk associated with the portion of the residual in excess of the maximum may appear to be negligible. However, the fact remains that the lessor must look to the resale market or elsewhere rather than to the lessee to recover the unguaranteed portion of the stipulated residual value of the leased property. The lessee has not guaranteed full recovery of the residual value, and the parties should not base their accounting on the assumption that the lessee has guaranteed it.

(3) Any payment that the lessee must make or can be required to make upon failure to renew or extend the lease at the expiration of the lease term, whether or not the payment would constitute a purchase of the lease property. In this connection, it should be noted that the definition of lease term (refer to paragraph .413) includes all periods, if any, for which failure to renew the lease imposes a penalty on the lessee in an amount such that renewal appears, at the inception of the lease, to be reasonably assured. If the lease term has been extended because of that provision, the related penalty shall not be included in the minimum lease payments.

(b) From the standpoint of the lessor: The payments described above plus any guarantee of the residual value or of rental payments beyond the lease term by a third party unrelated to either the lessee of the lessor,[410] provided the third party is financially capable of discharging the obligations that may arise from the guarantee. [FAS 13, paragraph 5.j.]

[410] If the guarantor is related to the lessor, the residual value shall be considered as unguaranteed.

.418A Penalty. Any requirement that is imposed or can be imposed on the lessee by the lease agreement or by factors outside the lease agreement to disburse cash, incur or assume a liability, perform services, surrender or transfer an asset or rights to an asset or otherwise forego an economic benefit, or suffer an economic detriment. Factors to consider when determining if an economic detriment may be incurred include, but are not limited to, the uniqueness of purpose or location of the property, the availability of a comparable replacement property, the relative importance or significance of the property to the continuation of the lessee's line of business or service to its customers, the existence of leasehold improvements or other assets whose value would be impaired by the lessee vacating or discontinuing use of the leased property, adverse tax consequences, and the ability or willingness of the lessee to bear the cost associated with relocation or replacement of the leased property at market rental rates or to tolerate other parties using the leased property. [FAS98, ¶22b]

.419 Related parties. A parent company and its subsidiaries, an owner company and its joint ventures (corporate or otherwise) and partnerships, and an investor (including a natural person) and its investees, provided that the parent company, owner enterprise, or investor has the ability to exercise significant influence over operating and financial policies of the related party, as significant influence is defined in section I82, paragraph 104. In addition to the examples of significant influence set forth in that paragraph, significant influence may be exercised through guarantees of indebtedness, extensions of credit, or through ownership of warrants, debt obligations, or other securities. If two or more enterprises are subject to the significant influence of a parent company, owner enterprise, investor (including a natural person), or common officers or directors, those enterprises shall be considered related parties with respect to each other. [FAS 13, paragraph 5.a.].

30. *FAS 66*, *Accounting for Sales of Real Estate,* defines the deposit method of accounting as follows:

Deposit Method

65. Under the deposit method, the seller does not recognize any profit, does not record notes receivable, continues to report in its financial statements the property and the related existing debt even if it has been assumed by the buyer, and discloses that those items are subject to a sales contract. The seller continues to charge depreciation to expense as a period cost for the property for which deposits have been received. Cash received from the buyer, including the initial investment and subsequent collections of principal and interest, is reported as a deposit on the contract except that, for sales that are not retail land sales, portions of cash received that are designated by the contract as interest and are not subject to refund offset carrying charges (property taxes and interest on existing debt) on the property. Interest collected that is subject to

refund and is included in the deposit account before a sale is consummated is accounted for as part of the buyer's initial investment at the time the sale is consummated.[FAS66, ¶7]

66. When a contract is canceled without a refund, deposits forfeited are recognized as income. When deposits on retail land sales are ultimately recognized as sales, the interest portion is recognized as interest income.

67. The seller's balance sheet presents nonrecourse debt assumed by the buyer among the liabilities; the debt assumed is not offset against the related property. The seller reports the buyer's principal payments on mortgage debt assumed as additional deposits with corresponding reductions of the carrying amount of the mortgage debt.

31. *FASB Technical Bulletin 85-3*, *Accounting for Operating Leases with Scheduled Rent Increases*, provides the following guidance:

Question

1. Certain operating lease agreements specify scheduled rent increases over the lease term. Such scheduled rent increases may, for example, be designed to provide an inducement or “rent holiday” for the lessee, to reflect the anticipated effects of inflation, to ease the lessee's near-term cash flow requirements, or to acknowledge the time value of money. For operating leases that include scheduled rent increases, is it ever appropriate for lessees or lessors to recognize rent expense or rental income on a basis other than the straight-line basis required by Statement 13?

Response

2. The effects of those scheduled rent increases, which are included in minimum lease payments under Statement 13, should be recognized by lessors and lessees on a straight-line basis over the lease term unless another systematic and rational allocation basis is more representative of the time pattern in which the leased property is physically employed. Using factors such as the time value of money, anticipated inflation, or expected future revenues to allocate scheduled rent increases is inappropriate because these factors do not relate to the time pattern of the physical usage of the leased property. However, such factors may affect the periodic reported rental income or expense if the lease agreement involves contingent rentals, which are excluded from minimum lease payments and accounted for separately under Statement 13, as amended by Statement 29.

32. *FASB Technical Bulletin 88-1*, *Issues relating to Accounting for Leases: Time Pattern of the Physical Use of the Property in an Operating Lease, Lease Incentives in an Operating Lease, Applicability of Leveraged Lease Accounting to Existing Assets of the Lessor, Money-Over-Money Lease Transactions, Wrap Lease Transactions*, provides the following guidance on operating leases:

TIME PATTERN OF THE PHYSICAL USE OF THE PROPERTY IN AN OPERATING LEASE

References: *FASB Statement No. 13, Accounting for Leases*, paragraph 15

FASB Technical Bulletin No. 85-3, Accounting for Operating Leases with Scheduled Rent Increases

Question 1

1. A lease agreement may include scheduled rent increases designed to accommodate the lessee's projected physical use of the property. For example, rents may escalate in contemplation of the lessee's physical use of the property even though the lessee takes possession of or controls the physical use of the property at the inception of the lease, or rents may escalate under a master lease agreement as the lessee adds additional equipment to the leased property or requires additional space or capacity (hereinafter referred to as additional leased property).

For operating leases that include those provisions, how should the rental payment obligation be recognized by the lessee and lessor in accordance with paragraph 15 of Statement 13 and Technical Bulletin 85-3?

Response

2. Both the lessee and the lessor should recognize the lease payments under Statement 13 and Technical Bulletin 85-3 as follows:

a. If rents escalate in contemplation of the lessee's physical use of the leased property, including equipment, but the lessee takes possession of or controls the physical use of the property at the beginning of the lease term, all rental payments, including the escalated rents, should be recognized as rental expense or rental revenue on a straight-line basis in accordance with paragraph 15 of Statement 13 and Technical Bulletin 85-3 starting with the beginning of the lease term.

b. If rents escalate under a master lease agreement because the lessee gains access to and control over additional leased property at the time of the escalation, the escalated rents should be considered rental expense or rental revenue attributable to the leased property and recognized in proportion to the additional leased property in the years that the lessee has control over the use of the additional leased property. The amount of rental expense or rental revenue attributed to the additional leased property should be proportionate to the relative fair value of the additional property, as determined at the inception of the lease, in the applicable time periods during which the lessee controls its use.

Background

3. This issue involves how to apply Technical Bulletin 85-3 to lease agreements that escalate rents in contemplation of the lessee's projected use of the property. The issue arises from paragraph 2 of Technical Bulletin 85-3, which states ". . . scheduled rent increases, which are included in minimum lease payments under Statement 13, should be recognized by lessors and lessees on a straight-line basis over the lease term UNLESS ANOTHER SYSTEMATIC AND RATIONAL ALLOCATION BASIS IS MORE REPRESENTATIVE OF THE TIME PATTERN IN WHICH THE LEASED PROPERTY IS PHYSICALLY EMPLOYED" (emphasis added).

4. This Technical Bulletin considers the right to control the use of the leased property as the equivalent of physical use. When the lessee controls the use of the leased property, recognition of rental expense or rental revenue should not be affected by the extent to which the lessee utilizes that property.

5. This Technical Bulletin makes a distinction between agreements that give the lessee the right to control the use of the leased property at the beginning of the lease term and those that do not. Escalated rents under agreements that give the lessee the right to control the use of the entire leased property at the beginning of the lease term should be included in the minimum lease payments and recognized on a straight-line basis over the lease term. When the agreement provides that the lessee gains control over additional leased property, rental expense or rental revenue should be recognized based on the relative fair value of the additional property leased and the period during which the lessee has the right to control the use of the additional property. This is the intent of Statement 13 and Technical Bulletin 85-3.

LEASE INCENTIVES IN AN OPERATING LEASE

References: *FASB Statement No. 13, Accounting for Leases*, paragraphs 15, 19, and 35-40

FASB Technical Bulletin No. 79-15, Accounting for Loss on a Sublease Not Involving the Disposal of a Segment

FASB Technical Bulletin No. 85-3, Accounting for Operating Leases with Scheduled Rent Increases

Question 2

6. An operating lease agreement with a new lessor may include incentives for the lessee to sign the lease, such as an up-front cash payment to the lessee, payment of costs for the lessee (such as moving expenses), or the assumption by the lessor of the lessee's preexisting lease with a third party. For operating leases that include such incentives, should lessees or lessors ever recognize those incentives as rental expense or rental revenue other than on a straight-line basis in accordance with paragraph 15 of Statement 13 and Technical Bulletin 85-3?

Response

7. Payments made to or on behalf of the lessee represent incentives that should be considered reductions of rental expense by the lessee and reductions of rental revenue by the lessor over the term of the new lease. Similarly, losses incurred by the lessor as a result of assuming a lessee's preexisting lease with a third party should be considered an incentive by both the lessor and the lessee. Incentives should be recognized on a straight-line basis over the term of the new lease in accordance with paragraph 15 of Statement 13, Technical Bulletin 85-3, and paragraphs 1-5 above.

8. The lessee's immediate recognition of expenses or losses, such as moving expenses, losses on subleases, or the write-off of abandoned leasehold improvements, is not changed by this Technical Bulletin. Rather, this Technical Bulletin addresses the question of when to recognize the incentive related to the new lessor's assumption of that expense or loss. The new lessor and the lessee should independently estimate any loss attributable to the assumption of a preexisting lease with a third party. For example, the lessee's estimate of the incentive could be based on a comparison of the new lease with the market rental rate available for similar lease property or the market rental rate from the same lessor without the lease assumption, and the lessor should estimate any loss based on the total remaining costs reduced by the expected benefits from the sublease or use of the assumed leased property.

9. For example, in conjunction with an operating lease of property for eight years, the lessor assumes the lessee's preexisting lease with a third party that has four years remaining. Assume that the old lease payment is $800 per year and the new lease payment is $1,200 per year. Also assume that the lessor estimates the loss on the assumed lease of $1,000 over its remaining term based on the ability to sublease the property for $550 per year. The lessee estimates the incentive as $960 based on a comparison of the preexisting lease rate to current rates for similar property. The accounting for that incentive is as follows:

Lessor Accounting

At inception:

Incentive to lessee	1,000	
Liability on sublease assumed		1,000

To record deferred cost and liability related to loss on assumption of remaining lease

Recurring journal entries in years 1-4:

Liability on sublease assumed (1,000/ 4 years)	250	
Sublease expense	550	
Cash		800

To record cash payment on sublease assumed and amortization of the liability on the sublease assumed

Cash	550	
Sublease revenue		550

To record cash received from sublease of the property

Recurring journal entries in years 1-8:

Cash	1,200	
Rental revenue		1,075
Incentive to lessee (1,000/ 8 years)		125

To record cash received on new lease and amortization of incentive over new lease term

Lessee Accounting

At inception:

Loss on sublease assumed by lessor	960	
Incentive from lessor		960

To record loss on sublease assumed in conjunction with new lease agreement

Recurring journal entries in years 1-8:

Lease expense	1,080	
Incentive from lessor (960/ 8 years)	120	
Cash		1,200

To record cash payment on new lease and amortization of incentive over the new lease term

Background

10. Some have suggested that incentives paid to or incurred on behalf of the lessee by the lessor are not part of the normal lessee-lessor relationship and should be recognized in income by the lessee in the period paid or incurred by the lessor. This Technical Bulletin views those incentives as an inseparable part of the new lease agreement that must be recognized as reductions to rental expense and rental revenue on a straight-line basis over the term of the new lease in accordance with paragraph 15 of Statement 13, Technical Bulletin 85-3, and paragraph 2 above.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *Issue Paper No. 25—Accounting for and Disclosures About Transactions with Affiliates and Other Related Party Transactions*
- *Issue Paper No. 34—Investment Income Due and Accrued*
- *Issue Paper No. 40—Real Estate Investments*
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapters 8 and 22
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapters 8

- Minutes from the Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force meeting on May 7, 1986, August 5, 1987, September 11, 1989 and December 4, 1989

Generally Accepted Accounting Principles
GAAP guidance applicable to operating leases, sale-leaseback transactions and leveraged leases, which is adopted and rejected is indicated in brackets paragraphs:

- *FASB Statement No. 13*, *Accounting for Leases*, as amended and interpreted by incorporating FASB Statements, Interpretations, and Technical Bulletins, which follow. [paragraphs 15, 16.(b., c., d.), 19.(a., b.), 23.(b., c.), 36, 37, 38.b., 39.c., 42-47 adopted; all other paragraphs rejected]
- *FASB Statement No. 22*, *Changes in the Provisions of Lease Agreements Resulting from Refundings of Tax-Exempt Debt (an amendment of FASB Statement No. 13)* [rejected in its entirety]
- *FASB Statement No. 23*, *Inception of the Lease (an amendment of FASB Statement No. 13)* [paragraph 10 adopted; all other paragraphs rejected]
- *FASB Statement No. 27*, *Classification of Renewals or Extensions of Existing Sales-Type or Direct Financing Leases (an amendment of FASB Statement No. 13)* [rejected in its entirety]
- *FASB Statement No. 28*, *Accounting for Sales with Leasebacks (an amendment of FASB Statement No. 13)* [adopted in its entirety, except guidance on capital leases is not applicable other than those leases that qualify as leveraged leases.]
- *FASB Statement No. 29*, *Determining Contingent Rentals (an amendment of FASB Statement No. 13)* [paragraphs 8, 11 adopted; remaining paragraphs rejected]
- *FASB Statement No. 98*, *Accounting for Leases*:
  -Sale-Leaseback Transactions Involving Real Estate
  -Sales-Type Leases of Real Estate
  -Definition of the Lease Term
  -Initial Direct Costs of Direct Financing Leases (an amendment of FASB Statements No. 13, 66 and 91 and a recession of FASB Statement No. 26 and Technical Bulletin No. 79-11) [paragraphs 1-13, 17-22.(a.-e., j.-n.) adopted; remaining paragraphs rejected]
- *FASB Statement No. 109*, *Accounting for Income Taxes* [paragraphs 256-258 adopted]
- *FASB Interpretation No. 19*, *Lessee Guarantee of the Residual Value of Leased Property (an interpretation of FASB Statement No. 13)* [rejected in its entirety]
- *FASB Interpretation No. 21*, *Accounting for Leases in a Business Combination (an interpretation of FASB Statement No. 13)* [rejected in its entirety]
- *FASB Interpretation No. 23*, *Leases of Certain Property Owned by a Governmental Unit or Authority (an interpretation of FASB Statement No. 13)* [rejected in its entirety]
- *FASB Interpretation No. 24*, *Leases Involving Only Part of a Building (an interpretation of FASB Statement No. 13)* [rejected in its entirety]
- *FASB Interpretation No. 26*, *Accounting for Purchase of a Leased Asset by the Lessee during the Term of the Lease (an interpretation of FASB Statement No. 13)* [rejected in its entirety]
- *FASB Interpretation 27*, *Accounting for a Loss on a Sublease (an interpretation of FASB Statement No. 13 and APB Opinion No. 30)* [adopted in its entirety]
- *FASB Technical Bulletin 79-10, Fiscal Funding Clauses in Lease Agreements* [rejected in its entirety.]
- *FASB Technical Bulletin 79-12, Interest Rate Used in Calculating the Present Value of Minimum Lease Payments* [rejected in its entirety]
- *FASB Technical Bulletin 79-13*, *Applicability of FASB Statement No. 13 to Current Value Financial Statements* [rejected in its entirety]
- *FASB Technical Bulletin 79-14*, *Upward Adjustment of Guaranteed Residual Values* [rejected in its entirely]
- *FASB Technical Bulletin 79-15*, *Accounting for Loss on a Sublease Not Involving the Disposal of a Segment* [adopted in its entirety]

- FASB Technical Bulletin 79-16(R), *Effect of a change in Income Tax Rate on the Accounting for Leveraged Leases* [adopted in its entirety]
- *FASB Technical Bulletin 79-17*, *Reporting Cumulative Effect Adjustment from Retroactive Application of FASB Statement No. 13* [rejected in its entirety]
- *FASB Technical Bulletin 79-18*, *Transition Requirement of Certain FASB Amendments and Interpretations of FASB Statement No. 13* [rejected in its entirety]
- *FASB Technical Bulletin 85-3*, *Accounting for Operating Leases with Scheduled Rent Increases* [adopted in its entirety]
- *FASB Technical Bulletin 86-2*, *Accounting for an Interest in the Residual Value of a Leased Asset:*
  -Acquired by a Third Party or
  -Retained by a Lessor That Sells the Related Minimum Rental Payments [adopted in its entirety]
- FASB Technical Bulletin 88-1, *Issues Related to Accounting for Leases*:
  -*Time Pattern of the Physical Use of the Property in an Operating Lease*
  -*Lease Incentives in an Operating Lease*
  -*Applicability of Leveraged Lease Accounting to Existing Assets of the Lessor*
  -*Money-Over-Money Lease Transactions*
  -*Wrap Lease Transactions*
  [paragraphs 1-12 adopted; remaining paragraphs rejected]

State Regulations

- No additional guidance obtained from state statutes or regulations.

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Statutory Issue Paper No. 23

Property Occupied by the Company

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 40

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. A reporting entity is required to record its investment in real estate that is occupied by the company as a separate line item in the Invested Asset section of the statutory balance sheet. Additionally, a reporting entity is required to record rental income and expense related occupancy of its own building. Under GAAP, property used predominantly in a reporting entity's operations is classified as an asset outside of invested assets. Additionally, GAAP prohibits the recognition of imputed investment income and rental expense for real estate used in the business.

2. The purpose of the issue paper is to establish statutory accounting principles for home office that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

3. For statutory accounting purposes, any real estate which is owned by and is more than 50% occupied by the reporting entity and its affiliates shall be considered "real estate occupied by the company." "More than 50% occupied" shall mean that the square footage occupied by the reporting entity and its affiliates totals more than 50% of the rentable square footage of the property, including common areas. This shall include property occupied by the reporting entity which is not necessarily home office (e.g. claims processing, data processing and branch centers). Property which does not meet this 50% requirement shall be classified as property held for the production of income or property held for sale.

4. A reporting entity's investment in property occupied by the company meets the definition of an asset as defined in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets* (Issue Paper No. 4) and is an admitted asset to the extent it conforms to the requirements of this issue paper. The asset shall be recorded in accordance with *Issue Paper No. 40—Real Estate Investments* (Issue Paper No. 40) (e.g., initial capitalization, valuation, including impairments of value, depreciation, interest expense on encumbrances, etc.). A reporting entity shall include in both its income and expenses an amount for rent relating to its occupancy of its own buildings. The amount recorded shall be at a rate comparable to rent received from others and/or rental rates of like property in the same area. If this is unavailable, it shall be derived from consideration of the repairs, expenses, taxes, and depreciation incurred, plus interest added at an average fair rate on the book value of the reporting entity's investment in its home office building.

DISCUSSION

5. The conclusion above clarifies current statutory accounting to include specific guidance on the definition of property occupied by the company. Additionally, the conclusion above changes current guidance to require property occupied by the reporting entity to be evaluated for impairment as specified in accordance with Issue Paper No. 40. Current statutory guidance requires property occupied by the company to be valued at depreciated cost (net of any encumbrances). *FASB Statement No. 121*,

Accounting for the Impairment of Long-Lived Assets and Long-Lived Assets to Be Disposed Of (FAS 121), is adopted in Issue Paper No. 40. The conclusion above rejects paragraph 52 of *FASB Statement No. 60*, *Accounting and Reporting by Insurance Enterprises* (FAS 60).

6. Recording property occupied by the company, net of any encumbrances, as an admitted asset is consistent with the Recognition Concept included in the Statement of Concepts. The Recognition Concept states,

> The ability to meet policyholder obligations as predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which may be unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet but rather should be charged against surplus when acquired or when availability otherwise becomes questionable.

Though in a depressed market it may take longer to liquidate than other invested assets, it is generally accepted that real estate is a marketable asset which is available to meet policyholder obligations.

7. So that the statement of operations and yield on invested assets of a reporting entity occupying its own real estate are comparable with a reporting entity that leases its offices under operating leases, rental income and expense are reported for the real estate occupied by the reporting entity. The rent charged should be comparable to the income that would be produced if the reporting entity was renting the real estate to a third party.

Drafting Notes/Comments

- Accounting for real estate is addressed in *Issue Paper No. 40—Real Estate Investments*.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

8. Chapter 4, Real Estate, in the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies (Life/A&H Accounting Practices and Procedures Manual) contains the following guidance on reporting for real estate occupied by the reporting entity:

> Directly-owned real estate is reported separately in the statutory financial statement. Holdings so reported are classified as properties (a) occupied by the company, (b) acquired in satisfaction of debt, and (c) investments in real estate. These classes may include real estate owned under contract of sale.
>
> In the statutory financial statement, a company must include in both its income and expenses an amount for rent relating to its occupancy of its own buildings. This amount can be the estimate current market rental value of the space involved, or it can be the amount derived from consideration of the repairs, expenses, taxes, and depreciation incurred, plus interest added at an average fair rate on the book value of the company's investment in its home office building. The figure thus determined, being both charged to expenses and credited to income, has no effect either on the company's overall net income or surplus.

9. Chapter 4, Real Estate, in the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies (P & C Accounting Practices and Procedures Manual) contains similar wording related to the reporting of real estate occupied by the reporting entity.

10. Chapter 19, Investment Income and Net Realized Gains, in the Life/A&H Accounting Practices and Procedures Manual states:

> Rent on Company-Owned Office Building
>
> Real estate income from company-owned property includes rent received from the leasing of space to others and also an imputed rental charge for the portion of the building occupied by the company. This rental charge is made on the theory that such space can be rented to others; therefore, the company is entitled to income on its investment. Some states requires that this rent be comparable to rent received from others and/or rental rates of like property in the same area. It should be noted that an offsetting charge is made to rent expense.

11. Chapter 15, Investment Income and Net Realized Gains, in the P & C Accounting Practices and Procedures Manual contains similar wording related to recording rent on real estate occupied by the reporting entity.

Generally Accepted Accounting Principles

12. *FAS 60*, *Accounting and Reporting by Insurance Enterprises*, contains the guidance relating to real estate occupied by the reporting entity. It states:

> Real Estate Used in the Business
>
> 52. Real estate shall be classified either as an investment or as real estate used in the enterprise's operations, depending on its predominant use. Depreciation and other real estate operating costs shall be classified as investment expenses or operating expenses consistent with the balance sheet classification of the related asset. Imputed investment income and rental expense shall not be recognized for real estate used in the business.

13. FAS 121 contains the following guidance for real estate occupied by the reporting entity:

> Assets to Be Held and Used
>
> Recognition and Measurement of Impairment
>
> 4. An entity shall review long-lived assets and certain identifiable intangibles to be held and used for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable.
>
> 5. The following are examples of events or changes in circumstances that indicate that the recoverability of the carrying amount of an asset should be assessed:
>
> a. A significant decrease in the market value of an asset
>
> b. A significant change in the extent or manner in which an asset is used or a significant physical change in an asset
>
> c. A significant adverse change in legal factors or in the business climate that could affect the value of an asset or an adverse action or assessment by a regulator
>
> d. An accumulation of costs significantly in excess of the amount originally expected to acquire or construct an asset
>
> e. A current period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with an asset used for the purpose of producing revenue.
>
> 6. If the examples of events or changes in circumstances set forth in paragraph 5 are present or if other events or changes in circumstances indicate that the carrying amount of an

asset that an entity expects to hold and use may not be recoverable, the entity shall estimate the future cash flows expected to result from the use of the asset and its eventual disposition. Future cash flows are the future cash inflows expected to be generated by an asset less the future cash outflows expected to be necessary to obtain those inflows. If the sum of the expected future cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset, the entity shall recognize an impairment loss in accordance with this Statement. Otherwise, an impairment loss shall not be recognized; however, a review of depreciation policies may be appropriate.[1]

[1] Paragraph 10 of *APB Opinion No. 20, Accounting Changes,* addresses the accounting for changes in depreciation estimates, and paragraph 32 addresses the accounting for changes in the method of depreciation. Whenever there is reason to assess the recoverability of the carrying amount of an asset under paragraphs 4 and 5 of this Statement, there may be reason to review the depreciation estimates and method under paragraphs 10 and 32 of Opinion 20. However, an impairment loss that results from applying this Statement should be recognized prior to performing that review. The provisions of Opinion 20 apply to the reporting of changes in the depreciation estimates and method regardless of whether an impairment loss is recognized under paragraph 6 of this Statement.

7. An impairment loss recognized in accordance with paragraph 6 shall be measured as the amount by which the carrying amount of the asset exceeds the fair value of the asset. The fair value of an asset is the amount at which the asset could be bought or sold in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available. If quoted market prices are not available, the estimate of fair value shall be based on the best information available in the circumstances. The estimate of fair value shall consider prices for similar assets and the results of valuation techniques to the extent available in the circumstances. Examples of valuation techniques include the present value of estimated expected future cash flows using a discount rate commensurate with the risks involved, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis.

8. In estimating expected future cash flows for determining whether an asset is impaired (paragraph 6), and if expected future cash flows are used in measuring assets that are impaired (paragraph 7), assets shall be grouped at the lowest level for which there are identifiable cash flows that are largely independent of the cash flows of other groups of assets.

9. Estimates of expected future cash flows shall be the best estimate based on reasonable and supportable assumptions and projections. All available evidence should be considered in developing estimates of expected future cash flows. The weight given to the evidence should be commensurate with the extent to which the evidence can be verified objectively. If a range is estimated for either the amount or timing of possible cash flows, the likelihood of possible outcomes shall be considered in determining the best estimate of future cash flows.

10. In limited circumstances, the test specified in paragraph 6 will be applicable at only the entity level because the asset being tested for recoverability does not have identifiable cash flows that are largely independent of other asset groupings. In those instances, if the asset is not expected to provide any service potential to the entity, the asset shall be accounted for as if abandoned or held for disposal in accordance with the provisions of paragraph 15 of this Statement. If the asset is expected to provide service potential, an impairment loss shall be recognized if the sum of the expected future cash flows (undiscounted and without interest charges) for the entity is less than the carrying amounts of the entity's assets covered by this Statement.

11. After an impairment is recognized, the reduced carrying amount of the asset shall be accounted for as its new cost. For a depreciable asset, the new cost shall be depreciated over the asset's remaining useful life. Restoration of previously recognized impairment losses is prohibited.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manuals for Life and Accident and Health Insurance Companies, Chapter 4, Real Estate
- Accounting Practices and Procedures Manuals for Property and Casualty Insurance Companies, Chapter 4, Real Estate
- Accounting Practices and Procedures Manuals for Life and Accident and Health Insurance Companies, Chapter 19, Investment Income and Net Realized Gains
- Accounting Practices and Procedures Manuals for Property and Casualty Insurance Companies, Chapter 15, Investment Income and Net Realized Gains
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 40—Real Estate Investments*

Generally Accepted Accounting Principles

- *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises*
- *FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and Long-Lived Assets to Be Disposed Of*

State Regulations

- No additional guidance obtained from state statutes or regulations.

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Statutory Issue Paper No. 24

Discontinued Operations and Extraordinary Items

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 24

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory accounting guidance does not define nor does it address the accounting treatment for the disposal of a segment of a business or extraordinary items.

2. GAAP guidance contained in Accounting Principles Board Opinion No. 30, *Reporting the Results of Operations - Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions, as amended* (APB 30) defines discontinued operations, requires accrual of losses associated with the disposal of a segment of a business and states that results of operations of discontinued operations should be disclosed as a separate line item in the balance sheet and in the income statement after income from the on-going operations of the reporting entity, net of applicable income taxes. It also contains guidance on the calculation of the gain or loss on the disposal of a segment of the business. Gains on the disposal of a segment of the business are not to be recorded until realized.

3. APB 30 also defines extraordinary items and requires extraordinary items to be disclosed as a separate line item in the income statement after income from the on-going operation of the reporting entity, net of applicable income taxes.

4. The purpose of this issue paper is to establish statutory accounting principles related to the accounting and reporting for the effects of the disposal of a segment of a business and extraordinary items that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

Discontinued Operations

5. If a loss is expected from the proposed sale or abandonment of a segment of business, the estimated loss shall be accrued at the measurement date, as defined in paragraph 13 below, in accordance with *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*. If a gain is expected, it shall be recognized when realized, in accordance with *Issue Paper No. 20—Gain Contingencies*, which ordinarily is the disposal date.

6. The determination of whether a gain or loss results from the disposal should be made at the measurement date based on estimates at that date of the net realizable value of the segment after giving consideration to any estimated costs and expenses directly associated with the disposal and, if a plan of disposal is to be carried out over a period of time and contemplates continuing operations during that period, to any estimated income or losses from operations. If it is expected that net losses from operations will be incurred between the measurement date and the expected disposal date, the computation of the gain or loss on disposal should also include an estimate of such amounts. If it is expected that net income will be generated from operations during that period the computation should include the estimated net

income, limited however to the amount of any loss otherwise recognizable for the disposal, with any remainder accounted for when realized. Any changes in the original estimate shall be accounted for in accordance with *Issue Paper No. 3—Accounting Changes*.

7. The results of a reporting entity's discontinued operations shall be reported consistently with the entity's reporting of continuing operations (i.e. no separate line item presentation in the balance sheet or statement of operations aggregating current and future losses from the measurement date).

8. Additionally, the notes to the financial statements for the period encompassing the measurement date and the year subsequent shall contain the following:

a. The identity of the segment of business that has been or will be discontinued,
b. The expected disposal date, if known (see definition in paragraph 13 below),
c. The expected manner of disposal,
d. A description of the remaining assets and liabilities of the segment at the balance sheet date and the estimated payout pattern,
e. The amounts related to the discontinued operations and the effect on the statement of operations including the balance sheet and income statement line items which have been affected.

9. If material revisions are made to the estimates of the cost to dispose of a segment in years subsequent to the disclosure required in paragraph 8 above, the nature and the effect of the revisions to the estimates shall be disclosed for the period in which the revision was made including the effect on income or loss from operations and the effect on the carrying amount of the remaining assets and liabilities of the segment at the balance sheet date.

Extraordinary Items

10. Extraordinary items, as defined in paragraph 13 below, shall be reported consistently with the reporting entity's reporting of continuing operations (i.e. no separate line item presentation in the balance sheet or statement of operations). Such items shall not be charged directly to surplus unless specifically addressed elsewhere within the codification.

11. The nature of an extraordinary event or transaction and the principle items entering into the determination of an extraordinary gain or loss shall be disclosed in the notes to the financial statements. This disclosure shall include the line items which have been affected by the estimate of the extraordinary item.

12. Material events or transactions that are either unusual or occur infrequently, but not both, are not considered extraordinary items. However, such material events or transactions shall be disclosed in the notes to the financial statements.

Definitions

13. For purposes of statutory accounting, the following definitions shall apply:

"Discontinued operations" shall be defined as the operations of a segment of a business that has been sold, abandoned, spun off, or otherwise disposed of or, although still operating, is the subject of a formal plan for disposal.

A "segment" of a business shall be defined as a component of an entity, likely in the form of a subsidiary, whose activities represent a separate major type of business or class of customer. The assets, results of operations, and activities of a segment must be clearly distinguished, physically and operationally and for financial reporting purposes, from the other assets, results of operations, and activities of the entity. The fact that the results of operations of the segment being sold or abandoned cannot be separately identified strongly suggests that the transaction should not be classified as the disposal of a segment of the business. The disposal of a segment of a business should be distinguished from other disposals of assets incident to the evolution of the entity's business, such as the disposal of a line of business or the shifting of marketing activities from one location to another.

"Measurement date" shall be defined as the date on which management having authority to approve the action commits itself to a formal plan to dispose of a segment of the business, whether by sale or abandonment. The plan, at a minimum, should include identification of the major assets to be disposed of, the expected method of disposal, the period expected to be required for completion of the disposal, an active program to find a buyer if disposal is to be by sale, the estimated results of operations of the segment from the measurement date to the disposal date (defined below), and the estimated proceeds or salvage to be realized by disposal.

"Disposal date" shall be defined as the date of closing the sale if the disposal is by sale or the date that operations cease if the disposal is by abandonment.

"Extraordinary items" shall be defined as those events or transactions which meet both of the following criteria:

(a) Unusual nature - the underlying event or transaction possesses a high degree of abnormality and is clearly unrelated to, or only incidentally related to, the ordinary and typical activities of the reporting entity, taking into account the environment in which the reporting entity operates.

(b) Infrequency of occurrence - the underlying event or transaction would not reasonably be expected to recur in the foreseeable future, taking into account the environment in which the reporting entity operates.

DISCUSSION

14. The conclusion above adopts the accounting principles relating to the accounting for the disposal of a segment of a business included in APB No. 30, paragraphs 13 through 18. These paragraphs define certain terminology relevant to the disposal of a segment and set forth criteria for recording a related loss. The conclusion above also adopts the definition of an extraordinary item included in paragraph 20 of APB 30. It rejects all other paragraphs relating to the accounting and reporting of discontinued operations, extraordinary items and unusual or infrequently occurring events and transactions. The conclusion above adopts the interpretations of APB 30 included in Accounting Interpretation of Accounting Principles Board Opinion 30, Reporting the Results of Operations (AIN-APB 30), relating to the definition of extraordinary items and terminology relevant to the disposal of a segment and the criteria for recording a related loss. It rejects all other interpretations of APB 30 relating to the accounting and reporting of discontinued operations, extraordinary items and unusual or infrequently occurring events and transactions. This statement also adopts *FASB Emerging Issues Task Force No. 85-36, Discontinued Operations with Expected Gain and Interim Operating Losses.*

15. This issue paper rejects *FASB Emerging Issues Task Force No. 94-3*, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*, and *FASB Emerging Issues Task Force No. 95-18, Accounting and Reporting for a Discontinued Business Segment When the Measurement Date Occurs after the Balance Sheet Date but before the Issuance of Financial Statements*.

16. As stated above, statutory accounting guidance does not address the accounting and reporting for discontinued operations and extraordinary items and industry practice is varied. Predominant practice has been to accrue losses resulting from discontinued operations, however, practice varies as to the

presentation of the loss. Some entities record extraordinary items as a charge directly to surplus; other entities do not separate extraordinary items from the results of continuing operations.

17. The conclusion above requires a loss associated with discontinued operations to be recorded at the measurement date. This is consistent with the conservatism concept in the Statement of Concepts. *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets* requires an estimated loss from a loss contingency to be recorded when (a) it is probable that a loss will be incurred and (b) the amount of the loss can be reasonably estimated.

Drafting Notes/Comments

None

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

18. Statutory guidance does not address the accounting treatment for the disposal of a segment or extraordinary items.

Generally Accepted Accounting Principles

19. *Accounting Principles Board Opinion No. 30, Reporting the Results of Operations - Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions* (APB 30), discusses discontinued operations and extraordinary items in the following excerpts:

> Income Statement Presentation and Disclosure
>
> 8. Discontinued Operations of a Segment of a Business. For purposes of this Opinion, the term discontinued operations refers to the operations of a segment of a business as defined in paragraph 13 that has been sold, abandoned, spun off, or otherwise disposed of or, although still operating, is the subject of a formal plan for disposal (see paragraph 14). The Board concludes that the results of continuing operations should be reported separately from discontinued operations and that any gain or loss from disposal of a segment of a business (determined in accordance with paragraphs 15 and 16) should be reported in conjunction with the related results of discontinued operations and not as an extraordinary item. Accordingly, operations of a segment that has been or will be discontinued should be reported separately as a component of income before extraordinary items and the cumulative effect of accounting changes (if applicable) in the following manner:

Income from continuing operations before income taxes[2]	$XXXX
Provision for income taxes	XXX
Income from continuing operations[2]	$XXXX
Discontinued operations(Note_____):	
Income (loss) from operations of discontinued Division X (less applicable income taxes of $_____)	$XXXX
Loss on disposal of Division X, including provision of $_____ for operating losses during phase-out period (less applicable income taxes of $_____)	XXXX
Net Income	$XXXX ====

Amounts of income taxes applicable to the results of discontinued operations and the gain or loss from disposal of the segment should be disclosed on the face of the income statement or in related notes. Revenues applicable to the discontinued operations should be separately disclosed in the related notes.

11. In the absence of discontinued operations and changes in accounting principles, the following main captions should appear in an income statement if extraordinary items are reported (paragraphs 17-19 of APB Opinion No. 9):

Income before extraordinary items[4]	$XXXX
Extraordinary items of less applicable income taxes of $_____) (Note_____)	XXX
Net income	$XXXX
	====

The caption extraordinary items should be used to identify separately the effects of events and transactions, other than the disposal of a segment of a business, that meet the criteria for classification as extraordinary as discussed in paragraphs 19-24. Descriptive captions and the amounts for individual extraordinary events or transactions should be presented, preferably on the face of the income statement, if practicable; otherwise disclosure in related notes is acceptable. The nature of an extraordinary event or transaction and the principal items entering into the determination of an extraordinary gain or loss should be described. The income taxes applicable to extraordinary items should be disclosed on the face of the income statement; alternatively disclosure in the related notes is acceptable. The caption net income should replace the three captions shown above if the income statement includes no extraordinary items.

Accounting for the Disposal of a Segment of a Business

13. For purposes of this Opinion, the term *segment of a business* refers to a component of an entity whose activities represent a separate major line of business or class of customer. A segment may be in the form of a subsidiary, a division, or a department, and in some cases a joint venture or other nonsubsidiary investee, provided that its assets, results of operations, and activities can be clearly distinguished, physically and operationally and for financial reporting purposes, from the other assets, results of operations, and activities of the entity. Financial statements of current and prior periods that include results of operations prior to the measurement date (as defined in paragraph 14) should disclose the results of operations of the disposed segment, less applicable income taxes, as a separate component of income before extraordinary items (see paragraph 8). The fact that the results of operations of the segment being sold or abandoned cannot be separately identified strongly suggests that the transaction should not be classified as the disposal of a segment of the business. The disposal of a segment of a business should be distinguished from other disposals of assets incident to the evolution of the entity's business, such as the disposal of part of a line of business, the shifting of production or marketing activities for a particular line of business from one location to another, the phasing out of a product line or class of service, and other changes occasioned by technological

[2] These captions should be modified appropriately when an entity reports an extraordinary item and/or the cumulative effect of a change in accounting principle in accordance with APB Opinion No. 20, *Accounting Changes*. The presentation of per share data will need similar modification.

[4] This caption should be modified appropriately when an entity reports the cumulative effect of an accounting change.

improvements. The disposal of two or more unrelated assets that individually do not constitute a segment of a business should not be combined and accounted for as a disposal of a segment of business.

14. **Definition of Measurement and Disposal Dates**. For purposes of applying the provisions of this Opinion, the measurement date of a disposal is the date on which the management having authority to approve the action commits itself to a formal plan to dispose of a segment of the business, whether by sale or abandonment. The plan of disposal should include, as a minimum, identification of the major assets to be disposed of, the expected method of disposal, the period expected to be required for completion of the disposal, an active program to find a buyer if disposal is to be by sale, the estimated results of operations of the segment from the measurement date to the disposal date, and the estimated proceeds or salvage to be realized by disposal. For purposes of applying this Opinion, the disposal date is the date of closing the sale if the disposal is by sale or the date that operations cease if the disposal is by abandonment.

15. **Determination of Gain or Loss on Disposal of a Segment of a Business.** If a loss is expected from the proposed sale or abandonment of a segment, the estimated loss should be provided for at the measurement date.[5] If a gain is expected, it should be recognized when realized, which ordinarily is the disposal date. The determination of whether a gain or a loss results from the disposal of a segment of a business should be made at the measurement date based on estimates at that date of the net realizable value of the segment after giving consideration to any estimated costs and expenses directly associated with the disposal and, if a plan of disposal is to be carried out over a period of time and contemplates continuing operations during that period, to any estimated income or losses from operations. If it is expected that net losses from operations will be incurred between the measurement date and the expected disposal date, the computation of the gain or loss on disposal should also include an estimate of such amounts. If it is expected that income will be generated from operations during that period the computation of the gain or loss should include the estimated income, limited however to the amount of any loss otherwise recognizable from the disposal; any remainder should be accounted for as income when realized. The Board believes that the estimated amounts of income or loss from operations of a segment between measurement date and disposal date included in the determination of loss on disposal should be limited to those amounts that can be projected with reasonable accuracy. In the usual circumstance, it would be expected that the plan of disposal would be carried out within a period of one year from the measurement date and that such projections of operating income or loss would not cover a period exceeding approximately one year.[6]

[5] If financial statements for a date prior to the measurement date have not been issued, and the expected loss provides evidence of conditions that existed at the date of such statements and affects estimates inherent in the process of preparing them, the financial statements should be adjusted for any change in estimates resulting from the use of such evidence. (See Statement on Auditing Standards No. 1, Codification of Auditing Standards and Procedures, paragraph 560.03.)

[6] When disposal is estimated to be completed within one year and subsequently is revised to a longer period of time, any revision of the net realizable value of the segment should be treated as a change in estimate (see paragraph 25).

16. Gain or loss from the disposal of a segment of a business should not include adjustments, costs, and expenses associated with normal business activities that should have been recognized on a going-concern basis up to the measurement date, such as adjustments of accruals on long-term contracts or write-down or write-off of receivables, inventories, property, plant, and equipment used in the business, equipment leased to others, deferred research and development costs, or other intangible assets. However, such adjustments, costs, and expenses which (a) are clearly a direct result of the decision to dispose of the segment and (b) are clearly not the adjustments of carrying amounts or costs, or expenses that should have been recognized on a going-concern basis prior to the measurement date should be included in determining the

gain or loss on disposal. Results of operations before the measurement date should not be included in the gain or loss on disposal.

17. Costs and expenses directly associated with the decision to dispose include items such as severance pay, additional pension costs, employee relocation expenses, and future rentals on long-term leases to the extent they are not offset by sub-lease rentals.

18. Disclosure. In addition to the amounts that should be disclosed in the financial statements (paragraph 8), the notes to financial statements for the period encompassing the measurement date should disclose:

a. the identity of the segment of business that has been or will be discontinued,
b. the expected disposal date, if known (see paragraph 14),
c. the expected manner of disposal,
d. a description of the remaining assets and liabilities of the segment at the balance sheet date,[7] and
e. the income or loss from operations and any proceeds from disposal of the segment during the period from the measurement date to the date of the balance sheet.

For periods subsequent to the measurement date and including the period of disposal, notes to the financial statements should disclose the information listed in (a), (b), (c), and (d) above and also the information listed in (e) above compared with the prior estimates.

[7] Consideration should be given to disclosing this information by segregation in the balance sheet of the net assets and liabilities (current and noncurrent) of the discontinued segment. Only liabilities which will be assumed by others should be designated as liabilities of the discontinued segment. If the loss on disposal cannot be estimated within reasonable limits, this fact should be disclosed.

20. Extraordinary items are events and transactions that are distinguished by their unusual nature and by the infrequency of their occurrence. Thus, both of the following criteria should be met to classify an event or transaction as an extraordinary item:

a. Unusual nature-the underlying event or transaction should possess a high degree of abnormality and be of a type clearly unrelated to, or only incidentally related to, the ordinary and typical activities of the entity, taking into account the environment in which the entity operates. (See discussion in paragraph 21.)

b. Infrequency of occurrence-the underlying event or transaction should be of a type that would not reasonably be expected to recur in the foreseeable future, taking into account the environment in which the entity operates. (See discussion in paragraph 22.)

21. Unusual Nature. The specific characteristics of the entity, such as type and scope of operations, lines of business, and operating policies should be considered in determining ordinary and typical activities of an entity. The environment in which an entity operates is a primary consideration in determining whether an underlying event or transaction is abnormal and significantly different from the ordinary and typical activities of the entity. The environment of an entity includes such factors as the characteristics of the industry or industries in which it operates, the geographical location of its operations, and the nature and extent of governmental regulation. Thus, an event or transaction may be unusual in nature for one entity but not for another because of differences in their respective environments. Unusual nature is not established by the fact that an event or transaction is beyond the control of management.

22. Infrequency of Occurrence. For purposes of this Opinion, an event or transaction of a type not reasonably expected to recur in the foreseeable future is considered to occur

infrequently. Determining the probability of recurrence of a particular event or transaction in the foreseeable future should take into account the environment in which an entity operates. Accordingly, a specific transaction of one entity might meet that criterion and a similar transaction of another entity might not because of different probabilities of recurrence. The past occurrence of an event or transaction for a particular entity provides evidence to assess the probability of recurrence of that type of event or transaction in the foreseeable future. By definition, extraordinary items occur infrequently. However, mere infrequency of occurrence of a particular event or transaction does not alone imply that its effects should be classified as extraordinary. An event or transaction of a type that occurs frequently in the environment in which the entity operates cannot, by definition, be considered as extraordinary, regardless of its financial effect.

23. Certain gains and losses should not be reported as extraordinary items because they are usual in nature or may be expected to recur as a consequence of customary and continuing business activities. Examples include:

a. Write down or write-off of receivables, inventories, equipment leased to others, deferred research and development costs, or other intangible assets.
b. Gains or losses from exchange or translation of foreign currencies, including those relating to major devaluations and revaluations.
c. Gains or losses on disposal of a segment of a business.
d. Other gains or losses from sale or abandonment of property, plant, or equipment used in the business.
e. Effects of a strike, including those against competitors and major suppliers.
f. Adjustment of accruals on long-term contracts.

In rare situations, an event or transaction may occur that clearly meets both criteria specified in paragraph 20 of this Opinion and thus gives rise to an extraordinary gain or loss that includes one or more of the gains or losses enumerated above. In these circumstances, gains or losses such as (a) and (d) above should be included in the extraordinary item if they are a direct result of a major casualty (such as an earthquake), an expropriation, or a prohibition under a newly enacted law or regulation that clearly meets both criteria specified in paragraph 20. However, any portion of such losses which would have resulted from a valuation of assets on a going concern basis should not be included in the extraordinary items. Disposals of a segment of a business should be accounted for pursuant to paragraph 13 and presented in the income statement pursuant to paragraph 8 even though the circumstances of the disposal meet the criteria specified in paragraph 20.

Adjustment of Amounts Reported in Prior Periods

25. Circumstances attendant to disposals of a segment of a business and extraordinary items frequently require estimates, for example, of associated costs and occasionally of associated revenue, based on judgment and evaluation of the facts known at the time of first accounting for the event. Each adjustment in the current period of a loss on disposal of a business segment or of an element of an extraordinary item that was reported in a prior period [should not be reported as a prior period adjustment unless it meets the criteria for a prior period adjustment as defined in paragraph 23 of APB Opinion No. 9. An adjustment that does not meet such criteria] should be separately disclosed as to year of origin, nature, and amount and classified separately in the current period in the same manner as the original item. If the adjustment is the correction of an error, the provisions of *APB Opinion No. 20, Accounting Changes*, paragraphs 36 and 37 should be applied.

Disclosure of Unusual or Infrequently Occurring Items

26. A material event or transaction that is unusual in nature or occurs infrequently but not both, and therefore does not meet both criteria for classification as an extraordinary item, should be reported as a separate component of income from continuing operations. The nature and financial effects of each event or transaction should be disclosed on the face of the income statement or, alternatively, in notes to the financial statements. Gains or losses of a similar nature

that are not individually material should be aggregated. Such items should not be reported on the face of the income statement net of income taxes or in any manner inconsistent with the provisions of paragraphs 8 and 11 of this Opinion or in any other manner that may imply that they are extraordinary items. Similarly, the earnings per share effects of those items should not be disclosed on the face of the income statement.[8]

[8] Exceptions to the final two sentences of this paragraph are specified in the following AICPA industry audit guides: Audits of Banks, p. 36; Audits of Fire and Casualty Insurance Company, p. 66; and Audits of Stock Life Insurance Companies, p. 89.

20. Note that the bracketed section of APB 30, paragraph 25 was amended by *FASB Statement No. 16, Prior Period Adjustments.*

OTHER SOURCES OF INFORMATION

21. The NAIC Technical Resource Group proposed draft life codification, Chapter 28, *Unassigned Surplus*, includes the following:

Extraordinary Items

Extraordinary items are events and transactions that are distinguished by their unusual nature and by the infrequency of their occurrence. Both of the following criteria should be met to classify an event or transaction as an extraordinary item:

a. Unusual nature - the underlying event or transaction should possess a high degree of abnormality and be of a type clearly unrelated to, or only incidentally related to, the ordinary and typical activities of the entity, taking into consideration the environment in which the entity operates.

b. Infrequency of occurrence - the underlying event or transaction should be of a type that would not reasonably be expected to recur in the foreseeable future, taking into account the environment in which the entity operates.

Unusual Nature. The specific characteristics of the entity, such as type and scope of operations, lines of business, and operating policies should be considered in determining ordinary and typical activities of an entity. The environment in which an entity operates is a primary consideration in determining whether an underlying event or transaction is abnormal and significantly different from the ordinary and typical activities of the entity. The environment of an entity includes such factors as the characteristics of its products and the geographic location of its operations. Thus, an event or transaction may be unusual in nature for one entity but not for another because of differences in their respective environments. Unusual nature is not established by the fact that an event or transaction is beyond the control of management.

Infrequency of Occurrence. An event or transaction of a type not reasonably expected to recur in the foreseeable future is considered to occur infrequently. Determining the probability of recurrence of a particular event or transaction in the foreseeable future should take into account the environment in which the entity operates. Accordingly, a specific transaction of one entity might meet that criterion and a similar transaction of another entity might not because of different probabilities of recurrence. The past occurrence of an event or transaction for a particular entity provides evidence to assess the probability of recurrence of that type of event or transaction in the foreseeable future. By definition, extraordinary items occur infrequently. However, mere infrequency of occurrence of a particular event or transaction does not alone imply that its effects should be classified as extraordinary. An event or transaction of a type that occurs frequently in the environment in which the entity operates cannot, by definition, be considered as extraordinary, regardless of the financial effect.

Materiality. An extraordinary event or transaction, if material, shall be classified separately in the Summary of Operations. Items shall be evaluated individually and not in the aggregate in determining whether an event or transaction is material.

Even though they do not meet the criteria for an extraordinary item, if material, gains and losses from extinguishment of debt, significant asset disposition after a pooling, discontinuation of accounting for the effects of certain types of regulation, shall be classified as an extraordinary item.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *Issue Paper No. 3—Accounting Changes*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 20—Gain Contingencies*

Generally Accepted Accounting Principles

- *Accounting Principles Board Opinion No. 30, Reporting the Results of Operations - Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*
- *Accounting Interpretation of Accounting Principles Board Opinion 30, Reporting the Results of Operations*
- *FASB Emerging Issues Task Force No. 85-36, Discontinued Operations with Expected Gain and Interim Operating Losses*
- *FASB Emerging Issues Task Force No. 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*
- *FASB Emerging Issues Task Force No. 95-18, Accounting and Reporting for a Discontinued Business Segment When the Measurement Date Occurs after the Balance Sheet Date but before the Issuance of Financial Statements*

State Regulations

- No additional guidance obtained from state statutes or regulations.

Other Sources of Information

- NAIC Technical Resource Group proposed draft life codification, Chapter 28, *Unassigned Surplus*

Statutory Issue Paper No. 25

Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties

STATUS
Finalized June 23, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 25

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Transactions with affiliates and other related parties are entered into in the ordinary course of business by reporting entities. Transactions may involve an exchange of assets and liabilities between the related parties or the performance of services. Such transactions may not necessarily be on an arm's length basis. Current statutory literature provides guidance on accounting for certain transactions between affiliates, which is based on whether the transactions are considered economic or non-economic transactions. It also requires reporting entities to disclose transactions with affiliates in the notes to the financial statements.

2. GAAP provides limited guidance on accounting for related party transactions, and there is no discussion regarding accounting for economic versus non-economic transactions with related parties. Rather, existing GAAP guidance focuses on disclosure of related party transactions with specific GAAP literature dealing with related party issues where there is a perceived potential for abusive accounting practices (e.g. sale lease-back transactions, equity accounting, nonmonetary transactions, etc.).

3. The purpose of this issue paper is to establish statutory accounting principles and disclosure requirements for related party transactions that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. Related parties are defined as entities that have common interests as a result of ownership, control, or affiliation or by contract. Related parties shall include but are not limited to the following:

a. Affiliates of the reporting entity, as defined in paragraph 5;

b. Trusts for the benefit of employees, such as pension and profit-sharing trusts and Employee Stock Ownership Plans that are managed by or under the trusteeship of management of the reporting entity, its parent or affiliates;

c. The principal owners of the reporting entity;

d. The management of the reporting entity, its parent or affiliates (including directors);

e. Members of the immediate families of principal owners and management of the reporting entity**,** its parent or affiliates and their management;

f. Parties with which the reporting entity may deal if either party directly or indirectly controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interest;

g. A party which can directly or indirectly significantly influence the management or operating policies of the reporting entity, which may include a provider who is contracting with the reporting entity. This is not intended to suggest that all provider contracts create related party relationships;

h. A party which has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests;

i. Attorney-in-fact of a reciprocal reporting entity or any affiliate of the attorney-in-fact; and

j. A U.S. manager of a U.S. Branch or any affiliate of the U.S. manager of a U.S. Branch.

5. An affiliate is defined as an entity that is within the holding company system or a party that, directly or indirectly, through one or more intermediaries, controls, is controlled by, or is under common control with the reporting entity. An affiliate includes a parent or subsidiary and partnerships, joint ventures and limited liability companies. An affiliate is any person that is directly or indirectly, owned or controlled by the same person or by the same group of persons, that, directly or indirectly, own or control the reporting entity.

6. Control is defined as the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a person or entity, whether through the (a) ownership of voting securities, (b) by contract other than a commercial contract for goods or nonmanagement services, (c) by contract for goods or nonmanagement services where the volume of activity results in a reliance relationship, (d) by common management, or (e) otherwise. Control shall be presumed to exist if a reporting entity and its affiliates directly or indirectly, own, control, hold with the power to vote, or hold proxies representing 10% or more of the voting interests of the entity.

7. The 10% ownership threshold shall be measured at the holding company level. For example, if one member of an affiliated group has a 5% interest in a company and a second member of the group has an 8% interest in the same company the total interest is 13%, and therefore, each member of the affiliated group shall be presumed to have control. These presumptions can be overcome by predominant evidence to the contrary, however, they shall stand until overcome by such predominant contradictory evidence. A reporting entity with 10% or more of the voting interest shall evaluate all facts and circumstances relating to the investment and reach a judgment about whether the presumption of control is overcome. The corollary is required to demonstrate control when a reporting entity owns less than 10% of the voting interest of an investee.

8. Related party transactions are subject to abuses because reporting entities may be induced to enter transactions that may not reflect economic realities or may not be fair and reasonable to the reporting entity or its policyholders. As such, related party transactions require specialized accounting rules and increased regulatory scrutiny.

Related Party Loans

9. Loans or advances (including debt, public or private) made by a reporting entity to its parent or principal owner shall be admitted if approval for the transaction has been obtained from the domiciliary commissioner and the loan or advance is determined to be collectible based on the parent or principal owner's independent payment ability. An affiliate's ability to pay shall be determined after consideration of the liquid assets or revenues available from external sources (i.e. determination shall not include dividend paying ability of the subsidiary making the loan or advance) which are available to repay the

balance and/or maintain its account on a current basis. Evaluation of the collectibility of loans or advances shall be made periodically. If, in accordance with *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets* (Issue Paper No. 5), it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made.

10. Loans or advances by a reporting entity to all other related parties shall be evaluated by management and nonadmitted if they do not constitute arm's-length transactions as defined in paragraph 13. Loans or advances made by a reporting entity to related parties (other than its parent or principal owner) that are economic transactions as defined in paragraph 13 shall be admitted. This includes financing arrangements with providers of health care services with whom the reporting entity contracts with from time to time. Such arrangements can include both loans and advances to these providers. Evaluation of the collectibility of loans or advances shall be made periodically. If, in accordance with Issue Paper No. 5 it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made.

11. Any advances under capitation arrangements made directly to providers, or to intermediaries that represent providers, that exceed one month's payment shall be nonadmitted assets.

12. Indirect loans are loans or extensions of credit to any person who is not an affiliate, where the reporting entity makes loans or extensions of credit with the agreement or understanding that the proceeds of the transactions, in whole or in substantial part, are to be used to make loans or extensions of credit to, to purchase assets of, or to make investments in, any affiliate of the reporting entity making the loans or extensions of credit. The admissibility of indirect loans made by a reporting entity for the benefit of its parent or principal owner shall be determined in accordance with the guidelines in paragraph 9. Indirect loans made for the benefit of all other related parties shall be evaluated and accounted for consistent with loans and advances to related parties as described in paragraphs 10 and 11.

Transactions Involving the Exchange of Assets or Liabilities

13. An arm's length transaction is defined as a transaction in which willing parties, each being reasonably aware of all relevant facts and neither under compulsion to buy, sell or loan, would be willing to participate. A transaction between related parties involving the exchange of assets or liabilities shall be designated as either an economic transaction or non-economic transaction. An economic transaction shall be defined as an arm's length transaction which results in the transfer of risks and rewards of ownership and represents a consummated act thereof, i.e. "permanence." The appearance of permanence is also an important criterion in assessing the economic substance of a transaction. In order for a transaction to have economic substance and thus warrant revenue (loss) recognition, it must appear unlikely to be reversed. If subsequent events or transactions reverse the effect of an earlier transaction prior to the issuance of the financial statements, the reversal shall be considered in determining whether economic substance existed in the case of the original transaction. Subsequent events are addressed in *Issue Paper No. 9—Subsequent Events*. An economic transaction must represent a bonafide business purpose demonstrable in measurable terms. A transaction which results in the mere inflation of surplus without any other demonstrable and measurable betterment is not an economic transaction. The statutory accounting shall follow the substance of the transaction and not the form of the transaction.

14. In determining whether there has been a transfer of the risks and rewards of ownership in the transfer of assets or liabilities between related parties, the following—and any other relevant facts and circumstances related to the transaction—shall be considered:

a. Whether the seller has a continuing involvement in the transaction or in the financial interest transferred, such as through the exercise of managerial authority to a degree usually associated with ownership;

b. Whether there is an absence of significant financial investment by the buyer in the financial interest transferred, as evidenced, for example, by a token down payment or by a concurrent loan to the buyer;

c. Whether repayment of debt that constitutes the principal consideration in the transaction is dependent on the generation of sufficient funds from the asset transferred;

d. Whether limitations or restrictions exist on the buyer's use of the financial interest transferred or on the profits arising from it;

e. Whether there is retention of effective control of the financial interest by the seller.

15. A transaction between related parties may meet the criteria for treatment as an economic transaction at one level of financial reporting but may not meet such criteria at another level of financial reporting. An example of such a transaction is a reporting entity purchasing securities at market value from an affiliated reporting entity that carried the securities at amortized cost. This transaction meets the criteria of an economic transaction at this level of financial reporting and therefore the selling reporting entity would record a gain and the acquiring reporting entity would record the securities at their cost (market value on the transaction date). At the common parent level of reporting, this transaction has resulted in the mere inflation of surplus, and therefore, is a non-economic transaction. The parent reporting entity shall defer the net effects of any gain or increase in surplus resulting from such transactions by recording a deferred gain and an unrealized loss. The deferred gain shall not be recognized by the parent reporting entity unless and until arms-length transaction(s) with independent third parties give rise to appropriate recognition of the gain.

16. A non-economic transaction shall be defined as any transaction that does not meet the criteria of an economic transaction. Similar to the situation described in paragraph 15, transfers of assets from a parent reporting entity to a subsidiary, controlled or affiliated entity shall be treated as non-economic transactions at the parent reporting level because the parent has continuing indirect involvement in the assets.

17. When accounting for a specific transaction reporting entities shall use the following valuation methods:

a. Economic transactions between related parties shall be recorded at fair value at the date of the transaction. To the extent that the related parties are affiliates under common control, the controlling reporting entity shall defer the effects of such transactions that result in gains or increases in surplus (see paragraph 15);

b. Non-economic transactions between reporting entities, which meet the definition of related parties above, shall be recorded at the lower of existing book values or fair values at the date of the transaction;

c. Non-economic transactions between a reporting entity and an entity that has no significant ongoing operations other than to hold assets that are primarily for the direct or indirect benefit or use of the reporting entity or its affiliates, shall be recorded at the fair value at the date of the transaction; however, to the extent that the transaction results in a gain, that gain shall be deferred until such time as permanence can be verified;

d. Transactions which are designed to avoid statutory accounting practices shall be included as if the reporting entity continued to own the assets or be obligated for a liability directly instead of through a subsidiary.

Examples of transactions that would be deemed to be non-economic include, security swaps of similar issues between or among affiliated companies, and swaps of dissimilar issues accompanied by exchanges of liabilities between or among affiliates.

Transactions Involving Services

18. Transactions involving services being provided by a related party may not be arm's-length. Amounts charged for services provided may not be at current market rates for such services or may be based on allocations of costs. Determining market rates for services is difficult because the circumstances surrounding each transaction are unique. Unlike transactions involving the exchange of assets and liabilities between related parties, transactions for services create income on one party's books and expense on the second party's books and therefore do not lend themselves to the mere inflation of surplus. These arrangements may be subject to regulatory approval.

19. Transactions involving services provided between related parties shall be recorded at the amount charged. Regulatory scrutiny of related party transactions where amounts charged for services do not meet the fair and reasonable standard established by Appendix A-440, may result in (a) amounts charged being recharacterized as dividends or capital contributions, (b) transactions being reversed, (c) receivable balances being nonadmitted, (d) or other regulatory action. Expenses that result from cost allocations shall be allocated subject to the same fair and reasonable standards, and the books and records of each party shall disclose clearly and accurately the precise nature and details of the transaction. See *Issue Paper No. 94—Allocation of Expenses* for additional discussion regarding the allocation of expenses.

Disclosure

20. The financial statements shall include disclosures of all material related party transactions. In some cases, aggregation of similar transactions by type of related party may be appropriate. Sometimes, the effect of the relationship between the parties may be so pervasive that disclosure of the relationship alone will be sufficient. If necessary to the understanding of the relationship, the name of the related party should be disclosed. Transactions shall not be purported to be arm's length transactions unless there is demonstrable evidence to support such statement. The disclosures shall include:

a. The nature of the relationships involved;

b. A description of the transactions for each of the periods for which financial statements are presented, and such other information considered necessary to obtain an understanding of the effects of the transactions on the financial statements. Exclude reinsurance transactions, and any non-insurance transactions which involve less than ½ of 1% of the total admitted assets of the reporting entity, and cost allocation transactions. The following information shall be provided if applicable:

1. Date of transaction,
2. Explanation of transaction,
3. Name of reporting entity,
4. Name of affiliate,
5. Description of assets received by reporting entity,
6. Statement value of assets received by reporting entity,
7. Description of assets transferred by reporting entity, and
8. Statement value of assets transferred by reporting entity.

c. The dollar amounts of transactions for each of the periods for which financial statements are presented and the effects of any change in the method of establishing the terms from that used in the preceding period;

d. Amounts due from or to related parties as of the date of each balance sheet presented and, if not otherwise apparent, the terms and manner of settlement;

e. Any guarantees or undertakings, written or otherwise, for the benefit of an affiliate or related party which result in a material contingent exposure of the reporting entity's or any related party's assets or liabilities;

f. A description of material management or service contracts and cost-sharing arrangements involving the reporting entity and any related party. This shall include, but is not limited to, sale lease-back arrangements, computer or fixed asset leasing arrangements and agency contracts, which remove assets otherwise recordable (and potentially nonadmitted) on the reporting entity's financial statements;

g. The nature of the control relationship whereby the reporting entity and one or more other enterprises are under common ownership or control and the existence of that control could result in operating results or financial position of the reporting entity significantly different from those that would have been obtained if the enterprises were autonomous. The relationship shall be disclosed even though there are no transactions between the enterprises.

h. The amount deducted from the value of an upstream intermediate company or ultimate parent owned, either directly or indirectly, via a downstream subsidiary, controlled, or affiliated company, in accordance with the *Purposes and Procedures Manual of the NAIC Securities Valuation Office*, "Procedures for Valuing Common Stocks and Stock Warrants."

DISCUSSION

21. This issue paper adopts *FASB Statement No. 57*, *Related Party Disclosures* (FAS 57) with a modification to paragraph 2, to require disclosure of compensation arrangements, expense allowances, and other similar items in the ordinary course of business. It expands the current statutory guidance on accounting and disclosure of transactions with affiliates to include all material related party transactions whereas current statutory guidance requires disclosures for transactions with affiliates, a more narrowly defined group. This modification was made because the nature of dealings with any related party can not be assumed to be at arm's length. The current statutory guidance with respect to accounting for transfers of assets between affiliates that are considered to be non-economic transactions (generally at lower of cost or market) differs from the GAAP guidance for accounting for transfers and exchanges between companies under common control. Current statutory guidance is considered appropriate because of the need to focus on individual reporting entities and the needs of individual states to monitor the obligations of individual reporting entities. GAAP guidance is established in Accounting Interpretations of *APB Opinion No. 16, #39*, *Transfers and Exchanges Between Companies Under Common Control* (AIN-APB 16, #39), which requires transfers and exchanges to be at historical cost similar to that in pooling of interests accounting. As a result, this issue paper rejects AIN-APB 16, #39. The complete requirements under current statutory guidance and FAS 57 are included in the Relevant Statutory Accounting and GAAP Guidance section below.

22. This issue paper adopts the current statutory guidance with respect to accounting for transfers of assets between affiliates and further expands that guidance to include all transactions (including transactions which relate to the transfer of liabilities) with related parties. It also replaces the 30 day rule by requiring the reversal of any gain or loss recognized on a transaction that subsequently does not meet the appearance of permanence. This issue paper also requires any net increase in the surplus of a parent reporting entity that results from transactions between affiliates where there is no demonstrable and measurable betterment to the parent company reporting entity other than the mere inflation of surplus to be reported as a deferred gain and shall not be recognized by the parent reporting entity until an arms length transaction with a third party gives rise to the recognition.

23. This issue paper adopts current statutory guidance with modification to recognize loans made to a reporting entity's parent or principal owner as an admitted asset if regulatory approval for the transaction has been obtained and the loan appears to be collectible based on the parent's independent ability to pay. Commissioner approval is considered necessary as an additional independent evaluation of such loans or advances due to the highly sensitive nature of such transactions and the significant potential for abuse. This independent evaluation is considered necessary to determine the admissibility of such loans or advances because a reporting entity could be induced by its parent or principal owner to enter into a loan or advance that it would not otherwise consider. Additionally, advances to providers under capitation arrangements that exceed one month's payment shall be nonadmitted. Loans to all other related parties shall be nonadmitted if they do not meet the criteria of an arm's length transaction. Current statutory accounting requires disclosures to include a description of related party transactions as well as other information necessary to obtain an understanding of the transaction. Subparagraph 20 b amends the exclusion to this requirement from non-insurance transactions which involve less than 1/2% of 1% of the total assets of the largest affiliated reporting entity to non-insurance transactions which involve less than 1/2% of 1% of the total admitted assets of the reporting entity.

24. The accounting and disclosure requirements adopted by the conclusion above are consistent with the Statement of Concepts which states:

> Conservative valuation procedures provide protection to policyholders against adverse fluctuations in financial condition or operating results. Statutory accounting should be reasonably conservative over the span of economic cycles and in recognition of the primary responsibility to regulate for financial solvency. Valuation procedures should, to the extent possible, prevent sharp fluctuations in surplus.
>
> Because these basic financial statements cannot be expected to provide all of the information necessary to evaluate an entity's short-term and long-term stability, management must supplement the financial statements with sufficient disclosures (e.g. notes to financial statements, management's discussion and analysis, and supplementary schedules and exhibits) to assist financial statement users in evaluating the information provided.

25. Additionally, such disclosures provide the statutory financial statement user information necessary in evaluating a reporting entity's statutory financial position and results of operations and in assessing the reporting entity's dependence on such relationships to continue operations.

Drafting Notes/Comments

- Accounting for investments in subsidiaries is addressed in *Issue Paper No. 46—Accounting for Investments in Subsidiary, Controlled and Affiliated Entities*.
- Accounting for business combinations is addressed in *Issue Paper No. 68—Business Combinations and Goodwill*.
- Accounting for holding company obligations are addressed in *Issue Paper No. 95—Holding Company Obligations*.
- Accounting and disclosures for related party reinsurance transactions are addressed in *Issue Paper No. 74—Life, Deposit-Type and Accident and Health Reinsurance* and *Issue Paper No. 75—Property and Casualty Reinsurance*.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

26. The NAIC Annual Statement Instructions for Life and Accident and Health Insurance Companies (Annual Statement Instructions) provide the following guidance with respect to reporting information on transactions with affiliates in the notes to the financial statements:

> 5. Information Concerning Parent, Subsidiaries and Affiliates

Instruction:

a. If the company is directly or indirectly owned or controlled by any other company, corporation, group of companies, partnership or individual, give full particulars.

b. List and describe transactions by the company or any affiliated insurer with any affiliate. Exclude reinsurance transactions, any non-insurance transactions which involve less than ½ of 1% of the total assets of the largest affiliated insurer, and cost allocation transactions that are based upon generally accepted accounting principles. The following information should be provided:

1. Date of transaction
2. Explanation of transaction
3. Name of insurer
4. Name of affiliate
5. Description of assets received by insurer
6. Statement value of assets received by insurer
7. Description of assets transferred by insurer
8. Statement value of assets transferred by insurer

c. If the company holds investments in its parent, affiliates, or subsidiaries, disclose the total statement value for each such asset category not included in Schedule D, Summary By Country.

d. If the Company owns shares of an upstream intermediate or ultimate parent, either directly or indirectly via a downstream subsidiary, controlled or affiliated company, disclose the amount deducted from the value of such company or companies, in accordance with the *Purposes and Procedures Manual of the NAIC Securities Valuation Office*.

e. Describe any guarantees or undertakings for the benefit of an affiliate which result in a material contingent exposure of the company's or any affiliated insurer's assets to liability, if not disclosed in Note 15. Report the total amount of guarantees for affiliates.

f. Describe management or service contracts and all cost-sharing arrangements, other than cost allocation arrangements based upon generally accepted accounting principles, involving the company or any affiliated insurer.

27. The Annual Statement Instructions provide illustrations for the above required disclosures.

28. The Annual Statement Instructions also require the preparation of Schedule Y - Information Concerning Activities of Insurer Members of a Holding Company Group. Part 2 of this schedule—Summary of Insurer's Transactions with Any Affiliates—was designed to provide an overview of transactions among holding company system members. A common schedule is prepared for inclusion in each of the individual annual statements and the consolidated annual statement. The intent of the schedule is to demonstrate the scope and direction of major fund and/or surplus flows throughout the holding company system. The instructions to the schedule provide detailed guidance on a column by column basis. This schedule requires additional disclosures that are not required or are in more detail than the information contained in the notes to the financial statements. The instructions for the schedule include the following guidance:

> Include the aggregate transactions, for the reporting period, within each category involving the parent company (companies), all insurance companies in the Holding Company System, and all other companies in the system with which an insurance company member had a transaction. Exclude: transactions of a non-insurer with an insurance company that are of a routine nature (i.e., the purchase of insurance coverage) and cost allocation transactions that are based upon generally accepted principles of accounting.

> If the insurer is both a payor and a recipient of amounts in any category, the net of these amounts should be reported on one line. Amounts of transactions that result in an increase in surplus should be shown as positive figures and transactions that result in a decrease in surplus should be reported enclosed in parentheses.
>
> If the nature of the transactions reported in Part 2 require explanation, report such in an explanatory note immediately following Part 2.

29. The NAIC Annual Statement Instructions for Property and Casualty Insurance Companies contain guidance substantially consistent with paragraphs 26 to 28 above.

30. The NAIC Annual Statement Instructions for Health Maintenance Organizations contain guidance substantially consistent with paragraphs 26 to 28 above.

31. The Introduction to the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies provides the following definition of terms used in connection with transactions with affiliates:

> “Arm's-length” Transactions
>
> An “arm's-length” transaction can be defined as a transaction in which a willing buyer and a willing seller, each being reasonably aware of all relevant facts and neither under compulsion to buy or sell, would be willing to participate.
>
> “Affiliate”
>
> An “affiliate” of, or person “affiliated” with a specific person, is a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified.
>
> “Control”
>
> The term “control” (including the terms “controlling by” and “under common control with”) means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract other than a commercial contract for goods or non-management services, or otherwise, unless the power is the result of an official position with or corporate office held by the person. Control shall be presumed to exist if any person, directly or indirectly, owns, controls, holds with the power to vote, or holds proxies, representing 10% or more of the voting securities of any other person.

32. The Introduction to the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies provides the following guidance with respect to accounting for assets transferred between affiliates:

> Accounting for Assets Transferred Between Affiliates
>
> Economic vs. Non-economic Gains
>
> An economic transaction is an arm's-length transaction which results in the transfer of risks and rewards of ownership and represents a consummated act thereof, i.e. “permanence.” Such a transaction must represent a bona fide business purpose demonstrable in measurable terms, such as the creation of a tax benefit, a betterment in cash flow position, etc. A transaction which results in the mere inflation of surplus without any other demonstrable and measurable betterment is not an economic transaction.
>
> A bona fide business purpose would exist, for example, if an asset was transferred in order to create a specific advantage/benefit. The advantage/benefit must inure to the benefit of the insurance company. A bona fide business purpose would not exist if the transaction was initiated

for the purpose of the inflation (deflation) of a particular company's financial statements including effects on the balance sheet or income statement.

Transfer of risks and rewards of ownership - “determining that the risks and other incidents of ownership have been transferred to the buyer requires an examination of the underlying facts and circumstances. The following circumstances may raise the question about the transfer of risks:

1. A continuing involvement by the seller in the transaction or in the assets transferred, such as through the exercise of managerial authority to a degree usually associated with ownership, perhaps in the form of a remarketing agreement or a commitment to operate the property.

2. Absence of significant financial investment by the buyer in the asset transferred, as evidenced, for example, by a token down payment or by a concurrent loan to the buyer.

3. Repayment of debt that constitutes the principal consideration in the transaction dependent on the generation of sufficient funds from the asset transferred.

4. Limitations or restrictions on the purchaser's use of the asset transferred or on the profits from it.

5. Retention of effective control of the asset by the seller.

   The first three items on the list are suggested by the Securities Exchange Commission Staff Accounting Bulletin 30; the last two are found in SEC Accounting Series Release No. 95, “Accounting for Real Estate Transactions where circumstances indicate that profits were not earned at the time the transactions were recorded” .*

   *(Note: From the Accountants' Handbook, 6th edition, Vol. 1, edited by Lee J. Seidler and D. R. Carmichael)

Security swaps of similar issues between or amongst affiliated companies would be considered as a non-economic transaction. Swaps of dissimilar issues accompanied by exchanges of liabilities between or amongst affiliates are considered non-economic transactions.

The appearance of permanence is also an important criterion in establishing the economic substance of a transaction. If subsequent events or transactions reverse the effect of an earlier transaction, the question is raised as to whether economic substance existed in the case of the original transaction. Basically, in order for a transaction to have economic substance and thus warrant revenue (loss) recognition, it must appear unlikely to be reversed.

It is important to note that in today's environment, where many of the transactions are complex and involve great uncertainty, it will be necessary to exercise professional judgment in the evaluation of whether economic substance exists as it is not possible to establish detailed guidelines sufficient to cover the realm of all possible transactions.

In the case of any gain from transfer of securities or other assets to an affiliate where it appears that, within a period beginning 30 days before the date of such transfer and ending 30 days after such date, the company has acquired by transfer from an affiliate, or has entered into a contract or option to acquire, substantially identical securities or assets, then no gain on the transfer to the affiliate shall be recognized in the Annual Statement.

The following is the exception to the 30-day rule:

1. Swaps of repurchased securities. The agreements must be formalized in writing and provide adequate collateral as defined by either statute or security valuation manual.

2. Gains on transfers which involve real estate will not be recognized if transferred back or repurchased within an 18-month period.

General Accounting Guidelines

When accounting for a specific transaction, the following valuation methods should be used. If the transaction involves the transfer of assets not covered by the attached [table] then the following general guidelines should be used:

- Economic based transfers between affiliates should be recorded at prevailing fair market values at the date of the transfer.

- Non-economic based transfers between affiliated insurers should be recorded at the lower of existing book values or prevailing fair market values at the date of transfer.

- Non-economic based transfers between an insurer and a non-insurance affiliate should be recorded at the prevailing fair market value at the date of transfer; however, to the extent that the transfer results in a gain, that gain should be deferred until such time as permanence can be verified.

- Transactions which are designed to avoid statutory accounting practices shall be included as if the insurer continued to own the assets directly instead of through a subsidiary. Therefore, the assets of a subsidiary will be valued as they would constitute lawful investments for the insurer if acquired or held by the insurer. (e.g., transaction dealing with agents' balances, furniture and equipment.)

- Assets may be valued on a different basis if held by a life insurer versus a property and casualty insurer; therefore, a regulator must take this into consideration when using the general guidelines.

- In the absence of specific guidelines or where doubt exists as to the propriety of a special accounting method the Insurance Department of the state of domicile should be consulted.

		TRANSACTION	VALUATION METHOD AFFILIATE NON-ECONOMIC TRANSACTION	ECONOMIC TRANSACTION
1.	Transfer of Bonds			
	a.	Appreciated	Cost (1)/Amortized	Market
	b.	Depreciated	LCM (1)	Market
2.	Transfer of Preferred Stock			
	a.	Sinking Fund	Cost (1)	Market
	b.	Perpetual Preferred Held by Life Co.	Cost (1)	Market
	c.	All others	Market	Market
3.	Transfer of Common Stock		Market	Market
4.	Transfer of Real Estate		Cost	Market

5.	Transfer of Loans or Loan Participations		
	a. Appreciated	Cost	Market
	b. Depreciated	LCM	Market
6.	Intercompany Loans	LCM (2)	Market (2)
7.	Sale/Leaseback	Cost/LCM (3)	Market
8.	Reverse Repurchase Agreements	LCM (2)	Market (2)
9.	Transfer of nonadmitted assets from an insurer to a non-insurer subsidiary	The value of the subsidiary must be adjusted and revalued as if the insurer held the assets.	Market (2)
10.	Transfer of Schedule BA asset	LCM	Market

NOTE: Cost = Book Value

(1) Assumes securities are in good standing or eligible for amortization, otherwise at market.
(2) Based on current market interest rates.
(3) LCM (Lower of Cost or Market) would apply under scenario involving depreciated assets.

33. The Insurance Holding Company System Model Laws, Regulations and Guidelines, which has been adopted by various states, specifies that certain disclosures be made in Form B of an insurer's registration statement (insurers required to file registration statements with the NAIC do so on the format prescribed by the NAIC). Form B instructions are as follows:

> ITEM 5. TRANSACTIONS AND AGREEMENTS
>
> Briefly describe the following agreements in force, and transactions currently outstanding or which have occurred during the last calendar year between the registrant and its affiliates:
>
> a. Loans, other investments, or purchases, sales or exchanges of securities of the affiliates by the Registrant or of the Registrant by its affiliates;
> b. Purchases, sales or exchanges of assets;
> c. Transactions not in the ordinary course of business;
> d. Guarantees or undertakings for the benefit of an affiliate which result in an actual contingent exposure of the Registrant's assets to liability, other than insurance contracts entered into in the ordinary course of the registrant's business;
> e. All management agreements, service contracts and all cost-sharing arrangements;
> f. Reinsurance agreements;
> g. Dividends and other distributions to shareholders;
> h. Consolidated tax allocation agreements; and
> i. Any pledge of the registrant's stock and/or of the stock of any subsidiary or controlling affiliate, for a loan made to any member of the insurance holding company system.
>
> No information need be disclosed if such information is not material for purposes of Section 4 of the Act.
>
> Sales, purchases, exchanges, loans or extensions of credit, investments or guarantees involving one-half of 1% or less of the registrant's admitted assets as of the 31st day of December next preceding shall not be deemed material.
>
> Note: Commissioner may by rule, regulation or order provide otherwise.

The description shall be in a manner as to permit the proper evaluation thereof by the Commissioner, and shall include at least the following: the nature and purpose of the transaction, the nature and amounts of any payments or transfers of assets between the parties, the identity of all parties to the transaction, and relationship of the affiliated parties to the registrant.

34. Section 5 of the Insurance Holding Company System Regulatory Act also contains the following guidance:

(2) The following transactions involving a domestic insurer and any person in its holding company system may not be entered into unless the insurer has notified the commissioner in writing of its intention to enter into the transaction at least thirty (30) days prior thereto, or such shorter period as the commissioner may permit, and the commissioner has not disapproved it within that period.

(a) Sales, purchases, exchanges, loans, extensions of credit, or investments, provided the transactions are equal to or exceed:

(i) With respect to nonlife insurers, the lesser of three percent (3%) of the insurer's admitted assets or twenty-five percent (25%) of surplus as regards policyholders as of the 31st day of December next preceding;

(ii) With respect to life insurers, three percent (3%) of the insurer's admitted assets as of the 31st day of December next preceding;

(b) Loans or extensions of credit to any person who is not an affiliate, where the insurer makes loans or extensions of credit with the agreement or understanding that the proceeds of the transactions, in whole or in substantial part, are to be used to make loans or extensions of credit to, to purchase assets of, or to make investments in, any affiliate of the insurer making the loans or extensions of credit.

35. The NAIC Model Law for HMO Investment Guidelines, contains the following:

Section 3. Excessive Commissions Prohibited—Interest of Officers and Directors.

(2) No such HMO shall knowingly invest in or loan upon any property, directly or indirectly, whether real or personal, in which any officer or director of such HMO has a financial interest, nor shall any such HMO make a loan of any kind to any officer or director of such HMO, except that this Section shall not apply in circumstances where the financial interest of such officer or director is only nominal, trifling or so remote as not to give rise to a conflict of interest. In any case, the Director may approve a transaction between an HMO and its officers or directors under this Section if he is satisfied that (a) the transaction is entered into in good faith for the advantage and benefit of the company, and (b) the amount of the proposed investment or loan does not violate any other provision of this Article nor exceed the reasonable, normal value of the property or the interest which the HMO proposed to acquire, and that the transaction is otherwise fair and reasonable, and (c) the transaction will not adversely affect, to any substantial degree, the liquidity of the company's investments or its ability thereafter to comply with requirements of this Article or the payment of its claims and obligations.

36. The NAIC *Financial Condition Examiners Handbook*, Section I, Part IV, Conducting Examinations*,* contains the following guidance:

a. Affiliates Defined

Affiliates exist when there is a relationship that offers the potential for self-dealing, transactions at less than arm's length, favorable treatment, or the ability to direct the outcome of events differently from what might result in the absence of that relationship.

Some examples of affiliates are:

- A company's affiliates
- Principal owners
- Management (including directors)
- Entities for which investments are accounted for by the equity method
- Pension and profit-sharing trusts managed by or under the trusteeship of management

An affiliate also includes any other person with which the reporting entity may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests. A third person also is affiliated if it can significantly influence the management or operating policies of the transacting parties or if it has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

b. Affiliated Transactions Defined

An affiliated transaction is any direct or indirect transaction between the reporting entity and an affiliate. Affiliated Transactions include transactions between:

- A parent company and its subsidiaries
- Subsidiaries of a common parent
- The reporting entity and:
  (1) Other affiliated businesses
  (2) Management (including directors)
  (3) Principal owners
  (4) Pension and profit-sharing trusts managed by or under the trusteeship of management
  (5) Other parties having the ability to exert significant influence

Generally Accepted Accounting Principles

37. FAS 57 provides the following guidance:

INTRODUCTION

1. The FASB has been asked to provide guidance on disclosures of transactions between related parties.[1] Examples of related party transactions include transactions between (a) a parent company and its subsidiaries; (b) subsidiaries of a common parent; (c) an enterprise and trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of the enterprise's management; (d) an enterprise and its principal owners, management, or members of their immediate families; and (e) affiliates. Transactions between related parties commonly occur in the normal course of business. Some examples of common types of transactions with related parties are: sales, purchases, and transfers of realty and personal property; services received or furnished, for example, accounting, management, engineering, and legal services; use of property and equipment by lease or otherwise; borrowings and lendings; guarantees; maintenance of bank balances as compensating balances for the benefit of another; intercompany billings based on allocations of common costs; and filings of consolidated tax returns. Transactions between related parties are considered to be related party transactions even though they may not be given accounting recognition. For example, an enterprise may receive services from a related party without charge and not record receipt of the services.

[1] Terms defined in the glossary (Appendix B) are in boldface type the first time they appear in this Statement.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Disclosures

2. Financial statements shall include disclosures of material related party transactions, other than compensation arrangements, expense allowances, and other similar items in the ordinary course of business. However, disclosure of transactions that are eliminated in the preparation of consolidated or combined financial statements is not required in those statements.[2] The disclosures shall include:[3]

a. The nature of the relationship(s) involved

b. A description of the transactions, including transactions to which no amounts or nominal amounts were ascribed, for each of the periods for which income statements are presented, and such other information deemed necessary to an understanding of the effects of the transactions on the financial statements

c. The dollar amounts of transactions for each of the periods for which income statements are presented and the effects of any change in the method of establishing the terms from that used in the preceding period

d. Amounts due from or to related parties as of the date of each balance sheet presented and, if not otherwise apparent, the terms and manner of settlement

3. Transactions involving related parties cannot be presumed to be carried out on an arm's length basis, as the requisite conditions of competitive, free-market dealings may not exist. Representations about transactions with related parties, if made, shall not imply that the related party transactions were consummated on terms equivalent to those that prevail in arm's length transactions unless such representations can be substantiated.

4. If the reporting enterprise and one or more other enterprises are under common ownership or management control and the existence of that control could result in operating results or financial position of the reporting enterprise significantly different from those that would have been obtained if the enterprises were autonomous, the nature of the control relationship shall be disclosed even though there are no transactions between the enterprises.

38. For purposes of FAS 57, certain terms are defined as follows:

a. Affiliate. A party that, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with an enterprise.

b. Control. The possession, direct or indirect, of the power to direct or cause the direction of the management and policies of an enterprise through ownership, by contract, or otherwise.

[2] The requirements of this Statement are applicable to separate financial statements of each or combined groups of each of the following: a parent company, a subsidiary, a corporate joint venture, or a 50-percent-or-less owned investee. However, it is not necessary to duplicate disclosures in a set of separate financial statements that is presented in the financial report of another enterprise (the primary reporting enterprise) if those separate financial statements also are consolidated or combined in a complete set of financial statements and both sets of financial statements are presented in the same financial report.

[3] In some cases, aggregation of similar transactions by type of related party may be appropriate. Sometimes, the effect of the relationship between the parties may be so pervasive that disclosure of the relationship alone will be sufficient. If necessary to the understanding of the relationship, the name of the related party should be disclosed.

c. Immediate family. Family members whom a principal owner or a member of management might control or influence or by whom they might be controlled or influenced because of the family relationship.

d. Management. Persons who are responsible for achieving the objectives of the enterprise and who have the authority to establish policies and make decisions by which those objectives are to be pursued. Management normally includes members of the board of directors, the chief executive officer, chief operating officer, vice presidents in charge of principal business functions (such as sales, administration, or finance), and other persons who perform similar policy making functions. Persons without formal titles also may be members of management.

e. Principal owners. Owners of record or known beneficial owners of more than 10 percent of the voting interests of the enterprise.

f. Related parties. Affiliates of the enterprise; entities for which investments are accounted for by the equity method by the enterprise; trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management; principal owners of the enterprise; its management; members of the immediate families of principal owners of the enterprise and its management; and other parties with which the enterprise may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests. Another party also is a related party if it can significantly influence the management or operating policies of the transacting parties or if it has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

39. GAAP literature acknowledges the basic problem of when to use predecessor basis vs. fair value or exchange price in accounting for transfers of noncash assets between related parties. Guidance on accounting for transfers of assets between affiliated companies includes the discussion section of EITF 85-21. This indicates that the SEC staff require transfers of assets between companies under common control or between a parent and its subsidiary be valued at their historical cost in the separate statements of each entity that is a party to the transaction. These views relate primarily to transfers of net assets (as in a business combination) or long-lived assets. The form of consideration, whether cash or other, does not change the method of accounting. Any excess paid over the historical cost is treated as a reduction of equity. Certain excerpts follows:

> The SEC Observer stated that the SEC staff's views on carrying over historical cost to record, in the separate financial statements of each entity, transfers between companies under common control or between a parent and its subsidiary run primarily to transfers of net assets (as in business combination) or long-lived assets. Those views would not normally apply to recurring transactions for which valuation is not in question (such as routine transfers of inventory) in the separate financial statements of each entity that is a party to the transaction.
>
> The Task Force members were not in agreement as to whether new basis accounting is acceptable for privately held companies. One Task Force member indicated that the authoritative literature could be read to support the practice. One Task Force member indicated that a concept of the reporting entity would be helpful. Some Task Force members indicated a need for FASB guidance.

40. EITF 84-39 discusses the transfer of monetary and nonmonetary assets among individuals and entities under common control. Certain excerpts follow:

> ISSUE
> When an asset (for example, real estate) is transferred from an individual to a corporation controlled by that individual in exchange for cash of stock, should the corporation record the transferred property at it fair value at the date of transfer or at its cost to the individual.
>
> EITF DISCUSSION
> The Task Force did not reach a consensus on this issue.
>
> Task Force members noted that diversity in practice in certain specific types of transactions, with some members starting from a presumption that carrying amounts should be adjusted to fair value at the date of transfer, while others preferred no change in carrying amount until an asset leaves the controlled group.

41. Accounting Interpretations of APB Opinion No. 16 (AIN-APB 16, #39) discusses transfers and exchanges between companies under common control:

> Question - Paragraph 5 of APB Opinion No. 16 states the Opinion does not apply to a transfer of net assets or to an exchange of shares between companies under common control. What are some examples of the types of transactions excluded from the Opinion by this provision and what accounting should be applied?
>
> Interpretation - In general, paragraph 5 excludes transfers and exchanges that do not involve outsiders. For example, a parent company may transfer the net assets of a wholly owned subsidiary into the parent company and liquidate the subsidiary, which is a change in legal organization but not a change in the entity. Likewise, a parent may transfer its interest in several partially owned subsidiaries to a new wholly owned subsidiary, which is again a change in legal organization but not in the entity. Also, a parent may exchange its ownership or the net assets of a wholly owned subsidiary for additional shares issued by the parent's partially owned subsidiary, thereby increasing the parent's percentage of ownership in the partially owned subsidiary but leaving all of the existing minority interest outstanding.
>
> None of the above transfers or exchanges is covered by APB Opinion No. 16. The assets and liabilities so transferred would be accounted for at historical cost in a manner similar to that in pooling of interests accounting.
>
> It should be noted, however, that purchase accounting applies when the effect of a transfer or exchange is to acquire all or part of the outstanding shares held by the minority interest of a subsidiary (see paragraph 43). The acquisition of all or part of a minority interest, however acquired, is never considered a transfer or exchange by companies under common control. (See Interpretation No. 26 of APB No. 16, “ Acquisition of Minority Interest.”)

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Introduction, Accounting for Assets Transferred Between Affiliates
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Introduction, Accounting for Assets Transferred Between Affiliates
- NAIC Annual Statement Instructions for Life and Accident and Health Insurance Companies, Notes to Financial Statements and Schedule Y
- NAIC Annual Statement Instructions for Property and Casualty Insurance Companies, Notes to Financial Statements and Schedule Y
- NAIC Annual Statement Instructions for Health Maintenance Organizations, Notes to Financial Statements and Schedule Y
- Insurance Holding Company System Model Regulation with Reporting Forms and Instructions, Form B

- Insurance Holding Company System Regulatory Act
- Model Law for HMO Investment Guidelines
- NAIC Financial Condition Examiners Handbook, Section I, Part IV, Conducting Examinations

Generally Accepted Accounting Principles

- *FASB Statement No. 57, Related Party Disclosures*
- *EITF 84-39, Transfers of Monetary and Nonmonetary Assets among Individuals and Entities under Common Control (Not a consensus opinion)*
- *EITF 85-21, Changes of Ownership Resulting in a New Basis of Accounting (Not a consensus opinion)*
- *Accounting Interpretations of APB Opinion No. 16, #39, Transfers and Exchanges Between Companies Under Common Control*

State Regulations

- Wisconsin Administrative Code Ins. 3.50

Statutory Issue Paper No. 26

Bonds, Excluding Loan-Backed and Structured Securities

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 26

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory guidance for bonds is contained in the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies. That guidance also establishes the NAIC's Securities Valuation Office (SVO) as an authority for the valuation of bonds.

2. The purpose of this paper is to establish statutory accounting principles for bonds, excluding loan-backed and structured securities (which are covered in *Issue Paper No. 43—Loan-Backed and Structured Securities* (Issue Paper No. 43)) that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

3. Bonds shall be defined as any securities representing a creditor relationship, whereby there is a fixed schedule for one or more future payments. This definition includes U.S. Treasury securities, U.S. government agency securities, municipal securities, corporate bonds, bank participations, convertible debt, certificates of deposit and commercial paper that have a fixed schedule of payments and a maturity date in excess of one year from the date of acquisition. Loan-backed and structured securities meet this definition, but are excluded from the scope of this issue paper, and are addressed in Issue Paper No. 43. Securities which meet the definition above, but have a maturity date of one year or less from the date of acquisition are addressed in *Issue Paper No. 28—Short-term Investments*. Mortgage loans and other real estate lending activities made in the ordinary course of business meet the definition above, but are not addressed in this issue paper. These types of transactions are addressed in issue papers 37 and 39.

4. Bonds meet the definition of assets as defined in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*, and are admitted assets to the extent they conform to the requirements of this paper.

Acquisitions and Sales

5. A bond acquisition or disposal shall be recorded on the trade date, not the settlement date except for the acquisition of private placement bonds which shall be recorded on the funding date. At acquisition, bonds shall be reported at their cost, including brokerage and other related fees, which cannot exceed the fair market value at the date of acquisition.

6. For reporting entities required to maintain an Interest Maintenance Reserve (IMR), the accounting for realized capital gains and losses on sales of bonds shall be in accordance with *Issue Paper No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*. For reporting entities not required to maintain an IMR, realized gains and losses on sales of bonds shall be recorded on the trade date, and shall be reported on the net realized capital gains or losses line of the Investment Income section of the Underwriting and Investment Exhibit.

Amortized Cost

7. Amortization of bond premium or discount shall be calculated using the scientific (constant yield) interest method taking into consideration specified interest and principal provisions over the life of the bond. Bonds containing call provisions (where the issue can be called away from the reporting entity at the issuer's discretion) shall be amortized to the call or maturity value/date which produces the lowest asset value (yield to worst).

Balance Sheet Amount

8. Bonds shall be valued and reported in accordance with the NAIC Valuations of Securities manual prepared by the Securities Valuation Office (Valuations of Securities manual). For reporting entities that maintain an Asset Valuation Reserve (AVR), the bonds shall be reported at amortized cost, except for those with an NAIC designation of 6, which shall be reported at the lower of amortized cost or fair market value. For reporting entities that do not maintain an AVR, bonds that are designated highest-quality and high-quality (NAIC designations 1 and 2, respectively) shall be reported at amortized cost; all other bonds (NAIC designations 3 to 6) shall be reported at the lower of amortized cost or fair market value.

Impairment

9. If it is determined that a decline in the fair market value of a bond is other than temporary, the cost basis of the bond shall be written down to fair market value as a new cost basis and the amount of the write down shall be accounted for as a realized loss. The new cost basis shall not be changed for subsequent recoveries in fair market value. Future declines in market value which are determined to be other than temporary, shall be recorded as realized losses. An impairment shall be considered to have occurred if it is probable that the reporting entity will be unable to collect all amounts due according to the contractual terms of a debt security in effect at the date of acquisition. A decline in fair market value which is other than temporary includes situations where a reporting entity has made a decision to sell a security prior to its maturity at an amount below its carrying value (i.e., amortized cost). This is consistent with *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets.*

Income

10. Interest income for any period consists of interest collected during the period, the change in the due and accrued interest between the beginning and end of the period as well as reductions for premium amortization and interest paid on acquisition of bonds, and the addition of discount accrual. In accordance with *Issue Paper No. 34—Investment Income Due and Accrued*, investment income shall be reduced for amounts which have been determined to be uncollectible. Contingent interest may be accrued if the applicable provisions of the underlying contract and the prerequisite conditions have been met.

11. A bond may provide for a prepayment penalty or acceleration fee in the event the bond is liquidated prior to its scheduled termination date. Such fees shall be reported as investment income when received.

Origination Fees

12. Origination fees represent fees charged to the borrower in connection with the process of originating or restructuring a transaction such as the private placement of bonds. The fees include, but are not limited to, points, management, arrangement, placement, application, underwriting, and other fees pursuant to such a transaction. Origination fees shall not be recorded until received in cash. Origination fees intended to compensate the reporting entity for interest rate risks (e.g., points), shall be amortized into income over the term of the bond consistent with paragraph 7 of this issue paper. Other origination fees shall be recorded in income immediately.

Origination, Acquisition, and Commitment Costs

13. Costs related to origination when paid in the form of brokerage and other related fees shall be capitalized as part of the cost of the bond, consistent with paragraph 5 of this issue paper. All other costs, including internal costs or costs paid to an affiliated entity related to origination, purchase or commitment to purchase bonds shall be charged to expense when incurred.

Commitment Fees

14. Commitment fees are fees paid to the reporting entity that obligate the reporting entity to make available funds for future borrowing under a specified condition. A fee paid to the reporting entity to obtain a commitment to make funds available at some time in the future, generally, is refundable only if the bond is issued. If the bond is not issued then the fees shall be recorded as investment income by the reporting entity when the commitment expires. A fee paid to the reporting entity to obtain a commitment to be able to borrow funds at a specified rate and with specified terms quoted in the commitment agreement, generally, is not refundable unless the commitment is refused by the reporting entity. This type of fee shall be deferred, and amortization shall depend on whether or not the commitment is exercised. If the commitment is exercised, then the fee shall be amortized in accordance with paragraph 7 of this issue paper over the life of the bond as an adjustment to the investment income on the bond. If the commitment expires unexercised, the commitment fee shall be recognized in income on the commitment expiration date.

Loaned Bonds

15. When bonds are loaned, they remain assets of the reporting entity and are not removed from the accounting records as the reporting entity remains the owner of the bonds. When collateral is provided for the general use of the reporting entity, the asset is recorded and the admissibility of the asset is determined as if the reporting entity owned the collateral asset. A liability for the return of that collateral must be established. When collateral not available for the general use of the reporting entity is provided, it should not be recognized as an asset of the reporting entity. When non-cash collateral is provided, the current market value of that collateral must be used to determine adequacy of the collateral held relative to the current market value of the loaned bonds/securities.

Wash Sales

16. When a bond is sold and the proceeds are reinvested within 30 days in the same or substantially the same security, such transfers shall be considered to be wash sales, and shall be accounted for as sales and disclosed as required by paragraph 19. Unless there is a concurrent contract to repurchase or redeem the transferred bond from the transferee, the transferor does not maintain effective control over the bond.

17. For the securities to be substantially the same, the criteria set forth in paragraph 28 of *FASB Statement No. 125*, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 125) must be met.

Exchanges and Conversions

18. If a bond is exchanged or converted into other securities, the fair value of the bond surrendered at the date of the exchange or conversion shall become the cost basis for the new securities with any gain or loss realized at the time of the exchange or conversion. If the fair value of the securities received in an exchange or conversion is more clearly evident than the fair value of the bond surrendered then it shall become the cost basis for the new securities. This is consistent with *Issue Paper No. 73—Nonmonetary Transactions*.

Disclosures

19. The following disclosures shall be made for bonds in the notes to the financial statements:

- Fair values in accordance with *Issue Paper No. 33—Disclosures about Fair Value of Financial Instruments;*

- Concentrations of credit risk in accordance with *Issue Paper No. 27—Disclosures of Information about Financial Instruments with Concentrations of Credit Risk*;
- The basis at which the bonds are stated;
- Amortization method;

  Description of any loaned bonds, including the amount, description of the collateral and whether or not the collateral is restricted;
- Reporting entities shall disclose the following information for wash sales, as defined in paragraph 16, involving transactions for securities with a NAIC designation of 3 or below, or unrated:
  a. A description of the reporting entity's objectives regarding these transactions;
  b. An aggregation of transactions by NAIC Designation 3 or below, or unrated;
  c. The number of transactions involved during the reporting period;
  d. The book value of securities sold;
  e. The cost of securities repurchased;
  f. The realized gains/losses associated with the securities involved.

DISCUSSION

20. The statutory accounting principles described in the summary conclusion section are consistent with current statutory accounting guidance for bonds, except as follows:

- Paragraphs 5 and 6 require bond acquisitions and dispositions to be recorded on the trade date, whereas current statutory guidance is silent.

- Paragraph 9 contains an impairment test that is not contained in the current statutory guidance, but which is considered consistent with the conservatism concept in the Statement of Concepts.

- Paragraph 11 requires that prepayment penalties and acceleration fees received from the liquidation of an investment prior to its maturity date be recorded as investment income. Current statutory accounting guidance allows for prepayment penalties and acceleration fees to be recorded as either capital gains or investment income.

- Paragraph 16 provides guidance on sales and subsequent repurchases of bonds which is intended to prevent "window dressing."

21. This issue paper adopts *AICPA Statement of Position 90-11, Disclosure of Certain Information by Financial Institutions About Debt Securities Held as Assets* and *AICPA Practice Bulletin No. 4*, *Accounting for Foreign Debt/Equity Swaps*. This issue paper rejects the GAAP guidance for debt securities, which is contained in *FASB Statement No. 115*, *Accounting for Certain Investments in Debt and Equity Securities* (FAS 115), *FASB Statement No. 91*, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases* (FAS 91), *FASB Emerging Issues Task Force No. 89-18, Divestitures of Certain Investment Securities to an Unregulated Commonly Controlled Entity under FIRREA*, and *FASB Emerging Issues Task Force No. 96-10*, *Impact of Certain Transactions on Held-to-Maturity Classifications Under FASB Statement No. 115*. The primary differences between the statutory accounting principles established in this issue paper and GAAP are as follows:

- FAS 115 requires investments in debt securities to be classified into three categories: held-to-maturity, available-for-sale and trading. Held-to-maturity securities are reported at amortized cost. Available-for-sale are reported at fair value, with unrealized gains or losses reported as a separate component of shareholders' equity. Trading securities are reported at fair value, with unrealized gains or losses included in earnings.

- GAAP does not require reporting of AVR or IMR and requires that realized gains and losses be included in income when realized.

- FAS 91 generally requires amortization of the security premium or discount over the remaining life of the security.

- FAS 91 allows deferral of certain origination costs.

22. This paper is consistent with *Issue Paper No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements* (Issue Paper No. 45), in defining what criteria must be met in order for securities to be considered substantially the same. Issue Paper No. 45 adopts paragraph 28 of FAS 125 and *AICPA Statement of Position 90-3*, *Definition of the Term Substantially the Same for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position* (SOP 90-3).

23. The statutory accounting principles established in this issue paper, attempt to smooth the effect upon a reporting entity's surplus of fair market value fluctuation of investments held by the reporting entity. This is consistent with the Statement of Concepts which states *"conservative valuation procedures provide protection to policyholders against adverse fluctuations in financial condition or operating results."* Statutory accounting principles for life insurance companies also use the concept of AVR and IMR adjustments to compensate for fair market value fluctuations over time.

Drafting Notes/Comments

- Loan-backed and structured securities are addressed in *Issue Paper No. 43—Loan-Backed and Structured Securities*.
- Repurchase and reverse repurchase agreements are addressed in *Issue Paper No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements*.
- AVR and IMR are addressed in *Issue Paper No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*.
- Short-term investments are addressed in *Issue Paper No. 28—Short-Term Investments*.
- The value of a CMO special purpose subsidiary is addressed in Issue Paper No. 86 - Securitization.
- Investment income due and accrued is addressed in *Issue Paper No. 34—Investment Income Due and Accrued*.
- Securities not yet valued by the SVO will follow SVO procedures for valuing such securities as being drafted by the SVO as directed by the Invested Asset Working Group of the Valuation of Securities (EX4) Task Force.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

24. The Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 1, Bonds and Loaned Backed and Structured Securities, states:

> Bonds are obligations issued by business units, governmental units, and certain nonprofit units, and having a fixed schedule for one or more future payments of money. This definition includes commercial paper, negotiable certificates of deposit, repurchase agreements, collateralized mortgage obligations (CMOs), mortgage participation certificates (MPCs), interest-only and principal-only certificates (IOs and POs), and equipment trust certificates. Governmental bonds may be classified as general obligation bonds secured by revenue from a restricted source. Corporate bonds are either secured by a claim to mortgage assets or other specific collateral, or by the general credit of the corporation, i.e., debentures. Such investments may be public issues or private placements. Bonds held for investment generate interest income to the investor. Their sale may result in capital gain or loss.

Bonds that pay interest at a rate greater than that which the market requires of similarly rated securities will sell at a “premium" above the face amount of the bond. Bonds with interest rates below the current market will sell at a "discount" from the face amount.

Authorizations and Limitations

Bonds may be subject to qualitative limitations determined by state regulations. For example, a U.S. Treasury Note may have no investment limitations while a railroad bond may have stringent restrictions, both individual (one particular railroad corporation) and in the aggregate (all railroad bonds).

Valuation

Bonds are generally valued at cost adjusted, i.e., amortized, to bring the value to par at maturity. Except for privately placed issues, cost cannot exceed the market value at the date of acquisition, including brokerage and other related fees. Carrying value should not exceed the call price for any particular issue.

Most bond holdings are subject to amortization under the valuation standards of the National Association of Insurance Commissioners and are to be carried at amortized cost. Bonds that do not qualify for amortization according to the NAIC Valuations of Securities manual are to be carried at the value contained in the manual or at book value, whichever is lower. Bonds not listed in the manual, or obligations listed with no value, require the determination of an acceptable value that can be justified to the appropriate regulatory agency.

The Valuation of Securities Task Force has classified bonds into six categories according to whether the bond can be amortized for establishing the investment value to be used in financial statements. A complete description of the NAIC s classification system, valuation bases to be applied, and the requirements and tests used in the classification of bonds may be obtained by reference to the Valuations of Securities manual, produced by the NAIC.

Most regulatory agencies reserve the privilege of directing the valuation of a specific obligation either not listed in the Valuations of Securities manual or affected by a material financial disclosure subsequent to the annual publication. Investments in foreign securities are accounted for in much the same manner. Procedures for valuation and conversion into U.S. currency are prescribed in the Valuations of Securities manual.

Nonadmitted Bonds

Bond classification as admitted assets varies at the discretion of the states. A bond may be classified as a nonadmitted asset to the extent that it fails a qualitative or quantitative limitation test or is otherwise unauthorized as outlined by the applicable state code. A certain percentage of such investments otherwise not qualifying for investment is commonly permitted by the state codes under a blanket clause or "basket provision" limiting the total quantity of these and other similar investments as a function of net admitted assets or surplus, or both.

For bonds not eligible for amortization, the difference between the amortized (book) value and the association (market) value is treated as a nonadmitted asset.

Premium and Discount

On acquisition, bonds are recorded in the general ledger at their cost. For bonds purchased at a premium, there is to be an annual amortization to reduce the recorded cost to par value. In the case of a bond with a call privilege, the amortized value used should be the lowest value produced by using the maturity date or the call features. The annual amortization of premium is normally accounted for as reduction to interest that has been collected during the year.

For bonds purchased at a discount, where cost is less than par value, there is to be an annual accrual of this discount to increase the ledger value to par value at maturity. The annual accrual of discount is generally accounted for as an addition to interest that has been collected during the year.

For bonds secured by U.S. governmental entities, amortization of premium and accrual of discount may require special handling, and the Valuations of Securities manual should be consulted.

Interest Income

If interest (including contingent interest) on a bond is recorded when received, an adjustment must be made to recognize due and accrued interest as of the reporting date. Interest income for any period consists of interest collected during the period and the change in the due and accrued interest between the beginning and end of the period, plus the adjustments for the accrual of discount, minus adjustment for the amortization of premium, and minus adjustment for interest paid on acquisition of bonds.

Contingent interest represents bondholder income generated through the occurrence of specific economic events in relation to the issuer. For example, contingent interest may become payable upon the attainment by the issuer of a given level of cash flow or income. In may respects, bonds with contingent interest provisions are similar to income bonds. Due and unpaid contingent interest may be recorded as income. The proper accrual of such income does, however, require an analysis of the applicable provisions in the underlying agreement and the verification that the prerequisite conditions have been met.

Commitment and Other Origination Fees

Commitment and other origination fees may arise from the private placement of bonds. Commitment fees are charged by the company to the borrower for promising to make available funds for future borrowing at currently specified interest rates. If the fee is not returnable to the borrower and the bond is not issued, the fee should be taken into income immediately. If the fee is returnable only if the bond is issued, it should not be considered income until it is determined that the bond will not be placed. If it is determined that the bond will be issued, the fee should be deferred and amortized using the interest method over the life of the loan. Other fees intended to compensate the company for interest rate risks associated with the commitment may be built into the interest rates specified and thus, if collected, would be amortized into income over the term of the bond.

Fees charged to borrowers for providing services related to the origination of a private placement should be taken into income immediately only if no portion of the loan is retained by the company. Otherwise, recognition of any fees related to the portion of the loan retained for investment purposes should be deferred until issue and amortized into income using the interest method over the life of the loan. Deferred fee income related to loans originated and retained for resale should be recognized upon sale.

Loaned Bonds or Bonds Subject to Reverse Repurchase Agreements

Where the state of domicile permits such activity, bonds may be loaned or placed under reverse repurchase arrangements with authorized brokers or dealers in securities.

When a bond is loaned, collateral consisting of cash and/or cash equivalent is pledged. The pledged collateral is maintained in an escrow account. The statement will continue to report the insurance company as owner of the bond.

The valuation of this bond will remain unaffected by the loan as long as the amount of the collateral is at least equal to the required amount specified in the Valuations of Securities manual. Failure to hold sufficient collateral may result in the admitted asset value being decreased.

25. The Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies contains similar guidance.

26. The *Purposes and Procedures Manual of the NAIC Securities Valuation Office* contains the following guidance:

> (B) Corporate Bonds--General Procedure. The analysis to determine an NAIC designation will be made in one of two ways. The first will be the direct use of ratings performed by other recognized rating agencies or organizations. The second will be the use of various security analysis techniques, both quantitative and subjective in nature.
>
> (1) Issuers That Have Securities Rated by Other Recognized Rating Agencies or Organizations.
>
> Ratings of other recognized rating organizations will be translated directly into an NAIC Designation. The SVO staff will have discretionary authority to downgrade ratings of other organizations but not to upgrade. If there are multiple differing ratings the SVO may use the highest rating but may also go lower where indicated. Where one issue of an issuer has a rating, this rating will be used as a benchmark in determining the ratings of other non-rated issues of the same issuer.
>
> A list of the approved agencies and the translation of their ratings into NAIC Designations is presented in Appendix B. To become an NAIC approved rating organization the candidate must submit to the NAIC's Securities Valuation Office proof that it has been designated a "Nationally Recognized Statistical Rating Organization" (NRSRO) by the Securities and Exchange Commission (SEC) of the Government of the United States of America. Such proof will be acceptable to the NAIC for designation as an NAIC approved rating organization. Rating organizations not so recognized by the SEC may be used by the SVO in its day to day operation when rated entities are not rated by an NAIC approved NRSRO and the quality of such ratings is determined to be substantially similar in quality to those of an NAIC approved NRSRO by SVO staff. The SVO may request whatever documentation deemed necessary to make such a determination. Such rating organizations will not, however, be granted NAIC approved rating organization status.
>
> (2) Issuers of Securities That are Not Rated by Any Other Recognized Rating Organization.
>
> The analysis to determine an NAIC Designation will generally be made up of three segments.
>
> (1) The SVO will apply a quantitative financial model to current and past financial statement data to determine a preliminary measure of the relative financial soundness of the issuer. The result should be expressed as a numeric score which can be ranked against other similar scores and these then related to the various NAIC Designations. It is important to emphasize that the result obtained from the model will not be the sole determinant of an NAIC Designation which determination will be subject to the second and third parts of the analysis which follow.
>
> (2) In the second segment of its analysis the SVO staff will review five years of historical financial data (when available), and any projected data made available to it. This review will cover the balance sheet, the income statement, and the statement of cash flows as obtained from the issuer's financial statements as well as the notes thereto. The staff will also review various standard financial ratios. In addition, the analyst will review the auditors opinion. Furthermore, the SVO analyst is expected to review any news media articles relating to the issuer or research reports that are available. The analysis would also include but is not limited to, a detailed review of the issuer's industry and operating environment as

well as the issuer's management/sponsorship, marketing capabilities, and cost structure to determine the extent of the issuer's competitive edge, if any. These characteristics, when viewed in context with the issuer's financial profile, will determine the ability of the company to respond to varying economic scenarios.

The result of the first two foregoing steps will be a judgment by the SVO analyst of the issuer's implied senior unsecured debt paying ability or rating expressed as an NAIC Designation. The ratings of all other securities of the same issuer (including preferred stocks) can be scaled either upwards or downwards based on that securities' relationship to senior unsecured debt in the capital structure as well as the strength of the credit.

(3) The final part of the analysis will focus on factors that are specific to the security under review as opposed to those relevant to the issuer. This will include a review of:

(a) Covenants
(b) Structure
(c) Collateral
(d) Third party financial support or other credit enhancements
(e) Any other factor specific to the security under review

At all times during the analysis the SVO analyst will have complete discretion to extend the investigation to whatever extent deemed necessary in order to arrive at an appropriate NAIC Designation

(C) Corporate Bonds--Special Factors. All bonds of the following types will be subject to the review procedures of Section 2(B), but the following special factors and statement value considerations will be addressed additionally as indicated.

(1) Collateralized Obligations. The ability of any type of collateral to enhance or fully support the contractual provisions of any security will be taken into account by the SVO only if acceptable documentary evidence is provided. This might include, but is not limited to the filing of the SVO's Collateral Loan form where appropriate, the original due diligence package, appraisal reports, valuations of business entities reports or any other relevant supporting information.

(2) Income Bonds that have paid contingent interest in full for the three most recent years and otherwise meeting the standards of review of Section 2(B) shall be valued on the Annual Statement at amortized cost. The method of amortization shall be straight line. Income bonds not meeting these requirements shall be valued on the Annual Statement at market value.

(3) Perpetual Bonds and Demand Notes not in default and otherwise meeting the requirements of Section 2(B) shall be valued on the Annual Statement at original cost by those insurers maintaining an AVR (see Section 6). All other insurers must value these bonds at market value. Any such bond or note will have its normal NAIC Designation followed by the letter C if the security is eligible for cost treatment.

(4) Church Bonds secured by a mortgage on the church property will have an NAIC Designation determined based on the requirements of Section 2(B) and the appraised value of such property. All others will be reviewed on the basis of sufficient cash flow to meet obligations as they mature.

(5) Oil and Gas Loans. Loans made on the basis of collateralized oil and gas revenues will be reviewed taking into account a reputable petroleum engineer's or geologist's estimates of existing reserves and the related oil and gas pay out and loan payment schedules.

(6) Equipment Trust Certificates will be reviewed first on the basis of an annually submitted SVO collateral valuation form and if that is not submitted then on the credit standing of the certificate issuer.

(7) Certificates of Deposit (negotiable and non-negotiable) will be considered under the general provisions of Section 2(B).

(8) Repurchase Agreements. Securities subject to repurchase agreements will have an NAIC Designation determined in accordance with Section 2(B).

(9) Reverse Repurchase Agreements. Securities subject to reverse repurchase agreements will have an NAIC Designation determined in accordance with Section 2(B) if the cash and/or cash equivalents pledged as collateral is equal to 100% or more of the market value of the financed securities as of the date of the statement. If other than identical securities are returned, the transaction is to be treated as an ordinary purchase and sale.

(10) Commercial Paper will be valued under the general procedures of Section 2(B).

(11) Convertible Bonds. Bonds eligible for amortized value will be so valued while bonds not eligible will be valued at the lower of market value or the then existing amortized value.

(12) New Enterprises created either as startup companies or as business combinations of pre-existing business units will be evaluated on the basis of projected income statements and balance sheets since prior figures are either not available or not meaningful. Insurers must submit such projections in order to justify ratings higher than the lowest quality category.

(13) Loaned Securities. Where permitted by an insurer's state of domicile, bonds loaned to others shall be valued in accordance with Section 2(B) if (i) Acceptable Collateral, as hereinafter defined, is pledged as security for the loan and (ii) except as set forth in the following sentence, the Acceptable Collateral pledged as security is, at the inception of the loan, in an amount equal to 102% of the market value of the loaned bonds. In the event that foreign bonds are the subject of the loan and the denomination of the currency of the Acceptable Collateral is other than the denomination of the currency of the loaned foreign bonds, the amount of Acceptable Collateral that shall be pledged shall be an amount equal to 105% of the market value of the loaned bonds. A decline in value of the acceptable collateral or an increase in the value of the loaned bonds during the term of the loan shall not result in the disqualification from valuation in accordance with Section 2(B) if, during the term the loan is outstanding, additional Acceptable Collateral is posted any time the amount of Acceptable Collateral declines to 100% of the market value of the loaned bonds (or 102% of the market value of the loaned bonds if Acceptable Collateral in an amount equal to 105% was required to be posted at the inception of the loan) in an amount equal to the difference between the 102% and 105%, respectively. For purposes of this provision, Acceptable Collateral shall mean cash and cash equivalents and shall also include securities issued by the U.S. Government or its agencies. The market value of loaned bonds shall include accrued interest on such loaned bonds. Any shortfall in the amount of the actual Acceptable Collateral posted and the required 102% or 105%, as applicable, shall be deducted from the otherwise determined statement value.

(14) Debtor in Possession (DIP) Financing. Such financing will not be considered to be equivalent to the prior existing debt of a bankrupt and reorganizing entity. Instead it will be considered for valuation based on its superior claim position,

collateral coverage, cash flow coverage of debt service and other strengths inherent in the structural factors unique to the DIP lending process.

(15) Bonds of Liquidating Corporations. Securities of such entities will be marked to market by all insurers and accorded on NAIC rating of "6". In the absence of an active market or a reliable quotation, the value of such securities will be analytically determined by the SVO staff, or the SVO, at its discretion, may accept a value determined by an independent organization approved by the SVO.

(16) Distressed Bonds trading at less than 25% of par at the date of valuation and which are not original issue deep discount bonds. Such securities will be marked to market by all insurers regardless of whether they are current as to all contractual provisions at the date of valuation.

(17) Pricing of Privately Placed and Illiquid Publicly Traded Bonds In or Near Default. The pricing of privately placed and illiquid publicly traded bonds will be analytically determined by the SVO staff, or the SVO, at its discretion, may accept a value determined by an independent organization approved by the SVO. The pricing of these securities will be dependent on three primary factors: (1) the ultimate recovery value in cents per dollar of par value expected to be received net of all reasonable costs of a workout or bankruptcy proceeding such as fees for accountants, lawyers, bankers, etc. (2) the expected timing of the receipt of such recovery value and (3) a discount rate to be applied to factors one and two that reflects market rates of discount for defaulted bonds in general adjusted for the current degree of uncertainty existing in the recovery amount.

Four states of recovery are generally recognized by the SVO and different discount rates reflecting more or less uncertainty will be used for securities in each state. These rates will vary with market conditions. The states are:

(a) Newly defaulted bonds where maximum uncertainty as to recovery exists.

(b) Defaulted securities where a preliminary plan of reorganization has been put forth for discussion.

(c) Defaulted securities where a generally agreed to but unsigned plan is on the table.

(d) Defaulted securities where a plan has been agreed to by all parties and a payout date has been set. This is the only case in which estimated value close to 100% of par will be achievable.

(18) Loan-backed and Structured Securities. The SVO encourages insurers to obtain ratings for loan-backed and structured securities submitted for an NAIC designation from an NAIC approved NRSRO. For unrated structured securities acquired by conversion i.e., securitization, refer to Section 6(B)(g)(i) for instructions.

(E) Instructions for Completing Schedule D of the NAIC Annual Statement

The following table indicates the appropriate entries to be made in Schedule D of the NAIC Annual Statement for all bonds except income bonds (see Section 2(C)(1)) and perpetual bonds and demand notes (see Section 2(C)(2)).

(1) For Insurers Maintaining an Asset Valuation Reserve (AVR) (see Section 6)

NAIC DESIGNATION COLUMN	AMORTIZED OR INVESTMENT VALUE COLUMN	MARKET VALUE COLUMNS	
		RATE	AMOUNT
1	Amortized Cost	SVO	
2	Amortized Cost	Market	Par Value X Rate
		Rate	or
3	Amortized Cost	if shown	Amortized Cost
		or	if No Rate
4	Amortized Cost	A.V.	Available
5	Amortized Cost	if No Rate	______________
6	The lesser of the	shown in	Lower of
	Market Value Amount	VOS	Amortized Cost or
	or Amortized Cost	Manual	Par Value times
			Market Rate

A.V. = Bond has been valued at amortized value and that value should appear in the Market Value Amount Column.

(2) For Property and Casualty Insurers and All Other Insurers Not Maintaining an Asset Valuation Reserve (AVR)

NAIC DESIGNATION COLUMN	AMORTIZED OR INVESTMENT VALUE COLUMN	MARKET VALUE COLUMNS	
		RATE	MARKET VALUE
1	Amortized Cost	SVO	Par Value X Rate
		Market	or A.V. if no
		Rate	rate available
2	Amortized Cost	if	
		shown	
3	The lesser of the	or	Lower of Amortized
	Market Value Amount	A.V.	Cost or Par Value
	or the Amortized Cost	if	X Rate
4	The lesser of the	No	Lower of Amortized
	Market Value Amount	Rate	Cost or Par Value
	or the Amortized Cost	shown	X Rate
5	The lesser of the	In	Lower of Amortized
	Market Value Amount	VOS	Cost or Par Value
	or the Amortized Cost	Manual	X Rate
6	The lesser of the		Lower of Amortized
	Market Value Amount		Cost or Par Value
	or the Amortized Cost		X Rate

A.V. = Bond has been valued at amortized value and that value should appear in the Market Value Amount Column.

27. The NAIC Annual Statement Instructions require that the notes to the financial statements of the Annual Statements include the following information to be disclosed about invested assets:

2. Basis of Valuation of Invested Assets

   a. Provide a statement of the valuation basis for invested assets, including bonds, stocks, derivative instruments, etc. State the method of amortization of bonds not backed by other loans, loan-backed bonds and structured securities.

Generally Accepted Accounting Principles

28. GAAP guidance is promulgated by FAS 115. Pertinent excerpts are as follows:

Accounting for Certain Investments in Debt and Equity Securities

6. At acquisition, an enterprise shall classify debt and equity securities into one of three categories: held-to-maturity, available-for-sale, or trading. At each reporting date, the appropriateness of the classification shall be reassessed.

Held-to-Maturity Securities

7. Investments in debt securities shall be classified as held-to-maturity and measured at amortized cost in the statement of financial position only if the reporting enterprise has the positive intent and ability to hold those securities to maturity.

Trading Securities and Available-for-Sale Securities

12. Investments in debt securities that are not classified as held-to-maturity and equity securities that have readily determinable fair values shall be classified in one of the following categories and measured at fair value in the statement of financial position:

   a. Trading securities. Securities that are bought and held principally for the purpose of selling them in the near term (thus held for only a short period of time) shall be classified as trading securities. Trading generally reflects active and frequent buying and selling, and trading securities are generally used with the objective of generating profits on short-term differences in price. Mortgage-backed securities that are held for sale in conjunction with mortgage banking activities, as described in FASB Statement No. 65, Accounting for Certain Mortgage Banking Activities, shall be classified as trading securities. (Other mortgage-backed securities not held for sale in conjunction with mortgage banking activities shall be classified based on the criteria in this paragraph and paragraph 7.)

   b. Available-for-sale securities. Investments not classified as trading securities (nor as held-to-maturity securities) shall be classified as available-for-sale securities.

Reporting Changes in Fair Value

13. Unrealized holding gains and losses for trading securities shall be included in earnings. Unrealized holding gains and losses for available-for-sale securities (including those classified as current assets) shall be excluded from earnings and reported as a net amount in a separate component of shareholders' equity until realized. Paragraph 36 of FASB Statement No. 109, Accounting for Income Taxes, provides guidance on reporting the tax effects of unrealized holding gains and losses reported in a separate component of shareholders' equity.

14. Dividend and interest income, including amortization of the premium and discount arising at acquisition, for all three categories of investments in securities shall continue to be included in earnings. This Statement does not affect the methods used for recognizing and measuring the amount of dividend and interest income. Realized gains and losses for securities classified as either available-for-sale or held-to-maturity also shall continue to be reported in earnings.

Impairment of Securities

16. For individual securities classified as either available-for-sale or held-to-maturity, an enterprise shall determine whether a decline in fair value below the amortized cost basis is other than temporary. For example, if it is probable that the investor will be unable to collect all amounts due according to the contractual terms of a debt security not impaired at acquisition, an other-than-temporary impairment shall be considered to have occurred.[4] If the decline in fair value is judged to be other than temporary, the cost basis of the individual security shall be written down to fair value as a new cost basis and the amount of the write-down shall be included in earnings (that is, accounted for as a realized loss). The new cost basis shall not be changed for subsequent recoveries in fair value. Subsequent increases in the fair value of available-for-sale securities shall be included in the separate component of equity pursuant to paragraph 13; subsequent decreases in fair value, if not an other-than-temporary impairment, also shall be included in the separate component of equity.

[4] A decline in the value of a security that is other than temporary is also discussed in AICPA Auditing Interpretation, Evidential Matter for the Carrying Amount of Marketable Securities, which was issued in 1975 and incorporated in Statement on Auditing Standards No. 1, Codification of Auditing Standards and Procedures, as Interpretation 20, and in SEC Staff Accounting Bulletin No.59, Accounting for Noncurrent Marketable Equity Securities.

29. The guidance for the accounting for loan origination costs and commitment fees is contained in FAS 91. Pertinent excerpts are as follows:

Loan Origination Fees and Costs

5. Loan origination fees shall be deferred and recognized over the life of the loan as an adjustment of yield[2] (interest income). Likewise, direct loan origination costs defined in paragraph 6 shall be deferred and recognized as a reduction in the yield of the loan except as set forth in paragraph 14 (for a troubled debt restructuring). Loan origination fees and related direct loan origination costs for a given loan shall be offset and only the net amount shall be deferred and amortized. The practice of recognizing a portion of loan origination fees as revenue in a period to offset all or part of the costs of origination shall no longer be acceptable.

[2] Methods for recognition of deferred fees and direct loan origination costs over the life of the loan as an adjustment of yield are set forth in paragraphs 18-20.

6. Direct loan origination costs of a completed loan shall include only (a) incremental direct costs of loan origination incurred in transactions with independent third parties for that loan and (b) certain costs directly related to specified activities performed by the lender for that loan. Those activities are: evaluating the prospective borrower's financial condition; evaluating and recording guarantees, collateral, and other security arrangements; negotiating loan terms; preparing and processing loan documents; and closing the transaction. The costs directly related to those activities shall include only that portion of the employees' total compensation and payroll-related fringe benefits directly related to time spent performing those activities for that loan and other costs related to those activities that would not have been incurred but for that loan.

7. All other lending-related costs, including costs related to activities performed by the lender for advertising, soliciting potential borrowers, servicing existing loans, and other

ancillary activities related to establishing and monitoring credit policies, supervision, and administration, shall be charged to expense as incurred. Employees' compensation and fringe benefits related to those activities, unsuccessful loan origination efforts, and idle time shall be charged to expense as incurred. Administrative costs, rent, depreciation, and all other occupancy and equipment costs are considered indirect costs and shall be charged to expense as incurred.

Commitment Fees and Costs

8. Except as set forth in subparagraphs (a) and (b) below, fees received for a commitment to originate or purchase a loan or group of loans shall be deferred and, if the commitment is exercised, recognized over the life of the loan as an adjustment of yield or, if the commitment expires unexercised, recognized in income upon expiration of the commitment

   a. If the enterprise's experience with similar arrangements indicates that the likelihood that the commitment will be exercised is remote,[3] the commitment fee shall be recognized over the commitment period on a straight-line basis as service fee income. If the commitment is subsequently exercised during the commitment period, the remaining unamortized commitment fee at the time of exercise shall be recognized over the life of the loan as an adjustment of yield.

   b. If the amount of the commitment fee is determined retrospectively as a percentage of the line of credit available but unused in a previous period, if that percentage nominal in relation to the stated interest rate on any related borrowing, and if that borrowing will bear a market interest rate at the date the loan is made, the commitment fee shall be recognized as service fee income as of the determination date.

9. Direct loan origination costs (described in paragraph 6) incurred to make a commitment to originate a loan shall be offset against any related commitment fee and the net amount recognized as set forth in paragraph 8.

Purchase of a Loan or Group of Loans

15. The initial investment in a purchased loan or group of loans shall include the amount paid to the seller plus any fees paid or less any fees received. The initial investment frequently differs from the related loan's principal amount at the date of purchase. This difference shall be recognized as an adjustment of yield over the life of the loan. All other costs incurred in connection with acquiring purchased loans or committing to purchase loans shall be charged to expense as incurred.

Other

17. Deferred net fees or costs shall not be amortized during periods in which interest income on a loan is not being recognized because of concerns about the realization of loan principal or interest.

Application of the Interest Method and Other Amortization Matters

18. Net fees or costs that are required to be recognized as yield adjustments over the life of the related loan(s) shall be recognized by the interest method except as set forth in

[3] The term remote is used here, consistent with its use in *FASB Statement No. 5, Accounting for Contingencies*, to mean that the likelihood is slight that a loan commitment will be exercised prior to its expiration.

paragraph 20. The objective of the interest method is to arrive at periodic interest income (including recognition of fees and costs) at a constant effective yield on the net investment in the receivable (that is, the principal amount of the receivable adjusted by unamortized fees or costs and purchase premium or discount). The difference between the periodic interest income so determined and the stated interest on the outstanding principal amount of the receivable is the amount of periodic amortization. [6] Under the provisions of this statement, the interest method shall be applied as follows when the stated interest rate is not constant throughout the term of the loan:

a. If the loan's stated interest rate increases during the term of the loan (so that interest accrued under the interest method in early periods would exceed interest at the stated rate), interest income shall not be recognized to the extent that the net investment in the loan would increase to an amount greater than the amount at which the borrower could settle the obligation. Prepayment penalties shall be considered in determining the amount at which the borrower could settle the obligation only to the extent that such penalties are imposed throughout the loan term. (Refer to Appendix B.)

b. If the loan's stated interest rate decreases during the term of the loan, the stated periodic interest received early in the term of the loan would exceed the periodic interest income that is calculated under the interest method. In that circumstance, the excess shall be deferred and recognized in those future periods when the constant effective yield under the interest method exceeds the stated interest rate. (Refer to Appendix B.)

c. If the loan's stated interest rate varies based on future changes in an independent factor, such as an index or rate (for example, the prime rate, the London Interbank Offered Rate (LIBOR), or the U.S. Treasury bill weekly average rate), the calculation of the constant effective yield necessary to recognize fees and costs shall be based either on the factor (the index or rate) that is in effect at the inception of the loan or on the factor as it changes over the life of the loan. [7] (Refer to Appendix B.)

[6] The "interest" method is also described in paragraph 16 *of APB Opinion No. 12, Omnibus Opinion--1967*, in the first sentence of paragraph 15 of *APB Opinion No. 21, Interest on Receivables and Payables*, and in paragraphs 235-239 of FASB Concepts Statement No. 6, Elements of Financial Statements.

[7] A variable rate loan whose initial rate differs from the rate its base factor would produce is also subject to the provisions of paragraphs 18(a) and (b).

19. Except as stated in the following sentence, the calculation of the constant effective yield necessary to apply the interest method shall use the payment terms required by the loan contract, and prepayments of principal shall not be anticipated to shorten the loan term. If the enterprise holds a large number of similar loans for which prepayments are probable and the timing and amount of prepayments can be reasonably estimated, the enterprise may consider estimates of future principal prepayments in the calculation of the constant effective yield necessary to apply the interest method. If the enterprise anticipates prepayments in applying the interest method and a difference arises between the prepayments anticipated and actual prepayments received, the enterprise shall recalculate the effective yield to reflect actual payments to date and anticipated future payments. The net investment in the loans shall be adjusted to the amount that would have existed had the new effective yield been applied since the acquisition of the loans. The investment in the loans shall be adjusted to the new balance with a corresponding charge or credit to interest income. Enterprises that anticipate prepayments shall disclose that policy and the significant assumptions underlying the prepayment

estimates. The practice of recognizing net fees over the estimated average life of a group of loans shall no longer be acceptable. (Refer to Appendix B.)

20. Certain loan agreements provide no scheduled payment terms (demand loans); others provide the borrower with the option to make multiple borrowings up to a specified maximum amount, to repay portions of previous borrowings, and then reborrow under the same contract (revolving lines of credit).

a. For a loan that is payable at the lender's demand, any net fees or costs may be recognized as an adjustment of yield on a straight-line basis over a period that is consistent with (1) the understanding between the borrower and lender or (2) if no understanding exists, the lender's estimate of the period of time over which the loan will remain outstanding; any unamortized amount shall be recognized when the loan is paid in full.

b. For revolving lines of credit (or similar loan arrangements), the net fees or costs shall be recognized in income on a straight-line basis over the period the revolving line of credit is active, assuming that borrowings are outstanding for the maximum term provided in the loan contract.

If the borrower pays all borrowings and cannot reborrow under the contract, any unamortized net fees or costs shall be recognized in income upon payment. The interest method shall be applied to recognize net unamortized fees or costs when the loan agreement provides a schedule for payment and no additional borrowings are provided for under the agreement.[8]

[8] For example, if the loan agreement provides the borrower with the option to convert a one-year revolving line of credit to a five-year term loan, during the term of the revolving line of credit the lender would recognize the net fees or costs as income on a straight-line basis using the combined life of the revolving line of credit and term loan. If the borrower elects to convert the line of credit to a term loan, the lender would recognize the unamortized net fees or costs as an adjustment of yield using the interest method. If the revolving line of credit expires and borrowings are extinguished, the unamortized net fees or costs would be recognized in income upon payment.

30. FAS 125 provides the following guidance:

28. To be substantially the same,[9] the asset that was transferred and the asset that is to be repurchased or redeemed need to have all of the following characteristics:

a. The same primary obligor (except for debt guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and the terms of the guarantee must be the same)
b. Identical form and type so as to provide the same risks and rights
c. The same maturity (or in the case of mortgage-backed pass-through and pay-through securities have similar remaining weighted-average maturities that result in approximately the same market yield)
d. Identical contractual interest rates
e. Similar assets as collateral
f. The same aggregate unpaid principal amount or principal amounts within accepted "good delivery" standards for the type of security involved.

[9] In this Statement, the term substantially the same is used consistently with the usage of that term in the *AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position*.

31. *AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position* (SOP 90-3) provides the following guidance:

> .13 To minimize diversity in practice, the AICPA Banking Committee, Savings and Loan Associations Committee, and Stockbrokerage and Investment Banking Committee believe the definition of substantially the same should be narrow. Therefore, the committees have concluded that for debt instruments, including mortgage-backed securities, to be substantially the same, all the following criteria must be met:
>
> a. The debt instruments must have the same primary obligor, except for debt instruments guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and terms of the guarantee must be the same.[1]
>
> b. The debt instruments must be identical in form and type so as to give the same risks and rights to the holder.[2]
>
> c. The debt instruments must bear the identical contractual interest rate.
>
> d. The debt instruments must have the same maturity except for mortgage-backed pass-through and pay-through securities for which the mortgages collateralizing the securities must have similar remaining weighted average maturities (WAMs) that result in approximately the same market yield.[3]
>
> e. Mortgage-backed pass-through and pay through securities must be collateralized by a similar pool of mortgages, such as single-family residential mortgages.
>
> f. The debt instruments must have the same aggregate unpaid principal amounts, except for mortgage-backed pass-through and pay-through securities, where the aggregate principal amounts of the mortgage-backed securities given up and the mortgage-backed securities reacquired must be within the accepted "good delivery" standard for the type of mortgage-backed security involved.[4]
>
> [1] The exchange of pools of single-family loans would not meet this criterion because the mortgages comprising the pool do not have the same primary obligor, and would therefore not be considered substantially the same.
>
> [2] For example, the following exchanges would not meet this criterion: GNMA I securities for GNMA II securities; loans to foreign debtors that are otherwise the same except for different U.S. foreign tax credit benefits (because such differences in the tax receipts associated with the loans result in instruments that vary "in form and type"); commercial paper for redeemable preferred stock.
>
> [3] For example, the exchange of a "fast-pay" GNMA certificate (that is, a certificate with underlying mortgage loans that have a high prepayment record) for a "slow-pay" GNMA certificate would not meet this criterion because differences in the expected remaining lives of the certificates result in different market yields.

[4] Participants in the mortgage-backed securities market have established parameters for what is considered acceptable delivery. These specific standards are defined by the Public Securities Association (PSA) and can be found in Uniform Practices for the Clearance and Settlement of Mortgage-Backed Securities and Other Related Securities, which is published by PSA.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies*, Chapter 1, Bonds and Loaned Backed and Structured Securities
- *Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies*, Chapter 1, Bonds and Loan Backed and Structured Securities
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 73—Nonmonetary Transactions*
- *Issue Paper No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements*
- *Purposes and Procedures Manual of the NAIC Securities Valuation Office*

Generally Accepted Accounting Principles

- *FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*
- *FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities*
- *FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
- *AICPA SOP 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as used In Certain Audit Guides and a Statement of Position*
- *AICPA SOP 90-11, Disclosure of Certain Information by Financial Institutions About Debt Securities Held as Assets*
- *AICPA Practice Bulletin No. 4, Accounting for Foreign Debt/Equity Swaps*
- *FASB Emerging Issues Task Force No. 89-18, Divestitures of Certain Investment Securities to an Unregulated Commonly Controlled Entity under FIRREA*
- *FASB Emerging Issues Task Force No. 96-10, Impact of Certain Transactions on Held-to-Maturity Classifications Under FASB Statement No. 115*

State Regulations

- No additional guidance obtained from state statutes or regulations.

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Statutory Issue Paper No. 27

Disclosure of Information about Financial Instruments with Concentration of Credit Risk

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 27

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. In the normal course of business, insurance enterprises enter into transactions involving investment contractual relationships which include but are not limited to time deposits, short-term investments, bonds, preferred stocks, mortgage loans, deposit accounts and notes payable, collectively called financial instruments. Many of these transactions can result in concentrations of credit risks in that significant fluctuations in one area of a financial market could result in material adverse financial consequences to an insurance enterprise. With certain exceptions, current statutory guidance does not require financial statement disclosure of financial instruments with concentration of credit risk. GAAP has specific disclosure requirements for financial instruments which have concentration of credit risk. This issue paper establishes statutory accounting principles for disclosure of financial instruments with concentration of credit risk that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

2. Except as noted in paragraph 14 of *FASB Statement No. 105*, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* (FAS 105), (included in the Relevant GAAP Guidance section of this Issue Paper), a reporting entity shall disclose all significant concentrations of credit risk arising from all financial instruments whether from an individual or group. Group concentrations of credit risk exist if a number of individuals or groups are engaged in similar activities and have similar economic characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic or other conditions. The following shall be disclosed in the notes to the financial statements about each significant concentration:

a. Information about the (shared) activity, region, or economic characteristic that identifies the concentration

b. The amount of the accounting loss due to credit risk the entity would incur if parties to the financial instruments that make up the concentration failed completely to perform according to the terms of the contracts and the collateral or other security, if any, for the amount due proved to be of no value to the entity

c. The entity's policy of requiring collateral or other security to support financial instruments subject to credit risk, information about the entity's access to that collateral or other security, and the nature and a brief description of the collateral or other security supporting those financial instruments.

DISCUSSION

3. The conclusion above adopts the provisions of FAS 105 as its relates to financial instruments with concentrations of credit risk (paragraphs 14 and 20). Disclosure of information about financial instruments with off-balance-sheet risk relating to derivative financial instruments is covered in *Issue Paper No. 85—Derivative Instruments* (Issue Paper No. 85) which contains all of the disclosure requirements for derivatives.

4. The Statement of Concepts states that *"Because these basic financial statements cannot be expected to provide all of the information necessary to evaluate an entity's short-term and long-term stability, management must supplement the financial statements with sufficient disclosures (e.g., notes to the financial statements, management's discussion and analysis, and supplementary schedules and exhibits) to assist financial statement users in evaluating the information provided."* Disclosures of financial instruments with concentration of credit risk is consistent with that objective.

5. The following represent examples where disclosure of concentration of credit risk may be warranted. These examples are not intended to be all inclusive.

a. Entities which invest in mortgage loans wherein a substantial portion of the loans are in farms and the debtors' ability to honor the contract is dependent upon the agribusiness economic sector.

b. Entities investing in mortgage loans wherein a substantial portion of the loans are located in one geographic region and the debtors' ability to honor the contract is dependent upon the economic stability of that region.

Drafting Notes/Comments

- Disclosure of information about financial instruments with off-balance-sheet risk is covered in *Issue Paper No. 85—Derivative Instruments*.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

6. There is no statutory guidance on disclosures about concentrations of credit risk. However, the NAIC Annual Statement Instructions for Life and Accident and Health and for Property and Casualty Insurance Companies require information about the geographic location of certain investments which provides some information about concentrations of credit risk (e.g. Schedule B on mortgage).

Generally Accepted Accounting Principles

7. FAS 105 discusses disclosure of concentration of credit risk as follows:

> 6. A financial instrument is cash, evidence of an ownership interest in an entity, or a contract that both:
>
> a. Imposes on one entity a contractual obligation[1] (1) to deliver cash or another financial instrument[2] to a second entity or (2) to exchange financial instruments on potentially unfavorable terms with the second entity

[1] Contractual obligations encompass both those that are conditioned on the occurrence of a specified event and those that are not. All contractual obligations that are financial instruments meet the definition of liability set forth in *FASB Concepts Statement No. 6, Elements of Financial Statements*, although some may not be recognized as liabilities in financial statements—may be "off-balance-sheet" —because they fail to meet some other criterion for recognition. For some financial instruments, the obligation is owed to or by a group of entities rather than a single entity.

[2] The use of the term financial instrument in this definition is recursive (because the term financial instrument is included in it), but it is not circular. It requires a chain of contractual obligations that ends with the delivery of cash or an ownership interest in an entity. Any number of obligations to deliver financial instruments can be links in a chain that qualifies a particular contract as a financial instrument.

b. Conveys to that second entity a contractual right[3] (1) to receive cash or another financial instrument from the first entity or (2) to exchange other financial instruments on potentially favorable terms with the first entity.

[3] Contractual rights encompass both those that are conditioned on the occurrence of a specified event and those that are not. All contractual rights that are financial instruments meet the definition of asset set forth in Concepts Statement 6, although some may not be recognized as assets in financial statements—may be "off-balance-sheet"--because they fail to meet some other criterion for recognition. For some financial instruments, the obligation is held by or due from a group of entities rather than a single entity.

7. The risk of accounting loss[4] from a financial instrument includes (a) the possibility that a loss may occur from the failure of another party to perform according to the terms of a contract (credit risk), (b) the possibility that future changes in market prices may make a financial instrument less valuable or more onerous (market risk),[5] and (c) the risk of theft or physical loss. This statement addresses credit and market risk only.

[4] Accounting loss refers to the loss that may have to be recognized due to credit and market risk as a direct result of the rights and obligations of a financial instrument.

[5] A change in market price may occur (for example, for interest-bearing financial instruments) because of changes in general interest rates (interest rate risk), changes in the relationship between general and specific market interest rates (an aspect of credit risk), or changes in the rates of exchange between currencies (foreign exchange risk).

8. Some financial instruments are recognized as assets, and the amount recognized reflects the risk of accounting loss to the entity. A receivable that is recognized and measured at the present value of future cash inflows, discounted at the historical interest rate (often termed amortized cost), is an example: the accounting loss that might arise from that account receivable cannot exceed the amount recognized as an asset in the statement of financial position.[6]

[6] It is possible that an economic loss could exceed that amount if, for example, the current market value of an asset was higher than the amount recognized in the statement of financial position. This Statement, however, does not address that economic loss.

12. This Statement requires disclosure of information about financial instruments that have off-balance-sheet risk and about financial instruments with concentrations of credit risk except as specifically modified by paragraphs 14 and 15. It does not change any requirements for recognition, measurement, or classification of financial instruments in financial statements.

14. The requirements of paragraphs 17, 18, and 20 do not apply to the following financial instruments, whether written or held:

a. Insurance contracts, other than financial guarantees and investment contracts, as discussed in *FASB Statements No. 60, Accounting and Reporting by*

Insurance Enterprises, and *No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*

b. Unconditional purchase obligations subject to the disclosure requirements of *FASB Statement No. 47, Disclosure of Long-Term Obligations*[9]

[9] Unconditional purchase obligations not subject to the requirements of Statement 47 are included in the scope of this Statement. That is, unconditional purchase obligations that require the purchaser to make payment without regard to delivery of the goods or receipt of benefit of the services specified by the contract and are not within the scope of Statement 47 (because they were not negotiated as part of a financing arrangement, for example) are included in the scope of this Statement.

c. Employers' and plans' obligations for pension benefits, postretirement health care and life insurance benefits, employee stock option and stock purchase plans, and other forms of deferred compensation arrangements, as defined in *FASB Statements No. 35, Accounting and Reporting by Defined Benefit Pension Plans, No. 87, Employers' Accounting for Pensions, No. 81, Disclosure of Postretirement Health Care and Life Insurance Benefits, No.43, Accounting for Compensated Absences,* as well as *APB Opinions No. 25, Accounting for Stock Issued to Employees*, and *No. 12, Omnibus Opinion--1967*

d. Financial instruments of a pension plan, including plan assets, when subject to the accounting and reporting requirements of Statement 87.[10]

[10] Financial instruments of a pension plan, other than the obligations for pension benefits, when subject to the accounting and reporting requirements of Statement 35 are included in the scope of this Statement.

e. Substantively extinguished debt subject to the disclosure requirements of *FASB Statement No. 76, Extinguishment of Debt*, and any assets held in trust in connection with an in-substance defeasance of that debt.

16. Generally accepted accounting principles contain specific requirements to disclose information about the financial instruments noted in paragraphs 14 and 15, and this Statement does not change those requirements. For all other financial instruments, the requirements in this Statement are in addition to other disclosure requirements prescribed by generally accepted accounting principles.

Disclosure of Concentrations of Credit Risk of All Financial Instruments

20. Except as noted in paragraph 14, an entity shall disclose all significant concentrations of credit risk arising from all financial instruments, whether from an individual counterparty or groups of counterparties. Group concentrations of credit risk exist if a number of counterparties are engaged in similar activities and have similar economic characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic or other conditions. The following shall be disclosed about each significant concentration:

a. Information about the (shared) activity, region, or economic characteristic that identifies the concentration.

b. The amount of the accounting loss due to credit risk the entity would incur if parties to the financial instruments that make up the concentration failed completely to perform according to the terms of the contracts and the collateral or other security, if any, for the amount due proved to be of no value to the entity.

c. The entity's policy of requiring collateral or other security to support financial instruments subject to credit risk, information about the entity's access to that collateral or other security, and the nature and a brief description of the collateral or other security supporting those financial instruments.

8. Paragraphs 9, 10, 11, 13, 15, 17, 18, and 19 of FAS 105 have been deleted from this section as they deal with Off-Balance sheet risk which will be addressed in Issue Paper No. 85.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- NAIC *Annual Statement Instructions for Life and Accident and Health and for Property and Casualty Insurance Companies*

Generally Accepted Accounting Principles

- *FASB Statement No. 105*, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*

State Regulations

- No additional guidance obtained from state statutes or regulations.

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Statutory Issue Paper No. 28

Short-Term Investments

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 2

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Short-term investments are investments which generally are in the form of bonds, commercial paper, money market instruments, repurchase agreements, and collateral and mortgage loans, whose maturity dates (or repurchase dates) at the time of acquisition were one year or less. Current statutory accounting guidance requires short-term investments to be carried in the same manner as similar long-term investments. Any premium or discount is amortized on a straight-line basis through the maturity date of the investment. This is different from GAAP which does not have the classification of short-term investments.

2. The purpose of this issue paper is to define short-term investments and to establish statutory accounting principles and related reporting that is consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

3. All investments with remaining maturities (or repurchase dates under repurchase agreements) of one year or less at the time of acquisition (excluding those investments classified as cash equivalents as defined in *Issue Paper No. 2—Definition of Cash* (Issue Paper No. 2)) shall be considered short-term investments. Short-term investments include, but are not limited to, bonds, commercial paper, money market instruments, repurchase agreements, and collateral and mortgage loans which meet the above criteria. Short-term investments shall not include certificates of deposit with contractual maturities of one year or less at the time of acquisition. In accordance with Issue Paper No. 2, these investments shall be classified as cash.

4. All short-term investments shall be accounted for in the same manner as similar long-term investments. Investments in money market funds shall be reported in accordance with the guidance in the Procedures for Valuing Common Stocks and Stock Warrants section of the *Purposes and Procedures Manual of the NAIC Securities Valuation Office*.

5. The following disclosures shall be made for short-term investments in the notes to the financial statements:

a. Fair values in accordance with *Issue Paper No. 33—Disclosures about Fair Value of Financial Instruments;*

b. Concentrations of credit risk in accordance with *Issue Paper No. 27—Disclosure of Information about Financial Instruments with Concentration of Credit Risk*;

c. Basis at which the short-term investments are stated.

DISCUSSION

6. The conclusion above rejects *FASB Statement No. 115*, *Accounting for Certain Investments in Debt and Equity Securities* (FAS 115), for those securities which have maturities of one year or less from the date of acquisition. The conclusion above is consistent with existing statutory guidance.

7. The above conclusion requires separate classification of those investments held by a reporting entity which have maturity dates of one year or less at the time of their acquisition from those with maturity dates of over one year at acquisition. The Statement of Concepts states that "*the cornerstone of solvency measurement is financial reporting. Therefore, the regulator's ability to effectively determine relative financial condition using financial statements is of paramount importance to the protection of policyholders.*"

8. GAAP classifies securities with original maturities of ninety days or less as cash equivalents and those over ninety days in one of the following categories in accordance with FAS 115: 1) trading; 2) available-for-sale; 3) held-to-maturity. Issue Paper No. 2 defines cash as "*a medium of exchange that a bank will accept for deposit and allow an immediate credit to the depositor's account*." Moreover, statutory accounting guidance does not recognize the GAAP classification of investments contained in FAS 115.

9. Negotiable certificates of deposit with a contractual maturity of one year or less at acquisition will no longer be classified as short-term investments. This change was made to address inconsistencies in the guidance between the Accounting Practices and Procedures Manuals for Property and Casualty Insurance Companies and Life and Accident and Health Insurance Companies (P&C and Life/A&H Accounting Practices and Procedures Manuals) and the *Purposes and Procedures Manual of the NAIC Securities Valuation Office* (SVO Purposes and Procedures). The P&C and Life/A&H Accounting Practices and Procedures Manuals require all nonnegotiable certificates of deposit to be classified as cash and negotiable certificates of deposit to be classified as short-term investments or bonds depending on the length to maturity at acquisition. The SVO Purposes and Procedures requires both negotiable and nonnegotiable certificates of deposit to be submitted to the SVO and valued under the general provisions for valuing bonds.

Drafting Notes/Comments

- Bonds and other long-term investments are addressed in separate issue papers.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

10. Statutory accounting guidance is contained in the P&C and Life/A&H Accounting Practices and Procedures Manuals, Chapter 5, *Cash and Short-term Investments*. Chapter 5 states:

> Short-term Investments
>
> Short-term investments are generally in the form of bonds, commercial paper, money market instruments, repurchase agreements, or collateral and mortgage loans whose maturities (or repurchase dates under repurchase agreements) at time of acquisition were one year or less.
>
> The accounting for short-term investments is the same as for similar long-term investments except that the method of accrual and amortization is always straight line and the assets are always valued at book value or market value.

11. Guidance for investments in money market funds is contained in the SVO Purposes and Procedures. Section 5(A) - Procedures for Valuing Common Stocks and Stock Warrants, states:

Shares of mutual funds, except for certain money market funds as defined by 17 CFR 270.2a-7 under the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.) and further defined in section 5(A)(a)(i) and 5(A)(a)(ii), regardless of the types or mix of securities owned (bonds, stock, money market instruments, or other type of investments) by the fund, are considered to be common shares which should be reported on Schedule D-Part 2-Section 2.

(i) A money market fund shall not require a reserve if the fund meets all of the following conditions:

(1) The fund shall maintain a money market fund rating in the highest category from an SVO recognized rating agency; and

(2) The fund shall maintain a constant net asset value per share at all times; and

(3) The Fund shall allow a maximum of seven day redemption of proceeds; and

(4) (a) The fund shall invest 100% of its total assets in U.S. treasury bills, notes, and bonds and collateralized repurchase agreements comprised of those obligations at all times (see Section 5(F) for a list of qualifying Funds), or

(b) The fund shall invest 100% of its total assets in certain securities listed in Section 6(B)(g)(i) and collateralized repurchase agreements comprised of those obligations at all times (see Section 5(G) for a list of qualifying Funds).

(ii) A money market fund shall establish a reserve using the bond class one reserve factor if the fund meets all of the following conditions:

(1) The fund shall invest at least 95% of its total assets in exempt securities listed in Section 6A(a), short-term debt instruments with a maturity of 397 days or less, class one bonds, and collateralized repurchase agreements comprised of those securities at all times (see Section 5(H) for a list of qualifying Funds): and

(2) The fund shall maintain a money market fund rating in the highest category by an SVO approved rating agency: and

(3) The fund shall maintain a constant net asset value per share at all times: and

(4) The fund shall allow a maximum of seven day redemption of proceeds:

(iii) A money market fund which qualifies for reserve exemption pursuant to Section 5(A)(a)(i) or inclusion in the bond class one reserve category pursuant to Section 5(A)(a)(ii) shall be reported on Schedule DA-Part 1.

(iv) In order to qualify for a reserve exemption pursuant to Section 5(A)(a)(i) or inclusion in the bond class one reserve category pursuant to Section 5(A)(a)(ii), a money market fund shall submit documentation on forms provided by the SVO staff. The forms shall include sufficient information to demonstrate compliance with the above requirements.

(v) In order to maintain the qualifications for exemption or inclusion in the bond class one reserve category, the fund shall report annually, current fund information to the SVO staff by November 15. In addition, the fund shall report to the SVO any change in investment policy which requires notice to shareholders.

12. Section 2(C)(7) of the SVO Purposes and Procedures indicates the following requirements for certificates of deposit: "Certificates of Deposit (negotiable and non-negotiable) will be considered under the general provisions of Section 2(B)."

Generally Accepted Accounting Principles

13. GAAP does not make the distinction between short-term and long-term investments. All investments in equity securities that have readily determinable fair values and all investments in debt securities follow FAS 115, which states:

a. Debt and equity securities that the enterprise has the positive intent and ability to hold to maturity are classified as held-to-maturity securities and reported at amortized cost.

b. Debt and equity securities that are bought and held principally for the purpose of selling them in the near term are classified as trading securities and reported at fair value, with unrealized gains and losses included in earnings.

c. Debt and equity securities not classified as either held-to-maturity securities or trading securities are classified as available-for-sale securities and reported at fair value, with unrealized gains and losses excluded from earnings and reported in a separate component of shareholders' equity.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 5, *Cash and Short-term Investments*
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 5, *Cash and Short-term Investments*
- *Issue Paper No. 2—Definition of Cash*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Purposes and Procedures Manual of the NAIC Securities Valuation Office*, Section 2 and Section 5

Generally Accepted Accounting Principles

- *FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities*

State Regulations

- No additional guidance obtained from state statutes or regulations.

Statutory Issue Paper No. 29

Prepaid Expenses (excluding deferred policy acquisition costs and other underwriting expenses, income taxes and guaranty fund assessments)

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 29

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. A prepaid expense is an amount which has been paid in advance of receiving future economic benefits anticipated by the payment. Current statutory accounting guidance requires prepaid expenses to be recorded as nonadmitted assets. This conflicts with the GAAP treatment which states that prepaid expenses are to be recorded as assets and expensed over the period that the benefits are received from the payment.

2. The purpose of this paper is to establish statutory accounting principles for the accounting for prepaid expenses that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

3. Prepaid expenses generally meet the definition of an asset in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets* (Issue Paper No. 4). Such expenditures also meet the criteria defining nonadmitted assets as specified in Issue Paper No. 4 (i.e. the assets are not readily available to satisfy policyholder obligations). Prepaid expenses shall be reported as nonadmitted assets and charged against unassigned funds (surplus). They shall be amortized against net income as the estimated economic benefit expires. In accordance with the reporting entity's capitalization policy, immaterial prepaid expenses may be expensed when purchased.

DISCUSSION

4. The conclusion above is consistent with the definition of nonadmitted assets as noted in Issue Paper No. 4. which defines an asset as "*probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.*" Issue Paper No. 4 further states that an asset that is not readily available to satisfy policyholder obligations shall be reported as a nonadmitted asset. Prepaid expenses meet the definition of a assets as they represent future economic benefits obtained as a result of past transactions. Additionally, prepaid expenses meet the definition of nonadmitted assets because they are not readily available to satisfy policyholder obligations.

Drafting Notes/Comments

- Guaranty fund assessments are addressed in *Issue Paper No. 35—Accounting for Guaranty Fund and Other Assessments.*
- Accounting for income taxes is addressed in *Issue Paper No. 83—Accounting for Income Taxes*.
- Deferred policy acquisition costs and other underwriting expenses are addressed in *Issue Paper No. 71—Policy Acquisition Costs and Commissions*.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

5. Chapter 9, *Nonadmitted Assets*, in the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies includes "other prepaid expenses" in its list of "Common Examples" of nonadmitted assets. Chapter 9, *Nonadmitted Assets*, in the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies contains similar wording.

6. Many states also include prepaid expenses as nonadmitted assets. An example is the Regulations of the Alabama Insurance Department, Regulation No. 18, *Admissibility of Assets*, which states "*Admitted assets, for example, will not include such items as furniture and fixtures, automobiles, supplies, prepaid expenses...*".

7. Some states nonadmit most prepaid expenses but allow particular prepaid expenses to be recorded as admitted assets. An example is the Virginia Insurance Laws, Title 38.2 - Insurance, Chapter 13, *Reports, Reserves and Examination, Insurance Holding Companies*, Article 2. Valuation and Admissibility of Assets which nonadmits "*prepaid and deferred expenses except prepaid property taxes*."

Generally Accepted Accounting Principles

8. *Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins, Chapter 3, Working Capital*, states:

> 4. For accounting purposes, the term current assets is used to designate cash and other assets or resources commonly identified as those which are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the business. Thus the term comprehends in general such resources as...(g) prepaid expenses such as insurance, interest, rents, taxes, unused royalties, current paid advertising service not yet received, and operating supplies.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 9, *Nonadmitted Assets*
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 9, *Nonadmitted Assets*

Generally Accepted Accounting Principles

- *Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins, Chapter 3, Working Capital*
- *AICPA Practice Bulletin No. 13, Direct-Response Advertising and Probable Future Benefits*
- *AICPA Statement of Position 93-7, Reporting on Advertising Costs*
- *FASB Emerging Issues Task Force No. 88-23, Lump-Sum Payments under Union Contracts*

State Regulations

- Virginia Insurance Laws, Title 38.2 - Insurance, Chapter 13, *Reports, Reserves and Examination, Insurance Holding Companies*, Article 2. Valuation and Admissibility of Assets
- Regulations of the Alabama Insurance Department, Regulation No. 18, *Admissibility of Assets*

Statutory Issue Paper No. 30

Investments in Common Stock (excluding investments in common stock of subsidiary, controlled, or affiliated entities)

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 30

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory guidance pertaining to the valuation of and accounting for common stock is contained in the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies. That guidance also established the NAIC's Securities Valuation Office (SVO) as the primary authority for the valuation of common stocks. The purpose of this issue paper is to establish statutory accounting principles for common stocks, including those loaned under a securities lending agreement, which are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

2. Accounting for investments in common stock of subsidiaries, controlled or affiliated entities (investments in affiliates) will be addressed in a separate issue paper.

SUMMARY CONCLUSION

3. For purposes of statutory accounting, common stocks (excluding investments in affiliates) are securities which represent a residual ownership in a corporation and shall include:

a. Publicly traded common stocks.

b. Master limited partnerships trading as common stock and American deposit receipts only if the security is traded on the New York, American, or NASDAQ exchanges.

c. Publicly traded common stock warrants.

d. Shares of mutual funds, except for certain money market funds and Class 1 Bond Funds as designated in the *Purposes and Procedures Manual of the NAIC Securities Valuation Office*, regardless of the types or mix securities owned by the fund (e.g., bonds, stock, money market instruments, or other type of investments).

e. Common stocks that are not publicly traded.

f. Common stocks that are restricted as to transfer of ownership. Restricted stock shall be defined as a security for which sale is restricted by governmental or contractual requirement (other than in connection with being pledged as collateral) except where that requirement terminates within one year or if the holder has the power by contract or otherwise to cause the requirement to be met within one year. Any portion of the security that can be reasonably expected to qualify for sale within one year is not considered restricted.

4. Common stocks meet the definition of assets as defined in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this paper.

5. Common stock acquisitions and dispositions shall be recorded on the trade date. Private placement stock transactions shall be recorded on the funding date.

6. Dividends on common stock shall be recorded as investment income on the ex-dividend date with a corresponding receivable to be extinguished upon receipt of cash (i.e., dividend income shall be recorded on stocks declared to be ex-dividends on or prior to the statement date). For reporting entities required to maintain an Asset Valuation Reserve (AVR), the accounting for realized capital gains and losses on sales of common stock shall be in accordance with *Issue Paper No. 7—Asset Valuation Reserve and Interest Maintenance Reserve* (Issue Paper No. 7). For reporting entities not required to maintain an AVR, realized gains and losses on sales of common stock shall be reported as realized gains/losses in the statement of operations.

7. At acquisition, common stocks shall be reported at their cost, including brokerage and other related fees. At each reporting date, investments in common stocks shall be valued and reported in accordance with the *Purposes and Procedures Manual of the NAIC Securities Valuation Office*. In those instances where fair market value is not available from the SVO, it is the responsibility of management to determine market value based on analytical or pricing mechanisms. For reporting entities required to maintain an AVR, the accounting for unrealized capital gains and losses shall be in accordance with Issue Paper No. 7. For reporting entities not required to maintain an AVR, unrealized capital gains and losses shall be recorded as a direct credit or charge to surplus.

8. For any decline in the fair value of a common stock which is determined to be other than temporary, the common stock shall be written down to fair value as the new cost basis and the amount of the write down shall be accounted for as a realized loss. For those reporting entities required to maintain an AVR, realized losses shall be accounted for in accordance with Issue Paper No. 7. Subsequent fluctuations in market value shall be recorded as unrealized gains or losses. Future declines in market value which are determined to be other than temporary, shall be recorded as realized losses. A decline in fair value which is other than temporary includes situations where a reporting entity has made a decision to sell a security at an amount below its carrying value (association value). This is consistent with *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets.*

9. An investor can subscribe for the purchase of stock, but not be required to make payment until a later time. Transactions of this nature are common in the formation of corporations. Common stock acquired under a subscription represents a conditional transaction in a security authorized for issuance but not yet actually issued. Such transactions are settled if and when the actual security is issued and the exchange or National Association of Securities Dealers (NASD) rules that the transactions are to be settled. Common stock acquired under a subscription shall be recorded as an admitted asset when the reporting entity or its designated custodian or transfer agent takes delivery of the security and the security is recorded in the name of the reporting entity or its nominee (i.e., the accounting for such common stock acquisitions shall be on the settlement date).

Loaned Stock

10. When stocks are loaned, they remain assets of the reporting entity and are not removed from the accounting records as the reporting entity remains the owner of the stocks. When collateral is provided for the general use of the reporting entity, the asset is recorded and the admissibility of the asset is determined as if the reporting entity owned the collateral asset. A liability for the return of that collateral must be established. When collateral not available for the general use of the reporting entity is provided, it should not be recognized as an asset of the reporting entity. When non-cash collateral is provided, the

current market value of that collateral must be used to determine adequacy of the collateral held relative to the current market value of the loaned stocks/securities.

Stock Splits, Stock Dividends, Payment in Kind Dividends, and Stock Exchanges

11. Stock splits, stock dividends, payment in kind dividends and stock exchanges shall be accounted for in accordance with *Issue Paper No. 73—Nonmonetary Transactions*.

Disclosures

12. The following disclosures shall be made for common stocks in the notes to the financial statements.

a. Basis at which the common stocks are stated.

b. If the reporting entity has entered into securities lending transactions, its policy for requiring collateral, a description of any loaned common stocks, including the amount, description of the collateral and whether or not the collateral is restricted.

c. A description, as well as the amount, of common stock that is restricted and the nature of the restriction.

DISCUSSION

13. The statutory accounting principles described in paragraphs 3-7 and in paragraph 10 above are consistent with current statutory accounting guidance for common stocks. This issue paper rejects the accounting principles set forth in *FASB Statement No. 115*, *Accounting for Certain Investments in Debt and Equity Securities* (FAS 115). The statutory accounting principles described above add additional conservatism to existing statutory guidance by adopting the concept of other than temporary declines and requiring those be charged to realized losses (paragraph 8) and requiring that certain common stock transactions not be recorded until settlement date (paragraph 9).

14. This issue paper adopts paragraphs 9-12, 15, 17, 23-31 and 61-65 of *FASB Statement No. 125*, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 125*)* as they relate to common stock. The guidance on loaned securities in this issue paper is drafted under the general rule that securities lending transactions do not meet the criteria for surrender of control necessary to classify the transaction as a sale. If the criteria in paragraph 9 of FAS 125 regarding surrender of control are met, the transaction shall be accounted for by the transferor as a sale of the "loaned" securities.

15. Paragraph 14 of FAS 125 is rejected as it relates to the classifications of securities under FAS 115. FAS 115 was rejected in *Issue Paper No. 26—Bonds, excluding Loan-Backed and Structured Securities*.

16. The statutory accounting principles outlined in the conclusion above are consistent with the concept of recognition in the Statement of Concepts. Pertinent excerpts follow:

> Recognition
>
> The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which are unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet but rather should be charged against surplus when acquired or when availability becomes questionable.

Drafting Notes/Comments

- Accounting for common stock holdings of subsidiary, controlled and affiliated entities is addressed in *Issue Paper No. 46—Accounting for Investments in Subsidiary, Controlled and Affiliated Entities*.
- Investment income due and accrued is addressed in *Issue Paper No. 34—Investment Income Due and Accrued*.
- Accounting for the Asset Valuation Reserve (AVR) equity component required for common stock holdings will be addressed in *Issue Paper No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*.
- Securities not yet valued by the SVO will follow SVO procedures for valuing such securities as being drafted by the SVO as directed by the Invested Asset Working Group of the Valuation of Securities (EX4) Task Force.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

17. The Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies provides guidance with respect to common stock (similar guidance is also in the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies). Pertinent excerpts are as follows:

> Shares of capital stock represent units of ownership in a corporation, including common and preferred stock, mutual fund shares, transferable savings and loan association shares, warrants, and options to purchase stock. A return on stock held for investment is generally in the form of cash dividends which are paid to the owner. Occasionally, dividends are paid in the form of additional shares of stock. Liquidation of stock investments may give rise to capital gains or losses. (Investment in stock of parents, subsidiaries or affiliates is discussed in Chapter 6.)
>
> Common stockholders are the residual owners of the corporation and assume the ultimate risk associated with ownership up to the limit of their investment. They are usually entitled to voting powers of ownership. At liquidation, their claim to assets is after those of creditors and preferred stockholders. Common stockholders may liquidate their ownership rights in a corporation by selling their shares in the secondary market.
>
> Valuation
>
> Common and preferred stocks are generally required to be reported at the value published in the Valuations of Securities manual published by the NAICs Valuation of Securities Task Force at the end of each year. This value is the subcommittee's determination of "market" for each listed stock.
>
> The valuation of stock purchase warrants, stock purchase options that may be exercised on December 31 of the year for which the annual statement is being prepared, loaned securities, and investments in subsidiaries shall be in accordance with the practices and procedures prescribed by the NAIC and the state of domicile.
>
> Securities not listed in the manual, securities listed with no value because insufficient information for valuation was submitted to the Valuation of Securities Task Force, and restricted stock require the determination of an acceptable value. Insurance companies are required to submit sufficient information on these securities to the NAIC Securities Valuation Office to permit them to determine market value.

Dividends

Dividends are usually recorded in the general ledger on a cash basis. Dividends receivable on qualified shares of stock are generally permitted as admitted assets to the extent that the dividend has been excluded from the determination of the market price of the holding (i.e., on stock selling ex-dividend). Dividends receivable are included in "Investment Income Due and Accrued" in the annual statement. The asset is developed by a determination of the dividend status of each stock investment at the balance sheet date. Thus, dividend income on stock for any period consists of dividends collected during the year and the change in the declared but unpaid dividends between the beginning and end of the period.

The *Valuations of Securities* manual has a complete listing of all stocks that are traded "ex-dividend" at the end of the year. An ex-dividend stock is one in which the issuing company has closed its stock ledger on a certain date and has declared a dividend payable to the stockholder of record, even though the stock may have been sold after the record date but prior to the payment date. The association value of ex-dividend stock includes no value for the dividend since the unpaid dividend does not transfer with ownership of the stock. The listing of ex-dividend stock contains the declared dividend rate for calculating the declared but unpaid dividends that are allowable for each stock owned by the company on the dividend record date.

Loaned Stock

Where the law or regulation of the insurer's state of domicile does not prohibit such activity, stock may be loaned to authorized securities broker/dealer or to authorized financial institutions.

Securities lending is conducted through open-ended agreements, which may be terminated on short notice by the lender or borrower. Securities loans are collateralized by cash and/or cash equivalents, and securities issued by the U.S. Government or its agencies. Securities lending transactions may be negotiated directly between an insurer and a borrower, or indirectly through an insurer's custodian/agent and a borrower.

When stocks are loaned, they remain assets of the insurance company and are not removed from the accounting records as the insurance company remains the owner of the stocks. When cash collateral is provided and it is deposited for the general use of the company, it becomes an asset of the company, and a liability for the return of that collateral must be established.

When non-cash collateral not available for the general use of the company is provided, it should not be recognized as an asset of the company. If balance sheet accounts are used for non-cash collateral control purposes, a contra account should be used to neutralize or zero out the balance sheet account so that no net asset value is reported in the assets of the insurance company. When non-cash collateral is used, current market value of that collateral must be used to determine adequacy of the collateral held relative to the current market value of the loaned stocks/securities.

As stated in the NAIC Valuations of Securities manual, the minimum collateral on securities loaned is 102% of the market value of loaned stocks. The value of collateral will at times exceed or go below 102% of the market value of securities loaned due to daily market fluctuations in both the stocks loaned and collateral. A daily "mark to market" or valuation procedure must be in place to ensure that the market value of the collateral never goes below 100% of the market value of securities loaned and that calls for additional collateral to maintain the 102% minimum which should be made on a timely basis.

If the collateral on stocks is denominated in a different currency than the stocks being loaned, the minimum collateral on these securities loaned is 105% of the market value of loaned stocks as noted in the NAIC Valuations of Securities manual. Again, the same daily valuation procedures noted above must be in place to ensure adequate collateral for stocks loaned.

The valuation of the stocks remain unaffected by the loan as long as the amount of collateral is at least equal to the minimum amounts specified above. Failure to hold sufficient collateral may result in the admitted assets value being decreased by the amount of insufficient collateral.

18. The *Purposes and Procedures Manual of the NAIC Securities Valuation Office* - Section 5 - *Procedures for Valuing Common Stocks and Stock Warrants* contains the following guidance:

(A) Common Stocks of Companies Not Classified as Being Subsidiaries, Controlled or Affiliated, Under Section 5(B).

(a) Association values for publicly traded common stocks and warrants, including, where permitted by law or regulation of an insurer's state of domicile, shares against which exchange traded call options are outstanding, and where the requirements of Section 5(C)(1) are met, shall be equal to market value at date of statement, excepting that, where permitted by law or regulation of an insurer's state of domicile, shares loaned to others shall be valued at the market value at date of statement if the Acceptable Collateral, as hereinafter defined, is pledged as security for the loan and except as set forth in the following sentence, the Acceptable Collateral pledged as security is, at the inception of the loan, in an amount equal to 102% of the market value of the loaned shares. In event that foreign shares are the subject of the loan and the denomination of the currency of the Acceptable Collateral is other than the denomination of the currency of the loaned foreign shares, the amount of Acceptable Collateral which shall be pledged shall be an amount equal to 105% of the market value of the loaned shares. A decline in value of the Acceptable Collateral or an increase in the value of the loaned shares during the term of the loan shall not result in disqualification from valuation in accordance with the above if, during the term the loan is outstanding, additional Acceptable Collateral is posted any time the amount of Acceptable Collateral declines to 100% of the market value of the loaned shares (or 102% of the market value or the loaned shares if Acceptable Collateral in an amount equal to 105% was required to be posted at the inception of the loan) in an amount equal to the difference between the 102% or 105% initially required to be posted and 100% or 102%, respectively. For purpose of this provision, Acceptable Collateral shall mean cash and cash equivalents and shall include securities issued by the U.S. Government or its agencies. Any shortfall in the amount of the actual Acceptable Collateral posted and the required 102% or 105%, as applicable, shall be deducted from the otherwise determined statement value.

Shares of mutual funds, except for certain money market funds as defined by 17 CFR 270.2a-7 under the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.) and further defined in section 5(A)(a)(i) and 5(A)(ii), regardless of the types or mix of securities owned (bonds, stock, money market instruments, or other type of investments) by the fund, are considered to be common shares which should be reported on Schedule D-Part 2-Section 2.

(i) A money market fund shall not require a reserve if the fund meets all of the following conditions:

(1) The fund shall maintain a money market fund rating in the highest category from an SVO recognized rating agency; and

(2) The fund shall maintain a constant net asset value per share at all times; and

(3) The Fund shall allow a maximum of seven day redemption of proceeds; and

(4) (a) The fund shall invest 100% of its total assets in U.S. treasury bills, notes, and bonds and collateralized repurchase agreements comprised of those obligations at all times (see Section 5(F) for a list of qualifying Funds), or

(b) The fund shall invest 100% of its total assets in certain securities listed in Section 6(B)(g)(i) and collateralized repurchase agreements comprised of those obligations at all times (see Section 5(G) for a list of qualifying Funds).

(ii) A money market fund shall establish a reserve using the bond class one reserve factor if the fund meets all of the following conditions:

(1) The fund shall invest at least 95% of its total assets in exempt securities listed in Section 6A(a), short-term debt instruments with a maturity of 397 days or less, class one bonds, and collateralized repurchase agreements comprised of those securities at all times (see Section 5(H) for a list of qualifying Funds): and

(2) The fund shall maintain a money market fund rating in the highest category by an SVO approved rating agency: and

(3) The fund shall maintain a constant net asset value per share at all times: and

(4) The fund shall allow a maximum of seven day redemption of proceeds:

(iii) A money market fund which qualifies for reserve exemption pursuant to Section 5(A)(a)(i) or inclusion in the bond class one reserve category pursuant to Section 5(A)(a)(ii) shall be reported on Schedule DA-Part 1.

(iv) In order to qualify for a reserve exemption pursuant to Section 5(A)(a)(i) or inclusion in the bond class one reserve category pursuant to Section 5(A)(a)(ii), a money market fund shall submit documentation on forms provided by the SVO staff. The forms shall include sufficient information to demonstrate compliance with the above requirements.

(v) In order to maintain the qualifications for exemption or inclusion in the bond class one reserve category, the fund shall report annually, current fund information to the SVO staff by November 15. In addition, the fund shall report to the SVO any change in investment policy which requires notice to shareholders.

(b) Association Values for common stocks which are not publicly traded, other than those issued by insurance companies (for which see Section (c) hereunder), shall be determined by the SVO Staff.

(c) Association Values for common stocks which are not publicly traded which are issued by insurance companies will be equal to book value, which shall be calculated as follows: by dividing the amount of its capital and surplus as shown in its last annual statement or subsequent report of examination (excluding from surplus, reserves required by statute and any portion of surplus properly allocable to policyholders, rather than stockholders) less the value (par or redemption value, whichever is the greater) of all of its preferred stock, if any, outstanding, by the number of shares of its common stock issued and outstanding.

(d) The foregoing provisions shall in all cases be subject to the procedures prescribed by state insurance department practices or laws concerning the use of acquisition cost or any other basis for the valuation of stocks of insurance companies.

(B) Common Stocks of Subsidiary, Controlled or Affiliated Companies (*section not included as not relevant to this issue paper*)

(C) Stock Warrants.

(1) Stock Warrants.

All warrants which are exercisable on the date of the Statement shall be valued at Association Value as defined below whether or not physically attached to any other security (See (D), hereunder, for the valuation of warrants exercisable into securities which are restricted as to transferability.)

(a) For publicly traded warrants (other than exchange traded) the Association Value shall be equal to market value.

(b) The Association Value for a warrant having no public market which is currently exercisable into shares of common stock which have no public market shall be the difference resulting from the subtraction from the analytically determined Association Value of the stock of the exercise price for the warrant.

(c) The Association Value for a warrant having no public market which is currently exercisable into shares of common stock which have a counterpart public market but which are themselves restricted shall be the difference resulting from the subtraction from the value of the common shares as determined under the procedures of Section 5(D) below of the exercise price for the warrant.

(d) Warrants having no public market and for which the first exercise date is subsequent to the date of the statement shall have no value for statement purposes.

(D) Common Stocks Having a Public Market Which Are Issued Under an Investment Letter or Are Otherwise Restricted as to Transferability.

Restricted common stocks (which for purposes of this section, are defined as restricted shares of an unaffiliated issuer held for a period of less than three years prior to the date of valuation) shall be valued by insurers in their Annual Statements on a basis which they are prepared to justify to the SVO staff. (Restrictions shall be considered to have expired for common stocks held at least three years prior to the date of valuation, and the regular valuation basis shall apply.) Such values shall be reviewed by the SVO staff as to the reasonableness of the valuation basis used. The results of the SVO staff's review will be made available to insurance departments and upon request to insurers holding said restricted common stocks.

Warrants exercisable into such restricted common stocks will be valued on the same special basis.

All restricted common stocks and warrants exercisable into the same should be appropriately noted in the Annual Statement, as required, in Schedule D- Part 2-Section 2.

Market values, where used in the determination of Association Values carried in the SVO manual, are not intended for use in valuing restricted common stocks, warrants as described in this section. Values for such restricted common stocks, warrants will not be carried in the SVO publication.

(E) Exceptions.

Where required by special conditions the foregoing standards may be varied by the Task Force.

(F) Money Market Funds Filed With The SVO Which Qualify Under Section 5(A)(a)(i)(4)(a)

(listing not included for purposes of this issue paper)

19. Several states have statutes that address valuation of common stocks not listed in the Valuations of Securities manual. In addition, one state clarifies the definition of common stock. See excerpts below:

- Delaware Statutes - Insurance Laws, Title 18 Insurance Code, Part I, Chapter 13 - Investments, Section 1311:

  As used in this section the term "common stock" includes transferable certificates of participation in business trusts.

- Utah Regulations - Utah Administrative Rules, Insurance, R590 Administration, Rule R590-116--Valuation of Assets

  6. Common Stocks.

     a. Common stocks are to be valued at market value. Market value as used for valuation of common stocks means in accordance with the values listed in "Valuation of Securities." For securities which are traded on a registered national securities exchange, but are not listed in that publication, market value may be established at the most recent published trade value. Securities not listed in and not actively traded on a registered national securities exchange shall have a market value in an amount that the insurer can justify to the commissioner.

- Massachusetts Statutes - Insurance Laws, PART I. -- Administration of the Government, TITLE XXII-- Corporations, Chapter 175 -- INSURANCE, Powers and Duties of Commissioner of Insurance, 175:11A - Valuation of securities and other investments

  (A)(1) Investments, shall be valued in accordance with the published valuation standards of the National Association of Insurance Commissioners. Securities investments as to which the National Association of Insurance Commissioners has not published valuation standards in its Valuation of Securities Manual or its successor publication shall be valued as follows:

  (a) All obligations having a fixed term and rate shall, if not in default as to principal and interest, be valued as follows: (i) if purchased at par, at par value; (ii) if purchased above or below par, on the basis of the purchase price adjusted so as to bring the value to par at maturity and so as to yield in the meantime the effective rate of interest at which the purchase was made; or in lieu of such method, according to such accepted method of valuation as is approved by the commissioner, but no such method shall be inconsistent with valuation methods used by insurers in general, or any method currently formulated or approved by the National Association of Insurance Commissioners.

(b) Purchase price shall in no case be taken at a higher figure than the actual market value at the time of purchase, plus actual brokerage, transfer, postage or express charges paid in the acquisition of such securities.

(c) Common, preferred or guaranteed stocks shall be valued at their market value or at the option of the company, they may be valued at purchase price if purchase price is less than market value.

- Florida Statutes - Insurance Laws, TITLE XXXVII-- INSURANCE, Chapter 625 -- Accounting, Investments, and Deposits by Insurers, Part I. Assets and Liabilities, 625.151- Securities valuation

(1) Securities, other than those referred to in §§ 625.141, held by an insurer shall be valued, in the discretion of the department, at their market value, or at their appraised value, or at prices determined by it as representing their fair market value.

- Georgia Regulations, Rules and Regulations of the State of Georgia, TITLE 120. -- Rules of the Comptroller General, 120-2. Insurance Department, Chapter 120-2-5 -- Valuation Procedures and Instructions for Bonds and Stocks, 120-2-5-.01 Establishing Values

(1) Each insurer reporting stocks and bonds as admitted assets in its annual statement shall be responsible for establishing a value for such securities. Except as otherwise provided by law, the procedures for establishing such values where applicable shall be as follows:

(a) Other than the nonadmissible exceptions listed in paragraph (2) of this Rule, values must comply with the rules for valuation contained in the National Association of Insurance Commissioners' Valuation of Securities Task Force publication, Valuations of Securities, for the applicable year.

(b) Securities not listed in the National Association of Insurance Commissioners' Committee on Valuation of Securities publication Valuation of Securities shall have no value, unless, upon application to such Committee on Valuation of Securities and submission of all relevant material required by the committee, and such committee establishes a value for the securities.

Generally Accepted Accounting Principles

20. FAS 115, paragraph 12, provides the following guidance with respect to common stocks:

Investments in debt securities that are not classified as held-to-maturity and equity securities that have readily determinable fair values shall be classified in one of the following categories and measured at fair value in the statement of financial position:

a. Trading securities. Securities that are bought and held principally for the purpose of selling them in the near term (thus held for only a short period of time) shall be classified as trading securities. Trading generally reflects active and frequent buying and selling, and trading securities are generally used with the objective of generating profits on short-term differences in price. (Note: remainder of paragraph not reproduced as not applicable to equity securities)

b. Available-for-sale securities. Investments not classified as trading securities (nor as held-to-maturity securities) shall be classified as available-for-sale securities.

21. Paragraph 13 of FAS 115 discusses reporting changes in fair value and states the following:

Unrealized holding gains and losses for trading securities shall be included in earnings. Unrealized holding gains and losses for available-for-sale securities (including those classified as current assets) shall be excluded from earnings and reported as a net amount in a separate component of shareholders' equity until realized. Paragraph 36 of FASB Statement No. 109, Accounting for Income Taxes, provides guidance on reporting the tax effects of unrealized holding gains and losses reported in a separate component of shareholders' equity.

22. Paragraph 14 of FAS 115 discusses income recognition and states the following:

Dividend and interest income, including amortization of the premium and discount arising at acquisition, for all three categories of investments in securities shall continue to be included in earnings. This Statement does not affect the methods used for recognizing and measuring the amount of dividend and interest income. Realized gains and losses for securities classified as either available-for-sale or held-to-maturity also shall continue to be reported in earnings.

23. Paragraph 16 of FAS 115 discusses impairment of securities and states the following:

For individual securities classified as either available-for-sale or held-to-maturity, an enterprise shall determine whether a decline in fair value below the amortized cost basis is other than temporary. For example, if it is probable that the investor will be unable to collect all amounts due accounting to the contractual terms of a debt security not impaired at acquisition, an other-than-temporary impairment shall be considered to have occurred.[4] If the decline in the fair value is judged to be other than temporary, the cost basis of the individual security shall be written down to fair value as a new cost basis and the amount of the write-down shall be included in earnings (that is, accounted for as a realized loss). The new cost basis shall not be changed for subsequent recoveries in fair value. Subsequent increases in the fair value of available-for-sale securities shall be included in the separate component of equity pursuant to paragraph 13; subsequent decreases in fair value, if not an other-than-temporary impairment, also shall be included in the separate component of equity.

[4] A decline in the value of a security that is other than temporary is also discussed in AICPA Auditing Interpretation, Evidential Matter for the Carrying Amount of Marketable Securities, which was issued in 1975 and incorporated in Statement on Auditing Standards No. 1, Codification of Auditing Standards and Procedures, as Interpretation 20, and in *SEC Staff Accounting Bulletin No. 59, Accounting for Noncurrent Marketable Equity Securities*.

24. FAS 125 provides the following guidance:

Accounting for Transfers and Servicing of Financial Assets

9. A transfer of financial assets (or all or a portion of a financial asset) in which the transferor surrenders control over those financial assets shall be accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if and only if all of the following conditions are met:

a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership (paragraphs 23 and 24).

b. Either (1) each transferee obtains the right—free of conditions that constrain it from taking advantage of that right (paragraph 25)—to pledge or exchange the transferred assets or (2) the transferee is a qualifying special-purpose entity (paragraph 26) and the holders of beneficial interests in that entity have the right—free of conditions that constrain them from taking advantage of that right (paragraph 25)—to pledge or exchange those interests.

c. The transferor does not maintain effective control over the transferred assets through (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (paragraphs 27-29) or (2) an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable (paragraph 30).

10. Upon completion of any transfer of financial assets, the transferor shall:

a. Continue to carry in its statement of financial position any retained interest in the transferred assets, including, if applicable, servicing assets (paragraphs 35-41), beneficial interests in assets transferred to a qualifying special-purpose entity in a securitization (paragraphs 47-58), and retained undivided interests (paragraph 33)

b. Allocate the previous carrying amount between the assets sold, if any, and the retained interests, if any, based on their relative fair values at the date of transfer (paragraphs 31-34).

11. Upon completion[3] of a transfer of assets that satisfies the conditions to be accounted for as a sale (paragraph 9), the transferor (seller) shall:

a. Derecognize all assets sold

b. Recognize all assets obtained and liabilities incurred in consideration as proceeds of the sale, including cash, put or call options held or written (for example, guarantee or recourse obligations), forward commitments (for example, commitments to deliver additional receivables during the revolving periods of some securitizations), swaps (for example, provisions that convert interest rates from fixed to variable), and servicing liabilities, if applicable (paragraphs 31, 32, and 35-41)

c. Initially measure at fair value assets obtained and liabilities incurred in a sale (paragraphs 42-44) or, if it is not practicable to estimate the fair value of an asset or a liability, apply alternative measures (paragraphs 45 and 46)

d. Recognize in earnings any gain or loss on the sale.

The transferee shall recognize all assets obtained and any liabilities incurred and initially measure them at fair value (in aggregate, presumptively the price paid).

[3] Although a transfer of securities may not be considered to have reached completion until the settlement date, this Statement does not modify other generally accepted accounting principles, including *FASB Statement No. 35*, *Accounting and Reporting by Defined Benefit Pension Plans*, and AICPA Statements of Position and audit and accounting Guides for certain industries, that require accounting at the trade date for certain contracts to purchase or sell securities.

12. If a transfer of financial assets in exchange for cash or other consideration (other than beneficial interests in the transferred assets) does not meet the criteria for a sale in paragraph 9, the transferor and transferee shall account for the transfer as a secured borrowing with pledge of collateral (paragraph 15).

Secured Borrowings and Collateral

15. A debtor may grant a security interest in certain assets to a lender (the secured party) to serve as collateral for its obligation under a borrowing, with or without recourse to other assets of the debtor. An obligor under other kinds of current or potential obligations, for example, interest rate swaps, also may grant a security interest in certain assets to a secured party. If collateral is transferred to the secured party, the custodial arrangement is commonly referred to as a pledge. Secured parties sometimes are permitted to sell or repledge (or otherwise transfer) collateral held under a pledge. The same relationships occur, under different names, in transfers documented as sales that are accounted for as secured borrowings (paragraph 12). The accounting for collateral by the debtor (or obligor) and the secured party depends on whether the secured party has taken control over the collateral and on the rights and obligations that result from the collateral arrangement:

a. If (1) the secured party is permitted by contract or custom to sell or repledge the collateral and (2) the debtor does not have the right and ability to redeem the collateral on short notice, for example, by substituting other collateral or terminating the contract, then

(i) The debtor shall reclassify that asset and report that asset in its statement of financial position separately (for example, as securities receivable from broker) from other assets not so encumbered.

(ii) The secured party shall recognize that collateral as its asset, initially measure it at fair value, and also recognize its obligation to return it.

b. If the secured party sells or repledges collateral on terms that do not give it the right and ability to repurchase or redeem the collateral from the transferee on short notice and thus may impair the debtor's right to redeem it, the secured party shall recognize the proceeds from the sale or the asset repledged and its obligation to return the asset to the extent that it has not already recognized them. The sale or repledging of the asset is a transfer subject to the provisions of this Statement.

c. If the debtor defaults under the terms of the secured contract and is no longer entitled to redeem the collateral, it shall derecognize the collateral, and the secured party shall recognize the collateral as its asset to the extent it has not already recognized it and initially measure it at fair value.

d. Otherwise, the debtor shall continue to carry the collateral as its asset, and the secured party shall not recognize the pledged asset.

Disclosures

17. An entity shall disclose the following:

a. If the entity has entered into repurchase agreements or securities lending transactions, its policy for requiring collateral or other security

b. If debt was considered to be extinguished by in-substance defeasance under the provisions of FASB Statement No. 76, Extinguishment of Debt, prior to the effective date of this Statement, a general description of the transaction and the amount of debt that is considered extinguished at the end of the period so long as that debt remains outstanding

c. If assets are set aside after the effective date of this Statement solely for satisfying scheduled payments of a specific obligation, a description of the nature of restrictions placed on those assets

d. If it is not practicable to estimate the fair value of certain assets obtained or liabilities incurred in transfers of financial assets during the period, a description of those items and the reasons why it is not practicable to estimate their fair value

e. For all servicing assets and servicing liabilities:

(1) The amounts of servicing assets or liabilities recognized and amortized during the period

(2) The fair value of recognized servicing assets and liabilities for which it is practicable to estimate that value and the method and significant assumptions used to estimate the fair value

(3) The risk characteristics of the underlying financial assets used to stratify recognized servicing assets for purposes of measuring impairment in accordance with paragraph 37

(4) The activity in any valuation allowance for impairment of recognized servicing assets—including beginning and ending balances, aggregate additions charged and reductions credited to operations, and aggregate direct write-downs charged against the allowances—for each period for which results of operations are presented.

Isolation beyond the Reach of the Transferor and Its Creditors

23. The nature and extent of supporting evidence required for an assertion in financial statements that transferred financial assets have been isolated—put presumptively beyond the reach of the transferor and its creditors, either by a single transaction or a series of transactions taken as a whole—depend on the facts and circumstances. All available evidence that either supports or questions an assertion shall be considered. That consideration includes making judgments about whether the contract or circumstances permit the transferor to revoke the transfer. It also may include making judgments about the kind of bankruptcy or other receivership into which a transferor or special-purpose entity might be placed, whether a transfer of financial assets would likely be deemed a true sale at law, whether the transferor is affiliated with the transferee, and other factors pertinent under applicable law. Derecognition of transferred assets is appropriate only if the available evidence provides reasonable assurance that the transferred assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any of its affiliates, except for an affiliate that is a qualifying special-purpose entity designed to make remote the possibility that it would enter bankruptcy or other receivership (paragraph 57.c.).

24. Whether securitizations isolate transferred assets may depend on such factors as whether the securitization is accomplished in one step or two steps (paragraphs 54-58). Many common financial transactions, for example, typical repurchase agreements and securities lending transactions, isolate transferred assets from the transferor, although they may not meet the other criteria for surrender of control.

Conditions That Constrain a Transferee

25. Many transferor-imposed or other conditions on a transferee's contractual right to pledge or exchange a transferred asset constrain a transferee from taking advantage of that right. However, a transferor's right of first refusal on a bona fide offer from a third party, a requirement to obtain the transferor's permission to sell or pledge that shall not be unreasonably withheld, or a prohibition on sale to the transferor's competitor generally does not constrain a transferee from pledging or exchanging the asset and, therefore, presumptively does not preclude a transfer containing such a condition from being accounted for as a sale. For example, a prohibition on sale to the transferor's competitor would not constrain the transferee if it were able to sell the transferred assets to a number of other parties; however, it would be a constraint if that competitor were the only potential willing buyer.

Qualifying Special-Purpose Entity

26. A qualifying special-purpose entity[7] must meet both of the following conditions:

a. It is a trust, corporation, or other legal vehicle whose activities are permanently limited by the legal documents establishing the special-purpose entity to:
   (1) Holding title to transferred financial assets
   (2) Issuing beneficial interests (If some of the beneficial interests are in the form of debt securities or equity securities, the transfer of assets is a securitization.)
   (3) Collecting cash proceeds from assets held, reinvesting proceeds in financial instruments pending distribution to holders of beneficial interests, and otherwise servicing the assets held
   (4) Distributing proceeds to the holders of its beneficial interests.

b. It has standing at law distinct from the transferor. Having standing at law depends in part on the nature of the special-purpose entity. For example, generally, under U.S. law, if a transferor of assets to a special-purpose trust holds all of the beneficial interests, it can unilaterally dissolve the trust and thereby reassume control over the individual assets held in the trust, and the transferor "can effectively assign his interest and his creditors can reach it."[8] In that circumstance, the trust has no standing at law, is not distinct, and thus is not a qualifying special-purpose entity.

[7] The description of a special-purpose entity is restrictive. The accounting for transfers of financial assets to special-purpose entities should not be extended to any entity that does not satisfy all of the conditions articulated in this paragraph.

[8] *Scott's Abridgment of the Law on Trusts,* §156 (Little, Brown and Company, 1960), 296.

Agreements That Maintain Effective Control over Transferred Assets

27. An agreement that both entitles and obligates the transferor to repurchase or redeem transferred assets from the transferee maintains the transferor's effective control over those assets, and the transfer is therefore to be accounted for as a secured borrowing, if and only if all of the following conditions are met:

a. The assets to be repurchased or redeemed are the same or substantially the same as those transferred (paragraph 28).
b. The transferor is able to repurchase or redeem them on substantially the agreed terms, even in the event of default by the transferee (paragraph 29).
c. The agreement is to repurchase or redeem them before maturity, at a fixed or determinable price.
d. The agreement is entered into concurrently with the transfer.

28. To be substantially the same,[9] the asset that was transferred and the asset that is to be repurchased or redeemed need to have all of the following characteristics:

a. The same primary obligor (except for debt guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and the terms of the guarantee must be the same)
b. Identical form and type so as to provide the same risks and rights
c. The same maturity (or in the case of mortgage-backed pass-through and pay-through securities have similar remaining weighted-average maturities that result in approximately the same market yield)
d. Identical contractual interest rates
e. Similar assets as collateral
f. The same aggregate unpaid principal amount or principal amounts within accepted "good delivery" standards for the type of security involved.

[9] In this Statement, the term substantially the same is used consistently with the usage of that term in the *AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position*.

29. To be able to repurchase or redeem assets on substantially the agreed terms, even in the event of default by the transferee, a transferor must at all times during the contract term have obtained cash or other collateral sufficient to fund substantially all of the cost of purchasing replacement assets from others.

30. A call option or forward contract that entitles the transferor to repurchase, prior to maturity, transferred assets not readily obtainable elsewhere maintains the transferor's effective control, because it would constrain the transferee from exchanging those assets, unless it is only a cleanup call.

Measurement of Interests Held after a Transfer of Financial Assets

Assets Obtained and Liabilities Incurred as Proceeds

31. The proceeds from a sale of financial assets consist of the cash and any other assets obtained in the transfer less any liabilities incurred. Any asset obtained that is not an interest in the transferred asset is part of the proceeds from the sale. Any liability incurred, even if it is related to the transferred assets, is a reduction of the proceeds. Any derivative financial instrument entered into concurrently with a transfer of financial assets is either an asset obtained or a liability incurred and part of the proceeds received in the transfer. All proceeds and reductions of proceeds from a sale shall be initially measured at fair value, if practicable.

Securities Lending Transactions

61. Securities lending transactions are initiated by broker-dealers and other financial institutions that need specific securities to cover a short sale or a customer's failure to deliver securities sold. Transferees ("borrowers") of securities generally are required to provide "collateral" to the transferor ("lender") of securities, commonly cash but sometimes other securities or standby letters of credit, with a value slightly higher than that of the securities "borrowed." If the "collateral" is cash, the transferor typically earns a return by investing that cash at rates higher than the rate paid or "rebated" to the transferee. If the "collateral" is other than cash, the transferor typically receives a fee. Securities custodians or other agents commonly carry out securities lending activities on behalf of clients. Because of the protection of "collateral" (typically valued daily and adjusted frequently for changes in the market price of the securities transferred) and the short terms of the transactions, most securities lending transactions in themselves do not impose significant credit risks on either party. Other risks arise from what the parties to the transaction do with the assets they receive. For example, investments made with cash "collateral" impose market and credit risks on the transferor.

62. In some securities lending transactions, the criteria in paragraph 9 are met, including the third criterion. Those transactions shall be accounted for (a) by the transferor as a sale of the "loaned" securities for proceeds consisting of the "collateral"[11] and a forward repurchase commitment and (b) by the transferee as a purchase of the "borrowed" securities in exchange for the "collateral" and a forward resale commitment. During the term of that agreement, the transferor has surrendered control over the securities transferred and the transferee has obtained control over those securities with the ability to sell or transfer them at will. In that case, creditors of the transferor have a claim only to the "collateral" and the forward repurchase commitment.

63. However, many securities lending transactions are accompanied by an agreement that entitles and obligates the transferor to repurchase or redeem the transferred assets before their maturity under which the transferor maintains effective control over those assets (paragraphs 27-30). Those transactions shall be accounted for as secured borrowings, in which cash (or securities that the holder is permitted by contract or custom to sell or repledge) received as "collateral" is considered the amount borrowed, the securities "loaned" are considered pledged as collateral against the cash borrowed, and any "rebate" paid to the transferee of securities is interest on the cash the transferor is considered to have borrowed. Collateral provided in securities lending transactions that are accounted for as secured borrowings shall be reported in the statement of financial position like other collateral, as set forth in paragraph 15.

[11] If the “collateral” is a financial asset that the holder is permitted by contract or custom to sell or repledge and the debtor does not have the right and ability to redeem the collateral on short notice, for example, by substituting other collateral or terminating the contract, that financial asset is proceeds of the sale of the “loaned” securities. To the extent that the “collateral” consists of letters of credit or other financial instruments that the holder is not permitted by contract or custom to sell or pledge, a securities lending does not satisfy the sale criteria and is accounted for as a loan of securities by the transferor to the transferee.

64. The transferor of securities being "loaned" accounts for cash received (or for securities received that may be sold or repledged and were obtained under agreements that are not subject to repurchase or redemption on short notice, for example, by substitution of other collateral or termination of the contract) in the same way whether the transfer is accounted for as a sale or a secured borrowing. The cash (or securities) received shall be recognized as the transferor's asset—as shall investments made with that cash, even if made by agents or in pools with other securities lenders—along with the obligation to return the cash (or securities).

Illustration—Securities Lending Transaction Treated as a Secured Borrowing

65. Accounting for a securities lending transaction treated as a secured borrowing:

Facts

Transferor's carrying amount and fair value of security loaned	$1,000
Cash "Collateral"	1,020
Transferor's return from investing cash collateral at a 5 percent annual rate	5
Transferor's rebate to the borrower at a 4 percent annual rate	4

The loaned securities cannot be redeemed on short notice, for example, by substitution of other collateral. For simplicity, the fair value of the security is assumed not to change during the 35-day term of the transaction.

Journal Entries for the Transferor

At inception:

Cash	1,020	
Payable under securities loan agreements		1,020
To record the receipt of cash collateral		

Securities loaned to broker	1,000	
Securities		1,000
To reclassify loaned securities that cannot be redeemed on short notice		

Money market instrument	1,020	
Cash		1,020
To record investment of cash collateral		

At conclusion:

Cash	1,025	
Interest		5
Money market instrument		1,020
To record results of investment		

Securities	1,000	
Securities loaned to broker		1,000
To record return of security		

Payable under securities loan agreements	1,020	
Interest ("rebate")	4	
Cash		1,024
To record repayment of cash collateral plus interest		

Journal Entries for the Transferee

At inception:

Receivable under securities loan agreements	1,020	
Cash		1,020
To record transfer of cash collateral		

Securities	1,000	
Obligation to return borrowed securities		1,000
To record receipt of borrowed securities that cannot be redeemed on short notice		

At conclusion:

Obligation to return borrowed securities	1,000	
Securities		1,000
To record the return of securities		

Cash	1,024	
Receivable under securities loan agreements		1,020
Interest revenue ("rebate")		4
To record the receipt of cash collateral and rebate interest		

Repurchase Agreements and "Wash Sales"

69. Furthermore, "wash sales" that previously were not recognized if the same financial asset was purchased soon before or after the sale shall be accounted for as sales under this Statement. Unless there is a concurrent contract to repurchase or redeem the transferred financial assets from the transferee, the transferor does not maintain effective control over the transferred assets.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life an Accident and Health Insurance Companies, Chapter 2, *Stocks*
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 2, *Stocks*
- *Purposes and Procedures Manual of the NAIC Securities Valuation Office*, Section 5—*Procedures for Valuing Common Stocks and Stock Warrants*
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*
- *Issue Paper No. 26—Bonds, excluding Loan-backed and Structured Securities*
- *Issue Paper No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements*
- *Issue Paper No. 73—Nonmonetary Transactions*

Generally Accepted Accounting Principles

- *FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities*
- *FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Exinguishments of Liabilities*

State Regulations

- Delaware Statutes - Insurance Laws, Title 18 Insurance Code, Part I, Chapter 13 - Investments, Section 1311
- Utah Regulations - Utah Administrative Rules, Insurance, R590 Administration, Rule R590-116--Valuation of Assets
- Massachusetts Statutes - Insurance Laws, PART I. -- Administration of the Government, TITLE XXII-- Corporations, Chapter 175 -- INSURANCE, Powers and Duties of Commissioner of Insurance, 175:11A - Valuation of securities and other investments

- Florida Statutes - Insurance Laws, TITLE XXXVII-- INSURANCE, Chapter 625 -- Accounting, Investments, and Deposits by Insurers, Part I. Assets and Liabilities, 625.151- Securities valuation
- Georgia Regulations, Rules and Regulations of the State of Georgia, TITLE 120. -- Rules of the Comptroller General, 120-2. Insurance Department, Chapter 120-2-5 -- Valuation Procedures and Instructions for Bonds and Stocks, 120-2-5-.01 Establishing Values

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Statutory Issue Paper No. 31

Leasehold Improvements Paid by the Reporting Entity as Lessee

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 19

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory guidance for leasehold improvements is limited and does not give specific guidance as to admissibility. Leasehold improvements are referred to in the real estate section of the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies. GAAP guidance allows leasehold improvements to be recorded as assets.

2. This issue paper establishes statutory accounting principles for leasehold improvements that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

3. For statutory accounting purposes, leasehold improvements shall be defined as lessee expenditures that are permanently attached to an asset a reporting entity is leasing under an operating lease.

4. Leasehold improvements that increase the value and enhance the usefulness of the leased asset meet the definition of assets defined in *Issue Paper No. 4—Definition of Assets and Nonadmitted* Assets (Issue Paper No. 4). Such expenditures also meet the criteria defining nonadmitted assets in that same paper (i.e., the asset is not readily marketable and available to satisfy policyholder obligations). Accordingly, such assets shall be reported as nonadmitted assets and charged against surplus and shall be amortized against net income over the shorter of their estimated useful life or the remaining life of the original lease excluding renewal or option periods as defined in *Issue Paper No. 67—Depreciation of Property and Amortization of Leasehold Improvements.* Leasehold improvements that do not meet the definition of an asset shall be charged to expense when acquired.

DISCUSSION

5. Issue Paper No. 4 defines an asset as "*probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events*." Issue Paper No. 4 also states that an asset not readily marketable and available to satisfy policyholder obligations *"shall be recorded as a nonadmitted asset and charged against surplus."* This is consistent with the Statement of Concepts, which states that a reporting entity's "*ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due."* Leasehold improvements meet the definition of an asset in that they provide future economic benefit to the reporting entity. However, because such assets are not readily available to satisfy policyholder obligations (i.e., they will revert to the lessor at the end of the lease term) they are considered nonadmitted assets. This is also consistent with the concept of conservatism included in the Statement of Concepts.

Drafting Notes/Comments

- Accounting for leases is addressed in *Issue Paper No. 22—Leases*.
- Lessors often provide or pay for improvements to leased property; Issue Paper No. 22 requires lessees to consider the value of such concessions and normalize rent revenue and rent expense on operating leases.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

6. Current statutory guidance is in the Accounting Practices and Procedures Manual for Life and Accident and Health and for Property and Casualty Insurance Companies, Chapter 4, Real Estate. Chapter 4 states:

> Because real estate leasehold improvements revert to the lessor at the end of the lease and the lessee receives benefits from the improvements only during the life of the lease, a leasehold improvement is subject to amortization over the lease life.

Generally Accepted Accounting Principles

7. GAAP guidance is very limited other than in *FASB Statement of Financial Accounting Concept No. 6*, *Elements of Financial Statements* (CON 6), which states:

> Most assets presently included in financial statements qualify as assets under the definition in paragraph 25 because they have future economic benefits... Inventories of raw materials, supplies, partially completed products, finished goods, and merchandise likewise obviously fit the definition as do productive resources, such as property, plant, equipment, tools, furnishings, leasehold improvements, natural resource deposits, and patents.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 4, Real Estate
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 4, Real Estate
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 22—Leases*

Generally Accepted Accounting Principles

- *FASB Statement of Financial Accounting Concept No. 6*, *Elements of Financial Statements*

State Regulations

- No additional guidance obtained from state statutes or regulations.

Statutory Issue Paper No. 32

Investments in Preferred Stock (excluding investments in preferred stock of subsidiary, controlled, or affiliated entities)

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 32

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory guidance pertaining to the valuation of and accounting for preferred stock is contained in the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies. That guidance also established the NAIC's Securities Valuation Office (SVO) as the primary authority for the valuation of preferred stocks. The purpose of this issue paper is to establish statutory accounting principles for preferred stocks, including those loaned under a securities lending agreement, which are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

2. Accounting for investments in preferred stock of subsidiaries, controlled or affiliated entities (investments in affiliates) will be addressed in *Issue Paper No. 46—Accounting for Investments in Subsidiary, Controlled and Affiliated Entities.*

SUMMARY CONCLUSION

3. For purposes of statutory accounting, preferred stocks (excluding investments in affiliates), which may or may not be publicly traded and may include shares against which exchange traded call options are outstanding, shall include:

a. Redeemable preferred stocks (including mandatory sinking fund preferred stocks and preferred stocks redeemable at the option of the holder).

b. Perpetual preferred stocks including nonredeemable preferred stocks and preferred stock redeemable at the option of the issuer.

Redeemable preferred stock shall be defined as preferred stock that by its terms must be redeemed by the issuing enterprise or is redeemable at the option of the investor. They include mandatory sinking fund preferred stock and payment-in-kind (PIK) preferred stock. Mandatory sinking fund preferred stocks shall be defined as redeemable preferred stock subject to a 100% mandatory sinking fund, annual installments of which will (1) commence not more than 10 years from the date of issue or December 31, 1978, if outstanding on that date; (2) be not less than 2% of the number of shares issued (or outstanding on December 31, 1978, if issued prior to that date); (3) provide for the redemption of the entire issue over a period not longer than 40 years from the date of issue, or December 31, 1978, if outstanding on that date. Redeemable preferred stock which is subject to a 100% mandatory sinking fund, but which do not at date of issue, or December 31, 1978 if outstanding at that time, meet one or more of the other requirements above, shall be considered as mandatory sinking fund preferred stock at the time the deficiency is cured through the passage of time or otherwise. Payment-in-kind (PIK) preferred stocks shall be defined as redeemable preferred stocks on which dividends can be paid in additional securities rather than cash at the option of the issuer. Perpetual preferred stock shall be defined as preferred stock with no redemption or sinking fund features and preferred stock redeemable at the option of the issuer.

4. Preferred stock meets the definition of an asset as defined in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets* and is an admitted asset to the extent it conforms to the requirements of this paper.

5. At acquisition, preferred stocks shall be reported at their cost, including brokerage and other related fees. Cost shall not exceed market value. Preferred stock acquisitions and dispositions shall be recorded on the trade date, not the settlement date except for private placement preferred stocks which shall be recorded on the funding date.

6. Redeemable preferred stock purchased at a premium shall be amortized to reduce the carrying value to the call or redemption value over the period to the call or earliest redemption date, whichever produces the lowest asset value. Redeemable preferred stock purchased at a discount shall be amortized to increase the carrying value to par value over the period to maturity or the latest redemption date. Amortization shall be calculated using the interest method and shall be reported as increases or decreases in dividends collected during the year.

7. Dividends on preferred stock (whether cumulative or noncumulative) other than mandatorily redeemable preferred stock shall be recorded as investment income on the ex-dividend date with a corresponding receivable to be extinguished upon receipt of cash (i.e., dividend income shall be recorded on preferred stocks declared to be ex-dividend on or prior to the statement date). Dividends on mandatorily redeemable preferred stock shall be accrued, even if not declared, using the interest method to the redemption price over the period ending on the redemption date.

8. For purposes of statutory accounting, preferred stocks shall be valued based on a) the underlying characteristics of the security, b) the quality rating of the security as defined in the *Purposes and Procedures Manual of the NAIC Securities Valuation Office* (SVO Purposes and Procedures) and reported in the Valuations of Securities manual published by the NAIC's Valuation of Securities Task Force at the end of each year and c) whether an Asset Valuation Reserve (AVR) is maintained by the reporting entity.

Reporting Entities That Do Not Maintain An AVR

9. Highest-quality or high-quality redeemable preferred stocks (which have characteristics of a debt security) shall be valued at cost or amortized cost. Other redeemable preferred stocks shall be valued at the lower of cost, amortized cost or market value. Highest-quality or high-quality perpetual preferred stocks (which have characteristics of an equity security) shall be valued at market value as reported in Valuations of Securities manual. Other perpetual preferred stock shall be valued at lower of cost or market value.

Reporting Entities That Do Maintain An AVR

10. Highest-quality, high-quality or medium quality redeemable preferred stocks (which have characteristics of a debt security) shall be valued at cost or amortized cost. Other redeemable preferred stocks shall be valued at the lower of cost, amortized cost or market value. Highest-quality, high-quality or medium quality perpetual preferred stocks (which have characteristics of an equity security) shall be valued at cost. Other perpetual preferred stock shall be valued at the lower of cost or market value.

Additional Valuation Guidance Applicable To All Reporting Entities

11. The SVO Purposes and Procedures classifies preferred stocks into six redeemable preferred stock quality categories and into six perpetual preferred stock quality categories. Preferred stocks shall be classified in accordance with the Valuations of Securities manual published by the NAIC's Valuation of Securities Task Force each reporting date. Unrealized gains and losses on perpetual preferred stocks shall be included as a direct credit or charge to surplus.

12. Restricted preferred stock shall be defined as a security for which sale is restricted by governmental or contractual requirement (other than in connection with being pledged as collateral) except where that requirement terminates within one year or if the holder has the power by contract or otherwise to cause the requirement to be met within one year. Any portion of the security that can be reasonable expected to qualify for sale within one year is not considered restricted.

13. PIK preferred stocks are considered redeemable preferred stock and shall be recorded initially at cost and accreted to the lower of (1) the call price or (2) par value, measured in either case at the end of the stock dividend period and based on all of the shares expected to be held at the end of that period, including those received as dividends. PIK stocks received as dividends should be recorded at market value. Any cash dividends paid during the stock dividend period on PIK stocks shall be accounted for as a reduction in the investment.

14. For any decline in the fair value of a preferred stock which is determined to be other than temporary, the cost basis of the preferred stock shall be written down to fair market value as the new cost basis and the amount of the write down shall be accounted for as a realized loss. For those reporting entities required to maintain an AVR, realized losses shall be accounted for in accordance with *Issue Paper No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*. For perpetual preferred stock, subsequent fluctuations in market value shall be recorded as unrealized gains or losses. Subsequent fluctuations in market value shall be recorded as unrealized gains and losses to the extent that they do not bring the investment above its new cost basis. Future declines in market value which are determined to be other than temporary, shall be recorded as realized losses. For perpetual preferred stock, a decline in fair value which is other than temporary includes situations where an investor has made a decision to sell a security at an amount below its carrying value. This is consistent with *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets.* For redeemable preferred stock, when a decline in fair value is determined to be other than temporary, the investment should be written down to fair value as the new cost basis and the amount of the write down shall be accounted for as a realized loss. For redeemable preferred stock, an impairment shall be considered to have occurred if it is probable that the investor will be unable to collect all amounts due according to the contractual terms of the security in effect at the date of acquisition. A decline in fair value which is other than temporary includes situations where an investor has made a decision to sell a security prior to its maturity at an amount below its carrying value (i.e., amortized cost).

15. A reporting entity can subscribe for the purchase of stock, but not be required to make payment until a later time. Transactions of this nature are common in the formation of corporations. Preferred stock acquired under a subscription represents a conditional transaction in a security authorized for issuance but not yet actually issued. Such transactions are settled if and when the actual security is issued and the exchange or National Association of Securities Dealers (NASD) rules that the transactions are to be settled. Preferred stock acquired under a subscription shall be recorded as an admitted asset when the reporting entity or its designated custodian or transfer agent takes delivery of the security and the security is recorded in the name of the reporting entity or its nominee, (i.e., the accounting for such preferred stock acquisitions shall be on the settlement date).

Loaned Preferred Stock

16. When preferred stocks are loaned, they remain assets of the reporting entity and are not removed from the accounting records as the reporting entity remains the owner of the stocks. When collateral is provided for the general use of the reporting entity, the asset is recorded and the admissibility of the asset is determined as if the reporting entity owned the collateral asset. A liability for the return of that collateral must be established. When collateral not available for the general use of the reporting entity is provided, it should not be recognized as an asset of the reporting entity. When non-cash collateral is provided, the current market value of that collateral must be used to determine adequacy of the collateral held relative to the current market value of the loaned stocks/securities.

Wash Sales

17. When preferred stock is sold and the proceeds are reinvested within 30 days in the same or substantially the same security, such transfers shall be considered to be wash sales, and shall be accounted for as sales and disclosed as required by paragraph 20. Unless there is a concurrent contract to repurchase or redeem the transferred preferred stock from the transferee, the transferor does not maintain effective control over the preferred stock.

18. For the securities to be substantially the same, the criteria set forth in paragraph 28 of *FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 125) must be met.

Exchanges and Conversions

19. If preferred stock is exchanged or converted into other securities, the fair value of the preferred stock surrendered at the date of the exchange or conversion shall become the cost basis for the new securities with any gain or loss realized at the time of the exchange or conversion. If the fair value of the securities received in an exchange or conversion is more clearly evident than the fair value of the preferred stock surrendered then it shall become the cost basis for the new securities. This treatment is consistent with *Issue Paper No. 73—Nonmonetary Transactions*.

Disclosures

20. The following disclosures shall be made for all preferred stocks in the notes to the financial statements:

a. Fair values in accordance with *Issue Paper No. 33—Disclosures about Fair Value of Financial Instruments;*

b. Concentrations of credit risk in accordance with *Issue Paper No. 27—Disclosure of Information about Financial Instruments with Concentrations of Credit Risk*;

c. Basis at which the preferred stocks are stated;

d. Description of any loaned preferred stock, including the amount, description of the collateral and whether or not the collateral is restricted;

e. A description, as well as the amount, of preferred stock that is restricted and the nature of the restriction.

f. Reporting entities shall disclose the following information for wash sales, as defined in paragraph 17, involving transactions for securities with a NAIC designation of 3 or below, or unrated:

1. A description of the reporting entity's objectives regarding these transactions;
2. An aggregation of transactions by NAIC Designation 3 or below, or unrated;
3. The number of transactions involved during the reporting period;
4. The book value of securities sold;
5. The cost of securities repurchased;
6. The realized gains/losses associated with the securities involved.

DISCUSSION

21. The statutory accounting principles described above do not recognize the GAAP accounting principles for valuation set forth in *FASB Statement No. 115*, *Accounting for Certain Investments in Debt and Equity Securities* (FAS 115); therefore, this issue paper rejects FAS 115.

22. The statutory accounting principles described above are consistent with current statutory accounting guidance for preferred stocks except as follows:

a. Specific guidelines for PIK preferred stocks are not included in current statutory guidance.

b. Specific guidelines for stock subscriptions are not included in current statutory guidance.

c. Specific guidelines for collateral deposited related to restricted stock that has been loaned are not included in current statutory guidance.

d. Specific guidelines for wash sales, other than transactions between affiliates, are not included in current statutory guidance.

23. This issue paper adopts paragraphs 9-12, 15, 17, 23-31 and 61-65 of *FASB Statement No. 125*, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 125*)* as they relate to preferred stock. The guidance on loaned securities in this issue paper is drafted under the general rule that securities lending transactions do not meet the criteria for surrender of control necessary to classify the transaction as a sale. If the criteria in paragraph 9 of FAS 125 regarding surrender of control are met, the transaction shall be accounted for by the transferor as a sale of the "loaned" securities.

24. Paragraph 14 of FAS 125 is rejected as it relates to classifications of securities under FAS 115. FAS 115 was rejected in *Issue Paper No. 26—Bonds, excluding Loan-Backed and Structured Securities* (Issue Paper No. 26). This issue paper rejects *FASB Emerging Issues Task Force No. 86-32, Early Extinguishment of a Subsidiary's Mandatorily Redeemable Preferred Stock.*

25. The statutory accounting principle outlined in the conclusion above accounts for preferred stocks based on the underlying characteristics of the securities and takes into consideration whether an Asset Valuation Reserve is maintained. This is consistent with the statutory accounting principles established in Issue Paper No. 26 and *Issue Paper No. 30—Investments in Common Stock (excluding investments in common stock of subsidiary, controlled, or affiliated entities).* Under the statutory principles outlined in the conclusion above, preferred stocks with underlying characteristics of a debt security are valued similar to bonds and preferred stocks with underlying characteristics of an equity instrument are valued similar to common stocks (except for reporting entities that maintain an AVR, where they are valued at cost). This is consistent with the Statement of Concepts which states that *"The regulator's need for meaningful,*

comparable financial information to determine an insurer's financial condition requires consistency in the development and application of statutory accounting principles."

Drafting Notes/Comments

- Accounting for preferred stock holdings of subsidiary, controlled and affiliated companies is addressed in *Issue Paper No. 46—Accounting for Investments in Subsidiary, Controlled and Affiliated Entities*.
- Investment income due and accrued is addressed in *Issue Paper No. 34—Investment Income Due and Accrued*.
- Accounting for the Asset Valuation Reserve (AVR) default component required for preferred stock holdings is addressed in *Issue Paper No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*.
- Securities not yet valued by the SVO will follow SVO procedures for valuing such securities as being drafted by the SVO as directed by the Invested Asset Working Group of the Valuation of Securities (EX4) Task Force.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

26. The Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies provides guidance with respect to preferred stock (similar guidance is also in the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies). Pertinent excerpts are as follows:

> Shares of capital stock represent units of ownership in a corporation, including common and preferred stock, mutual fund shares, transferable savings and loan association shares, warrants, and options to purchase stock. A return on stock held for investment is generally in the form of cash dividends which are paid to the owner. Occasionally, dividends are paid in the form of additional shares of stock. Liquidation of stock investments may give rise to capital gains or losses. (Investment in stock of parents, subsidiaries or affiliates is discussed in Chapter 6.)
>
> Common stockholders are the residual owners of the corporation and assume the ultimate risk associated with ownership up to the limit of their investment. They are usually entitled to voting powers of ownership. At liquidation, their claim to assets is after those of creditors and preferred stockholders. Common stockholders may liquidate their ownership rights in a corporation by selling their shares in the secondary market.
>
> Preferred stock is a corporate financing method embodying features of common stock and debt. Preferred stockholders have a prior claim to common stockholders on income and assets, but rank below creditors. Ownership of preferred stock usually does not include voting privileges. Numerous options may be designed into the issue including call features, cumulative dividend entitlements, and earnings participation. Generally the dividend rate on preferred stock is determined at issue and does not reflect variations in earnings of the issuer.
>
> Valuation
> Common and preferred stocks are generally required to be reported at the value published in the Valuations of Securities manual published by the NAIC's Valuation of Securities Task Force at the end of each year. This value is the subcommittee's determination of "market" for each listed stock.
>
> Preferred stocks in good standing subject to a 100% mandatory sinking fund shall be carried at cost, unless the company owned the preferred stock on Dec, 31, 1964, in which case the company may have the option of reporting them either at the association value on that date or at company cost. Preferred stock that is not in good standing is to be reported at the lower of cost or association value.

The valuation of stock purchase warrants, stock purchase options that may be exercised on December 31 of the year for which the annual statement is being prepared, loaned securities, and investments in subsidiaries shall be in accordance with the practices and procedures prescribed by the NAIC and the state of domicile.

Securities not listed in the manual, securities listed with no value because insufficient information for valuation was submitted to the Valuation of Securities Task Force, and restricted stock require the determination of an acceptable value. Insurance companies are required to submit sufficient information on these securities to the NAIC Securities Valuation Office to permit them to determine market value.

Dividends
Dividends are usually recorded in the general ledger on a cash basis. Dividends receivable on qualified shares of stock are generally permitted as admitted assets to the extent that the dividend has been excluded from the determination of the market price of the holding (i.e., on stock selling ex-dividend). Dividends receivable are included in "Investment Income Due and Accrued" in the annual statement. The asset is developed by a determination of the dividend status of each stock investment at the balance sheet date. Thus, dividend income on stock for any period consists of dividends collected during the year and the change in the declared but unpaid dividends between the beginning and end of the period.

The *Valuation of Securities* manual has a complete listing of all stocks that are traded "ex-dividend" at the end of the year. An ex-dividend stock is one in which the issuing company has closed its stock ledger on a certain date and has declared a dividend payable to the stockholder of record, even though the stock may have been sold after the record date but prior to the payment date. The association value of ex-dividend stock includes no value for the dividend since the unpaid dividend does not transfer with ownership of the stock. The listing of ex-dividend stock contains the declared dividend rate for calculating the declared but unpaid dividends that are allowable for each stock owned by the company on the dividend record date.

Loaned Stock
Where the law or regulation of the insurer's state of domicile does not prohibit such activity, stock may be loaned to authorized securities broker/dealers or to authorized financial institutions.

Securities lending is conducted through open-ended agreements, which may be terminated on short notice by the lender or borrower. Securities loans are collateralized by cash and/or cash equivalents, and securities issued by the U.S. Government or its agencies. Securities lending transactions may be negotiated directly between an insurer and a borrower, or indirectly through an insurer's custodian/agent and a borrower.

When stocks are loaned, they remain assets of the insurance company and are not removed from the accounting records as the insurance company remains the owner of the stocks. When cash collateral is provided and it is deposited for the general use of the company, it becomes an asset of the company, and a liability for the return of that collateral must be established.

When non-cash collateral not available for the general use of the company is provided, it should not be recognized as an asset of the company. If balance sheet accounts are used for non-cash collateral control purposes, a contra account should be used to neutralize or zero out the balance sheet account so that no net asset value is reported in the assets of the insurance company. When non-cash collateral is used, current market value of that collateral must be used to determine adequacy of the collateral held relative to the current market value of the loaned stocks/securities.

As stated in the NAIC Valuations of Securities manual, the minimum collateral on securities loaned is 102% of the market value of loaned stocks. The value of collateral will at times exceed or go below 102% of the market value of securities loaned due to daily market fluctuations in both the stocks loaned and collateral. A daily "mark to market" or valuation procedure must be in place to ensure that the market value of the collateral never goes below 100% of the market value of securities loaned and that calls for additional collateral to maintain the 102% minimum which should be made on a timely basis.

If the collateral on stocks is denominated in a different currency than the stocks being loaned, the minimum collateral on these securities loaned is 105% of the market value of loaned stocks as noted in the NAIC Valuations of Securities manual. Again, the same daily valuation procedures noted above must be in place to ensure adequate collateral for stocks loaned.

The valuation of the stocks remain unaffected by the loan as long as the amount of collateral is at least equal to the minimum amounts specified above. Failure to hold sufficient collateral may result in the admitted assets value being decreased by the amount of insufficient collateral.

27. The *Purposes and Procedures Manual of the NAIC Securities Valuation Office* - Section 3 - Procedures for Determining NAIC Designations for Preferred Stocks contains the following guidance:

(A) **Purpose** The purpose of assigning an NAIC Designations P1-6 and PSF 1-6 is to determine the appropriate values to be entered in Schedule D and the AVR.

(B) **General Procedures** For the purpose of analysis, preferred stocks are divided into two categories, perpetual and mandatory sinking fund preferred stocks. Perpetual preferreds are those which do not have any sinking fund provisions. Mandatory sinking fund preferred stock shall include those issues subject to a 100% mandatory sinking fund, annual installments of which will: (1) commence not more than 10 years from the date of issue or December 31, 1978, if outstanding on that date; (2) be not less than 2½% of the number of shares issued (or outstanding on December 31, 1978, if issued prior to that date); (3) provide for the redemption of the entire issue over a period not longer than 40 years from the date of issue, or December 31, 1978, if outstanding on that date. “Mandatory sinking fund preferred stock” that is subject to a 100% mandatory sinking fund, but that does not at date of issue, or December 31, 1978 if outstanding at that time, meet one or more of the other requirements of this Section, may qualify at such time as the deficiency is cured through the passage of time, or otherwise.

The analysis to determine an NAIC designation will be made in one of two ways. The first will be the direct use of ratings performed by other recognized rating agencies or organizations. The second will be the use of various security analysis techniques, both quantitative and subjective in nature.

(1) Issuers Which Have Securities Rated by Other Recognized Rating Agencies or Organizations.

Ratings of other recognized organizations will be translated directly into an NAIC Designation. The SVO staff will have discretionary authority to downgrade ratings of other organizations but not to upgrade. If there are multiple differing ratings the SVO may use the highest rating but may also go lower where indicated. Where one issue of an issuer has a rating, this rating will be used as a benchmark in determining the ratings of other non rated issues of the same issuer.

A list of the approved agencies and the translation of their rating into NAIC Designations is presented in Appendix B. To become an NAIC approved rating organization the candidate must apply to the NAIC’s Securities Valuation Office and file written documentation similar to that detailed in Section 2(B)(1) and an explanation of how their rating scale translates into the NAIC rating system.

(2) Issuers of Securities Which are Not Rated by Any Other Recognized Rating Organization.

The implied senior unsecured debt rating of any issuer will be used to determine how an issuer's preferred stock will be rated. Preferreds will in general be given a rating grade equal to that of the real or implied most junior level of debt. For example, if senior unsecured debt is rated or has an implied rating of 3 then the subordinated debt of this issuer would be rated 4 and the preferred stock would also be rated a 4. Whether a preferred will be rated high quality or not will depend upon how much debt precedes it in the capital structure and how well both interest and preferred dividends are covered by earnings. All preferred dividends and sinking fund requirements must have been paid for the last three years for any preferred to be rated P-5, PSF-5 or higher.

(C) Special Factors.

(1) Market Values for Privately Placed Preferred Stock. In determining a price for a directly placed preferred, the SVO staff will first look for a publicly traded comparable preferred stock. (i.e. one with similar basic characteristics) of the same issuer and use the yield from that issue to price the private issue. If no comparable issues are available, the staff will use the yields from Moody's Investors Services indices of preferred yields as of the close of the week preceding December 31.

(2) Preferred stocks of 100% owned insurance subsidiaries will be valued in the same manner as common stock of subsidiaries.

(3) Loaned Securities.

Where permitted by law or regulation of an insurer's state of domicile, preferred stocks loaned to others shall be valued in accordance with Section 3(B) at date of statement if the Acceptable Collateral, as hereinafter defined, is pledged as security for the loan and except as set forth in the following sentence, the Acceptable Collateral pledged as security is, at the inception of the loan, in an amount equal to 102% of the market value of the loaned shares. In event that foreign shares are the subject of the loan and the denomination of the currency of the Acceptable Collateral is other than the denomination of the currency of the loaned foreign shares, the amount of Acceptable Collateral which shall be pledged shall be an amount equal to 105% of the market value of the loaned shares. A decline in value of the Acceptable Collateral or an increase in the value of the loaned shares during the term of the loan shall not result in disqualification from valuation in accordance with the above if, during the term the loan is outstanding, additional Acceptable Collateral is posted any time the amount of Acceptable Collateral declines to 100% of the market value of the loaned shares (or 102% of the market value or the loaned shares if Acceptable Collateral in an amount equal to 105% was required to be posted at the inception of the loan) in an amount equal to the difference between the 102% or 105% initially required to be posted and 100% or 102%, respectively. For purpose of this provision, Acceptable Collateral shall mean cash and cash equivalents and shall include securities issued by the U.S. Government or its agencies. Any shortfall in the amount of the actual Acceptable Collateral posted and the required 102% or 105%, as applicable, shall be deducted from the otherwise determined statement value.

(4) Other Limited Life Preferred Shares.

Some examples of these are: Dutch Auction Rate Preferred Shares (DARTS), Fixed Rate Adjustable Preferred Stock (FRAPS), Stated Term Auction Preferred Shares (STRAPS), Fixed Rate Exchangeable Preferred Stock (FREPS), Marketed Auction Preferred Shares (MAPS), Stated Rate Auction Preferred

Shares (STAR), Share Adjusted Broker Remarketed Shares (SABRES). These shares will qualify to be valued at cost for companies maintaining an Asset Valuation Reserve and cost or amortized cost for all others as long as an “PSF 1 or 2,” “High Quality” designation, is maintained in both cases.

(D) Instructions for Completing Schedule D of the NAIC Year End Annual Statement.

The following tables indicate the appropriate entries to be entered in Schedule D Part 2-Section 1 of the NAIC Annual Statement for all preferred stocks.

(1) For Insurers Maintaining an Asset Valuation Reserve (AVR) (See Section 5)

NAIC DESIGNATION COLUMN	STATEMENT VALUE COLUMN	MARKET VALUE COLUMNS	
		RATE	AMOUNT
PSF-1 Thru PSF-3	Cost or Amortized Cost	SVO Market Rate	Par Value X Rate
PSF-4 Thru PSF6	Lower of Cost, Amortized Cost, or Market Value	SVO Market Rate	Par Value X Rate
P-1 Thru P-3	Cost	SVO Market Rate	Par Value X Rate
P-4 Thru P-6	Lower of Cost or Market Value	SVO Market Rate	Par Value X Rate

(2) For Insurers Not Maintaining an Asset Valuation Reserve (AVR)

NAIC DESIGNATION COLUMN	STATEMENT VALUE COLUMN	MARKET VALUE COLUMNS	
		RATE	AMOUNT
PSF-1 Thru PSF-2	Cost or Amortized Cost	SVO Market Rate	Par Value X Rate
PSF-3 Thru PSF6	Lower of Cost, Amortized Cost, or Market Value	SVO Market Rate	Par Value X Rate
P-1 Thru P-2	Market Value	SVO Market Rate	Par Value X Rate
P-3 Thru P-6	Lower of Cost or Market Value	SVO Market Rate	Par Value X Rate

Note: The quality ratings are defined in the SVO Purpose and Procedures as follows:

P-1	Highest quality perpetual preferred stock
P-2	High quality perpetual preferred stock
P-3	Medium quality perpetual preferred stock
P-4	Low quality perpetual preferred stock
P-5	Lower quality perpetual preferred stock
P-6	Lowest quality perpetual preferred stock

PSF1	Highest quality sinking fund or limited life preferred stock
PSF2	High quality sinking fund or limited life preferred stock
PSF3	Medium quality sinking fund or limited life preferred stock
PSF4	Low quality sinking fund or limited life preferred stock
PSF5	Lower quality sinking fund or limited life preferred stock
PSF6	Lowest quality sinking fund or limited life preferred stock

28. Several states have statutes that address valuation of preferred stocks. See excerpts below:

- Utah Regulations - Utah Administrative Rules, Insurance, R590 Administration, Rule R590-116--Valuation of Assets

  5. Preferred and Guaranteed Stocks.

     a. Preferred or guaranteed stocks in good standing are to be valued at cost by companies which are maintaining a mandatory securities valuation reserve. Companies not maintaining a mandatory securities valuation reserve shall value such stocks at market value.

     b. Preferred or guaranteed stocks not in good standing are to be valued at market value.

     c. Market value as used for valuation of preferred or guaranteed stocks means in accordance with the values listed in "Valuation of Securities." For securities which are traded on a registered national securities exchange, but are not listed in that publication, market value may be established at the most recent published trade value. Securities not listed and not actively traded on a major stock exchange shall have a market value in an amount that the insurer can justify to the commissioner.

     d. Preferred or guaranteed stocks of insurance subsidiaries are to be valued in accordance with the requirements of Section 31A-17-401(3)(a), U.C.A., and Section (4)(B) of this rule.

- Massachusetts Statutes - Insurance Laws, PART I. -- Administration of the Government, TITLE XXII-- Corporations, Chapter 175 -- INSURANCE, Powers and Duties of Commissioner of Insurance, 175:11A - Valuation of securities and other investments

  (A)(1) Investments, shall be valued in accordance with the published valuation standards of the National Association of Insurance Commissioners. Securities investments as to which the National Association of Insurance Commissioners has not published valuation standards in its Valuation of Securities Manual or its successor publication shall be valued as follows:

  (a) All obligations having a fixed term and rate shall, if not in default as to principal and interest, be valued as follows: (I) if purchased at par, at par value; (ii) if purchased above or below par, on the basis of the purchase price adjusted so as to bring the value to par at maturity and so as to yield in the meantime the effective rate of interest at which the purchase was made; or in lieu of such method, according to such accepted method of valuation as is approved by the commissioner, but no such method shall be inconsistent with valuation methods used by insurers in general, or any method currently formulated or approved by the National Association of Insurance Commissioners.

  (b) Purchase price shall in no case be taken at a higher figure than the actual market value at the time of purchase, plus actual brokerage, transfer, postage or express charges paid in the acquisition of such securities.

  (c) Common, preferred or guaranteed stocks shall be valued at their market value or at the option of the company, they may be valued at purchase price if purchase price is less than market value.

- Florida Statutes - Insurance Laws, TITLE XXXVII-- INSURANCE, Chapter 625 -- Accounting, Investments, and Deposits by Insurers, Part I. Assets and Liabilities, 625.151- Securities valuation

(1) Securities, other than those referred to in º 625.141, held by an insurer shall be valued, in the discretion of the department, at their market value, or at their appraised value, or at prices determined by it as representing their fair market value.

- Georgia Regulations, Rules and Regulations of the State of Georgia, TITLE 120. -- Rules of the Comptroller General, 120-2. Insurance Department, Chapter 120-2-5 -- Valuation Procedures and Instructions for Bonds and Stocks, 120-2-5-.01 Establishing Values

  (1) Each insurer reporting stocks and bonds as admitted assets in its annual statement shall be responsible for establishing a value for such securities. Except as otherwise provided by law, the procedures for establishing such values where applicable shall be as follows:

  (a) Other than the nonadmissible exceptions listed in paragraph 2 of this Rule, values must comply with the rules for valuation contained in the National Association of Insurance Commissioners' Valuation of Securities Task Force publication, Valuation of Securities, for the applicable year.

  (b) Securities not listed in the National Association of Insurance Commissioners' Committee on Valuation of Securities publication Valuation of Securities shall have no value, unless, upon application to such Committee on Valuation of Securities and submission of all relevant material required by the committee, and such committee establishes a value for the securities.

Generally Accepted Accounting Principles

29. GAAP guidance is promulgated by FAS 115. Pertinent excerpts are as follows:

Accounting for Certain Investments in Debt and Equity Securities

6. At acquisition, an enterprise shall classify debt and equity securities into one of three categories: held-to-maturity, available-for-sale, or trading. At each reporting date, the appropriateness of the classification shall be reassessed.

Held-to-Maturity Securities

7. Investments in debt securities shall be classified as held-to-maturity and measured at amortized cost in the statement of financial position only if the reporting enterprise has the positive intent and ability to hold those securities to maturity.

12. Investments in debt securities that are not classified as held-to-maturity and equity securities that have readily determinable fair values shall be classified in one of the following categories and measured at fair value in the statement of financial position:

a. Trading securities. Securities that are bought and held principally for the purpose of selling them in the near term (thus held for only a short period of time) shall be classified as trading securities. Trading generally reflects active and frequent buying and selling, and trading securities are generally used with the objective of generating profits on short-term differences in price. (Note: remainder of paragraph not reproduced as not applicable to preferred stock)

b. Available-for-sale securities. Investments not classified as trading securities (nor as held-to-maturity securities) shall be classified as available-for-sale securities.

13. Unrealized holding gains and losses for trading securities shall be included in earnings. Unrealized holding gains and losses for available-for-sale securities (including those classified as current assets) shall be excluded from earnings and reported as a net amount in a separate component of shareholders' equity until realized. Paragraph 36 of FASB Statement No. 109, Accounting for Income Taxes, provides guidance on reporting the tax effects of unrealized holding gains and losses reported in a separate component of shareholders' equity.

14. Dividend and interest income, including amortization of the premium and discount arising at acquisition, for all three categories of investments in securities shall continue to be included in earnings. This Statement does not affect the methods used for recognizing and measuring the amount of dividend and interest income. Realized gains and losses for securities classified as either available-for-sale or held-to-maturity also shall continue to be reported in earnings.

16. For individual securities classified as either available-for-sale or held-to-maturity, an enterprise shall determine whether a decline in fair value below the amortized cost basis is other than temporary. For example, if it is probable that the investor will be unable to collect all amounts due accounting to the contractual terms of a debt security not impaired at acquisition, an other-than-temporary impairment shall be considered to have occurred.[4] If the decline in the fair value is judged to be other than temporary, the cost basis of the individual security shall be written down to fair value as a new cost basis and the amount of the write-down shall be included in earnings (that is, accounted for as a realized loss). The new cost basis shall not be changed for subsequent recoveries in fair value. Subsequent increases in the fair value of available-for-sale securities shall be included in the separate component of equity pursuant to paragraph 13; subsequent decreases in fair value, if not an other-than-temporary impairment, also shall be included in the separate component of equity.

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[4] A decline in the value of a security that is other than temporary is also discussed in AICPA Auditing Interpretation, Evidential Matter for the Carrying Amount of Marketable Securities, which was issued in 1975 and incorporated in Statement on Auditing Standards No. 1, Codification of Auditing Standards and Procedures, as Interpretation 20, and in SEC Staff Accounting Bulletin No. 59, Accounting for Noncurrent Marketable Equity Securities.

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30. FAS 125 provides the following guidance:

Accounting for Transfers and Servicing of Financial Assets

9. A transfer of financial assets (or all or a portion of a financial asset) in which the transferor surrenders control over those financial assets shall be accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if and only if all of the following conditions are met:

a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership (paragraphs 23 and 24).

b. Either (1) each transferee obtains the right—free of conditions that constrain it from taking advantage of that right (paragraph 25)—to pledge or exchange the transferred assets or (2) the transferee is a qualifying special-purpose entity (paragraph 26) and the holders of beneficial interests in that entity have the right—free of conditions that constrain them from taking advantage of that right (paragraph 25)—to pledge or exchange those interests.

c. The transferor does not maintain effective control over the transferred assets through (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (paragraphs 27-29) or (2) an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable (paragraph 30).

10. Upon completion of any transfer of financial assets, the transferor shall:

a. Continue to carry in its statement of financial position any retained interest in the transferred assets, including, if applicable, servicing assets (paragraphs 35-41), beneficial interests in assets transferred to a qualifying special-purpose entity in a securitization (paragraphs 47-58), and retained undivided interests (paragraph 33)

b. Allocate the previous carrying amount between the assets sold, if any, and the retained interests, if any, based on their relative fair values at the date of transfer (paragraphs 31-34).

11. Upon completion[3] of a transfer of assets that satisfies the conditions to be accounted for as a sale (paragraph 9), the transferor (seller) shall:

a. Derecognize all assets sold

b. Recognize all assets obtained and liabilities incurred in consideration as proceeds of the sale, including cash, put or call options held or written (for example, guarantee or recourse obligations), forward commitments (for example, commitments to deliver additional receivables during the revolving periods of some securitizations), swaps (for example, provisions that convert interest rates from fixed to variable), and servicing liabilities, if applicable (paragraphs 31, 32, and 35-41)

c. Initially measure at fair value assets obtained and liabilities incurred in a sale (paragraphs 42-44) or, if it is not practicable to estimate the fair value of an asset or a liability, apply alternative measures (paragraphs 45 and 46)

d . Recognize in earnings any gain or loss on the sale.

The transferee shall recognize all assets obtained and any liabilities incurred and initially measure them at fair value (in aggregate, presumptively the price paid).

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[3] Although a transfer of securities may not be considered to have reached completion until the settlement date, this Statement does not modify other generally accepted accounting principles, including *FASB Statement No. 35, Accounting and Reporting by Defined Benefit Pension Plans*, and AICPA Statements of Position and audit and accounting Guides for certain industries, that require accounting at the trade date for certain contracts to purchase or sell securities.

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12. If a transfer of financial assets in exchange for cash or other consideration (other than beneficial interests in the transferred assets) does not meet the criteria for a sale in paragraph 9, the transferor and transferee shall account for the transfer as a secured borrowing with pledge of collateral (paragraph 15).

Secured Borrowings and Collateral

15. A debtor may grant a security interest in certain assets to a lender (the secured party) to serve as collateral for its obligation under a borrowing, with or without recourse to other assets of the debtor. An obligor under other kinds of current or potential obligations, for example, interest rate swaps, also may grant a security interest in certain assets to a secured party. If collateral is transferred to the secured party, the custodial arrangement is commonly referred to as a pledge. Secured parties sometimes are permitted to sell or repledge (or otherwise transfer) collateral held under a pledge. The same relationships occur, under different names, in transfers documented as sales that are accounted for as secured borrowings (paragraph 12). The accounting for collateral by the debtor (or obligor) and the secured party depends on whether the secured party has taken control over the collateral and on the rights and obligations that result from the collateral arrangement:

a. If (1) the secured party is permitted by contract or custom to sell or repledge the collateral and (2) the debtor does not have the right and ability to redeem the collateral on short notice, for example, by substituting other collateral or terminating the contract, then

(i) The debtor shall reclassify that asset and report that asset in its statement of financial position separately (for example, as securities receivable from broker) from other assets not so encumbered.

(ii) The secured party shall recognize that collateral as its asset, initially measure it at fair value, and also recognize its obligation to return it.

b. If the secured party sells or repledges collateral on terms that do not give it the right and ability to repurchase or redeem the collateral from the transferee on short notice and thus may impair the debtor's right to redeem it, the secured party shall recognize the proceeds from the sale or the asset repledged and its obligation to return the asset to the extent that it has not already recognized them. The sale or repledging of the asset is a transfer subject to the provisions of this Statement.

c. If the debtor defaults under the terms of the secured contract and is no longer entitled to redeem the collateral, it shall derecognize the collateral, and the secured party shall recognize the collateral as its asset to the extent it has not already recognized it and initially measure it at fair value.

d. Otherwise, the debtor shall continue to carry the collateral as its asset, and the secured party shall not recognize the pledged asset.

Disclosures

17. An entity shall disclose the following:

a. If the entity has entered into repurchase agreements or securities lending transactions, its policy for requiring collateral or other security

b. If debt was considered to be extinguished by in-substance defeasance under the provisions of FASB Statement No. 76, Extinguishment of Debt, prior to the effective date of this Statement, a general description of the transaction and the amount of debt that is considered extinguished at the end of the period so long as that debt remains outstanding

c. If assets are set aside after the effective date of this Statement solely for satisfying scheduled payments of a specific obligation, a description of the nature of restrictions placed on those assets

d. If it is not practicable to estimate the fair value of certain assets obtained or liabilities incurred in transfers of financial assets during the period, a description of those items and the reasons why it is not practicable to estimate their fair value

e. For all servicing assets and servicing liabilities:

(1) The amounts of servicing assets or liabilities recognized and amortized during the period

(2) The fair value of recognized servicing assets and liabilities for which it is practicable to estimate that value and the method and significant assumptions used to estimate the fair value

(3) The risk characteristics of the underlying financial assets used to stratify recognized servicing assets for purposes of measuring impairment in accordance with paragraph 37

(4) The activity in any valuation allowance for impairment of recognized servicing assets—including beginning and ending balances, aggregate additions charged and reductions credited to operations, and aggregate direct write-downs charged against the allowances—for each period for which results of operations are presented.

Isolation beyond the Reach of the Transferor and Its Creditors

23. The nature and extent of supporting evidence required for an assertion in financial statements that transferred financial assets have been isolated—put presumptively beyond the reach of the transferor and its creditors, either by a single transaction or a series of transactions taken as a whole—depend on the facts and circumstances. All available evidence that either supports or questions an assertion shall be considered. That consideration includes making judgments about whether the contract or circumstances permit the transferor to revoke the transfer. It also may include making judgments about the kind of bankruptcy or other receivership into which a transferor or special-purpose entity might be placed, whether a transfer of financial assets would likely be deemed a true sale at law, whether the transferor is affiliated with the transferee, and other factors pertinent under applicable law. Derecognition of transferred assets is appropriate only if the available evidence provides reasonable assurance that the transferred assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the

transferor or any of its affiliates, except for an affiliate that is a qualifying special-purpose entity designed to make remote the possibility that it would enter bankruptcy or other receivership (paragraph 57.c.).

24. Whether securitizations isolate transferred assets may depend on such factors as whether the securitization is accomplished in one step or two steps (paragraphs 54-58). Many common financial transactions, for example, typical repurchase agreements and securities lending transactions, isolate transferred assets from the transferor, although they may not meet the other criteria for surrender of control.

Conditions That Constrain a Transferee

25. Many transferor-imposed or other conditions on a transferee's contractual right to pledge or exchange a transferred asset constrain a transferee from taking advantage of that right. However, a transferor's right of first refusal on a bona fide offer from a third party, a requirement to obtain the transferor's permission to sell or pledge that shall not be unreasonably withheld, or a prohibition on sale to the transferor's competitor generally does not constrain a transferee from pledging or exchanging the asset and, therefore, presumptively does not preclude a transfer containing such a condition from being accounted for as a sale. For example, a prohibition on sale to the transferor’s competitor would not constrain the transferee if it were able to sell the transferred assets to a number of other parties; however, it would be a constraint if that competitor were the only potential willing buyer.

Qualifying Special-Purpose Entity

26. A qualifying special-purpose entity[7] must meet both of the following conditions:

a. It is a trust, corporation, or other legal vehicle whose activities are permanently limited by the legal documents establishing the special-purpose entity to:

(1) Holding title to transferred financial assets

(2) Issuing beneficial interests (If some of the beneficial interests are in the form of debt securities or equity securities, the transfer of assets is a securitization.)

(3) Collecting cash proceeds from assets held, reinvesting proceeds in financial instruments pending distribution to holders of beneficial interests, and otherwise servicing the assets held

(4) Distributing proceeds to the holders of its beneficial interests.

b. It has standing at law distinct from the transferor. Having standing at law depends in part on the nature of the special-purpose entity. For example, generally, under U.S. law, if a transferor of assets to a special-purpose trust holds all of the beneficial interests, it can unilaterally dissolve the trust and thereby reassume control over the individual assets held in the trust, and the transferor "can effectively assign his interest and his creditors can reach it."[8] In that circumstance, the trust has no standing at law, is not distinct, and thus is not a qualifying special-purpose entity.

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[7] The description of a special-purpose entity is restrictive. The accounting for transfers of financial assets to special-purpose entities should not be extended to any entity that does not satisfy all of the conditions articulated in this paragraph.

[8] *Scott’s Abridgment of the Law on Trusts,* §156 (Little, Brown and Company, 1960), 296.

Agreements That Maintain Effective Control over Transferred Assets

27. An agreement that both entitles and obligates the transferor to repurchase or redeem transferred assets from the transferee maintains the transferor’s effective control over those

assets, and the transfer is therefore to be accounted for as a secured borrowing, if and only if all of the following conditions are met:

a. The assets to be repurchased or redeemed are the same or substantially the same as those transferred (paragraph 28).
b. The transferor is able to repurchase or redeem them on substantially the agreed terms, even in the event of default by the transferee (paragraph 29).
c. The agreement is to repurchase or redeem them before maturity, at a fixed or determinable price.
d. The agreement is entered into concurrently with the transfer.

28. To be substantially the same,[9] the asset that was transferred and the asset that is to be repurchased or redeemed need to have all of the following characteristics:

a. The same primary obligor (except for debt guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and the terms of the guarantee must be the same)
b. Identical form and type so as to provide the same risks and rights
c. The same maturity (or in the case of mortgage-backed pass-through and pay-through securities have similar remaining weighted-average maturities that result in approximately the same market yield)
d. Identical contractual interest rates
e. Similar assets as collateral
f. The same aggregate unpaid principal amount or principal amounts within accepted “good delivery” standards for the type of security involved.

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[9] In this Statement, the term *substantially the same* is used consistently with the usage of that term in the AICPA Statement of Position 90-3, *Definition of the Term Substantially the Same for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position.*

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29. To be able to repurchase or redeem assets on substantially the agreed terms, even in the event of default by the transferee, a transferor must at all times during the contract term have obtained cash or other collateral sufficient to fund substantially all of the cost of purchasing replacement assets from others.

30. A call option or forward contract that entitles the transferor to repurchase, prior to maturity, transferred assets not readily obtainable elsewhere maintains the transferor's effective control, because it would constrain the transferee from exchanging those assets, unless it is only a cleanup call.

Measurement of Interests Held after a Transfer of Financial Assets

Assets Obtained and Liabilities Incurred as Proceeds

31. The proceeds from a sale of financial assets consist of the cash and any other assets obtained in the transfer less any liabilities incurred. Any asset obtained that is not an interest in the transferred asset is part of the proceeds from the sale. Any liability incurred, even if it is related to the transferred assets, is a reduction of the proceeds. Any derivative financial instrument entered into concurrently with a transfer of financial assets is either an asset obtained or a liability incurred and part of the proceeds received in the transfer. All proceeds and reductions of proceeds from a sale shall be initially measured at fair value, if practicable.

Securities Lending Transactions

61. Securities lending transactions are initiated by broker-dealers and other financial institutions that need specific securities to cover a short sale or a customer's failure to deliver

securities sold. Transferees ("borrowers") of securities generally are required to provide "collateral" to the transferor ("lender") of securities, commonly cash but sometimes other securities or standby letters of credit, with a value slightly higher than that of the securities "borrowed." If the "collateral" is cash, the transferor typically earns a return by investing that cash at rates higher than the rate paid or "rebated" to the transferee. If the "collateral" is other than cash, the transferor typically receives a fee. Securities custodians or other agents commonly carry out securities lending activities on behalf of clients. Because of the protection of "collateral" (typically valued daily and adjusted frequently for changes in the market price of the securities transferred) and the short terms of the transactions, most securities lending transactions in themselves do not impose significant credit risks on either party. Other risks arise from what the parties to the transaction do with the assets they receive. For example, investments made with cash "collateral" impose market and credit risks on the transferor.

62. In some securities lending transactions, the criteria in paragraph 9 are met, including the third criterion. Those transactions shall be accounted for (a) by the transferor as a sale of the "loaned" securities for proceeds consisting of the "collateral"[11] and a forward repurchase commitment and (b) by the transferee as a purchase of the "borrowed" securities in exchange for the "collateral" and a forward resale commitment. During the term of that agreement, the transferor has surrendered control over the securities transferred and the transferee has obtained control over those securities with the ability to sell or transfer them at will. In that case, creditors of the transferor have a claim only to the "collateral" and the forward repurchase commitment.

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[11] If the “collateral” is a financial asset that the holder is permitted by contract or custom to sell or repledge and the debtor does not have the right and ability to redeem the collateral on short notice, for example, by substituting other collateral or terminating the contract, that financial asset is proceeds of the sale of the “loaned” securities. To the extent that the “collateral” consists of letters of credit or other financial instruments that the holder is not permitted by contract or custom to sell or pledge, a securities lending does not satisfy the sale criteria and is accounted for as a loan of securities by the transferor to the transferee

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63. However, many securities lending transactions are accompanied by an agreement that entitles and obligates the transferor to repurchase or redeem the transferred assets before their maturity under which the transferor maintains effective control over those assets (paragraphs 27-30). Those transactions shall be accounted for as secured borrowings, in which cash (or securities that the holder is permitted by contract or custom to sell or repledge) received as "collateral" is considered the amount borrowed, the securities "loaned" are considered pledged as collateral against the cash borrowed, and any "rebate" paid to the transferee of securities is interest on the cash the transferor is considered to have borrowed. Collateral provided in securities lending transactions that are accounted for as secured borrowings shall be reported in the statement of financial position like other collateral, as set forth in paragraph 15.

64. The transferor of securities being “loaned” accounts for cash received (or for securities received that may be sold or repledged and were obtained under agreements that are not subject to repurchase or redemption on short notice, for example, by substitution of other collateral or termination of the contract) in the same way whether the transfer is accounted for as a sale or a secured borrowing. The cash (or securities) received shall be recognized as the transferor's asset—as shall investments made with that cash, even if made by agents or in pools with other securities lenders—along with the obligation to return the cash (or securities).

Illustration—Securities Lending Transaction Treated as a Secured Borrowing

65. Accounting for a securities lending transaction treated as a secured borrowing:

Facts

Transferor's carrying amount and fair value of security loaned	$1,000
Cash "collateral"	1,020
Transferor's return from investing cash collateral at a 5 percent annual rate	5
Transferor's rebate to the borrower at a 4 percent annual rate	4

The loaned securities cannot be redeemed on short notice, for example, by substitution of other collateral. For simplicity, the fair value of the security is assumed not to change during the 35-day term of the transaction.

Journal Entries for the Transferor

At inception:

Cash	1,020	
Payable under securities loan agreements		1,020

To record the receipt of cash collateral

Securities loaned to broker	1,000	
Securities		1,000

To reclassify loaned securities that cannot be redeemed on short notice

Money market instrument	1,020	
Cash		1,020

To record investment of cash collateral

At conclusion:

Cash	1,025	
Interest		5
Money market instrument		1,020

To record results of investment

Securities	1,000	
Securities loaned to broker		1,000

To record return of security

Payable under securities loan agreements	1,020	
Interest ("rebate")	4	
Cash		1,024

To record repayment of cash collateral plus interest

Journal Entries for the Transferee

At inception:

Receivable under securities loan agreements	1,020	
Cash		1,020

To record transfer of cash collateral

Securities	1,000	
Obligation to return borrowed securities		1,000

To record receipt of borrowed securities that cannot be redeemed on short notice

At conclusion:

Obligation to return borrowed securities	1,000	
Securities		1,000

To record the return of securities

Cash	1,024	
Receivable under securities loan agreements		1,020
Interest revenue ("rebate")		4

To record the receipt of cash collateral and rebate interest

Repurchase Agreements and "Wash Sales"

69. Furthermore, "wash sales" that previously were not recognized if the same financial asset was purchased soon before or after the sale shall be accounted for as sales under this Statement. Unless there is a concurrent contract to repurchase or redeem the transferred financial assets from the transferee, the transferor does not maintain effective control over the transferred assets.

OTHER SOURCES OF INFORMATION:

31. Accounting for Paid in Kind (PIK) Preferred Stocks (a form of redeemable preferred stock) is addressed in the NAIC Technical Resource Group Proposed Draft Life Codification:

> PIK stocks are redeemable issues of preferred stock which have been used frequently in the financing of leveraged acquisitions because the dividends are payable either in cash or in additional shares of the identical securities for a specified period, typically three to five years (the “stock dividend period”). The choice of paying cash or securities is the election of the issuer; however, it is assumed that in most instances dividends will be paid in securities as a means of preserving cash after the leveraged acquisition. PIKs are redeemable after a fixed period, typically, 15 to 20 years, and a sinking fund may be used to fund redemption after the tenth. PIKs are typically callable; however, the call provisions vary. Some issues are callable at any time at par; others have call protection under which the issues are not callable until the fifth year, either at par or at a premium. PIKs typically are exchangeable at the issuer’s election, either immediately or after a stated period, into junior subordinated debt or other securities of the issuer.
>
> PIK bonds typically have the option at each interest payment date of making interest payments in cash or in additional debt securities. These additional debt securities are referred to as baby or bunny bonds. Baby bonds generally have the same terms, including maturity dates and interest rates, as the original bonds. Interest on baby bonds may also be paid in cash or in additional like-kind debt securities at the option of the issuer.
>
> The method used by investors to account for investments in PIKs stocks and bonds should conform with the method used for investments in bonds and redeemable preferred stock. Therefore, the bond accounting method is appropriate because it is anticipated that dividends on PIKs will be paid in additional securities rather than cash (PIKs resemble zero coupon bonds). Accordingly, a form of level yield accounting similar to that used for zero coupons bonds is the preferable approach to recording income. Income under the level yield method is recognized by multiplying the level yield implicit in the PIK by the most recent balance sheet carrying amount.
>
> Specifically, investments in PIK stocks should be recorded initially at cost and accreted to the lower of (1) the call price or (2) par value, measured in either case at the end of the stock

dividend period and based on all of the shares expected to be held at the end of that period, including those received as dividends.

Investments in PIK bonds should be recorded initially at cost and accreted to the lower of (1) the call price or (2) par value so that at final maturity the bond's carrying amount will be equal to the aggregate principal amount of the original bonds and all baby bonds received.

Any cash dividends paid during the stock dividend period on PIK stocks are accounted for as a reduction in the investment. Any interest paid on PIK bonds are accounted for as a reduction in the investment.

At no time should PIK securities be carried on the balance sheet in excess of the current call price. In addition, in the event of impairment in the value of the PIK, losses should be recognized immediately to the extent of the impairment.

If the PIKs are exchanged for other securities of the issuer, the carrying amount of the PIKs at the date of exchange becomes the cost basis of the new securities.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Accounting for Assets Transferred Between Affiliates and Chapter 2, Stocks
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Accounting for Assets Transferred Between Affiliates and Chapter 2, Stocks
- *Purposes and Procedures Manual of the NAIC Securities Valuation Office*, Section 3 - Procedures for Determining NAIC Designations for Preferred Stocks
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liability, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*
- *Issue Paper No. 26—Bonds, excluding Loan-backed and Structured Securities*
- *Issue Paper No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements*
- *Issue Paper No. 73—Nonmonetary Transactions*

Generally Accepted Accounting Principles

- *FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities*
- *FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
- *Accounting Principles Board Opinion No. 29, Accounting for Nonmonetary Transactions*
- *FASB Emerging Issues Task Force No. 86-32, Early Extinguishment of a Subsidiary's Mandatorily Redeemable Preferred Stock*

State Regulations

- Delaware Statutes - Insurance Laws, Title 18 Insurance Code, Part I, Chapter 13 - Investments, Section 1311
- Utah Regulations - Utah Administrative Rules, Insurance, R590 Administration, Rule R590-116--Valuation of Assets
- Massachusetts Statutes - Insurance Laws, PART I. -- Administration of the Government, TITLE Xxii-- Corporations, Chapter 175 -- INSURANCE, Powers and Duties of Commissioner of Insurance, 175:11A - Valuation of securities and other investments
- Florida Statutes - Insurance Laws, TITLE XXXVII-- INSURANCE, Chapter 625 -- Accounting, Investments, and Deposits by Insurers, Part I. Assets and Liabilities, 625.151- Securities valuation

- Georgia Regulations, Rules and Regulations of the State of Georgia, TITLE 120. -- Rules of the Comptroller General, 120-2. Insurance Department, Chapter 120-2-5 -- Valuation Procedures and Instructions for Bonds and Stocks, 120-2-5-.01 Establishing Values

Other Sources of Information

- NAIC Technical Resource Group Proposed Draft Life Codification, Chapter 1, Bonds

Statutory Issue Paper No. 33

Disclosures about Fair Value of Financial Instruments

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 27

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Though disclosures about market values of certain investments are currently made in schedules included in the Annual Statements for Property and Casualty Insurance Companies and for Life and Accident and Health Insurance Companies, the annual statements contain no disclosures of fair values of other financial instruments. Furthermore, there are no specific disclosure requirements in the current statutory guidance requiring fair value disclosures in the financial statements. GAAP has specific disclosure requirements for the fair value of financial instruments. This issue paper establishes statutory accounting principles for disclosures about fair value of financial instruments that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

2. A financial instrument shall be defined as cash, evidence of an ownership interest in an entity, or a contract that both:

a. Imposes on one entity a contractual obligation (1) to deliver cash or another financial instrument to a second entity or (2) to exchange other financial instruments on potentially unfavorable terms with the second entity;

b. Conveys to that second entity a contractual right (1) to receive cash or another financial instrument from the first entity or (2) to exchange other financial instruments on potentially favorable terms with the first entity.

3. Examples of the financial instruments, which encompass both assets and liabilities recognized and not recognized in the statement of financial position, to which this issue paper apply include but are not limited to short-term investments, bonds, common stock, preferred stocks, mortgage loans, derivatives, financial guarantees written, standby letters of credit, notes payable and deposit-type contracts.

4. A reporting entity shall disclose in the notes to the financial statements the fair value of all financial instruments, summarized by type of financial instrument, for which it is practicable to estimate fair value, except for certain financial instruments named in paragraph 8 of *FASB Statement No. 107*, *Disclosure about Fair Value of Financial Instruments* (FAS 107), (which is excerpted in the Relevant GAAP Guidance section in paragraph 14 below). Fair value disclosed in the notes shall be presented together with the related admitted values in a form that makes it clear whether the fair values and admitted values represent assets or liabilities and to which line items in the Statement of Assets, Liabilities, Surplus and Other Funds they relate. Separate disclosure of this information in the notes is required even if such information is presented elsewhere in the financial statements. Unless specified otherwise in another issue paper the disclosures may be made net of encumbrances, if the asset or liability is so reported. A reporting entity shall also disclose the method(s) and significant assumptions used to

estimate the fair value of financial instruments. For example, the notes should specify the reported value of investments using market prices published by the Securities Valuation Office of the NAIC (SVO) investments.

5. For purposes of this issue paper, the fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. Market values published by the SVO, if available, shall always be the fair value amount disclosed. In the absence of SVO published market values or when amortized cost is used by the SVO as market value, quoted market prices by other third party organizations, if available, shall be used as the fair value of financial instruments. If neither SVO published market values nor quoted market prices are available, management's best estimate of fair value shall be based on the quoted market price of a financial instrument with similar characteristics or on industry recognized valuation techniques (for example, the present value of estimated future cash flows using a discount rate commensurate with the risks involved).

6. If it is not practicable for an entity to estimate the fair value of a financial instrument or a class of financial instruments, the following shall be disclosed:

a. Information pertinent to estimating the fair value of that financial instrument or class of financial instruments, such as the carrying amount, effective interest rate, and maturity

b. The reasons why it is not practicable to estimate fair value.

DISCUSSION

7. The conclusion above adopts FAS 107 as amended by *FASB Statement No. 119*, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (FAS 119), except that paragraph 15.c. of FAS 119 relating to disclosure of financial instruments held or issued for trading is rejected. This is consistent with the conclusions in *Issue Paper No. 26—Bonds, Excluding Loan-Backed and Structured Securities* (CMOs), *Issue Paper No. 30—Investments in Common Stock (excluding investments in common stock of subsidiary, controlled or affiliated entities)*, and *Issue Paper No. 32—Investments in Preferred Stock (including investments in common stock of subsidiary, controlled or affiliated entities)*, in which FASB Statement No. 115, is rejected. This issue paper adopts *FASB Emerging Issues Task Force No. 85-20*, *Recognition of Fees for Guaranteeing a Loan.* Furthermore, this issue paper requires that if the SVO publishes a market value, that amount should be used in the fair value disclosures required by this issue paper.

8. This issue paper rejects *FASB Statement No. 126, Exemptions from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities, an amendment of FAS 107.*

9. The Statement of Concepts states that:

> Because these basic financial statements cannot be expected to provide all of the information necessary to evaluate an entity's short-term and long-term stability, management must supplement the financial statements with sufficient disclosures (e.g., notes to the financial statements, management's discussion and analysis, and supplementary schedules and exhibits) to assist financial statement users in evaluating the information provided.

Disclosures about fair values of financial instruments is consistent with that objective.

10. Current statutory accounting already recognizes the usefulness of fair value disclosures, and requires that disclosure of amounts for certain financial instruments in the Annual Statement schedules. The conclusion above expands this requirement to include disclosure in the notes to the financial statements of all financial instruments.

11. Paragraph 4 above requires the disclosure of the fair value of all financial instruments if it is practicable to estimate those values. In the context of this issue paper, practicable means that an estimate of fair value can be made without incurring excessive costs. It is a dynamic concept: what is practicable for one entity might not be for another; what is not practicable in one year might be in another. For example, it might not be practicable for an entity to estimate the fair value of a class of financial instruments for which a quoted market price is not available because it has not yet obtained or developed the valuation model necessary to make the estimate, and the cost of obtaining an independent valuation appears excessive considering the materiality of the instruments to the entity. Practicability, that is, cost considerations, also may affect the required precision of the estimate; for example, while in many cases it might seem impracticable to estimate fair value on an individual instrument basis, it may be practicable for a class of financial instruments in a portfolio or on a portfolio basis. In those cases, the fair value of that class or of the portfolio should be disclosed. Finally, it might be practicable for an entity to estimate the fair value only of a subset of a class of financial instruments; the fair value of that subset should be disclosed.

12. Paragraph 8 of FAS 107, which is included in the Relevant GAAP Guidance section, discusses financial instruments which are exempt from fair value disclosure. Included as exempt instruments are insurance contracts, except for financial guaranty and investment contracts. Accordingly, the fair value disclosures should be made for guaranteed interest contracts (GICs), and liabilities associated with certain annuities and deposit accounts.

Drafting Notes/Comments

- Disclosure of concentration of credit risk is addressed in *Issue Paper No. 27—Disclosure of Information about Financial Instruments with Concentration of Credit Risk.*

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

13. The NAIC Annual Statement Instructions for Life and Accident and Health and for Property and Casualty Insurance Companies require market values to be included in several invested asset schedules (e.g. Schedule A on real estate, Schedule BA on other long term assets, Schedule C on collateral loans, Schedule D on bonds, Schedule DB on options, caps and floors and Schedule DC on futures options). The schedules and the notes to the financial statement, however, do not contain market values for all investments or other financial instruments that are required by this issue paper.

Generally Accepted Accounting Principles

14. FAS 107 discusses fair value disclosures as follows:

> 3. A financial instrument is defined as cash, evidence of an ownership interest in an entity, or a contract that both:
>
> a. Imposes on one entity a contractual obligation[1] (1) to deliver cash or another financial instrument[2] to a second entity or (2) to exchange other financial instruments on potentially unfavorable terms with the second entity

[1] Contractual obligations encompass both those that are conditioned on the occurrence of a specified event and those that are not. All contractual obligations that are financial instruments meet the definition of liability set forth in *FASB Concepts Statement No. 6, Elements of Financial Statements*, although some may not be recognized as liabilities in financial statements—may be "off-balance-sheet" —because they fail to meet some other criterion for recognition. For some financial instruments, the obligation is owed to or by a group of entities rather than a single entity.

[2] The use of the term financial instrument in this definition is recursive (because the term financial instrument is included in it), though it is not circular. The definition requires a chain of contractual

obligations that ends with the delivery of cash or an ownership interest in an entity. Any number of obligations to deliver financial instruments can be links in a chain that qualifies a particular contract as a financial instrument.

b. Conveys to that second entity a contractual right[3] (1) to receive cash or another financial instrument from the first entity or (2) to exchange other financial instruments on potentially favorable terms with the first entity.

[3] Contractual rights encompass both those that are conditioned on the occurrence of a specified event and those that are not. All contractual rights that are financial instruments meet the definition of asset set forth in Concepts Statement 6, although some may not be recognized as assets in financial statements—may be "off-balance-sheet" —because they fail to meet some other criterion for recognition. For some financial instruments, the right is held by or the obligation is due from a group of entities rather than a single entity.

4. The definition in paragraph 3 is essentially the same as that in paragraph 6 of Statement 105, which is hereby amended to conform to this Statement. Appendix A of Statement 105 provides examples of instruments that are included in and excluded from the definition of a financial instrument.

5. For purposes of this Statement, the fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. If a quoted market price is available for an instrument, the fair value to be disclosed for that instrument is the product of the number of trading units of the instrument times that market price.

6. Under the definition of fair value in paragraph 5, the quoted price for a single trading unit in the most active market is the basis for determining market price and reporting fair value. This is the case even if placing orders to sell all of an entity's holdings of an asset or to buy back all of a liability might affect the price, or if a market's normal volume for one day might not be sufficient to absorb the quantity held or owed by an entity.

7. This Statement requires disclosures about fair value for all financial instruments, whether recognized or not recognized in the statement of financial position, except for those specifically listed in paragraph 8. It applies to all entities. It does not change any requirements for recognition, measurement, or classification of financial instruments in financial statements.

8. The disclosures about fair value prescribed in paragraphs 10-14 are not required for the following:

a. Employers' and plans' obligations for pension benefits, other postretirement benefits including health care and life insurance benefits, employee stock option and stock purchase plans, and other forms of deferred compensation arrangements, as defined in *FASB Statements No. 35, Accounting and Reporting by Defined Benefit Pension Plans, No. 87, Employers' Accounting for Pensions, No. 106, Employers' Accounting for Postretirement Benefits Other Than Pensions*, and *No. 43, Accounting for Compensated Absences*, and *APB Opinions No. 25, Accounting for Stock Issued to Employees*, and *No. 12, Omnibus Opinion -- 1967*

b. Substantively extinguished debt subject to the disclosure requirements of *FASB Statement No. 76, Extinguishment of Debt*, and assets held in trust in connection with an in-substance defeasance of that debt.

c. Insurance contracts, other than financial guarantees and investment contracts, as discussed in *FASB Statements No. 60, Accounting and Reporting by*

Insurance Enterprises, and *No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*

d. Lease contracts as defined in *FASB Statement No. 13, Accounting for Leases* (a contingent obligation arising out of a canceled lease and a guarantee of a third-party lease obligation are not lease contracts and are included in the scope of this Statement)

e. Warranty obligations and rights

f. Unconditional purchase obligations as defined in paragraph 6 of *FASB Statement No. 47, Disclosure of Long-Term Obligations*

g. Investments accounted for under the equity method in accordance with the requirements of *APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock*

h. Minority interests in consolidated subsidiaries

i. Equity investments in consolidated subsidiaries

j. Equity instruments issued by the entity and classified in stockholders' equity in the statement of financial position.

9. Generally accepted accounting principles already require disclosure of or subsequent measurement at fair value for many classes of financial instruments. Although the definitions or the methods of estimation of fair value vary to some extent, and various terms such as market value, current value, or mark-to-market are used, the amounts computed under those requirements satisfy the requirements of this Statement and those requirements are not superseded or modified by this Statement.

Disclosures about Fair Value of Financial Instruments

10. An entity shall disclose, either in the body of the financial statements or in the accompanying notes, the fair value of financial instruments for which it is practicable to estimate that value. An entity also shall disclose the method(s) and significant assumptions used to estimate the fair value of financial instruments.

11. Quoted market prices, if available, are the best evidence of the fair value of financial instruments. If quoted market prices are not available, management's best estimate of fair value may be based on the quoted market price of a financial instrument with similar characteristics or on valuation techniques (for example, the present value of estimated future cash flows using a discount rate commensurate with the risks involved, option pricing models, or matrix pricing models).

12. In estimating the fair value of deposit liabilities, a financial entity shall not take into account the value of its long-term relationships with depositors, commonly known as core deposit intangibles, which are separate intangible assets, not financial instruments. For deposit liabilities with no defined maturities, the fair value to be disclosed under this Statement is the amount payable on demand at the reporting date. This Statement does not prohibit an entity from disclosing separately the estimated fair value of any of its nonfinancial intangible and tangible assets and nonfinancial liabilities.

13. For trade receivables and payables, no disclosure is required under this Statement when the carrying amount approximates fair value.

14. If it is not practicable for an entity to estimate the fair value of a financial instrument or a class of financial instruments, the following shall be disclosed:

> a. Information pertinent to estimating the fair value of that financial instrument or class of financial instruments, such as the carrying amount, effective interest rate, and maturity
>
> b. The reasons why it is not practicable to estimate fair value.
>
> 15. In the context of this Statement, practicable means that an estimate of fair value can be made without incurring excessive costs. It is a dynamic concept: what is practicable for one entity might not be for another; what is not practicable in one year might be in another. For example, it might not be practicable for an entity to estimate the fair value of a class of financial instruments for which a quoted market price is not available because it has not yet obtained or developed the valuation model necessary to make the estimate, and the cost of obtaining an independent valuation appears excessive considering the materiality of the instruments to the entity. Practicability, that is, cost considerations, also may affect the required precision of the estimate; for example, while in many cases it might seem impracticable to estimate fair value on an individual instrument basis, it may be practicable for a class of financial instruments in a portfolio or on a portfolio basis. In those cases, the fair value of that class or of the portfolio should be disclosed. Finally, it might be practicable for an entity to estimate the fair value only of a subset of a class of financial instruments; the fair value of that subset should be disclosed.

15. During 1994, the FASB issued FAS 119 which amended FAS 107 as follows:

> 15. Statement 107 is amended as follows:
>
> a. In paragraph 10, the following footnote is added after either in the body of the financial statements or in the accompanying notes:
>
> * If disclosed in more than a single note, one of the notes shall include a summary table. The summary table shall contain the fair value and related carrying amounts and cross-references to the location(s) of the remaining disclosures required by this Statement, as amended.
>
> b. In paragraph 10, the following is added after the first sentence:
>
> Fair value disclosed in the notes shall be presented together with the related carrying amount in a form that makes it clear whether the fair value and carrying amount represent assets or liabilities and how the carrying amounts relate to what is reported in the statement of financial position.
>
> c. The following is added to the end of paragraph 10:
>
> The disclosures shall distinguish between financial instruments held or issued for trading purposes, including dealing and other trading activities measured at fair value with gains and losses recognized in earnings, and financial instruments held or issued for purposes other than trading.
>
> d. The following paragraph and footnote are added after paragraph 13:
>
> In disclosing the fair value of a derivative financial instrument,** an entity shall not (a) combine, aggregate, or net that fair value with the fair value of nonderivative financial instruments or (b) net that fair value with the fair value of other derivative financial instruments -- even if those nonderivative or derivative financial instruments are considered to be related, for example, by a risk management strategy -- except to the extent that the offsetting of carrying amounts in the statement of financial position is permitted under the general principle in paragraphs 5 and 6 of FASB Interpretation No. 39, Offsetting of Amounts Related to Certain Contracts, or the exception for master netting arrangements in paragraph 10 of Interpretation 39.

** For purposes of this Statement, derivative financial instrument is used in the same sense as in paragraph 5 of *FASB Statement No. 119, Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments.*

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- NAIC Annual Statement Instructions for Life and Accident and Health and for Property and Casualty Insurance Companies

Generally Accepted Accounting Principles

- *FASB Statement No. 107, Disclosure about Fair Value of Financial Instruments*
- *FASB Statement No. 119, Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments*
- *FASB Statement No. 126, Exemptions from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities, an amendment of FAS 107*
- *FASB Emerging Issues Task Force No. 85-20, Recognition of Fees for Guaranteeing a Loan*

State Regulations

- No additional guidance obtained from state statutes or regulations.

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Statutory Issue Paper No. 34

Investment Income Due and Accrued

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 34

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory guidance pertaining to accounting for investment income due and accrued is contained in the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies. The purpose of this paper is to establish statutory accounting principles for investment income due and accrued which are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

2. Investment income due shall be defined as investment income earned and legally due to be paid to the reporting entity (i.e., receivable) as of the reporting date. Investment income accrued shall be defined as investment income earned as of the reporting date but not legally due to be paid to the reporting entity until subsequent to the reporting date.

3. In general, gross investment income shall be recorded as earned and shall include investment income collected during the period, the change in investment income due and accrued, the change in unearned investment income plus any amortization (e.g., discounts or premiums on bonds, origination fees on mortgage loans, etc.). Additional guidance on investment income recognition relative to specific types of investments is provided in issue papers on each specific type of investment.

4. Investment income due and accrued shall be recorded as an asset in accordance with *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets* (Issue Paper No. 4). An evaluation shall be made of such assets in accordance with *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets* (Issue Paper No. 5), to determine whether an impairment exists. Amounts determined to be uncollectible shall be written off through the statement of operations. Then an evaluation shall be made to determine nonadmitted amounts.

This two step process is set forth below.

> a) Investment income due and accrued shall be assessed for collectibility. If, in accordance with Issue Paper No. 5, it is probable the investment income due and accrued balance is uncollectible, the amount shall be written off and shall be charged against investment income in the period such determination is made.
>
> b) Any remaining investment income due and accrued (i.e., amounts considered probable of collection) representing either (1) amounts that are over 90 days past due (generated by any invested asset except mortgage loans in default), or (2) amounts designated elsewhere in the codification as nonadmitted shall be considered nonadmitted assets and recognized through a direct charge to surplus in accordance with Issue Paper No. 4. These nonadmitted amounts shall be subject to continuing assessments of collectibility and, if determined to be uncollectible, a

write-off shall be recorded in the period such determination is made in accordance with subparagraph (a) above.

5. Accrued interest on mortgage loans that are in default (as defined in *Issue Paper No. 37—Mortgage Loans*) shall be recorded as Investment Income Due and Accrued when such interest is deemed collectible. Interest can be accrued on mortgage loans in default if deemed collectible; if interest is deemed uncollectible, it shall not be accrued and any previously accrued amounts are to be written off in accordance with the guidelines in paragraph 4.a. above. If a loan in default has interest 180 days past due which has been assessed as collectible, all interest shall be considered a non-admitted asset and recognized through a direct charge to surplus as outlined in paragraph 4.b. above.

6. The following disclosures shall be made for investment income due and accrued in the notes to the financial statements.

- The bases by category of investment income for excluding (nonadmitting) any investment income due and accrued
- Disclose total amount excluded.

DISCUSSION

7. The Statutory Accounting Principles outlined in the conclusion above are consistent with current statutory accounting guidance for investment income due and accrued, except for the following:

- Current statutory accounting states that "*Income due, which is doubtful collectibility, should either not be accrued or should be treated as nonadmitted"*. However, the conclusion above requires that such amounts be accrued as earned and then written off in the period in which the determination is made that the amounts are uncollectible.

- Current statutory guidance states that accrued rent on real estate three months or more be treated as a nonadmitted asset. The conclusion above requires that accrued rent be assessed for collectibility and any uncollectible amounts written off in the period in which the determination is made that the amounts are uncollectible. Any remaining accrued rent past due three months or more (but determined to be collectible) shall be treated as a nonadmitted asset.

- Current statutory guidance states that accrued interest on mortgage loans past due twelve months or more be treated as a nonadmitted asset and accrued interest on loans in default, being voluntarily conveyed, or being foreclosed be added to the carrying value if such amounts are deemed to be recoverable from the ultimate disposition of the property. The conclusion above requires an assessment of the collectibility of the interest to determine if such should be accrued or written off. If the loan in default has interest which is 180 days past due and deemed to be collectible, all interest on the defaulted loan shall be considered a nonadmitted asset.

8. The statutory accounting principle outlined in the conclusion above accounts for investment income due and accrued in a manner consistent with the Statement of Concepts recognition concept which states that "*Revenue should be recognized only as the earnings process of the underlying underwriting or investment business is completed*". It recognizes any impairment (i.e., doubtful collection) of the asset in the period in which such a determination occurs in accordance with Issue Paper No. 5.

9. The Statement of Concepts also states:

> Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which are unavailable due to encumbrances or other third party interest should not be recognized on the balance sheet but rather should be charged against surplus when acquired or when availability otherwise becomes questionable.

10. Based on the above concept, investment income due and accrued should reflect only amounts that are available to meet policyholder obligations. Consistent with the conservatism concept, amounts for which collection is past due by a specified number of months, but for which the ultimate collection is not considered doubtful, should be recognized as nonadmitted assets through a direct charge against surplus in accordance with Issue Paper No. 4.

Drafting Notes/Comments

- Accounting for common and preferred stock holdings of subsidiary, controlled and affiliated entities will be addressed in *Issue Paper No. 46—Accounting for Investments in Subsidiary, Controlled and Affiliated Entities*.
- Accounting for joint ventures and partnerships will be addressed in *Issue Paper No. 48—Investments in Joint Ventures, Partnerships and Limited Liability Companies*.
- Accounting for recognition of investment income is addressed in separate issue papers on each type of investment.
- Accounting for investments in surplus notes is addressed in a separate issue paper.
- Accounting for mortgage loans, including valuation, is addressed in *Issue Paper No. 37—Mortgage Loans*.
- Accounting for policy loans is addressed in *Issue Paper No. 49—Policy Loans*.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

11. The Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies provides guidance with respect to unearned investment income and investment income due and accrued. Similar guidance is found in the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies. Pertinent excerpts from the Life and Accident and Health manual are as follows:

> CHAPTER 19
> INVESTMENT INCOME AND NET REALIZED GAINS
>
> Investment Income Due
>
> Income due represents certain amounts of income which are legally owed to the company as of the statement date but have not yet been received. Income due, which is doubtful collectibility, should either not be accrued or should be treated as nonadmitted. On certain bonds in default, the company should not report interest due because the association value of the bond includes such interest.
>
> Accrued Investment Income
>
> Income accrued represents interest that would be collectible if the obligation were to mature as of the statement date. The amounts that are shown as accrued for preferred stocks and common stocks are dividends on stocks declared to be ex-dividend on or prior to the statement date and payable after that date.

> Nonadmitted Investment Income
>
> Nonadmitted income represents any of the above-noted types of investment income reported as due or accrued if it is of doubtful collectibility. The company should not take credit for this as income. This is of particular importance regarding mortgage loans with interest that is past due twelve months or more and real estate with rents past due three months or more. These receivables should be deducted as nonadmitted.

12. The Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies provides additional guidance with respect to interest income on bonds and loan-backed and structured securities. Pertinent excerpts are as follows:

> CHAPTER 1
>
> Bonds and Loaned Backed and Structured Securities
> Interest income
>
> If interest (including contingent interest) on a bond is recorded when received, an adjustment must be made to recognize due and accrued interest as of the reporting date. Interest income for any period consists of interest collected during the period and the change in the due and accrued interest between the beginning and end of the period, plus the adjustments for the accrual of discount, minus adjustment for the amortization of premium, and minus adjustment for interest paid on acquisition of bonds.
>
> Contingent interest represents bondholder income generated through the occurrence of specific economic events in relation to the issuer. For example, contingent interest may become payable upon the attainment by the issuer of a given level of cash flow or income. In many respects, bonds with contingent interest provisions are similar to income bonds. Due and unpaid contingent interest may be recorded as income. The proper accrual of such income does, however, require an analysis of the applicable provisions in the underlying agreement and the verification that the prerequisite conditions have been met.

13. The Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies contains similar guidance.

14. The Accounting Practices and Procedures Manual for Life and Accident and Health and Property and Casualty Insurance Companies provides additional guidance with respect to dividends. Pertinent excerpts are as follows:

> CHAPTER 2
> STOCKS
>
> Dividends
>
> Dividends are usually recorded in the general ledger on a cash basis. Dividends receivable on qualified shares of stock are generally permitted as admitted assets to the extent that the dividend has been excluded from the determination of the market price of the holding (i.e., on stock selling ex-dividend). Dividends receivable are included in “Investment Income Due and Accrued” in the annual statement. The asset is developed by a determination of the dividend status of each stock investment at the balance sheet date. Thus, dividend income on stock for any period consists of dividends collected during the year and the change in the declared but unpaid dividends between the beginning and end of the period.
>
> The Valuation of Securities manual has a complete listing of all stocks that are traded “ex-dividend” at the end of the year. An ex-dividend stock is one in which the issuing company has closed its stock ledger on a certain date and has declared a dividend payable to the stockholder of record, even though the stock may have been sold after the record date but prior to the payment date. The association value of ex-dividend stock includes no value for the dividend

> since the unpaid dividend does not transfer with ownership of the stock. The listing of ex-dividend stock contains the declared dividend rate for calculating the declared but unpaid dividends that are allowable for each stock owned by the company on the dividend record date.

15. The Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies provides guidance with respect to mortgage loan interest income. Pertinent excerpts are as follows:

> CHAPTER 3
> MORTGAGE LOANS
>
> Interest
>
> Interest income on mortgage loans is recorded when earned during the any reporting period. An "inventory" of due and accrued interest must be determined at the end of each reporting period. Interest income includes adjustments for amortization or the accrual of discount.
>
> A portion of the interest due and accrued on mortgage loans may require treatment as a nonadmitted asset for reporting purposes. In general, amounts over one year past due are nonadmitted. In practice, some companies consider that interest past due for periods of less than one year indicates future uncollectibility, and may make a provision against operations for such amounts to establish an appropriate reserve. Alternatively, some companies may cease accrual of interest on loans that default on any payment. Therefore, the amount of due and accrued interest that is considered to be a nonadmitted asset depends on the policy regarding accrual determination, and whether reserves have been established by charges to operations. In the case of mortgage loans on which foreclosure action is pursued, delinquent interest may be recovered from the amount, if any, by which the proceeds on the eventual sale of the property exceed the unpaid principal balance.
>
> Contingent interest represents income generated through the occurrence of specific economic events in relation to the borrower. For example, contingent interest may become payable upon the attainment of a given level of cash flow or income. Contingent interest may be reported as income when received or accrued. The proper accrual of such income does, however, require an analysis of the applicable provisions in the underlying agreement and the verification that the prerequisite conditions have been met.
>
> Payments
>
> Payments on mortgage loans may be received in advance of due dates. Such payments may produce prepaid interest which is considered unearned and is recorded as a liability in the annual statement.
>
> Companies that use servicing agents for their mortgage loans should report the "Interest Due and Accrued" asset on the balance sheet consistently with the income statement treatment of the charge for servicing costs. If interest income is reported net of servicing costs, which is usual when the servicing agent fee is based on a percentage retention of each interest payment, then the interest receivable in the balance sheet should be net of the related servicing costs. If interest is reported gross, with the servicing costs reported as an expense item, then interest due and accrued should be reflected as an asset at the gross amount, with an appropriate liability to reflect the related servicing cost accrual.

16. The Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies contains similar guidance.

17. The Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies provides guidance with respect to real estate investment income. Pertinent excerpts are as follows:

> CHAPTER 4
> REAL ESTATE
>
> Income Derived from Real Estate
>
> Income on real estate, or on space in buildings owned and occupied by the company, usually is received periodically and in advance and any amount not received at the end of an accounting period should be set up as investment income due and unpaid to the extent that the amount applies to that accounting period. If the collectibility of unpaid rent is in doubt, or if the amount due exceeds a period specified by statute or regulation, most jurisdictions require that the entire amount be nonadmitted. Rental income paid in advance of the accounting period for which it is payable in whole or in part should be included in the liability for unearned investment income to the extent it applies to the succeeding accounting period. If rental income is to be received over a period shorter than the full lease period, the total rent to be received should be accrued periodically as if the rent were received over the total lease period. Interest expense on a mortgage is netted against the rental income for the period.

18. The Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies contains similar guidance.

19. The Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies provides guidance with respect to interest income on cash on deposit. Pertinent excerpts are as follows:

> CHAPTER 5
> CASH AND SHORT-TERM INVESTMENTS
>
> Income from Bank Deposits
>
> Income consists of the interest that is earned on interest-bearing bank deposits and on demand certificates of deposit. Earned interest consists of interest that is collected during the period, plus due or accrued interest at the end of the period, minus any unearned interest, and minus due or accrued interest, plus any unearned interest at the beginning of the period.
>
> The amount allowed as an admitted asset for due or accrued interest is the interest or dividends due and payable, but not credited, on deposits in banks and trust companies or on accounts with savings and loans associations.
>
> The accrued interest on savings accounts is admissible because, if the deposit was withdrawn at the statement date, interest would be paid to the date of withdrawal. Accrued interest on demand CD's may be wholly or partially not admitted in some states, as interest is payable at maturity and, if the certificates are redeemed early, an interest penalty may be assessed. The certificate must be examined to determine the status of accrued interest. If the certificate were to be redeemed before maturity, and the interest would be payable, the accrued interest may be admitted but not in an amount that exceeds that amount receivable if redeemed prior to maturity. The maximum amount of accrued interest that may be admitted on a certificate which provides for an interest penalty for early redemption is based upon a reduced interest rate.

20. The Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies contains similar guidance.

21. The Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies provides guidance with respect to interest income on policy loans. Pertinent excerpts are as follows:

> CHAPTER 7
> POLICY LOANS
>
> Interest
>
> Interest on a policy loan may be payable at either the beginning or end of the policy loan interest period. Where it is payable at the beginning of the period, appropriate balance sheet provision should be established for any unearned policy loan interest. Where it is payable at the end of the period, appropriate provision should be established for any accrued interest. Interest earned is reported as investment income.
>
> The calculation of investment income from a company's policy loans requires a determination of unearned or accrued interest. These are included in their respective accounts in the balance sheet as unearned or accrued investment income and not with the balance of policy loans. The calculation of accrued and unearned interest usually is made on a policy-by-policy basis, or for policies grouped by interest rate and policy anniversary or interest paid-to-date.
>
> Past-due interest normally is capitalized as an addition to the loan balance with the interest recorded as received.

22. The Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies provides the following in its list of admitted assets in Chapter 8:

> (k) Interest, Dividends and Real Estate Income Due and Accrued
>
> 1. The rents accrued and owing to the company on real and personal property, directly or beneficially owned
>
> 2. Interest or rents accrued on conditional sales agreements, chattel mortgages and real or personal property under lease to other corporations
>
> 3. The fixed and required interest due and accrued on bonds and other like evidences of indebtedness, not in default
>
> 4. Dividends receivable on shares of stock, provided that the market price taken for valuation purposes does not include the value of the dividend
>
> 5. The interest or dividends due and accrued, but not credited, on deposits in banks and trust companies or on accounts with savings and loan associations
>
> 6. Interest accrued on tax anticipation warrants
>
> 7. Interest accrued on secured loans

23. The Iowa state regulations provide the following guidance:

> In estimating the profits, a reserve for unearned premiums as set out in section 515.47, also a reserve for unpaid losses, expenses, and taxes which have been incurred shall be set up; and there shall also be held as nonadmitted assets all sums due the corporation on bonds and mortgages, bonds, stocks, and book accounts, of which no part of the principal or interest thereon has been paid during the year preceding such estimate of profits, and upon which suit for foreclosure or collection has not been commenced, or which, after judgment has been obtained thereon, shall have remained more than two years unsatisfied, and on which interest has not

been paid; and such judgment with the interest due or accrued thereon and remaining unpaid, shall also be so held.

Generally Accepted Accounting Principles

24. There is no specific GAAP guidance that addresses unearned investment income or investment income due and accrued.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 1, *Bonds and Loaned Backed and Structured Securities*, Chapter 2, *Stocks*, Chapter 3, *Mortgage Loans*, Chapter 4, *Real Estate*, Chapter 5, *Cash and Short-Term Investments*, Chapter 7, *Policy Loans*, Chapter 19, *Investment Income and Net Realized Gains*
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 1, *Bonds and Loan Backed and Structured Securities*, Chapter 2, *Stocks*, Chapter 3, *Mortgage Loans*, Chapter 4, *Real Estate*, Chapter 5, *Cash and Short-Term Investments*, Chapter 8, *Other Admitted Assets*, Chapter 15, *Investment Income*

Generally Accepted Accounting Principles

- No applicable GAAP guidance

State Regulations

- Iowa Statutes - Insurance Laws, TITLE XIII--COMMERCE, Subtitle 1. Insurance and Related Regulation, Chapter 515 --INSURANCE OTHER THAN LIFE, General Provisions, 515.45 Reserves

Statutory Issue Paper No. 35

Accounting for Guaranty Fund and Other Assessments

STATUS
Finalized December 6, 1999

Original SSAP: SSAP No. 35; Current Authoritative Guidance: SSAP No. 35R
This issue paper may not be directly related to the current authoritative statement.

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Guaranty fund assessments represent a funding mechanism employed by state insurance departments to provide funds to cover policyholder obligations of insolvent reporting entities. Most states have enacted legislation establishing guaranty funds for both life and health insurance and for property and casualty insurance to provide for covered claims or to meet other insurance obligations of insolvent insurers in the state. Guaranty funds generally make assessments after an insolvency based upon retrospective premium writings for Life and Accident and Health Insurance Companies or prospective premium writings for Property and Casualty Insurance Companies. However, a small number of states have guaranty funds that prefund, that is they assess members before an insolvency occurs. Reporting entities are subject to a variety of other assessments, such as workers' compensation second-injury funds and funds that pay operating costs of the insurance department, health related assessments, or the workers' compensation board.

2. State laws often allow for recoveries of guaranty fund assessments through refunds from the guaranty fund, premium tax credits, policy surcharges, and future premium rate structures.

3. Current statutory accounting provides only limited guidance on accounting for guaranty fund and other assessments; requiring that assessments be charged to taxes, licenses and fees, but not addressing when to recognize liabilities for assessments. *SOP 97-3*, *Accounting by Insurance and Other Enterprises for Insurance-Related Assessments* (SOP 97-3) dictates GAAP guidance. This issue paper establishes statutory accounting principles for guaranty fund and other assessments that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of* Assets (Issue Paper No. 5), requires accrual of a liability when both of the following conditions are met:

a. Information available prior to issuance of the statutory financial statements indicates that it is probable that an asset has been impaired or a liability has been incurred at the date of the statutory financial statements. It is implicit in this condition that it is probable that one or more future events will occur confirming the fact of the loss or incurrence of a liability, and

b. The amount of loss can be reasonably estimated.

For purposes of subparagraph 4 b., loss generally means assessment or assessment rate. Guaranty fund and other assessments shall be charged to expense (Taxes, Licenses and Fees) and a liability shall be accrued when those criteria are met except for certain health related assessments which shall be reported as a part of claims. Health related assessments that are reported as a part of claims instead of taxes, licenses and fees are those assessments that are designed for the purpose of spreading the risk of severe claims or adverse enrollment selection among all participating entities, and where the funds collected via the assessment are re-distributed back to the participating entities based upon the cost of specific claims, enrollment demographics, or other criteria affecting health care expenses.

5. For refunded guaranty fund assessments and assessments used to fund state operating expenses, reporting entities shall credit the refund or charge the assessment to expense when notification of the refund or assessment is made.

6. For guaranty fund assessments, subparagraph 4a is met when the insolvency has occurred, regardless of whether the assessments are based on premiums written before or after the insolvency. For purposes of applying this guidance, the insolvency shall be considered to have occurred when a reporting entity meets a state's (ordinarily the state of domicile of the insolvent reporting entity) statutory definition of an insolvent reporting entity. In most states, the reporting entity must be declared to be financially insolvent by a court of competent jurisdiction. In some states, there must also be a final order of liquidation. Loss-based administrative-type and second injury fund assessments are presumed probable when the losses on which the assessments are expected to be based are incurred.

7. Subparagraph 4b requires that the amounts can be reasonably estimated. For guaranty fund or other assessments, a reporting entity's estimate of the liability shall reflect an estimate of its share of the ultimate loss expected from the insolvency. The reporting entity shall also estimate any applicable premium tax credits and policy surcharges. An entity need not be able to compute the exact amounts of the assessments or be formally notified of such assessments by a guaranty fund to make a reasonable estimate of its liability. Entities subject to assessments may have to make assumptions about future events, such as when the fund making the assessment will incur costs and pay claims to determine the amounts and the timing of assessments. The best available information about market share or premiums by state and premiums by line of business generally should be used to estimate the amount of future assessments. Estimates of loss-based assessments should be consistent with estimates of the underlying incurred losses and should be developed based upon enacted laws or regulations and expected assessment rates. Premium tax credits or policy surcharges may only be considered in the estimate if it is probable they will be realized. Changes in the amount of the liability (or asset) as a result of the passage of time and revisions to estimates in the amount or timing of the payments shall be recorded in taxes, licenses and fees.

8. In accordance with Issue Paper No. 5, when the reasonable estimate of the loss is a range, the amount in the range that is considered the best estimate shall be accrued. When, in management’s opinion, no amount within management’s estimate of the range is a better estimate than any other amount, however, the midpoint (mean) of within management’s estimate in the range shall be accrued. For purposes of this issue paper, it is assumed that management can quantify the high end of the range. If management determines that the high end of the range cannot be quantified, then a range does not exist, and management’s best estimate shall be accrued.

9. The liability for assessments shall be established gross of any probable and estimable recoveries from premium tax credits and premium surcharges. Because assessments are generally paid before premium tax credits are realized or policy surcharges are collected, an asset may result, which represents a receivable for premium tax credits that will be taken and policy surcharges which will be collected in the future. These amounts, to the extent it is probable they will be realized, meet the definition of assets, as specified in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets* (Issue Paper No. 4), and are admitted assets to the extent they conform to the requirements of this issue paper. The asset shall be established and reported independent from the liability (not reported net).

10. In certain circumstances, a reporting entity acts as an agent for certain state agencies in the collection and remittance of fees or assessments. In these circumstances, the liability for the fees and

assessments rests with the policyholder rather than with the reporting entity. The reporting entity's obligation is to collect and subsequently remit the fee or assessment. When both the following conditions are met, an assessment should not be reported in the statement of operations of a reporting entity:

a. The assessment is reflected as a separately identifiable item on the billing to the policyholder; and

b. Remittance of the assessment by the reporting entity to the state is contingent upon collection from the insured.

Disclosure

11. In the event that the criteria in paragraph 4 are not met, the notes to the financial statements shall include the disclosure required by Issue Paper No. 5 which, indicates the nature of the assessments and states that an estimate of the liability cannot be made.

DISCUSSION

12. This issue paper applies Issue Paper No. 5 to guaranty fund and other assessments.

13. Current statutory practice is that assessments for life guaranty fund obligations (which are based on premiums written prior to the insolvency) are accrued at the time of the insolvency. Current statutory practice for property and casualty guaranty fund assessments varies. Not all property and casualty guaranty fund obligations are accrued at the time of the insolvency. Those that have not accrued the obligation believe that guaranty fund assessments that are based on premiums written after an insolvency should be accrued when the premiums are written, because the event that obligates the company is the writing of the premiums. This issue paper rejects that point of view, because it is inconsistent with the concepts of conservatism and recognition outlined in the Statement of Concepts. It is also inconsistent with the accounting principles set forth in Issue Paper No. 5. With respect to conservatism, the Statement of Concepts states that:

> Financial reporting by insurance enterprises requires the use of substantial judgments and estimates by management ... In order to provide a margin of protection for policyholders, the concept of conservatism should be followed when developing estimates as well as establishing accounting principles for statutory reporting.

With respect to recognition, the Statement of Concepts states that:

> Liabilities require recognition as they are incurred. Certain statutorily mandated liabilities may also be required to arrive at conservative estimates of liabilities and probable loss contingencies... Accounting treatments which tend to defer expense recognition do not generally represent acceptable SAP treatment.

Drafting Notes/Comments

- Voluntary Guaranty Funds should be accounted for in accordance with *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

14. The Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies mention guaranty fund surplus in their respective chapters on surplus. Both state that "Guaranty fund surplus for mutual companies" should be considered as part of surplus, for purposes of meeting the minimum surplus requirements.

15. The NAIC Annual Statement Instructions indicate that Taxes, Licenses & Fees should include guaranty fund assessments.

16. Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force discussed the accounting for guaranty fund and other assessments in Issues 91-1 through 91-4 and 92-1. The discussion focused around whether guaranty fund assessments could be reported as loss payments. The consensus reached was that guaranty fund assessments should be reported as expense items through Taxes, Licenses and Fees.

17. The Life and Health Insurance Guaranty Association Model Act provides the following guidance:

Section 9. Assessments

A. For the purpose of providing the funds necessary to carry out the powers and duties of the Association, the board of directors shall assess the member insurers, separately for each account, at such time and for such amounts as the board finds necessary. Assessments shall be due not less than thirty (30) days after prior written notice to the member insurers and shall accrue interest at [insert amount] percent per annum on and after the due date.

B. There shall be two (2) assessments, as follows:

(1) Class A assessments shall be made for the purpose of meeting administrative and legal costs and other expenses and examinations conducted under the authority of Section 12E. Class A assessments may be made whether or not related to a particular impaired or insolvent insurer.

(2) Class B assessments shall be made to the extent necessary to carry out the powers and duties of the Association under Section 8 with regard to an impaired or an insolvent insurer.

C. (1) The amount of any Class A assessment shall be determined by the board and may be made on a pro rata or non-pro rata basis. If pro rata, the board may provide that it be credited against future Class B assessments. A non-pro rata assessment shall not exceed $150 per member insurer in any one calendar year. The amount of any Class B assessment shall be allocated for assessment purposes among the accounts pursuant to an allocation formula which may be based on the premiums or reserves of the impaired or insolvent insurer or any other standard deemed by the board in its sole discretion as being fair and reasonable under the circumstances.

(2) Class B assessments against member insurers for each account and subaccount shall be in the proportion that the premiums received on business in this state by each assessed member insurer or policies or contracts covered by each account for the three (3) most recent calendar years for which information is available preceding the year in which the insurer became impaired or insolvent, as the case may be, bears to such premiums received on business in this state for such calendar years by all assessed member insurers.

(3) Assessments for funds to meet the requirements of the Association with respect to an impaired or insolvent insurer shall not be made until necessary to implement the purposes of this Act. Classification of assessments under Subsection B and computation of assessments under this subsection shall be made with a reasonable degree of accuracy, recognizing that exact determinations may not always be possible.

D. The Association may abate or defer, in whole or in part, the assessment of a member insurer if, in the opinion of the board, payment of the assessment would endanger the ability of the member insurer to fulfill its contractual obligations. In the event an assessment against a member insurer is abated, or deferred in whole or in part, the amount by which the assessment is abated or deferred may be assessed against the other member insurers in a manner consistent with the basis for assessments set forth in this section.

E. (1) The total of all assessments upon a member insurer for the life and annuity account and for each subaccount thereunder shall not in any one calendar year exceed two percent (2%) and for the health account shall not in any one calendar year exceed two percent (2%) of the insurer's average premiums received in this state on the policies and contracts covered by the account during the three (3) calendar years preceding the year in which the insurer became an impaired or insolvent insurer. If the maximum assessment, together with the other assets of the Association in any account, does not provide in any one year in either account an amount sufficient to carry out the responsibilities of the Association, the necessary additional funds shall be assessed as soon thereafter as permitted by this Act.

(2) The board may provide in the plan of operation a method of allocating funds among claims, whether relating to one or more impaired or insolvent insurers, when the maximum assessment will be insufficient to cover anticipated claims.

(3) If a one percent (1%) assessment for any subaccount of the life and annuity account in any one year does not provide an amount sufficient to carry out the responsibilities of the Association, then pursuant to Subsection C(2), the board shall access all subaccounts of the life and annuity account for the necessary additional amount, subject to the maximum stated in Subsection E(1) above.

Editor's Note: For interpretation of this section, see Guaranty Fund (EX4) Task Force minutes in 1988 Proceedings of the NAIC, Volume II, page 335.

F. The board may, by an equitable method as established in the plan of operation, refund to member insurers, in proportion to the contribution of each insurer to that account, the amount by which the assets of the account exceed the amount the board finds is necessary to carry out during the coming year the obligations of the Association with regard to that account, including assets accruing from assignment, subrogation, net realized gains and income from investments. A reasonable amount may be retained in any account to provide funds for the continuing expenses of the Association and for future losses.

G. It shall be proper for any member insurer, in determining its premium rates and policyowner dividends as to any kind of insurance within the scope of this Act, to consider the amount reasonably necessary to meet its assessment obligations under this Act.

H. The Association shall issue to each insurer paying an assessment under this Act, other than Class A assessment, a certificate of contribution, in a form prescribed by the Commissioner for the amount of the assessment so paid. All outstanding certificates shall be of equal dignity and priority without reference to amounts or dates of issue. A certificate of contribution may be shown by the insurer in its financial statement as an asset in such form and for such amount, if any, and period of time as the Commissioner may approve.

Comment: When an insurer is impaired or insolvent the member insurers will be assessed on the basis of the premiums they write in the state. This corresponds to the Association's liability which, in most cases, is limited to covered policies of residents. This assessment system provides a base broad enough to meet fairly large demands on the Association. Equally important, since it reflects the market share of each member in the state considered, it is an equitable method of apportioning the burden of the assessments.

The maximum assessment per year may be varied from state to state depending on the size of the base and the concentration of the business. The two percent maximum assessment per year should produce an adequate amount while at the same time not impose an undue strain in any given year on the assessed companies and their policyholders.

In order to prevent further financial difficulties caused by an assessment, Subsection D permits abatement of assessments when such financial difficulties might result. Subsections D and E provide some limitation on the amounts which can be assessed in any given year. If these limits are reached, to fulfill its responsibilities the Association is empowered to borrow funds which later can be repaid out of future assessments.

Subsection G provides that a member insurer may consider in its premium rates and dividend scale an amount reasonably necessary to meet its assessment obligations. This makes it clear that the cost can be ultimately passed on to the policyowners - i.e., to persons who enjoy the protection provided by the Act.

Subsection H provides that the Association shall issue to assessed insurers certificates of contribution in the amount levied. The certificates may be carried by an insurer in its annual statement as an asset in such form, amount and period as may be approved by the Commissioner. By permitting the companies to carry these certificates as an asset, to the extent of their estimated value, the impact on member insurers will be lessened.

18. The Post-Assessment Property and Liability Insurance Guaranty Association Model Act provides the following guidance:

Section 8. Powers and Duties of the Association

A. The Association shall:

(1) Be obligated to pay covered claims existing prior to the determination of the insolvency arising within thirty (30) days after the determination of insolvency, or before the policy expiration date if less than thirty (30) days after the determination of insolvency, or before the insured replaces the policy or causes its cancellation, if he does so within thirty (30) days of the determination. The obligation shall be satisfied by paying to the claimant an amount as follows:

(a) The full amount of a covered claim for benefits under a workers' compensation insurance coverage;

(b) An amount not exceeding $10,000 per policy for a covered claim for the return of unearned premium;

(c) An amount not exceeding $300,000 per claimant for all other covered claims.

In no event shall the Association be obligated to pay a claimant an amount in excess of the obligation of the insolvent insurer under the policy or coverage from which the claim arises. Notwithstanding any other provisions of this Act, a covered claim shall not include any claim filed with the Guaranty Fund after the final date set by the court for the filing of claims against the liquidator or receiver of an insolvent insurer. The Association shall pay only that amount of each unearned premium which is in excess of $100.

Comment: The obligation of the Association is limited to covered claims unpaid prior to insolvency, and to claims arising within thirty days after the insolvency, or until the policy is canceled or replaced by the insured, or it expires, whichever is earlier. The basic principle is to permit policyholders to make an orderly transition to other companies. There appears to be no reason why the Association should become in effect an insurer in competition with member insurers by continuing existing policies, possibly for several years. It is also felt that the control of the policies is properly in the hands of the liquidator. Finally, one of the major objections of the public to rapid termination, loss of unearned premiums with no corresponding coverage, is ameliorated by this bill since unearned premiums are permissible claims, up to $10,000, against the Association. The deductible amount ($100) and the maximums ($10,000 for the return of unearned premium; $300,000 for all other covered claims) represent the subcommittee's concept of practical limitations, but each state will wish to evaluate these figures.

[Alternate Section 8A(1)

A. The Association shall:

(1) Be obligated to pay covered claims existing prior to the determination of the insolvency arising within thirty (30) days after the determination of insolvency, or before the policy expiration date if less than thirty (30) days after the determination of insolvency, or before the insured replaces the policy or causes its cancellation, if he does so within thirty (30) days of the determination. The obligation shall extend to covered claims reported pursuant to an optional extended period to report claims sold to the insured by the liquidator. The obligation as to covered claims shall be satisfied by paying to the claimant an amount as follows:

(a) The full amount of a covered claim for benefits under a workers' compensation insurance coverage;

(b) An amount not exceeding $10,000 per policy for a covered claim for the return of unearned premium;

(c) An amount not exceeding $300,000 per claimant for all other covered claims.

In no event shall the Association be obligated to pay a claimant an amount in excess of the obligation of the insolvent insurer under the policy from which the claim arises. Notwithstanding any other provision of this Act, a covered claim shall not include any claim filed with the Guaranty Fund after the earlier of the final date for the filing of claims against the liquidator or receiver of an insolvent insurer or eighteen (18) months after the order of liquidation. The Association shall pay only that amount of each unearned premium which is in excess of $100.]

Comment: The Alternate Section 8A(1) should be used if the state includes a provision in its liquidation law giving the liquidator authority to sell a limited extended reporting period for claims-made policies.

(2) Be deemed the insurer to the extent of its obligation on the covered claims and to that extent shall have all rights, duties and obligations of the insolvent insurer as if the insurer had not become insolvent.

(3) Assess insurers amounts necessary to pay the obligations of the Association under Section 8A(1) subsequent to an insolvency, the expenses of handling covered claims subsequent to an insolvency, and other expenses authorized by this Act. The assessments of each member insurer shall be in the proportion that the net direct written premiums of the member insurer for the calendar year preceding the assessment bears to the net direct written premiums of all member insurers for the calendar year preceding the assessment. Each member insurer shall be notified of the assessment not later than thirty (30) days before it is due.

No member insurer may be assessed in any year an amount greater than two percent (2%) of that member insurer's net direct written premiums for the calendar year preceding the assessment. If the maximum assessment, together with the other assets of the Association, does not provide in any one year an amount sufficient to make all necessary payments, the funds available shall be prorated and the unpaid portion shall be paid as soon thereafter as funds become available. The Association shall pay claims in any order which it may deem reasonable, including the payment of claims as they are received from the claimants or in groups or categories of claims. The Association may exempt or defer, in whole or in part, the assessment of any member insurer, if the assessment would cause the member insurers financial statement to reflect amounts of capital or surplus less than the minimum amounts required for a certificate of authority by any jurisdiction in which the member insurer is authorized to transact insurance; provided, however, that during the period of deferment, no dividends shall be paid to shareholders or policyholders. Deferred assessments shall be paid when the payment will not reduce capital or surplus below required minimums. Payments shall be refunded to those companies receiving larger assessments by virtue of such deferment, or at the election of the company, credited against future assessments.

[Alternate Section 8A(3)

(3) Allocate claims paid and expenses incurred among the three (3) accounts separately, and assess member insurers separately for each account, amounts necessary to pay the obligations of the Association under Section 8A(1) subsequent to an insolvency, the expenses of handling covered claims subsequent to an insolvency and other expenses authorized by this Act. The assessments of each member insurer shall be in the proportion that the net direct written premiums of the member insurer for the calendar year preceding the assessment on the kinds of insurance in the account bears to the net direct written premiums of all member insurer's for the calendar year preceding the assessment on the kinds of insurance in the account. Each member insurer shall be notified of the assessment not later than thirty (30) days before it is due. No member insurer may be assessed in any one year on any account an amount greater than two percent (2%) of that member insurer's net direct written premiums for the calendar year preceding the assessment on the kinds of insurance in the account. If the maximum assessment, together with the other assets of the Association in any account, does not provide in any one year in any account an amount sufficient to make all necessary payments from that account, the funds available shall be pro-rated and the unpaid portion shall be paid as soon thereafter as funds become available. The Association shall pay claims in any order which it deems reasonable, including the payment of claims as they are received from the claimants or in groups or categories of claims. The Association may exempt or defer, in whole or in part, the assessment of any member insurer, if the assessment would cause the member insurer's financial statement to reflect amounts of capital or surplus less than the minimum amounts required for a certificate of authority by any jurisdiction in which the member insurer is authorized to transact insurance; provided, however, that during the period of deferment, no dividends shall be paid to shareholders or policyholders. Deferred assessments shall be paid when the payment will not reduce capital or surplus below required minimums. Payments shall be refunded to those companies receiving larger assessments by virtue of such deferment, or at the election of the company, credited against future assessments. Each member insurer may set off against any assessment, authorized payments made on covered claims and expenses incurred in the payment of claims by the member insurer if they are chargeable to the account for which the assessment is made.]

Comment: The maximum assessment per year may be varied from state to state depending on the size of the base. The figure used should produce sufficient funds to handle any possible insolvency, keeping in mind that the total amount may not be needed in one year. The two percent maximum used here would have produced in 1968 on a nationwide basis, from the kinds of insurance to which this Act applies, approximately $500,000,000.

(4) Investigate claims brought against the Association and adjust, compromise, settle and pay covered claims to the extent of the Association's obligation and deny all other claims and may review settlements, releases and judgments to which the insolvent insurer or its insureds were parties to determine the extent to which such settlements, releases and judgments may be properly contested.

(5) Notify such persons as the Commissioner directs under Section 10B(1).

Comment: The liquidation statutes of the state may describe the persons to be notified by the liquidator, but since this Association provides a distinctive service, the Commissioner may wish to require a separate notification by it.

(6) Handle claims through its employees or through one or more insurers or other persons designated as servicing facilities. Designation of a servicing facility is subject to the approval of the Commissioner, but the designation may be declined by a member insurer.

(7) Reimburse each servicing facility for obligations of the Association paid by the facility and for expenses incurred by the facility while handling claims on behalf of the Association and shall pay the other expenses of the Association authorized by this Act.

B. The Association may:

(1) Employ or retain such persons as are necessary to handle claims and perform other duties of the Association;

(2) Borrow funds necessary to effect the purposes of this Act in accordance with the plan of operation;

(3) Sue or be sued;

(4) Negotiate and become a party to such contracts as are necessary to carry out the purpose of this Act;

(5) Perform such other acts as are necessary or proper to effectuate the purpose of this Act;

(6) Refund to the member insurers in proportion to the contribution of each member insurer to the Association that amount by which the assets of the Association exceed the liabilities, if at the end of any calendar year, the board of directors finds that the assets of the Association exceed the liabilities of the Association as estimated by the board of directors for the coming year.

[Alternate Section 8B(6)

(6) Refund to the member insurers in proportion to the contribution of each member insurer to that account that amount by which the assets of the account exceed the liabilities, if at the end of any calendar year, the board of directors finds that the assets of the Association in any account exceed the liabilities of that account as estimated by the board of directors for the coming year.]

Comment: The subcommittee feels that the board of directors should determine the amount of the refunds to members when the assets of the Association exceed its liabilities. However, since this excess may be quite small, the board is given the option of retaining all or part of it to pay expenses and possibly remove the need for a relatively small assessment at a later time.

19. The 24-Hour Coverage Pilot Project Model Act provides the following discussion of guaranty fund assessments:

Section 15. Guaranty Fund Participation

The twenty-four hour medical insurance policy shall be classified as property and casualty coverage regardless of the carrier approved to provide the coverage. As such, the carrier shall be obligated to participate in the property and casualty guaranty association specified in [insert applicable section providing for participation in the property and casualty insurance guaranty association]. All premiums collected for the twenty-four hour medical insurance policy shall be considered assessable premiums for purposes of participation in the guaranty association. In the event of insolvency of the carrier, the guaranty association shall honor the full extent of the contractual obligation assumed by the carrier under the twenty-four hour medical insurance policy.

Section 16. Special Assessments

A carrier providing coverage to an employer through the twenty-four hour medical insurance policy is obligated to participate in the [insert reference to residual market mechanism, second injury fund or other fund that relies on assessments from workers' compensation insurance premiums]. For purposes of calculation of this special assessment, the commissioner shall establish by rule, or order, the amount of premium generated under the twenty-four hour medical insurance policy which shall be considered assessable premium.

Drafting Note: A state should consider the ratio of the workers' compensation standard premium to the total premium for both workers' compensation and the health insurance plan used by the employer in choosing an appropriate amount. States with relatively small residual market shares for workers' compensation may choose to exclude this section. States should consider loss based assessments, if applicable.

20. The Health Maintenance Organization Model Act contains the following:

Section 33. Insolvency Protection; Assessment

A. When a health maintenance organization in this state is declared insolvent by a court of competent jurisdiction, the [commissioner] may levy an assessment on health maintenance organizations doing business in this state to pay claims for uncovered expenditures for enrollees who are residents of this state and to provide continuation of coverage for subscribers or enrollees not covered under Section 15. The [commissioner] may not assess in any one calendar year more than two percent (2%) of the aggregate premium written by each health maintenance organization in this state the prior calendar year.

B. The [commissioner] may use funds obtained under Subsection A to pay claims for uncovered expenditures for subscribers or enrollees of an insolvent health maintenance organization who are residents of this state, provide for continuation of coverage for subscribers or enrollees who are residents of this state and are not covered under Section 15, and administrative costs. The [commissioner] may by regulation prescribe the time, manner and form for filing claims under this section or may require claims to be allowed by an ancillary receiver or the domestic liquidator or receiver.

C. (1) A receiver or liquidator of an insolvent health maintenance organization shall allow a claim in the proceeding in an amount equal to administrative and uncovered expenditures paid under this section.

(2) Any person receiving benefits under this section for uncovered expenditures is deemed to have assigned the rights under the covered health care plan certificates to the [commissioner] to the extent of the benefits received. The [commissioner] may require an assignment to it of such rights by any payee, enrollee, or beneficiary as a condition precedent to the receipt of any rights or benefits conferred by this section upon that person. The [commissioner] is subrogated to these rights against the assets of an insolvent health maintenance organization held by a receiver or liquidator of another jurisdiction.

(3) The assignment of subrogation rights of the [commissioner] and allowed claim under this subsection have the same priority against the assets of the insolvent health maintenance organization as those possessed by the person entitled to receive benefits under this section or for similar expenses in the receivership or liquidation.

D. When assessed funds are unused following the completion of the liquidation of a health maintenance organization, the [commissioner] will distribute on a pro rata basis any amounts received under Subsection A which are not *de minimis* to the health maintenance organizations that have been assessed under this section.

E. The aggregate coverage of uncovered expenditures under this section shall not exceed $300,000 with respect to one individual. Continuation of coverage shall not continue for more than the lesser of one year after the health maintenance organization coverage is terminated by insolvency or the remaining term of the contract. The [commissioner] may provide continuation of coverage on any reasonable basis; including, but not limited to, continuation of the health maintenance organization contract or substitution of indemnity coverage in a form determined by the [commissioner].

F. The [commissioner] may waive an assessment of a health maintenance organization if it would be or is impaired or placed in financially hazardous condition. A health maintenance organization which fails to pay an assessment within thirty (30) days after notice is subject to a civil forfeiture of not more than $1,000 per day and suspension or revocation of its certificate of authority. An action taken by the [commissioner] in enforcing the provisions of this section may be appealed by the health maintenance organization in accordance with [the administrative procedures act].

Drafting Comment: Section 33 is not recommended for all states. A state should carefully review its health maintenance organization market to determine whether the assessment procedure under this section is feasible. If health maintenance organization premium volume is small or dominated by a few organizations, a state may wish to rely solely on the protections provided under Section 14 and 15.

For those states where an assessment is feasible, this section provides assurance that funds will be available to pay uncovered expenditures even if those liabilities have been underestimated by the organization or have significantly escalated as the financial condition of the organization deteriorated. In addition, an assessment provides a means for continued coverage for those subscribers or enrollees who are not protected under Section 15.

Generally Accepted Accounting Principles

21. The *AICPA Audit and Accounting Guide: Stock Life Insurance* Companies contains the following in Chapter 7, *Capital and Surplus*:

> In lieu of capital stock, mutual companies are organized with prescribed minimum surplus which varies among states. Such surplus may take the form of guaranty funds, guaranty capital, or

other permanently designated funds subject to the payment of interest and subject to repayment under conditions prescribed by the respective state laws.

22. *AICPA Statement of Position 97-3, Accounting by Insurance and Other Enterprises for Insurance-Related Assessments* contains the following guidance (only pertinent sections included):

> Reporting Liabilities
>
> 10. Entities subject to assessments should recognize liabilities for insurance-related assessments when all of the following conditions are met:
>
> a. An assessment has been imposed or information available prior to the issuance of the financial statements indicates it is probable that an assessment will be imposed.
>
> b. The event obligating an entity to pay (underlying cause of) an imposed or probable assessment has occurred on or before the date of the financial statements.
>
> c. The amount of the assessment can be reasonably estimated.
>
> Probability of Assessment
>
> 11. Premium-based guaranty-fund assessments, expect those that are prefunded, are presumed probable when a formal determination of insolvency occurs, and presumed not probable prior to formal determination of insolvency. Prefunded guaranty-fund assessments and premium-based administrative-type assessments (as defined in paragraph 4), are presumed probable when the premiums on which the assessments are expected to be based are written. Loss-based administrative-type and second-injury fund assessments are presumed probable when the loss on which the assessments are expected to be based are incurred.
>
> Obligating Event
>
> 12. Because of the fundamental differences in how assessment mechanisms operate, the event that makes an assessment probable (for example, an insolvency) may not be the event that obligates the entity. The following defines the event that obligates an entity to pay an assessment for each kind of assessment defined in this SOP.
>
> 13. For premium-based assessments, the event that obligates the entity is generally writing the premium or becoming obligated to write or renew (such as multiple-year, noncancelable policies) the premiums on which the assessments are expected to be based. Some states, through law or regulatory practice, provide that an insurance enterprise cannot avoid paying a particular assessment even if that insurance enterprise reduces its premium writing in the future. In such circumstances, the event that obligates the entity is a formal determination of insolvency or similar triggering event. Regulatory practice would be determined based on the stated intentions or prior history of the insurance regulators.
>
> 14. For loss-based assessments, the event that obligates an entity is an entity's incurring the losses on which the assessments are expected to be based.

The SOP defines the condition of obligation differently than the issue paper. This issue paper indicates that the conditions of probability and obligation have been satisfied when insolvency has occurred, regardless of whether the assessment is based upon premiums or losses written, incurred or paid before or after the insolvency. This issue paper rejects SOP 97-3 because it is inconsistent with the concepts of conservatism and recognition outlined in the Statement of Concepts. It is also inconsistent with the accounting principles set forth in Issue Paper No. 5. This issue paper has incorporated language from the Ability to Reasonably Estimate the Liability section of the SOP in paragraph 7.

OTHER SOURCES OF INFORMATION

23. The draft discussion material from previous Property/Casualty codification projects provides the following guidance:

> CHAPTER X
> GUARANTEE FUND AND OTHER ASSESSMENTS
>
> The expense for guarantee fund and other assessments should be reported as taxes, licenses and fees in the annual statement (and not as loss payments) when incurred. Specific assessment practices differ from state to state. In general, however, when an assessment is made, in addition to the amount requested, an estimate of the ultimate range of assessment may be indicated. Experience has shown that these ranges may change dramatically within a short time frame. The expense is incurred when an insolvency has occurred, an assessment is probable, and the amount can be reasonably estimated.
>
> Accounting for Guarantee Fund and Other Assessments
>
> Guarantee fund and other assessments are incurred, must be expensed, and a liability established when the following criteria are met:
>
> a. An insolvency has occurred which creates an obligation for a state guarantee fund. This obligation will usually be evident when a company receives a court order for liquidation.
>
> b. Information available indicates that it is probable that a liability has been incurred.
>
> c. The amount of the liability can be reasonable estimated.
>
> The amount accrued must reflect the ultimate liability expected from the insolvency. The accrual will be determined net of anticipated premium tax offsets.
>
> If it is probable that a liability has been incurred from an insolvency, but it can not be reasonable estimate, a footnote should disclose the nature of the contingent liability and shall express the potential range of the anticipated loss exposure, when the potential liability is deemed material.
>
> Reporting for Guarantee Fund and Other Assessments
>
> The expense for guarantee fund and other assessments should be reported as taxes, licenses and fees in the annual statement (and not as loss payments) when incurred.
>
> Assessment for which the Insurance company acts as Agent for the State
>
> In certain circumstances, an insurance company acts as an agent for certain state agencies in the collection and remittance of fees or assessments. In these circumstances, the liability for the fees and assessments rests with the policyholder rather than with the insurance company. The insurance company's obligation is to collect and subsequently remit the fee or assessment. These situations differ from a premium tax liability whereby the insurance company is required to remit the premium tax whether or not the premium has been collected.
>
> When both the following conditions are met, an assessment should not be reported in the statement of operations of an insurance company:
>
> - The assessment is reflected as a separately identifiable item on the billing to the policyholder; and

> - Remittance of the assessment by the insurance company to the state is contingent upon collection from the insured.

24. NAIC Technical Resource Group Proposed Draft Life Codification provides the following guidance in Chapter 22, *General Expenses and Taxes, Licenses and Fees*:

> 6. All other taxes will include guaranty fund assessments and taxes of Canada or of any other foreign country not specifically provided for elsewhere. Guaranty fund and other assessments must be expended and a liability established when the following criteria are met:
>
> - An insolvency has occurred which creates an obligation for a state guaranty fund; this obligation will usually be evident when a company receives a court order for liquidation;
>
> - Information available indicates it is probable that a liability has been incurred; and
>
> - The amount of the loss can be reasonably estimated using the risk free investment rate of a bond having a duration equivalent to the duration of the liability.
>
> The amount accrued must reflect the ultimate loss exposure expected from the insolvency. The accrual will be determined net of estimated premium tax offsets and will reflect the present value of the anticipated payments.
>
> If it is probable a liability has been incurred from an insolvency, but it cannot be reasonably estimated, the nature of the contingent liability and the potential range of the anticipated loss exposure must be disclosed in the notes to the financial statements, when the potential liability is deemed material.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies, and Impairments of Assets*
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 27, *Paid-In or Contributed Surplus and Organizational Surplus*
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 24, *Paid-In or Contributed Surplus and Organizational Surplus*
- NAIC Annual Statement Instructions
- Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force, 92-1, Minutes, Meeting of February 21, 1992
- Life and Health Insurance Guaranty Association Model Act, Section 9 - Assessments
- Post-Assessment Property & Liability Insurance Guaranty Association Model Act, Section 8 - Assessments
- 24 Hour Coverage Pilot Project Model Act, Sections 15 and 16
- Health Maintenance Organization Model Act, Section 33
- Issue Paper No. 4—Definition of Assets and Nonadmitted Assets

Generally Accepted Accounting Principles

- *AICPA Audit and Accounting Guide: Stock Life Insurance Companies,* Chapter 7*, Capital and Surplus,* section 7.03
- *AICPA Statement of Position 97-3, Accounting by Insurance and Other Enterprises for Insurance-Related Assessments*

State Regulations

- No further guidance obtained from state statutes or regulations.

Other Sources of Information

- Draft discussion material from previous Property/Casualty Codification Projects, Chapter X, Guarantee Fund and Other Assessments
- NAIC Technical Resource Group Proposed Draft Life Codification, Chapter 22, *General Expenses and Taxes, Licenses and Fees*

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Statutory Issue Paper No. 36

Troubled Debt Restructurings

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 36

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. A troubled debt restructuring exists when a creditor, for economic or legal reasons related to the debtor's financial difficulties, grants a concession to the debtor that it would not otherwise grant. A troubled debt restructuring may include, but is not necessarily limited to, one or a combination of the following:

a. Transfer of assets to the creditor by the debtor, including a transfer resulting from foreclosure or repossession.

b. Transfer of an equity interest in the debtor to the creditor.

c. Modification of the terms of the debt, such as a reduction in the principal amount, interest rate or an extension of payment due dates.

Current statutory guidance on troubled debt restructurings is limited to guidance on accounting for loans that are in the process of foreclosure and real estate obtained through foreclosure.

2. GAAP guidance has established more comprehensive accounting principles in *FASB Statement No. 15*, *Accounting by Debtors and Creditors for Troubled Debt Restructurings* (FAS 15), as amended by *FASB Statement No. 114*, *Accounting by Creditors for Impairment of a Loan* (FAS 114), and *FASB Statement No. 118*, *Accounting by Creditors for Impairment of a Loan - Income Recognition and Disclosures* (FAS 118*).*

3. The purpose of this issue paper is to establish statutory accounting principles for troubled debt restructurings that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

Definition of Troubled Debt Restructuring

4. A troubled debt restructuring shall be defined as a debt restructuring whereby the creditor, for economic or legal reasons related to the debtor's financial difficulties, grants a concession to the debtor that it would not otherwise grant. That concession either stems from an agreement between the creditor and the debtor or is imposed by law or a court. For example, a creditor may restructure the terms of a debt to alleviate the burden of the debtor's near-term cash requirements, and many troubled debt restructurings involve modifying terms to reduce or defer cash payments required of the debtor in the near future to help the debtor attempt to improve its financial condition and eventually be able to pay the creditor. The creditor, for example, may accept cash, other assets, or an equity interest in the debtor in satisfaction of the debt though the value received is less than the amount of the debt because the creditor concludes that

step will maximize recovery of its investment. A troubled debt restructuring shall include debt that is fully satisfied by foreclosure, repossession, or other transfer of assets or by grant of equity securities by the debtor that is, in a technical sense, not restructured. The determination of whether a debt restructuring is considered a troubled debt restructuring, as defined above, shall be made independently for the debtor and the creditor.

5. A debt restructuring shall not necessarily be considered a troubled debt restructuring for purposes of this issue paper even if the debtor is experiencing some financial difficulties. For example, a troubled debt restructuring is not involved if

a. the fair value of cash, other assets, or an equity interest accepted by a creditor from a debtor in full satisfaction of its receivable at least equals the creditor's recorded investment in the receivable;

b. the fair value of cash, other assets, or an equity interest transferred by a debtor to a creditor in full settlement of its payable at least equals the debtor's carrying amount of the payable;

c. the creditor reduces the effective interest rate on the debt primarily to reflect a decrease in market interest rates in general or a decrease in the risk so as to maintain a relationship with a debtor that can readily obtain funds from other sources at the current market interest rate;

d. the debtor issues in exchange for its debt new marketable debt having an effective interest rate based on its market price that is at or near the current market interest rates of debt with similar maturity dates and stated interest rates issued by nontroubled debtors; or

e. the debtor, in connection with bankruptcy proceedings, enters into debt restructuring that results in a general restatement of most of the debtor's liabilities.

In general, a debtor that can obtain funds from sources other than the existing creditor at market interest rates at or near those for nontroubled debt is not involved in a troubled debt restructuring. A debtor in a troubled debt restructuring can obtain funds from sources other than the existing creditor, if at all, only at effective interest rates (based on market prices) so high that it cannot afford to pay them. Thus, in an attempt to protect as much of its investment as possible, the creditor in a troubled debt restructuring grants a concession to the debtor that it would not otherwise consider.

Accounting by Debtors

6. A debtor shall account for a troubled debt restructuring according to the type of the restructuring (transfer of assets in full settlement, grant of equity interest in full settlement, modification of terms or combination of types). Generally, troubled debt restructurings involving the transfer of assets or the grant of an equity interest shall be accounted for at the fair value of the assets transferred or the equity interest granted, as outlined in paragraph 20 of this issue paper. Troubled debt restructurings involving a modification of terms shall be accounted for prospectively, as outlined in paragraph 20 of this issue paper.

Accounting by Creditors

7. A creditor shall account for a troubled debt restructuring according to the type of the restructuring (receipt of assets in full satisfaction, modification of terms, combination of types). Generally, troubled debt restructurings involving the transfer of assets shall be accounted for at the fair value of the assets received, as outlined in paragraph 20 of this issue paper. Troubled debt restructurings involving modification of terms shall be accounted for at fair value (as determined by acceptable appraisal methodologies or, if applicable, the value determined in accordance with the *Purposes and Procedures Manual of the NAIC Securities Valuation Office* (SVO Purposes and Procedures). If the restructured loan is collateral dependent, fair value shall be the fair value of the collateral. If the restructured loan is not

collateral dependent, fair value shall be determined in accordance with the SVO Purposes and Procedures, if applicable, or at the present value of expected future cash flows, as discussed in paragraph 21 of this issue paper. If the determined fair value of the loan is less than the recorded investment in the loan (including accrued interest, net deferred loan fees or costs, and unamortized premium or discount), a new cost basis shall be established at the fair value with the difference being recorded as a realized loss in the statement of operations.

8. A creditor shall account for assets, including foreclosed property and equity interests in corporations, joint ventures, or partnerships, received in satisfaction of the loan at their fair value (as determined by acceptable appraisal methodologies or, if applicable, the value determined in accordance with the SVO Purposes and Procedures) at the time of restructuring or at the book value of the loan if lower. If the fair value is less than the book value, the required writedown shall be recognized as a realized capital loss. The creditor shall reclassify the asset from loans to the appropriate asset account, such as real estate or other invested assets, at the time that the creditor obtains clear title to the asset except for mortgage loans which shall be reclassified at the beginning of the redemption period unless it is probable that the mortgage loan will be redeemed. After the troubled debt restructuring, a creditor shall account for the assets received in satisfaction of the loan consistent with the statutory guidance for similar assets.

9. A creditor shall account for a modification of terms in accordance with paragraphs 20 and 21 of this issue paper. Any fees received in connection with a modification of terms of a troubled debt restructuring shall be applied as a reduction of the recorded investment in the loan. All costs associated with the restructuring, including direct loan origination costs, shall be charged to expense as incurred.

Disclosure

10. A debtor in a troubled debt restructuring shall follow the disclosure requirements described in paragraph 20 of this issue paper. A creditor in a troubled debt restructuring shall follow the disclosure requirements described in paragraph 22 of this issue paper except the requirement to record the activity in an allowance account, which is required in *Issue Paper No. 37—Mortgage Loans*.

DISCUSSION

11. This issue paper adopts FAS 15 with modification to specify that creditors shall reclassify assets obtained in a troubled debt restructuring from loans to the appropriate asset account at the time the creditor obtains clear title to the asset except for mortgage loans which shall be reclassified at the beginning of the redemption period unless it is probable that the mortgage loan will be redeemed (see paragraph 15 below for justification). It also adopts paragraphs 9, 22 and 25 of FAS 114 which require creditors to measure all loans that are restructured in a troubled debt restructuring involving a modification of terms in accordance with FAS 114. FAS 114 requires that impaired loans be measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. The values determined in accordance with the SVO Purposes and Procedures are used as a loan's observable market price or fair value. It also adopts FAS 118 (i.e., when the provisions of FAS 114 are applied in accounting for a troubled debt restructuring that involves a modification of terms, the provisions of FAS 118 apply). FAS 118 amends certain income recognition provisions previously required by FAS 114 as well as exempts troubled debt restructurings accounted for under FAS 114 from certain disclosure requirements. It also adopts *FASB Technical Bulletin 81-6*, *Applicability of Statement 15 to Debtors in Bankruptcy Situations* (FTB 81-6), which states that FAS 15 does not apply to debtors who, in connection with bankruptcy proceedings, enter into a troubled debt restructuring that results in a general restatement of the debtor's liabilities. It also adopts *FASB Technical Bulletin 80-2*, *Classification of Debt Restructuring by Debtors and Creditors* (FTB 80-2), which states that a debtor may have a troubled debt restructuring under FAS 15 even though the related creditor does not. *FASB Emerging Issue*

Task Force Issue No. 87-18, *Use of Zero Coupon Bonds in a Troubled Debt Restructuring* (EITF 87-18), *FASB Emerging Issue Task Force Issue No. 87-19, Substituted Debtors in a Troubled Debt Restructuring* (EITF 87-19), and *FASB Emerging Issue Task Force Issue No. 89-15*, *Accounting for a Modification of Debt Terms When the Debtor is Experiencing Financial Difficulties* (EITF 89-15), provide guidance on the application of FAS 15 and are adopted in this issue paper consistent with the modifications to FAS 15 discussed in this issue paper. This issue paper also adopts *FASB Emerging Issue Task Force Issue No. 96-22, Applicability of the Disclosures Required by FASB Statement No. 114 When a Loan Is Restructured in a Troubled Debt Restructuring into Two (or More) Loans.*

12. This issue paper is consistent with paragraph 14 of *FASB Statement No. 91*, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loan and Initial Direct Costs of Leases* (FAS 91), which requires that fees received in connection with a modification of terms of a troubled debt restructuring be applied as a reduction of the recorded investment in the loan and that all related costs be charged to expense as incurred. FAS 91 was rejected in Issue Paper Nos. 26, 37, and 43.

13. This issue paper rejects the GAAP guidance set forth in *FASB Emerging Issues Task Force Issue No. 94-8*, *Accounting for Conversion of a Loan into a Security in a Troubled Debt Restructuring* (EITF 94-8), which states that *FASB Statement No. 115*, *Accounting for Certain Investment in Debt and Equity Securities* (FAS 115), applies to securities received in connection with a loan restructuring. It also rejects the GAAP guidance set forth in *FASB Technical Bulletin 94-1*, *Application of Statement 115 to Debt Securities Restructured in a Troubled Debt Restructuring* (FTB 94-1), which states that FAS 115 applies to any loan that was restructured in a troubled debt restructuring involving a modification of terms that meets the definition of a security (as defined in FAS 115). It also rejects paragraph 6.d. of FAS 114 by requiring that the requirements of FAS 114 be applied to debt securities. This is consistent with the rejection of FAS 115 in *Issue Paper No. 26—Bonds, Excluding Loan-Backed and Structured Securities*, *Issue Paper No. 30—Investments in Common Stock (excluding investments in common stock of subsidiary, controlled, or affiliated companies)* and *Issue Paper No. 32—Investments in Preferred Stock (excluding investments in preferred stock of subsidiary, controlled, or affiliated companies).* Paragraph 13 of FAS 114 which requires impairment to be recognized through a valuation allowance is rejected. Paragraph 7 of this issue paper requires the difference between the fair value and the recorded value to be recorded as a realized loss in the statement of operations which is consistent with the rejection of the utilization of valuation allowances in statutory accounting. This issue paper requires assets to be recorded at the lower of fair value or book value. Practically speaking, this is no different from the FAS 114 requirement to record at fair value. In a troubled debt restructuring situation, it will be unusual for the fair value to exceed the book value.

14. The conclusions above are consistent with the accounting for impaired mortgage loans in *Issue Paper No. 37—Mortgage Loans* (Issue Paper No. 37) which adopts FAS 114 for accounting for collateral dependent loans.

15. Current statutory guidance does not specifically address accounting and disclosure by debtors and creditors for troubled debt restructuring. The SVO Purposes and Procedures provides a designation for “Bonds and Counterparties In or Near Default”. The accounting for such bonds is addressed in Issue Paper No. 26 which requires that such bonds be written down to fair market value, is consistent with this issue paper. The statutory literature also provides guidance on the reclassification of foreclosed mortgage loans to real estate. The guidance states that loans for which foreclosure proceedings have been completed, and where there are debtor redemption privileges, may temporarily retain their status as mortgage loans until the insurance company obtains clear title. This issue paper rejects this concept and allows the creditor to reclassify the asset at the beginning of the redemption period unless it is probable that the mortgage loan will be redeemed. This revision to current statutory accounting is justified because the nature of the asset has effectively changed when the foreclosure process has been substantially completed. This is also consistent with current industry practice.

16. The adoption of the statutory accounting principles specified in the conclusion above are consistent with the Statement of Concepts which states *"In order to provide a margin of protection for policyholders, the concept of conservatism should be followed when developing estimates as well as establishing accounting principles for statutory reporting"* and *"Statutory accounting should be reasonably conservative over the span of economic cycles and in recognition of the primary responsibility to regulate for financial solvency*".

Drafting Notes/Comments

- Accounting for mortgage loan impairments is addressed in *Issue Paper No. 37—Mortgage Loans*.
- Accounting for real estate is addressed in *Issue Paper No. 40—Real Estate Investments*.
- Accounting for collateral dependent loans is addressed in *Issue Paper No. 37—Mortgage Loans*.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

17. The Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies (Life/A&H Accounting Practices and Procedures Manual) and the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies (P & C Accounting Practices and Procedures Manual) each include the following in Chapter 3, Mortgage Loans (only the pertinent excerpts are included below):

> Valuation
>
> For loans that are in default, being voluntarily conveyed, or being foreclosed, the carrying value may be adjusted for unpaid interest and additional expenses, such as insurance, taxes and legal fees that have been incurred to protect the investment or to obtain clear title to the property to the extent that such amounts are deemed to be recoverable from the ultimate disposition of the property. However, if such interest and costs cannot reasonably be expected to be recovered, they should not be added to the carrying value, and the cost should be expensed.
>
> If, when reporting mortgage loans in default, the values of real estate have declined to less than the unpaid principal balances, an appropriate valuation reserve should be established to reflect the expected uncollectible amount.
>
> Mortgage loans that are in default, or which are under foreclosure proceedings, continue to be classified as mortgage loans. Loans for which foreclosure proceedings have been completed, even to the extent of the court granting title to the mortgages, may temporarily retain their status as mortgage loans, since in some states the mortgagor still has the privilege of redeeming the mortgage during a stated redemption period. During this period, the loan may remain classified as a mortgage loan until the insurance company obtains clear title. The asset is then transferred to the real estate account.

18. The Life/A&H Accounting Practices and Procedures Manual includes the following in Chapter 4, Real Estate (only the pertinent excerpts are included below):

> Cost
>
> The cost of real estate acquired through foreclosure or voluntary conveyance is recorded at the lower of fair market value at acquisition or cost. Cost includes the outstanding principal balance of the mortgage loan at the date of foreclosure or conveyance plus foreclosure costs, real estate taxes, insurance premiums and all other costs necessary to obtain clear title and to place the property in good repair. Uncollected interest or unrecovered advances made before foreclosure should also be included in cost.

> Statement Value
>
> Generally, the value of investment real estate and property acquired in satisfaction of debt may not exceed the lower of current market value or cost, plus capitalized improvements, less normal depreciation. In lieu of writing down investment real estate or taking part of the value as nonadmitted when market value is less than book value, an insurer may establish a reserve for specific properties as a liability.

19. The P & C Accounting Practices and Procedures Manual includes the following in Chapter 4, Real Estate (only the pertinent excerpts are included below):

> Cost
>
> The cost of real estate acquired through foreclosure generally includes the outstanding principal balance of the mortgage loan at the date of foreclosure, plus foreclosure costs, real estate taxes, insurance premiums, and all other costs necessary to obtain clear title and to place the property in good repair. Unrecovered advances made before foreclosure should also be included in cost. The total cost should not exceed the realizable value.
>
> Statement Value
>
> Generally, the value of investment real estate and property acquired in satisfaction of debt may not exceed the lower of current market value or cost, plus capitalized improvements, less normal depreciation. In lieu of writing down investment real estate or taking part of the value as nonadmitted when market value is less than book value, an insurer may establish a reserve for specific properties as a liability.

Generally Accepted Accounting Principles

20. FAS 15 provides the following definition and guidance for troubled debt restructuring:

> INTRODUCTION
>
> 2. A restructuring of a debt constitutes a troubled debt restructuring for purposes of this Statement if the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider. That concession either stems from an agreement between the creditor and the debtor or is imposed by law or a court. For example, a creditor may restructure the terms of a debt to alleviate the burden of the debtor's near-term cash requirements, and many troubled debt restructuring involve modifying terms to reduce or defer cash payments required of the debtor in the near future to help the debtor attempt to improve its financial condition and eventually be able to pay the creditor. Or, for example, the creditor may accept cash, other assets, or an equity interest in the debtor in satisfaction of the debt though the value received is less than the amount of the debt because the creditor concludes that step will maximize recovery of its investment.[1]
>
> [1] Although troubled debt that is fully satisfied by foreclosure, repossession, or other transfer of assets or by grant of equity securities by the debtor is, in a technical sense, not restructured, that kind of event is included in the term troubled debt restructuring in this Statement.
>
> 3. Whatever the form of concession granted by the creditor to the debtor in a troubled debt restructuring, the creditor's objective is to make the best of a difficult situation. That is, the creditor expects to obtain more cash or other value from the debtor, or to increase the probability of receipt, by granting the concession than by not granting it.

4. In this Statement, a receivable or payable (collectively referred to as debt) represents a contractual right to receive money or a contractual obligation to pay money on demand or on fixed or determinable dates that is already included as an asset or liability in the creditor's or debtor's balance sheet at the time of the restructuring. Receivables or payables that may be involved in troubled debt restructuring commonly result from lending or borrowing of cash, investing in debt securities that were previously issued, or selling or purchasing goods or services on credit. Examples are accounts receivable or payable, notes, debentures and bonds (whether those receivables or payables are secured or unsecured and whether they are convertible or nonconvertible), and related accrued interest, if any. Typically, each receivable or payable is negotiated separately, but sometimes two or more receivables or payables are negotiated together. For example, a debtor may negotiate with a group of creditors but sign separate debt instruments with each creditor. For purposes of this Statement, restructuring of each receivable or payable, including those negotiated and restructured jointly, shall be accounted for individually. The substance rather than the form of the receivable or payable shall govern. For example, to a debtor, a bond constitutes one payable even though there are many bondholders.

5. A troubled debt restructuring may include, but is not necessarily limited to, one or a combination of the following:

a. Transfer from the debtor to the creditor of receivables from third parties, real estate, or other assets to satisfy fully or partially a debt (including a transfer resulting from foreclosure or repossession).

b. Issuance or other granting of an equity interest to the creditor by the debtor to satisfy fully or partially a debt unless the equity interest is granted pursuant to existing terms for converting the debt into an equity interest.

c. Modification of terms of a debt, such as one or a combination of:

1. Reduction (absolute or contingent) of the stated interest rate for the remaining original life of the debt.

2. Extension of the maturity date or dates at a stated interest rate lower than the current market rate for new debt with similar risk.

3. Reduction (absolute or contingent) of the face amount or maturity amount of the debt as stated in the instrument or other agreement.

4. Reduction (absolute or contingent) of accrued interest.

6. Troubled debt restructuring may occur before, at, or after the stated maturity of debt, and time may elapse between the agreement, court order, etc. and the transfer of assets or equity interest, the effective date of new terms, or the occurrence of another event that constitutes consummation of the restructuring. The date of consummation is the time of the restructuring in this Statement.

7. A debt restructuring is not necessarily a troubled debt restructuring for purposes of this Statement even if the debtor is experiencing some financial difficulties. For example, a troubled debt restructuring is not involved if (a) the fair value[2] of cash, other assets, or an equity interest accepted by a creditor from a debtor in full satisfaction of its receivable at least equals the creditor's recorded investment in the receivable;[3] (b) the fair value of cash, other assets, or an equity interest transferred by a debtor to a creditor in full settlement of its payable at least equals the debtor's carrying amount of the payable; (c) the creditor reduces the effective interest rate on the debt primarily to reflect a decrease in market interest rates in general or a decrease in the risk so as to maintain a relationship with a debtor that can readily obtain funds from other sources at

the current market interest rate; or (d) the debtor issues in exchange for its debt new marketable debt having an effective interest rate based on its market price that is at or near the current market interest rates of debt with similar maturity dates and stated interest rates issued by nontroubled debtors. In general, a debtor that can obtain funds from sources other than the existing creditor at market interest rates at or near those for nontroubled debt is not involved in a troubled debt restructuring. A debtor in a troubled debt restructuring can obtain funds from sources other than the existing creditor in the troubled debt restructuring, if at all, only at effective interest rates (based on market prices) so high that it cannot afford to pay them. Thus, in an attempt to protect as much of its investment as possible, the creditor in a troubled debt restructuring grants a concession to the debtor that it would not otherwise consider.

[2] Defined in paragraph 13.

[3] Defined in footnote 17.

8. For purposes of this Statement, troubled debt restructurings do not include changes in lease agreements (the accounting is prescribed by *FASB Statement No. 13, Accounting for Leases*) or employment-related agreements (for example, pension plans and deferred compensation contracts). Nor do troubled debt restructuring include debtors' failures to pay trade accounts according to their terms or creditors' delays in taking legal action to collect overdue amounts of interest and principal, unless they involve an agreement between debtor and creditor to restructure.

(Note: Paragraph 9 not included as deleted or superseded)

10. This Statement supersedes *FASB Interpretation No. 2, Imputing Interest on Debt Arrangements Made under the Federal Bankruptcy Act*, and shall be applied to the types of situations that were covered by that Interpretation. Thus, it shall be applied to troubled debt restructuring consummated under reorganization, arrangement, or other provisions of the Federal Bankruptcy Act or other Federal statutes related thereto.[4] It also amends *APB Opinion No. 26, Early Extinguishment of Debt*, to the extent needed to exclude from that Opinion's scope early extinguishments of debt through troubled debt restructuring.

[4] This Statement does not apply, however, if under provisions of those Federal statutes or in a quasi-reorganization or corporate readjustment (*ARB No. 43, Chapter 7, Section A, Quasi-Reorganization or Corporate Readjustment*...) with which a troubled debt restructuring coincides, the debtor restates its liabilities generally.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Accounting by Debtors

12. A debtor shall account for a troubled debt restructuring according to the type of the restructuring as prescribed in the following paragraphs.

Transfer of Assets in Full Settlement

13. A debtor that transfers its receivables from third parties, real estate, or other assets to a creditor to settle fully a payable shall recognize a gain on restructuring of payables (see paragraph 21). The gain shall be measured by the excess of (i) the carrying amount of the payable settled (the face amount increased or decreased by applicable accrued interest and

applicable unamortized premium, discount, finance charges, or issue costs) over (ii) the fair value of the assets transferred to the creditor.[5] The fair value of the assets transferred is the amount that the debtor could reasonably expect to receive for them in a current sale between a willing buyer and a willing seller, that is, other than in a forced or liquidation sale. Fair value of assets shall be measured by their market value if an active market for them exists. If no active market exists for the assets transferred but exists for similar assets, the selling prices in that market may be helpful in estimating the fair value of the assets transferred. If no market price is available, a forecast of expected cash flows may aid in estimating the fair value of assets transferred, provided the expected cash flows are discounted at a rate commensurate with the risk involved.[6]

[5] Paragraphs 13, 15, and 19 indicate that the fair value of assets transferred or the fair value of an equity interest granted shall be used in accounting for a settlement of a payable in a troubled debt restructuring. That guidance is not intended to preclude using the fair value of the payable settled if more clearly evident than the fair value of the assets transferred or of the equity interest granted in a full settlement of a payable (paragraphs 13 and 15). (See paragraph 67 of *APB Opinion No. 16, Business Combinations*.) However, in a partial settlement of a payable (paragraph 19), the fair value of the assets transferred or of the equity interest granted shall be used in all cases to avoid the need to allocate the fair value of the payable between the part settled and the part still outstanding.

[6] Some factors that may be relevant in estimating the fair value of various kinds of assets are described in paragraphs 88 and 89 of APB Opinion No. 16, paragraphs 12-14 of *APB Opinion No. 21, Interest on Receivables and Payables*, and paragraph 25 of *APB Opinion No. 29, Accounting for Nonmonetary Transactions.*

14. A difference between the fair value and the carrying amount of assets transferred to a creditor to settle a payable is a gain or loss on transfer of assets.[7] The debtor shall include that gain or loss in measuring net income for the period of transfer, reported as provided in *APB Opinion No. 30, Reporting the Results of Operations*.

[7] The carrying amount of a receivable encompasses not only unamortized premium, discount, acquisition costs, and the like but also an allowance for uncollectible amounts and other “valuation” accounts, if any. A loss on transferring receivables to creditors may therefore have been wholly or partially recognized in measuring net income before the transfer and be wholly or partly a reduction of a valuation account rather than a gain or loss in measuring net income for the period of the transfer.

Grant of Equity Interest in Full Settlement

15. A debtor that issues or otherwise grants an equity interest to a creditor to settle fully a payable shall account for the equity interest at its fair value.[8] The difference between the fair value of the equity interest granted and the carrying amount of the payable settled shall be recognized as a gain on restructuring of payables (see paragraph 21).

[8] See footnote 5.

Modification of Terms

16. A debtor in a troubled debt restructuring involving only modification of terms of a payable--that is, not involving a transfer of assets or grant of an equity interest--shall account for the

effects of the restructuring prospectively from the time of restructuring, and shall not change the carrying amount of the payable at the time of the restructuring unless the carrying amount exceeds the total future cash payments specified by the new terms.[9] That is, the effects of changes in the amounts or timing (or both) of future cash payments designated as either interest or face amount shall be reflected in future periods.[10] Interest expense shall be computed in a way that a constant effective interest rate is applied to the carrying amount of the payable at the beginning of each period between restructuring and maturity (in substance the "interest" method prescribed by paragraph 15 of APB Opinion No. 21). The new effective interest rate shall be the discount rate that equates the present value of the future cash payments specified by the new terms (excluding amounts contingently payable) with the carrying amount of the payable.

[9] In this Statement, total future cash payments includes related accrued interest, if any, at the time of the restructuring that continues to be payable under the new terms.

[10] All or a portion of the carrying amount of the payable at the time of the restructuring may need to be reclassified in the balance sheet because of changes in the terms, for example, a change in the amount of the payable due within one year after the date of the debtor's balance sheet. A troubled debt restructuring of a short-term obligation after the date of a debtor's balance sheet but before that balance sheet is issued may affect the classification of that obligation in accordance with *FASB Statement No. 6, Classification of Short-Term Obligations Expected to Be Refinanced.*

17. If, however, the total future cash payments specified by the new terms of a payable, including both payments designated as interest and those designated as face amount, are less than the carrying amount of the payable, the debtor shall reduce the carrying amount to an amount equal to the total future cash payments specified by the new terms and shall recognize a gain on restructuring of payables equal to the amount of the reduction (see paragraph 21).[11] Thereafter, all cash payments under the terms of the payable shall be accounted for as reductions of the carrying amount of the payable, and no interest expense shall be recognized on the payable for any period between the restructuring and maturity of the payable.[12]

[11] If the carrying amount of the payable comprises several accounts (for example, face amount, accrued interest, and unamortized premium, discount, finance charges, and issue costs) that are to be continued after the restructuring, some possibly being combined, the reduction in carrying amount may need to be allocated among the remaining accounts in proportion to the previous balances. However, the debtor may choose to carry the amount designated as face amount by the new terms in a separate account and adjust another account accordingly.

[12] The only exception is to recognize interest expense according to paragraph 22.

18. A debtor shall not recognize a gain on a restructured payable involving indeterminate future cash payments as long as the maximum total future cash payments may exceed the carrying amount of the payable. Amounts designated either as interest or as face amount by the new terms may be payable contingent on a specified event or circumstance (for example, the debtor may be required to pay specified amounts if its financial condition improves to a specified degree within a specified period). To determine whether the debtor shall recognize a gain according to the provisions of paragraphs 16 and 17, those contingent amounts shall be included in the "total future cash payments specified by the new terms" to the extent necessary to prevent recognizing a gain at the time of restructuring that may be offset by future interest expense. Thus, the debtor shall apply paragraph 17 of *FASB Statement No. 5, Accounting for Contingencies*, in which probability of occurrence of a gain contingency is not a factor, and shall assume that

contingent future payments will have to be paid. The same principle applies to amounts of future cash payments that must sometimes be estimated to apply the provisions of paragraphs 16 and 17. For example, if the number of future interest payments is flexible because the face amount and accrued interest is payable on demand or becomes payable on demand, estimates of total future cash payments shall be based on the maximum number of periods possible under the restructured terms.

Combination of Types

19. A troubled debt restructuring may involve partial settlement of a payable by the debtor's transferring assets or granting an equity interest (or both) to the creditor and modification of terms of the remaining payable.[13] A debtor shall account for a troubled debt restructuring involving a partial settlement and a modification of terms as prescribed in paragraphs 16-18 except that, first, assets transferred or an equity interest granted in that partial settlement shall be measured as prescribed in paragraphs 13 and 15, respectively, and the carrying amount of the payable shall be reduced by the total fair value of those assets or equity interest.[14] A difference between the fair value and the carrying amount of assets transferred to the creditor shall be recognized as a gain or loss on transfer of assets. No gain on restructuring of payables shall be recognized unless the remaining carrying amount of the payable exceeds the total future cash payments (including amounts contingently payable) specified by the terms of the debt remaining unsettled after the restructuring. Future interest expense, if any, shall be determined according to the provisions of paragraphs 16-18.

[13] Even if the stated terms of the remaining payable, for example, the stated interest rate and the maturity date or dates, are not changed in connection with the transfer of assets or grant of an equity interest, the restructuring shall be accounted for as prescribed by paragraph 19.

[14] If cash is paid in a partial settlement of a payable in a troubled debt restructuring, the carrying amount of the payable shall be reduced by the amount of cash paid.

Related Matters

20. A troubled debt restructuring that is in substance a repossession or foreclosure by the creditor or other transfer of assets to the creditor shall be accounted for according to the provisions of paragraphs 13, 14, and 19.

21. Gains on restructuring of payables determined by applying the provisions of paragraphs 13-20 of this Statement shall be aggregated, included in measuring net income for the period of restructuring, and, if material, classified as an extraordinary item, net of related income tax effect, in accordance with paragraph 8 of *FASB Statement No. 4, Reporting Gains and Losses from Extinguishment of Debt*.

22. If a troubled debt restructuring involves amounts contingently payable, those contingent amounts shall be recognized as a payable and as interest expense in future periods in accordance with paragraph 8 of FASB Statement No. 5. Thus, in general, interest expense for contingent payments shall be recognized in each period in which (a) it is probable that a liability has been incurred and (b) the amount of that liability can be reasonably estimated. Before recognizing a payable and interest expense for amounts contingently payable, however, accrual or payment of those amounts shall be deducted from the carrying amount of the restructured payable to the extent that contingent payments included in “total future cash payments specified by the new terms” prevented recognition of a gain at the time of restructuring (paragraph 18).

23. If amounts of future cash payments must be estimated to apply the provisions of paragraphs 16-18 because future interest payments are expected to fluctuate--for example, the restructured terms may specify the stated interest rate to be the prime interest rate increased by a specified amount or proportion--estimates of maximum total future payments shall be based on the interest rate in effect at the time of the restructuring. Fluctuations in the effective interest rate after the restructuring from changes in the prime rate or other causes shall be accounted for as changes in estimates in the periods the changes occur. However, the accounting for those fluctuations shall not result in recognizing a gain on restructuring that may be offset by future cash payments (paragraphs 18 and 22). Rather, the carrying amount of the restructured payable shall remain unchanged, and future cash payments shall reduce the carrying amount until the time that any gain recognized cannot be offset by future cash payments.

24. Legal fees and other direct costs that a debtor incurs in granting an equity interest to a creditor in a troubled debt restructuring shall reduce the amount otherwise recorded for that equity interest according to paragraphs 15 and 19. All other direct costs that a debtor incurs to effect a troubled debt restructuring shall be deducted in measuring gain on restructuring of payables or shall be included in expense for the period if no gain on restructuring is recognized.

Disclosure by Debtors

25. A debtor shall disclose, either in the body of the financial statements or in the accompanying notes, the following information about troubled debt restructurings that have occurred during a period for which financial statements are presented:

a. For each restructuring: [15] a description of the principal changes in terms, the major features of settlement, or both.

b. Aggregate gain on restructuring of payables and the related income tax effect (paragraph 21).

c. Aggregate net gain or loss on transfers of assets recognized during the period (paragraphs 14 and 19).

d. Per share amount of the aggregate gain on restructuring of payables, net of related income tax effect.

26. A debtor shall disclose in financial statements for periods after a troubled debt restructuring the extent to which amounts contingently payable are included in the carrying amount of restructured payables pursuant to the provisions of paragraph 18. If required by paragraphs 9-13 of FASB Statement No. 5, a debtor shall also disclose in those financial statements total amounts that are contingently payable on restructured payables and the conditions under which those amounts would become payable or would be forgiven.

Accounting by Creditors

27. A creditor shall account for a troubled debt restructuring according to the type of the restructuring as prescribed in the following paragraphs. Paragraphs 28-42 do not apply to a receivable that the creditor is accounting for at market value in accordance with the specialized industry practice (for example, a marketable debt security accounted for at market value by a mutual fund). Estimated cash expected to be received less estimated costs expected to be

[15] Separate restructurings within a fiscal period for the same category of payables (for example, accounts payable or subordinated debentures) may be grouped for disclosure purposes.

incurred is not market value in accordance with specialized industry practice as that term is used in this paragraph.

Receipt of Assets in Full Satisfaction

28. A creditor that receives from a debtor in full satisfaction of a receivable either (i) receivables from third parties, real estate, or other assets or (ii) shares of stock or other evidence of an equity interest in the debtor, or both, shall account for those assets (including an equity interest) at their fair value at the time of the restructuring (see paragraph 13 for how to measure fair value).[16] The excess of (i) the recorded investment in the receivable[17] satisfied over (ii) the fair value of assets received is a loss to be recognized according to paragraph 35.

[16] Paragraphs 28 and 33 indicate that the fair value of assets received shall be used in accounting for satisfaction of a receivable in a troubled debt restructuring. That guidance is not intended to preclude using the fair value of the receivable satisfied if more clearly evident than the fair value of the assets received in full satisfaction of a receivable (paragraph 28). (See paragraph 67 of APB Opinion No. 16.) However, in a partial satisfaction of a receivable (paragraph 33), the fair value of the assets received shall be used in all cases to avoid the need to allocate the fair value of the receivable between the part satisfied and the part still outstanding.

[17] Recorded investment in the receivable is used in paragraphs 28-41 instead of carrying amount of the receivable because the latter is net of an allowance for estimated uncollectible amounts or other “valuation” account, if any, while the former is not. The recorded investment in the receivable is the face amount increased or decreased by applicable accrued interest and unamortized premium, discount, finance charges, or acquisition costs and may also reflect a previous direct write-down of the investment.

29. After a troubled debt restructuring, a creditor shall account for assets received in satisfaction of a receivable the same as if the assets had been acquired for cash.

Modification of Terms

(Note: Paragraphs 30-32 not included as superseded by FAS 114)

Combination of Types

33. A troubled debt restructuring may involve receipt of assets (including an equity interest in the debtor) in partial satisfaction of a receivable and a modification of terms of the remaining receivable.[22] A creditor shall account for a troubled debt restructuring involving a partial satisfaction and modification of terms as prescribed in paragraphs 30-32 (note: paragraphs 30-32 superseded by FAS 114) except that, first, the assets received shall be accounted for at their fair values as prescribed in paragraph 28 and the recorded investment in the receivable shall be reduced by the fair value of the assets received.[23]

[22] Even if the stated terms of the remaining receivable, for example, the stated interest rate and the maturity date or dates, are not changed in connection with the receipt of assets (including an equity interest in the debtor), the restructuring shall be accounted for as prescribed by paragraph 33.

[23] If cash is received in a partial satisfaction of a receivable, the recorded investment in the receivable shall be reduced by the amount of cash received.

Related Matters

34. A troubled debt restructuring that is in substance a repossession or foreclosure by the creditor, or in which the creditor otherwise obtains one or more of the debtor's assets in place of all or part of the receivable, shall be accounted for according to the provisions of paragraphs 28 and 33 and, if appropriate, 39.

(Note: Paragraphs 35-37 not included as superseded by FAS 114)

38. Legal fees and other direct costs incurred by a creditor to effect a troubled debt restructuring shall be included in expense when incurred.

39. A receivable from the sale of assets previously obtained in a troubled debt restructuring shall be accounted for according to APB Opinion No. 21 regardless of whether the assets were obtained in satisfaction (full or partial) of a receivable to which that Opinion was not intended to apply. A difference, if any, between the amount of the new receivable and the carrying amount of the assets sold is a gain or loss on sale of assets.

Disclosure by Creditors

40. A creditor shall disclose, either in the body of the financial statements or in the accompanying notes, the following information about troubled debt restructuring as of the date of each balance sheet presented:

a. (Note: not included as superseded by FAS 114)

b. The amount of commitments, if any, to lend additional funds to debtors owing receivables whose terms have been modified in troubled debt restructuring.

(Note: Paragraph 41 not included as superseded by FAS 114)

Substitution or Addition of Debtors

42. A troubled debt restructuring may involve substituting debt of another business enterprise, individual, or government unit[26] for that of the troubled debtor or adding another debtor (for example, as a joint debtor). That kind of restructuring should be accounted for according to its substance. For example, a restructuring in which, after the restructuring, the substitute or additional debtor controls, is controlled by, or is under common control[27] with the original debtor is an example of one that shall be accounted for by the creditor according to the provisions of paragraphs 30-32 (note: paragraphs 30-32 superseded by FAS 114). Those paragraphs shall also apply to a restructuring in which the substitute or additional debtor and original debtor are related after the restructuring by an agency, trust, or other relationship that in substance earmarks certain of the original debtor's funds or funds flows for the creditor although payments to the creditor may be made by the substitute or additional debtor. In contrast, a restructuring in which the substitute or additional debtor and the original debtor do not have any of the relationships described above after the restructuring shall be accounted for by the creditor according to the provisions of paragraphs 28 and 33.

[26] Government units include, but are not limited to, states, counties, townships, municipalities, school districts, authorities, and commissions.

[27] "Control" in this paragraph has the meaning described in paragraph 3 (c) of *APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock*, "The usual condition for control is ownership of a majority (over 50%) of the outstanding voting stock. The power to control may also exist with a lesser

percentage of ownership, for example, by contract, lease, agreement with other stockholders or by court decree."

21. FAS 114 modified certain provisions of FAS 15 to require creditors to measure all loans that are restructured in a troubled debt restructuring involving a modification of terms in accordance with FAS 114 which requires that impaired loans be measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. FAS 114 provides the following guidance:

> Definitions and Scope
>
> 4. For purposes of this Statement, a loan is a contractual right to receive money on demand or on fixed or determinable dates that is recognized as an asset in the creditor's statement of financial position. Examples include but are not limited to accounts receivable (with terms exceeding one year) and notes receivable.
>
> 5. This Statement applies to all creditors. It addresses the accounting by creditors for impairment of a loan by specifying how allowances for credit losses related to certain loans should be determined. This Statement also addresses the accounting by creditors for all loans that are restructured in a troubled debt restructuring involving a modification of terms of a receivable, except restructuring of loans excluded from the scope of this Statement in paragraph 6.b.-6.d., including those involving a receipt of assets in partial satisfaction of a receivable. The term troubled debt restructuring is used in this Statement consistent with its use in Statement 15.
>
> 6. This Statement applies to all loans that are identified for evaluation, uncollateralized as well as collateralized, except:
>
> a. Large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment. Those loans may include but are not limited to credit card, residential mortgage, and consumer installment loans.
>
> b. Loans that are measured at fair value or at the lower of cost or fair value, for example, in accordance with *FASB Statement No. 65, Accounting for Certain Mortgage Banking Activities*, or other specialized industry practice.
>
> c. Leases as defined in *FASB Statement No. 13, Accounting for Leases*.
>
> d. Debt securities as defined in *FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities*.
>
> 7. This Statement does not specify how a creditor should identify loans that are to be evaluated for collectibility.[1] A creditor should apply its normal loan review procedures in making that judgment. This Statement does not address when a creditor should record a direct write-down of an impaired loan, nor does it address how a creditor should assess the overall adequacy of the allowance for credit losses. In addition to the allowance calculated in accordance with this Statement, a creditor should continue to recognize an allowance for credit losses necessary to comply with Statement 5.

[1] Sources of information useful in identifying loans for evaluation that are listed in the AICPA's Auditing Procedure Study, Auditing the Allowance for Credit Losses of Banks, include a specific materiality criterion; regulatory reports of examination; internally generated listings such as "watch lists," past due reports, overdraft

listings, and listings of loans to insiders; management reports of total loan amounts by borrower; historical loss experience by type of loan; loan files lacking current financial data related to borrowers and guarantors; borrowers experiencing problems such as operating losses, marginal working capital, inadequate cash flow, or business interruptions; loans secured by collateral that is not readily marketable or that is susceptible to deterioration in realizable value; loans to borrowers in industries or countries experiencing economic instability; and loan documentation and compliance exception reports.

Recognition of Impairment

8. A loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. As used in this Statement and in Statement 5, as amended, all amounts due according to the contractual terms means that both the contractual interest payments and the contractual principal payments of a loan will be collected as scheduled in the loan agreement. This Statement does not specify how a creditor should determine that it is probable that it will be unable to collect all amounts due according to the contractual terms of a loan. A creditor should apply its normal loan review procedures in making that judgment. An insignificant delay or insignificant shortfall in amount of payments does not require application of this Statement. A loan is not impaired during a period of delay in payment if the creditor expects to collect all amounts due including interest accrued at the contractual interest rate for the period of delay. Thus, a demand loan or other loan with no stated maturity is not impaired if the creditor expects to collect all amounts due including interest accrued at the contractual interest rate during the period the loan is outstanding.

9. Usually, a loan whose terms are modified in a troubled debt restructuring already will have been identified as impaired because the condition specified in paragraph 8 will have existed before a formal restructuring. However, if a loan is excluded from the scope of this Statement under paragraph 6.a., a creditor may not have accounted for that loan in accordance with this Statement before the loan was restructured. The creditor shall apply the provisions of this Statement to that loan when it is restructured.

10. The term probable is used in this Statement consistent with its use in Statement 5, which defines probable as an area within a range of the likelihood that a future event or events will occur confirming the fact of the loss. That range is from probable to remote, as follows:

Probable. The future event or events are likely to occur.

Reasonably possible. The chance of the future event or events occurring is more than remote but less than likely.

Remote. The chance of the future event or events occurring is slight.

The term probable is further described in paragraph 84 of Statement 5, which states:

The conditions for accrual in paragraph 8 [of Statement 5] are not inconsistent with the accounting concept of conservatism. Those conditions are not intended to be so rigid that they require virtual certainty before a loss is accrued. They require only that it be probable that an asset has been impaired or a liability has been incurred and that the amount of loss be reasonably estimable.

Measurement of Impairment

11. Measuring impaired loans requires judgment and estimates, and the eventual outcomes may differ from those estimates. Creditors should have latitude to develop measurement

methods that are practical in their circumstances. Paragraphs 12-16 address those measurement methods.

12. Some impaired loans have risk characteristics that are unique to an individual borrower, and the creditor will apply the measurement methods described in paragraphs 13-16 on a loan-by-loan basis. However, some impaired loans may have risk characteristics in common with other impaired loans. A creditor may aggregate those loans and may use historical statistics, such as average recovery period and average amount recovered, along with a composite effective interest rate as a means of measuring those impaired loans.

13. When a loan is impaired as defined in paragraph 8 of this Statement, a creditor shall measure impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate, except that as a practical expedient, a creditor may measure impairment based on a loan's observable market price, or the fair value of the collateral if the loan is collateral dependent. Regardless of the measurement method, a creditor shall measure impairment based on the fair value of the collateral when the creditor determines that foreclosure is probable. A loan is collateral dependent if the repayment of the loan is expected to be provided solely by the underlying collateral. The creditor may choose a measurement method on a loan-by-loan basis. A creditor shall consider estimated costs to sell, on a discounted basis, in the measure of impairment if those costs are expected to reduce the cash flows available to repay or otherwise satisfy the loan. If the measure of the impaired loan is less than the recorded investment in the loan[2] (including accrued interest, net deferred loan fees or costs, and unamortized premium or discount), a creditor shall recognize an impairment by creating a valuation allowance with a corresponding charge to bad-debt expense or by adjusting an existing valuation allowance for the impaired loan with a corresponding charge or credit to bad-debt expense.

[2] The term recorded investment in the loan is distinguished from net carrying amount of the loan because the latter term is net of a valuation allowance, while the former term is not. The recorded investment in the loan does, however, reflect any direct write-down of the investment.

14. If a creditor measures an impaired loan using a present value amount, the creditor shall calculate that present value amount based on an estimate of the expected future cash flows of the impaired loan, discounted at the loan's effective interest rate. The effective interest rate of a loan is the rate of return implicit in the loan (that is, the contractual interest rate adjusted for any net deferred loan fees or costs, premium, or discount existing at the origination or acquisition of the loan).[3] The effective interest rate for a loan restructured in a troubled debt restructuring is based on the original contractual rate, not the rate specified in the restructuring agreement. If the loan's contractual interest rate varies based on subsequent changes in an independent factor, such as an index or rate (for example, the prime rate, the London interbank offered rate, or the U.S. Treasury bill weekly average), that loan's effective interest rate may be calculated based on the factor as it changes over the life of the loan or may be fixed at the rate in effect at the date the loan meets the impairment criterion in paragraph 8. The creditor's choice shall be applied consistently for all loans whose contractual interest rate varies based on subsequent changes in an independent factor. Projections of changes in the factor should not be made for purposes of determining the effective interest rate or estimating expected future cash flows.

[3] A loan may be acquired at a discount because of a change in credit quality or rate or both. When a loan is acquired at a discount that relates, at least in part, to the loan's credit quality, the effective interest rate is the

discount rate that equates the present value of the investor's estimate of the loan's future cash flows with the purchase price of the loan.

15. If a creditor measures an impaired loan using a present value calculation, the estimates of expected future cash flows shall be the creditor's best estimate based on reasonable and supportable assumptions and projections. All available evidence, including estimated costs to sell if those costs are expected to reduce the cash flows available to repay or otherwise satisfy the loan, should be considered in developing the estimate of expected future cash flows. The weight given to the evidence should be commensurate with the extent to which the evidence can be verified objectively. If a creditor estimates a range for either the amount or timing of possible cash flows, the likelihood of the possible outcomes shall be considered in determining the best estimate of expected future cash flows.

16. Subsequent to the initial measurement of impairment, if there is a significant change (increase or decrease) in the amount or timing of an impaired loan's expected future cash flows, or if actual cash flows are significantly different from the cash flows previously projected, a creditor shall recalculate the impairment by applying the procedures specified in paragraphs 12-15 and by adjusting the valuation allowance. Similarly, a creditor that measures impairment based on the observable market price of an impaired loan or the fair value of the collateral of an impaired collateral-dependent loan shall adjust the valuation allowance if there is a significant change (increase or decrease) in either of those bases. However, the net carrying amount of the loan shall at no time exceed the recorded investment in the loan.

(Note: Paragraphs 17-19 are not included as they are superseded or deleted by FAS 118)

Disclosures

20. A creditor shall disclose, either in the body of the financial statements or in the accompanying notes, the following information:

a. As of the date of each statement of financial position presented, the recorded investment in the loans for which impairment has been recognized in accordance with this Statement and the total allowance for credit losses related to those impaired loans

b. For each period for which results of operations are presented, the activity in the allowance for credit losses account, including the balance in the allowance for credit losses account at the beginning and end of each period, additions charged to operations, direct write-downs charged against the allowance, and recoveries of amounts previously charged off

c. The creditor's income recognition policy (paragraph 17.a. or 17.b.). A creditor that recognizes income in accordance with paragraph 17.a. also shall disclose the amount of interest income recognized in accordance with that paragraph.

Amendments to Existing Pronouncements

21. The first sentence of paragraph 23 of Statement 5 is replaced by the following:

If, based on current information and events, it is probable that the enterprise will be unable to collect all amounts due according to the contractual terms of the receivable, the condition in paragraph 8.a. is met. As used here, all amounts due according to the contractual terms means that both the contractual interest payments and the contractual principal payments will be collected as scheduled according to the receivable's contractual terms. However, a creditor need not consider an insignificant delay or insignificant shortfall in amount of payments as meeting the condition in paragraph 8.a.

22. Statement 15 is amended prospectively as follows:

a. The second sentence in paragraph 1 is replaced by:

A creditor in a troubled debt restructuring involving a modification of terms shall account for the restructured loan in accordance with the provisions of *FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan,* except that a troubled debt restructuring involving a modification of terms before the effective date of Statement 114 may continue to be accounted for and disclosed in accordance with this Statement as long as the restructured loan is not impaired based on the terms of the restructuring agreement.

b. Paragraph 30 is replaced by the following:

A creditor in a troubled debt restructuring involving only a modification of terms of a receivable—that is, not involving receipt of assets (including an equity interest in the debtor) —shall account for the troubled debt restructuring in accordance with the provisions of Statement 114.

c. In the second sentence of paragraph 33, paragraphs 30-32 is deleted and replaced by Statement 114. The third and fourth sentences are deleted.

d. In paragraph 34, the following is added after “foreclosure by the creditor,”: that is, the creditor receives physical possession of the debtor's assets regardless of whether formal foreclosure proceedings take place,

e. In the third sentence of paragraph 42, according to the provisions of paragraphs 30-32 is replaced by as prescribed in Statement 114. In the fourth sentence, those paragraphs are replaced by that Statement.

f. Paragraphs 31, 32, 35-37, 40.a., 41, and footnotes 18, 19, 21, 24, and 25 are superseded prospectively. (Refer to paragraph 27 of this Statement.)

23. In the last sentence of paragraph 47 of *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises*, the phrase realized gains and losses is replaced by income as prescribed in *FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan*.

24. In the first sentence of paragraph 14 of *FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, the phrase for purposes of applying paragraph 30 of that Statement is deleted.

25. *FASB Technical Bulletins No. 79-6, Valuation Allowances Following Debt Restructuring, and No. 79-7, Recoveries of a Previous Writedown under a Troubled Debt Restructuring Involving a Modification of Terms*, are superseded by this Statement.

Effective Date and Transition

26. This Statement shall be effective for financial statements for fiscal years beginning after December 15, 1994. Earlier application is encouraged. Previously issued annual financial statements shall not be restated. Initial application of this Statement shall be as of the beginning of an enterprise's fiscal year (that is, if the Statement is adopted prior to the effective date and during an interim period other than the first interim period, all prior interim periods of that fiscal year shall be restated).

27. This Statement applies to all troubled debt restructurings involving a modification of terms. However, if a loan that was restructured in a troubled debt restructuring involving a modification of terms before the effective date of this Statement is not impaired based on the terms specified by the restructuring agreement, a creditor may continue to account for the loan in accordance with the provisions of Statement 15 prior to its amendment by this Statement.

22. FAS 118 provides the following guidance:

Introduction and Background

1. *FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan*, was issued in May 1993 and addresses the accounting by creditors for impairment of certain loans. Statement 114 is effective for financial statements for fiscal years beginning after December 15, 1994.

2. The Board received several requests to delay the effective date of Statement 114 and to clarify how that Statement should be implemented. A delay was requested to allow more time to resolve implementation questions about the application of the income recognition provisions in paragraphs 17-19 of Statement 114 and to make the necessary changes to accounting systems.

3. This Statement amends Statement 114 to allow a creditor to use existing methods for recognizing interest income on impaired loans. To accomplish this, it eliminates the income recognition provisions in paragraphs 17-19 of Statement 114. As amended, Statement 114 does not address how a creditor should recognize, measure, or display interest income on an impaired loan. This Statement amends the disclosure requirements in Statement 114 to require information about the recorded investment in certain impaired loans and about how a creditor recognizes interest income related to those impaired loans.

4. Prior to the issuance of this Statement, Statement 114 provided for two alternative income recognition methods to be used to account for changes in the net carrying amount of an impaired loan subsequent to the initial measure of impairment. Under the first income recognition method, a creditor would accrue interest on the net carrying amount of the impaired loan and report other changes in the net carrying amount of the loan as an adjustment to bad-debt expense. Under the second income recognition method, a creditor would recognize all changes in the net carrying amount of the loan as an adjustment to bad-debt expense. While those income recognition methods are no longer required, this Statement does not preclude a creditor from using either of those methods.

5. Statement 114 requires that a creditor recognize impairment of a loan if the present value of expected future cash flows discounted at the loan's effective interest rate (or, alternatively, the observable market price of the loan or the fair value of the collateral) is less than the recorded investment in the impaired loan. If the present value of expected future cash flows (or, alternatively, the observable market price of the loan or the fair value of the collateral) is equal to or greater than the recorded investment in the impaired loan, no impairment is recognized. This Statement does not change those requirements. When the net carrying amount of an impaired loan equals the present value of expected future cash flows (or, alternatively, the observable market price of the loan or the fair value of the collateral), this Statement will affect only the classification of income (or expense) that results from changes in the measure of an impaired loan, not the total amount of income (or expense) recognized within a given reporting period. However, when a creditor's policies for recognizing interest income and for charging off loans result in a recorded investment in an impaired loan that is less than the present value of expected future cash flows discounted at the loan's effective interest rate (or, alternatively, the observable market price of the loan or the fair value of the collateral), this Statement will cause both the classification and the total amount of income (or expense) recognized within a given reporting period to be different from that which would have been determined in accordance with paragraphs 17-19 of Statement 114.

Standards of Financial Accounting and Reporting

Amendments to Statement 114

6. Statement 114 is amended as follows:

a. The following sentence is added after the second sentence of paragraph 8:

   For a loan that has been restructured in a troubled debt restructuring, the contractual terms of the loan agreement refers to the contractual terms specified by the original loan agreement, not the contractual terms specified by the restructuring agreement.

b. In the first sentence of paragraph 11, impaired loans is replaced by impairment of a loan.

c. In the last sentence of paragraph 12, those impaired loans is replaced by impairment of those loans.

d. In the last sentence of paragraph 13, measure of the impaired loan is replaced by present value of expected future cash flows (or, alternatively, the observable market price of the loan or the fair value of the collateral).

e. In the first sentence of paragraph 14, measures an impaired loan using is replaced by bases its measure of loan impairment on.

f. In the first sentence of paragraph 15, measures an impaired loan using is replaced by bases its measure of loan impairment on.

g. Paragraph 17 is replaced by the following:

   This Statement does not address how a creditor should recognize, measure, or display interest income on an impaired loan. Some accounting methods for recognizing income may result in a recorded investment in an impaired loan that is less than the present value of expected future cash flows (or, alternatively, the observable market price of the loan or the fair value of the collateral). In that case, while the loan would meet the definition of an impaired loan in paragraph 8, no additional impairment would be recognized. Those accounting methods include recognition of interest income using a cost-recovery method, a cash-basis method, or some combination of those methods. The recorded investment in an impaired loan also may be less than the present value of expected future cash flows (or, alternatively, the observable market price of the loan or the fair value of the collateral) because the creditor has charged off part of the loan.

h. Paragraphs 18 and 19 are deleted.

i. Paragraph 20 is replaced by the following paragraphs:

   A creditor shall disclose, either in the body of the financial statements or in the accompanying notes, the following information about loans that meet the definition of an impaired loan in paragraph 8 of this Statement:

   a. As of the date of each statement of financial position presented, the total recorded investment in the impaired loans at the end of each period and (1) the amount of that recorded investment for which there is a related allowance for credit losses determined in accordance with this Statement and the amount of that allowance and (2) the amount of that recorded investment for which there is no related allowance for credit losses determined in accordance with this Statement

b. The creditor's policy for recognizing interest income on impaired loans, including how cash receipts are recorded

c. For each period for which results of operations are presented, the average recorded investment in the impaired loans during each period, the related amount of interest income recognized during the time within that period that the loans were impaired, and, unless not practicable, the amount of interest income recognized using a cash-basis method of accounting during the time within that period that the loans were impaired.

Information about an impaired loan that has been restructured in a troubled debt restructuring involving a modification of terms need not be included in the disclosures required by paragraphs 20.a. and 20.c. in years after the restructuring if (i) the restructuring agreement specifies an interest rate equal to or greater than the rate that the creditor was willing to accept at the time of the restructuring for a new loan with comparable risk and (ii) the loan is not impaired based on the terms specified by the restructuring agreement. That exception shall be applied consistently for paragraphs 20.a. and 20.c. to all loans restructured in a troubled debt restructuring that meet the criteria in (i) and (ii).

For each period for which results of operations are presented, a creditor also shall disclose the activity in the total allowance for credit losses related to loans, including the balance in the allowance at the beginning and end of each period, additions charged to operations, direct write-downs charged against the allowance, and recoveries of amounts previously charged off. The total allowance for credit losses related to loans includes those amounts that have been determined in accordance with *FASB Statement No. 5, Accounting for Contingencies, and with this Statement.*

j. Paragraph 65 is deleted.

Effective Date and Transition

7. This Statement is effective concurrent with the effective date of Statement 114. Statement 114 is effective for financial statements for fiscal years beginning after December 15, 1994, with earlier application encouraged.

The provisions of this Statement need not be applied to immaterial items.

23. FTB 81-6 provides the following guidance:

Question

1. Does Statement 15 apply to troubled debt restructurings of debtors involved in bankruptcy proceedings?

Background

2. Some confusion has arisen about the interaction of paragraph 10 and footnote 4 of Statement 15. Paragraph 10 indicates that the Statement applies to troubled debt restructuring consummated under reorganization, arrangement, or other provisions of the Federal Bankruptcy Act or other federal statutes related thereto. However, footnote 4 to that paragraph states that the Statement does not apply ". . .if, under provisions of those Federal statutes or in a quasi-reorganization or corporate readjustment (ARB No. 43, Chapter 7, Section A, 'Quasi-

Reorganization or Corporate Readjustment . . .') with which a troubled debt restructuring coincides, the debtor restates its liabilities generally."

Response

3. Statement 15 does not apply to debtors who, in connection with bankruptcy proceedings, enter into troubled debt restructuring that result in a general restatement of the debtor's liabilities, that is, when such restructuring or modifications accomplished under purview of the bankruptcy court encompass most of the amount of the debtor's liabilities.

4. For example, companies involved with Chapter XI bankruptcy proceedings frequently reduce all or most of their indebtedness with the approval of their creditors and the court in order to provide an opportunity for the company to have a fresh start. Such reductions are usually by a stated percentage so that, for example, the debtor owes only 60 cents on the dollar. Because the debtor would be restating its liabilities generally, Statement 15 would not apply to the debtor's accounting for such reduction of liabilities.

5. On the other hand, Statement 15 would apply to an isolated troubled debt restructuring by a debtor involved in bankruptcy proceedings if such restructuring did not result in a general restatement of the debtor's liabilities.

24. FTB 80-2 provides the following guidance:

Question

1. In applying Statement 15, can a debt restructuring be a troubled debt restructuring for a debtor but not for the creditor?

Background

2. Paragraph 2 of Statement 15 states that "a restructuring of a debt constitutes a troubled debt restructuring for purposes of this Statement if the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider." Paragraph 7 points out that a debt restructuring is not necessarily a troubled debt restructuring simply because the debtor is experiencing some financial difficulties. That paragraph states in part:

> For example, a troubled debt restructuring is not involved if (a) the fair value[2] of cash, other assets, or an equity interest accepted by a creditor from a debtor in full satisfaction of its receivable at least equals the creditor's recorded investment in the receivable;[3] (b) the fair value of cash, other assets, or an equity interest transferred by a debtor to a creditor in full settlement of its payable at least equals the debtor's carrying amount of the payable; (c) the creditor reduces the effective interest rate on the debt primarily to reflect a decrease in market interest rates in general or a decrease in the risk so as to maintain a relationship with a debtor that can readily obtain funds from other sources at the current market interest rate; or (d) the debtor issues in exchange for its debt new marketable debt having an effective interest rate based on its market price that is at or near the current market interest rates of debt with similar maturity dates and stated interest rates issued by nontroubled debtors. [Emphasis added.]

[2] Defined in paragraph 13 [of Statement 15].

[3] Defined in footnote 17 [of Statement 15].

Response

3. Yes, a debtor may have a troubled debt restructuring under Statement 15 even though the related creditor does not have a troubled debt restructuring. The debtor and creditor must individually apply Statement 15 to the specific facts and circumstances to determine whether a troubled debt restructuring has occurred. Example (a) in paragraph 7 of Statement 15 identifies a type of debt restructuring that is not a troubled debt restructuring for purposes of the creditor's application of Statement 15; similarly, example (b) in paragraph 7 identifies a type of debt restructuring that is not a troubled debt restructuring for purposes of the debtor's application of Statement 15. Thus, Statement 15 establishes tests for applicability that are not symmetrical as between the debtor and the creditor when the debtor's carrying amount and the creditor's recorded investment differ.

Illustration

4. Creditor A makes a $10,000 interest-bearing loan to Debtor X and, when Debtor X later encounters financial difficulties, sells its receivable from Debtor X to Creditor B for $4,000 on a nonrecourse basis. Following the sale, the carrying amount of the loan payable by Debtor X would still be $10,000 and the recorded investment of the loan by Creditor B would be $4,000. If Debtor X subsequently transfers to Creditor B assets with a fair value of $5,500 in full settlement of the loan, that transaction would be a troubled debt restructuring for Debtor X because the fair value of the assets is less than the carrying amount of the loan, whereas Creditor B would not have a troubled debt restructuring because the fair value of the assets received exceeds its recorded investment in the loan.

25. FAS 91 provides the following guidance:

Fees and Costs in Refinancings or Restructuring

12. If the terms of the new loan resulting from a loan refinancing or restructuring other than a troubled debt restructuring are at least as favorable to the lender as the terms for comparable loans to other customers with similar collection risks who are not refinancing or restructuring a loan with the lender, the refinanced loan shall be accounted for as a new loan. This condition would be met if the new loan's effective yield is at least equal to the effective yield for such loans.[4] Any unamortized net fees or costs and any prepayment penalties from the original loan shall be recognized in interest income when the new loan is granted.

13. If the refinancing or restructuring does not meet the condition set forth in paragraph 12 or if only minor modifications are made to the original loan contract, the unamortized net fees or costs from the original loan and any prepayment penalties shall be carried forward as a part of the net investment in the new loan. In this case, the investment in the new loan shall consist of the remaining net investment in the original loan,[5] any additional amounts loaned, any fees received, and direct loan origination costs set forth in paragraph 6 associated with the refinancing or restructuring.

[4] The effective yield comparison considers the level of nominal interest rate, commitment and origination fees, and direct loan origination costs and would also consider comparison of other factors where appropriate, such as compensating balance arrangements.

[5] The net investment in the original loan includes the unpaid loan principal, any remaining unamortized net fees or costs, any remaining unamortized purchase premium or discount, and any accrued interest receivable.

14. Fees received in connection with a modification of terms of a troubled debt restructuring as defined in *FASB Statement No. 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings*, shall be applied as a reduction of the recorded investment in the loan. All related costs, including direct loan origination costs, shall be charged to expense as incurred.

26. EITF 94-8 provides the following guidance, as summarized in the *EITF Abstracts*:

ISSUE

Statement 115 applies to marketable equity securities and to all debt securities. Technical Bulletin 94-1 clarifies that securities received in connection with a debt restructuring are subject to Statement 115.

In a debt restructuring, the creditor may receive a debt security issued by the original debtor with a fair value that differs from the creditor's basis in the loan at the date of the debt restructuring.

The issues are (1) what the initial cost basis of a debt security of the original debtor received in the restructuring of a loan should be and (2) how the creditor should account for any difference between the creditor's basis in the loan and the fair value of the security at the date of the restructuring.

EITF DISCUSSION

The Task Force reached a consensus that the initial cost basis of a debt security of the original debtor received as part of a debt restructuring should be the security's fair value at the date of the restructuring. Any excess of the fair value of the security received over the net carrying amount of the loan should be recorded as a recovery on the loan. Any excess of the net carrying amount of the loan over the fair value of the security received should be recorded as a charge-off to the allowance for credit losses. Subsequent to the restructuring, the security should be accounted for according to the provisions of Statement 115.

The Task Force also reached a consensus that a security received in a restructuring in settlement of a claim for only the past-due interest on a loan should be measured at the security's fair value at the date of the restructuring and accounted for in a manner consistent with the entity's policy for recognizing cash received for past-due interest. Subsequent to the restructuring, the security should be accounted for according to the provisions of Statement 115.

27. FTB 94-1 provides the following guidance:

References:

FASB Statement No. 15, Accounting by Debtors and Creditors for Troubled Debt Restructuring

FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan, paragraph 27

FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities, paragraph 3

Question

1. For a loan that was restructured in a troubled debt restructuring involving a modification of terms, does Statement 115 apply to the accounting by the creditor (that is, investor) if the restructured loan meets the definition of a security in Statement 115?

Background

2. Statement 15 specifies the accounting for troubled debt restructuring and has been amended by Statement 114, which has changed a creditor's accounting for troubled debt restructuring involving a modification of terms. However, Statement 114 grandfathered certain previous troubled debt restructuring; that is, it does not require loans restructured prior to its effective date to be retroactively remeasured upon adoption of that Statement. Paragraph 27 of Statement 114 states that "if a loan that was restructured in a troubled debt restructuring involving a modification of terms before the effective date of this Statement is not impaired based on the terms specified by the restructuring agreement, a creditor may continue to account for the loan in accordance with the provisions of Statement 15 prior to its amendment by this Statement." (Although the term loan is defined in Statement 114 to encompass both loans that are securities and loans that are not, paragraph 6.d. of Statement 114 excludes all debt securities from the scope of that pronouncement.) Some have perceived an inconsistency between paragraph 27 of Statement 114 and paragraph 3 of Statement 115, which indicates that Statement 115 applies to all investments in debt securities.

Response

3. Statement 115 applies to all loans that meet the definition of a security in that Statement. Thus, any loan that was restructured in a troubled debt restructuring involving a modification of terms, including those restructured before the effective date of Statement 114, would be subject to the provisions of Statement 115 if the debt instrument meets the definition of a security. Paragraph 137 of Statement 115 defines a security as follows:

> A share, participation, or other interest in property or in an enterprise of the issuer or an obligation of the issuer that (a) either is represented by an instrument issued in bearer or registered form or, if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer, (b) is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment, and (c) either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations.

Effective Date and Transition

4. The provisions of this Technical Bulletin are effective for financial statements issued after April 30, 1994.

Appendix

BACKGROUND INFORMATION AND CONSIDERATION OF COMMENTS RECEIVED ON THE PROPOSED TECHNICAL BULLETIN

5. The perceived inconsistency between paragraph 27 of Statement 114 and paragraph 3 of Statement 115 was identified during the Board's discussion of the applicability of Statement 115 to "Brady bonds" that were received in a troubled debt restructuring. The phrase Brady bonds

refers to bonds issued to financial institutions by foreign governments (such as Mexico and Venezuela) under a program designed by Treasury Secretary Nicholas Brady in the late 1980s to help developing countries refinance their debt to those institutions.

6. If Statement 115 were not to apply to a debt security that was restructured in a troubled debt restructuring involving a modification of terms prior to the effective date of Statement 114, then the impairment provisions of neither Statement 114 nor Statement 115 would apply. Instead, the security would be accounted for under the provisions of Statement 15, which do not recognize the relevance of the time value of money or the security's fair value. For example, restructured securities that otherwise would be classified as available-for-sale would be accounted for at amortized cost.

7. Proposed *FASB Technical Bulletin No. 94-a, Application of Statement 115 to Debt Securities Restructured in a Troubled Debt Restructuring*, was released for comment on January 4, 1994. Twelve comment letters were received on the proposed Technical Bulletin. Most of the comment letters expressed support for issuing the Technical Bulletin; a few suggested clarifications, which have been implemented.

28. EITF 87-18 provides the following guidance:

ISSUE

In connection with a troubled debt restructuring, a debtor, with the creditor's approval, sells the collateral, which has a fair value less than the creditor's net investment in the related loan, and invests the proceeds in a series of zero coupon bonds that are received and held by the creditor as collateral for the newly restructured loan. The bonds will mature at a value equal to each year's debt service requirement under the newly restructured terms.

The issue is whether the sale of collateral, the purchase of the zero coupon bonds, and their receipt by the creditor as collateral require the creditor to recognize a loss equal to the amount by which the net investment in the loan exceeds the fair value of the zero coupon bonds.

EITF DISCUSSION

The Task Force reached a consensus that the creditor should recognize a loss on the satisfaction of the loan and record an asset for the fair value of the zero coupon bonds. Under paragraph 28 of Statement 15, the loss would be measured as the amount by which the creditor's net investment in the loan exceeds the fair value of the assets received in full satisfaction of the debt. Most Task Force members considered the transaction to be an in-substance foreclosure or settlement of the loan pursuant to paragraph 34 of Statement 15. Some Task Force members commented that the creditor should not be able to avoid loss recognition by refraining from legal foreclosure even though the creditor has effectively acknowledged accepting possession of what is designated to be the collateral.

29. EITF 87-19 provides the following guidance:

ISSUE

In connection with a troubled debt restructuring, a debtor, with the creditor's approval, sells the collateral (real estate) on a contract for deed for a purchase price, the present value of which is less than the creditor's net investment in the related loan. The creditor does not release its lien on the property. The seller-debtor provides 100 percent financing for the third-party purchaser, with payment terms identical to the seller-debtor's obligation under the restructured terms. The third-party purchaser must make the monthly payments directly to the creditor and not to the seller-debtor.

The issue is whether the sale of collateral and related requirement for the purchaser to make payments directly to the creditor warrant the creditor's recognition of a loss related to the amount by which the net investment in the loan exceeds the fair value of the payments to be received from the purchaser.

EITF DISCUSSION

The Task Force reached a consensus that the creditor should recognize a loss on the disposition of the original loan and record an asset for the fair value of the payments to be received from the purchaser. Under paragraph 28 of Statement 15, the loss would be measured as the amount by which the creditor's net investment in the loan exceeds the fair value of the assets received in full satisfaction of the debt. Some Task Force members considered the transaction to be an in-substance foreclosure or settlement of the loan pursuant to paragraph 34 of Statement 15. Others viewed it as the addition or substitution of a debtor pursuant to paragraph 42 of Statement 15. Some Task Force members commented that the creditor should not be able to avoid loss recognition by refraining from legal foreclosure even though the creditor has effectively repossessed the original collateral by approving its sale and requiring the purchaser's payments to be made directly to the creditor.

30. EITF 89-15 provides the following guidance:

ISSUE

An enterprise that is experiencing financial difficulties proposes to exchange new debt for existing debt with the same creditor or creditors. Although the terms of the new debt are more favorable to the creditor than the terms of the existing debt, the new debt terms are not representative of and are less favorable to the creditor than prevailing terms for new borrowings by enterprises with similar credit ratings. This transaction may occur, for example, when an enterprise operating in a regulated environment wishes to increase its capital.

The issue is whether an exchange of new debt for existing debt under the circumstances described above should be considered an extinguishment of debt as described in Opinion 26 resulting in recognition of a gain by the debtor in the period of the exchange.

EITF DISCUSSION

The Task Force reached a consensus that no gain should be recognized in the circumstances described above. The Task Force concluded that an exchange of existing debt for new debt with the same creditor, the terms of which are not representative of and are less favorable to the creditor than prevailing terms for new borrowings by enterprises with similar credit ratings, results in a concession to the debtor by the creditor and should be accounted for by both parties as a modification of an existing obligation under the provisions of Statement 15. The Task Force agreed that the consensus reached regarding this Issue applies from the date of the September 21, 1989 meeting.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 3, Mortgage Loans, and Chapter 4, Real Estate
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 3, Mortgage Loans, and Chapter 4, Real Estate
- Accounting Practices and Procedures of the Securities Valuation Office of the National Association of Insurance Commissioners
- *Issue Paper No. 24—Discontinued Operations and Extraordinary Items*
- *Issue Paper No. 26—Bonds, Excluding Loan-Backed and Structured Securities*
- *Issue Paper No. 30—Investments in Common Stock (excluding investments in common stock of subsidiary, controlled, or affiliated entities)*
- *Issue Paper No. 32—Investments in Preferred Stock (including investments in preferred stock of subsidiary, controlled, or affiliated entities)*

Generally Accepted Accounting Principles

- *FASB Statement No. 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings*
- *FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loan and Initial Direct Costs of Leases*
- *FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan*
- *FASB Statement No. 118, Accounting by Creditors for Impairment of a Loan - Income Recognition and Disclosures*
- *FASB Technical Bulletin 80-2, Classification of Debt Restructuring by Debtors and Creditors*
- *FASB Technical Bulletin 81-6, Applicability of Statement 15 to Debtors in Bankruptcy Situations*
- *FASB Technical Bulletin 94-1, Application of Statement 115 to Debt Securities Restructured in a Troubled Debt Restructuring*
- *FASB Emerging Issues Task Force Issue No. 94-8, Accounting for Conversion of a Loan into a Security in a Troubled Debt Restructuring*
- *FASB Emerging Issues Task Force Issue No. 87-18, Use of Zero Coupon Bonds in a Troubled Debt Restructuring*
- *FASB Emerging Issues Task Force Issue No. 87-19, Substituted Debtors in a Troubled Debt Restructuring*
- *FASB Emerging Issues Task Force Issue No. 89-15, Accounting for a Modification of Debt Terms When the Debtor is Experiencing Financial Difficulties*
- *FASB Emerging Issue Task Force Issue No. 96-22, Applicability of the Disclosures Required by FASB Statement No. 114 When a Loan Is Restructured in a Troubled Debt Restructuring into Two (or More) Loan*

State Regulations

- No additional guidance obtained from state statutes or regulations.

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Statutory Issue Paper No. 37

Mortgage Loans

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 37

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory guidance requires mortgage loans to be recorded on a reporting entity's balance sheet at the unpaid principal balance plus any unamortized premium or origination fees or less any unaccreted discount. The carrying value of loans that are in default may be adjusted for unpaid interest and additional expenses incurred to protect the investment, providing that such amounts are deemed to be recoverable from the ultimate disposition of the asset. Costs to acquire or originate mortgage loans are expensed as incurred. Origination fees, including points, are deferred.

2. The purpose of this issue paper is to establish statutory accounting principles for the accounting and reporting of mortgage loans and related fees that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

3. For statutory accounting purposes, a mortgage loan shall be defined as a debt obligation that is not a security, which is secured by a mortgage on real estate. (A security is a share, participation, or other interest in property or in an enterprise of the issuer or an obligation of the issuer that (a) either is represented by an instrument issued in bearer or registered form, or if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer, (b) is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment, and (c) either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations.) Mortgage loans meet the definition of assets as specified in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this issue paper.

Initial Investment

4. For mortgage loans originated by the reporting entity, the initial investment in mortgage loans shall be recorded at the principal amount of the loan net of any amounts deferred under the provisions of paragraphs 5 and 7 below. For mortgage loans purchased by a reporting entity, the initial investment shall be recorded as the amount paid to the seller. Accordingly, there may be a premium or discount on such loans resulting from a difference between the amount paid and the principal amount.

Loan Origination Fees

5. Loan origination fees shall be defined as fees charged to the borrower in connection with the process of originating, refinancing, or restructuring a loan. The term includes, but is not limited to, points, management, arrangement, placement, application, underwriting, and other fees pursuant to a lending transaction. Nonrefundable loan origination fees shall not be recorded until received in cash. Nonrefundable fees representing points shall be deferred as part of the loan balance and amortized over

the life of the loan in accordance with paragraph 8 of this issue paper. Nonrefundable fees other than points shall be recorded in the income statement upon receipt.

Loan Origination, Acquisition, and Commitment Costs

6. All costs incurred in connection with originating a loan, acquiring purchased loans or committing to purchase loans shall be charged to expense as incurred.

Commitment Fees

7. Commitment (or commitment standby) fees are fees paid to the reporting entity that obligate the reporting entity to make or acquire a loan or to satisfy an obligation of another party under a specified condition. A fee paid to the reporting entity to obtain a commitment to make funds available at some time in the future, generally, is refundable only if the loan is granted. If the loan is not granted, then the fees shall be recorded as investment income by the reporting entity when the commitment is no longer available. A fee paid to the reporting entity to obtain a commitment to be able to borrow funds at a specified rate and with specified terms quoted in the commitment agreement, generally, is not refundable unless the commitment is refused by the reporting entity. This type of fee shall be deferred, and amortization shall depend on whether or not the commitment is exercised. If the commitment is exercised, then the fee shall be amortized in accordance with paragraph 8 of this issue paper over the life of the loan as an adjustment to the investment income on the loan. If the commitment expires unexercised, the commitment fee shall be recognized in income on the commitment expiration date.

Amortization

8. Premiums and discounts on acquired loans, and mortgage interest points and commitment fees (if such qualify for amortization as described in the previous paragraph) shall be recognized as an adjustment of yield over the life of the loan (i.e., the period of time until total principal proceeds of the loan are received in cash) so as to produce a constant effective yield each year to maturity. If the reporting entity holds a large number of similar loans for which the prepayments of principal are probable, (probable is used in the same context as in paragraph 4 in *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*, which defines probable as the future event or events are likely to occur), and the timing and amount can be reasonably estimated, the reporting entity shall include estimates of future principal prepayments in the calculation of the constant effective yield necessary to apply the interest method. The amount recognized as an adjustment of yield shall be credited or charged to interest income in the calculation of net investment income.

Prepayments

9. Payments received in advance of due dates may produce prepaid interest which shall be recorded as a liability, Unearned Investment Income, on the reporting entity's balance sheet. The portion of the payments received in advance of due dates that represent prepayments of principal shall be recorded as a reduction in the mortgage loan balance.

10. A mortgage loan may provide for a prepayment penalty or acceleration fee in the event the loan is liquidated prior to its scheduled termination date. Such fees shall be reported as investment income when received.

Interest Income

11. Interest income shall be recorded as earned and shall be included in investment income in the Summary of Operations. Interest income shall include interest collected, the change in interest income due and accrued and the change in unearned interest income as well as amortization of premiums, discounts and deferred fees as specified in paragraph 8.

Accrued Interest

12. When a loan is determined to be in default (per the contractual terms of the loan), the accrued interest on the loan shall be recorded as investment income due and accrued if deemed collectible. If a loan in default has any investment income due and accrued which is 180 days past due and collectible, the investment income shall continue to accrue, but all interest related to the loan is to be reported as a nonadmitted asset. If accrued interest on a mortgage loan in default is not collectible, the accrued interest shall be written off immediately and no further interest accrued.

Impairments

13. A mortgage loan shall be considered to be impaired when, based on current information and events, it is probable that a reporting entity will be unable to collect all amounts due according to the contractual terms of the mortgage agreement. According to the contractual terms means that both the contractual principal payments and contractual interest payments of the mortgage loan will be collected as scheduled in the mortgage agreement. A reporting entity shall measure impairment based on the fair value (as determined by acceptable appraisal methodologies) of the collateral less estimated costs to obtain and sell. The difference between the net value of the collateral and the recorded investment in the mortgage loan shall be recognized as an impairment by creating a valuation allowance with a corresponding charge to unrealized loss or by adjusting an existing valuation allowance for the impaired loan with a corresponding charge or credit to unrealized gain or loss. Subsequent to the initial measurement of the impairment, if there is a significant change (increase or decrease) in the net value of the collateral, the reporting entity shall adjust the valuation allowance; however, the net carrying amount of the loan shall at no time exceed the recorded investment in the loan. For reporting entities required to maintain an asset valuation reserve (AVR), the unrealized gain or loss on impairments shall be included in the calculation of the AVR. If the impairment is other than temporary, a direct write down shall be recognized as a realized loss, and a new cost basis is established. This new cost basis shall not be changed for subsequent recoveries in value. Mortgage loans for which foreclosure is probable shall be considered permanently impaired.

Construction Loans

14. A construction loan shall be defined as a mortgage loan of less than three years in term, made for financing the cost of construction of a building or other improvement to real estate, which is secured by the real estate. The principal amount of a construction loan shall be the amount of funds disbursed to the borrower. If, in accordance with the terms of the contract, interest is deferred until the maturity of the loan, the accrued interest shall be included in the balance of the loan outstanding. The impairment test in paragraph 13 should be applied to all construction loans, regardless of whether there are any actual or anticipated defaults. Accordingly, construction loans shall not be reported at an amount greater than the fair value of the property. The percentage of completion of the property shall be considered in determining fair values of property securing construction loans.

Disclosures

15. The reporting entity shall make the disclosures for impaired loans as required by paragraph 20 of *FASB Statement No. 114*, *Accounting by Creditors for Impairment of a Loan* (FAS 114), as amended by paragraph 6(1) of *FASB Statement No. 118, Accounting by Creditors for Impairment of a Loan - Income Recognition and Disclosures, an amendment of FASB Statement No. 114* (FAS 118) in the annual audited statutory financial reports only. This is included in the Relevant GAAP Guidance section below.

16. The following additional disclosures shall also be made in the financial statements:

a. Fair values in accordance with *Issue Paper No. 27—Disclosure of Information about Financial Instruments with Concentration of Credit Risk* (Issue Paper No. 27), *Issue Paper No. 33—Disclosures about Fair Value of Financial Instruments and Issue Paper No. 85—*

Derivative Financial Instruments (as it relates to disclosure about financial instruments with off-balance-sheet risk),
b. Concentrations of credit risk in accordance with Issue Paper No. 27,
c. Description of the valuation basis of the mortgage loans,
d. Information on the minimum and maximum rates of interest received for new loans made by category,
e. Maximum percentage of any one loan to the value of security at the time of the loan,
f. Total carrying amount of mortgages with interest 180 days past due and the amount of interest past due thereon. Disclose the carrying amount and number of mortgage loans where interest has been reduced, by percent reduced and
g. Taxes, assessments, and amounts advanced not included in the mortgage loan total.

DISCUSSION

17. The conclusion differs with current statutory guidance in that loan origination fees shall be recorded in the income statement, except for points which will be deferred as part of the loan balance. Also, prepayment penalties are to be recorded as investment income. It rejects *FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring and Initial Direct Costs or Leases* (FAS 91) and *FASB Emerging Issues Task Force Issue No. 88-17*, *Accounting for Fees and Costs Associated with Loan Syndications and Loan Participations,* which provides that certain origination costs be deferred. It adopts FAS 114 and 118 for collateral dependent loans (FAS 114 and FAS 118 apply to loans other than mortgage loans), with the following modifications:

a. Impairment to be measured based on the fair value of the collateral less costs to obtain and sell, whereas that is just one option under FAS 114; and

b. The reporting entity is required to record any other than temporary impairment as a realized loss and shall not record subsequent recoveries in fair value.

The conclusion also adopts *FASB Emerging Issue Task Force Issue No. 84-19*, *Mortgage Loan Payment Modifications*, which considers the effects of accelerated payments. The conclusion rejects *AICPA Practice Bulletin 6, Amortization of Discounts on Certain Acquired Loans,* which provides alternative accounting for the loan balance under the cost recovery method in circumstances where the amounts, and timing of collections and the ultimate collectibility of the acquisition amount of the loan are not probable. This method is not consistent with the impairment provisions established by paragraph 13 of this issue paper.

18. Recording mortgage loans as admitted assets is consistent with the recognition concept in the Statement of Concepts (i.e., the existence of readily marketable assets available when both current and future obligations are due). Due to their similar nature to bonds, recording the mortgage loans at amortized cost is consistent with the principles used to record bonds at amortized cost.

19. Requiring reporting entities to defer commitment fees until the loan commitment terminates is more conservative than the GAAP treatment which allows for income recognition during the commitment period if the likelihood that the commitment will be exercised is remote.

20. Prepayment penalties represent consideration for interest income not received on a loan due to the prepayment. If that interest had been received it would have been recorded as investment income, therefore, it is appropriate to record the prepayment penalties as investment income. This is different from the current statutory guidance which allows a reporting entity to record the penalties as either investment income or realized capital gains.

21. By requiring reporting entities to reflect impairments in the value of a loan, the conclusion above is consistent with other issue papers on invested assets (e.g., bonds, common stock, preferred stock), which also require a reporting entity to record any impairment of an invested asset. It is also more conservative than allowing the reporting entity to continue to carry the impaired loan at amortized cost, when it is probable that the reporting entity will not receive the invested funds in accordance with the terms of the original agreement.

Drafting Notes/Comments

- Investment income due and accrued is addressed in *Issue Paper No. 34—Investment Income Due and Accrued*.
- Accounting for foreclosed assets is addressed in *Issue Paper No. 36—Troubled Debt Restructurings*.
- Loan-backed and structured securities are addressed in *Issue Paper No. 43—Loan-Backed and Structured Securities*.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

22. The Accounting Practices and Procedures Manual for Life and Accident and Health contains the statutory guidance for the accounting for mortgage loans. Excerpts from Chapter 3, Mortgage Loans, are as follows:

> Valuation
>
> Mortgage loans when acquired are recorded in the general ledger at the amount of unpaid principal balance. However, if they are acquired at a discount or premium, entries for the amount of such discount or premium may be made in separate ledger accounts. If so, the net book value of mortgage loans consists of the unpaid balances plus any unamortized premium balances and less any unamortized discount.
>
> Requirements for valuation of investments for reporting purposes indicate that mortgage loans that are not in default (regarding either principal or interest) should be valued at the unpaid principal balance. Further, mortgage loans acquired at a premium or at a discount are to be valued at amortized cost (i.e., net book value).
>
> Premium amortization or discount accretion over the full term of a loan normally implies the use of a method that produces a constant effective yield each year to maturity. However, if the period of amortization of accretion is relatively short, a straight-line method may be used.
>
> For loans that are in default, being voluntarily conveyed, or being foreclosed, the carrying value may be adjusted for unpaid interest and additional expenses, such as insurance, taxes and legal fees that have been incurred to protect the investment or to obtain clear title to the property to the extent that such amounts are deemed to be recoverable from the ultimate disposition of the property. However, if such interest and costs cannot reasonably be expected to be recovered, they should not be added to the carrying value, and the cost should be expensed.
>
> If, when reporting mortgage loans in default, the values of real estate have declined to less than the unpaid principal balances, an appropriate valuation reserve should be established to reflect the expected uncollectible amount.
>
> Mortgage loans that are in default, or which are under foreclosure proceedings, continue to be classified as mortgage loans. Loans for which foreclosure proceedings have been completed, even to the extent of the court granting title to the mortgages, may temporarily retain their status as mortgage loans, since in some states the mortgagor still has the privilege of redeeming the

mortgage during a stated redemption period. During this period, the loan may remain classified as a mortgage loan until the insurance company obtains clear title. The asset is then transferred to the real estate account.

Interest

Interest income on mortgage loans is recorded when earned during any reporting period. An "inventory" of due and accrued interest must be determined at the end of each reporting period. Interest income includes adjustments for amortization or the accrual of discount.

A portion of the interest due and accrued on mortgage loans may require treatment as a nonadmitted asset for reporting purposes. In general, amounts over one year past due are nonadmitted. In practice, some companies consider that interest past due for periods of less than one year indicates future uncollectibility, and may make a provision against operations for such amounts to establish an appropriate reserve. Alternatively, some companies may cease accrual of interest on loans that default on any payment. Therefore, the amount of due and accrued interest that is considered to be a nonadmitted asset depends on the policy regarding accrual determination, and whether reserves have been established by charges to operations. In the case of mortgage loans on which foreclosure action is pursued, delinquent interest may be recovered from the amount, if any, by which the proceeds on the eventual sale of the property exceed the unpaid principal balance.

Contingent interest represents income generated through the occurrence of specific economic events in relation to the borrower. For example, contingent interest may become payable upon the attainment of a given level of cash flow or income. Contingent interest may be reported as income when received or accrued. The proper accrual of such income does, however, require an analysis of the applicable provisions in the underlying agreement and the verification that the prerequisite conditions have been met.

Payments

Payments on mortgage loans may be received in advance of due dates. Such payments may produce prepaid interest which is considered unearned and is recorded as a liability in the annual statement.

Companies that use servicing agents for their mortgage loans should report the "Interest Due and Accrued" asset on the balance sheet consistently with the income statement treatment of the charge for servicing costs. If interest income is reported net of servicing costs, which is usual when the servicing agent fee is based on a percentage retention of each interest payment, then the interest receivable in the balance sheet should be net of the related servicing costs. If interest is reported gross, with the servicing costs reported as an expense item, then interest due and accrued should be reflected as an asset at the gross amount, with an appropriate liability to reflect the related servicing cost accrual.

Amounts paid to the insurance company by the mortgagor to cover future tax payments, insurance premiums, and other costs related to the property requires the creation of escrow accounts in the general ledger to record these liabilities. If such amounts are held by the servicing agents, they should be reported on the insurance company's balance sheet both as an asset and as a liability when they produce income for the insurance company. This may occur if the servicing agent invests the escrow funds and is required to remit the income (or portion thereof) to the insurance company.

> Prepayment penalties
>
> Some mortgage loans provide for a prepayment penalty or acceleration fee in the event the loan is liquidated prior to its scheduled termination date. Prepayment charges are intended to compensate the lender for expenses incurred in granting the loan as well as the potential loss of future earnings. Prepayment penalties may be reported as realized capital gains or investment income.
>
> Loan origination fees and costs
>
> Brokerage commissions, finders' fees, fees to cover loan processing and the like that are paid when acquiring mortgage loans usually are not significant and may be charged to operations when incurred. Points are additional fees and usually are expressed as a percentage of the funds disbursed. Points represent an adjustment of the loan interest rate to the current market. They should be deferred and amortized in the same manner as a premium paid on the mortgage.
>
> Commitment fees
>
> To obtain a commitment from the mortgage to make funds available at some time in the future, an applicant may pay a "commitment standby" fee to the mortgagee (e.g., an insurance company). This fee is returnable to the applicant if the loan is closed in accordance with the commitment. If the loan is not closed in accordance with the commitment, the fee becomes income to the mortgagee to cover the costs involved in making the funds available at the time the applicant requires the funds.
>
> The applicant also may pay a commitment fee to a mortgagee to obtain a commitment to be able to borrow funds at a specified rate and with specific terms quoted in the commitment. As this commitment has value to the applicant, and the mortgagee has incurred costs in reviewing the applicant's proposal, this fee is not returnable to the applicant unless the commitment is refused.
>
> The commitment fee should be deferred and, if the commitment is exercised, recognized over the life of the loan as an adjustment of yield. If the commitment expires unexercised, the commitment fee should be recognized in income on the commitment expiration date. If the commitment fee is an insignificant adjustment to the yield, the commitment fee may be recognized in income at the time of the funding of the loan.

23. The Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 3, Mortgage Loans, contains similar wording.

Generally Accepted Accounting Principles

24. GAAP guidance pertaining to a reporting entity's accounting for mortgage loans is contained in *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises* (FAS 60), as amended by FAS 114. Paragraph 47 of FAS 60, as amended by paragraph 23 of FAS 114 states:

> Mortgage loans shall be reported at outstanding principal balances if acquired at par value, or at amortized cost if purchased at a discount or premium, with an allowance for estimated uncollectible amounts, if any. Amortization and other related charges or credits shall be charged or credited to investment income. Changes in the allowance for estimated uncollectible amounts relating to mortgage loans shall be included in income as prescribed in *FASB Statement 114, Accounting by Creditors for Impairment of a Loan*.

25. The guidance for the accounting for loan origination costs and commitment fees is contained in FAS 91. Pertinent excerpts are as follows:

> Loan Origination Fees and Costs
>
> 5. Loan origination fees shall be deferred and recognized over the life of the loan as an adjustment of yield[2] (interest income). Likewise, direct loan origination costs defined in paragraph 6 shall be deferred and recognized as a reduction in the yield of the loan except as set forth in paragraph 14 (for a troubled debt restructuring). Loan origination fees and related direct loan origination costs for a given loan shall be offset and only the net amount shall be deferred and amortized. The practice of recognizing a portion of loan origination fees as revenue in a period to offset all or part of the costs of origination shall no longer be acceptable.
>
> [2] Methods for recognition of deferred fees and direct loan origination costs over the life of the loan as an adjustment of yield are set forth in paragraphs 18-20.
>
> 6. Direct loan origination costs of a completed loan shall include only (a) incremental direct costs of loan origination incurred in transactions with independent third parties for that loan and (b) certain costs directly related to specified activities performed by the lender for that loan. Those activities are: evaluating the prospective borrower's financial condition; evaluating and recording guarantees, collateral, and other security arrangements; negotiating loan terms; preparing and processing loan documents; and closing the transaction. The costs directly related to those activities shall include only that portion of the employees' total compensation and payroll-related fringe benefits directly related to time spent performing those activities for that loan and other costs related to those activities that would not have been incurred but for that loan.
>
> 7. All other lending-related costs, including costs related to activities performed by the lender for advertising, soliciting potential borrowers, servicing existing loans, and other ancillary activities related to establishing and monitoring credit policies, supervision, and administration, shall be charged to expense as incurred. Employees' compensation and fringe benefits related to those activities, unsuccessful loan origination efforts, and idle time shall be charged to expense as incurred. Administrative costs, rent, depreciation, and all other occupancy and equipment costs are considered indirect costs and shall be charged to expense as incurred.
>
> Commitment Fees and Costs
>
> 8. Except as set forth in subparagraphs (a) and (b) below, fees received for a commitment to originate or purchase a loan or group of loans shall be deferred and, if the commitment is exercised, recognized over the life of the loan as an adjustment of yield or, if the commitment expires unexercised, recognized in income upon expiration of the commitment:
>
> a. If the enterprise's experience with similar arrangements indicates that the likelihood that the commitment will be exercised is remote,[3] the commitment fee shall be recognized over the commitment period on a straight-line basis as service fee income. If the commitment is subsequently exercised during the commitment period, the remaining unamortized commitment fee at the time of exercise shall be recognized over the life of the loan as an adjustment of yield.

[3] The term remote is used here, consistent with its use in *FASB Statement No. 5, Accounting for Contingencies*, to mean that the likelihood is slight that a loan commitment will be exercised prior to its expiration.

b. If the amount of the commitment fee is determined retrospectively as a percentage of the line of credit available but unused in a previous period, if that percentage is nominal in relation to the stated interest rate on any related borrowing, and if that borrowing will bear a market interest rate at the date the loan is made, the commitment fee shall be recognized as service fee income as of the determination date.

9. Direct loan origination costs (described in paragraph 6) incurred to make a commitment to originate a loan shall be offset against any related commitment fee and the net amount recognized as set forth in paragraph 8.

Purchase of a Loan or Group of Loans

15. The initial investment in a purchased loan or group of loans shall include the amount paid to the seller plus any fees paid or less any fees received. The initial investment frequently differs from the related loan's principal amount at the date of purchase. This difference shall be recognized as an adjustment of yield over the life of the loan. All other costs incurred in connection with acquiring purchased loans or committing to purchase loans shall be charged to expense as incurred.

16. In applying the provisions of this Statement to loans purchased as a group, the purchaser may allocate the initial investment to the individual loans or may account for the initial investment in the aggregate. The cash flows provided by the underlying loan contracts shall be used to apply the interest method, except as set forth in paragraph 19. If prepayments are not anticipated pursuant to paragraph 19 and prepayments occur or a portion of the purchased loans is sold, a proportionate amount of the related deferred fees and purchase premium or discount shall be recognized in income so that the effective interest rate on the remaining portion of loans continues unchanged.

Other

17. Deferred net fees or costs shall not be amortized during periods in which interest income on a loan is not being recognized because of concerns about the realization of loan principal or interest.

Application of the Interest Method and Other Amortization Matters

18. Net fees or costs that are required to be recognized as yield adjustments over the life of the related loan(s) shall be recognized by the interest method except as set forth in paragraph 20. The objective of the interest method is to arrive at periodic interest income (including recognition of fees and costs) at a constant effective yield on the net investment in the receivable (that is, the principal amount of the receivable adjusted by unamortized fees or costs and purchase premium or discount). The difference between the periodic interest income so determined and the stated interest on the outstanding principal amount of the receivable is the amount of periodic amortization.[6] Under the provisions of this statement, the interest method shall be applied as follows when the stated interest rate is not constant throughout the term of the loan:

a. If the loan's stated interest rate increases during the term of the loan (so that interest accrued under the interest method in early periods would exceed interest at the stated rate), interest income shall not be recognized to the extent that the net investment in the loan would increase to an amount greater than the amount at which the borrower could settle the obligation. Prepayment penalties shall be considered in determining the amount at which the borrower could settle the obligation only to the extent that such penalties are imposed throughout the loan term. (Refer to Appendix B.)

b. If the loan's stated interest rate decreases during the term of the loan, the stated periodic interest received early in the term of the loan would exceed the periodic interest income that is calculated under the interest method. In that circumstance, the excess shall be deferred and recognized in those future periods when the constant effective yield under the interest method exceeds the stated interest rate. (Refer to Appendix B.)

c. If the loan's stated interest rate varies based on future changes in an independent factor, such as an index or rate (for example, the prime rate, the London Interbank Offered Rate (LIBOR), or the U.S. Treasury bill weekly average rate), the calculation of the constant effective yield necessary to recognize fees and costs shall be based either on the factor (the index or rate) that is in effect at the inception of the loan or on the factor as it changes over the life of the loan.[7] (Refer to Appendix B.)

[6] The "interest" method is also described in paragraph 16 of *APB Opinion No. 12, Omnibus Opinion--1967*, in the first sentence of paragraph 15 of *APB Opinion No. 21, Interest on Receivables and Payables,* and in paragraphs 235-239 of *FASB Concepts Statement No. 6, Elements of Financial Statements*.

[7] A variable rate loan whose initial rate differs from the rate its base factor would produce is also subject to the provisions of paragraphs 18(a) and (b).

19. Except as stated in the following sentence, the calculation of the constant effective yield necessary to apply the interest method shall use the payment terms required by the loan contract, and prepayments of principal shall not be anticipated to shorten the loan term. If the enterprise holds a large number of similar loans for which prepayments are probable and the timing and amount of prepayments can be reasonably estimated, the enterprise may consider estimates of future principal prepayments in the calculation of the constant effective yield necessary to apply the interest method. If the enterprise anticipates prepayments in applying the interest method and a difference arises between the prepayments anticipated and actual prepayments received, the enterprise shall recalculate the effective yield to reflect actual payments to date and anticipated future payments. The net investment in the loans shall be adjusted to the amount that would have existed had the new effective yield been applied since the acquisition of the loans. The investment in the loans shall be adjusted to the new balance with a corresponding charge or credit to interest income. Enterprises that anticipate prepayments shall disclose that policy and the significant assumptions underlying the prepayment estimates. The practice of recognizing net fees over the estimated average life of a group of loans shall no longer be acceptable. (Refer to Appendix B.)

20. Certain loan agreements provide no scheduled payment terms (demand loans); others provide the borrower with the option to make multiple borrowings up to a specified maximum amount, to repay portions of previous borrowings, and then reborrow under the same contract (revolving lines of credit).

a. For a loan that is payable at the lender's demand, any net fees or costs may be recognized as an adjustment of yield on a straight-line basis over a period that is consistent with (1) the understanding between the borrower and lender or (2) if no understanding exists, the lender's estimate of the period of time over which the loan will remain outstanding; any unamortized amount shall be recognized when the loan is paid in full.

> b. For revolving lines of credit (or similar loan arrangements), the net fees or costs shall be recognized in income on a straight-line basis over the period the revolving line of credit is active, assuming that borrowings are outstanding for the maximum term provided in the loan contract.
>
> If the borrower pays all borrowings and cannot reborrow under the contract, any unamortized net fees or costs shall be recognized in income upon payment. The interest method shall be applied to recognize net unamortized fees or costs when the loan agreement provides a schedule for payment and no additional borrowings are provided for under the agreement.[8]
>
> [8] For example, if the loan agreement provides the borrower with the option to convert a one-year revolving line of credit to a five-year term loan, during the term of the revolving line of credit the lender would recognize the net fees or costs as income on a straight-line basis using the combined life of the revolving line of credit and term loan. If the borrower elects to convert the line of credit to a term loan, the lender would recognize the unamortized net fees or costs as an adjustment of yield using the interest method. If the revolving line of credit expires and borrowings are extinguished, the unamortized net fees or costs would be recognized in income upon payment.
>
> Balance Sheet Classification
>
> 21. The unamortized balance of loan origination, commitment, and other fees and costs and purchase premiums and discounts that is being recognized as an adjustment of yield pursuant to this Statement shall be reported on the enterprise's balance sheet as part of the loan balance to which it relates.

26. GAAP guidance on the accounting for the impairment of a loan is contained in FAS 114, as amended by FAS 118. Pertinent excerpts, as amended, are as follows:

> 8. A loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. For a loan that has been restructured in a troubled debt restructuring, the contractual terms of the loan agreement refers to the contractual terms specified by the original agreement, not the restructuring agreement.
>
> 13. When a loan is impaired as defined in paragraph 8 of this Statement, a creditor shall measure impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate, except that as a practical expedient, a creditor may measure impairment based on a loan's observable market price, or the fair value of the collateral if the loan is collateral dependent. Regardless of the measurement method, a creditor shall measure impairment based on the fair value of the collateral when the creditor determines that foreclosure is probable. A loan is collateral dependent if the repayment of the loan is expected to be provided solely by the underlying collateral. The creditor may choose a measurement method on a loan-by-loan basis. A creditor shall consider estimated costs to sell, on a discounted basis, in the measure of impairment if those costs are expected to reduce the cash flows available to repay or otherwise satisfy the loan. If the present value of expected future cash flows (or, alternatively, the observable market price of the loan or the fair value of the collateral) is less than the recorded investment in the loan[2] (including accrued interest, net deferred loan fees or costs, and unamortized premium or discount), a creditor shall recognize an impairment by creating a valuation allowance with a corresponding charge to bad-debt expense or by adjusting an existing valuation allowance for the impaired loan with a corresponding charge or credit to bad-debt expense.

[2] The term recorded investment in the loan is distinguished from net carrying amount of the loan because the latter term is net of a valuation allowance, while the former term is not. The recorded investment in the loan does, however, reflect any direct write-down of the investment.

14. If a creditor bases its measure of loan impairment on a present value amount, the creditor shall calculate that present value amount based on an estimate of the expected future cash flows of the impaired loan, discounted at the loan's effective interest rate. The effective interest rate of a loan is the rate of return implicit in the loan (that is, the contractual interest rate adjusted for any net deferred loan fees or costs, premium, or discount existing at the origination or acquisition of the loan).[3] The effective interest rate for a loan restructured in a troubled debt restructuring is based on the original contractual rate, not the rate specified in the restructuring agreement. If the loan's contractual interest rate varies based on subsequent changes in an independent factor, such as an index or rate (for example, the prime rate, the London interbank offered rate, or the U.S. Treasury bill weekly average), that loan's effective interest rate may be calculated based on the factor as it changes over the life of the loan or may be fixed at the rate in effect at the date the loan meets the impairment criterion in paragraph 8. The creditor's choice shall be applied consistently for all loans whose contractual interest rate varies based on subsequent changes in an independent factor. Projections of changes in the factor should not be made for purposes of determining the effective interest rate or estimating expected future cash flows.

[3] A loan may be acquired at a discount because of a change in credit quality or rate or both. When a loan is acquired at a discount that relates, at least in part, to the loan's credit quality, the effective interest rate is the discount rate that equates the present value of the investor's estimate of the loan's future cash flows with the purchase price of the loan.

15. If a creditor bases its measure of loan impairment on a present value calculation, the estimates of expected future cash flows shall be the creditor's best estimate based on reasonable and supportable assumptions and projections. All available evidence, including estimated costs to sell if those costs are expected to reduce the cash flows available to repay or otherwise satisfy the loan, should be considered in developing the estimate of expected future cash flows. The weight given to the evidence should be commensurate with the extent to which the evidence can be verified objectively. If a creditor estimates a range for either the amount or timing of possible cash flows, the likelihood of the possible outcomes shall be considered in determining the best estimate of expected future cash flows.

16. Subsequent to the initial measurement of impairment, if there is a significant change (increase or decrease) in the amount or timing of an impaired loan's expected future cash flows, or if actual cash flows are significantly different from the cash flows previously projected, a creditor shall recalculate the impairment by applying the procedures specified in paragraphs 12-15 and by adjusting the valuation allowance. Similarly, a creditor that measures impairment based on the observable market price of an impaired loan or the fair value of the collateral of an impaired collateral-dependent loan shall adjust the valuation allowance if there is a significant change (increase or decrease) in either of those bases. However, the net carrying amount of the loan shall at no time exceed the recorded investment in the loan.

Disclosures

20. A creditor shall disclose, either in the body of the financial statements or in the accompanying notes, the following information about loans that meet the definition of an impaired loan in paragraph 8 of this Statement:

a. As of the date of each statement of financial position presented, the total recorded investment in the impaired loans at the end of each period and (1) the amount of that recorded investment for which there is a related allowance for credit losses determined in accordance with this Statement and the amount of that allowance and (2) the amount of that recorded investment for which there is no related allowance for credit losses determined in accordance with this Statement

b. The creditor's policy for recognizing interest income on impaired loans, including how cash receipts are recorded

c. For each period for which results of operations are presented, the average recorded investment in the impaired loans during each period, the related amount of interest income recognized during the time within that period that the loans were impaired, and, unless not practicable, the amount of interest income recognized using a cash-basis method of accounting during the time within that period that the loans were impaired.

Information about an impaired loan that has been restructured in a troubled debt restructuring involving a modification of terms need not be included in the disclosures required by paragraphs 20(a) and 20(c) in years after the restructuring if (i) the restructuring agreement specifies an interest rate equal to or greater than the rate that the creditor was willing to accept at the time of the restructuring for a new loan with comparable risk and (ii) the loan is not impaired based on the terms specified by the restructuring agreement. That exception shall be applied consistently for paragraphs 20(a) and 20(c) to all loans restructured in a troubled debt restructuring that meet the criteria in (i) and (ii).

For each period for which results of operations are presented, a creditor also shall disclose the activity in the total allowance for credit losses related to loans, including the balance in the allowance at the beginning and end of each period, additions charged to operations, direct write-downs charged against the allowance, and recoveries of amounts previously charged off. The total allowance for credit losses related to loans includes those amounts that have been determined in accordance with FASB No. 5, Accounting for Contingencies, and with this Statement.

27. *FASB Emerging Issue Task Force Issue No. 84-19, Mortgage Loan Payment Modifications* is adopted. Pertinent excerpts are as follows:

EITF 84-19 ISSUE
The borrower and lender enter into an agreement whereby the borrower increases his mortgage payments for a specified period, at the conclusion of which the lender forgives a portion of the remaining principal on the loan. The borrower may terminate the arrangement at any time but receives no principal reduction if he makes less than 12 consecutive increased payments.
The issue is how the lender should account for the portion of principal that may be forgiven.
1. Should the lender assume that the accelerated payments will be made to maturity and discount such accelerated payments using the current interest rate, thus recording a loss?
2. Should the lender assume that only 12 consecutive increased payments will be made and that other payments to maturity will be at the original rate and discount all payments using the current interest rate, thus recording a smaller loss?

3. Should the discount only be recorded as a loss when the borrower has made all the payments required or should the discount be accrued as a loss pro rata over the 12-month period?

EITF 84-19 DISCUSSION
The Task Force reached a consensus that, assuming it is probable that the borrower will continue to make the increased payments for the specified period, the expense relating to the partial forgiveness should be accrued over the period of increased payments. Task Force members indicated that this approach to the accounting has already been consistently applied in practice.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 3, Mortgage Loans
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 3, Mortgage Loans
- *Issue Paper No. 34—Investment Income Due and Accrued*

Generally Accepted Accounting Principles

- *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises*
- *FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*
- *FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan*
- *FASB Statement No. 118, Accounting by Creditors for Impairment of a Loan - Income Recognition and Disclosures, an amendment of FASB Statement No. 114*
- *FASB Emerging Issues Task Force Issue No. 84-19, Mortgage Loan Payment Modifications*
- *FASB Emerging Issues Task Force Issue 88-17, Accounting for Fees and Costs Associated with Loan Syndications and Loan Participations*
- *AICPA Practice Bulletin 6, Amortization of Discounts on Certain Acquired Loans*

State Regulations

- State regulations contain numerous references to mortgage loans. Due to the volume, specific references to each state regulation have not been reproduced in this issue paper.

Statutory Issue Paper No. 38

Acquisition, Development and Construction Arrangements

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 38

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Reporting entities may enter into real estate acquisition, development and construction (ADC) arrangements to finance the construction costs in which they have virtually the same risks and potential rewards as those of owners or joint venturers. In some instances, it may be inappropriate to account for such arrangements as loans. Current statutory accounting provides no specific guidance on the accounting for ADC arrangements. GAAP provides specific guidance for when to treat such arrangements as real estate/joint venture investments rather than as loans. This issue paper establishes statutory accounting principles for ADC arrangements that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

2. This paper provides guidance on when to account for ADC arrangements as mortgage loans and when to account for ADC arrangements as investments in real estate or real estate joint ventures. ADC arrangements shall be defined as lending agreements that are made to the owner of property to finance the acquisition, development and construction of real estate projects on the property in which the lender participates in expected residual profits. Expected residual profit is the amount of profit, whether called interest or another name (e.g., equity kicker) above a reasonable amount of interest and fees expected to be earned by the lender. ADC arrangements shall include participations in loans and purchased loans that meet that definition of ADC arrangements.

3. If the lender is expected to receive over 50% of the expected residual profits of the project, the ADC arrangement shall be classified and accounted for as an investment in real estate in accordance with *Issue Paper No. 40—Real Estate Investments*.

4. If the lender is expected to receive 50% or less of the expected residual profits, the ADC arrangement shall be classified and accounted for as a loan or as a real estate joint venture, depending on the circumstances. If any of the characteristics in paragraph 9.b. through 9.e. of AcSEC Practice Bulletin 1, Exhibit I, *ADC Arrangements* (PB1), which is excerpted in the Relevant GAAP Guidance section in paragraph 10 below, or if a qualifying personal guarantee (as defined in PB1) is present, the ADC arrangement shall be classified and accounted for as a construction loan in accordance with Issue Paper No. 37—Mortgage Loans. Otherwise, the ADC arrangement shall be classified and accounted for as a real estate joint venture in accordance with *Issue Paper No. 48—Investments in Joint Ventures, Partnerships and Limited Liability Companies.*

5. The factors that are evaluated in determining the accounting treatment at inception may subsequently change for some ADC arrangements, for example, as a result of a renegotiation of the terms. Consequently, the accounting treatment for an ADC arrangement shall be periodically reassessed, as described in paragraph 20 of PB1 contained in paragraph 10 below. Any changes in classification shall result in a reclassification of the asset at the amount the asset should be reported at under its new

classification with the net effect, if any, charged to income in the period that the change in classification is made.

6. Regardless of whether an ADC arrangement is accounted for as an investment in real estate, a joint venture, or a mortgage loan, the ADC arrangement meets the definition of an asset as defined in *Issue Paper No. 4—Definition of Assets and Nonadmitted* Assets and is an admitted asset to the extent it conforms to the requirements of this issue paper.

DISCUSSION

7. The conclusion above adopts PB1. Classifying and accounting for ADC arrangements in accordance with their economic substance rather than their form is consistent with a regulator's need for meaningful and comparable financial information, as stated in the Statement of Concepts. Furthermore, the conclusion is consistent with the conservatism concept in the Statement of Concepts in as much as certain ADC arrangements that otherwise would be accounted for as loans will be accounted for as investments in real estate. Accordingly, to the extent that the ADC project is expected to incur a loss, the lender shall recognize its share of those losses. The conclusion above also adopts *FASB Emerging Issues Task Force No. 86-21*, *Application of the AICPA Notice to Practitioners regarding Acquisition, Development, and Construction Arrangements to Acquisition of an Operating Property*.

Drafting Notes/Comments

- ADC arrangements may involve related parties, in which case Issue Paper No. 25 - Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties should also be followed.
- *Issue Paper No. 37—Mortgage Loans* addresses accounting for mortgage loans, including construction loans, and addresses impairment and disclosures.
- *Issue Paper No. 40—Real Estate Investments* addresses accounting for real estate investments, including how to account for sales of real estate, construction of real estate, impairment and disclosures.
- *Issue Paper No. 48—Investments in Joint Ventures, Partnerships and Limited Liability Companies* addresses accounting for joint ventures.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

8. Statutory literature does not specifically address ADC arrangements.

9. Some states specifically prohibit the investment in construction/developmental real estate. For example, Texas Insurance Code Chapter 3, *Life, Health and Accident Insurance,* Subchapter C, Reserves and Investments, Art. 3.33 Sec. 4 (1)(2) states:

> ... nothing in this article shall allow ownership of, development of, or equity interest in any residential property or subdivision, single or multiunit family dwelling property, or undeveloped real estate for the purpose of subdivision for or development of residential, single, or multiunit family dwellings, except acquisitions as provided in Subdivision (4) below, and such ownership, development, or equity interests shall be specifically prohibited;

Generally Accepted Accounting Principles

10. The accounting for ADC arrangements under GAAP is governed by PB1 as follows:

> 1. Financial institutions may enter into ADC arrangements in which they have virtually the same risks and potential rewards as those of owners or joint venturers. AcSEC believes that, in some instances, accounting for such arrangements as loans would not be appropriate and thus is providing this guidance in determining the proper accounting.

Scope

2. This notice applies only to those ADC arrangements in which the lender participates in expected residual profit, as further described below.

Expected Residual Profit

3. Expected residual profit is the amount of profit, whether called interest or another name, such as equity kicker, above a reasonable amount of interest and fees expected to be earned by the lender.

4. The extent of such profit participation and its forms may vary. An example of a simple form might be one in which the contractual interest and fees, if any, on a condominium project are considered to be at fair market rates; the expected sales prices are sufficient to cover at least principal, interest, and fees; and the lender shares in an agreed proportion, for example, 20 percent, 50 percent, or 90 percent, of any profit on sale of the units.

5. A slightly different form of arrangement may produce approximately the same result. For example, the interest rate and/or fees may be set at a level higher than in the preceding example, and the lender may receive a smaller percentage of any profit on sale of the units. Thus, a greater portion of the expected sales price is required to cover the contractual interest and/or fees, leaving a smaller amount to be allocated between the lender and the borrower. The lender’s share of expected residual profit in such an arrangement may be approximately the same as in the preceding example. A different arrangement may cause the same result if the interest rate and/or fees are set at a sufficiently high level and the lender does not share in any proportion of profit on sale of the units. Another variation is one in which the lender shares in gross rents or net cash flow from a commercial project, for example, an office building or an apartment complex.

6. The profit participation agreement may or may not be part of the mortgage loan agreement. Consequently, the auditor should be aware of the possibility that such agreements may exist and should design audit procedures accordingly. Those procedures could include inquiries to, and requests for written representation from, both the lender and the borrower.

7. The accounting guidance in paragraphs 16 and 17 is based on a consideration of the following characteristics of ADC arrangements. A particular ADC arrangement may have one or more of these characteristics.

Characteristics of ADC Arrangements Implying Investments in Real Estate or Joint Ventures

8. As stated in the “Scope” section, this notice applies to an ADC arrangement in which the lender participates in expected residual profit. In addition to the lender’s participation in expected residual profit, the following characteristics suggest that the risks and rewards of an ADC arrangement are similar to those associated with an investment in real estate or joint venture:

a. The financial institution agrees to provide all or substantially all necessary funds to acquire, develop, or construct the property. The borrower has title to but little or no equity in the underlying property.

b. The financial institution funds the commitment or origination fees or both by including them in the amount of the loan.

c. The financial institution funds all or substantially all interest and fees during the term of the loan by adding them to the loan balance.

d. The financial institution’s only security is the ADC project. The financial institution has no recourse to other assets of the borrower, and the borrower does not guarantee the debt.

e. In order for the financial institution to recover the investment in the project, the property must be sold to independent third parties, the borrower must obtain refinancing from another source, or the property must be placed in service and generate sufficient net cash flow to service debt principal and interest.

f. The arrangement is structured so that foreclosure during the project's development as a result of delinquency is unlikely because the borrower is not required to make any payments until the project is complete, and, therefore, the loan normally cannot become delinquent.

Characteristics of ADC Arrangements Implying Loans

9. Even though the lender participates in expected residual profit, the following characteristics suggest that the risks and rewards of an ADC arrangement are similar to those associated with a loan:

a. The lender participates in less than a majority of the expected residual profit.

b. The borrower has an equity investment, substantial to the project, not funded by the lender. The investment may be in the form of cash payments by the borrower or contribution by the borrower of land (without considering value expected to be added by future development or construction) or other assets. The value attributed to the land or other assets should be net of encumbrances. There may be little value to assets with substantial prior liens that make foreclosure to collect less likely. Recently acquired property generally should be valued at no higher than cost.

c. The lender has 1) recourse to substantial tangible, salable assets of the borrower, with a determinable sales value, other than the ADC project that are not pledged as collateral under other loans; or 2) the borrower has provided an irrevocable letter of credit from a creditworthy, independent third party to the lender for a substantial amount of the loan over the entire term of the loan.

d. A take-out commitment for the full amount of the financial institution's loans has been obtained from a creditworthy, independent third party. Take-out commitments often are conditional. If so, the conditions should be reasonable and their attainment probable.

e. Noncancelable sales contracts or lease commitments from creditworthy, independent third parties are currently in effect that will provide sufficient net cash flow on completion of the project to service normal loan amortization, that is, principal and interest. Any associated conditions should be probable of attainment.

Personal Guarantees

10. Some ADC arrangements include personal guarantees of the borrower and/or a third party. AcSEC believes that the existence of a personal guarantee alone rarely provides a sufficient basis for concluding that an ADC arrangement should be accounted for as a loan. In instances where the substance of the guarantee and the ability of the guarantor to perform can be reliably measured, and the guarantee covers a substantial amount of the loan, concluding that an ADC arrangement supported by a personal guarantee should be accounted for as a loan may be justified.

11. The substance of a personal guarantee depends on a) the ability of the guarantor to perform under the guarantee, b) the practicality of enforcing the guarantee in the applicable jurisdiction, and c) a demonstrated intent to enforce the guarantee.

12. Examples of personal guarantees that have the ability to perform would include those supported by liquid assets placed in escrow, pledged marketable securities, or irrevocable letters of credit from a creditworthy, independent third party[ies] in amounts sufficient to provide necessary equity support for an ADC arrangement to be considered a loan. In the absence of such support for the guarantee, the financial statements and other information of the guarantor may be considered to determine the guarantor's ability to perform. Due to the high-risk nature of many ADC arrangements, AcSEC believes financial statements that are current, complete, and include appropriate disclosures and that are reviewed or audited by independent CPAs are the most helpful in this determination.

13. Particular emphasis should be placed on the following factors when considering the financial statements of the guarantor:

a. Liquidity as well as net worth of the guarantor--There should be evidence of sufficient liquidity to perform under the guarantee. There may be little substance to a personal guarantee if the guarantor's net worth consists primarily of assets pledged to secure other debt.

b. Guarantees provided by the guarantor to other projects--If the financial statements do not disclose and quantify such information, inquiries should be made as to other guarantees. Also, it may be appropriate to obtain written representation from the guarantor regarding other contingent liabilities.

14. The enforceability of the guarantee in the applicable jurisdiction should also be determined. Even if the guarantee is legally enforceable, business reasons that might preclude the financial institution from pursuing the guarantee should be assessed. Those business reasons could include the length of time required to enforce a personal guarantee, whether it is normal business practice in that jurisdiction to enforce guarantees on similar transactions, and whether the lender must choose between pursuing the guarantee or the project's assets, but cannot pursue both. The auditor should consider obtaining written representation from management regarding its intent to enforce personal guarantees.

Sweat Equity

15. Some ADC arrangements recognize value, not funded by the lender, for the builder's efforts after inception of the arrangement, sometimes referred to as sweat equity. AcSEC believes that sweat equity is not at risk by the borrower at the inception of an ADC project. Consequently, AcSEC believes sweat equity should not be considered a substantial equity investment on the part of the borrower in determining whether the ADC arrangement should be treated as a loan.

Accounting Guidance

16. In the interest of more uniformity in accounting for ADC arrangements, AcSEC believes the following guidance is appropriate:

a. If the lender is expected to receive over 50 percent of the expected residual profit, as previously defined, from the project, the lender should account for income or loss from the arrangement as a real estate investment as specified by Statement of Financial Accounting Standards (SFAS) no. 67, Accounting for Costs and Initial Rental Operations of Real Estate Projects,[N1] and SFAS no. 66, Accounting for Sales of Real Estate.[N2]

[N1] Statement of Financial Accounting Standards (SFAS) no. 67, Accounting for Costs and Initial Rental Operations of Real Estate Projects (Stamford: FASB, 1982).

[N2] SFAS no. 66, Accounting for Sales of Real Estate (Stamford: FASB, 1982).

b. If the lender is expected to receive 50 percent or less of the expected residual profit, the entire arrangement should be accounted for either as a loan or a real estate joint venture, depending on the circumstances. At least one of the characteristics identified in paragraph 9.b.-9.e., or a qualifying personal guarantee should be present for the arrangement to be accounted for as a loan. Otherwise, real estate joint venture accounting would be appropriate.

1. In the case of a loan, interest and fees may be appropriately recognized as income subject to recoverability. Statement of Position SOP no. 75-2, Accounting Practices of Real Estate Investment Trusts,[N3] and the AICPA audit and accounting guide entitled, Savings and Loan Associations,[N4] provide guidance that may be relevant in those industries in assessing the recoverability of such loan amounts and accrued interest.

[N3] Statement of Position SOP no. 75-2, Accounting Practices of Real Estate Investment Trusts (New York: AICPA, 1975).

[N4] Committee on Savings and Loan Associations, Savings and Loan Associations (New York: AICPA, 1979).

2. In the case of a real estate joint venture, the provisions of SOP no. 78-9, Accounting for Investments in Real Estate Ventures,[N5] and SFAS no. 34, Capitalization of Interest Cost,[N6] as amended by SFAS no. 58, Capitalization of Interest Cost in Financial Statements That Include Investments Accounted for by the Equity Method,[N7] provide guidance for such accounting. In particular, paragraph 34 of SOP no. 78-9 provides guidance on the circumstances under which interest income should not be recognized.

[N5] SOP no. 78-9, Accounting for Investments in Real Estate Ventures (New York: AICPA, 1978).

[N6] SFAS no. 34, Capitalization of Interest Cost (Stamford: FASB, 1979).

[N7] SFAS no. 58, Capitalization of Interest Cost in Financial Statements That Include Investments Accounted for by the Equity Method (Stamford: FASB, 1982).

17. ADC arrangements accounted for as investments in real estate or joint ventures should be combined and reported in the balance sheet separately from those ADC arrangements accounted for as loans.

Other Considerations

18. Transactions have occurred in which the lender's share of the expected residual profit in a project is sold to the borrower or a third party for cash or other consideration. If the expected residual profit in an ADC arrangement accounted for as a loan is sold, AcSEC believes the proceeds from the sale should be recognized prospectively as additional interest over the remaining term of the loan. The expected residual profit is considered additional compensation to the lender, and the sale results in a quantification of the profit. When an ADC arrangement is

accounted for as an investment in real estate or joint venture and the expected residual profit is sold, gain recognition, if any, is appropriate only if the criteria of SFAS No. 66 are met after giving consideration to the entire ADC arrangement including the continuing relationship between the financial institution and the project.

19. If the financial institution was the seller of the property at the initiation of the project, gain recognition, if any, should be determined by reference to SFAS No. 66.

20. The factors that were evaluated in determining the accounting treatment at inception subsequently change for some ADC arrangements, for example, as a result of a renegotiation of the terms. Consequently, the accounting treatment for an ADC arrangement should be periodically reassessed. An ADC arrangement originally classified as an investment or joint venture could subsequently be treated as a loan if the risk to the lender diminishes significantly, and the lender will not be receiving over 50 percent of the expected residual profit in the project. The lender must demonstrate a change in the facts relied upon when initially making the accounting decision, not just the absence of, or reduced participation in, the expected residual profit. For instance, risk may be reduced if a valid take-out commitment from another lender who has the capability to perform under the commitment is obtained and all conditions affecting the take-out have been met, thus assuring the primary lender recovery of its funds. If the lender on the other hand assumes further risks and/or rewards in an ADC arrangement by, for example, releasing collateral supporting a guarantee and/or increasing its percentage of profit participation to over 50 percent, the lender's position may change to that of an investor in real estate. Neither an improvement in the economic prospects for the project or successful, on-going development of the project nor a deterioration in the economic prospects for the project justifies a change in classification of an ADC arrangement. A change in classification is expected to occur infrequently and should be supported by appropriate documentation. The change in factors in an ADC arrangement should be evaluated based on the guidance in this notice and accounted for prospectively.

21. If an ADC arrangement accounted for as a real estate joint venture continues into a permanent phase with the project generating a positive cash flow and paying debt service currently, income should be recognized in accordance with SOP No. 78-9.

22. Regardless of the accounting treatment for an ADC arrangement, management has a continuing responsibility to review the collectibility of uncollected principal, accrued interest, and fees and provide for appropriate allowances. The auditor should determine whether the allowances provided by management are adequate. In connection with this determination, the auditor should review relevant evidential matter including feasibility studies, appraisals, forecasts, non-cancelable sales contracts or lease commitments and information concerning the track record of the developer. In addition, ADC arrangements may involve related parties and the auditor should be aware of such a possibility and design procedures accordingly. Progress information may be less than desirable for the auditor's purpose and may require supplemental procedures. Additional procedures might include on-site inspection of projects or the independent use of experts such as property appraisers or construction consultants to assist in the assessment of the collateral value.

23. Many participations in loans or whole loans are bought and sold by other financial institutions. The accounting treatment for a purchase that involves ADC arrangements should be based on a review of the transaction at the time of purchase in accordance with the guidance in this notice. In applying this guidance, a participant would look to its individual percentage of expected residual profit; for example, a participant who will not share in any of the expected residual profit is not subject to this notice. However, the responsibility to review collectibility and provide allowances applies equally to purchased ADC arrangements. Any reciprocal transactions between institutions, including multi-party transactions, should be viewed in their entirety and accounted for in accordance with their combined effects.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 37—Mortgage Loans*
- *Issue Paper No. 40—Real Estate Investments*
- *Issue Paper No. 48—Investments in Joint Ventures, Partnerships and Limited Liability Companies*

Generally Accepted Accounting Principles

- AcSEC Practice Bulletin 1, Exhibit I, *ADC Arrangements*
- *FASB Emerging Issues Task Force No. 86-21*, *Application of the AICPA Notice to Practitioners regarding Acquisition, Development, and Construction Arrangements to Acquisition of an Operating Property*

State Regulations

- Texas Insurance Code, Chapter 3, *Life, Health and Accident Insurance,* Subchapter C, Reserves and Investments, Art. 3.33

Statutory Issue Paper No. 39

Reverse Mortgages

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 39

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. A reverse mortgage is a loan against home equity that guarantees cash advances to the homeowner and requires no repayment until a future time, usually when the borrower dies, sells the property or permanently moves. The term reverse mortgage is used to describe the timing of repayment of the mortgage obligation which is at the end of the contractual period (i.e., the mortgagee does not repay the obligation until the underlying collateral is liquidated). The proceeds from the sale of the property are used to pay off the balance of the loan. The borrower's obligation is limited to the value of the home at the time of sale and the lender has no recourse to other assets of the borrower or the borrower's estate. Usually, the borrower receives an annuity payment either (a) for as long as the borrower lives or (b) until a set percentage of the value of the collateral is reached. In the first type, there is mortality risk, as well as the collateral, interest rate, and credit risk found in traditional mortgage loans.

2. Current statutory guidance is contained in the Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force minutes of the March 13, 1995 meeting. GAAP does not specifically address reverse mortgages.

3. The purpose of this issue paper is to establish statutory accounting principles for the accounting and reporting of reverse mortgages that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. For purposes of this issue paper, a reverse mortgage loan shall be defined as a non-recourse loan with the following characteristics:

a. It is secured by a mortgage against the primary residence of the borrower;

b. It guarantees a stream of cash disbursements to the borrower, either for the life of the borrower with no limit or up to a set percentage of the value of the residence or is a line of credit which the borrower can draw upon as needed; and

c. It has no maturity date and requires no repayment until one of the following events occur:

i. The borrower dies,

ii. The borrower sells the residence,

iii. The residence ceases to be the borrower's primary residence, or

iv. The borrower terminates the loan by paying back the outstanding balance.

5. A reverse mortgage meets the definition of an asset as defined in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets* and is an admitted asset to the extent it conforms to the requirements of this issue paper. As such, it shall be recorded as an other invested asset on the reporting entity's balance sheet and Schedule BA, Other Long-Term Invested Assets, of the Annual Statement.

6. The accounting and reporting requirements for reverse mortgages shall be the same as those contained in paragraph 10 below. A reverse mortgage shall be considered to be impaired when, based on current information and events, it is probable that a reporting entity will be unable to collect all amounts due according to the contractual terms of the reverse mortgage. "According to the contractual terms" means that both the contractual principal payments and contractual interest payments of the loan will be collected as specified in the reverse mortgage agreement. The three major categories of risk affecting reverse mortgages are described in paragraph 10. Reverse mortgages subject to these risks shall be reported net of an appropriate actuarial reserve. The assumptions, cash flow projections, and evaluation of risk are to be reviewed and updated at least annually with any resulting adjustment made to the valuation allowance (contra-asset) and unrealized gains and losses, if the impairment is temporary. Subsequent to the initial measurement of impairment, if there is a significant change (increase or decrease) in the risk factors affecting the value of the mortgage, the reporting entity shall adjust the valuation allowance; however, the net carrying amount of the loan shall at no time exceed the recorded investment in the loan. The term recorded investment in the loan is distinguished from net carrying amount of the loan because the latter term is net of the valuation allowance, while the former term is not. The recorded investment (including accrued interest, net deferred loan fees, and unamortized premium or discount) in the loan does, however, reflect any direct write down of the investment. If the impairment is other than temporary, a direct write down (charge-off) shall be recognized and a new cost basis is established. Direct write-downs for other than temporary impairments of reverse mortgages shall also be included in realized losses. This new basis shall not be changed for subsequent recoveries in fair value.

7. The following disclosures shall be made for reverse mortgages in the financial statements:

a. A description of the reporting entity's accounting policies and methods, including the statistical methods and assumptions used in calculating the reserve,

b. The reserve amount which is netted against the asset value,

c. Investment income or loss recognized in the period as a result of the re-estimated cash flows, and

d. General information regarding the reporting entity's commitment under the agreement.

DISCUSSION

8. This issue paper adopts current statutory guidance.

9. Though, at the time a reverse mortgage agreement is ratified, the reporting entity has agreed to make payments to the borrower, this does not meet the definition of a liability, as defined in *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets* (Issue Paper No. 5). Issue Paper No. 5 defines a liability as certain or probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or to provide services to other entities in the future as a result of past transaction(s) or event(s). By making payments to the borrower, the reporting entity is converting one asset (cash) to another (an outstanding reverse mortgage). It is, therefore, not sacrificing any economic benefit and is not incurring a liability up to the amount that the reporting entity can record as an asset (i.e., the value of the collateral).

Drafting Notes/Comments

- Accounting for real estate acquired in satisfaction of debt is addressed in *Issue Paper No. 40—Real Estate Investments.*
- Accounting for Mortgage Loans is addressed in *Issue Paper No. 37—Mortgage Loans*.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

10. The Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force minutes of the March 13, 1995 meeting contained the following to be added to the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies:

> Description
>
> Reverse mortgages are primarily designed to allow senior citizens to convert home equity into cash without selling their home. A reverse mortgage is a non-recourse loan secured by the borrower's owner occupied principal residence. Loan proceeds are based on the current fair market value of the home and the age of the borrower and may be disbursed in a lump sum or periodically to provide cash flow to the borrower. In consideration of those payments, the borrower exchanges all or part of a claim to home equity.
>
> Principal and interest payments on the loan are deferred until the borrower moves, sells the property or dies. The loan is then repaid in a lump sum with proceeds from the sale of the property. The borrower's obligation is limited to the value of the home at the time of sale and the lender has no recourse to other assets of the borrower or the borrowers estate.
>
> Reverse mortgages are reported on Schedule BA of the Annual Statement as "Investment in Reverse Mortgages."
>
> Payments can be structured in many different ways to fit the financial needs of the borrower. In some contracts the borrower shares a percentage of the home appreciation with the lender. Three common types of payment plans are:
>
> 1. Tenure plan - borrower receives fixed monthly payments until the borrower permanently moves, sells the property or dies.
>
> 2. Term plan - borrower receives fixed monthly payments for a specified period of time.
>
> 3. Line of Credit - borrower draws upon a pre-determined line of credit as needed.
>
> Authorization and Limitation
>
> To be considered admitted assets, investments in reverse mortgages are limited to first lien mortgages only. Reverse mortgages also may be subject to mortgage loan limitations established by the state of domicile, including loan to value limitations. Loan to value calculations will be based on the most current appraisal of the collateral. Reappraisal of the collateral is required when existing reverse mortgages are purchased by an insurer.
>
> Origination Expenses and Fees
>
> All expenses associated with entering into reverse mortgages shall be recognized immediately as investment expense.
>
> Revenue associated with originating or otherwise acquiring reverse mortgages, including non-refundable fees, shall be amortized to investment income on a straight line basis over the period from inception to the expected maturity date.

Generally, fees are not paid by the borrower at the time of closing but become payable when the outstanding balance of the reverse mortgage becomes due. In these situations, no accounting entries are recorded at the time of closing. Investment income will be recognized and the outstanding balance of the loan will increase as the fees are amortized.

If fees are paid by the borrower at the time of closing, a liability should be established. Investment income will be recognized and the liability will decrease as the fees are amortized.

Interest Income and Accrued Interest Receivable

Interest is payable by the borrower when the outstanding balance of the reverse mortgage becomes due. Accrued interest should be calculated on the outstanding balance of the loan on a monthly basis. As it is earned, accrued interest should be recorded to investment income and added to the outstanding balance of the loan.

Valuation

The outstanding balance of the reverse mortgage will include the accumulation of amounts disbursed, accrued interest and amortized origination fees (origination fees not paid by the borrower at the time of closing). Neither the fair market value of the underlying collateral nor the liability for future cash payments guaranteed by the lender are recorded. They are, however, considered in cash flow projections and to the extent that estimated future cash payments exceed estimated future cash receipts, a valuation reserve is established. Future appreciation in property value beyond the valuation date is not included in the projection of cash receipts.

The lender's equity in the appreciation of the property, if any, is not recorded until realized upon the sale of the home.

The three major categories of risk affecting reverse mortgages are described below:

1. Mortality risk - risk of loan payments extending beyond the borrowers original projected life expectancy.

   Since most reverse mortgages guarantee a continuing monthly payment to the borrower, there is the possibility that the borrower will collect cash payments and accrue interest exceeding the appreciated value of the collateral. In situations where loan payments extend beyond the borrower's original projected life expectancy, the insurance company will experience a diminished yield, and may experience a loss. Reverse mortgage contracts should be combined into groups which are of sufficient size to provide an actuarially and statistically credible basis for estimating life expectancy to project future cash flows.

2. Collateral Risk - risk of deterioration in the value of the collateral such that it is insufficient to cover the loan balance. This risk must be evaluated loan-by-loan and is based on information obtained from periodic real estate appraisals, as required by the state of domicile, and other pertinent information.

3. Interest Rate Risk - risk of interest rates rising on adjustable rate reverse mortgages to the extent that accrued interest creates a collateral risk.

   Reverse mortgages subject to these risks shall be reported net of an appropriate actuarial reserve. The assumptions, cash flow projections and evaluation of risk are to be reviewed and updated at least annually, with any resulting adjustment made to the reserve. Assumptions should be applied consistently to similar loans.

Disclosure Requirements

The following should be disclosed in footnote 2, Basis of Valuation of Invested Assets:

1. A description of the company's accounting policies and methods, including the statistical methods and assumptions used in calculating the reserve.
2. The reserve amount which is netted against the asset value.
3. Investment income or loss recognized in the period as a result of the re-estimated cash flows.
4. General information regarding the insurer's commitment under the agreement.

Effective Date

These accounting and reporting guidelines are effective for the year ending December 31, 1995.

Generally Accepted Accounting Principles

11. GAAP does not specifically address reverse mortgages. GAAP guidance addressing mortgage loans is contained in *Issue Paper No. 37—Mortgage Loans*.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force minutes of the March 13, 1995 meeting
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 37—Mortgage Loans*
- *Issue Paper No. 40—Real Estate Investments*

Generally Accepted Accounting Principles

None

State Regulations

- No additional guidance obtained from state statutes or regulations.

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Statutory Issue Paper No. 40

Real Estate Investments

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 40

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory accounting guidance for real estate investments is provided in the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies. However, the Accounting Practices and Procedures Manuals contain no comprehensive guidance on accounting for sale of real estate or for real estate construction projects.

2. GAAP guidance for real estate is established in *FASB Statement No. 60*, *Accounting and Reporting by Insurance Enterprises* (FAS 60), *FASB Statement No. 66*, *Accounting for Sales of Real Estate* (FAS 66), *FASB Statement No. 67*, *Accounting for Costs and Initial Rental Operations of Real Estate Projects* (FAS 67), *FASB Statement No. 121*, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of*, and *AICPA Statement of Position 92-3*, *Accounting for Foreclosed Assets* (SOP 92-3). Current statutory guidance is similar to GAAP, except that GAAP requires recognition of impairment in the value of the investments through a writedown to the appropriate basis with a charge to realized gains and losses. Current statutory accounting guidance states that "Generally, the value of investment real estate and property acquired in satisfaction of debt may not exceed the lower of current market value or cost plus capitalized improvements, less normal depreciation." The current statutory guidance gives reporting entities three options when an impairment is recognized: a) write down the investment real estate, b) nonadmit part of the value, or c) establish a reserve for specific properties as a liability.

3. The purpose of this issue paper is to establish statutory accounting principles for real estate investments that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. Real estate investments shall be defined as direct-owned real estate properties acquired in exchange for consideration (including but not limited to cash, a contract for deed or mortgage, or other non-cash consideration), obtained through foreclosure or voluntary conveyance in satisfaction of a mortgage loan, or received as contributed surplus. Real estate investments meet the definition of assets defined in *Issue Paper No. 4—Definition of Assets and Nonadmitted* Assets and are admitted assets to the extent they conform to the requirements of this issue paper.

5. Real estate investments include real estate occupied by the company, which is defined in *Issue Paper No. 23—Property Occupied by the Company*, and certain acquisition, development and construction arrangements (ADC) as defined in *Issue Paper No. 38—Acquisition, Development and Construction Arrangements* (Issue Paper No. 38).

6. Real estate investments shall be reported net of encumbrances in the following balance sheet categories, with parenthetical disclosure of the amount of related encumbrances:

- Properties occupied by the company
- Properties held for the production of income
- Properties held for sale

7. Encumbrances represent outstanding mortgages or other debt related to the real estate investment and any unpaid accrued acquisition or construction costs. Interest expense shall be included in investment expenses.

8. The cost of real estate represents the fair market value of the consideration exchanged plus any costs incurred to place the real estate asset in usable condition, including but not limited to, brokerage fees, legal fees, demolition, clearing and grading, fees of architects and engineers, any additional expenditures made for equipment and fixtures that are made a permanent part of the structure and certain interest costs as provided for in *Issue Paper No. 44—Capitalization of Interest*. Where cost includes both land and building, the cost shall be allocated among the assets purchased based on the relative values determined using appraisals, as described in paragraph 12 below. The cost shall be reduced by any amounts received for sales of rights or privileges in connection with the property or by any cash recoveries received after acquiring title to the property. The cost of real estate which has been foreclosed upon shall be initially established in accordance with *Issue Paper No. 36—Troubled Debt* Restructurings. The cost of contributed real estate shall be initially established in accordance with *Issue Paper No. 73—Transactions* as a nonreciprocal transfer.

9. The cost of property included in real estate investments, other than land, shall be depreciated over the estimated useful life, not to exceed fifty years. Depreciation expense shall be included in investment expenses.

10. Properties occupied by the reporting entity and properties held for the production of income shall be carried at depreciated cost less encumbrances unless events or circumstances indicate the carrying amount of the asset (amount prior to reduction for encumbrances) may not be recoverable. Paragraph 5 of FAS 121 provides examples of events or changes in circumstances which indicate that the recoverability of the carrying amount of properties occupied by the reporting entity or properties held for the production of income should be assessed. If the events or changes in circumstances set forth in paragraph 5 of FAS 121 are present or if other events or changes in circumstances indicate that the carrying amount of properties occupied by the company or properties held for the production of income may not be recoverable, the reporting entity shall determine whether an impairment loss must be recognized in accordance with paragraph 6 of FAS 121. Property occupied by the reporting entity shall be evaluated using the asset grouping approach of paragraph 8 of FAS 121. FAS 121 is excerpted in paragraph 37 of this issue paper. An impairment loss is measured as the amount by which the individual carrying amounts exceed the fair value of properties occupied by the company or properties held for the production of income. Fair value is determined in accordance with paragraph 12 of this issue paper. If the fair value of the asset is less than the carrying value, the asset shall be written down to the fair value thereby establishing a new cost basis. The new cost basis shall not be changed for subsequent recoveries in fair value. The adjustment shall be recorded in the statement of operations as a realized loss.

11. Properties that the reporting entity has the intent to sell or is required to sell shall be classified as properties held for sale and carried at the lower of depreciated cost or fair value less encumbrances and estimated costs to sell the property consistent with paragraph 16 of FAS 121. The intent to sell a property exists when management, having the authority to approve the action, has committed to a plan to dispose of the asset, either by sale or abandonment. Fair value of the asset shall be determined in accordance with

paragraph 12 of this issue paper. Subsequent revisions to the fair value of the asset shall be accounted for in accordance with paragraph 17 of FAS 121.

12. The current fair value of real estate shall be determined on a property by property basis (i.e., increases in the fair value of one property shall not be used to offset declines in fair value of another) and shall be defined as the price that a property would bring in a competitive and open market under all conditions requisite to a fair sale (i.e., the buyer and seller acting prudently and knowledgeably with the price not affected by any undue stimulus). If market quotes are unavailable, estimates of fair value shall be determined by an appraisal (internal or third party), which is based upon an evaluation of all relevant data about the market, considering the following:

a. A physical inspection of the premises,

b. The present value of future cash flows generated by the property (Discounted Cash Flows), or capitalization of stabilized net operating income (Direct Capitalization),

c. current sales prices of similar properties with adjustments for differences in the properties (Sales Comparison Approach),

d. costs to sell the property if the reporting entity does not have the intent or ability to hold the real estate as an investment,

e. replacement costs of the improvements, less depreciation, plus the value of the land (Cost Approach).

All appraisals obtained to determine fair market value of real estate investments shall be no more than five years old. However, if conditions indicate there has been a significant decrease in the fair market value of a property, then a current appraisal shall be obtained. Additionally, appraisals shall be obtained for real estate investments at the time of foreclosure or contribution. Contributed real estate shall be supported by an independent third party appraisal at the date of contribution. If either of the previous conditions exist but an appraisal has not been obtained, the related property shall be considered a nonadmitted asset until the required appraisals are obtained.

Income, Expenses, and Capital Improvements

13. Rental income on real estate leased is addressed in *Issue Paper No. 22—Leases,* which requires that rental income be included in investment income. Expenses incurred in operating the real estate investment, including but not limited to, real estate taxes, utilities, and ordinary repair and maintenance, shall be charged to expense as incurred and included in investment expenses.

14. Expenditures that are necessary to put the asset back into good operating condition or to keep it in good operating condition, shall be charged to expense as incurred. Expenditures that add to or prolong the life of the property shall be added to the cost of the real estate (capitalized) and depreciated over the remaining estimated useful life of the property.

Sale of Real Estate

15. Recognition of profit on sales of real estate investments shall be accounted for in accordance with paragraphs 29, 33 and 34 below. Profit shall be recognized in full when real estate is sold, provided (a) the profit is determinable, that is, the collectibility of the sales price is reasonably assured or the amount that will not be collectible can be estimated, and (b) the earnings process is virtually complete, that is, the seller is not obliged to perform significant activities after the sale to earn the profit. Unless both conditions exist, recognition of all or part of the profit shall be postponed. Profit shall not be recognized by the full accrual method until all of the following criteria are met:

a. A sale is consummated,

b. The buyer's initial and continuing investments are adequate to demonstrate a commitment to pay for the property,

c. The seller's receivable is not subject to future subordination, and

d. The seller has transferred to the buyer the usual risks and rewards of ownership in a transaction that is in substance a sale and does not have a substantial continuing involvement with the property after the sale.

DISCUSSION

The calculation of the buyer's initial investment specified in subparagraph 9 of paragraph 29 below shall be modified to reflect that buyer's notes must be supported by letters of credit from institutions that are listed by the Securities Valuation Office of the National Association of Insurance Commissioners as meeting credit standards to be included in determining the buyer's initial investment. Any profit or loss is considered a realized gain or loss in the year of the sale in accordance with FAS 66.

Real Estate Projects Under Development

16. Costs and initial rental operations of real estate projects under development, which include ADC arrangements accounted for as real estate under the provisions of paragraph 3 of Issue Paper No. 38, shall be accounted for in accordance with paragraph 30 below. Costs incurred in connection with real estate projects shall be expensed as incurred unless the criteria established in paragraph 30 are met. The admitted value of a real estate project, or parts thereof, held for sale or development and sale shall not exceed the estimated selling price in the ordinary course of business less estimated costs of completion (to stage of completion assumed in determining the selling price), holding, and disposal (net realizable value). If costs exceed net realizable value, capitalization of eligible costs shall continue, however, an allowance shall be provided to reduce the admitted value to estimated net realizable value.

17. The statutory principles in this issue paper are consistent with the current statutory guidance except as follows:

- Paragraph 11 requires real estate held for sale to be carried at the lower of fair value less estimated costs to sell or depreciated cost. There are at least two states, Nevada and Arizona, which allow real property to be carried in excess of depreciated cost if supported by an appraisal.

- Paragraphs 10 and 11 distinguish between real estate held for sale and real estate not held for sale. Paragraph 11 requires the fair market value of real estate held for sale to be reduced by estimated selling costs in determining admitted value.

- Paragraph 10 provides that impairments for properties occupied by the company and properties held for the production of income shall be recorded as a realized loss. After an impairment is recognized, the carrying amount of the asset shall be accounted for as its new cost. Current statutory guidance provides three options for recording valuation adjustments: (a) direct write-down of asset, (b) nonadmit part of the asset, or (c) establish a reserve liability.

- Paragraph 12 provides for the utilization of appraisals in determining fair market value. The Accounting Practices and Procedures Manual for Life and Accident and Health and for Property and Casualty Insurance Companies define the term “appraised value” but do not require the use of an appraisal to support valuation allowances. At least two states, Minnesota and Missouri, have regulations that require the use of appraisals for certain real estate properties.

- Paragraph 6 conforms the balance sheet categories to be consistent with FAS 121. These differ from those required on the Property and Casualty Annual Statement and those required on the Life and Accident and Health Annual Statement. Real estate currently reported as "Other Properties" on the Property and Casualty Annual Statement shall be reported as "Properties held for the production of income" or "Properties held for sale." Real estate currently reported as "Properties Acquired in the Satisfaction of Debt" on the Life and Accident and Health Annual Statement shall be reported as "Properties held for the production of income" or "Properties held for sale."

- Paragraph 15 adopts the GAAP guidance for sales of real estate, which augments and clarifies the current statutory guidance on sales of real estate.

- Paragraph 16 adopts GAAP guidance for real estate construction projects; no current statutory guidance exists.

18. The statutory accounting principles established in this issue paper:

- Adopt *FASB Statement No. 66*, *Accounting for Sales of Real Estate,* with modification to paragraph 9 to indicate that only letters of credit from institutions listed by the Securities Valuation Office shall be included in determining the buyer's initial investment. Additionally, as they relate to FASB Statement 66, the following are adopted: *FASB Emerging Issues Task Force Issue No. 87-29*, *Exchange of Real Estate Involving Boot* (EITF 87-29), *FASB Emerging Issues Task Force Issue No. 86-6*, *Antispeculation Clauses in Real Estate Sales Contracts*, *FASB Emerging Issues Task Force Issue No. 88-12*, *Transfer of Ownership Interest as Part of Down Payment under FASB Statement No. 66*, *FASB Emerging Issues Task Force Issue No. 88-24*, *Effect of Various Forms of Financing under FASB Statement No. 66* and *FASB Emerging Issues Task Force Issue No. 87-9*, *Profit Recognition on Sales of Real Estate with Insured Mortgages or Surety Bonds* (EITF 87-9).

- This issue paper adopts *FASB Emerging Issues Task Force No. 84-17*, *Profit Recognition on Sales of Real Estate with Graduated Payment Mortgages or Insured Mortgages*, *FASB Emerging Issues Task Force No 89-13*, *Accounting for the Cost of Asbestos Removal*, *FASB Emerging Issues Task Force No. 89-14, Valuation of Repossessed Real Estate*, *FASB Emerging Issues Task Force No. 90-8*, *Capitalization of Costs to Treat Environmental Contamination*, and *FASB Emerging Issues Task Force No. 95-23, The Treatment of Certain Site Restoration /Environmental Exit Costs When Testing a Long-Lived Assets for Impairment*.

- Adopt *FASB Statement No. 67*, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*. Foreclosed real estate held for sale should be valued as described within *SOP 92-3*, *Accounting for Foreclosed Assets*.

- Adopt *SOP 92-1*, *Accounting for Real Estate Syndication Income* and *SOP 92-3*, *Accounting for Foreclosed Assets*.

- Adopt *FASB Statement No. 121*, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of,* for real estate investments except for paragraphs 13, 14.c. and 14.d. which were rejected in *Issue Paper No. 68—Business Combinations and Goodwill*.

- Reject *Accounting Research Bulletin No. 43*, *Restatement and Revision of Accounting Research Bulletins, "Chapter 10, Taxes, Section A-Real Estate and Personal Property Taxes*"

19. The statutory accounting principles outlined in the conclusion above are consistent with the conservatism and recognition concepts in the Statement of Concepts. Pertinent excerpts follow:

> Conservatism
>
> Conservative valuation procedures provide protection to policyholders against adverse fluctuations in financial condition or operating results. Statutory accounting should be reasonably conservative over the span of economic cycles and in recognition of the primary responsibility to regulate for financial solvency. Valuation procedures should, to the extent possible, prevent sharp fluctuations in surplus.
>
> Recognition
>
> The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which may be unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet but rather should be charged against surplus when acquired or when availability otherwise becomes questionable.
>
> Revenue should be recognized only as the earnings process of the underlying underwriting or investment business is completed. Accounting treatments which tend to defer expense recognition do not generally represent acceptable SAP treatment.

Drafting Notes/Comments

- Accounting for investments in real estate ventures are addressed in *Issue Paper No. 48—Investments in Joint Ventures, Partnerships and Limited Liability Companies*.
- Accounting for leases and sale-leaseback transactions involving real estate transactions are addressed in *Issue Paper No. 22—Leases*.
- *Issue Paper No. 36—Troubled Debt Restructurings* addresses accounting for the foreclosure of real estate; this paper addresses how to account for foreclosed real estate after foreclosure.
- *Issue Paper No. 34—Investment Income Due and Accrued* addresses requirements related to nonadmitted rental income due and accrued.
- Accounting for real estate occupied by the company is addressed in *Issue Paper No. 23—Property Occupied by the Company*.
- Accounting for leasehold improvements is addressed in *Issue Paper No. 31—Leasehold Improvements Paid by the Reporting Entity as Lessee.*
- *Issue Paper No. 44—Capitalization of Interest* addresses capitalization of interest.
- Accounting for real estate property acquired by mortgage guaranty insurers in settlement of a claim is addressed in *Issue Paper No. 88—Mortgage Guaranty Insurance*.
- Depreciation of assets, including acceptable and unacceptable methods and maximum lives and disclosures, will be addressed in *Issue Paper No. 67—Depreciation of Property and Amortization of Leasehold Improvements.*

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

20. The Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies includes the following guidance in Chapter 4, Real Estate:

> Directly-owned real estate is reported separately in the statutory financial statement. Holdings so reported are classified as properties (a) occupied by the company, (b) acquired in satisfaction of debt, and (c) investments in real estate. These classes may include real estate owned under contract of sale.
>
> When real estate is owned indirectly through partnerships or joint ventures, it is reported as “Other Invested Assets” in the statutory financial statement.
>
> Authorization and Limitations
>
> Statutes and regulations promulgated by the states concerning limitations on investments in real property are widely divergent. Generally speaking, the thrust of these limitations is to provide an aggregate maximum investment value on holdings of real property. A typical example would be that real estate investments not exceed a stipulated percentage of total admitted assets or surplus. Also common among these limitations are provisions requiring the disposal of foreclosed properties within a certain period of time.
>
> Cost
>
> The cost of real estate acquired by purchase is the actual amount paid upon purchase, plus the costs incurred to place the real estate asset in usable condition. Elements of cost should also include brokerage fees, legal fees, demolition, clearing and grading, fees of architects and engineers, and any additional expenditures made for equipment and fixtures that are made a permanent part of the structure. Cost should be reduced by any amounts received for sales of rights or privileges in connection with the property or by any cash recoveries received after acquiring title to the property.
>
> Where more than one property is acquired at a group price, or where the cost includes both land and building, the price paid must be allocated among the assets purchased. This normally is done on the basis of relative values, which may be determined by appraisals made for insurance purposes, by assessed valuations made for property tax purposes, by independent appraisal, or by some other reasonable method such as the previous owner's percentage allocation or underwriting estimates.
>
> If property is acquired in a non-cash transaction, the acquired property should be recorded at the fair market value of the property or other asset given if the market value of the property acquired cannot reasonably be determined.
>
> In determining the cost of investment real estate, an insurer should include the cost of personal property necessary to the income generating operations of the investment property. Furniture, fixtures, and equipment so capitalized should be depreciated over their useful lives.
>
> Real estate acquired in satisfaction of debt includes property acquired through foreclosure and through voluntary conveyance.
>
> The cost of real estate acquired through foreclosure or voluntary conveyance is recorded at the lower of fair market value at acquisition or cost. Cost includes the outstanding principal balance of the mortgage loan at the date of foreclosure or conveyance plus foreclosure costs, real estate taxes, insurance premiums, and all other costs necessary to obtain clear title and to place the property in good repair. Uncollected interest or unrecovered advances made before foreclosure should also be included in cost.

Book Value

For real estate that is occupied by the company and for investment real estate, book value would be the cost or other basic value, stated net of any encumbrance, plus additions and increases by adjustments, less retirements and decreases by adjustments, including depreciation. Encumbrances include mortgages and other related debt and may also include accrued costs of acquisition or construction.

The book value of real estate sold under contract of sale is the balance resulting from the cost of the property, less reductions for cash received on account and for any purchase money mortgage that may have been accepted.

Market Value

Market value is the price that a property would bring in a competitive and open market under all conditions requisite to a fair sale the buyer and seller acting prudently and knowledgeably with the price not affected by any undue stimulus.

Appraised Value

An appraisal is an opinion of estimated market value for an adequately described property, as of a specified date, supported by the analysis of relevant data. To arrive at this value, three methods are used:

1. Market Data Approach - a comparative analysis of current sales prices of similar properties, after making necessary adjustments for any difference in the properties.

2. Cost Approach - an estimated value based on the cost of reproduction or replacement of the improvements, less depreciation, plus the value of the land. (Land value is usually determined by the market data approach.)

3. Income Approach - an estimated value based on the capitalization of income and productivity. It is concerned with the present value of future income.

In most appraisals, all three approaches ordinarily will have something to contribute. Each is used independently to reach an estimated value. Then, by applying to each separate value a weight proportionate to its merits in that particular instance, a conclusion is reached concerning one appropriate value. This procedure is known as correlation.

Statement Value

The instructions for the annual statement require that the admitted value of properties occupied by the company (home office real estate) shall not exceed actual cost, plus capitalized improvements, less normal depreciation. This formula is to apply whether the property is held directly or indirectly by the company.

Generally, the value of investment real estate and property acquired in satisfaction of debt may not exceed the lower of current market value or cost plus capitalized improvements, less normal depreciation. In lieu of writing down investment real estate or taking part of the value as nonadmitted when market value is less than book value, an insurer may establish a reserve for specific properties as a liability.

Income Derived from Real Estate

Income on real estate, or on space in buildings owned and occupied by the company, usually is received periodically and in advance and any amount not received at the end of an accounting period should be set up as investment income due and unpaid to the extent that the amount applies to that accounting period. If the collectibility of unpaid rent is in doubt, or if the amount due exceeds a period specified by statute or regulation, most jurisdictions require that the entire amount be nonadmitted. Rental income paid in advance of the accounting period for which it is payable in whole or in part should be included in the liability for unearned investment income to the extent it applies to the succeeding accounting period. If rental income is to be received over a period shorter than the full lease period, the total rent to be received should be accrued periodically as if the rent were received over the total lease period. Interest expense on a mortgage is netted against the rental income for the period.

In the statutory financial statement, a company must include in both its income and expenses an amount for rent relating to its occupancy of its own buildings.

This amount can be the estimated current market rental value of the space involved, or it can be the amount derived from consideration of the repairs, expenses, taxes, and depreciation incurred, plus interest added at an average fair rate on the book value of the company's investment in its home office building. The figure thus determined, being both charged to expenses and credited to income, has no effect either on the company's overall net income or surplus.

Sale of Real Estate

A company can recognize the sale of any real estate that it owns as an immediate cash sale or as a contract of sale. In a sale for cash and/or mortgage, title transfers to the buyer when the sale is consummated. Any profit or loss on the sale is considered to be realized in the year of sale. In a sale involving an installment contract, often referred to as land contracts, title is retained by the seller and transferred to the buyer only when he has paid the entire sales price, or a substantial portion of it.

If the sale of real estate, including real estate occupied by the Company, includes a mortgage or other note from the Company, some states may require the transaction be reported as a financing transaction using the deposit method of accounting for sale-leaseback transaction.

An insurer does not take credit for any profit from the sale or exchange of its assets when the consideration received and otherwise properly reported as an admitted asset is in the form of an installment contract, unless such profit is fully reserved by a liability established which is equal to the portion of such profit which is unrealized. In computing the realized portion of the profit on installment contracts, payments are allocated at the rate the principal is reduced by said payments.

Depreciation and Amortization

The cost of property, other than land, should be depreciated over its estimated useful life. Useful lives for buildings and improvements can best be obtained from contractors, appraisers, engineers, and manufacturers. Estimates published by the Internal Revenue Service can be helpful in the selection of useful lives for specific assets. Depreciable life may at times be fixed by contract, such as in a leasehold investment.

A variety of depreciation methods is available and a company should select the method that is most appropriate provided, however, that the method is both systematic and rational. Depreciation methods in use include the straight-line method, and accelerated methods, such as sum-of-the-years digits and various declining balance methods.

Because real estate leasehold improvements revert to the lessor at the end of the lease and the lessee receives benefits from the improvements only during the life of the lease, a leasehold improvement is subject to amortization over the lease life.

> Expenses and Capital Improvements
>
> Repairs and maintenance expenditures may be classified as ordinary or extraordinary. As a general rule, expenditures for ordinary repairs that are necessary to put assets back into good operating condition, and for maintenance to keep them that way, are expensed as they are incurred.
>
> Extraordinary expenditures which add to or prolong the life of the property should be capitalized. In practice, most organizations establish a minimum capitalization amount. Individual expenditures below this minimum are expensed rather than capitalized to avoid capitalization of immaterial amounts. Other expenses in operating real estate are expensed as incurred.
>
> Other Real Estate Taxes
>
> Except for the development phase of a project, real and personal property taxes are charged against income. Real and personal property taxes are based upon the assessed valuation of property, as of a given date, as determined by the laws of a state or other taxing authority. The proper accounting treatment must determine when the liability for real and personal property taxes should be accrued. Consistency of application from year to year in establishing this liability is the most important consideration.
>
> The preferred basis for determining the liability and charges for real and personal property taxes should be established at the time of purchase. A practical aspect of the legal liability for these taxes must be considered when title to property is transferred during the taxable year, whereby the date of personal obligation generally controls. Adjustments for property taxes paid or accrued are frequently incorporated in agreements covering the sale of the real estate and determined between the buyer's and seller's obligations. Once established, this liability can be applied consistently throughout the ownership of the property.

21. The Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies provides similar guidance to the above paragraph.

22. The Accounting Practice and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 22, *General Expenses and Taxes, Licenses and Fees*, includes the following guidance:

> 11. Real estate expenses include all costs except salaries and wages of company employees that relate to real estate, whether occupied by the company or not.

23. The Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 19, *Expenses*, contains the following pertinent excerpts:

> 3. Taxes, Licenses, and Fees
>
> These are state and local insurance taxes, insurance department licenses and fees, allocable payroll taxes, and all other taxes excluding federal and foreign income and real estate taxes.
>
> Real estate taxes on investment properties are generally included with investment expenses, and capital stock taxes and apportioned payroll taxes may be reported as investment expenses.

24. Minnesota state regulations include the following specific guidelines related to valuation of real estate investments:

> 60A.122 Mortgage and real estate valuation
>
> An insurer shall establish written procedures, approved by the company's board of directors, for the valuation of commercial mortgage loans and real estate owned. The procedures must be made available to the commissioner upon request. The commissioner shall review the insurer's compliance with the procedures in any examination of the insurer under section 60A.031.
>
> 60A.123 Valuation of foreclosures; reserves
>
> Subdivision 1. Requirement. An insurer shall value its commercial mortgage loans and real estate acquired through foreclosure of commercial mortgage loans as provided in this section for the purpose of establishing reserves or carrying values of the investments and for statutory accounting purposes.
>
> Subdivision 2. Performing mortgage loan. A performing mortgage loan must be carried at its amortized cost.
>
> Subdivision 3. Distressed mortgage loan.
>
> (a) The insurer shall make an evaluation of the appropriate carrying value of its commercial mortgage loans which it classifies as distressed mortgage loans. The carrying value must be based upon one or more of the following procedures:
>
> (1) an internal appraisal;
>
> (2) an appraisal made by an independent appraiser;
>
> (3) the value of guarantees or other credit enhancements related to the loan.
>
> (b) The insurer may determine the carrying value of its distressed mortgage loans through either an evaluation of each specific distressed mortgage loan or by a sampling methodology. Insurers using a sampling methodology shall identify a sampling of its distressed mortgage loans that represents a cross section of all of its distressed mortgage loans. The insurer shall make an evaluation of the appropriate carrying value for each sample loan. The carrying value of all of the insurer's distressed mortgage loans must be the same percentage of their amortized acquisition cost as the sample loans. The carrying value must be based upon an internal appraisal or an appraisal conducted by an independent appraiser.
>
> (c) The insurer shall either take a charge against its surplus or establish a reserve for the difference between the carrying value and the amortized acquisition cost of its distressed mortgage loans.
>
> Subdivision 4. Delinquent mortgage loan.
>
> (a) The insurer shall make an evaluation of the appropriate carrying value of each delinquent mortgage loan. The carrying value must be based upon one or more of the following procedures:
>
> (1) an internal appraisal;
>
> (2) an appraisal by an independent appraiser;
>
> (3) the value of guarantees or other credit enhancements related to the loan.

(b) The insurer shall either take a charge against its surplus or establish a reserve for the difference between the carrying value and the amortized acquisition cost of its delinquent mortgage loans.

Subdivision 5. Restructured mortgage loan.

(a) The insurer shall make an evaluation of the appropriate carrying value of each restructured mortgage loan. The carrying value must be based upon one or more of the following procedures:

(1) an internal appraisal;

(2) an appraisal by an independent appraiser;

(3) the value of guarantees or other credit enhancements related to the loan.

(b) The insurer shall either take a charge against its surplus or establish a reserve for the difference between the carrying value and the amortized acquisition cost of its restructured mortgage loans.

Subdivision 6. Mortgage loan in foreclosure.

(a) The insurer shall make an evaluation of the appropriate carrying value of each mortgage loan in foreclosure. The carrying value must be based upon an appraisal made by an independent appraiser.

(b) The insurer shall take a charge against its surplus for the difference between the carrying value and the amortized acquisition cost of its mortgage loans in the process of foreclosure.

Subdivision 7. Real estate owned.

(a) The insurer shall make an evaluation of the appropriate carrying value of real estate owned. The carrying value must be based upon an appraisal made by an independent appraiser.

(b) The insurer shall take a charge against its surplus for the difference between the carrying value and the amortized acquisition cost of real estate owned.

60A.125 Property and mortgage loan appraisal

Subdivision 1. Mortgage loans in the process of foreclosure. An insurer may rely upon an appraisal by an independent appraiser to determine the carrying value of mortgage loans in the process of foreclosure only if the date of the appraisal is within six months of the date the foreclosure procedure is begun. If no appraisal exists, the insurer shall acquire an appraisal within six months after the foreclosure proceeding has begun.

Subdivision 2. Real estate owned. An insurer may rely upon an appraisal by an independent appraiser to determine the carrying value of real estate owned only if the date of the appraisal is within six months of the date when title to the property was acquired. If no appraisal exists, the insurer shall acquire an appraisal within six months after title to the property is acquired.

Subdivision 3. Charge taken. An insurer shall take a charge against the surplus for mortgage loans in the process of foreclosure and real estate owned in the first calendar year in which it holds a current appraisal made by an independent appraiser as provided in this section.

25. Missouri state regulations also include specific guidelines related to valuation of real estate investments:

> 20 CSR 200-13.100 Appraisal requirements
>
> Purpose: This rule upgrades the quality of real estate appraisals used by insurers by requiring appraisals meet the same standards as those applicable to federally-regulated financial institutions. This rule effectuates or aids in the interpretation of sections 375.330, 376.300 and 379.080, RSMo.
>
> Editor's Note: The secretary of state has determined that the publication of this rule in its entirety would be unduly cumbersome or expensive. The entire text of the material referenced has been filed with the secretary of state. This material may be found at the Office of the Secretary of State or at the headquarters of the agency and is available to any interested person at a cost established by state law.
>
> (1) Any real estate held as an investment for the production of income pursuant to section 375.330.1(7), RSMo, or any mortgage loan made pursuant to section 376.300.1(9) or 379.080.1(2)(f), RSMo, excluding purchase money mortgages as identified in section 376.300.1(9), RSMo, may be held as an admissible asset only if the appraisal --
>
> (A) Is made of real estate no more than one hundred twenty (120) days before the date the deed or mortgage is recorded in the appropriate public records;
>
> (B) Is a written statement that is independently and impartially prepared by a licensed or certified appraiser setting forth an opinion of defined value of an adequately described property as of a specific date, supported by presentation and analysis of relevant market information;
>
> (C) Provides the current market value of the real estate, that is the value of the real estate in an arms-length sale as of the date of the appraisal; and
>
> (D) Is made by an individual who is --
>
> 1. On the national registry of state-certified and licensed appraisers who are eligible to perform appraisals in federally related transactions, which national registry is maintained pursuant to United States P.L. 101-73, Title XI, Section 1103 (12 USC Section 3332); and
>
> 2. Certified or licensed to make the appraisal by the state in which the real estate is located.
>
> (2) Notwithstanding any provision of section (1) of this rule to the contrary, no appraisal is necessary in order to admit as an asset the holding of any debt or security issued, assumed or guaranteed by the United States, any state, territory or possession of the United States, the District of Columbia or any administration, agency, authority or instrumentality of them, but only to the extent that the debit or security is issued, assumed insured or guaranteed by any such entity.
>
> (3) Notwithstanding any provision of section (1) of this rule to the contrary, an insurer may establish written procedures, approved by the company's board of directors, for the valuation of its real estate and mortgage loans, which shall exempt the insurer from all of the provisions of section (1). The written procedures must be approved by the director. The director may review the insurer's compliance with these procedures. The director must be notified of any material changes to the written procedures. To be exempt under this section, an insurer's mortgage loan and real estate operations shall meet the following minimum standards:
>
> (A) The insurer shall hold a combined mortgage loan and real estate portfolio valued at three hundred (300) million dollars or more;

(B) The insurer shall establish written procedures and obtain board approval and approval by the director within one hundred twenty (120) days (August 6, 1993) of the effective date of this rule (April 8, 1993);

(C) The insurer, as part of the written procedures, shall establish a reasonable system of valuation of its mortgage loans and real estate which includes the following elements:

1. A system to value its real estate acquired through foreclosure for the purpose of establishing reserves or carrying values of the investments and for statutory accounting purposes;

2. A program for the training, education and certification of employees, at least one (1) of whom must be certified as described in paragraph (1)(D)1. of this rule, who conducts internal appraisals of investments, or a system involving the use of independent certified appraisers as described in paragraph (1)(D)1. of this rule. Any internal appraiser shall not be compensated, directly or indirectly, on the basis of the outcome of appraisals performed and shall have direct reporting access to the chief investment officer of the insurer; and

3. Carrying values for the foreclosed real estate shall be based upon the internal appraisal or an independent appraisal and the value of the guarantees or other credit enhancements related to the investment; and

(D) The audit report of the independent certified public accountant which prepares the audit of the insurer's annual statement shall contain findings by the auditor that --

1. The insurer has adopted valuation procedures meeting the requirements of section (3) of this rule;

2. The procedures adopted by the board of directors have been uniformly applied by the insurer in conformance with section (3) of this rule; and

3. The management of the insurer has an adequate system of internal controls.

26. Nevada Statutes - Insurance Laws, TITLE 57 --- INSURANCE - Chapter 681B - ASSETS AND LIABILITIES provides the following guidance on real estate valuation:

681B.180 Real property

1. Real property acquired pursuant to a mortgage loan or contract for sale, in the absence of a recent appraisal deemed by the commissioner to be reliable, shall not be valued at an amount greater than the unpaid principal of the defaulted loan or contract plus interest due and accrued at the date of such acquisition, together with any taxes and expenses paid or incurred in connection with such acquisition, and the cost of improvements thereafter made by the insurer and any amounts thereafter paid by the insurer on assessments levied for improvements in connection with the property.

2. Other real property held by an insurer shall not be valued at an amount in excess of fair value as determined by recent appraisal. If valuation is based on an appraisal more than 3 years old, the commissioner may, at his discretion, call for and require a new appraisal in order to determine fair value.

27. Arizona Statutes - Insurance Laws, TITLE 20-- INSURANCE, Chapter 3 FINANCIAL PROVISIONS AND PROCEDURES, Article 1. Assets and Liabilities provides similar guidance:

> 20-513 Real and personal property valuation
>
> A. Real property acquired pursuant to a mortgage loan or contract for sale, in the absence of a recent appraisal deemed by the director to be reliable, shall not be valued at an amount greater than the unpaid principal of the defaulted loan or contract at the date of such acquisition, together with any taxes and expenses paid or incurred in connection with such acquisition, and the cost of improvements thereafter made by the insurer and any amounts thereafter paid by the insurer on assessments levied for improvements in connection with the property.
>
> B. Other real property held by an insurer shall not be valued at an amount in excess of fair value as determined by recent appraisal. If valuation is based on an appraisal more than three years old, the director may at his discretion call for and require a new appraisal in order to determine fair value.
>
> C. Personal property acquired pursuant to chattel mortgages made in accordance with section 20-555 shall not be valued at an amount greater than the unpaid balance of principal on the defaulted loan at the date of acquisition, together with taxes and expenses incurred in connection with the acquisition, or the fair value of the property, whichever amount is the lesser.

Generally Accepted Accounting Principles

28. *FASB Statement No. 60*, *Accounting and Reporting by Insurance Enterprises*, provides the following guidance:

> 48. Real estate investments shall be reported at cost less accumulated depreciation and an allowance for any impairment in value. Depreciation and other related charges or credits shall be charged or credited to investment income. Changes in the allowance for any impairment in value relating to real estate investments shall be included in realized gains and losses.

29. *FASB Statement No. 66*, *Accounting for Sales of Real Estate,* provides the following guidance:

> INTRODUCTION
>
> 1. This Statement establishes standards for recognition of profit on all real estate sales transactions without regard to the nature of the seller's business. The Statement distinguishes between retail land sales and other sales of real estate because differences in terms of sales and selling procedures lead to different profit recognition criteria and methods. Accounting for real estate sales transactions that are not retail land sales is specified in paragraphs 3-43. Accounting for retail land sales transactions is specified in paragraphs 44-50. This Statement does not cover exchanges of real estate for other real estate, the accounting for which is covered in *APB Opinion No. 29, Accounting for Nonmonetary Transactions*.
>
> 2. Although this Statement applies to all sales of real estate, many of the extensive provisions were developed over several years to deal with complex transactions that are frequently encountered in enterprises that specialize in real estate transactions. The decision trees on pages 75-79 highlight the major provisions of the Statement and will help a user of the Statement identify criteria that determine when and how profit is recognized. Those using this Statement to determine the accounting for relatively simple real estate sales transactions will need to apply only limited portions of the Statement. The general requirements for recognizing all of the profit on a nonretail land sale at the date of sale are set forth in paragraphs 3-5 and are highlighted on the decision tree on page 75. Paragraphs 6-18 elaborate on those general provisions. Paragraphs 19-43 provide more detailed guidance for a variety of more complex transactions.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Real Estate Sales Other Than Retail Land Sales

Recognition of Profit by the Full Accrual Method

3. Profit shall be recognized in full when real estate is sold, provided (a) the profit is determinable, that is, the collectibility of the sales price is reasonably assured or the amount that will not be collectible can be estimated, and (b) the earnings process is virtually complete, that is, the seller is not obliged to perform significant activities after the sale to earn the profit. Unless both conditions exist, recognition of all or part of the profit shall be postponed. Recognition of all of the profit at the time of sale or at some later date when both conditions exist is referred to as the full accrual method in this Statement.

4. In accounting for sales of real estate, collectibility of the sales price is demonstrated by the buyer's commitment to pay, which in turn is supported by substantial initial and continuing investments that give the buyer a stake in the property sufficient that the risk of loss through default motivates the buyer to honor its obligation to the seller. Collectibility shall also be assessed by considering factors such as the credit standing of the buyer, age and location of the property, and adequacy of cash flow from the property.

5. Profit on real estate sales transactions[1] shall not be recognized by the full accrual method until all of the following criteria are met:

a. A sale is consummated (paragraph 6).

b. The buyer's initial and continuing investments are adequate to demonstrate a commitment to pay for the property (paragraphs 8-16).

c. The seller's receivable is not subject to future subordination (paragraph 17).

d. The seller has transferred to the buyer the usual risks and rewards of ownership in a transaction that is in substance a sale and does not have a substantial continuing involvement with the property (paragraph 18).

Paragraphs 19-43 describe appropriate accounting if the above criteria are not met.

Consummation of a Sale

6. A sale shall not be considered consummated until (a) the parties are bound by the terms of a contract, (b) all consideration has been exchanged, (c) any permanent financing for which the seller is responsible has been arranged, and (d) all conditions[2] precedent to closing have been performed. Usually, those four conditions are met at the time of closing or after closing, not when an agreement to sell is signed or at a preclosing.

[1] Profit on a sale of a partial interest in real estate shall be subject to the same criteria for profit recognition as a sale of a whole interest.

[2] Paragraph 20 provides an exception to this requirement if the seller is constructing office buildings, condominiums, shopping centers, or similar structures.

Buyer's Initial and Continuing Investment

7. “Sales value” shall be determined by:

   a. Adding to the stated sales price the proceeds from the issuance of a real estate option that is exercised and other payments that are in substance additional sales proceeds. These nominally may be management fees, points, or prepaid interest or fees that are required to be maintained in an advance status and applied against the amounts due to the seller at a later date.

   b. Subtracting from the sale price a discount to reduce the receivable to its present value and by the net present value of services that the seller commits to perform without compensation or by the net present value of the services in excess of the compensation that will be received. Paragraph 31 specifies appropriate accounting if services are to be provided by the seller without compensation or at less than prevailing rates.

8. Adequacy of a buyer's initial investment shall be measured by (a) its composition (paragraphs 9-10) and (b) its size compared with the sales value of the property (paragraph 11).

9. The buyer's initial investment shall include only: (a) cash paid as a down payment, (b) the buyer's notes supported by irrevocable letters of credit from an independent established lending institution,[3] (c) payments by the buyer to third parties to reduce existing indebtedness on the property, and (d) other amounts paid by the buyer that are part of the sales value. Other consideration received by the seller, including other notes of the buyer, shall be included as part of the buyer's initial investment only when that consideration is sold or otherwise converted to cash without recourse to the seller.

[3] An “independent established lending institution” is an unrelated institution such as a commercial bank unaffiliated with the seller.

10. The initial investment shall not include:

   a. Payments by the buyer to third parties for improvements to the property

   b. A permanent loan commitment by an independent third party to replace a loan made by the seller

   c. Any funds that have been or will be loaned, refunded, or directly or indirectly provided to the buyer by the seller or loans guaranteed or collateralized by the seller for the buyer[4]

[4] As an example, if unimproved land is sold for $100,000, with a down payment of $50,000 in cash, and the seller plans to loan the buyer $35,000 at some future date, the initial investment is $50,000 minus $35,000, or $15,000.

11. The buyer's initial investment shall be adequate to demonstrate the buyer's commitment to pay for the property and shall indicate a reasonable likelihood that the seller will collect the receivable. Lending practices of independent established lending institutions provide a reasonable basis for assessing the collectibility of receivables from buyers of real estate. Therefore, to qualify, the initial investment shall be equal to at least a major part of the difference between usual loan limits and the sales value of the property. Guidance on minimum initial investments in various types of real estate is provided in paragraphs 53 and 54.

12. The buyer's continuing investment in a real estate transaction shall not qualify unless the buyer is contractually required to pay each year on its total debt for the purchase price of the property an amount at least equal to the level annual payment that would be needed to pay that

debt and interest on the unpaid balance over no more than (a) 20 years for debt for land and (b) the customary amortization term of a first mortgage loan by an independent established lending institution for other real estate. For this purpose, contractually required payments by the buyer on its debt shall be in the forms specified in paragraph 9 as acceptable for an initial investment. Except as indicated in the following sentence, funds to be provided directly or indirectly by the seller (paragraph 10.c.) shall be subtracted from the buyer's contractually required payments in determining whether the initial and continuing investments are adequate. If a future loan on normal terms from an established lending institution bears a fair market interest rate and the proceeds of the loan are conditional on use for specified development of or construction on the property, the loan need not be subtracted in determining the buyer's investment.

Release Provisions

13. An agreement to sell property (usually land) may provide that part or all of the property may be released from liens securing related debt by payment of a release price or that payments by the buyer may be assigned first to released property. If either of those conditions is present, a buyer's initial investment shall be sufficient both to pay release prices on property released at the date of sale and to constitute an adequate initial investment on property not released or not subject to release at that time in order to meet the criterion of an adequate initial investment for the property as a whole.

14. If the release conditions described in paragraph 13 are present, the buyer's investment shall be sufficient, after the released property is paid for, to constitute an adequate continuing investment on property not released in order to meet the criterion of an adequate continuing investment for the property as a whole (paragraph 12).

15. If the amounts applied to unreleased portions do not meet the initial and continuing-investment criteria as applied to the sales value of those unreleased portions, profit shall be recognized on each released portion when it meets the criteria in paragraph 5 as if each release were a separate sale.

16. Tests of adequacy of a buyer's initial and continuing investments described in paragraphs 8-15 shall be applied cumulatively when the sale is consummated and annually afterward. If the initial investment exceeds the minimum prescribed, the excess shall be applied toward the required annual increases in the buyer's investment.

Future Subordination

17. The seller's receivable shall not be subject to future subordination. This restriction shall not apply if (a) a receivable is subordinate to a first mortgage on the property existing at the time of sale or (b) a future loan, including an existing permanent loan commitment, is provided for by the terms of the sale and the proceeds of the loan will be applied first to the payment of the seller's receivable.

Continuing Involvement without Transfer of Risks and Rewards

18. If a seller is involved with a property after it is sold in any way that results in retention of substantial risks or rewards of ownership, except as indicated in paragraph 43, the absence-of-continuing-involvement criterion has not been met. Forms of involvement that result in retention of substantial risks or rewards by the seller, and accounting therefore, are described in paragraphs 25-42.

Recognition of Profit When the Full Accrual Method Is Not Appropriate

19. If a real estate sales transaction does not satisfy the criteria in paragraphs 3-18 for recognition of profit by the full accrual method, the transaction shall be accounted for as specified in the following paragraphs.

Sale Not Consummated

20. The deposit method of accounting described in paragraphs 65-67 shall be used until a sale has been consummated (paragraph 6). "Consummation" usually requires that all conditions precedent to closing have been performed, including that the building be certified for occupancy. However, because of the length of the construction period of office buildings, apartments, condominiums, shopping centers, and similar structures, such sales and the related income may be recognized during the process of construction, subject to the criteria in paragraphs 41 and 42, even though a certificate of occupancy, which is a condition precedent to closing, has not been obtained.

21. If the net carrying amount of the property exceeds the sum of the deposit received, the fair value of the unrecorded note receivable, and the debt assumed by the buyer, the seller shall recognize the loss at the date the agreement to sell is signed.[5] If a buyer defaults, or if circumstances after the transaction indicate that it is probable the buyer will default and the property will revert to the seller, the seller shall evaluate whether the circumstances indicate a decline in the value of the property for which an allowance for loss should be provided.

[5] Paragraph 24 *of FASB Statement No. 67, Accounting for Costs and Initial Rental Operations of Real Estate Projects*, specifies the accounting for an excess of costs over net realizable value for property that has not yet been sold.

Initial or Continuing Investments Do Not Qualify

22. If the buyer's initial investment does not meet the criteria specified in paragraphs 8-11 for recognition of profit by the full accrual method and if recovery of the cost of the property is reasonably assured if the buyer defaults, the installment method described in paragraphs 56-61 shall be used. If recovery of the cost of the property is not reasonably assured if the buyer defaults or if cost has already been recovered and collection of additional amounts is uncertain, the cost recovery method (described in paragraphs 62-64) or the deposit method (described in paragraphs 65-67) shall be used. The cost recovery method may be used to account for sales of real estate for which the installment method would be appropriate.

23. If the initial investment meets the criteria in paragraphs 8-11 but the continuing investment by the buyer does not meet the criteria in paragraphs 12 and 16, the seller shall recognize profit by the reduced profit method described in paragraphs 68 and 69 at the time of sale if payments by the buyer each year will at least cover both of the following:

a. The interest and principal amortization on the maximum first mortgage loan that could be obtained on the property

b. Interest, at an appropriate rate,[6] on the excess of the aggregate actual debt on the property over such a maximum first mortgage loan

[6] Paragraphs 13 and 14 of APB Opinion No. 21, Interest on Receivables and Payables, provide criteria for selecting an appropriate rate for present-value calculations.

If the criteria specified in this paragraph for use of the reduced profit method are not met, the seller may recognize profit by the installment method (paragraphs 56-61) or the cost recovery method (paragraphs 62-64).

Receivable Subject to Future Subordination

24. If the seller's receivable is subject to future subordination as described in paragraph 17, profit shall be recognized by the cost recovery method (paragraphs 62-64).

Continuing Involvement without Transfer of Risks and Rewards

25. If the seller has some continuing involvement with the property and does not transfer substantially all of the risks and rewards of ownership, profit shall be recognized by a method determined by the nature and extent of the seller's continuing involvement. Generally, profit shall be recognized at the time of sale if the amount of the seller's loss of profit because of continued involvement with the property is limited by the terms of the sales contract. The profit recognized shall be reduced by the maximum exposure to loss. Paragraphs 26-43 describe some common forms of continuing involvement and specify appropriate accounting if those forms of involvement are present. If the seller has some other form of continuing involvement with the property, the transaction shall be accounted for according to the nature of the involvement.

26. The seller has an obligation to repurchase the property, or the terms of the transaction allow the buyer to compel the seller or give an option[7] to the seller to repurchase the property. The transaction shall be accounted for as a financing, leasing, or profit-sharing arrangement rather than as a sale.

27. The seller is a general partner in a limited partnership that acquires an interest in the property sold (or has an extended, noncancelable management contract requiring similar obligations) and holds a receivable from the buyer for a significant[8] part of the sales price. The transaction shall be accounted for as a financing, leasing, or profit-sharing arrangement.

28. The seller guarantees[9] the return of the buyer's investment or a return on that investment for a limited or extended period. For example, the seller guarantees cash flows, subsidies, or net tax benefits. If the seller guarantees return of the buyer's investment or if the seller guarantees a return on the investment for an extended period, the transaction shall be accounted for as a financing, leasing, or profit-sharing arrangement. If the guarantee of a return on the investment is for a limited period, the deposit method shall be used until operations of the property cover all operating expenses, debt service, and contractual payments. At that time, profit shall be recognized on the basis of performance of the services required, as illustrated in paragraphs 84-88.

[7] A right of first refusal based on a bona fide offer by a third party ordinarily is not an obligation or an option to repurchase.

[8] For this purpose, a significant receivable is a receivable in excess of 15 percent of the maximum first-lien financing that could be obtained from an independent established lending institution for the property. It would include:

a. A construction loan made or to be made by the seller to the extent that it exceeds the minimum funding commitment for permanent financing from a third party that the seller will not be liable for
b. An all-inclusive or wraparound receivable held by the seller to the extent that it exceeds prior-lien financing for which the seller has no personal liability
c. Other funds provided or to be provided directly or indirectly by the seller to the buyer
d. The present value of a land lease when the seller is the lessor (footnote 15)

[9] Guarantees by the seller may be limited to a specified period of time.

29. The seller is required to initiate or support operations or continue to operate the property at its own risk, or may be presumed to have such a risk, for an extended period, for a specified limited period, or until a specified level of operations has been obtained, for example, until rentals of a property are sufficient to cover operating expenses and debt service. If support is required or presumed to be required[10] for an extended period of time, the transaction shall be accounted for as a financing, leasing, or profit-sharing arrangement. If support is required or presumed to be required for a limited time, profit on the sale shall be recognized on the basis of performance of the services required. Performance of those services shall be measured by the costs incurred and to be incurred over the period during which the services are performed. Profit shall begin to be recognized when there is reasonable assurance that future rent receipts will cover operating expenses and debt service including payments due the seller under the terms of the transaction. Reasonable assurance that rentals will be adequate would be indicated by objective information regarding occupancy levels and rental rates in the immediate area. In assessing whether rentals will be adequate to justify recognition of profit, total estimated future rent receipts of the property shall be reduced by one-third as a reasonable safety factor unless the amount so computed is less than the rents to be received from signed leases. In this event, the rents from signed leases shall be substituted for the computed amount. Application of this method is illustrated in paragraphs 84-89.

[10] Support shall be presumed to be required if: (a) a seller obtains an interest as a general partner in a limited partnership that acquires an interest in the property sold; (b) a seller retains an equity interest in the property, such as an undivided interest or an equity interest in a joint venture that holds an interest in the property; (c) a seller holds a receivable from a buyer for a significant part of the sales price and collection of the receivable depends on the operation of the property; or (d) a seller agrees to manage the property for the buyer on terms not usual for the services to be rendered, and the agreement is not terminable by either the seller or the buyer.

30. If the sales contract does not stipulate the period during which the seller is obligated to support operations of the property, support shall be presumed for at least two years from the time of initial rental unless actual rental operations cover operating expenses, debt service, and other contractual commitments before that time. If the seller is contractually obligated for a longer time, profit recognition shall continue on the basis of performance until the obligation expires. Calculation of profits on the basis of performance of services is illustrated in paragraphs 84-89.

31. If the sales contract requires the seller to provide management services relating to the property after the sale without compensation or at compensation less than prevailing rates for the service required (paragraph 7) or on terms not usual for the services to be rendered (footnote 10(d)), compensation shall be imputed when the sale is recognized and shall be recognized in income as the services are performed over the term of the management contract.

32. The transaction is merely an option to purchase the property. For example, undeveloped land may be “sold” under terms that call for a very small initial investment by the buyer (substantially less than the percentages specified in paragraph 54) and postponement of additional payments until the buyer obtains zoning changes or building permits or other contingencies specified in the sales agreement are satisfactorily resolved. Proceeds from the issuance of the option by a property owner shall be accounted for as a deposit (paragraphs 65-67). Profit shall not be recognized until the option either expires or is exercised. When an option to purchase real estate is sold by an option holder,[11] the seller of the option shall recognize income by the cost recovery method (paragraphs 62-64) to the extent nonrefundable cash proceeds exceed the seller's cost of the option if the buyer's initial and continuing investments are not adequate for profit recognition by the full accrual method (paragraphs 7-16).

[11] When an option to purchase real estate is sold by an option holder, the sales value includes the exercise price of the option and the sales price of the option. For example, if the option is sold for $150,000 ($50,000 cash and a $100,000 note) and the exercise price is $500,000, the sales value is $650,000.

33. The seller has made a partial sale. A sale is a partial sale if the seller retains an equity interest in the property or has an equity interest in the buyer. Profit (the difference between the sales value and the proportionate cost of the partial interest sold) shall be recognized at the date of sale if:

a. The buyer is independent of the seller.
b. Collection of the sales price is reasonably assured (paragraph 4).
c. The seller will not be required to support the operations of the property or its related obligations to an extent greater than its proportionate interest.

34. If the buyer is not independent of the seller, for example, if the seller holds or acquires an equity interest in the buyer, the seller shall recognize the part of the profit proportionate to the outside interests in the buyer at the date of sale. If the seller controls the buyer, no profit on the sale shall be recognized until it is realized from transactions with outside parties through sale or operations of the property.

35. If collection of the sales price is not reasonably assured, the cost recovery or installment method of recognizing profit shall be used.

36. If the seller is required to support the operations of the property after the sale, the accounting shall be based on the nature of the support obligation. For example, the seller may retain an interest in the property sold and the buyer may receive preferences as to profits, cash flows, return on investment, and so forth. If the transaction is in substance a sale, the seller shall recognize profit to the extent that proceeds from the sale, including receivables from the buyer, exceed all of the seller's costs related to the entire property. Other examples of support obligations are described in paragraphs 29-31.

37. If individual units in condominium projects[12] or time-sharing interests are being sold separately and all the following criteria are met, profit shall be recognized by the percentage-of-completion method on the sale of individual units or interests:

a. Construction is beyond a preliminary stage.[13]

b. The buyer is committed to the extent of being unable to require a refund except for nondelivery of the unit or interest.[14]

c. Sufficient units have already been sold to assure that the entire property will not revert to rental property. In determining whether this condition has been met, the seller shall consider the requirements of state laws, the condominium or time-sharing contract, and the terms of the financing agreements.

[12] A condominium project may be a building, a group of buildings, or a complete project.

[13] Construction is not beyond a preliminary stage if engineering and design work, execution of construction contracts, site clearance and preparation, excavation, and completion of the building foundation are incomplete.

[14] The buyer may be able to require a refund, for example, if a minimum status of completion of the project is required by state law and that status has not been attained; if state law requires that a "Declaration of Condominium" be filed and it has not been filed, except that in some states the filing of the declaration is a routine matter and the lack of such filing may not make the sales contract voidable; if the sales contract provides that permanent financing at an acceptable cost must be available to the buyer at the time of closing and it is not available; or if the condominium units must be registered with either the Office of Interstate Land Sales Registration of the Department of Housing and Urban Development or the Securities and Exchange Commission, and they are not so registered.

d. Sales prices are collectible (paragraph 4).

e. Aggregate sales proceeds and costs can be reasonably estimated. Consideration shall be given to sales volume, trends of unit prices, demand for the units including seasonal factors, developer's experience, geographical location, and environmental factors.

If any of the above criteria is not met, proceeds shall be accounted for as deposits until the criteria are met.

38. The seller sells property improvements and leases the underlying land to the buyer of the improvements. In these circumstances, the transactions are interdependent and it is impracticable to distinguish between profits on the sale of the improvements and profits under the related lease. The transaction shall be accounted for as a lease of both the land and improvements if the term of the land lease to the buyer from the seller of the improvements either (a) does not cover substantially all of the economic life of the property improvements, thus strongly implying that the transaction is in substance a lease of both land and improvements, or (b) is not for a substantial period, for example, 20 years.

39. If the land lease described in paragraph 38 covers substantially all of the economic life of the improvements and extends for at least 20 years, the profit to be recognized on the sale of the improvements at the time of sale shall be (a) the present value of the rental payments[15] not in excess of the seller's cost of the land plus (b) the sales value of the improvements minus (c) the carrying value of the improvements and the land. Profit on (1) the buyer's rental payments on the land in excess of the seller's cost of the land and (2) the rent to be received on the land after the maturity of the primary indebtedness on the improvements or other customary amortization term shall be recognized when the land is sold or the rents in excess of the seller's cost of the land are accrued under the lease. Calculations of profit in those circumstances are illustrated in paragraphs 82 and 83.

[15] The present value of the specified rental payments is the present value of the lease payments specified in the lease over the term of the primary indebtedness, if any, on the improvements, or over the customary amortization term of primary debt instruments on the type of improvements involved. The present value is computed at an interest rate appropriate for (a) primary debt if the lease is not subordinated or (b) secondary debt if the lease is subordinated to loans with prior liens.

40. The sale of the property is accompanied by a leaseback to the seller of all or any part of the property for all or part of its remaining economic life. Real estate sale and leaseback transactions shall be accounted for in accordance with the provisions of this Statement and *FASB Statement No. 13, Accounting for Leases*, and *FASB Statement No. 28, Accounting for Sales with Leasebacks*. Statement 13 as amended by Statement 28 provides criteria for determining if a leaseback is a capital lease or an operating lease. If the leaseback is a capital lease, the seller-lessee shall record an asset and an obligation as prescribed by Statement 13. Regardless of whether the leaseback is a capital lease or an operating lease, a sale shall be recorded, and the property sold and any related debt assumed by the buyer shall be removed from the seller-lessee's balance sheet. The criteria in this Statement then shall be used to determine the amount of profit that would be recognized at the date of sale, absent the leaseback provisions. The profit so determined shall be accounted for in accordance with the provisions of Statements 13 and 28 (usually deferred and amortized over the term of the lease) unless other provisions of this Statement require postponement of profit recognition until a later event.

41. The sales contract or an accompanying agreement requires the seller to develop the property in the future, to construct facilities on the land, or to provide off-site improvements or amenities. The seller is involved with future development or construction work if the buyer is unable to pay amounts due for that work or has the right under the terms of the arrangement to defer payment until the work is done. If future costs of development can be reasonably estimated at the time of sale, profit allocable to (a) performance before the sale of the land and (b) the sale of the land shall be recognized when the sale of the land meets the criteria in paragraph 5. Profit allocable to

performance after the sale shall be recognized by the percentage-of-completion method as development and construction proceed, provided that cost and profit can be reasonably estimated from the seller's previous experience.

42. The profit shall be allocated to the sale of the land and the later development or construction work on the basis of estimated costs of each activity; the same rate of profit shall be attributed to each activity. No profit shall be recognized at the time of sale if future costs of development cannot be reasonably estimated at that time.

43. The seller will participate in future profit from the property without risk of loss (such as participation in operating profits or residual values without further obligation). If the transaction otherwise qualifies for recognition of profit by the full accrual method, the transfer of risks and rewards of ownership and absence of continuing involvement criterion shall be considered met. The contingent future profits shall be recognized when they are realized.[16] All the costs of the sale shall be recognized at the time of sale; none shall be deferred to periods when the contingent profits are recognized.

[16] Paragraph 17 of *FASB Statement No. 5, Accounting for Contingencies*, addresses accounting for gain contingencies.

Retail Land Sales

44. A single method of recognizing profit shall be applied to all sales transactions within a project[17] that have been consummated.[18] That method of recognizing profit shall be changed when certain conditions are met for the entire project (paragraph 49).

[17] A retail land sales "project" is a homogeneous, reasonably contiguous area of land that may, for development and marketing, be subdivided in accordance with a master plan.

[18] Retail land sales shall be considered consummated when all of the criteria in paragraph 47 are met.

Recognition of Profit

45. The full accrual method of accounting described in paragraphs 70-72 shall be applied to a sale if all of the following conditions are met:

a. Expiration of refund period. The buyer has made the down payment and each required subsequent payment until the period of cancellation with refund has expired. That period shall be the longest period of those required by local law, established by the seller's policy, or specified in the contract.

b. Sufficient cumulative payments. The cumulative payments of principal and interest equal or exceed 10 percent of the contract sales price.

c. Collectibility of receivables. Collection experience for the project in which the sale is made or for the seller's prior projects indicates that at least 90 percent of the contracts in the project in which the sale is made that are in force 6 months after the criteria in paragraph 46 are met will be collected in full.[19] The collection experience with the seller's prior projects may be applied to a new project if the prior projects:

[19] The six-month period is solely a test of eligibility for the accrual method and is not intended to restrict the recognition of profit before the six-month period expires.

(1) Had predominantly the same characteristics (type of land, environment, clientele, contract terms, sales methods)[20] as the new project.

(2) Had a sufficiently long collection period to indicate the percentage of current sales of the new project that will be collected to maturity. A down payment of at least 20 percent shall be an acceptable indication of collectibility.

d. Nonsubordination of receivables. The receivable from the sale is not subject to subordination to new loans on the property except that subordination by an individual lot buyer for home construction purposes is permissible if the collection experience on those contracts is the same as on contracts not subordinated.

e. Completion of development. The seller is not obligated to complete improvements of lots sold or to construct amenities or other facilities applicable to lots sold. Paragraphs 6-49 specify accounting methods that shall be used if the above criteria are not met.

46. The percentage-of-completion method of accounting [21] described in paragraphs 73-75 shall be applied to a sale that meets all of the following criteria:

a. The period of cancellation with refund has expired (paragraph 45.a.).

b. Cumulative payments equal or exceed l0 percent (paragraph 45.b.).

c. Receivables are collectible (paragraph 45.c.).

d. Receivables are not subject to subordination (paragraph 45.d.).

e. There has been progress on improvements. The project's improvements have progressed beyond preliminary stages, and there are indications that the work will be completed according to plan. Some indications of progress are:

(1) The expenditure of funds on the proposed improvements.
(2) Initiation of work on the improvements.
(3) Existence of engineering plans and work commitments relating to lots sold.
(4) Completion of access roads and amenities such as golf courses, clubs, and swimming pools.

In addition, there shall be no indication of significant delaying factors, such as the inability to obtain permits, contractors, personnel, or equipment, and estimates of costs to complete and extent of progress toward completion shall be reasonably dependable.

f. Development is practical. There is a reasonable expectation that the land can be developed for the purposes represented and the properties will be useful for those purposes at the end of the normal payment period. For example, it should be expected that legal restrictions, including environmental restrictions, will not seriously hamper development and that improvements such as access roads, water supply, and sewage treatment or removal are feasible within a reasonable time. Paragraphs 47 and 48 specify accounting methods that shall be used if the above criteria are not met.

[20] Examples of sales methods include telephone sales, broker sales, and site-visitation sales.

[21] In the AICPA Guide, Accounting for Retail Land Sales, this was called the “accrual method.”

47. The installment method of accounting described in paragraphs 56-61 shall be applied to a sale that meets all of the following criteria:

a. The period of cancellation with refund has expired (paragraph 45.a.).

b. Cumulative payments equal or exceed l0 percent (paragraph 45.b.).

c. The seller is financially capable. The seller is clearly capable of providing both land improvements and off-site facilities promised in the contract and of meeting all other representations it has made. It is financially capable of funding or bonding the planned improvements in the project when required. That capability may be indicated by the seller's equity capitalization, its borrowing capacity, or its positive cash flow from operations.

48. If a retail land sale transaction does not meet the criteria for accounting by the methods described in paragraphs 45-47, that transaction shall be accounted for as a deposit as described in paragraphs 65-67.

Change from Installment to Percentage-of-Completion Method

49. When all of the conditions in paragraph 46 are satisfied on a retail land sales project originally reported by the installment method, the percentage-of-completion method of accounting may be adopted for the entire project (current and prior sales) and the effect accounted for as a change in accounting estimate.[22]

Financial Statement Presentation and Disclosures

50. In addition to disclosures otherwise required by generally accepted accounting principles, the financial statements of enterprises with retail land sales operations shall disclose:

a. Maturities of accounts receivable for each of the five years following the date of the financial statements
b. Delinquent accounts receivable and the method(s) for determining delinquency
c. The weighted average and range of stated interest rates of receivables
d. Estimated total costs and estimated dates of expenditures for improvements for major areas from which sales are being made over each of the five years following the date of the financial statements
e. Recorded obligations for improvements

Financial statement presentations of retail land sales transactions are illustrated in paragraphs 95-97.

Amendments to Other Pronouncements

51. The references to the AICPA Industry Accounting Guides, Accounting for Profit Recognition on Sales of Real Estate and Accounting for Retail Land Sales, and the AICPA Statements of Position (SOPs) 75-6, Questions Concerning Profit Recognition on Sales of Real Estate and 78-4, Application of the Deposit, Installment, and Cost Recovery Methods in Accounting for Sales of Real Estate, are deleted from Appendix A of *FASB Statement No. 32, Specialized Accounting and Reporting Principles and Practices in AICPA Statements of Position and Guides on Accounting and Auditing Matters*. The references to the profit recognition Guide in paragraph 7 of

[22] The credit to income resulting from the change is the profit not yet recognized less (a) a discount, if required, to reduce the receivable balances to their present values at the date of change to the percentage-of-completion method (using the appropriate interest rates, as specified in paragraphs 13 and 14 of Opinion 21, in effect at the time of the original sales) and (b) the liability (also discounted) for remaining future performance. The computation is illustrated in paragraph 97.

FASB Statement No. 26, Profit Recognition on Sales-Type Leases of Real Estate, and in footnote "*" and paragraphs 23-25 of Statement 28 are amended to refer to *Statement No. 66, Accounting for Sales of Real Estate*.

Effective Date and Transition

52. This Statement shall be applied to real estate sales transactions entered into after December 31, 1982 and to changes in methods of accounting for real estate sales transactions made after that date. Earlier application is encouraged but not required. The disclosures required by paragraph 50 shall be provided in financial statements for periods ending after December 15, 1982.

Appendix A:
MINIMUM INITIAL INVESTMENTS

53. Minimum initial investment requirements for sales, other than retail land sales, that are to be accounted for by the full accrual method are specified in paragraph 11. The table of minimum initial investments in paragraph 54 is based on usual loan limits for various types of properties. However, lenders' appraisals of specific properties may differ. Therefore, if a recently placed permanent loan or firm permanent loan commitment for maximum financing of the property exists with an independent established lending institution, the minimum initial investment should be whichever of the following is greater:

a. The minimum percentage of the sales value (paragraph 7) of the property specified in paragraph 54

b. The lesser of:

   (1) The amount of the sales value of the property in excess of 115 percent of the amount of a newly placed permanent loan or firm permanent loan commitment from a primary lender that is an independent established lending institution
   (2) Twenty-five percent of the sales value

54. This table does not cover every type of real estate property. To evaluate initial investments on other types of property, enterprises may make analogies to the types of properties specified, or the risks of a particular property can be related to the risks of the properties specified. Use of this table is illustrated in paragraphs 77-83.

	Minimum Initial Investment Expressed as a Percentage of Sales Value
Land	
Held for commercial, industrial, or residential development to commence within two years after sale	20
Held for commercial, industrial, or residential development to commence after two years	25
Commercial and Industrial Property	
Office and industrial buildings, shopping centers, and so forth:	
Properties subject to lease on a long-term lease basis to parties with satisfactory credit rating; cash flow currently sufficient to service all indebtedness	10
Single-tenancy properties sold to a buyer with a satisfactory credit rating	15
All other	20
Other income-producing properties (hotels, motels, marinas, mobile home parks, and so forth):	

Cash flow currently sufficient to service all indebtedness	15
Start-up situations or current deficiencies in cash flow	25
Multifamily Residential Property	
Primary residence:	
Cash flow currently sufficient to service all indebtedness	10
Start-up situations or current deficiencies in cash flow	15
Secondary or recreational residence:	
Cash flow currently sufficient to service all indebtedness	15
Start-up situations or current deficiencies in cash flow	25
Single-Family Residential Property (including condominium or cooperative housing)	
Primary residence of the buyer	5[a]
Secondary or recreational residence	10[a]

[a] If collectibility of the remaining portion of the sales price cannot be supported by reliable evidence of collection experience, the minimum initial investment shall be at least 60 percent of the difference between the sales value and the financing available from loans guaranteed by regulatory bodies such as the Federal Housing Authority (FHA) or the Veterans Administration (VA), or from independent, established lending institutions. This 60-percent test applies when the independent first-mortgage financing is not utilized and the seller takes a receivable from the buyer for the difference between the sales value and the initial investment. If independent first mortgage financing is utilized, the adequacy of the initial investment on sales of single-family residential property should be determined in accordance with paragraph 53.

Appendix B:
DESCRIPTION OF CERTAIN METHODS OF ACCOUNTING FOR REAL ESTATE SALES TRANSACTIONS

55. This appendix describes several of the methods of profit recognition that are provided for by this Statement.

Installment Method

56. The installment method apportions each cash receipt and principal payment by the buyer on debt assumed between cost recovered and profit. The apportionment is in the same ratio as total cost and total profit bear to the sales value. The calculation is illustrated in paragraph 90.

57. If the stated interest rate is equal to or less than an appropriate interest rate, it is acceptable not to reduce the receivable to its present value. This ordinarily results in reducing profit recognized in the earlier years.

58. Under the installment method, the receivable less profits not recognized does not exceed what the property value would have been if the property had not been sold.

59. The income statement, or related footnotes, for the period including the date of sale presents the sales value, the gross profit that has not yet been recognized, and the total cost of the sale. Revenue and cost of sales (or gross profit) are presented as separate items on the income statement or are disclosed in the footnotes when profit is recognized as earned. This presentation is illustrated in paragraph 96.

60. Paragraph 75 describes accounting for obligations for future improvement costs under the percentage-of-completion method. That description applies as well to accounting for those obligations under the installment method.

61. If after adoption of the installment method the transaction meets the requirements for the full accrual method (specified in paragraphs 3-18) of recognizing profit for real estate sales other than retail land sales, the seller may then change to the full accrual method. The remaining profit that was not recognized is recognized in income at that time.

Cost Recovery Method

62. Under the cost recovery method, no profit is recognized until cash payments by the buyer, including principal and interest on debt due to the seller and on existing debt assumed by the buyer, exceed the seller's cost of the property sold.[23] The receivable less profits not recognized, if any, does not exceed what the depreciated property value would have been if the property had not been sold.

[23] For an all-inclusive or "wrap-around" receivable held by the seller, interest collected is recognized as income to the extent of, and as an appropriate offset to, interest expense on prior-lien financing for which the seller remains responsible.

63. The income statement for the period including the date of sale presents the sales value, the gross profit that has not yet been recognized, and the total cost of the sale. Gross profit not yet recognized is offset against the related receivable on the balance sheet. Principal collections reduce the related receivable, and interest collections on such receivables increase the unrecognized gross profit on the balance sheet. Gross profit is presented as a separate item of revenue on the income statement when it is recognized as earned.

64. If, after the adoption of the cost recovery method, the transaction meets the requirements for the full accrual method (specified in paragraphs 3-18), the seller may then change to the full accrual method. The remaining profit that was not recognized is recognized in income at that time.

Deposit Method

65. Under the deposit method, the seller does not recognize any profit, does not record notes receivable, continues to report in its financial statements the property and the related existing debt even if it has been assumed by the buyer, and discloses that those items are subject to a sales contract. The seller continues to charge depreciation to expense as a period cost for the property for which deposits have been received. Cash received from the buyer, including the initial investment and subsequent collections of principal and interest, is reported as a deposit on the contract except that, for sales that are not retail land sales, portions of cash received that are designated by the contract as interest and are not subject to refund offset carrying charges (property taxes and interest on existing debt) on the property. Interest collected that is subject to refund and is included in the deposit account before a sale is consummated is accounted for as part of the buyer's initial investment (paragraph 7) at the time the sale is consummated.

66. When a contract is canceled without a refund, deposits forfeited are recognized as income. When deposits on retail land sales are ultimately recognized as sales, the interest portion is recognized as interest income.

67. The seller's balance sheet presents nonrecourse debt assumed by the buyer among the liabilities; the debt assumed is not offset against the related property. The seller reports the buyer's principal payments on mortgage debt assumed as additional deposits with corresponding reductions of the carrying amount of the mortgage debt.

Reduced-Profit Method

68. A reduced profit is determined by discounting the receivable from the buyer to the present value of the lowest level of annual payments required by the sales contract over the maximum period specified in paragraph 12 and excluding requirements to pay lump sums. The present value is calculated using an appropriate interest rate, [24] but not less than the rate stated in the sales contract. This method permits profit to be recognized from level payments on the buyer's debt over the maximum term established in paragraph 12 and postpones recognition of other profits until lump sum or other payments are made.

[24] Paragraphs 13 and 14 of Opinion 21 provide criteria for selecting an appropriate rate for present value calculations.

69. To illustrate, assume a sale of land that cost the seller $800,000 and is being sold for $1,000,000 with the following financing:

Buyer's initial investment	$ 250,000
First mortgage note payable to an independent lending institution (Terms--15 percent interest payable annually over 20 years: $79,881 per year including principal and interest)	500,000
Second mortgage note payable to seller (Terms--12 percent interest payable annually over 25 years: $31,875 per year including principal and interest)	250,000
Total selling price	$1,000,000 ========

The amortization term of the second mortgage (25 years) exceeds the term permitted by paragraph 12 (20 years for sales of land). It is assumed that the payments by the buyer each year will meet the requirement in paragraph 23, that the reduced-profit method is to be applied, and that the market interest rate is 16 percent.

The present value of $31,875 per year for 20 years at a market rate of 16 percent is $31,875 x 5.92884 = $188,982.

The profit to be recognized at the time of sale is reduced by the difference between the face amount of the seller's receivable ($250,000) and the reduced amount ($188,982), or $61,018. The profit recognized at the time of sale is $1,000,000 (sales price) minus $800,000 (cost) minus $61,018, or $138,982. Additional profit of $61,018 is recognized as the second mortgage payments are received in years 21 through 25.

Full Accrual Method--Retail Land Sales

70. Revenues and costs are accounted for under the accrual method as follows:

a. The net receivable is discounted to the present value of the payments required. The present value is determined using an appropriate interest rate, [25] not less than the rate stated in the sales contract. The objective is to value the net receivable at the amount at which it could be sold without recourse to the seller at the date of the sales contract.

[25] Paragraphs 13 and 14 of Opinion 21 provide criteria for selecting an appropriate rate for present value calculations.

b. An allowance is provided for receivables that are not expected to be collected because of cancellation in subsequent periods. Receivable balances applicable to canceled contracts are charged in their entirety to the allowance for contract cancellations when those contracts are canceled.

c. Costs of sales (land and improvement costs incurred, carrying costs, and so forth) are based on sales net of those sales expected to be canceled in future periods.

71. Historical data is evaluated to predict the collection of receivables from current sales. The historical data is selected from a representative sample of receivables that reflect the latest available collection data and cover an adequate period of time. The receivables in the sample are considered uncollectible and the allowance for contract cancellations provided for previously recognized sales (paragraph 70.b.) is appropriately adjusted if payments due are unpaid at the end of the sample period selected for the following delinquency periods:

Percent of Contract Price Paid	Delinquency Period
Less than 25 percent	90 days
25 percent but less than 50 percent	120 days
50 percent and over	150 days

The specified delinquency periods may be extended if the seller's recent experience has been better or if the buyer has accepted, or is willing to accept, personal liability on its debt, provided that the buyer's ability to complete payment on the contract can be determined.

72. Many sellers have programs to accelerate collections of receivables or contract provisions that encourage prepayment with a reduction of the principal as the major incentive for prepayment. If a seller expects to institute those or similar programs in the future, the amount of profit recognized at the date of sale is reduced through charges to income for anticipated discounts not otherwise recognized. Reductions that are given sporadically are charged to income in the period they occur.

Percentage-of-Completion Method--Retail Land Sales

73. The earnings process is not complete if a seller is obliged to complete improvements of lots sold or to construct amenities and other facilities applicable to lots sold, if those obligations are significant in relation to total costs, and if they remain unperformed at the time the sale is recognized. Therefore, the amount of revenue recognized (the discounted contract price) at the time a sale is recognized is measured by the relationship of costs already incurred to total estimated costs to be incurred, including costs of the marketing effort. If performance [26] is incomplete, the portion of revenue related to costs not yet incurred is recognized as the costs are incurred.

[26] *Performance* means completion of the improvements required under the sales contract by either the seller or contractors retained by the seller. However, payments made to municipalities or other governmental organizations not under the direct or joint control of the seller constitute performance by the seller if those organizations are not financed solely by liens on property in the project and they undertake to complete the improvements without further risk or obligation of the seller.

74. The costs already incurred and total costs to be incurred include land cost, costs previously charged to expense, such as interest and project carrying costs incurred prior to sale, and selling costs [27] directly associated with a project. The accounting described in this paragraph and paragraph 73 is illustrated in paragraphs 91-95.

[27] Accounting for selling costs is addressed in *FASB Statement No. 67, Accounting for Costs and Initial Rental Operations of Real Estate Projects.*

75. If there is an obligation for future improvement costs that is recognized under the percentage-of-completion method:

a. Estimates are based on costs generally expected in the construction industry locally.

b. Unrecoverable costs of off-site improvements, utilities, and amenities are provided for. In determining the amount of unrecoverable costs, estimates of amounts to be recovered from future sale of the improvements, utilities, and amenities are discounted to present value as of the date the net unrecoverable costs are recognized.

76. Estimates of future improvement costs are reviewed at least annually. Changes in those estimates do not lead to adjustment of revenue applicable to future improvements that has been previously recorded unless the adjusted total estimated cost exceeds the applicable revenue. When cost estimates are revised, the relationship of the two elements included in the revenue not yet recognized--costs and profit--is recalculated on a cumulative basis to determine future income recognition as performance takes place. If the adjusted total estimated cost exceeds the applicable revenue previously recognized, the total anticipated loss is charged to income when it meets the criteria in paragraph 8 of Statement 5. When anticipated losses on lots sold are recognized, the enterprise also considers recognizing a loss on land and improvements not yet sold.

Appendix C:
ILLUSTRATIONS OF CALCULATIONS FOR RECOGNITION OF PROFIT ON SALES OF REAL ESTATE OTHER THAN RETAIL LAND SALES [28]

Exhibits

	Paragraph Numbers
I. Illustration of Effect of Land Lease--New Multifamily Residential Property	77-83
II. Illustration of Profit Recognition--Sale of Property with Construction and Support Obligations by Seller	84-89
Schedule A: Example of Profit Calculation (assuming actual rental revenue equals adjusted projection)	87
Schedule B: Example of Profit Calculation (assuming actual rental revenue equals unadjusted projection)	88
Schedule C: Calculation of Adjusted Projected Rental Revenue	89
III. Illustration of Profit Recognition--Installment Method, with Debt Assumed by Buyer	90

Exhibit I--Illustration of Effect of Land Lease--New Multifamily Residential Property

77. Land improvements may be sold and concurrently the land under the improvements may be leased to the buyer of the improvements.

78. This exhibit illustrates the effect of loans issued in connection with long-term land leases on evaluations of the adequacy of a buyer's initial investment if improvements on the land are sold separately. In addition, it demonstrates the limit that a lease places on profit recognition if the leased land is owned by the seller of the improvements, making the lease of land and sale of improvements interdependent transactions.

79. The calculations are illustrated for four different circumstances: two examples with a primary land lease and two with a subordinated land lease.

[28] The financing and interest rate assumptions in this appendix are based on conditions at the time the profit recognition Guide was issued. They should not be considered as indicative of financing and interest rate assumptions that would be appropriate under different circumstances and at different times.

80. Primary Land Lease: Land Owned by Third Party Lessor--Nonqualifying

Assumptions:	
Sales price of improvements	$ 875,000
	========
Represented by proceeds of:	
Cash down payment	$ 125,000
Loan by insurance company: lien on leasehold improvements, 28-year term, 8 1/2%, payable in equal monthly installments of principal and interest	657,000
Note received by seller from buyer: 12-year term, 9 1/2%, payable in equal monthly installments of principal and interest	93,000
	$ 875,000
	========

Land lease for 99 years @ $19,000/year, net, payable monthly in advance
Cost of constructing improvements--$750,000
No continuing involvement by seller

Computations:	
Present value of 336 monthly payments on land lease of $1,583.33 discounted at 8 1/2% (interest rate on loan from insurance company): $1,583.33 + ($1,583.33 x 127.9071)	$ 204,000
Loan from insurance company	657,000
Equivalent primary debt	861,000
Note receivable from buyer	93,000
Total debt or equivalent	954,000
Down payment	125,000
Sales value	$1,079,000
	========

Because 15% of the sales value of the improvements is $161,850, the initial investment of $125,000 (about 12% of adjusted sales value) is inadequate to recognize profit on the sale of improvements. The second test is therefore irrelevant.

81. Primary Land Lease: Land Owned by Third Party Lessor--Qualifying

Assumptions:

Sales price of improvements	$ 875,000
	========

Represented by proceeds of:

Cash down payment	$ 165,000
Loan by insurance company: lien on leasehold improvements, 28-year term, 8 1/2%, payable in equal monthly installments of principal and interest	657,000
Note received by seller from buyer: 12-year term, 9 1/2%, payable in equal monthly installments of principal and interest	53,000
	$ 875,000
	========

Land lease for 99 years @ $17,880/year, net, payable monthly in advance
Cost of constructing improvements--$750,000
No continuing involvement by seller

Computations:

Present value of 336 monthly payments on land lease of $1,490 discounted at 8 1/2% (interest rate on loan from insurance company): $1,490 + ($1,490 x 127.9071)	$ 192,000
Loan from insurance company	657,000
Equivalent primary debt	849,000
Note receivable from buyer	53,000
Total debt or equivalent	902,000
Down payment	165,000
Sales value	$1,067,000
	========

Because 15% of the sales value of the improvements is $160,050, the initial investment of $165,000 (15% of the sales value) is adequate to recognize profit on the sale of improvements. However, the second test must also be applied.

The initial investment required by the second test is:

Sales value	$1,067,000
115% of $849,000 (loan from primary lender)	976,350
	$ 90,650
	========

The initial investment of $165,000 exceeds the amount required, so recognition of profit on sale of improvements is appropriate. The second test may alternatively be applied as the ratio of total debt or equivalent to the equivalent primary debt: $902,000/$849,000 = 106%. Because 106% is less than 115%, the initial investment exceeds the difference between the sales value of the property and 115% of the equivalent primary debt.

Profit recognition:

Sales price of improvements	$ 875,000
Less: Cost of improvements	750,000
Profit recognized at time of sale	$ 125,000
	========

82. Subordinated Land Lease: Land Owned by Seller--Qualifying

Assumptions:

Sales price of improvements	$ 914,000
	========

Represented by proceeds of:

Cash down payment	$ 154,000
Loan by insurance company: first lien on the fee or on subordinated leasehold, 28-year term, 8 1/4%, payable in equal monthly installments of principal and interest	760,000
	$ 914,000
	========

Land lease for 99 years @ $11,580/year, net, payable monthly in advance, and 5% of gross rents
Cost of land--$200,000
Cost of constructing improvements--$750,000
No continuing involvement by seller

Computations:

Present value of 336 monthly payments on land lease at $965 discounted at 12% (imputed interest for a second lien receivable): $965 + ($965 x 96.432696)	$ 94,000
Loan from insurance company (primary debt	760,000
Total debt or equivalent	854,000
Down payment	154,000
Sales value	$1,008,000
	========

The initial investment ($154,000) is more than 15% of the sales value. (15% x $1,008,000 = $151,200).

The initial investment is also larger than the excess of the sales value over 115% of the primary debt.

Sales value	$1,008,000
115% of $760,000	874,000
Excess of sales value over 115% of debt	$ 134,000
	========

Therefore, the initial investment of $154,000 is adequate, and recognizing profit on the sale of the improvements is appropriate.

Profit recognition:

Sales value		$1,008,000
Less: Cost of improvements	$750,000	
Cost of land	200,000	950,000
Profit recognized at time of sale		$ 58,000
		========

The effect of including the present value of the lease is to reduce profit recognized by $106,000: $94,000 (present value of the land lease) - $200,000 (cost of land).

83. Subordinated Land Lease: Land Owned by Seller--Nonqualifying

Assumptions:	
Sales price of improvements	$ 875,000
	========
Represented by proceeds of:	
Cash down payment	$ 132,000
Loan by insurance company: first lien on the fee or on subordinated leasehold, 28-year term, 8 1/4%, payable in equal monthly installments of principal and interest	743,000
	$ 875,000
	========

Land lease for 99 years @ $19,332/year, net, payable monthly in advance
Cost of land--$200,000
Cost of improvements--$750,000
No continuing involvement by seller

Computations:	
Present value of 336 monthly payments on land lease of $1,611 discounted at 12% (imputed interest for a second lien receivable): $1,611 + ($1,611 x 96.432696)	$ 157,000
Loan from insurance company (primary debt)	743,000
Total debt or equivalent	900,000
Down payment	132,000
Sales value	$1,032,000
	========

The initial investment ($132,000) is less than 15% of the sales value (15% x $1,032,000 = $154,800), and therefore is inadequate to recognize profit on sale of improvements. Profit recognized at time of sale should not exceed that recognizable under the installment method as if the subordinated lease were an installment receivable.

Profit recognition on installment method:		
Sales value		$1,032,000
Less: Cost of improvements	$750,000	
Cost of land	200,000	950,000
Anticipated profit on sale of improvements		$ 82,000
		========

Cash received or to be received by the seller, other than the proceeds of the primary loan, is:

Down payment	$ 132,000
Present value of land lease payments	157,000
	$ 289,000
	========

The percentage of profit in each collection is therefore:

$$\frac{\$\ 82{,}000}{\$289{,}000} = 28.37\%$$

Profit recognizable in the period of sale is 28.37% of the down payment of $132,000, or $37,450. The remaining profit of $44,550 will be recognized at the rate of 28.37% of the portion of each lease payment that is equivalent to a reduction of principal on a loan of $157,000 for 28 years at 12%.

The effect of including the present value of the lease in the sales value of the improvements is to reduce the profit recognized on the improvements by $43,000: $157,000 (present value of the land lease) - $200,000 (cost of the land).

Exhibit II--Illustration of Profit Recognition--Sale of Property with Construction and Support Obligations by Seller

84. This exhibit illustrates the method of accounting required for a sale of property in which the seller is obligated to construct multifamily units and in which cash flow deficits are anticipated. The example applies to obligations of the seller specified in paragraphs 28-30.
FAS 66, Par. 85

85. Assumptions:

a. Company X develops and sells multifamily residential projects. The Company performs directly all developmental activities, including initial planning, site acquisition, obtaining of financing, and physical construction of the project.
b. During the year ended December 31, 19X1 the Company began a project of 100 units. The project was planned and substantial activity had been performed in 19X1 but physical construction had not started as of December 31, 19X1. However, all contracts had been let, and the Company had obtained construction financing.
c. On December 31, 19X1, the Company sold the project to a limited partnership syndication (fully formed) in which it is the sole general partner:

Sales value	$1,100,000
	========
Represented by proceeds of:	
Cash down payment	$ 165,000
Permanent financing assumed by the buyer, consisting of a 28-year 8 1/2% fully amortizing first mortgage loan by a conventional lender, payable in equal monthly payments of principal and interest to maturity	825,000
Second mortgage note received by the Company payable in equal monthly installments including interest at 9 1/2% over 12 years	110,000
	$1,100,000
	========

d. The closing occurred on December 31, 19X1 and included delivery or performance of the following:
   (1) The Company delivered to the buyer a legal title to the land and all existing improvements.
   (2) The Company delivered to the buyer a firm commitment from an outside lender for permanent financing, and the buyer assumed permanent financing formerly in the name of the Company.
   (3) The Company received from the buyer $165,000 cash and a second mortgage note for $110,000.
   (4) The Company signed a contract to deliver the completed project for a single price of $1,100,000.

e. Costs incurred by the Company and total costs estimated to complete the project, as of December 31, 19X1, were:

	Costs to Date	Estimated Costs to Complete	Total Estimated Costs
Land	$117,000		$117,000
Feasibility, zoning, architectural	35,000		35,000
Finance and other	85,000	$ 10,000	95,000
Site improvements		20,000	20,000
Building construction		571,000	571,000
Total	$237,000	$601,000	$838,000
	=======	=======	=======

f. The Company has completed an extensive market research and feasibility study analyzing its cost estimates, the rent-up incubation period, and subsequent rent levels. The initial rent-up will commence in 19X2. Accordingly, a support period of two years is presumed for 19X3 and 19X4.

g. Based on its market analysis, the projected results are as follows:

	19X2	19X3	19X4
Rental expense	$ 37,000	$ 58,000	$ 58,000
Debt service	93,000	93,000	93,000
Total	130,000	151,000	151,000
Rental revenue	(75,000)	(150,000)	(180,000)*
Anticipated net deficit (surplus)in cash flow	55,000	1,000	(29,000)
Safety factor of 1/3 of rental revenue	25,000	50,000	60,000
Adjusted anticipated net deficit in cash flow	$ 80,000	$ 51,000	$ 31,000
	======	========	========

h. Initial cost estimates by the Company on previous projects have never varied from final costs by more than one-half of one % of total costs.

86. Calculations of Profit to Be Recognized:

Schedules A and B (paragraphs 87 and 88) illustrate calculations of profit to be recognized in the period of sale, in the period of construction, and in each period in which the seller will support operations (19X2 - 19X4). The following features should be noted:

a. The percentage of estimated total profit to be recognized each period is determined by the ratio of gross costs incurred to the end of the period to total estimated gross costs of the project, including gross costs during the period of support of operations. (Construction costs should be included even if construction is performed by parties other than the seller.)

b. The estimated total profit that is the basis of the calculation in each period (that is, the profit to which the percentage in (a) is applied) is determined by adding the sales value and two-thirds of the projected revenue during the period of support of operations and deducting the estimated total costs of the project, including costs of operating the property and debt service.

(1) Actual amounts of revenue and costs are substituted for estimated amounts in the calculation as the actual amounts are known. However, in this illustration, remaining

estimates of future revenue and expense are not changed because of actual results even though experience might indicate that projections of future amounts should be revised.

(2) Projected and actual revenues in the calculation should exclude amounts that accrue to the buyer, for example, revenue in excess of the sum of operating expenses and debt service.

(3) One-third of projected revenue should be excluded from the estimate of profit to provide a margin of safety (refer to paragraph 85.g.). Actual results incorporated in the calculation need not be reduced by a safety factor.

(4) The calculation illustrated should be applied only if objective information is available regarding occupancy levels and rental rates for similar property in the immediate area. This will provide reasonable assurance that rent revenue from the project will be sufficient to cover operating expenses and debt service, including payments due to the seller under the terms of the transaction. Unless that evidence is available, no profit should be recognized on the transaction until rent revenue actually reaches levels that assure coverage of those costs.

c. Schedule A shows calculation of profit to be recognized each period on the assumption that actual revenue and costs are the same as those projected in paragraph 85.g. adjusted for the safety margin of one-third of revenue.

d. Schedule B shows calculation of profit to be recognized each period on the assumption that actual revenue and costs are the same as those projected in paragraph 85.g. before adjustment for safety margin.

e. Schedule C illustrates the calculation of estimated future rent receipts by adjustment for a safety margin.

87. Schedule A

Example of Profit Calculation
(assuming actual rental revenue equals adjusted projection)

REVENUES	
Sales value	$1,100,000
Adjusted--projected rental revenue [29]	
19X2	50,000
19X3	100,000
19X4	120,000
	1,370,000
COSTS	
Total estimated costs of project (paragraph 85.e.)	838,000
Estimated rental expenses and debt service	
19X2	130,000
19X3	151,000
19X4	151,000
	1,270,000
TOTAL PROJECTED PROFIT	$ 100,000
	========

Profit to be recognized:

$$\frac{\text{Cost to date}}{\text{Total costs}} \text{ x projected profit}$$

[29] Two-thirds of projected revenue during periods of support of operations; this can also be calculated as projected rental expenses plus projected service less projected deficit cash flow.

Profit recognized in period of sale:

$$\frac{\$\,237{,}000}{1{,}270{,}000} \times \$100{,}000 = \$18{,}661$$

Total profit to date	$ 18,661
Less profit previously reported	0
Current profit recognition	$ 18,661
	========

Profit recognized in period of construction:

$$\frac{\$\,838{,}000}{1{,}270{,}000} \times \$100{,}000 = \$65{,}984$$

Total profit to date	$ 65,984
Less profit previously recognized	18,661
Current profit recognition	$ 47,323
	========

Profit recognized during support period (19X2):

$$\frac{\$\,968{,}000}{1{,}270{,}000} \times \$100{,}000 = \$76{,}221$$

Total profit to date	$ 76,221
Less profit previously recognized	65,984
Current profit recognition	$ 10,237
	========

Profit recognized during support period (19X3):

$$\frac{\$1{,}119{,}000}{1{,}270{,}000} \times \$100{,}000 = \$88{,}110$$

Total profit to date	$ 88,110
Less profit previously recognized	76,221
Current profit recognition	$ 11,889
	========

Profit recognized during support period (19X4):

$$\frac{\$1{,}270{,}000}{1{,}270{,}000} \times \$100{,}000 = \$100{,}000$$

Total profit to date	$ 100,000
Less profit previously recognized	88,110
Current profit recognition	$ 11,890
	========

88. Schedule B

Example of Profit Calculation
(assuming actual rental revenue equals unadjusted projection)
(in thousands)

	Profit Recognized in Period of Sale	Profit Recognized in Period of Construction	Profit Recognized during Support Period		
			19X2	19X3	19X4

REVENUES					
Sales value	$1,100	$1,100	$1,100	$1,100	$1,100
Adjusted--projected rental revenue)*					
19X2	50	50	75†	75†	75†
19X3	100	100	100	150†	150†
19X4	120	120	120	150§	151‡
	1,370	1,370	1,395	1,475	1,476
COSTS					
Same as Schedule A	1,270	1,270	1,270	1,270	1,270
TOTAL PROJECTED PROFIT	$ 100	$ 100	$ 125	$ 205	$ 206
	=====	=====	=====	=====	=====

Profit to be recognized:

$$\frac{\text{Cost to date}}{\text{Total costs}} \times \text{projected profit}$$

Profit recognized in period of sale:

$$\frac{\$\ 237{,}000}{1{,}270{,}000} \times \$100{,}000 = \$18{,}661$$

Total profit to date	$ 18,661
Less profit previously reported	0
Current profit recognition	$ 18,661
	======

Profit recognized in period of construction:

$$\frac{\$\ 838{,}000}{1{,}270{,}000} \times \$100{,}000 = \$65{,}984$$

Total profit to date	$ 65,984
Less profit previously reported	18,661
Current profit recognition	$ 47,323
	======

Profit recognized during support period (19X2):

$$\frac{\$\ 968{,}000}{1{,}270{,}000} \times \$125{,}000 = \$95{,}276$$

Total profit to date	$ 95,276
Less profit previously reported	65,984
Current profit recognition	$ 29,292
	=======

Profit recognized during support period (19X3):

$$\frac{\$1{,}119{,}000}{1{,}270{,}000} \times \$205{,}000 = \$180{,}626$$

Total profit to date	$180,626
Less profit previously reported	95,276
Current profit recognition	$ 85,350
	=======

Profit recognized during support
period (19X4):

$\frac{\$1,270,000}{1,270,000} \times \$206,000 = \$206,000$

Total profit to date	$206,000
Less profit previously reported	180,626
Current profit recognition	$ 25,374
	=======

*Two-thirds of projected revenue during periods of support of operation; this can also be calculated as projected rental expenses plus projected debt service less projected deficit cash flow.
†Actual rental revenue.
‡Because the property has attained a level of occupancy in excess of the original adjusted projection, and there is no reason to believe that such occupancy level cannot be sustained, the projected 19X4 rental revenue should be adjusted to 19X3 actual rental revenue.
§Actual rental revenue excluding amounts not needed to meet cash flow requirements of the property.

89. Schedule C

Calculation of Adjusted Projected Rental Revenue

Assume an office building under development is sold together with an agreement to support operations of the property for three years. The projected annual rent roll is $1,000,000 of which $350,000 is supported by signed lease agreements. The projected rental revenue for the first year of operation is $600,000; the second year $750,000; and the third year $1,000,000. At the time of sale, the amounts to be included in the calculation would be as follows:

Year	Projected Rental Revenue	Safety Factor (33-1/3%)	Adjusted Projected Rental Revenue
1	$ 600,000	$200,000	$400,000
2	750,000	250,000	500,000
3	1,000,000	333,333	666,667

If at the time of sale there were signed lease agreements for $450,000, then the $450,000 would be used in year 1 because it is greater than the adjusted projected rental revenue. The adjusted projected rental revenue for years 2 and 3 would remain $500,000 and $666,667, respectively.

Exhibit III: Illustration of Profit Recognition--Installment Method, with Debt Assumed by Buyer

90. Assumptions:

Cash down payment	$ 150,000
Second mortgage payable by buyer to seller (10-year amortization of principal plus interest)	350,000
Total cash to be received by seller	500,000
First mortgage assumed by buyer (20-year amortization of principal plus interest)	500,000
Total sales price and sales value	1,000,000
Cost	600,000
Total profit	$ 400,000
	========

The initial investment is assumed to be inadequate for full profit recognition, and the installment method of accounting is assumed to be appropriate. It is also assumed that, after the down payment, the buyer pays $25,000 of principal on the first mortgage and $35,000 of principal on the second mortgage.

Profit recognition: Under the installment method, profit recognition attributable to the down payment is $60,000, representing 40% ($400,000/$1,000,000) of $150,000.

Profit recognition attributable to the principal payments by the buyer on the first and second mortgages is $24,000, representing 40% of $60,000 ($25,000 + $35,000).

Appendix D: Illustrations of Calculations for Recognition of Profit on Retail Land Sales [30]

Exhibits — Paragraph Numbers

I. Initial Measure of Consideration (Percentage-of-Completion Method)....................91-95
Schedule A: Present Value of Sales Contracts Receivable....................92
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Exhibit I--Initial Measure of Consideration (Percentage-of-Completion Method) (amounts in thousands)

91. Assumptions:

Gross sales contracts recorded in year 1 (stated interest of 6%)	$1,000
Estimated uncollectible principal amount (sales contracts of $200* less estimated down payments to be forfeited of $20)	(180)
Net sales contracts receivable	820
Down payments and collections in year 1 relative to above sales contracts ($80 + $20)	100
Collections projected (principal amounts) for years 2 through 10	$ 720
	=====
Land cost (applicable to sales contracts of $800)	$ 60
Selling expenses in year 1	300

[30] The financing and interest rate assumptions in this appendix are based on conditions at the time the profit recognition Guide was issued. They should not be considered as indicative of financing and interest rate assumptions that would be appropriate under different circumstances and at different times.

Future improvement costs (applicable to sales contracts of $800)	120
Minimum annual yield required on contracts receivable	12%

Discount Required:

Sales contracts receivable in year 1 (see above)	$ 720
Present value of 108 level monthly payments of $8.65 on sales contracts receivable (discounted at 12%) (Schedule A)	570
Discount required	$ 150
	=====

Computation of Revenue Applicable to Future Improvements:

$$\frac{\$120}{\$60 + \$300 + \$120} = 25\%$$

25% x $650($1,000 - $200 - $150) = $163

Profit Recognition in Year 1:

Revenue recognized:

Cash received in year 1	$ 100
Present value of balance of sales contracts receivable	570
(Net sales $820, less discount $150)	670
Less: revenue applicable to future improvements	163
Net revenue	507
Less: Costs and expenses ($60 + $300)	360
Pretax income	$ 147
	=====

*It is assumed that 90% of contracts in force 6 months after sales are recognized will ultimately be collected in full (paragraph 45).

92. Schedule A

Present Value of Sales Contracts Receivable
(amounts in thousands)

	Receivable Collections		Annual	Present Value
Year	Principal	Interest*	Collections	@ 12%
2	$ 62	$ 42	$104	$ 97
3	66	38	104	87
4	70	34	104	77
5	75	29	104	68
6	79	25	104	60
7	84	20	104	53
8	89	15	104	47
9	95	9	104	43
10	100	4	104	38
	$720	$216	$936	$570
	====	====	====	====

*Assumes no interest for year 1.

93. Schedule B

Computation of Interest Income for Financial Reporting Purposes
(amounts in thousands)

Year	Debit: Cash	Debit: Unamortized Valuation Discount	Credit: Contracts Receivable	Credit: Interest Income*
2	$104	$ 24	$ (62)	$ (66)
3	104	24	(66)	(62)
4	104	22	(70)	(56)
5	104	21	(75)	(50)
6	104	19	(79)	(44)
7	104	16	(84)	(36)
8	104	12	(89)	(27)
9	104	8	(95)	(17)
10	104	4	(100)	(8)
	$936	$150	$(720)	$(366)
	====	====	=====	=====

*Total interest income equals $216 stated interest plus $150 discount, or $366.

94. Schedule C

Determination of Income Tax Payable
(amounts in thousands)

Year	Principal Receipts	Profit from Installment Sale	Interest Income from Receivable	Selling Expense	Taxable Income (Loss)	Tax	Tax Effect of Loss Carry-forward from Year 1	Net Tax
1	$100	$ 82*		$(300)	$(218)			
2	62	48	$ 42		90	$(43)	$ 43	
3	66	51	38		89	(43)	43	
4	70	54	34		88	(42)	19	($ 23)
5	75	58	29		87	(42)		(42)
6	79	61	25		86	(41)		(41)
7	84	65	20		85	(41)		(41)
8	89	69	15		84	(40)		(40)
9	95	74	9		83	(40)		(40)
10	100	78	4		82	(40)		(40)
	$820	$640	$216	$(300)	$556	$(372)	$105†	($ 267)
	====	====	====	=====	====	=====	====	=====

Assumption: The installment method is used for income tax purposes.

* Profit on land sale computed on installment method as follows:

Gross profit = $800 - $180 = $620

Principal payment X profit margin: $80 x $620 = $62
$800

Forfeited down payments 20
$82
===

†Carryforward amount is 48% of $218 = $105.

95. Schedule D

Percentage-of-Completion Method-Illustration of Financial Statement Presentation of Transactions Assumed in Paragraph 91
(amounts in thousands)

		End of Year									
Balance Sheets	Beginning of Year 1	1	2	3	4	5	6	7	8	9	10
Assets:											
Cash	$300	$100	$204	$308	$389	$451	$514	$547	$581	$615	$649
Contracts receivable		720	658	592	522	447	368	284	195	100	
Less: Allowance for contract cancellations*		--									
Unamortized valuation discount		(150)	(126)	(102)	(80)	(59)	(40)	(24)	(12)	(4)	
		570	532	490	442	388	328	260	183	96	
Land	75	15	15	15	15	15	15	15	15	15	15
	$375	$685	$751	$813	$846	$854	$857	$822	$779	$726	$664
	====	====	====	====	====	====	====	====	====	====	===
Liabilities and equity:											
Deferred income taxes		$ 71	$103	$133	$137	$119	$100	$ 81	$ 59	$ 32	
Revenue applicable to future improvements†		163	163	163	163	163	163	122	81	40	
Capital stock	$375	375	375	375	375	375	375	375	375	375	$375
Retained earnings	____	76	110	142	171	197	219	244	264	279	289
	$375	$685	$751	$813	$846	$854	$857	$822	$779	$726	$664
	====	====	====	====	====	====	====	====	====	====	====

	Year										
Income Statements	1	2	3	4	5	6	7	8	9	10	Total
Revenues:											
Gross Sales	$1,000										$1,000
Less:											
Estimated uncollectible sales	(180)										(180)
Revenue applicable to future improvements	(163)										(163)
Valuation discount	(150)										(150)
Net sales	507										507
Improvement revenue--prior sales							$ 41	$ 41	$ 41	$ 40	163
Interest income (Schedule B)		$ 66	$ 62	$ 56	$ 50	$ 44	36	27	17	8	366
	507	66	62	56	50	44	77	68	58	48	1,036
Costs and expenses:											
Cost of sales	60										60
Improvement costs--prior sales							30	30	30	30	120
Selling expenses	300						___	___	___	___	300
	360	___	___	___	___	___	30	30	30	30	480
Income before provision for											

income taxes	147	66	62	56	50	44	47	38	28	18	556
Provision for income taxes:											
Current				23	42	41	41	40	40	40	267
Deferred	71	32	30	4	(18)	(19)	(19)	(22)	(27)	(32)	
	71	32	30	27	24	22	22	18	13	8	267
Net Income	$ 76	$ 34	$ 32	$ 29	$ 26	$ 22	$ 25	$ 20	$ 15	$ 10	$289
	===	===	===	===	===	===	===	===	===	===	====

* Assumes that all cancellations occurred in year 1 without refunds of down payments.

† Assumes that future performance occurred equally in years 7, 8, 9, and 10.

Note: The illustrative statements are not intended to represent retail land sales company financial statements because they include only items necessary to illustrate timing of revenue and income recognition.

EXHIBIT II--INSTALLMENT METHOD

96. Schedule A

Illustration of Financial Statement Presentation
Based on Assumptions in Paragraph 91
(amounts in thousands)

	Beginning	End of Year									
Balance Sheets	Of Year 1	1	2	3	4	5	6	7	8	9	10
Assets:											
Cash	$300	$100	$204	$308	$389	$451	$514	$547	$581	$615	$649
Contracts receivable		720	658	592	522	447	368	284	195	100	
Less: Profit applicable future improvements		(342)	(313)	(282)	(249)	(213)	(175)	(135)	(93)	(48)	
		378	345	310	273	234	193	149	102	52	
Land	75	15	15	15	15	15	15	15	15	15	15
	$375	$493	$564	$633	$677	$700	$722	$711	$698	$682	$664
	====	====	===	===	====	====	===	====	====	====	====
Liabilities and equity:											
Deferred income taxes			$ 33	$ 66	$ 75	$ 64	$ 54	$ 42	$ 29	$ 15	
Liability for future improvements	___	$120	120	120	120	120	120	90	60	30	
Capital stock	$375	375	375	375	375	375	375	375	375	375	$375
Retained earnings (deficit)	___	(2)	36	72	107	141	173	204	234	262	289
	$375	$493	$564	$633	$677	$700	$722	$711	$698	$682	$664
	====	===	===	===	===	===	===	===	===	===	===

	Point of Sale in	Year										
Income Statements	Year 1	1	2	3	4	5	6	7	8	9	10	Total
Revenues:												
Sales	$1,000	$1,000										$1,000
Interest income			$42	$38	$34	$29	$25	$20	$15	$ 9	$ 4	216
Profit deferred*	(427)	(427)										(427)
Profit recognized†			29	31	33	36	38	40	42	45	48	342
	573	573	71	69	67	65	63	60	57	54	52	1,131
Costs and expenses:												
Cost of Sales‡	225	225										225
Selling expenses	300	300										300

Loss on cancellations§		50										50
	525	575	___	___	___	___	___	___	___	___	___	575
Income (loss) before provision for income taxes	48	(2)	71	69	67	65	63	60	57	54	52	556
Provision for income taxes:												
Current					23	42	41	41	40	40	40	267
Deferred	23	___	33	33	9	(11)	(10)	(12)	(13)	(14)	(15)	___
	23		33	33	32	31	31	29	27	26	25	267
Net income (loss)	$ 25	$ (2)	$38	$36	$35	$34	$32	$31	$ 30	$28	$27	$289
	====	=====	===	===	===	===	===	===	===	===	===	====

Notes to Exhibit II, Schedule A (amounts in thousands)

*Computation of profit deferred:		
Sales		$1,000
Cost of sales (see Note‡)		(225)
Selling expense		(300)
Profit		$ 475
		=====
Percentage		47.5%
		=====
Uncollected receivables		$ 900
Profit percentage		47.5%
Profit deferred		$ 427
		=====

†Profit recognized is 47.5% of principal collections.

‡Costs applicable to gross sales contracts:		
Land		$ 75
Future development		150
		$ 225
		=====
§Loss on cancellations:		
Contracts cancelled in Year 1		$ 200
		=====
Unpaid balance		$ 180
Costs recovered (credited to cost of sales):		
Land at cost	$15	
Future development	30	(45)
Profit at 47.5% of $180		(85)
Unrecovered selling cost		$ 50
		=====

97. Schedule B

Installment Method Changed to Percentage-of-Completion
Method at Beginning of Year 4
(amounts in thousands)

	End of Year									
Balance Sheets	1	2	3	4	5	6	7	8	9	10
Assets:										
Cash	$100	$204	$308	$389	$451	$514	$547	$581	$615	$649
Contracts receivable	720	658	592	522	447	368	284	195	100	
Less:										
Profit applicable to										

future improvements	(342)	(313)	(282)							
Unamortized valuation discount				(80)	(59)	(40)	(24)	(12)	(4)	___
	378	345	310	442	388	328	260	183	96	___
Land	15	15	15	15	15	15	15	15	15	15
	$493	$564	$633	$846	$854	$857	$822	$779	726	$664
	====	====	====	====	====	====	====	====	====	====
Liabilities and equity:										
Deferred income taxes		$ 33	$ 66	$137	$119	$100	$ 81	$ 59	$ 32	
Liability for future improvements (revenue applicable to future improvements after Year 3)	$120	120	120	163	163	163	122	81	40	
Capital stock	375	375	375	375	375	375	375	375	375	$375
Retained earnings (deficit)	(2)	36	72	171	197	219	244	264	279	289
	$493	$564	$633	$846	$854	$857	$ 822	$779	$726	$664
	====	===	===	====	====	====	===	====	====	====

					Year						
Income Statements	1	2	3	4	5	6	7	8	9	10	Total
Revenues:											
Gross sales contracts recorded	$1,000										$1,000
Improvement revenue--prior sales							$41	$41	$41	$40	163
Profit deferred	(427)										(427)
Profit recognized		$29	$31								60
Interest income*		42	38	$56	$50	$44	36	27	17	8	318
Income resulting from change from installment to percentage-of-completion method† (described fully in notes to financial statements				137							137
	573	71	69	193	50	44	77	68	58	48	1,251
Costs and expenses:											
Cost of sales	225										225
Improvement costs--prior sales							30	30	30	30	120
Selling expenses	300										300
Loss on cancellations	50										50
	575	___	___	___	__	__	30	30	30	30	695
Income (loss) before provision for income taxes	(2)	71	69	193	50	44	47	38	28	18	556
Provision for income taxes:											
Current				23	42	41	41	40	40	40	267
Deferred		33	33	71	(18)	(19)	(19)	(22)	(27)	(32)	_____
		33	33	94	24	22	22	18	13	8	267
Net income (loss)	$ (2)	$38	$36	$ 99	$26	$22	$25	$20	$15	$10	$ 289
	=====	===	===	====	===	===	===	===	===	===	====

Notes to Exhibit II, Schedule B:

* Interest at stated rate for Years 2 and 3; 12% after change from installment to percentage-of-completion method.

† Computation of effect of change from installment to percentage-of-completion method:

	(Amounts in thousands)	
Profit not yet recognized under installment method:		
Original	$427	
Recognized in prior years	(60)	
Applicable to canceled contracts	(85)	$282
Less, valuation discount required:		
Receivables at beginning of year 4	592	
Present value of payments due (principal and interest) at 12%	(490)	102
		180
Less:		
Revenue to be recognized in future as performance takes place	163	
Costs to be recognized in future	(120)	43
Net amount credited to income (before taxes)		$137
		====

30. *FASB Statement No. 67*, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, provides the following guidance:

> 1. This Statement establishes accounting and reporting standards for acquisition, development, construction, selling, and rental costs associated with real estate projects. It also provides guidance for the accounting for initial rental operations and criteria for determining when the status of a rental project changes from nonoperating to operating.
>
> SCOPE AND APPLICABILITY
>
> 2. This Statement does not apply to:
>
> a. Real estate developed by an enterprise for use in its own operations,[1] other than for sale or rental.
>
> b. "Initial direct costs" of sales-type, operating, and other types of leases, which are defined in *FASB Statement No. 17, Accounting for Leases--Initial Direct Costs*. The accounting for initial direct costs is prescribed in *FASB Statement No. 13, Accounting for Leases*.
>
> c. Costs directly related to manufacturing, merchandising, or service activities as distinguished from real estate activities.
>
> Paragraphs 20-23 of this Statement do not apply to real estate rental activity in which the predominant rental period is less than one month.

[1] In this context, "real estate developed by an enterprise for use in its own operations" includes real estate developed by a member of a consolidated group for use in the operations of another member of the group (for example, a manufacturing facility developed by a subsidiary for use in its parent's operations) when the property is reported in the group's consolidated financial statements. However, such property is not "real estate developed for use in the enterprise's operations" when reported in the separate financial statements of the entity that developed it.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

General

3. Paragraphs 4-25 specify the accounting for the following as they relate to real estate projects: (a) preacquisition costs[2] (b) taxes and insurance, (c) project costs, (d) amenities, (e) incidental operations, (f) allocation of capitalized costs to components of a real estate project, (g) revisions of estimates, (h) abandonments and changes in use, (I) selling costs, (j) rental costs, and (k) costs in excess of estimated net realizable value.

[2] Terms defined in the glossary (Appendix A) are in boldface type the first time they appear in this Statement.

Acquisition, Development, and Construction Costs

Preacquisition Costs

4. Payments to obtain an option to acquire real property shall be capitalized as incurred. All other costs related to a property that are incurred before the enterprise acquires the property, or before the enterprise obtains an option to acquire it, shall be capitalized if all of the following conditions are met and otherwise shall be charged to expense as incurred:

a. The costs are directly identifiable with the specific property.

b. The costs would be capitalized if the property were already acquired.

c. Acquisition of the property or of an option to acquire the property is probable.[3] This condition requires that the prospective purchaser is actively seeking to acquire the property and has the ability to finance or obtain financing for the acquisition and that there is no indication that the property is not available for sale.

[3] Probable is defined in *FASB Statement No. 5, Accounting for Contingencies*, as “likely to occur” and is used in the same sense in this Statement.

5. Capitalized Preacquisition costs (a) shall be included as project costs upon the acquisition of the property or (b) to the extent not recoverable by the sale of the options, plans, etc., shall be charged to expense when it is probable that the property will not be acquired.

Taxes and Insurance

6. Costs incurred on real estate for property taxes and insurance shall be capitalized as property cost only during periods in which activities necessary to get the property ready for its intended use are in progress.[4] Costs incurred for such items after the property is substantially complete and ready for its intended use[5] shall be charged to expense as incurred.

[4] The phrase activities necessary to get the property ready for its intended use are in progress is used here with the same meaning as it has for interest capitalization in paragraph 17 of *FASB Statement No. 34, Capitalization of Interest Cost*.

[5] The phrase substantially complete and ready for its intended use is used here with the same meaning as it has for interest capitalization in paragraph 18 of Statement 34.

Project Costs

7. Project costs clearly associated with the acquisition, development, and construction of a real estate project shall be capitalized as a cost of that project. Indirect project costs that relate to several projects shall be capitalized and allocated to the projects to which the costs relate. Indirect costs that do not clearly relate to projects under development or construction, including general and administrative expenses, shall be charged to expense as incurred.

Amenities

8. Accounting for costs of amenities shall be based on management's plans for the amenities in accordance with the following:

a. If an amenity is to be sold or transferred in connection with the sale of individual units, costs in excess of anticipated proceeds shall be allocated as common costs because the amenity is clearly associated with the development and sale of the project. The common costs include expected future operating costs to be borne by the developer until they are assumed by buyers of units in a project.

b. If an amenity is to be sold separately or retained by the developer, capitalizable costs of the amenity in excess of its estimated fair value as of the expected date of its substantial physical completion shall be allocated as common costs. For the purpose of determining the amount to be capitalized as common costs, the amount of cost previously allocated to the amenity shall not be revised after the amenity is substantially completed and available for use. A later sale of the amenity at more or less than its estimated fair value as of the date of substantial physical completion, less any accumulated depreciation, results in a gain or loss that shall be included in net income in the period in which the sale occurs.

Costs of amenities shall be allocated among land parcels[6] benefited and for which development is probable.

[6] A land parcel may be considered to be an individual lot or unit, an amenity, or a phase.

9. Before an amenity is substantially completed and available for use, operating income (or loss) of the amenity shall be included as a reduction of (or an addition to) common costs. When an amenity to be sold separately or retained by the developer is substantially completed and available for use, current operating income and expenses of the amenity shall be included in current operating results.

Incidental Operations

10. Incremental revenue from incidental operations in excess of incremental costs of incidental operations shall be accounted for as a reduction of capitalized project costs. Incremental costs in excess of incremental revenue shall be charged to expense as incurred, because the incidental operations did not achieve the objective of reducing the costs of developing the property for its intended use.

Allocation of Capitalized Costs to the Components of a Real Estate Project

11. The capitalized costs of real estate projects shall be assigned to individual components of the project based on specific identification. If specific identification is not practicable, capitalized costs shall be allocated as follows:

a. Land cost and all other common costs[7] (prior to construction) shall be allocated to each land parcel benefited. Allocation shall be based on the relative fair value before construction.

[7] Including the costs of amenities to be allocated as common costs (paragraphs 8 and 9).

b. Construction costs shall be allocated to individual units in the phase on the basis of relative sales value of each unit.

If allocation based on relative value also is impracticable, capitalized costs shall be allocated based on area methods (for example, square footage) or other value methods as appropriate under the circumstances.

Revisions of Estimates

12. Estimates and cost allocations shall be reviewed at the end of each financial reporting period until a project is substantially completed and available for sale. Costs shall be revised and reallocated as necessary for material changes on the basis of current estimates.[8] Changes in estimates shall be reported in accordance with paragraph 31 of *APB Opinion No. 20, Accounting Changes*.

[8] Paragraph 76 of *Statement No. 66, Accounting for Sales of Real Estate*, discusses revisions of estimates relating to retail land sales accounted for by the percentage-of-completion method.

Abandonments and Changes in Use

13. If real estate, including rights to real estate, is abandoned (for example, by allowing a mortgage to be foreclosed or a purchase option to lapse), capitalized costs of that real estate shall be expensed. Such costs shall not be allocated to other components of the project or to other projects even if other components or other projects are capable of absorbing the losses.

14. Real estate donated to municipalities or other governmental agencies for uses that will benefit the project are not abandonments. The cost of the real estate donated shall be allocated as a common cost of the project.

15. Changes in the use of real estate comprising a project or a portion of a project may arise after significant development and construction costs have been incurred. If the change in use is made pursuant to a formal plan for a project that is expected to produce a higher economic yield (as compared to its yield based on use before change), the development and construction costs to be charged to expense shall be limited to the amount by which the capitalized costs incurred and to be incurred exceed the estimated value of the revised project when it is substantially complete and ready for its intended use.

16. In the absence of a formal plan for a project that is expected to produce a higher economic yield, the project costs to be charged to expense shall be limited to the amount by which total project costs exceed the estimated net realizable value of the property determined on the assumption it will be sold in its present state.

Costs Incurred to Sell and Rent Real Estate Projects, Including Initial Rental Operations

Costs Incurred to Sell Real Estate Projects

17. Costs incurred to sell real estate projects shall be capitalized if they (a) are reasonably expected to be recovered from the sale of the project or from incidental operations and (b) are incurred for (1) tangible assets that are used directly throughout the selling period to aid in the sale of the project or (2) services that have been performed to obtain regulatory approval of sales. Examples of costs incurred to sell real estate projects that ordinarily meet the criteria for capitalization are costs of model units and their furnishings, sales facilities, legal fees for preparation of prospectuses, and semipermanent signs.

18. Other costs incurred to sell real estate projects shall be capitalized as prepaid costs if they are directly associated with and their recovery is reasonably expected from sales that are being accounted for under a method of accounting other than full accrual.[9] Costs that do not meet the criteria for capitalization shall be expensed as incurred.

[9] FASB Statement 66 discusses the circumstances under which the appropriate accounting methods are to be applied, including the full accrual method.

19. Capitalized selling costs shall be charged to expense in the period in which the related revenue is recognized as earned. When a sales contract is canceled (with or without refund) or the related receivable is written off as uncollectible, the related unrecoverable capitalized selling costs shall be charged to expense or an allowance previously established for that purpose.

Costs Incurred to Rent Real Estate Projects

20. If costs incurred to rent real estate projects, other than initial direct costs,[10] under operating leases are related to and their recovery is reasonably expected from future rental operations, they shall be capitalized. Examples of such costs are costs of model units and their furnishings, rental facilities, semipermanent signs, "grand openings," and unused rental brochures. Costs that do not meet the criteria for capitalization shall be expensed as incurred, for example, rental overhead.

[10] Initial direct costs are defined in Statement 17. The accounting for initial direct costs is prescribed in Statement 13.

21. Capitalized rental costs directly related to revenue from a specific operating lease shall be amortized over the lease term. Capitalized rental costs not directly related to revenue from a specific operating lease shall be amortized over the period of expected benefit. The amortization period shall begin when the project is substantially completed and held available for occupancy.[11] Estimated unrecoverable amounts of unamortized capitalized rental costs associated with a lease or group of leases shall be charged to expense when it becomes probable that the lease(s) will be terminated.

[11] Refer to paragraph 22 for the definition of substantially completed and held available for occupancy.

Initial Rental Operations

22. When a real estate project is substantially completed and held available for occupancy, rental revenues and operating costs shall be recognized in income and expense as they accrue, all carrying costs (such as real estate taxes) shall be charged to expense when incurred, depreciation on the cost of the project shall be provided, and costs to rent the project shall be amortized in accordance with paragraph 21 of this Statement. A real estate project shall be considered substantially completed and held available for occupancy upon completion of tenant improvements by the developer but no later than one year from cessation of major construction activity (as distinguished from activities such as routine maintenance and cleanup).

23. If portions of a rental project are substantially completed and occupied by tenants or held available for occupancy and other portions have not yet reached that stage, the substantially completed portions shall be accounted for as a separate project. Costs incurred shall be allocated between the portions under construction and the portions substantially completed and held available for occupancy.

Recoverability

24. The carrying amount of a real estate project, or parts thereof, held for sale or development and sale shall not exceed net realizable value. If costs exceed net realizable value, capitalization of costs associated with development and construction of a property shall not cease, but rather an allowance shall be provided to reduce the carrying amount to estimated net realizable value, determined on the basis of an evaluation of individual projects. An individual project, for this purpose, consists of components that are relatively homogeneous, integral parts of a whole (for example, individual houses in a residential tract, individual units in a condominium complex, and individual lots in a subdivision and amenities). Therefore, a multi phase development consisting of a tract of single-family houses, a condominium complex, and a lot subdivision generally would be evaluated as three separate projects.

25. Evidence of insufficient rental demand for a rental project currently under construction may indicate an impairment of the carrying value. If it is probable that the insufficient rental demand is other than temporary, an allowance for losses shall be provided, whether or not construction is actually suspended.

Amendments to Other Pronouncement

26. The references to AICPA Statements of Position 78-3, Accounting for Costs to Sell and Rent, and Initial Rental Operations of, Real Estate Projects, and 80-3, Accounting for Real Estate Acquisition, Development, and Construction Costs, are deleted from Appendixes A and B of *FASB Statement No. 32, Specialized Accounting and Reporting Principles and Practices in AICPA Statements of Position and Guides on Accounting and Auditing Matters*, respectively.

Effective Date and Transition

27. This Statement shall be applied to costs of real estate projects incurred in fiscal years beginning after December 31, 1982. Earlier application is encouraged but not required.

31. *AICPA Statement of Position 92-3*, *Accounting for Foreclosed Assets,* provides the following guidance:

Scope

.01 This statement of position (SOP) provides guidance on determining the balance sheet treatment of foreclosed assets[1] after foreclosure. (Paragraphs A-6 and A-7 of the Appendix [paragraph .18] discuss the exclusion from this SOP of conclusions on the accounting treatment of results of operations related to foreclosed assets held for sale.) It applies to all reporting entities except those that account for assets at market value or fair value, such as broker-dealers, futures commission merchants, and investment companies. It applies to all assets obtained through foreclosure or repossession except for (a) inventories that are covered by chapter 4 of Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins; (b) marketable equity securities that are covered by Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (Statement) No. 12, Accounting for Certain Marketable Securities; and (c) foreclosed real estate previously owned by the lender and accounted for under FASB Statement No. 67, Accounting for Costs and Initial Rental Operations of Real Estate Projects. Except for the requirements in paragraphs .12 and .17, the conclusions of this SOP do not apply to in-substance foreclosed assets (see paragraph A-10 of the Appendix [paragraph .18]).

[1] As used in this SOP, the term foreclosed assets includes all assets received in satisfaction of a receivable in a troubled debt restructuring, as the term is used *in FASB Statement No. 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings*. It includes real property and personal property; equity interests in corporations, partnerships, and joint ventures; and beneficial interests in trusts.

Background

.02 Paragraph 29 of *FASB Statement No. 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings*, issued in 1977, requires the following: “After a troubled debt restructuring, a creditor shall account for assets received in satisfaction of a receivable the same as if the assets had been acquired for cash.” That requirement has been interpreted in diverse ways.

.03 The American Institute of Certified Public Accountants' (AICPA's) Industry Audit Guide Audits of Stock Life Insurance Companies requires that foreclosed real estate be carried at the lower of cost (less accumulated depreciation) or market value, net of any encumbrances. Paragraphs 17 and 21 of SOP 75-2, Accounting Practices of Real Estate Investment Trusts [section 10,060.17 and .21] (as amended by SOP 78-2 [section 10,170]), require that estimated losses on individual loans and properties be based on net realizable value. The guidance in the AICPA Audit and Accounting Guide Audits of Savings Institutions and in the Industry Audit Guide Audits of Finance Companies are consistent with SOPs 75-2 [section 10,060] and 78-2 [section 10,170]. The AICPA Industry Audit Guide Audits of Banks states that subsequent to foreclosure, a loss on foreclosed real estate should be recognized if cost cannot be recovered through sale or use, but it does not indicate how the loss is to be measured. The AICPA Audit and Accounting Guide Audits of Property and Liability Insurance Companies does not address accounting for foreclosed assets. [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

.04 In practice, accounting by creditors for foreclosed assets, particularly real estate assets, is diverse. After foreclosure, some enterprises continue to write down the carrying amount of foreclosed assets for subsequent, further declines in fair value; others do not. After foreclosure, some enterprises discount projected cash flows related to foreclosed assets in estimating net realizable value of those assets; others do not.

.08 AcSEC believes that all enterprises, not just financial institutions, should account for foreclosed assets held for sale the same way, except that enterprises that account for assets at market value or fair value should not change their accounting. AcSEC's primary objectives in issuing this statement of position are to reduce the inconsistencies and diversity in accounting for foreclosed assets and to improve the understandability, comparability, and relevance of amounts reported as foreclosed assets in balance sheets. Another objective is to make all of the AICPA Audit and Accounting Guides and SOPs consistent on this matter. Achieving those objectives will also address the needs of Congress and the thrift and banking regulators.

.09 This SOP affects the following AICPA statements of position and industry audit and accounting guides:

a. SOP 75-2, Accounting Practices of Real Estate Investment Trusts, paragraphs 15-23, 25, 27, 28, 29a, 29b , and 29c [section 10,060]
b. SOP 78-2, Accounting Practices of Real Estate Investment Trusts, paragraph 6 [section 10,170.06]
c. Audits of Banks
d. Audits of Savings Institutions
e. Audits of Finance Companies
f. Audits of Property and Liability Insurance Companies
g. Audits of Stock Life Insurance Companies
h. Guide for the Use of Real Estate Appraisal Information

Conclusions

Held-for-Sale Presumption

.10 Most enterprises do not intend to hold foreclosed assets for the production of income but intend to sell them; in fact, some laws and regulations applicable to financial institutions require the sale of foreclosed assets. Therefore, under this SOP, it is presumed that foreclosed assets are held for sale and not for the production of income. That presumption may be rebutted, except for in-substance foreclosed assets, by a preponderance of the evidence. If the held-for-sale presumption is not rebutted, the asset should be classified in the balance sheet as held for sale.

.11 The presumption of sale can be rebutted if (a) management intends to hold a foreclosed asset for the production of income, (b) that intent is not inconsistent with the enterprise's ability to do so or with laws or regulations, including the manner in which the laws or regulations are administered by federal or state regulatory agencies, and (c) that intent is supported by a preponderance of the evidence.

Foreclosed Assets Held for Sale

.12 After foreclosure, foreclosed assets held for sale should be carried at the lower of (a) fair value[2] minus estimated costs to sell or (b) cost[3]. Such determination should be made on an individual asset basis. If the fair value of the asset minus the estimated costs to sell the asset is less than the cost of the asset, the deficiency should be recognized as a valuation allowance. If the fair value of the asset minus the estimated costs to sell the asset subsequently increases and the fair value of the asset minus the estimated costs to sell the asset is more than its carrying amount, the valuation allowance should be reduced, but not below zero. Increases or decreases in the valuation allowance should be charged or credited to income.[4]

[2] Fair value, as used in this SOP, is defined in paragraph 13 of FASB Statement No. 15 as follows:

> The fair value of the assets transferred is the amount that the.[creditor] could reasonably expect to receive for them in a current sale between a willing buyer and a willing seller, that is, other than in a forced or liquidation sale. Fair value of assets shall be measured by their market value if an active market for them exists. If no active market exists for the assets transferred but exists for similar assets, the selling prices in that market may be helpful in estimating the fair value of the assets transferred. If no market price is available, a forecast of expected cash flows may aid in estimating the fair value of assets transferred, provided the expected cash flows are discounted at a rate commensurate with the risk involved.[6]
>
> [6] Some factors that may be relevant in estimating the fair value of various kinds of assets are described in paragraphs 88 and 89 of APB [Accounting Principles Board] Opinion No. 16 ["Business Combinations"], paragraphs 12-14 of APB Opinion No. 21, "Interest on Receivables and Payables," and paragraph 25 of APB Opinion No. 29, "Accounting for Nonmonetary Transactions."

[3] The cost of such assets at the time of foreclosure is the fair value of the asset foreclosed or repossessed. Any specific valuation allowance related to the loan should not be carried forward. This SOP provides no guidance for determining cost subsequent to foreclosure (see paragraphs A-6 and A-7 of the Appendix [paragraph .18]).

[4] Because the allowance is considered a valuation adjustment, insurance enterprises should report changes in the valuation allowance as realized gains and losses in income, not as unrealized gains and losses in equity.

.13 The amount of any senior debt (principal and accrued interest) to which the asset is subject should be reported as a liability at the time of foreclosure and not be deducted from the carrying amount of the asset; payments on such debt should be charged to the liability. Interest that accrues after foreclosure should be recognized as interest expense.

.14 *FASB Statement No. 67, Accounting for Costs and Initial Rental Operations of Real Estate Projects*, was extracted by the FASB from SOP 78-3, Accounting for Costs to Sell and Rent, and Initial Rental Operations of Real Estate Projects; SOP 80-3, Accounting for Real Estate Acquisition, Development, and Construction Costs, and the AICPA Industry Audit Guide Accounting for Retail Land Sales. These documents did not, in the opinion of AcSEC, apply to foreclosed real estate held for sale. AcSEC therefore believes that the fair-value test in this SOP, not the net-realizable-value test in FASB Statement No. 67, should be applied to foreclosed real estate held for sale, except when the foreclosed real estate was previously owned by the lender and accounted for under FASB Statement No. 67, in which case such foreclosed assets should be accounted for under FASB Statement No. 67.

Foreclosed Assets Held for the Production of Income

.15 After foreclosure, assets determined to be held for the production of income (and not held for sale) should be reported and accounted for in the same way that they would be had the assets been acquired other than through foreclosure.

Change in Classification

.16 If it is subsequently decided that a foreclosed asset classified as held for sale will be held for the production of income, the asset should be reclassified from the held-for-sale category. The reclassification should be made at the amount the asset's carrying amount would have been had the asset been held for the production of income since the time of foreclosure. Selling costs included in the valuation allowance should be reversed. The net effect should be reported in income from continuing operations in the period in which the decision not to sell the asset is made.

Effective Date and Transition

.17 This SOP should be applied to foreclosed assets in annual financial statements for periods ending on or after December 15, 1992, with earlier application permitted. On initial application of this SOP, all enterprises should adjust the carrying amount of foreclosed assets held for sale to the lower of (a) the fair value of the asset minus the estimated costs to sell the asset or (b) the cost of the asset as of the date of the initial adoption of this SOP. For many enterprises, adoption of this SOP will result in a change in accounting principle. The nature of the change should be disclosed in the financial statements of the period in which the change is made. Any adjustment arising from the initial application of this SOP should be included in income from continuing operations in the period in which the change is made. No restatement of previously issued financial statements or cumulative effect adjustments as of the beginning of the year this SOP is first applied is permitted.

32. *FASB Emerging Issues Task Force Issue No. 86-6*, *Antispeculation Clauses in Real Estate Sales Contracts* provides the following guidance relating to the use of “antispeculation” clauses:

ISSUE

Land sale agreements sometimes contain “antispeculation” clauses that require the buyer to develop the land in a specific manner or within a stated period of time. Antispeculation clauses may also prohibit certain uses of the property. If the buyer fails to comply with the provisions of the sales contract, the seller has the right, but not the obligation, to reacquire the property. Paragraph 26 of Statement 66 states that, if the terms of a transaction give the seller an option to repurchase the property, then the transaction is accounted for as a financing, leasing, or profit-sharing arrangement rather than as a sale.

The issue is whether Statement 66 precludes the seller from accounting for the transaction as a sale when an antispeculation clause exists.

EITF DISCUSSION

The Task Force reached a consensus that the contingent option described would not preclude recognition of a sale if the probability of the buyer not complying is remote. Task Force members described a number of factors that would lead them to conclude that buyer noncompliance is remote, including the economic loss to the buyer from repurchase and the buyer's perceived ability to comply with the provisions of the sales contract. Task Force members also indicated that a probability test would not be appropriate if the seller's repurchase option is not contingent upon compliance by the buyer.

33. *FASB Emerging Issues Task Force Issue No. 87-9*, *Profit Recognition on Sales of Real Estate with Insured Mortgages or Surety Bonds*, allows the modification of the down payment criteria established in FAS 66. For a seller of owner-occupied single-family residential homes that are financed under a FHA or VA government-insured program, the down payment criteria set forth in paragraphs 53 and 54 of FAS 66 is modified to the normal down payment requirements or loan limits established under those programs and profit may be recorded under the full accrual method provided that the mortgage receivable is insured from loss under the FHA or VA program. EITF 87-9 provides the following guidance:

> ISSUE
>
> Financial institutions and other sellers of real estate may require mortgage insurance on a portion of the financing provided to the buyer by the seller, particularly in transactions involving residential property. In addition, surety bonds may be accepted by sellers of real estate to support the buyer's notes in lieu of an irrevocable letter of credit.
>
> Paragraph 9 of Statement 66 provides that "the buyer's notes supported by irrevocable letters of credit from an independent established lending institution" may be included as part of the buyer's initial and continuing investment in determining whether it is appropriate for a seller of real estate to recognize profit on a transaction under the full accrual method.
> The issues are:
>
> 1. Whether a financial instrument (such as a surety bond) may be considered equivalent to an irrevocable letter of credit in determining whether it is appropriate to recognize income under the full accrual method if (a) the seller's rights of collection, (b) the surety's obligation for payment, and (c) the surety's recourse to the buyer under the instrument in the event of default are the same as for an irrevocable letter of credit.
> 2. Whether government or private mortgage insurance covering a part of the mortgage balance should be considered equivalent to an irrevocable letter of credit and included as part of the buyer's initial and continuing investment in determining whether it is appropriate to recognize profit under the full accrual method.
>
> A related subissue is whether the minimum down payment percentages set forth in Statement 66 apply or whether the loan limits in the government programs may be used if a buyer of single-family residential property qualifies for a Federal Housing Administration (FHA) or Veterans Administration (VA) loan that requires little (less than 5 percent) or no down payment and the principal amount of the mortgage is insured or guaranteed either in full or in part by the FHA or VA. Paragraph 11 of Statement 66 requires an initial investment that is adequate to demonstrate the buyer's commitment to pay for the property and is "equal to at least a major part of the difference between usual loan limits and the sales value of the property." Paragraphs 53 and 54 of Statement 66 provide guidance on the minimum initial investment in the property required by the buyer to demonstrate a commitment to pay for the property that is necessary for the seller to recognize profit under the full accrual method.
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> EITF DISCUSSION
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> On the first issue, the Task Force reached a consensus that an irrevocable financial instrument, such as a surety bond, from an established independent insuring institution that includes the preceding characteristics (such that the instrument has all the rights and obligations of an irrevocable letter of credit) may be considered by the seller to be equivalent to an irrevocable letter of credit and included as part of the buyer's initial and continuing investment in determining whether it is appropriate to recognize profit under the full accrual method. The Task Force noted that the requirement in Statement 66 to demonstrate the buyer's commitment to pay is an important criterion that must be met before profit is recognized by the full accrual method.
>
> On the second issue, the Task Force reached a consensus that mortgage insurance should not be considered the equivalent of an irrevocable letter of credit in the determination of whether it is

> appropriate to recognize profit under the full accrual method because the purchase of mortgage insurance is not deemed to demonstrate a commitment by the buyer to honor its obligation to pay for the property.
>
> With respect to the subissue, the Task Force reached a consensus that a seller of owner-occupied single-family residential homes that finances a sale under an FHA or VA government-insured program may use the normal down payment requirements or loan limits established under those programs as a surrogate for the down payment criteria set forth in paragraphs 53 and 54 of Statement 66 and may record profit under the full accrual method provided that the mortgage receivable is fully insured from loss under the FHA or VA program. In that specific circumstance, the Task Force believes that departure from the minimum initial investment criteria of Statement 66 is justified because all of the credit risk associated with the receivable from the sale is transferred to the governmental agency. However, the Task Force emphasized that in all other circumstances (for example, FHA or VA programs that provide for less than full insurance or seller financing using private mortgage insurance) the minimum initial investment criteria set forth in Statement 66 should be followed.
>
> Subsequently, several Task Force members indicated that they did not recall the consensus being limited to transactions that are fully insured under the FHA and VA programs. Some Task Force members indicated their belief that the consensus should be applied to all sales of residential property for which the seller provides financing under the FHA or VA program and the buyer has complied with the normal lending terms for those programs in the specific location of the property, irrespective of whether the mortgage is fully insured. Others suggested that they are uncomfortable addressing transactions that are not fully insured under those programs without a better understanding of how the programs insure the seller in the event of a default by the buyer.
>
> At a subsequent meeting, the Task Force discussed the FHA mortgage insurance program and the VA loan guarantee program with representatives from the FHA and the VA. An FHA representative confirmed that the FHA program normally insures 100 percent of the outstanding mortgage principal, and a VA representative stated that the VA program generally provides first-dollar loss coverage of either 40 or 50 percent of the qualified loan amount, but coverage of not more than $36,000. Coverage under the VA program is reduced on a pro rata basis as the principal of the loan is paid off. Neither program provides for split coverage with private insurers. Also, in the event of a default by the borrower, both the FHA and the VA programs provide for recourse against the borrower.
>
> The Task Force reached a consensus that the term fully should be deleted from the consensus reached above, thus permitting profit recognition under the full accrual method for all loans insured under the current FHA or VA programs. Task Force members noted that the consensus applies only to FHA and VA coverage and not to private mortgage insurance.

34. *FASB Emerging Issues Task Force Issue No. 87-29*, *Exchange of Real Estate Involving Boot* (EITF 87-29), suggests that a seller should follow FAS 66 for the monetary portion of a transaction involving an exchange of real estate involving boot. EITF 87-29 provides the following guidance:

> ISSUE
>
> Statement 66 indicates that the accounting for exchanges of real estate is covered by Opinion 29, which addresses nonmonetary transactions, and not by Statement 66. However, in Issue No. 86-29, "Nonmonetary Transactions: Magnitude of Boot and the Exceptions to the Use of Fair Value," the Task Force reached a consensus that an exchange of nonmonetary assets that would otherwise be based on recorded amounts under paragraph 21 of Opinion 29 but that involves boot should be considered a monetary (rather than nonmonetary) transaction if the boot is at least 25 percent of the fair value of the exchange. As a result of that consensus, an exchange of either (a) real estate held for sale in the ordinary course of business for real estate to be sold in the same line of business or (b) real estate not held for sale in the ordinary course of business for similar real estate would be recorded by both parties based on fair value when the boot is at least 25 percent of the fair value of the exchange. (Those types of exchanges will be referred to in this

Issue as exchanges of similar real estate.) The Task Force acknowledged that the ability to satisfactorily measure fair value is a prerequisite for the use of fair value. If the boot in an exchange of similar real estate is less than 25 percent, the pro rata gain recognition guidance in paragraph 22 of Opinion 29 would be applied by the receiver of boot, and the payer of boot would not recognize a gain.

The issues are:

1. Whether Statement 66 applies to an exchange of similar real estate that is not subject to Opinion 29 because the transaction involves enough boot for the exchange to be considered monetary under the consensus for Issue 86-29
2. If applicable, how Statement 66 should be applied.

EITF DISCUSSION

The Task Force reached a consensus that a transaction involving an exchange of similar real estate that is considered a monetary transaction under Issue 86-29 because boot is at least 25 percent of the fair value of the exchange would be allocated between two components: a monetary portion and a nonmonetary portion. The allocation between the monetary and nonmonetary portions of the transaction should be based on their relative fair values at the time of the transaction. For the receiver of boot, the monetary portion would be accounted for under Statement 66 as the equivalent of a sale of an interest in the underlying real estate, and the nonmonetary portion would be accounted for under paragraph 21 of Opinion 29. For the payer of boot, the monetary portion would be accounted for as an acquisition of real estate, and the nonmonetary portion would be accounted for under paragraph 21 of Opinion 29. Exhibit 87-29A presents an example of the application of this consensus.

35. *FASB Emerging Issues Task Force Issue No. 88-12*, *Transfer of Ownership Interest as Part of Down Payment under FASB Statement No. 66* provides the following guidance on accounting for sales of real estate:

ISSUE

Party A has a 75 percent interest in real estate and Party B has the other 25 percent interest. Party A sells its interest to Party B and receives a 10 percent cash down payment and a note for the balance of the sales price. For this transaction, paragraph 54 of Statement 66 specifies a minimum required initial investment of 15 percent of the sales value. Party B pledges the 100 percent interest in the property as security for the note to Party A; no debt is outstanding on the property.

Under paragraph 9 of Statement 66, only the 10 percent cash down payment of Party B would be included as part of the buyer's initial investment. Paragraph 11 of Statement 66 states that the initial investment should "be adequate to demonstrate the buyer's commitment to pay for the property and shall indicate a reasonable likelihood that the seller will collect the receivable."

The issues are:

1. Whether the buyer's ownership interest in a purchased property that is pledged as security for a note should be included as part of the buyer's initial investment in determining whether profit may be recognized under the full accrual method
2. If so, in other situations in which a note is collateralized by assets other than the purchased property (for example, other real estate properties or marketable securities), whether those assets should be included as part of the buyer's initial investment in determining whether profit may be recognized under the full accrual method.

The Task Force reached a consensus that Statement 66 precludes profit recognition under the full accrual method for this transaction because purchased property or other assets pledged as security for a note should not be included as part of the buyer's initial investment.

36. *FASB Emerging Issues Task Force Issue No. 88-24, Effects of Various Forms of Financing under FASB Statement No. 66* provides the following guidance on how profit should be recognized under FASB Statement No. 66:

ISSUE

The sale of real estate often involves significant financing relative to the sales price. That financing may be provided by independent third parties, the seller, or both. The financing may involve a nonrecourse mortgage (that is, the lender's only recourse upon default of the buyer is to repossess the underlying real estate) and it may involve the buyer's assumption of preexisting recourse or nonrecourse mortgage obligations of the seller.

Paragraph 3 of Statement 66 provides that profit shall be recognized in full when real estate is sold, provided (1) the profit is determinable, that is, the collectibility of the sales price is reasonably assured or the amount that will not be collectible can be estimated, and (2) the earnings process is virtually complete, that is, the seller is not obligated to perform significant activities after the sale to earn the profit. Paragraph 4 of Statement 66 states that collectibility of the sales price is demonstrated by the buyer's commitment to pay, which in turn is supported by substantial initial and continuing investments that give the buyer a stake in the property sufficient that the risk of loss through default motivates the buyer to honor its obligation to the seller. If the full profit is not recognized, Statement 66 requires use of the installment, cost recovery, or reduced-profit recognition methods in certain circumstances.

The issue is how profit should be recognized under Statement 66 when a real estate sales transaction involves various forms of financing.

EITF DISCUSSION

Modifying a previous consensus on this issue, the Task Force reached a consensus that the following guidelines should be applied by the seller to real estate sales transactions. (The requirements for the consummation of a real estate sales transaction and the appropriate accounting when some common forms of continuing involvement exist appear in paragraphs 6 and 25-43, respectively, of Statement 66 and are not affected by this consensus.)

1. The initial and continuing investment requirements for the full accrual method of profit recognition of Statement 66 are applicable unless the seller receives as the full sales value of the property (a) cash, without any seller contingent liability on any debt on the property incurred or assumed by the buyer, (b) the buyer's assumption of the seller's existing nonrecourse debt on the property, (c) the buyer's assumption of all recourse debt on the property with the complete release of the seller from those obligations, or (d) any combination of such cash and debt assumption. When the seller has unconditionally received all amounts it is entitled to from the sale and is not at risk related to the financing, the buyer's commitment to pay for the property is not a factor in the seller's recognition of profit.

2. To recognize profit by the full accrual method, debt incurred by the buyer that is secured by the property, whether incurred directly from the seller or other parties or indirectly through assumption, and payments to the seller from the proceeds of such indebtedness shall not be included as part of the buyer's initial investment. A sufficient amount of the buyer's own cash or other qualifying forms of investment demonstrates the buyer's commitment to pay for the property; however, the buyer's borrowing secured by the property does not demonstrate such a commitment. Paragraphs 9 and 10 of Statement 66 provide additional guidance on what are included in and excluded from initial investment.

3. Under the installment, cost recovery, and reduced-profit recognition methods, debt incurred by the buyer that is secured by the property, whether incurred directly from the seller or other parties or indirectly through assumption, and payments to the seller from the proceeds of such indebtedness are not considered buyer's cash payments. However, if the profit deferred under the applicable method exceeds the outstanding amount of seller financing and the outstanding amount of buyer's debt secured by the property for which the seller is contingently liable, the seller shall recognize the excess in income.

Exhibit 88-24A presents examples of the application of this consensus.

STATUS

No further EITF Discussion is planned

37. *FASB Statement No. 121*, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, provides the following guidance:

INTRODUCTION

1. This Statement establishes accounting standard for the impairment of long-lived assets, certain identifiable intangibles, and goodwill related to those assets to be held and used and for long-lived assets and certain identifiable intangibles to be disposed of.

2. Long-lived assets such as plant and equipment generally are recorded at cost, which is usually fair value at the date of acquisition. The original cost usually is reduced over time by depreciation (amortization) so that the cost to the asset is allocated to the periods in which the asset is used. That practice has been modified in some circumstances when an assets has been determined to be impaired, in which case the asset has been written down to a new carrying amount that is less than the remaining cost and a loss has been recognized. Accounting standards generally have not addressed when impairment losses should be recognized or how impairment losses should be measured. As a result, practice has been diverse.

SCOPE

3. This Statement applies to long-lived assets, certain identifiable intangibles, and goodwill related to those assets to be held and used and to long-lived assets and certain identifiable intangibles to be disposed of. The Statement applies to all entities. This Statement does not apply to financial instruments, long-term customer relationships of financial institution (for example, core deposit intangibles and credit cardholder intangibles), mortgage and other servicing rights, deferred policy acquisition costs, or deferred tax assets.

Assets to Be Held and Used

Recognition and Measurement of Impairment

4. An entity shall review long-lived assets and certain identifiable intangibles to be held and used for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable.

5. The following are examples of events or changes in circumstances that indicate that the recoverability of the carrying amount of an asset should be assessed:

a. A significant decrease in the market value of an asset
b. A significant change in the extent or manner in which an asset is used or a significant physical change in an asset
c. A significant adverse change in legal factors or in the business climate that could affect the value of an asset or an adverse action or assessment by a regulator
d. An accumulation of costs significantly in excess of the amount originally expected to acquire or construct an asset

e. A current period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with an asset used for the purpose of producing revenue.

6. If the examples of events or changes in circumstances set forth in paragraph 5 are present or if other events or changes in circumstances indicate that the carrying amount of an asset that an entity expects to hold and use may not be recoverable, the entity shall estimate the future cash flows expected to result from the use of the asset and its eventual disposition. Future cash flows are the future cash inflows expected to be generated by an asset less the future cash outflows expected to be necessary to obtain those inflows. If the sum of the expected future cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset, the entity shall recognize an impairment loss in accordance with this Statement. Otherwise, an impairment loss shall not be recognized; however, a review of depreciation policies may be appropriate.[1]

[1] Paragraph 10 of *APB Opinion No. 20, Accounting Changes*, addresses the accounting for changes in depreciation estimates, and paragraph 32 addresses the accounting for changes in the method of depreciation. Whenever there is reason to assess the recoverability of the carrying amount of an asset under paragraphs 4 and 5 of this Statement, there may be reason to review the depreciation estimates and method under paragraphs 10 and 32 of Opinion 20. However, an impairment loss that results from applying this Statement should be recognized prior to performing that review. The provisions of Opinion 20 apply to the reporting of changes in the depreciation estimates and method regardless of whether an impairment loss is recognized under paragraph 6 of this Statement.

7. An impairment loss recognized in accordance with paragraph 6 shall be measured as the amount by which the carrying amount of the asset exceeds the fair value of the asset. The fair value of an asset is the amount at which the asset could be bought or sold in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available. If quoted market prices are not available, the estimate of fair value shall be based on the best information available in the circumstances. The estimate of fair value shall consider prices for similar assets and the results of valuation techniques to the extent available in the circumstances. Examples of valuation techniques include the present value of estimated expected future cash flows using a discount rate commensurate with the risks involved, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis.

8. In estimating expected future cash flows for determining whether an asset is impaired (paragraph 6), and if expected future cash flows are used in measuring assets that are impaired (paragraph 7), assets shall be grouped at the lowest level for which there are identifiable cash flows that are largely independent of the cash flows of other groups of assets.

9. Estimates of expected future cash flows shall be the best estimate based on reasonable and supportable assumptions and projections. All available evidence should be considered in developing estimates of expected future cash flows. The weight given to the evidence should be commensurate with the extent to which the evidence can be verified objectively. If a range is estimated for either the amount or timing of possible cash flows, the likelihood of possible outcomes shall be considered in determining the best estimate of future cash flows.

10. In limited circumstances, the test specified in paragraph 6 will be applicable at only the entity level because the asset being tested for recoverability does not have identifiable cash flows that are largely independent of other asset groupings. In those instances, if the asset is not expected to provide any service potential to the entity, the asset shall be accounted for as if abandoned or held for disposal in accordance with the provisions of paragraph 15 of this Statement. If the asset is expected to provide service potential, an impairment loss shall be recognized if the sum of the expected future cash flows (undiscounted and without interest charges) for the entity is less than the carrying amounts of the entity's assets covered by this Statement.

11. After an impairment is recognized, the reduced carrying amount of the asset shall be accounted for as its new cost. For a depreciable asset, the new cost shall be depreciated over the asset's remaining useful life. Restoration of previously recognized impairment losses is prohibited.

Goodwill

12. If an asset being tested for recoverability was acquired in a business combination accounted for using the purchase method, the goodwill that arose in that transaction shall be included as part of the asset grouping (paragraph 8) in determining recoverability. If some but not all of the assets acquired in that transaction are being tested, goodwill shall be allocated to the assets being tested for recoverability on a pro rata basis using the relative fair values of the long-lived assets and identifiable intangibles acquired at the acquisition date unless there is evidence to suggest that some other method of associating the goodwill with those assets is more appropriate. In instances where goodwill is identified with assets that are subject to an impairment loss, the carrying amount of the identified goodwill shall be eliminated before making any reduction of the carrying amounts of impaired long-lived assets and identifiable intangibles.

Reporting and Disclosure

13. An impairment loss for assets to be held and used shall be reported as a component of income from continuing operations before income taxes for entities presenting an income statement and in the statement of activities of a not-for-profit organization. Although there is no requirement to report a subtotal such as “income from operations,” entities that present such a subtotal must include the impairment loss in that subtotal.

14. An entity that recognizes an impairment loss shall disclose all of the following in financial statements that include the period of the impairment write-down:

a. A description of the impaired assets and the facts and circumstances leading to the impairment
b. The amount of the impairment loss and how fair value was determined
c. The caption in the income statement or the statement of activities in which the impairment loss is aggregated if that loss has not been presented as a separate caption or reported parenthetically on the face of the statement
d. If applicable, the business segment(s) affected.

Recognition and Measurement

15. *APB Opinion No. 30, Reporting the Results of Operations--Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*, requires that certain assets to be disposed of be measured at the lower of carrying amount or net realizable value.[2] All long-lived assets and certain identifiable intangibles to be disposed of that are not covered by that Opinion and for which management, having the authority to approve the action, has committed to a plan to dispose of the assets, whether by sale or abandonment, shall be reported at the lower of carrying amount or fair value less cost to sell. The fair value of the assets to be disposed of shall be measured in accordance with paragraph 7 of this Statement.

[2] Paragraphs 13-16 of Opinion 30 prescribe the accounting for the disposal of a segment of a business. Paragraph 13 defines a segment of a business as “a component of an entity whose activities represent a separate major line of business or class of customer.” Paragraph 15 of that Opinion prescribes the determination of a gain or loss on the disposal of a segment of a business and states:

> In the unusual circumstance, it would be expected that the plan of disposal would be carried out within a period of one year from the measurement date and that such projections of operating income or loss would not cover a period exceeding approximately one year.

16. Cost to sell an asset to be disposed of generally includes the incremental direct costs to transact the sale of the asset such as broker commissions, legal and title transfer fees, and closing costs that must be incurred before legal title can be transferred. Costs generally excluded from cost to sell an asset to be disposed of include insurance, security services, utility expenses, and other costs of protecting or maintaining an asset. However, if a contractual agreement for the sale of an asset obligates an entity to incur costs in the future to effect the ultimate sale, those costs shall be included as adjustments to the cost to sell an asset to be disposed of. If the fair value of an asset is measured by the current market value or by using the current selling price for a similar asset, that fair value shall be considered to be a current amount and that fair value and cost to sell shall not be discounted. If the fair value of an asset is measured by discounting expected future cash flows and if the sale is expected to occur beyond one year, the cost to sell also shall be discounted. Assets to be disposed of covered by this Statement shall not be depreciated (amortized) while they are held for disposal.

17. Subsequent revisions in estimates of fair value less cost to sell shall be reported as adjustments to the carrying amount of an asset to be disposed of, provided that the carrying amount of the asset does not exceed the carrying amount (acquisition cost or other basis less accumulated depreciation or amortization) of the asset before an adjustment was made to reflect the decision to dispose of the asset.

Reporting and Disclosure

18. An entity that holds assets to be disposed of that are accounted for in accordance with paragraphs 15-17 of this Statement shall report gains or losses resulting from the application of those paragraphs as a component of income from continuing operations before income taxes for entities presenting an income statement and in the statement of activities of a not-for-profit organization. Although entities are not required to report a subtotal such as “income from operations,” entities that present such a subtotal must include the gains or losses resulting from the application of paragraphs 15-17 in that subtotal.

19. An entity that accounts for assets to be disposed of in accordance with paragraphs 15-17 shall disclose all of the following in financial statements that include a period during which those assets are held:

a. A description of assets to be disposed of, the facts and circumstances leading to the expected disposal, the expected disposal date, and the carrying amount of those assets
b. If applicable, the business segment(s) in which assets to be disposed of are held
c. The loss, if any, resulting from the application of paragraph 15 of this Statement
d. The gain or loss, if any, resulting from changes in the carrying amounts of assets to be disposed of that arises from application of paragraph 17 of this Statement
e. The caption in the income statement or statement of activities in which the gains or losses in (c) and (d) are aggregated if those gains or losses have not been presented as a separate caption or reported parenthetically on the face of the statement
f. The results of operations for assets to be disposed of to the extent that those results are included in the entity's results of operations for the period and can be identified.

OTHER RELEVANT INFORMATION:

38. The NAIC Technical Resource Group Proposed Draft Life Codification contains proposed revisions to Chapter 4, *Real Estate*, primarily related to statement value and requiring recognition of permanent impairments on real estate investments and adoption of the provisions of FAS 66 for accounting for sales of real estate. Certain other insignificant changes were also made in the text. Sections which contain proposed changes are as follows:

> Authorization and Limitations
>
> Often, statutes and regulations promulgated by the states include limitations on holding investments in real property. These limitations may include provisions requiring the disposal of foreclosed properties within a certain period of time.
>
> Market Value
>
> Market value is the price that a property would bring in a competitive and open market under all conditions requisite to a fair sale--the buyer and seller acting prudently and knowledgeably with the price not affected by any undue stimulus. Estimates of market value are determined by a qualified real estate appraiser.
>
> Appraised Value
>
> An appraisal is an opinion of estimated market value for an adequately described property, as of a specified date, supported by the analysis of relevant data. To arrive at this value, three methods are typically used:
>
> 1. Market Data Approach - a comparative analysis of current sales prices of similar properties, after making necessary and reasonable adjustments for any difference in the properties.
>
> 2. Cost Approach - an estimated value based on the cost of reproduction or replacement of the improvements, less depreciation, plus the value of the land. (Land value is usually determined by the market data approach.)
>
> 3. Income Approach - an estimated value based on the capitalization of income and productivity. It is concerned with the present value of future income future cash flows.
>
> Statement Value
>
> The statement value of all real estate shall be shown net of any encumbrance. The instructions for the annual statement require that the admitted value of properties occupied by the company (home office real estate) shall not exceed actual cost, plus capitalized improvements, less normal depreciation. This formula is to apply whether the property is held directly or indirectly by the company. If home office or investment real estate has been permanently impaired, the asset value must be reduced and a realized loss recorded. If the impairment on the properties is other than permanent, the property is valued at depreciated cost and no loss needs to be recognized. Real estate is considered permanently impaired when caused by obsolescence or condemnation as opposed to temporarily impaired which is caused by temporary market conditions which are expected to reverse themselves. Implicit within the designation “temporarily impaired” is the ability and intent to hold the real estate until such conditions are rectified.
>
> Properties acquired in satisfaction of debt which are held for investment, should be transferred at the lower of cost or current market value, as determined by a qualified appraiser, to the investment real estate category.
>
> The value of the investment real estate and property classified as property acquired in satisfaction of debt may not exceed the lower of current market value as determined by a

qualified appraiser or cost balance transferred from mortgage loan plus capitalized improvements, less normal depreciation. A realized loss is recognized if there is a permanent decrease in the market value of the property subsequent to the date of acquisition. If the decline in value is considered temporary an unrealized loss is recognized. In lieu of writing down investment real estate or taking part of the value as nonadmitted when market value is less than book value, an insurer may establish a reserve for specific properties as a contra-asset. This contra-asset is a specific reserve in addition to the general reserve established under the Asset Valuation Reserve.

Income Derived from Real Estate

Income on real estate usually is received periodically and in advance. Any amount not received at the end of an accounting period should be set up as investment income due and unpaid to the extent that the amount applies to that accounting period. If the collectibility of unpaid rent is in doubt, or if the amount due exceeds a three month period, the entire amount must be nonadmitted. Rental income paid in advance of the accounting period for which it is payable in whole or in part must be included in the liability for unearned investment income to the extent it applies to the succeeding accounting period. If rental income is to be received over a period shorter than the full lease period, the total rent to be received must be accrued periodically as if the rent were received over the total lease period. Interest expense on a mortgage is netted against the investment income for the period.

Sale of Real Estate

Life insurance companies must follow Statement of Financial Accounting Standards (FASB) No. 66 in determining whether a sale has taken place, whether all requirements have been met to recognize profit under the full accrual method, and, if not appropriate, which method of profit recognition should be followed: the deposit, installment or cost recovery method.

Sale of retail land must be accounted for under provisions of FASB #66: (1) by the full accrual method, (2) by the percentage-of-completion method, (3) by the installment sales method, or (4) by the deposit method.

Sale-leaseback transactions involving real estate must be accounted for under the provisions of FASB #98. A sale-leaseback transaction is one in which an owner sells the property and leases back the same property from the purchaser.

A company can recognize the sale of any real estate that it owns as an immediate cash sale or as a contract of sale. In a sale for cash and/or mortgage, title transfers to the buyer when the sale is consummated. Any profit or loss on the sale is considered to be realized in the year of sale. In a sale involving an installment contract, often referred to as land contracts, title is retained by the seller and transferred to the buyer only when he has paid the entire sales price, or a substantial portion of it.

If the sale of real estate, including real estate occupied by the Company, includes a mortgage or other note from the Company, some states may require the transaction be reported as a financing transaction using the deposit method of accounting for sale-leaseback transaction.

An insurer does not take credit for any profit from the sale or exchange of its assets when the consideration received and otherwise properly reported as an admitted asset is in the form of an installment contract, unless such profit is fully reserved by a liability established which is equal to the portion of such profit which is unrealized. In computing the realized portion of the profit on installment contracts, payments are allocated at the rate the principal is reduced by said payments.

39. The draft discussion material from previous Property/Casualty codification projects proposed changes to Chapter 4, *Real Estate*, primarily removing the option to establish a reserve for specific properties in lieu of writing down or nonadmitting part of the investment real estate balance when market

value is less than book value. In addition, it provides guidance on how to determine whether a decrease in market value has occurred and how a writedown would be recorded. Sections which contain proposed revisions are provided below:

> Statement Value
>
> The statement value of all real estate shall be shown net of any encumbrance. The instructions for the annual statement require that the admitted value of properties occupied by the company (home office real estate) shall not exceed actual costs, plus capitalized improvements, less normal depreciation. This formula is to apply whether the property is held directly or indirectly by the company.
>
> The value of all other real estate (investment real estate and property acquired in satisfaction of debt) may not exceed the lower of (a) current market value, or (b) cost plus capitalized improvements less normal depreciation. When market value is less than book value, insurers shall either: (a) write down book value to market value, or (b) nonadmit the excess of book value over market value.
>
> (In determining whether a decrease in the market value of investment real estate has occurred, the net income derived from each investment should be divided by an appropriate capitalization rate, and compared to the book value. If the result of this calculation is less than book value for two consecutive years, there would be a presumption that a decrease in value had occurred, which would indicate that a new appraisal of the real estate is appropriate.)
>
> If the book value is to be written down, it would be recorded as a Decrease by Adjustment in Book Value on Schedule A, carried forward to Part 1A as a Decrease by Adjustment in Book Value, and recorded as an unrealized capital loss on the Underwriting and Investment Exhibit. If the excess value is to be nonadmitted, the aggregate nonadmitted amount for all real estate would be recorded on Exhibit 1, and recorded as a change in nonadmitted assets on the Underwriting and Investment Exhibit.
>
> Sale of Real Estate
>
> A company may sell real estate for cash (and/or a mortgage), or as an installment sale. In a sale for cash (and/or mortgage), where title transfers to the buyer as part of the consummated transaction, any profit or loss on the sale shall be reported in the year of sale. Under installment contracts, the seller retains title until all or a substantial portion of payments have been made. The Seller shall recognize a profit on the sale (under a pro rata method) only to the extent that payments have been received. If the seller records the entire profit at the commencement of the contract, it shall establish a reserve to offset the portion of profits which are unrealized (i.e., not yet paid by the buyer). Losses on installment sales shall be recognized immediately. An insurer may elect to use an accounting method that is more conservative in its recognition of gains, such as the cost-recovery method or the deposit method if the facts of the situation so indicate.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 4, Real Estate, and Chapter 22, General Expenses and Taxes, Licenses and Fees
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 4, Real Estate, Chapter 19*, Expenses*, and Appendix A, Mortgage Guaranty Insurance Accounting Principles
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*

- *Issue Paper No. 22—Leases*
- *Issue Paper No. 23—Property Occupied by the Company*
- *Issue Paper No. 36—Troubled Debt Restructurings*
- *Issue Paper No. 38—Acquisition, Development and Construction Arrangements*
- *Issue Paper No. 44—Capitalization of Interest*
- *Issue Paper No. 68—Business Combinations and Goodwill*

Generally Accepted Accounting Principles

- *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises*
- *FASB Statement No. 66, Accounting for Sales of Real Estate*
- *FASB Statement No. 67, Accounting for Costs and Initial Rental Operations of Real Estate Projects*
- *FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and Long-Lived Assets to Be Disposed Of*
- *Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins, "Chapter 10, Taxes, Section A-Real Estate and Personal Property Taxes*
- *AICPA Statement of Position 92-1, Accounting for Real Estate Syndication Income*
- *AICPA Statement of Position 92-3, Accounting for Foreclosed Assets*
- *FASB Emerging Issues Task Force No. 84-17, Profit Recognition on Sales of Real Estate with Graduated Payment Mortgages or Insured Mortgages*
- *FASB Emerging Issues Task Force Issue No. 86-6, Antispeculation Clauses in Real Estate Sales Contracts*
- *FASB Emerging Issues Task Force Issue No. 87-9, Profit Recognition on Sales of Real Estate with Insured Mortgages or Surety Bonds*
- *FASB Emerging Issues Task Force Issue No. 87-29, Exchange of Real Estate Involving Boot*
- *FASB Emerging Issues Task Force Issue No. 88-12, Transfer of Ownership Interest as Part of Down Payment under FASB Statement No. 66*
- *FASB Emerging Issues Task Force Issue No. 88-24, Effects of Various Forms of Financing under FASB Statement No. 66*
- *FASB Emerging Issues Task Force No 89-13, Accounting for the Cost of Asbestos Removal*
- *FASB Emerging Issues Task Force No. 89-14, Valuation of Repossessed Real Estate*
- *FASB Emerging Issues Task Force No. 90-8, Capitalization of Costs to Treat Environmental Contamination*
- *FASB Emerging Issues Task Force No. 95-23, The Treatment of Certain Site Restoration /Environmental Exit Costs When Testing a Long-Lived Assets for Impairment.*

State Regulations

- Minnesota regulations - 60A.122 and 60A.123
- Missouri regulations 20 CSR 200-13.100
- Arizona Statutes - Insurance Laws, TITLE 20
- Nevada Statutes - Insurance Laws, TITLE 57

Other Sources of Information

- NAIC Technical Resource Group Proposed Draft Life Codification, Chapter 4, Real Estate
- Draft discussion material from previous Property/Casualty codification projects, Chapter 4, Real Estate

Statutory Issue Paper No. 41

Surplus Notes

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 41

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Reporting entities sometimes issue instruments that have the characteristics of both debt and equity. These instruments are commonly referred to as surplus notes, the term used herein, but are also referred to as surplus debentures or contribution certificates. These instruments are used for various reasons, including but not limited to:

a. Providing regulators with flexibility in dealing with problem situations to attract capital to reporting entities whose surplus levels are deemed inadequate to support their operations.

b. Providing a source of capital to mutual and other types of non-stock reporting entities who do not have access to traditional equity markets for capital needs.

c. Providing alternative source of capital to stock reporting entities, although not for the purpose of initially capitalizing the reporting entity.

Common attributes of surplus notes are that they are only allowable pursuant to the approval of the domiciliary state, the form and content require regulatory approval and interest may be paid and principal may be repaid only with the prior approval of the commissioner of the state of domicile.

2. Current statutory guidance allows that surplus notes may be reported as surplus and not as debt of the reporting entity. Statutory guidance for issuers of surplus notes is found in Chapter 27, Paid-in or Contributed Capital and Organizational Surplus*,* of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies (Life/A&H Accounting Practices and Procedures Manual) and Chapter 24, Paid-in or Contributed Capital and Organizational Surplus of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies (P&C Accounting Practices and Procedures Manual). Statutory guidance for holders of surplus notes is provided in the *Purposes and Procedures Manual of the NAIC Securities Valuation Office* (SVO Purposes and Procedures). GAAP does not distinguish surplus notes from other types of subordinated notes and requires them to be recorded as liabilities.

3. The purpose of this issue paper is to establish statutory accounting principles for issuers of surplus notes and holders of surplus notes that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

Issuers of Surplus Notes

4. Surplus notes issued by a reporting entity that are subject to strict control by the commissioner of the reporting entity's state of domicile and have been approved as to form and content shall be reported as surplus and not as debt only if the surplus note contains the following provisions:

a. Subordination to policyholders;

b. Subordination to claimant and beneficiary claims;

c. Subordination to all other classes of creditors other than surplus note holders; and

d. Interest payments and principal repayments require prior approval of the commissioner of the state of domicile.

The proceeds received by the issuer must be in the form of cash or other admitted assets having readily determinable values and liquidity satisfactory to the commissioner of the state of domicile.

5. Costs of issuing surplus notes (i.e., loan fees, legal fees, etc.) do not meet the definition of an asset as defined in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets* (Issue Paper No. 4). Accordingly, such costs shall be charged to operations when incurred.

6. Discount or premium, if any, shall be reported in the balance sheet as a direct deduction from or addition to the face amount of the note. Such discount or premium shall be charged or credited to the statement of operations concurrent with approved interest payments on the surplus note and in the same proportion or percentage as the approved interest payment is to the total estimated interest to be paid on the surplus note.

7. Interest shall be not be recorded as a liability nor an expense until approval for payment of such interest has been granted by the commissioner of the state of domicile. All interest, including interest in arrears, shall be expensed in the statement of operations when approved for payment. Unapproved interest:

a. Shall not be reported through operations;

b. Shall not be represented as an addition to the principal or notional amount of the instrument; and

c. Shall not accrue further interest, i.e., interest on interest.

8. As of the date of approval of principal repayment by the commissioner of the state of domicile, the issuer shall reclassify such approved payments from surplus to liabilities.

Disclosures

9. The notes to the financial statements of a reporting entity that issues surplus notes shall disclose the following as long as the surplus notes are outstanding:

a. Date issued,

b. Description of the assets received,

c. Holder of the note or if public the names of the underwriter and trustee,

d. Amount of note,

e. Carrying value of note,

f. The rate at which interest accrues,

g. Maturity dates or repayment schedules, if stated,

h. Unapproved interest and/or principal,

i. Interest and/or principal paid in the current year,

j. Total interest and/or principal paid on surplus notes,

k. Subordination terms,

l. Liquidation preference to the reporting entity's common and preferred shareholders and

m. The repayment conditions and restrictions.

In addition to the above a reporting entity shall identify all affiliates that hold any portion of a surplus debenture or similar obligation (including an offering registered under the Securities Act of 1933 or distributed pursuant to rule 144A under the Securities Act of 1933), and any holder of 10% or more of the outstanding amount of any surplus note registered under the Securities Act of 1933 or distributed pursuant to Rule 144A under the Securities Act of 1933.

Holders of Surplus Notes

10. Surplus notes meet the definition of an asset as defined in Issue Paper No. 4. Holders of surplus notes shall follow SVO valuation procedures. The valuation procedures documented in the SVO Purposes and Procedures are detailed in paragraph 17 of this issue paper. Surplus notes shall be accounted for in accordance with *Issue Paper No. 26—Bonds, Excluding Loan-Backed and Structured Securities* (Issue Paper No. 26). The admitted asset value of a surplus note shall not exceed the amount that would be admitted if the instrument was considered an equity instrument and added to any other equity investments in the issuer held directly or indirectly by the holder of the surplus note. Only interest that has been approved by the issuer's domiciliary commissioner shall be accrued as income by a holder of surplus notes in a manner consistent with Issue Paper No. 26.

DISCUSSION

11. The primary concern of regulators is the ability of a reporting entity to meet its obligations to its policyholders. Additionally, surplus notes are subordinated to policyholder, claimant and beneficiary claims, as well as debts owed to all other classes of creditors (other than surplus note holders). For these reasons, they are viewed as surplus by regulators. A reporting entity's ability to pay interest and repay principal on surplus notes is more restrictive than its ability to pay dividends on common stock since most states permit some level of dividends to be paid without prior approval of the commissioner. The restrictive nature and the level of regulatory control over surplus notes coupled with the requirement of surplus notes to be reviewed as to form and content (including approval of the assets received for the surplus notes) provides assurances that adequate surplus exists to meet policyholder obligations.

12. The conclusions reached in this issue paper are consistent with current statutory guidance which requires surplus notes to be reported as surplus. Reporting surplus notes as surplus is consistent with the objectives of statutory financial reporting outlined in the Statement of Concepts which states:

> Objectives of Statutory Financial Reporting
>
> The primary responsibility of each state insurance department is to regulate insurance companies in accordance with state laws with an emphasis on solvency for the protection of policyholders. The ultimate objective of solvency regulation is to ensure that policyholder, contractholder and other legal obligations are met when they come due and that companies maintain capital and surplus at all times and in such forms as required by statute to provide an adequate margin of safety. The cornerstone of solvency measurement is financial reporting. Therefore, the regulator's ability to effectively determine relative financial condition using financial statements is of paramount importance to the protection of policyholders. An accounting model based on the concepts of conservatism, consistency, and recognition is essential to useful statutory financial reporting.

Existing statutory guidance has been expanded by this issue paper to address the accounting for issuance costs of these instruments and to require the disclosure of unapproved principal, principal paid in the current year and total principal paid on surplus notes. These disclosures are parallel to disclosures required for interest.

13. The conclusions reached in this issue paper vary from GAAP which requires all debt instruments, including surplus notes, to be recorded as liabilities. GAAP does not have the concept of surplus but rather has the concept of stockholders' equity. Stockholders' equity is a measure of the amount of net assets available to stockholders after all other obligations have been satisfied. As a contrast to features of surplus notes that make them policyholders' surplus, certain preferred stocks issued by entities have redemption features or liquidation preferences that provide their holders more favorable treatment than is provided to holders of common stock. GAAP has tended to focus on disclosure of those features and liquidation preferences. The Securities and Exchange Commission has issued guidance that requires equity securities with debt like features, such as mandatorily redeemable preferred stock to be recorded outside of the equity section of the balance sheet because of their liability-like characteristics.

14. Under GAAP, holders of surplus notes are required to account for such investments either at amortized cost or market value depending on their ability and intent with respect to holding the securities to maturity. *FASB Statement No. 115*, *Accounting for Certain Investments in Debt and Equity Securities (FAS 115)* has been rejected in its entirety in Issue Paper No. 26, *Issue Paper No. 28—Short-Term Investments*, *Issue Paper No. 30—Investments in Common Stock (excluding investments in common stock of subsidiary, controlled, or affiliated entities)*, *Issue Paper No. 32—Investments in Preferred Stock (including investments in preferred stock of subsidiary, controlled, or affiliated entities)* and *Issue Paper No. 43—Loan-Backed and Structured Securities*.

Drafting Notes/Comments
None

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

Issuers

15. Chapter 24 of the P&C Accounting Practices and Procedures Manual and Chapter 27 of the Life/A&H Accounting Practices and Procedures manual provide the following guidance:

> Subordinated Surplus Debentures and Other Similar Instruments
>
> Insurers sometimes issue instruments that have the characteristics of both debt and equity. These instruments resemble debt inasmuch as they are repayable at interest and sometimes, dependent on the requirements of the domiciliary jurisdiction, include maturity dates and/or schedules of repayment. However, key provisions make these instruments tantamount to equity. These provisions are that they are allowable pursuant to the domiciliary jurisdiction's statutory, or

other regulatory provisions, approval requirements as to form and content and most importantly, interest may be paid and principal may be repaid only with the prior approval of the commissioner of the domiciliary jurisdiction. These instruments are sometimes referred to by other names including "surplus debentures", "contribution certificates", or "capital notes".

This type of funding shall not be used to initially capitalize an insurer other than a mutual or reciprocal insurer. However, this type of instrument provides regulators with flexibility in dealing with problem situations to attract capital to companies whose surplus levels are deemed inadequate to support an insurer's operations. It is noted that various jurisdictions' dividend limitations based on "earned surplus" inhibit possible investors from providing necessary surplus funding. Additionally, mutual and other types of non-stock insurers do not have access to the other forms of capital equity markets.

As noted in the various states' statutes that specifically provide for these types of instruments, these instruments may be reported as surplus and not as debt. This is due to the strict control which inures to the commissioners of those jurisdictions regarding the form and content of the instrument and the payment of interest and the repayment of principal.

The proceeds from this type of surplus acquisition must be in the form of cash, cash equivalents, or other assets having a readily determinable value satisfactory to the domiciliary commissioner. Insurers must clearly report the transaction in its "Notes to the Financial Statements" including the fact that payment of interest and repayment of principal is subject to the domiciliary jurisdiction's approval.

Interest on such instruments is to be reported as an expense and a liability only after payment has been approved. Accrued interest that has not been approved for payment:

1. should not be reported through operations;

2. should not be represented as an addition to the instrument; and,

3. may not accrue further interest, i.e., "interest on interest".

The amount of the accrued unapproved interest should be reflected in the "Notes to the Financial Statements".

When a domiciliary jurisdiction grants an insurer permission to report a surplus note instrument as a component of its surplus account, the surplus note document shall provide that in the event of liquidation, the claims under the instrument are subordinated to policyholder, claimant and beneficiary claims as well as debts owed to all other classes of creditors (creditors other than surplus note holder) and that all payment of principal and interest are not payable and shall not be paid until approved by the domiciliary commissioner. The claims of the holder of a surplus note may be superior to claims of the issuer's common and preferred shareholders if so provided in the instrument itself and duly authorized by the issuer. Such conditions shall also be clearly reported in the "Notes to the Financial Statements".

This section applies to all such above described instruments issued after the date of adoption (December 12, 1991).

16. NAIC Annual Statement Instructions contain the following guidance with respect to disclosure of surplus notes:

6. Capital and Surplus and Shareholders' and Policyholders' Dividend Restrictions

Instruction:

e. For each surplus debenture or similar obligation, except those surplus notes required or which are a prerequisite for purchasing an insurance policy and are held by the policyholder, included on Page 3, Line 24A, furnish the following information: date issued, interest rate, amount of note, carrying value (lower of amortized cost or market value), interest paid current year, total interest paid, accrued interest and date of maturity.

f. For each surplus debenture or similar obligation included in 6e, other than a surplus debenture which is issued in an offering registered under the Securities Act of 1933 or distributed in an underwritten offering pursuant to Rule 144A under the Securities Act of 1933, furnish:

- the name of the holder (indicate if parent or affiliate);
- description of the assets received; and
- the repayment conditions and restrictions.

For each surplus debenture or similar obligation included in 6e which is issued in an offering registered under the Securities Act of 1933 or distributed in an underwritten offering pursuant to Rule 144A under the Securities Act of 1933, furnish:

- the name of the underwriters (indicate if parent or affiliate);
- the name of the registrar/paying agent (indicate if parent or affiliate);
- the description of the assets received; and
- the repayment conditions and restrictions.

In addition to the above, identify all affiliates that hold any portion of a surplus debenture or similar obligation (including an offering registered under the Securities Act of 1933 or distributed pursuant to Rule 144A under the Securities Act of 1933), and any holder of ten percent (10%) or more of the outstanding amount of any surplus debenture registered under the Securities Act of 1933 or distributed pursuant to Rule 144A under the Securities Act of 1933.

Holders

17. The SVO Purposes and Procedures provides the following guidance with respect to investments in surplus notes:

Section 7: Procedures for Valuing Surplus Debentures

(A) An insurance company that owns surplus debenture(s) (notes) issued by another insurance company shall value the surplus debenture(s) as follows:

1. At amortized cost if the notes have been rated by a Nationally Recognized Statistical Rating Organization (NRSRO) and have a NAIC rating equivalent designation of 1. If the notes have been rated by more than one NRSRO, the lowest rating equivalent shall be used for purposes of this valuation procedure.

2. Notes that are not rated or have a NAIC rating equivalent designation of 2 through 6 shall be valued as follows:

   a. At its outstanding face value, notwithstanding the payment of interest and/or principal, when the notes were issued by an insurer whose capital and surplus (excluding the Asset Valuation Reserve and all surplus notes) is greater than or equal to the greater of 5% of its admitted assets (excluding separate accounts) or $6,000,000. The valuation should be calculated using the most recently filed statutory financial statement of the insurer that issued the notes;

   b. By applying the statement value factor to the outstanding face amount of the surplus notes, notwithstanding the payment of interest and/or principal, when the notes were issued by an insurer whose capital and surplus (excluding the Asset Valuation Reserve and all surplus notes) is less than the greater of 5% of admitted assets (excluding separate accounts) or $6,000,000. The statement value factor is equal to total capital and surplus, including surplus notes, less the greater of 5% of admitted assets (excluding separate accounts) or $6,000,000 divided by the surplus notes. The valuation should be calculated using the most recently filed statutory financial statement of the insurer that issued the notes;

3. At zero, notwithstanding any previous payments of interest and/or principal, when the notes are issued by an insurer which is subject to any order of liquidation, conservation, rehabilitation or a company action level event based on its risk-based capital.

Issuers of surplus debentures must obtain the latest rating letters from the NRSROs who rate their notes and file them with the Executive Director of the SVO semiannually on June l and December 1 of each year. If there is a change in the rating, the SVO should be notified immediately.

Surplus debenture(s) must not be valued in excess of the lesser of the value determined above or amortized cost and are to be reported in Schedule BA of the annual statement as other invested assets. For life insurers, the NRSRO rating equivalent may be used to report the surplus note statement value in the fixed income category of the other invested assets maximum reserve calculation. The maximum reserve factor should be the factors used for preferred-stocks not bonds. If no rating from a NRSRO exists, the surplus notes should be reserved on line 43 of the other invested asset maximum reserve calculation. This procedure is effective for all financial statements filed as of December 31, 1994, and thereafter.

(B) Issuers whose Surplus Notes are eligible for amortized value accounting by Holders pursuant to Section 7 (A). To be included on this list insurer holders or issuers must request listing and supply copies of appropriate NRSRO rating documents.

- Farmers Insurance Exchange
- General American Life Ins. Co.
- John Hancock Mutual Life Ins. Co.
- Massachusetts Mutual Life Ins. Co.
- Liberty Mutual Ins. Co.
- Metropolitan Life Ins. Co.
- National Life Ins. Co.
- Nationwide Mutual Ins. Co.
- New England Mutual Life Ins. Co.
- New York Life Ins. Co.
- Ohio National Life Ins. Co.
- Pacific Mutual Life Ins. Co.
- Principal Mutual Life Ins. Co.
- Prudential Insurance Company of America

18. Chapter 9 of the Life/A&H Accounting Practices and Procedures Manual provides the following guidance for holders of surplus notes:

Surplus Notes:

Insurers sometimes make subordinated surplus contributions to other insurers via an instrument variously referred to as “surplus notes”, “surplus debentures”, “contribution certificates”, “capital notes”, etc. Generally, these instruments allow for payment of interest and repayment of principal only with the approval of the commissioner of the domiciliary jurisdiction of the insurer receiving the surplus infusion and issuing the instrument. The form and content of such instruments are

> also subject to regulatory approval. Where such approval conditions exist, insurers should report these instruments as admitted assets only in an amount as determined by the Securities Valuation Office (SVO) of the National Association of Insurance Commissioners. The holders of such instruments should never be allowed an admitted asset value more than that which would be allowed by considering the instruments as equity instruments and adding same to any other equity investments in the issuer held directly or indirectly by the holder of the instruments. In addition, such instruments shall be considered in the limitations on investments in affiliates. Investment income on these instruments shall not be reported as accrued until payment by the issuer has been approved by the insurer's domiciliary commissioner.

Generally Accepted Accounting Principles

19. The distinction between a liability and equity instrument in GAAP is found in *FASB Statement of Financial Accounting Concepts No. 6*, *Elements of Financial Statements* (only pertinent excerpts are included):

> 55. Although the line between equity and liabilities is clear in concept, it may be obscured in practice. Applying the definitions to particular situations may involve practical problems because several kinds of securities issued by business enterprises seem to have characteristics of both liabilities and equity in varying degrees or because the names given some securities may not accurately describe their essential characteristics. For example, convertible debt instruments have both liability and residual-interest characteristics, which may create problems in accounting for them. (*APB Opinion No. 14, Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants*, and *APB Opinion No. 15, Earnings per Share*, both discuss problems of that kind.) Preferred stock also often has both debt and equity characteristics, and some preferred stocks may effectively have maturity amounts and dates at which they must be redeemed for cash.

20. FAS 115 provides the following guidance with respect to investments in surplus notes:

> FAS 115 Summary
> Summary
>
> This Statement addresses the accounting and reporting for investments in equity securities that have readily determinable fair values and for all investments in debt securities. Those investments are to be classified in three categories and accounted for as follows:
>
> - Debt securities that the enterprise has the positive intent and ability to hold to maturity are classified as held-to-maturity securities and reported at amortized cost.
> - Debt and equity securities that are bought and held principally for the purpose of selling them in the near term are classified as trading securities and reported at fair value, with unrealized gains and losses included in earnings.
> - Debt and equity securities not classified as either held-to-maturity securities or trading securities are classified as available-for-sale securities and reported at fair value, with unrealized gains and losses excluded from earnings and reported in a separate component of shareholders' equity.
>
> This Statement does not apply to unsecuritized loans. However, after mortgage loans are converted to mortgage-backed securities, they are subject to its provisions. This Statement supersedes *FASB Statement No. 12, Accounting for Certain Marketable Securities*, and related Interpretations and amends *FASB Statement No. 65, Accounting for Certain Mortgage Banking Activities*, to eliminate mortgage-backed securities from its scope.

OTHER SOURCES OF INFORMATION

21. Article 5 of Regulation S-X of the Securities and Exchange Commission provides the following pertinent guidance:

Redeemable Preferred Stocks

28. Preferred stocks subject to mandatory redemption requirements or whose redemption is outside the control of the issuer. (a) Include under this caption amounts applicable to any class of stock which has any of the following characteristics: (1) it is redeemable at a fixed or determinable price on a fixed or determinable date or dates whether by operation of a sinking fund or otherwise; (2) it is redeemable at the option of the holder; or (3) it has conditions for redemption which are not solely within the control of the issuer, such as stocks which must be redeemed out of future earnings. Amounts attributable to preferred stock which is not redeemable or is redeemable solely at the option of the issuer shall be included under §210.5-02.29 unless it meets one or more of the above criteria.

(b) State on the face of the balance sheet the title of each issue, the carrying amounts and redemption amount. (If there is more than one issue, these amounts may be aggregated on the face of the balance sheet and details concerning each issue may be presented in the note required by paragraph (c) below.) Show also the dollar amount of any shares subscribed but unissued, and show the deduction of subscriptions receivable therefrom. If the carrying value is different from the redemption amount, describe the accounting treatment for such difference in the note required by paragraph (c) below. Also state in this note or on the face of the balance sheet, for each issue, the number of shares authorized and the number of shares issued or outstanding, as appropriate [See §210.4-071]

(c) State in a separate note captioned "Redeemable Preferred Stocks" (1) a general description of each issue, including its redemption features (e.g. sinking fund, at option of holders, out of future earnings) and the rights, if any, of holders in the event of default, including the effect, if any, on junior securities in the event a required dividend, sinking fund, or other redemption payment(s) is not made; (2) the combined aggregate amount of redemption requirements for all issues each year for the five years following the date of the latest balance sheet; and (3) the changes in each issue for each period for which an income statement is required to be filed. [See also § 210.4-08(d).]

(d) Securities reported under this caption are not to be included under a general heading "stockholders' equity" or combined in a total with items described in captions 29, 30 or 31 which follow.

Non-Redeemable Preferred Stocks

29. Preferred stocks which are not redeemable or are redeemable solely at the option of the issuer. State on the face of the balance sheet, or if more than one issue is outstanding state in a note, the title of each issue and the dollar amount thereof. Show also the dollar amount of any shares subscribed but unissued, and show the deduction of subscriptions receivable therefrom. State on the face of the balance sheet or in a note, for each issue, the number of shares authorized and the number of shares issued or outstanding as appropriate [See § 210.4-07l. Show in a note or separate statement the changes in each class of preferred shares reported under this caption for each period for which an income statement is required to be filed. [See also § 210.4-08(d).

Common Stocks

30. Common stocks. For each class of common shares state, on the face of the balance sheet, the number of shares issued or outstanding, as appropriate [see §210.4 07] and the dollar amount thereof. If convertible, this fact should be indicated on the face of the balance sheet. For each class of common shares state, on the face of the balance sheet or in a note, the title of the issue, the number of shares authorized, and, if convertible, the basis of conversion [see also § 210.4-08(d)]. Show also the dollar amount of any common shares subscribed but unissued, and show the deduction of subscriptions receivable therefrom. Show in a note or statement the changes in each class of common shares for each period for which an income statement is required to be filed.

RELEVANT LITERATURE

Statutory Accounting

- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies
- NAIC Annual Statement instructions
- *Purposes and Procedures Manual of the NAIC Securities Valuation Office*
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Minutes of the Financial Condition (EX4) Subcommittee meeting of June 7, 1995.
- *Issue Paper No. 26—Bonds, Excluding Loan-Backed and Structured Securities*

Generally Accepted Accounting Principles

- *FASB Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements*
- *FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities*

State Regulations

- No additional guidance obtained from state statutes or regulations.

Other Sources of Information

- Article 5 of Regulation S-X of the Securities and Exchange Commission

Statutory Issue Paper No. 42

Sale of Premium Receivables

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 42

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory accounting guidance on the transfer or factoring of premium receivables with recourse is limited to the guidance provided in minutes of the Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force (Emerging Accounting Issues Working Group). GAAP accounting provides guidance on accounting for sales of receivables with recourse. The purpose of this issue paper is to establish statutory accounting principles for the sale or factoring of premium receivables that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

2. For purposes of this issue paper, receivables shall only include amounts due to the reporting entity for premium receivables (uncollected premium, agent's balance receivables and bills receivables). As used in this paper, receivables do not represent amounts due to the reporting entity generated by the sale of invested assets.

3. A transfer of receivables can take the form of a transfer with recourse or a transfer without recourse:

a. Recourse shall be defined as the right of a transferee of receivables to receive payment from the transferor of those receivables for (i) failure of the debtors to pay when due, (ii) the effects of prepayments, or (iii) adjustments resulting from defects in the eligibility of the transferred receivables, for example defects in the legal title of the transferred receivables. When the transferor has the right to repurchase ("call") or the transferee has the right to require the transferor to repurchase (a "put") the transferred receivables, the transfer shall be considered to have recourse.

b. Without recourse shall be defined as the transferor surrendering all of the future economic implications of the risks and rewards embodied in the transferred receivables.

4. A transfer of receivables with recourse shall not be recognized as a sale. A transfer of receivables without recourse shall only be recognized if the transferor receives cash for the receivables. The sale shall be recognized when cash is received.

5. If a transfer qualifies to be recognized as a sale, the difference between (a) the sales price and (b) the receivables transferred shall be recognized as a gain or loss. If receivables are sold with servicing retained and the stated servicing fee is less than a current (normal) servicing fee rate (a servicing fee rate that is representative of servicing fee rates most commonly used in comparable servicing agreements covering similar types of receivables) or no servicing fee is specified, the gain or loss recognized by the sale of receivables shall be adjusted to recognize the deviation of the stated servicing fee rate from the commonly used servicing fee rate and a liability shall be established to provide for a normal servicing fee

in each subsequent servicing period, which shall not be less than the estimated servicing costs. When the stated servicing fee is greater than a normal servicing fee the gain or loss shall not be adjusted and the excess servicing fee revenues shall not be recorded currently but shall be recorded when realized.

6. If the conditions of subparagraph 3b. are not met, or the transfer is for other than cash, the receivables shall remain on the transferor's financial statements. A liability shall be established in an amount equal to the greater of the carrying amount of the receivables transferred or the amount of the proceeds received. To the extent that the proceeds received are less than the carrying amount of receivables transferred, a loss shall be recorded. The carrying amount of the receivable balance shall be evaluated at each reporting period and adjusted for any uncollectible amounts. The liability shall be relieved as the transferee receives cash. When the proceeds received are greater than the receivables transferred the liability shall be relieved on a pro rata basis as the receivables are collected.

Disclosures

7. For transfers of receivables reported as sales, the transferor's financial statements shall disclose (a) the proceeds to the transferor and (b) the gain or loss recorded on the sale.

DISCUSSION

8. The conclusion above rejects paragraph 83 of *FASB Statement No. 125*, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 125) to the extent that it permits sales recognition for sales of receivables with recourse provisions.

9. Deferring the recognition of a gain for transfers of receivables which do not meet the criteria in subparagraph 3b. or are for other than cash is consistent with the conservatism concept in the Statement of Concepts. In addition, it prevents the recognition of income before the earnings process is completed as prescribed in the recognition concept of the Statement of Concepts. The receipt of cash for the transfer of receivables that were either admitted assets or non-admitted assets when there are no recourse provisions involved represents a completed transaction and as such the receivable is deemed to have been collected.

Drafting Notes/Comments

- Securitization of investments is addressed in *Issue Paper No. 86—Securitization*.
- Reinsurance receivables are addressed in *Issue Paper No. 75—Property and Casualty Reinsurance*.
- Related party transactions are addressed in *Issue Paper No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties*.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

10. Current statutory accounting guidance on the sale or factoring of premium receivables with recourse is limited to the guidance provided in the June 10, 1991 minutes of the Emerging Accounting Issues Working Group. This guidance relates to the accounting for “Intercompany Related Receivable Sales”. The minutes provide guidance as follows: “The working group concluded that, in most instances, this type of transaction should be treated as a loan or financing arrangement and FAS 77 should be used for guidance, particularly as it may relate to affiliates and also to transactions between affiliates.”

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force minutes of the June 10, 1991 meeting

Generally Accepted Accounting Principles

- *FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*

State Regulations

- No additional guidance obtained from state statutes or regulations.

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Statutory Issue Paper No. 43

Loan-Backed and Structured Securities

STATUS
Finalized March 16, 1998

Original SSAP: SSAP No. 43; Current Authoritative Guidance: SSAP No. 43R
This issue paper may not be directly related to the current authoritative statement.

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory accounting guidance for investments in loan-backed and structured securities is contained in the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies. That guidance also establishes the NAIC's Securities Valuation Office (SVO) as the primary authority for the valuation of such investments.

2. The purpose of this issue paper is to establish statutory accounting principles for investments in loan-backed and structured securities that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

3. Loan-backed securities shall be defined as pass-through certificates, collateralized mortgage obligations (CMOs) and other "securitized" loans not included in structured securities, as defined below, for which the payment of interest and/or principal is directly proportional to the interest and/or principal received by the issuer from the mortgage pool or other underlying securities. Structured securities shall be defined as loan-backed securities which have been divided into two or more classes for which the payment of interest and/or principal of any class of securities has been allocated in a manner which is not proportional to interest and/or principal received by the issuer from the mortgage pool or other underlying securities. Loan-backed securities and structured securities are collectively referred to as loan-backed securities in this issue paper.

4. Loan-backed securities meet the definition of assets as defined in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this issue paper.

5. The acquisitions and dispositions of loan-backed securities shall be recorded on the trade date. At acquisition, loan-backed securities shall be reported at their cost, including brokerage and related fees. For securities where all information is not known as of the trade date (i.e., actual payment factors, specific pools, etc.), a reporting entity shall make its best estimate based on known facts.

6. For reporting entities required to maintain an Interest Maintenance Reserve (IMR), the accounting for realized capital gains and losses on sales of loan-backed securities shall be in accordance with *Issue Paper No. 7—Asset Valuation Reserve and Interest Maintenance Reserve.* For reporting entities not required to maintain an IMR, realized gains and losses on sales of loan-backed securities shall be recorded on the trade date, and shall be reported on the net realized gains or losses line of the Investment Income section of the Statement of Operations.

Origination Fees

7. Origination fees represent fees charged to the borrower in connection with the process of originating or restructuring a transaction. The fees include, but are not limited to, points, management, arrangement, placement, application, underwriting, and other fees pursuant to such a transaction. Origination fees shall not be recorded until received in cash. Origination fees intended to compensate the reporting entity for interest rate risks (e.g., points), shall be amortized into income over the term of the loan-backed security consistent with paragraph 11 of this issue paper. Other origination fees shall be recorded as income upon receipt.

Origination, Acquisition, and Commitment Costs

8. Costs related to origination when paid in the form of brokerage and other related fees shall be capitalized as part of the cost of the loan-backed security, consistent with paragraph 5 of this issue paper. All other costs, including internal costs or costs paid to an affiliated entity related to origination, purchase, or commitment to purchase loan-backed securities, shall be charged to expense when incurred.

Commitment Fees

9. Commitment fees are fees paid to the reporting entity that obligate the reporting entity to make available funds for future borrowing under a specified condition. A fee paid to the reporting entity to obtain a commitment to make funds available at some time in the future, generally, is refundable only if the loan-backed security is issued. If the loan-backed security is not issued then the fees shall be recorded as investment income by the reporting entity when the commitment expires.

10. A fee paid to the reporting entity to obtain a commitment to borrow funds at a specified rate and with specified terms quoted in the commitment agreement, generally, is not refundable unless the commitment is refused by the reporting entity. This type of fee shall be deferred, and amortization shall depend on whether or not the commitment is exercised. If the commitment is exercised, then the fee shall be amortized in accordance with paragraph 11 of this issue paper over the life of the loan-backed security as an adjustment to the investment income on the loan-backed security. If the commitment expires unexercised, the commitment fee shall be recognized in income on the commitment expiration date.

Amortized Cost

11. The purchase discount or premium shall be amortized using the interest method as an adjustment to investment income. The interest method results in a constant effective yield equal to the prevailing rate at the time of purchase or at the time of subsequent adjustments to book value. The amortization period shall reflect estimates of the period over which redemption of the loan-backed securities is expected to occur, not the stated maturity period.

Balance Sheet Amount

12. Loan-backed securities shall be valued and reported in accordance with the NAIC Valuations of Securities manual prepared by the Securities Valuation Office. For reporting entities that maintain an Asset Valuation Reserve (AVR), the loan-backed securities shall be reported at amortized cost, except for those with an NAIC designation of 6, which shall be reported at the lower of amortized cost or market value. For reporting entities that do not maintain an AVR, loan-backed securities that are designated highest-quality and high-quality (NAIC designations 1 and 2, respectively) shall be reported at amortized cost; with all other loan-backed securities (NAIC designations 3 to 6) reported at the lower of amortized cost or market value.

Changes in Valuation

13. Changes in prepayment assumptions and the resulting cash flows shall be reviewed periodically. For securities that have the potential for loss of a portion of the original investment due to changes in interest rates or prepayments, such review shall be performed quarterly. Examples of securities that have the potential for loss of a portion of the original investment include CMO residuals and

mortgage-backed interest-only certificates. For such securities, an effective yield or internal rate of return is calculated at acquisition based on the purchase price and anticipated future cash flows. For other investments, such review may be performed annually. The prepayment rates of the underlying loans shall be used to determine prepayment assumptions. Prepayment assumptions should be applied consistently across portfolios to all securities backed by similar collateral (similar with respect to coupon, issuer, and age of collateral). Reporting entities should also use consistent assumptions across portfolios for similar collateral within controlled affiliated groups. Since each reporting entity may have a unique method for determining the prepayment assumptions, it is impractical to set standard assumptions for the industry. Relevant sources and rationale used to determine prepayment assumptions should be documented by the reporting entity.

14. Loan-backed securities shall be revalued using the new prepayment assumptions using either the prospective or retrospective adjustment methodologies, as defined in paragraph 31, consistently applied by type of securities. The prospective approach recognizes, through the recalculation of the effective yield to be applied to future periods, the effects of all cash flows whose amounts differ from those estimated earlier and the effects and changes in projected cash flows. Under this method, the recalculated effective yield will equate the carrying amount of the investment to the present value of the anticipated future cash flows. The recalculated yield is then used to accrue income on the investment balance for subsequent accounting periods. There are no accounting changes in the current period unless the undiscounted anticipated cash flow is less than the carrying amount of the investment. The retrospective methodology changes both the yield and the asset balance so that expected future cash flows produce a return on the investment equal to the return now expected over the life of the investment as measured from the date of acquisition. Under the retrospective method, the recalculated effective yield will equate the present value of the actual and anticipated cash flows with the original cost of the investment. The current balance is then increased or decreased to the amount that would have resulted had the revised yield been applied since inception, and investment income is correspondingly decreased or increased.

Impairment

15. Regardless of whether a reporting entity is using a prospective or retrospective method, if the revaluation based on new prepayment assumptions results in a negative yield (undiscounted estimated future cash flows are less than the current book value), an other than temporary impairment shall be considered to have occurred. Accordingly, the cost basis of the loan-backed security shall be written down to the undiscounted estimated future cash flows and the amount of the write down shall be accounted for as a realized loss (which shall be included in IMR). The new cost basis shall not be changed for subsequent recoveries in fair value. Therefore the prospective adjustment method must be utilized for periods subsequent to the loss recognition.

Income

16. Interest shall be accrued using the interest method using the redemption prices and redemption dates used for amortizing premiums and discounts. Interest income for any period consists of interest collected during the period, the change in the due and accrued interest between the beginning and end of the period as well as reductions for premium amortization and interest paid on acquisition of loan-backed securities, and the addition of discount accrual. Contingent interest may be accrued if the applicable provisions of the underlying contract and the prerequisite conditions have been met.

17. A loan-backed security may provide for a prepayment penalty or acceleration fee in the event the investment is liquidated prior to its scheduled termination date. Such fees shall be reported as investment income when received.

Loaned Loan-Backed Securities

18. When loan-backed securities are loaned, they remain either admitted or nonadmitted assets of the reporting entity and are not removed from the accounting records as the reporting entity remains the owner of the securities. When collateral is provided and it is deposited for the general use of the reporting entity, it becomes either an admitted or nonadmitted asset of the reporting entity based on its characteristics, and a liability for the return of that collateral must be established. When collateral not available for the general use of the reporting entity is provided, it should not be recognized as an asset of the reporting entity. When non-cash collateral is provided, the current market value of that collateral must be used to determine adequacy of the collateral held relative to the current market value of the loaned securities.

Wash Sales

19. When investments in loan-backed securities are sold and the proceeds are reinvested within 30 days in the same or substantially the same security, such transfers shall be considered to be wash sales, and shall be accounted for as sales and disclosed as required by paragraph 25. Unless there is a concurrent contract to repurchase or redeem the transferred security from the transferee, the transferor does not maintain effective control over the security.

Giantization/Megatization of FHLMC or FNMA Mortgage Backed Securities

20. Giantization/megatization of mortgage backed securities is defined as existing pools of FHLMC or FNMA mortgage-backed securities (MBS) with like coupon and prefix which are repooled together by the issuing agency creating a new larger security. The new Fannie Mae “Mega” or Freddie Mac “Giant” is a guaranteed MBS pass-through representing an undivided interest in the underlying pools of loans.

21. The benefits derived from giantization/megatization include:

a. Increased liquidity: Smaller MBS pools (particularly those with current face of less than $1 million) are less liquid than mortgage pools with current faces exceeding $5 million. Repooling smaller MBS pools into one, larger pool improves the marketability for the aggregate package;

b. Geographic diversity: Regrouping of multiple pools generally will create greater geographic pool loan diversity resulting in less prepayment variation due to regional economic factors;

c. Reduced administrative expenses: The reduced number of pools lowers bank custodial fees, pricing/factor service fees, and increases efficiency for the accounting and investment departments.

22. Repooled FHLMC and FNMA securities meet the definition of substantially the same as defined in *Issue Paper No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements* (Issue Paper No. 45*)*. The transaction shall not be considered a sale/purchase and no gain or loss shall be recognized. To properly document the repooling, the transaction shall be reported through Schedule D of the Annual Statement as a disposition and an acquisition.

23. Transaction fees charged by the issuing agencies shall be capitalized and amortized over the life of the repooled security.

Disclosures

24. In addition to the disclosures required for invested assets in general, reporting entities shall disclose the following about their loan-backed securities in the notes to the financial statements:

a. Fair values in accordance with *Issue Paper No. 33—Disclosures about Fair Value of Financial Instruments*

b. Concentrations of credit risk in accordance with *Issue Paper No. 27—Disclosure of Information about Financial Instruments with Concentration of Credit Risk*

c. Basis at which the loan-backed securities are stated

d. The adjustment methodology used for each type of security (prospective or retrospective)

e. Changes from the retrospective to the prospective adjustment methodology due to negative yield on specific securities.

f. If a reporting entity elects to use book value as of January 1, 1994 as the cost, for securities purchased prior to January 1, 1994 where historical cash flows are not readily available for applying the retrospective method, that fact shall be disclosed.

g. Descriptions of sources used to determine prepayment assumptions

h. Market value sources (The following sources shall be applied consistently 1) public market quotes, 2) fair value provided by the broker, 3) management estimate, 4) pricing service, 5) pricing matrix).

i. If the reporting entity has entered into securities lending transactions, its policy for requiring collateral and a description, including the amount, of loaned securities.

25. Reporting entities shall disclose the following information for wash sales, as defined in paragraph 19, involving transactions for securities with a NAIC designation of 3 or below, or unrated:

a. A description of the reporting entity's objectives regarding these transactions;

b. An aggregation of transactions by NAIC Designation 3 or below, or unrated;

c. The number of transactions involved during the reporting period;

d. The book value of securities sold;

e. The cost of securities repurchased;

f. The realized gains/losses associated with the securities involved.

DISCUSSION

26. The statutory accounting principles described in the summary conclusion section adopt current statutory accounting guidance, for loan-backed securities, contained in paragraph 32 (which becomes fully effective for 1995), except as follows:

a. Paragraph 5 requires loan-backed securities acquisitions and dispositions to be recorded on the trade date, whereas current statutory guidance is silent.

b. Paragraph 19 provides guidance on wash sales of loan-backed securities.

c. Paragraph 40 provides guidance concerning the criteria which constitutes what are the same or substantially the same investments as defined in conjunction with dollar repurchase agreements. Due to the similarities between the investments discussed herein and the investments which underlie dollar repurchase agreements, the utilization of the same criteria to define "the same and substantially the same" investments appears reasonable and consistent.

27. This issue paper rejects the GAAP guidance for loan-backed securities, which is contained in *FASB Statement No. 115*, *Accounting for Certain Investments in Debt and Equity Securities* (FAS 115), *FASB Statement No. 91*, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases* (FAS 91), *FASB Emerging Issues Task Force No. 89-4*, *Accounting for a Purchased Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate, FASB Emerging Issues Task Force No. 90-2, Exchange of Interest-Only and Principal-Only Securities for a Mortgage-Backed Security, FASB Emerging Issues Task Force No. 93-18, Recognition of Impairment for an Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate,* and *FASB Emerging Issues Task Force No. 96-12, Recognition of Interest Income and Balance Sheet Classification of Structured Notes.*. The primary differences between the statutory accounting principles established in this issue paper and GAAP are as follows:

a. FAS 115 requires investments in debt securities to be classified into three categories: held-to-maturity, available-for-sale and trading. Held-to-maturity securities are reported at amortized cost. Available-for-sale are reported at fair value, with unrealized gains or losses reported as a separate component of shareholders' equity. Trading securities are reported at fair value, with unrealized gains or losses included in earnings.

b. GAAP does not require reporting of AVR.

c. FAS 91 and EITF 89-4 require that (1) for other than high-risk loan-backed securities, adjustments to the effective yield be for changes in prepayment assumptions be made on a retrospective basis; (2) for high-risk CMOs, such adjustments be made on a prospective basis.

d. FAS 91 allows deferral of certain origination costs.

e. Under this issue paper, impairment is measured based on nondiscounted estimated cash flows. *Emerging Issues Task Force Issue No. FASB 93-18*, *Recognition of Impairment for an Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate.* (EITF 93-18) requires that impairment be measured based on discounted cash flows.

28. This issue paper adopts paragraphs 9-12, 15, 17, 23-31 and 61-65 of *FASB Statement No. 125*, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 125*)* as they relate to loan-backed securities. Paragraph 14 is rejected as it relates to the classifications of securities under FAS 115. FAS 115 was rejected in *Issue Paper No. 26—Bonds, Excluding Loan-Backed and Structured Securities.*

29. The guidance on loaned securities in this issue paper is drafted under the general rule that securities lending transactions do not meet the criteria for surrender of control necessary to classify the transaction as a sale. If the criteria in paragraph 9 of FAS 125 regarding surrender of control are met, the transaction shall be accounted for by the transferor as a sale of the "loaned" securities.

30. *AICPA Statement of Position 90-3*, *Definition of the Term Substantially the Same for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position* (SOP 90-3) is consistent with paragraph 35 of this issue paper and has been adopted in Issue Paper No. 45.

31. The statutory accounting principles established in this issue paper attempt to smooth the effect upon a reporting entity's surplus of fair value fluctuation of investments held by the reporting entity. This is consistent with the Statement of Concepts which states that *"conservative valuation procedures provide protection to policyholders against adverse fluctuations in financial condition or operating results."* Statutory accounting principles for life insurance companies also use the concept of AVR and Interest Maintenance Reserve (IMR) adjustments to compensate for fair value fluctuations over time.

Drafting Notes/Comments

- Investment income due and accrued is addressed in *Issue Paper No. 34—Investment Income Due and Accrued*.
- Accounting for AVR and IMR is addressed in *Issue Paper No. 7—Asset Valuation Reserve and Interest Maintenance Reserve.*
- *Issue Paper No. 26—Bonds, Excluding Loan-Backed and Structured Securities* addresses accounting for bonds.
- Special purpose subsidiaries used to securitize loans are addressed in *Issue Paper No. 86—Securitization*. That issue paper addresses the situation whereby a reporting entity securitizes loans through the special purpose entity, and then purchases the resultant securities as investments

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

32. Chapter 1, *Bonds and Loaned Backed and Structured Securities*, in the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies contains the following guidance relating to loan-backed and structured securities:

ACCOUNTING FOR LOAN-BACKED AND STRUCTURED SECURITIES (CMOs)

> Description
>
> Loan-backed and structured securities are financial instruments designed to channel funds from capital markets to mortgage borrowers. The investments are structured so that all or substantially all of the collections of principal and interest from the underlying collateral are paid through to the investor.
>
> Loan-backed securities are defined as pass-through certificates, collateralized mortgage obligations (CMOs) and other securitized loans not included in structured securities as defined in the next paragraph. The payment of interest and/or principal on loan-backed securities is directly proportional to the interest and/or principal received by the issuer from the mortgage pool or other underlying securities.
>
> Structured securities are defined as loan-backed securities which have been divided into two or more classes, where the payment of interest and/or principal of any class of the securities has been allocated in a manner which is not proportional to interest and/or principal received by the

issuer from the mortgage pool or underlying securities. Structured securities have been further defined as collateralized mortgage obligations and other structured securities for Schedule D reporting and disclosures.

These investments are issued by special-purpose corporations or trusts (issuer) established by a sponsoring parent organization. Mortgage loans or other securities securing the loan-backed obligation are acquired by the issuer and pledged to an independent trustee until the issuer's obligation has been fully satisfied. The investor can look only to the issuer's assets (primarily the trusteed assets or third parties such as insurers or guarantors) for repayment of the obligation. As a result, the sponsor and its other affiliates may have no financial obligation under the instrument, although one of those entities may retain the responsibility for servicing the underlying mortgage loans. Some sponsors do guarantee the performance of the underlying loans.

At purchase, loan-backed and structured securities are recorded at purchase cost. Discount or premium is recorded for the difference between the purchase price and the principal amount. The discount or premium is amortized using the interest method and is recorded as an adjustment to investment income. The interest method results in the recognition of a constant rate of return on the investment equal to the prevailing rate at the time of purchase or at the time of subsequent adjustments of book value.

Prepayment Assumptions

Prepayments are a significant variable element in the cash flow of the investment because they affect the yield and determine the expected maturity against which the yield is evaluated. Falling interest rates generate faster prepayment of the mortgages underlying the security, shortening its duration. This causes the insurance company to reinvest assets much sooner than expected at potentially less advantageous rates. This is called prepayment risk. Extension risk is created by rising interest rates which slow repayment and can significantly lengthen the duration of the security.

Because performance of these securities is highly sensitive to prepayment rates, assumptions must be reviewed at least annually. Assumptions used for securities that have the potential for loss of a portion of the original investment due to changes in interest rates or prepayments should be reviewed quarterly. Changes in prepayment assumptions and the resulting cash flows must be considered when determining the carrying value of the security in periods after purchase.

Securities should be revalued using the new prepayment assumptions resulting from the annual or quarterly review. The effective yield is calculated using anticipated cash flows of the security based on an assumption of prepayment rates of the underlying loans. Variable rate securities or floaters, should use a constant rate of interest determined at the date of the calculation.

Prepayment assumptions should be applied consistently across portfolios to all securities backed by similar collateral (similar with respect to coupon, issuer, and age of collateral). Companies should also use consistent assumptions across portfolios for similar collateral within controlled affiliated groups. Since each company may have a unique method for determining the prepayment assumptions, it is impractical to set standard assumptions for the industry.

Relevant sources and rationale used to determine prepayment assumptions should be documented by the company.

Adjustment Methodologies

Both the prospective and retrospective adjustment methodologies are acceptable when revaluing these investments. The methods require that the effective yield be recalculated at each reporting date if there has been a change in the underlying assumptions. A company or a controlled affiliated group must choose a method for each type of security and consistently apply it to the security type. A security type describes the principal payment and interest payment characteristics of the security. For structured securities, the issuing agencies have developed a set of standard definitions for REMIC and CMO bonds describing principal and interest payment types.

Prospective Method

The prospective approach recognizes, through the recalculation of the effective yield to be applied to future periods, the effects of all past cash flows whose amounts differ from those estimated earlier and the effects and changes in projected cash flows. Under this method, the recalculated effective yield will equate the carrying amount of the investment to the present value of anticipated future cash flows. The recalculated yield is then used to accrue income on the investment balance for the subsequent accounting period. No change in the carrying amount is required to be recognized unless the undiscounted anticipated cash flow is less than the carrying amount of the investment.

Retrospective Method

The retrospective method changes both the yield and the asset balance so that expected future cash flows produce a return on the investment equal to the return now expected over the life of the investment as measured from the date of acquisition. Under the retrospective method, the recalculated effective yield will equate the present value of the actual and anticipated cash flows with the original cost of the investment. The current balance of the investment is increased or decreased to the amount that would have resulted had the revised yield been applied since inception, and investment income is correspondingly decreased or increased.

Under this method, the adjustment to book value to recognize premium or discount on payments that differed from estimates is called a true-up. Since it is an adjustment to yield, the offset to the book value is a charge or credit to investment income.

Negative Yield

Using either the prospective or retrospective method, if the revaluation based on new prepayment assumptions results in a negative effective yield (estimated future cash flows are less than the current book value), the security should be valued at the undiscounted estimate of anticipated future cash flows. Writedowns representing a loss in value should be treated as a realized capital loss and included in the IMR. The loss should be amortized over the weighted average life consistent with the valuation of the security at the time of the loss recognition.

At the time of recognition, a new cost basis should be established for the security. In future periods, the security cannot be written up and therefore the prospective adjustment methodology must be used for periods subsequent to the loss recognition.

A company should be able to identify those securities for which a negative yield adjustment was taken.

Investment Limitations

Loan-backed securities including CMOs and other structured securities may be subject to limitations established by the state of domicile.

Effective Date

The guidance in this chapter is effective for the year ending December 31, 1994 for loan-backed and structured securities that have the potential for loss of a portion of the original investment, such as losses arising from changes in interest rates or prepayments rates. (These securities should include, but are not limited to, interest-only structured securities and structured securities purchased at a significant premium over par value.) These accounting and reporting principles are effective for all loan-backed and structured securities for the year ending December 31, 1995. Companies may adopt compliance earlier, if desired.

For securities purchased prior to January 1, 1994 where historical cash flows are not readily available for applying the retrospective method, the company may use January 1, 1994 as the acquisition date and the then book value as the cost for purposes of determining yield adjustments in future periods. If this option is selected, a company should disclose that fact in the footnote where it presents the amortization methods used.

33. The Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies contains similar guidance.

34. The *Purposes and Procedures Manual of the NAIC Securities Valuation Office* - Section 2 - Procedures for Determining NAIC Designations for Bonds contains guidance on loan-backed securities. Pertinent excerpts are as follows:

(1) Collateralized Obligations. The ability of any type of collateral to enhance or fully support the contractual provisions of any security will be taken into account by the SVO only if acceptable documentary evidence is provided. This might include, but is not limited to the filing of the SVO's Collateral Loan form where appropriate, the original due diligence package, appraisal reports, valuations of business entities reports or any other relevant supporting information.

(18) Loan-backed and Structured Securities. The SVO encourages insurers to obtain ratings for loan-backed and structured securities submitted for an NAIC designation from an NAIC approved NRSRO. For unrated structured securities acquired by conversion i.e., securitization, refer to Section 6(B)(g)(i) for instructions.

(E) Instructions for Completing Schedule D of the NAIC Annual Statement

The following table indicates the appropriate entries to be made in Schedule D of the NAIC Annual Statement for all bonds except income bonds (see Section 2(C)(1)) and perpetual bonds and demand notes (see Section 2(C)(2)).

(1) For Insurers Maintaining an Asset Valuation Reserve (AVR) (see Section 6)

NAIC DESIGNATION COLUMN	AMORTIZED OR INVESTMENT VALUE COLUMN	MARKET VALUE COLUMNS	
		RATE	AMOUNT
1	Amortized Cost	SVO Market Rate if shown or A.V. if No Rate shown in VOS Manual	
2	Amortized Cost		Par Value X Rate or Amortized Cost if No Rate Available
3	Amortized Cost		
4	Amortized Cost		
5	Amortized Cost		
6	The lesser of the Market Value Amount or Amortized Cost		Lower of Amortized Cost or Par Value times Market Rate

A.V. = Bond has been valued at amortized value and that value should appear in the Market Value Amount Column.

(2) For Property and Casualty Insurers and All Other Insurers Not Maintaining an Asset Valuation Reserve (AVR)

NAIC DESIGNATION COLUMN	AMORTIZED OR INVESTMENT VALUE COLUMN	MARKET VALUE COLUMNS	
		RATE	MARKET VALUE
1	Amortized Cost		Par Value X Rate or A.V. if no rate available
2	Amortized Cost	SVO Market Rate if shown or A.V. if No Rate shown In VOS Manual	
3	The lesser of the Market Value Amount Or the Amortized Cost		Lower of Amortized Cost or Par Value X Rate
4	The lesser of the Market Value Amount or the Amortized Cost		Lower of Amortized Cost or Par Value X Rate
5	The lesser of the Market Value Amount or the Amortized Cost		Lower of Amortized Cost or Par Value X Rate
6	The lesser of the Market Value Amount or the Amortized Cost		Lower of Amortized Cost or Par Value X Rate

A.V. = Bond has been valued at amortized value and that value should appear in the Market Value Amount Column.

35. Chapter 1, Bonds and Loan Backed and Structured Securities, of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, contains the following guidance concerning the criteria which constitutes investments which are "the same or substantially the same" for dollar repurchase agreements:

a. The mortgage-backed securities must have the same primary obligor, except for securities guaranteed by the United States or an agency, thereof, in which case the guarantor must be the same.

b. The mortgage-backed securities must be identical in form and type. For example, the exchange of GNMA I securities for GNMA II securities would not meet the criterion.

c. The mortgage-backed securities must bear the identical contractual interest rate.

d. The mortgage-backed securities must be similar with respect to maturities (expected remaining lives) resulting in approximately the same market yield.

e. The mortgage-backed securities must be collateralized by a similar pool of mortgages, such as single-family residential mortgages.

f. The aggregate principal amounts of the mortgage-backed securities sold and repurchased must be substantially the same. For mortgage-backed securities to meet this criterion, the principal amount of the certificates repurchased must be within 2.5

percent (plus or minus) of the principal amount of the original certificates. For example, if the principal amount of mortgage-backed securities sold is $1,000,000, the principal amount of mortgage-backed securities reacquired must be between $1,025,000 and $975,000 to qualify under this criterion.

Generally Accepted Accounting Principles

36. GAAP guidance is promulgated by FAS 115. Pertinent excerpts are as follows:

> Accounting for Certain Investments in Debt and Equity Securities
>
> 6. At acquisition, an enterprise shall classify debt and equity securities into one of three categories: held-to-maturity, available-for-sale, or trading. At each reporting date, the appropriateness of the classification shall be reassessed.
>
> Held-to-Maturity Securities
>
> 7. Investments in debt securities shall be classified as held-to-maturity and measured at amortized cost in the statement of financial position only if the reporting enterprise has the positive intent and ability to hold those securities to maturity.
>
> Trading Securities and Available-for-Sale Securities
>
> 12. Investments in debt securities that are not classified as held-to-maturity and equity securities that have readily determinable fair values shall be classified in one of the following categories and measured at fair value in the statement of financial position:
>
> a. Trading securities. Securities that are bought and held principally for the purpose of selling them in the near term (thus held for only a short period of time) shall be classified as trading securities. Trading generally reflects active and frequent buying and selling, and trading securities are generally used with the objective of generating profits on short-term differences in price. Mortgage-backed securities that are held for sale in conjunction with mortgage banking activities, as described in *FASB Statement No. 65, Accounting for Certain Mortgage Banking Activities*, shall be classified as trading securities. (Other mortgage-backed securities not held for sale in conjunction with mortgage banking activities shall be classified based on the criteria in this paragraph and paragraph 7.)
>
> b. Available-for-sale securities. Investments not classified as trading securities (nor as held-to-maturity securities) shall be classified as available-for-sale securities.
>
> Reporting Changes in Fair Value
>
> 13. Unrealized holding gains and losses for trading securities shall be included in earnings. Unrealized holding gains and losses for available-for-sale securities (including those classified as current assets) shall be excluded from earnings and reported as a net amount in a separate component of shareholders' equity until realized. Paragraph 36 of *FASB Statement No. 109, Accounting for Income Taxes*, provides guidance on reporting the tax effects of unrealized holding gains and losses reported in a separate component of shareholders' equity.
>
> 14. Dividend and interest income, including amortization of the premium and discount arising at acquisition, for all three categories of investments in securities shall continue to be included in earnings. This Statement does not affect the methods used for recognizing and measuring the amount of dividend and interest income. Realized gains and losses for securities classified as either available-for-sale or held-to-maturity also shall continue to be reported in earnings.

Impairment of Securities

16. For individual securities classified as either available-for-sale or held-to-maturity, an enterprise shall determine whether a decline in fair value below the amortized cost basis is other than temporary. For example, if it is probable that the investor will be unable to collect all amounts due according to the contractual terms of a debt security not impaired at acquisition, an other-than-temporary impairment shall be considered to have occurred.[4] If the decline in fair value is judged to be other than temporary, the cost basis of the individual security shall be written down to fair value as a new cost basis and the amount of the write-down shall be included in earnings (that is, accounted for as a realized loss). The new cost basis shall not be changed for subsequent recoveries in fair value. Subsequent increases in the fair value of available-for-sale securities shall be included in the separate component of equity pursuant to paragraph 13; subsequent decreases in fair value, if not an other-than-temporary impairment, also shall be included in the separate component of equity.

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[4] A decline in the value of a security that is other than temporary is also discussed in AICPA Auditing Interpretation, Evidential Matter for the Carrying Amount of Marketable Securities, which was issued in 1975 and incorporated in Statement on Auditing Standards No. 1, Codification of Auditing Standards and Procedures, as Interpretation 20, and in SEC Staff Accounting Bulletin No. 59, Accounting for Noncurrent Marketable Equity Securities.

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37. FAS 91 provides the following guidance:

Purchase of a Loan or Group of Loans

15. The initial investment in a purchased loan or group of loans shall include the amount paid to the seller plus any fees paid or less any fees received. The initial investment frequently differs from the related loan's principal amount at the date of purchase. This difference shall be recognized as an adjustment of yield over the life of the loan. All other costs incurred in connection with acquiring purchased loans or committing to purchase loans shall be charged to expense as incurred.

Application of the Interest Method and Other Amortization Matters

18. Net fees or costs that are required to be recognized as yield adjustments over the life of the related loan(s) shall be recognized by the interest method except as set forth in paragraph 20. The objective of the interest method is to arrive at periodic interest income (including recognition of fees and costs) at a constant effective yield on the net investment in the receivable (that is, the principal amount of the receivable adjusted by unamortized fees or costs and purchase premium or discount). The difference between the periodic interest income so determined and the stated interest on the outstanding principal amount of the receivable is the amount of periodic amortization.[6] Under the provisions of this Statement, the interest method shall be applied as follows when the stated interest rate is not constant throughout the term of the loan:

[6] The “interest” method is also described in paragraph 16 of APB Opinion No. 12, Omnibus Opinion--1967, in the first sentence of paragraph 15 of *APB Opinion No. 21, Interest on Receivables and Payables*, and in paragraphs 235-239 of *FASB Concepts Statement No. 6, Elements of Financial Statements*.

a. If the loan's stated interest rate increases during the term of the loan (so that interest accrued under the interest method in early periods would exceed interest at the stated rate), interest income shall not be recognized to the extent that the net investment in the loan would increase to an amount greater than the amount at which the borrower could settle the obligation. Prepayment penalties shall be considered in determining the amount at which the borrower could settle the obligation only to the extent that such penalties are imposed throughout the loan term. (Refer to Appendix B.)

b. If the loan's stated interest rate decreases during the term of the loan, the stated periodic interest received early in the term of the loan would exceed the periodic interest income that is calculated under the interest method. In that circumstance, the excess shall be deferred and recognized in those future periods when the constant effective yield under the interest method exceeds the stated interest rate. (Refer to Appendix B.)

c. The loan's stated interest rate varies based on future changes in an independent factor, such as an index or rate (for example, the prime rate, the London Interbank Offered Rate (LIBOR), or the U.S. Treasury bill weekly average rate), the calculation of the constant effective yield necessary to recognize fees and costs shall be based either on the factor (the index or rate) that is in effect at the inception of the loan or on the factor as it changes over the life of the loan. [7] (Refer to Appendix B.)

[7] A variable rate loan whose initial rate differs from the rate its base factor would produce is also subject to the provisions of paragraphs 18.a. and 18.b.

19. Except as stated in the following sentence, the calculation of the constant effective yield necessary to apply the interest method shall use the payment terms required by the loan contract, and prepayments of principal shall not be anticipated to shorten the loan term. If the enterprise holds a large number of similar loans for which prepayments are probable and the timing and amount of prepayments can be reasonably estimated, the enterprise may consider estimates of future principal prepayments in the calculation of the constant effective yield necessary to apply the interest method. If the enterprise anticipates prepayments in applying the interest method and a difference arises between the prepayments anticipated and actual prepayments received, the enterprise shall recalculate the effective yield to reflect actual payments to date and anticipated future payments. The net investment in the loans shall be adjusted to the amount that would have existed had the new effective yield been applied since the acquisition of the loans. The investment in the loans shall be adjusted to the amount that would have existed had the new effective yield been applied since the acquisition of the loans. The investment in the loans shall be adjusted to the new balance with a corresponding charge or credit to interest income. Enterprises that anticipate prepayments shall disclose that policy and the significant assumptions underlying the prepayment estimates. The practice of recognizing net fees over the estimated average life of a group of loans shall no longer be acceptable. (Refer to Appendix B.)

38. EITF 89-4 provides the following guidance:

Emerging Issues Task Force No. 89-4, Accounting for a Purchased Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-only Certificate

ISSUE

Collateralized mortgage obligations and certain participating interests in real estate mortgage investment conduits (REMICs) (hereinafter collectively referred to as CMOs) are typically issued by a special-purpose entity (the issuer). The issuer may be organized in a variety of legal forms, such as a trust, a corporation, or a partnership. Accordingly, an investor may purchase a CMO instrument in equity form (for example, trust interests, stock, or partnership interests) or nonequity form (for example, participating debt securities). CMOs are collateralized by mortgage loans or mortgage-backed securities that are transferred to the CMO trust or pool by a sponsor. The issuer is structured so that collections from the underlying collateral provide the cash flow to make principal and interest payments on the obligations, or tranches, of the issuer.

Some CMO instruments, regardless of legal form, are most like debt instruments because those CMO instruments have stated principal amounts and traditional defined interest rate terms. Purchasers of certain other CMO instruments are entitled to the excess, if any, of the issuer's cash inflows, including reinvestment earnings, over the cash outflows for debt service and administrative expenses. Those CMO instruments, regardless of legal form, may include instruments designated as residual interests and are “high-risk” in that these CMO instruments could result in the loss of a portion of the original investment.

When accounting for a purchased investment in a CMO, the issues are:

1. Which factors (legal form, economic substance, or other factors) should be considered in determining whether to account for CMO instruments as equity or nonequity

2. What attribute(s) of nonequity high-risk CMO instruments and mortgage-backed interest-only certificates distinguishes them as a group of instruments that should be accounted for similarly

3. How an investment in a nonequity high-risk CMO instrument or in a mortgage-backed interest-only certificate should be accounted for in subsequent periods; specifically, how current and expected future cash flows should be allocated between income and return of investment in each accounting period.

EITF DISCUSSION

The Task Force reached a consensus as follows:

Issue 1

The Task Force reached a consensus that the accounting for a purchased investment in a CMO instrument should generally be consistent with the form of the investment. However, some CMO instruments issued in the form of equity represent solely the purchase of a stream of future cash flows to be collected under preset terms and conditions. Consequently, a purchased investment in a CMO instrument in equity form meeting all of the following criteria is required to be accounted for as a nonequity investment regardless of the legal form of the instrument (for example, beneficial interest in a trust, common stock, or partnership interest):

1. The assets in the special-purpose entity were not transferred to the special-purpose entity by the purchaser of the CMO instrument. [1]

[1] An investor in a CMO instrument who transferred assets to the related special-purpose entity should follow the accounting established by Statement 77 or Technical Bulletin 85-2, as applicable.

2. The assets of the special-purpose entity consist solely of a large number of similar high-credit-quality monetary assets [2] (or one or more high-credit-quality mortgage-backed securities that provide an undivided interest in a large number of similar mortgage loans) for which prepayments are probable and the timing and amounts of prepayments can be reasonably estimated.

[2] High-credit-quality monetary assets as used herein include only (1) assets guaranteed by the U.S. government, its agencies, or other creditworthy guarantors and (2) mortgage loans or mortgage-backed securities sufficiently collateralized to ensure that the possibility of credit loss is remote.

3. The special-purpose entity is self-liquidating, that is, it will terminate when the existing assets are fully collected and the existing obligations of the special-purpose entity are fully paid.

4. Assets collateralizing the obligations of the special-purpose entity may not be exchanged, sold, or otherwise managed as a portfolio, and the purchaser has neither the right nor the obligation to substitute assets that collateralize the entity's obligations.

5. There is no more than a remote possibility that the purchaser would be required to contribute funds to the special-purpose entity to pay administrative expenses or other costs.

6. No other obligee of the special-purpose entity has recourse to the purchaser of the investment.

The ability of a purchaser of a CMO instrument to call other CMO tranches of the special-purpose entity generally will not preclude treatment of the purchaser's investment as a nonequity instrument provided all the above criteria are met.

CMO instruments issued in the form of equity that do not meet the above criteria should be accounted for under the provisions of Opinion 18 or ARB 51, as amended by Statement 94.

Issue 2

The Task Force reached a consensus that nonequity CMO instruments that have potential for loss of a significant portion of the original investment due to changes in (1) interest rates, (2) the prepayment rate of the assets of the CMO structure, or (3) earnings from the temporary reinvestment of cash collected by the CMO structure but not yet distributed to the holders of its obligations (reinvestment earnings) are high-risk CMO instruments and should be accounted for as described in Issue 3 below. Nonequity CMO instruments include all CMO instruments issued in debt form and those CMO instruments issued in equity form that meet all six criteria listed in Issue 1.

For example, most issuers of CMO obligations have excess cash flows each period after required bond payments and administrative costs have been paid. Typically, the excess cash flows arise primarily from the spread between the interest rate paid on the CMO obligations and the interest rate received on the issuer's assets. The issuer may sell nonequity instruments (often called

CMO residuals) that entitle the purchaser to these excess cash flows. These instruments often have little or no principal component. If mortgage prepayments increase or if the interest rate paid on variable-rate obligations of the issuer increases, or both, the total cash flow to the investor in the CMO residual would significantly decline, possibly leaving the investor unable to recover a significant portion of the initial purchase price. Therefore, these types of CMO instruments are high-risk CMO instruments.

Other mortgage-related instruments entitle an investor to receive cash flows designated as interest from specified mortgages or mortgage-backed securities. These instruments are often called interest-only certificates and are similar to high-risk nonequity CMO instruments due to the potential for loss related to prepayment risk. The Task Force also reached a consensus that mortgage-backed interest-only certificates should be accounted for in the same manner as high-risk nonequity CMO instruments (see Issue 3 below).

Nonequity CMO instruments that do not have the potential for loss of a significant portion of the original investment due to the factors enumerated above, such as principal-only certificates, are not high-risk CMO instruments. Premiums and discounts arising from the purchase of CMO instruments that are not high risk should be amortized in accordance with the provisions of Statement 91.

Issue 3

The Task Force reached a consensus that in accounting for each purchased high-risk nonequity CMO instrument for which it is appropriate to use amortized cost, the investor should allocate the total cash flows expected to be received over the estimated life of the investment between principal and interest in the following manner. [Note: See STATUS section.] At the date of purchase, an effective yield is calculated based on the purchase price and anticipated future cash flows. In the initial accounting period, interest income is accrued on the investment balance using that rate. Cash received on the investment is first applied to accrued interest with any excess reducing the recorded investment balance. At each reporting date, the effective yield is recalculated based on the amortized cost of the investment and the then-current estimate of future cash flows. This recalculated yield is then used to accrue interest income on the investment balance in the subsequent accounting period. This procedure continues until all cash flows from the investment have been received.

The amortized balance of the investment at the end of each period will equal the present value of the estimated future cash flows discounted at the newly calculated effective yield.

The estimated future cash flows at each reporting date should reflect the most current estimate of future prepayments. Prepayment estimates should be made using assumptions that are consistent with assumptions used by marketplace participants for similar instruments, which the Task Force understands may require the use of an estimate of future interest rates implied by the current yield curve. In addition, if future cash flows will be directly affected by changes in interest rates, current interest rates at or near the balance sheet date should be used to estimate those cash flows. [3] Estimates of cash flows from reinvestment earnings also should be based on rates that are not in excess of current interest rates for eligible investments as defined in the CMO instrument.

[3] For example, some CMO instruments have cash flows that are impacted by the interest paid to variable-rate tranche holders in the same CMO structure. Current rates should be used to estimate the amounts to be paid to the variable rate tranche holders and in turn the amount of future cash flows to be collected from the CMO instruments.

Investors in high-risk CMO instruments should evaluate each CMO instrument separately to determine whether expected future cash flows are adequate to recover the recorded investment balance. The recorded balance for each investment should not exceed the undiscounted estimated future cash flows; that is, the effective yield cannot be negative. Any write-down establishes a new cost, which then is used for purposes of calculating effective yields in subsequent periods.

If investments in high-risk CMO instruments are significant, the effective yield calculated at the reporting date, which will be used to accrue income in the following period, should be disclosed in the annual financial statements. Either the effective yield for each CMO instrument or the effective yield for the portfolio of CMO instruments may be disclosed. If significant, the carrying amount and fair value of investments in high-risk CMO instruments also should be disclosed in the annual financial statements. When market quotations are not available for these investments, estimates should be made.

The application of this consensus is limited to circumstances in which the CMO or similar instrument represents an interest in a pool of high-credit-quality monetary assets for which prepayments are probable and the timing and amounts of prepayments can be reasonably estimated.

This consensus supersedes the conclusions expressed by the Task Force in Issue No. 86-38, "Implications of Mortgage Prepayments on Amortization of Servicing Rights," Subissue C, "Unanticipated Prepayments and Interest-Only Certificates," with respect to interest-only certificates.

General Comments

The SEC Observer noted that the method of adopting the consensuses should be disclosed. If adoption of the consensuses materially affects comparability, the nature and effect of adoption (including a quantification of the effects, if practicable) also should be disclosed in the notes to the financial statements.

The SEC Observer expressed concern that the accounting prescribed by these consensuses might be analogized to similar investments in collateralized borrowing structures when (1) the underlying collateral is of a lesser credit quality than that defined in this consensus or (2) the cash flow from the underlying collateral cannot be reasonably estimated. The SEC staff believes that such investments should be accounted for following a conservative method that adequately reflects the nature of those high-risk structures.

The Task Force noted that some CMO instruments and interest-only certificates are economically similar to excess servicing receivables and other mortgage-related investments. Diverse accounting methods for amortizing investments in the various types of mortgage-related instruments have been established in accounting literature. In addition, different interpretations of existing literature have resulted in further diversity in practice. The Task Force acknowledged the need for more comprehensive guidance in this area and authorized the working group to submit a letter to the FASB encouraging the Board to establish uniform guidance through a short-term project separate from the financial instruments project. [Note: See STATUS section.]

STATUS

The methodologies for amortizing and adjusting the carrying value of excess servicing fee assets and investments in interest-only securities or other similar financial instruments will be considered by the FASB staff as part of the project on present-value-based measurements.

In May 1993, the FASB issued Statement 115, which addresses accounting for certain investments in debt and equity securities and supersedes Statement 12. Under Statement 115, a positive intent and ability to hold a debt security to maturity is a prerequisite for using amortized cost. A financial institution must consider whether it has the ability to hold a high-risk CMO instrument to maturity under existing regulatory requirements. (See Topic No. D-39 in Appendix D.)

Paragraph 16 of Statement 115 states that if the decline in fair value of a security is judged to be other than temporary, the cost basis of the individual security should be written down to fair value. That measure of impairment differs from the measure in Issue 3 of the Task Force's consensus. In Issue No. 93-18, "Recognition of Impairment for an Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate," the Task Force reached a consensus that Statement 115 changes the measure of impairment of the instruments addressed in Issue 89-4 from undiscounted cash flows to fair value.

Issue 93-18 also addresses whether Statement 115 changes the consensus on Issue 89-4 with respect to the timing of recognizing impairment of investments in high-risk nonequity collateralized mortgage obligation instruments and interest-only certificates. The Task Force decided to supersede that aspect of the consensus on Issue 89-4 with a new consensus that if the present value of estimated future cash flows discounted at a risk-free rate is less than the amortized cost basis of the instrument, an impairment loss should be recognized.

No further EITF discussion is planned.

39. EITF 93-18 provides the following guidance:

Emerging Issued Task Force No. 93-18 Impairment Recognition for a purchased Investment in a Collateralized Mortgage obligation Instrument or in a Mortgage-Bond Interest-only Certificate

ISSUE

Paragraph 16 of Statement 115 requires that if a decline in fair value of an individual security classified as either available-for-sale or held-to-maturity is judged to be other than temporary, the cost basis shall be written down to fair value. The measure of an impairment loss for the securities discussed in Issue No. 89-4, "Accounting for a Purchased Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate," was based on undiscounted future cash flows. The recognition of an impairment loss under Issue 89-4 occurs when the recalculated effective yield turns negative (that is, when the sum of the newly estimated undiscounted future cash inflows is less than the security's recorded balance) and the impairment recognized was a write-down such that the recalculated effective yield was zero.

The issues are (1) whether Statement 115 changes the measure of an impairment loss for those instruments addressed in Issue 89-4 (that is, investments in high-risk nonequity collateralized mortgage obligation instruments and interest-only certificates), (2) whether Statement 115 changes the consensus on Issue 89-4 about the timing for recognition of an impairment loss for those instruments, and (3) whether previously recognized impairment losses for those instruments should be remeasured at fair value for purposes of determining the cumulative catch-up adjustment upon initial adoption of Statement 115.

EITF DISCUSSION

The Task Force reached a consensus that Statement 115 changes the measure of impairment of the instruments addressed in Issue 89-4 from undiscounted cash flows to fair value.

> The Task Force also reached a consensus that if the present value of estimated future cash flows discounted at a risk-free rate (that is, the rate on monetary assets that are essentially risk free, as described in paragraph 4 of Statement 76) is less than the amortized cost basis of the instrument, an impairment loss should be recognized. That comparison should be made at each reporting date. The excess of the amortized cost basis over the instrument's fair value should be recognized as a realized loss in the income statement, thereby establishing a new cost basis for the security. The rate to be used to determine the present value amount is the risk-free rate for instruments with duration consistent with the security's estimated future cash flows at the time the instrument is tested for impairment. The term duration is used in its technical sense to mean the weighted-average time to receive all cash flows (interest, dividends, and principal), where the weights reflect the relative present values of the cash flows.
>
> The Task Force reiterated the guidance in Issue 89-4 that the estimated future cash flows at each reporting date should reflect the most current estimate of future prepayments and use the same assumptions that are specified by the consensus in Issue 89-4.
>
> The Task Force also reached a consensus that the amortized cost basis of those instruments that are determined to have an other-than-temporary impairment loss at the time of initial adoption of Statement 115 should be written down to fair value. The amount of the write-down should be included as part of the cumulative catch-up adjustment. If an enterprise has initially adopted Statement 115 in a reporting period prior to the period in which this consensus was reached (that is, the reporting period that includes March 24, 1994), an additional adjustment may be necessary to comply with this consensus. That adjustment, which also would be determined as of the date of initial adoption, should be reported as an additional cumulative catch-up adjustment in the reporting period that includes March 24, 1994.
>
> These consensuses are limited to those instruments that are within the scope of Issue 89-4.
>
> STATUS
>
> No further EITF discussion is planned.

40. *AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position* (SOP 90-3) provides the following guidance:

> 13 To minimize diversity in practice, the AICPA Banking Committee, Savings and Loan Associations Committee, and Stockbrokerage and Investment Banking Committee believe the definition of substantially the same should be narrow. Therefore, the committees have concluded that for debt instruments, including mortgage-backed securities, to be substantially the same, all the following criteria must be met:
>
> a. The debt instruments must have the same primary obligor, except for debt instruments guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and terms of the guarantee must be the same.[1]

[1] The exchange of pools of single-family loans would not meet this criterion because the mortgages comprising the pool do not have the same primary obligor, and would therefore not be considered substantially the same.

b. The debt instruments must be identical in form and type so as to give the same risks and rights to the holder.[2]

c. The debt instruments must bear the identical contractual interest rate.

d. The debt instruments must have the same maturity except for mortgage-backed pass-through and pay-through securities for which the mortgages collateralizing the securities must have similar remaining weighted average maturities (WAMs) that result in approximately the same market yield.[3]

e. Mortgage-backed pass-through and pay through securities must be collateralized by a similar pool of mortgages, such as single-family residential mortgages.

f. The debt instruments must have the same aggregate unpaid principal amounts, except for mortgage-backed pass-through and pay-through securities, where the aggregate principal amounts of the mortgage-backed securities given up and the mortgage-backed securities reacquired must be within the accepted "good delivery" standard for the type of mortgage-backed security involved. [4]

41. FAS 125 provides the following guidance:

Accounting for Transfers and Servicing of Financial Assets

9. A transfer of financial assets (or all or a portion of a financial asset) in which the transferor surrenders control over those financial assets shall be accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if and only if all of the following conditions are met:

a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership (paragraphs 23 and 24).

[2] For example, the following exchanges would not meet this criterion: GNMA I securities for GNMA II securities; loans to foreign debtors that are otherwise the same except for different U.S. foreign tax credit benefits (because such differences in the tax receipts associated with the loans result in instruments that vary "in form and type"); commercial paper for redeemable preferred stock.

[3] For example, the exchange of a "fast-pay" GNMA certificate (that is, a certificate with underlying mortgage loans that have a high prepayment record) for a "slow-pay" GNMA certificate would not meet this criterion because differences in the expected remaining lives of the certificates result in different market yields.

[4] Participants in the mortgage-backed securities market have established parameters for what is considered acceptable delivery. These specific standards are defined by the Public Securities Association (PSA) and can be found in Uniform Practices for the Clearance and Settlement of Mortgage-Backed Securities and Other Related Securities, which is published by PSA.

b. Either (1) each transferee obtains the right—free of conditions that constrain it from taking advantage of that right (paragraph 25)—to pledge or exchange the transferred assets or (2) the transferee is a qualifying special-purpose entity (paragraph 26) and the holders of beneficial interests in that entity have the right—free of conditions that constrain them from taking advantage of that right (paragraph 25)—to pledge or exchange those interests.

c. The transferor does not maintain effective control over the transferred assets through (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (paragraphs 27-29) or (2) an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable (paragraph 30).

10. Upon completion of any transfer of financial assets, the transferor shall:

a. Continue to carry in its statement of financial position any retained interest in the transferred assets, including, if applicable, servicing assets (paragraphs 35-41), beneficial interests in assets transferred to a qualifying special-purpose entity in a securitization (paragraphs 47-58), and retained undivided interests (paragraph 33)

b. Allocate the previous carrying amount between the assets sold, if any, and the retained interests, if any, based on their relative fair values at the date of transfer (paragraphs 31-34).

11. Upon completion[3] of a transfer of assets that satisfies the conditions to be accounted for as a sale (paragraph 9), the transferor (seller) shall:

a. Derecognize all assets sold

b. Recognize all assets obtained and liabilities incurred in consideration as proceeds of the sale, including cash, put or call options held or written (for example, guarantee or recourse obligations), forward commitments (for example, commitments to deliver additional receivables during the revolving periods of some securitizations), swaps (for example, provisions that convert interest rates from fixed to variable), and servicing liabilities, if applicable (paragraphs 31, 32, and 35-41)

c. Initially measure at fair value assets obtained and liabilities incurred in a sale (paragraphs 42-44) or, if it is not practicable to estimate the fair value of an asset or a liability, apply alternative measures (paragraphs 45 and 46)

d. Recognize in earnings any gain or loss on the sale.

The transferee shall recognize all assets obtained and any liabilities incurred and initially measure them at fair value (in aggregate, presumptively the price paid).

[3] Although a transfer of securities may not be considered to have reached completion until the settlement date, this Statement does not modify other generally accepted accounting principles, including *FASB Statement No. 35, Accounting and Reporting by Defined Benefit Pension Plans*, and AICPA Statements of Position and audit and accounting Guides for certain industries, that require accounting at the trade date for certain contracts to purchase or sell securities.

12. If a transfer of financial assets in exchange for cash or other consideration (other than beneficial interests in the transferred assets) does not meet the criteria for a sale in paragraph 9, the transferor and transferee shall account for the transfer as a secured borrowing with pledge of collateral (paragraph 15).

Secured Borrowings and Collateral

15. A debtor may grant a security interest in certain assets to a lender (the secured party) to serve as collateral for its obligation under a borrowing, with or without recourse to other assets of the debtor. An obligor under other kinds of current or potential obligations, for example, interest rate swaps, also may grant a security interest in certain assets to a secured party. If collateral is transferred to the secured party, the custodial arrangement is commonly referred to as a pledge. Secured parties sometimes are permitted to sell or repledge (or otherwise transfer) collateral held under a pledge. The same relationships occur, under different names, in transfers documented as sales that are accounted for as secured borrowings (paragraph 12). The accounting for collateral by the debtor (or obligor) and the secured party depends on whether the secured party has taken control over the collateral and on the rights and obligations that result from the collateral arrangement:

a. If (1) the secured party is permitted by contract or custom to sell or repledge the collateral and (2) the debtor does not have the right and ability to redeem the collateral on short notice, for example, by substituting other collateral or terminating the contract, then

(i) The debtor shall reclassify that asset and report that asset in its statement of financial position separately (for example, as securities receivable from broker) from other assets not so encumbered.

(ii) The secured party shall recognize that collateral as its asset, initially measure it at fair value, and also recognize its obligation to return it.

b. If the secured party sells or repledges collateral on terms that do not give it the right and ability to repurchase or redeem the collateral from the transferee on short notice and thus may impair the debtor's right to redeem it, the secured party shall recognize the proceeds from the sale or the asset repledged and its obligation to return the asset to the extent that it has not already recognized them. The sale or repledging of the asset is a transfer subject to the provisions of this Statement.

c. If the debtor defaults under the terms of the secured contract and is no longer entitled to redeem the collateral, it shall derecognize the collateral, and the secured party shall recognize the collateral as its asset to the extent it has not already recognized it and initially measure it at fair value.

d. Otherwise, the debtor shall continue to carry the collateral as its asset, and the secured party shall not recognize the pledged asset.

Disclosures

17. An entity shall disclose the following:

a. If the entity has entered into repurchase agreements or securities lending transactions, its policy for requiring collateral or other security

b. If debt was considered to be extinguished by in-substance defeasance under the provisions of FASB Statement No. 76, Extinguishment of Debt, prior to the effective date of this Statement, a general description of the transaction and the amount of debt that is considered extinguished at the end of the period so long as that debt remains outstanding

c. If assets are set aside after the effective date of this Statement solely for satisfying scheduled payments of a specific obligation, a description of the nature of restrictions placed on those assets

d. If it is not practicable to estimate the fair value of certain assets obtained or liabilities incurred in transfers of financial assets during the period, a description of those items and the reasons why it is not practicable to estimate their fair value

e. For all servicing assets and servicing liabilities:

(1) The amounts of servicing assets or liabilities recognized and amortized during the period

(2) The fair value of recognized servicing assets and liabilities for which it is practicable to estimate that value and the method and significant assumptions used to estimate the fair value

(3) The risk characteristics of the underlying financial assets used to stratify recognized servicing assets for purposes of measuring impairment in accordance with paragraph 37

(4) The activity in any valuation allowance for impairment of recognized servicing assets—including beginning and ending balances, aggregate additions charged and reductions credited to operations, and aggregate direct write-downs charged against the allowances—for each period for which results of operations are presented.

Isolation beyond the Reach of the Transferor and Its Creditors

23. The nature and extent of supporting evidence required for an assertion in financial statements that transferred financial assets have been isolated—put presumptively beyond the reach of the transferor and its creditors, either by a single transaction or a series of transactions taken as a whole—depend on the facts and circumstances. All available evidence that either supports or questions an assertion shall be considered. That consideration includes making judgments about whether the contract or circumstances permit the transferor to revoke the transfer. It also may include making judgments about the kind of bankruptcy or other receivership into which a transferor or special-purpose entity might be placed, whether a transfer of financial assets would likely be deemed a true sale at law, whether the transferor is affiliated with the transferee, and other factors pertinent under applicable law. Derecognition of transferred assets is appropriate only if the available evidence provides reasonable assurance that the transferred assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any of its affiliates, except for an affiliate that is a qualifying special-purpose entity designed to make remote the possibility that it would enter bankruptcy or other receivership (paragraph 57.c.).

24. Whether securitizations isolate transferred assets may depend on such factors as whether the securitization is accomplished in one step or two steps (paragraphs 54-58). Many common financial transactions, for example, typical repurchase agreements and securities lending transactions, isolate transferred assets from the transferor, although they may not meet the other criteria for surrender of control.

Conditions That Constrain a Transferee

25. Many transferor-imposed or other conditions on a transferee's contractual right to pledge or exchange a transferred asset constrain a transferee from taking advantage of that right. However, a transferor's right of first refusal on a bona fide offer from a third party, a requirement to obtain the transferor's permission to sell or pledge that shall not be unreasonably withheld, or a

prohibition on sale to the transferor's competitor generally does not constrain a transferee from pledging or exchanging the asset and, therefore, presumptively does not preclude a transfer containing such a condition from being accounted for as a sale. For example, a prohibition on sale to the transferor's competitor would not constrain the transferee if it were able to sell the transferred assets to a number of other parties; however, it would be a constraint if that competitor were the only potential willing buyer.

Qualifying Special-Purpose Entity

26. A qualifying special-purpose entity[7] must meet both of the following conditions:

a. It is a trust, corporation, or other legal vehicle whose activities are permanently limited by the legal documents establishing the special-purpose entity to:

(1) Holding title to transferred financial assets

(2) Issuing beneficial interests (If some of the beneficial interests are in the form of debt securities or equity securities, the transfer of assets is a securitization.)

(3) Collecting cash proceeds from assets held, reinvesting proceeds in financial instruments pending distribution to holders of beneficial interests, and otherwise servicing the assets held

(4) Distributing proceeds to the holders of its beneficial interests.

b. It has standing at law distinct from the transferor. Having standing at law depends in part on the nature of the special-purpose entity. For example, generally, under U.S. law, if a transferor of assets to a special-purpose trust holds all of the beneficial interests, it can unilaterally dissolve the trust and thereby reassume control over the individual assets held in the trust, and the transferor "can effectively assign his interest and his creditors can reach it."[8] In that circumstance, the trust has no standing at law, is not distinct, and thus is not a qualifying special-purpose entity.

[7] The description of a special-purpose entity is restrictive. The accounting for transfers of financial assets to special-purpose entities should not be extended to any entity that does not satisfy all of the conditions articulated in this paragraph.

[8] *Scott's Abridgment of the Law on Trusts,* §156 (Little, Brown and Company, 1960), 296.

Agreements That Maintain Effective Control over Transferred Assets

27. An agreement that both entitles and obligates the transferor to repurchase or redeem transferred assets from the transferee maintains the transferor's effective control over those assets, and the transfer is therefore to be accounted for as a secured borrowing, if and only if all of the following conditions are met:

a. The assets to be repurchased or redeemed are the same or substantially the same as those transferred (paragraph 28).

b. The transferor is able to repurchase or redeem them on substantially the agreed terms, even in the event of default by the transferee (paragraph 29).

c. The agreement is to repurchase or redeem them before maturity, at a fixed or determinable price.

d. The agreement is entered into concurrently with the transfer.

28. To be substantially the same,[9] the asset that was transferred and the asset that is to be repurchased or redeemed need to have all of the following characteristics:

a. The same primary obligor (except for debt guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and the terms of the guarantee must be the same)

b. Identical form and type so as to provide the same risks and rights

c. The same maturity (or in the case of mortgage-backed pass-through and pay-through securities have similar remaining weighted-average maturities that result in approximately the same market yield)

d. Identical contractual interest rates

e. Similar assets as collateral

f. The same aggregate unpaid principal amount or principal amounts within accepted "good delivery" standards for the type of security involved.

29. To be able to repurchase or redeem assets on substantially the agreed terms, even in the event of default by the transferee, a transferor must at all times during the contract term have obtained cash or other collateral sufficient to fund substantially all of the cost of purchasing replacement assets from others.

30. A call option or forward contract that entitles the transferor to repurchase, prior to maturity, transferred assets not readily obtainable elsewhere maintains the transferor's effective control, because it would constrain the transferee from exchanging those assets, unless it is only a cleanup call.

Measurement of Interests Held after a Transfer of Financial Assets

Assets Obtained and Liabilities Incurred as Proceeds

31. The proceeds from a sale of financial assets consist of the cash and any other assets obtained in the transfer less any liabilities incurred. Any asset obtained that is not an interest in the transferred asset is part of the proceeds from the sale. Any liability incurred, even if it is related to the transferred assets, is a reduction of the proceeds. Any derivative financial instrument entered into concurrently with a transfer of financial assets is either an asset obtained or a liability incurred and part of the proceeds received in the transfer. All proceeds and reductions of proceeds from a sale shall be initially measured at fair value, if practicable.

Securities Lending Transactions

61. Securities lending transactions are initiated by broker-dealers and other financial institutions that need specific securities to cover a short sale or a customer's failure to deliver securities sold. Transferees ("borrowers") of securities generally are required to provide "collateral" to the transferor ("lender") of securities, commonly cash but sometimes other securities or standby letters of credit, with a value slightly higher than that of the securities "borrowed." If the "collateral" is cash, the transferor typically earns a return by investing that cash at rates higher than the rate paid or "rebated" to the transferee. If the "collateral" is other than cash, the transferor typically receives a fee. Securities custodians or other agents commonly

[9] In this Statement, the term *substantially the same* is used consistently with the usage of that term in the *AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position.*

carry out securities lending activities on behalf of clients. Because of the protection of “collateral” (typically valued daily and adjusted frequently for changes in the market price of the securities transferred) and the short terms of the transactions, most securities lending transactions in themselves do not impose significant credit risks on either party. Other risks arise from what the parties to the transaction do with the assets they receive. For example, investments made with cash “collateral” impose market and credit risks on the transferor.

62. In some securities lending transactions, the criteria in paragraph 9 are met, including the third criterion. Those transactions shall be accounted for (a) by the transferor as a sale of the “loaned” securities for proceeds consisting of the “collateral”[11] and a forward repurchase commitment and (b) by the transferee as a purchase of the “borrowed” securities in exchange for the “collateral” and a forward resale commitment. During the term of that agreement, the transferor has surrendered control over the securities transferred and the transferee has obtained control over those securities with the ability to sell or transfer them at will. In that case, creditors of the transferor have a claim only to the “collateral” and the forward repurchase commitment.

63. However, many securities lending transactions are accompanied by an agreement that entitles and obligates the transferor to repurchase or redeem the transferred assets before their maturity under which the transferor maintains effective control over those assets (paragraphs 27-30). Those transactions shall be accounted for as secured borrowings, in which cash (or securities that the holder is permitted by contract or custom to sell or repledge) received as “collateral” is considered the amount borrowed, the securities “loaned” are considered pledged as collateral against the cash borrowed, and any “rebate” paid to the transferee of securities is interest on the cash the transferor is considered to have borrowed. Collateral provided in securities lending transactions that are accounted for as secured borrowings shall be reported in the statement of financial position like other collateral, as set forth in paragraph 15.

64. The transferor of securities being “loaned” accounts for cash received (or for securities received that may be sold or repledged and were obtained under agreements that are not subject to repurchase or redemption on short notice, for example, by substitution of other collateral or termination of the contract) in the same way whether the transfer is accounted for as a sale or a secured borrowing. The cash (or securities) received shall be recognized as the transferor's asset—as shall investments made with that cash, even if made by agents or in pools with other securities lenders—along with the obligation to return the cash (or securities).

Illustration—Securities Lending Transaction Treated as a Secured Borrowing

65. Accounting for a securities lending transaction treated as a secured borrowing:

Facts

Transferor’s carrying amount and fair value of security loaned	$1,000
Cash “collateral”	1,020
Transferor's return from investing cash collateral at a 5 percent annual rate	5
Transferor's rebate to the borrower at a 4 percent annual rate	4

The loaned securities cannot be redeemed on short notice, for example, by substitution of other collateral. For simplicity, the fair value of the security is assumed not to change during the 35-day term of the transaction.

[11] If the “collateral” is a financial asset that the holder is permitted by contract or custom to sell or repledge and the debtor does not have the right and ability to redeem the collateral on short notice, for example, by substituting other collateral or terminating the contract, that financial asset is proceeds of the sale of the “loaned” securities. To the extent that the “collateral” consists of letters of credit or other financial instruments that the holder is not permitted by contract or custom to sell or pledge, a securities lending does not satisfy the sale criteria and is accounted for as a loan of securities by the transferor to the transferee

Journal Entries for the Transferor

At inception:

Cash	1,020	
Payable under securities loan agreements		1,020

To record the receipt of cash collateral

Securities loaned to broker	1,000	
Securities		1,000

To reclassify loaned securities that cannot be redeemed on short notice

Money market instrument	1,020	
Cash		1,020

To record investment of cash collateral

At conclusion:

Cash	1,025	
Interest		5
Money market instrument		1,020

To record results of investment

Securities	1,000	
Securities loaned to broker		1,000

To record return of security

Payable under securities loan agreements	1,020	
Interest (“rebate”)	4	
Cash		1,024

To record repayment of cash collateral plus interest

Journal Entries for the Transferee

At inception:

Receivable under securities loan agreements	1,020	
Cash		1,020

To record transfer of cash collateral

Securities	1,000	
Obligation to return borrowed securities		1,000

To record receipt of borrowed securities that
cannot be redeemed on short notice

At conclusion:

Obligation to return borrowed securities	1,000	
Securities		1,000

To record the return of securities

Cash	1,024	
Receivable under securities loan agreements		1,020
Interest revenue ("rebate")		4
To record the receipt of cash collateral and rebate interest		

Repurchase Agreements and "Wash Sales"

69. Furthermore, "wash sales" that previously were not recognized if the same financial asset was purchased soon before or after the sale shall be accounted for as sales under this Statement. Unless there is a concurrent contract to repurchase or redeem the transferred financial assets from the transferee, the transferor does not maintain effective control over the transferred assets.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 1, *Bonds and Loaned Backed and Structured Securities*
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 1, *Bonds and Loan Backed and Structured Securities*
- *Purposes and Procedures Manual of the NAIC Securities Valuation Office*
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*
- *Issue Paper No. 27—Disclosure of Information about Financial Instruments with Concentrations of Credit Risk*
- *Issue Paper No. 33—Disclosures about Fair Value of Financial Instruments*
- *Issue Paper No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements*

Generally Accepted Accounting Principles

- *FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities*
- *FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*
- *FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
- *EITF 89-4, Accounting for a Purchased Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate*
- *FASB Emerging Issues Task Force No. 90-2, Exchange of Interest-Only and Principal-Only Securities for a Mortgage-Backed Security*
- *EITF 93-18, Recognition of Impairment for an Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate*
- *FASB Emerging Issues Task Force No. 96-12, Recognition of Interest Income and Balance Sheet Classification of Structured Notes*
- *AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position*

State Regulations

- No additional guidance obtained from state statutes or regulations.

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Statutory Issue Paper No. 44

Capitalization of Interest

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 44

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory guidance does not address capitalization of interest cost.

2. GAAP guidance allows capitalization of interest as part of the historical cost of acquiring certain assets.

3. The purpose of this issue paper is to establish statutory accounting principles for capitalization of interest cost that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. Under statutory accounting principles, the historical cost of acquiring an asset generally includes the necessary costs incurred to bring it to the condition and location necessary for its intended use. If an asset requires a period of time in which to carry out the activities necessary to bring it to that condition and location, the interest cost incurred during that period as a result of expenditures for the asset shall be included as a part of the historical cost of acquiring the asset.

5. Interest cost shall be capitalized for the following types of assets:

   a. Assets constructed or otherwise produced for an enterprise's own use (including assets constructed or produced for the enterprise by others for which deposits or progress payments have been made);

   b. Assets intended for sale or lease that are constructed or otherwise produced as discrete projects (e.g. real estate developments);

   c. Investments (equity, loans, and advances) accounted for by the equity method while the investee has activities in progress necessary to commence its planned principal operations provided that the investee's activities include the use of funds to acquire qualifying assets for its operations. The equity method is defined in *Issue Paper No. 46—Accounting for Investments in Subsidiary, Controlled and Affiliated Entities* (Issue Paper No. 46).

6. Interest cost shall not be capitalized for the following types of assets:

   a. Assets that are in use or ready for their intended use in the earning activities of the enterprise;

   b. Assets that are not being used in the earning activities of the enterprise and that are not undergoing the activities necessary to get them ready for use;

c. Investments accounted for by the equity method after the planned principal operations of the investee begin;

d. Investments in regulated investees that are capitalizing both the cost of debt and equity capital;

e. Assets acquired with gifts and grants that are restricted by the donor or grantor to acquisition of those assets to the extent that funds are available from such gifts and grants. Interest earned from temporary investment of those funds that is similarly restricted shall be considered an addition to the gift or grant for this purpose;

f. Nonadmitted assets.

7. The amount of interest cost to be capitalized for qualifying assets shall be determined in accordance with subparagraphs 12-16 of paragraph 14 below and subparagraph 6 of paragraph 17 below.

8. The capitalization period shall be in accordance with subparagraphs 17-19 of paragraph 14 below and subparagraph 7 of paragraph 17 below.

9. Disclosures shall be made in the financial statements or related notes in accordance with subparagraph 21 of paragraph 14 below.

10. Capitalized interest meets the definition of an asset defined in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets* and is an admitted asset to the extent it conforms to the requirements of this issue paper. Capitalized interest shall be assessed for impairment in conjunction with the assessment of the related asset. As outlined in paragraph 4 above, the capitalized interest is included as a part of the historical cost of acquiring the asset. Interest capitalization shall not cease when such an assessment requires recognition of a lower value for the asset than acquisition cost; rather the provision required to reduce acquisition cost to such lower value shall be increased appropriately.

DISCUSSION

11. The statutory principles described in the conclusion above adopt the GAAP accounting principles for capitalization of interest cost set forth in *FASB Statement No. 34*, *Capitalization of Interest Cost* (FAS 34), *FASB Statement No. 42*, *Determining Materiality for Capitalization of Interest Cost* (FAS 42), *FASB Statement No. 58*, *Capitalization of Interest Cost in Financial Statements That Include Investments Accounted for by the Equity Method* (FAS 58), and *FASB Statement No. 62*, *Capitalization of Interest Cost in Situations Involving Certain Tax-Exempt Borrowings and Certain Gifts and Grants* (FAS 62), except that nonadmitted assets are ineligible for capitalization of interest.

12. The statutory accounting principles described in the conclusion above are consistent with the recognition concept in the Statement of Concepts, because capitalized interest cost represents a component of the cost of the related asset which would be recoverable and available to fulfill policyholder obligations upon sale of the asset unless an impairment exists. Pertinent excerpts follow:

> Recognition
>
> The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which may be unavailable due to encumbrances or other third party interest should not be recognized on the balance sheet but rather should be charged against surplus when acquired or when availability otherwise becomes questionable.

Drafting Notes/Comments

- *Issue Paper No. 46—Accounting for Investments in Subsidiary, Controlled and Affiliated Entities*, addresses the equity method for accounting for investments in subsidiaries, controlled and affiliated companies.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

13. Statutory accounting literature does not address capitalization of interest cost.

Generally Accepted Accounting Principles

14. FAS 34 provides the following guidance:

INTRODUCTION

1. This Statement establishes standards of financial accounting and reporting for capitalizing interest cost as a part of the historical cost of acquiring certain assets. For the purposes of this Statement, interest cost includes interest recognized on obligations having explicit interest rates,[1] interest imputed on certain types of payables in accordance with *APB Opinion No. 21, Interest on Receivables and Payables*, and interest related to a capital lease determined in accordance with *FASB Statement No. 13, Accounting for Leases*.

[1] Interest cost on these obligations includes amounts resulting from periodic amortization of discount or premium and issue costs on debt.

2. Paragraphs 15 and 16 of Opinion 21 provide that the discount or premium that results from imputing interest for certain types of payables should be amortized as interest expense over the life of the payable and reported as such in the statement of income. Paragraph 12 of Statement 13 provides that, during the term of a capital lease, a portion of each minimum lease payment shall be recorded as interest expense. This Statement modifies Opinion 21 and Statement 13 in that the amount chargeable to interest expense under the provisions of those paragraphs is eligible for inclusion in the amount of interest cost capitalizable in accordance with this Statement.

3. Some enterprises now charge all interest cost to expense when incurred; some enterprises capitalize interest cost in some circumstances; and some enterprises, primarily public utilities, also capitalize a cost for equity funds in some circumstances. This diversity of practice and an observation that an increasing number of nonutility registrants were adopting a policy of capitalizing interest led the Securities and Exchange Commission to impose, in November 1974, a moratorium on adoption or extension of such a policy by most nonutility registrants until such time as the FASB established standards in this area.[2]

[2] Securities and Exchange Commission, ASR No. 163, Capitalization of Interest by Companies Other Than Public Utilities (Washington: November 14, 1974).

4. Appendix A provides additional background information. Appendix B sets forth the basis for the Board’s conclusions, including alternatives considered and reasons for accepting some and rejecting others.

5. The Addendum to *APB Opinion No. 2, Accounting for the ‘Investment Credit’*, states that “differences may arise in the application of generally accepted accounting principles as between regulated and nonregulated businesses, because of the effect in regulated businesses of the

rate-making process," and discusses the application of generally accepted accounting principles to regulated industries. Accordingly, the provisions of the Addendum shall govern the application of this Statement to those operations of an enterprise that are regulated for rate-making purposes on an individual-company-cost-of-service basis.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

6. The historical cost of acquiring an asset includes the costs necessarily incurred to bring it to the condition and location necessary for its intended use.[3] If an asset requires a period of time in which to carry out the activities [4] necessary to bring it to that condition and location, the interest cost incurred during that period as a result of expenditures for the asset is a part of the historical cost of acquiring the asset.

[3] The term intended use embraces both readiness for use and readiness for sale, depending on the purpose of acquisition.

[4] See paragraph 17 for a definition of those activities for purposes of this Statement.

7. The objectives of capitalizing interest are (a) to obtain a measure of acquisition cost that more closely reflects the enterprise's total investment in the asset and (b) to charge a cost that relates to the acquisition of a resource that will benefit future periods against the revenues of the periods benefited.

8. In concept, interest cost is capitalizable for all assets that require a period of time to get them ready for their intended use (an "acquisition period"). However, in many cases, the benefit in terms of information about enterprise resources and earnings may not justify the additional accounting and administrative cost involved in providing the information. The benefit may be less than the cost because the effect of interest capitalization and its subsequent amortization or other disposition, compared with the effect of charging it to expense when incurred, would not be material. In that circumstance, interest capitalization is not required by this Statement.

Assets Qualifying for Interest Capitalization

9. Subject to the provisions of paragraph 8, interest shall be capitalized for the following types of assets ("qualifying assets"):

a. Assets that are constructed or otherwise produced for an enterprise's own use (including assets constructed or produced for the enterprise by others for which deposits or progress payments have been made)

b. Assets intended for sale or lease that are constructed or otherwise produced as discrete projects (e.g., ships or real estate developments).

10. However, interest cost shall not be capitalized for inventories that are routinely manufactured or otherwise produced in large quantities on a repetitive basis because, in the Board's judgment, the informational benefit does not justify the cost of so doing. In addition, interest shall not be capitalized for the following types of assets:

a. Assets that are in use or ready for their intended use in the earning activities of the enterprise

b. Assets that are not being used in the earning activities of the enterprise and that are not undergoing the activities necessary to get them ready for use.

11. Land that is not undergoing activities necessary to get it ready for its intended use is not a qualifying asset. If activities are undertaken for the purpose of developing land for a particular

use, the expenditures to acquire the land qualify for interest capitalization while those activities are in progress. The interest cost capitalized on those expenditures is a cost of acquiring the asset that results from those activities. If the resulting asset is a structure, such as a plant or a shopping center, interest capitalized on the land expenditures is part of the acquisition cost of the structure. If the resulting asset is developed land, such as land that is to be sold as developed lots, interest capitalized on the land expenditures is part of the acquisition cost of the developed land.

The Amount of Interest Cost to Be Capitalized

12. The amount of interest cost to be capitalized for qualifying assets is intended to be that portion of the interest cost incurred during the assets' acquisition periods that theoretically could have been avoided (for example, by avoiding additional borrowings or by using the funds expended for the assets to repay existing borrowings) if expenditures for the assets had not been made.

13. The amount capitalized in an accounting period shall be determined by applying an interest rate(s) ("the capitalization rate") to the average amount of accumulated expenditures for the asset during the period. The capitalization rates used in an accounting period shall be based on the rates applicable to borrowings outstanding during the period. If an enterprise's financing plans associate a specific new borrowing with a qualifying asset, the enterprise may use the rate on that borrowing as the capitalization rate to be applied to that portion of the average accumulated expenditures for the asset that does not exceed the amount of that borrowing. If average accumulated expenditures for the asset exceed the amounts of specific new borrowings associated with the asset, the capitalization rate to be applied to such excess shall be a weighted average of the rates applicable to other borrowings of the enterprise.

14. In identifying the borrowings to be included in the weighted average rate, the objective is a reasonable measure of the cost of financing acquisition of the asset in terms of the interest cost incurred that otherwise could have been avoided. Accordingly, judgment will be required to make a selection of borrowings that best accomplishes that objective in the circumstances. For example, in some circumstances, it will be appropriate to include all borrowings of the parent company and its consolidated subsidiaries; for some multinational enterprises, it may be appropriate for each foreign subsidiary to use an average of the rates applicable to its own borrowings. However, the use of judgment in determining capitalization rates shall not circumvent the requirement that a capitalization rate be applied to all capitalized expenditures for a qualifying asset to the extent that interest cost has been incurred during an accounting period.

15. The total amount of interest cost capitalized in an accounting period shall not exceed the total amount of interest cost incurred by the enterprise in that period. In consolidated financial statements, that limitation shall be applied by reference to the total amount of interest cost incurred by the parent company and consolidated subsidiaries on a consolidated basis. In any separately issued financial statements of a parent company or a consolidated subsidiary and in the financial statements (whether separately issued or not) of unconsolidated subsidiaries and other investees accounted for by the equity method, the limitation shall be applied by reference to the total amount of interest cost (including interest on intercompany borrowings) incurred by the separate entity.

16. For the purposes of this Statement, expenditures to which capitalization rates are to be applied are capitalized expenditures (net of progress payment collections) for the qualifying asset that have required the payment of cash, the transfer of other assets, or the incurring of a liability on which interest is recognized (in contrast to liabilities, such as trade payables, accruals, and retainages on which interest is not recognized). However, reasonable approximations of net capitalized expenditures may be used. For example, capitalized costs for an asset may be used as a reasonable approximation of capitalized expenditures unless the difference is material.

The Capitalization Period

17. The capitalization period shall begin when three conditions are present:

a. Expenditures (as defined in paragraph 16) for the asset have been made.

b. Activities that are necessary to get the asset ready for its intended use are in progress.

c. Interest cost is being incurred.

Interest capitalization shall continue as long as those three conditions are present. The term activities is to be construed broadly. It encompasses more than physical construction; it includes all the steps required to prepare the asset for its intended use. For example, it includes administrative and technical activities during the preconstruction stage, such as the development of plans or the process of obtaining permits from governmental authorities; it includes activities undertaken after construction has begun in order to overcome unforeseen obstacles, such as technical problems, labor disputes, or litigation. If the enterprise suspends substantially all activities related to acquisition of the asset, interest capitalization shall cease until activities are resumed. However, brief interruptions in activities, interruptions that are externally imposed, and delays that are inherent in the asset acquisition process shall not require cessation of interest capitalization.

18. The capitalization period shall end when the asset is substantially complete and ready for its intended use. Some assets are completed in parts, and each part is capable of being used independently while work is continuing on other parts. An example is a condominium. For such assets, interest capitalization shall stop on each part when it is substantially complete and ready for use. Some assets must be completed in their entirety before any part of the asset can be used. An example is a facility designed to manufacture products by sequential processes. For such assets, interest capitalization shall continue until the entire asset is substantially complete and ready for use. Some assets cannot be used effectively until a separate facility has been completed. Examples are the oil wells drilled in Alaska before completion of the pipeline. For such assets, interest capitalization shall continue until the separate facility is substantially complete and ready for use.

19. Interest capitalization shall not cease when present accounting principles require recognition of a lower value for the asset than acquisition cost; the provision required to reduce acquisition cost to such lower value shall be increased appropriately.

Disposition of the Amount Capitalized

20. Because interest cost is an integral part of the total cost of acquiring a qualifying asset, its disposition shall be the same as that of other components of asset cost.

Disclosures

21. The following information with respect to interest cost shall be disclosed in the financial statements or related notes:

a. For an accounting period in which no interest cost is capitalized, the amount of interest cost incurred and charged to expense during the period

b. For an accounting period in which some interest cost is capitalized, the total amount of interest cost incurred during the period and the amount thereof that has been capitalized.

Effective Date and Transition

22. This Statement shall be applied prospectively in fiscal years beginning after December 15, 1979. Earlier application is permitted, but not required, in financial statements for fiscal years beginning before December 16, 1979 that have not been previously issued. With respect to qualifying assets in existence at the beginning of the fiscal year in which this Statement is first applied for which interest cost has not been previously capitalized, interest capitalization shall begin at that time. With respect to qualifying assets for which interest cost has been capitalized according to a method that differs from the provisions of this Statement, no adjustment shall be made to the amounts of interest cost previously capitalized, but interest cost capitalized after this Statement is first applied shall be determined according to the provisions of this Statement. With respect to assets in existence when this Statement is first applied for which interest cost has been capitalized but which do not qualify for interest capitalization according to the provisions of this Statement, no adjustments shall be made, but no additional amounts of interest cost shall be capitalized.

23. If early application is adopted in financial reports for interim periods of a fiscal year beginning before December 16, 1979, previously issued financial information for any interim periods of that fiscal year that precede the period of adoption shall be restated to give effect to the provisions of this Statement, and any subsequent presentation of that information shall be on the restated basis. This Statement shall not be applied retroactively for previously issued annual financial statements.

15. FAS 42 provides the following guidance:

INTRODUCTION

1. Paragraph 8 of *FASB Statement No. 34, Capitalization of Interest Cost*, states that:

In concept, interest cost is capitalizable for all assets that require a period of time to get them ready for their intended use (an "acquisition period"). However, in many cases, the benefit in terms of information about enterprise resources and earnings may not justify the additional accounting and administrative cost involved in providing the information. The benefit may be less than the cost because the effect of interest capitalization and its subsequent amortization or other disposition, compared with the effect of charging it to expense when incurred, would not be material. In that circumstance, interest capitalization is not required by this Statement.

Paragraph 9 of FAS 34 begins as follows:

> Subject to the provisions of paragraph 8, interest shall be capitalized for the following types of assets ("qualifying assets"). . . .

2. The Board has received a number of questions concerning how paragraph 8 should be construed in deciding whether capitalization of interest is required. Some have stated that paragraph 8 appears to establish new tests of materiality that allow an enterprise to measure the effect of interest capitalization on income by a pro forma prospective or retroactive computation without also considering the effect on current year income. The Board has concluded that new tests of materiality should not be established for interest capitalization and has, accordingly, decided to amend paragraph 8 of Statement 34 to delete the language that gave rise to those questions.

3. The Board has concluded that it can reach an informed decision on the basis of existing information without a public hearing and that the effective date and transition specified in paragraph 5 are advisable in the circumstances.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Amendment to FASB Statement No. 34

4. The last two sentences of paragraph 8 of Statement 34 are superseded and replaced by the following sentence:

> Accordingly, interest shall not be capitalized in the situations described in paragraph 10.

The introduction of paragraph 9 of Statement 34 is amended to read as follows:

> Interest shall be capitalized for the following types of assets ("qualifying assets"):

Effective Date and Transition

5. This Statement shall be effective for fiscal years beginning after December 15, 1979. The provisions of this Statement shall be applied at the same time as the provisions of Statement 34 are first applied. Enterprises that already have adopted the provisions of Statement 34 shall apply the provisions of this Statement in their next fiscal year beginning after October 15, 1980 and may, but are not required to, restate their financial statements for the year of initial adoption to reflect the provisions of this Statement.

16. FAS 58 provides the following guidance:

INTRODUCTION

1. The FASB has received several inquiries concerning (a) the limitations of FASB Statement No. 34, Capitalization of Interest Cost, relating to capitalization of interest cost in situations involving investees accounted for by the equity method and (b) the inconsistent requirements between (i) the limitations of Statement 34 on the capitalization of interest cost in situations involving investees accounted for by the equity method and (ii) the requirement of APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock, that income and owners' equity amounts should be the same whether a subsidiary is consolidated or accounted for by the equity method.

2. The basic issue is whether Statement 34 distinguishes qualifying assets owned by the parent and consolidated subsidiaries from those owned by unconsolidated subsidiaries, joint ventures, and other investees accounted for by the equity method for purposes of determining the amount of interest cost to be capitalized in the investor's financial statements. Although paragraph 15 of Statement 34 clearly limits the amount of interest available for capitalization in consolidated financial statements to that shown in those statements, neither paragraph 9 nor paragraph 15 of Statement 34 is explicit regarding any similar limitations on qualifying assets.

3. The Board has concluded that qualifying assets as described in Statement 34 are limited to those of the parent company and consolidated subsidiaries. The Board has also concluded that certain investments (equity, loans, and advances) accounted for by the equity method are qualifying assets of the investor (including parent company and consolidated subsidiaries). For the investment to be a qualifying asset, the investee must be undergoing activities in preparation for its planned principal operations provided that the investee's activities include the use of funds to acquire qualifying assets for its operations. The investment ceases to be a qualifying asset when those operations begin. Subsequent accounting for interest capitalized on the investment is specified by paragraph 19.b. of Opinion 18.

4. This Statement does not affect the accounting for and reporting of capitalized interest cost in the separate financial statements of investees.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Amendments to FASB Statement No. 34

5. The following subparagraph is added to paragraph 9 of Statement 34, which specifies the qualifying assets for which interest is to be capitalized:

> c. Investments (equity, loans, and advances) accounted for by the equity method while the investee has activities in progress necessary to commence its planned principal operations provided that the investee's activities include the use of funds to acquire qualifying assets for its operations.

6. The following subparagraphs are added to paragraph 10 of Statement 34, which specifies the types of assets for which interest is not capitalized:

> c. Assets that are not included in the consolidated balance sheet of the parent company and consolidated subsidiaries
>
> d. Investments accounted for by the equity method after the planned principal operations of the investee begin
>
> e. Investments in regulated investees that are capitalizing both the cost of debt and equity capital

7. The following sentence is added to paragraph 20 of Statement 34, which specifies the accounting for interest after it is capitalized:

> Interest capitalized on an investment accounted for by the equity method shall be accounted for in accordance with paragraph 19.b. of Opinion 18 which states: "A difference between the cost of an investment and the amount of underlying equity in net assets of an investee should be accounted for as if the investee were a consolidated subsidiary."

Amendments to Other Pronouncements

8. Paragraph 10 of *ARB No. 51, Consolidated Financial Statements*, requires accounting for a subsidiary on a step-by-step basis if control is obtained through purchase of two or more blocks of stock. Paragraph 19.m. of Opinion 18 requires retroactive adjustment for an investee that was previously accounted for on other than the equity method when that investee becomes qualified for use of the equity method. Paragraph 34 of *APB Opinion No. 20, Accounting Changes*, requires restatement of prior financial statements for changes in reporting entities. The following footnote is added to each of those paragraphs:

> The amount of interest cost capitalized through application of *FASB Statement No. 58, Capitalization of Interest Cost in Financial Statements That Include Investments Accounted for by the Equity Method*, shall not be changed when restating financial statements of prior periods.

Effective Date and Transition

9. This Statement shall be effective for investments made after June 30, 1982 except that investments contracted for but not yet made may be accounted for as specified in the next sentence. Investments existing at the effective date or date of earlier adoption of this Statement (a) may be accounted for according to the provisions of this Statement or (b) may continue to be accounted for by the method of interest capitalization previously used even though not in accordance with the provisions of this Statement. Earlier application is encouraged. This Statement may be applied retroactively for annual financial statements that have not been issued but shall not be applied retroactively for previously issued annual financial statements.

17. FAS 62 provides the following guidance:

INTRODUCTION

1. The FASB has received a number of requests to reconsider the issue of offsetting interest income against interest cost in the application of *FASB Statement No. 34, Capitalization of Interest Cost*, for purposes of determining either capitalization rates or limitations on the amount of interest to be capitalized. *FASB Technical Bulletin No. 81-5, Offsetting Interest Cost to Be Capitalized with Interest Income*, states that Statement 34 does not permit such offsetting. Other requests have been received to consider the issue of capitalization of interest cost in situations in which qualifying assets are acquired using gifts and grants restricted to the purchase of the specified assets.

2. The Board has concluded that Statement 34 should be amended to require offsetting of interest income against interest cost in certain circumstances involving tax-exempt borrowings that are externally restricted as specified in paragraph 3. Those situations include many governmental borrowings and most governmentally sponsored borrowings (such as industrial revenue bonds and pollution control bonds). In such situations, interest earned generally is considered in and is significant to the initial decision to acquire the asset, and the capitalization of net interest cost provides a better measure of the entity's net investment in the qualifying assets. The Board believes that in those circumstances the association is direct and the funds flows from borrowing, temporary investment, and construction expenditures are so intertwined and restricted as to require accounting for the total net cost of financing as a cost of the qualifying assets. The Board also concluded that in all other situations offsetting of interest income against interest cost is not appropriate. The Board further concluded that qualifying assets acquired with externally restricted gifts or grants should not be subject to capitalization of interest cost under Statement 34.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

3. Interest earned shall not be offset against interest cost in determining either capitalization rates or limitations on the amount of interest cost to be capitalized except in situations involving acquisition of qualifying assets financed with the proceeds of tax-exempt borrowings if those funds are externally restricted to finance acquisition of specified qualifying assets or to service the related debt.

4. The amount of interest cost capitalized on qualifying assets acquired with proceeds of tax-exempt borrowings that are externally restricted as specified in paragraph 3 shall be all interest cost of the borrowing less any interest earned on related interest-bearing investments acquired with proceeds of the related tax-exempt borrowings [1] from the date of the borrowing until the assets are ready for their intended use. Interest cost of a tax-exempt borrowing shall be eligible for capitalization on other qualifying assets of the entity when the specified qualifying assets are no longer eligible for interest capitalization.

[1] The interest cost and interest earned on any portion of the proceeds of the tax-exempt borrowings that are not designated for the acquisition of specified qualifying assets and servicing the related debt are excluded. The entire interest cost on that portion of the proceeds that is available for other uses (such as refunding of an existing debt issue other than a construction loan related to those assets) is eligible for capitalization on other qualifying assets.

Amendments to FASB Statement No. 34

5. The following subparagraph is added to paragraph 10 of Statement 34, which specifies the types of assets for which interest is not capitalized:

> f. Assets acquired with gifts and grants that are restricted by the donor or grantor to acquisition of those assets to the extent that funds are available from such gifts and grants. Interest earned from temporary investment of those funds that is similarly restricted shall be considered an addition to the gift or grant for this purpose.

6. The following footnote is added at the end of the first sentence of paragraph 13 of Statement 34, which deals with determining the amount of interest cost to be capitalized:

> *If qualifying assets are financed with the proceeds of tax-exempt borrowings and those funds are externally restricted to the acquisition of specified qualifying assets or to service the related debt, the amount of interest cost capitalized shall be determined in accordance with *FASB Statement No. 62, Capitalization of Interest Cost in Situations Involving Certain Tax-Exempt Borrowings and Certain Gifts and Grants*.

7. The following footnote is added to paragraph 17 of Statement 34, which specifies the period for interest capitalization:

> *In situations involving qualifying assets financed with the proceeds of tax-exempt borrowings that are externally restricted as specified in Statement 62, the capitalization period begins at the date of the borrowing.

Rescission of Technical Bulletin

8. *FASB Technical Bulletin No. 81-5, Offsetting Interest Cost to Be Capitalized with Interest Income*, is rescinded upon issuance of this Statement.

Effective Date and Transition

9. This Statement shall be effective for tax-exempt borrowing arrangements entered into and gifts or grants received after August 31, 1982, with earlier application encouraged in financial statements that have not been previously issued. This Statement may be, but is not required to be, applied retroactively to previously issued financial statements for fiscal years beginning after December 15, 1979. If previously issued financial statements are restated, the financial statements shall, in the year that this Statement is first applied, disclose the nature of any restatement and its effects on income before extraordinary items, net income, and related per share amounts for each restated year presented.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 46—Accounting for Investments in Subsidiary, Controlled and Affiliated Entities*

Generally Accepted Accounting Principles

- *FASB Statement No. 34, Capitalization of Interest Cost*
- *FASB Statement No. 42, Determining Materiality for Capitalization of Interest Cost*
- *FASB Statement No. 58, Capitalization of Interest Cost in Financial Statements That Include Investments Accounted for by the Equity Method*
- *FASB Statement No. 62, Capitalization of Interest Cost in Situations Involving Certain Tax-Exempt Borrowings and Certain Gifts and Grants*

State Regulations

- No additional guidance obtained from state statutes and regulations.

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Statutory Issue Paper No. 45

Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements

STATUS
Finalized March 16, 1998

Current Authoritative Guidance for Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements: SSAP No. 103
This issue paper may not be directly related to the current authoritative statement.

Original SSAP from Issue Paper: SSAP No. 45

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. The Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies contain guidance on accounting for bonds sold subject to reverse repurchase agreements and dollar repurchase agreements.

2. The purpose of this issue paper is to establish statutory accounting principles for repurchase and reverse repurchase agreements, including dollar repurchase and dollar reverse repurchase agreements, that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

3. Repurchase agreements, reverse repurchase agreements and dollar repurchase agreements meet the definition of assets as defined in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this issue paper.

Repurchase Agreements

4. Repurchase agreements shall be defined as agreements under which a reporting entity purchases securities and simultaneously agrees to resell the same or substantially the same securities at a stated price on a specified date within 12 months of the purchase. For securities to be substantially the same, the criteria set forth in paragraph 23 must be met, and for mortgage-backed securities excluding mortgage pass-through securities, the projected cash flows of the securities must be substantially the same under multiple scenario prepayment assumptions.

5. Repurchase agreements shall be accounted for as collateralized lendings. The underlying securities shall not be accounted for as investments owned by the reporting entity. The amount paid for the securities shall be reported as a short-term investment, and the difference between the amount paid and the amount at which the securities will be subsequently resold shall be reported as interest income calculated on a straight-line basis or scientific interest (constant yield) basis over the term of the agreement.

6. Reporting entities generally take possession of the underlying collateral under repurchase agreements and in many cases may obtain additional collateral when the estimated fair value of such securities falls below their current contract value. However, to the extent that the current fair value of the

collateral is less than the recorded amount, the shortfall shall be used to reduce the admitted asset value of the repurchase agreement.

Reverse Repurchase Agreements

7. Reverse repurchase agreements shall be defined as agreements under which a reporting entity sells securities and simultaneously agrees to repurchase the same or substantially the same securities at a stated price on a specified date within 12 months of the sale date. For securities to be substantially the same, the criteria set forth in paragraph 23 must be met, and for mortgage-backed securities excluding mortgage pass-through securities, the projected cash flows of the securities must be substantially the same under multiple scenario prepayment assumptions.

8. Reverse repurchase agreements shall be accounted for as collateralized borrowings (financing transactions). The underlying securities shall continue to be accounted for as an investment by the reporting entity. The proceeds from the sale of the securities shall be recorded as a liability, and the difference between the proceeds and the amount at which the securities will be subsequently reacquired shall be reported as interest expense on a straight-line basis or computed using the scientific (constant yield) interest method over the term of the agreement. Although recording these transactions gross tends to inflate assets and liabilities, it more closely reflects the financing nature of these transactions and their associated leverage impact to the financial statements.

Dollar Repurchase Agreements

9. Dollar repurchase and dollar reverse repurchase agreements shall be defined as repurchase and reverse repurchase agreements involving debt instruments that are pay-through securities collateralized with Government National Mortgage Association (GNMA), Federal Home Loan Mortgage Corporation (FHLMC) and Federal National Mortgage Association (FNMA) collateral, and pass-through certificates sponsored by GNMA, mortgage participation certificates issued by the FHLMC or similar securities issued by the FNMA. Dollar repurchase agreements are also commonly referred to as dollar roll transactions. To meet the definition of dollar repurchase and dollar reverse repurchase agreements, the securities underlying the agreements must meet the criteria set forth in paragraph 23, and for mortgage-backed securities excluding mortgage pass-through securities, the projected cash flows of the securities must be substantially the same under multiple scenario prepayment assumptions.

10. For the seller in a dollar reverse repurchase agreement, a liability is recorded for the amount of proceeds of the sale and the sold mortgage-backed securities are not removed from the accounting records. During the period of the agreement, interest income is recorded as if the mortgage-backed security had been held during the term of the agreement. This is offset by an equal amount of interest expense related to the proceeds received from the sale. Additional interest expense is recorded representing the difference between the sales price and the repurchase price of the mortgage-backed securities sold.

11. When the mortgage-backed securities are repurchased under the agreement, the original mortgage-backed securities sold are removed from the accounting records and the purchased mortgage-backed securities are recorded. The principal amount of the mortgage-backed securities repurchased must be in good delivery form.

12. If the principal amount repurchased is greater than the amount sold, the cash paid is recorded as an additional investment in the newly acquired certificates. If the principal amount repurchased is less than the amount sold, a gain or loss relating to the original certificates held is recorded.

13. For the purchaser in a dollar repurchase agreement, an asset is recorded for the amount of the purchase. Since the term of the agreement is limited to twelve months, it is accounted for as a short-term investment. Upon completion of the reverse repurchase agreement, cash is received in exchange for a

"substantially the same" security. The difference between the purchase and reselling price represents interest income for the lending of short-term funds.

Separate Transactions

14. Agreements to repurchase and resell securities that do not meet the definitions in paragraph 4, 7, or 9 of this issue paper shall be accounted for as two separate transactions, that is, as a sale and purchase or as a purchase and sale, in accordance with the relevant statutory accounting guidance. For example, sales of bonds would result in recognition of realized gains or losses.

Offsetting

15. Reporting entities may operate on both sides of the repurchase agreement market resulting in recording of liabilities and assets representing repurchase and reverse repurchase agreements, respectively. Reporting entities shall offset such liabilities and assets only to the extent that one of the following occurs:

a. A legal right of offset exists as defined in *Issue Paper No. 76—Offsetting and Netting of Assets and Liabilities* (Issue Paper No. 76), or

b. The securities have the same settlement date, are executed with the same counterparty in accordance with a master netting arrangement, involve securities that exist in "book entry" form, and settle on securities transfer systems that have the same key elements and operating characteristics as the Fedwire Securities Transfer System (Fedwire system).

Otherwise, separate assets and liabilities shall be recognized.

Disclosures

16. The following disclosures shall be made in the notes to the financial statements.

a. If the reporting entity has entered into repurchase agreements, its policy for requiring collateral or other security.

b. A description of the securities underlying the agreements, including book values and fair values, maturities, and weighted average interest rates for the following categories: (a) securities subject to reverse repurchase agreements, (b) securities subject to repurchase agreements, (c) securities subject to dollar repurchase agreements, and (d) securities subject to reverse dollar repurchase agreements.

c. A description of the terms of reverse repurchase agreements whose amounts are included in borrowed money.

DISCUSSION

17. The conclusion above adopts current statutory guidance for repurchase agreements, reverse repurchase agreements, and dollar repurchase and reverse repurchase agreements, with a modification to the definition of substantially the same security in the case of mortgage backed securities to be consistent with the "good delivery" standard in *AICPA Statement of Position 90-3*, *Definition of the Term Substantially the Same for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position* (SOP 90-3). The disclosure requirements are consistent with information requested in the general interrogatories section of the annual statement and have been expanded to include disclosure of the reporting entity's policy for requiring collateral or other security.

18. The conclusion above is consistent with GAAP, and, accordingly, adopts SOP 90-3 and *FASB Emerging Issues Task Force No. 84-20*, *GNMA Dollar Rolls*. Furthermore, the conclusion in this issue

paper is consistent with the *FASB Interpretation No. 39*, *Offsetting of Amounts Related to Certain Contracts—an interpretation of APB Opinion No. 10 and FASB Statement No. 105* (as it relates to reverse repurchase and repurchase agreements) and FASB Interpretation No. 41, *Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements—an interpretation of APB No. 10 and a modification of FASB Interpretation No. 39*. FIN 39 and FIN 41 are adopted in Issue Paper 76.

19. This issue paper also adopts paragraphs 9-13, 15-17, 23-25, 27-30 and 66-71 of FAS 125 as they relate to repurchase agreements, reverse repurchase agreements and dollar repurchase agreements. Paragraph 14 is rejected as it relates to the classifications of securities under FAS 115. FAS 115 was rejected in *Issue Paper No. 26—Bonds, Excluding Loan-Backed and Structured Securities*.

20. The statutory accounting principles outlined in the conclusion above are consistent with the conservatism concept in the Statement of Concepts in that repurchase agreements are reduced by the amounts of any collateral shortfalls. The guidance also prohibits the recognition of gains on sales of securities when there is an agreement to repurchase.

Drafting Notes/Comments

- AVR/IMR is addressed in *Issue Paper No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

21. Chapter 1 in the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies contain the following guidance relating to repurchase agreements and dollar repurchase agreements:

> When a bond is sold and an equivalent security (a security of the same issuer having equal principal value, coupon rate, and maturity date) is to be repurchased pursuant to the terms of the reverse repurchase agreement, the transaction is accounted for as a financing (borrowing) transaction. A liability is recorded for the amount of the proceeds of the sale and the sold securities are not removed from the accounting records. The differential in the selling price and the repurchased price is recorded as interest expense and not netted against interest income. Amortization of original premium or accrual of original discount and interest income on the sold securities are recorded as though the securities had not been sold.
>
> When a bond is sold and a security which is not an equivalent security is to be repurchased pursuant to a reverse repurchase agreement, the transaction is to be accounted for as two separate transactions. The sold security, including unamortized original premium for or unaccrued original discount, is to be removed from the accounting records and the resulting gain or loss recognized immediately. When the non-equivalent security is acquired pursuant to the reverse repurchase agreement, it is recorded at cost.
>
> Dollar Repurchase Agreements
>
> A dollar repurchase agreement is an agreement (contract) to sell and repurchase pass-through certificates sponsored by the Government National Mortgage Association (GNMA), mortgage participation certificates issued by the Federal Home Loan Mortgage Corporation (FHLMC) or similar securities issued by the Federal National Mortgage Association (FNMA). These instruments are generally referred to as mortgage-backed securities. These contracts do not fall under the definition of equivalent securities previously discussed under Loaned Bonds or Bonds Subject to Reverse Repurchase Agreements.

Where the law, rules, or regulations of the insurer's state of domicile permit such activity, mortgage-backed securities sold and reacquired under a dollar repurchase agreement or purchased and resold under a reverse dollar repurchase agreement should be accounted for as discussed below.

In dollar repurchase/dollar reverse repurchase agreements, the mortgage-backed securities involved may or may not be substantially the same. If the mortgage-backed securities are substantially the same, the dollar repurchase or dollar reverse repurchase agreement is treated as a financing. If the mortgage-backed securities are not substantially the same, the transactions are treated as a sale and purchase or purchase and sale of different securities.

For mortgage-backed securities to be substantially the same, all the following criteria must be met:

1. The mortgage-backed securities must have the same primary obligor, except for securities guaranteed by the United States or an agency thereof, in which case the guarantor must be the same.
2. The mortgage-backed securities must be identical in form and type. For example, the exchange of GNMA I securities for GNMA II securities would not meet the criterion.
3. The mortgage-backed securities must bear the identical contractual interest rate.
4. The mortgage-backed securities must be similar with respect to maturities (expected remaining lives) resulting in approximately the same market yield.
5. The mortgage-backed securities must be collateralized by a similar pool of mortgages, such as single-family residential mortgages.
6. The aggregate principal amounts of the mortgage-backed securities sold and repurchased must be substantially the same. For mortgage-backed securities to meet this criterion, the principal amount of the certificates repurchased must be within 2.5% (plus or minus) of the principal amount of the original certificates. For example, if the principal amount of mortgage-backed securities sold is $1,000,000, the principal amount of mortgage-backed securities reacquired must be between $1,025,000 and $975,000 to qualify under this criterion.

If the mortgage-backed securities involved in a dollar repurchase agreement qualify under the above criteria, the transactions shall be treated as financing for statutory accounting purposes. A liability is recorded for the amount of proceeds of the sale and the sold mortgage-backed securities are not removed from the accounting records. During the period of the agreement, interest income is recorded as if the mortgage-backed security had been held during the term of the agreement. This is offset by an equal amount of interest expense related to the proceeds received from the sale. Additional interest expense is recorded representing the difference between the sales price and the repurchase price of the mortgage-backed securities.

When the mortgage-backed securities are repurchased under the agreement, the original mortgage-backed securities sold are removed from the accounting records and the purchased mortgage-backed securities are recorded. The principal amount of the mortgage-backed securities repurchased may be more or less than the book value of the mortgage-backed securities sold (within 2.5%).

If the principal amount repurchased is greater than the amount sold, the cash paid is recorded as an additional investment in the newly acquired certificates. If the principal amount repurchased is less than the amount sold, a gain or loss relating to the original certificates held is recorded. For example, assume that the certificates sold had a book value of $1,000,000 and a market value of $800,000 on the date of sale. This represents a fair market value 20% below the book value. On the date of repurchase, the new certificates have a principal amount of $990,000 (within 2.5% of the book value at date of sale). A loss of $2,000 ($1,000,000—$990,000 x 20%) is recorded.

22. The NAIC Annual Statement Instructions for Life and Accident and Health Insurance Companies include the following in the general interrogatories related to repurchase and reverse repurchase agreements.

> 20. The information to be reported on all such transactions including securities involved in reverse repurchase agreements, loaned to others, and for any other securities that were made available for use by another person during the year covered by this statement must include, but not necessarily be limited to, the following items for each such transaction:
>
> (1) Dates of transaction-securities delivered on ____________________
> securities returned on ____________________
>
> (2) Complete description of securities involved ______________
>
> (3) Number of shares or amount of bond or other security ________________
>
> (4) Market value on date securities were delivered $ _________
>
> (5) Market value on date securities were returned $ __________
>
> (6) Collateral value held $ __________________________________
>
> (7) Form of collateral _______________________________________
>
> (8) Collateral held by _______________________________________
> (name and address)
>
> (9) Names and addresses of all other persons involved in
> transaction ____
>
> Assets owned at year-end which were not under the exclusive control of the company as shown in the General Interrogatories are to be identified in the asset schedules by placing the following symbols to the far right in the description column alongside each such asset:

LS	-	loaned or leased to others;
RR	-	subject to reverse repurchase agreement;
DR	-	dollar repurchase agreement;
DRR	-	dollar reverse repurchase agreement;
C	-	pledged as collateral;
DB	-	placed under option agreement;
DBP	-	placed under an option agreement involving “asset transfers with put options”;
R*	-	letter stock or otherwise restricted as to sale;
O	-	other.

> Companies that had reverse repurchase agreements for periods of two working days or less, with numerous transactions, should combine those transactions in a separate report or each federally insured financial institution and respond to items (4), (5), and (8) as shown in this interrogatory.
>
> Companies should complete a full report for all other transactions, for everything owned at December 31 and respond to all nine items in this interrogatory.
>
> * Private placements are not to be included unless specific restrictions as to sale are included as part of the security agreement.

Generally Accepted Accounting Principles

23. *AICPA Statement of Position 90-3*, *Definition of the Term Substantially the Same for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position* (SOP 90-3) provides the following guidance:

> .13 To minimize diversity in practice, the AICPA Banking Committee, Savings and Loan Associations Committee, and Stockbrokerage and Investment Banking Committee believe the definition of substantially the same should be narrow. Therefore, the committees have concluded that for debt instruments, including mortgage-backed securities, to be substantially the same, all the following criteria must be met:
>
> a. The debt instruments must have the same primary obligor, except for debt instruments guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and terms of the guarantee must be the same.[1]
>
> [1] The exchange of pools of single-family loans would not meet this criterion because the mortgages comprising the pool do not have the same primary obligor, and would therefore not be considered substantially the same.
>
> b. The debt instruments must be identical in form and type so as to give the same risks and rights to the holder.[2]
>
> [2] For example, the following exchanges would not meet this criterion: GNMA I securities for GNMA II securities; loans to foreign debtors that are otherwise the same except for different U.S. foreign tax credit benefits (because such differences in the tax receipts associated with the loans result in instruments that vary "in form and type"); commercial paper for redeemable preferred stock.
>
> c. The debt instruments must bear the identical contractual interest rate.
>
> d. The debt instruments must have the same maturity except for mortgage-backed pass-through and pay-through securities for which the mortgages collateralizing the securities must have similar remaining weighted average maturities (WAMs) that result in approximately the same market yield.[3]
>
> [3] For example, the exchange of a "fast-pay" GNMA certificate (that is, a certificate with underlying mortgage loans that have a high prepayment record) for a "slow-pay" GNMA certificate would not meet this criterion because differences in the expected remaining lives of the certificates result in different market yields.
>
> e. Mortgage-backed pass-through and pay through securities must be collateralized by a similar pool of mortgages, such as single-family residential mortgages.
>
> f. The debt instruments must have the same aggregate unpaid principal amounts, except for mortgage-backed pass-through and pay-through securities, where the aggregate principal amounts of the mortgage-backed securities given up and the mortgage-backed securities reacquired must be within the accepted "good delivery" standard for the type of mortgage-backed security involved.[4]

[4] Participants in the mortgage-backed securities market have established parameters for what is considered acceptable delivery. These specific standards are defined by the Public Securities Association (PSA) and can be found in Uniform Practices for the Clearance and Settlement of Mortgage-Backed Securities and Other Related Securities, which is published by PSA.

24. *FASB Interpretation No. 39, Offsetting of Amounts Related to Certain Contracts—an interpretation of APB Opinion No. 10 and FASB Statement No. 105* provides the following guidance:

> 5. Opinion 10, paragraph 7, states that "it is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except where a right of setoff exists." A right of setoff is a debtor's legal right, by contract or otherwise, to discharge all or a portion of the debt owed to another party by applying against the debt an amount that the other party owes to the debtor.[2] A right of setoff exists when all of the following conditions are met:
>
> [2] For purposes of this Interpretation, cash on deposit at a financial institution is to be considered by the depositor as cash rather than as an amount owed to the depositor.
>
> a. Each of two parties owes the other determinable amounts.
>
> b. The reporting party has the right to set off the amount owed with the amount owed by the other party.
>
> c. The reporting party intends to set off.
>
> d. The right of setoff is enforceable at law.
>
> A debtor having a valid right of setoff may offset the related asset and liability and report the net amount.[3]
>
> [3] This Interpretation does not address derecognition or nonrecognition of assets and liabilities. Derecognition by sale of an asset or extinguishment of a liability results in removal of a recognized asset or liability and generally results in the recognition of gain or loss. Although conceptually different, offsetting that results in a net amount of zero and derecognition with no gain or loss are indistinguishable in their effects on the statement of financial position. Likewise, not recognizing assets and liabilities of the same amount in financial statements achieves similar reported results.
>
> 6. Generally, debts may be set off if they exist between mutual debtors each acting in its capacity as both debtor and creditor. In particular cases, however, state laws about the right of setoff may provide results different from those normally provided by contract or as a matter of common law. Similarly, the U.S. Bankruptcy Code imposes restrictions on or prohibitions against the right of setoff in bankruptcy under certain circumstances. Legal constraints should be considered to determine whether the right of setoff is enforceable.

25. *FASB Interpretation No. 41*, *Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements—an interpretation of APB Opinion No. 10 and a modification of FASB Interpretation No. 39* (FIN 41) states the following:

> INTRODUCTION
>
> 1. The Board has been asked to clarify the circumstances in which amounts recognized as payables under repurchase agreements[1] may be offset against amounts recognized as

receivables under reverse repurchase agreements[2] and reported as a net amount in the statement of financial position.

[1] For purposes of this Interpretation, a repurchase agreement (repo) refers to a transaction that is accounted for as a collateralized borrowing in which a seller-borrower of securities sells those securities to a buyer-lender with an agreement to repurchase them at a stated price plus interest at a specified date or in specified circumstances. The "payable" under a repurchase agreement refers to the amount of the seller-borrower's obligation recognized for the future repurchase of the securities from the buyer-lender. In certain industries, the terminology is reversed; that is, entities in those industries refer to this type of agreement as a "reverse repo."

[2] For purposes of this Interpretation, a reverse repurchase agreement (reverse repo) refers to a transaction that is accounted for as a collateralized lending in which a buyer-lender buys securities with an agreement to resell them to the seller-borrower at a stated price plus interest at a specified date or in specified circumstances. The "receivable" under a reverse repurchase agreement refers to the amount due from the seller-borrower for the repurchase of the securities from the buyer-lender. In certain industries, the terminology is reversed; that is, entities in those industries refer to this type of agreement as a "repo."

INTERPRETATION

2. Paragraph 5 of *FASB Interpretation No. 39, Offsetting of Amounts Related to Certain Contracts*, sets forth the conditions necessary for a right of setoff to exist. Those conditions should be present to offset assets and liabilities in the statement of financial position unless offsetting is permitted by paragraph 10 of Interpretation 39 or by another accounting pronouncement listed in paragraph 7 of Interpretation 39.

3. Notwithstanding the condition in paragraph 5.c. of Interpretation 39, an enterprise may, but is not required to, offset amounts recognized as payables under repurchase agreements and amounts recognized as receivables under reverse repurchase agreements if all of the following conditions are met:

a. The repurchase and reverse repurchase agreements are executed with the same counterparty.

b. The repurchase and reverse repurchase agreements have the same explicit settlement date specified at the inception of the agreement.

c. The repurchase and reverse repurchase agreements are executed in accordance with a master netting arrangement.[3]

[3] The qualifications for a master netting arrangement are stated in paragraph 10 of Interpretation 39 and are discussed in paragraphs 21 and 30 of that Interpretation.

d. The securities underlying the repurchase and reverse repurchase agreements exist in "book entry" form and can be transferred only by means of entries in the records of the transfer system operator or securities custodian.[4]

[4] "Book entry" securities meeting the criterion in paragraph 3.d. exist only as items in accounting records maintained by a transfer system operator. This requirement does not preclude offsetting of securities held in "book entry" form solely because other securities of the same issue exist in other forms.

e. The repurchase and reverse repurchase agreements will be settled on a securities transfer system that operates in the manner described in paragraph 4, and the enterprise must have associated banking arrangements in place as described in paragraph 4. Cash settlements for securities transferred are made under established banking arrangements that provide that the enterprise will need available cash on deposit only for any net amounts that are due at the end of the business day. It must be probable[5] that the associated banking arrangements will provide sufficient daylight overdraft or other intraday credit[6] at the settlement date for each of the parties.

[5] The term probable is used in this Interpretation consistent with its use in paragraph 3.a. of FASB Statement No. 5, Accounting for Contingencies, to mean that a transaction or event is likely to occur.

[6] Daylight overdraft or other intraday credit refers to the accommodation in the banking arrangements that allows transactions to be completed even if there is insufficient cash on deposit during the day provided there is sufficient cash to cover the net cash requirement at the end of the day. That accommodation may be through a credit facility, including a credit facility for which a fee is charged, or from a deposit of collateral.

f. The enterprise intends to use the same account at the clearing bank or other financial institution at the settlement date in transacting both (1) the cash inflows resulting from the settlement of the reverse repurchase agreement and (2) the cash outflows in settlement of the offsetting repurchase agreement.

The enterprise's choice to offset or not must be applied consistently. Net receivables resulting from the application of this Interpretation should not be offset against net payables resulting from the application of this Interpretation in the statement of financial position.

4. In a securities transfer system for repurchase and reverse repurchase agreements that meets the requirements of paragraph e., cash transfers are initiated by notification from the owner of record of the securities to its securities custodian[7] to transfer those securities to the counterparty to the agreement. Under associated banking arrangements, each party to a same-day settlement of both a repurchase agreement and a reverse repurchase agreement would be obligated to pay a gross amount of cash for the securities transferred from its counterparty but would be able to reduce that gross obligation by notifying its securities custodian to transfer other securities to that counterparty the same day. Thus, each party is responsible for maintaining available cash on deposit only for the amount of any net payable unless it fails to instruct its securities custodian to transfer securities to its counterparty.[8] If both parties transfer the appropriate securities in settlement of the repurchase and reverse repurchase agreements, the party with a net receivable will not need any cash to facilitate the settlement, while the party with a net payable will need only to have available the required net amount due at the end of the business day.

[7] The securities custodian for a securities transfer system may be the bank or financial institution that executes securities transfers over the securities transfer system, and “book entry” securities exist only in electronic form on the records of the transfer system operator for each entity that has a security account with the transfer system operator. “Book entry” securities exist only as items of account on the “controlling” records of the transfer system operator. Banks or other financial institutions may maintain “subsidiary” records of “book entry” securities. “Book entry” securities may be transferred on the subsidiary records of a bank or financial institution but, for entities that have a security account with the transfer system operator, may be transferred from the account of such an entity only through the transfer system operator.

[8] Failure by either party to instruct its securities custodian to transfer securities owned of record would result in that party's failing to receive cash from the counterparty and, thereby, would require that party to have available cash on deposit for the gross payable due for securities transferred to it.

> The failure also should be an event of default under the master netting arrangement required by paragraph 3.c. The event of default, in turn, should entitle the other party to terminate the arrangement and demand the immediate net settlement of all contracts.

26. *FASB Statement No. 125*, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* provides the following guidance:

> Accounting for Transfers and Servicing of Financial Assets
>
> 9. A transfer of financial assets (or all or a portion of a financial asset) in which the transferor surrenders control over those financial assets shall be accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if and only if all of the following conditions are met:
>
> a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership (paragraphs 23 and 24).
>
> b. Either (1) each transferee obtains the right—free of conditions that constrain it from taking advantage of that right (paragraph 25)—to pledge or exchange the transferred assets or (2) the transferee is a qualifying special-purpose entity (paragraph 26) and the holders of beneficial interests in that entity have the right—free of conditions that constrain them from taking advantage of that right (paragraph 25)—to pledge or exchange those interests.
>
> c. The transferor does not maintain effective control over the transferred assets through (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (paragraphs 27-29) or (2) an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable (paragraph 30).
>
> 10. Upon completion of any transfer of financial assets, the transferor shall:
>
> a. Continue to carry in its statement of financial position any retained interest in the transferred assets, including, if applicable, servicing assets (paragraphs 35-41), beneficial interests in assets transferred to a qualifying special-purpose entity in a securitization (paragraphs 47-58), and retained undivided interests (paragraph 33).
>
> b. Allocate the previous carrying amount between the assets sold, if any, and the retained interests, if any, based on their relative fair values at the date of transfer (paragraphs 31-34).
>
> 11. Upon completion[3] of a transfer of assets that satisfies the conditions to be accounted for as a sale (paragraph 9), the transferor (seller) shall:
>
> a. Derecognize all assets sold
>
> b. Recognize all assets obtained and liabilities incurred in consideration as proceeds of the sale, including cash, put or call options held or written (for example, guarantee or recourse obligations), forward commitments (for example, commitments to deliver additional receivables during the revolving periods of some securitizations), swaps (for example, provisions that convert interest rates from fixed to variable), and servicing liabilities, if applicable (paragraphs 31, 32, and 35-41)
>
> c. Initially measure at fair value assets obtained and liabilities incurred in a sale (paragraphs 42-44) or, if it is not practicable to estimate the fair value of an asset or a liability, apply alternative measures (paragraphs 45 and 46)

d. Recognize in earnings any gain or loss on the sale.
The transferee shall recognize all assets obtained and any liabilities incurred and initially measure them at fair value (in aggregate, presumptively the price paid).

[3] Although a transfer of securities may not be considered to have reached completion until the settlement date, this Statement does not modify other generally accepted accounting principles, including *FASB Statement No. 35*, *Accounting and Reporting by Defined Benefit Pension Plans*, and AICPA Statements of Position and audit and accounting Guides for certain industries, that require accounting at the trade date for certain contracts to purchase or sell securities.

12. If a transfer of financial assets in exchange for cash or other consideration (other than beneficial interests in the transferred assets) does not meet the criteria for a sale in paragraph 9, the transferor and transferee shall account for the transfer as a secured borrowing with pledge of collateral (paragraph 15).

Recognition and Measurement of Servicing Assets and Liabilities

13. Each time an entity undertakes an obligation to service financial assets it shall recognize either a servicing asset or a servicing liability for that servicing contract, unless it securitizes the assets, retains all of the resulting securities, and classifies them as debt securities held-to-maturity in accordance with *FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities*. If the servicing asset or liability was purchased or assumed rather than undertaken in a sale or securitization of the financial assets being serviced, it shall be measured initially at its fair value, presumptively the price paid. A servicing asset or liability shall be amortized in proportion to and over the period of estimated net servicing income (if servicing revenues exceed servicing costs) or net servicing loss (if servicing costs exceed servicing revenues). A servicing asset or liability shall be assessed for impairment or increased obligation based on its fair value (paragraphs 35-38).

Financial Assets Subject to Prepayment

Interest-only strips, loans, other receivables, or retained interests in securitizations that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment shall be subsequently measured like investments in debt securities classified as available-for-sale or trading under Statement 115, as amended by this Statement (paragraph 233).[4]

[4] As a result of that amendment to Statement 115, securities that were previously classified as held-to-maturity may need to be reclassified. Reclassifications of interest-only strips or other securities from held-to-maturity to available-for-sale required to initially apply this Statement would not call into question an entity's intent to hold other debt securities to maturity in the future.

Secured Borrowings and Collateral

15. A debtor may grant a security interest in certain assets to a lender (the secured party) to serve as collateral for its obligation under a borrowing, with or without recourse to other assets of the debtor. An obligor under other kinds of current or potential obligations, for example, interest rate swaps, also may grant a security interest in certain assets to a secured party. If collateral is transferred to the secured party, the custodial arrangement is commonly referred to as a pledge. Secured parties sometimes are permitted to sell or repledge (or otherwise transfer) collateral held under a pledge. The same relationships occur, under different names, in transfers documented as sales that are accounted for as secured borrowings (paragraph 12). The accounting for collateral by the debtor (or obligor) and the secured party depends on whether the secured party

has taken control over the collateral and on the rights and obligations that result from the collateral arrangement:

a. If (1) the secured party is permitted by contract or custom to sell or repledge the collateral and (2) the debtor does not have the right and ability to redeem the collateral on short notice, for example, by substituting other collateral or terminating the contract, then
   (i) The debtor shall reclassify that asset and report that asset in its statement of financial position separately (for example, as securities receivable from broker) from other assets not so encumbered.
   (ii) The secured party shall recognize that collateral as its asset, initially measure it at fair value, and also recognize its obligation to return it.
b. If the secured party sells or repledges collateral on terms that do not give it the right and ability to repurchase or redeem the collateral from the transferee on short notice and thus may impair the debtor's right to redeem it, the secured party shall recognize the proceeds from the sale or the asset repledged and its obligation to return the asset to the extent that it has not already recognized them. The sale or repledging of the asset is a transfer subject to the provisions of this Statement.
c. If the debtor defaults under the terms of the secured contract and is no longer entitled to redeem the collateral, it shall derecognize the collateral, and the secured party shall recognize the collateral as its asset to the extent it has not already recognized it and initially measure it at fair value.
d. Otherwise, the debtor shall continue to carry the collateral as its asset, and the secured party shall not recognize the pledged asset.

Extinguishments of Liabilities

16. A debtor shall derecognize a liability if and only if it has been extinguished. A liability has been extinguished if either of the following conditions is met:

a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes delivery of cash, other financial assets, goods, or services or reacquisition by the debtor of its outstanding debt securities whether the securities are canceled or held as so-called treasury bonds.
b. The debtor is legally released[5] from being the primary obligor under the liability, either judicially or by the creditor.

[5] If nonrecourse debt (such as certain mortgage loans) is assumed by a third party in conjunction with the sale of an asset that serves as sole collateral for that debt, the sale and related assumption effectively accomplish a legal release of the seller-debtor for purposes of applying this Statement.

Disclosures

17. An entity shall disclose the following:

   a. If the entity has entered into repurchase agreements or securities lending transactions, its policy for requiring collateral or other security
   b. If debt was considered to be extinguished by in-substance defeasance under the provisions of *FASB Statement No. 76, Extinguishment of Debt*, prior to the effective date of this Statement, a general description of the transaction and the amount of debt that is considered extinguished at the end of the period so long as that debt remains outstanding
   c. If assets are set aside after the effective date of this Statement solely for satisfying scheduled payments of a specific obligation, a description of the nature of restrictions placed on those assets

d. If it is not practicable to estimate the fair value of certain assets obtained or liabilities incurred in transfers of financial assets during the period, a description of those items and the reasons why it is not practicable to estimate their fair value

e. For all servicing assets and servicing liabilities:

  (1) The amounts of servicing assets or liabilities recognized and amortized during the period

  (2) The fair value of recognized servicing assets and liabilities for which it is practicable to estimate that value and the method and significant assumptions used to estimate the fair value

  (3) The risk characteristics of the underlying financial assets used to stratify recognized servicing assets for purposes of measuring impairment in accordance with paragraph 37

  (4) The activity in any valuation allowance for impairment of recognized servicing assets—including beginning and ending balances, aggregate additions charged and reductions credited to operations, and aggregate direct write-downs charged against the allowances—for each period for which results of operations are presented.

23. The nature and extent of supporting evidence required for an assertion in financial statements that transferred financial assets have been isolated—put presumptively beyond the reach of the transferor and its creditors, either by a single transaction or a series of transactions taken as a whole—depend on the facts and circumstances. All available evidence that either supports or questions an assertion shall be considered. That consideration includes making judgments about whether the contract or circumstances permit the transferor to revoke the transfer. It also may include making judgments about the kind of bankruptcy or other receivership into which a transferor or special-purpose entity might be placed, whether a transfer of financial assets would likely be deemed a true sale at law, whether the transferor is affiliated with the transferee, and other factors pertinent under applicable law. Derecognition of transferred assets is appropriate only if the available evidence provides reasonable assurance that the transferred assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any of its affiliates, except for an affiliate that is a qualifying special-purpose entity designed to make remote the possibility that it would enter bankruptcy or other receivership (paragraph 57.c.).

24. Whether securitizations isolate transferred assets may depend on such factors as whether the securitization is accomplished in one step or two steps (paragraphs 54-58). Many common financial transactions, for example, typical repurchase agreements and securities lending transactions, isolate transferred assets from the transferor, although they may not meet the other criteria for surrender of control.

Conditions That Constrain a Transferee

25. Many transferor-imposed or other conditions on a transferee's contractual right to pledge or exchange a transferred asset constrain a transferee from taking advantage of that right. However, a transferor's right of first refusal on a bona fide offer from a third party, a requirement to obtain the transferor's permission to sell or pledge that shall not be unreasonably withheld, or a prohibition on sale to the transferor's competitor generally does not constrain a transferee from pledging or exchanging the asset and, therefore, presumptively does not preclude a transfer containing such a condition from being accounted for as a sale. For example, a prohibition on sale to the transferor’s competitor would not constrain the transferee if it were able to sell the transferred assets to a number of other parties; however, it would be a constraint if that competitor were the only potential willing buyer.

Agreements That Maintain Effective Control over Transferred Assets

27. An agreement that both entitles and obligates the transferor to repurchase or redeem transferred assets from the transferee maintains the transferor's effective control over those assets, and the transfer is therefore to be accounted for as a secured borrowing, if and only if all of the following conditions are met:

a. The assets to be repurchased or redeemed are the same or substantially the same as those transferred (paragraph 28).
b. The transferor is able to repurchase or redeem them on substantially the agreed terms, even in the event of default by the transferee (paragraph 29).
c. The agreement is to repurchase or redeem them before maturity, at a fixed or determinable price.
d. The agreement is entered into concurrently with the transfer.

28. To be substantially the same,[9] the asset that was transferred and the asset that is to be repurchased or redeemed need to have all of the following characteristics:

a. The same primary obligor (except for debt guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and the terms of the guarantee must be the same)
b. Identical form and type so as to provide the same risks and rights
c. The same maturity (or in the case of mortgage-backed pass-through and pay-through securities have similar remaining weighted-average maturities that result in approximately the same market yield)
d. Identical contractual interest rates
e. Similar assets as collateral
f. The same aggregate unpaid principal amount or principal amounts within accepted "good delivery" standards for the type of security involved.

[9] In this Statement, the term substantially the same is used consistently with the usage of that term in the *AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments*, as Used in Certain Audit Guides and a Statement of Position.

29. To be able to repurchase or redeem assets on substantially the agreed terms, even in the event of default by the transferee, a transferor must at all times during the contract term have obtained cash or other collateral sufficient to fund substantially all of the cost of purchasing replacement assets from others.

30. A call option or forward contract that entitles the transferor to repurchase, prior to maturity, transferred assets not readily obtainable elsewhere maintains the transferor's effective control, because it would constrain the transferee from exchanging those assets, unless it is only a cleanup call.

Repurchase Agreements and "Wash Sales"

66. Government securities dealers, banks, other financial institutions, and corporate investors commonly use repurchase agreements to obtain or use short-term funds. Under those agreements, the transferor ("repo party") transfers a security to a transferee ("repo counterparty" or "reverse party") in exchange for cash[12] and concurrently agrees to reacquire that security at a future date for an amount equal to the cash exchanged plus a stipulated "interest factor".

[12] Other securities or letters of credit rarely are exchanged in repurchase agreements instead of cash.

67. Repurchase agreements can be effected in a variety of ways. Some repurchase agreements are similar to securities lending transactions in that the transferee has the right to sell or repledge the securities to a third party during the term of the repurchase agreement. In other repurchase agreements, the transferee does no have he right to sell or repledge the securities during the term of the repurchase agreement. For example, in a tri-party repurchase agreement, the transferor transfers securities to an independent third-party custodian that holds the securities during the term of the repurchase agreement. Also, many repurchase agreements are for short terms, often overnight, or have indefinite terms that allow either party to terminate the arrangement on short notice. However, other repurchase agreements are for longer terms, sometimes until the maturity of the transferred asset. Some repurchase agreements calls for repurchase of securities that need not be identical to the securities transferred.

68. If the criteria of paragraph 9 are met, including the third criterion, the transferor shall account for the repurchase agreement as a sale of financial assets and a forward repurchase commitment, and the transferee shall account for the agreement as a purchase of financial assets and a forward resale commitment. Others transfers that are accompanied by an agreement to repurchase the transferred assets that shall be accounted for as sales include transfers with agreements to repurchase at maturity and transfers with repurchase agreements in which the transferee has not obtained collateral sufficient to fund substantially all of the cost of purchasing replacement assets.

69. Furthermore, “wash sales” that previously were not recognized if the same financial asset was purchased soon before or after the sale shall be accounted for as sales under this Statement. Unless there is a concurrent contract to repurchase or redeem the transferred financial assets from the transferee, the transferor does not maintain effective control over the transferred assets.

70. As with securities lending transactions, under many agreements to repurchase transferred assets before their maturity the transferor maintains effective control over those assets. Repurchase agreements that do not meet all the criteria in paragraph 9 shall be treated as secured borrowing. Fixed-coupon and dollar-roll repurchase agreements, and other contracts under which the securities to be repurchased need not be the same as securities sold, qualify as borrowing if the return of substantially the same (paragraph 28) securities as those concurrently transferred is assured. Therefore, those transactions shall be accounted for as secured borrowings by both parties to the transfer.

71. If a transferor has transferred securities to an independent third-party custodian, or to a transferee, under conditions that preclude the transferee from selling or repledging the assets during the terms of the repurchase agreement (as in most tri-party repurchase agreements), the transferor has not surrendered control over those assets. In those circumstances, the transferee does not acquire the right to sell or repledge the securities during the term of the repurchase agreement; therefore, it does not have access to the benefits embodied in those assets. The transferee shall not record those assets as its own, nor shall the transferor derecognize those assets.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 1, *Bonds and Loaned Backed and Structured Securities*
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 1, *Bonds and Loan Backed and Structured Securities*
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 76—Offsetting and Netting of Assets and Liabilities*
- NAIC Annual Statement Instructions for Life and Accident and Health Insurance Companies

Generally Accepted Accounting Principles

- *AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as used In Certain Audit Guides and a Statement of Position*
- *FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
- *FASB Interpretation No. 39, Offsetting of Amounts Related to Certain Contracts—an interpretation of APB Opinion No. 10 and FASB Statement No. 105*
- *FASB Interpretation No. 41, Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements—an interpretation of APB Opinion No. 10 and a modification of FASB Interpretation No. 39*
- *FASB Emerging Issues Task Force No. 84-20, GNMA Dollar Rolls*

State Regulations

- No additional guidance obtained from state statutes or regulations.

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Statutory Issue Paper No. 46

Accounting for Investments in Subsidiary, Controlled and Affiliated Entities

STATUS
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Current Authoritative Guidance for Investments in Subsidiary, Controlled and Affiliated Entities: SSAP No. 97

This issue paper may not be directly related to the current authoritative statement.

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Common Area

SUMMARY OF ISSUE

1. Current statutory accounting guidance for investments in subsidiaries, controlled and affiliated entities (hereafter referred to as SCA entities) specifies various valuation bases. The basic guidance is set forth in the *Purposes and Procedures Manual of the NAIC Securities Valuation Office* (SVO Purposes and Procedures) and the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies. GAAP guidance requires consolidation of majority-owned and controlled subsidiaries and the equity method for all other significant investments in subsidiaries and other entities where the reporting entity has the ability to exercise significant influence over operating and financial policies of the investee. Consolidation of majority-owned subsidiaries was rejected in *Issue Paper No. 1—Consolidation of Majority-Owned Subsidiaries*.

2. The purpose of this issue paper is to establish statutory accounting principles for investments in SCA entities that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

Definitions

3. A parent and subsidiary shall be defined as:

   a. Parent - An entity that directly or indirectly owns and controls the reporting entity.

   b. Subsidiary - An entity that is, directly or indirectly, owned and controlled by the reporting entity.

4. An affiliate shall be defined as an entity that is within the holding company system or a party that, directly or indirectly, through one or more intermediaries, controls, is controlled by, or is under common control with the reporting entity. An affiliate includes a parent or subsidiary and partnerships, joint ventures and limited liability companies as defined in *Issue Paper No. 48—Investments in Joint Ventures, Partnerships and Limited Liability Companies* (Issue Paper No. 48). Those entities are accounted for under the guidance provided in Issue Paper No. 48 which requires the equity method for all such investments.

5. Control means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of the investee, whether through the ownership of voting securities, by

contract other than a commercial contract for goods or nonmanagement services, by common management, or otherwise. Control shall be presumed to exist if a reporting entity and its affiliates directly or indirectly, own, control, hold with the power to vote, or hold proxies representing 10% or more of the voting interests of the entity. The 10% ownership threshold shall be measured at the holding company level. For example, if one member of an affiliated group has a 5% interest in an entity and a second member of the group has an 8% interest in the same entity the total interest is 13% and therefore each member of the affiliated group shall be presumed to have control. These presumptions can be overcome by predominant evidence to the contrary, however, they shall stand until overcome by such predominant contradictory evidence. A reporting entity with 10% or more of the voting interest shall evaluate all facts and circumstances relating to the investment and reach a judgment about whether the presumption of control is overcome. The corollary is required to demonstrate control when a reporting entity owns less than 10% of the voting interest of an investee.

6. Investments in SCA entities meet the definition of assets as defined in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this paper.

Applying the Market Valuation, Statutory Equity and GAAP Equity Methods

7. The admitted investments in SCA entities shall be recorded using a market valuation approach (as described in paragraph 7.a.), or equity methods (as described in paragraph 7.b.).

a. In order to use the market valuation approach for SCA entities, the following requirements apply:

i. Once the reporting entity elects to use the market valuation approach for a particular subsidiary, the reporting entity cannot change the valuation method to another method (e.g., equity) without the approval of the domiciliary commissioner;

ii. The subsidiary must be traded on one of the following three major exchanges: (1) the New York Stock Exchange, (2) the American Stock Exchange, or (3) the NASDAQ National exchange;

iii. The reporting entity must submit subsidiary information to the Securities Valuation Office (SVO) for their calculation of the subsidiary's market value. Such calculation could result in further discounts in market value above the established base discounts based on ownership percentages detailed below;

iv. Ownership percentages for determining the discount rate shall be measured at the holding company level;

v. If an investment in a SCA results in an ownership percentage between 10% and 50%, a base discount percentage between 0% and 20% on a sliding scale basis is required;

vi. If an investment in a SCA results in an ownership percentage greater than 50% up to and including 80%, a base discount percentage between 20% and 30% on a sliding scale basis is required;

vii. If an investment in a SCA results in an ownership percentage greater than 80% up to and including 85%, a minimum base discount percentage of 30% is required. Further, the SCA must have at least two million shares outstanding, with a total market value of at least $50 million in the public's control; and

viii. Any ownership percentages exceeding 85% will result in the SCA being recorded on an equity method.

b. If a SCA investment does not meet the requirements for the market valuation approach in paragraph 7.a. or, if the requirements are met, but a reporting entity elects not to use that approach, investments in SCAs shall be recorded as follows:

i. Investments in insurance SCA entities shall be recorded based on the underlying statutory equity of the respective entity's financial statements, adjusted for unamortized goodwill as provided for in *Issue Paper No. 68—Business Combinations and Goodwill* (Issue Paper No. 68);

ii. Investments in noninsurance SCA entities that have no significant ongoing operations other than to hold assets that are primarily for the direct or indirect benefit or use of the reporting entity or its affiliates, shall be recorded based on the underlying equity of the respective entity's financial statements adjusted to a statutory basis of accounting and the resultant proportionate share of the subsidiary's adjusted surplus, adjusted for unamortized goodwill as provided for in Issue Paper No. 68. Examples include but are not limited to: 1) an insurer and a SCA entity that leases autos, furniture, office equipment, or computer equipment to the insurer, 2) an insurer and a SCA entity that owns real estate property that is leased to the insurer for office space, and 3) an insurer and an SCA entity which holds investments which an insurer could acquire directly (i.e., "look through" investment subsidiary);

iii. Investments in noninsurance SCA entities that have significant ongoing operations beyond the holding of assets that are primarily for the direct or indirect benefit or use of the reporting entity or its affiliates, shall be recorded based on the audited GAAP equity of the investee. Examples include but are not limited to: 1) a property-casualty or life insurer and a SCA entity that is an oil and gas venture, and 2) a property-casualty or life insurer and a SCA manufacturer.

8. For investments in entities recorded on the underlying audited GAAP equity of the investee the amount to be recorded shall be defined as the initial investment in an investee at cost (as defined in Issue Paper No. 68). The carrying amount of the investment shall be adjusted to recognize the reporting entity's share of the audited GAAP basis earnings or losses of the investee after the date of acquisition, adjusted for any dividends received. A reporting entity's share of adjustments that are recorded directly to the investee's stockholder's equity under GAAP shall also be recorded as adjustments to the carrying value of the investment with an offsetting amount recorded directly to unrealized capital gains and losses on investments.

9. The statutory equity method of accounting, as described in subparagraph 7.b.i., shall be applied by recording an initial investment in an investee at cost, which is defined in Issue Paper No. 68 as the sum of a) any cash payment, b) the fair value of other assets distributed, c) the fair value of any liabilities assumed and d) any direct costs of the acquisition. After the date of acquisition, the initial investment amount shall be adjusted for the amortization of goodwill and to recognize the reporting entity's share of statutory basis earnings or losses and other changes in surplus (including changes in nonadmitted assets) of the investee. This represents the carrying amount of the investment. To apply the equity method of accounting to investees as described in subparagraphs 7.b.ii., certain adjustments shall be made to GAAP (or other basis) income to determine the reporting entity's share of the investee's statutory earnings and losses and other changes in surplus. Further guidance on recording the initial investment (including

goodwill and negative goodwill) and other aspects of applying the equity method are discussed in paragraph 11 below.

10. If the reporting entity is using an equity method, the reporting entity's share of undistributed earnings and losses of the investee shall be included in unrealized gains and losses of the reporting entity. The reporting entity's share of other changes in the investee's surplus (e.g., the change in the investee's nonadmitted assets) shall be recorded by the investor as a component of unrealized capital gains and losses on investments. If the reporting entity uses the market valuation approach outlined in paragraph 7.a., changes in that valuation shall be included in unrealized gains and losses. Dividends or distributions received from an investee shall be recognized in investment income when declared to the extent that they are not in excess of the undistributed accumulated earnings attributable to the investee. Dividends or distributions declared in excess of the undistributed accumulated earnings attributable to the investee shall reduce the carrying amount of the investment.

11. The procedures set forth below shall be followed by a reporting entity in applying an equity method of accounting, as applicable, to investments in SCA entities:

a. A difference between the cost of an investment and the underlying equity in the statutory book value (GAAP book value if a noninsurance SCA entity that has significant ongoing operations beyond the holding of assets that are primarily for the direct or indirect benefit or use of the reporting entity or its affiliates) of the acquired company at the date of acquisition shall be accounted for in accordance with Issue Paper No. 68.

b. A transaction of an investee of a capital nature that affects the reporting entity's share of stockholders' equity of the investee shall be reflected as an unrealized gain or loss (e.g., where the investee issues additional stock or a new class of stock that impacts the reporting entity's equity ownership in the investee, the reporting entity's recorded investment shall be adjusted to reflect the transaction).

c. Realized gains or losses on the sale of an investment in an SCA entity shall be recorded in an amount equal to the difference at the time of sale between the selling price and carrying amount of the investment plus any previously recorded unrealized gain or loss.

d. If financial statements of an investee are not sufficiently timely for the reporting entity to apply an equity method to the investee's current results of operations, the reporting entity shall record its share of the earnings or losses of an investee from the most recent available financial statements. A lag in reporting shall be consistent from period to period.

e. A reporting entity's share of losses of an investee may equal or exceed the carrying amount of an investment accounted for by an equity method plus advances made by the investor. The reporting entity shall discontinue applying an equity method when the investment (including advances) is reduced to zero and shall not provide for additional losses unless the reporting entity has guaranteed obligations of the investee or is otherwise committed to provide further financial support for the investee (guaranteed obligations meeting the definition of liabilities in *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets* (Issue Paper No. 5) shall be recorded as liabilities). If the investee subsequently reports net income, the reporting entity shall resume applying an equity method only after its share of that net income equals the share of net losses not recognized during the period that the equity method was suspended.

f. When an investee has outstanding cumulative preferred stock, the reporting entity shall compute its share of earnings (losses) after deducting the investee's preferred dividends, whether or not such dividends are declared.

g. An investment in an SCA entity may fall below the level of ownership described in paragraph 5 from the sale of a portion of an investment by the reporting entity, the sale of additional interests by an investee, or other transactions. The reporting entity shall discontinue accruing its share of the earnings or losses of the investee for an investment that no longer qualifies for an equity method. The earnings or losses that relate to the investment interests retained by the reporting entity and that were previously accrued shall remain as a part of the carrying amount of the investment. The investment account shall not be adjusted retroactively under the conditions described in this subparagraph. However, dividends received by the investor in subsequent periods which exceed the reporting entity's share of earnings for such periods shall be applied as a reduction of the carrying amount of the investment.

h. An investment in a SCA entity that was previously accounted for under one method may become qualified for use of another method (as described in paragraph 7) because of a change in the level of ownership (i.e., acquisition of additional interests by the reporting entity, acquisition or retirement of interests by the investee, or other transactions, or a change in facts or circumstances (e.g., paragraphs 7.a.i., 7.a.viii.)). When an investment qualifies for use of another method of accounting, the reporting entity shall adopt the new method of accounting and the investment shall be adjusted to reflect the reporting entity's equity interest in the SCA entity under the new method. A corresponding amount shall be recorded as an unrealized gain or loss.

12. A reporting entity that owns an interest in itself via direct ownership of shares of an upstream intermediate or ultimate parent shall reduce the value of such shares for the reciprocal ownership. If the shares of the parent are owned indirectly by a reporting entity, via a down-stream SCA entity, the directly held entity, which owns the parent's shares, shall have its value reduced for the reciprocal ownership.

13. Any parent reporting entity that owns an interest in itself via either direct or indirect ownership of a down-stream affiliate, which in turn owns shares of the parent reporting entity, shall eliminate its proportionate interest in these shares from the valuation of such affiliate.

Impairment

14. When there is a decline in the fair value of an asset owned by an SCA entity that is deemed to be other than temporary, the SCA entity shall write the asset down to fair value.

15. For any decline in the fair value of an investment in a SCA entity that is other than temporary, the investment shall be written down to fair value as the new cost basis and the amount of the write down shall be accounted for as a realized loss. The write down shall first be considered as an adjustment to any portion of the investment that is nonadmitted (e.g., goodwill). The new cost basis shall not be changed for subsequent recoveries in fair value. Future declines in fair value which are determined to be other than temporary, shall be recorded as realized losses. This is consistent with Issue Paper No. 5. An impairment shall be considered to have occurred if it is probable that the reporting entity will be unable to recover the carrying amount of the investment or there is evidence indicating inability of the investee to sustain earnings which would justify the carrying amount of the investment. A fair value of an investment that is below the carrying amount based on the statutory equity method or the existence of investee operating losses may indicate a loss in value, however, they are not necessarily indicative of a loss in value that is other than temporary.

Disclosures

16. The significance of an investment to the reporting entity's financial position and results of operations shall be considered in evaluating the extent of disclosures of the financial position and results

of operations of an investee. Disclosures as follow shall be made for all investments in SCA entities that exceed 10% of the total admitted assets of the reporting entity:

a. Financial statements of a reporting entity shall disclose (1) the name of each SCA entity and percentage of ownership of common stock, (2) the accounting policies of the reporting entity with respect to investments in SCA entities and (3) the difference, if any, between the amount at which the investment is carried and the amount of underlying equity in net assets (i.e., goodwill, other nonadmitted assets, market value or discounted market value adjustments) and the accounting treatment of the difference.

b. For those SCA entities for which a quoted market price is available, the aggregate value of each SCA investment based on the quoted market price and the difference, if any, between the amount at which the investment is carried and the quoted market price shall be disclosed.

c. Summarized information as to assets, liabilities, and results of operations shall be presented for SCA entities, either individually or in groups.

d. Conversion of outstanding convertible securities, exercise of outstanding options and warrants and other contingent issuances of an investee may have a significant effect on an investor's share of reported earnings or losses. Accordingly, material effects of possible conversions, exercises or contingent issuances shall be disclosed in notes to the financial statements of the reporting entity.

17. Any commitment or contingent commitment to a subsidiary, controlled or affiliated entity shall be disclosed (e.g., guarantees or commitments to provide additional capital contributions).

18. A reporting entity that recognizes an impairment loss shall disclose the following in the financial statements that include the period of the impairment writedown:

a. A description of the impaired assets and the facts and circumstances leading to the impairment.

b. The amount of the impairment and how fair value was determined.

DISCUSSION

19. The statutory accounting principles described in the summary conclusion section are consistent with current statutory accounting guidance for investments in SCA entities except as follows:

a. Current statutory guidance provides reporting entities with five alternatives for the valuation of common stock investments in subsidiary, controlled and affiliated companies: (1) statutory capital and surplus value, (2) net worth excluding nonadmitted assets, (3) net worth based on audited GAAP financial statements, (4) cost adjusted to reflect statutory basis operating results and (5) market value. Selection of the appropriate alternative depends on whether the investee is an insurance company, whether its stock is publicly traded and whether it is a noninsurance company with audited financial statements.

b. Current statutory accounting guidance allows investments in noninsurance companies to be carried on the audited GAAP equity basis of accounting regardless of the nature of the investee's business operations and its relationship to the investor's business operations. However, in certain circumstances adjustments to reflect the equity in net assets on a statutory basis are required.

c. Current statutory accounting guidance permits, in certain situations, the recognition of equity in an SCA entity's earnings as income rather than unrealized gains and losses in the reporting entity's financial statements.

20. The statutory accounting principles described in the summary conclusion above reject *Accounting Principles Board Opinion No. 18*, *The Equity Method of Accounting for Investments in Common Stock* (APB 18), *AICPA Accounting Interpretations*, *The Equity Method of Accounting for Investments in Common Stock: Accounting Interpretations of APB Opinion No. 18, FASB Technical Bulletin No. 79-19*, *Investor's Accounting for Unrealized Losses on Marketable Securities Owned by an Equity Method Investee, FASB Emerging Issues Task Force No. 87-21*, *Change of Accounting Basis in Master Limited Partnership Transactions,* and *FASB Emerging Issues Task Force No. 96-16*, *Investor's Accounting for an Investee When the Investor Owns a Majority of the Voting Stock but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights*. The statutory accounting principles differ from GAAP promulgated as follows:

a. APB 18 defines control as ownership of over 50% of the outstanding voting stock but states that it may exist with a lesser percentage of ownership. The statutory accounting principles above define control as ownership of 10% or more of the outstanding voting interests.

b. APB 18 specifies the GAAP equity method of accounting for investments where the investor has the ability to exercise significant influence over operating and financial policies of an investee even though the investor holds 50% or less and specifies investments of 20% or more should lead to a presumption that an investor has such influence unless there is evidence to the contrary. The statutory accounting principles above specify the statutory equity method, if applicable, for investments of 10% or more of the voting interests unless predominant evidence to the contrary is presented.

c. APB 18 paragraph 19.c. specifies that under the GAAP equity method, an investor recognizes its share of the earnings or losses of an investee in the income statement as a single amount except for extraordinary items, whereas the statutory accounting principles described in paragraph 10 of the conclusion above specify when amounts shall be included in unrealized gains and losses or investment income.

21. The statutory accounting principles described in paragraph 5 above state control shall be presumed to exist for investees for which 10 percent or more of the voting interest is owned and presumed not to exist for investees for which less than 10 percent of the voting interest is owned. These presumptions can be overcome if there is predominant evidence to the contrary. *FASB Interpretation No. 35*, *Criteria for Applying the Equity Method of Accounting for Investment in Common Stock an Interpretation of APB Opinion No. 18* (FIN 35), provides guidance on determining when such evidence exists. This issue paper adopts FIN 35 which is included in its entirety in paragraph 29.

22. The statutory accounting principles outlined in the conclusion above are consistent with the conservatism and recognition concepts in the Statement of Concepts. Pertinent excerpts follow:

> Conservatism
>
> Conservative valuation procedures provide protection to policyholders against adverse fluctuations in financial condition or operating results. Statutory accounting should be reasonably conservative over the span of economic cycles and in recognition of the primary responsibility to regulate for financial solvency. Valuation procedures should, to the extent possible, prevent sharp fluctuations in surplus.

> Recognition
>
> The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which are unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet but rather should be charged against surplus when acquired or when availability otherwise becomes questionable.
>
> Revenue should be recognized only as the earnings process of the underlying underwriting or investment business is completed. Accounting treatments which tend to defer expense recognition do not generally represent acceptable SAP treatment.

23. The statutory accounting principles outlined in the conclusion above require that the investment for noninsurance SCA entities that have no significant ongoing operations other than to hold assets that are primarily for the direct or indirect benefit or use of the reporting entity or its affiliates, and that do not qualify for the market valuation approach outlined in paragraph 7.a. or for which the reporting entity does not elect that approach, shall be recorded based on their underlying equity adjusted to a statutory basis of accounting. In applying the provisions of this issue paper to noninsurance SCA entities, the focus is on the primary operations of the SCA for purposes of determining if it is ancillary to the insurance industry and thereby requiring the application of provisions under subparagraph 7.b.ii. Entities whose primary operations do not provide services to the insurance industry fall under provisions of subparagraph 7.b.iii. It is not the intent of subparagraph 7.b.ii. to apply to an affiliate which has insignificant transactions within the insurance industry. Although this is a subjective rule, a bright line test would not benefit insurers or regulators. This rule requires judgment by the reporting entity in making the determination and provides flexibility to the regulator in analyzing the determination. This is consistent with the objectives of statutory financial reporting which emphasize the measurement of solvency for the protection of policyholders. This is consistent with the concepts of conservatism and recognition described above.

Drafting Notes/Comments

- Business combinations and goodwill are addressed in *Issue Paper No. 68—Business Combinations and Goodwill*.
- CMO special purpose subsidiaries are addressed in *Issue Paper No. 86—Securitization*.
- Investment income due and accrued is addressed in *Issue Paper No. 34—Investment Income Due and Accrued*.
- Accounting for related party transactions is addressed in *Issue Paper No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties*.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

24. The Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies provides the following guidance:

> CHAPTER 6
>
> INVESTMENTS IN SUBSIDIARY, CONTROLLED OR AFFILIATED COMPANIES
>
> Recent times have evidenced an increasing interest on the part of insurers in acquiring or organizing subsidiary companies for expanded corporate activities. Some insurers have done this through the vehicle of a separate holding company, whereas others have accommodated this aspect of their corporate operations and expansion directly within the framework of an existing insurance company.

Increasing interest has also developed within the regulatory agencies of various states, as well as the National Association of Insurance Commissioners (NAIC), with respect to regulation of investments in subsidiaries and the valuation of such investments. State insurance regulators are also concerned about transactions and commitments among parent, subsidiary, controlled, and affiliated companies because of the potential for detrimental impacts upon a particular insurance company.

Within this chapter the term SCA is intended to include parent, subsidiary, controlled, and affiliated companies.

Investments in SCA companies include debt security loans to and preferred and common stock. In general, the accounting for each type of investment is the same as it would be for any other bond, preferred stock, or common stock investment except that there are some special valuation considerations.

Loans to SCA companies are accounted for in the same manner as any other private placement bond. Preferred stock and common stock investments in SCA companies are subject to valuation procedures described below under Valuation.

A subsidiary, controlled, or affiliated company is generally defined in terms of controlling ownership in a company’s voting capital stock. Ownership of more than 50% provides undisputed control and 80% or more is sufficient for inclusion in a consolidated U.S. federal income tax return. When 50% or less of the outstanding stock is owned, control is dependent upon the influence that the owner of that block of stock may have on the other holders of outstanding capital stock.

The NAIC instructions for the annual statement define a “person” as an individual, corporation, or any other legal entity. A parent is any person that, directly or indirectly, owns or controls the insurer. A “subsidiary” is any person that is, directly or indirectly, owned or controlled by the insurer. An “affiliate” is any person that is, directly or indirectly, owned or controlled by the same person or by the same group of persons that, directly or indirectly, own or control the insurer. The term affiliate includes parents and subsidiaries. Control and affiliated status shall be presumed to exist if a person, directly or indirectly, owns, controls, holds with the power to vote, or holds proxies representing 10% or more of the voting securities of any other person.

Allowable Investments

The insurance codes and regulations of the various states contain provisions setting forth the existing restrictions on investments in SCA companies by insurance companies and insurance holding companies. In general, a company may not invest, either directly or indirectly, an amount equal to or more than a certain percentage of its assets or its capital and surplus in the common stock of any one corporation. In the case of an investment in an insurance subsidiary, an insurance company may be allowed to invest amounts different from (generally in excess of) the amount allowable for investment in a non-insurance SCA company.

Valuation

The ultimate authority for SCA company valuation basis and procedures, as with other regulatory aspects of insurance operations, resides with the various state insurance departments. In practice, however, most states have come to utilize the provisions of the *Purposes and Procedures Manual of the NAIC Securities Valuation Office* for the valuation of SCA companies. The specific provisions in this manual represent the efforts and recommendations of the NAIC Valuation of Securities (EX4) Task Force, and have been approved by the NAIC.

As noted in the *Purposes and Procedures Manual of the NAIC Securities Valuation Office*, the principal alternatives for the valuation of common stock investments in SCA companies include:

1. Statutory capital and surplus value for an insurer whose common capital stock is not publicly traded.

2. Net worth of a non-insurance company, adjusted to use only those assets that would constitute admitted assets if owned directly by an insurance company.

3. Net worth of a non-insurance company provided the financial statements have been audited by an independent certified public accountant in accordance with generally accepted auditing standards. Such value shall be adjusted to reflect the equity in net assets on a statutory basis for any down-stream insurance subsidiary. Also, the value is subject to the limitations on goodwill and other intangible assets described below.

4. Cost adjusted to reflect subsequent operating results of the SCA company. Operating results for an insurer should be in accordance with statutory accounting requirements. Operating results of a non-insurance company should be from an independent certified public accountant's audited financial statement prepared in accordance with generally accepted accounting principles. Such value shall be adjusted to reflect the equity in net assets on a statutory basis for any down-stream insurance subsidiary. Any goodwill and other intangible assets are subject to the limitations described below.

5. Market value for a partially owned company that is listed and publicly traded on a national securities exchange or entered in the NASDAQ National Market System.

A valuation basis used shall be used consistently thereafter unless a change is substantiated as reasonable and approved in writing by the NAIC Securities Valuation Office staff.

An insurer which owns an interest in itself via direct ownership of shares of an upstream intermediate or ultimate parent must reduce the value of such shares for the reciprocal ownership. If the shares of the parent are owned indirectly by an insurer, via a down-stream subsidiary, controlled or affiliated company, the directly held company, which owns the parent's shares, will have its value reduced for the reciprocal ownership.

Any parent insurer which owns an interest in itself via either direct or indirect ownership of a down-stream affiliate, which in turn owns shares of the parent insurer, shall eliminate its proportionate interest in these shares from the valuation of such affiliate. The Securities Valuation Office provides a worksheet for both of these reciprocal ownership elimination computations.

Valuation of common stock investments in SCA companies should be computed after provision for the liquidation value for any preferred stock interest in the SCA company.

The alternatives for market valuation of preferred stock investments in SCA companies are generally similar to those for non-SCA preferred shares. However, preferred stocks of wholly owned subsidiaries of insurance companies are valued in the same manner as the common stock of subsidiaries. The current manual should be consulted for the specific valuation basis in effect and the restrictions applicable to each basis.

Valuation of a CMO special purpose subsidiary is discussed in Chapter 1.

The change in value of subsidiaries is reported as part of the unrealized capital gain due to the change in the difference between asset value and cost.

Goodwill and Other Intangible Assets

The following provisions with respect to goodwill and other intangible assets are applicable:

1. Goodwill is defined as the difference between the cost and the net asset value of the subsidiary acquired. If the acquired subsidiary is an insurance company, statutory basis net asset value is used.

2. The statutory admissible amount of goodwill and other intangible assets in aggregate is limited at all times to a maximum of 10% of an insurance company's statutory capital and surplus.

3. For valuation purposes, the period over which goodwill may be written off (amortized to zero) is limited to 10 years.

4. Some special transitional provisions are included for goodwill in connection with subsidiaries acquired or under contract to be acquired on or prior to June 14, 1972.

Reporting on SCA Companies

The *Purposes and Procedures Manual of the NAIC Securities Valuation Office* provisions for the valuation of common stock investments in SCA Companies include requirements for the submission of reports on each SCA company to the Securities Valuation Office.

An original filing is to be made within 30 days after the acquisition or formation of a SCA company.

Thereafter, an annual filing is due not later than April 1 of each year for each directly and indirectly owned SCA company.

Accounting for Subsidiaries

Under statutory insurance accounting principles, the equity method of accounting for a subsidiary is usually limited to asset valuation of the subsidiary. The prevailing practice is to recognize equity in the undistributed income as an unidentified part of the unrealized capital gain due to change in the difference between asset value and cost. The practice of including equity in the undistributed income of subsidiaries in net gain from operations of a life insurer is followed by a minority of life insurers.

Accounting for a subsidiary using the equity method of accounting means that the parent company may recognize, in its income statement, its equity in the income of the subsidiary when it is reported by the subsidiary.

Under prevailing statutory accounting principles and practices, the accounting for a common stock investment in a subsidiary is the same as the accounting for any other common stock. The only difference is in the manner of investment valuation. However, the asset value of the subsidiary is the same under either of the acceptable alternatives described above. Nevertheless, the inclusion of equity in undistributed income of subsidiaries in net gain from operations can lead to certain abuses and, therefore, companies opting for its use should adhere to the following guidelines.

1. An insurer shall not include equity in undistributed income of subsidiaries in net gain from operations for any subsidiary unless it has the ability to exercise significant influence over the operating and financial policies of the subsidiary. That ability is presumed to exist for subsidiaries for which 20 percent or more of voting control is owned and is presumed not to exist for subsidiaries for which less than 20 percent of voting control is owned (unless otherwise defined by the domiciliary state). Both presumptions may be overcome by predominant evidence to the contrary. The ability to exercise influence or control may be indicated in several ways, such as representation on the board of directors, participation in policy-making processes, material intercompany transactions, interchange of managerial personnel, or technological dependency.

2. If an insurer includes in net gain from operations the equity in undistributed income of subsidiaries from any subsidiary, the insurer shall apply that practice to all subsidiaries that meet or exceed the significant influence test of the preceding paragraph.

3. Prior to changing the method for any subsidiary, the insurer shall first obtain approval from its domiciliary regulatory authority.

4. The filing of such separate supplemental information as may be required to disclose the equity in the undistributed income of the subsidiary.

25. The Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies provides similar guidance as above with the exception that it does not allow a reporting entity the option of including the equity in undistributed net income of subsidiaries in operations.

26. The *Purposes and Procedures Manual of the NAIC Securities Valuation Office* provides the following guidance in Section 5, Procedures for Valuing Common Stocks and Stock Warrants:

(B) Common Stocks of Subsidiary, Controlled or Affiliated Companies.

(a) Subject to the requirements of Section 5(B)(b), shares of common stock of an insurance or non-insurance company owned by an insurer, which insurer is either the parent of, or under direct or indirect common control, or affiliated with the issuer of such stock, shall have an Association Value determined on the basis of one of the following bases, provided, however, that such basis and the resultant value are reasonable and appropriate in the circumstances, and provided further that an insurer shall not be required to value the common stock of all its subsidiary, controlled and affiliated companies on the same basis. All of the following valuation bases shall be subject to an adjustment for any reciprocal share holdings as required by Section 5(B)(b)(x).

(i) the value of only such of the assets of such company as would constitute lawful investments for the insurer if acquired or held directly by the insurer; or

(ii) subject to the limitations imposed herein and under Section 5(B)(b)(ix), hereunder, the shares of a non-insurance company may be valued on the basis of the net worth of such company determined in accordance with generally accepted accounting principles, as of the end of its most recent fiscal year, provided, subject to (b) hereof, that the financial statements of the company for its most recent fiscal year have been audited by an independent certified public accountant in accordance with generally accepted auditing standards (the common stock of an insurance company may not be valued under this section); or

(If the common stock of a subsidiary, controlled or affiliated company is valued on the basis of generally accepted accounting principles in accordance with the provisions of this section, such value shall be adjusted to reflect the equity in net assets on a statutory basis with respect to the shares of any underlying insurance company subsidiaries and to reflect the market value appropriately discounted for any underlying company valued using option 5(B)(a)(v)); or

(iii) book value, defined as in Section 5(A)(c), provided, however, that the common stock of a non-insurance company may not be valued on the basis of this subsection (iii); or

(iv) subject to the limitations imposed under Section 5(B)(b)(ix), hereunder, a value equal to the cost of the common stock of such company, provided such value is determined and adjusted to reflect subsequent operating results (1) in the case of insurance companies in accordance with statutory accounting requirements, and (2) for other than insurance companies from an independent certified public accountant audited financial statement prepared in accordance with generally accepted accounting principles; or

(If the common stock of a subsidiary, controlled, or affiliated company is valued on the basis of generally accepted accounting principles in accordance with the provisions of this section the adjustment "to reflect subsequent operating results" shall include net changes in all the capital and surplus accounts on a statutory basis with respect to the shares of any underlying insurance company subsidiaries); or

(v) the market value of the common stock of the company, if the stock is listed on a national securities exchange or entered in the NASDAQ System (other securities traded over-the-counter will not be considered under this section); The share price will be discounted for legal restrictions requiring a registration before any sale may be made and the size and depth of the trading activity in relation to the publicly traded shares outstanding; or

(vi) See Section 3(C)(2) for valuation of preferred stocks of wholly-owned subsidiaries of insurance companies.

(vii) In applying the provisions of this section to insurers organized in foreign countries, the provisions of Subsection (i) of this section will be applied (based on financial statements for the most recent fiscal year as prepared by an independent certified public accountant), except where special considerations indicate other treatment would be appropriate; or

(viii) Any other value which the insurer can substantiate to the satisfaction of the SVO staff as being a reasonable value.

(b) (i) The provisions of Section 5(B) shall in all cases be subject to the procedures prescribed by state insurance department practices or laws concerning the use of acquisition cost or any other basis for the valuation of common stocks of subsidiary, controlled or affiliated companies.

(ii) Not later than April 1 of each year, every insurer shall file with the SVO staff, on the appropriate form prescribed by the Valuation of Securities Task Force, (Task Force), relevant information identifying, supporting and justifying the value of, and the basis of valuation used in accordance with the provisions of Section 5(B)(a) for each of its subsidiary, controlled or affiliated companies reported upon in the Annual Statement for the preceding year.

(iii) Within thirty (30) days after the acquisition or formation of a subsidiary, controlled or affiliated company, every insurer shall file with the SVO staff, on the appropriate form prescribed by the Task Force, relevant information identifying, supporting and justifying the value of, and the basis of valuation used in accordance with the provisions of Section 5(B)(a) for such company.

(iv) A valuation basis used for a subsidiary, controlled or affiliated company shall thereafter be consistently applied unless a change is substantiated as reasonable and on that basis is approved in writing by the SVO staff.

(v) If a subsidiary, controlled or affiliated company is valued on the basis of Section 5(B)(a)(ii) and its books are not audited at the time the valuation is included in the insurer's annual statement, the insurer shall thereafter report to the SVO staff and explain the difference, if any, between the value of such company as reported in the annual statement and the value as determined by audit. Such report and explanation shall be made as soon as possible following such audit.

(vi) If the common stock of any subsidiary, controlled or affiliated company is valued other than on the basis of market value as defined in Section 5(B)(a)(v), there shall be deducted from the otherwise determined value a sum equal to the value claimed for any of its assets which would not constitute admitted assets for the insurer if held directly by the insurer, if such assets

(1) are held by the company but used, under a lease arrangement or otherwise, significantly in the conduct of the insurer's business; or

(2) were acquired from or purchased for the benefit or use of the insurer by the company under circumstances that, in the opinion of the SVO staff, support a finding that the primary purpose of such acquisition was the evasion or avoidance of state laws or regulations pertaining to non-admitted assets.

(vii) The SVO staff may require filings to be by the use of such forms as it prescribes and may request such supplemental information as it deems desirable. The SVO staff shall utilize the information in such filings and supplemental information to make its determination as to the reasonableness and appropriateness of the valuation basis and the resultant value and shall notify the insurer and its state of domicile of such determination.

(viii) In making its determination as to the reasonableness and appropriateness of the valuation basis and the resultant value for each subsidiary, controlled or affiliated company, the SVO staff shall, among other relevant factors, take into account the following:

(1) the effect of subsidiary valuation on the solvency of the insurer (it being the intent hereof that doubt as to reasonableness shall be resolved by selection of a conservative valuation standard in those circumstances where the higher valuation would make an otherwise insolvent insurer appear solvent);

(2) if the valuation involves acquisition cost, the degree of affiliation between the insurer and the party from whom such company was acquired, the form of the consideration (cash, property, or the exchange of stock), evidence of ability to recover cost, and whether the acquisition price represented the result of arms-length dealing between economic equals; and,

(3) whether revaluation of assets is involved, and the reasonableness thereof.

(ix) With respect to values determined under Sections 5(B)(a)(ii) and 5(B)(a)(iv), amounts attributable to goodwill, as defined in (a) hereunder, and other intangibles shall not, except as provided in (b), hereunder, in the aggregate (of all direct and indirect subsidiaries), exceed, (either initially upon the acquisition of a subsidiary, or thereafter), 10% of the capital and surplus of an insurer, as reported in its next preceding Annual Statement. Such amounts shall, except as provided in (c) and (d), hereunder, be written off over a period not in excess of 10 years, commencing in all cases with the accounting period ending December 31, 1972. (For instructions as to the manner of write-off in certain cases, see (e) and (f), hereunder.)

(a) For the purposes of this section, "goodwill" shall be defined as the amount arising at a given point in time, resulting from an arms-length transaction involving the transfer of a business, representing the difference between the value of the consideration given and the net asset value of the properties acquired on the books of the predecessor company. With respect to insurance company subsidiaries "net asset value" shall mean statutory or annual statement book value. In addition any asset account representing the present value of future contractual or estimated revenue streams will also be deemed goodwill and subject to the limitations of this section.

(b) The limitation with respect to the permissible amount of goodwill shall not apply in the cases of subsidiaries acquired or under contract to be acquired on or prior to June 14, 1972.

(c) The write-off period for goodwill in the cases of subsidiaries described in (b), above, may, upon application to and approval by the Securities Valuation Office, be extended to not in excess of 20 years.

(d) Where warranted in exceptional cases, the Securities Valuation Office may require a more rapid write-off of goodwill than is otherwise provided in this section.

(e) In the cases of subsidiaries acquired or under contract to be acquired on or prior to June 14, 1972, an insurer may charge the write-off of goodwill to the common stock component of the Asset Valuation Reserve, where such a reserve exists.

(f) In the cases of subsidiaries acquired after June 14, 1972, amounts of goodwill in excess of 10% of an insurer's capital and surplus shall be written off immediately by a direct charge to surplus.

(x) An insurer which owns an interest in itself via direct ownership of shares of an upstream intermediate or ultimate parent must reduce the value of such shares for the reciprocal ownership. When such shares are owned directly their value, as determined under any option of Section 5(B)(a), will be reduced by a percentage amount calculated by dividing the common stockholders equity of the owning insurer by the common stockholders equity of the parent whose shares are owned. A filing with the Securities Valuation Office under the provisions of Section 5(B)(b)(ii) is required. If the shares of the parent are owned indirectly by an insurer, via a downstream subsidiary, controlled, or affiliated (SCA) company, the value of the directly held SCA company which statutorily consolidates the SCA company, which owns the parent shares, into its annual statement will have its value reduced by an amount equal to the common stockholders equity of the SCA owner divided by the common stockholders equity of the parent company whose shares are owned, multiplied times the statement value of the parents shares on the books of the SCA company owning such shares.

Any parent insurer, which owns an interest in itself, i.e., treasury stock, via either direct or indirect ownership of a downstream insurance or non-insurance subsidiary controlled or affiliated (SCA) company which in turn owns shares of the parent insurer, shall eliminate its proportionate interest in these shares from the statutory value of such SCA company as determined under the provision of Section 5(B)(a) if owned directly or from the statutory value of the direct SCA company which consolidates on either a GAAP or Statutory accounting basis the results of the SCA company owning the parent insurer's shares.

(xi) The SVO staff may question the reasonableness and appropriateness of the valuation basis or the resultant value for any subsidiary, controlled or affiliated company, and if, after giving notice and opportunity to be heard, the staff determines that such basis or value is not, under the specific circumstances of the case, reasonable and appropriate, the staff shall report such determination to the insurer and to the insurance department of the state in which the insurer is domiciled and may recommend to such department either an adjustment in valuation or the use of one of the other specified bases of valuation. The SVO staff shall notify the insurance departments of all states of any such determinations or redetermination of value. The SVO staff shall also report such findings of value to the Task Force.

27. The NAIC Annual Statement Instructions (Annual Statement Instructions) provide the following guidance:

SCHEDULE D PART 6 - SECTION 1
VALUATION OF SHARES OF
SUBSIDIARY, CONTROLLED OR AFFILIATED COMPANIES

If an insurer has any common stock or preferred stock reported for any of the following required groups, categories, or subcategories it shall report the subtotal amount of the corresponding group, category or subcategory, with the specified subtotal line number appearing in the same manner and location as the pre-printed total or grand total line and number.

Group or Category	Line Number
Preferred Stock:	
Parent	0199999
U.S. Property & Casualty Insurer	0299999
U.S. Life Insurer	0399999
Alien Insurer	0499999
Non-Insurer Which Controls Insurer	0599999
*Investment Subsidiary	0699999
Other Affiliates	0799999
Subtotal - Preferred Stock	0899999
Common Stock:	
Parent	0999999
U.S. Property & Casualty Insurer	1099999
U.S. Life Insurer	1199999
Alien Insurer	1299999
Non-Insurer Which Controls Insurer	1399999
Investment Subsidiary	1499999
Other Affiliates	1599999
Subtotal - Common Stock	1699999
Total - Preferred and Common Stock	1799999

*NOTE: Investment Subsidiary shall mean any subsidiary, other than a holding company, engaged or organized primarily in the ownership and management of investments for the insurer. An investment subsidiary shall not include any broker dealer or a money management fund managing funds other than those of the parent company. The following criteria is applicable:

1. 95% or more of the investment subsidiary's assets would qualify as admitted assets;
2. The investment subsidiary's total liabilities are 5% or less of total assets;
3. Combining the pro-rata ownership shares of the assets of all the investment subsidiaries with the owning insurer's assets does not violate any state requirements concerning diversification of investments or limitations on investments in a single entity; and
4. The investment subsidiary's statement value does not exceed the imputed value on a statutory accounting basis. If the statement value does exceed the imputed statutory value, the insurer may either non-admit the excess or categorize such subsidiary in the "All Other Affiliates" category.

Column 1 - Description

List the preferred and common stock for each subsidiary, controlled, or affiliated (SCA) company, as defined in the General Section of the Annual Statement Instructions.

Description of preferred and common stock payable in a foreign currency should include the purchase price in that foreign currency.

All CUSIP numbers must conform to those published by the Securities Valuation Office (SVO). CUSIP numbers for all purchased publicly issued securities are available from the broker's confirmation or the certificate and will be identical to those used by the SVO. For private placement securities NAIC has created a special number called a PPN to be assigned by the Standard and Poor's CUSP Bureau.

NAIC numbers for privately placed (unregistered) securities (PPNs) owned prior to December 31, 1988, were made available to all insurers by the SVO in a special publication in early 1989 and are published in the December 31, 1989, and all subsequent versions of the Valuations of Securities manual. Number assignments for privately issued securities purchased subsequent to December 31, 1988, will be made by a special NAIC facility at the Standard and Poor's CUSP Bureau. Call the SVO (212 285-0010) for details. Such a number must be obtained and provided to the SVO before any privately issued security in can be listed in the Valuations of Securities manual.

Column 3 - NAIC Valuation Method

Include the NAIC valuation method as detailed in the *Purposes and Procedures Manual of the NAIC Securities Valuation Office*.

Any NAIC Valuation Method which has not been approved by the filing of a SUB 1 form with the NAIC Securities Valuation Office and which is entered by the insurer under its own judgment shall have the letter "Z" appended to the method designation.

Column 4 - Do Insurer's Admitted Assets Include Intangible Assets Connected with Holding of Such Company's Stock?

State whether the admitted assets shown by the insurer in this statement include, through the carrying value of stock of the SCA Company valued under the *Purposes and Procedures Manual of the NAIC Securities Valuation Office*, include intangible assets arising out of the purchase of such stock by the insurer or the purchase by the SCA Company of the stock of a lower-tier company controlled by the SCA Company. For purposes of this question, intangible assets at purchase shall be defined as the excess of the purchase price over the tangible net worth (total assets less intangible assets and total liabilities) represented by such shares as recorded, immediately prior to the date of purchase, on the books of the company whose stock was purchased.

Column 5 - If Yes, Amount of Stock Intangible Assets

If the answer in Column 4 is "Yes", give the amount of intangible assets involved. The intangible assets shown for the SCA Company should include any intangible assets which are included in the SCA Company's carrying value of the stock of one or more lower-tier companies controlled by the SCA Company. In all cases, the current intangible assets equal the intangible assets at purchase, as defined above, minus any write-off thereof between the date of purchase and the statement date. If the answer in Column 4 is "No", state "N/A" in Column 5.

Columns 7 and 8 - Stock of Such Company Owned by Insurer on Statement Date

State the number of shares of stock of the SCA Company owned by the insurer on the statement date, and the percent owned of the outstanding shares of the same class.

SCHEDULE D - PART 6 - SECTION 2

If an insurer has any common or preferred stock reported for any of the following required groups, categories, or subcategories, it shall report the subtotal amount of the corresponding group, category or subcategory, with the specified subtotal line number appearing in the same manner and location as the pre-printed total or grand total line and number.

Group or Category	Line Number
Preferred Stock	0199999
Common Stock	0299999
Total - Preferred and Common Stock	0399999

Column 1 - Name of Lower-Tier Company

List each company which is controlled by an SCA Company by means of a holding of a controlling block of the outstanding stock, either directly or through one or more intervening companies which are also so controlled. Do not include companies which are themselves SCA Companies listed in Section 1.

Column 2 - Name of Company Listed in Section 1 Which Controls Lower-Tier Company

If more than one SCA Company controls the lower-tier company, list each SCA Company and complete Columns 3 through 5 separately for each.

Column 3 - Amount of Intangible Assets Included in Amount Shown in Column 5, Section 1

As explained in the instructions for Section 1, this amount is based on the intangible assets at purchase of the stock of the lower-tier company, reduced by any subsequent write-off. The amount shown is also based on the proportionate ownership of the lower-tier company by the reporting insurer.
Columns 4 and 5 - Stock in Lower-Tier Company Owned Indirectly by Insurer on Statement Date

These figures represent the proportionate ownership by the reporting insurer through the particular SCA Company.

Generally Accepted Accounting Principles

28. APB 18 requires the equity method of accounting when the investors' voting stock gives it the ability to exercise significant influence over operating and financial policies even though the investor holds 50% or less of the voting stock. Otherwise the cost method is required. APB 18 also requires disclosure of subsidiary information if significant in relation to investor's financial position or results of operations. Rather than repeat APB 18 in the Relevant GAAP Literature Section of this paper a summary from The Current Text - Section I82 - Investments: Equity Method is provided.

INVESTMENTS: EQUITY METHOD SECTION I82

Sources: APB Opinion 18; AICPA Interpretations of APB Opinion 18; FASB Statement 58; FASB Statement 94; FASB Statement 109; FASB Statement 115; FASB Interpretation 35; FASB Technical Bulletin 79-19

Summary

The equity method is a method of accounting for investments. An investor using the equity method initially records an investment at cost. Subsequently, the carrying amount of the investment is increased to reflect the investor's share of income of the investee and is reduced to reflect the investor's share of losses of the investee or dividends received form the investee. The investor's share of the income or losses of the investee is included in the investor's net income as the investee reports them. Adjustments similar to those made in preparing consolidated financial statements, such as elimination of intercompany gains and losses and amortization of the difference between cost and underlying equity in net assets, also are applicable to the equity method. Under the equity method, and investment in common stock is generally shown in the balance sheet of an investor as a single amount. Likewise, an investor's share of earnings or losses from its investment is ordinarily shown in its income statement as a single amount.

This section requires that an investor use the equity method to account for investments in corporate joint ventures. This section also requires use of the equity method to account for other investments in common stock if the investor has the ability to exercise significant influence over operating and financial policies of the investee enterprise. That ability is presumed to exist for investments of 20 percent or more and is presumed not to exist for investments of less than 20 percent; both presumptions may be overcome by predominant evidence to the contrary.

29. *FASB Interpretation No. 35*, *Criteria for Applying the Equity Method of Accounting for Investments in Common Stock an Interpretation of APB Opinion No. 18*, provides the following guidance:

INTRODUCTION

1. The Board has been asked to clarify the provisions of *APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock,* regarding application of that method to investments of 50 percent or less of the voting stock of an investee enterprise (other than a corporate joint venture).

INTERPRETATION

2. Opinion 18 requires that the equity method of accounting be followed by an investor whose investment in voting stock gives it the ability to exercise significant influence over operating and financial policies of an investee. The presumptions in paragraph 17 of Opinion 18 are intended to provide a reasonable degree of uniformity in applying the equity method. The presumptions can be overcome by predominant evidence to the contrary.

3. Evidence that an investor owning 20 percent or more of the voting stock of an investee may be unable to exercise significant influence over the investee's operating and financial policies requires an evaluation of all the facts and circumstances relating to the investment. The presumption that the investor has the ability to exercise significant influence over the investee's operating and financial policies stands until overcome by predominant evidence to the contrary. [1]

[1] Subject to the limitations on the use of the equity method identified in footnote 4 of Opinion 18. That footnote states that conditions that represent limitations on consolidation shall be applied as limitations to the use of the equity method.

4. Examples of indications that an investor may be unable to exercise significant influence over the operating and financial policies of an investee include:

a. Opposition by the investee, such as litigation or complaints to governmental regulatory authorities, challenges the investor's ability to exercise significant influence.

b. The investor and investee sign an agreement under which the investor surrenders significant rights as a shareholder. [2]

[2] See paragraph 9 of this Interpretation for a discussion of such agreements.

c. Majority ownership of the investee is concentrated among a small group of shareholders who operate the investee without regard to the views of the investor.

d. The investor needs or wants more financial information to apply the equity method than is available to the investee's other shareholders (for example, the investor wants quarterly financial information from an investee that publicly reports only annually), tries to obtain that information, and fails. [3]

[3] The subject of in ability to obtain financial information also is addressed in the American Institute of Certified Public Accountants' Codification of Statements on Auditing Standards, AU Section 332, "Evidential Matter for Long-Term Investments," paragraph 9.

e. The investor tries and fails to obtain representation on the investee's board of directors.

This list is illustrative and is not all-inclusive. None of the individual circumstances is necessarily conclusive that the investor is unable to exercise significant influence over the investee's operating and financial policies. However, if any of these or similar circumstances exists, an investor with ownership of 20 percent or more shall evaluate all facts and circumstances relating to the investment to reach a judgment about whether the presumption that the investor has the ability to exercise significant influence over the investee's operating and financial policies is overcome. It may be necessary to evaluate the facts and circumstances for a period of time before reaching a judgment.

EFFECTIVE DATE AND TRANSITION

5. The provisions of this Interpretation shall be effective for fiscal years beginning after June 15, 1981, with earlier application encouraged. Changes in the method of accounting for investments required by this Interpretation shall be recorded in accordance with paragraphs 19 (1) and (m) of Opinion 18, which provide that:

a. If the investor discontinues application of the equity method, the earnings and losses of the investee that were previously accrued shall remain as part of the carrying amount of the investment. The carrying amount of the investment shall not be adjusted retroactively.

b. If the investor begins applying the equity method, the investment, results of operations (current and prior periods presented), and retained earnings of the investor shall be adjusted retroactively.

This Interpretation was adopted by the unanimous vote of the seven members of the Financial Accounting Standards Board following submission to the Financial Accounting Standards Advisory Council.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 6, *Investments in Subsidiary, Controlled and Affiliated Companies*
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 6, *Investments in Subsidiary, Controlled and Affiliated Companies*
- *Purposes and Procedures Manual of the NAIC Securities Valuation Office*, Section 5, *Procedures for Valuing Common Stocks and Stock Warrants*
- *Issue Paper No. 1—Consolidation of Majority-Owned Subsidiaries*
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 48—Investments in Joint Ventures, Partnerships and Limited Liability Companies*
- *Issue Paper No. 68—Business Combinations and Goodwill*

Generally Accepted Accounting Principles

- *Accounting Principles Board Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock*
- *FASB Interpretation No. 35, Criteria for Applying the Equity Method of Accounting for Investments in Common Stock an Interpretation of APB Opinion No. 18*
- *FASB Technical Bulletin 79-19, Investor's Accounting for Unrealized Losses on Marketable Securities Owned by an Equity Method Investee*
- *FASB Emerging Issues Task Force No. 87-21, Change of Accounting Basis in Master Limited Partnership Transactions*
- *FASB Emerging Issues Task Force No. 96-16, Investor's Accounting for an Investee When the Investor Owns a Majority of the Voting Stock but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights*

State Regulations

- No additional guidance obtained from state statutes or regulations.

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Statutory Issue Paper No. 47

Uninsured Plans

STATUS
Finalized June 23, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 47

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. The Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies (Life/A&H and P & C Accounting Practices and Procedures Manuals) provide guidance on the recording and reporting of transactions related to uninsured plans. GAAP does not specifically address these types of transactions.

2. The purpose of this issue paper is to establish statutory accounting principles for Administrative Services Only (ASO), Administrative Services Contract (ASC) and Medicare or similarly structured cost based reimbursement contracts that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

3. For purposes of this issue paper, uninsured accident and health plans, including HMO administered plans, and uninsured property and casualty plans (collectively referred to as uninsured plans) are defined as plans for which a reporting entity as an administrator, performs administrative services such as claims processing for a third party that is at risk, and accordingly, the administrator has not issued an insurance policy, regardless of whether an identification card is issued. In the case of uninsured accident and health plans, the administrator may arrange for the provision of medical services through a contracted or employed provider network. The plan (whether insured by another reporting entity or self insured) bears all of the insurance risk, and there is no possibility of loss or liability to the administrator caused by claims incurred related to the plan. The administrator, however, may be subject to credit risk with regard to the risk bearing entity. An uninsured accident and health plan may be either an ASO plan or an ASC plan. Under an ASO plan, claims are paid from a bank account owned and funded directly by the uninsured plan sponsor; or, claims are paid from a bank account owned by the reporting entity, but only after the reporting entity has received funds from the uninsured plan sponsor that are adequate to fully cover the claim payments. Under an ASC plan, the reporting entity pays claims from its own bank accounts, and only subsequently receives reimbursement from the uninsured plan sponsor. No arrangement where the reporting entity receives a capitated payment for providing medical services to a third party shall qualify as an insured plan.

4. Uninsured accident and health plans also include Federal, state or other government department funded programs such as Medicare cost contracts where there is no underwriting risk to the reporting entity. Under Medicare cost contracts, service provided to recipients includes the direct delivery of health care for which the reporting entity is reimbursed based on costs incurred as provided for in regulations governing the administration of such contracts. Other such programs may include some Medicaid and Champus contracts for which administration or other non-underwriting services are provided.

5. Partially insured or combination plans exist, under which the reporting entity issues an insurance policy for some of the risks related to the claims (e.g. minimum premium and stop-loss plans), but acts as

an administrator for some, or all, of the claims paid by the plan. Such plans shall be treated as two plans: an insured plan (the part for which the reporting entity has issued a policy) and an uninsured plan (the part that meets the definition in paragraph 3 of this issue paper). The components related to uninsured plans shall be accounted for using the accounting principles established in this issue paper; the components related to insured plans shall be accounted for as insurance.

Revenue/Expense Recognition

6. The administrator's statement of operations shall exclude all income and expenses related to claims, losses, premiums, and other amounts received or paid on behalf of uninsured ASO or uninsured ASC plans. An administrator acting as a provider of services, that provides such services through a salaried network, where the cost allocation of the service provided to insured vs. uninsured plans cannot be reasonably determined, shall report medical and hospital expenses on a gross basis by type of expense and report revenue from uninsured plans on a gross basis as fee for service income.

7. Commissions, expenses, and taxes paid by the administrator to administer such plans shall be reported on a gross basis by type of expense. Where the only functions provided are administrative, administrative fees and related reimbursements from the plan shall be deducted from general expenses. Where the reporting entity provides both administration and health care services directly, income from Medicare or similarly structured cost based reimbursement contracts is not recorded as premium but is recorded as revenue on the appropriate line. Health care services rendered as “medical and hospital” categorized by type and administrative expenses by type of expense shall be reported on an incurred basis. Income from cost based reimbursement contracts is recorded as revenue because the service provided is for the direct delivery of care to recipients. There are risks associated with these plans in that all costs incurred under the contract may not be reimbursable and revenues may be adjusted based on subsequent challenges of costs included in filed cost reports. In addition, revenue may also be adjusted based on the performance under the terms of the contract or other external factors.

Amounts Receivable

8. Amounts receivable from uninsured plans for (a) claims and other costs paid by the administrator on behalf of the third party at risk and (b) fees related to services provided by the administrator to the plan meet the definition of assets as set forth in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*. A receivable shall not be recorded for unpaid claims. A receivable related to Medicare or a similarly cost based reimbursement contract shall only be recorded when services have been rendered.

9. An evaluation shall be made of the amounts receivable to determine any nonadmitted amounts. Next, an evaluation shall be made in accordance with *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets* (Issue Paper No. 5), to determine whether there is an impairment. This two step process is set forth below:

a. Uncollected uninsured plan receivables (excluding Medicare and similar government plans) over ninety days due shall be accounted for as a nonadmitted asset;

b. Remaining amounts determined to be uncollectible shall be written off. If in accordance with Issue Paper No. 5, it is probable the amount receivable is uncollectible, any uncollectible amount receivable shall be written off against operations in the period such determination is made. If it is reasonably possible a portion of the balance is uncollectible and is therefore not written off, disclosure requirements outlined in Issue Paper No. 5 shall be followed. This evaluation may consider irrevocable letters of credit to which the administrator is beneficiary, amounts on deposit with the administrator or other unrestricted funds available to the administrator.

10. The following shall provide additional guidance in determining the nonadmitted portion of amounts receivable from uninsured plans:

a. Amounts classified as nonadmitted assets collected subsequent to the date of the statutory financial statements shall not be used to decrease the nonadmitted asset otherwise calculated;

b. The due date is governed by the contractual billing date of the uninsured plan;

c. Medicare and similar government funded plans - Amounts due related to Medicare and similar government plans shall not be nonadmitted when they become over ninety days due. Appropriate reserves shall be established to cover costs incurred which may not be reimbursed upon final determination by the governing agencies under the cost contract or for adjustments to revenues based on performance under the terms of the contract or other external factors.

Liabilities

11. A liability shall be established for funds held by an administrator in its general assets for the benefit of an insured plan, or for funds which may be owed by the administrator in connection with the administration of an uninsured plan. A liability relating to one plan shall not be offset by an asset relating to a different plan. Administrators shall not record aggregate reserves, claim/loss reserves, or liabilities (except for Medicare or similarly structured cost based reimbursement contracts) for any other claim costs paid by the administrator on behalf of uninsured plans.

Disclosure

12. The statutory financial statements shall provide the following:

a. Information with regard to the profitability to the administrator of all ASO plans and the uninsured portions of partially insured plans for which the reporting entity serves as an ASO administrator;

For the total and each category separately provided: (i) net reimbursement for administrative expenses (including administrative fees) in excess of actual expenses, (ii) total net other income or expense (including interest paid to or received from plans), (iii) total net gain or loss from operations and (iv) the claim and reimbursement volume;

b. Information with regard to the profitability to the administrator of all ASC plans and the uninsured portions of partially insured plans for which the reporting entity serves as an ASC administrator;

For the total and each category separately provided: (i) gross reimbursement for medical cost incurred, (ii) gross administrative fees accrued, (iii) other income or expense (including interest paid to or received from plans), (iv) gross expenses incurred (claims and administrative) and (v) total net gain or loss from operations.

c. Information with regards to Medicare or similarly structured cost based reimbursement contracts shall include: (i) major components of revenue by payor, (ii) receivables from payors with account balances the greater of 10% of gross Health Care Receivables or $10,000, (iii) recorded allowances and reserves for adjustment of recorded revenues, (iv) adjustments to revenue resulting from audit of receivables related to revenues recorded in the prior period.

DISCUSSION

13. The conclusion above adopts existing statutory accounting guidance for uninsured accident and health plans and extends this guidance to other uninsured plans. The current statutory accounting disclosure requirements were expanded to include claim and reimbursement volume.

14. The Statement of Concepts states:

> The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which may be unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet but rather should be charged against surplus when acquired or when availability otherwise becomes questionable.

15. Based upon the above concept, ASO, ASC and Medicare or similarly structured cost based reimbursement contract, plan assets and liabilities should reflect only amounts that are available to meet both current and future policyholder obligations and obligations of the reporting entity, respectively.

16. Under the conservatism concept of statutory accounting, ASO and ASC plan receivables which are over ninety days due, shall be treated as nonadmitted assets and charged to surplus. In keeping with the concept of conservatism, subsequent collection of nonadmitted assets shall not be considered in the determination of period-end nonadmitted assets. These recoveries shall be accounted for in the period received.

Drafting Notes/Comments

- Accounting for claims of insured plans are addressed in *Issue Paper No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses.*
- Accounting for property and casualty high deductible and retrospective insurance contracts are addressed in *Issue Paper No. 65—Property and Casualty Contracts* and *Issue Paper No. 66—Accounting for Retrospectively Rated Contracts*, respectively.
- Accounting for Medicare and Medicaid Risk Contracts are addressed in *Issue Paper No. 54—Individual and Group Accident and Health Contracts.*

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

17. Chapter 8, Other Admitted Assets*,* of the Life/A&H Accounting Practices and Procedures Manual discusses uninsured accident and health plans as follows:

> Some insurers may act as administrators of accident and health plans under which the plans bear all of the risk of claims. Such plans are commonly termed administrative services only plans and are described in this manual as uninsured plans. The definition of risk used here for the purpose of classifying funding arrangements as they relate to the insurer is the possibility of liability to the insurer due to claims under an accident and health plan.
>
> In addition to plans under which there is no risk to the insurer, there are also partially insured or combination plans. Such plans may include, but are not limited to, plans described as minimum premium, cost-plus/stop-loss, or other similar names. For purposes of statutory financial statement reporting, combination plans or partially insured plans should be treated as, in effect, two plans: one insured and one uninsured. For accounting purposes, the components of a partially insured plan which are applicable to insured benefits should be classified as one would any insured plan. Those components which are related to uninsured and administrative services only should be treated as if they apply to an uninsured plan.

> A receivable from a plan relating to uninsured business must be reported as an asset and may not include amounts relating to claims unpaid by the insurer. Balances due and unpaid in excess of three months, except for those relating to Medicare or similar government plans, must be deducted as not admitted. Correspondingly, a liability must be established for a plan for which an insurer holds funds in its general assets or to which funds may be owed by the insurer, including funds due to certificate holders. An asset relating to one plan may not be offset by a liability relating to a different plan.

18. Chapter 13, Other Liabilities, of the P & C Accounting Practices and Procedures Manual contains similar guidance.

19. Chapter 13, Aggregate Reserves for Accident and Health Policies, of the Life/A&H Accounting Practices and Procedures Manual discusses aggregate reserves for uninsured accident and health plans as follows:

> The insurer's aggregate reserves should not include any amounts arising from uninsured accident and health plans or the uninsured portion of partially insured plans. The insured portion of any partially insured plan should be treated as any other insured plan with appropriate reserves established.

20. Chapter 10, Losses, of the P & C Accounting Practices and Procedures Manual discusses reserves for uninsured accident and health plans as follows:

> The insurers loss reserves should not include any amounts arising from uninsured accident and health plans or the uninsured portion of partially insured plans. The insured portion of any partially insured plan should be treated as any other insured plan with appropriate loss and loss adjustment expense reserves established.

21. Chapter 14, Accident and Health Claims, of the Life/A&H Accounting Practices and Procedures Manual discusses claim reserves for uninsured accident and health plans as follows:

> The insurers claim reserves should not include any amounts arising from uninsured accident and health plans or the uninsured portion of partially insured plans. The insured portion of any partially insured plan should be treated as any other insured plan with appropriate reserves established. This is the same treatment described with regard to aggregate reserves in Chapter 13.

22. Chapter 17, Other Liabilities, of the Life/A&H Accounting Practices and Procedures Manual discusses establishing a liability for uninsured accident and health plans as follows:

> Liability for Amounts Held Under Uninsured Accident and Health Plans
>
> A liability must be established for a plan for which an insurer holds funds in its general assets or to which funds may be owed by the insurer, including funds due to certificate holders. A liability relating to one plan may not be offset by an asset relating to a different plan.

23. Chapter 18, Premium Income, of the Life/A&H Accounting Practices and Procedures Manual discusses premium recognition on uninsured accident and health plans as follows:

> Amounts related to uninsured plans or the uninsured portion of partially insured plans must not be reported in premiums. Conversely income relating to the insured portion of any plan must be reported as premiums.

24. Chapter 14, Premiums, of the P & C Accounting Practices and Procedures Manual contains similar guidance.

25. Chapter 20, Policy and Contract Benefits, of the Life/A&H Accounting Practices and Procedures Manual discusses paying claims for uninsured accident and health plans as follows:

> Claims paid by the insurer under uninsured accident and health plans and the uninsured portion of partially insured accident and health plans should not be reported in the Summary of Operations. Claims payments under the insured portion of partially insured plans are reported as accident and health benefits.

26. Chapter 17, Loss and Loss Adjustment Expenses Incurred, of the P & C Accounting Practices and Procedures Manual discusses losses paid on uninsured accident and health plans as follows:

> Losses paid by the insurer under uninsured accident and health plans should not be reported in the underwriting and investment exhibits. Loss payments under the insured portion of partially insured plans are reported as accident and health losses.

27. Chapter 22, General Expenses and Taxes, Licenses and Fees, of the Life/A&H Accounting Practices and Procedures Manual discusses expenses of uninsured accident and health plans as follows:

> Uninsured accident and health plans have been discussed in prior chapters of this manual. Commissions, expenses, and taxes incurred by the insurer for such plans are to be reported on a gross basis by type of expense; however, administration fees and expense reimbursements relating to uninsured business are deducted in the general expense exhibit and general insurance expenses are to be reported in the Summary of Operations net of such fees and reimbursements.

28. Chapter 19, Expenses, of the P & C Accounting Practices and Procedures Manual contains similar guidance.

29. The NAIC Annual Statement Instructions for Property and Casualty Insurance Companies, the NAIC Annual Statement Instructions for Life, Accident and Health Insurance Companies and the NAIC Annual Statement Instructions for Health Maintenance Organizations include the following disclosure requirements:

> Gain or Loss to the Insurer from Uninsured A&H Plans and the Uninsured Portion of Partially Insured Plans
>
> Instruction:
>
> Provide information with regard to the profitability to the insurer (HMO) of uninsured accident and health plans and the uninsured portions of partially insured plans for which the company serves as administrator. For the total and each category separately provided: (1) net reimbursement for administrative expenses (including administrative fees) in excess of actual expenses, (2) total net other income or expense (including interest paid to or received from plans), and (3) total net gain or loss from operations.

Illustration:

The gain from operations from uninsured accident and health plans and the uninsured portion of partially uninsured plans was as follows during 19XX:

	(1)	(2)	(3)
	Uninsured Plans	Uninsured Portion of Partially Insured Plans	Total
i. Net reimbursement for administrative expenses over (under) actual expenses	$	$	$
ii. Other income or (expenses)	$	$	$
iii. Net gain or (loss) from operations	$	$	$

Generally Accepted Accounting Principles

30. There is no GAAP guidance specifically addressing Administrative Services Only plans.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapters 8, 13, 14, 17, 18, 20 and 22
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapters 10, 13, 14, 17 and 19
- NAIC Annual Statement Instructions for Property and Casualty Companies
- NAIC Annual Statement Instructions for Life, Accident and Health Insurance Companies
- NAIC Annual Statement Instructions for Health Maintenance Organizations

Generally Accepted Accounting Principles

- None

State Regulations

- No additional guidance obtained from state statutes or regulations.

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Statutory Issue Paper No. 48

Investments in Joint Ventures, Partnerships and Limited Liability Companies

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 48

> *Wholly-owned single real estate property in an LLC was scoped out of SSAP No. 48 by Issue Paper No. 149 and included within SSAP No. 40R.*

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory accounting guidance for investments in joint ventures and partnerships specifies the equity method of accounting and is provided in the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies. Current statutory accounting guidance does not address accounting for investments in limited liability companies.

2. GAAP addresses accounting for investments in partnerships and joint ventures in Accounting Interpretation of *APB Opinion No. 18*, *The Equity Method of Accounting for Investments in Common Stocks* (AIN APB 18). Although the interpretation states that *Accounting Principles Board Opinion No. 18*, *The Equity Method of Accounting for Investments in Common Stocks,* (APB 18) does not apply to investments in partnerships and joint ventures it suggests that many provisions of APB 18 may be applicable. As a result current practice generally is to account for such investments under the equity method.

3. The purpose of this issue paper is to establish statutory accounting principles for investments in joint ventures, partnerships, and limited liability companies that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. This issue paper addresses accounting for investments in any joint venture, partnership, or limited liability company whether or not it is considered to be controlled by or affiliated with the reporting entity.

5. Investments in joint ventures shall include investments in corporate joint ventures, and unincorporated joint ventures (also referred to as undivided interests in ventures). A corporate joint venture shall be defined as a corporation owned and operated by a small group (the joint venturers) as a separate and specific business or project for the mutual benefit of the members of the group. A corporate joint venture usually provides an arrangement under which each joint venturer may participate, directly or indirectly, in the overall management of the joint venture. Joint venturers thus have an interest or relationship other than as passive investors. An unincorporated joint venture is similar in its purpose but is not incorporated.

6. Investments in partnerships shall include investments in general partnership interests, and limited partnership interests. A general partnership shall be defined as an association in which each partner has unlimited liability. Each partner assumes joint and several liability for all partnership debts. A limited partnership shall be defined as a partnership having two classes of partners: (a) general partners who manage the partnership, subject to the partnership agreement, and have personal liability for the general obligations of the partnership and (b) limited partners who are passive investors and have no personal liability beyond their investment.

7. A limited liability company shall be defined as a form of business organization which is a hybrid of a corporation and partnership whereby the owners have limited liability like a corporation and profits may pass through to the owners for tax purposes like a partnership if certain criteria are met. The owner's personal liability is limited to his own acts and the owners can fully participate in the management of the business with no adverse impact on their limited liability.

8. Investments in the ventures which are defined in paragraphs 5 through 7 meet the definition of assets defined in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this paper. Investments in joint ventures, partnerships and limited liability companies shall be included in Other Invested Assets in the financial statements.

9. Investments in such ventures, except for limited partnerships with a minor ownership interest, shall be reported using an equity method as defined in paragraphs 7 through 13 of *Issue Paper No. 46—Accounting for Investments in Subsidiary, Controlled and Affiliated Entities* (Issue Paper No. 46). Limited partnerships in which the entity has a minor ownership interest (i.e., less than 10%) shall be recorded based on the underlying audited GAAP equity of the investee. The amount to be recorded shall be defined as the initial investment in an investee at cost (as defined in paragraph 7 of *Issue Paper No. 68—Business Combinations and Goodwill*). The carrying amount of the investment shall be adjusted to recognize the reporting entity's share of the audited GAAP basis earnings or losses of the investee after the date of acquisition, adjusted for any distributions received. A reporting entity's share of adjustments that are recorded directly to the investee's stockholder's equity under GAAP shall also be recorded as adjustments to the carrying value of the investment with an offsetting amount recorded to unrealized capital gains and losses on investments. The reporting entity's share of undistributed earnings and losses of the investee shall be included in unrealized gains and losses of the reporting entity. The reporting entity's share of other changes in the investee's surplus (e.g., the change in the investee's nonadmitted assets) shall be recorded by the investor as a component of unrealized capital gains and losses on investments. Distributions received from an investee shall be recognized in investment income when declared to the extent they are not in excess of the undistributed accumulated earnings attributable to the investee. If distributions declared exceed the investor's share of undistributed accumulated earnings after the date of the investment, this excess portion of the distribution shall be applied to reduce the carrying value of the investment.

Impairment

10. For any decline in the fair value of an investment in a joint venture, partnership or limited liability company which is determined to be other than temporary, the investment shall be written down to fair value as the new cost basis and the amount of the write down shall be accounted for as a realized loss. The write down shall first be considered as an adjustment to any portion of the investment that is nonadmitted (e.g., goodwill). The new cost basis shall not be changed for subsequent recoveries in fair value. Future declines in fair value, which are determined to be other than temporary, shall be recorded as realized losses. This is consistent with *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets.* An impairment shall be considered to have occurred if it is probable that the reporting entity will be unable to recover the carrying amount of the investment or there is evidence indicating inability of the investee to sustain earnings which would justify the carrying amount of the investment. Even if the fair value of an investment is below the carrying amount it is not necessarily indicative of a loss in value that is other than temporary. Similarly the existence of investee operating losses may indicate a loss in value; however, it is not necessarily indicative of a loss in value that is other than temporary. All factors shall be considered in determining whether a loss in value is other than temporary.

Disclosures

11. The significance of an investment to the reporting entity's financial position and results of operations shall be considered in evaluating the extent of disclosures of the financial position and results of operations of an investee. Disclosures as follow shall be made for all investments in joint ventures,

partnerships, or limited liability companies that exceed 10% of the total admitted assets of the reporting entity:

a. Financial statements of a reporting entity shall disclose (1) the name of each joint venture, partnership or limited liability company and percentage of ownership, (2) the accounting policies of the reporting entity with respect to investments in joint ventures, partnerships and limited liability companies and (3) the difference, if any, between the amount at which the investment is carried and the amount of underlying equity in net assets (i.e., nonadmitted goodwill or other nonadmitted assets) and the accounting treatment of the difference.

b. For those joint ventures, partnerships and limited liability companies for which a quoted market price is available, the aggregate value of each joint venture, partnership or limited liability company investment based on the quoted market price shall be disclosed.

c. Summarized information as to assets, liabilities, and results of operations shall be presented for joint ventures, partnerships and limited liability companies either individually or in groups.

12. Any commitment or contingent commitment to a joint venture, partnership or limited liability company shall be disclosed (e.g., guarantees or commitments to provide additional capital contributions).

13. A reporting entity that recognizes an impairment loss shall disclose the following in the financial statements that include the period of the impairment write down:

a. A description of the impaired assets and the facts and circumstances leading to the impairment.

b. The amount of the impairment and how fair value was determined.

DISCUSSION

14. The statutory accounting principles described in paragraphs 8 through 13 above are consistent with current statutory accounting except as follows:

- Current statutory accounting guidance addresses accounting for investments in partnerships and joint ventures but does not address accounting for investments in limited liability companies.
- Current statutory accounting guidance does not address accounting or disclosures for other than temporary impairments .
- Current statutory accounting guidance allows the reporting entity's equity in the net earnings of the investee to be recorded, in certain situations, as net investment income.

15. The statutory accounting principle described in paragraph 9 above is inconsistent with the GAAP promulgated in paragraph 17 of APB 18 which specifies "an investment of less than 20% of the voting stock of an investee should lead to a presumption that an investor does not have the ability to exercise significant influence unless such ability can be demonstrated. APB 18 is addressed in its entirety and rejected in Issue Paper No. 46. The related interpretation of APB 18, AIN APB 18, is also rejected.

16. The statutory accounting principles referred to in paragraph 9 above with respect to limited partnerships with a minor interest are inconsistent with GAAP guidance described in paragraph 8 of *AICPA Statement of Position 78-9, Accounting for Investments in Real Estate Ventures* (SOP 78-9),

which requires the use of the cost method for investments in limited partnerships where the limited partner's interest is so minor that the limited partner may have virtually no influence over the operating and financial policies. The remaining guidance in SOP 78-9 promotes the accounting prescribed under APB 18 which has been rejected in the above paragraph, therefore this issue paper rejects SOP 78-9.

17. The statutory accounting principles described in the conclusion above apply to limited liability companies. Limited liability companies are a form of business organization, authorized by statute in certain states, characterized by limited liability, management by members or managers, and limitations on the transferability of ownership interest. Limited liability companies have the potential for taxability as partnerships for federal income tax purposes. Although limited liability companies provide members with limited personal liability (traditionally available only to corporations and certain hybrids), this new form of organization typically has more qualities of a partnership than of a corporation. As a result, the accounting for investments in such organizations shall follow the accounting for investments in partnerships. This is consistent with the underlying characteristics of these entities which indicate that they generally have more qualities of a partnership than of a corporation.

18. The statutory accounting principles outlined in the conclusion above are consistent with the conservatism and recognition concepts in the Statement of Concepts. Pertinent excerpts follow:

> Conservatism
>
> Conservative valuation procedures provide protection to policyholders against adverse fluctuations in financial condition or operating results. Statutory accounting should be reasonably conservative over the span of economic cycles and in recognition of the primary responsibility to regulate for financial solvency. Valuation procedures should, to the extent possible, prevent sharp fluctuations in surplus.
>
> Recognition
>
> The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which are unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet but rather should be charged against surplus when acquired or when availability otherwise becomes questionable.
>
> Revenue should be recognized only as the earnings process of the underlying underwriting or investment business is completed. Accounting treatments which tend to defer expense recognition do not generally represent acceptable SAP treatment.

Drafting Notes/Comments

- Accounting for business combinations with a venture are addressed in *Issue Paper No. 68—Business Combinations and Goodwill.*
- Accounting for investments in subsidiary, controlled or affiliated entities and definition of the equity method of accounting for statutory accounting principles are addressed in *Issue Paper No. 46—Accounting for Investments in Subsidiary, Controlled and Affiliated Entities*.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

19. The Accounting Practices and Procedures Manual for Life and Accident and Health and Property and Casualty Insurance Companies provides the following guidance:

> Chapter 8 - Other Admitted Assets
>
> Partnerships and Joint Ventures

One investment alternative for insurers is the partnership or joint venture with equity interest in real estate, securities, petroleum and other assets. Real estate partnerships or joint ventures are the most predominant and include investments in apartment complexes, office buildings, shopping centers, mass housing projects, condominiums, and land purchases and sales.

A typical venture will be between partners who offer capital or expertise, or both, to invest in the undertaking. In such a venture, the partners usually are an insurance company (which provides the equity) and a developer (who provides the technical skill and performs the actual work).

The investment made by the insurance company can be the equity investment in the property being developed and/or the permanent financing of the venture (a mortgage loan). The equity investment is returned to the company through its share of cash contributions.

Each venture must maintain its own accounting records that report venture assets, liabilities, partnership equities, and operating income in conformity with generally accepted accounting principles. These are accounting records of the venture and not of the insurance company.

The accounting of a partnership or joint venture is similar to statutory accounting for a subsidiary on the equity method. (See Chapter 6.) Under the equity method of accounting the investment is carried in the balance sheet at the amount invested, plus the investing company's share of undistributed operating results.

There are three types of transactions affecting the insurance company's equity investment in the venture. These are:

1. The actual investment, which is the original contribution to the venture, plus any subsequent contributions;

2. Appreciation or depreciation of the investment, which is the company's share of the GAAP basis net income or loss of the venture;

3. Withdrawals of the company's share of the cash flow that is generated by the operations of the venture.

The partnership agreement designates the percentage of distribution of net income and cash flow between the partners. An insurance company's share of the GAAP net earnings (or losses) of the partnership are reported as investment income in the insurer's statutory financial statements. The second half of the accounting entry involved is to increase (or decrease) the book value of the partnership. Book value also represents the admitted value reported in the statutory financial statement and may be a negative amount. Cash distributions received reduce the company's investment (book value) directly and are not reflected as income except where earnings have not been previously reported.

The most recent financial statements of the partnership should generally be used by an investor to apply the equity method. When a lag in reporting exists, intervening events materially affecting the financial position or results of operations of the partnership should be analyzed to determine whether or not the financial statements of the investment should be adjusted. Reporting should be consistent from period to period. If the method of partnership accounting for tax purposes varies with the accounting for financial reporting purposes, it is necessary that a venture maintain separate accounting records for the areas of difference.

Any contingent commitment to a partnership or joint venture shall be disclosed in the Notes to Financial Statements of the annual statement.

20. The NAIC Annual Statement Instructions provide the following guidance:

SCHEDULE BA OTHER LONG-TERM INVESTED ASSETS OWNED

PARTS 1, 2, AND 3

Include only those classes of invested assets not clearly or normally includable in any other invested asset schedule. Give a detailed description of each investment and the underlying security. If an asset is to be recorded in Schedule BA, which is normally reported in one of the other invested asset schedules, make full disclosure in Column 1 or a footnote of the reason for recording such an asset in Schedule BA.

If an insurer has any detail lines reported for any of the following required groups, categories, or subcategories, it shall report the subtotal amount of the corresponding group, category, or subcategory, with the specified subtotal line number appearing in the same manner and location as the pre-printed total or grand total line and number:

Group or Category	Line Number
Oil and Gas Production	0199999
Transportation Equipment	0299999
Mineral Rights	0399999
Fixed or Variable Interest Rate Investments that have the underlying characteristics of:	
Bonds	0499999
Mortgage Loans	0599999
Other fixed income instruments	0699999
Joint Venture or Partnership Interests that have the underlying characteristics of:	
Fixed income instruments	0799999
Common Stocks	0899999
Real Estate	0999999
Other	1099999
Surplus Debentures, etc.	1199999
Any Other Class of Admitted Assets	1299999
TOTALS	9999999

The following listing is intended to give examples of investments to be included in each category, however the list should not be considered all inclusive and it should not be implied that any invested asset currently being reported in Schedules A, B or D is to be reclassified to Schedule BA:

Oil and Gas Production

Include: Offshore oil and gas leases

Transportation Equipment

Include: Aircraft owned under leveraged lease agreements
Motor Vehicle Trust Certificates

Mineral Rights

Include: Investments in extractive materials
Timber Deeds

Fixed or Variable Interest Rate Investments that have the underlying characteristics of a Bond, Mortgage Loan or other fixed income instrument

Include: Fixed income instruments that are not corporate or governmental unit obligations (Schedule D) or secured by real property (Schedule B).

Joint Ventures or Partnership Interests for which the primary underlying investments are considered to be:

Fixed Income Instruments

Include: Leveraged Buy-out Fund
A fund investing in the "Z" strip of Collateralized Mortgage Obligations
Mortgage Obligations

Common Stocks

Include: Venture Capital Funds

Real Estate

Include: Real estate development interest

Other

Include: Limited partnership interests in oil and gas production
Forest product partnerships

Generally Accepted Accounting Principles

21. APB 18 provides guidance on the cost method of accounting for investments in noncontrolled entities. Pertinent paragraphs follow:

> 3. Several terms are used in this Opinion as indicated:
>
> a. "Investor" refers to a business entity that holds an investment in voting stock of another company.
>
> b. "Investee" refers to a corporation that issued voting stock held by an investor.
>
> c. "Subsidiary" refers to a corporation which is controlled, directly or indirectly, by another corporation. The usual condition for control is ownership of a majority (over 50%) of the outstanding voting stock. The power to control may also exist with a lesser percentage of ownership, for example, by contract, lease, agreement with other stockholders or by court decree.
>
> d. "Corporate joint venture" refers to a corporation owned and operated by a small group of businesses (the "joint venturers") as a separate and specific business or project for the mutual benefit of the members of the group. A government may also be a member of the group. The purpose of a corporate joint venture frequently is to share risks and rewards in developing a new market, product or technology; to combine complementary technological knowledge; or to pool resources in developing production or other facilities. A corporate joint venture also usually provides an arrangement under which each joint venturer may participate, directly or indirectly, in the overall management of the joint venture. Joint venturers thus have an interest or relationship other than as passive investors. An entity which is a subsidiary of one of the "joint venturers" is not a corporate joint venture. The ownership of a corporate joint venture seldom changes, and its stock is usually not traded publicly. A minority public ownership, however, does not preclude a corporation from being a corporate joint venture.

DISCUSSION

5. Investments are sometimes held in stock of companies other than subsidiaries, namely corporate joint ventures and other noncontrolled corporations. These investments are usually accounted for by one of two methods-the cost method or the equity method. While practice varies to some extent, the cost method is generally followed for most investments in noncontrolled corporations, in some corporate joint ventures, and to a lesser extent in unconsolidated subsidiaries, particularly foreign. The equity method is generally followed for investments in unconsolidated domestic subsidiaries, some corporate joint ventures and some noncontrolled corporations. An adaptation of the cost method, the lower of cost or market, has also been followed for investments in certain marketable securities if a decline in market value is evidently not a mere temporary condition.

6. A summary of the two principal methods of accounting for the investments in common stock discussed in this Opinion follows:

    a. The cost method. An investor records an investment in the stock of an investee at cost, and recognizes as income dividends received that are distributed from net accumulated earnings of the investee since the date of acquisition by the investor. The net accumulated earnings of an investee subsequent to the date of investment are recognized by the investor only to the extent distributed by the investee as dividends. Dividends received in excess of earnings subsequent to the date of investment are considered a return of investment and are recorded as reductions of cost of the investment. A series of operating losses of an investee or other factors may indicate that a decrease in value of the investment has occurred which is other than temporary and should accordingly be recognized.

    b. The equity method. An investor initially records an investment in the stock of an investee at cost, and adjusts the carrying amount of the investment to recognize the investor’s share of the earnings or losses of the investee after the date of acquisition. The amount of the adjustment is included in the determination of net income by the investor, and such amount reflects adjustments similar to those made in preparing consolidated statements including adjustments to eliminate intercompany gains and losses, and to amortize, if appropriate, any difference between investor cost and underlying equity in net assets of the investee at the date of investment. The investment of an investor is also adjusted to reflect the investor’s share of changes in the investee’s capital. Dividends received from an investee reduce the carrying amount of the investment. A series of operating losses of an investee or other factors may indicate that a decrease in value of the investment has occurred which is other than temporary and which should be recognized even though the decrease in value is in excess of what would otherwise be recognized by application of the equity method.

7. Under the cost method of accounting for investments in common stock, dividends are the basis for recognition by an investor of earnings from an investment. Financial statements of an investor prepared under the cost method may not reflect substantial changes in the affairs of an investee. Dividends included in income of an investor for a period may be unrelated to the earnings (or losses) of an investee for that period. For example, an investee may pay no dividends for several periods and then pay dividends substantially in excess of the earnings of a period. Losses of an investee of one period may be offset against earnings of another period because the investor reports neither in results of operations at the time they are reported by the investee. Some dividends received from an investee do not cover the carrying costs of an investment whereas the investor’s share of the investee’s earnings more than covers those costs. Those characteristics of the cost method may prevent an investor from reflecting adequately the earnings related to an investment in common stock-either cumulatively or in the appropriate periods.

> 13. Some hold the view that neither the market value method nor the equity method is appropriate accounting for investments in common stock where the investor holds less than majority ownership of the voting stock. They would account for such investments at cost. Under that view the investor is not entitled to recognize earnings on its investment until a right to claim the earnings arises, and that claim arises only to the extent dividends are declared. The investor is considered to have no earnings on its investment unless it is in a position to control the distribution of earnings. Likewise, an investment or an investor's operations are not affected by losses of an investee unless those losses indicate a loss in value of the investment that should be recognized.
>
> OPINION
>
> 17. The Board concludes that the equity method of accounting for an investment in common stock should also be followed by an investor whose investment in voting stock gives it the ability to exercise significant influence over operating and financial policies of an investee even though the investor holds 50% or less of the voting stock. Ability to exercise that influence may be indicated in several ways, such as representation on the board of directors, participation in policy making processes, material intercompany transactions, interchange of managerial personnel, or technological dependency. Another important consideration is the extent of ownership by an investor in relation to the concentration of other shareholdings, but substantial or majority ownership of the voting stock of an investee by another investor does not necessarily preclude the ability to exercise significant influence by the investor. The Board recognizes that determining the ability of an investor to exercise such influence is not always clear and applying judgment is necessary to assess the status of each investment. In order to achieve a reasonable degree of uniformity in application, the Board concludes that an investment (direct or indirect) of 20% or more of the voting stock of an investee should lead to a presumption that in the absence of evidence to the contrary an investor has the ability to exercise significant influence over an investee. Conversely, an investment of less than 20% of the voting stock of an investee should lead to a presumption that an investor does not have the ability to exercise significant influence unless such ability can be demonstrated. When the equity method is appropriate, it should he applied in consolidated financial statements and in parent-company financial statements prepared for issuance to stockholders as the financial statements of the primary reporting entity. [7]
>
> [7] The equity method should not be applied to the investments described in this paragraph insofar as the limitations on the use of the equity method outlined in footnote 4 would be applicable to investments other than those in subsidiaries.

22. *AICPA Statement of Position 78-9*, *Accounting for Investments in Real Estate Ventures* (SOP 78-9), provides the following guidance:

> THE APPLICABILITY OF THE EQUITY METHOD OF ACCOUNTING
>
> Corporate Joint Ventures
>
> .04 APB Opinion 18 requires investments in corporate joint ventures to be accounted for by the equity method and includes guidance for applying that method in the financial statements of the investor. That opinion applies to corporate joint ventures created to own or operate real estate projects.
>
> .05 Paragraph 3 of APB Opinion 18 states that "an entity which is a subsidiary of one of the 'joint venturers' is not a corporate joint venture." A subsidiary, according to that opinion, refers to
>
> ...a corporation which is controlled, directly or indirectly, by another corporation. The usual condition for control is ownership of a majority (over 50 percent) of the outstanding voting stock.

The power to control may also exist with a lesser percentage of ownership, for example, by contract, lease, agreement with other stockholders, or by court decree.

Accordingly, an investment in a corporate subsidiary that is a real estate venture should be accounted for by the investor-parent using the principles applicable to investments in subsidiaries rather than those applicable to investments in corporate joint ventures. Minority shareholders in such a real estate venture should account for their investment using the principles applicable to investments in common stock set forth in APB Opinion 18 or in *FASB Statement No. 12, Accounting for Certain Marketable Securities*.

General Partnerships

.06 The staff of the American Institute of Certified Public Accountants issued an interpretation of APB Opinion 18 in November, 1971, which concludes that many of the provisions of APB Opinion 18 are appropriate in accounting for investments in certain unincorporated entities. The division believes that the principal difference, aside from income tax considerations, between corporate joint ventures and general partnerships is that the individual investors in general partnerships usually assume joint and several liability. The division believes, however, that the equity method enables noncontrolling investors in general partnerships to reflect the underlying nature of their investments in those ventures as well as it does for investors in corporate joint ventures. Accordingly, the division believes that investments in noncontrolled real estate general partnerships should be accounted for and reported under the equity method. This recommendation requires the one-line equity method of presentation in both the balance sheet and the statement of income.[1] Paragraph 19 of APB Opinion 18 should be used as a guide in applying the equity method. Investors in general partnerships should provide for income taxes on the profits accrued on their investment in the partnership regardless of the tax basis used in the partnership return. The tax liabilities applicable to partnership interests relate directly to the partners, and the accounting for income taxes generally contemplated by APB Opinion 11 is appropriate. Thus, the differences, if any, between income or loss recorded by a partner under the equity method and the partner’s share of distributable taxable income or loss from the partnership should be accounted for as timing differences unless they result from tax-exempt revenues or other permanent differences.

[1] Pro rata consolidation is not appropriate except in the limited circumstances described in paragraph .11.

.07 The division believes a general partnership that is controlled, directly or indirectly, by an investor is, in substance, a subsidiary of the investor. APB Opinion 18 states that the usual condition for control of a corporation is ownership of a majority (over 50 percent) of the outstanding voting stock. However, if partnership voting interests are not clearly indicated, a condition that would usually indicate control is ownership of a majority (over 50 percent) of the financial interests in profits or losses (see paragraph .25). The power to control may also exist with a lesser percentage of ownership, for example, by contract, lease, agreement with other partners, or by court decree. On the other hand, majority ownership may not constitute control if major decisions such as the acquisition, sale or refinancing of principal partnership assets must be approved by one or more of the other partners. The division believes that a controlling investor should account for its investment under the principles of accounting applicable to investments in subsidiaries. Accordingly, intercompany profits and losses on assets remaining within the group should be eliminated. A noncontrolling investor in a general partnership should account for its investment by the equity method and should be guided by the provisions of paragraph 19 of APB Opinion 18.

Limited Partnerships

.08 The division believes that the accounting recommendations for use of the equity method of accounting for investments in general partnerships are generally appropriate for accounting by limited partners for their investments in limited partnerships. A limited partner’s interest may be so minor that the limited partner may have virtually no influence over partnership operating and financial policies. Such a limited partner is, in substance, in the same position with respect to the investment as an investor that owns a minor common stock interest in a corporation, and, accordingly, accounting for the investment using the cost method may be appropriate. Under the cost method, income recognized by the investor is limited to distributions received, except that distributions that exceed the investor's share of earnings after the date of the investment are applied to reduce the carrying value of the investment. Also, differences between income or losses recognized for financial reporting purposes and the investor's share of taxable income or losses should be accounted for as timing differences unless they result from tax-exempt revenues or other permanent differences.

.09 The rights and obligations of the general partners in a limited partnership are different from those of the limited partners. Some believe that general partners should be deemed to have the controlling interest in a limited partnership. However, if limited partners have important rights, such as the right to replace the general partner or partners, approve the sale or refinancing of principal assets, or approve the acquisition of principal partnership assets, the partnership may not be under the control, directly or indirectly, of the general partnership interests. The division believes that the general partners are in control and should account for their investments in accordance with the recommendations in paragraph .07 only if the substance of the partnership or other agreements provides for control by the general partners.

.10 The division believes that if the substance of the partnership arrangement is such that the general partners are not in control of the major operating and financial policies of the partnership, a limited partner may be in control. An example could be a limited partner holding over 50 percent of the total partnership interest. A controlling limited partner should be guided in accounting for its investment by the principles for investments in subsidiaries. Noncontrolling limited partners should account for their investments by the equity method and should be guided by the provision of paragraph 19 of APB Opinion 18, as discussed in paragraphs .06 and .07, or by the cost method, as discussed in paragraph .08, as appropriate.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 6, *Investments in Subsidiary, Controlled or Affiliated Companies*, Chapter 8, *Other Admitted Assets*
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 6, *Investments in Subsidiary, Controlled or Affiliated Companies,* Chapter 8, *Other Admitted Assets*
- NAIC Annual Statement Instructions, Schedule BA
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 46—Accounting for Investments in Subsidiary, Controlled and Affiliated Entities*

Generally Accepted Accounting Principles

- *Accounting Principles Board Opinion No. 18, The Equity Method of Accounting for Investments in Common Stocks*, (APB 18)
- *Accounting Interpretation of APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stocks* (AIN APB 18), *Accounting Principles Board Opinion No. 18*, *The Equity Method of Accounting for Investments in Common Stock*
- *AICPA Statement of Position No. 78-9, Accounting for Investments in Real Estate Ventures*

State Regulations

- No additional guidance obtained from statutes or regulations.

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Statutory Issue Paper No. 49

Policy Loans

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 49

Type of Issue:
Life Specific

SUMMARY OF ISSUE

1. Current statutory accounting guidance for policy loans is provided in the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies (Life/A&H Accounting Practices and Procedures Manual). GAAP guidance is limited but is provided in the AICPA Audit and Accounting Guide: Stock Life Insurance Companies. Current statutory and GAAP guidance are consistent.

2. The purpose of this issue paper is to establish statutory accounting principles for policy loans that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

3. A policy (or contract) loan shall be defined as a loan to a policyholder, under the provisions of an insurance contract, that is secured by the cash surrender value or collateral assignment of the related policy or contract. Policy loans shall include:

a. Cash loans, including loans resulting from early payment benefits or accelerated payment benefits, on contracts when the terms of the contract specify that such payments are policy loans secured by the policy and

b. Automatic premium loans, which are loans made in accordance with policy provisions whereby delinquent premium payments are automatically paid from the cash value at the end of the established grace period for premium payments.

4. Policy loans meet the definition of assets defined in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets* and meet the criteria for admitted assets, except as specified in paragraphs 6 and 7 of this issue paper. Policy loans are readily available to satisfy policyholder obligations as the terms of the policy loan allow the reporting entity to offset an outstanding policy loan balance against the cash surrender value of the policy.

5. Policy loans shall be carried at the unpaid balance of the loan. The unpaid balance of the loan shall include any unpaid principal plus any accrued interest which is 90 days or more past due.

6. If the unpaid balance of the loan exceeds the cash surrender value or policy reserves established for the policy, the policy generally shall lapse. Cash surrender value shall be defined as the cash value of the basic policy plus cash value of any policy accumulations such as paid-up additions. The excess of the unpaid balance of the loan over the cash surrender value shall be evaluated for collectibility. If the amount is considered uncollectible, it shall be written off as a reduction of investment income in the statement of operations during the period it is determined to be uncollectible. Except for collateral

assignment loans, all other amounts in excess of the cash surrender value shall be considered nonadmitted assets. The change in this nonadmitted asset shall be recorded as an unrealized capital gain or loss as applicable.

7. A loan resulting from early payment benefits or accelerated payment benefits and secured by an assignment of the policy to the reporting entity as collateral for the loan shall be an admitted asset, except that any loan (including accrued interest) in excess of the policy reserve for that policy shall be nonadmitted. Upon death, the entire death benefit is recorded as a death benefit expense. The policy proceeds shall be used to repay the loan. Any proceeds in excess of that needed to repay the loan are payable to the named beneficiary.

8. Interest income on policy loans shall be recorded as earned and included in investment income consistent with *Issue Paper No. 34—Investment Income Due and Accrued*. For interest received before it is earned, unearned interest income shall be recorded as a liability in accordance with *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets.*

9. Accrued interest income on policy loans that is past due 90 days or more shall be reclassified from Investment Income Due and Accrued and included in the unpaid balance of the policy loan as defined in paragraph 5 above.

DISCUSSION

10. The statutory principles described in the conclusion above are consistent with current statutory guidance except for the following:

a. The definition of policy loans includes certain early payment benefits or accelerated payment benefits that by the terms of the applicable policy are policy loans. Existing statutory guidance does not specifically address such loans in the guidance on policy loans. The accounting treatment adopted in paragraph 7 above allows a loan resulting from an early payment benefit or an accelerated payment benefit to be an admitted asset if the loan amount plus accrued interest is less than the policy reserve and the loan is secured by the full assignment of the policy benefits to the reporting entity.

b. Past due interest has been defined in paragraph 9 as accrued interest that is past due 90 days or more.

c. Under current statutory guidance, the excess of the unpaid balance of the loan over the cash surrender value is a nonadmitted asset. The statutory accounting principle in paragraph 6 above requires different accounting treatment for uncollectible and collectible unpaid balances in excess of the cash surrender value.

11. The statutory accounting principles described in the conclusion above are consistent with the conservatism and recognition concepts in the Statement of Concepts. Pertinent excerpts follow:

> Conservatism
>
> Conservative valuation procedures provide protection to policyholders against adverse fluctuations in financial condition or operating results. Statutory accounting should be reasonably conservative over the span of economic cycles and in recognition of the primary responsibility to regulate for financial solvency. Valuation procedures should, to the extent possible, prevent sharp fluctuations in surplus.

> Recognition
>
> The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which may be unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet but rather should be charged against surplus when acquired or when availability otherwise becomes questionable.
>
> Revenue should be recognized only as the earnings process of the underlying underwriting or investment business is completed. Accounting treatments which tend to defer expense recognition do not generally represent acceptable SAP treatment.

Drafting Notes/Comments
None

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

12. The Life/A&H Accounting Practices and Procedures Manual provides the following guidance in Chapter 7, Policy Loans:

> In most states, the right to make a loan is among the standard provisions that are included in cash value life insurance policies. The policy usually provides:
>
> 1. That the company will advance on the security of the policy an amount which, with interest to either the next policy anniversary or premium due date, will not exceed the guaranteed cash value of the policy on that date;
>
> 2. That any outstanding loan and interest will be deducted from the proceeds;
>
> 3. That interest will be payable annually at either a fixed rate that is specified on the policy or at a variable rate with a description of how the rate is determined;
>
> 4. That interest that is not paid when due shall be added to the loan and shall bear interest at the same rate;
>
> 5. That if the total indebtedness equals or exceeds the cash value, the policy shall terminate; and,
>
> 6. That the policy owner may repay the loan either in whole or in part at any time while the policy is in force.
>
> In most states, the maximum interest rate on policy loans has been established by statute, although in several states the rate is determined by state insurance departments. Also, some companies have introduced variable interest rates which will reduce the variance in rates between policy loans and other borrowings.
>
> Cash Loans
>
> The request for a cash loan generally will originate with the policy owner in the form of an application for a cash loan. The insured will also be required to sign a loan agreement which specifies the original amount of the loan and may recite all the conditions of the loan. Other parties may also be required to sign the agreement because of contract limitations as to control or because of prior assignment. The agreement to make a cash loan may be made as a special endorsement on the check that the policy owner receives.

Automatic Premium Loans

An automatic premium loan (APL) is one which is made in accordance with the provision in some policies for automatically paying a delinquent premium from the cash value at the end of the grace period. A special loan agreement is not required because the policy owner previously requested the APL option. In some states the policy owner must specifically elect this provision for it to be effective.

The purpose of the APL provision is that, in the event of inadvertent nonpayment of premium or temporary inability to pay the premium, the policy is kept in full force. If the policy were allowed to lapse and the nonforfeiture options of reduced paid-up or extended term insurance were effective, the policy owner would then be required to comply with the reinstatement procedures, such as furnishing evidence of insurability.

Valuation

Policy loans are reported as admitted assets in the statutory financial statement. They are carried at the unpaid balance of the loan provided the unpaid balance does not exceed either the cash surrender value of the policy or the policy reserves. The cash surrender value generally consists of the cash value of the basic policy plus cash value of any policy accumulations such as paid-up additions.

In cases where the policy indebtedness exceeds the cash surrender value, the excess is a nonadmitted asset. The change in this nonadmitted asset is reflected as an unrealized capital gain or loss as applicable.

Interest

Interest on a policy loan may be payable at either the beginning or end of the policy loan interest period. Where it is payable at the beginning of the period, appropriate balance sheet provision should be established for any unearned policy loan interest. Where it is payable at the end of the period, appropriate provision should be established for any accrued interest. Interest earned is reported as investment income.

The calculation of investment income from a company's policy loans requires a determination of unearned or accrued interest. These are included in their respective accounts in the balance sheet as unearned or accrued investment income and not with the balance of policy loans. The calculation of accrued and unearned interest usually is made on a policy-by-policy basis, or for policies grouped by interest rate and policy anniversary or interest paid- to-date.

Past-due interest normally is capitalized as an addition to the loan balance with the interest recorded as received.

13. The Life/A&H Accounting Practices and Procedures Manual provides the following guidance in Chapter 19, Investment Income and Net Realized Gains:

Gross Investment Income

Investment income arises from interest on bonds, dividends on stock, interest on mortgage loans and policy loans, rent on real estate, and other miscellaneous sources. Such income is on a gross basis and does not reflect investment expenses, taxes, depreciation, depletion or interest on borrowed money. Gross investment income is composed of income collected during the period, the change in income due and accrued and the change in income unearned and nonadmitted.

14. The NAIC Annual Statement Instructions provide the following guidance related to Policy Loans:

> EXHIBIT 4 - UNREALIZED CAPITAL GAINS AND
> (LOSSES) ON INVESTMENTS
>
> Line 5 - Premium Notes, Policy Loans and Liens
>
> Include: In Column 3, the net change in the excess of premium notes, policy loans and other policy assets over net value and other policy liabilities on individual policies. (See Exhibit 14, Line 9.)
>
> EXHIBIT 13 - ASSETS
>
> Lines 5 & 6 - Policy Loans and Premium Notes
>
> Include: In Column 3 premium notes, policy loans, and other policy assets in excess of net value and of other policy liabilities on individual policies.
>
> Exclude: Interest due and accrued (include in Line 16).
>
> Premium extension agreements (include in Line 14).
>
> Policy liens under reinsurance agreements.
>
> Line 5 plus Line 6, Column 3 should agree with Exhibit 14, Line 9, Column 2.
>
> EXHIBIT 14 - ANALYSIS OF NON-ADMITTED ASSETS AND RELATED ITEMS
>
> Line 9 - Premium Notes, etc., in Excess of Net Value and Other Policy Liabilities on Individual Policies
>
> The change for the year should be included in Exhibit 4, Column 3, Line 5.

Generally Accepted Accounting Principles

15. The *AICPA Audit and Accounting Guide: Stock Life Insurance Companies* provides the following guidance in Chapter 4, Investment Operations:

> Policy Loans*
>
> 4.13 Life insurance companies generally must permit borrowing against the cash values of policies. Policy loans are carried at their unpaid balances including accumulated interest but not in excess of cash surrender values or in excess of policy reserves. Many policy contracts require the company to initiate an "automatic premium loan" to pay delinquent premiums.

* *FASB Statement No. 114*, *Accounting by Creditors for Impairment of a Loan*, addresses the accounting by creditors for impairment of certain loans. It is applicable to all creditors and to all loans, uncollateralized as well as collateralized, except large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment, loans that are measured at fair value or at the lower of cost or fair value, leases, and debt securities as defined in FASB Statement No. 115. It applies to all loans that are restructured in a troubled debt restructuring involving a modification of terms.

It requires that impaired loans that are within its scope be measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the loans' observable market price or the fair value of the collateral if the loan is collateral dependent.

The Statement amends *FASB Statement No. 5, Accounting for Contingencies*, to clarify that a creditor should evaluate the collectibility of both contractual interest and contractual principal of all receivables when assessing the need for a loss accrual. The Statement also amends *FASB Statement No. 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings*, to require a creditor to measure all loans that are restructured in a trouble debt restructuring involving a modification of terms in accordance with the Statement.

The Statement applies to financial statements for fiscal years beginning after December 15, 1994. Earlier application is encouraged.

The Glossary provides the following definitions:

> Automatic premium loan - A loan made under a provision in a life insurance policy that a premium not paid by the end of the grace period will be automatically paid from the proceeds of a policy loan made by the company if there is sufficient loan value.
>
> Policy loan - A loan made by a life insurance company to a policyholder on the security of the cash surrender value of his policy.

OTHER SOURCES OF INFORMATION

16. NAIC Technical Resource Group Proposed Draft Life Codification provides the following guidance in Chapter 20, Policy and Contract Benefits, related to early payment benefits or accelerated payment benefits:

> Early Payment or Accelerated Payment Benefits
>
> When an insurer offers the insured/policyowner an option to receive benefit payments early, typically when the insured is diagnosed with a terminal illness, accounting for the payments must be consistent with the terms of the contract. Either the loan method or policy reduction method shall be used to account for the payments.
>
>> Loan Method:
>>
>> When the terms of the contract recognize payments to be a loan on the policy with the policy serving as collateral, and interest is charged on the loan amount, all payments are reported as policy loans and included as an admitted asset of the insurer. Interest and fees (if any) are recorded when earned. Upon death or lapse (policy loan plus accrued interest equals the face amount), the policy is accounted for as a claim payment.
>>
>> Policy Reduction Method:
>>
>> When the payments result in a reduction in the amount of insurance, the payments are recorded as benefit payments with a corresponding release of a pro-rata portion of the policy reserve.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 34—Investment Income Due and Accrued*
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 7, Policy Loans*,* and Chapter 19, Investment Income and Net Realized Gains
- NAIC Annual Statement Instructions, Exhibit 4, Unrealized Capital Gains and Losses on Investments*,* Exhibit 13, Assets, Exhibit 14 - Analysis of Non-Admitted Assets and Related Items

Generally Accepted Accounting Principles

- *AICPA Audit and Accounting Guide: Stock Life Insurance Companies, Chapter* 4, *Investment Operations*

State Regulations

- No additional guidance obtained from state statutes or regulations.

Other Sources of Information

- NAIC Technical Resource Group Proposed Draft Life Codification, Chapter 20, Policy and Contract Benefits

Statutory Issue Paper No. 50

Classifications and Definitions of Insurance or Managed Care Contracts In Force

STATUS
Finalized June 23, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 50

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory guidance and state regulatory requirements use many different groupings, classifications and terminologies for insurance contracts in force. The Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies (Life/A&H Accounting Practices and Procedures Manual) groups life insurance contracts into four product type categories based on specific product or marketing attributes: ordinary, industrial, group and credit. The Life/A&H Accounting Practices and Procedures Manual separates accident and health contracts into the categories of individual, group and credit. The Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies (P&C Accounting Practices and Procedures Manual) groups property and casualty products by type of coverage only for purposes of presentation in the various Annual Statement exhibits and schedules.

2. GAAP classifies insurance contracts in force as either long-duration or short-duration based on the nature of the insurance enterprise's obligations and policyholder rights under the provisions of the contract. Long-duration contracts include contracts, such as whole life, guaranteed renewable term life, endowment, annuity, and title insurance contracts, that are expected to remain in force for an extended period. All other insurance contracts are considered short-duration contracts and include most property and liability and all credit insurance contracts.

3. The purpose of this issue paper is to provide a general framework for classifying insurance or managed care contracts into categories where the recognition of contract and policy reserves and related revenue, benefits, and claims is fundamentally different. Separate issue papers will establish the accounting principles for premium and income recognition and policy benefit and claim reserves for all contracts as defined herein, including comparisons of statutory accounting principles to GAAP.

SUMMARY CONCLUSION

Overview

4. The primary purpose of insurance, including managed care coverage, is to provide economic protection from identified risks occurring or discovered within a specified period. These risks include death, disability, health benefits, outliving one’s financial assets, and damage to property by an insured peril or damage or injury to the insured or third parties. The accounting for these contracts is significantly influenced by the terms of the insurance or managed care contract.

5. In order to provide for a conservative, consistent, and comparable method of accounting for insurance or managed care contracts, premiums and related benefits shall be recognized considering the policy term, premium payment requirements, risks assumed and benefits provided under the contract

using conservative assumptions as to interest, mortality, morbidity, and incurred costs for health benefits as applicable. The reserve and income recognition methods reflect the premium payment pattern and the insurance protection and/or benefits provided for in the insurance or managed care contract.

6. This issue paper establishes an overall framework for existing insurance or managed care contracts by identifying four broad categories of insurance or managed care contracts where the premium payment pattern and the protection and/or benefits provided are fundamentally different and therefore require different income recognition and reserving methods.

7. Insurance contracts providing any protection against death, disability, accident or illness in which the reporting entity assumes mortality or morbidity risk shall be classified as life or accident and health contracts, as applicable. Managed care contracts provide defined health care services to subscribers, members or policyholders, collectively referred to hereafter as subscribers, in return for fixed, periodic premiums (usually paid monthly) that are generally due at or before the beginning of the coverage period and shall be classified as health contracts. Contracts which insure against damage to property by an insured peril or damage or injury to the insured or third parties, generally over a fixed/limited period of time, shall be classified as property and casualty contracts. Contracts in which the reporting entity does not assume any mortality, morbidity, health benefit costs incurred or casualty risk and which act exclusively as investment vehicles shall be classified as deposit-type contracts. Such classification shall be made at the inception of the contract and shall not change.

Life Contracts

8. The primary purpose of life insurance is to provide financial assistance to a beneficiary at the insured's death. The long period of coverage involving the risk of death, a risk which increases with age, is the distinguishing characteristic by which life insurance is set apart from other forms of insurance. Life insurance is often sold on a level premium basis under which the annual premium remains constant even though the expected policy benefits and services do not occur evenly over the duration of the contract. Premium revenue generally exceeds expected policy benefits in the early years of the contract and it is necessary to accrue, as premium revenue is recognized, a liability for costs that are expected to be paid in the later years of the contracts.

9. The liability for expected costs relating to most types of life contracts is accrued over the current and expected renewal periods of the contracts. The net valuation premium is based upon an assumed interest rate and upon the frequency of death derived from mortality tables. The net premiums collected, after deducting benefits and other costs each year, are accumulated at interest. This accumulation, when combined with future net premiums and future investment income theoretically generates a sum sufficient to pay the claims resulting from the death or disabilities of the insured.

10. The liability which corresponds to this fund is referred to as the policy reserve. These contracts are generally expected to be in-force for an extended period of time and require the performance of various functions and services for an undefined period of time and are generally not subject to unilateral changes in their provisions. The policy reserve is generally calculated as the excess of the present value of future benefits to be paid to or on behalf of policyholders less the present value of future net premiums, discounted at valuation interest and mortality.

11. Life insurance contracts shall include contracts with life contingencies, including, but not limited to:

- Whole life contracts
- Endowment contracts
- Term life contracts
- Supplementary contracts
- Group life contracts

- Franchise life contracts
- Universal life type contracts
- Variable life contracts
- Limited payment contracts
- Credit life contracts
- Annuity contracts

Accident and Health Contracts

12. Health insurance policies or managed care contracts, offered by a health maintenance or similar organization, many life insurance and some property and casualty companies, may provide hospital, surgical, medical, loss of income, accidental death and dismemberment, or long-term care coverage as well as other health related benefits. The insurance protection involving economic loss resulting from a medical condition (e.g., medical care expenses or the risk of disability) is the distinguishing characteristic by which accident and health insurance or managed care contracts are set apart from other forms of insurance. Health coverage is currently furnished under group or individual contracts. Coverage sold to individuals can be subdivided according to the reporting entity's right to continue the policy, limitations on the reporting entity's right to increase premiums, as well as other factors.

13. Accident and health contracts also include risk contracts with Medicaid and Medicare whereby the reporting entity assumes insurance risk.

14. Managed care contracts are contracts that provide defined health care services to subscribers in return for fixed, periodic premiums (usually paid monthly) that are generally due at or before the beginning of the coverage period. Managed care means a system or technique(s) generally used by reporting entities to affect access to and control payment for health care services. Managed care techniques most often include one or more of the following: 1) review of medical necessity and appropriateness of services or site of services; 2) contracts with selected providers; 3) financial incentives for enrollees to use specific providers, services, or service sites; 4) controlled access to and coordination of services by a case manager; and 5) payor efforts to identify treatment alternatives and modify benefit restrictions for high cost patient care. Expenses for medical, hospital, pharmacy and other benefits are recognized based on the way the reporting entity provides for the contracted services. In some instances, this is through the payment of claims to providers as services are rendered which require a claims liability to be recorded as addressed in *Issue Paper No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses* (Issue Paper No. 55) or through capitated arrangements based on contracts with providers, where expense is recognized ratably over the contract period.

15. Similar to life insurance contracts, a significant amount of accident and health contracts is sold to individuals and groups on a level premium basis under which the annual premium remains constant even though the expected policy benefits and services may not occur evenly over the duration of the contract. Premium revenue for level premium contracts generally exceeds expected policy benefits in the early years of the contracts and it is necessary to accrue, as premium revenue is recognized, a liability for costs that are expected to be paid in the later years of the contracts.

16. The liability for expected costs relating to accident and health contracts sold on a level premium basis is accrued over the current and expected renewal periods of the contracts. The net valuation premium is based upon an assumed interest rate, persistency, and the frequency of expected death and disability claims generally derived from mortality and morbidity tables. The net premiums collected, after deducting benefits and other costs each year, are accumulated at interest. Similar to life insurance, this accumulation or policy reserve, when combined with future net premiums and future investment income theoretically generate a sum sufficient to pay the claims resulting from the death or disabilities of the insured or subscriber. The reserve is generally calculated as the excess of the present value of future

benefits to be paid to or on behalf of insureds or subscribers less the present value of future net premiums, discounted at valuation interest, mortality, and morbidity.

17. Accident and health contracts shall include contracts with health benefits or disability contingencies, including, but not limited to:

- Managed care contracts
- Income replacement contracts
- Expense reimbursement contracts
- Credit accident and health contracts
- Continuing care contracts
- Long-term care contracts
- Accidental death and dismemberment contracts

Deposit-Type Contracts

18. Deposit-type or investment contracts do not incorporate insurance risk. Contracts issued by insurers that do not incorporate risk from the death or disability of policyholders (mortality or morbidity risk) are more comparable to financial or investment instruments issued by other financial institutions than to insurance contracts.

19. Accounting for investment contracts issued by insurance enterprises should be consistent with the accounting for interest-bearing and other financial instruments where the reserve is either based on the accumulated amounts paid plus an income accumulation based on the contract provisions or based on the present value of future benefits, discounted at the applicable interest factor.

20. Deposit-type contracts shall include contracts without life or disability contingencies, including, but not limited to:

- Supplemental contracts
- Lottery payouts
- Structured settlements
- Guaranteed interest contracts
- Income settlement options
- Dividend and coupon accumulations
- Annuities certain
- Premium and other deposit funds

Property and Casualty Contracts

21. Contracts which insure against damage to property by an insured peril or damage or injury to the insured or third parties shall be classified as property and casualty contracts. Damages shall include both physical and financial damages. Premiums from property and casualty contracts are generally recognized as earned over the exposure period of the contract in proportion to the amount of insurance protection provided.

22. The exposure to insurance risk for most property and casualty insurance contracts does not vary significantly during the duration of the contract. Premiums from property and casualty contracts shall be recognized as earned premium as discussed in *Issue Paper No. 53—Property and Casualty Contracts - Premiums.*

23. These contracts shall include but shall not be limited to:

- Traditional property and casualty insurance contracts
- Title insurance contracts
- Mortgage and financial guaranty contracts

DISCUSSION

24. This issue paper establishes an overall framework for existing insurance contracts by identifying four broad categories of insurance contracts where the premium payment pattern and the insurance protection and/or benefits provided are fundamentally different and therefore require different income recognition and reserving methods. The framework established for the purposes of this issue paper differs from the SAP classifications. Additionally, this framework rejects the GAAP classifications (i.e., short-duration and long-duration) found in *FASB Statement No. 60*, *Accounting and Reporting by Insurance Enterprises* (FAS 60), *FASB Statement No. 97*, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments* (FAS 97), and *FASB Statement No. 120*, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts* (FAS 120*)*. However, this framework does incorporate certain elements of both SAP and GAAP. As new types of contracts are developed, based on their characteristics, the contracts can be readily classified into one of the four categories established by this issue paper. Establishing criteria for the evaluation of new products is consistent with the Statement of Concepts which states:

> The regulators' need for meaningful, comparable financial information to determine an insurer's financial condition requires consistency in the development and application of statutory accounting principles. Because the market place, the economic and business environment, and insurance industry products and practices are constantly changing, regulatory concerns are also changing. An effective statutory accounting model must be responsive to these changes and address emerging accounting issues. Precedent or historically accepted practice alone should not be sufficient justifications for continuing to follow a particular accounting principle or practice which may not coincide with the objectives of regulators.
>
> The multitude of unique circumstances and individual transactions makes it virtually impossible for any codification of accounting principles to be totally comprehensive. Application of SAP, either contained in the Accounting Practices and Procedures Manuals or defined as GAAP and adopted by the NAIC, to unique circumstances or individual transactions should be consistent with the concepts of conservatism, consistency, and recognition.

25. Distinguishing between life, accident and health, deposit-type, and property and casualty contracts is reflective of the insurer's obligations under the terms of the contract. The common attributes of insurance contracts are often readily identified with the duration of the contract, the insurer's ability to unilaterally change the terms of the contract, the premium payment pattern, as well as other factors. Based on the attributes, the following general issue papers have been developed:

Issue Paper	**Title**
Issue Paper No. 51	Life Contracts
Issue Paper No. 52	Deposit-Type Contracts
Issue Paper No. 53	Property Casualty Contracts - Premiums
Issue Paper No. 54	Individual and Group Accident and Health Contracts
Issue Paper No. 65	Property and Casualty Contracts

26. If additional guidance is necessary, separate issue papers will establish statutory accounting principles for specific insurance contracts as indicated below. Current statutory accounting for specific types of contracts will be evaluated for consistency with the basic concepts established in Issue Paper Nos. 51, 52, 53, 54, and 65, as well as for consistency with the Statement of Concepts. The descriptions of specific types of insurance contracts in paragraphs 2 to 52 of this issue paper are consistent with the descriptions of such contracts found in the *AICPA Audits of Property and Liability Insurance Companies* (AICPA P&C Audit and Accounting Guide*)* and the *AICPA Audits of Stock Life Insurance Companies* (AICPA Life Audit and Accounting Guide). A summary of those specific issue papers is as follows:

Issue Paper	**Title**
Life Contracts	
Issue Paper No. 56	Universal Life-Type Contracts, Policyholder Dividends, and Coupons
Issue Paper No. 59	Credit Life and Accident and Health Insurance Contracts
Issue Paper No. 74	Life, Deposit-Type and Accident and Health Reinsurance
Issue Paper No. 89	Separate Accounts
Accident and Health Contracts	
Issue Paper No. 59	Credit Life and Accident and Health Insurance Contracts
Issue Paper No. 74	Life, Deposit-Type and Accident and Health Reinsurance
Property and Casualty Contracts	
Issue Paper No. 57	Title Insurance
Issue Paper No. 69	Financial Guaranty Insurance
Issue Paper No. 88	Mortgage Guaranty Insurance
Issue Paper No. 75	Property and Casualty Reinsurance

27. Areas where premium, policy and claim reserves and related areas are accounted for similarly will be combined and discussed as a single topic. Those categories are as follows:

Issue Paper	**Title**
Issue Paper No. 55	Unpaid Claims, Losses and Loss Adjustment Expenses
Issue Paper No. 66	Accounting for Retrospectively Rated Contracts
Issue Paper No. 97	Underwriting Pools and Associations Including Intercompany Pools

Life Contracts

28. The contract for ordinary life insurance is between the company and the policy owner (often the insured). Many variations of ordinary life coverages are available to a purchaser of insurance, including participating, limited-payment periods, combinations of coverages, and decreasing (or increasing) death benefits. Industrial life insurance, also called “debit” insurance, is insurance under which premiums are paid monthly or more often, the face amount of the policy does not exceed a stated amount, and the words "industrial policy" are printed in prominent type on the face of the policy. Ordinary and industrial life insurance contracts are considered life contracts and include the following types of coverage as described in the following paragraphs.

29. *Whole life contracts* provide a fixed amount of insurance coverage over the life of the insured and the related benefits are normally payable only upon the insured's death. Premiums are paid over various periods as allowed by the terms of the policy contract. Whole life insurance contracts provide for nonforfeiture values, some common types being reduced paid up insurance, extended term insurance, and cash values, and some provide for the payment of policy dividends. A level premium is usually paid for

policies of this type; and the premium may be paid in annual or more frequent modes. An ordinary life (straight-life) policy stipulates that premiums are to be paid during the life of the insured.

30. *Endowment contracts* are principally savings contracts which incorporate an element of life insurance protection. Endowment insurance contracts provide a benefit if the insured survives the endowment period or the amount is paid to a beneficiary if the insured does not survive. A pure endowment contract only provides a benefit to the insured if he/she survives the endowment period. Endowment policies mature at a specified attained age of the insured or at the end of a specified period. Premium payments for endowment contracts are made over a specified period, but may also be made under a single-premium or limited-payment plan. Both whole life and endowment policies contain nonforfeiture or similar clauses which provide for a value in cash or some other form of insurance to be available in the event of failure to continue the required premiums.

31. *Term life contracts* provide insurance over a specified period of time. If the insured dies during this term, the face amount of the policy will be paid to the beneficiary. Policies for term insurance which are written for relatively short periods of time commonly grant the policyholder the right to renew for an additional period or periods up to a maximum age, such as 60 or 65, without requiring additional evidence of insurability. Rights to convert to whole life or endowment contracts may also be included in the contract. Term contracts may also be made for a period which will end when the insured reaches a certain age (for example, age 60 or 65). Such policies do not usually provide nonforfeiture values.

32. *Supplementary contracts with life contingencies* are a type of agreement between the insurance company and either the insured or the beneficiary, usually to provide for full or partial settlement of the amount payable upon the termination of an original contract. Generally, the proceeds are paid over the lifetime of one or more beneficiaries. This differs from a supplementary contract without life contingencies under which the proceeds are paid over a definite period without regard to the life of the beneficiary.

33. *Group life contracts* are insurance on the lives of a group of persons under a single master contract. Insurance of this type is customarily written on a yearly renewable term basis although some permanent group life is sold. Group life insurance is based on a master policy which usually precludes or disallows individual selection and is for the benefit of persons other than the policyholder. The individual insured members may receive certificates of insurance which evidence the contract. The contract is made by the policyholder and the insurer; there is no contract of insurance between the policyholder and the members. State statutes vary as to what constitutes a group and as to who may be a policyholder. Some states permit only employee-employer relationships in a group contract. Others permit union members, credit union members, or similar relationships in group contracts.

34. *Franchise life contracts* usually consist of individual policies offered to all persons in a general class (usually a work profession) who are related in some way such as belonging to a certain association.

35. *Universal life and variable life contracts* include those contracts which have terms that are not fixed and guaranteed relative to premium amounts, expense assessments, or benefits accruing to the policyholder. These contracts generally provide for death benefits and nonforfeiture values and may be issued on a fixed premium basis or on a flexible premium basis where the premiums are paid at the insured’s discretion.

36. *Limited-payment contracts* are contracts with terms that are fixed and guaranteed, and for which premiums are paid over a specified number of years or to a specified age. The insurance coverage continues for the remainder of the insured's life. A single-premium policy requires a lump-sum payment at the inception of the policy.

37. *Credit life contracts* are sold in connection with loans or other credit transactions not exceeding a stated duration and provide insurance protection against death. This form of insurance is generally issued in connection with the issuance of credit to an individual by a bank, retailer, finance company, or other similar organizations. This type of insurance most often protects the creditor to the extent of the unpaid balance of the loan in the form of decreasing term insurance; however, some credit life insurance is sold on a level-term basis.

38. An *annuity contract* is an arrangement whereby an annuitant is guaranteed to receive a series of stipulated amounts commencing either immediately or at some future date. A contract with a purchase rate guarantee represents a life contingency that would require an annuity contract to be classified as a life contract. Annuity contracts are issued to individuals or to groups. Group annuities are often the vehicle used to provide for a company's pension obligations to its employees. The main types of *annuity contracts with life contingencies* are discussed below.

a. A *deferred annuity* provides for the accumulation of funds to be applied at some future period designated by the policyholder. Premium payments can be made in a lump sum amount (single premium deferred annuity), or periodically (flexible or fixed premium deferred annuity) as allowed by the policy contract. At the end of the accumulation period, the policyholder may elect to receive a lump sum distribution or may elect to receive periodic payments for life, over specific period, or some combination thereof.

b. A *variable annuity* is an annuity which includes a provision for benefit payments which vary in accordance with the rate of return of the underlying investment portfolio selected by the policyholder. The considerations for a variable annuity are usually invested in a separate account in which the value of the contract share varies according to the performance of the separate account before the commencement of annuity payments as well as after. Premium payments can be made in lump sum amounts, or periodically as allowed by the policy contract. A minimum death benefit is often guaranteed during the annuity consideration accumulation period and these contracts are therefore classified as life contracts.

c. A *straight-life annuity* provides for periodic payments to the annuitant as long as the annuitant lives. Death of the annuitant constitutes completion of the contract and no further payments are made by the insurance company.

d. A *life annuity with a period certain* works essentially the same way as the straight-life annuity as the annuitant receives periodic payments for as long as the annuitant lives. However, if the annuitant dies before the end of the specified "certain" period, payments are continued to a beneficiary until the specified number of "certain" payments (i.e., the specified period in the contract) is completed.

e. A *refund annuity* is similar to the *life annuity with a period certain* in which the annuitant receives periodic payments for as long as the annuitant lives. There are two variants of this type of annuity. Under the cash refund annuity, a lump-sum payment is made at the death of the annuitant equal to the excess, if any, of the purchase price of the annuity over the sum of the annuity payments made to date of death. The installment refund annuity provides that annuity payments are to continue to a beneficiary after the death of the annuitant until the sum of all payments made equals the purchase price.

f. A *joint and survivorship annuity* provides for the continuation of payments after the death of one of the annuitants during the lifetime of the surviving annuitant.

Accident and Health Contracts

39. Accident and health contracts provide protection against economic losses resulting from accident, sickness, or medical condition. This coverage may be provided under individual policies, under group or franchise policies, managed care contracts, or Medicaid or Medicare risk contracts, or it may be provided under certain special types of policies, such as credit accident and health insurance.

40. The economic losses which accident and health policies cover, or the types of benefits provided, will vary with different policies. The broad categories of economic losses protected against are medical and hospital expense and income replacement. For example, payments for hospital, surgical, or medical expenses may be provided under a hospital expense policy, while under other policies, a more comprehensive form of coverage, known as major medical insurance, may be offered. Similarly, policies may provide monthly benefits for loss of income from disability, either on a short term or a long term basis, or only for disabilities due to accident. Loss of life from accident may be covered under accidental death policies, while under certain limited accident policies, only accidental death from air travel may be covered.

41. Accident and health policies may be categorized by the form of policy through which the coverage is provided; it may be categorized according to the benefits provided by the policy; or it may be categorized by the contingencies insured against. These variations in types of policies and the benefits provided must be considered in discussing the reserves for accident and health policies.

42. *Credit accident and health insurance contracts* are similar to credit life insurance except the insurance protection is in the form of disability insurance.

43. *Long-term care contracts* represent any contract or policy rider providing coverage for not less than twelve consecutive months for each covered person for one or more necessary diagnostic, preventive, therapeutic, rehabilitative, maintenance or personal care services, provided in a setting other than an acute care unit of a hospital. Under long-term care contracts, the insured event is generally the inability of the contractholder to perform certain activities of daily living as compared to medical contracts which generally provide insurance protection against accident or sickness or disabilities contracts which generally provide income replacement protection.

Deposit-Type Contracts

44. Under deposit-type contracts, the policyholder may assume all, some, or none of the investment risk, depending on the contract terms. Amounts can be deposited in lump sum, or periodically as allowed by the policy contract. Deposit-type contracts would include annuities certain, whose income payments have no reference to life contingencies and benefits are paid over a specified period (i.e., 10 years, 20 years, etc.)

Property and Casualty Contracts

45. Property and casualty contracts include a variety of types of coverage, including, but not limited to, fire, workers' compensation, automobile, multiple peril, professional and miscellaneous liability, and fidelity and surety bonds as further discussed below.

46. Types of insurance represent the perils that are insured by property and liability insurance companies and classified as property and casualty contracts. Some of the more important types of insurance are as follows:

a. *Fire and allied lines*, which include coverage for fire, windstorm, hail, and water damage (but not floods);

b. *Ocean marine*, which includes coverage for ships and their equipment, cargos, freight or money to be paid for use of the ships, and liability to third parties for damages. This type of insurance includes inland as well as ocean water transportation;

c. *Inland marine*, which covers property in transit. (It also includes floaters, which are policies that cover movable property, such as a tourist's personal property);

d. *Workers' compensation*, which compensates employees for injuries or illness sustained in the course of their employment;

e. *Automobile*, which covers personal injury or automobile damage sustained by the insured and the related liability to third parties for losses caused by the insured;

f. *Multiple peril*, which is a package coverage including most property and liability coverage except workers' compensation, automobile insurance, and surety bonds;

g. *Professional liability*, which covers physicians, surgeons, dentists, hospitals, engineers, architects, accountants, attorneys, and other professionals from liability arising from error or misconduct in providing or failing to provide professional service;

h. *Miscellaneous liability*, which covers most other physical and property damages not included under workers' compensation, automobile liability, and multiple peril policies. (Damages include death, cost of care, and loss of services resulting from bodily injury, as well as loss of use of property);

i. *Fidelity bonds*, which cover employers against dishonest acts by employees. Blanket fidelity bonds cover groups of employees; and

j. *Surety bonds*, which provide for monetary compensation to third parties for failure by the insured to perform specifically covered acts within a stated period. (Most surety bonds are issued for persons doing contract construction, persons connected with court actions, and persons seeking licenses and permits. Surety bonds also include financial guarantees.)

47. In addition to these types, insurance is provided by excess and surplus lines. *Excess liability* covers the insured against loss in excess of a stated amount, but only for losses as covered and defined in an underlying policy. The underlying amount is usually insured by another policy but can be retained by the insured. *Surplus lines* include coverage for risks that do not fit normal underwriting patterns, risks that are not commensurate with standard rates, or risks that will not be written by standard carriers because of general market conditions. These kinds of policies are generally written by carriers not licensed in the jurisdiction where the risk is located and generally are not subject to regulations governing premium rates or policy language.

48. Insurance is generally available to the individual as a means of protection against loss. There are instances, however, in which a person cannot obtain insurance in the voluntary insurance market. States have established *involuntary plans* to provide insurance to those with high risks who otherwise would be excluded from obtaining coverage. A common example is the Automobile Insurance Plan (formerly called the Assigned Risk Plan). Under this plan, all companies writing automobile insurance in a state are allocated a share of the involuntary business on an equitable basis. Other states use a reinsurance plan, under which each insurer accepts all applicants but may place high-risk drivers in a reinsurance pool, with premiums paid to and losses absorbed by the pool. Still another approach is a joint underwriting association, in which one or more servicing companies are designated to handle high-risk drivers. All insurers in the state may be required to participate in the underwriting results. Another example of involuntary plans includes Fair Access to Insurance Requirements (FAIR) plans. FAIR plans are federally approved, state-supervised programs established to provide coverage for property in high-risk areas. Companies that operate in the state are assessed for any underwriting losses experienced by the FAIR plan.

49. *Medical malpractice pools* were established when health-care professionals and institutions were experiencing difficulty in obtaining liability insurance in the voluntary insurance market. The pools were

established by law and currently exist in the majority of states. All insurers writing related liability insurance in such states are considered mandatory participants in the pools as a condition for their continuing authority to transact business in such states.

50. *Workers' compensation pools* are similar to FAIR plans. As with FAIR plans, companies operating in a given state are assessed a proportionate share, based on direct writings, of the underwriting results of the pool.

51. *Title insurance* insures, guarantees, or indemnifies owners of real property or the holders of liens or encumbrances thereon against loss or damage suffered by unidentified instances of defective titles, liens or encumbrances or the unmarketability of the title.

52. *Mortgage guaranty insurance* protects a lender against loss of all or a portion of the principal amount of a mortgage loan upon default of the mortgagor. This type of insurance provides no protection other than against loss due to default.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE (ONLY PERTINENT EXCERPTS ARE INCLUDED BELOW)

Statutory Accounting

53. The Life/A&H Accounting Practices and Procedures Manual provides the following guidance with respect to the classification of life and annuity contracts:

> CHAPTER 10
> AGGREGATE RESERVES FOR LIFE AND ANNUITY CONTRACTS
>
> Life Insurance
>
> All life insurance that is written can be separated into four lines of business: ordinary, industrial, group and credit.
>
> Ordinary life insurance is the most common type of the four lines, and it may consist of whole life, term, or endowment coverages. The contract is between the company and the insured (or the owner, if different). The payment of the premium by the insured/owner usually is sent directly to the home office of the company and not to a company agent.
>
> Many modifications of whole life, term, and endowment coverages are available to the insurance buyer. Such variations include limited payment periods, combinations of coverages, and decreasing (or increasing) death benefits. In addition, some policies, notably universal life policies, offer the insurance buyer the option to vary, or even suspend, premium payments over the life of the policy.
>
> Also considered as ordinary insurance is franchise insurance. It usually consists of individual policies offered to all persons in a general class (usually a work profession) who are related in some way such as belonging to a certain association. Some states require that this relationship be other than through the purchase of insurance.
>
> Industrial life insurance, also called debit insurance, can be defined as insurance under which premiums are paid weekly, or under which the premiums are payable monthly or more often if the face amount of the insurance provided in the policy does not exceed a stated amount and the words "industrial policy" are printed in prominent type on the face of the policy.
>
> Group life insurance is insurance on the lives of a group of members, the minimum number of which may be specified by statute. Group insurance is based on a master policy which usually precludes or disallows individual selection and is for the benefit of persons other than the policyholder. The individual insured members may receive certificates of insurance which evidence

> the contract. The contract is made by the policyholder and the insurer; there is no contract of insurance between the policyholder and the members. The various state statutes vary as to what constitutes a group and as to who may be a policyholder. Some states permit only employee-employer relationships in a group contract. Others permit union members, credit union members, or similar relationships in group contracts.
>
> The fourth line of life insurance is credit. Credit insurance may be either individual or group. All life and all accident and health insurance that is sold in connection with loans or other credit transactions not exceeding a stated duration is to be reported as credit insurance.

54. The Life/A&H Accounting Practices and Procedures Manual provides the following guidance with respect to the classification of accident and health contracts:

> CHAPTER 13
> AGGREGATE RESERVES FOR ACCIDENT AND HEALTH POLICIES
>
> Accident and health insurance provides protection against economic losses resulting from accident and/or sickness. This insurance may be provided under individual policies, under group or franchise policies, or it may be provided under certain special types of policies which bear unique titles such as credit insurance. The economic losses which accident and health insurance policies cover, or the types of benefits provided, will vary with different policies. For example, reimbursement for hospital, surgical, or medical expenses may be provided under a hospital expense policy, while under other policies, a more comprehensive form of coverage, known as major medical insurance, may be offered. Similarly, policies may provide monthly benefits for loss of income from disability, either on a short term or a long term basis, or only for disabilities due to accident. Loss of life from accident may be covered under accidental death policies, while under certain limited accident policies, only accidental death from air travel may be covered. Therefore, accident and health policies may be categorized by the form of policy through which the coverage is provided; it may be categorized according to the benefits provided by the policy; or it may be categorized by the contingencies insured against. These variations in types of policies and the benefits provided must be considered in discussing the reserves for accident and health insurance policies.
>
> Accident and health policies are offered by life companies, casualty companies, fraternal benefits societies, and certain specialty companies. While the coverage originated with casualty companies, it is now the life insurance companies which provide the majority of accident and health insurance. The history of the business is important because many of the concepts currently used originated from casualty insurance practices and use casualty terminology. Since the life insurance companies began writing this insurance, the form of the policies and the concept of coverages have changed, which also produced changes in reserving practices.
>
> Individual Accident and Health Policies
>
> Individual accident and health policies, other than credit insurance, are separated for reserve reporting purposes in the statutory financial statement into six classifications. The definitions are included in the instructions for the statutory financial statement and are based principally on the renewal agreement of the policy. There is some variation in the reserve requirements which apply to the different renewal classifications of policies but most reserve requirements apply to all individual policies.
>
> Group Policies
>
> All organizations that qualify to purchase group life insurance may also, by most state laws, purchase accident and health insurance. In many states, the definition of what constitutes an eligible group for accident and health insurance is entirely left up to any set of good underwriting practices established by the insurance company.

Credit Insurance

Credit accident and health insurance is insurance on a debtor to provide indemnity for payments becoming due on a specific loan or other credit transaction while the debtor is disabled as defined in the policy. Credit policies are limited to issues of 120 months or less in most states. Some states limit such policies to 60 months.
Credit accident and health insurance is sold as either individual or group coverage, and the reserves are included in the annual statement. Because of the significant growth in recent years of credit insurance coverages of 120 months or less are now reported as a separate line of business in the annual statement.

The premium payment methods of credit insurance may be single premium or monthly premium on the outstanding balance. Outstanding balance rates, used only for group coverage, are determined by multiplying a monthly rate times the amount of outstanding insured indebtedness. The premium so determined is remitted on each monthly due date to the insurer by the group creditor. Under single premium credit insurance, the premium rate is applied to the initial amount of insurance and generally is included in the debt. Creditors usually remit the single premium for each new insured once a month.

Although credit insurance may be written on an individual or a group basis, the major portion of credit insurance that is written today is group. The two types differ only in form, not in substance. Consequently, they are treated here as one, unless otherwise noted.

55. The P&C Accounting Practices and Procedures Manual and the Accounting Practices and Procedures Manual for Health Maintenance Organizations do not contain relevant guidance related to the classification and definitions of types of policies.

Generally Accepted Accounting Principles

56. FAS 60, as amended by FAS 120, provides the following guidance on definitions and classification of insurance contracts:

Summary

Insurance contracts, for purposes of this Statement, need to be classified as short-duration or long-duration contracts. Long-duration contracts include contracts, such as whole life, guaranteed renewable term life, endowment, annuity, and title insurance contracts, that are expected to remain in force for an extended period. All other insurance contracts are considered short-duration contracts and include most property and liability insurance contracts.

Premiums from short-duration contracts ordinarily are recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided. Claim costs, including estimates of costs for claims relating to insured events that have occurred but have not been reported to the insurer, are recognized when insured events occur.

Premiums from long-duration contracts are recognized as revenue when due from policyholders. The present value of estimated future policy benefits to be paid to or on behalf of policyholders less the present value of estimated future net premiums to be collected from policyholders are accrued when premium revenue is recognized. Those estimates are based on assumptions, such as estimates of expected investment yields, mortality, morbidity, terminations, and expenses, applicable at the time the insurance contracts are made. Claim costs are recognized when insured events occur.

INTRODUCTION

1. The primary purpose of insurance is to provide economic protection from identified risks occurring or discovered within a specified period. Some types of risks insured include death,

disability, property damage, injury to others, and business interruption. Insurance transactions may be characterized generally by the following:

a. The purchaser of an insurance contract makes an initial payment or deposit to the insurance enterprise in advance of the possible occurrence or discovery of an insured event.

b. When the insurance contract is made, the insurance enterprise ordinarily does not know if, how much, or when amounts will be paid under the contract.

2. Two methods of premium revenue and contract liability recognition for insurance contracts have developed, which are referred to as short-duration and long-duration contract accounting in this Statement. Generally, the two methods reflect the nature of the insurance enterprise's obligations and policyholder rights under the provisions of the contract.

3. Premiums from short-duration insurance contracts, such as most property and liability insurance contracts, are intended to cover expected claim[1] costs resulting from insured events that occur during a fixed period of short duration. The insurance enterprise ordinarily has the ability to cancel the contract or to revise the premium at the beginning of each contract period to cover future insured events. Therefore, premiums from short-duration contracts ordinarily are earned and recognized as revenue evenly as insurance protection is provided.

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[1] Terms defined in the glossary (Appendix A) are in boldface type the first time they appear in this Statement.

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4. Premiums from long-duration insurance contracts, including many life insurance contracts, generally are level even though the expected policy benefits and services do not occur evenly over the periods of the contracts. Functions and services provided by the insurer include insurance protection, sales, premium collection, claim payment, investment, and other services. Because no single function or service is predominant over the periods of most types of long-duration contracts, premiums are recognized as revenue over the premium-paying periods of the contracts when due from policyholders. Premium revenue from long-duration contracts generally exceeds expected policy benefits in the early years of the contracts and it is necessary to accrue, as premium revenue is recognized, a liability for costs that are expected to be paid in the later years of the contracts. Accordingly, a liability for expected costs relating to most types of long-duration contracts is accrued over the current and expected renewal periods of the contracts.

5. Title insurance contracts provide protection for an extended period and therefore are considered long-duration contracts. Premiums from title insurance contracts ordinarily are recognized as revenue on the effective date of the contract because most of the services associated with the contract have been rendered by that time. Estimated claim costs are recognized when premium revenue is recognized because the insurance provides protection against claims caused by problems with title to real estate arising out of ascertainable insured events that generally exist at that time.

APPLICABILITY AND SCOPE

6. This Statement establishes accounting and reporting standards for the general-purpose financial statements of stock life insurance enterprises, property and liability insurance enterprises[2], and title insurance enterprises, mutual life insurance enterprises, assessment enterprises, and fraternal benefit societies. Except for the sections on premium revenue and claim cost recognition and acquisition costs (paragraphs 9-11, 13-18, and 20-31), this Statement applies to mortgage guaranty insurance enterprises. FASB Statement 120, Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts, addresses the accounting for certain long-duration participating life insurance contracts.

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[2] Property and liability insurance enterprises, for purposes of this Statement include stock enterprises, mutual enterprises, and reciprocal interinsurance exchanges.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

General Principles

7. Insurance contracts, for purposes of this Statement, shall be classified as short-duration or long-duration contracts depending on whether the contracts are expected to remain in force[3] for an extended period. The factors that shall be considered in determining whether a particular contract can be expected to remain in force for an extended period are:

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[3] In force refers to the period of coverage, that is, the period during which the occurrence of insured events can result in liabilities of the insurance enterprise.

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a. Short-duration contract. The contract provides insurance protection for a fixed period of short duration and enables the insurer to cancel the contract or to adjust the provisions of the contract at the end of any contract period, such as adjusting the amount of the premiums charged or coverage provided.

b. Long-duration contract. The contract generally is not subject to unilateral changes in its provisions, such as noncancelable or guaranteed renewable contract, and requires the performance of various functions and services (including insurance protection) for an extended period.

8. Examples of short-duration contracts include most property and liability insurance contracts and certain term life insurance contracts, such as credit life insurance. Examples of long-duration contracts include whole life contracts, guaranteed renewable term life contracts, endowment contracts, annuity contracts, and title insurance contracts. Accident and health insurance contracts may be short-duration or long-duration depending on whether the contracts are expected to remain in force for an extended period. For example, individual and group insurance contracts that are noncancelable or guaranteed renewable (renewable at the option of the insured), or collectively renewable (individual contracts within a group are not cancelable), ordinarily are long-duration contracts.

57. FAS 97, as amended by FAS 120, provides the following guidance on definitions and classifications of insurance contracts:

Summary

This Statement establishes standards of accounting for certain long-duration contracts issued by insurance enterprises, referred to in this Statement as universal life-type contracts, that were not addressed by *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises*. The Statement also establishes standards of accounting for limited-payment long-duration insurance contracts and investment contracts and amends Statement 60 to change the reporting of realized gains and losses on investments.

New life insurance contracts have evolved since the development of specialized insurance industry accounting principles and practices in the early 1970s. Many of those new life insurance contracts have different provisions than do the life insurance contracts to which Statement 60 applies. Those new life insurance contracts are characterized by flexibility and discretion granted to one or both parties to the contract. Statement 60 identifies but does not address those contracts, noting that the accounting was under study by the insurance industry and the accounting and actuarial professions.

This Statement requires that the retrospective deposit method be used to account for universal life-type contracts. That accounting method establishes a liability for policy benefits at an amount determined by the account or contract balance that accrues to the benefit of the policyholder. Premium receipts are not reported as revenues when the retrospective deposit method is used. The Statement also requires that capitalized acquisition costs associated with universal life-type contracts be amortized based on a constant percentage of the present value of estimated gross profit amounts from the operation of a "book" of those contracts. Any gain or loss resulting from a policyholder's replacement of other life insurance contracts with universal life-type contracts is recognized in income of the period in which the replacement occurs.

This Statement requires that long-duration contracts issued by insurance enterprises that do not subject the enterprise to risks arising from policyholder mortality or morbidity (investment contracts) be accounted for in a manner consistent with the accounting for interest-bearing or other financial instruments. Payments received on those contracts are not reported as revenue.

This Statement also addresses limited-payment contracts that subject the insurance enterprise to mortality or morbidity risk over a period that extends beyond the period or periods in which premiums are collected and that have terms that are fixed and guaranteed. This Statement requires that revenue and income from limited-payment contracts be recognized over the period that benefits are provided rather than on collection of premiums.

58. AICPA P&C Audit and Accounting Guide provides the following definitions of types of insurance contracts:

Kinds of Insurance

1.04. Kinds of insurance, generally referred to as lines of insurance, represent the perils that are insured by property and liability insurance companies. Some of the more important lines of insurance are --

- Fire and allied lines, which include coverages for fire, windstorm, hail, and water damage (but not floods).

- Ocean marine, which includes coverage for ships and their equipment, cargos, freight or money to be paid for use of the ships, and liability to third parties for damages. (Ocean marine is perhaps the oldest form of insurance, dating back to at least 600 years to the days of the Venetian traders.)

- Inland marine, which covers property being transported other than transocean. (It also includes floaters, such as for personal property, jewelry, and furs.)

- Workers' compensation, which compensates employees for injuries or illness sustained in the course of their employment.

- Automobile, which covers personal injury or automobile damage sustained by the insured and liability to third parties for losses caused by the insured.

- Multiple peril, which is a package coverage including most property and liability coverages except workers' compensation, automobile insurance, and surety bonds.

- Professional liability, which covers physicians, surgeons, dentists, hospitals, engineers, architects, accountants, attorneys, and other professionals from liability arising from error or misconduct in providing or failing to provide professional service.

- Miscellaneous liability, which covers most other physical and property damages not included under workers' compensation or automobile liability policies. (Damages include death, cost of care, and loss of services resulting from bodily injury, as well as loss of use of property.)

- Fidelity bonds, which cover employers against dishonest acts by employees. Blanket fidelity bonds cover groups of employees.

- Surety bonds, which provide for monetary compensation to third parties for failure by the insured to perform specifically covered acts within a stated period. (Most surety bonds are issued for persons doing contract construction, persons connected with court actions, and persons seeking licenses and permits. Surety bonds also include financial guarantees.)

- Accident and health, which covers loss by sickness or accidental bodily injury. (It also includes forms of insurance that provide lump-sum or periodic payments in the event of loss by sickness or accident, such as disability income insurance and accidental death and dismemberment insurance.)

1.05. In addition to these lines, insurance is provided by excess and surplus lines. Excess liability covers the insured against loss in excess of a stated amount, but only for losses as covered and defined in an underlying policy. The underlying amount is usually insured by another policy but can be retained by the insured. Surplus lines include coverage for risks that do not fit normal underwriting patterns, risks that are not commensurate with standard rates, or risks that will not be written by standard carriers because of general market conditions. Policies are written by carriers not licensed in the jurisdiction where the risk is located and generally are not subject to regulations governing premium rates or policy language.

1.06. The lines and premium volume that may be written by a company are generally restricted by state insurance regulations. For example, total written premiums may be limited to a ratio of the company's statutory basis equity. (This and other insurance regulations developed by the National Association of Insurance Commissioners (NAIC) are discussed further in paragraphs 2.05 and 2.06 "NAIC Insurance Regulatory Information System.")

1.07. Insurance written by property and liability insurance companies may be broadly classified as personal lines, which consist of insurance policies issued to individuals, and commercial lines, which consist of policies issued to business enterprises. Personal lines generally consist of large numbers of relatively standard policies with relatively small premiums per policy. Examples are homeowner's and individual automobile policies. Commercial lines involve policies with relatively large premiums that are often retroactively adjusted based on claims experience. The initial premium is often only an estimate because it may be related to payroll or other variables. Examples are workers' compensation and general liability. Many large insurance companies have separate accounting, underwriting, and claim-processing procedures for these two categories.

1.08. Insurance is generally available to the individual as a means of protection against loss. There are instances, however, in which a person cannot obtain insurance in the voluntary insurance market. States have established programs to provide insurance to those with high risks who otherwise would be excluded from obtaining coverage. Following are some of the more common programs that provide the necessary coverage:

- Involuntary automobile insurance. States have a variety of methods for apportioning involuntary automobile insurance. The most widely used approach is the Automobile Insurance Plan (formerly called the Assigned Risk Plan). Under this plan, all companies writing automobile insurance in a state are allocated a share of the involuntary business on an equitable basis. Each automobile insurer operating in the state accepts a share of the undesirable drivers, based on the percent of the state's total auto insurance that it writes. For example, a company that writes 5 percent of the voluntary business in a state may be assigned 5 percent of the involuntary applicants. It is then responsible for collecting the premiums and paying the claims on the policies issued to these applicants. Other states use a reinsurance plan, under which each insurer accepts all applicants but may place high-risk drivers in a reinsurance pool, with premiums paid to and losses absorbed by the pool. Still another approach is a joint underwriting association, in which one or more servicing companies are designated to handle high-risk drivers. All insurers in the state may be required to participate in the underwriting results.

- FAIR plans. FAIR (Fair Access to Insurance Requirements) plans are federally approved, state-supervised programs established to provide coverage for property in high-risk areas. Companies that operate in the state are assessed for any underwriting losses experienced by the FAIR plan.

- Medical malpractice pools. These pools were established when health-care professionals and institutions were experiencing difficulty in obtaining liability insurance in the voluntary insurance market. The pools were established by law and currently exist in the majority of states. All insurers writing related liability insurance in such states are considered mandatory participants in the pools as a condition for their continuing authority to transact business in such states.

- Workers' compensation pools. These pools are similar to FAIR plans. As with FAIR plans, companies operating in a given state are assessed a proportionate share, based on direct writings, of the underwriting results of the pool.

59. *AICPA Life Audit and Accounting Guide, Chapter 3*, *Insurance Operations*, provides the following definitions of types of insurance contracts:

Types of Policies and Contracts

3.02. Policies and contracts usually issued by a life insurance company may generally be designated by the following broad classifications:

1. Life insurance policies.

2. Annuity contracts.

3. Accident and health contracts.

In addition, certain life insurance companies may issue policies which incorporate features of two or three of the broad categories shown above (e.g., an insurance-with-annuity policy). Each of the types of policies is commonly issued both on a participating and on a nonparticipating basis.

3.03. Life Insurance Policies. Life insurance coverage consists of the following basic classes:

1. Whole life.

2. Endowment.

3. Term.

4. Other.

3.04. Whole life policies provide insurance over the insured's entire life and the proceeds (face amount) are paid only upon death of the insured. A level premium is usually paid for policies of this type; and the premium may be paid in annual or more frequent modes. An ordinary-life (straight-life) policy stipulates that premiums are to be paid during the life of the insured. A limited-payment policy is one for which premiums are payable over a stipulated period of time (10, 20, 30 years, etc.). A single-premium policy requires a lump-sum payment at the inception of the policy.

3.05. Endowment policies provide insurance protection over the term of the endowment (i.e., from inception of the policy to the maturity date). Such contracts stipulate payment of the face amount of the policy to a beneficiary if the insured dies during the endowment period. However, if he is still living at the maturity date, the insured will receive the face amount of the policy. Endowment contracts can mature at a specified age of the insured or at the end of a specified period of time. The premiums for contracts of this nature are usually payable over the endowment period, but the premiums can be on a single-payment or limited-payment plan.

3.06. Both whole life and endowment policies contain nonforfeiture or similar clauses which provide for a value in cash or some other form of insurance to be available in the event of failure to continue the required premiums.

3.07. Term policies provide insurance over a specified period of time. If the insured dies during this term, the face amount of the policy will be paid to his beneficiary. Policies for term insurance which are written for relatively short periods of time commonly grant the policyholder the right to renew for an additional period or periods up to a maximum age, such as 60 or 65, without requiring additional evidence of insurability. Rights to convert to whole life or endowment contracts may also be included in the contract. Term contracts may also be made for a period which will end when the insured reaches a certain age (for example, age 60 or 65). Since the premium for term insurance provides for neither maturity benefits nor higher death rates at advanced ages, such policies do not usually accumulate cash surrender values. Collection of premiums for individual insurance may be by mail, where a notice of premium due is sent to the payor, or may be on the debit basis whereby an agent regularly calls at the home of the insured to collect small premium amounts. Usually, the more popular plans of debit life insurance are industrial plans paid up at age 65 or 70 or 10-pay or 20-pay life. Ordinary plans may also be administered on the debit basis.

3.08. In addition to individual policies, life insurance companies offer group life insurance, which insures lives of a group of persons under a single master contract. Insurance of this type is customarily written on a yearly renewable term basis although some permanent group life is sold.

3.09. In addition to the policies and contracts for life insurance mentioned above, there are other life insurance contracts which are becoming more prominent, such as credit life insurance. This form of insurance is generally issued in connection with the issuance of credit to an individual by a bank, retailer, finance company, or other similar organizations. This type of insurance most often protects the creditor to the extent of the unpaid balance of the loan in the form of decreasing term insurance; however, some credit life insurance is sold on a level-term basis.

3.10. In addition to the wide variety of whole life and endowment policies which are available from life insurance companies, the basic policies can be supplemented by the use of riders which are attached to and made a part of the contract. It is fairly common to provide for waiver of premiums through the use of a rider in the event of disability of the insured or for an accidental death benefit. The typical accidental death benefit is often referred to as double indemnity which means that the company will pay twice the amount of the policy if the insured dies through accidental means.

3.11. Annuity Contracts. An annuity contract is an arrangement whereby an annuitant is guaranteed to receive a series of stipulated amounts commencing either immediately or at some future date. Annuity contracts are issued to individuals or to groups. Group annuities are often the vehicle used to provide for a company's pension obligations to its employees.

3.12. The main types of annuities are the following:

3.13. Straight-life annuity -- The straight-life annuity provides for periodic payments to the annuitant as long as he lives. Death of the annuitant constitutes completion of the contract and no further payments are made by the insurance company.

3.14. Life annuity with a period certain -- The life annuity with a period certain works essentially the same way as the straight-life annuity, except that if the annuitant dies before the end of the specified period, payments are continued to a beneficiary until the specified number of payments is completed.

> 3.15. Refund annuity -- The refund annuity is similar to the annuity certain. There are two variants of this type of annuity. Under the cash refund annuity, a lump-sum payment is made at the death of the annuitant equal to the excess, if any, of the purchase price of the annuity over the sum of the annuity payments made to date of death. The installment refund annuity provides that annuity payments are to continue to a beneficiary after the death of the annuitant until the sum of all payments made equals the purchase price.
>
> 3.16. Joint and survivorship annuity -- The joint and survivorship annuity provides for the continuation of payments after the death of one of the annuitants during the lifetime of the surviving annuitant.
>
> 3.17. Variable annuity -- At present, variable annuities for individuals or groups are being introduced throughout the life insurance industry. A variable annuity is an annuity which includes a provision for benefit payments which vary in accordance with investment experience. The considerations for a variable annuity are usually invested in a separate account in which the value of the contract share varies according to the performance of the separate account before the commencement of annuity payments as well as after. Some variable annuities provide for a guaranteed minimum death benefit during the annuity consideration accumulation period.
>
> 3.18. Accident and Health Insurance Contracts. There is a great variety of accident and health contracts which life insurance companies may issue, but most contracts can be generally categorized as follows:
>
> 1. Protection against loss of income through partial or total disability.
>
> 2. Reimbursement of expenses
>
>   a. Hospital expenses, laboratory services, drugs, and so forth.
>
>   b. Surgical or medical expenses.
>
> 3.19. Much of the above coverage is currently being furnished under group contracts. Coverage furnished under individual contracts can be further subdivided according to the insured's right to continue his policy and the limitations on the insurer's right to increase premiums.

60. The *AICPA Audit and Accounting Guide: Health Care Organizations* provides the following guidance:

> Health Care Contracting
>
> 1.18 Contracts between a health care provider and a payor based on anything other than full charges requires the provider to accept some financial risk. The nature and degree of risk for the provider varies depending on the contract terms (for example, the definition of the unit of service or the basis for payment). In planning the audit of the health care provider, the auditor considers the audit risk associated with the entity’s health care contracts. For example, contracts with payments for services based on a discount from the provider’s established rates may have different risks than contracts with payments for services based on a capitated arrangement.
>
> 1.19 Generally, capitation payments are made at the beginning of each month and obligate the provider to render covered services during the month. Revenue is earned as a result of agreeing to provide services to qualified beneficiaries and not as a result of actually providing the care. If the provider’s accounting system records patient charges and establishes patient receivables as services are rendered, appropriate valuation allowances or adjustments should be recorded so only the amount of contract revenue is recorded.
>
> 1.20 A capitation contract may obligate the provider to assume the risk of physician referrals and other outside services. In this case, a liability for unpaid claims, including incurred but not reported claims, should be established. A lag analysis may be helpful in estimating the liability.

1.21 In addition to the capitation payments, the amount of contract revenue may be affected by factors such as reinsurance recoveries, deductibles, coinsurance, and risk pool adjustments. risk pool adjustments may be based on factors such as utilization or cost targets.

1.22 Sometimes health care providers enter preferred provider arrangements with self-insured employers whereby the provider guarantees that the employer's health care cost will not increase over a specified amount or percentage. In substance, these providers may have provided aggregate stop-loss insurance to the self-insured employer, and a material liability to the provider may exist. *FASB Statement No. 5, Accounting for Contingencies*, provides guidance on accounting for these contingencies. *FASB Statement No. 10, Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*, provides guidance on accounting for contingencies by governmental enterprises.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 10, Aggregate Reserves for Life and Annuity Contracts, Chapter 13, Aggregate Reserves for Accident and Health Policies
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies

Generally Accepted Accounting Principles

- *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises*
- *FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*
- *FASB Statement No. 120, Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*
- *AICPA Audit and Accounting Guide: Audits of Property and Liability Insurance Companies, Chapter 1, Nature, Conduct, and Regulation of the Business*
- *AICPA Audit and Accounting Guide: Audits of Stock Life Insurance Companies, Chapter 3, Insurance Operations*
- *AICPA Audit and Accounting Guide: Health Care Organizations, Chapter 1, Unique Considerations of Health Care Organizations*

State Regulations

- No additional guidance obtained from state statutes or regulations.

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Statutory Issue Paper No. 51

Life Contracts

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 51

Type of Issue
Life Specific

SUMMARY OF ISSUE

1. Current statutory accounting guidance on income recognition and policy reserves for life contracts as defined in *Issue Paper No. 50—Classifications and Definitions of Insurance or Managed Care Contracts In Force* (Issue Paper No. 50) is addressed in Chapter 10, Aggregate Reserves for Life and Annuity Contracts and Chapter 18, Premium Income, of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies (Life/A&H Accounting Practices and Procedures Manual). That guidance applies to premiums and considerations and related policy reserves for all contracts with life contingencies. Amounts left on deposit under optional settlement modes and amounts left to accumulate at interest are recognized as deposit-type funds or considerations for supplemental contracts, as appropriate. In addition, policy reserves must make a good and sufficient provision for all unmatured obligations guaranteed under the terms of the contracts and are generally computed based on the provisions of the NAIC Model Standard Valuation Law (SVL), the Actuarial Opinion and Memorandum Model Regulation, the Actuarial Standards of Practice promulgated by the Actuarial Standards Board and the actuarial guidelines adopted by the NAIC; however, variations by state do exist.

2. GAAP guidance for life contracts recognizes premium income when it is contractually due from the policyholder. However, for investment contracts and universal life-type contracts, GAAP requires the consideration received from the policyholder to be treated as a deposit. For limited-payment contracts, GAAP requires that income be recognized over the total benefit period rather than the premium collection period. GAAP guidance also requires policy reserves to be established using actuarial assumptions applicable at the time the insurance contracts are made or, for certain long-duration contracts, the balance that accrues to the benefit of the policyholder.

3. The purpose of this issue paper is to establish statutory accounting principles for income recognition and policy reserves for all contracts classified as life contracts as defined in Issue Paper No. 50, except for universal-life type contracts as discussed in *Issue Paper No. 56—Universal Life-Type Contracts, Policyholder Dividends, and Coupons* (Issue Paper No. 56) and credit insurance contracts as discussed in *Issue Paper No. 59—Credit Life and Accident and Health Insurance Contracts* that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. This issue paper prescribes the income recognition and general policy reserve requirements for all contracts with life contingencies discussed in Issue Paper No. 50. Also as discussed in Issue Paper No. 50, subsequent issue papers, where needed, will establish specific statutory accounting principles that are applicable to unique characteristics of certain life contracts (e.g., universal life-type, credit life and variable contracts).

Types of Premiums

5. The gross premium is the amount charged to the policyholder and taken into operations as premium income.

6. The net premium is the amount calculated on the basis of the interest and mortality table used to calculate the reporting entity's statutory policy reserves.

7. The difference between the gross premium and the net premium is referred to as 'loading.' Loading generally includes allowances for acquisition costs and other expenses but also includes the differences in mortality and interest assumptions utilized for pricing and statutory reserving purposes.

Premium Income Recognition

8. Premiums shall be recognized as income on the gross basis (amount charged to the policyholder) when due from policyholders under the terms of the insurance contract. As a result, premium income shall include first year and renewal premiums, as well as any related premium adjustments (i.e., retrospective premium contracts which are discussed in *Issue Paper No. 66—Accounting for Retrospectively Rated Contracts)* provided for by the insurance contract. In addition, single and flexible premium amounts shall also be recorded as premium income when received from the policyholder. Premiums on flexible premium products are discussed in Issue Paper No. 56. The contractual due date shall be established through the predetermined billing procedure agreed to by the parties. Further, the recognition of premium income and the change in loading shall be consistent with the assumptions made in calculating the related policy reserve.

9. Premium income shall include dividends, coupons, guaranteed annual pure endowments, and similar benefits provided by the insurance contract when such amounts are applied by the terms of the contract to provide additional paid-up insurance, annuities, or to shorten the endowment or premium-paying period. Premiums and considerations waived by the reporting entity under disability provisions contained in its policies and contracts, and reported in operations as a disability benefit, are included in premium income.

10. Premium income shall exclude premiums that have been received by the reporting entity prior to the reporting date but which are due on or after the next policy anniversary date (i.e., advance premiums as discussed below).

11. Premium income should be reduced for premiums returned and allowances to industrial policyholders for the direct payment of premiums.

12. Premium income shall be increased by reinsurance premiums assumed and reduced by reinsurance premiums ceded. Reinsurance premiums assumed and ceded shall be defined and addressed in *Issue Paper No. 74—Life, Deposit-Type and Accident and Health Reinsurance*.

13. Death or other benefits used to fund new policies shall be accounted for as a benefit payment and as a new premium, another type of income, or a liability, as appropriate.

Premium Adjustments

14. In the Summary of Operations, the change in gross deferred and uncollected premiums is recorded as premium income. Deferred premiums are further discussed in paragraph 21. Since only the net premiums are included in the computation of reserves and reported as an asset, it is necessary to adjust the gross premium for an amount representing the change in loading on deferred and uncollected premiums. The change in loading is included as an expense in the Summary of Operations and is not shown as a reduction to premium income.

Uncollected Premium Balances

15. Gross premiums that are due and unpaid as of the reporting date, net of loading, shall be classified as uncollected premiums. Uncollected premium balances which are less than 90 days past due meet the definition of assets as set forth in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*, and are admitted assets to the extent they conform to the requirements of this paper.

Other Considerations Received

16. Considerations for supplementary contracts, dividends left to accumulate at interest, and amounts deposited and accumulated for guaranteed interest and group annuity contracts shall be recognized as deposit-type funds or considerations for supplemental contracts, as appropriate. These amounts are further discussed in *Issue Paper No. 52—Deposit-Type Contracts*.

Policy Reserves

17. Statutory policy reserves shall be established for all unmatured contractual obligations guaranteed under the terms of the policies. Where separate benefits are included in a contract, a reserve for each benefit shall be established as required by Appendix A-820. These statutory policy reserves are generally calculated as the excess of the present value of future benefits to be paid to or on behalf of policyholders less the present value of future net premiums. Statutory policy reserves meet the definition of liabilities as defined in *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets* (Issue Paper No. 5). The actuarial methodologies referred to in the following paragraph meet the criteria required for reasonable estimates in Issue Paper No. 5.

18. The reserving methodologies and assumptions used in computation of policy reserves shall meet the provisions of Appendices A-820 and A-822, and the actuarial guidelines found in Part 9 of the Financial Examiners Handbook. Further, policy reserves shall be in compliance with those Actuarial Standards of Practice promulgated by the Actuarial Standards Board.

19. The preceding two paragraphs summarize the general reserve requirements for all types of life contracts. In addition to these general reserve requirements, Appendix A-820 provides additional guidance with respect to certain types of accumulation annuities classified as life contracts that have flexible features (e.g., guaranteed nonforfeiture benefits such as interest guarantees, annuitization options, bailout features, partial withdrawals) which can create varying benefit streams if elected by the policyholder. Specific policies with such flexible features covered by this additional guidance include individual and group annuity and pure endowment contracts, but excludes any disability and accidental death benefits in these contracts. For benefits under these contracts, reserves shall be established according to the commissioners' annuity reserve valuation method (CARVM). Generally, under CARVM, the difference between all possible future guaranteed benefits streams, including guaranteed nonforfeiture benefits, over the future considerations is computed as of the end of each contract year. Each of these differences is discounted to the reporting date at the applicable valuation interest rate. A reserve is then recorded based on the greatest present value difference of each of the contract year calculations.

Valuation (Reserve) Method and Deferred Premiums

20. Reserves shall be established for all benefits guaranteed under the terms of the policy as of the reporting date using appropriate valuation methods, interest, mortality, and morbidity, as appropriate. However, as a practical expedient, reserves have been generally calculated as of the policy anniversary date (i.e., terminal reserves), not the reporting date. As a result, it is necessary to adjust the terminal reserve back to the reporting date. The components used to compute a terminal reserve shall consist of an interest rate, a mortality and/or morbidity table, and a valuation method (e.g., net level, full preliminary term, Commissioners Reserve Valuation Method (CRVM), or Commissioners Annuity Reserve Valuation Method (CARVM)). A terminal reserve is based on the assumption that all net premiums have been received, all interest earned, and all benefits paid to the end of the policy year.

21. Since terminal reserves are computed as of the end of a policy year and not the reporting date, the terminal reserve must be converted to reflect that portion of the net premium that is unearned at the reporting date. This is generally accomplished using either the mean reserve method or the mid-terminal method as described below:

a. Under the mean reserve method, the policy reserve equals the average of the terminal reserve at the end of the policy year and the initial reserve (the initial reserve is equal to the previous year's terminal reserve plus the net annual valuation premium for the current policy year). When reserves are calculated on the mean reserve basis, it is assumed that the net premium for a policy is collected annually at the beginning of the policy year and that policies are issued ratably over the calendar year.

   However, as premiums are often received in installments more frequently than annually and since the calculation of mean reserves assumes payment of the current policy year's entire net annual premium, the policy reserve is overstated by the amount of net modal premiums not yet received for the current policy year as of the valuation date. As a result, it is necessary to compute and report a special asset to offset the overstatement of the policy reserve.

   This special asset is termed "deferred premiums." Deferred premiums are computed by taking the gross premium (or premiums) extending from (and including) the modal (monthly, quarterly, semiannual) premium due date or dates following the valuation date to the next policy anniversary date and subtracting any such deferred premiums that have actually been collected. Deferred premium assets shall also be reduced by loading. Since the calculation of mean reserves assumes payment of the current policy year's entire net annual premium, deferred premium assets are considered admitted assets to compensate for the overstatement of the policy reserve.

b. Under the mid-terminal method, the policy reserves are calculated as the average of the terminal reserves on the previous and the next policy anniversaries. These reserves shall be accompanied by an unearned premium reserve consisting of the portion of valuation premiums paid or due covering the period from the valuation date to the next policy anniversary date.

Advance Premiums

22. Advance premiums are those premiums that have been received by the reporting entity prior to the valuation date but which are due on or after the next policy anniversary date. The policyholder may remit one or more premiums in advance of specific due dates. Where premiums are remitted sufficiently far in advance, the premiums charged to the policyholder may be reduced or discounted to reflect the time value of money. The difference between the gross and discounted premium is ratably charged as interest in the Summary of Operations from the date of payment to the premium due date. At the premium due date, the amount received from the policyholder plus the accumulated interest equals the gross premium necessary to fund the policy. The total amount of such advance premiums, less any discount as of the valuation date, is reported as a liability in the statutory financial statement and is not considered premium income until due. The gross premium, not the net valuation premium, is recorded as the advance premium in recognition of the reporting entity's liability to refund such premiums in the event the policy is terminated.

Reserve Recognition

23. The difference between the policy reserves for life contracts at the beginning and end of the reporting period shall be reflected as the change in reserves in the Summary of Operations, except for any difference due to a change in valuation basis.

Change In Valuation Basis

24. A change in valuation basis shall be defined as a change in the interest rate, mortality assumption, or reserving method (e.g., net level, preliminary term, etc.) or other factors affecting the reserve computation of policies in force and meets the definition of an accounting change as defined in *Issue Paper No. 3—Accounting Changes* (Issue Paper No. 3). Consistent with Issue Paper No. 3, any increase (strengthening) or decrease (destrengthening) in actuarial reserves resulting from such a change in valuation basis shall be recorded directly to surplus rather than as a part of the reserve change recognized in the Summary of Operations. The impact on surplus is based on the difference between the reserve under the old and new methods as of the beginning of the year. This difference shall not be graded in over time unless an actuarial guideline adopted by the NAIC prescribes a new method and a specific transition that allows for grading.

Supplemental Benefits

25. In addition to the basic policy benefit, the insurance contract may provide supplemental benefits. Supplemental benefits include, but are not limited to, accidental death benefits and waiver of premium benefits. Appropriate reserves shall be established for these supplemental benefits based on the terms of the contract.

Unearned Income

26. Amounts assessed that represent compensation to the reporting entity for services to be provided in future periods and which are required to be refunded upon policy termination are not earned in the period assessed. Such amounts, if not already considered in the policy reserve, shall be reported as unearned income, a liability, and recognized as income as the related services are provided.

Accelerated Benefits

27. Accelerated benefits are benefits payable under a life insurance contract to a policyholder or certificateholder during the lifetime of the insured, in anticipation of death or upon the occurrence of specified life-threatening or catastrophic conditions as defined by the policy or rider. These benefits reduce the death benefit otherwise payable under the life insurance contract and are payable upon the occurrence of a single qualifying event which results in the payment of a benefit amount fixed at the time of acceleration. When benefits are provided through the acceleration of benefits under group or individual life policies or riders to such policies, policy reserves shall be determined in accordance with Appendices A-820 and A-822. Reserves for such benefits in the aggregate shall be sufficient to cover policies upon which no claim has yet arisen as well as policies upon which an accelerated claim has arisen. Accounting guidance for accelerated benefit payments made in the form of a loan are addressed in *Issue Paper No. 49—Policy Loans*. In addition, accelerated benefit payments, for those accelerated benefits that reduce the policy, shall not be deferred but shall be charged to the Summary of Operations as a benefit expense when paid to the policyholder.

Additional Reserves Not Included Elsewhere

28. Additional actuarial liabilities are commonly held for such items as:

a. Valuation net premiums in excess of gross premiums (i.e., deficiency reserves)

b. Provision for either nondeduction of deferred fractional premiums or return of premiums at death of the insured

c. Surrender values in excess of reserves otherwise required or carried

d. Substandard extra premiums, extra mortality on group conversions, and guaranteed insurability options

e. Additional reserves required based on cash flow testing and/or asset/liability matching requirements

f. Additional reserves for policies which contain conversion privileges or future contingent benefits

Disclosures

29. For life and annuity reserves the financial statements shall disclose the following:

a. A description of reserve practices concerning the following:

i. Waiver of deduction of deferred fractional premiums upon death of insured;

ii. Return of portion of final premium for periods beyond the date of death; and

iii. Amount of any surrender value promised in excess of the reserve as legally computed;

b. The methods employed in the valuation of substandard policies;

c. The amount of insurance, if any, for which the gross premiums are less than the net premiums according to the valuation standards;

d. The method used to determine tabular interest, tabular less actual reserves released, and tabular cost (by formula or from the basic data for such items); and

e. The nature of significant other reserve changes.

30. Disclose the amount of annuity actuarial reserves and deposit liabilities by withdrawal characteristics as follows:

a. Subject to discretionary withdrawal:

i. With market value adjustment, where withdrawal of funds is payable at all times, or prior to specified maturity dates where such dates are more than one year after the statement date and;

(a) In a lump sum with adjustments to reflect general changes in interest rates, or asset values since receipt of funds by the insurer;

(b) In installments over five years or more, with or without a reduction in the interest rate during the installment period;

ii. At book value less current surrender charge, where the withdrawal of funds is payable at all times, or at any time within one year from the statement date in a lump sum subject to a current fixed surrender charge of 5% or more and it does not contain a meaningful bail out rate as described in (v.(d)) below;

iii. At market value, where the withdrawal of funds is payable at current market value of the assets supporting the liabilities, the assets are stated at current market value, and the liabilities are stated at the current market value or per unit value of the assets supporting the liabilities. These liabilities are for contracts where the customer bears the entire investment risk;

iv. Total with adjustment or at market value;

v. At book value without adjustment (minimal or no charge or adjustment), where the withdrawal of funds is either payable at all times, or at any time (including a withdrawal on a scheduled payment date) within one year from the statement date and:

(a) In a lump sum without adjustment;

(b) In installments over less than five years, with or without a reduction in interest rate during the installment period;

(c) In a lump sum subject to a fixed surrender charge of less than 5%;

(d) In a lump sum subject to surrender charge, but such charge is waived if the credited rate falls below a specified "bail out" rate and the "bail out" rate is more than the maximum statutory valuation rate for life insurance policies for more than 20 years for new issues;

(e) All others;

b. Not subject to discretionary withdrawal;

c. Total gross;

d. Reinsurance ceded;

e. Total net.

31. If the reporting entity has reported life insurance premiums and annuity considerations deferred and uncollected on policies in force as of the financial statement date, disclose separately the amounts and the loading excluded for each of the following lines of business:

a. Industrial business;

b. Ordinary new business;

c. Ordinary renewal;

d. Credit life;

e. Group life;

f. Group annuity.

32. Disclose the aggregate amount of direct premiums written through managing general agents or third party administrators. For purposes of this disclosure, a managing general agent means the same as in Appendix A-225. If this amount is equal to or greater than 5% of surplus, provide the following information for each managing general agent and third party administrator:

a. Name and address of managing general agent or third party administrator;

b. Federal Employer Identification Number;

c. Whether such person holds an exclusive contract;

d. Types of business written;

e. Type of authority granted (i.e., underwriting, claims payment, etc.);

f. Total premium written.

33. Reporting entities shall disclose the relative percentage of participating insurance, the method of accounting for policyholder dividends, the amount of dividends, and the amount of any additional income allocated to participating policyholders in the financial statements.

DISCUSSION

SAP Considerations

34. The statutory accounting principles outlined in the conclusion above regarding income recognition and policy reserves for life contracts are consistent with the Statement of Concepts which states:

> Conservatism
>
> Financial reporting by insurance enterprises requires the use of substantial judgments and estimates by management. Such estimates may vary from the actual amounts for numerous reasons. To the extent that factors or events result in adverse variation from management's accounting estimates, the ability to meet policyholder obligations may be lessened. In order to provide a margin of protection for policyholders, the concept of conservatism should be followed when developing estimates as well as establishing accounting principles for statutory reporting.
>
> Conservative valuation procedures provide protection to policyholders against adverse fluctuations in financial condition or operating results. Statutory accounting should be reasonably conservative over the span of economic cycles and in recognition of the primary responsibility to regulate for financial solvency. Valuation procedures should, to the extent possible, prevent sharp fluctuations in surplus.
>
> Consistency
>
> The regulators' need for meaningful, comparable financial information to determine an insurer's financial condition requires consistency in the development and application of statutory accounting principles. Because the marketplace, the economic and business environment, and insurance industry products and practices are constantly changing, regulatory concerns are also changing. An effective statutory accounting model must be responsive to these changes and address emerging accounting issues. Precedent or historically accepted practice alone should not be sufficient justifications for continuing to follow a particular accounting principle or practice which may not coincide with the objectives of regulators.
>
> Recognition
>
> Liabilities require recognition as they are incurred. Certain statutorily mandated liabilities may also be required to arrive at conservative estimates of liabilities and probable loss contingencies (e.g., interest maintenance reserves, asset valuation reserves, and others).
>
> Revenue should be recognized only as the earnings process of the underlying underwriting or investment business is completed. Accounting treatments which tend to defer expense recognition do not generally represent acceptable SAP treatment.
>
> SAP income reflects the extent that changes have occurred in SAP assets and liabilities for current period transactions, except changes in capital resulting from receipts or distributions to owners. SAP income also excludes certain other direct charges to surplus which are not directly attributable to the earnings process, (e.g., changes in non-admitted assets).

35. Except as discussed in paragraphs 36-41, the statutory accounting principles outlined in the conclusion above regarding income recognition and policy reserves for life contracts are consistent with current statutory accounting.

Unearned Income

36. Unearned income and other similar amounts described in paragraph 26 are not currently addressed in statutory accounting. Unearned income and other similar amounts meet the definition of liabilities as defined in Issue Paper No. 5. Recording unearned income and other similar amounts as deferred income and recognizing the amounts as income only as the earnings process is completed is consistent with the objectives of the Statement of Concepts.

Cost of Collection Liability

37. Current statutory accounting requires a liability to be established for the costs of collecting deferred and uncollected premiums in excess of loading when loading is not adequate to cover these costs. As previously discussed, deferred premiums are only recorded when using the mean reserve method and are computed by taking the gross premium extending from the modal premium due date following the valuation date to the next policy anniversary date and subtracting any such deferred premiums that have actually been collected. As a result, current statutory accounting requires this liability to be established when using the mean reserve method but not the mid terminal reserve method. Due to the generally conservative nature of the mortality and interest rates prescribed in computing policy reserves, the requirement to establish a liability for the costs of collecting deferred and uncollected premiums in excess of loading has been eliminated. In addition, by eliminating the requirement to establish this liability, the inconsistent practice of requiring this liability to be established when using the mean reserve method as it relates to deferred premiums, but not the mid terminal reserve method has also been eliminated.

Premium Deficiency

38. Due to the manner in which the liability for the costs of collecting deferred and uncollected premiums in excess of loading has historically been computed, any deficiencies in gross deferred premiums relative to corresponding net deferred valuation premiums from the valuation date to the next policy anniversary date were accrued in this liability.

39. As further discussed in Appendix A-820, basic policy reserves are required to be increased in certain circumstances. If in any contract year the gross premium is less than the valuation net premium, the minimum reserve required shall be the greater of

a. the reserve currently held for the contract or

b. the reserve calculated by the method currently used but using minimum valuation standards of mortality and interest. The gross premium on the policy is substituted in this reserve calculation at each contract year in which it is less than the valuation net premium.

Although Appendix A-820 makes no explicit reference to deficiency reserves, the excess of reserves described in b) over those described in a) is often referred to as a deficiency reserve.

40. Historically, this calculation has been performed from the next policy anniversary forward. However, since the liability for the cost of collection in excess of loading has been eliminated, which considered deficiencies in gross deferred premiums relative to corresponding net deferred valuation premiums from the valuation date to the next policy anniversary date, this calculation should be performed from the valuation date through the end of the premium paying period.

Accelerated Benefits

41. Current statutory accounting does not address the accounting for accelerated benefits. Consistent with current statutory accounting which requires benefits paid to policyholders to be recorded as an expense in the Summary of Operations and the Statement of Concepts which generally prohibits accounting practices which defer the recognition of expense, this issue paper requires accelerated benefits to be charged to the Summary of Operations as a benefit expense when paid to the policyholder.

Deferred Premiums

42. Reserves for life contracts are generally calculated on the mean reserve basis. Mean reserves are calculated on the assumption that the net premium for a policy is collected annually at the beginning of the policy year. To the extent such premiums have not been collected, reserves calculated on the mean reserve basis overstate the required policy reserve for life contracts. As a result, an adjustment is needed to offset the overstatement of the policy reserve. Historically, this adjustment has been recorded as an asset called "deferred premiums." For practical reasons related to maintenance, accounting, and financial reporting of reserves for life contracts, these amounts have been reported as assets. As this practice does not affect net income or surplus and considering the importance of consistent financial reporting as well as the anticipated costs and benefits associated with changing this current and pervasive practice, this codification does not change the practice of presenting deferred premiums as admitted assets.

GAAP Considerations

43. Although this issue paper generally reflects the basic accounting for income recognition on life contracts prescribed by GAAP which requires that premiums from life contracts be recognized as income when due from policyholders and that policy reserves be established for the excess of the present value of future benefits and expenses over future net premiums, it rejects the GAAP literature referenced in paragraphs 44 and 45 for the reasons set forth therein.

44. The statutory accounting principles in this issue paper differ from GAAP which specifies different income recognition principles for different types of life contracts. *FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments* (FAS 97) excludes certain considerations received from premium income on universal life-type contracts and certain limited-payment contracts. For investment and universal life-type contracts, FAS 97 (paragraphs 15 and 19, respectively) recognizes the considerations received as funds on deposit and income is recognized from amounts assessed against policyholders for mortality, contract administration, and surrender charges, as applicable. For limited-payment contracts, FAS 97 (paragraph 16) specifies any gross premium received in excess of the net premium for limited-payment contracts shall be deferred and recognized in income in a constant relationship with insurance in force (when accounting for life insurance contracts) or with the amount of expected future benefit payments (when accounting for annuity contracts). These differences are inconsistent with the recognition concept in the Statement of Concepts which states that SAP income should reflect the extent that changes have occurred in SAP assets and liabilities for current period transactions, except changes in capital resulting from receipts or distributions to owners.

45. *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises* (FAS 60), FAS 97, *FASB Statement 120*, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts* (FAS 120), *AICPA Practice Bulletin No. 8, the AICPA Audits of Stock Life Insurance Companies* (AICPA Life Audit and Accounting Guide), and *AICPA Statement of Position 95-1*, *Accounting for Certain Activities of Mutual Life Insurance Enterprises* (SOP 95-1) prescribe the following with respect to policy reserves:

a. Specifies that policy reserves represent the present value of future benefits to be paid to or on behalf of policyholders and related expenses less the present value of future net premiums (portion of gross premium required to provide for all benefits and expenses).

b. Specifies that the liability is estimated using methods that include assumptions, such as estimates of expected investment yields, mortality, terminations, and expenses, applicable at the time the insurance contracts are made. The assumptions shall include provision for the risk of adverse deviation. Original assumptions shall continue to be used in subsequent accounting periods to determine changes in the liability for future policy benefits (often referred to as the "lock-in concept") unless a premium deficiency exists.

c. Specifies that a premium deficiency exists if the existing contract liabilities, together with the present value of future gross premiums, will not be sufficient (a) to cover the present value of future benefits to be paid to or on behalf of policyholders and settlement and maintenance costs relating to a block of long-duration contracts and (b) to recover unamortized acquisition costs.

d. Requires the retrospective deposit method of accounting for universal life-type contracts. That accounting method establishes a liability for policy benefits at an amount determined by the account or contract balance that accrues to the benefit of the policyholder.

e. Specifies that the liability for future policy benefits relating to certain participating contracts be equal to the sum of 1) the net level premium reserve for death and endowment policy benefits, 2) the liability for terminal dividends, and 3) any premium deficiency.

46. This issue paper rejects the GAAP literature related to policy reserves referred to in the preceding paragraph, including the excerpts shown in paragraphs 50-52 below. These GAAP pronouncements permit the use of generally less conservative assumptions of expected investment yields, mortality, terminations, and expenses applicable at the time the insurance contracts are made and usually produce smaller reserves than current SAP. Current SAP assumptions and estimates are generally more conservative in nature and therefore are more consistent with the objectives in the Statement of Concepts. Further, since the requirements for establishing policy reserves for life contracts are directly related to and are inseparable from the income recognition requirements on both a SAP and GAAP basis, the income recognition requirements of the GAAP literature referenced in this paragraph are similarly rejected in this issue paper.

47. GAAP does not specifically address valuation methods, deferred and uncollected premiums, advance premiums, liability for cost of collection, supplemental benefits, and miscellaneous reserves discussed above. Current practice is to account for these items in a manner similar to SAP but consistent with the GAAP reserve methods used to calculate the basic policy reserve.

Drafting Notes/Comments

- Issue Paper No. 50 addresses Classifications and Definitions of Insurance or Managed Care Contracts In Force.
- Issue Paper No. 52 addresses Deposit-Type Contracts.
- Issue Paper No. 53 addresses Property Casualty Contracts – Premiums.
- Issue Paper No. 54 addresses Individual and Group Accident and Health Contracts.
- Issue Paper No. 55 addresses Unpaid Claims, Losses and Loss Adjustment Expenses.
- Issue Paper No. 56 addresses Universal Life-Type Contracts, Policyholder Dividends, and Coupons.
- Issue Paper No. 59 addresses Credit Life and Accident and Health Insurance Contracts.
- Issue Paper No. 66 addresses Accounting for Retrospectively Rated Contracts.
- Issue Paper No. 74 addresses Life, Deposit-Type and Accident and Health Reinsurance.
- Issue Paper No. 89 addresses Separate Accounts.

- No guidance was added from FAS 120, AICPA Practice Bulletin No. 8 or the AICPA Life Audit and Accounting Guide since the guidance was not applicable or was already reflected in FAS 60, FAS 97, and SOP 95-1.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE (ONLY PERTINENT EXCERPTS ARE INCLUDED BELOW)

Statutory Accounting

48. The Life/A&H Accounting Practices and Procedures Manual provides the following guidance on life policy reserves:

> CHAPTER 10
> AGGREGATE RESERVES FOR LIFE AND ANNUITY CONTRACTS
>
> Life insurance pays the beneficiary on the death of the insured. An endowment pays the policyholder if he lives to the end of the period, or a beneficiary if the policyholder dies. An annuity or pure endowment pays the policyholder if he is living. Policies written today may include numerous provisions, which are either written directly into the policy or attached as a rider.
>
> This chapter discusses the reserves that a company must establish. Aggregate reserves are reported as liabilities in the statutory financial statement.
>
> Statutory Reserves
>
> This type of life insurance policy dictates the amount of the reserve that must be established and how long it must be maintained. Within the ordinary life and industrial line of business, there are three basic types of policies: whole life, endowment, and term. (Annuities and pure endowments are discussed later in this chapter.)
>
> Whole life insurance provides coverage for the life of the insured as long as the premiums are paid in conformity with the policy. Under a whole life plan of insurance, the company is obligated to maintain a reserve until the death of the insured.
>
> Term life insurance provides coverage only for the period that is specified in the policy. Under a term insurance plan, the company maintains a required reserve which reduces to zero upon expiration of the term period.
>
> Similar to term insurance, endowment life insurance provides coverage for a period specified in the policy. Unlike term insurance, the proceeds of endowment insurance are payable if the insured lives to the end of the period.
>
> In the aggregate, policy reserves for all life insurance policies that are reported in the statutory financial statements must equal or exceed reserves calculated by using certain assumptions and methods that produce the minimum required by law. Further, each state requires a Statement of Actuarial Opinion which provides the opinion of an actuary that aggregate reserves make good and sufficient provision for all unmatured obligations of the company guaranteed under the terms of its policies and meet the minimum requirements of the laws of the state of domicile.
>
> Minimum Reserves Required
>
> The components necessary to compute reserves are an interest rate, a mortality table, and a method of valuation. The standards for determining the minimum statutory reserves that are required in life insurance policies are prescribed in statutes or regulations. Generally, the states follow the provisions of the NAIC Model Valuation Law and its interpretations; however, variations by state do exist.

These standards vary by line of business and by issue date of the policy. Further limitations are placed on policies having nonforfeiture benefits.

Types of Reserves

The reserves calculated for a block of life insurance policies as of the valuation date may be based upon different assumptions concerning the anniversary (issue) date and the average date when premiums are due. The different types of reserves that may be used are terminal, initial, mid-terminal, and mean.

The terminal reserve is the policy reserve at the end of the policy year. It is based on the assumption that all net premiums have been received, all interest earned, and all benefits paid to the end of the policy year.

The initial reserve is the previous year's terminal reserve plus the net valuation premium for the current policy year. This reserve basis is not frequently utilized in financial reporting.

In computing reserves on ordinary insurance, most companies use mean reserves. These are defined as the average of the initial and terminal reserves for the current year, on the assumption that policies are issued uniformly throughout the calendar year on an annual premium basis. Any fractional premium (e.g., monthly, quarterly, semiannual) for the current policy year which is not yet due must be reported as a deferred premium.

Mid-terminal reserves are generally used to value industrial insurance, on which premiums are usually paid monthly or weekly. Mid-terminal reserves are the average of the terminal reserves on the last and the next policy anniversaries. These reserves must be accompanied by an unearned premium reserve consisting of the portion of valuation premiums paid or due covering the period from the valuation date to the due date of the next modal premium. Any premiums due beyond the valuation date but paid prior to that date are included in the advance premium liability. Certificates of fraternal benefit societies generally are reserved on a mid-terminal basis.

Reserves for permanent group life insurance plans usually are calculated in the same way as individual insurance and can be either mean (with deferred premium) or mid-terminal plus the unearned premium.

Supplemental Benefits

In addition to the basic death benefit, life insurance policies may provide other benefits. These supplemental benefits are sold for additional premiums or for a basic premium that has been calculated to include their costs. In either case, the company must establish appropriate reserves for these benefits. Examples of reserves for these benefits include:

1. Accidental death benefits. The most common additional death benefit is double indemnity which provides for an additional payment equal to the face amount of the policy in the event of accidental death. Triple indemnity also is offered, but it usually is limited to accidental death in connection with commercial travel.

2. Total and permanent disability benefits - active lives. It is common for a life insurance policy to be sold with an additional benefit for waiver of premiums upon the disability of the policyowner. This is called waiver of premiums benefit. The company, of course, must establish a reserve for waiver of premium benefits.

A benefit rider for disability payments to the policyowner/insured also may be attached to a life insurance policy.

3. Total and permanent disability benefits - disabled lives. In the event of a waiver of premiums or payment of benefits due to total and permanent disability, a reserve must be established to cover the present value of the future gross premium to be waived or the

> payments to be paid. Policies on which benefits are currently being paid are called disabled lives. For ordinary contracts this reserve usually is reported as a part of the aggregate life reserves. This is in addition to the basic policy reserve for active lives.

> Miscellaneous Reserves
>
> Since the actuarial liabilities must include provision for any contingent benefit or right which may arise, statutory statements provide for estimates of a number of miscellaneous reserve items. For example, state laws or regulations may require minimum reserves when valuation net premiums exceed gross premiums. The additional reserve needed to meet the minimum may appear separately as a miscellaneous reserve or may be included with the life reserve in accordance with the applicable state regulations. Similarly, provision for either nondeduction of deferred fractional premiums or return of premiums at death of the insured may be made as a separate reserve or as part of the life reserve. Approximate reserving methods are accepted and frequently used to estimate such items. Another minimum reserve which must be provided for is a reserve for surrender values in excess of reserves otherwise required or carried. There are other miscellaneous items commonly encountered, such as reserve for substandard extra premiums, a reserve for extra mortality on group conversions, and reserve for guaranteed insurability options.
>
> Changes in Valuation Bases
>
> Where the interest rate, mortality basis, reserving method (e.g., net level, preliminary term, etc.), or other basis affecting reserve computation of in force business is changed during the year, any increase or decrease in actuarial reserves resulting from this change in valuation basis must be charged directly to surplus rather than as a part of the reserve increase item in the summary of operations. For various reasons, any change in valuation bases which produces an increase in reserves (reserve strengthening) or decrease in reserves (reserve destrengthening) may require the approval of the applicable regulatory authority. Procedures and timing for such approval vary from state to state.

49. The Life/A&H Accounting Practices and Procedures Manual provides the following guidance with respect to premium income recognition:

> CHAPTER 18
> PREMIUM INCOME
>
> Premiums are generally recorded in the company's general ledger when received. This necessitates adjustments as of the balance sheet dates for premiums received in advance of their due date, for premiums which are due but have not yet been received, and for "deferred" premiums. Premium income reported in the Summary of Operations includes reinsurance assumed and is reduced by reinsurance ceded.
>
> Deductions should be made for premiums and annuity considerations returned and allowances to industrial policyholders for direct payment of premiums. Commissions and allowances on reinsurance premiums assumed and ceded may not be deducted.
>
> Single premiums and considerations include dividends, coupons, guaranteed annual pure endowments, and similar benefits applied to provide paid-up additional insurance or annuities. Renewal premiums collected are to include dividends and coupons applied to pay renewal premiums and to shorten the endowment or premium-paying period.
>
> Premiums and considerations waived by the company under disability provisions contained in its policies and contracts, and reported in operations as a disability benefit, are included in premium income.

Gross and Net Premiums and Loading

A “gross” premium is the amount charged to the policyholder and taken into operations as premium income. A “net” premium is the amount calculated on the basis of the interest and mortality table used to calculate the insurance company’s policy reserves.

The difference between the gross and net premium is called “loading.” Loading is an amount of the gross premium that provides the company with the funds to pay commissions, to meet operating expenses, to provide for contingencies, and to return a profit.

Deferred and Uncollected Premiums

The increase in reserves for life insurance policies which is charged against operations for the year is based on reserves frequently calculated on what is called the mean reserve basis. Mean reserves are calculated on the assumption that the entire annual premium for a policy is collected annually at the beginning of the policy year.

However, since premiums are often received in installments more frequently than annually and since the mean reserves assume payment of the current year’s net annual premium, it becomes necessary to compute and report a special asset item to offset the additional liability. This asset item is termed “deferred premiums.” It represents the premium (or premiums) extending from (and including) the modal (monthly, quarterly, semiannual) premium due date or dates following the valuation date to the next policy anniversary date. The company, therefore, reports deferred premiums not yet due as premium income “gross” and as an asset net of loading. Policies with premiums payable annually on the policy anniversary will not have deferred premiums.

Since the policy reserve liability calculated on the mean reserve basis assumes the collection of premiums to the following policy anniversary, deferred premiums (semiannual, quarterly, or monthly premiums due in the following year prior to the anniversary date) which have been collected in the current year reduce the deferred premium asset. The liability for advance premiums would consequently exclude such premiums.

Life insurance premium income also includes, on a gross basis, those premiums that have been billed and are due and unpaid on the valuation date. An asset item is allowable for any such uncollected premiums net of loading. Theoretically, only policies in their grace period would have uncollected premiums at the balance sheet date because policies beyond the grace period would have been lapsed. However, in actual practice most companies, to avoid processing a large number of transactions in the first month or so after the grace period, may not process policies with uncollected premium until 30 to 60 days after expiration of the grace period. These policies, therefore, may still be shown and valued as being premium-paying.

The amount of deferred and uncollected premiums that should be reported as an asset is the aggregate of the related net premiums because the sole purpose of the asset is to offset the net premium included in the policy reserves. If the company reported gross premiums deferred and uncollected as an asset, it would be required to provide an offset for the amount of loading for expenses and profits that have not yet been incurred or realized.

Net premiums deferred and uncollected may be determined in one of two ways. Either a seriatim listing of gross and net premiums may be prepared or the company may calculate ratios of net to gross premiums deferred and uncollected. In this second case, the company must be able to support its factors with studies that consider the mix of business, the amounts applicable first year and renewal premiums, and so forth. In any case, the company should be able to demonstrate that the net premiums are the same as those used in the calculation of the reserves.

In the Summary of Operations the change in gross deferred and uncollected premiums is taken in as premium income. Since only the net premiums are included in reserves and reported as an asset, it is necessary to make an adjustment for the change in the loading on deferred and uncollected premiums.

Cost of Collection in Excess of Loading

A liability should be provided for the cost of collection on premiums and annuity consideration deferred and uncollected in excess of total loading thereon if the company deems the loading to be inadequate. The increase in this item and the increase in loading on deferred and uncollected premiums are both recorded in the same line in the Summary of Operations. Provisions for cost of collection should include commissions, collection fees, and taxes contingent upon the collection of the deferred and uncollected premiums.

Premiums Received in Advance

Premium income reported in operations must exclude premiums that have been received by the company prior to the valuation date but which are due on or after the next policy anniversary date. The accounting treatment is the same for both life and accident and health premiums.

A policyholder may remit one or more premiums in advance of specific due dates. Where premiums are remitted sufficiently far in advance, the premiums may be discounted for interest from their due dates to the date of payment. The total amount of such gross premiums, less any discount as of the valuation date, is reported as a liability in the statutory financial statement. The gross premium less any discount is recorded as the advance premium, not the net valuation premium, in recognition of the company's liability to refund such premiums in the event the policy is terminated.

Advance premiums must be recorded for industrial as well as ordinary and group policies. Advance premiums received on group policies may be reported in the liability for premiums received in advance or as a 100% unearned premium reserve.

Premium and Other Deposit Funds

A company may also receive premiums over one year prior to their due date and include them in a premium deposit fund. These amounts are not reported as income. The premium deposit fund may or may not represent payment of specific future premiums. Interest at contracted rates is credited annually to each individual account. Interest on such funds must be accrued to the balance sheet date. The terms of the fund (interest rate, disposition, and so forth) are specified in the provisions of the policy or in a separate endorsement. An explanation of other deposit funds can be found in Chapter 12.

Amounts deposited and accumulated for guaranteed interest contracts may be included in this classification. Finally, other deposit items of a generally similar nature may also be included herein.

Withdrawals from deposit accounts to pay premiums are credited to the appropriate income account. Provision is made in the statutory financial statement for reporting the balance of such deposits as of the balance sheet date.

Industrial Policies

Mid-terminal reserves are generally held for industrial insurance policies. Because of the collection of premiums due after the statement date and up to the next policy anniversary is not assumed in the calculation of mid-terminal policy reserves, no deferred premium asset is recorded and no deferred premiums are taken into operations as premium income.

Uncollected premiums due on industrial policies are defined in the same way as uncollected ordinary premiums and are bound by the same limitations. For industrial policies on which an asset is recorded for uncollected premiums, reserves should be established on the same basis as for those where the premiums have been collected and such uncollected premiums are taken into operations as premium income.

Group Life Policies

Group term policies generally carry unearned premium or one-year term insurance reserves and where premiums are accounted for on a true monthly premium basis no deferred premium asset would generally be appropriate. However, where premiums are accounted for on an annual premium basis and payable in installments more frequently than annually, it would be appropriate to take deferred premiums into premium income and to set up a net deferred premium asset, based on the valuation standards used, together with an appropriate addition to reserves.

Uncollected premiums are allowed as an asset and should be recorded net of loading. The corresponding reserve liabilities must reflect the uncollected premiums that are taken as an asset.

Group permanent policies may have deferred and uncollected premiums if reserves are calculated on a mean basis. They may have only uncollected premiums if reserves are calculated on a mid-terminal basis.

Annuity Contracts

Certain annuity contracts, usually group pension contracts, frequently provide for the payment to the company of amounts other than premiums or considerations to be accumulated at interest for the purpose of providing pensions for employees at retirement and similar benefits. Amounts withdrawn from the fund to purchase annuity benefits reduce "Annuity and other fund deposits" and increase premium and annuity considerations.

Uncollected and deferred annuity considerations are calculated on deferred annuity contracts other than single payment contracts. The asset item is recorded net of loading.

Considerations for Supplementary Contracts

The Summary of Operations includes as income all policy proceeds which have been left with the company during the year under optional modes of settlement to provide beneficiaries or the policyowner with periodic income under a supplementary contract. Supplementary contracts may provide for an income payable for the lifetime of the payee(s), in which case the considerations would be reported as "Considerations for supplementary contracts with life contingencies." A supplementary contract may also provide for the payment of a periodic income for a specified number of years or for payments of a specified amount until the funds with interest earnings are exhausted. The considerations for such supplementary contracts are reported separately as "Considerations for supplementary contracts without life contingencies."

These considerations arise from proceeds retained at death, disability, surrender, or maturity of policies and annuity contracts. The amount of these retained proceeds is included in the amount reported in the Summary of Operations for policy and contract benefits.

Considerations for Dividend Accumulations

Another income item in the Summary of Operations is "Consideration for dividend accumulations." The accounting treatment for dividend accumulation deposits, dividend accumulation payments, and the change in the liability is similar to accounting for life insurance. Consideration for dividend accumulations represents the amount of policy dividends left on deposit with the company during the year to accumulate at interest. This amount would normally agree with the amount reported in the Dividends and Coupons to Policyholders exhibit of the annual statement as being left on deposit with the company.

Generally Accepted Accounting Principles

50. FAS 60, as amended by FAS 97 and FAS 120, provides the following guidance related to income recognition and related policy reserves for life and accident and health contracts:

Insurance contracts, for purposes of this Statement, need to be classified as short-duration or long-duration contracts. Long-duration contracts include contracts, such as whole-life, guaranteed renewable term life, endowment, annuity, and title insurance contracts, that are expected to remain in force for an extended period. All other insurance contracts are considered short-duration contracts and include most property and liability insurance contracts.

Premiums from long-duration contracts are recognized as revenue when due from policyholders. The present value of estimated future policy benefits to be paid to or on behalf of policyholders less the present value of estimated future new premiums to be collected from policyholders are accrued when premium revenue is recognized. Those estimates are based on assumptions, such as estimates of expected investment yields, mortality, morbidity, terminations, and expenses, applicable at the time the insurance contracts are made. Claim costs are recognized when insured events occur.

INTRODUCTION

1. The primary purpose of insurance is to provide economic protection from identified risks occurring or discovered within a specified period. Some types of risks insured include death, disability, property damage, injury to others, and business interruption. Insurance transactions may be characterized generally by the following:

a. The purchaser of an insurance contract makes an initial payment or deposit to the insurance enterprise in advance of the possible occurrence or discovery of an insured event.

b. When the insurance contract is made, the insurance enterprise ordinarily does not know if, how much, or when amounts will be paid under the contract.

2. Two methods of premium revenue and contract liability recognition for insurance contracts have developed, which are referred to as short-duration and long-duration contract accounting in this Statement. Generally, the two methods reflect the nature of the insurance enterprise's obligations and policyholder rights under the provisions of the contract.

3. Premiums from short-duration insurance contracts, such as most property and liability insurance contracts, are intended to cover expected claim[1] costs resulting from insured events that occur during a fixed period of short duration. The insurance enterprise ordinarily has the ability to cancel the contract or to revise the premium at the beginning of each contract period to cover future insured events. Therefore, premiums from short-duration contracts ordinarily are earned and recognized as revenue evenly as insurance protection is provided.

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[1] Terms defined in the glossary (Appendix A) are in boldface type the first time they appear in this Statement.

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4. Premiums from long-duration insurance contracts, including many life insurance contracts, generally are level even though the expected policy benefits and services do not occur evenly over the periods of the contracts. Functions and services provided by the insurer include insurance protection, sales, premium collection, claim payment, investment, and other services. Because no single function or service is predominant over the periods of most types of long-duration contracts, premiums are recognized as revenue over the premium-paying periods of the contracts when due from policyholders. Premium revenue from long-duration contracts generally exceeds expected policy benefits in the early years of the contracts and it is necessary to accrue, as premium revenue is recognized, a liability for costs that are expected to be paid in the later years of the contracts. Accordingly, a liability for expected costs relating to most types of long-duration contracts is accrued over the current and expected renewal periods of the contracts.

APPLICABILITY AND SCOPE

6. This Statement establishes accounting and reporting standards for the general-purpose financial statements of stock life insurance enterprises, property and liability insurance enterprises[2], title insurance enterprises, mutual life insurance enterprises, assessment enterprises, and fraternal benefit societies. Except for the sections on premium revenue and claim cost recognition and acquisition costs (paragraphs 9-11, 13-18, and 20-31), this Statement applies to mortgage guaranty insurance enterprises. *FASB Statement No. 120*, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*, addresses the accounting for certain long-duration participating life insurance contracts.*

* The accounting for certain long duration insurance contracts referred to as investment contracts, limited-payment contracts, and universal life-type contracts is established by FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments.

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[2] Property and liability insurance enterprises, for purposes of this Statement include stock enterprises, mutual enterprises, and reciprocal interinsurance exchanges.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

General Principles

10. Premiums from long-duration contracts shall be recognized as revenue when due from policyholders. A liability for expected costs relating to most types of long-duration contracts shall be accrued over the current and expected renewal periods of the contracts. The present value of estimated future policy benefits to be paid to or on behalf of policyholders less the present value of estimated future net premiums to be collected from policyholders (liability for future policy benefits) shall be accrued when premium revenue is recognized. Those estimates shall be based on assumptions, such as estimates of expected investment yields, mortality, morbidity, terminations, and expenses, applicable at the time the insurance contracts are made. In addition, liabilities for unpaid claims and claim adjustment expenses shall be accrued when insured events occur.

Liability for Future Policy Benefits

21. A liability for future policy benefits relating to long-duration contracts other than title insurance contracts (paragraph 17) shall be accrued when premium revenue is recognized. The liability, which represents the present value of future benefits to be paid to or on behalf of policyholders and related expenses less the present value of future net premiums (portion of gross premium required to provide for all benefits and expenses), shall be estimated using methods that include assumptions, such as estimates of expected investment yields, mortality, morbidity, terminations, and expenses, applicable at the time the insurance contracts are made. The liability also shall consider other assumptions relating to guaranteed contract benefits, such as coupons, annual endowments, and conversion privileges. The assumptions shall include provision for the risk of adverse deviation. Original assumptions shall continue to be used in subsequent accounting periods to determine changes in the liability for future policy benefits (often referred to as the "lock-in concept") unless a premium deficiency exists (paragraphs 35-37). Changes in the liability for future policy benefits that result from its periodic estimation for financial reporting purposes shall be recognized in income in the period in which the changes occur.

Investment Yields

22. Interest assumptions used in estimating the liability for future policy benefits shall be based on estimates of investment yields (net of related investment expenses) expected at the time insurance contracts are made. The interest assumption for each block of new insurance contracts

(a group of insurance contracts that may be limited to contracts issued under the same plan in a particular year) shall be consistent with circumstances, such as actual yields, trends in yields, portfolio mix and maturities, and the enterprise's general investment experience.

Mortality

23. Mortality assumptions used in estimating the liability for future policy benefits shall be based on estimates of expected mortality.

Morbidity

24. Morbidity assumptions used in estimating the liability for future policy benefits shall be based on estimates of expected incidences of disability and claim costs. Expected incidence of disability and claim costs for various types of insurance (for example, noncancelable and guaranteed renewable accident and health insurance contracts) and other factors, such as occupational class, waiting period, sex, age, and benefit period, shall be considered in making morbidity assumptions. The risk of antiselection (the tendency for lower terminations of poor risks) also shall be considered in making morbidity assumptions.

Terminations

25. Termination assumptions used in estimating the liability for future policy benefits shall be based on anticipated terminations and nonforfeiture benefits, using anticipated termination rates and contractual nonforfeiture benefits. Termination rates may vary by plan of insurance, age at issue, year of issue, frequency of premium payment, and other factors. If composite rates are used, the rates shall be representative of the enterprise's actual mix of business. Termination assumptions shall be made for long-duration insurance contracts without termination benefits because of the effects of terminations on anticipated premiums and claim costs.

Expenses

26. Expense assumptions used in estimating the liability for future policy benefits shall be based on estimates of expected nonlevel costs, such as termination or settlement costs, and costs after the premium-paying period. Renewal expense assumptions shall consider the possible effect of inflation on those expenses.

Premium Deficiency

32. A probable loss on insurance contracts exists if there is a premium deficiency relating to shot-duration or long-duration contracts. Insurance contracts shall be grouped consistent with the enterprise's manner of acquiring, servicing, and measuring the profitability of its insurance contracts to determine if a premium deficiency exists.

Long-Duration Contracts

35. Original policy benefit assumptions for long-duration contracts ordinarily continue to be used during the periods in which the liability for future policy benefits is accrued (paragraph 21). However, actual experience with respect to investment yields, mortality, morbidity, terminations, or expenses may indicate that existing contract liabilities, together with the present value of future gross premiums, will not be sufficient (a) to cover the present value of future benefits to be paid to or on behalf of policyholders and settlement and maintenance costs relating to a block of long-duration contracts and (b) to recover unamortized acquisition costs. In those circumstances a premium deficiency shall be determined as follows:

Present value of future payments for benefits and related settlement and maintenance costs, determined using revised assumptions based on actual and anticipated experience	$XX
Less the present value of future gross premiums, determined using revised assumptions based on actual and anticipated experience	XX

Liability for future policy benefits using revised assumptions	XX
Less the liability for future policy benefits at the valuation date, reduced by unamortized acquisition costs	XX

Premium deficiency	$XX
	=====

> 36. A premium deficiency shall be recognized by a charge to income and (a) a reduction of unamortized acquisition costs or (b) an increase in the liability for future policy benefits. If a premium deficiency does occur, future changes in the liability shall be based on the revised assumptions. No loss shall be reported currently if it results in creating future income. The liability for future policy benefits using revised assumptions based on actual and anticipated experience shall be estimated periodically for comparison with the liability for future policy benefits (reduced by unamortized acquisition costs) at the valuation date.
>
> 37. A premium deficiency, at a minimum, shall be recognized if the aggregate liability on an entire line of business is deficient. In some instances, the liability on a particular line of business may not be deficient in the aggregate, but circumstances may be such that profits would be recognized in early years and losses in later years. In those situations, the liability shall be increased by an amount necessary to offset the losses that would be recognized in later years.

51. FAS 97, as amended by FAS 120, provides the following guidance on premium income recognition:

> Summary
>
> This Statement establishes standards of accounting for certain long-duration contracts issued by insurance enterprises, referred to in this Statement as universal life-type contracts, that were not addressed by *FASB Statement No. 60*, *Accounting and Reporting by Insurance Enterprises*. The Statement also establishes standards of accounting for limited-payment long-duration insurance contracts and investment contracts and amends Statement 60 to change the reporting of realized gains and losses on investments.
>
> New life insurance contracts have evolved since the development of specialized insurance industry accounting principles and practices in the early 1970's. Many of those new life insurance contracts have different provisions than do the life insurance contracts to which Statement 60 applies. Those new life insurance contracts are characterized by flexibility and discretion granted to one or both parties to the contract. Statement 60 identifies but does not address those contracts, noting that the accounting was under study by the insurance industry and the accounting and actuarial professions.
>
> This Statement requires that the retrospective deposit method be used to account for universal life-type contracts. That accounting method establishes a liability for policy benefits at an amount

determined by the account or contract balance that accrues to the benefit of the policyholder. Premium receipts are not reported as revenues when the retrospective deposit method is used. The Statement also requires that capitalized acquisition costs associated with universal life-type contracts be amortized based on a constant percentage of the present value of estimated gross profit amounts from the operation of a "book" of those contracts. Any gain or loss resulting from a policyholder's replacement of other life insurance contracts with universal life-type contracts is recognized in income of the period in which the replacement occurs.

This Statement requires that long-duration contracts issued by insurance enterprises that do not subject the enterprise to risks arising from policyholder mortality or morbidity (investment contracts) be accounted for in a manner consistent with the accounting for interest-bearing or other financial instruments. Payments received on those contracts are not reported as revenue.

This Statement also addresses limited-payment contracts that subject the insurance enterprise to mortality or morbidity risk over a period that extends beyond the period or periods in which premiums are collected and that have terms that are fixed and guaranteed. This Statement requires that revenue and income from limited-payment contracts be recognized over the period that benefits are provided rather than on collection of premiums.

INTRODUCTION

1. *FASB Statement No. 60*, *Accounting and Reporting by Insurance Enterprises*, issued in June 1982, contains specialized accounting principles and practices based on AICPA insurance Industry Audit Guides and Statements of Position. Statement 60 identifies but does not address a number of areas that were being studied by the insurance industry and the accounting and actuarial professions when that Statement was issued. One of those areas is the accounting for universal life insurance and similar products that were developed after the issuance of the AICPA Guides and Statements of Position.

2. Statement 60 describes two methods of premium revenue and contract liability recognition, referred to as long-duration and short-duration contract accounting. Each method is designed to reflect the insurance enterprise's obligations and policyholder rights under the provisions of the contract. The insurance contracts addressed in this Statement are generally considered long-duration insurance contracts.

3. Recognition of premiums as revenue when due from policyholders and measurement of a liability for policyholder benefits based on a uniform percentage of anticipated premiums are distinguishing features of the accounting for long-duration insurance contracts specified in Statement 60. Because no single function or service is predominant over the periods of most long-duration insurance contracts, recognition of premiums as revenue over the premium-paying periods was considered a reasonable measure of service performed.

4. The differences between universal life insurance and the long-duration contracts described in Statement 60 led many to question the propriety of applying the accounting method described in Statement 60 to universal life insurance. Universal life insurance contracts lack the fixed and guaranteed terms that are typical for the contracts for which the accounting specified in Statement 60 was designed. Policyholders are frequently granted significant discretion over the amount and timing of premium payments. Insurers are frequently granted significant discretion over amounts that accrue to and that are assessed against policyholders.

5. Some long-duration insurance contracts that are addressed by Statement 60 have terms that are fixed and guaranteed but lack either the level premiums or the insurance protection characteristics contemplated in Statement 60. The increasing number of those contracts led the Board to reconsider the accounting for them at the same time it considered the accounting for universal life insurance.

APPLICABILITY AND SCOPE

6. This Statement applies to all insurance enterprises to which Statement 60 applies. The Statement establishes standards of financial accounting and reporting for three classes of long-duration contracts issued by those insurance enterprises and for reporting realized investment gains and losses. Those contracts are referred to in this Statement as investment contracts, limited-payment contracts, and universal life-type contracts. The accounting for long-duration contracts not otherwise addressed by this Statement is prescribed in Statement 60 and *FASB Statement No. 120, Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*.

7. Long-duration contracts that do not subject the insurance enterprise to risks arising from policyholder mortality or morbidity are referred to in this Statement as investment contracts. A mortality or morbidity risk is present if, under the terms of the contract, the enterprise is required to make payments or forego required premiums contingent upon the death or disability (in the case of life insurance contracts) or the continued survival (in the case of annuity contracts) of a specific individual or group of individuals. A contract provision that allows the holder of a long-duration contract to purchase an annuity at a guaranteed price on settlement of the contract does not entail a mortality risk until the right to purchase is executed. If purchased, the annuity is a new contract to be evaluated on its own terms.

8. Annuity contracts may require the insurance enterprise to make a number of payments that are not contingent upon the survival of the beneficiary, followed by payments that are made if the beneficiary is alive when the payments are due (often referred to as life-contingent payments). Such contracts are considered insurance contracts under this Statement and Statement 60 unless (a) the probability that life-contingent payments will be made is remote [1] or (b) the present value of the expected life-contingent payments relative to the present value of all expected payments under the contract is insignificant [2].

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[1] The term remote is defined in paragraph 3 of FASB Statement No. 5, *Accounting for Contingencies*, as "the chance of the future event or events occurring is slight."

[2] Webster's New World Dictionary, Second College Edition, defines the term insignificant as "having little or no importance; trivial."

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9. Long-duration insurance contracts with terms that are fixed and guaranteed, and for which premiums are paid over a period shorter than the period over which benefits are provided, are referred to in this Statement as limited-payment contracts. The period over which benefits are provided, as used in this Statement, includes the periods during which the insurance enterprise is subject to risk from policyholder mortality and morbidity and during which the insurance enterprise is responsible for administration of the contract. The benefit period does not include the subsequent period over which the policyholder or beneficiary may elect to have settlement proceeds disbursed.

10. Except as provided in paragraph 11 [not excerpted], long-duration insurance contracts with terms that are not fixed and guaranteed are referred to in this Statement as universal life-type contracts. Universal life-type contracts include contracts that provide either death or annuity benefits and are characterized by any one of the following features:

a. One or more of the amounts assessed by the insurer against the policyholder -- including amounts assessed for mortality coverage, contract administration, initiation, or surrender -- are not fixed and guaranteed by the terms of the contract.

b. Amounts that accrue to the benefit of the policyholder -- including interest accrued to policyholder balances -- are not fixed and guaranteed by the terms of the contract.

c. Premiums may be varied by the policyholder within contract limits and without consent of the insurer.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Investment Contracts

15. Investment contracts issued by an insurance enterprise, as defined in this Statement, do not incorporate significant insurance risk as that concept is contemplated in Statement 60 and shall not be accounted for as insurance contracts. Amounts received as payments for such contracts shall not be reported as revenues. Payments received by the insurance enterprise shall be reported as liabilities and accounted for in a manner consistent with the accounting for interest-bearing or other financial instruments.

Limited-Payment Contracts

16. Limited-payment contracts subject the insurer to risks arising from policyholder mortality and morbidity over a period that extends beyond the period or periods in which premiums are collected. For those contracts, the liability for policy benefits shall be established in accordance with the provisions of Statement 60. The collection of premium does not, however, represent the completion of an earnings process. Any gross premium received in excess of the net premium [3] shall be deferred and recognized in income in a constant relationship with insurance in force (when accounting for life insurance contracts) or with the amount of expected future benefit payments (when accounting for annuity contracts).

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[3] Statement 60 defines gross premium as “the premium charged to a policyholder for an insurance contract.” That Statement defines net premium as “the portion of the gross premium required to provide for all benefits and expenses.”

Universal Life-Type Contracts

17. The liability for policy benefits for universal life-type contracts shall be equal to the sum of:

a. The balance that accrues to the benefit of policyholders at the date of the financial statements[4]

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[4] Accounting methods that measure the liability for policy benefits based on policyholder balances are known as retrospective deposit methods.

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b. Any amounts that have been assessed to compensate the insurer for services to be performed over future periods (paragraph 20)

c. Any amounts previously assessed against policyholders that are refundable on termination of the contract

d. Any probable loss (premium deficiency) as described in paragraphs 35-37 of Statement 60

18. Amounts that may be assessed against policyholders in future periods, including surrender charges, shall not be anticipated in determining the liability for policy benefits. In the absence of a stated account balance or similar explicit or implicit contract value, the cash value, measured at the date of the financial statements, that could be realized by a policyholder upon surrender shall represent the element of liability described in paragraph 17.a. Provisions for adverse deviation shall not be made.

19. Premiums collected on universal life-type contracts shall not be reported as revenue in the statement of earnings of the insurance enterprise. Revenue from those contracts shall represent

amounts assessed against policyholders and shall be reported in the period that the amounts are assessed unless evidence indicates that the amounts are designed to compensate the insurer for services to be provided over more than one period.

20. Amounts assessed that represent compensation to the insurance enterprise for services to be provided in future periods are not earned in the period assessed. Such amounts shall be reported as unearned revenue and recognized in income over the period benefited using the same assumptions and factors used to amortize capitalized acquisition costs. Amounts that are assessed against the policyholder balance as consideration for origination of the contract, often referred to as initiation or front-end fees, are unearned revenues.

Other Amendments to Statement 60

29. This Statement adds the following footnote to paragraph 6 of Statement 60:

> *The accounting for certain long-duration insurance contracts referred to as investment contracts, limited-payment contracts, and universal life-type contracts is established by *FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*.

30. Paragraph 15 of Statement 60 is superseded by the following:

> Premiums from long-duration contracts, such as whole-life contracts, guaranteed renewable term life contracts, and title insurance contracts, shall be recognized as revenue when due from policyholders.

52. *AICPA Statement of Position No. 95-1*, *Accounting for Certain Insurance Activities of Mutual Life Insurance Enterprises*, provides the following guidance on premium revenue recognition and policy reserves:

12. Premiums from participating insurance contracts should be reported as revenue in the statement of earnings when due from policyholders.

Liability for Future Policy Benefits

15. A liability for future policy benefits relating to participating life insurance contracts should be equal to the sum of --

a. The net level premium reserve for death and endowment policy benefits.

b. The liability for terminal dividends.

c. Any probable loss (premium deficiency) as described in paragraphs 35-37 of FASB Statement No. 60.

16. The net level premium reserve should be calculated based on the dividend fund interest rate, if determinable, and mortality rates guaranteed in calculating the cash surrender values described in the contract. If the dividend fund interest rate is not determinable, the guaranteed interest rate used in calculating cash surrender values described in the contract should be used. If the dividend fund interest rate is not determinable and there is no guaranteed interest rate, the interest rate used in determining guaranteed nonforfeiture values should be used. Finally, if none of the above rates exists, then the interest rate used to determine minimum cash surrender values -- as set by the National Association of Insurance Commissioners' (NAIC) model standard nonforfeiture law--for the year of issue of the contract should be used. Regardless of the rate used, net premiums should be calculated as a constant percentage of the gross premiums.

17. Terminal dividends should be accrued in the liability for future policy benefits if the following conditions are both met: [4]

a. Payment of the dividend is probable.
b. The amount can be reasonably estimated.

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[4] These conditions should be used in the same sense that they are used in *FASB Statement No. 5*, *Accounting for Contingencies*.

If the two conditions are met (and they ordinarily will be), the terminal dividends should be recognized as an expense over the life of a book of participating life insurance contracts, at a constant rate based on the present value of the estimated gross margin amounts expected to be realized over the life of the book of contracts. The present value of estimated gross margins should be computed using the expected investment yield (net of related investment expenses). If significant negative gross margins are expected in any period, then the present value of gross margins before annual dividends, estimated gross premiums, or the balance of insurance in force should be substituted as the base for computing the expense amount to be recognized. (The base substituted in this calculation should be the same one substituted in the amortization of deferred acquisition costs discussed in paragraph 20.)

18. Increases in the liability for future policy benefits should be reported as an expense in the statement of earnings.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 10, Aggregate Reserves for Life and Annuity Contracts, Chapter 13, Aggregate Reserves for Accident and Health Policies, and Chapter 18, Premium Income
- *Issue Paper No. 3—Accounting Changes*
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 50—Classifications and Definitions of Insurance or Managed Care Contracts In Force*

Generally Accepted Accounting Principles

- *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises*
- *FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*
- *FASB Statement No. 120, Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*
- *AICPA Statement of Position 95-1, Accounting for Certain Activities of Mutual Life Insurance Enterprises*
- *FASB Interpretation No. 40, Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance and Other Enterprises, an interpretation of FASB Statements No. 12, 60, 97, and 113*
- *AICPA Practice Bulletin 8, Application of FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments, to Insurance Enterprises*
- *AICPA Audit and Accounting Guide: Stock Life Insurance Companies*

State Regulations

- No additional guidance obtained from state statutes or regulations. State regulations may be excerpted and discussed, as necessary, in subsequent issue papers dealing with unique aspects of specific life contracts.

Statutory Issue Paper No. 52

Deposit-Type Contracts

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 52

Type of Issue:
Life Specific

SUMMARY OF ISSUE

1. Current statutory accounting guidance on income recognition and policy reserves for deposit-type contracts, as defined in *Issue Paper No. 50—Classifications and Definitions of Insurance or Managed Care Contracts In Force* (Issue Paper No. 50) is addressed in Chapter 10, Aggregate Reserves for Life and Annuity Contracts, Chapter 12, Deposit Funds and Other Liabilities Without Life or Disability Contingencies, and Chapter 18, Premium Income of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies (Life/A&H Accounting Practices and Procedures Manual). That guidance applies to premiums, deposit-type funds, and considerations as well as related policy reserves for all life, annuity, deposit, and other similar contracts with and without life contingencies. Under current statutory accounting, considerations on deposit-type contracts are generally recorded as income in the Summary of Operations when received as either annuity considerations, deposit-type funds, considerations for supplemental contracts without life contingencies and dividend accumulations, or coupons left to accumulate at interest, as appropriate. In addition, policy reserves must make a good and sufficient provision for all unmatured obligations guaranteed under the terms of the contracts and are generally computed based on the provisions of the NAIC Model Standard Valuation Law (SVL), the Actuarial Opinion and Memorandum Model Regulation, the Actuarial Standards of Practice promulgated by the American Academy of Actuaries, and the actuarial guidelines adopted by the NAIC; however, variations by state do exist.

2. GAAP requires insurance contracts to be classified as short-duration or long-duration contracts. Long-duration contracts include contracts, such as whole-life, guaranteed renewable term life, endowment, and annuity contracts, that are expected to remain in force for an extended period. Long-duration contracts that do not subject the insurance enterprise to risks arising from policyholder mortality or morbidity are classified as investment contracts and are accounted for in a manner consistent with the accounting for interest-bearing or other financial instruments (i.e., the balance that accrues to the benefit of the policyholder). Payments received on those contracts are not reported as revenue.

3. The purpose of this issue paper is to establish statutory accounting principles for income recognition and policy reserves for deposit-type contracts that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

Introduction

4. As discussed in Issue Paper No. 50, deposit-type contracts are those contracts that do not subject the reporting entity to any risks arising from policyholder mortality or morbidity. A mortality or morbidity risk is present if, under the terms of the contract, the reporting entity is required to make payments or forego required premiums contingent upon the death or disability (in the case of life and disability insurance contracts) or the continued survival (in the case of annuity contracts) of a specific individual or group of individuals.

5. As in universal life-type contracts, as discussed in *Issue Paper No. 56—Universal Life-Type Contracts, Policyholder Dividends, and Coupons,* deposit-type contracts frequently grant policyholders significant discretion over the amount and timing of deposits and withdrawals. Reporting entities are frequently granted significant discretion over amounts that accrue to or that are assessed against policyholders.

6. Due to the absence of mortality and/or morbidity risk and the discretionary characteristics noted in the preceding paragraph, the accounting principles for income recognition and policy reserves for deposit-type contracts differ from the accounting for life contracts set forth in *Issue Paper No. 51—Life Contracts* (Issue Paper No. 51), accident and health contracts established in *Issue Paper No. 54—Individual and Group Accident and Health Contracts*, and credit insurance contracts as discussed in Is*sue Paper No. 59—Credit Life and Accident and Health Insurance Contracts*.

7. This issue paper prescribes the income recognition and policy reserve requirements for all contracts without life or disability contingencies. Contracts that generally do not subject the reporting entity to risks arising from policyholder mortality or morbidity include, but are not limited to certain types of the following policy categories:

- Supplemental contracts
- Lottery payouts
- Structured settlements
- Guaranteed interest contracts
- Income settlement options
- Annuities certain
- Dividend and coupon accumulations
- Premium and other deposit funds

As discussed in Issue Paper No. 50, subsequent issue papers, where needed, will establish specific statutory accounting principles that are applicable to unique characteristics of certain deposit-type contracts (e.g., separate accounts).

Income Recognition

8. Contracts issued by a reporting entity that do not incorporate mortality or morbidity risk shall not be accounted for as insurance contracts. Amounts received as payments for such contracts shall not be reported as revenues but shall be recorded directly to an appropriate policy reserve account.

Policy Reserves

9. The reserving methodologies and assumptions used in computation of policy reserves shall meet the provisions of Appendices A-820 and A-822, and the actuarial guidelines found in Part 9 of the NAIC Financial Examiners Handbook. Further, policy reserves shall be in compliance with those Actuarial Standards of Practice promulgated by the Actuarial Standards Board.

10. Policy reserves shall be established for all contractual obligations of the reporting entity arising out of the provisions of the contract. Where separate benefits are included in a contract, a reserve for each benefit shall be established as required in Appendix A-820. Statutory policy reserves meet the definition of liabilities as defined in *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets* (Issue Paper No. 5). The actuarial methodologies referred to in the following paragraph meet the criteria required for reasonable estimates in Issue Paper No. 5.

11. The policy reserve for contracts without life contingencies where the future benefits are fixed and guaranteed (e.g., supplemental contracts, lottery payouts, structured settlements, guaranteed interest contracts, income settlement options, annuities certain, and unmatured coupon accumulations) shall be based on the present value of the future guaranteed benefits discounted at the valuation interest rate. The

policy reserve for all other contracts (e.g., premium and other deposit funds, and dividend and matured coupon accumulations) shall be based on the accumulated amounts paid plus an income accumulation based on the contract provisions, less any withdrawals and applicable surrender charges.

12. Policy reserves shall be increased for reinsurance assumed and decreased for reinsurance ceded as further described in *Issue Paper No. 74—Life, Deposit-Type and Accident and Health Reinsurance*.

Structured Settlements

13. Reporting entities that have accepted an assignment of obligations under structured settlements shall record those obligations consistent with the accounting and reporting provided for structured settlements in paragraphs 16 and 17 of *Issue Paper No. 65—Property and Casualty Contracts*.

Cost Recognition

14. Interest credited to deposit-type contracts shall be recorded as an expense in the Summary of Operations when earned under the terms of the contract. Payments that represent a return of policyholder balances shall not be recorded as expenses. To the extent such payments differ from the recorded reserve, the difference shall be recorded in the Summary of Operations as a benefit expense.

Change In Valuation Basis

15. A change in valuation basis shall be defined as a change in the interest rate assumption or other factor affecting the reserve computation of policies in force and meets the definition of an accounting change as defined in *Issue Paper No. 3—Accounting Changes* (Issue Paper No. 3). Consistent with Issue Paper No. 3, any increase (strengthening) or decrease (destrengthening) in actuarial reserves resulting from such a change in valuation basis shall be recorded directly to surplus rather than as a part of the reserve change recognized in the Summary of Operations. The impact on surplus is based on the difference between the reserve under the old and new methods as of the beginning of the year. This difference shall not be graded in over time unless an actuarial guideline adopted by the NAIC prescribes a specific transition that allows for grading.

Unearned Income

16. Amounts assessed that represent compensation to the reporting entity for services to be provided in future periods and which are required to be refunded upon policy termination are not earned in the period assessed. Such amounts, if not already considered in the policy reserve, shall be reported as unearned income, a liability, and recognized as income as the related services are provided.

Additional Reserves Not Included Elsewhere

17. Additional actuarial liabilities are commonly held for such items as:

a. Surrender values in excess of reserves otherwise required or carried

b. Additional reserves required based on cash flow testing and/or asset/liability matching requirements.

Disclosures

18. For life and annuity reserves the financial statements shall disclose the following:

a. A description of reserve practices including the amount of any surrender value promised in excess of the reserve as legally computed;

b. The method of determination of tabular interest on funds not involving life contingencies; and

c. The nature of significant other reserve changes.

19. Disclose the amount of annuity actuarial reserves and deposit liabilities by withdrawal characteristics as follows:

a. Subject to discretionary withdrawal:

i. With market value adjustment, where withdrawal of funds is payable at all times, or prior to specified maturity dates where such dates are more than one year after the statement date and;

(a) In a lump sum with adjustments to reflect general changes in interest rates, or asset values since receipt of funds by the reporting entity; and

(b) In installments over five years or more, with or without a reduction in the interest rate during the installment period.

ii. At book value less current surrender charge, where the withdrawal of funds is payable at all times, or at any time within one year from the statement date in a lump sum subject to a current fixed surrender charge of 5% or more and it does not contain a meaningful bail out rate as described in subparagraph v.(d) below;

iii. At market value, where the withdrawal of funds is payable at current market value of the assets supporting the liabilities, the assets are stated at current market value, and the liabilities are stated at the current market value or per unit value of the assets supporting the liabilities. These liabilities are for contracts where the customer bears the entire investment risk;

iv. Total with adjustment or at market value;

v. At book value without adjustment (minimal or no charge or adjustment), where the withdrawal of funds is either payable at all times, or at any time (including a withdrawal on a scheduled payment date) within one year from the statement date and:

(a) In a lump sum without adjustment;

(b) In installments over less than five years, with or without a reduction in interest rate during the installment period;

(c) In a lump sum subject to a fixed surrender charge of less than 5%;

(d) In a lump sum subject to surrender charge, but such charge is waived if the credited rate falls below a specified “bail out” rate and the “bail out” rate is more than the maximum statutory valuation rate for life insurance policies for more than 20 years for new issues; and

(e) All others.

b. Not subject to discretionary withdrawal;

c. Total gross;

d. Reinsurance ceded;

e. Total net.

DISCUSSION

SAP Considerations

20. The statutory accounting principles outlined in the conclusion above regarding income recognition and policy reserves for deposit-type contracts are consistent with the Statement of Concepts which states:

> Conservatism
>
> Financial reporting by insurance enterprises requires the use of substantial judgments and estimates by management. Such estimates may vary from the actual amounts for numerous reasons. To the extent that factors or events result in adverse variation from management's accounting estimates, the ability to meet policyholder obligations may be lessened. In order to provide a margin of protection for policyholders, the concept of conservatism should be followed when developing estimates as well as establishing accounting principles for statutory reporting.
>
> Conservative valuation procedures provide protection to policyholders against adverse fluctuations in financial condition or operating results. Statutory accounting should be reasonably conservative over the span of economic cycles and in recognition of the primary responsibility to regulate for financial solvency. Valuation procedures should, to the extent possible, prevent sharp fluctuations in surplus.
>
> Consistency
>
> The regulators' need for meaningful, comparable financial information to determine an insurer's financial condition requires consistency in the development and application of statutory accounting principles. Because the marketplace, the economic and business environment, and insurance industry products and practices are constantly changing, regulatory concerns are also changing. An effective statutory accounting model must be responsive to these changes and address emerging accounting issues. Precedent or historically accepted practice alone should not be sufficient justifications for continuing to follow a particular accounting principle or practice which may not coincide with the objectives of regulators.
>
> Recognition
>
> Liabilities require recognition as they are incurred. Certain statutorily mandated liabilities may also be required to arrive at conservative estimates of liabilities and probable loss contingencies (e.g., interest maintenance reserves, asset valuation reserves, and others).

21. Except as discussed in next two paragraphs, the statutory accounting principles outlined in the conclusion above regarding income recognition and policy reserves for deposit-type contracts are consistent with current statutory accounting.

22. Current SAP require amounts received on annuity and supplemental contracts without life contingencies and dividend and coupon accumulations to be recorded in the Summary of Operations as income. This issue paper changes current SAP to require that amounts received on deposit-type contracts be recorded directly to policy reserves and not recorded as income. This change was made to reflect that cash inflows (premiums) on deposit-type contracts do not result from providing insurance and are therefore not considered revenue. Similarly, payments to policyholders that represent a return of policyholder balances are not considered expenses. Revenues and expenses arise from the investment of amounts received from policyholders and interest credited to their accounts, respectively.

23. Consistent with Issue Paper No. 51, recording unearned income and other similar amounts as deferred income and recognizing the amounts as income only as the earnings process is completed is consistent with the objectives of the Statement of Concepts.

24. Significant differences exist between life and deposit-type contracts. Life contracts provide insurance protection against death while deposit-type contracts do not provide for mortality risk but act exclusively as investment vehicles. Unlike life contracts, deposit-type contracts frequently grant significant discretion over the amount and timing of payments by policyholders as well as the amounts that accrue to or that are assessed against policyholders by the reporting entity. As a result of these differences, the accounting requirements also vary. Premium income on life contracts is generally recognized on the gross basis (amount charged to the policyholder) when due from policyholders under the terms of the insurance contract (e.g., single, renewal premiums, and any related premium adjustments) while income on deposit-type contracts is recorded based on the underlying performance of the invested assets. Due to these differences, the accounting for life and deposit-type contracts has been discussed in separate issue papers.

GAAP Literature

25. Consistent with Issue Papers Nos. 50 and 51, the GAAP literature, specifically *FASB Statement No. 60, Accounting and Reporting by Insurance* Enterprises (FAS 60), *FASB Statement No. 97*, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments* (FAS 97), and *FASB Statement 120*, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts* (FAS 120), for deposit-type contracts is rejected.

Drafting Notes/Comments

- Issue Paper No. 50 addresses Classifications and Definitions of Insurance or Managed Care Contracts In Force.
- Issue Paper No. 51 addresses Life Contracts.
- Issue Paper No. 53 addresses Property and Casualty Contracts – Premiums.
- Issue Paper No. 54 addresses Individual and Group Accident and Health Contracts.
- Issue Paper No. 55 addresses Unpaid Claims, Losses and Loss Adjustment Expenses.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE (only pertinent excerpts are included below)

Statutory Accounting

26. The Life/A&H Accounting Practices and Procedures Manual provides the following guidance with respect to policy reserves on deposit-type contracts:

> CHAPTER 10
> AGGREGATE RESERVES FOR LIFE AND ANNUITY CONTRACTS
>
> Annuity and Pure Endowment Contracts
>
> Whereas life insurance provides protection from the loss arising from dying too soon, an annuity protects against the loss from living too long. An annuity can be in either an accumulative (premium paying or paid-up deferred) period or a payout period. The company's obligation in each period is different and is described in detail in the annuity contract.
>
> Anticipated (and actual) mortality experience is different for persons purchasing annuity contracts than for persons who purchase life insurance. Mortality rates of annuitants are lower as a result of selection by the annuitants. For this reason, separate annuity mortality tables have been developed for the valuation of annuity contracts.
>
> Pure endowments, also, are insurance contracts against living too long. A pure endowment benefit is exactly the opposite of term life insurance because the benefits are paid only if the insured survives the term of the contract. No benefit is paid if the insured dies before the end of the term. Sales of pure endowments are somewhat unusual—the typical endowment contract

also includes some type of life insurance and, consequently, is valued as life insurance. Mortality tables for annuities also are used in reserving for pure endowment benefits.

Annuities and pure endowments can be sold either as individual contracts or as group contracts.

If there are interest rate guarantees on group annuity funds, additional reserves may be required by the statutes and regulations of the various states.

Reserves for group pension (group annuity) business involves more complex considerations, and a considerable degree of variation is permitted or prescribed by state regulations and statutes.

Miscellaneous Reserves

Since the actuarial liabilities must include provision for any contingent benefit or right which may arise, statutory statements provide for estimates of a number of miscellaneous reserve items. For example, state laws or regulations may require minimum reserves when valuation net premiums exceed gross premiums. The additional reserve needed to meet the minimum may appear separately as a miscellaneous reserve or may be included with the life reserve in accordance with the applicable state regulations. Similarly, provision for either nondeduction of deferred fractional premiums or return of premiums at death of the insured may be made as a separate reserve or as part of the life reserve. Approximate reserving methods are accepted and frequently used to estimate such items. Another minimum reserve which must be provided for is a reserve for surrender values in excess of reserves otherwise required or carried. There are other miscellaneous items commonly encountered, such as reserve for substandard extra premiums, a reserve for extra mortality on group conversions, and reserve for guaranteed insurability options.

Changes in Valuation Bases

Where the interest rate, mortality basis, reserving method (e.g., net level, preliminary term, etc.), or other basis affecting reserve computation of in force business is changed during the year, any increase or decrease in actuarial reserves resulting from this change in valuation basis must be charged directly to surplus rather than as a part of the reserve increase item in the summary of operations. For various reasons, any change in valuation bases which produces an increase in reserves (reserve strengthening) or decrease in reserves (reserve destrengthening) may require the approval of the applicable regulatory authority. Procedures and timing for such approval vary from state to state.

27. The Life/A&H Accounting Practices and Procedures Manual provides the following guidance with respect to policy reserves on deposit-type contracts:

CHAPTER 12
DEPOSIT FUNDS AND OTHER LIABILITIES WITHOUT LIFE OR DISABILITY CONTINGENCIES

Liability for Premium and Other Deposit Funds

When a company receives premiums over one year prior to their due date, such premium deposits are usually recorded as a liability. A premium deposit fund is not considered to be discounted premiums; instead, interest at contracted rates is credited annually to each individual account. The terms of the fund (interest rate, disposition, and so forth) are specified in the policy or in a separate endorsement. A liability is established in the statutory financial statement for the balance of such premium deposits and accrued interest to the valuation date.

Guarantee investment contracts and other deposit funds of generally similar nature will give rise to statement liability. The terms of such contracts including provisions for early term or surrender of the contracts, must be considered in establishing the appropriate statement liability.

The statutory financial statement differentiates this category of deposit items in the following manner:

1. Premium deposit funds represent deposits made by policyholders to pay premiums in considerations at some future date. The deposits will not, however, be credited to premium or consideration income accounts until the premium due dates. The liability should include any interest declared and credited or accrued.

2. Guaranteed interest contracts (GICs) provide that the contractholder place one or more deposits with the insurance company in exchange for repayment of those deposits plus interest at a guaranteed rate(s). Both the deposits and the repayments are made according to a schedule provided in the contract. Other features common to GICs are:

   (a) The GIC contractholder is typically the sponsor or trustee of an employee benefit plan (pension, profit-sharing, thrift, savings, etc.)

   (b) The guaranteed interest rate on GICs is closely associated with new money rates at the time of contract issue. Lower guaranteed rates may apply to deposits made after the date of issue.

   (c) GICs often contain guarantees which limit insurance company administrative expense charges.

   (d) GICs are usually nonparticipating, that is, the contractholder does not share in good or bad investment experience of the insurance company. Some GICs base the guaranteed rate on an investment or economic index.

   (e) GICs normally contain penalties for failure of the contractholder to make scheduled deposits. In addition, penalties and/or restrictions on early or unscheduled withdrawals of funds are common.

   The liability for GICs is subject to standard valuation law. Generally speaking, the minimum liability is equal to the future scheduled payments discounted back to the valuation date at the applicable valuation rate of interest. The minimum liability may exceed the amounts deposited accumulated at the guaranteed rates.

3. Other deposit items not otherwise included on Page 3.

Supplementary Contracts Without Life Contingencies

A supplementary contract is an agreement between the company and either the insured or the beneficiary, usually arrived at upon the termination of an original benefit contract, to provide for full or partial settlement of the amount payable under the original contract. However, such an agreement can be called a supplementary contract only when it is made for the payment of proceeds of a contract that has been written by the company. If the proceeds are to be paid over a definite period without regard to the life of the beneficiary, or are to be left at interest, the contract is termed a supplementary contract without life contingencies. (See Chapter 10).

Since supplementary contracts involve the payment of interest, the following terms become important. The “contract rate of interest” is the rate stated in the original policy or contract and is the minimum rate which may be paid on the amounts left under the option selected. If a company elects to establish a rate higher than the original contract rate as a minimum interest rate, this new rate becomes a “guaranteed rate.” In practice, some companies have established such guaranteed rates because of higher returns on investments than those anticipated when the original contracts were issued.

Reserves for supplementary contracts without life contingencies are reported as separate liability in the statutory financial statement. The reserve includes any interest credited or accrued to the statement date. For contracts being paid in installments, the reserve is the present value of the future payments.

28. The Life/A&H Accounting Practices and Procedures Manual provides the following guidance with respect to premium income recognition on deposit-type contracts:

CHAPTER 18
PREMIUM INCOME

Premiums are generally recorded in the company's general ledger when received. This necessitates adjustments as of the balance sheet dates for premiums received in advance of their due date, for premiums which are due but have not yet been received, and for "deferred" premiums. Premium income reported in the Summary of Operations includes reinsurance assumed and is reduced by reinsurance ceded.

Deductions should be made for premiums and annuity considerations returned and allowances to industrial policyholders for direct payment of premiums. Commissions and allowances on reinsurance premiums assumed and ceded may not be deducted.

Single premiums and considerations include dividends, coupons, guaranteed annual pure endowments, and similar benefits applied to provide paid-up additional insurance or annuities. Renewal premiums collected are to include dividends and coupons applied to pay renewal premiums and to shorten the endowment or premium-paying period.

Cost of Collection in Excess of Loading

A liability should be provided for the cost of collection on premiums and annuity consideration deferred and uncollected in excess of total loading thereon if the company deems the loading to be inadequate. The increase in this item and the increase in loading on deferred and uncollected premiums are both recorded in the same line in the Summary of Operations. Provisions for cost of collection should include commissions, collection fees, and taxes contingent upon the collection of the deferred and uncollected premiums.

Premiums Received in Advance

Premium income reported in operations must exclude premiums that have been received by the company prior to the valuation date but which are due on or after the next policy anniversary date. The accounting treatment is the same for both life and accident and health premiums.

A policyholder may remit one or more premiums in advance of specific due dates. Where premiums are remitted sufficiently far in advance, the premiums may be discounted for interest from their due dates to the date of payment. The total amount of such gross premiums, less any discount as of the valuation date, is reported as a liability in the statutory financial statement. The gross premium less any discount is recorded as the advance premium, not the net valuation premium, in recognition of the company's liability to refund such premiums in the event the policy is terminated.

Advance premiums must be recorded for industrial as well as ordinary and group policies. Advance premiums received on group policies may be reported in the liability for premiums received in advance or as a 100% unearned premium reserve.

Premium and Other Deposit Funds

A company may also receive premiums over one year prior to their due date and include them in a premium deposit fund. These amounts are not reported as income. The premium deposit fund may or may not represent payment of specific future premiums. Interest at contracted rates is credited annually to each individual account. Interest on such funds must be accrued to the balance sheet date. The terms of the fund (interest rate, disposition, and so forth) are specified in the provisions of the policy or in a separate endorsement. An explanation of other deposit funds can be found in Chapter 12.

Amounts deposited and accumulated for guaranteed interest contracts may be included in this classification. Finally, other deposit items of a generally similar nature may also be included herein.

Withdrawals from deposit accounts to pay premiums are credited to the appropriate income account. Provision is made in the statutory financial statement for reporting the balance of such deposits as of the balance sheet date.

Annuity Contracts

Certain annuity contracts, usually group pension contracts, frequently provide for the payment to the company of amounts other than premiums or considerations to be accumulated at interest for the purpose of providing pensions for employees at retirement and similar benefits. Amounts withdrawn from the fund to purchase annuity benefits reduce "Annuity and other fund deposits" and increase premium and annuity considerations.

Uncollected and deferred annuity considerations are calculated on deferred annuity contracts other than single payment contracts. The asset item is recorded net of loading.

Considerations for Supplementary Contracts

The Summary of Operations includes as income all policy proceeds which have been left with the company during the year under optional modes of settlement to provide beneficiaries or the policyowner with periodic income under a supplementary contract. Supplementary contracts may provide for an income payable for the lifetime of the payee(s), in which case the considerations would be reported as "Considerations for supplementary contracts with life contingencies." A supplementary contract may also provide for the payment of a periodic income for a specified number of years or for payments of a specified amount until the funds with interest earnings are exhausted. The considerations for such supplementary contracts are reported separately as "Considerations for supplementary contracts without life contingencies."

These considerations arise from proceeds retained at death, disability, surrender, or maturity of policies and annuity contracts. The amount of these retained proceeds is included in the amount reported in the Summary of Operations for policy and contract benefits.

Considerations for Dividend Accumulations

Another income item in the Summary of Operations is "Consideration for dividend accumulations." The accounting treatment for dividend accumulation deposits, dividend accumulation payments, and the change in the liability is similar to accounting for life insurance. Consideration for dividend accumulations represents the amount of policy dividends left on deposit with the company during the year to accumulate at interest. This amount would normally agree with the amount reported in the Dividends and Coupons to Policyholders exhibit of the annual statement as being left on deposit with the company.

Generally Accepted Accounting Principles

29. FAS 97, as amended by FAS 120, provides the following guidance with respect to deposit-type contracts:

Summary

This Statement establishes standards of accounting for certain long-duration contracts issued by insurance enterprises, referred to in this Statement as universal life-type contracts, that were not addressed by *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises*. The Statement also establishes standards of accounting for limited-payment long-duration insurance contracts and investment contracts and amends Statement 60 to change the reporting of realized gains and losses on investments.

New life insurance contracts have evolved since the development of specialized insurance industry accounting principles and practices in the early 1970's. Many of those new life insurance contracts have different provisions than do the life insurance contracts to which Statement 60 applies. Those new life insurance contracts are characterized by flexibility and discretion granted to one or both parties to the contract. Statement 60 identifies but does not address those contracts, noting that the accounting was under study by the insurance industry and the accounting and actuarial professions.

This Statement requires that the retrospective deposit method be used to account for universal life-type contracts. That accounting method establishes a liability for policy benefits at an amount determined by the account or contract balance that accrues to the benefit of the policyholder. Premium receipts are not reported as revenues when the retrospective deposit method is used. The Statement also requires that capitalized acquisition costs associated with universal life-type contracts be amortized based on a constant percentage of the present value of estimated gross profit amounts from the operation of a "book" of those contracts. Any gain or loss resulting from a policyholder's replacement of other life insurance contracts with universal life-type contracts is recognized in income of the period in which the replacement occurs.

This Statement requires that long-duration contracts issued by insurance enterprises that do not subject the enterprise to risks arising from policyholder mortality or morbidity (investment contracts) be accounted for in a manner consistent with the accounting for interest-bearing or other financial instruments. Payments received on those contracts are not reported as revenue.

This Statement also addresses limited-payment contracts that subject the insurance enterprise to mortality or morbidity risk over a period that extends beyond the period or periods in which premiums are collected and that have terms that are fixed and guaranteed. This Statement requires that revenue and income from limited-payment contracts be recognized over the period that benefits are provided rather than on collection of premiums.

APPLICABILITY AND SCOPE

6. This Statement applies to all insurance enterprises to which Statement 60 applies. The Statement establishes standards of financial accounting and reporting for three classes of long-duration contracts issued by those insurance enterprises and for reporting realized investment gains and losses. Those contracts are referred to in this Statement as investment contracts, limited-payment contracts, and universal life-type contracts. The accounting for long-duration contracts not otherwise addressed by this Statement is prescribed in Statement 60 and *FASB Statement No. 120*, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*.

7. Long-duration contracts that do not subject the insurance enterprise to risks arising from policyholder mortality or morbidity are referred to in this Statement as investment contracts. A mortality or morbidity risk is present if, under the terms of the contract, the enterprise is required to make payments or forego required premiums contingent upon the death or disability (in the case of life insurance contracts) or the continued survival (in the case of annuity contracts) of a specific individual or group of individuals. A contract provision that allows the holder of a long-duration contract to purchase an annuity at a guaranteed price on settlement of the contract does not entail a mortality risk until the right to purchase is executed. If purchased, the annuity is a new contract to be evaluated on its own terms.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Investment Contracts

15. Investment contracts issued by an insurance enterprise, as defined in this Statement, do not incorporate significant insurance risk as that concept is contemplated in Statement 60 and shall not be accounted for as insurance contracts. Amounts received as payments for such contracts shall not be reported as revenues. Payments received by the insurance enterprise shall be reported as liabilities and accounted for in a manner consistent with the accounting for interest-bearing or other financial instruments.

Universal Life-Type Contracts

17. The liability for policy benefits for universal life-type contracts shall be equal to the sum of:

a. The balance that accrues to the benefit of policyholders at the date of the financial statements[4]

[4] Accounting methods that measure the liability for policy benefits based on policyholder balances are known as retrospective deposit methods.

b. Any amounts that have been assessed to compensate the insurer for services to be performed over future periods (paragraph 20)

c. Any amounts previously assessed against policyholders that are refundable on termination of the contract

d. Any probable loss (premium deficiency) as described in paragraphs 35-37 of Statement 60.

18. Amounts that may be assessed against policyholders in future periods, including surrender charges, shall not be anticipated in determining the liability for policy benefits. In the absence of a stated account balance or similar explicit or implicit contract value, the cash value, measured at the date of the financial statements, that could be realized by a policyholder upon surrender shall represent the element of liability described in paragraph 17.a. Provisions for adverse deviation shall not be made.

19. Premiums collected on universal life-type contracts shall not be reported as revenue in the statement of earnings of the insurance enterprise. Revenue from those contracts shall represent amounts assessed against policyholders and shall be reported in the period that the amounts are assessed unless evidence indicates that the amounts are designed to compensate the insurer for services to be provided over more than one period.

20. Amounts assessed that represent compensation to the insurance enterprise for services to be provided in future periods are not earned in the period assessed. Such amounts shall be reported as unearned revenue and recognized in income over the period benefited using the same assumptions and factors used to amortize capitalized acquisition costs. Amounts that are assessed against the policyholder balance as consideration for origination of the contract, often referred to as initiation or front-end fees, are unearned revenues.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 10, Aggregate Reserves for Life and Annuity Contracts, Chapter 12, Deposit Funds and Other Liabilities Without Life or Disability Contingencies and Chapter 18, Premium Income
- *Issue Paper No. 3—Accounting Changes*
- *Issue Paper No. 50—Classifications and Definitions of Insurance or Managed Care Contracts In Force*
- *Issue Paper No. 51—Life Contracts*
- *Issue Paper No. 54—Individual and Group Accident and Health Contracts*
- *Issue Paper No. 56—Universal Life-Type Contracts, Policyholder Dividends, and Coupons*
- *Issue Paper No. 59—Credit Life and Accident and Health Insurance Contracts*
- *Issue Paper No. 74—Life, Deposit-Type and Accident and Health Reinsurance*
- Minutes of the Study Group on Accounting and Reporting Deposit-Type Business of the Accounting Practices and Procedures (EX4) Task Force from December 2, 1990 through March 6, 1994

Generally Accepted Accounting Principles

- *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises*
- *FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*
- *FASB Statement No. 120, Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*

State Regulations

- No additional guidance obtained from state statutes or regulations.

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Statutory Issue Paper No. 53

Property Casualty Contracts - Premiums

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 53

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory guidance for premium recognition for property and casualty contracts, as defined in *Issue Paper No. 50—Classifications and Definitions of Insurance Contracts In Force* (Issue Paper No. 50), is contained in the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies (P&C Accounting Practices Procedures Manual). Under current statutory accounting, different methods are used for recording premiums. Regardless of the method used, premiums are generally recognized as earned in the statement of operations over the period of risk in proportion to the amount of insurance protection provided. Premiums for title insurance, mortgage guaranty insurance, financial guaranty insurance, retrospectively rated or other experience-rated contracts and single or fixed premium policies with coverage periods in excess of thirteen months are not included in the scope of this issue paper, but will be addressed in separate issue papers.

2. GAAP provides only general guidance on how to record premium, however GAAP requires an unearned premium reserve to be established and premium revenue to be recognized over the period of risk in proportion to the amount of insurance protection provided.

3. The purpose of this issue paper is to establish statutory accounting principles for the recording and recognition of premium revenue for property and casualty contracts that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. This issue paper applies to property and casualty contracts as defined in Issue Paper No. 50. It will establish the basic underlying accounting principles for premium revenue recognition of property and casualty insurance contracts and will be used as the basis to ensure consistency when establishing statutory accounting principles for revenue recognition.

5. Except as provided for in paragraph 6, written premiums shall be defined as the contractually determined amount charged by the reporting entity to the policyholder for the effective period of the contract based on the expectation of risk, policy benefits and expenses associated with the coverage provided by the terms of the insurance contract. Frequently, insurance contracts are subject to audit by the insurer and the amount of premium charged is subject to adjustment based on the actual exposure. These premium adjustments are discussed in paragraph 10 of this paper.

6. For workers' compensation contracts, which have a premium based upon changes in the activities of the insured, written premiums may be recorded on an installment basis to match the billing to the policyholder. Under this type of arrangement, the premium is determined and billed according to the frequency stated in the contract and written premium is recorded on the basis of that frequency.

7. Written premiums for all other contracts shall be recorded on the effective date of the contract. Upon recording written premium, a liability, the unearned premium reserve, shall be established to reflect the amount of premium for the portion of the insurance coverage that has not yet expired. Unearned premium reserve meets the definition of a liability as defined in *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets* (Issue Paper No. 5).

8. The exposure to insurance risk for most property and casualty insurance contracts does not vary significantly during the contract period. Therefore, premiums from those types of property and casualty contracts shall be recognized in the statement of operations, as earned premium, using either the daily pro-rata or monthly pro-rata methods as described in paragraph 17. Certain issue papers provide for different methods of recognizing premium in the statement of operations for specific types of contracts. For contracts not separately identified in specific issue papers where the reporting entity can demonstrate the period of risk differs significantly from the contract period, premiums shall be recognized as revenue over the period of risk in proportion to the amount of insurance protection provided.

9. Additional premiums that are charged to policyholders for endorsements and for changes in coverage under the contract shall be recorded on the effective date of the endorsement and accounted for in a manner consistent with the methods discussed in paragraphs 7 and 8 so that at any point in time a liability is accrued for unearned premium equal to the premium amount charged for the unexpired portion of the policy endorsement.

10. Adjustments to the amount of premium charged for changes in the level of exposure to insurance risk (such as audit premiums on workers' compensation policies) are generally determined based upon audits conducted after the policy has expired. Reporting entities shall estimate audit premiums, the amount generally referred to as earned but unbilled (EBUB) premium, and shall record such amounts as an adjustment to premium, either through written premium or as an adjustment to earned premium. Such amounts meet the definition of assets as defined in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*. Such amounts shall be adjusted upon completion of the audit and the adjustment shall be recognized as revenue immediately. The estimate for EBUB may be determined using actuarially or statistically supported aggregate calculations using company historical unearned premium data, or per policy calculations. Upon completion of an audit that results in a return of premiums to the policyholder, earned premiums shall be reduced. Ten percent of EBUB in excess of collateral specifically held and identifiable on a per policy basis, must be reported in the annual statement as a nonadmitted asset, however, to the extent that amounts in excess of the 10% are not anticipated to be collected they shall be written off against operations in the period the determination is made. Reporting entities shall establish all of the requisite liabilities associated with the asset such as commissions and premium taxes.

11. When the anticipated losses, loss adjustment expenses commissions and other acquisition costs, and maintenance costs exceed the recorded unearned premium reserve, a premium deficiency reserve shall be recognized by recording an additional liability for the deficiency with a corresponding charge to operations. Commission and other acquisition costs need not be considered in the premium deficiency analysis to the extent they have previously been expensed. For purposes of determining if a premium deficiency exists, insurance contracts shall be grouped in a manner consistent with how policies are marketed, serviced and measured. A liability shall be recognized for each such grouping where a premium deficiency is indicated. Such deficiencies shall not be offset by anticipated profits in other policy groupings. If an reporting entity utilizes anticipated investment income as a factor in the premium deficiency calculation, disclosure of such shall be made in the notes to the financial statements.

Disclosure Requirements

12. Disclose the aggregate amount of direct premiums written through managing general agents or third party administrators. If this amount is equal to or greater than 5% of surplus, provide the following information for each managing general agent and third party administrator:

a. Name and address of managing general agent or third party administrator;
b. Federal Employer Identification Number;
c. Whether such person holds an exclusive contract;
d. Types of business written;
e. Type of authority granted (i.e., underwriting, claims payment, etc.); and
f. Total premium written.

DISCUSSION

13. This issue paper adopts current statutory guidance for all property and casualty contracts, except as outlined below. This issue paper modifies current statutory accounting to record the written premium based upon the effective date of the policy or endorsement, except for workers' compensation premiums as discussed in paragraph 6 and premiums which are subject to adjustment, whereas current statutory accounting allows the recording of the premium when the daily report is processed, when the premium is due, or when the premium is paid. This issue paper therefore rejects the conclusions of the Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force reached in 1990 and reaffirmed on March 8, 1993, as it relates to premiums other than workers' compensation, which allowed for certain written premiums to be recorded as billed. These changes were made to improve consistency in reporting. This is consistent with *Issue Paper No. 6—Amounts Due From Agents and Brokers* and *Issue Paper No. 10—Uncollected Premium Balances*. The pro-rata methods described in this issue paper provide for premium to be earned in proportion to the exposure to insurance risk for most property and casualty contracts as in most contracts the exposure to insurance risk does not vary significantly during the contract period. Property and casualty contracts where the exposure to insurance risk varies significantly during the contract period and it may not be appropriate to earn premium on a pro-rata basis are addressed in specific issue papers. For those few contracts not addressed in specific issue papers where the exposure to insurance risk varies significantly during the contract period, premiums shall be recognized as revenue over the period of risk in proportion to the amount of insurance protection provided. This paper also modifies current statutory accounting by requiring the recognition of a premium deficiency in circumstances described in paragraph 11. Current statutory guidance is silent regarding premium deficiency. This issue paper modifies current statutory guidance to allow EBUB to be recorded either through written premium or as an adjustment to earned premium. This change was made to provide consistency between the recording of this type of premium adjustment and retrospective premium adjustments.

14. The conclusions above reject *FASB Statement No. 60*, *Accounting and Reporting by Insurance Enterprises* (FAS 60). The recognition of unearned premium as earned is consistent with GAAP except for those policies where the exposure to insurance risk differs materially during the contract period for which specific methods have been provided for the recognition of unearned premium as earned in certain issue papers. The recognition of a percentage of EBUB premium in excess of collateral as a nonadmitted asset is also not required by GAAP but is consistent with the conservatism and recognition concepts of statutory accounting.

15. The unearned premium reserve meets the definition of a liability as defined in Issue Paper No. 5. That issue paper defines liabilities as certain or probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or to provide services to other entities in the future as a result of past transaction(s) or events. As stated in FAS 60 *"premiums from short-duration insurance contracts, such as property and liability insurance contracts, are intended to cover expected claims costs resulting from insured events that occur during a fixed period of short-duration."* Therefore,

the unearned premium reserve represents the premium to be earned in the future intended to cover the unexpired portion of the policy which generally relates to the future sacrifice of economic benefit, which are the claim costs the reporting entity will pay if losses are incurred during the contract period.

16. Recording the premium as revenue in proportion to the period that insurance protection is provided is consistent with the Recognition concept in the Statement of Concepts. The Recognition concept states, *"revenue should be recognized only as the earnings process of the underlying underwriting or investment business is completed."* Therefore, as the period that is protected expires, the underlying earnings process is completed and the revenue should be recognized.

Drafting Notes/Comments

- Accounting for specific types of property and casualty insurance contracts will be addressed in separate issue papers.
- Accounting for reinsurance will be addressed in *Issue Paper No. 74—Life and Accident and Health Reinsurance* and *Issue Paper No. 75—Property and Casualty Reinsurance*.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

17. Chapter 14, Premiums*,* in the P&C Accounting Practices and Procedures Manual contains the following guidance pertaining to premiums:

> Different methods of recording written premiums are used and generally follow the company's plan of operation. For example, premiums may be recorded when the daily report is processed, when the premium is due, or when the premium is paid. Many companies use combinations of these methods. Whatever recording method is used, premiums written include the following categories: direct premiums, assumed reinsurance premiums and ceded reinsurance premiums.
>
> Direct Premiums
>
> The major portion of most companies' premiums written is direct premiums. Direct premiums include all premiums arising from policies issued by the company acting as the primary insurance carrier. These premiums should be adjusted for any return or additional premiums arising from endorsements, cancellations, audits, and retrospective rating plans.
>
> Direct written premiums are generally recorded for the full policy term. See Chapter 7-Agents' Balances or Uncollected Premiums, for recording of uncollected premiums.
>
> Endorsement entries generally follow the same recording path as the original entries. Those policies subject to audit may be adjusted on a monthly, quarterly, semi-annual, or annual basis with the premium resulting from a physical review of the exposure immediately recorded as written. Adjustments resulting from retrospective rating plans are immediately recorded as written premiums.
>
> Assumed and Ceded Reinsurance Premiums
>
> Assumed reinsurance premiums include all premiums (less return premiums) from contracts issued to reinsure another insurance company. Ceded reinsurance premiums include all premiums (less return premiums) transferred to another insurance company for reinsurance purchased.
>
> Net Written Premiums
>
> The net written premiums of an insurance company are equal to the direct premiums, plus the reinsurance assumed premiums, less the reinsurance ceded premiums. Net written premiums are shown in the Underwriting and Investment Exhibit of the annual statement.

> Earned Premiums
>
> The earned premiums of an insurance company represent the pro rata portion of the premiums in force applicable to the expired portion of the policy term, plus or minus the premiums earned on audits and other adjustments. To compute earned premiums, deduct from net premium writings the net change which has taken place during the period in total unearned premium reserve.
>
> The Underwriting and Investment Exhibit of the annual statement shows the components of earned premiums during the year for each line of business. The total earned premiums are reported in the Statement of Income of the annual statement.
>
> Earned But Unbilled Premiums
>
> Earned but unbilled premiums (EBUB) typically arise out of the issuance of workers' compensation policies. Since workers' compensation premiums are usually based on payroll statistics, premium billings to the employer are generally estimated and are subject to insurer audit, at which time the true final premium is calculated. If the actual payroll exceeds the payroll figure used in the calculation of premium billings, an additional premium may be owed the insurer. If the actual payroll is less than that used in the premium billing calculation, a return premium may be owed the employer.
>
> An insurer may recognize as an asset accrued EBUB. Actuarially or statistically supported aggregate calculations, using company historical unearned premium data, or per policy calculations are acceptable methods of establishing this asset. To the extent an insurer chooses to recognize the asset for EBUB, it must establish all of the requisite liabilities associated with the asset such as commissions and premium taxes.
>
> EBUB should be reported in the annual statement as written premium and premium receivable. It should not be netted against unearned premiums. Ten percent of EBUB in excess of collateral specifically held and identifiable on a per policy basis must be reported in the annual statement as a non-admitted asset.

18. Chapter 12, Unearned Premiums, in the P&C Accounting Practices and Procedures Manual contains the following guidance pertaining to unearned premiums:

> At the expiration of an insurance contract or policy, the entire premium has been earned. Any point prior to expiration, the company is required to establish a pro rata portion of the premium as a liability to cover the remaining policy term. The company's total unearned premium reserve represents the unearned premium liability for all policies in force.
>
> A number of methods are used for the computation of the unearned premium reserve. In one method, the unearned premiums are calculated by applying the appropriate factors or fractions to the original premiums in force, segregated by line of business, term, and date of expiration. The premium for the full original term is used for this purpose because the factors or fractions are calculated on the basis. When a policy is canceled, the full original premium should be deducted from the total premium in force; otherwise, premiums in force and unearned premiums would be overstated. During the life of a policy, changes are frequently made, resulting in additional or return premiums. For example, a one-year policy may have its premium increased or decreased by a change in coverage after it has been in force for six months, in which case the insured might pay additional premium or receive a return premium. Theoretically, the full annual premium for changes should be calculated so that premiums in force for the one-year term may be correspondingly increased or decreased. However, as a practical matter, some companies adjust the premiums in force by the amount of the actual additional premium or return premium, other than in the event of cancellation, on the assumption that the resulting errors in the premiums in force will largely offset one another.

> One of the more common assumptions used by companies to calculate an unearned premium reserve is the monthly pro rata method. This method assumes that, on the average, the same amount of business is written each day of any month so that the mean will be the middle of the month. For example, one-year premiums written during the first three months of the year have, at the end of the year, the following unearned fractions: January-1/24; February-3/24; March-5/24.
>
> A second method is to calculate the unearned premium on each policy. At the end of each period, the calculation is made on each item of premium to ascertain the unexpired portion and to arrive at the aggregate unearned premium reserve.
>
> If a company assumes reinsurance, it must provide the same unearned premium reserve that would have been provided by the ceding company if reinsurance had not been placed.
>
> There are a number of methods used to calculate unearned premium reserve. Certain states have a provision in their statutes which prescribes the method or methods which should be used.
>
> Audited Policies
>
> Audited premiums are earned as soon as they are recorded, whether they are interim audits or final audits. Many audited policies are written with a deposit premium and provide for monthly, quarterly, or semi-annual audits in addition to the final audit after expiration. Deposit premiums should be earned in such a manner that in conjunction with interim and final audits, earned premium will be correctly reflected during the policy term.

19. Pertinent excerpts of the December 3, 1990 meeting minutes of the Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force (Emerging Accounting Issues Working Group) are as follows:

> At its September 10, 1990 meeting (EI 90-3) the working group then adopted the following accounting manual language subject to the development of suitable disclosures and interrogatories:
>
> Written premiums may be recorded at the processing point where the premium amount and term are determinable, e.g., when the daily report is processed, when the premium is billed, or when the premium is collected.
>
> Contracts which have both a fixed policy period and a fixed premium are recorded at the inception date for the term of the policy. This approach should be used in cases where policies have a fixed premium but offer policyholders the option to pay monthly, quarterly, or on some other modal basis, and in cases where the premium has been financed with the insurer receiving the full premium.
>
> For contracts which have a premium based upon changes in the activities of the insured, written premiums may be recorded on an installment basis to match the billing to the policyholder. Under this type of arrangement, the premium is determined and billed according to the frequency stated in the contract and written premium is recorded on the basis of that frequency.

Generally Accepted Accounting Principles

20. FAS 60 contains the following guidance pertaining to revenue recognition for short-duration contracts:

> 3. Premiums from short-duration insurance contracts, such as most property and liability insurance contracts, are intended to cover expected claim[1] costs resulting from insured events that occur during a fixed period of short duration. The insurance enterprise ordinarily has the ability to cancel the contract or to revise the premium at the beginning of each contract period to cover future insured events. Therefore, premiums from short-duration contracts ordinarily are earned and recognized as revenue evenly as insurance protection is provided.

> [1] Terms defined in the glossary (Appendix A) are in boldface type the first time they appear in this statement.
>
> 9. Premiums from short-duration insurance contracts ordinarily shall be recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided. A liability for unpaid claims (including estimates of costs for claims relating to insured events that have occurred but have not been reported to the insurer) and a liability for claim adjustment expenses shall be accrued when insured events occur.
>
> Premium Revenue Recognition
>
> Short-Duration Contracts
>
> 13. Premiums from short-duration contracts ordinarily shall be recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided. For those few types of contracts for which the period of risk differs significantly from the contract period, premiums shall be recognized as revenue over the period of risk in proportion to the amount of insurance protection provided. That generally results in premiums being recognized as revenue evenly over the contract period (or the period of risk, if different), except for those few cases in which the amount of insurance protection declines according to a predetermined schedule.

21. Paragraph 33 of FAS 60 provides the following guidance on accounting for premium deficiencies on short-duration contracts:

> A premium deficiency shall be recognized if the sum of expected claim costs and claim adjustment expenses, expected dividends to policyholders, unamortized acquisition costs, and maintenance costs exceeds related unearned premiums.[6]
>
> [6] Disclosure is required regarding whether the insurance enterprise considers anticipated investment income in determining if a premium deficiency relating to short-duration contracts exists (paragraph 60.e.).

22. The *AICPA Audit and Accounting Guide: Audits of Property and Liability Insurance Companies* contains the following regarding revenue recognition under GAAP:

> Revenue Recognition
>
> 3.32. Premiums from a short-duration contract ordinarily should be recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided. This generally results in premiums being recognized as revenue evenly over the contract period. Under a few kinds of contracts, the period of risk differs significantly from the contract period. An example is insurance policies for recreational vehicles issued for an annual period, covering claims that are incurred primarily in the summer months. Under other kinds of contracts, the amount of coverage declines over the contract period on a scheduled basis. In those cases, the premium is recognized as revenue over the period of risk in proportion to the amount of insurance protection provided. Unearned premiums, that portion of the premium applicable to the unexpired period of the policy, are included as an unearned premium reserve within the company's balance sheet.
>
> 3.33. As discussed in FASB Statement No. 60, some premiums are subject to subsequent adjustment (for example, retrospectively rated or other experience-rated insurance contracts). In these cases, the premium is determined after the period of the contract and is based on claim experience, or reporting-form contracts, for which the premium is adjusted after the period of the contract based on the value of insured property. If, as is usually the case, the ultimate premium is reasonably estimable, the estimated ultimate premium should be recognized as revenue over the

period of the contract. It should be revised to reflect current experience. However, if the ultimate premium cannot be reasonably estimated, the cost-recovery method or the deposit method may be used until the ultimate premium becomes reasonably estimable. Under the cost-recovery method, premiums are recognized as revenue in amounts equal to estimated claims as insured events occur until the ultimate premium is reasonably estimable, and recognition of income is postponed until then. Under the deposit method, premiums are not recognized as revenue and claims are not charged to expense until the ultimate premium is reasonably estimable, and income recognition is postponed until that time.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapters 12 and 14
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 6—Amounts Due From Agents and Brokers*
- *Issue Paper No. 10—Uncollected Premium Balances*
- *Issue Paper No. 50—Classifications and Definitions of Insurance Contracts In Force*
- Minutes of the December 3, 1990 meeting of the Emerging Accounting Issues Working Group

Generally Accepted Accounting Principles

- *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises*
- *AICPA Audit and Accounting Guide: Audits of Property and Liability Insurance Companies, Section 3.32, Revenue Recognition*

State Regulations

- No further guidance obtained from state statutes or regulations.

Statutory Issue Paper No. 54

Individual and Group Accident and Health Contracts

STATUS
Finalized June 23, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 54

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory accounting guidance on income recognition and policy reserves for individual and group accident and health contracts, as defined in *Issue Paper No. 50—Classifications and Definitions of Insurance or Managed Care Contracts In Force* (Issue Paper No. 50), is addressed in Chapter 13, Aggregate Reserves for Accident and Health Policies and Chapter 18, Premium Income, in the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies (Life/A&H Accounting Practices and Procedures Manual). That guidance addresses income recognition and policy reserves related to individual and group accident and health contracts. Under current statutory accounting, premiums are recorded on a gross basis when due from policyholders and policy and claim reserves are computed based upon specific contract provisions and the methods described in the NAIC Model Law, Minimum Reserve Standards for Individual and Group Health Insurance Contracts (Individual and Group Health Model Law), the Long-Term Care Insurance Model Regulation, and the Actuarial Standards of Practice promulgated by the American Academy of Actuaries. Further, policy and claim reserves must, in the aggregate, place a sound value on both present and future liabilities.

2. GAAP requires insurance contracts to be classified as short-duration or long-duration contracts. Long-duration contracts are those contracts expected to remain in force for an extended period and include certain noncancelable and guaranteed renewable accident and health contracts. All other insurance contracts are considered short-duration contracts and include most property and liability insurance contracts. Premiums from short-duration contracts ordinarily are recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided. Claim costs, including estimates of costs for claims relating to insured events that have occurred but have not been reported to the reporting entity, are recognized when insured events occur. GAAP guidance requires policy reserves for individual and group accident and health classified as long-duration to be established using actuarial assumptions applicable at the time the insurance contracts are made, or for short-duration contracts, using an unearned premium reserve.

3. The purpose of this issue paper is to establish statutory accounting principles for policy and claim reserves for all individual and group accident and health contracts consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts). Credit accident and health insurance contracts are discussed in *Issue Paper No. 59—Credit Life and Accident and Health Insurance Contracts*.

SUMMARY CONCLUSION

Income Recognition

4. Premiums shall be recognized as income on the gross basis (amount charged to the policyholder or subscriber exclusive of copayments or other charges related to the receipt of healthcare services) when due from policyholders or subscribers, but no earlier than the effective date of coverage under the terms of the contract. Due and uncollected premiums shall follow the guidance in *Issue Paper No. 10—*

Uncollected Premium Balances (Issue Paper No. 10), to determine the admissibility of premiums and related receivables. Premiums waived by the reporting entity under disability provisions contained in its policies and contracts, and reported in operations as a disability benefit, are included in premium income.

5. Premium income shall exclude premiums that have been received by the reporting entity on or prior to the valuation date but which are due after the valuation date (i.e., advance premiums as discussed below).

6. Premium income shall be reduced for premiums returned and allowances to industrial policyholders for the direct payment of premiums.

7. Premium income shall be increased by reinsurance premiums assumed and reduced by reinsurance premiums ceded. Reinsurance premiums assumed and ceded shall be defined and addressed in *Issue Paper No. 74—Life, Deposit-Type and Accident and Health Reinsurance*.

8. Advance premiums are those premiums that have been received by the reporting entity prior to or on the valuation date but which are due after the valuation date. The total amount of such advance premiums is reported as a liability in the statutory financial statement and is not considered premium income until due. The gross premium, not the net valuation premium, is recorded as the advance premium in recognition of the company's liability to refund such premiums in the event the policy is terminated.

9. As discussed in *Issue Paper No. 47—Uninsured Plans*, amounts received on behalf of uninsured plans or the uninsured portion of partially insured plans shall not be reported as premium income. Administrative fees for servicing the uninsured plans shall be deducted from general insurance expenses. Conversely, income relating to the insured portion of any plan shall be reported as premium income.

Reserve Requirements

10. The aggregate reserve for individual and group accident and health contracts generally consists of a policy reserve and a claim reserve as well as certain other miscellaneous reserves discussed in paragraphs 26 and 27. The aggregate reserve reflects the future liabilities arising under accident and health insurance policies. Policy reserves have traditionally been referred to as active life reserves and include unearned premium reserves. Policy reserves reflect that premiums cover future liabilities in addition to current claim costs and expenses. Claim reserves, sometimes referred to as disabled life reserves, are required on claims which involve continuing loss. The reserve in this case is a measure of the present value of future benefits or amounts not yet due as of the statement date (the unaccrued portion) which are expected to arise under claims which have been incurred as of the statement date. The aggregate reserve for individual and group accident and health contracts does not include claim liabilities which are the amounts payable at the reporting date (the accrued portion) and reflect the reporting entity's liability for benefits due as of the statement date. Claim liabilities are further discussed in *Issue Paper No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses.*

11. Policy reserves for individual and group accident and health contracts shall include an unearned premium reserve and, as applicable, an additional or contract reserve where constant or level premiums are assumed for certain noncancelable or guaranteed renewable contracts. The claim reserve shall consist of a reserve for the present value of amounts not yet due.

12. Statutory policy reserves shall be established for all unmatured contractual obligations of the reporting entity arising out of the provisions of the contract. Where separate benefits are included in a contract, a reserve for each benefit shall be established as required in Appendix A-820. A prospective gross premium valuation is the ultimate test of reserve adequacy as of a given valuation date. Statutory reserves meet the definition of liabilities as defined in *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets* (Issue Paper No. 5). The actuarial methodologies referred to in the following paragraph meet the criteria required for reasonable estimates in Issue Paper No. 5.

13. The reserving methodologies and assumptions used in calculating individual and group accident and health reserves shall meet the provisions of Appendices A-010, A-641, A-820 and A-822 and the actuarial guidelines found in Part 9 of the NAIC Financial Examiners Handbook. Further, policy reserves shall be in compliance with those Actuarial Standards of Practice promulgated by the Actuarial Standards Board.

Policy Reserves

14. Unearned premium reserves shall be required for all accident and health contracts for which premiums have been reported for a period beyond the date of valuation other than premiums paid in advance. The minimum unearned premium reserve that applies to the premium period beyond the valuation date shall be based on the valuation net modal premium if contract reserves are required and the gross modal unearned premium reserve if contract reserves are not required. If premiums due and unpaid are carried as an asset, such premiums must be treated as premiums in force, subject to unearned premium reserve determination. The value of unpaid commissions, premium taxes, and the cost of collection associated with due and unpaid premiums must be carried as an offsetting liability. In no event, however, shall the aggregate policy reserve for all contracts be less than the unearned gross premium under such contracts. Additionally, the reserve shall never be less than the expected claims for the period beyond the valuation date represented by the unearned premium reserve, to the extent not provided for elsewhere.

15. Contract or additional reserves on accident and health contracts shall be recorded when premiums and benefits are not earned or incurred at the same incidence over the policy period (e.g., contracts having premiums determined on an issue-age basis where premiums and related morbidity, risk of loss, and the cost of coverage are not evenly matched). This evaluation may be applied on a rating block basis if the total premiums for the block were developed to support the total risk assumed and expected expenses for the block each year, and a qualified actuary certifies the premium development (e.g., community-rated contracts).The additional reserves shall be set aside from the early years' level premiums to pay the claims that experience indicates will be incurred as the policy continues in force. The fact that the reporting entity may have the right to increase premiums or to decline renewal of the policies for certain reasons has no bearing on whether or not a contract or additional reserve should be held. These reserves shall apply to regardless of whether or not benefits are currently being received, and are in addition to unearned premium reserves discussed in paragraph 14.

16. Contract or additional reserves shall also be recorded where, due to the gross premium structure, the future benefits exceed the future net premiums (e.g., group conversion policies) or where the contract provides for the extension of benefits after the termination of the coverage (e.g., deferred maternity and other similar benefits).

17. A terminal reserve for accident and health contracts is the policy reserve at the end of a policy year to cover the assumed difference between future benefits and future net premiums. The components used to compute a terminal reserve shall consist of an interest rate, a mortality and/or morbidity table, and a valuation method (e.g., net level, one-year full preliminary term, and two-year full preliminary term) and where allowed, other assumptions. A terminal reserve is based on the assumption that all net premiums have been received, all interest earned, and all benefits paid to the end of the policy year.

18. Since terminal reserves are computed as of the end of a policy year and not the reporting date, the terminal reserve as of policy anniversaries immediately prior to and subsequent to the reporting date are adjusted to reflect that portion of the net premium that is unearned at the reporting date. This is generally accomplished using either the mean reserve method or the mid-terminal method as described in paragraph 22 of *Issue Paper No. 51—Life Contracts* (Issue Paper No. 51). Other appropriate methods, including an exact reserve valuation, may also be used.

19. For individual accident and health contracts, negative reserves on any benefit shall be offset against positive reserves for other benefits in the same policy but the mean reserve on any policy shall

never be taken as less than one-half the valuation net premium. The majority of group accident and health policies are written in conjunction with group life or other policies. If these policies are an experience rated package, positive or favorable margins on one of the contracts can offset the need to establish additional reserves on the other contracts.

Additional Reserves

20. When the expected claims payments or incurred costs, claim adjustment expenses and administration costs exceed the premiums to be collected for the remainder of a contract period, a premium deficiency reserve shall be recognized by recording an additional liability for the deficiency, with a corresponding charge to operations. For purposes of determining if a premium deficiency exists, contracts shall be grouped in a manner consistent with how policies are marketed, serviced and measured. A liability shall be recognized for each grouping where a premium deficiency is indicated. Deficiencies shall not be offset by anticipated profits in other policy groupings. Such accruals shall be made for any loss contracts, even if the contract period has not yet started.

Claim Reserves

21. Claim reserves shall be accrued for estimated cost of future health care services to be rendered that the reporting entity is currently obligated to provide as a result of premiums earned to date and that would be payable after the reporting date under the terms of arrangements, regulatory requirements or other requirements if the insured’s or subscriber’s illness or disability were to continue. It shall include a reserve for disability benefits covered under premium waiver provisions. For individual and group disability claims with a duration of less than two years, reserves may be based on the reporting entity’s experience, if credible, or other methods, as appropriate. Generally, reserves for disability income claims with durations of greater than two years shall be determined based on a tabular method using the age of the insured at the date of disablement, the number of months the insured already has been disabled, and the number of months remaining in the benefit period.

Reserve Recognition

22. The difference between the aggregate reserve for accident and health contracts at the beginning and end of the reporting period shall be reflected in the summary of operations, except for any difference due to a change in valuation basis.

Change In Valuation Basis

23. A change in valuation basis shall be defined as a change in the interest rate, mortality or morbidity assumption, or reserving method (e.g., net level, preliminary term, etc.) or other factors affecting the reserve computation of policies in force and meets the definition of an accounting change as defined in *Issue Paper No. 3—Accounting Changes* (Issue Paper No. 3). Consistent with Issue Paper No. 3, any increase (strengthening) or decrease (destrengthening) in actuarial reserves resulting from such a change in valuation basis shall be recorded directly to surplus rather than as a part of the reserve change recognized in the summary of operations. The impact on surplus is based on the difference between the reserve under the old and new methods as of the beginning of the year. This difference shall not be graded in over time unless an actuarial guideline adopted by the NAIC prescribes a new method and a specific transition that allows for grading.

Supplemental Benefits

24. In addition to the basic policy benefit, the contract may provide supplemental benefits. Supplemental benefits include, but are not limited to, accidental death benefits, dental and waiver of premium benefits. If the terms of the contract provide for these benefits, appropriate reserves shall be established in accordance with the applicable standards within this Codification.

Reserve Adequacy

25. As discussed in Appendix A-010, a prospective gross premium valuation is the ultimate test of the adequacy of a reporting entity’s accident and health reserves as of a given valuation date and shall be

determined on the basis of unearned premium reserves, contract or additional reserves, claim reserves (including claim liabilities), and miscellaneous reserves combined; however, each component shall be computed separately.

Additional Reserves Not Included Elsewhere

26. Reserve for experience-rating refunds or the dividend liability in group policies are discussed in *Issue Paper No. 66—Accounting for Retrospectively Rated Contracts*.

27. Additional actuarial or other liabilities are commonly held for such items as:

a. Surrender values in excess of reserves otherwise required or carried;

b. Additional reserves required based on cash flow testing and/or asset/liability matching requirements; and

c. Additional reserves for policies which contain conversion privileges or future contingent benefits.

Contracts Subject to Redetermination

28. This statement also applies to other contracts which are subject to redetermination such as Federal (and State) Groups – subject to rate adjustments through audits by the Office of Personnel Management ("OPM"). Reporting entities are required to give Federal Groups the lowest rates that are being charged to similar groups.

29. Amounts due from insureds or subscribers and amounts due to insureds or subscribers under contracts subject to redetermination meet the definitions of assets and liabilities as set forth in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets* and Issue Paper No. 5, respectively.

30. Contract redeterminations shall be estimated based on the experience to date. The method used to estimate the liability shall be reasonable based on the reporting entity's procedures, and consistent among reporting periods. An examination of contract requirements in relation to the rates being charged and the current status of applicable audits (e.g., OPM, Health Care Finance Administration and other Federal, state or government department) is a common method used to estimate such contract redeterminations.

31. Premium adjustments for contracts subject to redetermination are estimated for the portion of the policy period that has expired and shall be considered an immediate adjustment to premium. Accrued premium adjustments shall be recorded as a write-in for other-than-invested assets, with a corresponding entry to premiums; accrued return premium adjustments shall be recorded as a liability with a corresponding entry to premiums.

32. If, in accordance with Issue Paper No. 5, it is probable that the additional premium adjustment is uncollectible, any uncollectible premium shall be written off against operations in the period the determination is made and the disclosure requirements outlined in Issue Paper No. 5 shall be made.

33. Premium adjustments for contracts subject to redetermination shall be determined and billed or refunded in accordance with the policy provisions or contract provisions. If such premiums are not billed in accordance with the policy provisions or contract provisions, or the policy provisions or contract provisions do not address the due date of such premiums, the accrual shall be nonadmitted. This is consistent with the guidance for audit premiums established in Issue Paper No. 10.

Disclosures

34. Disclose the aggregate amount of direct premiums written through managing general agents or third party administrators. For purposes of this disclosure, a managing general agent means the same as in

Appendix A-225. If this amount is equal to or greater than 5% of surplus, provide the following information for each managing general agent and third party administrator:

a. Name and address of managing general agent or third party administrator;

b. Federal Employer Identification Number;

c. Whether such person holds an exclusive contract;

d. Types of business written;

e. Type of authority granted (i.e., underwriting, claims payment, etc.);

f. Total premium written.

35. If a premium deficiency reserve is established in accordance with paragraph 20, disclose the amount of that reserve.

DISCUSSION

36. This issue paper adopts the current statutory accounting guidance for premiums, policy reserves, and claim reserves associated with accident and health contracts. However, paragraph 20 of this issue paper expands the current requirements for reserving for contracts where due to the gross premium structure, future benefits exceed future premiums.

37. The statutory accounting principles outlined in the conclusion above are consistent with the conservatism, consistency and recognition concepts in the Statement of Concepts which state:

> Conservatism
>
> Financial reporting by insurance enterprises requires the use of substantial judgments and estimates by management. Such estimates may vary from the actual amounts for numerous reasons. To the extent that factors or events result in adverse variation from management's accounting estimates, the ability to meet policyholder obligations may be lessened. In order to provide a margin of protection for policyholders, the concept of conservatism should be followed when developing estimates as well as establishing accounting principles for statutory reporting.
>
> Conservative valuation procedures provide protection to policyholders against adverse fluctuations in financial condition or operating results. Statutory accounting should be reasonably conservative over the span of economic cycles and in recognition of the primary responsibility to regulate for financial solvency. Valuation procedures should, to the extent possible, prevent sharp fluctuations in surplus.
>
> Consistency
>
> The regulators' need for meaningful, comparable financial information to determine an insurer's financial condition requires consistency in the development and application of statutory accounting principles. Because the marketplace, the economic and business environment, and insurance industry products and practices are constantly changing, regulatory concerns are also changing. An effective statutory accounting model must be responsive to these changes and address emerging accounting issues. Precedent or historically accepted practice alone should not be sufficient justifications for continuing to follow a particular accounting principle or practice which may not coincide with the objectives of regulators.

Recognition

Liabilities require recognition as they are incurred. Certain statutorily mandated liabilities may also be required to arrive at conservative estimates of liabilities and probable loss contingencies (e.g., excess of statutory reserves over statement reserves, interest maintenance reserves, asset valuation reserves, and others).

Claim Reserves - Indemnity and Managed Care Contracts

38. As discussed in paragraph 21, claim reserves shall be accrued for estimated amounts that would be payable after the reporting date if the insured's illness or disability were to continue. For health maintenance organizations claims reserves shall be provided if the benefits for the event extend beyond the contract period. For claims with a duration of less than two years, there are a variety of acceptable methods for calculation. Some of them are: (a) use of the disabled life table—either a published table or one based on the insurer's experience; (b) use of an estimate made by the insurer's claim department for each policy (the individual judgment approach); or (c) other appropriate estimation techniques.

39. The method used to compute the claim reserve must be appropriate in the circumstances. Historical development might provide information as to the appropriateness of the method used by developing statistics to show that its method would (or actually did) produce adequate reserves for prior valuation periods. If the loss-of-time policy provides a waiver of premium benefit, the reserve for policies that are having their premiums waived should be included with the disabled life reserves.

Level Premiums - Indemnity Contracts

40. As discussed in paragraph 15 of this issue paper, contract or additional reserves on accident and health contracts shall be recorded when premiums and benefits are not earned or incurred at the same incidence over the policy period. The Life/A&H Accounting Practices and Procedures Manual requires contract reserves on individual accident and health policies but does not specifically extend this requirement to group policies. This issue paper clarifies current SAP to require contract reserves on group accident and health policies, including those group accident and health contracts that are individually underwritten.

Future Contingent Benefits - Indemnity Contracts

41. A reporting entity shall establish a reserve for future contingent benefits which extend beyond the termination of the policy, subject to specific contract provisions. Such provisions which accrue and are payable at some future date, are predicated on a condition or actual disability which existed at the termination of the contract and which is usually not known to the reporting entity at the time of the termination (e.g., deferred maternity benefits). In situations where the actual disability is not known to the reporting entity at the time of the termination, the reserve shall be computed based on relevant pricing, periodic, or industry studies of similar benefits on terminated policies. Reporting entities shall separately compute a reserve for deferred maternity benefits and any other extended benefits under group contracts.

Extension of Benefits - Indemnity Contracts

42. An additional reserve shall be required for group accident and health contracts which contain a conversion privilege. The minimum additional reserve shall equal the excess morbidity costs assumed in the premium payable on the terminated coverages. If future guaranteed rates are inadequate to meet future obligations, then additional reserves shall be established. A reserve shall be established to cover the expected benefit payments for any policy having a conversion privilege or other similar extension of benefits when the policy is terminated with no additional premiums due but the benefits extend beyond the termination date. However, for cases where the experience of the case or the experience of a block of cases is reflected back to the policyholder, the dividend liability or provision for experience rating refunds is a direct offset to the need to establish an additional reserve.

GAAP Literature

43. Consistent with Issue Papers Nos. 50 and 51, *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises* (FAS 60), relating to individual and group accident and health contracts is rejected for the reasons set forth in those issue papers. However, some of the elements regarding income recognition have been used in this issue paper.

Drafting Notes/Comments

- Issue Paper No. 50 addresses Classifications and Definitions of Insurance or Managed Care Contracts In Force.
- Issue Paper No. 51 addresses Life Contracts.
- Issue Paper No. 52 addresses Deposit-Type Contracts.
- Issue Paper No. 55 addresses Unpaid Claims, Losses and Loss Adjustment Expenses.
- Issue Paper No. 59 addresses Credit Life and Accident and Health Insurance Contracts.
- Issue Paper No. 66 addresses Accounting for Retrospectively Rated Contracts.
- Issue Paper No. 74 addresses Life, Deposit-Type and Accident and Health Reinsurance.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE (only pertinent excerpts are included below)

Statutory Accounting

44. Chapter 13, Aggregate Reserves For Accident and Health Policies, of the Life/A&H Accounting Practices and Procedures Manual provides the following guidance on individual and group accident and health reserves:

> Accident and health insurance provides protection against economic losses resulting from accident and/or sickness. This insurance may be provided under individual policies, under group or franchise policies, or it may be provided under certain special types of policies which bear unique titles such as credit insurance. The economic losses which accident and health insurance policies cover, or the types of benefits provided, will vary with different policies. For example, reimbursement for hospital, surgical, or medical expenses may be provided under a hospital expense policy, while under other policies, a more comprehensive form of coverage, known as major medical insurance, may be offered. Similarly, policies may provide monthly benefits for loss of income from disability, either on a short term or a long term basis, or only for disabilities due to accident. Loss of life from accident may be covered under accidental death policies, while under certain limited accident policies, only accidental death from air travel may be covered. Therefore, accident and health policies may be categorized by the form of policy through which the coverage is provided; it may be categorized according to the benefits provided by the policy; or it may be categorized by the contingencies insured against. These variations in types of policies and the benefits provided must be considered in discussing the reserves for accident and health insurance policies.
>
> Accident and health policies are offered by life companies, casualty companies, fraternal benefits societies, and certain specialty companies. While the coverage originated with casualty companies, it is now the life insurance companies which provide the majority of accident and health insurance. The history of the business is important because many of the concepts currently used originated from casualty insurance practices and use casualty terminology. Since the life insurance companies began writing this insurance, the form of the policies and the concept of coverages have changed, which also produced changes in reserving practices.
>
> At one time, all reporting of accident and health insurance was on the miscellaneous blank, which was originally designed for the casualty companies. The policies then offered were referred to as commercial policies under which the insurer had the right to cancel or fail to renew coverage. Some noncancellable accident and health insurance was written with specific reserve requirements for those policies. The premium rates for commercial policies were often on a uniform rate basis, with the same premium applying to a broad range of ages. Under the casualty concept, the reserves for these commercial policies consisted primarily of an unearned premium

reserve and claim reserve. The unearned premium reserve was intended to recognize that portion of a premium which covered a policy period extending beyond the valuation date. Claim reserves were required to recognize the liability of the company for claims which had not been paid or were being processed. The titles assigned to the various claim reserves were intended to reflect their payment status; however, over the years, procedures have changed and certain of the reserves are calculated differently but still bear the same titles. Reserves in the statutory financial statement required for accident and health insurance are measures of the value of liability for future obligations of an insurer. Two basic types of reserves are required to value the future liabilities arising under accident and health insurance policies. “Policy reserves” have traditionally been referred to as active life reserves and unearned premium reserves and are a recognition that premiums cover future liabilities in addition to current claim costs and expenses. “Claim reserves,” sometimes referred to as disabled life reserves, are required on claims which involve continuing loss. The reserve in this case is a measure of the present value of future benefits or amounts not yet due as of the statement date which are expected to arise under claims which have been incurred as of the statement date. “Claim liabilities,” to be discussed in a later chapter, are a measure of an insurer’s liability for benefits due as of the statement date.

In many respects, the reporting of accident and health insurance is similar to that used for life insurance but the reserving of accident and health insurance differs significantly from that used for life insurance. The separation of the claim reserve is an example of unique accident and health reserving and will be discussed later. This chapter will analyze accident and health reserves from a general standpoint and reference will be made to the numerous regulations on accident and health reserves which have been recommended by the NAIC and which have been promulgated at various times by the different states. It is not intended that those reserve recommendations be restated in this chapter but comments will be made to enhance their understanding.

Individual Accident and Health Policies

Individual accident and health policies, other than credit insurance, are separated for reserve reporting purposes in the statutory financial statement into six classifications. The definitions are included in the instructions for the statutory financial statement and are based principally on the renewal agreement of the policy. There is some variation in the reserve requirements which apply to the different renewal classifications of policies but most reserve requirements apply to all individual policies.

Legal Requirements for Reserves

For life insurance, the standard valuation law defines the minimum standard which a company’s aggregate reserves must meet. However, for accident and health insurance, the statutes of most states provide that the insurer shall maintain an active life reserve which shall place a sound value on its liabilities under its accident and health policies and be not less than the reserve according to the appropriate standards set forth in regulations issued by the insurance department. In other states which have not adopted specific reserve requirements for accident and health insurance, the requirement for reserves may be based on more general statutory requirements or on the instructions to the statutory financial statement. Those instructions provide that a reserve must be carried for any policy which provides guarantee of renewability, and the standards adopted by the NAIC in December 1964, are indicated to be an acceptable basis for such additional reserves. The report of the Industry Advisory Committee on Reserves for Individual Accident and Health Policies, approved by the NAIC in December 1964 has served as the basis for the reserve regulations promulgated by many insurance departments. Revisions in the regulations may change the reserve requirements, as well as provide for new morbidity tables, without a change in the reserve law of a state as is true for life insurance.

Unearned Premium Reserves

These reserves are established for all accident and health policies and are equivalent to the amount of the gross premium for that portion of the premium period which extends beyond the valuation date. The unearned portion may be computed on a pro rata basis using the actual due dates, or it may be computed on the "monthly pro rata method," which assumes that all premiums are collected evenly throughout the month. Special consideration should be given to the method used if there is a high concentration of premiums due on a given date because of company practices in the dating of policies. Care must be taken to insure consistency between unearned premium reserves and premiums reported as due and unpaid. For example, if a company is taking a due and unpaid premium for a policy as an asset, the appropriate portion of that premium should be included in the unearned premiums just as if the premium had actually been paid.

Active Life or Additional Reserves

These reserves arise as a consequence of the rating concept for the policy where a constant or "level premium" is assumed over a specified period of years during which the cost of insurance increases with the increasing age of the insured lives. This is similar in concept to the reserves provided for term life insurance policies, but again, there are distinct differences. The active life reserve is required of all in-force policies, which would include policies on those lives which are currently disabled and receiving benefits, and is in addition to any reserves required on those lives in connection with the claim. Active life reserves are necessary because the level premiums, as with life insurance, will likely prove to be inadequate to meet future claim costs as the policies mature. The additional reserves are, therefore, set aside from the early years' level premiums to pay the claims that experience indicates will be incurred as the policy continues in force. The fact that the insurer may have the right to increase premiums or to decline renewal of the policies for certain reasons has no bearing on the calculation of the active life reserves. These additional reserves are not required of policies with certain renewal agreements.

Specific morbidity tables, valuation methods and interest rates have been included in the NAIC recommendations as minimum standards. The policy reserves established and maintained by a company should place a sound value on both present and future liabilities under those policies and should not be less than the minimum values determined by the methods and bases described therein.

The morbidity tables specified in the NAIC recommendations should be viewed as minimum standards. While these morbidity tables have been developed from industry experience data, it has not been possible to recognize all the variations in policy benefits or underwriting philosophies of all companies. Appropriate modifications should be made to reflect the actual benefits provided in the policy. Similarly, recommended morbidity tables do not exist for certain benefits so there is a need to develop reserves based on the insurer's recent morbidity experience, or on recognized published morbidity experience, such that a sound value is placed on the liabilities under that benefit.

The NAIC recommendations permit alternative valuation procedures and assumptions. Often the great variety of benefits and options in accident and health policies make it impractical to precisely value each variation. Approximations such as those involving age groupings, groupings of several years of issue, or average amounts of indemnities are among those mentioned. Others include the computations of the reserve for a policy benefit as a percentage of some other policy benefit or the use of composite annual claim costs for all or any combination of the benefits included in the policies.

The insurer may employ the use of either the level premium, the one-year preliminary term, or the two-year preliminary term valuation methods. The reserves may be shown as mean reserves diminished by appropriate credit for valuation net deferred premiums or as mid-terminal reserves plus the gross or net unearned premium reserves. In no event, however, may the aggregate reserve for all policies be less than the unearned gross premium under such policies. For statement purposes, the net reserve liability may be shown as the excess of the mean reserve over the amount of net unpaid and deferred premiums or, regardless of the underlying method of calculation, it may be divided between the unearned gross premium reserve and a balancing item for the "additional reserve" which is generally based on the mid-terminal reserves. The insurer is required to attach to the statutory financial statement a description of the valuation standards used in calculating the reserves, and to specify the reserve basis, interest rates, and methods.

Because of the aggregate and average nature of policy reserves, deficiency reserves are normally not required for accident and health insurance. Negative reserves on any benefit may be offset against positive reserves for other benefits in the same policy but the mean reserve on any policy should never be taken as less than one-half the valuation net premium.

Reserves for cash value, return of premium, or other nonforfeiture benefits should be calculated using interest, mortality, and morbidity, provided the value of benefits payable upon death is included in the calculation; otherwise, reserves should be calculated on a sinking fund basis using interest and morbidity only. The aggregate policy reserves established for these, over and above any policy reserve required for other policy benefits, should not be less than the aggregate of any withdrawal benefits then payable. Where cash value or return of premium benefits are payable periodically, reserves should be calculated on a recurring term period basis, consistent with the payment cycle.

Group Policies

All organizations that qualify to purchase group life insurance may also, by most state laws, purchase accident and health insurance. In many states, the definition of what constitutes an eligible group for accident and health insurance is entirely left up to any set of good underwriting practices established by the insurance company.

Some insurers may act as administrators of accident and health plans under which the plans bear the risk of claims. Such plans are commonly terms “administrative services only” plans and are described in this manual as “uninsured plans.” For additional discussion see Chapter 8—Other Admitted Assets.

The insurer’s aggregate reserves should not include any amounts arising from uninsured accident and health plans or the uninsured portion of partially insured plans. The insured portion of any partially insured plan should be treated as any other insured plan with appropriate reserves established.

Legal Requirements for Reserves

The minimum reserve for active lives is the gross unearned premium. Unlike life insurance, where due and outstanding premium is a net valuation premium and reserves are also net valuation premium reserves, group accident and health due and outstanding premium and unearned premium reserves are reported on a gross basis. There is, therefore, no need to calculate loading or establish the excess of the cost of collection over loading for group accident and health policies. The liabilities established on due and outstanding premiums are discussed elsewhere in this manual.

Unearned Premium Reserves

The methods of computing group unearned premium reserves may vary between companies and even within a company, depending upon the premium due dates of the policies involved. The monthly pro rata gross unearned premium is a common method used. The assumption of uniform issuance is applied in the monthly pro rata method. At the end of the month in which the premium is due, one-half of the premium is considered to be earned and one-half is considered to be unearned.

Unearned premium reserves also may be based on the actual due date of the premium; this has been referred to as the “daily pro rata” method. It is the most precise basis. Sometimes a combination of the two methods is used. An unearned premium reserve of zero is established for all policies with monthly premium due dates of the first day of the month. For all other monthly policies, a uniform distribution is assumed. Most group accident and health policies are billed on a monthly basis but, in a few cases, quarterly, semiannual, and even triannual modes are encountered. Premium modes other than monthly can be handled in similar fashion.

Additional Reserves

Some states may require an additional reserve for policies which contain a conversion privilege. The minimum reserve should be the excess of the morbidity costs assumed in the premium to be payable on the terminated coverages. If the rates guaranteed into the future are inadequate to meet future obligations, then additional reserves should be established. However, for cases where the experience of the case or the experience of a block of cases is reflected back to the policyholder, the dividend liability or provision for experience rating refunds is a direct offset to the need to establish an additional reserve. Also, it should be noted that the vast majority of group accident and health policies are written in conjunction with a group life policy. In the case of an experience rated package of group life and group accident and health, policyholder margins available from the group life contract may also reduce the need to establish an additional reserve. A detailed discussion of the group dividend liability and experience rating refunds may be found below.

Reserve For Future Contingent Benefits

In addition to the unearned premium reserves for all group accident and health policies, a company may be required to establish a reserve for future contingent benefits. The most common of these is for deferred maternity benefits.

Employer groups frequently have female employees leaving for maternity reasons. These employees usually leave at some time before giving birth and are not members of the group at the time their hospitalization claim is presented. For this reason, most group policies are written to insure conception rather than birth. The requirement, therefore, is that the female employee be a member of the group at the time of conception for her to receive benefits upon giving birth.

One other contingent benefit that may be set up is a special reserve for major medical policies that have a high front-end deductible, such as $5,000 to $10,000. A claim reserve may not have been established since the insureds have not used up the deductible but future contingent benefits may be in the process of building as the deductibles are satisfied.

According to the NAIC instructions, any policy having similar extension of benefits must have such a reserve. It is intended that this reserve should be set up on the assumption that all insurance under policies containing an extension of benefits will terminate on the statement date.

Other Reserve Considerations
Claim Reserves

The treatment of active life reserves for accident and health policies has been discussed in three categories — individual, group, and credit. The requirements for each category were sufficiently unique to warrant separate consideration. The standards and practices employed in the computation of claim reserves, however, are for the most part the same for individual, group, and credit and will apply jointly unless specific reference is made to one line of business.

Claim reserves are reported as accident and health reserves. Estimated amounts that would be payable after the statement date if the insured’s liability were to continue represent the unaccrued benefits which make up the claim reserve. The accrued benefit, i.e., the amount payable on the balance sheet date, is reported as the claim liability in the balance sheet. Separating accrued and unaccrued portions of claims provision often is difficult because many methods of computing claim reserves generate one total amount based upon the company’s past experience.

Disabled Life Reserves For Loss-Of-Time Policies

The calculation of disabled life reserves for claims with a duration of more than two years is straightforward. The disabled life factors are based upon the age of the insured at the date of disablement, the number of months the insured already has been disabled, and the number of months remaining in the benefit period.

For claims with a duration of less than two years, there is a variety of acceptable methods for calculation. Some of them are: (a) use of the disabled life table—either a published table or one based on the insurer's experience; (b) use of an estimate made by the insurer's claim department for each policy (the individual judgment approach); (c) use of a "rule of thumb," such as setting the reserve equal to the prospective claim payments for 3 1/2 times the elapsed period of disability; or (d) a combination of the first three methods.

For any method it uses, the insurer should have statistics to show that its method would (or actually did) produce adequate reserves for prior valuation periods. If the loss-of-time policy provides a waiver of premium benefit, the reserve for policies that are having their premiums waived should be included with the disabled life reserves. A portion of the liability for incurred but not unreported loss-of-time claims may be unaccrued.

A shortage in the statutorily-determined reserves for loss-of-time claims may develop, since the experience of these claims is consolidated for those of more than and less than a duration of two years. Because of the legal requirement, claims of more than two years' duration must have tabular reserves in accordance with statutory requirements. The minimum reserves for these claims are set, therefore, and at least that amount should be reported. Consolidated experience may indicate, because of earlier terminations of payments and lump sum settlements, that these reserves are redundant. In any case, the reserve for the initial two years of incurrence must be sufficient in its own right and must not be reduced to offset a redundancy in the reserve for claims beyond two years' duration.

Claim Reserves For Other Than Loss-Of-Time Policies

The incurred claim reserve for various hospital and medical expense coverages may have an unaccrued portion. For example, if an insured has been hospitalized for 20 days as of a given valuation date, and it was estimated that he would be hospitalized for another 10 days for the same sickness, then the reserve for the 10 days of benefits should be established as a claim reserve. In practice, a total reserve for a given claim generally will be established and then divided by some predetermined means between claim reserves and claim liability. Due to the great latitude given the insurer in determining reserves for other than loss-of-time policies, the insurer is required to provide statistics that support the adequacy of the reserves for each major line of business.

The emergence of discount and the existence of certain minimum-premium policies and excess risk reinsurance may distort the above-mentioned tests. The adequacy of reserves is also affected by other factors, such as the existence of contractual premium clauses under which the insurer can require an additional premium to be paid under certain stipulated conditions.

45. The Life/A&H Accounting Practices and Procedures Manual provides the following guidance on individual and group accident and health premiums:

CHAPTER 18 PREMIUM INCOME

Accident and Health Policies

Accident and health insurance policies typically provide a grace period after the due date for the premium to be received before the policy is terminated. If the company is relatively assured of collecting the late premium, and has established an appropriate unearned premium reserve, it is permitted to record such due and uncollected premium as an admitted asset.

On accident and health policies, other than group, with premiums payable more frequently than quarterly, all due and unpaid premiums are not admitted if more than one period premium is overdue. Group premiums more than 90 days overdue also are disallowed as an admitted asset.

If gross accident and health uncollected premiums are recorded as income and as an asset, commissions on uncollected premiums are included in the liability for unpaid commissions.

The method used for determining the amount of uncollected premiums should be the same for group as for individual policies. This usually is done by preparing an inventory of premiums billed, due prior to the statement date but uncollected. If the company pays a different rate of commission on first-year premiums than on renewals, the premiums should be grouped to facilitate the calculation of the unpaid commissions.

Because the policyholder can terminate the policy at any time simply by not paying the premium, the company should consider its lapse experience in determining the amount it records as uncollected premiums. Recording older due premiums (although not more than 90 days past due), which have little or no unearned premium reserve, may overstate the company's financial condition. Direct mail mail-order insurance is a good example of business having high lapse rates. Many companies record no uncollected premiums on these policies.

Some insurers may act as administrators of accident and health plans under which the plans bear the risk of claims. Such plans are commonly termed "administrative services only" plans and are described in this manual as "uninsured plans." For additional discussion see Chapter 8—Other Admitted Assets.

Amounts related to uninsured plans or the uninsured portion of partially insured plans must not be reported in premiums. Conversely income relating to the insured portion of any plan must be reported as premiums.

Generally Accepted Accounting Principles

46. The *AICPA Audit and Accounting Guide: Health Care Organizations* provides the following guidance:

Revenue

10.04 Revenue usually is recorded when coverage is provided to an enrollee or the service is provided to a patient or resident. Revenue is classified based on the type of service rendered or contracted to be rendered. Examples of revenue include—

- Patient service revenue, which is derived from fees charged for patient care. This may be based on diagnosis related group (DRG) payments, resource-based relative value scales (RBRVS) payments, per diems, discounts, or other fee-for-service arrangements.

- Premium revenue, which is derived from capitation arrangements.

- Resident service revenue, which may be related to maintenance fees, rental fees, or amortization of advance fees.

Accounting for Loss Contracts

13.05 A prepaid health care provider enters into contracts to provide members with specified health care services for specified periods in return for fixed periodic premiums. The premium revenue is expected to cover health care costs and other costs over the terms of the contracts. Only in unusual circumstances would a provider be able to increase premiums on contracts in force to cover expected losses. A provider may be able to control or reduce future health care delivery costs to avoid anticipated losses, but the ability to avoid losses under existing contracts may be difficult to measure and to demonstrate. Associated entities such as hospitals, medical groups, and individual practice associations (IPAs) may enter into similar contracts with prepaid health care providers in which they agree to deliver identified health care services to the providers' members for specified periods in return for fixed fees.

13.06 *FASB Statement No. 5, Accounting for Contingencies*, states that a loss should be accrued in financial statements when it is probable that a loss has been incurred and the amount of the loss can be reasonably estimated. Accordingly, losses should be recognized when it is probable that expected future health care costs and maintenance costs under a group of existing contracts will exceed anticipated future premiums and stop-loss insurance recoveries on those contracts. For purposes of determining whether a loss exists, the expected future health care costs include all costs other than general and administrative, selling, maintenance, marketing and interest. The term maintenance costs refers to costs associated with maintaining announcement records and processing premium collections and payments. The estimated future health care costs and maintenance costs to be considered in determining whether a loss has been incurred should include fixed and variable, direct, and allocable indirect costs. Contracts should be grouped in a manner consistent with the provider's method of establishing premium rates, for example, by community rating practices, geographical area, or statutory requirements, to determine whether a loss has been incurred.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 13, Aggregate Reserves for Accident and Health Policies, and Chapter 18, Premium Income
- *Issue Paper No. 3—Accounting Changes*
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 10—Uncollected Premium Balances*
- *Issue Paper No. 47—Uninsured Plans*
- *Issue Paper No. 50—Classifications and Definitions of Insurance or Managed Care Contracts In Force*
- *Issue Paper No. 51—Life Contracts*
- *Issue Paper No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses*
- *Issue Paper No. 59—Credit Life and Accident and Health Insurance Contracts*
- *Issue Paper No. 66—Accounting for Retrospectively Rated Contracts*
- *Issue Paper No. 74—Life, Deposit-Type and Accident and Health Reinsurance*

Generally Accepted Accounting Principles

- *AICPA Audit and Accounting Guide: Health Care Organizations*

State Regulations

- No additional guidance obtained from state statutes or regulations.

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Statutory Issue Paper No. 55

Unpaid Claims, Losses and Loss Adjustment Expenses

STATUS
Finalized June 23, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 55

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory guidance for recording unpaid life and accident and health insurance claims is contained in Chapters 11 and 14 of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies (Life/A&H Accounting Practices and Procedures Manual). Current statutory guidance for recording unpaid property and casualty losses and loss adjustment expenses is contained in Chapters 10 and 11 of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies (P&C Accounting Practices and Procedures Manual). Current statutory guidance for recording unpaid managed care claims, losses and loss adjustment expenses is contained in Chapter 8 of the Accounting Practices and Procedures Manual for Health Maintenance Organizations (HMO Accounting Practices and Procedures Manual). This guidance requires the recognition of a liability for unpaid claims, losses and loss/claim adjustment expenses.

2. GAAP guidance for recording unpaid claims and unpaid losses and loss/claim adjustment expenses is substantially consistent with current statutory guidance. This guidance is found in *FASB Statement No. 60*, *Accounting and Reporting by Insurance Enterprises* (FAS 60).

3. The purpose of this issue paper is to establish statutory accounting principles for recording liabilities for unpaid claims and claim adjustment expenses for life insurance contracts and accident and health contracts and unpaid losses and loss adjustment expenses for property and casualty insurance contracts, that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts). The guidance set forth in this issue paper applies to all contracts as defined in *Issue Paper No. 50—Definitions and Classifications of Insurance or Managed Care Contracts In Force* (Issue Paper No. 50).

4. This issue paper does not address policy reserves for life and accident and health policies. These reserves are addressed in *Issue Paper No. 51—Life Contracts*, *Issue Paper No. 52—Deposit-Type Contracts*, *Issue Paper No. 54—Individual and Group Accident and Health Contracts* (Issue Paper No. 54), and *Issue Paper No. 59—Credit Life and Accident and Health Insurance Contracts*.

5. This issue paper does not address liabilities for punitive damages. These liabilities shall be recorded in accordance with *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets* (Issue Paper No. 5).

SUMMARY CONCLUSION

6. Claims, losses and loss/claim adjustment expenses shall be recognized as expense when a covered or insured event occurs. In most instances the covered or insured event is the occurrence of an incident which gives rise to a claim or the incurring of costs. For claims made type policies the covered or insured event is the reporting to the entity of the incident that gives rise to a claim. Claim payments and related expense payments are made subsequent to the occurrence of a covered or insured event and, in order to

recognize the expense of a covered or insured event that has occurred, it is necessary to establish a liability. The future payments associated with settling unpaid claims, unpaid losses and loss/claim adjustment expenses meet the definition of a liability as established in Issue Paper No. 5. Liabilities shall be established for any unpaid claims and unpaid losses (loss reserves), unpaid loss/claim adjustment expenses (loss/claim adjustment expense reserves) and incurred costs, with a corresponding charge to income.

7. The following are types of future costs relating to property and casualty contracts as defined in Issue Paper No. 50, which shall be considered in determining the liabilities for unpaid losses and loss adjustment expenses:

a. Reported Losses: Expected payments for losses relating to insured events that have occurred and have been reported to, but not paid by, the insurer as of the statement date;

b. Incurred But Not Reported Losses, (IBNR): Expected payments for losses relating to insured events that have occurred but have not been reported to the insurer as of the statement date. As a practical matter this also may include losses that have been reported to the company but have not yet been entered to the claims system or bulk provisions. Bulk provisions are reserves included with other IBNR reserves to reflect deficiencies in known case reserves;

c. Loss Adjustment Expenses: Costs expected to be incurred in connection with the adjustment and recording of losses defined in subparagraphs 7.a. and 7.b. of this issue paper. Examples of expenses incurred in these activities are estimating the amounts of losses, disbursing loss payments, maintaining records, general clerical, secretarial, office maintenance, occupancy costs, utilities, computer maintenance, supervisory and executive duties, supplies, and postage. Loss adjustment expenses can be classified into two broad categories: Defense and Cost Containment (DCC) and Adjusting and Other (AO):

1. DCC include defense, litigation, and medical cost containment expenses, whether internal or external. DCC include, but are not limited to, the following items:

i. Surveillance expenses;

ii. Fixed amounts for medical cost containment expenses;

iii. Litigation management expenses;

iv. Loss adjustment expenses for participation in voluntary and involuntary market pools if reported by accident year;

v. Fees or salaries for appraisers, private investigators, hearing representatives, reinspectors and fraud investigators, if working in defense of a claim, and fees or salaries for rehabilitation nurses, if such cost is not included in losses;

vi. Attorney fees incurred owing to a duty to defend, even when other coverage does not exist;

vii. The cost of engaging experts;

2. AO are those expenses other than DCC as defined in (1) above assigned to the

expense group "Loss Adjustment Expense." AO include, but are not limited to, the following items:

i. Fees and expenses of adjusters and settling agents;

ii. Loss adjustment expenses for participation in voluntary and involuntary market pools if reported by calendar year;

iii. Attorney fees incurred in the determination of coverage, including litigation between the insurer and the policyholder; and

iv. Fees and salaries for appraisers, private investigators, hearing representatives, reinspectors and fraud investigators, if working in the capacity of an adjuster.

8. The following future costs relating to life and accident and health indemnity contracts, as defined in Issue Paper No. 50, shall be considered in determining the liability for unpaid claims and claim adjustment expenses:

a. Accident and Health Claim Reserves: Reserves for claims that involve a continuing loss. This reserve is a measure of the future benefits or amounts not yet due as of the statement date which are expected to arise under claims which have been incurred as of the statement date. This shall include the amount of claim payments that are not yet due such as those amounts commonly referred to as disabled life reserves for accident and health claims. The methodology used to establish claim reserves is discussed in Issue Paper No. 54;

b. Claim Liabilities for Life/Accident and Health Contracts:

i. Due and Unpaid Claims: Claims for which payments are due as of the statement date;

ii. Resisted Claims in Course of Settlement: Liability for claims that are in dispute and are unresolved on the statement date. The liability either may be the full amount of the submitted claim or a percentage of the claim based on the reporting entity's past experience with similar resisted claims;

iii. Other Claims in the Course of Settlement: Liability for claims that have been reported but the reporting entity has not received all of the required information or processing has not otherwise been completed as of the statement date;

iv. Incurred But Not Reported Claims: Payments for which a covered event has occurred (such as death, accident or illness) but has not been reported to the reporting entity as of the statement date;

c. Claim Adjustment Expenses for Accident and Health Reporting Entities: Costs expected to be incurred in connection with the adjustment and recording of accident and health claims defined in subparagraphs 8.a. and 8.b. of this issue paper. Examples of expenses incurred in these activities are estimating the amounts of losses, disbursing loss payments, maintaining records, general clerical, secretarial, office maintenance, occupancy costs, utilities, computer maintenance, supervisory and executive duties, supplies, and postage;

d. Claim Adjustment Expenses for life entities: Costs expected to be incurred (including legal, investigation, etc.) in connection with the adjustment and recording of life claims in the course of settlement defined in subparagraph 8.b.

9. The following costs relating to managed care contracts as defined in Issue Paper No. 50 shall be considered in determining the claims unpaid and claims adjustment expenses:

a. Claims unpaid for Managed Care Reporting Entities:

i. Unpaid amounts for costs incurred in providing care to a subscriber, member or policyholder including inpatient claims, physician claims, referral claims, other medical claims, resisted claims in the course of settlement and other claims in the course of settlement;

ii. Incurred But Not Reported Claims: Liability for which a covered event has occurred (such as an accident, illness or other service) but has not been reported to the reporting entity as of the statement date;

iii. Additional medical costs resulting from failed contractors under capitation contracts and provision for losses incurred by contractors deemed to be related parties for which it is probable that the reporting entity will be required to provide funding;

b. Claim Adjustment Expenses for Managed Care Reporting Entities: Costs expected to be incurred in connection with the adjustment and recording of accident and health claims defined in subparagraph 9.a. of this issue paper. Examples of expenses incurred in these activities are estimating the amounts of losses, disbursing loss payments, maintaining records, general clerical, secretarial, office maintenance, occupancy costs, utilities, computer maintenance, supervisory and executive duties, supplies, and postage;

c. Liabilities for percentage withholds ("withholds") from payments made to contracted providers;

d. Liabilities for accrued medical incentives under contractual arrangements with providers and other risk-sharing arrangements whereby the health entity agrees to share savings with contracted providers.

10. The liability for claim reserves and claim liabilities, unpaid losses, and loss/claim adjustment expenses shall be based upon the estimated ultimate cost of settling the claims (including the effects of inflation and other societal and economic factors), using past experience adjusted for current trends, and any other factors that would modify past experience. These liabilities will not be discounted unless authorized by specific issue papers, including Issue Paper No. 54 and *Issue Paper No. 65—Property and Casualty Contracts*.

11. Various analytical techniques can be used to estimate the liability for IBNR claims or losses, future development on reported losses/claims, and loss/claim adjustment expenses. These techniques generally consist of statistical analysis of historical experience and are commonly referred to as loss

reserve projections. The estimation process is generally performed by line of business, grouping contracts with like characteristics and policy provisions. The decision to use a particular projection method and the results obtained from that method should be evaluated by considering the inherent assumptions underlying the method and the appropriateness of those assumptions to the circumstances. No single projection method is inherently better than any other in all circumstances. The results of more than one method should be considered.

12. For each line of business and for all lines of business in the aggregate, management shall record its best estimate of its liabilities for unpaid claims, unpaid losses, and loss/claim adjustment expenses. Because the ultimate settlement of claims (including IBNR for death claims and accident and health claims) is subject to future events, no single claim or loss and loss/claim adjustment expense reserve can be considered accurate with certainty. Management's analysis of the reasonableness of claim or loss and loss/claim adjustment expense reserve estimates shall include an analysis of the amount of variability in the estimate. If, for a particular line of business, management develops its estimate considering a range of claim or loss and loss/claim adjustment expense reserve estimates bounded by a high and a low estimate, the best estimate of the liability within that range shall be recorded. The high and low ends of the range shall not correspond to an absolute best-and-worst case scenario of ultimate settlements because such estimates may be the result of unlikely assumptions. Management's range shall be realistic and therefore shall not include the set of all possible outcomes but instead only those outcomes that are considered reasonable.

13. In the rare instances when, for a particular line of business, after considering the relative probability of the points within the estimated range, it is determined that no point within management's estimate of the range is a better estimate than any other point, the midpoint within management's estimate of the range shall be accrued. It is anticipated that using the midpoint in a range will be applicable only when there is a continuous range of possible values, and no amount within that range is any more probable than any other. For purposes of this issue paper, it is assumed that management can quantify the high end of the range. If management determines that the high end of the range cannot be quantified, then a range does not exist, and management's best estimate shall be accrued. This guidance is not applicable when there are several point estimates which have been determined as equally possible values, but those point estimates do not constitute a range. If there are several point estimates with equal probabilities, management should determine its best estimate of the liability.

14. If a reporting entity chooses to anticipate salvage and subrogation recoverables (including amounts recoverable from second injury funds where applicable), these recoverables shall be estimated in a manner consistent with paragraphs 10-12 of this issue paper and shall be deducted from the liability for unpaid claims or losses.

15. Changes in estimates of the liabilities for unpaid claims or losses and loss/claim adjustment expenses resulting from the continuous review process, including the consideration of differences between estimated and actual payments, shall be considered a change in estimate and shall be recorded in accordance with *Issue Paper No. 3—Accounting Changes* (Issue Paper No. 3). Issue Paper No. 3 requires changes in estimates to be included in the statement of operations in the period the change becomes known.

Disclosure

16. The financial statements shall include the following disclosures for each year full financial statements are presented. Life and annuity contracts are not subject to this disclosure requirement.

a. The balance in the liabilities for unpaid claims and unpaid losses and loss/claim adjustment expense reserves at the beginning and end of each year presented;

b. Incurred claims, losses and loss/claim adjustment expenses with separate disclosure of the provision for insured or covered events of the current year and of increases or decreases in the provision for insured or covered events of prior years;

c. Payments of claims, losses and loss/claim adjustment expenses with separate disclosure of payments of losses and loss/claim adjustment expenses attributable to insured or covered events of the current year and to insured or covered events of prior years;

d. The reasons for the change in the provision for incurred claims, losses and loss/claim adjustment expenses attributable to insured or covered events of prior years. The disclosure should indicate whether additional premiums or return premiums have been accrued as a result of the prior-year effects;

e. A summary of management's policies and methodologies for estimating the liabilities for losses and loss/claim adjustment expenses including discussion of claims for toxic waste cleanup, asbestos-related illnesses, or other environmental remediation exposures;

f. Disclosure of the amount paid and reserved for losses and loss/claim adjustment expenses for asbestos and/or environmental claims, on a gross and net of reinsurance basis (the reserves required to be disclosed in this section shall exclude amounts relating to policies specifically written to cover asbestos and environmental exposures);

g. Estimates of anticipated salvage and subrogation (including amounts recoverable from second injury funds, other governmental agencies, or quasi-governmental agencies, when applicable) deducted from the liability for unpaid claims or losses.

DISCUSSION

17. The statutory principles outlined in the conclusion above are consistent with the current statutory guidance for recording a liability for unpaid claims and unpaid losses and loss/claim adjustment expenses. Property and casualty insurers report the liability for loss adjustment expenses separate from the liability for losses while life and accident and health insurers and managed care providers accrue such expenses as part of the claim liability, claim reserve or claims payable. The description of the types of costs considered DCC and AO are consistent with the P&C Accounting Practices and Procedures Manual adopted by Accounting Practices and Procedures (EX4) Task Force in June 1995 to be effective for calendar years beginning January 1, 1997 (later revised to January 1, 1998). Recording estimated salvage and subrogation recoveries continues to be optional.

18. In addition to requiring management to record its best estimate of its unpaid liability for unpaid claims, unpaid losses and loss/claim adjustment expenses for each line of business, the conclusion expands current statutory guidance to require the accrual of the midpoint of a range of loss or loss adjustment expense reserve estimates when for a particular line of business, no point within management's range of reasonably possible estimates is determined to be a better estimate than any other point. This conclusion is consistent with Issue Paper No. 5 which states:

> When an amount within management's estimate of the range of a loss appears to be a better estimate than any other amount within the range, that amount shall be accrued. When, in management's opinion, no amount within management's estimate of the range is a better estimate than any other amount, however, the midpoint (mean) of management's estimate in the range shall be accrued. For purposes of this paragraph, it is assumed that management can quantify the high end of the range. If management determines that the high end of the range cannot be quantified, then a range does not exist, and management's best estimate shall be used.

Additionally, the conclusion expands the disclosure requirements of current statutory guidance to include the information set forth in paragraph 16. The disclosure required by paragraph 16 provides disclosure in those circumstances where the accompanying exhibits are not part of the company's financial statements (e.g., annual audit report) and is not intended to provide duplicative presentation in the annual statement filings.

19. The conclusions above are consistent with the guidance provided for the recognition of claim costs in FAS 60 with the exception of paragraph 13 of this issue paper which requires the accrual of the midpoint of management's estimate of the range of loss or loss adjustment expense reserve estimates when no point within management's continuous range of reasonably possible estimates is determined to be any more probable than any other. Although FAS 60 is rejected in Issue Paper No. 50, it is considered appropriate that the recognition of claims costs be consistent with those provisions of FAS 60 as they are consistent with the Statement of Concepts. The disclosures required in paragraph 16 are consistent with the guidance in *AICPA Statement of Position 94-5, Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises*. This pronouncement will be addressed in its entirety in a separate issue paper. This issue paper rejects AICPA Statement of Position 92-4, *Auditing Insurance Entities' Loss Reserves.*

20. The statutory accounting principles outlined in the conclusion above are consistent with the conservatism and recognition concepts in the Statement of Concepts. Pertinent excerpts follow:

> Conservatism
>
> Financial reporting by insurance enterprises requires the use of substantial judgments and estimates by management. Such estimates may vary from the actual amounts for numerous reasons. To the extent that factors or events result in adverse variation from management's accounting estimates, the ability to meet policyholder obligations may be lessened. In order to provide a margin of protection for policyholders, the concept of conservatism should be followed when developing estimates as well as establishing accounting principles for statutory reporting.
>
> Recognition
>
> Liabilities require recognition as they are incurred. Certain statutorily mandated liabilities may also be required to arrive at conservative estimates of liabilities and probable loss contingencies.

Drafting Notes/Comments

- Accounting for reinsurance is addressed in *Issue Paper No. 74—Life, Deposit-Type and Accident and Health Reinsurance* and *Issue Paper No. 75—Property and Casualty Reinsurance.*
- Accounting for title insurance is addressed in *Issue Paper No. 57—Title Insurance*.
- Excess statutory reserves are addressed in *Issue Paper No. 65—Property and Casualty Contracts*.
- Claims made insurance contracts are addressed in *Issue Paper No. 65—Property and Casualty Contracts*.
- Mortgage Guaranty contracts are addressed in *Issue Paper No. 88—Mortgage Guaranty Insurance*.
- Financial Guaranty contracts are addressed in *Issue Paper No. 69—Financial Guaranty Insurance*.
- Property and Casualty liabilities subject to discounting are discussed in *Issue Paper No. 65—Property and Casualty Contracts*.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

21. The P&C Accounting Practices and Procedures Manual, Chapter 10, Losses, includes the following guidance:

> Recognition
>
> Even though there are many methods of estimating unpaid losses, the underlying goal is to have unpaid losses reflect the liability outstanding for losses that have occurred as of the financial statement date. Losses, except for "claims-made" policies, are recognized as they occur and not as they are reported to the company. Because of this basis of recognition, unpaid losses are grouped in (1) reported and (2) incurred but not reported (IBNR). Reported losses are those of which the company has been notified. The incurred but not reported losses are those losses that have occurred but have not been reported to the company. As a practical matter, losses which have been reported to the company but not yet entered into the system may be included as IBNR.
>
> Valuation
>
> Generally, a company is required to determine what the value of its claims will be when ultimately settled. Excluding certain types of losses, discussed under Loss Reserve Discounting below, statutory accounting practices require that for every dollar of unpaid losses the company reserve a whole dollar for the future payment of those losses.
>
> Estimation of Reported Losses Unpaid
>
> Unpaid losses for claims that have been reported may be determined in many ways. One way is for the claim to be assigned to an individual who estimates the value of the claim as needed facts are gathered.
>
> Shown below are three examples of methods of calculating unpaid losses, which use information that may be maintained on an accident or report year basis. If historical information is maintained and used by accident year, then the unpaid losses include IBNR unpaid losses and the IBNR unpaid losses must be split from the total. If report year data is used, then the result is an unpaid loss figure for reported claims and IBNR unpaid losses must be estimated separately.
>
> Reported losses may be estimated based on paid loss patterns for particular lines or coverages. This method determines the pattern of prior years paid losses as they relate to ultimate losses. A percentage of paid losses to ultimate losses is calculated at each stage of development. This percentage is then divided into the paid losses for other years in the same stage of development to determine the estimated ultimate loss dollars. The paid losses are then subtracted from the ultimate loss dollars to determine the required unpaid loss amounts. The sum of these amounts for all open years is the total unpaid losses. This method, as is the case with respect to any method based in whole or in part on past experience, is only reliable to the extent there is sufficient volume of similar loss claims in prior years. In addition, changing trends and factors affecting a company's loss liability, such as inflation and trends in jury awards, must always be carefully considered and reflected. Special problems, such as changeovers from a tort to a no-fault system, require special consideration and treatment in estimating unpaid losses.
>
> Another means of establishing unpaid losses is to estimate ultimate loss counts and estimate the average ultimate cost of a claim. These two estimates are then multiplied by each other to establish an ultimate cost. Paid losses to date are subtracted from this ultimate cost figure to arrive at unpaid losses.
>
> The ultimate loss count may be determined by developing a percentage of losses reported at the particular stages of development of prior years. These percentages may then be divided into current reported losses to determine ultimate numbers. This, of course, is assuming that a representative

pattern is present for prior years. The average cost of incurred losses may be determined by developing the average cost of closed claims at various stages of development. After review of prior years average closed claim cost, a factor is developed and used to project trends in total loss costs. This trend factor is then applied to the average closed claim cost of prior years to determine an estimated average ultimate cost for the year being reviewed.

Another method that may be used is unpaid loss counts and average values of unpaid losses. The average value of unpaid losses is multiplied by the unpaid loss count to arrive at an ultimate figure. From this figure, partial payments are subtracted to arrive at a current unpaid loss amount. Average values of unpaid losses are determined by reviewing prior years information as it develops.

Some of the other methods that may be used include frequency and severity analysis and projection of loss ratios.

The foregoing are examples of the many general methods in use. Also, in practice, there are many variations to these methods. Some companies use a combination of methods to establish their unpaid losses. For example, for liability losses that require a great deal of time to settle, average unpaid loss amounts may be assigned until adequate information is compiled. Then the individual case estimate methods may be used.

Incurred But Not Reported Losses

With reported losses representing the liabilities for reported claims, the company must also record a liability for losses that are incurred but not reported. Various methods are used for estimating IBNR losses. Following are examples of two methods.

In a formula method, IBNR losses are related to some base, such as incurred losses, reported losses, premiums and exposures. Sometimes a formula approach is used in estimating total unpaid losses and the IBNR losses are separated from the reported losses by factoring.

In the averaging method, separate projections are made of IBNR claim counts and the average cost for which those claims will settle. The product of these two estimates is the IBNR unpaid losses.

Whatever methods are selected for establishing unpaid losses, the goal should always be reserve adequacy.

Recoveries from Salvage and Subrogation

Anticipated salvage and subrogation may be taken into account when determining ultimate incurred losses and unpaid losses, to the same extent that other factors affecting ultimate claim costs are taken into account. The company is expected to maintain appropriate data and perform appropriate actuarial tests to support the reasonableness of the anticipated salvage and subrogation recoveries.

Companies which have previously reported reserves gross of salvage and subrogation should report the change to the net method as a change in accounting principle. The cumulative effect on prior years of the change should be reported as a write-in item in the surplus section of the annual statement. The change in reserve calculated using the net method should be included in net income for the year of the change and all future years.

22. The P&C Accounting Practices and Procedures Manual, Chapter 11, Loss Adjustment Expenses, includes the following guidance:

The liability for unpaid loss adjustment expenses includes expenses that will be incurred in connection with the settlement of losses unpaid at the statement date. The liability should be the company's best estimate of the loss adjustment expenses that will be necessary to settle both reported and incurred but not reported unpaid losses. In addition to these expenses, the company must establish a liability for incurred but unpaid loss adjustment expenses, the same as for incurred and unpaid general expenses. The liability for unpaid loss adjustment expenses should provide for the estimated expenses necessary to adjust all unpaid losses irrespective of payments made to third party administrators, management companies or other entities, not specifically covered by a contract of insurance.

Allocated Loss Adjustment Expenses

Allocated unpaid loss adjustment expenses are calculated by various methods. Examples of methods used are as follows:

Calendar year paid allocated loss adjustment expense is related to the calendar year paid losses. The ratio developed on the basis is then multiplied by the amount of the loss reserve for each of these coverages to determine the unpaid amount.

Another method tracks accident year development and computes a ratio on an incurred-to-incurred basis. Prior accident years data is accumulated at various stages of development. The ratio of accumulated allocated loss adjustment expense paid to accumulated losses paid is calculated at each stage of development. This process should start with the oldest accident year and move forward. The ratio of paid-to-paid for each accident year under review is then compared to the paid-to-paid ratios for prior accident years at the same stage of development. After this comparison, the estimated ultimate incurred-to-incurred ratio is projected for the accident year under review, based on the subsequent development of prior years' paid-to-paid ratios. The estimated incurred losses for the accident year under review are then multiplied by the incurred-to-incurred ratio to determine ultimate allocated loss adjustment expense amounts. Paid allocated loss adjustment expense is then subtracted to arrive at the unpaid amount. This method recognizes that older claims may require larger amounts of loss expenses.

The liability-to-liability ratio method establishes the liability directly by multiplying the estimated loss liability for each accident year by an estimated liability-to-liability ratio (allocated loss adjustment expense liability to loss liability). It starts by calculating the liability-to-liability (outstanding-to-outstanding) ratios that should have been used in prior accident years at the same stage of development. These prior ratios are then reviewed, and an outstanding-to-outstanding ratio is selected for the accident year involved.

Again, if allocated loss adjustment expense levels increase with age, then the outstanding-to-outstanding ratios will increase with age up to some cut-off age. The selected outstanding-to-outstanding ratios by accident year have no permanence and must be reselected at the end of each new accounting date. This method also requires the maintenance of accident-year data on an all-time cumulative basis through each stage of development.

Unallocated Loss Adjustment Expenses

A commonly used method of calculating unpaid, unallocated loss adjustment expenses computes a paid, unallocated expense ratio to paid losses. Based on this paid-to-paid ratio, each coverage is reviewed as to the percentage of unallocated handling that is complete at the time the claim is opened. This percentage is subtracted from 100% to determine the work that remains to be done. This percentage is then multiplied by the developed paid-to-paid factor. The factor that results from this calculation is then multiplied by the outstanding unpaid losses to determine the unpaid, unallocated loss expenses.

For IBNR paid losses, the full paid-to-paid factor is normally used to determine unpaid, unallocated loss adjustment expenses. This is done because these claims have not been opened and therefore little, if any, work has been completed.

Unpaid loss adjustment expenses are shown as a liability on the annual statement.

23. The Life/A&H Accounting Practices and Procedures Manual, Chapter 11, Unpaid Life Insurance Claims, provides the following guidance:

> Life Insurance Claims
>
> A life insurance contract provides a death benefit, an annuity benefit, or an endowment benefit. The company knows (with few exceptions) the amount of its obligation to each policyholder when it is presented with a claim or when the policy matures. At any statement date the company will owe unpaid policy proceeds which must be provided for in its financial statements.
>
> In addition to the proceeds of the basic contracts, amounts may be payable for supplementary benefits attached to the basic contracts. These include accidental death benefits, payor death or disability benefits, premium waiver as a result of the disability of the insured, and in some instances, disability income benefits. As with the basic contract, the amount of accidental death benefits payable is a fixed amount, known to the company, once the criteria for payment has been established. Payor death requires reserving a specific number of premium payments contingent upon the insured living to a certain age. Payor disability, premium waiver, and disability income require the establishment of reserves based on appropriate morbidity factors and mortality factors. All or part of these reserves may be included in unpaid claims at statement date.
>
> For all practical purposes, payment of life insurance claims and the accrual of the liability for unpaid claims is the same for ordinary, industrial, and group coverages. The liability for unpaid claims consists of both reported and unreported claims. The instances where a company may not be able to make an exact determination of its liability for a life insurance claim might include claims that are being resisted by the company and those involving an accidental death of the insured.
>
> The liabilities that are reported in the statutory financial statement include the following:
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> 1. Due and unpaid. This item consists of claims on which all processing has been completed and which have been approved for payment, but which have not been paid prior to the statement date. The reported amount may be compiled from a claims register, an inventory of such claims, checks requested, or possibly drafts outstanding and, with an expeditious claims-paying system, may be small or zero.
>
> 2. Claims in course of settlement: resisted. This item contains the liability for claims that are in dispute and are unresolved on the statement date. The liability either may be the full amount of the submitted claim or a percentage of the claim that is based on the past experience of the company with similar resisted claims. The company should also accrue at year end for the estimated additional expenses (legal, investigation, etc.) involved in settling resisted claims. This latter item is included with other general expenses in the statutory financial statement.
>
> 3. Claims in course of settlement: other. These are claims that have been reported to the company but on which all required information has not been received, or the processing not otherwise completed, on the statement date. The company may include all claims that are being held up for reasons beyond its control. These may include awaiting the election of an option by a beneficiary, the completion of reasonable investigation, or determining who is entitled to receive the amount due. The amount of the liability may be based on the past experience of the company but it generally is a compilation of the claims that are pending at the statement date.
>
> 4. Incurred but not reported (IBNR) claims. This represents the company’s liability for claims that have not been reported to it but the insured had died or become disabled prior to the statement date. At the end of the year the liability for IBNR claims may be estimated using any of the following techniques or any other technique which has proved reasonable for the particular company:
>
>   a. Establish a cut-off period of a few weeks subsequent to year end and complete a list of all claims received during the cut-off period that relate to the prior year and then determine the liability for those claims using the same methods as for claims in the course of settlement.

b. Inventory the prior years IBNR claims that were received after the prior years cut-off period and on the basis of past experience, estimate those claims that will be reported thereafter.

c. Analyze the past years experience and project it into the future after considering various modifying factors, such as insurance in force, paid claims, and claim frequency and severity. This should be done by the company's actuary to ensure that all current actuarial assumptions and methods are used.

The policies on which claims have been incurred but not reported until after the statement date will be included in the valuation of insurance in force. By reserving the face amount of the policy as an IBNR claim, the reserve for IBNR claims would be redundant. The policy reserves on those claims, therefore, are deducted either from the aggregate reserves for life policies or from the IBNR claim reserve.

24. The Life/A&H Accounting Practices and Procedures Manual, Chapter 14, Accident And Health Claims provides the following guidance:

Accident and health insurance policies generally provide for the coverage of such benefits as hospital and medical payments, disability and loss of time (income), and accidental death and dismemberment. Claims on accident and health policies are payable in the manner dictated by the risk that is insured. Usually, hospital and medical and accidental death and dismemberment claims are paid in a lump sum after the loss is incurred. Disability and loss-of-time claims, for partial or total disability due to accident and sickness, are paid to the insured weekly or monthly during the period of disability, or a settlement may be reached between the company and the insured for a discounted lump sum payment.

The insurer's claims reserves should not include any amounts arising from uninsured accident and health plans or the uninsured portion of partially insured plans. The insured portion of any partially insured plan should be treated as any other insured plan with appropriate reserves established. This is the same treatment described with regard to aggregate reserves in Chapter 13.

Claim Liabilities and Reserves

Unpaid benefits on accident and health policies are discussed in this chapter and Chapter 13. Amounts that would not be payable on the statement date (the unaccrued portion) are detailed in Chapter 13 as claim reserves. The amounts that are payable on the statement date (the accrued portion) are covered below as claim liabilities.

The various methods described in the following paragraphs are not an exhaustive listing, nor are the descriptions of such methods necessarily complete.

Due and Unpaid Claims

The instructions for completing the statutory financial statement for life and accident and health companies state that only claims which are complete except for the payment of the amount due should be included. Claims that have not been paid, because all of the required information has not been received, should be included with claims in course of settlement. The amount of due and unpaid claims generally will be small. The amount of the liability usually is determined on an exact inventory basis of claims on hand ready to be paid. In practice, a seriatim calculation of this liability is very difficult. Many companies take the approach that if all information is available to pay a claim then it has been paid. All claims on which the Company has only partial information are reported as "Claims in course of settlement."

Claims in Course of Settlement: Other

This item includes the liability for resisted claims in the amount the insurer expects the claim to be settled and paid. The accrued claim liability for all unresisted claims also is included.

For loss-of-time (disability income) policies, the accrued portion of the next periodic payment must be included. For example, when payments on a claim are made to the insured on the fifteenth day of each month and when the valuation date is the end of the month, one-half of the monthly payment is accrued, but not yet due, on the valuation date if the insured is still disabled on the valuation date.

One method is to set up a reserve equal to one-half of all monthly payments being made for loss-of-time policies. A more accurate method to determine the accrued and unpaid liability on reported disability claims is to compute the total amount accrued to the valuation date for each claim, then subtract the amount that already has been paid.

For other than loss-of-time policies, various methods are used in determining liabilities for these claims. Because these methods may produce total claim liabilities, a breakdown between unaccrued and accrued amounts should be made for allocation between claim reserve and claim liability. Although not intended to be a complete list, the following are examples of these methods:

1. An estimate may be made for each outstanding claim. Generally, this is not feasible unless the number of claims is relatively small.

2. Average claim factors may be developed from actual claim experience on similar claims outstanding at previous statement dates. To determine the total liability, these average factors are applied to the current outstanding claims. The calculation of factors, and their application to outstanding claims, should be done separately for each major type of benefit. Furthermore, the average claim factors should recognize the effects of inflation.

3. A formula method determines the adequacy of the claim liability at previous statement dates and of the total claims incurred on a line of business through retrospective studies. The amount of claims paid is related to a pre-established base, such as premium in force, unearned premium reserve, and so on. The percentages developed are applied to the same base on the statement date to develop the current liability. The formula method may be desirable, also, because it can include a provision for the liability for claims incurred but unreported.

Incurred But Not Reported (IBNR) Claims

The formula method, previously described for computing claims in course of settlement, probably is the most commonly used method to calculate this liability. Another method, sometimes called the lag system, is based on the assumption that a significant portion of the incurred but unreported claims will be reported within a specified period after the statement date. Under this method, the insurer establishes a liability for the claims reported, plus an estimated amount for claims reported after the "lag" period. The instructions for preparing the statutory financial statement contain an illustration of a method for computing the reserve for future contingent benefits, i.e., deferred maternity benefits.

For any method that is used, the insurer should verify the appropriateness of the IBNR liability by retrospectively calculating the exact amount of the liability for past valuation period.

Statistical Computation

The statistics developed from prior experience are essential in computing the claim reserves on accident and health policies. The important dates required for individual claims include the incurred date of the claim, the reported date, and the date of the claim payment.

The reported date is the date the claimant notified the company and a claim file is opened. The payment date may be either the date the partial payment is made or the date the final payment is made.

The incurred date must be defined by the contract and any applicable statute for various coverages. For example, for deferred maternity benefits, the incurred date is the date of conception. For major medical coverages, the incurred date should take into account the date of disability, the date the initial expense was incurred, and the date the deductible was satisfied, if and as these features affect the company's contractual obligation under the claim. Hospital and surgical policies present less of a problem because either the date of admission to the hospital or the surgery date is utilized as the incurred date.

If subsequent treatment for the same condition falls within the definition of one illness, as set forth in a hospital, medical, or major medical contract, the original incurred date must be used and any payments considered part of the original claim. In summary, the assignment of incurred dates must bear a logical relationship to the situation creating the claim and must be consistently applied from year to year and is generally the date of the first compensable treatment.

In regard to loss-of-time disability policies with an elimination period, the duration of disablement shall be considered as dating from the time that benefits would have begun to accrue had there been no elimination period.

Reinsurance

On policies that have been reinsured, the liability for claims should be reduced by the amount recoverable from the reinsurer. The amount of reinsurance that is recoverable on claims relating to specific policies should be reported at actual amounts. For incurred but unreported claims, the liability should be estimated net of reinsurance recoverable, unless the company has reliable experience supporting an estimated separation into direct and reinsurance ceded portions. The latter situation usually arises under quota share group reinsurance.

25. The HMO Accounting Practices and Procedures Manual, Chapter 8, Liabilities, provides the following guidance:

LIABILITIES

COVERED AND UNCOVERED LIABILITIES

Any liability for health care expenses for which an enrollee is not responsible in the event of the insolvency of an HMO is deemed to be a covered liability. One method of assuring that an enrollee will not be liable for unpaid medical bills if an HMO becomes insolvent is through a "hold harmless" provision contained in provider contracts. This provision prohibits the provider from seeking payment for medical expenses directly from the enrollee. At present there is a standardized hold harmless agreement adopted as a "guideline" by the National Association of Insurance Commissioners and the National Association of Health Maintenance Organization Regulators and is an attachment to the Model HMO Act.

If this provision is present in provider contracts, then the medical expense for that provider is considered to be a covered liability.

Uncovered Liabilities

Uncovered liabilities are defined as those expenditures that are covered by the HMO for which an enrollee would also be liable in the event of the organization's insolvency. These are expenditures for health care services for which the HMO is at risk. They do not include expenditures for services when a provider has agreed not to bill the enrollee even though the provider is not paid by the HMO, or for services that are guaranteed, insured or assumed by a person or organization other than the HMO.

When preparing its annual statement, an HMO must determine the amount of both the covered and uncovered liabilities and report such amounts in the columns provided in the annual statement blank. The instructions to the annual statement also provide that the HMO describe in the notes to the financial statements the manner in which each liability reported as covered has been covered, i.e., hold harmless agreement, parental guarantee, etc.

Accrued and Unpaid Claims

The establishment and maintenance of adequate reserves is essential to the successful management of an HMO. Claim reserving techniques must be sufficient to project the amount of claims outstanding at the end of each financial reporting period. The amount reported should include provisions for claims that are known and pending as well as for claims incurred but not reported (IBNR).

The statutory annual statement blank contains a schedule for reporting the various parts of the unpaid claim liability. This is titled Schedule F, “Unpaid Claim Analysis.” The Unpaid Claim Analysis consists of two parts. Section 1 is used to report unpaid claims for the current year by line of business. For purposes of completing this report, claims are classified into four distinct types:

- Inpatient Claims
- Physician Claims
- Referral Claims
- Other Medical Claims

The information contained in Section 2 of Schedule F provides for an analysis of the claims unpaid for the prior year as reported on the previous year’s annual statement. The purpose for including this section is to measure the adequacy of the claim reserves established in the prior year’s annual statement by comparing the actual amount paid in the current year against the reserves that were previously established.

In Section 1 of Schedule F, column 2 is used to report the aggregate amount of claims in process of adjustment by classification; column 3 is used to report the estimated liability by classification for claims incurred but unreported (IBNR). The aggregate total of claims in the process of adjustment and the provision of IBNR claims is shown in column 4.

Before delving further into a discussion on developing incurred but not reported reserving techniques, it is important to review lines of business and determine what should be reported in each line. The following schedule reflects the various lines of business and indicates the nature of claim cost that should be reported under each line:

LINE OF BUSINESS

NATURE OF CLAIM COST

Inpatient Claims

Inpatient hospital costs of routine and ancillary services for HMO members while confined to an acute care hospital. Does not include out-of-area hospitalization.

Routine hospital service includes regular room and board (including intensive care units, coronary care units, and other special inpatient hospital units), dietary and nursing services, medical surgical supplies, medical social services, and the use of certain equipment and facilities for which the provider does not customarily make a separate charge.

Ancillary services may also include laboratory, radiology, drugs, delivery room and physical therapy services. Ancillary services may also include other special items and services for which charges are customarily made in addition to a routine service charge. Charges for non-HMO physician services provided in a hospital are included in this line item only if included as an undefined portion of charges by a hospital to the HMO. (If separately itemized or billed, physician charges should be included in referrals, above.) Include the cost of utilizing skilled nursing and intermediate care facilities.

Skilled nursing facilities are primarily engaged in providing skilled nursing care and related services for patients who require medical or nursing care of rehabilitation service. Intermediate care facilities are for individuals who do not require the degree of care and treatment which a hospital or skilled nursing care facility provides, but do require care and services above the level of room and board.

Physician Services Expenses for physician services provided under contractual arrangement to the HMO including the following:

LINE OF BUSINESS NATURE OF CLAIM COST

– Salaries, including fringe benefits, paid to physician for delivery of medical services;

– Capitated payments paid by the HMO to physicians for delivery of medical services to HMO subscribers;

– Fees paid by the HMO to physicians for delivery of medical services to HMO subscribers. This includes capitated referrals; (Do not include expenses for medical personnel time devoted to administrative tasks.)

Compensation, including fringe benefits, paid by the HMO to non-physician providers engaged in the delivery of medical services and to personnel engaged in activities in direct support of medical services. This includes dentists, psychologists, optometrists, podiatrists, externs, nurses, clinical personnel such as ambulance drivers, technicians, paraprofessionals, janitors, quality assurance analysts, administrative supervisors, secretaries to medical personnel, and medical clerks.

Referrals Expenses for providers not under HMO arrangements such as consultations.

Other Medical Costs directly associated with the delivery of medical services under HMO arrangements which are not appropriately assignable to the medical expense categories defined above; e.g., costs of medical supplies, medical administration expense (except compensation), malpractice insurance, etc.

Expenses for other non-contracted health delivery services including emergency room costs incurred by HMO members for which the HMO is responsible on a fee-for-service basis; and out-of-area service costs for emergency physician and hospital.

Another important aspect in reporting claim liabilities is to include only liabilities relating to actual amounts due providers or enrollees for health care services. Items consisting of withholds or the provision for withholds should be reported as a separate liability in the annual statement. Further, claims payable or claims incurred but not reported (IBNR) are not to be adjusted for amounts receivable from other HMOs or indemnity carriers such as coordination of benefits or subrogation. Such receivables are to be reported as an income item in the period received.

Determining IBNR Claims

There are a number of methods used to develop IBNR reserves. Two of the most common are the lag system which is based on the assumption that a majority of claims to be incurred will be reported within a given number of months after the statement date. Under this method, an HMO bases its reserve on an estimate of the reported claims within a specific time following the statement and it includes an amount for claims reported after the “lag” period. A second method bases claims on the development of prior years IBNR results and adjusts this amount for any increase or decrease in business and for the impact of inflation.

Regardless of the method used to develop IBNR claims, the method used should be tested through a retrospective analysis of claims for past periods.

Accrued Medical Incentive Pool

This amount represents the accrual for withholds from IPAs or are a “risk bonus” in capitate medical groups or other such arrangement in which the HMO may return incentive funds to providers. This liability shall not include percentage withholding from providers which should be reported separately. The amount due should be supported by signed agreements and the basis for establishing the liability should be documented when determining the amount of this liability.

AMOUNTS WITHHELD FOR RISK-SHARING

These amounts are also included in amounts withheld from providers, generally in a capitated fee arrangement, requiring the provider to share the risk in the event of adverse claim costs. These amounts are held pursuant to a written arrangement which outlines the circumstances under which the so-called gain or loss on the capitated arrangement has been determined. The amounts reported may carry over from one period to another and it may be difficult to determine. HMOs should maintain data to support the amounts withheld on an annual basis, as well as information to support all disbursements.

26. The minutes of the June 6, 1995 meeting of the Accounting Practices and Procedures (EX4) Task Force indicate the Task Force has adopted changes to Chapter 11, Loss Adjustment Expenses and Chapter 17, Loss Adjustment Expenses Incurred of the P&C Accounting Practices and Procedures Manual to be effective for calendar years beginning January 1, 1997 (later revised to January 1, 1998). The revised chapters are presented below:

CHAPTER 11

LOSS ADJUSTMENT EXPENSES

Every property/casualty insurer is required to maintain reserves in an amount estimated to provide for the expenses of adjustment or settlement of all losses or claims incurred on or prior to the date of statement, whether reported or unreported, which are unpaid as of such date and for which the insurer may be liable. The loss adjustment expense reserve maintained should be established at an amount which is irrespective of any payments made to third-party administrators, management companies, managing general agents, or other entities not specifically covered by a contract of insurance.

Loss adjustment expenses are categorized as “allocated” or “unallocated.” Separate data is shown relative to payments of these expenses and separate reserves are required to be stated for each component within Schedule P of the Annual Statement blank. Relative to allocated loss adjustment expenses, separate reserve provisions are required to be shown for known case reserves and incurred but not reported reserves, and for each of the segments, there is a further requirement to show reserves for direct plus assumed business as well as the ceded portion of those reserves. The actuarial techniques existent for determining the reserves required for each of these components are more precise relative to the allocated expenses because the payments and reserves history are more precisely apportioned to loss years and are thus more homogeneous. Unallocated loss adjustment expenses paid, apportioned to loss year based on formula, are less likely to present data with the same measure of homogeneity.

Allocated loss adjustment expenses can be identified with a particular claim and thus can be linked to the particular loss year underlying such claim. (Note: relative to claims-made type policies, claims are distributed on the basis of report year, i.e., the year a loss is reported to the insurer rather than the year in which the claim was incurred).

See Chapter 17 - Loss and Loss Adjustment Expenses Incurred for a description of the component parts of "Allocated Loss Adjustment Expenses."

The reserve for unallocated loss adjustment expenses should be apportioned to loss year. This apportionment may be based on a formula or formulas containing such items as claim counts or paid to paid patterns that reflect experience for the company and the line of business.

In circumstances involving reinsurance where the definition of allocated loss adjustment expense contained in the contract is consistent with the definition in Chapter 17, it is expected that there would be symmetry of annual statement presentation. In certain instances, where reinsurance contracts define expenses to be covered thereunder differently than the definition of allocated loss adjustment expenses in Chapter 17, there may be a difference in the classification of these expenses between the ceding and assuming parties.

In reviewing the adequacy of an insurer's loss adjustment expense reserves, it is important to group same homogeneously for proper analysis. This may require additional groupings other than the allocated and unallocated categories presented in the financial statements. Also of critical importance, is an evaluation of the company's claims handling procedures over time to discern changes in methods of claims handling, e.g., switching from outside counsel to in-house attorneys.

Frequently, the categories of loss adjustment expense are analyzed by reference to arrays of data by line of insurance that related such expenses to other parameters, such as paid losses, incurred losses or earned premiums. Accordingly, the examination of loss adjustment expense reserve requires some or all of the following procedures:

1. Evaluation of prior developments of reserves;

2. Evaluation of known case reserve adequacy patterns;

3. Evaluation of timing patterns of expense payments in terms of how billings are made as well as the philosophy of claims handling;

4. Notation of any material end-of period transactions which might distort analysis, e.g., major claim settlements;

5. Evaluation of premiums earning procedures or changes which might reflect new forms of policy issuance such as the issuance of cash-flow type policies.

Evaluation of the reasonableness of loss adjustment expense reserves involves many of the same skills that are needed to evaluate the reasonableness of loss reserves. The most typical utilized data arrays for allocated loss adjustment expenses usually present cumulative payments therefore, either separately or in relationship to cumulative loss payments. Ultimate payments or ratios are then calculated and current reserves are computed either by subtracting payments to date from projected ultimate payments or by applying the ultimate ratio to projected ultimate losses and then subtracting allocated loss adjustment expense paid to date.

Relative to unallocated loss adjustment expenses, a common method is to relate such cumulative payments by loss year to a common base, usually earned premium. Ultimate ratios of unallocated loss adjustment expenses to earned premiums are calculated. These ultimate ratios are then multiplied by the related calendar years' earned premiums with cumulative payments to date subtracted to arrive at the required reserves. The use of earned premiums as a base allows for reasonableness tests for a particular insurer as between years as well as amongst insurers, and is rooted in earned premiums being representative of exposures. This has its limitations in that the amount of such earned premiums is not adjusted for premium adequacy level changes and premium adequacy levels may be inconsistent. (Note: if premium adequacy/inadequacy levels are consistent, the use of earned premiums as base or benchmark will not necessarily result in distorted conclusions). In other words, doubled earned premium volume could mean doubled policy exposure and therefore doubled claims adjusting overhead, doubled premium adequacy with not concomitant claims adjusting overhead increase or somewhere in-between.

CHAPTER 17

LOSS AND LOSS ADJUSTMENT EXPENSES INCURRED

Losses Incurred

Losses incurred are reported in the Underwriting and Investment exhibits of the annual statement. Losses incurred are shown in a separate exhibit in the annual statement by adding the current year change in unpaid losses to the paid loss amount for the current year. The paid figure is direct paid losses, plus assumed paid losses, less ceded paid losses. Unpaid loss changes are also calculated on a basis net of reinsurance.

Loss Adjustment Expenses Incurred

Loss adjustment expenses incurred as presented in the annual statement comprise all expenses incurred in connection with the adjustment and recording of policy claims.

They include the total of the expense classification "Claim Adjustment Services" and the types of expenses incurred by company employees in connection with the adjustment and recording of claims. Examples of expenses incurred in these activities are estimating the amounts of claims, disbursing claims, maintaining records, general clerical, secretarial, office maintenance, supervisory and executive duties, supplies, and postage.

Loss adjustment expenses are either "allocated" or "unallocated." Allocated expenses are those that can usually be related to specific claims. Typically they are "Claim Adjustment Services" as modified to include defense, litigation and medical cost containment expenses, whether internal or external, including overhead, and to exclude fees and expenses of all adjusters and settling agents.

Allocated loss adjustment expenses are adjusted for reinsurance assumed and ceded in accordance with the terms of applicable reinsurance contracts. In addition, an assuming reinsurer may incur expenses in its adjustment of reinsured losses. Such expenses for "Claim Adjustment Services" modified as described above are also to be treated by the reinsurer as allocated expenses.

Unallocated expenses are those expenses other than allocated expenses as defined above assigned to the expense group "Loss Adjustment Expense."

For further information on allocation of expenses, see Chapter 19 - Expenses.

Uninsured Accident and Health Plans

See Chapter 14 - Premiums for the discussion of uninsured accident and health plans and partially insured accident and health plans.

Loss paid by the insurer under uninsured accident and health plans should not be reported in the underwriting and investment exhibits. Loss payments under the insured portion of partially insured plans are reported as accident and health losses.

27. The Minutes of the September 23, 1997 meeting of the Casualty Actuarial (Technical) Task Force contain the following:

Casualty Actuarial (Technical) Task Force
Clarification of Revised ALAE Definition

INTRODUCTION

> The Casualty Actuarial (Technical) Task Force (CATF) has extensively studied the issue of financial reporting inconsistencies that occur because of the different business procedures applied by insurers to settle claims. To increase the consistency of reporting between insurers, the task force recommended to the NAIC's Accounting Practices and Procedures (EX4) Task Force that a revised ALAE definition be adopted. The change was adopted by the Accounting Practices and Procedures (EX4) Task Force to be effective Jan. 1, 1998. The rule will be moved to the Annual Statement Instructions as it is deemed to be more of a financial reporting issue than an accounting guidance issue. The task force intends that the revised definition change the emphasis from assignment of claim expenses based on whether they could be specifically assigned to a single claim to a process where "Claim Adjustment Services" including defense, litigation and medical cost containment are assigned to the bucket or hopper currently known as "allocated loss adjustment expenses—ALAE" and remaining expenses associated with adjusting and recording policy claims are assigned to a bucket or hopper currently known as "unallocated loss adjustment expenses—ULAE." The titles containing the terms "allocated" and "unallocated" seem to be causing difficulties for those attempting to understand the revised definition because they associate the term "allocated" with assignment or tying the expenses to a specific claim. As a result, the CATF intends to pursue a future Blanks Proposal to change the titles. The ability of an insurer to assign a particular type of expense to a single claim is no longer the determining factor as to whether the claim expenses will deemed to be ALAE or ULAE. The goal of the task force in suggesting the change is to have consistent reporting of expenses related to defense, litigation and medical cost containment among the various companies. Thus whether a company uses its own employees or hires outside firms no longer matters.
>
> THE REVISED RULE
>
> The Annual Statement Instructions are amended (effective 1/1/98) to include a specific delineation between allocated and unallocated loss adjustment expenses, which states:
>
> Allocated loss adjustment expenses include defense, litigation and medical cost containment expenses, whether internal or external. Allocated loss adjustment expenses include the following items:
>
> i. Surveillance expenses;
> ii. Fixed amounts for medical cost containment expenses;
> iii. Litigation management expenses;
> iv. Loss adjustment expenses for participation in voluntary and involuntary market pools if reported by accident year;
> v. Fees or salaries for appraisers, private investigators, hearing representatives, reinspectors and fraud investigators, if working in defense of a claim, and fees or salaries for rehabilitation nurses, if such cost is not included in losses;
> vi. Attorney fees incurred owing to a duty to defend, even when other coverage does not exist; and
> vii. The cost of engaging experts.
>
> The foregoing list is not intended to be all inclusive.
>
> Unallocated loss adjustment expenses are those expenses other than allocated expenses as defined above assigned to the expense group "Loss Adjustment Expense." Unallocated loss adjustment expenses include the following items:

i. Fees of adjusters and settling agents;
ii. Loss adjustment expenses for participation in voluntary and involuntary market pools if reported by calendar year;
iii. Attorney fees incurred in the determination of coverage, including litigation between the insurer and the policyholder; and
iv. Fees or salaries for appraisers, private investigators, hearing representatives, reinspectors and fraud investigators, if working in the capacity of an adjuster.

The foregoing list is not intended to be all inclusive.

GUIDANCE IN ASSIGNING CLAIM ADJUSTMENT EXPENSES

The Casualty Actuarial (Technical) Task Force has been asked to provide additional guidance to clarify how various expenses should be classified once this change is implemented. As a result, several questions have been raised about the classification of Loss Adjustment Expenses. The questions and suggested answers follow:

1. Should surveillance expense be classified as ALAE, consistent with the NCCI's classification?

Answer: Yes, even though an apportionment among the claims may be required.

2. Please confirm that litigation management expenses, i.e., costs incurred to conduct audits of outside legal bills for cost containment expenses, should be classified as ALAE.

Answer: Yes, even though an apportionment among the claims may be required.

3. Should fixed amounts for medical cost containment expenses, such as medical bill review, that are not identified to specific claims be classified as ALAE or ULAE?

Answer: ALAE, even though an apportionment among the claims may be required. Note: medical cost containment expenses could be included in losses.

4. Certain voluntary and involuntary market pools (USAIG, MAELU, and JUAs) do not provide a split of LAE. How should they be treated?

Answer: ALAE if reported by accident year; ULAE if reported by calendar year.

5. What is the definition of an adjuster? Does it include appraisers, rehabilitation nurses, private investigators, hearing representatives, reinspectors or fraud investigators?

Answer: Any of the above are ALAE if they are working in defense of a claim. Any of the above are ULAE if they are working in the capacity as an adjuster, except for rehabilitation nurse expenses, which are ALAE. **Note:** rehabilitation nurse expenses could be included in losses.

6. If an attorney engages in adjustment activities, should the attorney's expense be classified as ULAE?

Answer: Yes

7. Do attorney expenses include expenses incurred in securing an opinion regarding matters of coverage, to defend denials of coverage or to evaluate issues of coverage?

Answer: Expenses incurred in the determination of coverage, including litigation between the insurer and the policyholder, are ULAE. Defense expenses incurred owing to a duty to defend, even when other coverage does not exist, are ALAE.

8. Are experts' expenses (doctors, engineers, architects, etc.) ALAE or ULAE? How about outside appraisers? These expenses do not fall neatly into the defense, litigation, medical cost containment or adjuster categories.

Answer: (a) the costs of experts are either ALAE or included in losses. (b) the costs of outside appraisers are ULAE unless the appraiser is working in defense of a claim in which case the costs are ALAE.

9. Does legal overhead for a subsidiary with its own law department (for example, charges passed down to a subsidiary from a corporate law department) become ALAE? If so, at what level must this data be captured (company, claim, product, coverage, etc.)? What is the meaning of overhead? Would it pertain to salaries/benefits etc. of staff associated with the above activities?

Answer: (a) ALAE. The fees charged should include overhead, just like an outside firm charges. Overhead should include the proportionate cost of floor space and associated staff salaries in the same manner as an outside law firm .(b) the level of detail should be enough to prepare Schedule P.

10. NAIC defines ALAE as expenses that can be related to specific claims. Why would Claims Adjuster expenses (e.g., Travel to a specific claim site, etc.) which can be related to a specific claim be excluded?

Answer: The first sentence in this question is inaccurate. The apportionment of claims expenses is not dependent on whether the expenses can be related to specific claims. Claims adjuster expenses are ULAE.

11. What is the NAIC's definition of "defense expense"?

Answer: Defense expense includes all expenses to defend claims, excluding adjuster expenses.

ADDITIONAL COMMENTS

a) There is no special concern about any potential tax problems, but there could be slight tax effects.

b) This new definition of ALAE/ULAE is not retroactive. However, prospectively the change could be implemented on a calendar year or an accident year basis. On a calendar year basis, the expenses in the new and older accident years have the new definition as they develop in the loss and expense triangles. On an accident year basis, the expenses in the new accident years have the new definition and the expenses in the older accident years have the old definition. It is optional to the company which way to do it. There is a split among companies as to which is easier. The actuary should be able to handle either way as long as it is known which choice was made. This information should be disclosed in Interrogatory 8 of Schedule P.

c) The old 45/5 rule for reporting ULAE payments was repealed by a CATF Blanks proposal which was adopted and effective with the 1997 Blank. Insurers should now apportion ULAE payments and reserves by year based on claim counts. For instance, the old rule was based mostly on the theory that 50% of the calendar year ULAE should be assigned to the year in which the claim file was opened (the current year) and 50% to the year in which it was closed. An insurer could now base the apportionment of payments and reserves by the number of claims outstanding, the number of claims reported, etc., or any relationship which seems appropriate. The ALAE payments and reserves are assigned to the accident year of the claim. When ALAE payments and reserves are apportioned, they should be apportioned based on dollars, not claim counts.

d) The task force will also consider a proposal to rename ALAE and ULAE.

28. The Minutes of the June 21, 1993, Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force provide the following with respect to non-renewable accident and health contracts:

> The consensus of the working group was that the presence of non-renewal provisions or expense incurred provisions in accident and health policies does not eliminate the requirement to establish sufficient reserves at a financial statement date to cover the estimated duration of an incurred illness under this type of policy.

29. The Minutes of the June 23, 1998, meeting of the Casualty Actuarial (Technical) Task Force contain the following:

> 1. Discuss Issues Related to the Implementation of the Definition of ALAE/ULAE
>
> Richard J. Roth, Jr. (Calif.) reported that inquiries related to the Jan. 1, 1998 implementation of a definition of allocated loss adjustment expenses (ALAE) and unallocated loss adjustment expenses (ULAE) had dropped off dramatically. He believed that the definition was achieving its intended goal to provide more uniform reporting of information in Schedule P. He believed that regulatory actuaries would benefit from obtaining data that more closely matches expenses between insurers.
>
> Elise Liebers (N.Y.) reported that she and Judy Pool (Ill.) had volunteered to address the various names selected to replace the terms "ALAE" and "ULAE" to coincide with the new definition. She advised that they had considered several proposals. A proposal by James F. Golz (Wausau) suggested ALAE be renamed *Special Claim Adjustment Expense (SCAE)* and that ULAE be renamed *General Claim Adjustment Expense (GCAE)*. A proposal by Mr. Roth suggested that ALAE be renamed *Defense and Cost Containment (DCC)* and that ULAE be renamed *Adjusting and Other (AO)*. Ms. Liebers added that an informal contest was also held to select a name. Ms. Liebers advised that she and Ms. Pool preferred the Golz proposal with a minor amendment. They proposed that ALAE be renamed *Special Claim Expense (SCE)* and that ULAE be renamed *General Claim Adjustment Expense (GCAE)*. They believed that "adjustment" in SACE would be confusing.
>
> Mr. Roth advised that a name would need to be selected at the meeting, as related Blanks proposals would need to be prepared. He asked each task force members to declare their preference. Upon motion by Clark Simcock (D.C.) and second by R. Michael Lamb (Ore.), the task force, by voice vote decided to rename ALAE and ULAE as *Defense and Cost Containment (DCC)* and *Adjusting and Other (AO)* respectively.
>
> Joe Pomilia (National Association of Independent Insurers—NAII) noted that there remained several places in the Blank where the term *loss adjustment expense* was used. He added that this could be confusing to insurers as they report information to the states and the NAIC. Mr. Roth advised that the new terms were a division of *loss adjustment expense* and as such should not be confusing.
>
> Mr. Roth noted that the information packet prepared for the task force contained two draft letters responding to the questions about the appropriate assignment of certain items to ULAE and ALAE. He asked if the task force agreed with the proposed responses. There were no changes suggested so Mr. Roth directed NAIC staff to distribute the letters (Attachments One through Four).

Generally Accepted Accounting Principles

30. FAS 60 provides the following guidance:

> Claim Cost Recognition
>
> 17. A liability for unpaid claim costs relating to insurance contracts other than title insurance contracts, including estimates of costs relating to incurred but not reported claims, shall be accrued when insured events occur. A liability for estimated claim costs relating to title insurance contracts including estimates of costs relating to incurred but not reported claims, shall be accrued when title insurance premiums are recognized as revenue (paragraphs 15 and 16).
>
> 18. The liability for unpaid claims shall be based on the estimated ultimate cost of settling the claims (including the effects of inflation and other societal and economic factors), using past experience adjusted for current trends, and any other factors that would modify past experience.[4] Changes in estimates of claim costs resulting from the continuous review process and differences between estimates and payments for claims shall be recognized in income of the period in which the estimates are changed or payments are made. Estimated recoveries on unsettled claims, such as salvage, subrogation, or a potential ownership interest in real estate, shall be evaluated in terms of their estimated realizable value and deducted from the liability for unpaid claims. Estimated recoveries on settled claims other than mortgage guaranty and title insurance claims also shall be deducted from the liability for unpaid claims.
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>
> [4] Certain disclosures are required if the time value of money is considered in estimating liabilities for unpaid claims and claim adjustment expenses relating to short-duration contracts (paragraph 60.d.).
>
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>
> 20. A liability for all costs expected to be incurred in connection with the settlement of unpaid claims (claim adjustment expenses) shall be accrued when the related liability for unpaid claims is accrued. Claim adjustment expenses include costs associated directly with specific claims paid or in the process of settlement, such as legal and adjusters' fees. Claim adjustment expenses also include other costs that cannot be associated with specific claims but are related to claims paid or in the process of settlement, such as internal costs of the claims function.[5]
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>
> [5] Title insurance internal claim adjustment expenses, which generally consist of fixed costs associated with a permanent staff handling a variety of functions including claim adjustment, ordinarily are expensed as period costs because the costs are insignificant.
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31. The *AICPA Audit and Accounting Guide: Property & Casualty Insurance Companies* (AICPA P&C Audit and Accounting Guide) provides the following guidance:

> **Loss Reserves**
>
> 8.17 Both SAP and GAAP require that insurance companies report a provision for all incurred losses that are unpaid as of the balance sheet date, including losses incurred but not reported. The liability is based on management’s estimate of the ultimate cost of settling each loss. The statutes of many states, however, require minimum reserves for certain lines, called excess Schedule P reserves, primarily bodily injury liability and workers’ compensation. The minimum reserves are based on the company’s actual loss ratio in the five years immediately preceding the most recent three years. The lowest ratios for these years, with a stipulated minimum ratio of 60 percent (65 percent for workers’ compensation) and a maximum ratio of 75 percent, are used. The determined ratio is applied to earned premium for each of the three most recent calendar years. The minimum reserves are then compared with the estimated liabilities for each of the three years, and any excess of the minimum over the estimates is reported as a separate liability in the statements prepared under SAP. Any changes in the excess reserves are reported as charges or credits directly to surplus. When financial statements are prepared in accordance with GAAP, the entries are reversed, and the excess reserves are restored to retained earnings.

32. *AICPA Statement of Position 92-4, Auditing Insurance Entities' Loss Reserves* provides the following guidance:

> **Estimating Methods**
> 2.8 Various analytical techniques exist to assist management, consulting actuaries, and independent auditors in estimating and evaluating the reasonableness of loss reserves. These techniques generally consist of statistical analyses of historical experience and are commonly referred to as loss reserve projections.
>
> 2.13 Loss reserve projections can be performed using a variety of mathematical approaches ranging from simple arithmetic projections using loss development factors to complex statistical models.
>
> 2.14 Within each of these methods, there are a variety of techniques and loss data that may be used; there are also methods that combine features of these basic methods. No single projection method is inherently better than any other in all circumstances.
>
> **Loss Reserve Ranges**
> 4.15 Because the ultimate settlement of claims is subject to future events, no single loss reserve estimate can be considered accurate with certainty. An audit approach should address the inherent variability of loss reserve estimates and the effect of that variability on audit risk. The development of a single loss reserve projection, by itself, does not address the concept of variability and may not provide sufficient evidence to evaluate the reasonableness of the loss reserve provision in the financial statements. An analysis of the reasonableness of loss reserves should include and analysis of the amount of variability in the estimate. One way to perform this analysis is to consider a range of loss reserve estimates bounded by a high and a low estimate. The high and low ends of the range should not correspond to an absolute best-and-worst case scenario of ultimate loss settlements, because such estimates may be the result of unlikely assumptions. The range should be realistic and therefore should not include the set of all possible outcomes but instead only those outcomes that are considered reasonable. Extreme projections should be critically analyzed and, if appropriate, be adjusted, given less credence, or discarded (this would apply to projections outside a cluster of other logical projections that fall within a narrower range).

33. *AICPA Statement of Position 94-5, Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises* (SOP 94-5) provides the following guidance:

> 10. Financial statements should disclose for each fiscal year for which an income statement is presented the following information about the liability for unpaid claims and claim adjustment expenses:
>
> a. The balance in the liability for unpaid claims and claim adjustment expenses at the beginning and end of each fiscal year presented, and the related amount of reinsurance recoverable
>
> b. Incurred claims and claim adjustment expenses with separate disclosure of the provision for insured events of the current fiscal year and of increases or decreases in the provision for insured events of prior fiscal years
>
> c. Payments of claims and claim adjustment expenses with separate disclosure of payments of claims and claim adjustment expenses attributable to insured events of the current fiscal year and to insured events of prior fiscal years
>
> Also, insurance enterprises should discuss the reasons for the change in the provision for incurred claims and claim adjustment expenses attributable to insured events of prior fiscal years and should indicate whether additional premiums or return premiums have been accrued as a result of the prior-year effects.

34. The *AICPA Audit and Accounting Guide: Health Care Organizations* provides the following guidance:

> Accounting for Health Care Costs
>
> 13.02 Health care costs should be accrued as services are rendered, including estimates of the costs of services rendered but not yet reported. Furthermore, if a provider of prepaid health care services is obligated to render services to specific members beyond the premium period due to provisions in the contract or regulatory requirements, the costs of such services to be incurred, net of any related anticipated revenues, also should be accrued currently. Costs that will be incurred after a contract is terminated, such as guaranteed salaries, rent, and depreciation, net of any anticipated revenues, should be accrued when it is determined that a contract with a sponsoring employer or other group will be terminated.
>
> 13.03 Amounts payable to hospitals, physicians, or other health care providers under risk-retention, bonus, or similar programs should be accrued during the contract period based on relevant factors, such as experience to date.
>
> 13.04 The basis for accruing health care costs and significant business and contractual arrangements with hospitals, physicians, or other associated entities should be disclosed in the notes to the financial statements.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life, Accident, and Health Insurance Companies, Chapter 11, Unpaid Life Insurance Claims, and Chapter 14, Accident and Health Claims
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 10, Losses, and Chapter 11, Loss Adjustment Expenses
- Accounting Practices and Procedures Manual for Health Maintenance Organizations, Chapter 8, Liabilities
- *Issue Paper No. 3—Accounting Changes*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 50—Classifications and Definitions of Insurance or Managed Care Contracts In Force*
- *Issue Paper No. 54—Individual and Group Accident and Health Contracts*
- Minutes of the June 6, 1995, Accounting Practices and Procedures (EX4) Task Force
- Minutes of the June 21, 1993, Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force
- Minutes of the September 23, 1997, meeting of the Casualty Actuarial (Technical) Task Force
- Minutes of the June 23, 1998, meeting of the Casualty Actuarial (Technical) Task Force

Generally Accepted Accounting Principles

- *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises*
- *AICPA Statement of Position 92-4, Auditing Insurance Entities' Loss Reserves*
- *AICPA Audit and Accounting Guide: Property & Casualty Insurance Companies*
- *AICPA Audit and Accounting Guide: Health Care Organizations*
- *AICPA Statement of Position 94-5, Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises*

State Regulations

- No further guidance obtained from state statutes or regulations

Other Sources of Information

- Casualty Actuarial Society, *Statement of Principles Regarding Property and Casualty Loss and Loss Adjustment Expense Reserves* (Also published as Appendix 2 to *Actuarial Standard of Practice No. 9, Actuarial Standards Board)*

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Statutory Issue Paper No. 56

Universal Life-Type Contracts, Policyholder Dividends, and Coupons

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 51

Type of Issue:
Life Specific

SUMMARY OF ISSUE

1. Current statutory accounting guidance for universal life-type contracts, policyholder dividends, and coupons is addressed in Chapter 10, Aggregate Reserves for Life and Annuity Contracts, Chapter 15, Liabilities Related to Policyholder Dividends, Chapter 18, Premium Income, and Chapter 20, Policy and Contract Benefits, of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies (Life/A&H Accounting Practices and Procedures Manual). General reserve requirements and accounting for life contracts has been established in *Issue Paper No. 50—Classifications and Definitions of Insurance or Managed Care Contracts In Force* (Issue Paper No. 50) and *Issue Paper No. 51—Life Contracts* (Issue Paper No. 51). Current SAP requires liabilities for dividends on participating policies to be established for dividends due and unpaid, dividends apportioned (or not yet apportioned) for payment in the following calendar year, and dividends left on deposit to accumulate at interest. Unmatured policyholder coupons are recorded at the present value of the unmatured coupons, discounted at interest and mortality.

2. GAAP guidance for universal life-type contracts and coupons requires policy reserves or liabilities to be established using the balance that accrues to the benefit of the policyholder and requires all dividends to be accrued based on the results to date, regardless of when due or payable.

3. The purpose of this issue paper is to provide additional guidance on certain unique features and characteristics relating to universal life-type contracts, policyholder dividends, and coupons consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. This issue paper applies to all universal life-type contracts described in Issue Paper No. 50, all participating contracts, and to all life insurance contracts with coupons. It applies the basic reserving principles relating to life contracts as established in Issue Paper No. 51, prescribes additional accounting requirements regarding unique features of universal life-type contracts, as well as accounting requirements for dividends on participating policies and coupons on life policies.

5. Universal life-type contracts include, among others, flexible premium universal life and fixed premium universal life contracts. Participating contracts include any contract where policyholders are entitled to policy dividends.

6. Premium recognition for fixed premium universal life-type contracts shall be consistent with the accounting requirements of Issue Paper No. 51. Premium on flexible premium universal life-type contracts shall be recorded when received from the policyholder.

Flexible Premium Universal Life-Type Contracts

7. Policy reserves are generally established as the excess of the present value of future benefits to be paid to or on behalf of policyholders less the present value of future net premiums. Unlike traditional life insurance contracts, flexible premium universal life-type contracts do not have guaranteed premiums and some assumption as to future premiums is required. Appendix A-585 establishes a minimum reserving method for universal life-type contracts by providing guidance on how to estimate future premiums on flexible premium universal life-type contracts so that traditional valuation methodologies could be used. Alternative minimum reserves shall be required, if applicable, for flexible premium universal life-type contracts if the guaranteed maturity premium is less than the valuation net premium. Appendix A-585 shall be used in establishing reserves for flexible premium universal life-type contracts.

Fixed Premium Universal Life-Type Contracts

8. Policy reserves are generally established as the excess of the present value of future benefits to be paid to or on behalf of policyholders less the present value of future net premiums. Fixed premium universal life-type contracts shall also follow the guidance in Appendix A-585. Certain fixed premium products offer the policyholder a secondary guarantee. A secondary guarantee provides the policyholder a guaranteed set of cash values, death benefits, and maturity benefits that will be provided regardless of the performance of the policy value. Appendix A-585 requires secondary guarantees to be considered when establishing policy reserves and shall be followed in establishing reserves for fixed premium universal life-type contracts.

Policyholder Dividend Liability

9. A reporting entity shall accrue, as applicable, the following items relating to participating policies. They are dividends due and unpaid, dividends apportioned (or not yet apportioned) for payment in the following twelve months, and dividends left on deposit to accumulate at interest.

10. Dividends due and unpaid represent dividends payable to the policyholder in the current year but which have not been disbursed or otherwise applied at the reporting date.

11. Dividends payable in the following calendar year represent the estimated amount of all dividends declared by a reporting entity’s board of directors prior to the end of the statement year which are not yet paid or due at the end of the year (dividends apportioned for payment) as well as all dividends payable in the following calendar year that have not been declared (dividends not yet apportioned for payment). For individual insurance the amount of this liability shall be equal to the aggregate amount of the dividends estimated to be payable in the following calendar year whether or not declared or apportioned. For group insurance and pensions, the amount of liability is generally equal to the portion of the dividend payable in the following calendar year which has been earned in the current calendar year.

12. Dividends left on deposit with the reporting entity shall be recorded in the amount of the deposit and accrued interest thereon. At the balance sheet date, the interest accrued but not yet credited to the policyholders’ accounts, shall be established as part of this liability.

Coupons

13. Some entities issue policies that guarantee an annual return, usually evidenced by a coupon that is part of the policy and matures on the policy’s anniversary. This return represents an annual pure endowment, and is essentially a return of premium previously paid by the policyholder. For matured coupons that have been left to accumulate, the liability is determined in the same way as the liability for dividend accumulations. Interest accrued is calculated for each coupon from the date each matures. The liability for unmatured policyholder coupons shall be the face value of the coupon, discounted at interest and mortality.

Disclosures

14. For life and annuity reserves the financial statements shall disclose the following:

  a. A description of reserve practices concerning the following:

    i. Waiver of deduction of deferred fractional premiums upon death of insured;

    ii. Return of portion of final premium for periods beyond the date of death; and

    iii. Amount of any surrender value promised in excess of the reserve as legally computed;

  b. The methods employed in the valuation of substandard policies;

  c. The amount of insurance, if any, for which the gross premiums are less than the net premiums according to the valuation standards;

  d. The method used to determine tabular interest, tabular less actual reserves released, and tabular cost (by formula or from the basic data for such items); and

  e. The nature of significant other reserve changes.

15. Disclose the amount of annuity actuarial reserves and deposit liabilities by withdrawal characteristics as follows:

  a. Subject to discretionary withdrawal:

    i. With market value adjustment, where withdrawal of funds is payable at all times, or prior to specified maturity dates where such dates are more than one year after the statement date and;

      (a) In a lump sum with adjustments to reflect general changes in interest rates, or asset values since receipt of funds by the insurer;

      (b) In installments over five years or more, with or without a reduction in the interest rate during the installment period;

    ii. At book value less current surrender charge, where the withdrawal of funds is payable at all times, or at any time within one year from the statement date in a lump sum subject to a current fixed surrender charge of 5% or more and it does not contain a meaningful bail out rate as described in (v.(d)) below;

    iii. At market value, where the withdrawal of funds is payable at current market value of the assets supporting the liabilities, the assets are stated at current market value, and the liabilities are stated at the current market value or per unit value of the assets supporting the liabilities. These liabilities are for contracts where the customer bears the entire investment risk;

    iv. Total with adjustment or at market value;

v. At book value without adjustment (minimal or no charge or adjustment), where the withdrawal of funds is either payable at all times, or at any time (including a withdrawal on a scheduled payment date) within one year from the statement date and:

(a) In a lump sum without adjustment;

(b) In installments over less than five years, with or without a reduction in interest rate during the installment period;

(c) In a lump sum subject to a fixed surrender charge of less than 5%;

(d) In a lump sum subject to surrender charge, but such charge is waived if the credited rate falls below a specified "bail out" rate and the "bail out" rate is more than the maximum statutory valuation rate for life insurance policies for more than 20 years for new issues;

(e) All others;

b. Not subject to discretionary withdrawal;

c. Total gross;

d. Reinsurance ceded;

e. Total net.

16. If the reporting entity has reported life insurance premiums and annuity considerations deferred and uncollected on policies in force as of the financial statement date, disclose separately the amounts and the loading excluded for each of the following lines of business:

a. Industrial business;

b. Ordinary new business;

c. Ordinary renewal;

d. Credit life;

e. Group life;

f. Group annuity.

17. Disclose the aggregate amount of direct premiums written through managing general agents or third party administrators. For purposes of this disclosure, a managing general agent means the same as in Appendix A-225. If this amount is equal to or greater than 5% of surplus, provide the following information for each managing general agent and third party administrator:

a. Name and address of managing general agent or third party administrator;

b. Federal Employer Identification Number;

c. Whether such person holds an exclusive contract;

d. Types of business written;

e. Type of authority granted (i.e., underwriting, claims payment, etc.);

f. Total premium written.

18. Reporting entities shall disclose the relative percentage of participating insurance, the method of accounting for policyholder dividends, the amount of dividends, and the amount of any additional income allocated to participating policyholders in the financial statements.

DISCUSSION

Statutory Guidance

19. The statutory accounting principles outlined in the conclusion above are consistent with current statutory accounting and Issue Paper No. 51.

Flexible Premium Universal Life-Type Contracts

20. As discussed in Issue Paper No. 51, policy reserves are generally established as the excess of the present value of future benefits to be paid to or on behalf of policyholders less the present value of future net premiums. Traditional life insurance contracts generally provide a guaranteed set of future cash values and death benefits for a stated premium. Flexible and fixed premium universal life contracts typically develop cash surrender values that are based on a retrospective accumulation of premiums less mortality and expense charges, at a rate of interest declared by the reporting entity or based upon an index. Features such as flexible premiums and variable interest contracts are not compatible with the valuation procedures used for traditional contracts.

21. Flexible premium contracts produce a special valuation problem in that some assumption as to future premiums is required. The method of estimating the present value of future benefits to be paid to or on behalf of policyholders less the present value of future net premiums must be modified to apply to a flexible premium universal life-type contract since neither future premiums nor future benefits are known for a particular policy. The Model UL Regulation established a minimum reserving method for universal life-type contracts by providing guidance on how to estimate future premiums and related benefits on flexible universal life-type contracts so that traditional valuation methodologies could be used.

22. The Model UL Regulation provides a method for calculating reserves for flexible premium universal life contracts as the present value of future guaranteed benefits less the present value of valuation net premiums where the present value of valuation net premiums takes into account an expense allowance, multiplied by a ratio. This ratio is determined at each valuation date as the policyholder account balance divided by the Guaranteed Maturity Fund (GMF), the ratio not to exceed 1. The GMF's are an accumulation of Guaranteed Maturity Premiums (GMP) which are level gross premiums that provide for endowment at the latest permissible maturity date under the contract. Alternative minimum reserves shall be required, if applicable, for flexible premium universal life-type contracts if the guaranteed maturity premium is less than the valuation net premium, both as defined in the Model UL Regulation.

Fixed Premium Universal Life-Type Contracts

23. Many reporting entities offer products whose cash values are calculated using universal life-type contract accumulation procedures, but which lack complete flexibility in premium payments. These products follow a similar set of valuation rules set forth in Appendix A-585. However, some of these products also offer the policyholder a secondary guarantee. A secondary guarantee provides the policyholder a guaranteed set of cash values, death benefits, and maturity benefits that will be provided regardless of the performance of the policy value.

24. Reserves for these products under Appendix A-585 are determined by computing the excess of the projected present value of future guaranteed benefits, taking into account secondary guarantees, over the present value of the future valuation net premium guaranteed at issue.

Policyholder Dividend Liability

25. Ordinary life and industrial life policies may be issued either on a participating or a nonparticipating plan. Under participating plans, policyholders are entitled to policy dividends that have been declared by the reporting entity's board of directors. These dividends reflect all or a part of the difference between the premium charged for a given class of policies and the actual cost of these policies as experienced by the reporting entity based on the terms of the contract.

26. On ordinary policies, the policyholder generally may choose one of five ways of receiving or using the dividend. If no choice is made, the policy usually states which option is to be automatically used. Dividends may be either (1) paid in cash, (2) applied as a reduction of the next premium, (3) applied to buy paid-up additional insurance, (4) left on deposit with the reporting entity to accumulate at a guaranteed rate of interest, or (5) applied to purchase one-year term insurance up to the maximum specified in the agreement (generally the policy cash surrender value) with any balance of the dividend being applied under one of the four other options. Other options may also be available.

27. On industrial policies, dividends are usually paid as premium credits (applied to pay renewal premiums) or as paid-up additional insurance, as specified in the policy.

28. Group life may also be issued on a participating or a nonparticipating basis. If the contract is nonparticipating, it may provide for refunds or premium adjustments through a variety of experience rating arrangements. The group contract may state the experience rating formula to be used in the calculation of refund of premium adjustment. See *Issue Paper No. 66—Accounting for Retrospectively Rated Contracts regarding* experience rating refunds.

29. A liability shall be established for the estimated dividends that will be paid on participating policies in the next twelve months, whether declared or not (dividends not yet apportioned for payment), since dividends are generally paid in the next policy year. Ordinary life contract dividends should also include those contingent on the payment of renewal premiums (generally first year dividends).

GAAP Guidance

30. In Issue Paper Nos. 50 and 51, the GAAP guidance (principally, *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises* (FAS 60), *FASB Statement No. 97*, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments* (FAS 97), and *AICPA Statement of Position 95-1*, *Accounting for Certain Activities of Mutual Life Insurance Enterprises* (SOP 95-1)) related to insurance contracts, including universal life-type and participating contracts, was rejected for the reasons set forth therein.

Drafting Notes/Comments

- SAP literature was not excerpted from Chapters 10 and 18 of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies since all such literature is included in Issue Paper 51 which is consistent with this issue paper.
- Issue Paper No. 50 addresses Classifications and Definitions of Insurance Contracts In Force.
- Issue Paper No. 51 addresses Life Contracts.
- Issue Paper No. 52 addresses Deposit-Type Contracts.
- Issue Paper No. 54 addresses Individual and Group Accident and Health Contracts.
- Issue Paper No. 55 addresses Unpaid Claims, Losses and Loss Adjustment Expenses.
- Issue Paper No. 66 addresses Accounting for Retrospectively Rated Contracts.
- Issue Paper No. 74 addresses Life, Deposit-Type and Accident and Health Reinsurance.
- Issue Paper No. 89 addresses Separate Accounts.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE (only pertinent excerpts are included below)

Statutory Accounting

31. The Life/A&H Accounting Practices and Procedures Manual, Chapter 15, Liabilities Related to Policyholder Dividends, provides the following guidance with respect to policyholder dividends:

> A company may have three liabilities for policyholder dividends. They are dividends due and unpaid, dividends apportioned (or not yet apportioned) for payment in the following calendar year, and dividends left on deposit to accumulate at interest. (Some companies may have an additional dividend liability to provide for amounts provisionally held for payment under deferred dividend policies beyond the following calendar year. Deferred dividend policies, generally prohibited or no longer issued, provide for dividends payable at less frequent intervals than annually.)
>
> Dividends Due and Unpaid
>
> These are dividends payable to the policyholder in the statement year but which have not been disbursed or otherwise applied at the balance sheet date. This may happen when the cash dividend has not yet been disbursed or, to a greater extent, when the premium to which the dividend is to be applied has not been collected and the full premium has been recorded as due and uncollected.
>
> Dividends applied to reduce the premium usually are recorded when the premium is collected. Thus, if a premium is due at the balance sheet date, the premium is recorded as uncollected and a liability for the dividend is established. This may not be the case if the company does all of its bookkeeping for due premiums as if the premium had been collected on the due date. If it does, it would have effectively applied all dividends except those payable in cash.
>
> Some companies pay a first policy year dividend conditional on the payment of the second year premium. Treatment would be similar to that of a dividend used to reduce premium payments.
>
> Dividends Payable in the Following Calendar Year
>
> The estimated amount of all dividends declared by a company's board of directors prior to the end of the statement year which are not yet paid or due at the end of the year, must be included under the liability "Dividends apportioned for payment" in the annual statement. Since companies may declare dividends to policyholders based on other than calendar year anniversary dates (i.e., July 1 to July 1), it is occasionally necessary to estimate the amount of dividends which may be ultimately paid. Thus, at December 31 of the current year, dividends payable from January 1 to June 30 of the following year would be reported under "Dividends apportioned for payment" and an estimate of dividends payable from July 1 of the following year to December 31 of the following year would be reported under "Dividends not yet apportioned". In other words, a company must establish a liability for all dividends payable in the following calendar year whether declared or not. In some instances, the board does not declare dividends until after the end of the year at which time the surplus earnings for the statement year will have been determined. The estimated amount of such dividends to be authorized for payment in the calendar year following the statement date must also be included under "Dividends not yet apportioned."
>
> For individual insurance the amount of this liability should be equal to the aggregate amount of the dividends estimated to be payable in the following calendar year whether or not declared or apportioned. Such dividends should include those contingent on the payment of renewal premiums (generally first year dividends).
>
> For group insurance and pensions, the amount of liability is generally equal to the portion of the dividend payable in the following calendar year which has been earned in the current calendar year. For group pensions the dividend year is generally a calendar year.

Dividend Accumulations

If the policyholder elects to leave the dividend on deposit with the company, the company must record an appropriate liability. This liability is for the amount of the deposit and accrued interest thereon. Interest usually is credited annually on the policy anniversary at the rate stated in the policy or at a rate declared by the company if greater than the stated contract or guaranteed rate. At the balance sheet date, the interest accrued but not yet credited to the policyholders' accounts, must be established as part of this liability.

Coupons

Some companies issue policies that guarantee an annual return, usually evidenced by a coupon that is part of the policy and matures on the policy's anniversary. This return represents an annual pure endowment, and is essentially a return of premium previously paid by the policyholder. Some states prohibit or strictly regulate policies with such provisions. To collect the return, in most cases, the policyholder must submit the coupon to the company. If the coupon is not submitted for payment, it should be treated as a deposit (accumulation) and accrue interest at the stated rate.

Coupons may be presented for cash, be used to reduce the premium, or left at interest. If the company permits, a coupon also may be used to purchase paid-up additional insurance.

The liability for unmatured coupons is generally carried as part of the policy reserve or as a separate policy liability. No matter how the liability is presented, it generally is the same as that for a one-year pure endowment policy in the amount of the face value of the coupon.

For matured coupons that have been left to accumulate, the liability is determined in the same way as the liability for dividend accumulations. Interest accrued is calculated for each coupon from the date each matures.

32. The Life/A&H Accounting Practices and Procedures Manual, Chapter 20, Policy and Contract Benefits, provides the following guidance with respect to policy and contract benefits including policyholder dividends:

Other Benefits

Other contract benefits reported in the Summary of Operations are:

1. Coupons, guaranteed annual pure endowments, and similar benefits.

2. Surrender benefits. These are amounts payable on termination of a policy other than by death or maturity. Such surrender benefits, where available, are guaranteed in the policy. The surrender value of additional insurance purchased by application of dividends is included in this item as well as amounts applied to repay any existing policy loan.

3. Interest on policy or contract funds. Included here are incurred interest payments made on deferred benefit payments and interest credited on premium and other deposit funds after deducting the discount allowed on policy proceeds paid in advance. Excluded from this item are interest on supplementary contracts, dividend accumulations and accumulations of coupons, and guaranteed annual pure endowments which do not exceed the annual premium and similar benefits.

4. Payments on supplementary contracts with life contingencies. In addition to the periodic payments incurred this would include the commuted value of any remaining guaranteed payments upon termination of the contract by death or surrender.

5. Payments on supplementary contracts without life contingencies and of dividend accumulations. The commuted value of any remaining payments upon termination of supplementary contracts without life contingencies by death or surrender would also be included.

6. Accumulated coupon payments.

Dividends to Policyholders

Individual life and health insurance policies may be issued either on a participating or a nonparticipating plan. Under the participating plan, policyholders are entitled to policy dividends that have been declared by the company's board of directors. These dividends reflect the difference between the premium charged for a given class of policies and the actual cost of these policies as experienced by the company. Under the nonparticipating plan, policies are written for a premium that is usually lower than the gross premium on participating insurance.

Group life and health insurance pensions also may be issued on a participating or a nonparticipating basis. If the contract is nonparticipating, it may provide for refunds or premium adjustments through a variety of experience rating arrangements. The group contract may state the experience rating formula to be used in the calculation of refund of premium adjustment. If the formula is stated, it will usually provide that the difference of premiums and interest over claims, reduced by applicable contingency reserves and a retention percentage, will be paid to the group contract holder. The retention percentage is based on the amount the company estimated to be necessary for administration costs, contingency reserves, insurance costs (for pooled experience in all similar groups, i.e., to pay some of the claims in other similar groups when these claims exceed the premiums collected for those similar groups), and a margin for profit. If the contract is participating, dividends will be paid in cash to the employer or, on his written request, be used toward the payment of the next premium.

Should dividend adjustments exceed the amounts contributed by an employer in a contributory plan, the excess must be used for the benefit of the employees—refunded to them, used to enable them to skip contributions for a period, or applied to buy additional insurance or benefits.

Dividends distributed to participating policyholders are not profits in a commercial sense; instead; they represent a return of a portion of the gross premium. The portion of the company's earnings before dividends that is not deemed necessary to strengthen surplus or contingency reserves may be distributed among individual policyholders.

The method of calculating dividends is rarely, if ever, stated in the policy. Instead, the policy makes some declaration that, perhaps, may state: "While this policy is in force...the share of the divisible surplus accruing on this policy shall be annually determined by the company and apportioned as a dividend payable on the following policy anniversary. It is not anticipated that a dividend will be payable for at least two years from date of issue." The statutes of various states describe the conditions under which policyholder dividends are to be declared and paid.

Each year the company must determine how much of the total earned surplus (previously existing, plus additions for the year) should be retained as a contingency fund (or as another special surplus appropriation) and how much should be distributed to the policyholders. It is important to note that no fixed relationship may exist between the surplus gain in a particular calendar year and the dividends distributed to the policyholders on the next policy anniversaries. The directors of the company make the decision as a matter of business judgment. The amount earmarked for distribution is designated as divisible surplus and, once set aside by action of the directors, loses its identity as surplus and becomes a liability of the company.

A company having both participating and nonparticipating policies in force usually must make a separate accounting of each class of insurance and include with its annual statement a separate statement of the operations of each class unless an overwhelming proportion of the business in force (90% of more in certain states) is either participating or nonparticipating. Some states limit the amount of surplus attributable to participating policies that may be transferred to the benefit of the stockholders.

Individual life insurance policies that will participate in the operating gains of the company are almost always sold as such. Occasionally, a company may pay a dividend on a nonparticipating policy or convert it to a participating plan. These situations, however, are very unusual.

Dividends are generally payable on the policy anniversary provided all premiums (annual premiums or installments) have been paid up to that date. The first dividend under a policy is usually paid at the end of the second or third policy year. Occasionally, a dividend is paid at the end of the first policy year on the condition that the annual premium for the second year has been collected.

On ordinary policies, the policyholder generally may choose one of five ways of receiving or using the dividend. If no choice is made, the policy usually states which option is to be automatically used. Dividends may be either (1) paid in cash, (2) applied as a reduction of the next premium, (3) applied to buy paid-up additional insurance, (4) left on deposit with the company to accumulate at a guaranteed rate of interest, or (5) applied to purchase one-year term insurance up to the maximum specified in the agreement (generally the policy cash surrender value) with any balance of the dividend being applied under one of the four other options. Other options may also be available.

On industrial policies, dividends are usually paid as premium credits (applied to pay renewal premiums) or as paid-up additional insurance, as specified in the policy.

Dividends to the policyholders incurred during the period represent the dividends paid or credited, adjusted to include the liabilities at the statement date for dividends due and unpaid, less the corresponding liabilities outstanding at the end of the previous period.

Generally Accepted Accounting Principles

33. FAS 60 provides the following guidance related to policyholder dividends (other relevant sections of FAS 60 have been excerpted in Issue Paper No. 51):

Policyholder Dividends

41. Policyholder dividends shall be accrued using an estimate of the amount to be paid.

42. If limitations exist on the amount of net income from participating insurance contracts of life insurance enterprises that may be distributed to stockholders, the policyholders’ share of net income on those contracts that cannot be distributed to stockholders shall be excluded from stockholders’ equity by a charge to operations and a credit to a liability relating to participating policyholders’ funds in a manner similar to the accounting for net income applicable to minority interests. Dividends declared or paid to participating policyholders shall reduce that liability; dividends declared or paid in excess of the liability shall be charged to operations. Income-based dividend provisions shall be based on net income that includes adjustments between general-purpose and statutory financial statements that will reverse and enter into future calculations of the dividend provision.

43. For life insurance enterprises for which there are no net income restrictions and that use life insurance dividend scales unrelated to actual net income, policyholder dividends (based on dividends anticipated or intended in determining gross premiums or as shown in published dividend illustrations at date insurance contracts are made) shall be accrued over the premium-paying periods of the contracts.

34. SOP 95-1 provides the following guidance on policy reserves for participating contracts issued by mutual life insurance enterprises, fraternal benefit societies and stock life insurance subsidiaries of mutuals or fraternals:

> Liability for Future Policy Benefits
>
> 15. A liability for future policy benefits relating to participating life insurance contracts should be equal to the sum of --
>
> a. The net level premium reserve for death and endowment policy benefits.
>
> b. The liability for terminal dividends.
>
> c. Any probable loss (premium deficiency) as described in paragraphs 35 to 37 of FASB Statement No. 60.
>
> 16. The net level premium reserve should be calculated based on the dividend fund interest rate, if determinable, and mortality rates guaranteed in calculating the cash surrender values described in the contract. If the dividend fund interest rate is not determinable, the guaranteed interest rate used in calculating cash surrender values described in the contract should be used. If the dividend fund interest rate is not determinable and there is no guaranteed interest rate, the interest rate used in determining guaranteed nonforfeiture values should be used. Finally, if none of the above rates exists, then the interest rate used to determine minimum cash surrender values -- as set by the National Association of Insurance Commissioners' (NAIC) model standard nonforfeiture law--for the year of issue of the contract should be used. Regardless of the rate used, net premiums should be calculated as a constant percentage of the gross premiums.
>
> 17. Terminal dividends should be accrued in the liability for future policy benefits if the following conditions are both met:[4]
>
> a. Payment of the dividend is probable.
> b. The amount can be reasonably estimated.
>
> [4] These conditions should be used in the same sense that they are used in FASB Statement No. 5, *Accounting for Contingencies*.
>
> If the two conditions are met (and they ordinarily will be), the terminal dividends should be recognized as an expense over the life of a book of participating life insurance contracts, at a constant rate based on the present value of the estimated gross margin amounts expected to be realized over the life of the book of contracts. The present value of estimated gross margins should be computed using the expected investment yield (net of related investment expenses). If significant negative gross margins are expected in any period, then the present value of gross margins before annual dividends, estimated gross premiums, or the balance of insurance in force should be substituted as the base for computing the expense amount to be recognized. (The base substituted in this calculation should be the same one substituted in the amortization of deferred acquisition costs discussed in paragraph 20.)
>
> 18. Increases in the liability for future policy benefits should be reported as an expense in the statement of earnings.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapters 15 and 20
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 50—Classifications and Definitions of Insurance or Managed Care Contracts In Force*
- *Issue Paper No. 51—Life Contracts*
- *Issue Paper No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses*
- *Issue Paper No. 66—Accounting for Retrospectively Rated Contracts*

Generally Accepted Accounting Principles

- *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises*
- *FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*
- *FASB Statement No. 120*, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*
- *AICPA Statement of Position 95-1*, *Accounting for Certain Activities of Mutual Life Insurance Enterprises*

State Regulations

- No additional guidance obtained from state statutes or regulations.

Statutory Issue Paper No. 57

Title Insurance

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 57

Type of Issue:
Property and Casualty

SUMMARY OF ISSUE

1. Current statutory guidance for premium revenue recognition, unpaid claims, losses, and loss adjustment expenses for title insurance contracts is contained in Appendix B of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies (P & C Accounting Practices and Procedures Manual). This guidance states that title insurance premiums are fully earned on the date of policy issuance; however, most states require title insurance companies to establish and maintain an unearned premium or reinsurance reserve. This guidance also states that title insurance companies are not required to give recognition to Incurred But Not Reported (IBNR) losses as a liability in statutory reporting; however, disclosure of IBNR is required in Schedule P by the NAIC Annual Statement Instructions - Title (Annual Statement Instructions). Current statutory guidance for title plants is contained in Appendix B of the P & C Accounting Practices and Procedures Manual. This guidance states that title insurers are authorized to invest in title plants and to classify them as admitted assets, subject to certain valuation restrictions.

2. GAAP guidance for premium revenue recognition is found in paragraph 16 of FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises* (FAS 60). GAAP guidance for claim cost recognition is found in paragraphs 17-20 of FAS 60. GAAP guidance for title plants is presented in FASB Statement No. 61, *Accounting for Title Plant* (FAS 61), as amended by FASB Statement No. 121, *Accounting for The Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (FAS 121).

3. The purpose of this issue paper is to establish statutory accounting principles for title insurance that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. A variety of services are generally provided (either by the title insurance underwriter, its agent or others) in connection with the transfer of title to real estate. Title insurance rates frequently are determined in the rate making process based on the bundle of services provided, including some or all of title search and examination and closing or escrow fees, referred to as "Gross All-Inclusive" premiums. By statute or custom, certain states exclude title search and examination and closing or escrow fees from the rate-making process for title insurance premiums; referred to as "Gross Risk Rate" premiums. Premiums shall be recorded at the date of policy issuance, on either the Gross All-Inclusive or Gross Risk Rate premium basis, consistent with the rate-making method used. Amounts paid to or retained by agents shall be reported as an expense.

5. A liability shall be established for all known unpaid claims and loss adjustment expenses (known claims reserve), consistent with paragraph 23 of this issue paper, with a corresponding charge to income. The future payments associated with settling known unpaid claims and loss adjustment expenses meet the

definition of a liability as established in *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets* (Issue Paper No. 5).

6. Premium revenue shall be deferred to the extent necessary to maintain a Statutory or Unearned Premium Reserve (SPR/UPR) determined in accordance with the reserve section detailed in paragraph 23 of this issue paper.

7. Additionally, a supplemental reserve shall be established consisting of any other reserves necessary, which when taken in combination with the reserves required by paragraphs 5 and 6 of this issue paper will be sufficient to cover the company's liabilities with respect to all known claims, IBNR claims, and loss adjustment expenses. The total of the known claims reserve, SPR/UPR, and the supplemental reserve shall not be less than the actuarially determined liability for the sum of known claims, IBNR claims, and loss adjustment expenses or the amount determined in accordance with paragraph 23 of this issue paper.

8. Consistent with the statutory objective of maintaining a SPR/UPR in an amount sufficient to purchase reinsurance, the criteria for revenue recognition in paragraphs 6 and 7 recognize the economics of the title insurance contract over the estimated period of exposure.

9. The actuarially determined liability for the sum of known claims reserve required in paragraph 5, and the IBNR claims and loss adjustment expenses required in paragraph 7 of this issue paper, shall be determined consistently with the guidance detailed in *Issue Paper No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses* (Issue Paper No. 55), except that anticipated salvage and subrogation shall not be deducted from the liability for unpaid claims.

10. Assets acquired in settlement of claims (e.g., mortgages and real estate) shall be accounted for consistent with the guidance related to the asset acquired. For example, an impaired loan shall be accounted for in accordance with *Issue Paper No. 37—Mortgage Loans*, and real estate acquired in foreclosure shall be accounted for in accordance with *Issue Paper No. 40—Real Estate Investments*.

11. The financial statements or notes thereto shall disclose the following items for each period presented:

a. The amount of premium revenue reported on the Gross All-Inclusive and on the Gross Risk Rate premium basis;

b. The amount of the known claims reserve, SPR/UPR, and the supplemental reserve;

c. Whether the insurer uses discounting in the calculation of its supplemental reserve, the method and rate used to determine the discount, and the amount of such discount.

12. Any material individual component of the reported expense categories shall be presented either on the face of the Summary of Operations or within the footnotes or related exhibits to the financial statements.

Title Plant

13. Title plants are an integrated and indexed collection of title records consisting of documents, maps, surveys, or entries affecting title to real property or any interest in or encumbrance on the property, which have been filed or recorded in the jurisdiction for which the title plant is established or maintained. They are tangible assets unique to the title insurance industry, and are the principal productive asset used to generate title insurance revenue and to mitigate the risk of claims. Title plant shall be reported as an admitted asset, subject to the following valuation restrictions:

a. Costs incurred to construct a title plant, including the costs incurred to obtain, organize, and summarize historical information in an efficient and useful manner, shall be capitalized until the title plant can be used by the company to conduct title searches and issue title insurance policies. The capitalized costs shall be directly related to, and properly identified with, the activities necessary to construct the title plant.

b. Purchased title plants, including a purchased undivided interest in a title plant, shall be recorded at cost at the date of acquisition. For a title plant acquired separately, cost shall be measured by the fair market value of the consideration given. For title plant acquired as part of a group of assets, cost shall be measured by the fair value of the consideration given and then cost shall be allocated to the title plant based on its fair value in relation to the total fair value of the group of assets acquired. For title plants acquired as part of a purchase of assets or in a business combination, cost shall be determined in accordance with *Issue Paper No. 68—Business Combinations and Goodwill*.

c. After the construction or purchase of a title plant, a company may decide to purchase or construct a title plant that antedates the period of time covered by the existing title plant (backplant). Costs to construct a backplant must be properly identifiable to qualify for capitalization.

d. Costs incurred after a title plant is operational to (a) convert the information from one storage and retrieval system to another; or (b) modify or modernize the storage and retrieval system shall not be capitalized.

e. Costs incurred to maintain a title plant shall be expensed as incurred.

f. Costs incurred to perform title searches shall be expensed as incurred.

g. The aggregate carrying value of an investment in a title plant or plants shall not exceed the lesser of twenty percent (20%) of admitted assets or forty percent (40%) of surplus to policyholders.

14. Certain circumstances may indicate that the value of the title plant may be impaired and, thus, the carrying value of the asset may not be recoverable. If there is an indication of possible impairment of value, the title plant shall be evaluated for impairment and recorded in accordance with Issue Paper No. 5. The following are examples of circumstances that may indicate impairment:

a. Effects of obsolescence, demand and other economic factors;

b. A significant change in the legal or business climate in the jurisdiction for which the title plant is established and maintained;

c. A current period operating or cash flow loss combined with a history of such losses or projections that indicate continued losses associated with the revenue produced by the title plant;

d. A lack of appropriate maintenance to keep the title plant up to date;

e. Abandonment of a title plant.

15. A properly maintained title plant has an indeterminate life and does not diminish in value with the passage of time, and accordingly, shall not be depreciated.

16. A title insurer may (a) sell its title plant and relinquish all rights to its future use; (b) sell an undivided ownership interest in its title plant; or (c) sell a copy of its title plant or the right to use it. Accounting and presentation for each type of sale noted shall be as follows:

a. When a title insurer sells its title plant and relinquishes all rights to its future use, consideration received shall be presented as a separate component of revenue net of the carrying value of the title plant sold.

b. When a title insurer sells an undivided ownership interest in its title plant, consideration received shall be presented as a separate component of revenue net of the pro rata portion of the carrying value of the title plant.

c. When a title insurer sells a copy of its title plant or the right to use it, consideration received shall be presented as a separate component of revenue and the carrying value of the title plant shall not be reduced.

DISCUSSION

17. The P & C Accounting Practices and Procedures Manual states that title insurance premiums are fully earned on the date of policy issuance; however, title insurance companies are required to establish and maintain an unearned premium or reinsurance reserve. The primary objective of the SPR/UPR is to maintain at all times a reserve amount which is sufficient to purchase reinsurance for the IBNR claims and related loss adjustment expenses. Consistent with this objective, the statutory principles in paragraph 6 of this issue paper retain current statutory guidance, which requires that changes in the amount of the SPR/UPR be reflected as an adjustment to premium revenue. Additionally, the supplemental reserve required in paragraph 7 of this issue paper is analogous to the concept of a premium deficiency reserve as discussed in *Issue Paper No. 53—Property and Casualty Contracts – Premiums* (Issue Paper No. 53). Consistent with Issue Paper No. 53, anticipated investment income may be used as a factor in the supplemental reserve calculation.

18. The conclusions reached in this issue paper are consistent with current statutory guidance except as follows with the exception that this issue paper requires consideration of IBNR claims and related loss adjustment expenses in evaluating the sufficiency of the SPR/UPR in order to conform with the Title Insurers Model Act. The Model Act requires the reporting entity's state of domicile to determine the appropriate unearned premium reserve to be set aside. This issue paper also requires the unearned premium reserve to be determined by the reporting entity's state of domicile. The determination by the state of domicile of this reserve is considered necessary given the nature of this product. This issue paper also requires that the liability for known claims reserves be calculated in accordance with Issue Paper No. 55, except that anticipated salvage and subrogation shall not be deducted from the liability for unpaid claims. Issue Paper No. 55 permits, but does not require, anticipated salvage and subrogation recoverables to be deducted from the liability for unpaid claims; whereas current statutory guidance for title insurers does not permit case basis loss and loss adjustment expense reserves to be reduced for anticipated salvage and subrogation.

19. This issue paper modifies current statutory accounting for title plant to require the evaluation and write-off of impairment in value. This is consistent with Issue Paper No. 5. This issue paper adopts FAS 61, modified for carrying value restrictions, as amended by paragraph 29 of *FASB Statement No. 121 - Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (FAS 121). Restrictions on the total carrying value of an investment in a title plant or plants have been set consistent with current statutory accounting outlined in the Title Insurers Model Act. FAS 121 is addressed in *Issue Paper No. 40—Real Estate Investments*.

20. The conclusions above reject FAS 60; however, it is considered appropriate to use the factors to be considered in the determination of the ultimate cost of settling claims included in FAS 60 when

establishing the reserves in accordance with paragraphs 5 and 7 of this issue paper. The concepts adopted above are consistent with GAAP literature except that GAAP requires immediate revenue recognition for title insurance contracts and the accrual of claims costs at the time title insurance premiums are recognized as revenue; whereas this issue paper requires that revenues be recognized consistent with the concepts discussed in paragraph 16.

21. The conclusions above are consistent with the regulatory objectives discussed in paragraph 17 of this issue paper and the concept of conservatism in the Statement of Concepts. The conclusions above are also consistent with the recognition and consistency concepts in the Statement of Concepts. Pertinent excerpts follow:

> Conservatism
>
> Financial reporting by insurance enterprises requires the use of substantial judgments and estimates by management. Such estimates may vary from the actual amounts for numerous reasons. To the extent that factors or events result in adverse variation from management's accounting estimates, the ability to meet policyholder obligations may be lessened. In order to provide a margin of protection for policyholders, the concept of conservatism should be followed when developing estimates as well as establishing accounting principles for statutory reporting.
>
> Recognition
>
> Revenue should be recognized only as the earnings process of the underlying underwriting or investment business is completed.
>
> SAP income reflects the extent that changes have occurred in SAP assets and liabilities for current period transactions, except changes in capital resulting from receipts or distributions to owners.
>
> Consistency
>
> The regulators' need for meaningful, comparable financial information to determine an insurer's financial condition requires consistency in the development and application of statutory accounting principles. Because the marketplace, the economic and business environment, and insurance industry products and practices are constantly changing, regulatory concerns are also changing. An effective statutory accounting model must be responsive to these changes and address emerging accounting issues. Precedent or historically accepted practice alone should not be sufficient justifications for continuing to follow a particular accounting principle or practice which may not coincide with the objectives of regulators.

Drafting Notes/Comments

- Segregated funds held for others (i.e., escrow funds) will be addressed in *Issue Paper No. 77—Disclosure of Accounting Policies, Risks & Uncertainties, and Other Disclosures*.
- Review of state statutes of not less than 38 states indicates the use of a SPR/UPR, we are not aware of any states without such a requirement.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

22. Amended guidance for title insurance was adopted by the Accounting Practices and Procedures (EX4) Task Force at its October 1, 1996 meeting.

TITLE INSURANCE ACCOUNTING PRINCIPLES SUPPLEMENT

INTRODUCTION

Title insurance insures up to the date of policy issuance that the insured has title to the insured property on a certain title estate, subject to exceptions and exclusions in the policy. Also, a title policy, when issued, has a one time charge to the insured under the policy and reserves are set aside by the title insurance company that issues said policy.

The business of title insurance differs from that of property and casualty insurance in that its basic goal is risk elimination and not loss reimbursement. This risk elimination function results in significantly lower losses than that of other lines of insurance. Because of this fact, the title insurance business is organized and functions differently and its accounting for revenues, losses and loss adjustment expenses, unearned premium reserves, title plants, and escrow funds differs.

This supplement is intended to present the most commonly used practices and procedures as to those differences. Otherwise, title insurance accounting is in agreement with those described elsewhere in this manual.

Title insurers perform many services in connection with the transfer of real estate; however, their principal function involves insuring, guaranteeing, or indemnifying owners of real property or the holders of liens or encumbrances thereon against loss or damage suffered by reason of defective titles, liens or encumbrances or, in most states, the unmarketability of the title.

A one-time nonrefundable charge is due on the effective date of the insurance. This is described in more detail in the section on title insurance revenue. The term of the policy is indefinite in that the policyholder is insured for as long as he or his heirs or devises have an interest in the property.

Before a title insurance policy is issued, skilled personnel must search and examine a variety of public records concerning the ownership, liens, and encumbrances on the subject real estate together with information relating to persons having an interest in the real property as well as maps and other records to determine that title to the property is insurable, or defects can be overcome.

In addition to insuring against defective records or examination of those records, an insurer insures against "non-record defects" such as:

- Forgeries
- Fraud
- Confusion of name in change of title
- Incompetency (minor or persons of unsound mind)
- Mistakes in public records
- Undisclosed or missing heirs
- Instruments executed under a fabricated or expired power of attorney
- Deeds delivered after death of grantor or grantee or without the consent of the grantor
- Deeds by persons supposedly single but actually married
- Wills not probated
- Liens against property (mechanic’s liens, tax liens, etc.)
- Falsified records

TITLE PLANTS

Title plants are an integrated and indexed collection of title records covering parcels of real estate within a county. They are tangible assets unique to the title insurance industry and are the principal productive asset used to generate title insurance revenue.

A title plant consists of (a) indexed and catalogued information for a period of time concerning the ownership of, and the encumbrance on, real estate, (b) information relating to persons having an interest in real property, (c) maps, plats, and so forth, (d) copies of prior title insurance policies and reports, and (e) other documents and records. In summary, a title plant constitutes a historical record of matters affecting title to parcels of land in a particular geographic area. The number of years covered by a title plant varies, depending on regulatory requirements and management decisions concerning the minimum information period needed to issue title insurance policies efficiently. Title plants are updated on a daily or other frequent basis by the addition of copies of documents on the status of title to specific parcels of real estate.

Authorization and Limitations

Title insurers are authorized to invest in title plants and to classify them as admitted assets in their financial statements subject to valuation restrictions which vary from state to state. Insurers' investments in title plants are detailed in Schedule "H" of the annual statement.

Valuation

Costs incurred to construct a title plant, including the costs incurred to obtain, organize and summarize historical information in an efficient and useful manner, should be capitalized until the title plant can be used by the company to conduct title searches and issue title insurance policies. The capitalized costs should be directly related to, and properly identified with, the activities necessary to construct the title plant.

After the construction or purchase of a title plant, a company may decide to purchase or construct a title plant (backplant) that antedates the period of time covered by the existing title plant. Costs to construct a backplant must be properly identifiable to qualify for capitalization.

Purchased title plants, including a purchased undivided interest in a title plant, should be recorded at cost at the date of acquisition. For a title plant acquired separately, cost should be measured by the fair market value of the consideration given. Title plants purchased as part of a group of assets or as part of a business combination accounted for as a purchase, should be accounted for in accordance with APB Opinion 16, "Business Combinations."

Costs incurred after a title plant is operational to (a) convert the information from one storage and retrieval system to another or (b) modify or modernize the storage and retrieval system should not be added to the carrying amount of the title plant. Such costs may be capitalized separately as Title Plant Improvements and charged to expense in a systematic and rational manner in accordance with Statement of Financial Accounting Standards No. 61, "Accounting for Title Plant."

Ordinarily, a title plant has an indeterminate life and does not diminish in value with the passage of time and accordingly should not be depreciated. However, in certain circumstances, evidence may exist that the value of a title plant has been impaired. Evidence of impairment includes the following:

a) a change in legal requirements or statutory practices,
b) effects of obsolescence, demand, and other economic factors,
c) actions of competitors and others that may affect competitive advantages,
d) failure to maintain the title plant properly on a current basis, or,
e) abandonment of a title plant or other circumstances that indicate obsolescence.

If such evidence exists, title plant values should be adjusted to the lower of carrying value or current fair values in accordance with Statement of Financial Accounting Standards No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of."

Maintenance of Title Plant

Costs incurred to maintain a title plant should be expensed as incurred. Title plant maintenance involves the updating of the title plant on a daily basis or other frequent basis by adding (a) reports on the current status of title to specific parcels of real estate and (b) other documents such as records relating to security or other ownership interests.

Cost of Title Searches

Costs incurred to perform title searches should be expensed as incurred. Title searches involve the process of searching through records for all recorded documents or updating information summarized in the most recently issued title report.

Sale of Title Plant

A title insurance company may (a) sell its title plant and relinquish all rights to its future use, (b) sell an undivided ownership interest in its title plant, that is, the right to its joint use, or (c) sell a copy of its title plant or the right to use it. If the company sells its title plant and relinquishes all future rights to its use, the amount received as consideration for the sale should be presented as a separate component of revenue, net of the carrying amount of the title plant. If the company sells an undivided ownership interest in its title plant, the amount received as consideration should be presented as a separate component of revenue, net of the pro rata portion of the carrying amount of the title plant. If the company sells a copy of its title plant or the right to use it, the amount received should be presented as a separate component of revenue. Ordinarily no cost should be allocated to the sale of a copy or the right to use a title plant.

STATUTORY PREMIUM RESERVE

The premium related to a title insurance policy is due upon the effective date of the insurance and is not refundable. The term of a title insurance policy is indefinite in that the policyholder is insured for as long as he or his heirs or devisees have an interest in the property. Since title insurance premiums are fully earned on the date of policy issuance, there are no unearned premiums for title insurers.

Most states require title insurance companies to establish and maintain a statutory premium reserve. Generally, the title insurance company must establish this statutorily required deferred income account based upon the law of its domiciliary state. The computation is based upon either premium revenue, number of policies issued, liability assumed, or combinations thereof. The reserve is drawn down in accordance with recovery or amortization formulas as prescribed by state law.

Generally, title insurance companies are required to hold, maintain and segregate investments in marketable admitted assets of a particular type and quality as prescribed by certain states' statutes in an amount at least equal to the statutory premium reserve. When applicable, such assets are summarized by investment type in a footnote to the "Assets" page of the annual statement.

TITLE INSURANCE REVENUE

The variety of services performed by a title insurance company in connection with the insurance of a real estate title may vary substantially according to local statutes, regulations or practices. This causes a substantial variance in the classification of these services on financial statements of title insurers. While all such services are an integral part of the transfer of title to real estate, services may in some markets be performed by title insurance companies, separately in competition with title insurance agents, or insurers may subcontract some functions to agents or others.

Where title insurance companies perform these services, it is often not possible to allocate specific revenue or costs to a separate function such as search, examination, closing, or escrow services with any precision. Many joint costs of the insurer cannot be adequately allocated to a specific function, and some functional elements of title insurance costs tend to overlap into other areas, e.g., a portion of search and escrow costs performed by a title insurance company could be partially allocated to an underwriting function.

In order to provide for consistency in reporting financial data in the annual statement, all title insurers must strictly follow the guidelines stated in this instruction. The NAIC has dictated that title insurance revenues reported in the annual statement be differentiated as to (1) two generally acceptable premium rate types, and (2) the distribution network for direct premiums written.

However, the NAIC has recognized that the data reported in Schedule “T” of the annual statement is not intended to be used for the calculation of the amount of premium tax due. In the event the basis used for the calculation of premium tax differs from the basis required for reporting in the annual statement, the company should submit to the respective state insurance department or other premium tax collection agency a separate schedule to support its premium tax calculation.

For the purpose of reporting in Schedule "T" and other schedules or exhibits in the annual statement, the amount of title insurance premiums to be reported by premium rate type shall be guided by the following definitions of the methods of reporting "Direct Premiums Written":

1. Gross All-Inclusive Premiums - Under this method of reporting direct premiums written, the title insurer and its title agent generally perform all the functions necessary to insure the risk and to issue a title insurance policy. The title insurer reports 100% of the premiums charged either through its branch office or its title agents. Direct premiums written reported under this method generally contemplates some or all of the following factors in the rate-making process:

   a. Cost of title search and examination
   b. Policy issuing cost
   c. Amount retained by agents/abstractors/attorneys
   d. Overhead and miscellaneous expenses
   e. Expected losses and LAE from underwriting the risk
   f. Profit margin.
   g. Additional activities (such as closing) may also be included in specific states.

2. Gross Risk Rate Premiums - This method of reporting direct premiums written generally applies to states where either by statute or custom the charge for title search and examination are excluded or charged for separately from the title insurance premiums. The cost factors contemplated in the rate-making process include the proportionate share of all of the factors listed in the "Gross All-Inclusive Premiums" except for the "Cost of the title search and examination."

The applicable premium rate type in effect for each state (either gross all-inclusive or gross risk rate) is reported in the “Premium Rate” column of Schedule “T."

Generally, the direct premiums written reported in the annual statement should fall within the definitions of either Gross All-Inclusive Premiums or Gross Risk Rate Premiums. The net risk or net remittance method is not an acceptable method of reporting premiums written. In the event the company uses another method, this method must be designated as “Other” in the “Premium Rate” column of Schedule “T” for each state and must be footnoted to define the basis for varying from either the Gross All-Inclusive or Gross Risk Rate method.

In addition to designating the premium rate type in effect for each state for direct premiums written in Schedule “T," title insurance companies must report direct premiums written by the distribution network within each state. The NAIC has designated three distribution networks, with direct premiums written reported in separate columns of Schedule “T," as well as in other schedules or exhibits of the annual statement, as follows:

1. Direct Operations - Includes direct premiums written at home office and branch office operations of the title insurer. No amounts attributable to agency operations (even wholly owned agencies) are to be included in this category.

2. Non-affiliated Agency Operations - Includes direct premiums written by non-affiliated agency operations. The standard for reporting as a non-affiliated agency is the affiliation standard established under the holding company laws of the domestic state jurisdiction.

3. Affiliated Agency Operations - Includes direct premiums written by affiliated agency operations, including wholly-owned agencies. The standard for reporting as an affiliated agency is the affiliation standard established under the holding company laws of the domestic state jurisdiction.

Revenues received for services performed by a title insurance company, other than premium, are to be reported under the "Other Income” category of Schedule "T."

EXPENSES

In the title insurance industry, there are expenses incurred in establishing and maintaining the distribution networks involved in acquiring and underwriting policies and servicing policyholders and third party claimants. Expenses are important elements of the company’s operations and accurate statistics are needed for comparisons and control. The instructions for uniform classification of expenses are a part of the NAIC Examiners Handbook - Volume 1.

Expense Group Classifications

Expenses for title insurance companies are listed in the “Operations and Investment Exhibit, Part 4, Expenses” of the annual statement. Expenses are specifically identified or allocated and reported for the following groups:

1. Title and Escrow Operating Expenses - Title and escrow operating expenses consist of all expenses incurred in relation to engaging in the business of title insurance, including costs associated with the following: issuing or offering to issue a title insurance policy; soliciting or negotiating the issuance of a title insurance policy; guaranteeing, warranting or otherwise insuring the correctness of title searches affecting title to real property; handling of escrows, settlements or closings; executing title insurance policies; effecting contracts of reinsurance and abstracting, searching or examining titles. Also included are specifically identifiable and allocated expenses relating to the following activities: supervision and training of employees and agents; operating costs for branch offices or agencies; underwriting activities; receiving and paying of premiums and commissions; maintaining general and detailed records; data processing; advertising and publicity; clerical, secretarial, office maintenance, supervisory and executive duties; postage and delivery; and all other functions reasonably associated with the business of title insurance. Title and escrow operating expenses do not include losses, loss adjustment expenses (allocated or unallocated), expense of other operations or investment expenses. The expenses include only amounts incurred directly by the company, and do not include expenses incurred by any agents (regardless of ownership interest).

2. Unallocated Loss Adjustment Expenses - Unallocated loss adjustment expenses (“ULAE”) are those indirect costs incurred by a title insurer, typically internal to the company, which are necessary to process claims or manage the claims settlement function and which are not incurred on a claim-specific basis. ULAE should include all costs of outside parties involved in claims adjusting services, but should not include any costs incurred by agents in settlement of title or other claims.

3. Other Operations - The amounts shown for this category represent the expenses incurred by the company in operations other than title and escrow, loss adjustment or investment activities.

4. Investment Expenses - Investment expenses are those expenses incurred in the investing of funds and the pursuit of investment income, including specifically identifiable and allocated expenses related to such activities as: initiating or handling orders and recommendations for investments; research; pricing; appraising and valuing; disbursing funds and collecting income; safekeeping of securities and valuable papers; maintaining general and detailed records; data processing; general clerical, secretarial, office maintenance, supervisory and executive duties; supplies, postage, and the like; and all other functions reasonably attributable to the investment of funds.

A company that pays management fees to an affiliate shall allocate these costs to the appropriate expense classification item (salaries, rent, postage, etc.) as if these costs had been borne directly by the company. Management or similar fees should not be reported as a one-line expense. It is appropriate for the company to estimate these expense allocations based on a formula or other reasonable basis.

Title and Escrow Operating Expenses are further broken down in the annual statement by the distribution network that gives rise to the expense incurrence. Accordingly, expenses are specifically identified or allocated (in accordance with reasonable allocation procedures consistently applied) to either Direct Operations, Non-affiliated Agency Operations or Affiliated Agency Operations. Some general guidelines for allocating these expenses to the appropriate distribution network are shown in the following table. The expense classification item (salaries, rent, postage, etc.) are those in the annual statement.

TABLE 1

General Guidelines for Classifying Expenses

Expenses to be Allocated to Distribution Network	**Principal Basis for Allocation**
Personnel costs:	
Salaries	Studies of employee activities
Employee relations and welfare	Pro rate on salary ratios
Payroll taxes	Pro rate on salary ratios
Other personnel costs	Pro rate on salary ratios
Amounts paid to or retained by title agents	Direct charge to non-affiliated or affiliated agents
Production services (purchased outside)	Study of company practices
Advertising	Pro rate on basis of Part 2A revenue distribution
Boards, bureaus and associations	Pro rate on basis of Part 2A revenue distribution
Title plant rent and maintenance	Study of company practices
Amounts charged off, net of recoveries	Direct charge by source of business
Marketing and promotional expenses	Pro rate on basis of Part 2A revenue distribution

Insurance	Pro rate on salary ratios
Directors’ fees	Pro rate on salary ratios
Travel and travel items	Study of company practices
Rent and rent items	Pro rate on salary ratios
Equipment	Pro rate on salary ratios
Printing, stationery, books and periodicals	Pro rate on salary ratios
Postage, telephone, messengers and express	Pro rate on salary ratios
Legal and auditing	Study of company practices
Taxes, licenses and fees	Study of company practices

Any other basis of allocation should be used if it yields more precise results than expenses allocated on the salaries or revenue distribution basis.

NOTES:

Claim adjustment services are all attributable to the Unallocated Loss Adjustment Expenses group.

Real estate expenses and real estate taxes are all attributable to the Investment Expenses group.

Expenses should be specifically identified or allocated to the Unallocated Loss Adjustment Expenses group or Other Operations group based on a study of company practices and employee activities.

AMOUNTS PAID TO OR RETAINED BY TITLE AGENTS

Unlike agents representing other lines of insurance whose primary function is to sell the policy and receive a sales commission, title insurance agents also perform various functions in connection with the issuance of a title insurance policy. These functions can include search and examination, abstracting, certain underwriting and closing services. Typically, the agent collects the entire charge for the title insurance transaction, retains a portion for his services, and forwards the insurer’s portion in accordance with individual agency contracts.

LOSSES AND LOSS ADJUSTMENT EXPENSES/RESERVES

Unlike most other forms of insurance, losses do not generally represent the largest liability or expense for title insurance companies. The emphasis is upon loss prevention and the duty to defend, rather than on reimbursement of losses. Therefore, title insurance companies incur large expenses in labor, equipment, etc. in maintaining title records and in searching and examining the titles to real estate and in curing defects found prior to the issuance of the policy and closing or escrow services.

The liability for unpaid losses is composed of (1) the loss reserve, net of recoveries, for undetermined title and other losses of which notice has been received (known claims reserve), (2) the statutory premium reserve, and (3) the excess of Schedule “P” reserves over statutory reserves (supplemental reserve).

Definitions

Allocated Loss Adjustment Expenses

Allocated loss adjustment expenses are those expenses that can be related to specific claims and include fees, salaries, overhead and expenses of lawyers for legal service in defense, trial or appeal of suit, other legal services rendered in connection with title claims, and general court costs and fees together with appeal costs and expenses. Allocated loss adjustment expenses should include all costs associated with attorneys involved in litigation of specific claims whether such attorneys are engaged as outside counsel or salaried employees of an insurer. The inclusion of “salaried employees” in the definition of allocated loss adjustment expenses is effective January 1, 1996. Allocated loss adjustment expenses also include any fee or expense, other than claim adjuster services, which is directly attributable to the defense of a particular claim. See definition of Unallocated Loss Adjustment Expenses below.

Incurred But Not Reported Reserve

The incurred but not reported reserve (“IBNR”) is an amount estimated to cover all unpaid losses, claims and allocated loss adjustment expenses arising under title insurance policies, guaranteed certificates of title, guaranteed searches and guaranteed abstracts of title, and all unpaid losses, claims and allocated loss adjustment expenses for which the title insurer may be liable and for which the insurer has not received notice by or on behalf of the insured, holder of a guarantee or escrow or security depositor. Title insurance companies are not required to give recognition to IBNR losses in statutory reporting unless a “supplemental reserve” is required. See the definition of Supplemental Reserve below.

Known Claims Reserve

The known claims reserve (referred to as the “loss reserve for undetermined title and other losses of which notice has been received”) is the amount estimated to be sufficient to cover all unpaid losses, claims and allocated loss adjustment expenses arising under title insurance policies, guaranteed certificates of title, guaranteed searches and guaranteed abstracts of title, and all unpaid losses, claims and allocated loss adjustment expenses for which the title insurer may be liable and for which the insurer has received notice by or on behalf of the insured, holder of a guarantee or escrow or security depositor. The known claims reserve also includes “bulk” reserves, if any - a provision for subsequent development on known claims.

Statutory Premium Reserve

See the “Statutory Premium Reserve” section above. The Statutory Premium Reserve (“SPR”) is considered a liquidation reserve and is equivalent to a property and casualty company’s IBNR reserve. Certain states’ statutes also require insurance companies to segregate investments in an amount at least equal to the SPR. If a title insurer becomes insolvent, the segregated assets are used to pay future claims or purchase reinsurance to settle future claims. In addition, the SPR is intended to provide a reserve for unallocated loss adjustment expenses on all claims.

Supplemental Reserve

The supplemental reserve is the excess of Schedule “P” reserves over statutory reserves (i.e., the excess of the known claims reserve + IBNR reserve + ULAE reserve [total Schedule “P” reserves] over the known claims reserve + SPR [statutory reserves]). The supplemental reserve requirement is effective January 1, 1996. Also see “Actuarial Opinion” below.

Title Insurance Losses

Title insurance losses should include all losses on any transaction for which a title insurance premium, rate or charge was made or contemplated. Escrow losses for which the company is contractually obligated should be included. Losses arising from defalcations for which the company is contractually obligated should also be included.

Unallocated Loss Adjustment Expenses

Unallocated loss adjustment expenses ("ULAE") are those expenses other than allocated loss adjustment expenses that are assigned to the expense group "loss adjustment expenses" (i.e. all other expenses, typically internal, necessary to process claims or manage the claims settlement function and which are not incurred on a claim-specific basis). ULAE should include all costs of outside parties involved in claims adjusting services. Schedule "P" reserves include an Unallocated Loss Expense Unpaid component, a reserve estimated to cover all unpaid unallocated loss adjustment expenses on all claims and losses provided for in the known claims reserve and the IBNR reserve. As noted above, the SPR is intended to provide a balance sheet reserve for ULAE on all claims. The requirement to separately report ULAE in the Operating and Investment Exhibit (Part 4 - Expenses) and the ULAE reserve in Schedule "P" is effective January 1, 1996.

Loss Reserving Requirements

Valuation

A company is required to determine what the value of its claims will be when they are ultimately settled, including inflation. Therefore, in general, loss and loss adjustment expense reserves are to be presented on a non-discounted basis. Also see "Loss Reserve Discounting" below.

Known Claims Reserves

The reserve for known claims is generally determined using established reasonable baseline reserves developed by tracking and analyzing historical claims data. These estimates are reviewed and adjusted as necessary.

Incurred But Not Reported Losses and Unallocated Loss Expense Unpaid

In addition to reserving for known claims, a title insurance company must also provide a liability for losses that are incurred but not reported and for unpaid ULAE in Schedule "P," effective January 1, 1996. Various methods are used for estimating these reserves. Whatever methods are selected for establishing unpaid losses, the goal should always be reserve adequacy. Also see "Actuarial Opinion" below.

Loss Reserve Discounting

Discounting of loss and loss adjustment expense reserves is allowed only if expressly permitted by the state insurance department to which the annual statement is being filed. If discounting of loss and loss adjustment expense reserves is reflected in an insurer's balance sheet liabilities as included in the annual statement, then the insurer must complete a reconciliation of the discounted liability to the whole dollar value of the reserves in Schedule "P." The insurer should also complete a note to the annual statement - Discounting of Unpaid Losses or Unpaid Loss Adjustment Expenses - as required by the annual statement instructions.

Actuarial Opinion

Effective January 1, 1996, the Schedule "P" reserves must be supported by an actuarial opinion from a qualified actuary who is a member in good standing of the American Academy of Actuaries, setting forth an opinion as to the adequacy of all loss reserves (known claims reserve, including bulk reserves (if any), + IBNR reserve + ULAE reserve).

Supplemental Reserve Computation - Schedule "P"

As noted above, the supplemental reserve, if any, is the excess of Schedule "P" reserves over statutory reserves. If a supplemental reserve is required, it shall be phased in as follows: twenty-five percent (25%) of the otherwise applicable supplemental reserve will be required until December 31, 1997; fifty percent (50%) of the otherwise applicable supplemental reserve will be required until December 31, 1998; seventy-five percent (75%) of the otherwise applicable supplemental reserve will be required until December 31, 1999; and, one hundred percent (100%) thereafter.

Recoveries from Salvage and Subrogation

Salvage and subrogation should be reflected using the following rules:

1. Paid losses must be reported net of realized, but not anticipated, salvage and subrogation. Case basis loss and loss adjustment expense reserves must not be reduced on account of anticipated salvage and subrogation.

2. Paid salvage and subrogation is not realized until a salvage asset or an actual payment pursuant to a subrogation right is in the direct control of the insurer and is admissible as an asset for statutory reporting purposes in its own right.

3. Salvage assets and payments pursuant to a subrogation right are to be booked at current market value. Current market value of real estate is to be established through an appraisal conducted by a qualified independent appraiser.

4. If a salvage asset is sold or revalued by the insurer within twelve months of realization for an amount less than the value at which it was originally placed on the books of the insurer, then the loss on disposition is to be treated as a decrease in paid salvage (same effect as an addition to the paid loss) on the corresponding claim. After twelve months, such salvage revaluation will be treated as a loss on disposition or change in value of an asset, and is not to be deducted from the salvage on the corresponding claim.

5. If a salvage asset is sold or revalued by the insurer within twelve months of realization for an amount greater than the value at which it was originally placed on the books of the insurer, then the gain on disposition is to be treated as an increase in paid salvage (same effect as a deduction to the paid loss) on the corresponding claim. After twelve months, such salvage revaluation will be treated as a gain on disposition or change in value of an asset, and is not to be added to the salvage on the corresponding claim.

6. IBNR reserves may make a provision for the expected value of future salvage and subrogation on open claims and IBNR claims. This provision must be actuarially determined and should not be based upon current case estimates.

TITLE REINSURANCE

Reinsurance is a contract whereby the reinsurer, for consideration received, agrees to indemnify the ceder or policy-issuing company in whole or in part against loss or liability which the ceder may sustain or incur under a separate and original contract of insurance ("policy") with the original insured owner, lender or lessee. The ceder or ceding company is the company which writes the policy insuring the owner, lender or lessee and cedes, lays off, or transfers to the reinsurer all or a portion of its policy risk or exposure which the reinsurer assumes or acquires under the reinsurance agreement or contract.

The principal functions of reinsurance are to provide insurers with capacity enabling them to write policies in larger amounts than could otherwise be written; to spread the risk of a potential loss in order to protect the insured's interest on very large transactions; and to protect the policy issuing company from insolvency in the event of a catastrophic loss.

Reinsurance is necessary when a title insurance company is limited to a certain amount of liability on a policy or transaction risk by either the insurer's self-imposed limitation, statutory limitation or the insured's limitation. Each title insurer internally sets a self-imposed limit where reinsurance is obtained when a policy is issued above that limit. Many states have limitations as to qualifications of insurers relating to single risk liability on risks issued on property in that state. In addition, the insureds on a title policy may also have restrictive liability limits pursuant to their own detailed analysis of a title insurer's financial strength and ability to pay a claim. These limitations are sometimes lower or more restrictive than state statutory limits or a title insurer's self-imposed limits. Therefore, on a certain risk which has all three types of limitations present, whichever limitation is lowest will determine how much reinsurance is necessary on a particular transaction. When reinsurance is purchased, the ceding company may reduce its net retained liability for the risk ceded. The reinsuring company would then be responsible for the appropriate reserves pertaining to its assumed liability or premium, subject to applicable rules and regulations of the state where the insured property is located.

Title insurance utilizes two main types of reinsurance. The most common type is facultative reinsurance that pertains to one individual, particular risk or transaction. The ceder may offer all or any part of a risk to one or more other title insurers or reinsurers who may either accept or reject that particular risk. The facultative reinsurance agreements utilized in the title industry have been developed by the American Land Title Association. The most common form utilized today is the 1994 ALTA Facultative Reinsurance Agreement. This agreement contains conditions and stipulations regarding ceder's cession and warranty, reinsurer's assumption, direct access, notices, investigation and settlement of claims, payment of losses, insolvency of ceder, recoupment and subrogation, rights of insured not prejudiced, laws applicable, actions by or on behalf of ceder, severability, notices-where sent and effective date.

Facultative reinsurance allows some flexibility in the spreading of the risk in which the ceder normally retains the primary risk and a share of the secondary level risk, which secondary level is structured on a coordinate and proportionate share among the secondary participants. There may also be other levels of reinsurance which are mainly utilized to induce reinsurers to accept more liability on larger than usual risks. These levels are called the tertiary, quaternary and quinary levels and they are each coordinate and proportionate as to each level. In other words, a reinsurer's secondary share is based on that reinsurer's secondary liability assumption divided by the total amount of secondary allocation of liability. If the ceding company retained a $5,000,000 primary, then they are responsible for 100% of the first level or primary retention retained. If the loss exceeds the primary into the secondary level, then the reinsurers as well as the ceder must pay off per their coordinate and proportionate share of that level until the secondary level is exhausted. If there is a tertiary level, the coordinate and proportionate tertiary percentage shares as to the total tertiary level control the payment of loss. And so on as to each level of liability.

The other type of reinsurance utilized in the title industry is called treaty reinsurance. This is mainly utilized by smaller companies that have a much smaller self-imposed or statutory limit and do not have the personnel to handle individual facultative agreements on each policy written over their threshold liability limit. This is usually done on an excess of loss basis where a treaty contract is negotiated where ceder is indemnified against loss in excess of a specified retention, normally subject to a specified limit, with respect to each risk covered by the treaty. Normally, the treaty contract specifies contingencies in the event the risk is greater than the treaty contract terms and therefore not covered under the treaty. Either the ceder may have to purchase facultative reinsurance, or the treaty reinsurer would assume all liability under the risk subject to the treaty ceder's primary retention and purchase its own facultative reinsurance on the liability in excess of the treaty limitations.

Schedule "F" of the annual statement summarizes relevant information for both assumed and ceded reinsurance.

SEGREGATED FUNDS HELD FOR OTHERS

Title insurers provide services in which they have custody and are accountable for cash and other assets belonging to others. Generally these services relate to real estate settlement services in which closing "escrow" funds are received and disbursed and note and contract collection services in which payments of principal and interest are received and disbursed. In addition, title insurers may hold cash or other assets as security for indemnity agreements with the company and others relating to title matters.

These "custodial" funds are set apart in special accounts and are excluded from title insurer's assets and liabilities in the statutory statement. However, the title insurer's accountability for these "custodial" funds is reported in a footnote and the detail of segregated deposits of these funds in banks, trust companies, and savings and loan associations are reported in Schedule "E" of the annual statement.

23. The Title Insurers Model Act was adopted by the Title Insurance Working Group of the Special Insurance Issues (E) Committee on December 4, 1995 and was adopted by the full membership of the NAIC at the March, 1996 Plenary Session (only the pertinent excerpts are included below):

Section 3. Definitions

W. "Title Plant" means a set of records consisting of documents, maps, surveys or entries affecting title to real property or any interest in or encumbrance on the property, which have been filed or recorded in the jurisdiction for which the title plant is established or maintained.

Section 9. Admitted Asset Standards

In determining the financial condition of a title insurer doing business under this Act, the general investment provisions of [insert reference to applicable provision of the insurance code governing investments] shall apply, except that an investment in a title plant or plants in an amount equal to the actual cost shall be allowed as an admitted asset for title insurers. The aggregate amount of the investment shall not exceed the lesser of twenty percent (20%) of admitted assets or forty percent (40%) of surplus to policyholders, as shown on the most recent annual statement of the title insurer on file with the commissioner.

Section 10. Reserves

In determining the financial condition of a title insurer doing business under this Act, the general provisions of the insurance code requiring the establishment of reserves sufficient to cover all known and unknown liabilities including allocated and unallocated loss adjustment expense, shall apply, except that a title insurer shall establish and maintain:

A A known claim reserve in an amount estimated to be sufficient to cover all unpaid losses, claims and allocated loss adjustment expenses arising under title insurance policies, guaranteed certificates of title, guaranteed searches and guaranteed abstracts of title, and all unpaid losses, claims and allocated loss adjustment expenses for which the title insurer may be liable, and for which the insurer has received notice by or on behalf of the insured, holder of a guarantee or escrow or security depositor.

B. A Statutory or Unearned Premium Reserve consisting of:

(1) The amount of statutory or unearned premium reserve required by the laws of the domiciliary state of the insurer if the insurer is a foreign or non-U.S. title insurer; or

(2) If the insurer is a domestic insurer of this state, a statutory or unearned premium reserve consisting of:

(a) The amount of the statutory or unearned premium or reinsurance reserve on the effective date of this Act, which balance shall be released in accordance with the law in effect at the time such sums were added to the reserve; and

(b) Out of total charges for policies of title insurance written or assumed commencing with the effective date of this Act, and until December 31, 1997, a title insurer shall add to and set aside in this reserve an amount equal to [insert amount] of the sum of the following items set forth in the title insurer's most recent annual statement on file with the commissioner:

(i) Direct premiums written;

(ii) Escrow and settlement service fees;

(iii) Other title fees and service charges including fees for closing protection letters; and

(iv) Premiums for reinsurance assumed less premiums for reinsurance ceded during year.

(c) Additions to the reserve after January 1, 1998 shall be made out of total charges for title insurance policies and guarantees written, equal to the sum of the following items, as set forth in the title insurer's most recent annual statement on file with the commissioner:

(i) For each title insurance policy on a single risk written or assumed after January 1, 1998, [insert amount] per $1,000 of net retained liability for policies under $500,000 and [insert amount] per $1,000 of net retained liability for policies of $500,000 or greater; and

(ii) [Insert amount] of escrow, settlement and closing fees collected in contemplation of the issuance of title insurance policies or guarantees.

(d) The aggregate of the amounts set aside in this reserve in any calendar year pursuant to Subsections B(2)(b) and B(2)(c) shall be released from the reserve and restored to net profits over a period of twenty (20) years pursuant to the following formula: thirty-five percent (35%) of the aggregate sum on July 1 of the year next succeeding the year of addition; fifteen percent (15%) of the aggregate sum on July 1 of each of the succeeding two (2) years; ten percent (10%) of the aggregate sum on July 1 of the next succeeding year; three percent (3%) of the aggregate sum on July 1 of each of the next three (3) succeeding years; two percent (2%) of the aggregate sum on July 1 of each of the next three (3) succeeding years; and one percent (1%) of the aggregate sum on July 1 of each of the next succeeding ten (10) years.

(e) The insurer shall calculate an adjusted statutory or unearned premium reserve as of the effective date of this Act. The adjusted reserve shall be calculated as if Subsections B(2)(b) through (B(2)(d) of this section had been in effect for all years beginning twenty (20) years prior to the effective date of this Act. For purposes of this calculation, the balance of the reserve as of that date shall be deemed to be zero. If the adjusted reserve so calculated exceeds the aggregate amount set aside for statutory or unearned premiums in the insurer's annual statement on file with the commissioner on the effective date of this Act, the insurer shall, out of total charges for policies of title insurance, increase its statutory or unearned premium reserve by an amount equal to one-sixth of that excess in each of the succeeding six years, commencing with the calendar year that includes the effective date of this Act, until the entire excess has been added.

(f) The aggregate of the amounts set aside in this reserve in any calendar year as adjustments to the insurer's statutory or unearned premium reserve pursuant to Subsection B(2)(e) shall be released from the reserve and restored to net profits, or equity if the additions required by Subsection B(2)(e) of this section reduced equity directly, over a period not exceeding ten (10) years pursuant to the following table:

Year of Addition	Release
Year 1*	Equally over 10 years
Year 2	Equally over 9 years
Year 3	Equally over 8 years
Year 4	Equally over 7 years
Year 5	Equally over 6 years
Year 6	Equally over 5 years

* (The calendar year following the effective date of this Act).

C. A supplemental reserve shall be established consisting of any other reserves necessary, when taken in combination with the reserves required by Subsections A and B of this section, to cover the company's liabilities with respect to all losses, claims and loss adjusted expenses.

D. Each title insurer subject to the provisions of this Act shall file with its annual statement required under [insert section] a certification by a member in good standing of the American Academy of Actuaries. The actuarial certification required of a title insurer must conform to the National Association of Insurance Commissioners' annual statement instructions for title insurers.

E. [Temporary Provision] The supplemental reserve required under Subsection C of this section shall be phased in as follows: twenty-five percent (25%) of the otherwise applicable supplemental reserve will be required until December 31, 1997; fifty percent (50%) of the otherwise applicable supplemental reserve will be required until December 31, 1998; and, seventy-five percent (75%) of the otherwise applicable supplemental reserve will be required until December 31, 1999.

24. The Annual Statement Instructions for Schedule P include the following guidance (only the pertinent excerpts are included below):

> Discounting of loss and loss adjustment expense reserves is allowed only if expressly permitted by the state insurance department to which this annual statement is being filed. If discounting of loss and loss adjustment expense reserves is reflected on Page 3 of this annual statement, a reconciliation is provided in Schedule P, Part 1. Work papers relating to any discount amounts must be available for examination upon request.

Generally Accepted Accounting Principles

25. FAS 60 provides the following guidance related to premium revenue recognition on long-duration contracts:

> 15. Premiums from long-duration contracts, such as whole-life contracts (including limited-payment and single-premium life contracts), guaranteed renewable term life contracts, endowment contracts, annuity contracts, and title insurance contracts, shall be recognized as revenue when due from policyholders.
>
> 16. Premiums from title insurance contracts shall be considered due from policyholders and, accordingly, recognized as revenue on the effective date of the insurance contract. However, the binder date (the date a commitment to issue a policy is given) is appropriate if the insurance enterprise is legally or contractually entitled to the premium on the binder date. If reasonably estimable, premium revenue and cost relating to title insurance contracts issued by agents shall be recognized when the agents are legally or contractually entitled to the premiums, using estimates based on past experience and other sources. If not reasonably estimable, premium revenue and costs shall be recognized when agents report the issuance of title insurance contracts.

26. FAS 60 provides the following guidance related to claim cost recognition:

> 17. A liability for unpaid claim costs relating to insurance contracts other than title insurance contracts, including estimates of costs relating to incurred but not reported claims, shall be accrued when insured events occur. A liability for estimated claim costs relating to title insurance contracts, including estimates of costs relating to incurred but not reported claims, shall be accrued when title insurance premiums are recognized as revenue (paragraphs 15 and 16).
>
> 18. The liability for unpaid claims shall be based on the estimated ultimate cost of settling the claims (including the effects of inflation and other societal and economic factors), using past experience adjusted for current trends, and any other factors that would modify past experience.[4] Changes in estimates of claim costs resulting from the continuous review process and differences between estimates and payments for claims shall be recognized in income of the period in which the estimates are changed or payments are made. Estimated recoveries on unsettled claims, such as salvage, subrogation, or a potential ownership interest in real estate, shall be evaluated in terms of their estimated realizable value and deducted from the liability for unpaid claims. Estimated recoveries on settled claims other than mortgage guaranty and title insurance claims also shall be deducted from the liability for unpaid claims.
>
> [4] Certain disclosures are required if the time value of money is considered in estimating liabilities for unpaid claims and claim adjustment expenses relating to short-duration contracts (paragraph 60.d.).
>
> 19. Real estate acquired in settling mortgage guaranty and title insurance claims shall be reported at fair value, that is, the amount that reasonably could be expected to be received in a current sale between a willing buyer and a willing seller. If no market price is available, the expected cash flows (anticipated sales price less maintenance and selling costs of the real estate) may aid in estimating fair value provided the cash flows are discounted at a rate commensurate with the risk involved. Real estate acquired in settling claims shall be separately reported in the balance sheet and shall not be classified as an investment. Subsequent reductions in the reported amount and realized gains and losses on the sale of real estate acquired in settling claims shall be recognized as an adjustment to claim costs incurred.
>
> 20. A liability for all costs expected to be incurred in connection with the settlement of unpaid claims (claim adjustment expenses) shall be accrued when the related liability for unpaid claims is accrued. Claim adjustment expenses include costs associated directly with specific claims paid or in the process of settlement, such as legal and adjusters' fees. Claim adjustment expenses

also include other costs that cannot be associated with specific claims but are related to claims paid or in the process of settlement, such as internal costs of the claims function.[5]

[5] Title insurance internal claim adjustment expenses, which generally consist of fixed costs associated with a permanent staff handling a variety of functions including claim adjustment, ordinarily are expensed as period costs because the costs are insignificant.

27. Accounting for title plant is contained in FAS 61, as amended by FAS 121. Pertinent excerpts are as follows:

> 1. A title plant consists of (a) indexed and catalogued information for a period concerning the ownership of, and encumbrances on, parcels of land in a particular geographic area; (b) information relating to persons having an interest in real estate; (c) maps and plats; (d) copies of prior title insurance contracts and reports; and (e) other documents and records. In summary, a title plant constitutes a historical record of all matters affecting title to parcels of land in a particular geographic area. The number of years covered by a title plant varies, depending on regulatory requirements and the minimum information period considered necessary to issue title insurance policies efficiently. Title plants are updated on a daily or other frequent basis by adding copies of documents on the current status of title to specific parcels of real estate.
>
> 3. Costs incurred to construct a title plant, including the costs incurred to obtain, organize, and summarize historical information in an efficient and useful manner, shall be capitalized until the title plant can be used by the enterprise to do title searches. To qualify for capitalization, costs need to be directly related to, and properly identified with, the activities necessary to construct the title plant.
>
> 4. Purchased title plant, including a purchased undivided interest in title plant, shall be recorded at cost at the date of acquisition. For title plant acquired separately, cost shall be measured by the fair value of consideration given.
>
> 5. An enterprise may decide to construct or purchase a title plant that antedates the period covered by its existing title plant (backplant). Costs to construct a backplant need to be identifiable to qualify for capitalization.
>
> 6. Capitalized costs of title plant shall not be depreciated or charged to income unless circumstances indicate that the carrying amount of the title plant has been impaired.
>
> 7. Costs incurred to maintain a title plant and to do title searches shall be expensed as incurred. Title plant maintenance involves the updating of the title plant on a daily or other frequent basis by adding (a) reports on the current status of title to specific parcels of real estate and (b) other documents, such as records relating to security or other ownership interests. Title searches involve the process of searching through records for all recorded documents or updating information summarized in the most recently issued title report.
>
> 8. Costs incurred after a title plant is operational (a) to convert the information from one storage and retrieval to another or (b) to modify or modernize the storage and retrieval system shall not be capitalized as title plant. Those costs, however, may be capitalized separately and charged to expense in a systematic and rational manner.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy

- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 10, *Losses*, and Chapter 11, *Loss Adjustment Expenses,* Appendix B*, Title Insurance Accounting Principles Supplement*
- *Issue Paper No. 3—Accounting Changes*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 37—Mortgage Loans*
- *Issue Paper No. 40—Real Estate Investments*
- *Issue Paper No. 50—Classifications and Definitions of Insurance or Managed Care Contracts in Force*
- *Issue Paper No. 53—Property and Casualty Contracts - Premiums*
- *Issue Paper No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses*
- Title Insurers Model Act, dated April 1996
- NAIC Annual Statement Instructions Title

Generally Accepted Accounting Principles

- *FASB Statement No. 5, Accounting for Contingencies*
- *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises*
- *FASB Statement No. 61*, *Accounting for Title Plant*
- *FASB Statement No. 121, Accounting for The Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*

State Regulations

- Review of state regulations for 38 states with respect to premium reserves.

Statutory Issue Paper No. 59

Credit Life and Accident and Health Insurance Contracts

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 59

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory accounting guidance on policy reserves for credit life and accident and health insurance contracts, as defined in *Issue Paper No. 50—Classifications and Definitions of Insurance or Managed Care Contracts In Force* (Issue Paper No. 50), is addressed in Chapter 10, Aggregate Reserves for Life and Annuity Contracts and Chapter 13, Aggregate Reserves for Accident and Health Policies of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies (Life/A&H Accounting Practices and Procedures Manual). That guidance addresses policy reserves related to all credit life and accident and health insurance contracts. Under current statutory accounting, credit life policy reserves may be based on either a gross unearned premium reserve or a mortality reserve. Credit accident and health policy reserves are established through a gross unearned premium reserve computed under various methods or an actuarial reserve not less than the gross unearned premium reserve.

2. GAAP requires insurance contracts to be classified as short-duration or long-duration contracts. Long-duration contracts include contracts, such as whole-life, guaranteed renewable term life, endowment, annuity, and title insurance contracts, that are expected to remain in force for an extended period. Other insurance contracts are generally considered short-duration contracts and include most property and liability insurance contracts as well as credit life and accident and health insurance contracts. Premiums from short-duration contracts ordinarily are recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided. Claim costs, including estimates of costs for claims relating to insured events that have occurred but have not been reported to the insurer, are recognized when insured events occur.

3. The purpose of this issue paper is to establish statutory accounting principles for credit life and accident and health insurance contract premium recognition and policy reserves that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts). Credit life and accident and health insurance contracts will be referred to collectively as "credit insurance" for purposes of this issue paper.

SUMMARY CONCLUSION

Definitions

4. Credit insurance is generally issued in connection with the issuance of credit to an individual by a bank, retailer, finance company, or other similar organization. This type of insurance most often protects the creditor to the extent of the unpaid balance of the loan. Contracts sold in connection with loans or other credit transactions, not exceeding a stated duration shall be reported as credit insurance. Mortgage guaranty insurance is addressed in *Issue Paper No. 88—Mortgage Guaranty Insurance*. Credit policies are generally limited to issues of 120 months or less in most states. Credit insurance is sold as either an individual or group policy and may provide for single or joint life coverage.

5. Credit life insurance, generally in the form of decreasing term insurance, is issued on the lives of debtors to cover payment of loan balances in case of death. Credit accident and health insurance is insurance on a debtor to either provide indemnity for payments becoming due on a specific loan or other credit transaction while the debtor is disabled.

6. Premiums for credit insurance contracts shall be defined as the contractually determined amount charged by the insurance company to the policyholder for the effective period of the contract.

Income Recognition and Policy Reserves

7. Consistent with *Issue Paper No. 51—Life Contracts* (Issue Paper No. 51), premiums shall be recognized in the summary of operations as income on the gross basis (amount charged to the policyholder) when due from policyholders under the terms of the insurance contract.

8. Policy reserves are established through either a gross unearned premium reserve or a mortality/morbidity reserve. The gross unearned premium reserve represents the estimated amount of premium for insurance coverage that has not yet expired. The mortality/morbidity reserve represents the estimated amount of future anticipated benefits, discounted at valuation interest and mortality/morbidity, to be incurred on policies in force. Policy reserves meet the definition of liabilities as defined in *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*.

9. When the level of insurance risk is constant during the contract period, policy reserves shall be recognized over the period of risk using either the daily pro-rata or monthly pro-rata methods as described in *Issue Paper No. 53—Property and Casualty Contracts - Premiums* (Issue Paper No. 53). Policy reserves for contracts where the level of insurance risk is not constant throughout the contract period shall be recognized over the period of risk in proportion to the amount of insurance protection provided. Various methods may be used to accomplish this as discussed in paragraphs 21 to 23. The reporting entity shall select the method that most closely reflects the pattern of insurance protection provided.

10. For credit accident and health contracts, the policy reserve recorded shall not be less than the gross unearned premium reserve. In addition, for all credit contracts in the aggregate, if the premium refund liability exceeds the aggregate recorded reserve, an additional liability shall be established. This premium refund (excess) liability may include consideration of commission, premium tax and other expenses recoverable.

11. The difference between the policy reserves at the beginning and end of the reporting period shall be reflected as the change in reserves or change in unearned premium, as appropriate, in the summary of operations, except for any difference due to a change in valuation basis. A change in valuation basis shall be accounted for consistent with paragraph 24 of Issue Paper No. 51.

12. When the anticipated benefits, expected dividends to policyholders and maintenance cost exceed the recorded policy reserve, a premium deficiency reserve shall be recognized by recording an additional liability for the excess deficiency with a corresponding charge to operations. Commission and other acquisition costs need not be considered in the premium deficiency analysis since they have previously been expensed.

DISCUSSION

13. This issue paper expands on current statutory guidance by requiring that policy reserves on credit insurance contracts be recognized over the exposure period of the contract in proportion to the amount of insurance protection provided. Under current statutory accounting, credit life policy reserves may be based on either a gross unearned premium reserve or a mortality reserve. Credit accident and health policy reserves are established through a gross unearned premium reserve computed under various methods. Additionally, this issue paper modifies current statutory accounting by requiring the recognition of a premium deficiency in circumstances described in the preceding paragraph. Current statutory

guidance does not specifically address premium deficiency reserves. These changes were made to improve consistency in accounting and reporting for credit insurance contracts.

GAAP Literature

14. Consistent with Issue Papers Nos. 50, 51 and *Issue Paper No. 54 - Individual and Group Accident and Health Contracts* (Issue Paper No. 54), *FASB Statement No. 60*, *Accounting and Reporting by Insurance Enterprises* (FAS 60), *FASB Statement No. 97*, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments* (FAS 97) and *FASB Statement 120*, *Accounting and Reporting by Mutual Life Assurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts* (FAS 120), are rejected for the reasons set forth in those issue papers. However, the GAAP concept of recognizing policy reserves over the period of risk in proportion to the amount of insurance protection provided has been considered in this issue paper.

Characteristics of Credit Life and Accident and Health Insurance Contracts

15. Accounting for credit life and accident and health insurance is significantly affected by the premium mode and the nature of the risks assumed. Both of these factors shall be considered in determining the most appropriate method in which to recognize the policy reserve over the exposure period of the contract in proportion to the amount of insurance protection provided.

16. The premium mode may be either a single premium or a monthly premium based on the outstanding loan balance. Under single premium credit insurance, the premium rate is applied to the initial amount of insurance and generally is included in the debt. The single premium is generally remitted to the insurer at the time the loan is made. Premiums which are collected monthly based on the insurance protection provided are generally the monthly outstanding balance type. Outstanding balance rates, used generally for group coverage, are determined by multiplying a monthly rate times the amount of outstanding insured indebtedness.

17. The nature of the risks assumed are impacted by the loan conditions as well as the type of coverage or benefits provided. Loan conditions include the loan term, amount, payment pattern, and interest rate. Coverage or benefit types for credit life insurance policies are generally either gross coverage, net payoff coverage, level coverage, or a combination of insurance plans. Gross coverage insures the gross indebtedness of a loan in the form of decreasing term insurance and is used for closed end loans such as installment loans. Net payoff coverage provides decreasing term insurance protection where the death benefit is equal to the scheduled amount due under a debt obligation at any time. This normally includes the outstanding principal and insurance premiums, plus any accrued interest since the last payment. Net payoff coverage is generally used for open end loans in which the monthly payment is not fixed (e.g., lines of credit, home equity loans, and variable rate loans). Level coverage is generally used for single payment closed-end loans and provides for the full payment of the loan at maturity using level term insurance as the plan of insurance. Balloon loans provide for monthly installment payments, plus a lump sum payment at maturity (the balloon). Frequently the installment portion of the loan is covered by decreasing term insurance, while the balloon is covered by level term insurance. Other times, decreasing term coverage is provided as a single policy (certificate) where the last month of the coverage decreases by an amount, or balloon, much greater than the regular monthly installment payment.

18. Credit accident and health insurance policies provide generally a monthly benefit payable as long as the insured remains disabled, or until the scheduled maturity of the loan, if earlier. Since the benefit is the full monthly payment of the loan, including interest charges, the coverage is gross coverage. In some cases, a lump sum, total and permanent disability coverage is offered. This coverage provides for the full payment of the loan balance if the insured is totally and permanently disabled.

Income Recognition and Policy Reserves

19. This issue paper requires gross premiums from credit insurance contracts to be recognized when due and for policy reserves to be recognized over the exposure period of the contract in proportion to the amount of insurance protection provided. To the extent the methods discussed below do not reflect the pattern of insurance protection provided, the insurer should modify or develop, if necessary, a method that recognizes net income from the policy over the exposure period of the contract in proportion to the amount of insurance protection provided.

20. Monthly outstanding balance credit policies are generally collected at the beginning of each month. Consequently, premium is generally earned at the end of the month and a gross unearned premium is only needed to the extent policies are issued during the month. When policies are issued throughout the month, a gross unearned premium reserve should be established based on the remaining proportionate amount of insurance protection to be provided using either the daily pro-rata or monthly pro-rata methods as described in Issue Paper No. 53.

21. Single premium credit life policy reserves shall be based on either a gross unearned premium reserve based on a refund formula, or a reserve based on assumed risks using mortality factors. In practice, various methods exist and are currently used to estimate the amount of gross unearned premiums applicable to the unexpired portion of the policies in force. For decreasing gross coverage, the gross unearned premium may be estimated using a Rule of 78's method; for decreasing net payoff coverage, either the Rule of 78's or the single-premium method is used; and for level coverage, the pro-rata method is generally used. The reporting entity shall select a method that reflects the pattern of insurance protection provided.

22. Policy reserves for credit A&H policies shall be based on a gross unearned premium reserve using either the pro rata, Rule of 78's, or actuarial methods. The actuarial reserve is the single premium for the debt's remaining term and amount. Most states require insurers to record a gross unearned premium reserve using the Rule of 78's method. In practice, a mean gross unearned premium reserve (average of the Rule of 78's and the pro rata methods) is often recorded. The reporting entity shall select a method that most closely reflects the pattern of insurance protection provided.

23. Recognizing net income in proportion to the amount of insurance protection provided is consistent with the recognition concept in the Statement of Concepts. The recognition concepts states, *"revenue should be recognized only as the earnings process of the underlying underwriting or investment business is completed."* Therefore, as the period that is protected expires, the underlying underwriting process is completed and the net income should be recognized.

Drafting Notes/Comments

- Issue Paper No. 50 addresses Classifications and Definitions of Insurance Contracts In Force.
- Issue Paper No. 51 addresses Life Contracts.
- Issue Paper No. 53 addresses Property and Casualty Contracts – Premiums.
- Issue Paper No. 54 addresses Individual and Group Accident and Health Contracts.
- Issue Paper No. 55 addresses Unpaid Claims, Losses and Loss Adjustment Expenses.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE (only pertinent excerpts are included below)

Statutory Accounting

24. The Life/A&H Accounting Practices and Procedures Manual provides the following guidance with respect to credit life insurance policies:

> CHAPTER 10
> AGGREGATE RESERVES FOR LIFE AND ANNUITY CONTRACTS
>
> Life Insurance
>
> The fourth line of life insurance is credit. Credit insurance may be either individual or group. All life and all accident and health insurance that is sold in connection with loans or other credit transactions not exceeding a stated duration is to be reported as credit insurance.
>
> Types of Reserves
>
> Reserves for credit insurance to a great extent depend on the premium payment plan which may be either a single premium or a monthly premium based on the outstanding loan balance. If the premium is included as part of the finance charge, and included with the total principal and interest to be paid, it is single premium credit insurance. The single premium is remitted to the insurer at the time the loan is made. State regulations may prohibit remittance of a single premium on a monthly basis by a creditor.
>
> If the premium is collected monthly for the amount of indemnity, the indemnity generally is the outstanding balance type. Reserves for credit life insurance on which premiums are remitted monthly are, in most cases, pro rata unearned premium.
>
> Reserves for single premium credit life may be computed by any of several methods. One method is unearned premium reserves based on the refund formula, usually called Sum of the Digits method or the "Rule of 78's" method. The "Rule of 78's" method assumes that refunds may be made to all insureds. Another method of computation establishes reserves in accordance with the assumed risks. This assumes that refunds will be made as they are experienced in the normal course of business, but not necessarily for all policies. Based on this method, reserves for single premium credit life insurance are established using mortality factors.

25. The Life/A&H Accounting Practices and Procedures Manual provides the following guidance with respect to credit accident and health insurance policies:

> CHAPTER 13
> AGGREGATE RESERVES FOR ACCIDENT AND HEALTH POLICIES
>
> Credit Insurance
>
> Credit accident and health insurance is insurance on a debtor to provide indemnity for payments becoming due on a specific loan or other credit transaction while the debtor is disabled as defined in the policy. Credit policies are limited to issues of 120 months or less in most states. Some states limit such policies to 60 months.
>
> Credit accident and health insurance is sold as either individual or group coverage, and the reserves are included in the annual statement. Because of the significant growth in recent years of credit insurance coverages of 120 months or less are now reported as a separate line of business in the annual statement.
>
> The premium payment methods of credit insurance may be single premium or monthly premium on the outstanding balance. Outstanding balance rates, used only for group coverage, are determined by multiplying a monthly rate times the amount of outstanding insured indebtedness.

The premium so determined is remitted on each monthly due date to the insurer by the group creditor. Under single premium credit insurance, the premium rate is applied to the initial amount of insurance and generally is included in the debt. Creditors usually remit the single premium for each new insured once a month.

Although credit insurance may be written on an individual or a group basis, the major portion of credit insurance that is written today is group. The two types differ only in form, not in substance. Consequently, they are treated here as one, unless otherwise noted.

Legal Requirements for Reserves

The reserve for single premium credit accident and health insurance is the unearned premium. Three methods are used to calculate unearned premiums: pro rata, "Rule of 78's," and actuarial. The actuarial reserve is the single premium for the debt's remaining term and amount; it is the most accurate method. Pro rata allocates the single premium proportionately to the remaining term, while "Rule of 78's" does it by using the ratio of the sum of the digits for the remaining term of the sum of the digits for the initial term. The "Rule of 78's" may substantially underreserve relative to the actuarial reserve.

Quite a few states prescribe minimum reserve standards in their credit insurance regulations. Typically, the requirement for credit A & H is either the gross unearned premium, or the actuarial reserve, but not less than the gross unearned premium. On outstanding balance group credit insurance, the gross unearned premium is generally calculated using the methods described above for other group accident and health policies.

Most companies calculate unearned premium reserves for single premium credit accident and health insurance as average factors. On the actuarial basis, the factor is the average of the single premium rates for the remaining number of months and the remaining number of months less one month. Similarly, companies that use the "Rule of 78's" will apply an average of 78's factors. These factors are applied to the single premium and are a function of the original term of the insurance and the number of months remaining in that term. The factor used to compute the reserve will be the average of the "Rule of 78's" factor for the number of months remaining, and the 78's factor for one less than the number of months remaining. This half-month assumption in both methods assumes that debtors become insured uniformly throughout each month.

Generally Accepted Accounting Principles

26. FAS 60, as amended by FAS 120, provides the following guidance:

> 3. Premiums from short-duration insurance contracts, such as most property and liability insurance contracts, are intended to cover expected claim[1] costs resulting from insured events that occur during a fixed period of short duration. The insurance enterprise ordinarily has the ability to cancel the contract or to revise the premium at the beginning of each contract period to cover future insured events. Therefore, premiums from short-duration contracts ordinarily are earned and recognized as revenue evenly as insurance protection is provided.

[1] Terms defined in the glossary (Appendix A) are in boldface type the first time they appear in this Statement.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

General Principles

7. Insurance contracts, for purposes of this Statement, shall be classified as short-duration or long-duration contracts depending on whether the contracts are expected to remain in force[3] for an extended period. The factors that shall be considered in determining whether a particular contract can be expected to remain in force for an extended period are:

a. Short-duration contract. The contract provides insurance protection for a fixed period of short duration and enables the insurer to cancel the contract or to adjust the provisions of the contract at the end of any contract period, such as adjusting the amount of premiums charged or coverage provided.

b. Long-duration contract. The contract generally is not subject to unilateral changes in its provisions, such as a noncancelable or guaranteed renewable contract, and requires the performance of various functions and services (including insurance protection) for an extended period.

8. Examples of short-duration contracts include most property and liability insurance contracts and certain term life insurance contracts, such as credit life insurance. Examples of long-duration contracts include whole-life contracts, guaranteed renewable term life contracts, endowment contracts, annuity contracts, and title insurance contracts. Accident and health insurance contracts may be short-duration or long-duration depending on whether the contracts are expected to remain in force for an extended period. For example, individual and group insurance contracts that are noncancelable or guaranteed renewable (renewable at the option of the insured), or collectively renewable (individual contracts within a group are not cancelable), ordinarily are long-duration contracts.

9. Premiums from short-duration insurance contracts ordinarily shall be recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided. A liability for unpaid claims (including estimates of costs for claims relating to insured events that have occurred but have not been reported to the insurer) and a liability for claim adjustment expenses shall be accrued when insured events occur.

Premium Revenue Recognition

Short-Duration Contracts

13. Premiums from short-duration contracts ordinarily shall be recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided. For those few types of contracts for which the period of risk differs significantly from the contract period, premiums shall be recognized as revenue over the period of risk in proportion to the amount of insurance protection provided. That generally results in premiums being recognized as revenue evenly over the contract period (or the period of risk, if different), except for those few cases in which the amount of insurance protection declines according to a predetermined schedule.

[3] *In force* refers to the period of coverage, that is, the period during which the occurrence of insured events can result in liabilities of the insurance enterprise.

27. The AICPA Audit and Accounting Guide: Stock Life Insurance Companies provides the following guidance:

> Term Contracts
>
> 8.18 A wide variety of term insurance contracts are issued. The clearly predominant service provided by many such term contracts is protection. Examples of term contracts where the predominant service is protection, include credit life insurance and other types of single or limited payment contracts of a relatively short duration. Gross premium revenues on such contracts should be recognized in proportion to the amounts of insurance in force. Expressed otherwise, written premiums should be recognized as earned during each year that a policy is in force in proportion to the ratio of the amount of insurance in force each year to the total of the annual amounts in force over the life of the policy.
>
> 8.23 The accounting for accident and health insurance policies, which are expected to be in force for a reasonable period of time and for which elements of expense or benefit costs are not level, should follow the same principle of accounting as followed for whole-life insurance. Accordingly, premium revenues should be recognized over the premium-paying period. For other kinds of health insurance, gross premiums should be recognized as revenues on a pro rata basis over the period covered by the premium except in those cases of credit accident and health where the coverage decreases by passage of time. For the latter type contracts, gross premiums should be recognized as revenues over the stated period of the contract in reasonable relationship to the anticipated claims.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 10, Aggregate Reserves for Life and Annuity Contracts, and Chapter 13, Aggregate Reserves for Accident and Health Policies
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 50—Classifications and Definitions of Insurance or Managed Care Contracts In Force*
- *Issue Paper No. 51—Life Contracts*
- *Issue Paper No. 53—Property and Casualty Contracts - Premiums*
- *Issue Paper No. 88—Mortgage Guaranty Insurance*

Generally Accepted Accounting Principles

- *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises*
- *FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*
- *FASB Statement No. 120, Accounting and Reporting by Mutual Life Assurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*
- AICPA Audit and Accounting Guide: Stock Life Insurance Companies

State Regulations

- No additional guidance obtained from state statutes or regulations.

Statutory Issue Paper No. 65

Property and Casualty Contracts

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 65

Type of Issue:
Property and Casualty

SUMMARY OF ISSUE

1. Current statutory accounting for property and casualty insurance contracts is provided in Chapters 10, 11, 12, 14, 17 and 21 of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies (P&C Accounting Practices and Procedures Manual). Property and casualty insurers may issue contracts that have unique features or require specific accounting treatment. Policies may be issued on a claims made basis, certain claims may be of the nature that it may be appropriate to discount the liabilities established, or such that the claim can be satisfied by purchasing an annuity or similar type investment to fund claim payments. Title insurance is a property and casualty insurance contract that is unique and is therefore specifically addressed in *Issue Paper No. 57—Title Insurance*.

2. GAAP guidance is provided in *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises* (FAS 60), *FASB Statement No. 113*, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts* (FAS 113), *AICPA Audit and Accounting Guide: Property & Casualty Insurance Companies* (AICPA P&C Audit and Accounting Guide) and in *AICPA Statement of Position 94-5, Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises* (SOP 94-5).

3. The purpose of this issue paper is to establish statutory accounting principles for property and casualty insurance contracts that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. In recent years insurers have begun offering policies with unique reporting features. Paragraphs 5 through 10 of this issue paper relate to policies commonly referred to as "claims made" policies. Property and casualty insurance contracts can be written to cover insured events on different reporting bases as follows:

a. Occurrence - These policies cover insured events that occur within the effective dates of the policy regardless of when they are reported to the insurer.

b. Claims Made - These policies cover insured events that are reported (as defined in the policy) within the effective dates of the policy subject to retroactive dates where applicable. Unlike an occurrence policy where a liability is recorded when the event occurs, a liability for a claims made policy shall be recorded when the event is reported to the insurer.

c. Extended Reporting - Endorsements to claims made policies covering insured events reported after the termination of a claims made contract but subject to the same retroactive dates where applicable. See paragraphs 7 and 8 for guidance for when premium shall be earned and losses shall be recorded.

Claims Made Policies

5. When an insured obtains claims made coverage they are normally replacing existing coverage. The existing coverage may have been a claims made policy or an occurrence policy. In either case, in an effort to reduce premium costs, the insured may request that the claims made coverage only cover claims reported within the effective dates of the policy that occur after a specified date. This specified date is referred to as the retroactive date of the claims made policy. This exclusion eliminates duplicate coverage when converting from occurrence coverage to claims made coverage.

6. The amount of the liability recorded for an insured event shall be determined in accordance with the provisions of paragraphs 6 through 12 of *Issue Paper No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses* (Issue Paper No. 55).

7. Premiums shall be recognized in accordance with *Issue Paper No. 53—Property Casualty Contracts - Premiums* (Issue Paper No. 53) unless the policy contains tail coverage as discussed in the following paragraphs.

8. An insured may be provided an extended reporting option to allow extended reporting of events. The extended reporting feature is commonly referred to as "tail coverage." Extended reporting provisions provided on a claims made policy modify the exposure period of the underlying contract and can be for a defined period (e.g., six months, one year, five years, etc.) or can be for an indefinite period.

9. Issue Paper No. 53 states *"Premiums from property and casualty contracts shall be recognized in the statement of operations, as earned premium using either the daily pro-rata or monthly pro-rata methods...unless a different method is specified in issue papers for specific types of property and casualty contracts"*. Therefore, when extended reporting provisions for a defined period are provided to the holder of a claims made policy, the insurer shall establish an unearned premium reserve. This liability shall represent the amount of premium charged for the tail coverage that has not yet expired and shall be earned over the tail period regardless of when the tail coverage is elected. When the claims costs and loss adjustment expenses anticipated to be reported during the extended reporting period, together with expected dividends to policyholders and maintenance cost exceed the recorded unearned premium reserve for a claims made policy, a premium deficiency reserve shall be recognized in accordance with Issue Paper No. 53.

10. When extended reporting provisions are for an undefined or indefinite period the policy has effectively been converted to an occurrence type policy. In such instances the premiums shall be recognized in accordance with Issue Paper No. 53 over the basic coverage period and the insurer shall establish a liability for all insured events that have occurred through the end of the policy period whether or not they have been reported. In establishing such reserves the insurer shall follow the guidance prescribed in Issue Paper No. 55.

Discounting

11. With the exception of fixed and determinable payments such as those emanating from workers' compensation tabular indemnity reserves and long-term disability claims, property and casualty loss reserves shall not be discounted.

12. Tabular reserves are indemnity reserves that are calculated using discounts determined with reference to actuarial tables which incorporate interest and contingencies such as mortality, remarriage, inflation, or recovery from disability applied to a reasonably determinable payment stream. This definition shall not include medical loss reserves or any loss adjustment expense reserves.

13. When establishing discounted loss reserve liabilities using a non-tabular method the liability shall be determined in accordance with *Actuarial Standard of Practice No. 20, Discounting of Property and Casualty Loss and Loss Adjustment Expense Reserves* (Actuarial Standard of Practice No. 20) but in no event shall the rate used exceed the lesser of the following two standards:

a. If the company's statutory invested assets are at least equal to the total of all policyholder reserves, the company's net rate of return on statutory invested assets, less 1.5%, otherwise, the company's average net portfolio yield rate less 1.5% as indicated by dividing the net investment income earned, as indicated by line 8 of the Underwriting and Investment Exhibit of the Annual Statement, by the average of the insurer's current and prior year total assets, as indicated on page 2 of the most currently filed annual financial statement; or

b. The current yield to maturity on a United States Treasury debt instrument with maturities consistent with the expected payout of the liabilities.

14. In accordance with *Issue Paper No. 3—Accounting Changes* (Issue Paper No. 3), a change in the discount rate used in discounting loss reserves shall be accounted for as a change in estimate. The provisions of Issue Paper No. 3 require changes in estimates to be included in the statement of operations in the period the change becomes known.

15. Insurers shall disclose the impact of discounting on the reserves for each line of business and reserve category, if any, the discount rate being utilized, and the tables used if applicable, as well as the impact of any change in the discount rate from the prior period. The disclosures required by paragraph 44 of this issue paper shall be made separately for tabular discounting and non-tabular discounting.

Structured Settlements

16. Structured settlements are periodic fixed payments to a claimant for a determinable period, or for life, for the settlement of a claim. Frequently a reporting entity will purchase an annuity to fund these future payments. Reporting entities may purchase an annuity in which the reporting entity is the owner and payee, or may purchase an annuity whereby the claimant is the payee. When annuities are purchased to fund periodic fixed payments they shall be accounted for as follows:

a. When the reporting entity is the owner and payee, no reduction shall be made to loss reserves and the annuity shall be recorded at its present value and accounted for as an other-than-invested asset as it meets the definition of an asset described in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*. Income from these annuities shall be treated as miscellaneous income. The present value of the annuity and the related amortization schedule shall be obtained from the issuing life insurance company at the time the annuity is purchased.

b. When a reporting entity has purchased an annuity and the claimant is the payee, the reporting shall reduce the loss reserve to the extent that the annuity provides for funding of future payments. The cost of these annuities shall be recorded as paid losses in such instances.

17. For each year that full financial statements are presented insurers shall disclose the following in accordance with paragraph 43 of this issue paper:

a. The amount of reserves no longer carried by the insurer because it has purchased annuities with the claimant as payee and the extent to which an insurer is contingently liable for such amounts should the issuers of the annuities fail to perform under the terms of the annuities.

b. The name, location and aggregate statement value of annuities due from any life insurer to the extent that the aggregate value of those annuities, equal or exceed 1% of the reporting entity's policyholders' surplus. This disclosure shall include all annuities for which the company has not obtained a release of liability from the claimant as a result of the purchase of an annuity. The company shall also disclose whether such life insurers are licensed in the company's state of domicile.

Excess Statutory Reserve

18. Current statutory guidance requires insurers to record an excess statutory reserve computed in accordance with the NAIC Annual Statement Instructions to Schedule P - Part 7. The types of insurance that currently are subject to the excess reserve are:

- auto liability
- other liability
- medical malpractice
- workers' compensation
- credit coverages

19. This issue paper eliminates the requirement to record excess statutory reserves. Excess statutory reserves do not meet the definition of a liability as set forth in *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets* (Issue Paper No. 5) which states:

> For purposes of statutory accounting, a "liability" shall be defined as certain or probable[1] future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or to provide services to other entities in the future as a result of past transaction(s) or event(s). A liability has three essential characteristics: (a) it embodies a present duty or responsibility to one or more other entities that entails settlement by probable[1] future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand, (b) the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice, and (c) the transaction or other event obligating the entity has already happened. This includes but is not limited to liabilities arising from policyholder obligations (e.g. policyholders benefits, reported claims and reserves for incurred but not reported claims). Liabilities shall be recorded on a Company's financial statements when incurred.
>
> [1] *FASB Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements* (CON 6), states: Probable is used with its usual general meaning, rather than in a specific accounting or technical sense (such as that *in FASB Statement 5, Accounting for Contingencies*, par. 3), and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved...

Policies with Coverage Periods Equal to or in Excess of Thirteen Months

20. Some property and casualty insurance contracts are written for coverage periods that equal or exceed thirteen months. These contracts may be single premium or fixed premium policies. These contracts generally are not subject to cancellation or premium modification by the insurer. The most common types of coverages with such periods offered by insurers are home warranty and mechanical breakdown. Revenues are generally not received in proportion to the level of exposure or period of exposure. In order to recognize the economic results of the contract over the contract period, statutory accounting must focus on establishing a liability for the estimated future policy benefits while taking into account estimated future premiums to be received. Insurers that issue such policies shall report unearned premiums in accordance with paragraph 47 of this issue paper. This guidance is primarily focused on home warranty and mechanical breakdown coverages and is not intended to include multiple year contracts comprised of single year policies each of which have separate premiums and annual aggregate

deductibles. This issue paper rejects current statutory guidance for warranty insurance reserves found in Chapter 12, Unearned Premiums, of the P&C Accounting Practices and Procedures Manual.

High Deductible Plans

21. Recently insurers have begun offering certain coverages, particularly workers' compensation coverage, under high deductible plans. These types of plans are different than self insurance coupled with an excess of loss policy in that state laws generally require the insurer to fund the deductible and to periodically review the financial viability of the insured and make an assessment of the suitability of the deductible plan to the insured. Several issues surrounding these types of plans exist, including the recording of claims below the deductible limit and the recording of the reimbursement of the deductible to the insurer.

22. Reserves for claims arising under high deductible plans shall be established net of the deductible, however, no reserve credit shall be permitted for any claim where any amount due from the insured has been determined to be uncollectible. The insurer shall disclose in the notes to the financial statements the amount of reserve credit that has been recorded for high deductibles on unpaid claims and the amounts that have been billed and are recoverable on paid claims.

23. If the policy form requires the insurer to pay for all claims including those under the deductible limit the insurer is subject to credit risk, not underwriting risk. The reimbursement of the deductible shall be accrued and recorded as a reduction of paid losses simultaneously with the recording of the paid loss by the insurer. Amounts accrued for the reimbursement of the deductible shall be billed in accordance with the provisions of the policy and the billed amount shall be accounted for as an asset. Ten percent of deductible recoverable in excess of collateral specifically held and identifiable on a per policy basis, must be reported in the annual statement as a nonadmitted asset, however, to the extent that amounts in excess of the 10% are not anticipated to be collected they shall be nonadmitted.

Environmental Exposures

24. Environmental exposures are any loss or potential loss, including third party claims, related directly or indirectly to the remediation of a site arising from past operations or waste disposal. Examples of environmental exposures include but are not limited to chemical waste, hazardous waste treatment, storage, or disposal facilities, industrial waste disposal facilities, landfills, superfund sites, toxic waste pits, and underground storage tanks.

25. Insurers that are potentially exposed to asbestos or environmental claims shall provide the disclosures required by paragraph 46 of this issue paper. Reserves for asbestos and environmental exposures shall be recorded consistently with Issue Paper No. 55.

Policyholder Dividends

26. Dividends to policyholders become liabilities of the company immediately when they are declared by the board of directors and shall be recorded as a liability in the annual statement. Incurred policyholder dividends are reported in the Statement of Income.

DISCUSSION

Claims Made Policies

27. This issue paper requires the recognition of an unearned premium reserve for claims made policies with defined extended reporting provisions and an unpaid loss reserve for claims made policies with undefined extended reporting periods, whereas current statutory guidance permits that such liabilities be reported with unearned premiums or loss reserves for those losses that have been incurred but not reported regardless of the nature of the extended reporting feature. This issue paper also requires insurers to record a premium deficiency reserve in instances when claim and loss adjustment expenses anticipated during a defined extended reporting period, together with certain other costs as described in paragraph 9 exceed the unearned premium reserve. Eliminating the option to record these reserves as loss reserves

when there is a defined extended reporting period is consistent with the concept that under claims made reporting policies, no loss has been incurred until it has been reported to the insurer. This change was made to be consistent with Issue Paper No. 53 which requires premiums to be earned over the period of exposure. Requiring these reserves to be classified as losses when a claims made policy has effectively been converted to an occurrence policy through an undefined extended reporting period is consistent with Issue Paper No. 55.

Discounting

28. The statutory principles outlined in the conclusion above are consistent with current statutory guidance for property and casualty insurance contracts. It expands current statutory guidance to permit insurers to use a discount rate that can be supported by Actuarial Standard of Practice No. 20 when discounting indemnity reserves established for future cash payments that are both fixed and determinable. Current statutory guidance limits the discount rate to that permitted by the insurer's domiciliary state. This change was made for consistency with the Statement of Concepts which states:

> The regulators' need for meaningful, comparable financial information to determine an insurer's financial condition requires consistency in the development and application of statutory accounting principles. Because the marketplace, the economic and business environment, and insurance industry products and practices are constantly changing, regulatory concerns are also changing. An effective statutory accounting model must be responsive to these changes and address emerging accounting issues. Precedent or historically accepted practice alone should not be sufficient justifications for continuing to follow a particular accounting principle or practice which may not coincide with the objectives of regulators.

29. FAS 60 states that the liability for unpaid clams shall be based on the ultimate cost of settling claims and also requires disclosure of amounts of reserves that are discounted as well as the range of discount rates used. No guidance is provided in FAS 60 with respect to the types of reserves that may be discounted. The Securities and Exchange Commission (SEC) permits discounting liabilities for unpaid loss and loss adjustment expenses at the same rates used for reporting to state regulatory authorities with respect to the same claim liabilities. Current practice under GAAP is to follow the SEC guidelines resulting in certain workers' compensation reserves and medical malpractice reserves being recorded at discounted amounts.

Structured Settlements

30. This paper adopts current statutory guidance for structured settlements. GAAP for structured settlements is found in FAS 113. FAS 113 is addressed in its entirety in *Issue Paper No. 75—Property and Casualty Reinsurance*. Statutory accounting and GAAP are consistent for the accounting of structured settlement annuities where the insurer is the owner and payee, and where the claimant is the owner and payee and the insurer has been released from its obligation. GAAP distinguishes those structured settlement annuities where the owner is the claimant and a legally enforceable release from the insurer's liability is obtained from those where the claimant is the owner and payee but the insurer has not been released from its obligation. GAAP requires the deferral of any gain resulting from the purchase of a structured settlement annuity where the claimant is the owner and payee yet the insurer has not been released from its obligation. Structured settlement annuities are an established practice and the pricing of annuities purchased from non-affiliates is dictated by an effective market. As a result statutory accounting views these settlements as completed transactions and considers the earnings process complete, thereby allowing for immediate gain recognition.

Excess Statutory Reserves

31. This issue paper eliminates the requirement to record excess statutory reserves. Historically, the requirement to record excess statutory reserves was a useful method to assist regulators in monitoring insurers and helped provide a level of conservatism in the liabilities established for losses and loss adjustment expenses. Current statutes in most states now require audited financial statements as well as actuarial certifications of the reported liabilities for losses and loss adjustment expenses for property and

casualty insurers. Current disclosure requirements provide regulators with meaningful information with respect to insurer's reserving practices. Therefore the recording of an arbitrary reserve is no longer justified.

32. Excess statutory reserves do not meet the definition of a liability as set forth in Issue Paper No. 5. The conclusion reached in this issue paper is consistent with the Statement of Concepts which states:

> Liabilities require recognition as they are incurred. Certain statutorily mandated liabilities may also be required to arrive at conservative estimates of liabilities and probable loss contingencies.

33. This conclusion is consistent with Issue Paper No. 55 which requires management of the insurer to record their best estimate of the liability for losses and loss adjustment expenses. GAAP does not require excess statutory reserves to be recorded and therefore the conclusions reached in this issue paper are consistent with GAAP.

Policies with Coverage Periods Equal to or in Excess of Thirteen Months

34. This issue paper adopts current statutory guidance for policies with coverage periods equal to or in excess of thirteen months and extends the guidance to cover warranty insurance reserves. This is consistent with GAAP which requires that premiums from contracts for which the period of risk differs significantly from the contract period be recognized as revenue over the period of risk in proportion to the amount of insurance protection provided.

High Deductible Plans

35. Current statutory guidance for high deductible plans is limited and practice varies. Some insurers attempt to bifurcate the amounts collected into premiums for the risks above the deductible and an administrative fee for administering the claims below the deductible. This has the effect of eliminating a portion of premium taxes that would otherwise be paid. Some insurers report the claims under the deductible limit as losses while others do not, and some insurers report the deductible reimbursement as premium while others do not. This issue paper requires insurers to record as a reduction of paid losses, all amounts that represent contractual reimbursements to the insurer.

36. Treatment of claims below the deductible limit for high deductible plans as a reduction of paid losses of the insurer is consistent with the insurer having no underwriting risk associated with the deductibles. Although the existence of the deductible does not eliminate the insurer's obligation to pay the claim the accounting treatment afforded the deductible is similar to ceded reinsurance balances.

Environmental Exposures

37. This issue paper adopts current statutory guidance for environmental exposures. While GAAP does not specifically address environmental exposures the Securities and Exchange Commission has issued guidance for public companies that is consistent with the current statutory requirements.

Policyholder Dividends

38. This issue paper is consistent with current statutory guidance for policyholder dividends for property casualty insurers. GAAP, for the recognition of policyholder dividends, is to accrue an estimate for amounts that will be paid even though they have not yet been declared by the board of directors. The accounting in this issue paper is a departure from Issue Paper No. 5 and from GAAP. However, codifying current statutory accounting was deemed appropriate as there are no apparent solvency concerns as a result of current statutory accounting for policyholder dividends.

Disclosure

39. The disclosure requirements of this issue paper provide for disclosures in those circumstances where the accompanying exhibits are not part of the company's financial statements (e.g., annual audit report) and are not intended to provide duplicative presentation in the annual statement filings.

Drafting Notes/Comments

- Reinsurance is addressed in *Issue Paper No. 75—Property and Casualty Reinsurance*.
- Title insurance is addressed in *Issue Paper No. 57—Title Insurance*.
- Discounting is prohibited by Issue Paper No. 55 unless it is specifically provided for in a specific issue paper.
- Financial guaranty insurance is addressed in *Issue Paper No. 69—Financial Guaranty Insurance*.

RELEVANT STATUTORY AND GAAP GUIDANCE

Statutory Accounting

40. The P&C Accounting Practices and Procedures Manual, Chapter 10, Losses, provides the following guidance:

> Structured Settlements
>
> If the company has purchased annuities, of which the company is owner and payee, to fund future payments that are fixed or determinable by settlement provisions or by workings of statutes, the present value of such annuities shall be disclosed in the annual statement as assets under “Aggregate write-ins for other-than-invested assets.” Income from these annuities is to be reported as “Aggregate write-ins for miscellaneous income” on Page 4 of the annual statement. The company shall not treat such transactions as paid losses. If the company discounts the applicable loss reserve as a result of the purchase of such annuity, the appropriate discounting disclosure is required (see Loss Reserve Discounting below.)
>
> If the claimant is the payee, the company may treat such transactions as paid losses. Appropriate disclosure of the contingent liability for such amounts must be disclosed in Notes to the Financial Statements of the annual statement.
>
> Only if the company assigns the obligation to make periodic payments to a third party and obtains a full and complete release from the claimant, may the claim be treated as a paid claim without additional disclosure.
>
> Claims-Made Policies
>
> In recent years some companies have issued “claims-made” policies for some liability coverages. Under these policies, losses are recognized as they are reported to the company rather than as they occur. The annual statement instructions have some special provisions for reporting losses under these policies.
>
> These policies frequently have extended reporting period provisions. The IBNR reserve should include provision for claims which will be reported under the extended reporting period coverage.
>
> Loss Reserve Discounting
>
> Present value discounting of property and casualty loss reserves is not a generally accepted statutory accounting practice except as respects fixed and determinable payments such as those emanating from workers’ compensation tabular indemnity reserves (defined below) and long-term disability claims. In the event, however, that an insurer is authorized by its domiciliary state to discount its liability loss reserves, the insurer should complete annual statement Schedule P as required by the annual statement instructions. The insurer should also complete the annual statement Note — Discounting of Liabilities for Unpaid Losses or Unpaid Loss Adjustment Expenses as required by the annual statement instructions.
>
> Tabular reserves are indemnity reserves that are calculated using discounts determined with reference to actuarial tables which incorporate interest and contingencies such as mortality, remarriage, inflation, or recovery from disability applied to a reasonably determinable payment stream. This definition shall not include medical loss reserves or any loss adjustment expense reserves.

Statutory Reserve Computation — Schedule P

Minimum statutory reserve calculations are made for auto liability, other liability, medical malpractice, workers' compensation, and credit coverages. Except for credit, the statutory reserve amount is calculated by comparing total losses and loss expenses incurred to earned premiums. Required ratios are set forth in the annual statement instructions for Schedule P.

The statutory reserve for credit is computed in accordance with annual statement instructions.

If a statutory reserve is required, it is shown as a liability on the annual statement. The offsetting charge is to surplus.

41. The P&C Accounting Practices and Procedures Manual, Chapter 12, Unearned Premiums, provides the following guidance:

Claims Made Extended Reporting Coverage Options Relating to Death, Disability or Retirement

Some claims-made policies provide extended reporting coverage at no additional charge in the event of death, disability or retirement of a natural person insured. In such instance, a policy reserve is required to assure that amounts collected by insurers to pay for these benefits are not earned prematurely and that an insurer with an aging book of business will not show adverse operating results simply because an increasing portion of insureds is earning the benefits for which it has paid.

Insurers providing future benefits under this endorsement should include an incremental premium charge for this coverage. It is important that a proportion of each years premiums be set aside to fund this liability. The concept of level funding, applied to these grants of extended reporting coverage is that the indicated incremental premium should not vary because an insurer: is just starting to write this business and does not expect any extended reporting options to be claimed in the near future; or has provided this type of coverage for several years and continues to write new business; or has ceased writing substantial amounts of new business but continues to renew existing accounts, expecting to grant increasing amounts of extended reporting coverage options without additional premium. Periodically insurers should re-evaluate the actuarial assumptions underlying the level premium charge based on any relevant information available at that time.

The amount of the policy reserve, when combined with premium appropriate for an on-going book of business, including some charge for extended reporting coverage, should be adequate to pay for all future claims arising from these coverage features. These future claims include those covered by future grants of extended reporting coverage, without diminishing future profitability below normal expectations for on-going business. If the loss rates for providing this coverage to an aging population are low enough to indicate a negative reserve, then the policy reserve should be set at zero.

Reserve estimates will normally assume that a portion of the existing population of insureds will not continue with the same insurer until qualifying for the benefit and exercising the option. Funding should not anticipate vesting or cash values for individual insureds unless specifically provided by contract.

These additional factors should be considered in estimating the reserve:

1. Loss trends;
2. Time value of money;
3. Nonrenewal rates;
4. Age and tenure eligibility requirements in the contracts;
5. Age and tenure demographics of the insured population;
6. Mortality considerations;
7. Morbidity considerations;
8. Pricing differentials (if any) related to age of insured;

9. Expected claim costs in relation to age of the insured and the number of years until retirement;
10. Waivers (if any) of charges for specialty changes before retirement;
11. Partial benefits (if any) for termination by either the insured or the insurer prior to retirement; and
12. Other factors that impact the value of future benefits.

Insurers may want to use policy reserving techniques that incorporate elements of life actuarial models in addition to the standard property and casualty actuarial techniques in establishing this policy reserve. This reserve, entitled extended reporting endorsement policy reserve, is most appropriately classified as a component part of the unearned premium reserve and should be considered to run more than one year from the date of the policy. The amount of the policy reserve and the accounting/actuarial policies used in determining it should be disclosed in a footnote to the financial statements. When the policy reserve is reviewed or computed at the close of each accounting period, the change in the policy reserve will flow into the net underwriting gain or loss which will result in a better matching of income and expense over the accumulation period of the policy benefit. In addition, an IBNR loss reserve will be established for those insureds which have exercised the extended reporting coverage option.

This reserve may alternatively be considered a claims reserve and included with unpaid losses by an insurer which has obtained authorization to do so from the commissioner of the state of domicile.

Unearned Premiums - Annual Statement Reporting

The Underwriting and Investment Exhibit of the annual statement shows the development of the unearned premium reserve, by line of business, net of reinsurance premiums assumed and ceded. The exhibit displays unearned premiums for policies running one year or less and for policies running more than one year. In addition, the exhibit shows the unearned premium reserves associated with advance premiums and with rate credits and retrospective adjustments. Advance premiums result when policies have been processed, and the premium has been paid prior to the effective date. These advance premiums are considered to be fully unearned. This unearned premium reserve is reported in the Liabilities, Surplus and Other Funds Exhibit of the annual statement.

As an alternative, companies may accumulate advance premiums in a suspense account until the effective dates of these policies. In this case, companies must then report the amount of the suspense account as a separate liability, Advance Premiums, on Page 3 of the annual statement under aggregate write-ins for liabilities. Using this treatment, companies would not include advance premiums in either written premium or the unearned premium reserve.

Unearned Premium - Warranty Insurance Reserves

For purposes of this rule, warranty insurance is defined as insurance covering mechanical breakdown, service contract agreements or maintenance agreements. At any point before the expiration of the insurance contract or policy the company is required to establish a portion of the premium as a liability to cover the remaining policy term. The unearned premium reserve shall equal the gross premium (after proportional reinsurance) multiplied by the ratio of expected future losses and expenses from the unexpired term of the contract to the total expected losses and expenses under the contract.

42. The NAIC Annual Statement Instructions to Schedule P provide the following guidance with respect to calculating the excess of statutory reserves over statement reserves:

SCHEDULE P - INTERROGATORIES

(I) Computation of excess statutory reserves over statement reserves. A percentage minimum loss and loss expense ratio is determined which is then applied to the net earned premiums. The result is then compared to the net losses and loss expenses incurred to give the required excess statutory reserves. If the company has permission from its state of domicile to discount loss and loss expense reserves, the company should compute the excess of statutory reserves over statement reserves using its discounted loss and loss expense reserves rather than the undiscounted reserves. The computation is required only for Auto Liability (Private Passenger and Commercial), Other Liability (including Products Liability), Medical Malpractice, Workers' Compensation, and Credit.

If the company was not in existence for the full five years prior to the statement date, this calculation should be based on the years in which the company was in existence.

Private Passenger Auto Liability and Commercial Auto Liability must be combined before calculating the statutory percentage. Occurrence and claims-made coverages must be combined for Other Liability (including Products Liability) and Medical Malpractice, respectively, before calculating the statutory percentage.

(a) Other than Credit. The percentage to be used is based on the company's actual loss and expense ratios in the five years immediately prior to the most recent three, provided that at least three of the five years have at least $1 million in net earned premium. See Schedule P, Part 1, Column 4 for premiums and Column (30) for loss and expense ratios. Use the lowest ratio of losses and loss expenses incurred for these years using only years which have at least $1 million in net earned premium. If the lowest qualifying ratio is less than 60%, then use 60% (65% for Workers' Compensation). If the lowest qualifying ratio is more than 75%, then use 75%. If at least three of the five years do not have at least $1 million in net earned premium, use 60% (65% for Workers' Compensation). Round percentage to nearest tenth of one percent. Indicate percentage used. The same percentage should be used for the three most recent years. The excess statutory reserve over the statement reserve is this percentage times the earned premium in Column 4 less the incurred amount in Column 27 for the required years. If negative, enter zero. Do not include premiums and losses for non-proportional insurance shown in Parts IN, IO, IP, and 1Q.

(b) Credit. Use the following formula and carry the result over to the annual statement.

1. Net unpaid losses on policies expired prior to October 1, current year
2. Reserve for Losses on policies expired in October, November and December, current year:
   (a) Net Premiums written on such policies
   (b) 50% of (a)
   (c) Net losses paid under such policies
   (d) Difference (b)-(c)
   (e) Net losses unpaid under such policies
   (f) Difference (d)-(e), show zero if negative
3. Reserve for accrued losses on policies in Force December 31, current year:
   (a) Net Premiums earned under such policies
   (b) 50% of (a)
   (c) Net losses paid under such policies
   (d) Difference (b)-(c)
   (e) Net losses unpaid under such policies
   (f) Difference (d)-(e), show zero if negative
4. Excess of Statutory Reserve over Statement Reserves 2(f) + 3(f) (Carry result over to annual statement.)

43. The NAIC Annual Statement Instructions, Note 14, provide the following guidance with respect to disclosure of structured settlements:

14. Structured Settlements

a. Instruction:

If the company has purchased annuities, under which the company is owner and payee, to fund future payments that are fixed or determinable by settlement provisions or by workings of statutes, the present value of such annuities shall be disclosed as assets under “Aggregate write-ins for other-than-invested assets” on Page 2 of the annual statement. The present value of the annuities should be obtained from the issuing life insurance company at the time the annuity is purchased. At the same time, an amortization schedule should be obtained since annual adjustments to the annuity's carrying value are necessary. If the total value of all annuities due from one life insurer equals or exceeds I percent of the Company's policyholders' surplus, list: the life insurer's name and location (headquarters); whether the life insurer is licensed in the company's state of domicile (i.e., yes or no is the requested response); and the statement value (i.e., present value) of the annuity(ies). The requested information is illustrated below. In addition, show the aggregate amount (i.e.. present value) of annuities due from all life insurers.

Illustration:

Life Insurance Company and Location	Licensed in Company's State of Domicile Yes/No	Statement Value (i.e., Present Value) of Annuities

b. Instruction:

If the company has purchased annuities of which the claimant is payee but for which the company is contingently liable, the amount of such contingent liability shall be disclosed in the Notes to Financial Statements, Note #8. This contingent liability is the amount of the liability due to the various claimants that have been offset by the purchase of the annuity. This liability may be measured by the amortized value (i.e., the present value obtained from the life insurer) of the annuities offsetting the liabilities. If the total value (i.e., present value) of all annuities due from one life insurer equals or exceeds I percent of the company's policyholders' surplus, list the life insurer's name and location (headquarters) and the amount of the reserve eliminated when the annuity was purchased. Report the total amount of loss reserves eliminated by annuities. This reserve is measured by the amortized value of the annuities offsetting the reserve. The requested information is illustrated below. In addition, show the aggregate amount (i.e., the present value which is obtained from the life insurer) of annuities due from all life insurers.

Illustration:

Life Insurance Company and Location	Loss Reserves Eliminated by Annuities
i. Total	$

44. The NAIC Annual Statement Instructions, Note 19, provide the following guidance with respect to discounting:

19. Discounting of Liabilities for Unpaid Losses or Unpaid Loss Adjustment Expenses

Instruction:

State whether or not any of the liabilities for unpaid losses or unpaid loss adjustment expenses are discounted, including liabilities for Workers' Compensation. If the company is required to respond to this note in the affirmative for non-tabular discounting, it must also respond in the affirmative to Schedule P Interrogatory #5, and complete Columns 31 and 32 of Part 1, Part IA, etc., of Schedule P.

If the answer is in the affirmative, furnish the following information for each line of business affected:

a. If a tabular basis is used:
   1. Identify table used.
   2. Rate(s) used to discount.
   3. The amount of discounted liability carried in the annual statement.
   4. The amount of tabular discount, disclosed by line of business and reserve category (i.e., case and IBNR).

Definition of Tabular Reserves:

Tabular reserves by accident year are indemnity reserves that are calculated using discounts determined with reference to actuarial tables which incorporate interest and contingencies such as mortality, remarriage, inflation, or recovery from disability applied to a reasonably determinable payment stream. This definition shall not include medical loss reserves or any loss adjustment expense reserves.

b. If a non-tabular basis is used:
   1. Rate(s) used to discount and the basis for the rate(s) used.
   2. Amount of non-tabular discount disclosed by line of business and reserve category (i.e., case, IBNR, Allocated Loss Adjustment Expense and Unallocated Adjustment Expense).
   3. The amount of non-tabular discounted liability carried in the annual statement.

c. If the rate(s) used to discount prior accident years' liabilities have changed from the previous annual statement:
   1. Amount of discounted current liabilities at current rate(s) assumption(s). (Exclude the current accident year.)
   2. Amount of discounted current liabilities at previous rate(s) assumption (s). (Exclude the current accident year.)
   3. Change in discounted liability due to change in interest rate(s) assumptions.(l-2)
   4. Amount of non-tabular discount, disclosed by line of business and reserve category (i.e., case, IBNR, allocated loss adjustment expense and unallocated loss adjustment expense).

Illustration:
The Company discounts the liabilities for unpaid losses for Workers' Compensation and Medical Malpractice claims. The Company does not discount unpaid loss adjustment expenses.

Reserves for Workers' Compensation claims have been discounted on a tabular basis using the _________ Table at ___%. The December 31, 19XX and December 31, 19XX liabilities include $____________ and $_____________ of such discounted reserves, respectively. The amount of discount for case and IBNR reserves at December 31, 19XX is as follows:

	Tabular Discount Included in Schedule P	
Schedule P Lines of Business	Part I *	
	(1)	(2)
	Case	IBNR
(1) Homeowner/Farmowners		
(2) Private Passenger Auto Liability/Medical		
(3) Commercial Auto/Truck Liability/Medical		
(4) Workers' Compensation		
(5) Commercial Multiple Peril		
(6.1) Medical Malpractice - occurrence		
(6.2) Medical Malpractice - claims made		
(7) Special Liability		
(8.1) Other Liability - occurrence		
(8.2) Other Liability - claims made		
(9) Special Property		
(10) Auto Physical Damage		
(11) Fidelity, Surety		
(12) Other (including Credit, Accident & Health)		
(13) International		
(14) Reinsurance A		
(15) Reinsurance B		
(16) Reinsurance C		
(17) Reinsurance D		
(18.1) Products Liability - occurrence		
(18.2) Products Liability - claims made		
(19) Financial Guaranty/Mortgage Guaranty		
(20) Total		
* Must exclude medical loss reserves and all loss adjustment expense reserves		

Medical Malpractice unpaid losses have been discounted on a non tabular basis using rates of from ____% to ____%. The discount rates used are based upon ____________________. The amount of the discount as of December 31, 19XX and December 31, 19XX respectively is $ __________ and $ __________ for losses and $ __________ and $ __________ for loss adjustment expense. The amount of discount at December 31, 19XX for case, IBNR, allocated LAE and unallocated LAE is as follows:

B. Non-Tabular Discount

	Non-Tabular Discount *			
Schedule P Lines of Business	(1)	(2)	(3)	(4)
			Allocated	Unallocated
	Case	IBNR	LAE	LAE
(1) Homeowners/Farmowners				
(2) Private Passenger Auto Liability/Medical				
(3) Commercial Auto/Truck Liability/Medical				
(4) Workers' Compensation				
(5) Commercial Multiple Peril				
(6.1) Medical Malpractice - occurrence				

(6.2) Medical Malpractice - claims made				
(7) Special Liability				
(8.1) Other Liability - occurrence				
(8.2) Other Liability - claims made				
(9) Special Property				
(10) Auto Physical Damage				
(11) Fidelity, Surety				
(12) Other (including Credit, Accident & Health)				
(13) International				
(14) Reinsurance A				
(15) Reinsurance B				
(16) Reinsurance C				
(17) Reinsurance D				
(18.1) Products Liability - occurrence				
(18.2) Products Liability - claims made				
(19) Financial Guaranty/Mortgage Guaranty				
(20) Total				
* Should include medical loss reserves and all loss adjustment expense reserves, whether reported as tabular or non-tabular in Schedule P				

The rates used to discount Medical Malpractice unpaid losses at December 31, 19XX have changed from the rates used at December 31, 19XX. At December 31, 19XX, the amount of discounted Medical Malpractice unpaid losses, excluding the current accident year, is $ __________. Had these unpaid losses been discounted at the rates used at December 31, 19XX the amount of discounted liabilities would be $__________. The reduction in the discounted liability due to the change in rates is $__________.

This illustration neither regulates, permits, nor prohibits the practice of discounting liabilities for unpaid losses or unpaid loss adjustment expenses.

45. Chapter 21, Dividends to Policyholders, of the P&C Accounting Practices and Procedures Manual provides the following guidance with respect to policyholder dividends:

> Most state insurance statutes establish the conditions under which dividends may be declared and paid to the policyholder. In general, they provide that dividends to policyholders become liabilities of the company immediately when they are declared by the board of directors. The dividends may be paid only out of unassigned (earned) surplus, in accordance with the rates approved by the board of directors. No dividend may be declared or paid when the surplus of a company is less than the minimum original surplus that is required for the kind or kinds of business which the company is authorized to transact. Also, no dividend may be declared or paid when the payment would reduce the company's surplus below its required minimum. No dividend may be declared or paid that is contrary to any restriction contained in the company's articles of incorporation. Certain states have additional restrictions on declaration of dividends to policyholders.
>
> State statutes usually provide that a company's board of directors or trustees may declare dividends to its policyholders and, in so doing, may establish reasonable classifications or groupings of policyholders and reasonable plans for the distribution of such dividends. This may be done for each general kind and group or class of insurance, and may establish reasonable territorial divisions upon policies expiring during a fixed period.
>
> In establishing the liability for dividends declared and unpaid, the dividend scale approved by the board of directors is applied to all policies in the designated groups or classes.

> The amount of policyholder dividends declared and unpaid should be recorded as a liability in the annual statement. Incurred policyholder dividends are reported in the Statement of Income; the amount so reported includes the paid amount (typically recorded as paid in the ledger asset reconciliation) plus the amount accrued at the end of the year (the dividends declared and unpaid), less the amount accrued at the beginning of the year.

46. The NAIC Annual Statement Instructions, Note 24, provide the following guidance with respect to environmental disclosures:

> 24. Asbestos/Environmental (Mass Tort) Reserves
>
> Instruction:
>
> If the company is potentially exposed to asbestos and/or environmental claims (mass tort), full disclosure of the reserving methodology for both case and IBNR reserves is required. Disclosure of the amount paid and reserved for losses and LAE for asbestos and/or environmental claims, on a gross and net of reinsurance basis, is also required.
>
> Does the company have on the books or has it ever written an insured for which you have identified a potential for the existence of a liability due to asbestos and/or environmental losses? Yes ( ) No ( )I
>
> If yes, describe the lines of business written for which there is potential exposure, the nature of the exposure or exposures and the company's methodology for reserving for both reported and IBNR losses.
>
> If yes, complete the following information, separately for asbestos-related and environmental losses (including coverage dispute costs) for each of the five most current calendar years on both a gross and net of reinsurance basis (more detailed breakdowns are acceptable):
>
> Beginning reserves: $________
> Incurred losses and loss adjustment expenses: ________
> Calendar year payments for losses and loss adjustment expenses: ________
> Ending reserves: $
>
> If yes, complete the following, separately for asbestos-related and environmental reserves:
>
> Does the company hold reserves for unreported claims? Yes ( ) No ( )
>
> Does the company hold reserves for future allocated loss adjustment expenses (including coverage dispute cost)? Yes( ) No ( )
>
> Definition of Environmental Loss
>
> Any loss or potential loss (including third-party claims) related directly or indirectly to the remediation of a site arising from past operations or waste disposal.
>
> Examples of Environmental Exposure:
>
> Chemical Waste
> Hazardous Waste TSD Facilities (Treatment, Storage and/or Disposal)
> Industrial Waste Disposal Facilities
> Landfills
> Superfund
> Toxic Waste Pits
> Underground Storage Tanks

47. The Financial Condition (EX4) Subcommittee adopted the following guidance at the June 7, 1995 meeting of the Subcommittee. The guidance was adopted by the full membership of the NAIC at the September 11, 1995 Plenary Session.

> Unearned Premium Reserve - Single or Fixed Premium Policies with Coverage Periods in Excess of Thirteen Months
>
> This rule shall apply to all contracts or policies (contracts), excluding financial guaranty contracts, mortgage guaranty products, and surety contracts that fulfill both of the following conditions:
>
> 1. The policy or contract term is greater than or equal to 13 months.
>
> 2. The insurer can neither cancel the contract, nor increase the premium during the policy or contract term.
>
> At any valuation date prior to the expiration of the contracts, the company is required to establish an adequate premium reserve, to be reported as the unearned premium reserve for the contracts, on all appropriate annual statement lines and exhibits. Each of the following three tests shall be calculated, for all direct and assumed contracts, in the aggregate by policy year for each line of business with the gross premium reserve being equal to the greatest of the following calculations for each policy year for each line of business. Any reserve credit applicable for reinsurance ceded shall be appropriately reflected in the annual statement with the resulting net premium reserve being established by the company. For reporting net information on the NAIC financial reporting blank, the UPR shall be recalculated on a net basis, which may include appropriate statutory permitted credits for reinsurance, salvage and subrogation.
>
> 1. The best estimate of the amounts refundable to the contractholders at the valuation date.
>
> 2. The gross premium multiplied by the ratio of (a) over (b), where:
>
>   (a) equals the best estimate of future expected gross losses and expenses to be incurred during the unexpired term of the contracts; and
>
>   (b) equals the best estimate of the total expected gross losses and expenses under the contracts.
>
>   The future and total expected losses and expenses are to be re-estimated no less frequently than annually, and the most recent estimate of these expected losses is to be used in this test.
>
> 3. The amount of the present value of the future expected gross losses and expenses to be incurred during the unexpired term of the contracts, reduced by the present value of the future guaranteed gross premiums, if any. In the calculation of the present value:
>
>   (a) Discounting is only permitted for future expected losses and expenses, and not incurred but unpaid losses and expenses.
>
>   (b) Losses and expense provisions may be discounted from the expected date the loss or expense is incurred, not from the expected date of payment, unless such lines of business are permitted to be discounted by the state of domicile.
>
>   (c) The rate of interest used to calculate the present values shall be reviewed and changed as necessary at each valuation date determined as not to exceed the lesser of the following two standards.
>
>   (i) if the company’s statutory invested assets are at least equal to the total of all policyholder reserves, the company’s net rate of return on statutory invested assets, less 1.5%, otherwise, the company's average net

portfolio yield rate less 1.5% as indicated by dividing the net investment income earned, as indicated by line 8 of the Underwriting and Investment Exhibit of the NAIC Annual Statement, by the average of the insurer's current and prior year total assets, as indicated on page 2 of the most currently filed annual financial statement; or

(ii) the current yield to maturity on a United States Treasury debt instrument maturing in five (5) years as of the valuation date.

For the purposes of tests (2) and (3) above, "expenses" shall include all incurred and anticipated expenses related to the issuance and maintenance of the policy, including loss adjustment expenses, policy issuance and maintenance expenses, commissions, and premium taxes.

This unearned premium methodology will result in premium earning patterns which are inconsistent with the assumptions implicit with the excess of statutory reserves over statement reserve calculation. Therefore, contracts subject to this rule will not be required to be included in such Schedule P Interrogatories calculation.

This section shall immediately apply to all inforce and subsequent business. At the company's option, the impact of this rule with regard to the choice of the interest rate under section 3 may be uniformly phased in over a three year period. The amount phased in shall be limited to the difference between the amounts calculated by using the rate mandated by this rule and the rate actually used by the company for discounting as of 12/31/94, so long as the latter rate does not exceed the constant treasury maturity rate determined by using yields from treasury bills with durations which match the duration of the company's existing liabilities for the inforce which is affected by this rule.

Additionally, where this rule produces a higher reserve than the company would have established through the use of their previous methodology, the company may request a phase in period, of not to exceed three years, from it domiciliary Commissioner. Such phase in period shall only be permitted if the company is able to demonstrate to the satisfaction of the Commissioner that it would not be operating in a hazardous financial condition and that there is not adverse risk to its insureds.

Generally Accepted Accounting Principle

48. The AICPA P&C Audit Guide provides the following guidance:

Accounting Principles

3.29 The specialized industry accounting principles for insurance enterprises are specified in FASB Statement No. 60. The following is a brief discussion of the principles and policies relating to the premium cycle. Readers should refer to the FASB Statement for specific guidance. Most property and liability insurance contracts are classified as short-duration contracts, and this guide generally focuses on such contracts.

Revenue Recognition

3.30 Premiums from a short-duration contract ordinarily should be recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided. This generally results in premiums being recognized as revenue evenly over the contract period. Under a few kinds of contracts, the period of risk differs significantly from the contract period. An example is insurance policies for recreational vehicles issued for an annual period, covering claims that are incurred primarily in the summer months. Under other kinds of contracts, the amount of coverage declines over the contract period on a scheduled basis. In those cases, the premium is recognized as revenue over the period of risk in proportion to the amount of insurance protection provided. Unearned premiums, that portion of the premium applicable to the unexpired period of the policy, are included as an unearned premium reserve within the company's balance sheet.

3.31 As discussed in FASB Statement No. 60, some premiums are subject to subsequent adjustment (for example, retrospectively rated or other experience-rated insurance contracts). In these cases, the premium is determined after the period of the contract and is based on claim experience, or reporting form contracts, for which the premium is adjusted after the period of the contract based on the value of insured property. If, as is usually the case, the ultimate premium is reasonably estimable, the estimated ultimate premium should be recognized as revenue over the period of the contract. It should be revised to reflect current experience. However, if the ultimate premium cannot be reasonably estimated, the cost-recovery method or the deposit method may be used until the ultimate premium becomes reasonably estimable. Under the cost-recovery method, premiums are recognized as revenue in amounts equal to estimated claims as insured events occur until the ultimate premium is reasonably estimable, and recognition of income is postponed until then. Under the deposit method, premiums are not recognized as revenue and claims are not charged to expense until the ultimate premium is reasonably estimable, and income recognition is postponed until that time.

The Loss Reserving and Claims Cycle

Accounting Practices

4.01 The specialized industry accounting principles for insurance enterprises are described in *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises, FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments, FASB Statement No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, and *SOP 92-5, Accounting for Foreign Property and Liability Reinsurance*.

4.02 Under GAAP, liabilities for the cost of unpaid claims, including estimates of the cost of claims incurred but not reported, are accrued when insured events occur. The liability for unpaid claims should be based on the estimated ultimate cost of settling the claims (that is, the total payments expected to be made) and should include the effects of inflation and other social and economic factors. Estimated recoveries on unpaid claims, such as salvage and subrogation are deducted from the liability for unpaid claims. A liability for those adjustment expenses expected to be incurred in the settlement of unpaid claims should be accrued when the related liability for unpaid claims is accrued. Changes in estimates of the liabilities resulting from their periodic review and differences between estimates and ultimate payments are reflected in the income of the period in which the estimates are changed or the claim is settled. If the liabilities for unpaid claims and claim-adjustment expenses are discounted (that is, the liabilities are not recorded at their ultimate cost because the time value of the money is token into consideration), the amount of the liabilities presented at present value in the financial statements and the range of interest rates used to discount those liabilities are required to be disclosed. For public companies, the SEC staff issued *Staff Accounting Bulletin No. 62, Discounting by Property/Casualty Insurance Companies*, which discusses the appropriate accounting and financial reporting when a company adopts or changes its policy with respect to discounting certain unpaid claims liabilities related to short-duration insurance contracts. The SEC issued *Financial Reporting Release No. 20, Rules and Guide for Disclosures Concerning Reserves for Unpaid Claims and Claim Adjustment Expenses of Property-Casualty Underwriters*, which requires additional disclosures concerning the underwriting and claims reserving experience of property-casualty underwriters. The SEC staff also issued *Staff Accounting Bulletin No. 87, Contingency Disclosures on Property/Casualty Insurance Reserves for Unpaid Claim Costs*, which provides guidance concerning those uncertainties surrounding property and casualty loss reserves that may require FASB Statement No. 5, Accounting for Contingencies, contingency disclosures and *Staff Accounting Bulletin No. 92, Accounting and Disclosures Relating to Loss Contingencies*, which provides the SEC staff's interpretation of current accounting literature relating to the following:

Offsetting of probable recoveries against probable contingent liabilities

Recognition of liabilities for costs apportioned to other potential responsible parties

Uncertainties in estimation of the extent of environmental or product liability

The appropriate discount rate for environmental or product liability, if discounting is appropriate

Accounting for exit costs
Financial statement disclosures and disclosure of certain information outside the basic financial statements

Salvage and Subrogation
4.30 After a claim has been settled, the possibility of salvage or subrogation may exist. Perhaps the simplest approach to determining the anticipated receivable is to estimate loss reserves using loss data that is net of salvage and subrogation recoveries. Many of the reserving methods for losses and loss adjustment expenses, however, can also be used to estimate salvage and subrogation recoveries.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapters 10, 11, 12, 14, 17 and 21
- NAIC Annual Statement Instructions to Schedule P
- *Issue Paper No. 3—Accounting Changes*
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 50—Classifications and Definitions of Insurance or Managed Care Contracts In Force*
- *Issue Paper No. 53—Property Casualty Contracts - Premiums*
- *Issue Paper No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses*
- *Issue Paper No. 57—Title Insurance*
- *Issue Paper No. 66—Accounting for Retrospectively Rated Contracts*
- NAIC Annual Statement Instructions to notes 14, 19, and 24
- Minutes to the Financial Condition (EX4) Subcommittee meeting of June 7, 1995.

Generally Accepted Accounting Principles

- *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises*
- *FASB Statement No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*
- *AICPA Audit and Accounting Guide: Property & Casualty Insurance Companies*
- *AICPA Statement of Position 94-5, Disclosure of Certain Matters in the Financial Statements of Insurance Enterprises*

State Regulations

- Texas Alternative Calculation for Schedule P reserves for High Deductible Plans
- Arkansas Insurance Department Bulletin 14-93 Guidelines for Implementation of Large Deductible Workers' Compensation Programs
- Florida Regulations FAC Rule 4-189.006 Guidelines for Large Deductible Workers' Compensation Filings
- Massachusetts Regulations 211 CMR 113.04 Workers' Compensation Deductibles Plan

Other Sources of Information

- *Actuarial Standard of Practice No. 20, Discounting of Property and Casualty Loss and Loss Adjustment Expense Reserves*

Statutory Issue Paper No. 66

Accounting for Retrospectively Rated Contracts

STATUS
Finalized June 23, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 66

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. A retrospectively rated contract is one which has final policy premium calculated based on the loss experience of the insured or subscriber during the term of the policy (including developments after the term of the policy) and the stipulated formula set forth in the policy. The periodic adjustment involves either the payment of return premium to the insured or subscriber or payment of an additional premium by the insured or subscriber, or both, depending on experience. Retrospective rating features are common in certain property and casualty contracts, group life, and group accident and health contracts. Contracts with retrospective rating features are referred to as loss sensitive contracts.

2. Current statutory guidance for accounting for retrospectively rated contracts is contained in Chapter 12, Unearned Premiums, of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies (P & C Accounting Practices and Procedures Manual) and Chapter 13, Aggregate Reserves for Accident and Health Policies, and Chapter 15, Liabilities Related to Policyholder Dividends, of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies (Life/A&H Accounting Practices and Procedures Manual) and the NAIC Annual Statement Instructions (Annual Statement Instructions). This guidance requires the recognition of a liability for return premium due to an insured or subscriber and an asset for additional premium due from an insured or subscriber under a retrospectively rated contract. Retrospective premiums reported as assets are subject to various requirements for asset admissibility.

3. GAAP guidance for accounting for retrospectively rated contracts is contained in *FASB Statement No. 60*, *Accounting and Reporting by Insurance Enterprises* (FAS 60), and *FASB Emerging Issues Task Force Issue No. 93-14*, *Accounting for Multiple-Year Retrospectively Rated Insurance Contracts by Insurance Enterprises and Other Enterprises* (EITF 93-14). This guidance also requires the recognition of a liability for return premium due to an insured and an asset for additional premium due from an insured under a retrospectively rated insurance contract.

4. The purpose of this issue paper is to establish statutory accounting principles for retrospectively rated contracts that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts). This issue paper applies to property and casualty contracts, life insurance contracts and accident and health contracts. Retrospective reinsurance contracts are not within the scope of this issue paper, they are addressed in *Issue Paper No. 75—Property and Casualty Reinsurance*.

SUMMARY CONCLUSION

5. Amounts due from insureds and amounts due to insureds under retrospectively rated contracts meet the definition of assets and liabilities as set forth in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets* (Issue Paper No. 4) and *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets* (Issue Paper No. 5), respectively. Amounts due from insureds

and amounts due to insureds under retrospectively rated contracts are admitted assets to the extent they conform to the requirements of this issue paper.

6. Initial premiums shall be recognized in accordance with *Issue Paper No. 51—Life Contracts*, *Issue Paper No. 53—Property Casualty Contracts - Premiums* (Issue Paper No. 53) and *Issue Paper No. 54—Individual and Group Accident and Health Contracts*.

7. Because policy periods do not always correspond to reporting periods and because an insureds loss experience may not be known with certainty until some time after the policy period expires, retrospective premium adjustments shall be estimated based on the experience to date using one of the following methods:

a. Property and Casualty Contracts

i. Use of actuarially accepted methods in accordance with filed and approved retrospective rating plans. This includes but is not limited to the application of historical ratios of retrospective rated developments to earned standard premium to develop a ratio which is then applied to those policies for which no retrospective calculation has been recorded or for which no modification to the recorded calculation is needed. This method results in the calculation of one amount which is either a net asset or a net liability;

ii. Reviewing each individual retrospectively rated risk, comparing known loss development (including IBNR) with that anticipated in the policy contract to arrive at the best estimate of return or additional premium earned at that point in time. This method results in the calculation of an asset or a liability for each risk. The total of all receivables shall be recorded as an asset and the total of all return premiums shall be recorded as a liability.

b. Life and Accident & Health Contracts: Reporting entities offering group coverage have extensive underwriting procedures and complex individually negotiated benefits and contracts. Due to cost and reporting deadlines, these factors make it difficult to establish an exact valuation of retrospective premium. The method used to estimate the liability shall be reasonable based on the reporting entity's procedures, and consistent among reporting periods. Common methods include a mathematical approach using a complex algorithm of the reporting entity's underwriting rules and experience rating practices, and an aggregate or group approach.

8. Assumptions used in estimating retrospective premium adjustments shall be consistent with the assumptions made in recording other assets and liabilities necessary to reflect the underwriting results of the reporting entity such as claim and loss reserves (including IBNR) and contingent commissions. Contingent commissions and other related expenses shall be adjusted in the same period the additional or return retrospective premiums are recorded.

9. Retrospective premium adjustments are estimated for the portion of the policy period that has expired and shall be considered an immediate adjustment to premium. Additional retrospective premiums and return retrospective premiums shall be recorded as follows:

a. Property And Casualty Insurers:

i. Accrued additional retrospective premiums shall be recorded as a receivable with a corresponding entry made either to written premiums or as an adjustment to earned premiums. Premiums not recorded through written premium when accrued shall be recorded through written premium when billed;

ii. Accrued return retrospective premiums shall be recorded as a write-in liability with a corresponding entry made either to written premiums or as an adjustment to earned premiums. Premiums not recorded through written premium when accrued shall be recorded through written premium when billed.

iii. Ceded retrospective premium balances payable shall be recorded as liabilities, consistent with *Issue Paper No. 75—Property and Casualty Reinsurance.* Ceded retrospective premiums recoverable shall be recorded as an asset. Consistent with *Issue Paper No. 76—Offsetting and Netting of Assets and Liabilities* (Issue Paper No. 76), ceded retrospective premium balances payable may be deducted from ceded retrospective premiums recoverable when a legal right of setoff exists.

b. Life and Accident & Health Insurers:

i. Accrued additional retrospective and other premiums shall be recorded as a write-in for other-than-invested assets, with a corresponding entry made to premiums;

ii. Accrued return retrospective and other premiums shall be recorded as a liability, Provision for experience rating refunds, with a corresponding entry to premiums.

10. The amount of accrued estimated retrospective premiums to be recorded as a nonadmitted asset for property and casualty insurers shall be determined as follows:

a. 100% of the amount recoverable from any person for whom any agents' balances or uncollected premiums are classified as nonadmitted, and item (b), plus item (c) or (d) below. Once an insurer has elected either (c) or (d) below, a change from one to the other requires approval from the insurer's domiciliary state and such change must be disclosed in the financial statements.

b. Retrospective premium adjustments shall be determined and billed or refunded in accordance with the policy provisions or contract provisions. If accrued additional retrospective premiums are not billed in accordance with the policy provisions or contract provisions, the accrual shall be nonadmitted.

c. 10% of any accrued retrospective premiums not offset by retrospective return premiums, other liabilities to the same party (other than loss and loss adjustment expense reserves), or collateral, not otherwise used. Collateral shall be of the same types and quality permitted for use in connection with reinsurance (types of acceptable collateral vary from state to state) or by financial guaranty coverage issued by an insurer having an "A" or better rating from a nationally recognized rating agency. The financial guaranty coverage must allow the insured under the financial guaranty policy the same degree of access to payments under that policy as a beneficiary has under a qualified letter of credit as described in Appendix A-785. Accrued retrospectively rated premiums relating to bulk IBNR must be allocated to individual policyholder accounts prior to applying collateral by account. If the insurer is unable to allocate amounts by account, no credit may be taken for collateral.

d. An amount calculated using the factors below for accrued retrospective premiums not offset by retrospective return premiums, other liabilities to the same party (other than loss and loss expense reserves), or collateral, not otherwise used. Collateral shall be of the same types and quality permitted for use in connection with reinsurance (types of acceptable collateral vary from state to state) or by financial guaranty coverage issued by an insurer having an "A" or better rating from a nationally recognized rating agency. The financial guaranty coverage must allow the insured under the financial guaranty policy the same degree of access to payments under that policy as a beneficiary has under a qualified letter of credit.

Accrued retrospectively rated premiums relating to bulk IBNR must be allocated to individual policyholder accounts prior to categorizing by Quality Rating.

Insured's Current Quality Rating*	Insured's Corporate Debit Equivalent to (S&P/Moody's)**	Percentage of Retro Premium to be Nonadmitted***
1	AAA, AA, A/Aaa, Aa, A	1%
2	BBB/Baa	2%
3	BB/Ba	5%
4	B/B	10%
5	CCC, CC, C/Caa, Ca	20%
6	CI, D/C, or insured in default on debt service payments, or insured's debt service payments are jeopardized upon filing of a bankruptcy petition	100%

* The Percentage of Retro Premium to be Nonadmitted is based upon the Insured's Current Quality Rating (i.e., if an insured's quality rating drops, the percentage relating to the lower quality rating is used in calculating the amount to be nonadmitted and vice versa).

** Insureds that do not have a debt rating issued by a publicly recognized rating agency are required to be rated by the NAIC's Securities Valuation Office (SVO).

*** In the event the insured has no debt rating (either from a publicly recognized rating agency or from the SVO) the insured's quality rating will be considered category 5 for purposes of this calculation (i.e., a factor of 20% shall be applied), unless the insurer is aware of conditions of the insured that would warrant a category 6 classification (i.e., a factor of 100%).

11. Once accrued retro premiums are billed, the due date is governed by *Issue Paper No. 6—Amounts Due From Agents and Brokers* (Issue Paper No. 6) (if premium is agency billed), or *Issue Paper No. 10—Uncollected Premium Balances* (Issue Paper No. 10) (if premium is direct billed). Life and accident & health insurers shall nonadmit any accrued retrospective premium that is more than 90 days due. If a reporting entity has more than one policy with the same insured, retrospective balances shall be netted in accordance with Issue Paper No. 76.

12. If, in accordance with Issue Paper No. 5, it is probable that the additional retrospective and other premium is uncollectible, any uncollectible additional retrospective and other premium shall be written off against operations in the period the determination is made. If it is reasonably possible a portion of the balance in excess of the nonadmitted portion determined in accordance with paragraph 11 of this issue paper is not anticipated to be collected, the disclosure requirements outlined in Issue Paper No. 5 shall be made.

Disclosure

13. The financial statements shall disclose the method used by the reporting entity to estimate retrospective and other premium adjustments. The amount of net premiums written that are subject to retrospective rating features and other adjustments, as well as the corresponding percentage to total net premiums written, shall be disclosed.

14. The financial statements shall disclose the calculation of nonadmitted retrospective premium. If a reporting entity chooses treatment described in paragraph 10.c. or 10.d., the appropriate exhibit must be included in the notes to financial statements in the Annual Statement. Once a reporting entity has elected either 10.c. or 10.d., a change from one to the other requires approval from the reporting entity's domiciliary state and such change must be disclosed in the financial statements.

DISCUSSION

15. This issue paper addresses premium adjustments for retrospectively rated contracts. Premium adjustments that have been billed are also addressed in Issue Paper No. 6 and Issue Paper No. 10. The statutory principles outlined in the conclusion above are consistent with the current statutory guidance for accounting for retrospectively rated contracts except as follows:

a. Paragraph 10 requires property and casualty entities to record accrued retrospective premium credits as an aggregate write in for other liabilities whereas current statutory provides for retrospective premium credits to be recorded with unearned premiums.

b. Paragraph 12 requires that any impairment of recorded additional retrospective premiums be charged against operations in the period in which the impairment is determined.

c. Paragraph 14 expands the disclosure requirements that are currently in place for property and casualty insurers to life and accident & health entities.

d. Paragraph 11 expands the requirement for accident and health entities to nonadmit any retrospective premium balances that are more than 90 days past due to life insurers.

These changes were made to be consistent with the approach reflected for earned but unbilled premiums (EBUB) in Issue Paper No. 53 and with the approach reflected in Issue Paper No. 5 which requires the recognition of a loss when an asset has been impaired.

16. The statutory principles outlined in the conclusion above are consistent with the guidance provided for accounting for retrospectively rated insurance contracts in FAS 60 and EITF 93-14 with the exception of the requirement to record certain amounts as nonadmitted. Although FAS 60 is rejected in *Issue Paper No. 50—Classifications and Definition of Insurance or Managed Care Contracts In Force* and EITF 93-14 is rejected in this issue paper since it applies only to multiple-year retrospectively rated contracts, it is considered appropriate that the accounting for retrospectively rated contracts be consistent with those provisions of both FAS 60 and EITF 93-14 as they are consistent with the Statement of Concepts.

17. The statutory accounting principles outlined in the conclusion above are consistent with the recognition concept in the Statement of Concepts of which a pertinent excerpt follows:

> Recognition
>
> The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which may be unavailable due to encumbrances or other third party interests should not be recognized on

> the balance sheet but rather should be charged against surplus when acquired or when availability otherwise becomes questionable.

18. Based on the above concept, accrued retrospective premium balances should reflect only amounts that are available to meet both current and future policyholder obligations. Therefore, amounts determined to be impaired should be charged to income in the period such determination is made. In addition, premium taxes and commissions relating to the accrued retrospective premium should be recorded. The adoption of this methodology will more appropriately provide the statutory financial statement reader with an indication of those assets available to meet policyholder obligations.

19. The statutory accounting principles outlined in the conclusion above are consistent with the conservatism concept in the Statement of Concepts of which a pertinent excerpt follows:

> Conservatism
>
> Financial reporting by insurance enterprises requires the use of substantial judgments and estimates by management. Such estimates may vary from the actual amounts for numerous reasons. To the extent that factors or events result in adverse variation from management's accounting estimates, the ability to meet policyholder obligations may be lessened. In order to provide a margin of protection for policyholders, the concept of conservatism should be followed when developing estimates as well as establishing accounting principles for statutory reporting.

Drafting Notes/Comments

- Earned but unbilled premiums are addressed in *Issue Paper No. 53—Property Casualty Contracts Premiums*.
- Retrospectively rated reinsurance contracts are addressed in *Issue Paper No. 75—Property and Casualty Reinsurance*.
- The definition of loss sensitive contracts included herein includes all contracts with retrospective rating features. The instructions to Schedule P - Part 7 require reporting for loss sensitive contracts subject to very specific percentage changes in premiums based on loss experience.
- Premium adjustments that have been billed are further discussed in *Issue Paper No. 6—Amounts Due from Agents and Brokers* and *Issue Paper No. 10—Uncollected Premium Balances*.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

20. The P & C Accounting Practices and Procedures Manual, Chapter 7, Agents' Balances or Uncollected Premiums*,* provides the following guidance regarding recording accrued retrospective premiums net of ceded reinsurance:

> The annual statement blank requires the following separation: (1) premiums and agents' balances in course of collection (i.e., premiums both booked and billed), less ceded reinsurance balances payable; (2) premium, agents' balances and installments booked but deferred and not yet due (e.g., premiums which have been booked but are not yet billed), less ceded reinsurance balances payable; (3) accrued retrospective premiums (i.e., accrued retrospective premiums which have not been booked or billed), less ceded retrospective rated balances payable.

21. The P & C Accounting Practices and Procedures Manual, Chapter 9, Nonadmitted Assets*,* point 5, lists examples of nonadmitted assets:

> Accrued retrospective premiums from whom any agents' balances or uncollected premiums are classified as nonadmitted.

22. The NAIC Annual Statement Instructions for Property and Casualty Insurance Companies, Notes and Miscellaneous, Instructions and Illustrations of How to Report Information in the Notes to Financial Statements*,* page 101, provide the following instructions:

Instruction:

Describe the basis used to determine the amount of accrued retrospective premiums reported as admitted assets in Line 9.3.

23. The P & C Accounting Practices and Procedures Manual, Chapter 12, Unearned Premiums*,* states the methodology that shall be used in determining the unearned premium reserve adjustment relating to accrued retrospective contracts following:

Retrospective Rated Policies

Retrospectively rated policies have a final premium calculated on the experience of the insured during the term of the policy (including developments after the term of the policy) and the stipulated formula set forth in the policy. The adjustment involves either the payment of a return premium to the insured or the payment of an additional premium by the insured.

Recognizing the need for reserve provisions to account for these potential additional or return premiums, provision has been made in the Underwriting and Investment Exhibit of the annual statement for the recording of a special unearned premium reserve fund by line of business called “Reserve for Rate Credits and Retrospective Adjustments Based on Experience.” Such amounts should be calculated using actuarially acceptable methods in accordance with filed and approved retrospective rating plans. Accrued net additional retrospective premiums are reported as assets and subject to collateralization requirements for asset admissibility.

Two methods are commonly employed by insurance companies in computing this unearned premium reserve. The first method is to build up for each line by policy year, a historical record of the ratio of retrospective rated developments to earned standard premium. The ratio is applied to the earned standard premium of those policies for which no retrospective calculation has yet been recorded, producing the indicated unearned premium. A second method is to review each individual retrospectively-rated risk, comparing known loss developments with those anticipated in the policy contract to arrive at the best estimate of return or additional premium due at that point in time.

24. The NAIC Annual Statement Instructions for Property and Casualty Insurance Companies, Underwriting and Investment Exhibit, Part 2A, Recapitulation of All Premiums*,* page 59, also sets forth the methodology for calculating and reporting for the reserve for accrued credits and retrospective premium:

The reserve for accrued credits and retrospective return premium adjustments based upon experience, Column 4, may be computed under one of two methods. The first method is to build up for each line by policy year, a historical record of the ratio of retrospective rated developments to earned standard premium. The ratio is then applied to the earned standard premium of those policies for which no retrospective calculation has yet been recorded, producing the indicated unearned premium. The second method is to review each individual retrospectively rated risk, comparing known-loss developments with those anticipated in the policy contract to arrive at the best estimate of return or additional premium due at that point in time. Include, as a negative amount in Column 4, the amount of net accrued retrospective debit adjustments only to the extent they are for incurred (paid and/or unpaid) losses, loss adjustment expenses and, if any, other underwriting expenses also included in the financial statement of the company.

25. The Annual Statement Instructions for Property and Casualty Insurance Companies, Exhibit 1, Analysis of Assets*,* provides additional guidance regarding admissibility:

Line 9.3 - Accrued Retrospective Premiums on Insurance Contracts

Include: Estimated additional direct premiums and assumed premiums accrued that will become due under prescribed terms from insureds or reinsureds under policies or reinsurance agreements containing retrospective rating formulas based on current or expired policies' experience, but not to exceed the limitations, if any, contained in such policies or reinsurance agreements. Net of reinsurance; plus reinsurance assumed fund balance minus reinsurance ceded balance

Exclude: Agents' balances or uncollected premium items (Line 9.1 and Line 9.2) and accrued rate credits

The amount reported in Column I must be zero and the amount reported in Column 2 must agree with the amount reported on Page 8, Part 2A, Line 33.

Include as non-admitted in Column 3, amounts for accrued retrospective premiums which represent:

a. 100% of the amount recoverable from any person for whom any agents' balances or uncollected premiums (Lines 9.1 or 9.2) are classified as non-admitted (Column 3), and item (b) or (c) below. Once an insurer has elected either (b) or (c) below, a change from one to the other requires approval from the insurer's domiciliary state and such change must be disclosed in Note #1 of Notes to Financial Statements.

b. 10% of any accrued retrospective premiums not offset by retrospective return premiums, other liabilities to the same party (other than loss and loss adjustment expense reserves), or collateral, not otherwise used. Collateral shall be of the same types and quality permitted for use in connection with reinsurance (see notes to Schedule F) or by financial guaranty coverage issued by an insurer having an "A" or better rating from a nationally recognized rating agency. The financial guaranty coverage must allow the insured under the financial guaranty policy the same degree of access to payments under that policy as a beneficiary has under a qualified letter of credit as per Section 11 of the NAIC Credit for Reinsurance Model Regulation. Accrued retrospectively rated premiums relating to bulk IBNR must be allocated to individual policyholder accounts prior to applying collateral by account. If the insurer is unable to allocate amounts by account, no credit may be taken for collateral.

c. An amount calculated using the factors below for accrued retrospective premiums not offset by retrospective return premiums, other liabilities to the same party (other than loss and loss expense reserves), or collateral, not otherwise used. Collateral shall be of the same types and quality permitted for use in connection with reinsurance (see notes to Schedule F) or by financial guaranty coverage issued by an insurer having an "A" or better rating from a nationally recognized rating agency. The financial guaranty coverage must allow the insured under the financial guaranty policy the same degree of access to payments under that policy as a beneficiary has under a qualified letter of credit as per Section 11 of the NAIC Credit for Reinsurance Model Regulation.

Accrued retrospectively rated premiums relating to bulk IBNR must be allocated to individual policyholder accounts prior to categorizing by Quality Rating.

Insured's Current Quality Rating*	Insured's Corporate Debt Equivalent to (S&P/Moody's)**	Percentage of Retro Premium to be Nonadmitted***
1	AAA, AA, A/Aaa, Aa, A	1%
2	BBB/Baa	2%
3	BB/Ba	5%
4	B/B	10%
5	CCC, CC, C/Caa, Ca	20%
6	CI, D/C, or insured in default on debt service payments, or insured's debt service payments are jeopardized upon filing of a bankruptcy petition.	100%

* The Percentage of Retro Premium to be Nonadmitted is based upon the Current Quality Rating (i.e., if an insured's quality rating drops, the percentage relating to the lower quality rating is used in calculating the amount to be nonadmitted and vice versa).

** Insureds that do not have a debt rating issued by a publicly recognized rating agency are required to be rated by the NAIC's Securities Valuation Office SVO.

*** In the event the insured has no debt rating (either from a publicly recognized rating agency or from the SVO), the insured's quality rating will be considered category 5 for purposes of this calculation (i.e., a factor of 20% shall be applied), unless the insurer is aware of conditions of the insured that would warrant a category 6 classification (i.e., a factor of 100%).

If an insurer chooses item (b) or (c) above, the appropriate exhibit must be included in Note #18 of the Notes to Financial Statements of the annual statement to summarize the calculation of nonadmitted retrospective premium (see instructions to Notes to Financial Statements).

Include as nonadmitted in Column 3, amounts for accrued retrospective premiums on assumed business which represents 100% of the amount accrued (gross of ceded reinsurance) for any reinsured for which any agents' balances or uncollected premiums (Lines 9.1 or 9.2) are classified as nonadmitted (Column 3).

26. The NAIC Annual Statement Instructions for Property and Casualty Insurance Companies, Schedule P Part 7, Supplement for Loss Sensitive Contracts, page 221 requires the following disclosure:

General

1. Only the experience on contracts that meet the following definition should be included in Schedule P, Part 7. The experience on all other contracts should not be included.

   Loss sensitive contracts shall meet the following criteria:

   Contracts where an increase in losses on a policy can cause an increase in net payment (by the insured) for that policy.

   The amount of additional payment (by the insured) must be at least 75% (50% for reinsurance contracts) of the additional losses, before application of aggregate and per accident/claimant limits or caps.

   The net amount paid (by the insured) must also be able to differ by at least 20% (10% for reinsurance contracts), from highest to lowest possible charge in reaction to the loss experience.

> The maximum possible payment by the insured should also be at least 15% (7.5% for reinsurance contracts) above what the insured would pay based on expected loss experience. In other words, the maximum charge should not approximate the expected charge.
>
> The additional payment shall be in the form of additional premiums or additional commissions.
>
> The additional losses and corresponding payments must flow through the income and balance sheets and cannot be "off-balance sheet." For example, a deductible feature does not make a contract "loss sensitive" under this definition, as neither the losses under the deductible nor the reimbursements for these losses flow through the income statement.
>
> 2. In all development exhibits, only reported data as of year end 1993 and subsequent is required. Data for prior year ends is encouraged, but not required. For each year end, data for all issue years is required.
>
> 3. Schedule P, Part 7 is only required of insurers who claim a reduction in their Risk-Based Capital for Loss Sensitive Contracts. Such insurers must complete the entire schedule in each year that they claim such credit.
>
> 4. Schedule P, Part 7A provides experience on primary contracts. Schedule P, Part 7B provides experience on reinsurance contracts. The segregation should be consistent with the Risk-Based Capital formula.
>
> Current Year Loss and LAE Reserves and Net Written Premium
>
> 5. Column (2) of Parts 7A and 7B of Schedule P, when combined, should agree with the net loss and loss expense reserves (undiscounted) reported in the corresponding Part I of Schedule P. Column (3) should reflect the reserve for Loss Sensitive Contracts only.
>
> 6. Column (5) of Parts 7A and 7B of Schedule P, when combined, should agree with the net written premiums reported in the Underwriting and Investment Exhibit. Column (6) should reflect the corresponding premium for Loss Sensitive Contracts only.
>
> 7. Columns (4) and (7) are ratios of (3) to (2) and (6) to (5), respectively. Express as percentages showing one decimal place (e.g., 24.2%).

27. Chapter 13, Aggregate Reserves For Accident And Health Policies, of the Life/A&H Accounting Practices and Procedures Manual provides the following guidance on individual and group accident and health reserves:

> Reserve For Experience-Rating Refunds Or The Dividend Liability In Group Insurance Policies
>
> Some group insurance policyholders may receive partial or full retrospective premium credit for their policy-year experience. On the statutory financial statement date, a provision for the experience rated refund is established based on the experience of the policy year up to the statement date. This liability may include certain funds contributed by the policyholder as a premium stabilization fund. Since many policy years do not end at the statutory financial statement date, subsequent experience may cause the rate credit actually to be greater or less than the liability established on the statement date. For this reason, the rate credit liability becomes a very difficult liability to establish and an equally difficult liability to reconcile. Only for the very smallest of group insurance carriers is it possible to do an exact valuation of this liability based on the company underwriting rules and practices. Larger group insurers have massive texts of underwriting procedures, along with complex individually negotiated benefits and contracts. For reasons of economy and reporting deadlines, few companies can establish an “exact” valuation of this liability. Some companies use a certain approach, using a complex

algorithm of the company's underwriting rules and experience rating practices. Other companies use aggregate or grouping approaches. Regardless of the approach used, the liability must stand the test of reasonableness and consistency. No company should pay experience refunds unless its contracts provide for such payment.

The experience rating refund may be reported as a separate liability item or may be included as an active life reserve.

28. The Life/A&H Accounting Practices and Procedures Manual, Chapter 15, Liabilities Related to Policyholder Dividends*,* provides the following guidance with respect to experience rated contracts:

Experience Rating Refunds (Retrospective Rate Credits)

Nonparticipating group insurance and pension contracts may be subject to experience rating. Experience credits for a given group are usually developed by determining the excess, if any, of the premium and investment income earned with respect to the group over the corresponding benefits and expenses incurred with respect to the group and applying an appropriate credibility adjustment to that excess.

At specified dates, such as the contract anniversary or the end of the calendar year, the experience of the contract is calculated and the refund, if any, is paid. If the balance sheet date falls between the dates on which the refund is paid, the experience up to the balance sheet date is calculated and the appropriate liability is established.

Generally Accepted Accounting Principles

29. FAS 60, paragraph 14, states the following:

If premiums are subject to adjustment (for example, retrospectively rated or other experience rated insurance contracts for which the premium is determined after the period of the contract based on claim experience or reporting-form contracts for which the premium is adjusted after the period of the contract based on the value of insured property), premium revenue shall be recognized as follows:

a. If, as is usually the case, the ultimate premium is reasonably estimable, the estimated ultimate premium shall be recognized as revenue over the period of the contract. The estimated ultimate premium shall be revised to reflect current experience.

b. If the ultimate premium cannot be reasonably estimated, the cost of recovery method or the deposit method may be used until the ultimate premium becomes reasonably estimable.

30. FAS 60, paragraph 44, states the following:

Retrospective and Contingent Commission Arrangements

If retrospective commission or experience refund arrangements exist under experience-rated insurance contracts, a separate liability shall be accrued for those amounts, based on experience and the provisions of the contract. Income in any period shall not include any amounts that are expected to be paid to agents or others in the form of experience refunds or additional commissions. Contingent commissions receivable or payable shall be accrued over the period in which related income is recognized.

31. EITF 93-14, includes the following:

ISSUE

An enterprise (for example, a manufacturing concern, a retailer, a service entity, or a financial institution) enters into a multiple-year retrospectively rated contract with an insurance company.

That contract is similar to the type of contract discussed in Issue No. 93-6, "Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises," and may cover various types of exposures such as product and environmental liability risks.

Those contracts include a "retrospective rating" provision that provides for at least one of the following based on contract experience: (1) changes in the amount or timing of future contractual cash flows, including premium adjustments, settlement adjustments, or refunds to the noninsurance enterprise, or (2) changes in the contract's future coverage. A critical feature of those contracts is that part or all of the retrospective rating provision is obligatory such that the retrospective rating provision creates for each party to the contract future rights and obligations as a result of past events. A retrospectively rated insurance contract that is not a multiple-year contract or that could be canceled by either party without further obligation is not covered by this Issue. Contracts used by enterprises in certain industries where risks are "pooled," like those discussed in paragraph 45 of Statement 5 and a reinsurance contract entered into by a captive insurer, are addressed by this Issue.

The issue is how a multiple-year retrospectively rated contract arising from an insurance transaction that is not a reinsurance contract should be accounted for.

EITF DISCUSSION

The Task Force reached a consensus that in order to be accounted for as insurance, an insurance contract must indemnify the insured as required by paragraph 44 of Statement 5. For those contracts that do not provide indemnification, the premium paid, less the amount of the premium to be retained by the insurer, should be accounted for as a deposit by the insured.

For a multiple-year retrospectively rated insurance contract accounted for as insurance, the Task Force reached a consensus that the insured should recognize a liability and the insurer should recognize an asset to the extent that the insured has an obligation to pay cash (or other consideration) to the insurer that would not have been required absent experience under the contract. The amount recognized in the current period should be computed, using a with-and-without method, as the difference between the insured's total contract costs before and after the experience under the contract as of the reporting date, including costs such as premium adjustments, settlement adjustments, and impairments of coverage. The amount of premium expense related to impairments of coverage should be measured in relation to the original contract terms. Future experience under the contract (that is, future losses and future premiums that would be paid regardless of past experience) should not be considered in measuring the amount to be recognized.

If the insured could terminate the contract prior to the end of its term and if termination would change the amounts paid (for example, if terminating the contract would cost less than continuing the contract in force), the liability resulting from the contract should be measured as follows:

1. If a decision to terminate has been made, the measurement should be based on an assumption of termination and on experience to date.

2. Otherwise, the measurement should be based on the lesser of the following:
   a. The total incremental amount that would be paid based on the with-and-without calculation assuming experience to date and assuming termination (that is, excluding the effects of future losses and future premiums that would have been paid regardless of experience to date).

   b. The total incremental amount that would be paid based on the with-and-without calculation assuming experience to date and assuming no termination (that is, excluding the effects of future losses and future premiums that would have been paid regardless of experience to date).

The insured should recognize an asset and the insurer should recognize a liability to the extent that any cash (or other consideration) would be payable by the insurer to the insured based on experience to date under the contract.

The insured and the insurer should account for changes in coverage in the same manner as changes in other contract costs. For example, the effects of decreases in coverage without a commensurate reduction in premium should be recognized as a loss by the insured and as a gain by the insurer when the event causing the decrease in coverage takes place.

The Task Force noted that deposit accounting cannot be used to avoid loss recognition that would otherwise be required (for example, if the insured has no future coverage relating to the deposit with the insurer and, therefore, the deposit is not recoverable).

The provisions of this consensus are effective as of November 18, 1993 and should be initially applied no later than the fourth quarter of 1993 for calendar-year enterprises in one of two ways:

1. By recognition of the net effect of applying the provisions at the beginning of an enterprise's current fiscal year as a cumulative effect of a change in accounting principle in accordance with paragraph 20 of Opinion 20. Under this approach, the disclosures required by paragraph 21 of Opinion 20 would be required as long as the income statement for the current fiscal year is presented. The provisions of Statement 3 apply to all interim periods presented.

2. By restatement of financial statements for all periods presented. The Task Force noted that the FASB Staff Views on Issue 93-6 that appear as Topic No. D-35 in Appendix D are useful guidance for applying this consensus.

STATUS

No further EITF discussion is planned.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapters 7, 9 and 12
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies - Chapters 13 and 15
- NAIC Annual Statement Instructions
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 6—Amounts Due From Agents and Brokers*
- *Issue Paper No. 10—Uncollected Premium Balances*
- *Issue Paper No. 53—Property Casualty Contracts - Premiums*
- *Issue Paper No. 75—Property and Casualty Reinsurance*
- *Issue Paper No. 76—Offsetting and Netting of Assets and Liabilities*

Generally Accepted Accounting Principles

- *FASB Statement 60, Accounting and Reporting by Insurance Companies*
- *FASB Emerging Issues Task Force No. 93-14, Accounting for Multiple-Year Retrospectively Rated Insurance Contracts*

State Regulations

- No additional guidance from state statutes or regulations.

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Statutory Issue Paper No. 67

Depreciation of Property and Amortization of Leasehold Improvements

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 19

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory guidance for accounting for the depreciation of property and the amortization of leasehold improvements is provided in Chapters 4 and 9 of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies (P&C Accounting Practices and Procedures Manual) and Chapter 4 of the Accounting Practices and Procedures Manual for Life, Accident, and Health Insurance Companies (Life/A&H Accounting Practices and Procedures Manual). This guidance requires:

a. The cost of directly owned property (except land), occupied by the company or held for investment, to be allocated to expense (depreciated) over the property's estimated useful life in a systematic and rational manner.

b. The cost of nonadmitted furniture and equipment (including EDP equipment) to either be fully expensed when purchased or depreciated over the property's estimated useful life.

c. The cost of leasehold improvements to be allocated to expense (amortized) over the term of the lease.

2. GAAP guidance for accounting for depreciation is provided in *Accounting Research Bulletin No. 43*, *Restatement and Revision of Accounting Research Bulletins* (ARB 43*),* Chapter 9, *Depreciation*, and *Accounting Principles Board Opinion No. 12*, *Omnibus Opinion - 1967* (APB 12*).* This guidance requires that the cost of depreciable assets, less salvage value (if any) be expensed over the estimated useful lives of the assets. GAAP guidance requires a leasehold improvement to be amortized over the remaining term of the lease or its estimated useful life, whichever is shorter.

3. The purpose of this issue paper is to establish statutory accounting principles for accounting for the depreciation of property and the amortization of leasehold improvements that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

4. *Issue Paper No. 16—Electronic Data Processing Equipment and Software* (Issue Paper No. 16), *Issue Paper No. 19—Furniture, Fixtures and Equipment* (Issue Paper No. 19), *Issue Paper No. 31—Leasehold Improvements Paid by the Reporting Entity as Lessee* (Issue Paper No. 31), and *Issue Paper No. 40—Real Estate Investments* (Issue Paper No. 40) each require the depreciation of these assets against net income as their estimated economic benefit expires.

SUMMARY CONCLUSION

5. The acquisition cost of all depreciable assets, net of salvage, shall be allocated to expense over the estimated useful lives of the assets in a systematic and rational manner. The acquisition cost of a leasehold improvement shall be allocated to expense over the shorter of its estimated useful life or the

original lease term excluding options or renewal periods. For leasehold improvements capitalized subsequent to inception of the lease, the cost shall be allocated to expense over the shorter of its estimated useful life or the remaining original lease term excluding options or renewal periods. Amounts capitalized for leasehold improvements in periods subsequent to the original lease term (i.e., during renewal periods), are amortized utilizing the shorter of the estimated useful life of the asset or the remaining term of the renewal period. In accordance with the reporting entity's capitalization policy, immaterial amounts incurred relative to leasehold improvements, can be expensed when purchased.

6. For the purposes of this issue paper, depreciable assets include all tangible capital assets classified as either admitted or nonadmitted in accordance with *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets* (Issue Paper No. 4). Land shall not be considered a depreciable asset.

7. Depreciation and amortization expense shall be recorded in the statement of income in accordance with *Issue Paper No. 94—Allocation of Expenses* (Issue Paper No. 94).

8. A variety of systematic depreciation and amortization methods is available such as the straight-line method, the sum-of-the-years' digits method, and various declining balance methods. The depreciation or amortization method selected shall be that which most appropriately allocates the cost of the depreciable asset or leasehold improvement over its estimated useful life. The use of the sinking fund or constant yield method does not constitute acceptable statutory accounting practice.

9. Useful lives of depreciable assets and leasehold improvements can be obtained from contractors, appraisers, engineers, and manufacturers, or they may be based on prior experience. Estimates published by the Internal Revenue Service can be helpful in the selection of useful lives for specific assets.

10. The following disclosures shall be made in the financial statements or notes thereto:

a. Depreciation and amortization expense for the period.

b. A general description of the method or methods used in computing depreciation and amortization with respect to major classes of depreciable assets and leasehold improvements.

11. Changes in the estimated useful lives of depreciable assets or leasehold improvements from one period to another shall be considered a change in accounting estimate and shall be accounted for in accordance with *Issue Paper No. 3—Accounting Changes* (Issue Paper No. 3). Changes in depreciation or amortization methods from one period to another shall be considered a change in accounting principle and shall be accounted for in accordance with Issue Paper No. 3.

DISCUSSION

12. The statutory principles outlined in the conclusion above are consistent with current statutory guidance except as follows:

a. Paragraph 5 requires the acquisition cost of all depreciable nonadmitted assets to be allocated to expense over their estimated useful lives. Current guidance allows nonadmitted depreciable assets to either be expensed when purchased or depreciated.

b. Paragraph 5 requires a leasehold improvement to be amortized over the shorter of the remaining original term of the lease excluding renewal or option periods or its estimated useful life. Amounts capitalized subsequent to the original lease term (i.e., during a renewal period) are amortized over the shorter of the estimated useful life of the asset or the remaining renewal period. Current guidance requires amortization over the remaining term of the lease.

c. Paragraph 10 requires disclosures with respect to depreciable assets and depreciation and, leasehold improvements and amortization in the notes to the financial statements.

13. The statutory principles outlined in the conclusion above are consistent with the following issue papers:

a. Issue Paper No. 4 which requires that assets be depreciated or amortized against income as the economic benefit expires.

b. Issue Paper No. 16 which requires that the cost of electronic data processing equipment and software be depreciated against net income as the estimated economic benefit expires.

c. Issue Paper No. 19 which requires that the cost of furniture, fixtures and equipment be depreciated against net income as the estimated economic benefit expires.

d. Issue Paper No. 31 which requires that the cost of leasehold improvements be depreciated against net income as the estimated economic benefit expires.

e. Issue Paper No. 40 which requires that the cost of property included in real estate investment, other than land, be depreciated over the estimated useful life.

14. This issue paper rejects Chapter 9 of ARB 43 however, it is considered appropriate to use the concepts of depreciating assets discussed in the GAAP guidance, which requires that the acquisition cost less salvage value be recorded as an expense over the estimated useful life of the asset, as the basis for the statutory guidance codified in this issue paper. Additionally, this issue paper rejects APB 12 although the disclosures required by this issue paper are consistent with the disclosures required therein.

RELEVANT STATUTORY AND GAAP GUIDANCE

Statutory Accounting

15. The P&C Accounting Practices and Procedures Manual, Chapter 4, Real Estate, provides the following guidance:

> Depreciation and Amortization
>
> The cost of property, other than land, should be depreciated over its estimated useful life. Useful lives for buildings and improvements can best be obtained from contractors, appraisers, engineers, and manufacturers. Estimates published by the Internal Revenue Service can be helpful in the selection of useful lives for specific assets. Depreciable life may at times be fixed by contract, such as in a leasehold investment.
>
> A variety of depreciation methods is available, and a company should select the method that is most appropriate provided, however, that the method is both systematic and rational. Depreciation methods in use include the straight-line method and accelerated methods, such as sum-of-years' digits and various declining balance methods.
>
> Because real estate leasehold improvements revert to the lessor at the end of the lease, and the lessee receives benefits from the improvements only during the life of the lease, a leasehold improvement is subject to amortization over the lease life.

The Accounting Practices and Procedures Manual for Life, Accident, and Heath Insurance Companies provides identical guidance.

16. The Life/A&H Accounting Practices and Procedures Manual, Chapter 9, Nonadmitted Assets, provides the following guidance:

> Equipment, Furniture, and Supplies: The company may record furniture and equipment as a ledger asset, depreciate it, and nonadmit it in the exhibit of assets in the statutory financial statements, or the company may expense the furniture and equipment when it is purchased. Supplies are normally expensed when purchased.

17. Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force minutes 90-4 provide the following guidance:

> The Working Group concluded that the use of the sinking fund or constant yield method does not constitute acceptable statutory accounting practice and that the practice should not be applied to new properties acquired in the future nor if the company changes its existing properties' method of depreciation. This conclusion would not impact those properties currently being depreciated using the constant yield method.

Generally Accepted Accounting Principles

18. Chapter 9, Section C of ARB 43, provides the following guidance:

> 5. The cost of a productive facility is one of the costs of the services it renders during its useful economic life. Generally accepted accounting principles require that this cost be spread over the expected useful life of the facility in such a way as to allocate it as equitably as possible to the periods during which services are obtained from the use of the facility. This procedure is known as depreciation accounting, a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational matter. It is a process of allocation, not of valuation.

19. *Accounting Principles Board Opinion No. 12*, *Omnibus Opinion - 1967,* provides the following guidance:

> DISCLOSURE OF DEPRECIABLE ASSETS AND DEPRECIATION
>
> 4. Disclosure of the total amount of depreciation expense entering into the determination of results of operations has become a general practice. The balances of major classes of depreciable assets are also generally disclosed. Practice varies, however, with respect to disclosure of the depreciation method or methods used.
>
> 5. Because of the significant effects on financial position and results of operations of the depreciation method or methods used, the following disclosures should be made in the financial statements or in notes thereto:
>
> a. Depreciation expense for the period,
>
> b. Balances of major classes of depreciable assets, by nature or function, at the balance-sheet date,
>
> c. Accumulated depreciation, either by major classes of depreciable assets or in total, at the balance-sheet date, and
>
> d. A general description of the method or methods used in computing depreciation with respect to major classes of depreciable assets.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapters 4 and 9
- Accounting Practices and Procedures Manual for Life, Accident and Health Insurance Companies, Chapter 4
- *Issue Paper No. 3—Accounting Changes*
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 16—Electronic Data Processing Equipment and Software*
- *Issue Paper No. 19—Furniture, Fixtures and Equipment*
- *Issue Paper No. 31—Leasehold Improvements Paid by the Reporting Entity as Lessee*
- *Issue Paper No. 40—Real Estate Investments*
- Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force minutes 89-1
- Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force minutes 89-2
- Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force minutes 89-3
- Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force minutes 89-4
- Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force minutes 90-1
- Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force minutes 90-2
- Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force minutes 90-3
- Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force minutes 90-4

Generally Accepted Accounting Principles

- *Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins, Chapter 9, Depreciation*
- *Accounting Principles Board Opinion No. 12, Omnibus Opinion - 1967*

State Regulations

- No additional guidance obtained from state statutes or regulations.

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Statutory Issue Paper No. 68

Business Combinations and Goodwill

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 68

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory accounting guidance and GAAP differ in accounting for business combinations. Current statutory guidance requires that an investment in a subsidiary, controlled or affiliated entity (SCA) be recorded at historical net asset value of the entity acquired (statutory book value for acquired entities). The difference between the value of the consideration given and the statutory net asset value is considered to be goodwill and under current statutory guidance may be recorded as an admitted asset, subject to certain limitations. Amortization of goodwill is limited to 10 years. However, individual state insurance laws and regulations vary with respect to requirements for the treatment of goodwill. Currently some states allow the admission of goodwill within the limits imposed by the *Purposes and Procedures Manual of the NAIC Securities Valuation Office* (SVO Purposes and Procedures), other states require goodwill to be nonadmitted.

2. Current statutory guidance does not specifically address the accounting for mergers, other than to require restatement of prior years for the effect of mergers. Current statutory practice is to account for mergers by combining or carrying forward the existing statutory amounts of assets, liabilities and related surplus accounts.

3. Under GAAP, business combinations are accounted for using either the pooling of interests method or the purchase method. GAAP has certain prerequisites which must be met for the pooling of interests method to be applied. This method accounts for a business combination as the uniting of the ownership interests of two or more companies by exchange of equity securities. No acquisition is recognized because the combination is accomplished without disbursing resources of the constituents. Therefore, the recorded assets and liabilities of the entities are carried forward at their historical amounts, and the income and expenses of the constituents for the prior periods are combined and retroactively restated.

4. Under GAAP, the purchase method of accounting is applied for business combinations which are not considered poolings of interests. Under the purchase method, the acquiring entity records the assets acquired and liabilities assumed at fair value. The difference between the cost of an acquired entity and the sum of the fair values of tangible and identifiable intangible assets (e.g., present value of future profits of a life entity) less the fair value of liabilities is recorded as goodwill. Amortization of goodwill is over the periods in which the acquiring entity benefits economically, not to exceed 40 years.

5. The purpose of this issue paper is to establish statutory accounting principles for business combinations that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts). It addresses:

- Accounting for purchases of Subsidiary, Controlled and Affiliated (SCA) investments (defined in *Issue Paper No. 46—Accounting for Investments in Subsidiary, Controlled and Affiliated Entities* (Issue Paper No. 46)),

- Accounting for purchases of partnerships, joint ventures and limited liability companies (defined in *Issue Paper No. 48—Investments in Joint Ventures, Partnerships and Limited Liability Companies*),
- Accounting for goodwill and
- Accounting for mergers.

SUMMARY CONCLUSION

Business Combinations

6. A business combination shall be accounted for as either a statutory purchase or a statutory merger. Business combinations that create a parent, subsidiary relationship shall be accounted for as a statutory purchase. Business combinations where equity of one entity is issued in exchange for the equity of another entity, which is then canceled, and prospectively only one entity exists, shall be accounted for as a statutory merger.

Statutory Purchases of SCA Investments

7. The statutory purchase method of accounting is defined as accounting for a business combination as the acquisition of one entity by another. It shall be used for all purchases of SCA entities including partnerships, joint ventures and limited liability companies. The acquiring reporting entity shall record its investment at cost. Cost is defined as the sum of a) any cash payment, b) the fair value of other assets distributed, c) the fair value of any liabilities assumed and d) any direct costs of the acquisition. Goodwill is defined as the difference between the cost of acquiring the entity and the reporting entity's share of the book value of the acquired entity. When the cost of the acquired entity is greater than the reporting entity's share of the book value, positive goodwill exists. When the cost of the acquired entity is less than the reporting entity's share of the book value, negative goodwill exists. Goodwill resulting from assumption reinsurance shall be recorded as a separate write-in for other-than-invested assets. All other goodwill shall be reported in the carrying value of the investment. A business combination accounted for under the statutory purchase method and in which the acquired entity is valued in accordance with paragraph 7.b.iii. of Issue Paper No. 46 shall determine the amount of positive goodwill or negative goodwill created by the combination using the reporting entity's share of the GAAP net book value of the acquired entity. Business combinations accounted for under the statutory purchase method and in which the acquired entity is valued in accordance with paragraph 7.b.i. or 7.b.ii. of Issue Paper No. 46 shall determine the amount of positive or negative goodwill created by the business combination using the reporting entity's share of the statutory book value of the acquired entity.

8. Under the statutory purchase method the historical bases of the acquired entity shall continue to be used in preparing its statutory financial statements except in those instances provided for in paragraph 8b. of Issue Paper No. 46. Therefore, pushdown accounting is not permitted.

Positive Goodwill and Negative Goodwill

9. Positive goodwill recorded under the statutory purchase method of accounting shall be admitted subject to the following limitation: Positive goodwill from all sources, including life, accident and health, and deposit-type assumption reinsurance, is limited in the aggregate to 10% of the parent reporting entity's capital and surplus as required to be shown on the statutory balance sheet of the reporting entity for its most recently filed statement with the domiciliary state commissioner adjusted to exclude any net positive goodwill, EDP equipment and operating system software, and net deferred tax assets. When negative goodwill exists it shall be recorded as a contra-asset. Positive or negative goodwill resulting from the purchase of a SCA shall be amortized to unrealized capital gains and losses on investments over the period in which the acquiring entity benefits economically, not to exceed 10 years. Positive or negative goodwill resulting from life, accident and health, and deposit-type assumption reinsurance shall be amortized to operations as a component of general insurance expenses over the period in which the assuming entity benefits economically, not to exceed 10 years. Goodwill shall be evaluated separately for each transaction.

Statutory Mergers

10. The statutory merger method of accounting is defined as accounting for a business combination in which the original investors in the investee receive equity of the reporting entity for their interest in the investee and only one entity survives. It shall be used for all business combinations accomplished by 1) issuing equity of a newly formed entity for the equity of the merging entities, 2) one entity issuing equity in exchange for the equity of another entity and immediately canceling the equity of that entity, or 3) the exchange of membership interest. Under the statutory merger method, no acquisition shall be recognized because the combination is accomplished without disbursing resources of the constituents. Ownership interest continues and the former statutory bases of accounting shall be retained. However, if one of the merged entities did not employ the statutory basis of accounting, the accounts shall be adjusted to the statutory bases with an offsetting adjustment to beginning surplus of the earliest period presented. The recorded assets, liabilities and related surplus accounts of the constituents shall be carried forward to the combined corporation at their recorded statutory amounts. The capital accounts of the entities shall be adjusted as necessary to reflect the appropriate par values of the capital stock of the new entity. Adjustments to the capital stock account shall be made to gross paid-in and contributed surplus, to the extent there is a balance in the account. Income of the combined entity shall include income of the constituents for the entire fiscal period in which the combination occurs and the balance sheet and the statement of operations for the two years presented shall be restated, as required by *Issue Paper No. 3—Accounting Changes*. Goodwill on the historical books of any merged entity that arose from a previous business combination involving the merged companies shall be charged or credited to surplus immediately.

Impairment

11. For any decline in the fair value of an entity, acquired through a purchase that is other than temporary, the investment shall be written down to fair value as the new cost basis and the amount of the write down shall be accounted for as a realized loss. The write down shall first be considered as an adjustment to any portion of the investment that is nonadmitted (e.g., nonadmitted goodwill). The new cost basis shall not be changed for subsequent recoveries in fair value. Future declines in fair value, which are determined to be other than temporary, shall be recorded as realized losses. This is consistent with *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of* Assets (Issue Paper No. 5). An impairment shall be considered to have occurred if it is probable that the reporting entity will be unable to recover the carrying amount of the investment or there is evidence indicating inability of the investee to sustain earnings which would justify the carrying amount of the investment. A fair value of an investment that is below the carrying amount based on the statutory equity method or the existence of investee operating losses may indicate a loss in value, however, they are not necessarily indicative of a loss in value that is other than temporary.

Disclosures

12. For business combinations accounted for under the statutory purchase method the financial statements shall disclose the following for as long as unamortized goodwill is reported as a component of the investment:

a. The name and brief description of the acquired entity;

b. Method of accounting, that is the statutory purchase method;

c. Cost of the acquired entity and the amount of goodwill; and

d. The amount of amortization of goodwill recorded for the period.

13. For business combinations taking the form of a statutory merger the financial statements shall disclose:

a. The names and brief description of the combined entities;

b. Method of accounting, that is the statutory merger method;

c. Description of the shares of stock issued in the transaction;

d. Details of the results of operations of the previously separate companies for the period before the combination is consummated that are included in the current combined net income, including revenue, net income, and other changes in surplus; and

e. A description of any adjustments recorded directly to surplus for any entity that previously did not prepare statutory statements.

14. The financial statements shall disclose the following information regarding goodwill resulting from assumption reinsurance:

a. The name of the ceding entity;

b. The type of business assumed;

c. The cost of the acquired business and the amount of goodwill; and

d. The amount of amortization of goodwill recorded for the period.

15. A reporting entity that recognizes an impairment loss shall disclose the following in the financial statements that include the period of the impairment write-down:

a. A description of the impaired assets and the facts and circumstances leading to the impairment; and

b. The amount of the impairment charged to realized capital gains and losses and how fair value was determined.

DISCUSSION

16. The statutory accounting principles described above reject *Accounting Principles Board Opinion No. 16*, *Business Combinations* (APB 16) and related interpretive pronouncements, *FASB Statement No. 38, Accounting for Preacquisition Contingencies of Purchased Enterprises, an amendment of APB Opinion No. 16* (FAS 38), and *Accounting Principles Board Opinion No. 17*, *Intangible Assets*, (APB 17) and related interpretive pronouncements by limiting the admitted value of an acquired entity. *FASB Statement No. 79*, *Elimination of Certain Disclosures for Business Combinations by Nonpublic Enterprises* (FAS 79) is rejected in this issue paper as the disclosures required by paragraphs 12 and 13 of this issue paper are the same for public and non-public entities. Interpretive literature that is rejected in this issue paper is included in the Relevant GAAP Literature section. This issue paper adopts *FASB Emerging Issues Task Force Issue No. 95-19*, *Determination of the Measurement Date for the Market Price of Securities Issued in a Purchase Business Combination.*

17. Paragraph 8 of this issue paper requires that the historical bases of an acquired entity be carried forward and therefore the allocation of the purchase price is not "pushed-down." Under GAAP, "push-down" accounting is not specifically promulgated but is suggested as appropriate by the SEC in certain circumstances as described in paragraph 30 below. Push-down accounting is often followed where the investor acquires 90% or more of the ownership interest in the investee. The statutory accounting principles described above reject push-down accounting. Current statutory guidance does not address "push-down" accounting.

18. The conclusions reached in this issue paper with respect to impairment are consistent with paragraph 12 of *FASB Statement No. 121*, *Accounting for the Impairment of Long-Lived Assets and for*

Long-Lived Assets to be Disposed Of (FAS 121) to the extent that it addresses impairment of goodwill. Paragraph 12 is therefore adopted. Paragraph 13 of FAS 121 is rejected as it addresses the distinction between continuous operations and discontinued operations. The concept of discontinued operations was rejected in *Issue Paper No. 24—Discontinued Operations and Extraordinary Items*. Paragraph 14 addresses disclosure requirements for impairments. Subparagraphs 14.a. and 14.b. are adopted. Subparagraph 14.c. is rejected as specific statutory reporting requirements have been addressed in the issue paper. Subparagraph 14.d. is rejected as it refers to business segments. FAS 121 is also addressed in *Issue Paper No. 40—Real Estate Investments*.

19. The statutory accounting principles described in the conclusion above are consistent with the current statutory guidance except as follows:

a. Current statutory guidance requires goodwill in excess of 10% of a reporting entity's statutory capital and surplus to be written off immediately as a direct charge to surplus. The statutory accounting principles above require all unamortized goodwill to be recorded as an asset and any amount in excess of 10% of statutory capital and surplus to be nonadmitted.

b. Current statutory guidance does not specifically address accounting for mergers.

c. Current statutory accounting does not address disclosure of impairments.

20. This change to current statutory referred to in subparagraph 19.a. of this issue paper was made in order to recognize that although regulatory limitations are placed on the admissibility of goodwill, it does represent an asset. Placing limitations on goodwill recognizes that in order to liquidate an investment where the insurer is a significant shareholder, full value of such investment may not be realized.

21. The statutory accounting principles outlined in the conclusion above are consistent with the conservatism and recognition concepts in the Statement of Concepts. Under the statutory purchase method described above, the historical bases of the acquired entity are used to value the investment. Goodwill attributable to an acquired entity is recorded as an asset, and treated as an admitted asset to the extent that, when added to existing recorded goodwill, it does not exceed 10% of the acquiring entity's capital and surplus. Admitting a portion of the goodwill recognizes that the acquired entity may be sold for fair value (which may include goodwill) to meet and fund policyholder obligations. This is consistent with *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*. Pertinent excerpts from the Statement of Concepts follow:

> Conservatism
>
> Conservative valuation procedures provide protection to policyholders against adverse fluctuations in financial condition or operating results. Statutory accounting should be reasonably conservative over the span of economic cycles and in recognition of the primary responsibility to regulate for financial solvency. Valuation procedures should, to the extent possible, prevent sharp fluctuations in surplus.
>
> Recognition
>
> The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which may be unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet but rather should be charged against surplus when acquired or when availability otherwise becomes questionable.

Revenue should be recognized only as the earnings process of the underlying underwriting or investment business is completed. Accounting treatments which tend to defer expense recognition do not generally represent acceptable SAP treatment.

Drafting Notes/Comments

- Accounting for investments in SCAs after acquisition is addressed in Issue Paper No. 46 - Accounting for Investments in Subsidiary, Controlled and Affiliated Entities.
- Assumption reinsurance is addressed in *Issue Paper No. 74—Life, Deposit-Type and Accident and Health Reinsurance.*

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

22. The *Purposes and Procedures Manual of the NAIC Securities Valuation Office*, Section 5. Procedures for Valuing Common Stocks and Stock Warrants provides the following guidance on valuation of acquired entities and goodwill under Section (B) Common Stocks of Subsidiary, Controlled or Affiliated Companies:

> (a) Subject to the requirements of Section 5 (B) (b), shares of common stock of an insurance or non-insurance company owned by an insurer, which insurer is either the parent of, or under direct or indirect common control, or affiliated with the issuer of such stock, shall have an Association Value determined on the basis of one of the following bases, provided, however, that such basis and the resultant value are reasonable and appropriate in the circumstances, and provided further that an insurer shall not be required to value the common stock of all its subsidiary, controlled and affiliated companies on the same basis. All of the following valuation bases shall be subject to an adjustment for any reciprocal shareholdings as required by Section 5 (B) (b) (x).
>
> (i) the value of only such of the assets of such company as would constitute lawful investments for the insurer if acquired or held directly by the insurer; or
>
> (ii) subject to the limitations imposed herein and under Section 5 (B) (b) (ix), hereunder, the shares of a non-insurance company may be valued on the basis of the net worth of such company determined in accordance with generally accepted accounting principles, as of the end of its most recent fiscal year, provided, subject to (b) hereof, that the financial statements of the company for its most recent fiscal year have been audited by an independent certified public accountant in accordance with generally accepted auditing standards (the common stock of an insurance company may not be valued under this section); or
>
> (If the common stock of a subsidiary, controlled or affiliated company is valued on the basis of generally accepted accounting principles in accordance with the provisions of this section, such value shall be adjusted to reflect the equity in net assets on a statutory basis with respect to the shares of any underlying insurance company subsidiaries and to reflect the market value appropriately discounted for any underlying company valued using option 5 (B) (a) (v)); or
>
> (iii) book value, defined as in Section 5 (A) (c), provided, however, that the common stock of a non-insurance company may not be valued on the basis of this subsection (iii); or
>
> (iv) subject to the limitations imposed under Section 5 (B) (b) (ix), hereunder, a value equal to the cost of the common stock of such company, provided such value is determined and adjusted to reflect subsequent operating results (1) in the case of insurance companies in accordance with statutory accounting requirements, and (2) for other than insurance companies from an independent certified public

accountant audited financial statement prepared in accordance with generally accepted accounting principles; or

(If the common stock of a subsidiary, controlled, or affiliated company is valued on the basis of generally accepted accounting principles in accordance with the provisions of this section the adjustment "to reflect subsequent operating results" shall include net changes in all the capital and surplus accounts on a statutory basis with respect to the shares of any underlying insurance company subsidiaries); or

(v) the market value of the common stock of the company, if the stock is listed on a national securities exchange or entered in the NASDAQ System (other securities traded over-the-counter will not be considered under this section); The share price will be discounted for legal restrictions requiring a registration before any sale may be made and the size and depth of the trading activity in relation to the publicly traded shares outstanding; or

(vi) See Section 3 (C) (2) for valuation of preferred stocks of wholly-owned subsidiaries of insurance companies.

(vii) In applying the provisions of this section to insurers organized in foreign countries, the provisions of Subsection (i) of this section will be applied (based on financial statements for the most recent fiscal year as prepared by an independent certified public accountant), except where special considerations indicate other treatment would be appropriate; or

(viii) any other value that the insurer can substantiate to the satisfaction of the SVO staff as being a reasonable value.

(b) (i) The provisions of Section 5 (B) shall in all cases be subject to the procedures prescribed by state insurance department practices or laws concerning the use of acquisition cost or any other basis for the valuation of common stocks of subsidiary, controlled or affiliated companies.

(ii) Not later than April 1 of each year, every insurer shall file with the SVO staff, on the appropriate form prescribed by the Valuation of Securities Task Force, (Task Force), relevant information identifying, supporting and justifying the value of, and the basis of valuation used in accordance with the provisions of Section 5(B)(a) for each of its subsidiary, controlled or affiliated companies reported upon in the Annual Statement for the preceding year.

(iii) Within thirty (30) days after the acquisition or formation of a subsidiary, controlled or affiliated company, every insurer shall file with the SVO staff, on the appropriated form prescribed by the Task Force, relevant information identifying, supporting and justifying the value of, and the basis of valuation used in accordance with the provisions of Section 5(B)(a) for such company.

(iv) A valuation basis used for a subsidiary, controlled or affiliated company shall thereafter be consistently applied unless a change is substantiated as reasonable and on that basis is approved in writing by the SVO staff.

(v) If a subsidiary, controlled or affiliated company is valued on the basis of Section 5 (B) (a) (ii) and its books are not audited at the time the valuation is included in the insurer's annual statement, the insurer shall thereafter report to the SVO staff and explain the difference, if any, between the value of such company as reported in the annual statement and the value as determined by audit. Such report and explanation shall be made as soon as possible following such audit.

(vi) If the common stock of any subsidiary, controlled or affiliated company is valued other than on the basis of market value as defined in Section 5 (B) (a) (v), there shall be deducted from the otherwise determined value a sum equal to the value claimed for any of its assets that would not constitute admitted assets for the insurer if held directly by the insurer, if such assets

(1) are held by the company but used, under a lease arrangement or otherwise, significantly in the conduct of the insurer's business; or

(2) were acquired from or purchased for the benefit or use of the insurer by the company under circumstances that, in the opinion of the SVO staff, support a finding that the primary purpose of such acquisition was the evasion or avoidance of state laws or regulations pertaining to non-admitted assets.

(vii) The SVO staff may require filings to be by the use of such forms as it prescribes and may requests such supplemental information as it deems desirable. The SVO staff shall utilize the information in such filings and supplemental information to make its determination as to the reasonableness and appropriateness of the valuation basis and the resultant value and shall notify the insurer and its state of domicile of such determination.

(viii) In making its determination as to the reasonableness and appropriateness of the valuation basis and the resultant value for each subsidiary, controlled or affiliated company, the SVO staff shall, among other relevant factors, take into account the following:

(1) the effect of subsidiary valuation on the solvency of the insurer (it being the intent hereof that doubt as to reasonableness shall be resolved by selection of a conservative valuation standard in those circumstances where the higher valuation would make an otherwise insolvent insurer appear solvent);

(2) if the valuation involves acquisition cost, the degree of affiliation between the insurer and the party from whom such company was acquired, the form of the consideration (cash, property, or the exchange of stock), evidence of ability to recover cost, and whether the acquisition price represented the result of arms-length dealing between economic equals; and,

(3) whether revaluation of assets is involved, and the reasonableness thereof.

(ix) With respect to values determined under Sections 5 (B) (a) (ii) and 5 (B) (a) (iv), amounts attributable to goodwill, as defined in (a) hereunder, and other intangibles shall not, except as provided in (b), hereunder, in the aggregate (of all direct and indirect subsidiaries), exceed, (either initially upon the acquisition of a subsidiary, or thereafter), 10% of the capital and surplus of an insurer, as reported in its next preceding Annual Statement. Such amounts shall, except as provided in (c) and (d), hereunder, be written off over a period not in excess of 10 years, commencing in all cases with the accounting period ending December 31, 1972. (For instructions as to the manner of write-off in certain cases, see (e) and (f), hereunder.)

(a) For the purposes of this section, "goodwill" shall be defined as the amount arising at a given point in time, resulting from an arms-length transaction involving the transfer of a business, representing the difference between the value of the consideration given and the net asset value of the properties acquired on the books of the predecessor company. With respect to insurance company subsidiaries "net asset value" shall mean statutory or annual statement book value. In addition any asset account representing the present value of future contractual or estimated revenue streams will also be deemed goodwill and subject to the limitations of this section.

(b) The limitation with respect to the permissible amount of goodwill shall not apply in the cases of subsidiaries acquired or under contract to be acquired on or prior to June 14, 1972.

(c) The write-off period for goodwill in the cases of subsidiaries described in (b), above, may, upon application to and approval by the Securities Valuation Office, be extended to not in excess of 20 years.

(d) Where warranted in exceptional cases, the Securities Valuation Office may require a more rapid write-off of goodwill than is otherwise provided in this section.

(e) In the cases of subsidiaries acquired or under contract to be acquired on or prior to June 14, 1972, an insurer may charge the write-off of goodwill to the common stock component of the Asset Valuation Reserve, where such a reserve exists.

(f) In the cases of subsidiaries acquired after June 14, 1972, amounts of goodwill in excess of 10% of an insurer's capital and surplus shall be written off immediately by a direct charge to surplus.

23. NAIC Annual Statement Instructions provide the following guidance on the restatement of prior year financial information presented after a merger occurs:

> Except in situations where a merger has occurred, amounts reported for assets, liabilities, surplus, revenues, and expenses for prior years in the current year's annual statement shall be identical to the amounts that were reported in the annual statement of the prior year. However, amounts reported in prior years may need to be adjusted in the current year as a result of the following:
>
> > Changes in accounting principles or practices or changes in the methods of applying accounting principles or practices.
> >
> > Changes in accounting estimates as a result of new events or new information.
> >
> > Corrections of errors in previously filed information.
> >
> > A merger.
>
> If changes are required for amounts reported in prior years, such changes should be included in the amounts reported for the current year and the effects of such changes should be reported as follows, unless these instructions or the NAIC Accounting Practices and Procedures manual for Life and Health specifically provide for a different treatment:
>
> (1) The cumulative effect of a change in accounting principles or practices or a change in the method of applying accounting principles or practices should be reported with an appropriate identifying title as a write-in item for gains and losses in surplus (Page 4, Line 46). The cumulative effect of changing to a new accounting principle is the difference between the amount of capital and surplus at the beginning of the year and the amount of capital and surplus that would have been reported at that date if the new accounting principle had been applied retroactively for all prior periods. An example of a

change in accounting principles would be a change in the method of accounting for pensions or other post-employment benefits.

(2) The effects of changes in accounting estimates are included in income and expenses in the Summary of Operations for the current year. For example, a change in estimate for reserves for accident and health claims related to prior years should be included in the Summary of Operations in disability benefits and benefits under accident and health policies (Page 4, Line 11) for the current year.

(3) The effects of changes resulting from corrections of errors in previously filed information (for example, mathematical mistakes, misapplication of accounting principles, or oversight or misuse of facts) should be reported as an adjustment to surplus in the current year. Such adjustments to surplus should be reported with an appropriate identifying title as a write-in item for gains and losses in surplus (Page 4, Line 46).

(4) In the case of a merger, prior year's amounts reported for assets, liabilities, surplus, revenues and expenses, as well as those amounts reflected in supporting Annual Statement schedules, should be reported on a merged basis consistent with the current year's post-merger reporting basis. A footnote should be inserted on each page of the Annual Statement which contains such merged amounts clearly detailing the circumstances.

24. Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force Issue No. 94-1 and 94-2 provide the following guidance:

> The working has been asked to consider whether it is acceptable statutory accounting practice for an insurer to continue to carry an asset for the unamortized goodwill arising from the acquisition of another insurer after the acquired insurer has been merged into the acquiring insurer (former parent)
>
> After considerable discussion, the working group reached a preliminary consensus that continuing to carry unamortized goodwill under such circumstances was not appropriate for statutory purpose and that the unamortized goodwill should have been charged to surplus at the time the acquired insurer was merged with the parent.
>
> After further discussion, the working group agreed to reaffirm the preliminary decision reached in March. In addition, they concluded that the issue of goodwill in general should be referred to the Codification of Statutory Accounting Principles Working Groups for the review of the appropriateness of goodwill for statutory purposes.

25. Individual state insurance laws and regulations vary with respect to requirements for the treatment of goodwill. Many states require goodwill to be nonadmitted. Certain states do allow the admission of goodwill but impose stringent limitations on the amount of goodwill that is considered an admitted asset.

Generally Accepted Accounting Principles

26. GAAP for business combinations is contained in APB 16 which was rejected in its entirety in this issue paper. Rather than repeat APB 16 in the Relevant GAAP Literature Section of this paper a summary of GAAP for Business Combinations from The Current Text - Section B50 - Business Combinations is provided.

BUSINESS COMBINATIONS SECTION B50

Sources: ARB 43, Chapter 1A; ARB 51; APB Opinion 16;
AICPA Interpretations of APB Opinion 16; FASB Statement 10;
FASB Statement 38; FASB Statement 72; FASB Statement 79;
FASB Statement 87; FASB Statement 106; FASB Statement 109;

FASB Statement 111; FASB Statement 121; FASB Interpretation 4;
FASB Interpretation 9; FASB Technical Bulletin 85-5

B50 Summary

A business combination occurs when a corporation and one or more incorporated or unincorporated businesses are brought together into one accounting entity. The single entity carries on the activities of the previously separate, independent enterprises. The purchase method and the pooling-of-interests method are both acceptable in accounting for business combinations, although not as alternatives in accounting for the same business combination. This section provides that a business combination shall be accounted for as a pooling of interests if it meets certain specified criteria. Business combinations that do not meet all of the specified criteria shall be accounted for as purchases.

The criteria for the pooling method relate to the attributes of the combining enterprises before the combination, the manner of combining the enterprises, and the absence of certain planned transactions after the combination. The pooling-of-interests method accounts for a business combination as the uniting of the ownership interests of two or more companies by exchange of equity securities. No acquisition is recognized because the combination is accomplished without disbursing resources of the constituents. Ownership interests continue and the former bases of accounting shall be retained. The recorded assets and liabilities of the constituents shall be carried forward to the combined corporation at their recorded amounts. Income of the combined corporation shall include income of the constituents for the entire fiscal period in which the combination occurs. The reported income of the constituents for prior periods shall be combined and restated as income of the combined corporation.

The purchase method accounts for a business combination as the acquisition of one enterprise by another. The acquiring corporation shall record at its cost the acquired assets less liabilities assumed. A difference between the cost of an acquired enterprise and the sum of the fair values of tangible and identifiable intangible assets less liabilities assumed shall be recorded as goodwill. The reported income of an acquiring corporation shall include the operations of the acquired enterprise after acquisition, based on the cost to the acquiring corporation.

27. *Accounting Principles Board Opinion No. 17*, *Intangible Assets* (APB 17), addresses goodwill and amortization of intangible assets. APB 17 specifies that the amortization period should not exceed 40 years and the straight line method is appropriate unless a company demonstrates that another method is more appropriate. APB 17 also requires companies to perform a subsequent review of amortization to determine if changes should be made in the amortization period:

SUMMARY

1. An enterprise may acquire intangible assets from others or may develop them itself. Many kinds of intangible assets may be identified and given reasonably descriptive names, for example, patents, franchises, trademarks, and the like. Other types of intangible assets lack specific identifiability. Both identifiable and unidentifiable assets may be developed internally. Identifiable intangible assets may be acquired singly, as a part of a group of assets, or as part of an entire enterprise, but unidentifiable assets cannot be acquired singly. The excess of the cost of an acquired company over the sum of identifiable net assets, usually called goodwill, is the most common unidentifiable intangible asset.

2. Accounting for an intangible asset involves the same kinds of problems as accounting for other long-lived assets, namely, determining an initial carrying amount, accounting for that amount after acquisition under normal business conditions (amortization), and accounting for that amount if the value declines substantially and permanently. Solving the problems is complicated by the characteristics of an intangible asset: its lack of physical qualities makes evidence of its existence elusive, its value is often difficult to estimate, and its useful life may be indeterminable.

Conclusions

9. The Board concludes that a company should record as assets the costs of intangible assets acquired from others, including goodwill acquired in a business combination. A company should record as expenses the costs to develop intangible assets which are not specifically identifiable. The Board also concludes that the cost of each type of intangible asset should be amortized by systematic charges to income over the period estimated to be benefited. The period of amortization should not, however, exceed forty years.

28. *FASB Statement No. 38, Accounting for Preacquisition Contingencies of Purchased Enterprise an amendment of APB Opinion No. 16* (FAS 38), deals with preacquisition contingencies. Amounts that can be reasonably estimated that are considered probable are recorded as a part of the allocation of the purchase price. Subsequent adjustments are included in net income when the adjustments are determined except in limited circumstances.

Summary

This Statement specifies how an acquiring enterprise should account for contingencies of an acquired enterprise that were in existence at the purchase date and for subsequent adjustments that result from those contingencies. Amounts that can be reasonably estimated for contingencies that are considered probable are recorded as a part of the allocation of the purchase price. Subsequent adjustments are included in net income when the adjustments are determined except in limited circumstances described in this Statement.

29. *FASB Statement No. 79*, *Elimination of Certain Disclosures for Business Combinations by Nonpublic Enterprises* (FAS 79), amends APB 16 to eliminate the requirement for nonpublic enterprises to disclose pro forma results of operations for business combinations accounted for by the purchase method:

INTRODUCTION

1. The FASB has undertaken research on financial reporting by private and small public companies to obtain information about the practices and views of managers, financial statement users, and public accountants involved with those companies.[1] A number of participants in those research efforts stated that the requirement to disclose pro forma results of operations for business combinations accounted for by the purchase method was unnecessary and too costly for private companies.

[1] Refer to (a) FASB Invitation to Comment, Financial Reporting by Private and Small Public Companies, 1981; (b) FASB Special Report, Financial Reporting by Privately Owned Companies: Summary of Responses to FASB Invitation to Comment, 1983; and (c) FASB Research Report, Financial Reporting by Private Companies: Analysis and Diagnosis, prepared by A. Rashad Abdel-Khalik, 1983.

2. Paragraph 96 of *APB Opinion No. 16, Business Combinations*, requires an acquiring enterprise to disclose the following information in financial statements of the period in which a business combination accounted for by the purchase method occurs:

   a. Results of operations for the current period as though the enterprises had combined at the beginning of the period, unless the acquisition was at or near the beginning of the period.

   b. Results of operations for the immediately preceding period as though the enterprises had combined at the beginning of that period if comparative financial statements are presented.

> 3. The Board has concluded that the disclosures prescribed by paragraph 96 of Opinion 16 should not be required in the financial statements of nonpublic enterprises. The basis for the Board's conclusions is presented in the appendix to this Statement.
>
> STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING
>
> 4. Disclosures of pro forma results of operations prescribed in paragraph 96 of Opinion 16 for business combinations accounted for by the purchase method are not required for nonpublic enterprises.
>
> 5. For purposes of this Statement, a nonpublic enterprise is an enterprise other than one (a) whose debt or equity securities are traded in a public market, including those traded on a stock exchange or in the over-the-counter market (including securities quoted only locally or regionally), or (b) whose financial statements are filed with a regulatory agency in preparation for the sale of any class of securities.
>
> Amendment to APB Opinion No. 16
>
> 6. The following footnote is added to the end of paragraph 96 of Opinion 16:
>
> * The disclosures prescribed by paragraph 96 are not required in the financial statements of nonpublic enterprises as defined by *FASB Statement No. 79, Elimination of Certain Disclosures for Business Combinations by Nonpublic Enterprises*.
>
> Effective Date
>
> 7. This Statement shall be effective for financial statements for fiscal years beginning after December 15, 1983. Earlier application is permitted in financial statements that have not previously been issued.

30. GAAP literature is silent on push-down basis of accounting, although it was raised by the FASB in a 1976 Discussion Memorandum on business combinations. The FASB has included the issue of push down in the New Basis Accounting part of its Consolidations and Related Matters project. The SEC staff's views regarding the application of pushdown accounting are discussed Staff Accounting Bulletin Topic 5J. The staff believes that purchase transactions that result in an entity becoming substantially wholly owned, should establish a new basis of accounting for the purchased assets and liabilities which should be reflected in the acquired entity's separate financial statements. In circumstances where outside interest in the form of minority stockholders, or holders of public debt or preferred stock remain, the staff would encourage but generally not insist on the application of pushdown accounting.

31. *FASB Statement No 121*, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of,* provides the following guidance with respect to the impairment of goodwill.

> Goodwill
>
> 12. If an asset being tested for recoverability was acquired in a business combination accounted for using the purchase method, the goodwill that arose in that transaction shall be included as part of the asset grouping (paragraph 8) in determining recoverability. If some but not all of the assets acquired in that transaction are being tested, goodwill shall be allocated to the assets being tested for recoverability on a pro rata basis using the relative fair values of the long-lived assets and identifiable intangibles acquired at the acquisition date unless there is evidence to suggest that some other method of associating the goodwill with those assets is more appropriate. In instances where goodwill is identified with assets that are subject to an impairment loss, the carrying amount of the identified goodwill shall be eliminated before making any reduction of the carrying amounts of impaired long-lived assets and identifiable intangibles.

Reporting and Disclosure

13. An impairment loss for assets to be held and used shall be reported as a component of income from continuing operations before income taxes for entities presenting an income statement and in the statement of activities of a not-for-profit organization. Although there is no requirement to report a subtotal such as “income from operations,” entities that present such a subtotal must include the impairment loss in that subtotal.

14. An entity that recognizes an impairment loss shall disclose all of the following in financial statements that include the period of the impairment write-down:

a. A description of the impaired assets and the facts and circumstances leading to the impairment

b. The amount of the impairment loss and how fair value was determined

c. The caption in the income statement or the statement of activities in which the impairment loss is aggregated if that loss has not been presented as a separate caption or reported parenthetically on the face of the statement

d. If applicable, the business segment(s) affected.

32. *FASB Emerging Issues Task Force Issue No. 95-19*, *Determination of the Measurement Date for the Market Price of Securities Issued in a Purchase Business Combination* provides the following guidance.

ISSUE

Opinion 16 appears to include contradictory guidance about the date that should be used to value equity securities issued to effect a business combination accounted for using the purchase method. Paragraph 74 of Opinion 16 states that “the market price for a reasonable period before and after the date the terms of the acquisition are agreed to and announced should be considered in determining the fair value of securities issued.” On the other hand, paragraph 94 of Opinion 16 refers to determining the cost of an acquired company as of the date of acquisition, which is defined in paragraph 93 as, “ordinarily . . . the date assets are received and other assets are given or securities are issued.” This Issue addresses that apparent contradiction.

The interval between initiating and completing a business combination may involve an extended period of time. Although management of the companies involved may agree to and announce the terms of a business combination at the initiation date, internal or external contingencies, such as the need to obtain shareholder or regulatory approvals, may exist and prevent concurrent consummation of the combination. Because of the length of time that may be required to resolve those contingencies, the market price of the securities that are expected to be issued to effect a purchase business combination may fluctuate. As a result, the total cost of the acquired company assigned by the acquirer may vary significantly depending on the date that is used to value the securities that are issued.

The issue is what date should be used to value marketable equity securities issued to effect a business combination accounted for using the purchase method.

EITF DISCUSSION

The Task Force reached a consensus that the value of marketable equity securities issued to effect a purchase business combination should be determined, pursuant to the guidance in paragraph 74 of Opinion 16, based on the market price of the securities over a reasonable period of time before and after the two companies have reached agreement on the purchase price and the proposed transaction is announced. In other words, the date of measurement of the value of the marketable equity securities should not be influenced by the need to obtain shareholder or

> regulatory approvals. Task Force members observed that the reasonable period of time referred to in paragraph 74 of Opinion 16 is intended to be very short, such as a few days before and after the acquisition is agreed to and announced. Task Force members also observed that in transactions involving a hostile tender offer, the measurement date for the value of the marketable equity securities occurs when the proposed transaction is announced and sufficient shares have been tendered to make the offer binding or when the proposed acquisition becomes nonhostile, as evidenced by the target company's agreement to the purchase price.
>
> The Task Force also reached a consensus that if the purchase price (the number of shares or other consideration) is subsequently changed, a new measurement date for valuing the marketable equity securities that will be issued to effect the combination is established as of the date of the change. Task Force members observed that a change to the purchase price may result from further negotiations or from changes in the market price of the equity securities causing, perhaps pursuant to the initial agreement, a change in the security's exchange ratio or in a cash component of the purchase price.
>
> The Task Force reached a consensus that the consensuses described in this Issue should only be applied prospectively to purchase business combinations consummated after November 16, 1995.

OTHER SOURCES OF INFORMATION

33. The draft discussion material from previous Life codification project provides the following guidance on mergers in the Introduction section under Accounting for Assets Transferred Between Affiliates:

> A merger or consolidation of insurance companies under common control is to be recorded at book value. The combined surplus should not be enhanced or reduced as a result of the restructuring. A bulk reinsurance agreement of all the business where substantially all of the assets and substantially all of the liabilities are transferred in order to create a shell is to be considered a merger or consolidation for purposes of this section.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 6, *Investments in Subsidiaries, Controlled or Affiliated Companies*
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 6, *Investments in Subsidiaries, Controlled or Affiliated Companies*
- *Purposes and Procedures Manual of the NAIC Securities Valuation Office*
- Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force Issue No. 94-1 and 94-2
- *Issue Paper No. 3—Accounting Changes*
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairment of Assets*
- *Issue Paper No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties*
- *Issue Paper No. 46—Accounting for Investments in Subsidiary, Controlled and Affiliated Entities*
- *Issue Paper No. 48—Investments in Joint Ventures, Partnerships and Limited Liability Companies*

Generally Accepted Accounting Principles

- *FASB Statement No 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*
- *FASB Emerging Issues Task Force Issue No. 95-19, Determination of the Measurement Date for the Market Price of Securities Issued in a Purchase Business Combination*

Rejected Herein

- *Accounting Principles Board Opinion No. 16, Business Combinations*
- *Accounting Principles Board Opinion No. 17, Intangible Assets*
- *FASB Statement No. 38, Accounting for Preacquisition Contingencies of Purchased Enterprises*
- *FASB Statement No. 79, Elimination of Certain Disclosures for Business Combinations by Nonpublic Enterprises*

Related and Interpretive Literature Also Rejected Herein

- *AICPA Accounting Interpretations, Business Combinations: Accounting Interpretations of Accounting Principles Board Opinion No. 16*
- *FASB Statement No. 10, Extension of "Grandfather" Provisions for Business Combinations*
- *AICPA Accounting Interpretations, Intangible Assets: Unofficial Accounting Interpretations of Accounting Principles Board Opinion No. 17*
- *FASB Emerging Issues Task Force No. 85-14, Securities That Can Be Acquired for Cash in a Pooling of Interests*
- *FASB Emerging Issues Task Force No. 86-9, IRC Section 338 and Push-Down Accounting*
- *FASB Emerging Issues Task Force No. 86-10, Pooling with 10 Percent Cash Payout Determined by Lottery*
- *FASB Emerging Issues Task Force No. 87-11, Allocation of Purchase Price to Assets to Be Sold*
- *FASB Emerging Issues Task Force No. 87-15, Effect of a Standstill Agreement on Pooling-of-Interests Accounting*
- *FASB Emerging Issues Task Force No. 87-16, Whether the 90 Percent Test for a Pooling of Interests Is Applied Separately to Each Company or on a Combined Basis*
- *FASB Emerging Issues Task Force Issue No. 87-27, Poolings of Companies that Do Not Have a Controlling Class of Common Stock*
- *FASB Emerging Issues Task Force Issue No. 88-26, Controlling Preferred Stock in a Pooling of Interests*
- *FASB Emerging Issues Task Force Issue No. 88-27, Effect of Unallocated Shares in an Employee Stock Ownership Plan on Accounting for Business Combinations*
- *FASB Emerging Issues Task Force Issue No. 89-7, Exchange of Assets or Interest in a Subsidiary for a Noncontrolling Equity Interest in a New Entity*
- *FASB Emerging Issues Task Force Issue No. 90-5, Exchanges of Ownership Interest between Entities under Common Control*
- *FASB Emerging Issues Task Force No. 90-6, Accounting for Certain Events Not Addressed in Issue No. 87-11 Relating to an Acquired Operating Unit to Be Sold*
- *FASB Emerging Issues Task Force No. 90-12, Allocating Basis to Individual Assets and Liabilities for Transactions within the Scope of Issue No. 88-16*
- *FASB Emerging Issues Task Force No. 90-13, Accounting for Simultaneous Common Control Mergers*
- *FASB Emerging Issues Task Force No. 91-5, Nonmonetary Exchange of Cost-Method Investments*
- *FASB Emerging Issues Task Force Issue No. 92-9, Accounting for the Present Value of Future Profits Resulting from the Acquisition of a Life Insurance Company*
- *FASB Emerging Issues Task Force No. 93-7, Uncertainties Related to Income Taxes in a Purchase Business Combination*
- *FASB Emerging Issues Task Force No. 95-3, Recognition of Liabilities in Connection with a Purchase Business Combination*

- *FASB Emerging Issues Task Force No. 95-8, Accounting for Contingent Consideration Paid to the Shareholders of an Acquired Enterprise in a Purchase Business Combination*
- *FASB Emerging Issues Task Force No. 95-12, Pooling of Interests with a Common Interest in a Joint Venture*
- *FASB Emerging Issues Task Force No. 95-14, Recognition of Liabilities in Anticipation of a Business Combination*
- *FASB Emerging Issues Task Force No. 96-8, Accounting for a Business Combination When the Issuing Company Has Targeted Stock*
- *FASB Technical Bulletin 85-5, Issues Related to Accounting for Business Combinations*
- *FASB Interpretations No. 4, Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method an interpretation of FASB Statement No. 2*

State Regulations

- Indiana Insurance Statutes Title 27, Article 1, Chapter 12, *Life Insurance Company Powers and Policy Requirements*
- Indiana Insurance Statutes Title 27, Article 1, Chapter 13*, Casualty, Fire and Marine Insurance Company Powers and Policy Requirements*
- Pennsylvania Advance Laws to the Insurance Code, *Act 8--SB701*

Other Sources of Information

- Draft discussion material from previous Life Codification projects.

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Statutory Issue Paper No. 69

Financial Guaranty Insurance

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 60

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Financial guaranty insurance provides protection against financial loss as a result of default, changes in interest rate levels, differentials in interest rate levels between markets or products, fluctuations in exchange rates between currencies, inconvertibility of one currency into another, inability to withdraw funds held in a foreign country resulting from restrictions imposed by a governmental body, changes in the value of specific assets or commodities, financial or commodity indices, or price levels in general. Financial guaranty insurance does not provide protection from losses which occur due to fortuitous physical events, failure or deficiency in the operation of equipment, or the inability to extract natural resources. Additionally, it does not provide coverage from losses related to various types of bonds (e.g., individual or schedule public official bond; a contract bond; a court bond), credit insurance, guaranteed investment contracts, and residual value insurance.

2. Current statutory guidance for financial guaranty insurance is provided in the Financial Guaranty Insurance Model Act. The Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies provides no guidance that is specific to financial guaranty insurance.

3. GAAP guidance for insurance contracts is provided by *FASB Statement No. 60*, *Accounting and Reporting by Insurance Enterprises* (FAS 60), however, FAS 60 does not contain guidance that is specific to financial guaranty insurance contracts. Under GAAP, premiums are generally earned in proportion to the amortization of the insured principal over the term of each insured debt obligation.

4. The purpose of this issue paper is to establish statutory accounting principles for the recording and recognition of premium revenue and unpaid losses, losses, and loss adjustment expenses that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

Premium Revenue Recognition

5. Written premium shall be recorded in accordance with *Issue Paper No. 53—Property Casualty Contracts - Premiums.*

6. When premiums are paid on the installment basis, premium revenue shall be recognized in the statement of operations using the monthly pro-rata method. Premiums not paid on the installment basis shall be recognized in the statement of operations in proportion with the amount and expected coverage period of the insured risk.

7. When the anticipated losses, loss adjustment expenses, and maintenance cost exceed the recorded unearned premium reserve and contingency reserve, a premium deficiency reserve shall be recognized by recording an additional liability for the excess deficiency with a corresponding charge to operations.

Commission and other acquisition costs need not be considered in the premium deficiency analysis since they have previously been expensed. If an entity utilizes anticipated investment income as a factor in the premium deficiency calculation, disclosure of such shall be made in the notes to the financial statements.

Unpaid Losses and Loss Adjustment Expense Recognition

8. Unpaid losses and loss adjustment expenses shall be recognized in accordance with *Issue Paper No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses* (Issue Paper No. 55). Each financial guaranty insurer shall establish and maintain reserves for unpaid losses and loss adjustment expenses. The initial date of default shall be considered the incident which gives rise to a claim. Such method shall be used to determine loss reserves, which shall include a reserve for claims reported and unpaid net of collateral. A deduction from loss reserves shall be allowed for the time value of money by application of a discount rate equal to the average rate of return on the admitted assets of the financial guaranty insurer as of the date of the computation of the reserve. The discount rate shall be adjusted at the end of each calendar year. In addition, a reserve component for incurred but not reported claims shall be reasonably estimated if deemed necessary by the financial guaranty insurer or required by the commissioner following an examination or actuarial analysis.

Contingency Reserve

9. In addition to the unearned premium reserve and the liability established for unpaid losses and loss adjustment expenses, financial guaranty insurers shall maintain a liability referred to as a statutory contingency reserve. The purpose of this reserve is to protect policyholders against loss during periods of extreme economic contraction.

10. The contingency reserve required shall be the greater of fifty percent of premiums written for each category or the amount provided by applying the following percentages to the principal guaranteed in each calendar year. The premiums written shall be net of reinsurance if the reinsurer has established a contingency reserve.

a.	Municipal obligation bonds	0.55 percent
b.	Special revenue bonds	0.85 percent
c.	Investment grade Industrial Development Bonds (IDBs) secured by collateral or having a term of seven years or less, and utility first mortgage obligations	1.00 percent
d.	Other investment grade IDBs	1.50 percent
e.	Other IDBs	2.50 percent
f.	Investment grade obligations, secured by collateral or having a term of seven years or less	1.00 percent
g.	Other investment grade obligations	1.50 percent
h.	Non-investment grade consumer debt obligations	2.00 percent
i.	Non-investment grade assetbacked securities	2.00 percent
j.	All other non-investment grade obligations	2.50 percent

11. Additions to the reserve for items a. through e. in paragraph 10 above shall be equal to the greater of one-eightieth of the amounts derived by applying the appropriate contribution specified above shall be made each quarter for a period of twenty (20) years. Additions to the reserve for items f through j. in paragraph 10 above shall be equal to the greater of one-sixtieth of the amounts derived by applying the appropriate contribution specified shall be made each quarter for a period of fifteen (15) years.

12. For contingency reserves required to maintained for 20 years, contributions may be discontinued if the total reserve established for all categories in subparagraphs 10 a. through 10 e. exceeds the sum of the percentages contained therein multiplied by the unpaid principal guaranteed. For contingency reserves required to maintained for 15 years, contributions may be discontinued if the total reserve established for

all categories in subparagraphs 10 f. through 10 j. exceeds the sum of the percentages contained therein multiplied by the unpaid principal guaranteed.

13. The contingency reserve may also be released in the following circumstances:

a. For contingency reserves required to be maintained for 20 years:

i. in any year in which actual incurred losses exceed 35% of the corresponding earned premiums, with commissioner approval;

ii. if the reserve has been in existence less than 40 quarters, upon demonstration that the amount is excessive in relation to the outstanding obligations under the insurer's financial guarantees, with commissioner approval;

ii. if the reserve has been in existence more than 40 quarters, upon demonstration that the amount is excessive relation to the outstanding obligations under the insurer's financial guarantees, upon 30 days prior written notice to the commissioner.

b. For contingency reserves required to be maintained for 15 years:

i. in any year in which actual incurred losses exceed 65% of the corresponding earned premiums, with commissioner approval;

ii. if the reserve has been in existence less than 30 quarters, upon demonstration that the amount is excessive in relation to the outstanding obligations under the insurer's financial guarantees, with commissioner approval;

iii. if the reserve has been in existence more than 30 quarters, upon demonstration that the amount is excessive relation to the outstanding obligations under the insurer's financial guarantees, upon 30 days prior written notice to the commissioner.

Any reductions shall be made on a first-in first-out basis. Changes in the reserve shall be recorded through surplus.

Disclosures

14. Financial guaranty insurers shall make all disclosures required by other issue papers within the codification, including but not limited to the requirements of Issue Paper No. 55 and *Issue Paper No. 77—Disclosures of Accounting Policies, Risks & Uncertainties, and Other Disclosures.*

DISCUSSION

15. This issue paper rejects current statutory guidance set forth in the Financial Guaranty Insurance Model Act. However, some of the circumstances that allow a reporting entity to reduce its contingency reserves in the model were adopted in this issue paper. One of these circumstances provide that the reduction is allowed if it is approved by the commissioner. Commissioner approval of a reserve reduction will only be considered as a viable means of reducing a reserve where the reporting entity can clearly demonstrate to the commissioner that the existing reserves are excessive. This issue paper is generally consistent with statutes adopted in New York with modifications to require an IBNR reserve in certain situations and recognition of a premium deficiency in certain instances as described in paragraph 7. The requirement to record a deficiency reserve was made for consistency with the requirements of Issue Paper No. 55. Additionally, this issue paper expands current statutory guidance by utilizing principal guaranteed to determine a maximum required contingency reserve.

16. The contingency reserve does not meet the definition of a liability which is set forth in *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets.* However, it is consistent with the "*ultimate objective of solvency regulations*" as stated in the Statement of Concepts. This states,

> the ultimate objective of solvency regulation is to ensure that policyholder, contract holder and other legal obligations are met when they come due and that companies maintain capital and surplus at all times and in such forms as required by statute to provide an adequate margin of safety.

Additionally, recording the contingency reserve as a liability is consistent with the Statement of Concepts which states:

> Liabilities require recognition as they are incurred. Certain statutorily mandated liabilities may also be required to arrive at conservative estimates of liabilities and probable loss contingencies (e.g., excess of statutory reserves over statement reserves, interest maintenance reserves, asset valuation reserves, and others).

17. This issue paper is inconsistent with GAAP in that GAAP requires all premiums to be recognized in the statement of operations in a manner consistent with the expiration of the insured risk. This issue paper requires installment billings to be recognized in operations using the monthly pro-rata method. FAS 60 was rejected in *Issue Paper No. 50—Definitions and Classifications of Insurance or Managed Care Contracts In Force*.

18. Discounting the liability established for unpaid claims, losses and loss adjustment expenses is consistent with *Issue Paper No. 65—Property Casualty Contracts* because the payments to be made for losses incurred with respect to insured events are generally fixed and determinable once the insured event has occurred.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

19. The Financial Guaranty Insurance Model Act provides the following guidance: (only pertinent excerpts are included)

> **Section 1. Definitions**
>
> A. As used in this article:
>
> (1) Financial guaranty insurance means a surety bond, insurance policy or, when issued by an insurer, an indemnity contract and any guaranty similar to the foregoing types, under which loss is payable upon proof of occurrence of financial loss to an insured claimant, obligee or indemnity as a result of any of the following events:
>
> (a) Failure of any obligor on any debt instrument or other monetary obligation (including common or preferred stock guarantied under a surety bond, insurance policy or indemnity contract) to pay when due principal, interest, premium, dividend or purchase price of or on the instrument or obligation, when the failure is the result of a financial default or insolvency, regardless of whether the obligation is incurred directly or as guarantor by or on behalf of another obligor that has also defaulted;
>
> (b) Changes in the levels of interest rates, whether short or long term, or the differential in interest rates between various markets or products;

(c) Changes in the rate of exchange of currency;

(d) Inconvertibility of one currency into another for any reason, or inability to withdraw funds held in a foreign country resulting from restrictions imposed by a governmental authority;

(e) Changes in the value of specific assets or commodities, financial or commodity indices, or price levels in general; or

(f) Other events which the commissioner determines are substantially similar to any of the foregoing.

(2) Notwithstanding Paragraph (1) of this subsection, financial guaranty insurance shall not include:

(a) Insurance of any loss resulting from any event described in Subsection A(1) of this section, if the loss is payable only upon the occurrence of any of the following, as specified in a surety bond, insurance policy or indemnity contract:

(i) A fortuitous physical event;

(ii) A failure of or deficiency in the operation of equipment; or

(iii) An inability to extract or recover a natural resource;

(b) An individual or schedule public official bond;

(c) A contract bond, including bid, payment or maintenance bond, or a performance bond where the bond is guarantying the execution of a contract other than a contract of indebtedness or other monetary obligation;

(d) A court bond required in connection with judicial, probate, bankruptcy or equity proceedings, including waiver, probate, open estate and life tenant bond;

(e) A bond running to the federal, state, county, municipal government or other political subdivision, as a condition precedent to granting of a license to engage in a particular business or of a permit to exercise a particular privilege;

(f) A loss security bond or utility payment indemnity bond running to a governmental unit, railroad or charitable organization;

(g) A lease, purchase and sale or concessionaire surety bond;

(h) Credit unemployment insurance, meaning insurance on a debtor in connection with a specific loan or other credit transaction, to provide payments to a creditor in the event of unemployment of the debtor for the installments or other periodic payments becoming due while a debtor is unemployed;

Drafting Note: Subparagraph (h) is to be used by states which do not authorize credit unemployment insurance as a separate line of business but do permit this line to be written.

(i) Credit insurance, meaning insurance indemnifying manufacturers, merchants or educational institutions extending credit against loss or damage resulting from nonpayment of debts owed to them for goods or services provided in the normal course of their business;

(j) Guaranteed investment contracts issued by life insurance companies which provide that the life insurer itself will make specified payments in exchange for specific premiums or contributions;

(k) Residual value insurance authorized by Section [insert section];

(l) Mortgage guaranty insurance authorized by Section [insert section];

(m) Indemnity contracts or similar guaranties, to the extent that they are not otherwise limited or proscribed by this chapter, in which a life insurer:

(i) Guaranties its obligations or indebtedness or the obligations or indebtedness of a subsidiary (as defined in Section [insert section]) other than a financial guaranty insurance corporation; provided that:

(I) To the extent that any such obligations or indebtedness are backed by specific assets, the assets must at all times be owned by the insurer or the subsidiary; and

(II) In the case of the guaranty of the obligations or indebtedness of the subsidiary that are not backed by specific assets of the life insurer, the guaranty terminates once the subsidiary ceases to be a subsidiary; or

(ii) Guaranties obligations or indebtedness (including the obligation to substitute assets where appropriate) with respect to specific assets acquired by a life insurer in the course of normal investment activities and not for the purpose of resale with credit enhancement, or guaranties obligations or indebtedness acquired by its subsidiary, provided that the assets acquired pursuant to this item (ii) have been:

(I) Acquired by a special purpose entity, whose sole purpose is to acquire specific assets of the life insurer or the subsidiary and issue securities or participation certificates backed by such assets; or

(II) Sold to an independent third party; or

(iii) Guaranties obligations or indebtedness of an employee or agent of the life insurer; or

(n) Any other form of insurance covering risks which the commissioner determines to be substantially similar to any of the foregoing.

Section 2. Organization; Financial Requirements

(A) A financial guaranty insurance corporation may be organized and licensed in the manner prescribed in Section [insert section], except as modified by the following provisions:

(1) A corporation organized for the purpose of transacting financial guaranty insurance may, subject to all the applicable provisions of this chapter, be licensed to transact the following additional kinds of insurance:

(a) Residual value insurance, as authorized by Section [insert section];

(b) Surety insurance, as authorized by Section [insert section]; and

(c) Credit insurance, as authorized by Section [insert section].

(2) A corporation may only assume those lines of insurance for which it is licensed to write direct business.

(3) Prior to the issuance of a license, a corporation shall submit for the approval of the commissioner a plan of operation detailing the types and projected diversification of guaranties that will be issued, the underwriting procedures that will be followed, managerial oversight methods, investment policies and such other matters as may be prescribed by the commissioner.

(4) A financial guaranty corporation shall be subject to all of the provisions of this chapter applicable to property and casualty insurers to the extent that the provisions are not inconsistent with the provisions of this Act.

(5) A financial guaranty insurance corporation's investments in any one entity insured by that corporation shall not exceed one percent of its admitted assets as of the end of the prior calendar year.

(B) A financial guaranty corporation shall not transact business unless:

(1) It has paid-in capital of at least $10 million and paid-in surplus of at least $40 million, and shall at all times thereafter maintain a minimum surplus to policyholders of $35 million;

(2) It establishes a contingency reserve, net of reinsurance, as follows:

(a) The contributions to the reserve shall be calculated by applying the following percentages to the net principal written each calendar year of guaranties of:

(i) Municipal obligation bonds, 0.8 percent;

(ii) Special revenue bonds, 1.2 percent;

(iii) Industrial development bonds, 1.6 percent;

(iv) Secured investment grade obligations, 1.6 percent;

(v) Investment grade obligations not secured, 2.5 percent; and

(vi) All other obligations guarantied, 3.0 percent.

(b) (i) Quarterly additions to the reserve for Items (i), (ii) and (iii) of Subparagraph (a) above shall be equal to the greater of one-eightieth of the amounts derived by applying the appropriate contribution specified in Subparagraph (a) or fifty percent (50%) of the quarterly earned premiums on such guaranties and shall be maintained for a period of twenty (20) years; and

(ii) Quarterly additions to the reserve for Items (iv), (v) and (vi) of Subparagraph (a) above shall be equal to the greater of one-fortieth of the amounts derived by applying the appropriate contribution specified in Subparagraph (a) or fifty percent (50%) of the quarterly earned premiums on such guaranties and shall be maintained for a period of ten (10) years.

(c) The reserve may be released thereafter in the same manner, except that a part of the reserve may be released proportional to the reduction in net total liabilities resulting from reinsurance and the reinsurer shall, on the effective date of the reinsurance, establish a reserve in an amount equal to the amount released.

(d) Withdrawals from the contingency reserve, to the extent of any excess, may be made from the earliest contributions to the reserve remaining:

(i) With the approval of the commissioner, in any year in which the actual incurred losses exceed thirty-five percent (35%) of earned premiums, or

(ii) Upon thirty (30) days prior notice to the commissioner, provided that the contingency reserve has been in existence for forty (40) quarters, for reserves subject to Item (i) of Subparagraph (b) of this paragraph, and twenty (20) quarters, for reserves subject to Item (ii) of Subparagraph (b) of this section, upon demonstration that the amount carried is excessive in relation to the corporations outstanding obligations.

(3) In addition to the contingency reserve, the case basis method or other method as may be prescribed by the commissioner shall be used to determine loss reserves, in a manner consistent with Section [insert section], which shall include a reserve for claims reported and unpaid net of collateral. A deduction from loss reserves shall be allowed for the time value of money by application of a discount rate equal to the average rate of return on the admitted assets of the insurer as of the date of the computation of the reserve. The discount rate shall be adjusted at the end of each calendar year.

(4) It shall maintain an unearned premium reserve, net of reinsurance, computed on the monthly pro rata basis, where premiums are paid on an installment basis. All other such premiums paid shall be earned proportionately with the expiration of exposure, or by such other method as the commissioner may prescribe or approve.

Generally Accepted Accounting Principles

20. FAS 60 provides the following guidance with respect to revenue recognition:

> 9. Premiums from short-duration insurance contracts ordinarily shall be recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided. A liability for unpaid claims (including estimates of costs for claims relating to insured events that have occurred but have not been reported to the insurer) and a liability for claim adjustment expenses shall be accrued when insured events occur.
>
> 13. Premiums from short-duration contracts ordinarily shall be recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided. For those few types of contracts for which the period of risk differs significantly from the contract period, premiums shall be recognized as revenue over the period of risk in proportion to the amount of insurance protection provided. That generally results in premiums being recognized as revenue evenly over the contract period (or the period of risk, if different), except for those few cases in which the amount of insurance protection declines according to a predetermined schedule.
>
> Premium Deficiency
>
> 32. A probable loss on insurance contracts exists if there is a premium deficiency relating to short-duration or long-duration contracts. Insurance contracts shall be grouped consistent with the enterprise's manner of acquiring, servicing, and measuring the profitability of its insurance contracts to determine if a premium deficiency exists.
>
> Short-Duration Contracts
>
> 33. A premium deficiency shall be recognized if the sum of expected claim costs and claim adjustment expenses, expected dividends to policyholders, unamortized acquisition costs, and maintenance costs exceeds related unearned premiums.
>
> 34. A premium deficiency shall first be recognized by charging any unamortized acquisition costs to expense to the extent required to eliminate the deficiency. If the premium deficiency is greater than unamortized acquisition costs, a liability shall be accrued for the excess deficiency.

RELEVANT LITERATURE

Statutory Accounting

- The Financial Guaranty Insurance Model Act
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 50—Classifications and Definitions of Insurance or Managed Care Contracts in Force*
- *Issue Paper No. 53—Property Casualty Contracts - Premiums*
- *Issue Paper No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses*
- *Issue Paper No. 65—Property and Casualty Contracts*
- *Issue Paper No. 77—Disclosure of Accounting Policies, Risks & Uncertainties, and Other Disclosures*

Generally Accepted Accounting Principles

- *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises*

State Regulations

- Chapter 28, Article 69 of New York Statutes - Insurance Laws
- Chapter 1, Article 5 of California Statutes - Insurance Laws

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Statutory Issue Paper No. 71

Policy Acquisition Costs and Commissions

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 71

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Acquisition costs are those costs that are incurred in the acquisition of new and renewal insurance contracts and include those costs that vary with and are primarily related to the acquisition of new and renewal insurance contracts (e.g., agent and broker commissions, certain underwriting and policy issue costs, and medical and inspection fees). Current statutory guidance on the accounting for policy acquisition costs and commissions is contained in Chapters 8 and 18 of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies and Chapters 8, 17, and 21 of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies. Under this current guidance, policy acquisition costs and commissions are expensed as incurred.

2. GAAP guidance on the accounting for acquisition costs is primarily contained in *FASB Statement No. 60*, *Accounting and Reporting by Insurance Enterprises* (FAS 60) and FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments* (FAS 97). Under GAAP accounting, policy acquisition costs and commissions are deferred and amortized to income.

3. The purpose of this issue paper is to establish statutory accounting principles for policy acquisition costs that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. Acquisition costs and commissions shall be expensed as incurred. Determination of when acquisition costs and commissions have been incurred shall be made in accordance with *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets.*

5. Contingent commission liabilities shall be determined in accordance with the terms of each individual commission agreement. Commission liabilities determined on the basis of a formula that relates to loss experience shall be established for the earned portion. Assumptions used to calculate the contingent commission liability shall be consistent with the terms of the policy contract and with the assumptions made in recording other assets and liabilities necessary to reflect underwriting results of the reporting entity such as retrospective premium adjustments and loss reserves, including incurred but not reported.

6. Levelized commissions occur in situations where agents receive normal (non-level) commissions with payments made by a third party. It is intended, but not necessarily guaranteed, that the amounts paid to the agents by the third party would ultimately be repaid (with interest explicit or implied) to the third party by levelized payments (which are less than the normal first year commissions but exceed the normal renewal commissions) from the reporting entity. These transactions are, in fact, funding agreements between a reporting entity and a third party. The continuance of the stream of payments specified in the

levelized commission contract is a mechanism to bypass recognition of those expenses which are ordinarily charged to expense in the first year of the contract. Consequently, the normal link between the persistency of the policy, the continuance of the premium payment or the maintenance of the agent's license with the reporting entity is not maintained with respect to the payment stream.

7. The use of an arrangement where commission payments are not linked to traditional elements such as premium payments and policy persistency, but rather are linked to the repayment of an advance amount requires the establishment of a liability for the full amount of the unpaid principal and accrued interest which is payable to a third party related to levelized commissions.

DISCUSSION

8. This issue paper maintains the current statutory accounting for policy acquisition costs and commissions which differs from GAAP. GAAP accounting for policy acquisition costs and commissions is driven by the objective of matching revenues and expenses, therefore these costs are deferred and amortized to income as the related premium is recognized as revenue for FAS 60 products or in proportion to estimated gross profits for FAS 97 products. The primary objective of statutory accounting is to measure solvency. The guidance adopted in this paper is consistent with the Statement of Concepts which states:

> Accounting treatments which tend to defer expense recognition do not generally represent acceptable SAP treatment.

9. The statutory accounting principles established in this issue paper are consistent with *Issue Paper No. 50—Definitions and Classifications of Insurance Contracts* which rejects FAS 60 and FAS 97.

Drafting Notes/Comments

None

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

10. Chapter 17, Other Liabilities, of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies contains the following guidance on levelized commissions:

> Levelized Commission
>
> The accounting treatment for certain transactions, characterized as levelized commissions, which results in enhancement of surplus, has been determined to be inappropriate for statutory reporting.
>
> These transactions are, in fact, funding agreements between an insurer and a third party. Agents receive normal (non-level) commissions with payments made by the third party. It is intended, but not necessarily guaranteed, that the amounts paid to the agents would ultimately be repaid (with interest explicit or implied) to the third party by "levelized" payments (which are less than the normal first year commissions but exceed the normal renewal commissions) from the insurer. The continuance of the stream of payments specified in the levelized commission contract is a mechanism to bypass recognition of those expenses which are ordinarily charged to expense in the first year of the contract. Consequently, the normal link between the persistency of the policy, the continuance of premium payment or the maintenance of the agents license with the insurer is not maintained with respect to the payment stream.
>
> The use of an arrangement where commission payments are not linked to traditional elements such as premium payments and policy persistency but rather are linked to the repayment of an advanced amount requires the establishment of a liability in the full amount of the unpaid principal and accrued interest.

11. Chapter 18, Commissions, of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies contains the following guidance on commissions:

> Financial statements should not reflect paid or incurred commissions on an earned premium basis, except for commissions based on loss experience. If commissions by contract are paid on an earned premium basis, but are not dependent on the loss experience of the insurance written, a reserve should be established for unpaid commissions. This reserve shall also be offset against "Agents' Balances or Uncollected Premiums".
>
> Commissions payable on reinsurance assumed business should be included as an offset to "Agents' Balances or Uncollected Premiums". Commissions receivable on reinsurance ceded business should be included as an offset to "Ceded Reinsurance Balances Payable", which are included in "Agents' Balances or Uncollected Premiums".
>
> Contingent Commission
>
> Some insurance companies, to encourage quantity and quality of production, or to penetrate a line of business or geographical area, will enter into special commission arrangements with some of their agents. The incentive for the selection of good risks is that the agent is allowed to share in the profitability of the insurance he produces. The terms of the arrangement usually will be set forth in a "contingency commission agreement", which is either incorporated as part of the agency contract or as a separate contract. The agreement will provide for the dates upon which accountings are to be rendered to determine the contingent commissions, items to be included in the calculation, and a provision for the calculation, if any, in the event the contract is canceled.
>
> The determination of the contingent commission liability is based upon the terms of the commission agreement. If the contract specifies that commissions will be determined on the basis of a formula that relates to loss experience, a commission liability must be established for the earned portion. The unpaid liability for commissions that are based upon loss experience should be included in a separate liability heading - "Contingent Commissions and Other Similar Charges".
>
> Some agency contracts provide for vesting of the agents' commissions for renewals or policy adjustments. The contract also may specify that the company will pay the agent for the commutation of commissions payable on future premium collections. Such payments must be included as a commission expense. If the company has incurred a liability to commutate an agent's commission at the balance sheet date, the liability should be included as an offset to "Agents' Balances or Uncollected Premiums".

12. Chapter 21 of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies contains the following guidance on commissions:

> Commission Incurred
>
> Except for commissions on deferred and uncollected life insurance premiums, commissions are generally recognized as incurred in the Summary of Operations when it is probable that they will become payable.

13. Chapter 19 of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies and Chapter 20 of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies simply address the classification of expenses; therefore, there is no explicit guidance for taxes, licenses and fees and general expenses.

14. Chapter 8 of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies contains the following guidance:

> In no event should a specifically described nonadmitted asset be recorded as an admitted asset or be used to defer an expense that has been incurred and has no liquidating value, e.g., material used in previous advertising campaigns or supplies that are not resalable.

Generally Accepted Accounting Principles

15. Statement of Accounting Concepts No. 6 establishes the following definition of an asset:

> 26. An asset has three essential characteristics: (a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (b) a particular entity can obtain the benefit and control others' access to it, and (c) the transaction or other event giving rise to the entity's right to or control of the benefit has already occurred.

16. FAS 60 contains the following guidance on the accounting for acquisition costs:

> 28. Acquisition costs are those costs that vary with and are primarily related to the acquisition of new and renewal insurance contracts. Commissions and other costs (for example, salaries of certain employees involved in the underwriting and policy issue functions, and medical and inspection fees) that are primarily related to insurance contracts issued or renewed during the period in which the costs are incurred shall be considered acquisition costs.
>
> 29. Acquisition costs shall be capitalized and charged to expense in proportion to premium revenue recognized. To associate acquisition costs with related premium revenue, acquisition costs shall be allocated by groupings of insurance contracts consistent with the enterprise's manner of acquiring, servicing, and measuring the profitability of its insurance contracts. Unamortized acquisition costs shall be classified as an asset.
>
> 30. If acquisition costs for short-duration contracts are determined based on a percentage relationship of costs incurred to premiums from contracts issued or renewed for a specified period, the percentage relationship and the period used, once determined, shall be applied to applicable unearned premiums throughout the period of the contracts.
>
> 31. Actual acquisition costs for long-duration contracts shall be used in determining acquisition costs to be capitalized as long as gross premiums are sufficient to cover actual costs. However, estimated acquisition costs may be used if the difference is not significant. Capitalized acquisition costs shall be charged to expense using methods that include the same assumptions used in estimating the liability for future policy benefits.

17. The guidance in FAS 60 was modified by FAS 97 as follows:

> 22. Capitalized acquisition costs shall be amortized over the life of a book of universal life-type contracts at a constant rate based on the present value of the estimated gross profit amounts expected to be realized over the life of the book of contracts. The present value of estimated gross profits shall be computed using the rate of interest that accrues to policyholder balances (sometimes referred to as the contract rate). If significant negative gross profits are expected in any period, the present value of estimated gross revenues, gross costs, or the balance of insurance in force shall be substituted as the base for computing amortization.
>
> 23. Estimated gross profit, as the term is used in paragraph 22, shall include estimates of the following elements, each of which shall be determined based on the best estimate of that individual element over the life of the book of contracts without provision for adverse deviation:
>
> a. Amounts expected to be assessed for mortality (sometimes referred to as the cost of insurance) less benefit claims in excess of related policyholder balances
>
> b. Amounts expected to be assessed for contract administration less costs incurred for contract administration (including acquisition costs not included in capitalized acquisition costs as described in paragraph 24)

c. Amounts expected to be earned from the investment of policyholder balances less interest credited to policyholder balances

d. Amounts expected to be assessed against policyholder balances upon termination of a contract (sometimes referred to as surrender charges)

e. Other expected assessments and credits, however characterized.

24. The amortization method based on the present value of estimated gross profits described in paragraphs 22 and 23 of this Statement differs from that provided in Statement 60, which is based on expected premium revenues. This Statement does not define the costs to be included in acquisition costs but does describe those that are not eligible to be capitalized under this Statement. Acquisition costs are addressed in paragraphs 28-31 of Statement 60. Acquisition costs that vary in a constant relationship to premiums or insurance in force, are recurring in nature, or tend to be incurred in a level amount from period to period shall be charged to expense in the period incurred.

25. In computing amortization, interest shall accrue to the unamortized balance of capitalized acquisition costs and unearned revenues at the rate used to discount expected gross profits. Estimates of expected gross profit used as a basis for amortization shall be evaluated regularly, and the total amortization recorded to date shall be adjusted by a charge or credit to the statement of earnings if actual experience or other evidence suggests that earlier estimates should be revised. The interest rate used to compute the present value of revised estimates of expected gross profits shall be either the rate in effect at the inception of the book of contracts or the latest revised rate applied to the remaining benefit period. The approach selected to compute the present value of revised estimates shall be applied consistently in subsequent revisions to computations of expected gross profits.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 8 - Other Admitted Assets, Chapter 17 - Other Liabilities, Chapter 21 - Commissions
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 8 - Other Admitted Assets, Chapter 18 - Commissions
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*

Generally Accepted Accounting Principles

- *FASB Statement of Accounting Concepts No. 6, Elements of Financial Statements*
- *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises*
- *FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*

State Regulations

- No additional guidance obtained from state statutes or regulations.

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Statutory Issue Paper No. 72

Statutory Surplus

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 72

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory guidance for capital stock, paid-in or contributed surplus and organizational surplus, and unassigned surplus is provided in Chapter 23, Capital Stock, Chapter 24, Paid-In or Contributed Surplus and Organizational Surplus, and Chapter 25, Unassigned Funds (Surplus) of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies (P&C Accounting Practices and Procedures Manual) and in Chapter 26, Capital Stock, Chapter 27, Paid-In or Contributed Surplus and Organizational Surplus and Chapter 28, Unassigned Funds (Surplus) of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies (Life/A&H Accounting Practices and Procedures Manual).

2. GAAP does not provide specific guidance on surplus but rather provides guidance on shareholders' equity which encompasses capital stock, additional paid in capital and retained earnings. The AICPA Audit and Accounting Guide: Stock Life Insurance Companies (AICPA Life Audit and Accounting Guide) and the AICPA Audit and Accounting Guide: Property & Casualty Insurance Companies (AICPA P&C Audit and Accounting Guide) contain several references to surplus, however, they do not provide specific guidance on surplus.

3. The purpose of this issue paper is to establish statutory accounting principles for statutory surplus that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. Statutory surplus of a reporting entity consists of the following:

a. capital stock;

b. treasury stock;

c. gross paid-in and contributed surplus;

d. surplus notes;

e. unassigned funds (surplus);

f. special surplus funds;

g. other than special surplus funds;

Capital Stock

5. The articles of incorporation set forth the number of authorized shares of capital stock and the par value of each share. The capital stock account represents the number of shares issued times the par value of each share. When no par value is set forth, the reporting entity shall declare a "stated value" and record such amount in the capital stock account. Changes in the par value of a reporting entity's capital stock shall be reflected as a reclassification between the capital stock account and gross paid-in and contributed surplus.

6. Notes or other receivables received for the issuance of capital stock satisfied by receipt of cash or readily marketable securities prior to the filing of the annual statement shall be treated as a Type I subsequent event in accordance with *Issue Paper No. 9—Subsequent Events* (Issue Paper No. 9) and as such shall be considered an admitted asset based on the evidence of collection and approval of the domiciliary commissioner. To the extent that the notes or other receivables are not satisfied, they shall be nonadmitted.

Treasury Stock

7. Treasury stock is capital stock that has been issued and subsequently reacquired by the reporting entity. It is held for either reissuance or cancellation in the future. When a reporting entity's stock is acquired for purposes other than retirement, or when ultimate disposition has not yet been decided, the cost of acquired stock shall be reported as treasury stock which reduces statutory surplus. The acquisition of treasury stock has no effect on either the number of shares issued or the amount of paid up capital shown in the capital stock account. Cancellation of treasury stock shall reduce the capital stock account by the par value or stated value and reduce paid-in or contributed surplus by the excess of cost over par value or stated value.

Gross Paid-in and Contributed Surplus

8. Gross paid-in and contributed surplus is the amount of capital received in excess of the par value of the stock issued. Changes in the par value of a reporting entity's capital stock shall be reflected as a reclassification between the capital stock account and gross paid-in and contributed surplus. Forgiveness of a reporting entity's obligations to its parent or other stockholders shall be accounted for as contributed surplus.

9. Notes or other receivables received as additional capital contributions satisfied by receipt of cash or readily marketable securities prior to the filing of the annual statement shall be treated as a Type I subsequent event in accordance with Issue Paper No. 9 and as such shall be considered an admitted asset based on the evidence of collection and approval of the domiciliary commissioner. To the extent that the notes or other receivables are not satisfied, they shall be nonadmitted.

10. Real estate or other assets received as additional capital contributions are nonreciprocal transfers as defined in *Issue Paper No. 73—Nonmonetary Transactions*.

11. Stock purchase warrants issued in return for cash shall be credited to gross paid-in and contributed surplus. When debt instruments are issued with conversion features, no value shall be assigned to the conversion features unless the conversion feature is clearly separable from the debt obligation in the form of a detachable stock purchase warrant. In such instances the relative fair value of the detachable stock purchase warrant at time of issue shall be credited to gross paid-in and contributed surplus.

Surplus Notes

12. Surplus notes are financial instruments that are subject to strict control by the commissioner of the reporting entity's state of domicile and have been approved by the commissioner as to form and content. These instruments are commonly referred to as surplus notes but are also referred to as surplus debentures or contribution certificates. *Issue Paper No. 41—Surplus Notes* (Issue Paper No. 41) provides

the specific characteristics of surplus notes and provides accounting guidance for surplus notes. Only notes meeting the requirements of Issue Paper No. 41 shall be accounted for as surplus notes.

Unassigned Funds (Surplus)

13. Unassigned funds (surplus) represents the undistributed and unappropriated amount of surplus at the balance sheet date. Certain components of unassigned funds (surplus) are addressed in more detail in other issue papers. Unassigned funds (surplus) is comprised of:

a. Net Income
Net income resulting from insurance and other operating activities of the reporting entity since its inception.

b. Unrealized Capital Gains and Losses on Investments
The cumulative unrealized capital gain or loss that results from differences between the prescribed statement value of investments carried at market value and the cost of those investments is a component of unassigned funds (surplus). This component changes as periodic unrealized gains and losses are credited or charged directly to unassigned funds (surplus).

c. Effect of Exchange Rate Fluctuations
The cumulative gain or loss due to translating foreign operations to U.S. dollars and changes in balance sheet asset and liability values due to foreign currency translation are recorded as unrealized capital gains and losses and therefore are a component of unassigned funds (surplus). This component changes as the exchange rates fluctuate.

d. Nonadmitted Assets
The nonadmitted values of assets owned by a reporting entity are a reduction of unassigned funds (surplus). This component of unassigned funds (surplus) changes as nonadmitted asset values change. Changes in nonadmitted asset values are charged or credited directly to unassigned funds (surplus).

e. Provision for Reinsurance
A reporting entity must establish a statutory liability, provision for reinsurance, for unsecured reinsurance recoverables from unauthorized reinsurers and certain overdue balances from authorized reinsurers. The liability is charged directly to unassigned funds (surplus). Therefore, at any point in time there is a reduction of unassigned funds (surplus) equal to a reporting entity's liability for unauthorized reinsurance.

f. Asset Valuation Reserves
Where an Asset Valuation Reserve is required to be recorded as a statutory liability, there is a reduction of unassigned funds (surplus) in an amount equal to the liability. Changes to the Asset Valuation Reserve are charged or credited directly to unassigned funds (surplus).

g. Separate Accounts
A life insurer's balance sheet includes the total assets and liabilities of any separate accounts business which it maintains and, therefore, the surplus, if any, of its separate accounts business. Changes in the surplus of the separate accounts business of an insurer are charged or credited directly to unassigned funds (surplus).

h. Subscribers Savings Accounts
Subscribers Savings Accounts (SSA) are unique to reciprocals. SSAs represent a portion of a reciprocal insurance company's surplus that has been identified as subscribers (policyholders) accounts. When the source of amounts credited to the subscriber accounts

is from the reciprocal's operations, the amounts are reported as unassigned funds (surplus).

i. Dividends to Stockholders

Dividends declared are charged directly to unassigned funds (surplus) on the declaration date and are carried as a liability until paid. The amount of the dividend is the cash paid if it is a cash dividend, the fair market value of the assets distributed if it is property dividend, or the par value of the company's stock if it is a stock dividend. A stock dividend is recorded as a transfer from unassigned funds (surplus) to capital stock. Stock dividends have no effect on total capital and surplus while other forms of dividends reduce surplus. Forgiveness by a reporting entity of any debt, surplus note or other obligation of its parent or other stockholders shall be accounted for as a dividend. Dividends paid to related parties are subject to the requirements of *Issue Paper No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties*.

j. Change in Accounting Principles

The effects of a change in accounting principle or the application of an accounting principle, such as a change in reserve account because of a change in valuation basis, are reported as a charge or credit to unassigned funds (surplus). The effect of these changes shall not be included in the determination of net income or loss.

k. Correction of an Error

Corrections of errors in previously reported financial statements are charged or credited directly to unassigned funds (surplus). The effect of corrections of errors shall not be included in the determination of net income or loss.

l. Stock Issuance Expenses

Expenses relating to the issuance of capital stock, for example underwriting commissions and filing fees are charged to unassigned funds (surplus).

m. Change in Surplus as a Result of Reinsurance

Life and accident and health insurers report increases in surplus that result from certain types of reinsurance transactions on a net of tax basis. As profits emerge from the ceded business the increase in surplus is amortized to income as described in paragraph 39.

n. Changes in Deferred Tax Assets and Deferred Tax Liabilities

Consistent with the conclusions reached in *Issue Paper No. 83—Accounting for Income Taxes*, changes in deferred tax assets and deferred tax liabilities, including changes attributable to changes in tax rates and changes in tax status, if any, shall be recognized as a separate component of unassigned funds (surplus).

o. Other

This category includes other gains and losses in surplus not specifically identified elsewhere in this issue paper including but not limited to; net proceeds from life insurance on employees and unearned compensation relating to stock issuances made under compensatory Employee Stock Ownership Plans, Stock Option Plans and Stock Purchase Plans.

Special Surplus Funds

14. A reporting entity may establish a segregated surplus account to provide for contingencies. Surplus thus appropriated is called appropriated surplus or special surplus funds. Surplus resulting from any retroactive reinsurance transaction entered by a property and casualty insurer must be recorded as an appropriation of surplus by the ceding company (special surplus from retroactive reinsurance account).

Voluntary and general contingency reserves which are not actual liabilities of the reporting entity are shown as appropriated surplus or special surplus funds.

Other Than Special Surplus Funds

15. Amounts provided to reporting entities, other than stock companies, in the organization stage to defray the expenses and meet initial minimum surplus requirements required to obtain a license to do the business of insurance shall be reported as a separate component of surplus called Other than Special Surplus Funds. Examples of these types of deposits include but are not limited to: guaranty fund notes, contribution certificates, and subscriber accounts that represent individual subscriber contributions.

Changes in Statutory Surplus

16. The components of the change in the capital and surplus accounts shall be presented for each year for which an income statement is presented.

Disclosure

17. The financial statements shall disclose the following items:

a. the number of shares of each class of capital stock authorized, issued and outstanding as of the balance sheet date and the par value or stated value of each class;

b. the dividend rate, liquidation value and redemption schedule (including prices and dates) of any preferred stock issues;

c. dividend restrictions, if any, and an indication if the dividends are cumulative;

d. the portion of the profits that may be paid as ordinary dividends to stockholders;

e. a description of any restrictions placed on the unassigned funds (surplus) funds including for whom the surplus is being held;

f. for mutual reciprocals and similarly organized entities, the total amount of advances to surplus not repaid, if any;

g. the total amount of stock held by the reporting entity, including stock of affiliated entities, for special purposes such as conversion of preferred stock, employee stock options and stock purchase warrants;

h. a description of the reasons for changes in the balances of any special surplus funds from the prior period;

i. the cumulative portion of unassigned funds (surplus) represented or reduced by each of the following items:

   i. unrealized gains and losses;
   ii. nonadmitted asset values;
   iii. separate account business;
   iv. asset valuation reserves;
   v. provision for reinsurance;

j. For reciprocal insurance companies only:

   i. the amount of surplus identified as subscriber savings accounts;
   ii. the source of the funds (either from the reciprocal's operations or contributed by the individual subscriber) and, the reporting location in surplus;

iii. the conditions upon which the balances are paid to the subscribers;

k. Disclosures required by *Issue Paper No. 41—Surplus Notes*;

l. Disclosures required by *Issue Paper No. 9—Subsequent Events*.

DISCUSSION

18. The statutory accounting principles set forth in this issue paper adopt current statutory accounting guidance and are also consistent with the statutory guidance for surplus notes set forth in Issue Paper No. 41.

19. This issue paper is consistent with the requirements of the Annual Statement Instructions that the changes in the capital and surplus accounts be reflected for each year for which an income statement is presented. This is consistent with *Accounting Principles Board Opinion No. 12, Omnibus Opinion - 1967* (APB 12) paragraphs 9 and 10. These paragraphs are adopted with modification to eliminate the option of disclosing changes in the notes to the financial statements rather than in the Statement of Capital and Surplus. This issue paper is consistent with the disclosure requirements of paragraphs 10 and 11 of *Accounting Principles Board Opinion No. 10, Omnibus Opinion -1966* (APB 10). Those provisions of APB 10 are adopted herein. This issue paper also adopts paragraph 28 of *Accounting Principles Board Opinion No. 9, Reporting the Results of Operations* and *FASB Emerging Issues Task Force Issue No. 88-9, Put Warrants,* with a modification to reject guidance related to earnings per share.

20. This issue paper expands current statutory accounting to require disclosure of the reasons for changes in the balance of special surplus funds and the components of unassigned funds (surplus) as of the date of the financial statements. This change was made to enhance comparability of financial statements. To the extent that disclosures required by this issue paper are made within specific notes, schedules, or exhibits to the financial statements, those disclosures are not required to be duplicated in a separate note. Annual statutory financial statements which are not accompanied by Annual Statement exhibits and schedules (e.g., annual audit reports) shall include all disclosures required by this issue paper.

21. This issue paper rejects *FASB Emerging Issue Task Force Issue No. 85-1*, *Classifying Notes Received for Capital Stock* (EITF 85-1), which generally requires notes received as capital contributions to be recorded as a debit to equity rather than as an asset. Paragraphs 6 and 9 of this issue paper require that such notes are recorded as admitted assets if they are satisfied by receipt of cash or readily marketable securities prior to the filing of the statement. To the extent that the notes or other receivables are not satisfied, they shall be nonadmitted. This issue paper also rejects *FASB Emerging Issue Task Force Issue No. 85-2, Classification of Costs Incurred in a Takeover Defense* and *FASB Technical Bulletin No. 85-6, Accounting for a Purchase of Treasury Shares at a Price Significantly in Excess of the Current Market Price of the Shares and the Income Statement Classification of Costs Incurred in Defending against a Takeover Attempt.*

22. This issue paper adopts paragraph 12 of *Accounting Principles Board Opinion No. 6*, *Status of Accounting Research Bulletins* (APB 6) which provides accounting guidance for treasury stock transactions with modification to eliminate the option of recording treasury stock as an asset. Current statutory guidance is limited on recording transactions involving treasury stock. This issue paper rejects paragraphs 1 through 11 and paragraphs 13 through 24 of APB 6.

23. Current statutory accounting does not address stock purchase warrants. The conclusions reached in this issue paper are consistent with *APB Opinion No. 14*, *Accounting for Convertible Debt and Debt and Debt Issued with Stock Purchase Warrants* (APB 14) which was adopted in *Issue Paper No. 80—. Disclosures* regarding stock purchase warrants required by this issue paper are an expansion of current statutory guidance.

24. This issue paper rejects *Accounting Research Bulletin No. 43*, Chapter 1, *Prior Opinions* (ARB 43). The underlying concepts addressed by ARB 43, Chapter 1, are addressed within other relevant GAAP literature to the extent they are applicable.

25. Paragraph 14 of this issue paper addresses appropriated surplus and special surplus funds. This statutory accounting treatment is consistent with paragraph 15 of *FASB Statement No. 5*, *Accounting For Contingencies*, (FAS 5) and therefore paragraph 15 of FAS 5 is adopted herein.

26. The changes to current statutory accounting referred to in paragraphs 20 through 23 of this issue paper were made to provide guidance where current statutory is silent and practice may be diverse. Providing statutory guidance to be followed by all reporting entities meets the objective of the Statement of Concepts which states:

> Consistency
> The regulators' need for meaningful, comparable financial information to determine an insurer's financial condition requires consistency in the development and application of statutory accounting principles. Because the marketplace, the economic and business environment, and insurance industry products and practices are constantly changing, regulatory concerns are also changing. An effective statutory accounting model must be responsive to these changes and address emerging accounting issues. Precedent or historically accepted practice alone should not be sufficient justifications for continuing to follow a particular accounting principle or practice which may not coincide with the objectives of regulators.

27. The statutory accounting principles set forth in this issue paper are also consistent with references to surplus found in the AICPA Life Audit and Accounting Guide and the AICPA P&C Audit and Accounting Guide. Although GAAP does not specifically address surplus, statutory surplus is not comparable to stockholders' equity under GAAP. Stockholders' equity is meant to be a measure of the net equity in a reporting entity held by the owners, while statutory surplus is meant to provide an indication of the excess of assets readily available to meet policyholder obligations over those obligations.

28. Several components of the surplus section of a reporting entity's statutory balance sheet are also components of the stockholders' equity section of the reporting entity's GAAP balance sheet.

a. Capital stock and treasury stock are treated consistently between statutory surplus and stockholders' equity;

b. Gross paid-in and contributed surplus for statutory reporting purposes is consistent with the accounting treatment afforded to additional paid in capital in a reporting entity's stockholders' equity under GAAP reporting.

29. As discussed in Issue Paper No. 41, GAAP treats surplus notes as liabilities and not as equity whereas Issue Paper No. 41 as well as current statutory guidance account for the notes as surplus.

30. Statutory accounting utilizes unassigned funds (surplus) to account for several additional components of policyholder surplus. These items include net income, unrealized gains and losses on investments and unrealized gains and losses resulting from exchange rate fluctuations, nonadmitted asset values, certain statutory liabilities such as the asset valuation reserve and the provision for reinsurance, the effects of changes in accounting principles and corrections of errors, appropriations of surplus, separate accounts, subscriber savings accounts, stock issuance expenses and dividends to stockholders.

31. GAAP requires some of the items in unassigned funds (surplus) to be reflected in retained earnings while others are reported as a separate and distinct component of stockholders' equity. Those items that are accounted for as part of retained earnings include:

a. net income;

b. effect of changes in accounting principles;

c. corrections of errors;

d. dividends to stockholders.

GAAP distinguishes between stock dividends and stock splits for purposes of reclassifications between paid in capital and retained earnings although total stockholders' equity is not affected. This issue paper adopts paragraphs 1 through 4 and 10 through 16 of *Accounting Research Bulletin No. 43, Chapter 7B, Stock Dividends and Stock Split-ups.*

32. Those items in unassigned funds (surplus) that are reported as separate and distinct components of stockholders' equity under GAAP include:

a. unrealized gain or loss on investments;

b. unrealized gain or loss resulting from exchange rate fluctuations.

The amount of unrealized gains or losses on investments may differ between GAAP and statutory reporting because of the amounts at which investments are reported in the balance sheet under the different bases of accounting. Unrealized gains and losses relating to exchange rate fluctuations will differ as well because GAAP requires certain types of gains and losses relating to exchange rate fluctuations to be charged or credited to operations in the period of the change.

33. GAAP does not recognize statutory liabilities such as the provision for reinsurance or the asset valuation reserve and therefore those items are not components of stockholders' equity whereas they are components of unassigned funds (surplus).

34. For GAAP, stock issuance expenses are accounted as a reduction of additional paid in capital whereas for statutory purposes they are accounted for as a reduction of unassigned funds (surplus).

Drafting Notes/Comments

- *Issue Paper No. 3—Accounting Changes*, provides guidance on reporting changes in accounting principles and corrections of errors.
- *Issue Paper No. 84—Quasi-reorganizations*, permits adjustments to surplus and capital accounts for the effects of a quasi-reorganization in limited situations.
- *Issue Paper No. 41—Surplus Notes*, provides the accounting and disclosure requirements for such instruments.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

35. Chapter 23, Capital Stock, of the P&C Accounting Practices and Procedures Manual provides the following guidance:

> The articles of incorporation set forth the number of authorized shares of capital stock and the par value of each share, and the number of shares to be issued and sold so as to provide at least the minimum paid-up capital.

Minimum Capital

Many states require that, upon the organization or admission of an insurance company, a minimum amount of paid-up capital must be established and maintained for that particular company at all future times. If capital exceeds the minimum required, some states may permit reductions of capital with the commissioner's consent.

Minimum requirements may be based on the number of lines of business a company writes with a minimum amount for the first line and an additional amount for each line. Other states may require a fixed amount for a certain type of company. The requirements of any jurisdiction are intended, in accordance with sound business practices, to meet the needs of the proposed business.

Par Value Requirements

Traditionally, insurance companies have issued one class of stock, par value common stock, and many states have statutes or rules establishing the minimum par value per share.

In recent years, some states have begun permitting insurers to issue the same classes of stock as noninsurers. This includes issuing of common stock with no par value. The par value of a company's common stock must be consistent with the statutes and regulations of the domiciliary state.

The statues and regulations of some jurisdictions permit an insurer to issue preferred stock. They should be reviewed carefully prior to the issuance of any preferential shares.

Original Stock Sale

Most states have detailed regulations with regard to the original sale of a company's stock. These regulations may include, but are not necessarily limited to, provisions relating to the following:

1. Organization permits and certificate of authority;

2. Registration of securities;

3. Form of subscription agreement and subscription requirements;

4. Promoter stock;

5. Consideration for shares;

6. Payment for shares;

7. Form of certificates representing shares;

8. Deposit and escrow requirements;

9. Fractional shares;

10. Liability of subscribers and shareholders for unpaid shares;

11. Shareholders' pre-emptive rights;

12. Organization expenses and liability of incorporators.

Prior to any organization activity, any individual or group of individuals desiring to establish an insurance company should consult with the regulatory authority of the state in which it will be domiciled. Establishing an insurance company is a complex procedure and careful attention must be paid to the particular requirements of the state of domicile.

> Subsequent Stock Issues
>
> The statutes and regulations of the domiciliary state should be consulted prior to the offering or issuance of any stock.
>
> Treasury Stock
>
> Treasury stock is capital stock of the company that has been issued, fully paid for, and subsequently reacquired by the company. It is held for either reissuance or cancellation in the future.
>
> An insurance company is customarily restricted in the amount of treasury stock it is authorized to hold, and in the reasons for holding such stock. The restrictions of some states permit an insurance company to own treasury stock only when the company's net assets exceed the sum of its paid-up capital and its required surplus, after deducting the surplus attributable to unrealized appreciation in value or revaluation of the company's assets, and any increase arising from the surrender of the company's own shares.
>
> Statutes and regulations of the various jurisdictions may vary. In some states, recently organized insurers may only acquire treasury stock with the permission of the state regulatory authority. Reporting requirements have also been promulgated. Statutes may provide that such acquisition be approved by the stockholders or by the board of directors, and require sufficient surplus to cover the acquisition. Some states permit acquisition of the company's own shares without stockholder or board approval for the following purposes:
>
> 1. Redemption or purchase of its redeemable shares at a cost not to exceed the redemption price;
> 2. Elimination of fractional shares;
> 3. Collection or compromise of debt to the corporation;
> 4. Payment to dissenting stockholders entitled to payment for their shares.
>
> The acquisition of treasury stock has no effect on either the number of shares issued or the amount of paid-up capital shown in the capital stock account. However, the use of treasury stock for the cancellation of capital stock does reduce the capital stock account. Treasury stock is reported as a reduction of surplus.

Chapter 26, Capital Stock, of the Life/A&H Accounting Practices and Procedures Manual contains similar guidance.

36. Chapter 24, Paid-In or Contributed Surplus and Organizational Surplus, of the P&C Accounting Practices and Procedures Manual provides the following guidance:

> This chapter discusses paid-in or contributed surplus stock companies and organizational surplus for mutual companies, the amounts required upon incorporation, and the amounts to be maintained at all times.
>
> Besides paid-in capital (common stock), stock insurance companies are required to have a minimum amount of initial paid-in surplus. Mutual companies, which, because of their corporate structure, do not issue capital stock are required to have a minimum amount of initial organizational surplus. Most states require companies to maintain a minimum amount of surplus.
>
> Initial contributed or organizational surplus is obtained to provide both protection to the policyholders and the necessary working capital with which a company can pay the expense of commencing business. The minimum surplus a company must have and at all times maintain is customarily somewhat less than the initial amount required to obtain a certificate of authority.

> While paid-in or organizational surplus will not be decreased (except upon a return of original investment), unassigned surplus deficits are subtracted from the amount of original surplus to determine if a company has fallen below the required minimum surplus.
>
> Surplus, for purposes of meeting the minimum requirements, consists of:
>
> Paid-in or contributed surplus for stock companies;
>
> Guaranty fund surplus for mutual companies;
>
> Subordinated surplus debentures, notes, or similar instruments;
>
> Special or appropriated surplus;
>
> Unassigned surplus;
>
> Organizational surplus for mutual companies.
>
> Minimum Surplus Requirements - Stock Companies
>
> Most states require a minimum surplus at the time of organization. This amount, which is generally represented by paid-in surplus, may be determined by the nature of the company or by the number of lines a company writes. State statutes may further require a minimum surplus to be maintained permanently.
>
> Minimum Surplus Requirements - Mutual Companies
>
> Mutual companies, upon organization, are required to have an organizational surplus which usually conforms to the capital required of a stock company. In addition to this permanent surplus, an expendable surplus may also be required at the time of organization. Some states do not require a permanent surplus for a mutual company if the assessment liability of its members is unlimited. The statutes and regulations of the state of domicile should be consulted with regard to the appropriate requirements.
>
> The funds necessary to meet initial surplus requirements will generally be generated either by applications for insurance or by contribution notes.
>
> Minimum Surplus Requirements - Reciprocals
>
> State statutes should be reviewed for surplus requirements of reciprocals, which are usually similar to the requirements for mutual companies.
>
> Capital or Surplus Impairment
>
> State statutes vary widely with regard to the impairment of capital or minimum surplus in a stock company or a permanent surplus in a mutual company. In most cases, an order or notice is issued requiring correction of the impairment. Correcting such an impairment may entail issuing new capital stock, surplus or contribution notes, subordinated debentures, or some other means such as a contribution to paid-in surplus. If time limitations are not met, further action will be taken.

Chapter 27, Paid-In or Contributed Surplus and Organizational Surplus, of the Life/A&H Accounting Practices and Procedures Manual contains similar guidance.

37. Chapter 25, Unassigned Funds (Surplus), of the P&C Accounting Practices and Procedures Manual provides the following guidance:

Unassigned funds (surplus) is the undistributed and unappropriated amount of surplus and includes net income as well as the following items.

Unrealized Capital Gains and Losses on Investments

The annual statement includes a framework for calculating the unrealized capital gains and losses. Unrealized capital gains and losses result from a change in the prescribed statement value of investments between reporting dates. The change in the net unrealized capital gain or loss is a direct credit or charge to unassigned surplus.

Change in Nonadmitted Assets

The change in nonadmitted assets between the current and prior years statement is charged or credited directly to unassigned surplus. (See Chapter 9-Nonadmitted Assets.)

Change in Liability for Unauthorized Reinsurance

Where credit is not allowed for unauthorized reinsurance, the ceding insurer must establish a liability. Any change in the liability should be charged or credited directly to unassigned surplus. (See Chapter 22-Reinsurance.)

Change in Foreign Exchange Adjustment

Assets and liabilities in foreign currency are subject to adjustment to the prevailing foreign exchange rate. The change in the foreign exchange adjustment between the current and prior statement is charged or credited directly to unassigned surplus. (See Chapter 13-Other Liabilities.)

Change in Excess of Statutory Reserves Over Statement Reserves

Certain liability and compensation loss and loss expense reserves are subject to statutory minimums. The change in such statutory reserve between the current and prior years statement is charged or credited directly to unassigned surplus. (See Chapter 10-Losses.)

Dividends to Stockholders

Dividends to stockholders may only be paid from unassigned surplus. The amount available may be affected by numerous factors; for example, the insurance laws of the state of domicile, the existence of contractual commitment such as a borrowing agreement, etc. The corporation, as a matter of policy through its board of directors, may limit the amount of dividends and retain profits.

Dividends declared by the board are charged directly to unassigned surplus and are carried as a liability in the balance sheet until paid. The amount of the dividend is the actual amount paid in cash, the fair market value of the property, or the par value of the company's stock. A stock dividend is recorded as a transfer from unassigned surplus to capital.

Stock Issuance Expenses

Expenses relating to the issuance of capital stock, for example underwriting commissions and filing fees, are chargeable to the unassigned surplus account and not to paid-in surplus.

Appropriations of Surplus

A company may establish a segregated surplus account to provide for contingencies. Surplus thus segregated is called appropriated surplus or special surplus funds. Voluntary and general contingency reserves which are not actual liabilities of the company should be shown as appropriated surplus or as special surplus funds. An appropriation of surplus is recorded as a transfer from unassigned surplus to special surplus funds.

Subscribers Savings Accounts

Subscribers Savings Accounts (SSA) represent a portion of a reciprocal insurance company's surplus that has been identified as subscribers (policyholders) accounts. SSA is unique to reciprocals as the policyholders are also the owners of the company.

There are two sources for deposits to subscriber accounts. In the first, the individual subscriber may be the source of certain deposits to subscriber accounts, as some reciprocals may require subscriber contributions to join the reciprocal. In the second, the reciprocal is the source, by identifying as SSA a portion of its unassigned surplus generated from its operations. The source of SSA has a bearing on the proper financial statement presentation.

When the source of amounts credited to the subscriber accounts is the individual subscriber, these amounts should be reported in Other Than Special Surplus.

When the source of amounts credited to the subscriber accounts is from the reciprocals operations, it is appropriate to report these amounts as Unassigned Surplus. In this case, the individual subscriber accounts are merely an internal recordkeeping device and not an indicator of restrictions on the funds, or an obligation to pay these amounts to the subscribers. Reciprocal-generated funds that are identified as SSA are an integral part of the company's operational surplus and are fully available to meet the obligations of the reciprocal. Therefore, when the source of SSA is the reciprocal, financial statement presentation should report SSA as part of the Unassigned Surplus. The Notes to Financial Statements should also disclose pertinent information concerning amounts identified as SSA and conditions of repayment. The amount of surplus from operations that is identified as SSA is generally at the determination of the management of the company and its Board of Directors.

SSA balances may be paid, depending upon domiciliary state law, to subscribers upon termination of their association with the company, regardless of the source of the SSA. In this instance, any unpaid amounts owed to terminated subscribers must be reported as a liability.

Also, if deemed prudent by the company management, periodic partial payments from SSA may be made to subscribers under certain predetermined situations. For example, distributions may be made to those subscribers whose account balances exceed an established threshold. If the company has declared that it will distribute a certain amount of its Unassigned Surplus identified as SSA, but has not actually distributed the amounts by the next reporting date then the company should decrease Unassigned Surplus by the amount approved and report the unpaid amount as a liability. Other than these instances, SSA is typically not owed to the subscribers, and should not be treated as a liability.

Chapter 28, Unassigned Funds (Surplus), of the Life/A&H Accounting Practices and Procedures Manual contains similar guidance.

38. The NAIC Annual Statement Instructions require the following disclosures regarding capital and surplus and policyholders' dividend restrictions.

Instruction:

a. Shareholders' dividends - State terms of dividend restrictions, if any; indicate if dividends are cumulative and indicate what proportion of the profits of the company may be paid to stockholders.

b. For each issue of preferred stock, indicate exact description of issue, dividend rate, par value, stated value and liquidation value. If the preferred stock is redeemable, indicate the redemption prices and dates.

c. Unassigned surplus - Describe any restrictions which have been placed on the unassigned surplus funds. Indicate for whom the surplus is being held, and for mutual companies only, the total amount of advances to surplus not repaid, if any.

d. Indicate the total amount of stock held by the company, including stock of affiliated companies, for special purposes such as conversion of preferred stock and employee stock options.

39. Section 4 of the Life and Health Reinsurance Agreements Model Regulation provides the following guidance for ceded reinsurance:

> C(1) Agreements entered into after the effective date of this regulation which involve the reinsurance of business issued prior to the effective date of the agreements, along with any subsequent amendments thereto, shall be filed by the ceding company with the commissioner within thirty (30) days from its date of execution. Each filing shall include data detailing the financial impact of the transaction. The ceding insurer's actuary who signs the financial statement actuarial opinion with respect to valuation of reserves shall consider this regulation and any applicable actuarial standards of practice when determining the proper credit in financial statements filed with this department. The actuary should maintain adequate documentation and be prepared upon request to describe the actuarial work performed for inclusion in the financial statements and to demonstrate that such work conforms to this regulation.
>
> C(2) Any increase in surplus net of federal income tax resulting from arrangements described in Subsection C(1) shall be identified separately on the insurer's statutory financial statement as a surplus item (aggregate write-ins for gains and losses in surplus in the Capital and Surplus Account, page 4 of the Annual Statement) and recognition of the surplus increase as income shall be reflected on a net of tax basis in the "Reinsurance ceded" line, page 4 of the Annual Statement as earnings emerge from the business reinsured.
>
> {For example, on the last day of calendar year N, company XYZ pays a $20 million initial commission and expense allowance to company ABC for reinsuring an existing block of business. Assuming a 34% tax rate, the net increase in surplus at inception is $13.2 million ($20 million - $6.8 million) which is reported on the "Aggregate write-ins for gains and losses in surplus" line in the Capital and Surplus account. $6.8 million (34% of $20 million) is reported as income on the "Commissions and expense allowances on reinsurance ceded" line of the Summary of Operations.
>
> At the end of year N+1 the business has earned $4 million. ABC has paid $.5 million in profit and risk charges in arrears for the year and has received a $1 million experience refund. Company ABC's annual statement would report $1.65 million (66% of ($4 million - $1 million - $.5 million) up to a maximum of $13.2 million) on the "Commissions and expense allowance on reinsurance ceded" line of the Summary of Operations, and -$1.65 million on the "Aggregate write-ins for gains and losses in surplus" line of the Capital and Surplus account. The experience refund would be reported separately as a miscellaneous income item in the Summary of Operations.}

40. The Annual Statement Instructions require the following disclosures for Subscriber Savings Accounts:

> Instruction:
>
> For reciprocal insurance companies only, describe the amount of surplus identified as subscriber savings accounts; indicate the source of the funds (either from the reciprocal's operations or contribution by the individual subscriber) and, the reporting location in surplus; and describe the conditions upon which the balances are paid to the subscribers.
>
> Illustration:
>
> At December 31, 19XX the Company has $_____ identified to subscriber savings accounts. Of this amount, $_____ is from company operations and is reported in Unassigned Funds (Page 3, Line 24C). The balance identified to subscriber savings account, $____, was contributed directly by subscribers and is separately reported in Other Than Special Surplus Funds (Page 3,

Line 23C). The subscriber savings account balances are paid to the subscribers upon the termination from the Company.

Generally Accepted Accounting Principles

41. ARB 43, Chapter 1, *Prior Opinions,* provides the following guidance:

1. Unrealized profit should not be credited to income account of the corporation either directly or indirectly, through the medium of charging against such unrealized profits amounts which would ordinarily fall to be charged against income account. Profit is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that the collection of the sale price is not reasonably assured. An exception to the general rule may be made in respect of inventories in industries (such as packing-house industry) in which owing to the impossibility of determining costs it is a trade custom to take inventories at net selling prices, which may exceed cost.

2. Capital surplus, however created, should not be used to relieve the income account of the current or future years of charges which would otherwise fall to be made there against. This rule might be subject to the exception that where, upon reorganization, a reorganized company would be relieved of charges which would require to be made against income if the existing corporation were continued, it might be regarded as permissible to accomplish the same result without reorganization provided the facts were as fully revealed to and the action as formally approved by the shareholders as in reorganization.

3. Earned surplus of a subsidiary company created prior to acquisition does not form a part of the consolidated earned surplus of the parent company and subsidiaries; nor can any dividend declared out of such surplus properly be credited to the income account of the parent company.

4. While it is perhaps in some circumstances permissible to show stock of a corporation held in its own treasury as an asset, if adequately disclosed, the dividends on stock so held should not be treated as a credit to the income account of the company.

5. Notes or accounts receivable due from officers, employees, or affiliated companies must be shown separately and not included under a general heading such as notes receivable or accounts receivable.

6. If capital stock is issued nominally for the acquisition of property and it appears that at about the same time, and pursuant to a previous agreement or understanding, some portion of the stock so issued is donated to the corporation, it is not permissible to treat the par value of the stock nominally issued for the property as the cost of that property. If stock so donated is subsequently sold, it is not permissible to treat the proceeds as a credit to surplus of the corporation.

Section B -- Opinion Issued by Predecessor Committee

1. Following an inquiry made by the New York Stock Exchange, a predecessor committee on accounting procedure in 1938 issued the following report:

“Profits or Losses on Treasury Stock”

2. “The executive committee of the American Institute of Accountants has directed that the following report of the committee on accounting procedure, which it received at a meeting on April 8, 1938, be published, without approval or disapproval of the committee, for the information of members of the Institute:

> To the Executive Committee,
> American Institute of Accountants:
>
> 3. "This committee has had under consideration the question regarding treatment of purchase and sale by a corporation of its own stock, which was raised during 1937 by the New York Stock Exchange with the Institute's special committee on cooperation with stock exchanges.
>
> 4. "As a result of discussions which then took place, the special committee on cooperation with stock exchanges made a report which was approved by the committee on accounting procedure and the executive committee, and a copy of which was furnished to the committee on stock list of the New York Stock Exchange. The question raised was stated in the following form:
>
> 5. "Should the difference between the purchase and resale prices of a corporation's own common stock be reflected in earned surplus (either directly or through inclusion in the income account) or should such difference be reflected in capital surplus?"
>
> 6. "The opinion of the special committee on cooperation with stock exchanges reads in part as follows:
>
> 7. "Apparently there is general agreement that the difference between the purchase price and the stated value of a corporation's common stock purchased and retired should be reflected in capital surplus. Your committee believes that while the net asset value of the shares of common stock outstanding in the hands of the public may be increased or decreased by such purchase and retirement, such transactions relate to the capital of the corporation and do not give rise to corporate profits or losses. Your committee can see no essential difference between (a) the purchase and retirement of a corporation's own common stock and the subsequent issue of common shares, and (b) the purchase and resale of its own common stock."
>
> 8. "This committee is in agreement with the views thus expressed; it is aware that such transactions have been held to give rise to taxable income, but it does not feel that such decisions constitute any bar to the application of correct accounting procedure as above outlined.
>
> 9. "The special committee on cooperation with stock exchanges continued and concluded its report with the following statement:
>
> 10. "Accordingly, although your committee recognizes that there may be cases where the transactions involved are so inconsequential as to be immaterial, it does not believe that, as a broad general principle, such transactions should be reflected in earned surplus (either directly or through inclusion in the income account)."
>
> 11. "This committee agrees with the special committee on cooperation with stock exchanges, but thinks it desirable to point out that the qualification should not be applied to any transaction which, although in itself inconsiderable in amount, is a part of a series of transactions which in the aggregate are of substantial importance.
>
> 12. "This committee recommends that the views expressed be circulated for the information of members of the Institute."

42. APB 12, *Omnibus Opinion 1967*, provides the following guidance:

> 9. Paragraph 7 of *APB Opinion No. 9, Reporting the Results of Operations*, states that "The statement of income and the statement of retained earnings (separately or combined) are designed to reflect, in a broad sense, the 'results of operations'." Paragraph 28 of APB Opinion No. 9 states that certain capital transactions ". . . should be excluded from the determination of net income or the results of operations under all circumstances." Companies generally have reported the current year's changes in stockholders' equity accounts other than retained earnings in separate statements or notes to the financial statements when presenting both financial position and results of operations for one or more years. A question has arisen as to whether,

because of the language of APB Opinion No. 9, changes in stockholders' equity accounts other than retained earnings are required to be reported.

10. When both financial position and results of operations are presented, disclosure of changes in the separate accounts comprising stockholders' equity (in addition to retained earnings) and of the changes in the number of shares of equity securities during at least the most recent annual fiscal period and any subsequent interim period presented is required to make the financial statements sufficiently informative. Disclosure of such changes may take the form of separate statements or may be made in the basic financial statements or notes thereto.

43. *Accounting Principles Board Opinion No. 9*, *Reporting the Results of Operations*, provides the following guidance:

Capital Transactions

28. The Board reaffirms the conclusion of the former committee on accounting procedure that the following should be excluded from the determination of net income or the results of operations under all circumstances: (a) adjustments or charges or credits resulting from transactions in the company's own capital stock, 5 (b) transfers to and from accounts properly designated as appropriated retained earnings (such as general purpose contingency reserves or provisions for replacement costs of fixed assets) and (c) adjustments made pursuant to a quasi-reorganization.

44. APB 10, Omnibus Opinion - 1966 requires the following disclosures for liquidation preferences:

10. Companies at times issue preferred (or other senior) stock which has a preference in involuntary liquidation considerably in excess of the par or stated value of the shares. The relationship between this preference in liquidation and the par or stated value of the shares may be of major significance to the users of the financial statements of those companies and the Board believes it highly desirable that it be prominently disclosed. Accordingly, the Board recommends that, in these cases, the liquidation preference of the stock be disclosed in the equity section of the balance sheet in the aggregate, either parenthetically or "in short," rather than on a per share basis or by disclosure in notes.

11. In addition, the financial statements should disclose, either on the face of the balance sheet or in notes pertaining thereto:

a. the aggregate or per share amounts at which preferred shares may be called or are subject to redemption through sinking fund operations or otherwise;
b. the aggregate and per share amounts of arrearages in cumulative preferred dividends.

45. FAS 5 provides the following guidance with respect to appropriations of retained earnings:

Appropriation of Retained Earnings

15. Some enterprises have classified a portion of retained earnings as "appropriated" for loss contingencies. In some cases, the appropriation has been shown outside the stockholders' equity section of the balance sheet. Appropriation of retained earnings is not prohibited by this Statement provided that it is shown within the stockholders' equity section of the balance sheet and is clearly identified as an appropriation of retained earnings. Costs or losses shall not be charged to an appropriation of retained earnings, and no part of the appropriation shall be transferred to income.

46. *APB 6*, *Status of Accounting Research Bulletins* provides the following guidance for treasury stock transactions:

12. The Board considers that the following accounting practices, in addition to the accounting practices indicated in Chapter 1B, are acceptable, and that they appear to be more in accord with current developments in practice:

a. When a corporation's stock is retired, or purchased for constructive retirement (with or without an intention to retire the stock formally in accordance with applicable laws):

i. an excess of purchase price over par or stated value may be allocated between capital surplus and retained earnings. The portion of the excess allocated to capital surplus should be limited to the sum of (a) all capital surplus arising from previous retirements and net "gains" on sales of treasury stock of the same issue and (b) the prorata portion of capital surplus paid in, voluntary transfers of retained earnings, capitalization of stock dividends, etc., on the same issue. For this purpose, any remaining capital surplus applicable to issues fully retired (formal or constructive) is deemed to be applicable prorata to shares of common stock. Alternatively, the excess may be charged entirely to retained earnings in recognition of the fact that a corporation can always capitalize or allocate retained earnings for such purposes.

ii. an excess of par or stated value over purchase price should be credited to capital surplus.

b. When a corporation's stock is acquired for purposes other than retirement (formal or constructive), or when ultimate disposition has not yet been decided, the cost of acquired stock may be shown separately as a deduction from the total of capital stock, capital surplus, and retained earnings, or may be accorded the accounting treatment appropriate for retired stock, or in some circumstances may be shown as an asset in accordance with paragraph 4 of Chapter 1A of ARB 43. "Gains" on sales of treasury stock not previously accounted for as constructively retired should be credited to capital surplus; "losses" may be changed to capital surplus to the extent that previous net "gains" from sales or retirements of the same class of stock are included therein, otherwise to retained earnings.

c. Treasury stock delivered to effect a "pooling of interests" should be accounted for as though it were newly issued, and the cost thereof should receive the accounting treatment appropriate for retired stock.

13. Laws of some states govern the circumstances under which a corporation may acquire its own stock and prescribe the accounting treatment therefore. Where such requirements are at variance with paragraph 12, the accounting should conform to the applicable law. When state laws relating to acquisition of stock restrict the availability of retained earnings for payment of dividends or have other effects of a significant nature, these facts should be disclosed.

47. *EITF 85-1*, *Classifying Notes Received for Capital Stock, provides the following guidance*.

Issue
An enterprise receives a note, rather than cash, as a contribution to its equity. The transaction may be a sale of capital stock or a contribution to paid-in capital.

The issue is whether an enterprise should report the note receivable as a reduction of shareholders' equity or as an asset.

EITF Discussion
The Task Force reached a consensus that reporting the note as an asset is generally not appropriate, except in very limited circumstances when there is substantial evidence of ability and intent to pay within a reasonably short period of time. Some Task Force members would require collateralization, or payment of the note prior to issuance of the financial statements, to permit asset recognition.

The SEC requires that public companies report notes received in payment for the enterprise's stock as a deduction from shareholders' equity. Task Force members confirmed that the predominant practice is to offset the notes and stock in the equity section. However, such notes may be recorded as an asset if collected in cash prior to issuance of the financial statements.

Some Task Force members stated that they were aware of very few cases in which nonpublic companies reported such notes as an asset except in circumstances in which they (1) were secured by irrevocable letters of credit or other liquid collateral or were discountable at a bank and (2) included a stated maturity in a reasonably short period of time.

The SEC Observer stated that, for registrants, exceptions to the general rule would be very rare.

Status
No further EITF discussion is planned.

48. *ARB 43, Chapter 7B, Stock Dividends and Split-ups,* provides the following guidance:

Section B -- Stock Dividends and Stock Split-ups

1. The term stock dividend as used in this section refers to an issuance by a corporation of its own common shares to its common shareholders without consideration and under conditions indicating that such action is prompted mainly by a desire to give the recipient shareholders some ostensibly separate evidence of a part of their respective interests in accumulated corporate earnings without distribution of cash or other property which the board of directors deems necessary or desirable to retain in the business.

2. The term stock split-up as used in this chapter refers to an issuance by a corporation of its own common shares to its common shareholders without consideration and under conditions indicating that such action is prompted mainly by a desire to increase the number of outstanding shares for the purpose of effecting a reduction in their unit market price and, thereby, of obtaining wider distribution and improved marketability of the shares.

3. This chapter is not concerned with the accounting for a distribution or issuance to shareholders of (a) shares of another corporation theretofore held as an investment, or (b) shares of a different class, or (c) rights to subscribe for additional shares or (d) shares of the same class in cases where each shareholder is given an election to receive cash or shares.

4. The discussion of accounting for stock dividends and split-ups that follows is divided into two parts. The first deals with the problems of the recipient. The second deals with the problems of the issuer.

As to the Issuer
Stock dividends

10. As has been previously stated, a stock dividend does not, in fact, give rise to any change whatsoever in either the corporation’s assets or its respective shareholders’ proportionate interests therein. However, it cannot fail to be recognized that, merely as a consequence of the expressed purpose of the transaction and its characterization as a dividend in related notices to shareholders and the public at large, many recipients of stock dividends look upon them as distributions of corporate earnings and usually in an amount equivalent to the fair value of the additional shares received. Furthermore, it is to be presumed that such views of recipients are materially strengthened in those instances, which are by far the most numerous, where the issuances are so small in comparison with the shares previously outstanding that they do not have any apparent effect upon the share market price and, consequently, the market value of the shares previously held remains substantially unchanged. The committee therefore believes that where these circumstances exist the corporation should in the public interest account for the transaction by transferring from earned surplus to the category of permanent capitalization (represented by the capital stock and capital surplus accounts) an amount equal to the fair value of the additional shares issued. Unless this is done, the amount of earnings which the shareholder may believe to have been distributed to him will be left, except to the extent

otherwise dictated by legal requirements, in earned surplus subject to possible further similar stock issuances or cash distributions.

11. Where the number of additional shares issued as a stock dividend is so great that it has, or may reasonably be expected to have, the effect of materially reducing the share market value, the committee believes that the implications and possible constructions discussed in the preceding paragraph are not likely to exist and that the transaction clearly partakes of the nature of a stock split-up as defined in paragraph 2. Consequently, the committee considers that under such circumstances there is no need to capitalize earned surplus, other than to the extent occasioned by legal requirements. It recommends, however, that in such instances every effort be made to avoid the use of the word dividend in related corporate resolutions, notices, and announcements and that, in those cases where because of legal requirements this cannot be done, the transaction be described, for example, as a split-up effected in the form of a dividend.

12. In cases of closely-held companies, it is to be presumed that the intimate knowledge of the corporations' affairs possessed by their shareholders would preclude any such implications and possible constructions as are referred to in paragraph 10. In such cases, the committee believes that considerations of public policy do not arise and that there is no need to capitalize earned surplus other than to meet legal requirements.

13. Obviously, the point at which the relative size of the additional shares issued becomes large enough to materially influence the unit market price of the stock will vary with individual companies and under differing market conditions and, hence, no single percentage can be laid down as a standard for determining when capitalization of earned surplus in excess of legal requirements is called for and when it is not. However, on the basis of a review of market action in the case of shares of a number of companies having relatively recent stock distributions, it would appear that there would be few instances involving the issuance of additional shares of less than, say, 20% or 25% of the number previously outstanding where the effect would not be such as to call for the procedure referred to in paragraph 10.

14. The corporate accounting recommended in paragraph 10 will in many cases, probably the majority, result in the capitalization of earned surplus in an amount in excess of that called for by the laws of the state of incorporation; such laws generally require the capitalization only of the par value of the shares issued, or, in the case of shares without par value, an amount usually within the discretion of the board of directors. However, these legal requirements are, in effect, minimum requirements and do not prevent the capitalization of a larger amount per share.

Stock Split-ups

15. Earlier in this chapter a stock split-up was defined as being confined to transactions involving the issuance of shares, without consideration moving to the corporation, for the purpose of effecting a reduction in the unit market price of shares of the class issued and, thus, of obtaining wider distribution and improved marketability of the shares. Where this is clearly the intent, no transfer from earned surplus to capital surplus or capital stock account is called for, other than to the extent occasioned by legal requirements. It is believed, however, that few cases will arise where the aforementioned purpose can be accomplished through an issuance of shares which is less than, say, 20% or 25% of the previously outstanding shares.

16. The committee believes that the corporation's representations to its shareholders as to the nature of the issuance is one of the principal considerations in determining whether it should be recorded as a stock dividend or a split-up. Nevertheless, it believes that the issuance of new shares in ratios of less than, say, 20% or 25% of the previously outstanding shares, or the frequent recurrence of issuances of shares, would destroy the presumption that transactions represented to be split-ups should be recorded as split-ups.

RELEVANT LITERATURE

Statutory Accounting

- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 23, Capital Stock, Chapter 24, Paid-In or Contributed Surplus and Organizational Surplus, Chapter 25, Unassigned Funds (Surplus)
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 26, Capital Stock, Chapter 27, Paid-In or Contributed Surplus and Organizational Surplus, Chapter 28, Unassigned Funds (Surplus)
- NAIC Annual Statement Instructions
- Life and Health Reinsurance Agreements Model Regulation
- *Issue Paper No. 3—Accounting Changes*
- *Issue Paper No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*
- *Issue Paper No. 9—Subsequent Events*
- *Issue Paper No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties*
- *Issue Paper No. 73—Nonmonetary Transactions*
- *Issue Paper No. 41—Surplus Notes*
- *Issue Paper No. 75—Property and Casualty Reinsurance*
- *Issue Paper No. 78—Employee Stock Ownership Plans*
- *Issue Paper No. 80—Debt*
- *Issue Paper No. 81—Foreign Currency Transactions and Translations*
- *Issue Paper No. 82—Stock Option and Stock Purchase Plans*
- *Issue Paper No. 83—Accounting for Income Taxes*
- *Issue Paper No. 84—Quasi-reorganizations*

Generally Accepted Accounting Principles

- AICPA Audit and Accounting Guide: Property & Casualty Insurance Companies
- AICPA Audit and Accounting Guide: Stock Life Insurance Companies
- *Accounting Research Bulletin No. 43, Chapter 1, Prior Opinions. Chapter 7B, Stock Dividends and Stock Split-ups*
- *Accounting Principles Board Opinion No. 6, Status of Accounting Research*
- *Accounting Principles Board Opinion No. 9, Reporting the Results of Operations Bulletins*
- *Accounting Principles Board Opinion No. 10, Omnibus Opinion 1966*
- *Accounting Principles Board Opinion No. 12, Omnibus Opinion 1967*
- *Accounting Principles Board Opinion No. 14, Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants*
- *FASB Statement No. 5, Accounting for Contingencies*
- *FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities*
- *FASB Emerging Issues Task Force Issue No. 85-1, Classifying Notes Received for Capital Stock*
- *FASB Emerging Issue Task Force Issue No. 85-2, Classification of Costs Incurred in a Takeover Defense*
- *FASB Emerging Issues Task Force Issue No. 88-9, Put Warrants*
- *FASB Technical Bulletin No. 85-6, Accounting for a Purchase of Treasury Shares at a Price Significantly in Excess of the Current Market Price of the Shares and the Income Statement Classification of Costs Incurred in Defending against a Takeover Attempt*

State Regulations

- No additional guidance obtained from state statutes or regulations.

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Statutory Issue Paper No. 73

Nonmonetary Transactions

STATUS
Finalized March 16, 1998

Current Authoritative Guidance for Nonmonetary Transactions: SSAP No. 95
This issue paper may not be directly related to the current authoritative statement.

Original SSAP from Issue Paper: SSAP No. 28

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory guidance does not establish a general rule for accounting for nonmonetary transactions. Current statutory accounting guidance regarding nonmonetary transactions related to assets transferred between affiliates is provided in the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies (Life/A&H and P&C Accounting Practices & Procedures Manuals).

2. GAAP addresses accounting for nonmonetary transactions primarily in *Accounting Principles Board Opinion No. 29*, *Accounting for Nonmonetary Transactions* (APB 29), *FASB Interpretation No. 30*, *Accounting for Involuntary Conversions of Nonmonetary Assets to Monetary Assets* (FIN 30), *FASB Emerging Issues Task Force Issue No. 86-29*, *Nonmonetary Transactions: Magnitude of Boot and the Exceptions to the Use of Fair Value* (EITF 86-29) and in *FASB Emerging Issues Task Force Issue No. 93-11*, *Accounting for Barter Transactions Involving Barter Credits* (EITF 93-11). GAAP addresses accounting for stock dividends and stock splits in *Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins* (ARB 43).

3. The purpose of this issue paper is to establish statutory accounting principles for nonmonetary transactions that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. The definitions of certain terms used in this issue paper are:

a. Monetary assets and liabilities are assets and liabilities whose amounts are fixed in terms of units of currency by contract or otherwise. Examples are cash; amounts due from agents, brokers, and intermediaries; policy loans; accounts payable and other amounts receivable or payable in cash.

b. Nonmonetary assets and liabilities are assets and liabilities other than monetary ones. Examples are investments in common stocks; furniture fixtures and equipment; real estate and liabilities for rent collected in advance.

c. Exchange (or exchange transaction) is a reciprocal transfer between a reporting entity and another entity that results in the reporting entity acquiring assets or services or satisfying liabilities by surrendering other assets or services or incurring other obligations.

d. Nonreciprocal transfer is a transfer of assets or services in one direction, either from a reporting entity to its owners (whether or not in exchange for their ownership interests) or another entity, or from owners or another entity to the reporting entity. A reporting entity's reacquisition of its outstanding stock is an example of a nonreciprocal transfer.

5. Except as addressed in other issue papers, as discussed in paragraph 11 of this issue paper, nonmonetary transactions shall be accounted for in accordance with APB 29 which is excerpted in paragraph 20 of this issue paper. The accounting for such transactions shall be based on the fair values, as defined in APB 29, paragraph 25, of the assets (or services) involved. In a reciprocal transfer, the fair value of the asset surrendered shall be used to measure the cost unless the fair value of the asset received is more clearly evident. A nonmonetary asset received in a nonreciprocal transfer shall be recorded at the fair value of the asset received. A nonmonetary asset transferred to a stockholder or other entity in a nonreciprocal transfer shall be accounted for at the fair value of the asset transferred and a gain or loss on disposition of the asset recognized for the difference, if any, between fair value and carrying value of the asset transferred.

6. Fair value of assets received or transferred in a nonreciprocal transfer shall be measured based on statutory accounting principles for the type of asset transferred. Accordingly, the value shall be determined in accordance with *Issue Paper No. 26—Bonds, Excluding Loan-Backed and Structured Securities, Issue Paper No. 30—Investments in Common Stock (excluding investments in common stock of subsidiary, controlled, or affiliated entities)*, *Issue Paper No. 32—Investments in Preferred Stock (including investments in preferred stock of subsidiary, controlled, or affiliated entities), Issue Paper No. 37—Mortgage Loans*, *Issue Paper No. 39—Reverse Mortgages, Issue Paper No. 40—Real Estate Investments, Issue Paper No. 43—Loan-Backed and Structured Securities* or other applicable statement. The guidance provided in *Issue Paper No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties* shall be followed in accounting for nonreciprocal transactions.

7. Stock received in the form of a stock dividend or stock split shall not result in the recognition of income. The cost basis of stock held shall be reallocated ratably to the total shares held after receipt of the stock dividend or stock split.

8. Involuntary conversions of nonmonetary assets to monetary assets (for example, as a result of total or partial destruction, theft, seizure, or condemnation) are monetary transactions for which gain or loss shall be recognized even though a reporting entity reinvests or is obligated to reinvest the monetary assets in replacement nonmonetary assets. In some cases, a nonmonetary asset may be destroyed or damaged in one accounting period, and the amount of monetary assets to be received is not determinable until a subsequent accounting period. In those cases, gain or loss shall be recognized in accordance with the conclusions in *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets* (Issue Paper No. 5) or *Issue Paper No. 20—Gain Contingencies* (Issue Paper No. 20), as applicable. Gain or loss resulting from an involuntary conversion of a nonmonetary asset to monetary assets shall be reported consistently with the reporting entity's reporting of continuing operations and disclosed in the notes to financial statements in accordance with *Issue Paper No. 24—Discontinued Operations and Extraordinary Items* (Issue Paper No. 24).

9. A difference between the amount of gain or loss recognized for tax purposes and that recognized for accounting purposes may constitute a temporary difference to be accounted for in accordance with *Issue Paper No. 83—Accounting for Income Taxes*.

Disclosure

10. A reporting entity that engages in a nonmonetary transaction during a period shall disclose in the financial statements or notes thereto the nature of the transaction, the basis of accounting for the assets transferred, and gains or losses recognized on transfers.

DISCUSSION

11. Although not meant to be all inclusive, accounting for specific nonmonetary transactions and unique circumstances is addressed in the following issue papers:

- *Issue Paper No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties* (Issue Paper No. 25),
- *Issue Paper No. 68—Business Combinations and Goodwill*,
- *Issue Paper No. 72—Statutory Surplus*,
- *Issue Paper No. 78—Employee Stock Ownership Plans*, and
- *Issue Paper No. 82—Stock Option and Stock Purchase Plans*.

12. This issue paper establishes a general rule for accounting for nonmonetary transactions not specifically addressed in the issue papers noted above and expands on current statutory guidance to establish guidance for stock dividends and stock splits received, other types of nonmonetary transactions and involuntary conversions of nonmonetary assets to monetary assets. The guidance established in this issue paper is consistent with the guidance provided in Issue Paper No. 30 which addresses cash dividends and requires that dividends on common stock be recorded as investment income when declared with a corresponding receivable to be extinguished upon receipt of cash. This issue paper also expands the disclosure requirements related to nonmonetary transactions.

13. This issue paper adopts APB 29.

14. This issue paper adopts ARB 43, Chapter 7, Section B paragraphs 1-9 as such relates to the receipt of stock in the form of a stock dividend or stock split. This conclusion is consistent with the recognition concept included in the Statement of Concepts which states *"Revenue should be recognized only as the earnings process of the underlying underwriting or investment business is completed"*.

15. This issue paper adopts FIN 30 with modification to provide that gain or loss contingencies be recognized in accordance with the conclusions in Issue Paper No. 5 or Issue Paper No. 20, as applicable, and that gain or loss resulting from an involuntary conversion of nonmonetary assets to monetary assets be accounted for in continuing operations and disclosed in accordance with Issue Paper No. 24.

16. This issue paper adopts EITF 86-29 and EITF 93-11 consistent with the general rule discussed in paragraph 12 above.

17. This issue paper rejects paragraph 16 of *Accounting Principles Board Opinion No. 6*, *Status of Accounting Research Bulletins* and *Emerging Issues Task Force No. 96-4, Accounting for Reorganizations Involving a Non-Pro Rata Split-off of Certain Nonmonetary Assets to Owners*

18. The conclusions above are consistent with the recognition concept included in the Statement of Concepts. The recognition concept states:

> The principal focus of solvency measurement is determination of financial condition through analysis of the balance sheet. However, protection of the policyholders can only be maintained through continued monitoring of the financial condition of the insurance enterprise. Operating performance is another indicator of an enterprise's ability to maintain itself as a going concern. Accordingly, the income statement is a secondary focus of statutory accounting and should not be diminished in importance to the extent contemplated by a liquidation basis of accounting.
>
> The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which are unavailable due to encumbrances or other third party interests should not be recognized on the

balance sheet but rather should be charged against surplus when acquired or when availability otherwise becomes questionable.

Liabilities require recognition as they are incurred. Certain statutorily mandated liabilities may also be required to arrive at conservative estimates of liabilities and probable loss contingencies (e.g., excess of statutory reserves over statement reserves, interest maintenance reserves, asset valuation reserves, and others).

Revenue should be recognized only as the earnings process of the underlying underwriting or investment business is completed. Accounting treatments which tend to defer expense recognition do not generally represent acceptable SAP treatment.

SAP income reflects the extent that changes have occurred in SAP assets and liabilities for current period transactions, except changes in capital resulting from receipts or distributions to owners. SAP income also excludes certain other direct charges to surplus which are not directly attributable to the earnings process, (e.g., changes in non-admitted assets).

Drafting Notes/Comments

None

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

19. Current statutory guidance does not establish a general rule for accounting for nonmonetary transactions. Current statutory accounting guidance regarding nonmonetary transactions related to assets transferred between affiliates is addressed in Issue Paper No. 25.

Generally Accepted Accounting Principles

20. APB 29 provides the following guidance:

> INTRODUCTION
>
> 1. Most business transactions involve exchanges of cash or other monetary assets or liabilities[1] for goods or services. The amount of monetary assets or liabilities exchanged generally provides an objective basis for measuring the cost of nonmonetary assets or services received by an enterprise as well as for measuring gain or loss on nonmonetary assets transferred from an enterprise. Some transactions, however, involve either (a) an exchange with another entity (reciprocal transfer[1]) that involves principally nonmonetary assets or liabilities[1] or (b) a transfer of nonmonetary assets for which no assets are received or relinquished in exchange (nonreciprocal transfer[1]). Both exchanges and nonreciprocal transfers that involve little or no monetary assets or liabilities are referred to in this section as nonmonetary transactions.
>
> [1] See paragraph 3 of this Opinion for definitions of these terms.
>
> 2. Questions have been raised concerning the determination of the amount to assign to a nonmonetary asset transferred to or from an enterprise in a nonmonetary transaction and also concerning the recognition of a gain or loss on a nonmonetary asset transferred from an enterprise in a nonmonetary transaction. Practice has varied; some nonmonetary transactions have been accounted for at the estimated fair value of the assets transferred and some at the amounts at which the assets transferred were previously recorded. This opinion sets forth the views of the Board on accounting for nonmonetary transactions.

Definitions

3. The meanings of certain terms used in this section are:

   a. Monetary assets and liabilities are assets and liabilities whose amounts are fixed in terms of units of currency by contract or otherwise. Examples are cash, short- or long-term accounts and notes receivable in cash, and short- or long-term accounts and notes payable in cash.[2]

   b. Nonmonetary assets and liabilities are assets and liabilities other than monetary ones. Examples are inventories; investments in common stocks; property, plant and equipment; and liabilities for rent collected in advance.[2]

   c. Exchange (or exchange transaction) is a reciprocal transfer between an enterprise and another entity that results in the enterprise's acquiring assets or services or satisfying liabilities by surrendering other assets or services or incurring other obligations.[3]

   d. Nonreciprocal transfer[3] is a transfer of assets or services in one direction, either from an enterprise to its owners (whether or not in exchange for their ownership interests) or another entity or from owners or another entity to the enterprise. An entity's reacquisition of its outstanding stock is an example of a nonreciprocal transfer.

   e. Productive assets are assets held for or used in the production of goods or services by the enterprise. Productive assets include an investment in another entity if the investment is accounted for by the equity method but exclude an investment not accounted for by that method. Similar productive assets are productive assets that are of the same general type, that perform the same function or that are employed in the same line of business.

Applicability

4. This Opinion does not apply to the following transactions:

   a. A business combination accounted for by an enterprise according to the provisions of *APB Opinion No. 16, Business Combinations*,

   b. A transfer of nonmonetary assets solely between companies or persons under common control, such as between a parent company and its subsidiaries or between two subsidiary corporations of the same parent, or between a corporate joint venture and its owners,

[2] *APB Statement No. 3, Financial Statements Restated for General Price-Level Changes,* paragraphs 17-19, and Appendix B, contains a more complete explanation of monetary and nonmonetary items.

[3] *APB Statement No. 4, Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises*, paragraphs 180-183, contains a more complete explanation of exchanges and nonreciprocal transfers.

c. Acquisition of nonmonetary assets or services on issuance of the capital stock of an enterprise,[4] and

[4] The Board has deferred consideration of accounting for those transactions pending completion and consideration of Accounting Research Studies on intercorporate investments and stockholders' equity except to the extent they are covered in *APB Opinion No. 25, Accounting for Stock Issued to Employees*.

d. Stock issued or received in stock dividends and stock splits which are accounted for in accordance with ARB No. 43, Chapter 7B.

This Opinion applies to regulated companies in accordance with the Addendum to *APB Opinion No. 2, Accounting for the Investment Credit, 1962* and it amends *APB Statement No. 4, Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises*, to the extent it relates to measuring transfers of certain nonmonetary assets. Some exchanges of nonmonetary assets involve a small monetary consideration, referred to as “boot,” even though the exchange is essentially nonmonetary. This Opinion also applies to those transactions. For purposes of applying this Opinion, events and transactions in which nonmonetary assets are involuntarily converted (for example, as a result of total or partial destruction, theft, seizure, or condemnation) to monetary assets that are then reinvested in other nonmonetary assets--are monetary transactions since the recipient is not obligated to reinvest the monetary consideration in other nonmonetary assets.

DISCUSSION

Present Accounting for Nonmonetary Transactions

5. Nonreciprocal Transfers with Owners. Some nonmonetary transactions are nonreciprocal transfers between an enterprise and its owners. Examples include (a) distribution of nonmonetary assets, such as marketable equity securities, to stockholders as dividends, (b) distribution of nonmonetary assets, such as marketable equity securities, to stockholders to redeem or acquire outstanding capital stock of the enterprise, (c) distribution of nonmonetary assets, such as capital stock of subsidiaries, to stockholders in corporate liquidations or plans of reorganization that involve disposing of all or a significant segment of the business (the plans are variously referred to as spin-offs, split-ups, and split-offs), and (d) distribution of nonmonetary assets to groups of stockholders, pursuant to plans of rescission or other settlements relating to a prior business combination, to redeem or acquire shares of capital stock previously issued in a business combination. Accounting for decreases in owners' equity that result from nonreciprocal nonmonetary transactions with owners has usually been based on the recorded amount of the nonmonetary assets distributed.

6. Nonreciprocal Transfers with Other Than Owners. Other nonmonetary transactions are nonreciprocal transfers between an enterprise and entities other than its owners. Examples are the contribution of nonmonetary assets by an enterprise to a charitable organization and the contribution of land by a governmental unit for construction of productive facilities by an enterprise. Accounting for nonmonetary assets received in a nonreciprocal transfer from an entity other than an owner has usually been based on fair value of the assets received while accounting for nonmonetary assets transferred to another entity has usually been based on the recorded amount of the assets relinquished.

7. Nonmonetary Exchanges. Many nonmonetary transactions are exchanges of nonmonetary assets or services with another entity. Examples include (a) exchange of product held for sale in the ordinary course of business (inventory) for dissimilar property as a means of selling the product to a customer, (b) exchange of product held for sale in the ordinary course of business (inventory) for similar product as an accommodation - that is, at least one party to the exchange reduces transportation costs, meets immediate inventory needs, or otherwise reduces

costs or facilitates ultimate sale of the product–and not as a means of selling the product to a customer, and (c) exchange of productive assets–assets employed in production rather than held for sale in the ordinary course of business - for similar productive assets or for an equivalent interest in similar productive assets. Examples of exchanges in category (c) include the trade of player contracts by professional sports organizations, exchange of leases on mineral properties, exchange of one form of interest in an oil producing property for another form of interest, exchange of real estate for real estate. Accounting for nonmonetary assets acquired in a nonmonetary exchange has sometimes been based on the fair value of the assets relinquished and sometimes on the recorded amount of the assets relinquished.

Differing Views

8. Views of accountants differ as to appropriate accounting for all of the types of nonmonetary transactions described in paragraphs 5-7.

9. Nonreciprocal Transfers of Nonmonetary Assets to Owners. Some believe that accounting for nonreciprocal transfers of nonmonetary assets to owners should be based on the carrying amount of the nonmonetary assets transferred because only that method is consistent with the historical cost basis of accounting.

10. Others believe that accounting for transfers of nonmonetary assets to reduce certain owners' interests other than through a reorganization, liquidation, or rescission of a prior business combination should be based on the fair value of the nonmonetary assets distributed or the fair value of the stock representing the owners' equity eliminated, whichever is more clearly evident. In their view, disposing of the value represented by a nonmonetary asset is a significant economic event, and the unrecorded increase or decrease that has resulted in the value of the nonmonetary asset since its acquisition should be recognized.

11. Many who agree with accounting based on fair value for a nonreciprocal transfer of a nonmonetary asset that reduces certain owners' interests also believe that distributing a nonmonetary asset as an ordinary dividend (but not distributing a nonmonetary asset as a liquidating dividend or in a spin-off, reorganization or similar distributions) may be regarded as equivalent to an exchange with owners and therefore recorded at the fair value of the nonmonetary asset distributed, particularly if the dividend is distributable as either cash or the nonmonetary asset at the election of the owner. They believe that failure to recognize the fair value of nonmonetary assets transferred may both misstate the dividend and fail to recognize gains and losses on nonmonetary assets that have already been earned or incurred by the enterprise and should be recognized on distributing the assets for dividend purposes.

12. Others generally agree with the view that nonreciprocal transfers of nonmonetary assets to certain owners should be accounted for at fair value but believe that dividends and other prorata distributions to owners are essentially similar to liquidating dividends or distributions in spin-offs and reorganizations and should be accounted for at the recorded amount of the asset transferred.

13. Nonreciprocal Receipts of Nonmonetary Assets. Many believe that a nonmonetary asset received in a nonreciprocal transfer from other than owners should be recorded at fair value because fair value is the only value relevant to the recipient enterprise. Others believe that such nonmonetary assets should be recorded at a nominal value since fair value cannot be reasonably determined in view of performance obligations usually agreed to by the recipient as a consideration for the transfer.

14. Nonreciprocal Transfers of Nonmonetary Assets to Other Than Owners. Some believe that accounting for a nonreciprocal transfer of a nonmonetary asset to an entity other than an owner should be based on the carrying amount of the asset transferred because only that method is consistent with the historical cost basis of accounting. Others believe that failure to recognize the fair value of a nonmonetary asset transferred may both understate (or overstate) expenses incurred and fail to recognize gains or losses on nonmonetary assets that have already

been earned or incurred by the enterprise and should be recognized when the transfer of the asset is recognized as an expense.

15. Exchange Transactions. Some believe that accounting for an exchange of nonmonetary assets between an enterprise and another entity (an enterprise or individual acting in a capacity other than a stockholder of the enterprise) should be based on the fair values of the assets involved, while others believe that accounting for the exchange should be based on the carrying amount of the asset transferred from the enterprise. Those who advocate the former view believe it to be the only method consistent with the accounting principle that an asset acquired should be recorded at its cost as measured by the fair value of the asset relinquished to acquire it. Those advocating the latter view believe that revenue should be recognized only if an exchange involves monetary assets; therefore recognizing fair value is inappropriate unless a monetary asset is received in an exchange.

16. Many accountants who accept the concept that accounting for an exchange of nonmonetary assets should be based on fair value believe that problems of measurement and questions about the conditions for recognizing revenue require modification of the concept in two types of exchanges. They therefore conclude that:

a. Fair values should not be recognized if an enterprise exchanges product or property held for sale in the ordinary course of business for product or property to be sold in the same line of business. The emphasis in that exchange, in their view, is on developing economical ways to acquire inventory for resale to customers rather than on marketing inventory to obtain revenue from customers. Therefore, "swapping" inventories between enterprises that are essentially competitors and not customers of each other is merely an incidental early stage of an earning process, and revenue should not be recognized until the time of sale of the exchanged products (in the same or another form) to a customer of the enterprise.

b. Fair value should not be recognized if an enterprise exchanges a productive asset for a similar productive asset or an equivalent interest in the same or similar productive asset. Therefore, revenue should not be recognized merely because one productive asset is substituted for a similar productive asset but rather should be considered to flow from the production and sale of the goods or services to which the substituted productive asset is committed.

17. Fair Value Not Determinable. General agreement exists that a nonmonetary transaction, regardless of form, should not be recorded at fair value if fair value is not determinable within reasonable limits. Major uncertainties concerning realizability of the fair value proposed to be assigned to a nonmonetary asset received in a nonmonetary transaction are indicative of an inability to determine fair value within reasonable limits. Some believe that only an exchange transaction between parties with essentially opposing interests provides an independent test of fair value to be used in measuring the transaction; therefore fair value is determinable within reasonable limits only in a negotiated exchange transaction. Others believe that fair value in a nonreciprocal transfer is also often determinable within reasonable limits and should be recognized in certain types of transactions.

OPINION

Basic Principle

18. The Board concludes that in general accounting for nonmonetary transactions should be based on the fair values[5] of the assets (or services) involved which is the same basis as that used in monetary transactions. Thus, the cost of a nonmonetary asset acquired in exchange for another nonmonetary asset is the fair value of the asset surrendered to obtain it, and a gain or loss should be recognized on the exchange. The fair value of the asset received should be used to measure the cost if it is more clearly evident than the fair value of the asset surrendered. Similarly, a nonmonetary asset received in a nonreciprocal transfer should be recorded at the fair value of the asset received. A transfer of a nonmonetary asset to a stockholder or to another entity in a nonreciprocal transfer should be recorded at the fair value of the asset transferred, and a gain or loss should be recognized on the disposition of the asset. The fair value of an entity's own stock reacquired may be a more clearly evident measure of the fair value of the asset distributed in a nonreciprocal transfer if the transaction involves distribution of a nonmonetary asset to eliminate a disproportionate part of owners' interests (that is, to acquire stock for the treasury or for retirement).

[5] See paragraph 25 for determination of fair value.

19. The Board believes that certain modifications of the basic principle are required to accommodate problems of measurement and questions about the conditions for recognizing revenue. These modifications are specified in paragraphs 20-23.

Modifications of the Basic Principle

20. Fair Value Not Determinable. Accounting for a nonmonetary transaction should not be based on the fair values of the assets transferred unless those fair values are determinable within reasonable limits (paragraph 25).

21. Exchanges. If the exchange is not essentially the culmination of an earning process, accounting for an exchange of a nonmonetary asset between an enterprise and another entity should be based on the recorded amount (after reduction, if appropriate, for an indicated impairment of value) of the nonmonetary asset relinquished. The Board believes that the following two types of nonmonetary exchange transactions do not culminate an earning process:

a. An exchange of a product or property held for sale in the ordinary course of business for a product or property to be sold in the same line of business to facilitate sales to customers other than the parties to the exchange, and

b. An exchange of a productive asset not held for sale in the ordinary course of business for a similar productive asset or an equivalent interest in the same or similar productive asset (similar productive asset is defined in paragraph 3 and examples are given in paragraph 7).[6]

[6] The fact that an exchange of productive assets is not a taxable transaction for tax purposes may be evidence that the assets exchanged are similar for purposes of applying this Opinion.

22. The exchanges of nonmonetary assets that would otherwise be based on recorded amounts (paragraph 21) may include an amount of monetary consideration. The Board believes that the recipient of the monetary consideration has realized gain on the exchange to the extent that the amount of the monetary receipt exceeds a proportionate share of the recorded amount of

the asset surrendered. The portion of the cost applicable to the realized amount should be based on the ratio of the monetary consideration to the total consideration received (monetary consideration plus the estimated fair value of the nonmonetary asset received) or, if more clearly evident, the fair value of the nonmonetary asset transferred. The Board further believes that the entity paying the monetary consideration should not recognize any gain on a transaction covered in paragraph 21 but should record the asset received at the amount of the monetary consideration paid plus the recorded amount of the nonmonetary asset surrendered. If a loss is indicated by the terms of a transaction described in this paragraph or in paragraph 21, the entire indicated loss on the exchange should be recognized.

23. Nonreciprocal Transfers to Owners. Accounting for the distribution of nonmonetary assets to owners of an enterprise in a spin-off or other form of reorganization or liquidation or in a plan that is in substance the rescission of a prior business combination should be based on the recorded amount (after reduction, if appropriate, for an indicated impairment of value) of the nonmonetary assets distributed. A prorata distribution to owners of an enterprise of shares of a subsidiary or other investee company that has been or is being consolidated or that has been or is being accounted for under the equity method is to be considered to be equivalent to a spin-off. Other nonreciprocal transfers of nonmonetary assets to owners should be accounted for at fair value if the fair value of the nonmonetary asset distributed is objectively measurable and would be clearly realizable to the distributing entity in an outright sale at or near the time of the distribution.

Applying the Basic Principle

24. The Board's conclusions modify to some extent existing practices as described in paragraphs 5-7. The conclusions are based on supporting reasons given in paragraphs 8-17.

25. Fair value of a nonmonetary asset transferred to or from an enterprise in a nonmonetary transaction should be determined by referring to estimated realizable values in cash transactions of the same or similar assets, quoted market prices, independent appraisals, estimated fair values of assets or services received in exchange, and other available evidence. If one of the parties in a nonmonetary transaction could have elected to receive cash instead of the nonmonetary asset, the amount of cash that could have been received may be evidence of the fair value of the nonmonetary assets exchanged.

26. Fair value should be regarded as not determinable within reasonable limits if major uncertainties exist about the realizability of the value that would be assigned to an asset received in a nonmonetary transaction accounted for at fair value. An exchange involving parties with essentially opposing interests is not considered a prerequisite to determining a fair value of a nonmonetary asset transferred; nor does an exchange insure that a fair value for accounting purposes can be ascertained within reasonable limits. If neither the fair value of a nonmonetary asset transferred nor the fair value of a nonmonetary asset received in exchange is determinable within reasonable limits, the recorded amount of the nonmonetary asset transferred from the enterprise may be the only available measure of the transaction.

27. A difference between the amount of gain or loss recognized for tax purposes and that recognized for accounting purposes may constitute a temporary difference to be accounted for according to *FASB Statement No. 109, Accounting for Income Taxes*.

Disclosure

28. An enterprise that engages in one or more nonmonetary transactions during a period should disclose in financial statements for the period the nature of the transactions, the basis of accounting for the assets transferred, and gains or losses recognized on transfers.[7]

[7] *Paragraph 12 of ARB No 51, Consolidated Financial Statements*, includes additional disclosures that are preferred if a parent company disposes of a subsidiary during the year.

21. ARB 43, Chapter 7, Section B provides the following guidance (only the pertinent excerpts are included below):

As to the Recipient

5. One of the basic problems of accounting is that of income determination. Complete discussion of this problem is obviously beyond the scope of this chapter. Basically, income is a realized gain and in accounting is recognized, recorded, and stated in accordance with certain principles as to time and amount.

6. If there is an increase in the market value of his holdings, such unrealized appreciation is not income. In the case of a stock dividend or split-up, there is no distribution, division, or severance of corporate assets. Moreover, there is nothing resulting therefrom that the shareholder can realize without parting with some of his proportionate interest in the corporation.

7. The foregoing are important points to be considered in any discussion of the accounting procedures to be followed by the recipient of a stock dividend or split-up since many arguments put forward by those who favor recognizing stock dividends as income are in substance arguments for the recognition of corporate income as income to the shareholder as it accrues to the corporation, and prior to its distribution to the shareholder; the acceptance of such arguments would require the abandonment of the separate entity concept of corporation accounting.

8. The question as to whether or not stock dividends are income has been extensively debated; the arguments pro and con are well known.[1] The situation cannot be better summarized, however, than in the words approved by Mr. Justice Pitney in Eisner v. Macomber, 252 U.S. 189, wherein it was held that stock dividends are not income under the Sixteenth Amendment, as follows:

> "A stock dividend really takes nothing from the property of the corporation and adds nothing to the interests of the stockholders. Its property is not diminished and their interests are not increased ... the proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest, the new shares and the original shares together representing the same proportional interests that the original shares represented before the issue of the new ones."

[1] See, for instance, Freeman, "Stock Dividends and the New York Stock Exchange," American Economic Review, December, 1931 (pro), and Whitaker, "Stock Dividends, Investment Trusts, and the Exchange," American Economic Review, June, 1931 (con).

9. Since a shareholder's interest in the corporation remains unchanged by a stock dividend or split-up except as to the number of share units constituting such interest, the cost of the shares previously held should be allocated equitably to the total shares held after receipt of the stock dividend or split-up. When any shares are later disposed of, a gain or loss should be determined on the basis of the adjusted cost per share.

22. FIN 30 provides the following guidance (only the pertinent excerpts are included below):

> 1. The FASB has been asked whether gain or loss results from an involuntary conversion of a nonmonetary asset to monetary assets if the monetary assets are subsequently reinvested in a similar nonmonetary asset.[1] Generally, if a nonmonetary asset is involuntarily converted, gain or loss for the difference between the cost[2] of the nonmonetary asset and the amount of monetary assets received has been recognized in income in the period of the involuntary conversion. In other cases, that difference has been accounted for as an adjustment to the cost basis of a nonmonetary asset that is subsequently acquired as replacement property.
>
> [1] The terms "nonmonetary" and "monetary" as used in this Interpretation have the same meaning as those terms have in *APB Opinion No. 29, Accounting for Nonmonetary Transactions*.
>
> [2] As used in this Interpretation, the term cost refers to the cost of a nonmonetary asset or to its carrying amount, if different.
>
> INTERPRETATION
>
> 2. Involuntary conversions of nonmonetary assets to monetary assets are monetary transactions for which gain or loss shall be recognized even though an enterprise reinvests or is obligated to reinvest the monetary assets in replacement nonmonetary assets. As discussed in paragraph 11 of this Interpretation, however, the requirement to recognize gain does not apply to certain involuntary conversions of LIFO inventories.[3]
>
> [3] Paragraph 14.b. of *APB Opinion No. 28, Interim Financial Reporting*, provides an exception for the liquidation of a LIFO inventory at an interim date if replacement is expected by year-end. Accordingly, that exception applies to an involuntary conversion of a LIFO inventory if replacement is expected by year-end.
>
> 3. In some cases, a nonmonetary asset may be destroyed or damaged in one accounting period, and the amount of monetary assets to be received is not determinable until a subsequent accounting period. In those cases, gain or loss shall be recognized in accordance with *FASB Statement No. 5, Accounting for Contingencies.*
>
> 4. Gain or loss resulting from an involuntary conversion of a nonmonetary asset to monetary assets shall be classified in accordance with the provisions of *APB Opinion No. 30, Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*.
>
> 5. Gain or loss resulting from an involuntary conversion of a nonmonetary asset to monetary assets that is not recognized for income tax reporting purposes in the same period in which the gain or loss is recognized for financial reporting purposes is a temporary difference for which comprehensive recognition of deferred taxes, as described in *FASB Statement No. 109, Accounting for Income Taxes*, is required.

23. EITF 86-29 provides the following guidance (only the pertinent excerpts are included below):

> ISSUE
>
> The basic principle contained in Opinion 29 is that the exchange of nonmonetary assets should be recorded at fair value. Certain modifications to that basic principle are contained in paragraphs 21 and 22 of Opinion 29. (The Task Force previously discussed certain aspects of those modifications in Issues No. 84-29, "Gain and Loss Recognition on Exchanges of Productive Assets and the Effect of Boot," and No. 85-43, "Sale of Subsidiary for Equity Interest in Buyer.")

The issues are (1) how the accounting for certain nonmonetary transactions should be affected by the magnitude of boot and (2) how the exceptions to the use of fair value should be applied.

EITF DISCUSSION

The Task Force reached a consensus that the decision as to whether an exchange involving products or properties held for sale (paragraph 21.a. of Opinion 29) should be measured using the recorded amounts or fair value depends on whether the products or properties received will be sold in the same line of business as the products or properties given up.

Further, the Task Force reached a consensus that the decision as to whether an exchange of similar productive assets (paragraph 21.b.) should be measured using the recorded amounts or fair value should be based on a "same line of business" test.

Some Task Force members expressed the view that the exchange of a controlled business (as defined in ARB 51) for an investment in an entity that is not controlled, but is in the same line of business, would not necessarily meet the definition of a similar productive asset and would have to be evaluated based on individual facts and circumstances. No consensus was reached on this issue.

The Task Force reached a consensus that a product or property held for sale and exchanged for a productive asset did not fall within the modifications to the basic principle of Opinion 29 (even if they were in the same line of business) and should be recorded at fair value.

The Task Force discussed an exchange of nonmonetary assets that would otherwise be based on recorded amounts but that also involves boot, reached a consensus that the transaction should be considered monetary (rather than nonmonetary) if the boot is significant, and agreed that "significant" should be defined as at least 25 percent of the fair value of the exchange. As a monetary transaction, both parties would record the exchange at fair value. If the boot in a transaction is less than 25 percent, the pro rata gain recognition guidance in paragraph 22 of Opinion 29 should be applied by the receiver of boot, and the payer of boot would not recognize a gain. The Task Force acknowledged that the ability to satisfactorily measure fair value is a prerequisite to the use of fair value.

The Task Force also discussed various exchanges involving investments accounted for by consolidation and by the equity method. The Task Force reached a consensus that an enterprise should account for an exchange of securities in which it acquires control of a subsidiary as a business combination in accordance with Opinion 16. An enterprise should account for an exchange of securities accounted for by consolidation or by the equity method for an investment in which it does not acquire control of a business but for which it will account by the equity method, as a nonmonetary transaction in accordance with Opinion 29. The Task Force noted that the provisions of this consensus were not intended to apply to exchanges involving joint ventures or the acquisition of a minority interest.

Additionally, several Task Force members and the SEC Observer expressed concern that a literal application of the consensus to an exchange in which an enterprise acquires control of a business could result in the recognition of gain on transactions that are in substance an exchange of similar productive assets or result in a 100 percent write-up of an asset in circumstances in which an entity has not transferred control of the asset. For example, Company A transfers an asset to Company B in exchange for shares of Company B. As a result of the exchange, Company A acquires control of Company B; Company A also indirectly retains control of the asset received by Company B. The Task Force agreed that Company A should account for this transaction as a partial sale (to minority shareholders of Company B), and gain recognition should be limited to that portion of the asset treated as sold. If Company B accounts for the exchange at fair value, profit applicable to the portion of the asset indirectly controlled by Company A would be eliminated in Company A's consolidation of Company B.

Further, the Task Force observed that the consensus is not intended to change the application of Opinion 16 or to eliminate the need to exercise judgment in those circumstances in which the substance of a transaction indicates that fair value accounting is not appropriate. That is, if Opinion 16 is to apply, the substance of the transaction must be a business combination.

STATUS

Issues relating to the exchange of real estate involving boot were discussed in Issue No. 87-29, “Exchange of Real Estate Involving Boot.” For that Issue, the Task Force reached a consensus that a transaction involving an exchange of similar real estate that is considered a monetary transaction under Issue 86-29 because boot is at least 25 percent of the fair value of the exchange would be allocated between two components: a monetary portion and a nonmonetary portion. (An exchange of similar real estate is defined in Issue 87-29 as an exchange of either (a) real estate held for sale in the ordinary course of business for real estate to be sold in the same line of business or (b) real estate not held for sale in the ordinary course of business for similar real estate.) The allocation between the monetary and nonmonetary portions of the transaction should be based on their relative fair values at the time of the transaction. For the receiver of boot, the monetary portion would be accounted for under Statement 66 as the equivalent of a sale of an interest in the underlying real estate, and the nonmonetary portion would be accounted for under paragraph 21 of Opinion 29. For the payer of boot, the monetary portion would be accounted for as an acquisition of real estate, and the nonmonetary portion would be accounted for under paragraph 21 of Opinion 29. Exhibit 87-29A presents an example of the application of the consensus reached on Issue 87-29.

No further EITF discussion is planned.

24. EITF 93-11 provides the following guidance (only the pertinent excerpts are included below):

ISSUE

In a barter transaction involving barter credits, an enterprise enters into a transaction to exchange a nonmonetary asset (for example, inventory) for barter credits. Those transactions may occur directly between principals to the transaction or include a third party whose business is to facilitate those types of exchanges (for example, a barter company).

The barter credits can be used to purchase goods or services, such as advertising time, from either the barter company or members of its barter exchange network. The goods and services to be purchased may be specified in a barter contract or limited to items made available by members of the exchange network. Some arrangements may require the payment of cash in addition to the barter credits to purchase goods or services. Barter credits also may have a contractual expiration date, at which time they become worthless.

The issue is whether Opinion 29 should be applied to an exchange of a nonmonetary asset for barter credits and, if so, the amount of profit or loss, if any, that should be recognized.

EITF DISCUSSION

The Task Force reached a consensus that transactions in which nonmonetary assets are exchanged for barter credits should be accounted for under Opinion 29. An impairment of the nonmonetary asset exchanged should be recognized prior to recording the exchange if the fair value of that asset is less than its carrying amount. The impairment should be measured as the amount by which the carrying amount of the asset exceeds its fair value. Recognition of an impairment loss also would be required in an exchange of assets or contractual rights not reported in the balance sheet (for example, operating leases) if the transferor is not relieved of primary liability for the related obligation. The definition of fair value in paragraph 13 of Statement 15 may be useful in determining the fair value of the nonmonetary asset. The Task Force noted that fair value should not be based on an estimate of the value of the barter credits to be received. After an impairment is recognized, the reduced carrying amount of the nonmonetary asset becomes its new cost. [Note: See STATUS section.]

If an exchange involves the transfer or assumption of an operating lease, impairment of that lease should be measured as the amount of the remaining lease costs (discounted rental payments and unamortized leasehold improvements) in excess of the discounted amount of probable sublease rentals for the remaining lease term. [Note: See STATUS section.]

The Task Force also reached a consensus that in reporting the exchange of a nonmonetary asset for barter credits, it should be presumed that the fair value of the nonmonetary asset exchanged is more clearly evident than the fair value of the barter credits received and that the barter credits should be reported at the fair value of the nonmonetary asset exchanged. The Task Force noted, however, that that presumption might be overcome if an entity can convert the barter credits into cash in the near term, as evidenced by a historical practice of converting barter credits into cash shortly after receipt, or if independent quoted market prices exist for items to be received upon exchange of the barter credits. It also should be presumed that the fair value of the nonmonetary asset does not exceed its carrying amount unless there is persuasive evidence supporting a higher value. An impairment loss on the barter credits should be recognized if it subsequently becomes apparent that (1) the fair value of any remaining barter credits is less than the carrying amount or (2) it is probable that the enterprise will not use all of the remaining barter credits.

STATUS

In March 1995, the FASB issued Statement 121 which requires that long-lived assets and certain identifiable intangibles to be held and used be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Statement 121 establishes accounting standards for the recognition and measurement of impairment losses and sets forth an approach to determining an asset's fair value. Statement 121 also requires that long-lived assets and certain identifiable intangibles to be disposed of be reported at the lower of carrying amount or fair value less cost to sell.

No further EITF discussion is planned.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Introduction, *Accounting for Assets Transferred Between Affiliates*
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Introduction, *Accounting for Assets Transferred Between Affiliates*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 20—Gain Contingencies*
- *Issue Paper No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties*
- *Issue Paper No. 30—Investments in Common Stock (excluding investments in common stock of subsidiary, controlled, or affiliated companies)*
- *Issue Paper No. 68—Business Combinations and Goodwill*
- *Issue Paper No. 72—Statutory Surplus*
- *Issue Paper No. 78—Employee Stock Ownership Plans*
- *Issue Paper No. 82—Stock Option and Stock Purchase Plans*
- *Issue Paper No. 83—Accounting for Income Taxes*

Generally Accepted Accounting Principles

- *Accounting Principles Board Opinion No. 6, Status of Accounting Research Bulletins, paragraph 16*
- *Accounting Principles Board Opinion No. 29, Accounting for Nonmonetary Transactions*
- *Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins, Chapter 7, Section B, Stock Dividends and Stock Split-ups*
- *FASB Interpretation No. 30, Accounting for Involuntary Conversions of Nonmonetary Assets to Monetary Assets*
- *FASB Emerging Issues Task Force Issue No. 86-29, Nonmonetary Transactions: Magnitude of Boot and the Exceptions to the Use of Fair Value*
- *FASB Emerging Issues Task Force Issue No. 93-11, Accounting for Barter Transactions Involving Barter Credits*
- *Emerging Issues Task Force No. 96-4, Accounting for Reorganizations Involving a Non-Pro Rata Split-off of Certain Nonmonetary Assets to Owners*

State Regulations

- No additional guidance obtained from state statutes or regulations.

Statutory Issue Paper No. 74

Life, Deposit-Type and Accident and Health Reinsurance

STATUS
Finalized March 16, 1998

Original SSAP: SSAP No. 61; Current Authoritative Guidance: SSAP No. 61R
This issue paper may not be directly related to the current authoritative statement.

Type of Issue:
Life Specific

SUMMARY OF ISSUE

1. Reinsurance is an agreement by which a reporting entity transfers all or part of its risk under a contract to another reporting entity. Current statutory guidance on the accounting for life and accident and health reinsurance is contained in Chapters 17, 21 and 24 of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies (Life/A&H Accounting Practices and Procedures Manual).

2. GAAP guidance on the accounting for life and accident and health reinsurance is primarily contained in *FASB Statement No. 113*, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts* (FAS 113). In several instances*,* FAS 113 differs from the current statutory guidance.

3. The purpose of this issue paper is to establish statutory accounting principles for reinsurance of life, deposit-type and accident and health contracts that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. This issue paper applies to life and accident and health contracts and deposit-type contracts as defined in *Issue Paper No. 50—Classifications and Definitions of Insurance or Managed Care Contracts In Force* (Issue Paper No. 50). The provisions of Chapter 24 of the Life/A&H Accounting Practices and Procedures Manual (Chapter 24) and the accounting related items in the proposed Actuarial Guideline JJJ - *Guideline Concerning Questions and Answers Related to the Life and Health Reinsurance Agreements Model Regulation* (the proposed Actuarial Guideline JJJ), which provided further clarification of reinsurance accounting as provided in Chapter 24, are adopted as the statutory accounting principles for life and accident and health reinsurance except that all deposit-type contracts reinsured are to be accounted for under the Deposit Accounting section of Chapter 24. Goodwill resulting from the deferral of losses by the assuming entity at the inception of assumption reinsurance agreements shall be included in the total goodwill of a reporting entity when calculating the amount of goodwill that is a nonadmitted asset pursuant to *Issue Paper No. 68—Business Combinations and Goodwill*.

5. With respect to other accounting matters, the provisions of Chapter 17 (included in paragraph 14 of this issue paper) of the Life/A&H Accounting Practices and Procedures Manual that relate to reinsurance in unauthorized companies and funds held under reinsurance treaties with unauthorized reinsurers are adopted as statutory accounting principles. The provisions of Chapter 21 (included in paragraph 15 of this issue paper) of the Life/A&H Accounting Practices and Procedures Manual that relate to commissions and expense allowances on ceded and assumed reinsurance are adopted as statutory accounting principles. In addition, the Annual Statement Instructions require reinsurance disclosures in

notes 10 through 15 to the Annual Statement. These disclosures (included in paragraph 18 of this issue paper) are also adopted as statutory accounting principles.

6. If it is probable that reinsurance recoverables on paid or unpaid claim or benefit payments will be uncollectible, consistent with *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets,* amounts shall be written off through a charge to the Statement of Operations by reversing the accounts previously utilized to establish the reinsurance recoverable.

DISCUSSION

7. The statutory accounting for life and accident and health reinsurance was recently revised through amendments to Chapter 24 and further clarified by the proposed Actuarial Guideline JJJ. The GAAP guidance for life and accident and health reinsurance is contained principally within FAS No. 113 which is adopted with modification for property and casualty reinsurance in *Issue Paper No. 75—Property and Casualty Reinsurance* and by this issue paper for life, deposit-type and accident and health reinsurance. This issue paper applies to all accident and health reinsurance written by life and health and property and casualty insurers. The statutory accounting principles established by this issue paper differ substantially from GAAP, reflecting much more detailed guidance as follows:

a. Reserve credits taken by ceding entities as a result of reinsurance contracts are netted against the ceding entity's policy and claim reserves and unpaid claims. Under GAAP, reinsurance recoverables are reported as assets.

b. For statutory reporting, first year and renewal ceding commissions on indemnity reinsurance of new business (ceding commissions on ceded in-force business are included in the calculation of initial gain or loss, see paragraph 7.d.) are recognized as income. Under GAAP, ceding commissions are reported first as a reduction of deferred acquisition costs (DAC) and then if DAC is completely eliminated any excess is established as unearned revenue.

c. As discussed in Issue Paper No. 50, statutory accounting defines deposit-type contracts as those contracts which do not include any mortality or morbidity risk. GAAP defines investment contracts as those that do not subject the reporting entity to significant policyholder mortality or morbidity risk. (The distinction is any mortality or morbidity risk for statutory purposes vs. significant mortality or morbidity risk for GAAP purposes.) Therefore, a contract may be considered an investment contract for GAAP purposes, and that same contract may be considered other than deposit-type for statutory purposes. A reinsurance treaty covering contracts that have insignificant mortality or morbidity risk (i.e., contracts classified as other than deposit-type contracts for statutory purposes, but investment contracts for GAAP purposes) that does not transfer that mortality or morbidity risk, but does transfer all of the significant risk inherent in the business being reinsured (e.g., lapse, credit quality, reinvestment or disintermediation risk) qualifies for reinsurance accounting for statutory reporting purposes, but would not qualify for reinsurance accounting treatment for GAAP purposes.

d. For statutory reporting, initial gains or losses on indemnity reinsurance of in-force blocks of business have unique accounting treatment. A portion of the initial gains or losses (equal to the tax effect of the initial gain or loss in surplus) is reported as commissions and expense allowances on reinsurance ceded in the statement of operations. The remainder of the initial gains or losses is reported on a net-of-tax basis as a write-in for gain or loss in surplus in the Capital and Surplus Account. In subsequent years, the ceding entity recognizes income on the reinsurance ceded line for the net-of-tax profits that emerged on the reinsured block of business with a corresponding decrease in the write-in for gain or loss in surplus. Under GAAP, the cost of reinsurance is amortized to income over the life of the reinsured contracts or the reinsurance contract period, depending on whether the reinsurance contract is long or short-duration. The difference, if any, between amounts paid for a reinsurance contract and the amount of the liabilities for policy benefits relating to the underlying reinsured contracts is part of the estimated cost to be amortized.

e. Statutory accounting prohibits recognition of a gain or loss in connection with the sale, transfer or reinsurance of an in-force block of business between affiliated entities in a non-economic transaction. Any difference between the assets transferred by the ceding entity and the liabilities, including unamortized IMR, shall be deferred and amortized under the interest method. Under GAAP, such transactions are treated as capital contributions or dividends.

f. Statutory accounting requires that a liability be established through a provision reducing surplus for unsecured reinsurance recoverables from unauthorized reinsurers. Under GAAP, no such liability is required. However, both statutory accounting and GAAP require an assessment of the collectibility of recorded reinsurance recoverables.

g. Statutory accounting as defined in Chapter 24 prescribes offsetting certain reinsurance premiums. However, FAS 113 states that for GAAP, offsets can occur only when a right of setoff exists.

8. Amounts due from reinsurers on paid claims and benefits are reported as assets under both statutory accounting and GAAP. Reserve credits deducted by ceding entities from their direct and assumed policy and claim reserves and unpaid claims represent amounts that will be recovered from reinsurers. These reinsurance recoverables meet the statutory definition of an asset established in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets;* however, this asset will continue to be presented as a contra liability in statutory financial statements because a change to “gross” presentation would necessitate extensive changes in and restatement of the reporting of ceded reinsurance in schedules and exhibits of the NAIC Annual Statement.

9. This issue paper maintains current statutory accounting principles that require that losses to the assuming entity at the inception of assumption reinsurance agreements (i.e., liabilities exceed assets) be deferred as goodwill and amortized over the life of the policies, but for a period not to exceed 10 years. This issue paper clarifies that goodwill recorded by an assuming entity related to an assumption reinsurance agreement shall be considered with goodwill of an entity in determining the amount of goodwill to be nonadmitted. If assets exceed liabilities at the inception of the assumption reinsurance agreement, the assuming entity shall record a deferred liability and amortize the amount using the interest method over the expected life of the business, but for a period not to exceed 10 years.

10. *Issue Paper No. 52—Deposit-Type Contracts* (Issue Paper No. 52) establishes statutory accounting principles for income recognition and policy reserves for deposit-type contracts. Under Issue Paper No. 52, reinsurance of deposit-type contracts, which by definition do not have insurance risk, will be accounted for under the provisions of the Deposit Accounting section of Chapter 24. This is consistent with the GAAP treatment of investment contracts under FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments, but is inconsistent with reinsurance accounting treatment in Chapter 24 which would allow for reinsurance accounting treatment if the risks other than mortality and morbidity were transferred.

11. The impact of gains or losses from reinsurance of in-force blocks of business can be effectively monitored because such gains and losses are shown as a single line item in the surplus section.

12. The statutory accounting for non-economic assumption reinsurance transactions between affiliated entities is consistent with *Issue Paper No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties*.

13. The statutory requirement to establish a liability, Reinsurance in Unauthorized Companies, for unsecured reinsurance recoverables from unauthorized reinsurers is contained in various state statutes, the Life/A&H Accounting Practices and Procedures Manual (Chapter 17) and the Instructions to the Life, Accident and Health Annual Statement, Schedule S - Part 3. This requirement maintains current statutory accounting, and is consistent with the recognition concept and conservatism concept in the Statement of Concepts, which also allows for certain mandated liabilities.

> Liabilities require recognition as they are incurred. Certain statutorily mandated liabilities may also be required to arrive at conservative estimates of liabilities and probable loss contingencies (e.g., excess of statutory over statement reserves, interest maintenance reserves, asset valuation reserves, and others).
>
> Financial reporting by insurance enterprises requires the use of substantial judgments and estimates by management. Such estimates may vary from the actual amounts for numerous reasons. To the extent that factors or events result in adverse variation from management's accounting estimates, the ability to meet policyholders obligations may be lessened. In order to provide a margin of protection for policyholders, the concept of conservatism should be followed when developing estimates as well as establishing accounting principles for statutory reporting.

Drafting Notes/Comments

- Deposit accounting for Property and Casualty Companies is currently being considered by the AICPA. Codification may have to be amended to acknowledge an additional SAP/GAAP difference should the AICPA adopt guidance for Life Insurance Companies that differs from Chapter 24.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

14. Chapter 17 of the Life/A&H Accounting Practices and Procedures Manual provides the following guidance on reinsurance in unauthorized companies:

> Reinsurance in Unauthorized Companies
>
> This liability is established to offset credit taken in various balance sheet accounts for reinsurance ceded to unauthorized reinsurers. Credit for reinsurance with unauthorized companies also may be permitted if the ceding company holds securities or cash of the assuming company equal to the reserve credit taken. Such deposits are to be held under the control of the ceding company. Additionally, any securities held under such an arrangement must be investments that the ceding company is allowed to make under the provision of the investment sections of the insurance statutes. Other permissible arrangements include irrevocable trusts or "clean" letters of credit. If the assuming company is not licensed or is not an authorized reinsurer in the domiciliary state of the ceding company or if the reinsurance does not meet required standards, the ceding company must set up a net liability equal to the following:
>
> 1. Reserve credits taken including any Interest Maintenance Reserve (IMR) liability adjustment, plus
>
> 2. Claim liability credits taken on paid and unpaid (in course of settlement) claims recoverable, plus
>
> 3. Other asset increases or liability reductions resulting from amounts recoverable from the assuming company including commissions, expense allowances, modified coinsurance

reserve adjustments, experience rating refunds, and estimated incurred but not reported claim liabilities, less

4. Deposits by or funds withheld from the reinsurer, as provided for in the reinsurance treaty, pledged as security for the payment of reinsurance obligations. Such deposits or funds are typically held by the ceding company or are placed in a trust or custodial agreement. Amounts placed in trust or custodial accounts are held subject to withdrawal by, and under the control of, the ceding insurer, less

5. Amounts of reinsurance recoverables covered by a clean, irrevocable letter of credit issued by a qualified banking institution, less

6. Amounts contractually due the assuming company.

The net liability defined above should never be less than zero for any particular reinsurer. Caution should be exercised in taking credit for items in 4, 5, and 6 above since state requirements vary considerably. The change in liability for unauthorized reinsurance is a direct charge or credit to surplus.

Funds Held Under Reinsurance Treaties with Unauthorized Reinsurers

This liability is for funds deposited by or contractually withheld from unauthorized reinsurers. Please note that the withholding of reinsurance premiums represents only one method of securing net reinsurance liabilities. Letters of credit from or funds escrowed in a financial institution represent two other commonly accepted methods.

15. Chapter 21 of the Life/A&H Accounting Practices and Procedures Manual provides the following guidance on expense allowances and reinsurance commissions:

Expense Allowances on Reinsurance

For reinsurance it is common for the assuming insurer to provide an expense allowance to cover expenses of the ceding insurer. The allowance is frequently nonspecific with respect to premium taxes and other general expenses of the ceding insurer and it is usually combined with and accounted for as part of the commissions on reinsurance assumed or ceded.

The portion of reinsurance expense allowances which represents specific reimbursement of premium taxes should be accounted for as premium tax. Any portion specifically reimbursing general expenses should be accounted for as other general expense. Each should be excluded from commissions and expense allowances on reinsurance assumed or ceded.

Reinsurance Commission Accounting Practices

Under current statutory accounting practices and procedures, commissions on direct business, commissions and expense allowances on reinsurance assumed, and commissions and expense allowances on reinsurance ceded are each accounted for separately in the Summary of Operations and on the balance sheet. Accordingly, commissions and expense allowances on reinsurance ceded are reported as income or revenue earned in the Summary of Operations and the balance sheet provision for due and accrued amounts is reported as an asset. This differs from the more customary statutory accounting practice of reporting insurance transactions net of reinsurance in the Summary of Operations and on the balance sheet with reliance upon supporting exhibits for the reinsurance information.

16. Chapter 24 of the Life/A&H Accounting Practices and Procedures Manual provides statutory accounting guidance for life and accident and health reinsurance. A portion of that guidance is excerpted below:

A. Indemnity Reinsurance

Transfer of Risk

Reinsurance agreements must transfer risk from the ceding company to the reinsurer in order to receive the reinsurance accounting treatment discussed in this chapter. If the terms of the agreement violate the risk transfer criteria contained herein, i.e., limits or diminishes the transfer of risk by the ceding company to the reinsurer, the agreement shall be accounted for as discussed in the Deposit Accounting section below. In addition, any contractual feature that delays timely reimbursement, violates the conditions of reinsurance accounting.

This paragraph applies to all life and accident and health reinsurance agreements except for yearly renewable term reinsurance agreements and non-proportional reinsurance agreements such as stop loss and catastrophe reinsurance. All reinsurance agreements covering insurance products or similar products of the type identified in A(6) of Appendix A shall follow the guidance for reinsurance accounting contained in this chapter provided the reinsurance agreement (1) transfers significant insurance risk and (2) does not contain any of the conditions set forth in Appendix A. All products not of the type identified in A(6) of Appendix A or covered in the following two paragraphs, shall follow the guidance for reinsurance accounting contained in this chapter provided that the agreement (1) transfers one or more of the risk categories described in A(6) and (2) does not contain any of the conditions set forth in Appendix A. Contracts that fail to meet the requirements for reinsurance accounting shall follow the guidance contained in the Deposit Accounting section.

Yearly renewable term reinsurance agreements that transfer a proportionate share of mortality or morbidity risk inherent in the business being reinsured and do not contain any of the conditions described in Appendix A(2), (3), (4), (8), (9), (10) or (11), shall follow the guidance for reinsurance accounting. Contracts that fail to meet the requirements for reinsurance accounting shall follow the guidance contained in the Deposit Accounting section.

For non-proportional reinsurance agreements such as stop loss and catastrophe reinsurance agreements, contract terms should be evaluated to assess whether they transfer significant risk to the reinsurer. For example, prepayment schedules and accumulating retentions from multiple years are contractual features inherently designed to delay the timing of reimbursement to the ceding company limits the risk to the reinsurer. Regardless of what a particular feature might be called, any feature that can delay timely reimbursement violates the conditions for reinsurance accounting. Transfer of insurance risk requires that the reinsurer's payment to the ceding company depend on and directly vary with the amount and timing of claims settled under the reinsured contracts. Contractual features that can delay timely reimbursement prevent this condition from being met. Reinsurance accounting shall apply to all non-proportional agreements that transfer significant risk and do not contain any provisions that protect the reinsurer from incurring a loss. Contracts that fail to meet the requirements for reinsurance accounting shall follow the guidance contained in the Deposit Accounting section.

Accounting and Reporting of Reinsurance

The obligation of reporting reinsurance in force and of determining unpaid premiums and incurred claims and other balances is generally on the ceding company because it knows the current status of the policies it has written directly and reinsured. A lag will develop between the time of the entry of the underlying policy transaction on the books of the ceding company and the transmittal of information and its entry on the books of the assuming company. The assuming company shall estimate any material unreported premiums and related costs, since it alone has the responsibility for determining its own financial condition and for preparing accurate financial statements.

The ceding company must report these items in its balance sheet:

1. Credits (deductions) to its policy and claim reserves and unpaid claims;
2. Premiums or other amounts payable on reinsured risks;
3. Amounts recoverable on claims, surrender values, dividends, experience rating refunds, taxes, commissions, and other expenses;
4. Modified coinsurance reserves; and
5. Amounts receivable or payable for funds withheld.

Similarly, in its balance sheet, the assuming company must report:

1. Reserves for reinsurance assumed reduced by any modified coinsurance reserves;
2. Reinsurance premiums receivable or other amounts receivable
3. Amounts payable for claims, surrender values, dividends, experience rating refunds, taxes, commissions, and other expenses; and
4. Amounts receivable or payable for funds withheld by the ceding company.

While the various balances that a company (ceding or assuming) has with its reinsurance partners will result in a net amount, the proper way to report them is in their separate classifications. The balances of one company shall not be netted against those of any other company. Each reinsurance agreement must be accounted for separately.

Reinsurance Premiums

For all reinsurance arrangements, the assuming company must report premiums under the terms of the reinsurance contract as income and establish any asset or liability consistent with the methods and assumptions used to establish its policy reserves and guidance contained in Chapter 18, Premium Income, of this manual. The ceding company shall reduce premium income by the amounts paid or payable to the reinsurers. The ceding company shall reduce its deferred and uncollected premiums reported as an asset and the assuming company shall record an asset for premiums payable to the reinsurer on those insurance policies with premiums collected on a basis more frequent than annual covered by the reinsurance arrangement. On those insurance policies covered by the reinsurance arrangement with premiums collected annually, the ceding company shall establish a liability and the assuming company shall record an asset for premiums payable to the reinsurer.

Reinsurance Benefit Payments

Policy benefit payments paid or payable by the reinsurer shall be reported in the Summary of Operations and reduces the ceding company's reported benefit payments. The reinsurer shall establish a liability for its share of any unpaid claim payments and the ceding company shall reduce any policy and contract claim liability with respect to the reinsured policies or establish a receivable for the amount due from the reinsurer for claims paid.

Expenses

The taxes, commissions, and other expenses that will be paid by the assuming company to the ceding company are agreed upon when the reinsurance agreement is negotiated. These items are calculated in accordance with the reinsurance agreement and usually relate to premiums or claims or both. At the statement date, the amount of unpaid expenses is generally based upon the amount of premiums and claims unpaid at that date.

Some coinsurance contracts provide that the assuming company pay to the ceding company a commission that exceeds the first-year premium. In the absence of any guarantees for payment of future premiums (for example, persistency guarantees), these commissions are accounted for on the cash basis. If, however, the ceding company guarantees that premiums will be paid in the future, which, in essence, returns the excess commission, it must record the excess commission as a liability. This liability is then to be released as future premiums are paid to the assuming company. The rate of release is determined in accordance with the anticipated experience and reasonable commission rate for first-year and renewal premiums. Excess commissions such as these are nothing more than a means of financing for the ceding company.

If renewal expense allowances in any accounting period are not sufficient to cover anticipated allocable renewal expenses of the ceding insurer on the portion of the business reinsured, a liability is to be established by the ceding company for the present value of the shortfall. In establishing this liability, assumptions are to be used equal to the applicable statutory reserve basis on the business reinsured. Anticipated allocable expenses includes commissions, premium taxes and direct expenses including, but not limited to, billing, valuation, claims and maintenance expected by the company at the time the business is reinsured.

Experience Refunds

Some reinsurance contracts, generally proportional reinsurance, provide that the reinsurer will refund an agreed upon portion of its profit to the ceding company. The reinsurance contract will provide the calculation and the factors to be included.

If the contract provides for experience refunds, the ceding company must record, as an asset, the amount of the refund receivable as of the statement date, but reduced by any amount that is contingent upon future experience. The assuming company is also required to record, as a liability, the amount of the refund calculated at the statement date, but without regard to any effects that future experience might have.

Credits for Ceded Reinsurance

The credit taken by the ceding company under the coinsurance arrangement is calculated using the same methodology and assumptions used in determining its policy and claim reserves. It is, of course, only for the percentage of the risk that was reinsured. Under modified coinsurance, the reserve credit is reduced by the modco deposit retained by the ceding company. If the company reinsures on a yearly renewable term basis, it is itself buying insurance for the portion of the ceded amount at risk. The amount of yearly renewable term reinsurance that is required on a given policy generally decreases each year as the company's reserve increases. The net amount at risk may increase, however, on interest sensitive products such as universal life. The amount at risk on accident and health yearly renewal term reinsurance will remain level and the reinsurance premium increases each year.

The reserve credit taken by the ceding company is reported as a reduction to the reserves and not as an asset of the company. The ceding company's reserve credit and assuming company's reserve for yearly renewable term reinsurance shall be computed as the one year term mean reserve on the amount of insurance ceded. The ceding company must use the same mortality and interest bases which were used for valuing the original policy before reinsurance. The credit may also be computed on a pro rata basis if the result is not materially different from the credit computed on the mean reserve basis. For all types of reinsurance, the ceding company also takes credit for other amounts due from the reinsurer such as unpaid claims and claims incurred but not reported. If contemplated by the reinsurance contract, recognition of related assets and liabilities must occur (policy loans, due and deferred premiums, etc.).

Non-proportional reinsurance is generally purchased in order to safeguard the company's aggregate loss potential. This form of reinsurance is entered into on an annual basis to limit the claims experience of the company and thereby protect its financial integrity. When the period of the arrangement exceeds one year, the contract must be carefully reviewed to determine if the end result more closely follows proportional reinsurance. No reserve credit is taken for non-proportional reinsurance unless the aggregate attachment point has in fact been penetrated. In order for a company to reflect reserve credits on a prospective basis, the company will need to demonstrate that the present value of expected recoveries using realistic assumptions and not statutory assumptions required for the underlying policy reserves, to be realized from the reinsurer is in excess of the present value of the reinsurance premiums guaranteed to be paid by the ceding insurer under the terms of the contract. Because non-proportional reinsurance aggregates experience, and does not indemnify the ceding insurer for each policy loss, the use of statutory assumptions underlying the insured policies is inappropriate for determining any reserve credit to be taken by the ceding insurer. Historical experience, pricing assumptions and asset shares should be considered in determining if the reinsurer may be reasonably expected to pay any claims. The reserve credit taken may only reflect these reasonable expectations. This treatment of non-proportional reinsurance is similar to the way property and casualty (P&C) reinsurance is considered. This is because these modes of reinsurance more closely follow P&C indemnification principles than life insurance formula basis, and because these coverages are very similar to excess insurance on P&C products. In determining the appropriate reserve credit, the probability of a loss penetrating to the reinsurer's level of coverage (using reasonable assumptions) must be multiplied by the expected amount of recovery. This is the same as reserve credits on coinsurance where the probability of a claim (i.e., mortality) is multiplied by the expected return (i.e., death benefit). In that the coverage is for aggregate experience, the mortality assumptions underlying any one policy risk is inappropriate to analyze the appropriate credits for non-proportional coverage.

Accounting for Interest Maintenance Reserve (IMR)

The interest-related gain or loss (net of taxes) associated with the sale, transfer or reinsurance of a block of liabilities must be credited or charged to the IMR in accordance with the IMR instructions contained in the NAIC Annual Statement Instructions Manual.

Reserves for Reinsurance Assumed

In assuming any insurance risks, the assuming company is required to establish policy reserves that are consistent with its obligations. The reserves it must establish, therefore, are also dependent upon the arrangement of reinsurance that is used. For risks transferred under the reinsurance arrangement, policy and claim reserves must be at least equal to the required reserves calculated using the same methodology and assumptions that would be used if the reinsurer had written the risk directly.

Accounting for Modified Coinsurance Arrangements

When the intent of the parties and the terms of the reinsurance contract are to enter into a modified coinsurance arrangement, the following accounting applies.

Ceding Company

In a modified coinsurance arrangement, the ceding company retains the assets equal to the modified coinsurance reserve. This reserve represents a prepayment of the reinsurer's future obligation. Premiums paid or payable to the reinsurer net of any experience refunds shall result in the reduction of premium income. Policy benefit payments paid by the reinsurer shall reduce the ceding company's reported policy benefits. Expense allowances paid by the reinsurer shall be reported separately in the Summary of Operations as earned. The modified coinsurance reserve is included in the category of policy reserves. The modified coinsurance reserve adjustment from period-to-period shall be reported separately in the Summary of Operations.

Assuming Company (Reinsurer)

Premiums received or receivable by the reinsurer shall increase premium income net of any experience refunds and policy benefit payments paid by the reinsurer shall increase the reported policy benefits. Expense allowances paid by the reinsurer shall be reported separately in the Summary of Operations when payable. The statutory policy reserves excludes the modified coinsurance reserve. The modified coinsurance reserve adjustment from period-to-period shall be reported separately in the Summary of Operations. The reinsurer's accounting of its obligations shall be consistent with the ceding company's accounting for the transfer of the obligations.

Accounting for Coinsurance With Funds Withheld Arrangements

When the intent of the parties and the terms of the reinsurance contract are to enter into a coinsurance arrangement with funds withheld, the following accounting applies.

Ceding Company

Premiums paid or payable to the reinsurer net of any experience refunds shall reduce premium income. Policy benefit payments paid by the reinsurer shall reduce the ceding company's reported policy benefits. Expense allowances paid by the reinsurer shall be reported separately in the Summary of Operations as earned. A net reduction to policy reserves shall be taken for the portion of the obligation assumed by the reinsurer. Any amounts withheld by the ceding company shall be recorded as a separate liability. Any interest due or payable on the amounts withheld shall be recorded as interest on indebtedness.

Assuming Company (Reinsurer)

Premiums received or receivable by the reinsurer net of any experience refunds shall increase premium income and policy benefit payments paid by the reinsurer shall increase the reported policy benefits. Expense allowances paid by the reinsurer shall be reported separately in the Summary of Operations when payable. The reinsurer shall record its share of the statutory policy reserves attributable to the business identified in the contract. Any funds withheld by the ceding company shall be recorded as an accounts receivable. Any interest earned or receivable on the funds withheld shall be recorded as miscellaneous income.

Uncollectible Reinsurance

The ceding and assuming companies must determine if reinsurance receivables are collectible. To the extent that the amounts are determined to be uncollectible, these amounts shall be charged to operations. Companies must write off uncollectible reinsurance receivables through the accounts previously utilized to establish the receivables.

Unauthorized Reinsurance

If the reinsurer is not authorized to do business, or is not otherwise approved, the reinsurance is considered to be unauthorized. The Model Law on Credit for Reinsurance specifying the conditions under which reinsurance credit may be taken, shall be followed. (For further discussion of the liability for unauthorized reinsurance see Chapter 17).

Gains and Losses on Indemnity Reinsurance

Under an indemnity reinsurance arrangement the ceding company continues to be liable to the policyholders and the reinsurer has no obligations to them except in the case of cut-through agreements. Typically the ceding company will continue to perform all functions in connection with claims and other policyholder services. Gains and losses on indemnity reinsurance are defined as the net experience under the reinsurance contract within a calendar year. Net experience (underwriting gains or loss) includes ceded premiums, claims, expense allowances, reserve adjustments, any IMR liability adjustment and experience refunds and dividends.

Losses that occur in any year of an indemnity reinsurance contract are immediately recognized. For reinsurance of in-force blocks of business, gains that occur in the initial calendar year are accounted for in accordance with Section 4, subsection C of Appendix B.

For indemnity reinsurance agreements entered into for other than in-force blocks of business, the gains and losses are immediately recognized by the ceding and assuming company.

Recaptures and Commutations

A recapture or a commutation of a reinsurance agreement is a transaction which results in the complete and final settlement and discharge of all present and future obligations between the parties arising out of the agreement or a portion of the agreement. Reasons for commuting reinsurance agreements often include: perceived financial instability of the reinsurer, inefficiencies associated with the runoff of longer tailed liabilities, or significantly different evaluation of ultimate loss costs. The assumed reserves and reserve credits taken are eliminated by the reinsurer and ceding insurer, respectively. The reinsurer and ceding insurer must also make any required IMR liability adjustment changes. Any net gain or loss is reported in the Summary of Operations.

Deposit Accounting

To the extent that a reinsurance contract does not, despite its form, provide for sufficient transfer of risk, amounts paid are to be accounted for and reported as deposits in the NAIC annual and interim financial statements in the following manner:

1. At the outset of the reinsurance contract the net consideration paid by the ceding company (premiums less commissions or other allowances) shall be recorded as a deposit on the ceding company's books and as a liability on the assuming company's books. The deposit may be reported as an asset in the ceding company's statement if (a) the assuming company is licensed, accredited or otherwise qualified in the ceding company's state of domicile under Section 1 of the NAIC Model Law on Credit for Reinsurance or (b) there are funds held by or on behalf of the ceding company which meet the requirements of Section 2 of that law. Throughout the life of the contract receipts and disbursements shall be recorded through the deposit/liability accounts. Income and losses shall be recognized by a party when, according to the terms of the contract, it has earned the amount and the other party has no recourse to repayment of such amount in future periods. When the contract is completed, or when there is a loss payment in excess of the deposit, any difference between consideration and recoveries shall be recorded as other miscellaneous insurance income or miscellaneous insurance loss.

2. No deduction shall be made from the policy or claim reserves on the ceding company's balance sheet, schedules and exhibits.

3. The assuming company shall record net considerations to be returned to the ceding company as liabilities.

B. Assumption Reinsurance

A company may sell all or part of a block of insurance business through an assumption reinsurance agreement. Typically, under an assumption reinsurance arrangement, the reinsurance contract is intended to effect a novation, thereby to extinguish the ceding company's liability to the policyholder. Assumption reinsurance requires that the reinsurer issue assumption certificates to the existing policyholders and take over responsibility for policyholder services. On occasion, the reinsurer will contract with the original company to continue to provide such services on a fee basis or may contract with a third party. Regulatory approval of assumption reinsurance arrangements is usually required. Approval is also usually required from the policyholders, who have a predetermined time period in which to accept or reject the reinsurance transfer. After the deadline has passed, approval is considered implied for all outstanding responses. For those policyholders that reject the transfer, the reinsurance agreement typically converts to a indemnity arrangement. Under this circumstance, reinsurance accounting, as defined earlier in this chapter, is to be followed.

Accounting for Assumption Reinsurance Transactions

Accounting for assumption reinsurance transactions involves all existing assets and liabilities with respect to the assumed policies. This involves policy reserves, policy loans, net due and deferred premiums, dividend accumulations, dividend liability, policy claims, advance premiums, unearned interest on policy loans, etc. The total effect of all of these assets and liabilities is collectively referred to as net policy liabilities.

Typically, because a block of in-force business has value, the sale transaction will result in a gain to the ceding company. If the policies are somewhat mature and have reasonably large net policy liabilities, the transaction probably will result in a transfer of cash or other assets by the ceding company. In this case, the net policy liabilities released by the ceding company will be greater than the value of the assets transferred. If the policies are young and have very small net policy liabilities, the assuming company may pay some amount in the purchase. The ceding company is to follow accounting for indemnity reinsurance for the policies sold until it has been formally relieved of the legal liability by either consent from the policyholders or when the expiration period for objecting to the transfer has expired. Upon release of the liability or risk, the ceding company shall recognize any gain or loss immediately. The gain or loss shall be the difference between the book value of the assets and liabilities including any unamortized IMR allocated or related to the block of business transferred. Direct and ceded balances are to be eliminated and gains are to be taken into income proportionally as the policyholders approve the transfer or at the end of the response period.

The assuming company is to value the assets acquired at the date of acquisition at their market values, and the reserves are to be established according to statutory requirements based on the benefits in the individual policies reinsured. If the liabilities exceed the assets, the difference represents goodwill that must be amortized using the interest method over the life of the policies, but for a period not to exceed 10 years. If the assets exceed the liabilities, the assuming company shall record a deferred liability and amortize the amount using the interest method over the expected life of the business but not to exceed ten years.

Upon initiation of the assumption reinsurance contract, the ceding and assuming companies are to report all balances reinsured as direct adjustments to the Balance Sheet. Any net gain or loss is reported as miscellaneous income when recognized.

Accounting for Non-economic Assumption Reinsurance Transactions

When the sale, transfer, or reinsurance of an in-force block of business occurs between affiliated companies that is not an economic transaction, the ceding and assuming company shall not recognize any gain or loss. The statutory liabilities and any unamortized IMR shall be transferred from the ceding company to the assuming company without adjustment. The assuming company shall amortize any transferred IMR at the same rate or amount that would have occurred for the ceding company. To the extent that the value of the assets transferred by the ceding company or the net asset value recorded by the assuming company differs from the liabilities including any unamortized IMR, the ceding and assuming company shall defer and amortize their respective differences consistent with the interest method described for non-affiliated transactions.

Effective Date

The revised accounting and reporting practices set forth in this chapter that were adopted on December 4, 1995, shall be effective for all accounting periods beginning on or after January 1, 1996, and shall apply to reinsurance agreements entered into or amended on or after January 1, 1996. The revised accounting and reporting practices shall not apply to reinsurance agreements in force on January 1, 1996.

For accounting periods commencing on or after January 1, 1996, agreements which were: (a) entered into on or after January 1, 1996, and which do not transfer risk shall be accounted for as deposits; (b) amended on or after January 1, 1996, and which do not transfer risk shall be accounted for prospectively as deposits with the appropriate reclassification of outstanding reinsurance balances as deposits with no surplus impact; or (c) amended on or after January 1, 1996, a change in accounting principle associated with the revised accounting in this chapter shall be applied prospectively with no adjustment to surplus. Not withstanding the effective dates noted above, any insurer which has previously been subject to compliance with the Life and Health Reinsurance Agreements Model Regulation or substantially similar regulation shall be guided by the effective date of the regulation.

CHAPTER 24 — APPENDIX A

The contents of this appendix is taken from the Life and Health Reinsurance Agreements Model Regulation.

Section 4. Accounting Requirements

A. No insurer subject to this regulation shall, for reinsurance ceded, reduce liability or establish any asset in any financial statement filed with the Department if, by the terms of the reinsurance agreement, in substance or effect, any of the following conditions exist:

(1) Renewal expense allowances provided or to be provided to the ceding ins by the reinsurer in any accounting period are not sufficient to cover anticipated allocable renewal expenses of the ceding insurer on the portion of the business reinsured, unless a liability is established for the present value of the shortfall (using assumptions equal to the applicable statutory reserve basis on the business reinsured). Those expenses include commissions, premium taxes and direct expenses including, but not limited to, billing, valuation, claims and maintenance expected by the company at the time the business is reinsured;

(2) The ceding insurer can be deprived of surplus or assets at the reinsurer’s option or automatically upon the occurrence of some event, such as the insolvency of the ceding insurer, except that termination of the reinsurance agreement by the reinsurer for nonpayment of reinsurance premiums or other amounts due, such as modified coinsurance reserve adjustments, interest and adjustments on funds withheld, and tax reimbursements, shall not be considered to be such a deprivation of surplus or assets;

(3) The ceding insurer is required to reimburse the reinsurer for negative experience under the reinsurance agreement, except that neither offsetting experience refunds against current and prior years’ losses under the agreement nor payment by the ceding insurer of an amount equal to current and prior years’ losses under the agreement upon voluntary termination of in force reinsurance by the ceding insurer shall be considered such a reimbursement to the reinsurer for negative experience. Voluntary termination does not include situations where termination occurs because of unreasonable provisions which allow the reinsurer to reduce its risk under the agreement. An example of such a provision is the right of the reinsurer to increase reinsurance premiums or risk and expense charges to excessive levels forcing the ceding company to prematurely terminate the reinsurance treaty;

(4) The ceding insurer must, at specific points in time scheduled in the agreement, terminate or automatically recapture all or part of the reinsurance ceded;

(5) The reinsurance agreement involves the possible payment by the ceding insurer to the reinsurer of amounts other than from income realized from the reinsured policies. For example, it is improper for a ceding company to pay reinsurance premiums, or other fees or charges to a reinsurer which are greater than the direct premiums collected by the ceding company;

(6) The treaty does not transfer all of the significant risk inherent in the business being reinsured. The following table identifies for a representative sampling of products or type of business, the risks which are considered to be significant. For products not specifically included, the risks determined to be significant shall be consistent with this table.

Risk categories:

(a) Morbidity

(b) Mortality

(c) Lapse

This is the risk that a policy will voluntarily terminate prior to the recoupment of a statutory surplus strain experienced at issue of the policy.

(d) Credit Quality (Cl)

This is the risk that invested assets supporting the reinsured business will decrease in value. The main hazards are that assets will default or that there will be a decrease in earning power. It excludes market value declines due to changes in interest rate.

(e) Reinvestment (C3)

This is the risk that interest rates will fall and funds reinvested (coupon payments or monies received upon asset maturity or call) will therefore earn less than expected. If asset durations are less than liability durations, the mismatch will increase.

(f) Disintermediation (C3)

This is the risk that interest rates rise and policy loans and surrenders increase or maturing contracts do not renew at anticipated rates of renewal. If asset durations are greater than the liability durations, the mismatch will increase. Policyholders will move their funds into new products offering higher rates. The company may have to sell assets at a loss to provide for these withdrawals.

+ – Significant 0 – Insignificant

RISK CATEGORY

	a	b	c	d	e	f
Health Insurance—other than LTC/LTD*	+	0	+	0	0	0
Health Insurance—LTC/LTD*	+	0	+	+	+	0
Immediate Annuities	0	+	0	+	+	0
Single Premium Deferred Annuities	0	0	+	+	+	+
Flexible Premium Deferred Annuities	0	0	+	+	+	+
Guaranteed Interest Contracts	0	0	0	+	+	+
Other Annuity Deposit Business	0	0	+	+	+	+
Single Premium Whole Life	0	+	+	+	+	+
Traditional Non-Par Permanent	0	+	+	+	+	+
Traditional Non-Par Term	0	+	+	0	0	0
Traditional Par Permanent	0	+	+	+	+	+
Traditional Par Term	0	+	+	0	0	0
Adjustable Premium Permanent	0	+	+	+	+	+
Indeterminate Premium Permanent	0	+	+	+	+	+
Universal Life Flexible Premium	0	+	+	+	+	+
Universal Life Fixed Premium	0	+	+	+	+	+
Universal Life Fix Premium dump-in premiums allowed	0	+	+	+	+	+

*LTC = Long Term Care Insurance

LTD = Long Term Disability Insurance

(7) (a) The credit quality, reinvestment, or disintermediation risk is significant for the business reinsured and the ceding company does not (other than for the classes of business excepted in Paragraph (7)(b)) either transfer the underlying assets to the reinsurer or legally segregate such assets in a trust or escrow account or otherwise establish a mechanism satisfactory to the commissioner which legally segregates, by contract or contract provision, the underlying assets.

(b) Notwithstanding the requirements of Paragraph (7)(a), the assets supporting the reserves for the following classes of business and any classes of business which do not have a significant credit quality, reinvestment or disintermediation risk may be held by the ceding company without segregation of such assets:

- Health Insurance—LTC/LTD
- Traditional Non-Par Permanent

- Traditional Par Permanent
- Adjustable Premium Permanent
- Indeterminate Premium Permanent
- Universal Life Fixed Premium
  (no dump-in premiums allowed)

The associated formula for determining the reserve interest rate adjustment must use a formula which reflects the ceding company's investment earnings and incorporates all realized and unrealized gains and losses reflected in the statutory statement. The following is an acceptable formula:

$$\text{Rate} = \frac{2\,(I + CG)}{X+Y-I-CG}$$

Where:

I is the net investment income (Exhibit 2, Line 16, Column 7)

CG is capital gains less capital losses (Exhibit 4, Line 10, Column 6)

X is the current year cash and invested assets (Page 2, Line 10A, Column 1) plus investment income due and accrued (Page 2, Line 16, Column 1) less borrowed money (Page 3, Line 22, Column 1)

Y is the same as X but for the prior year

Drafting Note: Line references are for the 1992 annual statement. Line references may be deleted or should be updated if regulation is adopted after calendar year 1992. Be aware that annual statement line references may change from year to year.

(8) Settlements are made less frequently than quarterly or payments due from the reinsurer are not made in cash within ninety (90) days of the settlement date.

(9) The ceding insurer is required to make representations or warranties not reasonably related to the business being reinsured.

(10) The ceding insurer is required to make representations or warranties about future performance of the business being reinsured.

(11) The reinsurance agreement is entered into for the principal purpose of producing significant surplus aid for the ceding insurer, typically on a temporary basis, while not transferring all of the significant risks inherent in the business reinsured and, in substance or effect, the expected potential liability to the ceding insurer remains basically unchanged.

CHAPTER 24 — APPENDIX B

B. Notwithstanding Subsection A, an insurer subject to this regulation may, with the prior approval of the commissioner, take such reserve credit or establish such asset as the commissioner may deem consistent with the Insurance Law (or Code), Rules or Regulations, including actuarial interpretations or standards adopted by the Department.

C. (1) Agreements entered into after the effective date of this regulation which involve the reinsurance of business issued prior to the effective date of the agreements, along with any subsequent amendments thereto, shall be filed by the ceding company with the commissioner within thirty (30) days from its date of execution. Each filing shall include data detailing the financial impact of the transaction. The ceding insurer's actuary who signs the financial statement actuarial opinion with respect to valuation of reserves shall consider this regulation and any applicable actuarial standards of practice when determining the proper credit in financial statements filed with this department. The actuary should maintain adequate documentation and be prepared upon request to describe the actuarial work performed for inclusion in the financial statements and to demonstrate that such work conforms to this regulation.

(2) Any increase in surplus net of federal income tax resulting from arrangements described in Subsection C(1) shall be identified separately on the insurer's statutory financial statement as a surplus item (aggregate write-ins for gains and losses in surplus in the Capital and Surplus Account, page 4 of the Annual Statement) and recognition of the surplus increase as income shall be reflected on a net of tax basis in the "Reinsurance ceded" line, page 4 of the Annual Statement as earnings emerge from the business reinsured.

{For example, on the last day of calendar year N, company XYZ pays a $20 million initial commission and expense allowance to company ABC for reinsuring an existing block of business. Assuming a 34% tax rate, the net increase in surplus at inception is $13.2 million ($20 million—$6.8 million) which is reported on the "Aggregate write-ins for gains and losses in surplus" line in the Capital and Surplus account. $6.8 million (34% of $20 million) is reported as income on the "Commissions and expense allowances on reinsurance ceded" line of the Summary of Operations.

At the end of year N+1 the business has earned $4 million. ABC has paid $.5 million in profit and risk charges in arrears for the year and has received a $1 million experience refund. Company ABC's annual statement would report $1.65 million (66% of [$4 million—$1 million—$.5 million] up to a maximum of $13.2 million) on the "Commissions and expense allowance on reinsurance ceded" line of the Summary of Operations, and—$1.65 million on the "Aggregate write-ins for gains and losses in surplus" line of the Capital and Surplus account. The experience refund would be reported separately as a miscellaneous income item in the Summary of Operations.}

17. The proposed Actuarial Guideline JJJ, which follows, provided further clarification of reinsurance accounting:

Draft: 11/17/95

Adopted by the Life and Health Actuarial (Technical) Task Force on 12/1/95

ACTUARIAL GUIDELINE JJJ

GUIDELINE CONCERNING QUESTIONS AND ANSWERS RELATED
TO THE LIFE AND HEALTH REINSURANCE AGREEMENTS
MODEL REGULATION

Background

In September 1992 a revision of the Life and Health Reinsurance Agreements Model Regulation was adopted by the NAIC. Since then a number of questions have arisen by regulators regarding its application and interpretation. In early 1994 the Reinsurance Working Group was formed and charged by the Life and Health Actuarial (Technical) Task Force to provide guidance in interpreting provisions of the model regulation. This charge is being met through the completion of this Guideline in the form of a Q&A document which discusses and adds a degree of insight into certain aspects of the regulation. This document is not intended to expand the content of the model regulation. Each state will retain the authority and ability to independently interpret its own regulation. This document gives some insight into the intent of the original drafters of the model regulation and provides interpretive guidance regarding certain of its provisions.

Text

Section 3

Question: Aside from assumption reinsurance, what other type of reinsurance is exempt from the model regulation?

Answer: The model exempts all yearly renewable term (YRT) and certain nonproportional reinsurance arrangements, such as stop loss and catastrophic reinsurance. The purpose behind the exemption of these types of arrangements was because these did not normally provide significant surplus relief and therefore were not the target of this regulation. Users of the regulation should, however, be cautious of any reinsurance arrangements which could be created to misstate a company's true financial position or attempt to circumvent the regulation by artificially labeling an agreement YRT. If a YRT provides incidental reserve credits for the ceding insurer's net amount at risk for the year with no other "allowance" to enhance surplus, or a catastrophic arrangement which takes a reserve credit for actual losses beyond the attachment point or the unearned premium reserve (UPR) of the current year's premium, there will most likely be no regulatory concern. The NAIC Examiners Handbook (Part 5–Reinsurance section) provides significant insight into all reinsurance agreements, whether covered by this regulation or not. Section II(B)(4) provides discussion on a reinsurance agreement's effect on surplus and provides areas of concern to the regulator in determining a bona fide transfer of risk. Additional pertinent information is contained in the reinsurance chapter of the NAIC Accounting Practices and Procedures Manual which provides accounting guidance.

Section 4A

Question: What is disallowed in the case of non-complying coinsurance with funds withheld treaties? modified coinsurance treaties?

Answer: The underlying intent of the section is to ensure that a company's financial condition is appropriately stated and not distorted by artificially enhancing surplus through "reinsurance" arrangements that do not fully transfer risks to the reinsurer or which otherwise fail to comply with the standards contained in the regulation. Therefore, all reserve credits, liability reductions or assets established by the ceding insurer that are supported by or conditioned on the treaty should be non-admitted to the extent called for in the regulation for any reinsurance agreement that does not comply with Section 4A.

If a reinsurance agreement is such that one or more of its terms violates or fails to comply with the provisions of the model regulation, a company should not include any liability reduction or any asset recognition in any financial statement. A liability reduction or asset may appear in the financial statement in various forms: reserve credits, receivables or transferred funds.

Funds that have been received or credited by the ceding insurer, such as commissions or other front end allowances, regardless of the name given it, shall not be recognized as a surplus enhancement on the annual statement. If so reported, the entire value of such funds currently reported should be non-admitted.

Both forms of coinsurance, funds withheld and modified coinsurance, have an implicit or explicit reserve credit being taken. A modified coinsurance (modco) deposit is also reflected within the same line as an offset to the reserve credit. This ultimately reflects aggregate reserves being reported as if there were no reinsurance. So long as the modco deposit is for the sole purpose of paying FUTURE claims, the modco deposit may be offset against the implicit reserve credit with no additional penalty (other than the nonadmission of any front end allowance as discussed above) being assessed against the ceding insurer.

With regard to coinsurance with funds withheld, the reserve credit taken will be initially nonadmitted. The funds withheld may serve several purposes. It may be funds withheld which the ceding company owes to the reinsurer as a liability payable, such as the last accounting quarter's premium payable. The funds may also be used, similar to modco, to hold funds to be applied against FUTURE claim payments, with the funds having no other liability. To the extent that funds are available solely for paying future claims, such amount may be used to reduce the otherwise nonadmitted reserve credit. Care must be taken that no reduction in the nonadmitted reserve credit be taken when funds serve another purpose, such as being payable to the reinsurer, in addition to the reinsurer's obligation to pay claims.

An insurer is legally able to enter into contracts with other entities, including other insurers. The provisions of such a contract will be required to be accounted for based on the terms and conditions of the agreement. If the agreement meets the conditions of an acceptable reinsurance arrangement, the ceding insurer is afforded the additional benefit of being able to reduce its otherwise required statutory liabilities by a reserve "credit." If the agreement does not meet the conditions of this regulation, no reserve credit, whether as an asset or as an offset to liability, may be taken. This treatment does not rescind or otherwise eliminate the existence of the contract. Additional pertinent information is contained in the reinsurance chapter of the NAIC Accounting Practices and Procedures Manual which provides accounting guidance for such agreements.

Section 4A(1)

Question: What should be included in the renewal expense allowances with regard to direct expenses? An allocation of salaries? Computer usage? Or just marginal expenses directly related to the business reinsured such as claim payment expenses, postage, etc.? Should the renewal expense allowances cover actual anticipated allocable expenses of a small company in a start-up mode (i.e. high expenses) or should they be based on what expected expenses would be once the company is more mature?

Answer: The primary purpose of the model regulation is to prohibit credit for reinsurance under financial arrangements where the ceding company enters into an agreement for the principal purpose of producing significant surplus aid for the ceding insurer on a temporary basis, while not transferring all of the significant risks inherent in the business being reinsured.

Section 4A(1) implements the purpose of the model by prohibiting credit for reinsurance in certain instances where the ceding insurer is afforded a large ceding commission at the inception of the agreement resulting in a significant increase in surplus only to have the surplus increase be drained away in subsequent periods because renewal expense allowances provided under the agreement are insufficient to cover the direct allocable costs estimated at the time the business is reinsured, which are anticipated to be incurred by the ceding insurer in maintaining the business reinsured.

The model allows an exception to complete disallowance of credit for reinsurance in situations where the ceding insurer reflects a liability for the present value of the shortage between renewal expense allowances provided under the agreement and the direct allocable costs expected in the future by the insurer in maintaining the business reinsured. This liability must be calculated using actuarial assumptions that are consistent with those utilized in the statutory reserve calculation. The expenses to be accounted for in establishing this liability should represent all costs of the ceding insurer in servicing the business that is subject to the agreement.

In determining what the ceding insurer should include in the renewal expenses with regard to direct expenses, there should be an allocation of all renewal expenses anticipated at the time the business is reinsured including salaries, computer usage, postage, etc. This comprehensive calculation should be done regardless of whether a company is in a start-up mode (and experiencing high expenses) or is otherwise more mature but, recognizing that the anticipated expense levels may be estimated, a comparison with pricing assumptions may be considered in determining the reasonableness of such assumptions.

If insurance department staff encounter an agreement that does not comply with Section 4A(1) of the model, this area of non-compliance should be addressed by the posting of a reserve for the present value of the deficiency rather than denial for credit for reinsurance, assuming that no other area of non-compliance is encountered with the agreement and that the assets received corresponding to the ceding commission are in compliance with other statutes and regulations. For example, the assets received corresponding to the ceding commission must be admissible and not subject to repayment to the reinsurer.

NOTE: Some states have adopted versions of the model regulation that do not allow partial credit when renewal expense allowances are deficient. In those states complete disallowance of reinsurance credit would result for treaties that do not comply with the renewal expense allowance requirement.

Section 4A(2)

Question: With regard to existing business, should the coinsurance reserve percentage or the coinsurance reserve amount not be allowed to increase in a combination coinsurance/modified coinsurance treaty? How would the rule be applicable to the difference between the total reserve and the amount of funds withheld in a coinsurance with funds withheld treaty?

Answer: Section 4A(2) disallows reinsurance credit if the ceding company can be deprived of assets at the reinsurer’s option or automatically upon the occurrence of some event. Thus a provision in a coinsurance with funds withheld treaty that allows the reinsurer to convert the treaty to coinsurance at some later date would be in violation of the model regulation. Although the parties could have entered into a coinsurance agreement at its inception, regulators are concerned that the reinsurer would take assets from the ceding company at a time that would be to the detriment of the ceding company’s policyholders.

Under a combination coinsurance/modified coinsurance (co/modco) arrangement the ceding company and the reinsurer both establish reserves for future claim payments. When a claim becomes payable, the reserves held by each party must be used proportionally to pay the claim. Treaty provisions that adjust the reserves each party holds in lieu of transferring funds owed to the reinsurer are acceptable. However, adjustment of reserves in lieu of payment when funds are owed to the ceding company is a violation of the model regulation since it is a depletion of the ceding company’s assets. This is the case even if the agreement provides for this adjustment at inception and never requires a payment to be owed by the reinsurer. Noncompliance with the model regulation would exist if both the coinsurance amount and the coinsurance percentage (for existing business) were allowed to increase on any settlement date.

Under a coinsurance with funds withheld treaty the reinsurer establishes the entire amount of reserve liability on its share of reinsured policies, but the ceding company withholds assets from the reinsurer, typically in an amount less than the reserves, to offset future obligations. There is no duty on the part of the reinsurer to maintain the book value of the withheld assets at a certain level as there is under co/modco, where the book value of the assets supporting the modco reserves must equal the modco reserves. Provided the withheld assets are not withheld for any purpose other than the payment of future claims, it is not a violation of the model regulation for the reinsurer to require full use of withheld assets for the payment of claims prior to using any other assets owned by the reinsurer.

Section 4A(2) and 4A(5)

Question: Should a reinsurer have a unilateral right to establish underlying cost of insurance rates or credited interest rates for policies that are wholly or partially reinsured?

Answer: No, only the ceding company has the contractual relationship with the insured and the right to set the cost of insurance rates charged policyholders and to set the rates of interest credited to them. However, a representation (but not a warranty) that the ceding company shall vary nonguaranteed elements reinsured in a manner consistent with the ceding company’s documented procedures at the time the agreement was entered into does not violate the requirements of the regulation.

Question: May a reinsurance contract allow the reinsurer to increase the cost of insurance that the ceding company must pay under the treaty?

Answer: So long as the aggregate amounts payable by the ceding company in any settlement period do not exceed the income of the reinsured policies during that period, the treaty's structure would not be in violation of Section A(5) of the model regulation. There is not compliance with Section A(5) if any increases could exceed income.

Question: If a reinsured policy allows the ceding company to guarantee rates of interest to be credited to the policyholder that are greater than those guaranteed by the policy, may a reinsurance contract allow the reinsurer to limit its participation in the credited rate as long as it at least provides for the amount based on the rate guaranteed in the contract?

Answer: Again, so long as there is no possibility that the ceding company will have to make payments for which it is not fully reimbursed, no violation exists. Otherwise, the treaty would not be in compliance with Sections 4A(2) and 4A(5).

Section 4A(7)

Question: Is asset segmentation an acceptable mechanism for legal segregation of assets?

Answer: Generally no. Segmentation involves the allocation of a company's general account investment earnings over several lines of business, or various groups of policies within those lines, such that the performance of one corporate bond, for example, may affect the earnings of several segments within a company. The accounting for the segmentation is largely internal, and the detail of the record-keeping varies from company to company.

The fundamental purpose of the requirement for a reinsurance treaty to employ the use of a segregated asset portfolio (SAP) is that all payments (interest, benefits, allowances, etc.) must be made from the SAP, to eliminate any problems that could arise in determining what asset or assets should be sold, and to avoid disputes in the event of insolvency. Any sale of assets that could affect policies not subject to reinsurance, or policies subject to reinsurance with other reinsurers is problematic.

In addition, auditing the performance of a treaty using traditional segmentation methods would be extremely difficult and prone to disagreement, which could provide a reinsurer with broad leverage to contest amounts due that reinsurer, especially in the event of insolvency or rehabilitation of the ceding company.

It is important to determine that the arrangement in place does in fact transfer all of the risks of the underlying assets supporting the reinsured business to the reinsurer.

Question: If some policies out of a group of similar policies are fully or partially reinsured, and the remainder are not, must the assets supporting the reinsured policies be legally segregated from those supporting the business that is not?

Answer: Yes. Assets supporting policies that are not reinsured may not be part of an SAP.

Question: If a percentage of all policies in a block of business is reinsured, must the company segregate that percentage of the assets supporting the business, or can it segregate all the assets?

Answer: The company may segregate only assets supporting the reinsured portion or the segregated asset portfolio may represent the entire block of business if the reinsured portion is the same for all policies. In the later case, the reinsurer would take its proportionate share of the SAP performance.

Question: If the ceding company cedes a portion of each policy in a block of business to one reinsurer and a portion to another, while retaining some itself, does it have to segregate assets separately for each reinsurer, or is it acceptable to have all the assets segregated together with each reinsurer responsible for its portion of the investment risk?

Answer: The ceding company should not segregate assets separately for each reinsurer if the treaties are virtually identical.

Question: At the time assets are legally segregated under a coinsurance with funds withheld treaty, should they be valued at market value, statutory value or some combination?

Answer: The assets should be valued at their statutory admitted assets value.

Question: When the assets are legally segregated, how are the funds withheld payables and receivables reported?

Answer: The payables and receivables are recorded in the same manner as in a funds withheld treaty where the assets are not legally segregated and will usually mirror the value of the funds withheld account. However, the funds withheld account, which reflects the statutory admitted value of the assets in the SAP, will fluctuate, and thus may differ from the reserves on the reinsured business.

Section 4A(8)

Question: Can a company get around this provision if its treaty states that amounts receivable from the reinsurer are payable (due) at a later date?

Answer: No. All amounts receivable from reinsurers are nonadmitted if not paid within 90 days after the end of the period in which the amounts became receivable. The period may not be longer than one quarter (3 months). These amounts include ceding commissions withheld by reinsurers. A ceding commission is an amount that should be paid “up front” and not over time. Furthermore, arguments that the ceding commission was in fact paid but was then deposited with the reinsurer to create a funds withheld from ceding insurer account are unacceptable. Paid means paid.

Question: Does this section permit modco with funds withheld, since this type of reinsurance involves a receivable from the reinsurer?

Answer: Since the funds withheld would be structured as a receivable, the treaty would be in violation of this section.

Section 4A(9)

Question: Can a treaty impose specific controls on the way the ceding company conducts its business? Examples of such controls include the following:

a. Limits on the amount of dividends to be paid to stockholders in any year.
b. Limits on the amount of new business to be issued in any year.
c. Under certain conditions, the right of the reinsurer to replace the ceding company’s investment manager.
d. Restrictions on the types of investments to be held by the ceding company.
e. Increased risk charges under certain circumstances, such as risk based capital ratios falling to a specified level.

Answer: Treaty provisions such as those illustrated above appear frequently. They represent an understanding between the ceding company and the reinsurer at inception of the treaty. The impact and intent of the provisions must be analyzed to determine that they do not relate to general business practices of the ceding company, and are reasonably related to the business being reinsured; provisions that only apply to the business reinsured would generally not be in violation of Section 4A(9).

Section 4A(10)

Question: When, if ever, may references to projections be made in a reinsurance treaty?

Answer: Accounting Requirement A-10 prohibits treaty provisions where "the ceding insurer is required to make representations or warranties about the future performance of the business being reinsured." (It should be noted that "representations or warranties" need not appear in a treaty section entitled "Representations and Warranties" to be considered as such.)

Provisions relating to projections appear in the following forms:

a. Tables of scheduled amounts, typically showing the amount of outstanding surplus relief expected at different times during the life of the treaty, clearly drawn from projections of future profitability of the block of business being reinsured, but not identified as such. This does not represent violations of either Accounting Requirement A-9 or of Accounting Requirement A-10, because they were agreed to at inception of the treaty, and are reasonably related to the business being reinsured. However, the treaty must clearly disclose that these tables do not constitute a guarantee as to the future profitability of the business reinsured.

b. Statements acknowledging that, at inception of the treaty, the reinsurer has received and reviewed projections of the future profitability of the business being reinsured. Such statements do not represent a violation of Accounting Requirement A-9 as long as:

    1. there is no language in the treaty implying reliance by the reinsurer on such projections, and
    2. language is included stating, in essence, that the reinsurer acknowledges that the ceding insurer is unable to make any guarantees regarding the future profitability of the business being reinsured.

c. Statements requiring that, if "projected results are not met," the reinsurer will take some form of action, such as an increased risk charge. The statements differ from those discussed in Paragraph a. above in that numerical values (drawn form the projections) are not shown in the treaty. Language of this type would be in violation of Accounting Requirement A-10 because it implies a warranty about the future performance of the business being reinsured, on the basis of projections that are not part of the contract.

18. The Annual Statement Instructions require the following disclosures related to reinsurance. Notes 10-12 relate to all reserves including direct, assumed and ceded business. Notes 13-15 relate specifically to reinsurance.

10. Life and Annuities Reserves

Instruction:

A. Describe reserve practices concerning the following:

Waiver of deduction of deferred fractional premiums upon death of insured;
Return of portion of final premium for periods beyond the date of death; and

Note if any surrender value is promised in excess of the reserve as legally computed.

B. State methods employed in the valuation of substandard policies.

C. State the amount of insurance, if any, for which the gross premiums are less than the net premiums according to the standard of valuation required by this state. If not reported in Exhibit 8, Section G, Line 10700001, state the amount of reserves and indicate where reported.

D. Have the Tabular Interest (Page 7, Part A, Line 4), Tabular Less Actual Reserve Released (Page 7, Part A, Line 5) and Tabular Cost (Page 7, Part A, Line 9) been determined by formula as described for these lines in the instructions for Page 7 or from the basic data for such items?

E. Describe the method of determination of Tabular Interest on funds not involving life contingencies under Page 7, Part B, Line 3.

F. Disclose the nature of significant other increases (net) under Page 7, Part B, Line 5.

Illustration:

A. The Company waives deduction of deferred fractional premiums upon death of insured and returns any portion of the final premium beyond the date of death. Surrender values are not promised in excess of the legally computed reserves.

B. Extra premiums are charged for substandard lives for policies issued prior to July 1, 19__, plus the gross premium for a rated age.

Mean reserves are determined by computing the regular mean reserve for the plan at the rated age and holding, in addition, one-half (1/2) of the extra premium charge for the year. Policies issued after July 1, 19__, for substandard lives, are charged an extra premium plus the regular premium for the true age. Mean reserves are based on appropriate multiples of standard rates of mortality.

C. As of December 31, 19__, the Company had $__________ of insurance in force for which the gross premiums are less than the net premiums according to the standard valuation set by the State of ________________. Reserves to cover the above insurance totaled $__________ at year-end and are reported in Exhibit 8, Sections A and B.

D. The Tabular Interest (Page 7, Part A, Line 4) has been determined by formula as described in the instructions for Page 7 (or, alternatively, from the basic date for the calculation of policy reserves).

The Tabular Less Actual Reserve Released (Page 7, Part A, Line 5) has been determined by formula as described in the instructions for Page 7 (or, alternatively, from the basic data for the calculation of reserves and the actual reserves released).

The Tabular Cost (Page 7, Part A, Line 9) has been determined by formula as described in the instructions for Page 7 (or, alternatively, from the basic data for the calculation of policy reserves).

E. For the determination of Tabular Interest on funds not involving life contingencies under Page 7, Part B, Line 3, for each valuation rate of interest, the tabular interest is calculated as one hundredth of the product of such valuation rate of interest times the mean of the amount of funds subject to such valuation rate of interest held at the beginning and end of the year of valuation. The total amount of all such products is entered under Page 7, Part B, Line 3.

F. The details for “Other Increases” (net) under Page 7, Part B, Line 5 are:

	1	2	ORDINARY				GROUP	
			3	4	5	6	7	8
ITEM	Total	Industrial Life	Life Insurance	Individual Annuities	Supplementary Contracts	Credit Life Group and Individual	Life Insurance	Annuities
5.01								
5.02								
5.03								
5.04								
.								
.								
.								
.								
5.99 Total								

11. Analysis of Annuity Actuarial Reserves and Deposit Liabilities by Withdrawal Characteristics

Instruction:

Disclose the amount of annuity actuarial reserves and deposit liabilities by withdrawal characteristics as follows:

1. Subject to discretionary withdrawal:
   - 1.1 – With market value adjustment.
   - 1.2 – At book value less current surrender charge of 5% or more.
   - 1.3 – At market value.
   - 1.4 – Total with adjustment or at market value.
   - 1.5 – At book value without adjustment (minimal or no charge or adjustment).

2. Not subject to discretionary withdrawal.
3. Total (gross).
4. Reinsurance ceded.
5. Total (net) (3) – (4).
   Reconcile the total annuity reserves and deposit fund liabilities amount disclosed in this note to the appropriate sections of Exhibit 8 and Exhibit 10, Line 19, Column 1 of the Life, Accident & Health Annual Statement and the corresponding lines in the Separate Accounts Statement.

A. Withdrawal Characteristic Classification Instructions:

1. Classify annual statement liabilities as “subject to discretionary withdrawal with market value adjustments” (1.1 above) where withdrawal of funds is payable at all times, or prior to specified maturity dates where such dates are more than one year after the statement date and:

   (a) In a lump sum with adjustments to reflect general changes in interest rates, or asset values since receipt of funds by the insurer. The adjustments either may be based on the insurer’s own investment experience with an assumed duration to the average maturity of the underlying assets, or related to an index, or related to the maturity date of the liability; or

(b) In installments over five years or more, with or without a reduction in the interest rate during the installment period.

2. Classify annual statement liabilities as “subject to discretionary withdrawal at book value less surrender charge” (1.2 above) where the withdrawal of funds is payable at all times, or at any time within one year from the statement date in a lump sum subject to a current fixed surrender charge of 5% or more and it does not contain a meaningful bail out rate as provided in (4)(d) below.

3. Classify annual statement liabilities as “subject to discretionary withdrawal at market value” (1.3 above) where the withdrawal of funds is payable at current market value of the assets supporting the liabilities, the assets are stated at current market value, and the liabilities are stated at the current market value or per unit value of the assets supporting the liabilities. These liabilities are for contracts where the customer bears the entire investment risk.

4. Classify all other annual statement liabilities as “subject to discretionary withdrawal at book value (minimal or no charge or adjustments)” (1.5 above) where the withdrawal of funds is either payable at all times, or at any time (including a withdrawal on a scheduled payment date) within one year from the statement date and:

(a) In a lump sum without adjustment; or

(b) In installments over less than five years, with or without a reduction in interest rate during the installment period; or

(c) In a lump sum subject to a fixed surrender charge of less than 5%; or

(d) In a lump sum subject to a surrender charge, but such charge is waived if the credited rate falls below a specified “bail out” rate and the “bail out” rate is more than the maximum statutory valuation rate for life insurance policies for more than 20 years for new issues; or

(e) All others.

(The one year period from statement date covers both contracts with specified maturity dates on which withdrawal is permitted in accordance with (a) or (b) and contracts providing for a surrender charge which decreases by duration.)

B. Additional Instructions:

1. The annual statement liabilities to be covered by this note are both those actuarial reserves and deposit fund liabilities reported in the Life, Accident & Health Statement and those reported in the Separate Accounts Statement. Include actuarial reserves for annuities (other than disability annuities) and supplementary contracts with life contingencies reported in Exhibit 8; actuarial reserves for annuities, certain supplementary contracts without life contingencies, and deposit fund liabilities for annuities reported in Exhibit 10. Include all annuity actuarial reserves and deposit liabilities reported in the Separate Accounts Statement in this note.

2. Separate each actuarial reserve or deposit fund liability by its withdrawal characteristics, e.g., subject to discretionary withdrawal – with adjustment, etc. If a product contains more than one type of provision for either the individual policyholder or the participant to withdraw funds from the insurer, e.g., routine

withdrawals are at book value, other withdrawals are at market value, separate the product’s reserves into the appropriate categories. Shared employer group or jointly underwritten arrangements are to be reported as direct business.

3. Briefly describe the methods of estimation utilized to complete this disclosure if more precise information was unavailable.

Illustration:

Withdrawal Characteristics of Annuity Actuarial Reserves and Deposit Liabilities

		(1) Amount	(2) % of Total
1.	Subject to discretionary withdrawal:		
	1.1 – With market value adjustment	$________	________%
	1.2 – At book value less current surrender charge of 5% of more	________	________
	1.3 – At market value	________	________
	1.4– Total with adjustment or at market value	________	________
	1.5 – At book value without adjustment (minimal or no charge or adjustment)	________	________
2.	Not subject to discretionary withdrawal	________	________
3.	Total (gross)	________	100 %
4.	Reinsurance ceded	________	
5.	Total (net)* (3) – (4)	$________	

*Reconciliation of total annuity actuarial reserves and deposit fund liabilities.

Life & Accident & Health Annual Statement:

6.	Exhibit 8, Section B, Total (net)	$ ________
7.	Exhibit 8, Section C, Total (net)	________
8.	Exhibit 10, Line 19, Column 1	________
9.	Subtotal	________

Separate Accounts Annual Statement:

10.	Exhibit 6, Line 0299999, Column 2	________
11.	Exhibit 6, Line 0399999, Column 2	________
12.	Page 3, Line 3	________
13.	Subtotal	________
14.	Combined Total	$________

12. Premium and Annuity Considerations Deferred and Uncollected

Instruction:

If the company has reported on Page 2, life insurance premiums and annuity considerations deferred and uncollected on policies in force December 31 of current year, show separately the amounts and the loading excluded for each of the following lines of business: industrial business, ordinary new business, ordinary renewal, credit life, group life, and group annuity.

Illustration:

Deferred and uncollected life insurance premiums and annuity considerations as of December 31, 19XX, were as follows:

	Type	(1) Gross	(2) Net of Loading
i.	Industrial	$__________	$__________
ii.	Ordinary new business	__________	__________
iii.	Ordinary renewal	__________	__________
iv.	Credit Life	__________	__________
v.	Group Life	__________	__________
vi.	Group Annuity	__________	__________
vii.	Totals	$__________	$__________

13. Ceded Reinsurance Report

Section 1 – General Interrogatories

A. Are any of the reinsurers, listed in Schedule S as non-affiliated, owned in excess of 10% or controlled, either directly or indirectly, by the company or by any representative, officer, trustee, or director of the company? Yes ( ) No ( ) If yes, give full details.

B. Have any policies issued by the company been reinsured with a company chartered in a country other than the United States (excluding U.S. Branches of such companies) which is owned in excess of 10% or controlled directly or indirectly by an insured, a beneficiary, a creditor or an insured or any other person not primarily engaged in the insurance business? Yes () No ( ) If yes, give full details.

Section 2 – Ceded Reinsurance Report – Part A

A. Does the company have any reinsurance agreements in effect under which the reinsurer may unilaterally cancel any reinsurance for reasons other than for nonpayment of premium or other similar credits? Yes ( ) No ( )

i) If yes, what is the estimated amount of the aggregate reduction in surplus of a unilateral cancellation by the reinsurer as of the date of this statement, for those agreements in which cancellation results in a net obligation of the company to the reinsurer, and for which such obligation is not presently accrued? Where necessary, the company may consider the current or anticipated experience of the business reinsured in making this estimate. $________________

ii) What is the total amount of reinsurance credits taken, whether as an asset or as a reduction of liability, for these agreements in this statement? $________________

B. Does the company have any reinsurance agreements in effect such that the amount of losses paid or accrued through the statement date may result in a payment to the reinsurer of amounts which, in aggregate and allowing for offset of mutual credits from other reinsurance agreements with the same reinsurer, exceed the total direct premium collected under the reinsured policies? Yes ( ) No ( ) If yes, give full details.

Section 3 – Ceded Reinsurance Report – Part B

A. What is the estimated amount of the aggregate reduction in surplus, (for agreements other than those under which the reinsurer may unilaterally cancel for reasons other than for nonpayment of premium or other similar credits that are reflected in Section 2 above) of termination of ALL reinsurance agreements, by either party, as of the date of this statement? Where necessary, the company may consider the current or anticipated experience of the business reinsured in making this estimate. $_________________

B. Have any new agreements been executed or existing agreements amended, since January 1 of the year of this statement, to include policies or contracts which were in force or which had existing reserves established by the company as of the effective date of the agreement? Yes ( ) No ( )

If yes, what is the amount of reinsurance credits, whether an asset or a reduction of liability, taken for such new agreements or amendments? $__________________

14. Uncollectible Reinsurance

Instruction:

Describe uncollectible reinsurance written off during the year reported in the following annual statement classifications, including the name or names of the reinsurer(s):

1. Claims incurred;
2. Claim adjustment expenses incurred;
3. Premiums earned;
4. Other.

Illustration:

i. The Company has written off in the current year reinsurance balances due from the companies listed below, the amount of: $______
which is reflected as:

ii. Losses incurred $______
iii. Loss adjustment expenses incurred $______
iv. Premiums earned $______
v. Other $

Company	Amount
XYZ	$
ZYX	$

15. Commutation of Ceded Reinsurance

Instruction:

Describe commutation of ceded reinsurance during the year reported in the following annual statement classifications, including the name or names of the reinsurer(s):

1. Claims incurred;
2. Claim adjustment expenses incurred;
3. Premiums earned;
4. Other.

Illustration:

Commutation of Reinsurance Reflected in Income and Expenses.

The company has reported in its operations in the current year as a result of commutation of reinsurance with the companies listed below, amounts which are reflected as:

i. Losses incurred $_____
ii. Loss adjustment expenses incurred $_____
iii. Premiums earned $_____
iv. Other $_____

Company	Amount
XYZ	$_____
ZYX	$_____

Generally Accepted Accounting Principles

19. FAS 113 contains the following guidance with respect to reporting assets and liabilities related to reinsurance transactions:

> Reporting Assets and Liabilities Related to Reinsurance Transactions
>
> 14. Reinsurance contracts that are legal replacements of one insurer by another (often referred to as assumption and novation) extinguish the ceding company's liability to the policyholder and result in removal of related assets and liabilities from the financial statements of the ceding enterprise. Reinsurance contracts in which a ceding enterprise is not relieved of the legal liability to its policyholder do not result in removal of the related assets and liabilities from the ceding enterprise's financial statements. Ceding enterprises shall report estimated reinsurance receivables arising from those contracts separately as assets. Amounts paid to the reinsurer relating to the unexpired portion of reinsured contracts (prepaid reinsurance premiums) also shall be reported separately as assets.
>
> 15. Amounts receivable and payable between the ceding enterprise and an individual reinsurer shall be offset only when a right of offset exists, as defined in Interpretation 39.
>
> 16. The amounts of earned premiums ceded and recoveries recognized under reinsurance contracts either shall be reported in the statement of earnings, as separate line items or parenthetically, or those amounts shall be disclosed in the footnotes to the financial statements.

20. FAS 113 contains the following guidance with respect to reinsurance of long-duration contracts:

> Reinsurance of Long-Duration Contracts
>
> 12. Indemnification of the ceding enterprise against loss or liability relating to insurance risk in reinsurance of long-duration contracts requires the reasonable possibility that the reinsurer may realize significant loss from assuming insurance risk as that concept is contemplated in Statement 60 and FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*. Statement 97 defines long-duration contracts that do not subject the insurer to mortality or morbidity risks as investment contracts. Consistent with that definition, a contract that does not subject the reinsurer to the reasonable possibility of significant loss from the events insured by the underlying insurance contracts does not indemnify the ceding enterprise against insurance risk.
>
> 13. The evaluation of mortality or morbidity risk in contracts that reinsure policies subject to Statement 97 shall be consistent with the criteria in paragraphs 7 and 8 of that Statement. Evaluation of the presence of insurance risk in contracts that reinsure other long-duration contracts (such as those that reinsure ordinary life contracts or contracts

that provide benefits related only to illness, physical injury, or disability) also shall be consistent with those criteria.

Recognition of Revenues and Costs for Reinsurance of Long-Duration Contracts

25. Amortization of the estimated cost of reinsurance of long-duration contracts that meets the conditions for reinsurance accounting depends on whether the reinsurance contract is long duration or short duration. The cost shall be amortized over the remaining life of the underlying reinsured contracts if the reinsurance contract is long duration, or over the contract period of the reinsurance if the reinsurance contract is short duration. Determining whether a contract that reinsures a long-duration insurance contract is long duration or short duration in nature is a matter of judgment, considering all of the facts and circumstances. The assumptions used in accounting for reinsurance costs shall be consistent with those used for the reinsured contracts. The difference, if any, between amounts paid for a reinsurance contract and the amount of the liabilities for policy benefits relating to the underlying reinsured contracts is part of the estimated cost to be amortized.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *Issue Paper No. 4—Definition of Assets and Admitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties*
- *Issue Paper No. 50—Classifications and Definitions of Insurance or Managed Care Contracts in Force*
- *Issue Paper No. 51—Life Contracts*
- *Issue Paper No. 52—Deposit-Type Contracts*
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 17 - Other Liabilities
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 21 - Commissions
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 24 - Reinsurance (including appendices A and B)
- NAIC Annual Statement Instructions for Life and Accident and Health Insurance Companies, Notes to Financial Statements and Schedule S

Generally Accepted Accounting Principles

- *FASB Statement No. 113*, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*
- *FASB Statement No. 5*, *Accounting for Contingencies*

State Regulations

- No additional guidance obtained from state statutes or regulations.

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Statutory Issue Paper No. 75

Property and Casualty Reinsurance

STATUS
Finalized March 16, 1998

Original SSAP: SSAP No.62; Current Authoritative Guidance: SSAP No. 62R

This issue paper may not be directly related to the current authoritative statement.

Type of Issue:
Property and Casualty

SUMMARY OF ISSUE

1. Reinsurance is the assumption by an insurer of all or part of a risk undertaken originally by another insurer. Current statutory guidance on the accounting for property and casualty reinsurance is contained in Chapters 7, 8, and 22 of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies (P&C Accounting Practices and Procedures Manual).

2. GAAP guidance on the accounting for property and casualty reinsurance is primarily contained in FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts* (FAS 113*)* and Emerging Issues Task Force Issue No. 93-6, *Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises* (EITF 93-6). In certain instances*,* FAS 113 differs from the current statutory guidance.

3. The purpose of this issue paper is to establish statutory accounting principles for property and casualty reinsurance that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. This issue paper applies to property and casualty contracts as defined in *Issue Paper No. 50—Classifications and Definitions of Insurance or Managed Care Contracts In Force*. The provisions of Chapter 8 of the P&C Accounting Practices and Procedures Manual that relate to reinsurance recoverable on paid losses (included in paragraph 16 of this issue paper) and Chapter 22 of the P&C Accounting Practices and Procedures Manual (Chapter 22) are adopted as the statutory accounting principles for property and casualty reinsurance except as modified in paragraph 5 below. In addition, the Annual Statement Instructions that require reinsurance disclosures in notes 11, 12, 13, 15, 16 and 17 to the Annual Statement are also adopted as statutory accounting principles.

5. Ceded reinsurance premiums payable (net of ceding commission) shall be classified as a liability. Consistent with *Issue Paper No. 76—Offsetting and Netting of Assets and Liabilities* (Issue Paper No. 76), ceded reinsurance premiums payable may be deducted from amounts due from the reinsurer, such as amounts due on assumed reinsurance, when a legal right of offset exists.

6. Notwithstanding the fact that reinsurance recoverables on paid losses may meet the criteria for offsetting under the provisions of Issue Paper No. 76, reinsurance recoverables on paid losses are to be reported as an asset without any available offset.

7. The Property and Casualty Annual Statement Instructions to Schedule F provide for a minimum reserve for uncollectible reinsurance with an additional reserve required if a company's experience indicates that a higher amount should be provided. The excess reserve over the minimum amount should

be charged through the Statement of Operations by reversing the accounts previously utilized to establish the reinsurance recoverable.

DISCUSSION

8. Statutory accounting for property and casualty reinsurance was recently revised through amendments to Chapter 22. These amendments adopted FAS 113 with modification and EITF 93-6 with modification. This issue paper rejects AICPA Statement of Position No. 92-5*, Accounting for Foreign Property and Liability Reinsurance*. As a result, the statutory accounting principles established by this issue paper are generally consistent with GAAP except for the following significant exceptions:

a. Reinsurance recoverables on unpaid case-basis and incurred but not reported losses and loss adjustment expenses shall be presented as a contra-liability netted against the liability for gross losses and loss adjustment expenses. Under GAAP, these recoverables are reported as assets.

b. Amounts paid for prospective reinsurance that meet the conditions for reinsurance accounting shall be reported as a reduction of unearned premiums whereas under GAAP, the unamortized portion of the amount paid for prospective reinsurance is recorded as a prepaid asset.

c. The gain created by a retroactive reinsurance contract because the amount paid to the reinsurer is less than the gross liabilities for losses and loss adjustment expenses ceded to the reinsurer is reported in the income statement as a write-in gain in “other income” by the ceding entity and a write-in loss by the assuming entity. The gain created by a retroactive reinsurance contract is restricted as a special surplus account until the actual retroactive reinsurance recovered is in excess of the consideration paid. Under GAAP, gains arising from retroactive reinsurance contracts are deferred and recognized over the settlement period.

d. Statutory accounting requires that a liability be established through a provision reducing surplus for unsecured reinsurance recoverables from unauthorized reinsurers and for certain overdue balances due from authorized reinsurers. Under GAAP, no such liability is required. However, both statutory accounting and GAAP require an assessment of the collectibility of recorded reinsurance recoverables.

e. Some reinsurance treaties contain adjustable features that provide for adjustment of commission, premium or amount of coverage, based on loss experience. Chapter 22 and EITF 93-6 require recognition of these adjustable features in the period in which the loss event(s) giving rise to the adjustment occurs. Under EITF 93-6, the asset or liability arising from the adjustable feature may be computed under the assumption that the treaty will be terminated prior to the end of its term if such termination is permitted under the contract and to do so results in a lower asset or liability (“lesser of” provision). Statutory accounting requires that the asset or liability arising from the adjustable feature be computed based on experience to date under the contract, and the impact of early termination may only be considered at the time the contract has actually been terminated.

f. Structured settlements are addressed in *Issue Paper No. 65—Property and Casualty Contracts* (Issue Paper No. 65). Statutory accounting and FAS 113 are consistent in accounting for structured settlement annuities where the reporting entity is the owner and payee, and where the claimant is the payee and the reporting entity has been released from its obligation. FAS 113 distinguishes structured settlement annuities where the claimant is the payee and a legally enforceable release from the reporting entity’s liability is obtained from those where the claimant is the payee but the reporting entity has not been released from its obligation. GAAP requires the deferral of any gain resulting from the purchase of a structured settlement annuity where the reporting entity has not been released from its obligation.

9. Reinsurance recoverables on paid losses and loss adjustment expenses are reported as an asset under both statutory accounting and GAAP. Reinsurance recoverables on unpaid losses and loss adjustment expenses also meet the statutory definition of an asset established in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*; however, this asset will continue to be presented as a contra-liability in statutory financial statements because a change to "gross" presentation would necessitate extensive changes in and restatement of the reporting of ceded reinsurance in schedules and exhibits of the Annual Statement. This "net" presentation is consistent with the reporting of salvage and subrogation established by *Issue Paper No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses*. Statutory requirements for offsetting and netting are addressed in Issue Paper No. 76.

10. The statutory reporting of amounts paid for prospective reinsurance contracts that have not been amortized to income described in subparagraph 8.b. is consistent with the "net" reporting discussed in paragraph 9.

11. The statutory accounting for gains and losses resulting from retroactive reinsurance contracts is consistent with the Statement of Concepts which states:

> The cornerstone of solvency measurement is financial reporting. Therefore, the regulator's ability to effectively determine relative financial condition using financial statements is of paramount importance.

12. The statutory requirement to establish a liability, Provision for Reinsurance, for unsecured reinsurance recoverables from unauthorized reinsurers and overdue balances from authorized reinsurers is contained in the Instructions to the Property and Casualty Annual Statement, Schedule F - Part 7 which are adopted in this issue paper as part of Chapter 22. The Schedule F provision for reinsurance was maintained as part of statutory accounting as an added measure of conservatism consistent with the Statement of Concepts. Maintaining this conservatism was deemed appropriate as there is no other apparent independent measure of the adequacy of the estimates. Maintaining this requirement is in contrast to the elimination of the excess statutory reserve in Issue Paper No. 65. It was determined that sufficient information is available to regulators regarding the adequacy of reserves such that the additional conservatism provided by the excess statutory reserve is no longer justified. Paragraph 7 of this issue paper requires that any portion of reinsurance recoverables deemed to be uncollectible as a result of a reporting entity's experience being higher that the amounts provided by the minimum Schedule F provision shall be written off through a charge to operations, whereas current statutory accounting would require any additional amount to be added to the Schedule F provision resulting in a direct charge to surplus. This change was made to reflect known losses as charges to operations as opposed to direct charges to surplus.

13. Statutory accounting requires the calculation related to adjustable features to be computed based on experience to date because, from a regulatory standpoint, it is improper to recognize the favorable impact of early termination of the contract until such time as the contract is actually terminated.

14. Ceded reinsurance premiums payable are no longer deducted from agents' balances and uncollected premiums because this payable meets the definition of a liability as established in *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets* and it does not meet the criteria for offsetting under the provisions of Issue Paper No. 76.

Drafting Notes/Comments

- Reinsurance for life and accident and health contracts is addressed in *Issue Paper No. 74—Life and Accident and Health Reinsurance*.

- Structured settlements for property and casualty insurers are addressed in *Issue Paper No. 65—and Casualty Contracts*.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

15. Chapter 7 of the P&C Accounting Practices and Procedures Manual, Agents' Balance or Uncollected Premiums, provides the following guidance on ceded premiums payable:

> Ceded Reinsurance Premiums Payable
>
> Ceded reinsurance premiums payable are those premiums that are due to other insurance companies for coverages purchased to reduce the ceding company's liability. Ceded reinsurance premiums payable are deducted from agents' balances or uncollected premiums in the balance sheet. (See Chapter 22 - Reinsurance.)

16. Chapter 8 of the P&C Accounting Practices and Procedures Manual provides the following guidance on reinsurance recoverable on paid losses:

> (f) Funds held or deposited with reinsured companies, whether they are premiums withheld for unearned premium and outstanding loss reserves or advances for loss payments, are admitted assets provided they do not exceed the liabilities they secure and provided the reinsured is solvent. Those funds which are in excess of the liabilities, and any funds held by insolvent reinsureds, should be nonadmitted.
>
> (h) Reinsurance recoverable on loss payments is an admitted asset. Unauthorized reinsurance is included in this asset and reflected separately as a liability to the extent required. Penalty for overdue on authorized companies will be reflected as a liability. (See Chapter 22 - Reinsurance.)

17. The guidance for calculating the penalty for unauthorized reinsurance and the penalty for overdue balances from authorized reinsurers is contained in the Annual Statement Instructions.

18. The current statutory accounting for property and casualty reinsurance is contained in the P&C Accounting Practices and Procedures Manual, Chapter 22, Reinsurance. Chapter 22 provides the following guidance with respect to the determination of whether a reinsurance contract qualifies for reinsurance accounting:

> Reinsurance Contracts Must Include Transfer of Risk
>
> The essential ingredient of a reinsurance contract is the shifting of risk. The essential element of every true reinsurance contract is the undertaking by the reinsurer to indemnify the ceding insurer (i.e., reinsured company), not only in form but in fact, against loss or liability by reason of the original insurance. Unless the so-called reinsurance contract contains this essential element of risk transfer, no credit whatsoever shall be allowed on account thereof in any accounting or financial statement of the ceding insurer**.**
>
> Insurance risk involves uncertainties about both (a) the ultimate amount of net cash flows from premiums, commissions, claims and claims settlement expenses (underwriting risk) and (b) the timing of the receipt and payment of those cash flows (timing risk). Actual or imputed investment returns are not an element of insurance risk. Insurance risk is fortuitous - the possibility of adverse events occurring is outside the control of the insured.
>
> Determining whether a contract with a reinsurer provides indemnification against loss or liability (transfer of risk) relating to insurance risk requires a complete understanding of that contract and other contracts or agreements between the ceding company and related reinsurers. A complete understanding includes an evaluation of all contractual features that (a) limit the amount of

insurance risk to which the reinsurer is subject (such as through experience refunds, cancellation provisions, adjustable features, or additions of profitable lines of business to the reinsurance contract) or (b) delay the timely reimbursement of claims by the reinsurer (such as through payment schedules or accumulating retentions from multiple years).

Indemnification of the ceding company against loss or liability relating to insurance risk in reinsurance requires both of the following:

1. The reinsurer assumes significant insurance risk under the reinsured portions of the underlying insurance contracts.

2. It is reasonably possible that the reinsurer may realize a significant loss from the transaction.

A reinsurer shall not be considered to have assumed significant insurance risk under the reinsured contracts if the probability of a significant variation in either the amount or timing of payments by the reinsurer is remote. Implicit in this condition is the requirement that both the amount and timing of the reinsurers payments depend on and directly vary with the amount and timing of claims settled by the ceding company. Contractual provisions that delay timely reimbursement to the ceding company would prevent this condition from being met.

The ceding company's evaluation of whether it is reasonably possible for a reinsurer to realize a significant loss from the transaction shall be based on the present value of all cash flows between the ceding and assuming companies under reasonably possible outcomes, without regard to how the individual cash flows are described or characterized. An outcome is reasonably possible if its probability is more than remote. The same interest rate shall be used to compute the present value of cash flows for each reasonably possible outcome tested. A constant interest rate shall be used in determining those present values because the possibility of investment income varying from expectations is not an element of insurance risk. Judgment is required to identify a reasonable and appropriate interest rate.

Significance of loss shall be evaluated by comparing the present value of all cash flows, determined as described in the above paragraph, with the present value of the amounts paid or deemed to have been paid to the reinsurer. If, based on this comparison, the reinsurer is not exposed to the reasonable possibility of significant loss, the ceding company shall be considered indemnified against loss or liability relating to insurance risk only if substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts has been assumed by the reinsurer. In this narrow circumstance, the reinsurers economic position is virtually equivalent to having written the insurance contract directly. This condition is met only if insignificant insurance risk is retained by the ceding company on the reinsured portions of the underlying insurance contracts, so that the reinsurers exposure to loss is essentially the same as the insurers.

Payment schedules and accumulating retentions from multiple years are contractual features inherently designed to delay the timing of reimbursement to the ceding company. Regardless of what a particular feature might be called, any feature that can delay timely reimbursement violates the conditions for reinsurance accounting. Transfer of insurance risk requires that the reinsurers payment to the ceding company depend on and directly vary with the amount and timing of claims settled under the reinsured contracts. Contractual features that can delay timely reimbursement prevent this condition from being met. Therefore, any feature that may affect the timing of the reinsurers reimbursement to the ceding company should be closely scrutinized.

19. The effective date for adopting the accounting and reporting requirements outlined in paragraph 18 are contained in Chapter 22 as follows:

> Effective Date: Transition Rule
>
> The revised accounting and reporting practices set forth in this chapter that were adopted on September 18, 1994 shall be effective for all accounting periods beginning on or after January 1, 1995 and shall apply to: (a) reinsurance contracts entered into, renewed, or amended on or after January 1, 1994, (an amendment is any revision or adjustment of contractual terms, but the payment of premiums or reimbursement of losses recoverable under the contract shall not constitute an amendment); and (b) reinsurance contracts in force on January 1, 1995 which cover losses occurring or claims made on or after that date on policies reinsured under such contracts.
>
> The revised accounting and reporting provisions shall not apply to: (a) reinsurance contracts which cover only losses occurring or claims made before January 1, 1994 and which were entered into before January 1, 1994, and were not subsequently renewed or amended; and (b) reinsurance contracts that expired before, and were not renewed or amended after, January 1, 1995.
>
> Previously reported amounts relating to contracts to which these revised accounting practices are not applicable shall not be restated. However, for accounting periods commencing on and after January 1, 1995, balances relating to contracts which were entered into, renewed or amended on or after January 1, 1994 and which do not transfer insurance risk shall be reclassified as deposits and shall be accounted for and reported in the manner described under the caption "Reinsurance Contracts Must Include Transfer of Risk".
>
> Insurers may elect to comply with these revised accounting practices for accounting periods commencing before January 1, 1995.

20. Chapter 22 requires the following accounting for reinsurance contracts that do not qualify for reinsurance accounting (i.e., do not transfer insurance risk):

> To the extent that a reinsurance contract does not, despite its form, transfer both components of insurance risk, all or part of the contract shall be accounted for and reported as deposits in the NAIC annual and interim financial statements in the following manner:
>
> 1. At the outset of the reinsurance contract the net consideration paid by the ceding company (premiums less commissions or other allowances) shall be recorded as a deposit on the ceding company's books and as a liability on the assuming company's books. The deposit may be reported as an admitted asset in the ceding company's annual statement (as a write-in item for other-than-invested assets) if (a) the assuming company is licensed, accredited or otherwise qualified in the ceding company's state of domicile under Section 1 of the NAIC Model Law on Credit for Reinsurance or (b) there are funds held by or on behalf of the ceding company which meet the requirements of Section 2 of that law. Throughout the life of the contract receipts and disbursements shall be recorded through the deposit/liability accounts. When the contract is completed, or when there is a loss payment in excess of the deposit, any difference between consideration and recoveries shall be recorded as other income or loss.
>
> 2. No deduction shall be made from the loss and loss adjustment expense reserves on the ceding company's balance sheet, schedules and exhibits.
>
> 3. The assuming company shall record net consideration to be returned to the ceding company as liabilities.

21. Chapter 22 requires the following accounting for reinsurance contracts that qualify for reinsurance accounting (i.e., transfer insurance risk).The guidance for retroactive reinsurance contracts was revised by the Property Casualty Reinsurance Study Group at its December 13, 1995 meeting. This

guidance was adopted by the membership of the NAIC at the March 1996 Plenary Session. Changes adopted have been underlined and struckthrough in this paragraph.

Accounting for Reinsurance

Reinsurance recoverables shall be recognized in a manner consistent with the liabilities (including estimated amounts for claims incurred but not reported) relating to the underlying reinsured contracts. Assumptions used in estimating reinsurance recoverables shall be consistent with those used in estimating the related liabilities. Accounting for members of a reinsurance pool shall follow the accounting for the pool member which wrote the underlying policy.

Accounting for reinsurance depends on whether the contract is considered prospective or retroactive. Prospective reinsurance is reinsurance in which a reinsurer agrees to reimburse a ceding company for losses that may be incurred as a result of future insurable events covered under contracts subject to the reinsurance. Retroactive reinsurance is reinsurance in which a reinsurer agrees to reimburse a ceding company for liabilities incurred as a result of past insurable events covered under contracts subject to the reinsurance. A reinsurance contract may include both prospective and retroactive reinsurance provisions.

The distinction between prospective and retrospective reinsurance contracts is based on whether the contract reinsures future or past insured events covered by the underlying insurance policies. For example, in occurrence-based insurance, the insured event is the occurrence of a loss covered by the insurance contract. In claims-made insurance, the insured event is the reporting to the insurer, within the period specified by the policy, of a claim for a loss covered by the insurance contract. A claims-made reinsurance contract that reinsures claims asserted to the reinsurer in a future period as a result of insured events that occurred prior to entering into the reinsurance contract is a retroactive contract. (However, a reinsurance contract that reinsures claims reported to an insurer that are covered under currently effective claims-made insurance policies is a prospective reinsurance contract.)

It is not uncommon for a reinsurance arrangement to be initiated before the beginning of a policy period but not finalized until after the policy period begins. Whether there was agreement in principle at the beginning of the policy period and, therefore, the contract is substantively prospective must be determined based on the facts and circumstances. However, except as respects business assumed by a U.S. reinsurer from ceding companies domiciled outside the U.S. and not affiliated with such reinsurer, or business assumed by a U.S. reinsurer where either the lead reinsurer or a majority of the capacity on the contract is domiciled outside the U.S. and is not affiliated with such reinsurer, if a contract entered into, renewed or amended on or after January 1, 1994 has not been finalized, reduced to a written form and signed by the parties within nine months after the commencement of the policy period covered by the reinsurance arrangement, then the arrangement is presumed to be retroactive and must be accounted for as a retroactive reinsurance contract. This presumption shall not apply to: (a) facultative reinsurance contracts; nor to (b) reinsurance contracts with more than one reinsurer which are signed by the lead reinsurer (i.e. the reinsurer setting the terms of the contract for the reinsurers) within nine months after the commencement of the policy period covered by the reinsurance contract; nor to (c) reinsurance contracts with more than one reinsurer (whether signed by the lead reinsurer or not) which were entered into, renewed or amended on or before December 31, 1996, (and which were not renewed or amended after that date) if reinsurers representing more than 50% of the capacity on the contract have signed cover notes, placement slips or similar documents describing the essential terms of coverage and exclusions within nine months after the commencement of the policy period covered by the reinsurance arrangement.

When practicable, prospective and retroactive provisions included within a single contract shall be accounted for separately. If separate accounting for prospective and retroactive provisions included within a single contract is impracticable, the contract shall be accounted for as a retroactive contract provided the conditions for reinsurance accounting are met.

Accounting for Prospective Reinsurance Contracts

Amounts paid for prospective reinsurance that meets the conditions for reinsurance accounting shall be reported as a reduction of written and earned premiums by the ceding company and shall be earned over the remaining contract period in proportion to the amount of reinsurance protection provided. If the amounts paid are subject to adjustment and can be reasonably estimated, the basis for amortization shall be the estimated ultimate amount to be paid.

Changes in amounts of estimated reinsurance recoverables shall be recognized as a reduction of gross losses and loss expenses incurred in the current periods statement of income. Reinsurance recoverables on paid losses shall be reported as an asset, reinsurance recoverables on loss and loss adjustment expense payments, in the balance sheet. Reinsurance recoverables on unpaid case-basis and incurred but not reported losses and loss adjustment expenses shall be netted against the liability for gross losses and loss adjustment expenses.

Accounting for Retroactive Reinsurance Contracts

Certain reinsurance contracts which transfer both components of insurance risk cover liabilities which occurred prior to the effective date of the contract. Due to potential abuses involving the creation of surplus to policyholders, and the distortion of underwriting results, a special accounting treatment for such agreements is warranted.

Effective for accounting periods commencing on or after January 1, 1995, all retroactive reinsurance contracts entered into, renewed or amended on or after January 1, 1994 (including subsequent development of such transactions) must be fully disclosed in the NAIC annual and interim financial statements required to be filed and shall be accounted for and reported in the following manner:

1. The ceding company must record, without recognition of the retroactive reinsurance, its loss and loss expense reserves on a gross basis on its balance sheet and in all schedules and exhibits.

2. The assuming company must exclude the retroactive reinsurance from its loss and loss expense reserves and from its schedules and exhibits.

3. The ceding company and the assuming company must report by write-in item on Page 3, the total amount of all retroactive reinsurance, identified as “retroactive reinsurance reserve ceded or assumed”, recorded as a contra-liability by the ceding company and as a liability by the assuming company.

4. The ceding company must, by write-in item on Page 3, restrict surplus resulting from any retroactive reinsurance as a special surplus fund, designated as “special surplus from retroactive reinsurance account”.

5. The surplus gain from any retroactive reinsurance may not be classified as unassigned funds [considered earned surplus] until such time as the actual retroactive reinsurance-recovered is in excess of the consideration paid.

6. The “special surplus from retroactive reinsurance account” for each respective retroactive reinsurance contract shall be reduced at the time the ceding company begins to recover funds from the assuming company in amounts exceeding the consideration paid by the ceding company under such agreement, or adjusted as provided in paragraph 10 below.

7. For each agreement, the reduction in the “special surplus from retroactive reinsurance” account must be limited to the lesser of:

    (a) the actual amount recovered in excess of consideration paid; or

(b) the initial surplus gain resulting from the respective retroactive reinsurance contract.

Any remaining balance in the "retroactive reinsurance reserve ceded or assumed", account derived from any such agreement must be returned to unassigned funds upon elimination of all policy obligations subject to the retroactive reinsurance contract.

8. The ceding company shall report the initial gain arising from a retroactive reinsurance transaction (i.e., the difference between the consideration paid to the reinsurer and the total reserves ceded to the reinsurer) as a write-in item on Page 4, to be identified as "Retroactive Reinsurance Gain" and included under "Other Income" in the Underwriting and Investment Exhibit Statement of Income.

9. The assuming company shall report the initial loss arising from a retroactive reinsurance transaction, as defined in the preceding paragraph 8, as a write-in item on Page 4, to be identified as Retroactive Reinsurance Loss and included under Other Income in the Underwriting and Investment Exhibit Statement of Income.

10. Any subsequent increase or reduction in the total reserves ceded under a retroactive reinsurance agreement shall be reported in the manner described in the preceding paragraphs 8 and 9, in order to recognize the gain or loss arising from such increase or reduction in reserves ceded. The "Special Surplus from Retroactive Reinsurance Account" write-in entry on Page 3 and the pertinent entry in the Notes to the Financial Statement shall be adjusted, upward or downward, to reflect such increase or reduction in reserves ceded. The "Special Surplus from Retroactive Reinsurance Account" write-in entry must be equal to or less than the total ceded reserves under all retroactive reinsurance agreements in-force as of the date of the financial statement. Special surplus arising from a retroactive reinsurance transaction shall be considered to be earned surplus (i.e., transferred to Unassigned Funds) only when cash recoveries from the assuming company exceed the consideration paid by the ceding company as respects such retroactive reinsurance transaction.

11. Each retroactive reinsurance contract shall be included in the Notes to Financial Statements relating to "Ceded or Assumed Unpaid Loss and Loss Adjustment Expenses".

12. The consideration paid for a retroactive reinsurance contract shall be reported as a decrease in Exhibit 3 ledger assets by the ceding company and as an increase in Exhibit 3 ledger assets by the assuming company (as a write-in item).

(For an illustration of ceding company accounting entries see Question 33 in Appendix A.)

This procedure regarding accounting for retroactive reinsurance contracts shall not apply to the following types of contracts (which shall be accounted for as prospective reinsurance contracts):

1. Structured settlement annuities for individual claims purchased to implement settlements of policy obligations;

2. Novations, i.e. (a) transactions in which the original direct insurer's obligations are completely extinguished, resulting in no further exposure to loss arising on the business novated or (b) transactions in which the original assuming company's obligations are completely extinguished, resulting in no further exposure to loss arising on the business novated, provided that (i) the parties to the transaction are not affiliates (or if affiliates, that the transaction has the prior approval of the domiciliary regulators of the parties) and (ii) the accounting for

the original reinsurance agreement will not be altered from retroactive to prospective

3. The termination of, or reduction in participation in, reinsurance treaties entered into in the ordinary course of business; or

4. Intercompany reinsurance contracts, and any amendments thereto, among companies 100% owned by a common parent or ultimate controlling person provided there is no gain in surplus as a result of the transaction.

Except for its accounting and reporting provisions, this procedure regarding retroactive reinsurance shall not apply to transactions transferring liabilities in connection with a court-ordered rehabilitation, liquidation or receivership with written approval of the ceding company's domiciliary commissioner.

Retroactive reinsurance contracts resulting in surplus gain to the ceding company (with or without risk transfer) entered into between affiliates or between insurers "under common control" (as those terms are defined in the NAIC Model Insurance Holding Company Regulatory Act) shall be reported in annual and interim statements as follows:

1. The consideration paid by the ceding company shall be recorded as a deposit and reported as a non-admitted asset in Exhibit 1; and

2. No deduction shall be made from loss and loss adjustment expense reserves on the ceding company's balance sheet, schedules and exhibits.

Required Terms for Reinsurance Contracts

In addition to credit for reinsurance requirements applicable to reinsurance transactions generally, no credit or deduction from liabilities shall be allowed for reinsurance recoverable in annual or interim statements required to be filed by the ceding company where the agreement was entered into after the effective date of these requirements unless each of the following conditions is satisfied:

1. The contract must contain an acceptable insolvency clause.

2. Recoveries due the ceding company must be available without delay for payment of losses and claim obligations incurred under the agreement, in a manner consistent with orderly payment of incurred policy obligations by the ceding company.

3. The agreement shall constitute the entire contract between the parties and must provide no guarantee of profit, directly or indirectly, from the reinsurer to the ceding company or from the ceding company to the reinsurer.

4. The agreement must provide for reports of premiums and losses, and payment of losses, no less frequently than on a quarterly basis. The report of premiums and losses shall set forth the ceding company's total loss and loss expense reserves on the policy obligations subject to the agreement, so that the respective obligations of the ceding company and reinsurer will be recorded and reported on a basis consistent with this manual.

5. With respect to retroactive reinsurance contracts the following additional conditions apply. The consideration to be paid by the ceding company for the retroactive reinsurance must be a sum certain stated in the agreement. Direct or indirect compensation to the ceding company or reinsurer is prohibited. Any provision for subsequent adjustment on the basis of actual experience in regard to policy obligations transferred, or on the basis of any other formula, is prohibited in connection with a retroactive reinsurance transaction, except that

provision may be made for the ceding company's participation in the reinsurer's ultimate profit, if any, under the agreement. A retroactive reinsurance contract may not be canceled or rescinded without the approval of the commissioner of the domiciliary state of the ceding company.

Characteristics of Reinsurance Contracts

Each reinsurance contract may be individually drafted. Commonly included contract provisions that may affect accounting practices include:

1. Reporting responsibility of the ceding insurer. Should be clearly spelled out both as to details required and time schedules.

2. Payment terms. Time schedules, currencies intended and the rights of the parties to withhold funds should be established.

3. Payment of premium taxes. Customarily the responsibility of the ceding company, a recital of nonliability of the reinsurer may be found.

4. Termination. May be on a "cut-off" or "run-off" basis. A "cut-off" provision stipulates that the reinsurer shall not be liable for loss as a result of occurrences taking place after the date of termination. A "run-off" provision stipulates that the reinsurer shall remain liable for loss under reinsured policies in force at the date of termination as a result of occurrences taking place after the date of termination until such time as the term of the policy expires.

5. Insolvency clause. Should provide for the survival of the reinsurer's obligations in the event of insolvency of the ceding company, without diminution because of the insolvency.

Reinsurance contracts shall not permit entry of an order of rehabilitation or liquidation to constitute an anticipatory breach by the insurer nor grounds for retroactive revocation or retroactive cancellation of any contracts of the insurer.

Reinsurance Assumed

The segregation of premiums, losses and expenses arising from reinsurance assumed transactions is required for the Underwriting and Investment Exhibit of the annual statement.

Non-proportional assumed reinsurance transactions should be included in the reinsurance lines of business in the annual statement under four subcategories while all proportional reinsurance (first dollar pro-rata reinsurance) must be allocated to the appropriate lines of business.

Reinsurance premiums receivable at the end of the accounting period are combined with direct business receivables and reported as "Agents' balances or uncollected premiums". Where the ceding insurer withholds premium funds pursuant to the terms of the reinsurance contract, such assets should be shown by the assuming company as "Funds held by or deposited with reinsured companies". Reinsurance premiums more than 90 days overdue should not be included as receivable except (a) to the extent the assuming insurer maintains unearned premium and loss reserves as to the ceding insurer, under normal principles of offset accounting, or (b) where the ceding insurer is licensed and in good standing in assuming insurer's state of domicile. Reinsurance premiums are due pursuant to the original contract terms (as the contract stood on the date of execution); in the absence of a specific contract date, reinsurance premiums will be deemed due thirty (30) days after the date on which (1) notice or demand of premium due is provided to the ceding insurer or (2) the assuming insurer books the premium (See Chapter 9 - Nonadmitted Assets).

A lag will develop between the time of the entry of the underlying policy transaction on the books of the ceding insurer and the transmittal of information and its entry on the books of the assuming company. Assuming companies shall estimate such unreported premiums and related costs to the extent necessary to prevent material distortions in the loss development contained in the assuming company's annual statement schedules where calendar year premiums are compared to accident year losses.

Amounts payable by reinsurers on losses are generally classified in the annual statement as unpaid losses. Assumed reinsurance payable on paid losses should be classified as a separate liability item on the balance sheet. IBNR losses on assumed reinsurance business are netted with ceded losses on the balance sheet but are shown separately by annual statement line of business in the Underwriting and Investment Exhibit.

Reinsurance Ceded

The Underwriting and Investment Exhibit of the annual statement presents segregated data on the premiums, losses and expenses from reinsurance ceded transactions in a manner similar to reinsurance assumed.

Ceded reinsurance transactions should be included in the annual statement line of business which relates to the direct or assumed transactions creating the cession or retrocession.

Premiums due reinsurers ("ceded balances payable") are shown as contra assets contained in "Agents' balances or uncollected premiums." Amounts that are withheld by the ceding company from sums that would otherwise be payable under the reinsurance contract are reportable as "Funds held by company under reinsurance treaties."

Adjustable Feature/Retrospective Rating

Reinsurance treaties may provide for adjustment of commission, premium, or amount of coverage, based on loss experience. Examples are:

1. Commission Adjustments:

   Contingent or Straight Profit—The reinsurer returns to the ceding company a stipulated percentage of the profit produced by the business assumed from the ceding insurer. Profit may be calculated for any specified period of time, but the calculation is often based on an average over a period of years.

   Sliding Scale—A provisional rate of commission is paid over the course of the treaty, with a final adjustment based on the experience of the business ceded under the treaty.

   An accrual shall be maintained for these adjustable features based upon the experience recorded for the period.

2. Premium Adjustments:

   The initial provisional or deposit premium is recalculated retrospectively, based on loss experience under the treaty during a specified period of time; the calculation is often based on an average over a period of years.

   If the reinsurance treaty incorporates an obligation on the part of the ceding company to pay additional premium to the assuming company based upon loss experience under the treaty, a liability in the amount of such additional premium shall be recognized by the ceding company during the accounting period in which the loss event(s) giving rise to the obligation to pay such additional premium occur(s). The assuming company shall recognize an asset in the same amount.

If the reinsurance treaty incorporates an obligation on the part of the assuming company to refund to the ceding company any portion of the consideration received by the assuming company based upon loss experience under the treaty, an asset in the amount of any such refund shall be recognized by the ceding company during the accounting period in which the loss event(s) giving rise to the obligation to make such refund occur(s). The assuming company shall recognize a liability in the same amount.

3. Adjustments in the Amount of Coverage:

The amount of coverage available for future periods is adjusted, upward or downward, based on loss experience under the treaty during a specified period of time.

If the reinsurance treaty incorporates a provision under which the reinsurance coverage afforded to the ceding company may be increased or reduced based upon loss experience under the treaty, an asset or a liability shall be recognized by the ceding company in an amount equal to that percentage of the consideration received by the assuming company which the increase or reduction in coverage represents of the amount of coverage originally afforded. Such asset or liability shall be recognized during the accounting period in which the loss event(s) (or absence thereof) giving rise to the increase or decrease in reinsurance coverage occur(s), and shall be amortized over all accounting periods for which the increased or reduced coverage is applicable. The term “consideration” shall mean, for this purpose, the annualized deposit premium for the period used as the basis for calculating the adjustment in the amount of coverage to be afforded thereafter under the treaty.

Effective Date

The accounting and reporting provisions set forth in paragraphs 1, 2 and 3 above shall be effective for all accounting periods beginning on or after January 1, 1996, and shall apply to reinsurance contracts entered into, renewed or amended on or after January 1, 1994.

Commissions

Commissions payable on reinsurance assumed business should be included as an offset to “Agents” Balances or Uncollected Premiums. Commissions receivable on reinsurance ceded business should be included as an offset to “Ceded Reinsurance Balances Payable”. (See Chapter 18 - Commissions.)

If the ceding commission paid under a non-proportional reinsurance contract exceeds the anticipated acquisition cost of the business ceded, the ceding company shall establish a liability, equal to the difference between the anticipated acquisition cost and the reinsurance commissions received, to be amortized pro rata over the life of the reinsurance contract.

Those reinsurance contracts drafted in form as pro rata but which, in fact, contain per loss deductibles to be retained by the ceding carrier shall be considered non-proportional for the purposes of the paragraph above.

Provision for Reinsurance

The liability “Provision for Reinsurance” is reflected on page three of the Annual Statement, and the change between years is recorded as a gain or loss directly to surplus.

The details of this calculation can be found in Schedule “F-Part 7” of the Annual Statement. The appropriate instructions for calculating this liability can be found in the Instructions to the Annual Statement.

This provision is calculated separately for unauthorized and authorized companies in Schedule F. An authorized reinsurer is one that is licensed, accredited or approved by the ceding insurers state of domicile; an unauthorized reinsurer is not so licensed, accredited or approved.

Disputed Items

Occasionally a reinsurer will question whether an individual claim is covered under a reinsurance contract or may even attempt to nullify an entire treaty. A ceding insurer, depending upon the individual facts, may or may not choose to continue to take credit for such disputed balances. The Annual Statement Instructions require notification of a dispute by a formal written communication from the reinsurer denying the validity of coverage. Additionally, the "Notes to Financial Statements" require footnote disclosure of material amounts and the status of disputed items. Furthermore, a ceding insurer may take no credit whatsoever for reinsurance recoverables in dispute with an affiliate.

Commutations

A commutation of a reinsurance contract is a transaction which results in the complete and final settlement and discharge of all present and future obligations between the parties arising out of the agreement.

Reasons for commuting reinsurance contracts often include: (1) perceived financial instability of the reinsurer, (2) inefficiencies associated with the runoff of longer tailed liabilities, (3) significantly different evaluation of ultimate loss costs or (4) the reinsurers withdrawal from the reinsurance marketplace.

In commutation agreements, the present value of the reinsurers estimated ultimate losses are paid by the reinsurer to the ceding insurer. The ceding insurer immediately establishes the ultimate loss reserve as its liability and the cash received as a negative paid loss, thus creating a reduction in policyholders surplus equal to the difference between the ultimate and present value of the loss reserve.

The reinsurer, on the other hand, has eliminated a loss reserve carried at ultimate cost for a cash payout calculated at present value. The result is an increase in policyholders surplus equal to the difference between the ultimate and present value of the loss reserves.

Commuted balances must be accounted for by writing them off through the accounts, exhibits and schedules in which they were originally recorded.

Uncollectible Reinsurance

Uncollectible reinsurance balances must be accounted for by writing them off through the accounts, exhibits and schedules in which they were originally recorded.

22. Chapter 22 requires the following disclosures with respect to reinsurance. The guidance for retroactive reinsurance contracts was revised by the Property Casualty Reinsurance Study Group at their December 13, 1995 meeting. This guidance was adopted by the membership of the NAIC at the March 1996 Plenary Session. Changes adopted have been underlined and struckthrough in this paragraph.

Reporting of Reinsurance Transactions

Ceded reinsurance disclosures in the Notes to Financial Statements of the annual statement indicates the impact on the insurers surplus if all its reinsurance were canceled. The effect of return commissions, sliding scale commissions, as well as minimum and maximum commissions, is required to be calculated and then measured as factors reducing surplus.

Portfolio reinsurance is the transfer of the entire liability of an insurer for in force policies or outstanding losses, or both, as respects a described segment of the insurers business. Loss portfolio transfers are to be accounted for as retroactive reinsurance which is discussed earlier in this chapter.

A specific interrogatory requires information on reinsurance of risk accompanied by an agreement to release the reinsurer from liability, in whole or in part, from any loss that may occur on the risk or portion thereof.

A commonly accepted practice among affiliated insurers is the sharing of underwriting results ("pooling") in accordance with predetermined ratios. This is normally accomplished by a procedure whereby all affiliated insurers reinsure their direct business with the major insurers. Business is then retroceded to the affiliates so that each member of the group receives its predetermined share of the gross group business.

Detailed disclosure of certain reinsurance transactions is required in various notes to financial statements. These include retroactive reinsurance, unsecured reinsurance recoverables, reinsurance recoverables in dispute, write off of uncollectible reinsurance, and reinsurance commutations.

23. Chapter 22 provides the following guidance on the National Flood Insurance Program:

National Flood Insurance Program

This program was created by the Federal Emergency Management Agency (FEMA) and is designed to involve private insurers in a "write-your-own" (WYO) flood insurance program financially backed by FEMA at no risk to the insurer. To become a participating WYO company, the insurer signs a document with the Federal Insurance Administration (FIA) of the Federal Emergency Management Agency known as the Financial Assistance/Subsidy Arrangement.

Premium rates are set by FEMA. The WYO participating companies write the flood insurance coverage qualifying for the program on their own policies, perform their own underwriting, premium collections, claim payments, administration, and premium tax payments for policies written under the program.

Monthly accountings are made to FIA and participants are allowed to draw upon FEMA letters of credit for deficiencies of losses, loss expenses and administrative expenses in excess of premiums, subject to certain percentage limitations on expenses.

For purposes of statutory reporting in the WYO participating insurers' annual statements, balances due from or to FEMA should be treated as ceded reinsurance balances receivable or payable in Schedule F, FEMA should be identified as the reinsurer and assigned the NAIC Company Code 46990.

24. The Annual Statement Instructions require the following disclosures related to reinsurance:

11. Unsecured Reinsurance Recoverables

Instruction:

If the company has with any individual reinsurers, authorized or unauthorized, an unsecured aggregated recoverables losses, paid and unpaid including IBNR, loss adjustment expenses, and unearned premium that exceeds 3% of the company's policyholder surplus, list each individual reinsurer and the unsecured aggregated recoverable pertaining to that reinsurer. If the individual reinsurer is part of a group, list the individual reinsurers, each of its related group members having reinsurance with the reporting company, and the total unsecured aggregate recoverables for the entire group.

Include: The NAIC group code number, where appropriate, and the Federal Employer Identification Number for each individual company.

12. Reinsurance Recoverable in Dispute

Instruction:

Reinsurance recoverable on paid and unpaid (including IBNR) losses in dispute by reason of notification, arbitration or litigation shall be identified in the schedule if the amounts in dispute from any company (and/or affiliate) exceeds 5% of the ceding company's policyholders surplus or if the aggregate of all disputed items exceeds 10% of the ceding company's policyholder surplus. "Notification" means a formal written communication from a reinsurer denying the validity of the coverage.

Illustration:

Name of Reinsurer	Total Amount in Dispute (Including IBNR)	Notification	Arbitration	Litigation
A - Reinsurer	$10,000			$10,000
B - Reinsurer	$20,000		$10,000	$10,.000
C - Reinsurer	$30,000	$30,000		

13. Reinsurance Assumed and Ceded

a. Instruction:

Report the maximum amount of return commission which would have been due reinsurers if they or you had canceled all of your company's reinsurance or if you or a receiver had canceled all of your company's insurance assumed as of the end of the period covered by this annual statement with the return of the unearned premium reserve. Equity amounts should be computed by applying the fixed or provisional commission rate for each contract to the unearned premium reserve. Line (iii) of Column 5 plus Line (iv) must equal Page 3, Column 1, Line 9.

Illustration:

	ASSUMED REINSURANCE		CEDED REINSURANCE		NET	
	(1) Premium Reserve	(2) Commission Equity	(3) Premium Reserve	(4) Commission Equity	(5) Premium Reserve	(6) Commission Equity
i. Affiliates	$ ______	$ ______	$ ______	$ ______	$ ______	$ ______
ii. All Other	______	______	______	______	______	______
iii. TOTAL	$ ______	$ ______	$ ______	$ ______	$ ______	$ ______

iv. Direct Unearned Premium Reserve $ ______

b. Instruction:

Additional or return commission predicated on loss experience or on any other form of profit sharing arrangements in this annual statement as a result of existing contractual arrangements are accrued as follows:

Illustration:

	REINSURANCE			
	(1) DIRECT	(2) Assumed	(3) Ceded	(4) NET
i. Contingent Commission	$ ______	$ ______	$ ______	$ ______
ii. Sliding Scale Adjustments	______	______	______	______
iii. Other Profit Commission Arrangements	______	______	______	______
iv. TOTAL	$ ______	$ ______	$ ______	$ ______

c. Instruction:

Disclose all contracts of reinsurance covering losses that have occurred prior to the inception of the contract that have not been accounted for in conformity with the instructions contained in the NAIC *Accounting Practices and Procedures* manual, Chapter 22.

Illustration:

All contracts of reinsurance covering losses that have occurred prior to the inception of the contract have been accounted for in conformity with the instructions contained in the NAIC *Accounting Policies and Procedures* manual, Chapter 22, except for the following:

15. Uncollectible Reinsurance

Instruction:

Describe uncollectible reinsurance written off during the year reported in the following annual statement classifications, including the names or names of the reinsurer(s):

1. Losses incurred;
2. Loss adjustment expenses incurred;
3. Premiums earned;
4. Other.

Illustration:

Uncollectible Reinsurance Balances Written Off Through Income and Expense

The Company has written off in the current year reinsurance balances due (from the companies listed below) in the amount of : $________, which is reflected as:

i.	Losses incurred	$ __________
ii.	Loss adjustment expenses incurred	$ __________
iii.	Premiums earned	$ __________
iv.	Other	$ __________

Company	Amount
XYZ	$ _______
ZYX	$ _______

16. Commutation of Ceded Reinsurance

Instruction:

Describe the commutation of ceded reinsurance during the year reported in the following annual statement classifications, including the name or names of the reinsurer(s):

i. Losses incurred $ __________
ii. Loss adjustment expenses incurred $ __________
iii. Premiums earned $ __________
iv. Other $ __________

Illustration:

Commutation of Ceded Reinsurance

The Company has reported in its operations in the current year as a result of commutation of reinsurance with the companies listed below, amounts which are reflected as:

i. Losses incurred $ __________
ii. Loss adjustment expenses incurred $ __________
iii. Premiums earned $ __________
iv. Other $ __________

Company	Amount
XYZ	$ _______
ZYX	$ _______

17. Retroactive Reinsurance

Instruction:

The following shall be completed for all retroactive reinsurance contracts that transfer liabilities for losses that have already occurred and that will generate special surplus transactions. Transactions utilizing "Deposit Accounting" shall not be reported in this note.

The insurer (assuming or ceding) shall assign a unique number to each retroactive reinsurance contract and shall utilize this number for as long as the contract exists. The summary (aggregate of all retroactive reinsurance contracts) is to be reported in the form below. For further guidance, refer to Chapter 22 of the NAIC *Accounting Policies and Procedures* manual. Analysis in a similar format on individual retroactive reinsurance contracts may be necessary upon request.

	Reported Company	
	(1)	(2)
As:	Assumed	Ceded
A. Reserves Transferred:		
1. Initial Reserves	$ __________	$ __________
2. Adjustments - Prior Year(s)	__________	__________
3. Adjustments - Current Year	__________	__________
4. Total	$ __________	$ __________
B. Consideration Paid or Received		
1. Initial	$ __________	$ __________
2. Adjustments - Prior Year(s)	__________	__________
3. Adjustments - Current Year	__________	__________
4. Total	$ __________	$ __________
C. Amounts Recovered/Paid (cumulative)		
1. Prior Year(s)	$ __________	$ __________
2. Current Year	__________	__________
3. Total	$ __________	$ __________
D. Special Surplus from Retroactive Insurance		
1. Initial	$ __________	$ __________
2. Adjustments - Prior Year(s)	__________	__________
3. Adjustments - Current Year	__________	__________
4. Closing Balance	$ __________	$ __________

E. List the other insurers included in the above transactions

Assumed Company	Amount	Ceded Company	Amount
	$ ________		$ ________
	________		________
	________		________
	________		________
Total	$ ________ *	Total	$ ________ *

* Total amounts must agree with totals in A.4.

25. The NAIC Annual Statement Instructions for Property and Casualty Insurance Companies provide the following guidance for line 3 of Schedule F-Part 7, Provision for Overdue Reinsurance:

> Line 3 - Line 1 x Line 2
> If the company's experience indicates that a higher amount should be provided, such higher amount should be entered

Generally Accepted Accounting Principles

26. As noted in paragraph 8, FAS 113 is generally consistent with Chapter 22. The paragraphs that follow are excerpts from FAS 113 which provide guidance on areas that differ from Chapter 22 (see paragraph 8 for a summary of differences).

27. FAS 113 eliminated the practice of insurance enterprises of reporting assets and liabilities relating to reinsured contracts net of the effects of reinsurance:

> Reporting Assets and Liabilities Related to Reinsurance Transactions
>
> 14. Reinsurance contracts that are legal replacements of one insurer by another (often referred to as assumption and novation) extinguish the ceding enterprise's liability to the policyholder and result in removal of related assets and liabilities from the financial statements of the ceding enterprise. Reinsurance contracts in which a ceding enterprise is not relieved of the legal liability to its policyholder do not result in removal of the related assets and liabilities from the ceding enterprise's financial statements. Ceding enterprises shall report estimated reinsurance receivables arising from those contracts separately as assets. Amounts paid to the reinsurer relating to the unexpired portion of reinsured contracts (prepaid reinsurance premiums) also shall be reported separately as assets.
>
> 15. Amounts receivable and payable between the ceding enterprise and an individual reinsurer shall be offset only when a right of setoff exists, as defined in Interpretation 39.
>
> 16. The amounts of earned premiums ceded and recoveries recognized under reinsurance contracts either shall be reported in the statement of earnings, as separate line items or parenthetically, or those amounts shall be disclosed in the footnotes to the financial statements.

28. FAS 113 contains the following guidance on retroactive reinsurance agreements:

> 22. Amounts paid for retroactive reinsurance that meets the conditions for reinsurance accounting shall be reported as reinsurance receivables to the extent those amounts do not exceed the recorded liabilities relating to the underlying reinsured contracts. If the recorded liabilities exceed the amounts paid, reinsurance receivables shall be increased to reflect the difference and the resulting gain deferred. The deferred gain shall be amortized over the estimated remaining settlement period. If the amounts and timing of the reinsurance recoveries can be reasonably estimated, the deferred gain shall be amortized using the effective interest rate inherent in the amount paid to the reinsurer and the estimated timing and amounts of recoveries from the reinsurer (the interest method). Otherwise, the proportion of actual recoveries to total estimated recoveries (the recovery method) shall determine the amount of amortization.
>
> 23. If the amounts paid for retroactive reinsurance exceed the recorded liabilities relating to the underlying reinsured contracts, the ceding enterprise shall increase the related liabilities or reduce the reinsurance receivable or both at the time the reinsurance contract is entered into, so that the excess is charged to earnings.
>
> 24. Changes in the estimated amount of the liabilities relating to the underlying reinsured contracts shall be recognized in earnings in the period of the change. Reinsurance receivables shall reflect the related change in the amount recoverable from the reinsurer, and a gain to be deferred and amortized, as described in paragraph 22, shall be adjusted or established as a result.[6] When changes in the estimated amount recoverable from the reinsurer or in the timing of receipts related to that amount occur, a cumulative amortization adjustment shall be recognized in earnings in the period of the change so that the deferred gain reflects the balance that would have existed had the revised estimate been available at the inception of the reinsurance transaction.

[6] Decreases in the estimated amount of the liabilities shall reduce the related amount recoverable from the reinsurer and accordingly reduce previously deferred gains. However, if the revised estimate of the liabilities is less than the amounts paid to the reinsurer, a loss shall not be deferred. The resulting difference shall be recognized in earnings immediately as described in paragraph 23.

29. EITF 93-6 contains the following guidance on multiple-year retrospectively rated reinsurance contracts:

> ISSUE
>
> An insurer (ceding enterprise) may enter into a multiple-year retrospectively rated reinsurance contract (RRC) with a reinsurer (assuming enterprise). Examples of these contracts may include transactions referred to as "funded catastrophe covers." These contracts include a "retrospective rating" provision that provides for at least one of the following based on contract experience: (1) changes in the amount or timing of future contractual cash flows, including premium adjustments, settlement adjustments, or refunds to the ceding enterprise, or (2) changes in the contract's future coverage. A critical distinguishing feature of these contracts is that part or all of the retrospective rating provision is obligatory such that the retrospective rating provision creates future rights and obligations as a result of past events. A retrospectively rated contract that could be canceled by either party without further obligation is not covered by this Issue.
>
> The issues are (1) to the extent that the ceding enterprise has an obligation to make payments to the reinsurer that would not have been required absent experience to date under the contract (for example, payments that would not have been required if losses had not been experienced), whether the ceding enterprise should recognize a liability and the assuming enterprise should recognize an asset, (2) to the extent that a ceding enterprise would be entitled to receive a payment from the reinsurer based on experience to date under the contract (for example, the ceding enterprise would receive a payment if no future losses occur), whether the ceding enterprise should recognize an asset and the assuming enterprise should recognize a liability, and (3) how to account for changes in coverage based on past experience under the contract.
>
> EITF DISCUSSION
>
> The Task Force reached a consensus that in order to be accounted for as reinsurance, a contract that reinsures risks arising from short-duration insurance contracts must meet all of the following conditions: (1) the contract must qualify as a short-duration contract under paragraph 7.a. of Statement 60, (2) the contract must not contain features that prevent the risk transfer criteria in paragraphs 8-13 of Statement 113 from being reasonably applied (and those criteria must be met), and (3) the ultimate premium expected to be paid or received under the contract must be reasonably estimable and allocable in proportion to the reinsurance protection provided as required by paragraph 14.a. and 14.b. of Statement 60 and paragraph 21 of Statement 113. If any of these conditions are not met, a deposit method of accounting should be applied by the ceding and assuming enterprises. With respect to condition (2) above, a Task Force member asked whether a contract could be split for purposes of evaluating risk transfer. An FASB staff representative responded that Statement 113 applies to "a contract" and that determining the substance of a contract is a judgmental matter. If an agreement with a reinsurer consists of both risk transfer and nonrisk transfer coverages that have been combined into a single legal document, those coverages must be considered separately for accounting purposes. The FASB staff representative noted that paragraphs 59 and 60 of Statement 113 indicate that the Board did not intend for different kinds of exposures combined in a program of reinsurance to be evaluated for risk transfer and accounted for together because that would allow contracts that do not meet the conditions for reinsurance accounting to be accounted for as reinsurance by being designated as part of a program that in total meets the conditions for reinsurance accounting.
>
> For contracts that meet all of the conditions described above, the Task Force reached the following consensuses:
>
> Issue 1. The ceding enterprise should recognize a liability and the assuming enterprise should recognize an asset to the extent that the ceding enterprise has an obligation to pay cash (or other consideration) to the reinsurer that would not have been required absent experience under the contract. The amount recognized in the current period should be computed, using a with-and-

without method, as the difference between the ceding enterprise's total contract costs before and after the experience under the contract as of the reporting date, including costs such as premium adjustments, settlement adjustments, and impairments of coverage. The amount of premium expense related to impairments of coverage should be measured in relation to the original contract terms. Future experience under the contract (that is, future losses and future premiums that would be paid regardless of past experience) should not be considered in measuring the amount to be recognized.

In applying the consensus reached in Issue 1, if the ceding enterprise could terminate the contract prior to the end of its term and if termination would change the amounts paid (for example, if terminating the contract would cost less than continuing the contract in force), the liability resulting from the contract should be measured as follows:

1. If a decision to terminate has been made, the measurement should be based on an assumption of termination and experience to date.

2. Otherwise, the measurement should be based on the lesser of the following:

   a. The total incremental cost that would be paid based on the with-and-without calculation assuming experience to date and assuming termination (that is, excluding the effects of future losses and future premiums that would have been paid regardless of experience to date) or

   b. The total incremental cost that would be paid based on the with-and-without calculation assuming experience to date and assuming no termination (that is, excluding the effects of future losses and future premiums that would have been paid regardless of experience to date).

Issue 2. The ceding enterprise should recognize an asset and the assuming enterprise should recognize a liability to the extent that any cash (or other consideration) would be payable from the assuming enterprise to the ceding enterprise based on experience to date under the contract.

Issue 3. The ceding enterprise and the assuming enterprise should account for changes in coverage in the same manner as changes in other contract costs. For example, the effects of decreases in coverage without a commensurate reduction in premium should be recognized as a loss by the ceding enterprise and as a gain by the assuming enterprise when the event causing the decrease in coverage takes place.

The Task Force noted that deposit accounting cannot be used to avoid loss recognition that would otherwise be required (for example, the ceding enterprise has no future coverage relating to the deposit with the reinsurer and therefore the deposit is not recoverable).

The provisions of these consensuses are effective as of July 22, 1993 (for example, they are to be initially applied no later than the third quarter of 1993 for calendar-year enterprises) and are to be initially applied in one of two ways:

1. By recognition of the net effect of applying the provisions at the beginning of an enterprise's current fiscal year as a cumulative effect of a change in accounting principle in accordance with paragraph 20 of Opinion 20. Under this approach, the disclosures required by paragraph 21 of Opinion 20 would be required as long as the income statement for the current fiscal year is presented. The Task Force noted that the provisions of Statement 3 apply to all interim periods presented.

2. By restatement of financial statements for all periods presented as long as that restatement is not prohibited by Statement 113.

The SEC Observer stated that in addition to the disclosures provided under Opinion 20, the SEC staff will require registrants to disclose the nature and the significance of the transactions giving rise to the change. The SEC Observer also noted that registrants would be required to make SAB 74 disclosures for the financial statements filed prior to the period in which this change is adopted.

The Task Force requested that the FASB staff views on Issue 93-6, distributed to the Task Force as Supplement No. 1 (Revised) to the Issue Summary and the FASB Viewpoints article, "Accounting for Reinsurance: Questions and Answers about Statement 113," be included in Appendix D of EITF Abstracts. [Note: See Appendix D, Topics No. 34 and 35.]

STATUS

A related issue was discussed in Issue No. 93-14, "Accounting for Multiple-Year Retrospectively Rated Insurance Contracts by Insurance Enterprises and Other Enterprises." That Issue considers how a multiple-year retrospectively rated contract arising from an insurance transaction that is not a reinsurance contract should be accounted for. The consensuses reached in Issue 93-14 were consistent with those reached in this Issue.

No further EITF discussion is planned.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 50—Classifications and Definitions of Insurance or Managed Care Contracts in Force*
- *Issue Paper No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses*
- *Issue Paper No. 65—Property and Casualty Contracts*
- *Issue Paper No. 76—Offsetting and Netting of Assets and Liabilities*
- Accounting Practices and Procedures Manual for Property and Casualty Insurance, Chapters 7, 8, and 22 (including Appendix A)
- NAIC Annual Statement Instructions for Property and Casualty Insurance Companies, Notes to Financial Statements and Schedule F
- Minutes of the December 3, 1995, meeting of the Property Casualty Reinsurance Study Group

Generally Accepted Accounting Principles

- *FASB Statement No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*
- *FASB Statement No. 5, Accounting for Contingencies*
- *FASB Emerging Issues Task Force Issue No. 93-6, Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises*-SEC Staff Accounting Bulletin No. 92, Accounting and Disclosures Relating to Loss Contingencies
- *AICPA Statement of Position No. 92-5, Accounting for Foreign Property and Liability Reinsurance*
- FASB Viewpoints, "Accounting for Reinsurance: Questions and Answers about Statement 113," FASB *Status Report*, February 26, 1993

State Regulations

- No additional guidance obtained from state statutes or regulations.

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National Association of Insurance Commissioners

Accounting Practices and Procedures Manual

As of March 2015

Volume III

NAIC

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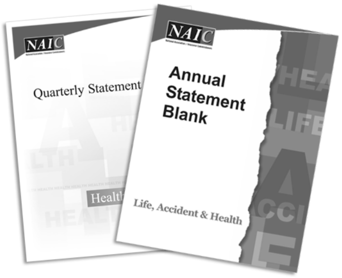
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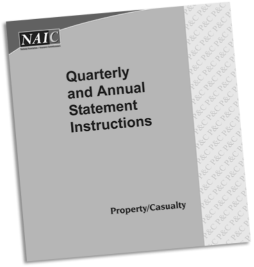
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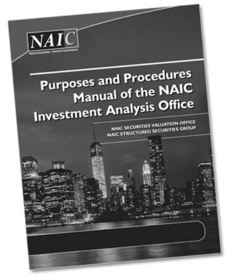
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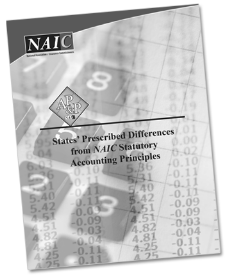

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DEDICATION

The *Accounting Practices and Procedures Manual* is dedicated to Norris Clark, California Department of Insurance (retired), Chair of the Codification of Statutory Accounting Principles Working Group, and its successors, the Statutory Accounting Principles and Emerging Accounting Issues (E) Working Groups from September 1994 through July 2004, and to Joseph Fritsch, New York Department of Financial Services (retired), Chair of the Statutory Accounting Principles (E) Working Group from 2004 through December 2012.

Your dedication, leadership, intelligence and passion were the driving forces behind the creation and continued development of the comprehensive statutory accounting and financial reporting model presented in this publication. Your contributions throughout the years are appreciated and will not be forgotten.

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How to Use This Manual

The contents of this manual are arranged as follows:

Volume I:

- Table of Contents
- Summary of Changes
- Preamble
- Statements of Statutory Accounting Principles
- Index to the Statements of Statutory Accounting Principles
- Glossary
- Appendix A – Excerpts of NAIC Model Laws
- Appendix B – Interpretations of the Emerging Accounting Issues (E) Working Group

Volume II:

- Appendix C – Actuarial Guidelines
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- Appendix E – Issue Papers 76-150
- Appendix F – Policy Statements
- Appendix G – Implementation Guide for the Model Audit Rule
- Appendix H – Superseded SSAPs and Nullified Interpretations (This appendix is no longer included within the printed Manual but is still accessible within the AP&P Folio View CD-ROM and on the "Updates to the Accounting Practices and Procedures (AP&P) Manual" webpage, www.naic.org/committees_e_app_manual_updates.htm).

The arrangement of material as indicated above is included in the Table of Contents at the front of each Volume. A detailed Table of Contents also proceeds each section covering the material within.

Summary of Changes:

This section provides a summary of the changes that were made to the As of March 2014 version of the *Accounting Practices and Procedures Manual* to create the As of March 2015 version. This is divided into substantive revisions to statutory accounting principles, nonsubstantive revisions to statutory accounting principles, and revisions to the appendices included in the Manual. This is a key resource for users who are looking to identify changes from the prior edition.

Preamble:

Each and every user of the Manual should read this section. Many regulators consider this document one of the most important parts of the Manual as it provides the foundation for statutory accounting principles (SAP). Some of the significant topics covered in the Preamble include codification project background, statement of concepts, statutory hierarchy, materiality and disclosures.

Statements of Statutory Accounting Principles:

As indicated by the Statutory Hierarchy, the Statements of Statutory Accounting Principles (SSAPs) are the primary authoritative statutory accounting practices and procedures promulgated by the NAIC. These statements are the result of issue papers that have been exposed for public comment and finalized. Finalized issue papers are in Appendix E and ARE NOT authoritative. While it is not intended that there be any significant differences between an underlying issue paper and the resultant SSAP, if differences exist, the SSAP prevails and shall be considered definitive. Readers may use the NAIC website to keep abreast of substantive and nonsubstantive

changes to the SSAPs. Completely superseded SSAPs are no longer authoritative and have been removed from the printed Manual but are available for reference on the "Updates to the Accounting Practices and Procedures (AP&P) Manual" webpage (www.naic.org/committees _e_app_manual_updates.htm). The completely superseded SSAPs have been retained in Appendix H – Superseded SSAPs and Nullified Interpretations within the AP&P Folio View CD-ROM.

The cover page of each SSAP contains a STATUS section that can affect the implementation of each SSAP. The STATUS section contains the following:

> TYPE OF ISSUE – SSAPs designated as Common Area apply to all insurers. Although the nomenclature or terms provided in the prescribed annual statement forms may vary among different types of insurers, only one set of nomenclature or terms may have been used in the SSAP. For example, the Statement of Income found in the Property and Casualty Annual Statement shall be considered as synonymous with the Summary of Operations found in the Life and Health Annual Statement.
>
> ISSUED – Date when the SSAP was adopted by the NAIC. SSAPs designated with Initial Draft were adopted by the NAIC Plenary in March 1998 as part of the Codification Project (SSAP Nos. 1-73). The date included for SSAP No. 74, and subsequent SSAPs, denotes when the Statutory Accounting Principles (E) Working Group adopted the SSAP.
>
> EFFECTIVE DATE – Date representing when the SSAP is effective. Many times there are additional details relative to the transition provided within the SSAP.
>
> AFFECTS/AFFECTED BY – A useful tool for tracking relationships between statements and interpretations is contained within these sections. The "affects" section is used when a SSAP substantively amends or supersedes previously issued SSAPs. Nullified INTs are also noted in this section. Readers are referenced to another SSAP in the "affected by" section if the SSAP has been substantively amended or superseded. Text within paragraphs substantively amended or superseded may also be "shaded" to notify readers that revised guidance is available.
>
> INTERPRETED BY – This section includes a reference to the applicable Interpretation (INT) of the Emerging Accounting Issues (E) Working Group contained within Appendix B of the Manual which provides interpretative guidance as a result of issues raised by users of the Manual or related GAAP guidance. INTs are generally effective when adopted. Readers should note that the Manual only contains the INTs finalized through December 2014 due to the fact that the Manual is published annually. Readers may use the NAIC website, as indicated on the inside front cover of the Manual, to keep abreast of recently issued INTs.

Refer to the Relevant Literature and Effective Date and Transition sections of the SSAP for details of substantive and nonsubstantive changes.

Appendix A – Excerpts of NAIC Model Laws:

In most cases, the source document for information included in Appendix A is an NAIC Model Regulation or Law. These Appendices are referenced by specific SSAPs and should only be used in context of the Appendix and the SSAP that references it.

Appendix B – Interpretations of the Emerging Accounting Issues (E) Working Group:

The Emerging Accounting Issues (E) Working Group (EAIWG) is responsible for responding to SAP questions that generally relate to application, interpretation and clarification. Appendix B includes the final interpretations of the EAIWG through December 2014. Once an INT is

finalized, the related SSAP will contain reference to the applicable INT. Interpretations that have been nullified are removed from the printed Manual and posted for reference on the "Updates to the Accounting Practices and Procedures (AP&P) Manual" webpage (www.naic.org/committees_e_app_manual_updates.htm). The nullified INTs are retained in Appendix H – Superseded SSAPs and Nullified Interpretations within the AP&P Folio View CD-ROM.

Appendix C – Actuarial Guidelines:

The NAIC Life Actuarial (A) Task Force and Health Actuarial (B) Task Force have been asked on many occasions to assist a particular state insurance department in interpreting a statute dealing with an actuarial topic relative to an unusual policy form or situation not contemplated at the time of original drafting of a particular statute. The Life Actuarial (A) Task Force and Health Actuarial (B) Task Force, in developing interpretations or guidelines, must often consider the intent of the statute, the reasons for initially adopting the statute and the current situation. The Life Actuarial (A) Task Force and Health Actuarial (B) Task Force feel that for those situations which are sufficiently common to all states, the publishing of actuarial guidelines on these topics would be beneficial to the regulatory officials in each state and would promote uniformity in regulation which is beneficial to everyone. To this end, the Life Actuarial (A) Task Force and Health Actuarial (B) Task Force have developed certain actuarial guidelines and will continue to do so as the need arises. The guidelines are not intended to be viewed as statutory revisions but merely a guide to be used in applying a statute to a specific circumstance.

Appendix D – GAAP Cross-Reference to SAP:

As expressed in the Statement of Concepts, SAP utilizes the framework established by Generally Accepted Accounting Principles (GAAP). Appendix D includes GAAP pronouncements that have been considered in the development of SAP. This listing includes GAAP pronouncements issued through December 2014. This Appendix is a valuable and efficient tool for readers who are interested in the status of a particular GAAP pronouncement in the SAP model.

Appendix E – Issue Papers:

This section includes all of the issue papers associated with SSAPs adopted by the Statutory Accounting Principles (E) Working Group through December 2014. The issue papers are used as the first step in developing new SSAPs and contain a recommended conclusion, discussion and relevant literature section. Issue papers **DO NOT** constitute an authoritative level of statutory accounting, as supported by the statutory hierarchy, and should only be used as reference material. Nevertheless, issue papers are an important part of the Manual because they reference the history and discussion of the related SSAP. The "Relevant Statutory Accounting and GAAP Guidance" section of the issue paper contains excerpts of accounting guidance in place at the time the Statutory Accounting Principles (E) Working Group considered (but not necessarily adopted) when forming the conclusions reached in the resultant SSAP.

Appendix F – Policy Statements:

This section includes the NAIC Policy Statements applicable to SAP. These statements provide the basis by which SAP is maintained, documentation of the agenda process and other important issues that affect this manual.

Appendix G – Implementation Guide for Model Audit Rule:

This section includes the NAIC Implementation Guide for the Model Audit Law. This section is for informational purposes. The Implementation Guide should not be viewed as a requirement of complying with the *Accounting Practices and Procedures Manual.*

Appendix H – Completely Superseded SSAPs and Nullified Interpretations

In 2013, the Statutory Accounting Principles (E) Working Group adopted a proposal to remove completely superseded SSAPs and nullified interpretations (INTs) from the printed Manual and

include these items on the "Updates to the Accounting Practices and Procedures (AP&P) Manual" webpage (www.naic.org/committees_e_app_manual_updates.htm). By including on this password-protected updates page, all who annually subscribe to the printed *Accounting Practices and Procedures Manual* will continue to have access to the superseded and nullified guidance for historical purposes. The completely superseded SSAPs and nullified INTs have been retained in Appendix H – Superseded SSAPs and Nullified Interpretations within the AP&P Folio View CD-ROM.

How to Use this Manual …

... to account for a certain item under NAIC SAP

As the SSAPs represent the highest level of NAIC statutory authority, readers should begin their search there. The Index to SSAPs is a useful tool to identify which SSAP(s) address the issue. Once the pertinent SSAP has been identified, it can be used to locate other documents that may also address the issue. On the SSAP cover page, readers will be referred to other SSAPs if there have been substantive changes made to it or INTs if there have been interpretations of the SSAP. Within the body of the SSAP, readers may be referred to Appendix A or C for further guidance. There is a reference located at the end of each SSAP to issue paper(s) used in the development of the SSAP. The DISCUSSION section of the issue paper provides documentation supporting the conclusions reached in the SSAP. As supported by the statutory hierarchy, readers should only utilize the issue papers as support to the SSAP as they ARE NOT authoritative. The Statutory Hierarchy contains a detailed listing of levels of authoritative literature.

... to compare SAP to GAAP for a particular issue

Appendix D is an excellent reference for users who are interested in determining how SAP addresses an issue that has been adopted by GAAP. Appendix D provides a reference to the SSAP or INT that addresses a particular GAAP pronouncement. As indicated in the Preamble, users should not utilize GAAP until and unless adopted by the NAIC. Within the body of the applicable SSAP or INT, readers will find documentation as to the reason for adoption, rejection, or adoption with modification of a particular GAAP pronouncement.

... to identify the relationship between the Manual and State law

Once a reader has identified the accounting treatment for a particular transaction or issue within the Manual, one must consider the effect of state law. That is, the Manual is not intended to preempt states' legislative and regulatory authority. It is intended to establish a comprehensive basis of accounting recognized and adhered to if not in conflict with state statutes and/or regulations, or when the state statutes and/or regulations are silent. For instance, if a state prohibits the admission of goodwill, insurers domiciled in that state are required to nonadmit all goodwill instead of following the NAIC guidance contained within *SSAP No. 68—Business Combinations and Goodwill*. Insurers should refer to their state laws and regulations regarding deviations from this manual.

... to obtain updates to the latest published Manual

The Manual contains information as of December 2014. Please note that there will be modifications to the accounting pronouncements included in the Manual from year to year, as such guidance is subject to the maintenance process. To address this, the NAIC has a website dedicated to providing updates on the latest information impacting statutory accounting. A user must pre-order the As of March 2016 Manual in order to obtain access to the changes occurring during 2015 that are maintained within this password-protected website. Once access is granted, a user may enter the website and download an issue paper, statement of statutory accounting principles, appendix or interpretation that affects the Manual. This website also includes the latest minutes of the Statutory Accounting Principles (E) Working Group and Emerging Accounting Issues (E) Working Group. To learn more about how to obtain updates to the latest published Manual, refer to the Maintenance Process page, which precedes the Table of Contents.

... to learn how changes are made to the Manual and how to stay abreast of such changes

Appendix F contains several NAIC Policy Statements that document the process by which the Manual will be modified. It also outlines the process by which the Statutory Accounting Principles (E) Working Group and the Emerging Accounting Issues (E) Working Group will conduct their business. Readers are able to track the development of SAP by attending the national meetings of the working groups or through use of the NAIC website. Further details regarding the website can be found at www.naic.org.

... to contact the NAIC regarding questions about the Manual

The following NAIC staff may be contacted regarding questions about the Manual:

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Josh Arpin	Accounting and Reinsurance Policy Advisor	Statutory Accounting Reinsurance	(816) 783-8481	jarpin@naic.org
SVO		SVO P&P Manual	(212) 398-9000	SVOinquirydesk@naic.org
Statutory Accounting & Reporting Help Line		Annual Statement Reporting & Statutory Accounting	(816) 783-8400	

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Summary of Changes to the *As of March 2014 Version* of the *Accounting Practices and Procedures Manual* included in the *As of March 2015 Version*

The following represents a summary of the changes that were made to the *As of March 2014* version of the *Accounting Practices and Procedures Manual* (Manual) to create the *As of March 2015* version.

The first section summarizes substantive revisions to statutory accounting principles. Substantive revisions introduce original or modified accounting principles. Substantive revisions can be reflected in an existing SSAP or a new SSAP. When substantive revisions are made to an existing SSAP, the front of the SSAP identifies the substantive changes and effective date of the substantive revisions. If substantive revisions in an existing SSAP are depicted by underlines (new language) and strikethroughs (removed language), this tracking will not be shown in subsequent manuals. Substantively revised SSAPs and new SSAPs usually refer to a corresponding issue paper that will reflect the substantive revisions for historical purposes. If language in an existing SSAP is superseded, the superseded language is shaded, with the reader referred to the new or substantively revised SSAP. SSAPs that are completely superseded and interpretations that are nullified are included in Appendix H.

The second section summarizes the nonsubstantive revisions to statutory accounting principles. Nonsubstantive changes are characterized as language clarifications which do not modify the original intent of a SSAP, or changes to reference material. Nonsubstantive changes are depicted by underlines (new language) and strikethroughs (removed language) and will not be shown as marked in subsequent manuals.

The third section summarizes any revisions to the appendices in the Manual.

1. Substantive Revisions – Statutory Accounting Principles		
Section	**Reference**	**Description**
SSAP No. 40R SSAP No. 48	2013-17	Revisions related to wholly-owned single real estate held in an LLC, which meets specific conditions, with an effective date of Jan. 1, 2015.
SSAP No. 106 SSAP No. 35R	2014-01 2014-13	New SSAP moves guidance on the Affordable Care Act Section 9010 from SSAP No. 35R and includes nonsubstantive edits to the disclosures.
SSAP No. 107 SSAP No. 35R	2014-12 2013-28	New SSAP addresses the risk-sharing provisions of the Affordable Care Act known as risk adjustment, reinsurance and risk corridors. With this adoption, the disclosures previously located within SSAP No. 35R are moved to this SSAP and INT 13-04 is nullified.
2. Nonsubstantive Revisions – Statutory Accounting Principles		
Section	**Reference**	**Description**
Preamble	2013-35	Revisions clarify that as of Sept. 15, 2009, AICPA SOPs will no longer be reviewed for statutory accounting.
SSAP No. 1 SSAP No. 4	2014-16	Revisions clarify the guidance for restricted assets.
SSAP No. 3 SSAP No. 68	2013-29	Revisions clarify that the disclosure exemption for mergers with shell entities does not change the Jan. 1 date to determine the cumulative effect in accounting principle.
SSAP No. 11	2014-07	Revisions identify the adoption of specific paragraphs from *Accounting Principles Board Opinion (APB) 12, Omnibus Opinion – 1967* and add guidance to reflect previously adopted GAAP, with minor technical edits.
SSAP No. 16R	2014-04	Revisions make the capitalization policy disclosure consistent with other SSAPs.

SSAP No. 19 SSAP No. 22	2014-05	Revisions adopt with modification *ASU 2014-05–Service Concession Arrangements* to clarify that service concession arrangements are not within the scope of SSAP No. 22 and shall not be recognized as property, plant or equipment in SSAP No. 19.
SSAP No. 26 SSAP No. 43R	2014-02	Revisions incorporate a new “structured note” disclosure and clarify that the guidance in SSAP No. 43R pertains to structured securities, not structured notes.
SSAP No. 35R	2013-28	Revisions include disclosures pertaining to the risk-sharing provisions of the Affordable Care Act programs (risk adjustment, reinsurance and risk corridors). These disclosures were subsequently moved to SSAP No. 107.
SSAP No. 55	2014-19	Revisions clarify that claims-related losses for extra contractual obligations and bad faith lawsuits are to be included in losses. Also, technical revisions related to prepaid adjustment expenses.
SSAP No. 56	2014-18	Revisions clarify the reporting of separate accounts disclosures.
SSAP No. 57	2014-06	Revisions to the disclosure requirements, with corresponding terminology revisions.
SSAP No. 86	2013-32	Revisions adopt *ASU 2013-10–Inclusion of the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) as a Benchmark Interest Rate for Hedge Accounting Purposes.* This ASU defines a benchmark interest rate and eliminates the restriction on different rates for similar hedges.
	2014-09	Revisions reject *ASU 2014-03–Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps—Simplified Hedge Accounting Approach (PCC)* as not applicable.
	2014-11	Revisions clarify the reporting of derivatives between Schedule DB and the balance sheet.
SSAP No. 92 SSAP No. 102	2013-37	Revisions adopt by reference *ASU 2011-09–Disclosures about an Employer’s Participation in a Multiemployer Plan* and incorporate limited additional disclosures for multiemployer plans.
SSAP No. 97	2013-31	Revisions add reference in Appendix B – Determining the Valuation Method, to the SSAP’s downstream holding company guidance.
SSAP No. 101	2014-20	Revisions clarify the RBC authorized control level used in the DTA calculation.
SSAP No. 104R	2014-17	Revisions adopt *ASU 2014-12–Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period* with an effective date of Jan. 1, 2016, with early adoption permitted.
3. Revisions to the Appendices		
Section	**Reference**	**Description**
Appendix A	2014-21	Revisions incorporate changes to *Appendix A-010: Minimum Reserve Standards for Individual and Group Health Insurance Contracts* to allow the 2012 Group Long-Term Disability Table adopted by the Health Actuarial (B) Task Force with a Jan. 1, 2017, effective date and early adoption permitted.

Appendix B	2013-04 (EAIWG) 2014-12 (SAPWG) 2014-26 (SAPWG)	*INT 13-04: Accounting for the Risk-Sharing Provisions of the Affordable Care Act* was adopted to provide temporary guidance on the risk-sharing provisions. This INT was subsequently nullified by SSAP No. 107 and moved to Appendix H. Placement revisions move GAAP guidance identified as rejected from INT 99-00 into Issue Paper No. 99. INT 99-00 was nullified and moved to Appendix H.
Appendix C	2014-22	*Actuarial Guideline XLVII: Application of Company Experience in the Calculation of Claim Reserves Under the 2012 Group Long-Term Disability Valuation Table* has been added. *Actuarial Guideline XLVIII: Actuarial Opinion and Memorandum Requirements for the Reinsurance of Policies Required to be Valued Under Sections 6 and 7 of the NAIC Valuation of Life Insurance Policies Model Regulation* (Model 830) has been added. Actuarial Interpretations 38 through 41 have been added to Appendix C2.
Appendix D	2013-35	Revisions update the appendix based on the consideration of GAAP through the statutory review process. These revisions are not tracked as changes. Additionally, revisions clarify that as of Sept. 15, 2009, AICPA SOPs will no longer be reviewed for statutory accounting.
Appendix E	2013-34 2014-03 2014-14 2013-35 2014-26 2014-08 2014-01 2014-13 2013-17 2014-12	Revisions reflect the rejection of the following GAAP guidance as not applicable to statutory accounting in *Issue Paper No. 99—Nonapplicable GAAP Pronouncements* (Issue Paper No. 99): • *ASU 2012-04–Technical Corrections and Improvements* • *ASU 2013-12–Definition of a Public Business Entity, An Addition to the Master Glossary* • *ASU 2014-10–Development Stage Entities* • *SOP 09-1–Performing Agreed-Upon Procedures Engagements That Address the Completeness, Accuracy, or Consistency of XBRL-Tagged Data* Placement revisions move GAAP guidance identified as rejected from INT 99-00 into Issue Paper No. 99. Additionally, revisions add reference of the original SSAP that corresponds with each issue paper, as well as the current authoritative SSAP guidance. The following issue papers were adopted or amended: • *Issue Paper No. 148—Affordable Care Act Section 9010 Assessment* • *Issue Paper No. 149—Wholly-Owned Single Real Estate Property in an LLC* • *Issue Paper No. 150—Accounting for the Risk-Sharing Provisions of the Affordable Care Act*
Appendix F	N/A	No revisions have been made to this appendix.
Appendix G	N/A	No revisions have been made to this appendix.
Appendix H	2014-26 2013-04 (EAIWG) 2014-12 (SAPWG)	Revisions add nullified INTs: • *INT 99-00: Compilation of Rejected EITFs* • *INT 13-04: Accounting for the Risk-Sharing Provisions of the Affordable Care Act*

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Appendix E
Statutory Issue Papers

Introduction

Appendix E includes all of the issue papers associated with SSAPs adopted through December 2014. The issue papers are used as the first step in developing new or substantively revised SSAPs and contain a recommended conclusion, discussion, and relevant literature section. While the issue papers do not constitute an authoritative level of statutory accounting guidance, as defined by the statutory hierarchy, they are an important part of this Manual because they reference the history and discussion of the related SSAP.

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Statutory Issue Paper No. 76

Offsetting and Netting of Assets and Liabilities

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 64

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory guidance does not provide guidance on the reporting of assets and liabilities when a valid right of setoff exists (offsetting). As a result amounts are not consistently netted for statutory reporting. However, current statutory accounting does require that certain assets and liabilities be shown as a net amount for reporting purposes (netting) regardless of whether a valid right of setoff exists.

2. GAAP guidance on offsetting is provided in paragraph 7 of *Accounting Principles Board Opinion No. 10*, *Omnibus Opinion - 1966* (APB 10) and *FASB Interpretation No. 39, Offsetting of Amounts Related to Certain Contracts* (FIN 39). This guidance allows offsetting only when a valid right of setoff exists and specified conditions are met or where netting is specifically permitted by other GAAP pronouncements. FIN 39 defines the conditions under which a valid right of setoff exists.

3. The purpose of this issue paper is to establish statutory accounting principles on offsetting assets and liabilities that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts) and to provide a reporting mechanism for the netting of assets and liabilities when required by this codification.

SUMMARY CONCLUSION

4. Assets and liabilities shall be offset and reported net only when a valid right of setoff exists except as provided for in paragraphs 5 and 7. A right of setoff is a reporting entity's legal right, by contract or otherwise, to discharge all or a portion of the debt owed to another party by applying against the debt an amount that the other party owes to the reporting entity. A valid right of setoff exists only when all the following conditions are met:

   a. Each of the two parties owes the other determinable amounts. An amount shall be considered determinable for purposes of this provision when it is reliably estimable by both parties to the agreement.

   b. The reporting party has the right to setoff the amount owed with the amount owed by the other party.

   c. The reporting party intends to setoff.

   d. The right of setoff is enforceable by law.

5. Assets and liabilities that meet the criteria for offset shall not be netted when prohibited by specific issue papers. An example of such is in the case of reinsurance recoverables on paid losses and ceded premiums payable as provided for in *Issue Paper No. 75—Property and Casualty Reinsurance* (Issue Paper No. 75).

6. Amounts due to or from affiliates shall be offset and reported net only when the provisions of paragraph 4 above are met.

7. Netting of assets and liabilities for reporting purposes when no valid right of setoff exists shall be allowed only when provided for by specific issue papers. An example of such is in the case of real estate investments required to be shown net of encumbrances as provided for in *Issue Paper No. 40—Real Estate Investments* (Issue Paper No. 40).

DISCUSSION

8. The conclusions above require offsetting when a valid right of setoff exists, unless prohibited in specific issue papers. This issue paper adopts paragraphs 1, 7, and 13 of APB 10 and FIN 39 with a modification to prohibit offsetting as provided in specific issue papers and require netting when provided in specific issue papers. GAAP uses the same criteria to permit offsetting as described in paragraph 4 of this issue paper and also permits netting where existing GAAP literature specifically prescribes it. Because this modification exists, there will be circumstances where items are offset under GAAP but not under statutory accounting principles.

9. Likewise, there are instances as provided for in specific issue papers where balances which do not meet the criteria in paragraph 4 are shown net for statutory reporting purposes where existing GAAP literature would not allow the amounts to be reflected as a single net balance. This difference is reflective of the varying objectives of regulation.

10. *FASB Interpretation No. 41, Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements* (FIN 41) is a further interpretation of paragraph 7 of APB 10 and FIN 39. The guidance adopted in *Issue Paper No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements* (Issue Paper No. 45) is consistent with FIN 41. However, Issue Paper No. 45 did not adopt FIN 41 because offsetting was not addressed in its entirety in the paper. The adoption of paragraph 7 of APB 10 and FIN 39 make it appropriate to adopt FIN 41 in this issue paper. This issue paper also adopts *FASB Emerging Issues Task Force No. 86-25, Offsetting Foreign Currency Swaps*.

11. The statutory principles outlined in the conclusion above are consistent with the consistency concept in the Statement of Concepts. A pertinent excerpt follows:

> Consistency
>
> The regulators' need for meaningful, comparable financial information to determine an insurer's financial condition requires consistency in the development and application of statutory accounting principles.

12. The conclusions reached in this issue paper are consistent with the definition of liabilities in *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets* (Issue Paper No. 5) which defines a liability as *certain or probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or to provide services to other entities in the future as a result of past transaction(s) or event(s)* and the definition of assets in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets* (Issue Paper No. 4) which defines an asset as *probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events*. Assets and liabilities exist independent of each other unless the requirements of paragraph 4 of this issue paper are met.

Drafting Notes/Comments

- *Issue Paper No. 2—Definition of Cash* requires netting cash accounts with positive and negative balances.

- *Issue Paper No. 40—Real Estate Investments* requires encumbrances on real estate investments to be netted against the investment.
- *Issue Paper No. 74—Life, Deposit-Type and Accident and Health Reinsurance* prohibits offsetting of reinsurance recoverables on paid losses with ceded premiums payable and requires due premiums from policyholders to be netted with premiums due the reinsurer.
- *Issue Paper No. 75—Property and Casualty Reinsurance* prohibits offsetting of reinsurance recoverables on paid losses with ceded premiums payable.
- *Issue Paper No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements* addresses FIN 41, *Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements*.

RELEVANT STATUTORY AND GAAP GUIDANCE

Statutory Accounting

13. The Property and Casualty Accounting Practices and Procedures Manual (P&C Accounting Practices and Procedures Manual), Chapter 22, Reinsurance, provides the following guidance:

> Accounting for Prospective Reinsurance Contracts:
>
> Amounts paid for prospective reinsurance that meet the conditions for reinsurance accounting shall be reported as a reduction of written and earned premiums by the ceding company and shall be earned over the remaining contract period in proportion to the amount of reinsurance protection provided. If the amounts paid are subject to adjustment and can be reasonably estimated, the basis for amortization shall be the estimated ultimate amount to be paid.
>
> Changes in amounts of estimated recoverables shall be recognized as a reduction of gross losses and loss expenses incurred in the current period's statement of income. Reinsurance recoverables on paid losses shall be reported as an asset, "reinsurance recoverables on loss and loss adjustment expense payments", in the balance sheet. Reinsurance recoverables on unpaid case-basis and incurred but not reported losses and loss adjustment expenses shall be netted against the liability for gross losses and loss adjustment expenses.
>
> Accounting for Retroactive Reinsurance Contracts:
>
> Certain reinsurance contracts which transfer both components of insurance risk cover liabilities which occurred prior to the effective date of the contract. Due to potential abuses involving the creation of surplus to policyholders, and the distortion of underwriting results, a special accounting treatment for such agreements is warranted.
>
> Effective for accounting periods commencing on or after January 1, 1995, all retroactive reinsurance contracts entered into, renewed or amended on or after January 1, 1994 (including subsequent development of such transactions) must be fully disclosed in the NAIC annual and interim financial statements required to be filed and shall be accounted for in the following manner:
>
> 1. The ceding company must record, without recognition of the retroactive reinsurance, its loss and loss expense reserves on a gross basis on its balance sheet and in all schedules and exhibits.
>
> 2. The assuming company must exclude the retroactive reinsurance from its loss and loss expense reserves and from its schedules and exhibits.
>
> 3. The ceding company and the assuming company must report by write-in item on Page 3, the total amount of all retroactive reinsurance, identified as "retroactive reserve ceded or assumed" recorded as a contra-liability by the ceding company and as a liability by the assuming company.

14. The P&C Accounting Practices and Procedures Manual, Chapter 4, Real Estate, provides the following guidance:

> Book Value
>
> In general, book value refers to amounts at which individual items are stated in books of account of in financial statements. For real estate that is occupied by the company, and for investment in real estate, this would be cost or other basic value, stated net of any encumbrances, plus additions and increases by adjustments, less retirements and decreases by adjustments, including depreciation. Encumbrances include mortgages and other related debt, and may also include accrued costs of acquisition or construction.
>
> Statement Value
>
> Real estate shall be shown net of any encumbrance. The instructions for the annual statement require that the admitted value of properties occupied by the company (home office real estate) shall not exceed actual costs, plus capitalized improvement, less normal depreciation. This formula is to apply whether the property is held directly or indirectly by the company.

Similar guidance is provided in The Accounting Practices and Procedures Manual for Life, Accident and Health Insurance Companies, Chapter 4, Real Estate.

Generally Accepted Accounting Principles

15. Paragraph 7 of APB 10 provides the following guidance:

> 1. It is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except where a right of setoff exists. Accordingly, the offset of cash or other assets against the tax liability or other amounts owing to governmental bodies is not acceptable except in the circumstances described in paragraph 3 below.
>
> 2. Most securities now issued by governments are not by their terms designed specifically for the payment of taxes and, accordingly, should not be deducted from taxes payable on the balance sheet.
>
> 3. The only exception to this general principle occurs when it is clear that a purchase of securities (acceptable for the payment of taxes) is in substance an advance payment of taxes that will be payable in the relatively near future, so that in the special circumstances the purchase is tantamount to the prepayment of taxes. This occurs at times, for example, as an accommodation to a local government and in some instances when governments issue securities that are specifically designated as being acceptable for the payment of taxes of those governments.

16. FIN 39 provides the following guidance:

> INTERPRETATION
>
> General Principle
>
> 5. Opinion 10, paragraph 7, states that “it is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except where a right of setoff exists.” A right of setoff is a debtor's legal right, by contract or otherwise, to discharge all or a portion of the debt owed to another party by applying against the debt an amount that the other party owes to the debtor. A right of setoff exists when all of the following conditions are met:
>
> a. Each of two parties owes the other determinable amounts.
> b. The reporting party has the right to set off the amount owed with the amount owed by the other party.
> c. The reporting party intends to set off.

d. The right of setoff is enforceable at law.

A debtor having a valid right of setoff may offset the related asset and liability and report the net amount.

6. Generally, debts may be set off if they exist between mutual debtors each acting in its capacity as both debtor and creditor. In particular cases, however, state laws about the right of setoff may provide results different from those normally provided by contract or as a matter of common law. Similarly, the U.S. Bankruptcy Code imposes restrictions on or prohibitions against the right of setoff in bankruptcy under certain circumstances. Legal constraints should be considered to determine whether the right of setoff is enforceable.

Special Applications

7. Various accounting pronouncements specify accounting treatments in circumstances that result in offsetting or in a presentation in a statement of financial position that is similar to the effect of offsetting. This Interpretation does not modify the accounting treatment in the particular circumstances prescribed by any of the following pronouncements:

FASB Statements and Interpretations
APB Opinions
Accounting Research Bulletins
FASB Technical Bulletins
AICPA Accounting Interpretations
AICPA Audit and Accounting Guides
AICPA Industry Audit Guides
AICPA Statements of Position

Examples of those pronouncements are:
FASB Statement No. 13, Accounting for Leases (leveraged leases, paragraphs 42-47)
FASB Statement No. 87, Employers' Accounting for Pensions (accounting for pension plan assets and liabilities)
FASB Statement No. 106, Employers' Accounting for Postretirement Benefits Other Than Pensions (accounting for plan assets and liabilities)
FASB Statement No. 109, Accounting for Income Taxes (net tax asset or liability amounts reported)
APB Opinion No. 30, Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions (reporting of discontinued operations)
AICPA Audit and Accounting Guides, Audits of Brokers and Dealers in Securities (trade date accounting for trading portfolio positions), *and Construction Contractors and Audits of Federal Government Contractors* (advances received on construction contracts)
AICPA Industry Audit Guide, Audits of Banks (reciprocal balances with other banks)

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapters 4 and 22
- Accounting Practices and Procedures Manual for Life, Accident and Health Insurance Companies, Chapter 4
- *Issue Paper No. 2—Definition of Cash*
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 40—Real Estate Investments*

- *Issue Paper No. 75—Property and Casualty Reinsurance*
- *Issue Paper No. 74—Life, Deposit-Type and Accident and Health Reinsurance*
- *Issue Paper No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements*.

Generally Accepted Accounting Principles

- *Accounting Principles Board Opinion No. 10, Omnibus Opinion - 1966*
- *FASB Interpretation No. 39, Offsetting of Amounts Related to Certain Contracts*
- *FASB Interpretation No. 41, Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements*
- *FASB Emerging Issues Task Force No. 86-25, Offsetting Foreign Currency Swaps*

State Regulations

No additional guidance obtained from state statutes or regulations.

Statutory Issue Paper No. 77

Disclosure of Accounting Policies, Risks & Uncertainties, and Other Disclosures

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 1

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. GAAP guidance for the disclosure of accounting policies is contained in *Accounting Principles Board Opinion No. 22*, *Disclosure of Accounting Policies* (APB 22). This guidance requires the identification and description of accounting principles followed by a company and the methods of applying those principles that materially affect the determination of financial position or results of operations. Current statutory guidance requires a general disclosure that the financial statements have been prepared in accordance with the Annual Statement Instructions and Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies (Life/A&H and P&C Accounting Practices and Procedures Manuals) except to the extent state laws differ. The impact of such deviations is required to be disclosed if material. The disclosure of certain accounting policies within specific notes to the Annual Statement is required by the Annual Statement Instructions.

2. GAAP guidance for the disclosure of permitted accounting practices is contained in *AICPA Statement of Position No. 94-5*, *Disclosure of Certain Matters in the Financial Statements of Insurance Enterprises* (SOP 94-5). This guidance requires the disclosure of those permitted statutory accounting practices that have a material impact on statutory surplus or risk based capital or when prescribed statutory accounting practices do not address the accounting for the transaction. Current statutory guidance is contained in the Annual Statement Instructions for both Property and Casualty and Life, Accident and Health Insurance Companies (Annual Statement Instructions), *Notes to the Financial Statements.* This guidance requires the disclosure of any accounting practices not in conformity with the Annual Statement Instructions and the Accounting Practices and Procedures Manuals.

3. GAAP guidance for the disclosure of risk and uncertainties is contained in *AICPA Statement of Position No. 94-6*, *Disclosure of Certain Significant Risks and Uncertainties* (SOP 94-6*)*. This guidance requires the disclosure about risks and uncertainties in four areas at the date of the financial statements: nature of operations, use of estimates in the preparation of financial statements, certain significant estimates, and current vulnerability due to certain concentrations. Current statutory guidance requires certain specific disclosures of risks and uncertainties, however, the requirements are not as broad as those of SOP 94-6.

4. The purpose of this issue paper is to establish statutory accounting principles for the disclosure of accounting policies, risks and uncertainties, and other disclosures that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

5. Except as noted in paragraph 8, the disclosure requirements of paragraphs 6-21 of this issue paper do not apply to quarterly financial statements. To the extent that disclosures required by this or any other

issue paper are made within specific notes, schedules or exhibits to the financial statements, those disclosures are not required to be duplicated in a separate note. Annual statutory financial statements which are not accompanied by Annual Statement exhibits and schedules (e.g., annual audit report) shall include all disclosures required by this statement.

Accounting Policies

6. For the purposes of this issue paper, accounting polices are defined as the specific accounting principles and the methods of applying those principles that are utilized in preparing the statutory financial statements.

7. Disclosure shall be made of all accounting policies that affect the assets, liabilities, capital and surplus or results of operations of the reporting company. The disclosure should encompass important judgments as to the appropriateness of principles relating to recognition of revenue particularly when selecting between acceptable alternatives, or methods particular to the business.

8. Disclosure of accounting policies generally should be made in a separate *Summary of Significant Accounting Policies* preceding the notes to the financial statements or as the initial note. If the reporting entity has changed the accounting policies since the end of its preceding year, the changes shall be disclosed in the quarterly financial statements.

9. NAIC statutory accounting practices and procedures are those that are set forth in the Accounting Practices and Procedures Manual. If a reporting entity employs accounting practices that depart from NAIC accounting practices and procedures, disclosure of the following information about those accounting practices that affect statutory surplus or risk-based capital shall be made:

a. A description of the accounting practice.

b. A statement that the accounting practice differs from NAIC statutory accounting practices and procedures.

c. The monetary effect on statutory surplus of using an accounting practice which differs from NAIC statutory accounting practices and procedures.

10. Disclosure of the following information shall be made about accounting practices when NAIC statutory accounting practices and procedures do not address the accounting for the transaction:

a. A description of the transaction and of the accounting practice used.

b. A statement that NAIC statutory accounting practices and procedures do not address the accounting for the transaction.

Risks and Uncertainties

11. Companies shall make disclosures in their financial statements about risks and uncertainties existing as of the date of those statements in the following areas:

a. Nature of operations

b. Use of estimates in the preparation of financial statements

c. Certain significant estimates

d. Current vulnerability due to certain concentrations

12. *Nature of Operations*: Financial statements should include a description of the ownership and relationships of the reporting entity and all affiliated companies, and a description of the major products

or services the reporting entity sells or provides and its principal markets, including the locations of those markets. If the entity operates in more than one business, the disclosure should also indicate the relative importance of its operations in each business and the basis for the determination (e.g., assets, revenues, or earnings). Disclosures about the nature of operations need not be quantified; relative importance could be conveyed by use of terms such as predominately, about equally, or major.

13. *Use of Estimates in the Preparation of Financial Statements*: Financial statements shall include an explanation that the preparation of financial statements in conformity with the Annual Statement Instructions and Accounting Practices and Procedures Manuals requires the use of management's estimates.

14. *Certain Significant Estimates*: Disclosure regarding an estimate should be made when known information available prior to issuance of the financial statements indicates that both of the following criteria are met:

a. It is at least reasonably possible that the estimate of the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements will change in the near term due to one or more future confirming events.

b. The effect of the change would be material to the financial statements.

The disclosure should indicate the nature of the uncertainty and include an indication that it is at least reasonably possible that a change in the estimate will occur in the near term (generally, a period of time not to exceed one year from the date of the financial statements). If the estimate involves a loss contingency as defined in *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies, and Impairments of Assets* (Issue Paper No. 5), the disclosure shall include an estimate of the possible loss or range of loss, or state that such an estimate cannot be made. Reporting entities should disclose the factors that cause the estimate to be sensitive to change.

15. *Current Vulnerability Due to Certain Concentrations*: Vulnerability from concentrations arises because an entity is exposed to risk of loss greater than it would have had it mitigated its risk through diversification. Such risks manifest themselves differently, depending on the nature of the concentration, and vary in significance.

16. Financial statements shall disclose the concentrations described in paragraph 17 of this issue paper if, based on information known to management prior to issuance of the financial statements, all of the following criteria are met:

a. The concentration exists at the date of the financial statements.

b. The concentration makes the enterprise vulnerable to the risk of a near-term severe (more than material but less than catastrophic) impact.

c. It is at least reasonably possible that the events that could cause the severe impact will occur in the near term.

17. Concentrations, including known group concentrations, described below require disclosure if they meet the criteria of paragraph 16 of this issue paper. (Group concentrations exist if a number of counterparties or items that have similar economic characteristics collectively expose the reporting entity to a particular kind of risk.) Some concentrations may fall into more than one category.

a. *Concentrations in the volume of business transacted with a particular customer, supplier, or lender*. The potential for the severe impact can result, for example, from total or partial loss of the business relationship. For the purposes of this issue paper, it is always considered at least reasonably possible that any customer will be lost in the near term.

b. *Concentrations in revenue from particular products or services*. The potential for severe impact can result, for example, from volume or price changes for a particular source of revenue.

c. Concentrations in the available sources of materials, labor, services, licenses, or other rights used in the entity's operations. The potential for severe impact can result, for example, from changes in the availability to the entity of a resource or a right.

d. *Concentrations in the market or geographic area in which an entity conducts its operations*. The potential for severe impact can result, for example, from negative effects of the economic and political forces within the market or geographic area. For the purposes of this issue paper, it is always considered at least reasonably possible that operations located outside an entity's home country will be disrupted in the near term.

Other Disclosures

18. Separate issue papers have disclosure requirements specific to the topics addressed in those issue papers. Additional disclosure requirements not addressed in other issue papers are included herein.

19. For each year that a balance sheet is presented, reporting entities shall disclose the following information in the notes to the financial statements:

a. Amounts not recorded in the financial statements that represent segregated funds held for others, the nature of the assets and the related fiduciary responsibilities associated with such assets. One example of such an item is escrow accounts held by title insurance companies.

b. The amount and nature of any assets pledged to others as collateral.

20. The financial statements shall disclose forward commitments which are not derivative instruments (e.g., the commitment to purchase a GNMA security two months after the commitment date, or a private placement six months after the commitment date).

Supplemental Investment Disclosure

21. For the current year, reporting entities shall disclose the information required by Appendix A-001, Investments of Insurers. A Summary Investment Schedule and Investment Risk Interrogatories shall be filed with the audited statutory financial statements. The Summary Investment Schedule shall be filed with the Annual Statement whereas the interrogatories shall be filed as a supplement to the Annual Statement by April 1 for the applicable reporting period.

DISCUSSION

22. This issue paper adopts APB 22, Accounting Research Bulletin No. 43, Chapter 2A, *Form of Statements – Comparative Financial Statements*, SOP 94-5 and SOP 94-6. The disclosures related to loss reserves adopted in *Issue Paper No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses* (Issue Paper No. 55), are consistent with the guidance in SOP 94-5. However, Issue Paper No. 55 did not adopt SOP 94-5 because it was to be addressed in its entirety in this issue paper.

23. The statutory principles outlined in the conclusion above expand current statutory guidance relative to accounting policies, risks and uncertainties and other disclosures as follows:

a. Paragraph 7 of this issue paper requires disclosure of all accounting policies that affect the assets, liabilities, capital and surplus or results of operations in all statutory financial statements. Current statutory guidance requires disclosure of certain accounting policies in the notes to the Annual Statement as well as disclosure of all accounting policies that affect the assets, liabilities, capital and surplus or results of operations but only to the extent those financial statements are audited.

b. Paragraph 11 requires the disclosure of certain risks and uncertainties existing at the date of the financial statements. Current statutory guidance requires this disclosure in statutory financial statements to the extent those financial statements are audited. This issue paper expands that requirement to include annual statement filings.

These changes were made to enhance the usefulness of financial statements to regulators and other users.

24. The statutory principles outlined in paragraphs 9 and 10 in the conclusion above expand current statutory guidance by requiring disclosure of accounting practices that depart from NAIC accounting practices and procedures and that have an effect on risk based capital or statutory surplus. This change was made because risk based capital is viewed as a primary indicator of a reporting entity's solvency.

25. The disclosure requirements of this issue paper are consistent with the Statement of Concepts which states *"... management must supplement the financial statements with sufficient disclosures (e.g., notes to financial statements, management discussion and analysis, and supplementary schedules and exhibits) to assist financial statement users in evaluating the information provided."*

26. The conclusions reached in this issue paper are consistent with GAAP except to the extent they are not required to be made in interim statutory financial statements. GAAP requires these disclosures in all financial statements regardless of the period.

27. The information required by this issue paper provides disclosure in those circumstances where the accompanying exhibits and schedules are not part of the company's financial statements (e.g., annual audit report) and is not intended to provide duplicative presentation in the annual statement filings.

Drafting Notes/Comments

- The disclosure requirements of this issue paper relative to risks and uncertainties are separate from and do not change in any way the requirements or criteria of Issue Paper No. 5.
- Disclosures relating to environmental liabilities are addressed in *Issue Paper No. 65—Property Casualty Contracts.*

RELEVANT STATUTORY AND GAAP GUIDANCE

Statutory Accounting

28. The Annual Statement Instructions for both Property and Casualty and Life, Accident and Health Insurance Companies (Notes to the Financial Statements) provide the following guidance:

1. Basis of Presentation

Instruction:

Indicate that the statement has been completed in accordance with the NAIC *Annual Statement Instructions* and *Accounting Practices and Procedures* manuals except to the extent that state law differs. Note any deviations from the rules to the extent this deviation impacts the financial information contained in the annual statement.

Illustration:

The accompanying financial statements of the Company have been prepared in conformity with the *Annual Statement Instructions* and *Accounting Practices and Procedures* Annual Statement Instructions except for the following item(s) which resulted in surplus being increased (decreased) by $__________. The deviation(s) are as follows:

Generally Accepted Accounting Principles

29. APB 22 provides the following guidance (note all references to statement of changes in financial position have been amended to statement of cash flows by FASB Statement No. 95, *Statement of Cash Flows*):

> DISCUSSION
>
> 5. Financial statements are the end product of the financial accounting process, which is governed by generally accepted accounting principles on three levels: pervasive principles, broad operating principles, and detailed principles.[1] Applying generally accepted accounting principles requires that judgment be exercised as to the relative appropriateness of acceptable alternative principles and methods of application in specific circumstances of diverse and complex economic activities. Although the combined efforts of professional accounting bodies, of business, and of the regulatory agencies have significantly reduced the number of acceptable alternatives and are expected to reduce the number further, judgment must nevertheless be exercised in applying principles at all three levels.
>
> [1] See *APB Statement No. 4, Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises*, Chapter 6, 7, and 8. This Opinion amends Statement No. 4 insofar as it relates to disclosure of accounting policies.
>
> 6. The accounting policies of a reporting entity are the specific accounting principles and the methods of applying those principles that are judged by the management of the entity to be the most appropriate in the circumstances to present fairly financial position, cash flows, and results of operations in accordance with generally accepted accounting principles and that, accordingly, have been adopted for preparing the financial statements.
>
> 7. The accounting policies adopted by a reporting entity can affect significantly the presentation of its financial position, cash flows, and results of operations. Accordingly, the usefulness of financial statements for purposes of making economic decisions about the reporting entity depends significantly upon the user's understanding of the accounting policies followed by the entity.
>
> OPINION
>
> Applicability
>
> 8. The Board concludes that information about the accounting policies adopted by a reporting entity is essential for financial statement users. When financial statements are issued purporting to present fairly financial position, cash flows, and results of operations in accordance with generally accepted accounting principles, a description of all significant accounting policies of the reporting entity should be included as an integral part of the financial statements. In circumstances where it may be appropriate to issue one or more of the basic financial statements without the others, purporting to present fairly the information given in accordance with generally accepted accounting principles, statements so presented should also include disclosure of the pertinent accounting policies.

9. The Board also concludes that information about the accounting policies adopted and followed by not-for-profit entities should be presented as an integral part of their financial statements.

10. The provisions of paragraphs 8 and 9 above are not intended to apply to unaudited financial statements issued as of a date between annual reporting dates (e.g., each quarter) if the reporting entity has not changed its accounting policies since the end of its preceding fiscal year. [2]

[2] The Board recognizes also that it may be appropriate to omit disclosure in some other circumstances for example, from financial statements restricted to internal use only (see Statement on Auditing Procedures No. 38, paragraphs 5 and 6) and from certain special reports in which incomplete or no financial presentations are made (see Statement on Auditing Procedures No. 33, Chapter 13, paragraphs 9 and 10).

11. This Opinion does not supersede any prior pronouncement of the American Institute of Certified Public Accountants relating to disclosure requirements.

Content

12. Disclosure of accounting policies should identify and describe the accounting principles followed by the reporting entity and the methods of applying those principles that materially affect the determination of financial position, cash flows, or results of operations. In general, the disclosure should encompass important judgments as to appropriateness of principles relating to recognition of revenue and allocation of asset costs to current and future periods; in particular, it should encompass those accounting principles and methods that involve any of the following:

a. A selection from existing acceptable alternatives;

b. Principles and methods peculiar to the industry in which the reporting entity operates, even if such principles and methods are predominantly followed in that industry;

c. Unusual or innovative applications of generally accepted accounting principles (and, as applicable, of principles and methods peculiar to the industry in which the reporting entity operates).

13. Examples of disclosures by a business entity commonly required with respect to accounting policies would include, among others, those relating to basis of consolidation, depreciation methods, amortization of intangibles, inventory pricing, accounting for research and development costs (including basis for amortization), translation of foreign currencies, recognition of profit on long-term construction-type contracts, and recognition of revenue from franchising and leasing operations. This list of examples is not all-inclusive.

14. Financial statement disclosure of accounting policies should not duplicate details (e.g., composition of inventories or of plant assets) presented elsewhere as part of the financial statements. In some cases, the disclosure of accounting policies should refer to related details presented elsewhere as part of the financial statements; for example, changes in accounting policies during the period should be described with cross-reference to the disclosure required by APB Opinion No. 20, Accounting Changes, of the current effect of the change and of the pro forma effect of retroactive application.

Format

15. The Board recognizes the need for flexibility in matters of format (including the location) of disclosure of accounting policies provided that the reporting entity identifies and describes its significant accounting policies as an integral part of its financial statements in accordance with

the foregoing guides in this Opinion. The Board believes that the disclosure is particularly useful if given in a separate Summary of Significant Accounting Policies preceding the notes to financial statements or as the initial note. Accordingly, it expresses its preference for that format under the same or a similar title.

30. SOP 94-6 provides the following guidance:

Introduction
.01 The volatile business and economic environment underscores a need for improved disclosure about the significant risks and uncertainties that face reporting entities. In 1987, the AICPA issued the Report of the Task Force on Risks and Uncertainties (the Report), which was intended to help standards setting bodies and others identify practical methods of improving the information communicated to users of financial statements to help them assess those risks and uncertainties. This Statement of Position (SOP) is largely based on the Report. The central feature of this SOP's disclosure requirements is selectivity: specified criteria serve to screen the host of risks and uncertainties that affect every entity so that required disclosures are limited to matters significant to a particular entity.

.02 The disclosures focus primarily on risks and uncertainties that could significantly affect the amounts reported in the financial statements in the near term or the near-term functioning of the reporting entity. The risks and uncertainties this SOP deals with can stem from the nature of the entity's operations, from the necessary use of estimates in the preparation of the entity's financial statements, and from significant concentrations in certain aspects of the entity's operations.

Scope
.03 This SOP applies to financial statements prepared in conformity with generally accepted accounting principles (GAAP) applicable to nongovernmental entities. It applies to all entities that issue such statements[1] While this SOP applies to complete interim financial statements, it does not apply to condensed or summarized interim financial statements. If comparative financial statements are presented, the disclosure requirements apply only to the financial statements for the most recent fiscal period presented.

[1] However, see *Accounting Principles Board (APB) Opinion No. 28, Interim Financial Reporting*, paragraph 30, for guidance on disclosure of contingencies in summarized interim financial information of publicly traded companies.

.04 The disclosure requirements do not encompass risks and uncertainties that might be associated with management or key personnel, proposed changes in government regulations; proposed changes in accounting principles,[2] or deficiencies in the internal control structure. Nor do they encompass the possible effects of acts of God, war, or sudden catastrophes.

Relationship to Other Pronouncements
.05 The disclosure requirements of this SOP in many circumstances are similar to or overlap the disclosure requirements in certain pronouncements of the Financial Accounting Standards Board (FASB), such as *FASB Statement of Financial Accounting Standards No. 5, Accounting for Contingencies,* and, for public business enterprises, FASB Statement No. 14, Financial Reporting for Segments of a Business Enterprise. The disclosure requirements of this SOP in many circumstances also are similar to or overlap the disclosure requirements in certain pronouncements of the Securities and Exchange Commission (SEC). This SOP does not alter the requirements of any FASB or SEC pronouncement.

.06 Certain disclosure requirements in this SOP supplement the requirements of other authoritative pronouncements. In many cases, however, the disclosure requirements in this SOP, particularly those relating to certain significant estimates, will be met or partly met by compliance with such other pronouncements.

Definitions

.07 This SOP uses the following terms with the definitions indicated:

Near term. A period of time not to exceed one year from the date of the financial statements.

Severe impact. (Used in reference to current vulnerability due to certain concentrations. See paragraph .21.) A significant financially disruptive effect on the normal functioning of the entity. Severe impact is a higher threshold than material. Matters that are important enough to influence a user's decisions are deemed to be material,[3] yet they may not be so significant as to disrupt the normal functioning of the entity. Some events are material to an investor because they might affect the price of an entity's capital stock or its debt securities, but they would not necessarily have a severe impact on (disrupt) the enterprise itself. The concept of severe impact, however, includes matters that are less than catastrophic.[4]

[2] SEC Staff Accounting Bulletin 74 requires disclosure, both in Management's Discussion and Analysis (MD&A) and in the notes to the financial statements, concerning accounting standards that have been issued but that have not yet been adopted. Also, Auditing Interpretation No. 3 of SAS No. 1, section 410, "The Impact on an Auditor's Report of an FASB Statement Prior to the Statement's Effective Date" (AICPA, *Professional Standards,* vol. 1, AU section 9410.13-.18) addresses reporting considerations when financial statements will have to be restated in the future because an authoritative accounting pronouncement that is not yet effective will require retroactive application of its provisions by prior-period adjustment.

[3] *FASB Concepts Statement No. 2*, *Qualitative Characteristics of Accounting Information,* defines *materiality* as "the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement."

[4] Matters that are catastrophic include, for example, those that would result in bankruptcy.

Conclusions

.08 The Accounting Standards Executive Committee (AcSEC) Of the AICPA has concluded that reporting entities should make disclosures in their financial statements beyond those now required or generally made in financial statements about the risks and uncertainties existing as of the date of those statements in the following areas:

a. Nature of operations

b. Use of estimates in the preparation of financial statements

c. Certain significant estimates

d. Current vulnerability due to certain concentrations

These four areas of disclosure are not mutually exclusive. The information required by some may overlap. Accordingly; the disclosures required by this SOP may be combined in various ways, grouped together, or placed in diverse parts of the financial statements, or included as part of the disclosures made pursuant to the requirements of other authoritative pronouncements.

.09 The following detailed discussion of the four areas of disclosure enumerated in paragraph .08 should be read in conjunction with the "Illustrative Disclosures" in appendix A [paragraph .27] of this SOP, which provide guidance for implementing them.

Nature of Operations

.10 Financial statements should include a description of the major products or services the reporting entity sells or provides and its principal markets including the locations of those markets. If the entity operates in more than one business, the disclosure should also indicate the relative importance of its operations in each business and the basis for the determination for example assets, revenues, or earnings. Not-for-profit organizations' disclosures should briefly describe the principal services performed by the entity and the revenue sources for the entity's services. Disclosures about the nature of operations need not be quantified; relative importance could be conveyed by use of terms such as predominately, about equally, or major and other.[5]

Use of Estimates in the Preparation of Financial Statements

.11 Financial statements should include an explanation that the preparation of financial statements in conformity with GAAP requires the use of management's estimates.

Certain Significant Estimates

.12 Various accounting pronouncements require disclosures about uncertainties addressed by those pronouncements. In particular, paragraphs 9-12, and 17.b. and footnote 6 of FASB Statement No. 5 specify disclosures to be made about contingencies [6] that exist at the date of the financial statements. The disclosure requirements of paragraphs 9-12 of Statement No. 5 are further clarified in *FASB Interpretation No. 14, Reasonable Estimation of the Amount of a Loss.* In addition to disclosures required by FASB Statement No. 5 and other accounting pronouncements, this SOP requires disclosures regarding estimates used in the determination of the carrying amounts of assets or liabilities or in disclosure of gain or loss contingencies, as described below

.13 Disclosure regarding an estimate should be made when known information available prior to issuance of the financial statements indicates that both of the following criteria are met:

a. It is at least reasonably possible[7] that the estimate of the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements will change in the near term due to one or more future confirming events.

b. The effect of the change would be material to the financial statements.

[5] See paragraph B-17 in appendix B [paragraph .28] for a comparison of this SOP's disclosure requirements concerning nature of operations with the disclosure requirements for public companies in *FASB Statement No. 14, Financial Reporting for Segments of a Business Enterprise.*

[6] FASB Statement No. 5 defines a contingency as "an existing condition, situation, or set of circumstances involving uncertainty as to possible gain (hereinafter a 'gain contingency') or loss (hereinafter a 'loss contingency') to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the acquisition of an asset or the reduction of a liability or the loss or impairment of an asset or the incurrence of a liability."

[7] The term reasonably possible is used in this SOP consistent with its use in FASB Statement No. 5 to mean that the chance of a future transaction or event occurring is more than remote but less than likely.

.14 The disclosure should indicate the nature of the uncertainty and include an indication that it is at least reasonably possible[8] that a change in the estimate will occur in the near term.[9] If the estimate involves a loss contingency covered by FASB Statement No. 5, the disclosure also should include an estimate of the possible loss or range of loss, or state that such an estimate cannot be made. Disclosure of the factors that cause the estimate to be sensitive to change is encouraged but not required.

.15 Many entities use risk-reduction techniques to mitigate losses or the uncertainty that may result from future events. If the entity determines that the criteria in paragraph .13 are not met as a result of risk-reduction techniques, the disclosures described in paragraph .14 and disclosure- of the risk reduction techniques are encouraged but not required.

.16 This SOP's disclosure requirements are separate from and do not change in any way the disclosure requirements or criteria of FASB Statement No. 5; rather, the disclosures required under this SOP supplement the disclosures required under Statement No. 5 as follows:

- If an estimate (including estimates that involve contingencies covered by FASB Statement No. 5) meets the criteria for disclosure under paragraph .13 of this SOP, this SOP requires disclosure of an indication that it is at least reasonably possible that a change in the estimate will occur in the near term; FASB Statement No. 5 does not distinguish between near-term and long-term contingencies.
- An estimate that does not involve a contingency covered by Statement No. 5, such as estimates associated with long-term operating assets and amounts reported under profitable long-term contracts, may meet the criteria in paragraph .13. This SOP requires disclosure of the nature of the estimate and an indication that it is at least reasonably possible that a change in the estimate will occur in the near term.

.17 Whether an estimate meets the criteria for disclosure under this SOP does not depend on the amount that has been reported in the financial statements, but rather on the materiality of the effect that using a different estimate would have had on the financial statements. Simply because an estimate resulted in the recognition of a small financial statement amount, or no amount, does not mean that disclosure is not required under this SOP.

.18 The following are examples of assets and liabilities and related revenues and expenses, and of disclosure of gain or loss contingencies included in financial statements that, based on facts and circumstances existing at the date of the financial statements, may be based on estimates that are particularly sensitive to change in the near term:

- Inventory subject to rapid technological obsolescence
- Specialized equipment subject to technological obsolescence
- Valuation allowances for deferred tax assets based on future taxable income
- Capitalized motion picture film production costs
- Capitalized computer software costs
- Deferred policy acquisition costs of insurance enterprises
- Valuation allowances for commercial and real estate loans
- Environmental remediation-related obligations
- Litigation-related obligations
- Contingent liabilities for obligations of other entities

[8] The words reasonably possible need not be used in the disclosures required by this SOP

[9] FASB Statement No. 5 states in paragraph 17.b .that "adequate disclosure shall be made of contingencies that might result in gains, but care shall be exercised to avoid misleading implications as to the likelihood of realization"

- Amounts reported for long-term obligations, such as amounts reported for pensions and postemployment benefits
- Estimated net proceeds recoverable, the provisions for expected loss to be incurred, or both, on disposition of a business or assets
- Amounts reported for long-term contracts

The above list is not intended to be all-inclusive.

.19 The following are examples of events or changes in circumstances that indicate that an estimate associated with the carrying amount of a long-lived asset may be particularly sensitive to change in the near term:[10]

a. A significant decrease in the market value of an asset

b. A significant change in the extent or manner in which an asset is used

c. A significant adverse change in legal factors or in the business climate that affects the value of an asset

d. An accumulation of costs significantly in excess of the amount originally expected to acquire or construct an asset

e. A history of losses associated with an asset, a projection or forecast (if either is available) that demonstrates continuing losses associated with an asset, or both

[10] On November 29, 1993, the FASB issued an exposure draft of a proposed Statement of Financial Accounting Standards, Accounting for the Impairment of Long-Lived Assets. This list was derived from the list in the FASB exposure draft of examples of events or changes in circumstances that indicate that the recoverability of the carrying amount of a long-lived asset should be assessed for impairment. Any final Statement may contain additional or revised examples.

Current Vulnerability Due to Certain Concentrations

.20 Vulnerability from concentrations arises because an entity is exposed to risk of loss greater than it would have had it mitigated its risk through diversification. Such risks of loss manifest themselves differently, depending on the nature of the concentration, and vary in significance.

.21 Financial statements should disclose the concentrations described in paragraph .22 if, based on information known to management prior to issuance of the financial statements, all of the following criteria are met:

a. The concentration exists at the date of the financial statements.

b. The concentration makes the enterprise vulnerable to the risk of a near-term severe impact.

c. It is at least reasonably possible that the events that could cause the severe impact will occur in the near term.

.22 Concentrations, including known group concentrations, described below require disclosure if they meet the criteria of paragraph .21. (Group concentrations exist if a number of counterparties or items that have similar economic characteristics collectively expose the reporting entity to a particular kind of risk.) Some concentrations may fall into more than one category.

a. Concentrations in the volume of business transacted with a particular customer, supplier, lender, grantor, or contributor. The potential for the severe impact can result, for example, from total or partial loss of the business relationship. For purposes of this SOP, it is always considered at least reasonably possible that any customer, grantor, or contributor will be lost in the near term.

b. Concentrations in revenue from particular products, services, or fund-raising events. The potential for the severe impact can result, for example, from volume or price changes or the loss of patent protection for the particular source of revenue.

c. Concentrations in the available sources of supply of materials, labor, or services, or of licenses or other rights used in the entity's operations. The potential for the severe impact can result, for example, from changes in the availability to the entity of a resource or a right.

d. Concentrations in the market or geographic area [11] in which an entity conducts its operations. The potential for the severe impact can result, for example, from negative effects of the economic and political forces within the market or geographic area. For purposes of this SOP, it is always considered at least reasonably possible that operations located outside an entity's home country will be disrupted in the near term.

[11] *FASB Statement No. 14, Financial Reporting for Segments of a Business Enterprise*, paragraph 34, provides guidance on determining foreign geographic areas

.24 Disclosure of concentrations meeting the criteria of paragraph .21 should include information that is adequate to inform users of the general nature of the risk associated with the concentration. For those concentrations of labor (paragraph .22c) subject to collective bargaining agreements and concentrations of operations located outside of the entity's home country (paragraph .22d) that meet the criteria of paragraph .21, the following specific disclosures are required:

- For labor subject to collective bargaining agreements, disclosure should include both the percentage of the labor force covered by a collective bargaining agreement and the percentage of the labor force covered by a collective bargaining agreement that will expire within one year.
- For operations located outside the entity's home country, disclosure should include the carrying amounts of net assets and the geographic areas in which they are located.

Adequate information about some concentrations may already be presented in diverse parts of the financial statements. For example, adequate information about assets or operations located outside the entity's home country may be included in disclosures made to comply with FASB Statement No. 14. In accordance with paragraph .08 of this SOP, such information need not be repeated.

Application of Disclosure Criteria

.25 An assessment of whether a disclosure is required should not be found to be in error simply as a result of future events; For example, reporting a concentration not followed by a severe impact does not imply that the disclosure should not have been made, because something that has only a reasonably possible chance of occurring obviously might not occur. Similarly, the occurrence of a severe impact related to a concentration not disclosed in the prior-year financial statements would not suggest noncompliance with this SOP s requirements if an appropriate judgment had been made that a near term severe impact was not at least reasonably possible at the prior reporting date. In addition, a severe impact may arise from a concentration of which management did not have knowledge at the time the financial statements were issued.

31. SOP 94-5 provides the following guidance:

Introduction
.01 Most of the accounting principles related to disclosures for insurance enterprises were promulgated over twenty years ago when the insurance regulatory and business environments were less complex and volatile. Accordingly, the AICPA Accounting Standards Executive Committee (AcSEC) added a project to its agenda to consider whether new disclosures should be required in insurance enterprises' financial statements. This statement of position (SOP) is a result of that project.

.02 This SOP applies to annual and complete sets of interim financial statements prepared in conformity with generally accepted accounting principles (GAAP) of life and health insurance enterprises (including mutual life insurance enterprises), property and casualty insurance enterprises, reinsurance enterprises, title insurance enterprises, mortgage guaranty insurance enterprises, financial guaranty insurance enterprises, assessment enterprises, fraternal benefit societies, reciprocal or interinsurance exchanges, pools other than public-entity risk pools, syndicates, and captive insurance companies. Furthermore, AICPA Auditing Interpretation No. 12, "Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis" (AICPA, *Professional Standards, vol. 1,* AU section 9623.60.79), requires auditors to apply the same disclosure criteria for statutory financial statements as they do for financial statements prepared in conformity with GAAP.

Relationship to Other Pronouncements
.03 In some circumstances, the disclosure requirements in this SOP may be similar to, or overlap, the disclosure requirements in certain other authoritative accounting pronouncements issued by the Financial Accounting Standards Board (FASB), the American Institute of Certified Public Accountants (AICPA), and the Securities and Exchange Commission (SEC). For example—

- *FASB Statement of Financial Accounting Standards No. 5, Accounting for Contingencies,* requires certain disclosures related to loss contingencies, including catastrophe losses of property and casualty insurance companies.
- *FASB Statement No. 60*, *Accounting and Reporting by Insurance Enterprises,* requires certain disclosures about liabilities for unpaid claims and claim adjustment expenses and statutory capital.
- *FASB Statement No. 113*, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, requires certain disclosures about reinsurance transactions.
- *AICPA Statement of Position 94-6*, *Disclosure* of *Certain Significant Risks and Uncertainties* requires disclosures about certain significant estimates.

The SEC Securities Act Guide 6, *Disclosures Concerning Unpaid Claims and Claim Adjustment Expenses of Property-Casualty Insurance Underwriters,* requires disclosures of information about liabilities for unpaid claims and claim adjustment expenses.

The disclosure requirements in this SOP supplement the disclosure requirements in other authoritative pronouncements. This SOP does not alter the requirements of any FASB or SEC pronouncement.

Conclusions
.04 The disclosure requirements in this section should be read in conjunction with appendix A, "Illustrative Disclosures" [paragraph .13], and appendix B, "Discussion of Conclusions" [paragraph .14], of this SOP.

Permitted Statutory Accounting Practices
.05 Insurance enterprises currently prepare their statutory financial statements in accordance with accounting principles and practices prescribed or permitted by the insurance department of their state of domicile. The National Association of Insurance Commissioners (NAIC) currently

has a project under way to codify statutory accounting practices through a complete revision of its *Accounting Practices and Procedures Manuals,* that, when complete, is expected to replace prescribed or permitted statutory accounting practices as the statutory basis of accounting for insurance enterprises (referred to hereafter as the "codification"). Therefore, the codification will likely result in changes to what is currently considered a prescribed statutory accounting practice. Furthermore, postcodification permitted statutory accounting practices will be exceptions to the statutory basis of accounting.

.06 Prescribed precodification statutory accounting practices include state laws, regulations, and general administrative rules applicable to all insurance enterprises domiciled in a particular state, NAIC *Annual Statement Instructions;* the NAIC *Accounting Practices and Procedures Manuals;* the *Securities Valuation Manual* (published by the NAIC Securities Valuation Office); NAIC official proceedings; and the NAIC *Examiners' Handbook.*

.07 Permitted statutory accounting practices include practices not described in paragraph .06 but allowed by the domiciliary state insurance department. Insurance enterprises may request permission from the domiciliary state insurance department to use a specific accounting practice in the preparation of their statutory financial statements (a) when the enterprise wishes to depart from the prescribed statutory accounting practices, or (b) when prescribed statutory accounting practices do not address the accounting for the transaction.

.08 The disclosures in this paragraph should be made for permitted statutory accounting practices for the most recent fiscal year presented regardless of when the permitted statutory accounting practice was initiated. Insurance enterprises should disclose the following information about permitted statutory accounting practices that individually or in the aggregate materially affect statutory surplus or risk-based capital, including GAAP practices when the permitted practices differ from the prescribed statutory accounting practices:

a. A description of the permitted statutory accounting practice

b. A statement that the permitted statutory accounting practice differs from prescribed statutory accounting practices

c. The monetary effect on statutory surplus

Insurance enterprises should disclose the following information about permitted statutory accounting practices, excluding GAAP practices used when prescribed statutory accounting practices do not address the accounting for the transaction:

a. A description of the transaction and of the permitted statutory accounting practice used

b. A statement that prescribed statutory accounting practices do not address the accounting for the transaction

APPENDIX A

Illustrative Disclosures

A-l. The illustrations included in this appendix are guides to implementation of the disclosures required by this SOP. Insurance enterprises are not required to display the information contained herein in the specific manner or in the degree of detail illustrated. Alternative disclosure presentations are permissible if they satisfy the disclosure requirements of this SOP.

Permitted Statutory Accounting Practices

A-2. The following is an illustration of disclosures that an insurance enterprise would make before the codification is complete, to meet the requirements of paragraph .08 of this SOP.

> *Note X. Permitted Statutory Accounting Practices*
> Property and Casualty Company, Inc., domiciled in ABC State, prepares its statutory financial statements in accordance with accounting practices prescribed or permitted by the ABC State Insurance Department. Prescribed statutory accounting practices include a variety of publications of the National Association of Insurance Commissioners (NAIC), as well as state laws, regulations, and general administrative rules. Permitted statutory accounting practices encompass all accounting practices not so prescribed.
>
> The company received written approval from the ABC State Insurance Department to discount loss reserves at a rate of X percent for statutory accounting purposes, which differs from prescribed statutory accounting practices. Statutory accounting practices prescribed by ABC state require that loss reserves be discounted at Y percent. As of December 31, 19X3, that permitted transaction increased statutory surplus by $XX million over what it would have been had prescribed accounting practice been followed.

RELEVANT LITERATURE

Statutory Accounting

- NAIC Annual Statement Instructions
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses*

Generally Accepted Accounting Principles

- *Accounting Principles Board Opinion No. 22, Disclosure of Accounting Policies*
- *Accounting Research Bulletin No. 43, Chapter 2A*, *Form of Statements – Comparative Financial Statements*
- AICPA *Statement of Position No. 94-6, Disclosure of Certain Significant Risks and Uncertainties*
- AICPA *Statement of Position No. 94-5, Disclosure of Certain Matters in the Financial Statements of Insurance Enterprises*

State Regulations

- No additional guidance obtained from state statutes or regulations.

Statutory Issue Paper No. 78

Employee Stock Ownership Plans

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 12

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory accounting guidance for the plan sponsors' accounting for Employee Stock Ownership Plans (ESOPs) is provided in the Accounting Practices and Procedures Manuals for Life and Accident and Health (Life/A&H Accounting Practices and Procedures Manual) and for Property and Casualty Insurance Companies (P & C Accounting Practices and Procedures Manual). This guidance provides that debt obligations of ESOPs must be recorded as debt obligations of company sponsors, except when the ESOP has both the ability and intent to satisfy the debt from sources other than dividends on the company stock, contributions from the company or the sale or exchange of the company's securities.

2. GAAP addresses the plan sponsors' accounting for ESOPs in *AICPA Statement of Position 93-6, Employers' Accounting for Employee Stock Ownership Plans* (SOP 93-6) and *FASB Emerging Issues Task Force Issue No. 89-11*, *Sponsor's Balance Sheet Classification of Capital Stock with a Put Option Held by an Employee Stock Ownership Plan* (EITF 89-11).

3. The purpose of this issue paper is to establish statutory accounting principles for the plan sponsors' accounting for ESOPs that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts). It does not address financial reporting by ESOPs.

SUMMARY CONCLUSION

4. An ESOP is an employee benefit plan that is described by the Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code of 1986 as a stock bonus plan, or a combination stock bonus and money purchase pension plan, designed to invest primarily in employer stock. For such plans, reporting entities shall adopt SOP 93-6 except that debt obligations of ESOPs shall be reported consistent with *Issue Paper No. 80—Debt* (Issue Paper No. 80) and the related income tax effects shall be accounted for consistent with *Issue Paper No. 83—Accounting for Income Taxes* (Issue Paper No. 83), as further clarified in this issue paper. There are two basic forms of ESOPs: nonleveraged and leveraged. A summary of the financial reporting for each is provided below.

Leveraged ESOPs

5. A leveraged ESOP borrows money to acquire shares of the employer company (sponsor). The money may be borrowed from the plan sponsor or from an outside lender, with or without a guarantee from the plan sponsor. The debt usually is collateralized by the employer's shares. As required by Issue Paper No. 80, debt obligations of ESOPs shall be reported as borrowed money by company sponsors, except when the ESOP has both the ability and intent to satisfy the debt from sources other than dividends on the company stock, contributions from the company, or the sale or exchange of the company's securities.

6. The sponsor shall report the issuance of shares or the sale of treasury shares to an ESOP when they occur. The consideration recorded for the stock issued is unearned compensation and the unearned ESOP shares shall be reported as a separate reduction of surplus as a component of unassigned funds.

7. The unearned shares initially held by the ESOP in a suspense account are called suspense or unallocated shares. As the debt is repaid (generally from employer contributions and dividends on the employer's stock) suspense shares are released and must be allocated to individual accounts as of the end of the ESOP's fiscal year. As ESOP shares are committed to be released, unearned ESOP shares should be credited and, depending on the purpose for which the shares are released, either (a) compensation cost, (b) dividends payable, or (c) compensation liabilities should be charged as outlined in paragraph 26 of this issue paper.

8. Because employers control the use of dividends on unallocated shares, dividends on unallocated shares are not considered dividends for financial reporting purposes (although such dividends are generally subject to normal dividend requirements under state statutes or regulations). Dividends on unallocated shares used to pay debt service should be reported as a reduction of debt or of accrued interest payable. Dividends on unallocated shares paid to participants or added to participant accounts should be reported as compensation cost. Dividends on allocated shares should be charged to unallocated surplus.

9. If the ESOP sells the suspense shares and uses the proceeds to repay the debt, the employer shall report the release of the suspense shares as a credit to unearned ESOP shares based on the cost of the shares to the ESOP, charge debt, and accrued interest payable and recognize the difference in paid-in capital. However, if there is a difference between the amount paid to an outside lender and the net carrying amount of the debt, such difference shall be reported as a capital gain or loss on extinguishment of debt as defined in Issue Paper No. 80 and, accordingly, shall be charged to operations and disclosed in the notes to the financial statements in accordance with *Issue Paper No. 24—Discontinued Operations and Extraordinary Items* (Issue Paper No. 24).

10. If an employer reacquires the suspense shares from the ESOP, the purchase of the shares should be accounted for as a treasury stock transaction as outlined in paragraph 26 of this issue paper.

Nonleveraged ESOPs

11. Employers with nonleveraged ESOPs should report compensation cost equal to the contribution called for in the period under the plan as outlined in paragraph 26 of this issue paper.

12. Employers with nonleveraged ESOPs should charge dividends on shares held by the ESOPs to unallocated surplus, except that dividends on suspense account shares of a pension reversion ESOP should be accounted for the same way as dividends on suspense account shares of leveraged ESOPs.

Pension Reversion ESOPs

13. Pension reversion ESOPs are created by transferring the assets of a defined benefit pension plan to an existing or newly created ESOP and may be leveraged or nonleveraged. Pension reversion ESOPs should be accounted for as outlined in paragraph 26 of this issue paper.

Issues Related to Accounting for Income Taxes

Leveraged ESOPs

14. The amount of ESOP-related expense for a leveraged ESOP for a period may differ from the amount of the ESOP-related income tax deduction (prescribed by income tax rules and regulations) for that period. Such differences should be reported in accordance with Issue Paper No. 83.

15. If the cost of shares committed to be released is greater than their fair value, the employer should credit the tax effect of the amount by which the deductible expense exceeds the book expense to unassigned funds. Conversely, if the cost of shares committed to be released is less than their fair value,

the employer should charge the tax effect of the amount by which the book expense exceeds the deductible expense to unassigned funds to the extent of previous credits to unassigned funds related to cost exceeding fair value of ESOP shares committed to be released in previous periods.

16. Furthermore, the tax benefit of tax-deductible dividends on allocated ESOP shares should be recorded as a reduction of income tax expense allocated to continuing operations.

Nonleveraged ESOPs

17. Employers with nonleveraged ESOPs may accrue compensation cost for financial reporting purposes earlier than the cost is deductible for income tax purposes. Accruing the compensation cost earlier for financial reporting purposes creates a temporary difference that shall be accounted for in accordance with Issue Paper No. 83.

Other

18. Under federal income tax regulations, employer securities (such as convertible preferred stock) that are held by participants in an ESOP and that are not readily tradable on an established market must include a put option. Securities subject to such repurchase obligations shall be reported as outstanding and as a component of surplus. The repurchase obligation shall be disclosed in accordance with paragraph 19 below.

Disclosures

19. An employer sponsoring an ESOP shall disclose the following information about the plan, if applicable.

a. A description of the plan, the basis for determining contributions, including the employee groups covered, and the nature and effect of significant matters affecting comparability of information for all periods presented. For leveraged ESOPs and pension reversion ESOPs, the description should include the basis for releasing shares and how dividends on allocated and unallocated shares are used;

b. A description of the accounting policies followed for ESOP transactions, including the method of measuring compensation and the classification of dividends on ESOP shares;

c. The amount of compensation cost recognized during the period;

d. The number of allocated shares, committed-to-be-released shares, and suspense shares held by the ESOP at the balance sheet date;

e. The fair value of unearned ESOP shares at the balance sheet date;

f. The existence and nature of any repurchase obligation, including disclosure of the fair value of the shares allocated as of the balance sheet date, which are subject to a repurchase obligation.

DISCUSSION

20. The Life/A&H Accounting Practices and Procedures Manual and the P & C Accounting Practices and Procedures Manual provide that debt obligations of Employee Stock Ownership Plans (ESOPs) must be recorded as debt obligations of company sponsors, except when the ESOP has both the ability and intent to satisfy the debt from sources other than dividends on the company stock, contributions from the company or the sale or exchange of the company's securities. This issue paper is consistent with current statutory guidance. It expands on current statutory guidance to address the accounting for ESOPs in greater detail and to expand the disclosure requirements for ESOPs.

21. This issue paper adopts the GAAP guidance set forth in SOP 93-6 except for:

a. Paragraphs 13 and 25 to the extent that those paragraphs require reporting all debt obligations of an ESOP as liabilities. Statutory accounting provides an exception in situations where the ESOP has both the ability and intent to satisfy the debt from sources other than dividends on the company stock, contributions from the company or the sale or exchange of the company's securities. Pursuant to current statutory guidance and Issue Paper No. 80, such obligations do not meet the definition of liabilities (of the sponsor) as defined in *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*.

b. Paragraphs 28-34 and paragraphs 44 and 53.b. as they relate to the calculation and reporting of earnings per share.

c. Paragraph 37 as it relates to reporting gains and losses on extinguishment of debt. Such gains and losses shall be accounted for and disclosed consistent with Issue Paper No. 24.

22. Under federal income tax regulations, employer securities (such as convertible preferred stock) that are held by participants in an ESOP and that are not readily tradable on an established market must include a put option. Pursuant to Securities and Exchange Commission (SEC) *Codification of Financial Reporting Policies*, Section 211 - Redeemable Preferred Stocks, SEC reporting companies are required to report such securities outside of permanent equity for GAAP reporting purposes. The SEC states that there is a significant difference between a security with mandatory redemption requirements or whose redemption is outside the control of the issuer and conventional equity capital. The SEC believes that it is necessary to highlight the future cash obligations attached to this type of security so as to distinguish it from permanent capital. There is no such requirement for non-SEC reporting companies. Paragraph 18 of this issue paper requires reporting of such securities consistent with the GAAP requirements for non-SEC reporting companies and is consistent with the accounting for capital stock as discussed in *Issue Paper No. 72—Statutory Surplus*. Additionally, paragraph 19 of this issue paper requires disclosure of the existence and nature of any repurchase obligation. EITF 89-11 addresses the accounting for SEC reporting companies and is therefore rejected.

23. This issue paper is consistent with the reporting of ESOP debt as discussed in Issue Paper No. 80.

24. The conclusions above are consistent with the Statement of Concepts which states:

Objectives of Statutory Financial Reporting

The primary responsibility of each state insurance department is to regulate insurance companies in accordance with state laws with an emphasis on solvency for the protection of policyholders. The ultimate objective of solvency regulation is to ensure that policyholder, contractholder and other legal obligations are met when they come due and that companies maintain capital and surplus at all times and in such forms as required by statute to provide an adequate margin of safety. The cornerstone of solvency measurement is financial reporting. Therefore, the regulator's ability to effectively determine relative financial condition using financial statements is of paramount importance to the protection of policyholders. An accounting model based on the concepts of conservatism, consistency, and recognition is essential to useful statutory financial reporting.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

25. The P & C Accounting Practices and Procedures Manual, Chapter 13 and the Life/A&H Accounting Practices and Procedures Manual, Chapter 17 include the following guidance in (only the pertinent excerpts are included below):

Debt Obligations of Employee Stock Ownership Plans (ESOP)

Insurance company sponsors of ESOP's must record the debt obligations of such ESOP's on the books of the company in all situations, except when the ESOP has both the ability and intent to satisfy the debt from sources other than dividends on the company's stock, contributions from the company, or the sale or exchange of the company's securities.

Generally Accepted Accounting Principles

26. SOP 93-6 provides the following guidance related to debt obligations of ESOPs (only the pertinent excerpts are included below):

Scope

1. This statement of position (SOP) provides guidance on employers' accounting for employee stock ownership plans (ESOPs). It applies to all employers with ESOPs, both leveraged and nonleveraged. It does not address financial reporting by ESOPs.[1]

[1] Financial reporting by ESOPs is discussed in the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*.

2. An ESOP is an employee benefit plan that is described by the Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code (IRC) of 1986 as a stock bonus plan, or combination stock bonus and money purchase pension plan, designed to invest primarily in employer stock.

3. This SOP supersedes American Institute of Certified Public Accountants (AICPA) SOP 76-3, *Accounting Practices for* Certain *Employee Stock Ownership Plans,* and affects certain Emerging Issues Task Force (EITF) consensuses. A list of the documents affected is provided in appendix D of this SOP.

Background

4. SOP 76-3 was issued in December 1976, primarily to deal with accounting and reporting issues relevant to employers with leveraged ESOPs, and it has been the primary source of guidance on the subject.

5. Since the issuance of SOP 76-3, Congress has revised laws concerning ESOPs several times and the Internal Revenue Service (IRS) and the U.S. Department of Labor have issued many regulations covering the operation of plans, which actions have resulted in changes in the way ESOPs may operate and the reasons they are established by companies. Those changes, the most significant of which are described in Appendix C, were factors in the growth in the number of plans from fewer than 2,500 plans in 1976 to nearly 10,000 at the end of 1990.[2]

[2] Statistics from an unpublished study completed in 1991 by the National Center for Employer Ownership, Oakland, Calif.

6. The increase in the number of ESOPs since the issuance of SOP 76-3 was matched by an increase in their complexity. It is no longer possible to describe a typical ESOP. ESOPs are used for many purposes in addition to furthering employee ownership, some of which were not contemplated when SOP 76-3 was issued. These include the following:

- To fund a matching program for a sponsor's 401(k) saving plan, formula-based profit-sharing plan, and other employee benefits
- To raise new capital or to create a marketplace for the existing stock
- To replace lost benefits from the termination of other retirement plans or provide benefits under postretirement benefit plans, particularly medical benefits
- To be part of the financing package in leveraged buy-outs
- To provide a tax-advantaged means for owners to terminate their ownership
- To be part of a long-term program to restructure the equity section of a plan sponsor's balance sheet
- To defend the company against hostile takeovers

7. The borrowing arrangements used by leveraged ESOPs have also become more diverse. When SOP 76- 3 was issued, most leveraged ESOPs borrowed from outside lenders, and the loan terms were relatively simple. Since then, internally leveraged ESOPs (ESOPs that borrow from the sponsor) have become more common. Furthermore, some ESOP loans are now structured so that a large portion of the debt service will be paid with dividends on shares held by the ESOP rather than with employer contributions.

8. Employers' accounting for ESOP transactions, particularly the measurement of compensation cost and the treatment of dividends on shares held by an ESOP, has been a source of accounting controversy for many years. Even when SOP 76-3 was issued, there was disagreement about some ESOP issues.[3] Changes in laws and regulations that apply to ESOPs and the increased diversity in the structure and purpose of ESOPs have called new attention to the limitations of SOP 76-3. Furthermore, SOP 76-3 does not address some of the accounting issues presented by the new ESOPs. Although the EITF has addressed a number of ESOP issues, it has done so on an ad hoc basis.

[3] Paragraph 13 of SOP 76-3 presents a minority view that disagrees with that SOP's recommendations on reporting dividends paid and earnings per share.

9. Therefore, the Accounting Standards Executive Committee (AcSEC) undertook this project to reconsider SOP 76-3 and to consider current ESOP issues that are not specifically addressed in the accounting literature. AcSEC's objective in issuing this SOP is to enhance the relevance and representational faithfulness of financial statements of employers that sponsor ESOPs.

10. There are two basic forms of ESOP: nonleveraged and leveraged. This SOP addresses the financial reporting for each separately.

Conclusions

11. The following conclusions should be read in conjunction with the "Discussion of Conclusions" beginning with paragraph 59 of this SOP. That section explains considerations that were deemed significant by members of AcSEC in reaching the conclusions.

Leveraged ESOPs

12. Unlike other kinds of employee benefit plans, an ESOP is permitted by ERISA to borrow from a related party or with the assistance of a related party. A leveraged ESOP borrows money to acquire shares of the employer company. The debt usually is collateralized by the employer's shares. The shares initially held by the ESOP in a suspense account are called *suspense shares.*[4] The debt is generally repaid by the ESOP from employer contributions and dividends on the employer's stock. As the debt is repaid, suspense shares are released from the suspense account, and the released shares must be allocated to individual accounts as of the end of the ESOP's fiscal year. The money can be borrowed by the ESOP from the sponsor, with or without

a related outside loan, or directly from an outside lender. Outside loans to the ESOP are generally guaranteed by the sponsor.

[4] Terms defined in the glossary are in italicized type the first time they appear in this SOP.

Reporting the Purchase of Shares by ESOPs

13. An employer should report the issuance of shares or the sale of treasury shares to an ESOP when they occur and should report a corresponding charge to unearned ESOP shares, a contra-equity account. That account should be presented as a separate item in the balance sheet. Furthermore, even if a leveraged ESOP buys outstanding shares of employer stock on the market rather than from the employer, the employer should charge unearned ESOP shares and credit either cash or debt, depending on whether the ESOP is internally or externally leveraged (see paragraph 24).

Reporting the Release of ESOP Shares

14. ESOP shares are released for different purposes: to compensate employees directly, to settle employer liabilities for other employee benefits, and to replace dividends on *allocated shares* that are used for debt service. As ESOP shares are committed to be released, unearned ESOP shares should be credited and, depending on the purpose for which the shares are released, either (a) compensation cost, (b) dividends payable, or (c) compensation liabilities should be charged. Regardless of the account charged, the amount of the charge should be based on fair values[5] of *committed-to-be-released shares.*

[5] Paragraph 20 of this SOP contains guidance on fair value.

15. Under this SOP, when shares are committed to be released, rather than when shares are legally released, is significant for accounting purposes. That refinement was made in recognition of the fact that ESOP shares are legally released from an ESOP's suspense account (and from serving as collateral for ESOP debt) when debt payments are made, but the employee service to which the shares released relates is continuous. Accordingly, for purposes of reporting compensation cost and satisfaction of liabilities under this SOP, accounting recognition should occur when shares are committed to be released, which may occur before the shares are legally released. Shares that have not been legally released, but that relate to employee services rendered during an accounting period (interim or annual) ending before the related debt service payment is made, should be considered committed to be released. The periods of employee service to which shares relate is generally specified in the ESOP documents.

16. Some employers establish ESOPs that are not linked to any other employee benefit or compensation promise; therefore, the ESOP shares directly compensate the employees. For ESOP shares committed to be released to compensate employees directly, the employer should recognize compensation cost equal to the fair value of the shares committed to be released. The shares generally should be deemed to be committed to be released ratably during an accounting period as the employees perform services, and, accordingly, average fair values should be used to determine the amount of compensation cost to recognize each reporting period (interim or annual). The amount of compensation cost recognized in previous interim periods should not be adjusted for subsequent changes in the fair value of shares.

17. Some employers agree to provide a specified or determinable benefit, such as a contribution to a 401(k) plan or to a formula profit-sharing plan, to employees and use the ESOP to partially or fully fund the benefit. Employers should recognize compensation cost and liabilities

associated with providing such benefits to employees in the same manner they would had an ESOP not been used to fund the benefit. For ESOP shares committed to be released to settle liabilities for such benefits, employers should report satisfaction of the liabilities when the shares are committed to be released to settle the liability. The number of shares released to settle the liability is based on the fair value of shares as of dates specified by the employers, which are usually specified in the ESOP documents.

18. The IRC allows employers to use dividends on ESOP shares that have been allocated to participants for debt service if participants are allocated shares of employer stock with a fair value no less than the amount of the dividends used for debt service. If shares released will include shares designated to replace *dividends on previously allocated shares used for debt service,* employers should report the settlement of the dividend payable when the shares are committed to be released to replace the dividends on shares used for debt service. (See paragraphs 21 and 22; only dividends on allocated shares should be charged to retained earnings.) The number of shares committed to be released to replace the dividends on allocated shares used for debt service is based on the fair value of shares as of dates specified by the employer, which are usually specified in the ESOP documents based on the employer's interpretation of current IRS regulations.

19. Unearned ESOP shares should be credited as shares are committed to be released based on the cost of the shares to the ESOP. Employers should charge or credit the difference between the fair value of shares committed to be released and the cost of those shares to the ESOP to shareholders' equity in the same manner as gains and losses on sales of treasury stock (generally to additional paid-in capital).

Fair Value

20. The fair value of ESOP shares is needed to apply certain provisions of this SOP. The fair value of an ESOP share is the amount the seller could reasonably expect to receive for it in a current sale between a willing buyer and a willing seller, that is, other than a forced or liquidation sale. For shares that are traded, the price in the most active market should be used to measure fair value. If there is no market price, the employer's best estimate of fair value should be used. The use of independent experts may be necessary to estimate fair value. For example, the amount determined in a recent (within twelve months of the employer's year-end) independent stock valuation report may aid in determining the best estimate of fair value.

Reporting Dividends on ESOP Shares

21. Because employers control the use of dividends on unallocated shares, dividends on unallocated shares are not considered dividends for financial reporting purposes. Dividends on unallocated shares used to pay debt service should be reported as a reduction of debt or of accrued interest payable. Dividends on unallocated shares paid to participants or added to participant accounts should be reported as compensation cost.

22. Dividends on allocated shares should be charged to retained earnings. The dividends payable may be satisfied either by contributing cash to the participant accounts, by contributing additional shares to participant accounts, or by releasing shares from the ESOP's suspense account to participant accounts (see paragraph 18).

Reporting Redemptions of ESOP Shares

23. Regardless of whether an ESOP is leveraged of nonleveraged, employers are required to give a put option to participants holding ESOP shares that are not readily tradable, which on exercise requires employers to repurchase the shares at fair value. Furthermore, public company sponsors sometimes offer cash redemption options to participants who are eligible to withdraw traded shares from their accounts. Employers should report the satisfaction of such option exercises as purchases of treasury stock.

Reporting of Debt and of Interest

24. For purposes of applying this SOP, ESOP debt is characterized as follows:

- *Direct loan* — A loan made by a lender other than the employer to the ESOP. Such loans often include some formal guarantee or commitment by the employer.
- *Indirect loan* — A loan made by the employer to the ESOP, with a related outside loan to the employer.
- *Employer loan* — A loan made by the employer to the ESOP, with no related outside loan.

ESOPs with indirect loans and employer loans are often referred to as internally leveraged.

25. Employers that sponsor an ESOP with a direct loan should report the obligations of the ESOP to the outside lender as liabilities. Furthermore, employers should accrue interest cost on the debt and should report cash payments to the ESOP that are used by the ESOP to service debt, regardless of whether the source of cash is employer contributions or dividends, as reductions of the debt and accrued interest payable when the ESOP makes the payments to the outside lender.

26. Employers that sponsor an ESOP with an indirect loan should report outside loans as liabilities. Employers should not report a loan receivable from the ESOP as an asset and should, therefore, not recognize interest income on such receivable. Employers should accrue interest cost on the outside loan and should report loan payments as reductions of the principal and accrued interest payable. Contributions to the ESOP and the concurrent payments from the ESOP to the employer for debt service would not be recognized in the employer's financial statements.

27. Employers that sponsor an ESOP with an employer loan should not report the ESOP's note payable and the employer's note receivable in the employer's balance sheet. Accordingly, employers should not recognize interest cost or interest income on an employer loan.

Earnings per Share

28. For purposes of computing primary and fully diluted earnings per share (EPS), ESOP shares that have been committed to be released should be considered outstanding. ESOP shares that have not been committed to be released should not be considered outstanding.

29. Employers with ESOPs that hold convertible preferred stock may encounter unique EPS issues. The remainder of this section provides guidance on how to deal with some of those issues, particularly the following:

- Whether convertible preferred shares held by an ESOP should be considered common stock equivalents
- How to determine the number of shares assumed to be outstanding in the if-converted EPS computations
- How earnings applicable to common stock in if-converted EPS computations should be adjusted for dividends on allocated shares used for debt service
- Whether prior periods' EPS should be restated for changes in conversion rates

This SOP does not provide a step-by-step discussion of how to apply the if-converted method to compute EPS and does not address all possible EPS questions that may arise. Accounting Principles Board (APB) Opinion No. 15, *Earnings per Share*; the AICPA's accounting Interpretations of that Opinion; and illustrations 4 and 5 in appendix A of this SOP provide additional guidance.

30. *Common Stock Equivalents.* APB Opinion No. 15 requires that a convertible security, which at the time of issuance has terms that make it for all practical purposes substantially the equivalent to a common stock, should be regarded as a common stock equivalent. For convertible preferred stock not held by an ESOP, an effective yield test is applied to the securities at the time of issuance to determine whether the securities should be considered common stock equivalents. However, the terms of convertible preferred shares held by ESOPs generally differ from other convertible preferred stock in two ways:

a. Convertible preferred shares held by ESOPs generally cannot remain outstanding indefinitely.

b. ESOP participants cannot withdraw their convertible preferred shares from the plan; the terms generally require participants to redeem the shares with the employer or convert the shares to common stock when participants withdraw their account balances from the ESOP plan. (Whether a participant chooses redemption of conversion depends on the value of the employer's common stock in relation to the stated minimum value of the convertible preferred stock.)

ESOP shares with such characteristics should always be considered common stock equivalents. However, if the convertible preferred shares held by an ESOP may be withdrawn from the plan and sold to someone other than the employer or other ESOP participants, the employer should apply the effective yield test to determine whether the shares should be considered common stock equivalents.

31. *Number of Shares Outstanding.* Under this SOP, ESOP shares are not considered outstanding until they are committed to be released. For ESOP shares considered common stock equivalents, the number of common shares that would be issued on conversion of the convertible shares held by an ESOP that have been committed to be released should be deemed outstanding in the if-converted EPS computations for both primary and fully diluted EPS if the effect is dilutive. Convertible preferred shares held by the ESOP that have not been committed to be released should not be considered outstanding and, accordingly, would be excluded from the if-converted computations for both primary and fully diluted EPS.

32. When participants withdraw account balances containing convertible preferred shares from an ESOP, they may be entitled to receive common shares or cash with a value equal to either the fair value of the convertible preferred shares of a stated minimum value per share. Accordingly, if the value of the common stock issuable is less than the stated minimum value or the fair value of the preferred, participants may receive common shares or cash with a value greater than the value of the common shares issuable at the stated conversion rate. In determining EPS, the employer should presume that such a shortfall will be made up with shares of common stock. However, that presumption may be overcome if past experience or a stated policy provides a reasonable basis to believe that the shortfall will be paid in cash.[6] In applying the if-converted method, the number of common shares issuable on assumed conversion, which should be included in the denominator of the EPS calculation, should be the greater of (a) the shares issuable at the stated conversion rate and (b) the shares issuable if the participants were to withdraw the shares from their accounts. Shares issuable on assumed withdrawal should be computed for primary earnings based on the ratio of (a) the average fair value of the convertible stock or, if greater, its stated minimum value, to (b) the average fair value of the common stock. For fully diluted EPS, the ratio should be (a) the end-of-period fair value of the convertible stock or, if greater, the stated minimum value, to (b) the end-of-period value of the common stock, if that ratio is more dilutive than the primary EPS ratio. The appropriate ratios should then be applied to the shares issuable at the state conversion rate to determine the number of shares issuable on assumed withdrawal.

[6] Financial Accounting Standards Board (FASB) Interpretation No. 31, *Treatment of Stock Compensation Plan in EPS Computations,* used such a presumption for stock appreciation rights and other variable plan awards.

33. *Adjustments to Earnings.* Employers that use dividends on allocated ESOP shares to pay debt service should adjust earnings applicable to common shares in the if-converted computation for the difference (net of income taxes) between the amount of compensation cost reported and the amount of compensation cost that would have been reported if the allocated shares had been converted to common stock at the beginning of the period.

34. *Changes in Conversion Rates.* In consonance with paragraphs 56-58 of APB Opinion 15, prior period EPS should not be restated for changes in the conversion rates.

Accounting for Terminations

35. Upon termination of a leveraged ESOP, either in whole or in part, all outstanding debt related to the shares being terminated must be repaid or refinanced. An ESOP may repay the debt using an employer contribution to the plan, dividends on ESOP shares, the proceeds from selling suspense shares to the employer or to another party, or some combination of these. The law limits the shares employers may reacquire to the number of shares with a fair value equal to the applicable unpaid debt and requires that the remaining shares, if any, be allocated to participants.

36. If the employer makes a contribution to the ESOP or pays dividends on unallocated shares that are used by the ESOP to repay the debt, the employer should charge the debt and accrued interest payable when the ESOP makes the payment to the outside lender. Similarly, an employer sponsoring an ESOP with an indirect loan should report loan repayments as reductions of the debt and accrued interest payable.

37. If the ESOP sells the suspense shares and used the proceeds to repay the debt, the employer should report the release of the suspense shares as a credit to unearned ESOP shares based on the cost of the shares to the ESOP, charge debt, and accrued interest payable, and recognize the difference in paid-in capital. However, if there is a difference between the amount paid to an outside lender and the net carrying amount of the debt, paragraph 20 of APB Opinion No. 26, *Early Extinguishment of Debt,* as amended by FASB Statement of Financial Accounting Standards No. 4, *Reporting Gains and Losses from Extinguishment of Debt,* requires that difference to be included in the employer's income when the debt is extinguished.

38. If an employer reacquires the suspense shares from the ESOP, the purchase of the shares should be accounted for as a treasury stock transaction. The treasury stock should be reported at the fair value of the shares at the reacquisition date. Unearned ESOP shares should be credited for the cost of the shares, and the difference should be recognized in additional paid-in capital.

39. If the fair value of the suspense shares on the termination date is more than the unpaid debt balance, the release of the remaining suspense shares to participants should be charged to compensation in accordance with paragraphs 14-18 of this SOP. That is, compensation cost should equal the fair value of the shares at the date the ESOP debt is extinguished, because that is when the shares are committed to be released.

Nonleveraged ESOPs

40. An employer with a nonleveraged ESOP periodically contributes its shares or cash to its ESOP on behalf of employees. The shares contributed or acquired with the cash contributed, which may be outstanding shares, treasury shares, or newly issued shares, are allocated to participant accounts and held by the ESOP until distributed to the employees at a future date, such as on the date of termination or retirement. The shares of employer stock obtained by the nonleveraged ESOP must be allocated to individual participant accounts as of the end of the ESOP's fiscal year.

Reporting Purchase of Shares by ESOPs

41. Employers with nonleveraged ESOPs should report compensation cost equal to the contribution called for in the period under the plan. Compensation cost should be measured as the fair value of the shares contributed to or committed to be contributed to the ESOP or as the cash contributed to or committed to be contributed to the ESOP, as appropriate under the terms of the plan.

Reporting Dividends on ESOP Shares

42. Employers with nonleveraged ESOPs should charge dividends on shares held by the ESOPs to retained earnings, except that dividends on suspense account shares of a pension reversion ESOP should be accounted for the same way as dividends on suspense account shares of leveraged ESOPs.

Reporting Redemptions of ESOP Shares

43. Regardless of whether an ESOP is leveraged or nonleveraged, employers are required to give a put option to participants holding ESOP shares that are not readily tradable, which on exercise requires the employer to repurchase the shares at fair value. Furthermore, public company sponsors sometimes offer cash redemption options to participants who are eligible to withdraw traded shares from their accounts, which on exercise requires the employer to repurchase the shares at fair value. Employers should report the satisfaction of such option exercises as purchases of treasury stock.

Earnings per Share

44. All shares held by a nonleveraged ESOP should be treated as outstanding in computing the employer’s EPS, except the suspense account shares of a pension reversion ESOP, which should not be treated as outstanding until they are committed to be released for allocation to participant accounts. If a nonleveraged ESOP holds convertible preferred stock, the guidance in paragraphs 29-34 of this SOP for leveraged ESOPs should be considered.

Pension Reversion ESOPs

45. An employer that terminates a defined benefit pension plan may avoid part of the excise tax on an asset reversion by transferring the assets to an existing or newly created ESOP, which could be either leveraged or nonleveraged. The reverted assets may be used either to purchase shares of the employer stock or to retire existing ESOP debt.

46. If the assets from the pension plan are used by the ESOP to purchase employer shares, the employer should report the share issuance the same way as other share issuances to an ESOP. The issuance of shares or the sale of treasury shares to the ESOP should be recognized when it occurs, and a corresponding charge to unearned ESOP shares, a contra-equity account, should be reported. If the shares are purchased on the market, the employer should similarly charge unearned ESOP shares. (The credit would be to cash.)

47. Because the number of shares the ESOP acquires in a pension plan reversion is usually more than the IRS permits to be allocated to participant accounts in a single year, some of the shares are held in a suspense account until they are committed to be released in future years for allocation to participant accounts. The guidance in this SOP, for shares held by leveraged ESOPs, should be applied to suspense account shares.

48. If the assets from the pension plan reversion are used to repay the debt of an existing ESOP, ESOP shares are committed to be released from suspense. In such situations, the guidance for leveraged ESOPs in this SOP should be followed. The employer should reduce the debt as it is repaid and reduce unearned ESOP shares as shares are committed to be released. How the committed-to-be-released shares are used determines what accounts are charged upon release of shares (see paragraphs 14-18).

Issues Related to Accounting for Income Taxes

Leveraged ESOPs

49. For employers with leveraged ESOPs, the amount of ESOP-related expense reported under this SOP for a period may differ from the amount of the ESOP-related income tax deduction (prescribed by income tax rules and regulations) for that period. Differences result if (a) the fair value of shares committed to be released differs from the cost of those shares to the ESOP and (b) the timing of expense recognition is different for income tax and financial reporting purposes. Such differences should be reported in accordance with *FASB Statement No. 109*, *Accounting for Income Taxes.* Similar differences arise from employee stock options. Paragraph 36.e. of Statement No. 109 requires that the tax effects of expenses for employee stock options recognized differently for financial reporting and tax purposes be recognized in the related component of shareholders' equity.

50. In accordance with paragraph 36.e. of Statement No. 109, if the cost of shares committed to be released is greater than their fair value, the employer should credit the tax effect of the amount by which the deductible expense exceeds the book expense to shareholders' equity. Conversely, if the cost of shares committed to be released is less than their fair value, the employer should charge the tax effect of the amount by which the book expense exceeds the deductible expense to shareholders' equity to the extent of previous credits to shareholders' equity related to cost exceeding fair value of ESOP shares committed to be released in previous periods.

51. Furthermore, the tax benefit of tax-deductible dividends on allocated ESOP shares should be recorded as a reduction of income tax expense allocated to continuing operations. Under paragraph 36.f. of FASB Statement No. 109, the tax benefit of tax-deductible dividends on unallocated ESOP shares that are charged to retained earnings should be credited to shareholders' equity. However, because dividends on unallocated shares would not be charged to retained earnings under this SOP, paragraph 36.f. of Statement No. 109 would not apply to ESOP shares accounted for under this SOP.

Nonleveraged ESOPs

52. Employers with nonleveraged ESOPs may accrue compensation cost for financial reporting purposes earlier than the cost is deductible for income tax purposes. Accruing the compensation cost earlier for financial reporting purposes creates a temporary difference under Statement No. 109.

Disclosures

53. An employer sponsoring an ESOP should disclose the following information about the plan, if applicable:

a. A description of the plan, the basis for determining contributions, including the employee groups covered, and the nature and effect of significant matters affecting comparability of information for all periods presented. For leveraged ESOPs and pension reversion ESOPs, the description should include the basis for releasing shares and how dividends on allocated and unallocated shares are used.

b. A description of the accounting policies followed for ESOP transactions, including the method of measuring compensation, the classification of dividends on ESOP shares, and the treatment of ESOP shares for EPS computations. If the employer has both old ESOP shares for which it does not adopt the guidance in this SOP and new ESOP shares for which the guidance in the SOP is required (see paragraphs 54 and 55), the accounting policies for both blocks of shares shall be described.

c. The amount of compensation cost recognized during the period.

d. The number of allocated shares, committed-to-be-released shares, and suspense shares held by the ESOP at the balance-sheet date. This disclosure should be made separately for shares accounted for under this SOP and for grandfathered ESOP shares (see paragraphs 54 and 55).

e. The fair value of unearned ESOP shares at the balance-sheet date for shares accounted for under this SOP. (Future tax deductions will be allowed only for the ESOP's cost of unearned ESOP shares.) This disclosure need not be made for old ESOP shares for which the employer does not apply the guidance in this SOP (see paragraphs 55 and 56).

f. The existence and nature of any repurchase obligation, including disclosure of the fair value[7] of the shares allocated as of the balance-sheet date, which are subject to a repurchase obligation.

[7] See paragraph 20 for guidance on fair value.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manuals for Life and Accident and Health Insurance Companies, Chapter 17, Other Liabilities
- Accounting Practices and Procedures Manuals for Property and Casualty Insurance Companies, Chapter 13, Other Liabilities
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 24—Discontinued Operations and Extraordinary Items*
- *Issue Paper No. 72—Statutory Surplus*
- *Issue Paper No. 80—Debt*
- *Issue Paper No. 83—Accounting for Income Taxes*

Generally Accepted Accounting Principles

- *AICPA Statement of Position 93-6, Employers' Accounting for Employee Stock Ownership Plans.*
- *FASB Emerging Issues Task Force Issue No. 89-11, Sponsor's Balance Sheet Classification of Capital Stock with a Put Option Held by an Employee Stock Ownership Plan*

State Regulations

- No additional guidance obtained from state statutes or regulations.

Other Sources of Information

- Securities and Exchange Commission *Codification of Financial Reporting Policies*, Section 211 - Redeemable Preferred Stocks

Statutory Issue Paper No. 80

Debt

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 15

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory accounting guidance for debt is provided in the Accounting Practices and Procedures Manuals for Life and Accident and Health (Life/A&H Accounting Practices and Procedures Manual) and for Property and Casualty Insurance Companies (P & C Accounting Practices and Procedures Manual). This guidance provides that debt be reported at the unpaid amount at the balance sheet date. Loans secured by mortgages on company real estate are treated as a reduction from the asset value of such real estate. Additionally, debt obligations of Employee Stock Ownership Plans ("ESOP") must be recorded as debt obligations of company sponsors, except when the ESOP has both the ability and intent to satisfy the debt from sources other than dividends on the company stock, contributions from the company or the sale or exchange of the company's securities. See *Issue Paper No. 41—Surplus Notes* (Issue Paper No. 41) for discussion of surplus notes.

2. GAAP addresses accounting for debt in *Accounting Principles Board Opinion No. 14*, *Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants* (APB 14), *Accounting Principles Board Opinion No. 21*, *Interest on Receivables and Payables* (APB 21)*, Accounting Principles Board Opinion No. 26*, *Early Extinguishment of Debt* (APB 26), *FASB Statement No. 4*, *Reporting Gains and Losses from Extinguishment of Debt* (FAS 4), *FASB Statement No. 47*, *Disclosure of Long Term Obligations* (FAS 47), *FASB Statement No. 76*, *Extinguishment of Debt* (FAS 76), *FASB Statement No. 84*, *Induced Conversions of Convertible Debt* (FAS 84) and in *AICPA Statement of Position 93-6, Employers' Accounting for Employee Stock Ownership Plans* (SOP 93-6).

3. The purpose of this issue paper is to establish statutory accounting principles for debt that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. Debt shall be reported as a liability unless it is debt on real estate (i.e., reported as a reduction in the carrying value of real estate) in accordance with *Issue Paper No. 40—Real Estate Investments* (Issue Paper No. 40), or is offset against another asset in accordance with *Issue Paper No. 76—Offsetting and Netting of Assets and Liabilities* (Issue Paper No. 76) or is specified elsewhere within the codification. Instruments that meet the requirements to be recorded as surplus as specified in *Issue Paper No. 41—Notes*, are not considered debt. Interest on debt shall be accrued over the life of the debt and charged to operations, except when capitalized in accordance with *Issue Paper No. 44—Capitalization of Interest* (Issue Paper No. 44). Interest payable shall include interest payable on all debt reported as a liability, approved interest on surplus notes and interest payable on debt reported as a reduction in the carrying value of real estate.

5. Debt discount or premium, if any, shall be reported in the balance sheet as a direct deduction from or addition to the face amount of the note. Such discount or premium shall be amortized over the life of the note using the interest method.

6. Debt issuance costs (i.e., loan fees, legal fees, etc.) do not meet the definition of an asset as defined in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets* (Issue Paper No. 4). Accordingly, such costs shall be charged to operations.

7. Debt obligations of ESOPs shall be reported as borrowed money by company sponsors, except when the ESOP has both the ability and intent to satisfy the debt from sources other than dividends on the company stock, contributions from the company or the sale or exchange of the company's securities. ESOPs are addressed in *Issue Paper No. 78—Employee Stock Ownership Plans*.

8. Debt which is subject to a troubled debt restructuring shall be accounted for in accordance with *Issue Paper No. 36—Troubled Debt Restructurings* (Issue Paper No. 36).

9. Convertible debt securities that are convertible into common stock of the issuer or an affiliated company at a specified price at the option of the holder and which are sold at a price not significantly in excess of the face amount shall be accounted for solely as debt at the time of issuance. An expense shall be recognized, equal to the fair value of additional securities granted or other consideration issued to induce conversion subsequent to the issuance of convertible debt securities.

10. Proceeds from debt issued with detachable stock purchase warrants shall be allocated based on the relative fair value of the two securities at the time of issuance. The value attributable to the warrants shall be accounted for as paid-in capital.

11. Other types of debt securities shall be accounted for in accordance with the substance of the transaction.

12. Debt shall be considered extinguished if the debtor is relieved of primary liability for the debt by the creditor and it is probable that the debtor will not be required to make future payments as guarantor of the debt. Even if the creditor does not relieve the debtor of its primary obligation, such debt shall be considered extinguished if the debtor irrevocably places cash or other monetary assets (that are essentially risk free as to the amount, timing, and collection of interest and principal) in a trust to be used solely for satisfying scheduled payments of both interest and principal of a specific obligation and the possibility that the debtor will be required to make future payments with respect to that debt is remote. The monetary assets held by the trust shall provide cash flows (from interest and maturity of those assets) that approximately coincide, as to timing and amount, with the scheduled interest and principal payments on the debt that is being extinguished. Gains and losses from extinguishment of debt are capital gains or losses, and shall be charged to operations in accordance with *Issue Paper No. 24—Discontinued Operations and Extraordinary Items* (Issue Paper No. 24).

13. The financial statements or notes thereto shall disclose the following items related to debt:

- date issued;
- pertinent information concerning the kind of borrowing (e.g. debentures, commercial paper outstanding, bank loans, lines of credit, etc.);
- face amount of the debt;
- carrying value of debt;
- the rate at which interest accrues;
- the effective interest rate;
- the combined aggregate amount of maturities and sinking fund requirements for each of the five years following the latest balance sheet presented;

- collateral requirements;
- a summary of significant debt terms and covenants and any violations;
- interest paid in the current year;
- if debt was considered to be extinguished by in-substance defeasance prior to the effective date of this issue paper and any of the debt remains outstanding, a general description of the transaction and the amount of debt that is considered extinguished at the end of the period; and
- if assets are set aside after the effective date of this issue paper solely for satisfying scheduled payments of a specific obligation, a description of the nature of restrictions placed on those assets

DISCUSSION

14. This issue paper adopts current statutory guidance for debt. It expands on current statutory guidance to address the accounting for debt discount and premium, debt issuance costs, convertible debt securities, debt issued with detachable stock purchase warrants and extinguishment of debt. It also expands current statutory guidance to address disclosure requirements regarding the carrying value of the debt, effective interest rate, combined aggregate amount of maturities and sinking fund requirements for each of the five years following the latest balance sheet presented and interest paid in the current year.

15. This issue paper adopts APB 14 and FAS 84. The requirement in paragraph 13 to disclose the aggregate amount of maturities and sinking fund requirements for each of the next five years is consistent with subparagraph 10b of *FASB Statement No. 47*, *Disclosure of Long Term Obligations*.

16. This issue paper adopts APB 21 with a modification to require that debt issuance costs be charged to operations. These costs represent deferred charges which are immediately expensed for statutory accounting, whereas GAAP requires that such costs be reported on the balance sheet as deferred charges and be recognized over the period of the borrowing as an adjustment to the effective interest rate. Immediately expensing debt issuance costs is consistent with the Statement of Concepts which states "Accounting treatments which tend to defer expense recognition do not generally represent acceptable SAP treatment".

17. This issue paper rejects FAS 4 and *FASB Statement No. 64*, *Extinguishment of Debt Made to Satisfy Sinking Fund Requirements—an Amendment of FASB Statement No. 4*. This issue paper also rejects *FASB Emerging Issues Task Force No. 84-40, Long-Term Debt Repayable by a Capital Stock*.

18. This issue paper adopts APB 26 with modification to require that gains and losses from extinguishment of debt be reported as capital gains or losses, and charged to operations in accordance with Issue Paper No. 24. This issue paper adopts paragraphs 13 and 25 of SOP 93-6 with a modification to exclude debt obligations when the ESOP has both the ability and intent to satisfy the debt from sources other than dividends on the company's stock, contributions from the company or the sale or exchange of the company's securities. Such obligations do not meet the definition of liabilities (of the sponsor) as defined in *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets* (Issue Paper No. 5). This issue paper rejects paragraph 37 of SOP 93-6 as it relates to reporting gain and losses on extinguishment of debt. Such gains and losses shall be accounted for consistent with Issue Paper No. 24. SOP 93-6 will be addressed in its entirety in Issue Paper No. 78.

19. This issue paper adopts *FASB Emerging Issues Task Force No. 90-19, Convertible Bonds with Issuer Option to Settle for Cash upon Conversion*, with a modification to reject guidance related to earnings per share and *FASB Technical Bulletin No. 80-1*, *Early Extinguishment of Debt through Exchange for Common or Preferred Stock*, with a modification to reject guidance related to classification of the loss as an extraordinary item.

20. Additionally, this issue paper adopts the following pronouncements which clarify and/or provide guidance in certain circumstance (such pronouncements are not reproduced herein due to length and limited scope):

Accounting Principles Board Opinion No. 12, paragraphs 16 and 17, Omnibus Opinion – 1967
AICPA Accounting Interpretations of APB 21, Interest on Receivables and Payables
AICPA Accounting Interpretations of APB 26, Early Extinguishment of Debt
FASB Emerging Issues Task Force No. 85-9, Revenue Recognition on Options to Purchase Stock of Another Entity
FASB Emerging Issues Task Force No. 85-17, Accrued Interest upon Conversion of Convertible Debt
FASB Emerging Issues Task Force No. 85-29, Convertible Bonds with a "Premium Put"
FASB Emerging Issues Task Force No. 86-8, Sale of Bad-Debt Recovery Rights
FASB Emerging Issues Task Force No. 86-15, Increasing-Rate Debt
FASB Emerging Issues Task Force No. 86-18, Debtor's Accounting for a Modification of Debt Terms
FASB Emerging Issues Task Force No. 86-28, Accounting Implications of Indexed Debt Instruments
FASB Emerging Issues Task Force No. 86-36, Invasion of a Defeasance Trust
FASB Emerging Issues Task Force No. 95-15, Recognition of Gain or Loss When a Binding Contract Requires a Debt Extinguishment to Occur at a Future Date for a Specified Amount

21. This issue paper is consistent with the reporting for surplus notes as addressed in Issue Paper No. 41, the reporting of encumbrances on real estate as discussed in Issue Paper No. 40, the offsetting of assets and liabilities as addressed in Issue Paper No. 76 and the reporting of gains and losses on troubled debt restructurings as discussed in Issue Paper No. 36.

22. The conclusions above are consistent with the Statement of Concepts which states:

> Objectives of Statutory Financial Reporting
>
> The primary responsibility of each state insurance department is to regulate insurance companies in accordance with state laws with an emphasis on solvency for the protection of policyholders. The ultimate objective of solvency regulation is to ensure that policyholder, contractholder and other legal obligations are met when they come due and that companies maintain capital and surplus at all times and in such forms as required by statute to provide an adequate margin of safety. The cornerstone of solvency measurement is financial reporting. Therefore, the regulator's ability to effectively determine relative financial condition using financial statements is of paramount importance to the protection of policyholders. An accounting model based on the concepts of conservatism, consistency, and recognition is essential to useful statutory financial reporting.

Drafting Notes/Comments

- Reverse repurchase agreements are addressed in *Issue Paper No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements*.
- Pledged assets are addressed in *Issue Paper No. 77—Disclosure of Accounting Policies, Risks & Uncertainties, and Other Disclosures*.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

23. The P & C Accounting Practices and Procedures Manual includes the following guidance in Chapter 13 (only the pertinent excerpts are included below):

Borrowed Money

Borrowed money includes liabilities for loans except those secured by mortgages on company real estate and surplus loans. The amount to be reported is the amount unpaid at the balance sheet date. Resolution authorizing borrowed money are usually shown in the minutes of the board of directors, executive, investment, or finance committees.

Loans secured by mortgages on company real estate are treated as a reduction from the asset value of such real estate rather than as "Borrowed Money." For further discussion, see Chapter 4-Real Estate.

Surplus loans, i.e., subordinated surplus debentures, are covered in Chapter 24-Paid-In or Contributed Surplus.

Interest Payable

Interest payable includes interest on "Borrowed Money" as well as interest on real estate and surplus loans. It also includes interest on funds held as a deposit or security, such as those held by a ceding company against a reinsurer. Further treatment of funds held by a ceding company may be found in Chapter 22-Reinsurance.

The interest on "Borrowed Money" is also shown parenthetically as part of the caption of this liability item in the annual statement.

Debt Obligations of Employee Stock Ownership Plans (ESOP)

Insurance company sponsors of ESOP's must record the debt obligations of such ESOP's on the books of the company in all situations, except when the ESOP has both the ability and intent to satisfy the debt from sources other than dividends on the company's stock, contributions from the company, or the sale or exchange of the company's securities.

24. The Life/A&H Accounting Practices and Procedures Manual includes the following guidance in Chapter 17 (only the pertinent excerpts are included below):

Borrowed Money

Borrowed money is debt, other than subordinated surplus debentures, contribution notes, or similar indebtedness. The amount to be reported is the amount unpaid at the balance sheet date plus the related accrued interest. See Chapter 27 for a discussion of subordinated surplus debentures, etc.

Debt Obligations of Employee Stock Ownership Plans (ESOP)

Insurance company sponsors of ESOP's must record the debt obligations of such ESOP's on the books of the company in all situations, except when the ESOP has both the ability and intent to satisfy the debt from sources other than dividends on the company's stock, contributions from the company, or the sale or exchange of the company's securities.

25. The NAIC Annual Statement Instructions (Annual Statement Instructions) for Property and Casualty Insurance Companies provide the following guidance. Substantially similar guidance is provided in the Annual Statement Instructions for Life and Accident and Health Insurance Companies.

7. Borrowed Money

Instruction:

Furnish pertinent information concerning the kind of borrowing (e.g., debentures, commercial paper outstanding, bank loan, lines of credit, etc.). Indicate redemption price, if any, interest features, collateral requirements, maturity date, etc., for money borrowed by the company. Also include information regarding material loan provisions (i.e., convenants) that must be satisfied or maintained on a continuing basis and indicate if the society is in violation of any such loan provisions. Identify the terms of reverse repurchase agreements whose amounts have been included in the liability for borrowed money.

Generally Accepted Accounting Principles

26. APB 14 provides the following guidance (only the pertinent excerpts are included below):

CONVERTIBLE DEBT

Discussion

3. Convertible debt securities discussed herein are those debt securities which are convertible into common stock of the issuer or an affiliated company at a specified price at the option of the holder and which are sold at a price or have a value at issuance not significantly in excess of the face amount. The terms of such securities generally include (1) an interest rate which is lower than the issuer could establish for nonconvertible debt, (2) an initial conversion price which is greater than the market value of the common stock at time of issuance, and (3) a conversion price which does not decrease except pursuant to antidilution provisions. In most cases such securities also are callable at the option of the issuer and are subordinated to nonconvertible debt.

7. The most important reason given for accounting for convertible debt solely as debt is the inseparability of the debt and the conversion option. A convertible debt security is a complex hybrid instrument bearing an option, the alternative choices of which cannot exist independently of one another. The holder ordinarily does not sell one right and retain the other. Furthermore the two choices are mutually exclusive; they cannot both be consummated. Thus, the security will either be converted into common stock or be redeemed for cash. The holder cannot exercise the option to convert unless he forgoes the right to redemption, and vice versa.

Opinion

12. The Board is of the opinion that no portion of the proceeds from the issuance of the types of convertible debt securities described in paragraph 3 should be accounted for as attributable to the conversion feature. In reaching this conclusion, the Board places greater weight on the inseparability of the debt and the conversion option (as described in paragraph 7) and less weight on practical difficulties.

DEBT WITH STOCK PURCHASE WARRANTS

Opinion

16. The Board is of the opinion that the portion of the proceeds of debt securities issued with detachable stock purchase warrants which is allocable to the warrants should be accounted for as paid-in capital. The allocation should be based on the relative fair values of the two securities at time of issuance.[2] Any resulting discount or premium on the debt securities should be accounted for as such.[3] The same accounting treatment applies to issues of debt securities (issued with detachable warrants) which may be surrendered in settlement of the exercise price of the warrant. However, when stock purchase warrants are not detachable from the debt and the debt security must be surrendered in order to exercise the warrant, the two securities taken together are substantially equivalent to convertible debt and the accounting specified in paragraph 12 should apply.

[2] The time of issuance generally is the date when agreement as to terms has been reached and announced, even though the agreement is subject to certain further actions, such as directors' or stockholders' approval. APB 14 Footnote 3

[3] See Chapter 15 of ARB No. 43 (as amended by paragraph 19 of APB Opinion No. 6 and paragraph 17 of APB Opinion No. 9) and paragraphs 16 and 17 of APB Opinion No. 12.

17. When detachable warrants are issued in conjunction with debt as consideration in purchase transactions, the amounts attributable to each class of security issued should be determined separately, based on values at the time of issuance.[2] The debt discount or premium is obtained by comparing the value attributed to the debt securities with the face amount thereof.

OTHER TYPES OF DEBT SECURITIES

Opinion

18. The Board recognizes that it is not practicable in this Opinion to discuss all possible types of debt with conversion features, debt issued with stock purchase warrants, or debt securities with a combination of such features. Securities not explicitly discussed in this Opinion should be dealt with in accordance with the substance of the transaction. For example, when convertible debt is issued at a substantial premium, there is a presumption that such premium represents paid-in capital.

27. APB 21 provides the following guidance (only the pertinent excerpts are included below):

> Opinion
>
> 15. Amortization of discount and premium. With respect to a note which by the provisions of this Opinion requires the imputation of interest, the difference between the present value and the face amount should be treated as discount or premium[8] and amortized as interest expense or income over the life of the note in such a way as to result in a constant rate of interest when applied to the amount outstanding at the beginning of any given period. This is the "interest" method described in and supported by paragraphs 16 and 17 of *APB Opinion No. 12, Omnibus Opinion--1967*. However, other methods of amortization may be used if the results obtained are not materially different from those which would result from the "interest" method.
>
> [8] Differences between the recognition for financial accounting purposes and income tax purposes of discount or premium resulting from determination of the present value of a note should be treated as timing differences in accordance with *APB Opinion No. 11, Accounting for Income Taxes*.
>
> 16. Statement presentation of discount and premium. The discount or premium resulting from the determination of present value in cash or non-cash transactions is not an asset or liability separable from the note which gives rise to it. Therefore, the discount or premium should be reported in the balance sheet as a direct deduction from or addition to the face amount of the note. It should not be classified as a deferred charge or deferred credit. The description of the note should include the effective interest rate; the face amount should also be disclosed in the financial statements or in the notes to the statements.[9] Amortization of discount or premium should be reported as interest in the statement of income. Issue costs should be reported in the balance sheet as deferred charges.
>
> [9] Refer to the Appendix for illustrations of balance sheet presentation.

28. APB 26 provides the following guidance (only the pertinent excerpts are included below):

> Opinion
>
> 19. Reduction of alternatives. The Board concludes that all extinguishments of debt before scheduled maturities are fundamentally alike. The accounting for such transactions should be the same regardless of the means used to achieve the extinguishment.
>
> 20. Disposition of amounts. A difference between the reacquisition price and the net carrying amount of the extinguished debt should be recognized currently in income of the period of extinguishment as losses or gains and identified as a separate item.[1] The criteria in APB Opinion No. 9 should be used to determine whether the losses or gains are ordinary or extraordinary items. Gains and losses should not be amortized to future periods.
>
> [1] If upon extinguishment of debt, the parties also exchange unstated (or stated) rights or privileges, the portion of the consideration exchanged allocable to such unstated (or stated) rights or privileges should be given appropriate accounting recognition. Moreover, extinguishment transactions between related entities may be in essence capital transactions.

> 21. Convertible debt. The extinguishment of convertible debt before maturity does not change the character of the security as between debt and equity at that time. Therefore, a difference between the cash acquisition price of the debt and its net carrying amount should be recognized currently in income in the period of extinguishment as losses or gains.

29. FAS 47 provides the following guidance (only the pertinent excerpts are included below):

> 10. The following information shall be disclosed for each of the five years following the date of the latest balance sheet presented:
>
> b. The combined aggregate amount of maturities and sinking fund requirements for all long-term borrowings

30. FAS 84 provides the following guidance (only the pertinent excerpts are included below):

> APPLICABILITY AND SCOPE
>
> 2. This Statement applies to conversions of convertible debt to equity securities pursuant to terms that reflect changes made by the debtor to the conversion privileges provided in the terms of the debt at issuance (including changes that involve the payment of consideration) for the purpose of inducing conversion. This Statement applies only to conversions[2] that both (a) occur pursuant to changed conversion privileges that are exercisable only for a limited period of time and (b) include the issuance of all of the equity securities issuable pursuant to conversion privileges included in the terms of the debt at issuance for each debt instrument that is converted. The changed terms may involve reduction of the original conversion price thereby resulting in the issuance of additional shares of stock, issuance of warrants or other securities not provided for in the original conversion terms, or payment of cash or other consideration to those debt holders who convert during the specified time period. This Statement does not apply to conversions pursuant to other changes in conversion privileges or to changes in terms of convertible debt instruments that are different from those described in this paragraph.
>
> [2] For purposes of this Statement, a conversion includes an exchange of a convertible debt instrument for equity securities or a combination of equity securities and other consideration, whether or not the exchange involves legal exercise of the contractual conversion privileges included in terms of the debt.
>
> STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING
>
> Recognition of Expense upon Conversion
>
> 3. When convertible debt is converted to equity securities of the debtor pursuant to an inducement offer described in paragraph 2 of this Statement, the debtor enterprise shall recognize an expense equal to the fair value of all securities and other consideration transferred in the transaction in excess of the fair value of securities issuable pursuant to the original conversion terms. The expense shall not be reported as an extraordinary item.
>
> 4. The fair value of the securities or other consideration shall be measured as of the date the inducement offer is accepted by the convertible debt holder. Normally this will be the date the debt holder converts the convertible debt into equity securities or enters into a binding agreement to do so.

31. SOP 93-6 provides the following guidance related to debt obligations of ESOPs (only the pertinent excerpts are included below):

Leveraged ESOPs

12. Unlike other kinds of employee benefit plans, an ESOP is permitted by ERISA to borrow from a related party or with the assistance of a related party. A leveraged ESOP borrows money to acquire shares of the employer company. The debt usually is collateralized by the employer's shares. The shares initially held by the ESOP in a suspense account are called *suspense shares*.[4] The debt is generally repaid by the ESOP from employer contributions and dividends on the employer's stock. As the debt is repaid, suspense shares are released from the suspense account, and the released shares must be allocated to individual accounts as of the end of the ESOP's fiscal year. The money can be borrowed by the ESOP from the sponsor, with or without a related outside loan, or directly from an outside lender. Outside loans to the ESOP are generally guaranteed by the sponsor.

[4] Terms defined in the glossary are in italicized type the first time they appear in this SOP.

Reporting the Purchase of Shares by ESOPs

13. An employer should report the issuance of shares or the sale of treasury shares to an ESOP when they occur and should report a corresponding charge to unearned ESOP shares, a contra-equity account. That account should be presented as a separate item in the balance sheet. Furthermore, even if a leveraged ESOP buys outstanding shares of employer stock on the market rather than from the employer, the employer should charge unearned ESOP shares and credit either cash or debt, depending on whether the ESOP is internally or externally leveraged (see paragraph 24).

Reporting of Debt and of Interest

24. For purposes of applying this SOP, ESOP debt is characterized as follows:

- *Direct loan* - A loan made by a lender other than the employer to the ESOP. Such loans often include some formal guarantee or commitment by the employer.
- *Indirect* loan - A loan made by the employer to the ESOP, with a related outside loan to the employer.
- *Employer loan* - A loan made by the employer to the ESOP, with no related outside loan.

ESOPs with indirect loans and employer loans are often referred to as internally leveraged.

25. Employers that sponsor an ESOP with a direct loan should report the obligations of the ESOP to the outside lender as liabilities. Furthermore, employers should accrue interest cost on the debt and should report cash payments to the ESOP that are used by the ESOP to service debt, regardless of whether the source of cash is employer contributions or dividends, as reductions of the debt and accrued interest payable when the ESOP makes the payments to the outside lender.

26. Employers that sponsor an ESOP with an indirect loan should report outside loans as liabilities. Employers should not report a loan receivable from the ESOP as an asset and should, therefore, not recognize interest income on such receivable. Employers should accrue interest cost on the outside loan and should report loan payments as reductions of the principal and accrued interest payable. Contributions to the ESOP and the concurrent payments from the ESOP to the employer for debt service would not be recognized in the employer's financial statements.

27. Employers that sponsor an ESOP with an employer loan should not report the ESOP's note payable and the employer's note receivable in the employer's balance sheet. Accordingly, employers should not recognize interest cost or interest income on an employer loan.

Accounting for Terminations

35. Upon termination of a leveraged ESOP, either in whole or in part, all outstanding debt related to the shares being terminated must be repaid or refinanced. An ESOP may repay the debt using an employer contribution to the plan, dividends on ESOP shares, the proceeds from selling suspense shares to the employer or to another party, or some combination of these. The law limits the shares employers may reacquire to the number of shares with a fair value equal to the applicable unpaid debt and requires that the remaining shares, if any, be allocated to participants.

36. If the employer makes a contribution to the ESOP or pays dividends on unallocated shares that are used by the ESOP to repay the debt, the employer should charge the debt and accrued interest payable when the ESOP makes the payment to the outside lender. Similarly, an employer sponsoring a ESOP with an indirect loan should report loan repayments as reductions of the debt and accrued interest payable.

37. If the ESOP sells the suspense shares and used the proceeds to repay the debt, the employer should report the release of the suspense shares as a credit to unearned ESOP shares based on the cost of the shares to the ESOP, charge debt, and accrued interest payable, and recognize the difference in paid-in capital. However, if there is a difference between the amount paid to an outside lender and the net carrying amount of the debt, paragraph 20 of *APB Opinion No. 26*, *Early Extinguishment of Debt*, as amended by *FASB Statement of Financial Accounting Standards No. 4, Reporting Gains and Losses from Extinguishment of Debt,* requires that difference to be included in the employer's income when the debt in extinguished.

38. If an employer reacquires the suspense shares from the ESOP, the purchase of the shares should be accounted for as a treasury stock transaction. The treasury stock should be reported at the fair value of the shares at the reacquisition date. Unearned ESOP shares should be credited for the cost of the shares, and the difference should be recognized in additional paid-in capital.

39. If the fair value of the suspense shares on the termination date is more than the unpaid debt balance, the release of the remaining suspense shares to participants should be charged to compensation in accordance with paragraphs 14 to 18 of this SOP. That is, compensation cost should equal the fair value of the shares at the date the ESOP debt is extinguished, because that is when the shares are committed to be released.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manuals for Life and Accident and Health Insurance Companies, Chapter 4, Real Estate and Chapter 17, Other Liabilities
- Accounting Practices and Procedures Manuals for Property and Casualty Insurance Companies, Chapter 4, Real Estate and Chapter 13, Other Liabilities
- NAIC Annual Statement Instructions for Property and Casualty Insurance Companies
- NAIC Annual Statement Instructions for Life and Accident and Health Insurance Companies
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 23—Property Occupied by the Company*
- *Issue Paper No. 24—Discontinued Operations and Extraordinary Items*
- *Issue Paper No. 36—Troubled Debt Restructurings*
- *Issue Paper No. 40—Real Estate Investments*

- *Issue Paper No. 41—Surplus Notes*
- *Issue Paper No. 44—Capitalization of Interest*
- *Issue Paper No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements*
- *Issue Paper No. 76—Offsetting and Netting of Assets and Liabilities*

Generally Accepted Accounting Principles

- *Accounting Principles Board Opinion No. 12, paragraphs 16 and 17, Omnibus Opinion – 1967*
- *Accounting Principles Board Opinion No. 14, Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants*
- *Accounting Principles Board Opinion No. 21, Interest on Receivables and Payables*
- *Accounting Principles Board Opinion No. 26, Early Extinguishment of Debt*
- *FASB Statement No. 4, Reporting Gains and Losses from Extinguishment of Debt*
- *FASB Statement No. 47, Disclosure of Long Term Obligations*
- *FASB Statement No. 64, Extinguishment of Debt Made to Satisfy Sinking Fund Requirements—an Amendment of FASB Statement No. 4*
- *FASB Statement No. 84, Induced Conversions of Convertible Debt*
- *AICPA Statement of Position 93-6, Employers' Accounting for Employee Stock Ownership Plans*
- *AICPA Accounting Interpretations of APB 21, Interest on Receivables and Payables*
- *AICPA Accounting Interpretations of APB 26, Early Extinguishment of Debt*
- *FASB Emerging Issues Task Force No. 84-40, Long-Term Debt Repayable by a Capital Stock*
- *FASB Emerging Issues Task Force No. 85-9, Revenue Recognition on Options to Purchase Stock of Another Entity*
- *FASB Emerging Issues Task Force No. 85-17, Accrued Interest upon Conversion of Convertible Debt*
- *FASB Emerging Issues Task Force No. 85-29, Convertible Bonds with a "Premium Put"*
- *FASB Emerging Issues Task Force No. 86-8, Sale of Bad-Debt Recovery Rights*
- *FASB Emerging Issues Task Force No. 86-15, Increasing-Rate Debt*
- *FASB Emerging Issues Task Force No. 86-18, Debtor's Accounting for a Modification of Debt Terms*
- *FASB Emerging Issues Task Force No. 86-28, Accounting Implications of Indexed Debt Instruments*
- *FASB Emerging Issues Task Force No. 86-36, Invasion of a Defeasance Trust*
- *FASB Emerging Issues Task Force No. 90-19, Convertible Bonds with Issuer Option to Settle for Cash upon Conversion*
- *FASB Emerging Issues Task Force No. 95-15, Recognition of Gain or Loss When a Binding Contract Requires a Debt Extinguishment to Occur at a Future Date for a Specified Amount*
- *FASB Technical Bulletin No. 80-1, Early Extinguishment of Debt through Exchange for Common or Preferred Stock*

State Regulations

- No additional guidance obtained from state statutes or regulations.

Statutory Issue Paper No. 81

Foreign Currency Transactions and Translations

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 23

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. A foreign currency transaction is a transaction denominated in a currency other than the reporting entity's functional currency. The reporting entity's functional currency is defined as the currency of the primary economic environment in which the reporting entity operates. Foreign currency translation is the translation of financial statements, denominated in the reporting entity's functional currency, into U.S. dollars prior to their incorporation into financial statements through consolidation or the equity method of accounting.

2. Current statutory guidance for accounting for foreign currency transactions is provided in Chapters 13 and 25 of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies (P&C Accounting Practices and Procedures Manual) and Chapter 8 of the Accounting Practices and Procedures Manual for Life, Accident, and Health Insurance Companies (Life/A&H Accounting Practices and Procedures Manual). This guidance requires foreign currency transactions to be recorded in U.S. dollars at the exchange rate in effect at the time of the transaction. At each subsequent statement date, all net assets recorded in each foreign currency are converted to U.S. dollars at the exchange rate in effect at the statement date. Property and casualty insurers record a change in net assets due to changes in foreign exchange rates between the original transaction date and the current statement date as an additional and separate asset or liability with a corresponding adjustment made directly to surplus. Life and accident and health insurers record an additional and separate asset or liability with a corresponding entry to capital gain or loss.

3. Limited statutory guidance for accounting for foreign currency transactions is also provided in the *Purposes and Procedures Manual of the NAIC Securities Valuation Office* (SVO Purposes and Procedures). This guidance requires that market values for securities payable in other than U.S. dollars to be computed by obtaining a quotation in the foreign currency from a reputable source and converting that quotation into U.S. dollars using the exchange rates published in the Valuation of Securities Manual.

4. GAAP guidance for accounting for foreign currency transactions is provided in *FASB Statement No. 52*, *Foreign Currency Translation* (FAS 52). This guidance requires each asset, liability, revenue, expense, gain, or loss arising from a transaction to be measured and recorded in the functional currency of the recording entity by use of the exchange rate in effect at that date. Subsequently, at each balance sheet date, assets and liabilities that are denominated in a currency other than the functional currency of the recording entity are adjusted to reflect the current exchange rate. Any changes in the assets or liabilities from the date of the original transaction to the balance sheet date resulting from exchange rate fluctuations, are included in net income for the period in which the change occurred.

5. GAAP guidance for accounting for foreign currency translation is also provided in FAS 52. This guidance requires all assets and liabilities to be translated at the exchange rate at the balance sheet date, while revenues, expenses, gains, and losses are translated at the exchange rate in effect at the dates on which the transactions were recognized. Because translation at the exchange rates at the dates the

numerous revenues, expenses, gains, and losses are recognized is generally impractical, an appropriately weighted average exchange rate for the period may be used to translate those elements.

6. The purpose of this issue paper is to establish statutory accounting principles for accounting for foreign currency transactions and translation that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

7. For the purposes of this issue paper, a U.S. domiciled entity's reporting currency shall be defined as the U.S. dollar, regardless of the primary economic environment in which the reporting entity operates. In order to ensure consistency, all elements of statutory financial statements shall be reported in U.S. dollars.

8. Each foreign currency transaction shall be examined and a determination made if the foreign currency transaction was made in support of insurance operations denominated in the same foreign currency. For example, some reporting entities engage in operations in foreign countries with the premiums collected and claims paid in local currency. As in any insurance operation there will at times be uncollected premiums, policy reserves, unpaid claims, and other incomplete transactions that must be recorded in the reporting entity's balance sheet. Premiums, reserves, and claims normally are recorded in U.S. dollars at the rate of exchange that is in effect at the time the policy is written, or when the claim is incurred. Changes in exchange rates, while not affecting the foreign policyholder, do affect the value of the foreign business as it is recorded in U.S. dollars.

9. Foreign currency transactions made in support of insurance operations denominated in the same foreign currency, such as foreign branches, shall be accounted for as follows:

a. Canadian Insurance Operations

Canadian insurance operations, resulting in less than 10% of the reporting entity's admitted assets, less than 10% of the reporting entity's liabilities and less than 10% of the reporting entity's net premium, can be translated to U.S. dollars by making an adjustment to the net assets of the foreign operation. The adjustment is calculated by summarizing the assets and liabilities in the foreign currency and in U.S. dollars. The net value is converted to U.S. dollars at the current rate of exchange and compared with the net value in U.S. dollars recorded by the reporting entity. Any difference in the net value to current exchange rates is recorded as a separate asset or liability and the change in the foreign exchange adjustment is recorded as an unrealized capital gain or loss.

b. All Other Foreign Insurance Operations

All other foreign insurance operations must be translated to U.S. dollars as follows: each financial statement line shall be translated to U.S. dollars by applying the following exchange rates: 1) for assets and liabilities, the exchange rate at the balance sheet date shall be used and 2) for revenues, expenses, gains, losses and surplus adjustments, the exchange rate at the dates on which those elements are recognized shall be used. Because translation at the exchange rates at the dates the numerous revenues, expenses, gains, losses and surplus adjustments are recognized is generally impractical, an appropriately weighted average exchange rate for the period may be used to translate those elements. Gains or losses due to translating foreign operations to U.S. dollars shall be recorded as an unrealized capital gain or loss.

10. All other foreign currency transactions shall be accounted for as follows:

a. Assets and liabilities denominated in foreign currencies shall be accounted for at their U.S. dollar equivalent values using exchange rates at the balance sheet date. Income and expenses recognized during an accounting period shall be recorded at an appropriately weighted average exchange rate.

b. Changes in balance sheet asset and liability values due to fluctuations in foreign currency exchange rates shall be recorded as unrealized capital gains and losses until the asset is sold or exchanged or the liability is settled. Upon settlement, previously recorded unrealized capital gains and losses shall be reversed and the foreign exchange profit or loss for the entire holding period shall be recorded as a realized capital gain or loss.

c. Transactions involving settlement in cash, such as purchases, payment of expenses, sales, and receipt of income, shall be recorded at their U.S. dollar equivalent value based on the foreign currency exchange rate as of the transaction date. Any foreign currency exchange gains or losses on purchases, payment of expenses, sales, maturities or changes in income or expense accruals should be recorded as capital gain or loss realized on the purchase, sale or maturity.

11. Nominal information such as par value of investments may be expressed in the foreign currency or U.S. dollar equivalent (description of issue), but where the information is displayed comparatively (column of par values), U.S. dollar equivalent amount should be used. The U.S. dollar equivalent amount is translated utilizing the exchange rate at the balance sheet date. Ratios and factors should be based on data that is entirely consistent with respect to currency.

12. A currency in a highly inflationary environment (one that has cumulative inflation of approximately 100% or more over a three year period) is not considered stable enough to serve as a functional currency and the more stable currency of the reporting parent is to be used instead. If a reporting entity's books of record are not maintained in its functional currency, remeasurement into the functional currency is required. That remeasurement is required before translation into the reporting currency. The remeasurement process is intended to produce the same result as if the reporting entity's books of record had been maintained in the functional currency. The remeasurement of and subsequent accounting for transactions denominated in a currency other than the functional currency shall be in recognized as a realized gain or loss in the statement of operations.

DISCUSSION

13. This issue paper rejects current statutory accounting principles. Current statutory guidance for property and casualty insurers provides that fluctuations in the value of assets and liabilities be summarized and recorded as a net asset or liability with an offsetting adjustment made directly to surplus. Current statutory guidance for life and accident and health insurers provides that fluctuations in the values of assets and liabilities be summarized and recorded as a net asset or liability with a corresponding entry recorded as a capital gain or loss. The conclusions reached in this issue paper require all assets and liabilities to be translated at the exchange rate in effect at the balance sheet date with the corresponding entry recorded as an unrealized gain or loss (see paragraph 14 for reference to exemption for certain Canadian branch operations). This change to require life and accident and health insurers to reflect the translation gain or loss as unrealized was made to conform accounting treatment for the translation adjustment between property and casualty insurers and life and health insurers. Requiring all assets and liabilities to be translated at the exchange rate in effect at the balance sheet date provides more meaningful information to regulators and other financial statement users. The statutory principles outlined in the conclusion above are consistent with draft statutory guidance prepared by the Invested Assets Working Group of the Valuation of Securities (EX4) Task Force.

14. Subparagraph 9.a. of this issue paper affords different treatment to certain Canadian branch operations. As a matter of historic practice, U.S. reporting entities have treated Canadian branch operations in their statutory statements as if they were U.S. dollar denominated operations. This practice was established at a time when the Canadian and U.S. dollars were at or close to equivalent. The cost of translating each line item for immaterial Canadian operations is perceived to exceed the benefits of line-by-line exactness. Consideration has also been given to the impact on risk-based capital and the asset valuation reserve of reporting entities under the provisions of subparagraph 9 a. and the impact is not considered to be material.

15. The statutory principles outlined in the conclusion above are not consistent with current GAAP as follows:

a. Subparagraph 9.a. Allows changes in balance sheet asset and liability values due to exchange rate fluctuations of a reporting entity's Canadian insurance operations comprising less than 10% of the reporting entity's admitted assets and liabilities and net premium to be recorded as unrealized capital gains or losses with a corresponding adjustment made to a net asset or liability. GAAP requires each asset and liability account to be adjusted.

b. Paragraph 10 allows changes in balance sheet asset and liability values due to exchange rate fluctuations to be recorded as unrealized capital gains or losses. GAAP requires that fluctuations in asset values that arose as a result of transactions denominated in a foreign currency be recorded as part of net income. GAAP requires that a gain or loss resulting from translating the financial statements of an operation that has a functional currency other than the U.S. dollar be recorded as unrealized. Recording gains and losses as a result of fluctuations in exchange rates as unrealized gains and losses for statutory purposes affords these fluctuations the same accounting treatment as fluctuations in the market values of equity securities.

This issue paper rejects FAS 52, *Foreign Currency Translation, FASB Emerging Issues Task Force No. 87-12, Foreign Debt-for-Equity Swaps, FASB Emerging Issues Task Force No. 87-26, Hedging of Foreign Currency Exposure with a Tandem Currency, FASB Emerging Issues Task Force No. 92-4, Accounting for a Change in Functional Currency When an Economy Ceases to Be Considered Highly Inflationary, FASB Emerging Issues Task Force No. 95-2, Determination of What Constitutes a Firm Commitment for Foreign Currency Transactions Not Involving a Third Party, FASB Emerging Issues Task Force No. 96-15, Accounting for the Effects of Changes in Foreign Currency Exchange Rates on Foreign-Currency-Denominated Available-for-Sale Debt Securities and FASB Interpretation No. 37, Accounting for Translation Adjustments upon Sale of Part of an Investment in a Foreign Entity, an interpretation of FASB Statement No. 52, and Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins*, Chapter 12.

16. The statutory principles outlined in the conclusion above are consistent with the recognition and consistency concepts in the Statement of Concepts. Pertinent excerpts follow:

> Consistency
> The regulators' need for meaningful, comparable financial information to determine an insurer's financial condition requires consistency in the development and application of statutory accounting principles.
>
> Recognition
> The principal focus of solvency measurement is determination of financial condition through analysis of the balance sheet. However, protection of the policyholders can only be maintained through continued monitoring of the financial condition of the insurance enterprise.

Drafting Notes/Comments

- Forward exchange contracts are addressed in a separate issue paper.

RELEVANT STATUTORY AND GAAP GUIDANCE

Statutory Accounting

17. The P&C Accounting Practices and Procedures Manual, Chapter 13, Other Liabilities, provides the following guidance:

> Net Adjustments in Assets and Liabilities Due to Foreign Exchange Rates
>
> An insurance company may have assets or liabilities payable in foreign currencies.
>
> Differences between the exchange rates when the original entries were recorded and the current statement date result in changes in net asset value. Reductions in net asset value are shown under this caption, while increases are recorded as an asset under aggregate write-ins for other-than-invested assets. If different foreign currencies are involved, the assets and liabilities must be segregated accordingly and applied against the proper exchange rate. The exchange rates to be used are those published in the NAIC *Valuation of Securities* manual.

18. The P&C Accounting Practices and Procedures Manual, Chapter 25, Unassigned Funds (Surplus) provides the following guidance with respect to foreign exchange adjustments:

> Change in Foreign Exchange Adjustment
>
> Assets and liabilities in foreign currency are subject to adjustment to the prevailing foreign exchange rate. The change in the foreign exchange adjustment between the current and prior statement is charged or credited directly to unassigned surplus. (See Chapter 13-Other Liabilities.)

19. The Life/A&H Accounting Practices and Procedures Manual, Chapter 8, Other Admitted Assets, provides the following guidance:

> Foreign Exchange Adjustment
>
> Some insurers engage in operations in foreign countries, with the premiums collected and claims paid in the local currency. As in any insurance operations there will at all times be uncollected premiums, policy reserves, unpaid claims, and other incomplete transactions that must be recorded in the insurer's balance sheet in the annual statement.
>
> For ease in maintaining policy records, the premiums, reserves and claims normally are recorded in U.S. dollars at the rate of exchange that is in effect at the time the policy is written, or when the company receives notification of the claim. Changes in exchange rates, while not affecting the foreign policyholder, do affect the value of the foreign business as it is recorded in U.S. dollars. Because of the constant fluctuations in the foreign currencies' exchange rates, it may be confusing and unduly burdensome to adjust individual policy and claims records to current rates. Most companies, therefore, make such adjustment to the net balance of the assets and liabilities in each foreign currency.
>
> The adjustment is calculated by summarizing the assets and liabilities in each foreign currency and in U.S. dollars, as recorded in the company's policy and claim records. The net value in the foreign currency is converted to U.S. dollars at the current rate of exchange and compared with the net value in U.S. dollars recorded by the company. Any difference in adjustment of the net value to current exchange rates is recorded as a separate asset or liability if the current rate is greater or less than the rate used by the company.
>
> Change in foreign exchange adjustments generally are reported as capital gain or loss.

20. The SVO Purposes and Procedures Manual, Section 1, provides the following guidance:

> Market values for securities payable in other than U.S. dollars will be computed by obtaining a quotation in the foreign currency from a reputable source and converting that quotation into U.S. dollars using the exchange rates published in the VOS Manual.

Generally Accepted Accounting Principles

21. FAS 52 provides the following guidance:

> STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING
>
> Objectives of Translation
>
> 4. Financial statements are intended to present information in financial terms about the performance, financial position, and cash flows of an enterprise. For this purpose, the financial statements of separate entities within an enterprise, which may exist and operate in different economic and currency environments, are consolidated and presented as though they were the financial statements of a single enterprise. Because it is not possible to combine, add, or subtract measurements expressed in different currencies, it is necessary to translate into a single reporting currency [2] those assets, liabilities, revenues, expenses, gains, and losses that are measured or denominated in a foreign currency [3]. However, the unity presented by such translation does not alter the underlying significance of the results and relationships of the constituent parts of the enterprise. It is only through the effective operation of its constituent parts that the enterprise as a whole is able to achieve its purpose. Accordingly, the translation of the financial statements of each component entity of an enterprise should accomplish the following objectives:
>
> a. Provide information that is generally compatible with the expected economic effects of a rate change on an enterprise's cash flows and equity
>
> b. Reflect in consolidated statements the financial results and relationships of the individual consolidated entities as measured in their functional currencies in conformity with U.S. generally accepted accounting principles
>
> [2] For convenience, this Statement assumes that the enterprise uses the U.S. dollar (dollar) as its reporting currency. However, a currency other than the dollar may be the reporting currency in financial statements that are prepared in conformity with U.S. generally accepted accounting principles. For example, a foreign enterprise may report in its local currency in conformity with U.S. generally accepted accounting principles. If so, the requirements of this Statement apply.
>
> [3] To measure in foreign currency is to quantify an attribute of an item in a unit of currency other than the reporting currency. Assets and liabilities are denominated in a foreign currency if their amounts are fixed in terms of that foreign currency regardless of the exchange rate changes. An asset or liability may be both measured and denominated in one currency, or it may be measured in one currency and denominated in another. To illustrate: Two foreign branches of a U.S. Company, one Swiss and one German, purchase identical assets on credit from a Swiss vendor at identical prices stated in Swiss francs. The German branch measures the cost (an attribute) of that asset in German marks. Although the corresponding liability is also measured in marks, it remains denominated in Swiss francs since the liability must be settled in a specific number of Swiss francs. The Swiss branch measures the asset and liability in Swiss francs. Its liability is both measured and denominated in Swiss francs. Although assets and liabilities can be measured in various currencies, rights to receive or obligations to pay fixed amounts of a currency are, by definition, denominated in that currency.
>
> The Functional Currency
>
> 5. The assets, liabilities, and operations of a foreign entity shall be measured using the functional currency of that entity. An entity's functional currency is the currency of the primary economic environment in which the entity operates; normally, that is the currency of the environment in which an entity primarily generates and expends cash. Appendix A provides guidance for determination of the functional currency. The economic factors cited in Appendix A,

and possibly others, should be considered both individually and collectively when determining the functional currency.

6. For an entity with operations that are relatively self-contained and integrated within a particular country, the functional currency generally would be the currency of that country. However, a foreign entity's functional currency might not be the currency of the country in which the entity is located. For example, the parent's currency generally would be the functional currency for foreign operations that are a direct and integral component or extension of the parent company's operations.

7. An entity might have more than one distinct and separable operation, such as a division or branch, in which case each operation may be considered a separate entity. If those operations are conducted in different economic environments, they might have different functional currencies.

8. The functional currency (or currencies) of an entity is basically a matter of fact, but in some instances the observable facts will not clearly identify a single functional currency. For example, if a foreign entity conducts significant amounts of business in two or more currencies, the functional currency might not be clearly identifiable. In those instances, the economic facts and circumstances pertaining to a particular foreign operation shall be assessed in relation to the Board's stated objectives for foreign currency translation (paragraph 4). Management's judgment will be required to determine the functional currency in which financial results and relationships are measured with the greatest degree of relevance and reliability.

9. Once the functional currency for a foreign entity is determined, that determination shall be used consistently unless significant changes in economic facts and circumstances indicate clearly that the functional currency has changed. Previously issued financial statements shall not be restated for any change in the functional currency.

10. If an entity's books of record are not maintained in its functional currency, remeasurement into the functional currency is required. That remeasurement is required before translation into the reporting currency. If a foreign entity's functional currency is the reporting currency, remeasurement into the reporting currency obviates translation. The remeasurement process is intended to produce the same result as if the entity's books of record had been maintained in the functional currency. The remeasurement of and subsequent accounting for transactions denominated in a currency other than the functional currency shall be in accordance with the requirements of this Statement (paragraphs 15 and 16). Appendix B provides guidance for remeasurement into the functional currency.

The Functional Currency in Highly Inflationary Economies

11. The financial statements of a foreign entity in a highly inflationary economy shall be remeasured as if the functional currency were the reporting currency. Accordingly, the financial statements of those entities shall be remeasured into the reporting currency according to the requirements of paragraph 10. For the purposes of this requirement, a highly inflationary economy is one that has cumulative inflation of approximately 100 percent or more over a 3-year period.

Translation of Foreign Currency Statements

12. All elements of financial statements shall be translated by using a current exchange rate. For assets and liabilities, the exchange rate at the balance sheet date shall be used. For revenues, expenses, gains, and losses, the exchange rate at the dates on which those elements are recognized shall be used. Because translation at the exchange rates at the dates the numerous revenues, expenses, gains, and losses are recognized is generally impractical, an appropriately weighted average exchange rate for the period may be used to translate those elements.

13. If an entity's functional currency is a foreign currency, translation adjustments result from the process of translating that entity's financial statements into the reporting currency. Translation adjustments shall not be included in determining net income but shall be reported separately and accumulated in a separate component of equity.

14. Upon sale or upon complete or substantially complete liquidation of an investment in a foreign entity, the amount attributable to that entity and accumulated in the translation adjustment component of equity shall be removed from the separate component of equity and shall be reported as part of the gain or loss on sale or liquidation of the investment for the period during which the sale or liquidation occurs.

Foreign Currency Transactions

15. Foreign currency transactions are transactions denominated in a currency other than the entity's functional currency. Foreign currency transactions may produce receivables or payables that are fixed in terms of the amount of foreign currency that will be received or paid. A change in exchange rates between the functional currency and the currency in which a transaction is denominated increases or decreases the expected amount of functional currency cash flows upon settlement of the transaction. That increase or decrease in expected functional currency cash flows is a foreign currency transaction gain or loss that generally shall be included in determining net income for the period in which the exchange rate changes. Likewise, a transaction gain or loss (measured from the transaction date or the most recent intervening balance sheet date, whichever is later) realized upon settlement of a foreign currency transaction generally shall be included in determining net income for the period in which the transaction is settled. The exceptions to this requirement for inclusion in net income of transaction gains and losses are set forth in paragraphs 20 and 21 and pertain to certain intercompany transactions and to transactions that are designated as, and effective as, economic hedges of net investments and foreign currency commitments.

16. For other than forward exchange contracts (paragraphs 17-19), the following shall apply to all foreign currency transactions of an enterprise and its investees:

a. At the date the transaction is recognized, each asset, liability, revenue, expense, gain, or loss arising from the transaction shall be measured and recorded in the functional currency of the recording entity by use of the exchange rate in effect at that date (paragraphs 26-28).
b. At each balance sheet date, recorded balances that are denominated in a currency other than the functional currency of the recording entity shall be adjusted to reflect the current exchange rate.

Transaction Gains and Losses to Be Excluded from Determination of Net Income

20. Gains and losses on the following foreign currency transactions shall not be included in determining net income but shall be reported in the same manner as translation adjustments (paragraph 13):

a. Foreign currency transactions that are designated as, and are effective as, economic hedges of a net investment in a foreign entity, commencing as of the designation date
b. Intercompany foreign currency transactions that are of a long-term-investment nature (that is, settlement is not planned or anticipated in the foreseeable future), when the entities to the transaction are consolidated, combined, or accounted for by the equity method in the reporting enterprise's financial statements

21. A gain or loss on a forward contract or other foreign currency transaction that is intended to hedge an identifiable foreign currency commitment (for example, an agreement to purchase or sell equipment) shall be deferred and included in the measurement of the related foreign currency transaction (for example, the purchase or the sale of the equipment). Losses shall not

be deferred, however, if it is estimated that deferral would lead to recognizing losses in later periods. A foreign currency transaction shall be considered a hedge of an identifiable foreign currency commitment provided both of the following conditions are met:

a. The foreign currency transaction is designated as, and is effective as, a hedge of a foreign currency commitment.
b. The foreign currency commitment is firm.

The required accounting shall commence as of the designation date. The portion of a hedging transaction that shall be accounted for pursuant to this paragraph is limited to the amount of the related commitment. If a hedging transaction that meets conditions (a) and (b) above exceeds the amount of the related commitment, the gain or loss pertaining to the portion of the hedging transaction in excess of the commitment shall be deferred to the extent that the transaction is intended to provide a hedge on an after-tax basis. A gain or loss so deferred shall be included as an offset to the related tax effects in the period in which such tax effects are recognized; consequently, it shall not be included in the aggregate transaction gain or loss disclosure required by paragraph 30. A gain or loss pertaining to the portion of a hedging transaction in excess of the amount that provides a hedge on an after-tax basis shall not be deferred. Likewise, a gain or loss pertaining to a period after the transaction date of the related commitment shall not be deferred. If a foreign currency transaction previously considered a hedge of a foreign currency commitment is terminated before the transaction date of the related commitment, any deferred gain or loss shall continue to be deferred and accounted for in accordance with the requirements of this paragraph.

Exchange Rates

26. The exchange rate is the ratio between a unit of one currency and the amount of another currency for which that unit can be exchanged at a particular time. If exchangeability between two currencies is temporarily lacking at the transaction date or balance sheet date, the first subsequent rate at which exchanges could be made shall be used for purposes of this Statement. If the lack of exchangeability is other than temporary, the propriety of consolidating, combining, or accounting for the foreign operation by the equity method in the financial statements of the enterprise shall be carefully considered (ARB 43, Chapter 12, paragraph 8).

27. The exchange rates to be used for translation of foreign currency transactions and foreign currency statements are as follows:

a. Foreign Currency Transactions - The applicable rate at which a particular transaction could be settled at the transaction date shall be used to translate and record the transaction. At a subsequent balance sheet date, the current rate is that rate at which the related receivable or payable could be settled at that date.
b. Foreign Currency Statements - In the absence of unusual circumstances, the rate applicable to conversion of a currency for purposes of dividend remittances shall be used to translate foreign currency statements.[4]

[4] If unsettled intercompany transactions are subject to and translated using preference or penalty rates, translation of foreign currency statements at the rate applicable to dividend remittances may cause a difference between intercompany receivables and payables. Until that difference is eliminated by settlement of the intercompany transaction, the difference shall be treated as a receivable or payable in the enterprise's financial statements.

28. If a foreign entity whose balance sheet date differs from that of the enterprise is consolidated or combined with or accounted for by the equity method in the financial statements of the enterprise, the current rate is the rate in effect at the foreign entity's balance sheet date for purposes of applying the requirements of this Statement to that foreign entity.

Use of Averages or Other Methods of Approximation

29. Literal application of the standards in this Statement might require a degree of detail in record keeping and computations that could be burdensome as well as unnecessary to produce reasonable approximations of the results. Accordingly, it is acceptable to use averages or other methods of approximation. For example, the propriety of using average rates to translate revenue and expense amounts is noted in paragraph 12. Likewise, the use of other time-and effort-saving methods to approximate the results of detailed calculations is permitted.

Disclosure

30. The aggregate transaction gain or loss included in determining net income for the period shall be disclosed in the financial statements or notes thereto. For that disclosure, gains and losses on forward contracts determined in conformity with the requirements of paragraphs 18 and 19 shall be considered transaction gains or losses. Certain enterprises, primarily banks, are dealers in foreign exchange. Although certain gains or losses from dealer transactions may fit the definition of transaction gains or losses in this Statement, they may be disclosed as dealer gains or losses rather than as transaction gains or losses.

31. An analysis of the changes during the period in the separate component of equity for cumulative translation adjustments shall be provided in a separate financial statement, in notes to the financial statements, or as part of a statement of changes in equity. At a minimum, the analysis shall disclose:

a. Beginning and ending amount of cumulative translation adjustments
b. The aggregate adjustment for the period resulting from translation adjustments (paragraph 13) and gains and losses from certain hedges and intercompany balances (paragraph 20)
c. The amount of income taxes for the period allocated to translation adjustments (paragraph 24)
d. The amounts transferred from cumulative translation adjustments and included in determining net income for the period as a result of the sale or complete or substantially complete liquidation of an investment in a foreign entity (paragraph 14)

32. An enterprise's financial statements shall not be adjusted for a rate change that occurs after the date of the enterprise's financial statements or after the date of the foreign currency statements of a foreign entity if they are consolidated, combined, or accounted for by the equity method in the financial statements of the enterprise. However, disclosure of the rate change and its effects on unsettled balances pertaining to foreign currency transactions, if significant, may be necessary.

OTHER SOURCES OF INFORMATION

22. The Invested Assets Working Group of the Valuation of Securities (EX4) Task Force presented the following draft guidance to the Blanks Task Force:

Attachment A

NAIC ACCOUNTING PRINCIPLES ACCOUNTING FOR INVESTMENTS DENOMINATED IN FOREIGN CURRENCY OTHER THAN INVESTMENTS HELD IN SUPPORT OF INSURANCE BUSINESS DENOMINATED IN THE SAME FOREIGN CURRENCY

Investments denominated in foreign currencies other than investments held in support of insurance business denominated in the same foreign currency, should be accounted for at their

U.S. dollar equivalent values. Income recognized during an accounting period should be recorded at its weighted average U.S. dollar equivalent value, and balance sheet data should be recorded at its U.S. dollar equivalent value as of the balance sheet date.

Changes in balance sheet investment value due to foreign currency translation should be recorded as unrealized capital gains and losses on such investment until the investment is repaid or sold. Upon sale or repayment previously recorded unrealized capital gains and losses should be reversed and the foreign exchange profit or loss for the entire holding period should be recorded as a realized capital gain or loss.

Transactions involving settlement in cash, such as purchases, sales, and receipt of income, should be recorded at their U.S. dollar equivalent value based on the foreign currency exchange rate as of the transaction date. Any foreign currency exchange gains or losses on purchases, sales, maturities or changes in income accruals should be recorded as capital gain or loss realized on the purchase, sale or maturity or as adjustments to income respectively.

Nominal information such as par value may be expressed in the foreign currency or U.S. dollar equivalent (description of issue), but where the information is displayed comparatively (column of par values), U.S. dollar equivalent amount should be used. Ratios and factors should be based on data that is entirely consistent with respect to currency.

Attachment B

ACCOUNTING FOR INVESTMENTS DENOMINATED IN FOREIGN CURRENCY HELD IN SUPPORT OF INSURANCE BUSINESS DENOMINATED IN THE SAME FOREIGN CURRENCY

Some insurers engage in operations in foreign countries with the premiums collected and claims paid in local currency. As in any insurance operation there will at times be uncollected premiums policy reserves, unpaid claims, and other incomplete transactions that must be recorded in the insurer's balance sheet in the annual statement. For ease in maintaining policy records, the premiums reserves, and claims normally are recorded in U.S. dollars at the rate of exchange that is in effect at the time the policy is written, or when the company receives notification of the claim. Changes in exchange rates, while not affecting the foreign policyholder, do affect the value of the foreign business as it is recorded in U.S. dollars.

Canadian operations, comprising less than 10% of the insurance company’s assets or liabilities can be translated to U.S. dollars by making an adjustment to the net assets of the foreign operation. The adjustment is calculated by summarizing the assets and liabilities in the foreign currency and in U.S. dollars. The net value is converted to U.S. dollars at the current rate of exchange and compared with the net value in U.S. dollars recorded by the company. Any difference in the net value to current exchange rates is recorded as a separate asset or liability and the change in the foreign exchange adjustment is recorded as an unrealized capital gain or loss.

All other foreign operations must be translated to U.S. dollars in accordance with the provisions of Financial Accounting Standards Board Statement of Financial Accounting Standard (FAS) No. 52, Foreign Currency Translation. FAS 52 requires each financial statement line to be translated to U.S. dollars by applying the following exchange rates: l) the current exchange rate at the balance sheet date to assets and liabilities and 2) a weighted average rate to revenue, expenses, gains, losses and surplus adjustments. The weighted-average rate is aimed at approximating the translation that would have been achieved had the current rate at the time of each translation been applied. Gains or losses due to translating foreign operations to U.S. dollars should be recorded as an unrealized capital gain or loss.

Source for language of Attachment B: Foreign Exchange Adjustment. Chapter 8, Phase II of Life and Health Accounting Manual Codification Project

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapters 13 and 25
- Accounting Practices and Procedures Manual for Life, Accident and Health Insurance Companies, Chapter 8
- *Purposes and Procedures Manual of the NAIC Securities Valuation Office*, Section 1

Generally Accepted Accounting Principles

- *FASB Statement No. 52, Foreign Currency Translation*
- *FASB Emerging Issues Task Force No. 87-12, Foreign Debt-for-Equity Swaps*
- *FASB Emerging Issues Task Force No. 87-26, Hedging of Foreign Currency Exposure with a Tandem Currency*
- *FASB Emerging Issues Task Force No. 92-4, Accounting for a Change in Functional Currency When an Economy Ceases to Be Considered Highly Inflationary*
- *FASB Emerging Issues Task Force No. 95-2, Determination of What Constitutes a Firm Commitment for Foreign Currency Transactions Not Involving a Third Party*
- *FASB Emerging Issues Task Force No. 96-15, Accounting for the Effects of Changes in Foreign Currency Exchange Rates on Foreign-Currency-Denominated Available-for-Sale Debt Securities*
- *FASB Interpretation No. 37, Accounting for Translation Adjustments upon Sale of Part of an Investment in a Foreign Entity, an interpretation of FASB Statement No. 52*
- *Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins, Chapter 12*

State Regulations

None

Other Sources of Information

- The Invested Assets Working Group of the Valuation of Securities (EX4) Task Force draft guidance to the Blanks Task Force
- NAIC Technical Resource Group Proposed Draft Life Codification, Chapter 8

Statutory Issue Paper No. 82

Stock Options and Stock Purchase Plans

STATUS
Finalized March 16, 1998

Current Authoritative Guidance for Stock Options and Stock Repurchase Plans: SSAP No. 104R
This issue paper may not be directly related to the current authoritative statement.

Original SSAP from Issue Paper: SSAP No. 13

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory guidance provides for disclosures concerning deferred compensation plans such as profit sharing, stock options or incentive plans in the NAIC Annual Statement Instructions. However, specific guidance regarding the accounting for such plans is not currently provided.

2. GAAP addresses the accounting for stock issued to employees in *Accounting Principles Board Opinion No. 25*, *Accounting for Stock Issued to Employees* (APB 25), *Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins* (ARB 43), *Accounting Interpretation of Accounting Principles Board Opinion No. 25*, *Accounting for Stock Issued to Employees* (AIN-APB 25), *FASB Interpretation No. 28*, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans* (FIN 28), *FASB Interpretation No. 38*, *Determining the Measurement Date for Stock Option, Purchase, and Award Plans Involving Junior Stock* (FIN 38) and *FASB Statement No. 123*, *Accounting for Stock-Based Compensation* (FAS 123).

3. This purpose of this issue paper is to establish statutory accounting principles for employee stock options and stock purchase plans that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. A plan is any arrangement to issue stock to officers and employees, as a group or individually. Stock purchase and stock option plans shall be classified as either compensatory or noncompensatory. A reporting entity recognizes no compensation expense for services received in return for stock issued through noncompensatory plans. Stock purchase and stock option plans which do not meet the criteria of a noncompensatory plan shall be classified as compensatory. A reporting entity recognizes compensation cost for stock issued through compensatory plans.

Noncompensatory Plans

5. The following four characteristics are essential in a noncompensatory plan:

a. substantially all full-time employees meeting limited employment qualifications may participate (employees owning a specified percent of the outstanding stock and executives may be excluded);

b. stock is offered to eligible employees equally or based on a uniform percentage of salary or wages (the plan may limit the number of shares of stock that an employee may purchase through the plan);

c. the time permitted for exercise of an option or purchase right is limited to a reasonable period; and

d. the discount from the market price of the stock is no greater than would be reasonable in an offer of stock to stockholders or others.

Compensatory Plans

6. Consideration that a reporting entity receives for stock issued through employee stock option, purchase, and award plans in the form of services shall be measured by the fair value of the stock at the measurement date less the amount, if any, that the employee is required to pay.

7. The measurement date for determining compensation cost in stock option, purchase, and award plans is the first date on which are known both (1) the number of shares that an individual employee is entitled to receive and (2) the option or purchase price, if any. That date for many or most plans is the date an option or purchase right is granted or stock is awarded to an individual employee. However, the measurement date may be later than the date of grant or award in plans with variable terms that depend on events after the date of grant or award. Thus, a reporting entity recognizes compensation cost for stock issued through compensatory plans unless the employee pays an amount that is at least equal to the quoted market price of the stock at the measurement date.

8. Compensation cost in stock option, purchase, and award plans shall be recognized as an expense of one or more periods in which an employee performs services and also as part or all of the consideration received for stock issued to the employee through a plan. The grant or award may specify the period or periods during which the employee performs services, or the period or periods may be inferred from the terms or from the past pattern of grants or awards. An employee may perform services in several periods before a reporting entity issues stock for those services. The reporting entity shall accrue compensation expense in each period in which the services are performed. If the measurement date is later than the date of grant or award, a reporting entity shall record the compensation expense each period from date of grant or award to date of measurement based on the fair value of the stock at the end of each period.

9. Quoted market prices in active markets are the best evidence of fair value and are to be used as fair value, if available. If quoted market prices are not available, the estimate of fair value shall be based on the best information available in the circumstances.

10. If stock is issued in a plan before some or all of the services are performed, part of the consideration recorded for the stock issued is unearned compensation and shall be reported as a component of unassigned funds. The unearned compensation should be accounted for as expense of the period or periods in which the employee performs service.

Accounting for Income Tax Benefits

11. A reporting entity may obtain an income tax benefit related to stock issued to an employee through a stock option, purchase, or award plan. Generally, the reporting entity is entitled to a deduction for income tax purposes of the amount that an employee reports as ordinary income, and the deduction is allowable to the corporation in the year in which the amount is includable in the gross income of the employee. Thus, the amount and timing of the deduction for income tax purposes, if any, may differ from the related compensation expense recognized in the financial statements. For example, the reporting entity may be entitled to a deduction for income tax purposes even though no compensation expense is recognized in measuring net income.

12. The income tax reduction, if any, related to a stock option, purchase, or award plan shall be accounted for within one or more of the following three components:

a. Income tax expense for a period shall be reduced by no more than the income tax reduction related to the stock option, purchase, or award plan that is proportionate to compensation expense recognized during the period, for such plan.

b. Compensation expense that is deductible in the income tax return for a period different from the one in which such expense is reported in measuring net income results in a temporary difference. Deferred income taxes shall be recognized for such differences and included with all deferred income taxes as a separate component of gains and losses in surplus consistent with *Issue Paper No. 83—Accounting for Income Taxes*.

c. The remainder of the income tax reduction, if any, is related to an amount that is deductible for income tax purposes but does not affect net income. The remainder of the income tax reduction shall not be included in income, but shall be added to capital stock or gross paid-in and contributed surplus in the period of the income tax reduction. Conversely, a tax reduction may be less than if recorded compensation expenses were deductible for income tax purposes. If so, the reporting entity may deduct the difference from capital stock or gross paid-in and contributed surplus in the period of the income tax reduction, to the extent that income tax reductions under the same or similar compensatory stock option, purchase, or award plans have been included in capital stock or gross paid-in and contributed surplus.

13. In certain situations, it may be advantageous to the reporting entity to compensate an employee to make an option that is detrimental to him but advantageous to the company. A reporting entity may, either by cash payment or otherwise reimburse an employee for his action related to a stock option, purchase, or award plan that results in a reduction of income taxes of the reporting entity; for example, in incentive stock purchase plans a reduction in the purchase price of stock is allowed. The reporting entity shall include any such reimbursement as an expense.

14. Stock option, purchase, and award plans of the principal stockholder (i.e., a holding company) or equity instruments granted or otherwise transferred directly to an employee by a principal stockholder shall be treated as contributed surplus by the principal stockholder with the offsetting charge accounted for in accordance with this issue paper, unless such transfers are clearly for a purpose other than compensation for services rendered the reporting entity.

15. Compensation expense related to stock appreciation rights and other variable stock option or award plans shall be measured at the end of each period as the amount by which the quoted market value of the shares of the enterprise's stock covered by a grant exceeds the option price or value specified under the plan and should be accrued as a charge to expense over the periods the employee performs the related services. Changes in the quoted market value should be reflected as an adjustment of accrued compensation and compensation expense in the periods in which the changes occur until the date the number of shares and purchase price, if any, are both known.

Disclosure

16. The notes to financial statements shall disclose deferred stock compensation plans for employees such as profit sharing, stock options or incentive plans. If warranted by materiality, the following information with regard to stock options shall be furnished and analogous information shall be supplied for warrants or rights:

a. A brief description of the terms of each option arrangement including the title and amount of securities to option; the year or years during which the options were granted; and the year or years during which the optionees became, or will become, entitled to exercise the options;

b. The number of shares under option at the end of the statement year; the number of shares with respect to which options became exercisable during the year; and the number of shares with respect to which options were exercised during the year; and the option price and fair market value thereof, per share, and in total for each of the three categories;

c. The required information may be summarized as appropriate with respect to each of these categories. The above information shall be supplied whether the stock involved relates to the company, the parent of the company, a subsidiary of the company, or an affiliated corporation. The information shall be shown separately for (1) agents and brokers and (2) employees and others.

DISCUSSION

17. Current statutory guidance provides for disclosures concerning deferred compensation plans such as profit sharing, stock options or incentive plans in the Annual Statement Instructions. This issue paper is consistent with such guidance. This issue paper expands current statutory guidance to provide specific guidance regarding the accounting for such plans. *Issue Paper No. 78—Employee Stock Ownership* Plans (Issue Paper No. 78) addresses the accounting for Employee Stock Ownership Plans by the plan sponsor.

18. This issue paper rejects FAS 123. FAS 123 encourages, but does not require, that companies report stock based compensation plans using a fair value method of accounting versus the intrinsic value method of accounting promulgated in APB 25. The differences between these two methods of accounting primarily affect the accounting related to stock option plans. Under the intrinsic value method of accounting, the compensation cost of such plans is measured by the excess, if any, of the market price of the underlying stock versus the exercise price of the option at the measurement date. The fair value method of accounting requires that a fair value be determined for the options, generally by utilization of option-pricing models or other valuation techniques, and that the fair value be charged to compensation cost with a corresponding credit to paid in capital. The fair value method of accounting for these plans is rejected because it does not reflect a change in statutory assets or liabilities. Consistent with rejection of FAS 123, the disclosure requirements in the conclusion above retain the current statutory requirements.

19. This issue paper adopts GAAP guidance set forth in APB 25 except for paragraph 19 regarding disclosure. The disclosure required by this issue paper is consistent with the disclosure requirements of ARB 43, Chapter 13B, prior to its amendment by FAS 123. This issue paper adopts GAAP guidance set forth in ARB 43 with modification to exclude the additions to paragraph 2 and the deletion of paragraph 15 pursuant to FAS 123. This issue paper also adopts the GAAP guidance set forth in AIN-APB 25. This issue paper also adopts the GAAP guidance set forth in FIN 28 and FIN 38.

20. Additionally, this issue paper adopts the following pronouncements which clarify and/or provide guidance in certain circumstances (such pronouncements are not reproduced herein due to length and limited scope):

FASB Emerging Issues Task Force Issue No. 84-13, Purchase of Stock Options and Stock Appreciation Rights in a Leveraged Buyout
FASB Emerging Issues Task Force Issue No. 84-18, Stock Option Pyramiding
FASB Emerging Issues Task Force Issue No. 85-45, Business Combinations: Settlement of Stock Options and Awards
FASB Emerging Issues Task Force Issue No. 87-6, Adjustments Relating to Stock Compensation Plans
FASB Emerging Issues Task Force Issue No. 87-23, Book Value Stock Purchase Plans
FASB Emerging Issues Task Force Issue No. 87-33, Stock Compensation Issues Related to Market Decline
FASB Emerging Issues Task Force Issue No. 88-6, Book Value Plans in an Initial Public Offering

> *FASB Emerging Issues Task Force Issue No. 90-7, Accounting for a Reload Stock Option*
> *FASB Emerging Issues Task Force Issue No. 90-9, Changes to Fixed Employee Stock Option Plans as a Result of Equity Restructuring*
> *FASB Emerging Issues Task Force Issue No. 94-6, Accounting for the Buyout of Compensatory Stock Options*
> *FASB Emerging Issues Task Force Issue No. 95-16, Accounting for Stock Compensation Arrangements with Employer Loan Features under APB Opinion No. 25*

This issue paper rejects the following pronouncements:

> *FASB Emerging Issues Task Force Issue No. 96-3, Accounting for Equity Instruments That Are Issued for Consideration Other Than Employee Services Under FASB Statement No. 123*
> *FASB Emerging Issues Task Force Issue No. 96-18, Accounting for Equity Instruments with Variable Terms That Are Issue For Consideration Other Than Employee Services Under FASB Statement No. 123*

21. The conclusions above are consistent with the consistency and recognition concepts in the Statement of Concepts. Pertinent excerpts follow:

> Consistency
>
> The regulators' need for meaningful, comparable financial information to determine an insurer's financial condition requires consistency in the development and application of statutory accounting principles. Because the marketplace, the economic and business environment, and insurance industry products and practices are constantly changing, regulatory concerns are also changing. An effective statutory accounting model must be responsive to these changes and address emerging accounting issues. Precedent or historically accepted practice alone should not be sufficient justifications for continuing to follow a particular accounting principle or practice which may not coincide with the objectives of regulators.
>
> Recognition
>
> The principal focus of solvency measurement is determination of financial condition through analysis of the balance sheet. However, protection of the policyholders can only be maintained through continued monitoring of the financial condition of the insurance enterprise. Operating performance is another indicator of an enterprise's ability to maintain itself as a going concern. Accordingly, the income statement is a secondary focus of statutory accounting and should not be diminished in importance to the extent contemplated by a liquidation basis of accounting.
>
> The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which are unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet but rather should be charged against surplus when acquired or when availability otherwise becomes questionable.
>
> Liabilities require recognition as they are incurred. Certain statutorily mandated liabilities may also be required to arrive at conservative estimates of liabilities and probable loss contingencies (e.g., excess of statutory reserves over statement reserves, interest maintenance reserves, asset valuation reserves, and others).
>
> Revenue should be recognized only as the earnings process of the underlying underwriting or investment business is completed. Accounting treatments which tend to defer expense recognition do not generally represent acceptable SAP treatment.
>
> SAP income reflects the extent that changes have occurred in SAP assets and liabilities for current period transactions, except changes in capital resulting from receipts or distributions to

owners. SAP income also excludes certain other direct charges to surplus which are not directly attributable to the earnings process, (e.g., changes in non-admitted assets).

Drafting Notes/Comments

- *Issue Paper No. 78—Employee Stock Ownership Plans* addresses the accounting for Employee Stock Ownership Plans by the plan sponsor.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

22. The Life Annual Statement Instructions provide the following guidance (only the pertinent excerpts are included below):

> 6. Retirement Plans, Deferred Compensation and Other Postretirement Benefit Plans
>
> b. Deferred Compensation Plans
>
> 1. Indicate if the company has deferred compensation plans for officers or employees such as profit sharing, stock options or incentive plans.
>
> 2. If warranted by materiality, the following information with regard to stock options should be furnished and analogous information should be supplied for warrants or rights:
>
> a. A brief description of the terms of each option arrangement including the title and amount of securities to option; the year or years during which the options were granted; and the year or years during which the optionees became, or will become, entitled to exercise the options.
>
> b. The number of shares under option at the end of the statement year; the number of shares with respect to which options became exercisable during the year; and the number of shares with respect to which options were exercised during the year; and the option price and fair market value thereof, per share, and in total for each of the three categories.
>
> Options to buy stock are deemed to be granted on the date that a designated number of shares are assigned to a specific individual, notwithstanding the stipulation at that time that such options are not exercisable until certain attached conditions are met, such as those relating to persistency of insurance produced by the optionee or his continuance in employment for a period of years.
>
> The required information may be summarized as appropriate with respect to each of these categories. The above information should be supplied whether the stock involved relates to the company, the parent of the company, a subsidiary of the company, or an affiliated corporation. The information should be shown separately for (1) agents and brokers and (2) employees and others.

The Property and Casualty Annual Statement Instructions contain similar guidance.

Generally Accepted Accounting Principles

23. ARB 43 provides the following guidance (only the pertinent excerpts are included below):

> Chapter 13: COMPENSATION:
>
> Section B -- Compensation Involved in Stock Option and Stock Purchase Plans
>
> 1. The practice of granting to officers and other employees options to purchase or rights to subscribe for shares of a corporation's capital stock has been followed by a considerable number of corporations over a period of many years. To the extent that such options and rights involve a measurable amount of compensation, this cost of services received should be accounted for as such. The amount of compensation involved may be substantial and omission of such costs from the corporation's accounting may result in overstatement of net income to a significant degree. Accordingly, consideration is given herein to the accounting treatment of compensation represented by stock options or purchase rights granted to officers and other employees.[1]
>
> [1] Bulletin 37, "Accounting for Compensation in the Form of Stock Options," was issued in November, 1948. Issuance of a revised bulletin in 1953 and its expansion to include stock purchase plans were prompted by the very considerable increase in the use of certain types of option and purchase plans following the enactment in 1950 of Section 130A of the Internal Revenue Code. This section granted specialized tax treatment to employee stock options if certain requirements were met as to the terms of the option, as to the circumstances under which the option was granted and could be exercised and as to the holding and disposal of the stock acquired thereunder. In general, the effect of Section 130A is to eliminate or minimize the amount of income taxable to the employee as compensation and to deny to the issuing corporation any tax deduction in respect of such restricted options. In 1951, Federal Salary Stabilization Board issued rules and regulations relating to stock options and purchase rights granted to employees whereby options generally comparable in nature to the restricted stock options specified in Section 130A might be considered for its purposes not to involve compensation, or to involve compensation only in limited amounts.
>
> 2. For convenience, this section will discuss primarily the problems of compensation raised by stock option plans. However, the committee feels that substantially the same problems may be encountered in connection with stock purchase plans made available to employees, and the discussion below is applicable to such plans also. *FASB Statement No. 123, Accounting for Stock-Based Compensation,* specifies a fair value based method of accounting for stock-based compensation plans and encourages entities to adopt that method for all arrangements under which employees receive shares of stock or other equity instruments of the employer or the employer incurs liabilities to employees in amounts based on the price of the employer's stock. However, Statement 123 permits an employer in determining its net income to continue to apply the accounting provisions of this section and Opinion 25 to all its stock-based employee compensation arrangements. Entities that continue to apply this section and Opinion 25 shall comply with the disclosure requirements of Statement 123.
>
> Rights Involving Compensation
>
> 3. Stock options involving an element of compensation usually arise out of an offer or agreement by an employer corporation to issue shares of its capital stock to one or more officers or other employees (hereinafter referred to as grantees) at a stated price. The grantees are accorded the right to require issuance of the shares either at a specified time or during some determinable period. In some cases the grantee's options are exercisable only if at the time of exercise certain conditions exist, such as that the grantee is then or until a specified date has been an employee. In other cases, the grantees may have undertaken certain obligations, such as to remain in the employment of the corporation for at least a specified period, or to take the shares only for investment purposes and not for resale.
>
> Rights Not Involving Compensation

> 4. Stock option plans in many cases may be intended not primarily as a special form of compensation but rather as an important means of raising capital, or as an inducement to obtain greater or more widespread ownership of the corporation's stock among its officers and other employees. In general, the terms under which such options are granted, including any conditions as to exercise of the options or disposal of the stock acquired, are the most significant evidence ordinarily available as to the nature and purpose of a particular stock option or stock option plan. In practice, it is often apparent that a particular option or plan involves elements of two or more of the above purposes. Where the inducements are not larger per share than would reasonably be required in an offer of shares to all shareholders for the purpose of raising an equivalent amount of capital, no compensation need be presumed to be involved.
>
> 5. Stock purchase plans also are frequently an integral part of a corporation's program to secure equity capital or to obtain widespread ownership among employees, or both. In such cases, no element of compensation need be considered to be present if the purchase price is not lower than is reasonably required to interest employees generally or to secure the contemplated funds.
>
> Other Considerations
>
> 14. Upon exercise of an option the sum of the cash received and the amount of the charge to income should be accounted for as the consideration received on issuance of the stock.
>
> 15. In connection with financial statements, disclosure should be made as to the status of the option or plan at the end of the period of report, including the number of shares under option, the option price, and the number of shares as to which options were exercisable. As to options exercised during the period, disclosure should be made of the number of shares involved and the option price thereof.

24. APB 25, prior to amendment by FAS 123 as FAS 123 is rejected in this issue paper, provides the following guidance (only the pertinent excerpts are included below):

> 1. Many corporations have adopted various plans, contracts, and agreements to compensate officers and other employees by issuing to them stock of the employer corporation. Under traditional stock option and stock purchase plans an employer corporation grants options to purchase a fixed number of shares of stock of the corporation at a stated price during a specified period or grants rights to purchase shares of stock of the corporation at a stated price, often at a discount from the market price of the stock at the date the rights are granted. Stock options and purchase rights are normally granted for future services of employees. *Accounting Research Bulletin No. 43, Chapter 13B, Compensation Involved in Stock Option and Stock Purchase Plans (1953*), contains the principles of accounting for those plans (reproduced in Appendix B).
>
> 2. Among traditional plans not described in Chapter 13B of ARB No. 43 are plans in which an employer corporation awards to employees shares of stock of the corporation for current or future services. Some corporations have replaced or supplemented traditional plans with more complex plans, contracts, and agreements for issuing stock. An arrangement may be based on variable factors that depend on future events; for example, a corporation may award a variable number of shares of stock or may grant a stock option with a variable option price. Other arrangements combine the characteristics of two or more types of plans, and some give an employee an election.
>
> 3. Accounting for employee services received as consideration for stock issued is included in an accounting research study[1] on stockholders' equity that is in process.

[1] Accounting research studies are not pronouncements of the Board or of the Institute but are published for the purpose of stimulating discussion on important accounting matters.

4. This Opinion deals with some aspects of accounting for stock issued to employees through both noncompensatory and compensatory plans (a plan is any arrangement to issue stock to officers and employees, as a group or individually). ARB No. 43, Chapter 13B remains in effect for traditional stock option and stock purchase plans except that the measure of compensation is redefined in this Opinion. This Opinion recognizes certain practices that evolved after Chapter 13B of ARB No. 43 was adopted and applies the principles of that chapter to other plans in which the number of shares of stock that may be acquired by or awarded to an employee and the option or purchase price, if any, are known or determinable at the date of grant or award. It also specifies the accounting for (a) plans in which either the number of shares of stock or the option or purchase price depends on future events and (b) income tax benefits related to stock issued to employees through stock option, purchase, and award plans. Appendix A to the Opinion illustrates measuring and accounting for compensation under typical plans.

Differing Views

5. Some accountants believe that compensation cost for all compensatory plans should be recorded at the date of grant or not later than the date of exercise. They believe that past experience and outside evidence of values can overcome difficulties in measuring compensation. Other accountants believe that compensation need not be recorded if an employee pays an amount that is at least equal to the market price of the stock at the date of grant and that problems in accounting for compensation plans pertain to plans in which the number of shares of stock or the option or purchase price cannot be determined until after the date of grant or award. Still other accountants, although they agree in principle with the first group, believe that progress will result from specifying the accounting for plans with variable factors but leaving Chapter 13B of ARB No. 43 in effect with modifications while the entire topic of accounting for compensation involving stock is studied.

6. Some accountants believe that a tax benefit attributable to compensation that is deductible in computing taxable income but is not recorded as an expense of any period results from a permanent difference. The benefit should therefore be recorded under paragraphs 33 and 34 of *APB Opinion No 11, Accounting for Income Taxes*, as a reduction of income tax expense for the period that the benefit is received. Other accountants believe that the tax benefit results from issuing stock and should be accounted for as an adjustment of capital in addition to par or stated value of capital stock in accordance with paragraph 52 of APB Opinion No. 11.

OPINION

Noncompensatory Plans

7. Paragraphs 4 and 5 of Chapter 13B of ARB No. 43 describe stock option and stock purchase plans that may not be intended primarily to compensate employees. An employer corporation recognizes no compensation for services in computing consideration received for stock that is issued through noncompensatory plans. The Board concludes that at least four characteristics are essential in a noncompensatory plan: (a) substantially all full-time employees meeting limited employment qualifications may participate (employees owning a specified percent of the outstanding stock and executives may be excluded), (b) stock is offered to eligible employees equally or based on a uniform percentage of salary or wages (the plan may limit the number of shares of stock that an employee may purchase through the plan), (c) the time permitted for exercise of an option or purchase right is limited to a reasonable period, and (d) the discount from the market price of the stock is no greater than would be reasonable in an offer of stock to stockholders or others. An example of a noncompensatory plan is the "statutory" employee stock purchase plan that qualifies under Section 423 of the Internal Revenue Code.

Compensatory Plans

8. Plans that do not possess the four characteristics of noncompensatory plans are classified as compensatory plans. Since the major principles of Chapter 13B of ARB No. 43 are

not changed, classification as a compensatory plan does not necessarily require that compensation cost be recognized.[2]

[2] All compensation arrangements involving stock, regardless of the name given, should be accounted for according to their substance. For example, an arrangement in which the consideration for stock issued to an employee is a nonrecourse note secured by the stock issued may be in substance the same as the grant of a stock option and should be accounted for accordingly. The note should be classified as a reduction of stockholders' equity rather than as an asset.

9. Services as Consideration for Stock Issued. The consideration that a corporation receives for stock issued through a stock option, purchase, or award plan consists of cash or other assets, if any, plus services received from the employee.

10. Measuring Compensation for Services. Compensation for services that a corporation receives as consideration for stock issued through employee stock option, purchase, and award plans should be measured by the quoted market price of the stock at the measurement date less the amount, if any, that the employee is required to pay. That is the principle in Chapter 13B of ARB No. 43 with two modifications: (a) the meaning of fair value of stock for compensatory plans is narrowed and (b) the measurement date for plans with a variable number of shares of stock or a variable option or purchase price is different.

a. Quoted market price is substituted for fair value. The Board acknowledges the conclusion in Chapter 13B that "market quotations at a given date are not necessarily conclusive evidence" of fair value of shares of stock but concludes that, for purposes of this Opinion, the unadjusted quoted market price of a share of stock of the same class that trades freely in an established market should be used in measuring compensation. An employee's right to acquire or receive shares of stock is presumed to have a value and that value stems basically from the value of the stock to be received under the right. However, the value of the right is also affected by various other factors, some of which tend to diminish its value and some of which tend to enhance it. Those opposing factors include a known future purchase price (or no payment), restrictions on the employee's right to receive stock, absence of commissions on acquisition, different risks as compared with those of a stockholder, tax consequences to the employee, and restrictions on the employee's ability to transfer stock issued under the right. The effects of the opposing factors are difficult to measure, and a practical solution is to rely on quoted market price to measure compensation cost related to issuing both restricted (or letter) and unrestricted stock through stock option, purchase, or award plans. If a quoted market price is unavailable, the best estimate of the market value of the stock should be used to measure compensation.

b. The measurement date for determining compensation cost in stock option, purchase, and award plans is the first date on which are known both (1) the number of shares that an individual employee is entitled to receive and (2) the option or purchase price, if any. That date for many or most plans is the date an option or purchase right is granted or stock is awarded to an individual employee and is therefore unchanged from Chapter 13B of ARB No. 43. However, the measurement date may be later than the date of grant or award in plans with variable terms that depend on events after date of grant or award.

Thus a corporation recognizes compensation cost for stock issued through compensatory plans unless the employee pays an amount that is at least equal to the quoted market price of the stock at the measurement date.

11. Applying the measurement principle--The following supplements paragraph 10 for special situations in some plans.

a. Measuring compensation by the cost to an employer corporation of reacquired (treasury) stock that is distributed through a stock option, purchase, or award plan is not acceptable practice. The only exception is that compensation cost under a plan with all the provisions described in paragraph 11.c. may be measured by the cost of stock that the corporation (1) reacquires during the fiscal period for which the stock is to be awarded and (2) awards shortly thereafter to employees for services during that period.

b. The measurement date is not changed from the grant or award date to a later date solely by provisions that termination of employment reduces the number of shares of stock that may be issued to an employee.

c. The measurement date of an award of stock for current service may be the end of the fiscal period, which is normally the effective date of the award, instead of the date that the award to an employee is determined if (1) the award is provided for by the terms of an established formal plan, (2) the plan designates the factors that determine the total dollar amount of awards to employees for the period (for example, a percent of income), although the total amount or the individual awards may not be known at the end of the period, and (3) the award pertains to current service of the employee for the period.

d. Renewing a stock option or purchase right or extending its period establishes a new measurement date as if the right were newly granted.

e. Transferring stock or assets to a trustee, agent, or other third party for distribution of stock to employees under the terms of an option, purchase, or award plan does not change the measurement date from a later date to the date of transfer unless the terms of the transfer provide that the stock (1) will not revert to the corporation, (2) will not be granted or awarded later to the same employee on terms different from or for services other than those specified in the original grant or award, and (3) will not be granted or awarded later to another employee.

f. The measurement date for a grant or award of convertible stock or (stock that is otherwise exchangeable for other securities of the corporation) is the date on which the ratio of conversion (or exchange) is known unless other terms are variable at that date (paragraph 10.b.). The higher of the quoted market price at the measurement date of (1) the convertible stock granted or awarded or (2) the securities into which the original grant or award is convertible should be used to measure compensation.

g. Cash paid to an employee to settle an earlier award of stock or to settle a grant of option to the employee should measure compensation cost. If the cash payment differs from the earlier measure of the award of stock or grant of option, compensation cost should be adjusted (paragraph 15). The amount that a corporation pays to an employee to purchase stock previously issued to the employee through a compensation plan is “cash paid to an employee to settle an earlier award of stock or to settle a grant of option” if stock is reacquired shortly after issuance. Cash proceeds that a corporation receives from sale of awarded stock or stock issued on exercise of an option and remits to the taxing authorities to cover required withholding of income taxes on an award is not “cash paid to an employee to settle an earlier award of stock or to settle a grant of option” in measuring compensation cost.

h. Some plans are a combination of two or more types of plans. An employer corporation may need to measure compensation for the separate parts. Compensation cost for a combination plan permitting an employee to elect one part should be measured according to the terms that an employee is most likely to elect based on the facts available each period.

12. Accruing Compensation Cost. Compensation cost in stock option, purchase, and award plans should be recognized as an expense of one or more periods in which an employee performs services and also as part or all of the consideration received for stock issued to the employee through a plan. The grant or award may specify the period or periods during which the employee performs services, or the period or periods may be inferred from the terms or from the past pattern of grants or awards (ARB No. 43, Chapter 13B, paragraph 14; APB Opinion No. 12, Omnibus Opinion--1967, paragraph 6).

13. An employee may perform services in several periods before an employer corporation issues stock to him for those services. The employer corporation should accrue compensation expense in each period in which the services are performed. If the measurement date is later than the date of grant or award, an employer corporation should record the compensation expense each period from date of grant or award to date of measurement based on the quoted market price of the stock at the end of each period.

14. If stock is issued in a plan before some or all of the services are performed,[3] part of the consideration recorded for the stock issued is unearned compensation and should be shown as a separate reduction of stockholders' equity. The unearned compensation should be accounted for as expense of the period or periods in which the employee performs service.

[3] State law governs the issuance of a corporation's stock including the acceptability of issuing stock for future services.

15. Accruing compensation expense may require estimates, and adjustment of those estimates in later periods may be necessary (*APB Opinion No. 20, Accounting Changes*, paragraphs 31-33. For example, if a stock option is not exercised (or awarded stock is returned to the corporation) because an employee fails to fulfill an obligation, the estimate of compensation expense recorded in previous periods should be adjusted by decreasing compensation expense in the period of forfeiture.

16. Accounting for Income Tax Benefits. An employer corporation may obtain an income tax benefit related to stock issued to an employee through a stock option, purchase, or award plan. A corporation is usually entitled to a deduction for income tax purposes of the amount that an employee reports as ordinary income, and the deduction is allowable to the corporation in the year in which the amount is includable in the gross income of the employee. Thus, a deduction for income tax purposes may differ from the related compensation expense that the corporation recognizes,[4] and the deduction may be allowable in a period that differs from the one in which the corporation recognizes compensation expense in measuring net income.

[4] A corporation may be entitled to a deduction for income tax purposes even though it recognizes no compensation expenses in measuring net income.

17. An employer corporation should reduce income tax expense for a period by no more of a tax reduction under a stock option, purchase, or award plan than the proportion of the tax reduction that is related to the compensation expense for the period. Compensation expenses that are deductible in a tax return in a period different from the one in which they are reported as expenses in measuring net income result in temporary differences, and deferred taxes should be recorded in accordance with the provisions of *FASB Statement No. 109, Accounting for Income Taxes*. The remainder of the tax reduction, if any, is related to an amount that is deductible for income tax purposes but does not affect net income. The remainder of the tax reduction should

not be included in income but should be added to capital in addition to par or stated value of capital stock in the period of the tax reduction. Conversely, a tax reduction may be less than if recorded compensation expenses were deductible for income tax purposes. If so, the corporation may deduct the difference from additional capital in the period of the tax reduction to the extent that tax reductions under the same or similar compensatory stock option, purchase, or award plans have been included in additional capital.

18. A corporation may, either by cash payment or otherwise--for example, by allowing a reduction in the purchase price of stock--reimburse an employee for his action related to a stock option, purchase, or award plan that results in a reduction of income taxes of the corporation. The corporation should include the reimbursement in income as an expense.

19. Disclosure. ARB No. 43 Chapter 13B, specifies in paragraph 15 the disclosures related to stock option and stock purchase plans that should be made in financial statements.[5]

[5] Other disclosure requirements are in Regulation S-X for financial statements filed with the Securities and Exchange Commission and in listing agreements of the stock exchanges for financial statements included in annual reports to stockholders.

25. AIN-APB 25 provides the following guidance (only the pertinent excerpts are included below):

1. STOCK PLANS ESTABLISHED BY A PRINCIPAL STOCKHOLDER

Question--Accounting for compensatory and noncompensatory stock option, purchase and award plans adopted by a corporation is discussed in APB Opinion No. 25 and ARB No. 43, Chapter 13B. Should a corporation account for plans or transactions (“plans”), if they have characteristics otherwise similar to compensatory plans adopted by corporations, that are established or financed by a principal stockholder (i.e., one who either owns 10% or more of the corporation's common stock or has the ability, directly or indirectly, to control or influence significantly the corporation)?

Interpretation--It is difficult to evaluate a principal stockholder's intent when he establishes or finances a plan with characteristics otherwise similar to compensatory plans generally adopted by corporations. A principal stockholder may be satisfying his generous nature, settling a moral obligation, or attempting to increase or maintain the value of his own investment. If a principal stockholder's intention is to enhance or maintain the value of his investment by entering into such an arrangement, the corporation is implicitly benefiting from the plan by retention of, and possibly improved performance by, the employee. In this case, the benefits to a principal stockholder and to the corporation are generally impossible to separate. Similarly, it is virtually impossible to separate a principal stockholder's personal satisfaction from the benefit to the corporation. *Accounting Principles Board Statement No. 4, Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises*, paragraph 127 states that “Financial accounting emphasizes the economic substance of events even though the legal form may differ from the economic substance and suggest different treatment.”

The economic substance of this type of plan is substantially the same for the corporation and the employee, whether the plan is adopted by the corporation or a principal stockholder. Consequently, the corporation should account for this type of plan when one is established or financed by a principal stockholder unless (1) the relationship between the stockholder and the corporation's employee is one which would normally result in generosity (i.e., an immediate family relationship), (2) the stockholder has an obligation to the employee which is completely unrelated to the latter's employment (e.g., the stockholder transfers shares to the employee because of personal business relationships in the past, unrelated to the present employment situation), or (3) the corporation clearly

> does not benefit from the transaction (e.g., the stockholder transfers shares to a minor employee with whom he has had a close relationship over a number of years).
>
> This type of plan should be treated as a contribution to capital by the principal stockholder with the offsetting charge accounted for in the same manner as compensatory plans adopted by corporations.
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> Compensation cost should be recognized as an expense of one or more periods in accordance with the provisions of APB Opinion No. 25, paragraphs 12-15.
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> The corporation should account for tax benefits, if any, from this type of plan in accordance with the provisions of APB Opinion No. 25, paragraphs 16-18. If the corporation receives no tax benefit from this type of plan, but would have received such benefit had the plan been adopted by the corporation, the absence of such tax benefit is one of the variables in estimating the plan's cost to the corporation (see APB Opinion No. 16, paragraph 89).

26. FIN 28, prior to amendment by FAS 123 as FAS 123 is rejected in this issue paper, provides the following guidance (only the pertinent excerpts are included below):

> FIN 28 Summary
>
> This Interpretation clarifies aspects of accounting for compensation related to stock appreciation rights and other variable stock option or award plans. The Interpretation specifies that compensation should be measured at the end of each period as the amount by which the quoted market value of the shares of the enterprise's stock covered by a grant exceeds the option price or value specified under the plan and should be accrued as a charge to expense over the periods the employee performs the related services. Changes in the quoted market value should be reflected as an adjustment of accrued compensation and compensation expense in the periods in which the changes occur until the date the number of shares and purchase price, if any, are both known.
>
> INTRODUCTION
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> 1. The FASB has been asked to clarify whether the provisions of *APB Opinion No. 25, Accounting for Stock Issued to Employees*, apply to stock appreciation rights and, if so, how the Opinion should be applied. Similar questions have been raised about awards under other stock compensation plans with variable terms, that is, plans for which the number of shares of stock the employee may receive, the price per share the employee must pay, or both the number of shares and the price are unknown at the date of grant or award. Appendix A provides additional background information about these matters. Appendix B illustrates applications of this Interpretation.
>
> INTERPRETATION
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> 2. APB Opinion No. 25 applies to plans for which the employer's stock is issued as compensation or the amount of cash paid as compensation is determined by reference to the market price of the stock or to changes in its market price. Plans involving stock appreciation rights and other variable plan awards[1] are included in those plans dealt with by Opinion No. 25. When stock appreciation rights or other variable plan awards are granted, an enterprise shall measure compensation as the amount by which the quoted market value of the shares of the enterprise's stock covered by the grant exceeds the option price or value specified, by reference to a market price or otherwise, subject to any appreciation limitations under the plan. Changes, either increases or decreases, in the quoted market value of those shares between the date of grant and the measurement date[2] result in a change in the measure of compensation for the right or award.

[1] Plans for which the number of shares of stock that may be acquired by or awarded to an employee or the price or both are not specified or determinable until after the date of grant or award are referred to in this Interpretation as "variable plan awards." However, plans described in paragraph 11.c. of Opinion No. 25 (see paragraph 12 in Appendix A of this Interpretation) and book value stock option, purchase, or award plans are not covered by this Interpretation. Plans under which an employee may receive cash in lieu of stock or additional cash upon the exercise of a stock option are variable plans for purposes of this Interpretation if the amount is contingent on the occurrence of future events.

[2] Paragraph 10 of Opinion No. 25 defines the measurement date as "the first date on which are known both (1) the number of shares that an individual employee is entitled to receive and (2) the option or purchase price, if any." Generally, the number of shares of stock that may be acquired or awarded under stock appreciation rights and many other variable plan awards are not known until the date that they are exercised.

3. Compensation determined in accordance with paragraph 2 shall be accrued as a charge to expense over the period or periods the employee performs the related services (hereinafter referred to as the "service period"). If the stock appreciation rights or other variable plan awards are granted for past services, compensation shall be accrued as a charge to expense of the period in which the rights or awards are granted. If the service period is not defined in the plan or some other agreement, such as an employment agreement, as a shorter or previous period, the service period shall be presumed to be the vesting period.[3]

[3] For purposes of this Interpretation, stock appreciation rights and other variable plan awards become vested when the employee's right to receive or retain shares or cash under the rights or awards is not contingent upon the performance of additional services. Frequently, the vesting period is the period from the date of grant to the date the rights or awards become exercisable.

4. Compensation accrued during the service period in accordance with paragraph 3 shall be adjusted in subsequent periods up to the measurement date[4] for changes, either increases or decreases, in the quoted market value of the shares of the enterprise's stock covered by the grant but shall not be adjusted below zero. The offsetting adjustment shall be made to compensation expense of the period in which changes in the market value occur. Except as provided in paragraph 5, the accrued compensation for a right that is forfeited or canceled shall be adjusted by decreasing compensation expense in the period of forfeiture, in accordance with paragraph 15 of APB Opinion No. 25.

[4] See footnote 2.

5. For purposes of applying paragraph 11.h.[5] of APB Opinion No. 25, compensation expense for a combination plan[6] involving stock appreciation rights or other variable plan awards (including those that are granted after the date of grant of related stock options) shall be measured according to the terms the employee is most likely to elect based on the facts available each period. An enterprise shall presume that the employee will elect to exercise the stock appreciation rights or other variable plan awards, but the presumption may be overcome if past experience or the terms of a combination plan that limit the market appreciation available to the employee in the stock appreciation rights or other variable plan awards provide evidence that the employee will elect to exercise the related stock option. If an enterprise has been accruing compensation for a stock appreciation right or other variable plan award and a change in circumstances provides evidence that the employee will likely elect to exercise the related stock option, accrued compensation recorded for the right or award shall not be adjusted.[7] If the employee elects to exercise the stock option, the accrued compensation recorded for the right or award shall be recognized as a consideration for the stock issued. If all parts of the grant or award (e.g., both the option and the right or award) are forfeited or canceled, accrued compensation shall be adjusted by decreasing compensation expense in that period.

> [5] See paragraph 13 in Appendix A of this Interpretation.
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> [6] See paragraph 10 in Appendix A of this Interpretation.
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> [7] A change in the circumstances may be indicated by market appreciation in excess of any appreciation limitations under the plan or the cancellation or forfeiture of the stock appreciation right or other variable plan award without a concurrent cancellation or forfeiture of the related stock option. A subsequent decrease in market value that reduces the appreciation to a level below the limitations under the plan would require adjustment of accrued compensation in accordance with paragraph 4 of this Interpretation if evidence then indicates that the employee will elect to exercise the stock appreciation right or other variable plan award.

27. FIN 38, prior to amendment by FAS 123 as FAS 123 is rejected in this issue paper, provides the following guidance (only the pertinent excerpts are included below):

> FIN 38 Summary
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> *APB Opinion No. 25, Accounting for Stock Issued to Employees*, specifies that the measurement date for determining compensation cost in stock option, purchase, and award plans is the first date on which are known both (a) the number of shares that an individual employee is entitled to receive and (b) the option or purchase price, if any. Opinion 25 also specifies that the measurement date for a grant or award of convertible stock is the date on which the ratio of conversion is known unless other terms are variable at that date. Questions have been raised about determining the measurement date for stock option, purchase, and award plans involving junior stock, a separate class of stock issued to certain employees that is subordinate to an employer's regular common stock but is convertible into common stock if specified future events occur. This Interpretation clarifies that the measurement date for grants under stock option, purchase, and award plans involving junior stock is the date on which the number of shares of the employer's regular common stock that an employee is entitled to receive in exchange for the junior stock is known. This Interpretation is effective for grants made to employees on or after March 14, 1984 under stock option, purchase, and award plans involving junior stock.
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> INTRODUCTION
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> 1. The Board has been asked to clarify certain provisions of APB Opinion No. 25, Accounting for Stock Issued to Employees, relating to determining the measurement date for grants made to employees under stock option, purchase, and award plans involving junior stock. As used in this Interpretation, the term junior stock refers to a specific type of stock issued to employees that generally is subordinate to an employer's regular common stock with respect to voting, liquidation, and dividend rights and is convertible[1] into regular common stock if certain performance goals are achieved or if certain transactions occur. Junior stock generally is not transferable, except back to the issuing enterprise, and has a fair value lower than regular common stock because of its subordinate rights and the uncertainty of conversion to regular common stock.
>
> [1] Junior stock that is not convertible per se but that has restrictions that lapse (such as restrictions that lapse when certain performance goals are achieved) so that it ultimately becomes regular common stock is considered to be convertible for purposes of applying this Interpretation.
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> 2. Stock option, purchase, and award plans involving junior stock are designed to provide that an employer ultimately will issue shares of regular common stock to employees. Those plans are variable plans[2] because the number of shares of regular common stock that an individual employee is entitled to receive is not known until certain performance goals are achieved or certain transactions occur. Therefore, for purposes of measuring compensation cost under Opinion 25, the measurement date for grants under stock option, purchase, and award plans

involving junior stock is the first date on which are known both the number of shares of the employer's regular common stock that an employee is entitled to receive in exchange for the junior stock and the option or purchase price, if any.

[2] The term variable plan, as used in this Interpretation, is defined in paragraph 14.

3. In considering the convertible features of junior stock, paragraph 11.f. of Opinion 25 indicates that the measurement date for a grant or award of convertible stock is the date on which the ratio of conversion is known, unless other terms are variable at that date. Because conversion of junior stock to regular common stock generally is contingent on achieving certain performance goals or on certain transactions occurring, the conversion ratio[3] is not known with certainty until those future events occur. After those goals are achieved or those transactions occur, the conversion ratio is determinable and, accordingly, the number of shares of regular common stock that an individual is entitled to receive is known.

[3] If junior stock becomes convertible only to an equal number of shares of regular common stock upon achieving certain performance goals, the conversion ratio is either one-to-zero or one-to-one; some junior stock plans provide for different ratios of conversion depending on the level of performance attained.

4. Compensation cost for stock option, purchase, and award plans involving junior stock shall be accrued according to the provisions of paragraphs 2-4 of *FASB Interpretation No. 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans*, and paragraph 11.g. of Opinion 25. However, the provisions of paragraph 2 of Interpretation 28 shall be applied only when it becomes probable[4] that certain performance goals will be achieved or certain transactions will occur; that probability may or may not be present at the date junior stock is issued.

[4] Probable is used here, consistent with its use in FASB Statement No. 5, Accounting for Contingencies, to mean that it is likely that certain performance goals will be achieved or certain transactions will occur.

5. Stock option, purchase, and award plans involving junior stock generally are based on certain performance goals being achieved or certain transactions occurring within specific periods. Some plans, however, do not specify a period during which those future events must occur. If it is probable that the future event will occur at some time, compensation cost shall be charged to expense over the period from the date the future event becomes probable to the date the future event is most likely to occur or the end of any required service period.[5] Other plans provide for different ratios of conversion of junior stock to regular common stock within a specific period based on variable performance goals. If achieving more than one performance goal is probable, compensation cost shall be based on the highest ratio of conversion of junior stock to regular common stock attributable to those goals whose achievement is probable. However, the final measure of compensation cost shall be based on the ratio of conversion attributable to the performance goal achieved at the measurement date. For all plans, total compensation shall be based on the market price of the regular common stock as of the date compensation cost is determined.

[5] The term service period, as used in this Interpretation, is defined in paragraph 16.

6. Total compensation cost shall be the amount by which the market price at the measurement date of the employer's regular common stock that an employee is entitled to receive exceeds the amount that the employee paid or will pay for the junior stock. If vesting provisions cause junior stock to become convertible to regular common stock after the measurement date, compensation cost shall be recognized during the period from (a) the first date that it becomes probable that the future events will occur or the date the events have occurred to (b) the date that junior stock becomes convertible or the end of the service period, whichever occurs first. If junior stock does not become convertible to regular common stock but cash is paid to an employee to purchase previously issued junior stock, total compensation cost is the amount by which cash paid to the employee exceeds the amount initially paid by the employee for the junior stock.

28. FAS 123 provides the following guidance (only the pertinent excerpts are included below):

INTRODUCTION

1. This Statement establishes a fair value[1] based method of accounting for **stock-based compensation plans**. It encourages entities to adopt that method in place of the provisions of *APB Opinion No. 25*, *Accounting for Stock Issued to Employees,* for all arrangements under which employees receive shares of stock or other equity instruments of the employer or the employer incurs liabilities to employees in amounts based on the price of its stock.

[1] Terms defined in Appendix E, the glossary, are set in boldface type the first time they appear.

2. This Statement also establishes fair value as the measurement basis for transactions in which an entity acquires goods or services from nonemployees in exchange for equity instruments. This Statement uses the term *compensation* in its broadest sense to refer to the consideration paid for goods or services, regardless of whether the supplier is an employee or not. For example, employee compensation includes both cash salaries or wages and other consideration that may be thought of more as means of attracting, retaining and motivating employees than as direct payment for services rendered.

3. Opinion 25, issued in 1972, requires compensation cost[2] for stock-based employee compensation plans to be recognized based on the difference, if any, between the quoted market price of the stock and the amount an employee must pay to acquire the stock. Opinion 25 specifies different dates for the pertinent quoted market price of the stock used in measuring compensation cost, depending on whether the terms of an award[3] are fixed or variable, as those terms are defined in Opinion 25.

[2] This Statement refers to recognizing *compensation cost* rather than *compensation expense* because part of the amount recognized in a period may be capitalized as part of the cost to acquire an asset, such as inventory.

[3] The Statement used the term award as the collective noun for multiple instruments with the same terms granted at the same time either to a single employee or to a group of employees. An award may specify multiple vesting dates, referred to as graded vesting, and different parts of an award may have different expected lives.

4. Since 1972, stock options and other forms of stock-based employee compensation plans have become increasingly common. Also, option-pricing models have become widely used for measuring the value of stock options and similar equity instruments other than those issued to employees as compensation. Opinion 25 has been criticized for producing anomalous results and for providing little general guidance to use in deciding how to account for new forms of stock-based employee compensation plans. Several FASB Interpretations and Technical Bulletins have dealt with specific kinds of plans, and the Emerging Issues Task Force has considered numerous related issues.

5. Because of the perceived deficiencies in Opinion 25, early in the 1980s the AICPA's Accounting Standards Executive Committee, the staff of the Securities and Exchange Commission, most of the larger accounting firms, industry representatives and others asked the Board to reconsider the accounting specified in Opinion 25. This Statement, which is the result of that reconsideration, establishes an accounting method based on the fair value of equity instruments awarded to employees as compensation that mitigates many of the deficiencies in Opinion 25. The Board encourages entities to adopt the new method. However, this Statement permits an entity in determining its net income to continue to apply the accounting provisions of Opinion 25 to its stock-based employee compensation arrangements. An entity that continues to apply Opinion 25 must comply with the disclosure requirements of this Statement, which supersede the disclosure requirements of paragraph 19 of Opinion 25. This Statement also supersedes or amends other accounting pronouncements listed in Appendix D. Appendix A explains the reasons the Board decided not to require recognition of compensation cost for stock-based employee compensation arrangements measured in accordance with the fair value based method described in this Statement.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Scope and Alternative Accounting Methods

6. This Statement applies to all transactions in which an entity acquires goods or services by issuing equity instruments[4] or by incurring liabilities to the supplier in amounts based on the price of the entity's common stock or other equity instruments. Therefore, it applies to all transactions in which an entity grants shares of its common stock, stock options, or other equity instruments to its employees, except for equity instruments held by an employee stock ownership plan.[5]

[4] An entity may conditionally transfer an equity instrument to another party under an arrangement that permits that party to choose at a later date of for a specified time whether to deliver the consideration for it or to forfeit the right to the conditionally transferred instrument with no further obligation. In that situation, the equity instrument is not *issued* until the issuing entity has received the consideration, such as cash, an enforceable right to receive cash, other financial instruments, goods, or services, agreed to by the parties to the transaction. For that reason, this Statement does not use the term *issued* for the grant of stock options or other equity instruments subject to service or performance conditions (or both) for vesting.

[5] *AICPA Statement of Position No. 93-6*, *Employers' Accounting for Employee Stock Ownership Plans,* specifies the accounting by employers for employee stock ownership plans.

7. The accounting for all stock-based compensation arrangements with employees or others shall reflect the inherent rights and obligations, regardless of how those arrangements are described. For example, the rights and obligations embodied in a transfer to stock to an employee for consideration of a nonrecourse note are substantially the same as if the transaction were structured as the grant of a stock option, and the transaction shall be accounted for as such. The terms of the arrangement may affect the fair value of the stock options or other equity instruments and shall be appropriately reflected in determining that value. For example, whether an employee who is granted an implicit option structured as the exchange of shares of stock for a nonrecourse note is required to pay nonrefundable interest on the note affects the fair value of the implicit option.

Accounting for Transactions with Other Than Employees

8. Except for transactions with employees that are within the scope of Opinion 25, all transactions in which goods or services are the consideration received for the issuance of equity instruments shall be accounted for based on the fair value of the consideration received or the fair value of the equity instruments issued, whichever is more reliably measurable. The fair value of goods or services received from suppliers other than employees frequently is reliably measurable and therefore indicates the fair value of the equity instruments issued. The fair value

of the equity instruments issued shall be used to measure the transaction if that value is more reliably measurable than the fair value of the consideration received.[6] A common example of the latter situation is the use of the fair value of tradable equity instruments issued in a purchase business combination to measure the transaction because the value of the equity instruments issued is more reliably measurable than the value of the business acquired.

[6] The consideration received for issuing equity instruments, like the consideration involved in a repurchase of treasury shares, may include intangible rights. *FASB Technical Bulletin No. 85-6*, *Accounting for a Purchase of Treasury Shares at a Price Significantly in Excess of the Current Market Price of the Shares and the Income Statement Classification of Costs Insured in Defending Against a Takeover Attempt,* provides pertinent guidance.

9. This Statement uses the term *fair value* for assets and financial instruments, including bother liability and equity instruments, with the same meaning as in *FASB Statement No. 121*, *Accounting for the Impairment of Long-Lived Assets and for Long-Live Assets to be Disposed Of*, Statement 121 says that the fair value of an asset is

> ...the amount at which the asset could be bought or sold in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available. If quoted market prices are not available, the estimate of fair value shall be based on the best information available in the circumstances. Examples of valuation techniques include the present value of estimated expected future cash flows using a discount rate commensurate with the risks involved, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis [paragraph 7].

10. If the fair value of the goods or services received is not reliably measurable, paragraph 8 of this Statement requires that the measure of the cost of goods or services acquired in a transaction with other than an employee is based on the fair value of the equity instruments issued. However, this Statement does not prescribe the **measurement date**, that is, the date of the stock price on which the fair value of the equity instrument is based, for a transaction with a nonemployee (paragraphs 70-73).

Accounting for Transactions with Employees

11. This Statement provides a choice of accounting methods for transactions with employees that are within the scope of Opinion 25. Paragraphs 16-44 of this Statement describe a method of accounting based on the fair value, rather than the **intrinsic value**, of an employee stock option or a similar equity instrument. The Board encourages entities to adopt the fair value based method of accounting, which is preferable to the Opinion 25 method for purposes of justifying a change in accounting principle under *APB Opinion No. 20*, *Accounting Changes*.[7] However, an entity may continue to apply Opinion 25 in accounting for its stock-based employee compensation arrangements. An entity that does so shall disclose pro forma net income and, if presented, earnings per share, determined as if the fair value based method had been applied in measuring compensation cost (paragraph 45).

[7] Opinion 20, paragraph 8, provides that initial adoption of an accounting principle for a transaction that the entity has not previously had to account for is not a change in accounting principle.

12. The fair value based method described in paragraphs 16-44 of this Statement applies for (a) measuring stock-based employee compensation cost by an entity that adopts that method for accounting purposes and (b) determining the pro forma disclosures required of an entity that measures stock-based employee compensation cost in accordance with the intrinsic value based

method in Opinion 25. Neither those paragraphs (16-44) nor subsequent paragraphs (45-54) of this Statement affect application of the *accounting provisions* of Opinion 25 by an entity that continues to apply it in determining reported net income.

13. For convenience, in describing the fair value based method, paragraphs 16-44 of this Statement refer only to *recognition* or *accounting* requirements. However, those provisions apply equally in determining the pro forma amounts that must be disclosed if an entity continues to apply Opinion 25.

14. An entity shall apply the same accounting method—either the fair value based method described in this Statement or the intrinsic value based method in Opinion 25—in accounting for all of its stock-based employee compensation arrangements. Once an entity adopts the fair value based method for those arrangements, that election shall not be reversed.[8]

15. Equity instruments granted or otherwise transferred directly to an employee by a **principal stockholder** are stock-based employee compensation to be accounted for by the entity under either Opinion 25 or this Statement, whichever method the entity is applying, unless the transfer clearly is for a purpose other than compensation.[9] The substance of a transaction in which a principal stockholder directly transfers equity instruments to an employee as compensation is that the principal stockholder makes a capital contribution to the entity and the entity awards equity instruments to its employee. An example of a situation in which a direct transfer of equity instruments to an employee from a principal stockholder is not compensation cost is a transfer to settle an obligation of the principal stockholder unrelated to employment by the reporting entity.

[8] APB Opinion No. 22, *Disclosure of Accounting Policies,* requires an entity to include a description of all significant accounting policies as an integral part of the financial statements. The method used to account for stock-based employee compensation arrangements is an accounting policy to be included in that description.

[9] That accounting has been required since 1973 in accordance with AICPA Accounting Interpretation 1, “Stock Plans Established by a Principal Stockholder,” of Opinion 25.

VALUATION OF EQUITY INSTRUMENTS ISSUED FOR EMPLOYEE SERVICES

Measurement Basis

16. Frequently, part or all of the consideration received for equity instruments issued to employees is past or future employee services. Equity instruments issued to employees and the cost of the services received as consideration shall be measured and recognized based on the fair value of the equity instruments issued. The portion of the fair value of an equity instrument attributed to employee services is net of the amount, if any, that employees pay for the instrument when it is granted. Paragraphs 17-25 of this Statement provide guidance on how to measure the fair value of stock-based employee compensation. Paragraphs 26-33 provide guidance on how to attribute compensation cost to the periods in which employees render the related services. Appendix B, which is an integral part of this Statement, provides additional guidance on both measurement and attribution of employee compensation cost.

Measurement Objective and Date

17. The objective of the measurement process is to estimate the fair value, based on the stock price at the **grant date**, of stock options or other equity instruments to which employees become entitled when they have rendered the requisite service and satisfied any other conditions necessary to earn the right to benefit from the instruments (for example, to exercise stock options or to sell shares of stock). Restrictions that continue in effect after employees have earned the rights to benefit from their instruments, such as the inability to transfer **vested** employee stock options to third parties, affect the value of the instruments actually issued and therefore are

reflected in estimating their fair value. However, restrictions that stem directly from the forfeitability of instruments to which employees have not yet earned the right, such as the inability either to exercise a nonvested option or to sell **nonvested stock**, do not affect the value of the instruments issued at the vesting date, and their effect therefore is not included in that value. Instead, no value is attributed to instruments that employees forfeit because they fail to satisfy specified service- or performance-related conditions.

Measurement Methods

Awards That Call for Settlement by Issuing Equity Instruments

18. The fair value of a share of nonvested stock awarded to an employee shall be measured at the market price (or estimated market price, if the stock is not publicly traded) of a share of the same stock as if it were vested and issued on the grant date. Nonvested stock granted to employees usually is referred to as **restricted stock**, but this Statement reserves that term for shares whose sale is contractually or governmentally restricted after the shares are vested and fully outstanding. The fair value of a share of restricted stock awarded to an employee, that is, a share that will be restricted after the employee has a vested right to it, shall be measured at its fair value, which is the same amount as a share of similarly restricted stock issued to nonemployees.

19. The fair value of a stock option (or its equivalent) granted by a **public entity** shall be estimated using an option-pricing model (for example, the Black-Scholes or a binomial model) that takes into account as of the grant date the exercise price and expected life of the option, the current price of the underlying stock and its expected **volatility**, expected dividends on the stock (except as provided in paragraphs 32 and 33), and the risk-free interest rate for the expected term of the option. For options that a U.S. entity grants on its own stock, the risk-free interest rate used shall be the rate currently available on zero-coupon U.S. government issues with a remaining term equal to the expected life of the options. Guidance on selecting other assumptions is provided in Appendix B. The fair value of an option estimated at the grant date shall not be subsequently adjusted for changes in the price of the underlying stock or its volatility, the life of the option, dividends on the stock or the risk-free interest rate.

20. A **nonpublic entity** shall estimate the value of its options based on the factors described in the preceding paragraph, except that a nonpublic entity need not consider the expected volatility of its stock over the expected life of the option. The result of excluding volatility in estimating an option's value is an amount commonly termed **minimum value**.

21. It should be possible to reasonably estimate the fair value of most stock options and other equity instruments at the date they are granted. Appendix B illustrates techniques for estimating the fair values of several options with complicated features. However, in unusual circumstances, the terms of a stock option or other equity instrument may make it virtually impossible to reasonably estimate the instrument's fair value at the date it is granted. For example, it may be extremely difficult, if not impossible, to reasonably estimate the fair value of a stock option whose exercise price decreases (or increases) by a specified amount with specified changes in the price of the underlying stock. Similarly, it may not be possible to reasonably estimate the value of a convertible instrument if the conversion ratio depends on the outcome of future events.

22. If it is not possible to reasonably estimate the fair value of an option or other equity instrument at the grant date, the final measure of compensation cost shall be the fair value based on the stock price and other pertinent factors at the first date at which it is possible to reasonably estimate that value. Generally, that is likely to be the date at which the number of shares to which an employee is entitled and the exercise price are determinable. Estimates of compensation cost for periods during which it is not possible to determine fair value shall be based on the current intrinsic value of the award, determined in accordance with the terms that would apply if the option or similar instrument had been currently exercised.

23. If an employee stock purchase plan satisfies all of the following criteria, the plan is not compensatory. Therefore, the discount from market price merely reduces the proceeds from issuing the related shares of stock.

a) The plan incorporates no option features other than the following, which may be incorporated:

(1) Employees are permitted a short period of time—not exceeding 31 days—after the purchase price has been fixed to enroll in the plan.

(2) The purchase price is based solely on the stock's market price at date of purchase, and employees are permitted to cancel participation before the purchase date and obtain a refund of amounts previously paid (such as those paid by payroll withholdings).

b) The discount from the market price does not exceed the greater of (1) a per-share discount that would be reasonable in a recurring offer of stock to stockholders or others or (2) the per-share amount of stock issuance costs avoided by not having to raise a significant amount of capital by a public offering. A discount of 5 percent or less from the market price shall be considered to comply with this criterion without further justification.

c) Substantially all full-time employees that meet limited employment qualifications may participate on an equitable basis.

24. A plan provision that establishes the purchase price as an amount based on the lesser of the stock's market price at date of grant or its market price at date of purchase is, for example, an option feature that causes the plan to be compensatory. Similarly, a plan in which the purchase price is based on the stock's market price at date of grant and that permits a participating employee to cancel participation before the purchase date and obtain a refund of amounts previously paid is a compensatory plan.

Awards That Call for Settlement in Cash

25. Some awards of stock-based compensation result in the entity's incurring a liability because employees can compel the entity to settle the award by transferring its cash or other assets to employees rather than by issuing equity instruments. For example, an entity may incur a liability to pay an employee either on demand or at a specified date an amount to be determined by the increase in the entity's stock price from a specified level. The amount of the liability for such an award shall be measured each period based on the current stock price. The effects of change in the stock price during the **service period** are recognized as compensation cost over the service period in accordance with the method illustrated in *FASB Interpretation No. 28*, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans.* Changes in the amount of the liability due to stock price changes after the service period are compensation cost of the period in which the changes occur.

Recognition of Compensation Cost

26. The total amount of compensation cost recognized for an award of stock-based employee compensation shall be based on the number of instruments that eventually vest. No compensation cost is recognized for awards that employees forfeit either because they fail to satisfy a service requirement for vesting, such as for a **fixed award**, or because the entity does not achieve a **performance condition**, unless the condition is a target stock price or specified amount of intrinsic value on which vesting or exercisability is conditioned. For awards with the latter condition, compensation cost shall be recognized for awards to employees who remain in service for the requisite period regardless of whether the target stock price or amount of intrinsic value is reached.[10] Previously recognized compensation cost shall not be reversed if a vested employee stock option expires unexercised.

[10] The existence of a target stock price that must be achieved to make an option exercisable generally affect the value of the option. Option-pricing models have been adapted to value many of those *path-dependent* options.

27. For purposes of this Statement, a stock-based employee compensation award becomes vested when an employee's right to receive or retain shares of stock or cash under the award is not contingent on the performance of additional services. Typically, an employee stock option that is vested also is immediately exercisable. However, if performance conditions affect either the exercise price or the exercisability date, the service period used for attribution purposes shall be consistent with the assumptions used in estimating the fair value of the award. Paragraphs 209 and 310 in Appendix B illustrate how to account for an option whose exercise price depends on a performance condition.

28. An entity may choose at the grant date to base accruals of compensation cost on the best available estimate of the number of options or other equity instruments that are expected to vest and to revise that estimate, if necessary, if subsequent information indicates that actual forfeitures are likely to differ from initial estimates. Alternatively an entity may begin accruing compensation cost as if all instruments granted that are subject only to a service requirement are expected to vest. The effect of actual forfeitures would then be recognized as they occur. Initial accruals of compensation cost for an award with a performance condition that will determine the number of options or shares to which all employees receiving the award will be entitled shall be based on the best estimate of the outcome of the performance condition, although forfeitures by individual employees may either be estimated at the grant date or recognized only as they occur.[11]

[11] For convenience, the remainder of this document refers to options or shares *expected to vest* because referring specifically to both acceptable methods of accounting for forfeitures by individual employees each time the point is mentioned would be too unwieldy.

29. Compensation cost estimated at the grant date for the number of instruments that are expected to vest based on performance-related conditions, as well as those in which vesting is contingent only on future service for which the entity chooses to estimate forfeitures at the grant date pursuant to paragraph 28, shall be adjusted for subsequent changes in the expected or actual outcome of service- and performance-related conditions until the vesting date. The effect of a change in the estimated number of shares or options expected to vest is a change in an estimate, and the cumulative effect of the change on current and prior periods shall be recognized in the period of the change.

30. The compensation cost for an award of equity instruments to employees shall be recognized over the period(s) in which the related employee services are rendered by a charge to compensation cost and a corresponding credit to equity (paid-in capital) if the award is for future service. If the service period is not defined as an earlier or shorter period, the service period shall be presumed to be the period from the grant date to the date that the award is vested and its exercisability does not depend on continued employee service (paragraph 27). If an award is for past services, the related compensation cost shall be recognized in the period in which it is granted.

31. Compensation cost for an award with a graded vesting schedule shall be recognized in accordance with the method described in Interpretation 28 if the fair value of the award is determined based on different expected lives for the options that vest each year, as it would be if the award is viewed as several separate awards, each with a different vesting date. If the expected life or lives of the award is determined in another manner, the related compensation cost may be recognized on a straight-line basis. However, the amount of compensation cost

recognized at any date must at least equal the value of the vested portion of the award at that date. Appendix B illustrates application of both attribution methods to an award accounted for by the fair value based method.

32. Dividends or dividend equivalents paid to employees on the portion of an award of stock or other equity instruments that vests shall be charged to retained earnings. Nonforfeitable dividends or dividend equivalents paid on shares of stock that do not vest shall be recognized as additional compensation cost. The choice of whether to estimate forfeitures at the grant date or to recognize the effect of forfeitures as they occur described in paragraph 28 also applies to recognition of nonforfeitable dividends paid on shares that do not vest.

33. If employees received only the dividends declared on the class of stock granted to them after the stock becomes vested, that value of the award at the grant date shall be reduced by the present value of dividends expected to be paid on the stock during the vesting period, discounted at the appropriate risk-free interest rate. The fair value of an award of stock options on which dividend equivalents are paid to employees or are applied to reduce the exercise price pursuant to antidilution provisions shall be estimated based on a dividend payment of zero.

Additional Awards and Modifications of Outstanding Awards

34. The fair value of each award of equity instruments, including an award of **reload options**, shall be measured separately based on its terms and the current stock price and related factors at the date it is granted.

35. A modification of the terms of an award that makes it more valuable shall be treated as an exchange of the original award for a new award. In substance, the entity repurchases the original instrument by issuing a new instrument of greater value, incurring additional compensation cost for that incremental value. The incremental value shall be measured by the difference between (a) the fair value of the modified option determined in accordance with the provisions of this Statement and (b) the value of the old option immediately before its terms are modified, determined based on the shorter of (1) its remaining expected life or (2) the expected life of the modified option. Appendix B provides further guidance on and illustrates the accounting for modifications of both vested and nonvested options.

36. Exchanges of options or changes to their terms in conjunction with business combinations, spin-offs, or other equity restructurings, except for those made to reflect the terms of the exchange of shares in a business combination accounted for as a pooling of interests, are modifications for purposes of this Statement. However, a change to the terms of an award in accordance with antidilution provisions that are designed, for example, to equalize an option’s value before and after a stock split or a stock dividend is not a modification of an award for purposes of this Statement.

Settlements of Awards

37. An entity occasionally may repurchase equity instruments issued to employees after the employees have vested rights to them. The amount of cash or other assets paid (or liabilities incurred) to repurchase an equity instrument shall be charged to equity, provided that the amount paid does not exceed the value of the instruments repurchased. For example, an entity that repurchases for $10 a share of stock on the date it becomes vested does not incur additional compensation cost if the market price of the stock is $10 at that date. However, if the market price of the stock is only $8 at that date, the entity incurs an additional $2 ($10 - $8) of cost. An entity that settles a nonvested award for cash has, in effect, vested the award, and the amount of compensation cost measured at the grant date but not yet recognized shall be recognized at the date of repurchase.

38. For employee stock options, the incremental amount, if any, to be recognized as additional compensation cost upon cash settlement shall be determined based on a comparison of the amount paid with the value of the option repurchased, determined based on the remainder

of its original expected life at that date. As indicated in paragraph 37, if stock options are repurchased before they become vested, the amount of unrecognized compensation cost shall be recognized at the date of the repurchase.

39. The accounting shall reflect the terms of a stock-based compensation plan as those terms are mutually understood by the employer and the employees who receive awards under the plan. Generally, the written plan provides the best evidence of its terms. However, an entity's past practice may indicate that the **substantive terms** of a plan differ from its written terms. For example, an entity that grants a **tandem award** consisting of either a stock option or a cash stock appreciation right (SAR) is obligated to pay cash on demand if the choice is the employee's, and the entity thus incurs a liability to the employee. In contract, if the choice is the entity's, it can avoid transferring its assets by choosing to settle in stock, and the award qualifies as an equity instrument. However, if an entity that nominally has the choice of settling awards by issuing stock generally settles in cash, or if the entity generally settles in cash whenever an employee asks for cash settlement, the entity probably is settling a substantive liability rather than repurchasing an equity instrument. The substantive terms shall be the basis for the accounting.

40. To restrict control to a limited group, for example, the members of a particular family, a nonpublic entity may obligate itself to repurchase its equity instruments for their fair value at the date of repurchase. In practice, such an obligation is not deemed to convert the stock to a liability. This Statement is not intended to change that view of the effect of a fair value repurchase agreement for a nonpublic entity. Thus, a nonpublic entity may grant or otherwise issue to employees equity instruments subject to such a repurchase agreement. The repurchase agreement does not convert those equity instruments to liabilities, provided that the repurchase price is the fair value of the stock at the date of repurchase.

Accounting for Tax Consequences of Equity Instruments Awarded to Employees

41. Income tax regulations specify allowable tax deductions for stock-based employee compensation arrangements in determining an entity's income tax liability. Compensation cost recognized under this Statement is measured based on the fair value of an award to an employee. Under existing U.S. tax law, allowable tax deductions are generally measured at a specified date as the excess of the market price of the related stock over the amount the employee is required to pay for the stock (that is, at intrinsic value). The **time value** component of the fair value of an option is not tax deductible. Therefore, tax deductions generally will arise in different amounts and in different periods from compensation cost recognized in financial statements.

42. The cumulative amount of compensation cost recognized for a stock-based award that ordinarily results in a future tax deduction under existing tax law shall be considered to be a deductible temporary difference in applying *FASB Statement No. 109*, *Accounting for Income Taxes*. The deferred tax benefit (or expense) that results from increases (or decreases) in that temporary difference, for example, as additional service is rendered and the related cost is recognized, shall be recognized in the income statement. Recognition of compensation cost for an award that ordinarily does not result in tax deductions under existing tax law shall not be considered to result in a deductible temporary difference in applying Statement 109. A future event, such as an employee's disqualifying disposition of stock under existing U.S. tax law, can give rise to a tax deduction for an award that ordinarily does not result in a tax deduction. The tax effects of such an event shall be recognized only when it occurs.

43. Statement 109 requires a deferred tax asset to be evaluated for future realization and to be reduced by a valuation allowance if, based on the weight of the available evidence, it is more likely than not that some portion or all of the deferred tax asset will not be realized. Differences between (a) the deductible temporary difference computed pursuant to paragraph 42 and (b) the tax deduction inherent in the current fair value of the entity's stock shall not be considered in measuring either the gross deferred tax asset of the need for a valuation allowance for a deferred tax asset recognized under this Statement.

44. If a deduction reported on a tax return for a stock-based award exceeds that cumulative compensation cost for that award recognized for financial reporting, the tax benefit for that excess deduction shall be recognized as additional paid-in capital. If the deduction reported on a tax return is less than the cumulative compensation cost recognized for financial reporting, the write-off of a related deferred tax asset in excess of the benefits of the tax deduction, net of the related valuation allowance, if any, shall be recognized in the income statement except to the extent that there is remaining additional paid-in capital from excess tax deductions from previous stock-based employee compensation awards accounted for in accordance with the fair value based method in this Statement. In that situation, the amount of the write-off shall be charged against that additional paid-in capital.

Disclosures

45. Regardless of the method used to account for stock-based employee compensation arrangements, the financial statements of an entity shall include the disclosures specified in paragraphs 46-48. In addition, an entity that continues to apply Opinion 25 shall disclose for each year for which an income statement is provided the pro forma net income and, if earnings per share is presented, pro forma earnings per share, as if the fair value based accounting method in this Statement had been used to account for stock-based compensation cost. Those pro forma amounts shall reflect the difference between compensation cost, if any, included in net income in accordance with Opinion 25 and the related cost measured by the fair value based method, as well as additional tax effects, if any, that would have been recognized in the income statement if the fair value based method had been used. the required pro forma amounts shall reflect no other adjustments to reported net income or earnings per share.

46. An entity with one or more stock-based compensation plans shall provide a description of the plan(s), including the general terms of awards under the plan(s), such as vesting requirements, the maximum term of options granted, and the number of shares authorized for grants of options or other equity instruments. An entity that uses equity instruments to acquire goods or services other than employee services shall provide disclosures similar to those required by this paragraph and paragraphs 47 and 48 to the extent that those disclosures are important in understanding the effects of those transactions on the financial statements.

47. The following information shall be disclosed for each year for which an income statement is provided:

a. The number and weighted-average exercise prices of options for each of the following groups of options: (1) those outstanding at the beginning of the year, (2) those outstanding at the end of the year, (3) those exercisable at the end of the year, and those (4) granted, (5) exercised, (6) forfeited, or (7) expired during the year.

b. The weighted-average grant-date fair value of options granted during the year. If the exercise prices of some options differ from the market price of the stock on the grant date, weighted-average exercise prices and weighted-average fair values of options shall be disclosed separately for options whose exercise price (1) equals, (2) exceeds, or (3) is less than the market price of the stock on the grant date.

c. The number and weighted-average grant-date fair value of equity instruments other than options, for example, shares of nonvested stock, granted during the year.

d. A description of the method and significant assumptions used during the year to estimate the fair values of options, including the following weighted-average information: (1) risk-free interest rate, (2) expected life, (3) expected volatility, and (4) expected dividends.

e. Total compensation cost recognized in income for stock-based employee compensation awards.

f. The terms of significant modifications of outstanding awards.

An entity that grants options under multiple stock-based employee compensation plans shall provide the foregoing information separately for different types of awards to the extent that the differences in the characteristics of the awards make separate disclosure important to an understanding of the entity's use of stock-based compensation. For example, separate disclosure of weighted-average exercise prices at the end of the year for options with a fixed exercise price and those with an indexed exercise price is likely to be important, as would segregating the number of options not yet exercisable into those that will become exercisable based solely on employees rendering additional service and those for which an additional condition must be met for the options to become exercisable.

48. For options outstanding at the date of the latest statement of financial position presented, the range of exercise prices (as well as the weighted-average exercise price) and the weighted-average remaining contractual life shall be disclosed. If the range of exercise prices is wide (for example, the highest exercise price exceeds approximately 150 percent of the lowest exercise price), the exercise prices shall be segregated into ranges that are meaningful for assessing the number and timing of additional shares that may be issued and the cash that may be received as a result of option exercises. The following information shall be disclosed for each range:

a. The number, weighted-average exercise price, and weighted-average remaining contractual life of options outstanding

b. The number and weighted-average exercise price of options currently exercisable.

Earnings per Share Implications

49. *APB Opinion No. 15*, *Earnings per Share*, requires that employee stock options, nonvested stock, and similar equity instruments granted to employees be treated as common stock equivalents in computing earnings per share. The number of nonvested equity instruments used in computing primary earnings per share shall be the same as the number that are used in measuring the related compensation cost in accordance with this Statement. Fully diluted earnings per share shall continue to be based on the actual number of options or shares granted and not yet forfeited, unless doing so would be antidilutive. If vesting is contingent on other factors, such as the level of future earnings, the shares or options shall be treated as contingent shares in accordance with paragraph 62 of Opinion 15. AICPA Accounting Interpretation 91, "Earnings Conditions," of Opinion 15 provides additional guidance on applying paragraph 62 of Opinion 15 to stock-based employee compensation plans. If stock options or other equity instruments are granted during a period, the shares issuable shall be weighted to reflect the portion of the period during which the equity instruments were outstanding.

50. In applying the treasury stock method of Opinion 15, the assumed proceeds shall be the sum of (a) the amount, if any, the employee must pay, (b) the amount of compensation cost attributed to future services and not yet recognized, and (c) the *Interpretation No. 31*, *Treatment of Stock Compensation Plans in EPS Computations,* provides detailed examples of the treatment of stock compensation plans accounted for under Opinion 25 in earnings per share computations. Although the related cost and tax amounts will differ if the fair value based accounting method in this Statement is applied, the principles in Interpretation 31 remain applicable.

Effective Date and Transition

51. The requirement in paragraph 8 of this Statement shall be effective for transactions entered into after December 15, 1995.

52. The recognition provisions of this Statement may be adopted upon issuance. Regardless of when an entity initially adopts those provisions, they shall be applied to all awards granted after the beginning of the fiscal year in which the recognition provisions are first applied. The recognition provisions shall not be applied to awards granted in fiscal years before the year of initial adoption except to the extent that prior years' awards are modified or settled in cash after the beginning of the fiscal year in which the entity adopts the recognition provisions. Accounting for modifications and settlements of awards initially accounted for in accordance with Opinion 25 is discussed and illustrated in Appendix B.

53. The disclosure requirements of this Statement shall be effective for financial statements for fiscal years beginning after December 15, 1995, or for the fiscal year for which this Statement is initially adopted for recognizing compensation cost, whichever comes first. The disclosure requirements need not be applied in an interim report unless a complete set of financial statements is presented for that period. Pro forma disclosures for awards granted in the first fiscal year beginning after December 15, 1994 need not be included in financial statements for that fiscal year but shall be presented subsequently whenever financial statements for that fiscal year are presented for comparative purposes with financial statements for a later fiscal year.

54. During the initial phase-in period, the effects of applying this Statement for either recognizing compensation cost or providing pro forma disclosures are not likely to be representative of the effects on reported net income for future years, for example, because options vest over several years and additional awards generally are made each year, If that situation exists, the entity shall include a statement to that effect. The entity also may wish to provide supplemental disclosure of the effect of applying the fair value based accounting method to all awards made in fiscal years beginning before the date of initial adoption that were not vested at that date.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- NAIC Annual Statement Instructions
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 78—Employee Stock Ownership Plans*
- *Issue Paper No. 83—Accounting for Income Taxes*

Generally Accepted Accounting Principles

- *Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees*
- *Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins,* Chapter 13, Section B,
- *Accounting Interpretation of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees*
- *FASB Statement No. 123, Accounting for Stock-Based Compensation*
- *FASB Interpretation No. 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans*
- *FASB Interpretation No. 38, Determining the Measurement Date for Stock Option, Purchase, and Award Plans Involving Junior Stock*
- *FASB Emerging Issues Task Force Issue No. 84-13, Purchase of Stock Options and Stock Appreciation Rights in a Leveraged Buyout*
- *FASB Emerging Issues Task Force Issue No. 84-18, Stock Option Pyramiding*
- *FASB Emerging Issues Task Force Issue No. 85-45, Business Combinations, Settlement of Stock Options and Awards*
- *FASB Emerging Issues Task Force Issue No. 87-6, Adjustments Relating to Stock Compensation Plans*

- *FASB Emerging Issues Task Force Issue No. 87-23, Book Value Stock Purchase Plans*
- *FASB Emerging Issues Task Force Issue No. 87-33, Stock Compensation Issues Related to Market Decline*
- *FASB Emerging Issues Task Force Issue No. 88-6, Book Value Plans in an Initial Public Offering*
- *FASB Emerging Issues Task Force Issue No. 90-7, Accounting for a Reload Stock Option*
- *FASB Emerging Issues Task Force Issue No. 90-9, Changes to Fixed Employee Stock Option Plans as a Result of Equity Restructuring*
- *FASB Emerging Issues Task Force Issue No. 94-6, Accounting for the Buyout of Compensatory Stock Options*
- *FASB Emerging Issues Task Force Issue No. 95-16, Accounting for Stock Compensation Arrangements with Employer Loan Features under APB Opinion No. 25*
- *FASB Emerging Issues Task Force Issue No. 96-3, Accounting for Equity Instruments That Are Issued for Consideration Other Than Employee Services Under FASB Statement No. 123*
- *FASB Emerging Issues Task Force Issue No. 96-18, Accounting for Equity Instruments with Variable Terms That Are Issue For Consideration Other Than Employee Services Under FASB Statement No. 123*

State Regulations

- No additional guidance obtained from state statutes or regulations.

Statutory Issue Paper No. 83

Accounting for Income Taxes

STATUS
Finalized March 16, 1998

Current Authoritative Guidance for Income Taxes: SSAP No. 101
This issue paper may not be directly related to the current authoritative statement.

Original SSAP from Issue Paper: SSAP No. 10

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory accounting principles, as applied to income taxes, generally only reflect a reporting entity's incurred current taxes and do not consider the tax effects of differences between statutory accounting income and taxable income. While there have always been differences between statutory accounting income and taxable income, tax law changes since 1984 have resulted in greater differences between the two accounting methods. As a result, statutory surplus does not clearly reflect a reporting entity's ultimate income tax obligation for transactions recorded in the financial statements.

2. GAAP guidance on accounting for income taxes is provided in *FASB Statement No. 109, Accounting for Income Taxes* (FAS 109).

3. Current statutory accounting guidance is not specific with respect to:

a. The definition of incurred taxes as it relates to accounting for tax contingencies and the "true-up" portion of the equity tax of mutual life insurance companies and

b. The criteria for admissibility of income tax recoverables from the Internal Revenue Service (IRS) and the definition of "settled within a reasonable time" as applied to recoverables from a reporting entity's parent pursuant to a written income tax allocation agreement.

4. The purpose of this paper is to establish statutory accounting principles for income taxes that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

5. For purposes of statutory accounting, "income taxes incurred" includes current income taxes, the amount of federal and foreign income taxes paid (recovered) or payable (recoverable) for the current year. Current income taxes are defined as:

a. Current year estimates of federal and foreign income taxes (including the equity tax of a mutual life insurer and the "true-up" of such tax), based on tax returns for the current year, and tax contingencies for current and all prior years, to the extent not previously provided, computed in accordance with *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets* (Issue Paper No. 5) and

b. Amounts incurred or received during the current year relating to prior periods, to the extent not previously provided, as such amounts are deemed to be changes in accounting estimates as defined in *Issue Paper No. 3—Accounting Changes* (Issue Paper No. 3).

6. Additionally, for purposes of statutory accounting, a reporting entity's Statement of Assets, Liabilities, Surplus and Other Funds, shall include deferred income tax assets (DTAs) and liabilities (DTLs). DTAs and DTLs are the expected future tax consequences of temporary differences generated by statutory accounting, as defined in paragraph 11 of FAS 109. FAS 109 is excerpted in paragraph 50 of this issue paper.

7. A reporting entity's deferred tax assets and liabilities are computed as follows:

a. Temporary differences are identified and measured using a "balance sheet" approach whereby statutory and tax basis balance sheets are compared,

b. Temporary differences include unrealized gains and losses and nonadmitted assets but do not include asset valuation reserve (AVR), interest maintenance reserve (IMR), Schedule F penalties and, in the case of a mortgage guaranty insurer, amounts attributable to its statutory contingency reserve to the extent that "tax and loss" bonds have been purchased,

c. Total DTAs and DTLs are computed using enacted tax rates and

d. Consistent with FAS 109, a DTL is not recognized for amounts described in paragraph 31 of FAS 109.

8. Changes in DTAs and DTLs, including changes attributable to changes in tax rates and changes in tax status, if any, shall be recognized as a separate component of gains and losses in unassigned funds (surplus).

9. Gross DTAs shall be admitted in an amount equal to the sum of:

a. Federal income taxes paid in prior years that can be recovered through loss carrybacks for existing temporary differences that reverse by the end of the subsequent calendar year,

b. The lesser of:

i. The amount of gross DTAs, after the application of paragraph 9.a., expected to be realized within one year of the balance sheet date, or

ii. Ten percent of statutory capital and surplus as required to be shown on the statutory balance sheet of the reporting entity for its most recently filed statement with the domiciliary state commissioner adjusted to exclude any net DTAs, EDP equipment and operating system software and any net positive goodwill; and

c. The amount of gross DTAs, after the application of paragraphs 9.a. and 9.b., that can be offset against existing DTLs.

10. In computing a reporting entity's gross DTA pursuant to paragraph 9;

a. Existing temporary differences that reverse by the end of the subsequent calendar year shall be determined in accordance with paragraphs 228 and 229 of FAS 109;

b. In determining the amount of federal income taxes that can be recovered through loss carrybacks, the amount and character (i.e., ordinary versus capital) of the loss carrybacks and the impact, if any, of the Alternative Minimum Tax shall be determined in accordance with the provisions of the Internal Revenue Code, and regulations thereunder;

c. The amount of carryback potential that may be considered in calculating the gross DTAs of a reporting entity in subparagraph 9.a. above, that files a consolidated income tax return with one or more affiliates, may not exceed the amount that the reporting entity could reasonably expect to have refunded by its parent; and

d. The phrases "reverse by the end of the subsequent calendar year" and "realized within one year of the balance sheet date" are intended to accommodate interim reporting dates and reporting entities that file on an other than calendar year basis for federal income tax purposes.

11. Current income tax recoverables are defined to include all current income taxes, including interest, reasonably expected to be recovered in a subsequent accounting period, whether or not a return or claim has been filed with the taxing authorities. Current income tax recoverables are assets, as defined in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets* (Issue Paper No. 4), and are reasonably expected to be recovered if the refund is attributable to an overpayment of estimated tax payments, an error, a carryback, as defined in paragraph 289 of FAS 109, or an item for which the reporting entity has *substantial authority,* as defined in paragraph 52 of this issue paper.

12. In the case of a reporting entity that files a consolidated income tax return with one or more affiliates, income tax transactions (including payment of tax contingencies to its parent) between the affiliated parties shall be recognized if:

a. Such transactions are *economic transactions* as defined in *Issue Paper No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties* (Issue Paper No. 25),

b. Are pursuant to a written income tax allocation agreement and

c. Income taxes incurred are accounted for in a manner consistent with the principles of FAS 109, as modified by this issue paper.

Amounts owed to a reporting entity pursuant to a recognized transaction shall be treated as a loan or advance, and nonadmitted, pursuant to Issue Paper No. 25, to the extent that the recoverable is not settled within 90 days of the filing of a consolidated income tax return, or where a refund is due the reporting entity's parent, within 90 days of the receipt of such refund.

13. Income taxes incurred shall be allocated to net income and realized capital gains or losses in a manner consistent with paragraph 38 of FAS 109. Furthermore, income taxes incurred or received during the current year attributable to prior years shall be allocated, to the extent not previously provided, to net income in accordance with Issue Paper No. 3 unless attributable, in whole or in part, to realized capital gains or losses, in which case, such amounts shall be apportioned between net income and realized capital gains and losses, as appropriate.

14. Income taxes incurred in interim periods shall be computed using an estimated annual effective current tax rate for the annual period in accordance with the methodology described in paragraphs 19 and 20 of *Accounting Principles Board Opinion No. 28*, *Interim Financial Reporting* (APB 28). Estimates of the annual effective tax rate at the end of interim periods are, of necessity, based on estimates and are subject to subsequent refinement or revision. If a reliable estimate cannot be made, the actual effective tax rate for the year-to-date may be the best estimate of the annual effective tax rate. If a reporting entity is unable to estimate a part of its "ordinary" income (or loss) or the related tax (or benefit) but is otherwise able to make a reliable estimate, the tax (or benefit) applicable to the item that cannot be estimated shall

be reported in the interim period in which the item is reported. APB 28 is excerpted in paragraph 51 of this issue paper.

15. Statutory financial statement disclosure shall be made in a manner consistent with the provisions of paragraphs 43-45 and 48 of FAS 109. However, required disclosures with regard to a reporting entity's valuation allowance shall be replaced with disclosures relating to the nonadmittance of some portion or all of a reporting entity's DTAs. Additionally, to the extent that the sum of a reporting entity's "income taxes incurred" (i.e., current income taxes) and the change in its DTAs and DTLs is different from the result obtained by applying the federal statutory rate to its pretax net income, a reporting entity shall disclose the nature of the significant reconciling items. Current statutory financial statement disclosure, as it relates to intercompany tax allocation agreements, is retained. Current statutory financial statement disclosure is excerpted in paragraphs 42 and 43 of this issue paper. Paragraphs 16-21 describe the disclosure requirements as modified for the difference between the requirements of FAS 109 and those prescribed by this issue paper.

16. The components of the net DTA or DTL recognized in a reporting entity's balance sheet shall be disclosed as follows:

a. The total of all DTAs (admitted and nonadmitted);

b. The total of all DTLs;

c. The total DTAs nonadmitted as the result of the application of paragraph 9; and

d. The net change during the year in the total DTAs nonadmitted.

17. To the extent that DTLs are not recognized for amounts described in paragraph 31 of FAS 109, the following shall be disclosed:

a. A description of the types of temporary differences for which a DTL has not been recognized and the types of events that would cause those temporary differences to become taxable;

b. The cumulative amount of each type of temporary difference;

c. The amount of the unrecognized DTL for temporary differences related to investments in foreign subsidiaries and foreign corporate joint ventures that are essentially permanent in duration if determination of that liability is practicable or a statement that determination is not practicable; and

d. The amount of the DTL for temporary differences other than those in item c. above that is not recognized in accordance with the provisions of paragraphs 31 of FAS 109.

18. The significant components of income taxes incurred (i.e., current income tax expense) and the changes in DTAs and DTLs shall be disclosed. Those components would include, for example:

a. Current tax expense or benefit;

b. The change in DTAs and DTLs (exclusive of the effects of other components listed below);

c. Investment tax credits;

d. The benefits of operating loss carryforwards; and

e. Adjustments of a DTA or DTL for enacted changes in tax laws or rates or a change in the tax status of the reporting entity.

19. Additionally, to the extent that the sum of a reporting entity's income taxes incurred and the change in its DTAs and DTLs is different from the result obtained by applying the federal statutory rate to its pretax net income, a reporting entity shall disclose the nature of the significant reconciling items.

20. A reporting entity shall also disclose the following:

a. The amounts, origination dates and expiration dates of operating loss and tax credit carryforwards available for tax purposes; and

b. The amount of federal income taxes incurred in the current year and each preceding year, which are available for recoupment in the event of future net losses.

21. If a reporting entity's federal income tax return is consolidated with those of any other entity or entities, the following shall be disclosed:

a. A list of names of the entities with whom the reporting entity's federal income tax return is consolidated for the current year; and

b. The substance of the written agreement, approved by the reporting entity's Board of Directors, which sets forth the manner in which the total combined federal income tax for all entities is allocated to each entity which is a party to the consolidation. (If no written agreement has been executed, give an explanation of why such an agreement has not been executed.) Additionally, the disclosure shall include the manner in which the entity has an enforceable right to recoup federal income taxes in the event of future net losses which it may incur or to recoup its net losses carried forward as an offset to future net income subject to federal income taxes.

DISCUSSION

22. Statutory accounting principles with respect to income taxes incurred (i.e., current income taxes), as set forth in this issue paper, differ from current statutory guidance as follows:

a. The definition of current income taxes is clarified by defining such taxes to include current year estimates of federal and foreign income taxes, based on tax returns for the current year, tax contingencies computed in accordance with Issue Paper No. 5, and all amounts incurred or received during the current year relating to prior periods, to the extent not previously provided, as such amounts are deemed to be changes in accounting estimates as defined in Issue Paper No. 3. In the case of a mutual life insurance company, current income tax includes the reporting entity's best estimate of its equity tax for the current year, after recomputation (i.e., including the "true-up") in accordance with the guidance contained in Emerging Accounting Issues Working Group Positions 86-1, True-up of Federal Income Taxes for Mutual Life Insurance Companies, and 95-3 & 4, Equity Tax.

b. The definition of current income tax recoverables is modified by defining such amounts as including all current income taxes reasonably expected to be received in a subsequent period, whether or not a return or claim has been filed with the taxing authorities. The criteria for admissibility of current income tax recoverables is also modified by admitting them if they are reasonably expected to be recovered pursuant to Issue Paper No. 4.

c. Statutory accounting principles with respect to the recognition of income tax transactions between affiliated parties that file a consolidated income tax return are modified to ensure that such transactions are recognized consistently among all reporting entities.

d. Statutory accounting principles with respect to the computation of income taxes incurred in interim periods is modified by requiring the use of the estimated annual effective tax rate for purposes of computed income taxes incurred in interim periods as such a method allows for the comparison of income tax rates among reporting entities, recognizes that an interim period is an integral part of the annual accounting period, and adopts paragraphs 19 and 20 of APB 28.

e. Financial statement disclosure is expanded to include disclosure of the components of current income tax expense, DTAs and DTLs, information as to the portion of a reporting entity's DTAs that are nonadmitted and, items for which DTLs have not been established in order to provide meaningful information to the users of a reporting entity's financial statements.

f. Current statutory accounting practice of recording extraordinary amounts of taxes relating to prior years as a component of gains and losses in surplus has been changed to provide that all changes in estimates of income taxes incurred will be recorded in statutory income consistent with Issue Paper No. 3.

23. The definition of current income taxes is clarified to ensure that current income taxes incurred are computed in accordance with the Statement of Concepts, to enhance the comparability of financial statements, and, with respect to the inclusion of tax contingencies, to ensure consistency with the recognition principle of the Statement of Concepts which requires the recognition of liabilities as they are incurred.

24. The definition of current income tax recoverables, and their admissibility, is modified by defining such amounts as including all current income taxes reasonably expected to be received in a subsequent period, whether or not a return or claim has been filed with the taxing authorities, so that such amounts are recorded and admitted based on reasonably objective criteria (i.e., expectation of recovery) and not predicated on subjective criteria (e.g., receipt within a specific timeframe). Current statutory accounting principles' use of subjective criteria precludes reporting entities that are continually under Internal Revenue Service (IRS) audit pursuant to the Coordinated Examination Program from admitting valid income tax recoverables since the IRS will not refund such amounts until an audit is completed. As a result, many of these taxpayers do not file amended income tax returns but rather present these valid claims to the IRS during the audit as "affirmative adjustments".

25. The principles of FAS 109, including the recognition of DTAs and DTLs, are adopted with the following modifications:

a. For purposes of this issue paper, income taxes do not include state income taxes. State income taxes (including franchise taxes) shall be computed in accordance with Issue Paper No. 5 and shall be limited to (a) taxes due as a result of the current year's taxable income calculated in accordance with state laws and regulations and (b) amounts incurred or received during the current year relating to prior periods, to the extent not previously provided as such amounts are deemed to be changes in accounting estimates. Property and casualty insurance companies shall report state income taxes as other underwriting expenses under the caption "Taxes, licenses, and fees." Life and accident and health insurance companies shall report such amounts as general expense under the "Insurance taxes, licenses, and fees, excluding federal income taxes." Other health entities shall report such amounts as general administration expenses under the caption "Taxes, licenses, and fees." State income taxes are excluded from the definition of income taxes to ensure comparability of financial statements, since such taxes are generally not significant to the surplus of a reporting entity and, since not all state taxes are based on income.

b. In order to ensure that a reporting entity's surplus is conservatively measured, the *more likely than not* criteria of paragraph 17.e. of FAS 109 is replaced by the realization criteria in paragraph 9 of this issue paper.

c. DTAs are not reduced by a valuation allowance. Instead, that portion of a reporting entity's DTAs that is not realizable pursuant to this issue paper is nonadmitted.

d. Temporary differences do not include AVR, IMR, Schedule F penalties and, in the case of a mortgage guaranty insurer, amounts attributable to its statutory contingency reserve to the extent that "tax and loss" bonds have been purchased. Current statutory guidance on the accounting for "tax and loss" bonds is excerpted in paragraph 40 of this issue paper.

e. Changes in DTAs and DTLs, including amounts attributable to changes in tax rates and changes in tax status are not included in net income in accordance with paragraphs 27 and 28 of FAS 109, but rather are allocated to gains and losses in surplus pursuant to this issue paper.

f. Paragraphs 29-30, 36-37, 39, 41-42, 46 and 49-59 of FAS 109 are not adopted, inasmuch as they are not applicable to insurance companies or are inconsistent with other statutory accounting principles. Paragraph 47 of FAS 109 is adopted with modification to provide for the disclosures required for non-public reporting entities.

26. The recognition of DTAs and DTLs is consistent with the Statement of Concepts and Issue Paper Nos. 4 and 5, respectively. While Emerging Accounting Issues Working Group Position EI 89-2, Establishing a Liability for Deferred Federal Income Taxes for Statutory Accounting Purposes allows the recording of DTLs, this issue paper requires the recording of DTLs. In defining the objectives of statutory financial reporting the Statement of Concepts states:

> The primary responsibility of each state insurance department is to regulate insurance companies in accordance with state laws with an emphasis on solvency for the protection of policyholders. The ultimate objective of solvency regulation is to ensure that policyholder, contractholder and other legal obligations are met when they come due and that companies maintain capital and surplus at all times and in such forms as required by statute to provide an adequate margin of safety. The cornerstone of solvency measurement is financial reporting. Therefore, the regulator's ability to effectively determine relative financial condition using financial statements is of paramount importance to the protection of policyholders. An accounting model based on the concepts of conservatism, consistency, and recognition is essential to useful statutory financial reporting.

27. Recognition of DTAs and DTLs and the requisite determination that the temporary differences underlying DTAs and DTLs will result in taxable or deductible amounts ensures that statutory surplus reflects the tax consequences of recorded events and is consistent with the assumptions inherent in the financial statements that the reported assets and liabilities will be recovered and settled, respectively. The conclusion reached with respect to the nonadmissibility of Section 847 deposits in Emerging Accounting Issues Working Group Position EI-93-4, Section 847 Deposits, need not be revisited as the tax effect of loss reserve discounting (i.e., a DTA) will be recognized, subject to a nonadmissibility test.

28. DTAs embody the three characteristics of assets, as described in Issue Paper No. 4, for the following reasons:

a. A DTA "embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows" inasmuch as deductible temporary differences reduce taxable income and taxes payable in future years thereby contributing indirectly to future net cash inflows,

b. A reporting entity has exclusive rights to the future benefit associated with its DTA and

c. A DTA is the tax effect of the difference between the tax basis of an asset or liability and its reported amount in the financial statements, and is therefore attributable to a "transaction or other event giving rise to the entity's right to or control of the benefit [that] has already occurred."

29. DTLs embody the three characteristics of liabilities, as described in Issue Paper No. 5, for the following reasons:

a. Inasmuch as a DTL stems from a legal obligation imposed by a taxing authority, it "embodies a present duty or responsibility to one or more other entities that entails settlement by probable future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand,"

b. While a reporting entity may be able to delay the future reversal of the temporary differences, a DTL embodies a reporting entity's duty or responsibility to pay a tax "leaving it little or no discretion to avoid the future sacrifice," and

c. A DTL is the tax effect of the difference between the tax basis of an asset or liability and its reported amount in the financial statements, and is therefore attributable to a "transaction or other event obligating the entity [that] has already happened."

30. Temporary differences do not include differences, such as AVR, IMR, Schedule F penalties, or tax-exempt interest, inasmuch as these differences do not result in taxable or deductible amounts in future years when the related asset or liability for statutory reporting purposes is recovered or settled. Additionally, IMR is excluded from the definition of temporary differences since it is already net of current taxes paid (i.e., in essence a deferred tax has already been recorded). To the extent that a U.S. mortgage guaranty insurer has purchased "tax and loss" bonds, corresponding amounts of its statutory contingency reserve are excluded from the definition of temporary differences in order to preserve the statutory admissibility of "tax and loss" bonds and to ensure that the tax effect of the reserve is not double counted in a mortgage guaranty insurer's surplus.

31. By adoption of the principles of FAS 109, as modified in this issue paper, temporary differences include unrealized gains and losses. As a result, unrealized gains and losses of reporting entities shall be recorded, net of any allocated DTA or DTL, in gains and losses in surplus. The amount allocated shall be computed in a manner consistent with paragraph 38 of FAS 109.

32. This statement rejects *FASB Interpretation No. 18*, *Accounting for Income Taxes in Interim Periods…an interpretation of APB Opinion No. 28*.

33. The following lists Accounting Principles Board Opinions that are adopted or rejected by this statement:

a. *Accounting Principles Board Opinion No. 2, Accounting for the "Investment Credit,"* paragraphs 9-15 are adopted with modification to utilize the cost reduction method only and rejects all other paragraphs;

b. *Accounting Principles Board Opinion No. 4 (Amending No. 2), Accounting for the "Investment Credit,"* is rejected in its entirety;

c. *Accounting Principles Board Opinion No. 10, Omnibus Opinion—1966,* paragraph 6 is adopted;

d. *Accounting Principles Board Opinion No. 23, Accounting for Income Taxes—Special Areas,* paragraphs 1-3, 5-9, 12-13, and 15-18 are adopted, and paragraphs 19-25, and 31-33 are rejected;

e. *Accounting Principles Board Opinion No. 28, Interim Financial Reporting,* paragraphs 19 and 20 are adopted and all other paragraphs rejected;

34. The following lists FASB Technical Bulletins that are adopted or rejected by this statement:

a. *FASB Technical Bulletin No. 79-9*, *Accounting in Interim Periods for Changes in Income Tax Rates* is rejected in its entirety;

b. *FASB Technical Bulletin No. 82-1*, *Disclosure of the Sale or Purchase of Tax Benefits through Tax Leases* is adopted in its entirety.

35. The following lists FASB Emerging Issues Task Force Issues that are adopted or rejected by this statement:

a. *FASB Emerging Issues Task Force No. 91-8*, *Application of FASB Statement No. 96 to a State Tax Based on the Greater of a Franchise Tax or an Income Tax*, is rejected in its entirety;

b. *FASB Emerging Issues Task Force No. 92-8*, *Accounting for the Income Tax Effects under FASB Statement No. 109 of a Change in Functional Currency When an Economy Ceases to Be Considered Highly Inflationary*, is adopted in its entirety;

c. *FASB Emerging Issues Task Force No. 93-13*, *Effect of a Retroactive Change in Enacted Tax Rates That Is Included in Income from Continuing Operations*, is rejected in its entirety;

d. *FASB Emerging Issues Task Force No. 93-16*, *Application of FASB Statement No. 109 to Basis Differences within Foreign Subsidiaries That Meet the Indefinite Reversal Criterion of APB Opinion No. 23*, is rejected in its entirety;

e. *FASB Emerging Issues Task Force No. 93-17*, *Recognition of Deferred Tax Assets for a Parent Company's Excess Tax Basis in the Stock of a Subsidiary That Is Accounted for as a Discontinued Operation*, is adopted in its entirety;

f. *FASB Emerging Issues Task Force No. 94-10, Accounting by a Company for the Income Tax Effects of Transactions among or with Its Shareholders under FASB Statement No. 109*, is rejected in its entirety;

g. *FASB Emerging Issues Task Force No. 95-9*, *Accounting for Tax Effects of Dividends in France in Accordance with FASB Statement No. 109*, is rejected in its entirety;

h. *FASB Emerging Issues Task Force No. 95-10, Accounting for Tax Credits Related to Dividend Payments in Accordance with FASB Statement No. 109*, is rejected in its entirety;

i. *FASB Emerging Issues Task Force No. 95-20, Measurement in the Consolidated Financial Statements of a Parent of the Tax Effects Related to the Operations of a Foreign Subsidiary That Receives Tax Credits Related to Dividend Payments*, is rejected in its entirety.

36. This statement rejects *AICPA Accounting Interpretations*, *Accounting for the Investment Credit: Accounting Interpretations of APB Opinion No. 4* in its entirety.

Drafting Notes/Comments
None

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

37. Chapter 20, Federal Income Taxes, of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies (P&C Accounting Practices and Procedures Manual) provides the following guidance:

> Beginning with the Revenue Act of 1921, the Internal Revenue Code incorporates certain sections which govern the federal income taxation of property/liability insurance companies. The 1986 Tax Reform Act ("TRA") dramatically changed the manner in which such insurers are taxed, repealing Sections 821 through 826 of the Code and eliminating the differences that previously existed in the taxation of mutual and stock property/liability companies. The taxation of property/liability insurers is governed by Section 831 and 832 of the Internal Revenue Code of 1986.
>
> With the enactment of the TRA, not only were the differences in tax treatment between mutual and stock companies eliminated, but, for the first time, a single property/liability tax return was developed — Form 1120-PC. Gone are the Protection Against Loss ("PAL") account and Form 1120M for mutual property/liability insurers, although provisions concerning the runoff of existing PAL accounts still exist.
>
> Section 832 of the Code continues to define "gross income" as:
>
> "A combined gross amount earned during the taxable year, from investment income and from underwriting income as provided in this subsection, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Association of Insurance Commissioners. . ."
>
> Small insurers continue to be eligible for different tax treatment, although they were also affected by the TRA. Any property/liability company with less than $350,000 per year in (the greater of) net written or direct written premiums is exempt from federal income taxation under Code Section 501(c)(15). Property/liability insurers with net written premiums or direct written premiums (whichever is greater) in excess of $350,000, but less than $1,200,000, may make an election to be taxed only on taxable investment income. In the case of a member of a controlled group of corporations, the direct or net written premiums of the controlled group are aggregated in order to determine if the company may make the election. The ownership test for a control group is 50%, rather than 80%, for purposes of determining eligibility for the small company provision.
>
> Each company must establish an appropriate liability for federal income taxes payable in its annual statement. This liability must be sufficient to cover computed taxes for current and prior years that are currently payable (total income tax less estimated tax payments), and any additional taxes the company expects to pay.
>
> This chapter considers the method of accounting for federal income tax, and the differences between annual statement "net income" and "taxable income."

Method of Accounting for Federal Income Taxes

As mentioned above, the statutory method of accounting as used in the annual statement plays the key role in determining the federal income tax liability of property/liability insurers. The insurance sections of the Internal Revenue Code in general provide that taxable income should be computed on the basis of the underwriting and investment exhibits of the annual statement except where such basis conflicts with other preemptive provisions of the Code. Such preemptive provisions have been dramatically increased as a result of the 1986 TRA.

Differences Between Annual Statement "Net Income" and "Taxable Income"

Due to specific Internal Revenue Code provisions which affect determination of taxable income, there have always been differences between annual statement "net income" and "taxable income," such as tax exempt interest income, depreciation expense, etc.

The TRA, however, introduced four major provisions at variance with annual statement accounting which increase the taxable income of property/liability insurers:

1. Discounting of loss reserves. Property/liability insurers are required to discount loss and loss adjustment expense reserves in the following manner:

   - The discount rate is a moving average of the mid-term applicable federal rate under Code Section 1274, which fluctuates from year to year;

   - The payout period is based on industry averages, but the company may elect to use its own experience;

   - The maximum payout period for former Schedule O lines is three years and ten years for all lines that were reported in Schedule P before the 1989 annual statement; and

   - There is an extension of the 10-year payout period for certain reserves remaining at the end of ten years.

     The impact of discounting is to spread the deduction for ultimate incurred losses and loss adjustment expenses over a number of years to reflect the assumed investment earnings on those reserves.

2. Revenue Offset. Property/liability insurers must include in taxable income annually 20% of the increase (decrease) in their unearned premium reserves.

   There is also a transition rule whereby 20% of a company's unearned premium reserve at the end of 1986 is includable in taxable income ratably over a six year period beginning in 1987.

3. Proration. Property/liability insurers are now required to reduce their deduction for losses incurred by 15% of the sum of the tax exempt interest and the deduction for dividends received. This proration rule does not apply to tax exempt interest and the deductible portion of dividends received or accrued on stock or obligations acquired by the insurer before August 8, 1986.

4. Alternative Minimum Tax. A new corporate tax concept was introduced wherein a tax is imposed on a company's "economic" income at a reduced rate of 20%. The corporation's tax liability will be the higher of the regular tax or this alternative minimum tax.

   Certain tax preference items are added to a company's (or a group's) consolidated taxable income resulting in alternative minimum taxable income. Tax preferences should include:

- 50% of excess of book income over taxable income adjusted for other tax preferences.

- Interest on certain private activity municipal bonds issued after August 8, 1986.

- Accelerated depreciation on real and personal property, to the extent it is in excess of depreciation calculated under an alternative method.

Book income is annual statement net income for mutual insurance companies. For stock insurers that file GAAP financial statements, book income is GAAP net income. Beginning in 1990, this preference will be based on adjusted current earnings ("ACE"), similar to earnings and profits, rather than statutory income. Also in 1990, the preference will equal 75% of the excess of ACE over taxable income, plus other preferences.

(The Superfund Revenue Act of 1986 requires corporations to pay an "environmental" tax, set at an annual rate of $12 per $10,000 of alternative minimum taxable income, payable even if the corporation pays no alternative minimum tax. This tax of .12% is levied on a corporation's modified alternative minimum taxable income over $2,000,000.)

Other Additions To Annual Statement "Net Income"

Examples of additions are:

1. Provisions for federal income taxes deducted in the annual statement;

2. Excess of realized capital losses over realized capital gains in the annual statement;

3. Gain on sale of capital assets in excess of annual statement gain;

4. Excess of annual statement depreciation and amortization over tax depreciation and amortization;

5. Cost of assets, leasehold improvements, acquisition of leases, and special assessments on real estate owned, which have been included as expenses in the annual statement, but which are capital improvements for tax purposes;

6. Charitable donations exceeding deductible limits;

7. Premiums for officers' or employees' life insurance policies where the company is the beneficiary;

Deductions From Annual Statement "Net Income"

Examples of deductions are:

1. Tax-exempt interest as reduced by proration;

2. Dividends received deduction as reduced by proration;

3. Excess of tax depreciation and amortization over annual statement depreciation and amortization;

4. Carry-forward of any allowable deductions, such as excess charitable contributions;

5. Operating or capital loss carry-forwards allowable to the company;

6. Federal income tax refunds included in "net income";

7. Items previously not deductible for tax purposes that were charged to annual statement in prior years;

8. Loss on sale of capital assets in excess of annual statement loss.

* See above for discounting, revenue offset, proration and anticipation of salvage and subrogation.

Reporting Federal Income Taxes

Federal income taxes can appear in the following places in the annual statement:

Recoverable federal income taxes are allowable as an admitted asset and appear as an asset on the balance sheet. Note, however, that the NAIC does not recognize as an admitted deferred asset “special estimated tax payments” authorized by Section 847 of the Internal Revenue Code.

Federal income taxes due or accrued are included as a liability on the “Liabilities, Surplus and Other Funds” page of the balance sheet.

Federal income taxes incurred during the year are reported as a deduction from income in the Underwriting and Investment Exhibit of the Statement of Income.

Federal income taxes incurred or refunded during the year relating to prior period adjustments are to be included with current year provisions for taxes, but in some instances, if material, they may be charged or credited directly to unassigned surplus in the capital and surplus account.

Also, a footnote to the Statement of Income discloses the amount of federal income taxes incurred and available for recoupment in the event of future net losses. Further, it discloses the amount of any net losses carried forward and available to offset future net income subject to federal income taxes.

Federal income taxes paid are included in the Statement of Changes in Financial Position.

General Interrogatories include a series of questions regarding federal income taxes. They disclose whether a consolidated return is filed and, if so, the methods used to allocate the taxes between the companies. (See Chapter 8-Other Admitted Assets.)

Federal Income Tax Recoverable - Consolidated Return

In the case of an insurer that is a party to a consolidated tax return with one or more affiliates, the caption for federal income tax recoverable should reflect the source of the recoverable such as “Federal Income Tax Recoverable - Parent.”

Insurers may recognize intercompany transactions arising from income tax allocations among companies participating on a consolidated tax return provided the following conditions are met:

1. There is a written agreement describing the method of allocation and the manner in which intercompany balances will be settled, and

2. Such agreement requires that any intercompany balance will be settled within a reasonable time following the filing of the consolidated tax return, and

3. Such agreement complies with regulations promulgated by the Internal Revenue Service, and

4. Any receivables arising out of such allocation meet the criteria for admitted assets as prescribed by the domiciliary state of the insurer, and

5. Liabilities which offset the related intercompany receivables are established by other companies participating in the consolidated tax return.

38. Chapter 23, Federal Income Taxes, of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies (Life/A&H Accounting Practices and Procedures Manual) provides the following guidance:

Introduction

With the passage of the Deficit Reduction Act of 1984, Congress substantially changed the taxation of life insurance companies under the U.S. Internal Revenue Code. From 1958 through 1983, life insurance companies were taxed under the provisions of the Life Insurance Company Income Tax Act of 1959 which prescribed a complex three phase taxing formula unique to such companies. The 1984 Act mandated a simpler single-phase basis of taxation which essentially parallels the taxation of the income of other corporations. Subsequent modifications have retained the basic single-phase system.

However, there are several aspects of determining life insurance company taxable income that are unique to the life insurance industry. The most notable of these are deductions for increases in life insurance company reserves, deductions for dividends to policyholders, the special treatment of the company's share of tax exempt interest and dividends received deduction, and the small life insurance company deduction.

Definition of a Life Insurance Company for Federal Income Tax Purposes

To obtain the special treatment afforded life insurance companies under the Internal Revenue Code, a business enterprise must meet the Internal Revenue Code's definition of a life insurance company. A life insurance company is defined as a company for which, during the taxable year, more than half of its business is the issuance of insurance and annuity contracts or the reinsuring of risks underwritten by insurance companies, provided that more than 50% of its total reserves consist of life insurance reserves and unearned premiums and unpaid losses on noncancellable life, accident, or health policies. As a result of this definition in the Internal Revenue Code, companies that are incorporated as life insurance companies under applicable state insurance laws may not qualify as life insurance companies for federal income tax purposes.

Deduction for Increase in Reserves

Life insurance companies are permitted deductions in each tax year for the net amount of the increase in:

- Life insurance reserves (as defined in the Internal Revenue Code).
- Unearned premiums and unpaid losses not included in life insurance reserves.
- Other items set forth in the Internal Revenue Code.

In general, a life insurance reserve is defined in the Internal Revenue Code as a liability amount which is required by state law and which:

- Is computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest, and
- Recognizes the company's future liability for unaccrued claims from life insurance, annuity, and noncancellable accident and health insurance contracts.

Noncancellable accident and health insurance is defined to include guaranteed renewable accident and health insurance.

Calculation of Life Insurance Reserves for Deduction Purposes

Prior to the 1984 Act, a life insurance company's reserves for federal income tax purposes were generally based upon those held in its statutory annual statement. As a result of the 1984 Act, federal standards were established for the calculation of life insurance reserves for income tax purposes and may be summarized as follows:

- The reserve calculation method is specified—in general, a company is to use the Commissioners' Reserve Valuation Method (CRVM) for life insurance contracts, the Commissioners' Annuity Reserve Valuation Method (CARVM) for annuity contracts and a two-year full preliminary term for noncancellable accident and health insurance.

- The interest rate is specified—beginning in 1988 it has been the greater of:

  An interest rate determined by the Internal Revenue Service based on an average of monthly interest rates for certain Treasury obligations, referred to as the "applicable federal interest rate" (AFR), or

  The "prevailing state assumed interest rate", i.e., the highest interest rate which at least 26 states permit to be used for statutory annual statement reserves for such contracts.

- The mortality/morbidity basis is specified—the "prevailing commissioners' standard tables for mortality and morbidity", i.e., the most recent tables adopted by the NAIC which at least 26 states permit to be used for reserve determination for such contracts. In the event there are no "prevailing commissioners' standard tables", the Secretary of the Treasury is authorized to specify the mortality or morbidity tables to be used.

Life insurance companies are permitted to use the larger of the reserve amount calculated by the foregoing rules or the net surrender value of the contract to determine the reserve deduction for the tax year. In any event, the tax reserve cannot exceed the reserve amount shown on the company's annual statement.

As a result of legislation in 1986, certain other reserves which generally are not discounted for annual statement purposes, such as accident and health unpaid claims, now must be discounted for tax deduction purposes using a discounting method and rate specified by the Internal Revenue Code.

Deduction for Policyholder Dividends

As a result of the 1984 Act, the deduction by a stock life insurance company for policyholder dividends paid or accrued during a taxable year generally is not subject to limitation. However, a mutual life insurance company is required by the Internal Revenue Code to reduce its deduction for policyholder dividends (and, next, its deduction for increase in reserves) by an amount referred to as the "differential earnings amount." According to the 1984 Act Congressional Conference Report, "...This reduction reflects recognition that, to some extent, policyholder dividends paid by mutual companies are distributions of the companies' earnings to the policyholders as owners..."

The Internal Revenue Code's definition of "policyholder dividends" includes the following items:

- Amounts returned to policyholders where the amounts so returned were not fixed in the policy but, instead, depended on the experience of the company or the discretion of management.

- Excess interest, defined as any amount in the nature of interest paid or credited to policyholders in excess of the prevailing state assumed interest rate (rather than in excess of the minimum rate guaranteed in the contract).

- Premium adjustments, defined as any reduction in the premiums which would have been required to be paid under the contracts.

- Experience-rated refunds, defined as including a refund based on the experience of the policyholder.

Under the Internal Revenue Code, the differential earnings amount for mutual companies is determined by multiplying an individual company's "average equity base" for the taxable year by the "differential earnings rate." The average equity base is an amount calculated by each mutual company. It is based on specific rules in the Internal Revenue Code and includes a company's capital and surplus. The differential earnings rate is computed by the Internal Revenue Service based on information reported by all mutual life insurance companies and the 50 largest stock life insurance companies. The rate for each year is announced by the Internal Revenue Service.

Company's Share of Tax-Exempt Interest and Dividends-Received Deduction

In determining taxable income for most corporations, tax exempt interest is excluded and a deduction is allowed for a percent of United States source dividend income received. However, special rules apply as to life insurance companies. Life insurance companies are allowed to reduce taxable income by only the "company's share" of the tax exempt interest and the dividends received deduction. The "company's share" is calculated using specific rules in the Internal Revenue Code.

Small Life Insurance Company Deduction

For life insurance companies with assets of less than $500 million, a special small company deduction from taxable income is allowed. The deduction is equal to 60% of tentative life insurance company taxable income up to $3 million. This deduction is reduced by 15% of tentative life insurance company taxable income between $3 million and $15 million (at $15 million, the deduction becomes zero). For purposes of the $500 million asset ceiling, all members of a controlled group, including nonlife insurance companies, are treated as one company.

Other Considerations

Alternative Minimum Tax

The Tax Reform Act of 1986 replaced the prior add-on minimum tax with a new alternative minimum tax (AMT) on corporations. The AMT is, in substance, an alternative tax calculation which applies if it exceeds the regular tax.

The AMT is applicable to all companies, including life insurance companies, and is intended to ensure that no taxpayer with substantial economic income can avoid income tax through the use of exclusions, deductions, and credits. The AMT is equal to 20% of the recomputed taxable income that recognizes certain adjustments and items of tax preference. The significant adjustment for life insurance companies for the tax years 1987, 1988, and 1989 was the book income adjustment. This adjustment increases (but does not decrease) the alternative minimum taxable income by 50% of the difference between pretax financial statement income and taxable income. Another adjustment, applicable only to mutual companies, limits the reduction in book income for policyholder dividends.

Starting with 1990, the calculation of alternative minimum taxable income has been based on an earnings and profits concept rather than a book income adjustment. Among the adjustments for tax years beginning after 1989 that are of importance to life insurance companies are a requirement to amortize acquisition costs, the addback of the company's share of tax exempt interest and the dividends received deduction, and the addback of the small company deduction.

Policyholders' Surplus Account

A stock life insurance company may be required to maintain a memorandum account for tax purposes called the "policyholders' surplus account." The policyholders' surplus account represents, in effect, income of a stock life insurance company for which tax was deferred under pre-1984 tax rules. Under the 1984 Act, there can be no additions to the policyholders' surplus account after 1983. However, reductions in the policyholders' surplus account are included in taxable income in the year in which such reductions occur (referred to as "Phase III income").

Phase III income can occur as a result of any of the following circumstances:

- The company makes certain distributions to shareholders, either as dividends or redemptions of stock, which are in excess of the shareholders' surplus account and are considered as reductions of the policyholders' surplus account.

- The policyholders' surplus account exceeds certain maximums based on net premiums and life insurance reserves.

- The company ceases to qualify as a life insurance company for tax purposes.

Statutory Treatment of Federal Income Taxes

In addition to United States income taxes, federal income taxes in the annual statement include income taxes levied by foreign countries and United States possessions. The handling of federal income taxes can appear in different places in the annual statement. These places are:

- Federal income tax recoverable is reported as an asset subject to asset admissibility criteria.

- Federal income taxes due or accrued are reported as a liability.

- Federal income taxes incurred during the year (excluding tax on capital gains) are deducted in the Summary of Operations.

- Federal income taxes incurred during the year relating to prior-period adjustments generally are included with current year taxes. However, in extraordinary instances it may be appropriate to charge such adjustments directly to the surplus account.

- Federal income taxes incurred during the year on capital gains are shown as a reduction of Gross Capital Gains and Losses on Investments.

Insurers may recognize transactions arising from income tax allocations among companies participating in a consolidated return, provided certain conditions are met.

39. Chapter 19, Expenses, of the P&C Accounting Practices and Procedures Manual provides the following guidance with respect to state income taxes:

Expense Group Classifications

Expenses for fire and casualty insurance companies are allocated to expense groups as follows:

B. Other Underwriting Expenses

Other underwriting expenses are classified into three categories as follows:

3. Taxes, Licenses, and Fees

These are state and local insurance taxes, insurance department licenses and fees, allocable payroll taxes, and all other taxes excluding federal and foreign income and real estate taxes.

All other taxes might include: (1) qualifying bond premiums; (2) statement publication fees; (3) advertising required by law; (4) personal property taxes; (5) state income taxes; (6) capital stock taxes; (7) business or corporation licenses or fees; (8) marine profits taxes; (9) documentary stamps on reinsurance; (10) guaranty association assessments; and (11) any other taxes.

Real estate taxes on investment properties are generally included with investment expenses, and capital stock taxes and apportioned payroll taxes may be reported as investment expenses.

40. Appendix A, Mortgage Guaranty Insurance Accounting Principles Supplement of the P&C Accounting Practices and Procedures Manual provides the following guidance with respect to “tax and loss” bonds of U.S. mortgage guaranty insurance companies:

BONDS

U.S. Mortgage Guaranty Tax and Loss Bonds

To obtain a current federal income tax benefit derived from annual additions to the statutory contingency reserve (for tax purposes, the “mortgage guaranty account”), mortgage guaranty insurers must purchase “tax and loss” bonds to the extent of such benefits. These bonds are noninterest bearing obligations of the U.S. Treasury, and mature 10 years after issue. The usual purpose of “tax and loss” bonds is to satisfy taxes that will be due in 10 years when the tax benefit is reversed; however, the bonds may be redeemed earlier in the event of excess underwriting losses. (See chapter on Contingency Reserve.) These bonds are carried as an asset for statutory purposes allowing mortgage insurers to conserve capital.

FEDERAL INCOME TAXES

Contingency Reserve (for Tax Purposes, the “Mortgage Guaranty Account”)

Under IRS Code Section 832(e), mortgage guaranty insurers are permitted to deduct from gross income the annual addition to the contingency reserve. The tax deduction is generally an amount equal to (a) 50% of earned premium or (b) taxable income as computed prior to this special deduction if less than 50% of earned premium. Annual deductions not utilized for tax purposes during the current period may be carried forward for eight years on a basis similar to net operating losses. The amount deducted must be restored to gross income after ten years; however, the amount may be restored to gross income at an earlier date in the event of a taxable net operating loss.

The tax deduction is permitted only if special “U.S. Mortgage Guaranty Tax and Loss Bonds” are purchased in an amount equal to the tax benefit derived from the deduction (see section on “Bonds”). Upon redemption the “tax and loss” bonds can be used to satisfy the additional tax liability that arises when the deduction is restored to income.

The purchase of “tax and loss” bonds will often defer the entire tax expense that would otherwise be payable on the current year’s taxable income.

41. Chapter 22, General Expenses and Taxes, Licenses and Fees of the Life/A&H Accounting Practices and Procedures Manual contains the following guidance with respect to state income taxes:

Classification of Expenses

The following points should be noted with respect to specific classifications of expenses:

12. Taxes, licenses and fees generally include all payments to federal, state, local, and foreign governments with the exception of federal income taxes.

Taxes, Licenses, and Fees Due or Accrued

Taxes, licenses, and fees which are unpaid but applicable to the accounting period should be accrued and reported as a liability in the balance sheet. With respect to premium taxes and state income taxes, the amount accrued should relate to the related premiums or taxable income recorded in the period, less, of course, prepayments of those taxes. Payroll taxes accrued should include all unpaid taxes applicable to salaries and wages which have been paid, plus taxes applicable to accrued payroll.

42. The NAIC Annual Statement Instructions for Property and Casualty Insurance Companies provides the following guidance with respect to federal income taxes:

UNDERWRITING AND INVESTMENT EXHIBIT

STATEMENT OF INCOME

Line 15 - Federal and Foreign Income Taxes Incurred

Include: Current year provisions for federal and foreign income taxes, and federal and foreign income taxes incurred or refunded during the year relating to prior period adjustments. In some instances such prior period adjustments, if material, may be charged or credited directly to Unassigned Surplus in the “Capital and Surplus Account.”

The statutory method of accounting as used in the annual statement plays the key role in determining the federal income tax liability of property and casualty insurance companies. The insurance sections of the Internal Revenue Code, in general, provide that taxable income should be computed on the basis of the underwriting and investment exhibits of the annual statement except where such basis conflicts with other preemptive provisions of the Internal Revenue Code.

The amount of this item equals Line 14 of Exhibit 2, adjusted for reserves in Line 6 on page 3 of the current and prior years’ statements, and recoverables in Line 14, Column 4 on Page 2 of current and prior years’ statements.

The amount of this item equals Line 9, Page 5, adjusted for reserves in Line 6 on Page 3 of the current and prior years’ statements, and recoverables in Line 14, Column 4 on Page 2 of current and prior years’ statements.

CAPITAL AND SURPLUS ACCOUNT

Line 29 - Extraordinary Amounts of Taxes for Prior Years

Include: Interest and expenses related to prior year taxes on this line.

ASSETS, PAGE 2

Line 14 - Federal Income tax Recoverable

In the case on an insurer that is a party to a consolidated tax return with one or more affiliates, the caption for Federal Income Tax Recoverable should reflect the source of the recoverable; e.g., Federal Income Tax Recoverable - Parent.

Insurers may recognize intercompany transactions arising from income tax allocations among companies participating in a consolidated income tax return, provided the following conditions are met:

1. There is a written agreement describing the method of allocation and the manner in which intercompany balances will be settled, and

2. Such agreement requires that any intercompany balance will be settled within a reasonable time following the filing of the consolidated tax return, and

3. Such agreement complies with regulations promulgated by the Internal Revenue Service, and

4. Any receivables arising out of such allocation meet the criteria for admitted assets as prescribed by the domiciliary state of the insurer, and

5. Liabilities which offset the related intercompany receivables are established by other companies participating in the consolidated tax return.

NOTES TO FINANCIAL STATEMENTS

4. Federal Income Tax Allocation

Instruction:

a. If the company’s federal income tax return is combined with those of any other entity or entities, provide the following:

1. A list of names of the entities with whom the company’s federal income tax return is combined for the current year.

2. The substance of the written agreement, approved by the company’s Board of Directors, which sets forth the manner in which the total combined federal income tax for all entities is allocated to each entity which is a party to the consolidation. (If no written agreement has been executed, give an explanation of why such an agreement has not been executed.) Describe the method of allocation, setting forth the manner in which the company has an enforceable right to recoup federal income taxes in the event of future net losses which it may incur or to recoup its net losses carried forward as an offset to future net income subject to federal income taxes.

b. If the company incurred federal income taxes which are available for recoupment in the event of future net losses, indicate the amount available for recoupment from the current year, the first preceding year, and the second preceding year.

c. If the company incurred net losses which are carried forward and are available to offset future net income subject to income taxes, indicate the amounts carried forward from the current year and each of the six years preceding the current year.

Illustration:

a. 1. The Company's federal income tax return is combined with the following entities:

The Affiliated Company

2. The method of allocation between the companies is subject to written agreement, approved by the Board of Directors. Allocation is based upon separate return calculations with current credit for net losses. Intercompany tax balances are settled annually in the first quarter.

b. The amount of federal income taxes incurred and available for recoupment in the event of future net losses is:
current year $ __________; first preceding year $ ___________;
second preceding year $ __________

c. The amount of net losses carried forward and available to offset future net income subject to federal income taxes is:
current year $ _________; first preceding year $_________;
second preceding year $_________; third preceding year $_________;
fourth preceding year $_________; fifth preceding year $_________;
sixth preceding year $_________

43. The NAIC Annual Statement Instructions for Life and Accident and Health Insurance Companies provides the following guidance with respect to federal income taxes:

SUMMARY OF OPERATIONS (EXCLUDING UNREALIZED CAPITAL GAINS & LOSSES)

Line 30 - Federal Income Taxes Incurred

Include: Income and excess profits taxes, of any foreign country or of any possession of the U.S., incurred on operations.

Exclude: Taxes on capital gains and Extraordinary amounts of taxes relating to prior years.

The total of the amount in Line 30 minus extraordinary amounts of taxes reported in the "Details of Write-ins Aggregated at Line 46 for Gains and Losses in Surplus" on Line 46 plus Exhibit 3, Footnote (a), Line 1, Column B should be equal to Exhibit 12, Line 23.2 plus Page 3, Line 14A, current year, plus Page 2, Line 14, prior year, minus Page 3, Line 14A, prior year, minus Page 2, Line 14, Column 4, current year.

ASSETS, PAGE 2

Line 14 - Federal Income Tax Recoverable

In the case on an insurer that is a party to a consolidated tax return with one or more affiliates, the caption for Federal Income Tax Recoverable should reflect the source of the recoverable; e.g., Federal Income Tax Recoverable - Parent.

Insurers may recognize intercompany transactions arising from income tax allocations among companies participating in a consolidated income tax return, provided the following conditions are met:

1. There is a written agreement describing the method of allocation and the manner in which intercompany balances will be settled, and

2. Such agreement requires that any intercompany balance will be settled within a reasonable time following the filing of the consolidated tax return, and

3. Such agreement complies with regulations promulgated by the Internal Revenue Service, and

4. Any receivables arising out of such allocation meet the criteria for admitted assets as prescribed by the domiciliary state of the insurer, and

5. Liabilities which offset the related intercompany receivables are established by other companies participating in the consolidated tax return.

NOTES TO FINANCIAL STATEMENTS

5. Federal Income Tax Allocation

Instruction:

If the company's federal income tax return is combined with those of any other entity or entities, provide the following:

a. A list of names of the entities with whom the company's federal income tax return is combined for the current year.

b. The substance of the written agreement, approved by the company's Board of Directors, which sets forth the manner in which the total combined federal income tax for all entities is allocated to each entity which is a party to the consolidation. (If no written agreement has been executed, give an explanation of why such an agreement has not been executed.) Describe the method of allocation, setting forth the manner in which the company has an enforceable right to recoup federal income taxes in the event of future net losses which it may incur or to recoup its net losses carried forward as an offset to future net income subject to federal income taxes.

Illustration:

a. The Company's federal income tax return is combined with the following entities:

The Affiliated Company

b. The method of allocation between the companies is subject to written agreement, approved by the Board of Directors. Allocation is based upon separate return calculations with current credit for net losses. Intercompany tax balances are settled annually in the first quarter.

44. Emerging Accounting Issues Working Group Position EI-86-1, *True-up of Federal Income Taxes for Mutual Life Insurance Companies*, provides the following guidance:

True–Up of Federal Income Taxes for Mutual Life Insurance Companies

The second issue discussed was adjustment of the ownership differential earnings amount provided under the Deficit Reduction Act of 1984. Attached to these minutes is a memorandum prepared by Ernst & Whinney which provided the background material for the discussion.

Accounting issues discussed were as follows:

1. What is the most appropriate option for mutual life insurers to adopt in accruing for 1984 and 1985 in the absence of an announced differential rate by the U.S. Treasury?

2. Should the adjustments to federal income taxes of prior years' tax liability relative to the true–up be reported through operations or as a direct charge to surplus?

The working group concluded the following:

1. "Best estimates" should be used in accruing for the 1984 and 1985 tax liabilities in the absence of an announced differential rate by the U.S. Treasury.

2. Adjustments of prior years' tax liability relative to the true–up should be reported through the operations statement.

45. Emerging Accounting Issues Working Group Position EI 87-6, *Accounting for the Impact of the Tax Reform Act of 1986*, provides the following guidance (However, note that reference to the FASB relates to consideration of deferred taxes pursuant to *FASB Statement of Financial Accounting Standards No. 96*, *Accounting for Income Taxes*, which was superseded by FAS 109):

Accounting for Impact of the Tax Reform Act of 1986 (Loss Reserves Discounting)

The question of accounting on a statutory basis for the implications of tax reform was initially raised by Mary Jan Robertson, Vice President–Controller of United Capital Insurance Company. Subsequent to, and, independent of her request, tax reform impact questions were also referred to the Emerging Issues Working Group by action of the Financial Condition (EX4) Subcommittee.

The Tax Reform Act of 1986 made significant changes in the taxation of property and casualty insurance companies. Among the changes are "fresh start" provisions, loss reserve discounting, limitation in the deduction of the unearned premium, taxation of a portion of previously tax–exempt income, imposition of an alternative minimum tax in some cases and lower rates. The act changes the timing of tax payments and taxable income may be considerably higher than before, particularly in the first few years:

The working group considered the following issues:

1. Should the loss reserve discounting required for federal tax purposes be reflected in the insurer's statutory statement?

   The working group concluded that loss reserve discounting required for federal tax purposes was not an acceptable statutory accounting treatment.

2. Should a deferred tax asset, i.e., prepaid income taxes, arising from current timing differences be permitted on a statutory basis?

   The consensus of the working group was that a deferred tax asset should not be permitted for statutory accounting purposes. The consensus was based, among other things, on the following:

   a. The asset is not convertible to cash; it generally only reflects timing differences.

   b. The asset is not recoverable within a definitive and short (1 to 2 years) time frame nor is the value readily determinable.

   c. Statutory accounting has not previously recognized prepaid or deferred liability items (e.g., prepaid rent and deferred acquisition expenses).

> d. In the majority of companies, i.e., those with growing premium volume and increasing loss reserve levels, the deferred tax asset would continually grow, probably to a very significant size.
>
> The Financial Accounting Standard Board (FASB) has also reviewed this issue. FASB may allow some balance sheet recognition of a deferred tax asset, but it will be limited to a 3–year carryback amount if the amount and calculation thereof is clearly demonstrable. The working group believes in most cases, this will provide insignificant relief to property/casualty insurers.
>
> The working group recommends to all insurance departments and to the NAIC Examiner Team that their financial analysis process take into consideration the impact on surplus caused by the new tax law. In some cases, effective tax rates will be very high, in excess of 100%, and that obviously will impact surplus. As a result, IRIS tests and other financial ratios which are surplus dependent may be distorted. Examiners and analysts should be cognizant of tax impact when evaluating companies. In certain situations, analytical recognition of additional equity resulting from deferred or prepaid taxes should be considered when determining financial stability and writing capacity. The working group believes this will be very pertinent with respect to new, growing companies writing long tail lines and to small, monoline, professional malpractice companies.

46. Emerging Accounting Issues Working Group Position EI 89-2, *Establishing a Liability for Deferred Federal Income Taxes for Statutory Accounting Purposes*, provides the following guidance on deferred taxes:

> Establishing a Liability for Deferred Federal Income Taxes for Statutory Accounting Purposes
>
> The issue summary for this topic was also prepared by Mr. Schaefer of the Michigan Insurance Bureau. A Michigan property and casualty insurer had established a liability for deferred federal income taxes consisting of a protection against loss account, unrealized gains from securities purchased at a discount and unrealized gains or losses from the write-up or write-down of the market value on stocks. While statutory accounting allows the deferral of taxes through the establishment of a P.A.L. account, the 1986 Tax Reform Act repealed the deduction for such an account.
>
> The issue identified was:
>
> Should the reporting of a liability for deferred federal income taxes be allowed under statutory accounting principles?
>
> The working group concluded that while the existing accounting does not prohibit the establishment of a deferred tax liability, such a liability is not required. If an insurer does establish such a liability, it should be done on a consistent basis from year to year. In accordance with present annual statement instructions, it should not be included in the federal income tax liability.

47. Emerging Accounting Issues Working Group Position EI 93-4, *Section 847 Deposits*, provides the following guidance on the asset admissibility of these deposits:

> 2. Section 847 Deposits (Prepaid Federal Income Taxes)
>
> This issue submitted by Dakota Truck Underwriters (Attachment B) was first considered by the working group in September 1993 (EI 93-3). The discussion at that meeting revealed that additional research was needed to provide information to the working group. John Baily (Coopers & Lybrand) summarized the result of such research (Attachment C). He indicated that this issue was not unlike the general issue of deferred tax assets considered and rejected by the working group previously.

> The working group voted to reject the recommendation to allow reciprocal insurers an admitted asset for Section 847 deposits. The working group also reiterated its position against deferred taxes for statutory purposes.

48. Emerging Accounting Issues Working Group Position EI 95-3, *Equity Tax*, provides the following guidance on statutory accounting for a mutual life insurer's equity tax:

> Norris Clark (Calif.) summarized an issue submitted by Martin Carus (N.Y.) (Attachment A) regarding a component of federal income taxes for mutual life insurance companies commonly referred to as the "equity tax." The question is whether it is more appropriate to charge that component of federal income taxes directly to surplus or through operations as income tax expense.
>
> Armand de Palo (The Guardian Life Insurance Company of America) was recognized to present some additional information in support for charging the "equity tax" directly to surplus (Attachment B). Mr. Clark distributed minutes from a 1986 meeting of the working group (Attachment C) that include a discussion of this topic, and a recent letter received from John J. Palmer (Life of Virginia) concerning the issue (Attachment D).
>
> After further discussion, the working group reached a tentative consensus that this component of federal income taxes should be recorded as tax expense in the summary of operations and should not be charged directly to surplus. The issue will be further discussed at the Winter National Meeting in San Antonio in anticipation of reaching a final consensus.

49. Emerging Accounting Issues Working Group Position EI 95-4, *Equity Tax*, provides the following guidance on statutory accounting for a mutual life insurer's equity tax:

> 1. Equity Tax
>
> Norris Clark (Calif.) summarized the issue and reviewed the preliminary consensus from the Fall National Meeting that the component of federal income taxes known as the "equity tax" should be recorded as tax expense in the summary of operations and should not be charged directly to surplus.
>
> After further discussion the working group affirmed the preliminary conclusion.

Generally Accepted Accounting Principles

50. FAS 109 provides the following relevant guidance:

> **STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING**
>
> **SCOPE**
>
> 3. This Statement establishes the standards of financial accounting and reporting for income taxes that are currently payable and for the tax consequences of:
>
> a. Revenues, expenses, gains, or losses that are included in taxable income of an earlier or later year than the year in which they are recognized in financial income
> b. Other events that create differences between the tax bases of assets and liabilities and their amounts for financial reporting
> c. Operating loss or tax credit carrybacks for refunds of taxes paid in prior years and carryforwards to reduce taxes payable in future years.
>
> **Objectives and Basic Principles**
>
> 6. One objective of accounting for income taxes is to recognize the amount of taxes payable or refundable for the current year. A second objective is to recognize deferred tax liabilities and

assets for the future tax consequences of events[3] that have been recognized in an enterprise's financial statements or tax returns.

[3] Some events do not have tax consequences. Certain revenues are exempt for taxation and certain expenses are not deductible. In the United States, for example, interest earned on certain municipal obligations is not taxable and fines are not deductible.

7. Ideally, the second objective might be stated more specifically to recognize the *expected* future tax consequences of events that have been recognized in the financial statements or tax returns. However, the objective is realistically constrained because (a) the tax payment or refund that results from a particular tax return is a joint result of all the items included in that return, (b) taxes that will be paid or refunded in future years are the joint result of events of the current or prior years and events of future years, and (c) information available about the future is limited. As a result, attribution of taxes to individual items and events is arbitrary and, except in the simplest situations, requires estimates and approximations.

8. To implement the objectives in light of these constraints, the following basic principles (the only exceptions are identified in paragraph 9) are applied in accounting for income taxes at the date of the financial statements:

a. A current tax liability or asset is recognized for the estimated taxes payable or refundable on tax returns for the current year.
b. A deferred tax liability or asset is recognized for the estimated future tax effects attributable to temporary differences and carryforwards.
c. The measurement of current and deferred tax liabilities and assets is based on provisions of the enacted law; the effects of future changes in tax laws or rates are not anticipated.
d. The measurement of deferred tax assets is reduced, if necessary, by the amount of any tax benefits that, based on available evidence, are not expected to be realized.

9. The only exceptions in applying those basic principles are that this Statement:

a. Continues certain exceptions to the requirements for recognition of deferred taxes for the areas addressed by APB Opinion No. 23*, Accounting for Income Taxes - Special Areas*, as amended by this Statement (paragraphs 31-34)
b. Provides special transitional procedures for temporary differences related to deposits in statutory reserve funds by U.S. steamship enterprises (paragraph 32)
c. Does not amend accounting for leveraged leases as required by FASB Statement No. 13, *Accounting for Leases*, and FASB Interpretation No. 21, *Accounting for Leases in a Business Combination* (paragraphs 256-258)
d. Prohibits recognition of a deferred tax liability or asset related to goodwill (or the portion thereof) for which amortization is not deductible for tax purposes (paragraph 30)
e. Does not amend Accounting Research Bulletin No. 51, *Consolidated Financial Statements,* for income taxes paid on intercompany profits on assets remaining within the group, and prohibits recognition of a deferred tax asset for the difference between the tax basis of the assets in the buyer's tax jurisdiction and their cost as reported in the consolidated financial statements
f. Prohibits recognition of a deferred tax liability or asset for differences related to assets and liabilities that, under FASB Statement No. 52, *Foreign Currency Translation,* are remeasured from the local currency into the functional currency using historical exchange rates that result from (1) changes in exchange rates or (2) indexing for tax purposes.

Temporary Differences

10. Income taxes currently payable[4] for a particular year usually include the tax consequences of most events that are recognized in the financial statements for that year. However, because tax laws and financial accounting standards differ in their recognition and measurement of assets, liabilities, equity, revenues, expenses, gains, and losses, differences arise between:

a. The amount of taxable income and pretax financial income for a year
b. The tax bases of assets or liabilities and their reported amounts in financial statements.

[4] References in this Statement to income taxes currently payable and (total) income tax expense are intended to include also income taxes currently refundable and (total) income tax benefit, respectively.

11. An assumption inherent in an enterprise's statement of financial position prepared in accordance with generally accepted accounting principles is that the reported amounts of assets and liabilities will be recovered and settled, respectively. Based on that assumption, a difference between the tax basis of an asset or a liability and its reported amount in the statement of financial position will result in taxable or deductible amounts in some future year(s) when the reported amounts of assets are recovered and the reported amounts of liabilities are settled. Examples follow:

a. Revenues or gains that are taxable after they are recognized in financial income. An asset (for example, a receivable from an installment sale) may be recognized for revenues or gains that will result in future taxable amounts when the asset is recovered.
b. Expenses or losses that are deductible after they are recognized in financial income. A liability (for example, a product warranty liability) may be recognized for expenses or losses that will result in future tax deductible amounts when the liability is settled.
c. Revenues or gains that are taxable before they are recognized in financial income. A liability (for example, subscriptions received in advance) may be recognized for an advance payment for goods or services to be provided in future years. For tax purposes, the advance payment is included in taxable income upon the receipt of cash. Future sacrifices to provide goods or services (or future refunds to those who cancel their orders) will result in future tax deductible amounts when the liability is settled.
d. Expenses or losses that are deductible before they are recognized in financial income. The cost of an asset (for example, depreciable personal property) may have been deducted for tax purposes faster than it was depreciated for financial reporting. Amounts received upon future recovery of the amount of the asset for financial reporting will exceed the remaining tax basis of the asset, and the excess will be taxable when the asset is recovered.
e. A reduction in the tax basis of depreciable assets because of tax credits.[5] Amounts received upon future recovery of the amount of the asset for financial reporting will exceed the remaining tax basis of the asset, and the excess will be taxable when the asset is recovered.
f. ITC accounted for by the deferral method. Under Opinion 2, ITC is viewed and accounted for as a reduction of the cost of the related asset (even though, for financial statement presentation, deferred ITC may be reported as deferred income). Amounts received upon future recovery of the reduced cost of the asset for financial reporting will be less than the tax basis of the asset, and the difference will be tax deductible when the asset is recovered.

g. An increase in the tax basis of assets because of indexing whenever the local currency is the functional currency. The tax law for a particular tax jurisdiction might require adjustment of the tax basis of a depreciable (or other) asset for the effects of inflation. The inflation-adjusted tax basis of the asset would be used to compute future tax deductions for depreciation or to compute gain or loss on sale of the asset. Amounts received upon future recovery of the local currency historical cost of the asset will be less than the remaining tax basis of the asset, and the difference will be tax deductible when the asset is recovered.

h. Business combinations accounted for by the purchase method. There may be differences between the assigned values and the tax bases of the assets and liabilities recognized in a business combination accounted for as a purchase under APB Opinion No. 16, Business Combinations. Those differences will result in taxable or deductible amounts when the reported amounts of the assets and liabilities are recovered and settled, respectively.

[5] The Tax Equity and Fiscal Responsibility Act of 1982 provided taxpayers with the choice of either (a) taking the full amount of Accelerated Cost Recovery System (ACRS) deductions and a reduced tax credit (that is, investment tax credit and certain other tax credits) or (b) taking the full tax credit and a reduced amount of ACRS deductions.

Recognition and Measurement

16. An enterprise shall recognize a deferred tax liability or asset for all temporary differences[6] and operating loss and tax credit carryforwards in accordance with the provisions of paragraph 17. Deferred tax expense or benefit is the change during the year in an enterprise's deferred tax liabilities and assets.[7] For deferred tax liabilities and assets acquired in a purchase business combination during the year, it is the change since the combination date. Total income tax expense or benefit for the year is the sum of deferred tax expense or benefit and income taxes currently payable or refundable.

[6] Refer to paragraph 9. A deferred tax liability shall be recognized for the temporary differences addressed by Opinion 23 in accordance with the requirements of this Statement (paragraphs 31-34) and that Opinion, as amended.

[7] Paragraph 230 addresses the manner of reporting the transaction gain or loss that is included in the net change in a deferred tax liability or asset when the reporting currency is the functional currency.

17. Deferred taxes shall be determined separately for each tax-paying component (an individual entity or group of entities that is consolidated for tax purposes) in each tax jurisdiction. That determination includes the following procedures:

a. Identify (1) the types and amounts of existing temporary differences and (2) the nature and amount of each type of operating loss and tax credit carryforward and the remaining length of the carryforward period

b. Measure the total deferred tax liability for taxable temporary differences using the applicable tax rate (paragraph 18)

c. Measure the total deferred tax asset for deductible temporary differences and operating loss carryforwards using the applicable tax rate

d. Measure deferred tax assets for each type of tax credit carryforward

e. Reduce deferred tax assets by a valuation allowance if, based on the weight of available evidence, it is *more likely than not* (a likelihood of more than 50 percent) that some portion or all of the deferred tax assets will not be realized. The valuation allowance should be sufficient to reduce the deferred tax asset to the amount that is more likely than not to be realized.

18. The objective is to measure a deferred tax liability or asset using the enacted tax rate(s) expected to apply to taxable income in the periods in which the deferred tax liability or asset is expected to be settled or realized. Under current U.S. federal tax law, if taxable income exceeds a specified amount, all taxable income is taxed, in substance, at a single flat rate. That rate shall be used for measurement of a deferred tax liability or asset by enterprises for which graduated tax rates are not a significant factor. Enterprises for which graduated tax rates are a significant factor shall measure a deferred tax liability or asset using the average graduated tax rate applicable to the amount of estimated annual taxable income in the periods in which the deferred tax liability or asset is estimated to be settled or realized (paragraph 236). Other provisions of enacted tax laws should be considered when determining the tax rate to apply to certain types of temporary differences and carryforwards (for example, the tax law may provide for different tax rates on ordinary income and capital gains). If there is a phased-in change in tax rates, determination of the applicable tax rate requires knowledge about when deferred tax liabilities and assets will be settled and realized.

19. In the U.S. federal tax jurisdiction, the applicable tax rate is the regular tax rate, and a deferred tax asset is recognized for alternative minimum tax credit carryforwards in accordance with the provisions of paragraph 17.d. and 17.e. of this Statement. If alternative tax systems exist in jurisdictions other than the U.S. federal jurisdiction, the applicable tax rate is determined in a manner consistent with the tax law after giving consideration to any interaction (that is, a mechanism similar to the U.S. alternative minimum tax credit) between the two systems.

20. All available evidence, both positive and negative, should be considered to determine whether, based on the weight of that evidence, a valuation allowance is needed. Information about an enterprise's current financial position and its results of operations for the current and preceding years ordinarily is readily available. That historical information is supplemented by all currently available information about future years. Sometimes, however, historical information may not be available (for example, start-up operations) or it may not be as relevant (for example, if there has been a significant, recent change in circumstances) and special attention is required.

21. Future realization of the tax benefit of an existing deductible temporary difference or carryforward ultimately depends on the existence of sufficient taxable income of the appropriate character (for example, ordinary income or capital gain) within the carryback, carryforward period available under the tax law. The following four possible sources of taxable income may be available under the tax law to realize a tax benefit for deductible temporary differences and carryforwards:

a. Future reversals of existing taxable temporary differences
b. Future taxable income exclusive of reversing temporary differences and carryforwards
c. Taxable income in prior carryback year(s) if carryback is permitted under the tax law
d. Tax-planning strategies (paragraph 22) that would, if necessary, be implemented to, for example:
   (1) Accelerate taxable amounts to utilize expiring carryforwards
   (2) Change the character of taxable or deductible amounts from ordinary income or loss to capital gain or loss
   (3) Switch from tax-exempt to taxable investments.

Evidence available about each of those possible sources of taxable income will vary for different tax jurisdictions and, possibly, from year to year. To the extent evidence about one or more sources of taxable income is sufficient to support a conclusion that a valuation is not necessary, other sources need not be considered. Consideration of each source is required, however, to determine the amount of the valuation allowance that is recognized for deferred tax assets.

22. In some circumstances, there are actions (including elections for tax purposes) that (a) are prudent and feasible, (b) an enterprise ordinarily might not take, but would take to prevent an operating loss or tax credit carryforward from expiring unused, and (c) would result in realization

of deferred tax assets. This Statement refers to those actions as tax-planning strategies. An enterprise shall consider tax-planning strategies in determining the amount of valuation allowance required. Significant expenses to implement a tax-planning strategy or any significant losses that would be recognized if that strategy were implemented (net of any recognizable tax benefits associated with those expenses or losses) shall be included in the valuation allowance. Refer to paragraphs 246-251 for additional guidance.

23. Forming a conclusion that a valuation allowance is not needed is difficult when there is negative evidence such as cumulative losses in recent years. Other examples of negative evidence include (but are not limited to) the following:

a. A history of operating loss or tax credit carryforwards expiring unused
b. Losses expected in early future years (by a presently profitable entity)
c. Unsettled circumstances that, if unfavorably resolved, would adversely affect future operations and profit levels on a continuing basis in future years
d. A carryback, carryforward period that is so brief that it would limit realization of tax benefits if (1) a significant deductible temporary difference is expected to reverse in a single year or (2) the enterprise operates in a traditionally cyclical business.

24. Examples (not prerequisites) of positive evidence that might support a conclusion that a valuation allowance is not needed when there is negative evidence include (but are not limited to) the following:

a. Existing contracts or firm sales backlog that will produce more than enough taxable income to realize the deferred tax asset based on existing sales prices and cost structures
b. An excess of appreciated asset value over the tax basis of the entity's net assets in an amount sufficient to realize the deferred tax asset
c. A strong earnings history exclusive of the loss that created the future deductible amount (tax loss carryforward or deductible temporary difference) coupled with evidence indicating that the loss (for example, an unusual, infrequent, or extraordinary item) is an aberration rather than a continuing condition.

25. An enterprise must use judgment in considering the relative impact of negative and positive evidence. The weight given to the potential effect of negative and positive evidence should be commensurate with the extent to which it can be objectively verified. The more negative evidence that exists (a) the more positive evidence is necessary and (b) the more difficult it is to support a conclusion that a valuation allowance is not need for some portion or all of the deferred tax asset.

An Enacted Change in Tax Laws or Rates

27. Deferred tax liabilities and assets shall be adjusted for the effect of a change in tax laws or rates. The effect shall be included in income from continuing operations for the period that includes the enactment date.

A Change in Tax Status of an Enterprise

28. An enterprise's tax status may change from nontaxable to taxable or from taxable to nontaxable. An example is a change from a partnership to a corporation and vice versa. A deferred tax liability or asset shall be recognized for temporary differences in accordance with the requirements of this Statement at the date that a nontaxable enterprise becomes a taxable enterprise. A deferred tax liability or asset shall be eliminated at the date an enterprise ceases to be a taxable enterprise. In either case, the effect of (a) an election for a voluntary change in tax status is recognized on the approval date or on the filing date if approval is not necessary and (b) a change in tax status that results from a change in tax law is recognized on the enactment date.

The effect of recognizing or eliminating the deferred tax liability or asset shall be included in income from continuing operations.

Opinion 23 and U.S. Steamship Enterprise Temporary Differences

31. A deferred tax liability is not recognized for the following types of temporary differences unless it becomes apparent that those temporary differences will reverse in the foreseeable future:

a. An excess of the amount for financial reporting over the tax basis of an investment in a foreign subsidiary or a foreign corporate joint venture as defined in *APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock,* that is essentially permanent in duration.
b. Undistributed earnings of a domestic subsidiary or a domestic corporate joint venture that is essentially permanent in duration that arose in fiscal years beginning on or before December 15, 1992[9]
c. "Bad Debt reserves" for tax purposes of U.S. savings and loan associations (and other "qualified thrift lenders) that arose in tax years beginning before December 31, 1987 (that is, the base year amount)
d. "Policyholders' surplus" of stock life insurance companies that arose in fiscal years beginning on or before December 15, 1992.

The indefinite reversal criterion of Opinion 23 shall not be applied to analogous types of temporary differences.

[9] A last-in, first-out (LIFO) pattern determines whether reversals pertain to differences that arose in fiscal years beginning on or before December 15, 1992.

32. A deferred tax liability shall be recognized for the following types of taxable temporary differences:

a. An excess of the amount for financial reporting over the tax basis of an investment in a domestic subsidiary that arises in fiscal years beginning after December 15, 1992
b. An excess of the amount for financial reporting over the tax basis of an investment in a 50-percent-or-less-owned investee except as provided in paragraph 31.a. and 31.b. for a corporate joint venture that is essentially permanent in duration
c. "Bad debt reserves" for tax purposes of U.S. savings and loan associations (and other "qualified" thrift lenders) that arise in tax years beginning after December 31, 1987 (that is, amounts in excess of the base-year amount).

The tax effects of temporary differences related to deposits in statutory reserve funds by U.S. steamship enterprises that arose in fiscal years beginning on or before December 15, 1992 and that were not previously recognized shall be recognized when those temporary differences reverse or in their entirety at the beginning of the fiscal year for which this Statement is first applied.

33. Whether an excess of the amount for financial reporting over the tax basis of an investment in a more-than-50-percent-owned domestic subsidiary is a taxable temporary difference must be assessed. It is not a taxable temporary difference if the tax law provides a means by which the reported amount of that investment can be recovered tax-free and the enterprise expects that it will ultimately use that means. For example, under current U.S. federal tax law:

a. An enterprise may elect to determine taxable gain or loss on the liquidation of an 80-percent-or-more-owned subsidiary by reference to the tax basis of the subsidiary's net assets rather than by reference to the parent company's tax basis for the stock of that subsidiary.

b. An enterprise may execute a statutory merger whereby a subsidiary is merged into the parent company, the minority shareholders receive stock of the parent, the subsidiary's stock is cancelled, and no taxable gain or loss results if the continuity of ownership, continuity of business enterprise, and certain other requirements of the tax law are met.

Some elections for tax purposes are available only if the parent company owns a specified percentage of the subsidiary's stock. The parent company sometimes may own less than that specified percentage, and the price per share to acquire a minority interest may significantly exceed the per share equivalent of the amount reported as minority interest in the consolidated financial statements. In those circumstances, the excess of the amount for financial reporting over the tax basis of the parent's investment in the subsidiary is not a taxable temporary difference if settlement of the minority interest is expected to occur at the point in time when settlement would not result in a significant cost. That could occur, for example, toward the end of the life of the subsidiary, after it has recovered and settled most of its assets and liabilities, respectively. The fair value of the minority interest ordinarily will approximately equal its percentage of the subsidiary's net assets if those net assets consist primarily of cash.

34. A deferred tax asset shall be recognized for an excess of the tax basis over the amount for financial reporting of an investment in a subsidiary or corporate joint venture that is essentially permanent in duration only if it is apparent that the temporary difference will reverse in the foreseeable future. The need for a valuation allowance for that deferred tax asset and other deferred tax assets related to Opinion 23 temporary differences (for example, a deferred tax asset for foreign tax credit carryforwards or for a savings and loan association's bad-debt reserve for financial reporting) shall be assessed. Paragraph 21 identifies four sources of taxable income to be considered in determining the need for and amount of a valuation allowance for those and other deferred tax assets. One source is future reversals of temporary differences. Future reversals of taxable differences for which a deferred tax liability has not been recognized based on the exceptions cited in paragraph 31, however, shall not be considered. Another source is future taxable income exclusive of reversing temporary differences and carryforwards. Future distributions of future earnings of a subsidiary or corporate joint venture, however, shall not be considered except to the extent that a deferred tax liability has been recognized for existing undistributed earnings or earnings have been remitted in the past.

Intraperiod Tax Allocation

35. Income tax expense or benefit for the year shall be allocated among continuing operations, discontinued operations, extraordinary items, and items charged or credited directly to shareholders' equity (paragraph 36). The amounts allocated to continuing operations is the tax effect of the pretax income or loss from continuing operations that occurred during the year, plus or minus income tax effects of (a) changes in circumstances that cause a change in judgment about the realization of deferred tax assets in future years (paragraph 26), (b) changes in tax laws or rates (paragraph 27), (c) changes in tax status (paragraph 28), and (d) tax-deductible dividends paid to shareholders (except as set forth in paragraph 36 for dividends paid on unallocated shares held by an employer stock ownership plan [ESOP] or any other stock compensation arrangement). The remainder is allocated to items other than continuing operations in accordance with the provisions of paragraph 38.

36. The tax effects of the following items occurring during the year are charged or credited directly to related components of shareholders' equity:

a. Adjustments of the opening balance of retained earnings for certain changes in accounting principles or a correction of an error

b. Gains and losses included in comprehensive income but excluded from net income (for example, translation adjustments under Statement 52 and changes in the carrying amount of marketable securities under FASB Statement No. 12, Accounting for Certain Marketable Securities)
c. An increase or decrease in contributed capital (for example, deductible expenditures reported as a reduction of the proceeds from issuing capital stock)
d. An increase in the tax basis of assets acquired in a taxable business combination accounted for as a pooling of interests and for which a tax benefit is recognized at the date of the business combination
e. Expenses for employee stock options recognized differently for financial reporting and tax purposes (refer to paragraph 17 of APB Opinion No. 25, Accounting for Stock Issued to Employees)
f. Dividends that are paid on unallocated shares held by an ESOP and that are charged to retained earnings
g. Deductible temporary differences and carryforwards that existed at the date of a quasi reorganization (except as set forth in paragraph 39).

37. The tax benefit of an operating loss carryforward or carryback (other than those carryforwards referred to at the end of this paragraph) shall be reported in the same manner as the source of the income or loss in the current year and not in the same manner as (a) the source of the operating loss carryforward or taxes paid in a prior year or (b) the source of expected future income that will result in realization of a deferred tax asset for an operating loss carryforward from the current year. The only exceptions are as follows:

a. Tax effects of deductible temporary differences and carryforwards that existed at the date of a purchase business combination and for which a tax benefit is initially recognized in subsequent years in accordance with the provisions of paragraph 30
b. Tax effects of deductible temporary differences and carryforwards that are allocated to shareholders' equity in accordance with the provisions of paragraph 36 (items c. and e.-g.).

38. If there is only one item other than continuing operations, the portion of income tax expense or benefit for the year that remains after the allocation to continuing operations is allocated to that item. If there are two or more items other than continuing operations, the amount shall be allocated among those other items in proportion to their individual effects on income tax expense or benefit for the year. When there are two or more items other than continuing operations, the sum of the separately calculated, individual effects of each item sometimes may not equal the amount of income tax expense or benefit for the year that remains after the allocation to continuing operations. In those circumstances, the procedures to allocate the remaining amount to items other than continuing operations are as follows:

a. Determine the effect on income tax expense or benefit for the year of the total net loss for all net loss items
b. Apportion the tax benefit determined in (a) ratably to each net loss item
c. Determine the amount that remains, that is, the difference between (1) the amount to be allocated to all items other than continuing operations and (2) the amount allocated to all net loss items
d. Apportion the tax expense determined in (c) ratably to each net gain item.

39. The tax benefits of deductible temporary differences and carryforwards as of the date of a quasi reorganization as defined and contemplated in ARB No. 43, Chapter 7, “Capital Accounts,” ordinarily are reported as a direct addition to contributed capital if the tax benefits are recognized in subsequent years. The only exception is for enterprises that have previously both adopted Statement 96 and effected a quasi reorganization that involves only the elimination of a deficit in retained earnings by a concurrent reduction in contributed capital prior to adopting this Statement. For those enterprises, subsequent recognition of the tax benefit of prior deductible temporary differences and carryforwards is included in income and reported as required by

paragraph 37 (without regard to the referenced exceptions) and then reclassified from retained earnings to contributed capital. Those enterprises should disclose (a) the date of the quasi reorganization, (b) the manner of reporting the tax benefits and that it differs from present accounting requirements for other enterprises and (c) the effect of those tax benefits on income from continuing operations, income before extraordinary items, and on net income (and on related per share amounts).

Separate Financial Statements of a Subsidiary

40. The consolidated amount of current and deferred tax expense for a group that files a consolidated tax return shall be allocated among the members of the group when those members issue separate financial statements. This Statement does not require a single allocation method. The method adopted, however, shall be systematic, rational, and consistent with the broad principles established by this Statement. A method that allocates current and deferred taxes to members of the group by applying this Statement to each member as if it were a separate taxpayer[10] meets those criteria. Examples of methods that are not consistent with the broad principles established by this Statement include:

a. A method that allocates only current taxes payable to a member of the group that has taxable temporary differences
b. A method that allocates deferred taxes to a member of the group using a method fundamentally different from the asset and liability method described in this Statement (for example, the Opinion 11 deferred method)
c. A method that allocates no current or deferred tax expense to a member of the group that has taxable income because the consolidated group has no current or deferred tax expense.

[10] In that situation. the sum of the amounts allocated to individual members of the group may not equal the consolidated amounts. That may also be the result when there are intercompany transactions between members of the consolidated group. The criteria are satisfied, nevertheless, after giving effect to the type of adjustments (including eliminations) normally present in preparing consolidated financial statements.

41. In a classified statement of financial position, an enterprise shall separate deferred tax liabilities and assets into a current amount and a noncurrent amount. Deferred tax liabilities and assets shall be classified as current or noncurrent based on the classification of the related asset or liability for financial reporting. A deferred tax liability or asset that is not related to an asset or liability for financial reporting (paragraph 15), including deferred tax assets related to carryforwards, shall be classified according to the expected reversal date of the temporary difference pursuant to *FASB Statement No. 37, Balance Sheet Classification of Deferred Income Taxes.* The valuation allowance for a particular tax jurisdiction shall be allocated between current and noncurrent deferred tax assets for that tax jurisdiction on a pro rata basis.

42. For a particular tax-paying component of an enterprise and within a particular tax jurisdiction, (a) all current deferred tax liabilities and assets shall be offset and presented as a single amount and (b) all noncurrent deferred tax liabilities and assets shall be offset and presented as a single amount. However, an enterprise shall not offset deferred tax liabilities and assets attributable to different tax-paying components of the enterprise or to different tax jurisdictions.

Financial Statement Disclosure

43. The components of the net deferred tax liability or asset recognized in an enterprise's statement of financial position shall be disclosed as follows:

a. The total of all deferred tax liabilities measured in procedure (b) of paragraph 17

b. The total of all deferred tax assets measured in procedures (c) and (d) of paragraph 17
c. The total valuation allowance recognized for deferred tax assets determined in procedure (e) of paragraph 17.

The net change during the year in the total valuation allowance also shall be disclosed. A public enterprise shall disclose the approximate tax effect of each type of temporary difference and carryforward that gives rise to a significant portion of deferred tax liabilities and deferred tax assets (before allocation of valuation allowances). A nonpublic enterprise shall disclose the types of significant temporary differences and carryforwards but may omit disclosure of the tax effects of each type. A public enterprise that is not subject to income taxes because its income is taxed directly to its owners shall disclose that fact and the net difference between the tax bases and the reported amounts of the enterprise's assets and liabilities.

44. The following information shall be disclosed whenever a deferred tax liability is not recognized because of the exceptions to comprehensive recognition of deferred taxes for any of the areas addressed by Opinion 23 (as amended by this Statement) or for deposits in statutory reserve funds by U.S. steamship enterprises:

a. A description of the types of temporary differences for which a deferred tax liability has not been recognized and the types of events that would cause those temporary differences to become taxable
b. The cumulative amount of each type of temporary difference
c. The amount of the unrecognized deferred tax liability for temporary differences related to investments in foreign subsidiaries and foreign corporate joint ventures that are essentially permanent in duration if determination of that liability is practicable or a statement that determination is not practicable
d. The amount of the deferred tax liability for temporary differences other than those in (c) above (that is, undistributed domestic earnings, the bad-debt reserve for tax purposes of a U.S. savings and loan association or other qualified thrift lender, the policyholders' surplus of a life insurance enterprise, and the statutory reserve funds of a U.S. steamship enterprise) that is not recognized in accordance with the provisions of paragraphs 31 and 32.

45. The significant components of income tax expense attributable to continuing operations for each year presented shall be disclosed in the financial statements or notes thereto. Those components would include, for example:

a. Current tax expense or benefit
b. Deferred tax expense or benefit (exclusive of the effects of other components listed below)
c. Investment tax credits
d. Government grants (to the extent recognized as a reduction of income tax expense)
e. The benefits of operating loss carryforwards
f. Tax expense that results from allocating certain tax benefits either directly to contributed capital or to reduce goodwill or other noncurrent intangible assets of an acquired entity
g. Adjustments of a deferred tax liability or asset for enacted changes in tax laws or rates or a change in the tax status of the enterprise
h. Adjustments of the beginning-of-the-year balance of a valuation allowance because of a change in circumstances that causes a change in judgment about the realizability of the related deferred tax asset in future years.

46. The amount of income tax expense or benefit allocated to continuing operations and the amounts separately allocated to other items (in accordance with the provisions of paragraphs 35-39) shall be disclosed for each year for which those items are presented.

47. A public enterprise shall disclose a reconciliation using percentages or dollar amounts of (a) the reported amount of income tax expense attributable to continuing operations for the year to (b) the amount of income tax expense that would result from applying domestic federal statutory tax rates to pretax income from continuing operations. The “statutory” tax rates shall be the regular tax rates if there are alternative tax systems. The estimated amount and the nature of each significant reconciling item shall be disclosed. A nonpublic enterprise shall disclose the nature of significant reconciling items but may omit a numerical reconciliation. If not otherwise evident from the disclosures required by this paragraph and paragraphs 43-46, all enterprises shall disclose the nature and effect of any other significant matters affecting comparability of information for all periods presented.

48. An enterprise shall disclose (a) the amounts and expiration dates of operating loss and tax credit carryforwards for tax purposes and (b) any portion of the valuation allowance for deferred tax assets for which subsequently recognized tax benefits will be allocated to reduce goodwill or other noncurrent intangible assets of an acquired entity or directly to contributed capital (paragraphs 30 and 36).

49. An entity that is a member of a group that files a consolidated tax return shall disclose in its separately issued financial statements:

a. The aggregate amount of current and deferred tax expense for each statement of earnings presented and the amount of any tax-related balances due to or from affiliates as of the date of each statement of financial position presented

b. The principal provisions of the method by which the consolidated amount of current and deferred tax expense is allocated to members of the group and the nature and effect of any changes in that method (and in determining related balances to or from affiliates) during the years for which the disclosures in (a) above are presented.

Effective Date and Transition

50. This Statement shall be effective for fiscal years beginning after December 15, 1992. Earlier application is encouraged. Financial statements for any number of consecutive fiscal years before the effective date may be restated to conform to the provisions of this Statement. Initial application of this Statement shall be as of the beginning of an enterprise's fiscal year (that is, if the Statement is adopted prior to the effective date and during an interim period other than the first interim period, all prior interim periods of that fiscal year shall be restated). Application of the requirements for recognition of a deferred tax liability or asset for a restated interim or annual period shall be based on the facts and circumstances as they existed at that prior date and without the benefit of hindsight.

51. The effect of initially applying this Statement shall be reported as the effect of a change in accounting principle in a manner similar to the cumulative effect of a change in accounting principle (APB Opinion No. 20, Accounting Changes, paragraph 20) except for initially recognized tax benefits of the type required by this Statement to be excluded from comprehensive income. If the earliest year restated is not presented in the financial statements, the beginning balance of retained earnings and, if necessary, any other components of shareholders' equity for the earliest year presented shall be adjusted for the effect of the restatement as of that date. Paragraph 30 addresses the manner of reporting acquired tax benefits initially recognized subsequent to a business combination and paragraph 36 identifies five items ((c)-(g)) for which tax benefits are excluded from comprehensive income and allocated directly to contributed capital or retained earnings. Pro forma effects of retroactive application (Opinion 20, paragraph 21) are not required if statements of earnings presented for prior years are not restated.

52. When initially presented, the financial statements for the year this Statement is first adopted shall disclose:

a. The effect, if any, of adopting this Statement on pretax income from continuing operations (for example, the effect of adjustments for prior purchase business combinations and for regulated enterprises) for the year of adoption if restated financial statements for the prior year are not presented

b. The effect of any restatement on income from continuing operations, income before extraordinary items, and net income (and on related per share amounts) for each year for which restated financial statements are presented.

Prior Business Combinations

53. If financial statements for prior years are restated, all purchase business combinations that were consummated in those prior years shall be remeasured in accordance with the requirements of this Statement.

54. For a purchase business combination consummated prior to the beginning of the year for which this Statement is first applied, any balance remaining as of that date for goodwill or negative goodwill shall not be adjusted to equal the amount it would be if financial statements for the year of the combination and subsequent years were restated. However, except for leveraged leases and except as provided in paragraph 55, (a) remaining balances as of the date of initially applying this Statement for assets and liabilities acquired in that combination shall be adjusted from their net-of-tax amounts to their pretax amounts and (b) any differences between those adjusted remaining balances and their tax bases are temporary differences. A deferred tax liability or asset shall be recognized for those temporary differences pursuant to the requirements of this Statement as of the beginning of the year for which this Statement is first applied.

55. If, for a particular business combination, determination of the adjustment for any or all of the assets and liabilities referred to in paragraph 54 is impracticable, either because the necessary information is no longer available or because the cost to develop that information is excessive, none of the remaining balances of any assets and liabilities acquired in that combination shall be adjusted to pretax amounts, that is, all remaining amounts that were originally assigned on a net-of-tax basis pursuant to paragraph 89 of Opinion 16 shall not be adjusted. Any differences between those unadjusted remaining balances and their tax bases are temporary differences, and a deferred tax liability or asset shall be recognized for those temporary differences pursuant to the requirements of this Statement as of the beginning of the year for which this Statement is first applied.

56. The net effect of the adjustments required by paragraphs 54 and 55 shall be included in the effect of initially applying this Statement and reported in accordance with the provisions of paragraph 51.

Assets of Regulated Enterprises Reported on a Net-of-Tax or After-Tax Basis

57. Some regulated enterprises that apply Statement 71 have accounted for certain components of construction in progress on either a net-of-tax or after-tax basis, or both. Upon initial application of this Statement, those enterprises shall make appropriate adjustments required by this Statement to account for the net-of-tax and after-tax components of construction in progress as if the requirements of this Statement were applied to that construction in progress in all prior years. Except as provided in paragraph 58, the reported amount of plant in service at the beginning of the year for which this Statement is first applied shall be similarly adjusted.

58. If determination of the adjustment to plant in service referred to in paragraph 57 is impracticable, either because the necessary information is no longer available or because the cost to develop that information is excessive, any difference between the reported amount and the tax basis of that plant in service is a temporary difference, and a deferred tax liability shall be recognized for that temporary difference. If, as a result of an action by a regulator, it is probable that amounts required for settlement of that deferred tax liability will be recovered from customers through future rates, an asset and the related deferred tax liability for that additional temporary difference shall be recognized for that probable future revenue.

> 59. The net effect of the adjustments required by paragraphs 57 and 58 shall be included in the effect of initially applying this Statement and reported in accordance with the provisions of paragraph 51.
>
> 289. **GLOSSARY**
>
> **Carrybacks**
>
> Deductions or credits that cannot be utilized on the tax return during a year that may be carried back to reduce taxable income or taxes payable in a prior year. An operating loss carryback is an excess of tax deductions over gross income in a year; a tax credit carryback is the amount by which tax credits available for utilization exceed statutory limitations. Different tax jurisdictions have different rules about whether excess deductions or credits may be carried back and the length of the carryback period.
>
> **Carryforwards**
>
> Deductions or credits that cannot be utilized on the tax return during a year that may be carried forward to reduce taxable income or taxes payable in a future year. An operating loss carryforward is an excess of tax deductions over gross income in a year; a tax credit carryforward is the amount by which tax credits available for utilization exceed statutory limitations. Different tax jurisdictions have different rules about whether excess deductions or credits may be carried forward and the length of the carryforward period. The terms carryforward, operating loss carryforward, and tax credit carryforward refer to the amounts of those items, if any, reported in the tax return for the current year.

51. APB 28 provides the following guidance (However, note that FAS 109 supersedes APB Opinion Nos. 11 and 24 and amends APB Opinion No. 23);

> 19. In reporting interim financial information, income tax provisions should be determined under the procedures set forth in APB Opinion Nos. 11, 23, and 24. At the end of each interim period the company should make its best estimate of the effective tax rate expected to be applicable for the full fiscal year. The rate so determined should be used in providing for income taxes on a current year-to-date basis. The effective tax rate should reflect anticipated investment tax credits, foreign tax rates, percentage depletion, capital gains rates, and other available tax planning alternatives. However, in arriving at this effective tax rate no effect should be included for the tax related to significant unusual or extraordinary items that will be separately reported or reported net of their related tax effect in reports for the interim period or for the fiscal year.[2]
>
> [2] Disclosure should be made of the reasons for significant variations in the customary relationship between income tax expense and pretax accounting income, if they are not otherwise apparent from the financial statements or from the nature of the entity's business (refer to FASB Statement No. 109, *Accounting for Income Taxes,* paragraph 47).
>
> 20. The tax effects of losses that arise in the early portion of a fiscal year should be recognized only when the tax benefits are expected to be (a) realized during the year or (b) recognizable as a deferred tax asset at the end of the year in accordance with the provisions of Statement 109. An established seasonal pattern of loss in early interim periods offset by income in later interim periods should constitute evidence that realization is more likely than not, unless other evidence indicates the established seasonal pattern will not prevail. The tax effects of losses incurred in early interim periods may be recognized in a later interim period of a fiscal year if their realization, although initially uncertain, later becomes more likely than not. When the tax effects of losses that arise in the early portions of a fiscal year are not recognized in that interim period, no tax provision should be made for income that arises in later interim periods until the tax effects of the previous interim losses are utilized.[3] The tax effect of a valuation allowance expected to be necessary for a deferred tax asset at the end of the year for originating deductible temporary differences and carryforwards during the year should be included in the effective tax

rate. The effect of a change in the beginning-of-the-year balance of a valuation allowance as a result of a change in judgment about the realizability of the related deferred tax asset in future years shall not be apportioned among interim periods through an adjustment of the effective tax rate but shall be recognized in the interim period in which the change occurs. The effects of new tax legislation shall not be recognized prior to enactment. The tax effect of a change in tax laws or rates on taxes currently payable or refundable for the current year shall be reflected after the effective dates prescribed in the statutes in the computation of the annual effective tax rate beginning no earlier than the first interim period that includes the enactment date of the new legislation. The effect of a change in tax laws or rates on a deferred tax liability or asset shall not be apportioned among interim periods through an adjustment of the annual effective tax rate. The tax effect of a change in tax laws or rates on taxes payable or refundable for a prior year shall be recognized as of the enactment date of the change as tax expense (benefit) for the current year.

[3] The tax benefits of interim losses accounted for in this manner would not be reported as extraordinary items in the results of operations of the interim period.

OTHER SOURCES OF INFORMATION

52. Federal Income Tax Regulation Section 1.6662-4(d) provides the following guidance:

(d) Substantial authority (1) *Effect of having substantial authority*. If there is substantial authority for the tax treatment of an item, the item is treated as if it were shown properly on the return for the taxable year in computing the amount of the tax shown on the return. Thus, for purposes of section 6662(d), the tax attributable to the item is not included in the understatement for that year. (For special rules relating to tax shelter items see section 1.6662-4(g).)

(2) *Substantial authority standard*. The substantial authority standard is an objective standard involving an analysis of the law and application of the law to relevant facts. The substantial authority standard is less stringent than the “more likely than not” standard (the standard that is met when there is a greater than 50-percent likelihood of the position being upheld), but more stringent than the reasonable basis standard (the standard which, if satisfied, generally will prevent imposition of the penalty under section 6662(b)(1) for negligence). The possibility that a return will not be audited or, if audited, that an item will not be raised on audit, is not relevant in determining whether the substantial authority standard (or the reasonable basis standard) is satisfied.

(3) *Determination of whether substantial authority is present*. (i) Evaluation of authorities. There is substantial authority for the tax treatment of an item only if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment. All authorities relevant to the tax treatment of an item, including the authorities contrary to the treatment, are taken into account in determining whether substantial authority exists. The weight of authorities is determined in light of the pertinent facts and circumstances in the manner prescribed by paragraph (d)(3)(ii) of this section. There may be substantial authority for more than one position with respect to the same item. Because the substantial authority standard is an objective standard, the taxpayer's belief that there is substantial authority for the tax treatment of an item is not relevant in determining whether there is substantial authority for that treatment.

(ii) Nature of analysis. The weight accorded an authority depends on its relevance and persuasiveness, and the type of document providing the authority. For example, a case or revenue ruling having some facts in common with the tax treatment at issue is not particularly relevant if the authority is materially distinguishable on its facts, or is otherwise inapplicable to the tax treatment at issue. An authority that merely states a conclusion ordinarily is less persuasive than one that reaches its conclusion by cogently relating the applicable law to pertinent facts. The weight of an authority from which information has been deleted, such as a private letter ruling, is diminished to the extent that the deleted information may have affected the authority's conclusions. The type of document also must be considered. For example, a revenue ruling is accorded greater weight than a private letter ruling addressing the same issue. An older private letter ruling, technical advice memorandum, general counsel memorandum or action on decision generally must be accorded less weight than a more recent one. Any document described in the preceding sentence that is more than 10 years old generally is accorded very little weight. However, the persuasiveness and relevance of a document, viewed in light of subsequent developments, should be taken into account along with the age of the document. There may be substantial authority for the tax treatment of an item despite the absence of certain types of authority. Thus, a taxpayer may have substantial authority for a position that is supported only by a well-reasoned construction of the applicable statutory provision.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 22, General Expenses and Taxes, Licenses and Fees, and Chapter 23, Federal Income Taxes
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 19, Expenses, Chapter 20, Federal Income Taxes, and Appendix A, Mortgage Guaranty Insurance Accounting Principles Supplement
- NAIC Annual Statement Instructions for Property and Casualty Insurance Companies
- NAIC Annual Statement Instructions for Life and Accident and Health Insurance Companies
- *Issue Paper No. 3—Accounting Changes*
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties*
- Emerging Accounting Issues Working Group Position EI 86-1, True-up of Federal Income Taxes for Mutual Life Insurance Companies
- Emerging Accounting Issues Working Group Position EI 87-6, Accounting for the Impact of the Tax Reform Act of 1986
- Emerging Accounting Issues Working Group Position EI 89-2, Establishing a Liability for Deferred Federal Income Taxes for Statutory Accounting Purposes
- Emerging Accounting Issues Working Group Position EI 93-4, Section 847 Deposits
- Emerging Accounting Issues Working Group Position EI 95-3, Equity Tax
- Emerging Accounting Issues Working Group Position EI 95-4, Equity Tax

Generally Accepted Accounting Principles

- *FASB Statement No. 109, Accounting for Income Taxes*
- *FASB Interpretation No. 18, Accounting for Income Taxes in Interim Periods…an interpretation of APB Opinion No. 28*
- *Accounting Principles Board Opinion No. 2, Accounting for the "Investment Credit"*
- *Accounting Principles Board Opinion No. 4 (Amending No. 2), Accounting for the "Investment Credit"*
- *Accounting Principles Board Opinion No. 10, Omnibus Opinion–1966*
- *Accounting Principles Board Opinion No. 23, Accounting for Income Taxes–Special Areas-Accounting Principles Board Opinion No. 28, Interim Financial Reporting*
- *FASB Technical Bulletin No. 79-9, Accounting for Interim Periods for Changes in Income Tax Rates*
- *FASB Technical Bulletin No. 82-1, Disclosure of the Sale or Purchase of Tax Benefits through Tax Leases*
- *FASB Emerging Issues Task Force No. 91-8, Application of FASB Statement No. 96 to a State Tax Based on the Greater of a Franchise Tax or an Income Tax*

- *FASB Emerging Issues Task Force No. 92-8, Accounting for the Income Tax Effects under FASB Statement No. 109 of a Change in Functional Currency When an Economy Ceases to Be Considered Highly Inflationary*
- *FASB Emerging Issues Task Force No. 93-13, Effect of a Retroactive Change in Enacted Tax Rates That Is Included in Income from Continuing Operations*
- *FASB Emerging Issues Task Force No. 93-16, Application of FASB Statement No. 109 to Basis Differences within Foreign Subsidiaries That Meet the Indefinite Reversal Criterion of APB Opinion No. 23*
- *FASB Emerging Issues Task Force No. 93-17, Recognition of Deferred Tax Assets for a Parent Company's Excess Tax Basis in the Stock of a Subsidiary That Is Accounted for as a Discontinued Operation*
- *FASB Emerging Issues Task Force No. 94-10, Accounting by a Company for the Income Tax Effects of Transactions among or with Its Shareholders under FASB Statement No. 109*
- *FASB Emerging Issues Task Force No. 95-9, Accounting for Tax Effects of Dividends in France in Accordance with FASB Statement No. 109*
- *FASB Emerging Issues Task Force No. 95-10, Accounting for Tax Credits Related to Dividend Payments in Accordance with FASB Statement No. 109*
- *FASB Emerging Issues Task Force No. 95-20, Measurement in the Consolidated Financial Statements of a Parent of the Tax Effects Related to the Operations of a Foreign Subsidiary That Receives Tax Credits Related to Dividend Payments*
- *AICPA Accounting Interpretation, Accounting for the Investment Credit: Accounting Interpretations of APB Opinion No. 4*

Other Sources of Information

- Federal Income Tax Regulation Section 1.6662-4(d)

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Statutory Issue Paper No. 84

Quasi-Reorganizations

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 72

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Readjustments of additional paid in capital as if a reporting entity were reorganized but without the occurrence of a formal reorganization are considered to be quasi-reorganizations. Generally, quasi-reorganizations result in the elimination of a deficit retained earnings and establishment of a new basis for assets and liabilities. Current statutory accounting guidance does not address quasi-reorganizations.

2. GAAP addresses accounting for quasi-reorganizations in *Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins* (ARB 43) and in Accounting Research Bulletin No. 46, *Discontinuance of Dating Earned Surplus* (ARB 46). Guidance is also provided in the Securities and Exchange Commission *Codification of Financial Reporting Policies*, Section 210 and in the Staff Accounting Bulletins--Codification.

3. The purpose of this issue paper is to establish statutory accounting principles for quasi-reorganizations that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. Restatement of gross paid in and contributed surplus and unassigned funds (surplus) under a quasi-reorganization shall be permitted only if the criteria in both subparagraphs 4 a and 4 b and either subparagraph 4 c or 4 d are met:

a. Such restatement is approved in writing by the domiciliary Commissioner;

b. An 80% or greater change in the ultimate ownership of the reporting entity has occurred within six months prior to approval of such restatement;

c. A new business plan has been adopted that results in a substantive change in the operations and business mix of the reporting entity and the situation or circumstances that gave rise to the negative unassigned funds (surplus) will not be part of the ongoing operations;

d. The reporting entity is a shell company with no existing operations, inforce policies or outstanding claims.

5. As defined in *Issue Paper No. 72—Statutory Surplus*, unassigned funds (surplus) represents the undistributed and unappropriated amount of surplus at the balance sheet date. In no instance shall restatement result in the unassigned funds (surplus) account being greater than zero or the gross paid in and contributed surplus account being less than zero immediately following the restatement. Total surplus

as regards policyholders shall remain unchanged following such restatement. The following components of unassigned funds (surplus) shall be considered in determining the amount available for restatement:

a. Net Income
b. Effect of Exchange Rate Fluctuations
c. Dividends to Stockholders
d. Change in Accounting Principles
e. Correction of an Error
f. Stock Issuance Expenses

6. The assets and liabilities of the reporting entity shall continue to be carried at historical cost or other value required under statutory accounting principles. No adjustments to assets or liabilities shall be made to reflect the effect of a quasi-reorganization.

7. The impact of the restatement shall be disclosed in the notes to financial statements as long as financial statements for the period of the reorganization are presented. The effective date of the reorganization shall be disclosed for a period of ten years following the reorganization.

DISCUSSION

8. Current statutory accounting guidance does not address quasi-reorganizations. Quasi-reorganization is a concept in GAAP that is intended to apply in very limited situations. The effect in GAAP accounting for a quasi-reorganization is to eliminate negative retained earnings by capitalizing negative retained earnings to paid-in capital; and, to adjust net assets downward, but not upward, to fair value (i.e., individual assets may be written up or liabilities reduced as appropriate, but only to the extent that the aggregate net adjustment does not increase net assets). Quasi-reorganizations are initiated for various purposes, including to facilitate the payment of dividends by a reporting entity that is currently profitable but has negative retained earnings prior to the quasi-reorganization.

9. The conclusion permits the restatement of gross paid in and contributed surplus and unassigned funds (surplus) under a quasi-reorganization in certain limited circumstances. The conclusion also requires that total surplus as regards policyholders remain unchanged following such restatement and that the assets and liabilities of the reporting entity be carried at historical cost or other value required under statutory accounting principles and not revalued pursuant to a quasi-reorganization. This conclusion allows regulatory flexibility in instances where there has been a change in the ultimate ownership, the business plan of the reporting entity has substantively changed the operations and business mix of the reporting entity and the situation or circumstances that gave rise to the negative unassigned funds (surplus) will not be part of the ongoing operations, or the reporting entity is a shell company with no existing operations or outstanding policies. This conclusion is consistent with the regulatory need for consistent data on a year-to-year basis in order to monitor performance of insurance enterprises on a continuing basis. The conclusion is also consistent with the requirement to retain the historical basis of reporting following a business combination as discussed in *Issue Paper No. 68—Business Combinations and Goodwill*.

10. This issue paper adopts Chapter 7, Section A of ARB 43 with a modification to permit restatement of gross paid in and contributed surplus and unassigned funds (surplus) only in certain limited circumstances. In addition, this issue paper requires that the assets and liabilities of the reporting entity continue to be carried at historical cost or other value required under statutory accounting principles and that no changes to total surplus as regards policyholders are to be made to reflect the effect of a quasi-reorganization. This issue paper adopts ARB 46 with modification to require disclosure of the impact of the restatement in the notes to financial statements as long as financial statements for the period of reorganization are presented.

11. The statutory accounting principles outlined in the conclusion above are consistent with the conservatism concept in the Statement of Concepts, as follows:

> Conservatism
>
> Conservative valuation procedures provide protection to policyholders against adverse fluctuations in financial condition or operating results. Statutory accounting should be reasonably conservative over the span of economic cycles and in recognition of the primary responsibility to regulate for financial solvency. Valuation procedures should, to the extent possible, prevent sharp fluctuations in surplus.
>
> Consistency
>
> The regulators' need for meaningful, comparable financial information to determine an insurer's financial condition requires consistency in the development and application of statutory accounting principles. Because the marketplace, the economic and business environment, and insurance industry products and practices are constantly changing, regulatory concerns are also changing. An effective statutory accounting model must be responsive to these changes and address emerging accounting issues. Precedent or historically accepted practice alone should not be sufficient justifications for continuing to follow a particular accounting principle or practice which may not coincide with the objectives of regulators.

Drafting Notes/Comments
None

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
None

Generally Accepted Accounting Principles
12. ARB 43 provides the following guidance (only the pertinent excerpts are included below):

> Chapter 7: CAPITAL ACCOUNTS
> Section A -- Quasi-Reorganization or Corporate Readjustment
>
> (Amplification of Institute Rule No. 2 of 1934)
>
> 1. A rule was adopted by the Institute in 1934 which read as follows:
>
> "Capital surplus, however created, should not be used to relieve the income account of the current or future years of charges which would otherwise fall to be made thereagainst. This rule might be subject to the exception that where, upon reorganization, a reorganized company would be relieved of charges which would require to be made against income if the existing corporation were continued, it might be regarded as permissible to accomplish the same result without reorganization provided the facts were as fully revealed to and the action as formally approved by the shareholders as in reorganization."[1]
>
> [1] See chapter 1A, paragraph 2.
>
> 2. Readjustments of the kind mentioned in the exception to the rule fall in the category of what are called quasi-reorganizations. This section does not deal with the general question of quasi-reorganizations, but only with cases in which the exception permitted under the rule of 1934 is availed of by a corporation. Hereinafter such cases are referred

to as readjustments. The problems which arise fall into two groups: (a) what may be permitted in a readjustment and (b) what may be permitted thereafter.

Procedure in Readjustment

3. If a corporation elects to restate its assets, capital stock, and surplus through a readjustment and thus avail itself of permission to relieve its future income account or earned surplus account of charges which would otherwise be made thereagainst, it should make a clear report to its shareholders of the restatements proposed to be made, and obtain their formal consent. It should present a fair balance sheet as at the date of the readjustment, in which the adjustment of carrying amounts is reasonably complete, in order that there may be no continuation of the circumstances which justify charges to capital surplus.

4. A write-down of assets below amounts which are likely to be realized thereafter, though it may result in conservatism in the balance sheet at the readjustment date, may also result in overstatement of earnings or of earned surplus when the assets are subsequently realized. Therefore, in general, assets should be carried forward as of the date of readjustment at fair and not unduly conservative amounts, determined with due regard for the accounting to be employed by the company thereafter. If the fair value of any asset is not readily determinable a conservative estimate may be made, but in that case the amount should be described as an estimate and any material difference arising through realization or otherwise and not attributable to events occurring or circumstances arising after that date should not be carried to income or earned surplus.

5. Similarly, if potential losses or charges are known to have arisen prior to the date of readjustment but the amounts thereof are then indeterminate, provision may properly be made to cover the maximum probable losses or charges. If the amounts provided are subsequently found to have been excessive or insufficient, the difference should not be carried to earned surplus nor used to offset losses or gains originating after the readjustment, but should be carried to capital surplus.

6. When the amounts to be written off in a readjustment have been determined, they should be charged first against earned surplus to the full extent of such surplus; any balance may then be charged against capital surplus. A company which has subsidiaries should apply this rule in such a way that no consolidated earned surplus survives a readjustment in which any part of losses has been charged to capital surplus.

7. If the earned surplus of any subsidiaries cannot be applied against the losses before resort is had to capital surplus, the parent company's interest in such earned surplus should be regarded as capitalized by the readjustment just as surplus at the date of acquisition is capitalized, so far as the parent is concerned.

8. The effective date of the readjustment, from which the income of the company is thereafter determined, should be as near as practicable to the date on which formal consent of the stockholders is given, and should ordinarily not be prior to the close of the last completed fiscal year.

Procedure after Readjustment

9. When the readjustment has been completed, the company's accounting should be substantially similar to that appropriate for a new company.

10. After such a readjustment earned surplus previously accumulated cannot properly be carried forward under that title. A new earned surplus account should be established, dated to show that it runs from the effective date of the readjustment, and this dating should be disclosed in financial statements until such time as the effective date is no longer deemed to possess any special significance.

> 11. Capital surplus originating in such a readjustment is restricted in the same manner as that of a new corporation; charges against it should be only those which may properly be made against the initial surplus of a new corporation.
>
> 12. It is recognized that charges against capital surplus may take place in other types of readjustments to which the foregoing provisions would have no application. Such cases would include readjustments for the purpose of correcting erroneous credits made to capital surplus in the past. In this statement the committee has dealt only with that type of readjustment in which either the current income or earned surplus account or the income account of future years is relieved of charges which would otherwise be made thereagainst.

13. ARB 46 provides the following guidance (only the pertinent excerpts are included below):

> 1. Paragraph 10 of Chapter 7(a), Quasi-Reorganization or Corporate Readjustment, of Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins, reads as follows:
>
>> After such a readjustment earned surplus previously accumulated cannot properly be carried forward under that title. A new earned surplus account should be established, dated to show that it runs from the effective date of the readjustment, and this dating should be disclosed in financial statements until such time as the effective date is no longer deemed to possess any special significance.
>
> 2. The committee believes that the dating of earned surplus following a quasi-reorganization would rarely, if ever, be of significance after a period of ten years. It also believes that there may be exceptional circumstances in which the discontinuance of the dating of earned surplus could be justified at the conclusion of a period less than ten years.

OTHER SOURCES OF INFORMATION

14. Securities and Exchange Commission *Codification of Financial Reporting Policies*, Section 210 provides the following guidance (only the pertinent excerpts are included below):

> 210 Quasi-Reorganization ASR 25:
> Inquiry has been made from time to time as to the conditions under which a quasi-reorganization has come to be applied in accounting to the corporate procedures in the course of which a company, without the creation of new corporate entity and without the intervention of formal court proceedings, is enabled to eliminate a deficit whether resulting from operations or the recognition of other losses or both and to establish a new earned surplus account for the accumulation of earnings subsequent to the date selected as the effective date of the quasi-reorganization.
> It has been the Commission’s view for some time that a quasi-reorganization may not be considered to have been effected unless at least all of the following conditions exist:
> (1) Earned surplus, as of the date selected, is exhausted;
> (2) Upon consummation of the quasi-reorganization, no deficit exists in any surplus account;
> (3) The entire procedure is made known to all persons entitled to vote on matters of general corporate policy and the appropriate consents to the particular transactions are obtained in advance in accordance with the applicable law and charter provisions;
> (4) The procedure accomplishes, with respect to the accounts, substantially what might be accomplished in a reorganization by legal proceedings---namely, the restatement of assets in terms of present conditions as well as appropriate modifications of capital and capital surplus, in order to obviate so far as possible the necessity of future reorganizations of like nature.
> It is implicit in such a procedure that reductions in the carrying value of assets at the effective date may not be made beyond a point which gives appropriate recognition to conditions which appear to have resulted in relatively permanent reductions in asset values; as for example, complete or partial obsolescence, lessened utility value, reduction in investment value due to changed economic conditions, or, in the case of current assets, declines in indicated realization value. It is also implicit in a procedure of this kind that it is not to be employed recurrently but only

under circumstances which would justify an actual reorganization or formation of a new corporation, particularly if the sole or principal purpose of the quasi-reorganization is the elimination of a deficit in earned surplus resulting from operating losses.
In the case of the quasi-reorganization of a parent company, it is an implicit result of such procedure that the effective date should be recognized as having the significance of a date of acquisition of control of subsidiaries. Likewise, in consolidated statements, earned surplus of subsidiaries at the effective date should be excluded from earned surplus on the consolidated balance sheet.

15. The Securities and Exchange Commission Staff Accounting Bulletins--Codification provides the following guidance (only the pertinent excerpts are included below):

S.Quasi-Reorganization

Facts:

As a consequence of significant operating losses and/or recent write-downs of property, plant and equipment, a company's financial statements reflect an accumulated deficit. The company desires to eliminate the deficit by reclassifying amounts from paid-in-capital. In addition, the company anticipates adopting a discretionary change in accounting principles[1] that will be recorded as a cumulative-effect type of accounting change. The recording of the cumulative effect will have the result of increasing the company's retained earnings.

[1] Discretionary accounting changes require the filing of a preferability letter by the registrant's independent accountant pursuant to Item 601 of Regulation S-K and Rule 10-01(b)(6) of Regulation S-X, 17 CFR §§229.601 and 210.10-01(b)(^), respectively.

Question 1:

May the company reclassify its capital accounts to eliminate the accumulated deficit without satisfying all of the conditions enumerated in Section 210[2] of the Codification of Financial Reporting Policies for a quasi-reorganization?

[2] Accounting Series Release No. 25 (May 29, 1941).

Interpretive Response:

No. The staff believes a deficit reclassification of any nature is considered to be a quasi-reorganization. As such, a company may not reclassify or eliminate a deficit in retained earnings unless all requisite conditions set forth in Section 210[3] for a quasi-reorganization are satisfied.[4]

[3] Section 210 indicates the following conditions under which a quasi-reorganization can be effected without the creation of a new corporate entity and without the intervention of formal court proceedings:

(1) Earned surplus, as of the date selected, is exhausted;
(2) Upon consummation of the quasi-reorganization, no deficit exists in any surplus account;
(3) The entire procedure is made known to all persons entitled to vote on matters of general corporate policy and the appropriate consents to the particular transactions are obtained in advance in accordance with the applicable laws and charter provisions;
(4) The procedure accomplishes, with respect to the accounts, substantially what might be accomplished in a reorganization by legal proceedings--namely, the restatement of assets in terms of present conditions as well as appropriate modifications of capital and capital

surplus, in order to obviate so far as possible the necessity of future reorganizations of like nature.

[4] In addition, Accounting Research Bulletin (ARB) No. 43, Chapter 7A, outlines procedures that must be followed in connection with and after a quasi-reorganization.

Question 2:

Must the company implement the discretionary change in accounting principle simultaneously with the quasi-reorganization or may it adopt the change after the quasi-reorganization has been effected?

Interpretive Response:

The staff has taken the position that the company should adopt the anticipated accounting change prior to or as an integral part of the quasi-reorganization. Any such accounting change should be effected by following generally accepted accounting principles with respect to the change.[5]

Chapter 7A of Accounting Research Bulletin (ARB) No. 43 indicates that, following a quasi-reorganization, a "company's accounting should be substantially similar to that appropriate for a new company." The staff believes that implicit in this "fresh-start" concept is the need for the company's accounting principles in place at the time of the quasi-reorganization to be those planned to be used following the reorganization to avoid a misstatement of earnings and retained earnings after the reorganization.[6] Chapter 7A of ARB No. 43 states, in part, "... in general, assets should be carried forward as of the date of the readjustment at fair and not unduly conservative amounts, determined with due regard for the accounting to be employed by the Company thereafter (emphasis added)."

In addition, the staff believes that adopting a discretionary change in accounting principle that will be reflected in the financial statements within 12 months following the consummation of a quasi-reorganization leads to a presumption that the accounting change was contemplated at the time of the quasi-reorganization.[7]

[5] Accounting Principles Board Opinion No. 20 provides accounting principles to be followed when adopting accounting changes. In addition, many newly-issued accounting pronouncements provide specific guidance to be followed when adopting the accounting specified in such pronouncements.

[6] Certain newly-issued accounting standards do not require adoption until some future date. The staff believes, however, that if the registrant intends or is required to adopt those standards within 12 months following the quasi-reorganization, the registrant should adopt those standards prior to or as an integral part of the quasi-reorganization. Further, registrants should consider early adoption of standards with effective dates more than 12 months subsequent to a quasi-reorganization.

[7] Certain accounting changes require restatement of prior financial statements. The staff believes that if a quasi-reorganization had been recorded in a restated period, the effects of the accounting change on quasi-reorganization adjustments should also be restated to properly reflect the quasi-reorganization in the restated financial statements.

Question 3:

In connection with a quasi-reorganization, may there be a write-up of net assets?

Interpretive Response:

No. The staff believes that increases in the recorded values of specific assets (or reductions in liabilities) to fair value are appropriate providing such adjustments are factually supportable, however, the amount of such increases are limited to offsetting adjustments to reflect decreases in other assets (or increases in liabilities) to reflect their new fair value. In other words, a quasi-reorganization should not result in a write-up of net assets of the registrant. (Added by SAB No. 78, 8/25/88.)

Question 4:

The interpretive response to question 1 indicates that the staff believes that a deficit reclassification of any nature is considered to be a quasi-reorganization, and accordingly, must satisfy all the conditions of Section 210.[8] Assume a company has adopted Statement of Financial Accounting Standards ("SFAS") No. 96, has satisfied all the requisite conditions of Section 210, and has eliminated a deficit in retained earnings by a concurrent reduction in paid-in capital, but did not need to restate assets and liabilities by a charge to capital because assets and liabilities were already stated as fair values. How should the company reflect the tax benefits of operating loss or tax credit carryforwards for financial reporting purposes that existed as of the date of the quasi-reorganization when such tax benefits are subsequently recognized for financial reporting purposes?

[8] Supra Note 3.

Interpretive Response:

The staff believes SFAS No. 96 requires that any subsequently recognized tax benefits of operating loss or tax credit carryforwards that existed as of the date of a quasi-reorganization be reported as a direct addition to paid-in capital. The staff believes that this position is consistent with the "new company" or "fresh-start" concept embodied in Section 210,[9] and in existing accounting literature regarding quasi-reorganizations, and with the FASB staff's justification for such a position when they stated that a "new enterprise would not have tax benefits attributable to operating losses or tax credits that arose prior to its organization date.[10]

[9] Section 210 discusses the "conditions under which a quasi-reorganization has come to be applied in accounting to the corporate procedures in the course of which a company, without creation of new corporate entity and without intervention of formal court proceedings, is enabled to eliminate a deficit whether resulting from operations or recognition of other losses or both and to establish a new earned surplus account for the accumulation of earnings subsequent to the date selected as the effective date of the quasi-reorganization." It further indicates that "it is implicit in a procedure of this kind that it is not to be employed recurrently but only under circumstances which would justify an actual reorganization or formation of a new corporation, particularly if the sole purpose of the quasi-reorganization is the elimination of a deficit in earned surplus resulting from operating losses."[Emphasis added.]

[10] Special Report: A Guide to Implementation of Statement 96 on Accounting for Income Taxes; Financial Accounting Standards Board (March 1989); question 26, page 36 and 37, states in part: "ARB No. 43, Chapter 7, "Capital Accounts," states that after a quasireorganization, the enterprise's accounting should be substantially similar to that appropriate for a new enterprise. As such, any subsequently recognized tax benefit of an operating loss or tax credit carryforward for financial reporting that existed at the date of a quasi reorganization should not be included in the determination of income of the "new" enterprise, regardless of whether losses that gave rise to an operating loss carryforward were charged to income prior to the quasi reorganization or directly

to contributed capital as part of the quasi reorganization. A new enterprise would not have tax benefits attributable to operating losses or tax credits that arose prior to its organization date."

The FASB recognized that a practice existed of recording deficit elimination type quasi-reorganizations without evaluating the concurrent need to restate assets and liabilities to fair values, and provided guidance on accounting for the tax benefits of carryforward items subsequent to such an event.[11] This practice and accounting is not permitted by Section 210, and accordingly, is not appropriate for registrants. The staff believes that all registrants that comply with the requirements of Section 210 in effecting a quasi-reorganization should apply the accounting required by the first sentence of paragraph 54 of SFAS No. 96 for the tax benefits of tax carryforward items.[12] Therefore, even though the only effect of a quasi-reorganization is the elimination of a deficit in retained earnings because assets and liabilities are already stated at fair values and the revaluation of assets and liabilities is unnecessary (or a write up of net assets is prohibited as indicated in the interpretive response to question 3 above), subsequently recognized tax benefits of operating loss or tax credit carryforward items should be recorded as a direct addition to paid-in capital.

[11] SFAS No. 96 (December 1987); paragraph 54, states: "Some quasi reorganization involve only the elimination of a deficit in retained earnings by a concurrent reduction in contributed capital. For that type of reorganization, subsequent recognition of the tax benefit of a prior operating loss or tax credit carryforward for financial reporting is reported as required by paragraph 52 and then reclassified from retained earnings to contributed capital." [Emphasis added.] Also, Supra Note 10.

[12] The first sentence or paragraph 54 of SFAS No. 96 states: "The tax benefit of an operating loss or tax credit carryforward for financial reporting as of the date of a quasi-reorganization as defined and contemplated (involving write-offs directly to contributed capital) in ARB No. 43, Chapter 7, "Capital Accounts," is reported as a direct addition to contributed capital if the tax benefits are recognized in subsequent years".

Question 5:

If a company had previously recorded a quasi-reorganization that only resulted in the elimination of a deficit in retained earnings, may the company reverse such entry and "undo" its quasi-reorganization?

Interpretive Response:

No. The staff believes APB Opinion No. 20 would preclude such a change in accounting. It states: "a method of accounting that was previously adopted for a type of transaction or event which is being terminated or which was a single, nonrecurring event in the past should not be changed." [Emphasis added.][13]

[13] Accounting Principles Board Opinion No. 20 (July 1971); paragraph 16.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *Issue Paper No. 68—Business Combinations and Goodwill*
- *Issue Paper No. 72—Statutory Surplus*

Generally Accepted Accounting Principles

- *Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins, Chapter 7, Section A, Quasi-reorganization or Corporate Readjustment*
- *Accounting Research Bulletin No. 46, Discontinuance of Dating Earned Surplus*

State Regulations

- No additional guidance obtained from state statutes or regulations.

Other Sources of Information

- Securities and Exchange Commission Codification of Financial Reporting Policies, Section 210
- Securities and Exchange Commission Staff Accounting Bulletins - Codification, Topic 5, S

Statutory Issue Paper No. 85

Derivative Instruments

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Original SSAP and Current Authoritative Guidance: SSAP No. 27 and SSAP No. 86

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Chapter 8 of the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies (Life/A&H and P&C Accounting Practices and Procedures Manuals) contains guidance on accounting for derivative instruments. This guidance provides two alternatives for accounting for derivative instruments: (a) Hedge accounting, or (b) Immediate recognition (mark to market) accounting. Specific accounting guidance for Income Generation Transactions was adopted by the Financial Condition (EX4) Subcommittee on December 14, 1996.

2. GAAP is not applied uniformly for different types of derivatives because there is no comprehensive authoritative accounting guidance. To the extent that specific accounting guidance does not exist for some derivatives, practice is based on analogy to the literature that does exist for other derivatives. The key GAAP accounting literature applicable to derivatives, which is primarily addressed in *FASB Statement No. 80*, *Accounting for Futures Contracts* (FAS 80), *FASB Statement No. 52*, *Foreign Currency Translation* (FAS 52), and *FASB Emerging Issues Task Force Issue No. 84-36*, *Interest Rate Swap Transactions* (EITF 84-36), is based on hedge accounting for futures and foreign exchange contracts, settlement accounting for interest rate swaps and mark to market accounting.

3. The purpose of this issue paper is to establish statutory accounting principles for derivative instruments (hereinafter referred to as derivatives), that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. This issue paper adopts the Derivative Instruments guidance of Chapter 8 of the Life/A&H and P&C Accounting Practices and Procedures Manuals. Paragraphs 6 through 10 herein summarize the key provisions of the guidance. Derivatives shall be defined as swaps, options, forwards, futures, caps, floors, and collars. The following are general definitions for these derivative instruments:

a. Swaps: Swaps are contracts to exchange, for a period of time, the investment performance of one underlying instrument for the investment performance of another underlying instrument, typically without exchanging the instruments themselves. Swaps can be viewed as a series of forward contracts that settle in cash rather than by physical delivery. Swaps generally are negotiated over-the-counter directly between the dealer and the end user. Interest rate swaps are the most common form of swap contract. However, foreign currency and commodity swaps also are common;

b. Options: Options are contracts that give the option holder (purchaser of the option rights) the right, but not the obligation, to enter into a transaction with the option writer (seller of the option rights) on terms specified in the contract. A call option allows the holder to buy the underlying instrument, while a put option allows the holder to sell the underlying instrument. Options are traded on exchanges and over the counter;

c. Forwards: Forward contracts are agreements (other than a futures) between two parties that commit one party to purchase and the other to sell the instrument or commodity underlying the contract at a specified future date. Forward contracts fix the price, quantity, quality, and date of the purchase and sale. Some forward contracts involve the initial payment of cash and may be settled in cash instead of by physical delivery of the underlying instrument;

d. Futures: Futures are standardized forward contracts traded on organized exchanges. Each exchange specifies the standard terms of futures contracts it sponsors. Futures contracts are available for a wide variety of underlying instruments, including insurance, agricultural commodities, minerals, debt instruments (such as U.S. Treasury bonds and bills), composite stock indices, and foreign currencies;

e. Caps: Caps are option contracts in which the cap writer (seller), in return for a premium, agrees to limit, or cap, the cap holder's (purchaser) risk associated with an increase in a reference rate or index. For example, in an interest rate cap, if rates go above a specified interest rate level (the strike price or the cap rate), the cap holder is entitled to receive cash payments equal to the excess of the market rate over the strike price multiplied by the notional principal amount. Because a cap is an option-based contract, the cap holder has the right but not the obligation to exercise the option. If rates move down, the cap holder has lost only the premium paid. A cap writer has virtually unlimited risk resulting from increases in interest rates above the cap rate;

f. Floors: Floors are option contracts in which the floor writer (seller), in return for a premium, agrees to limit the risk associated with a decline in a reference rate or index. For example, in an interest rate floor, if rates fall below an agreed rate, the floor holder (purchaser) will receive cash payments from the floor writer equal to the difference between the market rate and an agreed rate multiplied by the notional principal amount;

g. Collars: A collar is a combination of a cap and a floor (one purchased and one written). A collar fixes the rate between two levels (the strike prices of the cap and the floor).

5. To the extent a derivative is in an asset position, the instrument meets the definition of an asset as defined in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets* and, subject to certain limitations, meets the criteria for an admitted asset as specified in that same paper. To the extent a derivative is in a liability position, the instrument meets the definition of a liability as defined in *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets* (Issue Paper No 5).

6. Hedging transaction is defined as a derivative transaction which is entered into and maintained to reduce: (a) the risk of a change in the value, yield, price, cash flow, or quantity of assets or liabilities which the reporting entity has acquired or incurred or anticipates acquiring or incurring, or (b) the currency exchange rate risk or the degree of exposure as to assets or liabilities which a reporting entity has acquired or incurred or anticipates acquiring or incurring. Derivatives used by reporting entities in hedging activities shall be accounted for in a manner consistent with the item hedged. For example, if the item being hedged is accounted for at amortized cost, the hedging derivative also is accounted for at amortized cost. If the item being hedged is accounted for at market value, the hedging derivative also is accounted for at market value.

7. To qualify for hedge accounting, the derivative shall be designated as a hedge of a specific asset, liability, or anticipated transaction. The specific asset, liability, or anticipated transaction to be hedged must expose the reporting entity to a risk and the designated derivative transaction must reduce that

exposure. Examples of items that expose the reporting entity to risk include change in the value, yield, price, cash flow, or quantity of, or degree of exposure with respect to assets, liabilities, or future cash flows which a reporting entity has acquired or incurred, or anticipates acquiring or incurring. To satisfy the condition of risk reduction, the reporting entity shall demonstrate how the derivative instrument reduces risk by using an appropriate method. There are a variety of methods available that can be used to demonstrate risk reduction, including methods which analyze the correlation of gains and losses on the derivative in relation to the losses and gains on the hedged asset, liability, or future cash flow. Included in the concept of hedge accounting is the notion of settlement accounting for interest rate swaps that are matched through designation with an asset or a liability on the balance sheet. Under settlement accounting, periodic net cash settlements under the swap agreement are recognized in income when they accrue.

8. Reporting entities shall set specific criteria at the inception of the hedge as to what will be considered effective in measuring the hedge and apply those criteria in the ongoing assessment of actual hedge results. For example, if correlation is used to measure the effectiveness of a hedge, high correlation of changes in the fair value of the derivative and the fair value of the item being hedged should be probable so that such changes will substantially offset each other throughout the hedge period. Other methods used should demonstrate a similar result to be considered effective. Also, at the inception of the hedge, formal documentation of the hedging instrument and the related hedged item, including the nature of the risk being hedged, shall be drafted and retained for future reference. Upon termination of the derivative that qualifies for hedge accounting, the gain or loss shall adjust the basis of the hedged item. If the item being hedged is subject to IMR, the gain or loss on the hedging derivative instrument shall be subject to IMR upon termination. Reporting entities shall account for a derivative at estimated fair value if it ceases to be effective as a hedge (that is, the gains and losses on the derivative no longer offset the losses and gains on the hedged instrument) and recognize the gain or loss currently in earnings.

9. Alternatively, reporting entities may mark derivatives to market (immediate recognition method) from inception to termination. Generally, this alternative is used where it is impractical to allocate gains and losses to specific hedged assets, liabilities, or future cash flows. This alternative shall be used for derivatives that are entered into for other-than-hedging purposes, when a portfolio has been hedged and the reporting entity is unable to assign the hedging instrument to specific assets and liabilities, or for derivatives that are not specifically addressed elsewhere in this guidance.

10. Other-than-hedging is defined as any transaction which does not qualify for hedge accounting, including active derivatives trading by a reporting entity who enters into derivatives for purposes of generating profits on short-term differences in market movements and not for risk reduction purposes. Unrealized gains and losses cannot be deferred when categorized as other-than-hedging.

11. The reporting entity’s choice between accounting methods discussed in paragraphs 6 through 9 (hedge versus immediate recognition) shall be applied consistently for each individual instrument over the life of the derivative. A change in method shall be justified by a significant change in circumstance.

Income Generation Transactions

12. Income generation transactions are defined as derivative instruments written or sold to generate additional income or return to the reporting entity. They include covered options, caps, and floors (e.g., a reporting entity writes an equity call option on stock which it already owns).

13. Because these transactions require writing derivatives, they expose the reporting entity to potential future liabilities for which the reporting entity receives a premium up front. Because of this risk, dollar limitations and additional constraints are imposed requiring that the transactions be “covered” (i.e., offsetting assets can be used to fulfill potential obligations). To this extent, the combination of the derivative and the covering asset works like a reverse hedge where an asset owned by the reporting entity in essence hedges the derivative risk.

14. As with derivatives in general, these instruments include a wide variety of terms regarding maturities, range of exercise periods and prices, counterparties, underlying instruments, etc.

15. The principal features of income generation transactions are:

a. Premium received is initially recorded as a deferred liability;

b. The accounting of the covering asset or underlying interest controls the accounting of the derivative. The covering asset/underlying interest is accounted at either mark-to-market (e.g., common stocks) or (amortized) cost (e.g., bonds);

c. The gain/loss on termination of the derivative is a capital item. For life insurance companies, it shall be subject to IMR treatment if interest rate related;

d. For options which are exercised, the remaining premium shall adjust the proceeds (cost) associated with the exercise resulting in no explicit gain or loss reported for the derivative itself.

16. The principal features of written fixed income covered call options are:

a. The general approach is to value at cost (i.e., consideration received) without amortization over the life of the contract;

b. An alternative to the general approach combines the accounting of the written option with the covering asset and then uses standard accounting for callable bonds (yield to worst amortization) on the adjusted asset. This method prevents the possibility of future loss recognition upon exercise while at the same time providing recognition of the income feature of the option over time. This approach would appear most relevant for longer-lived covered European call options, which are in substance like callable bonds;

c. For life insurance companies, the gain or loss flows through the IMR if the covering asset or underlying interest is subject to the IMR using callable bond rules to determine the remaining life;

d. Reporting entities are responsible for timely recognition of any probable losses that may occur as a result of the strategy. If the exercise price is below the covering asset's book value, the asset shall be evaluated for write down or disclosure treatment in accordance with Issue Paper No. 5. All relevant factors such as whether the option is currently exercisable, the fair value of the bond relative to its exercise price, to what extent the statement value of the option premium offsets any loss on the asset, or how any IMR transaction on exercise would affect surplus and income shall be considered.

17. Written fixed income covered call options shall be accounted for as follows:

STATUS OF OPTION	COVERING ASSET VALUED AT AMORTIZED COST	COVERING ASSET VALUED AT MARKET VALUE
Open	Record premium as deferred liability. Carry at consideration received. (1) Alternatively, attach premium to covering asset and amortize (under yield to worse scenario) using standard callable bond accounting . (2)	Record premium as deferred liability. Mark to market with changes in market value recorded as unrealized adjustments to surplus – gain/loss.
Closed – Expired	Premium received recognized as realized capital gain. Gain from expiration to flow through IMR, if applicable. (3)	Premium received recognized as realized capital gain.
Closed – Exercised	Adjust disposition proceeds. (Include in capital gain/loss of disposed asset.) Gain or loss from disposition to flow through IMR, if applicable. (3)	Adjust disposition proceeds. (Include in capital gain/loss of disposed asset.)
Closed – Terminated	Recognize net amount as realized capital gain/loss. Gain or loss from disposition to flow through IMR, if applicable. (3)	Recognize net amount as realized capital gain/loss.

Notes:

1. A general statement will be added to the instructions stating that reporting entities writing options for income generation purposes are responsible for the timely recognition of any probable losses that may occur as a result of the strategy due to holding and accounting for options on Schedule DB – Part B.

2. Report derivative and its market value on Schedule DB – Part B. Include accounting on Schedule D – Part 1.

3. If premium is attached to covering asset, the accounting treatment for the covering asset applies.

18. The principal features of written covered put options are:

a. The accounting for the underlying interest instead of the covering asset governs the accounting of the written put while it is open. For example, if a reporting entity wrote a put requiring it to purchase a certain common stock (underlying interest) at a specific price, the reporting entity might cover that option by holding cash or cash equivalents (covering asset). The accounting for the common stock would govern the accounting of the option in this case;

b. As with covered call writing for life insurance companies, gain/loss on termination may be subject to IMR over the remaining life of the underlying interest;

c. As with covered call writing, reporting entities writing put options for income generation purposes are responsible for timely recognition of any probable losses that may occur as a result of the strategy;

19. Written covered put options shall be accounted for as follows:

STATUS OF OPTION	UNDERLYING INTEREST VALUED AT AMORTIZED COST	UNDERLYING INTEREST VALUED AT MARKET VALUE
Open	Record premium as deferred liability. Carry at consideration received. (1)	Record premium as deferred liability. Mark to market with changes in market value recorded as unrealized adjustments to surplus – gain/loss.
Closed – Expired	Premium received recognized as realized capital gain. Gain from expiration to flow through IMR, if applicable.	Premium received recognized as realized capital gain.
Closed – Exercised	Adjust acquisition cost by premium received.	Adjust acquisition cost by premium received.
Closed – Terminated	Recognize net amount as realized capital gain/loss. Gain or loss from disposition to flow through IMR, if applicable.	Recognize net amount as realized capital gain/loss.

Notes:

1. Reporting entities writing options for income generation purposes are responsible for the timely recognition of any probable losses that may occur as a result of the strategy due to holding and accounting for options on Schedule DB – Part B.

20. The principal features of written fixed income caps and floors are:

a. The value of the premium received shall be amortized into income over the life of the contract. For caps and floors, where the reporting entity is selling off possible excess interest/income, the value of the covering asset is not relevant;

b. Again, gain/loss may be subject to IMR. The expected maturity would be the derivative contract's maturity.

21. Written fixed income caps and floors shall be accounted for as follows:

STATUS OF OPTION	COVERING ASSET VALUED AT AMORTIZED COST	COVERING ASSET VALUED AT MARKET VALUE
Open	Record premium as deferred liability. Carry at amortized value. (Alternatively carry at consideration received if within 1 year of maturity.) Amortize over life of contract to produce constant yield. Record any interest expense as "Other Investment Income" – negative value.	Record premium as deferred liability. Mark to market with changes in market value recorded as unrealized adjustments to surplus – gain/loss.
Closed – Matured	Would usually mature at zero amortized value. Any remaining unamortized value recognized as ordinary income through a final amortization adjustment.	Premium received recognized as realized capital gain.
Closed – Exercised	Not applicable.	Not applicable.
Closed – Terminated	Recognize net amount as realized capital gain/loss. Gain/loss on termination to flow through IMR, if applicable.	Recognize net amount as realized capital gain/loss.

22. Examples of accounting and presentation based on varying assumptions can be found in the October 1, 1996 minutes of the Accounting Practices and Procedures (EX4) Task Force.

Disclosure Requirements

23. Reporting entities shall disclose the following for all derivative contracts outstanding:

a. Disclosures by category of instrument:

i. Notional or contract amounts;
ii. Carrying and fair values;
iii. A description of the accounting policies for derivatives;

iv. A discussion of the market risk, credit risk, and cash requirements of the derivative instruments.

b. General Disclosures:

i. A description of the reporting entity's objectives for holding or issuing the derivatives, the context needed to understand those objectives, and its strategies for achieving those objectives, including the classes of derivatives used;

ii. A description of how each category of derivative is reported in the financial statements including the policies for recognizing (or reasons for not recognizing) and measuring the derivatives held or issued, and when recognized, where those instruments and related gains and losses are reported.

24. Reporting entities shall disclose the following for derivatives held for other-than-hedging purposes:

a. Average fair value of the derivative instruments during the reporting period together with the related end-of-period fair value distinguishing between assets and liabilities;

b. Net gains or losses disaggregated by class, business activity or other category that is consistent with the management of those activities and where the net gains or losses are reported.

25. The financial statements shall disclose details of covered items and/or written transactions to allow evaluation of cash flow implications for all written covered options used for income generation.

DISCUSSION

26. The Summary Conclusion adopts the aforementioned sections of current statutory accounting principles (Chapter 8) for derivatives including insurance futures and insurance futures options. These principles are consistent with the Statement of Concepts because they provide recognition of derivatives as assets or liabilities, and recognition of income (gains) or expense (losses) based on how the reporting entity uses the derivative to reduce risk related to an existing exposure. It also provides a consistent approach to accounting for the many types of derivatives currently available to reporting entities.

27. This issue paper clarifies that the immediate recognition method of accounting (mark to market) shall be applied in situations where a reporting entity enters into a derivative for other-than-hedging purposes, when a portfolio has been hedged, or for derivatives that are not specifically addressed elsewhere in this guidance. Other-than-hedging is defined as any transaction which does not qualify for hedge accounting, including active derivatives trading by a reporting entity who enters into derivatives for purposes of generating profits on short-term differences in market movements and not for risk reduction purposes. This clarification is added so that unrealized gains and losses, particularly losses, cannot be deferred when categorized as other-than-hedging. This is consistent with the conservatism concept in the Statement of Concepts. Further, the immediate recognition method of accounting is not precluded from being utilized in situations where the derivative qualifies for hedge accounting.

28. This issue paper also provides that the determination of hedge accounting or immediate recognition accounting shall be made for each individual instrument. A reporting entity may utilize immediate recognition accounting for certain derivatives within a category and hedge accounting for other derivatives within that same category. This is a change from current statutory accounting principles, which provide that the categories to which immediate recognition accounting treatment is applied should be consistent from period to period.

29. While there is a separate section in the current statutory accounting guidance for insurance futures and related instruments, the accounting is similar to that of other derivatives. Therefore, the conclusion does not differentiate futures or options accounting from insurance futures or insurance futures options accounting, however, the distinctions in current statutory guidance in accounting and reporting for these instruments are adopted. The separate section for insurance futures and insurance futures options was incorporated into the current Life/A&H and P&C Accounting Practices & Procedures Manuals because insurance futures are viewed by insurance regulators as insurance-related transactions and not as investment-related transactions. As a result, insurance futures and insurance futures options are reported on Schedule DC and not Schedule DB as for other non-insurance derivatives. Also, income related to insurance futures and insurance futures options is reported as an aggregate write-in for miscellaneous income not as investment income and any asset is recorded as an aggregate write-in for other-than-invested assets.

30. Current statutory accounting does not specifically address settlement accounting for interest rate swaps. Under certain conditions (as set forth in EITF Issue No. 84-36), GAAP permits settlement accounting for interest rate swaps. Therefore, EITF Issue Nos. 84-36 and 84-7 are adopted.

31. Under settlement accounting, periodic net cash settlements under the swap agreement are recognized in income when they accrue. Settlement accounting is considered a conservative approach, and in many instances, produces an accounting result which is similar to hedge accounting. Such accounting is widely accepted in practice and provides an accounting approach that is consistent with the purpose of entering into such an instrument; that is, to change the interest rate characteristics of the balance sheet item to which it is matched. When this issue paper refers to hedge accounting, it encompasses the notion of settlement accounting for interest rate swaps that are matched through designation with an asset or a liability on the balance sheet.

32. The accounting and reporting for derivative instruments used for income generation is intended to meet (1) regulatory needs focusing on company and industry solvency, (2) company needs focusing on administrative and cost considerations, and (3) the general need to provide meaningful and relevant information regarding the substance of the transactions and holdings for all users of the financial statements.

a. The approach is conservative and reduces the potential for income manipulation. Income is not recognized early in the holding period only to be reversed by future losses. This consideration is particularly important for options which could have lower exercise prices than the combined statement values of the derivative and the covering asset;

b. The approach is reasonably simple and consistent with Statutory accounting. It builds on accounting guidance which already exists in the NAIC Accounting Practices and Procedures Manual and in the Annual Statement Instructions regarding hedging;

c. The approach looks to the substance of the transactions involved:

   i. It matches the accounting of the derivative with the accounting of the covering asset or underlying interest;

   ii. It includes an alternative treatment which combines the derivative with the covering asset. This results in a treatment analogous to callable bonds where the option feature is combined with the asset rather than in two pieces;

   iii. It allows for recognition of the time value/interest rate factor implicit in the pricing of these instruments, particularly relevant for derivatives with longer maturities.

33. Under GAAP, although there is no authoritative accounting guidance for written covered options, written options are generally reported at fair value with changes in fair value reported in earnings because written options do not qualify for hedge accounting except to the extent of the premium received. However, certain GAAP practice considers that the writer will never sustain a loss on a written covered option if the strike price of the option exceeds the book value of the covered asset, and the writer intends to deliver the covered asset if the option is exercised instead of settling the option in cash. Under these circumstances, certain GAAP practice includes carrying the option at cost with the option premium recorded in income when the options is exercised, at its expiration, or, if designated as a hedge, deferred as an adjustment of the cost of the covered asset.

34. Based on the inconsistency in the accounting results and the uncertainty surrounding the GAAP accounting for derivatives, other GAAP pronouncements are rejected as discussed below. Although some view GAAP accounting for derivatives as more conservative because of the stricter requirements of hedge accounting, statutory requirements are sufficiently restricted so that they are consistent with the conservatism and recognition principles of the Statement of Concepts.

35. GAAP is not applied uniformly for different types of derivatives because there is no comprehensive authoritative accounting guidance. Under GAAP, there are different rules for different derivatives and there are different rules for different uses of derivatives. To the extent that specific GAAP accounting guidance does not exist for some derivatives, practice is based on analogy to the literature that does exist for other derivatives. Also, the accounting for futures, forwards, options and swaps differs depending on whether these instruments are denominated in a domestic currency or in a foreign currency. The guidance in FAS 80 is used for futures contracts, and, by analogy, for certain other derivatives when they are denominated in the domestic currency of the entity. Although certain of the notions of designation, risk reduction and correlation from FAS 80 are incorporated in this paper, FAS 80 is rejected since statutory accounting principles as clarified herein provide sufficient guidance for hedge accounting. Consistent with *Issue Paper No. 81—Foreign Currency Transactions and Translations*, FAS 52 is rejected for reasons set forth in that paper. However, some of the elements of FAS 52 have been incorporated into this paper. The guidance in FAS 52 generally is applied when these instruments are denominated in a foreign currency that is not the functional currency of the entity. Also, this issue paper rejects the following GAAP pronouncements, which are limited to very narrow situations for which the broad accounting described in this issue paper is sufficient (such pronouncements are not reproduced herein due to length and limited scope):

- *FASB Emerging Issues Task Force No. 84-14, Deferred Interest Rate Setting*
- *FASB Emerging Issues Task Force Issue No. 86-34, Futures Contracts Used as Hedges of Anticipated Reverse Repurchase Transactions*
- *FASB Emerging Issues Task Force Issue No. 87-2, New Present Value Method of Valuing Speculative Foreign Exchange Contracts*
- *FASB Emerging Issues Task Force Issue No. 88-8, Mortgage Swaps*
- *FASB Emerging Issues Task Force Issue No. 90-17, Hedging Foreign Currency Risk with Purchased Options*
- *FASB Emerging Issues Task Force Issue No. 91-1, Hedging Intercompany Foreign Currency Risks*
- *FASB Emerging Issues Task Force Issue No. 91-4, Hedging Foreign Currency Risks with Complex Options and Similar Transactions*
- *FASB Emerging Issues Task Force Issue No. 95-11, Accounting for Derivative Instruments Containing both a Written Option-Based Component and a Forward-Based Component*
- *FASB Emerging Issues Task Force Issue No. 96-11, Accounting for Forward Contracts and Purchase Options to Acquire Securities Covered Under FASB Statement No. 115*

36. Because of inconsistencies in the accounting for derivatives, the FASB has been involved in a long-term project to address the accounting for off-balance-sheet financial instruments and is currently involved in deliberations to change the current accounting for derivatives under GAAP.

Disclosure Requirements

37. The disclosures required by FAS 105 cover financial instruments with off-balance-sheet risk of accounting loss. The scope includes derivatives with off-balance sheet risk as well as other types of financial instruments. FAS 105 is adopted for all financial instruments with off-balance-sheet risk with the following modifications:

a. The disclosures required in paragraph 17 shall distinguish between derivatives entered into for hedging purposes and for other-than-hedging purposes;

b. Paragraph 19 is rejected. It addresses voluntary disclosures not required by this issue paper.

38. FAS 119 extends the requirements of FAS 105 to all derivatives and requires additional disclosures. FAS 119 is adopted with the following modifications:

a. The disclosures required in paragraph 8 shall distinguish between derivatives entered into for hedging purposes and for other-than-hedging purposes;

b. The disclosures required for trading derivatives by paragraph 10 shall be required for derivatives entered into for other-than-hedging purposes;

c. Only the required disclosures in FAS 119 are adopted by this issue paper not the voluntary quantitative or qualitative disclosures. Therefore, paragraphs 12 and 13 are rejected.

39. Current statutory guidance provides specific information relating to derivatives in Schedules DB and DC of the Annual Statement. GAAP requires disclosures about derivative financial instruments in accordance with FAS 119. FAS 119 requires a distinction between derivatives used for trading and other than trading purposes for purposes of disclosure in the notes to the financial statements. Other information is required in the notes, such as notional amounts, carrying and fair values by category of derivative, a description of the accounting policies for derivatives, market and credit risk as well as other optional quantitative and qualitative information. Most of the required disclosures can be derived from information provided on Schedules DB and DC of the Annual Statement. The disclosure requirements are not intended to provide duplicative presentation in the annual statement filings but are required in those circumstances where the accompanying exhibits which contain certain required disclosures are not part of the reporting entity's financial statements (e.g., annual audit report). The disclosures required by FAS 119 are modified in that the classification of the disclosures shall be based on the accounting methodology adopted for the instrument based on hedge accounting or immediate recognition accounting, rather than on the notions of trading and other than trading in FAS 119.

Drafting Notes

- The accounting for investments in mortgage backed securities, collateralized mortgage obligations, real estate mortgage investment conduits, interest-only securities and principal-only securities, among others, is primarily addressed in *Issue Paper No. 43—Loan-Backed and Structured Securities.*

- The Invested Asset Working Group of the Valuation of Securities (EX4) Task Force met on June 2, 1996 and considered four derivatives projects. In October of 1996, the Blanks Task Force will consider incorporation of certain changes to current derivatives guidance, a summary of which is provided in paragraph 49.

RELEVANT STATUTORY AND GAAP GUIDANCE

Statutory Accounting

40. Chapter 8 in the Life/A&H and P&C Accounting Practices and Procedures Manuals contains the following guidance relating to derivative instruments:

> Derivative Instruments
>
> Derivative instruments are reported in Schedule DB of the annual statement using the definitions below. Specific accounting procedures for each derivative instrument will depend on the definition below that best describes the instrument. State investment laws and regulations should be consulted for applicable limitations on the use of derivative instruments.
>
> Definitions:
>
> "Underlying Interest" means the asset(s), liability(ies) or other interest(s) underlying a Derivative Instrument, including, but not limited to, any one or more securities, currencies, rates, indices, commodities, Derivative Instruments or other financial market instruments.
>
> "Option" means an agreement giving the buyer the right to buy or receive, sell or deliver, enter into, extend or terminate, or effect a cash settlement based on the actual or expected price level, performance or value of, one or more Underlying Interests.
>
> "Cap" means an agreement obligating the seller to make payments to the buyer, each payment under which is based on the amount, if any, that a reference price, level, performance or value of one or more Underlying Interests exceeds a predetermined number, sometimes called the strike/cap rate or price.
>
> "Floor" means an agreement obligating the seller to make payments to the buyer, each payment under which is based on the amount, if any, that a predetermined number, sometimes called the strike/floor rate or price, exceeds a reference price, level, performance or value of one or more Underlying Interests.
>
> "Collar" means an agreement to receive payments as the buyer of an Option, Cap or Floor and to make payments as the seller of a different Option, Cap or Floor.
>
> "Swap" means an agreement to exchange or net payments at one or more times based on the actual or expected price, level, performance or value of one or more Underlying Interests.
>
> "Forward" means an agreement (other than a Futures) to make or take delivery of, or effect a cash settlement based on the actual or expected price, level, performance or value of, one or more Underlying Interests.
>
> "Futures" means an agreement traded on an exchange, board of trade or contract market, to make or take delivery of, or effect a cash settlement based on the actual or expected price, level, performance or value of, one or more Underlying Interests.
>
> General Accounting Guidance:
>
> Hedging:
> Derivative instruments used by insurers in hedging transactions should be accounted for in a manner consistent with the item hedged prior to termination. Upon termination, the gains and losses from the derivative instrument will adjust the basis of the hedged item.

Alternatively, companies may mark derivative instruments of a given type to market from inception to termination with gains and losses recognized currently. Generally this alternative is used where it is impractical to allocate gains and losses to specific hedged assets or liabilities. The accounting treatment and categories to which this accounting treatment is applied should be consistent from period to period. However, derivative instruments hedging items which are subject to IMR will follow hedge accounting (amortized book value) while the instruments are still open and that the gains/losses will be subject to IMR upon termination.

For a derivative instrument to qualify for hedge accounting, the item to be hedged must expose the company to a risk and the designated derivative transaction must reduce that exposure. Examples include the risk of a change in the value, yield, price, cash flow, or quantity of, or degree of exposure with respect to assets, liabilities or future cash flows which an insurer has acquired or incurred, or anticipates acquiring or incurring.

A company should set specific criteria at the inception of the hedge as to what will be considered effective in measuring the hedge and then apply those criteria in the ongoing assessment based on actual hedge results. Insurers should account for a derivative instrument at market value if it ceases to be "effective" as a hedge and recognize the gain or loss currently to the extent it has not been offset by the effects of changes on the hedged item.

Documentation Guidance:

An insurer shall maintain documentation and records relating to derivative instruments opened during the year, instruments outstanding at year end, and instruments terminated during the year. Minimum required documentation is as follows:

(a) For derivative instruments opened during the year:

(1) A description, for each instrument, of the purpose of the transaction, including:

- A brief description of the assets and/or liabilities hedged by the instrument.
- A brief description of the manner in which the instrument reduces risk.
- A reference to the company's hedge program under which such transaction is internally authorized.

(2) Signature of approval, for each instrument, by person(s) authorized, either by the insurer's board of directors or a committee authorized by the board, to approve such transactions.

(3) A description, for each instrument, of the nature of the transaction, including:

- The date of the transaction.
- A complete and accurate description of the specific derivative instrument, including description of the underlying securities, currencies, rates, indices, commodities, derivative instruments, or other financial market instruments.
- Number of contracts or notional amount.
- Date of maturity, expiry or settlement.
- Strike price, rate or index, (opening price for futures contracts).
- Counterparty, or exchange on which the transaction was traded.
- Cost or consideration received, if any, for opening transaction.

(4) A description of the company methodology used to verify that opening transactions do not exceed limitations promulgated by the insurers state of domicile.

(b) For derivative instruments terminated during the year:

(1) Signature of approval, for each instrument, by person(s) authorized, either by the insurer's board of directors or a committee authorized by the board, to approve such transactions.

(2) A description, for each instrument, of the nature of the transaction, including:

- The date of the transaction.
- A complete and accurate description of the specific derivative instrument, including description of the underlying securities, currencies, rates, indices, commodities, derivative instruments, or other financial market instruments.
- Number of contracts or notional amount.
- Date of maturity, expiry or settlement.
- Strike price, rate or index, (termination price for futures contracts).
- Counterparty, or exchange on which the transaction was traded.
- Consideration paid or received, if any, on termination.

(3) Description of company methodology to verify that derivative instruments were effective hedges.

(4) Identification of any derivative instruments that ceased to be effective as hedges.

(c) For derivative instruments open at year end:

(1) A description of the methodology used to verify the continued effectiveness of hedges.

(2) An identification of any derivative instruments which have ceased to be effective as hedges.

(3) A description of company methodology to determine market values of derivative instruments.

(4) Copy of Master Agreements, if any, where indicated on Schedule DB Part E Section 1.

Specific Accounting Procedures for Derivative Instruments

(a) Call and Put Options, Caps, and Floors:

(1) Accounting at Date of Acquisition (purchase) or Issuance (written):

The premium paid or received for purchasing or writing a call option, put option, cap or floor shall be carried as an asset (purchase) or liability (written) on the balance sheet (Aggregate Write-in for Invested Asset (or) Liability).

(2) Statement Value:

- Open derivative instruments hedging items carried at amortized cost (where company does not elect to recognize gain/loss currently):
    - Options, caps and floors purchased or written shall be valued at amortized cost in a manner consistent with the hedged item.
    - The amortization period and methods used should in general result in a constant effective yield over the life of the hedged item or program. (For floating rate securities, the estimated effective yield should be based on the current rate so the changes in yields attributable to changes in interest rates will be recognized in the period of change.) Specific treatment includes:
        - Holdings in derivative instruments purchased or written within a year of maturity or expiry need not be amortized;
        - For anticipatory hedges, the derivative instrument may be carried at cost until the anticipated hedged transaction occurs or it is determined that the hedge was not effective;
        - For other derivative instruments, the amortization period is usually from date of acquisition (issuance) of the derivative instrument to maturity of the hedged item or program.
    - For hedges where the cost of the derivative instrument is combined with the hedged item, the statement value would be zero. The market value of the hedging and hedged items will be determined and reported separately.
    - If during the life of the derivative instrument, it is no longer effective as a hedge, valuation at amortized cost ceases and the derivative instrument shall be valued at its current market value (marked to market) with gains and losses recognized as adjustments to surplus to the extent they ceased to be effective hedges.
    - Open derivative instruments hedging items carried at market value, (where company does not elect to recognize gain/loss currently):
        - Options, caps or floors purchased or written shall be valued at current market value (marked to market) with changes in market value recognized currently consistent with the hedged item.
        - Usually this will result in unrealized gain/loss treatment with adjustment to surplus.

    - For hedges where the cost of the derivative instrument is combined with the hedged item, the market value of the hedging and hedged items will be determined and reported separately. The cost (book value) basis used to figure gain/loss on the derivative instrument will be zero.

  - Companies which elect to recognize gain/loss currently on derivative instruments acting as hedges shall make that determination at the start of the transaction and shall apply the methodology consistently between periods and by category.

    - For hedges of items which are not subject to IMR, options, caps or floors purchased or written shall be valued at current market value (marked to market) with unrealized gains/losses recognized as adjustments to surplus.

    - For hedges of items which are subject to IMR, options, caps and floors purchased or written shall be valued at amortized cost as in (2)(a) above.

(3) Cash Flows and Income:

- Where the cost of the derivative instrument is not combined with the hedged item:

  - Amortization of premium or discount on derivative instruments is an adjustment to net investment (operating) income through Exhibit 2;

  - Periodic cash flows and accruals of income/expense are to be reported in a manner consistent with the hedged item, usually as other investment income (operating income) to be reported in Exhibit 2.

- Where the cost of the derivative instrument is combined with the hedged item, the cash flows and income of the derivative instrument on Schedule DB will be zero. All related amortization and cash flow accounting will be reported with the hedged item instead of with the derivative instrument.

(4) Gain/Loss on Termination (includes closing, exercise, maturity, and expiry):

- Exercise of an Option: The remaining book value of the derivative instrument shall become an adjustment to the cost or proceeds of the hedged item(s) received or disposed of individually or in aggregate.

- Sale, maturity, expiry, or other closing transaction of a derivative instrument which is an effective hedge — Any gain or loss on the transaction will adjust the basis (or proceeds) of the hedged item(s) individually or in aggregate.

- Gain/loss on termination of derivatives will be recognized currently in net income (realized gain/loss) to the extent they ceased to be effective hedges.

- Where it is impractical to allocate gains or losses from effective hedges to specific hedged assets or liabilities, the company may recognize (realize) the gain/loss on termination in net income. Companies which elect to recognize gain/loss on derivative instruments acting as hedges shall make that determination at the start of the derivative transaction and shall apply the methodology consistently between periods and by investment category.

  - For insurers subject to IMR the gain/loss will be subject to IMR if the hedged items are subject to IMR.

(b) Swaps, Collars and Forwards:

An interest rate swap is a contractual agreement between two parties to exchange interest rate payments (usually fixed for variable) based on a specified amount of underlying assets or liabilities (known as the notional amount) for a specified period. The swap does not involve an exchange of principal. The result of these transactions is to transform payments from a variable rate to a fixed rate, from a fixed rate to a variable rate or from one variable rate index to another variable rate index.

Interest rate swaps have historically been entered into for the purpose of lowering borrowing costs, obtaining otherwise unavailable financing terms, and/or improving asset and liability management through a reduction of an entity’s exposure to interest rate risk. Banks and brokers will enter into an interest rate swap with an interested party before a swap partner is found, creating a swap portfolio. This activity allows the corporation that desires a swap transaction immediate access to the market. This secondary market also allows a swap participant a vehicle to unwind or reverse swap positions it no longer wants or receive cash if the position to be disposed of is favorable in relation to the current market.

While swaps may involve the trading of interest on liabilities or assets, insurance industry members have used swaps to match return on assets to contract obligations. Insurers also have acted as an intermediary or broker in the process of arranging a swap. Swaps may involve long periods of time and significant amounts of interest on substantial notional amounts. Unmatched or naked swaps are sometimes written where no underlying asset or liability exists.

The risk to the parties of a swap agreement is reduced by the fact that no transfer of principal is involved. The cash exchanged between the parties is usually the net interest differential only.

In general, interest rate swaps are off-balance-sheet items, disclosed in the footnotes to the financial statements. With respect to the income statement, swap payments flow through other income or expense. The recording of capital gains or losses arises only in the event that one party to a swap agreement defaults. In such a circumstance, the defaulting party is required to make a lump sum payment to the other party in exchange for the release of their obligations under the contract. The amount of the lump sum payment represents the capital gain/loss recorded by each party.

(1) Accounting at Date of Opening Position:

Any premium paid or received at date of opening shall be carried as an asset (paid) or liability (received) on the balance sheet (Aggregate Write-in for Invested Asset (or) Liability).

(2) Statement Value:

- Open derivative instruments hedging items carried at amortized cost (where the company does not elect to recognize gain/loss currently):
  - Swaps, collars and forwards shall be valued at amortized cost in a manner consistent with hedged item.
  - The amortization period and methods used should in general result in a constant effective yield over the life of the hedged item or program. (For floating rate securities the estimated effective yield should be based on the current rate so the changes in yields attributable to changes in interest rates will be recognized in the period of change.) Specific treatment includes:
    - Holdings in derivative instruments purchased or written within a year of maturity or expiry need not be amortized;
    - For anticipatory hedges, the derivative instrument may be carried at cost until the anticipated hedged transaction occurs or it is determined that the hedge was not effective;
    - For other derivative instruments the amortization period is usually from date of acquisition (issuance) of the derivative instrument to maturity of the hedged item or program.
  - For hedges where the cost of the derivative instrument is combined with the hedged item, the statement value would be zero. The market value of the hedging and hedged items will be determined and reported separately.
  - If during the life of the derivative instrument it is no longer effective as a hedge, valuation at amortized cost ceases and the derivative instrument shall be valued at its current market value (marked to market) with gains and losses recognized as adjustments to surplus to the extent that it ceased to be an effective hedge.
- Open derivative instruments hedging items carried at market value (where company does not elect to recognize gain/loss currently):
  - Swaps, collars or forwards shall be valued at current market value (marked to market) with changes in market value recognized currently consistent with the hedged item.

    - Usually this will result in unrealized gain/loss treatment with adjustment to surplus.

    - For hedges where the derivative instrument is combined with the hedged item, the market value of the hedging and hedged items will be determined and reported separately. The cost (book value) basis used to figure gain/loss on the derivative instrument will be zero.

- Open foreign currency swap and forward contracts hedging foreign currency exposure on items denominated in a foreign currency and translated into U.S. dollars (where the company does not elect to recognize gain/loss currently):

    - The foreign exchange premium (discount) on the currency contract will be amortized into income over the life of the contract. The foreign exchange premium (discount) is defined as the foreign currency (notional) amount to be received (paid) times the net of the forward rate minus the spot rate at the time the contract was opened.

        - Amortization is not required if the contract was entered into within a year of maturity.

    - A foreign currency translation adjustment should be reflected as an unrealized gain/loss (surplus adjustment) using the same procedures as done to translate the hedged item.

    - The unrealized gain/loss for the period equals the foreign currency (notional) amount to be received (paid) times the net of the current spot rate minus the prior period end spot rate.

    - The statement value of the currency contract equals the amortized (premium) discount plus the cumulative unrealized gain/(loss) on the contract. The cumulative unrealized gain/(loss) equals the foreign currency (notional) amount to be received (paid) times the net of the current spot rate minus the spot rate at the time the contract was opened.

    - Recognition of unrealized gains/losses and amortization of foreign exchange premium/discount on anticipated firm commitments may be deferred until the hedged transaction occurs. These deferred gains/losses will adjust the basis or proceeds of the hedged transaction when it occurs.

    - For hedges where the cost of the foreign currency contract is combined with the hedged item, the statement value would be zero. The market value of the hedging and hedged items will be determined and reported separately.

    - If during the life of the currency contract it is not effective as a hedge, valuation at amortized cost ceases. To the extent it ceased to be an effective hedge, a cumulative unrealized gain/loss will be recognized as an adjustment to surplus equal to the notional amount times the difference between the forward rate available for the remaining maturity of the contract (i.e., the forward rate as of the balance sheet date) and the forward rate at the time it ceased to be an effective hedge.

- Companies which elect to recognize gain/loss currently on derivative instruments acting as hedges shall make that determination at the start of the transaction and shall apply the methodology consistently between periods and by category.

    - For hedges of items which are not subject to IMR, derivative instruments shall be valued at current market value (marked to market) with unrealized gains/losses recognized as adjustments to surplus.

    - For hedges of items which are subject to IMR, derivative instruments shall be valued at amortized cost as in (2)(a) above.

(3) Cash Flows and Income:

- Where the cost of the derivative instrument is not combined with the hedged item:

    - Amortization of premium or discount on derivative instruments is an adjustment to net investment (operating) income through Exhibit 2.

    - Periodic cash flows and accruals of income/expense are to be reported in a manner consistent with the hedged item, usually as other investment income (operating income) to be reported in Exhibit 2.

- Where the cost of the derivative instrument is combined with the hedged item, the cash flows and income of the derivative instrument on Schedule DB will be zero. All related amortization and cash flow accounting will be reported with the hedged item instead of with the derivative instrument.

(4) Gain/Loss on Termination (includes closing, exercise, maturity, and expiry):

- Exercise — The remaining book value of the derivative instrument shall become an adjustment to the cost or proceeds of the hedged item(s) received or disposed of individually or in aggregate.

- Sale, maturity, expiry, or other closing transaction of a derivative instrument which is an effective hedge — Any gain or loss on the transaction will adjust the basis (or proceeds) of the hedged item(s) individually or in aggregate.

- Gain/loss on termination of derivatives will be recognized currently in net income (realized gain/loss) to the extent they ceased to be effective hedges.

- Where it is impractical to allocate gains or losses from effective hedges to specific hedged assets or liabilities, the company may recognize (realize) the gain/loss on termination in net income. Companies which elect to recognize gain/loss on derivative instruments acting as hedges shall make that determination at the start of the derivative transaction and shall apply the methodology consistently between periods and by investment category.

  - For insurers subject to IMR the gain/loss will be subject to IMR if the hedged items are subject to IMR.

(c) Futures

(1) Accounting at Date of Acquisition:

Positions in futures contracts shall be initially valued at the amount of cash deposits (i.e., basis or book value of the contract), if any, placed with a broker. Subsequent additions (reductions) in cash deposits plus changes in contract value from date of contract opening (i.e., variation margin) paid (received) will increase (decrease) the book value of the futures contract.

(2) Statement Value:

- Hedges of Items Carried at Amortized Cost (where the company does not elect to recognize gain/loss currently):

  - Futures shall be valued at book value.

  - Book value of open futures contracts need not be amortized.

  - For hedges where the cost of the futures contract is combined with the hedged item, the statement value would be equal to cash deposits outstanding. The market value of the hedging and hedged items will be determined and reported separately. Market value on futures contracts is limited to the value of the cash deposits outstanding.

  - If during the life of the futures contract it is no longer effective as a hedge, valuation at book value (deferral accounting) ceases. A gain/(loss) equal to the variation margin received (paid) shall be recognized as an adjustment to surplus to the extent it ceased to be an effective hedge. Statement value will be limited to the cash deposits outstanding.

- Hedges of Items carried at Market Value (where company does not elect to recognize gain/loss currently):

    - Changes in contract value from date of contract opening (i.e., variation margin) shall be recognized currently consistent with the hedged item. Statement value will be limited to the cash deposits outstanding.

    - Usually this will result in unrealized gain/loss treatment with adjustment to surplus.

    - For hedges where the variation margin of the futures contract is combined with the hedged item, the market value of the hedging and hedged items will be determined and reported separately.

- Open foreign currency futures contracts hedging foreign currency exposure on item(s) denominated in a foreign currency and translated into U.S. dollars (where the company does not elect to recognize gain/loss currently):

    - The foreign exchange premium (discount) on the currency contract will be amortized into investment income over the life of the contract. The foreign exchange premium (discount) is defined as the foreign currency (notional) amount to be received (paid) times the net of the forward rate minus the spot rate at the time the contract was opened. The cumulative income recognized since the contract was opened should be reported as recognized variation margin received or (paid).

        - Amortization is not required if the contract was entered into within a year of maturity.

    - A foreign currency translation adjustment should be reflected as an unrealized gain/loss (surplus adjustment) using the same procedures as is done to translate the hedged item. The cumulative unrealized gain/(loss) which equals the foreign currency (notional) amount to be received (paid) times the net of the current spot rate minus the spot rate at the time the contract was opened should be reported as recognized variation margin received or (paid).

    - The statement value of the currency futures contract is book value, including any increase (decrease) for amortization of foreign exchange (premium) discount ((c)(i) above) plus the foreign exchange translation gain/(loss) ((c)(ii) above), which is reported as deferred variation margin.

    - Recognition of unrealized gains/losses and amortization of foreign exchange premium/discount on anticipated firm commitments may be deferred until the hedged transaction occurs. These deferred gains/losses will adjust the basis or proceeds of the hedged transaction when it occurs.

- For hedges where the variation margin of the foreign currency contract is combined with the hedged item, the statement value would equal the cash deposits outstanding. The market value of the hedging and hedged items will be determined and reported separately. Market value on futures contracts is limited to the value of the cash deposits outstanding.

- If during the life of the currency contract it is not effective as a hedge, valuation at amortized cost ceases. To the extent it ceased to be an effective hedge, a cumulative unrealized gain/loss will be recognized as an adjustment to surplus equal to the notional amount times the difference between the forward rate available for the remaining maturity of the contract (i.e., the forward rate as of the balance sheet date) and the forward rate at the time it ceased to be an effective hedge.

- Companies which elect to recognize gain/loss currently on futures contracts acting as hedges shall make that determination at the start of the transaction and shall apply the methodology consistently between periods and by category.

  - For hedges of items which are not subject to IMR, changes in contract value from date of contract opening (i.e., variation margin) shall be recognized currently as unrealized gain/loss adjustment to surplus. Statement value will be limited to the cash deposits outstanding.

  - For hedges of items which are subject to IMR, derivative instruments shall be valued at amortized cost as in (2)(a) above.

(3) Gain/Loss on Termination:

- Settlement at maturity of a futures contract — The remaining variation margin of the futures contract shall become an adjustment to the cost or proceeds of the hedged item(s) received, disposed of or held, individually or in aggregate.

- Sale or other closing transaction of a futures contract which is an effective hedge — any gain or loss on the transaction will adjust the basis (or proceeds) of the hedged item(s) individually or in aggregate.

- Gain/loss on termination of futures contracts will be recognized currently in net income (realized gain/loss) to the extent they ceased to be effective hedges.

- Where it is impractical to allocate gains or losses from effective hedges to specific hedged assets or liabilities, the company may recognize (realize) the gain/loss on termination in net income. Companies which elect to recognize gain/loss on futures contracts acting as hedges shall make that determination at the start of the derivative transaction and shall apply the methodology consistently between periods and by investment category.

- For insurers subject to IMR the gain/loss will be subject to IMR if the hedged items are subject to IMR.

41. Chapter 8 in the Life/A&H and P&C Accounting Practices and Procedures Manuals contain the following guidance relating to insurance futures and insurance future options:

> Insurance Futures and Insurance Futures Options
>
> The statutes, regulations and administrative rulings of the insurers domiciliary state establish the authority to engage in transactions with respect to insurance futures and insurance futures options. In the absence of specific written authority, the Insurance Department of the insurers domiciliary state should be consulted as to such authority.
>
> In those jurisdictions which authorize transactions with respect to insurance futures and insurance futures options, an insurance company is generally permitted, subject to applicable quantitative limitations, to use such instruments to hedge against adverse development in its incurred losses. This strategy typically would involve any or a combination of (i) the purchase of insurance futures contracts, (ii) the purchase of a call option on insurance futures contracts, or (iii) the sale (writing) of a put option on insurance futures contracts.
>
> Insurance Futures Contracts:
>
> An insurance futures contract is a futures contract based on an underlying index of performance of insurance contracts (policies) or factors relating thereto. An insurance futures contract also may be defined more specifically under the statutes, regulations and administrative rulings of a particular state. In connection with a given insurance futures position, an insurer is required by the listing exchange to maintain a margin deposit with respect to the underlying insurance futures contracts purchased.
>
> An insurer should report the amount of any margin deposit as an asset on its balance sheet, which deposit should be reflected as an aggregate write-in for other-than-invested assets. The specific statutory accounting treatment of increases or decreases in the value of the subject contracts will depend on whether the insurance futures position constitutes a hedge of the insurers incurred losses. The determination of whether an insurance futures position constitutes a hedge is typically determined pursuant to the statutes, rules and administrative rulings of an insurers domiciliary state. Although many states prohibit an insurer from taking an insurance futures position that does not constitute a hedge, the following presents both hedge accounting and other-than-hedge accounting treatment. Other-than-hedge accounting should be used in the event that an original hedge position loses its character as such, until such time as the position is terminated as required by state law.
>
> Insurance Futures - Hedge Accounting:
>
> The following treatment would be applicable to insurance futures positions that effectively hedge an insurers incurred losses. With respect to any insurance futures position which corresponds to incurred losses for the current reporting period, any increases (decreases) in the value of the insurance futures contracts should be reported as an increase (decrease) in the insurers other income, as an aggregate write-in for miscellaneous income for the subject period. With respect to any insurance futures position which corresponds to a period beyond the current reporting period, any increases (decreases) in the value of the underlying insurance futures contracts should be reported as a direct increase (decrease) in the insurers surplus, as an aggregate write-in for gains and losses in surplus. When such insurance futures position thereafter corresponds to a current reporting period, the initial increase (decrease) in direct surplus should be reversed and such amount should be appropriately reported as an increase (decrease) to the insurers other income, as an aggregate write-in for miscellaneous income for the current period, along with any current changes in value of the insurance futures contracts. In either of the foregoing instances, the increase (decrease) in the market value of the insurance futures contracts should either (i) increase (decrease) the aggregate write-in for other-than-invested assets, to the extent that such

increase (decrease) effects the corresponding margin deposit, or (ii) increase (decrease) cash or other assets, to the extent of mark-to-market payments that are not maintained as a margin deposit. When the insurance futures position is eventually closed, any corresponding margin balance (i.e., aggregate write-in for other-than-invested assets) shall be transferred to the insurers cash or other assets, as appropriate.

Insurance Futures – Other-Than-Hedge Accounting:

If the insurance futures position is no longer effective as a hedge, any increases (decreases) in the value of the insurance futures contracts should be reported as an aggregate write-in for miscellaneous income. When the insurance futures positions eventually close, any corresponding margin balance (i.e., aggregate write-in for other-than-invested assets) should be transferred to the insurers cash or other assets, as appropriate.

Options on Insurance Futures Contracts:

An insurance futures option is either a put or call option on an insurance futures contract. An insurance futures call option is a contract under which the holder has the right to purchase the underlying insurance futures contract covered by the option at a stated price (strike price) on or before a fixed expiration date. An insurance futures put option gives the holder the right to sell the underlying insurance futures contract. The consideration paid (received) for the purchase (sale) of an insurance futures option is referred to as a premium. Because all insurance futures options relate to an underlying insurance futures contract, the statutory accounting treatment of insurance futures options generally follows the treatment afforded insurance futures contracts.

An insurer should report the amount of any premium paid for an insurance futures option as an asset on its balance sheet, which premium should be reflected as an aggregate write-in for other-than-invested assets. Similarly, an insurer should report the amount of any premium received for the sale (writing) of an insurance futures option as a liability on its balance sheet, which premium should be reflected as an aggregate write-in for liabilities. The specific statutory accounting treatment of increases or decreases in the market value of the subject insurance futures option will depend on whether such position constitutes a hedge of the insurers incurred losses. As with insurance futures contracts, the determination of whether a particular position constitutes a hedge is typically determined pursuant to the statutes, rules and administrative rulings of an insurers domiciliary state. Although many states prohibit an insurer from taking an insurance futures option position that does not constitute a hedge, the following presents both hedge accounting and other-than-hedge accounting treatment. Other-than-hedge accounting should be used in the event that an original hedge position loses its characters as such, until such time as the position is terminated as required by state law.

Options on Insurance Futures Contracts - Hedge Accounting:

The following treatment would be applicable to insurance futures options positions that effectively hedge an insurers incurred losses.

(a) Purchase of Call Options — With respect to any call option which corresponds to incurred losses for the current reporting period, any increases (decreases) in the market value of the option should be reported as an increase (decrease) in the insurers other income, as an aggregate write-in for miscellaneous income for the subject period. With respect to any call option which corresponds to a period beyond the current reporting period, any increases (decreases) in the market value of the underlying option should be reported as a direct increase (decrease) in the insurer’s surplus, as an aggregate write-in for gains and losses in surplus. When such option thereafter corresponds to a current reporting period, the initial increase (decrease) in direct surplus should be reversed and such amount should be appropriately reported as an increase (decrease) to the insurer’s other income, as an aggregate write-in for miscellaneous income for the current period, along with any current changes in the market value of the option.

If the option position is terminated through a closing transaction, the corresponding balance of the asset (i.e., aggregate write-in for other-than-invested assets) should be eliminated, with a corresponding charge to cash or other assets, as appropriate. If the option is exercised, the corresponding balance of the asset should be eliminated, with a corresponding charge to either (i) insurance futures margin (i.e., aggregate write-in for other-than-invested assets), to the extent of margin deposit requirements, or (ii) cash or other assets, as appropriate. If the option expires, the corresponding balance of the asset should be eliminated, with an appropriate decrease to the insurer's other income, as an aggregate write-in for miscellaneous income.

(b) Sale (Writing) of Put Options — The statutory accounting treatment for the sale (writing) of insurance futures put options is essentially the mirror image of the foregoing treatment presented with respect to purchased call options. Upon termination (through a closing transaction), exercise or expiry of the put option, the corresponding balance of the liability (i.e., aggregate write-in for liabilities) should be eliminated, in the mirror image of the foregoing treatment.

Options on Insurance Futures Contracts – Other-Than-Hedge Accounting:

If the insurance futures option position is no longer effective as a hedge, any increases (decreases) in the value option should be reported as an aggregate write-in for miscellaneous income.

42. The NAIC Annual Statement Instructions for both Life, Accident and Health and Property and Casualty companies require the following disclosures for derivative instruments:

Instruction:

Disclose the following information by category of derivative financial instrument:

a. A description of the Company's objectives for holding or issuing derivative financial instruments, the context needed to understand those objectives, and its strategies for achieving those objectives including the classes of derivative financial instrument used.

b. The nature and terms of derivative financial instruments, including, at a minimum, a discussion of: 1) the credit and market risk of those instruments, and 2) the cash requirements of those instruments (including the effects of possible termination payments).

Illustration for Interest Rate Swaps (Companies should modify the following to reflect appropriately their own circumstances):

The Company uses interest rate swaps to reduce market risks from changes in interest rates and to alter interest rate exposures arising from mismatches between assets and liabilities. Under interest rate swaps, the Company agrees with other parties to exchange, at specified intervals, the difference between fixed-rate and floating-rate interest amounts calculated by reference to an agreed notional principal amount. Generally, no cash is exchanged at the outset of the contract and no principal payments are made by either party. A single net payment is usually made by one counterparty at each due date. See Schedule DB.

The Company is exposed to credit-related losses in the event of nonperformance by counterparties to financial instruments, but it does not expect any counterparties to fail to meet their obligations given their high credit ratings. The credit exposure of interest rate swaps is represented by the fair value (market value) of contracts with a positive fair value (market value) at the reporting date.

Illustration for All Other Derivatives Listed in Schedule DB (Caps, Collars, Futures, etc.):

The note(s) may resemble the illustration for interest rate swaps. For additional illustrations, see C.M. Antis' *Financial Accounting Series Special Report, Illustrations of Financial Instrument Disclosures* (No. 144-c), December 1994, published by the Financial Accounting Standards Board.

43. The following guidance for derivatives used for income generation was adopted by the Financial Condition (EX4) Subcommittee on December 14, 1996:

INCOME GENERATION ACCOUNTING PROJECT
EXECUTIVE SUMMARY
JULY 10, 1996

INTRODUCTION

Income Generation transactions are ones where the company writes (or sells) derivative instruments to generate additional income or return to the company. They include covered options, caps and floors such as when a company writes an equity call option on stock which it already owns. Currently they represent a small portion of the insurance industry's derivative activity in terms of number of companies involved, number of transactions, and dollar amounts involved. The possibility of greater company involvement in the future exists given recent guidance and inclusion in the Model Investment Law.

Because these transactions involve writing derivative transactions, they expose the company to potential future liabilities for which the company receives a premium up front. Because of this risk, state laws and the Model Investment Law impose dollar limitations and additional constraints requiring that they be "covered," i.e., that there be offsetting assets which can be used to fulfill potential obligations. To this extent the combination of instruments works like a reverse hedge where an asset owned by the company in essence hedges the derivative risk.

As with derivatives in general these instruments include a wide variety of terms regarding maturities, range of exercise periods and prices, counterparties, underlying instruments, etc.

GENERAL ATTRIBUTES

The proposed accounting and reporting approach is intended to meet (1) Regulatory needs focusing on company and Industry solvency (2) company needs focusing on administrative and cost considerations, and (3) the general need to provide meaningful and relevant information regarding the substance of the transactions and holdings for all users of the financial statements.

1. The approach is conservative and reduces the potential for income manipulation. Income is not recognized early in the holding period only to be reversed by future losses. This consideration is particularly important for options which could have lower exercise prices than the combined statement values of the derivative and the covering asset.

2. The approach is reasonably simple and consistent with Statutory accounting. It builds on accounting guidance which already exists in the *NAIC Accounting Practices and Procedures Manual* and in the *Annual Statement Instructions* regarding hedging.

3. The approach looks to the substance of the transactions involved.

   - It matches the accounting of the derivative with the accounting of the covering asset or underlying interest.

- It includes an alternative treatment which combines the derivative with the covering asset. This results in a treatment analogous to callable bonds where the option feature is combined with the asset rather than in two pieces.
- It allows for recognition of the time value/interest rate factor implicit in the pricing of these instruments, particularly relevant for derivatives with longer maturities.

ACCOUNTING SPECIFICS

The accounting specifics attached are presented in table form. Completed sections include

- Covered Call Writing
  - Covering Item at Amortized Cost
  - Covering Item at Market
- Covered Put Writing
  - Underlying Interest at Amortized Cost
  - Underlying Interest at Market
- Covered Cap and Floor Writing
  - Covering Item at Amortized Cost
  - Covering Item at Market
- Accounting Examples
- AVR Implications
- Approval by AVR/IMR Study Group
- Formal Blanks Proposal

General

The principal features to date are:

1. The premium received is initially recorded as a deferred liability.

2. The accounting of the covering asset or underlying interest controls the accounting of the derivative. The covering asset/underlying interest is accounted at either mark-to-market (e.g., common stocks) or (amortized) cost (e.g., for bonds).

3. The gain/loss on termination of the derivative is a capital item. For life insurance companies, it would be subject to IMR treatment if interest rate related.

4. For options which are exercised, the remaining premium would adjust the proceeds (cost) associated with the exercise resulting in no explicit gain or loss reported for the derivative itself.

Covered puts and fixed income transactions have several specific features which are presented below.

Fixed Income Call Options

The principal specific features are:

1. The general approach is to value at cost (i.e., consideration received) without amortization over the life of the contract.

2. An alternative to the general approach combines the accounting of the written option with the covering asset and then uses standard accounting for callable bonds (yield to worst amortization) on the adjusted asset. This method prevents the possibility of future loss recognition upon exercise while at the same time providing recognition of the income

feature of the option over time. This approach would appear most relevant for longer-lived covered European call options, which are in substance like callable bonds.

3. For life insurance companies the gain or loss flows through the IMR if the underlying interest or covering asset is subject to the IMR using callable bond rules to determine the remaining life.

4. Companies writing options for income generation purposes are responsible for timely recognition of any probably losses that may occur as a result of the strategy. If the exercise price is below the covering asset's book value, the asset should be evaluated for write down or disclosure treatment along the lines of Codification Issue Paper #5 *Definition of Liabilities, Loss Contingencies, and Impairments of Assets* taking into consideration all relevant factors such as whether the option is currently exercisable, the fair value of the bond relative to its exercise price, to what extent the statement value of the option premium offsets any loss on the asset, or how any IMR transaction on exercise would affect surplus and income.

Puts

The principal features are:

1. The accounting for the underlying interest instead of the covering asset governs the accounting of the written put while it is open. For example, if a company wrote a put requiring it to purchase a certain common stock (underlying interest) at a specific price, the company might cover that option by holding cash or cash equivalents (covering asset). The accounting for the common stock would govern the accounting of the option in this case.

2. As with covered call writing for life insurance companies, gain/loss on termination may be subject to IMR over the remaining life of the underlying interest.

3. As with covered call writing, companies writing put options for income generation purposes are responsible for timely recognition of any probably losses that may occur as a result of the strategy.

Fixed Income Caps and Floors

The principal specific features are:

1. The value of the premium received would be amortized into income over the life of the contract. For caps and floors, where the company is selling off possible excess interest/income, the value of the covering asset is not relevant.

2. Again, gain/loss may be subject to IMR. The expected maturity would be the derivative contract's maturity.

WRITTEN CALL OPTIONS – INCOME GENERATION
PROPOSED STATUTORY ACCOUNTING TREATMENT
APPLICABLE TO ALL INSURANCE COMPANIES
JULY 30, 1996

STATUS OF OPTION	COVERING ASSET AT AMORTIZED COST	COVERING ASSET AT MARKET VALUE
Open	Record premium as deferred liability. Carry at consideration received. (1) Alternatively, attach premium to covering asset and amortize (under yield to worse scenario) using standard callable bond accounting. (2)	Record premium as deferred liability. Mark to market with changes in market value recorded as unrealized adjustments to surplus – gain/loss.
Closed – Expired	Premium received recognized as realized capital gain. Gain from expiration to flow through IMR if applicable. (3)	Premium received recognized as realized capital gain.
Closed – Exercised	Adjust disposition proceeds. (Include in capital gain/loss of disposed asset.) Gain or loss from disposition to flow through IMR if applicable. (3)	Adjust disposition proceeds. (Include in capital gain/loss of disposed asset.)
Closed – Terminated	Recognize net amount as realized capital gain/loss. Gain or loss from disposition to flow through IMR if applicable. (3)	Recognize net amount as realized capital gain/loss.

NOTES

1. A general statement will be added to the instructions stating that companies writing options for income generation purposes are responsible for the timely recognition of any probable losses that may occur as a result of the strategy due to holding and accounting for options on Schedule DB – Part B.

2. Report derivative and its market value on Schedule DB – Part B. Include accounting on Schedule D – Part 1.

3. If premium is attached to covering asset, the accounting treatment for the covering asset applies.

WRITTEN PUT OPTIONS – INCOME GENERATION
PROPOSED STATUTORY ACCOUNTING TREATMENT
APPLICABLE TO ALL INSURANCE COMPANIES
JULY 30, 1996

STATUS OF OPTION	**UNDERLYING INTEREST AT AMORTIZED COST**	**UNDERLYING INTEREST AT MARKET VALUE**
Open	Record premium as deferred liability. Carry at consideration received. (1)	Record premium as deferred liability. Mark to market with changes in market value recorded as unrealized adjustments to surplus – gain/loss.
Closed – Expired	Premium received recognized as realized capital gain. Gain from expiration to flow through IMR if applicable.	Premium received recognized as realized capital gain.
Closed – Exercised	Adjust acquisition cost by premium received.	Adjust acquisition cost by premium received.
Closed – Terminated	Recognized net amount as realized capital gain/loss. Gain or loss from disposition to flow through IMR if applicable.	Recognize net amount as realized capital gain/loss.

NOTES

1. A general statement will be added to the instructions stating that companies writing options for income generation purposes are responsible for the timely recognition of any probable losses that may occur as a result of the strategy due to holding and accounting for options on Schedule DB – Part B.

WRITTEN CAPS AND FLOORS – INCOME GENERATION
PROPOSED STATUTORY ACCOUNTING TREATMENT
APPLICABLE TO ALL INSURANCE COMPANIES
JULY 30, 1996

STATUS OF OPTION	COVERING ASSET AT AMORTIZED COST	COVERING ASSET AT MARKET VALUE
Open	Record premium as deferred liability. Carry at amortized value. (Alternatively carry at consideration received if within 1 yr of maturity.) Amortize over life of contract to produce constant yield. Record any interest expense as “Other Investment Income” – negative value.	Record premium as deferred liability. Mark to market with changes in market value recorded as unrealized adjustments to surplus – gain/loss.
Closed – Matured	Would usually mature at zero amortized value. Any remaining unamortized value recognized as ordinary income through a final amortization adjustment.	Premium received recognized as realized capital gain.
Closed – Exercised	Not applicable.	Not applicable.
Closed – Terminated	Recognize net amount as realized capital gain/loss. Gain/loss on termination to flow through IMR if applicable.	Recognize net amount as realized capital gain/loss.
Disclosure	(OPEN ITEM—being addressed by other Interested Persons.) Details of covered items and/or written transactions to allow actuaries to evaluate cash flow implication.	(OPEN ITEM—being addressed by other Interested Persons.) Details of covered items and/or written transactions to allow actuaries to evaluate cash flow implications.

Generally Accepted Accounting Principles

44. The key GAAP literature relating to hedge accounting for derivative financial instruments is found in FAS 80. Paragraphs 3 and 4 of FAS 80 state, in part:

> 3. A change in the market value of a futures contract shall be recognized as a gain or loss in the period of the change unless the contract meets the criteria specified in this Statement to qualify as a hedge of an exposure to price or interest rate risk. If the hedge criteria are met, the accounting for the futures contract shall be related to the accounting

> for the hedged item so that changes in the market value of the futures contract are recognized in income when the effects of related changes in the price or interest rate of the hedged item are recognized.
>
> 4. In applying this Statement, both of the following conditions shall be met for a futures contract to qualify as a hedge:
>
>   a. The item to be hedged exposes the enterprise to price (or interest rate) risk. In this Statement, risk refers to the sensitivity of an enterprise's income for one or more future periods to changes in market prices or yields of existing assets, liabilities, firm commitments, or anticipated transactions. To meet this condition, the item or group of items intended to be hedged must contribute to the price or interest rate risk of the enterprise. In determining if this condition is met, the enterprise shall consider whether other assets, liabilities, firm commitments, and anticipated transactions already offset or reduce the exposure. An enterprise that cannot assess risk by considering other relevant positions and transactions for the enterprise as a whole because it conducts its risk management activities on a decentralized basis can meet this condition if the item intended to be hedged exposes the particular business unit that enters into the contract.
>
>   b. The futures contract reduces that exposure and is designated as a hedge. At the inception of the hedge and throughout the hedge period, high correlation of changes in (1) the market value of the futures contract(s) and (2) the fair value of, or interest income or expense associated with, the hedged item(s) shall be probable so that the results of the futures contract(s) will substantially offset the effects of price or interest rate changes on the exposed item(s). In addition to assessing information about the correlation during relevant past periods, the enterprise also shall consider the characteristics of the specific hedge, such as the degree of correlation that can be expected at various levels of higher or lower market prices or interest rates. A futures contract for a commodity or a financial instrument different from the item intended to be hedged may qualify as a hedge provided there is a clear economic relationship between the prices of the two commodities or financial instruments, and provided high correlation is probable.

45. Paragraph 21 of FAS 52 states, in part:

> A gain or loss on a forward contract or other foreign currency transaction that is intended to hedge an identifiable foreign currency commitment (for example, an agreement to purchase or sell equipment) shall be deferred and included in the measurement of the related foreign currency transaction...A foreign currency transaction shall be considered a hedge of an identifiable foreign currency commitment provided both of the following conditions are met:
>
> a. The foreign currency transaction is designated as, and is effective, as a hedge of a foreign currency commitment.
> b. The foreign currency commitment is firm.

46. The key GAAP literature relating to interest rate swap transactions is EITF 84-36, in which the Task Force concluded that:

> ...if there is an underlying debt obligation on the balance sheet of the company entering into the swap transaction, the company should account for the swap agreement like a hedge of the obligation and record interest expense using the revised interest rate, with any fees or other payments amortized as yield adjustments.

47. FAS 105, as amended by FAS 119, provides the following guidance on disclosures for financial instruments with off-balance sheet risk, including derivatives:

6. A financial instrument is cash, evidence of an ownership interest in an entity, or a contract that both:

a. Imposes on one entity a contractual obligation[1] (1) to deliver cash or another financial instrument[2] to a second entity or (2) to exchange financial instruments on potentially unfavorable terms with the second entity

b. Conveys to that second entity a contractual right[3] (1) to receive cash or another financial instrument from the first entity or (2) to exchange other financial instruments on potentially favorable terms with the first entity.

[1] *Contractual obligations* encompass both those that are conditioned on the occurrence of a specified event and those that are not. All contractual obligations that are financial instruments meet the definition of *liability* set forth in FASB Concepts Statement No. 6, *Elements of Financial Statements*, although some may not be recognized as liabilities in financial statements—may be "off-balance-sheet"—because they fail to meet some other criterion for recognition. For some financial instruments, the obligations is owed to or by a group of entities rather than a single entity.

[2] The use of the term *financial instrument* in this definition is recursive (because the term *financial instrument* is included in it), though it is not circular. The definition requires a chain of contractual obligations that ends with the delivery of cash or an ownership in an entity. Any number of obligations to deliver financial instruments can be links in a chain that qualifies a particular contract as a financial instrument.

[3] *Contractual rights* encompass both those that are conditioned on the occurrence of a specified event and those that are not. All contractual rights that are financial instruments meet the definition of *asset* set forth in Concepts Statement 6, although some may not be recognized as assets in financial statements —may be "off-balance-sheet"—because they fail to meet some other criterion for recognition. For some financial instruments, the right is held by or the obligation is due from a group of entities rather than a single entity.

7. The risk of accounting loss[4] from a financial instrument includes (a) the possibility that a loss may occur from the failure of another party to perform according to the terms of a contract (credit risk), (b) the possibility that future changes in market prices may make a financial instrument less valuable or more onerous (market risk),[5] and (c) the risk of theft or physical loss. This Statement addresses credit and market risk only.

[4] Accounting loss refers to the loss that may have to be recognized due to credit and market risk as a direct result of the rights and obligations of a financial instrument.

[5] A change in market price may occur (for example, for interest-bearing financial instruments) because of changes in general interest rates (interest rate risk), changes in the relationship between general and specific market interest rates (an aspect of credit risk), or changes in the rates of exchange between currencies (foreign exchange risk).

Disclosure of Extent, Nature, and Terms of Financial Instruments with Off-Balance-Sheet Risk

17. For financial instruments with off-balance-sheet risk*, except as noted in paragraphs 14 and 15, an entity shall disclose either in the body of the financial statements or in the accompanying notes the following information by category of financial instrument:[12]

a. The face or contract amount (or notional principal amount if there is no face or contract amount)

b. The nature and terms, including, at a minimum, a discussion of (1) the credit and market risk of those instruments, (2) the cash requirements of those instruments, and (3) the related accounting policy pursuant to the requirements of APB Opinion No. 22, Disclosure of Accounting Policies.[13]

* Similar disclosures are required for derivative financial instruments without off-balance-sheet risk in paragraph 8 of FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments.*

[12] In this Statement, category of financial instrument refers to class of financial instrument, business activity, risk, or other category that is consistent with the management of those instruments. If disaggregation of financial instruments is other than by class, the entity also shall describe for each category the classes of financial instruments included in that category. Practices for grouping and separately identifying—classifying—similar financial instruments in statement of financial position, in notes to financial statements, and in various regulatory reports have developed an become generally accepted, largely without being codified in authoritative literature. In this Statement, *class of financial instrument* refers to those classifications.

[13] Paragraph 12 of Opinion 22 as amended by FASB Statement No. 95, *Statement of Cash Flows*, says:

Disclosure of accounting policies should identify and describe the accounting principles followed by the reporting entity and the methods of applying those principles that materially affect the determination of financial position, statement of cash flows, or result of operations. In general, the disclosure should encompass important judgments as to appropriateness of principles relating to recognition of revenue and allocation of asset costs to current and future periods; in particular, it should encompass those accounting principles and methods that involve any of the following:

a. A selection from existing acceptable alternatives.

b. Principles and methods peculiar to the industry in which the reporting operates, even if such principles and methods are predominantly followed in that industry.

c. Unusual or innovative applications of generally accepted accounting principles (and, as applicable, of principles and methods peculiar to the industry in which the reporting entity operates).

The disclosures required in paragraph 17 shall distinguish between financial instruments with off-balance-sheet risk held or issue for trading purposes, included dealing and other trading activities measured at fair value with gains and losses recognized in earnings, and financial instruments with off-balance-sheet risk held or issued for purposes other than trading.

Disclosure of Credit Risk of Financial Instruments with Off-Balance-Sheet Credit Risk

18. For financial instruments with off-balance-sheet credit risk, except as noted in paragraphs 14 and 15, an entity shall disclose either in the body of the financial statements or in the accompanying notes the following information by category of financial instrument:

a. The amount of accounting loss the entity would incur if any party to the financial instrument failed completely to perform according to the terms of the contract and the collateral or other security, if any, for the amount due proved to be of no value to the entity

b. The entity's policy of requiring collateral or other security to support financial instruments subject to credit risk, information about the entity's access to that collateral or other security, and the nature and a brief description of the collateral or other security supporting those financial instruments.

19. An entity may find that disclosing additional information about the extent of collateral or other security for the underlying instrument indicates better the extent of credit risk. Disclosure of that additional information in those circumstances is encouraged.

48. FAS 119 provides the following guidance on disclosures for derivatives:

8. For options held and other derivative financial instruments not included in the scope of Statement 105 (because they do not have off-balance-sheet risk of accounting loss, as defined in Statement 105), an entity shall disclose either in the body of the financial statements or in the accompanying notes the following information by category of financial instrument:[1]

a. The face or contract amount (or notional principal amount if there is no face or contract amount)[2]

b. The nature and terms, including, at a minimum, a discussion of (1) the credit and market risk of those instruments, (2) the cash requirements of those instruments, and (3) the related accounting policy pursuant to the requirements of APB Opinion No. 22, Disclosure of Accounting Policies.

[1] In this Statement, *category of financial instrument* refers to class of financial instrument, business activity, risk, or other category that is consistent with the management of those instruments. If disaggregation of financial instruments is other than by class, the entity also shall describe for each category the classes of financial instruments included in that category.

[2] Disclosure of the face or contract amount of financial instruments, including those within the scope of Statement 105, may be misleading when the instruments are leveraged and the leverage features are not adequately disclosed. For example, the optional amounts of the interest rate swap may be misleading if the contract's settlement payments are based on a formula that multiplies the effect of interest rate changes. Disclosure of the nature and terms of those instruments requires a discussion of the leverage features and their general effects on (a) the credit and market risk, (b) the cash requirements, and (c) the related accounting policy.

9. The disclosures required in paragraph 8 of this Statement shall distinguish between derivative financial instruments held or issued for:

a. Trading purposes, including dealing and other trading activities measured at fair value with gains and losses recognized in earnings

b. Purposes other than trading.

10. Entities that hold or issue derivative financial instruments for trading purposes shall disclose, either in the body of the financial statements or in the accompanying notes, the following:

a. The average fair value of those derivative financial instruments during the reporting period[3], presented together with the related end-of-period fair value, distinguishing between assets and liabilities

b. The net gains or losses (often referred to as net trading revenues) arising from trading activities during the reporting period disaggregated by class, business activity, risk, or other category that is consistent with the management of those activities and where those net trading gains or losses are reported in the income statement. If the disaggregation is other than by class, the entity also shall describe for each category the classes of derivative financial instruments, other financial instruments, and nonfinancial assets and liabilities from which the net trading gains or losses arose.

[3] The calculation based on average fair value based on daily balances is preferable to a calculation based on less frequent intervals. It is, however, sufficient to disclose average fair value based on the most frequent interval that a trader's systems generate for management, regulatory, or other reasons.

11. Entities that hold or issue derivative financial instruments for purposes other than trading shall disclose the following:

a. A description of the entity's objectives for holding or issuing the derivative financial instruments, the context needed to understand those objectives, and its strategies for achieving those objectives, including the classes of derivative financial instruments used[4]

b. A description of how each class of derivative financial instrument is reported in the financial statements including the policies for recognizing (or reasons for not recognizing) and measuring the derivative financial instruments held or issued, and when recognized, where those instruments and related gains and losses are reported in the statements of financial position and income.

c. For derivative financial instruments that are held or issued and accounted for as hedges of anticipated transactions (both firm commitments and forecasted transactions for which there is no firm commitment), (1) a description of the anticipated transactions whose risks are hedged, including the period of time until the anticipated transactions are expected to occur, (2) a description of the classes of derivative financial instruments used to hedge the anticipated transactions, (3) the amount of hedging gains and losses explicitly deferred,[5] and (4) a description of the transactions or other events that result in the recognition in earnings of gains or losses deferred by hedge accounting.

12. Entities are encouraged, but not required, to disclose quantitative information about interest rate, foreign exchange, commodity price, or other market risks of derivative financial instruments that is consistent with the way the entity manages or adjusts those risks and that is useful for comparing the results of applying the entity's strategies to its objectives for holding or issuing the derivative financial instruments. Quantitative disclosures about the risks of derivative financial instruments are likely to be even more useful, and less likely to be perceived to be out of context or otherwise misunderstood, if similar information is disclosed about the risks of other financial instruments or nonfinancial assets and liabilities to which the derivative financial instruments are related by a risk management or other strategy.

13. Appropriate ways of reporting the quantitative information encouraged in paragraph 12 will differ for different entities and will likely evolve over time as management approaches and measurement techniques evolve. Possibilities include disclosing (a) more details about current positions and perhaps activity during the period, (b) the hypothetical effects on equity, or on annual income, of several possible changes in market prices, (c) a gap analysis of interest rate repricing or maturity dates, (d) the duration of the financial instruments, or (e) the entity's value at risk from derivative financial instruments and from other positions at the end of the reporting period and the average value at risk during the year. This list is not exhaustive, and entities are encouraged to develop other ways of reporting the quantitative information.

[4] For example, if an entity's objective for a derivative position is to keep a risk arising from the entity's nonderivative assets below a specified level, the context would be a description of those assets and their risk, and a strategy might be purchasing put options in a specified proportion to the assets at risk.

[5] For purposes of the disclosure of hedging gains and losses, the term *explicitly deferred* refers to deferrals in separate accounts in the manner required by *FASB Statement No. 80*, *Accounting for Futures Contract*, for hedges of anticipated transactions and by *FASB Statement No. 52*, *Foreign Currency Translation*, for hedges of firm commitments. Those deferrals are in contrast to implicit deferrals that are (a) embedded in related carrying amounts for hedges of recognized assets and liabilities or (b) not recorded because changes in the value of the hedging instrument are no recognized.

OTHER SOURCES OF INFORMATION

49. Excerpts from the Invested Asset Working Group of the Valuation of Securities (EX4) Task Force Meeting on June 2, 1996

> Derivatives Projects
>
> Ann Bottelli (Prudential Insurance) gave a report on four derivatives projects that had been ongoing in the Invested Asset Working Group. The first report dealt with a blanks proposal to add a column to Schedule DB Part E Section 1 dealing with off-balance sheet exposure for derivatives securities. This amount is needed for risk based capital calculations. Following Ms. Bottelli's comments, a motion was made and seconded to adopt the blanks proposal and send it on to the Blanks Task Force. That motion passed. (Attachment A)
>
> Ms. Bottelli next gave a report on the required disclosure for anticipatory hedging. The disclosure would bring NAIC disclosure in line with generally accepted accounting principles (GAAP) disclosure requirements for derivatives securities. Following Ms. Bottelli's comments on the reporting mechanisms, Larry Gorski (Ill.) pointed out that this report and blanks proposal was in no way an endorsement for the use of anticipatory hedging, which he pointed out is prohibited in certain states. Following Mr. Gorski's comments, a motion was made and seconded to adopt the blanks proposal and forward it to the Blanks Task Force. That motion passed. (Attachment B)
>
> Next, Ms. Bottelli gave a report dealing with guidance for the interest maintenance reserve (IMR) for hedging. This guidance will appear in the Financial Examiners Handbook and will deal with IMR gains and losses from derivative hedges. A motion was made and seconded to send this proposal to the Accounting Handbook and Instructions Working Group. That motion passed. (Attachment C)
>
> Finally, Ms. Bottelli gave a report dealing with the accounting for income generating derivative transactions. This report contained two blanks proposal items, as well as definitional material that should be added to the Accounting Practices and Procedures Handbook. Following Ms. Bottelli's comments, Mr. Gorski again pointed out that this report was in no way an endorsement of using derivatives for anything other than hedging purposes. Following some concerns by the working group members that they did not have sufficient time to review this proposal, a motion was made and seconded to receive the report by the working group. (Attachment D) That motion was passed by the working group. Ron Newton (Texas) asked if the two blanks proposals would be sent to the Blanks Task Force. Mr. Gorski responded that they would be held until a final review could be done by the Invested Asset Working Group members.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies and for Property and Casualty Insurance Companies, Chapter 8, *Other Admitted Assets*
- Annual Statement Instructions for Property and Casualty Insurance Companies
- Annual Statement Instructions for Life, Accident and Health Insurance Companies
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 81—Foreign Currency Transactions and Translations*
- Minutes of the December 14, 1996, meeting of the Financial Condition (EX4) Subcommittee (Minutes included the Executive Summary of the Income Generation Accounting Project dated July 10, 1996)

Generally Accepted Accounting Principles

- *FASB Statement No. 52, Foreign Currency Translation*
- *FASB Statement No. 80, Accounting for Futures Contracts*
- *FASB Statement No. 105, Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*
- *FASB Statement No. 107, Disclosure about Fair Value of Financial Instruments*
- *FASB Statement No. 119, Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments*
- *FASB Emerging Issues Task Force Issue No. 84-7, Termination of Interest Rate Swaps*
- *FASB Emerging Issues Task Force Issue No. 84-14, Deferred Interest Rate Setting*
- *FASB Emerging Issues Task Force Issue No. 84-36, Interest Rate Swap Transactions*
- *FASB Emerging Issues Task Force Issue No. 86-34, Futures Contracts Used as Hedges of Anticipated Reverse Repurchase Transactions*
- *FASB Emerging Issues Task Force Issue No. 87-2, Net Present Value Method of Valuing Speculative Exchange Contracts*
- *FASB Emerging Issues Task Force Issue No. 88-8, Mortgage Swaps*
- *FASB Emerging Issues Task Force Issue No. 90-17, Hedging Foreign Currency Risk with Purchased Options*
- *FASB Emerging Issues Task Force Issue No. 91-1, Hedging Intercompany Foreign Currency Risks*
- *FASB Emerging Issues Task Force Issue No. 91-4, Hedging Foreign Currency Risks with Complex Options and Similar Transactions*
- *FASB Emerging Issues Task Force Issue No. 96-11, Accounting for Forward Contracts and Purchase Options to Acquire Securities Covered Under FASB Statement No. 115*

Other Sources of Information

- Minutes of the June 2, 1996 meeting of the Invested Asset Working Group of the Valuation of Securities (EX4) Task Force

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Statutory Issue Paper No. 86

Securitization

STATUS
Finalized March 16, 1998

Current Authoritative Guidance for Securitization: SSAP No. 103
This issue paper may not be directly related to the current authoritative statement.

Original SSAP from Issue Paper: SSAP No. 33

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. An asset securitization is the process of converting assets which would normally serve as collateral for a loan into securities. The largest category of securitized assets is real estate mortgage loans which serve as collateral for mortgage-backed securities.

2. Current statutory guidance for asset securitizations is provided in the Minutes of the March 26, 1990 meeting of the Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force and in the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies (Life/A&H Accounting Practices and Procedures Manual), Chapter 17, Other Liabilities.

3. In June 1996 the Financial Accounting Standards Board issued *FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 125). This standard supersedes *FASB Statement No. 77, Reporting by Transferors for Transfers of Receivables with Recourse,* (FAS 77) and *FASB Technical Bulletin 85-2, Accounting for Collateralized Mortgage Obligations (CMOs)* (FTB 85-2). The types of transactions contemplated in the statement recognize recent innovations in the financial markets. It addresses transfers accomplished through securitizations as well as other types of transfers.

4. The purpose of this issue paper is to establish statutory accounting principles for asset securitizations and securitizations of policy acquisition costs that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts). This issue paper is not intended to address transfers accomplished by means other than securitization.

SUMMARY CONCLUSION

Accounting for Securitizations of Financial Assets

5. As used in this issue paper a financial asset shall be defined as cash, evidence of an ownership interest in an entity, or a contract that conveys both

a. Imposes on one entity a contractual obligation (i) to deliver cash or another financial instrument to a second entity or (ii) to exchange other financial instruments on potentially unfavorable terms with a second entity; and

b. Conveys to that second entity a contractual right (i) to receive cash or another financial instrument from the first entity or (ii) to exchange other financial instruments on potentially favorable terms with the first entity.

6. A securitization in which the transferor surrenders control over the financial asset transferred shall be accounted for as a sale, with recognition of proceeds and measurement of a gain or loss only to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The portion of the securitization for which beneficial interests in the transferred assets are received shall not be accounted for as a sale, but shall be treated as an exchange of assets with no measurement of a gain or loss. All other securitizations shall be accounted for as secured borrowings in accordance with paragraph 13.

7. The transferor has surrendered control if, and only if, all of the following conditions are met:

a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.

b. The transferee is a qualifying special-purpose entity and the holders of beneficial interests in that entity have the right— free of transferor-imposed conditions that constrain them from taking advantage of that right—to pledge or exchange those interests.

c. The transferor does not maintain effective control over the transferred assets through (1) an agreement that entitles and obligates the transferor to repurchase or redeem them before their maturity or (2) an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable.

8. A beneficial interest shall be defined as the right to receive all or portions of specified cash inflows to a trust or other entity, including senior and subordinated shares of interest or principal inflows to be “passed through” or “paid through,” premiums due guarantors, and residual interests. Residual interests are interests in the cash flows of the trust or other entity, after the cash flows of structured securities issued by the trust are met.

9. Upon completion of the securitization of financial assets meeting the criteria for sales treatment required by paragraph 7, the transferor shall:

a. Eliminate the transferred assets from the statement of financial position.

b. Allocate the previous carrying amount of the transferred assets to the securities representing beneficial interests retained by the reporting entity, if any, and the securities representing beneficial interests not retained, if any, based on the relative fair values of the transferred assets at the date of transfer.

c. Record in its statement of financial position, the allocated carrying value of the securities representing retained beneficial interests in the assets (e.g., loan-backed securities).

d. Recognize all additional assets obtained (i.e., other than the securities representing retained beneficial interests which are recorded in accordance with 9.c.) and liabilities incurred in consideration as proceeds of the sale.

e. Initially measure such additional assets obtained and liabilities incurred in the sale at fair value.

f. For reporting entities required to maintain an Interest Maintenance Reserve (IMR), the accounting for realized capital gains and losses shall be in accordance with *Issue Paper No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*. For reporting entities not required to maintain an IMR, realized gains and losses shall be reported as net realized capital gains or losses in the Investment Income section of the Underwriting and Investment Exhibit.

10. The successor (transferee) shall recognize all assets obtained and any liabilities incurred and initially measure them at fair value.

11. A qualifying special-purpose entity (including CMO special-purpose entities) as used in this issue paper must meet all of the following conditions:

a. It is a trust, corporation, or other legal vehicle whose activities are permanently limited by the legal documents establishing the special-purpose entity to:

1. Holding title to transferred financial assets
2. Issuing beneficial interests (If some of the beneficial interests are in the form of debt securities or equity securities, the transfer of assets is a securitization.)
3. Collecting cash proceeds from assets held, reinvesting proceeds in financial instruments pending distribution to holders of beneficial interests, and otherwise servicing the assets held
4. Distributing proceeds to the holders of its beneficial interests.

b. It has a standing at law distinct from the transferor. Having standing at law depends in part on the nature of the special-purpose entity. For example, generally, under U.S. law, if a transferor of assets to a special-purpose trust holds all of the beneficial interests, it can unilaterally dissolve the trust, and thereby resume control over the individual assets held in the trust, and the transferor can effectively assign its interest and its creditors can reach it. In that circumstance, the trust has no standing at law, is not distinct, and thus is not a qualified special-purpose entity. A special-purpose entity that has distinct standing at law may still be an affiliate of the transferor.

Investments in Special-Purpose Entities

12. Reporting entities that have qualifying special-purpose entities as affiliates shall carry their investment in such entity at its underlying statutory book value in accordance with *Issue Paper No. 46—Accounting for Investments in Subsidiary, Controlled and Affiliated Entities.* Additionally, transactions entered involving affiliated qualifying special-purpose entities are subject to the provisions of *Issue Paper No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties*.

Secured Obligations and Collateral

13. Securitizations of financial assets that do not meet the criteria for sale treatment set forth in paragraph 7 shall be presumed to be secured borrowings and shall be recorded as follows. Financial assets shall remain on the reporting entity's books and a liability shall be recorded to reflect the proceeds from the issuance of any type of certificate. Non-cash proceeds shall be recorded as a contra liability and netted against the liability. The liability shall be reduced as the obligation to holders of beneficial interests is repaid. Financial assets pledged as collateral shall not be offset against the liability reflecting the proceeds of the transaction.

Recognition of Servicing Rights

14. Servicing rights become a distinct asset or liability only when contractually separated from the underlying assets by sale or securitization of the assets with servicing retained or separate purchase or assumption of the servicing. If distinct servicing rights to transferred assets exist and are retained by the reporting entity, the reporting entity shall recognize a servicing asset or liability. When the servicing fees to be received exceed the cost of servicing the transferred assets, a servicing asset is recognized and nonadmitted. When the cost of servicing the transferred assets is greater than the servicing fees to be received, a liability shall be recorded for the excess to recognize this obligation. A corresponding loss shall be recorded through the income statement. The servicing asset or liability shall be amortized into income in proportion to, and over the period of estimated servicing income (if an asset) or estimated

servicing loss (if a liability). The servicing asset or liability shall be measured in a manner consistent with paragraphs 13 and 35-38 of FAS 125.

Sales of Future Revenues

15. In addition to securitization of assets, some reporting entities have entered into transactions characterized as a sale of future revenues. These transactions are sometimes referred to as securitizations and are sometimes characterized as selling deferred acquisition costs. A sale of future revenues by a reporting entity shall not result in the immediate recognition of income or surplus. The proceeds of any such sale shall be established as a liability and shall be reduced as the proceeds are repaid.

DISCUSSION

16. The conclusions reached in this issue paper are consistent with the statutory guidance set forth in the minutes of the March 26, 1990 meeting of the Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force (Emerging Accounting Issues Working Group) which address securitization of mortgage loans and mortgage-backed securities except that the gain on sale shall be recognized immediately rather than deferred and amortized over the life of the retained interests. This issue paper is also consistent with the minutes of the February 21, 1992 meeting of the Emerging Accounting Issues Working Group which addressed financings secured by mortgage loans which have related repurchase agreements.

17. This issue paper adopts FAS 125, with the following modifications:

a. This issue paper requires servicing rights assets to be nonadmitted.

b. This issue paper does not permit sales treatment for transactions where recourse provisions exist or where “call” or “put” options exist on the transferred assets whereas GAAP would permit the recognition of the transfer as a sale under some circumstances.

c. This issue paper requires debtors to provide disclosure when a secured party is permitted to sell or pledge financial assets transferred as collateral whereas FAS 125 requires the encumbered assets to be reported separately from unencumbered assets.

d. This issue paper does not address transfers of financial assets accomplished in a manner other than through securitizations whereas FAS 125 does address such transfers.

e. Paragraph 14 is rejected as it is not applicable.

18. With respect to securitizations meeting the criteria of paragraph 7, statutory and GAAP do not recognize as a sale, any portion of the transfer for which securities representing beneficial interests in the transferred assets (e.g., CMOs) are obtained by the transferor. Statutory and GAAP do recognize that the securitized assets (e.g., mortgages) are no longer assets of the reporting entity and that the reporting entity has essentially replaced the transferred assets with securities representing a beneficial interest in the transferred assets.

19. This paper is consistent with GAAP in that the securities representing the retained beneficial interests are recorded by the reporting entity in the statement of financial position at their allocated carrying value, since the securities represent a continuing control over a previous asset, albeit in a different form. Thus, no gain or loss is recognized on the retained beneficial interest.

20. The guidance set forth in this issue paper with respect to reporting pledged collateral and the related liability for the proceeds received from transactions not recognized as sales on a gross basis and not offsetting those amounts is consistent with the guidance set forth in *Issue Paper No. 76—Offsetting and Netting of Assets and Liabilities.*

21. This issue paper is consistent with the current statutory guidance provided in the Life/A&H Accounting Practices and Procedures Manual. Recording the proceeds received currently for future revenue as a liability is consistent with the concepts of conservatism and recognition in the Statement of Concepts.

22. While servicing rights meet the definition of an asset, they do not meet the definition of an admitted asset. The conclusion to nonadmit the asset is consistent with the concept of conservatism in the Statement of Concepts.

Drafting Notes/Comments

- Extinguishment of debt is addressed in *Issue Paper No. 80—Debt*.
- Levelized commissions are addressed in *Issue Paper No. 71—Policy Acquisition Costs and Commissions*.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

23. The Life/A&H Accounting Practices and Procedures Manual, Chapter 17, Other Liabilities, provides the following guidance with respect to the sale of future revenue.

> Sale of Future Revenues
>
> The immediate recognition of proceeds from certain transactions characterized as “sale” of future revenues in income and/or surplus has been determined to be inappropriate for purposes of statutory reporting. These transactions are sometimes referred to as “securitization” and are sometimes characterized as selling “deferred acquisition costs”. Accordingly, a liability should be established for the amount of proceeds, which shall be reduced as the proceeds are repaid.

24. The Minutes of the March 26, 1990 meeting of the Emerging Accounting Issues Working Group provide the following guidance.

> Accounting for Real Estate Mortgage Investment Conduits (REMIC’s)
>
> The subject of accounting for REMIC’s (Real Estate Mortgage Investment Conduits) has been discussed or deferred at a number of meetings of the working group. It was discussed briefly at the October 13, 1988 meeting (EI 88–4) and in greater detail at subsequent meetings. An issue summary prepared by Norris Clark (Attachment A) was used as the initial basis for discussion.
>
> Under the Tax Reform Act of 1986, mortgages may be placed in trust and certificates, junior and senior, may be issued. Certificate holders are entitled to receive a proportionate share of the payments made on the underlying pool of mortgages. This mortgage pass–through may be treated as a Real Estate Mortgage Investment conduit (REMIC) under the act. Generally an insurer will transfer a pool of mortgages to the trust and receive the Senior Certificates (seniors) and Junior Certificates (juniors). The seniors are then offered to the public at a somewhat lower interest rate than the pool will produce. The insurer will retain the juniors, at least initially. Rights to receive payment on the juniors will be subordinate to the rights of the seniors. A third type of instrument, a residual instrument, may also be part of the REMIC. This part may be very small.

At its June 5, 1989 meeting (89–2), the working group reached conclusions on the following two issues relating to REMIC's:

1. If an insurer holds a junior, how should it report its holdings, as a bond or equity or some other form of security?

   It was the consensus of the working group that the holding of a junior should be reported as a bond.

2. If a junior is a bond, how should it be valued?

   The consensus of the working group was that it should be valued in accordance with procedures established by the NAIC Securities Valuation Office. (However, this conclusion was modified by the group during its March 26, 1990 meeting. See Number 3. below.)

   A third issue was also discussed at the June 5, 1989 meeting (EI 89–2) and at subsequent meetings of the working group. At the December 4, 1989 meeting (EI 89–4) the working group reviewed a paper (Attachment B) in the form of an issue summary prepared by Ransom Jones of Goldman, Sachs. Mr. Jones and Katherine Mason agreed to illustrate a transaction for the March 1990 meeting (Attachment C). Mr. Clark also provided an illustration (Attachment D) of the transaction which had been the impetus for his original issue summary.

   Following a discussion of the material provided, the working group reached the following conclusions on accounting for these transactions:

1. How should the allocated basis of each of the layers or tranches be determined?

   The consensus of the working group was that fair market value should be used in determining the allocated basis for each tranche.

2. Should the exchange of mortgages and the issuing of securities be considered a sale and should a gain or loss be recognized?

   The group agreed that the transaction should be considered a sale. It further agreed that any gain or loss arising from the sale of the senior tranche should be recognized. The working group concluded loss, if any, should be recognized immediately. A gain on the sale should be deferred and amortized over the life of the juniors and residuals but in no event faster than the risk retained by the insurer is eliminated.

3. At what value should the juniors and/or residuals be carried by the insurer?

   It was the consensus of the working group that juniors and residuals should initially be carried at their allocated book value. They should be amortized as cash is received and should be periodically assessed as to realizability and valued downward.

25. The minutes of the February 21, 1992, meeting of the Emerging Accounting Issues Working Group provide the following guidance.

Accounting for Financing Secured by Mortgage Loans

This issue was previously discussed under the caption "Secured Borrowing" during the September 16, 1991 and December 9, 1991 meetings (EI 91-3 and EI 91-4). An issue summary was prepared for this meeting but was revised, particularly with respect to the accounting issues, during the meeting (See Attachment D).

This is an arrangement that creates participation interests in a block of existing mortgage loans for the purposes of utilizing such interests as collateralization for obtaining temporary financing.

Specifically, an insurer (the “transferor”) transfers a designated portion of its portfolio of mortgage loans to a grantor trust. In exchange, the transferor receives mortgage pass-through certificates evidencing one hundred percent beneficial ownership of the trust and the underlying mortgage loans. This phase of the transaction is effected by a pooling and servicing agreement between the transferor and the transferee.

The transaction utilizes a senior/subordinated structure for the transferee. One or more classes of certificates has a senior or first priority lien on the mortgage loan cash flows. One or more classes of subordinated certificates has a subordinated lien on the assets of the trust. The creation of the subordinated certificates may allow the senior certificates to obtain an investment grade rating from various rating agencies.

In the second phase of the transaction, the transferor enters into a reverse repurchase facility with a financier providing cash for liquidity. This facility is initially in place for one year (with an option by the transferor for an additional year) and will allow the transferor to enter into discrete repurchase transactions for the sale to the financier and subsequent repurchase by the transferor of the higher rated certificates held by the transferor pursuant to the first phase.

An individual repurchase transaction, as drawn on the line of credit provided by the financier, may be for a term as short as overnight or as long as two years. Each transaction is required to be over-collateralized by an amount which will vary relative to the length of the term of the particular sale/repurchase. The certificates that are transferred and serve as collateral remain registered in the name of the transferor, and principal and interest payments thereon shall, absent foreclosure, be for the account of the transferor. At such times as the transferor has satisfied its obligation to the financier under the repurchase facility, the transferor holds the certificates free and clear of any liens.

In the event that the transferor fails to make a required payment of the repurchase price or if the transferor is the subject of insolvency proceedings, then an event of default occurs which enables the financier to foreclose on the collateral and pay itself back the amount of such borrowings. Any collateral remaining would be returned to the transferor.

Preliminary, the working group identified the following issues and reached the following conclusions:

1. Is the transfer of mortgages to the trust a non-economic event?

   Yes. The transaction would be non-economic because an economic event requires a permanent transfer of the risks and rewards of ownership as defined by FAS 77.

2. How should the ownership of the mortgages be accounted for on the balance sheet of the transferor?

   The mortgages should continue to be reported on the balance sheet at the transferor's carrying value, continue to be amortized, and continue to be reported on Schedule B with disclosure in the Notes to the Financial Statements. Each mortgage which has been transferred to the trust should be denoted with a 'c' to indicate its use as collateral as described on page 2-1 of the NAIC Annual Statement Instructions for Life, Accident and Health Insurance Companies and the Instructions for Fire and Casualty Insurance Companies.

   Disclosure in the Notes to the Financial Statements should include the number and dollar amounts of mortgages transferred to the trust by type, dollar amounts of the senior and junior certificates, and the life of the trust. Appropriate disclosure should also be made, as applicable, in the General Interrogatories of the Annual Statement. Since the mortgages continue on the books of the insurer/transferor under their previous classifications, no assets or liabilities are shown by the company for the trust.

3. How should an insurance company account for borrowings under this type of arrangement?

The borrowing transaction would result in an increase in cash or cash equivalents, and a like increase in the liability, borrowed money.

A disclosure should be made in the Notes to the Financial Statement as required for “Borrowed Money”.

Because of the interest of and certain concerns raised by industry observers at the meeting, the chairman agreed to expose the foregoing preliminary conclusions through these minutes. Final adoption of conclusions by the working group will be made at the June 1992 meeting.

In addition, proposed Accounting Manual language was developed by the working group. The proposed language (for exposure) is attached as Attachment E.

Generally Accepted Accounting Principles

26. *FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* provides the following guidance:

> Accounting for Transfers and Servicing of Financial Assets
>
> 9. A transfer of financial assets (or all or a portion of a financial asset) in which the transferor surrenders control over those financial assets shall be accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if and only if all of the following conditions are met:
>
> a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership (paragraphs 23 and 24).
>
> b. Either (1) each transferee obtains the right—free of conditions that constrain it from taking advantage of that right (paragraph 25)—to pledge or exchange the transferred assets or (2) the transferee is a qualifying special-purpose entity (paragraph 26) and the holders of beneficial interests in that entity have the right—free of conditions that constrain them from taking advantage of that right (paragraph 25)—to pledge or exchange those interests.
>
> c. The transferor does not maintain effective control over the transferred assets through (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (paragraphs 27-29) or (2) an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable (paragraph 30).
>
> 10. Upon completion of any transfer of financial assets, the transferor shall:
>
> a. Continue to carry in its statement of financial position any retained interest in the transferred assets, including, if applicable, servicing assets (paragraphs 35-41), beneficial interests in assets transferred to a qualifying special-purpose entity in a securitization (paragraphs 47-58), and retained undivided interests (paragraph 33)
>
> b. Allocate the previous carrying amount between the assets sold, if any, and the retained interests, if any, based on their relative fair values at the date of transfer (paragraphs 31-34).
>
> 11. Upon completion[3] of a transfer of assets that satisfies the conditions to be accounted for as a sale (paragraph 9), the transferor (seller) shall:
>
> a. Derecognize all assets sold
>
> b. Recognize all assets obtained and liabilities incurred in consideration as proceeds of the sale, including cash, put or call options held or written (for

example, guarantee or recourse obligations), forward commitments (for example, commitments to deliver additional receivables during the revolving periods of some securitizations), swaps (for example, provisions that convert interest rates from fixed to variable), and servicing liabilities, if applicable (paragraphs 31, 32, and 35-41)

c. Initially measure at fair value assets obtained and liabilities incurred in a sale (paragraphs 42-44) or, if it is not practicable to estimate the fair value of an asset or a liability, apply alternative measures (paragraphs 45 and 46)

d. Recognize in earnings any gain or loss on the sale.

The transferee shall recognize all assets obtained and any liabilities incurred and initially measure them at fair value (in aggregate, presumptively the price paid).

[3] Although a transfer of securities may not be considered to have reached completion until the settlement date, this Statement does not modify other generally accepted accounting principles, including FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, and AICPA Statements of Position and audit and accounting Guides for certain industries, that require accounting at the trade date for certain contracts to purchase or sell securities.

12. If a transfer of financial assets in exchange for cash or other consideration (other than beneficial interests in the transferred assets) does not meet the criteria for a sale in paragraph 9, the transferor and transferee shall account for the transfer as a secured borrowing with pledge of collateral (paragraph 15).

Recognition and Measurement of Servicing Assets and Liabilities

13. Each time an entity undertakes an obligation to service financial assets it shall recognize either a servicing asset or a servicing liability for that servicing contract, unless it securitizes the assets, retains all of the resulting securities, and classifies them as debt securities held-to-maturity in accordance with FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities. If the servicing asset or liability was purchased or assumed rather than undertaken in a sale or securitization of the financial assets being serviced, it shall be measured initially at its fair value, presumptively the price paid. A servicing asset or liability shall be amortized in proportion to and over the period of estimated net servicing income (if servicing revenues exceed servicing costs) or net servicing loss (if servicing costs exceed servicing revenues). A servicing asset or liability shall be assessed for impairment or increased obligation based on its fair value (paragraphs 35-38).

Financial Assets Subject to Prepayment

14. Interest-only strips, loans, other receivables, or retained interests in securitizations that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment shall be subsequently measured like investments in debt securities classified as available-for-sale or trading under Statement 115, as amended by this Statement (paragraph 233).[4]

[4] As a result of that amendment to Statement 115, securities that were previously classified as held-to-maturity may need to be reclassified. Reclassifications of interest-only strips or other securities from held-to-maturity to available-for-sale required to initially apply this Statement would not call into question an entity's intent to hold other debt securities to maturity in the future.

Secured Borrowings and Collateral

15. A debtor may grant a security interest in certain assets to a lender (the secured party) to serve as collateral for its obligation under a borrowing, with or without recourse to other assets of the debtor. An obligor under other kinds of current or potential obligations, for example, interest rate swaps, also may grant a security interest in certain assets to a secured party. If collateral is transferred to the secured party, the custodial arrangement is commonly referred to as a pledge. Secured parties sometimes are permitted to sell or repledge (or otherwise transfer) collateral held under a pledge. The same relationships occur, under different names, in transfers documented as sales that are accounted for as secured borrowings (paragraph 12). The accounting for collateral by the debtor (or obligor) and the secured party depends on whether the secured party has taken control over the collateral and on the rights and obligations that result from the collateral arrangement:

a. If (1) the secured party is permitted by contract or custom to sell or repledge the collateral and (2) the debtor does not have the right and ability to redeem the collateral on short notice, for example, by substituting other collateral or terminating the contract, then

   (i) The debtor shall reclassify that asset and report that asset in its statement of financial position separately (for example, as securities receivable from broker) from other assets not so encumbered.

   (ii) The secured party shall recognize that collateral as its asset, initially measure it at fair value, and also recognize its obligation to return it.

b. If the secured party sells or repledges collateral on terms that do not give it the right and ability to repurchase or redeem the collateral from the transferee on short notice and thus may impair the debtor's right to redeem it, the secured party shall recognize the proceeds from the sale or the asset repledged and its obligation to return the asset to the extent that it has not already recognized them. The sale or repledging of the asset is a transfer subject to the provisions of this Statement.

c. If the debtor defaults under the terms of the secured contract and is no longer entitled to redeem the collateral, it shall derecognize the collateral, and the secured party shall recognize the collateral as its asset to the extent it has not already recognized it and initially measure it at fair value.

d. Otherwise, the debtor shall continue to carry the collateral as its asset, and the secured party shall not recognize the pledged asset.

Extinguishments of Liabilities

16. A debtor shall derecognize a liability if and only if it has been extinguished. A liability has been extinguished if either of the following conditions is met:

a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes delivery of cash, other financial assets, goods, or services or reacquisition by the debtor of its outstanding debt securities whether the securities are canceled or held as so-called treasury bonds.

b. The debtor is legally released[5] from being the primary obligor under the liability, either judicially or by the creditor.

[5] If nonrecourse debt (such as certain mortgage loans) is assumed by a third party in conjunction with the sale of an asset that serves as sole collateral for that debt, the sale and related assumption effectively accomplish a legal release of the seller-debtor for purposes of applying this Statement.

Disclosures

17. An entity shall disclose the following:

a. If the entity has entered into repurchase agreements or securities lending transactions, its policy for requiring collateral or other security

b. If debt was considered to be extinguished by in-substance defeasance under the provisions of FASB Statement No. 76, Extinguishment of Debt, prior to the effective date of this Statement, a general description of the transaction and the amount of debt that is considered extinguished at the end of the period so long as that debt remains outstanding

c. If assets are set aside after the effective date of this Statement solely for satisfying scheduled payments of a specific obligation, a description of the nature of restrictions placed on those assets

d. If it is not practicable to estimate the fair value of certain assets obtained or liabilities incurred in transfers of financial assets during the period, a description of those items and the reasons why it is not practicable to estimate their fair value

e. For all servicing assets and servicing liabilities:

   (1) The amounts of servicing assets or liabilities recognized and amortized during the period

   (2) The fair value of recognized servicing assets and liabilities for which it is practicable to estimate that value and the method and significant assumptions used to estimate the fair value

   (3) The risk characteristics of the underlying financial assets used to stratify recognized servicing assets for purposes of measuring impairment in accordance with paragraph 37

   (4) The activity in any valuation allowance for impairment of recognized servicing assets—including beginning and ending balances, aggregate additions charged and reductions credited to operations, and aggregate direct write-downs charged against the allowances—for each period for which results of operations are presented.

Isolation beyond the Reach of the Transferor and Its Creditors

23. The nature and extent of supporting evidence required for an assertion in financial statements that transferred financial assets have been isolated—put presumptively beyond the reach of the transferor and its creditors, either by a single transaction or a series of transactions taken as a whole—depend on the facts and circumstances. All available evidence that either supports or questions an assertion shall be considered. That consideration includes making judgments about whether the contract or circumstances permit the transferor to revoke the transfer. It also may include making judgments about the kind of bankruptcy or other receivership into which a transferor or special-purpose entity might be placed, whether a transfer of financial assets would likely be deemed a true sale at law, whether the transferor is affiliated with the transferee, and other factors pertinent under applicable law. Derecognition of transferred assets is appropriate only if the available evidence provides reasonable assurance that the transferred assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any of its affiliates, except for an affiliate that is a qualifying special-purpose entity designed to make remote the possibility that it would enter bankruptcy or other receivership (paragraph 57.c.).

24. Whether securitizations isolate transferred assets may depend on such factors as whether the securitization is accomplished in one step or two steps (paragraphs 54-58). Many common financial transactions, for example, typical repurchase agreements and securities lending transactions, isolate transferred assets from the transferor, although they may not meet the other criteria for surrender of control.

Conditions That Constrain a Transferee

25. Many transferor-imposed or other conditions on a transferee's contractual right to pledge or exchange a transferred asset constrain a transferee from taking advantage of that right. However, a transferor's right of first refusal on a bona fide offer from a third party, a requirement to obtain the transferor's permission to sell or pledge that shall not be unreasonably withheld, or a prohibition on sale to the transferor's competitor generally does not constrain a transferee from pledging or exchanging the asset and, therefore, presumptively does not preclude a transfer containing such a condition from being accounted for as a sale. For example, a prohibition on

sale to the transferor's competitor would not constrain the transferee if it were able to sell the transferred assets to a number of other parties; however, it would be a constraint if that competitor were the only potential willing buyer.

Qualifying Special-Purpose Entity

26. A qualifying special-purpose entity[7] must meet both of the following conditions:

a. It is a trust, corporation, or other legal vehicle whose activities are permanently limited by the legal documents establishing the special-purpose entity to:
   (1) Holding title to transferred financial assets
   (2) Issuing beneficial interests (If some of the beneficial interests are in the form of debt securities or equity securities, the transfer of assets is a securitization.)
   (3) Collecting cash proceeds from assets held, reinvesting proceeds in financial instruments pending distribution to holders of beneficial interests, and otherwise servicing the assets held
   (4) Distributing proceeds to the holders of its beneficial interests.

b. It has standing at law distinct from the transferor. Having standing at law depends in part on the nature of the special-purpose entity. For example, generally, under U.S. law, if a transferor of assets to a special-purpose trust holds all of the beneficial interests, it can unilaterally dissolve the trust and thereby reassume control over the individual assets held in the trust, and the transferor "can effectively assign his interest and his creditors can reach it."[8] In that circumstance, the trust has no standing at law, is not distinct, and thus is not a qualifying special-purpose entity.

[7] The description of a special-purpose entity is restrictive. The accounting for transfers of financial assets to special-purpose entities should not be extended to any entity that does not satisfy all of the conditions articulated in this paragraph.

[8] *Scott's Abridgment of the Law on Trusts,* §156 (Little, Brown and Company, 1960), 296.

Agreements That Maintain Effective Control over Transferred Assets

27. An agreement that both entitles and obligates the transferor to repurchase or redeem transferred assets from the transferee maintains the transferor's effective control over those assets, and the transfer is therefore to be accounted for as a secured borrowing, if and only if all of the following conditions are met:

a. The assets to be repurchased or redeemed are the same or substantially the same as those transferred (paragraph 28).
b. The transferor is able to repurchase or redeem them on substantially the agreed terms, even in the event of default by the transferee (paragraph 29).
c. The agreement is to repurchase or redeem them before maturity, at a fixed or determinable price.
d. The agreement is entered into concurrently with the transfer.

28. To be substantially the same,[9] the asset that was transferred and the asset that is to be repurchased or redeemed need to have all of the following characteristics:

[9] In this Statement, the term substantially the same is used consistently with the usage of that term in the AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position.

a. The same primary obligor (except for debt guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and the terms of the guarantee must be the same)
b. Identical form and type so as to provide the same risks and rights
c. The same maturity (or in the case of mortgage-backed pass-through and pay-through securities have similar remaining weighted-average maturities that result in approximately the same market yield)
d. Identical contractual interest rates
e. Similar assets as collateral
f. The same aggregate unpaid principal amount or principal amounts within accepted "good delivery" standards for the type of security involved.

29. To be able to repurchase or redeem assets on substantially the agreed terms, even in the event of default by the transferee, a transferor must at all times during the contract term have obtained cash or other collateral sufficient to fund substantially all of the cost of purchasing replacement assets from others.

30. A call option or forward contract that entitles the transferor to repurchase, prior to maturity, transferred assets not readily obtainable elsewhere maintains the transferor's effective control, because it would constrain the transferee from exchanging those assets, unless it is only a cleanup call.

Measurement of Interests Held after a Transfer of Financial Assets

Assets Obtained and Liabilities Incurred as Proceeds

31. The proceeds from a sale of financial assets consist of the cash and any other assets obtained in the transfer less any liabilities incurred. Any asset obtained that is not an interest in the transferred asset is part of the proceeds from the sale. Any liability incurred, even if it is related to the transferred assets, is a reduction of the proceeds. Any derivative financial instrument entered into concurrently with a transfer of financial assets is either an asset obtained or a liability incurred and part of the proceeds received in the transfer. All proceeds and reductions of proceeds from a sale shall be initially measured at fair value, if practicable.

Retained Interests

33. Other interests in transferred assets—those that are not part of the proceeds of the transfer—are retained interests over which the transferor has not relinquished control. They shall be measured at the date of the transfer by allocating the previous carrying amount between the assets sold, if any, and the retained interests, based on their relative fair values. That procedure shall be applied to all transfers in which interests are retained, even those that do not qualify as sales. Examples of retained interests include securities backed by the transferred assets, undivided interests, servicing assets, and cash reserve accounts and residual interests in securitization trusts. If a transferor cannot determine whether an asset is a retained interest or proceeds from the sale, the asset shall be treated as proceeds from the sale and accounted for in accordance with paragraph 31.

Servicing Assets and Liabilities

35. Servicing of mortgage loans, credit card receivables, or other financial assets includes, but is not limited to, collecting principal, interest, and escrow payments from borrowers; paying taxes and insurance from escrowed funds; monitoring delinquencies; executing foreclosure if necessary; temporarily investing funds pending distribution; remitting fees to guarantors, trustees, and others providing services; and accounting for and remitting principal and interest payments to the holders of beneficial interests in the financial assets. Servicing is inherent in all financial assets; it becomes a distinct asset or liability only when contractually separated from the underlying assets by sale or securitization of the assets with servicing retained or separate purchase or assumption of the servicing.

36. An entity that undertakes a contract to service financial assets shall recognize either a servicing asset or a servicing liability, unless the transferor securitizes the assets, retains all of the resulting securities, and classifies them as debt securities held-to-maturity in accordance with Statement 115, in which case the servicing asset or liability may be reported together with the asset being serviced. Each sale or securitization with servicing retained or separate purchase or assumption of servicing results in a servicing contract. A servicer of financial assets commonly receives the benefits of servicing—revenues from contractually specified servicing fees, late charges, and other ancillary sources, including “float,” all of which it is entitled to receive only if it performs the servicing—and incurs the costs of servicing the assets. Each servicing contract results in a servicing asset or servicing liability. Typically, the benefits of servicing are expected to be more than adequate compensation to the servicer for performing the servicing, and the contract results in a servicing asset. However, if the benefits of servicing are not expected to adequately compensate the servicer for performing the servicing, the contract results in a servicing liability.

37. A servicer that recognizes a servicing asset or servicing liability shall account for the contract to service financial assets separately from those assets, as follows:

a. Report servicing assets separately from servicing liabilities in the statement of financial position (paragraph 13).

b. Initially measure servicing assets retained in a sale or securitization of the assets being serviced at their allocated previous carrying amount based on relative fair values, if practicable, at the date of the sale or securitization (paragraphs 10, 33, 34, and 42-46).

c. Initially measure servicing assets purchased or servicing liabilities assumed at fair value (paragraph 13).

d. Initially measure servicing liabilities undertaken in a sale or securitization at fair value, if practicable (paragraphs 11.b., 11.c., and 42-46).

e. Account separately for rights to future interest income from the serviced assets that exceeds contractually specified servicing fees. Those rights are not servicing assets; they are financial assets, effectively interest-only strips to be accounted for in accordance with paragraph 14 of this Statement.

f. Subsequently measure servicing assets by amortizing the amount recognized in proportion to and over the period of estimated net servicing income—the excess of servicing revenues over servicing costs (paragraph 13).

g. Subsequently evaluate and measure impairment of servicing assets as follows:

(1) Stratify servicing assets based on one or more of the predominant risk characteristics of the underlying financial assets. Those characteristics may include financial asset type,[10] size, interest rate, date of origination, term, and geographic location.

[10] For example, for mortgage loans, financial asset type refers to the various conventional or government guaranteed or insured mortgage loans and adjustable-rate or fixed-rate mortgage loans.

(2) Recognize impairment through a valuation allowance for an individual stratum. The amount of impairment recognized shall be the amount by which the carrying amount of servicing assets for a stratum exceeds their fair value. The fair value of servicing assets that have not been recognized shall not be used in the evaluation of impairment.

(3) Adjust the valuation allowance to reflect changes in the measurement of impairment subsequent to the initial measurement of impairment. Fair value in excess of the carrying amount of servicing assets for that stratum, however, shall not be recognized. This Statement does not address when an entity should record a direct write-down of recognized servicing assets (paragraph 13).

h. Subsequently measure servicing liabilities by amortizing the amount recognized in proportion to and over the period of estimated net servicing loss—the excess of servicing costs over servicing revenues. However, if subsequent events have increased the fair value of the liability above the carrying amount, for example, because of significant changes in the amount or timing of actual or expected future cash flows from the cash flows previously projected, the servicer shall revise its earlier estimates and recognize the increased obligation as a loss in earnings (paragraph 13).

38. As indicated above, transferors sometimes agree to take on servicing responsibilities when the future benefits of servicing are not expected to adequately compensate them for performing that servicing. In that circumstance, the result is a servicing liability rather than a servicing asset.

Fair Value

42. The fair value of an asset (or liability) is the amount at which that asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available. If a quoted market price is available, the fair value is the product of the number of trading units times market price.

43. If quoted market prices are not available, the estimate of fair value shall be based on the best information available in the circumstances. The estimate of fair value shall consider prices for similar assets and liabilities and the results of valuation techniques to the extent available in the circumstances. Examples of valuation techniques include the present value of estimated expected future cash flows using a discount rate commensurate with the risks involved, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis. Valuation techniques for measuring financial assets and liabilities and servicing assets and liabilities shall be consistent with the objective of measuring fair value. Those techniques shall incorporate assumptions that market participants would use in their estimates of values, future revenues, and future expenses, including assumptions about interest rates, default, prepayment, and volatility. In measuring financial liabilities and servicing liabilities at fair value by discounting estimated future cash flows, an objective is to use discount rates at which those liabilities could be settled in an arm's-length transaction.

44. Estimates of expected future cash flows, if used to estimate fair value, shall be the best estimate based on reasonable and supportable assumptions and projections. All available evidence shall be considered in developing estimates of expected future cash flows. The weight given to the evidence shall be commensurate with the extent to which the evidence can be verified objectively. If a range is estimated for either the amount or timing of possible cash flows, the likelihood of possible outcomes shall be considered in determining the best estimate of future cash flows.

If It Is Not Practicable to Estimate Fair Value

45. If it is not practicable to estimate the fair values of assets, the transferor shall record those assets at zero. If it is not practicable to estimate the fair values of liabilities, the transferor shall recognize no gain on the transaction and shall record those liabilities at the greater of:

a. The excess, if any, of (1) the fair values of assets obtained less the fair values of other liabilities incurred, over (2) the sum of the carrying values of the assets transferred

b. The amount that would be recognized in accordance with FASB Statement No. 5, Accounting for Contingencies, as interpreted by FASB Interpretation No. 14, Reasonable Estimation of the Amount of a Loss.

Securitizations

47. Financial assets such as mortgage loans, automobile loans, trade receivables, credit card receivables, and other revolving charge accounts are assets commonly transferred in securitizations. Securitizations of mortgage loans may include pools of single-family residential mortgages or other types of real estate mortgage loans, for example, multifamily residential mortgages and commercial property mortgages. Securitizations of loans secured by chattel mortgages on automotive vehicles as well as other equipment (including direct financing or sales-type leases) also are common. Both financial and nonfinancial assets can be securitized; life insurance policy loans, patent and copyright royalties, and even taxi medallions also have been securitized. But securitizations of nonfinancial assets are outside the scope of this Statement.

48. An originator of a typical securitization (the transferor) transfers a portfolio of financial assets to a special-purpose entity, commonly a trust. In "pass-through" and "pay-through" securitizations, receivables are transferred to the special-purpose entity at the inception of the securitization, and no further transfers are made; all cash collections are paid to the holders of beneficial interests in the special-purpose entity. In "revolving-period" securitizations, receivables are transferred at the inception and also periodically (daily or monthly) thereafter for a defined period (commonly three to eight years), referred to as the revolving period. During the revolving period, the special-purpose entity uses most of the cash collections to purchase additional receivables from the transferor on prearranged terms.

49. Beneficial interests in the qualifying special-purpose entity are sold to investors and the proceeds are used to pay the transferor for the assets transferred. Those beneficial interests may comprise either a single class having equity characteristics or multiple classes of interests, some having debt characteristics and others having equity characteristics. The cash collected from the portfolio is distributed to the investors and others as specified by the legal documents that established the qualifying special-purpose entity.

50. Pass-through, pay-through, and revolving-period securitizations that meet the criteria in paragraph 9 qualify for sale accounting under this Statement. All financial assets obtained or retained and liabilities incurred by the originator of a securitization that qualifies as a sale shall be recognized and measured as provided in paragraph 11; that includes the implicit forward contract to sell new receivables during a revolving period, which may become valuable or onerous to the transferor as interest rates and other market conditions change.

Revolving-Period Securitizations

51. The value of the forward contract implicit in a revolving-period securitization arises from the difference between the agreed-upon rate of return to investors on their beneficial interests in the trust and current market rates of return on similar investments. For example, if the agreed-upon annual rate of return to investors in a trust is 6 percent, and later market rates of return for those investments increased to 7 percent, the forward contract's value to the transferor (and burden to the investors) would approximate the present value of 1 percent of the amount of the investment for each year remaining in the revolving structure after the receivables already transferred have been collected. If a forward contract to sell receivables is entered into at the market rate, its value at inception may be zero. Changes in the fair value of the forward contract are likely to be greater if the investors receive a fixed rate than if the investors receive a rate that varies based on changes in market rates.

52. Gain or loss recognition for revolving-period receivables sold to a securitization trust is limited to receivables that exist and have been sold. Recognition of servicing assets or liabilities for revolving-period receivables is similarly limited to the servicing for the receivables that exist and have been transferred. As new receivables are sold, rights to service them become assets or liabilities and are recognized.

53. Revolving-period securitizations may use either a discrete trust, used for a single securitization, or a master trust, used for many securitizations. To achieve another securitization

using an existing master trust, a transferor first transfers additional receivables to the trust and then sells additional ownership interests in the trust to investors. Adding receivables to a master trust, in itself, is neither a sale nor a secured borrowing under paragraph 9, because that transfer only increases the transferor's beneficial interest in the trust's assets. A sale does not occur until the transferor receives consideration other than beneficial interests in the transferred assets. Transfers that result in an exchange of cash, that is, either transfers that in essence replace previously transferred receivables that have been collected or sales of beneficial interests to outside investors, are transfers in exchange for consideration other than beneficial interests in the transferred assets and thus are accounted for as sales (if they satisfy all the criteria in paragraph 9) or as secured borrowings.

Isolation of Transferred Assets in Securitizations

54. A securitization, carried out in one transfer or a series of transfers, may or may not isolate the transferred assets beyond the reach of the transferor and its creditors. Whether it does depends on the structure of the securitization transaction taken as a whole, considering such factors as the type and extent of further involvement in arrangements to protect investors from credit and interest rate risks, the availability of other assets, and the powers of bankruptcy courts or other receivers.

55. In certain securitizations, a corporation that, if it failed, would be subject to the U.S. Bankruptcy Code transfers financial assets to a special-purpose trust in exchange for cash. The trust raises that cash by issuing to investors beneficial interests that pass through all cash received from the financial assets, and the transferor has no further involvement with the trust or the transferred assets. The Board understands that those securitizations generally would be judged as having isolated the assets, because in the absence of any continuing involvement there would be reasonable assurance that the transfer would be found to be a true sale at law that places the assets beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.

56. In other securitizations, a similar corporation transfers financial assets to a special-purpose entity in exchange for cash and beneficial interests in the transferred assets. That entity raises the cash by issuing to investors commercial paper that gives them a senior interest in cash received from the financial assets. The beneficial interests retained by the transferring corporation represent a junior interest to be reduced by any credit losses on the financial assets in trust. The commercial paper interests are highly rated by credit rating agencies largely because the transferor is highly rated. Depending on facts and circumstances, the Board understands that those "single-step" securitizations often would be judged in the United States as not having isolated the assets, because the nature of the continuing involvement may make it difficult to obtain reasonable assurance that the transfer would be found to be a true sale at law that places the assets beyond the reach of the transferor and its creditors in U.S. bankruptcy (paragraph 83). If the transferor fell into bankruptcy and the transfer was found not to be a true sale at law, investors in the transferred assets might be subjected to an automatic stay that would delay payments due them, and they might have to share in bankruptcy expenses and suffer further losses if the transfer was recharacterized as a secured loan.

57. Still other securitizations use two transfers intended to isolate transferred assets beyond the reach of the transferor and its creditors, even in bankruptcy. In those "two-step" structures:

a. First, the corporation transfers financial assets to a special-purpose corporation that, although wholly owned, is so designed that the possibility that the transferor or its creditors could reclaim the assets is remote. This first transfer is designed to be judged to be a true sale at law, in part because the transferor does not provide "excessive" credit or yield protection to the special-purpose corporation, and the Board understands that transferred assets are likely to be judged beyond the reach of the transferor or the transferor's creditors even in bankruptcy.

b. Second, the special-purpose corporation transfers the assets to a trust, with a sufficient increase in the credit or yield protection on the second transfer (provided by a junior retained beneficial interest or other means) to merit the high credit rating sought by third-party investors who buy senior beneficial interests in the trust. Because of that aspect of its design, that second transfer might not be judged to be a true sale at law and, thus, the transferred assets could at least in theory be reached by a bankruptcy trustee for the special-purpose corporation.

c. However, the special-purpose corporation is designed to make remote the possibility that it would enter bankruptcy, either by itself or by substantive consolidation into a bankruptcy of its parent should that occur. For example, its charter forbids it from undertaking any other business or incurring any liabilities, so that there can be no creditors to petition to place it in bankruptcy. Furthermore, its dedication to a single purpose is intended to make it extremely unlikely, even if it somehow entered bankruptcy, that a receiver under the U.S. Bankruptcy Code could reclaim the transferred assets because it has no other assets to substitute for the transferred assets.

The Board understands that the “two-step” securitizations described above, taken as a whole, generally would be judged under present U.S. law as having isolated the assets beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.

58. A securitization by an entity subject to a possible receivership under procedures different from the U.S. Bankruptcy Code may isolate transferred assets from the transferor and its creditors even though it uses only one transfer directly to a special-purpose entity that issues beneficial interests to investors and the transferor provides credit or yield protection. For example, the Board understands that assets transferred by a U.S. bank are not subject to an automatic stay under Federal Deposit Insurance Corporation (FDIC) receivership and could only be obtained by the receiver if it makes the investors completely whole, that is, the investors must be paid compensation equivalent to all the economic benefits contained in the transferred assets, including bargained-for yield, before the FDIC could obtain those assets. Those limited powers appear insufficient to place the transferred assets within reach of the receiver. The powers of other receivers for entities not subject to the U.S. Bankruptcy Code, and of bankruptcy trustees in other jurisdictions, vary considerably, and therefore some receivers may be able to reach transferred financial assets, and others may not.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *Issue Paper No. 1—Consolidation of Majority-Owned Subsidiaries*
- *Issue Paper No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*
- *Issue Paper No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties*
- *Issue Paper No. 46—Accounting for Investments in Subsidiary, Controlled and Affiliated Entities*
- *Issue Paper No. 42—Sale of Premium Receivables*
- *Issue Paper No. 76—Offsetting and Netting of Assets and Liabilities*
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies
- Minutes of the March 26, 1990, meeting of the Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force
- Minutes of the February 21, 1992, meeting of the Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force

Generally Accepted Accounting Principles

- *FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*

State Regulations

- No additional guidance obtained from state statutes or regulations.

Statutory Issue Paper No. 87

Other Admitted Assets

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 21

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets* (Issue Paper No. 4) provides the definition of admitted and nonadmitted assets.

2. Current statutory accounting guidance for admitted assets is provided throughout the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies (Life/A&H and P & C Accounting Practices and Procedures Manuals). Other admitted assets are specifically addressed in Chapter 8 of both manuals.

3. Current GAAP provides guidance relative to asset recognition and certain specific accounting and reporting requirements for assets identified within this issue paper. Such guidance is presented in *FASB Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements* (CON 6), *FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan* (FAS 114) and *FASB Technical Bulletin 85-4, Accounting for Purchases of Life Insurance* (FTB 85-4).

4. The purpose of this issue paper is to establish statutory accounting principles for admitted assets which are not specifically addressed in other issue papers.

SUMMARY CONCLUSION

5. The definition and accounting treatment for admitted assets is outlined in paragraphs 2 and 3 of Issue Paper No. 4 as follows:

> For purposes of statutory accounting, an asset shall be defined as: probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. An asset has three essential characteristics: (a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (b) a particular entity can obtain the benefit and control others' access to it, and (c) the transaction or other event giving rise to the entity's right to or control of the benefit has already occurred. These assets shall then be evaluated to determine whether they are admitted.
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> As stated in the Statement of Concepts, *"The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which are unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet"*, and are, therefore, considered nonadmitted. For purposes of the Codification, a nonadmitted asset shall be defined as an asset meeting the criteria in paragraph 2 above, which is accorded limited or no value in statutory reporting and is one which is:
>
> a. Specifically identified within the Codification as a nonadmitted asset or
> b. Not specifically identified within the Codification as an admitted asset.

> If an asset meets one of these criteria, the asset shall be reported as a nonadmitted asset and charged against surplus unless otherwise specifically addressed within the Codification. The asset shall be depreciated or amortized against net income as the estimated economic benefit expires. In accordance with the reporting entity's capitalization policy, immaterial amounts of furniture, fixtures, and equipment, or supplies, can be expensed when purchased.

6. Consistent with paragraph 5, the following assets shall be considered admitted and shall be reported in accordance with Issue Paper No. 4. These admitted assets are not addressed in other issue papers.

Collateral Loans

7. Collateral loans are unconditional obligations for the payment of money secured by the pledge of an investment and meet the definition of assets as defined in Issue Paper No. 4, and, are admitted assets to the extent they conform to the requirements of this paper. The outstanding principal balance on the loan and any related accrued interest shall be recorded as an admitted asset subject to the following further limitations:

- Loan Impairment - Determination as to the impairment of a collateral loan shall be based on current information and events. When it is considered probable that any portion of amounts due under the contractual terms of the loan will not be collected the loan is considered impaired. The impairment shall be measured based on the fair value of the collateral less estimated costs to obtain and sell such collateral. The difference between the net value of the collateral and the recorded asset shall be written off in accordance with *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets* (Issue Paper No. 5).

- Nonadmitted Asset - In accordance with *Issue Paper No. 90—Nonadmitted Assets* (Issue Paper No. 90) collateral loans secured by assets that do not qualify as investments shall be nonadmitted. Further, any amount of the loan outstanding which is in excess of the permitted relationship of fair value of the pledged investment to the collateral loan shall be treated as a nonadmitted asset.

Cash Value of Life Insurance Where the Reporting Entity is Owner and Beneficiary

8. The cash value of life insurance policies where the reporting entity is the owner and beneficiary is similar to a cash deposit that is realizable on demand. As such, the cash value of a life insurance policy as of the date to which premiums have been paid, less any outstanding policy loans and surrender charges, shall be reported as an admitted asset.

Receivables for Securities

9. Sales of securities are recorded as of the trade date. A receivable due from the broker is established in instances when a security has been sold, but the proceeds from the sale have not been received. Unless the receivable for securities, other than a receivable arising from the sale of a security which was acquired on a "To Be Announced" ("TBA") basis and which has yet to be actually received (see paragraph 12), meets the criteria noted in paragraph 11 below, the receivable for securities is an admitted asset to the extent it conforms to the requirements of this paper.

10. An evaluation shall be made in accordance with Issue Paper No. 5, to determine if there is an impairment. If, in accordance with Issue Paper No. 5, it is probable the balance, or any portion thereof, is uncollectible, any uncollectible receivable shall be written off and charged against income in the period the determination is made. If it is reasonably possible, but not probable, the balance or a portion of the balance is uncollectible and is not written off, disclosure requirements outlined in Issue Paper No. 5 shall be followed.

11. Receivables for securities not received within 15 days from the settlement date shall be nonadmitted, and shall be classified as other-than-invested assets.

12. Receivables arising from the secondary sale of securities acquired on a TBA basis which have not yet been received by the seller in the secondary sale transaction, may be admitted until the security is exchanged for payment. TBA securities are originally purchased well in advance of the actual date of security issuance (frequently 90 days or more). Accordingly, secondary sales of securities so acquired may occur before the date of issuance. Sales of securities so acquired always include a provision that requires simultaneous delivery of the security and receipt of consideration. Upon the secondary sale, and prior to the actual receipt, of a security acquired on a TBA basis, the seller in the secondary sale transaction records a liability for the book value of the security thus sold and a receivable for the consideration reflected in the secondary sale transaction. Profits or losses emanating from the secondary sale transaction are recorded in the same manner as profits and losses emanating from any other sale transaction involving an investment.

Other Amounts Receivable Under Reinsurance Contracts

13. Amounts receivable from Servicemen's Group Life Insurance (SGLI) or Federal Employees' Group Life Insurance (FEGLI) pools and Federal Crop Insurance programs shall be reported as admitted assets.

Guaranteed Investment Contracts

14. Guaranteed Investment Contracts (GICs) purchased for investment purposes meet the definition of assets as defined in Issue Paper No. 4, and are admitted assets to the extent they conform to the requirements of this paper.

15. Purchases for which all contractual rights and ownership of the GIC result in an investment similar to a corporate bond shall be accounted for in accordance with the guidance in *Issue Paper No. 26—Bonds, excluding Loan-backed and Structured Securities*.

16. An investment in a GIC payment stream is created when an intermediary purchases individual GICs, pools them, and sells the rights to the payment stream. These investments shall be reported as other long-term invested assets and shall be carried at amortized cost consistent with current statutory accounting.

17. If, in accordance with Issue Paper No. 5, it is probable that the carrying value of a GIC is not fully recoverable the investment shall be considered impaired. Accordingly, the cost basis of the investment shall be written down to the undiscounted estimated cash flows and the amount of the write down shall be accounted for as a capital loss. The new cost basis shall not be changed for subsequent recoveries in fair value.

State Guarantee Association Promissory Notes

18. State guarantee associations have the statutory authority to reinsure any or all of the policies of an impaired or insolvent insurer. When this is done, the assuming carrier receives assets supporting the liabilities from the insolvent company's estate and/or the responsible state guarantee association. If available, the state guarantee association transfers cash at the closing of the transaction. Promissory notes may be utilized in the event a guarantee association does not have the funds on hand or is unable to raise the funds by the closing date. These promissory notes are essentially credit risk free because the notes are backed by all member insurers of an association.

19. Promissory notes issued by state guarantee associations taken by an insurance company in connection with funding an assumption reinsurance agreement meet the definition of assets as defined in Issue Paper No. 4, are admitted assets to the extent they conform to the requirements of this paper, and shall be reported as a note receivable – other-than-invested assets.

DISCUSSION

20. For those items specifically addressed within this issue paper the principles established are consistent with current statutory accounting practices except as follows:

a. With respect to the principles outlined in paragraph 7, collateral loans, the conclusion modifies current statutory accounting to require the evaluation and recording of an impairment in value of collateral loans. The method of evaluating and recording an impairment of value is consistent with FAS 114 which was adopted in *Issue Paper No. 37—Mortgage Loans*.

b. With respect to the principles outlined in paragraph 11, receivables for securities, the conclusion modifies current statutory accounting to require that amounts not received within 15 days from the settlement date be nonadmitted. Issue Paper No. 4 states that an asset not readily available to satisfy policyholder obligations *"shall be recorded as a nonadmitted asset and charged against surplus."* This is consistent with the Statement of Concepts, which states that an insurer's *"ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due*." Receivables for securities not received within 15 days from the settlement date are not considered readily available to satisfy policyholder obligations. Nonadmitting such receivables is also consistent with the conservatism concept of the Statement of Concepts.

c. With respect to the principles outlined in paragraph 17, guaranteed investment contracts, the conclusion modifies current statutory accounting to require the write-off of the portion of the asset not expected to be recoverable in accordance with Issue Paper No. 5.

d. Deposits in suspended depositories are considered nonadmitted assets as provided for in Issue Paper No. 90 as the amounts are not available to satisfy obligations to policyholders.

By requiring reporting entities to reflect impairments in the value of other admitted assets, the conclusions reached above are consistent with other issue papers on invested assets and specifically with Issue Paper No. 5. It is also more conservative than allowing a reporting entity to carry such impaired assets at a value in excess of that which may be realizable.

21. Current statutory accounting, as outlined in Chapter 8 of the P&C Accounting Practices and Procedures Manual, lists certain other assets that may be considered admitted assets should "sufficient subsidiary records to provide detail for the annual statement schedule of other invested assets" exist. The examples provided are investments not considered to be prevalent or significant in industry and as such have not been included in this issue paper.

22. This issue paper adopts FTB 85-4 with modification. FTB 85-4 permits recognition of the cash surrender value of life insurance where the reporting entity is either the owner or beneficiary; whereas this issue paper requires that the reporting entity be both the owner and beneficiary. The cash values of life insurance policies meet the definition of assets defined in Issue Paper No. 4. When the reporting entity is not the owner of the policy, the cash value is not readily available to satisfy policyholder obligations and, therefore, is a nonadmitted asset.

23. The statutory accounting principles discussed above are consistent with the concepts of conservatism and recognition as outlined in the Statement of Concepts.

> Conservatism
>
> Conservative valuation procedures provide protection to policyholders against adverse fluctuations in financial condition or operating results. Statutory accounting should be reasonably conservative over the span of economic cycles and in recognition of the primary responsibility to regulate for financial solvency.
>
> Recognition
>
> The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which are unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet but rather should be charged against surplus when acquired or when availability otherwise becomes questionable.

Drafting Notes/Comments

- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*, discusses and outlines the appropriate treatment for the impairment of assets.
- *Issue Paper No. 26—Bonds, Excluding Loan-Backed and Structured Securities*, discusses and outlines the appropriate recording and valuation of bonds.
- *Issue Paper No. 37—Mortgage Loans*, discusses and outlines the appropriate recording and valuation of mortgage loans.
- *Issue Paper No. 43—Loan-Backed and Structured Securities*, discusses and outlines the appropriate recording and valuation of structured securities.
- Specific other admitted assets discussed in current statutory guidance excerpted below but not addressed in this issue paper are discussed in other issue papers.
- The NAIC Annual Statement Instructions regarding Receivables for Securities were adopted by the Blank's Task Force on October 14 and 15, 1996, to be effective beginning with 1998 Annual Statements.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting Guidance

24. Chapter 8 of the Life/A&H Accounting Practices and Procedures Manual provides the following guidance:

> The various states specify certain assets, all or portions of, which may be admitted in determining statutory unassigned surplus. This chapter discusses some of the more common assets that are not discussed in other chapters. Each company should consult the laws and regulations of their state of domicile regarding other admitted assets.
>
> Other admitted assets not discussed in this chapter include premium notes, reinsurance receivables, deferred and uncollected premiums, tax refunds, investment income due and accrued, and investment settlements pending. In no event should a specifically described nonadmitted asset be recorded as an admitted asset or be used to defer an expense that has been incurred and has no liquidating value, e.g., material used in previous advertising campaigns or supplies that are not resalable.
>
> Collateral Loans
>
> Collateral loans are unconditional obligations for the payment of money secured by the pledge of an investment. The various states regulate a life insurance company's investment in collateral loans. Generally, these regulations deal with the legal form of the assignment and the relationship of the market value of the pledged investment to the collateral loan. The amount of the loan in excess of the permitted relationship is customarily nonadmitted. Also, the collateral loan may be admissible only if the collateral itself is an authorized investment. In some

jurisdictions the collateral must be combined with the like securities held directly in determining if maximum investment limitations are being exceeded.

Guaranteed Investment Contracts (GICs)

Absent specific statutory authority, the purchase of a guaranteed investment contract by an insurer for investment purposes, either directly or in the secondary market, should be considered the purchase of a direct corporate obligation of the issuer and such asset should be considered a bond and should be reported in Schedule D. This treatment applies only when the purchaser acquires all contractual rights and ownership of the guaranteed investment contract.

Absent specific statutory guidance, the purchase by an insurer of a payment stream in the secondary market should be reported in Schedule BA as “Other Long-Term Invested Assets.”

The normal NAIC valuation procedures apply.

State Guarantee Association Promissory Notes

State guarantee associations have the statutory authority to reinsure any or all of the policies of an impaired or insolvent insurer. When this is done, the assuming carrier receives assets supporting the liabilities from the insolvent company’s estate and/or the responsible state guarantee association. If available, the state guarantee association transfers cash at the closing of the transaction. Promissory notes may be utilized in the event a guarantee association does not have the funds on hand or is unable to raise the funds by the closing date.

These promissory notes are essentially credit risk free because the notes are backed by all member insurers of an association. Funds to transfer the obligations via assumption reinsurance are obtained through assessments of solvent companies doing business in the state. If the maximum assessment allowed in any one year does not provide the necessary funds, additional assessments are made as soon thereafter as permitted by the guaranty association act.

Promissory notes issued by state guarantee associations taken by an insurance company in connection with funding an assumption reinsurance agreement shall be reported on the asset page, aggregate write-ins for other-than-invested assets line, as a note receivable–miscellaneous asset. Interest income shall be recorded in the Summary of Operations on the line entitled aggregate write-ins for miscellaneous income.

All promissory notes issued subsequent to the effective date of this guidance are subject to the following condition. The note must contain a clause which stipulates that in the event the state guarantee association fails to fulfill its obligations on the promissory note, the note and the related liabilities assumed by the insurance company will revert back to the state guarantee association.

This guidance is effective June 7, 1995.

The following paragraphs are addressed in other issue papers and as such the Chapter 8 discussion is not excerpted here.

- Partnerships and Joint Ventures
- Amounts Due From Affiliated Companies
- Investments in Real Estate, Equipment and Other Assets Involving Leases
- Electronic Data Processing and Related Equipment
- Foreign Exchange Adjustment
- Deposits on Interest Rate Futures Contracts
- Amounts Receivable Relating to Uninsured Accident and Health Plans
- Derivative Instruments
- Insurance Futures and Insurance Futures Options
- Reverse Mortgages

25. Chapter 8 of the P & C Accounting Practices and Procedures Manual provides the following guidance:

> The various states specify certain assets that may be admitted in determining statutory unassigned surplus. This chapter discusses some of the more common assets that are not discussed in other chapters. Each company should consult the laws and regulations of its state of domicile regarding limitations on admissibility and a more specific description of other admitted assets.
>
> (a) The amount fairly estimated as recoverable on cash deposited in a closed bank or trust company is an admitted asset, if qualifying under the provisions of the various states prior to the suspension of such bank or trust company.
>
> (b) Collateral loans are unconditional obligations for the payment of money secured by the pledge of an investment. The accounting is similar to that for mortgage loans. If the individual loan exceeds the excess of the permitted relationship of the market value of the pledged investment to the collateral loan, the excess is customarily treated as a nonadmitted asset. Also, the collateral loan is admitted only if the collateral itself is an authorized investment.
>
> (c) Guaranteed Investment Contracts (GICs)
>
> Absent specific statutory authority, the purchase of a guaranteed investment contract by an insurer for investment purposes, either directly or in the secondary market, should be considered the purchase of a direct corporate obligation of the issuer and such asset should be considered a bond and should be reported in Schedule D. This treatment applies only when the purchaser acquires all contractual rights and ownership of the guaranteed investment contract.
>
> Absent specific statutory guidance, the purchase by an insurer of a payment stream in the secondary market should be reported in Schedule BA as "Other Long-Term Invested Assets."
>
> (e) Other invested assets that do not fall within the scope of previous chapters require sufficient subsidiary records to provide detail for the annual statement schedule of other invested assets. Examples of such assets which may be admissible:
>
> 1. Loan on or investments in oil and gas production payments, except those considered securities and listed in the schedule of stocks;
> 2. transportation equipment;
> 3. timber deeds;
> 4. mineral rights;
> 5. equipment trusts;
> 6. deposits relating to interest rate futures contracts;
> 7. any other admitted investment not clearly includable in other schedules.
>
> The statutory method for accounting for lease and sale leaseback arrangements is governed largely by the form of the agreement to which the insurance company is party. The Financial Accounting Standards Board statements (FASB) 13, 28 and 66 are commonly used as guidelines where not in conflict with statutory accounting practices. Conservatism and policyholder protection are the objectives.
>
> (o) Cash value of life insurance policies where the company is beneficiary is somewhat analogous to a cash deposit that is realizable on demand. The admissibility of the cash value of life insurance policies is based on general business practice. The admitted amount is the cash value as of the date to which premiums have been paid. (See Chapter 16 Other Income.)

The following paragraphs are addressed in other issue papers and as such the Chapter 8 discussion is not excerpted here.

> (d) Partnerships and Joint Ventures
>
> (f) Funds held by or deposited with reinsured companies
>
> (g) Bills receivable taken for premiums
>
> (h) Reinsurance recoverable on loss payments
>
> (i) Federal income taxes recoverable
>
> (j) Electronic Data Processing Equipment
>
> (k) Interest, Dividends and Real Estate Income Due and Accrued
>
> (l) Amounts due from affiliated companies
>
> (m) Equities and deposits in pools and associations
>
> (n) Amounts Receivable Relating to Uninsured Accident and Health Plans (See Chapter 13 - Other Liabilities.)
>
> (p) lease-purchase transactions
>
> Derivative Instruments
>
> Insurance Futures and Insurance Futures Options
>
> Reverse Mortgages

26. The NAIC Annual Statement Instructions for Life and Accident and Health and for Property and Casualty Insurance Companies specify that the following be classified as Other-Than-Invested Assets:

> Amounts not received within 15 days of the end of the period that are due from brokers when a security has been sold, but the proceeds have not yet been received.

Generally Accepted Accounting Principles

27. Asset recognition is governed by CON 6. An asset is defined in paragraphs 25 and 26 of CON 6 as follows:

> Assets are probable[18] future economic benefits obtained or controlled by particular entity as a result of past transactions or events.
>
> An asset has three essential characteristics: (a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (b) a particular entity can obtain the benefit and control others’ access to it, and (c) the transaction or other event giving rise to the entity’s right to or control of the benefit has already occurred.

[18] *Probable* is used with its usual general meaning, rather than in a specific accounting or technical sense (such as that in FASB Statement No. 5, *Accounting for Contingencies*, par. 3), and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved (Webster's *New World Dictionary of the American Language*, 2d college ed. [New York Simon and Schuster 1982], p. 1132). Its inclusion in the definition is intended to acknowledge that business and other economic activities occur in an environment characterized by uncertainty in which few outcomes are certain (pars. 44-48).

28. Accounting for the impairment of a loan is contained in FAS 114, as amended by *FASB Statement No. 118*, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures* (FAS 118). Pertinent excerpts are as follows:

> 8. A loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement.
>
> 13. When a loan is impaired as defined in paragraph 8 of this statement, a creditor shall measure impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate, except that as a practical expedient, a creditor may measure impairment based on a loan's observable market price, or the fair value of the collateral if the loan is collateral dependent. Regardless of the measurement method, a creditor shall measure impairment based on the fair value of the collateral when the creditor determines that foreclosure is probable. A loan is collateral dependent if the repayment of the loan is expected to be provided solely by the underlying collateral. The creditor may choose a measurement method on a loan by loan basis. A creditor shall consider estimated costs to sell, on a discounted basis, in the measure of impairment if those costs are expected to reduce the cash flows available to repay or otherwise satisfy the loan. If the present value of expected future cash flows (or, alternatively, the observable market price of the loan or the fair value of collateral) is less than the recorded investment in the loan (including accrued interest, net deferred loan fees or costs, and unamortized premiums or discounts), a creditor shall recognize an impairment by creating a valuation allowance with a corresponding charge to bad-debt expense or by adjusting an existing valuation allowance for the impaired loan with a corresponding charge or credit to bad-debt expense.

29. Accounting for purchases of life insurance is contained in FTB 85-4. Pertinent excerpts are as follows:

> 1. How should an entity[1] account for an investment in life insurance?
>
> [1] The provisions of this Technical Bulletin apply to all entities that purchase life insurance in which the entity is either the owner or beneficiary of the contract, without regard to the funding objective of the purchase. Such purchases would typically include those intended to meet loan covenants or to fund deferred compensation agreements, buy-sell agreements, or postemployment death benefits. Purchases of life insurance by retirement plans that are subject to FASB Statement No. 35, Accounting and Reporting by Defined Benefit Pension Plans, are not addressed by this Technical Bulletin.
>
> Response
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> 2. The amount that could be realized under the insurance contract as of the date of the statement of financial position should be reported as an asset. The change in cash surrender or contract value during the period is an adjustment of premiums paid in determining the expense or income to be recognized under the contract for the period.
>
> Effective Date And Transition
>
> 3. The provisions of this Technical Bulletin are effective for insurance policies acquired after November 14, 1985.
>
> Appendix
>
> Background
>
> 4. In November 1970, the AICPA issued an Accounting Interpretation entitled "Accounting for Key-Man Life Insurance." That Accounting Interpretation identified the cash surrender value method as generally accepted accounting for purchases of life insurance. New

types of life insurance contracts, new provisions in traditional contracts, and changes in the insurance industry have led some to question the 1970 Accounting Interpretation. In October 1984, the AICPA's Accounting Standards Executive Committee (AcSEC) approved an Issues Paper entitled "Accounting for Key-Person Life Insurance." In the Issues Paper, AcSEC reaffirmed support of the cash surrender value method as the only generally accepted method. The AcSEC position differed from the position of the AICPA Insurance Companies Committee, which supported use of a different method in certain circumstances. AcSEC was concerned that diversity would develop in practice because of the difference between those positions and requested that the FASB consider the matter.

5. A premium paid by a purchaser of life insurance serves a variety of purposes. A portion of the premium pays the insurer for assumption of mortality risk and provides for recovery of the insurer's contract acquisition, initiation, and maintenance costs. Another portion of the premium contributes to the accumulation of contract values. The relative amounts of premium payment credited to various contract attributes change over time as the age of the insured party increases and as earnings are credited to previously established contract values.

6. An insurance contract is significantly different from most investment agreements. The various attributes of the policy could be obtained separately through term insurance and purchase of investment. The combination of benefits and contract values could not, however, typically be acquired absent the insurance contract. Continued protection from mortality risk and realization of scheduled increases in contract accumulation usually requires payment of future premiums.

7. The payment of insurance premiums may take a number of different forms. The insurance contract may be purchased through payment of a single premium, as opposed to the typical series of future premiums. Alternatively, the premium payments may be made through loans from the insurance company that are secured by policy cash surrender values. The pattern of premium payments is a decision that does not alter the underlying nature of the insurance contract.

Consideration of Comments Received on Proposed Technical Bulletin

8. A proposed Technical Bulletin, Accounting for Business-Owned Life Insurance, was released for comment on June 28, 1985. Forty-seven letters of comment were received on the proposed Technical Bulletin. Certain of the comments received and consideration of them are discussed in the following paragraphs.

9. Some respondents view the dominant objective of a life insurance contract to be investment. Subject to certain criteria evidencing an intent to continue the contract, they maintain that the contract meets the definition of an asset established in paragraph 19 of Concepts Statement 3, which states, "Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events" (footnote reference omitted). Those who hold this view suggested that such contracts should be accounted for using methods that result in reporting the investment in life insurance at amounts different from those stipulated in the contract.

10. This Technical Bulletin does not take that view. The current capacity to realize contract benefits is limited to settlement amounts specified in the contract. Additional amounts in excess of cash surrender value, which would be reported as assets under the various alternative accounting methods suggested, are created by future events, which typically include premium payments and earnings credited to contract amounts.

11. Paragraph 123 of Concepts Statement 3 discusses the occurrence of past events and the role of future events in the recognition of assets.

> Since the transaction or event giving rise to the enterprise's right to the future economic benefit must already have occurred, the definition excludes from assets items that may in the future become an enterprise's assets but have not yet become its assets. An enterprise has no asset for a particular future economic benefit if the transactions or events that give it access to and control of the benefit are yet in the future.

12. Some respondents asserted that reporting an insurance investment at its realizable value represents an accounting based on liquidation values. Those respondents suggested that the entity acquiring an insurance contract is, in many cases, economically or contractually committed to maintain the contract in force. They maintained that such a commitment virtually assures that benefits in excess of premiums paid would be realized and that the policy should be reported on a basis other than its cash surrender value.

13. This Technical Bulletin does not accept that view. The amount realizable under an insurance investment represents settlement values agreed to by an independent buyer and seller. The variety of yields and contract accumulation patterns available in the insurance marketplace provides the buyer and seller a variety of insurance and settlement options. There is no compelling justification to depart from the recording of such contracts based on agreed provisions. The commitment referred to by respondents is, in the staff's view, a commitment to ensure that assets are available to meet contractual obligations. The presence of such a commitment does not change the measurement of the asset that is expected to satisfy the obligation.

14. Some respondents asserted that policy features, most notably the business exchange rider, were significant factors in determining the proper accounting for the policy. The business exchange rider allows a company to use values in an existing policy to insure a different employee when the originally insured employee leaves the company. They maintain that this feature gives the employer the ability to transfer the contract freely and enhances the employer's ability to realize the future value of the investment. They further maintain that the increased probability of realizing future values should lead to the reporting of amounts in excess of cash surrender value.

15. This Technical Bulletin rejects that view. The business exchange rider is a significant development in the design of business insurance products and reduces additional policy costs if a covered employee leaves the company. Such a provision does not affect the realization of future benefits under the insurance contract, nor does it change the traditional underwriting decisions involved in insuring a new life. Instead, the provision only reduces the cost of obtaining those benefits by allowing a new employee to be insured without the costs that are typically associated with obtaining a new policy.

RELEVANT LITERATURE

Statutory Accounting Practices and Procedures

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 8
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 8
- NAIC Annual Statement Instructions for Life and Accident and Health and for Property and Casualty Insurance Companies
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 26—Bonds, Excluding Loan-Backed and Structured Securities*
- *Issue Paper No. 37—Mortgage Loans*
- *Issue Paper No. 68—Business Combinations and Goodwill*
- *Issue Paper No. 90—Nonadmitted Assets*

Generally Accepted Accounting Principles

- *FASB Statement No. 114, Accounting by Creditors for the Impairment of a Loan*
- *Accounting Principles Board Opinion No. 21, Interest on Receivables and Payables*
- *FASB Emerging Issues Task Force No. 88-5, Recognition of Insurance Death Benefits*
- *FASB Technical Bulletin 85-4, Accounting for Purchases of Life Insurance*

State Regulations

- No additional guidance obtained from state statutes or regulations.

Statutory Issue Paper No. 88

Mortgage Guaranty Insurance

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 58

Type of Issue:
Property and Casualty

SUMMARY OF ISSUE

1. Mortgage guaranty insurance protects a lender against loss of all or a portion of the principal amount of a mortgage loan upon default of the mortgagor. It differs from other types of property and casualty insurance in that coverage is long-term, and in most cases premiums are level and paid monthly. Most states require issuers of mortgage guaranty contracts to be monoline insurers and impose limitations on the aggregate amount of risk insured based on geographic territories. Additionally, states may limit mortgage guaranty insurers to reinsure with only selected reinsurers.

2. Current statutory guidance for issuers of mortgage guaranty insurance contracts is provided in Appendix A of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies (P & C Accounting Practices and Procedures Manual) and the Mortgage Guaranty Insurance Model Act.

3. Although GAAP guidance for mortgage guaranty insurance is provided in *FASB Statement No. 60*, *Accounting and Reporting by Insurance Enterprises* (FAS 60), certain aspects of accounting for mortgage guaranty insurance contracts are specifically excluded from FAS 60. The aspects of FAS 60 not applicable to mortgage guaranty insurance relate to premium revenue, claims cost recognition, and acquisition costs.

4. To fill this void in GAAP, the AICPA exposed a draft statement of position in October 1980. The statement of position proposed that premiums be recognized evenly over the anticipated policy term. Costs of acquiring business such as salaries and commissions, generally would be deferred and amortized as the related premiums were earned. Losses on claims, including expenses of settlement, such as appraisal fees, generally would be recognized as of the initial default date.

5. The statement of position was never issued and there has been no further GAAP guidance relating to accounting for premium revenue and claims cost recognition and acquisition costs relating to mortgage guaranty insurance contracts.

6. Although there is no promulgated GAAP guidance, common practice is to recognize revenue as follows:

   a. For single premium plans, revenues are recognized over the policy life in relation to the expiration of risk;

   b. For annual premium plans, revenues are earned on a pro rata basis over the applicable year;

c. For monthly premium plans, revenues are earned either in the month received or the month due.

7. Losses and loss adjustment expenses are generally recognized on the default date regardless of when claims are reported to the insurer.

8. The purpose of this issue paper is to establish statutory accounting principles for recording premium revenue and the liability for unpaid losses and loss adjustment expenses that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

Premium Revenue Recognition

9. Written premium shall be recorded in accordance with *Issue Paper No. 53—Property and Casualty Contracts - Premiums* (Issue Paper No. 53). Premium revenue shall be earned as follows:

a. For single premium plans, revenues shall be earned over the policy life in relation to the expiration of risk;

b. For annual premium plans, revenues shall be earned on a pro rata basis over the applicable year;

c. Additional first year premiums on nonlevel policies shall be deferred and amortized to income over the anticipated premium paying period of the policy in relation to the expiration of risk;

d. Initial renewal premiums that are higher than subsequent renewals shall be deferred and amortized over the remaining anticipated premium paying period in a manner consistent with additional first year premiums (i.e., in relation to the expiration of risk);

e. For monthly premium plans, revenues shall be earned in the month to which they relate.

10. When the anticipated losses, loss adjustment expenses, commissions and other acquisition costs, and maintenance costs exceed the recorded unearned premium reserve, contingency reserve, and the estimated future renewal premium on existing policies, a premium deficiency reserve shall be recognized by recording an additional liability for the excess deficiency with a corresponding charge to operations. Commission and other acquisition costs need not be considered in the premium deficiency analysis since they have previously been expensed. If an insurer utilizes anticipated investment income as a factor in the premium deficiency calculation, disclosure of such shall be made in the financial statements.

Unpaid Losses and Loss Adjustment Expense Recognition

11. Unpaid losses and loss adjustment expenses shall be recognized in accordance with *Issue Paper No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses* (Issue Paper No. 55). For mortgage guaranty insurance contracts, the date of default shall be considered the incident that gives rise to a claim as discussed in Issue Paper No. 55. If a claim is ultimately presented, the date of default shall be considered the loss incurred date.

12. The process for estimating the liability shall include projections for losses that have been reported as well as those that have been incurred but not reported. The estimates shall be made based on historical data, trends, economic factors, and other statistical information including paid claims, reported losses, insurance in force statistics, and risk statistics.

13. Real estate and mortgages are acquired by mortgage guaranty insurers to mitigate losses. These assets shall be shown on the balance sheet at the lower of cost or net realizable value, net of encumbrances. Any gains or losses from the holding or disposition of these assets shall be recorded as a component of losses incurred. Any rental income or holding expenses shall be included in loss adjustment expenses.

Contingency Reserve

14. In addition to the unearned premium reserve, mortgage guaranty insurers shall maintain a liability referred to as a statutory contingency reserve. The purpose of this reserve is to protect policyholders against loss during periods of extreme economic contraction. The annual addition to the liability shall equal 50% of the earned premium from mortgage guaranty insurance contracts and shall be maintained for ten years regardless of the coverage period for which premiums were paid. With commissioner approval, when required by statute, the contingency reserve may be released in any year in which actual incurred losses exceed 35% of the corresponding earned premiums. Any such reductions shall be made on a first-in first-out basis. Changes in the reserve shall be recorded directly to surplus.

Disclosures

15. Mortgage guaranty insurers shall make all disclosures required by other issue papers within the codification, including but not limited to the requirements of Issue Paper No. 55*,* and *Issue Paper No. 77—Disclosures of Accounting Policies, Risks & Uncertainties, and Other Disclosures.*

DISCUSSION

16. This issue paper is not consistent with current statutory guidance as follows:

a. Premium Recognition

i. The P & C Accounting Practices and Procedures Manual distinguishes premiums for high risk policies from other policies. The conclusions reached in this issue paper make no such distinction because the concept is implicit in the requirement to earn revenues in relation to the expiration of risk.

ii. Certain states dictate by statute that a specific formula, table, or earnings curve be utilized to determine earned premiums. To the extent that the requirements are based on the exposure period and the relative risk during that period, they are consistent with the concepts set forth in this issue paper.

iii. The Mortgage Guaranty Insurance Model Act provides no specific guidance on premium revenue recognition other than the requirement to establish an unearned premium reserve. The method of establishing such reserve is based on regulation of the state of domicile.

iv. Current statutory guidance has no requirement to establish a premium deficiency reserve.

b. Contingency Reserve

The contingency reserve may be recorded through income or directly to surplus. This issue paper requires changes in the reserve to be recorded through surplus.

i. The Model Act requires that the contingency reserve shall be computed as an amount equal to 50% of the unearned premium after the establishment of the unearned premium reserve. This issue paper requires the establishment of a contingency reserve based on earned premium. Consistent with the Model Act, this issue paper provides that reserves can be reduced if Commissioner approval is obtained. However, Commissioner approval of a reserve reduction will only be considered as a viable means of reducing a reserve where the reporting entity can clearly demonstrate to the commissioner that the existing reserves are excessive.

17. Issue Paper No. 53 requires recognition of premium on a pro-rata basis over the period of exposure except when specific issue papers require different methods because the level of risk may vary significantly over the exposure period. Losses related to mortgage guaranty policies can occur over an exposure period which extends for the term of the mortgage. The pattern of normal loss incidence is not uniform over the exposure period and tends to peak in the earlier years. This issue paper provides guidance for premium recognition that is based on the exposure period of the contract and the underlying risk. Recognizing premiums over the exposure period and in relation to the underlying risk allows insurers to determine methods appropriate to the contracts they write versus requiring insurers to use methods that may not appropriately reflect such risks. Premiums collected on an annual payment plan may not be sufficient to cover the risk in early years. Subparagraph 9 b. requires annual premiums to be earned over the applicable year and does not permit an insurer to accrue premiums which may be collected in future years. Additional first year premiums and initial renewal premiums that are higher than subsequent renewals may be front loaded to expedite the collection of premium. Subparagraphs 9 c. and 9 d. require an insurer to defer the revenue and amortize it in relation to the expiration of risk.

18. The changes referred to in paragraph 16 were made to improve consistency in reporting among insurers that offer mortgage guaranty contracts as well as to improve consistency in reporting between reporting periods. This is consistent with the Statement of Concepts which states:

> Consistency
>
> The regulators' need for meaningful, comparable financial information to determine an insurer's financial condition requires consistency in the development and application of statutory accounting principles. Because the marketplace, the economic and business environment, and insurance industry products and practices are constantly changing, regulatory concerns are also changing. An effective statutory accounting model must be responsive to these changes and address emerging accounting issues. Precedent or historically accepted practice alone should not be sufficient justifications for continuing to follow a particular accounting principle or practice which may not coincide with the objectives of regulators.

19. This issue paper expands current statutory guidance with respect to the recognition of losses. The P & C Accounting Practices and Procedures Manual provides guidance that losses shall be recognized when they occur. This issue paper defines the occurrence date as the date of default of a loan.

20. This issue paper is inconsistent with Issue Paper No. 22 which requires rental income on property to be recorded as investment income whereas this issue paper requires recognition of rental income as a reduction of loss adjustment expense.

21. The inconsistency between mortgage guaranty insurers and all other insurers in the reporting of all real estate obtained through foreclosure and in the recognition of rental income is reflective of the nature of the risks underwritten. Losses on real estate incurred by mortgage guaranty insurers can be viewed as resulting from underwriting activities and not investing activities. Because mortgage guaranty insurers are generally required to be monoline companies, and are prohibited from investing in real estate,

the inconsistency with all property casualty insurers will not hinder evaluation of the mortgage guaranty insurers results.

22. The contingency reserve does not meet the definition of a liability which is set forth in *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*. However, it is consistent with the "*ultimate objective of solvency regulations*" as stated in the Statement of Concepts. This states:

> the ultimate objective of solvency regulation is to ensure that policyholder, contract holder and other legal obligations are met when they come due and that companies maintain capital and surplus at all times and in such forms as required by statute to provide an adequate margin of safety.

Additionally, recording the contingency reserve as a liability is consistent with the Statement of Concepts which states:

> Liabilities require recognition as they are incurred. Certain statutorily mandated liabilities may also be required to arrive at conservative estimates of liabilities and probable loss contingencies (e.g., excess of statutory reserves over statement reserves, interest maintenance reserves, asset valuation reserves, and others).

23. This issue paper is inconsistent with the guidance set forth in the AICPA exposure draft for mortgage guaranty insurance for the following reasons:

a. This issue paper requires that acquisition costs shall be accounted for in accordance with *Issue Paper No. 71—Policy Acquisition Costs and Commissions* rather than deferred as indicated in the exposure draft.

b. Paragraph 14 of this issue paper requires insurers to establish a contingency reserve. The AICPA exposure draft has no such requirement.

24. This issue paper is consistent with Issue Paper No. 55 which requires the ultimate cost of all known and unknown claims as well as related settling costs to be recorded when an insured event occurs.

Drafting Notes/Comments

- U.S. Mortgage Guaranty Tax and Loss Bonds and Contingency Reserve (for tax purposes, the Mortgage Guaranty Account) are addressed in *Issue Paper No. 83—Accounting for Income Taxes*.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

25. Appendix A, Mortgage Guaranty Insurance Accounting Principles Supplement, of the P & C Accounting Practices and Procedures Manual provides the following guidance with respect to accounting for mortgage guaranty insurance: (only pertinent excerpts are included)

> Insured Risk
>
> The nature of the insured risk is influenced by certain factors which set the mortgage guaranty insurance product in some respects apart from other types of insurance.
>
> 1. Exposure Period

The period of exposure for a particular risk is significantly longer for mortgage insurance than for other property/liability insurance products. The exposure period for mortgage insurance can run for the term of the mortgage; however, the average policy life is seven years. The policy is terminated when the mortgage obligation is satisfied or the lender elects to cancel or not renew the policy.

Mortgage insurance is renewable at the option of the insured and at the renewal rate quoted when the policy commitment was issued. Disability income and certain life and health insurance products are other policies written with similar terms regarding renewal rate and cancellation.

In contrast to mortgage insurance, most property/liability products need not be renewed by the insurer at the expiration of the policy. The fact that mortgage insurance is guaranteed renewable at a definite rate is one of the factors necessitating the establishment of a contingency reserve. In effect, this reserve protects not only against catastrophic economic events, but also against a decrease in the quality of the insurance portfolio because of adverse selection at each renewal period.

2. Losses

The insured peril—the default of a borrower—arises from the credit risk associated with mortgage loans. The frequency of loss is strongly influenced by economic conditions. The likelihood of individual default is further increased if the property has deteriorated since a borrower in financial difficulty will be less able to sell the property at a price sufficient to discharge the mortgage.

Mortgage insurance losses can be divided into three categories:

(a) Normal losses associated with regular business cycles, interruptions in the borrower’s earning power and random errors made in evaluating the insured’s willingness or ability to meet mortgage obligations.

(b) Defaults caused by adverse local economic conditions.

(c) Widespread defaults caused by a severe depression in the U.S. economy.

The possible magnitude of loss contemplated in the last category has no analogy in any other private property/liability line of insurance.

3. Loss Incidence

Losses are incurred over an exposure period which can, as previously discussed, run for the term of the mortgage. The pattern of normal loss incidence is not uniform over the exposure period. The loss incidence peaks in the earlier years.

When a loan has been delinquent two or four months, the mortgage insurance policy requires the lender to notify the insurer. Further, the lender agrees to institute foreclosure proceedings six to nine months from the date of delinquency. Foreclosure can require an additional 18 months which could mean a considerable delay between the delinquency and the date of the claim. Without adverse economic conditions, most delinquencies do not result in a claim. Once a claim is presented, payment normally is made within one or two months and ultimate loss costs can be known relatively quick. An exception is the case where an insurer chooses to take the title to the property and sell it. Thus, reporting of losses and loss payments occur within the period that title is held by the insurer.

Pool Insurance

In addition to insuring mortgage loans on an individual basis (primary insurance), mortgage guaranty insurance is provided on pools of mortgage loans. Typically, such insurance supports mortgage-backed securities or group sales. Unlike other pool or group products, each loan is individually underwritten.

Pool insurance may be provided on loans that are already insured by primary insurance, in which case the pool insurance provides an additional level of coverage, or it may be provided on loans without primary insurance (usually loans with loan-to-value ratios below 80%). Generally, pool insurance provides 100% coverage and includes a stop-loss limit of liability which may range from 5% to 20% of the initial aggregate principal balance. Because of regulatory requirements in some states, pool insurance usually uses participating reinsurance arrangements to limit the exposure of any one mortgage insurer of a pool of loans to 25% of each mortgage insured.

Pool insurance policies are not cancelable by the insurer except for nonpayment of premium. These policies are generally written on mortgage pools having terms of up to 30 years. However, for all practical purposes, it is expected that the life of each pool will be considerably shorter than 30 years and will result in average policy life of 8 to 12 years. This compares to an individual policy which has an average term of 7 years.

In the case of default, the insurer has the same options as with individual insured mortgage loans. However, pool insurance loss payments are reduced by any settlements under primary insurance and subject to the stop-loss limit.

Three kinds of mortgage-backed securities which use pool insurance are described as follows:

1. Mortgage-Backed Bonds

   Issued by banks, savings and loan associations and other mortgage lenders as a general obligation of the issuing institution. These bonds are collateralized by a pool or mortgages and have a stated rate of return and maturity date.

2. Mortgage Revenue Bonds

   Issued by state and local housing authorities to support housing affordability for targeted income groups.

3. Mortgage Pass-Through Certificates

   Issued by banks, savings and loan associations, mortgage bankers and others providing an undivided interest in a pool of mortgages with principal and interest payment passed to the certificate holder as received.

Special Regulatory Requirements for Mortgage Insurers

1. Risk Ratio

   Since the inception of the private mortgage insurance industry in 1957, private mortgage insurers have been required to operate within a 25-to-1 ratio of risk to surplus, a ratio which many state insurance commissioners have determined to be prudent for the protection of lenders. For the purposes of arriving at this risk ratio, the regulatory authorities have defined “risk” as the total amount of exposure (percentage coverage) relating to the insurance in force, and “surplus” as policyholders’ surplus (capital, paid-in surplus, and unassigned surplus) plus the contingency reserve.

2. Statutory Contingency Reserve

   This is a special statutory reserve designed to protect policyholders against loss during a period of extreme economic contraction. By law, insurers must set aside 50 cents of each premium dollar earned and maintain the contingency reserve for a period of ten years, regardless of the length of coverage of the particular policy for which premium was paid. In most states, with the approval of the insurance commissioner, the contingency reserve may be reduced when losses in a calendar year exceed 35% of earned premiums (20% in some states).

REAL ESTATE

Generally, real estate owned by mortgage guaranty insurance companies consists of two types; (a) properties occupied by the company; or (b) real estate owned as a result of claim settlement. Real estate owned and held for use by the company is accounted for in the same manner as other fire and casualty companies.

Claims Settlement Costs

The cost of real estate acquired in the settlement of claims is similar in computation to that acquired by other insurers through a foreclosure process. Generally the cost of real estate acquired through foreclosure or in settlement of claims includes the outstanding principal balance of the mortgage loan on the date of foreclosure, plus accumulated interest, unpaid real estate taxes, insurance premiums, and all other costs necessary to obtain clear title and place the property in good repair.

If a property acquired in settlement of a claim is rented prior to disposal, the rental income received on such property is recorded as a reduction of loss adjustment expenses. Generally, expenditures for ordinary repairs is necessary to maintain the property in good operating condition, utilities, and real estate taxes paid after the acquisition of the property are recorded as loss adjustment expenses. Expenditures for major improvements made to the property are generally capitalized.

Statement Value

The statement value of real estate acquired in settlement of claims is generally accounted for at its net realizable value (the amount of cash, or its equivalent, expected to be realized upon disposal, net of costs such as maintenance and selling expenses required to be incurred prior to sale). In lieu of writing down real estate when realizable value is less than cost, a loss reserve may be established as a liability.

The excess of acquisition cost over realizable value on property disposed of at a later date is recorded to losses paid for the period in which the reduction in realizable value has been determined.

LOSSES

Recognition

The underlying goal of estimating unpaid losses is to have unpaid losses reflect the liability outstanding for losses that have been incurred as of the report date. Losses are recognized as they occur and not as they are reported to the company. Because of this basis of recognition, unpaid losses are grouped as (1) reported and (2) incurred but not reported (IBNR). Reported losses are those incurred losses of which the mortgage insurer has been notified by the lender through delinquent loan reporting and/or filing a claim for payment. The incurred but not reported losses are those losses that have occurred that have not been reported to the company.

Valuation

1. Estimation of Reported Losses Unpaid

   Unpaid losses are estimated based on predictions of loss frequency and loss severity. These estimates are based on historic data, trends, economic information, and other statistical information.

   Loss frequency and loss severity estimates are made for three separate categories:

   (a) Insured loans that have resulted in the conveyance of property which remains unsold

   (b) Insured loans in the process of foreclosure

   (c) Insured loans in default

2. Incurred But Not Reported Losses

   With the reported and unpaid loss category of the reserve representing the liabilities for reported claims and delinquencies, the mortgage insurer must also record a liability for losses that are incurred but not reported.

   Estimates of loss frequency and loss severity for incurred but not reported losses are made based on historic data, trends, economic factors, and other statistical data in relation to paid claims, the reserve for reported losses unpaid, insurance in force statistics, and risk statistics.

CONTINGENCY RESERVE

The contingency reserve, as described in several statutes, is established and maintained for the purpose of protecting insureds against the effect of adverse economic cycles. The reserve is variously described as a premium reserve, or loss reserve, or is not specifically described. The annual contribution to the contingency reserve is deductible in the computation of the federal income tax liability as described in the chapter on “Federal Income Taxes.”

In most jurisdictions, the annual addition to the contingency reserve liability is 50% of earned premium. One jurisdiction requires that the reserve contribution be based upon the loan amount of outstanding mortgages insured or 50% of earned premiums, whichever is higher. In another jurisdiction, the annual addition applicable to the mortgage pool insurance business segment is based upon insured risk. Each annual addition to the contingency reserve must be maintained for 10 years before being released, except that releases are permitted (on a first-in, first-out basis) at an earlier date should actual losses exceed established percentages of earned premiums as set forth in the statutes.

There are two predominant practices being used to report the effect of contingency reserve transactions. “Practice One” is to report changes to the reserve in the income statement; “Practice Two” is to report changes as a direct adjustment to surplus.

Under Practice One, the liability for the contingency reserve is included in loss reserves and the net addition to (or deduction from) the contingency reserve liability is reported as a deduct from (or addition to) underwriting income in the income statement.

Under Practice Two, the liability for contingency reserves is reported as a separate line item among other liabilities. The net addition to (or deduction from) the contingency reserve liability is not recorded in the income statement, but rather it is reported as a direct adjustment to surplus.

Prior to computing financial ratios and results for an insurer: (1) underwriting income comparisons between insurers using the differing practices will require an adjustment to account for the differing treatments of additions to (or deductions from) the contingency reserve, and (2) as with the risk ratio calculation, the contingency reserve must be added to policyholders' surplus. In addition, if appropriate, statutory net income should be adjusted for any federal income tax consequences arising from the purchase of tax and loss bonds (see Federal Income Taxes chapter). These adjustments may require information not found in the annual statement.

UNEARNED PREMIUMS

There are a variety of statutory accounting methods used by mortgage guaranty insurers to determine the earned and unearned portion of premiums written. The rate at which premiums are earned differs based on type of policy, the loan-to-value ratio of the mortgage and the policy term (single premium versus annual renewals).

Certain states dictate through statute or regulation a specific formula or table to be used for the above policy types. Special attention is placed on single premium (multiple year) policies and on the "excess risk" portion of the initial annual premium.

Renewal Premiums, Annual Premiums and Level Premiums

Renewal premiums and annual premiums on policies with a loan-to-value of 90% or less are earned on a monthly pro rata basis using the 13-month method (sometimes called the 1/24 method because 1/24 is earned in each of the first and last months, and 1/12 in each of the other 11 months). This method assumes that the effective dates of policies are spread evenly throughout the month and that the average date is the 15th.

Level premium policies are handled the same as the above. Thus, a three-year policy payable in three equal annual installments is booked the same way as the three successive one-year policies.

Annual Premiums on High-Risk Policies

In some jurisdictions, the portion of the first year's premium which exceeds twice the annual renewal rate is earned on a deferred basis. (These premiums usually relate to mortgages with loan-to-value ratios in excess of 90%.)

Single Premiums

Single premiums are typically recognized on a deferred basis and then earned according to various statutorily mandated earnings curves.

LOSS AND LOSS ADJUSTMENT EXPENSES INCURRED

Mortgage guaranty insurance accounting differs from property insurance accounting in that if real estate is acquired, salvage value is recognized. If a property is in claims settlement, the difference between the cost of the property and its estimated net realizable value is recorded as loss expense at the date of acquisition. Further, in some jurisdictions, net additions to the contingency reserve are reported as part of incurred losses (see chapter on Contingency Reserve).

26. The Mortgage Guaranty Insurance Model Act provides the following guidance: (only pertinent excerpts included)

Section 16. Reserves

A. Unearned Premium Reserves

A mortgage guaranty insurance company shall compute and maintain an unearned premium reserve as set forth by regulation adopted by the commissioner of insurance.

B. Loss Reserve

A mortgage guaranty insurance company shall compute and maintain adequate case basis and other loss reserves which accurately reflect loss frequency and loss severity and shall include components for claims reported and for claims incurred but not reported, including estimated losses on:

(1) Insured loans which have resulted in the conveyance of property which remains unsold;

(2) Insured loans in the process of foreclosure;

(3) Insured loans in default for four (4) months or for any lesser period which is defined as default for such purposes in the policy provisions; and

(4) Insured leases in default for four (4) months or for any lesser period which is defined as default for such purposes in policy provisions.

C. Contingency Reserve

Each mortgage guaranty insurance company shall establish a contingency reserve out of net premium remaining (gross premiums less premiums returned to policyholders net of reinsurance) after establishment of the unearned premium reserve. The mortgage guaranty insurance company shall contribute to the contingency reserve an amount equal to fifty percent (50%) of such remaining unearned premiums. Contributions to the contingency reserve made during each calendar year shall be maintained for a period of one hundred and twenty months (120), except that withdrawals may be made by the company in any year in which the actual incurred losses exceed thirty-five percent (35%) of the corresponding earned premiums, and no such releases shall be made without prior approval by the commissioner of insurance of the insurance company's state of domicile.

If the coverage provided in this act exceeds the limitations set forth herein, the commissioner of insurance shall establish a rate formula factor that will produce a contingency reserve adequate for the added risk assumed. The face amount of an insured mortgage shall be computed before any reduction by the mortgage guaranty insurance company's election to limit its coverage to a portion of the entire indebtedness.

D. Reinsurance

Whenever a mortgage guaranty insurance company obtains reinsurance from an insurance company which is properly licensed to provide such reinsurance or from an appropriate governmental agency, the mortgage guaranty insurer and the reinsurer shall establish and maintain the reserves required in this chapter in appropriate proportions in relation to the risk retained by the original insurer and ceded to the assuming reinsurer so that the total reserves established shall not be less than the reserves required by this chapter.

E. Miscellaneous

(1) Whenever the laws of any other jurisdiction, in which a mortgage guaranty insurance company subject to the requirement of this act, is also licensed to transact mortgage guaranty insurance, require a larger unearned premium reserve or contingency reserve in the aggregate than that set forth herein, the establishment of such larger unearned premium reserve or contingency reserve in the aggregate shall be deemed to be in compliance with this chapter.

(2) Unearned premium reserves and contingency reserves shall be computed and maintained on risks insured after the effective date of this chapter as required by Sections 16A and 16C. Unearned premium reserves and contingency reserves on risks insured before the effective date of this chapter may be computed and maintained as required previously.

Section 17. Regulations

The commissioner shall have the authority to promulgate rules and regulations deemed necessary to effectively implement the requirements of this chapter.

Generally Accepted Accounting Principles

- No specific GAAP guidance obtained.

OTHER SOURCES OF INFORMATION

27. The AICPA Exposure Draft on mortgage guaranty insurance provides the following guidance.

> Conclusions with respect to earning premium
>
> 19. Single premiums should be earned on a pro rata basis throughout the policy term, or on a declining basis if the amount of coverage significantly declines during the policy term. Annual premiums should be earned on the same basis. Level annual premiums should be earned on a pro rata basis over the policy term (usually one year). Additional first-year premiums on nonlevel policies, that is, the difference between first-year and level renewal premiums, should be deferred and amortized to income over the anticipated premium-paying period of the policies in relation to total anticipated premium receipts excluding the additional first-year premiums. If the dollar amount of coverage significantly declines during the anticipated premium-paying period, the additional first-year premium should be amortized to income in relation to anticipated coverage. If the initial renewal premium rate is higher than subsequent renewal premium rates, the excess premiums should be deferred and amortized to income over the remaining anticipated premium paying period of the policies in the same manner as the additional first-year premiums (this does not apply to policies with reduced premiums in later years, such as the tenth year or later). Level renewal premiums and the portion of the first-year premium equal to the level renewal premium should be earned on a pro rata basis over the policy term (generally one year). When significant differences between anticipated and actual renewal premiums occur, the predetermined amortization of additional first-year premiums should be adjusted to reflect actual experience.
>
> Conclusions with respect to premium deficiencies
>
> 36. When anticipated losses and loss adjustment expenses, maintenance expenses and unamortized deferred acquisition costs exceed unearned premiums and estimated renewal premiums on existing policies, a provision for the anticipated premium deficiency should be provided. Premium deficiencies should be determined by reasonable groupings of business based on line of business or geographical area. (Premium deficiencies should be recognized by writing off any unamortized deferred acquisition costs to the extent required. If the deficiencies are more than the unamortized deferred acquisition costs, a separate liability should be provided for the excess deficiency).
>
> 37. In addition, companies that consider anticipated investment income in computing premium deficiencies should disclose the fact in their financial statements, together with the effects on the financial statements.
>
> Conclusions with respect to recording claims

49. Losses should be accrued as of the initial default date, however, if a company can demonstrate that another date is more appropriate, such as 60 or 90 days after the initial default losses may be accrued as of that date.

50. In addition, companies that discount loss or loss adjustment expense reserves (see paragraphs 56 through 59) should disclose that fact in their financial statements, together with the effects on the financial statements.

51. No conclusion has been reached regarding whether loss reserves should be discounted; that is, whether the time value of money should be considered in determining loss reserves. This issue, as it applies to all insurance companies, is being considered separately by the AICPA Insurance Companies Committee.

RELEVANT LITERATURE

Statutory Accounting

- Accounting Practices and Procedures Manual for Property and Casualty Insurers, Appendix A
- The Mortgage Guaranty Insurance Model Act
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 22—Leases*
- *Issue Paper No. 53—Property Casualty Contracts - Premiums*

  Issue Paper No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses
- *Issue Paper No. 65—Property and Casualty Contracts*
- *Issue Paper No. 71—Policy Acquisition Costs and Commissions*
- *Issue Paper No. 77—Disclosure of Accounting Policies, Risks & Uncertainties, and Other Disclosures*

Generally Accepted Accounting Principles

- *FASB Statement No. 60*, *Accounting and Reporting by Insurance Enterprises*

State Regulations

- No additional guidance obtained from state regulations or laws.

Other Sources of Information

- AICPA Exposure Draft on Mortgage Guaranty Insurance
- California Insurance Code §§ 12640.01 to 12640.18 (1961/1993)
- Illinois Administration Regulation, TITLE 50 §§ 202.10 to 202.60 (1982/1986)
- New York Insurance Law §§ 6501 to 6507 (1984/1994)
- Wisconsin Administrative Code §§ 3.09 (1992)

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Statutory Issue Paper No. 89

Separate Accounts

STATUS
Finalized March 13, 2000

Original SSAP and Current Authoritative Guidance: SSAP No. 56

Type of Issue:
Life Specific

SUMMARY OF ISSUE

1. Current statutory accounting guidance for separate accounts is addressed in Chapter 25, Separate Accounts*,* of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies (Life/A&H Accounting Practices and Procedures Manual). General reserve requirements and accounting for all life and annuity contracts with life contingencies has been established in *Issue Paper No. 51—Life Contracts* (Issue Paper No. 51). Current statutory accounting for separate accounts varies by state.

2. GAAP guidance for separate account contracts requires investments to be reported at market value except for separate account contracts with guaranteed investment returns. For those separate accounts, the related assets are generally reported in accordance with *FASB Statement No. 60*, *Accounting and Reporting by Insurance Enterprises* (FAS 60), as amended by *FASB Statement No. 114*, *Accounting by Creditors for Impairment of a Loan* (FAS 114), *FASB Statement No. 115*, *Accounting for Certain Investments in Debt and Equity Securities* (FAS 115) and *FASB Statement No. 121*, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of* (FAS 121). GAAP guidance for separate account contracts requires policy reserves or liabilities to be established using the balance that accrues to the benefit of the policyholder.

3. The purpose of this issue paper is to provide guidance on accounting and reporting for separate accounts in both the general account and separate account statement, consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

Introduction

4. Separate accounts are used to fund variable life insurance, variable annuities, modified guaranteed annuities and modified guaranteed life insurance, or various group contracts under pension or other employee benefit plans where funds are held in a separate account to support a liability. When separate accounts are established and filed accordingly, they may be used to fund guaranteed benefits. Separate account contracts may also be used to accumulate funds which are intended to be applied at some later time to provide life insurance or to accumulate proceeds applied under settlement or dividend options.

5. Assets held in separate accounts are owned by the insurer. All investment income and realized and unrealized capital gains and losses from assets allocated to a separate account, net of related investment expenses, are generally reflected in the separate account and, except for modified guaranteed annuities, modified guaranteed life insurance, and separate accounts established and filed to provide guaranteed benefits, investment performance is generally not guaranteed by the insurer. Charges relating to contract guarantees, administration, and investment management are deducted from separate accounts.

General Account Reporting

6. Insurance activities such as sales, underwriting and contract administration, premium collection and payment of premium taxes, claims, and benefits are functions of the insurance company distinct from the separate account and shall be accounted for as transactions of the general account.

7. For those separate account contracts classified as life contracts under *Issue Paper No. 50—Classifications and Definitions of Insurance or Managed Care Contracts In Force*, premiums and annuity considerations shall be recorded as income in the Summary of Operations of the general account, and as transfers to premiums and considerations in the separate account statement. Deposit-type contracts shall be recorded in the general account in accordance with *Issue Paper No. 52—Deposit-Type Contracts*. Charges (e.g., fees associated with investment management, administration, and contract guarantees) assessed on the separate accounts, as well as the net gain from operations of the separate account shall be recorded as income in the Summary of Operations of the general account. Expenses relating to investment management, administration, and contract guarantees pertaining to separate account operations, as well as benefits and surrenders incurred on behalf of separate account contracts classified as life contracts, net transfers between separate accounts, commissions, and premium taxes (if any) shall be recorded as expenses in the Summary of Operations of the general account.

8. The general account shall include the total assets and liabilities, including transfers due or accrued, of any separate accounts business which it maintains and, therefore, the surplus, if any, of its separate accounts business. Transfers to the general account due or accrued shall be reported on a net basis so that the asset and the liability totals of the general account are not overstated. Changes in the surplus of the separate accounts business of an insurer, except for changes resulting from the net gain from operations of the separate account, shall be charged or credited directly to the unassigned funds (surplus) of the general account.

9. Where a variable annuity contract or variable life insurance contract contains a guaranteed minimum death benefit, any reserve liability for such death benefit provision shall be recorded and held in the general account based on the reserving guidance in paragraphs 24 and 25. Any differences between the benefit paid and the separate account asset value of the contract shall be charged against or credited to the general account in its net gain from operations.

10. Separate account surplus may not become negative. For example, for separate account contracts which have annuitized (i.e., contracts in the payout stage), lower than expected mortality on variable annuity contracts containing mortality guarantees may cause a deficiency in the investment funds underlying the contract reserves. Thus the general account incurs an expense and the separate account realizes revenue to cover this deficiency, if necessary. Conversely, excess funds from higher than expected mortality will result in mortality gains that are included in the Summary of Operations of the separate account and are ultimately recorded as equity in net income from separate account operations as discussed in paragraph 7.

11. For variable products, separate account surplus created through the use of the commissioners' reserve valuation method (CRVM), commissioners' annuity reserve valuation method (CARVM), or other reserving methods, shall be reported by the general account as an unsettled transfer from the separate account. The net change on such transfers shall be included as a part of the net gain from operations in the general account.

12. Surplus funds transferred from the general account to the separate account, commonly referred to as seed money, and earnings accumulated thereon shall be reported as surplus in the separate accounts until transferred or repatriated to the general account. The transfer of such funds between the separate account and the general account shall be reported as surplus contributed or withdrawn during the year.

13. If an Asset Valuation Reserve (AVR) is required for investments held by separate accounts, it is combined with the general account AVR and accounted for in the general account financial statements (see *Issue Paper No. 7—Asset Valuation Reserve and Interest Maintenance Reserve* (Issue Paper No. 7)). The criteria for determining when an AVR is required for separate accounts are described in paragraph 17 of this issue paper.

Separate Account Reporting

14. The separate accounts annual statement is concerned with the flow of funds related to investment activities and obligations of the separate accounts and with the transfer of funds between the separate account and the general account. As a result, the separate account statement shall report only the assets, liabilities, and operations of the separate account and shall not include general account expenses related to investment management, administration, or contract guarantees pertaining to separate account operations which are recorded in the general account.

15. The separate account records premiums, considerations (net of loading for sales charges such as commissions and premium taxes) and receipts (other than for net investment income and realized capital gains and losses) as income transfers from the general account. Net investment income and realized and unrealized capital gains and losses relating to the investment operations of the separate account are recorded as income in the Summary of Operations. When the contract provides for such, expenses and taxes associated with the separate account investment operations shall be deducted in the determination of net investment income. Deposits and withdrawals on deposit-type contracts shall be recorded in the Summary of Operations. Benefits and surrenders, reserve transfers, policy loans, policyholder charges (e.g., fees associated with investment management, administration, and contract guarantees), and federal income taxes relating to the separate account are recorded as expense transfers to the general account in the Summary of Operations. The net change in aggregate reserves relating to separate account contracts is reported as an expense in the Summary of Operations.

16. Assets supporting fund accumulation contracts (GICs), which do not participate in underlying portfolio experience, with a fixed interest rate guarantee, purchased under a retirement plan or plan of deferred compensation, established or maintained by an employer, will be recorded as if the assets were held in the general account. Assets supporting all other contractual benefits shall be recorded at market value on the date of valuation, or if there is no readily available market, then in accordance with the valuation procedures in the applicable contract.

Separate Account AVR and IMR Reporting

17. An AVR is generally required for separate accounts when the insurer, rather than the policyholder/contractholder, suffers the loss in the event of asset default or market value loss. An AVR is required unless:

a. The asset default or market value risk is borne directly by the policyholders, or

b. The regulatory authority for such separate accounts already explicitly provides for a reserve for asset default risk, where such reserves are essentially equivalent to the AVR.

18. Assets supporting traditional variable annuities and variable life insurance generally do not require an AVR because the policyholders/contractholders bear the risk of change in the value of the assets. However, an AVR is required for that portion of the assets representing the insurer's equity interest in the investments of the separate account (e.g., seed money).

19. Assets supporting typical modified guaranteed contracts, market value adjusted contracts, and contracts with book value guarantees similar to contracts generally found in the general account do require an AVR because the insurer is responsible for credit related asset loss.

20. Certain separate accounts are also required to maintain an Interest Maintenance Reserve (IMR). The IMR requirements for investments held in separate accounts are applied on an account by account basis. If an IMR is required for a separate account, all of the investments in that separate account are subject to the requirement. If an IMR is not required for a separate account, none of the investments in that separate account are subject to the requirement.

21. An IMR is required for separate accounts with assets recorded at book value, but is not required for separate accounts with assets recorded at market value. For example, separate accounts for traditional variable annuities or variable life insurance do not require an IMR because assets and liabilities are valued at market value.

22. If an IMR is required for investments held by separate accounts, it is kept separate from the general account IMR and accounted for in the separate accounts statement.

23. The AVR and IMR shall be calculated and reported in accordance with the Annual Statement Instructions.

Policy Reserves

24. Statutory policy reserves shall be established for all contractual obligations of the insurer arising out of the provisions of the insurance contract. Where separate benefits are included in a contract, a reserve for each benefit shall be established as required in Appendix A-820. These statutory policy reserves are generally calculated as the excess of the present value of future benefits to be paid to or on behalf of policyholders less the present value of future net premiums. Statutory policy reserves meet the definition of liabilities as defined in *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets* (Issue Paper No. 5). The actuarial methodologies referred to in the following paragraph meet the criteria required for reasonable estimates in Issue Paper No. 5.

25. The reserving methodologies and assumptions used in computation of policy reserves shall also meet the provisions of Appendix A-250, A-270, A-255, A-585, A-588, A-620, A-820 A-822, and the actuarial guidelines found in Part 9 of the NAIC Financial Examiners Handbook. Where separate account contracts have guaranteed elements, the basis for determining the value of the liability shall be consistent with the basis used for asset values (i.e., valuation interest rates as defined in Appendix A-820 shall be used when assets are recorded as if held in the general account and current interest rates based on market rates shall be used when assets are recorded at market.) Further, policy reserves shall be in compliance with those Actuarial Standards of Practice promulgated by the Actuarial Standards Board.

Other Liabilities

26. The separate account shall accrue as a liability, subject to contractual provisions, amounts payable, including, but not limited to:

- Charges for investment management, administration, and contract guarantees
- Investment expenses
- Investment taxes, licenses, and fees (Investment taxes such as real estate taxes, licenses and fees (excluding federal income taxes) are usually paid directly by the separate account but may be transferred to the general account for payment)
- Federal income taxes
- Unearned investment income
- Net transfer due to (from) the general account
- Remittances and items not allocated
- Payable for investments purchased
- Net adjustments in assets and liabilities due to foreign exchange rates

Seed Money

27. When a new separate account is initiated, the insurer may make a temporary transfer of surplus funds commonly referred to as seed money to the separate account. Such funds and earnings accumulated thereon shall be reported as surplus in the separate accounts statement until transferred or repatriated to the general account. The transfer of such funds to and from the separate account shall be reported as surplus contributed or withdrawn during the year.

Disclosures

28. The general account financial statement shall include a description of the general nature and characteristics of the various kinds of separate accounts business conducted by the company and included in the company's Separate Accounts Statement. For each grouping (as detailed in paragraph 29), the following shall be disclosed:

a. Premiums, considerations or deposits received during the year;

b. Reserves by the valuation basis of the investments supporting the reserves at the financial statement date. List reserves for separate accounts whose assets are carried at market value separately from those whose assets are carried at amortized cost/book value;

c. Reserves by withdrawal characteristics, i.e., whether or not the separate account is subject to discretionary withdrawal or market value adjustment, or to withdrawal at book value with or without surrender charge;

d. Reserves for asset default risk, as described in paragraph 15.b., that are recorded in lieu of AVR.

29. Separate accounts shall be addressed in the following groupings (which are the same as those used for risk-based capital):

a. Separate Accounts with Guarantees:

i. Indexed separate accounts, which are invested to mirror an established index which is the basis of the guarantee;

ii. Nonindexed separate accounts, with reserve interest rate at no greater than 4% and/or fund long-term interest guarantee in excess of a year that does not exceed 4%;

iii. Nonindexed separate accounts, with reserve interest rate at greater than 4% and/or fund long-term interest guarantee in excess of a year that exceeds 4%.

b. Nonguaranteed Separate Accounts—Variable separate accounts, where the benefit is determined by the performance and/or market value of the investments held in the separate account. Include variable accounts with incidental risks, nominal expense, and minimum death benefit guarantees.

30. Provide a reconciliation of the amount reported as transfers to and from separate accounts in the Summary of Operations of the separate accounts statement and the amount reported as net transfers to or from separate accounts in the Summary of Operations of the general accounts statement.

DISCUSSION

Statutory Guidance

31. Consistent with Issue Paper No. 7, this issue paper adopts current statutory guidance for AVR and IMR for Life and Accident and Health insurance companies.

32. The statutory accounting principles outlined in the conclusion above regarding accounting and reporting for separate account life and annuity contracts are consistent with current statutory accounting, except for separate account deposit-type contracts which shall be accounted for consistent with the guidance in *Issue Paper No. 52—Deposit-Type Contracts.* The statutory accounting principles outlined in the conclusion above are consistent with the Statement of Concepts which states:

> Conservatism
>
> Financial reporting by insurance enterprises requires the use of substantial judgments and estimates by management. Such estimates may vary from the actual amounts for numerous reasons. To the extent that factors or events result in adverse variation from management's accounting estimates, the ability to meet policyholder obligations may be lessened. In order to provide a margin of protection for policyholders, the concept of conservatism should be followed when developing estimates as well as establishing accounting principles for statutory reporting.
>
> Conservative valuation procedures provide protection to policyholders against adverse fluctuations in financial condition or operating results. Statutory accounting should be reasonably conservative over the span of economic cycles and in recognition of the primary responsibility to regulate for financial solvency. Valuation procedures should, to the extent possible, prevent sharp fluctuations in surplus.
>
> Consistency
>
> The regulators' need for meaningful, comparable financial information to determine an insurer's financial condition requires consistency in the development and application of statutory accounting principles. Because the marketplace, the economic and business environment, and insurance industry products and practices are constantly changing, regulatory concerns are also changing. An effective statutory accounting model must be responsive to these changes and address emerging accounting issues. Precedent or historically accepted practice alone should not be sufficient justifications for continuing to follow a particular accounting principle or practice which may not coincide with the objectives of regulators.
>
> Recognition
>
> Liabilities require recognition as they are incurred. Certain statutorily mandated liabilities may also be required to arrive at conservative estimates of liabilities and probable loss contingencies (e.g., interest maintenance reserves, asset valuation reserves, and others).
>
> Revenue should be recognized only as the earnings process of the underlying underwriting or investment business is completed. Accounting treatments which tend to defer expense recognition do not generally represent acceptable SAP treatment.
>
> SAP income reflects the extent that changes have occurred in SAP assets and liabilities for current period transactions, except changes in capital resulting from receipts or distributions to owners. SAP income also excludes certain other direct charges to surplus which are not directly attributable to the earnings process, (e.g., changes in non-admitted assets).

GAAP Guidance

33. In Issue Paper No. 7, *Issue Paper No. 26—Bonds, Excluding Loan-Backed and Structured Securities, Issue Paper No. 50—Classifications and Definitions of Insurance or Managed Care Contracts In Force* (Issue Paper No. 50), and *Issue Paper No. 51—Life Contracts*, the GAAP guidance (principally, FAS 60, *FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, FAS 115, *FASB Statement 120, Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*, and *AICPA Statement of Position 95-1, Accounting for Certain Activities of Mutual Life Insurance Enterprises*) related to insurance contracts and separate account assets and liabilities was rejected for the reasons set forth therein.

Drafting Notes/Comments

- Issue Paper No. 50 addresses Classifications and Definitions of Insurance or Managed Care Contracts In Force.
- Issue Paper No. 51 addresses Life Contracts.
- Issue Paper No. 52 addresses Deposit-Type Contracts.
- This issue paper references the *Purposes and Procedures Manual of the NAIC Securities Valuation Office*. The guidance for AVR/IMR was subsequently moved to the Annual Statement Instructions for Life and Accident and Health Insurance Companies. SSAP No. 56 references the Annual Statement Instructions.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE (ONLY PERTINENT EXCERPTS ARE INCLUDED BELOW)

Statutory Accounting

34. The Life/A&H Accounting Practices and Procedures Manual, Chapter 25, Separate Accounts, provides the following guidance with respect to separate accounts:

SEPARATE ACCOUNTS

> A life insurance company is authorized by state statutes to establish separate accounts and to allocate thereto, pursuant to agreements, amounts paid to it. Separate accounts may be used:
>
> 1. to provide for annuities, whether ultimately payable in guaranteed fixed amounts or variable amounts or both;
>
> 2. to provide life insurance where the benefits, premiums, or both, are payable on a variable basis and for which the reserves vary according to the investment experience of the underlying separate account;
>
> 3. to accumulate funds which are intended to be applied at some later time to provide life insurance, whether fixed or variable or both; or
>
> 4. to accumulate, or hold in a separate account, proceeds applied under settlement or dividend options.
>
> All investment income and capital gains and losses (whether or not realized) from assets allocated to a separate account are, in accordance with applicable agreements, credited to or charged against the separate account policyholders. Investment performance is generally not guaranteed by the insurance company.
>
> Assets allocated to separate accounts are owned by the insurer and the insurer is not a trustee by reason of the separate accounts. However, if permitted or required by state law, a separate agreement may provide that the portion of the assets of the separate account equal to the

reserves and other contract liabilities of the separate account shall not be chargeable with liabilities arising out of any other business of the insurer.

State statutes generally provide that amounts allocated to a separate account and accumulations on those amounts may be invested and reinvested without regard to any requirements or limitations imposed upon an insurer by the investment statutes which apply to insurers generally.

Some statutes provide that to the extent that the insurer's reserve liability, with regard to benefits guaranteed as to dollar amounts and duration and funds guaranteed as to principle amount or stated rate of interest, is maintained in a separate account, a portion of the assets of the account at least equal to the reserve liability with regard to these benefits shall be invested in accordance with the investment statutes of the domiciliary state. These assets shall be reported separately and valued in accordance with the rules otherwise applicable to the insurer generally.

Assets allocated to a separate account, other than those provided for guaranteed benefits as described above, are valued at their market value on the date of valuation, or if there is no readily available market, then in accordance with the applicable contract.

The reserve or liability under a contract with a separate account provision is usually determined on the basis of the market value of the assets in the separate account.

Separate accounts may be used to fund individual variable life insurance, individual variable annuities, group variable life insurance, group variable annuities and various group contracts under pension or other employee benefit plans where funds are held in a separate account essentially as a liability. The financial experience on these separate accounts is reported in the annual statement of separate accounts business.

Relationships of the Separate Accounts Annual Statement and the Life and Accident and Health Annual Statement

Accounting for separate account business involves both the general account of a company and the separate accounts. The separate accounts annual statement is concerned primarily with the investment activities of the separate accounts and with the flow of funds from and to the general account. Insurance activities such as sales, underwriting and contract administration, premium collection and payment of premium taxes, claims, and benefits are functions of the insurance company distinct from the separate account fund and are accounted for as transactions of the general account; the expenses incurred on account of these functions are reported in the life and accident and health annual statement. Thus, premiums and considerations and benefit payments on separate accounts business are reported respectively in the premiums and annuity considerations exhibit and the policy contract claims exhibit of the life and accident and health statement. Similarly the policy exhibit and the exhibit of annuities and supplementary contracts with life contingencies in the life and accident and health statement includes variable annuity contracts.

Expenses incurred on contracts with separate accounts (other than direct investment expenses) are generally reported in the general account. Fees related to these expenses are charged to the separate accounts policyholders. Federal income taxes and taxes incurred on separate account investments are reported in the separate account statement, but other taxes, i.e., taxes on consideration, are reported in the general account. Where a variable annuity contract contains a guaranteed minimum benefit such as return of consideration paid on death within a specified period, any excess of the benefit paid over the separate account asset value of the contract would customarily be a charge against the general account. Any reserve liability for such death benefit provisions is normally carried in the general account.

Under a variable annuity contract containing mortality guarantees which are reserved in the general account, when lighter than expected mortality causes a deficiency in the investment funds underlying the contract reserves, the general account must transfer funds to the separate account. Conversely, excess funds form higher than expected mortality are transferred to the general account. As a general rule, the total statement value of the assets held in a separate account must be equal to (never less than) the total separate account reserve liability of the contracts participating in the separate account. If mortality gains are allowed to accumulate in the separate account, these accumulations may be reported as surplus.

Overview of the Flow of Funds and Accounting

Gross purchase payments received are reported in the life and accident and health statement. In the case of a variable life or variable annuity contract, the net purchase payment is transferred immediately to the separate account. In most cases, the purchase payment transferred will be net (gross minus loading).

If a net purchase payment on a variable annuity is not accounted for as consideration received, it should be transferred to the separate account as an “annuity deposit” or “purchase payment reserve” (or similar term). The loading might be treated as a consideration for accounting purposes. At such time as the accumulation is to be applied to purchase an annuity or supplementary contract, the entire accumulation (net purchase payments plus investment income) is transferred to the general account to be accounted for as consideration received. Appropriate taxes on the total amount of such consideration (including all accumulated investment income) are deducted before the remaining funds are either transferred back to the separate account as consideration for a variable annuity or supplementary contract or used to buy a fixed annuity or supplementary contract in the general account. The return of the fund or surrender or death prior to maturity is generally reported as a return of purchase payments. This is the equivalent of the redemption by the issuer of shares in a mutual fund, which a variable annuity in the accumulation stage closely resembles.

In the employee benefit area, separate accounts may be used to fund part or all of unallocated pension funds during the accumulation phase and group variable annuities in the payout phase. Amounts of consideration or purchase payments are received from the employer through the general account and transferred to the separate account after deducting any loading for expenses, etc. Funds withdrawn for the purchase of fixed or variable annuities are transferred to the general account where they are reported as considerations received. Applicable taxes are deducted prior to purchase of an annuity for a retiring employee.

Under certain arrangements, employee benefit funds may be put into a separate account to be accumulated until withdrawn to be used for various purposes. Such funds would not be reported as income; amounts transferred from the general account are reported net of amount returned.

Generally, considerations, purchase payments, deposits, etc., received by a separate account are recorded on a cash basis.

Life and annuity benefits and payments on supplementary contracts are paid through the general account with funds transferred from the separate account. The liability for any benefits transferred but unpaid at year-end would be carried by the general account.

Some variable annuity contracts, during the accumulation period, permit the contract holder to transfer funds between the separate account and the general account. In order to avoid inflating the income reported in either or both accounts, special provision is made for transferring these reserves between the general account and the separate accounts.

Individual variable annuity contracts usually contain guarantees for mortality and expense assumptions. Charges for these guarantees, and for administrative and investment management expenses, are usually expressed as an annual percentage of the asset value of the contract and may also include an amount per contract. Such charges may be calculated and deducted from the separate account on a daily, weekly, or monthly basis—generally the same interval at which the separate account is valued. Group contracts with separate account provisions may have similar arrangements.

Charges, when deducted from the separate account asset values, are usually transferred to the general account. Charges deducted but not yet transferred are usually carried as a liability in the separate accounts statement. Some companies prefer to accumulate the mortality and expense guarantee charges in the separate account as surplus.

Investment expenses incurred may be payable directly by the separate accounts or may be incurred by the general account to be reimbursed by the separate accounts. Investment expenses incurred by the general account on behalf of the separate accounts may be reported in the life and accident and health statement. These investment expenses may be deducted from this statement, on a line by line basis, and entered in the same way in the separate accounts statement; or they may be deducted as a single negative item in the life and accident and health statement and entered as a summary item in the separate accounts statement.

Investment taxes such as real estate taxes, licenses and fees (excluding federal income taxes) are usually paid directly by the separate accounts but may be transferred to the general account for payment. Federal income taxes are not paid directly by the separate accounts. The amount of federal income tax estimated as incurred is transferred to the general account.

A reserve for future federal income taxes is provided for in the separate accounts statement. The purpose of this item is to recognize that the amount of capital gains credited to contract holders at any time is the net after deducting capital gains taxes which would be payable under the assumption that all assets were disposed of at that point in time. This deduction is reflected in the increase in the liability item, “Reserves for future federal income taxes.” Note that a decrease in unrealized capital gains would cause a decrease in this reserve.

When a new separate account is initiated, the company may make a temporary transfer of surplus funds commonly referred to as “seed money” to the separate account. Such funds are reported as surplus in the separate accounts statement and the transfer of such funds to and from the separate account would be reported as surplus contributed or withdrawn during the year. The rules and regulations of various states restrict the sale, exchange, or transfer of assets between the general and separate accounts.

Separate accounts, as reported in the statement blank, would normally not develop a gain from operations because (a) gains or losses arising from mortality and expenses are reflected in the general account; (b) investment expenses and taxes are deducted from investment gains and losses; and (c) investment gains and losses after expenses and taxes are absorbed in the increase in reserve liabilities. A gain from operations could arise from earnings on contributed surplus maintained in a separate account or when a company does not transfer mortality and expense guarantee charges out of the separate accounts. Note that a separate account surplus can never be permitted to become negative.

Mortality gains and losses can be handled in either of two ways.

1. If the separate accounts are being reported on a zero gain from operations basis, then any net gain from mortality should be transferred to the general account, or, if a loss, a transfer of an offset amount should be made from the general account. In either case, on the aggregate write-in lines under “Other transfers from the separate accounts” in the Summary of Operations page of the separate accounts statement, appropriately captioned, e.g., “Other transfers (net),” may be used. An offset to a mortality loss would be a negative entry.

2. If mortality gains or losses are to be permitted to flow through to the gain from operations and the surplus account is to be kept at zero, then a counterbalancing entry must appear in the surplus account. Since surplus in a separate account cannot be permitted to be negative, a counterbalancing contribution to surplus from the general account must be made whenever surplus would otherwise become negative.

The analysis of increase in reserves illustrates how the year-end reserves reported are developed from the operations of the separate account. It follows in a general way the corresponding analysis in the life and accident and health statement.

Separate Account Reporting in the Life and Accident and Health Statement

Transfer transactions affect both the life and accident and health and the separate accounts statements but to avoid duplicate detailed reporting, and also to avoid complicating the life and accident and health statement, the details of the transfer are shown only in the separate accounts statement. Aggregate transfer items are netted and shown in the inserts on the liabilities page and in the Reconciliation of Cash and Invested Assets in the separate accounts statement. These same net totals would be included as single line entries on appropriate pages of the life and accident and health statement.

The asset page of the life and accident and health statement provides for the entry of the totals from the asset page of the separate accounts statements. The liabilities page of the life and accident and health statement provides for two entries from the separate accounts statements. The first entry shows the amount of transfers to the separate accounts due or accrued. This item is entered on a net basis so that if there is an amount due from the separate accounts to the general accounts, the net of the two will be entered as a negative item. The reason for this treatment is that a more normal treatment, under which an amount due the general account from the separate account is entered as an asset in the life and accident and health statement, would inflate both the assets and the liabilities totals of the life and accident and health annual statement. The second entry on the liabilities page of the life and accident and health statement is for the total liabilities entry from the separate accounts statement.

The Summary of Operations and Analysis of Operations by Lines of Business of the life statement provide for entry of net transfers to separate accounts--there is no one source for this figure in the separate accounts statement. Items relating to separate accounts may also appear as direct entries to surplus.

35. The Separate Accounts Annual Statement Blank Instructions provide the following guidance with respect to separate accounts:

GENERAL

The instructions for completing the general account are to be followed to the extent applicable. This supplement provides additional instructions that are unique to the Separate Accounts Blank as well as some that differ from those for the Life and Accident and Health Blank. Where there is a conflict with the Life Blank's instructions use these instructions. The reporting date must be plainly written or stamped at the top of all pages, exhibits and schedules (and duplicate schedules) and also upon all inserted schedules and loose sheets.

The separate accounts statement reports only the operations of the separate accounts themselves. It assumes that the administration of the contracts is reflected in the general account statement-hence, administrative expense does not appear in the Separate Accounts Statement, premiums and considerations are net of loading, and the expenses and taxes are those associated with the separate account investment operations.

Receipts other than income from investments are handled as a transfer from the general account. Similarly, amounts providing for the payment of benefits, including surrender benefits and various other payments, appear as transfers from the separate account to the general account. When eventually paid, these items are reported in the general account statement. The assets and liabilities are strictly those which arise from the operations of the separate accounts themselves, i.e., policy and contract reserves and items related to the making of investments, including investment expenses and taxes due or accrued. Unpaid transfers due the general account, such as surplus, contractual benefits, or contractual charges, would also appear on the liability page.

36. The June 5, 1995 minutes of the Separate Accounts Working Group of the Accounting Practices and Procedures (EX4) Task Force provide the following guidance with respect to separate accounts:

> 1. Accounting for Separate Account Surplus
>
> Peter Storms (Arthur Andersen) provided a summary of the work accomplished to date relative to accounting for separate account surplus. Mr. Storms noted that the interested parties group continues to support its original recommendation.
>
> Tomoko Stock (Calif.) stated that California opposes the recommendation of the interested parties group. Specifically, they oppose the reporting of fee income, generated through the use of Commissioners Annuity Reserve Valuation Method (CARVM), being allowed to flow through the general account's income statement on an accrual basis. Ms. Stock suggested that this treatment of fee income inflates current income and has a potential impact on stockholder dividends. The California position is to recognize the income as it is realized.
>
> Jack Gies (Conn.) noted that surplus created through the use of CARVM is a book item, not a cash item. He also noted that the income earned from separate account fees is fairly certain to be realized either through mortality and expense charges or through surrender charges.
>
> Working group members noted that the accounting treatment being proposed assumes that CARVM is being applied in an accurate and prudent manner.
>
> Alan Close (Northwestern Mutual Life) stated that his recommendation included a different balance sheet presentation from that recommended by the interested parties group, with an approach that stresses the appropriate measure of assets and liabilities. He noted, however, that his recommendation supported the income statement presentation recommended by the interested parties group.
>
> Bill Carroll (American Council of Life Insurance—ACLI) noted that the ACLI's committee on statutory accounting met in May 1995 and voted to support the recommendation of the interested parties.
>
> After being duly moved and seconded, the working group voted to adopt the accounting treatment for separate account surplus which requires that separate account surplus created through the use of CARVM be recorded as an unsettled transfer from the separate accounts; that separate account seed money and earnings accumulated thereon, be reported in the separate accounts until repatriated; and that the net gain from separate accounts operations be included in the general account summary of operations. Blank proposals to effect this accounting treatment will be prepared for submission prior to July 1, 1995.
>
> Ms. Stock noted that the adopted accounting treatment will include parenthetical entries on the balance sheet to specifically identify amounts in the transfer account that are related to the use of CARVM.
>
> The working group noted, that in adopting this accounting treatment, it will be necessary for the Risk-Based Capital Task Force to revise the life risk-based capital report to include the separate accounts transfer balance with the separate accounts surplus when applying the risk-based capital charge. Blaine Shepherd (Minn.) stated that he would report this issue to the Risk-Based Capital Task Force.

37. Chapter 16, *Asset Valuation Reserve and Interest Maintenance Reserve*, in the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies states the instructions for calculating the AVR and IMR are contained in the Annual Statement Instructions for Life and Accident and Health Insurance Companies.

38. Section 6. *Interest Maintenance Reserve and Asset Valuation Reserve for Life Insurance Companies* and *Fraternal Benefit Societies of the Purposes and Procedures Manual of the NAIC Securities Valuation Office* contains the following excerpts (note that this is not quoted in its entirety):

> This Section applies to all life insurance companies and fraternal benefit societies. The Section describes in general terms, principles of the calculation for Interest Maintenance Reserve (IMR) for realized gains and losses from fixed income investments and the Asset Valuation Reserve (AVR) on all invested assets held by a company. [Refer to the NAIC's Life and Health Annual Statement Instructions for specific reporting guidance.] The IMR is a single component reserve. The AVR breaks down into two major components and each component has two subcomponents:
>
> The Default Component--
>
> (i) Other Than Mortgage Subcomponent
> (ii) The Mortgage Subcomponent
>
> The Equity Component--
>
> (i) The Common Stock Subcomponent
> (ii) The Real Estate and Other Invested Assets Subcomponent
>
> (A) Interest Maintenance Reserve (IMR). This reserve applies to realized capital gains and losses net of tax on short-term and long-term fixed income investments. These gains and losses are from the disposal of investments as reported in Schedule D, Part 4 for long-term bonds and preferred stock; Schedule DA, short-term bonds; Schedule DB, interest rate hedges; Schedule B, mortgage loans; or Schedule BA for other fixed income investments. The reserve captures the realized capital gains and losses resulting from changes in the general level of interest rates. These gains and losses are to be amortized into investment income over the expected remaining life of the investments sold. The IMR also applies to certain liability gains/losses related to changes in interest rates. These gains and losses are to be amortized into investment income over the expected remaining life of the liability released.
>
> The current year's IMR is equal to:
>
> The beginning balance
> plus (minus) the realized capital gains (losses) net of tax attributed to interest rate changes
> plus (minus) realized liability gains (losses) net of tax attributed to interest rate changes
> less an amortization amount
>
> (a) Interest Related Realized Capital Gains and Losses:
>
> The gains and losses are to be reported net of applicable capital gains taxes allocated in accordance with an insurers established policy.
>
> A realized gain or loss on each debt security and mortgage backed security will be an interest related gain or loss if the debt security's beginning NAIC rating did not change by more than one classification at the end of the holding period. The holding period is defined as the period from the date of purchase to the date of sale. With respect to Class One Bond Mutual Funds, "realized capital gains and (losses)" include any capital gains and losses realized by the Company, whether from sale of the Fund or capital gains distributions by the Fund. However, where the gain on a convertible bond or preferred stock sold while "in the money" is included in IMR, the expected maturity date is defined as the next conversion date. "In the money" is defined to mean that the number of shares available currently or at next conversion date, multiplied by their current market price, is greater than the statement value of the convertible asset. However, for a convertible bond or convertible preferred stock purchased while its conversion value exceeds its

par value, any gain or loss realized from its sale before conversion must be excluded from the IMR and included in the AVR. Conversion value is defined to mean the number of shares available currently or at next conversion date, multiplied by the stock's current market price. The holding period is defined as the period from the date of purchase to the date of sale. For end of period classification, the most recent available rating should be used. For debt securities acquired before January 1, 1991, the debt security's rating as of December 31, 1990 should be the beginning rating used for this purpose. A debt security's gain or loss should not be included in this reserve if the debt security rating was ever a "6" during the holding period.

Preferred stock that did not have an NAIC/SVO rating classification of "PSF-4", "PSF-5", "PSF-6" or "P-4", "P-5" or "P-6" at any time during the holding period should be reported as interest related gains and (losses) in the Interest Maintenance Reserve if the stock's beginning NAIC/SVO rating did not change by more than one classification at the end of the holding period.

For preferred stocks acquired before January 1, 1993, the holding period is assumed to have begun in December 31, 1992.

For Class One Bond Mutual Funds, the holding period is defined as one calendar year to expected maturity.

Determination of IMR gain or loss on multiple lots of the same securities should follow the underlying accounting treatment in determining the gain or loss. Thus, the rating classifications, on a purchase lot basis, should be compared to the rating classification at the end of the holding period to determine IMR or AVR gain or loss.

Losses recognized on loan-backed bonds and other structured securities that have a negative effective yield at the date of valuation should be treated as realized losses and included in the reserve as if the security had been sold and the loss considered an interest rate loss. If the security is valued using the prospective adjustment methodology, a negative effective yield occurs when the net undiscounted sum of anticipated future cash flows of the security is less than the current book value of the security at the date of valuation. If the security is valued using the retrospective adjustment methodology, a negative effective yield occurs when the net undiscounted sum of actual and anticipated cash flows is less than the original cost of the investment.

Capital gains and losses net of capital gains tax on mortgage loans, where interest is not more than 90 days past due, not in process of foreclosure, not in course of voluntary conveyance, or have not had restructured terms over the prior two years will be classified as an interest rate gain or loss. Prepayment penalties recorded as capital gains on mortgage securities are also considered to be due to interest rate changes.

Realized gains and losses on fixed income investments recorded on Schedule BA should be classified as an interest gain or loss if they are in the nature of those defined for bonds, preferred stocks and mortgages.

Realized gains and losses, net of capital gains tax, on derivative investments arising out of transactions entered into solely for the purpose of altering the interest rate characteristics of the company's assets and/or liabilities should be allocated to the IMR and amortized into income over the remaining life of the assets or liabilities associated with the derivative instruments. Gains or (losses) on dollar repurchase agreements that are traded for the fee have no IMR (or AVR) impact because they are treated as financings.

If during the course of the year, the SVO removes the classification of "class one" from a Class One Bond Mutual Fund, the company shall not report capital gains or (losses) on this schedule. Any such removal of the "class one" classification will cause the Fund to be reported as common stock on the applicable schedules.

(b) Liability gains/(losses) Subject to IMR Amortization

1) Reinsurance -

The interest rate related gain or loss (net of taxes) associated with the sale, transfer or reinsurance of a block of liabilities must be credited or charged to the IMR and then amortized into income provided:

1. the portion of the block reinsured represents more than 5% of a company's general account liabilities (Page 3, Line 26 of the Annual Statement),

2. the transaction is irrevocable and is to a non-affiliate and

3. the transaction was completed in the current year.

A company may elect to use a lower materiality threshold than the 5% specified in Item 1 above provided that such election is applied consistently to all transactions subsequent to the election, and the election is conveyed to the Insurance Department of the state of domicile. Once a threshold is elected, it can only be changed with the prior approval of the Insurance Department of the state of domicile.

The amount of the gain or loss that is interest rate related and its IMR amortization should be determined using the following procedure for the portion of the block sold, transferred or reinsured.

1. Identify the IMR balance and future amortization arising from the past and present dispositions of the assets associated with the block of liabilities.

2. Identify the IMR balance and future amortization that would result if the remaining assets associated with the block of liabilities were to be sold.

3. Define the interest rate related gain or (loss) net of taxes to be the negative of the sum of the IMR balances determined in steps 1 and 2. The future amortization of the gain or loss is the negative of the sum of the amortization determined in steps 1 and 2.

The associated assets are the assets allocable to the reinsured block of business for the purposes of investment income allocation. If the company has not been tracking the investment income of the block, it should retrospectively identify the assets using procedures consistent with its usual investment income allocation procedures. The associated assets are not necessarily the same as the assets transferred as part of the transaction.

2.) Market Value Adjustments

Material gains or losses resulting from market value adjustments on policies and contracts backed by assets that are valued at book, including the marginal tax impact, should be captured by the IMR and amortized in a manner consistent with the determination of the market value adjustment. A gain or loss is considered material if it is in excess of both .01% of liabilities and $1,000,000. The amortization schedules should be determined in a manner consistent with the determination of associated market value adjustment.

(d) Amortization into income:

There are two acceptable methods for accumulating and calculating the amortization schedule. A company can select either the seriatim method or the grouped method for calculating IMR amortization. Although a company is not precluded from changing methods on a prospective basis, the overriding consideration is the reasonableness of the amortization. However, once a method is selected for a particular year's capital gains, the amortization is locked in and cannot be changed (at least not without the specific approval of the commissioner).

1. Seriatim Method--The amount of each capital gain or (loss), net of capital gains tax, amortized in a given year using the seriatim method is the excess of the amount of income that would have been reported in that year, had the asset not been disposed of, over the amount of income that would have been reported had the asset been repurchased at its sale price. The capital gains tax associated with or allocated to each gain or (loss) should be amortized in proportion to the amortization of the gain or (loss).

For loan-backed bonds and structured securities that are valued using currently anticipated prepayments use an amortization schedule developed using the anticipated future cash flows of the security sold consistent with the prepayment assumptions that would have been used to value the security had the security been purchased at its sale price.

The seriatim calculation on an asset by asset basis is the desired approach, but since a seriatim approach may impose an administrative burden on some companies, each company may use the method employed by that company to amortize interest related capital gains and losses among lines of business and policyholders in accordance with the investment income allocation process as approved by the state insurance department.

2. Grouped Method-- A company may use a standard "simplified method" by which the capital gains and (losses), net of capital gains tax, are grouped according to the number of calendar years to expected maturity.

The groupings are based on the years to expected maturity as of the date of sale.

0 calendar years to expected maturity,
1 calendar year to expected maturity,
2 to 5 calendar years to expected maturity,
6 to 10 calendar years to expected maturity,
11 to 15 calendar years to expected maturity,
16 to 20 calendar years to expected maturity,
21 to 25 calendar years to expected maturity,
over 25 calendar years to expected maturity.

The amortization schedule for the current year is the sum of the gains and losses by maturity groupings times the appropriate factor for the current and future years. The maturity groupings and factors are found in 6(B)(j).

The presence of sinking fund payments, amortization schedules, expected prepayments, and adjustable interest rates complicate the determination of the number of calendar years to expected maturity. The expected maturity date is:

For fixed income instruments with fixed contractual repayment dates and amounts (including bonds, preferred stock, callable or convertible bonds and preferreds), the expected maturity is defined as the contractual retirement date that produces the lowest amortization value for Annual Statement purposes (lowest internal rate of return or "yield to worst"). Potential retirement dates include all possible call dates, and the contractual maturity date where a convertible bond or convertible preferred stock is sold while its conversion value exceeds it statement value and the gain is included in IMR, the expected maturity date is defined as the next conversion date. Conversion value is defined to mean the number of shares of common stock available currently or at the next conversion date, multiplied by the stock's current market price. When the instrument's contractual terms include scheduled sinking fund payments of fixed amounts, an additional calculation of yield to average life should be included in the analysis where average life is defined as the date at which the instrument is 50% repaid. For puttable instruments, where the exercise option rests with the investor, expected maturity is the put or maturity date that produces the highest internal rate of return. For Class One Bond Mutual Funds, use one calendar year to expected maturity. For perpetual instruments, the expected maturity is 30 years from the current date.

However, where a callable bond purchased at a premium is called or sold after the expected maturity date, there should be no amortization of the call premium or interest rate related gain or loss and the gain or loss should be taken into income immediately. Similarly there should be no amortization of any interest rate related gain or loss arising if a convertible bond or preferred stock is disposed of after the expected maturity date.

For liability gains and losses included in the IMR, amortization should be determined in a manner consistent with the determination of associated market value adjustment or assets transferred.

“Calendar years to expected maturity” means the calendar year of expected maturity minus the calendar year of sale date.

For purposes of the grouped method, the following additional assumptions are applicable:

- For fixed income investments, other than residential mortgages and residential mortgage pass-throughs, without a maturity date or sinking fund schedule, a maturity date 30 years from the current year should be used.

- For loan-backed bonds and other structured securities that are valued using currently anticipated prepayments use the remaining weighted average life of principal and interest payments consistent with the prepayment assumptions that would have been used to value the security had the security been repurchased at its sale price.

(e) Separate Accounts

Interest Maintenance Reserve (IMR) requirements for investments reported in the separate accounts statement are applied on an account by account basis. If an IMR is required for a separate account, all of the investments in the separate account are subject to the requirement. If an IMR is not required for a separate account, none of the investments in that separate account are subject to the requirement.

An IMR is required for separate accounts valued at book, but is not required for separate accounts valued at market. For example, separate accounts for traditional variable annuities, or variable life insurance do not require an IMR because assets and liabilities are valued at market.

If an IMR is required for investments in the separate accounts statement, it is kept separate from the general accounts IMR and accounted for in the separate accounts statement. For further details see rules as explained in Sec (6) (A) (f).

(f) Negative IMR

A negative IMR balance may be recorded as a negative liability in either the general account or the separate accounts statements of a company only to the extent that it is covered or offset by a positive IMR liability in the other statement.

The following information is presented to assist in determining the proper accounting:

General Account IMR Balance	Separate Accounting IMR Balance	Net IMR Balance
Positive	Positive	Positive (See rule a)
Negative	Negative	Negative (See rule b)
Positive	Negative	Positive (See rule c)
Positive	Negative	Negative (See rule d)
Negative	Positive	Positive (See rule e)
Negative	Positive	Negative (See rule f)

Rules:

a) If both balances are positive, then report each as a liability in its respective statement.

b) If both balances are negative, then no portion of the negative balances is allowable as a negative liability in either statement. Report a zero for the IMR liability in each statement. If there is any disallowed negative IMR balance in the general account statement, record the disallowed portion as a positive amount for Disallowed IMR in a write-in line for assets not admitted in Exhibit 14. If there is any disallowed negative IMR balance in the separate accounts statement, determine the change in the disallowed portion and make a direct charge or credit to the surplus account for the Change in Disallowed IMR.

c) If the general account balance is positive, the separate accounts balance is negative and the combined net balance is positive, then all of the negative IMR balance is allowable as a negative liability in the separate accounts statement.

d) If the general account balance is positive, the separate account balance is negative, and the combined net balance is negative, then the negative amount not covered by the positive amount is not allowable. Report only the allowable portion as a negative liability in the separate accounts statement, and follow the instructions in b) above for handling the disallowed portion of negative IMR balances in the separate accounts statement.

e) If the general account balances is negative, the separate account balance is positive, and the combined net balance is positive, then all of the negative IMR balance is allowable as a negative liability in the general account statement.

f) If the general account balance is negative, the separate account balance is positive, and the combined net balance is negative, the negative amount not covered by the positive amount is not allowable. Report only the allowable portion as a negative liability in the general account statement, and follow the instructions in b) above for handling the disallowed portion of negative IMR balances in the general account statement.

(B) Asset Valuation Reserve (AVR). This reserve shall apply to the specific risk characteristics of all the invested asset categories excluding cash, policy loans, premium notes, collateral loans and income receivables. The specific assets to be included in each subcomponent are:

The Default Component

The Other Than Mortgage Loans Component shall include all fixed income investments that are corporate or governmental unit obligations, excepting those listed in subsection (g) as exempt from the AVR reserve, preferred stock and loan backed securities as reported in Schedule D - Part 1 and Part 2 -- Section 1, and Schedule DA, and counterparty exposure arising from derivative transactions as reported in Schedule DB - Part E - Section 1.

The Mortgage Loans Subcomponent shall include all farm, commercial, residential mortgages as reported in Schedule B and Schedule DA.

The Equity Component

The Common Stock Subcomponent shall include all affiliated and unaffiliated common stock investments as reported in Schedule D, Part 2--Section 2.

The Real Estate and Other Invested Asset Subcomponent shall include all real estate reported on Schedule A and all Other Invested Assets as reported on Schedule BA and DA.

(a) Calculation of the AVR:

The current year's AVR by subcomponent is equal to:

The beginning balance
plus (minus) the realized capital gains (losses) net of tax as allocated by the company on assets corresponding to the subcomponent
plus (minus) unrealized capital gains (losses) on assets corresponding to the subcomponent
plus (minus) transfers between components
plus an annual contribution
plus any voluntary contribution
plus (minus) an adjustment up to zero or down to maximum.

(b) Realized Capital Gains and Losses:

Report all realized credit-related (default) and equity capital gains and (losses), net of capital gains tax applicable to the assets in each component and subcomponent including those realized capital gains and (losses) that are incurred on Separate Accounts assets for which AVR treatment is required. Exclude all interest rate related capital gains and (losses) from the AVR.

A realized gain or loss on a debt security will be a credit related gain or loss if the debt security's beginning NAIC/SVO rating changed by more than one classification at the end of the holding period. The holding period is defined as the period from the date of purchase to the date of sale. For debt securities acquired before January 1, 1991 the debt securities rating as of December 31, 1990 should be the beginning rating used for this purpose. A debt security gain or loss should always be included in this reserve if the bond rating was ever a "6" during the holding period. Determination of the AVR gain or loss on multiple lots of the same fixed income securities should follow the underlying accounting treatment in determining gain or loss. Thus, the rating classifications, on a purchase lot basis, should be compared to the rating classification at the end of the holding period to determine IMR or AVR gain or loss. Permanent impairment write-downs are treated as credit-related (losses).

Preferred stock that had an NAIC/SVO rating classification of "PSF-4", "PSF-5", "PSF-6", "P-4", "P-5" or "P-6" at any time during the holding period shall be reported as credit related gains and (losses) in the Asset Valuation Reserve.

However, for a convertible bond or preferred stock purchased while its conversion value exceeds its par value, any gain or loss realized from its sale before conversion must be included in the Equity Component of the AVR. Conversion Value is defined to mean the number of share available currently or at next conversion date, multiplied by the stock's current market price.

For preferred stocks acquired before January 1, 1993 the holding period is presumed to have begun on December 31, 1992.

In addition, all gains or losses, net of capital gains taxes, on mortgage loans, where interest is more than 90 days past due, in the process of foreclosure in course of voluntary conveyance, or have had restructured terms over the prior two years, would be classified as credit related gains or losses. Permanent impairment writedowns are also treated as credit losses.

Realized gains or losses net of capital gains tax on portfolio or general hedging instruments should be included with the hedged assets. Gains or losses net of capital gains tax on hedges used as specific hedges should be included only if the specific hedged asset is sold or disposed.

Realized gains or losses on derivative instruments not accounted for as specific (as opposed to general) hedge transactions should be allocated to the component and subcomponent of the assets associated with the derivative instruments used in the general hedge.

Realized gains or losses, net of capital gains resulting from the sale of U.S. Government Securities and the direct or guaranteed securities of agencies which are backed by the full faith and credit of the U.S. Government are exempt from the AVR. This category is detailed in Section 6(B)(g)(i).

The gains or (losses) are to be reported net of applicable capital gains taxes as allocated by the company.

(c) Unrealized Capital Gains and Losses:

Unrealized gains and losses should be summarized by subcomponent asset type and included in the reserve computation including those unrealized capital gains and (losses) that are incurred on Separate Account assets for which AVR treatment is required. The equity method of accounting is allowed in accounting for the operating results of subsidiary, controlled or affiliated companies. If the equity accounting method is used, the amount of the undistributed income or loss reported in Exhibit 2 of the Annual Statement less the amount of any dividends received is to be included as an unrealized capital gain or loss when computing the Common Stock Subcomponent. Unrealized gains and (losses) for Affiliated Life Insurance Companies which are maintaining their own AVR are excluded since the maximum reserve factor for such companies is 0%.

Unrealized gains or losses on hedging instruments should be included with the hedged instruments.

(d) Transfers Between Components:

If the sum of a subcomponent's beginning balance, realized gains and losses and unrealized gains and losses is greater than the ending maximum of the subcomponent, and the balance of its sister subcomponent is below its maximum reserve, the excess must be transferred to the other subcomponent of the Default or Equity components up to that subcomponent's maximum.

If after the above transfers, the Equity or Default component is greater than total maximum for the component, the excess may be transferred to the other component or may be released to surplus.

If the balance before transfers of any of the four sub-components is negative, and the balance before transfers of its “sister” subcomponent within the same component is positive, the negative amount should be transferred to the “sister” sub-component to the extent that the transfer does not reduce the positive balance before transfers of the “sister” sub-component to less than 50% of its balance prior to the transfer.

No other transfers may be made without Commissioner approval. No transfers between the AVR and IMR are allowed.

(e) Annual Contribution:

The formula for the annual contribution to a subcomponent is as follows:

The contribution rate times the difference between the subcomponent maximum amount and the accumulated balance. (Accumulated balance is shown on Page 49, Line 6 of the Annual Statement). This number will be positive when the maximum reserve exceeds the accumulated balance and negative when the accumulated balance is in excess of the maximum reserve.

(f) Contribution Rate:

The contribution rate is 20% per year.

(h) Voluntary Contribution to the Reserves:

Companies may make voluntary contributions to the subcomponents. Voluntary contributions will become a permanent part of the AVR once they have been reported and may not be removed in subsequent years.

39. The NAIC Annual Statement Instructions provide the following guidance (note that this is not quoted in its entirety):

INTEREST MAINTENANCE RESERVE

Interest Maintenance Reserve (IMR) requirements for investments reported in the Separate Accounts Statement are applied on an account by account basis. If an IMR is required for a separate account, all of the investments in that separate account are subject to the requirement. If an IMR is not required for a separate account, none of the investments in that separate account are subject to the requirement.

An IMR is required for separate accounts valued at book but is not required for separate accounts valued at market. For example, separate accounts for traditional variable annuities, or variable life insurance do not require an IMR because assets and liabilities are valued at market.

If an IMR is required for investments in the Separate Accounts Statement, it is kept separate from the General Account IMR and accounted for in the Separate Accounts Statement.

ASSET VALUATION RESERVE

Asset Valuation Reserve (AVR) requirements for investments reported in the Separate Accounts Statement are applied on an account by account basis. If an AVR is required for a separate account, all of the investments in that separate account are subject to the requirement. If an AVR is not required for a separate account, none of the investments in that separate account are subject to the requirement (except to the extent that such investments represent the company’s capital and surplus interest in those investments).

Whether or not an AVR is required for separate account assets depends primarily on whether the insurer or policyholder/contractholder suffers the loss in the event of asset default or market value loss. An important exception to this is when specific state regulation provides an alternative to the AVR.

An AVR is required for separate account investments unless:

1. The asset default or market value risk is essentially borne directly by the policyholders, or

2. The regulatory authority for such separate accounts already explicitly provides for establishment of a reserve for asset default risk where such reserves are essentially equivalent to the AVR.

For example, assets supporting traditional variable annuities, and variable life insurance do not require an AVR because the policyholders/contractholders bear the risk of change in the value of assets. However, an AVR is required for that portion representing the company's equity interest in the investments of such a separate account, (seed money interest, for example). Assets supporting typical modified guaranteed contracts or market value adjusted contracts do require an AVR because the company is responsible for credit related asset loss. Another category of contracts requiring an AVR is contracts with book value guarantees similar to contracts generally found in the general account.

An example of the exception referred to in (2) above are contracts with market value separate accounts funding guaranteed benefits where state regulation provides alternatives to the AVR.

The following criteria are presented to assist in determining when an AVR or an IMR are required for investments in the Separate Accounts Statement:

Assets	Liabilities	Does Co. Suffer Asset Loss?	If Yes, Any Other Provision?	AVR*	IMR	Example Product
Market	Market	No	--	No	No	Variable Annuity
Market	Market**	Yes	No	Yes	No	Modified Gtd. Annuity
Market	Market	Yes	Yes	No***	No	MV S/A funding Gtd. Benefits
Book	Book	No	--	No	No	--
Book	Book	Yes	No	Yes	Yes	GIC in S/A
Book	Book	Yes	Yes	No***	Yes	--

* However, an AVR is required for that portion representing the company's equity interest in the investments of such a separate account.

** But not less than adjusted cash surrender value.

*** You must establish an AVR reserve unless there is a statutory requirement for the equivalent of an AVR reserve for such products.

> If an AVR is required for investments in the Separate Accounts Statement, it is combined with the General Account AVR and accounted for in the General Account Statement. Worksheets supporting the separate accounts portion of the reserve are included in the Separate Accounts Statement.
>
> When the AVR Default Component covers assets valued at market, use one of the following two methods (applied consistently by separate account) to determine when a gain or loss (net of capital gains tax) is credited or charged to the AVR:
>
> 1. A gain or (loss) is recorded as for the general account rules, i.e., upon sale of an asset which has changed more than one rating category or upon asset default. Once an asset is in default, all subsequent market value changes are reflected in the AVR, or
>
> 2. A similar procedure to Method 1 above is followed but, additionally, a gain or (loss) is recorded whenever an asset held changes by more than one rating category. As there might be more than one such event for a particular asset, e.g., a two rating downgrade followed by subsequent sale of the asset, the amount charged the AVR is net of any prior amounts charged for that asset.
>
> When an AVR is required for the company's equity or capital and surplus interest in the investments of a particular separate account that does not otherwise require an AVR, the AVR requirement is based on the company's equity interest as of the statement date, expressed as a percent of total assets of the particular separate account. Once the equity interest percentage has been determined, it is applied to the realized and unrealized capital gains and losses and the investments of that particular separate account to determine the amounts to be included in the separate accounts data used for development of the current AVR. If the company's equity interest in all such separate accounts is less than 1/10th of 1% of the company's total admitted assets, the equity interest in the investments of such separate accounts is exempt from AVR requirements.

40. Most state regulations refer to the literature of the NAIC for guidance on the calculation of AVR and IMR. An example is the Texas Administration Code, Title 28 - Insurance, Chapter 7, *Corporate and Finance*, which states:

> (4) Asset valuation reserve (AVR) -- A reserve applied to the specific risk characteristics of all the invested asset categories except cash, policy loans, premium notes, collateral loans, and income receivables. Asset valuation reserves shall be calculated as prescribed by the NAIC and adopted from time to time by the State Board of Insurance under the Texas Administrative Code, Title 28, Chapter 7.
>
> (12) Interest maintenance reserve (IMR) -- A reserve applied to realized capital gains and losses on short-term and long-term fixed investments. These gains and losses are from the disposal of investments as reported in Schedule D, part 1 -- Bonds, or Schedule B -- Mortgage Loans of the current annual statement. The reserve captures the realized capital gains and losses resulting from changes in the general level of interest rates as prescribed by the NAIC and adopted from time to time by the State Board of Insurance under the Texas Administrative Code, Title 28, Chapter 7.

Generally Accepted Accounting Principles

41. FAS 60 provides the following guidance related to separate accounts:

> Separate Accounts
>
> 53. Separate accounts represent assets and liabilities that are maintained by an insurance enterprise for purposes of funding fixed-benefit or variable annuity contracts, pension plans, and

> similar activities. The contract holder generally assumes the investment risk, and the insurance enterprise receives a fee for investment management, certain administrative expenses, and mortality and expense risks assumed.
>
> 54. Investments in separate accounts shall be reported at market except for separate account contracts with guaranteed investment returns. For those separate accounts, the related assets shall be reported in accordance with paragraphs 45-51. Separate account assets and liabilities ordinarily shall be reported as summary totals in the financial statements of the insurance enterprise.
>
> The reporting requirements of FAS 60, paragraphs 45-51, have been amended by *FASB Statement No. 91*, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, FAS 97, FAS 114, FAS 115, and FAS 121.

42. AVR and IMR are not addressed in current GAAP literature.

43. Paragraph 28 of FAS 97, as amended by FAS 115, addresses the GAAP accounting for realized gains and losses. It states:

> Reporting of Realized Investment Gains and Losses of Investments
>
> 28. Statement 60 required that insurance enterprises report realized gains and losses in the statement of earnings below operating earnings and net of applicable income taxes. This Statement precludes that practice. Realized gains and losses shall be reported in the statement of earnings as a component of other income, on a pretax basis, and shall not be deferred to future periods either directly or indirectly. The first sentence of paragraph 50 of Statement 60 is superseded by the following: Realized gains and losses on all investments (except investments that are classified as trading securities and those that are accounted for as hedges as described in FASB Statements No. 52, Foreign Currency Translation, and No. 80, Accounting for Futures Contracts) shall be reported in the statement of earnings as a component of other income, on a pretax basis. Realized gains and losses shall be presented as a separate item in the statement of earnings or disclosed in the notes to the financial statements. Realized gains and losses shall not be deferred, either directly or indirectly.

OTHER SOURCES OF INFORMATION

44. The draft discussion material from previous Life Codification projects contains the following excerpts:

> Chapter 16A - Interest Maintenance Reserve
>
> All U.S. life insurance companies and fraternal benefit societies are required to establish an Interest Maintenance Reserve (IMR) for realized gains and losses resulting from changes in the overall level of interest rates on fixed income investments. The IMR is calculated in accordance with instructions promulgated by the Valuation of Securities (EX4) Task Force of the National Association of Insurance Commissioners and contained in the Life Accident and Health Annual Statement Instructions and the Valuation of Securities manual. Because the instructions for the calculation of the IMR are periodically revised, the current publications should be consulted.
>
> The purpose of the IMR is to protect surplus from investment transactions that are entered into as a reaction to interest rate movements. The IMR minimizes the effect that realized capital gains and losses attributable to interest rate movement have on current year operations by deferring and amortizing such capital gains and losses, net of tax, over the approximate remaining life of the investments sold. The IMR applies to realized capital gains and losses, net of tax, on short-term and long-term fixed income securities, including bonds, notes, preferred stock and mortgages.

Chapter 16B - Asset Valuation Reserve

All U.S. life insurance companies and fraternal benefit societies must include as a liability in their statutory financial statement an Asset Valuation Reserve (AVR) on fixed income and equity investments. The AVR is calculated in accordance with instructions promulgated by the Valuation of Securities (EX4) Task Force of the National Association of Insurance Commissioners and contained in the Life, Accident and Health Annual Statement Instructions and the Valuation of Securities manual. Because the instructions for the calculation of the AVR are periodically revised, the current publications should be consulted.

The purpose of the AVR is to establish a provision for the volatile incidence of asset losses and recognize appropriately the long term return expectations for equity type investments. The AVR provides a mechanism to absorb unrealized and credit-related realized gains and losses on all invested asset categories excluding cash, policy loans, premium notes, collateral notes and income receivable.

The AVR contains two components, default and equity, each designed to address specific asset risk areas. The default component is further divided into the bond and preferred stock subcomponent and the mortgage subcomponent; the equity component is comprised of the common stock subcomponent and the real estate and other invested asset subcomponent. Increases or decreases to the reserve are charged or credited directly to surplus. The AVR is limited to maximums by subcomponent, and no subcomponent of the AVR may be less than zero. Transfers between subcomponents or between components may be required or may be allowed without commissioner approval when negative or certain maximum subcomponent balances occur.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapters 10, 16 and 25
- NAIC Annual Statement Instructions
- *Purposes and Procedures Manual of the NAIC Securities Valuation Office*, Section 6. Interest Maintenance Reserve and Asset Valuation Reserve for Life Insurance Companies and Fraternal Benefit Societies
- Minutes to the Separate Accounts Working Group Meeting of June 5, 1995
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*
- *Issue Paper No. 50—Classifications and Definitions of Insurance or Managed Care Contracts In Force*
- *Issue Paper No. 5—Life Contracts*
- *Issue Paper No. 52—Deposit-Type Contracts*

Generally Accepted Accounting Principles

- *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises*
- *FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*
- *FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*
- *FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan*
- *FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities*
- *FASB Statement No. 120, Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*

- *FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of*
- *AICPA Statement of Position 95-1, Accounting for Certain Activities of Mutual Life Insurance Enterprises*

State Regulations

- Texas Administration Code, Title 28 - Insurance, Chapter 7, *Corporate and Finance*

Other Sources of Information

- Draft discussion material from previous Life Codification projects, Chapter 16A, *Interest Maintenance Reserve,* and Chapter 16B, *Asset Valuation Reserve*

Statutory Issue Paper No. 90

Nonadmitted Assets

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 20

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. As described in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets* (Issue Paper No. 4), one of the cornerstones of statutory accounting is the use of nonadmitted assets. The use of nonadmitted assets is consistent with the recognition concept in the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

2. Current statutory accounting guidance for nonadmitted assets is provided throughout the Accounting Practices and Procedures Manuals for Life and Accident and Health Insurance Companies and Property and Casualty Insurance Companies (Life/A&H and P&C Accounting Practices and Procedures Manuals).

3. The purpose of this issue paper is to establish statutory accounting principles for nonadmitted assets which are not specifically addressed in other issue papers, consistent with the Statement of Concepts and Issue Paper No. 4.

SUMMARY CONCLUSION

4. The definition and accounting treatment for nonadmitted assets is outlined in paragraph 3 of Issue Paper No. 4 as follows:

> As stated in the Statement of Concepts, "The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which may be unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet", and are, therefore, considered nonadmitted.

Issue Paper No. 4 defines nonadmitted assets as follows:

> An asset meeting the criteria in paragraph 2 above which is accorded limited or no value in statutory reporting and is one which is:
>
> a. Specifically identified within the Codification as a nonadmitted asset or
>
> b. Not specifically identified within the Codification as an admitted asset.
>
> If an asset meets one of these criteria, the asset shall be reported as a nonadmitted asset and charged against surplus unless otherwise specifically addressed within the Codification. The asset shall be depreciated or amortized against net income as the estimated economic benefit expires.

5. This paper shall not be considered an all-inclusive list of nonadmitted assets. Certain admitted assets and nonadmitted assets are addressed in other issue papers. Assets not addressed in specific issue papers are nonadmitted until specifically authorized.

6. Consistent with paragraph 4, the following assets shall be nonadmitted and shall be reported in accordance with Issue Paper No. 4.

Deposits in Suspended Depositories

7. Amounts on deposit with suspended depositories may not be fully recoverable. Any amounts not reasonably expected to be recovered shall be written off in accordance with *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets* (Issue Paper No. 5). Amounts in excess of that written off shall be nonadmitted as they are not available to satisfy obligations to policyholders.

Bills Receivable Not for Premium and Loans Unsecured or Secured by Assets That Do Not Qualify As Investments

8. In accordance with Issue Paper No. 5, amounts determined to be uncollectible or otherwise impaired shall be written off. Amounts in excess of that written off are not considered to be properly collateralized as there are no underlying assets which would otherwise be admitted assets. Such amounts shall be nonadmitted as they may be of questionable economic value if needed to fulfill policyholder obligations.

Loans on Personal Security, Cash Advances To, Or In The Hands Of, Officers Or Agents And Travel Advances

9. In accordance with Issue Paper No. 5, amounts determined to be uncollectible or otherwise impaired shall be written off. Amounts in excess of that written off typically are unsecured and as such have no underlying assets which would otherwise be admitted assets. Such amounts shall be nonadmitted as they may be of questionable economic value if needed to fulfill policyholder obligations. Some of these items may also be considered prepaid expenses which, per *Issue Paper No. 29—Prepaid Expenses (excluding deferred policy acquisition costs and other underwriting expenses, income taxes, and guaranty fund assessments),* are nonadmitted.

All “Non-Bankable” Checks

10. Examples of “non-bankable” checks are NSF (non-sufficient funds) checks, post dated checks, or checks for which payment has been stopped. Although these checks may still maintain probable future benefits (and thus meet the definition of assets), at the date on which they are non-bankable they are not available for policyholder obligations and shall be nonadmitted until the uncertainty related to the probable future benefit is resolved and the checks are converted to available funds.

Trade Names And Other Intangible Assets

11. These assets, by their nature, are not readily marketable and available to satisfy policyholder obligations and shall be nonadmitted.

Automobiles, Airplanes and Other Vehicles

12. Automobiles, airplanes and other vehicles meet the definition of assets established in Issue Paper No. 4. However, they are not readily available to satisfy policyholder obligations and as a result the undepreciated portion shall be nonadmitted. The accounting for these assets shall be consistent with the accounting for equipment provided in *Issue Paper No. 19—Furniture, Fixtures and Equipment*.

Company's Stock as Collateral for Loan

13. When a reporting entity lends money and accepts its own stock as collateral for the loan, it shall report the amount of the loan receivable and any related accrued interest on the loan as a nonadmitted asset. The asset is nonadmitted as the collateral could not be used to satisfy the obligation in the event of default.

DISCUSSION

14. For those items specifically addressed within this issue paper the principles established are consistent with current statutory accounting practices except as follows:

a. With respect to the principles outlined in paragraphs 7, 8 and 9, current statutory accounting nonadmits a portion of or the entire amount of the asset. The conclusion above requires the write-off of the portion not expected to be recoverable in accordance with Issue Paper No. 5 with any remaining amounts being nonadmitted as outlined above.

b. In relation to paragraph 7, such treatment is consistent with current statutory accounting for life and accident and health insurance companies but is a change for property and casualty insurance companies as current statutory accounting requires only "the amounts on deposit in excess of what reasonably can be estimated as recoverable" to be nonadmitted.

c. Paragraphs 12 and 13 identify assets that are to be treated as nonadmitted assets. These assets are generally recognized as nonadmitted assets in current statutory accounting practice although they were not previously specifically stated as such.

15. The statutory accounting principles outlined above are consistent with the conservatism and recognition concepts in the Statement of Concepts, current statutory accounting guidance and Issue Paper No. 4.

> Conservatism
>
> Conservative valuation procedures provide protection to policyholders against adverse fluctuations in financial condition or operating results. Statutory accounting should be reasonably conservative over the span of economic cycles and in recognition of the primary responsibility to regulate for financial solvency.
>
> Recognition
>
> The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which are unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet but rather should be charged against surplus when acquired or when availability otherwise becomes questionable.
>
> Accounting treatments which tend to defer expense recognition do not generally represent acceptable SAP treatment.

16. Statutory treatment differs from GAAP in that GAAP does not have a concept of nonadmitted assets and would recognize the items addressed above as assets to the extent they remain collectible or recoverable.

Drafting Notes/Comments

- Issue Paper No. 5 discusses and outlines the appropriate treatment for the impairment of assets.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

17. The Life/A&H and P&C Accounting Practices and Procedures Manuals, page iv and page v, respectively, provide the following guidance:

> ASSETS
>
> paragraph 1
>
> Because of the conservatism intrinsic to insurance accounting, certain assets may be accorded limited or no value in statutory reporting, i.e., nonadmitted assets.

18. Chapter 9, Nonadmitted Assets, of the P&C Accounting Practices and Procedures Manual provides guidance as outlined below. Many of the items given as examples in Chapter 9 have been addressed in separate issue papers and therefore are not addressed in the conclusion of this issue paper. Additionally, the accounting treatment for such items addressed in separate issue papers may no longer be consistent with the accounting treatment outlined in Chapter 9.

> Because, in many respects, the statutory balance sheet is presented on a conservative basis, certain assets (which may have a recognized value in noninsurance corporations) are accorded no value and thus reduce the reported surplus of the insurance company. Some assets may be nonadmitted because they do not conform to the laws and regulations of the various states and other assets may be nonadmitted because they are not readily convertible to liquid assets. Changes in the amount of nonadmitted assets are charged or credited directly to surplus.
>
> The following are examples of nonadmitted assets:
>
> 1. Excess of Book Value over Market Value of Securities: In keeping with the concept of presenting the balance sheet on a conservative basis, the unrealized loss on stocks and impaired bonds reduces the admitted asset value on the annual statement.
>
> 2. Deposits in Suspended Depositories (less the estimated recoverable amount): The amounts on deposit in excess of what reasonably can be estimated as recoverable are nonadmitted.
>
> 3. Agents' Balances or Uncollected Premiums Over Three Months Due: The statutes of most states require that agents' balances or uncollected premiums over three months due be nonadmitted because of the uncertainty of collection. The over three months rule does not apply to ceded reinsurance premiums payable due from solvent insurance companies provided the assuming insurer maintains sufficient reserves as to the ceding insurer to apply the principles of offset accounting or the ceding insurer is licensed and in good standing in the state of the assuming insurer's domicile.
>
> 4. Future installments on all policies for which one or more installments are over three months due.
>
> 5. Accrued retrospective premiums from any person for whom any agents' balances or uncollected premiums are classified as nonadmitted.

6. Bills Receivable, Taken for Premiums: Bills or notes receivable are used as methods of financing premiums usually in states where installment premiums are not permitted or customary. If any portion of a bill or note receivable is unpaid past the due date of the installment, the entire bill or note is classified as nonadmitted. Also, on bills or notes not past due, the excess of the balance due over the unearned premium on the underlying policy or policies is classified as a nonadmitted asset. To the extent bills receivable are taken for premium for retrospectively rated policies, such bills must meet the same criteria required of accrued retrospective premiums to be reported as an admitted asset.

7. Electronic Data Processing Equipment: Application systems software may be expensed when purchased or established as a nonadmitted asset and written off over a period of years not to exceed the software's expected useful life.

8. Equipment, Furniture and Supplies: The company may record furniture and equipment as a ledger asset, depreciate it, and nonadmit it in the exhibit of assets in the statutory financial statements, or the company may expense the furniture and equipment when it is purchased. Supplies are normally expensed when purchased.

9. Bills Receivable, Not Taken for Premiums: All bills or notes receivable - except those from an insured for premiums, or those fully secured by collateral- are classified as nonadmitted.

10. Loans on Personal Security: Loans on personal security by definition are not properly secured by collateral. Therefore, they are classified as nonadmitted.

11. Prepaid Expenses.

12. Cash Advances To, or In the Hands Of, Officers or Agents: These amounts are not secured by collateral and are, therefore, nonadmitted.

13. Travel Advances: Travel advances are nonadmitted since they are unsecured balances due from employees.

14. Surplus Notes: Insurers sometimes make subordinated surplus contributions to other insurers via an instrument variously referred to as "surplus notes", "surplus debentures", "contribution certificates", "capital notes", etc. Generally, these instruments allow for payment of interest and repayment of principal only with the approval of the commissioner of the domiciliary jurisdiction of the insurer receiving the surplus infusion and issuing the instrument. The form and content of such instruments are also subject to regulatory approval. Where such approval conditions exist, insurers should report these instruments as admitted assets only in an amount as determined by the Securities Valuation Office (SVO) of the National Association of Insurance Commissioners. The holders of such instruments should never be allowed an admitted asset value more than that which would be allowed by considering the instruments as equity instruments and adding same to any other equity investments in the issuer held directly or indirectly by the holder of the instruments. In addition, such instruments shall be considered in the limitations on investments in affiliates. Investment income on these instruments shall not be reported as accrued until payment by the issuer has been approved by the insurer's domiciliary commissioner.

19. Chapter 9, Nonadmitted Assets, of the Life/A&H Accounting Practices and Procedures Manual provides the following guidance:

> Some assets or portions thereof may be nonadmitted because they do not conform to the laws and regulations of the various states. As a result, certain assets which normally would be accorded value in noninsurance corporations are accorded no value and thus reduce the reported surplus of the insurance company. In addition, state regulations require that certain

expenditures which could normally be capitalized by a noninsurance company be charged as an expense.

Common Examples
Some examples of assets which are nonadmitted due to either an uncertainty as to their collectibility or an insufficient basis for determining their valuation or other reasons are:

1. deposits in suspended depositories;
2. agents' debit balances;
3. bills receivable which are not properly secured by collateral;
4. loans on personal security (endorsed or not) which are not properly secured by collateral;
5. cash advance to or in the hands of officers or agents;
6. travel advances;
7. depreciated cost of applications software;
8. depreciated cost of equipment and furniture;
9. prepaid loss adjustment expenses;
10. other prepaid expenses;
11. all "NSF", post dated, payment stopped or otherwise non-bankable checks;
12. group accident and health premiums more than 90 days past due;
13. individual accident and health premiums which are more than one modal premium past due;
14. the excess of premium notes over policy reserves on individual policies;
15. collateral loans secured by assets which do not qualify as investments.

RELEVANT LITERATURE

Statutory Accounting Practices and Procedures

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, page iv and Chapter 9
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, page v and Chapter 9
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 19—Furniture, Fixtures and Equipment*
- *Issue Paper No. 29—Prepaid Expenses (excluding deferred policy acquisition costs and other underwriting expenses, income taxes, and guaranty fund assessments)*

Generally Accepted Accounting Principles

None

State Regulations

- No additional guidance obtained from state statutes or regulations.

Statutory Issue Paper No. 92

Statement of Cash Flow

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 69

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory guidance on the Statement of Cash Flow is contained in the Annual Statement Instructions for Life and Accident and Health Insurance Companies and the Annual Statement Instructions for Property and Casualty Insurance Companies (Annual Statement Instructions).

2. GAAP guidance on the Statement of Cash Flow is primarily contained in *FASB Statement No. 95*, *Statement of Cash Flows* (FAS 95). Under GAAP, cash receipts and payments are classified according to whether they stem from operating, investing, or financing activities. FAS 95 also requires that investing and financing activities not resulting in cash receipts or payments in the period be disclosed separately.

3. The purpose of this issue paper is to establish statutory accounting principles for the Statement of Cash Flow that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. The Statement of Cash Flow shall be prepared using the direct method. Cash from operations shall be reported consistent with the Statement of Income, excluding the effect of current and prior year accruals. Only the cash portion of a transaction shall be reported in the Statement of Cash Flow. For purposes of the Statement of Cash Flow, cash shall include short term investments. Specific instructions for the classification of items are provided in the Annual Statement Instructions.

Disclosures

5. The financial statements shall disclose the following:

a. Transactions considered to be investing and financing activities that affect recognized assets or liabilities but do not result in cash receipts or cash payments in the period (in narrative or schedule form);

b. The cash and noncash aspects of the above transactions identified as investing or financing activities consistent with the classifications provided by the Annual Statement Instructions. Examples of noncash investing and financing transactions include:

i. Converting debt to equity;
ii. Acquiring assets by assuming directly related liabilities, such as purchasing a building by incurring a mortgage to the seller;
iii. Exchanging noncash assets or liabilities for other noncash assets or liabilities.

DISCUSSION

6. This issue paper changes current statutory accounting to require that only cash transactions be included in the Statement of Cash Flow. The current Annual Statement Instructions are unclear and appear to indicate that any amount shown as consideration would be included in the statement.

7. Although the broad categories of cash receipts and disbursements are similar between GAAP and statutory accounting, there are differences in the individual items included in each category. The primary objective of the statutory statement is to enhance the ability to measure and monitor solvency of a reporting entity. The statutory statement is integrated into numerous other exhibits and schedules in the Annual Statement to facilitate preparation of the Statement of Cash Flow and to provide consistent reporting of information.

8. The focus of the GAAP Statement of Cash Flows is on a broad group of users of financial information. Those users include investors and creditors whose focus is assessing financial performance of the company. GAAP also provides for the use of two distinct methods of reporting cash flows known as the direct and indirect methods. Because GAAP is not consistent with the statutory objectives discussed above, FAS 95, *FASB Statement No. 102*, Statement of Cash Flows—*Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale, an amendment of FASB Statement No. 95,* and *FASB Statement No. 104, Statement of Cash Flows—Net Reporting of Certain Cash Receipts and Cash Payments and Classification of Cash Flows from Hedging Transactions, an amendment of FASB Statement No. 95,* are rejected in this issue paper.

9. This issue paper adopts *FASB Emerging Issues Task Force Issue No. 95-13*, *Classification of Debt Issue Costs in the Statement of Cash Flows* which requires that cash payments for debt issue costs shall be classified as a financing activity in the Statement of Cash Flow.

10. Statutory guidance regarding disclosure about noncash investing and financing activities was added to provide users with complete disclosure of the investing and financing activities of a reporting entity.

Drafting Notes/Comments

None

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

11. The Annual Statement Instructions for Property and Casualty Insurance Companies include the following guidance for the statement of cash flow. Similar language is provided in the Annual Statement Instructions for Life, Accident and Health Insurance Companies:

> The statement of cash flows is prepared using the direct method. Lines one through nine should be prepared in a manner consistent with the Statement of Income, excluding the effect of current and prior year accruals. The following provides the method of preparing the statement. All revenue, expenditures, purchase and sales items should be entered gross.

The remaining portion of the guidance provided by the Annual Statement Instructions is a cross reference schedule which facilitates the preparation of the statement of cash flow by providing a series of calculations using various exhibits and schedules of a reporting entity's Annual Statement.

Generally Accepted Accounting Principles

12. *FASB Statement No. 95*, *Statement of Cash Flows,* as amended by *FASB Statement No. 102*, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale, an amendment of FASB Statement No. 95, FASB Statement No. 104, Statement of Cash Flows—Net Reporting of Certain Cash Receipts and Cash Payments and Classification of Cash Flows from Hedging Transactions, an amendment of FASB Statement No. 95* and *FASB Statement No. 117*, *Financial Statements of Not-for-Profit Organizations,* contains the following guidance on the accounting and reporting of cash flows:

> Introduction
>
> 1. This Statement establishes standards for providing a statement of cash flows in general-purpose financial statements. This Statement supersedes *APB Opinion No. 19, Reporting Changes in Financial Position*, and requires a business enterprise to provide a statement of cash flows in place of a statement of changes in financial position. It also requires that specified information about noncash investing and financing transactions and other events be provided separately.
>
> 2. Opinion 19 permitted but did not require enterprises to report cash flow information in the statement of changes in financial position. Since that Opinion was issued, the significance of information about an enterprise's cash flows has increasingly been recognized. In *FASB Concepts Statement No. 5, Recognition and Measurement in Financial Statements of Business Enterprises*, paragraph 13, the Board says, "A full set of financial statements for a period should show: . . . Cash flows during the period." Moreover, certain problems have been identified in current practice, including the ambiguity of terms such as funds, lack of comparability arising from diversity in the focus of the statement (cash, cash and short-term investments, quick assets, or working capital) and the resulting differences in definitions of funds flows from operating activities (cash or working capital), differences in the format of the statement (sources and uses format or activity format), variations in classifications of specific items in an activity format, and the reporting of net changes in amounts of assets and liabilities rather than gross inflows and outflows. The lack of clear objectives for the statement of changes in financial position has been suggested as a major cause of that diversity.
>
> Scope
>
> 3. A business enterprise or not-for-profit organization that provides a set of financial statements that reports both financial position and results of operations shall also provide a statement of cash flows for each period for which results of operations are provided. In this Statement enterprise encompasses both business enterprises and not-for-profit organizations, and the phrase investors, creditors, and others encompasses donors. The terms income statement and net income apply to a business enterprise; the terms statement of activities and change in net assets apply to a not-for-profit organization. A statement of cash flows is not required for defined benefit pension plans and certain other employee benefit plans or for certain investment companies as provided by *FASB Statement No. 102, Statement of Cash Flows--Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale*.
>
> Purpose of a Statement of Cash Flows
>
> 4. The primary purpose of a statement of cash flows is to provide relevant information about the cash receipts and cash payments of an enterprise during a period.
>
> 5. The information provided in a statement of cash flows, if used with related disclosures and information in the other financial statements, should help investors, creditors, and others to (a) assess the enterprise's ability to generate positive future net cash flows; (b) assess the

enterprise's ability to meet its obligations, its ability to pay dividends, and its needs for external financing; (c) assess the reasons for differences between net income and associated cash receipts and payments; and (d) assess the effects on an enterprise's financial position of both its cash and noncash investing and financing transactions during the period.

6. To achieve its purpose of providing information to help investors, creditors, and others in making those assessments, a statement of cash flows should report the cash effects during a period of an enterprise's operations, its investing transactions, and its financing transactions. Related disclosures should report the effects of investing and financing transactions that affect an enterprise's financial position but do not directly affect cash flows during the period. A reconciliation of net income and net cash flow from operating activities, which generally provides information about the net effects of operating transactions and other events that affect net income and operating cash flows in different periods, also should be provided.

Focus on Cash and Cash Equivalents

7. A statement of cash flows shall explain the change during the period in cash and cash equivalents. The statement shall use descriptive terms such as cash or cash and cash equivalents rather than ambiguous terms such as funds. The total amounts of cash and cash equivalents at the beginning and end of the period shown in the statement of cash flows shall be the same amounts as similarly titled line items or subtotals shown in the statements of financial position as of those dates.

8. For purposes of this Statement, cash equivalents are short-term, highly liquid investments that are both:

a. Readily convertible to known amounts of cash
b. So near their maturity that they present insignificant risk of changes in value because of changes in interest rates.

Generally, only investments with original maturities of three months or less qualify under that definition.

9. Examples of items commonly considered to be cash equivalents are Treasury bills, commercial paper, money market funds, and federal funds sold (for an enterprise with banking operations). Cash purchases and sales of those investments generally are part of the enterprise's cash management activities rather than part of its operating, investing, and financing activities, and details of those transactions need not be reported in a statement of cash flows.

10. Not all investments that qualify are required to be treated as cash equivalents. An enterprise shall establish a policy concerning which short-term, highly liquid investments that satisfy the definition in paragraph 9 are treated as cash equivalents. For example, an enterprise having banking operations might decide that all investments that qualify except for those purchased for its trading account will be treated as cash equivalents, while an enterprise whose operations consist largely of investing in short-term, highly liquid investments might decide that all those items will be treated as investments rather than cash equivalents. An enterprise shall disclose its policy for determining which items are treated as cash equivalents. Any change to that policy is a change in accounting principle that shall be effected by restating financial statements for earlier years presented for comparative purposes.

Gross and Net Cash Flows

11. Generally, information about the gross amounts of cash receipts and cash payments during a period is more relevant than information about the net amounts of cash receipts and payments. However, the net amount of related receipts and payments provides sufficient information not only for cash equivalents, as noted in paragraph 9, but also for certain other

classes of cash flows specified in paragraphs 12, 13, and 28.

12. For certain items, the turnover is quick, the amounts are large, and the maturities are short. For certain other items, such as demand deposits of a bank and customer accounts payable of a broker-dealer, the enterprise is substantively holding or disbursing cash on behalf of its customers. Only the net changes during the period in assets and liabilities with those characteristics need be reported because knowledge of the gross cash receipts and payments related to them may not be necessary to understand the enterprise's operating, investing, and financing activities.

13. Items that qualify for net reporting because their turnover is quick, their amounts are large, and their maturities are short are cash receipts and payments pertaining to (a) investments (other than cash equivalents), (b) loans receivable, and (c) debt, providing that the original maturity of the asset or liability is three months or less.

Banks, savings institutions, and credit unions are not required to report gross amounts of cash receipts and cash payments for (a) deposits placed with other financial institutions and withdrawals of deposits, (b) time deposits accepted and repayments of deposits, and (c) loans made to customers and principal collections of loans. When those enterprises constitute part of a consolidated enterprise, net amounts of cash receipts and cash payments for deposit or lending activities of those enterprises shall be reported separate from gross amounts of cash receipts and cash payments for other investing and financing activities of the consolidated enterprise, including those of a subsidiary of a bank, savings institution, or credit union that is not itself a bank, savings institution, or credit union.

Classification of Cash Receipts and Cash Payments

14. A statement of cash flows shall classify cash receipts and cash payments as resulting from investing, financing, or operating activities.

Cash Flows from Investing Activities

15. Investing activities include making and collecting loans and acquiring and disposing of debt or equity instruments and property, plant, and equipment and other productive assets, that is, assets held for or used in the production of goods or services by the enterprise (other than materials that are part of the enterprise's inventory). Investing activities exclude acquiring and disposing of certain loans or other debt or equity instruments that are acquired specifically for resale, as discussed in Statement 102.

16. Cash inflows from investing activities are:

a. Receipts from collections or sales of loans made by the enterprise and of other entities' debt instruments (other than cash equivalents and certain debt instruments that are acquired specifically for resale) that were purchased by the enterprise
b. Receipts from sales of equity instruments of other enterprises (other than certain equity instruments carried in a trading account) and from returns of investment in those instruments
c. Receipts from sales of property, plant, and equipment and other productive assets.

17. Cash outflows for investing activities are:

a. Disbursements for loans made by the enterprise and payments to acquire debt instruments of other entities (other than cash equivalents and certain debt instruments that are acquired specifically for resale)

b. Payments to acquire equity instruments of other enterprises (other than certain equity instruments carried in a trading account)

c. Payments at the time of purchase or soon before or after purchase to acquire property, plant, and equipment and other productive assets.

Cash Flows from Financing Activities

18. Financing activities include obtaining resources from owners and providing them with a return on, and a return of, their investment; receiving restricted resources that by donor stipulation must be used for long-term purposes; borrowing money and repaying amounts borrowed, or otherwise settling the obligation; and obtaining and paying for other resources obtained from creditors on long-term credit.

19. Cash inflows from financing activities are:

a. Proceeds from issuing equity instruments

b. Proceeds from issuing bonds, mortgages, notes, and from other short- or long-term borrowing.

c. Receipts from contributions and investment income that by donor stipulation are restricted for the purposes of acquiring, constructing, or improving property, plant, equipment, or other long-lived assets or establishing or increasing a permanent endowment or term endowment.

20. Cash outflows for financing activities are:

a. Payments of dividends or other distributions to owners, including outlays to reacquire the enterprise’s equity instruments

b. Repayments of amounts borrowed

c. Other principal payments to creditors who have extended long-term credit.

Cash Flows from Operating Activities

21. Operating activities include all transactions and other events that are not defined as investing or financing activities in paragraphs 15-20. Operating activities generally involve producing and delivering goods and providing services. Cash flows from operating activities are generally the cash effects of transactions and other events that enter into the determination of net income.

22. Cash inflows from operating activities are:

a. Cash receipts from sales of goods or services, including receipts from collection or sale of accounts and both short- and long-term notes receivable from customers arising from those sales. The term goods includes certain loans and other debt and equity instruments of other enterprises that are acquired specifically for resale, as discussed in Statement 102.

b. Cash receipts from returns on loans, other debt instruments of other entities, and equity securities--interest and dividends

c. All other cash receipts that do not stem from transactions defined as investing or financing activities, such as amounts received to settle lawsuits; proceeds of insurance settlements except for those that are directly related to investing or financing activities, such as from destruction of a building; and refunds from suppliers.

23. Cash outflows for operating activities are:

a. Cash payments to acquire materials for manufacture or goods for resale, including principal payments on accounts and both short- and long-term notes payable to suppliers for those materials or goods. The term goods includes certain loans and other debt and equity instruments of other enterprises that are acquired specifically for resale, as discussed in Statement 102.

b. Cash payments to other suppliers and employees for other goods or services

c. Cash payments to governments for taxes, duties, fines, and other fees or penalties

d. Cash payments to lenders and other creditors for interest

e. All other cash payments that do not stem from transactions defined as investing or financing activities, such as payments to settle lawsuits, cash contributions to charities, and cash refunds to customers.

24. Certain cash receipts and payments may have aspects of more than one class of cash flows. For example, a cash payment may pertain to an item that could be considered either inventory or a productive asset. If so, the appropriate classification shall depend on the activity that is likely to be the predominant source of cash flows for the item. For example, the acquisition and sale of equipment to be used by the enterprise or rented to others generally are investing activities. However, equipment sometimes is acquired or produced to be used by the enterprise or rented to others for a short period and then sold. In those circumstances, the acquisition or production and subsequent sale of those assets shall be considered operating activities.

Foreign Currency Cash Flows

25. A statement of cash flows of an enterprise with foreign currency transactions or foreign operations shall report the reporting currency equivalent of foreign currency cash flows using the exchange rates in effect at the time of the cash flows. An appropriately weighted average exchange rate for the period may be used for translation if the result is substantially the same as if the rates at the dates of the cash flows were used. The statement shall report the effect of exchange rate changes on cash balances held in foreign currencies as a separate part of the reconciliation of the change in cash and cash equivalents during the period.

Content and Form of the Statement of Cash Flows

26. A statement of cash flows for a period shall report net cash provided or used by operating, investing, and financing activities and the net effect of those flows on cash and cash equivalents during the period in a manner that reconciles beginning and ending cash and cash equivalents.

27. In reporting cash flows from operating activities, enterprises are encouraged to report major classes of gross cash receipts and gross cash payments and their arithmetic sum--the net cash flow from operating activities (the direct method). Enterprises that do so should, at a minimum, separately report the following classes of operating cash receipts and payments:

a. Cash collected from customers, including lessees, licensees, and the like

b. Interest and dividends received. Interest and dividends that are donor restricted for long-term purposes as noted in paragraphs 18 and 19(c) are not part of operating cash receipts.

c. Other operating cash receipts, if any

d. Cash paid to employees and other suppliers of goods or services, including suppliers of insurance, advertising, and the like

e. Interest paid

f. Income taxes paid

g. Other operating cash payments, if any.

Enterprises are encouraged to provide further breakdowns of operating cash receipts and payments that they consider meaningful and feasible. For example, a retailer or manufacturer might decide to further divide cash paid to employees and suppliers (category (d) above) into payments for costs of inventory and payments for selling, general, and administrative expenses.

28. Enterprises that choose not to provide information about major classes of operating cash receipts and payments by the direct method as encouraged in paragraph 27 shall determine and report the same amount for net cash flow from operating activities indirectly by adjusting net income of a business enterprise or change in net assets of a not-for-profit organization to reconcile it to net cash flow from operating activities (the indirect or reconciliation method). That requires adjusting net income of a business enterprise or change in net assets of a not-for-profit organization to remove (a) the effects of all deferrals of past operating cash receipts and payments, such as changes during the period in inventory, deferred income, and the like, and all accruals of expected future operating cash receipts and payments, such as changes during the period in receivables and payables, and (b) the effects of all items whose cash effects are investing or financing cash flows, such as depreciation, amortization of goodwill, and gains or losses on sales of property, plant, and equipment and discontinued operations (which relate to investing activities), and gains or losses on extinguishment of debt (which is a financing activity).

29. The reconciliation of net income of a business enterprise or change in net assets of a not-for-profit organization to net cash flow from operating activities described in paragraph 28 shall be provided regardless of whether the direct or indirect method of reporting net cash flow from operating activities is used. That reconciliation shall separately report all major classes of reconciling items. For example, major classes of deferrals of past operating cash receipts and payments and accruals of expected future operating cash receipts and payments, including at a minimum changes during the period in receivables pertaining to operating activities, in inventory, and in payables pertaining to operating activities, shall be separately reported. Enterprises are encouraged to provide further breakdowns of those categories that they consider meaningful. For example, changes in receivables from customers for an enterprise's sale of goods or services might be reported separately from changes in other operating receivables. In addition, if the indirect method is used, amounts of interest paid (net of amounts capitalized) and income taxes paid during the period shall be provided in related disclosures.

30. If the direct method of reporting net cash flow from operating activities is used, the reconciliation of net income of a business enterprise or change in net assets of a not-for-profit organization to net cash flow from operating activities shall be provided in a separate schedule. If the indirect method is used, the reconciliation may be either reported within the statement of cash flows or provided in a separate schedule, with the statement of cash flows reporting only the net cash flow from operating activities. If the reconciliation is presented in the statement of cash flows, all adjustments to net income of a business enterprise or change in net assets of a not-for-profit organization to determine net cash flow from operating activities shall be clearly identified as reconciling items.

31. Except for items described in paragraphs 12 and 13, both investing cash inflows and outflows and financing cash inflows and outflows shall be reported separately in a statement of cash flows-for example, outlays for acquisitions of property, plant, and equipment shall be reported separately from proceeds from sales of property, plant, and equipment; proceeds of borrowings shall be reported separately from repayments of debt; and proceeds from issuing stock shall be reported separately from outlays to reacquire the enterprise's stock.

Information about Noncash Investing and Financing Activities

32. Information about all investing and financing activities of an enterprise during a period that affect recognized assets or liabilities but that do not result in cash receipts or cash payments in the period shall be reported in related disclosures. Those disclosures may be either narrative or summarized in a schedule, and they shall clearly relate the cash and noncash aspects of transactions involving similar items. Examples of noncash investing and financing transactions are converting debt to equity; acquiring assets by assuming directly related liabilities, such as

> purchasing a building by incurring a mortgage to the seller; obtaining an asset by entering into a capital lease; obtaining a building or investment asset by receiving a gift; and exchanging noncash assets or liabilities for other noncash assets or liabilities. Some transactions are part cash and part noncash; only the cash portion shall be reported in the statement of cash flows.
>
> Cash Flow per Share
>
> 33. Financial statements shall not report an amount of cash flow per share. Neither cash flow nor any component of it is an alternative to net income as an indicator of an enterprise's performance, as reporting per share amounts might imply.

13. *FASB Emerging Issues Task Force Issue No. 95-13, Classification of Debt Issue Costs in the Statement of Cash Flows* contains the following guidance:

> ISSUE
> Debt issue costs generally are incurred in connection with the issuance of debt securities or other short- or long-term borrowings. Opinion 21 requires that debt issue costs be reported in the balance sheet as deferred charges. Generally, debt issue costs are capitalized as an asset and amortized over the term of the debt.
>
> Statement 95 requires that cash receipts and payments in a statement of cash flows be classified as operating, investing, or financing activities. However, some believe that Statement 95 does not provide specific guidance on the classification of debt issue costs in the statement of cash flows. Because debt issue costs have aspects of more than one class of cash flows, diversity in practice has arisen. Some companies have reported the cash outflow for debt issue costs as a financing activity, while others have reported the outflow for those costs as an operating activity.
>
> The issue is how cash payments for debt issue costs should be classified in the statement of cash flows.
>
> EITF DISCUSSION
> The Task Force reached a consensus that cash payments for debt issue costs should be classified in the statement of cash flows as a financing activity.

RELEVANT LITERATURE

Statutory Accounting

- NAIC *Annual Statement Instructions for Property and Casualty Insurance Companies*
- NAIC *Annual Statement Instructions for Life, Accident and Health Insurance Companies*

Generally Accepted Accounting Principles

- FASB Statement No. 95, *Statement of Cash Flows*
- FASB Statement No. 102, *Statement of Cash Flows--Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale*, *an amendment of FASB Statement No. 95*
- FASB Statement No. 104, *Statement of Cash Flows--Net Reporting of Certain Cash Receipts and Cash Payments and Classification of Cash Flows from Hedging Transactions, an amendment of FASB Statement No. 95*
- FASB Emerging Issues Task Force Issue No. 95-13, *Classification of Debt Issue Costs in the Statement of Cash Flows*

State Regulations

- No additional guidance obtained from state statutes or regulations.

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Statutory Issue Paper No. 94

Allocation of Expenses

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 70

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Expenses involved in acquiring and underwriting policies and servicing policyholders and third-party claimants are important elements of a reporting entity's operations. Uniformity in the classification, allocation and reporting of expenses and expense statistics by reporting entities within the same industry is critical in a regulatory environment and is consistent with both the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts) and the FASB Statements of Financial Accounting Concepts (GAAP Statement of Concepts). Such uniformity is necessary for the effective review of operations of a specific entity, comparisons across the industry and control/regulation of the industry.

2. Current statutory accounting is outlined in the Accounting Practices and Procedures Manuals for Property and Casualty and for Life and Accident and Health Insurance Companies (P&C Accounting Practices and Procedures Manual and Life/A&H Accounting Practices and Procedures Manual) and in the NAIC Annual Statement Instructions (Annual Statement Instructions).

3. This issue paper establishes rules on presentation and allocation of certain expenses of reporting entities into general categories and the apportionment of shared expenses between members of a group of companies. The scope of this issue paper is limited to the general categories. Disclosure in notes or exhibits to the financial statements is required for principal components of those categories.

SUMMARY CONCLUSION

4. This paper establishes uniform expense allocation rules to classify expenses within prescribed principal groupings. It is necessary to allocate those expenses which may contain characteristics of more than one classification, which this issue paper will refer to as allocable expenses.

5. Allocable expenses for property and casualty insurance companies shall be classified into one of three categories on the Underwriting and Investment Exhibit as follows:

- Loss adjustment expenses - Expenses incurred in the adjusting, recording and paying of claims (including expenses associated with commutations).

- Investment expenses - Expenses incurred in the investing of funds and pursuit of investment income. Such expenses include those specifically identifiable and allocated costs related to activities such as initiating and handling orders, researching and recommending investments (i.e., investment strategy), appraising, valuing, disbursing funds and collecting income, securities safekeeping, real estate taxes, records maintenance, data processing, support personnel, postage and supplies, office overhead, management and executive duties and all other functions reasonably associated with the investment of funds.

- Other underwriting expenses - Allocable expenses other than loss expenses and investment related expenses.

6. Similarly for life and accident and health insurers allocable expenses shall be categorized as general insurance expenses; insurance taxes, licenses and fees; or investment expenses which are netted against investment income on the Summary of Operations.

7. Allocation to the above categories should be based on a method that yields the most accurate results. Specific identification of an expense with an activity that is represented by one of the categories above will generally be the most accurate method. Where specific identification is not feasible allocation of expenses should be based upon pertinent factors or ratios such as studies of employee activities, salary ratios or similar analyses.

8. Allocation may be entirely to one expense category based upon the type of expense incurred, for example, premium taxes would be 100% allocated to Other Underwriting Expenses for property and casualty companies. Other expenses may be allocated across several categories, such as salaries, which may be allocated to both general insurance expenses and net investment income of a life and accident and health company.

9. Many entities operate within a group where personnel and facilities are shared. Shared expenses, including expenses under the terms of a management contract, shall be apportioned to the entities incurring the expense as if the expense had been paid solely by the incurring entity. The apportionment shall be completed based upon specific identification to the entity incurring the expense. Where specific identification is not feasible apportionment shall be based upon pertinent factors or ratios. Any basis adopted to apportion expenses shall be that which yields the most accurate results and may result from special studies of employee activities, salary ratios, premium ratios or similar analyses. Expenses that relate solely to the operations of a reporting entity, such as personnel costs associated with the adjusting and paying of claims, must be borne solely by the reporting entity and are not to be apportioned to other entities within a group. Pertinent factors in making this determination shall include which entity has the ultimate obligation to pay the expense. Apportioned expenses are subject to presentation and allocation as provided in paragraphs 5 through 8.

10. Any material individual component of the reported expense categories shall be presented either on the face of the Summary of Operations or within the footnotes or related exhibits to the financial statements.

DISCUSSION

11. The summary conclusions outlined above were formulated based upon, and are consistent with, current statutory accounting practices and procedures as set out in the P&C and Life/A&H Accounting Practices and Procedures Manuals, the Annual Statement Instructions and additional guidance contained in the Financial Condition Examiners Handbook. The conclusions are also consistent with the Statutory Statements of Concepts which states the following:

> SAP utilizes the framework established by GAAP.
>
> Consistency
>
> The regulators' need for meaningful, comparable financial information to determine an insurer's financial condition requires consistency in the development and application of statutory accounting principles.

The conclusions are also consistent with the GAAP Statements of Concepts which are excerpted in paragraphs 16 and 17.

12. The exhibits to the annual statement display the effects of allocation of allocable expenses to the various categories as well as provide an appropriate level of detail as to the nature of the classifications of expenses being allocated. The disclosure required by Paragraph 10 provides disclosure as to the nature of the significant allocable expenses in those circumstances where the accompanying exhibits are not part of the company's financial statements (e.g. annual audit report) and is not intended to provide duplicative presentation in the annual statement filings.

Drafting Notes/Comments

- *Issue Paper No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses*, defines and discusses losses and loss adjustment expenses.
- Detailed classification tables, which are included in current statutory guidance for property and casualty companies, are not included in this issue paper. Such guidance is not considered necessary for the establishment of accounting standards/policies.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

13. The P&C Accounting Practices and Procedures Manual, Chapter 19, Expenses, provides the following guidance:

> In the insurance industry, there are expenses involved in acquiring and underwriting policies and servicing the policyholders and third party claimants. These expenses will be discussed in this chapter. (Commissions are discussed in Chapter 18.)
>
> Regulation Number 30, called the "Uniform Classification of Expenses of Fire and Marine and Casualty and Surety Insurer," was effective January 1, 1949, for licensed New York companies. The NAIC prescribed similar uniform accounting instructions for expense reporting effective January 1, 1949. These acts brought uniformity to the industry.
>
> This uniformity is helpful since expenses are important elements of the company's operations and accurate statistics are needed for comparisons and control. The instructions for uniform classification of expenses are a part of the NAIC *Examiners Handbook—Volume I*.
>
> Expense Group Classifications
>
> Expenses for fire and casualty insurance companies are allocated to expense groups as follows:
>
> A. Loss Adjustment Expenses
>
> Loss adjustment expenses constitute expenses incurred in connection with the adjusting, recording, and paying of claims. (See Chapter 17-Loss and Loss Adjustment Expenses Incurred.)
>
> B. Other Underwriting Expenses
>
> Other underwriting expenses are classified into three categories as follows:

1. Acquisition, Field Supervision, and Collection Expenses

   Acquisition costs consist of all expenses incurred in relation to the production of new and renewal insurance business. Also included are specifically identifiable and allocated expenses relating to the following activities: commissions, bonuses, allowances, and other compensation paid to agents and brokers; operating costs for agencies or branch offices; training agents and brokers; underwriting new risks; issuing new policies; receiving and paying of premiums and commissions; maintaining general and detailed records; data processing; advertising and publicity; clerical, secretarial, office maintenance, supervisory, and executive duties; postage and supplies; and all other functions reasonably associated with the production of new and renewal insurance business, such as premium collection.

2. General Expenses

   This category includes all expenses not assignable to other expense groups.

3. Taxes, Licenses, and Fees

   These are state and local insurance taxes, insurance department licenses and fees, allocable payroll taxes, and all other taxes excluding federal and foreign income and real estate taxes.

   All other taxes might include: (1) qualifying bond premiums; (2) statement publication fees; (3) advertising required by law; (4) personal property taxes; (5) state income taxes; (6) capital stock taxes; (7) business or corporation licenses or fees; (8) marine profits taxes; (9) documentary stamps on reinsurance; (10) guaranty association assessments; and (11) any other taxes.

   Real estate taxes on investment properties are generally included with investment expenses, and capital stock taxes and apportioned payroll taxes may be reported as investment expenses.

C. Investment Expenses

These comprise expenses incurred in the investing of funds and the pursuit of investment income, including specifically identifiable and allocated expenses related to such activities as: initiating or handling orders and recommendations for investments; research; pricing; appraising and valuing; disbursing funds and collecting income; safekeeping of securities and valuable papers; maintaining general and detailed records; data processing; general clerical, secretarial, office maintenance, supervisory, and executive duties; supplies, postage, and the like; and all other functions reasonably attributable to the investment of funds.

Allocation of Expenses to Expense Groups

Some general guidelines for allocating to expense groups are shown in the following table. The expenses shown are those in the annual statement.

TABLE 19

General Guidelines for Classifying Expenses

Expenses to be Allocated to Expense Groups	Principal Basis for Allocation
Claim adjustment services	Direct charge to loss adjustment expense
Commission and brokerage	Direct charge to other underwriting acquisition
Advertising	Direct charge to other underwriting acquisition
Boards, bureaus, associations	Direct charge to other underwriting - general
Surveys and underwriting reports	Direct charge to other underwriting - general
Audit of insureds' records	Direct charge to other underwriting - general
Salaries	Studies of employee activities
Employee relations and welfare	Pro rate on salary ratios
Insurance	Pro rate on salary ratios
Directors' fees	Pro rate on salary ratios
Travel and travel items	Special studies
Rent and rent items	Pro rate on salary ratios
Equipment	Pro rate on salary ratios
Printing and stationery	Pro rate on salary ratios
Postage, telephone and telegraph, exchange and express	Pro rate on salary ratios
Legal and auditing	Special studies
Taxes, licenses, and fees (Except payroll taxes)	Special studies
Real estate expenses	Investment expenses
Real estate taxes	Investment expenses
Miscellaneous	Special studies

Any other basis of allocation which yields a more accurate result may be used for those expenses being allocated on the basis of salaries. Any basis of allocation which is found to be inappropriate should be discounted.

Apportionment of Joint Expenses

Many insurance companies operate on a group basis, sharing personnel and facilities in conducting business. When this occurs, the expenses involved must be properly apportioned to the company incurring the expenses, and included in the same expense classifications as if originally paid by that company.

Some examples of specifically identifiable expenses that may be incurred solely on behalf of one company, and charged directly to the applicable company are:

1. Advertising;

2. Claims adjustment services;

3. Commissions and brokerages;

4. Taxes and real estate expenses;

5. Employees' salaries;

6. Any other expenses that can be attributed directly in whole or in part to a specific company.

The following table contains some general guidelines for apportioning joint expenses among companies.

TABLE 19-B
General Guidelines for Apportioning Joint Expenses

Expense Item	Basis for Apportionment
Advertising	Percentage of premiums
Boards, bureaus, associations	Special studies
Surveys and underwriting reports	Special studies
Audit of insureds' records	Special studies
Salaries	Studies of employee activities
Employee relations and welfare	Salaries
Insurance	Salaries
Travel and travel items	Special studies
Rent and rent items	Salaries
Equipment	Salaries
Printing and Stationery	Salaries
Postage, telephone and telegraph, exchange and express	Salaries

Legal and auditing	Special studies
Payroll taxes	Salaries
Miscellaneous	Special studies

Any other basis of allocation should be used if it yields more precise results than expenses allocated on the salaries or premium basis. If clearly inappropriate, allocation based on salaries or premium should not be employed.

A company that pays joint expenses, which are ultimately apportioned and charged to other companies in the group, should credit the apportioned expenses to the same expense items charged when the payment was made. Apportionment expenses generally should not be reported as income nor be accumulated in a separate account used to reduce total expenses for the company.

14. The Life/A&H Accounting Practices and Procedures Manual, Chapter 22, General Expenses and Taxes, Licenses and Fees, provides the following guidance:

> General expenses include virtually all of the expenses of a life insurance company other than benefits to policyholders, commissions, and taxes, licenses and fees.
>
> The statutory financial statement provides for two broad categories of general expenses: (1) insurance, which is further subdivided into life insurance, accident and health insurance, and all other lines of business and (2) investment. In addition, general expenses are allocated to more detailed lines of business in the Analysis of Operations by Lines of Business. In the Summary of Operations, the investment expense portion of general expenses is classified as an offset to investment income while general insurance expenses are reported separately in the expense section of the summary.

15. The Annual Statement Instructions for Property and Casualty Companies - Underwriting and Investment Exhibit - Part 4 - Expenses provides the following guidance:

> A company that pays any affiliated entity (including a managing general agent) for the management, administration, or service of all or part of its business or operations shall allocate these costs to the appropriate expense classification items (salaries, rent, postage, etc.) as if these costs had been borne directly by the company. Management, administration, or similar fees should not be reported as a one-line expense. The company may estimate these expense allocations based on a formula or other reasonable basis.
>
> A company that pays any non-affiliated entity (including a managing general agent) for the management, administration, or service of all or part of its business or operations shall allocate these costs to the appropriate expense classification item as follows:
>
> a) Payments for claims handling or adjustment services shall be allocated to “Loss Adjustment Expenses” (Column 1) in the Underwriting and Investment Exhibit–Part 4. If the total of such expenses incurred equals or exceeds 10% of the total incurred “Loss Adjustment Expenses” (Column 1, Line 22), the company shall allocate these costs to the appropriate expense classification items as if these costs had been borne directly by the company. If such expenses are less than 10% of the total, they may be reported on Line 1 of Column 1.
>
> b) Payments for services other than claims handling or adjustment services shall be allocated to the appropriate expense classification items as if these costs had been borne directly by the company, if the total of such fees paid equals or exceeds 10% of the total incurred “Other Underwriting Expenses” (Column 2, Line 22). If the total is less then 10%, the payments may be reported on Line 2 if the fees are calculated as a percentage of premium, or on Line 3 if the fees are not calculated as a percentage of premium.

> The total management and service fees paid to affiliates and non-affiliates shall be reported in the footnote to the Underwriting and Investment Exhibit-Part 4 of the annual statement, and the method(s) used for allocation shall be disclosed in the Notes to the Financial Statements. The company shall use the same allocation method(s) on a consistent basis.

The Annual Statement Instructions for Life and Accident and Health Companies contains similar guidance.

Generally Accepted Accounting Principles

16. *FASB Statement of Financial Accounting Concepts No. 2*, *Summary of Principal Conclusions,* provides the following guidance:

> Comparability and Consistency
>
> Information about a particular enterprise gains greatly in usefulness if it can be compared with similar information about other enterprises and with similar information about the same enterprise for some other period or some other point in time. Comparability between enterprises and consistency in the application of methods over time increases the informational value of comparisons of relative economic opportunities or performance. The significance of information, especially quantitative information, depends to a great extent on the user's ability to relate it to some benchmark.

17. *FASB Statement of Financial Accounting Concepts No. 5*, *Recognition and Measurement in Financial Statements of Business Enterprises,* provides the following guidance:

> paragraph 20
>
> Classification in financial statements facilitates analysis by grouping items with essentially similar characteristics and separating items with essentially different characteristics. Analysis aimed at objectives such as predicting amounts, timing, and uncertainty of future cash flows requires financial information segregated into reasonably homogeneous groups. For example, components of financial statements that consist of items that have similar characteristics in one or more respects, such as continuity or recurrence, stability, risk, and reliability, are likely to have more predictive value than if their characteristics are dissimilar.

OTHER SOURCES OF INFORMATION

18. The Financial Condition Examiners Handbook - Volume 1, Chapter 6 provides the following guidance:

> 22. GENERAL INSTRUCTIONS IN CONNECTION WITH OPERATING EXPENSE CLASSIFICATIONS
>
> A. Joint Expenses
>
> Whenever personnel or facilities are used in common by two or more companies, or whenever the personnel or facilities of one company are used in the activities of two or more companies, the expenses involved shall be apportioned in accordance with the regulations relating to Joint Expenses, and such apportioned expenses shall be allocated by each company to the same operating expense classifications as if the expenses had been borne wholly. Any difference between the actual amount paid, and the amount of such apportioned expenses shall be included in the operating expense classification "Miscellaneous."

PART II
RULES RELATING TO THE ALLOCATION OF JOINT EXPENSES TO COMPANIES

1. JOINT EXPENSES

A. Joint Expenses, as described in Part 1, Sec. 22 (A), shall be allocated to companies as follows:

Expenses To Be Allocated To Companies (as amended)	Bases of Allocation to Companies
Advertising	Premiums
Boards, Bureaus, and Associations	Special Studies
Surveys and Underwriting Reports	Special Studies
Audit of Assureds' Records	Special Studies
Salaries	See Special Instructions Relating to the Allocation of Salaries and Other Expenses (Part V)
Employee Relations and Welfare	Overhead on Salaries
Insurance	Overhead on Salaries
Travel and Travel Items	Special Studies
Rent and Rent Items	Overhead on Salaries
Equipment	Overhead on Salaries
Printing and Stationery	Overhead on Salaries
Postage, Telephone and Telegraph, Exchange and Express	Overhead on Salaries
Legal and Auditing	Special Studies
Payroll Taxes	Overhead on Salaries
Miscellaneous	Special Studies

B. Definitions

The term Premiums used as a basis of allocation means that the allocation of expenses shall follow the percentages of applicable premiums.

The term Special Studies used as a basis of allocation means that expenses shall be analyzed and bases of allocation applied as dictated by that analysis.

The term Overhead on Salaries used as a basis of allocation means that the allocation of expenses shall follow the percentages of the applicable salaries allocation.

C. Other Bases Permitted or Prescribed

For those operating expense classifications permitting the basis, Overhead on Salaries or Premiums, any other basis of allocation may be adopted which yields more accurate results. The bases Overhead on Salaries and Premiums shall not be used if clearly in appropriate.

PART III

RULES RELATING TO THE
COMPOSITION OF, AND ALLOCATION TO, EXPENSE GROUPS

(as amended 1953 Proc. II 643-644)

1. LIST OF EXPENSE GROUPS

Expense reported in the operating expense classifications shall be allocated to the following expense groups:

Investment Expenses
Loss Adjustment Expenses
Acquisition, Field Supervision and Collection Expenses
Taxes
General Expenses

2. COMPOSITION OF THE EXPENSE GROUPS (as amended)

The composition of each group shall be as follows:

A. Investment Expenses

Investment Expenses shall comprise all expenses incurred wholly or partially in connection with the investing of funds and the obtaining of investment income, including related expenses incurred in the following activities: initiating or handling orders and recommendations; doing research; pricing; appraising and valuing; paying and receiving; entering and keeping general and detail records, safe keeping; collecting, recording, calculating and accruing investment income; general clerical, secretarial, office maintenance, supervisory and executive duties; handling personnel, supplies, main, etc.; and all other activities reasonably attributable to the investing of funds and the obtaining of investment income.

B. Loss Adjustment Expenses

Loss Adjustment Expenses shall comprise all expenses incurred wholly or partially in connection with the adjustment and recording of policy claims, including the totals of the operating expense classification, Claim Adjustment Services; the types of expenses included in Claim Adjustment Services, when the activities resulting in such types of expenses are performed by employees; and including related expenses incurred in the following activities: estimating amounts of claims; paying and receiving; entering and keeping general and detail records; general clerical, secretarial, office maintenance, supervisory and executive duties; handling personnel, supplies, mail, etc.; and all other activities reasonably attributable to the adjustment and recording of policy claims in connection with claims reported, paid and outstanding, and reinsurance thereon.

C. Acquisition, Field Supervision, and Collection Expenses

(1) Acquisition, Field Supervision and Collection Expenses shall comprise all expenses incurred wholly or partially in the following activities:

a. Soliciting and procuring business and developing the sales field;

b. Writing policy contracts, and checking and directly supervising the work of policy writers;

c. Receiving and paying of premiums and commissions; entering into or setting up records of premiums and commissions receivable and payable for collection purposes; balancing and maintaining such records; corresponding with and visiting insureds and producers for the purpose of collecting premiums or adjusting differences; checking current accounts from producers; auditing of records of delinquent agents; and services of collection agencies; (Do not include activities in connection with accounts receivable from and payable to branch or other officers within the company.)

d. Compiling and distributing expiration lists, notices of premiums due, lists of premiums or premium balances receivable and payable, contingent and other commission statements, production statements for acquisition and field supervision purposes, and similar data;

e. Maintaining good will of insureds and producers; activities of field men; contact work related to acquisition, field supervision and collection; making contracts and agreements with producers; and activities in connection with agency appointments and replacements; (Do not include: inspections of risks when carried on by personnel employed by the insurance company, engaged full time in physical inspection of risks and activities directly related thereto; audits for the purpose of premium determination; and activities in connection with the adjustment of policy claims.)

f. Rendering service to agents and other producers, such as providing office space, personnel, telephone, etc. and obtaining agents' licenses; (Do not include fees paid for agents' licenses.)

g. Advertising and publicity of every nature related to acquisition, field supervision and collection; (In addition to applicable salaries, etc., include the entire amount shown in the operating expense classification, Advertising.)

h. Miscellaneous activities of agents, brokers and producers other than employees, when performed by them: inspections; quoting premiums; signing policies; examining and mailing policies, applications and daily reports; compiling figures for current account; correspondence and sundry bookkeeping and clerical work;

i. Other activities reasonably attributable to those operations listed in "a" to "h," such as: keeping general and detail records; paying and receiving, general clerical, secretarial, office maintenance, supervisory and executive work; and handling personnel, supplies, mail, etc.

(2) Commission and Allowances: When the whole or a part of any amount in the operating expense classifications Commission and Brokerage—Direct, and Allowances to Managers and Agents is paid specifically for services other than those set forth under "a" to "i," and when such services are not duplicated or otherwise compensated by the company, the amount thereof shall be allocated to expense groups other than Acquisition, Field Supervision and Collection, and such allocations shall be justified by detailed statements and data calculated and prepared in accordance with the methods prescribed in these Rules showing amounts of expenditures, property allocated to expense groups and lines of business.

When Allowances to Managers and Agents represent a division of expenses shared with other companies, the aforementioned statements and data shall show the division of such shared expenses calculated and prepared in accordance with the methods prescribed in these Rules.

The calculation and preparation of the aforementioned statements and data shall be subject to verification and audit by insurance department personnel.

The instructions under the heading Commission and Allowances to not apply to Commission and Brokerage—Reinsurance Assumed, or Commission and Brokerage—Reinsurance Ceded.

D. Taxes

Taxes shall comprise the totals of the operating expense classification Taxes, Licenses and Fees.

E. General Expenses

General Expenses shall comprise all expenses not assignable by these rules to other expense groups.

3. ALLOCATION TO EXPENSE GROUPS (as amended)

A. Expenses shall be allocated to expense groups as follows:

Expenses To Be Allocated Expense Groups	Allocation to Expense Groups
Claim Adjustment Services:	
Direct	Loss Adjustment Expenses
Reinsurance Assumed	Loss Adjustment Expenses
Reinsurance Ceded	Loss Adjustment Expenses
Commission and Brokerage:	
Direct	See Commission and Allowances (Part III, Sec. 2 (C)(2))
Reinsurance Assumed	Acquisition, Field Supervision and Collection Expenses
Reinsurance Ceded	Acquisition, Field Supervision and Collection Expenses
Contingent—Net	Acquisition, Field Supervision and Collection Expenses
Policy and Membership Fees	Acquisition, Field Supervision and Collection Expenses
Allowances to Managers and Agents	See Commission and Allowances (Part III, Sec. 2 (C)(2))
Advertising	Acquisition, Field Supervision and Collection Expenses
Boards, Bureaus and Associations	General Expenses
Surveys and Underwriting	General Expenses
Reports	General Expenses
Audit of Assureds' Records	See Special Instructions Relating
Salaries	to the Allocation of Salaries and Other Expenses (Part V)
Employee Relations and Welfare	Overhead on Salaries
Insurance	Overhead on Salaries
Directors' Fees	Overhead on Salaries
Travel and Travel Items	Special Studies
Rent and Rent Items	Overhead on Salaries
Equipment	Overhead on Salaries
Printing and Stationery	Overhead on Salaries
Postage, Telephone and Telegraph, Exchange and Express	Overhead on Salaries
Legal and Auditing	Special Studies
Taxes, Licenses and Fees	Taxes
Real Estate Expenses	Investment Expenses
Real Estate Taxes	Investment Expenses
Income from Special Services	Special Studies
Miscellaneous	Special Studies

B. Definitions

For definitions of the term Overhead on Salaries and Special Studies, see Part II, Sec. 1 (B).

C. Other Bases Permitted or Prescribed

For those operating expense classifications permitting the basis Overhead on Salaries, any other basis of allocation may be adopted which yields more accurate results. The basis Overhead on Salaries shall not be used if clearly inappropriate.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 19
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 22
- Annual Statement Instructions for Property and Casualty Companies and for Life and Accident and Health Companies

Generally Accepted Accounting Principles

- *FASB Statement of Financial Accounting Concepts No. 2, Summary of Principal Conclusions*
- *FASB Statement of Financial Accounting Concepts No. 5, Recognition and Measurement in Financial Statements of Business Enterprises*

State Regulations

- No additional guidance obtained from state statutes or regulations.

Other Sources of Information

- Financial Condition Examiners Handbook - Volume 1, Chapter 6

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Statutory Issue Paper No. 95

Holding Company Obligations

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 15

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Statutory accounting currently requires disclosure of holding company obligations which are guaranteed. It does not specifically address a reporting entity subsidiaries' accounting treatment of obligations of a holding company parent when the subsidiary does not guarantee the obligation, however, it is accepted statutory practice that these obligations are not recorded or disclosed.

2. The Financial Accounting Standards Board (FASB) has been unable to reach a consensus that any particular method of presentation is preferable related to this issue. The SEC staff believes that when debt is incurred in connection with or otherwise related to the acquisition of a subsidiary in a purchase transaction and a subsidiary subsequently files a registration statement in connection with a public offering of its stock or debt, the parent company's debt, related interest expense, and allocable debt issue costs should be reflected in the subsidiary's financial statements included in the public offering if (1) the subsidiary is to assume the debt of the parent, either presently or in a planned transaction in the future, (2) the proceeds of a debt or equity offering of the subsidiary will be used to retire all or a part of the parent company's debt, or (3) the subsidiary guarantees or pledges its assets as collateral for the parent company's debt.

3. The purpose of this issue paper is to establish statutory accounting principles for recording and disclosure requirements of holding company obligations and any related guarantees in the financial statements of a subsidiary that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. In situations where the reporting entity does not guarantee the obligation of the holding company, there is no legal obligation on the part of the reporting entity. Therefore, the reporting entity shall not record the obligation of its parent holding company unless the obligation relates to services or benefits incurred by a non-insurance parent company or holding company on its behalf. In these situations, the reporting entity shall recognize an expense for its share of the services or benefits incurred on its behalf during the period by the parent company or holding company based on an allocation from the parent or holding company. A liability shall be established for any such amounts due, but not yet paid. The amount of expense incurred and the allocation methodology utilized by the provider of such benefits shall also be disclosed. *Issue Paper No. 8—Accounting for Pensions* (Issue Paper No. 8), *Issue Paper No. 11—Compensated Absences* (Issue Paper No. 11), *Issue Paper No. 13—Employers' Accounting for Postemployment Benefits* (Issue Paper No. 13), and *Issue Paper No. 14—Employers' Accounting for Postretirement Benefits Other Than Pensions* (Issue Paper No. 14) address specific examples where the obligation relates to benefits provided to the subsidiary by a non-insurance parent company or holding company.

5. If the reporting entity guarantees an obligation of the holding company, the guidance in *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets* (Issue Paper No. 5) shall be followed for determining the recording and disclosure of the guarantee. Issue Paper Nos. 8, 11, 13 and 14 provide specific accounting and disclosure guidelines for employee benefit plans when the reporting entity is directly liable for obligations under the plan.

DISCUSSION

6. Statutory accounting requires that a reporting entity record only its direct assets and direct obligations and not those of related parties. If the reporting entity has no legal obligation related to the holding company's obligations, the entity shall not record those obligations unless there is a guarantee of such debt that would require recording under the guidance in Issue Paper No. 5 or unless the obligation falls under the requirements discussed in paragraph 4. This is supported by the recognition concept included in the Statement of Concepts.

7. This issue paper rejects the requirements of *SEC Staff Accounting Bulletin No. 73, Push-Down Basis of Accounting Required in Certain Limited Circumstances* (SAB 73). The subsidiary has no direct legal obligation and, therefore, SAB 73 is inconsistent with statutory accounting principles as described in the Statement of Concepts. Other than the instances described in paragraph 4, the only way funding can be provided by the reporting entity to the holding company is through the payment of dividends and these payments are restricted to the amounts approved by the state insurance departments for the purpose of providing protection of surplus. As a result, the holding company can not legally require the reporting entity to fund debt payments in excess of the allowable dividends.

Drafting Notes/Comments

None

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

8. As discussed above, there is no current statutory guidance specifically related to this issue. The following disclosure requirements are outlined in the NAIC Annual Statement Instructions for Property and Casualty Companies - Notes to Financial Statements:

> 5. Information Concerning Parent, Subsidiaries and Affiliates
>
> e. Describe guarantees or undertakings for the benefit of an affiliate which result in a material contingent exposure of the company's or any affiliated insurer's assets to liability, if not disclosed. Report the total amount of guarantees for affiliates.
>
> 9. Contingent Liabilities
>
> a. Report briefly the nature of any material contingent liabilities including but not limited to: notes receivable discounted, reverse repurchase agreements, accounts and agents' balances assigned, accommodation paper, additional taxes, guarantees of liabilities of other companies (including companies that act as dealers in Over the Counter derivative instruments or as a Futures Commissions Merchant establishing of compensating balances, long-term contracts, loan take-out agreements and indemnification agreements, deferred expense contracts, structured settlements and arrangements between parents, subsidiaries or affiliates. Include in the disclosure: The date incurred or discovered; the nature of the contingent liability, contract, agreement or commitment; the amount or amounts, if known; the status as of the annual statement date; and all other information necessary for a full disclosure. Report the total amount of contingent liabilities.

The Annual Statement Instructions for Life and Accident and Health Companies contain similar requirements.

OTHER SOURCES OF INFORMATION

9. SAB 73 provides the following guidance:

Facts:
Company A (or Company A and related persons) acquired substantially all of the common stock of Company B in one or a series of purchase transactions.

Question 1:
Must Company B's financial statements presented in either its own or Company A's subsequent filings with the Commission reflect the new basis of accounting arising from Company A's acquisition of Company B when Company B's separate corporate entity is retained?

Interpretative Response:
Yes. The staff believes that purchase transactions that result in an entity becoming substantially wholly owned (as defined in Rule 1-02 (z) of Regulation S-X) establish a new basis of accounting for the purchased assets and liabilities.

When the form of ownership is within the control of the parent the basis of accounting for purchased assets and liabilities should be the same regardless of whether the entity continues to exist or is merged into the parent's operations. Therefore, Company A's cost of acquiring Company B should be "pushed down", i.e., used to establish a new accounting basis in Company B's separate financial statements.

Question 2:
What is the staff's position if Company A acquired less than substantially all of the common stock of Company B or Company B had publicly held debt or preferred stock at the time Company B became wholly owned?

Interpretative Response:
The staff recognizes that the existence of outstanding public debt, preferred stock or a significant minority interest in a subsidiary might impact the parent's ability to control the form of ownership. Although encouraging its use, the staff generally does not insist on the application of push down accounting in these circumstances. [Added by SAB No. 54, 11/3/83]

Question 3:
Company A borrows funds to acquire substantially all of the common stock of Company B. Company B subsequently files a registration statement in connection with a public offering of its stock or debt. Should Company B's new basis ("push down") financial statements include Company's A debt related to its purchase of Company B?

Interpretative Response:
The staff believes that Company A's debt, related interest expense and allocable debt issue costs should be reflected in Company B's financial statements included in the public offering (or an initial registration under the Exchange Act) if: (1) Company B is to assume the debt of Company A, either presently or in a planned transaction in the future; (2) the proceeds of a debt or equity offering of Company B will be used to retire all or a part of Company A's debt; or (3) Company B guarantees or pledges its assets as collateral for Company A's debt.

Other relationships may exist between Company A and Company B, such as the pledge of Company B's stock as collateral for Company A's debt. While in this latter situation, it may be clear that Company B's cash flows will service all or part of Company A's debt, the staff does not insist that the debt be reflected in Company B's financial statements providing there is full and prominent disclosure of the relationship between the Companies A and B and the actual or potential cash flow commitment. In this regard, the staff believes that Statements of Financial

Accounting Standards Nos. 5 and 57 requires sufficient disclosure to allow users of Company B's financial statements to fully understand the impact of the relationship on Company B's present and future cash flows. Rule 4-08(e) of Regulation S-X (17 CFR 210.4-08(e)) also requires disclosure of restrictions which limit the payment of dividends. Therefore, the staff believes that the equity section of Company B's balance sheet and any pro forma financial information and capitalization tables should clearly disclose that this arrangement exists.[(4)]

Regardless of whether the debt is reflected in Company B's financial statements, the notes to Company B's financial statements should generally disclose, at a minimum: (1) the relationship between Company A and Company B; (2) a description of any arrangements that result in Company B's guarantee, pledge of assets or stock, etc. that provides security for Company A's debt; (3) the extent (in the aggregate and for each of the five years subsequent to the date of the latest balance sheet presented) to which Company A is dependent on Company B's cash flows to service its debt and the method by which this will occur; and (4) the impact of such cash flows on Company B's ability to pay dividends or other amounts to holders of its securities.

Additionally, the staff believes Company B's Management's Discussion and Analysis of Financial Condition and Results of Operations should discuss any material impact of the servicing of Company A's debt on its own liquidity pursuant to Item 303(a)(1) of Regulations S-K (17 CFR 229.303(a)(1)). (Added by SAB No. 73, 12/30/87.)

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 8—Accounting for Pensions*
- *Issue Paper No. 11—Compensated Absences*
- *Issue Paper No. 13—Employers' Accounting for Postemployment Benefits*
- *Issue Paper No. 14—Employers' Accounting for Postretirement Benefits Other Than Pensions*

State Regulations

- No additional guidance obtained from state statutes or regulations.

Other Sources of Information

- SEC Staff Accounting Bulletin No. 73

Statutory Issue Paper No. 96

Other Liabilities

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 67

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory accounting guidance for the other liabilities is provided in Chapter 17, Other Liabilities, of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies and Chapter 13, Other Liabilities, of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies.

2. The purpose of this issue paper is to establish statutory accounting principles for other liabilities, including self-insurance reserves, which are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

3. For purposes of identifying other liabilities, the discussion, definition and accounting treatment outlined in *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets* (Issue Paper No. 5) must be considered. This paper is not an all-inclusive list of other liabilities. Certain other liabilities are covered in other issue papers. All other liabilities, whether or not specifically identified in this issue paper shall be recorded and disclosed in accordance with Issue Paper No. 5, which states that "a liability shall be recorded on a reporting entity's financial statements when incurred".

4. Specific accounting treatment and where appropriate, a definition of certain other liabilities, is discussed below.

Self-Insurance

5. Self-insurance occurs when an entity retains insurance risks associated with the entity's day-to-day operations that are commonly transferred to an insurer through an insurance contract. Self-insurance can also be described as a decision not to insure or non-insurance. To the extent that an event occurs, obligating the entity in accordance with the definition of a liability or impairment of an asset in Issue Paper No. 5, for which insurance coverage has not been obtained, the entity shall record either the appropriate write-down of the assets, if applicable, or reserves shall be established using the same estimation methodology an insurance company uses when an insurance contract is issued for the type of insurance risk which is self-insured. *Issue Paper No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses* describes the specific reserving guidance which should be followed.

6. The related costs should be treated similarly to comparable expenses and allocated appropriately (see *Issue Paper No. 94—Allocation of Expenses*). As a result of this treatment, the costs are accounted for based on the nature of the underlying expenses.

7. The mere fact that a decision is made not to insure against losses that can reasonably be expected some time in the future does not necessitate accrual by the entity if it is not probable that an asset has been impaired or a liability incurred at the date of the financial statements.

Amounts Withheld or Retained by Company as Agent or Trustee

8. A reporting entity may, in the normal course of its business, withhold funds as an agent or trustee which will ultimately be paid to others. Amounts withheld or retained by an entity as trustee or agent shall be recorded as a liability when the salaries or other compensation are expensed (8(a and b)) or the funds are received (8(c, d and e)). Examples of such occurrences are:

a. As an employer, the reporting entity deducts and withholds federal and state income taxes, social security taxes, charitable contributions, savings plan deductions, garnishments, employee contributions to pension plans, employee share of group life and health insurance premiums, and other employee salary withholdings or deductions.

b. Amounts due under deferred compensation arrangements shall be accrued in accordance with the provisions of *Issue Paper No. 14—Employers' Accounting for Postretirement Benefits Other Than Pensions.* Segregated funds (i.e., Rabbi trusts and similar arrangements) shall not be netted against the accrued liability unless the requirements of *Issue Paper No. 76—Offsetting and Netting of Assets and Liabilities* are met.

c. Many reporting entities invest in commercial and residential mortgages. The entity may require the mortgagor to prepay real estate taxes and property insurance premiums which the entity will hold in escrow and pay when due.

d. Deposits held by a reporting entity in connection with leases of investment property.

e. Any other funds the reporting entity may receive and hold in a fiduciary capacity.

Remittances and Items Not Allocated

9. Cash receipts cannot always be identified for a specific purpose or, for other reasons, applied to a specific account when received. The reporting entity shall record a liability for these cash receipts when the funds are received. Such liability accounts are generally referred to as suspense accounts. Examples of such receipts include:

a. Premium payments received with the application for policies which have not yet been issued;

b. Premium payments in an amount different than the amount billed by the reporting entity;

c. Unidentified cash receipts.

Interest Payable

10. Interest payable includes interest on borrowed money as well as interest on real estate and approved interest on surplus notes. It also includes interest on funds held as a deposit or security, such as those held by a ceding company against a reinsurer. The amount to be reported is the amount which has accrued and is unpaid at the balance sheet date. The Property and Casualty Annual Statement includes a specific line to record accrued interest. Accrued interest for Life and Accident and Health Companies shall be recorded with the liability.

Payable to Parent, Subsidiaries and Affiliates

11. A liability shall be established for expenditures incurred on behalf of the reporting entity by a parent, affiliates, or subsidiaries or for amounts owed through other intercompany transactions. Examples of such expenses are executive salaries, workers' compensation insurance premiums, pension contributions, etc. The liability shall be identified as an intercompany balance.

12. Reinsurance transactions are not considered liabilities of this nature and are covered in *Issue Paper No. 74—Life, Deposit-Type and Accident and Health Reinsurance* and *Issue Paper No. 75—Property and Casualty Reinsurance.*

DISCUSSION

13. This issue paper adopts *FASB Statement No. 116, Accounting for Contributions Received and Contributions made* and *AICPA Statement of Position 96*-1, *Environmental Remediation Liabilities*.

14. The principles established are consistent with current statutory accounting principles and with Issue Paper No. 5. The requirement that liabilities be recorded when they are incurred is also consistent with the recognition principle described in the Statement of Concepts.

15. The liabilities addressed above are not specifically discussed in GAAP, however, they are considered liabilities and therefore are treated consistently with the GAAP guidance referenced in Issue Paper No. 5. The "Scope of the Statement" section of *FASB Statement No. 5*, *Accounting for Contingencies*, includes a reference to the fact that self-insurance is covered under the scope of the statement.

Drafting Notes/Comments

- Interest payable on surplus notes is addressed in *Issue Paper No. 41—Surplus Notes*.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

16. Chapter 17, Other Liabilities, of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies discusses accounting for other liabilities as follows:

> Amounts Withheld or Retained by Company as Agent or Trustee
>
> The life insurance company may, in the normal course of its business, withhold funds as an agent or trustee which will ultimately be paid to others. Funds held must be identified as to whom they are held for, as well as the amount, so that the liability can be confirmed by subsequent payments or confirmation by the payee. Examples of such occurrences are:
>
> 1. As an employer, the life insurance company deducts and withholds federal and state income taxes, social security taxes, employee contributions to pension plans, and employees' share of group life and health insurance premiums. Such funds are recorded as a liability of the company at the time gross salaries are expensed and the liability is subsequently cleared by payment.
>
> 2. Many life insurance companies invest in commercial and residential mortgages. The company may require the mortgagor to prepay real estate taxes and property insurance premiums which the company will hold in escrow and pay when due.
>
> 3. Any other funds the company may receive and hold in a fiduciary capacity.
>
> Remittances and Items Not Allocated
>
> Cash receipts cannot always be identified for a specific purpose or, for other reasons, applied to a specific account when received. It is undesirable, costly, and imprudent for a company to delay depositing such receipts until the payment can be identified. Cash receipts should be deposited intact when received for good accounting control and to be available for investment by the company. It is customary for life insurance companies to maintain one or more liability accounts to record cash receipts which cannot be specifically allocated. Such liability accounts are generally referred to as suspense accounts. Examples of such receipts include:

> 1. Premium payments received with the application for policies which have not yet been issued;
>
> 2. Premium payments of amount different than the amount billed by the company;
>
> 3. Unidentified cash receipts.
>
> Special attention should be given to the verification and clearance of suspense accounts. The outstanding suspense items should be aged. Any suspense item that has not been cleared after a specified time should be investigated. If premium payments are allowed to remain in suspense for a long period of time, it is possible that a policy might be improperly lapsed for nonpayment of premium or have nonforfeiture options or automatic premium loan options applied.
>
> Payable to Parent, Subsidiaries and Affiliates
>
> A liability should be established for amounts payable to a parent, subsidiary or affiliate for intercompany disbursements. Examples of such expenses are executive salaries, workers' compensation insurance premiums, pension contributions, etc. The purpose of separating this liability from other accounts is to identify intercompany balances.

17. Chapter 13 of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Other Liabilities, discusses accounting for other liabilities as follows:

> Other liabilities are those liabilities not specifically covered by other chapters. Included in this category are the following annual statement captions:
>
> Borrowed Money
> Interest Payable
> Stockholder Dividends Declared and Unpaid
> Policyholder Dividends Declared and Unpaid
> Amounts Withheld or Retained by Company for Account of Others
> Provision for Reinsurance
> Excess of Statutory Reserves over Statement Reserves
> Net Adjustments in Assets and Liabilities Due to Foreign Exchange Rates
> Liability for Amounts Held Under Uninsured Accident and Health Plans
> Drafts Outstanding
> Payable to Affiliates
> Payable for Securities
> Debt Obligations of Employee Stock Ownership Plans
> Postretirement Benefits Other Than Pensions
>
> Interest Payable
>
> Interest payable includes interest on "Borrowed Money" as well as interest on real estate and surplus loans. It also includes interest on funds held as a deposit or security, such as those held by a ceding company against a reinsurer. Further treatment of funds held by a ceding company may be found in Chapter 22, Reinsurance.
>
> The interest on "Borrowed Money" is also shown parenthetically as part of the caption of this liability item in the annual statement.
>
> Amounts Withheld or Retained by Company for Account of Others
>
> Items to be included under this classification are:
>
> 1. Amounts withheld from employee payrolls and unpaid at the balance sheet date. These include federal, state and city taxes and social security taxes, savings bonds deductions, charitable contributions, savings plan deductions, employee retirement plan

contributions, garnishments, group life and health insurance premiums, and other employee salary withholdings or deductions.

2. Deposits held by the company in connection with leases of investment property.

3. Escrow balances required of mortgagors for property taxes and insurance on real estate pledged for mortgages held by the company.

4. Any other funds the company holds in a fiduciary capacity for the account of others. This excludes reinsurance funds held, which are reported elsewhere and covered in Chapter 22-Reinsurance.

Payable to Affiliates

Amounts shown under this caption include unreimbursed expenditures on behalf of the company by a parent, affiliates, or subsidiaries or amounts owing through other intercompany transactions.

Reinsurance transactions are not normally reported on this line. For further information, see Chapter 22-Reinsurance.

Generally Accepted Accounting Principles

18. *FASB Statement No. 5, Accounting for Contingencies*

SCOPE OF THIS STATEMENT

56. Some respondents to the Exposure Draft proposed that the Statement not deal with accrual and disclosure of loss contingencies in general but, rather, only with the following three specific matters: “self-insurance,” risk of losses from catastrophes assumed by property and casualty insurance companies including reinsurance companies, and threat of expropriation.

57. The Board has concluded, however, that the broad issue of accrual and disclosure of loss contingencies should be dealt with in a single Statement, just as the Discussion Memorandum encompasses “the broad issue of accounting for future losses.” As the Discussion Memorandum stated, “future losses of all types presently known to affect enterprises and new types of future losses that may arise are conceptually included in the scope of this project.”

RISK OF FUTURE LOSS OR DAMAGE OF ENTERPRISE PROPERTY, INJURY TO OTHERS, DAMAGE TO THE PROPERTY OF OTHERS, AND BUSINESS INTERRUPTION

85. Some persons contend that the decision not to purchase insurance against losses that can be reasonably expected sometime in the future (such as risk of loss or damage of enterprise property, injury to others, damage to the property of others, and business interruption) justifies periodic accrual for those losses without regard to whether it is probable that an asset has been impaired or a liability incurred at the date of the financial statements. As a basis for their position, they frequently cite the following factors: matching of revenue and expense, spreading the burden of irregularly occurring costs to successive generations of customers, and conservatism. They also believe that accrual of estimated losses from those types of risks improves the comparability of the financial statements of enterprises that purchase insurance. Some contend that a prohibition against periodic accrual for uninsured losses will force enterprises to purchase insurance coverage that would not otherwise be purchased.

86. In the Board’s judgment, however, the mere existence of risk, at the date of an enterprise’s financial statements, does not mean that a loss should be accrued. Anticipation of asset impairments or liabilities or losses from business interruption that do not relate to the current or a prior period is not justified by the matching concept.

87. The Board’s view regarding the contention that periodic accrual for uninsured losses is a way of providing protection against loss and improving comparability among enterprises that do

not purchase insurance, and the contention that prohibition of accrual will force enterprises to purchase insurance are discussed in paragraphs 61-66. The Board's position regarding periodic accrual for uninsured risks and other loss contingencies on the grounds of spreading the burden of irregularly occurring costs to successive generations of customers or on the grounds of conservatism is discussed in paragraphs 81-84.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 17
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 13
- *Issue Paper No. 14—Employers' Accounting for Postretirement Benefits Other Than Pensions*
- *Issue Paper No. 76—Offsetting and Netting of Assets and Liabilities*
- *Issue Paper No. 74—Life, Deposit-Type and Accident and Health Reinsurance*
- *Issue Paper No. 75—Property and Casualty Reinsurance*

Generally Accepted Accounting Principles

- *FASB Statement No. 5, Accounting for Contingencies*
- *FASB Statement No. 116, Accounting for Contributions Received and Contributions Made*
- *AICPA Statement of Position 96-1, Environmental Remediation Liabilities*

State Regulations

- No additional guidance obtained from state statutes or regulations.

Statutory Issue Paper No. 97

Underwriting Pools and Associations Including Intercompany Pools

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 63

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Underwriting pools and associations can be categorized as follows: involuntary, voluntary, and intercompany.

2. Involuntary pools represent a mechanism employed by states to provide insurance coverage to those with higher than average probability of loss who otherwise would be excluded from obtaining coverage. Reporting entities are generally required to participate in the underwriting results, including premiums, losses, expenses, and other operations of involuntary pools, based on their proportionate share of similar business written in the state. Involuntary plans are also referred to as residual market plans, involuntary risk pools, and mandatory pools.

3. Voluntary pools are similar to involuntary pools except they are not state mandated and a reporting entity participates in the pool voluntarily. In addition, voluntary pools are not limited to the provision of insurance coverage to those with higher than average probability of loss, but often are used to provide greater capacity for risks with exceptionally high levels of insurable values (e.g., aircraft, nuclear power plants, refineries, and offshore drilling platforms).

4. Intercompany pooling relates to business which is pooled among affiliated entities who are party to a pooling arrangement.

5. Current statutory accounting provides limited guidance on accounting for a reporting entity's participation in underwriting pools and associations. Although it is not specifically stated in the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies (Life/A&H and P&C Accounting Practices & Procedures Manuals), certain annual statement schedules do require that the reporting entity's participation in the pools' underwriting results be recorded on a gross basis. However, the guidance does not address whether participation in the pools should be recorded using accrual or cash basis accounting. Reporting entities are currently utilizing both approaches. GAAP guidance related to underwriting pools and associations is limited to *FASB Statement No. 113*, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts* (FAS 113). FAS 113 states that involuntary plans are included within the scope of the statement; therefore the reinsurance activity should be recorded on a gross basis.

6. The purpose of this issue paper is to establish statutory accounting principles for underwriting pools and associations that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

7. *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets* (Issue Paper No. 5), defines a liability and states that the definition "includes but is not limited to liabilities arising from policyholder obligations (e.g., policyholder benefits, reported claims and reserves for

incurred but not reported claims).” Issue Paper No. 5 requires liabilities to be recorded on a reporting entity’s financial statements when incurred.

8. Participation in a pool may be on a joint and several basis, i.e., in addition to a proportional share of losses and expenses incurred by the pool, participants will be responsible for their share of any otherwise unrecoverable obligations of other pool participants. In certain instances, one or more entities may be designated as servicing carriers for purposes of policy issuance, claims handling, and general administration of the pooled business, while in other cases a pool manager or administrator performs all of these functions and simply bills pool participants for their respective shares of all losses and expenses incurred by the pool. In either case, liabilities arising from pooled business are generally incurred on a basis similar to those associated with non-pooled business, and should therefore be treated in a manner consistent with the guidelines set forth in Issue Paper No. 5 and in paragraph 7 of this issue paper.

9. Intercompany pooling arrangements involve establishment of a conventional quota share reinsurance agreement under which all of the pooled business is ceded to the lead entity and then retroceded back to the pool participants in accordance with their stipulated shares. In such arrangements, only the policy issuing entity has direct liability to its policyholders or claimants; other pool participants are liable as reinsurers for their share of the issuing entity’s obligations. Although participants may use different assumptions (e.g., discount rates) in recording transactions, the timing of recording transactions shall be consistently applied by all participants.

10. Underwriting results shall be accounted for on a gross basis whereby the participant’s portion of premiums, losses, expenses, and other operations of the pools are recorded separately in the financial statements rather than netted against each other. Premiums and losses shall be recorded as direct, assumed, and/or ceded as applicable. If the reporting entity is a direct writer of the business premiums, losses shall be recorded as directly written and accounted for in the same manner as other business which is directly written by the entity. To the extent that premium is ceded to a pool, premiums and losses shall be recorded in the same manner as any other reinsurance arrangement. A reporting entity who is a member of a pool shall record its participation in the pool as assumed business as in any other reinsurance arrangement.

11. Equity interests in, or deposits receivable from, a pool represent cash advances to provide funding for operations of the pool. These are admitted assets and shall be recorded separately from receivables and payables related to a pool’s underwriting results. Receivables and payables related to underwriting results should be accounted for in accordance with the guidance in paragraphs 7 to 10, above. If, in accordance with Issue Paper No. 5, it is probable that these receivables are uncollectible, any uncollectible amounts shall be written off against operations in the period such determination is made. If it is reasonably possible a portion of the balance is uncollectible but is not written off, disclosure requirements outlined in Issue Paper No. 5 shall be followed.

12. If a reporting entity is part of a group of affiliated entities which utilizes a pooling arrangement under which the pool participants cede substantially all of their direct and assumed business to the pool, the financial statements shall include:

a. A description of the basic terms of the arrangement and the related accounting;

b. Identification of the lead entity and of all affiliated entities participating in the intercompany pool (include NAIC Company Codes) and indication of their respective percentage shares of the pooled business;

c. Description of the lines and types of business subject to the pooling agreement;

d. Description of cessions to non-affiliated reinsurers of business subject to the pooling agreement, and indication of whether such cessions were prior to or subsequent to the cession of pooled business from the affiliated pool members to the lead entity;

e. Identification of all pool members which are parties to reinsurance agreements with non-affiliated reinsurers covering business subject to the pooling agreement and which have a contractual right of direct recovery from the non-affiliated reinsurer per the terms of such reinsurance agreements;

f. Explanation of any discrepancies between entries regarding pooled business on the assumed and ceded reinsurance schedules of the lead entity and corresponding entries on the assumed and ceded reinsurance schedules of other pool participants;

g. Description of intercompany sharing, if other than in accordance with the pool participation percentage, of the Provision for Reinsurance (Schedule F, Part 7) and the write–off of uncollectible reinsurance.

DISCUSSION

13. This issue paper applies Issue Paper No. 5 to underwriting pools and associations.

14. There are a variety of types of underwriting pools and associations. Examples include, but are not limited to Assigned Risk Plans, Joint Underwriting Associations, Reinsurance Pools, Fair Access to Insurance Requirements Plans, Comprehensive Health Insurance Plans, and Workers' Compensation Pools.

15. Certain underwriting pools and associations, such as Assigned Risk Plans, require the reporting entity to accept a share of the undesirable risks based on the percent of the premium written in that state. The reporting entity is then responsible for collecting premiums and paying claims on policies issued to these applicants. Other underwriting pools and associations, such as Joint Underwriting Associations, require all entities in the state to participate in the underwriting results, however, a servicing company is designated to issue the policies and pay the claims for these risks on behalf of the pool.

16. Current statutory practice related to underwriting pools and associations is varied. A "pay-as-you-go" (cash basis) approach has been adopted by many entities. This issue paper rejects that treatment because it is inconsistent with the concepts of conservatism and recognition outlined in the Statement of Concepts. It is also inconsistent with the accounting principles set forth in Issue Paper No. 5. With respect to conservatism, the Statement of Concepts states:

> Financial reporting by insurance enterprises requires the use of substantial judgments and estimates by management...In order to provide a margin of protection to policyholders, the concept of conservatism should be followed when developing estimates as well as establishing accounting principles for statutory reporting.

17. With respect to recognition, the Statement of Concepts states that:

> *"Liabilities require recognition as they are incurred...Accounting treatments which tend to defer expense recognition do not generally represent acceptable SAP treatment."*

18. Many reporting entities have adopted the practice of netting the underwriting results related to their participation in underwriting pools and associations. Although the Life/A&H and P&C Accounting Practices and Procedures Manuals do not specifically state that the reporting entity's participation in the pool's underwriting results shall be recorded on a gross basis, the Annual Statement Instructions for Property and Casualty Insurance Companies require a separate disclosure of "the net reserves for losses

and expenses for the entity's share of underwriting pools' and associations' unpaid loss and expenses which are included in reserves." The instructions also require that reinsurance assumed from and ceded to underwriting pools and associations be disclosed separately thereby establishing the requirement to record reinsurance on a gross basis.

19. All forms of underwriting pools and associations should be accounted for consistently. It would be inconsistent to require reporting entities to account for underwriting results related to assigned risk plans on a gross basis and underwriting results related to joint underwriting associations on a net basis. Accounting for the plans consistently enables regulators to more effectively compare results of the individual entities participating in the plans.

20. The consistency requirement of paragraph 19 is supported by the Statement of Concepts which states that:

> The regulator's need for meaningful, comparable financial information to determine an insurer's financial condition requires consistency in the development and application of statutory accounting principles. Because the marketplace, the economic and business environment, and insurance industry products and practices are constantly changing, regulatory concerns are also changing. An effective statutory accounting model must be responsive to these changes and address emerging accounting issues. Precedent or historically accepted practice alone should not be sufficient justifications for continuing to follow a particular accounting principle or practice which may not coincide with the objectives of regulators.

21. There is no specific GAAP guidance related to underwriting pools and associations other than in FAS 113 which states that involuntary risk pools are included within the scope of the statement and thereby requires the reinsurance activity to be recorded on a gross basis.

Drafting Notes/Comments
None

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

22. The P&C Accounting Practices and Procedures Manual, Chapter 14, *Premiums*, discusses the following:

> Underwriting Pools, Associations, and Syndicates
> Companies also participate as members of an underwriting pool, association, or syndicate organized to provide special insurance coverages. Operating results, including the applicable premiums, are distributed to member companies based on their prescribed share.
>
> Usually, statements are received by the company showing the total premiums written, as well as the member company's participation. These premiums are recorded on a summary basis (usually by line of business) as direct or assumed business depending on the requirements of the particular association.

23. The P&C Accounting Practices and Procedures Manual, Chapter 22, R*einsurance*, discusses the following:

> Fronting arrangements, servicing carrier business, and pools and association business are often accomplished using reinsurance contracts. The guidance included in this chapter also applies to these types of contracts, except as specifically exempted.

24. The Annual Statement Instructions for Property and Casualty Insurance Companies, General Section, discusses the following requirements related to the actuarial opinion:

> 8. The scope paragraph should contain a sentence such as the following:
>
> "I have examined the actuarial assumptions and methods used in determining reserves listed below, as shown in the Annual Statement of the Company as prepared for filing with state regulatory officials, as of December 31, 19__."
>
> The paragraph should list items and amounts with respect to which the actuary is expressing an opinion. The list should include but not necessarily be limited to:
>
> A. Reserve for Unpaid Losses (Page 3, Line 1);
> B. Reserve for Unpaid Loss Adjustment Expenses (Page 3, Line 2);
> C. Reserve for Unpaid Losses - Direct and Assumed (Schedule P, Part 1, Totals from Cols. 13 and 15); and
> D. Reserve for Unpaid Loss Adjustment Expenses - Direct and Assumed (Schedule P, Part 1, Totals from Cols. 17, 19, and 22).
>
> If the actuary includes the Excess of Statutory over Statement Reserves to the above list, the actuary must also opine on the reserves excluding this amount.
>
> 9. The actuary should state that the items in paragraph 8, on which he or she is expressing an opinion, reflect the following items:
>
> A. ...
> B. ...
> C. The net reserves for losses and expenses for the company's share of voluntary and involuntary underwriting pools' and associations' unpaid losses and expenses which are included in reserves shown on Page 3 - Liability, Surplus and Other Funds, Lines 1 and 2, $__________.
>
> 11. The actuary should comment in the scope section on each of the following topics, describing the effect of each on loss or loss expense reserves: ...underwriting pools or associations,...

25. The Annual Statement Instructions for Property and Casualty Insurance Companies, Section referring to Assets, discusses the following disclosure requirement:

> Line 17 - Equities and Deposits in Pools and Associations
>
> In the event that the insurer has equity in, or deposits receivable from, underwriting associations, pools, etc., the equity interests and deposits receivable should be reported here.

26. The Annual Statement Instructions for Property and Casualty Insurance Companies, Section referring to Schedule F-Part 1-Assumed Reinsurance and Schedule F-Part 3-Ceded Reinsurance, requires reinsurance assumed from and ceded to mandatory pools and associations be disclosed separately from voluntary pools and associations.

27. The Property and Casualty Reinsurance Study Group of the Accounting Practices and Procedures (EX4) Task Force adopted the following disclosure requirements for intercompany pooling arrangements at its September 29, 1996 meeting.

PROPOSED INSTRUCTIONS
PROPERTY/CASUALTY ANNUAL STATEMENT FOOTNOTE

Intercompany Pooling Arrangements

Instruction:

If the company is part of a group of affiliated insurers which utilizes a pooling arrangement that affects the solvency and integrity of the insurer's reserves under which the pool participants cede substantially all of their direct and assumed business to the pool, describe the basic terms of such arrangement[s] and the related accounting. The disclosure should include:

- Identification of the lead company and of all affiliated companies participating in the intercompany pool (include NAIC Company Codes) and indication of their respective percentage shares of the pooled business.

- Description of the lines and types of business subject to the pooling agreement.

- Description of cessions to non-affiliated reinsurers of business subject to the pooling agreement, and indication of whether such cessions were prior to or subsequent to the cession of pooled business from the affiliated pool members to the lead company.

- Identification of all pool members which are parties to reinsurance agreements with non-affiliated reinsurance reinsurers covering business subject to the pooling agreement and which have a contractual right of direct recovery from the non-affiliated reinsurer per the terms of such reinsurance agreements.

- Explanation of any discrepancies between entries regarding pooled business on the assumed and ceded reinsurance schedules of the lead company and corresponding entries on the assumed and ceded reinsurance schedules of other pool participants.

- Description of intercompany sharing, if other than in accordance with the pool participation percentage, of the Provision for Reinsurance (Schedule F, Part 7) and the write–off of uncollectible reinsurance.

Illustration

ALTERNATIVE 1: EXTERNAL REINSURANCE PRIOR TO POOLING

The Company participates in an intercompany reinsurance pooling arrangement in which The ABC Insurance Company is the lead company. Under the terms of the arrangement, all of the property-casualty underwriting risks of the intercompany pool participants except other accident & health are reinsured with the lead company after each individual company's external reinsurance is transacted among third parties. This pool of property-casualty net underwriting risks is then retroceded from the lead company to the other non-lead pool participants based on pool participation percentages.

The names, NAIC company codes and pool participation percentages of the ABC Group's intercompany pooling arrangement are as follows:

Pool Participant	NAIC Company Code	Pool Participation %
The ABC Insurance Company	00001	75%
The ABC Casualty Company	0000100002	10%
The ABC Indemnity Company	00003	10%
ABC Fire Insurance Company	00004	5%

ALTERNATIVE 2: EXTERNAL REINSURANCE AFTER POOLING

The Company participates in an intercompany reinsurance pooling arrangement in which The ABC Insurance Company is the lead company. Under the terms of the arrangement, all of the property–casualty underwriting risks of the intercompany pool participants except other accident & health are reinsured with the lead company. After reinsurance is transacted among third parties by the lead company, the remaining pool of property-casualty underwriting risks is the then retroceded to the other non–lead pool participants based on pool participation percentages.

The names, NAIC company codes and pool participation percentages of the ABC Group's intercompany pooling arrangement are as follows:

Pool Participant	NAIC Company Code	Pool Participation %
The ABC Insurance Company	00001	75%
The ABC Casualty Company	0000100002	10%
The ABC Indemnity Company	00003	10%
ABC Fire Insurance Company	00004	5%

Generally Accepted Accounting Principles

28. The AICPA Audit and Accounting Guide: Audits of Property and Casualty Insurance Companies describes several types of involuntary plans in Chapter 1, *Nature, Conduct, and Regulation of the Business.*

29. FAS 113 discusses the following:

> 50. Several respondents questioned whether servicing carriers for involuntary risk pools should be included in the Statement's scope. Servicing carriers generally retain the primary obligation to the policyholder and have no right to offset claim liabilities against amounts due from other pool participants. Although the credit risk associated with involuntary pools may be reduced because of the pool membership's joint and several liability, the servicing carrier is still dependent on the ability of other pool members to pay their proportionate share of claims. State authorities oversee such pools and may act to support the solvency of pool, but that action generally is voluntary. The Board concluded that it was unable to effectively distinguish servicing carrier business from other types of reinsurance for accounting purposes. Separate presentation or disclosure of servicing carrier activity is not precluded by this Statement.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapters 14 and 22
- The Annual Statement Instructions for Property and Casualty Insurance Companies
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*

Generally Accepted Accounting Principles

- AICPA Audit and Accounting Guide: Audits of Property and Casualty Insurance Companies, Chapter 1, *Nature, Conduct, and Regulation of the Business*, Section 1.08
- *FASB Statement No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*

State Regulations

- No additional guidance obtained from state statutes or regulations.

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Statutory Issue Paper No. 99

Nonapplicable GAAP Pronouncements

STATUS
Updated for actions taken by the Statutory Accounting Principles (E) Working Group and the Emerging Accounting Issues (E) Working Group through December 2014

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. For items presented to the Statutory Accounting Principles (E) Working Group, ~~T~~this issue paper~~statement~~ addresses Generally Accepted Accounting Principles (GAAP) pronouncements that are nonapplicable due to one of the following reasons:

a. The pronouncement does not relate to the insurance industry;

b. The pronouncement is not within the objectives of statutory accounting;

c. The pronouncement would not add a substantive amount of guidance to statutory accounting due to the narrow scope of the topic;

d. The pronouncement relates to transition of a previously issued GAAP pronouncement.

2. For items presented to the Emerging Accounting Issues (E) Working Group, this issue paper includes references to EITFs that have been rejected for the following reasons:

a. Rejected as not applicable to statutory accounting;

b. Rejected without providing additional statutory guidance;

c. Rejected on the basis of issues rejected in a SSAP.

EITFs that were rejected on the basis of issues rejected in a SSAP (paragraph 2.c.) are denoted with an asterisk after the EITF number. Additional information related to those rejected issues is located in Appendix H, *Interpretation 99-00—Compilation of Rejected EITFs*.

SUMMARY CONCLUSION

~~2~~3. GAAP pronouncements[1] not considered applicable to ~~the~~ NAIC ~~codification project~~statutory accounting principles are summarized as follows:

GAAP Pronouncement	Title
FASB Accounting Standards Updates (ASU)	
ASU 2009-02	Omnibus Update—Amendments to Various Topics for Technical Corrections
ASU 2009-13	Revenue Recognition: Multiple Deliverable Revenue Arrangements

[1] GAAP guidance that is rejected explicitly in an SSAP is not included within this listing.

GAAP Pronouncement	Title
ASU 2009-15	Accounting for Own-Share Lending Arrangements in Contemplation of Convertible Debt Issuance or Other Financing
ASU 2010-01	Equity: Accounting for Distributions to Shareholders with Components of Stock and Cash
ASU 2010-03	Extractive Activities—Oil and Gas (Topic 932): Oil and Gas Reserve Estimation and Disclosures
ASU 2010-16	Entertainment—Casinos (Topic 924): Accruals for Casino Jackpot Liabilities
ASU 2010-17	Revenue Recognition—Milestone Method (Topic 605): Milestone Method of Revenue Recognition
ASU 2010-24	Health Care Entities (Topic 954): Presentation of Insurance Claims and Related Insurance Recoveries
ASU 2010-25	Plan Accounting—Defined Contribution Pension Plans (Topic 962): Reporting Loans to Participants by Defined Contribution Pension Plans
ASU 2010-27	Other Expenses (Topic 720): Fees Paid to the Federal Government by Pharmaceutical Manufacturers
ASU 2011-05	Comprehensive Income (Topic 220): Presentation of Comprehensive Income
ASU 2011-07	Health Care Entities (Topic 954): Presentation and Disclosure of Patient Service Revenue, Provision for Bad Debts, and the Allowance for Doubtful Accounts for Certain Health Care Entities
ASU 2011-12	Comprehensive Income (Topic 220): Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in ASU 2011-05
ASU 2012-01	Health Care Entities (Topic 954): Continuing Care Retirement Communities—Refundable Advance Fees
ASU 2012-04	Technical Corrections and Improvements
ASU 2012-07	Entertainment—Films (Topic 926): Accounting for Fair Value Information That Arises after the Measurement Date and Its Inclusion in the Impairment Analysis of Unamortized Film Costs
ASU 2013-02	Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income
ASU 2013-07	Presentation of Financial Statements (Topic 205): Liquidation Basis of Accounting
ASU 2013-12	Definition of a Public Business Entity—An Addition to the Master Glossary
ASU 2014-10	Development Stage Entities (Topic 915): Elimination of Certain Financial Reporting Requirements, Including an Amendment to Variable Interest Entities Guidance in Topic 810, Consolidation
Pre-Codification FASB Statements (FAS)	
FAS 03	Reporting Accounting Changes in Interim Financial Statements—an amendment of APB Opinion No. 28
FAS 06	Classification of Short-Term Obligations Expected to Be Refinanced—an amendment of ARB No. 43, Chapter 3A
FAS 11	Accounting for Contingencies: Transition Method—an amendment of FASB Statement No. 5
FAS 14	Financial Reporting for Segments of a Business Enterprise
FAS 18	Financial Reporting for Segments of a Business Enterprise: Interim Financial Statements—an amendment of FASB Statement No. 14
FAS 19	Financial Accounting and Reporting by Oil and Gas Producing Companies

GAAP Pronouncement	Title
FAS 21	Suspension of the Reporting of Earnings per Share and Segment Information by Nonpublic Enterprises—an amendment of APB Opinion No. 15 and FASB Statement No. 14
FAS 24	Reporting Segment Information in Financial Statements That Are Presented in Another Enterprise's Financial Report—an amendment of FASB Statement No. 14
FAS 25	Suspension of Certain Accounting Requirements for Oil and Gas Producing Companies—an amendment of FASB Statement No. 19
FAS 30	Disclosure of Information about Major Customers—an amendment of FASB Statement No. 14
FAS 35	Accounting and Reporting by Defined Benefit Pension Plans
FAS 37	Balance Sheet Classification of Deferred Income Taxes—an amendment of APB Opinion No. 11
FAS 44	Accounting for Intangible Assets of Motor Carriers—an amendment of Chapter 5 of ARB No. 43 and an Interpretation of APB Opinions 17 and 30
FAS 45	Accounting for Franchise Fee Revenue
FAS 47	Disclosure of Long-Term Obligations
FAS 48	Revenue Recognition When Right of Return Exists
FAS 49	Accounting for Product Financing Arrangements
FAS 50	Financial Reporting in the Record and Music Industry
FAS 51	Financial Reporting by Cable Television Companies
FAS 53	Financial Reporting by Producers and Distributors of Motion Picture Films
FAS 63	Financial Reporting by Broadcasters
FAS 65	Accounting for Certain Mortgage Banking Activities
FAS 68	Research and Development Arrangements
FAS 69	Disclosures about Oil and Gas Producing Activities—an amendment of FASB Statements 19, 25, 33, and 39
FAS 71	Accounting for the Effects of Certain Types of Regulation
FAS 72	Accounting for Certain Acquisitions of Banking or Thrift Institutions—an amendment of APB Opinion No. 17, an Interpretation of APB Opinions 16 and 17, and an amendment of FASB Interpretation No. 9
FAS 73	Reporting a Change in Accounting for Railroad Track Structures—an amendment of APB Opinion No. 20
FAS 75	Deferral of the Effective Date of Certain Accounting Requirements for Pension Plans of State and Local Governmental Units—an amendment of FASB Statement No. 35
FAS 78	Classification of Obligations That Are Callable by the Creditor—an amendment of ARB No. 43, Chapter 3A
FAS 85	Yield Test for Determining whether a Convertible Security Is a Common Stock Equivalent—an amendment of APB Opinion No. 15
FAS 89	Financial Reporting and Changing Prices
FAS 90	Regulated Enterprises—Accounting for Abandonments and Disallowances of Plant Costs—an amendment of FASB Statement No. 71
FAS 92	Regulated Enterprises—Accounting for Phase-In Plans— an amendment of FASB Statement No. 71
FAS 93	Recognition of Depreciation by Not-for-Profit Organizations
FAS 99	Deferral of the Effective Date of Recognition of Depreciation by Not-for-Profit Organizations—an amendment of FASB Statement No. 93

GAAP Pronouncement	Title
FAS 101	Regulated Enterprises—Accounting for the Dis-continuation of Application of FASB Statement No. 71
FAS 110	Reporting by Defined Benefit Pension Plans of Investment Contracts—an amendment of FASB Statement No. 35
FAS 111	Rescission of FASB Statement No. 32 and Technical Corrections
FAS 117	Financial Statements of Not-for-Profit Organizations
FAS 124	Accounting for Certain Investments Held by Not-For-Profit Organizations
FAS 128	Earnings per Share
FAS 130	Reporting Comprehensive Income
FAS 131	Segment Disclosures
FAS 134	Accounting for Mortgage-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise, an amendment of FASB Statement No. 65
FAS 135	Rescission of FASB Statement No. 75 and Technical Corrections
FAS 136	Transfers of Assets to a Not-For-Profit Organization or Charitable Trust that Raises or Holds Contributions for Others
FAS 139	Rescission of FASB Statement No. 53
FAS 143	Accounting for Asset Retirement Obligations
FAS 147	Acquisitions of Certain Financial Institutions, an amendment of FASB Statements No. 72 and 144 and FASB Interpretation No. 9
FAS 151	Inventory Costs, and amendment of ARB No. 43 (FAS 151), Chapter 4
FAS 160	Noncontrolling Interests in Consolidated Financial Statements—an Amendment of ARB No. 51
Pre-Codification FASB Interpretations	
FIN 01 (APB 20)	Accounting Changes Related to the Cost of Inventory
FIN 08 (FASB 6)	Classification of a Short-Term Obligation Repaid Prior to Being Replaced by a Long-Term Security
FIN 09 (APB 16 & 17)	Applying APB Opinions No. 16 and 17 When a Savings and Loan Association or a Similar Institution is Acquired in a Business Combination Accounted for by the Purchase Method
FIN 31 (APB 15 & FASB 28)	Treatment of Stock Compensation Plans in EPS Computations
FIN 33 (FASB 34)	Applying FASB Statement No. 34 to Oil and Gas Producing Operations Accounted for by the Full Cost Method
FIN 36 (FASB 19)	Accounting for Exploratory Wells in Progress at the End of a Period
FIN 42 (FASB 116)	Accounting for Transfers of Assets in Which a Not-for-Profit Organization is Granted Variance Power
FIN 47 (FASB 143)	Accounting for Conditional Asset Retirement Obligations
Pre-Codification Accounting Principles Board Opinions (APB)	
APB 13	Amending Paragraph 6 of APB Opinion No. 9, Application to Commercial Banks
APB 15	Earnings Per Share

GAAP Pronouncement	Title
Pre-Codification Accounting Research Bulletins (ARB)	
ARB 43	Restatement and Revision of Accounting Research Bulletins, Chapter 4
ARB 45	Long-Term Construction-Type Contracts
Pre-Codification FASB Technical Bulletins (TB)	
TB 79-1	Purpose and Scope of FASB Technical Bulletins and Procedures for Issuance
TB 79-3	Subjective Acceleration Clauses in Long-Term Debt Agreements
TB 79-4	Segment Reporting of Puerto Rican Operations
TB 79-5	Meaning of the Term “Customer” as it Applies to Health Care Facilities under FASB Statement No. 14
TB 79-8	Applicability of FASB Statements 21 and 33 to Certain Brokers and Dealers in Securities
TB 82-2	Accounting for the Conversion of Stock Options into Incentive Stock Options as a Result of the Economic Recovery Tax Act of 1981
TB 84-1	Accounting for Stock Issued to Acquire the Results of a Research and Development Arrangement
TB 85-1	Accounting for the Receipt of Federal Home Loan Mortgage Corporation Participating Preferred Stock
TB 87-2	Computation of a Loss on an Abandonment
TB 87-3	Accounting for Mortgage Servicing Fees and Rights
TB 90-1	Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts
Pre-Codification FASB Staff Positions (FSP)	
FSP FAS 19-1	Accounting for Suspended Well Costs
FSP FAS 117-1	Endowments of Not-for-Profit Organizations: Net Asset Classification of Funds Subject to an Enacted Version of the Uniform Prudent Management of Institutional Funds Act, and Enhanced Disclosures for All Endowment Funds
FSP FAS 126-1	Disclosure and Interim Reporting for Obligors for Conduit Debt Securities
FSP FAS 143-1	Accounting for Electronic Equipment Waste Obligations
FSP FAS 150-3	Effective Date, Disclosures and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests Under FASB Statement No. 150
FSP FAS 150-5	Issuer’s Accounting Under FASB Statement 150 for Freestanding Warrants and Other Similar Instruments on Shares That are Redeemable
FSP FIN 46(R)-7	Application of FASB Interpretation No. 46(R) to Investment Companies
FSP AAGINV-1 and SOP 94-4-1	Reporting of Fully Benefit-Responsive Investment Contracts Held by Certain Investment Companies Subject to the AICPA Investment Company Guide and Defined-Contribution Health and Welfare and Pension Plans
FSP AUG AIR-1	Accounting for Planned Major Maintenance Activities
FSP SOP 78-9-1	Interaction of AICPA Statement of Position 78-9 and EITF Issue 04-5
FSP SOP 90-7-1	An Amendment of AICPA Statement of Position 90-7
FSP SOP 94-3-1 and AAG HCO-1	Omnibus Changes to Consolidate and Equity Method Guidance for Not-For-Profit Organizations
FSP SOP 07-1-1	Effective Date of AICPA Statement of Position 07-1

GAAP Pronouncement	Title
FSP EITF 85-24-1	Application of EITF Issue No. 85-24 When Cash for the Right to Future Distribution Fees for Shares Previously Sold is Received from Third Parties
Pre-Codification AICPA Statement of Positions	
SOP 14040	Confirmation of Insurance Policies in Force
SOP 14060	Auditing Property and Liability Reinsurance
SOP 14070	Auditing Life Reinsurance
SOP 74-8	Financial Accounting and Reporting by Colleges and Universities
SOP 75-2	Accounting Practices of Real Estate Investment Trusts
SOP 76-3	Accounting Practices for Certain Employee Stock Ownership Plans
SOP 78-9-1	Interaction of AICPA Statement of Position 78-9 and EITF Issue No. 04-5
SOP 78-10	Accounting Principles and Reporting Practices for Certain Nonprofit Organizations
SOP 81-1	Accounting for Performance of Construction-Type and Certain Production-Type Contracts
SOP 82-1	Accounting and Financial Reporting for Personal Financial Statements
SOP 83-1	Reporting by Banks of Investment Securities Gains or Losses
SOP 85-3	Accounting by Agricultural Producers and Agricultural Cooperatives
SOP 87-2	Accounting for Joint Costs of Informational Materials and Activities of Not-For-Profit Organizations That Include a Fund-Raising Appeal
SOP 88-1	Accounting for Developmental and Preoperating Costs, Purchases and Exchanges of Take-off and Landing Slots, and Airframe Modifications
SOP 89-2	Reports on Audited Financial Statements of Investment Companies
SOP 89-3	Questions Concerning Accountants' Services on Prospective Financial Statements
SOP 89-5	Financial Accounting and Reporting by Providers of Prepaid Health Care Services
SOP 89-7	Report on the Internal Control Structure in Audits of Investment Companies
SOP 90-1	Accountants' Services on Prospective Financial Statements for Internal Use Only and Partial Presentations
SOP 90-2	Report on Internal Control Structure in Audits of Futures Commission Merchants
SOP 90-7	Financial reporting by entities in reorganization under the Bankruptcy Code
SOP 90-8	Financial Accounting and Reporting by Continuing Care Retirement Communities
SOP 91-1	Software Revenue Recognition
SOP 92-2	Questions and Answers on the Term *Reasonably Objective Basis* and Other Issues Affecting Prospective Financial Statements
SOP 92-6	Accounting and Reporting by Health and Welfare Benefit Plans
SOP 92-8	Auditing Property/Casualty Insurance Entities Statutory Financial Statements—Applying Certain Requirements of the NAIC Annual Statement Instructions
SOP 92-9	Audits of Not-for-Profit Organizations Receiving Federal Awards
SOP 93-1	Financial Accounting and Reporting for High-Yield Debt Securities by Investment Companies
SOP 93-2	Determination, Disclosure, and Financial Statement Presentation of Income, Capital Gain, and Return of Capital Distributions by Investment Companies
SOP 93-3	Rescission of Accounting Principles Board Statements

GAAP Pronouncement	Title
SOP 93-4	Foreign Currency Accounting and Financial Statement Presentation for Investment Companies
SOP 93-5	Reporting on Required Supplementary Information Accompanying Compiled or Reviewed Financial Statements of Common Interest Realty Associations
SOP 93-8	The Auditor's Consideration of Regulatory Risk-Based Capital for Life Insurance Enterprises
SOP 94-1	Inquiries of State Insurance Regulators
SOP 94-2	The Application of the Requirements of Accounting Research Bulletins, Opinions of the Accounting Principles Board, and Statements and Interpretations of the Financial Accounting Standards Board to Not-for-Profit Organizations
SOP 94-3	Reporting of Related Entities by Not-for-Profit Organizations
SOP 94-4	Reporting of Investment Contracts Held by Health and Welfare Benefit Plans and Defined-Contribution Pension Plans
SOP 95-2	Financial Reporting by Nonpublic Investment Partnerships
SOP 95-3	Accounting for Certain Distribution Costs of Investment Companies
SOP 95-4	Letters for State Insurance Regulators to Comply with the NAIC Model Audit Rule
SOP 95-5	Auditor's Reporting on Statutory Financial Statements of Insurance Enterprises
SOP 98-2	Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising
SOP 98-3	Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards
SOP 98-6	Reporting on Management's Assessment Pursuant to the Life Insurance Ethical Market Conduct Program of the Insurance Marketplace Standards Association
SOP 98-8	Engagements to Perform Year 2000 Agreed-Upon Procedures Attestation Engagements Pursuant to Rule 17a-5 of the Securities Exchange Act of 1934, Rule 17Ad-18 of the Securities Exchange Act of 1934, and Advisories No. 17-98 and No. 42-98 of the Commodity Futures Trading Commission
SOP 99-1	Guidance To Practitioners In Conducting And Reporting On An Agreed-Upon Procedures Engagement To Assist Management In Evaluating The Effectiveness Of Its Corporate Compliance Program
SOP 99-2	Accounting for and Reporting of 401(h) Features of Defined Benefit Pension Plans
SOP 99-3	Accounting and Reporting of Certain Defined Contribution Plan Investments and Other Disclosure Matters
SOP 00-1	Auditing Health Care Third-Party Revenues and Related Receivables
SOP 00-2	Accounting by Producers of Films
SOP 01-1	Amendment to Scope of Statement of Position 95-2, Financial Reporting by Nonpublic Investment Partnerships, to include Commodity Pools
SOP 01-2	Accounting and Reporting by Health and Welfare Benefit Plans
SOP 01-3	Performing Agreed-Upon Procedures Engagements That Address Internal Control Over Derivative Transactions as Required by the New York State Insurance Law
SOP 01-4	Reporting Pursuant to the Association for Investment Management and Research Performance Presentation Standards

GAAP Pronouncement	Title
SOP 01-6	Accounting by Certain Entities (Including Entities with Trade Receivables) That Lend to or Finance the Activities of Others
SOP 02-1	Performing Agreed Upon Procedures Engagements That Address Annual Claims Prompt Payment Reports as Required by the New Jersey Administrative Code
SOP 02-2	Accounting for Derivative Instruments and Hedging Activities by Not-for-Profit Health Care Organizations, and Clarification of the Performance Indicator
SOP 03-2	Attest Engagements on Greenhouse Gas Emissions Information
SOP 03-4	Reporting Financial Highlights and Schedule of Investments by Nonregistered Investment Partnerships: An Amendment to the Audit and Accounting Guide Audits of Investment Companies and AICPA Statement of Position 95-2, Financial Reporting by Nonpublic Investment Partnerships
SOP 03-5	Financial Highlights of Separate Accounts: An Amendment to the Audit and Accounting Guide “Audits of Investment Companies”
SOP 04-1	Auditing the Statement of Social Insurance
SOP 04-2	Accounting for Real Estate Time-Sharing Transactions
SOP 06-1	Reporting Pursuant to the Global Investment Performance Standards
SOP 07-1	Clarification of the Scope of the Audit and Accounting Guide Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies
SOP 07-2	Attestation Engagements That Address Specified Compliance Control Objectives and Related Controls at Entities That Provide Services to Investment Companies, Investment Advisers, or Other Service Providers
SOP 09-1	Performing Agreed-Upon Procedures Engagements That Address the Completeness, Accuracy or Consistency of XBRL-Tagged Data
Pre-Codification FASB EITF	
EITF 84-9	Deposit Float of Banks
EITF 85-8	Amortization of Thrift Intangibles
EITF 85-12	Retention of Specialized Accounting for Investments in Consolidation
EITF 85-13	Sale of Mortgage Service Rights on Mortgages Owned by Others
EITF 85-18	Earnings-per-Share Effect of Equity Commitment Notes
EITF 85-23	Effect of a Redemption Agreement on Carrying Value of a Security
EITF 85-24	Distribution Fees by Distributors of Mutual Funds That Do Not Have a Front-End Sales Charge
EITF 85-27	Recognition of Receipts from Made-Up Rental Shortfalls
EITF 85-31	Comptroller of the Currency’s Rule on Deferred Tax Debits
EITF 85-41	Accounting for Savings and Loan Associations under FSLIC Management Consignment Program
EITF 85-42	Amortization of Goodwill Resulting from Recording Time Savings Deposits at Fair Values
EITF 85-44	Differences between Loan Loss Allowances for GAAP and RAP
EITF 86-2	Retroactive Wage Adjustments Affecting Medicare Payments
EITF 86-3	Retroactive Regulations regarding IRC Section 338 Purchase Price Allocations
EITF 86-5	Classifying Demand Notes with Repayment Terms
EITF 86-7	Recognition by Homebuilders of Profit from Sales of Land and Related Construction Contracts

GAAP Pronouncement	Title
EITF 86-12	Accounting by Insureds for Claims-Made Insurance Policies
EITF 86-13	Recognition of Inventory Market Declines at Interim Reporting Dates
EITF 86-24	Third-Party Establishment of Collateralized Mortgage Obligations
EITF 86-27	Measurement of Excess Contributions to a Defined Contribution Plan or Employee Stock Ownership Plan
EITF 86-30	Classification of Obligations When a Violation is Waived by the Creditor
EITF 86-31	Reporting the Tax Implications of a Pooling of a Bank and a Savings and Loan Association
EITF 86-40	Investments in Open-End Mutual Funds That Invest in U.S. Government Securities
EITF 86-44	Effect of a Change in Tax Law on Investments in Safe Harbor Leases
EITF 86-46	Uniform Capitalization Rules for Inventory under the Tax Reform Act of 1986
EITF 87-4	Restructuring of Operations: Implications of SEC Staff Accounting Bulletin No. 67
EITF 87-10	Revenue Recognition by Television (Barter) Syndicators
EITF 87-20	Offsetting Certificates of Deposit against High-Coupon Debt
EITF 87-22	Prepayments to the Secondary Reserve of the FSLIC
EITF 87-24	Allocation of Interest to Discontinued Operations
EITF 87-30	Sale of a Short-Term Loan Made under a Long-Term Credit Commitment
EITF 88-4	Classification of Payment Made to IRS to Retain Fiscal Year
EITF 88-16	Basis in Leveraged Buyout Transactions
EITF 88-19	FSLIC-Assisted Acquisitions of Thrifts
EITF 88-20	Difference between Initial Investment and Principal Amount of Loans in a Purchased Credit Card Portfolio
EITF 88-25	Ongoing Accounting and Reporting for a Newly Created Liquidating Bank
EITF 89-3	Balance Sheet Presentation of Savings Accounts in Financial Statements of Credit Unions
EITF 89-19	Accounting for a Change in Goodwill Amortization for Business Combinations Initiated Prior to the Effective Date of FASB Statement No. 72
EITF 89-20	Accounting for Cross Border Tax Benefit Leases
EITF 90-4	Earnings-per-Share Treatment of Tax Benefits for Dividends on Stock Held by an Employee Stock Ownership Plan
EITF 90-16	Accounting for Discontinued Operations Subsequently Retained
EITF 90-18	Effect of a “Removal of Accounts” Provision on the Accounting for a Credit Card Securitization
EITF 91-6	Revenue Recognition of Long-Term Power Sales Contracts
EITF 91-9	Revenue and Expense Recognition for Freight Services in Process
EITF 91-10	Accounting for Special Assessments and Tax Increment Financing Entities (TIFEs)
EITF 92-3	Earnings-per-Share Treatment of Tax Benefits for Dividends on Unallocated Stock Held by an Employee Stock Ownership Plan
EITF 92-5	Amortization Period for Net Deferred Credit Card Origination Costs
EITF 92-7	Accounting by Rate-Regulated Utilities for the Effects of Certain Alternative Revenue Programs
EITF 92-12	Accounting for OPEB Costs by Rate-Regulated Enterprises
EITF 92-13	Accounting for Estimated Payments in Connection with the Coal Industry Retiree Health Benefit Act of 1992
EITF 93-1	Accounting for Individual Credit Card Acquisitions

GAAP Pronouncement	Title
EITF 93-9	Application of FASB Statement No. 109 in Foreign Financial Statements Restated for General Price-Level Changes
EITF 93-12	Recognition and Measurement of the Tax Benefit of Excess Tax-Deductible Goodwill Resulting from a Retroactive Change in Tax Law
EITF 94-2	Treatment of Minority Interests in Certain Real Estate Investment Trusts
EITF 95-1	Revenue Recognition on Sales with a Guaranteed Minimum Resale Value
EITF 95-4	Revenue Recognition on Equipment Sold and Subsequently Repurchased Subject to an Operating Lease
EITF 95-6	Accounting by a Real Estate Investment Trust for an Investment in a Service Corporation
EITF 95-7	Implementation Issues Related to the Treatment of Minority Interests in Certain Real Estate Investment Trusts
EITF 95-22	Balance Sheet Classification of Borrowings Outstanding under Revolving Credit Agreements That Include both a Subjective Acceleration Clause and a Lock-Box Arrangement
EITF 96-7	Accounting for Deferred Taxes on In-Process Research and Development Activities Acquired in a Purchase Business Combination
EITF 96-16 *	Investor's Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights
EITF 96-17	Revenue Recognition under Long-Term Power Sales Contracts That Contain both Fixed and Variable Pricing Terms
EITF 97-1	Implementation Issues in Accounting for Lease Transactions, Including Those Involving Special-Purpose Entities
EITF 97-2	Application of FASB Statement No. 94 and APB Opinion No. 16 to Physician Practice Management Entities and Certain Other Entities with Contractual Management Arrangements
EITF 97-3 *	Accounting for Fees and Costs Associated with Loan Syndications and Loan Participations after the Issuance of FASB Statement No. 25
EITF 97-4	Deregulation of the Pricing of Electricity
EITF 97-6	Application of Issue No. 96-20 to Qualifying Special-Purpose Entities Receiving Transferred Financial Assets Prior to the Effective Date of FASB Statement No. 125
EITF 97-7	Accounting for Hedges of the Foreign Currency Risk Inherent in an Available-for-Sale Marketable Equity Security
EITF 97-9	Effect on Pooling-of-Interests Accounting of Certain Contingently Exercisable Options or Other Equity Instruments
EITF 97-10 *	The Effect of Lessee Involvement in Asset Construction
EITF 97-15	Accounting for Contingency Arrangements Based on Security Prices in a Purchase Business Combinations
EITF 98-1	Valuation of Debt Assumed in a Purchase Business Combination
EITF 99-5	Accounting for Pre-Production Costs Related to Long-Term Supply Arrangements
EITF 99-6	Impact of Acceleration Provisions in Grants Made between Initiation and Consummation of a Pooling-of-Interests Business Combination
EITF 99-7	Accounting for an Accelerated Share Repurchase Program
EITF 99-11	Subsequent Events Caused by Year 2000
EITF 99-13	Application of Issue No. 97-10 and FASB Interpretation No. 23 to Entities that Enter into Leases with Governmental Entities

GAAP Pronouncement	Title
EITF 99-15	Accounting for Decreases in Deferred Tax Asset Valuation Allowances Established in a Purchase Business Combination as a Result of a Change in Tax Regulations
EITF 99-16	Accounting for Transactions with Elements of Research and Development Arrangements
EITF 99-18	Effect on Pooling-of-Interests Accounting on Contracts Indexed to a Company's Own Stock
EITF 99-19	Reporting Revenue Gross as a Principal versus Net as an Agent
EITF 00-4	Majority Owner's Accounting for a Transaction in the Shares of a Consolidated Subsidiary and a Derivative Indexed to the Minority Interest in That Subsidiary
EITF 00-6	Accounting for Freestanding Derivative Financial Instruments Indexed to, and Potentially Settled in, the Stock of a Consolidated Subsidiary
EITF 00-10	Accounting for Shipping and Handling Fees and Costs
EITF 00-14	Accounting for Certain Sales Incentives
EITF 00-15	Classification in the Statement of Cash Flows of the Income Tax Benefit Received by a Company upon Exercise of a Nonqualified Employee Stock Option
EITF 00-17	Measuring the Fair Value of Energy-Related Contracts in Applying Issue No. 98-10
EITF 00-19	Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, A Company's Own Stock
EITF 00-22	Accounting for "Points" and Certain Other Time-Based or Volume-Based Sales Incentive Offers, and Offers for Free Products or Services to be Delivered in the Future
EITF 01-3	Accounting in a Business Combination for Deferred Revenue of an Acquiree
EITF 01-5 *	Application of FASB Statement No. 52 to an Investment Being Evaluated for Impairment That Will Be Disposed Of
EITF 01-6	The Meaning of "Indexed to a Company's Own Stock"
EITF 01-9	Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)
EITF 01-12	The Impact of the Requirements of FASB Statement No. 133 on Residual Value Guarantees in Connection with a Lease
EITF 01-14	Income Statement Characterization of Reimbursements Received for "Out-of-Pocket" Expenses Incurred
EITF 02-3 *	Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities
EITF 02-6	Classification in the Statement of Cash Flows of Payments Made to Settle an Asset Retirement Obligation within the Scope of FASB Statement No. 143
EITF 02-7 *	Unit of Accounting for Testing Impairment of Indefinite-Lived Intangible Assets
EITF 02-8	Accounting for Options Granted to Employees in Unrestricted, Publicly Traded Shares of an Unrelated Entity
EITF 02-13 *	Deferred Income Tax Considerations in Applying the Goodwill Impairment Test in FASB Statement No. 142
EITF 02-14 *	Whether the Equity Method of Accounting Applies When an Investor Does Not Have an Investment in Voting Stock of an Investee but Exercises Significant Influence through Other Means

GAAP Pronouncement	Title
EITF 02-16	Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor
EITF 02-17 *	Recognition of Customer Relationship Intangible Assets Acquired in a Business Combination
EITF 03-2	Accounting for the Transfer to the Japanese Government of the Substantial Portion of Employee Pension Fund Liabilities
EITF 03-6 *	Participating Securities and the Two-class Method under FASB Statement No. 128
EITF 03-10	Application of Issue No. 02-16 by Resellers to Sales Incentives Offered to Consumers by Manufacturers
EITF 03-11 *	Reporting Realized Gains and Losses on Derivative Instruments That Are Subject to FASB Statement No. 133 and Not “Held for Trading Purposes” as Defined in Issue No. 02-3
EITF 03-12	The Impact of FASB Interpretation No. 45 on Issue No. 95-1
EITF 03-13	Applying the Conditions in Paragraph 42 of FASB Statement No. 144 in Determining Whether to Report Discontinued Operations
EITF 03-16 *	Accounting for Investments in Limited Liability Companies
EITF 04-1	Accounting for Preexisting Relationships between the Parties to a Business Combination
EITF 04-2	Whether Mineral Rights are Tangible or Intangible Assets
EITF 04-3	Mining Assets: Impairment and Business Combinations
EITF 04-4	Allocation of Goodwill to Reporting Units for a Mining Enterprise
EITF 04-5	Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights
EITF 04-6	Accounting for Stripping Costs Incurred During Production in the Mining Industry
EITF 04-7	Determining Whether an Interest is a Variable Interest in a Potential Variable Interest Entity
EITF 04-8	The Effect of Contingently Convertible Instruments on Diluted Earnings per Share
EITF 04-10	Determining Whether to Aggregate Operating Segments That Do Not Meet the Quantitative Thresholds
EITF 04-13	Accounting for Purchases and Sales of Inventory with the Same Counterparty
EITF 05-5	Accounting for Early Retirement or Postemployment Programs with Specified Features (Such as Term Specified in Altersteilzeit Early Retirement Arrangements)
EITF 05-6	Determining the Amortization Period for Leasehold Improvements Purchased after Lease Inception or Acquired in a Business Combination
EITF 05-8	Income Tax Consequences of Issuing Convertible Debt with a Beneficial Conversion Feature
EITF 06-1	Accounting for Consideration Given by a Specific Provider to Manufacturers or Resellers of Equipment Necessary for an End-Customer to Receive Service from the Service Provider
EITF 06-07	Issuer's Accounting for a Previously Bifurcated Conversion Option in a Convertible Debt Instrument When the Conversion Option No Longer Meets the Bifurcation Criteria in FASB Statement No. 133
EITF 06-10	Accounting for Deferred Compensation and Postretirement Benefit Aspects of Collateral Assignment Split-Dollar Life Insurance Arrangements

GAAP Pronouncement	Title
EITF 07-1	Accounting for Collaborative Arrangements
EITF 07-4	Application of the Two-Class Method under FAS 128 to Master Limited Partnerships
EITF 07-5	Determining Whether an Instrument (or Embedded Feature) is Indexed to an Entity's Own Stock
EITF 08-8	Accounting for an Instrument (or an embedded feature) with a Settlement Amount That is Based on the Stock of an Entity's Consolidated Subsidiary
Pre-Codification AICPA Practice Bulletins (PB)	
PB 2	Elimination of Profits Resulting From Intercompany Transfers of LIFO Inventories
PB 5	Income Recognition on Loans to Financially Troubled Countries
PB 11	Accounting for Preconfirmation Contingencies in Fresh-Start Reporting
PB 12	Reporting Separate Investment Fund Option Information of Defined-Contribution Pension Plans
PB 14	Accounting and Reporting by Limiting Liability Companies and Limited Liability Partnerships
Pre-Codification AICPA Accounting Interpretations (AIN)	
AIN-APB15	Computing Earnings per Share: Accounting Interpretations of APB Opinion No. 15

DISCUSSION

~~3~~4. This issue paper rejects the nonapplicable GAAP pronouncements listed in the Summary Conclusion.

5. If the Emerging Accounting Issues (E) Working Group deems an interpretation would provide statutory accounting guidance, other than the knowledge that the item is rejected per one of the conditions in paragraph 2, a separate interpretation will continue to be incorporated within Appendix B.

Drafting Notes/Comments

None

RELEVANT LITERATURE

Statutory Accounting

None

State Regulations

- No additional guidance obtained from state statutes or regulations.

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Statutory Issue Paper No. 100

Health Care Delivery Assets—Supplies, Pharmaceuticals and Surgical Supplies, and Durable Medical Equipment

STATUS
Finalized June 23, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 73

Type of Issue:
Health Entities

SUMMARY OF ISSUE

1. This issue paper applies only to reporting entities which directly provide health care services to subscribers, members or policyholders. Such providers acquire and retain assets not directly addressed in current statutory guidelines. These assets, commonly referred to as "health care delivery assets", are assets used in connection with the direct delivery of health care services in facilities owned or operated by the reporting entity and include supplies, pharmaceuticals and surgical supplies, and durable medical equipment.

2. The purpose of this issue paper is to establish statutory accounting principles for health care delivery assets—supplies, pharmaceuticals and surgical supplies, and durable medical equipment that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

3. Supplies, pharmaceuticals and surgical supplies, and durable medical equipment meet the definition of assets established in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets* (Issue Paper No. 4). Pharmaceuticals and surgical supplies, and durable medical equipment held by reporting entities and used for the direct delivery of health care services are assets which are used to fulfill policyholder obligations within the meaning of Issue Paper No. 4 and are admitted assets to the extent that they conform to the requirements of this issue paper.

4. The reporting entity shall maintain a control system that provides for identification of quantities on hand and appropriate valuation (lower of cost or market) of supplies, pharmaceuticals and surgical supplies, and durable medical equipment.

5. Supplies except for pharmaceuticals and surgical supplies discussed in paragraph 6 (e.g., linens, uniforms and garments, food and other commodities, and housekeeping, maintenance, and office supplies) shall be nonadmitted assets.

6. Pharmaceutical and surgical supplies (e.g. drugs, surgical items (such as implants), and medical dressings) used directly in the treatment of medical conditions shall be admitted assets.

7. Durable medical equipment includes consumable or salable equipment such as wheelchairs, crutches and braces, that is generally classified as inventory, and is of a nature that it may be reused. Subscribers, members or policyholders may utilize durable medical equipment on a temporary basis and later return the equipment to the provider. The provider shall recognize the diminution in value, if any, as a result of use of such equipment.

8. In accordance with the reporting entity's capitalization policy, immaterial amounts of medical supplies, pharmaceuticals and surgical supplies, and durable medical equipment may be expensed when purchased.

DISCUSSION

9. Supplies as defined in this issue paper are nonadmitted assets because they are consumed in the normal operations of a hospital or medical facility and would generally have limited or no value in the event of liquidation.

10. Pharmaceuticals and surgical supplies, and durable medical equipment are admitted assets as defined in this issue paper because they are used to fulfill benefit requirements, they are tightly controlled and the nature of such items would generally permit the recovery of costs upon liquidation.

11. This issue paper rejects the AICPA Audit and Accounting Guide: Health Care Organizations.

12. The statutory accounting principles established in this issue paper are consistent with the recognition concept in the Statement of Concepts which states:

> The principal focus of solvency measurement is determination of financial condition through analysis of the balance sheet. However, protection of the policyholders can only be maintained through continued monitoring of the financial condition of the insurance enterprise. Operating performance is another indicator of an enterprise's ability to maintain itself as a going concern. Accordingly, the income statement is a secondary focus of statutory accounting and should not be diminished in importance to the extent contemplated by a liquidation basis of accounting.
>
> The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which are unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet but rather should be charged against surplus when acquired or when availability otherwise becomes questionable.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

13. The Health Maintenance Organization Model Act, dated July 1995 states the following:

> **Section 5. Powers of Health Maintenance Organizations**
>
> A. The powers of a health maintenance organization include, but are not limited to, the following:
>
> (1) The purchase, lease, construction, renovation, operation or maintenance of hospitals, medical facilities, or both, and their ancillary equipment, and property reasonably required for its principal office or for purposes necessary to the transaction of the business of the organization;
>
> **Section 12. Investments**
>
> With the exception of investments made in accordance with Section 5A(1), the funds of a health maintenance organization shall be invested only in accordance with [cite section of law or regulation implementing the NAIC Health Maintenance Organization Investment Guidelines.]

Generally Accepted Accounting Principles

14. The AICPA Audit and Accounting Guide: Health Care Organizations states the following:

> 6.02. Supplies usually are not material to the financial position of health care organizations. However, because of the volume of supply transactions, they may materially affect operations. Supplies typically include medical and surgical supplies; pharmaceuticals; linens; uniforms, and garments; food and other commodities; and housekeeping, maintenance, and office supplies.
>
> 6.04. Accounting for property and equipment, supplies, and other assets of health care organizations is similar to that used by other business organizations.

Other Sources of Information

15. The NAIC Survey on State Practice Regarding Admissibility of Health Care Delivery Assets dated January 1996 conducted by the Risk-Based Capital Task Force surveyed the state insurance departments that regulate HMOs to determine if and to what degree that they allow HMOs to admit health care delivery assets. Responses from 38 state insurance departments indicated that the vast majority admit such assets at book value. A number of state insurance departments noted that they do place varying limits on the amount of certain health care delivery assets that can be admitted. However, none of the respondent states indicated that they did not admit such assets.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Health Maintenance Organization Model Act, dated July 1995
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*

Generally Accepted Accounting Principles

- The AICPA Audit and Accounting Guide: Health Care Organizations

State Regulations

- No additional guidance obtained from state statutes or regulations.

Other Sources of Information

- NAIC Survey on State Practice Regarding Admissibility of Health Care Delivery Assets dated January 1996
- American Academy of Actuaries Report on Simplification of the Health Risk-Based Capital Formula dated June 1996

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Statutory Issue Paper No. 101

Health Care Delivery Assets—Furniture, Medical Equipment and Fixtures, and Leasehold Improvements in Health Care Facilities

STATUS
Finalized June 23, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 73

Type of Issue:
Health Entities

SUMMARY OF ISSUE

1. This issue paper applies only to reporting entities which directly provide health care services to subscribers, members or policyholders. Such providers acquire and retain assets not directly addressed in current statutory guidelines. These assets commonly referred to as "health care delivery assets", are assets used in connection with the direct delivery of health care services in facilities owned or operated by the reporting entity and include furniture, medical equipment and fixtures and leasehold improvements.

2. Furniture, medical equipment and fixtures used in connection with the direct provision of health care services include diagnostic equipment, laboratory equipment, patient monitoring equipment, hospital beds, examining tables, and operating room equipment.

3. The purpose of this issue paper is to establish statutory accounting principles for health care delivery assets - furniture, medical equipment and fixtures and leasehold improvements in health care facilities that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. Furniture, medical equipment and fixtures, and leasehold improvements in health care facilities owned or operated by the reporting entity meet the definition of assets established in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets* (Issue Paper No. 4). Furniture, medical equipment and fixtures, and leasehold improvements held by health reporting entities and used for the direct delivery of health care services are admitted assets to the extent that they conform to the requirements of this issue paper. Furniture, fixtures and equipment, and leasehold improvements which are not used in the direct delivery of health care (e.g., for administrative activities including claims processing, billing, and maintenance of medical records) are nonadmitted assets and are addressed in *Issue Paper No. 19—Furniture, Fixtures, and Equipment* and *Issue Paper No. 31—Leasehold Improvements Paid by the Reporting Entity as Lessee*, respectively.

5. These assets shall be depreciated over their estimated useful lives but for a period not to exceed three years, except for a leasehold improvement which shall be amortized against net income over the shorter of its estimated useful life or the remaining life of the original lease excluding renewal or option periods, using methods detailed in *Issue Paper No. 67—Depreciation of Property and Amortization of Leasehold Improvements*.

6. In accordance with the reporting entity's capitalization policy, immaterial amounts of furniture, medical equipment and fixtures, and leasehold improvements may be expensed when purchased.

DISCUSSION

7. Furniture, medical equipment and fixtures and leasehold improvements in health care facilities owned or operated by the reporting entity used in the direct delivery of health care are admitted assets as defined in this issue paper because they are used to fulfill benefit requirements.

8. The AICPA Audit and Accounting Guide: Health Care Organizations is rejected in *Issue Paper No. 100—Health Care Delivery Assets – Supplies, Pharmaceuticals and Surgical Supplies, and Durable Medical Equipment*.

9. The statutory accounting principles established in this issue paper are consistent with the recognition concept in the Statement of Concepts which states:

> The principal focus of solvency measurement is determination of financial condition through analysis of the balance sheet. However, protection of the policyholders can only be maintained through continued monitoring of the financial condition of the insurance enterprise. Operating performance is another indicator of an enterprise's ability to maintain itself as a going concern. Accordingly, the income statement is a secondary focus of statutory accounting and should not be diminished in importance to the extent contemplated by a liquidation basis of accounting.
>
> The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which are unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet but rather should be charged against surplus when acquired or when availability otherwise becomes questionable.

Drafting Notes/Comments

- Land and building, including health care facilities, are addressed in *Issue Paper No. 23—Property Occupied by the Company*.
- Electronic Data Processing Equipment and Software are addressed in *Issue Paper No. 16—Electronic Data Processing Equipment and Software*.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

10. The Accounting Practices and Procedures Manual for Health Maintenance Organizations (Chapter 5, *Other Admitted Assets*) states:

> INVESTMENTS INVOLVING EQUIPMENT
>
> The statutory method of accounting for equipment arrangements is governed largely by the form of the agreement to which the HMO is a party.

11. The Accounting Practices and Procedures Manual for Health Maintenance Organizations (Chapter 6, *Nonadmitted Assets*) states:

> COMMON EXAMPLES
>
> Some examples of assets which are non-admitted due to either an uncertainty as to their collectibility or an insufficient basis for determining their valuation or for other reasons are:
>
> (6) net book value of equipment and furniture (except certain electronic data processing equipment and medical equipment)

12. The Health Maintenance Organization Model Act, dated July 1995 states the following:

> **Section 5. Powers of Health Maintenance Organizations**
>
> A. The powers of a health maintenance organization include, but are not limited to, the following:
>
> (1) The purchase, lease, construction, renovation, operation or maintenance of hospitals, medical facilities, or both, and their ancillary equipment, and property reasonably required for its principal office or for purposes necessary to the transaction of the business of the organization;
>
> **Section 12. Investments**
>
> With the exception of investments made in accordance with Section 5A(1), the funds of a health maintenance organization shall be invested only in accordance with [cite section of law or regulation implementing the NAIC Health Maintenance Organization Investment Guidelines.]

Generally Accepted Accounting Principles

13. The AICPA Audit and Accounting Guide: Health Care Organizations states the following:

> 6.01. Health care organizations use various types of property and equipment. Those assets may be material to the financial position of institutional health organizations, such as hospitals and nursing homes. Typical accounts used to record property and equipment transactions are land, land improvements, buildings and improvements, leasehold improvements, equipment (fixed and movable), leased property and equipment, accumulated depreciation and amortization, and construction in progress.
>
> 6.04. Accounting for property and equipment, supplies, and other assets of health care organizations is similar to that used by other business organizations.
>
> 6.05. Depreciation and amortization of property and equipment are recorded in conformity with GAAP. Useful lives assigned to depreciable assets should be reasonable, based on the circumstances. The American Hospital Association publishes useful guidelines for classifications and estimated useful lives for property and equipment used by hospitals. Those guidelines also may be useful to other health care organizations. If there is a potential that an asset is impaired, health care organizations should consider the guidance in *FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of.*

Other Sources of Information

14. The NAIC Survey on State Practice Regarding Admissibility of Health Care Delivery Assets dated January 1996 conducted by the Risk Based Capital Task Force surveyed the state insurance departments that regulate HMOs to determine if and to what degree that they allow HMOs to admit health care delivery assets. Responses from 38 state insurance departments indicated that the vast majority admit such assets at book value. A number of state insurance departments noted that they do place varying limits on the amount of certain health care delivery assets that can be admitted. However, none of the respondent states indicated that they did not admit such assets.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- The Accounting Practices and Procedures Manual for Health Maintenance Organizations, Chapter 5, *Other Admitted Assets* and Chapter 6, *Nonadmitted Assets*
- Health Maintenance Organization Model Act, dated July 1995
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*

- *Issue Paper No. 16—Electronic Data Processing Equipment and Software*
- *Issue Paper No. 19—Furniture, Fixtures and Equipment*
- *Issue Paper No. 23—Property Occupied by the Company*
- *Issue Paper No. 31—Leasehold Improvements Paid by the Reporting Entity as Lessee*
- *Issue Paper No. 67—Depreciation of Property and Amortization of Leasehold Improvements*

Generally Accepted Accounting Principles

- The AICPA Audit and Accounting Guide: Health Care Organizations

State Regulations

- No additional guidance obtained from state statutes or regulations.

Other Sources of Information

- NAIC Survey on State Practice Regarding Admissibility of Health Care Delivery Assets dated January 1996
- American Academy of Actuaries Report on Simplification of the Health Risk-Based Capital Formula dated June 1996

Statutory Issue Paper No. 103

Accounting for the Issuance of Insurance-Linked Securities Issued by a Property and Casualty Insurer Through a Protected Cell

STATUS
Finalized June 13, 2000

Original SSAP and Current Authoritative Guidance: SSAP No. 74

Type of Issue:
Property and Casualty

SUMMARY OF ISSUE

1. Insurance–linked securities are fully funded corporate securities with special language that requires the securityholder to forgive or defer some or all payments of interest or principal if actual insurance losses surpass a specified amount, or trigger event. Should a triggering event occur, an insurer or reinsurer that issued insurance-linked securities can pay claims with all or a portion of the securityholder proceeds. To the extent that securityholders proceeds are at risk of loss, the insurer or reinsurer can write down its liability for the securities, and recognize a surplus benefit in an equal amount.

2. Chapter 1 of the *Accounting Practices and Procedures Manual for Property/Casualty Insurance Companies* does not specifically address accounting for the issuers of insurance-linked securities issued through a protected cell. Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 133 - *Accounting for Derivative Instruments and Hedging Activities* (FAS 133) dictates that these types of contracts would be accounted for as reinsurance.

3. The purpose of this issue paper is to provide guidance for protected cells that is consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

Definitions

4. The Protected Cell Model Act (included in its entirety in the Relevant Statutory Accounting and GAAP Guidance section) includes a complete listing of definitions used in this issue paper.

General

5. An insurance-linked security can be issued by the insurer through a protected cell for purchase by investors. A protected cell is retained within the insurance or reinsurance company and is used to insulate the proceeds of the securities offering from the general business risks of the insurer, granting an additional comfort level for investors of the securitized instrument. The insurance exposures that have been securitized by the insurance-linked security are attributed to the protected cell.

6. Under the terms of the security, the principal may be paid to the investor on a specified maturity date, with interest, unless a trigger event occurs. The proceeds of the security offering will collateralize (i) the issuer's obligation under an insurance or reinsurance agreement if a trigger event occurs and (ii) the issuer's obligation to repay the security if a trigger event does not occur.

7. If the trigger event takes place before a specified date, the issuer is relieved of some or its entire obligation to repay the securityholders, and the investor incurs a loss of some or all of its investment. The security must be issued with an indemnity trigger.

8. In an insurance-linked security, the insurer that originated the transaction has hedged its portfolio of insurance risks by transferring certain of those risks to the securityholders. Should the triggering event occur, the issuer would incur a loss that would be partly offset by the amount of liability to securityholders from which it is relieved. This issue paper provides statutory accounting guidance solely for indemnity triggered insurance securitization transactions conducted through a protected cell.

Accounting for Prefunded Insurance-Linked Securities for Business Attributed to the Protected Cell from the General Account

General Account Reporting

9. Activities such as sales, underwriting and contract administration, premium collection and payment of premium taxes, and claims processing are activities of the insurance company distinct from the protected cell and shall be accounted for as transactions of the general account.

10. Amounts paid to the protected cell for underwriting risks, which ultimately will be securitized by the protected cell, shall be reported separately as a reduction of written and earned premiums in the current period general account's statement of income. This premium is earned by the general account in accordance with *Issue Paper No. 53—Property Casualty Contracts–Premiums*.

11. At the maturity of the protected cell all assets and liabilities of the protected cell are distributed based on the contractual agreement with the securityholders. If after this distribution assets still reside in the protected cell, these assets shall be attributed to the general account and recognized as an adjustment to surplus.

12. Insurance claim liabilities arising from past insurable events attributed to the protected cell account from the general account shall be accounted for as retro-active reinsurance as prescribed in *Issue Paper No. 75—Property and Casualty Reinsurance*.

13. General account recoverables from the protected cell as a result of an indemnity based securitized event, shall be recognized separately as a reduction of gross losses and loss expenses incurred in the current period general account's statement of income. General account recoverables from the protected cell on unpaid reported and incurred but not reported losses and loss adjustment expenses shall be netted against the liability for gross losses and loss adjustment expenses in the general account's balance sheet. Recoverables from the protected cell shall not exceed the assets carried at fair value in the protected cell.

14. The general account shall include an aggregate write-in for the total assets and an aggregate write-in for liabilities of any protected cell which it maintains. Transfers to the general account due or accrued shall be reported on a net basis so that the asset and the liability totals of the general account are not overstated.

Protected Cell Reporting

15. The protected cell annual statement is concerned with the investment activities and obligations relating to insurance-linked securities attributed to that protected cell. As a result, the protected cell statement shall report only the financial activities of the protected cell and shall not include general account expenses related to insurance activities which are recorded for in the general account.

16. The protected cell shall record premium income for transactions attributed to it by the general account as income reported in the protected cell's statement of income. This premium attribution is earned by the protected cell in accordance with *Issue Paper No. 53— Property Casualty Contracts–Premiums*.

17. The obligation from the issuance of the insurance-linked security is recorded as Funds Held Under Securitization Agreement, a liability on the protected cell balance sheet which is reported at its contractual value which will be the lower of the scheduled amount to be repaid to investors or the fair value of the investments in the protected cell. All protected cell assets shall be reported at fair value. Interest expenses payable to securityholders associated with the protected cell investment operations shall be deducted in the determination of net operating income of the cell. Net investment income and realized capital gains and losses relating to the investment operations of the protected cell are recorded as net investment income. Payables to the general account shall not exceed the assets carried at fair value in the protected cell.

18. Changes in both (i.) the fair value of the protected cell invested assets and (ii.) the protected cell contractual (or discounted) value of liabilities to investors shall be reported as an unrealized gain/loss in the equity section of the protected cell balance sheet.

19. When the trigger event occurs with respect to the underlying exposures attributed to the protected cell, the protected cell shall record the appropriate incurred losses in its current period statement of income. Correspondingly, the Funds Held Under Securitization Agreement shall be reduced and offset by gross losses incurred in the current period Statement of Income. The applicable funds to cover the subject exposure are then attributed to the general account via a balance sheet account, "Due to/from the General Account."

20. If the trigger event does not take place on or before the contractual maturity date, the protected cell repays the bond principal as prescribed in the debt contract by reducing Funds Held Under Securitization Agreement.

Disclosures

General Account

21. Prior to the adoption of formal blanks changes by the NAIC Blanks Task Force, the general account shall reflect all activities with its protected cells as an aggregate write-in in its statutory balance sheet and income statement. The general account shall also disclose in its notes to the financial statements the types and amounts of exposures /risks attributed to each of its protected cells.

Protected Cells

22. Each protected cell of a protected cell company shall prepare and submit to all states where the protected cell company is licensed and the NAIC the following supplemental financial information:

a. Balance Sheet
b. Income Statement
c. Statement of Cash Flows
d. Investment Schedules as typically required for a property/casualty insurer
e. Schedule P

DISCUSSION

23. This issue paper prescribes the accounting for the issuance of insurance-linked securities issued by a property and casualty insurer through a protected cell. This guidance was adopted by the Insurance Securitization Working Group of the Financial Condition (E) Committee in 1999. The Emerging Accounting Issues Working Group adopted the guidance as "NAIC Preferred Accounting Treatment" in October 1999. This issue is specifically scoped out of FAS 133, and therefore the protected cell concept is unique to statutory accounting.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

24. In October 1999, the Emerging Accounting Issues Working Group adopted as "NAIC Preferred Accounting Treatment" the issue summary titled *Accounting for the Issuance of Insurance-Linked Securities Issued by a Property and Casualty Insurer through a Protected Cell*. The guidance included in the Summary Conclusion section of this issue paper is consistent with the previously adopted issue summary.

Generally Accepted Accounting Principles

25. The following language is included in FAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*:

> 192. Example 26: Disaster Bond. A bond that pays a coupon above that of an otherwise comparable traditional bond; however, all or a substantial portion of the principal amount is subject to loss if a specified disaster experience occurs.
>
> Scope Application: A disaster bond can be viewed as a fixed-rate bond combined with a conditional exchange contract (an option). The investor receives an additional coupon interest payment in return for giving the issuer an option indexed to industry loss experience on a specified disaster. Because the option contract is indexed to the specified disaster experience, it cannot be viewed as being clearly and closely related to an investment in a fixed-rate bond. Therefore, the embedded derivative should be separated from the host contract and accounted for by both parties pursuant to the provisions of this Statement.
>
> However, if the "embedded derivative" entitles the holder of the option (that is, the issuer of the disaster bond) to be compensated only for changes in the value of specified assets or liabilities for which the holder is at risk (including the liability for insurance claims payable due to the specified disaster) as a result of an identified insurable event (refer to paragraph 10.c.(2)), a separate instrument with the same terms as the "embedded derivative" would not meet the Statement's definition of a derivative in paragraphs 6–11. In that circumstance, because the criterion in paragraph 12.c. would not be met, there is no embedded derivative to be separated from the host contract, and the disaster bond would not be subject to the requirements of this Statement. The investor is essentially providing a form of insurance or reinsurance coverage to the issuer.

26. This issue paper only contemplates transactions with an indemnity-based trigger, as such they would be excluded from FAS 133 and accounting for as reinsurance under FAS 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*.

Other Sources

27. The Insurance Securitization Working Group developed the following Protected Cell Model Act. Details of considerations made in drafting this model act can be found in the minutes of the working group.

PROTECTED CELL COMPANY MODEL ACT

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Section 1. Short Title

This Act may be cited as the “Protected Cell Company Act.”

Section 2. Purpose

This Act is adopted to provide a basis for the creation of protected cells by a domestic insurer as one means of accessing alternative sources of capital and achieving the benefits of insurance securitization. Investors in fully funded insurance securitization transactions provide funds that are available to pay the insurer’s insurance obligations or to repay the investors or both. The creation of protected cells is intended to be a means to achieve more efficiencies in conducting insurance securitizations.

Drafting Note: Under the terms of the typical debt instrument underlying an insurance securitization transaction, prepaid principal is repaid to the investor on a specified maturity date with interest, unless a trigger event occurs. The insurance securitization proceeds secure both the protected cell company’s insurance obligations if a trigger event occurs, as well as the protected cell company’s obligation to repay the insurance securitization investors if a trigger event does not occur. Insurance securitization transactions have been performed through alien companies in order to utilize efficiencies available to alien companies that are not currently available to domestic companies. This Act is adopted in order to create more efficiency in conducting insurance securitization, to allow domestic protected cell companies easier access to alternative sources of capital, and to promote the benefits of insurance securitization generally.

Section 3. Definitions

For the purposes of this Act, the following terms shall have the following meanings:

A. “Domestic insurer” means an insurer domiciled in the State of [insert state].

B. “Fully funded” means that, with respect to any exposure attributed to a protected cell, the fair value of the protected cell assets, on the date on which the insurance securitization is effected, equals or exceeds the maximum possible exposure attributable to the protected cell with respect to such exposures.

C. “General account” means the assets and liabilities of a protected cell company other than protected cell assets and protected cell liabilities.

D. “Indemnity trigger” means a transaction term by which relief of the issuer’s obligation to repay investors is triggered by its incurring a specified level of losses under its insurance or reinsurance contracts.

E. “Fair value” of an asset (or liability) means the amount at which that asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available. If a quoted market price is available, the fair value is the product of the number of trading units times market price. If quoted market prices are not available, the estimate of fair value shall be based on the best information available. The estimate of fair value shall consider prices for similar assets and liabilities and the results of valuation techniques to the extent available in the circumstances. Examples of valuation techniques include the present value of estimated expected future cash flows using a discount rate commensurate with the risks involved, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis. Valuation techniques for measuring financial assets and liabilities and servicing assets and liabilities shall be consistent with the objective of measuring fair value. Those techniques shall incorporate assumptions that market participants would use in their estimates of values, future revenues, and future expenses, including assumptions about interest rates, default, prepayment, and volatility. In measuring financial liabilities and servicing liabilities at fair value by discounting estimated future cash flows, an objective is to use discount rates at which those liabilities could be settled in an arm’s-length transaction. Estimates of expected future cash flows, if used to estimate fair value, shall be the best estimate based on reasonable and supportable assumptions and projections. All available evidence shall be considered in developing estimates of expected future cash flows. The weight given to the evidence shall be commensurate with the extent to which the evidence can be verified objectively. If a range is estimated for either the amount or timing of possible cash flows, the likelihood of possible outcomes shall be considered in determining the best estimate of future cash flows.

F. “Non-indemnity trigger” means a transaction term by which relief of the issuer’s obligation to repay investors is triggered solely by some event or condition other than the individual protected cell company incurring a specified level of losses under its insurance or reinsurance contracts.

G. “Protected cell” means an identified pool of assets and liabilities of a protected cell company segregated and insulated by means of this Act from the remainder of the protected cell company’s assets and liabilities.

Drafting Note: This term is meant to reference identification of statutorily segregated assets and liabilities through the accounting function. By attributing certain assets and liabilities to a protected cell on the protected cell company’s books and records, and otherwise complying with the provisions of this Act, the protected cell company will receive statutory insulation of those assets and liabilities from the protected cell company’s other assets and liabilities not identified in the accounting records as attributable to the protected cell.

H. “Protected cell account” means a specifically identified bank or custodial account established by a protected cell company for the purpose of segregating the protected cell assets of one protected cell from the protected cell assets of other protected cells and from the assets of the protected cell company’s general account.

Drafting Note: This term is meant to reference a custodial account established to hold and invest protected cell assets, such that protected cell assets are also distinct and identifiable from the assets of the general account.

I. “Protected cell assets” means all assets, contract rights and general intangibles, identified with and attributable to a specific protected cell of a protected cell company.

J. “Protected cell company” means a domestic insurer that has one or more protected cells.

K. “Protected cell company insurance securitization” means the issuance of debt instruments, the proceeds from which support the exposures attributed to the protected cell, by a protected cell company where repayment of principal or interest, or both, to investors pursuant to the transaction terms is contingent upon the occurrence or nonoccurrence of an event with respect to which the protected cell company is exposed to loss under insurance or reinsurance contracts it has issued.

L. “Protected cell liabilities” means all liabilities and other obligations identified with and attributable to a specific protected cell of a protected cell company.

Section 4. Establishment of Protected Cells

A. A protected cell company may establish one or more protected cells with the prior written approval of the commissioner of a plan of operation or amendments thereto submitted by the protected cell company with respect to each protected cell in connection with an insurance securitization. Upon the written approval of the commissioner of the plan of operation, which shall include, but not be limited to, the specific business objectives and investment guidelines of the protected cell, the protected cell company may, in accordance with the approved plan of operation, attribute to the protected cell insurance obligations with respect to its insurance business and obligations relating to the insurance securitization and assets to fund the obligations. A protected cell shall have its own distinct name or designation, which shall include the words “protected cell.” The protected cell company shall transfer all assets attributable to a protected cell to one or more separately established and identified protected cell accounts bearing the name or designation of that protected cell. Protected cell assets shall be held in the protected cell accounts for the purpose of satisfying the obligations of that protected cell.

Drafting Note: Insert the title of the chief insurance regulatory official wherever the term “commissioner” appears.

B. All attributions of assets and liabilities between a protected cell and the general account shall be in accordance with the plan of operation approved by the commissioner. No other attribution of assets or liabilities may be made by a protected cell company between the protected cell company’s general account and its protected cells. Any attribution of assets and liabilities between the general account and a protected cell, or from investors in the form of principal on a debt instrument issued by a protected cell company in connection with a protected cell company securitization shall be in cash or in readily marketable securities with established market values.

C. The creation of a protected cell does not create, in respect of that protected cell, a legal person separate from the protected cell company. Amounts attributed to a protected cell under this Act, including assets transferred to a protected cell account, are owned by the protected cell company and the protected cell company may not be, nor hold itself out to be, a trustee with respect to those protected cell assets of that protected cell account. Notwithstanding the foregoing, the protected cell company may allow for a security interest to attach to protected cell assets or a protected cell account when in favor of a creditor of the protected cell and otherwise allowed under applicable law.

D. This Act shall not be construed to prohibit the protected cell company from contracting with or arranging for an investment advisor, commodity trading advisor, or other third party to manage the protected cell assets of a protected cell, provided that all remuneration, expenses and other compensation of the third party advisor or manager are payable from the protected cell assets of that protected cell and not from the protected cell assets of other protected cells or the assets of the protected cell company's general account.

E. (1) A protected cell company shall establish administrative and accounting procedures necessary to properly identify the one or more protected cells of the protected cell company and the protected cell assets and protected cell liabilities attributable to the protected cells. It shall be the duty of the directors of a protected cell company to:

(a) Keep protected cell assets and protected cell liabilities separate and separately identifiable from the assets and liabilities of the protected cell company's general account and;

(b) Keep protected cell assets and protected cell liabilities attributable to one protected cell separate and separately identifiable from protected cell assets and protected cell liabilities attributable to other protected cells.

(2) Notwithstanding the foregoing, if this section is violated, the remedy of tracing shall be applicable to protected cell assets when commingled with protected cell assets of other protected cells or the assets of the protected cell company's general account. The remedy of tracing shall not be construed as an exclusive remedy.

F. The protected cell company shall, when establishing a protected cell, attribute to the protected cell assets with a value at least equal to the reserves and other insurance liabilities attributed to that protected cell.

Section 5. Use and Operation of Protected Cells

A. The protected cell assets of a protected cell may not be charged with liabilities arising out of any other business the protected cell company may conduct. All contracts or other documentation reflecting protected cell liabilities shall clearly indicate that only the protected cell assets are available for the satisfaction of those protected cell liabilities.

B. The income, gains and losses, realized or unrealized, from protected cell assets and protected cell liabilities shall be credited to or charged against the protected cell without regard to other income, gains or losses of the protected cell company, including income, gains or losses of other protected cells. Amounts attributed to any protected cell and accumulations on the attributed amounts may be invested and reinvested without regard to any requirements or limitations of Section [insert reference applicable sections of the insurance code imposing limitations on insurance company investments] and the investments in a protected cell or cells shall not be taken into account in applying the investment limitations otherwise applicable to the investments of the protected cell company.

C. Assets attributed to a protected cell shall be valued at their fair value on the date of valuation.

D. A protected cell company shall, in respect of any of its protected cells, engage in fully funded indemnity triggered insurance securitization to support in full the protected cell exposures attributable to that protected cell. A protected cell company insurance securitization that is non-indemnity triggered shall qualify as an insurance securitization under the terms of this Act only after the commissioner, in accordance with the authority granted under Section 9 of this Act, adopts regulations addressing the methods of funding of the portion of the risk that is not indemnity based, accounting, disclosure, risk based capital treatment, and assessing risks associated with such securitizations. A protected cell company insurance securitization that is not fully funded, whether indemnity triggered or non-indemnity triggered, is prohibited. Protected cell assets may be used to pay interest or other consideration on any outstanding debt or other obligation attributable to that protected cell, and nothing in this subsection shall be construed or interpreted to prevent a protected cell company from entering into a swap agreement or other transaction for the account of the protected cell that has the effect of guaranteeing interest or other consideration.

E. In all protected cell company insurance securitizations, the contracts or other documentation effecting the transaction shall contain provisions identifying the protected cell to which the transaction will be attributed. In addition, the contracts or other documentation shall clearly disclose that the assets of that protected cell, and only those assets, are available to pay the obligations of that protected cell. Notwithstanding the foregoing, and subject to the provisions of this Act and any other applicable law or regulation, the failure to include such language in the contracts or other documentation shall not be used as the sole basis by creditors, reinsurers or other claimants to circumvent the provisions of this Act.

F. A protected cell company shall only be authorized to attribute to a protected cell account the insurance obligations relating to the protected cell company's general account. Under no circumstances shall a protected cell be authorized to issue insurance or reinsurance contracts directly to policyholders or reinsureds or have any obligation to the policyholders or reinsureds of the protected cell company's general account.

G. At the cessation of business of a protected cell in accordance with the plan approved by the commissioner, the protected cell company shall voluntarily close out the protected cell account.

Section 6. Reach of Creditors and Other Claimants

A. (1) Protected cell assets shall only be available to the creditors of the protected cell company that are creditors in respect to that protected cell and shall thereby be entitled, in conformity with the provisions of this Act, to have recourse to the protected cell assets attributable to that protected cell, and shall be absolutely protected from the creditors of the protected cell company that are not creditors in respect of that protected cell and who, accordingly, shall not be entitled to have recourse to the protected cell assets attributable to that protected cell. Creditors with respect to a protected cell shall not be entitled to have recourse against the protected cell assets of other protected cells or the assets of the protected cell company's general account.

(2) Protected cell assets shall only be available to creditors of a protected cell company after all protected cell liabilities have been extinguished or otherwise provided for in accordance with the plan of operation relating to that protected cell.

B. When an obligation of a protected cell company to a person arises from a transaction, or is otherwise imposed, in respect of a protected cell:

(1) That obligation of the protected cell company shall extend only to the protected cell assets attributable to that protected cell, and the person shall, with respect to that obligation, be entitled to have recourse only to the protected cell assets attributable to that protected cell; and

(2) That obligation of the protected cell company shall not extend to the protected cell assets of any other protected cell or the assets of the protected cell company's general account, and that person shall not, with respect to that obligation, be entitled to have recourse to the protected cell assets of any other protected cell or the assets of the protected cell company's general account.

C. When an obligation of a protected cell company relates solely to the general account, the obligation of the protected cell company shall extend only to, and that creditor shall, with respect to that obligation, be entitled to have recourse only to, the assets of the protected cell company's general account.

D. The activities, assets, and obligations relating to a protected cell are not subject to the provisions of Section [insert applicable sections of the insurance code addressing life and health and property and casualty guaranty or insolvency funds], and neither a protected cell nor a protected cell company shall be assessed by or otherwise be required to contribute to any guaranty fund or guaranty association in this state with respect to the activities, assets, or obligations of a protected cell. Nothing in this subsection shall affect the activities or obligations of an insurer's general account.

E. In no event shall the establishment of one or more protected cells alone constitute or be deemed to be a fraudulent conveyance, an intent by the protected cell company to defraud creditors, or the carrying out of business by the protected cell company for any other fraudulent purpose.

Section 7. Conservation, Rehabilitation or Liquidation of Protected Cell Companies

A. Notwithstanding any contrary provision in the insurance code of this state, the regulations promulgated under the insurance code of this state, or any other applicable law or regulation, upon any order of conservation, rehabilitation or liquidation of a protected cell company, the receiver shall be bound to deal with the protected cell company's assets and liabilities, including protected cell assets and protected cell liabilities, in accordance with the requirements set forth in this Act.

B. With respect to amounts recoverable under a protected cell company insurance securitization, the amount recoverable by the receiver shall not be reduced or diminished as a result of the entry of an order of conservation, rehabilitation or liquidation with respect to the protected cell company notwithstanding any provisions to the contrary in the contracts or other documentation governing the protected cell company insurance securitization.

Drafting note: A number of states require a liquidator to cancel policies within a pre-specified time period in the event of a liquidation. While reviewing the Plan of Operation, commissioners should consider the termination provisions, if any, of the securitization instruments in the event of the cancellation of all of the insurance policies underlying the securitization in order to assess whether any portion of the risk premium relating to those underlying policies should equitably be returned to the estate of the general account.

Section 8. No Transaction of an Insurance Business

A protected cell company insurance securitization shall not be deemed to be an insurance or reinsurance contract. An investor in a protected cell company insurance securitization shall not, by sole means of this investment, be deemed to be transacting an insurance business in this state. The underwriters or selling agents (and their partners, directors, officers, members, managers, employees, agents, representatives and advisors) involved in a protected cell company insurance securitization shall not be deemed to be conducting an insurance or reinsurance agency, brokerage, intermediary, advisory or consulting business by virtue of their activities in connection therewith.

Section 9. Authority to Adopt Regulations

The commissioner may promulgate regulations necessary to effectuate the purposes of this Act.

Section 10. Effective Date

This Act shall become effective on [insert date].

RELEVANT LITERATURE

Statutory Accounting

- Emerging Accounting Issues Working Group Minutes 99-3

Generally Accepted Accounting Principles

- FAS 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*
- FAS 133, *Accounting for Derivative Instruments and Hedging Activities*

State Regulations

- No additional guidance obtained from state statutes or regulations.

Other Sources

- Protected Cell Model Act

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Statutory Issue Paper No. 104

Reinsurance Deposit Accounting - An Amendment to SSAP No. 62—Property and Casualty Reinsurance

STATUS
Finalized September 12, 2000

Original SSAP and Current Authoritative Guidance: SSAP No. 62R

Type of Issue:
Property and Casualty

SUMMARY OF ISSUE

1. *SSAP No. 62—Property and Casualty Reinsurance* (SSAP No. 62) prescribes the accounting treatment for reinsurance contracts that do not transfer both components of insurance risk (underwriting risk and timing risk). The requirements for Generally Accepted Accounting Principles (GAAP) are contained within American Institute of Certified Public Accountants (AICPA) *Statement of Position No. 98-7, Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That do not Transfer Insurance Risk* (SOP No. 98-7).

2. The purpose of this issue paper is to address the requirements of SOP 98-7 and amend the deposit accounting provisions of SSAP No. 62. In considering GAAP guidance as reflected in SOP 98-7, the purpose of this issue paper is to amend the deposit accounting provisions of SSAP No. 62 and remain consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

Deposit Accounting
3. This issue paper supersedes paragraph 34 of SSAP No. 62. The following guidance shall be followed when reinsurance contracts do not transfer both components of insurance risk.

4. To the extent that a reinsurance agreement does not, despite its form, transfer both components of insurance risk, all or part of the agreement shall be accounted for and reported as deposits in the following manner:

a. At the outset of the reinsurance agreement, the net consideration paid by the ceding entity (premiums less commissions or other allowances) shall be recorded as a deposit by the ceding company and as a liability by the assuming entity. The deposit shall be reported as an admitted asset by the ceding company if (i) the assuming company is licensed, accredited or otherwise qualified in the ceding company's state of domicile as described in Appendix A-785 or (ii) there are funds held by or on behalf of the ceding company which meet the requirements of paragraph 16 of Appendix A-785;

b. At subsequent reporting dates, the amount of the deposit/liability should be adjusted by calculating the effective yield on the deposit agreement to reflect actual payments to date (receipts and disbursements should be recorded through the deposit/liability accounts) and expected future payments (as discussed below), with a corresponding credit or charge to interest income or interest expense;

c. The calculation of the effective yield should use the estimated amount and timing of cash flows. If a change in the actual or estimated timing or amount of cash flows occurs, the effective yield should be recalculated to reflect the revised actual or estimated cash flows. The deposit should be adjusted to the amount that would have existed at the reporting date had the new effective yield been applied since the inception of the reinsurance agreement. Changes in the carrying amount of the deposit asset/liability resulting from changes in the effective yield shall be recorded as interest income or interest expense.

d. It shall be assumed that any cash transactions for the settlement of losses will reduce the asset/liability accounts by the amount of the cash transferred. When the remaining losses are revalued upward, an increase in the deposit liability shall be recorded as interest expense – by the assuming insurer. Conversely, the ceding insurer shall increase its deposit (asset) with an offsetting credit to interest income; and increase its outstanding loss liability with an offsetting charge to incurred losses;

e. No deduction shall be made from the loss and loss adjustment expense reserves on the ceding company's Statement of Financial Position, schedules, and exhibits;

f. The assuming company shall record net consideration to be returned to the ceding company as a liability.

(For an illustration of the provisions of paragraph 4 see Exhibit A)

Disclosures

5. The financial statements shall disclose the following with respect to reinsurance agreements that have been accounted for as deposits:

a. A description of the reinsurance agreements.
b. Any adjustment of the amounts initially recognized for expected recoveries. The individual components of the adjustment (e.g., interest accrual, change due to a change in estimated or actual cash flow) shall be disclosed separately.

DISCUSSION

6. Subsequent to the adoption of SSAP No. 62, the AICPA issued SOP 98-7. This SOP provides guidance on how to account for insurance and reinsurance contracts that do no transfer insurance risk. It applies to all entities and all insurance and reinsurance contracts that do not transfer insurance risk, except for long-term life and health insurance contracts. The method used to account for insurance and reinsurance contracts that do not transfer insurance risk is referred to in this SOP as deposit accounting. The SOP does not address when deposit accounting should be applied.

7. This issue paper adopts, with modification, AICPA SOP 98-7 paragraphs 10 to 12 and 19 (subsection b only). The fundamental concepts of SSAP No. 62 are based upon the fact that unless a reinsurance contract contains a transfer of insurance risk, no underwriting credit shall be granted. The critical ingredient of a reinsurance contract is the transfer of risk. The essential element of every true reinsurance agreement is the undertaking by the reinsurer to indemnify the ceding entity, i.e., reinsured entity, not only in form but in fact, against loss or liability by reason of the original insurance. Insurance risk involves uncertainties about both (a) the ultimate amount of net cash flows from premiums, commissions, claims, and claims settlement expenses (underwriting risk) and (b) the timing of the receipt and payment of those cash flows (timing risk). SOP 98-7 paragraphs 10 to 12 requires the use of the interest method for contracts that transfer neither timing nor underwriting risk and contracts that only transfer timing risk. This issue paper adopts the interest method contained with those paragraphs, but modifies the SOP to require the interest method when the contract does not transfer one or both components of insurance risk.

8. The issue paper rejects AICPA SOP 98-7 paragraphs 13 to 17 and 19 (subsections a and c). This is due to the fact that the SOP allows entities to take underwriting credit for contracts that only transfer significant underwriting risk. This is in direct conflict with the fundamental concept that reinsurance contracts must transfer insurance risk (both underwriting and timing risks).

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

9. SSAP No. 62 paragraph 34:

> **Deposit Accounting**
>
> 34. To the extent that a reinsurance agreement does not, despite its form, transfer both components of insurance risk, all or part of the agreement shall be accounted for and reported as deposits in the following manner:
>
> a. At the outset of the reinsurance agreement the net consideration paid by the ceding entity (premiums less commissions or other allowances) shall be recorded as a deposit by the ceding entity and as a liability by the assuming entity. The deposit shall be reported as an admitted asset by the ceding entity if (i) the assuming entity is licensed, accredited or otherwise qualified in the ceding entity's state of domicile as described in Appendix A-785 or (ii) there are funds held by or on behalf of the ceding entity as described in Appendix A-785;
>
> b. Throughout the life of the agreement, receipts and disbursements shall be recorded through the deposit/liability accounts;
>
> c. When individual case reserves are the basis for the deposit and the assuming entity pays in excess of the amount transferred by the ceding entity, the amount paid in excess of the deposit received shall be recognized as a loss by the assuming entity and as a gain by the ceding entity as Other Income in the statement of income;
>
> d. When the agreement is completed, or when there is a loss payment in excess of the deposit, any difference between consideration and recoveries shall be recorded in the Other Income or Loss account as a loss to the reinsurer and as a gain in the Other Income or Loss account by the reinsured;
>
> e. With regard to bulk reserves,(i.e., IBNR) it shall be assumed that any cash transactions for the settlement of losses will reduce the asset/liability accounts by the amount of the cash transferred. When the remaining losses are revalued upward, an increase in the liability shall be recorded as a loss recognized by the assuming entity. Conversely, the ceding entity shall increase its deposit (asset) and outstanding loss liability;
>
> f. No deduction shall be made from the loss and loss adjustment expense reserves on the ceding entity's balance sheet, schedules, and exhibits; and
>
> g. The assuming entity shall record net consideration to be returned to the ceding entity as liabilities.

10. The Property Casualty Reinsurance Study Group of the Accounting Practices and Procedures (E) Task Force reviewed SOP 98-7 in detail. The Study Group adopted its position at its March 7, 1999 meeting. The conclusion of this issue paper is consistent with the Study Group's recommendation. The applicable section of the minutes is included herein:

Michael Moriarty (N.Y.) opened the meeting by inviting Keith Bell (Travelers) to comment on his previously submitted proposal to revise statutory accounting guidance to permit accrual of interest income or expense related to funds held on deposit type transactions. Mr. Bell stated that the intent of the proposed revision was to make the statutory rules more consistent with Generally Accepted Accounting Procedures (GAAP) treatment, by using the interest method to reflect the actual cash flows and to periodically adjust the implicit rate of interest.

Peter Medley (Wis.) raised a question regarding the interest rate to be used for this purpose. Frank Maffa (American Reinsurance Company) explained that reinsurance agreements which did not satisfy risk transfer requirements had to be accounted for as deposit-transactions, and suggested that it would be appropriate to recognize the interest income or expense associated with the funds on deposit in a timely manner over the life of the transaction. Mr. Moriarty commented that he saw no reason not to permit accrual of such amounts and asked Norris Clark (Calif.) to explain how the proposed revision would be implemented. Mr. Clark said that the proposal would go from the study group to the Accounting Practices and Procedures Task Force, which would presumably consider the proposal to be a codification maintenance item which need not be referred to the Emerging Accounting Issues Task Force before the proposal could be implemented as a revision to the pertinent language in SSAP No. 62 and the corresponding section of the Accounting Practices and Procedures Manual for Property and Casualty Companies.

Thomas Burke (N.H.) moved to adopt the proposal and Mr. Clark seconded the motion which passed on a 4 to 1 vote of the study group members.

Generally Accepted Accounting Principles

11. AICPA SOP 98-7 paragraphs 9 to 20:

Initial Measurement

9. At inception, a deposit asset or liability should be recognized for insurance and reinsurance contracts accounted for under deposit accounting and should be measured based on the consideration paid or received, less any explicitly identified premiums or fees to be retained by the insurer or reinsurer, irrespective of the experience of the contract. Accounting for such fees should be based on the terms of the contract. Deposit assets and liabilities should be reported on a gross basis, unless the right of offset exists as defined in *FASB Interpretation No. 39, Offsetting of Amounts Related to Certain Contracts.* The accounting by the insured and insurer are symmetrical, except as noted in paragraph 15 of this SOP.

Subsequent Measurement

Insurance and Reinsurance Contracts That Transfer Only Significant Timing Risk and Insurance and Reinsurance Contracts That Transfer Neither Significant Timing Nor Underwriting Risk

10. For insurance and reinsurance contracts that transfer only significant timing risk or that transfer neither significant timing nor significant underwriting risk, the amount of the deposit asset or liability should be adjusted at subsequent reporting dates by calculating the effective yield on the deposit to reflect actual payments to date and expected future payments (as discussed in paragraph 11 below), with a corresponding credit or charge to interest income or expense. This approach is consistent with the interest method described in *Accounting Principles Board (APB) Opinion No. 21, Interest on Receivables and Payables,* and *FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases.*

11. The calculation of the effective yield should use the estimated amount and timing of cash flows. Consistent with paragraph 19 of FASB Statement No. 91, if a change in the actual or estimated timing or amount of cash flows occurs, the effective yield should be recalculated to reflect the revised actual or estimated cash flows. The deposit should be adjusted to the amount that would have existed at the balance-sheet date had the new effective yield been applied since

the inception of the insurance or reinsurance contract. Changes in the carrying amount of the deposit should be reported as interest income or interest expense.

12. Significant changes in the expected amounts of aggregate cash flows are expected to occur infrequently because of the nature of these kinds of contracts. Should a significant change occur in the total amount of actual or estimated cash flows, the enterprise should determine whether the change indicates that the contract does include significant underwriting risk and therefore should be converted to the accounting for contracts that transfer only significant underwriting risk. (See paragraphs 13 through 15 for the accounting guidance for insurance and reinsurance contracts that transfer only significant underwriting risk.) In addition, a contract that transfers only significant timing risk, which subsequently is determined also to transfer significant underwriting risk, cannot be accounted for under insurance or reinsurance accounting when the revised determination is made.

Insurance and Reinsurance Contracts That Transfer Only Significant Underwriting Risk

13. Until such time as a loss is incurred that will be reimbursed under an insurance or reinsurance contract that transfers only significant underwriting risk, the deposit should be measured based on the unexpired portion of the coverage provided. Once a loss is incurred that will be reimbursed under such a contract, then the deposit should be measured by the present value of the expected future cash flows arising from the contract plus the remaining unexpired portion of the coverage provided.

14. Changes in the recorded amount of the deposit, other than the unexpired portion of the coverage provided, arising from an insurance or reinsurance contract that transfers only significant underwriting risk should be recorded in an insured's income statement as an offset against the loss recorded by the insured that will be reimbursed under the insurance or reinsurance contract and in an insurer's income statement as an incurred loss. Insurance enterprises should record the reduction in the deposit related to the unexpired portion of the coverage provided as an adjustment to incurred losses. Insurance enterprises should disclose the amounts related to those deposit contracts that are reported in incurred losses in their statement of earnings. (See paragraph 19.) If the insured is an enterprise other than an insurance enterprise, the reduction in the deposit related to the unexpired portion of the coverage provided should be recorded as an expense.

15. For the insured or ceding enterprise, the discount rate used to determine the deposit asset should be the current rate on United States government obligations with similar cash-flow characteristics, adjusted for default risk. Consideration of the default risk, if any, should be based on the assessment of the creditworthiness of the insurer. For the insurer or assuming enterprise, the discount rate used to determine the deposit liability should be the current rate on United States government obligations with similar cash-flow characteristics. These rates should be established at the date of each loss incurred and used for the remaining life of the contract and should not be changed. If numerous losses occur, the use of average rates is permitted because establishing individual rates might require detailed recordkeeping and computations that could be burdensome and unnecessary to produce reasonable approximations of the results.

Insurance and Reinsurance Contracts With Indeterminate Risk

16. Uncertainties surrounding insurance and reinsurance contracts with indeterminate risk are analogous to those often associated with foreign property and liability reinsurance as addressed in *SOP 92-5*, *Accounting for Foreign Property and Liability Reinsurance.* As a result, the guidance in SOP 92-5, regarding the open-year method, should be followed. The open-year method should not, however, be used to defer losses that otherwise would be recognized pursuant to FASB Statement No. 5.

17. Under the open-year method, the effects of the contracts are not included in the determination of net income until sufficient information becomes available to reasonably estimate

and allocate premiums. The open-year method requires that these effects be aggregated in the balance sheet. If sufficient information becomes available to reasonably estimate and allocate premiums, the insurance or reinsurance contract with indeterminate risk should be reclassified into one of the three categories as an insurance or reinsurance contract that transfers neither significant timing nor significant underwriting risk, transfers only significant timing risk, or transfers only significant underwriting risk, as appropriate, and accounted for accordingly. The change in deposit assets or liabilities that result if sufficient information becomes available is treated as a change in accounting estimate in accordance with *APB Opinion 20, Accounting Changes.*

Disclosures

18. Entities should disclose a description of the contracts accounted for as deposits and the separate amounts of total deposit assets and total deposit liabilities reported in the statement of financial position.

19. Insurance enterprises should disclose the following information regarding the changes in the recorded amount of the deposit arising from an insurance or reinsurance contract that transfers only significant underwriting risk:

a. The present values of initial expected recoveries that will be reimbursed under the insurance or reinsurance contracts that have been recorded as an adjustment to incurred loses

b. Any adjustment of amounts initially recognized for expected recoveries (The individual components of the adjustment (meaning, interest accrual, the present value of additional expected recoveries, and the present value of reductions in expected recoveries) should be disclosed separately.)

c. The amortization expense attributable to the expiration of coverage provided under the contract

20. This SOP is effective for financial statements for fiscal years beginning after June 15, 1999, with earlier adoption encouraged. Previously issued annual financial statements should not be restated. The initial application of this SOP should be as of the beginning of an entity's fiscal year (that is, if the SOP is adopted prior to the effective date and during an interim period, all prior interim periods should be restated). The effect of initially adopting this SOP should be reported as a cumulative effect of a change in accounting principle (in accordance with the provisions of APB Opinion 20).

RELEVANT LITERATURE

Statutory Accounting

- *SSAP No. 62—Property and Casualty Reinsurance*
- March 7, 1999 minutes of the P/C Reinsurance Study Group

Generally Accepted Accounting Principles

- *American Institute of Certified Public Accountants (AICPA) Statement of Position No. 98-7, Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That do not Transfer Insurance Risk*

State Regulations

- No additional guidance obtained from state statutes or regulations.

Exhibit A
Illustration of a Reinsurance Contract That Is Accounted for as a Deposit using the Interest Method

Assumptions:

Premium = $1,000 (assumes no commissions or allowances)
Coverage Period = 1 year
Initial expected recoveries = $225 per year (at end of year) for five years
Initial Implicit rate = 4 percent*

*present value of $225 per year for five years at 4 percent = $1,000

At the end of Year 2, the timing of anticipated recoveries under the reinsurance contract changes. A reevaluation of the implicit interest rate produces a rate of 3.63 percent and an asset of $640 at the end of the year.

Description	Interest Income	Cash Recoveries	Deposit Balance
Initial payment			$1,000
Year 1 (4%)	$ 40		$1,040
End of Year 1		$ (225)	$ 815
Year 2 (4 %)	$ 33		$ 848
End of Year 2		$ (200)	$ 648
Yield adjustment	$ (8)		$ 640
Year 3 (3.63 %)	$ 23		$ 663
End of Year 3		$ (175)	$ 488
Year 4 (3.63 %)	$ 18		$ 506
End of Year 4		$ (175)	$ 331
Year 5 (3.63 %)	$ 12		$ 343
End of Year 5		$ (175)	$ 168
Year 6 (3.63 %)	$ 7		$ 175
End of Year 6		$ (175)	$ 0

At the inception of the contract, the ceding insurer records a deposit asset of $1,000 and the assuming company, a $1,000 deposit liability. The asset is admitted providing the conditions for credit for reinsurance are met.

At subsequent reporting dates, the deposit asset is adjusted by calculating the effective yield on the reinsurance agreement to reflect actual payments to date and expected future payments with a corresponding credit to interest income by the ceding company and interest expense by the assuming company.

At the end of year two, it is determined that the expected cash flows will differ from previous estimates, resulting in a lower effective yield on the deposit asset. The deposit asset is adjusted to the amount that would have existed at the reporting date had the new effective yield been applied from the inception of the reinsurance agreement. The adjustment is charged to interest income, i.e., as a reduction of interest income. Interest income during the remaining term of the agreement is reduced accordingly (i.e., the yield is reduced from 4.0% to 3.63%).

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Statutory Issue Paper No. 105

Reporting on the Costs of Start-Up Activities

STATUS
Finalized September 12, 2000

Original SSAP and Current Authoritative Guidance: SSAP No. 76

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. This issue paper addresses start-up costs. In practice, various terms are used to refer to start-up costs, such as preopening, preoperating, and organization costs. For purpose of this issue paper, these costs are referred to as start-up costs. Current statutory accounting guidance is provided in *SSAP No. 17—Preoperating and Research and Development Costs* (SSAP No. 17). American Institute of Certified Public Accountants (AICPA) Statement of Position 98-5, *Reporting on the Costs of Start-Up Activities,* (SOP 98-5) specifically addresses the reporting of start-up costs.

2. The purpose of this issue paper is to adopt SOP 98-5 with modification to add certain disclosure requirements, which is consistent with SSAP No. 17 and the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

3. Cost of start-up activities, including organization costs, shall be expensed as incurred. Start-up activities are defined broadly as those one-time activities related to: (1) opening a new facility; (2) introducing a new product or service; (3) conducting business in a new territory; (4) conducting business with a new class of customer or beneficiary; (5) initiating a new process in an existing facility; or (6) commencing some new operation. Start-up activities include activities related to organizing a new entity (commonly referred to as organization costs).

4. Cost of start-up activities incurred in an accounting period shall be disclosed in the annual audited statutory financial report only.

DISCUSSION

5. This issue paper adopts SOP 98-5, which requires costs of start-up activities and organization costs to be expensed as incurred. This is consistent with SSAP No. 17 and the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy.

6. *SSAP No. 4—Assets and Nonadmitted Assets* (SSAP No. 4) defines an asset *as "probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events."* Although in some instances start-up and organization costs may appear to comply with the definition of an asset established by SSAP No. 4, it is not consistent with the "Conservatism" concept included in the Statement of Concepts to presume that it is "probable" that an entity in a start-up phase will generate future economic benefits. Start-up and organization costs, therefore, do not meet the definition of an asset for statutory accounting purposes and as such should be expensed as incurred. To expense rather than to capitalize such costs is also consistent with the Recognition concept included in the Statement of Concepts, which states that a reporting entity's "ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due."

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

7. SSAP No. 17, paragraph 2 states:

> Preoperating, including organization and start up costs, and research and development costs shall be expensed as incurred. Preoperating and research and development costs are incurred for such new projects as: (a) arranging operations for a new company (e.g., legal, actuarial and accounting costs associated with regulatory approval and licensing and issuance of stock); (b) establishing production, sales or service facilities at a new site; (c) changing operations or production significantly; or (d) developing and producing a new product, adopting a new process or offering a new service.

Generally Accepted Accounting Principles

8. SOP 98-5, paragraph 12 states:

> **Conclusions**
>
> **Accounting for Start-Up Costs**
>
> .12 Costs of start-up activities, including organization costs, should be expensed as incurred.

Drafting Notes/Comments

- SOP 98-5 contains illustrations that provide examples. These illustrations should not be interpreted to be all-inclusive.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *SSAP No. 17—Preoperating and Research and Development Costs*
- *SSAP No. 4—Assets and Nonadmitted Assets*

Generally Accepted Accounting Principles

- *AICPA Statement of Position 98-*5, *Reporting on the Costs of Start-Up Activities*

State Regulations

- No additional guidance obtained from state statutes or regulations.

Statutory Issue Paper No. 106

Real Estate Sales – An Amendment to SSAP No. 40—Real Estate Investments

STATUS
Finalized September 12, 2000

Current Authoritative Guidance for Real Estate Sales: SSAP No. 40
This issue paper may not be directly related to the current authoritative statement.

Original SSAP from Issue Paper: SSAP No. 77

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory accounting guidance for Real Estate is provided in *SSAP No. 40—Real Estate Investments* (SSAP No. 40). SSAP No. 40 adopted *FASB Statement No. 66, Accounting for Sales of Real Estate* (FAS 66), with modification to paragraph 9 to indicate that only letters of credit from institutions listed by the Securities Valuation Office shall be included in determining the buyer's initial investment. Although FAS 66 states that it is applicable to all sales of real estate, it does not explicitly define real estate or identify the real estate transactions to which it is specifically applicable.

2. Paragraph 1 of *FASB Statement No. 66, Accounting for Sales of Real Estate*, states, "This Statement establishes standards for recognition of profit on all real estate sales transactions without regard to the nature of the seller's business." *FASB Interpretation No. 43, Real Estate Sales an interpretation of FASB Statement No. 66* (FIN 43) clarifies that the phrase "all real estate sales" to include sales of real estate with property improvements or integral equipment that cannot be removed and used separately from the real estate without incurring significant costs. *FASB Emerging Issues Task Force No. 00-13*, *Determining Whether Equipment is "Integral Equipment" Subject to FASB Statements No. 66 and No. 98* (EITF 00-13) adds guidance relative to the definition of integral equipment.

3. The purpose of this issue paper is to adopt FIN 43 and EITF 00-13 which is consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. This issue paper supersedes paragraphs 16 and 17 of SSAP No. 40. The following guidance shall be followed when accounting for the sales of real estate.

5. Recognition of profit on sales of real estate investments shall be accounted for in accordance with *FASB Statement No. 66, Accounting for Sales of Real Estate* (FAS 66), except as modified in paragraph 6 of this statement, *FASB Emerging Issues Task Force No. 87-9, Profit Recognition on Sales of Real Estate with Insured Mortgages or Surety Bonds* (EITF 87-9), *FASB Emerging Issues Task Force No.* 87-29, *Exchange of Real Estate Involving Boot* (EITF 87-29), *FASB Interpretation No. 43, Real Estate Sales an interpretation of FASB Statement No. 66* (FIN 43) and *FASB Emerging Issues Task Force No. 00-13, Determining Whether Equipment is "Integral Equipment" Subject to FASB Statements No. 66 and No. 98*. This issue paper applies to all sales of real estate including real estate with property improvements or integral equipment. The terms "property improvements" and "integral equipment" refer to any physical structure or equipment attached to the real estate that cannot be removed and used separately without incurring significant costs, such as an office building. Profit shall be recognized in full when real estate is sold, provided (a) the profit is determinable, that is, the collectibility of the sales price is reasonably

assured or the amount that will not be collectible can be estimated, and (b) the earnings process is virtually complete, that is, the seller is not obliged to perform significant activities after the sale to earn the profit. Unless both conditions exist, recognition of all or part of the profit shall be postponed. Profit shall not be recognized by the full accrual method until all of the following criteria are met:

a. A sale is consummated;

b. The buyer's initial and continuing investments are adequate to demonstrate a commitment to pay for the property;

c. The seller's receivable is not subject to future subordination; and

d. The seller has transferred to the buyer the usual risks and rewards of ownership in a transaction that is in substance a sale and does not have a substantial continuing involvement with the property after the sale.

6. The calculation of the buyer's initial investment specified in paragraph 9 of FAS 66 shall be modified to reflect that buyer's notes must be supported by letters of credit from institutions that are listed by the Securities Valuation Office of the National Association of Insurance Commissioners as meeting credit standards to be included in determining the buyer's initial investment. Any profit or loss is considered a realized gain or loss in the year of the sale in accordance with FAS 66.

DISCUSSION

7. This issue paper adopts FIN 43, which clarifies that the phrase "all real estate sales" includes sales of real estate with property improvements or integral equipment that cannot be removed and used separately from the real estate without incurring significant costs. This is consistent with SSAP No. 40 and the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy. This issue paper also adopts EITF 00-13 which clarifies use of the term "integral equipment".

Drafting Notes/Comments

- Accounting for leases and sale-leaseback transactions involving real estate transactions are addressed in *SSAP No. 22—Leases*.
- Accounting for leasehold improvements is addressed in *SSAP No. 19—Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements*.
- Accounting for transfers and servicing of financial assets and extinguishments of liabilities is addressed in *SSAP No. 18—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

8. SSAP No. 40, paragraphs 16 and 17 state:

> **Sale of Real Estate**
>
> 16. Recognition of profit on sales of real estate investments shall be accounted for in accordance with *FASB Statement No. 66, Accounting for Sales of Real Estate* (FAS 66), except as modified in paragraph 17 of this statement*, FASB Emerging Issues Task Force No. 87-9, Profit Recognition on Sales of Real Estate with Insured Mortgages or Surety Bonds* (EITF 87-9), and *FASB Emerging Issues Task Force No. 87-29, Exchange of Real Estate Involving Boot* (EITF 87-29). Profit shall be recognized in full when real estate is sold, provided (a) the profit is determinable, that is, the collectibility of the sales price is reasonably assured or the amount that will not be collectible can be estimated, and (b) the earnings process is virtually complete, that is, the seller is not obliged to perform significant activities after the sale to earn the profit. Unless

both conditions exist, recognition of all or part of the profit shall be postponed. Profit shall not be recognized by the full accrual method until all of the following criteria are met:

a. A sale is consummated;

b. The buyer's initial and continuing investments are adequate to demonstrate a commitment to pay for the property;

c. The seller's receivable is not subject to future subordination; and

d. The seller has transferred to the buyer the usual risks and rewards of ownership in a transaction that is in substance a sale and does not have a substantial continuing involvement with the property after the sale.

17. The calculation of the buyer's initial investment specified in paragraph 9 of FAS 66 shall be modified to reflect that buyer's notes must be supported by letters of credit from institutions that are listed by the Securities Valuation Office of the National Association of Insurance Commissioners as meeting credit standards to be included in determining the buyer's initial investment. Any profit or loss is considered a realized gain or loss in the year of the sale in accordance with FAS 66.

Generally Accepted Accounting Principles

9. FIN 43 provides the following guidance:

INTERPRETATION

2. Statement 66 applies to all sales of real estate, including real estate with property improvements or integral equipment. The terms property improvements and integral equipment as they are used in this Interpretation refer to any physical structure or equipment attached to the real estate that cannot be removed and used separately without incurring significant cost. Examples include an office building, a manufacturing facility, a power plant, and a refinery.

3. The provisions of Statement 66 do not apply to transactions that involve the following:

a. The sale of only property improvements or integral equipment without a concurrent (or contemplated) sale of the underlying land[1]

[1] Except for sales of property improvements or integral equipment with the concurrent lease (whether explicit or implicit in the transaction) of the underlying land to the buyer. Those transactions should be accounted for in accordance with paragraphs 38 and 39 of Statement 66. In addition, sales of property improvements or integral equipment subject to an existing lease of the underlying land are also subject to the provisions of Statement 66.

b. The sale of the stock or net assets of a subsidiary or a segment of a business if the assets of that subsidiary or that segment, as applicable, contain real estate, unless the transaction is, in substance, the sale of real estate

c. The sale of securities that are accounted for in accordance with *FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities*.[2]

[2] Sales of those types of securities are addressed by *FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.

4. In the first sentence of paragraph 38 of Statement 66, the phrase property improvements is interpreted to include both property improvements and integral improvements (to conform that paragraph to the scope clarification provided by this Interpretation).

10. EITF 00-13 provides the following guidance:

1. With the issuance of Interpretation 43, which concludes that sales of integral equipment are within the scope of Statement 66, determining whether equipment constitutes "integral equipment" has taken on increased importance as that determination now affects whether the detailed guidance in Statement 66 should be applied to a transfer of equipment. Further, the appropriateness of sales-type lease classification by lessors for leases involving equipment is also impacted by the determination of whether the equipment to be leased is "integral equipment." In addition, that determination is important for reaching a conclusion as to whether Statement 98, with its more stringent provisions, applies to a sale-leaseback transaction.

2. Integral equipment is defined in Interpretation 43 as "any physical structure or equipment attached to the real estate that cannot be removed and used separately without incurring significant cost." The authoritative pronouncements governing the accounting for leasing transactions and sales of real estate do not provide any guidance for interpreting the phrase "cannot be removed and used separately without incurring significant cost," and, as a result, there may be diversity in practice with respect to determining what constitutes "integral equipment" for the purpose of applying Statements 13, 66, and 98.

3. This issue is how the determination of whether equipment is integral equipment should be made.

EITF 00-13 DISCUSSION

4. The Task Force agreed that the phrase "cannot be removed and used separately without incurring significant cost" contains two distinct concepts: (a) the ability to remove the equipment without incurring significant cost and (b) the ability of a different entity to use the equipment at another location without significant diminution in utility or value. The Task Force reached a consensus that the determination of whether equipment is integral equipment should be based on the significance of the cost to remove the equipment from its existing location (which would include the cost of repairing damage done to the existing location as a result of the removal), combined with the decrease in the value of the equipment as a result of that removal. The Task Force agreed that, at a minimum, the decrease in the value of the equipment as a result of its removal is the estimated cost to ship and reinstall the equipment at a new site. The nature of the equipment, and the likely use of the equipment by other potential users, should be considered in determining whether any additional diminution in fair value exists beyond that associated with costs to ship and install the equipment.

5. When the combined total of both the cost to remove plus the decrease in value (for leasing transactions, the information used to estimate those costs and the decrease in value should be as of lease inception) exceeds 10 percent of the fair value of the equipment (installed) (for leasing transactions, at lease inception), the equipment is integral equipment.

6. Refer to Exhibit 00-13A for an example that illustrates the application of this consensus.

Exhibit 00-13A

ILLUSTRATION OF THE APPLICATION OF THE EITF CONSENSUS
ON ISSUE 00-13

Company A leases equipment to Company B for use in a manufacturing facility. The fair value of the production equipment (installed) at lease inception is $1,075,000. The estimated cost to remove the equipment after installation (estimate is as of the beginning of the lease term) is $80,000, which includes $30,000 to repair damage to the existing location as a result of the removal. The estimated cost to ship and reinstall the equipment at a new site (estimated as of the beginning of the lease term) is $85,000. For this example, assume that the equipment would have the same fair value (installed) to the seller and a potential buyer. Therefore, there is no diminution in fair value of the equipment beyond the discount a purchaser would presumably require to cover the cost to ship and reinstall the equipment.

In accordance with this consensus, Company A would assess whether or not the production equipment is integral equipment as follows ($80,000 + $85,000) ÷ $1,075,000 = 15.3 percent. Because the cost of removal combined with the diminution in value exceeds 10 percent of the fair value (installed) of the production equipment, the cost to remove the equipment and use it separately is deemed to be significant. Therefore, the production equipment is integral equipment.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *SSAP No. 40—Real Estate Investments*

Generally Accepted Accounting Principles

- *FASB Interpretation No. 43, Real Estate Sales, an interpretation of FASB Statement No. 66*
- *FASB Statement No. 66, Accounting for Sales of Real Estate*
- *FASB Emerging Issues Task Force No. 00-13, Determining Whether Equipment is "Integral Equipment" Subject to FASB Statements No. 66 and No. 98*

State Regulations

- No additional guidance obtained from state statutes or regulations.

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Statutory Issue Paper No. 107

Certain Health Care Receivables and Receivables Under Government Insured Plans

STATUS
Finalized August 8, 2001

Original SSAP and Current Authoritative Guidance: SSAP No. 84

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. *SSAP No. 4—Assets and Nonadmitted Assets* (SSAP No. 4) provides the definition of admitted and nonadmitted assets.

2. Pharmaceutical rebates are arrangements between pharmaceutical companies and reporting entities in which the reporting entities receive rebates based upon the drug utilization of its subscribers at participating pharmacies. Reporting entities use different ways to record pharmacy rebates on their financial statements. These rebates are sometimes recorded as receivables by reporting entities using estimates based upon historical trends which should be adjusted to reflect significant variables involved in the calculation, such as number of prescriptions written/filled, type of drugs prescribed, use of generic vs. brand-name drugs, etc. In some cases, the reporting entity determines the amount of the rebate due based on the actual use of various prescription drugs during the accumulation period and then invoices the pharmaceutical company. In other cases, an affiliated or unaffiliated pharmacy benefits management company may determine the amount of the rebate based on a listing (of prescription drugs filled) prepared for the reporting entity's review. The reporting entity will confirm the listing and the pharmaceutical rebate receivable. The pharmacy benefits management company will then collect the amount due from the pharmaceutical company for remittance to the reporting entity. Some reporting entities do not participate in rebate arrangements at all but receive similar benefits through contracted discounts on pharmaceutical purchases. Current statutory accounting guidance does not specifically address the admittance of pharmaceutical rebates.

3. Claim overpayments may occur as a result of several events, including but not limited to claim payments made in error to a provider. Reporting entities often establish receivables for claim overpayments. Claim overpayments may meet the conditions for the right of offset as defined in *SSAP No. 64—Offsetting and Netting of Assets and Liabilities* (SSAP No. 64). Since claim overpayments are not specifically identified as an admitted asset within the Accounting Practices and Procedures Manual effective January 1, 2001 they would be reported as nonadmitted.

4. A health entity may make loans or advances to large hospitals or other providers. Such loans or advances are supported by legally enforceable contracts and are generally entered into at the request of the provider. In many cases, loans or advances are paid monthly and are intended to represent one month of fee-for-service claims activity with the respective provider. At least for large hospitals with many sources of cash flow, an offset for these loans and advances exists in the reporting entity's combined reported and unreported claims liability and claims reserve. Additionally, such loans and advances are generally reconciled quarterly against actual claim utilization (allowing for adequate run-out of such claims) pursuant to contractual terms. In such cases, the reconciled differences are settled and the advance payments for future months may be adjusted based upon the materiality of reconciled differences. Current

statutory guidance in *SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties* (SSAP No. 25) is limited to loans and advances to related parties.

5. The glossary to the statements of statutory accounting principles contained in the Accounting Practices and Procedures Manual effective January 1, 2001, defines a capitation arrangement as a compensation plan used in connection with some managed care contracts in which a physician or other medical provider is paid a flat amount, usually on a monthly basis, for each subscriber who has elected to use that physician or medical provider. Risk-sharing agreements are contracts between reporting entities and providers with a risk-sharing element based upon utilization. The compensation payments for risk-sharing agreements are typically estimated monthly and settled annually. These agreements can result in receivables due from the providers if annual utilization is different than that used in estimating the monthly compensation. SSAP No. 25 provides accounting guidance for loans and advances and advances under capitation arrangements to providers who meet the definition of related parties.

6. Current GAAP provides guidance relative to defining a health care receivable and accounting guidance on loan impairment. Such guidance is presented in the American Institute of Certified Public Accountants (AICPA) Audit and Accounting Guide: Health Care Organizations. This audit guide was rejected in *SSAP No. 73—Health Care Delivery Assets – Supplies, Pharmaceuticals and Surgical Supplies, Durable Medical Equipment, Furniture, Medical Equipment and Fixtures, and Leasehold Improvements in Health Care Facilities.*

7. *SSAP No. 47—Uninsured Plans* (SSAP No. 47) paragraph 10.c. provides accounting guidance for the admissibility of uninsured Medicare and similar government funded plans. Current statutory accounting guidance does not specifically address the admittance of amounts receivable under government insured plans.

8. The purpose of this issue paper is to establish statutory accounting principles for pharmaceutical rebate receivables, claim overpayment receivables, loans and advances to providers who do not meet the definition of related parties, capitation arrangement receivables, risk-sharing receivables, and amounts receivable under government insured plans consistent with the Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

9. The definition and accounting treatment for nonadmitted assets is outlined in paragraph 3 of SSAP No. 4 as follows:

> As stated in the Statement of Concepts, "The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which are unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet", and are, therefore, considered nonadmitted. For purposes of statutory accounting principles, a nonadmitted asset shall be defined as an asset meeting the criteria in paragraph 2 above, which is accorded limited or no value in statutory reporting , and is one which is:
>
> a. Specifically identified within the Accounting Practices and Procedures Manual as a nonadmitted asset; or
>
> b. Not specifically identified as an admitted asset within the Accounting Practices and Procedures Manual.
>
> If an asset meets one of these criteria, the asset shall be reported as a nonadmitted asset and charged against surplus unless otherwise specifically addressed within the Accounting Practices and Procedures Manual. The asset shall be depreciated or amortized against net income as the estimated economic benefit expires. In accordance with the reporting entity's capitalization policy,

immaterial amounts of furniture, fixtures, equipment, or supplies, can be expensed when purchased.

10. Pharmaceutical rebate receivables, claim overpayment receivables, loans and advances to providers, capitation arrangement receivables, risk-sharing receivables, and amounts receivable under government insured plans meet the definition of assets as set forth in SSAP No. 4, and are admitted assets to the extent that the requirements for admission defined in this issue paper are met.

11. This issue paper shall not be considered an all-inclusive list of health care receivables. Certain health care receivables are addressed in other statements. Health care receivable assets not addressed in other statements or this statement are nonadmitted assets.

Pharmaceutical Rebate Receivables

12. Pharmaceutical rebates receivables consist of reasonably estimated amounts and billed amounts. Both the billed amount and the estimated amount shall be admitted assets subject to the conditions specified below:

a. Estimated amounts shall be related solely to actual prescriptions filled during the 3 months immediately preceding the reporting date;

b. Billed amounts represent pharmaceutical rebate receivables that have been invoiced or confirmed in writing but not collected as of the reporting date. Billed amounts for an estimated amount under paragraph 12.a. above shall be admitted only if the determination of the rebate, based on actual prescriptions filled, occurs and is invoiced or confirmed in writing within the 2 months following the reporting date of the estimated amount. Adjustments to previously billed amounts related to prior periods shall be nonadmitted until invoiced or confirmed in writing. Pharmaceutical rebates that have not been collected within 90 days of the invoice date or confirmation date shall be nonadmitted. Furthermore, if accrued pharmaceutical rebate receivables are not invoiced or confirmed in writing in accordance with the contract provisions, the accrual shall be nonadmitted; and

c. Evaluation of the collectibility of pharmaceutical rebate receivables shall be made periodically. If in accordance with *SSAP No. 5—Liabilities, Contingencies and Impairments of Assets* (SSAP No. 5), it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made.

13. The method used to reasonably estimate the receivable shall be consistent from period to period and shall be adjusted periodically for any changes in the underlying pharmaceutical rebate contract provisions. The financial statements shall disclose information regarding the reporting entity's pharmaceutical rebates in accordance with paragraph 26 of this issue paper.

14. Income from pharmaceutical rebates of insured plans shall be reported as a reduction to claims expense on the summary of operations.

15. Receivable and payable balances related to uncollected pharmaceutical rebates of uninsured plans shall be recorded on the financial statements of the reporting entity. Any pharmaceutical rebates earned by the reporting entity that are in excess of the amounts to be remitted to the uninsured plan pursuant to an administrative services agreement shall be determined consistent with the requirements of paragraphs 12 and 13 and shall be reported on the balance sheet as an amount receivable relating to uninsured accident and health plans, and as a reduction to general expenses on the statement of operations.

Claim Overpayment Receivables

16. A claim overpayment shall not be recorded as a receivable until invoiced. To the extent that the claim overpayment meets the setoff conditions in SSAP No. 64 and the overpayment is a specific identifiable payment and not an estimate, the receivable may be admitted up to the amount of the payable to the provider for reported claims (i.e., excluding incurred but not reported claims). The receivable and payable shall be reported gross rather than netted on the balance sheet. Evaluation of the collectibility of claim overpayment receivables shall be made periodically. If in accordance with SSAP No. 5, it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made. Amounts in excess of that written off that do not meet the right of offset conditions shall be nonadmitted as they are not available to satisfy policyholder obligations.

Loans and Advances to Providers

17. Loans or advances to providers who meet the definition of related parties in SSAP No. 25 shall follow the guidance in that statement. To the extent a loan or advance to a non-related party provider meets the setoff conditions in SSAP No. 64, the loan or advance may be admitted up to the amount of the payable to the provider for reported claims (i.e., excluding incurred but not reported claims).

18. In addition, a loan or advance to a non-related party hospital shall be admitted up to the amount of claims incurred and payable to the hospital, if all of the following conditions are met:

a. The loan or advance meets the setoff conditions in SSAP No. 64;
b. The loan or advance is supported by a legally enforceable contract;
c. The loan or advance is administered pursuant to contractual terms;
d. The contractual terms of the agreement provide for separate quarterly reconciliations;
e. Each quarterly reconciliation shall be completed within nine months of the end of such quarter; and
f. A quarterly reconciled difference shall be settled within 90 days of the date the reconciliation is completed.

19. If a quarterly reconciliation is not performed or settled in accordance with paragraphs 18.e. and 18.f. above, all assets for loans or advances to that hospital shall be nonadmitted.

20. The receivable and payable shall be reported gross rather than netted on the balance sheet. Evaluation of the collectibility of loans and advances to providers shall be made periodically. If in accordance with SSAP No. 5, it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made. Amounts in excess of that written off that do not meet the right of offset conditions shall be nonadmitted as they are not available to satisfy policyholder obligations.

Capitation Arrangement Receivables

21. Advances to providers under capitation arrangements that are made under the terms of an approved provider services contract in anticipation of future services shall be admitted to the extent that the advanced amount does not exceed one month of average capitation payments for the subject provider during the preceding twelve months, and provided that the contract cannot be terminated before the end of the month for which the advanced amount was paid. Evaluation of the collectibility of capitation arrangement receivables shall be made periodically. If in accordance with SSAP No. 5, it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made.

Risk-Sharing Receivables

22. Risk-sharing receivables may consist of reasonably estimated amounts and billed amounts. Both the billed amount and the estimated amount shall be admitted assets subject to the conditions specified below:

a. Risk-sharing receivables and payables shall only be recorded when reasonably estimated. Estimates of risk-sharing receivables may be admitted if based on at least six months of actual claims experience for each risk-sharing contract. The contractual terms of any risk-sharing agreement shall provide for evaluation of the experience under the contract at least annually. The determination of the risk-sharing balance shall commence no later than 6 months following the close of such annual period, and the balance shall be invoiced no later than 8 months following close of the annual period;

b. Billed amounts represent risk-sharing receivables that have been invoiced but not collected as of the reporting date. Risk-sharing receivables and payables shall be invoiced or refunded in accordance with the contractual provisions of the risk-sharing agreement. Adjustments resulting in increases to previously billed amounts related to prior periods shall be nonadmitted until invoiced. Adjustments resulting in decreases to previously billed amounts shall be recognized immediately. Risk-sharing receivables that have not been collected within 90 days of the date of invoicing shall be nonadmitted;

c. Risk-sharing receivables and payables shall be reported gross rather than netted on the balance sheet. However, if a reporting entity has both a receivable and payable balance with the same provider and the balances meet the setoff conditions in SSAP No. 64, those balances shall be netted in accordance with SSAP No. 64; and

d. Evaluation of the collectibility of risk-sharing receivables shall be made quarterly. If in accordance with SSAP No. 5, it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made.

23. The method used to reasonably estimate the receivable shall be consistent from period to period and shall be adjusted periodically for any changes in the underlying risk-sharing contract. The financial statements shall disclose information regarding the reporting entity’s risk-sharing receivables in accordance with paragraph 27 of this issue paper.

24. Income/expense from risk-sharing contracts shall be reported as a component of claims expense on the summary of operations.

Amounts Receivable Under Government Insured Plans

25. Amounts receivable under government insured plans, including amounts over 90 days due, that qualify as accident and health contracts in accordance with *SSAP No. 50—Classifications and Definitions of Insurance or Managed Care Contracts in Force* shall be admitted assets. Amounts receivable under government insured plans include but are not limited to receivables under Medicare, Medicaid and similarly funded government insured plans. Evaluation of the collectibility of amounts receivable under government insured plans shall be made periodically. If in accordance with SSAP No. 5, it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made.

Disclosures

26. The financial statements shall disclose the method used by the reporting entity to estimate pharmaceutical rebate receivables. Furthermore, for the most recent three years and for each quarter therein, the reporting entity shall also disclose the following:

a. Estimated balance of pharmacy rebate receivables as reported on the financial statements;
b. Pharmacy rebates as invoiced or confirmed in writing; and
c. Pharmacy rebates collected.

An example of this disclosure is shown in Exhibit A to this issue paper.

27. The financial statements shall disclose the method used by the reporting entity to estimate its risk-sharing receivables. If any receivable and payable balances with the same provider are netted, the reporting entity shall disclose the gross receivable and payable balances in the notes to the financial statements. Furthermore, for the most recent three years, the reporting entity shall also disclose the following:

a. Risk-sharing receivables as estimated and reported on the prior year financial statements for annual periods ending in the current year;
b. Risk-sharing receivables as estimated and reported on the financial statements for annual periods ending in the current year and the following year;
c. Risk-sharing receivables invoiced as determined after the annual period;
d. Risk-sharing receivables not yet invoiced; and
e. Amounts collected from providers as payments under risk-sharing contracts.

An example of this disclosure is shown in Exhibit B to this issue paper.

Effective Date and Transition

28. Upon adoption of this issue paper, the NAIC will release a Statement of Statutory Accounting Principle (SSAP) for comment. The SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the Accounting Practices and Procedures Manual should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will contain an effective date of years ending on or after December 31, 2001.

29. Prior to January 1, 2003, reporting entities may transition the invoicing provision outlined in paragraph 12 and shall invoice pharmaceutical rebates on no less than a semi-annual basis. Furthermore, prior to January 1, 2003, reporting entities may transition the 90 day admissibility provision outlined in paragraph 12 and shall nonadmit pharmaceutical rebates if such rebates have not been collected within 180 days of the invoicing date.

30. Prior to January 1, 2003, reporting entities may transition the invoicing provision outlined in paragraph 22 and shall invoice the risk-sharing balance no later than 11 months days following the close of the annual period.

DISCUSSION

31. The statutory accounting principles outlined above are consistent with the conservatism and recognition concepts in the Statement of Concepts, current statutory accounting guidance and SSAP No. 4.

> Conservatism
>
> Conservative valuation procedures provide protection to policyholders against adverse fluctuations in financial condition or operating results. Statutory accounting should be reasonably conservative over the span of economic cycles and in recognition of the primary responsibility to regulate for financial solvency.
>
> Recognition
>
> The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which are unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet but rather should be charged against surplus when acquired or when availability otherwise becomes questionable.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

32. SSAP No. 47 paragraph 8 provides guidance on accounting for amounts receivable from uninsured plans:

> 8. Amounts receivable from uninsured plans for (a) claims and other costs paid by the administrator on behalf of the third party at risk and (b) fees related to services provided by the administrator to the plan meet the definition of assets as set forth in SSAP No. 4—Assets and Nonadmitted Assets. A receivable shall not be recorded for unpaid claims. A receivable related to Medicare or a similarly structured cost based reimbursement contract shall only be recorded when services have been rendered.

33. SSAP No. 47 paragraph 10.c. provides guidance on determining the nonadmitted portion of amounts receivable from Medicare and similar government funded uninsured plans:

> 10 c. Medicare and similar government funded plans—Amounts due related to Medicare and similar government plans shall not be nonadmitted when they become over ninety days due. Appropriate reserves shall be established to cover costs incurred which may not be reimbursed upon final determination by the governing agencies under the cost contract or for adjustments to revenues based on performance under the terms of the contract or other external factors.

34. SSAP No. 64 paragraph 2 provides guidance on accounting for offsetting and netting of assets and liabilities:

> 2. Assets and liabilities shall be offset and reported net only when a valid right of setoff exists except as provided for in paragraphs 3 and 4. A right of setoff is a reporting entity's legal right, by contract or otherwise, to discharge all or a portion of the debt owed to another party by applying an amount that the other party owes to the reporting entity against the debt. A valid right of setoff exists only when all the following conditions are met:
>
> a. Each of the two parties owes the other determinable amounts. An amount shall be considered determinable for purposes of this provision when it is reliably estimable by both parties to the agreement;
>
> b. The reporting party has the right to setoff the amount owed with the amount owed by the other party;

> c. The reporting party intends to setoff; and
>
> d. The right of setoff is enforceable at law.

35. SSAP No. 25 paragraphs 7 and 8 include the following guidance for loans or advances by a reporting entity:

> 7. Loans or advances by a reporting entity to all other related parties shall be evaluated by management and nonadmitted if they do not constitute arm's-length transactions as defined in paragraph 10. Loans or advances made by a reporting entity to related parties (other than its parent or principal owner) that are economic transactions as defined in paragraph 10 shall be admitted. This includes financing arrangements with providers of health care services with whom the reporting entity contracts with from time to time. Such arrangements can include both loans and advances to these providers. Evaluation of the collectibility of loans or advances shall be made periodically. If, in accordance with SSAP No. 5, it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made.
>
> 8. Any advances under capitation arrangements made directly to providers, or to intermediaries that represent providers, that exceed one month's payment shall be nonadmitted assets.

Generally Accepted Accounting Principles

36. The AICPA Audit and Accounting Guide: Health Care Organizations states the following:

> 5.01. Receivables may include amounts due for (*a*) health care services from patients, residents, third-party payors, and employers; (*b*) premiums and stop-loss insurance recoveries; (*c*) intercompany transactions; (*d*) promises to give in future periods (pledges); and (*e*) amounts due from employees, physicians, or others. All loans, such as loans to physicians, should be evaluated periodically for impairment. Loans that are included in the scope of *FASB Statement No. 114*, *Accounting by Creditors for Impairments of a Loan*, should be evaluated based on the provisions of that statement. A loan is impaired when, based on current information and events, it is probable that the provider will be unable to collect all amounts due, including principal and interest, according to the contractual terms of the loan agreement. If the provider measures an impaired loan using a present value amount, the creditor should calculate that present value based on an estimate of the expected future cash flows of the impaired loan, discounted at the loan's effective interest rate.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *SSAP No. 4—Assets and Nonadmitted Assets*
- *SSAP No. 5—Liabilities, Contingencies and Impairment of Assets*
- *SSAP No. 20—Nonadmitted Assets*
- *SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties*
- *SSAP No. 47—Uninsured Plans*
- *SSAP No. 64—Offsetting and Netting of Assets and Liabilities*

Generally Accepted Accounting Principles

- The AICPA Audit and Accounting Guide: Health Care Organizations

State Regulations

- No additional guidance obtained from state statutes or regulations

ISSUE PAPER NO. 107 – EXHIBIT A – ILLUSTRATION OF PHARMACEUTICAL REBATE RECEIVABLES

(000 omitted)

Quarter	Estimated Pharmacy Rebates as Reported on Financial Statements	Pharmacy Rebates as Invoiced/ Confirmed	Actual Rebates Collected Within 90 Days of Invoicing/ Confirmation	Actual Rebates Collected Within 91 to 180 Days of Invoicing/ Confirmation	Actual Rebates Collected More Than 180 Days After Invoicing/ Confirmation
12/31/2003	$150	$147			
9/30/2003	130	133	$62		
6/30/2003	142	143	70	$55	
3/30/2003	157	152	65	42	$20
12/31/2002	125	132	70	27	20
9/30/2002	123	129	62	31	14
6/30/2002	112	120	54	20	16
3/31/2002	110	118	57	39	20
12/31/2001	68	75	34	20	10
9/30/2001	60	59	27	17	10
6/30/2001	57	60	31	15	10
3/31/2001	45	50	25	18	7

ISSUE PAPER NO. 107 – EXHIBIT B – ILLUSTRATION OF RISK-SHARING RECEIVABLES
(000 omitted)

Calendar Year	Evaluation Period Year Ending	Risk-Sharing Receivable as Estimated and Reported in the Prior Year	Risk-Sharing Receivable as Estimated and Reported in the Current Year	Risk-Sharing Receivable Invoiced	Risk-Sharing Receivable Not Invoiced	Actual Risk-Sharing Amounts Collected in Year Invoiced	Actual Risk-Sharing Amounts Collected First Year Subsequent	Actual Risk-Sharing Amounts Collected Second Year Subsequent	Actual Risk-Sharing Amounts Collected – All Other
2003	2003	$245	$232	$155	$77	$0			
	2004	XXX	$189	XXX	$189	XXX	XXX		
2002	2002	$223	$225	$203	$22	$0	$200		
	2003	XXX	$245	XXX	$245	XXX	XXX	XXX	XXX
2001	2001	$190	$178	$174	$4	$0	$170	$5	
	2002	XXX	$223	XXX	$223	$XXX	XXX	XXX	XXX

DRAFTING NOTE: If there were only one contract or if all contracts have the same experience period, then there would only be an entry in either the “Invoiced” or “Not Invoiced” column for the current year. This example assumes varying dates on experience periods for multiple contracts. Assumptions: Two risk-sharing contracts are in place, one with an experience period that ends 3/31/03 and one with an experience period that ends 10/31/03.

The $155,000 receivable for the contract period that ends 3/31/03 would be invoiced no later than 11/30/03 (or 8 months days following close of the contract period) and could be received no later than 2/28/04. Therefore, the $155,000 would appear in the “Invoiced” column in 2003 but not shown as received in 2003. Further, the $189,000 estimate for the experience period that ends 3/31/04 could be recorded on the December 31, 2003 financial statement, since there is more than six months of experience under the contract.

The contract with the experience period that ends 10/31/03 with an estimated $77,000 receivable would be invoiced by 6/30/04 and received by 09/30/04. Therefore, it would appear in the “Not Invoiced” column and not shown as received in 2003. However, no estimate could be reported on the December 31, 2003 financial statement for the experience period that ends 10/31/04, because there is less than six months of experience under the contract.

Statutory Issue Paper No. 108

Multiple Peril Crop Insurance

STATUS
Finalized September 12, 2000

Original SSAP and Current Authoritative Guidance: SSAP No. 78

Type of Issue:
Property and Casualty

SUMMARY OF ISSUE

1. Farming has always been an inherently risky enterprise because farmers operate at the mercy of nature and frequently are subjected to weather-related perils such as droughts, floods, hurricanes, and other natural disasters. Since the 1930s, many farmers have been able to transfer part of the risk of loss in production to the federal government through the subsidized Multiple Peril Crop Insurance (MPCI) program administered by the Federal Crop Insurance Corporation (FCIC), an agency of the United States Department of Agriculture. Major legislation enacted in 1980 and 1994 restructured the MPCI program. The 1980 legislation enlisted, for the first time, private insurance companies to sell, service, and share the risk of MPCI insurance policies. Subsequently, in 1994, the Federal Crop Insurance Reform and Department of Agriculture Reorganization Act revised the program to offer farmers two primary levels of insurance coverage, catastrophic and buy-up.

2. Catastrophic insurance is designed to provide farmers with protection against extreme crop losses for a small processing fee. Buy-up insurance provides protection against more typical and smaller crop losses in exchange for a policyholder-paid premium. The government subsidizes the total premium for catastrophic insurance and a portion of the premium for buy-up insurance. Farmers who purchase buy-up crop insurance must choose both the coverage level (the proportion of the crop to be insured) and the unit price (such as, per bushel) at which any loss is calculated. With respect to the coverage level of production, farmers can choose to insure as much as 85 percent of normal production or as little as 50 percent of normal production at different price levels. With respect to the unit price, farmers choose whether to value their insured production at FCICs full estimated market price or at a percentage of the full price.

3. In recent years, FCIC has introduced a new risk management tool called revenue insurance. Unlike traditional crop insurance, which insures against losses in the level of crop production, revenue insurance plans insure against losses in revenue. The plans protect the farmer from the effects of declines in crop prices or declines in crop yields, or both. Like traditional buy-up insurance, the government subsidizes a portion of the premiums. One of the plans, called Crop Revenue Coverage, is available in many states for major crops. Two other plans, called Income Protection and Revenue Assurance, are available to farmers in only limited areas.

4. Companies participate in the MPCI program with FCIC through the Standard Reinsurance Agreement (SRA) per the terms of which the insurance companies share in the underwriting results of each policy. In 1999, MPCI gross written premium was $2.3 billion and total insurance in force amounted to over $30.9 billion. The program has unique loss exposure characteristics, which resulted in a gross loss ratio over 200% for 1988 and 1993.

5. The SRA reinsurance terms provide a company the flexibility to limit its exposure on a state by state basis. MPCI premium is not expense loaded, therefore FCIC pays the insurance companies, on behalf of the policyholder, a percent of premium for administrative expenses associated with selling and servicing crop insurance policies, including the expenses associated with adjusting claims.

6. The FCIC utilizes an escrow account to distribute or collect additional funds. Premium (collected from the policyholders and the federal government subsidy) is deposited in the escrow account and is available to pay the claims arising under the program.

7. Existing statutory accounting practices do not address the distinctive characteristics of the MPCI line of business. Current practices within the industry vary. Accordingly, this issue paper establishes statutory accounting principles for direct MPCI premium written and the related business ceded to FCIC, and is consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy. This issue paper also establishes statutory accounting principles for the recently enacted Aquatic Crop Reinsurance Agreement (hereinafter included in the term MPCI).

8. Commercial multiple-peril crop reinsurance and crop hail insurance would not be impacted by this issue paper and would continue to follow existing statutory accounting principles.

SUMMARY CONCLUSION

Premium Recognition

9. MPCI gross premium is defined as the contractually determined amount specified by FCIC to the policyholder for the effective period of the contract based on the actuarially determined expectation of risk and policy benefits associated with the coverage provided by the terms of the insurance contract. In addition, gross premium shall also include the government premium subsidy paid on behalf of the policyholder.

10. MPCI ceded premium and losses are defined as the amount calculated by applying the proportional and non-proportional factors as stated in the SRA. An example of this application is shown in Exhibit A to this issue paper.

11. MPCI written premium shall be recorded as soon as an estimate can be made, but no later than the processing date. Upon recording written premium, a liability for the unearned premium reserve shall be established to reflect the amount of premium for the portion of the insurance coverage that has not yet expired. Premiums shall be recognized as revenue over the period of risk in proportion to the amount of insurance protection provided.

12. The company shall disclose the method used to compute the unearned premium reserve in the financial statements.

Amounts Receivable or Payable

13. The company shares underwriting risk with FCIC and can earn or lose money according to the claims it must pay farmers for crop losses. The company earns underwriting profits when the net retained premiums exceed the net crop loss claims paid. The company incurs underwriting losses when the net claims paid for crop losses exceed the net retained premiums. These definitions do not consider underwriting expenses, which would be included for traditional statutory accounting underwriting gains and losses. The use of the terms underwriting gains and losses in this issue paper are unique to the MPCI program. As the premiums of the program are held by FCIC in escrow, the company shall recognize as a write-in asset a receivable from FCIC for the amount of the underwriting gain (as defined in this paragraph). Whereas, when the company is in an underwriting loss position, the company shall recognize a write-in liability to the FCIC for the amount of the underwriting loss (as defined in this paragraph), as the monies held in the escrow account are not sufficient to cover the company's claims. In accordance with the SRA, funds that remain in escrow will be distributed to the company at the conclusion of the contract period if the contract results in a gain to the company. If the company owes additional funds to the escrow (i.e., it is in a loss position), those funds are remitted on a periodic basis until the contract expires. These amounts shall be recorded net as the program meets the requirements of offsetting as defined in *SSAP No. 64—Offsetting and Netting of Assets and Liabilities* (SSAP No. 64). In accordance with *SSAP No. 21—Other Admitted Assets* (SSAP No. 21), the amount receivable under the Federal Crop Insurance program shall be reported as an admitted asset.

14. Amounts receivable from policyholders meet the definition of an admitted asset as set forth in *SSAP No. 4—Assets and Nonadmitted Assets* (SSAP No. 4) and should be accounted for in accordance with *SSAP No. 6—Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due From Agents and Brokers* (SSAP No. 6). The due date shall be governed by contractual due date of the premium billing, and not the effective date of the contract.

Unpaid Losses and Loss Adjustment Expenses

15. In accordance with *SSAP No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses* (SSAP No. 55), losses and loss adjustment expenses shall be recognized as expense when a covered or insured event occurs.

16. The covered or insured event is the occurrence of an incident which gives rise to a claim or the incurring of costs. Claim payments and related expense payments are made subsequent to the occurrence of a covered or insured event and, in order to recognize the expense of a covered or insured event, it is necessary to establish a liability. The following are the types of future costs relating to the MPCI program:

a. Reported Losses: Expected payments for losses relating to insured events that have occurred and have been reported to, but not paid by, the insurer as of the statement date;

b. Incurred But Not Reported Losses, (IBNR): Expected payments for losses relating to insured events that have occurred but have not been reported to the insurer as of the statement date;

c. Loss Adjustment Expenses: Costs expected to be incurred in connection with the adjustment and recording of losses defined in subparagraphs 16a. and 16b. of this issue paper.

Administrative Expense Payment

17. FCIC pays the insurance companies a percent of premium for administrative expenses associated with selling and servicing crop insurance policies, including the expenses associated with adjusting claims. The expense payment associated with the catastrophic coverage shall be recorded as a reduction of loss expenses whereas the expense payment for the buy-up coverage shall be recorded as a reduction of other underwriting expenses. The company shall disclose the total amounts received for each type of coverage.

Escrow Account

18. The escrow account shall not be recorded on the financial statements of the insurance company. This account is considered an FCIC account and as such is not owned by the insurance company, however, the company's underwriting gain is reflected as a receivable in accordance with paragraph 13.

Effective Date

19. This issue paper is effective for SRA contracts entered into after January 1, 2001. A change resulting from the adoption of this issue paper shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Correction of Errors*.

DISCUSSION

20. The conclusions reached in this issue paper are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy. The issue paper also relies on the conclusions reached in various other issue papers. Due to the unique terms and complicated provisions in the MPCI program and the SRA, there is very little specific guidance for insurers when accounting for MPCI premiums and losses.

21. The definition of gross premium is consistent with the contractual provisions of the MPCI program. The policyholder pays a portion of the buy-up coverage with the remainder subsidized by FCIC. As such it is consistent and reasonable to report both components as gross premium. The ceded premium is computed using the factors given in the SRA. The SRA is unlike traditional reinsurance agreements in that it includes both proportional and non-proportional coverage within the same agreement contingent upon underwriting

results. As such, it is essential that each company compute and report ceded premiums consistently. Exhibit A is included to provide an illustration of the computation. Written premium in this issue paper is accounted for differently than *SSAP No. 53—Property Casualty Contracts - Premiums* (SSAP No. 53). SSAP No. 53 states that written premium shall be recorded on the effective date of the contract whereas this issue paper states that written shall be recorded on the processing date. This difference is due to the fact that policyholders engage in the contracts before they know how much acreage will be covered under the contract. Once the crops have been planted, an acreage report is generated which is used to compute the premium due under the contract. Therefore, it would be unreasonable for the insurance company to record written premium on the effective date, as the premium is not yet determinable.

22. The amounts receivable or payable from FCIC are addressed in SSAP No. 21. SSAP No. 21 states that amounts receivable from Federal Crop Insurance programs shall be reported as admitted assets. The amount receivable from policyholders is addressed in SSAP No. 6. This issue paper clarifies that the due date of the receivable shall be governed by the contractual due date of the premium billing as the premiums are computed months after the contracts are effective. If the receivables were aged as of the effective date, they could be non-admitted before they billed.

23. Unpaid losses and loss adjustment expenses shall be recorded consistent with SSAP No. 55. The conclusions reached in SSAP No. 55 are consistent with the provisions of the MPCI program.

24. FCIC pays the insurance companies a percent of premium for the administrative expenses associated with selling and servicing crop insurance policies, including the expenses associated with adjusting claims. The requirement to show these payments as reductions in loss adjustment expenses and other underwriting expenses is because the MPCI premium is not expense loaded. Some companies simply pass these payments to the agents in lieu of commissions. In that case, the remittance would then also be recorded as an increase in other underwriting expenses (i.e., commission expense) and there would be no effect on net income.

Drafting Notes/Comments

25. Companies writing MPCI as their predominate line of insurance can experience distorted Insurance Regulatory Information System (IRIS) ratios based upon the accounting for this line of business. The acceptable ranges for the IRIS ratios should either be changed or the ratios should be footnoted by NAIC based upon the uniqueness on the MPCI line of insurance. The IRIS ratios most often affected are gross premiums to surplus, agent's balances to surplus, and liabilities to liquid assets.

26. Commercial Reinsurance discussed in SSAP No. 62.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

Statutory literature does not specifically address the MPCI program.

Generally Accepted Accounting Principles

GAAP literature does not specifically address the MPCI program.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *SSAP No. 3—Accounting Changes and Corrections or Errors*
- *SSAP No. 4—Definition of Assets and Nonadmitted Assets*
- *SSAP No. 6—Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due From Agents and Brokers*
- *SSAP No. 21—Other Admitted Assets*
- *SSAP No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses*

- *SSAP No. 62—Property and Casualty Reinsurance*
- *SSAP No. 64—Offsetting and Netting of Assets and Liabilities*

Generally Accepted Accounting Principles

- No further guidance obtained from GAAP literature

State Regulations

- No further guidance obtained from state statutes or regulations

Other Sources of Information

- United States General Accounting Office Testimony Before the Committee on Agriculture, Nutrition, and Forestry, U.S. Senate, March 17, 1999
- KPMG Peat Marwick Multi-Peril Crop Insurance Revenue Recognition Survey, December 18, 1996

EXHIBIT A - ILLUSTRATION OF CEDED PREMIUMS AND LOSSES

NOTES TO THE ILLUSTRATION

Fund — The reinsurance fund specified in the Standard Reinsurance Agreement (SRA).

Column 1 — Reinsured Company proportional reinsurance retention percentage.

Column 2 — Gross Written Premium equals the insured paid premium amount plus premium subsidy provided by FCIC.

Column 3 — Net Retained Premium is the Reinsured Company retained premium after proportional reinsurance. Gross Written Premium (Column 2) times the Reinsured Company retention percentage (Column 1).

Column 4 — Proportional Ceded Premium is the premium retained by FCIC after proportional reinsurance. Gross Written Premium (Column 2) minus the Reinsured Company Net Retained Premium (Column 3).

Column 5 — Reinsured Company proportional reinsurance retention percentage (Column 1).

Column 6 — Gross Losses equals total claim payments to insured.

Column 7 — Net Retained Losses are the Reinsured Company retained losses after proportional reinsurance. Gross Losses (Column 6) times the Reinsured Company retention percentage (Column 5).

Column 8 — Proportional Ceded Losses are the losses retained by FCIC after proportional reinsurance. Gross Losses (Column 7) minus the Reinsured Company Net Retained Losses (Column 7).

Column 9 — Retained Loss Ratio is the Reinsured Company's Net Retained Losses (Column 7) divided by the Reinsured Company's Net Retained Premium (Column 3).

Column 10 — Underwriting (Gain)/Loss is the Reinsured Company share of the MPCI program gain or loss after calculating the non-proportional reinsurance provided in the SRA.

Column 11 — Non-Proportional Ceded Premium is equal to the Reinsured Company Net Retained Premium (Column 3) minus Net Retained Losses (Column 7) minus an Underwriting (Gain) (Column 10) if one exists. This is FCIC's share of the underwriting gain after proportional reinsurance, based on the non-proportional reinsurance gain sharing factors specified in the SRA.

Column 12 — Non-Proportional Ceded Losses is equal to the Reinsured Company Net Retained Premium (Column 3) minus Net Retained Losses (Column 7) minus an Underwriting Loss (Column 10) if one exists. This is FCIC's share of the underwriting loss after proportional reinsurance, based on the non-proportional reinsurance loss sharing factors specified in the SRA.

Column 13 — Final Retained Premium is equal to the Reinsured Company Net Retained Premium (Column 3) minus the Non-Proportional Ceded Premium (Column 11). The Reinsured Company Net Retained Premium after proportional reinsurance is reduced by the amount of FCIC's underwriting gain share after non-proportional reinsurance.

Column 14 Final Retained Losses is equal to the Reinsured Company Net Retained Premium (Column 3) minus the Non-Proportional Ceded Losses (Column 12). The Reinsured Company Net Retained Losses after proportional reinsurance are reduced by the amount of FCIC's underwriting loss share after non-proportional reinsurance.

Column 15 Final Retained Loss Ratio is equal to Final Retained Losses divided by Final Retained Premium.

(a) Calculated based on the loss ratios for each fund by state. Net Retained Premium (Col 3) is applied to the percentages of Section II. C. and D. of the Standard Reinsurance Agreement.

(b) If the fund is in a GAIN position then there would be Non-proportional ceded premium. If the fund is in a LOSS position then there would be Non-proportional ceded losses.

Since each fund and state stands alone in the calculations, there is a possibility of Non-proportional ceded premium AND ceded losses within the same reinsurance year. There is also the possibility of this within the same fund (some states with a Gain and some states with a Loss).

Exhibit A - Illustration of Ceded Premiums and Losses

Fund	(1) Retention %	(2) Gross Written Premium	(3) Net Retained Premium (Col 2 x Col 1)	(4) Proportional Ceded Premium (Col 2 - Col 3)
Assigned Risk	20%	20,000,000	4,000,000	16,000,000
Developmental	35%	10,000,000	3,500,000	6,500,000
Dev - CRC	35%	5,000,000	1,750,000	3,250,000
Dev - CAT	35%	5,000,000	1,750,000	3,250,000
Commercial	100%	100,000,000	100,000,000	0
Comm - CRC	100%	20,000,000	20,000,000	0
Comm - CAT	100%	40,000,000	40,000,000	0
Total Premium		200,000,000	171,000,000	29,000,000

Fund	(5) Retention %	(6) Gross Losses	(7) Net Retained Losses (Col 6 x Col 5)	(8) Proportional Ceded Losses (Col 6 - Col 7)	(9) Retained Loss Ratio (Col 7/Col 3)	(10) Underwriting (Gain)Loss (a)
Assigned Risk	20%	40,000,000	8,000,000	32,000,000	200.0%	184,000
Developmental	35%	16,000,000	5,600,000	10,400,000	160.0%	525,000
Dev - CRC	35%	7,000,000	2,450,000	4,550,000	140.0%	210,000
Dev - CAT	35%	4,000,000	1,400,000	2,600,000	80.0%	(157,500)
Commercial	100%	80,000,000	80,000,000	0	80.0%	(18,800,000)
Comm - CRC	100%	18,000,000	18,000,000	0	90.0%	(1,880,000)
Comm - CAT	100%	22,000,000	22,000,000	0	55.0%	(12,500,000)
Total Losses		187,000,000	137,450,000	49,550,000	80.4%	(32,418,500)

Fund	(11) Non-Proportional Ceded Premium (b) (Col 3 - Col 7 - Col 10 "Gain")	(12) Non- Proportional Ceded Losses (b) (Col 3 - Col 7 + Col 10 "Loss")	(13) Final Retained Premium (Col 3 - Col 11)	(14) Final Retained Losses (Col 7 - Col 12)	(15) Final Retained Loss Ratio (Col 14/Col 13)
Assigned Risk	0	3,816,000	4,000,000	4,184,000	104.6%
Developmental	0	1,575,000	3,500,000	4,025,000	115.0%
Dev - CRC	0	490,000	1,750,000	1,960,000	112.0%
Dev - CAT	192,500	0	1,557,500	1,400,000	89.9%
Commercial	1,200,000	0	98,800,000	80,000,000	81.0%
Comm - CRC	120,000	0	19,880,000	18,000,000	90.5%
Comm - CAT	5,500,000	0	34,500,000	22,000,000	63.8%
Total	7,012,500	5,881,000	163,987,500	131,569,000	80.2%

Statutory Issue Paper No. 109

Depreciation of Nonoperating System Software – An Amendment to SSAP No. 16—Electronic Data Processing Equipment and Software

STATUS
Finalized September 12, 2000

Current Authoritative Guidance for Depreciation of Nonoperating System Software: SSAP No. 16R
This issue paper may not be directly related to the current authoritative statement.

Original SSAP from Issue Paper: SSAP No. 79

Type of Issue:
Common

SUMMARY OF ISSUE

1. *SSAP No. 16—Electronic Data Processing Equipment and Software* (SSAP No. 16) requires depreciation of all electronic data processing (EDP) equipment and software for a period not to exceed three years. This requirement is applicable to both operating and nonoperating system software.

2. The purpose of this issue paper is to amend SSAP No. 16 to allow the depreciation of nonoperating system software over the lesser of its useful life or five years rather than three years. The conclusions outlined in this issue paper are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

3. This issue paper amends paragraph 3 and 8 of SSAP No. 16. The following guidance shall be followed for depreciation of EDP equipment, operating system software and nonoperating system software.

4. EDP equipment and operating system software shall be depreciated over the lesser of its useful life or three years. Nonoperating system software shall be depreciated over the lesser of its useful life or five years. In either case, the methods detailed in *SSAP No. 19—Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements* shall be used.

Effective Date

5. EDP equipment and operating system software capitalized prior to January 1, 2001 shall be depreciated over the lesser of its remaining useful life or three years. Nonoperating system software capitalized prior to January 1, 2001 shall be depreciated over the lesser of its remaining useful life or five years.

DISCUSSION

6. A different amortization period for nonoperating system software, often called “applications software,” was not discussed during the initial drafting of SSAP No. 16. The amortization period for admitted EDP and software was discussed as part of the overall debate about whether any or all EDP and operating systems software should be an admitted asset. Amortization of nonoperating system software over a five year period does not violate the Statement of Concepts as illustrated below:

a. Allowing amortization of nonoperating system software over its useful life by an appropriate method requires an insurer to appropriately recognize the expense and its income effect over time;

b. The statutory accounting concept of conservatism is served by continuing to nonadmit nonoperating system software. It is not violated by allowing amortization over a longer period of time than three years if that period is no longer than the software's useful life; and

c. Implementation of SSAP No. 16 as drafted may adversely affect companies and regulators by requiring insurers to accelerate expense recognition in a manner that was not foreseen. A number of states allow amortization of admitted EDP equipment and software over periods as long as 10 years, and current statutory accounting (prior to implementation of SSAP No. 16) provides the option of amortizing nonoperating systems software over its useful life. In addition, the initial draft of Issue Paper No. 16 allowed depreciation of nonadmitted EDP and software against net income as the estimated economic benefit expired. In 1999 insurers made significant purchases of nonoperating system software, in many cases to ensure that the software was not subject to the "year 2000 problem."

7. SSAP No. 16 currently requires EDP equipment and software capitalized prior to January 1, 2001 to be depreciated over the lesser of its remaining useful life or three years; therefore it is important that this issue paper be implemented concurrently with the effective date of SSAP No. 16.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

8. SSAP No. 16 paragraphs 3 and 8:

> 3. EDP equipment and software shall be depreciated for a period not to exceed three years using methods detailed in *SSAP No. 19—Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements*.
>
> 8. EDP equipment and software capitalized prior to January 1, 2001 shall be depreciated over the shorter of its remaining useful life or three years.

Generally Accepted Accounting Principles

9. GAAP does not address the issue of different depreciation periods for operating and nonoperating system software.

Drafting Notes/Comments

- *AICPA Statement of Position 98-1: Accounting for Costs of Computer Software Developed or Obtained for Internal Use* will be addressed in a separate issue paper.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *SSAP No. 16—Electronic Data Processing Equipment and Software*
- *SSAP No. 19—Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements*

Statutory Issue Paper No. 110

Life Contracts, Deposit-Type Contracts and Separate Accounts, Amendments to SSAP No. 51—Life Contracts, SSAP No. 52—Deposit-Type Contracts, and SSAP No. 56—Separate Accounts

STATUS
Finalized September 12, 2000

Original SSAP and Current Authoritative Guidance: SSAP No. 51, SSAP No. 52 and SSAP No. 56

Type of Issue:
Life

SUMMARY OF ISSUE

1. *SSAP No. 51—Life Contracts* (SSAP No. 51) prescribes the accounting treatment for life contracts, *SSAP No. 52—Deposit-Type Contracts* (SSAP No. 52) prescribes the accounting treatment for deposit-type contracts, and *SSAP No. 56—Separate Accounts* (SSAP No. 56) prescribes the accounting treatment for separate accounts.

2. The purpose of this issue paper is to amend SSAP No. 51, SSAP No. 52 and SSAP No. 56 to incorporate the guidance included in appendices A-200, A-695 and A-830 and remain consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

3. Statutory policy reserves for those group annuity contracts or other contracts that, in whole or in part, establish the insurer's obligations by reference to a segregated portfolio of assets not owned by the insurer shall be established in accordance with the guidance in Appendix A-695.

4. Statutory policy reserves for those contracts with nonlevel premiums or benefits, or contracts with secondary guarantees shall be established in accordance with the guidance in Appendix A-830.

5. Statutory policy reserves for those group life contracts utilizing a separate account that meet the requirements outlined in paragraph 1 of Appendix A-200 shall be computed in accordance with the guidance in that appendix.

6. This issue paper amends paragraph 43 of SSAP No. 51 to the following:

> This statement incorporates the requirements of Appendices A-225, A-235, A-585, A-620, A-695, A-812, A-820, A-821, A-822, A-825, A-830 and the Actuarial Standards Board *Actuarial Standards of Practice.*

7. This issue paper amends paragraph 19 of SSAP No. 52 to the following:

> This statement incorporates the requirements of Appendices A-235, A-695, A-820, A-822, A-825, and the Actuarial Standards Board *Actuarial Standards of Practice*.

8. This issue paper amends the first sentence of paragraph 23 of SSAP No. 56 to the following:

> The reserving methodologies and assumptions used in computation of policy reserves shall also meet the provisions of Appendices A-200, A-250, A-270, A-255, A-585, A-588, A-620, A-695, A-820, A-822, and the actuarial guidelines found in Appendix C of this Manual.

9. This issue paper amends paragraph 30 of SSAP No. 56 to the following:

> This statement incorporates the requirements of Appendices A-200, A-250, A-255, A-270, A-585, A-588, A-620, A-695, A-812, A-820, A-821, A-822, A-825, and the Actuarial Standards Board *Actuarial Standards of Practice*.

Effective Date

10. This issue paper is effective for years beginning January 1, 2001. Contracts issued prior to January 1, 2001 shall be accounted for based on the laws and regulations of the domiciliary state.

DISCUSSION

11. Subsequent to the NAIC's adoption of SSAP No. 51, SSAP No. 52, and SSAP No. 56, the NAIC adopted the Separate Accounts Funding Guaranteed Minimum Benefits Under Group Contracts Model Regulation, the Synthetic Guaranteed Investment Contracts Model Regulation, and the Valuation of Life Insurance Policies Model Regulation. Appendices A-200, A-695 and A-830 excerpt the accounting guidance from each of these three model regulations, respectively. This issue paper incorporates the requirements of these appendices.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

12. SSAP No. 51 paragraph 43:

> 43. This statement incorporates the requirements of Appendices A-225, A-235, A-585, A-620, A-812, A-820, A-821, A-822, A-825, and the Actuarial Standards Board *Actuarial Standards of Practice.*

13. SSAP No. 52, paragraph 19:

> 19. This statement incorporates the requirements of Appendices A-235, A-820, A-822, A-825, and the Actuarial Standards Board Actuarial Standards of Practice.

14. SSAP No. 56, paragraph 23:

> 23. The reserving methodologies and assumptions used in computation of policy reserves shall also meet the provisions of Appendices A-250, A-270, A-255, A-585, A-588, A-620, A-820, A-822, and the actuarial guidelines found in Appendix C of this Manual. Where separate account contracts have guaranteed elements, the basis for determining the value of the liability shall be consistent with the basis used for asset values (i.e., valuation interest rates as defined in Appendix A-820 shall be used when assets are recorded as if held in the general account and current interest rates based on market rates shall be used when assets are recorded at market). Further, policy reserves shall be in compliance with those Actuarial Standards of Practice promulgated by the Actuarial Standards Board.

15. SSAP No. 56, paragraph 30:

> 30. This statement incorporates the requirements of Appendices A-250, A-255, A-270, A-585, A-588, A-620, A-812, A-820, A-821, A-822, A-825, and the Actuarial Standards Board *Actuarial Standards of Practice*.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *SSAP No. 50—Classifications and Definitions of Insurance or Managed Care Contracts In Force*
- *SSAP No. 51—Life Contracts*
- *SSAP No. 52—Deposit-Type Contracts*
- *SSAP No. 56—Separate Accounts*

Generally Accepted Accounting Principles

- *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises*
- *FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*
- *FASB Statement No. 120, Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*
- *AICPA Statement of Position 95-1, Accounting for Certain Activities of Mutual Life Insurance Enterprises*
- *FASB Interpretation No. 40, Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance and Other Enterprises, an interpretation of FASB Statements No. 12, 60, 97, and 113*
- *AICPA Practice Bulletin 8, Application of FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments, to Insurance Enterprises*
- *AICPA Audit and Accounting Guide: Stock Life Insurance Companies*

State Regulations

- No additional guidance obtained from state statutes or regulations.

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Statutory Issue Paper No. 111

Software Revenue Recognition

STATUS
Finalized December 4, 2000

Current Authoritative Guidance for Software Revenue Recognition: SSAP No. 16R
This issue paper may not be directly related to the current authoritative statement.

Original SSAP from Issue Paper: SSAP No. 81

Type of Issue:
Common Area

SUMMARY OF ISSUE:

1. During the development of the initial Statements of Statutory Accounting Principles (SSAP) issues related to software revenue recognition were deemed to be not applicable to statutory accounting. Since the development of the initial SSAPs, significant changes have occurred in the world of technology and the opportunities available to insurance entities to license, sell, lease or otherwise market computer software have greatly expanded.

2. Generally Accepted Accounting Principles (GAAP) guidance for software revenue recognition was originally addressed in Statement of Position (SOP) 91-1, *Software Revenue Recognition*. SOP 91-1 was published to provide guidance on applying GAAP to software transactions and to narrow the range of revenue recognition practices that were in use before its issuance. Since the distribution of SOP 91-1, practice issues have been identified that are not addressed adequately in SOP 91-1. Therefore, the American Institute of Certified Public Accountants (AICPA) issued SOP 97-2, *Software Revenue Recognition* to replace SOP 91-1. SOP 97-2 has been modified by the issuance of SOP 98-4, *Deferral of the Effective Date of a Provision of SOP 97-2, Software Revenue Recognition* and SOP 98-9*, Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions*. SOP 97-2 has also been interpreted by the Emerging Issues Task Force (EITF) 00-3, *Application of AICPA Statement of Position 97-2 to Arrangements That Include the Right to Use Software Stored on Another Entity's Hardware*.

3. The purpose of this issue paper is to address SOP 97-2, SOP 98-4, SOP 98-9 and EITF 00-3 and establish statutory accounting principles that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION:

4. This issue paper adopts SOP 97-2 paragraphs 6 through 91 with certain modifications, SOP 98-9 paragraphs 6 through 8 and EITF 00-3. This issue paper rejects SOP 98-4 as not applicable because the effective date of the corresponding SSAP is expected to be January 1, 2002.

5. The modifications to SOP 97-2 are as follows:

   a. Paragraph 10 is amended to require that entities follow the guidance outlined in *SSAP No. 5—Liabilities, Contingencies and Impairments of Assets* rather than *Statement of Financial Accounting Standard* (FAS) *No. 5*, *Accounting for Contingencies*;

b. Paragraph 33 is amended to remove the reference to *Technical Bulletin* (TB) *No. 79-10: Fiscal Funding Clauses in Lease Agreements*;

c. Paragraph 57 is amended to remove the reference to *FAS No. 86*, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*;

d. Paragraph 73 is rejected as not applicable to statutory accounting.

Effective Date and Transition

6. Upon adoption of this issue paper, the NAIC will release a Statement of Statutory Accounting Principle (SSAP) for comment. The SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the Accounting Practices and Procedures Manual should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will contain an effective date of years beginning on or after January 1, 2002.

DISCUSSION:

7. The modifications to SOP 97-2 were made in order to maintain consistency with current statutory accounting principles and the Statement of Concepts.

a. Paragraph 10 is amended because it includes a reference to FAS No. 5, *Accounting for Contingencies*. SSAP No. 5—*Liabilities, Contingencies and Impairments of Assets* contains the authoritative statutory accounting for loss contingencies;

b. Paragraph 33 is amended because it includes a reference to TB No. 79-10. The removal of the reference does not change the accounting prescribed in SOP 97-2 and it eliminates any possible conflict with the fact that TB No. 79-10 is rejected by SSAP No. 22 — *Leases*;

c. Paragraph 57 was amended because it includes a reference to FAS No. 86. Paragraph 57 is not impacted by the removal of FAS No. 86 because it is used in the context of a piece of historical evidence. SSAP No. 17 - *Preoperating and Research and Development Costs* requires all such costs to be expensed, therefore there is no capitalization experience to analyze;

d. Paragraph 73 was deemed to be not applicable because of the requirement to follow FAS No. 86 in the case of capitalizing funded software-development costs. This approach is inconsistent with the provisions of SSAP No. 17 and the requirement to expense such costs. The directive to expense such costs eliminates the need for this paragraph.

8. SOP 98-4 as well as the effective date paragraphs of SOP 97-2 and SOP 98-9 were not adopted in this issue paper as it is expected that the effective date for the SSAP will be January 1, 2002.

9. EITF 00-3 was adopted because it supports the principles adopted in SOP 97-2.

10. SOP 97-2 includes several references to GAAP pronouncements that were deemed not applicable in the initial SSAPs. This includes Accounting Research Bulletin No. 45, *Long-Term Construction-Type Contracts*, SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*, FAS No. 48, *Revenue Recognition When Right of Return Exists* and FAS 68, *Research and*

Development Arrangements. These GAAP pronouncements are deemed to be applicable to statutory accounting only to the extent that SOP 97-2 references them.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE:

Statutory Accounting

11. In general, the initial SSAPs deemed the relevant GAAP guidance to be not applicable to statutory accounting. As discussed above, technology and the environment have changed significantly since the original SSAPs were adopted and therefore guidance is now needed.

Generally Accepted Accounting Principles

12. *AICPA Statement of Position 97-2*, *Software Revenue Recognition* provides the following:

> Conclusions
>
> .06 The following conclusions should be read in conjunction with the Basis for Conclusions section, beginning with paragraph .93 of this SOP, and the examples in appendix A, Examples of the Application of Certain Provisions of this SOP.
>
> Basic Principles
>
> .07 Software arrangements range from those that provide a license for a single software product to those that, in addition to the delivery of software or a software system, require significant production, modification, or customization of software. If an arrangement to deliver software or a software system, either alone or together with other products or services, requires significant production, modification, or customization of software, the entire arrangement should be accounted for in conformity with Accounting Research Bulletin (ARB) No. 45, Long-Term Construction-Type Contracts, using the relevant guidance herein, and in SOP 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts.
>
> .08 If the arrangement does not require significant production, modification, or customization of software, revenue should be recognized when all of the following criteria are met.
>
> - Persuasive evidence of an arrangement exists.
> - Delivery has occurred.
> - The vendor’s fee is fixed or determinable.
> - Collectibility is probable.
>
> .09 Software arrangements may provide licenses for multiple software deliverables (for example, software products, upgrades/enhancements, PCS, or services), which are termed multiple elements. A number of the elements may be described in the arrangement as being deliverable only on a when-and-if-available basis. When-and-if-available deliverables should be considered in determining whether an arrangement includes multiple elements. Accordingly, the requirements of this SOP with respect to arrangements that consist of multiple elements should be applied to all additional products and services specified in the arrangement, including those described as being deliverable only on a when-and-if-available basis.
>
> .10 If an arrangement includes multiple elements, the fee should be allocated to the various elements based on vendor-specific objective evidence of fair value, regardless of any separate prices stated within the contract for each element. Vendor-specific objective evidence of fair value is limited to the following:
>
> - The price charged when the same element is sold separately
> - For an element not yet being sold separately, the price established by management having the relevant authority; it must be probable that the price, once established, will not change before the separate introduction of the element into the marketplace
>
> The amount allocated to undelivered elements is not subject to later adjustment. However, if it becomes probable that the amount allocated to an undelivered element will result in a loss on

that element of the arrangement, the loss should be recognized pursuant to FASB Statement No. 5, Accounting for Contingencies. When a vendor's pricing is based on multiple factors such as the number of products and the number of users, the amount allocated to the same element when sold separately must consider all the factors of the vendor's pricing structure.

.11 If a discount is offered in a multiple-element arrangement, a proportionate amount of that discount should be applied to each element included in the arrangement based on each element's fair value without regard to the discount. However, as discussed in paragraph .37, no portion of the discount should be allocated to any upgrade rights. Moreover, to the extent that a discount exists, the residual method described in paragraph .12 attributes that discount entirely to the delivered elements.

.12 If sufficient vendor-specific objective evidence does not exist for the allocation of revenue to the various elements of the arrangement, all revenue from the arrangement should be deferred until the earlier of the point at which (a) such sufficient vendor-specific objective evidence does exist or (b) all elements of the arrangement have been delivered. The following exceptions to this guidance are provided.

- If the only undelivered element is PCS, the entire fee should be recognized ratably (see paragraphs .56 through .62).
- If the only undelivered element is services that do not involve significant production, modification, or customization of software (for example, training or installation), the entire fee should be recognized over the period during which the services are expected to be performed (see paragraphs .63 through .71).
- If the arrangement is in substance a subscription, the entire fee should be recognized ratably (see paragraphs .48 and .49).
- If the fee is based on the number of copies, the arrangement should be accounted for in conformity with paragraphs .43 through .47.
- There may be instances in which there is vendor-specific objective evidence of the fair values of all undelivered elements in an arrangement but vendor-specific objective evidence of fair value does not exist for one or more of the delivered elements in the arrangement. In such instances, the fee should be recognized using the residual method, provided that (a) all other applicable revenue recognition criteria in this SOP are met and (b) the fair value of all of the undelivered elements is less than the arrangement fee. Under the residual method, the arrangement fee is recognized as follows: (a) the total fair value of the undelivered elements, as indicated by vendor-specific objective evidence, is deferred and (b) the difference between the total arrangement fee and the amount deferred for the undelivered elements is recognized as revenue related to the delivered elements.

.13 The portion of the fee allocated to an element should be recognized as revenue when the criteria in paragraph .08 of this SOP are met with respect to the element. In applying those criteria, the delivery of an element is considered not to have occurred if there are undelivered elements that are essential to the functionality of the delivered element, because the customer would not have the full use of the delivered element.

.14 No portion of the fee (including amounts otherwise allocated to delivered elements) meets the criterion of collectibility if the portion of the fee allocable to delivered elements is subject to forfeiture, refund, or other concession if any of the undelivered elements are not delivered. In order for the revenue related to an arrangement to be considered not subject to forfeiture, refund, or other concession, management must intend not to provide refunds or concessions that are not required under the provisions of the arrangement. All available evidence should be considered to determine whether the evidence persuasively indicates that the revenue is not subject to forfeiture, refund, or other concession. Although no single item of evidence may be persuasive, the following additional items should be considered:

- Acknowledgment in the arrangement of products not currently available or not to be delivered currently
- Separate prices stipulated in the arrangement for each deliverable element

- Default and damage provisions as defined in the arrangement
- Enforceable payment obligations and due dates for the delivered elements that are not dependent on the delivery of the future deliverable elements, coupled with the intent of the vendor to enforce rights of payment
- Installation and use of the delivered software
- Support services, such as telephone support, related to the delivered software being provided currently by the vendor

Regardless of the preceding, the vendor's historical pattern of making refunds or other concessions that were not required under the original provisions (contractual or other) of other arrangements should be considered more persuasive than terms included in the arrangement that indicate that no concessions are required.

Evidence of an Arrangement

.15 Practice varies with respect to the use of written contracts. Although a number of sectors of the industry rely upon signed contracts to document arrangements, other sectors of the industry that license software (notably the packaged software sector) do not.

.16 If the vendor operates in a manner that does not rely on signed contracts to document the elements and obligations of an arrangement, the vendor should have other forms of evidence to document the transaction (for example, a purchase order from a third party or on-line authorization). If the vendor has a customary business practice of utilizing written contracts, evidence of the arrangement is provided only by a contract signed by both parties.

.17 Even if all other requirements set forth in this SOP for the recognition of revenue are met (including delivery), revenue should not be recognized on any element of the arrangement unless persuasive evidence of an arrangement exists.

Delivery

.18 The second criterion in paragraph .08 for revenue recognition is delivery. The principle of not recognizing revenue before delivery applies whether the customer is a user or a reseller. Except for arrangements in which the fee is a function of the number of copies, delivery is considered to have occurred upon the transfer of the product master or, if the product master is not to be delivered, upon the transfer of the first copy. For software that is delivered electronically, the delivery criterion of paragraph .08 is considered to have been met when the customer either (a) takes possession of the software via a download (that is, when the customer takes possession of the electronic data on its hardware), or (b) has been provided with access codes that allow the customer to take immediate possession of the software on its hardware pursuant to an agreement or purchase order for the software. In such cases, revenue should be recognized if the other criteria of paragraph .08 have been satisfied.

.19 Paragraphs .20 through .25 provide guidance on determining whether delivery is considered to have occurred in certain kinds of software transactions.

Customer Acceptance

.20 After delivery, if uncertainty exists about customer acceptance of the software, license revenue should not be recognized until acceptance occurs.

Determining Delivery—Multiple Copies of Software Products Versus Multiple Licenses

.21 Arrangements to use multiple copies of a software product under site licenses with users and to market multiple copies of a software product under similar arrangements with resellers should be distinguished from arrangements to use or market multiple single licenses of the same software.

- In the former kind of arrangement, duplication is incidental to the arrangement and the delivery criterion is met upon the delivery of the first copy or product master. The vendor may be obligated to furnish up to a specified number of copies of the software, but only if the copies are requested by the user. The licensing fee is payable even if no additional copies are requested by the user or reseller. If the other criteria in this SOP for revenue recognition are met, revenue should be recognized upon delivery of the first copy or product master. The estimated costs of duplication should be accrued at that time.

- In the latter kind of arrangement, the licensing fee is a function of the number of copies delivered to, made by, or deployed by the user or reseller. Delivery occurs and revenue should be recognized as the copies are made by the user or sold by the reseller if the other criteria in this SOP for revenue recognition are met.

Delivery Other Than to the Customer

.22 Delivery should not be considered complete unless the destination to which the software is shipped is the customer's place of business or another site specified by the customer. In addition, if a customer specifies an intermediate site but a substantial portion of the fee is not payable until the delivery by the vendor to another site specified by the customer, revenue should not be recognized until the delivery is made to that other site.

Delivery Agents

.23 Vendors may engage agents, often referred to as fulfillment houses, to either duplicate and deliver or only deliver software products to customers. Revenue from transactions involving delivery agents should be recognized when the software is delivered to the customer. Transferring the fulfillment obligation to an agent of the vendor does not relieve the vendor of the responsibility for delivery. This is the case even if the vendor has no direct involvement in the actual delivery of the software product to the customer.

Authorization Codes

.24 In a number of software arrangements, vendors use authorization codes, commonly referred to as keys, to permit customer access to software that otherwise would be restricted. Keys are used in a variety of ways and may serve different purposes. For example, permanent keys may be used to control access to the software, or additional permanent keys may be necessary for the duplication of the software. Temporary keys may be used for the same purposes and also may be used to enhance the vendor's ability to collect payment or to control the use of software for demonstration purposes.

.25 In software arrangements involving the use of keys, delivery of a key is not necessarily required to satisfy the vendor's delivery responsibility. The software vendor should recognize revenue on delivery of the software if all other requirements for revenue recognition under this SOP and all of the following conditions are met.

- The customer has licensed the software and the vendor has delivered a version of the software that is fully functional except for the permanent key or the additional keys (if additional keys are used to control the reproduction of the software).
- The customer's obligation to pay for the software and the terms of payment, including the timing of payment, are not contingent on delivery of the permanent key or additional keys (if additional keys are used to control the reproduction of the software).
- The vendor will enforce and does not have a history of failing to enforce its right to collect payment under the terms of the original arrangement.

In addition, if a temporary key is used to enhance the vendor's ability to collect payment, the delivery of additional keys, whether temporary or permanent, is not required to satisfy the vendor's delivery responsibility if (a) the above conditions are met and (b) the use of a temporary key in such circumstances is a customary practice of the vendor. Selective issuance of temporary keys might indicate that collectibility is not probable or that the software is being used only for demonstration purposes.

Fixed or Determinable Fees and Collectibility

.26 The other prerequisites in paragraph .08 for revenue recognition are that (a) the vendor's fee is fixed or determinable and (b) collectibility is probable. A software licensing fee is not fixed or determinable if the amount is based on the number of units distributed or copied, or the expected number of users of the product. Revenue recognition for variable-pricing arrangements is discussed in paragraphs .43 through .47 of this SOP. Additionally, if an arrangement includes (a) rights of return or (b) rights to refunds without return of the software, FASB Statement No. 48 requires that conditions that must be met in order for the vendor to recognize revenue include that the amount of future returns or refunds can be reasonably estimated.

Factors That Affect the Determination of Whether a Fee is Fixed or Determinable and Collectible

.27 A number of arrangements that call for fixed or determinable payments, including minimum royalties or license fees from resellers, specify a payment period that is short in relation to the period during which the customer is expected to use or market the related products. Other arrangements have payment terms that extend over a substantial portion of the period during which the customer is expected to use or market the related products. Because a product's continuing value may be reduced due to the subsequent introduction of enhanced products by the vendor or its competitors, the possibility that the vendor still may provide a refund or concession to a creditworthy customer to liquidate outstanding amounts due under the original terms of the arrangement increases as payment terms become longer.

.28 For the reason cited in paragraph .27 any extended payment terms in a software licensing arrangement may indicate that the fee is not fixed or determinable. Further, if payment of a significant portion of the software licensing fee is not due until after expiration of the license or more than twelve months after delivery, the licensing fee should be presumed not to be fixed or determinable. However, this presumption may be overcome by evidence that the vendor has a standard business practice of using long-term or installment contracts and a history of successfully collecting under the original payment terms without making concessions. In such a situation, a vendor should consider such fees fixed or determinable and should recognize revenue upon delivery of the software, provided all other conditions for revenue recognition in this SOP have been satisfied.

.29 If it cannot be concluded that a fee is fixed or determinable at the outset of an arrangement, revenue should be recognized as payments from customers become due (assuming all other conditions for revenue recognition in this SOP have been satisfied).

.30 For reseller arrangements, the following factors also should be considered in evaluating whether the fixed or determinable fee and collectibility criteria for revenue recognition are met.

- Business practices, the reseller's operating history, competitive pressures, informal communications, or other factors indicate that payment is substantially contingent on the reseller's success in distributing individual units of the product.
- Resellers are new, undercapitalized, or in financial difficulty and may not demonstrate an ability to honor a commitment to make fixed or determinable payments until they collect cash from their customers.
- Uncertainties about the potential number of copies to be sold by the reseller may indicate that the amount of future returns cannot be reasonably estimated on delivery; examples of such factors include the newness of the product or marketing channel, competitive products, or dependence on the market potential of another product offered (or anticipated to be offered) by the reseller.
- Distribution arrangements with resellers require the vendor to rebate or credit a portion of the original fee if the vendor subsequently reduces its price for a product and the reseller still has rights with respect to that product (sometimes referred to as price protection). If a vendor is unable to reasonably estimate

> future price changes in light of competitive conditions, or if significant uncertainties exist about the vendor's ability to maintain its price, the arrangement fee is not fixed or determinable. In such circumstances, revenue from the arrangement should be deferred until the vendor is able to reasonably estimate the effects of future price changes and the other conditions of this SOP have been satisfied.

.31 Customer Cancellation Privileges. Fees from licenses cancelable by customers are neither fixed nor determinable until the cancellation privileges lapse. Fees from licenses with cancellation privileges expiring ratably over the license period are considered to become determinable ratably over the license period as the cancellation privileges lapse. In applying the provisions of this paragraph, obligations related to warranties for defective software, including warranties that are routine, short-term, and relatively minor, should be accounted for in conformity with FASB Statement No. 5. Additionally, short-term rights of return, such as thirty-day money-back guarantees, should not be considered cancellation privileges; the related returns should be accounted for in conformity with FASB Statement No. 48.

.32 Fiscal Funding Clauses. Fiscal funding clauses sometimes are found in software license arrangements in which the licensees are governmental units. Such clauses generally provide that the license is cancelable if the legislature or funding authority does not appropriate the funds necessary for the governmental unit to fulfill its obligations under the licensing arrangement.

.33 Consistent with FASB Technical Bulletin No. 79-10, Fiscal Funding Clauses in Lease Agreements, a software licensing arrangement with a governmental unit containing a fiscal funding clause should be evaluated to determine whether the uncertainty of a possible license arrangement cancellation is a remote contingency. If the likelihood is assessed as remote, the software licensing arrangement should be considered noncancelable. Such an assessment should include the factors discussed in paragraphs .27 and .28 of this SOP. If the likelihood is assessed as other than remote, the license should be considered cancelable, thus precluding revenue recognition. A fiscal funding clause with a customer other than a governmental unit that is required to include such a clause creates a contingency that precludes revenue recognition until the requirements of the clause and all other provisions of this SOP have been satisfied.

Multiple-Element Arrangements

.34 As discussed in paragraph .09, multiple-element arrangements to which contract accounting does not apply may include customer rights to any combination of additional software deliverables, services, or PCS. If contract accounting does not apply, individual elements in such arrangements should be accounted for in accordance with paragraphs .08 through .14. Paragraphs .35 through .73 provide guidance on the application of those paragraphs to multiple-element arrangements.

Additional Software Deliverables and Rights to Exchange or Return Software

.35 As part of a multiple-element arrangement, a vendor may agree to deliver software currently and to deliver additional software in the future. The additional deliverables may include upgrades/enhancements or additional software products. Additionally, a vendor may provide the customer with the right to exchange or return software, including the right to transfer software from one hardware platform or operating system to one or more other platforms or operating systems (a platform-transfer right).

.36 Upgrades/enhancements. As part of a multiple-element arrangement, a vendor may agree to deliver software currently and provide the customer with an upgrade right for a specified upgrade/enhancement. The upgrade right may be evidenced by a specific agreement, commitment, or the vendor's established practice. (Rights to receive unspecified upgrades/enhancements on a when-and-if-available basis are PCS, as it has been redefined in this SOP.) The upgrade right should be accounted for as a separate element in accordance with paragraphs .08 through .14. Guidance on the application of those paragraphs to multiple-element software arrangements that include upgrade rights is given in paragraphs .37 and .38.

.37 If a multiple-element arrangement includes an upgrade right, the fee should be allocated between the elements based on vendor-specific objective evidence of fair value. The fee allocated to the upgrade right is the price for the upgrade/enhancement that would be charged to existing users of the software product being updated. If the upgrade right is included in a multiple-element arrangement on which a discount has been offered (see paragraph .11), no portion of the discount should be allocated to the upgrade right. If sufficient vendor-specific evidence exists to reasonably estimate the percentage of customers that are not expected to exercise the upgrade right, the fee allocated to the upgrade right should be reduced to reflect that percentage. This estimated percentage should be reviewed periodically. The effect of any change in that percentage should be accounted for as a change in accounting estimate.

.38 The amount of the fee allocated to the upgrade right should be recognized as revenue when the conditions in paragraphs .08 through .14 are met. If sufficient vendor-specific objective evidence does not exist for the allocation of the fee to the upgrade right, revenue from the arrangement should be deferred until the earlier of the point at which (a) such sufficient vendor-specific objective evidence does exist or (b) all elements of the arrangement have been delivered.

.39 Additional Software Products. As part of a multiple-element arrangement, a vendor may agree to deliver software currently and deliver specified additional software products in the future. The rights to these additional products may be included either in the terms of a PCS arrangement or in a separate agreement. Even if the rights to the additional software products are included in a PCS arrangement, the revenue allocable to the additional software products should be accounted for separately from the PCS arrangement as an element of a multiple-element arrangement.

.40 Multiple-element arrangements that include rights to undelivered additional software products that are not subscriptions (see paragraphs .48 and .49) should be accounted for in accordance with paragraphs .08 through .14 of this SOP. Guidance on the application of those paragraphs to such arrangements is provided in paragraphs .41 through .47 below.

.41 The fee from the arrangement should be allocated among the products based on vendor-specific objective evidence of fair value. The allocation should be based on the relative sales prices (determined pursuant to paragraphs .10 and .11 of this SOP) of the products. If vendor-specific objective evidence of fair value does not exist, paragraph .12 of this SOP requires that all revenue from the arrangement be deferred until the earlier of the point at which (a) such sufficient vendor-specific objective evidence does exist or (b) all elements of the arrangement have been delivered. The fee allocated to the additional software products should not be reduced by the percentage of any customers that are not expected to exercise the right to receive additional software products.

.42 If the arrangement is based on a price per product (not a price per copy), the portion of the fee allocated to a product should be recognized as revenue when the product is delivered, assuming all other provisions of paragraphs .08 through .14 of this SOP are met.

.43 Some fixed fee license or reseller arrangements provide customers with the right to reproduce or obtain copies at a specified price per copy (rather than per product) of two or more software products up to the total amount of the fixed fee. A number of the products covered by the arrangement may not be deliverable or specified at the inception of the arrangement. Although the price per copy is fixed at the inception of the arrangement, an allocation of the arrangement fee to the individual products generally cannot be made, because the total revenue allocable to each software product is unknown and depends on the choices to be made by the customer and, sometimes, future development activity while the arrangement is in effect. Nevertheless, as discussed in paragraph .46 of this SOP, in certain situations, revenue can be allocated to the products that are undeliverable or not specified at the inception of the arrangement.

.44 In arrangements in which no allocation can be made, until the first copy or product master of each product covered by the arrangement has been delivered to the customer assuming the provisions of paragraphs .08 through .14 of this SOP are met, revenue should be recognized as copies of delivered products either (a) are reproduced by the customer or (b) are furnished to the customer if the vendor is duplicating the software. Once the vendor has delivered the product master or the first copy of all products covered by the arrangement, any licensing fees not previously recognized should be recognized. (At that point, only duplication of the software is required to satisfy the vendor's delivery requirement. As discussed in paragraph .21 of this SOP, duplication of the software is incidental to the arrangement, and delivery is deemed to have occurred upon delivery of the product master or first copy.) When the arrangement terminates, the vendor should recognize any licensing fees not previously recognized.

.45 The revenue from the kind of arrangements discussed in paragraph .44 should not be recognized fully until at least one of the following conditions is met.

- Delivery is complete for all products covered by the arrangement.
- The aggregate revenue attributable to all copies of the software products delivered is equal to the fixed fee, provided that the vendor is not obligated to deliver additional software products under the arrangement.

.46 Nevertheless, certain arrangements that include products that are not deliverable at the inception impose a maximum number of copies of the undeliverable product(s) to which the customer is entitled. In such arrangements, a portion of the arrangement fee should be allocated to the undeliverable product(s). This allocation should be made assuming that the customer will elect to receive the maximum number of copies of the undeliverable product(s).

.47 The revenue allocated to the delivered products should be recognized when the product master or first copy is delivered. If, during the term of the arrangement, the customer reproduces or receives enough copies of these delivered products so that revenue allocable to the delivered products exceeds the revenue previously recognized, such additional revenue should be recognized as the copies are reproduced or delivered. The revenue allocated to the undeliverable product(s) should be reduced by a corresponding amount.

.48 As part of a multiple-element arrangement with a user, a vendor may agree to deliver software currently and to deliver unspecified additional software products in the future (including unspecified platform transfer rights that do not qualify for exchange accounting as described in paragraphs .50 through .55). For example, the vendor may agree to deliver all new products to be introduced in a family of products over the next two years. These arrangements are similar to arrangements that include PCS in that future deliverables are unspecified. Nevertheless, they are distinguished from arrangements that include PCS because the future deliverables are products, not unspecified upgrades/enhancements.

.49 The software elements of the kinds of arrangements discussed in paragraph .48 should be accounted for as subscriptions. No allocation of revenue should be made among any of the software products, and all software product-related revenue from the arrangement should be recognized ratably over the term of the arrangement beginning with delivery of the first product. If the term of the arrangement is not stated, the revenue should be recognized ratably over the estimated economic life of the products covered by the arrangement, beginning with delivery of the first product. An intent on the part of the vendor not to develop new products during the term of the arrangement does not relieve the vendor of the requirement to recognize revenue ratably over the term of the arrangement, beginning with the delivery of the first product.

.50 Rights to Exchange or Return Software. As part of an arrangement, a software vendor may provide the customer with the right to return software or to exchange software for products with no more than minimal differences in price, functionality, or features. The accounting for returns is significantly different from the accounting for exchanges. Although it is sometimes difficult to determine whether a transaction is a return or exchange of software, the fact that the software is not returned physically does not preclude accounting for the transaction as either an exchange or as a return. If the software is not returned physically and the customer contractually is entitled to continue to use the previously delivered software, the arrangement should be accounted for in the manner prescribed in the section herein entitled “Additional Software Products” (see paragraphs .39 through .49). If the software is not returned physically and the customer contractually is not entitled to continue to use the previously delivered software, the transaction should be accounted for either as a return or as an exchange, as discussed in the following paragraphs.

.51 If the rights discussed in the previous paragraph are offered to users (but not resellers), the exchanges are analogous to “exchanges by ultimate customers of one item for another of the same kind, quality, and price . . . [that] are not considered returns" described in footnote 3 of FASB Statement No. 48. Conversely, exchanges by users of software products for dissimilar software products or for similar software products with more than minimal differences in price, functionality, or features are considered returns, and revenue related to arrangements that provide users with the rights to make such exchanges should be accounted for in conformity with FASB Statement No. 48. If the other product(s) is not available at the time the initial product is delivered, there should be persuasive evidence that demonstrates there will be no more than minimal differences in price, features, or functionality among the products in order for the right to qualify as a right to exchange. Additionally, if the vendor expects to incur a significant amount of development costs related to the other product, the other product should be considered to have more than a minimal difference in functionality.

.52 As part of a multiple-element arrangement, a vendor may grant a user a platform-transfer right. Depending on the circumstances, the exercise of a platform-transfer right may represent an exchange, a return, or additional software products for accounting purposes. If the customer contractually is entitled to continue to use the software that was delivered originally (in addition to the software that is to be delivered for the new platform), the platform transfer right should be accounted for in the manner prescribed in the section herein entitled “Additional Software Products” (see paragraphs .39 through .49).

.53 If, as part of a multiple-element arrangement, a vendor offers a user (not a reseller) a platform-transfer right, and the provisions of paragraphs .08 through .14 of this SOP are met, the revenue from the software license should be recognized upon the initial delivery of the software, and the exercise of the platform-transfer right should be treated as an exchange, if the platform-transfer right —

- Is for the same product (see paragraph .54)
- Does not increase the number of copies or concurrent users of the software product available under the license arrangement.

.54 Products are considered to be the same product if there are no more than minimal differences among them in price, features, and functions, and if they are marketed as the same product, even though there may be differences arising from environmental variables such as operating systems, databases, user interfaces, and platform scales. Indicators of "marketed as the same product" include (a) the same product name (although version numbers may differ) and (b) a focus on the same features and functions.

.55 As part of their standard sales terms or as a matter of practice, vendors may grant resellers the rights to exchange unsold software for other software (including software that runs on a different hardware platform or operating system). Because the reseller is not the ultimate customer (see paragraph .51), such exchanges, including those referred to as stock balancing arrangements, should be accounted for as returns. Arrangements that grant rights to make such exchanges should be accounted for in conformity with FASB Statement No. 48, even if the vendors require the resellers to purchase additional software to exercise the exchange rights.

Postcontract Customer Support

.56 Software arrangements may include the right to PCS. PCS includes the right to receive PCS services or unspecified upgrades/enhancements, or both, offered to users or resellers. A vendor may develop historical patterns of regularly providing all customers or certain kinds of customers with the services or unspecified upgrades/enhancements normally associated with PCS, or may anticipate doing so, even though there is no written contractual obligation or the stipulated PCS term commences at some date after delivery. In those situations, an implied PCS arrangement exists that commences upon product delivery. For purposes of applying the guidance in this SOP, PCS includes a vendor's expected performance based on such patterns, even if performance is entirely at the vendor's discretion and not pursuant to a formal agreement.

.57 If a multiple-element software arrangement includes explicit or implicit rights to PCS, the total fees from the arrangement should be allocated among the elements based on vendor-specific objective evidence of fair value, in conformity with paragraph .10. The fair value of the PCS should be determined by reference to the price the customer will be required to pay when it is sold separately (that is, the renewal rate). The portion of the fee allocated to PCS should be recognized as revenue ratably over the term of the PCS arrangement, because the PCS services are assumed to be provided ratably. However, revenue should be recognized over the period of the PCS arrangement in proportion to the amounts expected to be charged to expense for the PCS services rendered during the period if—

- Sufficient vendor-specific historical evidence exists demonstrating that costs to provide PCS are incurred on other than a straight-line basis. In making this determination, the vendor should take into consideration allocated portions of cost accounted for as research and development (R&D) costs and the amortization of costs related to the upgrade-enhancement capitalized in conformity with FASB Statement No. 86, Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed. Such costs should be considered as part of the costs to provide PCS.
- The vendor believes that it is probable that the costs incurred in performing under the current arrangement will follow a similar pattern.

Because the timing, frequency, and significance of unspecified upgrades/enhancements can vary considerably, the point at which unspecified upgrades/enhancements are expected to be delivered should not be used to support income recognition on other than a straight-line basis.

.58 If sufficient vendor-specific objective evidence does not exist to allocate the fee to the separate elements and the only undelivered element is PCS, the entire arrangement fee should be recognized ratably over (a) the contractual PCS period (for those arrangements with explicit rights to PCS) or (b) the period during which PCS is expected to be provided (for those arrangements with implicit rights to PCS).

.59 PCS revenue may be recognized together with the initial licensing fee on delivery of the software if all of the following conditions are met.

a. The PCS fee is included with the initial licensing fee.
b. The PCS included with the initial license is for one year or less.
c. The estimated cost of providing PCS during the arrangement is insignificant.
d. Unspecified upgrades/enhancements offered during PCS arrangements historically have been and are expected to continue to be minimal and infrequent.

If PCS revenue is recognized upon the delivery of the software, the vendor must accrue all estimated costs of providing the services, including upgrades/enhancements. Upgrades/enhancements are not developed solely for distribution to PCS customers; revenues are expected to be earned from providing the enhancements to other customers as well. Therefore, costs should be allocated between PCS arrangements and other licenses.

.60 A determination that unspecified upgrades/enhancements offered during the PCS arrangement are expected to be minimal and infrequent should be evidenced by the patterns of minimal and infrequent unspecified upgrades/enhancements offered in previous PCS arrangements. A conclusion that unspecified upgrades/enhancements are expected to be minimal and infrequent should not be reached simply because unspecified upgrades/enhancements have been or are expected to be offered less frequently than on an annual basis. Regardless of the vendor's history of offering unspecified upgrades/enhancements to initial licensees, PCS should be accounted for separately from the initial licensing fee if the vendor expects to offer upgrades/enhancements that are greater than minimal or more than infrequent to the users or resellers of the licensed software during the PCS arrangement.

.61 Postdelivery Telephone Support at No Additional Charge. Postdelivery telephone support provided to users by the vendor at no additional charge should be accounted for as PCS, in conformity with this SOP, regardless of whether the support is provided explicitly under the licensing arrangement. Although such telephone support may be offered or available for periods exceeding one year, if the vendor has established a history of providing substantially all the telephone support within one year of the licensing or sale of the software, the PCS may be considered to have a term of one year or less in applying paragraph .59, item (b) of this SOP. Accordingly, revenue allocable to telephone support may be recognized together with the initial licensing fee on delivery of the software if all the conditions in paragraph .59 of this SOP are met. This provision applies only to telephone support provided at no additional charge. If revenue allocable to telephone support is recognized together with the licensing fee on delivery, the vendor should accrue the estimated cost of providing that support.

.62 PCS Granted by Resellers. An arrangement in which a vendor grants a reseller the right to provide unspecified upgrades/enhancements to the reseller’s customers is an implied PCS arrangement between the vendor and the reseller, even if the vendor does not provide direct telephone support to the reseller’s customers. If sufficient vendor-specific objective evidence does not exist to allocate the fee to the software and the PCS, revenue from both the licensing arrangement and the PCS should be recognized ratably over the period during which PCS is expected to be provided.

Services

.63 Certain arrangements include both software and service elements (other than PCS-related services). The services may include training, installation, or consulting. Consulting services often include implementation support, software design or development, or the customization or modification of the licensed software.

.64 If an arrangement includes such services, a determination must be made as to whether the service element can be accounted for separately as the services are performed. Paragraph .65 discusses the criteria that must be considered in making such a determination. If the nature of the services is such that the service element does not qualify for separate accounting as a service, contract accounting must be applied to both the software and service elements included in the arrangement. Paragraphs .74 through .91 of this SOP address the application of contract accounting to software arrangements.

.65 In order to account separately for the service element of an arrangement that includes both software and services, sufficient vendor-specific objective evidence of fair value must exist to permit allocation of the revenue to the various elements of the arrangement (as discussed in paragraphs .10 and .12). Additionally, the services (a) must not be essential to the functionality of any other element of the transaction and (b) must be described in the contract such that the total price of the arrangement would be expected to vary as the result of the inclusion or exclusion of the services.

.66 If an arrangement includes services that meet the criteria of paragraph .65 for separate accounting, revenue should be allocated among the service and software elements of the contract. This allocation should be based on vendor-specific objective evidence of fair values. (Fair values are not necessarily the same as any separate prices stated for the separate elements of the arrangement.) Revenue allocated to the service element should be recognized as the services are performed or, if no pattern of performance is discernible, on a straight-line basis over the period during which the services are performed.

.67 If vendor-specific objective evidence of the fair value does not exist to allocate a portion of the fee to the service element, and the only undelivered element is services that do not involve significant production, modification, or customization of the software (for example, training or installation), the entire arrangement fee should be recognized as the services are performed. If no pattern of performance is discernible, the entire arrangement fee should be recognized on a straight-line basis over the period during which the services are performed.

.68 An important factor to consider in determining whether the services are essential to the functionality of any other element is whether the software included in the arrangement is considered core or off-the-shelf software. Core software is software that a vendor uses in creating other software. It is not sold as is because customers cannot use it unless it is customized to meet system objectives or customer specifications. Off-the-shelf software is software that is marketed as a stock item that can be used by customers with little or no customization.

.69 Software should be considered off-the-shelf software if it can be added to an arrangement with insignificant changes in the underlying code and it could be used by the customer for the customer's purposes upon installation. Actual use by the customer and performance of other elements of the arrangement is not required to demonstrate that the customer could use the software off-the-shelf. If significant modifications or additions to the off-the-shelf software are necessary to meet the customer's purpose (for example, changing or making additions to the software, or because it would not be usable in its off-the-shelf form in the customer's environment), the software should be considered core software for purposes of that arrangement. If the software that is included in the arrangement is not considered to be off-the-shelf software, or if significant modifications or additions to the off-the-shelf software are necessary to meet the customer's functionality, no element of the arrangement would qualify for accounting as a service, and contract accounting should be applied to both the software and service elements of the arrangement.

.70 Factors indicating that the service element is essential to the functionality of the other elements of the arrangement, and consequently should not be accounted for separately, include the following.

- The software is not off-the-shelf software.
- The services include significant alterations to the features and functionality of the off-the-shelf software.
- Building complex interfaces is necessary for the vendor's software to be functional in the customer's environment.
- The timing of payments for the software is coincident with performance of the services.
- Milestones or customer-specific acceptance criteria affect the realizability of the software-license fee.

.71 Judgment is required in determining whether the obligation to provide services in addition to the delivery of software should be accounted for separately as a service element. Services that qualify for accounting as a service element of a software arrangement always are stated separately and have one or more of the following characteristics.

- The services are available from other vendors.
- The services do not carry a significant degree of risk or unique acceptance criteria.
- The software vendor is an experienced provider of the services.
- The vendor is providing primarily implementation services, such as implementation planning, loading of software, training of customer personnel, data conversion, building simple interfaces, running test data, and assisting in the development and documentation of procedures.
- Customer personnel are dedicated to participate in the services being performed.

.72 Funded Software-Development Arrangements. Software-development arrangements that are fully or partially funded by a party other than the vendor that is developing the software typically provide the funding party with some or all of the following benefits:

- Royalties payable to the funding party based solely on future sales of the product by the software vendor (that is, reverse royalties)
- Discounts on future purchases by the funding party of products produced under the arrangement
- A nonexclusive sublicense to the funding party, at no additional charge, for the use of any product developed (a prepaid or paid-up nonexclusive sublicense)

.73 A funded software-development arrangement within the scope of FASB Statement No. 68, Research and Development Arrangements, should be accounted for in conformity with that Statement. If the technological feasibility of the computer software product pursuant to the provisions of FASB Statement No. 86 has been established before the arrangement has been entered into, FASB Statement No. 68 does not apply because the arrangement is not a research and development arrangement. Accounting for costs related to funded software-development arrangements is beyond the scope of this SOP. However, if capitalization of the software-development costs commences pursuant to FASB Statement No. 86, any income from the funding party under a funded software-development arrangement should be credited first to the amount of the development costs capitalized. If the income from the funding party exceeds the amount of development costs capitalized, the excess should be deferred and credited against future amounts that subsequently qualify for capitalization. Any deferred amount remaining after the project is completed (that is, when the software is available for general release to customers and capitalization has ceased) should be credited to income.

Contract Accounting

.74 If an arrangement to deliver software or a software system, either alone or together with other products or services, requires significant production, modification, or customization of software, the service element does not meet the criteria for separate accounting set forth in paragraph .65. The entire arrangement should be accounted for in conformity with ARB No. 45, using the relevant guidance in SOP 81-1. Nevertheless, transactions that normally are accounted for as product sales should not be accounted for as long-term contracts merely to avoid the delivery requirements normally associated with product sales for revenue recognition.

.75 In applying contract accounting, the vendor must use either the percentage-of-completion method or the completed-contract method. The determination of the appropriate method should be made according to the recommendations in paragraphs 21 through 33 of SOP 81-1.

.76 Segmentation. Software contracts may have discrete elements that meet the criteria for segmenting in paragraphs 39 through 42 of SOP 81-1. If a contract is segmented, each segment is treated as a separate profit center. Progress-to-completion for each segment should be measured in conformity with paragraphs .78 through .80 of this SOP.

.77 Some vendors of arrangements that include software combined with services or hardware or both do not identify the elements separately and do not sell them separately because of agreements with their suppliers. Other vendors who are not restricted by such agreements nevertheless bid or negotiate software and other products and services together. Arrangements that do not meet the segmentation criteria in paragraph 40 of SOP 81-1 are prohibited from being segmented, unless the vendor has a history of providing the software and other products and services to customers under separate arrangements and the arrangement meets the criteria in paragraph 41 of SOP 81-1.

.78 Measuring Progress-to-Completion Under the Percentage-of-Completion Method. Paragraph 46 of SOP 81-1 describes the approaches to measuring progress on contracts (or segments thereof) under the percentage-of-completion method. Those approaches are grouped into input and output measures, as follows.

- Input measures are made in terms of efforts devoted to a contract. They include the methods based on costs and on efforts expended. Output measures are made in terms of results achieved. They include methods based on units produced, units delivered, contract milestones, and value added. For contracts under which separate units of output are produced, progress can be measured on the basis of units of work completed.

For software contracts, an example of an input measure is labor hours; an example of an output measure is arrangement milestones, such as the completion of specific program modules.

.79 If, as discussed in paragraph .76 of this SOP, a software contract includes a discrete element that meets the segmentation criteria of SOP 81-1, the method chosen to measure progress-to-completion on the element should be the method that best approximates progress-to-completion. Progress-to-completion on separate elements of the same software arrangement may be measured by different methods. The software vendor should choose measurement methods consistently, however, so that it uses similar methods to measure progress-to-completion on similar elements.

.80 Output measures, such as value-added or arrangement milestones, may be used to measure progress-to-completion on software arrangements, but many companies use input measures because they are established more easily. As noted in paragraph 47 of SOP 81-1, "The use of either type of measure requires the exercise of judgment and the careful tailoring of the measure to the circumstances." Further, paragraph 51 of SOP 81-1 states that

> The acceptability of the results of input or output measures deemed to be appropriate to the circumstances should be periodically reviewed and confirmed by alternative measures that involve observation and inspection. For example, the results provided by the measure used to determine the extent of progress may be compared to the results of calculations based on physical observations by engineers, architects, or similarly qualified personnel. That type of review provides assurance somewhat similar to that provided for perpetual inventory records by periodic physical inventory counts.

.81 Input Measures. Input measures of progress-to-completion on arrangements are made in terms of efforts devoted to the arrangement and, for software arrangements, include methods based on costs, such as cost-to-cost measures, and on efforts expended, such as labor hours or labor dollars. Progress-to-completion is measured indirectly, based on an established or assumed relationship between units of input and productivity. A major advantage of input measures is that inputs expended are easily verifiable. A major disadvantage is that their relationship to progress-to-completion may not hold if inefficiencies exist or if the incurrence of the input at a particular point does not indicate progress-to-completion.

.82 Costs incurred should be included in measuring progress-to-completion only to the extent that they relate to contract performance. Items not specifically produced for the arrangement, such as hardware purchased from third parties or off-the-shelf software, should not be included in the measurement of progress-to-completion.

.83 Labor hours often are chosen as the basis for measuring progress-to-completion, because they closely approximate the output of labor-intensive processes and often are established more easily than output measures. Core software requires labor-intensive customization. Therefore, labor hours provide a good measure of progress-to-completion on elements of software arrangements that involve the customization of core software.

.84 If the measurement of progress-to-completion is based primarily on costs, the contribution to that progress of hardware and software that were produced specifically for the arrangement may be measurable and recognizable before delivery to the user's site. For example, efforts to install, configure, and customize the software may occur at the vendor's site.

The costs of such activities are measurable and recognizable at the time the activities are performed.

.85 Output Measures. Progress on arrangements that call for the production of identifiable units of output can be measured in terms of the value added or milestones reached. Although progress-to-completion based on output measures is measured directly from results achieved, thus providing a better approximation of progress than is provided by input measures, output measures may be somewhat unreliable because of the difficulties associated with establishing them.

.86 In order for the value added to be verifiable, the vendor must identify elements or subcomponents of those elements. If output measures are neither known nor reasonably estimable, they should not be used to measure progress-to-completion.

.87 If value added by off-the-shelf software is to be included in the measurement of progress-to-completion, such software cannot require more than minor modifications and must be usable by the customer for the customer’s purpose in the customer’s environment. If more than minor modifications or additions to the off-the-shelf software are necessary to meet the functionality required under the arrangement terms, either by changing or making additions to the software, or because the software would not be usable by the customer in its off-the-shelf form for the customer's purpose in the customer's environment, it should be accounted for as core software.

.88 Value added by the customization of core software should be included in the measurement of progress-to-completion of the customization and installation at the user's site. However, if the installation and customization processes are divided into separate output modules, the value of core software associated with the customization of a module should be included in the measurement of progress-to-completion when that module is completed.

.89 Contract milestones may be based on contractual project plans. Contractual provisions generally require the performance of specific tasks with the approval or acceptance by the customer; project plans generally schedule inspections in which the project's status is reviewed and approved by management. The completion of tasks that trigger such inspections are natural milestones because they are subject to relatively independent review as an intrinsic part of the project management process.

.90 Considerations other than progress-to-completion affect the amounts that become billable at particular times under many arrangements. Accordingly, although the achievement of contract milestones may cause arrangement revenues to become billable under the arrangement, the amounts billable should be used to measure progress-to-completion only if such amounts indeed indicate such progress.

.91 The milestones that are selected to measure progress-to-completion should be part of the management review process. The percentage-of-completion designated for each milestone should be determined considering the experience of the vendor on similar projects.

.92 This SOP is effective for transactions entered into in fiscal years beginning after December 15, 1997. Earlier application is encouraged as of the beginning of fiscal years or interim periods for which financial statements or information have not been issued. Retroactive application of the provisions of this SOP is prohibited.

13. *AICPA Statement of Position 98-4, Deferral of the Effective Date of a Provision of SOP 97-2, Software Revenue Recognition* provides the following:

Conclusions

.05 The second sentences of paragraphs 10, 37, 41, and 57 of SOP 97-2, which limit what is considered VSOE [vendor-specific objective evidence] of the fair value of the various elements in a multiple-element arrangement, and the related examples noted in paragraph .03 of this SOP need not be applied to transactions entered into before fiscal years beginning after March 15, 1999.

.06 All other provisions of SOP 97-2, including the remainder of paragraph 10, should be applied as stated in SOP 97-2. Accordingly, this SOP does not alter the requirements that (a) any allocation of the fee in a multiple-element arrangement to the various elements should be based on the fair values of each element, (b) those fair values must be supported by VSOE, and (c) in instances where there is insufficient VSOE of the fair values of each element to allow for an allocation of revenue to each element, all revenue from the arrangement should be deferred pursuant to paragraph 12 of that SOP.

Effective Date and Transition

.07 This SOP is effective as of March 31, 1998. If an enterprise had applied SOP 97-2 in an earlier period for financial statements or information already issued prior to the promulgation of this SOP, amounts reported in those financial statements or as part of that information may be restated to reflect the deferral of the effective date of the second sentences of paragraphs 10, 37, 41, and 57 of SOP 97-2 and the related examples noted in paragraph .03 of this SOP.

14. *AICPA Statement of Position 98-9, Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions* provides the following:

Conclusions

.06 The following changes are made to SOP 97-2.

a. The following sentence is added to the end of paragraph 11 of SOP 97-2.

Moreover, to the extent that a discount exists, the residual method described in paragraph 12 [of SOP 97-2] attributes that discount entirely to the delivered elements.

b. The following is added to the end of paragraph 12 of SOP 97-2.

There may be instances in which there is vendor-specific objective evidence of the fair values of all undelivered elements in an arrangement but vendor-specific objective evidence of fair value does not exist for one or more of the delivered elements in the arrangement. In such instances, the fee should be recognized using the residual method, provided that (a) all other applicable revenue recognition criteria in this SOP [SOP 97-2] are met and (b) the fair value of all of the undelivered elements is less than the arrangement fee. Under the residual method, the arrangement fee is recognized as follows: (a) the total fair value of the undelivered elements, as indicated by vendor-specific objective evidence, is deferred and (b) the difference between the total arrangement fee and the amount deferred for the undelivered elements is recognized as revenue related to the delivered elements.

c. The following example is added to appendix A of SOP 97-2, following "Multiple Element Arrangements—Products and Services—Example 3."

Multiple Element Arrangements—Products and Services—Example 4

Facts
A vendor sells software product A for $950. The license arrangement for product A always includes one year of "free" PCS. The annual renewal price of PCS is $150.
Revenue Recognition
Assuming that, apart from the lack of vendor-specific objective evidence of the fair value of the delivered software element, all applicable revenue recognition criteria in this SOP [SOP 97-2] are met, revenue in the amount of $150 should be deferred and recognized in

income over the one-year PCS service period. Revenue of $800 should be allocated to the software element and recognized upon delivery of the software.

Discussion
Vendor-specific objective evidence of the fair value of the software does not exist because the software is never sold separately. Consequently, sufficient vendor-specific objective evidence of fair value does not exist for the allocation of revenue to the various elements based on their relative fair values. Paragraph 12 of this SOP [SOP 97-2] states, however, that the residual method should be used when there is vendor-specific objective evidence of the fair values of all undelivered elements; all other applicable revenue recognition criteria in this SOP [SOP 97-2] are met; and the fair value of all of the undelivered elements is less than the total arrangement fee.
If there had been vendor-specific objective evidence of the fair value of the delivered software but not of the undelivered PCS, the entire arrangement fee would be deferred and recognized ratably over the contractual PCS period in accordance with paragraphs 12 and 58 [of SOP 97-2].

.07 Paragraph 5 of SOP 98-4, Deferral of the Effective Date of a Provision of SOP 97-2, Software Revenue Recognition, is replaced with the following.

The second sentences of paragraphs 10, 37, 41, and 57 of SOP 97-2 which limit what is considered VSOE [vendor-specific objective evidence] of the fair value of the various elements in a multiple-element arrangement, and the related examples noted in paragraph 3 of this SOP [SOP 98-4] need not be applied to transactions entered into before fiscal years beginning after March 15, 1999.

.08 All provisions of SOP 97-2 for software transactions outside the scope of this SOP and all other provisions of SOP 97-2 for transactions within the scope of this SOP should be applied as stated in SOP 97-2.

Effective Date and Transition

.09 The provisions of this SOP that extend the deferral of the application of certain passages of SOP 97-2 are effective December 15, 1998. All other provisions of this SOP are effective for transactions entered into in fiscal years beginning after March 15, 1999. Earlier adoption is permitted as of the beginning of fiscal years or interim periods for which financial statements or information has not been issued. Retroactive application of the provisions of this SOP is prohibited.

15. *EITF 00-3: Application of AICPA Statement of Position 97-2 to Arrangements That Include the Right to Use Software Stored on Another Entity's Hardware* provides the following:

EITF 00-3 ISSUE

1. In connection with the licensing of software products, some vendors are offering arrangements in which end users of the software do not take possession of the software. Rather, the software application resides on the vendor's or a third party's hardware, and the customer accesses and uses the software on an as-needed basis over the Internet or via a dedicated line ("hosting").

2. Structurally, the form of those arrangements may be split into two elements-(a) the right to use software and (b) the hosting service. The arrangements may or may not include a license right to the software and the customer may or may not have an option to take delivery of the software.

3. SOP 97-2 establishes standards for recognition of revenue for licensing, selling, leasing, or otherwise marketing computer software. The scope of SOP 97-2 includes arrangements that provide for multiple deliverables (for example, software products and services), which are termed

multiple elements. Under SOP 97-2, if an arrangement includes multiple elements, the fee should be allocated to the various elements based on vendor-specific objective evidence (VSOE) of fair value and recognized when certain criteria are met. One of the criteria for revenue recognition is that delivery has occurred. In addition, if a multiple-element arrangement includes both software and services, the portion of the fee allocable to the services is recognized separately as the services are performed, provided certain criteria are met.

4. The issues are:

Issue 1—Whether SOP 97-2 applies to arrangements that require the vendor to host the software.

Issue 2—Whether SOP 97-2 applies to arrangements in which the customer has an option to take delivery of the software. If so, when does delivery of the software occur and how does the vendor's hosting obligation impact revenue recognition?

EITF 00-3 DISCUSSION

5. The Task Force reached a consensus that a software element covered by SOP 97-2 is only present in a hosting arrangement if the customer has the contractual right to take possession of the software at any time during the hosting period without significant penalty 1 and it is feasible for the customer to either run the software on its own hardware or contract with another party unrelated to the vendor to host the software. Therefore, SOP 97-2 only applies to hosting arrangements in which the customer has such an option. Arrangements that do not give the customer such an option are service contracts and are outside the scope of SOP 97-2. The Task Force observed that hosting arrangements that are service arrangements may include multiple elements that affect how revenue should be attributed.

6. The Task Force also reached a consensus that for those hosting arrangements in which the customer has the option, as described above, to take possession of the software, delivery of the software occurs when the customer has the ability to take immediate possession of the software. The Task Force observed that if the software element is within the scope of SOP 97-2, all of the SOP's requirements for recognizing revenue, including VSOE of fair value and the requirement that the fee allocated to the software element not be subject to forfeiture, refund, or other concession, must be met in order to recognize revenue upon delivery for the portion of the fee allocated to the software element. The portion of the fee allocated to the hosting element should be recognized as the service is provided. The Task Force noted that hosting arrangements that are, pursuant to this Issue, within the scope of SOP 97-2 may also include other elements, such as specified or unspecified upgrade rights, in addition to the software product and the hosting service.

7. The Task Force observed that if the vendor sells, leases, or licenses software that is within the scope of SOP 97-2, then the development costs of such software should be accounted for in accordance with Statement 86. Conversely, if the vendor never sells, leases, or licenses the software in an arrangement within the scope of SOP 97-2, then the software is utilized in providing services and the development costs of the software should be accounted for in accordance with SOP 98-1. However, if during such software's development or modification, the vendor develops a substantive plan to sell, lease, or otherwise market the software externally, the development costs of the software should be accounted for in accordance with Statement 86.

EITF 00-3 STATUS

8. No further EITF discussion is planned.

RELEVANT LITERATURE:

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *SSAP No. 5—Liabilities, Contingencies and Impairments of Assets*
- *SSAP No. 17—Preoperating and Research and Development Costs*
- *SSAPs No. 22—Leases*

Generally Accepted Accounting Principles

- *AICPA Statement of Position 97-2: Software Revenue Recognition*
- *AICPA Statement of Position 98-4: Deferral of the Effective Date of a Provision of SOP 97-2, Software Revenue Recognition*
- *AICPA Statement of Position 98-9: Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions*
- *EITF 00-3: Application of AICPA Statement of Position 97-2 to Arrangements That Include the Right to Use Software Stored on Another Entity's Hardware*

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Statutory Issue Paper No. 112

Accounting for the Costs of Computer Software Developed or Obtained for Internal Use and Web Site Development Costs

STATUS
Finalized December 4, 2000

Current Authoritative Guidance for Costs of Computer Software Developed or Obtained for Internal Use and Web Site Development Costs: SSAP No. 16R
This issue paper may not be directly related to the current authoritative statement.

Original SSAP from Issue Paper: SSAP No. 82

Type of Issue:
Common Area

SUMMARY OF ISSUE:

1. Current statutory accounting guidance for accounting for the costs of computer software developed or obtained for internal use and web site development costs is provided in *SSAP No. 16R—Electronic Data Processing Equipment and Software* (SSAP No. 16R) and *SSAP No. 17—Preoperating and Research and Development Costs* (SSAP No. 17). However, these SSAPs do not provide specific guidance on accounting for internal use software and web site development costs.

2. GAAP guidance for these issues is established in *AICPA Statement of Position 98-1*, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use* (SOP 98-1) and *FASB Emerging Issue Task Force No. 00-2*, *Accounting for Web Site Development Costs* (EITF 00-2). Current statutory guidance is similar to GAAP, except that these issues are not specifically addressed.

3. The purpose of this issue paper is to address SOP 98-1 and EITF 00-2 and establish statutory accounting principles that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION:

4. This issue paper adopts SOP 98-1 paragraphs 11-42 and paragraph 93 with certain modifications. This issue paper also adopts EITF 00-2 in its entirety.

5. The modifications to SOP 98-1 are as follows:

a. Paragraph 11 states that the accounting for costs of reengineering activities, which often are associated with new or upgraded software applications, is not included within the scope of this SOP. This issue paper expands upon that paragraph to require that such costs shall be expensed as incurred.

b. Paragraph 32 is amended to require that entities who license internal-use computer software follow the operating lease provisions outlined in *SSAP No. 22— Leases* (SSAP No. 22);

c. Paragraph 36 is amended to require that entities follow the amortization guidelines as established in paragraph 9 of *SSAP No. 19—Furniture, Fixtures and Equipment;*

Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements (SSAP No. 19);

d. Paragraph 37 is amended to require that capitalized operating system software shall be depreciated for a period not to exceed three years. Capitalized nonoperating system software shall be depreciated for a period not to exceed five years. This treatment is consistent with the guidelines of SSAP No. 16 and *Issue Paper No. 109—Depreciation of Nonoperating System Software – An Amendment to SSAP No. 16—Electronic Data Processing Equipment and Software* (Issue Paper No. 109);

e. Paragraph 40 is amended to require that if during the development of internal-use software, an entity decides to market the software to others, the entity shall immediately expense any amounts previously capitalized;

f. Paragraph 41 is amended to require entities to follow the disclosure provisions outlined in paragraph 5 of SSAP No. 16 and paragraph 5 of SSAP No. 17;

g. Paragraph 42 is amended to require an effective date of January 1, 2002; and

h. Any software costs capitalized in accordance with this issue paper shall be deemed nonoperating system software costs. Nonoperating system software is a nonadmitted asset in accordance with SSAP No. 16.

6. In accordance with the reporting entity's capitalization policy, immaterial amounts of such costs can be expensed when incurred.

Effective Date and Transition

7. Upon adoption of this issue paper, the NAIC will release a Statement of Statutory Accounting Principle (SSAP) for comment. The SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the Accounting Practices and Procedures Manual should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will contain an effective date of years beginning on or after January 1, 2002.

DISCUSSION:

8. The modifications to SOP 98-1 were made in order to maintain consistency with current statutory accounting principles and the Statement of Concepts.

a. Paragraph 11 states that the accounting for costs of reengineering activities, which often are associated with new or upgraded software applications, is not included within the scope of this SOP. This issue paper expands upon that paragraph to require that such costs shall be expensed as incurred. This treatment is consistent with the GAAP equivalent contained within *Emerging Issues Task Force Issue No. 97-13*, *Accounting for Costs Incurred in Connection with a Consulting Contract or an Internal Project That Combines Business Process Reengineering and Information Technology Transformation*.

b. Paragraph 32 states that even though *FASB Statement No. 13, Accounting for Leases* (FAS 13), excludes licensing agreements from its scope, entities should analogize to that Statement when determining the asset acquired in a software licensing arrangement. The concepts outlined in FAS 13 are inconsistent with the provisions of SSAP. No. 22, therefore paragraph 32 was amended to require that licensing agreements shall be treated as operating leases;

c. Paragraph 36 was modified to remain consistent with the amortization guidelines contained within SSAP No. 19 paragraph 9;

d. Paragraph 37 was amended to remain consistent with the depreciable lives guidelines contained within SSAP No. 16 and the recently adopted Issue Paper No. 109;

e. Paragraph 40 requires that if, during the development of internal-use software, an entity decides to market the software to others, the entity should follow *FASB Statement No. 86, Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed* (FAS No. 86). Amounts previously capitalized under this SOP should be evaluated at each balance sheet date in accordance with paragraph 10 of FAS No. 86. Capitalized software costs should be amortized in accordance with paragraph 8 of FAS No. 86. Both paragraphs 8 and 10 are rejected in SSAP No. 17 and therefore the most conservative measure is to expense such amounts immediately;

f. Paragraph 41 includes references to various different GAAP pronouncements for its disclosure requirements. This paragraph was modified as SSAP Nos. 16 and 17 already include the pertinent disclosure requirements;

g. Paragraph 42 indicates that SOP 98-1 is effective for financial statements for fiscal years beginning after December 15, 1998. The paragraph was modified to allow an effective date of January 1, 2002 so as to provide ample opportunity for statutory accounting user implementation; and

h. In order to remain consistent with the treatment of nonoperating system software, the nonadmission criteria outlined in paragraph 2 of SSAP No. 16 were included in this issue paper. In order to prevent the possible misclassification of nonoperating system software as operating software, the working group felt it was appropriately conservative to classify all software costs capitalized in accordance with this issue paper as nonoperating system software costs. The Glossary to the SSAPs defines operating and nonoperating system software as:

> The operating system is a program or a series of programs controlling the data job and task management operations of a computer or a computer network through executive scheduling and monitoring. It increases the productivity of a computer installation by managing the allocation of all available computer resources including the control processing unit, main storage and input/output devices.
>
> Nonoperating systems software such as language processors, library routines and debugging aides and other computer software are not considered operating system software.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE:

Statutory Accounting

9. In general, capitalization of software is provided for in SSAP No. 16. This issue paper provides more specific guidelines for capitalization of internal software and web site development costs. SSAP No. 16 renders the following instruction:

2. EDP equipment and software generally meet the definition of assets established in *SSAP No. 4—Assets and Nonadmitted Assets*. EDP equipment and operating system software are admitted assets to the extent they conform to the requirements of this statement. Nonoperating system software are nonadmitted assets.

3. EDP equipment and software shall be depreciated for a period not to exceed three years using methods detailed in *SSAP No. 19—Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements*.

4. The aggregate amount of admitted EDP equipment and operating system software (net of accumulated depreciation) shall be limited to three percent of the reporting entity's capital and surplus as required to be shown on the statutory balance sheet of the reporting entity for its most recently filed statement with the domiciliary state commissioner adjusted to exclude any EDP equipment and operating system software, net deferred tax assets and net positive goodwill.

Disclosures

5. The following disclosures shall be made in the financial statements:

a. Depreciation and amortization expense for the period;

b. For EDP equipment and operating system software, balances of major classes of depreciable assets, by nature or function, at the balance sheet date;

c. For EDP equipment and operating system software, accumulated depreciation and amortization, either by major classes of depreciable assets or in total, at the balance sheet date; and

d. A general description of the method or methods used in computing depreciation with respect to major classes of depreciable assets.

6. Refer to the preamble for further discussion regarding disclosure requirements. The disclosures in paragraph 5 above shall be included in the annual audited statutory financial reports only.

Effective Date and Transition

7. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*.

8. EDP equipment and software capitalized prior to January 1, 2001 shall be depreciated over the shorter of its remaining useful life or three years.

Generally Accepted Accounting Principles

10. *AICPA Statement of Position 98-1*, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use* provides the following:

.11 Accounting for costs of reengineering activities, which often are associated with new or upgraded software applications, is not included within the scope of this SOP.

Conclusions

Characteristics of Internal-Use Computer Software

.12 For purposes of this SOP, internal-use software is software having the following characteristics:

a. The software is acquired, internally developed, or modified solely to meet the entity’s internal needs.

b. During the software's development or modification, no substantive plan exists or is being developed to market the software externally.

A substantive plan to market software externally could include the selection of a marketing channel or channels with identified promotional, delivery, billing, and support activities. To be considered a substantive plan under this SOP, implementation of the plan should be reasonably possible. Arrangements providing for the joint development of software for mutual internal use (for example, cost-sharing arrangements) are not substantive plans to market software for purposes of this SOP. Similarly, routine market feasibility studies are not substantive plans to market software for purposes of this SOP.

.13 An entity must meet both characteristics in paragraph .12 for software to be considered for internal use.

.14 An entity's past practices related to selling software may help determine whether the software is for internal use or is subject to a plan to be marketed externally. For example, an entity in the business of selling computer software often both uses and sells its own software products. Such a past practice of both using and selling computer software creates a rebuttable presumption that any software developed by that entity is intended for sale, lease, or other marketing, and thus is subject to the guidance in FASB Statement No. 86.

.15 Computer software to be sold, leased, or otherwise marketed includes software that is part of a product or process to be sold to a customer and should be accounted for under FASB Statement No. 86. For example, software designed for and embedded in a semiconductor chip is included in the scope of FASB Statement No. 86 because it is an integral part of the product. By contrast, software for internal use, though it may be used in developing a product, is not part of or included in the actual product or service sold. If software is used by the vendor in the production of the product or providing the service but the customer does not acquire the software or the future right to use it, the software is covered by this SOP. For example, for a communications company selling telephone services, software included in a telephone switch is part of the internal equipment used to deliver a service but is not part of the product or service actually being acquired or received by the customer.

.16 The Appendix [paragraph .93] provides examples of when computer software is and is not for internal use.

Stages of Computer Software Development

.17 The following table illustrates the various stages and related processes of computer software development.

Preliminary Project Stage	**Application Development Stage**	**Post-Implementation/ Operation Stage**
▪ Conceptual formulation of alternatives	▪ Design of chosen path, including software configuration and software interfaces	▪ Training
▪ Evaluation of alternatives	▪ Coding	▪ Application maintenance
▪ Determination of existence of needed technology	▪ Installation of hardware	
▪ Final selection of alternatives	▪ Testing, including parallel processing phase	

The SOP recognizes that the development of internal-use computer software may not follow the order shown above. For example, coding and testing are often performed simultaneously. Regardless, for costs incurred subsequent to completion of the preliminary project stage, the SOP should be applied based on the nature of the costs incurred, not the timing of their incurrence. For example, while some training may occur in the application development stage, it should be expensed as incurred as required in paragraphs .21 and .23.

Research and Development

.18 The following costs of internal-use computer software are included in research and development and should be accounted for in accordance with the provisions of FAS No. 2:

a. Purchased or leased computer software used in research and development activities where the software does not have alternative future uses.

b. All internally developed internal-use computer software (including software developed by third parties, for example, programmer consultants) if (1) the software is a pilot project (that is, software of a nature similar to a pilot plant as noted in paragraph 9.h. of FASB Statement No. 2) or (2) the software is used in a particular research and development project, regardless of whether the software has alternative future uses.

Capitalize or Expense

.19 Preliminary Project Stage. When a computer software project is in the preliminary project stage, entities will likely—

a. Make strategic decisions to allocate resources between alternative projects at a given point in time. For example, should programmers develop a new payroll system or direct their efforts toward correcting existing problems in an operating payroll system?

b. Determine the performance requirements (that is, what it is that they need the software to do) and systems requirements for the computer software project it has proposed to undertake.

c. Invite vendors to perform demonstrations of how their software will fulfill an entity's needs.

d. Explore alternative means of achieving specified performance requirements. For example, should an entity make or buy the software? Should the software run on a mainframe or a client server system?

e. Determine that the technology needed to achieve performance requirements exists.

f. Select a vendor if an entity chooses to obtain software.

g. Select a consultant to assist in the development or installation of the software.

.20 Internal and external costs incurred during the preliminary project stage should be expensed as they are incurred.

.21 Application Development Stage. Internal and external costs incurred to develop internal-use computer software during the application development stage should be capitalized. Costs to develop or obtain software that allows for access or conversion of old data by new systems should also be capitalized. Training costs are not internal-use software development costs and, if incurred during this stage, should be expensed as incurred.

.22 The process of data conversion from old to new systems may include purging or cleansing of existing data, reconciliation or balancing of the old data and the data in the new system, creation of new/additional data, and conversion of old data to the new system. Data conversion often occurs during the application development stage. Data conversion costs, except as noted in paragraph .21, should be expensed as incurred.

.23 Post-Implementation/Operation Stage. Internal and external training costs and maintenance costs should be expensed as incurred.

.24 Upgrades and Enhancements. For purposes of this SOP, upgrades and enhancements are defined as modifications to existing internal-use software that result in additional functionality—

that is, modifications to enable the software to perform tasks that it was previously incapable of performing. Upgrades and enhancements normally require new software specifications and may also require a change to all or part of the existing software specifications. In order for costs of specified upgrades and enhancements to internal-use computer software to be capitalized in accordance with paragraphs .25 and .26, it must be probable that those expenditures will result in additional functionality.

.25 Internal costs incurred for upgrades and enhancements should be expensed or capitalized in accordance with paragraphs .20-.23. Internal costs incurred for maintenance should be expensed as incurred. Entities that cannot separate internal costs on a reasonably cost-effective basis between maintenance and relatively minor upgrades and enhancements should expense such costs as incurred.

.26 External costs incurred under agreements related to specified upgrades and enhancements should be expensed or capitalized in accordance with paragraphs .20-.23. (If maintenance is combined with specified upgrades and enhancements in a single contract, the cost should be allocated between the elements as discussed in paragraph .33 and the maintenance costs should be expensed over the contract period.) However, external costs related to maintenance, unspecified upgrades and enhancements, and costs under agreements that combine the costs of maintenance and unspecified upgrades and enhancements should be recognized in expense over the contract period on a straight-line basis unless another systematic and rational basis is more representative of the services received.

.27 Capitalization of costs should begin when both of the following occur.

a. Preliminary project stage is completed.

b. Management, with the relevant authority, implicitly or explicitly authorizes and commits to funding a computer software project and it is probable that the project will be completed and the software will be used to perform the function intended. Examples of authorization include the execution of a contract with a third party to develop the software, approval of expenditures related to internal development, or a commitment to obtain the software from a third party.

.28 When it is no longer probable that the computer software project will be completed and placed in service, no further costs should be capitalized, and guidance in paragraphs .34 and .35 on impairment should be applied to existing balances.

.29 Capitalization should cease no later than the point at which a computer software project is substantially complete and ready for its intended use. For purposes of this SOP, computer software is ready for its intended use after all substantial testing is completed.

.30 New software development activities should trigger consideration of remaining useful lives of software that is to be replaced. When an entity replaces existing software with new software, unamortized costs of the old software should be expensed when the new software is ready for its intended use.

Capitalizable Costs

.31 Costs of computer software developed or obtained for internal use that should be capitalized include only the following:

a. External direct costs of materials and services consumed in developing or obtaining internal-use computer software. Examples of those costs include but are not limited to fees paid to third parties for services provided to develop the software during the application development stage, costs incurred to obtain computer software from third parties, and travel expenses incurred by employees in their duties directly associated with developing software.

b. Payroll and payroll-related costs (for example, costs of employee benefits) for employees who are directly associated with and who devote time to the internal-use computer software project, to the extent of the time spent directly on the project. Examples of employee activities include but are not limited to coding and testing during the application development stage.

c. Interest costs incurred while developing internal-use computer software. Interest should be capitalized in accordance with the provisions of FASB Statement No. 34, Capitalization of Interest Cost.

General and administrative costs and overhead costs should not be capitalized as costs of internal-use software.

.32 Entities often license internal-use software from third parties. Though *FASB Statement No. 13, Accounting for Leases*, excludes licensing agreements from its scope, entities should analogize to that Statement when determining the asset acquired in a software licensing arrangement.

Multiple-Element Software Arrangements Included in Purchase Price

.33 Entities may purchase internal-use computer software from a third party. In some cases, the purchase price includes multiple elements, such as training for the software, maintenance fees for routine maintenance work to be performed by the third party, data conversion costs, reengineering costs, and rights to future upgrades and enhancements. Entities should allocate the cost among all individual elements. The allocation should be based on objective evidence of fair value of the elements in the contract, not necessarily separate prices stated within the contract for each element. Those elements included in the scope of this SOP should be accounted for in accordance with the provisions of this SOP.

Impairment

.34 Impairment should be recognized and measured in accordance with the provisions of FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of. Paragraph 8 of FASB Statement No. 121 requires that assets should be grouped at the lowest level for which there are identifiable cash flows that are largely independent of the cash flows of other groups of assets. FASB Statement No. 121 guidance is applicable, for example, when one of the following occurs related to computer software being developed or currently in use:

a. Internal-use computer software is not expected to provide substantive service potential,
b. A significant change occurs in the extent or manner in which the software is used or is expected to be used,
c. A significant change is made or will be made to the software program,
d. Costs of developing or modifying internal-use computer software significantly exceed the amount originally expected to develop or modify the software.

.35 Paragraph 10 of FASB Statement No. 121 requires that “if the asset is not expected to provide any service potential to the entity, the asset shall be accounted for as if abandoned or held for disposal in accordance with the provisions of paragraph 15 of [FASB Statement No. 121].” When it is no longer probable that computer software being developed will be completed and placed in service, the asset should be reported at the lower of the carrying amount or fair value, if any, less costs to sell. The rebuttable presumption is that such uncompleted software has a fair value of zero. Indications that the software may no longer be expected to be completed and placed in service include the following:

a. A lack of expenditures budgeted or incurred for the project
b. Programming difficulties that cannot be resolved on a timely basis
c. Significant cost overruns
d. Information has been obtained indicating that the costs of internally developed software will significantly exceed the cost of comparable third-party software or software products, so that management intends to obtain the third-party software or software products instead of completing the internally developed software

e. Technologies are introduced in the marketplace, so that management intends to obtain the third-party software or software products instead of completing the internally developed software

f. Business segment or unit to which the software relates is unprofitable or has been or will be discontinued.

Amortization

.36 The costs of computer software developed or obtained for internal use should be amortized on a straight-line basis unless another systematic and rational basis is more representative of the software's use.

.37 In determining and periodically reassessing the estimated useful life over which the costs incurred for internal-use computer software will be amortized, entities should consider the effects of obsolescence, technology, competition, and other economic factors. Entities should consider rapid changes that may be occurring in the development of software products, software operating systems, or computer hardware and whether management intends to replace any technologically inferior software or hardware. Given the history of rapid changes in technology, software often has had a relatively short useful life.

.38 For each module or component of a software project, amortization should begin when the computer software is ready for its intended use, regardless of whether the software will be placed in service in planned stages that may extend beyond a reporting period. For purposes of this SOP, computer software is ready for its intended use after all substantial testing is completed. If the functionality of a module is entirely dependent on the completion of other modules, amortization of that module should begin when both that module and the other modules upon which it is functionally dependent are ready for their intended use.

Internal-Use Computer Software Marketed

.39 If, after the development of internal-use software is completed, an entity decides to market the software, proceeds received from the license of the computer software, net of direct incremental costs of marketing, such as commissions, software reproduction costs, warranty and service obligations, and installation costs, should be applied against the carrying amount of that software. No profit should be recognized until aggregate net proceeds from licenses and amortization have reduced the carrying amount of the software to zero. Subsequent proceeds should be recognized in revenue as earned.

.40 If, during the development of internal-use software, an entity decides to market the software to others, the entity should follow FASB Statement No. 86. Amounts previously capitalized under this SOP should be evaluated at each balance sheet date in accordance with paragraph 10 of FASB Statement No. 86. Capitalized software costs should be amortized in accordance with paragraph 8 of FASB Statement No. 86. A pattern of deciding to market internal-use software during its development creates a rebuttable presumption that any software developed by that entity is intended for sale, lease, or other marketing, and thus is subject to the guidance in FASB Statement No. 86.

Disclosures

.41 This SOP does not require any new disclosures; disclosure should be made in accordance with existing authoritative literature, including *Accounting Principles Board (APB) Opinion No. 12, Disclosure of Depreciable Assets and Depreciation; APB Opinion No. 22, Disclosure of Accounting Policies* (for example, amortization methods); FASB Statement Nos. 2 and 121; and *SOP 94-6, Disclosure of Certain Significant Risks and Uncertainties*.

Effective Date and Transition

.42 This SOP is effective for financial statements for fiscal years beginning after December 15, 1998, and should be applied to internal-use computer software costs incurred in those fiscal years for all projects, including those projects in progress upon initial application of this SOP. Earlier application is encouraged in fiscal years for which annual financial statements have not been issued.

Appendix

.93

Examples Illustrating When Computer Software Is for Internal Use

1. A manufacturing entity purchases robots and customizes the software that the robots use to function. The robots are used in a manufacturing process that results in finished goods.
2. An entity develops software that helps it improve its cash management, which may allow the entity to earn more revenue.
3. An entity purchases or develops software to process payroll, accounts payable, and accounts receivable.
4. An entity purchases software related to the installation of an online system used to keep membership data.
5. A travel agency purchases a software system to price vacation packages and obtain airfares.
6. A bank develops software that allows a customer to withdraw cash, inquire about balances, make loan payments, and execute wire transfers.
7. A mortgage loan servicing entity develops or purchases computer software to enhance the speed of services provided to customers.
8. A telecommunications company develops software to run its switches that are necessary for various telephone services such as voice mail and call forwarding.
9. An entity is in the process of developing an accounts receivable system. The software specifications meet the company’s internal needs and the company did not have a marketing plan before or during the development of the software. In addition, the company has not sold any of its internal-use software in the past. Two years after completion of the project, the company decided to market the product to recoup some or all of its costs.
10. A broker-dealer entity develops a software database and charges for financial information distributed through the database.
11. An entity develops software to be used to create components of music videos (for example, the software used to blend and change the faces of models in music videos). The entity then sells the final music videos, which do not contain the software, to another entity.
12. An entity purchases software to computerize a manual catalog and then sells the manual catalog to the public.
13. A law firm develops an intranet research tool that allows firm members to locate and search the firm’s databases for information relevant to their cases. The system provides users with the ability to print cases, search for related topics, and annotate their personal copies of the database.

Examples Illustrating When Computer Software Is Not Internal Use

14. An entity sells software required to operate its products, such as robots, electronic game systems, video cassette recorders, automobiles, voice-mail systems, satellites, and cash registers.
15. A pharmaceutical company buys machines and writes all of the software that allows the machines to function. The pharmaceutical company then sells the machines, which help control the dispensation of medication to patients and help control inventory, to hospitals.
16. A semiconductor entity develops software embedded in a microcomputer chip used in automobile electronic systems.
17. An entity purchases software to computerize a manual catalog and then sells the computer version and the related software to the public.

18. A software company develops an operating system for sale and for internal use. Though the specifications of the software meet the company's internal needs, the company had a marketing plan before the project was complete. In addition, the company has a history of selling software that it also uses internally and the plan has a reasonable possibility of being implemented.
19. An entity is developing software for a point-of-sale system. The system is for internal use; however, a marketing plan is being developed concurrently with the software development. The plan has a reasonable possibility of being implemented.
20. A telecommunications entity purchases computer software to be used in research and development activities.
21. An entity incurs costs to develop computer software for another entity under a contract with that other entity.

11. EITF 00-2 provides the following:

EITF 00-2 ISSUE

1. Companies are incurring significant costs to develop Internet web sites. These companies may be "Internet" companies, traditional "brick and mortar" companies, or service companies. The web sites may be used to promote or advertise products or services, supplant manual processes or services, sell products (including software) or services, or to do a combination of all three. Further, due to rapid changes in technology, new uses for web sites are being developed. Diversity in practice exists in accounting for web site development costs. Some entities capitalize web site development costs, others expense such costs, and still others capitalize some of those costs and expense the rest.

2. The issue is how an entity should account for costs incurred to develop a web site.

EITF 00-2 DISCUSSION

3. The Task Force discussed the accounting for web site development costs and reached the following consensuses.

Costs Incurred in the Planning Stage

4. Planning stage activities are described in detail in Exhibit 00-2A. The Task Force reached a consensus that, regardless of whether the web site planning activities specifically relate to software, all costs incurred in the planning stage should be expensed as incurred.

Costs Incurred in the Web Site Application and Infrastructure Development Stage

5. As described in Exhibit 00-2A, the web site application and infrastructure development stage involves acquiring or developing hardware and software to operate the web site. The cost of hardware is outside the scope of this Issue. SOP 98-1 provides guidance for distinguishing between internal-use software and software to be sold, leased, or otherwise marketed. A key aspect of the definition of internal-use software is that it excludes software for which a plan exists or for which a plan is being developed to market the software externally. The Task Force reached a consensus that all costs relating to software used to operate a web site should be accounted for under SOP 98-1 unless a plan exists or is being developed to market the software externally, in which case the costs relating to the software should be accounted for pursuant to Statement 86. Fees incurred for web site hosting, which involve the payment of a specified, periodic fee to an Internet service provider in return for hosting the web site on its server(s) connected to the Internet, generally would be expensed over the period of benefit.

Costs Incurred to Develop Graphics

6. For purposes of this Issue, graphics involve the overall design of the web page (use of borders, background and text colors, fonts, frames, buttons, and so forth) that affect the "look and feel" of the web page and generally remain consistent regardless of changes made to the content. The Task Force reached a consensus that graphics are a component of software and that the costs of developing initial graphics should be accounted for pursuant to SOP 98-1 for internal-use software, and pursuant to Statement 86 for software marketed externally. Modifications to graphics after a web site is launched should be evaluated to determine whether the modifications represent maintenance or enhancements of the web site. The accounting for maintenance and enhancements is discussed in paragraph 8.

Costs Incurred to Develop Content

7. Content refers to information included on the web site, which may be textual or graphical in nature (although the specific graphics described in paragraph 6, above, are excluded from content). For example, articles, product photos, maps, and stock quotes and charts are all forms of content. Content may reside in separate databases that are integrated into (or accessed from) the web page with software, or it may be coded directly into the web pages. The Task Force observed that the accounting for web site content involves issues that also apply to other forms of content or information that are not unique to web sites. Accordingly, the Task Force concluded that the accounting for content should be addressed as a separate EITF Issue.

Costs Incurred in the Operating Stage

8. As described in Exhibit 00-2A, costs incurred during the operating stage include training, administration, maintenance, and other costs to operate an existing web site. The Task Force reached a consensus that the costs of operating a web site should not be accounted for differently from the costs of other operations; that is, those costs should be expensed as incurred. However, costs incurred in the operation stage that involve providing additional functions or features to the web site should be accounted for as, in effect, new software. That is, costs of upgrades and enhancements that add functionality should be expensed or capitalized based on the general model of SOP 98-1 (which requires certain costs relating to upgrades and enhancements to be capitalized if it is probable that they will result in added functionality) or, for software that is marketed, Statement 86 (which applies its software capitalization model to "product enhancements," which include improvements that extend the life or significantly improve the marketability of a product). The Task Force observed that the determination of whether a change to web site software results in (a) an upgrade or enhancement, if internal-use software, or (b) a product enhancement, if externally marketed software, is a matter of judgment based on the specific facts and circumstances. The Task Force also observed that SOP 98-1 indicates that entities that cannot separate internal costs on a reasonably cost-effective basis between maintenance and relatively minor upgrades and enhancements must expense such costs as incurred.

Transition

9. The consensuses in this Issue are effective for web site development costs incurred for fiscal quarters beginning after June 30, 2000 (including costs incurred for projects in process as of the beginning of the quarter of adoption of these consensuses). Earlier application is encouraged. The Task Force observed that an entity may elect to adopt the consensuses as a cumulative effect of a change in accounting principles in accordance with Opinion 20.

10. Exhibit 00-2A illustrates the application of the above-described consensuses to specific web site development costs.

EITF 00-2 STATUS

11. No further EITF discussion is planned.

EXHIBIT 00-2A
APPLICATION OF THE EITF CONSENSUSES ON ISSUE 00-2

Planning Stage	
Web Site Development Activity	**Accounting Required by Issue 00-2**
a. Develop a business, project plan, or both. This may include identification of specific goals for the web site (for example, to provide information, supplant manual processes, conduct e-commerce, and so forth), a competitive analysis, identification of the target audience, creation of time and cost budgets, and estimates of the risks and benefits.	Expense as incurred.
b. Determine the functionalities (for example, order placement, order and shipment tracking, search engine, e-mail, chat rooms, and so forth) of the web site.	Expense as incurred.
c. Identify necessary hardware (for example, the server) and web applications. Web applications are the software needed for the web site's functionalities. Examples of web applications are search engines, interfaces with inventory or other back-end systems, as well as systems for registration and authentication of users, commerce, content management, usage analysis, and so forth.	Expense as incurred.
d. Determine that the technology necessary to achieve desired functionalities exists. Factors might include, for example, target audience numbers, user traffic patterns, response time expectations, and security requirements.	Expense as incurred.
e. Explore alternatives for achieving functionalities (for example, internal versus external resources, custom-developed versus licensed software, company-owned versus third-party-hosted applications and servers).	Expense as incurred.
f. Conceptually formulate and/or identify graphics and content (refer to "Graphics and Content Development Stages" for further discussion).	Expense as incurred.
g. Invite vendors to demonstrate how their web applications, hardware, or service will help achieve the web site's functionalities.	Expense as incurred.
h. Select external vendors or consultants.	Expense as incurred.
i. Identify internal resources for work on the web site design and development.	Expense as incurred.
j. Identify software tools and packages required for development purposes.	Expense as incurred.
k. Address legal considerations such as privacy, copyright, trademark, and compliance.	Expense as incurred.

Web Site Application and Infrastructure Development Stage	
Web Site Development Activity	**Accounting Required by Issue 00-2**
	The discussion of web site application and infrastructure development assumes that any software is developed for the entity's internal needs and no plan exists or is being developed to market the software externally (refer to paragraph 12 of SOP 98-1). Software for which a plan exists or is being developed to market the software externally is subject to Statement 86, and costs associated with the development of that software should be expensed until technological feasibility is established (refer to paragraph 4 of Statement 86).
a. Acquire or develop the software tools required for the development work (for example, HTML editor, software to convert existing data to HTML form, graphics software, multimedia software, and so forth).	Apply SOP 98-1. Costs incurred to purchase software tools, or costs incurred during the application development stage for internally developed tools, generally should be capitalized unless they are used in research and development and (1) do not have any alternative future uses or (2) are internally developed and represent a pilot project or are being used in a specific research and development project (see paragraph 18 of SOP 98-1).
b. Obtain and register an Internet domain name.	Generally, capitalize pursuant to paragraph 24 of APB 17.
c. Acquire or develop software necessary for general web site operations, including server operating system software, Internet server software, web browser software, and Internet protocol software.	Apply SOP 98-1. Generally, capitalize pursuant to paragraphs 21 and 31 of SOP 98-1.
d. Develop or acquire and customize code for web applications (for example, catalog software, search engines, order processing systems, sales tax calculation software, payment systems, shipment tracking applications or interfaces, e-mail software, and related security features).	Apply SOP 98-1. Generally, capitalize pursuant to paragraphs 21 and 31 of SOP 98-1.
e. Develop or acquire and customize database software and software to integrate distributed applications (for example, corporate databases and accounting systems) into web applications.	Apply SOP 98-1. Generally, capitalize pursuant to paragraphs 21 and 31 of SOP 98-1.
f. Develop HTML web pages or develop templates and write code to automatically create HTML pages.	Apply SOP 98-1. Generally, capitalize pursuant to paragraphs 21 and 31 of SOP 98-1.
g. Purchase the web and application server(s), Internet connection (bandwidth), routers, staging servers (where preliminary changes to the web site are made in a test environment), and production servers (accessible to customers using the web site). Alternatively, these services may be provided by a third party via a hosting arrangement.	Acquisitions of servers and related hardware infrastructure are outside the scope of this Issue. Payments for hosting arrangements should be expensed over the period of benefit.

h. Install developed applications on the web server(s).	Apply SOP 98-1. Generally, capitalize pursuant to paragraphs 21 and 31 of SOP 98-1.
i. Create initial hypertext links to other web sites or to destinations within the web site. Depending on the site, links may be extensive or minimal.	Apply SOP 98-1. Generally, capitalize pursuant to paragraphs 21 and 31 of SOP 98-1.
j. Test the web site applications (for example, stress testing).	Apply SOP 98-1. Generally, capitalize pursuant to paragraphs 21 and 31 of SOP 98-1.

Graphics and Content Development Stages	
Web Site Development Activity	**Accounting Required by Issue 00-2**
a. Create initial graphics for the web site. Graphics include the design or layout of each page (that is, the graphical user interface), color, images, and the overall "look and feel" and "usability" of the web site. Creation of graphics may involve coding of software, either directly or through the use of graphic software tools. The amount of coding depends on the complexity of the graphics.	Apply SOP 98-1. Initial graphics are part of the software and generally should be capitalized pursuant to paragraph 21 of SOP 98-1.
b. Create content or populate databases. Content may be created or acquired to populate databases or web pages. Content may be acquired from unrelated parties or may be internally developed.	To be addressed in a future EITF Issue.
c. Enter initial content into the web site. Content is text or graphical information (exclusive of graphics described in (a) above) on the web site which may include information on the entity, products offered, information sources that the user subscribes to, and so forth. Content may originate from databases that must be converted to HTML pages or databases that are linked to HTML pages through integration software. Content also may be coded directly into web pages.	Apply SOP 98-1. Paragraph 22 of SOP 98-1 specifies that "data conversion costs" should be expensed as incurred. Similarly, costs to input content into a web site generally should be expensed as incurred. Software used to integrate a database with a web site generally should be capitalized pursuant to paragraph 21 of SOP 98-1.

Operating Stage	
Web Site Development Activity	**Accounting Required by Issue 00-2**
a. Train employees involved in support of the web site.	Apply SOP 98-1. Generally, expense as incurred pursuant to paragraph 23 of SOP 98-1.
b. Register the web site with Internet search engines.	Expense as incurred. These expenditures represent advertising costs and are expensed as incurred pursuant to paragraph 26 of SOP 93-7.
c. Perform user administration activities.	Apply SOP 98-1. Generally, expense as incurred pursuant to paragraph 23 of SOP 98-1.
d. Update site graphics (for updates of graphics related to major enhancements, refer to (h), below).	Apply SOP 98-1. Generally, expense as incurred pursuant to paragraph 23 of SOP 98-1.

e. Perform regular backups.	Apply SOP 98-1. Generally, expense as incurred pursuant to paragraph 23 of SOP 98-1.
f. Create new links.	Apply SOP 98-1. Generally, expense as incurred pursuant to paragraph 23 of SOP 98-1.
g. Verify that links are functioning properly and update existing links (that is, link management or maintenance).	Apply SOP 98-1. Generally, expense as incurred pursuant to paragraph 23 of SOP 98-1.
h. Add additional functionalities or features.	Apply SOP 98-1. Generally, capitalize if they meet the definition of "upgrades and enhancements" in paragraph 24 of SOP 98-1.
i. Perform routine security reviews of the web site and, if applicable, of the third-party host.	Apply SOP 98-1. Generally, expense as incurred pursuant to paragraph 23 of SOP 98-1.
j. Perform usage analysis.	Apply SOP 98-1. Generally, expense as incurred pursuant to paragraph 23 of SOP 98-1.

RELEVANT LITERATURE:

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *SSAP No. 16—Electronic Data Processing Equipment and Software*
- *SSAP No. 17—Preoperating and Research and Development Costs*
- *SSAP No. 19—Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements*
- *SSAP No. 22—Leases*
- *Issue Paper No. 109—Depreciation of Nonoperating System Software – An Amendment to SSAP No. 16—Electronic Data Processing Equipment and Software*

Generally Accepted Accounting Principles

- *AICPA Statement of Position 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*
- *EITF 00-2, Accounting for Web Site Development Costs*

Statutory Issue Paper No. 113

Mezzanine Real Estate Loans

STATUS
Finalized June 11, 2001

Original SSAP and Current Authoritative Guidance: SSAP No. 83

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. The purpose of this issue paper is to establish statutory accounting principles for the accounting and reporting guidelines of Mezzanine Real Estate Loans (MREL).

SUMMARY CONCLUSION

2. For statutory accounting purposes, a MREL shall be defined as a debt obligation that is not a security, which is secured by a pledge of equity interest in an entity that owns real estate. (A security is a share, participation, or other interest in property or in an enterprise of the issuer or an obligation of the issuer) that:

a. Either is represented by an instrument issued in bearer or registered form, or if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer;

b. Is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment; and

c. Either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations).

3. MREL's meet the definition of assets as specified in *SSAP No. 4—Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this issue paper.

4. Reporting entities holding MREL's shall follow the accounting and disclosure requirements defined within *SSAP No. 37—Mortgage Loans* (SSAP No. 37).

5. In order for a MREL to qualify as an admitted asset, the MREL agreement (the agreement) shall:

a. Require that each pledgor abstain from granting additional security interests in the equity interest pledged; and

b. In addition to satisfaction of the requirements set forth in paragraphs c and d below, the MREL lender shall employ techniques to minimize the likelihood or impact of a bankruptcy filing on the part of the real estate owner and, if different, on the part of the mezz borrower. These techniques may include (by way of example and not limitation) one or more of the following: (i) separateness covenants, (ii) cash management techniques, (iii) exceptions to the non-recourse provisions for damages arising out of the mezz borrower's failure to comply with covenants prohibiting additional debt, transfers of the real estate, transfers of pledged interests, and violation of the single asset/single purpose covenants, (iv) full recourse liability in the event of a bankruptcy filing on the part of the real estate owner and, if different, on the part of the mezz borrower, and (v) loan guaranties; and

The selection of techniques that are applied in the instance of any particular MREL to achieve said purposes requires an exercise of judgment by the MREL lender. The reasonableness of the techniques utilized in any particular MREL will be assessed in light of the credit characteristics of the MREL borrower, any guarantors and the underlying real estate at the time of origination. Utilizing this standard provides flexibility to the MREL lender and provides a basis for the regulator and auditor in analyzing the reasonableness of the judgment of the MREL lender; and

c. The real estate owner and, if different, the mezz borrower shall:

i. Hold no assets other than, in the case of the real estate owner, the real property, and in the case of the mezz borrower (if different), the equity interest in the real estate owner;

ii. Not engage in any business other than, in the case of the real estate owner, the ownership and operation of the real estate, and in the case of the mezz borrower (if different), holding an ownership interest in the real estate owner; and

iii. Not incur additional debt, other than limited trade payables, a first mortgage loan (in the case of the real estate owner), and the MREL (in the case of the mezz borrower, if different).

d. At the time of the initial investment, the MREL lender shall corroborate that the sum of the first mortgage and the MREL does not exceed 100% of the value of the real estate as evidenced by a current appraisal. Acceptable appraisal methods are described in paragraph 11 of *SSAP No. 40—Real Estate Investments*.

e. The MREL lender shall report in Appendix A-001 to its annual statement the amount and percentages of its total admitted assets held in MREL and the largest three investments held in MREL except that such detail shall not be required for assets held in MREL totaling less than 2.5% of its total admitted assets.

Effective Date

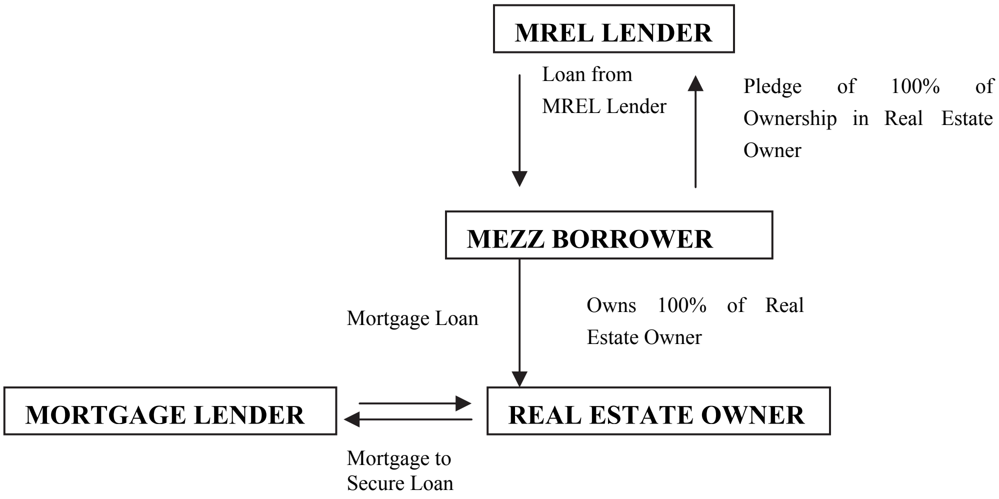
6. Upon adoption of this issue paper, the NAIC will release a Statement of Statutory Accounting Principle (SSAP) for comment. The SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the Accounting Practices and Procedures Manual should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will contain an effective date for years ending on or after December 31, 2001.

DISCUSSION

Definition of MREL

7. An MREL is a loan secured by a pledge of direct or indirect equity interests in an entity that owns real estate (the "real estate owner"). The real estate owner is typically the borrower under a mortgage loan secured by the same real estate. The MREL borrower ("mezz borrower") may be the real estate owner or one or more of the holder(s) of the direct or indirect equity interest(s) in the real estate owner. As used herein, "direct equity interests" means the then issued and outstanding shares or units of partnership, membership or other beneficial interests in the real estate owner, and "indirect equity

interests" means the then issued and outstanding shares or units of partnership, membership or other beneficial interests in a member, partner, shareholder or other holder of direct equity interests in the real estate owner. The following illustrates one typical MREL structure:



Typical Sources and Market Characteristics of MRELs

8. Significant portions of large real estate loans are now originated with the intent of securitizing[1] the real estate mortgage loan. Mortgage loans targeted for securitization are typically subject to uniform underwriting and structuring requirements, including requirements that (a) the mortgage loan satisfy a loan to value ratio of 65% or less, (b) prohibit encumbrance of the real estate to secure additional debt, and (c) the borrower satisfy certain SPE (special purpose entity) requirements (as described below).

9. In many instances, the subject real estate project requires financing in excess of 65% of the value of the property. By utilizing a MREL, the real estate owner is able to obtain a low cost first mortgage loan and the mezz borrower is able to obtain additional project financing in the form of the MREL without jeopardizing the securitization of the first mortgage loan by subjecting the real estate to additional liens.

10. Like its securitized mortgage loan counterpart, MRELs typically have common underwriting and structuring characteristics. As noted above, MRELs are secured by a pledge of the mezz borrower's equity interest in the real estate owner. Similar to securitized loan requirements, the documents evidencing the MREL require that (a) the mezz borrower abstain from granting additional security interests in its equity interest in the real estate owner, and (b) both the real estate owner and the mezz borrower be a special purpose, bankruptcy remote corporation, limited liability company or limited partnership (a "SPE"). In the case of a limited partnership SPE, the general partner of such SPE must in turn be a SPE (and if the real estate owner is a limited partnership, the general partnership interest is also pledged to secure the MREL). The SPE requirements are intended to protect both the mortgage lender and the MREL lender from the risks associated with bankruptcy filings and consolidation of claims relating to affiliated entities.[2]

[1] A "securitized" real estate loan is a loan combined with other loans secured by real estate for sale in the secondary market, typically in the form of a commercial mortgaged backed security.

[2] In order to comply with typical SPE requirements, an entity must, among other things: (i) hold no assets other than, in the case of the real estate owner, the real property, and in the case of the mezz borrower, the equity interest in the real estate owner; (ii) not engage in any business other than, in the case of the real estate owner, the ownership and operation of the real estate, and in the case of the mezz borrower, the ownership of the real estate owner; (iii) not incur additional debt, other than limited trade payables, a first mortgage loan (in the case of the real estate owner), and the MREL (in the case of the mezz borrower); and (iv) have at all times an independent director or member whose vote is required for, among other things, a voluntary bankruptcy filing.

MREL Lender Remedies

11. Should the mezz borrower default on its obligations under the MREL, the MREL lender has the right to assume ownership and control of the real estate owner by realizing upon its security interest in the equity interest in the real estate owner. Similar to foreclosure of a junior mortgage position, the goal of this remedy is to gain control over the ownership and operation of the real estate and thereby preserve both the good standing of the mortgage loan and the equity in the real estate that will ultimately repay the MREL.

12. Unlike foreclosure of a junior mortgage, the remedies afforded a MREL lender can typically be exercised very quickly and reach conclusion much faster than foreclosure; in most jurisdictions, a MREL lender can exercise remedies under the applicable Uniform Commercial Code (UCC)[3] without the need for judicial action. Further, most MRELs are structured with cash management requirements that protect both the mortgage lender and the MREL lender from misapplication of rents and other income generated by the real estate. Finally, unlike most holders of junior mortgage liens, MREL lenders are typically able to negotiate notice and cure rights from the holders of the mortgage debt. These rights give the MREL lender the ability to preserve the good standing of the mortgage loan (thereby avoiding accrual of default interest and ultimately foreclosure) while the MREL lender exercises its remedies and gains control over the real estate, while remaining subordinate to the first mortgage obligation.

Remedy Comparison

13. Below is a description of several different forms of subordinated real estate investments, the security that the investment relies upon for repayment and the related default/foreclosure scenarios for each type of investment:

	First Mortgage	**Second Mortgage**	**Mezzanine Real Estate Loan**	**Comm. Mtg Back Security (AA & Down)**
Security	First lien on property (deed of trust)	Second lien on property (deed of trust)	Lien on ownership interest in the real estate owner	Rights to subordinated cash flow from trust
Default/Fore-Closure Remedy	Become owner of property free and clear of all liens	Become owner of property subject to first mortgage	Control owner of property subject to first mortgage	Become holder of subordinated interest in cash flow and prop. Residual
Comment		If 1st mortgage not kept/brought current by 2nd then 1st may foreclose	If 1st mortgage not kept/brought current by MREL Lender then 1st may foreclose	

14. As shown above, the downside credit outcome for a MREL is essentially the same as the outcome for a second mortgage. Both investment types rely on excess cash flow beyond the first mortgage for

[3] See Exhibit A for a detail question and answer with respect to the requirements of the UCC for MRELs.

payment, and in a default scenario both ultimately result in the lender controlling real property with a first mortgage in place that requires current payments.

15. Foreclosure of a second mortgage varies by state law (judicial vs. statutory) and for a MREL is generally the same in all states under the UCC. The MREL remedy process is typically quicker than the judicial process and is similar in time to states with a statutory foreclosure process.

16. MRELs are also documented with monthly payment requirements and hard maturity dates. Like loans secured by a second mortgage, MRELs' typical return characteristics do not vary with the amount of cash flow available for payment. MRELs are passive investments, with no or very little authority over management of the real property prior to default, but similar to other debt instruments have protective covenants (rules), which, if violated, trigger the right to exercise the remedies discussed above.

17. MRELs meet the definition of assets as specified in SSAP No. 4 and are admitted assets to the extent they conform to the requirements of SSAP No. 37 and this issue paper (particularly, paragraph 5). Recording MRELs as admitted assets is consistent with the recognition concept in the Statement of Concepts (i.e., the existence of readily marketable assets available when both current and future obligations are due). Due to their similarity to second mortgages, the requirement to account and disclose MRELs in accordance with SSAP No. 37 is concordant with the principle of consistency in the Statement of Concepts.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

18. As MRELs are not currently defined or identified as admitted assets within the Accounting Practices and Procedures Manual, they are currently nonadmitted in accordance with SSAP No. 4

19. The Invested Assets Working Group addressed the admissibility of MRELs at its August 28, 2000 working group meeting. The following represents an excerpt from a report containing its recommendation as to the admissibility of such assets:

> In addition to reviewing the material you provided, the IAWG also heard a presentation (including recommendations) from Interested Persons on Mezzanine Loans. The IAWG agrees that Mezzanine Loans meet the definition of assets contained in *SSAP No. 4—Assets and Nonadmitted Assets* and should be admitted assets if they conform to the requirements of *SSAP No. 37—Mortgage Loans*. However, we also believe Mezzanine Loans should be treated as an entirely new type of asset class. Accordingly, the IAWG recommends that any proposed regulatory accounting guidance first precisely define a mezzanine loan by reference to its structural features and legal characteristics. For example, we understand that the borrower takes ownership rights in the entity owning the property. This legal interest is not the same thing as an interest in real estate secured by a mortgage lien. Therefore, it will be important to identify how the state Uniform Commercial Code will define an ownership interest and how an insurer investor perfects a security interest in ownership rights. Ownership rights in the entity may also subject the insurer to owner related liabilities that should be considered in accounting guidance. Further, to the extent the real estate is to play a significant role in recovering the value of the loan in a default situation, it is also important to understand how the insurer effectively ensures that the borrower cannot further encumber its real estate. In this regard, the IAWG noted that the written discussion paper presented by the Interested Persons did not provide an authoritative description of the structural or other characteristics of this type of asset. The IAWG also recommends that the Risk Based Capital Task Force should determine the appropriate Risk Based Capital treatment for Mezzanine Loans.

Generally Accepted Accounting Principles

20. See *Issue Paper No. 37—Mortgage Loans* for applicable GAAP references.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *SSAP No. 4—Assets and Nonadmitted Assets*
- *SSAP No. 37—Mortgage Loans*

Generally Accepted Accounting Principles

- *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises*
- *FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*
- *FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan*
- *FASB Statement No. 118, Accounting by Creditors for Impairment of a Loan - Income Recognition and Disclosures, an amendment of FASB Statement No. 114*
- *FASB Emerging Issues Task Force Issue No. 84-19, Mortgage Loan Payment Modifications*
- *FASB Emerging Issues Task Force Issue No. 88-17, Accounting for Fees and Costs Associated with Loan Syndications and Loan Participations*
- *AICPA Practice Bulletin 6, Amortization of Discounts on Certain Acquired Loans*

ISSUE PAPER 113 – EXHIBIT A

Uniform Commerical Code Questions and Answers

As further background on the treatment and structure of a mezzanine real estate loan, the following questions and answers are presented.

1. How is a security interest of this type characterized under the UCC?

   - Either investment property, general intangible or instrument
   - Security interest in shares of a corporation should be investment property. See § 9-102(a)(49); § 8-102(a)(15); § 8-103(a)
   - Partnership or limited liability company- generally a general intangible. See § 9-102(a)(42)
   - If such interests represented in writing could be classified as "instruments". See § 9-102(47).
   - Possibility of misclassification of an interest in a closely held corporation as an instrument. See In re U.S. Physicians, Inc., 236 B.R. 593 (Bankr. E.D. Penn. 1999)
   - Require borrowers to opt into Article 8. See § 8-102(a)(15)(iii)(b) investment property.

2. How does the insurer perfect its security interest?

   - A security interest in investment property is perfected by either obtaining "control", See § 9-314, or filing a financing statement. See § 9-312(a).
   - An interest that is perfected by control has priority over one perfected by filing. See § 9-328.
   - A secured party has control of investment property when the secured party may transfer that property without further consent from the owner. See § 8-106.
   - If the collateral is a certificated security in bearer form control is achieved by possession. See § 8-106(a).
   - If the collateral is a certificated security in registered form control is achieved when the secured party takes possession of the certificate and the certificate is endorsed to the party or is registered in the party's name upon issue or transfer. See § 8-106(b). Certificated securities are accompanied by executed stock powers.
   - If the collateral is an uncertificated security control is achieved by "delivery" of the security, which can be achieved by the secured party becoming the registered owner, or the issuer providing that it will comply with instructions of the secured party without further action from the registered owner. See § 8-106(c). A pledge or security interest in uncertificated securities is typically acknowledged by the issuer delivering an "Initial Transaction Statement". See § 8-408.
   - An interest in a general intangible is perfected by filing a financing statement. See § 9-310.
   - An interest in an instrument may be perfected by filing a financial statement, See § 9-312(a), or by possession. See § 9-313.
   - Security interest extends to all proceeds generated by the pledged securities. See § 9-306(1).
   - Typically, regardless of the nature of the securities pledged, the secured party will file UCC financing statements as a precautionary measure.

3. What steps does the insurer take to realize on the collateral?

   - Once the borrower is in default, the secured party may possess the collateral either through the judicial process or any other peaceful means. See § 9-610(b).
   - If the secured party has perfected by control it has the ability to foreclose on the collateral without additional steps. See § 9 - 601.
   - The UCC provides that disposition of collateral following default must be conducted in a commercially reasonable manner. See § 9-610(b).

4. Does the answer differ under the old UCC and the amended UCC, due to take effect in 2001?

- The most significant change relevant to these transactions is that a security interest in an instrument may now be perfected by filing; where the prior Article 9 allowed perfection of an instrument only by possession. See § 9-312(a).
- Where a subsequent purchaser is unaware of the secured party's interest, the interest may be extinguished upon purchase. See § 9-330(d). This risk is minimized by the secured party obtaining an Initial Transaction Statement confirming registration of the pledge of uncertificated securities and by the secured party taking possession of certificated securities together with executed stock powers.
- The filing of a financing statement does not constitute notice. See § 9-331.

5. Could a fraudulent borrower further encumber the real estate and thus defeat the insurer's interest in the real estate?

Yes, but some factors that mitigate the risk:

- Typically, a mezzanine loan will have a hard lockbox. Since no cash will flow to a subsequent encumbering lender, most mortgagees would be dissuaded from loaning funds with the security of a second mortgage.
- Until securitization sometimes second mortgage is required for just this reason.
- The Special Purpose Entity (SPE) organizational documents will prohibit such a mortgage. Any reputable lender will ask for opinion of counsel that the mortgage is authorized. Reputable counsel would obtain copies of the organizational documents before rendering an opinion and the lender might request such documents as well.
- Sometimes the secured lender is given special member status where its vote/consent is required for specified actions such as the grant of subordinate liens.
- Violation of the entity's organizational documents would subject the grant of a subordinate mortgage to challenge as an ultra vires act.
- The securitized first mortgage will make the grant of additional liens on the property an event of default. No reputable mortgagee would lend money with the risk of an immediate default under the first mortgage. The risk of such a default might also deter the borrower from placing the mortgage on the property.
- The granting of an additional lien will likely trigger liability under the non-recourse carveouts under the first and mezzanine loan documents. Fraud is typically a carve-out from the non-recourse provisions of the documents and violation of the SPE covenants may also be a carve-out. There may be an express carveout for voluntary liens. Assuming the entity/individual guarantying the non-recourse carveouts (typically entities or individuals affiliated with both the mortgage borrower and the mezzanine borrower) has assets available to satisfy claims, the triggering of a significant non-recourse carveout liability is a substantial deterrent. Payments under the carveouts would also provide a source of repayment to the mezzanine lender.

6. Could a lender inherit borrower liabilities for say, environmental remediation?

Yes, but some factors that mitigate the risk:

- Mezzanine lenders typically require Phase I Environmental reports and further testing if the Phase I indicates a problem.
- Prior to foreclosing on the ownership interest in the property owner, the mezzanine lender would update its initial Phase I.

- It is common to obtain for the benefit of the Mezzanine Lender as well as the First Mortgagee an environmental indemnification. The value of this will depend upon the creditworthiness of the indemnifying party.
- The SPE covenants will limit the activities the entity may engage in which if honored would limit the obligations that a mezzanine lender would assume. Violation of the SPE covenants would trigger personal recourse liability in those situations when the SPE covenants are carve-outs to the non-recourse provisions.
- The lender protections against environmental liabilities in a first mortgage situation may be overrated since to sell the property with significant environmental problems is likely to result in significant loss. Most often the lender assesses the environmental liability and may elect to take title and cure the problem before selling. The mezzanine lender may similarly elect to take title and cure the problem if that makes economic sense.
- The mezzanine lender assumes ownership of stock/membership interest/partnership interests in a SPE that holds title to potentially contaminated real estate. By avoiding any action that would cause a court "to pierce the corporate veil" (a difficult standard for a plaintiff to overcome) the mezzanine lender's sole exposure it its investment in the SPE. The Lender can be further insulated by transferring ownership of the real estate SPE to an SPE created by the mezzanine lender.

7. Are there similar types of structural risks introduced by this structure that should be part of the criteria for determining whether mortgage loan treatment is appropriate?

You have identified the three major risks:

- Certainty of ability to foreclose
- Possibility that junior mortgages or liens could encumber the property with no ability to foreclose out the mortgages or liens
- Liability for entity level obligations

There are some distinct advantages:

- A mezzanine lender can gain control over the property in say 30 days as compared to years in judicial foreclosure states.
- The lockbox structure, atypical in a classic second mortgage, prevents the borrower from milking the property and diverting cash.
- The SPE structure, atypical with second mortgages prior to the advent of securitized transactions, limits the activities of the borrower to the single mortgaged property making it less likely that other activities or properties adversely affect the mortgaged property.
- The Intercreditor Agreement with the First Mortgagee is likely to be more advantageous than any agreement reached by a second mortgagee. Cure rights can frequently be obtained.

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Statutory Issue Paper No. 114

Accounting for Derivative Instruments and Hedging Activities

STATUS
Finalized October 16, 2001

Original SSAP and Current Authoritative Guidance: SSAP No. 86

Type of Issue
Common Area

SUMMARY OF ISSUE

1. *SSAP No. 31—Derivative Instruments* (SSAP No. 31) contains guidance on accounting for derivative instruments. The applicable GAAP guidance is included in *Financial Accounting Standard No. 133*, *Accounting for Derivative Instruments and Hedging Activities* (FAS 133), FAS 137, *Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133 an amendment of FASB Statement No. 133* (FAS 137), FAS 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities—an amendment of FASB Statement No. 133* (FAS 138) and their related Emerging Issues Task Force Issues.

2. The purpose of this issue paper is to address the concepts outlined in FAS 133 and establish a comprehensive statutory accounting model for derivative instruments. This issue paper will also reassess the provisions of SSAP No. 31. The result will be a new SSAP, which will supersede SSAP No. 31. The purpose also includes development of an accounting model for derivatives that is consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION:

3. SSAP No. 31 is superseded in its entirety by the conclusions outlined in this issue paper.

4. This issue paper addresses the recognition of derivatives and measurement of derivatives used in:

a. Hedging transactions;
b. Income generation transactions; and
c. Replication transactions

Definitions (for purposes of this issue paper)

5. "Derivative instrument" means an agreement, option, instrument or a series or combination thereof:

a. To make or take delivery of, or assume or relinquish, a specified amount of one or more underlying interests, or to make a cash settlement in lieu thereof; or

b. That has a price, performance, value or cash flow based primarily upon the actual or expected price, level, performance, value or cash flow of one or more underlying interests.

6. Derivative instruments include, but are not limited to; options, warrants used in a hedging transaction and not attached to another financial instrument, caps, floors, collars, swaps, forwards, futures

and any other agreements or instruments substantially similar thereto or any series or combination thereof.

a. “Caps” are option contracts in which the cap writer (seller), in return for a premium, agrees to limit, or cap, the cap holder’s (purchaser) risk associated with an increase in a reference rate or index. For example, in an interest rate cap, if rates go above a specified interest rate level (the strike price or the cap rate), the cap holder is entitled to receive cash payments equal to the excess of the market rate over the strike price multiplied by the notional principal amount. Because a cap is an option-based contract, the cap holder has the right but not the obligation to exercise the option. If rates move down, the cap holder has lost only the premium paid. A cap writer has virtually unlimited risk resulting from increases in interest rates above the cap rate;

b. “Collar” means an agreement to receive payments as the buyer of an option, cap or floor and to make payments as the seller of a different option, cap or floor;

c. “Floors” are option contracts in which the floor writer (seller), in return for a premium, agrees to limit the risk associated with a decline in a reference rate or index. For example, in an interest rate floor, if rates fall below an agreed rate, the floor holder (purchaser) will receive cash payments from the floor writer equal to the difference between the market rate and an agreed rate multiplied by the notional principal amount;

d. “Forwards” are agreements (other than a futures) between two parties that commit one party to purchase and the other to sell the instrument or commodity underlying the contract at a specified future date. Forward contracts fix the price, quantity, quality, and date of the purchase and sale. Some forward contracts involve the initial payment of cash and may be settled in cash instead of by physical delivery of the underlying instrument;

e. “Futures” are standardized forward contracts traded on organized exchanges. Each exchange specifies the standard terms of futures contracts it sponsors. Futures contracts are available for a wide variety of underlying instruments, including insurance, agricultural commodities, minerals, debt instruments (such as U.S. Treasury bonds and bills), composite stock indices, and foreign currencies;

f. “Options” are contracts that give the option holder (purchaser of the option rights) the right, but not the obligation, to enter into a transaction with the option writer (seller of the option rights) on terms specified in the contract. A call option allows the holder to buy the underlying instrument, while a put option allows the holder to sell the underlying instrument. Options are traded on exchanges and over the counter;

g. “Swaps” are contracts to exchange, for a period of time, the investment performance of one underlying instrument for the investment performance of another underlying instrument, typically without exchanging the instruments themselves. Swaps can be viewed as a series of forward contracts that settle in cash rather than by physical delivery. Swaps generally are negotiated over-the-counter directly between the dealer and the end user. Interest rate swaps are the most common form of swap contract. However, foreign currency and commodity swaps also are common;

h. “Warrants” are instruments that give the holder the right to purchase an underlying financial instrument at a given price and time or at a series of prices and times outlined in the warrant agreement. Warrants may be issued alone or in connection with the sale of other securities, for example, as part of a merger or recapitalization agreement, or to facilitate divestiture of the securities of another business entity.

7. “Firm commitment” is an agreement with an unrelated party, binding on both parties and expected to be legally enforceable, with the following characteristics:

a. The agreement specifies all significant terms, including the quantity to be exchanged, the fixed price, and the timing of the transaction. The fixed price may be expressed as a specified amount of an entity’s functional currency or of a foreign currency. It may also be expressed as a specified interest rate or specified effective yield;

b. The agreement includes a disincentive for nonperformance that is sufficiently large to make performance probable; and

c. For investments in subsidiary, controlled, and affiliated entities (as defined by *SSAP No. 46—Investments in Subsidiary, Controlled, and Affiliated Entities*) and investments in limited liability companies (as defined by *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies*) it must be probable that acquisition will occur within a reasonable period of time.

8. A hedging transaction is defined as a derivative transaction which is entered into and maintained to reduce:

a. The risk of a change in the fair value or cash flow of assets and liabilities which the reporting entity has acquired or incurred or has a firm commitment to acquire or incur or for which the entity has forecasted acquisition or incurrence; or

b. The currency exchange rate risk or the degree of exposure as to assets and liabilities which a reporting entity has acquired or incurred or has a firm commitment to acquire or incur or for which the entity has forecasted acquisition or incurrence.

9. “Income generation transaction” is defined as derivatives written or sold to generate additional income or return to the reporting entity. They include covered options, caps, and floors (e.g., a reporting entity writes an equity call option on stock that it already owns).

10. “Replication (Synthetic Asset) transaction” is a derivative transaction entered into in conjunction with other investments in order to reproduce the investment characteristics of otherwise permissible investments. A derivative transaction entered into by an insurer as a hedging or income generation transaction shall not be considered a replication (synthetic asset) transaction.

11. “Forecasted transaction” is a transaction that is expected to occur for which there is no firm commitment. Because no transaction or event has yet occurred and the transaction or event when it occurs will be at the prevailing market price, a forecasted transaction does not give an entity any present rights to future benefits or a present obligation for future sacrifices.

12. An “underlying” is a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable. An underlying may be a price or rate of an asset or liability but is not the asset or liability itself.

Embedded Derivative Instruments

13. Contracts that do not in their entirety meet the definition of a derivative instrument, such as bonds, insurance policies, and leases, may contain “embedded” derivative instruments—implicit or explicit terms that affect some or all of the cash flows or the value of other exchanges required by the contract in a manner similar to a derivative instrument. The effect of embedding a derivative instrument in another type of contract (“the host contract”) is that some or all of the cash flows or other exchanges

that otherwise would be required by the contract, whether unconditional or contingent upon the occurrence of a specified event, will be modified based on one or more underlyings. An embedded derivative instrument shall not be separated from the host contract and accounted for separately as a derivative instrument.

Impairment

14. This issue paper adopts the impairment guidelines established by *SSAP No. 5—Liabilities, Contingencies and Impairments of Assets* (SSAP No. 5) for the underlying financial assets or liabilities.

Recognition and Measurement of Derivatives Used in Hedging Transactions

15. Derivative instruments represent rights or obligations that meet the definitions of assets (*SSAP No. 4—Assets and Nonadmitted Assets*) or liabilities (SSAP No. 5) and shall be reported in financial statements. In addition, derivative instruments also meet the definition of financial instruments as defined in *SSAP No. 27—Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk, Financial Instruments with Concentrations of Credit Risk and Disclosures about Fair Value of Financial Instruments* (SSAP No. 27). Should the cost basis of the derivative instrument be undefined (i.e., no premium is paid), the instrument shall be disclosed in accordance with paragraphs 8-10 of SSAP No. 27. Derivative instruments are admitted assets to the extent they conform to the requirements of this issue paper.

16. Derivative instruments used in hedging transactions that meet the criteria of a highly effective hedge shall be considered an effective hedge and valued and reported in a manner that is consistent with the hedged asset or liability (referred to as hedge accounting). For instance, assume an entity has a financial instrument on which it is currently receiving income at a variable rate but wishes to receive income at a fixed rate and thus enters into a swap agreement to exchange the cash flows. If the transaction qualifies as an effective hedge and a financial instrument on a statutory basis is valued and reported at amortized cost, then the swap would also be valued and reported at amortized cost. Derivative instruments used in hedging transactions that do not meet the criteria of an effective hedge shall be accounted for at fair value and the changes in the fair value shall be recorded as unrealized gains or unrealized losses (referred to as fair value accounting).

17. Entities shall not bifurcate the effectiveness of derivatives. A derivative instrument is either classified as an effective hedge or an ineffective hedge. Entities must account for the derivative using fair value accounting if it is deemed to be ineffective. Entities may redesignate a derivative in a hedging relationship even though the derivative was used in a previous hedging relationship that proved to be ineffective. An entity shall prospectively discontinue hedge accounting for an existing hedge if any one of the following occurs:

a. Any criterion in paragraphs 20-23 is no longer met;

b. The derivative expires or is sold, terminated, or exercised (impact recorded as realized gains or losses or, for effective hedges of firm commitments or forecasted transactions, in a manner that is consistent with the hedged transaction – see paragraph 18);

c. The entity removes the designation of the hedge; or

d. The derivative is deemed to be impaired in accordance with paragraph 14. A permanent decline in a counterparty's credit quality/rating is one example of impairment required by paragraph 14, for derivatives used in hedging transactions.

18. For those derivatives which qualify for hedge accounting, the change in the carrying value or cash flow of the derivative shall be recorded consistently with how the changes in the carrying value or cash flow of the hedged asset, liability, firm commitment or forecasted transaction are recorded.

Hedge Designations

19. An entity may designate a derivative instrument as hedging the exposure to:

a. Changes in the fair value of an asset or a liability or an identified portion thereof that is attributable to a particular risk. This type of hedge can be utilized regardless of whether the hedged asset or liability is recorded in the financial statements at fair value;

b. Variability in expected future cash flows that is attributable to a particular risk. That exposure may be associated with an existing recognized asset or liability (such as all or certain future interest payments on variable-rate debt) or a forecasted transaction; or

c. Foreign currency exposure. Specific examples include a fair value or cash flow hedge of a firm commitment or financial instrument.

Fair Value Hedges

20. Fair value hedges qualify for hedge accounting if all of the following criteria are met:

a. At inception of the hedge, the formal documentation requirements of paragraph 26 are met;

b. Both at inception of the hedge and on an ongoing basis, the hedging relationship must be highly effective in achieving offsetting changes in fair value attributable to the hedged risk during the period that the hedge is designated. An assessment of effectiveness is required whenever financial statements or earnings are reported, and at least every three months. All assessments of effectiveness shall be consistent with the risk management strategy documented for that particular hedging relationship;

c. The term highly effective has the same meaning as the notion of high correlation as utilized in *FAS No. 80*, *Accounting for Futures Contracts* (FAS 80). As a result, highly effective describes a fair value hedging relationship where the change in the fair value of the derivative hedging instrument is within 80 to 125 percent of the opposite change in the fair value of the hedged item attributable to the hedged risk. It shall also apply when an R-squared of .80 or higher is achieved when using a regression analysis technique. Further guidance on determining effectiveness can be found within Exhibit A and B;

d. The hedged item is specifically identified as either all or a specific portion of a recognized asset or liability or of an unrecognized firm commitment. The hedged item is a single asset or liability (or a specific portion thereof) or is a portfolio of similar assets or a portfolio of similar liabilities (or a specific portion thereof); and

e. If similar assets or similar liabilities are aggregated and hedged as a portfolio, the individual assets or individual liabilities must share the risk exposure for which they are designated as being hedged. The change in fair value attributable to the hedged risk for each individual item in a hedged portfolio must be expected to respond in a generally proportionate manner to the overall change in fair value of the aggregate portfolio attributable to the hedged risk.

Cash Flow Hedges

21. Cash flow hedges qualify for hedge accounting if all of the following criteria are met:

a. At inception of the hedge, the formal documentation requirements of paragraph 26 are met;

b. Both at inception of the hedge and on an ongoing basis, the hedging relationship shall be highly effective in achieving offsetting cash flows attributable to the hedged risk during the term of the hedge. An assessment of effectiveness is required whenever financial statements or earnings are reported, and at least every three months. All assessments of effectiveness shall be consistent with the originally documented risk management strategy for that particular hedging relationship; and

c. The term highly effective has the same meaning as the notion of high correlation as utilized in FAS No. 80. As a result, highly effective describes a cash flow hedging relationship where the change in the cash flows of the derivative hedging instrument is within 80 to 125 percent of the opposite change in the cash flows of the hedged item attributable to the hedged risk. It shall also apply when an R-squared of .80 or higher is achieved when using a regression analysis technique. Further guidance on determining effectiveness can be found within Exhibit A and B.

Hedging Forecasted Transactions

22. A forecasted transaction is eligible for designation as a hedged transaction in a cash flow hedge if all of the following additional criteria are met:

a. The forecasted transaction is specifically identified as a single transaction or a group of individual transactions. If the hedged transaction is a group of individual transactions, those individual transactions must share the same risk exposure for which they are designated as being hedged. Thus, a forecasted purchase and a forecasted sale cannot both be included in the same group of individual transactions that constitute the hedged transaction.

b. The occurrence of the forecasted transaction is probable. An assessment of the likelihood that a forecasted transaction will take place should not be based solely on management's intent because intent is not verifiable. The transaction's probability should be supported by observable facts and the attendant circumstances. Consideration should be given to the following circumstances in assessing the likelihood that a transaction will occur:

i. The frequency of similar past transactions;
ii. The financial and operational ability of the entity to carry out the transaction;
iii. Substantial commitments of resources to a particular activity (for example, a manufacturing facility that can be used in the short run only to process a particular type of commodity);
iv. The extent of loss or disruption of operations that could result if the transaction does not occur; and
v. The likelihood that transactions with substantially different characteristics might be used to achieve the same business purpose (for example, an entity that intends to raise cash may have several ways of doing so, ranging from a short-term bank loan to a common stock offering).

The term probable requires a significantly greater likelihood of occurrence than the phrase more likely than not. In addition, both the length of time until a forecasted transaction is projected to occur and the quantity of the forecasted transaction are considerations in determining probability. Other factors being equal, the more distant a forecasted transaction is, the less likely it is that the transaction would be considered probable and the stronger the evidence that would be needed to support an assertion that it is probable. For example, a transaction forecasted to occur in five years may be less likely than a transaction forecasted to occur in one year. However, forecasted interest payments for the next 20 years on variable-rate debt typically would be probable if supported by an existing contract. Additionally, other factors being equal, the greater the physical quantity or future value of a forecasted transaction, the less likely it is that the transaction would be considered probable and the stronger the evidence that would be required to support an assertion that it is probable. For example, less evidence generally would be needed to support forecasted investments of $100,000 in a particular month than would be needed to support forecasted investments of $950,000 in that month by an entity, even if its investments have averaged $950,000 per month for the past 3 months.

A forecasted transaction that is expected to occur with 2 months of the original forecasted date (or time frame) may still be considered probable. If the transaction will not occur until greater than 2 months after the original forecasted date, it is no longer probable and will be accounted for as per the following paragraph.

If a forecasted transaction is determined to no longer be probable per the standards above, hedge accounting shall cease immediately and any deferred gains or losses on the derivative must be recognized in unrealized gains or losses. If an entity demonstrates a pattern of determining that hedged forecasted transactions probably will not occur, such action would call into question both the entity's ability to accurately predict forecasted transactions and the propriety of using hedge accounting in the future for similar forecasted transactions. Accordingly, hedging of forecasted transactions will no longer be permitted by that entity.

c. If the hedged transaction is the forecasted purchase or sale of a nonfinancial asset, the designated risk being hedged is (1) the risk of changes in the functional-currency-equivalent cash flows attributable to changes in the related foreign currency exchange rates or (2) the risk of changes in the cash flows relating to all changes in the purchase price or sales price of the asset (reflecting its actual location if a physical asset), not the risk of changes in the cash flows relating to the purchase or sale of a similar asset in a different location or of a major ingredient.

d. If the hedged transaction is the forecasted purchase or sale of a financial asset or liability or the variable cash inflow or outflow of an existing financial asset or liability, the designated risk being hedged is (1) the risk of changes in the cash flows of the entire asset or liability, such as those relating to all changes in the purchase price or sales price (regardless of whether that price and the related cash flows are stated in the entity’s functional currency or a foreign currency), (2) the risk of changes in its cash flows attributable to changes in the designated benchmark interest rate, (3) the risk of changes in the functional-currency-equivalent cash flows attributable to changes in the related foreign currency exchange rates, or (4) the risk of changes in its cash flows attributable to default or changes in the obligor’s creditworthiness, and changes in the spread over the benchmark interest rate with respect to the hedged item’s credit sector at inception of the hedge. Two or more of the above risks may be designated simultaneously as being hedged. The benchmark interest rate being hedged in a hedge of interest rate risk must specifically be identified as part of the designation and documentation at the inception of the hedging relationship. An entity may not designate prepayment risk as the risk being hedged.

Foreign Currency Hedges

23. For foreign currency hedges, this issue paper adopts paragraphs 36-42 (except for last sentence of paragragh 38) of FAS No. 133 and paragraphs 4.b.- 4.o. of FAS No. 138 which amend FAS No. 133.

Hedge Effectiveness

24. The measurement of hedge effectiveness for a particular hedging relationship shall be consistent with the entity's risk management strategy and the method of assessing hedge effectiveness that was documented at the inception of the hedging relationship, as discussed in paragraph 26.

25. The gain or loss on a derivative designated as a cash flow hedge and assessed to be effective is reported consistently with the hedged item. If an entity's defined risk management strategy for a particular hedging relationship excludes a specific component of the gain or loss, or related cash flows, on the hedging derivative from the assessment of hedge effectiveness (as discussed in Exhibit B), that excluded component of the gain or loss shall be recognized as an unrealized gain or loss. For example, if the effectiveness of a hedge with an option contract is assessed based on changes in the option's intrinsic value, the changes in the option's time value would be recognized in unrealized gains or losses. Time value is equal to the fair value of the option less its intrinsic value.

Documentation Guidance

26. At inception of the hedge, documentation must include:

a. A formal documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge, including identification of the hedging instrument, the hedged item, the nature of the risk being hedged, and how the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value or variability in cash flows attributable to the hedged risk will be assessed. There must be a reasonable basis for how the entity plans to assess the hedging instrument's effectiveness;

b. An entity's defined risk management strategy for a particular hedging relationship may exclude certain components of a specific hedging derivative's change in fair value, such as time value, from the assessment of hedge effectiveness, as discussed in paragraph 63 of FAS 133;

c. Signature of approval, for each instrument, by person(s) authorized, either by the entity's board of directors or a committee authorized by the board, to approve such transactions; and

d. A description of the reporting entity's methodology used to verify that opening transactions do not exceed limitations promulgated by the state of domicile.

27. For all derivatives terminated, expired, or exercised during the year:

a. Signature of approval, for each instrument, by person(s) authorized, either by the entity's board of directors or a committee authorized by the board, to approve such transactions;

b. A description, for each instrument, of the nature of the transaction, including:

i. The date of the transaction;

ii. A complete and accurate description of the specific derivative, including description of the underlying securities, currencies, rates, indices, commodities, derivatives, or other financial market instruments;
iii. Number of contracts or notional amount;
iv. Date of maturity, expiry or settlement;
v. Strike price, rate or index (termination price for futures contracts);
vi. Counterparty, or exchange on which the transaction was traded; and
vii. Consideration paid or received, if any, on termination.

c. Description of the reporting entity's methodology to verify that derivatives were effective hedges; and

d. Identification of any derivatives that ceased to be effective as hedges.

28. For derivatives open at quarter-end:

a. A description of the methodology used to verify the continued effectiveness of hedges;
b. An identification of any derivatives which have ceased to be effective as hedges;
c. A description of the reporting entity's methodology to determine fair values of derivatives;
d. Copy of Master Agreements, if any, where indicated on Schedule DB Part E Section 1.

Recognition and Measurement of Derivatives Used in Income Generation Transactions

General

29. Income generation transactions are defined as derivatives written or sold to generate additional income or return to the reporting entity. They include covered options, caps, and floors (e.g., a reporting entity writes an equity call option on stock that it already owns).

30. Because these transactions require writing derivatives, they expose the reporting entity to potential future liabilities for which the reporting entity receives a premium up front. Because of this risk, dollar limitations and additional constraints are imposed requiring that the transactions be "covered" (i.e., offsetting assets can be used to fulfill potential obligations). To this extent, the combination of the derivative and the covering asset works like a reverse hedge where an asset owned by the reporting entity in essence hedges the derivative risk.

31. As with derivatives in general, these instruments include a wide variety of terms regarding maturities, range of exercise periods and prices, counterparties, underlying instruments, etc.

32. The principal features of income generation transactions are:

a. Premium received is initially recorded as a deferred liability;
b. The accounting of the covering asset or underlying interest controls the accounting of the derivative. The covering asset/underlying interest is accounted at either fair value (e.g., common stocks) or (amortized) cost (e.g., bonds);
c. The gain/loss on termination of the derivative is a capital item. For life insurance companies, it shall be subject to IMR treatment if interest rate related;
d. For options which are exercised, the remaining premium shall adjust the proceeds (cost) associated with the exercise resulting in no explicit gain or loss reported for the derivative itself.

Written Fixed Income Covered Call Options

33. The principal features of written fixed income covered call options are:

a. The general approach is to value at cost (i.e., consideration received) without amortization over the life of the contract if the original duration is less than one year, otherwise carry at amortized cost;

b. An alternative to the general approach combines the accounting of the written option with the covering asset and then uses standard accounting for callable bonds (yield to worst amortization) on the adjusted asset. This method prevents the possibility of future loss recognition upon exercise while at the same time providing recognition of the income feature of the option over time. This approach would appear most relevant for longer-lived covered European call options, which are in substance like callable bonds;

c. For life insurance companies, the gain or loss flows through the IMR if the covering asset or underlying interest is subject to the IMR using callable bond rules to determine the remaining life;

d. Reporting entities are responsible for timely recognition of any probable losses that may occur as a result of the strategy. If the exercise price is below the covering asset's book value, the asset shall be evaluated for write down or disclosure treatment in accordance with SSAP No. 5. All relevant factors such as whether the option is currently exercisable, the fair value of the bond relative to its exercise price, to what extent the statement value of the option premium offsets any loss on the asset, or how any IMR transaction on exercise would affect unassigned funds (surplus) and income shall be considered.

34. Written fixed income covered call options shall be accounted for as follows:

STATUS OF OPTION	COVERING ASSET VALUED AT AMORTIZED COST	COVERING ASSET VALUED AT FAIR VALUE
Open	Record premium as deferred liability. Carry at amortized value. (Alternatively carry at consideration received if original duration is less than 1 year to maturity.) Alternatively, attach premium to covering asset and amortize (under yield to worse scenario) using standard callable bond accounting.	Record premium as deferred liability. Changes in fair value recorded as unrealized adjustments to unassigned funds (surplus) – gain/loss.
Closed – Expired	Premium received recognized as realized capital gain. Gain from expiration to flow through IMR, if applicable. (1)	Premium received recognized as realized capital gain.
Closed – Exercised	Adjust disposition proceeds. (Include in capital gain/loss of disposed asset.) Gain or loss from disposition to flow through IMR, if applicable. (1)	Adjust disposition proceeds. (Include in capital gain/loss of disposed asset.)
Closed – Terminated	Recognize net amount as realized capital gain/loss. Gain or loss from disposition to flow through IMR, if applicable. (1)	Recognize net amount as realized capital gain/loss.

NOTE:

(1) If premium is attached to covering asset, the accounting treatment for the covering asset applies.

Written Covered Put Options

35. The principal features of written covered put options are:

a. The accounting for the underlying interest instead of the covering asset governs the accounting of the written put while it is open. For example, if a reporting entity wrote a put requiring it to purchase a certain common stock (underlying interest) at a specific price, the reporting entity might cover that option by holding cash or cash equivalents (covering asset). The accounting for the common stock would govern the accounting of the option in this case;

b. As with covered call writing for life insurance companies, gain/loss on termination may be subject to IMR over the remaining life of the underlying interest;

c. As with covered call writing, entities writing put options for income generation purposes are responsible for timely recognition of any probable losses that may occur as a result of the strategy.

36. Written covered put options shall be accounted for as follows:

STATUS OF OPTION	UNDERLYING INTEREST VALUED AT AMORTIZED COST	UNDERLYING INTEREST VALUED AT FAIR VALUE
Open	Record premium as deferred liability. Carry at amortized value. (Alternatively carry at consideration received if original duration is less than 1 year to maturity.)	Record premium as deferred liability. Changes in fair value recorded as unrealized adjustments to unassigned funds (surplus) – gain/loss.
Closed – Expired	Premium received recognized as realized capital gain. Gain from expiration to flow through IMR, if applicable.	Premium received recognized as realized capital gain.
Closed – Exercised	Adjust acquisition cost by premium received.	Adjust acquisition cost by premium received.
Closed – Terminated	Recognize net amount as realized capital gain/loss. Gain or loss from disposition to flow through IMR, if applicable.	Recognize net amount as realized capital gain/loss.

Written Fixed Income Caps and Floors

37. The principal features of written fixed income caps and floors are:

a. The value of the premium received shall be amortized into income over the life of the contract. For caps and floors, where the entity is selling off possible excess interest/income, the value of the covering asset is not relevant;

b. Gain/loss may be subject to IMR. The expected maturity would be the derivative contract's maturity.

38. Written fixed income caps and floors shall be accounted for as follows:

STATUS OF OPTION	COVERING ASSET VALUED AT AMORTIZED COST	COVERING ASSET VALUED AT FAIR VALUE
Open	Record premium as deferred liability. Carry at amortized value. (Alternatively carry at consideration received if original duration is less than 1 year to maturity.) Amortize over life of contract to produce constant yield. Record any interest expense as "Other Investment Income" – negative value.	Record premium as deferred liability. Changes in fair value recorded as unrealized adjustments to unassigned funds (surplus) – gain/loss.
Closed – Matured	Would usually mature at zero amortized value. Any remaining unamortized value recognized as ordinary income through a final amortization adjustment.	Premium received recognized as realized capital gain.
Closed – Exercised	Not applicable.	Not applicable.
Closed – Terminated	Recognize net amount as realized capital gain/loss. Gain/loss on termination to flow through IMR, if applicable.	Recognize net amount as realized capital gain/loss.

Recognition and Measurement of Derivatives Used in Replication (Synthetic Asset) Transactions

39. Replication (Synthetic Asset) transaction means a derivative transaction entered into in conjunction with other investments in order to reproduce the investment characteristics of otherwise permissible investments. A derivative transaction entered into by an insurer as a hedging or income generation transaction shall not be considered a replication (synthetic asset) transaction.

40. Any premium paid or received shall be carried as an asset or liability on the balance sheet (Aggregate Write-in for Invested Asset (or) Liability). Premiums paid or received on the replication (synthetic asset) derivative should be amortized into investment income or expense until the exercise, termination or maturity date of the derivative.

41. If the replication (synthetic asset) transaction would be carried at amortized cost and the cash instrument used is carried at amortized cost, then the derivative used should be carried at amortized cost. The derivative may be valued at fair value when both the replication (synthetic asset) and the cash instrument are valued at amortized cost. This is consistent with the alternative valuation methods available for hedges. If the replication (synthetic asset) transaction would be carried at fair value and/or the cash instrument used is carried at fair value, then the derivative used should be carried at fair value.

	(a)	(b)	(c)	(d)
	If the Replication (Synthetic Asset) is Valued at:	And Cash Instrument(s) Used is (are) Valued at:	The Derivative is Valued at:	Alternative Derivative Value Basis:
1.	Amortized Cost	Amortized Cost	Amortized Cost	Fair value
2.	Fair value	Fair value	Fair value	N/A
3.	Amortized Cost	Fair value	Fair value	N/A
4.	Fair value	Amortized Cost	Fair value	N/A

42. In the case of No. 3 in the chart above, the fair values for the cash instrument and derivative, when added together, shall not exceed the replication (synthetic asset) statement value. If this does occur, the excess shall reduce the fair value of the derivative.

43. If the replication (synthetic asset) transaction involves the exchange of interest related cash flows (default free assets), then the cash flows should be accrued as investment income. If the replication (synthetic asset) transaction involves the exchange of total return or change in index cash flows, then the cash flows should be segregated between interest income and fair value (equity) changes. The interest income portion should be accrued as investment income.

44. If the derivative is carried at fair value, the periodic change in the fair value should be recorded as an unrealized gain or loss adjustment to surplus until the transaction is terminated. If the replication (synthetic asset) transaction involves the exchange of total return or change in index cash flows, then the cash flows should be segregated between interest income and fair value (equity) changes. The fair value (equity) change should be recognized as a deferred asset/liability until the termination of the contract. Gains or losses on the derivative at termination or sale should be recognized as realized.

Disclosure Requirements

45. Reporting entities shall disclose the following for all derivative contracts used:

a. General disclosures:

i. A description of the reporting entity's objectives for using derivatives, i.e., hedging, income generation or replication;

ii. A description of the context needed to understand those objectives and its strategies for achieving those objectives;

iii. The description for hedging objectives shall identify the category, e.g., fair value hedges, cash flow hedges, or foreign currency hedges, and for all objectives, the type of instrument(s) used;

iv. A description of the accounting policies for derivatives including the policies for recognizing (or reasons for not recognizing) and measuring the derivatives used, and when recognized, where those instruments and related gains and losses are reported;

v. The net gain or loss recognized in unrealized gains or losses during the reporting period representing the component of the derivative instruments' gain or loss, if any, excluded from the assessment of hedge effectiveness; and

vi. The net gain or loss recognized in unrealized gains or losses during the reporting period resulting from derivatives that no longer qualify for hedge accounting.

b. Disclosures by type of instrument outstanding, e.g., call options, floors, etc.:

i. Notional or contract amounts;

ii. Carrying and fair values; and

iii. A discussion of the market risk, credit risk, and cash requirements of the derivatives.

c. For derivatives held for other-than-hedging purposes in addition to a and b above:

i. Average fair value of the derivatives during the reporting period together with the related end-of-period fair value distinguishing between assets and liabilities;

ii. Net gains or losses detailed by class, business activity or other category that is consistent with the management of those activities and where the net gains or losses are reported.

d. The financial statements shall disclose details of covered items and/or written transactions to allow evaluation of cash flow implications for all written covered options used for income generation.

e. For derivatives accounted for as cash flow hedges of a forecasted transaction, disclose:

i. The maximum length of time over which the entity is hedging its exposure to the variability in future cash flows for forecasted transactions excluding those forecasted transactions related to the payment of variable interest on existing financial instruments; and

iii. The amount of gains and losses classified in unrealized gains/losses related to cash flow hedges that have been discontinued because it was no longer probable that the original forecasted transactions would occur by the end of the originally specified time period or within 2 months of that date.

f. The disclosure requirements of 45 a, 45 b, and 45 e shall be included in the Annual Statement. Refer to the preamble for further discussion regarding interim disclosure requirements. The disclosure requirements of paragraphs 45.a.- 45.e. shall be included in the annual audited statutory financial reports. Paragraph 55 of the Preamble states that disclosures made within specific schedules or exhibits to the Annual Statement need not be duplicated in a separate note.

Effective Date

46. Upon adoption of this issue paper, the NAIC will release a Statement of Statutory Accounting Principle (SSAP) for comment. The SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the Accounting Practices and Procedures Manual should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will contain an effective date of years ending on or after December 31, 2002.

DISCUSSION

47. The purpose of this issue paper is two-fold. First, to provide a comprehensive source on accounting for derivatives used in hedges, income generation and replication transactions. Second, to address the GAAP guidance that has been issued subsequent to the finalization of SSAP No. 31. In general, this issue paper adopts the framework established by FAS No. 133 for fair value and cash flow hedges, but not its technical guidance (discussed further in subsequent paragraphs). This issue paper adopts the provisions of FAS No. 133 and 138 related to foreign currency hedges. With the exception of guidance specific to foreign currency hedges and amendments specific to refining the hedging of interest rate risk (under FAS 138, the risk of changes in the benchmark interest rate would be the hedged risk), this issue paper rejects FAS No. 137 and 138 as well as the various related Emerging Issues Task Force interpretations (complete listing found in RELEVANT LITERATURE section of this issue paper). It should be noted that the conclusions reached in this issue paper are not intended to usurp the rules and regulations put forth by states in their respective investment laws. The contents of this issue paper are intended to provide accounting guidance on the use of derivatives as allowed by an insurer's state of domicile. It is not intended to imply that insurers may use derivatives or cash instruments that the insurer's state of domicile does not allow under the state's insurance regulatory requirements, e.g., in replication transactions.

Definitions

48. This issue paper defines a derivative instrument somewhat differently than FAS No. 133. The Statutory Accounting Principles (SAP) working group evaluated the FAS No. 133 definition and found that it was inconsistent with the manner in which derivatives are regulated in the insurance industry. While FAS 133 defines derivatives in the context of the characteristics contained in an instrument, the working group concluded that a definition based upon the legal form/contractual rights and obligations is more relevant to statutory reporting. As a result, the definition of a derivative in paragraph 5 of this issue paper is not intended to include life contracts, accident and health contracts, property and casualty contracts and deposit-type contracts as defined within SSAP No. 50—*Classifications and Definitions of Insurance or Managed Care Contracts in Force*. Some of these contracts may be considered derivatives under the FAS No. 133 definition.

Embedded Derivative Instruments

49. FAS No. 133 requires that a contract containing an embedded derivative be accounted for separately from the host contract unless the embedded instrument is clearly and closely related to economic characteristics and risks of the host contract. This issue paper rejects that requirement and stipulates that such embedded derivatives shall not be accounted for separately from the host contract. The SAP working group does not believe this provision is applicable to insurance companies as evidenced by the FASB's difficulty in providing guidance for certain life contracts that include features not associated with insured events. In addition, the SAP working group believes the insurance specific definition of a derivative used in paragraph 5 of this issue paper excludes a majority of the contracts that would include embedded derivatives.

Impairment

50. This issue paper adopts the impairment guidelines of SSAP No. 5. The application of such shall be consistent with the hedged or replicated asset. For instance, a derivative used in a hedging transaction would follow the impairment guidelines for the hedged asset, whereas a derivative used in a replication transaction would follow the impairment guidelines for the asset it is replicating. For derivatives used in hedging transactions one example of an impairment in accordance with SSAP No. 5 would be the permanent decline in the counterparty's credit rating/quality. This example is not applicable to replication transactions as a reporting entity might be try to replicate a similar scenario.

Recognition and Measurement of Derivatives Used in Hedging Transactions

51. The SAP working group believes that a prudent use of derivatives can be an important tool in a sound risk management strategy. Risk management is the practice of defining the risk level an entity desires, identifying the risk level it currently has, and using derivative or other financial instruments to adjust the actual risk level to the desired risk level. Therefore, this issue paper allows holders of derivative instruments used in hedging transactions that meet the criteria of an effective hedge to value and report the derivative in a manner that is consistent with the hedged asset or liability (referred to as hedge accounting). This would allow derivatives that effectively hedge assets valued at amortized cost to also be valued at amortized cost.

52. This treatment is a dramatic departure from the requirements of FAS No. 133 in which all derivatives are valued and reported at fair value. This is possible for GAAP accounting because of the existence of *FAS No. 115, Accounting for Certain Investments in Debt and Equity Securities* (FAS No. 115) which requires a majority of GAAP (debt and equity) investments to be recorded at fair value. Therefore, the GAAP model is consistent within its framework to value many financial instruments at fair value. FAS No. 115 has been rejected by several SSAPs as regulators have concluded that the fluctuations of fair value from period to period violates the concepts of conservatism and consistency (further discussion can be found within Issue Paper Nos. 26, 30, 32 and 43). The result of rejecting FAS No. 115 results in a mixed valuation model in which certain financial instruments are valued at cost while some others are recognized at fair value (e.g., non-impaired bonds are recorded at amortized cost, equity instruments valued at fair value, real estate valued at cost or fair value depending upon management's intent). The SAP working group does not believe it is appropriate to value all derivatives at fair value if the assets they are intended to hedge are not also recognized at fair value. Under the FAS No. 133 model, an insurer cannot utilize hedge accounting for debt securities that the entity has the positive intent and ability to hold to maturity as such securities are classified as held-to-maturity securities and reported at amortized cost. This is due to the fact that fluctuations in fair value of the derivative would not offset the fluctuations in fair value of the debt security as the debt security is recorded at amortized cost and there is no impact on surplus for changes in its fair value. By utilizing the concept of emulating valuation of the hedged assets and derivatives adopted in this issue paper consistency is achieved within the mixed valuation model. The concept of emulating valuation also supports the conservatism concept of statutory accounting in that using the amortized values and unrealized gains or losses, derivatives used in hedging should be protected from significant temporary gains from being incorporated into earnings. Further, the conservatism concept is supported in permanent losses by application of the impairment requirement.

53. This issue paper also adopts a provision to recognize the changes in fair value of a derivative that does not meet the criteria for hedge accounting to be recorded as unrealized gains or losses. SSAP No. 31 requires these changes to be recognized currently in earnings. The SAP working group believes the SSAP No. 31 treatment is inconsistent with similar guidance for equity investments in that the earnings process has not been completed.

Hedge Designations

54. This issue paper adopts the hedge designation framework established in FAS No. 133 in that entities may designate a derivative instrument as hedging the exposure to changes in fair value, variability in expected future cash flow or foreign currency exposures. This decision was made so that statutory accounting would be consistent for entities that must also conform to the documentation requirements of FAS No. 133.

55. This issue paper allows entities to hedge a portfolio of similar assets or similar liabilities but does not advocate hedging of an entire portfolio with dissimilar risks (referred to as macro hedging). If similar assets or similar liabilities are aggregated and hedged as a portfolio, the individual assets or individual

liabilities must share the same risk exposure for which they are designated as being hedged. In a fair value hedge, the change in fair value attributable to the hedged risk for each individual item in a hedged portfolio must be expected to respond in a generally proportionate manner to the overall change in fair value of the aggregate portfolio attributable to the hedged risk. That is, if the change in fair value of a hedged portfolio attributable to the hedged risk was 10 percent during a reporting period, the change in the fair values attributable to the hedged risk for each item constituting the portfolio should be expected to be within a fairly narrow range, such as 9 percent to 11 percent. In contrast, an expectation that the change in fair value attributable to the hedged risk for individual items in the portfolio would range from 7 percent to 13 percent would be inconsistent with this provision. In aggregating loans in a portfolio to be hedged, an entity may choose to consider some of the following characteristics, as appropriate: loan type, loan size, nature and location of collateral, interest rate type (fixed or variable) and the coupon interest rate (if fixed), scheduled maturity, prepayment history of the loans (if seasoned), and expected prepayment performance in varying interest rate scenarios.

56. To qualify for hedge accounting, this issue paper requires that fair value, cash flow and foreign currency hedges must be highly effective in achieving its offsetting objectives. The term "highly effective" is specifically defined within this issue paper unlike FAS No. 133. The SAP working group defined this term so that consistent application of effectiveness could be attained. Additionally, the issue paper rejects the FAS No. 133 concept of identifying and separately accounting for the effective and ineffective portions of a single hedge. This issue paper instructs entities not to bifurcate effectiveness; an entity either has an effective hedge (must use hedge accounting) or an ineffective hedge (must use fair value accounting). Again, deviation from FAS No. 133 was made for consistency.

57. The provisions of FAS No. 133 and 138 related to hedging foreign currency are adopted in this issue paper as they do not violate the principles that define the Statement of Concepts.

Documentation

58. This issue paper adopts documentation guidance, which is a combination of the requirements of FAS No. 133 and SSAP No. 31. None of the requirements of SSAP No. 31 were removed and the FAS No. 133 requirements were added so that entities that also complete GAAP statements would not have to maintain separate documentation.

Recognition and Measurement of Derivatives Used in Income Generation Transactions

59. This issue paper retains the requirements of SSAP No. 31 for income generation transactions. This guidance is needed for those entities who wish to write or sell derivatives in an attempt to generate additional income and therefore do not use these types of derivatives to hedge risk exposures.

Recognition and Measurement of Derivatives Used in Replication (Synthetic Asset) Transactions

60. The guidance included for replication transactions was adopted as "NAIC Preferred Accounting Treatment" by the Emerging Accounting Issues working group on June 7, 1999. Inclusion in this issue paper of the preferred accounting guidance for replications formalizes its position within the Statutory Hierarchy.

Disclosures

61. This issue paper adopts disclosure requirements that represent a combination of the provisions of FAS No. 133 and SSAP No. 31.

Drafting Notes/Comments

- The issue of disclosing derivatives embedded within financial assets will be addressed by the Invested Asset (E) Working Group
- The issue of accounting for and the reporting of insurance derivatives (used in hedging insurance exposures) will be addressed by the Insurance Securitization (E) Working Group.
- The general reference to FAS No. 133 and 138 for foreign currency hedges will be replaced with the specific language in the SSAP once the staff has an opportunity to meld the two pronouncements together.
- The reporting guidance referred to in paragraph 18 will be refined by the FAS No. 133 Subgroup after further deliberation.
- The language specific to Insurance Futures and Insurance Futures Options has not been included in this issue paper due to the lack of activity in this market.

RELEVANT STATUTORY AND GAAP GUIDANCE:

Statutory Accounting

62. *SSAP No. 31—Derivative Instruments* provides the current statutory guidance for most derivative transactions.

63. The Emerging Accounting Issues Working Group adopted as NAIC preferred accounting treatment the conclusions reached in this issue paper for replication transactions. The following was taken from the June 7, 1999, minutes of the Working Group:

> Mr. Clark reported that the working group had reached a tentative consensus on the issue of accounting for replication transactions during an interim conference call on May 12, 1999. This consensus was exposed on the NAIC website after the 1999 Spring National Meeting, and the NAIC staff received no comments on it.
>
> Mr. Medley questioned whether the word “consideration” could be used instead of “premium” as shown on Attachment A Part (b) (see attachment 4 to the 5/12/99 conference call minutes). Maria Avila (Northwestern Mutual Life), on behalf of interested parties, indicated that the change would not modify the intent or conclusion of the proposal. Mr. Johnson made a motion to finalize the tentative consensus, as modified, and grant the proposal preferred NAIC accounting treatment. Mr. Ford seconded the motion. The working group unanimously adopted the motion.
>
> Mr. Clark stressed that this issue falls under the old working group rules and, thus, the working group can only grant preferred NAIC accounting treatment. This issue will also be addressed by the Codification of Statutory Accounting Principles working group when SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities is reviewed under the maintenance process.

Generally Accepted Accounting Principles

64. FAS 133 provides the following guidance (the language shown in italics has been amended by FAS No. 137 and 138):

> INTRODUCTION
>
> 1. This Statement addresses the accounting for derivative instruments, including certain derivative instruments embedded in other contracts, and hedging activities.
>
> 2. Prior to this Statement, hedging activities related to changes in foreign exchange rates were addressed in *FASB Statement No. 52, Foreign Currency Translation. FASB Statement No. 80, Accounting for Futures Contracts*, addressed the use of futures contracts in other hedging activities. Those Statements addressed only certain derivative instruments and differed in the criteria required for hedge accounting. In addition, the Emerging Issues Task Force (EITF) addressed the accounting for various hedging activities in a number of issues.

3. In developing the standards in this Statement, the Board concluded that the following four fundamental decisions should serve as cornerstones underlying those standards:

a. Derivative instruments represent rights or obligations that meet the definitions of assets or liabilities and should be reported in financial statements.
b. Fair value is the most relevant measure for financial instruments and the only relevant measure for derivative instruments. Derivative instruments should be measured at fair value, and adjustments to the carrying amount of hedged items should reflect changes in their fair value (that is, gains or losses) that are attributable to the risk being hedged and that arise while the hedge is in effect.
c. Only items that are assets or liabilities should be reported as such in financial statements.
d. Special accounting for items designated as being hedged should be provided only for qualifying items. One aspect of qualification should be an assessment of the expectation of effective offsetting changes in fair values or cash flows during the term of the hedge for the risk being hedged.

Those fundamental decisions are discussed individually in paragraphs 217–231 of Appendix C.

4. This Statement standardizes the accounting for derivative instruments, including certain derivative instruments embedded in other contracts, by requiring that an entity recognize those items as assets or liabilities in the statement of financial position and measure them at fair value. If certain conditions are met, an entity may elect to designate a derivative instrument as follows:

a. A hedge of the exposure to changes in the fair value of a recognized asset or liability, or of an unrecognized firm commitment, that are attributable to a particular risk (referred to as a fair value hedge)
b. A hedge of the exposure to variability in the cash flows of a recognized asset or liability, or of a forecasted transaction, that is attributable to a particular risk (referred to as a cash flow hedge)
c. A hedge of the foreign currency exposure of (1) an unrecognized firm commitment (a foreign currency fair value hedge), (2) an available-for-sale security (a foreign currency fair value hedge), (3) a forecasted transaction (a foreign currency cash flow hedge), or (4) a net investment in a foreign operation.

This Statement generally provides for matching the timing of gain or loss recognition on the hedging instrument with the recognition of (a) the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk or (b) the earnings effect of the hedged forecasted transaction. Appendix A provides guidance on identifying derivative instruments subject to the scope of this Statement and on assessing hedge effectiveness and is an integral part of the standards provided in this Statement. Appendix B contains examples that illustrate application of this Statement. Appendix C contains background information and the basis for the Board's conclusions. Appendix D lists the accounting pronouncements superseded or amended by this Statement. Appendix E provides a diagram for determining whether a contract is a freestanding derivative subject to the scope of this Statement.

Scope and Definition

5. This Statement applies to all entities. Some entities, such as not-for-profit organizations and defined benefit pension plans, do not report earnings as a separate caption in a statement of financial performance. The application of this Statement to those entities is set forth in paragraph 43.

Derivative Instruments

6. A derivative instrument is a financial instrument or other contract with all three of the following characteristics:

a. It has (1) one or more underlyings and (2) one or more notional amounts or payment provisions or both. Those terms determine the amount of the settlement or settlements, and, in some cases, whether or not a settlement is required.

b. It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.

c. Its terms require or permit net settlement, it can readily be settled net by a means outside the contract, or it provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

7. Underlying, notional amount, and payment provision. An underlying is a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable. An underlying may be a price or rate of an asset or liability but is not the asset or liability itself. A notional amount is a number of currency units, shares, bushels, pounds, or other units specified in the contract. The settlement of a derivative instrument with a notional amount is determined by interaction of that notional amount with the underlying. The interaction may be simple multiplication, or it may involve a formula with leverage factors or other constants. A payment provision specifies a fixed or determinable settlement to be made if the underlying behaves in a specified manner.

8. Initial net investment. Many derivative instruments require no initial net investment. Some require an initial net investment as compensation for time value (for example, a premium on an option) or for terms that are more or less favorable than market conditions (for example, a premium on a forward purchase contract with a price less than the current forward price). Others require a mutual exchange of currencies or other assets at inception, in which case the net investment is the difference in the fair values of the assets exchanged. A derivative instrument does not require an initial net investment in the contract that is equal to the notional amount (or the notional amount plus a premium or minus a discount) or that is determined by applying the notional amount to the underlying.

9. Net settlement. A contract fits the description in paragraph 6.c. if its settlement provisions meet one of the following criteria:

a. Neither party is required to deliver an asset that is associated with the underlying or that has a principal amount, stated amount, face value, number of shares, or other denomination that is equal to the notional amount (or the notional amount plus a premium or minus a discount). For example, most interest rate swaps do not require that either party deliver interest-bearing assets with a principal amount equal to the notional amount of the contract.

b. One of the parties is required to deliver an asset of the type described in paragraph 9.a., but there is a market mechanism that facilitates net settlement, for example, an exchange that offers a ready opportunity to sell the contract or to enter into an offsetting contract.

c. One of the parties is required to deliver an asset of the type described in paragraph 9.a., but that asset is readily convertible to cash or is itself a derivative instrument. An example of that type of contract is a forward contract that requires delivery of an exchange-traded equity security. Even though the number of shares to be delivered is the same as the notional amount of the contract and the price of the shares is the underlying, an exchange-traded security is readily convertible to cash. Another example is a swaption—an option to require delivery of a swap contract, which is a derivative.

Derivative instruments embedded in other contracts are addressed in paragraphs 12-16.

10. Notwithstanding the conditions in paragraphs 6-9, the following contracts are not subject to the requirements of this Statement:

a. “Regular-way” security trades. Regular-way security trades are contracts with no net settlement provision and no market mechanism to facilitate net settlement (as described in paragraphs 9.a. and 9.b.). They provide for delivery of a security within the time generally established by regulations or conventions in the marketplace or exchange in which the transaction is being executed.

b. Normal purchases and normal sales. Normal purchases and normal sales are contracts with no net settlement provision and no market mechanism to facilitate net settlement (as described in paragraphs 9.a. and 9.b.). They provide for the purchase or sale of something other than a financial instrument or derivative instrument that will be delivered in quantities expected to be used or sold by the reporting entity over a reasonable period in the normal course of business.

c. Certain insurance contracts. Generally, contracts of the type that are within the scope of *FASB Statements No. 60, Accounting and Reporting by Insurance Enterprises, No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, and *No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, are not subject to the requirements of this Statement whether or not they are written by insurance enterprises. That is, a contract is not subject to the requirements of this Statement if it entitles the holder to be compensated only if, as a result of an identifiable insurable event (other than a change in price), the holder incurs a liability or there is an adverse change in the value of a specific asset or liability for which the holder is at risk. The following types of contracts written by insurance enterprises or held by the insureds are not subject to the requirements of this Statement for the reasons given:

(1) Traditional life insurance contracts. The payment of death benefits is the result of an identifiable insurable event (death of the insured) instead of changes in a variable.

(2) Traditional property and casualty contracts. The payment of benefits is the result of an identifiable insurable event (for example, theft or fire) instead of changes in a variable.

However, insurance enterprises enter into other types of contracts that may be subject to the provisions of this Statement. In addition, some contracts with insurance or other enterprises combine derivative instruments, as defined in this Statement, with other insurance products or nonderivative contracts, for example, indexed annuity contracts, variable life insurance contracts, and property and casualty contracts that combine traditional coverages with foreign currency options. Contracts that consist of both derivative portions and nonderivative portions are addressed in paragraph 12.

d. Certain financial guarantee contracts. Financial guarantee contracts are not subject to this Statement if they provide for payments to be made only to reimburse the guaranteed party for a loss incurred because the debtor fails to pay when payment is due, which is an identifiable insurable event. In contrast, financial guarantee contracts are subject to this Statement if they provide for payments to be made in response to changes in an underlying (for example, a decrease in a specified debtor’s creditworthiness).

e. Certain contracts that are not traded on an exchange. Contracts that are not exchange-traded are not subject to the requirements of this Statement if the underlying on which the settlement is based is one of the following:

(1) A climatic or geological variable or other physical variable

(2) The price or value of (a) a nonfinancial asset of one of the parties to the contract provided that the asset is not readily convertible to cash or (b) a nonfinancial liability of one of the parties to the contract provided that the liability does not require delivery of an asset that is readily convertible to cash

(3) Specified volumes of sales or service revenues of one of the parties to the contract.

If a contract has more than one underlying and some, but not all, of them qualify for one of the exceptions in paragraphs 10.e.(1), 10.e.(2), and 10.e.(3), the application of this Statement to that contract depends on its predominant characteristics. That is, the contract is subject to the requirements of this Statement if all of its underlyings, considered in combination, behave in a manner that is highly correlated with the behavior of any of the component variables that do not qualify for an exception.

f. Derivatives that serve as impediments to sales accounting. A derivative instrument (whether freestanding or embedded in another contract) whose existence serves as an impediment to recognizing a related contract as a sale by one party or a purchase by the counterparty is not subject to this Statement. For example, the existence of a guarantee of the residual value of a leased asset by the lessor may be an impediment to treating a contract as a sales-type lease, in which case the contract would be treated by the lessor as an operating lease. Another example is the existence of a call option enabling a transferor to repurchase transferred assets that is an impediment to sales accounting under *FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.

11. Notwithstanding the conditions of paragraphs 6-10, the reporting entity shall not consider the following contracts to be derivative instruments for purposes of this Statement:

a. Contracts issued or held by that reporting entity that are both (1) indexed to its own stock and (2) classified in stockholders' equity in its statement of financial position

b. Contracts issued by the entity in connection with stock-based compensation arrangements addressed in *FASB Statement No. 123, Accounting for Stock-Based Compensation*

c. Contracts issued by the entity as contingent consideration from a business combination. The accounting for contingent consideration issued in a business combination is addressed in *APB Opinion No. 16, Business Combinations*. In applying this paragraph, the issuer is considered to be the entity that is accounting for the combination using the purchase method.

In contrast, the above exceptions do not apply to the counterparty in those contracts. In addition, a contract that an entity either can or must settle by issuing its own equity instruments but that is indexed in part or in full to something other than its own stock can be a derivative instrument for the issuer under paragraphs 6-10, in which case it would be accounted for as a liability or an asset in accordance with the requirements of this Statement.

Embedded Derivative Instruments

12. Contracts that do not in their entirety meet the definition of a derivative instrument (refer to paragraphs 6-9), such as bonds, insurance policies, and leases, may contain "embedded" derivative instruments—implicit or explicit terms that affect some or all of the cash flows or the value of other exchanges required by the contract in a manner similar to a derivative instrument. The effect of embedding a derivative instrument in another type of contract ("the host contract") is that some or all of the cash flows or other exchanges that otherwise would be required by the contract, whether unconditional or contingent upon the occurrence of a specified event, will be modified based on one or more underlyings. An embedded derivative instrument shall be separated from the host contract and accounted for as a derivative instrument pursuant to this Statement if and only if all of the following criteria are met:

a. The economic characteristics and risks of the embedded derivative instrument are not clearly and closely related to the economic characteristics and risks of the host contract. Additional guidance on applying this criterion to various contracts containing embedded derivative instruments is included in Appendix A of this Statement.

b. The contract ("the hybrid instrument") that embodies both the embedded derivative instrument and the host contract is not remeasured at fair value under otherwise applicable generally accepted accounting principles with changes in fair value reported in earnings as they occur.

c. A separate instrument with the same terms as the embedded derivative instrument would, pursuant to paragraphs 6-11, be a derivative instrument subject to the requirements of this Statement. (The initial net investment for the hybrid instrument shall not be considered to be the initial net investment for the embedded derivative.)

13. For purposes of applying the provisions of paragraph 12, an embedded derivative instrument in which the underlying is an interest rate or interest rate index that alters net interest payments that otherwise would be paid or received on an interest-bearing host contract is considered to be clearly and closely related to the host contract unless either of the following conditions exist:

a. The hybrid instrument can contractually be settled in a such a way that the investor (holder) would not recover substantially all of its initial recorded investment.

b. The embedded derivative could at least double the investor's initial rate of return on the host contract and could also result in a rate of return that is at least twice what otherwise would be the market return for a contract that has the same terms as the host contract and that involves a debtor with a similar credit quality.

Even though the above conditions focus on the investor's rate of return and the investor's recovery of its investment, the existence of either of those conditions would result in the embedded derivative instrument not being considered clearly and closely related to the host contract by both parties to the hybrid instrument. Because the existence of those conditions is assessed at the date that the hybrid instrument is acquired (or incurred) by the reporting entity, the acquirer of a hybrid instrument in the secondary market could potentially reach a different conclusion than could the issuer of the hybrid instrument due to applying the conditions in this paragraph at different points in time.

14. However, interest-only strips and principal-only strips are not subject to the requirements of this Statement provided they (a) initially resulted from separating the rights to receive contractual cash flows of a financial instrument that, in and of itself, did not contain an embedded derivative that otherwise would have been accounted for separately as a derivative pursuant to the provisions of paragraphs 12 and 13 and (b) do not incorporate any terms not present in the original financial instrument described above.

15. An embedded foreign currency derivative instrument shall not be separated from the host contract and considered a derivative instrument under paragraph 12 if the host contract is not a financial instrument and it requires payment(s) denominated in (a) the currency of the primary economic environment in which any substantial party to that contract operates (that is, its functional currency) or (b) the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in international commerce (for example, the U.S. dollar for crude oil transactions). Unsettled foreign currency transactions, including financial instruments, that are monetary items and have their principal payments, interest payments, or both denominated in a foreign currency are subject to the requirement in Statement 52 to recognize any foreign currency transaction gain or loss in earnings and shall not be considered to contain embedded foreign currency derivative instruments under this Statement. The same proscription applies to available-for-sale or trading securities that have cash flows denominated in a foreign currency.

16. In subsequent provisions of this Statement, both (a) a derivative instrument included within the scope of this Statement by paragraphs 6-11 and (b) an embedded derivative instrument that has been separated from a host contract as required by paragraph 12 are collectively referred to as derivative instruments. If an embedded derivative instrument is separated from its host contract, the host contract shall be accounted for based on generally accepted accounting principles applicable to instruments of that type that do not contain embedded derivative instruments. If an entity cannot reliably identify and measure the embedded derivative instrument that paragraph 12 requires be separated from the host contract, the entire contract shall be measured at fair value with gain or loss recognized in earnings, but it may not be designated as a hedging instrument pursuant to this Statement.

Recognition of Derivatives and Measurement of Derivatives and Hedged Items

17. An entity shall recognize all of its derivative instruments in its statement of financial position as either assets or liabilities depending on the rights or obligations under the contracts. All derivative instruments shall be measured at fair value. The guidance in *FASB Statement No. 107, Disclosures about Fair Value of Financial Instruments*, as amended, shall apply in determining the fair value of a financial instrument (derivative or hedged item). If expected future cash flows are used to estimate fair value, those expected cash flows shall be the best estimate based on reasonable and supportable assumptions and projections. All available evidence shall be considered in developing estimates of expected future cash flows. The weight given to the evidence shall be commensurate with the extent to which the evidence can be verified objectively. If a range is estimated for either the amount or the timing of possible cash flows, the likelihood of possible outcomes shall be considered in determining the best estimate of future cash flows.

18. The accounting for changes in the fair value (that is, gains or losses) of a derivative depends on whether it has been designated and qualifies as part of a hedging relationship and, if so, on the reason for holding it. Either all or a proportion of a derivative may be designated as the hedging instrument. The proportion must be expressed as a percentage of the entire derivative so that the profile of risk exposures in the hedging portion of the derivative is the same as that in the entire derivative. (Thus, an entity is prohibited from separating a compound derivative into components representing different risks and designating any such component as the hedging instrument, except as permitted at the date of initial application by the transition provisions in paragraph 49.) Subsequent references in this Statement to a derivative as a hedging instrument include the use of only a proportion of a derivative as a hedging instrument. Two or more derivatives, or proportions thereof, may also be viewed in combination and jointly designated as the hedging instrument. Gains and losses on derivative instruments are accounted for as follows:

a. No hedging designation. The gain or loss on a derivative instrument not designated as a hedging instrument shall be recognized currently in earnings.

b. Fair value hedge. The gain or loss on a derivative instrument designated and qualifying as a fair value hedging instrument as well as the offsetting loss or gain on the hedged item attributable to the hedged risk shall be recognized currently in earnings in the same accounting period, as provided in paragraphs 22 and 23.

c. Cash flow hedge. The effective portion of the gain or loss on a derivative instrument designated and qualifying as a cash flow hedging instrument shall be reported as a component of other comprehensive income (outside earnings) and reclassified into earnings in the same period or periods during which the hedged forecasted transaction affects earnings, as provided in paragraphs 30 and 31. The remaining gain or loss on the derivative instrument, if any, shall be recognized currently in earnings, as provided in paragraph 30.

d. Foreign currency hedge. The gain or loss on a derivative instrument or nonderivative financial instrument designated and qualifying as a foreign currency hedging instrument shall be accounted for as follows:

   (1) The gain or loss on the hedging derivative or nonderivative instrument in a hedge of a foreign-currency-denominated firm commitment and the

offsetting loss or gain on the hedged firm commitment shall be recognized currently in earnings in the same accounting period, as provided in paragraph 37.

(2) The gain or loss on the hedging derivative instrument in a hedge of an available-for-sale security and the offsetting loss or gain on the hedged available-for-sale security shall be recognized currently in earnings in the same accounting period, as provided in paragraph 38.

(3) The effective portion of the gain or loss on the hedging derivative instrument in a hedge of a forecasted foreign-currency-denominated transaction shall be reported as a component of other comprehensive income (outside earnings) and reclassified into earnings in the same period or periods during which the hedged forecasted transaction affects earnings, as provided in paragraph 41. The remaining gain or loss on the hedging instrument shall be recognized currently in earnings.

(4) The gain or loss on the hedging derivative or nonderivative instrument in a hedge of a net investment in a foreign operation shall be reported in other comprehensive income (outside earnings) as part of the cumulative translation adjustment to the extent it is effective as a hedge, as provided in paragraph 42.

19. In this Statement, the change in the fair value of an entire financial asset or liability for a period refers to the difference between its fair value at the beginning of the period (or acquisition date) and the end of the period adjusted to exclude (a) changes in fair value due to the passage of time and (b) changes in fair value related to any payments received or made, such as in partially recovering the asset or partially settling the liability.

Fair Value Hedges
General

20. An entity may designate a derivative instrument as hedging the exposure to changes in the fair value of an asset or a liability or an identified portion thereof (“hedged item”) that is attributable to a particular risk. Designated hedging instruments and hedged items qualify for fair value hedge accounting if all of the following criteria and those in paragraph 21 are met:

a. At inception of the hedge, there is formal documentation of the hedging relationship and the entity’s risk management objective and strategy for undertaking the hedge, including identification of the hedging instrument, the hedged item, the nature of the risk being hedged, and how the hedging instrument’s effectiveness in offsetting the exposure to changes in the hedged item’s fair value attributable to the hedged risk will be assessed. There must be a reasonable basis for how the entity plans to assess the hedging instrument’s effectiveness.

(1) For a fair value hedge of a firm commitment, the entity’s formal documentation at the inception of the hedge must include a reasonable method for recognizing in earnings the asset or liability representing the gain or loss on the hedged firm commitment.

(2) An entity’s defined risk management strategy for a particular hedging relationship may exclude certain components of a specific hedging derivative’s change in fair value, such as time value, from the assessment of hedge effectiveness, as discussed in paragraph 63 in Section 2 of Appendix A.

b. Both at inception of the hedge and on an ongoing basis, the hedging relationship is expected to be highly effective in achieving offsetting changes in fair value attributable to the hedged risk during the period that the hedge is designated. An assessment of effectiveness is required whenever financial statements or earnings are reported, and at least every three months. If the hedging instrument (such as an at-the-money option contract) provides only one-sided offset of the hedged risk, the increases (or decreases) in the fair value of the hedging instrument must be expected to be highly effective in offsetting the decreases (or increases) in the fair value of the hedged item. All assessments of effectiveness shall be consistent with the risk management strategy documented for that particular hedging relationship (in accordance with paragraph 20.a. above).

c. If a written option is designated as hedging a recognized asset or liability, the combination of the hedged item and the written option provides at least as much potential for gains as a result of a favorable change in the fair value of the combined instruments as exposure to losses from an unfavorable change in their combined fair value. That test is met if all possible percentage favorable changes in the underlying (from zero percent to 100 percent) would provide at least as much gain as the loss that would be incurred from an unfavorable change in the underlying of the same percentage.

(1) A combination of options (for example, an interest rate collar) entered into contemporaneously shall be considered a written option if either at inception or over the life of the contracts a net premium is received in cash or as a favorable rate or other term. (Thus, a collar can be designated as a hedging instrument in a fair value hedge without regard to the test in paragraph 20.c. unless a net premium is received.) Furthermore, a derivative instrument that results from combining a written option and any other nonoption derivative shall be considered a written option.

A nonderivative instrument, such as a Treasury note, shall not be designated as a hedging instrument, except as provided in paragraphs 37 and 42 of this Statement.

The Hedged Item

21. An asset or a liability is eligible for designation as a hedged item in a fair value hedge if all of the following criteria are met:

a. The hedged item is specifically identified as either all or a specific portion of a recognized asset or liability or of an unrecognized firm commitment. The hedged item is a single asset or liability (or a specific portion thereof) or is a portfolio of similar assets or a portfolio of similar liabilities (or a specific portion thereof).

(1) If similar assets or similar liabilities are aggregated and hedged as a portfolio, the individual assets or individual liabilities must share the risk exposure for which they are designated as being hedged. The change in fair value attributable to the hedged risk for each individual item in a hedged portfolio must be expected to respond in a generally proportionate manner to the overall change in fair value of the aggregate portfolio attributable to the hedged risk. That is, if the change in fair value of a hedged portfolio attributable to the hedged risk was 10 percent during a reporting period, the change in the fair values attributable to the hedged risk for each item constituting the portfolio should be expected to be within a fairly narrow range, such as 9 percent to 11 percent. In contrast, an expectation that the change in fair value attributable to the hedged risk for individual items in the portfolio would range from 7 percent to 13 percent would be inconsistent with this provision. In aggregating loans in a portfolio to be hedged, an entity may choose to consider some of the following characteristics, as appropriate: loan type, loan size, nature and location of collateral, interest rate type (fixed or variable) and the coupon interest rate (if fixed), scheduled maturity, prepayment history of the loans (if seasoned), and expected prepayment performance in varying interest rate scenarios.

(2) If the hedged item is a specific portion of an asset or liability (or of a portfolio of similar assets or a portfolio of similar liabilities), the hedged item is one of the following:

(a) A percentage of the entire asset or liability (or of the entire portfolio)

(b) One or more selected contractual cash flows (such as the portion of the asset or liability representing the present value of the interest payments in the first two years of a four-year debt instrument)

(c) A put option, a call option, an interest rate cap, or an interest rate floor embedded in an existing asset or liability that is not an embedded derivative accounted for separately pursuant to paragraph 12 of this Statement

(d) The residual value in a lessor's net investment in a direct financing or sales-type lease.

If the entire asset or liability is an instrument with variable cash flows, the hedged item cannot be deemed to be an implicit fixed-to-variable swap (or similar instrument) perceived to be embedded in a host contract with fixed cash flows.

b. The hedged item presents an exposure to changes in fair value attributable to the hedged risk that could affect reported earnings. The reference to affecting reported earnings does not apply to an entity that does not report earnings as a separate caption in a statement of financial performance, such as a not-for-profit organization, as discussed in paragraph 43.

c. The hedged item is not (1) an asset or liability that is remeasured with the changes in fair value attributable to the hedged risk reported currently in earnings *(for example, if foreign exchange risk is hedged, a foreign-currency-denominated asset for which a foreign currency transaction gain or loss is recognized in earnings)*, (2) an investment accounted for by the equity method in accordance with the requirements of APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock, (3) a minority interest in one or more consolidated subsidiaries, (4) an equity investment in a consolidated subsidiary, (5) a firm commitment either to enter into a business combination or to acquire or dispose of a subsidiary, a minority interest, or an equity method investee, or (6) an equity instrument issued by the entity and classified in stockholders' equity in the statement of financial position.

d. If the hedged item is all or a portion of a debt security (or a portfolio of similar debt securities) that is classified as held-to-maturity in accordance with *FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities,* the designated risk being hedged is the risk of changes in its fair value attributable to changes in the obligor's creditworthiness or if the hedged item is an option component of a held-to-maturity security that permits its prepayment, the designated risk being hedged is the risk of changes in the entire fair value of that option component. (The designated hedged risk for a held-to-maturity security may not be the risk of changes in its fair value attributable to changes in market interest rates or foreign exchange rates. If the hedged item is other than an option component that permits its prepayment, the designated hedged risk also may not be the risk of changes in its overall fair value.)

e. If the hedged item is a nonfinancial asset or liability (other than a recognized loan servicing right or a nonfinancial firm commitment with financial components), the designated risk being hedged is the risk of changes in the fair value of the entire hedged asset or liability (reflecting its actual location if a physical asset). That is, the price risk of a similar asset in a different location or of a major ingredient may not be the hedged risk. Thus, in hedging the exposure to changes in the fair value of gasoline, an entity may not designate the risk of changes in the price of crude oil as the risk being hedged for purposes of determining effectiveness of the fair value hedge of gasoline

f. If the hedged item is a financial asset or liability, a recognized loan servicing right, or a nonfinancial firm commitment with financial components, the designated risk being hedged is (1) the risk of changes in the overall fair value of the entire hedged item, (2) the risk of changes in its fair value attributable to changes in market interest rates, (3) the risk of changes in its fair value attributable to changes in the related foreign currency exchange rates (refer to paragraphs 37 and 38*)*, or (4) the risk of changes in its fair value attributable to changes in *the* obligor's creditworthiness. If the risk designated as being hedged is not the risk in paragraph 21.f.(1) above, two or more of the other risks (market interest rate risk, foreign currency exchange risk, and credit risk) may simultaneously be designated as being hedged. An entity may not simply designate prepayment risk as the risk being hedged for a financial asset. However, it can designate the option component of a prepayable instrument as the hedged item in a fair value hedge of the entity's exposure to changes in the fair value of that "prepayment" option, perhaps thereby achieving the objective of its desire to hedge prepayment risk. The effect of an embedded derivative of the same risk class must be considered in designating a hedge of an individual risk. For example, the effect of an embedded prepayment option must be considered in designating a hedge of market interest rate risk.

22. Gains and losses on a qualifying fair value hedge shall be accounted for as follows:

a. The gain or loss on the hedging instrument shall be recognized currently in earnings.
b. The gain or loss (that is, the change in fair value) on the hedged item attributable to the hedged risk shall adjust the carrying amount of the hedged item and be recognized currently in earnings.

If the fair value hedge is fully effective, the gain or loss on the hedging instrument, adjusted for the component, if any, of that gain or loss that is excluded from the assessment of effectiveness under the entity's defined risk management strategy for that particular hedging relationship (as discussed in paragraph 63 in Section 2 of Appendix A), would exactly offset the loss or gain on the hedged item attributable to the hedged risk. Any difference that does arise would be the effect of hedge ineffectiveness, which consequently is recognized currently in earnings. The measurement of hedge ineffectiveness for a particular hedging relationship shall be consistent with the entity's risk management strategy and the method of assessing hedge effectiveness that was documented at the inception of the hedging relationship, as discussed in paragraph 20.a. Nevertheless, the amount of hedge ineffectiveness recognized in earnings is based on the extent to which exact offset is not achieved. Although a hedging relationship must comply with an entity's established policy range of what is considered "highly effective" pursuant to paragraph 20.b. in order for that relationship to qualify for hedge accounting, that compliance does not assure zero ineffectiveness. Section 2 of Appendix A illustrates assessing hedge effectiveness and measuring hedge ineffectiveness. Any hedge ineffectiveness directly affects earnings because there will be no offsetting adjustment of a hedged item's carrying amount for the ineffective aspect of the gain or loss on the related hedging instrument.

23. If a hedged item is otherwise measured at fair value with changes in fair value reported in other comprehensive income (such as an available-for-sale security), the adjustment of the hedged item's carrying amount discussed in paragraph 22 shall be recognized in earnings rather than in other comprehensive income in order to offset the gain or loss on the hedging instrument.

24. The adjustment of the carrying amount of a hedged asset or liability required by paragraph 22 shall be accounted for in the same manner as other components of the carrying amount of that asset or liability. For example, an adjustment of the carrying amount of a hedged asset held for sale (such as inventory) would remain part of the carrying amount of that asset until the asset is sold, at which point the entire carrying amount of the hedged asset would be recognized as the cost of the item sold in determining earnings. An adjustment of the carrying amount of a hedged interest-bearing financial instrument shall be amortized to earnings;

amortization shall begin no later than when the hedged item ceases to be adjusted for changes in its fair value attributable to the risk being hedged.

25. An entity shall discontinue prospectively the accounting specified in paragraphs 22 and 23 for an existing hedge if any one of the following occurs:

a. Any criterion in paragraphs 20 and 21 is no longer met.
b. The derivative expires or is sold, terminated, or exercised.
c. The entity removes the designation of the fair value hedge.

In those circumstances, the entity may elect to designate prospectively a new hedging relationship with a different hedging instrument or, in the circumstances described in paragraphs 25.a. and 25(c) above, a different hedged item or a hedged transaction if the hedging relationship meets the criteria specified in paragraphs 20 and 21 for a fair value hedge or paragraphs 28 and 29 for a cash flow hedge.

26. In general, if a periodic assessment indicates noncompliance with the effectiveness criterion in paragraph 20.b., an entity shall not recognize the adjustment of the carrying amount of the hedged item described in paragraphs 22 and 23 after the last date on which compliance with the effectiveness criterion was established. However, if the event or change in circumstances that caused the hedging relationship to fail the effectiveness criterion can be identified, the entity shall recognize in earnings the changes in the hedged item's fair value attributable to the risk being hedged that occurred prior to that event or change in circumstances. If a fair value hedge of a firm commitment is discontinued because the hedged item no longer meets the definition of a firm commitment, the entity shall derecognize any asset or liability previously recognized pursuant to paragraph 22 (as a result of an adjustment to the carrying amount for the firm commitment) and recognize a corresponding loss or gain currently in earnings.

Impairment

27. An asset or liability that has been designated as being hedged and accounted for pursuant to paragraphs 22-24 remains subject to the applicable requirements in generally accepted accounting principles for assessing impairment for that type of asset or for recognizing an increased obligation for that type of liability. Those impairment requirements shall be applied after hedge accounting has been applied for the period and the carrying amount of the hedged asset or liability has been adjusted pursuant to paragraph 22 of this Statement. Because the hedging instrument is recognized separately as an asset or liability, its fair value or expected cash flows shall not be considered in applying those impairment requirements to the hedged asset or liability.

Cash Flow Hedges

General

28. An entity may designate a derivative instrument as hedging the exposure to variability in expected future cash flows that is attributable to a particular risk. That exposure may be associated with an existing recognized asset or liability (such as all or certain future interest payments on variable-rate debt) or a forecasted transaction (such as a forecasted purchase or sale). Designated hedging instruments and hedged items or transactions qualify for cash flow hedge accounting if all of the following criteria and those in paragraph 29 are met:

a. At inception of the hedge, there is formal documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge, including identification of the hedging instrument, the hedged transaction, the nature of the risk being hedged, and how the hedging instrument's effectiveness in hedging the exposure to the hedged transaction's variability in cash flows attributable to the hedged risk will be assessed. There must be a reasonable basis for how the entity plans to assess the hedging instrument's effectiveness.

(1) An entity's defined risk management strategy for a particular hedging relationship may exclude certain components of a specific hedging derivative's change in fair value from the assessment of hedge effectiveness, as discussed in paragraph 63 in Section 2 of Appendix A.

(2) Documentation shall include all relevant details, including the date on or period within which the forecasted transaction is expected to occur, the specific nature of asset or liability involved (if any), and the expected currency amount or quantity of the forecasted transaction.

(a) The phrase expected currency amount refers to hedges of foreign currency exchange risk and requires specification of the exact amount of foreign currency being hedged.

(b) The phrase expected . . . quantity refers to hedges of other risks and requires specification of the physical quantity (that is, the number of items or units of measure) encompassed by the hedged forecasted transaction. If a forecasted sale or purchase is being hedged for price risk, the hedged transaction cannot be specified solely in terms of expected currency amounts, nor can it be specified as a percentage of sales or purchases during a period. The current price of a forecasted transaction also should be identified to satisfy the criterion in paragraph 28.b. for offsetting cash flows.

The hedged forecasted transaction shall be described with sufficient specificity so that when a transaction occurs, it is clear whether that transaction is or is not the hedged transaction. Thus, the forecasted transaction could be identified as the sale of either the first 15,000 units of a specific product sold during a specified 3-month period or the first 5,000 units of a specific product sold in each of 3 specific months, but it could not be identified as the sale of the last 15,000 units of that product sold during a 3-month period (because the last 15,000 units cannot be identified when they occur, but only when the period has ended).

b. Both at inception of the hedge and on an ongoing basis, the hedging relationship is expected to be highly effective in achieving offsetting cash flows attributable to the hedged risk during the term of the hedge, except as indicated in paragraph 28.d. below. An assessment of effectiveness is required whenever financial statements or earnings are reported, and at least every three months. If the hedging instrument, such as an at-the-money option contract, provides only one-sided offset against the hedged risk, the cash inflows (outflows) from the hedging instrument must be expected to be highly effective in offsetting the corresponding change in the cash outflows or inflows of the hedged transaction. All assessments of effectiveness shall be consistent with the originally documented risk management strategy for that particular hedging relationship.

c. If a written option is designated as hedging the variability in cash flows for a recognized asset or liability, the combination of the hedged item and the written option provides at least as much potential for favorable cash flows as exposure to unfavorable cash flows. That test is met if all possible percentage favorable changes in the underlying (from zero percent to 100 percent) would provide at least as much favorable cash flows as the unfavorable cash flows that would be incurred from an unfavorable change in the underlying of the same percentage. (Refer to paragraph 20.c.(1).)

d. If a hedging instrument is used to modify the interest receipts or payments associated with a recognized financial asset or liability from one variable rate to another variable rate, the hedging instrument must be a link between an existing designated asset (or group of similar assets) with variable cash flows and an existing designated liability (or group of similar liabilities) with variable cash flows and be highly effective at achieving offsetting cash flows. A link exists if the basis (that is, the rate index on which the interest rate is based) of one leg of an interest rate swap is the same as the basis of the interest receipts for the designated asset and the basis of the other leg of the swap is the same as the basis of the interest payments for the designated liability. In this situation, the criterion in the first sentence in paragraph 29.a. is applied separately to the designated asset and the designated liability.

A nonderivative instrument, such as a Treasury note, shall not be designated as a hedging instrument for a cash flow hedge.

The Hedged Forecasted Transaction

29. A forecasted transaction is eligible for designation as a hedged transaction in a cash flow hedge if all of the following additional criteria are met:

a. The forecasted transaction is specifically identified as a single transaction or a group of individual transactions. If the hedged transaction is a group of individual transactions, those individual transactions must share the same risk exposure for which they are designated as being hedged. Thus, a forecasted purchase and a forecasted sale cannot both be included in the same group of individual transactions that constitute the hedged transaction.

b. The occurrence of the forecasted transaction is probable.

c. The forecasted transaction is a transaction with a party external to the reporting entity (except as permitted by paragraph 40) and presents an exposure to variations in cash flows for the hedged risk that could affect reported earnings.

d. The forecasted transaction is not the acquisition of an asset or incurrence of a liability that will subsequently be remeasured with changes in fair value attributable to the hedged risk reported currently in earnings *(for example, if foreign exchange risk is hedged, the forecasted acquisition of a foreign-currency-denominated asset for which a foreign currency transaction gain or loss will be recognized in earnings). However, forecasted sales on credit and the forecasted accrual of royalties on probable future sales by third-party licensees are not considered the forecasted acquisition of a receivable*. If the forecasted transaction relates to a recognized asset or liability, the asset or liability is not remeasured with changes in fair value attributable to the hedged risk reported currently in earnings.

e. If the variable cash flows of the forecasted transaction relate to a debt security that is classified as held-to-maturity under Statement 115, the risk being hedged is the risk of changes in its cash flows attributable to *default or changes in the obligor's creditworthiness*. For those variable cash flows, the risk being hedged cannot be the risk of changes in its cash flows attributable to *changes in market interest rates*.

f. The forecasted transaction does not involve a business combination subject to the provisions of Opinion 16 and is not a transaction (such as a forecasted purchase, sale, or dividend) involving (1) a parent company's interests in consolidated subsidiaries, (2) a minority interest in a consolidated subsidiary, (3) an equity-method investment, or (4) an entity's own equity instruments.

g. If the hedged transaction is the forecasted purchase or sale of a nonfinancial asset, the designated risk being hedged is (1) the risk of changes in the functional-currency-equivalent cash flows attributable to changes in the related foreign currency exchange rates or (2) the risk of changes in the cash flows relating to all changes in the purchase price or sales price of the asset (reflecting its actual location if a physical asset), not the risk of changes in the cash flows relating to the purchase or sale of a similar asset in a different location or of a major ingredient. Thus, for example, in hedging the exposure to changes in the cash flows relating to the purchase of its bronze bar inventory, an entity may not designate the risk of changes in the cash flows relating to purchasing the copper component in bronze as the risk being hedged for purposes of assessing offset as required by paragraph 28.b..

h. If the hedged transaction is the forecasted purchase or sale of a financial asset or liability or the variable cash inflow or outflow of an existing financial asset or liability, the designated risk being hedged is (1) *the risk of changes in the cash flows of the entire asset or liability*, such as those relating to all changes in the purchase price or sales price (regardless of whether that price and the related cash flows are stated in the entity's functional currency or a foreign currency), (2) the risk of changes in its cash flows attributable to changes in *market interest rates*, (3) the risk of changes in the functional-currency-equivalent cash flows attributable to changes in the related foreign currency exchange rates *(refer to paragraph 40)*, or (4) the risk of changes in its cash flows attributable to *default or changes in the obligor's creditworthiness*. Two or more of the above risks may be designated simultaneously as being hedged. An entity may not designate prepayment risk as the risk being hedged (refer to paragraph 21.f.).

30. The effective portion of the gain or loss on a derivative designated as a cash flow hedge is reported in other comprehensive income, and the ineffective portion is reported in earnings. More specifically, a qualifying cash flow hedge shall be accounted for as follows:

a. If an entity's defined risk management strategy for a particular hedging relationship excludes a specific component of the gain or loss, or related cash flows, on the hedging derivative from the assessment of hedge effectiveness (as discussed in paragraph 63 in Section 2 of Appendix A), that excluded component of the gain or loss shall be recognized currently in earnings. For example, if the effectiveness of a hedge with an option contract is assessed based on changes in the option's intrinsic value, the changes in the option's time value would be recognized in earnings. Time value is equal to the fair value of the option less its intrinsic value.

b. Accumulated other comprehensive income associated with the hedged transaction shall be adjusted to a balance that reflects the lesser of the following (in absolute amounts):

(1) The cumulative gain or loss on the derivative from inception of the hedge less (a) the excluded component discussed in paragraph 30.a. above and (b) the derivative's gains or losses previously reclassified from accumulated other comprehensive income into earnings pursuant to paragraph 31

(2) The portion of the cumulative gain or loss on the derivative necessary to offset the cumulative change in expected future cash flows on the hedged transaction from inception of the hedge less the derivative's gains or losses previously reclassified from accumulated other comprehensive income into earnings pursuant to paragraph 31.

That adjustment of accumulated other comprehensive income shall incorporate recognition in other comprehensive income of part or all of the gain or loss on the hedging derivative, as necessary.

c. A gain or loss shall be recognized in earnings, as necessary, for any remaining gain or loss on the hedging derivative or to adjust other comprehensive income to the balance specified in paragraph 30.b. above.

Section 2 of Appendix A illustrates assessing hedge effectiveness and measuring hedge ineffectiveness. Examples 6 and 9 of Section 1 of Appendix B illustrate the application of this paragraph.

31. Amounts in accumulated other comprehensive income shall be reclassified into earnings in the same period or periods during which the hedged forecasted transaction affects earnings (for example, when a forecasted sale actually occurs). If the hedged transaction results in the acquisition of an asset or the incurrence of a liability, the gains and losses in accumulated other comprehensive income shall be reclassified into earnings in the same period or periods during which the asset acquired or liability incurred affects earnings (such as in the periods that depreciation expense, interest expense, or cost of sales is recognized). However, if an entity expects at any time that continued reporting of a loss in accumulated other comprehensive income would lead to recognizing a net loss on the combination of the hedging instrument and

the hedged transaction (and related asset acquired or liability incurred) in one or more future periods, a loss shall be reclassified immediately into earnings for the amount that is not expected to be recovered. For example, a loss shall be reported in earnings for a derivative that is designated as hedging the forecasted purchase of inventory to the extent that the cost basis of the inventory plus the related amount reported in accumulated other comprehensive income exceeds the amount expected to be recovered through sales of that inventory. (Impairment guidance is provided in paragraphs 34 and 35.)

32. An entity shall discontinue prospectively the accounting specified in paragraphs 30 and 31 for an existing hedge if any one of the following occurs:

a. Any criterion in paragraphs 28 and 29 is no longer met.
b. The derivative expires or is sold, terminated, or exercised.
c. The entity removes the designation of the cash flow hedge.

In those circumstances, the net gain or loss shall remain in accumulated other comprehensive income and be reclassified into earnings as specified in paragraph 31. Furthermore, the entity may elect to designate prospectively a new hedging relationship with a different hedging instrument or, in the circumstances described in paragraphs 32.a. and 32.c., a different hedged transaction or a hedged item if the hedging relationship meets the criteria specified in paragraphs 28 and 29 for a cash flow hedge or paragraphs 20 and 21 for a fair value hedge.

33. *If a cash flow hedge is discontinued because it is probable that the original forecasted transaction will not occur, the net gain or loss in accumulated other comprehensive income shall be immediately reclassified into earnings.*

34. Existing requirements in generally accepted accounting principles for assessing asset impairment or recognizing an increased obligation apply to an asset or liability that gives rise to variable cash flows (such as a variable-rate financial instrument), for which the variable cash flows (the forecasted transactions) have been designated as being hedged and accounted for pursuant to paragraphs 30 and 31. Those impairment requirements shall be applied each period after hedge accounting has been applied for the period, pursuant to paragraphs 30 and 31 of this Statement. The fair value or expected cash flows of a hedging instrument shall not be considered in applying those requirements. The gain or loss on the hedging instrument in accumulated other comprehensive income shall, however, be accounted for as discussed in paragraph 31.

35. If, under existing requirements in generally accepted accounting principles, an impairment loss is recognized on an asset or an additional obligation is recognized on a liability to which a hedged forecasted transaction relates, any offsetting net gain related to that transaction in accumulated other comprehensive income shall be reclassified immediately into earnings. Similarly, if a recovery is recognized on the asset or liability to which the forecasted transaction relates, any offsetting net loss that has been accumulated in other comprehensive income shall be reclassified immediately into earnings.

Foreign Currency Hedges

36. *Consistent with the functional currency concept in Statement 52*, an entity may designate the following types of hedges of foreign currency exposure, as specified in paragraphs 37-42:

a. A fair value hedge of an unrecognized firm commitment or *an available-for-sale security*
b. A cash flow hedge of a forecasted foreign-currency-denominated transaction or a forecasted intercompany foreign-currency-denominated transaction
c. A hedge of a net investment in a foreign operation.

The criterion in paragraph 21.c.(1) requires that a recognized asset or liability that may give rise to a foreign currency transaction gain or loss under Statement 52 (such as a foreign-currency-

denominated receivable or payable) not be the hedged item in a foreign currency fair value or cash flow hedge because it is remeasured with the changes in the carrying amount attributable to what would be the hedged risk (an exchange rate change) reported currently in earnings. Similarly, the criterion in paragraph 29.d. requires that the forecasted acquisition of an asset or the incurrence of a liability that may give rise to a foreign currency transaction gain or loss under Statement 52 not be the hedged item in a foreign currency cash flow hedge because, subsequent to acquisition or incurrence, the asset or liability will be remeasured with changes in the carrying amount attributable to what would be the hedged risk reported currently in earnings. A foreign currency derivative instrument that has been entered into with another member of a consolidated group can be a hedging instrument in the consolidated financial statements only if that other member has entered into an offsetting contract with an unrelated third party to hedge the exposure it acquired from issuing the derivative instrument to the affiliate that initiated the hedge.

Foreign Currency Fair Value Hedges

37. Unrecognized firm commitment. A derivative instrument or a nonderivative financial instrument that may give rise to a foreign currency transaction gain or loss under Statement 52 can be designated as hedging changes in the fair value of an unrecognized firm commitment, or a specific portion thereof, attributable to foreign currency exchange rates. The designated hedging relationship qualifies for the accounting specified in paragraphs 22-27 if all the fair value hedge criteria in paragraphs 20 and 21 are met.

38. Available-for-sale security. A nonderivative financial instrument shall not be designated as the hedging instrument in a fair value hedge of the foreign currency exposure of an available-for-sale security. A derivative instrument can be designated as hedging the changes in the fair value of an available-for-sale debt security (or a specific portion thereof) attributable to changes in foreign currency exchange rates. The designated hedging relationship qualifies for the accounting specified in paragraphs 22-27 if all the fair value hedge criteria in paragraphs 20 and 21 are met. An available-for-sale equity security can be hedged for changes in the fair value attributable to changes in foreign currency exchange rates and qualify for the accounting specified in paragraphs 22-27 only if the fair value hedge criteria in paragraphs 20 and 21 are met and the following two conditions are satisfied:

a. The security is not traded on an exchange (or other established marketplace) on which trades are denominated in the investor’s functional currency.

b. Dividends or other cash flows to holders of the security are all denominated in the same foreign currency as the currency expected to be received upon sale of the security.

The change in fair value of the hedged available-for-sale equity security attributable to foreign exchange risk is reported in earnings pursuant to paragraph 23 and not in other comprehensive income.

39. Gains and losses on a qualifying foreign currency fair value hedge shall be accounted for as specified in paragraphs 22-27. The gain or loss on a nonderivative hedging instrument attributable to foreign currency risk is the foreign currency transaction gain or loss as determined under Statement 52. That foreign currency transaction gain or loss shall be recognized currently in earnings along with the change in the carrying amount of the hedged firm commitment.

Foreign Currency Cash Flow Hedges

40. A nonderivative financial instrument shall not be designated as a hedging instrument in a foreign currency cash flow hedge. *A derivative instrument designated as hedging the foreign currency exposure to variability in the functional-currency-equivalent cash flows associated with either a forecasted foreign-currency-denominated transaction (for example, a forecasted export sale to an unaffiliated entity with the price to be denominated in a foreign currency) or a forecasted intercompany foreign-currency-denominated transaction (for example, a forecasted sale to a foreign subsidiary or a forecasted royalty from a foreign subsidiary) qualifies for hedge accounting if all of the following criteria are met:*

a. *The operating unit that has the foreign currency exposure is a party to the hedging instrument (which can be an instrument between a parent company and its subsidiary—refer to paragraph 36).*

b. The hedged transaction is denominated in a currency other than *that* unit's functional currency.

c. All of the criteria in paragraphs 28 and 29 are met, except for the criterion in paragraph 29.c. that requires that the forecasted transaction be with a party external to the reporting entity.

d. If the hedged transaction is a group of individual forecasted foreign-currency-denominated transactions, a forecasted inflow of a foreign currency and a forecasted outflow of the foreign currency cannot both be included in the same group.

41. A qualifying foreign currency cash flow hedge shall be accounted for as specified in paragraphs 30-35.

Hedges of the Foreign Currency Exposure of a Net Investment in a Foreign Operation

42. A derivative instrument or a nonderivative financial instrument that may give rise to a foreign currency transaction gain or loss under Statement 52 can be designated as hedging the foreign currency exposure of a net investment in a foreign operation. The gain or loss on a hedging derivative instrument (or the foreign currency transaction gain or loss on the nonderivative hedging instrument) that is designated as, and is effective as, an economic hedge of the net investment in a foreign operation shall be reported in the same manner as a translation adjustment to the extent it is effective as a hedge. The hedged net investment shall be accounted for consistent with Statement 52; the provisions of this Statement for recognizing the gain or loss on assets designated as being hedged in a fair value hedge do not apply to the hedge of a net investment in a foreign operation.

Accounting by Not-for-Profit Organizations and Other Entities That Do Not Report Earnings

43. An entity that does not report earnings as a separate caption in a statement of financial performance (for example, a not-for-profit organization or a defined benefit pension plan) shall recognize the gain or loss on a hedging instrument and a nonhedging derivative instrument as a change in net assets in the period of change unless the hedging instrument is designated as a hedge of the foreign currency exposure of a net investment in a foreign operation. In that case, the provisions of paragraph 42 of this Statement shall be applied. Entities that do not report earnings shall recognize the changes in the carrying amount of the hedged item pursuant to paragraph 22 in a fair value hedge as a change in net assets in the period of change. Those entities are not permitted to use cash flow hedge accounting because they do not report earnings separately. Consistent with the provisions of FASB Statement No. 117, Financial Statements of Not-for-Profit Organizations, this Statement does not prescribe how a not-for-profit organization should determine the components of an operating measure, if one is presented.

Disclosures

44. An entity that holds or issues derivative instruments (or nonderivative instruments that are designated and qualify as hedging instruments pursuant to paragraphs 37 and 42) shall disclose its objectives for holding or issuing those instruments, the context needed to understand those objectives, and its strategies for achieving those objectives. The description shall distinguish between derivative instruments (and nonderivative instruments) designated as fair value hedging instruments, derivative instruments designated as cash flow hedging instruments, derivative instruments (and nonderivative instruments) designated as hedging instruments for hedges of the foreign currency exposure of a net investment in a foreign operation, and all other derivatives. The description also shall indicate the entity's risk management policy for each of those types of hedges, including a description of the items or transactions for which risks are hedged. For derivative instruments not designated as hedging instruments, the description shall indicate the purpose of the derivative activity. Qualitative disclosures about an entity's objectives and strategies for using derivative instruments may be more meaningful if such objectives and strategies are described in the context of an entity's overall risk management profile. If

appropriate, an entity is encouraged, but not required, to provide such additional qualitative disclosures.

45. An entity's disclosures for every reporting period for which a complete set of financial statements is presented also shall include the following:

Fair value hedges

a. For derivative instruments, as well as nonderivative instruments that may give rise to foreign currency transaction gains or losses under Statement 52, that have been designated and have qualified as fair value hedging instruments and for the related hedged items:
   (1) The net gain or loss recognized in earnings during the reporting period representing (a) the amount of the hedges' ineffectiveness and (b) the component of the derivative instruments' gain or loss, if any, excluded from the assessment of hedge effectiveness, and a description of where the net gain or loss is reported in the statement of income or other statement of financial performance
   (2) The amount of net gain or loss recognized in earnings when a hedged firm commitment no longer qualifies as a fair value hedge.

Cash flow hedges

b. For derivative instruments that have been designated and have qualified as cash flow hedging instruments and for the related hedged transactions:
   (1) The net gain or loss recognized in earnings during the reporting period representing (a) the amount of the hedges' ineffectiveness and (b) the component of the derivative instruments' gain or loss, if any, excluded from the assessment of hedge effectiveness, and a description of where the net gain or loss is reported in the statement of income or other statement of financial performance
   (2) A description of the transactions or other events that will result in the reclassification into earnings of gains and losses that are reported in accumulated other comprehensive income, and the estimated net amount of the existing gains or losses at the reporting date that is expected to be reclassified into earnings within the next 12 months
   (3) The maximum length of time over which the entity is hedging its exposure to the variability in future cash flows for forecasted transactions excluding those forecasted transactions related to the payment of variable interest on existing financial instruments
   (4) The amount of gains and losses reclassified into earnings as a result of the discontinuance of cash flow hedges because it is probable that the original forecasted transactions will not occur.

Hedges of the net investment in a foreign operation

c. For derivative instruments, as well as nonderivative instruments that may give rise to foreign currency transaction gains or losses under Statement 52, that have been designated and have qualified as hedging instruments for hedges of the foreign currency exposure of a net investment in a foreign operation, the net amount of gains or losses included in the cumulative translation adjustment during the reporting period.

The quantitative disclosures about derivative instruments may be more useful, and less likely to be perceived to be out of context or otherwise misunderstood, if similar information is disclosed about other financial instruments or nonfinancial assets and liabilities to which the derivative instruments are related by activity. Accordingly, in those situations, an entity is encouraged, but not required, to present a more complete picture of its activities by disclosing that information.

Reporting Changes in the Components of Comprehensive Income

46. An entity shall display as a separate classification within other comprehensive income the net gain or loss on derivative instruments designated and qualifying as cash flow hedging instruments that are reported in comprehensive income pursuant to paragraphs 30 and 41.

47. As part of the disclosures of accumulated other comprehensive income, pursuant to paragraph 26 of FASB Statement No. 130, Reporting Comprehensive Income, an entity shall separately disclose the beginning and ending accumulated derivative gain or loss, the related net change associated with current period hedging transactions, and the net amount of any reclassification into earnings.

Effective Date and Transition

48. *This Statement shall be effective for all fiscal quarters of all fiscal years beginning after June 15, 1999*. Initial application of this Statement shall be as of the beginning of an entity's fiscal quarter; on that date, hedging relationships shall be designated anew and documented pursuant to the provisions of this Statement. Earlier application of all of the provisions of this Statement is encouraged but is permitted only as of the beginning of any fiscal quarter that begins after issuance of this Statement. Earlier application of selected provisions of this Statement is not permitted. This Statement shall not be applied retroactively to financial statements of prior periods.

49. At the date of initial application, an entity shall recognize all freestanding derivative instruments (that is, derivative instruments other than embedded derivative instruments) in the statement of financial position as either assets or liabilities and measure them at fair value, pursuant to paragraph 17. The difference between a derivative's previous carrying amount and its fair value shall be reported as a transition adjustment, as discussed in paragraph 52. The entity also shall recognize offsetting gains and losses on hedged assets, liabilities, and firm commitments by adjusting their carrying amounts at that date, as discussed in paragraph 52.b. Any gains or losses on derivative instruments that are reported independently as deferred gains or losses (that is, liabilities or assets) in the statement of financial position at the date of initial application shall be derecognized from that statement; that derecognition also shall be reported as transition adjustments as indicated in paragraph 52. Any gains or losses on derivative instruments reported in other comprehensive income at the date of initial application because the derivative instruments were hedging the fair value exposure of available-for-sale securities also shall be reported as transition adjustments; the offsetting losses and gains on the securities shall be accounted for pursuant to paragraph 52.b.. Any gain or loss on a derivative instrument reported in accumulated other comprehensive income at the date of initial application because the derivative instrument was hedging the variable cash flow exposure of a forecasted (anticipated) transaction related to an available-for-sale security shall remain in accumulated other comprehensive income and shall not be reported as a transition adjustment. The accounting for any gains and losses on derivative instruments that arose prior to the initial application of the Statement and that were previously added to the carrying amount of recognized hedged assets or liabilities is not affected by this Statement. Those gains and losses shall not be included in the transition adjustment.

50. *At the date of initial application, an entity also shall recognize as an asset or liability in the statement of financial position any embedded derivative instrument that is required pursuant to paragraphs 12-16 to be separated from its host contract if the hybrid instrument in which it is embedded was issued, acquired, or substantively modified by the entity after December 31, 1997. For all of its hybrid instruments that exist at the date of initial application and were issued or acquired before January 1, 1998 and not substantively modified thereafter, an entity may choose either (a) not to apply this Statement to any of those hybrid instruments or (b) to recognize as assets or liabilities all the derivative instruments embedded in those hybrid instruments that would be required pursuant to paragraphs 12-16 to be separated from their host contracts. That choice is not permitted to be applied to only some of an entity's individual hybrid instruments and must be applied on an all-or-none basis.*

51. If an embedded derivative instrument is to be separated from its host contract in conjunction with the initial application of this Statement, the entity shall consider the following in determining the related transition adjustment:

a. The carrying amount of the host contract at the date of initial application shall be based on its fair value on the date that the hybrid instrument was issued or acquired by the entity and shall reflect appropriate adjustments for subsequent activity, such as subsequent cash receipts or payments and the amortization of any premium or discount on the host contract arising from the separation of the embedded derivative.

b. The carrying amount of the embedded derivative instrument at the date of initial application shall be its fair value.

c. The transition adjustment shall be the difference at the date of initial application between (1) the previous carrying amount of the hybrid instrument and (2) the sum of the new net carrying amount of the host contract and the fair value of the embedded derivative instrument. The entity shall not retroactively designate a hedging relationship that could have been made had the embedded derivative instrument initially been accounted for separate from the host contract.

52. The transition adjustments resulting from adopting this Statement shall be reported in net income or other comprehensive income, as appropriate, as the effect of a change in accounting principle and presented in a manner similar to the cumulative effect of a change in accounting principle as described in paragraph 20 of APB Opinion No. 20, Accounting Changes. Whether a transition adjustment related to a specific derivative instrument is reported in net income, reported in other comprehensive income, or allocated between both is based on the hedging relationships, if any, that had existed for that derivative instrument and that were the basis for accounting under generally accepted accounting principles before the date of initial application of this Statement.

a. If the transition adjustment relates to a derivative instrument that had been designated in a hedging relationship that addressed the variable cash flow exposure of a forecasted (anticipated) transaction, the transition adjustment shall be reported as a cumulative-effect-type adjustment of accumulated other comprehensive income.

b. *If the transition adjustment relates to a derivative instrument that had been designated in a hedging relationship that addressed the fair value exposure of an asset, a liability, or a firm commitment, the transition adjustment for the derivative shall be reported as a cumulative-effect-type adjustment of net income. Concurrently, any gain or loss on the hedged item (that is, difference between the hedged item's fair value and its carrying amount) shall be recognized as an adjustment of the hedged item's carrying amount at the date of initial application, but only to the extent of an offsetting transition adjustment for the derivative. That adjustment of the hedged item's carrying amount shall also be reported as a cumulative-effect-type adjustment of net income. The transition adjustment related to the gain or loss reported in accumulated other comprehensive income on a derivative instrument that hedged an available-for-sale security, together with the loss or gain on the related security (to the extent of an offsetting transition adjustment for the derivative instrument), shall be reclassified to earnings as a cumulative-effect-type adjustment of both net income and accumulated other comprehensive income.*

c. If a derivative instrument had been designated in multiple hedging relationships that addressed both the fair value exposure of an asset or a liability and the variable cash flow exposure of a forecasted (anticipated) transaction, the transition adjustment for the derivative shall be allocated between the cumulative-effect-type adjustment of net income and the cumulative-effect-type adjustment of accumulated other comprehensive income and shall be reported as discussed in paragraphs 52.a. and 52.b. above. Concurrently, any gain or loss on the hedged item shall be accounted for at the date of initial application as discussed in paragraph 52.b. above.

d. Other transition adjustments not encompassed by paragraphs 52.a., 52.b. and 52.c. above shall be reported as part of the cumulative-effect-type adjustment of net income.

53. Any transition adjustment reported as a cumulative-effect-type adjustment of accumulated other comprehensive income shall be subsequently reclassified into earnings in a manner consistent with paragraph 31. For those amounts, an entity shall disclose separately in the year of initial application the amount of gains and losses reported in accumulated other comprehensive income and associated with the transition adjustment that are being reclassified into earnings during the 12 months following the date of initial application.

54. At the date of initial application, an entity may transfer any held-to-maturity security into the available-for-sale category or the trading category. An entity will then be able in the future to designate a security transferred into the available-for-sale category as the hedged item, or its variable interest payments as the cash flow hedged transactions, in a hedge of the exposure to changes in *market interest rates, changes in foreign currency exchange rates*, or changes in its overall fair value. (Paragraph 21.d. precludes a held-to-maturity security from being designated as the hedged item in a fair value hedge of *market* interest rate risk or the risk of changes in its overall fair value. Paragraph 29.e. similarly precludes the variable cash flows of a held-to-maturity security from being designated as the hedged transaction in a cash flow hedge of *market* interest rate risk.) The unrealized holding gain or loss on a held-to-maturity security transferred to another category at the date of initial application shall be reported in net income or accumulated other comprehensive income consistent with the requirements of paragraphs 15.b. and 15.c. of Statement 115 and reported with the other transition adjustments discussed in paragraph 52 of this Statement. Such transfers from the held-to-maturity category at the date of initial adoption shall not call into question an entity's intent to hold other debt securities to maturity in the future.

55. At the date of initial application, an entity may transfer any available-for-sale security into the trading category. After any related transition adjustments from initially applying this Statement have been recognized, the unrealized holding gain or loss remaining in accumulated other comprehensive income for any transferred security at the date of initial application shall be reclassified into earnings (but not reported as part of the cumulative-effect-type adjustment for the transition adjustments), consistent with paragraph 15.b. of Statement 115. If a derivative instrument had been hedging the variable cash flow exposure of a forecasted transaction related to an available-for-sale security that is transferred into the trading category at the date of initial application and the entity had reported a gain or loss on that derivative instrument in other comprehensive income (consistent with paragraph 115 of Statement 115), the entity also shall reclassify those derivative gains and losses into earnings (but not report them as part of the cumulative-effect-type adjustment for the transition adjustments).

56. At the date of initial application, mortgage bankers and other servicers of financial assets may choose to restratify their servicing rights pursuant to paragraph 37.g. of Statement 125 in a manner that would enable individual strata to comply with the requirements of this Statement regarding what constitutes "a portfolio of similar assets." As noted in footnote 9 of this Statement, mortgage bankers and other servicers of financial assets that designate a hedged portfolio by aggregating servicing rights within one or more risk strata used under paragraph 37.g. of Statement 125 would not necessarily comply with the requirement in paragraph 21.a. of this Statement for portfolios of similar assets, since the risk stratum under paragraph 37.g. of Statement 125 can be based on any predominant risk characteristic, including date of origination or geographic location. The restratification of servicing rights is a change in the application of an accounting principle, and the effect of that change as of the initial application of this Statement shall be reported as part of the cumulative-effect-type adjustment for the transition adjustments.

65. FAS 137 provides the following:

Amendments to Statement 133

3. Statement 133 is amended as follows:

a. The first sentence of paragraph 48 is replaced by the following:

> This Statement shall be effective for all fiscal quarters of all fiscal years beginning after June 15, 2000.

b. Paragraph 50 is replaced by the following:

> At the date of initial application, an entity shall choose to either (a) recognize as an asset or liability in the statement of financial position all embedded derivative instruments that are required pursuant to paragraphs 12-16 to be separated from their host contracts or (b) select either January 1, 1998 or January 1, 1999 as a transition date for embedded derivatives. If the entity chooses to select a transition date, it shall recognize as separate assets and liabilities (pursuant to paragraphs 12-16) only those derivatives embedded in hybrid instruments issued, acquired, or substantively modified by the entity on or after the selected transition date. That choice is not permitted to be applied to only some of an entity's individual hybrid instruments and must be applied on an all-or-none basis.

Effective Date

4. This Statement is effective upon issuance. An entity that has already applied the provisions of Statement 133 and has issued interim or annual financial statements reflecting that application may not revert to a previous method of accounting for derivative instruments and hedging activities.

66. FAS 138 provides the following (certain sections not affecting the excerpted FAS No. 133 guidance excluded):

Amendments to Statement 133

4. Statement 133 is amended as follows:

Amendment Related to Normal Purchases and Normal Sales

a. Paragraph 10.b. is replaced by the following:

> Normal purchases and normal sales. Normal purchases and normal sales are contracts that provide for the purchase or sale of something other than a financial instrument or derivative instrument that will be delivered in quantities expected to be used or sold by the reporting entity over a reasonable period in the normal course of business. However, contracts that have a price based on an underlying that is not clearly and closely related to the asset being sold or purchased (such as a price in a contract for the sale of a grain commodity based in part on changes in the S&P index) or that are denominated in a foreign currency that meets neither of the criteria in paragraphs 15.a. and 15.b. shall not be considered normal purchases and normal sales. Contracts that contain net settlement provisions as described in paragraphs 9.a. and 9.b. may qualify for the normal purchases and normal sales exception if it is probable at inception and throughout the term of the individual contract that the contract will not settle net and will result in physical delivery. Net settlement (as described in paragraphs 9.a. and 9.b.) of contracts in a group of contracts similarly designated as normal purchases and normal sales would call into question the classification of all such contracts as normal purchases or normal sales. Contracts that require cash settlements of gains or losses or are otherwise settled net on a

periodic basis, including individual contracts that are part of a series of sequential contracts intended to accomplish ultimate acquisition or sale of a commodity, do not qualify for this exception. For contracts that qualify for the normal purchases and normal sales exception, the entity shall document the basis for concluding that it is probable that the contract will result in physical delivery. The documentation requirements can be applied either to groups of similarly designated contracts or to each individual contract.

Amendments to Redefine Interest Rate Risk

b. Paragraph 21 is amended as follows:

(1) The first sentence of subparagraph (d) is replaced by the following:

> If the hedged item is all or a portion of a debt security (or a portfolio of similar debt securities) that is classified as held-to-maturity in accordance with FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities, the designated risk being hedged is the risk of changes in its fair value attributable to credit risk, foreign exchange risk, or both. If the hedged item is an option component of a held-to-maturity security that permits its prepayment, the designated risk being hedged is the risk of changes in the entire fair value of that option component.

(2) In the first parenthetical sentence of subparagraph (d), changes in market interest rates or foreign exchange rates is replaced by interest rate risk.

(3) In subparagraph (f)(2), market interest rates is replaced by the designated benchmark interest rate (referred to as interest rate risk).

(4) In subparagraph (f)(3), (refer to paragraphs 37 and 38) is replaced by (referred to as foreign exchange risk) (refer to paragraphs 37, 37A, and 38).

(5) In subparagraph (f)(4), both is inserted between to and changes and the obligor's creditworthiness is replaced by the obligor's creditworthiness and changes in the spread over the benchmark interest rate with respect to the hedged item's credit sector at inception of the hedge (referred to as credit risk).

(6) In the second sentence of subparagraph (f), market is deleted.

(7) In subparagraph (f), the following sentences and footnote are added after the second sentence:

> The benchmark interest rate being hedged in a hedge of interest rate risk must be specifically identified as part of the designation and documentation at the inception of the hedging relationship. Ordinarily, an entity should designate the same benchmark interest rate as the risk being hedged for similar hedges, consistent with paragraph 62; the use of different benchmark interest rates for similar hedges should be rare and must be justified. In calculating the change in the hedged item's fair value attributable to changes in the benchmark interest rate, the estimated cash flows used in calculating fair value must be based on all of the contractual cash flows of the entire hedged item. Excluding some of the hedged item's contractual cash flows (for example, the portion of the interest coupon in excess of the benchmark interest rate) from the calculation is not permitted.

(8) In the fourth sentence of subparagraph (f), overall is inserted between exposure to changes in the and fair value of that.

(9) In the last sentence of subparagraph (f), market is deleted.

c. Paragraph 29 is amended as follows:

(1) In the first sentence of subparagraph (e), default or changes in the obligor's creditworthiness is replaced by credit risk, foreign exchange risk, or both.

(2) In the last sentence of subparagraph (e), changes in market interest rates is replaced by interest rate risk.

(3) In the first sentence of subparagraph (h), (or the interest payments on that financial asset or liability) is added after sale of a financial asset or liability.

(4) In subparagraph (h)(1), the risk of changes in the cash flows of the entire asset or liability is replaced by the risk of overall changes in the hedged cash flows related to the asset or liability.

(5) In subparagraph (h)(2), market interest rates is replaced by the designated benchmark interest rate (referred to as interest rate risk).

(6) In subparagraph (h)(3), (refer to paragraph 40) is replaced by (referred to as foreign exchange risk) (refer to paragraphs 40, 40A, 40B, and 40C).

(7) In subparagraph (h)(4), default or changes in the obligor's creditworthiness is replaced by default, changes in the obligor's creditworthiness, and changes in the spread over the benchmark interest rate with respect to the hedged item's credit sector at inception of the hedge (referred to as credit risk).

(8) In subparagraph (h), the following sentences are added after the second sentence:

The benchmark interest rate being hedged in a hedge of interest rate risk must be specifically identified as part of the designation and documentation at the inception of the hedging relationship. Ordinarily, an entity should designate the same benchmark interest rate as the risk being hedged for similar hedges, consistent with paragraph 62; the use of different benchmark interest rates for similar hedges should be rare and must be justified. In a cash flow hedge of a variable-rate financial asset or liability, either existing or forecasted, the designated risk being hedged cannot be the risk of changes in its cash flows attributable to changes in the specifically identified benchmark interest rate if the cash flows of the hedged transaction are explicitly based on a different index, for example, based on a specific bank's prime rate, which cannot qualify as the benchmark rate. However, the risk designated as being hedged could potentially be the risk of overall changes in the hedged cash flows related to the asset or liability, provided that the other criteria for a cash flow hedge have been met.

d. Paragraph 54 is amended as follows:

(1) In the second sentence, market interest rates, changes in foreign currency exchange rates, is replaced by the designated benchmark interest rate.

(2) In the third and fourth (parenthetical) sentences, market is deleted.

(3) In the penultimate sentence of footnote 14, market interest rates is replaced by interest rate risk.

e. In the first sentence of paragraph 90, market is deleted.

Amendments Related to Hedging Recognized Foreign-Currency-Denominated Assets and Liabilities

f. In paragraph 21.c.(1), (for example, if foreign exchange risk is hedged, a foreign-currency-denominated asset for which a foreign currency transaction gain or loss is recognized in earnings) is deleted.

g. Paragraph 29.d. is amended as follows:

1) In the first sentence, (for example, if foreign exchange risk is hedged, the forecasted acquisition of a foreign-currency-denominated asset for which a foreign currency transaction gain or loss will be recognized in earnings) is deleted.

(2) The second sentence is deleted.

h. In paragraph 29.g.(2), (reflecting its actual location if a physical asset) is replaced by reflecting its actual location if a physical asset (regardless of whether that price and the related cash flows are stated in the entity's functional currency or a foreign currency).

i. The following subparagraph is added after subparagraph (c) of paragraph 30:

d. In a cash flow hedge of the variability of the functional-currency-equivalent cash flows for a recognized foreign-currency-denominated asset or liability that is remeasured at spot exchange rates under paragraph 15 of Statement 52, an amount that will offset the related transaction gain or loss arising from the remeasurement and adjust earnings for the cost to the purchaser (income to the seller) of the hedging instrument shall be reclassified each period from other comprehensive income to earnings.

j. Paragraph 36 is amended as follows:

(1) In the first sentence, Consistent with the functional currency concept in Statement 52 is replaced by If the hedged item is denominated in a foreign currency.

(2) In subparagraph (a), an available-for-sale security is replaced by a recognized asset or liability (including an available-for-sale security).

(3) Subparagraph (b) is replaced by the following:
A cash flow hedge of a forecasted transaction, an unrecognized firm commitment, the forecasted functional-currency-equivalent cash flows associated with a recognized asset or liability, or a forecasted intercompany transaction.

(4) The first two sentences following subparagraph (c) are replaced by the following:

The recognition in earnings of the foreign currency transaction gain or loss on a foreign-currency-denominated asset or liability based on changes in the foreign currency spot rate is not considered to be the remeasurement of that asset or liability with changes in fair value attributable to foreign exchange risk recognized in earnings, which is discussed in the criteria in paragraphs 21.c.(1) and 29.d. Thus, those criteria are not impediments to either a foreign currency fair value or cash flow hedge of such a foreign-currency-denominated asset or liability or a foreign currency cash flow hedge of the forecasted acquisition or incurrence of a foreign-currency-denominated asset or liability whose carrying amount will be remeasured at spot exchange rates under paragraph 15 of Statement 52.

k. The following paragraph is added after paragraph 36:

36A. The provisions in paragraph 36 that permit a recognized foreign-currency-denominated asset or liability to be the hedged item in a fair value or cash flow hedge of foreign currency exposure also pertain to a recognized foreign-currency-denominated receivable or payable that results from a hedged forecasted foreign-currency-denominated sale or purchase on credit. An entity may choose to designate a single cash flow hedge that encompasses the variability of functional currency cash flows attributable to foreign exchange risk related to the settlement of the foreign-currency-denominated receivable or payable resulting from a forecasted sale or purchase on credit. Alternatively, an entity may choose to designate a cash flow hedge of the variability of functional currency cash flows attributable to foreign exchange risk related to a forecasted foreign-currency-denominated sale or purchase on credit and then separately designate a foreign currency fair value hedge of the resulting recognized foreign-currency-denominated receivable or payable. In that case, the cash flow hedge would terminate (be dedesignated) when the hedged sale or purchase occurs and the foreign-currency-denominated receivable or payable is recognized. The use of the same foreign currency derivative instrument for both the cash flow hedge and the fair value hedge is not prohibited though some ineffectiveness may result.

l. The following paragraph is added after paragraph 37:

37A. Recognized asset or liability. A nonderivative financial instrument shall not be designated as the hedging instrument in a fair value hedge of the foreign currency exposure of a recognized asset or liability. A derivative instrument can be designated as hedging the changes in the fair value of a recognized asset or liability (or a specific portion thereof) for which a foreign currency transaction gain or loss is recognized in earnings under the provisions of paragraph 15 of Statement 52. All recognized foreign-currency-denominated assets or liabilities for which a foreign currency transaction gain or loss is recorded in earnings may qualify for the accounting specified in paragraphs 22-27 if all the fair value hedge criteria in paragraphs 20 and 21 and the conditions in paragraphs 40.a. and 40.b. are met.

m. Paragraph 40 is amended as follows:

(1) The second sentence is replaced by the following:

A derivative instrument designated as hedging the foreign currency exposure to variability in the functional-currency-equivalent cash flows associated with a forecasted transaction (for example, a forecasted export sale to an unaffiliated entity with the price to be denominated in a foreign currency), a recognized asset or liability, an unrecognized firm commitment, or a forecasted intercompany transaction (for example, a forecasted sale to a foreign subsidiary or a forecasted royalty from a foreign subsidiary) qualifies for hedge accounting if all the following criteria are met:

(2) The following subparagraph is added:

e. If the hedged item is a recognized foreign-currency-denominated asset or liability, all the variability in the hedged item's functional-currency-equivalent cash flows must be eliminated by the effect of the hedge. (For example, a cash flow hedge cannot be used with a variable-rate foreign-currency-denominated asset or liability and a derivative based solely on changes in exchange rates because the derivative does not eliminate all the variability in the functional currency cash flows.)

Amendments Related to Intercompany Derivatives

n. In the last sentence of paragraph 36, in a fair value hedge or in a cash flow hedge of a recognized foreign-currency-denominated asset or liability or in a net investment hedge is added after can be a hedging instrument.

o. The following paragraphs are added after paragraph 40:

40A. Internal derivative. A foreign currency derivative contract that has been entered into with another member of a consolidated group (such as a treasury center) can be a hedging instrument in a foreign currency cash flow hedge of a forecasted borrowing, purchase, or sale or an unrecognized firm commitment in the consolidated financial statements only if the following two conditions are satisfied. (That foreign currency derivative instrument is hereafter in this section referred to as an internal derivative.)

a. From the perspective of the member of the consolidated group using the derivative as a hedging instrument (hereafter in this section referred to as the hedging affiliate), the criteria for foreign currency cash flow hedge accounting in paragraph 40 must be satisfied.

b. The member of the consolidated group not using the derivative as a hedging instrument (hereafter in this section referred to as the issuing affiliate) must either (1) enter into a derivative contract with an unrelated third party to offset the exposure that results from that internal derivative or (2) if the conditions in paragraph 40B are met, enter into derivative contracts with unrelated third parties that would offset, on a net basis for each foreign currency, the foreign exchange risk arising from multiple internal derivative contracts.

40B. Offsetting net exposures. If an issuing affiliate chooses to offset exposure arising from multiple internal derivative contracts on an aggregate or net basis, the derivatives issued to hedging affiliates may qualify as cash flow hedges in the consolidated financial statements only if all of the following conditions are satisfied:

a. The issuing affiliate enters into a derivative contract with an unrelated third party to offset, on a net basis for each foreign currency, the foreign exchange risk arising from multiple internal derivative contracts, and the derivative contract with the unrelated third party generates equal or closely approximating gains and losses when compared with the aggregate or net losses and gains generated by the derivative contracts issued to affiliates.

b. Internal derivatives that are not designated as hedging instruments are excluded from the determination of the foreign currency exposure on a net basis that is offset by the third-party derivative. In addition, nonderivative contracts may not be used as hedging instruments to offset exposures arising from internal derivative contracts.

c. Foreign currency exposure that is offset by a single net third-party contract arises from internal derivative contracts that mature within the same 31-day period and that involve the same currency exposure as the net third-party derivative. The offsetting net third-party derivative related to that group of contracts must offset the aggregate or net exposure to that currency, must mature within the same 31-day period, and must be entered into within 3 business days after the designation of the internal derivatives as hedging instruments.

d. The issuing affiliate tracks the exposure that it acquires from each hedging affiliate and maintains documentation supporting linkage of each internal derivative contract and the offsetting aggregate or net derivative contract with an unrelated third party.

e. The issuing affiliate does not alter or terminate the offsetting derivative with an unrelated third party unless the hedging affiliate initiates that action. If the issuing affiliate does alter or terminate any offsetting third-party derivative (which should be rare), the hedging affiliate must prospectively cease hedge accounting for the internal derivatives that are offset by that third-party derivative.

40C. A member of a consolidated group is not permitted to offset exposures arising from multiple internal derivative contracts on a net basis for foreign currency cash flow exposures related to recognized foreign-currency-denominated assets or liabilities. That prohibition includes situations in which a recognized foreign-currency-denominated asset or liability in a fair value hedge or cash flow hedge results from the occurrence of a specifically identified forecasted transaction initially designated as a cash flow hedge.

Amendments for Certain Interpretations of Statement 133 Cleared by the Board Relating to the Derivatives Implementation Group Process

p. In the second sentence of paragraph 12, host is inserted between would be required by the and contract, whether unconditional.

Amendments to Implement Guidance in Implementation Issue No. G3, “Discontinuation of a Cash Flow Hedge”

q. Paragraph 33 is replaced by the following:
The net derivative gain or loss related to a discontinued cash flow hedge shall continue to be reported in accumulated other comprehensive income unless it is probable that the forecasted transaction will not occur by the end of the originally specified time period (as documented at the inception of the hedging relationship) or within an additional two-month period of time thereafter, except as indicated in the following sentence. In rare cases, the existence of extenuating circumstances that are related to the nature of the forecasted transaction and are outside the control or influence of the reporting entity may cause the forecasted transaction to be probable of occurring on a date that is beyond the additional two-month period of time, in which case the net derivative gain or loss related to the discontinued cash flow hedge shall continue to be reported in accumulated other comprehensive income until it is reclassified into earnings pursuant to paragraph 31. If it is probable that the hedged forecasted transaction will not occur either by the end of the originally specified time period or within the additional two-month period of time and the hedged forecasted transaction also does not qualify for the exception described in the preceding sentence, that derivative gain or loss reported in accumulated other comprehensive income shall be reclassified into earnings immediately.

r. The following is added at the end of paragraph 45.b.(4):
by the end of the originally specified time period or within the additional period of time discussed in paragraph 33.

Amendments to Implement Guidance in Implementation Issue No. H1, “Hedging at the Operating Unit Level”

s. In the last sentence of paragraph 37, and the conditions in paragraphs 40.a. and 40(b) is added between paragraphs 20 and 21 and are met.

t. In the third sentence of paragraph 38, and the conditions in paragraphs 40.a. and 40.b. is added between paragraphs 20 and 21 and are met.

u. In paragraph 42, provided the conditions in paragraphs 40.a. and 40.b. are met is added to the end of the first sentence.

Amendments to Implement Guidance in Implementation Issue No. H2, “Requirement That the Unit with the Exposure Must Be a Party to the Hedge”

v. Paragraph 40 is amended as follows:

(1) Subparagraph (a) is replaced by the following:
For consolidated financial statements, either (1) the operating unit that has the foreign currency exposure is a party to the hedging instrument or (2) another member of the consolidated group that has the same functional currency as that operating unit (subject to the restrictions in this subparagraph and related footnote) is a party to the hedging instrument. To qualify for applying the guidance in (2) above, there may be no intervening subsidiary with a different functional currency. (Refer to paragraphs 36, 40A, and 40B for conditions for which an intercompany foreign currency derivative can be the hedging instrument in a cash flow hedge of foreign exchange risk.)

(2) In subparagraph (b), that is replaced by the hedging.

OTHER SOURCES OF INFORMATION:

67. The Financial Accounting Standards Board established the Derivatives Implementation Group to address execution of FAS No. 133. The Derivatives Implementation Group addressed two issues related to effectiveness that are applicable to this issue paper. The issues have been authored by the FASB staff and represents the staff's views, although FASB has discussed the responses at a public meeting and chosen not to object to dissemination of those responses. Official positions of the FASB are determined only after extensive due process and deliberation. E7: *Hedging—General: Methodologies to Assess Effectiveness of Fair Value and Cash Flow Hedges* and E8: *Hedging–General: Assessing Hedge Effectiveness of Fair Value and Cash Flow Hedges Period-by-Period or Cumulatively under a Dollar-Offset Approach* are included as part of Exhibit A:

RELEVANT LITERATURE:

Statutory Accounting

- *SSAP No. 31 – Derivative Instruments*
- Minutes of the June 7, 1999 Emerging Accounting Issues (E) Working Group meeting

Generally Accepted Accounting Principles

- *FASB Statement No. 80, Accounting for Futures Contracts*
- *FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities*
- *FASB Statement No. 137, Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133 - an amendment of FASB Statement No. 133*
- *FASB Statement No. 138, Accounting for Certain Derivative Instruments and Certain Hedging Activities - an amendment of FASB Statement No. 133*
- *EITF 98-10, Accounting for Contracts Involved in Energy Trading and Risk Management Activities*
- *EITF 98-12, Application of Issue No. 96-13 to Forward Equity Sales Transactions*
- *EITF 99-01, Accounting for Debt Convertible into the Stock of a Consolidated Sub*
- *EITF 99-02, Accounting for Weather Derivatives*
- *EITF 99-03, Application of Issue No. 96-13 to Derivative Instruments with Multiple Settlement Alternatives*
- *EITF 99-08, Accounting for Transfers of Assets That Are Derivative Instruments but That Are Not Financial Assets*
- *EITF 99-09, Effect of Derivative Gains and Losses on the Capitalization of Interest*
- *EITF 00-07, Application of Issue No. 96-13 to Equity Derivative Instruments That Contain Certain Provisions That Require Net Cash Settlement If Certain Events outside the Control of the Issuer Occur*
- *EITF 00-09, Classification of a Gain or Loss from a Hedge of Debt That Is Extinguished*
- *FASB Derivatives Implementation Group E7: Hedging—General: Methodologies to Assess Effectiveness of Fair Value and Cash Flow Hedges and E8: Hedging–General: Assessing Hedge Effectiveness of Fair Value and Cash Flow Hedges Period-by-Period or Cumulatively under a Dollar-Offset Approach*

EXHIBIT A - DISCUSSION OF HEDGING EFFECTIVENESS

The Financial Accounting Standards Board established the Derivatives Implementation Group in 1999 to address execution of FAS No. 133. The Derivatives Implementation Group addressed two issues related to effectiveness that are applicable to this issue paper. The issues have been authored by the FASB staff and represents the staff's views, although FASB has discussed the responses at a public meeting and chosen not to object to dissemination of those responses. Official positions of the FASB are determined only after extensive due process and deliberation.

No. E7: Hedging—General: Methodologies to Assess Effectiveness of Fair Value and Cash Flow Hedges

Paragraph references: 20.b., 22, 28.b., 62, 86, 87
Date cleared by Board: May 17, 2000

QUESTION

1. Since Statement 133 provides an entity with flexibility in choosing the method it will use in assessing hedge effectiveness, must an entity use a dollar-offset approach in assessing effectiveness?

BACKGROUND

2. Paragraph 20.b. of Statement 133 states, in part:

> Both at inception of the [fair value] hedge and on an ongoing basis, the hedging relationship is expected to be highly effective in achieving offsetting changes in fair value attributable to the hedged risk during the period that the hedge is designated. An assessment of effectiveness is required whenever financial statements or earnings are reported, and at least every three months.

3. Paragraph 28.b. indicates a similar requirement that the hedging relationship be expected to be highly effective in achieving offsetting changes in cash flows attributable to the hedged risk during the period that the hedge is designated.

4. Paragraph 22 of Statement 133 states, in part:

> The measurement of hedge ineffectiveness for a particular hedging relationship shall be consistent with the entity's risk management strategy and the method of assessing hedge effectiveness that was documented at the inception of the hedging relationship, as discussed in paragraph 20.a. Nevertheless, the amount of hedge ineffectiveness recognized in earnings is based on the extent to which exact offset is not achieved.

5. Paragraph 62 emphasizes that each entity must "define at the time it designates a hedging relationship the method it will use to assess the hedge's effectiveness in achieving offsetting changes in fair value or offsetting cash flows attributable to the risk being hedged." It also states, "This Statement does not specify a single method for either assessing whether a hedge is expected to be highly effective or measuring hedge ineffectiveness."

RESPONSE

6. No. Statement 133 requires an entity to consider hedge effectiveness in two different ways—in prospective considerations and in retrospective evaluations.

a. Prospective considerations

Upon designation of a hedging relationship (as well as on an ongoing basis), the entity must be able to justify an expectation that the relationship will be highly effective over future periods in achieving offsetting changes in fair value or cash flows. That expectation, which is forward-looking, can be based upon regression or other statistical analysis of past changes in fair values or cash flows as well as on other relevant information.

b. Retrospective evaluations

At least quarterly, the hedging entity must determine whether the hedging relationship has been highly effective in having achieved offsetting changes in fair value or cash flows through the date of the periodic assessment. That assessment can be based upon regression or other statistical analysis of past changes in fair values or cash flows as well as on other relevant information. If an entity elects at the inception of a hedging relationship to utilize the same regression analysis approach for both prospective considerations and retrospective evaluations of assessing effectiveness, then during the term of that hedging relationship those regression analysis calculations should generally incorporate the same number of data points. Electing to utilize a regression or other statistical analysis approach instead of a dollar-offset approach to perform retrospective evaluations of assessing hedge effectiveness may affect whether an entity can apply hedge accounting for the current assessment period as discussed below.

7. Paragraph 62 requires that at the time an entity designates a hedging relationship, it must define and document the method it will use to assess the hedge's effectiveness. That paragraph also states that ordinarily "an entity should assess effectiveness for similar hedges in a similar manner; use of different methods for similar hedges should be justified." Furthermore, it requires that an entity use that defined and documented methodology consistently throughout the period of the hedge. If an entity elects at the inception of a hedging relationship to utilize a regression analysis approach for prospective considerations of assessing effectiveness and the dollar-offset method to perform retrospective evaluations of assessing effectiveness, then that entity must abide by the results of that methodology as long as that hedging relationship remains designated. Thus, in its retrospective evaluation, an entity might conclude that, under a dollar-offset approach, a designated hedging relationship does not qualify for hedge accounting for the period just ended, but that the hedging relationship may continue because, under a regression analysis approach, there is an expectation that the relationship will be highly effective in achieving offsetting changes in fair value or cash flows in future periods. In its retrospective evaluation, if that entity concludes that, under a dollar-offset approach, the hedging relationship has not been highly effective in having achieved offsetting changes in fair value or cash flows, hedge accounting may not be applied in the current period. Whenever a hedging relationship fails to qualify for hedge accounting in a certain assessment period, the overall change in fair value of the derivative for that current period is recognized in earnings (not reported in other comprehensive income for a cash flow hedge) and the change in fair value of the hedged item would not be recognized in earnings for that period (for a fair value hedge).

8. If an entity elects at the inception of a hedging relationship to utilize a regression analysis (or other statistical analysis) approach for either prospective considerations or retrospective evaluations of assessing effectiveness, then that entity must periodically update its regression analysis (or other statistical analysis). For example, if there is significant ineffectiveness measured and recognized in earnings for a hedging relationship, which is calculated each assessment period, the regression analysis should be rerun to determine whether the expectation of high effectiveness is still valid. As long as an entity reruns its regression analysis and determines that the hedging relationship is still expected to be highly effective, then it can continue to apply hedge accounting without interruption.

9. In all instances, the actual measurement of hedge ineffectiveness to be recognized in earnings each reporting period is based on the extent to which exact offset is not achieved as specified in paragraph 22 of Statement 133 (for fair value hedges) or paragraph 30 (for cash flow hedges). That requirement applies even if a regression or other statistical analysis approach for both prospective considerations and retrospective evaluations of assessing effectiveness supports an expectation that the hedging relationship will be highly effective and demonstrates that it has been highly effective, respectively.

10. The application of a regression or other statistical analysis approach to assessing effectiveness is complex. Those methodologies require appropriate interpretation and understanding of the statistical inferences.

E8: Hedging–General: Assessing Hedge Effectiveness of Fair Value and Cash Flow Hedges Period-by-Period or Cumulatively under a Dollar-Offset Approach

Paragraph references: 20.b., 28.b., 30, 62, 64, 67
Date cleared by Board: June 28, 2000

QUESTION

1. In periodically assessing retrospectively the effectiveness of a fair value hedge (or a cash flow hedge) in having achieved offsetting changes in fair values (or cash flows), an entity compares the change in the hedging instrument's fair value (or cash flows) to the change in the hedged item's fair value (or hedged transaction's cash flows) attributable to the hedged risk. If an entity elects at inception of a hedging relationship to utilize the dollar-offset approach for retrospective evaluations of assessing effectiveness, then should that entity base that comparison on (a) the fair value (or cash flow) changes that have occurred during the period being assessed (that is, on a period-by-period basis) or (b) the cumulative fair value (or cash flow) changes to date from the inception of the hedge? Is that entity permitted to use either a period-by-period approach or a cumulative approach on individual fair value hedges (or cash flow hedges) under a dollar-offset approach?

BACKGROUND

2. Paragraph 20.b. of Statement 133 states, in part:

> Both at inception of the [fair value] hedge and on an ongoing basis, the hedging relationship is expected to be highly effective in achieving offsetting changes in fair value attributable to the hedged risk during the period that the hedge is designated. An assessment of effectiveness is required whenever financial statements or earnings are reported, and at least every three months.…All assessments of effectiveness shall be consistent with the risk management strategy documented for that particular hedging relationship.

3. Paragraph 28.b. states, in part:

> Both at inception of the [cash flow] hedge and on an ongoing basis, the hedging relationship is expected to be highly effective in achieving offsetting cash flows attributable to the hedged risk during the term of the hedge, except as indicated in paragraph 28.d. below. An assessment of effectiveness is required whenever financial statements or earnings are reported, and at least every three months.…All assessments of effectiveness shall be consistent with the originally documented risk management strategy for that particular hedging relationship.

4. Paragraph 30.b. states that "the effective portion of the gain or loss on a derivative designated as a cash flow hedge is reported in other comprehensive income." Paragraph 30.b. specifies how the effective portion to be reported in other comprehensive income should be calculated. The calculation of the

effective portion is, in part, based on "cumulative gain or loss on the derivative from inception of the hedge."

5. Paragraph 67 of the Statement states, in part:

> If the hedge initially qualifies for hedge accounting, the entity would continue to assess whether the hedge meets the effectiveness test and also would measure any ineffectiveness during the hedge period. If the hedge fails the effectiveness test at any time (that is, if the entity does not expect the hedge to be highly effective at achieving offsetting changes in fair values or cash flows), the hedge ceases to qualify for hedge accounting.

RESPONSE

6. In periodically (that is, at least quarterly) assessing retrospectively the effectiveness of a fair value hedge (or a cash flow hedge) in having achieved offsetting changes in fair values (or cash flows) under a dollar-offset approach, Statement 133 permits an entity to use either a period-by-period approach or a cumulative approach on individual fair value hedges (or cash flow hedges). The period-by-period approach involves comparing the changes in the hedging instrument's fair values (or cash flows) that have occurred during the period being assessed to the changes in the hedged item's fair value (or hedged transaction's cash flows) attributable to the risk hedged that have occurred during the same period. The cumulative approach involves comparing the cumulative changes (to date from inception of the hedge) in the hedging instrument's fair values (or cash flows) to the cumulative changes in the hedged item's fair value (or hedged transaction's cash flows) attributable to the risk hedged. At inception of the hedge, an entity may choose either approach in designating how effectiveness will be assessed, depending on the nature of the hedge documented in accordance with paragraphs 20.a. and 28.a. For example, an entity may decide that the cumulative approach is generally preferred, yet may wish to use the period-by-period approach in certain circumstances.

7. Paragraph 62 requires that at the time an entity designates a hedging relationship, it must define and document the method it will use to assess the hedge's effectiveness. That paragraph also states that ordinarily "an entity should assess effectiveness for similar hedges in a similar manner; use of different methods for similar hedges should be justified." Furthermore, it requires that an entity use that defined and documented methodology consistently throughout the period of the hedge. If an entity elects at inception of a hedging relationship to base its comparison of changes in fair value (or cash flows) on a cumulative approach, then that entity must abide by the results of that methodology as long as that hedging relationship remains designated. Electing to utilize a period-by-period approach instead of a cumulative approach (or vice versa) to perform retrospective evaluations of assessing hedge effectiveness under the dollar-offset method may affect whether an entity can apply hedge accounting for the current assessment period.

8. If an entity elects to base its comparison of changes in fair value (or cash flows) on a period-by-period approach, the period cannot exceed three months. Fair value (or cash flow) patterns of the hedging instrument or the hedged item (or hedged transaction) in periods prior to the period being assessed are not relevant.

9. The foregoing guidance relates to an entity's periodic retrospective assessment and determining whether a hedging relationship continues to qualify for hedge accounting; it does not relate to the actual measurement of hedge ineffectiveness to be recognized in earnings under hedge accounting. The actual measurement of ineffectiveness is based on the extent to which exact offset is not achieved as specified in paragraph 22 for fair value hedges or paragraph 30 for cash flow hedges.

10. The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to

dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

EXHIBIT B – ASSESSMENT OF HEDGING EFFECTIVENESS

The following is based on paragraphs 62-70 of FAS 133 to offer additional guidance on assessing hedging effectiveness. The intent of such is to remain consistent with FAS 133 with respect to assessing hedge effectiveness.

1. This issue paper requires that an entity define at the time it designates a hedging relationship the method it will use to assess the hedge's effectiveness in achieving offsetting changes in fair value or offsetting cash flows attributable to the risk being hedged. It also requires that an entity use that defined method consistently throughout the hedge period to assess at inception of the hedge and on an ongoing basis whether it expects the hedging relationship to be highly effective in achieving offset. If the entity identifies an improved method and wants to apply that method prospectively, it must discontinue the existing hedging relationship and designate the relationship anew using the improved method. Although this issue paper suggests a method for assessing whether a hedge is expected to be highly effective or measuring hedge ineffectiveness, the appropriateness of a given method of assessing hedge effectiveness can depend on the nature of the risk being hedged and the type of hedging instrument used. Ordinarily, however, an entity should assess effectiveness for similar hedges in a similar manner; use of different methods for similar hedges should be justified.

2. In defining how hedge effectiveness will be assessed, an entity must specify whether it will include in that assessment all of the gain or loss on a hedging instrument. This issue paper permits (but does not require) an entity to exclude all or a part of the hedging instrument's time value from the assessment of hedge effectiveness, as follows:

a. If the effectiveness of a hedge with an option contract is assessed based on changes in the option's intrinsic value, the change in the time value of the contract would be excluded from the assessment of hedge effectiveness.

b. If the effectiveness of a hedge with an option contract is assessed based on changes in the option's minimum value, that is, its intrinsic value plus the effect of discounting, the change in the volatility value of the contract would be excluded from the assessment of hedge effectiveness.

c. If the effectiveness of a hedge with a forward or futures contract is assessed based on changes in fair value attributable to changes in spot prices, the change in the fair value of the contract related to the changes in the difference between the spot price and the forward or futures price would be excluded from the assessment of hedge effectiveness.

In each circumstance above, changes in the excluded component would be included in unrealized gains or losses. As noted in paragraph 1, the effectiveness of similar hedges generally should be assessed similarly; that includes whether a component of the gain or loss on a derivative is excluded in assessing effectiveness. No other components of a gain or loss on the designated hedging instrument may be excluded from the assessment of hedge effectiveness.

3. In assessing the effectiveness of a cash flow hedge, an entity generally will need to consider the time value of money if significant in the circumstances. Considering the effect of the time value of money is especially important if the hedging instrument involves periodic cash settlements. An example of a situation in which an entity likely would reflect the time value of money is a tailing strategy with futures contracts. When using a tailing strategy, an entity adjusts the size or contract amount of futures contracts used in a hedge so that earnings (or expense) from reinvestment (or funding) of daily settlement gains (or losses) on the futures do not distort the results of the hedge. To assess offset of expected cash flows when a tailing strategy has been used, an entity could reflect the time value of money, perhaps by

comparing the present value of the hedged forecasted cash flow with the results of the hedging instrument.

4. Whether a hedging relationship qualifies as highly effective sometimes will be easy to assess. If the critical terms of the hedging instrument and of the entire hedged asset or liability (as opposed to selected cash flows) or hedged forecasted transaction are the same, the entity could conclude that changes in fair value or cash flows attributable to the risk being hedged are expected to completely offset at inception and on an ongoing basis. For example, an entity may assume that a hedge of a forecasted purchase of a commodity with a forward contract will be highly effective if:

a. The forward contract is for purchase of the same quantity of the same commodity at the same time and location as the hedged forecasted purchase.
b. The fair value of the forward contract at inception is zero.
c. Either the change in the discount or premium on the forward contract is excluded from the assessment of effectiveness and included directly in unrealized gains and losses pursuant to paragraph 22B or the change in expected cash flows on the forecasted transaction is based on the forward price for the commodity.

5. However, assessing hedge effectiveness can be more complex. For example, hedge effectiveness would be reduced by the following circumstances, among others: a. A difference between the basis of the hedging instrument and the hedged item or hedged transaction (such as a Deutsche mark-based hedging instrument and Dutch guilder-based hedged item), to the extent that those bases do not move in tandem. b. Differences in critical terms of the hedging instrument and hedged item or hedged transaction, such as differences in notional amounts, maturities, quantity, location, or delivery dates. Hedge effectiveness also would be reduced if part of the change in the fair value of a derivative is attributable to a change in the counterparty's creditworthiness.

6. A hedge that meets the effectiveness test specified in paragraphs 20.b. and 21.b. (that is, both at inception and on an ongoing basis, the entity expects the hedge to be highly effective at achieving offsetting changes in fair values or cash flows) also must meet the other hedge accounting criteria to qualify for hedge accounting. If the hedge initially qualifies for hedge accounting, the entity would continue to assess whether the hedge meets the effectiveness test. If the hedge fails the effectiveness test at any time (that is, if the entity does not expect the hedge to be highly effective at achieving offsetting changes in fair values or cash flows), the hedge ceases to qualify for hedge accounting. The discussions of measuring hedge effectiveness in the examples in the remainder of this Exhibit assume that the hedge satisfied all of the criteria for hedge accounting at inception.

Assuming Effectiveness in a Hedge with an Interest Rate Swap

7. An entity may assume effectiveness in a hedging relationship of interest rate risk involving an interest-bearing asset or liability and an interest rate swap if all of the applicable conditions in the following list are met:

Conditions applicable to both fair value hedges and cash flow hedges

a. The notional amount of the swap matches the principal amount of the interest-bearing asset or liability.
b. The fair value of the swap at its inception is zero.
c. The formula for computing net settlements under the interest rate swap is the same for each net settlement. (That is, the fixed rate is the same throughout the term, and the variable rate is based on the same index and includes the same constant adjustment or no adjustment.)
d. The interest-bearing asset or liability is not prepayable.

e. Any other terms in the interest-bearing financial instruments or interest rate swaps are typical of those instruments and do not invalidate the assumption of no ineffectiveness.

Conditions applicable to fair value hedges only

f. The expiration date of the swap matches the maturity date of the interest-bearing asset or liability.
g. There is no floor or ceiling on the variable interest rate of the swap.
h. The interval between repricings of the variable interest rate in the swap is frequent enough to justify an assumption that the variable payment or receipt is at a market rate (generally three to six months or less).

Conditions applicable to cash flow hedges only

i. All interest receipts or payments on the variable-rate asset or liability during the term of the swap are designated as hedged, and no interest payments beyond the term of the swap are designated as hedged.
j. There is no floor or cap on the variable interest rate of the swap unless the variable-rate asset or liability has a floor or cap. In that case, the swap must have a floor or cap on the variable interest rate that is comparable to the floor or cap on the variable-rate asset or liability. (For this purpose, comparable does not necessarily mean equal. For example, if a swap's variable rate is LIBOR and an asset's variable rate is LIBOR plus 2 percent, a 10 percent cap on the swap would be comparable to a 12 percent cap on the asset.)
k. The repricing dates match those of the variable-rate asset or liability.
l. The index on which the variable rate is based matches the index on which the asset or liability's variable rate is based.

8. The fixed rate on a hedged item need not exactly match the fixed rate on a swap designated as a fair value hedge. Nor does the variable rate on an interest-bearing asset or liability need to be the same as the variable rate on a swap designated as a cash flow hedge. A swap's fair value comes from its net settlements. The fixed and variable rates on a swap can be changed without affecting the net settlement if both are changed by the same amount. That is, a swap with a payment based on LIBOR and a receipt based on a fixed rate of 5 percent has the same net settlements and fair value as a swap with a payment based on LIBOR plus 1 percent and a receipt based on a fixed rate of 6 percent.

9. Comparable credit risk at inception is not a condition for assuming effectiveness even though actually achieving perfect offset would require that the same discount rate be used to determine the fair value of the swap and of the hedged item or hedged transaction. To justify using the same discount rate, the credit risk related to both parties to the swap as well as to the debtor on the hedged interest-bearing asset (in a fair value hedge) or the variable-rate asset on which the interest payments are hedged (in a cash flow hedge) would have to be the same. However, because that complication is caused by the interaction of interest rate risk and credit risk, which are not easily separable, comparable creditworthiness is not considered a necessary condition to assume no ineffectiveness in a hedge of interest rate risk.

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Statutory Issue Paper No. 116

Claim Adjustment Expenses, Amendments to SSAP No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses

STATUS
Finalized October 16, 2001

Current Authoritative Guidance for Claim Adjustment Expenses, Unpaid Claims, Losses and Loss Adjustment Expenses: SSAP No. 55

This issue paper may not be directly related to the current authoritative statement.

Original SSAP from Issue Paper: SSAP No. 85

Type of Issue:
Life and Health, Health Entities

SUMMARY OF ISSUE

1. *SSAP No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses* (SSAP No. 55) prescribes the accounting treatment for recording unpaid claims and claim adjustment expenses for life insurance contracts and accident and health contracts and unpaid losses and loss adjustment expenses for property and casualty insurance contracts.

2. The purpose of this issue paper is to amend SSAP No. 55 to provide clarification regarding what costs should be classified as claim adjustment expenses on accident and health contracts. The conclusions outlined in the issue paper are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

RECOMMENDED CONCLUSION

3. Certain claim adjustment expenses reduce the number or cost of health services thereby resulting in lower premiums or lower premium increases. These claim adjustment expenses shall be classified as cost containment expenses.

4. This issue paper amends paragraph 6.c. of SSAP No. 55 to the following:

c. Claim Adjustment Expenses for Accident and Health Reporting Entities: Costs expected to be incurred in connection with the adjustment and recording of accident and health claims defined in subparagraphs 6.a. and 6.b. Claim adjustment expenses, including legal expenses, can be subdivided into cost containment expenses and other claim adjustment expenses:

i. Cost containment expenses: Expenses that actually serve to reduce the number of health services provided or the cost of such services. The following are examples of items that shall be considered "cost containment expenses" only if they result in reduced levels of costs or services:

(a) Case management activities;

(b) Utilization review;

(c) Detection and prevention of payment for fraudulent requests for reimbursement;

(d) Network access fees to Preferred Provider Organizations and other network-based health plans (including prescription drug networks), and allocated internal salaries and related costs associated with network development and/or provider contracting;

(e) Consumer education solely relating to health improvement and relying on the direct involvement of health personnel (this would include smoking cessation and disease management programs, and other programs that involve hands on medical education); and

(f) Expenses for internal and external appeals processes.

ii. Other claim adjustment expenses: Claim adjustment expenses as defined in paragraph 6.c. that are not cost containment expenses. Examples of other claim adjustment expenses are:

(a) Estimating the amounts of losses and disbursing loss payments;

(b) Maintaining records, general clerical, and secretarial;

(c) Office maintenance, occupancy costs, utilities, and computer maintenance;

(d) Supervisory and executive duties; and

(e) Supplies and postage.

5. This issue paper amends paragraph 7.b. of SSAP No. 55 to the following:

b. Claim Adjustment Expenses for Managed Care Reporting Entities: Costs expected to be incurred in connection with the adjustment and recording of accident and health claims defined in subparagraph 7.a. of this statement. Claim adjustment expenses, including legal expenses, can be subdivided into cost containment expenses and other claim adjustment expenses:

i. Cost containment expenses: Expenses that actually serve to reduce the number of health services provided or the cost of such services. The following are examples of items that shall be considered "cost containment expenses" only if they result in reduced levels of costs or services:

(a) Case management activities;

(b) Utilization review;

(c) Detection and prevention of payment for fraudulent requests for reimbursement;

(d) Network access fees to Preferred Provider Organizations and other network-based health plans (including prescription drug networks), and allocated internal salaries and related costs associated with network development and/or provider contracting;

(e) Consumer education solely relating to health improvement and relying on the direct involvement of health personnel (this would include smoking cessation and disease management programs, and other programs that involve hands on medical education); and

(f) Expenses for internal and external appeals processes.

ii. Other claim adjustment expenses: Claim adjustment expenses as defined in paragraph 7.b. that are not cost containment expenses. Examples of other claim adjustment expenses are:

(a) Estimating the amounts of losses and disbursing loss payments;

(b) Maintaining records, general clerical, and secretarial;

(c) Office maintenance, occupancy costs, utilities, and computer maintenance;

(d) Supervisory and executive duties; and

(e) Supplies and postage.

Effective Date

6. This issue paper is effective for years ending on and after December 31, 2003.

DISCUSSION

7. In the past, no definitive statutory guidance existed addressing claim adjustment expenses and which expenses should be classified as claim adjustment expenses. In January 2000, the Statutory Accounting Principles Working Group requested assistance from the Accident and Health Working Group of the Life and Health Actuarial Task Force (A&HWG) in providing clarification as to what expenses should be classified as claim adjustment expenses and whether certain claim adjustment expenses should receive special treatment for reporting purposes. The A&HWG made its final recommendations at its March 23, 2001 meeting. The A&HWG determined that claim adjustment expenses shall be subdivided into cost containment expenses and other claim adjustment expenses. The A&HWG also developed a list of items that qualify as cost containment expenses. This issue paper adopts the recommendations of the A&HWG.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

8. SSAP No. 55, paragraph 6.c.:

> 6.c. Claim Adjustment Expenses for Accident and Health Reporting Entities: Costs expected to be incurred in connection with the adjustment and recording of accident and health claims defined in subparagraphs 6.a. and 6.b. Examples of expenses incurred in these activities are estimating the amounts of losses, disbursing loss payments, maintaining records, general clerical, secretarial, office maintenance, occupancy costs, utilities, computer maintenance, supervisory and executive duties, supplies, and postage;

9. SSAP No. 55, paragraph 7.b.:

> 7.b. Claim Adjustment Expenses for Managed Care Reporting Entities: Costs expected to be incurred in connection with the adjustment and recording of accident and health claims

defined in subparagraph 7.a. of this statement. Examples of expenses incurred in these activities are estimating the amounts of losses, disbursing loss payments, maintaining records, general clerical, secretarial, office maintenance, occupancy costs, utilities, computer maintenance, supervisory and executive duties, supplies, and postage;

10. The Accident and Health Working Group of the Life and Health Actuarial Task Force (A&HWG) reviewed in detail the topics of claim adjustment expenses and medical cost containment expenses and whether certain claim adjustment expenses should be included in losses or loss adjustment expenses. The A&HWG made its final recommendations at its March 23, 2001 meeting. The conclusion of this issue paper is consistent with the A&HWG's recommendation. The applicable section of the minutes is included herein:

> At the 2000 Spring National Meeting, a request for assistance concerning codification issues was received from the Statutory Accounting Principles (E) Working Group (pages 90-91 of the *Life and Health Actuarial Subscription*, February 2000). The Accident and Health Working Group sent preliminary recommendations to the Statutory Accounting (E) Principles Working Group at the Fall National Meeting (Attachment Seven-B of the Accident and Health Working Group's Sept. 8, 2000, minutes). The recommendations addressed whether cost containment expenses should be included in losses or loss adjustment expenses. The Codification Subteam of the Accident and Health Working Group continued work on addressing how the prior recommendations could be implemented into the Health Annual Statement and in the Life, Accident and Health Annual Statement. This was the focus of the Feb.15 and March 2 conference calls.
>
> At the 2001 Spring National Meeting, John Rink (NE), chair of the Codification Subteam, reviewed the proposed memorandum to the Statutory Accounting Principles (E) Working Group. Mr. Rink noted that the recommendations in the proposed memorandum were designed to generate minimal changes to the annual statements, but still implement the prior recommendations of the Accident and Health Working Group.
>
> Mike Batte (NM) moved, John Hartnedy (AR) seconded and the working group agreed to forward the recommendations with the proposed revisions to the Statutory Accounting (E) Principles Working Group. The final memo to the Statutory Accounting Principles (E) Working Group is Attachment Twelve-A.

11. Applicable excerpts from Attachment Twelve-A to the minutes of the March 23, 2001, meeting of the Accident and Health Working Group of the Life and Health Actuarial Task Force are included herein:

> The Accident and Health Working Group (A&HWG) addressed cost containment expenses in a Sept. 11, 2000, memorandum to the Statutory Accounting Principles Working Group. This document is Attachment Seven-B of the Sept. 8, 2000 minutes of the Accident and Health Working Group and may be found on pages 160-162 of the Sept. 2000 *Life & Health Actuarial Subscription.*
>
> In that memorandum, nine items were identified that could be considered cost containment expenses. Those nine items were further divided into two groupings. One grouping included the following expenses:
>
> 1. Clinical quality assurance and other types of medical care quality improvement efforts.
> 2. Provider contracting and credentialing costs.
> 3. Consumer education not exclusively relating to health improvement, such as newsletters and e-mails designed to provide health improvement ideas.
>
> Another grouping identified in the Sept. 11 memorandum included the following expenses:
>
> 1. Case management activities.
> 2. Concurrent utilization review.
> 3. Prospective utilization review.
> 4. Detection and prevention of payment for fraudulent requests for reimbursement.

5. Network access fees to Preferred Provider Organizations and other network-based health plans, including prescription drug networks.
6. Consumer education solely relating to health improvement and relying on the direct involvement of health personnel. This would include smoking cessation and disease management programs, and other programs that involve hands on medical education.

These expenses reduce the number or cost of health services, which results in lower premiums or lower premium increases. These six expenses will be the only expenses referenced as "cost containment expenses" in this memorandum.

In the Sept. 11 memorandum, the A&HWG recommended that cost containment expenses, as identified above, be included as losses for statutory reporting purposes, and that quality assurance expenses not be included as losses for statutory reporting. The remainder of this memorandum addresses how the Sept. 11 recommendations may be implemented in the Health Blank and in the Life, Accident and Health Blank.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- SSAP No. 55—*Unpaid Claims, Losses and Loss Adjustment Expenses*

EXHIBIT A: Illustration of Marked Changes to Amended SSAPs

The following depicts the amendments made by this issue paper as "marked changes" (new text underlined and deleted text struck-through):

SSAP No. 55 paragraph 6.c.:

c. Claim Adjustment Expenses for Accident and Health Reporting Entities: Costs expected to be incurred in connection with the adjustment and recording of accident and health claims defined in subparagraphs 6.a. and 6.b. Claim adjustment expenses, including legal expenses, can be subdivided into cost containment expenses and other claim adjustment expenses:~~Examples of expenses incurred in these activities are:~~

i. Cost containment expenses: Expenses that actually serve to reduce the number of health services provided or the cost of such services. The following are examples of items that shall be considered "cost containment expenses" only if they result in reduced levels of costs or services:

(a) Case management activities;

(b) Utilization review;

(c) Detection and prevention of payment for fraudulent requests for reimbursement;

(d) Network access fees to Preferred Provider Organizations and other network-based health plans (including prescription drug networks), and allocated internal salaries and related costs associated with network development and/or provider contracting;

(e) Consumer education solely relating to health improvement and relying on the direct involvement of health personnel (this would include smoking cessation and disease management programs, and other programs that involve hands on medical education); and

(f) Expenses for internal and external appeals processes.

ii. Other claim adjustment expenses: Claim adjustment expenses as defined in paragraph 6.c. that are not cost containment expenses. Examples of other claim adjustment expenses are:

(a) Estimating the amounts of losses and ~~,~~disbursing loss payments;~~,~~

(b) Maintaining records, general clerical, and secretarial;~~,~~

(c) Office maintenance, occupancy costs, utilities, and computer maintenance;~~,~~

(d) Supervisory and executive duties;~~,~~ and

(e) Supplies~~,~~ and postage.

SSAP No. 55 paragraph 7.b.:

b. Claim Adjustment Expenses for Managed Care Reporting Entities: Costs expected to be incurred in connection with the adjustment and recording of accident and health claims defined in subparagraph 7.a. of this statement. Claim adjustment expenses, including legal expenses, can be subdivided into cost containment expenses and other claim adjustment expenses: ~~Examples of expenses incurred in these activities are~~

i. Cost containment expenses: Expenses that actually serve to reduce the number of health services provided or the cost of such services. The following are examples of items that shall be considered "cost containment expenses" only if they result in reduced levels of costs or services:

(a) Case management activities;

(b) Utilization review;

(c) Detection and prevention of payment for fraudulent requests for reimbursement;

(d) Network access fees to Preferred Provider Organizations and other network-based health plans (including prescription drug networks), and allocated internal salaries and related costs associated with network development and/or provider contracting;

(e) Consumer education solely relating to health improvement and relying on the direct involvement of health personnel (this would include smoking cessation and disease management programs, and other programs that involve hands on medical education); and

(f) Expenses for internal and external appeals processes.

ii. Other claim adjustment expenses: Claim adjustment expenses as defined in paragraph 7.b. that are not cost containment expenses. Examples of other claim adjustment expenses are:

(a) Estimating the amounts of losses and~~,~~ disbursing loss payments;~~,~~

(b) Maintaining records, general clerical, and secretarial;~~,~~

(c) Office maintenance, occupancy costs, utilities, and computer maintenance;~~,~~

(d) Supervisory and executive duties;~~,~~ and

(e) Supplies~~,~~ and postage.~~;~~

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Statutory Issue Paper No. 118

Investments in Subsidiary, Controlled and Affiliated Entities, A Replacement of SSAP No. 46

STATUS
Finalized December 9, 2002

Original SSAP and Current Authoritative Guidance: SSAP No. 68 and SSAP No. 97

Type of Issue:
Common Area

1. The purpose of this issue paper is to establish statutory accounting principles for investments in subsidiaries, controlled and affiliated entities (hereinafter referred to as SCA entities) that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

2. This issue paper replaces the conclusions reached in *SSAP No. 46—Investments in Subsidiary, Controlled and Affiliated Entities* (SSAP No. 46) and nullifies the following interpretations of the Emerging Accounting Issues Working Group:

   a. INT 99-03 – Accounting for Investment in Subsidiary, Controlled or Affiliated Entities with Subsequent Downstream Investment in an Insurance Company

   b. INT 99-28 – Accounting for SCA Mutual Funds, Broker-Dealers and Similar Entities Under SSAP No. 46

   c. INT 00-01 – Investment in a Foreign SCA Entity

   d. INT 01-22 – Use of Interim Financial Statements in Computing Reporting Entity's Investment in Subsidiary Under the GAAP Equity Method (conclusion was incorporated into SSAP)

   e. INT 01-24 – Application of SSAP No. 46 and 48 to Certain Noninsurance Subsidiary, Controlled or Affiliated Entities

SUMMARY CONCLUSION

Definitions

3. The interpretations of the Emerging Accounting Issues Working Group, which interpret SSAP No. 46 that are affected by the new SSAP, which will be the result of this issue paper, will be identified in the new SSAP.

4. Parent and subsidiary are defined as follows:

   a. Parent—An entity that directly or indirectly owns and controls the reporting entity;

   b. Subsidiary—An entity that is, directly or indirectly, owned and controlled by the reporting entity.

5. An affiliate is defined as an entity that is within the holding company system or a party that, directly or indirectly, through one or more intermediaries, controls, is controlled by, or is under common control with the reporting entity. An affiliate includes a parent or subsidiary and may also include partnerships, joint ventures, and limited liability companies as defined in *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies* (SSAP No. 48). Those entities are accounted for under the guidance provided in SSAP No. 48, which requires an equity method for all such investments.

6. Control is defined as the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of the investee, whether through the (a) ownership of voting securities, (b) by contract other than a commercial contract for goods or nonmanagement services, (c) by common management, or (d) otherwise. Control shall be presumed to exist if a reporting entity and its affiliates directly or indirectly, own, control, hold with the power to vote, or hold proxies representing 10% or more of the voting interests of the entity.

7. The 10% ownership threshold shall be measured at the holding company level. For example, if one member of an affiliated group has a 5% interest in an entity and a second member of the group has an 8% interest in the same entity, the total interest is 13% and therefore each member of the affiliated group shall be presumed to have control. These presumptions can be overcome by predominant evidence to the contrary, however, they shall stand until overcome by such predominant contradictory evidence. *FASB Interpretation No. 35, Criteria for Applying the Equity Method of Accounting for Investments in Common Stock, an Interpretation of APB Opinion No. 18*, provides guidance on determining when such evidence exists. A reporting entity with 10% or more of the voting interest shall evaluate all facts and circumstances relating to the investment and reach a judgment about whether the presumption of control is overcome. The corollary is required to demonstrate control when a reporting entity owns less than 10% of the voting interest of an investee.

8. Investments in SCA entities meet the definition of assets as defined in *SSAP No. 4—Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this issue paper.

Applying the Market Valuation, Audited Statutory Equity and Audited GAAP Equity Methods

9. The admitted investments in SCA entities shall be recorded using either the market valuation approach (as described in paragraph 9.a.), or one of the equity methods (as described in paragraph 9.b.).

a. In order to use the market valuation approach for SCA entities, the following requirements apply:

i. The subsidiary must be traded on one of the following three major exchanges: (1) the New York Stock Exchange, (2) the American Stock Exchange, or (3) the NASDAQ National exchange;

ii. The reporting entity must submit subsidiary information to the Securities Valuation Office (SVO) for its calculation of the subsidiary's market value. Such calculation could result in further discounts in market value above the established base discounts based on ownership percentages detailed below;

iii. Ownership percentages for determining the discount rate shall be measured at the holding company level;

iv. If an investment in a SCA results in an ownership percentage between 10% and 50%, a base discount percentage between 0% and 20% on a sliding scale basis is required;

v. If an investment in a SCA results in an ownership percentage greater than 50% up to and including 80%, a base discount percentage between 20% and 30% on a sliding scale basis is required;

vi. If an investment in a SCA results in an ownership percentage greater than 80% up to and including 85%, a minimum base discount percentage of 30% is required.

vii. Further, the SCA must have at least two million shares outstanding, with a total market value of at least $50 million in the public's control; and

viii. Any ownership percentages exceeding 85% will result in the SCA being recorded on an equity method.

b. If a SCA investment does not meet the requirements for the market valuation approach in paragraph 9.a. or, if the requirements are met, but a reporting entity elects not to use that approach, the reporting entity's proportionate share of its investments in SCAs shall be recorded as follows:

i. Investments in U.S. insurance SCA entities shall be recorded based on the underlying audited statutory equity of the respective entity's financial statements, adjusted for any unamortized goodwill as provided for in *SSAP No. 68—Business Combinations and Goodwill* (SSAP No. 68). Reporting entities shall record investments in U.S. insurance SCA entities on at least a quarterly basis, and shall base the investment value on the most recent quarterly information available from the SCA. Entities may recognize their investment in U.S. insurance SCA entities based on the unaudited statutory equity in the SCAs year-end Annual Statement if the annual SCA audit is not complete as of the filing deadline. The recorded statutory equity shall be adjusted for audit adjustments, if any, as soon as the annual audit has been completed. Annual consolidated audits are allowed if completed in accordance with the Model Regulation Requiring Annual Audited Financial Reports as adopted by the SCA's domiciliary state;

ii. Investments in noninsurance SCA entities that are engaged in the following transactions or activities:

(a) Collection of balances as described in *SSAP No. 6—Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due From Agents and Brokers*

(b) Sale/lease or rental of EDP Equipment and Software as described in *SSAP No. 16—Electronic Data Processing Equipment and Software* and *SSAP No. 79—Depreciation of Nonoperating System Software*

(c) Sale/lease or rental of furniture, fixtures, equipment or leasehold improvements as described in *SSAP No. 19—Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements*

(d) Loans to employees, agents, brokers, representatives of the reporting entity or SCA as described in *SSAP No. 20—Nonadmitted Assets*

(e) Sale/lease or rental of automobiles, airplanes and other vehicles as described in *SSAP No. 20—Nonadmitted Assets*

(f) Providing insurance services on behalf of the reporting entity including but not limited to accounting, actuarial, auditing, data processing, underwriting, collection of premiums, payment of claims and benefits, policyowner services

(g) Acting as an insurance or administrative agent or an agent for a government instrumentality performing an insurance function (e.g. processing of state workers' compensations plans, managing assigned risk plans, Medicaid processing etc).

(h) Purchase or securitization of acquisition costs

and if 20% or more of the SCA's revenue is generated from the reporting entity and its affiliates, then the underlying equity of the respective entity's audited Generally Accepted Accounting Principles (GAAP) financial statements shall be adjusted to a statutory basis of accounting (refer to paragraph 10). For purposes of this section, revenue means GAAP revenue reported in the audited GAAP financial statements excluding realized and unrealized capital gains/losses. Paragraphs 18-20 provide guidance for investments in holding companies;

iii. Investments in noninsurance SCA entities that do not qualify under subparagraph 9.b.ii. shall be recorded based on the audited GAAP equity of the investee;

iv. Investments in foreign insurance SCA entities shall be recorded based on the underlying audited U.S. GAAP equity of the respective entity adjusted to a statutory basis of accounting in accordance with paragraph 10 and adjusted for reserves of the foreign insurance SCA with respect to the business it assumes directly and indirectly from a U.S. insurer using the statutory accounting principles promulgated by the NAIC in the *Accounting Practices and Procedures Manual*.

The recorded GAAP equity shall be adjusted for any audit adjustments resulting from either the annual GAAP audit of the respective entity or, if the entity is a member of a consolidated group of insurers, the annual audit of the consolidated group of companies, as soon as determined. GAAP is defined as those pronouncements included in the United States GAAP Hierarchy as described in *AICPA Statement of Auditing Standard No. 69, The Meaning of "Presents Fairly in Conformity With GAAP"*. Foreign SCA entities are defined as those entities incorporated or otherwise legally formed under the laws of a foreign country. Foreign insurance SCA entities are defined as alien insurers formed according to the legal requirements of a foreign country. Investments in foreign noninsurance SCA entities shall follow the guidance in 8 b. ii., and 8 b. iii. above.

10. Statutory basis for accounting for investments in noninsurance SCA entities, subject to paragraph 9 b. ii. and foreign insurance SCA entities, subject to paragraph 9.b.iv., shall be based on the underlying audited U.S. GAAP equity of the respective entity with the following adjustments:

a. Nonadmit assets pursuant to the following statutory accounting principles as promulgated by the NAIC in the *Accounting Practices and Procedures Manual*;

i. *SSAP No. 6—Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due From Agents and Brokers*

ii. *SSAP No. 19—Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements*

iii. *SSAP No. 20—Nonadmitted Assets*

iv. *SSAP No. 29—Prepaid Expenses*

v. *SSAP No. 16—Electronic Data Processing Equipment and Software*

vi. *SSAP No. 79—Depreciation of Nonoperating System Software*

b. Expense costs that are capitalized in accordance with GAAP but are expensed pursuant to statutory accounting as promulgated by the NAIC in the *Accounting Practices and Procedures Manual* (e.g., deferred policy acquisition costs);

c. Adjust depreciation for certain assets in accordance with the following statutory accounting principles:

i. *SSAP No. 16—Electronic Data Processing Equipment and Software* and *SSAP No. 79—Depreciation of Nonoperating System Software*

ii. *SSAP No. 19—Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements*

d. Nonadmit the amount of goodwill of the SCA in excess of 10% of the audited GAAP equity of the SCA's last audited financial statements.

e Nonadmit amount of the net deferred tax assets (DTAs) of the SCA in excess of 10% of the audited GAAP equity of the SCA's last audited financial statements.

f. Adjust the GAAP annuity account value reserves of a foreign insurance SCA, with respect to the business it wrote directly, using the commissioners' annuity reserve valuation method (CARVM) as defined in paragraphs 12 and 13 of Appendix A-820 (including the reserving provisions in the various Actuarial Guidelines which support CARVM). The valuation interest rate and mortality tables to be used in applying CARVM should be that prescribed by the foreign insurance SCA's country of domicile. If the Foreign SCA's country of domicile does not prescribe the necessary tables and/or rates, no reserve adjustment shall be made.

11. The recorded GAAP equity shall be adjusted for any audit adjustments resulting from either the annual GAAP audit of the respective entity or, if the entity is a member of a consolidated group of insurers, the audit of the consolidated group of companies, as soon as determined. GAAP is defined as those pronouncements included in the United States GAAP Hierarchy as described in *AICPA Statement of Auditing Standards No. 69, The Meaning of "Presents Fairly in Conformity With GAAP."* The statutory equity method as described in paragraph 9.b.i., 9.b.ii. and 9.b.iii. shall be applied by recording an initial and subsequent investment in an investee at cost (excluding any investment in an investee's surplus notes), which is defined in SSAP No. 68 as the sum of (a) any cash payment, (b) the fair value of other assets distributed, (c) the fair value of any liabilities assumed, and (d) any direct costs of the acquisition. After the date of acquisition, the investment amount shall be adjusted for the amortization of goodwill and

the reporting entity's share of the change in special surplus funds, other than special surplus funds and unassigned funds (surplus), as defined in *SSAP No. 72—Surplus and Quasi-reorganizations*. This represents the carrying amount of the investment.

12. Once the reporting entity elects to use a valuation approach for a particular subsidiary, the reporting entity may not change the valuation method to another method without the approval of the domiciliary commissioner. For instance, if an entity selects the market valuation method, it may not change to an equity method or vice versa without approval from the domiciliary commissioner. The only exception to this notification requirement is the case in which an investment in a SCA entity that was previously accounted for under one method no longer qualifies under that method because of a change in the level of ownership, (i.e., acquisition of additional interests by the reporting entity) acquisition or retirement of interests by the investee, or a change in facts or circumstances (e.g., paragraphs 9.a.i., 9.a.vii.). Further, in order for an entity to transfer from a paragraph 9.a., 9.b.ii. or 9.b.iii. valuation to a paragraph 9.b.iv. valuation, the SCA shall not exceed the 20% threshold (as defined in paragraphs 9.b.ii. and 9.b.iii.) for three consecutive years. When an investment qualifies for use of another method of accounting, the reporting entity shall adopt the new method of accounting and the investment shall be adjusted to reflect the reporting entity's equity interest in the SCA entity under the new method. A corresponding amount shall be recorded as an unrealized gain or loss.

13. If the reporting entity is using an equity method, the reporting entity's share of undistributed earnings and losses of the investee shall be included in unrealized gains and losses of the reporting entity. The reporting entity's share of other changes in the investee's surplus (e.g., the change in the investee's nonadmitted assets) shall be recorded by the investor as a component of unrealized capital gains and losses on investments. If the reporting entity uses the market valuation approach outlined in paragraph 9.a., changes in that valuation shall be included in unrealized gains and losses. Dividends or distributions received from an investee shall be recognized in investment income when declared to the extent that they are not in excess of the undistributed accumulated earnings attributable to the investee. Dividends or distributions declared in excess of the undistributed accumulated earnings attributable to the investee shall reduce the carrying amount of the investment.

14. For investments in entities recorded based on the underlying audited GAAP equity of the investee, the amount to be recorded shall be defined as the initial investment in an investee at cost (as defined in SSAP No. 68). The carrying amount of the investment shall be adjusted to recognize the reporting entity's share of the audited GAAP basis earnings or losses of the investee after the date of acquisition, adjusted for any dividends received. A reporting entity's share of adjustments that are recorded directly to the investee's stockholder's equity under GAAP shall also be recorded as adjustments to the carrying value of the investment with an offsetting amount recorded directly to unrealized capital gains and losses on investments.

15. On at least a quarterly basis, the procedures set forth below shall be followed by a reporting entity in applying an equity method of accounting (as described in paragraphs 9.b.i. through 9.b.iv.), as applicable, to investments in SCA entities:

a. A difference between the cost of an investment and the underlying equity in the statutory or GAAP book value, as applicable, of the acquired company at the date of acquisition shall be accounted for in accordance with SSAP No. 68;

b. A transaction of an investee of a capital nature that affects the reporting entity's share of stockholders' equity of the investee shall be reflected as an unrealized gain or loss (e.g., where the investee issues additional stock or a new class of stock that impacts the reporting entity's equity ownership in the investee, the reporting entity's recorded investment shall be adjusted to reflect the transaction);

c. Realized gains or losses on the sale of an investment in a SCA entity shall be recorded in an amount equal to the difference at the time of sale between the selling price and carrying amount of the investment plus any previously recorded unrealized gain or loss;

d. If financial statements of an investee are not sufficiently timely for the reporting entity to apply an equity method to the investee's current results of operations, the reporting entity shall record its share of the earnings or losses of an investee from the most recent available financial statements. A lag in reporting shall be consistent from period to period;

e. A reporting entity's share of losses of an investee may equal or exceed the carrying amount of an investment accounted for by an equity method plus advances made by the investor. The reporting entity shall discontinue applying an equity method when the investment (including advances) is reduced to zero and shall not provide for additional losses unless the reporting entity has guaranteed obligations of the investee or is otherwise committed to provide further financial support for the investee (guaranteed obligations meeting the definition of liabilities in *SSAP No. 5—Liabilities, Contingencies and Impairments of Assets* shall be recorded as liabilities). If the investee subsequently reports net income, the reporting entity shall resume applying an equity method only after its share of that net income equals the share of net losses not recognized during the period that an equity method was suspended;

f. When an investee has outstanding cumulative preferred stock, the reporting entity shall compute its share of earnings (losses) after deducting the investee's preferred dividends, whether or not such dividends are declared;

g. An investment in a SCA entity may fall below the level of ownership described in paragraph 6 from the sale of a portion of an investment by the reporting entity, the sale of additional interests by an investee, or other transactions. The reporting entity shall discontinue accruing its share of the earnings or losses of the investee for an investment that no longer qualifies for an equity method. The earnings or losses that relate to the investment interests retained by the reporting entity and that were previously accrued shall remain as a part of the carrying amount of the investment. The investment account shall not be adjusted retroactively under the conditions described in this subparagraph. However, dividends received by the investor in subsequent periods which exceed the reporting entity's share of earnings for such periods shall be applied as a reduction of the carrying amount of the investment.

16. A reporting entity that owns an interest in itself via direct ownership of shares of an upstream intermediate or ultimate parent shall reduce the value of such shares for the reciprocal ownership. If the shares of the parent are owned indirectly by a reporting entity, via a downstream SCA entity, the directly held entity, which owns the parent's shares, shall have its value reduced for the reciprocal ownership.

17. Any parent reporting entity that owns an interest in itself via either direct or indirect ownership of a down-stream affiliate, which in turn owns shares of the parent reporting entity, shall eliminate its proportionate interest in these shares from the valuation of such affiliate.

Investments in Holding Companies

18. Valuation of a holding company depends upon the nature of the SCA entities it holds in accordance with paragraph 9 and the guidance contained in the applicable SSAP for non-SCA investments. If an SCA investment of the holding company does not meet the provisions of paragraph 9.a. or if it elects not to use the guidance in paragraph 9.a., and instead uses the guidance in paragraph 9.b., then the holding company would look to its underlying assets and record them as follows:

a. Investments by a holding company in insurance SCA entities are recorded based upon the guidance in paragraph 9.b.i.;

b. Investments by a holding company in noninsurance SCA entities that primarily provide services or hold assets that are for the direct or indirect use of the reporting entity or its affiliates are recorded based upon the guidance in paragraph 9.b.ii. or 9.b.iii. as applicable;

c. Investments by a holding company in noninsurance SCA entities that do not qualify under paragraph 18.b. above shall be recorded based upon the guidance in paragraph 9.b.iii.; and

d. Investments by a holding company in foreign insurance and noninsurance SCA entities shall be recorded based upon the guidance in paragraphs 9.b.iv. above.

19. In lieu of separate GAAP audits of SCA entities of the holding company, the insurer can choose to have a GAAP audit performed at the holding company level with a consolidating balance sheet showing GAAP equity of all the SCA entities. The consolidating balance sheet shall then be adjusted for GAAP to SAP differences of the insurance entities and paragraph 9.b.ii. 9.b.iii. and 9.b.iv. entities under the holding company. This adjusted amount would then be the reported value of the investment in holding company at the higher level insurance company.

20. A purchased holding company is valued in accordance with the provisions above and the provisions of SSAP No. 68.

Investment in Preferred Stock or Surplus Notes of a Subsidiary, Controlled and Affiliated Entity

21. When the reporting entity also holds an investment in preferred stock or surplus note(s) of an SCA and the carrying amount determined in accordance with paragraphs 9.b. and 10 includes preferred stock or surplus note(s), the investment in the SCA must be separated into its components. The carrying amount of the SCA is reduced by the value of the SCA's preferred stock or surplus note(s).

22. Investments in the preferred stock of an SCA shall be accounted for and reported in accordance with the provisions of *SSAP No. 32—Investments in Preferred Stock* (SSAP No. 32). This statement amends the title of SSAP No. 32 as follows:

> *SSAP No. 32—Investments in Preferred Stock (including ~~excluding~~ investments in preferred stock of subsidiary, controlled, or affiliated entities)*

This statement amends paragraphs 2 and 3 of SSAP No. 32 to the following:

> 2. Investments in preferred stock of subsidiaries, controlled or affiliated entities are included within the scope of this statement.

3. Preferred stock (including investment in affiliates), which may or may not be publicly traded and may include shares against which exchange traded call options are outstanding, shall include:

23. Investments in the surplus notes of an SCA shall be accounted for and reported in accordance with the provisions of *SSAP No. 41—Surplus Notes.*

24. The following example is provided to illustrate the accounting and reporting. The reporting entity holds 100% of the preferred stock. The SCA issued the preferred stock for $50,000. The investment in the SCA, measured in accordance with this SSAP is $250,000 including the preferred stock of the SCA. The investment in the SCA is $200,000 ($250,000-50,000) and the preferred stock is measured and reported in accordance with SSAP No. 32.

Impairment

25. When there is a decline in the fair value of an asset owned by a SCA entity that is other than temporary, the SCA entity shall write the asset down to fair value.

26. For any decline in the fair value of an investment in a SCA entity that is other than temporary, the investment shall be written down to fair value as the new cost basis and the amount of the write down shall be accounted for as a realized loss. The write down shall first be considered as an adjustment to any portion of the investment that is nonadmitted (e.g., goodwill). The new cost basis shall not be changed for subsequent recoveries in fair value. Future declines in fair value, which are determined to be other than temporary shall be recorded as realized losses. An impairment shall be considered to have occurred if it is probable that the reporting entity will be unable to recover the carrying amount of the investment or there is evidence indicating inability of the investee to sustain earnings, which would justify the carrying amount of the investment. A fair value of an investment that is below the carrying amount based on the statutory equity method or the existence of investee operating losses may indicate a loss in value, however, they are not necessarily indicative of a loss in value that is other than temporary.

Consolidation

27. Majority-owned subsidiaries shall not be consolidated for individual entity statutory reporting. This does not exempt certain reporting entities that are members of an affiliated group from the requirement to issue consolidated or combined annual statements as supplemental information in accordance with NAIC guidelines.

Disclosures

28. The significance of an investment to the reporting entity's financial position and results of operations shall be considered in evaluating the extent of disclosures of the financial position and results of operations of an investee. The following disclosures shall be made for all investments in SCA entities that exceed 10% of the total admitted assets of the reporting entity:

a. Financial statements of a reporting entity shall disclose (i) the name of each SCA entity and percentage of ownership of common stock, (ii) the accounting policies of the reporting entity with respect to investments in SCA entities, and (iii) the difference, if any, between the amount at which the investment is carried and the amount of underlying equity in net assets (i.e., goodwill, other nonadmitted assets, market value or discounted market value adjustments) and the accounting treatment of the difference;

b. For those SCA entities for which a quoted market price is available, the aggregate value of each SCA investment based on the quoted market price and the difference, if any, between the amount at which the investment is carried and the quoted market price shall be disclosed;

c. Summarized information as to assets, liabilities, and results of operations shall be presented for SCA entities, either individually or in groups;

d. Conversion of outstanding convertible securities, exercise of outstanding options and warrants and other contingent issuances of an investee may have a significant effect on an investor's share of reported earnings or losses. Accordingly, material effects of possible conversions, exercises or contingent issuances shall be disclosed in notes to the financial statements of the reporting entity; and

e. For those SCA entities in which the reporting entity elected, or was required to change its valuation method as described in paragraph 12, a description of the reason for the change and the amount of adjustment recorded as unrealized gains or losses shall be disclosed. The entity shall also disclose whether commissioner approval was obtained in accordance with paragraph 12.

29. Any commitment or contingent commitment to a SCA entity shall be disclosed (e.g., guarantees or commitments to provide additional capital contributions).

30. A reporting entity that recognizes an impairment loss shall disclose the following in the financial statements that include the period of the impairment write down:

a. A description of the impaired assets and the facts and circumstances leading to the impairment; and

b. The amount of the impairment and how fair value was determined.

31. Refer to the preamble for further discussion regarding disclosure requirements. The disclosures in paragraph 28.d. above shall be included in the annual audited statutory financial reports only.

Effective Date and Transition

32. Upon adoption of this issue paper, the NAIC will release a Statement of Statutory Accounting Principle (SSAP) for comment. The SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the *Accounting Practices and Procedures Manual* should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will contain an effective date of years ending on or after December 31, 2004.

DISCUSSION

33. This issue paper replaces the conclusions reached in SSAP No. 46. The amendments to SSAP No. 46 included in this issue paper are considered substantive by the Statutory Accounting Principles Working Group as they replace the judgment in determining application of statutory equity method versus the audited GAAP equity with a specific "bright-line" test. The following represents the substantive changes from SSAP No. 46 that are included in this issue paper:

SSAP No. 46 Paragraph	IP 118 No. Paragraph	Description
7 and 13.h	12	Retains guidance from SSAP No. 46 but includes a specific requirement in order to transfer from a noninsurance market or statutory equity method to an audited GAAP method.
7.b.i.	9.b.i.	Adds an audit requirement.
7.b.ii.	9.b.ii. and 9.b.iii.	Removes ambiguous language related to “significant ongoing operations” with a bright-line test.
7.b.iii.	9.b.ii.	Removes ambiguous language related to “significant ongoing operations” with default position.
-	9.b.iv.	New language included for investments in foreign SCA entities.
8	-	Paragraph removed in its entirety. This paragraph was interpreted to be in conflict with paragraph 7 of SSAP No. 46.
11	9 and 10	Language from SSAP No. 46 moved to paragraphs 9 and 10 of issue paper to provide further clarity.
13.a.	15.a.	References to noninsurance SCA as defined in SSAP No. 46 paragraph 7.b.ii. removed as definition of such SCA was modified by this issue paper.
-	28.e.	New disclosure related to change in valuation method was added.

34. This issue paper nullifies the following interpretations of the Emerging Accounting Issues Working Group:

a. *INT 99-03: Accounting for Investment in Subsidiary, Controlled or Affiliated Entities with Subsequent Downstream Investment in an Insurance Company* is nullified because INT 01-06 provided for a more descriptive application for holding companies. As this issue paper incorporates the guidance in INT 01-06, the conclusions reached in INT 99-3 are no longer necessary.

b. *INT 99-28: Accounting for SCA Mutual Funds, Broker-Dealers and Similar Entities Under SSAP No. 46* is nullified because there is no longer a need to differentiate certain SCA investments as the term “significant operations” has now been defined.

c. *INT 00-01: Investment in a Foreign SCA Entity* is nullified by the conclusions reached in paragraph 9.b.iv.

d. *INT 01-24: Application of SSAP No. 46 and 48 to Certain Noninsurance Subsidiary, Controlled or Affiliated Entities* is nullified by the conclusions reached in paragraph 9 and Exhibit A.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

35. See Issue Paper No. 46 for statutory references.

Generally Accepted Accounting Principles

36. See Issue Paper No. 46 for GAAP references.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *SSAP No. 46—Investments in Subsidiary, Controlled and Affiliated Entities*

Generally Accepted Accounting Principles

- See Issue Paper No. 46 for GAAP references.

State Regulations

- No additional guidance obtained from state statutes or regulations

EXHIBIT A – ILLUSTRATIVE EXAMPLES FOR PROVISION OF PARAGRAPH 9.b.

Example 1:

Insurance Company A owns 100% of a third party administrator, TPA1. TPA1 processes claims for noninsurance companies and for Medicare and Medicaid programs. TPA1 is completely independent from Insurance Company A and as such does not receive any management income or lease income from Insurance Company A or its affiliates. TPA1 does not process claims for Insurance Company A.

Equity Method – Insurance Company A would value TPA1 under 9 b. iii. (audited GAAP equity) as TPA1's revenue from Insurance Company A is less than 20%.

Example 2:

Insurance Company A owns 100% of a company that processes insurance claims, TPA2. TPA2 processes claims for Insurance Company A, Insurance Company B, Insurance Company C and Insurance Company D. TPA2 owns the EDP equipment and software necessary to provide administrative services to its customers. Insurance Companies B, C and D are not affiliates of Insurance Company A. The processing of claims for Insurance Company A constitutes 15% of the revenues of TPA2.

Equity Method – Insurance Company A would value TPA2 under 9 b. iii. (audited GAAP equity) as TPA2's revenue from Insurance Company A is less than 20%.

Example 3:

Insurance Companies A, B, C and D each own 25% of a company, TPA3, that provides administrative services, including all EDP processing, to Insurance Companies A, B, C and D. TPA3 owns the EDP equipment and software and furniture, fixtures and equipment necessary to provide administrative services to its customers. TPA3 does not provide administrative services to any other entities. Insurance Companies A, B, C and D are not part of the same insurance holding company system. The processing that TPA3 does for each of Insurance Companies A, B, C and D constitutes 25% of its business and revenues.

Equity Method – Insurance Company A, B, C and D would value TPA3 under 9 b. ii. (audited GAAP equity adjusted to SAP or audited SAP equity) as TPA3's revenue from each Insurance Company A, B, C and D is greater than 20%.

Example 4:

Insurance Company A owns 100% of a company, TPA4, that provides administrative services, including EDP processing, to Insurance Company A, Insurance Company B, Bank C and Manufacturing Company D. TPA4 owns the EDP equipment and software necessary to provide administrative services to its customers. Insurance Company A, Insurance Company B, Bank C and Manufacturing Company D are not affiliates, i.e. none of the four companies are related to one another. The processing that TPA4 does for Insurance Company A represents 40% of TPA4's business and revenues.

Equity Method – Insurance Company A would value TPA4 under 9 b. ii. (audited GAAP equity adjusted to SAP or audited SAP equity) as TPA4's revenue from Insurance Company A is greater than 20%.

Example 5:

Insurance Company A owns 100% of a company, TPA5, that provides claims administration services, including EDP processing, to Insurance Company A, Insurance Company B, numerous self-insured companies and Medicare. TPA5 owns the EDP equipment and software necessary to provide administrative services to its customers. Insurance Company A, Insurance Company B and the self-insured companies are not affiliates, i.e., they are not related to one another. Insurance Companies A and B may provide stop-loss coverage to some of the self-insured companies for whom TPA5 provides claims administration services. The processing that TPA5 does for Insurance Company A represents 51% of TPA5's business and revenues.

Equity Method – Insurance Company A would value TPA5 under 9 b. ii. (audited GAAP equity adjusted to SAP or audited SAP equity) as TPA4's revenue from Insurance Company A is greater than 20%.

Example 6:
Insurance Company A holds an 18.77% Partnership Interest in LPA. This fund was organized for the primary purpose of investing in investment vehicles and commodity pools as a "fund of funds" investment manager. The insurer is a limited partner. The general partner is not affiliated with the insurer. Quoting from the limited partnership agreement Section 3.1 – "The general partner shall be vested with the complete control of the business of the fund. The limited partners shall have no responsibility for the management of the fund and shall have no authority or right to act on behalf of the fund or to bind the fund in connection with any matter." The largest holding on their 12/31/99 audited GAAP financials was $293.6 million of "Investments in limited partnerships and investment funds, at fair value." Beyond that they have $28.0 million of cash and cash equivalents and $90k of dividends and interest receivable.

Equity Method – Insurance Company A would value LPA under 9 b. iii. (audited GAAP equity) as less than 20% of LPA's investment income is for the benefit of Insurance Company A.

Example 7:
Insurance Company A holds a 25% Partnership Interest in LPB. Similar to the LPA above, LPB is another limited partnership investment where the insurer owns greater than a 10% interest. The LP fund was organized primarily for the purpose of making investments in media businesses. The fund's general partner is not affiliated with the insurer. The general partner manages all of the affairs of the Fund, i.e., controls the business activities of the fund. The largest holding on their 12/31/99 unaudited GAAP financials (assume for this example that audited statements are not and will not be prepared) was $194.0 million of "Portfolio investments at fair value." This was made up of a combination of partnership and stock investments. Total assets were $200.8 million at 12/31/99.

Equity Method – Insurance Company A would value LPB under 9 b. ii. (audited GAAP equity adjusted to SAP or audited SAP equity) as more than 20% of the investment income of LPB is for the benefit of Insurance Company A.

Example 8:
Insurance Company A holds a 25% Partnership Interest in LLP. LLP is a real estate development limited partnership in which the insurer holds a 25% interest as a limited partner. The LLP's general partner is not affiliated with the insurer. The general partner manages the affairs of partnership including decisions on properties to acquire and/or develop. Assets of the partnership include real estate properties, both residential and commercial. Total assets of the partnership are $1 billion and total liabilities $500 million, primarily outside debt. LLP prepares annual audited GAAP financial statements, however, they are not completed prior to the insurer filing its annual financial statements.

Equity Method – Insurance Company A would value LLP under 9 b. ii. (audited GAAP equity adjusted to SAP or audited SAP equity) as more than 20% of the investment income of LLP is for the benefit of Insurance Company A.

Statutory Issue Paper No. 119

Capitalization Policy, An Amendment to SSAP Nos. 4, 19, 29, 73, 79 and 82

STATUS
Finalized June 10, 2002

Current Authoritative Guidance for Capitalization Policy: SSAP No. 4, SSAP No. 19, SSAP No. 29 and SSAP No. 73

This issue paper may not be directly related to the current authoritative statement.

Original SSAP from Issue Paper: SSAP No. 87

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. The purpose of this issue paper is to establish a statutory capitalization policy that is consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

2. This issue paper amends certain conclusions reached in *SSAP No. 4–Assets and Nonadmitted Assets* (SSAP No. 4), *SSAP No. 19–Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements* (SSAP No. 19)*, SSAP No. 29–Prepaid Expenses* (SSAP No. 29)*, SSAP No. 73–Health Care Delivery Assets - Supplies, Pharmaceuticals and Surgical Supplies, Durable Medical Equipment, Furniture, Medical Equipment and Fixtures, and Leasehold Improvements in Health Care Facilities* (SSAP No. 73), *SSAP No. 79–Depreciation of Nonoperating System Software – An Amendment to SSAP No. 16–Electronic Data Processing Equipment and Software* (SSAP No. 79) and *SSAP No. 82– Accounting for the Costs of Computer Software Developed or Obtained for Internal Use and Web Site Development Costs* (SSAP No. 82).

RECOMMENDED CONCLUSION

3. In general, this issue paper amends the phrase “in accordance with the reporting entity's capitalization policy, immaterial amounts … can be expensed …” to “in accordance with the reporting entity’s capitalization policy, amounts less than a predefined threshold … shall be expensed …”. A predefined threshold shall be established, for each asset class identified by SSAP Nos. 19, 29, 73, 79 and 82, by management based upon an analysis of circumstances unique to the entity and shall not be adjusted from period to period except under extenuating circumstances. If an entity demonstrates a pattern of varying its capitalization policy from period to period without sufficient evidence as determined by the reporting entity’s domestic regulator, such action would call into question both the entity's ability to accurately establish a predefined threshold and the propriety of expensing or capitalizing certain assets. Accordingly, entities shall expense all immaterial amounts (i.e., entity is no longer allowed to establish its own capitalization policy).

4. This issue paper amends paragraph 3 of SSAP No. 4 to the following:

> As stated in the Statement of Concepts, "The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which are unavailable due to

encumbrances or other third party interests should not be recognized on the balance sheet," and are, therefore, considered nonadmitted. For purposes of statutory accounting principles, a nonadmitted asset shall be defined as an asset meeting the criteria in paragraph 2 above, which is accorded limited or no value in statutory reporting, and is one which is:

a. Specifically identified within the Accounting Practices and Procedures Manual as a nonadmitted asset; or

b. Not specifically identified as an admitted asset within the Accounting Practices and Procedures Manual.

If an asset meets one of these criteria, the asset shall be reported as a nonadmitted asset and charged against surplus unless otherwise specifically addressed within the Accounting Practices and Procedures Manual. The asset shall be depreciated or amortized against net income as the estimated economic benefit expires. In accordance with the reporting entity's capitalization policy, amounts less than a predefined threshold of furniture, fixtures, equipment, or supplies, shall be expensed when purchased.

5. This issue paper amends paragraphs 3 and 6 of SSAP No. 19 to the following:

> In accordance with the reporting entity's capitalization policy, amounts less than a predefined threshold of such assets shall be expensed when purchased.

6. This issue paper amends paragraph 3 of SSAP No. 29 to the following:

> In accordance with the reporting entity's capitalization policy, prepaid expenses less than a predefined threshold shall be expensed when purchased.

7. This issue paper amends paragraph 10 of SSAP No. 73 to the following:

> In accordance with the reporting entity's capitalization policy, amounts less than a predefined threshold of medical supplies, pharmaceuticals and surgical supplies, durable medical equipment, furniture, medical equipment and fixtures, and leasehold improvements shall be expensed when purchased.

8. This issue paper amends paragraph 4 of SSAP No. 79 to the following:

> In accordance with the reporting entity’s capitalization policy, amounts less than a predefined threshold shall be expensed when purchased, otherwise the assets shall be capitalized and depreciated in accordance with this statement.

9. This issue paper amends paragraph 4 of SSAP No. 82 to the following:

> In accordance with the reporting entity’s capitalization policy, amounts less than a predefined threshold of such costs shall be expensed when incurred.

10. The reporting entity shall maintain a capitalization policy containing the predefined thresholds for each asset class to be made available for the department(s) of insurance.

Disclosures

11. The financial statements shall disclose if the written capitalization policy and the resultant predefined thresholds changed from the prior period and the reason(s) for such change.

Effective Date and Transition

12. Upon adoption of this issue paper, the NAIC will release a Statement of Statutory Accounting Principle (SSAP) for comment. The SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the Accounting Practices and Procedures Manual should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will contain an effective date of years beginning on or after January 1, 2004.

DISCUSSION

13. This issue paper replaces the subjectivity associated with capitalizing assets based upon materiality with a more quantifiable concept of capitalizing assets above a predefined threshold. This amendment is in harmony with the principle of consistency found in the Statement of Concepts. That is, the concept of materiality used in previous SSAPs was subject to interpretation and manipulation from period to period whereas the predefined threshold model used in this issue paper provides a definitive benchmark that can be quantified and judged from period to period. This issue paper requires entities to disclose their threshold, explain how they reached their threshold and offer support if they modify their capitalization policy. Previous statements, due to the subjective nature of expensing immaterial amounts, did not require this disclosure. The issue paper also includes a penalty for entities that manipulate their capitalization policy from period to period. The NAIC believe this issue paper provides a more consistent and transparent capitalization framework than previous statements.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

14. SSAP No. 4 paragraph 3:

> 3. As stated in the Statement of Concepts, "The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which are unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet," and are, therefore, considered nonadmitted. For purposes of statutory accounting principles, a nonadmitted asset shall be defined as an asset meeting the criteria in paragraph 2 above, which is accorded limited or no value in statutory reporting, and is one which is:
>
> a. Specifically identified within the Accounting Practices and Procedures Manual as a nonadmitted asset; or
>
> b. Not specifically identified as an admitted asset within the Accounting Practices and Procedures Manual.
>
> If an asset meets one of these criteria, the asset shall be reported as a nonadmitted asset and charged against surplus unless otherwise specifically addressed within the Accounting Practices and Procedures Manual. The asset shall be depreciated or amortized against net income as the estimated economic benefit expires. In accordance with the reporting entity's capitalization policy, immaterial amounts of furniture, fixtures, equipment, or supplies, can be expensed when purchased.

15. SSAP No. 19 paragraphs 3 and 6:

> 3. In accordance with the reporting entity's capitalization policy, immaterial amounts of such assets can be expensed when purchased.

> 6. In accordance with the reporting entity's capitalization policy, immaterial amounts of such assets can be expensed when acquired.

16. SSAP No. 29 paragraph 3:

> 3. In accordance with the reporting entity's capitalization policy, immaterial prepaid expenses may be expensed when purchased.

17. SSAP No. 73 paragraph 10:

> 10. In accordance with the reporting entity's capitalization policy, immaterial amounts of medical supplies, pharmaceuticals and surgical supplies, durable medical equipment, furniture, medical equipment and fixtures, and leasehold improvements may be expensed when purchased.

18. SSAP No. 79 paragraph 4:

> 4. In accordance with the reporting entity’s capitalization policy, immaterial amounts may be expensed when purchased, otherwise the assets shall be capitalized and depreciated in accordance with this statement.

19. SSAP No. 82 paragraph 4:

> 4. In accordance with the reporting entity’s capitalization policy, immaterial amounts of such costs can be expensed when incurred.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *SSAP No. 4–Assets and Nonadmitted Assets*
- *SSAP No. 19–Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements*
- *SSAP No. 29–Prepaid Expenses*
- *SSAP No. 73–Health Care Delivery Assets - Supplies, Pharmaceuticals and Surgical Supplies, Durable Medical Equipment, Furniture, Medical Equipment and Fixtures, and Leasehold Improvements in Health Care Facilities*
- *SSAP No. 79–Depreciation of Nonoperating System Software – An Amendment to SSAP No. 16–Electronic Data Processing Equipment and Software*
- *SSAP No. 82–Accounting for the Costs of Computer Software Developed or Obtained for Internal Use and Web Site Development Costs*

Generally Accepted Accounting Principles

- No guidance obtained from GAAP

EXHIBIT A: Illustration of Marked Changes to Amended SSAPs

The following depicts the amendments made by this issue paper as "marked changes" (new text underlined and deleted text struck-through):

SSAP No. 4 paragraph 3:

3. As stated in the Statement of Concepts, "The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which are unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet," and are, therefore, considered nonadmitted. For purposes of statutory accounting principles, a nonadmitted asset shall be defined as an asset meeting the criteria in paragraph 2 above, which is accorded limited or no value in statutory reporting, and is one which is:

a. Specifically identified within the Accounting Practices and Procedures Manual as a nonadmitted asset; or

b. Not specifically identified as an admitted asset within the Accounting Practices and Procedures Manual.

If an asset meets one of these criteria, the asset shall be reported as a nonadmitted asset and charged against surplus unless otherwise specifically addressed within the Accounting Practices and Procedures Manual. The asset shall be depreciated or amortized against net income as the estimated economic benefit expires. In accordance with the reporting entity's capitalization policy, ~~immaterial~~ amounts less than a predefined threshold of furniture, fixtures, equipment, or supplies, ~~can~~ shall be expensed when purchased.

SSAP No. 19 paragraphs 3 and 6:

3. In accordance with the reporting entity's capitalization policy, ~~immaterial~~ amounts less than a predefined threshold of such assets ~~can~~ shall be expensed when purchased.

6. In accordance with the reporting entity's capitalization policy, ~~immaterial~~ amounts less than a predefined threshold of such assets ~~can~~ shall be expensed when purchased.

SSAP No. 29 paragraph 3:

3. In accordance with the reporting entity's capitalization policy, ~~immaterial~~ prepaid expenses less than a predefined threshold shall ~~may~~ be expensed when purchased.

SSAP No. 73 paragraph 10:

10. In accordance with the reporting entity's capitalization policy, ~~immaterial~~ amounts less than a predefined threshold of medical supplies, pharmaceuticals and surgical supplies, durable medical equipment, furniture, medical equipment and fixtures, and leasehold improvements ~~may~~ shall be expensed when purchased.

SSAP No. 79 paragraph 4:

4. In accordance with the reporting entity's capitalization policy, ~~immaterial~~ amounts less than a predefined threshold shall ~~may~~ be expensed when purchased, otherwise the assets shall be capitalized and depreciated in accordance with this statement.

SSAP No. 82 paragraph 4:

4. In accordance with the reporting entity's capitalization policy, ~~immaterial~~ amounts less than a predefined threshold of such costs ~~can~~ shall be expensed when incurred.

Statutory Issue Paper No. 121

Accounting for the Impairment or Disposal of Real Estate Investments

STATUS
Finalized March 15, 2004

Original SSAP and Current Authoritative Guidance: SSAP No. 90

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory accounting guidance for the impairment or disposal of real estate investments is provided in *SSAP No. 40—Real Estate Investments* (SSAP No. 40). Guidance for accounting for discontinued operations is found in *SSAP No. 24—Discontinued Operations and Extraordinary Items* (SSAP No. 24). Further, *SSAP No. 68—Business Combinations and Goodwill* (SSAP No. 68) contains guidance for impairment of goodwill arising from a business combination.

2. Generally Accepted Accounting Principles (GAAP) guidance for these issues was previously found in *Financial Accounting Standards Board (FASB) Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (FAS 121) and *Accounting Principles Board (APB) Opinion No. 30, Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions* (APB 30). FAS 121 was superseded by *FASB Statement No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets* (FAS 144). APB 30 was superseded in part by FAS 144.

3. This issue paper establishes statutory accounting principles for the impairment or disposal of real estate investments and the treatment of long-lived assets associated with discontinued operations including nonadmitted intangible assets other than goodwill, such as trade names (referred to collectively as long-lived assets). This statement is not intended to conflict with guidance concerning operating results associated with discontinued operations, which is contained in SSAP No. 24.

4. This issue paper supersedes SSAP No. 40, paragraphs 9, 10 and 19.

5. This issue paper does not apply to (a) goodwill, (b) servicing assets, (c) financial instruments, including investments in equity securities accounted for under the cost or equity method, (d) deferred policy acquisition costs, and (e) deferred tax assets. This issue paper also does not apply to long-lived assets for which the accounting is prescribed by FASB Statement No. 86, Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed as adopted with modification to preclude the capitalization of software development costs in SSAP No. 17—Preoperating and Research and Development Costs. For a discussion on software development costs, see the guidance in SSAP No. 82—Accounting for the Costs of Computer Software Developed or Obtained for Internal Use and Web Site Development Costs. Statutory guidance on goodwill is in SSAP No. 68.

RECOMMENDED CONCLUSION

Recognition and Measurement of an Impairment Loss

6. For purposes of this Statement, impairment is the condition that exists when the carrying amount of a long-lived asset exceeds its fair value. An impairment loss shall be recognized only if the carrying amount of a long-lived asset is not recoverable and exceeds its fair value. The carrying amount of a long-

lived asset is not recoverable if it exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset. That assessment shall be based on the carrying amount of the asset at the date it is tested for recoverability, whether in use or under development. An impairment loss shall be measured as the amount by which the carrying amount of a long-lived asset exceeds its fair value.

When to Test a Long-Lived Asset for Recoverability

7. A long-lived asset shall be tested for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable. The following are examples of such events or changes in circumstances:

a. A significant decrease in the market price of a long-lived asset

b. A significant adverse change in the extent or manner in which a long-lived asset is being used or in its physical condition

c. A significant adverse change in legal factors or in the business climate that could affect the value of a long-lived asset, including an adverse action or assessment by a regulator

d. An accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of a long-lived asset

e. A current-period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with the use of a long-lived asset

f. A current expectation that, more likely than not, a long-lived asset will be sold or otherwise disposed of significantly before the end of its previously estimated useful life.

8. When a long-lived asset is tested for recoverability, it also may be necessary to review depreciation estimates and methods as required by *SSAP No. 3—Accounting Changes and Corrections of Errors* (SSAP No. 3). Any revision to the remaining useful life of a long-lived asset resulting from that review also shall be considered in developing estimates of future cash flows used to test the asset for recoverability. However, any change in the accounting method for the asset resulting from that review shall be made only after applying this Statement.

Grouping Long-Lived Assets to Be Held and Used

9. For purposes of recognition and measurement of an impairment loss, a long-lived asset or assets shall not be grouped with other assets and liabilities at the lowest level for which identifiable cash flows are largely independent of the cash flows of other assets and liabilities for properties occupied by the company.

10. In limited circumstances, a long-lived asset (for example, a corporate headquarters facility) may not have identifiable cash flows that are largely independent of the cash flows of other assets and liabilities and of other asset groups that consist of properties occupied by the company. In those circumstances, the asset group for that asset shall include all assets and liabilities of the entity.

New Cost Basis

11. If an impairment loss is recognized, the adjusted carrying amount of a long-lived asset shall be its new cost basis. For a depreciable long-lived asset, the new cost basis shall be depreciated (amortized) over the remaining useful life of that asset. Restoration of a previously recognized impairment loss is prohibited.

Estimates of Future Cash Flows Used to Test a Long-Lived Asset for Recoverability

12. Estimates of future cash flows used to test the recoverability of a long-lived asset shall include only the future cash flows (cash inflows less associated cash outflows) that are directly associated with, and that are expected to arise as a direct result of, the use and eventual disposition of the asset. Those estimates shall exclude interest charges that will be recognized as an expense when incurred.

13. Estimates of future cash flows used to test the recoverability of a long-lived asset shall incorporate the entity's own assumptions about its use of the asset and shall consider all available evidence. The assumptions used in developing those estimates shall be reasonable in relation to the assumptions used in developing other information used by the entity for comparable periods, such as internal budgets and projections, accruals related to incentive compensation plans, or information communicated to others. However, if alternative courses of action to recover the carrying amount of a long-lived asset are under consideration or if a range is estimated for the amount of possible future cash flows associated with the likely course of action, reporting entities shall use their best estimate in testing the recoverability of a long-lived asset.

14. Estimates of future cash flows used to test the recoverability of a long-lived asset shall be made for the remaining useful life of the asset to the entity.

15. Estimates of future cash flows used to test the recoverability of a long-lived asset that is in use, including a long-lived asset for which development is substantially complete, shall be based on the existing service potential of the asset at the date it is tested. The service potential of a long-lived asset encompasses its remaining useful life, cash-flow-generating capacity, and for tangible assets, physical output capacity. Those estimates shall include cash flows associated with future expenditures necessary to maintain the existing service potential of a long-lived asset, including those that replace the service potential of component parts of a long-lived asset (for example, the roof of a building) and component assets other than the primary asset of an asset group. Those estimates shall exclude cash flows associated with future capital expenditures that would increase the service potential of a long-lived asset.

16. Estimates of future cash flows used to test the recoverability of a long-lived asset that is under development shall be based on the expected service potential of the asset when development is substantially complete. Those estimates shall include cash flows associated with all future expenditures necessary to develop a long-lived asset, including interest payments that will be capitalized as part of the cost of the asset.

17. If a long-lived asset that is under development is part of an asset group that is in use, estimates of future cash flows used to test the recoverability of that group shall include the cash flows associated with future expenditures necessary to maintain the existing service potential of the group as well as the cash flows associated with all future expenditures necessary to substantially complete the asset that is under development.

Fair Value

18. A discussion of fair value is contained in the Glossary to the Statements of Statutory Accounting Principles. This issue paper requires properties occupied by the company, that are determined to be subject to recoverability testing as discussed in paragraphs 7 and 8, to follow the guidance in SSAP No. 40, paragraph 11.

Real Estate Investment Categories

19. SSAP No. 40 states that real estate investments shall be reported in the balance sheet categories of properties occupied by the company, properties held for the production of income, and properties held

for sale. However, the accounting guidance in FAS 144 distinguishes between long-lived assets to be held and used and long-lived assets to be disposed of. For statutory accounting purposes, long-lived assets to be held and used encompass properties occupied by the company and properties held for the production of income. Further, FAS 144 bifurcates the category of long-lived assets to be disposed of into long-lived assets to be disposed of other than by sale and long-lived assets to be disposed of by sale. Long-lived assets to be disposed of other than by sale shall be classified either as properties occupied by the company or as properties held for the production of income. Long-lived assets to be disposed of by sale shall be classified as properties held for sale.

Long-Lived Assets to Be Disposed Of Other Than by Sale

20. A long-lived asset to be disposed of other than by sale (for example, by abandonment, in an exchange for a similar productive long-lived asset, or in a distribution to owners in a spinoff) shall continue to be classified as held and used until disposal. Paragraphs 6-19 shall apply while the asset is classified as held and used. If a long-lived asset is to be abandoned or distributed to owners in a spinoff together with other assets (and liabilities) as a group and that disposal group is a segment, paragraph 33 shall apply to the disposal group at the date of disposal.

Long-Lived Asset to Be Abandoned

21. For purposes of this Statement, a long-lived asset to be abandoned is disposed of when it ceases to be used. If an entity commits to a plan to abandon a long-lived asset before the end of its previously estimated useful life, depreciation estimates shall be revised in accordance with SSAP No. 3 to reflect the use of the asset over its shortened useful life. A long-lived asset that has been temporarily idled shall not be accounted for as if abandoned.

Long-Lived Asset to Be Exchanged for a Similarly Productive Long-Lived Asset or to Be Distributed to Owners in a Spinoff

22. For purposes of this Statement, a long-lived asset to be exchanged for a similarly productive long-lived asset or to be distributed to owners in a spinoff is disposed of when it is exchanged or distributed. If the asset is tested for recoverability while it is classified as held and used, the estimates of future cash flows used in that test shall be based on the use of the asset for its remaining useful life, assuming that the disposal transaction will not occur. In addition to any impairment losses required to be recognized while the asset is classified as held and used, an impairment loss, if any, shall be recognized when the asset is disposed of if the carrying amount of the asset exceeds its fair value.

Long-Lived Assets to Be Disposed Of by Sale

Recognition

23. A long-lived asset to be sold shall be classified as held for sale in the period in which all of the following criteria are met:

a. Management, having the authority to approve the action, commits to a plan to sell the asset;

b. The asset is available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets;

c. An active program to locate a buyer and other actions required to complete the plan to sell the asset have been initiated;

d. The sale of the asset is probable, and transfer of the asset is expected to qualify for recognition as a completed sale, within one year, except as permitted by paragraph 24;

e. The asset is being actively marketed for sale at a price that is reasonable in relation to its current fair value;

f. Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

If at any time the criteria in this paragraph are no longer met (except as permitted by paragraph 24), a long-lived asset classified as held for sale shall be reclassified as held and used in accordance with paragraphs 31 and 32.

24. Events or circumstances beyond an entity's control may extend the period required to complete the sale of a long-lived asset beyond one year. An exception to the one-year requirement in paragraph 23.d. shall apply in the following situations in which such events or circumstances arise:

a. If at the date an entity commits to a plan to sell a long-lived asset the entity reasonably expects that others (not a buyer) will impose conditions on the transfer of the asset that will extend the period required to complete the sale and (1) actions necessary to respond to those conditions cannot be initiated until after a firm purchase commitment is obtained and (2) a firm purchase commitment is probable within one year.

b. If an entity obtains a firm purchase commitment and, as a result, a buyer or others unexpectedly impose conditions on the transfer of a long-lived asset previously classified as held for sale that will extend the period required to complete the sale and (1) actions necessary to respond to the conditions have been or will be initiated in a timely manner and (2) a favorable resolution of the delaying factors is expected.

c. If during the initial one-year period, circumstances arise that previously were considered unlikely and, as a result, a long-lived asset previously classified as held for sale is not sold by the end of that period and (1) during the initial one-year period the entity initiated actions necessary to respond to the change in circumstances, (2) the asset is being actively marketed at a price that is reasonable given the change in circumstances, and (3) the criteria in paragraph 23 are met.

25. A long-lived asset that is newly acquired and that will be sold rather than held and used shall be classified as held for sale at the acquisition date only if the one-year requirement in paragraph 23.d. is met (except as permitted by paragraph 24) and any other criteria in paragraph 23 that are not met at that date are probable of being met within a short period following the acquisition (usually within three months).

26. If the criteria in paragraph 23 are met after the balance sheet date but before issuance of the financial statements, a long-lived asset shall continue to be classified as held and used in those financial statements when issued. The information required by paragraph 39 shall be disclosed in the notes to the financial statements. If the asset is tested for recoverability (on a held-and-used basis) as of the balance sheet date, the estimates of future cash flows used in that test shall consider the likelihood of possible outcomes that existed at the balance sheet date, including the assessment of the likelihood of the future sale of the asset. That assessment made as of the balance sheet date shall not be revised for a decision to sell the asset after the balance sheet date. An impairment loss, if any, to be recognized shall be measured as the amount by which the carrying amount of the asset exceeds its fair value at the balance sheet date.

Measurement

27. A long-lived asset classified as held for sale shall be measured at the lower of its carrying amount or fair value less cost to sell. If the asset is newly acquired, the carrying amount of the asset shall be established based on its fair value less cost to sell at the acquisition date. A long-lived asset shall not be depreciated (amortized) while it is classified as held for sale. Interest and other expenses attributable to the liabilities of a disposal classified as held for sale shall continue to be accrued.

28. Costs to sell are the incremental direct costs to transact a sale, that is, the costs that result directly from and are essential to a sale transaction and that would not have been incurred by the entity had the decision to sell not been made. Those costs include broker commissions, legal and title transfer fees, and closing costs that must be incurred before legal title can be transferred. Those costs exclude expected future losses associated with the operations of a long-lived asset while it is classified as held for sale.

29. The carrying amounts of any assets that are not covered by this Statement that are included in a disposal classified as held for sale shall be adjusted in accordance with other applicable statements of statutory accounting principles prior to measurement.

30. A realized loss shall be recognized in the summary of operations for any initial or subsequent write-down to fair value less cost to sell. A gain shall not be recognized for any subsequent increase in fair value less cost to sell until the asset is sold. The loss shall adjust only the carrying amount of a long-lived asset, whether classified as held for sale individually or as part of a disposal group. A gain or loss not previously recognized that results from the sale of a long-lived asset shall be recognized at the date of sale.

Changes to a Plan of Sale

31. If circumstances arise that previously were considered unlikely and, as a result, an entity decides not to sell a long-lived asset previously classified as held for sale, the asset shall be reclassified as held and used. A long-lived asset that is reclassified shall be measured individually at the lower of its (a) carrying amount before the asset was classified as held for sale, adjusted for any depreciation (amortization) expense that would have been recognized had the asset been continuously classified as held and used, or (b) fair value at the date of the subsequent decision not to sell.

32. Any required adjustment to the carrying amount of a long-lived asset that is reclassified as held and used shall be included in income from operations in the period of the subsequent decision not to sell. That adjustment shall be reported in the same income statement caption used to report a loss, if any, recognized in accordance with paragraph 34.

Reporting Long-Lived Assets and Disposal Groups to Be Disposed Of

Reporting Discontinued Operations

33. For purposes of reporting income and losses related to discontinued operations; any reference to the phrase “component of an entity” is replaced with “segment” as defined in SSAP No. 24.

Reporting Disposal Gains or Losses in Operations

34. Any disposal gain or loss recognized for long-lived assets shall be included as a net realized gain or loss in the summary of operations.

Reporting a Long-Lived Asset or Disposal Group Classified as Held for Sale

35. A long-lived asset classified as held for sale shall be presented separately in the balance sheet. The assets and liabilities of a disposal classified as held for sale shall be presented separately in the asset and liability sections, respectively, of the balance sheet. Those assets and liabilities shall not be offset and presented as a single amount. The major classes of assets and liabilities classified as held for sale shall be separately disclosed either on the face of the balance sheet or in the notes to financial statements (paragraph 39).

Reporting Impairment

36. Any impairment loss recognized on long-lived assets shall be recorded in the summary of operations as a realized loss.

Disclosures

37. The following information shall be disclosed in the notes to the financial statements that include the period in which an impairment loss is recognized:

a. A description of the impaired assets and the facts and circumstances leading to the impairment;

b. The amount of the impairment loss and how fair value was determined; and

38. The caption in the summary of operations, which includes the impairment loss.

39. The following information shall be disclosed in the notes to the financial statements that cover the period in which a long-lived asset either has been sold or is classified as held for sale:

a. A description of the facts and circumstances leading to the expected disposal, the expected manner and timing of that disposal.

b. If applicable, the gain or loss recognized and if not separately presented on the face of the summary of operations, the caption in the summary of operations that includes that gain or loss.

40. If paragraphs 31 and 32 apply, a description of the facts and circumstances leading to the decision to change the plan to sell the asset; and its effect on the results of operations for the period and any prior periods presented shall be disclosed in the notes to financial statements that include the period of that decision.

Effective Date and Transition

41. Upon adoption of this issue paper, the NAIC will release a SSAP for comment. The SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the Accounting Practices and Procedures Manual should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will contain an effective date of years beginning on or after January 1, 2004.

DISCUSSION

42. FAS 144 supersedes FAS 121 and in part APB 30. FAS 144 retains the requirements of FAS 121 to (a) recognize an impairment loss only if the carrying amount of a long-lived asset is not recoverable from its undiscounted cash flows and (b) measure an impairment loss as the difference between the carrying amount and fair value of the asset. FAS 144 requires that a long-lived asset to be abandoned, exchanged for a similar productive asset, or distributed to owners in a spinoff be considered held and used until it is disposed of. FAS 144 also sets forth that the accounting model for long-lived assets to be disposed of by sale is used for all long-lived assets, whether previously held and used or newly acquired. FAS 144 also resolves implementation issues that came about in the application of existing guidance.

43. SSAP No. 40 states that real estate investments shall be reported in the balance sheet categories of properties occupied by the company, properties held for the production of income, and properties held for sale. However, the accounting guidance in FAS 144 distinguishes between long-lived assets to be held and used and long-lived assets to be disposed of. For statutory accounting purposes, long-lived assets to be held and used encompass properties occupied by the company and properties held for the production of income and will be referred to as such in this issue paper. Further, FAS 144 bifurcates the category of long-lived assets to be disposed of into long-lived assets to be disposed of other than by sale and long-lived assets to be disposed of by sale. In this issue paper, long-lived assets to be disposed of other than by sale shall be classified either as properties occupied by the company or as properties held for the production of income, as set forth in paragraph 27 of FAS 144 which is adopted in this issue paper. Long-lived assets to be disposed of by sale shall be classified as properties held for sale.

44. FAS 144 contains substantial guidance concerning the concept of grouping of assets for the purposes of measurement of an impairment loss. Grouping would seem to allow for the offsetting of gains on certain assets with losses on other assets in the same grouping, possibly resulting in no impairment loss being recognized. This is contrary to the concept of conservatism in the Statement of Concepts. As such, grouping of assets for the purpose of determining whether an impairment loss has occurred will not be allowed for statutory accounting purposes.

45. During the drafting process of this issue paper, an initial determination was made that SSAP Nos. 24, 40, 68 would be amended as a result of adopting FAS 144. Ultimately, only SSAP No. 40 was amended relative to adoption of FAS 144 as discussed below.

46. This issue paper adopts FAS 144 with modification to paragraphs 9, 17, 18, 19, 21, 25, 28, 35, 36, 37, 41, 42, 44, 45 and 47. Further, this issue paper rejects paragraphs 10-14, paragraphs 22-24, 26.d., and 43 of FAS 144. Refer to paragraph 47 of this issue paper for additional information with regard to these paragraphs.

47. The following modifications to FAS 144 were made in order to maintain consistency with current statutory accounting principles and the Statement of Concepts:

a. Paragraph 9 is amended to require that changes in depreciation estimates and methods and amortization periods found as a result of a test for recoverability should be accounted for in accordance with SSAP No. 3;

b. Paragraphs 10-14, which address the grouping of assets, are rejected, as reporting entities should apply the guidance in this statement to each of its assets on an individual basis;

c. Paragraphs 17, 18, 19 and 21 discuss estimates of future cash flows used to test the recoverability of a long-lived asset, and states that a probability-weighted approach may be useful in considering the likelihood of those possible outcomes. For statutory accounting purposes, reporting entities shall use their best estimate in testing the recoverability of a long-lived asset;

d. Paragraphs 22-24, which discuss fair value, are rejected. The definition of fair value is in the glossary to the Statement of Statutory Accounting Principles. In addition, this statement allows a modification to use for determining the fair value of properties occupied by company.

e. Paragraph 25 is amended to require that an impairment loss on properties occupied by the company and properties held for the production of income shall be recorded in the summary of operations as a realized loss;

f. Paragraph 28 is amended to require that changes in depreciation estimates shall be accounted for in accordance with SSAP No. 3;

g. If the sale is expected to occur beyond one year, paragraph 35 allows the cost to sell to be discounted. For statutory accounting purposes, the cost to sell shall not be discounted;

h. Paragraph 36 is amended to remove the reference to goodwill, as FAS 144 does not include goodwill within its scope unless such goodwill is included in an asset group that is or includes a reporting unit; paragraph 18 of this issue paper does not recognize a reporting unit. Paragraph 36 is further amended to require reporting entities to adjust all assets in accordance with other applicable statements of statutory accounting principles prior to measurement;

i. Paragraph 37 is amended to clarify that losses recognized as a result of adjustments to fair value less cost to sell shall be recorded in the summary of operations as a realized gain/loss. Paragraph 37 is also modified to disallow the recognition of any gain for subsequent increases in fair value less cost to sell until the asset is sold. This is consistent with the concept of conservatism found in the Statement of Concepts;

j. Within paragraphs 41, 42 and 44 of FAS 144 addressing discontinued operations, any reference to the phrase “component of an entity” is replaced with “segment” as defined in SSAP No. 24;

k. Paragraph 42 is amended to state that the results of operations of a discontinued operation shall be reported consistently with the entity’s reporting of continuing operations. This is consistent with the guidance found in paragraph 5 of SSAP No. 24;

l. Paragraph 44 is amended to state that adjustments to amounts previously reported related to continuing operations shall be reported consistently with the entity’s reporting of continuing operations. This is consistent with the guidance found in paragraph 5 of SSAP No. 24. In addition, subparagraphs a. through c. of paragraph 44 are adopted into paragraph 5 of SSAP No. 24;

m. Paragraph 45 is amended to state that a gain or loss on an asset classified as held for sale that has been disposed of shall be included in the summary of operations as a realized gain or loss;

n. The disclosures in paragraphs 47.a. and 47.b. are adopted with respect to properties held for sale, except for the disclosures related to major classes of assets, as grouping has been rejected in this issue paper. Subparagraphs 47.c. and 47.d. are rejected as such paragraphs relate to discontinued operations and segment reporting. The disclosures included in paragraphs 6 and 7 of SSAP No. 24 are more appropriate given the differences between statutory and GAAP reporting of discontinued operations;

o. Paragraph 26.d. requires the disclosure of the segment in which an impaired asset is reported. This paragraph is rejected, as statutory accounting requires accounting and reporting at the legal entity level. Further, any additional references to segments, reporting units, or disposal groups found in FAS 144 are also rejected, except with regard to a segment within the context of discontinued operations; and

p. Paragraph 43 is rejected and the guidance related to the recognition of losses/income expected between the measurement date and the expected disposal date included in paragraph 4 of SSAP No. 24 is retained, as such guidance is consistent with the concept of conservatism in the Statement of Concepts.

48. Paragraphs 12-14 of FAS 121 address the impairment of goodwill, and paragraphs 12, 14.a. and 14.b. of FAS 121 were adopted in SSAP No. 68. However, paragraph 12 of FAS 121 was superseded by FASB Statement No. 142, Goodwill and Other Intangible Assets (FAS 142), which was rejected in SSAP No. 68. Given the applicability of the guidance found in paragraph 12 of FAS 121 to statutory accounting principles, the impairment guidance found in FAS 121, paragraph 12 is retained. Paragraph 12 of FAS 121 has been excerpted in *Issue Paper No. 68—Business Combinations and Goodwill*, paragraph 31.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

49. SSAP No. 40 paragraphs 4, 8, 9, 10, 11, and 19:

> 4. Real estate investments shall be reported net of encumbrances in the following balance sheet categories, with parenthetical disclosure of the amount of related encumbrances:
>
> a. Properties occupied by the company;
>
> b. Properties held for the production of income; and
>
> c. Properties held for sale.
>
> 8. The cost of property included in real estate investments, other than land, shall be depreciated over the estimated useful life, not to exceed fifty years. Depreciation expense shall be included in investment expenses.
>
> 9. Properties occupied by the company and properties held for the production of income shall be carried at depreciated cost less encumbrances unless events or circumstances indicate the carrying amount of the asset (amount prior to reduction for encumbrances) may not be recoverable. Paragraph 5 of *FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (FAS 121), provides examples of events or changes in circumstances which indicate that the recoverability of the carrying amount of properties occupied by the company or properties held for the production of income should be assessed. If the events or changes in circumstances set forth in paragraph 5 of FAS 121 are present or if other events or changes in circumstances indicate that the carrying amount of properties occupied by the company or properties held for the production of income may not be recoverable, the entity shall determine whether an impairment loss must be recognized in accordance with paragraph 6 of FAS 121. Property occupied by the company shall be evaluated using the asset grouping approach of paragraph 8 of FAS 121. An impairment loss is measured as the amount by which the individual carrying amounts exceed the fair value of properties occupied by the company or properties held for the production of income. Fair value is determined in accordance with paragraph 11 of this statement. If the fair value of the asset is less than the carrying value, the asset shall be written down to the fair value thereby establishing a new cost basis. The new cost basis shall not be changed for subsequent recoveries in fair value. The adjustment shall be recorded in the statement of operations as a realized loss.

10. Properties that the reporting entity has the intent to sell or is required to sell shall be classified as properties held for sale and carried at the lower of depreciated cost or fair value less encumbrances and estimated costs to sell the property consistent with paragraph 16 of FAS 121. The intent to sell a property exists when management, having the authority to approve the action, has committed to a plan to dispose of the asset, either by sale or abandonment. Fair value of the asset shall be determined in accordance with paragraph 11 of this statement. Subsequent revisions to the fair value of the asset shall be accounted for in accordance with paragraph 17 of FAS 121.

11. The current fair value of real estate shall be determined on a property by property basis (i.e., increases in the fair value of one property shall not be used to offset declines in fair value of another) and shall be defined as the price that a property would bring in a competitive and open market under all conditions requisite to a fair sale (i.e., the buyer and seller acting prudently and knowledgeably with the price not affected by any undue stimulus). If market quotes are unavailable, estimates of fair value shall be determined by an appraisal (internal or third party), which is based upon an evaluation of all relevant data about the market, considering the following:

a. A physical inspection of the premises;

b. The present value of future cash flows generated by the property (Discounted Cash Flows), or capitalization of stabilized net operating income (Direct Capitalization);

c. Current sales prices of similar properties with adjustments for differences in the properties (Sales Comparison Approach);

d. Costs to sell the property if the reporting entity does not have the intent or ability to hold the real estate as an investment; and

e. Replacement costs of the improvements, less depreciation, plus the value of the land (Cost Approach).

19. An entity that recognizes an impairment loss shall disclose all of the following in financial statements that include the period of the impairment write-down:

a. A description of the impaired assets and the facts and circumstances leading to the impairment;

b. The amount of the impairment loss and how fair value was determined; and

c. The caption in the statement of operations in which the impairment loss is aggregated.

50. SSAP No. 24 paragraphs 4, 6 and 7:

4. The determination of whether a gain or loss results from the disposal shall be made at the measurement date based on estimates at that date of the net realizable value of the segment after giving consideration to any estimated costs and expenses directly associated with the disposal and, if a plan of disposal is to be carried out over a period of time and contemplates continuing operations during that period, to any estimated income or losses from operations. If it is expected that net losses from operations will be incurred between the measurement date and the expected disposal date, the computation of the gain or loss on disposal shall also include an estimate of such amounts. If it is expected that net income will be generated from operations during that period the computation shall include the estimated net income, limited however to the amount of any loss otherwise recognizable for the disposal, with any remainder accounted for when realized. Any changes in the original estimate shall be accounted for in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*.

6. Additionally, the financial statements for the period encompassing the measurement date and the year subsequent shall contain the following:

a. The identity of the segment of business that has been or will be discontinued;

b. The expected disposal date, if known (see definition in paragraph 2 above);

c. The expected manner of disposal;

d. A description of the remaining assets and liabilities of the segment at the balance sheet date; and

e. The amounts related to the discontinued operations and the effect on the financial statements, including the balance sheet and income statement line items which have been affected.

7. If material revisions are made to the estimates of the cost to dispose of a segment in years subsequent to the disclosure required in paragraph 6 above, the nature and the effect of the revisions to the estimates shall be disclosed for the period in which the revision was made including the effect on income or loss from operations and the effect on the carrying amount of the remaining assets and liabilities of the segment at the balance sheet date.

51. SSAP No. 3 paragraphs 3-6:

Change in Accounting Principle

3. A change in accounting principle results from the adoption of an accepted accounting principle, or method of applying the principle, which differs from the principles or methods previously used for reporting purposes. A change in the method of applying an accounting principle shall be considered a change in accounting principle.

4. A characteristic of a change in accounting principle is that it concerns a choice from among two or more statutory accounting principles. However, a change in accounting principle is neither (a) the initial adoption of an accounting principle in recognition of events or transactions occurring for the first time or previously immaterial in their effect, nor (b) the adoption or modification of an accounting principle necessitated by transactions or events that are clearly different in substance from those previously occurring.

5. The cumulative effect of changes in accounting principles shall be reported as adjustments to unassigned funds (surplus) in the period of the change in accounting principle. The cumulative effect is the difference between the amount of capital and surplus at the beginning of the year and the amount of capital and surplus that would have been reported at that date if the new accounting principle had been applied retroactively for all prior periods.

Change in Accounting Estimate

6. Changes in estimates used in accounting are necessary consequences of periodic presentations of financial statements which require estimating the effects of future events. Examples of items for which estimates are necessary include service lives of depreciable assets and changes in loss reserve estimates for property and casualty companies. Accounting estimates change as new events occur, as more experience is acquired, or as additional information is obtained.

Generally Accepted Accounting Principles

52. FAS 144 provides the following:

Long-Lived Assets to Be Held and Used

Recognition and Measurement of an Impairment Loss

7. For purposes of this Statement, impairment is the condition that exists when the carrying amount of a long-lived asset (asset group) exceeds its fair value. An impairment loss shall be recognized only if the carrying amount of a long-lived asset (asset group) is not recoverable and exceeds its fair value. The carrying amount of a long-lived asset (asset group) is not recoverable if it exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset (asset group). That assessment shall be based on the carrying amount of the asset (asset group) at the date it is tested for recoverability, whether in use (paragraph 19) or under development (paragraph 20). An impairment loss shall be measured as the amount by which the carrying amount of a long-lived asset (asset group) exceeds its fair value.

When to Test a Long-Lived Asset for Recoverability

8. A long-lived asset (asset group) shall be tested for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable. The following are examples of such events or changes in circumstances:

a. A significant decrease in the market price of a long-lived asset (asset group)

b. A significant adverse change in the extent or manner in which a long-lived asset (asset group) is being used or in its physical condition

c. A significant adverse change in legal factors or in the business climate that could affect the value of a long-lived asset (asset group), including an adverse action or assessment by a regulator

d. An accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of a long-lived asset (asset group)

e. A current-period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with the use of a long-lived asset (asset group)

f. A current expectation that, more likely than not, a long-lived asset (asset group) will be sold or otherwise disposed of significantly before the end of its previously estimated useful life.

9. When a long-lived asset (asset group) is tested for recoverability, it also may be necessary to review depreciation estimates and method as required by APB Opinion No. 20, Accounting Changes, or the amortization period as required by *FASB Statement No. 142, Goodwill and Other Intangible Assets*. Any revision to the remaining useful life of a long-lived asset resulting from that review also shall be considered in developing estimates of future cash flows used to test the asset (asset group) for recoverability (paragraph 18). However, any change in the accounting method for the asset resulting from that review shall be made only after applying this Statement.

Grouping Long-Lived Assets to Be Held and Used

10. For purposes of recognition and measurement of an impairment loss, a long-lived asset or assets shall be grouped with other assets and liabilities at the lowest level for which identifiable cash flows are largely independent of the cash flows of other assets and liabilities. However, an impairment loss, if any, that results from applying this Statement shall reduce only the carrying amount of a long-lived asset or assets of the group in accordance with paragraph 14.

11. In limited circumstances, a long-lived asset (for example, a corporate headquarters facility) may not have identifiable cash flows that are largely independent of the cash flows of other assets and liabilities and of other asset groups. In those circumstances, the asset group for that long-lived asset shall include all assets and liabilities of the entity.

12. Goodwill shall be included in an asset group to be tested for impairment under this Statement only if the asset group is or includes a reporting unit. Goodwill shall not be included in

a lower-level asset group that includes only part of a reporting unit. Estimates of future cash flows used to test that lower-level asset group for recoverability shall not be adjusted for the effect of excluding goodwill from the group.

13. Other than goodwill, the carrying amounts of any assets (such as accounts receivable and inventory) and liabilities (such as accounts payable, long-term debt, and asset retirement obligations) not covered by this Statement that are included in an asset group shall be adjusted in accordance with other applicable generally accepted accounting principles prior to testing the asset group for recoverability.

14. An impairment loss for an asset group shall reduce only the carrying amounts of a long-lived asset or assets of the group. The loss shall be allocated to the long-lived assets of the group on a pro rata basis using the relative carrying amounts of those assets, except that the loss allocated to an individual long-lived asset of the group shall not reduce the carrying amount of that asset below its fair value whenever that fair value is determinable without undue cost and effort. (Example 1 of Appendix A illustrates the allocation of an impairment loss for an asset group.)

New Cost Basis

15. If an impairment loss is recognized, the adjusted carrying amount of a long-lived asset shall be its new cost basis. For a depreciable long-lived asset, the new cost basis shall be depreciated (amortized) over the remaining useful life of that asset. Restoration of a previously recognized impairment loss is prohibited.

Estimates of Future Cash Flows Used to Test a Long-Lived Asset for Recoverability

16. Estimates of future cash flows used to test the recoverability of a long-lived asset (asset group) shall include only the future cash flows (cash inflows less associated cash outflows) that are directly associated with and that are expected to arise as a direct result of the use and eventual disposition of the asset (asset group). Those estimates shall exclude interest charges that will be recognized as an expense when incurred.

17. Estimates of future cash flows used to test the recoverability of a long-lived asset (asset group) shall incorporate the entity’s own assumptions about its use of the asset (asset group) and shall consider all available evidence. The assumptions used in developing those estimates shall be reasonable in relation to the assumptions used in developing other information used by the entity for comparable periods, such as internal budgets and projections, accruals related to incentive compensation plans, or information communicated to others. However, if alternative courses of action to recover the carrying amount of a long-lived asset (asset group) are under consideration or if a range is estimated for the amount of possible future cash flows associated with the likely course of action, the likelihood of those possible outcomes shall be considered. A probability-weighted approach may be useful in considering the likelihood of those possible outcomes. (Example 2 of Appendix A illustrates the use of that approach when alternative courses of action are under consideration.)

18. Estimates of future cash flows used to test the recoverability of a long-lived asset (asset group) shall be made for the remaining useful life of the asset (asset group) to the entity. The remaining useful life of an asset group shall be based on the remaining useful life of the primary asset of the group. For purposes of this Statement, the primary asset is the principal long-lived tangible asset being depreciated or intangible asset being amortized that is the most significant component asset from which the asset group derives its cash-flow-generating capacity. Factors that an entity generally should consider in determining whether a long-lived asset is the primary asset of an asset group include the following: (a) whether other assets of the group would have been acquired by the entity without the asset, (b) the level of investment that would be required to replace the asset, and (c) the remaining useful life of the asset relative to other assets of the group. If the primary asset is not the asset of the group with the longest remaining useful life, estimates of future cash flows for the group should assume the sale of the group at the end of the remaining useful life of the primary asset.

19. Estimates of future cash flows used to test the recoverability of a long-lived asset (asset group) that is in use, including a long-lived asset (asset group) for which development is substantially complete, shall be based on the existing service potential of the asset (asset group) at the date it is tested. The service potential of a long-lived asset (asset group) encompasses its remaining useful life, cash-flow-generating capacity, and for tangible assets, physical output capacity. Those estimates shall include cash flows associated with future expenditures necessary to maintain the existing service potential of a long-lived asset (asset group), including those that replace the service potential of component parts of a long-lived asset (for example, the roof of a building) and component assets other than the primary asset of an asset group. Those estimates shall exclude cash flows associated with future capital expenditures that would increase the service potential of a long-lived asset (asset group).

20. Estimates of future cash flows used to test the recoverability of a long-lived asset (asset group) that is under development shall be based on the expected service potential of the asset (group) when development is substantially complete. Those estimates shall include cash flows associated with all future expenditures necessary to develop a long-lived asset (asset group), including interest payments that will be capitalized as part of the cost of the asset (asset group).

21. If a long-lived asset that is under development is part of an asset group that is in use, estimates of future cash flows used to test the recoverability of that group shall include the cash flows associated with future expenditures necessary to maintain the existing service potential of the group (paragraph 19) as well as the cash flows associated with all future expenditures necessary to substantially complete the asset that is under development (paragraph 20). (Example 3 of Appendix A illustrates that situation.)

Fair Value

22. The fair value of an asset (liability) is the amount at which that asset (liability) could be bought (incurred) or sold (settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available. However, in many instances, quoted market prices in active markets will not be available for the long-lived assets (asset groups) covered by this Statement. In those instances, the estimate of fair value shall be based on the best information available, including prices for similar assets (groups) and the results of using other valuation techniques.

23. A present value technique is often the best available valuation technique with which to estimate the fair value of a long-lived asset (asset group). Paragraphs 39-54 of *FASB Concepts Statement No. 7, Using Cash Flow Information and Present Value in Accounting Measurements*, discuss the use of two present value techniques to measure the fair value of an asset (liability). The first is expected present value, in which multiple cash flow scenarios that reflect the range of possible outcomes and a risk-free rate are used to estimate fair value. The second is traditional present value, in which a single set of estimated cash flows and a single interest rate (a rate commensurate with the risk) are used to estimate fair value. Either present value technique can be used for a fair value measurement. However, for long-lived assets (asset groups) that have uncertainties both in timing and amount, an expected present value technique will often be the appropriate technique. (Example 4 of Appendix A illustrates the use of that technique.)

24. If a present value technique is used, estimates of future cash flows shall be consistent with the objective of measuring fair value. Assumptions that marketplace participants would use in their estimates of fair value shall be incorporated whenever that information is available without undue cost and effort. Otherwise, the entity may use its own assumptions.

Reporting and Disclosure

25. An impairment loss recognized for a long-lived asset (asset group) to be held and used shall be included in income from continuing operations before income taxes in the income statement of a business enterprise and in income from continuing operations in the statement of

activities of a not-for-profit organization. If a subtotal such as "income from operations" is presented, it shall include the amount of that loss.

26. The following information shall be disclosed in the notes to the financial statements that include the period in which an impairment loss is recognized:

a. A description of the impaired long-lived asset (asset group) and the facts and circumstances leading to the impairment

b. If not separately presented on the face of the statement, the amount of the impairment loss and the caption in the income statement or the statement of activities that includes that loss

c. The method or methods for determining fair value (whether based on a quoted market price, prices for similar assets, or another valuation technique)

d. If applicable, the segment in which the impaired long-lived asset (asset group) is reported under FASB Statement No. 131, Disclosures about Segments of an Enterprise and Related Information.

Long-Lived Assets to Be Disposed Of Other than by Sale

27. A long-lived asset to be disposed of other than by sale (for example, by abandonment, in an exchange for a similar productive long-lived asset, or in a distribution to owners in a spinoff) shall continue to be classified as held and used until it is disposed of. Paragraphs 7-26 shall apply while the asset is classified as held and used. If a long-lived asset is to be abandoned or distributed to owners in a spinoff together with other assets (and liabilities) as a group and that disposal group is a component of an entity, paragraphs 41-44 shall apply to the disposal group at the date it is disposed of.

Long-Lived Asset to Be Abandoned

28. For purposes of this Statement, a long-lived asset to be abandoned is disposed of when it ceases to be used. If an entity commits to a plan to abandon a long-lived asset before the end of its previously estimated useful life, depreciation estimates shall be revised in accordance with Opinion 20 to reflect the use of the asset over its shortened useful life (refer to paragraph 9). A long-lived asset that has been temporarily idled shall not be accounted for as if abandoned.

Long-Lived Asset to Be Exchanged for a Similar Productive Long-Lived Asset or to Be Distributed to Owners in a Spinoff

29. For purposes of this Statement, a long-lived asset to be exchanged for a similar productive long-lived asset or to be distributed to owners in a spinoff is disposed of when it is exchanged or distributed. If the asset (asset group) is tested for recoverability while it is classified as held and used, the estimates of future cash flows used in that test shall be based on the use of the asset for its remaining useful life, assuming that the disposal transaction will not occur. In addition to any impairment losses required to be recognized while the asset is classified as held and used, an impairment loss, if any, shall be recognized when the asset is disposed of if the carrying amount of the asset (disposal group) exceeds its fair value.

Long-Lived Assets to Be Disposed Of by Sale

Recognition

30. A long-lived asset (disposal group) to be sold shall be classified as held for sale in the period in which all of the following criteria are met:

a. Management, having the authority to approve the action, commits to a plan to sell the asset (disposal group).

b. The asset (disposal group) is available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets (disposal groups). (Examples 5–7 of Appendix A illustrate when that criterion would be met.)

c. An active program to locate a buyer and other actions required to complete the plan to sell the asset (disposal group) have been initiated.

d. The sale of the asset (disposal group) is probable, and transfer of the asset (disposal group) is expected to qualify for recognition as a completed sale, within one year, except as permitted by paragraph 31. (Example 8 of Appendix A illustrates when that criterion would be met.)

e. The asset (disposal group) is being actively marketed for sale at a price that is reasonable in relation to its current fair value.

f. Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

If at any time the criteria in this paragraph are no longer met (except as permitted by paragraph 31), a long-lived asset (disposal group) classified as held for sale shall be reclassified as held and used in accordance with paragraph 38.

31. Events or circumstances beyond an entity's control may extend the period required to complete the sale of a long-lived asset (disposal group) beyond one year. An exception to the one-year requirement in paragraph 30.d. shall apply in the following situations in which such events or circumstances arise:

a. If at the date an entity commits to a plan to sell a long-lived asset (disposal group) the entity reasonably expects that others (not a buyer) will impose conditions on the transfer of the asset (group) that will extend the period required to complete the sale and (1) actions necessary to respond to those conditions cannot be initiated until after a firm purchase commitment is obtained and (2) a firm purchase commitment is probable within one year. (Example 9 of Appendix A illustrates that situation.)

b. If an entity obtains a firm purchase commitment and, as a result, a buyer or others unexpectedly impose conditions on the transfer of a long-lived asset (disposal group) previously classified as held for sale that will extend the period required to complete the sale and (1) actions necessary to respond to the conditions have been or will be timely initiated and (2) a favorable resolution of the delaying factors is expected. (Example 10 of Appendix A illustrates that situation.)

c. If during the initial one-year period, circumstances arise that previously were considered unlikely and, as a result, a long-lived asset (disposal group) previously classified as held for sale is not sold by the end of that period and (1) during the initial one-year period the entity initiated actions necessary to respond to the change in circumstances, (2) the asset (group) is being actively marketed at a price that is reasonable given the change in circumstances, and (3) the criteria in paragraph 30 are met. (Example 11 of Appendix A illustrates that situation.)

32. A long-lived asset (disposal group) that is newly acquired and that will be sold rather than held and used shall be classified as held for sale at the acquisition date only if the one-year requirement in paragraph 30.d. is met (except as permitted by paragraph 31) and any other criteria in paragraph 30 that are not met at that date are probable of being met within a short period following the acquisition (usually within three months).

33. If the criteria in paragraph 30 are met after the balance sheet date but before issuance of the financial statements, a long-lived asset shall continue to be classified as held and used in those financial statements when issued. The information required by paragraph 47.a. shall be disclosed in the notes to the financial statements. If the asset (asset group) is tested for recoverability (on a held-and-used basis) as of the balance sheet date, the estimates of future

cash flows used in that test shall consider the likelihood of possible outcomes that existed at the balance sheet date, including the assessment of the likelihood of the future sale of the asset. That assessment made as of the balance sheet date shall not be revised for a decision to sell the asset after the balance sheet date. An impairment loss, if any, to be recognized shall be measured as the amount by which the carrying amount of the asset (asset group) exceeds its fair value at the balance sheet date.

Measurement

34. A long-lived asset (disposal group) classified as held for sale shall be measured at the lower of its carrying amount or fair value less cost to sell. If the asset (disposal group) is newly acquired, the carrying amount of the asset (disposal group) shall be established based on its fair value less cost to sell at the acquisition date. A long-lived asset shall not be depreciated (amortized) while it is classified as held for sale. Interest and other expenses attributable to the liabilities of a disposal group classified as held for sale shall continue to be accrued.

35. Costs to sell are the incremental direct costs to transact a sale, that is, the costs that result directly from and are essential to a sale transaction and that would not have been incurred by the entity had the decision to sell not been made. Those costs include broker commissions, legal and title transfer fees, and closing costs that must be incurred before legal title can be transferred. Those costs exclude expected future losses associated with the operations of a long-lived asset (disposal group) while it is classified as held for sale. If the sale is expected to occur beyond one year as permitted in limited situations by paragraph 31, the cost to sell shall be discounted.

36. The carrying amounts of any assets that are not covered by this Statement, including goodwill, that are included in a disposal group classified as held for sale shall be adjusted in accordance with other applicable generally accepted accounting principles prior to measuring the fair value less cost to sell of the disposal group.

37. A loss shall be recognized for any initial or subsequent write-down to fair value less cost to sell. A gain shall be recognized for any subsequent increase in fair value less cost to sell, but not in excess of the cumulative loss previously recognized (for a write-down to fair value less cost to sell). The loss or gain shall adjust only the carrying amount of a long-lived asset, whether classified as held for sale individually or as part of a disposal group. A gain or loss not previously recognized that results from the sale of a long-lived asset (disposal group) shall be recognized at the date of sale.

Changes to a Plan of Sale

38. If circumstances arise that previously were considered unlikely and, as a result, an entity decides not to sell a long-lived asset (disposal group) previously classified as held for sale, the asset (disposal group) shall be reclassified as held and used. A long-lived asset that is reclassified shall be measured individually at the lower of its (a) carrying amount before the asset (disposal group) was classified as held for sale, adjusted for any depreciation (amortization) expense that would have been recognized had the asset (disposal group) been continuously classified as held and used, or (b) fair value at the date of the subsequent decision not to sell.

39. Any required adjustment to the carrying amount of a long-lived asset that is reclassified as held and used shall be included in income from continuing operations in the period of the subsequent decision not to sell. That adjustment shall be reported in the same income statement caption used to report a loss, if any, recognized in accordance with paragraph 45. If a component of an entity is reclassified as held and used, the results of operations of the component previously reported in discontinued operations in accordance with paragraph 43 shall be reclassified and included in income from continuing operations for all periods presented.

40. If an entity removes an individual asset or liability from a disposal group previously classified as held for sale, the remaining assets and liabilities of the disposal group to be sold shall continue to be measured as a group only if the criteria in paragraph 30 are met. Otherwise, the remaining long-lived assets of the group shall be measured individually at the lower of their

carrying amounts or fair values less cost to sell at that date. Any long-lived assets that will not be sold shall be reclassified as held and used in accordance with paragraph 38.

Reporting Long-Lived Assets and Disposal Groups to Be Disposed Of

Reporting Discontinued Operations

41. For purposes of this Statement, a component of an entity comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. A component of an entity may be a reportable segment or an operating segment (as those terms are defined in paragraph 10 of Statement 131), a reporting unit (as that term is defined in Statement 142), a subsidiary, or an asset group (as that term is defined in paragraph 4).

42. The results of operations of a component of an entity that either has been disposed of or is classified as held for sale shall be reported in discontinued operations in accordance with paragraph 43 if both of the following conditions are met: (a) the operations and cash flows of the component have been (or will be) eliminated from the ongoing operations of the entity as a result of the disposal transaction and (b) the entity will not have any significant continuing involvement in the operations of the component after the disposal transaction. (Examples 12-15 of Appendix A illustrate disposal activities that do or do not qualify for reporting as discontinued operations.)

43. In a period in which a component of an entity either has been disposed of or is classified as held for sale, the income statement of a business enterprise (or statement of activities of a not-for-profit organization) for current and prior periods shall report the results of operations of the component, including any gain or loss recognized in accordance with paragraph 37, in discontinued operations. The results of operations of a component classified as held for sale shall be reported in discontinued operations in the period(s) in which they occur. The results of discontinued operations, less applicable income taxes (benefit), shall be reported as a separate component of income before extraordinary items and the cumulative effect of accounting changes (if applicable). For example, the results of discontinued operations may be reported in the income statement of a business enterprise as follows:

Income from continuing operations before income taxes	$XXXX
Income taxes	XXX
Income from continuing operations 24	$XXXX
Discontinued operations (Note X)	
Loss from operations of discontinued Component X (including loss on disposal of $XXX)	XXXX
Income tax benefit	XXXX
Loss on discontinued operations	XXXX
Net income	$XXXX

A gain or loss recognized on the disposal shall be disclosed either on the face of the income statement or in the notes to the financial statements (paragraph 47.b.).

44. Adjustments to amounts previously reported in discontinued operations that are directly related to the disposal of a component of an entity in a prior period shall be classified separately in the current period in discontinued operations. The nature and amount of such adjustments shall be disclosed. Examples of circumstances in which those types of adjustments may arise include the following:

a. The resolution of contingencies that arise pursuant to the terms of the disposal transaction, such as the resolution of purchase price adjustments and indemnification issues with the purchaser

b. The resolution of contingencies that arise from and that are directly related to the operations of the component prior to its disposal, such as environmental and product warranty obligations retained by the seller

c. The settlement of employee benefit plan obligations (pension, postemployment benefits other than pensions, and other postemployment benefits), provided that the settlement is directly related to the disposal transaction.

Reporting Disposal Gains or Losses in Continuing Operations

45. A gain or loss recognized for a long-lived asset (disposal group) classified as held for sale that is not a component of an entity shall be included in income from continuing operations before income taxes in the income statement of a business enterprise and in income from continuing operations in the statement of activities of a not-for-profit organization. If a subtotal such as "income from operations" is presented, it shall include the amounts of those gains or losses.

Reporting a Long-Lived Asset or Disposal Group Classified as Held for Sale

46. A long-lived asset classified as held for sale shall be presented separately in the statement of financial position. The assets and liabilities of a disposal group classified as held for sale shall be presented separately in the asset and liability sections, respectively, of the statement of financial position. Those assets and liabilities shall not be offset and presented as a single amount. The major classes of assets and liabilities classified as held for sale shall be separately disclosed either on the face of the statement of financial position or in the notes to financial statements (paragraph 47.a.).

Disclosure

47. The following information shall be disclosed in the notes to the financial statements that cover the period in which a long-lived asset (disposal group) either has been sold or is classified as held for sale:

a. A description of the facts and circumstances leading to the expected disposal, the expected manner and timing of that disposal, and, if not separately presented on the face of the statement, the carrying amount(s) of the major classes of assets and liabilities included as part of a disposal group

b. The gain or loss recognized in accordance with paragraph 37 and if not separately presented on the face of the income statement, the caption in the income statement or the statement of activities that includes that gain or loss

c. If applicable, amounts of revenue and pretax profit or loss reported in discontinued operations

d. If applicable, the segment in which the long-lived asset (disposal group) is reported under Statement 131.

48. If either paragraph 38 or paragraph 40 applies, a description of the facts and circumstances leading to the decision to change the plan to sell the long-lived asset (disposal group) and its effect on the results of operations for the period and any prior periods presented shall be disclosed in the notes to financial statements that include the period of that decision.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *SSAP No. 3—Accounting Changes and Corrections of Errors*
- *SSAP No. 24—Discontinued Operations and Extraordinary Items*

- *SSAP No. 40—Real Estate Investments*

Generally Accepted Accounting Principles

- *FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and Long-Lived Assets to Be Disposed Of*
- *FASB Statement No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets*

EXHIBIT A: Illustration of Marked Changes to Amended SSAPs

The following depicts the amendments made by this issue paper as "marked changes" (new text underlined and deleted text struck-through). These amendments may ultimately be revised in the final statement of statutory accounting principle.

SSAP No. 40 paragraph 9:

Properties occupied by the company and properties held for the production of income shall be carried at depreciated cost less encumbrances unless events or circumstances indicate the carrying amount of the asset (amount prior to reduction for encumbrances) may not be recoverable. Paragraph 8~~5~~ of *FASB Statement No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets* (FAS 144)~~FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets to be Disposed Of (FAS 121)~~, provides examples of events or changes in circumstances which indicate that the recoverability of the carrying amount of properties occupied by the company or properties held for the production of income should be assessed. If the events or changes in circumstances set forth in paragraph 8~~5~~ of FAS 144~~121~~ are present or if other events or changes in circumstances indicate that the carrying amount of properties occupied by the company or properties held for the production of income may not be recoverable, the entity shall determine whether an impairment loss must be recognized in accordance with paragraph 7~~6~~ of FAS 144~~121~~. In evaluating the recoverability of properties ~~occupied by the company or properties~~ held for the production of income, the reporting entity should utilize the methods of estimating future cash flows in accordance with paragraphs 16-21 of FAS 144. Property occupied by the company shall be evaluated using the asset grouping approach of ~~paragraph 8 of FAS 121~~ paragraphs 10 and 11 of FAS 144. An impairment loss is measured as the amount by which the individual carrying amounts exceed the fair value of properties occupied by the company or properties held for the production of income. Fair value is determined in accordance with paragraph 11 of SSAP No. 40~~this statement~~. If the fair value of the asset is less than the carrying value, the asset shall be written down to the fair value thereby establishing a new cost basis. The new cost basis shall not be changed for subsequent recoveries in fair value. The adjustment shall be recorded in the statement of operations as a realized loss.

SSAP No. 40 paragraph 10:

Properties that the reporting entity has the intent to sell or is required to sell shall be classified as properties held for sale and carried at the lower of depreciated cost or fair value less encumbrances and estimated costs to sell the property consistent with paragraph 34~~16~~ of FAS 144~~121~~. The intent to sell a property exists when the criteria set forth in paragraph 30 of FAS 144 are met.~~management, having the authority to approve the action, has committed to a plan to dispose of the asset, either by sale or abandonment.~~ Fair value of the asset shall be determined in accordance with paragraph 11 of SSAP No. 40~~this statement~~. Subsequent revisions to the fair value of the asset shall be accounted for in accordance with paragraph 37~~17~~ of FAS 144, as modified by this issue paper ~~121~~.

SSAP No. 40 paragraph 19:

~~An entity that recognizes an impairment loss shall disclose all of the following in financial statements that include the period of the impairment write-down:~~

~~a. A description of the impaired assets and the facts and circumstances leading to the impairment;~~

~~b. The amount of the impairment loss and how fair value was determined; and~~

~~c. The caption in the statement of operations in which the impairment loss is aggregated.~~

An entity that recognizes an impairment loss shall disclose all of the following in financial statements that include the period of the impairment write-down:

a. A description of the impaired assets and the facts and circumstances leading to the impairment;

b. The amount of the impairment loss and how fair value was determined; and

c. The caption in the statement of operations in which the impairment loss is aggregated.

In the period in which a property classified as held for sale has either been sold or is classified as held for sale, the reporting entity shall disclose the following:

a. A description of the facts and circumstances leading to the expected disposal, the expected manner and timing of that disposal; and

b. If applicable, the gain or loss recognized and if not separately presented on the face of the statement of operations, the caption in the statement of operations that includes that gain or loss.

If the reporting entity makes changes to a plan of sale in accordance with paragraphs 38 and 40 of FAS 144, in the period of that decision the reporting entity shall disclose a description of the facts and circumstances leading to the decision to change the plan to sell the asset and its effect on the results of operations for the period and any prior periods presented.

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Statutory Issue Paper No. 122

Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities

STATUS
Adopted December 8, 2003

Current Authoritative Guidance for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities: SSAP No. 103
This issue paper may not be directly related to the current authoritative statement.

Original SSAP from Issue Paper: SSAP No. 91

Type of Issue:
Common

SUMMARY OF ISSUE

1. Current statutory accounting guidance for transfers and servicing of financial assets and extinguishments of liabilities is provided in *SSAP No. 18—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (SSAP No. 18). Current statutory accounting guidance for asset securitizations and securitizations of policy acquisition costs is provided in *SSAP No. 33—Securitization* (SSAP No. 33). Current statutory accounting guidance for repurchase agreements, reverse repurchase agreements, dollar repurchase and dollar reverse repurchase agreements is provided in *SSAP No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements* (SSAP No. 45). SSAP No. 18, SSAP No. 33 and SSAP No. 45 adopted *FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 125) with modification for statutory accounting purposes. The modifications to FAS 125 primarily relate to:

a. The nonadmission of servicing rights assets;

b. The accounting for repurchase agreements, reverse repurchase agreements, and dollar repurchase agreements;

c. The accounting for realized gains and losses for reporting entities required to maintain an IMR;

d. The accounting for financial assets subject to prepayment;

e. The accounting for assets pledged as collateral;

f. The accounting for leases in accordance with *SSAP No. 22—Leases* (SSAP No. 22)*;*

g. The accounting for sales of receivables with recourse; and

h. Paragraph 14 of FAS 125 is rejected as it relates to classifications of securities under *FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities* (FAS 115). FAS 115 is rejected in *SSAP No. 26—Bonds, excluding Loan-backed and Structured Securities* (SSAP No. 26).

2. In September 2000, the Financial Accounting Standards Board (FASB) issued *FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*

(FAS 140). FAS 140 replaces FAS 125. FAS 140 reconsiders or clarifies the guidance in FAS 125 concerning the following:

a. Circumstances in which a special-purpose entity (SPE) can be considered qualifying;

b. Circumstances in which the assets held by a qualifying SPE should appear in the consolidated financial statements of the transferor;

c. Whether sale accounting is precluded if the transferor holds a right to repurchase transferred assets that is attached to, is embedded in, or is otherwise transferable with the financial assets;

d. Circumstances in which sale accounting is precluded if transferred financial assets can be removed from a SPE by the transferor (for example under a removal-of-accounts provision (ROAP);

e. Whether arrangements that obligate, but do not entitle, a transferor to repurchase or redeem transferred financial assets should affect the accounting for those transfers;

f. The impact of the powers of the Federal Deposit Insurance Corporation (FDIC) on isolation of assets transferred by financial institutions;

g. Whether transfers of financial assets measured using the equity method of accounting should continue to be included in the scope of FAS 125;

h. Whether disclosures should be enhanced to provide more information about assumptions used to determine the fair value of retained interests and the gain or loss on financial assets sold in securitizations; and

i. The accounting for and disclosure about collateral that can be sold or repledged.

3. The purpose of this issue paper is to establish statutory accounting principles for transfers and servicing of financial assets, including asset securitizations and securitizations of policy acquisition costs, extinguishments of liabilities, repurchase agreements and reverse repurchase agreements, including dollar repurchase and dollar reverse repurchase agreements that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts). This issue paper discusses generalized situations. Facts and circumstances and specific contracts need to be considered carefully in applying this issue paper. Securitizations of nonfinancial assets are outside the scope of this issue paper.

RECOMMENDED CONCLUSION

4. See *SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties* (SSAP No. 25) for additional accounting and disclosure guidance concerning related party transactions. In addition the guidance for the following topics have been addressed in Interpretations of the Emerging Accounting Issues Working Group:

a. *INT 99-22: EITF 98-8 Accounting for Transfers of Investments That Are in Substance Real Estate* resolved this conflict between application of *SSAP No. 40—Real Estate Investments* and SSAP No. 18.

b. *INT 99-21: EITF 98-7 Accounting for Exchanges of Similar Equity Method Investments* resolved this conflict between application of *SSAP No. 28—Nonmonetary Transactions* and SSAP No. 18.

5. SSAP No. 18, SSAP No. 33 and SSAP No. 45 are superseded by the conclusions outlined in this issue paper.

6. This issue paper does not address the securitization of mortality or morbidity risk. The NAIC's Insurance Securitization Working Group of the Financial Condition (E) Committee is charged with the development of model laws, model regulations and proposed accounting guidance for the securitization of mortality and morbidity risk. When such proposed accounting guidance is finalized the development of an issue paper will be considered.

7. Except as discussed in paragraphs 57 and 89, a transfer of a group of financial assets, or a portion of a financial asset in which the transferor surrenders control over those financial assets shall be accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if, and only if, all of the following conditions are met:

a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership (see paragraphs 18 and 19);

b. Either (i) each transferee obtains the right, free of conditions that constrain it from taking advantage of that right (see paragraphs 20-24), to pledge or exchange the transferred assets or (ii) the transferee is a qualifying special-purpose entity as defined in paragraph 26 and the holders of beneficial interests in that entity have the right, free of conditions that constrain them from taking advantage of that right (see paragraph 25), to pledge or exchange those interests and no condition both constrains the transferee (or holder) from taking advantage of its right to pledge or exchange and provide more than a trivial benefit to the transferor; and

c. The transferor does not maintain effective control over the transferred assets through (i) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (see paragraphs 39-41) or (ii) the ability to unilaterally cause the holder to return specific assets, other than through a cleanup call (see paragraphs 23-24 and 42-46).

8. Upon completion of any transfer of financial assets, the transferor shall:

a. Continue to carry in its balance sheet any retained interest in the transferred assets, including, if applicable, beneficial interests in assets transferred to a qualifying special-purpose entity in a securitization, and retained undivided interests (see paragraphs 9.c., 49 and 50); and

b. Allocate the previous carrying amount between the assets sold, if any, and the retained interests, if any, based on their relative fair values at the date of transfer (see paragraphs 49 and 50).

9. Upon completion of a transfer of assets that satisfies the conditions to be accounted for as a sale (see paragraph 7), the transferor (seller) shall:

a. Eliminate the transferred assets from the balance sheet;

b. Allocate the previous carrying amount of the transferred assets to the securities representing beneficial interests retained by the reporting entity, if any, and the securities representing beneficial interests not retained, if any, based on the relative fair values of the transferred assets at the date of transfer;

c. Record in its balance sheet, the allocated carrying value of the securities representing retained beneficial interests in the assets (e.g., loan-backed securities). Subsequent to the transfer of assets:

i. Retained residuals are to be carried at fair value with the difference between fair value and the allocated cost basis recognized as an unrealized gain or loss;

ii. Retained beneficial interests shall be accounted for in accordance with the statutory accounting principles for the specific asset type (e.g., bonds shall be accounted for in accordance with SSAP No. 26, loan-backed securities shall be accounted for in accordance with *SSAP No. 43—Loan-Backed and Structured Securities*, preferred stock in accordance with *SSAP No. 32—Investments in Preferred Stock (including investments in preferred stock of subsidiary, controlled or affiliated entities)*.

d. Recognize all additional assets obtained (i.e., other than the securities representing retained beneficial interests which are recorded in accordance with 9 c.) and liabilities incurred in consideration as proceeds of the sale;

e. Initially measure such additional assets obtained and liabilities incurred in the sale at fair value (see Glossary), or if it is not practicable to estimate the fair value of an asset or a liability, apply alternative measures (paragraph 51); and

f. For reporting entities required to maintain an Interest Maintenance Reserve (IMR), the accounting for realized and unrealized capital gains and losses shall be in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve* (SSAP No. 7). For reporting entities not required to maintain an IMR, realized capital gains and losses shall be reported as net realized capital gains or losses in the statement of income, and unrealized capital gains and losses shall be reported as net unrealized gains and losses in unassigned funds (surplus).

10. The transferee shall recognize all assets obtained and any liabilities incurred, and initially measure them at fair value (in aggregate, presumptively the price paid).

11. Repurchase agreements, reverse repurchase agreements, and dollar repurchase agreements are described in paragraphs 68-78. When an asset is sold and the proceeds are reinvested within 30 days in the same or substantially the same security, such transfers shall be considered to be wash sales and shall be accounted for as sales and disclosed as required by paragraph 92. Unless there is a concurrent contract to repurchase or redeem the transferred financial assets from the transferee, the transferor does not maintain effective control over the transferred assets.

12. If a transfer of financial assets in exchange for cash or other consideration (other than beneficial interests in the transferred assets) (a) does not meet the criteria for a sale in paragraph 7, or (b) is a sale of receivables with recourse (see paragraph 89); the transferor and transferee shall account for the transfer as a secured borrowing with pledge of collateral (see paragraph 14).

Recognition and Measurement of Servicing Assets and Liabilities

13. Servicing rights become a distinct asset or liability only when contractually separated from the underlying assets by sale or securitization of the assets with servicing retained, or separate purchase or assumption of the servicing. If distinct servicing rights to transferred assets exist and are retained by the reporting entity, the reporting entity shall recognize a servicing asset or liability. When the servicing fees to be received exceed the cost of servicing the transferred assets, a servicing asset is recognized and nonadmitted. When the cost of servicing the transferred assets is greater than the servicing fees to be

received, a liability shall be recorded for the excess to recognize this obligation. A corresponding loss shall be recorded through the Summary of Operations in other income. If the servicing asset or liability was purchased or assumed rather than undertaken in a sale or securitization of the financial assets being serviced, it shall be measured initially at its fair value, presumptively the price paid. The servicing asset or liability shall be amortized into income in proportion to, and over the period of estimated servicing income (if an asset) or estimated servicing loss (if a liability). A servicing asset or liability shall be assessed for impairment or increased obligation based on its fair value.

Secured Borrowings and Collateral

14. A debtor may grant a security interest in certain assets to a lender (the secured party) to serve as collateral for its obligation under a borrowing, with or without recourse to other assets of the debtor. An obligor under other kinds of current or potential obligations, for example, interest rate swaps, also may grant a security interest in certain assets to a secured party. If collateral is transferred to the secured party, the custodial arrangement is commonly referred to as a pledge. Secured parties sometimes are permitted to sell or repledge (or otherwise transfer) collateral held under a pledge. The same relationships occur, under different names, in transfers documented as sales that are accounted for as secured borrowings (see paragraph 12). The accounting for collateral by the debtor (or obligor) and the secured party depends on whether the secured party has taken control over the collateral, and on the rights and obligations that result from the collateral arrangement:

a. If the secured party is permitted to sell or repledge the collateral, and the debtor does not have the right and ability to redeem the collateral on short notice, (e.g., by substituting other collateral or terminating the contract), then:

   The debtor shall reclassify that asset and report that asset in its balance sheet separately (for example, as security pledged to creditors) from other assets not so encumbered;

   The secured party shall recognize that collateral as its asset, initially measure it at fair value, and also recognize its obligation to return it.

b. If the secured party sells or repledges collateral on terms that do not give it the right and ability to repurchase or redeem the collateral from the transferee on short notice, the secured party shall recognize the proceeds from the sale or the asset repledged and its obligation to return the asset to the extent that it has not already recognized them. The sale or repledging of the asset is a transfer subject to the provisions of this statement;

c. If the debtor defaults under the terms of the secured contract and is no longer entitled to redeem the collateral, it shall derecognize the collateral. The secured party shall recognize the collateral as an asset (to the extent it has not already recognized it) and initially measure it at fair value;

d. Otherwise, the debtor shall continue to carry the collateral as an asset, and the secured party shall not recognize the pledged asset.

15. Insurers may enter into certain transactions that require the granting of a security interest in certain assets to another party to serve as collateral for their performance under a contract. If the assets pledged are recorded as admitted assets under *SSAP No. 4—Assets and Nonadmitted Assets* (SSAP No. 4) and are not impaired under the provisions of *SSAP No. 5—Liabilities, Contingencies and Impairments of Assets* (SSAP No. 5), the pledging insurer records the collateral as an admitted asset until committing a contract default that has not been cured in accordance with the contract provisions. At the time of an uncured default, the provisions of paragraph 14 above shall be used to determine the appropriate accounting treatment for the collateral. If the secured party utilizes collateral to offset all or a portion of

the liability owed by the pledging insurer as a result of the default, then the collateral amount utilized to offset the liability shall be removed from the balance sheet. At the same time, the amount of the liability that was offset shall be removed from the balance sheet since that obligation has been satisfied through the secured party's utilization of that collateral. To the extent that an uncured default remains without the secured party utilizing the collateral to offset the obligation, the pledging insurer shall only record an admitted asset for the amount of collateral that it can redeem.

Extinguishments of Liabilities

16. A debtor shall derecognize a liability if, and only if, it has been extinguished (see *SSAP No. 15—Debt and Holding Company Obligations*). A liability has been extinguished if either of the following conditions is met:

a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes delivery of cash, other financial assets, goods, or services or reacquisition by the debtor of its outstanding debt securities whether the securities are canceled or held as so-called treasury bonds; or

b. The debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor.

17. If a creditor releases a debtor from primary obligation on the condition that a third party assumes the obligation and that the original debtor becomes secondarily liable, that release extinguishes the original debtor's liability. However, in those circumstances, whether or not explicit consideration was paid for that guarantee, the original debtor becomes a guarantor. As a guarantor, it shall recognize a guarantee obligation in the same manner as would a guarantor that had never been primarily liable to that creditor, with due regard for the likelihood that the third party will carry out its obligations. The guarantee obligation shall be initially measured at fair value, and that amount reduces the gain or increases the loss recognized on extinguishment.

Isolation Beyond the Reach of the Transferor and Its Creditors

18. The nature and extent of supporting evidence required for an assertion in financial statements that transferred financial assets have been isolated—put presumptively beyond the reach of the transferor and its creditors, either by a single transaction or a series of transactions taken as a whole—depend on the facts and circumstances. All available evidence that either supports or questions an assertion shall be considered. That consideration includes making judgments about whether the contract or circumstances permit the transferor to revoke the transfer. It also may include making judgments about the kind of bankruptcy or other receivership into which a transferor or special-purpose entity might be placed, whether a transfer of financial assets would likely be deemed a true sale at law, whether the transferor is affiliated with the transferee, and other factors pertinent under applicable law. Derecognition of transferred assets is appropriate only if the available evidence provides reasonable assurance that the transferred assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor. Transactions between related parties or affiliates are accounted for in accordance with SSAP No. 25.

19. Many common financial transactions, for example, typical repurchase agreements and securities lending transactions, isolate transferred assets from the transferor, although they may not meet the other criteria for surrender of control.

Conditions That Constrain a Transferee

20. Sale accounting is allowed under paragraph 7 only if each transferee has the right to pledge, or the right to exchange, the transferred assets or beneficial interests it received, but constraints on that right

also matter. Many transferor-imposed or other conditions on a transferee's right to pledge or exchange a transferred asset both constrain a transferee from pledging or exchanging the transferred assets and, through that constraint, provide more than a trivial benefit to the transferor. For example, a provision in the transfer contract that prohibits selling or pledging a transferred loan receivable not only constrains the transferee but also provides the transferor with the more-than-trivial benefits of knowing who has the asset, a prerequisite to repurchasing the asset, and of being able to block the asset from finding its way into the hands of a competitor for the loan customer's business or someone that the loan customer might consider an undesirable creditor. Transferor-imposed contractual constraints that narrowly limit timing or terms, for example, allowing a transferee to pledge only on the day assets are obtained or only on terms agreed with the transferor, also constrain the transferee and presumptively provide the transferor with more-than-trivial benefits.

21. However, some conditions do not constrain a transferee from pledging or exchanging the asset and therefore do not preclude a transfer subject to such a condition from being accounted for as a sale. For example, a transferor's right of first refusal on the occurrence of a bona fide offer to the transferee from a third party presumptively would not constrain a transferee, because that right in itself does not enable the transferor to compel the transferee to sell the assets and the transferee would be in a position to receive the sum offered by exchanging the asset, albeit possibly from the transferor rather than the third party. Further examples of conditions that presumptively would not constrain a transferee include (a) a requirement to obtain the transferor's permission to sell or pledge that is not to be unreasonably withheld, (b) a prohibition on sale to the transferor's competitor if other potential willing buyers exist, (c) a regulatory limitation such as on the number or nature of eligible transferees (as in the case of securities issued under Securities Act Rule 144A or debt placed privately), and (d) illiquidity, for example, the absence of an active market. Judgment is required to assess the significance of some conditions. For example, a prohibition on sale to the transferor's competitor would be a significant constraint if that competitor were the only potential willing buyer other than the transferor.

22. A condition imposed by a transferor that constrains the transferee presumptively provides more than a trivial benefit to the transferor. A condition not imposed by the transferor that constrains the transferee may or may not provide more than a trivial benefit to the transferor. For example, if the transferor refrains from imposing its usual contractual constraint on a specific transfer because it knows an equivalent constraint is already imposed on the transferee by a third party, it presumptively benefits more than trivially from that constraint. However, the transferor cannot benefit from a constraint if it is unaware at the time of the transfer that the transferee is constrained.

Transferor's Rights or Obligations to Reacquire Transferred Assets

23. Some rights or obligations to reacquire transferred assets both constrain the transferee and provide more than a trivial benefit to the transferor, thus precluding sale accounting under paragraph 7. For example, a freestanding call option written by a transferee to the transferor benefits the transferor and, if the transferred assets are not readily obtainable in the marketplace, is likely to constrain a transferee because it might have to default if the call was exercised and it had exchanged or pledged the assets. A freestanding forward purchase-sale contract between the transferor and the transferee on transferred assets not readily obtainable in the marketplace would benefit the transferor and is likely to constrain a transferee in much the same manner. Judgment is necessary to assess constraint and benefit. For example, put options written to the transferee generally do not constrain it, but a put option on a not-readily-obtainable asset may benefit the transferor and effectively constrain the transferee if the option is sufficiently deep-in-the-money when it is written that it is probable that the transferee will exercise it and the transferor will reacquire the transferred asset. In contrast, a sufficiently out-of-the-money call option held by the transferor may not constrain a transferee if it is probable when the option is written that it will not be exercised. Freestanding rights to reacquire transferred assets that are readily obtainable presumptively do not constrain the transferee from exchanging or pledging them and thus do not preclude sale accounting under paragraph 7.

24. Other rights or obligations to reacquire transferred assets, regardless of whether they constrain the transferee, may result in the transferor's maintaining effective control over the transferred assets, as discussed in paragraphs 42-46, thus precluding sale accounting under paragraph 7.

Conditions That Constrain a Holder of Beneficial Interests in a Qualifying SPE

25. The considerations in paragraphs 20-23, about conditions that may or may not constrain a transferee that is not a qualifying special-purpose entity (SPE) from pledging or exchanging the transferred assets, also extend to conditions that may or may not constrain a beneficial interest holder (BIH) from pledging or exchanging its beneficial interests in assets transferred to a qualifying SPE. For example, if BIHs agree to sell their beneficial interests in a qualifying SPE back to the transferor upon request at the price paid plus a stated return, that arrangement clearly conveys more than a trivial benefit to the transferor; sale accounting for the transfer to the qualifying SPE would be precluded if that agreement constrained a BIH from exchanging or pledging its beneficial interest.

Qualifying SPE

26. A qualifying SPE is a trust or other legal vehicle that meets all of the following conditions:

a. It is demonstrably distinct from the transferor (paragraphs 27 and 28);

b. Its permitted activities:

i. Are significantly limited;

ii. Were entirely specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds; and

iii. May be significantly changed only with the approval of the holders of at least a majority of the beneficial interests held by entities other than any transferor, its affiliates, and its agents (paragraphs 29 and 30).

c. It shall hold only:

i. Financial assets transferred to it that are passive in nature (paragraph 31);

ii. Passive derivative financial instruments that pertain to beneficial interests (other than another derivative financial instrument) issued or sold to parties other than the transferor, its affiliates, or its agents (paragraphs 31 and 32);

iii. Financial assets (for example, guarantees or rights to collateral) that would reimburse it if others were to fail to adequately service financial assets transferred to it or to timely pay obligations due to it and that it entered into when it was established, when assets were transferred to it, or when beneficial interests (other than derivative financial instruments) were issued by the SPE;

iv. Servicing rights related to financial assets that it holds;

v. Temporarily, nonfinancial assets obtained in connection with the collection of financial assets that it holds (paragraph 33);

vi. Cash collected from assets that it holds and investments purchased with that cash pending distribution to holders of beneficial interests that are appropriate for that purpose (that is, money-market or other relatively risk-free instruments without options and with maturities no later than the expected distribution date).

d. If it can sell or otherwise dispose of noncash financial assets, it can do so only in automatic response to one of the following conditions:

i. Occurrence of an event or circumstance that:

(a) Is specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds;

(b) Is outside the control of the transferor, its affiliates, or its agents; and

(c) Causes, or is expected at the date of transfer to cause, the fair value of those financial assets to decline by a specified degree below the fair value of those assets when the SPE obtained them (paragraphs 34 and 35.)

ii. Exercise by a BIH (other than the transferor, its affiliates, or its agents) of a right to put that holder's beneficial interest back to the SPE (paragraph 36);

iii. Exercise by the transferor of a call specified in the legal documents that established the SPE, transferred assets to the SPE, or created the beneficial interests in the transferred assets that it holds (paragraphs 42-46);

iv. Termination of the SPE or maturity of the beneficial interests in those financial assets on a fixed or determinable date that is specified at inception (paragraph 37).

Need to Be Demonstrably Distinct from the Transferor

27. A qualifying SPE is demonstrably distinct from the transferor only if it cannot be unilaterally dissolved by any transferor, its affiliates, or its agents and either:

a. At least 10 percent of the fair value of its beneficial interests is held by parties other than any transferor, its affiliates, or its agents; or

b. The transfer is a guaranteed mortgage securitization.

28. An ability to unilaterally dissolve an SPE can take many forms, including but not limited to holding sufficient beneficial interests to demand that the trustee dissolve the SPE, the right to call all the assets transferred to the SPE, and a right to call or a prepayment privilege on the beneficial interests held by other parties.

Limits on Permitted Activities

29. The powers of the SPE must be limited to those activities allowed by paragraph 26 for it to be a qualifying SPE. Many kinds of entities are not so limited. For example, any bank, insurance company, pension plan, or investment company has powers that cannot be sufficiently limited for it to be a qualifying SPE.

30. The BIHs other than any transferor, its affiliates, or its agents may have the ability to change the powers of a qualifying SPE. If the powers of a previously qualifying SPE are changed so that the SPE is no longer qualifying, unless the conditions in paragraph 7.b. are then met by the SPE itself and the conditions in paragraphs 7.a. and 7.c. continue to be met, that change would bring the transferred assets held in the SPE back under the control of the transferor (paragraph 47).

Limits on What a Qualifying SPE May Hold

31. A financial asset or derivative financial instrument is passive only if holding the asset or instrument does not involve its holder in making decisions other than the decisions inherent in servicing. An equity instrument is not passive if the qualifying SPE can exercise the voting rights and is permitted to choose how to vote. Investments are not passive if through them, either in themselves or in combination with other investments or rights, the SPE or any related entity, such as the transferor, its affiliates, or its agents, is able to exercise control, as defined in *SSAP No. 46—Investments in Subsidiary, Controlled, and Affiliated Entities* (SSAP No. 46), over the investee. A derivative financial instrument is not passive if, for example, it includes an option allowing the SPE to choose to call or put other financial instruments that would allow it and its related entities to control 10% of more of the financial instruments issuer; but other derivative financial instruments can be passive, for example, interest rate caps and swaps and forward contracts. Derivative financial instruments that result in liabilities, like other liabilities of a qualifying SPE, are a kind of beneficial interest in the qualifying SPE's assets.

32. A derivative financial instrument pertains to beneficial interests (other than another derivative financial instrument) issued only if it:

a. Is entered into:

   i. When the beneficial interests are issued by the qualifying SPE to parties other than the transferor, its affiliates, or its agents or sold to such other parties after being issued by the qualifying SPE to the transferor, its affiliates, or its agents; or

   ii. When a passive derivative financial instrument needs to be replaced upon occurrence of an event or circumstance (specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds) outside the control of the transferor, its affiliates, or its agents, for example, when the counterparty to the derivative defaults or is downgraded below a specified threshold.

b. Has a notional amount that does not initially exceed the amount of those beneficial interests and is not expected to exceed them subsequently;

c. Has characteristics that relate to, and partly or fully but not excessively counteract, some risk associated with those beneficial interests or the related transferred assets.

33. A qualifying SPE may hold nonfinancial assets other than servicing rights only temporarily and only if those nonfinancial assets result from collecting the transferred financial assets. For example, a qualifying SPE could be permitted to temporarily hold foreclosed nonfinancial collateral. In contrast, an entity cannot be a qualifying SPE if, for example, it receives from a transferor significant secured financial assets likely to default with the expectation that it will foreclose on and profitably manage the securing nonfinancial assets.

Limits on Sales or Other Dispositions of Assets

34. Examples of requirements to sell, exchange, put, or distribute (hereinafter referred to collectively as dispose of) noncash financial assets that are permitted activities of a qualifying SPE—because they respond automatically to the occurrence of an event or circumstance that:

a. Is specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds;

b. Is outside the control of the transferor, its affiliates, or its agents; and

c. Causes, or is expected to cause, the fair value of those assets to decline by a specified degree below the fair value of those assets when the qualifying SPE obtained them—include requirements to dispose of transferred assets in response to:

i. A failure to properly service transferred assets that could result in the loss of a substantial third-party credit guarantee;

ii. A default by the obligor;

iii. A downgrade by a major rating agency of the transferred assets or of the underlying obligor to a rating below a specified minimum rating;

iv. The involuntary insolvency of the transferor; or

v. A decline in the fair value of the transferred assets to a specified value less than their fair value at the time they were transferred to the SPE.

35. The following are examples of powers or requirements to dispose of noncash financial assets that are not permitted activities of a qualifying SPE, because they do not respond automatically to the occurrence of a specified event or circumstance outside the control of the transferor, its affiliates, or its agents that causes, or is expected to cause, the fair value of those transferred assets to decline by a specified degree below the fair value of those assets when the SPE obtained them:

a. A power that allows an SPE to choose to either dispose of transferred assets or hold them in response to a default, a downgrade, a decline in fair value, or a servicing failure;

b. A requirement to dispose of marketable equity securities upon a specified decline from their "highest fair value" if that power could result in disposing of the asset in exchange for an amount that is more than the fair value of those assets at the time they were transferred to the SPE;

c. A requirement to dispose of transferred assets in response to the violation of a nonsubstantive contractual provision (that is, a provision for which there is not a sufficiently large disincentive to ensure performance).

36. A qualifying SPE may dispose of transferred assets automatically to the extent necessary to comply with the exercise by a BIH (other than the transferor, its affiliates, or its agents) of its right to put beneficial interests back to the SPE in exchange for:

a. A full or partial distribution of those assets;

b. Cash (which may require that the SPE dispose of those assets or issue beneficial interests to generate cash to fund settlement of the put);

c. New beneficial interests in those assets.

37. A qualifying SPE may have the power to dispose of assets to a party other than the transferor, its affiliate, or its agent on termination of the SPE or maturity of the beneficial interests, but only automatically on fixed or determinable dates that are specified at inception. For example, if an SPE is required to dispose of long-term mortgage loans and terminate itself at the earlier of (a) the specified maturity of beneficial interests in those mortgage loans or (b) the date of prepayment of a specified amount of the transferred mortgage loans, the termination date is a fixed or determinable date that was specified at inception. In contrast, if that SPE has the power to dispose of transferred assets on two

specified dates and the SPE can decide which transferred assets to sell on each date, the termination date is not a fixed or determinable date that was specified at inception.

Investments in Special-Purpose Entities

38. Reporting entities that have qualifying special-purpose entities as affiliates shall carry their investment in such entity at its underlying statutory book value in accordance with SSAP No. 46. Additionally, transactions entered involving affiliated qualifying special-purpose entities are subject to the provisions of SSAP No. 25.

Agreements That Maintain Effective Control Over Transferred Assets

39. An agreement that both entitles and obligates the transferor to repurchase or redeem transferred assets from the transferee maintains the transferor's effective control over those assets, and the transfer is therefore to be accounted for as a secured borrowing, if and only if all of the following conditions are met:

a. The assets to be repurchased or redeemed are the same or substantially the same as those transferred (paragraph 40);

b. The transferor is able to repurchase or redeem them on substantially the agreed terms, even in the event of default by the transferee (paragraph 41);

c. The agreement is to repurchase or redeem them before maturity, at a fixed or determinable price; and

d. The agreement is entered into concurrently with the transfer.

40. To be substantially the same, the asset that was transferred and the asset that is to be repurchased or redeemed need to have all of the following characteristics:

a. The same primary obligor (except for debt guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and the terms of the guarantee must be the same);

b. Identical form and type so as to provide the same risks and rights;

c. The same maturity (or in the case of mortgage-backed pass-through and pay-through securities have similar remaining weighted-average maturities that result in approximately the same market yield);

d. Identical contractual interest rates;

e. Similar assets as collateral; and

f. The same aggregate unpaid principal amount or principal amounts within accepted good delivery standards for the type of security involved.

41. To be able to repurchase or redeem assets on substantially all of the agreed terms, even in the event of default by the transferee, a transferor must at all times during the contract term have obtained cash or other collateral sufficient to fund substantially all of the cost of purchasing replacement assets from others.

Ability to Unilaterally Cause the Return of Specific Transferred Assets

42. Some rights to reacquire transferred assets (or to acquire beneficial interests in transferred assets held by a qualifying SPE), regardless of whether they constrain the transferee, may result in the transferor's maintaining effective control over the transferred assets through the unilateral ability to cause the return of specific transferred assets. Such rights preclude sale accounting under paragraph 7. For example, an attached call in itself would not constrain a transferee who is able, by exchanging or pledging the asset subject to that call, to obtain substantially all of its economic benefits. An attached call could result, however, in the transferor's maintaining effective control over the transferred asset(s) because the attached call gives the transferor the ability to unilaterally cause whoever holds that specific asset to return it. In contrast, transfers of financial assets subject to calls embedded by the issuers of the financial instruments, for example, callable bonds or prepayable mortgage loans, do not preclude sale accounting. Such an embedded call does not result in the transferor's maintaining effective control, because it is the issuer rather than the transferor who holds the call.

43. If the transferee is a qualifying SPE, it has met the conditions in paragraph 26 and therefore must be constrained from choosing to exchange or pledge the transferred assets. In that circumstance, any call held by the transferor is effectively attached to the assets and could—depending on the price and other terms of the call—maintain the transferor's effective control over transferred assets through the ability to unilaterally cause the transferee to return specific assets. For example, a transferor's unilateral ability to cause a qualifying SPE to return to the transferor or otherwise dispose of specific transferred assets at will or, for example, in response to its decision to exit a market or a particular activity, could provide the transferor with effective control over the transferred assets.

44. A call that is attached to transferred assets maintains the transferor's effective control over those assets if, under its price and other terms, the call conveys more than a trivial benefit to the transferor. Similarly, any unilateral right to reclaim specific assets transferred to a qualifying SPE maintains the transferor's effective control over those assets if the right conveys more than a trivial benefit to the transferor. A call or other right conveys more than a trivial benefit if the price to be paid is fixed, determinable, or otherwise potentially advantageous, unless because that price is so far out of the money or for other reasons it is probable when the option is written that the transferor will not exercise it. Thus, for example, a call on specific assets transferred to a qualifying SPE at a price fixed at their principal amount maintains the transferor's effective control over the assets subject to that call. Effective control over transferred assets can be present even if the right to reclaim is indirect. For example, if an embedded call allows a transferor to buy back the beneficial interests of a qualifying SPE at a fixed price, then the transferor remains in effective control of the assets underlying those beneficial interests. A cleanup call, however, is permitted as an exception to that general principle.

45. A right to reclaim specific transferred assets by paying their fair value when reclaimed generally does not maintain effective control, because it does not convey a more than trivial benefit to the transferor. However, a transferor has maintained effective control if it has such a right and also holds the residual interest in the transferred assets. For example, if a transferor can reclaim such assets at termination of the qualifying SPE by purchasing them in an auction, and thus at what might appear to be fair value, then sale accounting for the assets it can reclaim would be precluded. Such circumstances provide the transferor with a more than trivial benefit and effective control over the assets, because it can pay any price it chooses in the auction and recover any excess paid over fair value through its residual interest.

46. A transferor that has a right to reacquire transferred assets from a qualifying SPE does not maintain effective control if the reclaimed assets would be randomly selected and the amount of the assets reacquired is sufficiently limited because that would not be a right to reacquire specific assets. Nor does a transferor maintain effective control through an obligation to reacquire transferred assets from a qualifying SPE if the transfer could occur only after a specified failure of the servicer to properly service

the transferred assets that could result in the loss of a third-party guarantee (paragraph 34.c.i.) or only after a BIH other than the transferor, its affiliate, or its agent requires a qualifying SPE to repurchase that beneficial interest (paragraph 36.b.), because the transferor could not cause that reacquisition unilaterally.

Changes That Result in the Transferor's Regaining Control of Assets Sold

47. A change in law, status of the transferee as a qualifying SPE, or other circumstance may result in the transferor's regaining control of assets previously accounted for appropriately as having been sold, because one or more of the conditions in paragraph 7 are no longer met. Such a change, unless it arises solely from either the initial application of this issue paper or a change in market prices (for example, an increase in price that moves into-the-money a freestanding call that was originally sufficiently out-of-the-money that it was judged not to constrain the transferee), is accounted for in the same manner as a purchase of the assets from the former transferee(s) in exchange for liabilities assumed (paragraph 9). After that change, the transferor recognizes in its financial statements those assets together with liabilities to the former transferee(s) or BIHs in those assets (paragraph 30). The transferor initially measures those assets and liabilities at fair value on the date of the change, as if the transferor purchased the assets and assumed the liabilities on that date. The former transferee would derecognize the assets on that date, as if it had sold the assets in exchange for a receivable from the transferor. Subsequent to that date, the reporting entity shall follow statutory accounting for the assets and liabilities in accordance with the guidance in the SSAPs.

Assets Obtained and Liabilities Incurred as Proceeds

48. The proceeds from a sale of financial assets consist of the cash and any other assets obtained in the transfer less any liabilities incurred. Any asset obtained that is not an interest in the transferred asset is part of the proceeds from the sale. Any liability incurred, even if it is related to the transferred assets, is a reduction of the proceeds. Any derivative financial instrument entered into concurrently with a transfer of financial assets is either an asset obtained or a liability incurred and part of the proceeds received in the transfer. All proceeds and reductions of proceeds from a sale shall be initially measured at fair value.

Retained Interests

49. Other interests in transferred assets—those that are not part of the proceeds of the transfer—are retained interests over which the transferor has not relinquished control. They shall be measured at the date of the transfer by allocating the previous carrying amount between the assets sold, if any, and the retained interests, based on their relative fair values. That procedure shall be applied to all transfers in which interests are retained, even those that do not qualify as sales. Examples of retained interests include securities backed by the transferred assets, undivided interests, servicing assets, and cash reserve accounts and residual interests in securitization trusts. If a transferor cannot determine whether an asset is a retained interest or proceeds from the sale, the asset shall be treated as proceeds from the sale and accounted for in accordance with paragraph 48.

50. If the retained interests are subordinated to more senior interests held by others, that subordination may concentrate into the retained interests most of the risks inherent in the transferred assets and shall be taken into consideration in estimating the fair value of the retained interests. For example, if the amount of the gain recognized, after allocation, on a securitization with a subordinated retained interest is greater than the gain would have been had the entire asset been sold, the transferor needs to be able to identify why that can occur. Otherwise, it is likely that the impact of the retained interest being subordinate to a senior interest has not been adequately considered in the determination of the fair value of the subordinated retained interest.

If It Is Not Practicable to Estimate Fair Values

51. If it is not practicable to estimate the fair values of assets, the transferor shall record those assets at an allocated cost basis of zero. If it is not practicable to estimate the fair values of liabilities, the transferor shall recognize no gain on the transaction and shall record those liabilities at the greater of:

a. The excess, if any, of (i) the fair values of assets obtained less the fair values of other liabilities incurred, over (ii) the sum of the carrying values of the assets transferred;

b. The amount that would be recognized in accordance with SSAP No. 5.

Securitizations

52. Financial assets such as mortgage loans are assets commonly transferred in securitizations. Securitizations of mortgage loans may include pools of single-family residential mortgages or other types of real estate mortgage loans, for example, multifamily residential mortgages and commercial property mortgages. Both financial and nonfinancial assets can be securitized; life insurance policy loans, patent and copyright royalties also have been securitized. Securitizations of nonfinancial assets are outside the scope of this issue paper.

53. An originator of a typical securitization (the transferor) transfers a portfolio of financial assets to an SPE, commonly a trust. In "pass-through" and "pay-through" securitizations, receivables are transferred to the SPE at the inception of the securitization, and no further transfers are made; all cash collections are paid to the holders of beneficial interests in the SPE. In "revolving-period" securitizations, receivables are transferred at the inception and also periodically (daily or monthly) thereafter for a defined period (commonly three to eight years), referred to as the revolving period. During the revolving period, the SPE uses most of the cash collections to purchase additional receivables from the transferor on prearranged terms.

54. Beneficial interests in the SPE are sold to investors and the proceeds are used to pay the transferor for the assets transferred. Those beneficial interests may comprise either a single class having equity characteristics or multiple classes of interests, some having debt characteristics and others having equity characteristics. The cash collected from the portfolio is distributed to the investors and others as specified by the legal documents that established the SPE.

55. Pass-through, pay-through, and revolving-period securitizations that meet the criteria in paragraph 7 qualify for sale accounting under this issue paper. All financial assets obtained or retained and liabilities incurred by the originator of a securitization that qualifies as a sale shall be recognized and measured as provided in paragraph 9; that includes the implicit forward contract to sell new receivables during a revolving period, which may become valuable or onerous to the transferor as interest rates and other market conditions change.

Sales of Future Revenues

56. In addition to securitization of assets, some reporting entities have entered into transactions characterized as a sale of future revenues. These transactions are sometimes referred to as securitizations and are sometimes characterized as selling deferred acquisition costs. A sale of future revenues by a reporting entity shall not result in the immediate recognition of income or surplus. The proceeds of any such sale shall be established as a liability and shall be reduced as the proceeds are repaid.

Removal-of-Accounts Provisions

57. Many transfers of financial assets in securitizations empower the transferor to reclaim assets subject to certain restrictions. Such a power is sometimes called a removal-of-accounts provision (ROAP). If there is a ROAP, the transfer of assets shall not be accounted for as a sale.

Securities Lending Transactions

58. When securities are loaned, they remain assets of the reporting entity and are not removed from the accounting records. Any fees received by the transferor for loaning the securities shall be recorded as miscellaneous income. During a securities lending transaction, collateral is pledged by the transferee to the transferor that has loaned the securities. If the collateral pledged by the transferee is not available for the general use of the transferor (restricted), then the transferor shall not reflect the collateral in the transferor's balance sheet as an asset, and the transferor shall not establish a liability for the return of the collateral. However, if the collateral pledged is available for the general use of the transferor (unrestricted), then the collateral shall be recorded as an asset on the transferor's balance sheet and a separate liability shall be established on the transferor's balance sheet to record the obligation to return the collateral. The failure by the transferor to maintain sufficient collateral for the loaned securities would result in nonadmission of the undercollateralized portion. The specific collateral requirements are as follows:

a. The reporting entity shall receive collateral having a fair value as of the transaction date at least equal to 102 percent of the fair value of the loaned securities at that date. If at any time the fair value collateral is less than 100 percent of the fair value of the loaned securities, the counterparty shall be obligated to deliver additional collateral, the fair value of which, together with the fair value of all collateral then held in connection with the transaction at least equals 102 percent of the fair value of the loaned securities;

b. In the event that foreign securities are loaned and the denomination of the currency of the collateral is other than the denomination of the currency of the loaned foreign securities, the amount of collateral shall be at least equal to 105 percent of the fair value of the loaned securities at that date. If at any time the fair value is less than 102 percent of the fair value of the loaned securities, the reporting entity must obtain additional collateral, the fair value of which together with the fair value of all collateral then held in connection with the transaction at least equals 105 percent of the fair value of the loaned securities.

59. Securities lending transactions are generally initiated by broker-dealers and other financial institutions that need specific securities to cover a short sale or a customer's failure to deliver securities sold. Securities lending transactions typically extend less than one year. Transferees (borrowers) of securities generally are required to provide collateral to the transferor (lender) of securities, commonly cash but sometimes other securities or standby letters of credit, with a value slightly higher than that of the securities borrowed. If the collateral is cash, the transferor typically earns a return by investing that cash at rates higher than the rate paid or rebated to the transferee. If the collateral is other than cash, the transferor typically receives a fee. Securities custodians or other agents commonly carry out securities lending activities on behalf of clients. Because of the protection of collateral (typically valued daily and adjusted frequently for changes in the market price of the securities transferred) and the short terms of the transactions, most securities lending transactions in themselves do not impose significant credit risks on either party. Other risks arise from what the parties to the transaction do with the assets they receive. For example, investments made with cash collateral impose market and credit risks on the transferor.

60. Many securities lending transactions are accompanied by an agreement that entitles and obligates the transferor to repurchase or redeem the transferred assets before their maturity under which the transferor maintains effective control over those assets (paragraphs 39-41). Those transactions shall be

accounted for as secured borrowings, in which cash (or securities that the holder is permitted by contract or custom to sell or repledge) received as collateral is considered the amount borrowed, the securities loaned are considered pledged as collateral against the cash borrowed, and any rebate paid to the transferee of securities is interest on the cash the transferor is considered to have borrowed. Collateral provided in securities lending transactions that are accounted for as secured borrowings shall be reported and disclosed like other collateral, as set forth in paragraphs 14 and 58.

61. In some transactions, characterized as securities lending, all of the criteria in paragraph 7 are met, including the effective control criterion in paragraph 7.c., and consideration other than beneficial interests in the transferred assets is received. During the term of such agreements, the transferor has surrendered control over the securities transferred and the transferee has obtained control over those securities, with the ability to sell or transfer them at will. In that case, creditors of the transferor have a claim only to the collateral and the forward repurchase commitment. Those transactions shall be accounted for:

a. By the transferor as a sale of the loaned securities, for proceeds consisting of the collateral and a forward repurchase commitment. (If the collateral is a financial asset that the holder is permitted to sell or repledge and the debtor does not have the right and ability to redeem the collateral on short notice, e.g., by substituting other collateral or terminating the contract, that financial asset is proceeds of the sale of the loaned securities. To the extent that the collateral consists of letters of credit or other financial instruments that the holder is not permitted to sell or pledge, a securities lending transaction does not satisfy the sale criteria and is accounted for as a loan of securities by the transferor to the transferee); and

b. By the transferee as a purchase of the borrowed securities in exchange for the collateral and a forward resale commitment.

Repurchase Agreements and "Wash Sales"

62. Government securities dealers, banks, other financial institutions, and corporate investors commonly use repurchase agreements to obtain or use short-term funds. Under those agreements, the transferor ("repo party") transfers a security to a transferee ("repo counterparty" or "reverse party") in exchange for cash and concurrently agrees to reacquire that security at a future date for an amount equal to the cash exchanged plus a stipulated "interest" factor. Repurchase agreements, reverse repurchase agreements and dollar repurchase agreements meet the definition of assets as defined in SSAP No. 4 and are admitted assets to the extent they conform to the requirements of this statement.

63. Repurchase agreements can be effected in a variety of ways. Some repurchase agreements are similar to securities lending transactions in that the transferee has the right to sell or repledge the securities to a third party during the term of the repurchase agreement. In other repurchase agreements, the transferee does not have the right to sell or repledge the securities during the term of the repurchase agreement. For example, in a tri-party repurchase agreement, the transferor transfers securities to an independent third-party custodian that holds the securities during the term of the repurchase agreement. Also, many repurchase agreements are for short terms, often overnight, or have indefinite terms that allow either party to terminate the arrangement on short notice. However, other repurchase agreements are for longer terms, sometimes until the maturity of the transferred asset. Some repurchase agreements call for repurchase of securities that need not be identical to the securities transferred.

64. If the criteria in paragraph 7 are met, including the criterion in paragraph 7.c.i., the transferor shall account for the repurchase agreement as a sale of financial assets and a forward repurchase commitment, and the transferee shall account for the agreement as a purchase of financial assets and a forward resale commitment. Other transfers that are accompanied by an agreement to repurchase the transferred assets that shall be accounted for as sales include transfers with agreements to repurchase at

maturity and transfers with repurchase agreements in which the transferee has not obtained collateral sufficient to fund substantially all of the cost of purchasing replacement assets.

65. Furthermore, "wash sales" that previously were not recognized if the same financial asset was purchased within 30 days before or after the sale shall be accounted for as sales under this issue paper. Unless there is a concurrent contract to repurchase or redeem the transferred financial assets from the transferee, the transferor does not maintain effective control over the transferred assets.

66. As with securities lending transactions, under many agreements to repurchase transferred assets before their maturity the transferor maintains effective control over those assets. Repurchase agreements that do not meet all the criteria in paragraph 7 shall be treated as secured borrowings. Fixed-coupon and dollar-roll repurchase agreements, and other contracts under which the securities to be repurchased need not be the same as the securities sold, qualify as borrowings if the return of substantially the same (paragraph 40) securities as those concurrently transferred is assured. Therefore, those transactions shall be accounted for as secured borrowings by both parties to the transfer.

67. If a transferor has transferred securities to an independent third-party custodian, or to a transferee, under conditions that preclude the transferee from selling or repledging the assets during the term of the repurchase agreement (as in most tri-party repurchase agreements), the transferor has not surrendered control over those assets.

Repurchase Agreements

68. Repurchase agreements are defined as agreements under which a reporting entity purchases securities and simultaneously agrees to resell the same or substantially the same securities at a stated price on a specified date. For securities to be substantially the same, the criteria defined in paragraph 40 must be met, and for mortgage-backed securities excluding mortgage pass-through securities, the projected cash flows of the securities must be substantially the same under multiple scenario prepayment assumptions.

69. For repurchase agreements that are accounted for as collateralized lendings in accordance with paragraph 66 of this statement, the underlying securities shall not be accounted for as investments owned by the reporting entity. The amount paid for the securities shall be reported as a short-term investment, and the difference between the amount paid and the amount at which the securities will be subsequently resold shall be reported as interest income, calculated on the straight-line method or the scientific interest (constant yield) method, over the term of the agreement.

70. Reporting entities generally take possession of the underlying collateral under repurchase agreements and in many cases may obtain additional collateral when the estimated fair value of such securities falls below their current contract value. However, to the extent that the current fair value of the collateral is less than the recorded amount, the shortfall shall reduce the admitted asset value of the repurchase agreement.

Reverse Repurchase Agreements

71. Reverse repurchase agreements are defined as agreements under which a reporting entity sells securities and simultaneously agrees to repurchase the same or substantially the same securities at a stated price on a specified date. For securities to be substantially the same, the criteria defined in paragraph 40 must be met, and for mortgage-backed securities excluding mortgage pass-through securities, the projected cash flows of the securities must be substantially the same under multiple scenario prepayment assumptions.

72. For reverse repurchase agreements that are accounted for as collateralized borrowings in accordance with paragraph 66 of this statement, the underlying securities shall continue to be accounted

for as an investment by the reporting entity. The proceeds from the sale of the securities shall be recorded as a liability, and the difference between the proceeds and the amount at which the securities will be subsequently reacquired shall be reported as interest expense, calculated on the straight-line method or the scientific interest (constant yield) method, over the term of the agreement.

Collateral Requirements

73. The collateral requirements for repurchase and reverse repurchase agreements are as follows:

Repurchase Transaction

a. The reporting entity shall receive as collateral transferred securities having a fair value at least equal to 102 percent of the purchase price paid by the reporting entity for the securities. If at anytime the fair value of the collateral is less than 100 percent of the purchase price paid by the reporting entity, the counterparty shall be obligated to provide additional collateral, the fair value of which, together with fair value of all collateral then held in connection with the transaction, at least equals 102 percent of the purchase price.

Reverse Repurchase Transaction

b. The reporting entity shall receive collateral having a fair value as of the transaction date at least equal to 95 percent of the fair value of the securities transferred by the reporting entity in the transaction as of that date. If at anytime the fair value of the collateral is less than 95 percent of the fair value of the securities so transferred, the counterparty shall be obligated to deliver additional collateral, the fair value of which, together with the fair value of all collateral then held in connection with the transaction, at least equals 95 percent of the fair value of the transferred securities.

Dollar Repurchase Agreements

74. Dollar repurchase and dollar reverse repurchase agreements are defined as repurchase and reverse repurchase agreements involving debt instruments that are pay-through securities collateralized with Government National Mortgage Association (GNMA), Federal Home Loan Mortgage Corporation (FHLMC) and Federal National Mortgage Association (FNMA) collateral, and pass-through certificates sponsored by GNMA, mortgage participation certificates issued by the FHLMC or similar securities issued by the FNMA. Dollar repurchase agreements are also commonly referred to as dollar roll transactions. To meet the definition of dollar repurchase and dollar reverse repurchase agreements, the securities underlying the agreements must meet the criteria defined in paragraph 40, and for mortgage-backed securities excluding mortgage pass-through securities, the projected cash flows of the securities must be substantially the same under multiple scenario prepayment assumptions.

75. For the seller in a dollar reverse repurchase agreement accounted for as collateralized borrowing in accordance with paragraph 66 of this statement, a liability is recorded for the amount of proceeds of the sale and the sold mortgage-backed securities are not removed from the accounting records. During the period of the agreement, interest income is recorded as if the mortgage-backed security had been held during the term of the agreement. This is offset by an equal amount of interest expense related to the proceeds received from the sale. Additional interest expense is recorded representing the difference between the sales price and the repurchase price of the mortgage-backed securities sold.

76. When the mortgage-backed securities are repurchased under the agreement, the original mortgage-backed securities sold are removed from the accounting records and the purchased mortgage-backed securities are recorded. The principal amount of the mortgage-backed securities repurchased must be in good delivery form consistent with paragraph 40.

77. If the principal amount repurchased is greater than the amount sold, the cash paid is recorded as an additional investment in the newly acquired certificates. If the principal amount repurchased is less than the amount sold, a gain or loss relating to the original certificates held is recorded.

78. For the purchaser in a dollar repurchase agreement accounted for as collateralized lending in accordance with paragraph 67 of this statement, an asset is recorded for the amount of the purchase. Upon completion of the reverse repurchase agreement, cash is received in exchange for a "substantially the same" security. The difference between the purchase and reselling price represents interest income for the lending of short-term funds.

Separate Transactions

79. Agreements to repurchase and resell securities that do not meet the definitions in paragraphs 60 and 66 of this issue paper shall be accounted for as two separate transactions, that is, as a sale and purchase or as a purchase and sale, in accordance with the relevant statutory accounting guidance. For example, sales of bonds would result in recognition of realized gains or losses.

Offsetting

80. Reporting entities may operate on both sides of the repurchase agreement market resulting in recording of liabilities and assets representing repurchase and reverse repurchase agreements, respectively.

81. Reporting entities shall offset such liabilities and assets only to the extent that one of the following occurs:

a. A legal right of offset exists as defined in *SSAP No. 64—Offsetting and Netting of Assets and Liabilities* (SSAP No. 64); or

b. The securities have the same settlement date, are executed with the same counterparty in accordance with a master netting arrangement, involve securities that exist in "book entry" form, and settle on securities transfer systems that have the same key elements and operating characteristics as the Fedwire Securities Transfer System.

82. Otherwise, separate assets and liabilities shall be recognized.

Loan Syndications

83. Borrowers often borrow amounts greater than any one lender is willing to lend. Therefore, it is common for groups of lenders to jointly fund those loans. That may be accomplished by a syndication under which several lenders share in lending to a single borrower, but each lender loans a specific amount to the borrower and has the right to repayment from the borrower.

84. A loan syndication is not a transfer of financial assets. Each lender in the syndication shall account for the amounts it is owed by the borrower. Repayments by the borrower may be made to a lead lender who then distributes the collections to the other lenders of the syndicate. In those circumstances, the lead lender is also functioning as a servicer and, therefore, shall only recognize its portion of the loan as an asset.

Loan Participations

85. Groups of banks or other entities also may jointly fund large borrowings through loan participations in which a single lender makes a large loan to a borrower and subsequently transfers undivided interests in the loan to other entities.

86. Transfers by the originating lender may take the legal form of either assignments or participations. The transfers are usually on a nonrecourse basis, and the transferor (originating lender) continues to service the loan. The transferee (participating entity) may or may not have the right to sell or transfer its participation during the term of the loan, depending upon the terms of the participation agreement.

87. If the loan participation agreement gives the transferee the right to pledge or exchange those participations and the other criteria in paragraph 7 are met, the transfers to the transferee shall be accounted for by the transferor as sales of financial assets. A transferor's right of first refusal on a bona fide offer from a third party, a requirement to obtain the transferor's permission that shall not be unreasonably withheld, or a prohibition on sale to the transferor's competitor is a limitation on the transferee's rights but presumptively does not constrain a transferee from exercising its right to pledge or exchange. However, if the loan participation agreement constrains the transferees from pledging or exchanging their participations, the transferor has not relinquished control over the loan and shall account for the transfers as secured borrowings.

Factoring Arrangements

88. Factoring arrangements are a means of discounting accounts receivable on a nonrecourse, notification basis. Accounts receivable are sold outright, usually to a transferee (the factor) that assumes the full risk of collection, without recourse to the transferor in the event of a loss. Debtors are directed to send payments to the transferee. Factoring arrangements that meet the criteria in paragraph 7 shall be accounted for as sales of financial assets because the transferor surrenders control over the receivables to the factor.

Transfers of Receivables with Recourse

89. In a transfer of receivables with recourse, the transferor is obligated under the terms of the recourse provision to make payments to the transferee or to repurchase receivables sold under certain circumstances, typically for defaults up to a specified percentage. A transfer of receivables with recourse shall not be recognized as a sale but rather, as a financing. A transfer of receivables without recourse shall only be recognized if the transferor receives cash for the receivables. The sale shall be recognized when cash is received. Sales of premium receivables are addressed in *SSAP No. 42—Sale of Premium Receivables*.

Disclosures

90. A reporting entity shall disclose the following:

a. For collateral:

i. If the entity has entered into repurchase agreements or securities lending transactions, its policy for requiring collateral or other security;

ii. If the entity has pledged any of its assets as collateral that are not reclassified and separately reported in the statement of financial position pursuant to paragraph 14.a., the carrying amount and classification of those assets as of the date of the latest statement of financial position presented;

iii. If the entity has accepted collateral that it is permitted by contract or custom to sell or repledge, the fair value as of the date of each statement of financial position presented of that collateral and of the portion of that collateral that it has sold or repledged, and information about the sources and uses of that collateral; and

iv. For securities lending transactions, disclose collateral for transactions that extend beyond one year from the reporting date.

b. If debt was considered to be extinguished by in-substance defeasance, a general description of the transaction and the amount of debt that is considered extinguished at the end of the period so long as that debt remains outstanding;

c. If assets are set aside solely for satisfying scheduled payments of a specific obligation, a description of the nature of restrictions placed on those assets;

d. If it is not practicable to estimate the fair value of certain assets obtained or liabilities incurred in transfers of financial assets during the period, a description of those items and the reasons why it is not practicable to estimate their fair value;

e. For all servicing assets and servicing liabilities:

i. The amounts of servicing assets nonadmitted or liabilities recognized and amortized during the period; and

ii. The fair value of recognized servicing assets and liabilities for which it is practicable to estimate that value and the method and significant assumptions used to estimate the fair value.

f. If the entity has securitized financial assets during any period presented and accounts for that transfer as a sale, for each major asset type (for example, mortgage loans):

i. Its accounting policies for initially measuring the retained interests, if any, including the methodology (whether quoted market price, prices based on sales of similar assets and liabilities, or prices based on valuation techniques) used in determining their fair value (Glossary); and

ii. The characteristics of securitizations (a description of the transferor's continuing involvement with the transferred assets, including, but not limited to, servicing, recourse, and restrictions on retained interests) and the gain or loss from sale of financial assets in securitizations;

iii. The key assumptions used in measuring the fair value of retained interests at the time of securitization (including, at a minimum, quantitative information about discount rates, expected prepayments including the expected weighted-average life of prepayable financial assets, and anticipated credit losses, if applicable); and

iv. Cash flows between the securitization SPE and the transferor (including proceeds from new securitizations, purchases of delinquent or foreclosed loans, servicing fees, and cash flows received on interests retained.)

g. If the entity has retained interests in securitized financial assets at the date of the latest statement of financial position presented, for each major asset type (for example, mortgage loans):

i. Its accounting policies for subsequently measuring those retained interests, including the methodology (whether quoted market price, prices based on sales of similar assets and liabilities, or prices based on valuation techniques) used in determining their fair value (Glossary);

ii. The key assumptions used in subsequently measuring the fair value of those interests (including, at a minimum, quantitative information about discount rates, expected prepayments including the expected weighted-average life of prepayable financial assets, and anticipated credit losses, including expected static pool losses, if applicable);

iii. A sensitivity analysis or stress test showing the hypothetical effect on the fair value of those interests of two or more unfavorable variations from the expected levels for each key assumption that is reported under ii. above independently from any change in another key assumption, and a description of the objectives, methodology, and limitations of the sensitivity analysis or stress test; and

iv. For the securitized assets and any other financial assets that the entity manages together with the retained interests[1]:

(a) The total principal amount outstanding, the portion that has been derecognized, and the portion that continues to be recognized in each category reported in the statement of financial position, at the end of the period;

(b) Delinquencies at the end of the period; and

(c) Credit losses, net of recoveries, during the period.

v. Disclosure of average balances during the period is encouraged, but not required.

h. Description of any loaned securities, including the amount, a description of, and the policy for, requiring collateral, and whether or not the collateral is restricted;

i. A description of the securities underlying repurchase and reverse repurchase agreements, dollar repurchase and dollar reverse repurchase agreements, including book values and fair values, maturities, and weighted average interest rates for the following categories: (i) securities subject to reverse repurchase agreements; (ii) securities subject to repurchase agreements; (iii) securities subject to dollar repurchase agreements; and (iv) securities subject to dollar reverse repurchase agreements; and

j. A description of the terms of reverse repurchase agreements whose amounts are included in borrowed money.

91. Disclose any transfers of receivables with recourse.

92. A reporting entity shall disclose the following information for wash sales, as defined in paragraph 11, involving transactions for securities with a NAIC designation of 3 or below, or unrated:

a. A description of the reporting entity's objectives regarding these transactions;

b. An aggregation of transactions by NAIC Designation 3 or below, or unrated;

c. The number of transactions involved during the reporting period;

d. The book value of securities sold;

[1] Excluding securitized assets that an entity continues to service but with which it has no other continuing involvement.

e. The cost of securities repurchased; and

f. The realized gains/losses associated with the securities involved.

93. Refer to the preamble for further discussion regarding disclosure requirements. The disclosures required by paragraph 92 shall be made for the current quarter in the quarterly statement and for the year in the annual statement.

Effective Date and Transition

94. Upon adoption of this issue paper, the NAIC will release a Statement of Statutory Accounting Principle (SSAP) for comment. The SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the *Accounting Practices and Procedures Manual* should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will be effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after January 1, 2005, and shall be applied prospectively.

95. For each servicing contract in existence before January 1, 2005, previously recognized or nonadmitted servicing rights and excess servicing receivables shall be combined, net of any previously recognized servicing obligations under that contract, as a servicing asset (nonadmitted) or liability. Thereafter, the subsequent measurement provisions of this statement shall be applied to the servicing assets (nonadmitted) or liabilities for those servicing contracts.

DISCUSSION

96. The accounting guidance in this issue paper is consistent with the guidance included in SSAP No. 18, SSAP No. 33 and SSAP No. 45, and is expanded to include issues addressed in FAS 140.

97. This statement adopts FAS 140 with the following modifications:

a. Servicing rights assets are nonadmitted;

b. Sales treatment is not permitted for transactions including recourse provisions or removal-of-accounts provisions on the transferred assets whereas GAAP would permit the recognition of the transfer as a sale under some circumstances;

c. As statutory financial statements are prepared on a legal entity basis, special purpose entities shall not be consolidated in a reporting entity's statutory financial statements;

d. Leases shall be accounted for in accordance with SSAP No. 22;

e. Reporting entities required to maintain an IMR shall account for realized and unrealized capital gains and losses in accordance with SSAP No. 7; and

f. The concepts of revolving-period securitizations, banker's acceptances and risk participations in banker's acceptances are not applicable for statutory accounting purposes.

98. This issue paper adopts *AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as used In Certain Audit Guides and a Statement of Position*. This statement adopts *FASB Emerging Issues Task Force No. 87-34, Sale of Mortgage Servicing Rights with a Subservicing Agreement, FASB Emerging Issues Task Force No. 88-11, Allocation of Recorded Investment When a Loan as Part of a Loan is Sold, FASB Emerging Issues Task Force No. 88-18, Sales of*

Future Revenues, FASB Emerging Issues Task Force No. 88-22, Securitization of Credit Card and Other Receivable Portfolios, FASB Emerging Issues Task Force No. 90-21, Balance Sheet Treatment of a Sale of Mortgage Servicing Rights with a Subservicing Agreement, FASB Emerging Issues Task Force No. 95-5, Determination of What Risks and Rewards, If Any, Can Be Retained and Whether Any Unresolved Contingencies May Exist in a Sale of Mortgage Loan Servicing Rights and *FASB Emerging Issues Task Force No. 96-19, Debtor's Accounting for a Modification or Exchange of Debt Instruments*.

99. This issue paper rejects *FASB Emerging Issues Task Force No. 84-5, Sale of Marketable Securities with a Put Option,* and *FASB Emerging Issues Task Force No. 92-2, Measuring Loss Accruals by Transferors of Receivables with Recourse*.

RELEVANT STATUTORY AND GAAP GUIDANCE:

Statutory Accounting

100. SSAP No. 18 provides the following guidance:

> **SUMMARY CONCLUSION**
>
> 3. Except as discussed in paragraph 35, a transfer of a group of financial assets, or a portion of a financial asset in which the transferor surrenders control over those financial assets shall be accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if, and only if, all of the following conditions are met:
>
> a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership (see paragraphs 12 and 13);
>
> b. Either (i) each transferee obtains the right, free of conditions that constrain it from taking advantage of that right (see paragraph 14), to pledge or exchange the transferred assets or (ii) the transferee is a qualifying special-purpose entity as defined in paragraph 9 of SSAP No. 33 and the holders of beneficial interests in that entity have the right, free of conditions that constrain them from taking advantage of that right (see paragraph 14), to pledge or exchange those interests; and
>
> c. The transferor does not maintain effective control over the transferred assets through (i) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (see paragraphs 15-17) or (ii) an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable (see paragraph 18).
>
> 4. Upon completion of any transfer of financial assets, the transferor shall:
>
> a. Continue to carry in its balance sheet any retained interest in the transferred assets, including, if applicable, beneficial interests in assets transferred to a qualifying special-purpose entity in a securitization (see SSAP No. 33), and retained undivided interests (see paragraph 20); and
>
> b. Allocate the previous carrying amount between the assets sold, if any, and the retained interests, if any, based on their relative fair values at the date of transfer (see paragraphs 19 and 20).
>
> 5. Upon completion of a transfer of assets that satisfies the conditions to be accounted for as a sale (see paragraph 3), the transferor (seller) shall:

a. Eliminate the transferred assets from the balance sheet;

b. Allocate the previous carrying amount of the transferred assets to the securities representing beneficial interests retained by the reporting entity, if any, and the securities representing beneficial interests not retained, if any, based on the relative fair values of the transferred assets at the date of transfer;

c. Record in its balance sheet, the allocated carrying value of the securities representing retained beneficial interests in the assets (e.g., loan-backed securities);

d. Recognize all additional assets obtained (i.e., other than the securities representing retained beneficial interests which are recorded in accordance with 5 c.) and liabilities incurred in consideration as proceeds of the sale;

e. Initially measure such additional assets obtained and liabilities incurred in the sale at fair value; and

f. For reporting entities required to maintain an Interest Maintenance Reserve (IMR), the accounting for realized capital gains and losses shall be in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*. For reporting entities not required to maintain an IMR, realized gains and losses shall be reported as net realized capital gains or losses in the statement of income.

6. The transferee shall recognize all assets obtained and any liabilities incurred, and initially measure them at fair value (in aggregate, presumptively the price paid).

7. Repurchase agreements, reverse repurchase agreements, and dollar repurchase agreements shall meet the definition of SSAP No. 45. When an asset is sold and the proceeds are reinvested within 30 days in the same or substantially the same security, such transfers shall be considered to be wash sales and shall be accounted for as sales and disclosed as required by paragraph 37. Unless there is a concurrent contract to repurchase or redeem the transferred financial assets from the transferee, the transferor does not maintain effective control over the transferred assets.

8. If a transfer of financial assets in exchange for cash or other consideration (other than beneficial interests in the transferred assets) (a) does not meet the criteria for a sale in paragraph 3, or (b) is a sale of receivables with recourse (see paragraph 35); the transferor and transferee shall account for the transfer as a secured borrowing with pledge of collateral (see paragraph 10).

Recognition and Measurement of Servicing Assets and Liabilities

9. Servicing rights become a distinct asset or liability only when contractually separated from the underlying assets by sale or securitization of the assets with servicing retained, or separate purchase or assumption of the servicing. If distinct servicing rights to transferred assets exist and are retained by the reporting entity, the reporting entity shall recognize a servicing asset or liability. When the servicing fees to be received exceed the cost of servicing the transferred assets, a servicing asset is recognized and nonadmitted. When the cost of servicing the transferred assets is greater than the servicing fees to be received, a liability shall be recorded for the excess to recognize this obligation. A corresponding loss shall be recorded through the Summary of Operations. The servicing asset or liability shall be amortized into income in proportion to, and over the period of estimated servicing income (if an asset) or estimated servicing loss (if a liability). A servicing asset or liability shall be assessed for impairment or increased obligation based on its fair value.

Secured Borrowings and Collateral

10. A debtor may grant a security interest in certain assets to a lender (the secured party) to serve as collateral for its obligation under a borrowing, with or without recourse to other assets of the debtor. An obligor under other kinds of current or potential obligations, for example, interest rate swaps, also may grant a security interest in certain assets to a secured party. If collateral is transferred to the secured party, the custodial arrangement is commonly referred to as a pledge. Secured parties sometimes are permitted to sell or repledge (or otherwise transfer) collateral held under a pledge. The same relationships occur, under different names, in transfers documented as sales that are accounted for as secured borrowings (see paragraph 8). The accounting for collateral by the debtor (or obligor) and the secured party depends on whether the secured party has taken control over the collateral, and on the rights and obligations that result from the collateral arrangement:

a. If the secured party is permitted to sell or repledge the collateral, and the debtor does not have the right and ability to redeem the collateral on short notice, (e.g., by substituting other collateral or terminating the contract), then:

i. The debtor shall disclose the amount of such assets and the secured party's right to sell or repledge such collateral;

ii. The secured party shall recognize that collateral as its asset, initially measure it at fair value, and also recognize its obligation to return it.

b. If the secured party sells or repledges collateral on terms that do not give it the right and ability to repurchase or redeem the collateral from the transferee on short notice, the secured party shall recognize the proceeds from the sale or the asset repledged and its obligation to return the asset to the extent that it has not already recognized them. The sale or repledging of the asset is a transfer subject to the provisions of this statement;

c. If the debtor defaults under the terms of the secured contract and is no longer entitled to redeem the collateral, it shall derecognize the collateral. The secured party shall recognize the collateral as an asset (to the extent it has not already recognized it) and initially measure it at fair value;

d. Otherwise, the debtor shall continue to carry the collateral as an asset, and the secured party shall not recognize the pledged asset.

Extinguishments of Liabilities

11. A debtor shall derecognize a liability if, and only if, it has been extinguished (see SSAP No. 15). A liability has been extinguished if either of the following conditions is met:

a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes delivery of cash, other financial assets, goods, or services or reacquisition by the debtor of its outstanding debt securities; or

b. The debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor.

Isolation Beyond the Reach of the Transferor and Its Creditors

12. The nature and extent of supporting evidence required for an assertion in financial statements that transferred financial assets have been isolated—put presumptively beyond the reach of the transferor and its creditors, either by a single transaction or a series of transactions taken as a whole—depend on the facts and circumstances. All

available evidence that either supports or questions an assertion shall be considered. That consideration includes making judgments about whether the contract or circumstances permit the transferor to revoke the transfer. It also may include making judgments about the kind of bankruptcy or other receivership into which a transferor or special-purpose entity might be placed, whether a transfer of financial assets would likely be deemed a true sale at law, whether the transferor is affiliated with the transferee, and other factors pertinent under applicable law. Derecognition of transferred assets is appropriate only if the available evidence provides reasonable assurance that the transferred assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any of its affiliates, except for an affiliate that is a qualifying special-purpose entity designed to make remote the possibility that it would enter bankruptcy or other receivership (see SSAP No. 33).

13. Many common financial transactions, for example, typical repurchase agreements (see SSAP No. 45) and securities lending transactions, isolate transferred assets from the transferor, although they may not meet the other criteria for surrender of control.

Conditions That Constrain a Transferee

14. Many transferor-imposed or other conditions on a transferee's contractual right to pledge or exchange a transferred asset constrain a transferee from taking advantage of that right. However, a transferor's right of first refusal on a bona fide offer from a third party, a requirement to obtain the transferor's permission to sell or pledge that shall not be unreasonably withheld, or a prohibition on sale to the transferor's competitor generally does not constrain a transferee from pledging or exchanging the asset and, therefore, presumptively does not preclude a transfer containing such a condition from being accounted for as a sale. For example, a prohibition on sale to the transferor's competitor would not constrain the transferee if it were able to sell the transferred assets to a number of other parties; however, it would be a constraint if that competitor were the only potential willing buyer.

Agreements That Maintain Effective Control Over Transferred Assets

15. An agreement that both entitles and obligates the transferor to repurchase or redeem transferred assets from the transferee maintains the transferor's effective control over those assets, and the transfer is therefore to be accounted for as a secured borrowing, if and only if all of the following conditions are met:

    a. The assets to be repurchased or redeemed are the same or substantially the same as those transferred (see paragraph 16);

    b. The transferor is able to repurchase or redeem them on substantially the agreed terms, even in the event of default by the transferee (see paragraph 17);

    c. The agreement is to repurchase or redeem them before maturity, at a fixed or determinable price; and

    d. The agreement is entered into concurrently with the transfer.

16. To be substantially the same, the asset that was transferred and the asset that is to be repurchased or redeemed need to have all of the following characteristics:

    a. The same primary obligor (except for debt guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and the terms of the guarantee must be the same);

    b. Identical form and type so as to provide the same risks and rights;

c. The same maturity (or in the case of mortgage-backed pass-through and pay-through securities have similar remaining weighted-average maturities that result in approximately the same market yield);

d. Identical contractual interest rates;

e. Similar assets as collateral; and

f. The same aggregate unpaid principal amount or principal amounts within accepted good delivery standards for the type of security involved.

17. To be able to repurchase or redeem assets on substantially all of the agreed terms, even in the event of default by the transferee, a transferor must at all times during the contract term have obtained cash or other collateral sufficient to fund substantially all of the cost of purchasing replacement assets from others.

18. A call option or forward contract that entitles the transferor to repurchase, prior to maturity, transferred assets not readily obtainable elsewhere maintains the transferor's effective control, because it would constrain the transferee from exchanging those assets, unless it is only a cleanup call.

Assets Obtained and Liabilities Incurred as Proceeds

19. The proceeds from a sale of financial assets consist of the cash and any other assets obtained in the transfer less any liabilities incurred. Any asset obtained that is not an interest in the transferred asset is part of the proceeds from the sale. Any liability incurred, even if it is related to the transferred assets, is a reduction of the proceeds. Any derivative financial instrument entered into concurrently with a transfer of financial assets is either an asset obtained or a liability incurred and part of the proceeds received in the transfer. All proceeds and reductions of proceeds from a sale shall be initially measured at fair value.

Retained Interests

20. Other interests in transferred assets—those that are not part of the proceeds of the transfer—are retained interests over which the transferor has not relinquished control. They shall be measured at the date of the transfer by allocating the previous carrying amount between the assets sold, if any, and the retained interests, based on their relative fair values. That procedure shall be applied to all transfers in which interests are retained, even those that do not qualify as sales. Examples of retained interests include securities backed by the transferred assets, undivided interests, servicing assets, and cash reserve accounts and residual interests in securitization trusts. If a transferor cannot determine whether an asset is a retained interest or proceeds from the sale, the asset shall be treated as proceeds from the sale and accounted for in accordance with paragraph 19.

Fair Value

21. The fair value of an asset (or liability) is the amount at which that asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available. If a quoted market price is available, the fair value is the product of the number of trading units times market price.

22. If quoted market prices are not available, the estimate of fair value shall be based on the best information available. The estimate of fair value shall consider prices for similar assets and liabilities and the results of valuation techniques to the extent available in the

circumstances. Examples of valuation techniques include the present value of estimated expected future cash flows using a discount rate commensurate with the risks involved, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis. Valuation techniques for measuring financial assets and liabilities and servicing assets and liabilities shall be consistent with the objective of measuring fair value. Those techniques shall incorporate assumptions that market participants would use in their estimates of values, future revenues, and future expenses, including assumptions about interest rates, default, prepayment, and volatility. In measuring financial liabilities and servicing liabilities at fair value by discounting estimated future cash flows, an objective is to use discount rates at which those liabilities could be settled in an arm's-length transaction.

23. Estimates of expected future cash flows, if used to estimate fair value, shall be the best estimate based on reasonable and supportable assumptions and projections. All available evidence shall be considered in developing estimates of expected future cash flows. The weight given to the evidence shall be commensurate with the extent to which the evidence can be verified objectively. If a range is estimated for either the amount or timing of possible cash flows, the likelihood of possible outcomes shall be considered in determining the best estimate of future cash flows.

If It Is Not Practicable to Estimate Fair Values

24. If it is not practicable to estimate the fair values of assets, the transferor shall record those assets at zero. If it is not practicable to estimate the fair values of liabilities, the transferor shall recognize no gain on the transaction and shall record those liabilities at the greater of:

a. The excess, if any, of (i) the fair values of assets obtained less the fair values of other liabilities incurred, over (ii) the sum of the carrying values of the assets transferred;

b. The amount that would be recognized in accordance with *SSAP No. 5—Liabilities, Contingencies and Impairments of Assets*.

Securities Lending Transactions

25. When securities are loaned, they remain assets of the reporting entity and are not removed from the accounting records. Any fees received by the transferor for loaning the securities should be recorded as miscellaneous income. During a securities lending transaction, collateral is pledged by the transferee to the transferor that has loaned the securities. If the collateral pledged by the transferee is not available for the general use of the transferor (restricted), then the transferor shall not reflect the collateral in the transferor's balance sheet as an asset, and the transferor shall not establish a liability for the return of the collateral. However, if the collateral pledged is available for the general use of the transferor (unrestricted), then the collateral shall be recorded as an asset on the transferor's balance sheet and a separate liability shall be established on the transferor's balance sheet to record the obligation to return the collateral. The failure by the transferor to maintain sufficient collateral for the loaned securities would result in nonadmission of the undercollateralized portion. The specific collateral requirements are as follows:

a. The reporting entity shall receive collateral having a fair value as of the transaction date at least equal to 102 percent of the fair value of the loaned securities at that date. If at any time the fair value collateral is less than 100 percent of the fair value of the loaned securities, the counterparty shall be obligated to deliver additional collateral, the fair value of which, together with the fair value of all collateral then held in connection with the transaction at least equals 102 percent of the fair value of the loaned securities.

b. In the event that foreign securities are loaned and the denomination of the currency of the collateral is other than the denomination of the currency of the loaned foreign securities, the amount of collateral shall be at least equal to 105 percent of the fair value of the loaned securities at that date. If at any time the fair value is less than 102 percent of the fair value of the loaned securities, the reporting entity must obtain additional collateral, the fair value of which together with the fair value of all collateral then held in connection with the transaction at least equals 105 percent of the fair value of the loaned securities.

26. Securities lending transactions are generally initiated by broker-dealers and other financial institutions that need specific securities to cover a short sale or a customer's failure to deliver securities sold. Transferees (borrowers) of securities generally are required to provide collateral to the transferor (lender) of securities, commonly cash but sometimes other securities or standby letters of credit, with a value slightly higher than that of the securities borrowed. If the collateral is cash, the transferor typically earns a return by investing that cash at rates higher than the rate paid or rebated to the transferee. If the collateral is other than cash, the transferor typically receives a fee. Securities custodians or other agents commonly carry out securities lending activities on behalf of clients. Because of the protection of collateral (typically valued daily and adjusted frequently for changes in the market price of the securities transferred) and the short terms of the transactions, most securities lending transactions in themselves do not impose significant credit risks on either party. Other risks arise from what the parties to the transaction do with the assets they receive. For example, investments made with cash collateral impose market and credit risks on the transferor.

27. Securities lending transactions are accompanied by an agreement that entitles and obligates the transferor to repurchase or redeem the transferred assets before their maturity under which the transferor maintains effective control over those assets (see paragraphs 15-18). Those transactions shall be accounted for as secured borrowings, in which cash (or securities that the holder is permitted by contract or custom to sell or repledge) received as collateral is considered the amount borrowed, the securities loaned are considered pledged as collateral against the cash borrowed, and any rebate paid to the transferee of securities is interest on the cash the transferor is considered to have borrowed. Collateral provided in securities lending transactions that are accounted for as secured borrowings shall be reported and disclosed like other collateral, as set forth in paragraphs 10 and 25.

28. In some transactions, characterized as securities lending, all of the criteria in paragraph 3 are met. During the term of such agreements, the transferor has surrendered control over the securities transferred and the transferee has obtained control over those securities, with the ability to sell or transfer them at will. In that case, creditors of the transferor have a claim only to the collateral and the forward repurchase commitment. Those transactions shall be accounted for:

a. By the transferor as a sale of the loaned securities, for proceeds consisting of the collateral and a forward repurchase commitment. (If the collateral is a financial asset that the holder is permitted to sell or repledge and the debtor does not have the right and ability to redeem the collateral on short notice, e.g., by substituting other collateral or terminating the contract, that financial asset is proceeds of the sale of the loaned securities. To the extent that the collateral consists of letters of credit or other financial instruments that the holder is not permitted to sell or pledge, a securities lending transaction does not satisfy the sale criteria and is accounted for as a loan of securities by the transferor to the transferee); and

b. By the transferee as a purchase of the borrowed securities in exchange for the collateral and a forward resale commitment.

Loan Syndications

29. Borrowers often borrow amounts greater than any one lender is willing to lend. Therefore, it is common for groups of lenders to jointly fund those loans. That may be accomplished by a syndication under which several lenders share in lending to a single borrower, but each lender loans a specific amount to the borrower and has the right to repayment from the borrower.

30. Each lender in the syndication shall account for the amounts it is owed by the borrower. Repayments by the borrower may be made to a lead lender who then distributes the collections to the other lenders of the syndicate. In those circumstances, the lead lender is also functioning as a servicer and, therefore, shall only recognize its portion of the loan as an asset.

Loan Participations

31. Groups of banks or other entities also may jointly fund large borrowings through loan participations in which a single lender makes a large loan to a borrower and subsequently transfers undivided interests in the loan to other entities.

32. Transfers by the originating lender may take the legal form of either assignments or participations. The transfers are usually on a nonrecourse basis, and the transferor (originating lender) continues to service the loan. The transferee (participating entity) may or may not have the right to sell or transfer its participation during the term of the loan, depending upon the terms of the participation agreement.

33. If the loan participation agreement gives the transferee the right to pledge or exchange those participations and the other criteria in paragraph 3 are met, the transfers to the transferee shall be accounted for by the transferor as sales of financial assets. A transferor’s right of first refusal on a bona fide offer from a third party, a requirement to obtain the transferor’s permission that shall not be unreasonably withheld, or a prohibition on sale to the transferor’s competitor is a limitation on the transferee’s rights but presumptively does not constrain a transferee from exercising its right to pledge or exchange. However, if the loan participation agreement constrains the transferees from pledging or exchanging their participations, the transferor has not relinquished control over the loan and shall account for the transfers as secured borrowings.

Factoring Arrangements

34. Factoring arrangements are a means of discounting accounts receivable on a nonrecourse, notification basis. Accounts receivable are sold outright, usually to a transferee (the factor) that assumes the full risk of collection, without recourse to the transferor in the event of a loss. Debtors are directed to send payments to the transferee. Factoring arrangements that meet the criteria in paragraph 3 shall be accounted for as sales of financial assets because the transferor surrenders control over the receivables to the factor.

Transfers of Receivables with Recourse

35. In a transfer of receivables with recourse, the transferor is obligated under the terms of the recourse provision to make payments to the transferee or to repurchase receivables sold under certain circumstances, typically for defaults up to a specified percentage. A transfer of receivables with recourse shall not be recognized as a sale but rather, as a financing. A transfer of receivables without recourse shall only be recognized if the transferor receives cash for the receivables. The sale shall be recognized when cash is received. Sales of premium receivables are addressed in SSAP No. 42.

Disclosures

36. A reporting entity shall disclose the following:

    a. If it is not practicable to estimate the fair value of certain assets obtained or liabilities incurred in transfers of financial assets during the period, a description of those items and the reasons why it is not practicable to estimate their fair value;

    b. Description of any loaned securities, including the amount, a description of, and the policy for, requiring collateral, and whether or not the collateral is restricted; and

    c. For all servicing assets and servicing liabilities:

        i. The amounts of servicing assets nonadmitted or liabilities recognized and amortized during the period; and

        ii. The fair value of servicing liabilities for which it is practicable to estimate that value and the method and significant assumptions used to estimate the fair value.

37. A reporting entity shall disclose the following information for wash sales, as defined in paragraph 7, involving transactions for securities with a NAIC designation of 3 or below, or unrated:

    a. A description of the reporting entity's objectives regarding these transactions;

    b. An aggregation of transactions by NAIC Designation 3 or below, or unrated;

    c. The number of transactions involved during the reporting period;

    d. The book value of securities sold;

    e. The cost of securities repurchased; and

    f. The realized gains/losses associated with the securities involved.

38. Refer to the preamble for further discussion regarding disclosure requirements. The disclosures required by paragraph 37 shall be made for the current quarter in the quarterly statement and for the year in the annual statement.

Relevant Literature

39. This statement adopts FAS 125 with modification to paragraphs 9, 10.a., 11.d., 13, 15-17, 35-41, and 68. Additionally, paragraphs 14, 59-60, 77-81, and 83 are rejected. The modifications to FAS 125 primarily relate to (a) the nonadmission of servicing rights assets, (b) the accounting for repurchase agreements, reverse repurchase agreements, and dollar repurchase agreements, (c) the accounting for realized gains and losses for reporting entities required to maintain an IMR, (d) the accounting for financial assets subject to prepayment, (e) the accounting for assets pledged as collateral, (f) the accounting for leases in accordance with *SSAP No. 22—Leases*, and (g) the accounting for sales of receivables with recourse. Paragraphs 77-81 are rejected because they are not applicable to the insurance industry.

40. This statement adopts AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as used In Certain Audit Guides and a Statement of Position. This statement adopts FASB Emerging Issues Task Force

No. 87-34, Sale of Mortgage Servicing Rights with a Subservicing Agreement, FASB Emerging Issues Task Force No. 88-11, Allocation of Recorded Investment When a Loan as Part of a Loan is Sold, FASB Emerging Issues Task Force No. 88-18, Sales of Future Revenues, FASB Emerging Issues Task Force No. 88-22, Securitization of Credit Card and Other Receivable Portfolios, FASB Emerging Issues Task Force No. 90-21, Balance Sheet Treatment of a Sale of Mortgage Servicing Rights with a Subservicing Agreement, FASB Emerging Issues Task Force No. 95-5, Determination of What Risks and Rewards, If Any, Can Be Retained and Whether Any Unresolved Contingencies May Exist in a Sale of Mortgage Loan Servicing Rights and FASB Emerging Issues Task Force No. 96-19, Debtor's Accounting for a Modification or Exchange of Debt Instruments.

41. This statement rejects FASB Statement No. 127, Deferral of the Effective Date of Certain Provisions of FASB Statement No. 125, an amendment of FASB Statement No. 125, FASB Emerging Issues Task Force No. 84-5, Sale of Marketable Securities with a Put Option, FASB Emerging Issues Task Force No. 92-2, Measuring Loss Accruals by Transferors of Receivables with Recourse, and FASB Emerging Issues Task Force No. 96-20, Impact of FASB Statement No. 125 on Consolidation of Special-Purpose Entities.

Effective Date and Transition

42. This statement shall be effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after January 1, 2001, and shall be applied prospectively.

43. For each servicing contract in existence before January 1, 2001, previously recognized or nonadmitted servicing rights and excess servicing receivables shall be combined, net of any previously recognized servicing obligations under that contract, as a servicing asset (nonadmitted) or liability. Thereafter, the subsequent measurement provisions of this statement shall be applied to the servicing assets (nonadmitted) or liabilities for those servicing contracts.

101. SSAP No. 33 provides the following guidance:

Accounting for Securitizations of Financial Assets

3. A financial asset shall be defined as cash, evidence of an ownership interest in an entity, or a contract that both

a. Imposes on one entity a contractual obligation (i) to deliver cash or another financial instrument to a second entity or (ii) to exchange other financial instruments on potentially unfavorable terms with the second entity; and

b. Conveys to that second entity a contractual right (i) to receive cash or another financial instrument from the first entity or (ii) to exchange other financial instruments on potentially favorable terms with the first entity.

4. A securitization in which the transferor surrenders control over the financial asset transferred shall be accounted for as a sale, with recognition of proceeds and measurement of a gain or loss only to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The portion of the securitization for which beneficial interests in the transferred assets are received shall not be accounted for as a sale, but shall be treated as an exchange of assets with no measurement of a gain or loss. All other securitizations shall be accounted for as secured borrowings in accordance with paragraph 11.

5. The transferor has surrendered control if, and only if, all of the following conditions are met:

a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership;

b. The transferee is a qualifying special-purpose entity and the holders of beneficial interests in that entity have the right—free of transferor-imposed conditions that constrain them from taking advantage of that right—to pledge or exchange those interests; and

c. The transferor does not maintain effective control over the transferred assets through (i) an agreement that entitles and obligates the transferor to repurchase or redeem them before their maturity, or (ii) an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable.

6. A beneficial interest shall be defined as the right to receive all or portions of specified cash inflows to a trust or other entity, including senior and subordinated shares of interest or principal inflows to be "passed through" or "paid through," premiums due guarantors, and residual interests. Residual interests are interests in the cash flows of the trust or other entity, after the cash flows of structured securities issued by the trust are met.

7. Upon completion of the securitization of financial assets meeting the criteria for sales treatment required by paragraph 5, the transferor shall:

a. Eliminate the transferred assets from the statement of financial position;

b. Allocate the previous carrying amount of the transferred assets to the securities representing beneficial interests retained by the reporting entity, if any, and the securities representing beneficial interests not retained, if any, based on the relative fair values of the transferred assets at the date of transfer;

c. Record in its statement of financial position, the allocated carrying value of the securities representing retained beneficial interests in the assets (e.g., loan-backed securities);

d. Recognize all additional assets obtained (i.e., other than the securities representing retained beneficial interests which are recorded in accordance with 7 c.) and liabilities incurred in consideration as proceeds of the sale;

e. Initially measure such additional assets obtained and liabilities incurred in the sale at fair value; and

f. For reporting entities required to maintain an Interest Maintenance Reserve (IMR), the accounting for realized capital gains and losses shall be in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*. For reporting entities not required to maintain an IMR, realized gains and losses shall be reported as net realized capital gains or losses line in the Investment Income section of the Underwriting and Investment Exhibit.

8. The successor (transferee) shall recognize all assets obtained and any liabilities incurred and initially measure them at fair value.

9. A qualifying special-purpose entity (including a CMO special-purpose entity) as used in this statement must meet all of the following conditions:

a. It is a trust, corporation, or other legal vehicle whose activities are permanently limited by the legal documents establishing the special-purpose entity to:

i. Holding title to transferred financial assets;

ii. Issuing beneficial interests (If some of the beneficial interests are in the form of debt securities or equity securities, the transfer of assets is a securitization.);

iii. Collecting cash proceeds from assets held, reinvesting proceeds in financial instruments pending distribution to holders of beneficial interests, and otherwise servicing the assets held; and

iv. Distributing proceeds to the holders of its beneficial interests.

b. It has a standing at law distinct from the transferor. Having standing at law depends in part on the nature of the special-purpose entity. For example, generally, under U.S. law, if a transferor of assets to a special-purpose trust holds all of the beneficial interests, it can unilaterally dissolve the trust, and thereby resume control over the individual assets held in the trust, and the transferor can effectively assign its interest and its creditors can reach it. In that circumstance, the trust has no standing at law, is not distinct, and thus is not a qualified special-purpose entity. A special-purpose entity that has distinct standing at law may still be an affiliate of the transferor.

Investments in Special-Purpose Entities

10. Reporting entities that have qualifying special-purpose entities as affiliates shall carry their investment in such entity at its underlying statutory book value in accordance with *SSAP No. 46—Investments in Subsidiary, Controlled, and Affiliated Entities*. Additionally, transactions entered involving affiliated qualifying special-purpose entities are subject to the provisions of *SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties*.

Secured Obligations and Collateral

11. Securitizations of financial assets that do not meet the criteria for sale treatment set forth in paragraph 5 shall be presumed to be secured borrowings and shall be recorded as follows. Financial assets shall remain on the reporting entity's books and a liability shall be recorded to reflect the proceeds from the issuance of any type of certificate. Non-cash proceeds shall be recorded as a contra liability and netted against the liability. The liability shall be reduced as the obligation to holders of beneficial interests is repaid. Financial assets pledged as collateral shall not be offset against the liability reflecting the proceeds of the transaction.

Recognition of Servicing Rights

12. Servicing rights become a distinct asset or liability only when contractually separated from the underlying assets by sale or securitization of the assets with servicing retained or separate purchase or assumption of the servicing. If distinct servicing rights to transferred assets exist and are retained by the reporting entity, the reporting entity shall recognize a servicing asset or liability. When the servicing fees to be received exceed the cost of servicing the transferred assets, a servicing asset is recognized and nonadmitted. When the cost of servicing the transferred assets is greater than the servicing fees to be received, a liability shall be recorded for the excess to recognize this obligation. A corresponding loss shall be recorded through the Summary of Operations. The servicing asset or liability shall be amortized into income in proportion to, and over the period of estimated servicing income (if an asset) or estimated servicing loss (if a liability). The servicing asset or liability shall be measured in a manner consistent with paragraphs 13 and 35-38 of *FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 125).

Sales of Future Revenues

13. In addition to securitization of assets, some reporting entities have entered into transactions characterized as a sale of future revenues. These transactions are sometimes referred to as securitizations and are sometimes characterized as selling deferred acquisition costs. A sale of future revenues by a reporting entity shall not result in the immediate recognition of income or surplus. The proceeds of any such sale shall be established as a liability and shall be reduced as the proceeds are repaid.

Relevant Literature

14. This statement adopts portions of FAS 125, with the following modifications (FAS 125 is addressed in its entirety in *SSAP No. 18—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities)*:

    a. This statement requires servicing rights assets to be nonadmitted;

    b. This statement does not permit sales treatment for transactions where recourse provisions exist or where “call” or “put” options exist on the transferred assets whereas GAAP would permit the recognition of the transfer as a sale under some circumstances;

    c. This statement requires debtors to provide disclosure when a secured party is permitted to sell or pledge financial assets transferred as collateral whereas FAS 125 requires the encumbered assets to be reported separately from unencumbered assets;

    d. This statement does not address transfers of financial assets accomplished in a manner other than through securitizations whereas FAS 125 does address such transfers; and

    e. Paragraph 14 is rejected as it is not applicable.

Effective Date and Transition

15. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*.

102. SSAP No. 45 provides the following guidance:

> 2. Repurchase agreements, reverse repurchase agreements and dollar repurchase agreements meet the definition of assets as defined in *SSAP No. 4—Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this statement.
>
> **Repurchase Agreements**
>
> 3. Repurchase agreements are defined as agreements under which a reporting entity purchases securities and simultaneously agrees to resell the same or substantially the same securities at a stated price on a specified date within 12 months of the purchase. For securities to be substantially the same, the criteria defined in paragraph 14 must be met, and for mortgage-backed securities excluding mortgage pass-through securities, the projected cash flows of the securities must be substantially the same under multiple scenario prepayment assumptions.
>
> 4. Repurchase agreements shall be accounted for as collateralized lendings. The underlying securities shall not be accounted for as investments owned by the reporting entity. The amount paid for the securities shall be reported as a short-term investment, and the difference between the amount paid and the amount at which the securities will be subsequently resold shall be reported as interest income, calculated on the straight-line method or the scientific interest (constant yield) method, over the term of the agreement.
>
> 5. Reporting entities generally take possession of the underlying collateral under repurchase agreements and in many cases may obtain additional collateral when the estimated fair value of such securities falls below their current contract value. However, to the extent that the current fair value of the collateral is less than the recorded amount, the shortfall shall reduce the admitted asset value of the repurchase agreement.
>
> **Reverse Repurchase Agreements**
>
> 6. Reverse repurchase agreements are defined as agreements under which a reporting entity sells securities and simultaneously agrees to repurchase the same or substantially the same securities at a stated price on a specified date within 12 months of the sale date. For securities to be substantially the same, the criteria defined in paragraph 13 must be met, and for mortgage-backed securities excluding mortgage pass-through securities, the projected cash flows of the securities must be substantially the same under multiple scenario prepayment assumptions.
>
> 7. Reverse repurchase agreements shall be accounted for as collateralized borrowings (financing transactions). The underlying securities shall continue to be accounted for as an investment by the reporting entity. The proceeds from the sale of the securities shall be recorded as a liability, and the difference between the proceeds and the amount at which the securities will be subsequently reacquired shall be reported as interest expense, calculated on the straight-line method or the scientific interest (constant yield) method, over the term of the agreement. Although recording these transactions gross tends to inflate assets and liabilities, it more closely reflects the financing nature of the transactions and their associated leverage impact to the financial statements.
>
> **Collateral Requirements**
>
> 8. The collateral requirements for repurchase and reverse repurchase agreements are as follows:
>
> Repurchase Transaction

a. The reporting entity shall receive as collateral transferred securities having a fair value at least equal to 102 percent of the purchase price paid by the reporting entity for the securities. If at any time the fair value of the collateral is less than 100 percent of the purchase price paid by the reporting entity, the counterparty shall be obligated to provide additional collateral, the fair value of which, together with fair value of all collateral then held in connection with the transaction, at least equals 102 percent of the purchase price.

Reverse Repurchase Transaction

b. The reporting entity shall receive collateral having a fair value as of the transaction date at least equal to 95 percent of the fair value of the securities transferred by the reporting entity in the transaction as of that date. If at anytime the fair value of the collateral is less than 95 percent of the fair value of the securities so transferred, the counterparty shall be obligated to deliver additional collateral, the fair value of which, together with the fair value of all collateral then held in connection with the transaction, at least equals 95 percent of the fair value of the transferred securities.

Dollar Repurchase Agreements

9. Dollar repurchase and dollar reverse repurchase agreements are defined as repurchase and reverse repurchase agreements involving debt instruments that are pay-through securities collateralized with Government National Mortgage Association (GNMA), Federal Home Loan Mortgage Corporation (FHLMC) and Federal National Mortgage Association (FNMA) collateral, and pass-through certificates sponsored by GNMA, mortgage participation certificates issued by the FHLMC or similar securities issued by the FNMA. Dollar repurchase agreements are also commonly referred to as dollar roll transactions. To meet the definition of dollar repurchase and dollar reverse repurchase agreements, the securities underlying the agreements must meet the criteria defined in paragraph 13, and for mortgage-backed securities excluding mortgage pass-through securities, the projected cash flows of the securities must be substantially the same under multiple scenario prepayment assumptions.

10. For the seller in a dollar reverse repurchase agreement, a liability is recorded for the amount of proceeds of the sale and the sold mortgage-backed securities are not removed from the accounting records. During the period of the agreement, interest income is recorded as if the mortgage-backed security had been held during the term of the agreement. This is offset by an equal amount of interest expense related to the proceeds received from the sale. Additional interest expense is recorded representing the difference between the sales price and the repurchase price of the mortgage-backed securities sold.

11. When the mortgage-backed securities are repurchased under the agreement, the original mortgage-backed securities sold are removed from the accounting records and the purchased mortgage-backed securities are recorded. The principal amount of the mortgage-backed securities repurchased must be in good delivery form consistent with paragraph 13.

12. If the principal amount repurchased is greater than the amount sold, the cash paid is recorded as an additional investment in the newly acquired certificates. If the principal amount repurchased is less than the amount sold, a gain or loss relating to the original certificates held is recorded.

13. For the purchaser in a dollar repurchase agreement, an asset is recorded for the amount of the purchase. Since the term of the agreement is limited to twelve months, it is accounted for as a short-term investment. Upon completion of the reverse repurchase agreement, cash is received in exchange for a “substantially the same” security. The

difference between the purchase and reselling price represents interest income for the lending of short-term funds.

Criteria to Meet Substantially the Same

14. For debt instruments, including mortgage-backed securities, to be substantially the same, all the following criteria must be met:

a. The debt instruments must have the same primary obligor, except for debt instruments guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and terms of the guarantee must be the same;

b. The debt instruments must be identical in form and type so as to give the same risks and rights to the holder;

c. The debt instruments must bear the identical contractual interest rate;

d. The debt instruments must have the same maturity except for mortgage-backed pass-through and pay-through securities for which the mortgages collateralizing the securities must have similar remaining weighted average maturities (WAMs) that result in approximately the same market yield;

e. Mortgage-backed pass-through and pay through securities must be collateralized by a similar pool of mortgages, such as single-family residential mortgages; and

f. The debt instruments must have the same aggregate unpaid principal amounts, except for mortgage-backed pass-through and pay-through securities, where the aggregate principal amounts of the mortgage-backed securities given up and the mortgage-backed securities reacquired must be within the accepted “good delivery” standard for the type of mortgage-backed security involved.

Separate Transactions

15. Agreements to repurchase and resell securities that do not meet the definitions in paragraph 3, 6, or 8 of this statement shall be accounted for as two separate transactions, that is, as a sale and purchase or as a purchase and sale, in accordance with the relevant statutory accounting guidance. For example, sales of bonds would result in recognition of realized gains or losses.

Offsetting

16. Reporting entities may operate on both sides of the repurchase agreement market resulting in recording of liabilities and assets representing repurchase and reverse repurchase agreements, respectively.

17. Reporting entities shall offset such liabilities and assets only to the extent that one of the following occurs:

a. A legal right of offset exists as defined in *SSAP No. 64—Offsetting and Netting of Assets and Liabilities* (SSAP No. 64), or

b. The securities have the same settlement date, are executed with the same counterparty in accordance with a master netting arrangement, involve securities that exist in “book entry” form, and settle on securities transfer systems that have the same key elements and operating characteristics as the Fedwire Securities Transfer System.

Otherwise, separate assets and liabilities shall be recognized.

Disclosures

18. The following disclosures shall be made in the financial statements:

a. If the reporting entity has entered into repurchase agreements, its policy for requiring collateral or other security;

b. A description of the securities underlying the agreements, including book values and fair values, maturities, and weighted average interest rates for the following categories: (i) securities subject to reverse repurchase agreements; (ii) securities subject to repurchase agreements; (iii) securities subject to dollar repurchase agreements; and (iv) securities subject to dollar reverse repurchase agreements; and

c. A description of the terms of reverse repurchase agreements whose amounts are included in borrowed money.

19. Refer to the preamble for further discussion regarding disclosure requirements.

Relevant Literature

20. This statement adopts AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as Used In Certain Audit Guides and a Statement of Position.

21. This statement adopts paragraphs 9-13, 15-17, 23-25, 27-30 and 66-71 of *FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 125), as they relate to repurchase agreements, reverse repurchase agreements and dollar repurchase agreements.

22. This statement adopts FASB Emerging Issues Task Force No. 84-20, GNMA Dollar Rolls. This statement is consistent with FASB Interpretation No. 39, Offsetting of Amounts Related to Certain Contracts—an interpretation of APB Opinion No. 10 and FASB Statement No. 105 (FIN 39) (as it relates to reverse repurchase and repurchase agreements) and FASB Interpretation No. 41, Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements—an interpretation of APB Opinion No. 10 and a modification of FASB Interpretation No. 39 (FIN 41). FIN 39 and FIN 41 are adopted in SSAP No. 64.

23. This statement rejects paragraph 14 of FAS 125 as it relates to the classifications of securities under *FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities* (FAS 115). FAS 115 is rejected in *SSAP No. 26—Bonds, excluding Loan-backed and Structured Securities*.

Effective Date and Transition

24. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*.

103. *INT 01-31: Assets Pledged as Collateral* (INT 01-31) provides the following guidance:

INT 01-31 Issue

1. Insurers may enter into certain transactions that require the granting of a security interest in certain assets to another party to serve as collateral for their performance under a contract. The arrangement is commonly referred to as a pledge, typically accomplished by delivery of assets to the secured party or to an independent custodian. In these transactions, the pledging

insurer typically (1) continues to receive the income on the pledged collateral and (2) can remove and substitute other securities with little or no advance notice to the secured party as long as they comply with related investment quality and market value agreement provisions. Examples include collateral pledged under investment, derivative, debt obligations and policyholder transactions.

2. Specific examples of collateral pledged for derivative and investment transactions include but are not limited to: (1) securities posted with a broker as margin for futures and options transactions, (2) securities pledged to secure credit exposure with swap counterparties, (3) securities pledged under reverse repurchase agreements or securitizations that are accounted for as secured borrowing transactions and (4) securities pledged under securities lending transactions.

3. Specific examples of collateral pledged for debt obligations and policyholder transactions include but are not limited to assets pledged to secure (1) debt borrowings from or insurance contracts issued to banking entities and (2) insurance contracts issued to governmental entities such as municipalities.

4. Under these transactions, the fair value of the securities pledged as collateral may exceed the contract balance (swap fair value, advance balance, policyholder account balance, etc). For this interpretation, this excess carrying value of securities pledged over the corresponding asset or contract balance is called the “overcollateralization” amount.

5. The accounting issue is whether the assets pledged as collateral under the various transactions mentioned above should be considered admitted assets.

INT 01-31 Discussion

6. The working group reached a consensus that if the collateral had not been pledged in the examples described above, it is assumed the underlying asset would be recorded as an admitted asset under SSAP No. 4 (e.g. they are readily marketable assets available to meet both current and future policyholder obligations). In addition, it is assumed that the asset would not be considered impaired under SSAP No. 5 due to a default, market value decline, or other loss contingency.

7. Therefore, for the examples described above, the pledging insurer would record the collateral (including the overcollateralization amount) as an admitted asset until they have committed a contract default that has not been cured in accordance with the contract provisions. This accounting is in accordance with the provisions of SSAP Nos. 18, 33 and 45. This consensus of reporting collateral as an admitted asset is further supported by SSAP Nos. 4 and 5 since generally, the insurer can readily substitute pledged assets. Additionally, an insurer may typically unwind the transaction allowing the assets to be available to the pledging insurer to meet policyholder obligations. Furthermore, no event has occurred to indicate an impairment or potential loss contingency with respect to such pledged assets. The fact that some pledged assets may constitute an overcollaterlization amount does not change this analysis. Accordingly, all assets pledged in support of these type transactions should also be admitted.

8. At the time of an uncured default, the provisions of paragraph 10 of SSAP No. 18 shall be used to determine the appropriate accounting treatment for the collateral. If the secured party utilizes collateral to offset all or a portion of the liability owed by the pledging insurer as a result of the default, then the collateral amount utilized to offset the liability shall be removed from the balance sheet. At the same time, the amount of the liability that was offset should be removed from the balance sheet since that obligation has been satisfied through the secured party’s utilization of that collateral. To the extent that an uncured default remains without the secured party utilizing the collateral to offset the obligation, the pledging insurer should only record an admitted asset for the amount of collateral that it can redeem.

INT 01-31 Status

9. The consensus position of this interpretation is consistent with the position of the NAIC Invested Asset (E) Working Group. This interpretation will be reviewed by the FAS 140 Subgroup of the NAIC Statutory Accounting Principles (E) Working Group in conjunction of its consideration of incorporating GAAP pronouncement *FAS 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, a replacement of FASB Statement 125* into the statutory accounting model. As such, this interpretation is subject to amendment pending disposition of the FAS 140 Subgroup's review of collateral and FAS 140 in its entirety.

Generally Accepted Accounting Principles

104. FAS 140 provides the following guidance:

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Accounting for Transfers and Servicing of Financial Assets

9. A transfer of financial assets (or all or a portion of a financial asset) in which the transferor surrenders control over those financial assets shall be accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if and only if all of the following conditions are met:

a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership (paragraphs 27 and 28).
b. Each transferee (or, if the transferee is a qualifying SPE (paragraph 35), each holder of its beneficial interests) has the right to pledge or exchange the assets (or beneficial interests) it received, and no condition both constrains the transferee (or holder) from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor (paragraphs 29-34).
c. The transferor does not maintain effective control over the transferred assets through either (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (paragraphs 47-49) or (2) the ability to unilaterally cause the holder to return specific assets, other than through a cleanup call (paragraphs 50-54).

10. Upon completion of any transfer of financial assets, the transferor shall:

a. Continue to carry in its statement of financial position any retained interest in the transferred assets, including, if applicable, servicing assets (paragraphs 61-67), beneficial interests in assets transferred to a qualifying SPE in a securitization (paragraphs 73-84), and retained undivided interests (paragraphs 58 and 59)
b. Allocate the previous carrying amount between the assets sold, if any, and the retained interests, if any, based on their relative fair values at the date of transfer (paragraphs 56-60).

11. Upon completion 3 of a transfer of assets that satisfies the conditions to be accounted for as a sale (paragraph 9), the transferor (seller) shall:

a. Derecognize all assets sold
b. Recognize all assets obtained and liabilities incurred in consideration as proceeds of the sale, including cash, put or call options held or written (for example, guarantee or recourse obligations), forward commitments (for example, commitments to deliver additional receivables during the revolving periods of some securitizations), swaps (for example, provisions that convert interest rates from fixed to variable), and servicing liabilities, if applicable (paragraphs 56, 57, and 61-67)

c. Initially measure at fair value assets obtained and liabilities incurred in a sale (paragraphs 68-70) or, if it is not practicable to estimate the fair value of an asset or a liability, apply alternative measures (paragraphs 71 and 72)
d. Recognize in earnings any gain or loss on the sale.

The transferee shall recognize all assets obtained and any liabilities incurred and initially measure them at fair value (in aggregate, presumptively the price paid).

12. If a transfer of financial assets in exchange for cash or other consideration (other than beneficial interests in the transferred assets) does not meet the criteria for a sale in paragraph 9, the transferor and transferee shall account for the transfer as a secured borrowing with pledge of collateral (paragraph 15).

Recognition and Measurement of Servicing Assets and Liabilities

13. Each time an entity undertakes an obligation to service financial assets it shall recognize either a servicing asset or a servicing liability for that servicing contract, unless it transfers the assets to a qualifying SPE in a guaranteed mortgage securitization, retains all of the resulting securities, and classifies them as debt securities held-to-maturity in accordance with *FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities*. If the servicing asset or liability was purchased or assumed rather than undertaken in a sale or securitization of the financial assets being serviced, it shall be measured initially at its fair value, presumptively the price paid. A servicing asset or liability shall be amortized in proportion to and over the period of estimated net servicing income (if servicing revenues exceed servicing costs) or net servicing loss (if servicing costs exceed servicing revenues). A servicing asset or liability shall be assessed for impairment or increased obligation based on its fair value (paragraphs 61-64).

Financial Assets Subject to Prepayment

14. Interest-only strips, retained interests in securitizations, loans, other receivables, or other financial assets that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment, except for instruments that are within the scope of Statement 133, shall be subsequently measured like investments in debt securities classified as available-for-sale or trading under Statement 115, as amended (paragraph 362).

Secured Borrowings and Collateral

15. A debtor may grant a security interest in certain assets to a lender (the secured party) to serve as collateral for its obligation under a borrowing, with or without recourse to other assets of the debtor. An obligor under other kinds of current or potential obligations, for example, interest rate swaps, also may grant a security interest in certain assets to a secured party. If collateral is transferred to the secured party, the custodial arrangement is commonly referred to as a pledge. Secured parties sometimes are permitted to sell or repledge (or otherwise transfer) collateral held under a pledge. The same relationships occur, under different names, in transfers documented as sales that are accounted for as secured borrowings (paragraph 12). The accounting for noncash 4 collateral by the debtor (or obligor) and the secured party depends on whether the secured party has the right to sell or repledge the collateral and on whether the debtor has defaulted.

a. If the secured party (transferee) has the right by contract or custom to sell or repledge the collateral, then the debtor (transferor) shall reclassify that asset and report that asset in its statement of financial position separately (for example, as security pledged to creditors) from other assets not so encumbered.
b. If the secured party (transferee) sells collateral pledged to it, it shall recognize the proceeds from the sale and its obligation to return the collateral. The sale of the collateral is a transfer subject to the provisions of this Statement.
c. If the debtor (transferor) defaults under the terms of the secured contract and is no longer entitled to redeem the pledged asset, it shall derecognize the pledged asset,

and the secured party (transferee) shall recognize the collateral as its asset initially measured at fair value or, if it has already sold the collateral, derecognize its obligation to return the collateral.

d. Except as provided in paragraph 15.c., the debtor (transferor) shall continue to carry the collateral as its asset, and the secured party (transferee) shall not recognize the pledged asset.

Extinguishments of Liabilities

16. A debtor shall derecognize a liability if and only if it has been extinguished. A liability has been extinguished if either of the following conditions is met:

a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes delivery of cash, other financial assets, goods, or services or reacquisition by the debtor of its outstanding debt securities whether the securities are canceled or held as so-called treasury bonds.

b. The debtor is legally released 5 from being the primary obligor under the liability, either judicially or by the creditor.

Disclosures

17. An entity shall disclose the following:

a. For collateral:

(1) If the entity has entered into repurchase agreements or securities lending transactions, its policy for requiring collateral or other security

(2) If the entity has pledged any of its assets as collateral that are not reclassified and separately reported in the statement of financial position pursuant to paragraph 15.a., the carrying amount and classification of those assets as of the date of the latest statement of financial position presented

(3) If the entity has accepted collateral that it is permitted by contract or custom to sell or repledge, the fair value as of the date of each statement of financial position presented of that collateral and of the portion of that collateral that it has sold or repledged, and information about the sources and uses of that collateral

b. If debt was considered to be extinguished by in-substance defeasance under the provisions of *FASB Statement No. 76, Extinguishment of Debt*, prior to the effective date of Statement 125, 6 a general description of the transaction and the amount of debt that is considered extinguished at the end of the period so long as that debt remains outstanding

c. If assets are set aside after the effective date of Statement 125 solely for satisfying scheduled payments of a specific obligation, a description of the nature of restrictions placed on those assets

d. If it is not practicable to estimate the fair value of certain assets obtained or liabilities incurred in transfers of financial assets during the period, a description of those items and the reasons why it is not practicable to estimate their fair value

e. For all servicing assets and servicing liabilities:

(1) The amounts of servicing assets or liabilities recognized and amortized during the period

(2) The fair value of recognized servicing assets and liabilities for which it is practicable to estimate that value and the method and significant assumptions used to estimate the fair value

(3) The risk characteristics of the underlying financial assets used to stratify recognized servicing assets for purposes of measuring impairment in accordance with paragraph 63

(4) The activity in any valuation allowance for impairment of recognized servicing assets—including beginning and ending balances, aggregate additions charged and reductions credited to operations, and aggregate direct write-downs charged against the allowances—for each period for which results of operations are presented.

f. If the entity has securitized financial assets during any period presented and accounts for that transfer as a sale, for each major asset type (for example, mortgage loans, credit card receivables, and automobile loans):
   (1) Its accounting policies for initially measuring the retained interests, if any, including the methodology (whether quoted market price, prices based on sales of similar assets and liabilities, or prices based on valuation techniques) used in determining their fair value (paragraphs 68-70)
   (2) The characteristics of securitizations (a description of the transferor's continuing involvement with the transferred assets, including, but not limited to, servicing, recourse, and restrictions on retained interests) and the gain or loss from sale of financial assets in securitizations
   (3) The key assumptions 7 used in measuring the fair value of retained interests at the time of securitization (including, at a minimum, quantitative information about discount rates, expected prepayments including the expected weighted-average life of prepayable financial assets, 8 and anticipated credit losses, if applicable)
   (4) Cash flows between the securitization SPE and the transferor, unless reported separately elsewhere in the financial statements or notes (including proceeds from new securitizations, proceeds from collections reinvested in revolving-period securitizations, purchases of delinquent or foreclosed loans, servicing fees, and cash flows received on interests retained)

g. If the entity has retained interests in securitized financial assets at the date of the latest statement of financial position presented, for each major asset type (for example, mortgage loans, credit card receivables, and automobile loans):
   (1) Its accounting policies for subsequently measuring those retained interests, including the methodology (whether quoted market price, prices based on sales of similar assets and liabilities, or prices based on valuation techniques) used in determining their fair value (paragraphs 68-70)
   (2) The key assumptions used in subsequently measuring the fair value of those interests (including, at a minimum, quantitative information about discount rates, expected prepayments including the expected weighted-average life of prepayable financial assets, and anticipated credit losses, including expected static pool losses, 9 if applicable)
   (3) A sensitivity analysis or stress test showing the hypothetical effect on the fair value of those interests of two or more unfavorable variations from the expected levels for each key assumption that is reported under (2) above independently from any change in another key assumption, and a description of the objectives, methodology, and limitations of the sensitivity analysis or stress test
   (4) For the securitized assets and any other financial assets that it manages together with them: 10
      (a) The total principal amount outstanding, the portion that has been derecognized, and the portion that continues to be recognized in each category reported in the statement of financial position, at the end of the period
      (b) Delinquencies at the end of the period
      (c) Credit losses, net of recoveries, during the period

   Disclosure of average balances during the period is encouraged, but not required.

Implementation Guidance

18. Appendix A describes certain provisions of this Statement in more detail and describes their application to certain types of transactions. Appendix A is an integral part of the standards provided in this Statement.

Effective Date and Transition

19. Except as provided in paragraphs 20-25, this Statement shall be effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after March 31, 2001.

This Statement shall be applied prospectively, 11 except as provided in paragraphs 20, 21, 23, and 24. Earlier or retroactive application of this Statement is not permitted.

20. For each servicing contract in existence before January 1, 1997, previously recognized servicing rights and "excess servicing" receivables that do not exceed contractually specified servicing fees shall be combined, net of any previously recognized servicing obligations under that contract, as a servicing asset or liability. Previously recognized servicing receivables that exceed contractually specified servicing fees shall be reclassified as interest-only strips receivable. Thereafter, the subsequent measurement provisions of this Statement shall be applied to the servicing assets or liabilities for those servicing contracts (paragraph 63) and to the interest-only strips receivable (paragraph 14).

21. The provisions of paragraph 14 and the amendment to Statement 115 (paragraph 362) shall be effective for financial assets held on or acquired after January 1, 1997.

22. Paragraphs 17.f. and 17.g. shall be effective for financial statements for fiscal years ending after December 15, 2000. The information required to be disclosed about securitizations of financial assets during the period that are accounted for as sales need not be reported for periods ending on or before December 15, 2000, for which an income statement is presented for comparative purposes.

23. Collateral previously recognized in financial statements in accordance with the requirements of paragraphs 15.a.ii. and 15.b. of Statement 125 that is no longer to be recognized in accordance with paragraph 15 of this Statement shall no longer be recognized in financial statements for fiscal years ending after December 15, 2000, and financial statements for previous periods presented for comparative purposes shall be restated accordingly. The requirements for reclassification of certain assets in paragraph 15.a. of this Statement and for disclosure about collateral pledged and accepted in paragraphs 17.a.(2) and 17.a.(3) shall be effective for financial statements for fiscal years ending after December 15, 2000; that information need not be reported for periods ending on or before December 15, 2000, for which a statement of financial position is presented for comparative purposes.

24. Assets transferred on or before March 31, 2001, and transfers of assets after that date required by commitments made before that date to transferees or beneficial interest holders (BIHs) other than the transferor, its affiliates, 12 or its agents shall continue to be accounted for under the previous accounting standards for transfers of assets that applied when the transferor made or committed to those transfers. Transfers of assets after that date, unless required by commitments made before that date to transferees or BIHs unrelated to the transferor, shall be subject to all the provisions of this Statement.

25. A formerly qualifying SPE that fails to meet one or more conditions for being a qualifying SPE under this Statement shall continue to be considered a qualifying SPE if it maintains its qualifying status under previous accounting standards, does not issue new beneficial interests after the effective date, and does not receive assets it was not committed to receive (through a commitment to BIHs unrelated to the transferor) before the effective date. Otherwise, the formerly qualifying SPE and assets transferred to it shall be subject to other consolidation policy standards and guidance and to all the provisions of this Statement.

Appendix A: IMPLEMENTATION GUIDANCE

Introduction

26. This appendix describes certain provisions of this Statement in more detail and describes how they apply to certain types of transactions. This appendix discusses generalized situations. Facts and circumstances and specific contracts need to be considered carefully in applying this Statement. This appendix is an integral part of the standards provided in this Statement.

Isolation beyond the Reach of the Transferor and Its Creditors

27. The nature and extent of supporting evidence required for an assertion in financial statements that transferred financial assets have been isolated—put presumptively beyond the reach of the transferor and its creditors, either by a single transaction or a series of transactions taken as a whole—depend on the facts and circumstances. All available evidence that either supports or questions an assertion shall be considered. That consideration includes making judgments about whether the contract or circumstances permit the transferor to revoke the transfer. It also may include making judgments about the kind of bankruptcy or other receivership into which a transferor or SPE might be placed, whether a transfer of financial assets would likely be deemed a true sale at law, whether the transferor is affiliated with the transferee, and other factors pertinent under applicable law. Derecognition of transferred assets is appropriate only if the available evidence provides reasonable assurance that the transferred assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any consolidated affiliate of the transferor that is not a special-purpose corporation or other entity designed to make remote the possibility that it would enter bankruptcy or other receivership (paragraph 83.c.).

28. Whether securitizations isolate transferred assets may depend on such factors as whether the securitization is accomplished in one step or two steps (paragraphs 80-84). Many common financial transactions, for example, typical repurchase agreements and securities lending transactions, isolate transferred assets from the transferor, although they may not meet the other criteria for surrender of control.

Conditions That Constrain a Transferee

29. Sale accounting is allowed under paragraph 9.b. only if each transferee has the right to pledge, or the right to exchange, the transferred assets or beneficial interests it received, but constraints on that right also matter. Many transferor-imposed or other conditions on a transferee's right to pledge or exchange a transferred asset both constrain a transferee from pledging or exchanging the transferred assets and, through that constraint, provide more than a trivial benefit to the transferor. For example, a provision in the transfer contract that prohibits selling or pledging a transferred loan receivable not only constrains the transferee but also provides the transferor with the more-than-trivial benefits of knowing who has the asset, a prerequisite to repurchasing the asset, and of being able to block the asset from finding its way into the hands of a competitor for the loan customer’s business or someone that the loan customer might consider an undesirable creditor. Transferor-imposed contractual constraints that narrowly limit timing or terms, for example, allowing a transferee to pledge only on the day assets are obtained or only on terms agreed with the transferor, also constrain the transferee and presumptively provide the transferor with more-than-trivial benefits.

30. However, some conditions do not constrain a transferee from pledging or exchanging the asset and therefore do not preclude a transfer subject to such a condition from being accounted for as a sale. For example, a transferor's right of first refusal on the occurrence of a bona fide offer to the transferee from a third party presumptively would not constrain a transferee, because that right in itself does not enable the transferor to compel the transferee to sell the assets and the transferee would be in a position to receive the sum offered by exchanging the asset, albeit possibly from the transferor rather than the third party. Further examples of conditions that presumptively would not constrain a transferee include (a) a requirement to obtain the transferor's permission to sell or pledge that is not to be unreasonably withheld, (b) a prohibition on sale to the transferor's competitor if other potential willing buyers exist, (c) a regulatory limitation such as on the number or nature of eligible transferees (as in the case of securities issued under Securities Act Rule 144A or debt placed privately), and (d) illiquidity, for example, the absence of an active market. Judgment is required to assess the significance of some conditions. For example, a prohibition on sale to the transferor’s competitor would be a significant constraint if that competitor were the only potential willing buyer other than the transferor.

31. A condition imposed by a transferor that constrains the transferee presumptively provides more than a trivial benefit to the transferor. A condition not imposed by the transferor that constrains the transferee may or may not provide more than a trivial benefit to the transferor. For example, if the transferor refrains from imposing its usual contractual constraint on a specific transfer because it knows an equivalent constraint is already imposed on the transferee by a third party, it presumptively benefits more than trivially from that constraint. However, the transferor cannot benefit from a constraint if it is unaware at the time of the transfer that the transferee is constrained.

Transferor's Rights or Obligations to Reacquire Transferred Assets

32. Some rights or obligations to reacquire transferred assets both constrain the transferee and provide more than a trivial benefit to the transferor, thus precluding sale accounting under paragraph 9.b. For example, a freestanding call option written by a transferee to the transferor benefits the transferor and, if the transferred assets are not readily obtainable in the marketplace, is likely to constrain a transferee because it might have to default if the call was exercised and it had exchanged or pledged the assets. A freestanding forward purchase-sale contract between the transferor and the transferee on transferred assets not readily obtainable in the marketplace would benefit the transferor and is likely to constrain a transferee in much the same manner. Judgment is necessary to assess constraint and benefit. For example, put options written to the transferee generally do not constrain it, but a put option on a not-readily-obtainable asset may benefit the transferor and effectively constrain the transferee if the option is sufficiently deep-in-the-money when it is written that it is probable that the transferee will exercise it and the transferor will reacquire the transferred asset. In contrast, a sufficiently out-of-the-money call option held by the transferor may not constrain a transferee if it is probable when the option is written that it will not be exercised. Freestanding rights to reacquire transferred assets that are readily obtainable presumptively do not constrain the transferee from exchanging or pledging them and thus do not preclude sale accounting under paragraph 9.b.

33. Other rights or obligations to reacquire transferred assets, regardless of whether they constrain the transferee, may result in the transferor's maintaining effective control over the transferred assets, as discussed in paragraphs 50-54, thus precluding sale accounting under paragraph 9.c.(2). [15]

Conditions That Constrain a Holder of Beneficial Interests in a Qualifying SPE

34. The considerations in paragraphs 29-32, about conditions that may or may not constrain a transferee that is not a qualifying SPE from pledging or exchanging the transferred assets, also extend to conditions that may or may not constrain a BIH from pledging or exchanging its beneficial interests in assets transferred to a qualifying SPE. For example, if BIHs agree to sell their beneficial interests in a qualifying SPE back to the transferor upon request at the price paid plus a stated return, that arrangement clearly conveys more than a trivial benefit to the transferor; sale accounting for the transfer to the qualifying SPE would be precluded if that agreement constrained a BIH from exchanging or pledging its beneficial interest.

Qualifying SPE

35. A qualifying SPE 16 is a trust or other legal vehicle that meets all of the following conditions:

a. It is demonstrably distinct from the transferor (paragraph 36).

b. Its permitted activities (1) are significantly limited, (2) were entirely specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds, and (3) may be significantly changed only with the approval of the holders of at least a majority of the beneficial interests held by entities other than any transferor, its affiliates, and its agents (paragraphs 37 and 38).

c. It may hold only:

(1) Financial assets transferred to it that are passive in nature (paragraph 39)

(2) Passive derivative financial instruments that pertain to beneficial interests (other than another derivative financial instrument) issued or sold to parties other than the transferor, its affiliates, or its agents (paragraphs 39 and 40)

(3) Financial assets (for example, guarantees or rights to collateral) that would reimburse it if others were to fail to adequately service financial assets transferred to it or to timely pay obligations due to it and that it entered into when it was established, when assets were transferred to it, or when beneficial interests (other than derivative financial instruments) were issued by the SPE

(4) Servicing rights related to financial assets that it holds

(5) Temporarily, nonfinancial assets obtained in connection with the collection of financial assets that it holds (paragraph 41)

(6) Cash collected from assets that it holds and investments purchased with that cash pending distribution to holders of beneficial interests that are appropriate for that purpose (that is, money-market or other relatively risk-free instruments without options and with maturities no later than the expected distribution date).

d. If it can sell or otherwise dispose of noncash financial assets, it can do so only in automatic response to one of the following conditions:

(1) Occurrence of an event or circumstance that (a) is specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds; (b) is outside the control of the transferor, its affiliates, or its agents; and (c) causes, or is expected at the date of transfer to cause, the fair value of those financial assets to decline by a specified degree below the fair value of those assets when the SPE obtained them (paragraphs 42 and 43)

(2) Exercise by a BIH (other than the transferor, its affiliates, or its agents) of a right to put that holder's beneficial interest back to the SPE (paragraph 44)

(3) Exercise by the transferor of a call or ROAP specified in the legal documents that established the SPE, transferred assets to the SPE, or created the beneficial interests in the transferred assets that it holds (paragraphs 51-54 and 85-88)

(4) Termination of the SPE or maturity of the beneficial interests in those financial assets on a fixed or determinable date that is specified at inception (paragraph 45).

Need to Be Demonstrably Distinct from the Transferor

36. A qualifying SPE is demonstrably distinct from the transferor only if it cannot be unilaterally dissolved by any transferor, its affiliates, or its agents and either (a) at least 10 percent of the fair value of its beneficial interests is held by parties other than any transferor, its affiliates, or its agents or (b) the transfer is a guaranteed mortgage securitization. 17 An ability to unilaterally dissolve an SPE can take many forms, including but not limited to holding sufficient beneficial interests to demand that the trustee dissolve the SPE, the right to call all the assets transferred to the SPE, and a right to call or a prepayment privilege on the beneficial interests held by other parties.

Limits on Permitted Activities

37. The powers of the SPE must be limited to those activities allowed by paragraph 35 for it to be a qualifying SPE. Many kinds of entities are not so limited. For example, any bank, insurance company, pension plan, or investment company has powers that cannot be sufficiently limited for it to be a qualifying SPE.

38. The BIHs other than any transferor, its affiliates, or its agents may have the ability to change the powers of a qualifying SPE. If the powers of a previously qualifying SPE are changed

so that the SPE is no longer qualifying, unless the conditions in paragraph 9.b. are then met by the SPE itself and the conditions in paragraphs 9.a. and 9.c. continue to be met, that change would bring the transferred assets held in the SPE back under the control of the transferor (paragraph 55).

Limits on What a Qualifying SPE May Hold

39. A financial asset or derivative financial instrument is passive only if holding the asset or instrument does not involve its holder in making decisions other than the decisions inherent in servicing (paragraph 61). An equity instrument is not passive if the qualifying SPE can exercise the voting rights and is permitted to choose how to vote. Investments are not passive if through them, either in themselves or in combination with other investments or rights, the SPE or any related entity, such as the transferor, its affiliates, or its agents, is able to exercise control or significant influence (as defined in generally accepted accounting principles for consolidation policy and for the equity method, respectively) over the investee. A derivative financial instrument is not passive if, for example, it includes an option allowing the SPE to choose to call or put other financial instruments; but other derivative financial instruments can be passive, for example, interest rate caps and swaps and forward contracts. Derivative financial instruments that result in liabilities, like other liabilities of a qualifying SPE, are a kind of beneficial interest in the qualifying SPE's assets.

40. A derivative financial instrument pertains to beneficial interests (other than another derivative financial instrument) issued only if it:

a. Is entered into (1) when the beneficial interests are issued by the qualifying SPE to parties other than the transferor, its affiliates, or its agents or sold to such other parties after being issued by the qualifying SPE to the transferor, its affiliates, or its agents or (2) when a passive derivative financial instrument needs to be replaced upon occurrence of an event or circumstance (specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds) outside the control of the transferor, its affiliates, or its agents, for example, when the counterparty to the derivative defaults or is downgraded below a specified threshold

b. Has a notional amount that does not initially exceed the amount of those beneficial interests and is not expected to exceed them subsequently

c. Has characteristics that relate to, and partly or fully but not excessively counteract, some risk associated with those beneficial interests or the related transferred assets.

41. A qualifying SPE may hold nonfinancial assets other than servicing rights only temporarily and only if those nonfinancial assets result from collecting the transferred financial assets. For example, a qualifying SPE could be permitted to temporarily hold foreclosed nonfinancial collateral. In contrast, an entity cannot be a qualifying SPE if, for example, it receives from a transferor significant secured financial assets likely to default with the expectation that it will foreclose on and profitably manage the securing nonfinancial assets. A qualifying SPE also may hold the residual value of a sales-type or a direct financing lease only to the extent that it is guaranteed at the inception of the lease either by the lessee or by a third party financially capable of discharging the obligations that may arise from the guarantee (paragraph 89).

Limits on Sales or Other Dispositions of Assets

42. Examples of requirements to sell, exchange, put, or distribute (hereinafter referred to collectively as dispose of) noncash financial assets that are permitted activities of a qualifying SPE—because they respond automatically to the occurrence of an event or circumstance that (a) is specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds; (b) is outside the control of the transferor, its affiliates, or its agents; and (c) causes, or is expected to cause, the fair value of those assets to decline by a specified degree below the fair value of those assets when the qualifying SPE obtained them—include requirements to dispose of transferred assets in response to:

a. A failure to properly service transferred assets that could result in the loss of a substantial third-party credit guarantee
b. A default by the obligor
c. A downgrade by a major rating agency of the transferred assets or of the underlying obligor to a rating below a specified minimum rating
d. The involuntary insolvency of the transferor
e. A decline in the fair value of the transferred assets to a specified value less than their fair value at the time they were transferred to the SPE.

43. The following are examples of powers or requirements to dispose of noncash financial assets that are not permitted activities of a qualifying SPE, because they do not respond automatically to the occurrence of a specified event or circumstance outside the control of the transferor, its affiliates, or its agents that causes, or is expected to cause, the fair value of those transferred assets to decline by a specified degree below the fair value of those assets when the SPE obtained them:

a. A power that allows an SPE to choose to either dispose of transferred assets or hold them in response to a default, a downgrade, a decline in fair value, or a servicing failure
b. A requirement to dispose of marketable equity securities upon a specified decline from their "highest fair value" if that power could result in disposing of the asset in exchange for an amount that is more than the fair value of those assets at the time they were transferred to the SPE
c. A requirement to dispose of transferred assets in response to the violation of a nonsubstantive contractual provision (that is, a provision for which there is not a sufficiently large disincentive to ensure performance).

44. A qualifying SPE may dispose of transferred assets automatically to the extent necessary to comply with the exercise by a BIH (other than the transferor, its affiliates, or its agents) of its right to put beneficial interests back to the SPE in exchange for:

a. A full or partial distribution of those assets
b. Cash (which may require that the SPE dispose of those assets or issue beneficial interests to generate cash to fund settlement of the put)
c. New beneficial interests in those assets.

45. A qualifying SPE may have the power to dispose of assets to a party other than the transferor, its affiliate, or its agent on termination of the SPE or maturity of the beneficial interests, but only automatically on fixed or determinable dates that are specified at inception. For example, if an SPE is required to dispose of long-term mortgage loans and terminate itself at the earlier of (a) the specified maturity of beneficial interests in those mortgage loans or (b) the date of prepayment of a specified amount of the transferred mortgage loans, the termination date is a fixed or determinable date that was specified at inception. In contrast, if that SPE has the power to dispose of transferred assets on two specified dates and the SPE can decide which transferred assets to sell on each date, the termination date is not a fixed or determinable date that was specified at inception.

Qualifying SPEs and Consolidated Financial Statements

46. A qualifying SPE shall not be consolidated in the financial statements of a transferor or its affiliates.

Maintaining Effective Control over Transferred Assets

Agreement to Repurchase or Redeem Transferred Assets

47. An agreement that both entitles and obligates the transferor to repurchase or redeem transferred assets from the transferee maintains the transferor's effective control over those assets under paragraph 9.c.(1), and the transfer is therefore to be accounted for as a secured borrowing, if and only if all of the following conditions are met:

a. The assets to be repurchased or redeemed are the same or substantially the same as those transferred (paragraph 48).
b. The transferor is able to repurchase or redeem them on substantially the agreed terms, even in the event of default by the transferee (paragraph 49).
c. The agreement is to repurchase or redeem them before maturity, at a fixed or determinable price.
d. The agreement is entered into concurrently with the transfer.

48. To be substantially the same, 18 the asset that was transferred and the asset that is to be repurchased or redeemed need to have all of the following characteristics:
a. The same primary obligor (except for debt guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and the terms of the guarantee must be the same)
b. Identical form and type so as to provide the same risks and rights
c. The same maturity (or in the case of mortgage-backed pass-through and pay-through securities, similar remaining weighted-average maturities that result in approximately the same market yield)
d. Identical contractual interest rates
e. Similar assets as collateral
f. The same aggregate unpaid principal amount or principal amounts within accepted “good delivery” standards for the type of security involved.

49. To be able to repurchase or redeem assets on substantially the agreed terms, even in the event of default by the transferee, a transferor must at all times during the contract term have obtained cash or other collateral sufficient to fund substantially all of the cost of purchasing replacement assets from others.

Ability to Unilaterally Cause the Return of Specific Transferred Assets

50. Some rights to reacquire transferred assets (or to acquire beneficial interests in transferred assets held by a qualifying SPE), regardless of whether they constrain the transferee, may result in the transferor’s maintaining effective control over the transferred assets through the unilateral ability to cause the return of specific transferred assets. Such rights preclude sale accounting under paragraph 9.c.(2). For example, an attached call in itself would not constrain a transferee who is able, by exchanging or pledging the asset subject to that call, to obtain substantially all of its economic benefits. An attached call could result, however, in the transferor’s maintaining effective control over the transferred asset(s) because the attached call gives the transferor the ability to unilaterally cause whoever holds that specific asset to return it. In contrast, transfers of financial assets subject to calls embedded by the issuers of the financial instruments, for example, callable bonds or prepayable mortgage loans, do not preclude sale accounting. Such an embedded call does not result in the transferor’s maintaining effective control, because it is the issuer rather than the transferor who holds the call.

51. If the transferee is a qualifying SPE, it has met the conditions in paragraph 35.d. and therefore must be constrained from choosing to exchange or pledge the transferred assets. In that circumstance, any call held by the transferor is effectively attached to the assets and could—depending on the price and other terms of the call—maintain the transferor’s effective control over transferred assets through the ability to unilaterally cause the transferee to return specific assets. For example, a transferor's unilateral ability to cause a qualifying SPE to return to the transferor or otherwise dispose of specific transferred assets at will or, for example, in response to its decision to exit a market or a particular activity, could provide the transferor with effective control over the transferred assets.

52. A call that is attached to transferred assets maintains the transferor’s effective control over those assets if, under its price and other terms, the call conveys more than a trivial benefit to the transferor. Similarly, any unilateral right to reclaim specific assets transferred to a qualifying SPE maintains the transferor’s effective control over those assets if the right conveys more than a trivial benefit to the transferor. A call or other right conveys more than a trivial benefit if the price

to be paid is fixed, determinable, or otherwise potentially advantageous, unless because that price is so far out of the money or for other reasons it is probable when the option is written that the transferor will not exercise it. Thus, for example, a call on specific assets transferred to a qualifying SPE at a price fixed at their principal amount maintains the transferor's effective control over the assets subject to that call. Effective control over transferred assets can be present even if the right to reclaim is indirect. For example, if an embedded call allows a transferor to buy back the beneficial interests of a qualifying SPE at a fixed price, then the transferor remains in effective control of the assets underlying those beneficial interests. A cleanup call, however, is permitted as an exception to that general principle.

53. A right to reclaim specific transferred assets by paying their fair value when reclaimed generally does not maintain effective control, because it does not convey a more than trivial benefit to the transferor. However, a transferor has maintained effective control if it has such a right and also holds the residual interest in the transferred assets. For example, if a transferor can reclaim such assets at termination of the qualifying SPE by purchasing them in an auction, and thus at what might appear to be fair value, then sale accounting for the assets it can reclaim would be precluded. Such circumstances provide the transferor with a more than trivial benefit and effective control over the assets, because it can pay any price it chooses in the auction and recover any excess paid over fair value through its residual interest.

54. A transferor that has a right to reacquire transferred assets from a qualifying SPE does not maintain effective control if the reclaimed assets would be randomly selected and the amount of the assets reacquired is sufficiently limited (paragraph 87.a.), because that would not be a right to reacquire specific assets. Nor does a transferor maintain effective control through an obligation to reacquire transferred assets from a qualifying SPE if the transfer could occur only after a specified failure of the servicer to properly service the transferred assets that could result in the loss of a third-party guarantee (paragraph 42.a.) or only after a BIH other than the transferor, its affiliate, or its agent requires a qualifying SPE to repurchase that beneficial interest (paragraph 44.b.), because the transferor could not cause that reacquisition unilaterally.

Changes That Result in the Transferor's Regaining Control of Assets Sold

55. A change in law, status of the transferee as a qualifying SPE, or other circumstance may result in the transferor's regaining control of assets previously accounted for appropriately as having been sold, because one or more of the conditions in paragraph 9 are no longer met. Such a change, unless it arises solely from either the initial application of this Statement or a change in market prices (for example, an increase in price that moves into-the-money a freestanding call that was originally sufficiently out-of-the-money that it was judged not to constrain the transferee), is accounted for in the same manner as a purchase of the assets from the former transferee(s) in exchange for liabilities assumed (paragraph 11). After that change, the transferor recognizes in its financial statements those assets together with liabilities to the former transferee(s) or BIHs in those assets (paragraph 38). The transferor initially measures those assets and liabilities at fair value on the date of the change, as if the transferor purchased the assets and assumed the liabilities on that date. The former transferee would derecognize the assets on that date, as if it had sold the assets in exchange for a receivable from the transferor.

Measurement of Interests Held after a Transfer of Financial Assets

Assets Obtained and Liabilities Incurred as Proceeds

56. The proceeds from a sale of financial assets consist of the cash and any other assets obtained in the transfer less any liabilities incurred. Any asset obtained that is not an interest in the transferred asset is part of the proceeds from the sale. Any liability incurred, even if it is related to the transferred assets, is a reduction of the proceeds. Any derivative financial instrument entered into concurrently with a transfer of financial assets is either an asset obtained or a liability incurred and part of the proceeds received in the transfer. All proceeds and reductions of proceeds from a sale shall be initially measured at fair value, if practicable.

Illustration—Recording Transfers with Proceeds of Cash, Derivatives, and Other Liabilities

57. Company A sells loans with a fair value of $1,100 and a carrying amount of $1,000. Company A retains no servicing responsibilities but obtains an option to purchase from the transferee loans similar to the loans sold (which are readily obtainable in the marketplace) and assumes a limited recourse obligation to repurchase delinquent loans.

Company A agrees to provide the transferee a return at a floating rate of interest even though the contractual terms of the loan are fixed rate in nature (that provision is effectively an interest rate swap).

Fair Values	
Cash proceeds	$1,050
Interest rate swap	40
Call option	70
Recourse obligation	60

Net Proceeds	
Cash received	$1,050
Plus: Call option	70
Interest rate swap	40
Less: Recourse obligation	(60)
Net proceeds	$1,100

Gain on Sale	$1,100
Net proceeds	1,000
Carrying amount of loans sold	$ 100
Gain on sale	

Journal Entry		
Cash	1,050	
Interest rate swap	40	
Call option	70	
Loans		1,000
Recourse obligation		60
Gain on sale		100
To record transfer		

Retained Interests

58. Other interests in transferred assets—those that are not part of the proceeds of the transfer—are retained interests over which the transferor has not relinquished control. They shall be measured at the date of the transfer by allocating the previous carrying amount between the assets sold, if any, and the retained interests, based on their relative fair values. Allocation procedures shall be applied to all transfers in which interests are retained, even those that do not qualify as sales. Examples of retained interests include securities backed by the transferred assets, undivided interests, servicing assets, and cash reserve accounts and residual interests in securitization trusts. If a transferor cannot determine whether an asset is a retained interest or proceeds from the sale, the asset shall be treated as proceeds from the sale and accounted for in accordance with paragraph 56.

59. If the retained interests are subordinated to more senior interests held by others, that subordination may concentrate into the retained interests most of the risks inherent in the transferred assets and shall be taken into consideration in estimating the fair value of the retained interests. For example, if the amount of the gain recognized, after allocation, on a securitization

with a subordinated retained interest is greater than the gain would have been had the entire asset been sold, the transferor needs to be able to identify why that can occur. Otherwise, it is likely that the impact of the retained interest being subordinate to a senior interest has not been adequately considered in the determination of the fair value of the subordinated retained interest.

Illustration—Recording Transfers of Partial Interests

60. Company B sells a pro rata nine-tenths interest in loans with a fair value of $1,100 and a carrying amount of $1,000. There is no servicing asset or liability, because Company B estimates that the benefits of servicing are just adequate to compensate it for its servicing responsibilities.

Fair values	
Cash proceeds for nine-tenths sold	$990
One-tenth interest retained [($990÷9/10)×1/10]	110

Carrying Amount Based on Relative Fair Values

	Fair Value	Percentage Of Total Fair Value	Allocated Carrying Amount
Nine-tenths interest sold	$ 990	90	$ 900
One-tenth interest retained	110	10	100
Total	$ 1,100	100	$ 1,000

Gain on Sale

Net proceeds	$ 990
Carrying amount of loans sold	900
Gain on sale	$ 90

Journal Entry

Cash	990	
Loans		900
Gain on sale		90
To record transfer		

Servicing Assets and Liabilities

61. Servicing of mortgage loans, credit card receivables, or other financial assets commonly includes, but is not limited to, collecting principal, interest, and escrow payments from borrowers; paying taxes and insurance from escrowed funds; monitoring delinquencies; executing foreclosure if necessary; temporarily investing funds pending distribution; remitting fees to guarantors, trustees, and others providing services; and accounting for and remitting principal and interest payments to the holders of beneficial interests in the financial assets. Servicing is inherent in all financial assets; it becomes a distinct asset or liability only when contractually separated from the underlying assets by sale or securitization of the assets with servicing retained or separate purchase or assumption of the servicing.

62. An entity that undertakes a contract to service financial assets shall recognize either a servicing asset or a servicing liability, with only one exception. (That exception is if the transferor transfers the assets in a guaranteed mortgage securitization, retains all of the resulting securities, and classifies them as debt securities held-to-maturity in accordance with Statement 115, in which case the servicing asset or liability may be reported together with the asset being serviced.) Each sale or securitization with servicing retained or separate purchase or assumption of servicing results in a servicing contract. A servicer of financial assets commonly receives the benefits of servicing—revenues from contractually specified servicing fees, late charges, and other ancillary sources, including “float,” all of which it is entitled to receive only if it performs the

servicing—and incurs the costs of servicing the assets. Each servicing contract results in a servicing asset or servicing liability. Typically, the benefits of servicing are expected to be more than adequate compensation to a servicer for performing the servicing, and the contract results in a servicing asset. However, if the benefits of servicing are not expected to adequately compensate a servicer for performing the servicing, the contract results in a servicing liability. (A servicing asset may become a servicing liability, or vice versa, if circumstances change, and the initial measure for servicing may be zero if the benefits of servicing are just adequate to compensate the servicer for its servicing responsibilities.)

63. A servicer that recognizes a servicing asset or servicing liability shall account for the contract to service financial assets separately from those assets, as follows:

a. Report servicing assets separately from servicing liabilities in the statement of financial position (paragraph 13).

b. Initially measure servicing assets retained in a sale or securitization of the assets being serviced at their allocated previous carrying amount based on relative fair values, if practicable, at the date of the sale or securitization (paragraphs 10, 58-60, and 68-72).

c. Initially measure servicing assets purchased or servicing liabilities assumed at fair value (paragraph 13).

d. Initially measure servicing liabilities undertaken in a sale or securitization at fair value, if practicable (paragraphs 11.b., 11.c., and 68-72).

e. Account separately for rights to future interest income from the serviced assets that exceeds contractually specified servicing fees. Those rights are not servicing assets; they are financial assets, effectively interest-only strips to be accounted for in accordance with paragraph 14 of this Statement.

f. Subsequently measure servicing assets by amortizing the amount recognized in proportion to and over the period of estimated net servicing income—the excess of servicing revenues over servicing costs (paragraph 13).

g. Subsequently evaluate and measure impairment of servicing assets as follows:

(1) Stratify servicing assets based on one or more of the predominant risk characteristics of the underlying financial assets. Those characteristics may include financial asset type, 19 size, interest rate, date of origination, term, and geographic location.

(2) Recognize impairment through a valuation allowance for an individual stratum. The amount of impairment recognized shall be the amount by which the carrying amount of servicing assets for a stratum exceeds their fair value. The fair value of servicing assets that have not been recognized shall not be used in the evaluation of impairment.

(3) Adjust the valuation allowance to reflect changes in the measurement of impairment subsequent to the initial measurement of impairment. Fair value in excess of the carrying amount of servicing assets for that stratum, however, shall not be recognized. This Statement does not address when an entity should record a direct write-down of recognized servicing assets (paragraph 13).

h. Subsequently measure servicing liabilities by amortizing the amount recognized in proportion to and over the period of estimated net servicing loss—the excess of servicing costs over servicing revenues. However, if subsequent events have increased the fair value of the liability above the carrying amount, for example, because of significant changes in the amount or timing of actual or expected future cash flows from the cash flows previously projected, the servicer shall revise its earlier estimates and recognize the increased obligation as a loss in earnings (paragraph 13).

64. As indicated above, transferors sometimes agree to take on servicing responsibilities when the future benefits of servicing are not expected to adequately compensate them for performing that servicing. In that circumstance, the result is a servicing liability rather than a servicing asset. For example, if in the transaction illustrated in paragraph 57 the transferor had agreed to service the loans without explicit compensation and it estimated the fair value of that

servicing obligation at $50, net proceeds would be reduced to $1,050, gain on sale would be reduced to $50, and the transferor would report a servicing liability of $50.

Illustration—Sale of Receivables with Servicing Retained

65. Company C originates $1,000 of loans that yield 10 percent interest income for their estimated lives of 9 years. Company C sells the $1,000 principal plus the right to receive interest income of 8 percent to another entity for $1,000. Company C will continue to service the loans, and the contract stipulates that its compensation for performing the servicing is the right to receive half of the interest income not sold. The remaining half of the interest income not sold is considered an interest-only strip receivable. At the date of the transfer, the fair value of the loans, including servicing, is $1,100. The fair value of the servicing asset is $40.

Fair values	
Cash proceeds	$1,000
Servicing asset	40
Interest-only strip receivable	60

Carrying Amount Based on Relative Fair Values

	Fair Value	Percentage Of Total Fair Value	Allocated Carrying Amount
Loans sold	$ 1,000	91.0	$ 910
Servicing asset	40	3.6	36
Interest-only strip receivable	60	5.4	54
Total	$ 1,100	100.0	$ 1,000

Gain on Sale	
Net proceeds	$ 1000
Carrying amount of loans sold	910
Gain on sale	$ 90

Journal Entries

Cash	1000	
Loans		910
Gain on sale		90
To record transfer		
Servicing asset	36	
Interest-only strip receivable	54	
Loans		90
To record servicing asset and interest-only strip receivable		
Interest-only strip receivable	6	
Equity		6
To begin to subsequently measure interest-only strip receivable like an available-for-sale security (paragraph 14)		

66. The previous illustration demonstrates how a transferor would account for a simple sale or securitization in which servicing is retained. Company C might instead transfer the financial assets to a corporation or a trust that is a qualifying SPE. The qualifying SPE then securitizes the loans by selling beneficial interests to the public. The qualifying SPE pays the cash proceeds to the original transferor, which accounts for the transfer as a sale and derecognizes the financial

assets assuming that the criteria in paragraph 9 are met. Securitizations often combine the elements shown in paragraphs 57, 60, and 65, as illustrated below.

Illustration—Recording Transfers of Partial Interests with Proceeds of Cash, Derivatives, Other Liabilities, and Servicing

67. Company D originates $1,000 of prepayable loans that yield 10 percent interest income for their 9-year expected lives. Company D sells nine-tenths of the principal plus interest of 8 percent to another entity. Company D will continue to service the loans, and the contract stipulates that its compensation for performing the servicing is the 2 percent of the interest income not sold. Company D obtains an option to purchase from the transferee loans similar to the loans sold (which are readily obtainable in the marketplace) and incurs a limited recourse obligation to repurchase delinquent loans.

Fair values	
Cash proceeds	$900
Call option	70
Recourse obligation	60
Servicing asset	90
One-tenth interest retained	100

Net Proceeds	
Cash received	$900
Plus: Call option	70
Less: Recourse obligation	(60)
Net proceeds	$910

Carrying Amount Based on Relative Fair Values

	Fair Value	Percentage Of Total Fair Value	Allocated Carrying Amount
Interest sold	$ 910	83	$ 830
Servicing asset	90	8	80
One-tenth interest retained	100	9	90
Total	$ 1,100	100	$ 1,000

Gain on Sale	
Net proceeds	$ 910
Carrying amount of loans sold	830
Gain on sale	$ 80

Journal Entries		
Cash	900	
Call option	70	
Loans		830
Recourse obligation		60
Gain on sale		80
To record transfer		
Servicing asset	80	
Loans		80
To record servicing asset		

At the time of the transfer, Company D reports its one-tenth retained interest in the loans at its allocated carrying amount of $90.

Fair Value

68. The fair value of an asset (or liability) is the amount at which that asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available. If a quoted market price is available, the fair value is the product of the number of trading units times that market price.

69. If quoted market prices are not available, the estimate of fair value shall be based on the best information available in the circumstances. The estimate of fair value shall consider prices for similar assets and liabilities and the results of valuation techniques to the extent available in the circumstances. Examples of valuation techniques include the present value of estimated future cash flows, [20] option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis. Valuation techniques for measuring financial assets and liabilities and servicing assets and liabilities shall be consistent with the objective of measuring fair value. Those techniques shall incorporate assumptions that market participants would use in their estimates of values, future revenues, and future expenses, including assumptions about interest rates, default, prepayment, and volatility. [21] In measuring financial liabilities and servicing liabilities at fair value, the objective is to estimate the value of the assets required currently to (a) settle the liability with the holder or (b) transfer a liability to an entity of comparable credit standing.

70. Estimates of expected future cash flows, if used to estimate fair value, shall be based on reasonable and supportable assumptions and projections. All available evidence shall be considered in developing estimates of expected future cash flows. The weight given to the evidence shall be commensurate with the extent to which the evidence can be verified objectively. If a range is estimated for either the amount or timing of possible cash flows, the likelihood of possible outcomes shall be considered either directly, if applying an expected cash flow approach, or indirectly through the risk-adjusted discount rate, if determining the best estimate of future cash flows.

If It Is Not Practicable to Estimate Fair Values

71. If it is not practicable to estimate the fair values of assets, the transferor shall record those assets at zero. If it is not practicable to estimate the fair values of liabilities, the transferor shall recognize no gain on the transaction and shall record those liabilities at the greater of:

a. The excess, if any, of (1) the fair values of assets obtained less the fair values of other liabilities incurred, over (2) the sum of the carrying values of the assets transferred

b. The amount that would be recognized in accordance with *FASB Statement No. 5, Accounting for Contingencies*, as interpreted by *FASB Interpretation No. 14, Reasonable Estimation of the Amount of a Loss*.

Illustration—Recording Transfers If It Is Not Practicable to Estimate a Fair Value

72. Company E sells loans with a carrying amount of $1,000 to another entity for cash plus a call option to purchase loans similar to the loans sold (which are readily obtainable in the marketplace) and incurs a limited recourse obligation to repurchase any delinquent loans. Company E undertakes to service the transferred assets for the other entity. In Case 1, Company E finds it impracticable to estimate the fair value of the servicing contract, although it is confident that servicing revenues will be more than adequate compensation for performing the servicing. In Case 2, Company E finds it impracticable to estimate the fair value of the recourse obligation.

Fair Values	**Case 1**	**Case 2**
Cash proceeds	$1,050	$1,050
Servicing asset	XX*	40

Call option	70	70
Recourse obligation	60	XX*
Fair value of loans transferred	1,100	1,100

* Not practicable to estimate fair value

Net Proceeds	Case 1	Case 2
Cash received	$1,050	$1,050
Plus: Call option	70	70
Less: Recourse obligation	(60)	XX
Net proceeds	$1,060	$1,120

Carrying Amount Based on Relative Fair Values (Case 1)

	Fair Value	Percentage Of Total Fair Value	Allocated Carrying Amount
Loans sold	$ 1,060	100	$ 1,000
Servicing asset	0	0	0
Total	$ 1,060	100	$ 1,000

Carrying Amount Based on Relative Fair Values (Case 2)

	Fair Value	Percentage Of Total Fair Value	Allocated Carrying Amount
Loans sold	$ 1,120	97	$ 970
Servicing asset	40	3	30
Total	$ 1,160	100	$ 1,000

Journal Entries	Case 1		Case 2	
Cash	1,050		1,050	
Servicing asset	0*		30	
Call option	70		70	
Loans		1,000		1,000
Recourse obligation		60		150†
Gain on sale		60		0
To record transfer				

* Assets shall be recorded at zero if an estimate of the fair value of the assets is not praticable.

† The amount recorded as a liability in this example equals the sum of the known assets less the fair value of the known liabilities, that is, the amount that results in no gain or loss.

Securitizations

73. Financial assets such as mortgage loans, automobile loans, trade receivables, credit card receivables, and other revolving charge accounts are assets commonly transferred in securitizations. Securitizations of mortgage loans may include pools of single-family residential mortgages or other types of real estate mortgage loans, for example, multifamily residential mortgages and commercial property mortgages. Securitizations of loans secured by chattel mortgages on automotive vehicles as well as other equipment (including direct financing or sales-type leases) also are common. Both financial and nonfinancial assets can be securitized; life insurance policy loans, patent and copyright royalties, and even taxi medallions also have been securitized. But securitizations of nonfinancial assets are outside the scope of this Statement.

74. An originator of a typical securitization (the transferor) transfers a portfolio of financial assets to an SPE, commonly a trust. In "pass-through" and "pay-through" securitizations,

receivables are transferred to the SPE at the inception of the securitization, and no further transfers are made; all cash collections are paid to the holders of beneficial interests in the SPE. In "revolving-period" securitizations, receivables are transferred at the inception and also periodically (daily or monthly) thereafter for a defined period (commonly three to eight years), referred to as the revolving period. During the revolving period, the SPE uses most of the cash collections to purchase additional receivables from the transferor on prearranged terms.

75. Beneficial interests in the SPE are sold to investors and the proceeds are used to pay the transferor for the assets transferred. Those beneficial interests may comprise either a single class having equity characteristics or multiple classes of interests, some having debt characteristics and others having equity characteristics. The cash collected from the portfolio is distributed to the investors and others as specified by the legal documents that established the SPE.

76. Pass-through, pay-through, and revolving-period securitizations that meet the criteria in paragraph 9 qualify for sale accounting under this Statement. All financial assets obtained or retained and liabilities incurred by the originator of a securitization that qualifies as a sale shall be recognized and measured as provided in paragraph 11; that includes the implicit forward contract to sell new receivables during a revolving period, which may become valuable or onerous to the transferor as interest rates and other market conditions change.

Revolving-Period Securitizations

77. The value of the forward contract implicit in a revolving-period securitization arises from the difference between the agreed-upon rate of return to investors on their beneficial interests in the trust and current market rates of return on similar investments. For example, if the agreed-upon annual rate of return to investors in a trust is 6 percent, and later market rates of return for those investments increased to 7 percent, the forward contract’s value to the transferor (and burden to the investors) would approximate the present value of 1 percent of the amount of the investment for each year remaining in the revolving structure after the receivables already transferred have been collected. If a forward contract to sell receivables is entered into at the market rate, its value at inception may be zero. Changes in the fair value of the forward contract are likely to be greater if the investors receive a fixed rate than if the investors receive a rate that varies based on changes in market rates.

78. Gain or loss recognition for revolving-period receivables sold to a securitization trust is limited to receivables that exist and have been sold. Recognition of servicing assets or liabilities for revolving-period receivables is similarly limited to the servicing for the receivables that exist and have been transferred. As new receivables are sold, rights to service them become assets or liabilities and are recognized.

79. Revolving-period securitizations may use either a discrete trust, used for a single securitization, or a master trust, used for many securitizations. To achieve another securitization using an existing master trust, a transferor first transfers additional receivables to the trust and then sells additional ownership interests in the trust to investors. Adding receivables to a master trust, in itself, is neither a sale nor a secured borrowing under paragraph 9, because that transfer only increases the transferor’s beneficial interest in the trust’s assets. A sale or secured borrowing does not occur until the transferor receives consideration other than beneficial interests in the transferred assets. Transfers that result in an exchange of cash, that is, either transfers that in essence replace previously transferred receivables that have been collected or sales of beneficial interests to outside investors, are transfers in exchange for consideration other than beneficial interests in the transferred assets and thus are accounted for as sales (if they satisfy all the criteria in paragraph 9) or as secured borrowings.

Isolation of Transferred Assets in Securitizations

80. A securitization carried out in one transfer or a series of transfers may or may not isolate the transferred assets beyond the reach of the transferor and its creditors. Whether it does

depends on the structure of the securitization transaction taken as a whole, considering such factors as the type and extent of further involvement in arrangements to protect investors from credit and interest rate risks, the availability of other assets, and the powers of bankruptcy courts or other receivers.

81. In certain securitizations, a corporation that, if it failed, would be subject to the U.S. Bankruptcy Code transfers financial assets to a special-purpose trust in exchange for cash. The trust raises that cash by issuing to investors beneficial interests that pass through all cash received from the financial assets, and the transferor has no further involvement with the trust or the transferred assets. The Board understands that those securitizations generally would be judged as having isolated the assets, because in the absence of any continuing involvement there would be reasonable assurance that the transfer would be found to be a true sale at law that places the assets beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.

82. In other securitizations, a similar corporation transfers financial assets to an SPE in exchange for cash and beneficial interests in the transferred assets. That entity raises the cash by issuing to investors commercial paper that gives them a senior interest in cash received from the financial assets. The beneficial interests retained by the transferring corporation represent a junior interest to be reduced by any credit losses on the financial assets in trust. The commercial paper interests are highly rated by credit rating agencies only if both (a) the credit enhancement from the junior interest is sufficient and (b) the transferor is highly rated. Depending on facts and circumstances, the Board understands that those “single-step” securitizations often would be judged in the United States as not having isolated the assets, because the nature of the continuing involvement may make it difficult to obtain reasonable assurance that the transfer would be found to be a true sale at law that places the assets beyond the reach of the transferor and its creditors in U.S. bankruptcy (paragraph 113). If the transferor fell into bankruptcy and the transfer was found not to be a true sale at law, investors in the transferred assets might be subjected to an automatic stay that would delay payments due them, and they might have to share in bankruptcy expenses and suffer further losses if the transfer was recharacterized as a secured loan.

83. Still other securitizations use two transfers intended to isolate transferred assets beyond the reach of the transferor and its creditors, even in bankruptcy. In those “two-step” structures:

a. First, the corporation transfers financial assets to a special-purpose corporation that, although wholly owned, is so designed that the possibility that the transferor or its creditors could reclaim the assets is remote. This first transfer is designed to be judged to be a true sale at law, in part because the transferor does not provide “excessive” credit or yield protection to the special-purpose corporation, and the Board understands that transferred assets are likely to be judged beyond the reach of the transferor or the transferor's creditors even in bankruptcy.

b. Second, the special-purpose corporation transfers the assets to a trust or other legal vehicle with a sufficient increase in the credit or yield protection on the second transfer (provided by a junior retained beneficial interest or other means) to merit the high credit rating sought by third-party investors who buy senior beneficial interests in the trust. Because of that aspect of its design, that second transfer might not be judged to be a true sale at law and, thus, the transferred assets could at least in theory be reached by a bankruptcy trustee for the special-purpose corporation.

c. However, the special-purpose corporation is designed to make remote the possibility that it would enter bankruptcy, either by itself or by substantive consolidation into a bankruptcy of its parent should that occur. For example, its charter forbids it from undertaking any other business or incurring any liabilities, so that there can be no creditors to petition to place it in bankruptcy. Furthermore, its dedication to a single purpose is intended to make it extremely unlikely, even if it somehow entered bankruptcy, that a receiver under the U.S. Bankruptcy Code could reclaim the transferred assets because it has no other assets to substitute for the transferred assets.

The Board understands that the "two-step" securitizations described above, taken as a whole, generally would be judged under present U.S. law as having isolated the assets beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.

84. The powers of receivers for entities not subject to the U.S. Bankruptcy Code (for example, banks subject to receivership by the FDIC) vary considerably, and therefore some receivers may be able to reach financial assets transferred under a particular arrangement and others may not. A securitization may isolate transferred assets from a transferor subject to such a receiver and its creditors even though it is accomplished by only one transfer directly to an SPE that issues beneficial interests to investors and the transferor provides credit or yield protection. For entities that are subject to other possible bankruptcy, conservatorship, or other receivership procedures in the United States or other jurisdictions, judgments about whether transferred assets have been isolated need to be made in relation to the powers of bankruptcy courts or trustees, conservators, or receivers in those jurisdictions.

Removal-of-Accounts Provisions

85. Many transfers of financial assets in securitizations empower the transferor to reclaim assets subject to certain restrictions. Such a power is sometimes called a removal-of-accounts provision (ROAP). Whether a ROAP precludes sale accounting depends on whether the ROAP results in the transferor's maintaining effective control over specific transferred assets (paragraphs 9.c.(2) and 51-54).

86. The following are examples of ROAPs that preclude transfers from being accounted for as sales:

a. An unconditional ROAP or repurchase agreement that allows the transferor to specify the assets that may be removed, because such a provision allows the transferor unilaterally to remove specific assets

b. A ROAP conditioned on a transferor's decision to exit some portion of its business, because whether it can be triggered by canceling an affinity relationship, spinning off a business segment, or accepting a third party's bid to purchase a specified (for example, geographic) portion of the transferor's business, such a provision allows the transferor unilaterally to remove specific assets.

87. The following are examples of ROAPs that do not preclude transfers from being accounted for as sales:

a. A ROAP for random removal of excess assets, if the ROAP is sufficiently limited so that the transferor cannot remove specific transferred assets, for example, by limiting removals to the amount of the transferor's retained interest and to one removal per month

b. A ROAP for defaulted receivables, because the removal would be allowed only after a third party's action (default) and could not be caused unilaterally by the transferor

c. A ROAP conditioned on a third-party cancellation, or expiration without renewal, of an affinity or private-label arrangement, because the removal would be allowed only after a third party's action (cancellation) or decision not to act (expiration) and could not be caused unilaterally by the transferor.

88. A ROAP that can be exercised only in response to a third party's action that has not yet occurred does not maintain the transferor's effective control over assets potentially subject to that ROAP. However, when a third party's action (such as default or cancellation) or decision not to act (expiration) occurs that allows removal of assets to be initiated solely by the transferor, the transferor must recognize any assets subject to the ROAP, whether the ROAP is exercised or not. If the ROAP is exercised, the assets are recognized because the transferor has reclaimed the assets. If the ROAP is not exercised, the assets are recognized because the transferor now

can unilaterally cause the qualifying SPE to return those specific assets and, therefore, the transferor once again has effective control over those transferred assets (paragraph 55).

Securities Lending Transactions

91. Securities lending transactions are initiated by broker-dealers and other financial institutions that need specific securities to cover a short sale or a customer's failure to deliver securities sold. Transferees ("borrowers") of securities generally are required to provide "collateral" to the transferor ("lender") of securities, commonly cash but sometimes other securities or standby letters of credit, with a value slightly higher than that of the securities "borrowed.” If the "collateral" is cash, the transferor typically earns a return by investing that cash at rates higher than the rate paid or "rebated" to the transferee. If the "collateral" is other than cash, the transferor typically receives a fee. Securities custodians or other agents commonly carry out securities lending activities on behalf of clients. Because of the protection of "collateral" (typically valued daily and adjusted frequently for changes in the market price of the securities transferred) and the short terms of the transactions, most securities lending transactions in themselves do not impose significant credit risks on either party. Other risks arise from what the parties to the transaction do with the assets they receive. For example, investments made with cash "collateral" impose market and credit risks on the transferor.

92. In some securities lending transactions, the criteria in paragraph 9 are met, including the effective control criterion in paragraph 9.c., and consideration other than beneficial interests in the transferred assets is received. Those transactions shall be accounted for (a) by the transferor as a sale of the "loaned" securities for proceeds consisting of the cash "collateral" 22 and a forward repurchase commitment and (b) by the transferee as a purchase of the "borrowed" securities in exchange for the "collateral" and a forward resale commitment. During the term of that agreement, the transferor has surrendered control over the securities transferred and the transferee has obtained control over those securities with the ability to sell or transfer them at will. In that case, creditors of the transferor have a claim only to the "collateral" and the forward repurchase commitment.

93. However, many securities lending transactions are accompanied by an agreement that entitles and obligates the transferor to repurchase or redeem the transferred assets before their maturity under which the transferor maintains effective control over those assets (paragraphs 47-49). Those transactions shall be accounted for as secured borrowings, in which cash (or securities that the holder is permitted by contract or custom to sell or repledge) received as "collateral" is considered the amount borrowed, the securities "loaned" are considered pledged as collateral against the cash borrowed and reclassified as set forth in paragraph 15.a., and any "rebate" paid to the transferee of securities is interest on the cash the transferor is considered to have borrowed.

94. The transferor of securities being “loaned” accounts for cash received in the same way whether the transfer is accounted for as a sale or a secured borrowing. The cash received shall be recognized as the transferor's asset—as shall investments made with that cash, even if made by agents or in pools with other securities lenders—along with the obligation to return the cash. If securities that may be sold or repledged are received, the transferor of the securities being “loaned” accounts for those securities in the same way as it would account for cash received.

Illustration—Securities Lending Transaction Treated as a Secured Borrowing

95. The following example illustrates the accounting for a securities lending transaction treated as a secured borrowing, in which the securities borrower sells the securities upon receipt and later buys similar securities to return to the securities lender:

Facts

Transferor’s carrying amount and fair value of security loaned	$1,000
Cash “collateral”	1,020
Transferor’s return from investing cash collateral at a 5 percent annual rate	5
Transferor’s rebate to the securities borrower at a 4 percent annual rate	4

For simplicity, the fair value of the security is assumed not to change during the 35-day term of the transaction.

Journal Entries for the Transferor

At inception:

Cash	1,020	
Payable under securities loan agreements		1,020
To record the receipt of cash collateral		
Securities pledged to creditors	1,000	
Securities		1,000
To reclassify loaned securities that the secured party has the right to sell or repledge		
Money market instrument	1,020	
Cash		1,020
To record investment of cash collateral		

At conclusion:

Cash	1,025	
Interest		5
Money market instrument		1,020
To record results of investment		
Securities	1,000	
Securities pledged to creditors		1,000
To record return of security		
Payable under securities loan agreements	1,020	
Interest ("rebate")	4	
Cash		1,024
To record repayment of cash collateral plus interest		

Journal Entries for the Transferee

At inception:

Receivable under securities loan agreements	1,020	
Cash		1,020
To record transfer of cash collateral		
Cash	1,000	
Obligation to return borrowed securities		1,000
To record sale of borrowed securities to a third party and the resulting obligation to return securities that it no longer holds		

At conclusion:

Obligation to return borrowed securities	1,000	
Cash		1,000
To record the repurchase of securities borrowed		
Cash	1,024	
Receivable under securities loan agreements		1,020
Interest revenue ("rebate")		4
To record the receipt of cash collateral and rebate interest		

Repurchase Agreements and "Wash Sales"

96. Government securities dealers, banks, other financial institutions, and corporate investors commonly use repurchase agreements to obtain or use short-term funds. Under those agreements, the transferor ("repo party") transfers a security to a transferee ("repo counterparty" or "reverse party") in exchange for cash 23 and concurrently agrees to reacquire that security at a future date for an amount equal to the cash exchanged plus a stipulated "interest" factor.

97. Repurchase agreements can be effected in a variety of ways. Some repurchase agreements are similar to securities lending transactions in that the transferee has the right to sell or repledge the securities to a third party during the term of the repurchase agreement. In other repurchase agreements, the transferee does not have the right to sell or repledge the securities during the term of the repurchase agreement. For example, in a tri-party repurchase agreement, the transferor transfers securities to an independent third-party custodian that holds the securities during the term of the repurchase agreement. Also, many repurchase agreements are for short terms, often overnight, or have indefinite terms that allow either party to terminate the arrangement on short notice. However, other repurchase agreements are for longer terms, sometimes until the maturity of the transferred asset. Some repurchase agreements call for repurchase of securities that need not be identical to the securities transferred.

98. If the criteria in paragraph 9 are met, including the criterion in paragraph 9.c.(1), the transferor shall account for the repurchase agreement as a sale of financial assets and a forward repurchase commitment, and the transferee shall account for the agreement as a purchase of financial assets and a forward resale commitment. Other transfers that are accompanied by an agreement to repurchase the transferred assets that shall be accounted for as sales include transfers with agreements to repurchase at maturity and transfers with repurchase agreements in which the transferee has not obtained collateral sufficient to fund substantially all of the cost of purchasing replacement assets.

99. Furthermore, "wash sales" that previously were not recognized if the same financial asset was purchased soon before or after the sale shall be accounted for as sales under this Statement. Unless there is a concurrent contract to repurchase or redeem the transferred financial assets from the transferee, the transferor does not maintain effective control over the transferred assets.

100. As with securities lending transactions, under many agreements to repurchase transferred assets before their maturity the transferor maintains effective control over those assets. Repurchase agreements that do not meet all the criteria in paragraph 9 shall be treated as secured borrowings. Fixed-coupon and dollar-roll repurchase agreements, and other contracts under which the securities to be repurchased need not be the same as the securities sold, qualify as borrowings if the return of substantially the same (paragraph 48) securities as those concurrently transferred is assured. Therefore, those transactions shall be accounted for as secured borrowings by both parties to the transfer.

101. If a transferor has transferred securities to an independent third-party custodian, or to a transferee, under conditions that preclude the transferee from selling or repledging the assets during the term of the repurchase agreement (as in most tri-party repurchase agreements), the transferor has not surrendered control over those assets.

Loan Syndications

102. Borrowers often borrow amounts greater than any one lender is willing to lend. Therefore, it is common for groups of lenders to jointly fund those loans. That may be accomplished by a syndication under which several lenders share in lending to a single borrower, but each lender loans a specific amount to the borrower and has the right to repayment from the borrower.

103. A loan syndication is not a transfer of financial assets. Each lender in the syndication shall account for the amounts it is owed by the borrower. Repayments by the borrower may be made to a lead lender that then distributes the collections to the other lenders of the syndicate. In those

circumstances, the lead lender is simply functioning as a servicer and, therefore, shall not recognize the aggregate loan as an asset.

Loan Participations

104. Groups of banks or other entities also may jointly fund large borrowings through loan participations in which a single lender makes a large loan to a borrower and subsequently transfers undivided interests in the loan to other entities.

105. Transfers by the originating lender may take the legal form of either assignments or participations. The transfers are usually on a nonrecourse basis, and the transferor ("originating lender") continues to service the loan. The transferee ("participating entity") may or may not have the right to sell or transfer its participation during the term of the loan, depending upon the terms of the participation agreement.

106. If the loan participation agreement gives the transferee the right to pledge or exchange those participations and the other criteria in paragraph 9 are met, the transfers to the transferee shall be accounted for by the transferor as sales of financial assets. A transferor's right of first refusal on a bona fide offer from a third party, a requirement to obtain the transferor's permission that shall not be unreasonably withheld, or a prohibition on sale to the transferor's competitor if other potential willing buyers exist is a limitation on the transferee's rights but presumptively does not constrain a transferee from exercising its right to pledge or exchange. However, if the loan participation agreement constrains the transferees from pledging or exchanging their participations, the transferor presumptively receives a more than trivial benefit, has not relinquished control over the loan, and shall account for the transfers as secured borrowings.

Factoring Arrangements

112. Factoring arrangements are a means of discounting accounts receivable on a nonrecourse, notification basis. Accounts receivable are sold outright, usually to a transferee (the factor) that assumes the full risk of collection, without recourse to the transferor in the event of a loss. Debtors are directed to send payments to the transferee. Factoring arrangements that meet the criteria in paragraph 9 shall be accounted for as sales of financial assets because the transferor surrenders control over the receivables to the factor.

Transfers of Receivables with Recourse

113. In a transfer of receivables with recourse, the transferor provides the transferee with full or limited recourse. The transferor is obligated under the terms of the recourse provision to make payments to the transferee or to repurchase receivables sold under certain circumstances, typically for defaults up to a specified percentage. The effect of a recourse provision on the application of paragraph 9 may vary by jurisdiction. In some jurisdictions, transfers with full recourse may not place transferred assets beyond the reach of the transferor and its creditors, but transfers with limited recourse may. A transfer of receivables with recourse shall be accounted for as a sale, with the proceeds of the sale reduced by the fair value of the recourse obligation, if the criteria in paragraph 9 are met. Otherwise, a transfer of receivables with recourse shall be accounted for as a secured borrowing.

Extinguishments of Liabilities

114. If a creditor releases a debtor from primary obligation on the condition that a third party assumes the obligation and that the original debtor becomes secondarily liable, that release extinguishes the original debtor's liability. However, in those circumstances, whether or not explicit consideration was paid for that guarantee, the original debtor becomes a guarantor. As a guarantor, it shall recognize a guarantee obligation in the same manner as would a guarantor that had never been primarily liable to that creditor, with due regard for the likelihood that the third party will carry out its obligations. The guarantee obligation shall be initially measured at fair value, and that amount reduces the gain or increases the loss recognized on extinguishment.

RELEVANT LITERATURE

Statutory Accounting

- *SSAP No. 18—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
- *SSAP No. 33—Securitization*
- *SSAP No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements*
- *Purposes and Procedures Manual of the NAIC Securities Valuation Office*

Generally Accepted Accounting Principles

- *FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
- *AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as used In Certain Audit Guides and a Statement of Position*
- *FASB Emerging Issues Task Force No. 87-34, Sale of Mortgage Servicing Rights with a Subservicing Agreement*
- *FASB Emerging Issues Task Force No. 88-11, Allocation of Recorded Investment When a Loan as Part of a Loan is Sold*
- *FASB Emerging Issues Task Force No. 88-18, Sales of Future Revenues*
- *FASB Emerging Issues Task Force No. 88-22, Securitization of Credit Card and Other Receivable Portfolios*
- *FASB Emerging Issues Task Force No. 90-21, Balance Sheet Treatment of a Sale of Mortgage Servicing Rights with a Subservicing Agreement*
- *FASB Emerging Issues Task Force No. 95-5, Determination of What Risks and Rewards, If Any, Can Be Retained and Whether Any Unresolved Contingencies May Exist in a Sale of Mortgage Loan Servicing Rights*
- *FASB Emerging Issues Task Force No. 96-19, Debtor's Accounting for a Modification or Exchange of Debt Instruments*

EXHIBIT A - GLOSSARY

Asset Securitization

An asset securitization is the process of converting assets which would normally serve as collateral for a loan into securities. The largest category of securitized assets is real estate mortgage loans, which serve as collateral for mortgage-backed securities.

Beneficial Interests

Rights to receive all or portions of specified cash inflows to a trust or other entity, including senior and subordinated shares of interest, principal, or other cash inflows to be passed-through or paid-through, premiums due to guarantors, commercial paper obligations and residual interests, whether in the form of debt or equity.

Beneficial Interest Holder ("BIH")

Holder of beneficial interests

Cleanup Call

An option held by the servicer, which may be the transferor, to purchase transferred financial assets, or the remaining beneficial interests not held by the transferor, its affiliates, or its agents in a qualifying SPE (or in a series of beneficial interests in transferred assets within a qualifying SPE), when the amount of outstanding assets falls to a level at which the cost of servicing those assets becomes burdensome in relation to the benefits or servicing.

Collateral

Personal or real property in which a security interest has been given.

Derecognize

Remove previously recognized assets or liabilities from the balance sheet.

Derivative Financial Instrument

A derivative instrument (as defined in *SSAP No. 86—Accounting for Derivative Instruments and Hedging, Income Generation, and Replication (Synthetic Asset) Transactions*) that is a financial instrument (refer to SSAP No. 27, paragraph 2).

Embedded Call (See Issue Paper on FAS 140 paragraphs 50 and 52)

A call option held by the issuer of a financial instrument that is part of and trades with the underlying instrument. For example, a bond may allow the issuer to call it by posting a public notice well before its stated maturity that asks the current holder to submit it for early redemption and provides that interest ceases to accrue on the bond after the early redemption date. Rather than being an obligation of the initial purchaser of the bond, an embedded call trades with and diminishes the value of the underlying bond.

Financial Asset

Cash, evidence of an ownership interest in an entity, or a contract that conveys to a second entity a contractual right (a) to receive cash or another financial instrument from a first entity or (b) to exchange other financial instruments on potentially favorable terms with the first entity.

Financial Liability

A contract that imposes on one entity a contractual obligation (a) to deliver cash or another financial instrument to a second entity or (b) to exchange other financial instruments on potentially unfavorable terms with the second entity.

Guaranteed Mortgage Securitization

A securitization of mortgage loans which includes a substantive guarantee by a third party.

Proceeds

Cash, derivatives, or other assets that are obtained in a transfer of financial assets, less any liabilities incurred.

Recourse

The right of a transferee of receivables to receive payment from the transferor of those receivables for (a) failure of debtors to pay when due, (b) the effects of prepayments, or (c) adjustments resulting from defects in the eligibility of the transferred receivables.

Residual

Residuals are a class of retained or purchased beneficial interests that have rights to the last cash flows from the pool of securitized assets and are not rated by a NRSRO. Residuals are to be carried at fair value with the difference between fair value and the allocated cost basis recognized as an unrealized gain or loss.

Securitization

The process by which financial assets are transformed into securities.

Security Interest

A form of interest in property that provides that upon default of the obligation for which the security interest is given, the property may be sold in order to satisfy that obligation.

Seller

A transferor that relinquishes control over financial assets by transferring them to a transferee in exchange for consideration.

Servicing Asset

A contract to service financial assets under which the estimated future revenues from contractually specified servicing fees, late charges, and other ancillary revenues are expected to more than adequately compensate the servicer for performing the servicing. A servicing contract is either (a) undertaken in conjunction with selling or securitizing the financial assets being serviced or (b) purchased or assumed separately.

Servicing Liability

A contract to service financial assets under which the estimated future revenues from stated servicing fees, late charges, and other ancillary revenues are not expected to adequately compensate the servicer for performing the servicing.

Transfer

The conveyance of a noncash financial asset by and to someone other than the issuer of that financial asset. Thus, a transfer includes selling a receivable, putting it into a securitization trust, or posting it as collateral but excludes the origination of that receivable, the settlement of that receivable, or the restructuring of that receivable into a security in a troubled debt restructuring.

Transferee

An entity that receives a financial asset, a portion of a financial asset, or a group of financial assets from a transferor.

Transferor

An entity that transfers a financial asset, a portion of a financial asset, or a group of financial assets that it controls to another entity.

Undivided Interest

Partial legal or beneficial ownership of an asset as a tenant in common with others. The proportion owned may be pro rata, for example, the right to receive 50 percent of all cash flows from a security, or non-pro rata, for example, the right to receive the interest from a security while another has the right to the principal.

Unrestricted Collateral

Securities received that may be sold or repledged and which were obtained under agreements that are not subject to repurchase or redemption on short notice, for example, by substitution of other collateral or termination of the contract.

Unilateral Ability (See Issue Paper on FAS 140 paragraphs 50 and 51)

A capacity for action not dependent on the actions (or failure to act) of any other party.

EXHIBIT B - ILLUSTRATIONS

1. Illustration—Recording Transfers with Proceeds of Cash, Derivatives, and Other Liabilities

Company A sells loans with a fair value of $1,100 and a carrying amount of $1,000. Company A retains no servicing responsibilities but obtains an option to purchase from the transferee loans similar to the loans sold (which are readily obtainable in the marketplace) and assumes a limited recourse obligation to repurchase delinquent loans.

Company A agrees to provide the transferee a return at a floating rate of interest even though the contractual terms of the loan are fixed rate in nature (that provision is effectively an interest rate swap).

Fair Values	
Cash proceeds	$1,050
Interest rate swap	40
Call option	70
Recourse obligation	60

Net Proceeds	
Cash received	$1,050
Plus: Call option	70
Interest rate swap	40
Less: Recourse obligation	(60)
Net proceeds	$1,100

Gain on Sale	$1,100
Net proceeds	1,000
Carrying amount of loans sold	$ 100
Gain on sale	

Journal Entry		
Cash	1,050	
Interest rate swap	40	
Call option	70	
Loans		1,000
Recourse obligation		60
Gain on sale		100
To record transfer		

2. Illustration—Recording Transfers of Partial Interests

Company B sells a pro rata nine-tenths interest in loans with a fair value of $1,100 and a carrying amount of $1,000. There is no servicing asset or liability, because Company B estimates that the benefits of servicing are just adequate to compensate it for its servicing responsibilities.

Fair values	
Cash proceeds for nine-tenths sold	$990
One-tenth interest retained [($990 ÷9/10)×1/10]	110

Carrying Amount Based on Relative Fair Values

	Fair Value	Percentage Of Total Fair Value	Allocated Carrying Amount
Nine-tenths interest sold	$ 990	90	$ 900
One-tenth interest retained	110	10	100
Total	$ 1,100	100	$ 1,000

Gain on Sale	
Net proceeds	$ 990
Carrying amount of loans sold	900
Gain on sale	$ 90

Journal Entry		
Cash	990	
Loans		900
Gain on sale		90
To record transfer		

3. Illustration—Sale of Receivables with Servicing Retained

Company C originates $1,000 of loans that yield 10 percent interest income for their estimated lives of 9 years. Company C sells the $1,000 principal plus the right to receive interest income of 8 percent to another entity for $1,000. Company C will continue to service the loans, and the contract stipulates that its compensation for performing the servicing is the right to receive half of the interest income not sold. The remaining half of the interest income not sold is considered an interest-only strip receivable. At the date of the transfer, the fair value of the loans, including servicing, is $1,100. The fair value of the servicing asset is $40.

Fair Values	
Cash proceeds	$1,000
Servicing asset	40
Interest-only strip receivable	60

Carrying Amount Based on Relative Fair Values

	Fair Value	Percentage Of Total Fair Value	Allocated Carrying Amount
Loans sold	$ 1,000	91.0	$ 910
Servicing asset	40	3.6	36
Interest-only strip receivable	60	5.4	54
Total	$ 1,100	100.0	$ 1,000

Gain on Sale	
Net proceeds	$ 1000
Carrying amount of loans sold	910
Gain on sale	$ 90

Journal Entries

Cash	1000	
Loans		910
Gain on sale		90
To record transfer		
Servicing asset	36	
Interest-only strip receivable	54	
Loans		90
To record servicing asset and interest-only strip receivable		
Interest-only strip receivable	6	
Equity		6
To begin to subsequently measure interest-only strip receivable like an available-for-sale security (FAS 140 paragraph 14)		

4. Illustration—Recording Transfers of Partial Interests with Proceeds of Cash, Derivatives, Other Liabilities, and Servicing

Company D originates $1,000 of prepayable loans that yield 10 percent interest income for their 9-year expected lives. Company D sells nine-tenths of the principal plus interest of 8 percent to another entity. Company D will continue to service the loans, and the contract stipulates that its compensation for performing the servicing is the 2 percent of the interest income not sold. Company D obtains an option to purchase from the transferee loans similar to the loans sold (which are readily obtainable in the marketplace) and incurs a limited recourse obligation to repurchase delinquent loans.

Fair Values

Cash proceeds	$900
Call option	70
Recourse obligation	60
Servicing asset	90
One-tenth interest retained	100

Net Proceeds

Cash received	$900
Plus: Call option	70
Less: Recourse obligation	(60)
Net proceeds	$910

Carrying Amount Based on Relative Fair Values

	Fair Value	Percentage Of Total Fair Value	Allocated Carrying Amount
Interest sold	$ 910	83	$ 830
Servicing asset	90	8	80
One-tenth interest retained	100	9	90
Total	$ 1,100	100	$ 1,000

Gain on Sale	
Net proceeds	$ 910
Carrying amount of loans sold	830
Gain on sale	$ 80

Journal Entries		
Cash	900	
Call option	70	
Loans		830
Recourse obligation		60
Gain on sale		80
To record transfer		
Servicing asset	80	
Loans		80
To record servicing asset		

At the time of the transfer, Company D reports its one-tenth retained interest in the loans at its allocated carrying amount of $90.

5. Illustration—Recording Transfers If It Is Not Practicable to Estimate a Fair Value

Company E sells loans with a carrying amount of $1,000 to another entity for cash plus a call option to purchase loans similar to the loans sold (which are readily obtainable in the marketplace) and incurs a limited recourse obligation to repurchase any delinquent loans. Company E undertakes to service the transferred assets for the other entity. In Case 1, Company E finds it impracticable to estimate the fair value of the servicing contract, although it is confident that servicing revenues will be more than adequate compensation for performing the servicing. In Case 2, Company E finds it impracticable to estimate the fair value of the recourse obligation.

Fair Values	**Case 1**	**Case 2**
Cash proceeds	$1,050	$1,050
Servicing asset	XX*	40
Call option	70	70
Recourse obligation	60	XX*
Fair value of loans transferred	$1,100	$1,100

* Not practicable to estimate fair value

Net Proceeds	**Case 1**	**Case 2**
Cash received	$1,050	$1,050
Plus: Call option	70	70
Less: Recourse obligation	(60)	XX
Net proceeds	$1,060	$1,120

Carrying Amount Based on Relative Fair Values (Case 1)

	Fair Value	Percentage Of Total Fair Value	Allocated Carrying Amount
Loans sold	$ 1,060	100	$ 1,000
Servicing asset	0	0	0
Total	$ 1,060	100	$ 1,000

Carrying Amount Based on Relative Fair Values (Case 2)

	Fair Value	Percentage Of Total Fair Value	Allocated Carrying Amount
Loans sold	$ 1,120	97	$ 970
Servicing asset	40	3	30
Total	$ 1,160	100	$ 1,000

Journal Entries	**Case 1**		**Case 2**	
Cash	1,050		1,050	
Servicing asset	0*		30	
Call option	70		70	
Loans		1,000		1,000
Recourse obligation		60		150†
Gain on sale		60		0
To record transfer				

* Assets shall be recorded at zero if an estimate of the fair value of the assets is not praticable.

† The amount recorded as a liability in this example equals the sum of the known assets less the fair value of the known liabilities, that is, the amount that results in no gain or loss.

6. The following example illustrates the accounting for a securities lending transaction treated as a secured borrowing, in which the securities borrower sells the securities upon receipt and later buys similar securities to return to the securities lender:

Facts	
Transferor’s carrying amount and fair value of security loaned	$1,000
Cash “collateral”	1,020
Transferor’s return from investing cash collateral at a 5 percent annual rate	5
Transferor’s rebate to the securities borrower at a 4 percent annual rate	4

For simplicity, the fair value of the security is assumed not to change during the 35-day term of the transaction.

Journal Entries for the Transferor

At inception:		
Cash	1,020	
Payable under securities loan agreements		1,020
To record the receipt of cash collateral		

Securities pledged to creditors	1,000	
Securities		1,000

To reclassify loaned securities that the secured party has the right to sell or repledge

Money market instrument	1,020	
Cash		1,020

To record investment of cash collateral

At conclusion:

Cash	1,025	
Interest		5
Money market instrument		1,020

To record results of investment

Securities	1,000	
Securities pledged to creditors		1,000

To record return of security

Payable under securities loan agreements	1,020	
Interest (“rebate”)	4	
Cash		1,024

To record repayment of cash collateral plus interest

Journal Entries for the Transferee

At inception:

Receivable under securities loan agreements	1,020	
Cash		1,020

To record transfer of cash collateral

Cash	1,000	
Obligation to return borrowed securities		1,000

To record sale of borrowed securities to a third party and the resulting obligation to return securities that it no longer holds

At conclusion:

Obligation to return borrowed securities	1,000	
Cash		1,000

To record the repurchase of securities borrowed

Cash	1,024	
Receivable under securities loan agreements		1,020
Interest revenue (“rebate”)		4

To record the receipt of cash collateral and rebate interest

Statutory Issue Paper No. 123

Accounting for Pensions, A Replacement of SSAP No. 8

STATUS
Finalized September 15, 2003

Current Authoritative Guidance for Accounting for Pensions: SSAP No. 102
This issue paper may not be directly related to the current authoritative statement.

Original SSAP from Issue Paper: SSAP No. 89

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory accounting guidance for employers' pension obligations is provided in *SSAP No. 8—Pensions* (SSAP No. 8). This issue paper supersedes the conclusions reached in SSAP No. 8 and incorporates the guidance in *INT 99-24: Accounting for Restructuring Charges, INT 99-26: Offsetting Pension Assets and Liabilities, INT 01-16: Measurement Date for SSAP No. 8 Actuarial Valuations, INT 01-17: Accounting for Nonqualified Retirement Plans, Nonvested Ancillary Benefits Within Retirement Plans, and Protected Benefits Such as Early Retirement Subsidies in Retirement Plans*, as well as some of the guidance in *INT 02-18: Accounting for the Intangible Asset as Described in SSAP No. 8 Paragraph 9.d.v. and 9.f.*

2. The changes made in this issue paper regarding the accounting treatment of the additional minimum pension liability will create a nonsubstantive change to *SSAP No. 72—Surplus and Quasi-reorganizations*. Unassigned funds (surplus) will include changes in the additional minimum pension liability.

3. Generally Accepted Accounting Principles (GAAP) guidance for these issues is established in *Financial Accounting Standards Board (FASB) Statement No. 87, Employers' Accounting for Pensions* (FAS 87), *FASB Statement No. 88, Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits* (FAS 88), *FASB Statement No. 132, Employers' Disclosures about Pensions and Other Postretirement Benefits* (FAS 132), and *FASB Statement No. 130, Other Comprehensive Income* (FAS 130).

4. The purpose of this issue paper is to establish statutory accounting principles for an employer's pension obligations that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

Defined Benefit Plans

5. A defined benefit plan defines the amount of the pension benefit that will be provided to the plan participant at retirement or termination. For such benefit plans, reporting entities shall adopt FAS 87 with modifications to exclude non-vested employees and to account for the additional minimum pension liability. Therefore, the cost related to services rendered prior to becoming eligible and vested in the plan are recognized as a component of the net periodic pension cost in the period the employee becomes vested. Any intangible asset or prepaid expense, other than the intangible asset associated with the transition obligation recorded as of January 1, 2001, resulting from adoption of the provisions of this issue paper shall be considered a nonadmitted asset, as such an asset cannot be readily converted to cash

to satisfy policyholder obligations. This is consistent with the definition of assets and nonadmitted assets set forth in *SSAP No. 4—Assets and Nonadmitted Assets*.

6. If the accumulated benefit obligation exceeds the fair value of plan assets, the reporting entity shall recognize a liability (including unfunded accrued pension cost) that is at least equal to the unfunded accumulated benefit obligation. Recognition of an additional minimum liability is required if an unfunded accumulated benefit obligation exists and (a) a prepaid pension cost asset has been recognized as a nonadmitted asset, (b) the liability already recognized as unfunded accrued pension cost is less than the unfunded accumulated benefit obligation, or (c) no accrued or prepaid pension cost has been recognized.

7. If an additional minimum liability is recognized an equal amount shall be recognized as an intangible asset, provided that the asset recognized shall not exceed the amount of unrecognized prior service cost (unrecognized prior service cost shall include unamortized incremental liability). If an intangible asset generated by the additional minimum liability is recognized, only that portion in excess of the unamortized incremental liability associated with the transition shall be nonadmitted. If an additional liability required to be recognized exceeds unrecognized prior service cost, the excess (which would represent a net loss not yet recognized as net periodic pension cost) shall be reported as a component of unassigned funds (surplus), net of any tax benefits that result from considering such losses as temporary differences for purposes of applying the provisions of *SSAP No. 10—Income Taxes*.

8. When a new determination of the amount of additional liability is made, the related intangible asset and the balance accumulated in unassigned funds (surplus) shall be eliminated or adjusted as necessary.

9. If a reporting entity settles or curtails a defined benefit plan, the reporting entity shall immediately recognize all previously unrecognized amounts as discussed below. A settlement is a transaction which is irrevocable and releases the employer from responsibility for the pension obligation by eliminating the risks relative to the obligation and the assets associated with the plan (e.g., making lump-sum cash payments to plan participants in exchange for their rights to receive specified pension benefits or purchasing nonparticipating annuity contracts to cover vested benefits). If a settlement occurs and the net result is a loss, such loss is recognized at the time of the settlement. If the net result is a gain, such gain is not recognized until the proceeds are received by the reporting entity. A curtailment is an event which significantly alters the makeup of the pension plan. If a curtailment occurs, there are generally two components to any gain or loss (e.g., a reduction in the years of service required or the employees covered). Any unrecognized prior service cost shall be recognized as a loss. An increase or decrease in pension benefit obligations due to the curtailment will also result in a gain or loss, and is combined with the prior service cost loss. If the net result of the curtailment is a loss, such loss shall be recognized when it is probable that the curtailment will occur and that the effects can be reasonably estimated. If the net result is a gain, such gain shall not be recognized in earnings until the employees terminate or the plan suspension or amendment is adopted and the proceeds are received by the reporting entity. When such settlement or curtailment gains are recognized, any excess tax surcharges shall also be recognized.

Defined Contribution Plans

10. A defined contribution plan defines the amount of the employer's contributions to the plan and its allocation to plan participants. The pension benefit provided to the plan participant at retirement or termination depends on the amount of employer and employee contributions, earnings on plan investments and, in some plans, other participant forfeitures.

11. For defined contribution plans, the reporting entity shall expense contributions required by the plan over the period in which the employee vests in those contributions. Contributions to plan participants' accounts made prior to vesting shall be treated as prepaid expenses, and shall be

nonadmitted. Contributions required after participants terminate or retire shall be accrued and an expense shall be recorded over the working lives of the participants beginning at the date the participant initially vests in plan contributions.

12. Certain defined contribution plans may define the employer’s contribution as a percentage of the plan participants’ individual compensation rather than as a specific dollar amount which is allocated among the plan participants. If an employer's contributions to a defined contribution plan are in excess of those required under the plan and required to be allocated to individual participants, such amounts are recorded as a prepaid expense and nonadmitted under statutory accounting principles.

Disclosures

13. The following disclosures shall be made for defined benefit pension plans for which the reporting entity is directly liable:

a. A reconciliation of beginning and ending balances of the benefit obligation showing separately, if applicable, the effects during the period attributable to service cost, interest cost, contributions by plan participants, actuarial gains and losses, foreign currency exchange rate changes, benefits paid, plan amendments, business combinations, divestitures, curtailments, settlements, and special termination benefits;

b. The amount of the pension obligation for non-vested employees as of the most recent actuarial valuation date;

c. A reconciliation of beginning and ending balances of the fair value of plan assets showing separately, if applicable, the effects during the period attributable to actual return on plan assets, foreign currency exchange rate changes, contributions by the reporting entity, contributions by plan participants, benefits paid, business combinations, divestitures, and settlements;

d. The funded status of the plan, the amounts not recognized in the statement of financial position, and the amounts recognized in the statement of financial position, including:

i. The amount of any unamortized prior service cost;

ii. The amount of any unrecognized net gain or loss (including asset gains and losses not yet reflected in market-related value);

iii. The amount of any remaining unamortized, unrecognized net obligation or net asset existing at the initial date of application of this statement;

iv. The net pension or other postretirement benefit prepaid assets or accrued liabilities; and

v. Any intangible asset;

e. The amount of net periodic benefit cost recognized, showing separately the service cost component, the interest cost component, the expected return on plan assets for the period, the amortization of the unrecognized incremental liability or incremental asset (see paragraph 20), the amount of recognized gains and losses, the amount of prior service cost recognized, and the amount of gain or loss recognized due to a settlement or curtailment;

f. The amount included in unassigned funds (surplus) for the period arising from a change in the additional minimum pension liability recognized pursuant to paragraph 7;

g. On a weighted-average basis, the following assumptions used in the accounting for the plan: assumed discount rate, rate of compensation increase (for pay-related plans), and expected long-term rate of return on plan assets;

h. If applicable, the amounts and types of securities of the reporting entity and related parties included in plan assets, the approximate amount of future annual benefits of plan participants covered by insurance contracts issued by the reporting entity or related parties, and any significant transactions between the reporting entity or related parties and the plan during the period;

i. If applicable, any alternative amortization method used to amortize prior service amounts or unrecognized net gains and losses pursuant to paragraphs 26 and 33 of FAS 87;

j. If applicable, any substantive commitment, such as past practice or a history of regular benefit increases, used as the basis for accounting for the benefit obligation;

k. If applicable, the cost of providing special or contractual termination benefits recognized during the period and a description of the nature of the event; and

l. An explanation of any significant change in the benefit obligation or plan assets not otherwise apparent in the other disclosures required by this statement.

Amounts related to the reporting entity’s results of operations shall be disclosed for each period for which an income statement is presented. Amounts related to the reporting entity’s statement of financial position shall be disclosed for each balance sheet presented.

14. The reporting entity shall disclose the amount of cost recognized for defined contribution pension plans during the period separately from the amount of cost recognized for defined benefit plans. The disclosures shall include a description of the nature and effect of any significant changes during the period affecting comparability, such as a change in the rate of employer contributions, a business combination, or a divestiture.

15. The reporting entity shall disclose the amount of contributions to multiemployer plans during the period. The reporting entity may disclose total contributions to multiemployer plans without disaggregating the amounts attributable to pensions and other postretirement benefits. The disclosures shall include a description of the nature and effect of any changes affecting comparability, such as a change in the rate of employer contributions, a business combination, or a divestiture.

16. Refer to the preamble for further discussion regarding disclosure requirements.

Consolidated/Holding Company Plans

17. The employees of many reporting entities are members of a plan sponsored by a parent company or holding company. A reporting entity who participates in these plans and is not directly liable for obligations under the plan shall recognize pension expense equal to its allocation from the holding company or parent company of the required contribution to the plan for the period. A liability shall be established for any such contributions due and unpaid. Furthermore, the reporting entity shall disclose in the notes to the financial statements that its employees participate in a plan sponsored by the holding company for which the reporting entity has no legal obligation. The amount of expense incurred and the allocation methodology utilized by the provider of such benefits shall also be disclosed. If the reporting

entity is directly liable for obligations under the plan, then the requirements outlined above in paragraphs 5-13 and 20-24 of this issue paper shall be applied.

DISCUSSION

18. The conclusions in paragraphs 5-13 and 20-24 adopt FAS 87, FAS 88, and FAS 132 with certain modifications. Those modifications and additional information from nullified interpretations are listed below:

a. Calculation of the pension obligation shall exclude non-vested employees. Partially vested employees are included only to the extent of their vested amounts;

b. A liability for ancillary benefits (primarily death and disability benefits) shall be accrued prior to the triggering event of these benefits for purposes of Projected Benefit Obligation (PBO) and Service Cost (SC) in accordance with the guidance in FAS 87 (use of a general vesting standard rather than an Internal Revenue Service income tax vesting standard);

c. A liability for protected, nonvested benefits shall be accrued for purposes of PBO and SC in accordance with the guidance in FAS 87 (use of a general vesting standard rather than an Internal Revenue Service income tax vesting standard);

d. A liability for nonvested, nonqualified benefits prior to retirement or when there is no longer a substantial risk of forfeiture, shall be accrued for purposes of PBO and SC in accordance with the guidance in FAS 87 (use of a general vesting standard rather than an Internal Revenue Service income tax vesting standard);

e. Entities shall perform actuarial analysis consistent with the three month guideline contained within FAS 87;

f. A reporting entity that utilizes an actuarial valuation as of a date prior to the financial statement date to measure plan assets and obligations, and determines that an additional minimum liability is required to be established in accordance with paragraph 37 of FAS 87, and if the reporting entity contributes amounts to the plan to fund that additional minimum liability prior to the financial statement date, such amount funded may be used to reduce the additional minimum liability recognized in the reporting entity's financial statements;

g. It is not acceptable statutory accounting practice to offset pension or postretirement benefits other than pensions (OPEB) liability generated by one plan against the prepaid asset of another plan;

h. Reporting entities may downsize their operations and in doing so, often offer severance pay and other benefits to displaced workers. Costs associated with downsizing shall be recorded as an expense in the financial statements;

i. The prepaid asset which results from an excess of the fair value of plan assets over the pension obligation shall be recorded as a nonadmitted asset;

j. Any intangible asset offsetting the minimum pension liability (excluding the unamortized incremental liability associated with transition) shall be nonadmitted and charged to surplus;

k. Any additional minimum liability in excess of unrecognized prior service cost that is reported as a component of unassigned funds (surplus), shall be classified as an aggregate write-in for gains and losses in surplus;

l. As of January 1, 2001 the pension obligation or asset not previously recognized related to vested employees may be recorded immediately or may be amortized over future periods;

m. Paragraphs 36-38 of FAS 87 are adopted with modifications described in paragraph 7 of this issue paper;

n. A net gain (net of excess tax surcharge) resulting from the settlement or curtailment of a pension plan is not recognized until the proceeds are received by the reporting entity;

o. The reduced disclosure requirements for nonpublic entities described in paragraph 8 of FAS 132 are rejected. All reporting entities shall follow the disclosure requirements included in paragraph 5 of FAS 132;

p. For the disclosures relating to the initial date of application in paragraph 5 of FAS 132, January 1, 2001 shall be considered the initial date of application; and

q. Pension disclosures relating to other comprehensive income in paragraph 5 of FAS 132 shall be made for unassigned funds (surplus) on a statutory basis.

19. This issue paper also adopts *FASB Emerging Issues Task Force No. 88-1, Determination of Vested Benefit Obligation for a Defined Benefit Pension Plan*, *FASB Emerging Issues Task Force No. 90-3, Accounting for Employers' Obligations for Future Contributions to a Mutliemployer Pension Plan*, *FASB Emerging Issues Task Force No. 91-7, Accounting for Pension Benefits Paid by Employers after Insurance Companies Fail to Provide Annuity Benefits*, and *FASB Emerging Issues Task Force No 96-5, Recognition of Liabilities for Contractual Termination Benefits or Changing Benefit Plan Assumptions in Anticipation of a Business Combination*.

Effective Date and Transition

20. As of January 1, 2001, the transition obligation or asset shall be determined as the difference between the vested projected benefit obligation and the fair value of plan assets. If prior to the effective date of January 1, 2001, the reporting entity has adopted FAS 87 for statutory accounting purposes, the transition obligation or asset calculated above shall be compared to those amounts previously recorded under FAS 87. The difference between these amounts represents an incremental asset or liability. If the reporting entity has not previously adopted FAS 87 for statutory accounting purposes, the entire transition asset or obligation represents the incremental asset or liability.

21. As of January 1, 2001, if the reporting entity calculates an incremental liability, this liability shall be recognized according to one of the two following methods:

a. The reporting entity may elect to record the entire incremental liability as a direct charge to surplus;

b. Alternatively, the reporting entity may elect to amortize the incremental liability as a component of net periodic pension cost over a period not to exceed 20 years.

22. As of January 1, 2001, if the reporting entity calculates an incremental asset, this asset shall be recognized according to one of the two following methods:

a. The reporting entity may elect to record the entire incremental asset as a direct credit to surplus;

b. Alternatively, the reporting entity may elect to accrue the incremental asset as a component of net periodic pension cost in an amount each period such that total net periodic pension cost may be reduced to an amount not less than zero (i.e., the accrual of the incremental asset may be used to offset current period net periodic pension cost).

23. An incremental asset resulting from a transition obligation that is less than an amount previously recorded under FAS 87 shall first reduce the recorded liability. Any remaining incremental asset shall be recorded as nonadmitted.

24. This issue paper is effective for years ending on or after, December 31, 2003. SSAP No. 8 applies to the calculation of the transition obligation in accordance with the adoption of FAS 87 for periods prior to the adoption of this statement. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*. For reporting entities that expensed the additional minimum pension liability through income prior to January 1, 2004 under SSAP No. 8, if the additional minimum pension liability subsequently decreases because of factors such as asset value recovery, the reversal of the expense shall be through unassigned funds (surplus). Restatement of previously expensed additional minimum liability amounts through the income statement is not permitted.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

25. The following is excerpted from Interpretation 02-18

> The working group reached a consensus to require reporting entities to recognize the entire minimum pension liability in the financial statement. Further, any intangible asset offsetting the minimum pension liability shall be nonadmitted and charged to surplus.

26. See Issue Paper No. 8 for additional statutory references

Generally Accepted Accounting Principles

27. The following is excerpted from *FASB Statement No. 130, Other Comprehensive Income* (FAS 130):

> 10. This Statement uses the term comprehensive income to describe the total of all components of comprehensive income, including net income.[4] This Statement uses the term other comprehensive income to refer to revenues, expenses, gains, and losses that under generally accepted accounting principles are included in comprehensive income but excluded from net income. This Statement does not require that an enterprise use the terms comprehensive income or other comprehensive income in its financial statements, even though those terms are used throughout this Statement.[5]
>
> [4] FAS130, Footnote 4--This Statement uses the term net income to describe a measure of financial performance resulting from the aggregation of revenues, expenses, gains, and losses that are not items of other comprehensive income as identified in this Statement. A variety of other terms such as net earnings or earnings may be used to describe that measure.
>
> [5] FAS130, Footnote 5--Paragraph 40 of Concepts Statement 5 states that "just as a variety of terms are used for net income in present practice, the Board anticipates that total nonowner changes in equity, comprehensive loss, and other equivalent terms will be used in future financial statements as names for comprehensive income."

28. See Issue Paper No. 8 for additional GAAP references

OTHER SOURCES OF INFORMATION

29. See Issue Paper No. 8 for Other Sources of Information

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *SSAP No. 8—Pensions*
- *Issue Paper No. 3—Accounting Changes*
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 8—Accounting for Pensions*
- Minutes from the June 23, 1987, meeting of the Accounting Practices and Procedures (EX4) Task Force
- Minutes from the September 15, 1987, meeting of the Accounting Practices and Procedures (EX4) Task Force
- Minutes from the June 12, 1986, meeting of the Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force
- Minutes from the September 8, 1986, meeting of the Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 17, Other Liabilities
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies
- NAIC Annual Statement Instructions for Life and Accident and Health Insurance Companies
- *NAIC Annual Statement Instructions for Property and Casualty Insurance Companies*
- Employers' Accounting for Postretirement Benefits Other Than Pensions—Field Test of the Statutory Proposal—prepared by the Codification Advisory Group, September 20, 1992
- *INT 02-18: Accounting for the Intangible Asset as Described in SSAP No. 8 Paragraph 9.d.v. and 9.f.*
- *INT 01-1: Measurement Date for SSAP No. 8 Actuarial Valuations*
- *INT 01-17: Accounting for Nonqualified Retirement Plans, Nonvested Ancillary Benefits Within Retirement Plans, and Protected Benefits Such as Early Retirement Subsidies in Retirement Plans*
- *INT 99-24: Accounting for Restructuring Charges*
- *INT 99-26: Offsetting Pension Assets and Liabilities*

Generally Accepted Accounting Principles

- *FASB Statement No. 87, Employers' Accounting for Pensions*
- *FASB Statement No. 88, Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*
- *FASB Statement No. 132, Employers' Disclosures about Pensions and Other Postretirement Benefits*
- *FASB Emerging Issues Task Force No. 88-1, Determination of Vested Benefits Obligation for a Defined Benefit Pension Plan*
- *FASB Emerging Issues Task Force No. 90-3, Accounting for Employers' Obligations for Future Contributions to a Mutliemployer Pension Plan*
- *FASB Emerging Issues Task Force No. 91-7, Accounting for Pension Benefits Paid by Employers after Insurance Companies Fail to Provide Annuity Benefits*
- *FASB Emerging Issues Task Force No. 96-5, Recognition of Liabilities for Contractual Termination Benefits or Changing Benefit Plan Assumptions in Anticipation of a Business Combination*

- *FASB Statement No. 130, Other Comprehensive Income*

State Regulations

- No additional guidance obtained from state statutes or regulations.

Other Sources of Information

- *NAIC Technical Resource Group Proposed Draft Life Codification, Chapter 22, General Expenses and Taxes, Licenses and Fees*
- Draft discussion material from previous Property/Casualty codification projects - Chapter on Non-Claim Operating Expenses

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Statutory Issue Paper No. 124

Treatment of Cash Flows When Quantifying Changes in Valuation and Impairments, An Amendment to SSAP No. 43—Loan-Backed and Structured Securities

STATUS
Finalized December 2, 2007

Original SSAP and Current Authoritative Guidance: SSAP No. 43R

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. *SSAP No. 43—Loan-Backed and Structured Securities* (SSAP No. 43) requires that loan-backed and structured securities shall be revalued using new prepayment assumptions by utilizing either the prospective or retrospective adjustment methodologies. When calculating these new prepayment assumptions, SSAP No. 43 states that undiscounted cash flows should be utilized.

2. Concerns have been raised that an undiscounted cash flows approach for impairment analysis does not properly evaluate certain asset-backed or structured securities. These securities are subject to other than temporary impairment due to deterioration in the credit quality of the underlying securities which serve as the source of cash flow for the payment of interest, and, depending upon the structure of the security, in some cases may also serve as the source for a substantial portion of the return of principal. The issue is that other than temporarily impaired securities are not accurately identified or reported under SSAP No. 43 impairment analysis.

3. The purpose of this issue paper is to amend SSAP No. 43 to require the use of fair value for impairment analysis and subsequent valuation of loan-backed and structured securities, and remain consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy.

SUMMARY CONCLUSION

4. This issue paper amends paragraphs 14 through 16 of SSAP No. 43 to the following:

> 14. The prospective approach recognizes, through the recalculation of the effective yield to be applied to future periods, the effects of all cash flows whose amounts differ from those estimated earlier and the effects and changes in projected cash flows. Under the prospective method, the recalculated effective yield will equate the carrying amount of the investment to the present value of the anticipated future cash flows. The recalculated yield is then used to accrue income on the investment balance for subsequent accounting periods. There are no accounting changes in the current period unless ~~the undiscounted anticipated cash flow is less than the carrying amount of the investment~~ the security is determined to be other than temporarily impaired.
>
> 15. The retrospective methodology changes both the yield and the asset balance so that expected future cash flows produce a return on the investment equal to the return now expected over the life of the investment as measured from the date of acquisition. Under the retrospective method, the recalculated effective yield will equate the present value of the actual and anticipated cash flows with the original cost of the investment. The current balance is then increased or decreased to the amount that would have resulted had the

revised yield been applied since inception, and investment income is correspondingly decreased or increased.

16. ~~Regardless of whether a reporting entity is using a prospective or retrospective method, if the revaluation based on new currently estimated cash flows results in a negative yield (i.e., undiscounted estimated future cash flows are less than the current book value), an other than temporary impairment shall be considered to have occurred.~~ If it is determined that the decline in fair value of the security is ~~an~~ other than temporary, ~~impairment has occurred,~~ then the cost basis of the security shall be written down to fair value. ~~the undiscounted estimated future cash flows and t~~The amount of the write down shall be accounted for as a realized loss. An interest related decline in value shall be considered other than temporary only when a reporting entity has the intent to sell the investment, at the reporting date, before recovery of the cost of the investment. For reporting entities required to maintain an AVR/IMR, the accounting for the entire amount of the realized capital loss shall be in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*. Credit related other than temporary impairment losses shall be recorded through the AVR; interest related other than temporary impairment losses shall be recorded through the IMR. The new cost basis shall not be changed for subsequent recoveries in fair value. Therefore, the prospective adjustment method must be utilized for periods subsequent to the loss recognition.

Effective Date and Transition

5. Upon adoption of this issue paper, the NAIC will release a Statement of Statutory Accounting Principle (SSAP) for comment. The SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the Accounting Practices and Procedures Manual should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will be effective for reporting periods beginning on or after January 1, 2009. A change resulting from the adoption of the finalized SSAP shall be accounted for prospectively.

DISCUSSION

6. Two forms of asset-backed or structured securities, commonly referred to as principal protected securities and combination notes, pose a significant risk of credit related impairment. A typical principal protected security is structured such that cash and securities are deposited in a trust, with the trust issuing new securities on the basis of the deposited assets. The cash is used to purchase a zero coupon U.S. government strip (or similar low risk security) with the intent that it will accrete to an amount equal to the original principal of the structured security at maturity. The deposited higher risk securities support the payment of interest. In dynamically hedged structures, the allocation to the low risk securities varies throughout the life of the structured security based on the performance of the higher risk assets. In this type of structure, the higher risk assets may be supporting the interest payments as well as providing for a substantial portion, or potentially all, of the return of principal.

7. The allocation to the low risk strip is used as a hedge to advocate the position that the security is "principal protected" since the intent is for the investor to be "guaranteed" a return of principal at maturity. This position ignores the economic reality that in some structured security arrangements, particularly those that are dynamically hedged or leveraged, the initial value of the low risk strip may be a very small percentage of the principal value of the assets in the trust, with the balance being in residual tranches of higher risk securities.

8. Recently there have been a large number of residual tranches used in principal protected securities that have experienced significant declines in value purely as a result of the crystallization of credit risk. When the value of the residual securities in these structures is diminished, the market value of

the structured security moves toward the present value of the low risk strip. Though the value of the structured securities has often been significantly impaired, in many cases, other than temporary impairment recognition would not be required in the financial statements under an undiscounted cash flows approach to impairment analysis.

9. From an admitted asset perspective, in such an instance, a reporting entity with solvency or liquidity problems could only sell such an investment, or force the trust to unwind, for an amount that would be substantially less than the original value of the security. Thus, the fair value of the investment is the amount that would be available to the reporting entity to meet its current and future obligations, and is the amount that should be reflected in the financial statements.

10. SSAP No. 43 impairment guidance does not properly identify these securities as other than temporarily impaired. The use of undiscounted cash flows causes concern among regulators because it ignores the credit dynamic described in paragraphs 6 through 9, and does not provide for proper analysis or valuation of these securities. The fair value of the security in such a situation is what remains of the principal at the measurement date, and it is a substantially diminished value. In order to provide for conservative, consistent and accurate financial statements, an impairment approach that utilizes fair value is necessary to properly analyze and value this class of securities.

11. During discussion of this issue, concerns were raised regarding the impact of the proposed changes to SSAP No. 43 on certain high quality loan-backed securities, such as those issued by the Government National Mortgage Association (GNMA) which are backed by the full faith and credit of the U.S. Government, or those issued by the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC) which are generally considered to be of extremely high credit quality. The primary concern was that under a fair value impairment approach, these securities would be considered other than temporarily impaired when in an unrealized loss position due to the general fluctuation of market interest rates, though a reporting entity had the intent to hold such a security to maturity.

12. In 2006, the Emerging Accounting Issues Working Group (EAIWG) of the NAIC released *INT 06-07: Definition of Phrase "Other Than Temporary"*(INT 06-07), to address the GAAP guidance issued by the FASB in *FSP FAS 115-1/124-1: The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments* (FSP FAS 115-1/124-1). Within INT 06-07, the EAIWG concluded that interest related declines in value should only be considered other than temporary impairments when a reporting entity has the intent to sell the security at the reporting date, before recovery of the cost of the investment. When evaluating for interest related impairment, a reporting entity should consider whether its cash or working capital requirements and contractual or regulatory obligations indicate that an investment may need to be sold before the forecasted recovery occurs.

13. Given this interpretation by the EAIWG, and considering that the primary motivation of regulators in proposing revisions to SSAP No. 43 impairment guidance was the proper recognition of credit quality related impairment, the Statutory Accounting Principles Working Group (SAPWG) included language in the exposure draft to specify that interest related declines in value should be considered other than temporary only when the reporting entity has the intent to sell the security, at the reporting date, before recovery of the cost of the investment. This additional guidance is consistent with the statutory accounting interpretation provided in INT 06-07.

14. For clarification purposes, the SAPWG also added language relevant to reporting entities required to maintain an Asset Valuation Reserve (AVR) and an Interest Maintenance Reserve (IMR). The additional guidance specifies that, for companies required to maintain such reserves, credit related other than temporary impairment losses are to be recorded through the AVR, while interest related other than temporary impairment losses are to be recorded through the IMR.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

15. SSAP No. 43, paragraphs 14 through 16:

> 14. The prospective approach recognizes, through the recalculation of the effective yield to be applied to future periods, the effects of all cash flows whose amounts differ from those estimated earlier and the effects and changes in projected cash flows. Under the prospective method, the recalculated effective yield will equate the carrying amount of the investment to the present value of the anticipated future cash flows. The recalculated yield is then used to accrue income on the investment balance for subsequent accounting periods. There are no accounting changes in the current period unless the undiscounted anticipated cash flow is less than the carrying amount of the investment.
>
> 15. The retrospective methodology changes both the yield and the asset balance so that expected future cash flows produce a return on the investment equal to the return now expected over the life of the investment as measured from the date of acquisition. Under the retrospective method, the recalculated effective yield will equate the present value of the actual and anticipated cash flows with the original cost of the investment. The current balance is then increased or decreased to the amount that would have resulted had the revised yield been applied since inception, and investment income is correspondingly decreased or increased.
>
> 16. Regardless of whether a reporting entity is using a prospective or retrospective method, if the revaluation based on new prepayment assumptions results in a negative yield (i.e., undiscounted estimated future cash flows are less than the current book value), an other than temporary impairment shall be considered to have occurred. If it is determined that a decline in the fair value of a loan-backed security is other than temporary, the cost basis of the security shall be written down to the undiscounted estimated future cash flows and the amount of the write down shall be accounted for as a realized loss (which shall be included in Interest Maintenance Reserve (IMR), if applicable). The new cost basis shall not be changed for subsequent recoveries in fair value. Therefore, the prospective adjustment method must be utilized for periods subsequent to the loss recognition.

16. INT 06-07, paragraphs 1 through 8:

> 1. The Accounting Practices and Procedures Manual contains guidance for determining when an investment is considered impaired within each of the above identified statements. Those statements should also be used to determine the measurement of an impairment loss. Each of the above statements also makes reference to an “other than temporary” decline in fair value. This interpretation is designed to address questions related to that phrase, as well as summarize the statutory accounting process for determining when an investment is considered impaired.
>
> **Step 1: Determine Whether an Investment Is Impaired**
>
> 2. The decision for determining when an investment is considered impaired is dictated by the applicable SSAP and the respective impairment indicators included in each of the SSAPs. If an impairment indicator is present, the determination of an impairment shall be assessed at the individual security or investment level as reported in the annual statement and supporting schedules. For those SSAPs that require the reporting entity to use the fair value to determine if an impairment has occurred, the determination of that value shall be consistent with how the term fair value is defined within the Glossary of the Accounting Practices and Procedures Manual. Once a reporting entity has determined that an impairment indicator is present, the reporting entity shall continue to evaluate whether the investment is impaired each subsequent reporting period until either (a) the investment experiences a recovery of the fair value up to (or beyond) its carrying value or (b) the investor recognizes an other-than-temporary impairment loss.

Step 2: Evaluate Whether an Impairment Is Other Than Temporary

3. There are numerous factors to be considered when determining whether an impairment is other than temporary and their relative significance will vary from case to case. The Emerging Accounting Issues Working Group (working group) has been asked if the phrase "other than temporary" should be interpreted to mean "permanent". The working group1 believes the Statutory Accounting Principles Working Group consciously chose the phrase "other than temporary" as the analysis was not intended to determine whether an individual security or investment was "permanently impaired." The fair value of assets may decline for various reasons. The market price may be affected by general market conditions, which reflect prospects for the economy as a whole, or by specific information pertaining to an industry or an individual company. Such declines require further investigation by management. Acting upon the premise that a write-down may be required, management should consider all available evidence to evaluate the fair value of its investment.

4. The working group believes that the following items are only a few examples of the factors, which, individually or in combination, indicate that a security's decline in value is specific to an issuer's fundamental credit difficulties, or that a non-interest related decline is other than temporary and that a write-down of the carrying value is required:

a. The length of time and the extent to which the fair value has been less than cost;

b. The financial condition and short-term prospects of the issuer, including any specific events that may influence the operations of the issuer, such as changes in technology, that may impair the earnings potential of the asset or the discontinuance of a segment of the business that may affect the future earnings potential; or

c. The intent and ability of the holder to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in value.

5. An interest related impairment should be deemed other-than-temporary when an investor has the intent to sell an investment, at the reporting date, before recovery of the cost of the investment. The investor should consider whether its cash or working capital requirements and contractual or regulatory obligations indicate that the investment may need to be sold before the forecasted recovery occurs. The term "interest related" includes a declining value due to both increases in the risk free interest rate and general credit spread widening. Credit spreads can widen or contract for a variety of reasons, including supply/demand imbalances in the marketplace or perceived higher/lower risk of an entire sector. If the declining value is caused, in whole or in part, due to credit spreads widening, but not due to fundamental credit problems of the issuer, the change in credit spreads is deemed to be interest related. Fundamental credit problems exist with the issuer when there is evidence of financial difficulty that may result in the issuer being unable to pay principal or interest when due.

6. Unless evidence exists to support the assertion that the decline in fair value below carrying value is temporary, a write-down, accounted for as a realized loss, should be recorded. In accordance with the guidance of the SSAPs, such loss should be recognized in income for the period in which other than temporary impairment is determined to have occurred. The adjusted carrying value reflecting the impairment loss of the individual security or investment shall be the new cost basis of the individual security or investment.

7. The working group has also been asked if it is appropriate for reporting entities, independent auditors or state examiners to apply predefined thresholds to the phrase "other than temporary"? The working group is aware that certain insurers, independent auditors and state examiners, over time, have developed quantitative thresholds as "rules of thumb" to assist in the evaluation of asset impairment. One rule of thumb in particular suggests that if the fair value is less than its carrying value by 20 percent or more, then it is considered to be other than temporarily impaired. Another suggests that an asset is other than temporarily impaired if the fair value has been less than cost for more than 6 months. The use of a numerical threshold may

provide the basis for a preliminary assumption that – without considering all relevant circumstances – an impairment may have occurred. Identifying the impairment is only the beginning of the analysis; it cannot appropriately be used as a substitute for a full analysis of all relevant qualitative considerations. Exclusive reliance on such thresholds removes the ability of management to apply its judgment, a concept inherent to the impairment model.

Step 3: If the Impairment is Other Than Temporary, the Cost Basis of the Individual Asset Shall Be Written Down to a New Cost Basis and the Amount of the Write-Down Is Accounted for as a Realized Loss

8. If an impairment is considered other than temporary, the cost or carrying value of the asset should be written down to reflect its value in accordance with the relevant SSAP. A company's management should follow the impairment guidance in the SSAP pertaining to that particular asset class while considering various factors on a case-by-case basis in determining the amount of the realized loss that should be recorded.

Generally Accepted Accounting Principles

- No additional guidance obtained from GAAP.

OTHER SOURCES OF INFORMATION

- No additional guidance obtained from state statutes or regulations.

RELEVANT LITERATURE

Statutory Accounting

- *Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy*
- *SSAP No. 43—Loan-Backed and Structured Securities*
- *SSAP No. 3—Accounting Changes*
- *SSAP No. 4—Definition of Assets and Nonadmitted Assets*
- *SSAP No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*
- *INT 06-07: Definition of Phrase "Other Than Temporary"*

Generally Accepted Accounting Principles

- *FASB Statement No. 115: Accounting for Certain Investments in Debt and Equity Securities*
- *FASB Statement No. 125: Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
- *FASB Emerging Issues Task Force No. 99-20: Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets*

State Regulations

- No additional guidance obtained from state statutes or regulations.

Other Sources of Information

No additional guidance obtained from other sources of information.

Statutory Issue Paper No. 125

Accounting for Low Income Housing Tax Credit Property Investments

STATUS
Finalized December 6, 2004

Original SSAP and Current Authoritative Guidance: SSAP No. 48 and SSAP No. 93

Type of Issue:
Common Area

SUMMARY OF ISSUE:

1. *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies* (SSAP No. 48) prescribes accounting treatment for the valuation of Limited Liability Companies. However, current statutory accounting principles do not specifically address accounting for the unique manner in which federal Low Income Housing Tax Credit Property (LIHTC) investments provide a return of investment. Due to the fact that most of these investments are structured as limited partnerships, the majority of these investments fall within the current guidance prescribed by SSAP No. 48. LIHTC investments provide a return on investment in a unique manner, which is not fully recognized under current statutory accounting in SSAP No. 48.

2. Generally accepted accounting principles (GAAP) guidance for federal LIHTC investments is addressed in *Emerging Issues Task Force* (EITF) *94-1: Accounting for Tax Benefits Resulting from Investments in Affordable Housing Projects* (EITF 94-1). EITF 94-1 is listed as not applicable to statutory accounting in *Issue Paper No. 99—Nonapplicable GAAP Pronouncements* (Issue Paper No. 99).

3. The purpose of this issue paper is to provide statutory accounting principles for LIHTC by reconsidering the applicability of EITF 94-1 as appropriate statutory accounting treatment and the development of an accounting model for federal LIHTC investments that is consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

4. Some states have enacted laws that create programs by which transferable state tax credits are granted to entities under certain specified conditions (e.g., an entity makes an investment in a particular industry). Investments in transferable state tax credits are not within the scope of this issue paper.

RECOMMENDED CONCLUSION

5. This issue paper supersedes paragraph 1 of SSAP No. 48, as follows:

> 1. This statement establishes statutory accounting principles for investments in joint ventures, partnerships, and limited liability companies. This statement does not address the accounting for investments in partnerships and limited liability companies that invest in federal Low Income Housing Tax Credit Properties as discussed in *Issue Paper No. 125—Accounting for Low Income Housing Tax Credit Property Investments.*

6. This issue paper modifies Issue Paper No. 99 to remove the reference to EITF 94-1 and in turn, adopts EITF 94-1 with certain modifications.

7. Subject to adoption of a Statement of Statutory Accounting Principles on this topic federal, LIHTC investments held by reporting entities will meet the definition of an asset as specified in *SSAP No. 4—Assets and Nonadmitted Assets* and are admissible assets to the extent that they comply with the requirements of this issue paper.

8. The modifications to EITF 94-1 are as follows:

a. LIHTC investments (regardless of whether they are guaranteed) shall be initially recorded at cost and carried at amortized cost unless considered impaired as discussed in paragraphs 13-16. The amortized cost method utilized shall be similar to the amortized cost method discussed in EITF 94-1, with a modification to include federal tax benefits during the holding period because the primary value of the LIHTC is derived during the property holding period (typically 15 years). An illustration has been in Appendix A to this statement. A reporting entity investor using the cost method shall amortize any excess of the carrying amount of the investment over its estimated residual value during the periods in which federal tax credits are allocated to the investor. The estimated residual value used in determining the amount to be amortized is the estimated residual value at the end of the last period in which federal tax credits are allocated to the investor and should not reflect anticipated inflation. Annual amortization should be based on the proportion of federal tax credits received in the current year to total estimated federal tax credits to be allocated to the investor.

b. All LIHTC investments in which an investor is a partner or limited partner in affordable housing project for both legal and tax purposes and the investor's liability is limited to its capital investment shall follow the accounting guidance of this issue paper.

c. Federal tax credits shall be recognized in the income statement as an offset to federal taxes in the tax reporting year in which the tax credit is utilized in accordance with *SSAP No. 10—Income Taxes* (SSAP No. 10).

d. Tax benefits received, other than tax credits, shall be accounted for pursuant to SSAP No. 10. Amortization shall be reported as a component of net investment income.

e. *AICPA Statement of Position 78-9, Accounting for Investments in Real Estate Ventures* (SOP 78-9) is rejected for purposes of statutory accounting in SSAP No. 48. This issue paper does not intend to establish SOP 78-9 as applicable to statutory accounting.

f. *FASB Interpretation No. 46, Consolidation of Variable Interest Entities* (FIN 46) is rejected for purposes of statutory accounting in *SSAP No. 3—Accounting Changes and Corrections of Errors* (SSAP No. 3). This issue paper does not intend to establish FIN 46 as applicable to statutory accounting.

g. Many LIHTC investments require future equity contributions by the investor (equity contributions), that may be contingent on a variety of conditions, such as such as receiving representations, contract performance, meeting occupancy requirements, etc. If the commitment by the investor to provide equity contributions meets the definition of a liability as defined in *SSAP No. 5—Liabilities Contingencies and Impairments of Assets* a liability shall be recorded. If the commitment to provide equity contributions does not meet the definition of a liability, the contingent commitment shall be disclosed in the notes to the financial statements with other contingent commitments.

h. *EITF 85-16: Leveraged Leases* (EITF 85-16) is adopted for purposes of statutory accounting in *SSAP No. 22—Leases* (SSAP No. 22). This issue paper does not intend to readdress the conclusions reached in SSAP No. 22.

i. *SSAP No. 46—Investments in Subsidiary, Controlled, and Affiliated Entities* and *SSAP No. 88—Investments in Subsidiary, Controlled, and Affiliated Entities, a Replacement of SSAP No. 46* should be utilized to account for investments that qualify as subsidiary, controlled or affiliated entities.

j. The impairment guidance contained in this issue paper shall be followed.

k. For statutory accounting purposes, deferred taxes are not reported as a component of income from continuing operations in the income statement; rather, deferred taxes are recognized as a separate component of gains and losses in unassigned funds (surplus).

9. Additional funding that does not result in additional federal tax credits for the investor shall be expensed as a component of net investment income. In the event for a reporting entity obtains additional federal tax credits occurs for a LIHTC investment, the following shall be applied:

a. If additional tax credits are allocated without additional funding, the additional tax credits shall not be afforded any value; rather, the tax benefit is only recognized when realized.

b. If additional funding directly related to the additional tax credits is required, the provisions of this issue paper shall be followed as if the additional funding were a new investment in LIHTC properties.

10. An investment amortized to residual value in accordance with paragraph 8.a. of this issue paper shall not be revalued under any other method during or subsequent to the amortization period, other than as in this issue paper.

11. Changes in estimated losses shall be accounted for in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors* as a change in estimate and included as a component of net investment income.

12. This issue paper shall be interpreted by *INT 02-07: Definition of Phrase "Other Than Temporary."* The remaining Interpretations of SSAP No. 48 are deemed not applicable.

Impairment

13. Reporting entities with investments in LIHTC properties shall complete and document an impairment analysis at each reporting period. If it is determined that an impairment exists, the book value of the LIHTC investment shall be compared to the present value of future federal tax benefits discounted at a risk free rate of return, i.e., the rate on U.S. Treasury obligations of a similar duration,_and the investment shall be written down if the book value is higher. This will result in a new cost basis and the amount of the write-down shall be accounted for as a realized loss. The new cost basis shall not be changed for subsequent recoveries in fair value.

14. Among other things, an impairment shall be considered to have occurred if it is probable that future federal tax benefits will not be received as expected. For purposes of determining impairment, future federal tax benefits consist of both estimated tax losses and anticipated tax credits. Loan default or a reasonable probability of credit recapture would signify that tax benefits would not be received as expected.

15. In a multi-tiered partnership, whereby one limited partnership exists only to hold interests in other limited partnerships that are each invested in different developments, the impairment should be determined at the lowest tier. The partnership that holds the assets in which the impairment is determined to exist will be adjusted to a new cost basis representing the lower of book value or the present value of future federal tax benefits discounted at a risk free rate of interest. This new cost basis and related realized loss shall be recognized by the holder of a LIHTC investments.
16. It should be noted that a foreclosure of a single property within an LIHTC investment fund only affects the loss of federal tax credits on a proportional basis. For example, a foreclosure of one property in a six property fund generating equal levels of credits would only eliminate 1/6 of the credits, thereby, only affecting 1/6 of the LIHTC investment fund value to the individual investors.

Audited Financial Statements

17. The reporting entity's return and book value of an LIHTC investment is reliant upon maintaining federal tax credit eligibility and not its share of the equity as reported on a financial statement. As such, a reporting entity shall monitor the federal tax credit eligibility of an LIHTC investment through requiring either audited GAAP or audited tax basis financial statements. In the event an audited GAAP or audited tax basis financial statement is not obtained, the asset shall be nonadmitted.

Effective Date and Transition

18. Upon adoption of this issue paper, the NAIC will release a Statement of Statutory Accounting Principle (SSAP) for comment. The SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the Accounting Practices and Procedures Manual should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will contain an effective date of years ending on or after December 31, 2005. A change resulting from the adoption of the finalized SSAP shall be accounted for as a change in accounting principle in accordance with SSAP No. 3.

DISCUSSION

19. The purpose of this issue paper is to address the unique manner in which LIHTC investments provide a return on investment by reconsidering the applicability of EITF 94-1 as appropriate statutory accounting treatment and the development of an accounting model for LIHTC investments that is consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy.

20. SSAP No. 48 prescribes accounting treatment for the valuation of limited liability companies. Most of these investments are structured as limited partnerships, and, the majority of these investments fall within the guidance prescribed by SSAP No. 48. LIHTC investments provide a return on investment in a unique manner, which is not fully recognized under current statutory accounting in SSAP No. 48. Currently, such treatment would generally lead to a valuation based on the audited generally accepted accounting principles (GAAP) equity of the limited partnership and; consequently, its underlying real estate investment. However, this treatment does not recognize the value of the federal tax credits (a direct offset to federal income taxes) and the pass through of federal tax losses to the investor. Resale valuation of these investments is based on the present value of the future stream of federal tax credits and deductible losses, and not the market value of the underlying real estate.

21. Current guidance under SSAP No. 48 would require that the equity accounting approach be used to account for investments in LIHTC structured in the form of investments in limited partnerships. One of the implicit assumptions behind the equity methodology is that the operating activities of the entity are reflective of the value being created by the entity. However, this assumption is contrary to how a LIHTC investment provides investment return. The market value of an LIHTC investment is generally unaffected

by the operational activities occurring at the operational level of the entity (i.e. generally considered to be the "property" level for investments in more traditional equity real estate deals). Rather, the value of an LIHTC is directly tied to the remaining stream of federal tax benefits (credits and tax losses) available to LIHTC investors. Investments in LIHTC investments, and the related pricing to the investors, are driven primarily by the level of federal tax credits and tax losses that are projected to be produced by the LIHTC during its "credit-producing life."

22. This critical element of value is typically known with a high degree of certainty before the deal is marketed to potential investors. The degree of certainty regarding projected federal tax credits and tax losses, coupled with market rate returns and below market risk when compared to alternative investments, are what attract investors to an LIHTC investment. Likewise, there is an active secondary market for LIHTC deals. As with primary market transactions, pricing is driven by the remaining federal tax credit and deductible loss streams in the LIHTC investment at resale. Structurally, these investments are typically owned by multiple investors with varying interests in a top tier limited partnership, which in turn holds direct interests in the operating limited partnerships within a single LIHTC investment fund. In other words, a single investor may hold a 15% interest in the "fund" level partnership, which in turns owns 99% interests in 10 operating level limited partnerships. Although, not technically guaranteed as contemplated in EITF 94-1, investment risk in LIHTC's has proven to be historically low, typically reflecting a default experience similar to that of secured commercial mortgages versus the higher loss rate typically associated with equity real estate investments.

23. The proportional amortized cost method discussed in EITF 94-1 is in line with the Statutory Accounting Concepts of Conservatism and Recognition because the primary value of the LIHTC is derived during the property holding period (typically 15 years). In contrast, GAAP basis financial statements for the limited partnership generally utilize a 40-year depreciation life, which ultimately is picked up by the investor when applying the GAAP equity method.

24. The proportional amortized cost approach results in an investment balance at the end of each accounting period that is more indicative of the liquidation value at that point in time than does the equity method. An impairment analysis should also be made when facts and circumstances indicate an impairment has occurred as well as at the end of each accounting period. If it is probable that the future federal tax benefits will not be received as expected, then an impairment exists, and, the investment should be written down to the lower of fair value or the present value of future federal tax benefits discounted at a risk free rate of return. Since write-down adjustments would be based on actual property level foreclosure or loss of qualification due to occupancy levels or other compliance issues with tax code provisions within an LIHTC fund, subjectivity with respect to the timing and the amount of the write-down would be eliminated. An impairment shall be recorded as a realized loss and the investment written down to the new cost basis.

25. In summary, application of the equity method of accounting for LIHTC investments is inappropriate because the value of the asset is independent from the value of the real estate. Investment balances provided by this methodology are not necessarily reflective of the value that would be received if the assets were to be liquidated. Therefore, the adoption of the proportional cost amortization approach outlined in EITF 94-1 is recommended. This approach leads to a more realistic valuation of the investment and takes into account the fact that the primary value to the investor dissipates to zero when the federal tax credits are no longer available.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

26. *SSAP No. 22—Leases* provides the following adoption of EITF 85-16 in the relevant literature section of the SSAP.

> Relevant Literature
>
> 26. This statement rejects FAS 13, as amended and interpreted, except for certain of the guidance on operating leases, sale-leaseback transactions and leveraged leases (i.e., paragraphs 15, 16.(b., c., d.), 19.(a., b.), 23.(b., c.), 36, 37, 38.b., 39.c. and, 42-47). A complete list of all FASB Statements, Interpretations and Technical Bulletins adopted and rejected in this statement is as follows:
>
> a. FASB Statement No. 13, Accounting for Leases, [paragraphs 15, 16.(b., c., d.), 19.(a., b.), 23.(b., c.), 36, 37, 38.b., 39.c., 42-47 adopted; all other paragraphs rejected];
>
> aa. FASB Emerging Issues Task Force No. 85-16, Leveraged Leases [adopted in its entirety]

27. *SSAP No. 48—Investments in Joint Ventures, Partnerships and Limited Liability Companies* provides the following inclusion of limited liability companies in the scope paragraph.

> SCOPE OF STATEMENT
>
> 1. This statement establishes statutory accounting principles for investments in joint ventures, partnerships, and limited liability companies.

Generally Accepted Accounting Principles

28. EITF 94-1: Accounting for Tax Benefits from Investments in Affordable Housing Projects provides the following guidance regarding the valuation of

> EITF 94-1 ISSUE
>
> The Revenue Reconciliation Act of 1993, enacted in August 1993, retroactively extended and made permanent the affordable housing credit, which had expired after June 30, 1992. Investors in entities operating qualified affordable housing projects receive tax benefits in the form of tax deductions from operating losses and tax credits. The tax credits are allowable on the tax return each year over a 10-year period as a result of renting a sufficient number of units to qualifying tenants and are subject to restrictions on gross rentals paid by those tenants. These credits are subject to recapture over a 15-year period starting with the first year tax credits are earned. Corporate investors generally purchase an interest in a limited partnership that operates the qualified affordable housing projects.
>
> The issue is how an entity that invests in a qualified affordable housing project through a limited partnership should account for its investment.
>
> EITF 94-1 DISCUSSION
>
> The Task Force reached a consensus that immediate recognition at the time the investment is purchased of the entire benefit of the tax credits to be received during the term of a limited partnership investment in a qualified affordable housing project is not appropriate (that is, affordable housing credits should not be recognized in the financial statements prior to their inclusion in the investor's tax return).
>
> The Task Force reached a consensus that an entity that invests in a qualified affordable housing project through a limited partnership investment may elect to account for the investment using the effective yield method (described in the following two paragraphs) provided all of the following conditions are met:
>
> a. The availability (but not necessarily the realization) of the tax credits allocable to the investor is guaranteed by a creditworthy entity through a letter of credit, a tax indemnity agreement, or another similar arrangement.
>
> b. The investor's projected yield based solely on the cash flows from the guaranteed tax credits is positive.

c. The investor is a limited partner in the affordable housing project for both legal and tax purposes and the investor's liability is limited to its capital investment.

Under the effective yield method, the investor recognizes tax credits as they are allocated and amortizes the initial cost of the investment to provide a constant effective yield over the period that tax credits are allocated to the investor. The effective yield is the internal rate of return on the investment, based on the cost of the investment and the guaranteed tax credits allocated to the investor. Any expected residual value of the investment should be excluded from the effective yield calculation. Cash received from operations of the limited partnership or sale of the property, if any, should be included in earnings when realized or realizable.

Under the effective yield method, the tax credit allocated, net of the amortization of the investment in the limited partnership, is recognized in the income statement as a component of income taxes attributable to continuing operations. Any other tax benefits received should be accounted for pursuant to Statement 109.

For a limited partnership investment in a qualified affordable housing project not accounted for using the effective yield method, the Task Force reached a consensus that the investment should be accounted for in accordance with SOP 78-9. (In accounting for such an investment under SOP 78-9, the consensuses in this Issue that are not related to the effective yield method should be applied.) The Task Force observed that SOP 78-9 generally requires use of the equity method of accounting for limited partnership investments unless the limited partner's interest is so minor as to give the partner virtually no influence over partnership operating and financial policies. [Note: See STATUS section.] The Task Force also noted that the AICPA's Accounting Standards Executive Committee is reconsidering the guidance in SOP 78-9 in its project titled, "Accounting for Investors' Interests in Unconsolidated Real Estate Joint Ventures."

The Task Force also reached a consensus that an investor using the cost method should amortize any excess of the carrying amount of the investment over its estimated residual value during the periods in which tax credits are allocated to the investor. The estimated residual value used in determining the amount to be amortized is the estimated residual value at the end of the last period in which tax credits are allocated to the investor and should not reflect anticipated inflation. Annual amortization should be based on the proportion of tax credits received in the current year to total estimated tax credits to be allocated to the investor.

The Task Force reached a consensus that a limited partnership investment in a qualified affordable housing project should be reviewed periodically for impairment.

The Task Force reached a consensus that a liability should be recognized for delayed equity contributions that are unconditional and legally binding. A liability also should be recognized for equity contributions that are contingent upon a future event when that contingent event becomes probable. The Task Force observed that Statement 5, Issue No. 85-16, "Leveraged Leases," and Concepts Statement 6 provide additional guidance on the accounting for delayed equity contributions.

The Task Force observed that the decision to apply the effective yield method of accounting would be an accounting policy decision rather than a decision to be applied to individual investments that qualify for use of the effective yield method. The SEC Observer commented that the SEC staff believes that it would be inappropriate to extend the effective yield method of accounting to analogous situations.

Exhibit 94-1A illustrates the application of the consensuses in this Issue to a limited partnership investment in an affordable housing project accounted for using the cost, equity, and effective yield methods.

EITF 94-1 STATUS

The SEC Observer at the May 18-19, 1995 meeting discussed a related issue in an announcement. The announcement addresses the SEC staff's position concerning the application of the equity method to investments in limited partnerships. [Note: See Topic No. D-46 in Appendix D.]

Interpretation 46, which was issued in January 2003, addresses consolidation by business enterprises of variable interest entities, which may include some limited partnerships. Interpretation 46 requires a variable interest entity to be consolidated by an enterprise if that enterprise will absorb a majority of the entity's expected losses or is entitled to receive a majority of the entity's expected residual returns or both. The consolidation requirements of Interpretation 46 apply immediately to variable interest entities created after January 31, 2003. The consolidation requirements apply to older entities in the first fiscal year or interim period beginning after June 15, 2003. Certain of the disclosure requirements apply in all financial statements issued after January 31, 2003, regardless of when the variable interest entity was established.

FSP FIN 46-6 deferred the effective date for applying the provisions of Interpretation 46 for:
1. Interests held by a public entity in variable interest entities created before February 1, 2003, if the public entity has not issued financial statements reporting that interest in accordance with Interpretation 46. The application of Interpretation 46 to those interests is deferred until the end of the first period ending after December 15, 2003.
2. Nonregistered investment companies accounting for their investments in accordance with the specialized accounting guidance in the investment company Guide.
No further EITF discussion is planned.

See Appendix A to this issue paper for illustration of the amortized cost method (modified to include tax benefits).

EITF 85-16: Leveraged Leases

EITF 85-16 (B) DISCUSSION
The Task Force reached a consensus that the type of recourse debt resulting from the delayed equity investment does not contradict the notion of nonrecourse under paragraph 42.c. of Statement 13 and, therefore, does not preclude leveraged lease accounting as long as other requirements of leveraged lease accounting are met. The Task Force also agreed that the lessor's related obligation should be recorded as a liability at present value at the inception of the lease. The Task Force agreed that recognition of the liability would increase the lessor's net investment on which the lessor bases its pattern of income recognition. It was noted that while the increase to the net investment results in an increase in income, it tends to be offset by the accrual of interest on the liability.

RELEVANT LITERATURE

Statutory Accounting
- *SSAP No. 3—Accounting Changes and Corrections of Errors*
- *SSAP No. 48—Investments in Joint Ventures, Partnerships and Limited Liability Companies*

Generally Accepted Accounting Principles
- *EITF 94-1: Accounting for Tax Benefits from Investments in Affordable Housing Projects*
- *AICPA Statement of Position 78-9, Accounting for Investments in Real Estate Ventures*
- *FASB Interpretation No. 46, Consolidation of Variable Interest Entities*
- *EITF 85-16: Leveraged Leases*

State Regulations
- No additional guidance obtained from state statutes or regulations.

Other Sources:
- Internal Revenue Code Section 42-Low-Income Housing Credit

Appendix A – Low Income Housing Tax Credit Property Investments

A Limited Partnership Investment in an Affordable Housing Project Accounted for Using the Amortized Cost Method (modified to include tax benefits):

This appendix is based on EITF 94-1 “Schedule 3 Cost Method with Amortization with modifications to include tax benefits.

Terms:
Date of Investment: January 1, 20X1
Purchase Price of Investment: $100,000

Assumptions:

1. All cash flows (except initial investment) occur at the end of each year.
2. Depreciation expense is computed, for book and tax purposes, using the straight-line method with a 27.5 year life (the same method is used for simplicity).
3. The investor made a $100,000 investment for a 5 percent limited partnership interest in the project at the beginning of the first year of eligibility for the tax credit.
4. The partnership finances the project cost of $4,000,000 with 50 percent equity and 50 percent debt.
5. The annual tax credit allocation (equal to 8 percent of the project's original cost) will be received for a period of 10 years.
6. The investor's tax rate is 35 percent.
7. For simplicity, the project will operate with break-even pretax cash flows including debt service during the first 15 years of operations.
8. The project's taxable and book loss will be equal to depreciation expense.
9. The investor will maintain the investment for 15 years (so there will be no recapture of tax credits).
10. The investor expects that the estimated residual value of the investment will be zero.

	Beginning Investment Balance	Tax Credits	Tax Depreciation	Tax Loss Benefit	Total Tax Benefits	Amortization	Ending Investment Balance
Year	1	2	3	4	5	6	7
0							100,000
1	100,000	16,000	7,273	2,546	18,546	9,358	90,642
2	90,642	16,000	7,273	2,546	18,546	9,358	81,285
3	81,285	16,000	7,273	2,546	18,546	9,358	71,927
4	71,927	16,000	7,273	2,546	18,546	9,358	62,569
5	62,569	16,000	7,273	2,546	18,546	9,358	53,212
6	53,212	16,000	7,273	2,546	18,546	9,358	43,854
7	43,854	16,000	7,273	2,546	18,546	9,358	34,496
8	34,496	16,000	7,273	2,546	18,546	9,358	25,139
9	25,139	16,000	7,273	2,546	18,546	9,358	15,781
10	15,781	16,000	7,273	2,546	18,546	9,358	6,423
11	6,423		7,273	2,546	2,546	1,285	5,139
12	5,139		7,273	2,546	2,546	1,285	3,854
13	3,854		7,273	2,546	2,546	1,285	2,569
14	2,569		7,273	2,546	2,546	1,285	1,285
15	1,285		7,273	2,546	2,546	1,285	-
Total		160,000	109,095	38,190	198,190	100,000	

1. Beginning-of-year investment for a 5 percent limited partnership interest in the project.
2. 8 percent tax credit on $200,000 tax basis of the underlying assets.
3. Tax Loss = Tax Depreciation (assumption 7) - $200,000 tax basis of the underlying assets using the straight-line method over 27.5 years.
4. Column (3) × 35% tax rate).
5. Column (2) + column (4)
6. Proportional amortization - $100,000 x column 5 / column 5 total
7. Beginning-of-year investment for a 5 percent limited partnership interest in the project (column 1) net of amortization in column 6.

Statutory Issue Paper No. 126

Accounting for Transferable State Tax Credits

STATUS
Finalized December 5, 2005

Original SSAP: SSAP No. 94; Current Authoritative Guidance: SSAP No. 94R
This issue paper may not be directly related to the current authoritative statement.

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. The purpose of this issue paper is to establish statutory accounting principles for transferable state tax credits that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

2. Currently, generally accepted accounting principles do not provide separate guidance for transferable state tax credits; general guidance for income taxes is found in *FASB Statement No. 109, Accounting for Income Taxes* (FAS 109). *SSAP No. 10—Income Taxes* (SSAP No. 10), paragraph 2 notes the adoption of FAS 109 with modifications for state income taxes, the realization criteria for deferred tax assets, and the recording of the impact of changes in its deferred tax balances.

3. Investments in Low Income Housing Tax Credits as discussed in *SSAP No. 93—Accounting for Low Income Housing Tax Credit Property Investments*, which involve an investment by a reporting entity in a limited liability company or similar entity that earns tax credits as a consequence of its operating activities involving low income housing developments and passes those tax credits to its investors, are not within the scope of this issue paper.

SUMMARY CONCLUSION

Definitions

4. Some states have enacted laws that create programs by which transferable state tax credits are granted to entities under certain specified conditions (e.g., an entity makes an investment in a particular industry). The terms of these state tax credits vary from state to state and, within a state, from program to program. However, many of these state tax credit programs share the following four characteristics:

a. The tax credit is nonrefundable;

b. The holder of the transferable state tax credit may sell or otherwise transfer the transferable state tax credit to another entity, which can likewise resell or transfer the credit;

c. The transferable state tax credit will expire if not used by a predetermined date; and

d. The transferable state tax credit can be applied against either state income tax or state premium tax.

5. For purposes of this issue paper, such programs will be referred to as "transferable state tax credits." The criteria in subparagraphs 4.b., 4.c. and 4.d. must be present in order for the transferable state

tax credit to receive the accounting treatment described in this issue paper. When a reporting entity purchases a transferable state tax credit from another entity, the transaction does not result in a continuing investment in a business entity (i.e. limited partnership).

6. Subject to adoption of a Statement of Statutory Accounting Principles (SSAP) on this topic, transferable state tax credits held by reporting entities will meet the definition of assets as specified in *SSAP No. 4—Assets and Nonadmitted Assets* and will be admissible assets to the extent that they comply with the requirements of the SSAP.

Acquisition

7. Transferable state tax credits are recorded at cost at the date of acquisition.

Balance Sheet Treatment

8. Transferable state tax credits expected to be realized are initially recorded at cost.

9. Transferable state tax credits shall be established gross of any related state tax liabilities and reported in the category of other-than-invested assets (not reported net).

10. As transferable state tax credits are redeemed, the carrying value of the tax credits is reduced dollar for dollar by the amount of transferable state tax credits applied toward the reporting entity's applicable state tax liability.

Income Statement Treatment

11. Gains on transferable state tax credits are deferred until the value of the transferable state tax credits utilized exceeds the cost of the transferable state tax credits or until the transferable state tax credits are sold to other entities and the payment received is greater than the book value.

12. Losses on transferable state tax credits are recognized when known.

13. Gains and losses on transferable state tax credits are reflected in other income.

Impairment

14. An impairment shall be considered to have occurred if it is probable that the reporting entity will be unable to recover the carrying amount of the transferable state tax credits. Transferable state tax credits should be evaluated for impairment at each reporting date.

15. When there is a decline in the realizability of a transferable state tax credit owned by the reporting entity that is other than temporary, the asset shall be written down to the expected realizable amount and the amount of the write down shall be accounted for as a realized loss. The expected realizable value is the new cost basis.

16. The new cost basis shall not be changed for subsequent recoveries in realizability.

Disclosures

17. The following disclosures shall be made in the financial statements. For purposes of this disclosure, total unused transferable state tax credits represent the entire transferable state tax credits available:

a. Carrying value of transferable state tax credits gross of any related state tax liabilities by state and in total,

b. Total unused transferable state tax credits by state;

c. Method of estimating utilization of remaining transferable state tax credits or other projected recovery of the current carrying value.

d. Impairment amount recognized in the reporting period, if any.

Effective Date and Transition

18. Upon adoption of this issue paper, the NAIC will release a Statement of Statutory Accounting Principle (SSAP) for comment. The SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the *Accounting Practices and Procedures Manual* should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will contain an effective date of years ending on or after December 31, 2006.

DISCUSSION

19. This issue paper provides new statutory accounting guidance for a type of investment, which is not currently addressed in the *Accounting Practices and Procedures Manual*. Therefore, in accordance with SSAP No. 4, they default to a nonadmitted asset. In evaluating transferable state tax credits, several points were considered. The transferable characteristics of these state tax credit are a major factor in developing statutory accounting guidance, which would admit investments in transferable state tax credits that comply with the guidance.

20. It is consistent with the Statement of Concepts, conservatism to report the transferable state tax credits at cost.

21. Reporting the transferable state tax credits gross is consistent with other reporting and with the principles in *SSAP No. 64—Offsetting and Netting of Assets and Liabilities.* State premium tax liabilities for multiple states are reported on the same annual statement line on the liabilities page of the annual statement. Therefore, if a reporting entity wrote business in multiple states, it would violate the *SSAP No. 64—Offsetting and Netting of Assets and Liabilities* offsetting criteria to net the premium tax liability from one state against a premium tax credit of another state.

22. The primary reason for purchasing transferable state tax credits is to reduce state premium tax expenses. They are not purchased for investment income, so it seems appropriate to report transferable state tax credits as other-than-invested assets. Losses are realized losses in the other income category.

23. It is consistent with the concept of conservatism to delay any recognition of gain on the utilization or sales of transferable state tax credits until the gain is realized. Realization is determined to have occurred when the state tax credits are utilized and meet or exceed the cost of the credits, or credits are sold and the sales price realized meets or exceeds the cost of state tax credits sold.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

24. *SSAP No. 10—Income Taxes* provides the following references on state income taxes:

2. For purposes of accounting for federal and foreign income taxes, reporting entities shall adopt FASB Statement No. 109, Accounting for Income Taxes (FAS 109) with modifications for state income taxes, the realization criteria for deferred tax assets, and the recording of the impact of changes in its deferred tax balances. As a result, financial statements will recognize current and deferred income tax assets and liabilities in accordance with the provisions of this statement.

4. State taxes (including premium, income and franchise taxes) shall be computed in accordance with SSAP No. 5 and shall be limited to (a) taxes due as a result of the current year's taxable basis calculated in accordance with state laws and regulations and (b) amounts incurred or received during the current year relating to prior periods, to the extent not previously provided as such amounts are deemed to be changes in accounting estimates. Property and casualty insurance companies shall report state taxes as other underwriting expenses under the caption "Taxes, licenses, and fees." Life and accident and health insurance companies shall report such amounts as general expenses under the caption "Insurance taxes, licenses, and fees, excluding federal income taxes." Other health entities shall report such amounts as general administration expenses under the caption "Taxes, licenses, and fees." State tax recoverables that are reasonably expected to be recovered in a subsequent accounting period are admitted assets. State taxes are reasonably expected to be recovered if the refund is attributable to overpayment of estimated tax payments, errors, carrybacks, or items for which the reporting entity has authority to recover under a state regulation or statute.

1.1 A – SSAP No. 10 establishes statutory accounting principles for current and deferred federal and foreign income taxes and current state income taxes. In general, SSAP No. 10 adopts the concepts of FAS 109, with modifications. The primary differences and modifications are summarized below:

1.2 State Income Tax

- FAS 109 – State income taxes should be included as “income taxes incurred.” Deferred state income taxes are provided.
- SSAP No. 10 – State income taxes should be included as “Taxes, Licenses, and Fees” by property and casualty insurers and as “Insurance taxes, licenses, and fees, excluding federal income taxes” by life and accident and health insurers. No deferred state income taxes are provided.

25. Statutory accounting guidance does not currently address transferable state tax credits, therefore, in accordance with *SSAP No. 4—Assets and Nonadmitted Assets* (SSAP No. 4), transferable state tax credits default to nonadmitted assets at this time.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *SSAP No. 10—Income Taxes*

Generally Accepted Accounting Principles

- *FASB Statement No. 109, Accounting for Income Taxes* was adopted with modification in *SSAP No. 10—Income Taxes*

State Regulations

- No additional guidance obtained from state statutes or regulations

Implementation Guide

On 1/1/X1 SAM Insurance Company purchased transferable state tax credits for a cost of $100,000. The transferable state tax credits are redeemable for $160,000 and expire at the end of 12/31/X4. SAM initially expects to utilize the tax credits before expiration. in their state of domicile in the amount of $40,000 per year. In year X4, SAM sells the remaining $30,000 in transferable state tax credits for $20,000

1/1/x1	Transferable state tax credits	100,000	
	Cash		100,000
	To record the purchase of the tax credits		
6/30/x1	Premium tax expense	40,000	
	Premium taxes payable to domiciliary state		40,000
	To record premium tax expense and accrue the liability in Year 1.		
10/1/x1	Premium tax payable	40,000	
	Transferable state tax credits		40,000
	To record the use of tax credits in Year 1. The reporting entity expects to be able to utilize remaining tax credits before expiration.		
6/30/x2	Premium tax expense	60,000	
	Premium taxes payable to domiciliary state		60,000
	To record premium tax expense and accrue the liability in Year 2.		
9/30/x2	Premium tax payable	60,000	
	Transferable state tax credits		60,000
	To record the use of taxes credits in Year 2. The reporting entity expects to be able to utilize remaining tax credits before expiration.		
6/30/x3	Premium tax expense	30,000	
	Premium taxes payable to domiciliary state		30,000
	To record premium tax expense and accrue the liability in Year 3.		
9/30/x3	Premium tax payable	30,000	
	Other income		30,000
	To record the use of premium tax credits in excess of cost and recognize a gain on premium tax credits in other income. The Company intends to sell the remaining tax credits in year 4.		
6/30/x4	Cash	20,000	
	Other income		20,000
	To record the sale of the remaining tax credits.		

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Statutory Issue Paper No. 127

Exchanges of Nonmonetary Assets, A Replacement of SSAP No. 28—Nonmonetary Transactions

STATUS
Finalized March 6, 2006

Original SSAP and Current Authoritative Guidance: SSAP No. 90 and SSAP No. 95

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Existing statutory accounting literature for nonmonetary transactions is maintained within *SSAP No. 28—Nonmonetary Transactions* (SSAP No. 28), which is based on *Accounting Principles Board Opinion No. 29, Accounting for Nonmonetary Transactions* (APB 29). APB 29 is based on the principle that exchanges of nonmonetary assets should be measured based on the fair value of the assets exchanged. However, this guidance includes an exception to this basic premise for nonmonetary exchanges of similar productive assets. *Statement of Financial Accounting Standards No. 153*: *Exchanges of Nonmonetary Assets, an amendment of APB Opinion No. 29* (FAS 153), eliminates this exception and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. A nonmonetary exchange has commercial substance if the future cash flows of the reporting entity are expected to change significantly as a result of the exchange.

2. The concept of similar productive assets is brought into statutory accounting by the adoption of APB 29 in SSAP No. 28. The concept of commercial substance introduced in FAS 153 is not explicitly discussed in statutory accounting.

FAS 153 affects the following:

- *APB Opinion No. 29, Accounting for Nonmonetary Transactions* (APB 29) which is adopted in *SSAP No. 28—Nonmonetary Transactions*
- Amends *FAS 19, Financial Accounting and Reporting by Oil and Gas Producing Companies*, which is not applicable to statutory accounting
- Amends *FAS 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, A Replacement of FASB Statement 125*, which is adopted with modification in *SSAP No. 91—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (SSAP No. 91)
- Amends FAS 144, which is adopted with modification in *SSAP No. 90—Accounting for the Impairment or Disposal of Real Estate Investments* (SSAP No. 90)

3. Statutory accounting principles currently exist for nonmonetary exchanges in *SSAP No. 28—Nonmonetary Transactions* (SSAP No. 28). Some elements of APB 29 were adopted and modified for statutory accounting and reporting directly within SSAP No. 28. Other requirements of APB 29 were adopted through reference as in paragraph 3 of SSAP No. 28:

> 3. Except as addressed in other statements (including, but not limited to, *SSAP No. 12—Employee Stock Ownership Plans* (SSAP No. 12), *SSAP No. 13—Stock Option and Stock Purchase Plans* (SSAP No. 13), *SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties* (SSAP No. 25), *SSAP No. 68—Business*

Combinations and Goodwill (SSAP No. 68), and *SSAP No. 72—Surplus and Quasi*-reorganizations (SSAP No. 72)), nonmonetary transactions shall be accounted for in accordance with *Accounting Principles Board Opinion No. 29, Accounting for Nonmonetary Transactions* (APB 29). The accounting for such transactions shall be based on the fair values of the assets (or services) involved, as defined in paragraph 25 of APB 29.

4. The purpose of this issue paper is to update statutory accounting principles for nonmonetary transactions by updating conclusions reached in SSAP No. 28 related to APB 29 with those included in FAS 153. Consequently, this issue paper adopts FAS 153 with modifications to change GAAP references to those applicable to statutory accounting. In addition, references made to APB 29 within SSAP No. 28 will be replaced with the actual amended guidance resulting from FAS 153.

5. In addition, the purpose of this issue paper is to also amend language used in *SSAP No. 90—Accounting for the Impairment or Disposal of Real Estate Investments, Discontinued Operations* (SSAP No. 90) affected by FAS 153.

SUMMARY CONCLUSION

Definitions

6. The definitions of certain terms used in this statement are:

a. Monetary assets and liabilities are assets and liabilities whose amounts are fixed in terms of units of currency by contract or otherwise. Examples are cash; amounts due from agents, brokers, and intermediaries; policy loans; accounts payable; and other amounts receivable or payable in cash;

b. Nonmonetary assets and liabilities are assets and liabilities other than monetary ones. Examples are common stocks; furniture, fixtures, and equipment; real estate and liabilities for rent collected in advance;

c. Exchange (or exchange transaction) is a reciprocal transfer between a reporting entity and another entity that results in the reporting entity acquiring assets or services or satisfying liabilities by surrendering other assets or services or incurring other obligations. A reciprocal transfer of a nonmonetary asset shall be deemed an exchange only if the transferor has no substantial continuing involvement in the transferred asset such that the usual risks and rewards of ownership of the asset are transferred.

d. Nonreciprocal transfer is a transfer of assets or services in one direction, either from a reporting entity to its owners (whether or not in exchange for their ownership interests) or another entity, or from owners or another entity, to the reporting entity. An insurance company's reacquisition of its outstanding stock is an example of a nonreciprocal transfer.

7. Nonmonetary transactions shall be accounted for in accordance with this statement, except as addressed by other statements or interpretations including but not limited to *SSAP No. 12—Employee Stock Ownership Plans* (SSAP No. 12), *SSAP No. 13—Stock Option and Stock Purchase Plans* (SSAP No. 13), *SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties* (SSAP No. 25), *SSAP No. 68—Business Combinations and Goodwill* (SSAP No. 68), *SSAP No. 72—Surplus and Quasi-reorganizations* (SSAP No. 72), *SSAP No. 91—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (SSAP No. 91), *INT 99-21: EITF 98-7: Accounting for Exchanges of Similar Equity Method Investments, INT 00-12: EITF 99-4: Accounting for Stock Received from the Demutualization of a Mutual Insurance Company, INT 00-26: EITF 98-3: Determining Whether a Nonmonetary Transactions Involves Receipt of Productive Assets or*

of a Business (INT 00-26), *INT 00-29: EITF 99-17: Accounting for Advertising Barter Transactions* (INT 00-29), and *INT 03-16: Contribution of Stock* (INT 03-16).

8. Accounting for nonmonetary transactions shall generally be based on the fair values of the assets (or services) involved, as defined in paragraph 16, which is the same basis as that used in monetary transactions. Thus, the cost of a nonmonetary asset acquired in exchange for another nonmonetary asset (reciprocal transactions) is the fair value of the asset surrendered to obtain it, and a gain or loss should be recognized on the exchange. The fair value of the asset received should be used to measure the cost if it is more clearly evident than the fair value of the asset surrendered. Similarly, a nonmonetary asset received in a nonreciprocal transfer should be recorded at the fair value of the asset received as defined in paragraph 9. A transfer of a nonmonetary asset to a stockholder or to another entity in a nonreciprocal transfer should be recorded at the fair value of the asset transferred, and a gain or loss should be recognized on the disposition of the asset. The fair value of a reporting entity's own stock reacquired may be a more clearly evident measure of the fair value of the asset distributed in a nonreciprocal transfer if the transaction involves distribution of a nonmonetary asset to eliminate a disproportionate part of owners' interests (that is, to acquire stock for the treasury or for retirement).

9. Fair value of assets received or transferred in a nonreciprocal transfer shall be measured based on statutory accounting principles for the type of asset transferred. Accordingly, the value shall be determined in accordance with *SSAP No. 26—Bonds, Excluding Loan-Backed and Structured Securities, SSAP No. 30—Investments in Common Stock (excluding investments in common stock of subsidiary, controlled, or affiliated entities), SSAP No. 32—Investments in Preferred Stock (including investments in preferred stock of subsidiary, controlled, or affiliated entities), SSAP No. 37—Mortgage Loans, SSAP No. 39—Reverse Mortgages, SSAP No. 40—Real Estate Investments, SSAP No. 43—Loan-backed and Structured Securities* or other applicable statement. The guidance provided in SSAP No. 25 shall be followed in accounting for nonreciprocal transactions with affiliates and other related parties as defined in that statement.

10. A nonmonetary exchange shall be measured based on the recorded amount (after reduction, if appropriate, for an indicated impairment of value) of the nonmonetary asset(s) relinquished (*SSAP No. 90—Accounting for the Impairment or Disposal of Real Estate Investments, Discontinued Operations*, (paragraph 20)), and not on the fair values of the exchanged assets, if any of the following conditions apply:

a. *Fair Value Not Determinable*. The fair value of neither the asset(s) received nor the asset(s) relinquished is determinable within reasonable limits (paragraph 16).

b. *Exchange Transaction to Facilitate Sales to Customers*. The transaction is an exchange of a product or property held for sale in the ordinary course of business for a product or property to be sold in the same line of business to facilitate sales to customers other than the parties to the exchange.

c. *Exchange Transaction That Lacks Commercial Substance*. The transaction lacks commercial substance (paragraph 11).

11. A nonmonetary exchange has commercial substance if the entity's future cash flows are expected to significantly change as a result of the exchange. The entity's future cash flows are expected to significantly change if either of the following criteria is met:

a. The configuration (risk, timing, and amount)[1] of the future cash flows of the asset(s) received differs significantly from the configuration of the future cash flows of the asset(s) transferred.

b. The entity-specific value[2] of the asset(s) received differs from the entity-specific value of the asset(s) transferred, and the difference is significant in relation to the fair values of the assets exchanged.

A qualitative assessment will, in some cases, be conclusive in determining that the estimated cash flows of the entity are expected to significantly change as a result of the exchange.

12. In the United States and some other tax jurisdictions, a transaction is not given effect for tax purposes unless it serves a legitimate business purpose other than tax avoidance. In assessing the commercial substance of an exchange, tax cash flows that arise solely because the tax business purpose is based on achieving a specified financial reporting result shall not be considered.

13. Stock received in the form of a stock dividend or stock split shall not result in the recognition of income. The cost basis of stock held shall be reallocated ratably to the total shares held after receipt of the stock dividend or stock split.

14. The exchanges of nonmonetary assets that would otherwise be based on recorded amounts (paragraphs 10 and 11) may include an amount of monetary consideration. The recipient of the monetary consideration has realized gain on the exchange to the extent that the amount of the monetary receipt exceeds a proportionate share of the recorded amount of the asset surrendered. The portion of the cost applicable to the realized amount should be based on the ratio of the monetary consideration to the total consideration received (monetary consideration plus the estimated fair value of the nonmonetary asset received) or, if more clearly evident, the fair value of the nonmonetary asset transferred. However, the entity paying the monetary consideration should not recognize any gain on a transaction covered in paragraphs 10 and 11 but should record the asset received at the amount of the monetary consideration paid plus the recorded amount of the nonmonetary asset surrendered. If a loss is indicated by the terms of a transaction described in this paragraph or in paragraphs 10 and 11, the entire indicated loss on the exchange should be recognized.

15. *Nonreciprocal Transfers to Owners*. Accounting for the distribution of nonmonetary assets to owners of an enterprise in a spin-off or other form of reorganization or liquidation or in a plan that is in substance the rescission of a prior business combination should be based on the recorded amount (after reduction, if appropriate, for an indicated impairment of value) (An indicated impairment of value of a long-lived asset covered by SSAP No. 90 shall be determined in accordance with paragraph 20 of that Statement.) of the nonmonetary assets distributed. A prorata distribution to owners of an enterprise of shares of a subsidiary or other investee company that has been or is being consolidated or that has been or is being accounted for under the equity method is to be considered to be equivalent to a spin-off. Other nonreciprocal transfers of nonmonetary assets to owners should be accounted for at fair value if the fair value of the nonmonetary asset distributed is objectively measurable and would be clearly realizable to the distributing entity in an outright sale at or near the time of the distribution.

[1] The configuration of future cash flows is composed of the risk, timing, and amount of the cash flows. A change in any one of those elements would be a change in configuration.

[2] An entity-specific value (referred to as an entity-specific measurement in Concepts Statement 7) is different from a fair value measurement. As described in paragraph 24.b. of Concepts Statement 7, an entity-specific value attempts to capture the value of an asset or liability in the context of a particular entity. For example, an entity computing an entity-specific value of an asset would use its expectations about its use of that asset rather than the use assumed by marketplace participants. If it is determined that the transaction has commercial substance, the exchange would be measured at fair value, rather than at the entity-specific value.

16. Fair value of a nonmonetary asset transferred to or from a reporting entity in a nonmonetary transaction should be determined by referring to estimated realizable values in cash transactions of the same or similar assets, quoted market prices, independent appraisals, estimated fair values of assets or services received in exchange, and other available evidence. If one of the parties in a nonmonetary transaction could have elected to receive cash instead of the nonmonetary asset, the amount of cash that could have been received may be evidence of the fair value of the nonmonetary assets exchanged.

17. Fair value should be regarded as not determinable within reasonable limits if major uncertainties exist about the realizability of the value that would be assigned to an asset received in a nonmonetary transaction accounted for at fair value. An exchange involving parties with essentially opposing interests is not considered a prerequisite to determining a fair value of a nonmonetary asset transferred; nor does an exchange insure that a fair value for accounting purposes can be ascertained within reasonable limits. If neither the fair value of a nonmonetary asset transferred nor the fair value of a nonmonetary asset received in exchange is determinable within reasonable limits, the recorded amount of the nonmonetary asset transferred from the enterprise may be the only available measure of the transaction.

18. A difference between the amount of gain or loss recognized for tax purposes and that recognized for accounting purposes may constitute a temporary difference to be accounted for according to *SSAP No. 10—Income Taxes*.

19. Involuntary conversions of nonmonetary assets to monetary assets (for example, as a result of total or partial destruction, theft, seizure, or condemnation) are monetary transactions for which gain or loss shall be recognized even though a reporting entity reinvests or is obligated to reinvest the monetary assets in replacement nonmonetary assets. In some cases, a nonmonetary asset may be destroyed or damaged in one accounting period, and the amount of monetary assets to be received is not determinable until a subsequent accounting period. In those cases, gain or loss shall be recognized in accordance with the conclusions in *SSAP No. 5—Liabilities, Contingencies and Impairments of Assets* (SSAP No. 5). Gain or loss resulting from an involuntary conversion of a nonmonetary asset to monetary assets shall be reported consistently with the reporting entity's reporting of continuing operations and disclosed in the notes to financial statements in accordance with *SSAP No. 24—Discontinued Operations and Extraordinary Items* (SSAP No. 24).

20. Language used in the accounting guidance for long-lived assets to be disposed of other than by sale in paragraphs 18-20 of *SSAP No. 90—Accounting for the Impairment or Disposal of Real Estate Investments, Discontinued Operations* (SSAP No. 90), including section titles, shall be amended as follows:

> Long-Lived Assets to Be Disposed Of Other Than By Sale
>
> 18. A long-lived asset to be disposed of other than by sale (for example, by abandonment, in an exchange measured based on the recorded amount of the nonmonetary asset relinquished~~for a similar productive long-lived asset~~, or in a distribution to owners in a spinoff) shall continue to be classified as held and used until disposal. Paragraphs 4-17, and 31-35 shall apply while the asset is classified as held and used. If a long-lived asset is to be abandoned or distributed to owners in a spinoff together with other assets (and liabilities) as a group and that disposal group is a segment, paragraphs 31-35 shall apply to the disposal group at the date of disposal.
>
> Long-Lived Asset to Be Abandoned
>
> 19. For purposes of this statement, a long-lived asset to be abandoned is disposed of when it ceases to be used. If an entity commits to a plan to abandon a long-lived asset before the end of its previously estimated useful life, depreciation estimates shall be revised in accordance with SSAP No. 3 to reflect the use of the asset over its shortened useful life.

A long-lived asset that has been temporarily idled shall not be accounted for as if abandoned.

Long-Lived Asset to Be Exchanged ~~for a Similarly Productive Long-Lived Asset~~ or to Be Distributed to Owners in a Spinoff

20. For purposes of this statement, a long-lived asset to be disposed of in an exchange measured based on the recorded amount of the nonmonetary asset relinquished ~~exchanged for a similarly productive long-lived asset~~ or to be distributed to owners in a spinoff is disposed of when it is exchanged or distributed. If the asset is tested for recoverability while it is classified as held and used, the estimates of future cash flows used in that test shall be based on the use of the asset for its remaining useful life, assuming that the disposal transaction will not occur. In addition to any impairment losses required to be recognized while the asset is classified as held and used, an impairment loss, if any, shall be recognized when the asset is disposed of if the carrying amount of the asset exceeds its fair value.[3]

Disclosures

21. A reporting entity that engages in a nonmonetary transaction during a period shall disclose the following in the financial statements:

a. The nature of the transaction;

b. The basis of accounting for the assets transferred; and

c. Gains or losses recognized on transfers.

22. Refer to the preamble for further discussion regarding disclosure requirements. The disclosure in paragraph 21 above shall be included in the annual audited statutory financial reports only.

Effective Date and Transition

23. Upon adoption of this issue paper, the NAIC will release a Statement of Statutory Accounting Principle (SSAP) for comment. The SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the *Accounting Practices and Procedures Manual* should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will contain an effective date of years ending on or after December 31, 2006.

DISCUSSION

24. In December 2004, the FASB issued SFAS No. 153: *Exchanges of Nonmonetary Assets, an amendment of APB Opinion No. 29* (APB 29) to improve the comparability of cross-boarder financial reporting. Working with the International Accounting Standards Board (IASB), FAS 153 was issued as part of a joint effort between the FASB and the IASB to develop a single set of high-quality accounting standards by eliminating a narrow difference between existing accounting standards relative to nonmonetary exchanges.

25. Although not meant to be all inclusive, accounting for specific nonmonetary transactions and unique circumstances is addressed in the following statements of statutory accounting principles:

- *SSAP No. 12—Employee Stock Ownership Plans* (SSAP No. 12),

[3] The provisions of this paragraph apply to nonmonetary exchanges that are not recorded at fair value under the provisions of paragraphs 10 and 15 of this issue paper.

- *SSAP No. 13—Stock Options and Stock Purchase Plans* (SSAP No. 13),
- *SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties* (SSAP No. 25),
- *SSAP No. 68—Business Combinations and Goodwill* (SSAP No. 68),
- *SSAP No. 72—Surplus and Quasi-reorganizations* (SSAP No. 72),
- *SSAP No. 91—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (SSAP No. 91),
- *INT 99-21: EITF 98-7: Accounting for Exchanges of Similar Equity Method Investments,*
- *INT 00-12: EITF 99-4: Accounting for Stock Received from the Demutualization of a Mutual Insurance Company,*
- *INT 00-26: EITF 98-3: Determining Whether a Nonmonetary Transactions Involves Receipt of Productive Assets or of a Business (INT 00-26),*
- *INT 00-29: EITF 99-17: Accounting for Advertising Barter Transactions* (INT 00-29), and
- *INT 03-16: Contribution of Stock* (INT 03-16).

26. This issue paper updates general statutory guidance for accounting for nonmonetery transactions not specifically addressed in the statements of statutory accounting principles noted above and carries forward current statutory guidance for stock dividends and stock splits received, other types of nonmonetary transactions and involuntary conversions of nonmonetary assets to monetary assets. The guidance in this issue paper remains consistent with the guidance provided in *SSAP No. 30—Investments in Common Stock (excluding investment in common stock of subsidiary, controlled, or affiliated entities)* (SSAP No. 30), which addresses cash dividends and requires that dividends on common stock be recorded as investment income when declared with a corresponding receivable to be extinguished upon receipt of cash. This issue paper carries forward the disclosure requirements related to nonmonetary transactions from SSAP No. 28.

27. This issue paper adopts APB 29 as modified by FAS 153.

28. This issue paper adopts FAS 153 with modifications for references to statements of statutory accounting principles.

29. This issue paper continues the adoption of ARB 43, Chapter 7, Section B paragraphs 1-9 as such relates to the receipt of stock in the form of a stock in the form of a stock dividend or stock split. This conclusion is consistent with the recognition concept included in the Statement of Concepts, which states, *"Revenue should be recognized only as the earnings process of the underlying underwriting or investment business is completed".*

30. This issue paper continues the adoption of FIN 30 with modification to provide that gain or loss contingencies be recognized in accordance with the conclusion in SSAP No. 5 and that gain or loss resulting from an involuntary conversion of nonmonetary assets to monetary assets be accounted for in continuing operations and disclosed in accordance with *SSAP No. 24—Discontinued Operations and Extraordinary Items*.

31. This issue paper continues the adoption of EITF 86-29 and EITF 93-11 consistent with the general rule discussed in paragraph 26 above.

32. This issue paper continues the rejection of paragraph 16 of *Accounting Principles Board Opinion No. 6, Status of Accounting Research Bulletins and Emerging Issues Task Force No. 96-4, Accounting for Reorganizations Involving a Non-Pro Rata Split-off of Certain Nonmonetary Assets to Owners*.

33. The conclusions above are consistent with the recognition concept included in the Statement of Concepts. The recognition concept states:

> The principal focus of solvency measurement is determination of financial condition through analysis of the balance sheet. However, protection of the policyholders can only be maintained through continued monitoring of the financial condition of the insurance enterprise. Operating performance is another indicator of an enterprise's ability to maintain itself as a going concern. Accordingly, the income statement is a secondary focus of statutory accounting and should not be diminished in importance to the extent contemplated by a liquidation basis of accounting.
>
> The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which are unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet but rather should be charged against surplus when acquired or when availability otherwise becomes questionable.
>
> Liabilities require recognition as they are incurred. Certain statutorily mandated liabilities may also be required to arrive at conservative estimates of liabilities and probable loss contingencies (e.g., interest maintenance reserves, asset valuation reserves, and others).
>
> Revenue should be recognized only as the earnings process of the underlying underwriting or investment business is completed. Accounting treatments which tend to defer expense recognition do not generally represent acceptable SAP treatment.
>
> SAP income reflects the extent that changes have occurred in SAP assets and liabilities for current period transactions, except changes in capital resulting from receipts or distributions to owners. SAP income also excludes certain other direct charges to surplus which are not directly attributable to the earnings process, (e.g., changes in non-admitted assets).

Drafting Notes/Comments

34. None

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

35. Statutory accounting principles currently exist for nonmonetary exchanges in *SSAP No. 28—Nonmonetary Transactions* (SSAP No. 28). Statutory accounting guidance regarding nonmonetary transactions related to assets transferred between affiliates currently exists in *SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and other Related Parties* (SSAP No. 25).

Generally Accepted Accounting Principles

36. APB 29, as amended by FAS 153, provides the following guidance:

> INTRODUCTION
>
> 1. Most business transactions involve exchanges of cash or other monetary assets or liabilities[1] for goods or services. The amount of monetary assets or liabilities exchanged generally provides an objective basis for measuring the cost of nonmonetary assets or

services received by an enterprise as well as for measuring gain or loss on nonmonetary assets transferred from an enterprise. Some transactions, however, involve either (a) an exchange with another entity (reciprocal transfer[1]) that involves principally nonmonetary assets or liabilities[1] or (b) a transfer of nonmonetary assets for which no assets are received or relinquished in exchange (nonreciprocal transfer[1]). Both exchanges and nonreciprocal transfers that involve little or no monetary assets or liabilities are referred to in this section as nonmonetary transactions.

[1] See paragraph 3 of this Opinion for definitions of these terms.

2. Questions have been raised concerning the determination of the amount to assign to a nonmonetary asset transferred to or from an enterprise in a nonmonetary transaction and also concerning the recognition of a gain or loss on a nonmonetary asset transferred from an enterprise in a nonmonetary transaction. Practice has varied; some nonmonetary transactions have been accounted for at the estimated fair value of the assets transferred and some at the amounts at which the assets transferred were previously recorded. This Opinion sets forth the views of the Board on accounting for nonmonetary transactions.

Definitions

3. The meanings of certain terms used in this section are:

a. Monetary assets and liabilities are assets and liabilities whose amounts are fixed in terms of units of currency by contract or otherwise. Examples are cash, short or long-term accounts and notes receivable in cash, and short- or long-term accounts and notes payable in cash.[2]

b. Nonmonetary assets and liabilities are assets and liabilities other than monetary ones. Examples are inventories; investments in common stocks; property, plant and equipment; and liabilities for rent collected in advance. [2]

[2] *APB Statement No. 3, Financial Statements Restated for General Price-Level Changes*, paragraphs 17-19, and Appendix B, contains a more complete explanation of monetary and nonmonetary items.

c. Exchange (or exchange transaction) is a reciprocal transfer between an enterprise and another entity that results in the enterprise's acquiring assets or services or satisfying liabilities by surrendering other assets or services or incurring other obligations. A reciprocal transfer of a nonmonetary asset shall be deemed an exchange only if the transferor has no substantial continuing involvement in the transferred asset such that the usual risks and rewards of ownership of the asset are transferred.

d. Nonreciprocal transfer is a transfer of assets or services in one direction, either from an enterprise to its owners (whether or not in exchange for their ownership interests) or another entity or from owners or another entity to the enterprise. An entity's reacquisition of its outstanding stock is an example of a nonreciprocal transfer.

e. Productive assets are assets held for or used in the production of goods or services by the enterprise. Productive assets include an investment in another entity if the investment is accounted for by the equity method but exclude an investment not accounted for by that method. Similar productive assets are productive assets that are of the same general type, that perform the same function or that are employed in the same line of business.

[3] [This footnote has been deleted. See Status page.]

Applicability

4. This Opinion does not apply to the following transactions:

a. A business combination accounted for by an enterprise according to the provisions of *FASB Statement No. 141, Business Combinations*, [3a]

[3a] Paragraph 10 of Statement 141 states that an exchange of a business for a business is a business combination.

b. A transfer of nonmonetary assets solely between companies or persons under common control, such as between a parent company and its subsidiaries or between two subsidiary corporations of the same parent, or between a corporate joint venture and its owners,

c. Acquisition of nonmonetary assets or services on issuance of the capital stock of an enterprise,[4]

[4] *FASB Statement No. 123 (revised 2004), Share-Based Payment*, applies to all transactions in which an entity acquires goods or services by issuing its shares or other equity instruments (except for equity instruments held by an employee stock ownership plan or by incurring liabilities to the supplier (a) in amounts based, at least in part, on the price of the entity's shares or other equity instruments or (b) that require or may require settlement by issuance of the entity's shares or other equity instruments.

d. Stock issued or received in stock dividends and stock splits which are accounted for in accordance with ARB No. 43, Chapter 7B,

e. A transfer of assets to an entity in exchange for an equity interest in that entity,

f. A pooling of assets in a joint undertaking intended to find, develop, or produce oil or gas from a particular property or group of properties, as described in paragraph 44 of *FASB Statement No. 19, Financial Accounting and Reporting by Oil and Gas Producing Companies*, as amended by *FASB Statements No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, No. 145, Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections, and No. 153, Exchanges of Nonmonetary Assets*,

g. The exchange of a part of an operating interest owned for a part of an operating interest owned by another party that is subject to paragraph 47.e. of Statement 19, and

h. The transfer of a financial asset within the scope of *FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.

Some exchanges of nonmonetary assets involve a small monetary consideration, referred to as "boot," even though the exchange is essentially nonmonetary. This Opinion also applies to those transactions. For purposes of applying this Opinion, events and transactions in which nonmonetary assets are involuntarily converted (for example, as a result of total or partial destruction, theft, seizure, or condemnation) to monetary assets that are then reinvested in other nonmonetary assets—are monetary transactions since the recipient is not obligated to reinvest the monetary consideration in other nonmonetary assets.

DISCUSSION

Present Accounting for Nonmonetary Transactions

5. *Nonreciprocal Transfers with Owners.* Some nonmonetary transactions are nonreciprocal transfers between an enterprise and its owners. Examples include (a) distribution of nonmonetary assets, such as marketable equity securities, to stockholders as dividends, (b) distribution of nonmonetary assets, such as marketable equity securities, to stockholders to redeem or acquire outstanding capital stock of the enterprise, (c) distribution of nonmonetary assets, such as capital stock of subsidiaries, to stockholders in corporate liquidations or plans of reorganization that involve disposing of all or a significant segment of the business (the plans are variously referred to as spin-offs, split-ups, and split-offs), and (d) distribution of nonmonetary assets to groups of stockholders, pursuant to plans of rescission or other settlements relating to a prior business combination, to redeem or acquire shares of capital stock previously issued in a business combination. Accounting for decreases in owners' equity that result from nonreciprocal nonmonetary transactions with owners has usually been based on the recorded amount of the nonmonetary assets distributed.

6. *Nonreciprocal Transfers with Other Than Owners.* Other nonmonetary transactions are nonreciprocal transfers between an enterprise and entities other than its owners. Examples are the contribution of nonmonetary assets by an enterprise to a charitable organization and the contribution of land by a governmental unit for construction of productive facilities by an enterprise. Accounting for nonmonetary assets received in a nonreciprocal transfer from an entity other than an owner has usually been based on fair value of the assets received while accounting for nonmonetary assets transferred to another entity has usually been based on the recorded amount of the assets relinquished.

7. *Nonmonetary Exchanges.* Many nonmonetary transactions are exchanges of nonmonetary assets or services with another entity. Examples include (a) exchange of product held for sale in the ordinary course of business (inventory) for dissimilar property as a means of selling the product to a customer, (b) exchange of product held for sale in the ordinary course of business (inventory) for similar product as an accommodation - that is, at least one party to the exchange reduces transportation costs, meets immediate inventory needs, or otherwise reduces costs or facilitates ultimate sale of the product—and not as a means of selling the product to a customer, and (c) exchange of productive assets—assets employed in production rather than held for sale in the ordinary course of business - for similar productive assets or for an equivalent interest in similar productive assets. Examples of exchanges in category (c) include the trade of player contracts by professional sports organizations, exchange of leases on mineral properties, exchange of one form of interest in an oil producing property for another form of interest, exchange of real estate for real estate. Accounting for nonmonetary assets acquired in a nonmonetary exchange has sometimes been based on the fair value of the assets relinquished and sometimes on the recorded amount of the assets relinquished.

Differing Views

8. Views of accountants differ as to appropriate accounting for all of the types of nonmonetary transactions described in paragraphs 5-7.

9. *Nonreciprocal Transfers of Nonmonetary Assets to Owners.* Some believe that accounting for nonreciprocal transfers of nonmonetary assets to owners should be based on the carrying amount of the nonmonetary assets transferred because only that method is consistent with the historical cost basis of accounting.

10. Others believe that accounting for transfers of nonmonetary assets to reduce certain owners' interests other than through a reorganization, liquidation, or rescission of a prior business combination should be based on the fair value of the nonmonetary assets distributed or the fair value of the stock representing the owners' equity eliminated, whichever is more clearly evident. In their view, disposing of the value represented by a nonmonetary asset is a significant economic event, and the unrecorded increase or decrease that has resulted in the value of the nonmonetary asset since its acquisition should be recognized.

11. Many who agree with accounting based on fair value for a nonreciprocal transfer of a nonmonetary asset that reduces certain owners' interests also believe that distributing a nonmonetary asset as an ordinary dividend (but not distributing a nonmonetary asset as a liquidating dividend or in a spin-off, reorganization or similar distributions) may be regarded as equivalent to an exchange with owners and therefore recorded at the fair value of the nonmonetary asset distributed, particularly if the dividend is distributable as either cash or the nonmonetary asset at the election of the owner. They believe that failure to recognize the fair value of nonmonetary assets transferred may both misstate the dividend and fail to recognize gains and losses on nonmonetary assets that have already been earned or incurred by the enterprise and should be recognized on distributing the assets for dividend purposes.

12. Others generally agree with the view that nonreciprocal transfers of nonmonetary assets to certain owners should be accounted for at fair value but believe that dividends and other prorata distributions to owners are essentially similar to liquidating dividends or distributions in spin-offs and reorganizations and should be accounted for at the recorded amount of the asset transferred.

13. *Nonreciprocal Receipts of Nonmonetary Assets.* Many believe that a nonmonetary asset received in a nonreciprocal transfer from other than owners should be recorded at fair value because fair value is the only value relevant to the recipient enterprise. Others believe that such nonmonetary assets should be recorded at a nominal value since fair value cannot be reasonably determined in view of performance obligations usually agreed to by the recipient as a consideration for the transfer.

14. *Nonreciprocal Transfers of Nonmonetary Assets to Other Than Owners.* Some believe that accounting for a nonreciprocal transfer of a nonmonetary asset to an entity other than an owner should be based on the carrying amount of the asset transferred because only that method is consistent with the historical cost basis of accounting. Others believe that failure to recognize the fair value of a nonmonetary asset transferred may both understate (or overstate) expenses incurred and fail to recognize gains or losses on nonmonetary assets that have already been earned or incurred by the enterprise and should be recognized when the transfer of the asset is recognized as an expense.

15. *Exchange Transactions.* Some believe that accounting for an exchange of nonmonetary assets between an enterprise and another entity (an enterprise or individual acting in a capacity other than a stockholder of the enterprise) should be based on the fair values of the assets involved, while others believe that accounting for the exchange should be based on the carrying amount of the asset transferred from the enterprise. Those who advocate the former view believe it to be the only method consistent with the accounting principle that an asset acquired should be recorded at its cost as measured by the fair value of the asset relinquished to acquire it. Those advocating the latter view believe that revenue should be recognized only if an exchange involves monetary assets; therefore recognizing fair value is inappropriate unless a monetary asset is received in an exchange.

16. Many accountants who accept the concept that accounting for an exchange of nonmonetary assets should be based on fair value believe that problems of measurement and questions about the conditions for recognizing revenue require modification of the concept in two types of exchanges. They therefore conclude that:

    a. Fair values should not be recognized if an enterprise exchanges product or property held for sale in the ordinary course of business for product or property to be sold in the same line of business. The emphasis in that exchange, in their view, is on developing economical ways to acquire inventory for resale to customers rather than on marketing inventory to obtain revenue from customers. Therefore, "swapping" inventories between enterprises that are essentially competitors and not customers of each other is merely an incidental early stage of an earning process, and revenue should not be recognized until the time of sale of the exchanged products (in the same or another form) to a customer of the enterprise.

    b. Fair value should not be recognized if an enterprise exchanges a productive asset for a similar productive asset or an equivalent interest in the same or similar productive asset. Therefore, revenue should not be recognized merely because one productive asset is substituted for a similar productive asset but rather should be considered to flow from the production and sale of the goods or services to which the substituted productive asset is committed.

17. *Fair Value Not Determinable.* General agreement exists that a nonmonetary transaction, regardless of form, should not be recorded at fair value if fair value is not determinable within reasonable limits. Major uncertainties concerning realizability of the fair value proposed to be assigned to a nonmonetary asset received in a nonmonetary transaction are indicative of an inability to determine fair value within reasonable limits. Some believe that only an exchange transaction between parties with essentially opposing interests provides an independent test of fair value to be used in measuring the transaction; therefore fair value is determinable within reasonable limits only in a negotiated exchange transaction. Others believe that fair value in a nonreciprocal transfer is also often determinable within reasonable limits and should be recognized in certain types of transactions.

OPINION

Basic Principle

18. The Board concludes that in general accounting for nonmonetary transactions should be based on the fair values[5] of the assets (or services) involved which is the same basis as that used in monetary transactions. Thus, the cost of a nonmonetary asset acquired in exchange for another nonmonetary asset is the fair value of the asset surrendered to obtain it, and a gain or loss should be recognized on the exchange. The fair value of the asset received should be used to measure the cost if it is more clearly evident than the fair value of the asset surrendered. Similarly, a nonmonetary asset received in a nonreciprocal transfer should be recorded at the fair value of the asset received. A transfer of a nonmonetary asset to a stockholder or to another entity in a nonreciprocal transfer should be recorded at the fair value of the asset transferred, and a gain or loss should be recognized on the disposition of the asset. The fair value of an entity's own stock reacquired may be a more clearly evident measure of the fair value of the asset distributed in a nonreciprocal transfer if the transaction involves distribution of a nonmonetary asset to eliminate a disproportionate part of owners' interests (that is, to acquire stock for the treasury or for retirement).

[5] See paragraph 25 for determination of fair value.

19. The Board believes that certain modifications of the basic principle are required to accommodate problems of measurement and questions about the conditions for recognizing revenue. These modifications are specified in paragraphs 20-23.

Modifications of the Basic Principle

20. A nonmonetary exchange shall be measured based on the recorded amount (after reduction, if appropriate, for an indicated impairment of value) of the nonmonetary asset(s) relinquished, [5a] and not on the fair values of the exchanged assets, if any of the following conditions apply:

[5a] An indicated impairment of value of a long-lived asset within the scope of Statement 144 shall be determined in accordance with paragraph 29 of that Statement.

a. Fair Value Not Determinable. The fair value of neither the asset(s) received nor the asset(s) relinquished is determinable within reasonable limits (paragraph 25).

b. Exchange Transaction to Facilitate Sales to Customers. The transaction is an exchange of a product or property held for sale in the ordinary course of business for a product or property to be sold in the same line of business to facilitate sales to customers other than the parties to the exchange.

c. Exchange Transaction That Lacks Commercial Substance. The transaction lacks commercial substance (paragraph 21).

Commercial Substance

21. A nonmonetary exchange has commercial substance if the entity's future cash flows[5b] are expected to significantly change as a result of the exchange. The entity's future cash flows are expected to significantly change if either of the following criteria is met:

[5b] *FASB Concepts Statement No. 7, Using Cash Flow Information and Present Value in Accounting Measurements*, contains guidance that may be useful in evaluating changes in future cash flows.

a. The configuration (risk, timing, and amount) [5c] of the future cash flows of the asset(s) received differs significantly from the configuration of the future cash flows of the asset(s) transferred.

[5c] The configuration of future cash flows is composed of the risk, timing, and amount of the cash flows. A change in any one of those elements would be a change in configuration.

b. The entity-specific value[5d] of the asset(s) received differs from the entity-specific value of the asset(s) transferred, and the difference is significant in relation to the fair values of the assets exchanged.

[5d] An entity-specific value (referred to as an entity-specific measurement in Concepts Statement 7) is different from a fair value measurement. As described in paragraph 24.b. of Concepts Statement 7, an entity-specific value attempts to capture the value of an asset or liability in the context of a particular entity. For example, an entity computing an entity-specific value of an asset would use its expectations about its use of that asset rather than the use assumed by marketplace participants. If it is determined that the transaction has commercial substance, the exchange would be measured at fair value, rather than at the entity-specific value.

A qualitative assessment will, in some cases, be conclusive in determining that the estimated cash flows of the entity are expected to significantly change as a result of the exchange.

[6] [This footnote has been deleted. See Status page.]

21A. In the United States and some other tax jurisdictions, a transaction is not given effect for tax purposes unless it serves a legitimate business purpose other than tax avoidance. In assessing the commercial substance of an exchange, tax cash flows that arise solely because the tax business purpose is based on achieving a specified financial reporting result shall not be considered.

22. The exchanges of nonmonetary assets that would otherwise be based on recorded amounts (paragraph 21) may include an amount of monetary consideration. The Board believes that the recipient of the monetary consideration has realized gain on the exchange to the extent that the amount of the monetary receipt exceeds a proportionate share of the recorded amount of the asset surrendered. The portion of the cost applicable to the realized amount should be based on the ratio of the monetary consideration to the total consideration received (monetary consideration plus the estimated fair value of the nonmonetary asset received) or, if more clearly evident, the fair value of the nonmonetary asset transferred. The Board further believes that the entity paying the monetary consideration should not recognize any gain on a transaction covered in paragraph 21 but should record the asset received at the amount of the monetary consideration paid plus the recorded amount of the nonmonetary asset surrendered. If a loss is indicated by the terms of a transaction described in this paragraph or in paragraph 21, the entire indicated loss on the exchange should be recognized.

23. Nonreciprocal Transfers to Owners. Accounting for the distribution of nonmonetary assets to owners of an enterprise in a spin-off or other form of reorganization or liquidation or in a plan that is in substance the rescission of a prior business combination should be based on the recorded amount (after reduction, if appropriate, for an indicated impairment of value) [6a] of the nonmonetary assets distributed. A prorata distribution to owners of an enterprise of shares of a subsidiary or other investee company that has been or is being consolidated or that has been or is being accounted for under the equity method is to be considered to be equivalent to a spin-off. Other nonreciprocal transfers of nonmonetary assets to owners should be accounted for at fair value if the fair value of the nonmonetary asset distributed is objectively measurable and would be clearly realizable to the distributing entity in an outright sale at or near the time of the distribution.

[6a] An indicated impairment of value of a long-lived asset covered by Statement 144 shall be determined in accordance with paragraph 29 of that Statement.

Applying the Basic Principle

24. The Board's conclusions modify to some extent existing practices as described in paragraphs 5 to 7. The conclusions are based on supporting reasons given in paragraphs 8-17.

25. Fair value of a nonmonetary asset transferred to or from an enterprise in a nonmonetary transaction should be determined by referring to estimated realizable values in cash transactions of the same or similar assets, quoted market prices, independent appraisals, estimated fair values of assets or services received in exchange, and other available evidence. If one of the parties in a nonmonetary transaction could have elected to receive cash instead of the nonmonetary asset, the amount of cash that could have been received may be evidence of the fair value of the nonmonetary assets exchanged.

26. Fair value should be regarded as not determinable within reasonable limits if major uncertainties exist about the realizability of the value that would be assigned to an asset received in a nonmonetary transaction accounted for at fair value. An exchange involving parties with essentially opposing interests is not considered a prerequisite to determining a fair value of a nonmonetary asset transferred; nor does an exchange insure that a fair value for accounting purposes can be ascertained within reasonable limits. If neither the fair value of a nonmonetary asset transferred nor the fair value of a nonmonetary asset received in exchange is determinable within reasonable limits, the recorded amount of the nonmonetary asset transferred from the enterprise may be the only available measure of the transaction.

27. A difference between the amount of gain or loss recognized for tax purposes and that recognized for accounting purposes may constitute a temporary difference to be accounted for according to *FASB Statement No. 109, Accounting for Income Taxes*.

Disclosure

28. An enterprise that engages in one or more nonmonetary transactions during a period should disclose in financial statements for the period the nature of the transactions, the basis of accounting for the assets transferred, and gains or losses recognized on transfers.[7]

[7] Paragraph 12 of ARB No 51, Consolidated Financial Statements, includes additional disclosures that are preferred if a parent company disposes of a subsidiary during the year.

37. ARB 43, Chapter 7, Section B provides the following guidance (only the pertinent excerpts are included below):

As to the Recipient

5. One of the basic problems of accounting is that of income determination. Complete discussion of this problem is obviously beyond the scope of this chapter. Basically, income is a realized gain and in accounting is recognized, recorded, and stated in accordance with certain principles as to time and amount.

6. If there is an increase in the market value of his holdings, such unrealized appreciation is not income. In the case of a stock dividend or split-up, there is no distribution, division, or severance of corporate assets. Moreover, there is nothing resulting therefrom that the shareholder can realize without parting with some of his proportionate interest in the corporation.

7. The foregoing are important points to be considered in any discussion of the accounting procedures to be followed by the recipient of a stock dividend or split-up since many arguments put forward by those who favor recognizing stock dividends as income are in substance arguments for the recognition of corporate income as income to the shareholder as it accrues to the corporation, and prior to its distribution to the shareholder; the acceptance of such arguments would require the abandonment of the separate entity concept of corporation accounting.

8. The question as to whether or not stock dividends are income has been extensively debated; the arguments pro and con are well known.[1] The situation cannot be better summarized, however, than in the words approved by Mr. Justice Pitney in Eisner v. Macomber, 252 U.S. 189, wherein it was held that stock dividends are not income under the Sixteenth Amendment, as follows:

"A stock dividend really takes nothing from the property of the corporation and adds nothing to the interests of the stockholders. Its property is not diminished and their interests are not increased . . . the proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest, the new shares and the original shares together representing the same proportional interests that the original shares represented before the issue of the new ones."

[1] See, for instance, Freeman, "Stock Dividends and the New York Stock Exchange," American Economic Review, December, 1931 (pro), and Whitaker, "Stock Dividends, Investment Trusts, and the Exchange," American Economic Review, June, 1931 (con).

9. Since a shareholder's interest in the corporation remains unchanged by a stock dividend or split-up except as to the number of share units constituting such interest, the cost of the shares previously held should be allocated equitably to the total shares held after receipt of the stock dividend or split-up. When any shares are later disposed of, a gain or loss should be determined on the basis of the adjusted cost per share.

38. FIN 30 provides the following guidance (only the pertinent excerpts are included below):

1. The FASB has been asked whether gain or loss results from an involuntary conversion of a nonmonetary asset to monetary assets if the monetary assets are subsequently reinvested in a similar nonmonetary asset.[1] Generally, if a nonmonetary asset is involuntarily converted, gain or loss for the difference between the cost[2] of the nonmonetary asset and the amount of monetary assets received has been recognized in income in the period of the involuntary conversion. In other cases, that difference has been accounted for as an adjustment to the cost basis of a nonmonetary asset that is subsequently acquired as replacement property.

[1] The terms "nonmonetary" and "monetary" as used in this Interpretation have the same meaning as those terms have in *APB Opinion No. 29, Accounting for Nonmonetary Transactions*.

[2] As used in this Interpretation, the term cost refers to the cost of a nonmonetary asset or to its carrying amount, if different.

INTERPRETATION

2. Involuntary conversions of nonmonetary assets to monetary assets are monetary transactions for which gain or loss shall be recognized even though an enterprise reinvests or is obligated to reinvest the monetary assets in replacement nonmonetary assets. As discussed in paragraph 11 of this Interpretation, however, the requirement to recognize gain does not apply to certain involuntary conversions of LIFO inventories.[3]

[3] Paragraph 14.b. of *APB Opinion No. 28, Interim Financial Reporting*, provides an exception for the liquidation of a LIFO inventory at an interim date if replacement is expected by year-end. Accordingly, that exception applies to an involuntary conversion of a LIFO inventory if replacement is expected by year-end.

3. In some cases, a nonmonetary asset may be destroyed or damaged in one accounting period, and the amount of monetary assets to be received is not determinable until a subsequent accounting period. In those cases, gain or loss shall be recognized in accordance with *FASB Statement No. 5, Accounting for Contingencies*.

4. Gain or loss resulting from an involuntary conversion of a nonmonetary asset to monetary assets shall be classified in accordance with the provisions of *APB Opinion No. 30, Reporting the Results of Operations—-Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*.

5. Gain or loss resulting from an involuntary conversion of a nonmonetary asset to monetary assets that is not recognized for income tax reporting purposes in the same period in which the gain or loss is recognized for financial reporting purposes is a temporary difference for which comprehensive recognition of deferred taxes, as described in *FASB Statement No. 109, Accounting for Income Taxes*, is required.

39. EITF 86-29 provides the following guidance (only the pertinent excerpts are included below):

ISSUE

The basic principle contained in Opinion 29 is that the exchange of nonmonetary assets should be recorded at fair value. Certain modifications to that basic principle are contained in paragraphs 21 and 22 of Opinion 29. (The Task Force previously discussed certain aspects of those modifications in Issues No. 84-29, "Gain and Loss Recognition on Exchanges of Productive Assets and the Effect of Boot," and No. 85-43, "Sale of Subsidiary for Equity Interest in Buyer.")

The issues are (1) how the accounting for certain nonmonetary transactions should be affected by the magnitude of boot and (2) how the exceptions to the use of fair value should be applied.

EITF DISCUSSION

The Task Force reached a consensus that the decision as to whether an exchange involving products or properties held for sale (paragraph 21.a. of Opinion 29) should be measured using the recorded amounts or fair value depends on whether the products or properties received will be sold in the same line of business as the products or properties given up.

Further, the Task Force reached a consensus that the decision as to whether an exchange of similar productive assets (paragraph 21.b.) should be measured using the recorded amounts or fair value should be based on a "same line of business" test.

Some Task Force members expressed the view that the exchange of a controlled business (as defined in ARB 51) for an investment in an entity that is not controlled, but is in the same line of business, would not necessarily meet the definition of a similar productive asset and would have to be evaluated based on individual facts and circumstances. No consensus was reached on this issue.

The Task Force reached a consensus that a product or property held for sale and exchanged for a productive asset did not fall within the modifications to the basic principle of Opinion 29 (even if they were in the same line of business) and should be recorded at fair value.

The Task Force discussed an exchange of nonmonetary assets that would otherwise be based on recorded amounts but that also involves boot, reached a consensus that the transaction should be considered monetary (rather than nonmonetary) if the boot is significant, and agreed that "significant" should be defined as at least 25 percent of the fair value of the exchange. As a monetary transaction, both parties would record the exchange at fair value. If the boot in a transaction is less than 25 percent, the pro rata gain recognition guidance in paragraph 22 of Opinion 29 should be applied by the receiver of boot, and the payer of boot would not recognize a gain. The Task Force acknowledged that the ability to satisfactorily measure fair value is a prerequisite to the use of fair value.

The Task Force also discussed various exchanges involving investments accounted for by consolidation and by the equity method. The Task Force reached a consensus that an enterprise should account for an exchange of securities in which it acquires control of a subsidiary as a business combination in accordance with Opinion 16. An enterprise should account for an exchange of securities accounted for by consolidation or by the equity method for an investment in which it does not acquire control of a business but for which it will account by the equity method, as a nonmonetary transaction in accordance with Opinion 29. The Task Force noted that the provisions of this consensus were not intended to apply to exchanges involving joint ventures or the acquisition of a minority interest.

Additionally, several Task Force members and the SEC Observer expressed concern that a literal application of the consensus to an exchange in which an enterprise acquires control of a business could result in the recognition of gain on transactions that are in substance an exchange of similar productive assets or result in a 100 percent write-up of an asset in circumstances in which an entity has not transferred control of the asset. For example, Company A transfers an asset to Company B in exchange for shares of Company B. As a result of the exchange, Company A acquires control of Company B; Company A also indirectly retains control of the asset received by Company B. The Task Force agreed that Company A should account for this transaction as a partial sale (to minority shareholders of Company B), and gain recognition should be limited to that portion of the asset treated as sold. If Company B accounts for the exchange at fair value, profit applicable to the portion of the asset indirectly controlled by Company A would be eliminated in Company A's consolidation of Company B.

Further, the Task Force observed that the consensus is not intended to change the application of Opinion 16 or to eliminate the need to exercise judgment in those circumstances in which the substance of a transaction indicates that fair value accounting is not appropriate. That is, if Opinion 16 is to apply, the substance of the transaction must be a business combination.

STATUS

Issues relating to the exchange of real estate involving boot were discussed in Issue No. 87-29, "Exchange of Real Estate Involving Boot." For that Issue, the Task Force reached a consensus that a transaction involving an exchange of similar real estate that is considered a monetary transaction under Issue 86-29 because boot is at least 25 percent of the fair value of the exchange would be allocated between two components: a monetary portion and a nonmonetary portion. (An exchange of similar real estate is defined in Issue 87-29 as an exchange of either (a) real estate held for sale in the ordinary course of business for real estate to be sold in the same line of business or (b) real estate not held for sale in the ordinary course of business for similar real estate.) The allocation between the monetary and nonmonetary portions of the transaction should be based on their relative fair values at the time of the transaction. For the receiver of boot, the monetary portion would be accounted for under Statement 66 as the equivalent of a sale of an interest in the underlying real estate, and the nonmonetary portion would be accounted for under paragraph 21 of Opinion 29. For the payer of boot, the monetary portion would be accounted for as an acquisition of real estate, and the nonmonetary portion would be accounted for under paragraph 21 of Opinion 29. Exhibit 87-29A presents an example of the application of the consensus reached on Issue 87-29.

No further EITF discussion is planned.

40. EITF 93-11 provides the following guidance (only the pertinent excerpts are included below):

ISSUE

In a barter transaction involving barter credits, an enterprise enters into a transaction to exchange a nonmonetary asset (for example, inventory) for barter credits. Those transactions may occur directly between principals to the transaction or include a third party whose business is to facilitate those types of exchanges (for example, a barter company).

The barter credits can be used to purchase goods or services, such as advertising time, from either the barter company or members of its barter exchange network. The goods and services to be purchased may be specified in a barter contract or limited to items made available by members of the exchange network. Some arrangements may require the payment of cash in addition to the barter credits to purchase goods or services. Barter credits also may have a contractual expiration date, at which time they become worthless.

The issue is whether Opinion 29 should be applied to an exchange of a nonmonetary asset for barter credits and, if so, the amount of profit or loss, if any, that should be recognized.

EITF DISCUSSION

The Task Force reached a consensus that transactions in which nonmonetary assets are exchanged for barter credits should be accounted for under Opinion 29. An impairment of the nonmonetary asset exchanged should be recognized prior to recording the exchange if the fair value of that asset is less than its carrying amount. The impairment should be measured as the amount by which the carrying amount of the asset exceeds its fair value. Recognition of an impairment loss also would be required in an exchange of assets or contractual rights not reported in the balance sheet (for example, operating leases) if the transferor is not relieved of primary liability for the related obligation. The definition of fair value in paragraph 13 of Statement 15 may be useful in determining the fair value of the nonmonetary asset. The Task Force noted that fair value should not be based on an estimate of the value of the barter credits to be received. After an impairment is recognized, the reduced carrying amount of the nonmonetary asset becomes its new cost. [Note: See STATUS section.]

If an exchange involves the transfer or assumption of an operating lease, impairment of that lease should be measured as the amount of the remaining lease costs (discounted rental payments and unamortized leasehold improvements) in excess of the discounted amount of probable sublease rentals for the remaining lease term. [Note: See STATUS section.]

The Task Force also reached a consensus that in reporting the exchange of a nonmonetary asset for barter credits, it should be presumed that the fair value of the nonmonetary asset exchanged is more clearly evident than the fair value of the barter credits received and that the barter credits should be reported at the fair value of the nonmonetary asset exchanged. The Task Force noted, however, that that presumption might be overcome if an entity can convert the barter credits into cash in the near term, as evidenced by a historical practice of converting barter credits into cash shortly after receipt, or if independent quoted market prices exist for items to be received upon exchange of the barter credits. It also should be presumed that the fair value of the nonmonetary asset does not exceed its carrying amount unless there is persuasive evidence supporting a higher value. An impairment loss on the barter credits should be recognized if it subsequently becomes apparent that (1) the fair value of any remaining barter credits is less than the carrying amount or (2) it is probable that the enterprise will not use all of the remaining barter credits.

STATUS

In March 1995, the FASB issued Statement 121 which requires that long-lived assets and certain identifiable intangibles to be held and used be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Statement 121 establishes accounting standards for the recognition and measurement of impairment losses and sets forth an approach to determining an asset's fair value. Statement 121 also requires that long-lived assets and certain identifiable intangibles to be disposed of be reported at the lower of carrying amount or fair value less cost to sell.

In August 2001, the FASB issued Statement 144. Statement 144 addresses financial accounting and reporting for the impairment of long-lived assets and for long-lived assets to be disposed of and supersedes Statement 121.

No further EITF discussion is planned.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy,
- *SSAP No. 5—Liabilities, Contingencies and Impairments of Assets,*
- *SSAP No. 10—Income Taxes,*
- *SSAP No. 12—Employee Stock Ownership Plans,*
- *SSAP No. 13—Stock Options and Stock Purchase Plans,*
- *SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties,*
- *SSAP No. 28—Nonmonetary Transactions,*
- *SSAP No. 30—Investments in Common Stock (excluding investments in common stock of subsidiary, controlled, or affiliated entities),*
- *SSAP No. 68—Business Combinations and Goodwill,*
- *SSAP No. 72—Surplus and Quasi-Reorganizations,*
- *SSAP No. 91—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,*
- *INT 99-21: EITF 98-7: Accounting for Exchanges of Similar Equity Method Investments,*
- *INT 00-12: EITF 99-4: Accounting for Stock Received from the Demutualization of a Mutual Insurance Company,*
- *INT 00-26: EITF 98-3: Determining Whether a Nonmonetary Transactions Involves Receipt of Productive Assets or of a Business,*
- *INT 00-29: EITF 99-17: Accounting for Advertising Barter Transactions, and*
- *INT 03-16: Contribution of Stock*

Generally Accepted Accounting Principles

- *Accounting Principles Board Opinion No. 6, Status of Accounting Research Bulletins, paragraph 16,*
- *Accounting Principles Board Opinion No. 29, Accounting for Nonmonetary Transactions,*

- *Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins, Chapter 7, Section B, Stock Dividends and Stock Split-ups,*
- *FASB No. 153, Exchanges of Nonmonetary Assets, an amendment of APB Opinion No. 29,*
- *FASB Interpretation No. 30, Accounting for Involuntary Conversions of Nonmonetary Assets to Monetary Assets,*
- *FASB Emerging Issues Task Force Issue No. 86-29: Nonmonetary Transactions: Magnitude of Boot and the Exceptions to the Use of Fair Value,*
- *FASB Emerging Issues Task Force Issue No. 93-11: Accounting for Barter Transactions Involving Barter Credits,*
- *FASB Emerging Issues Task Force Issue No. 96-4: Accounting for Reorganizations Involving a Non-Pro Rata Split-off of Certain Nonmonetary Assets to Owners,*
- *FASB Emerging Issues Task Force Issue No. 98-3: Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business*
- *FASB Emerging Issues Task Force Issue No. 98-7: Accounting for Exchanges of Similar Equity Method Investments,*
- *FASB Emerging Issues Task Force Issue No. 99-4: Accounting for Stock Received from the Demutualization of a Mutual Insurance Company,* and
- *FASB Emerging Issues Task Force Issue No. 99-17: Accounting for Advertising Barter Transactions.*

STATE REGULATIONS

- No additional guidance obtained from state statutes or regulations.

Statutory Issue Paper No. 128

Settlement Requirements for Intercompany Transactions, An Amendment to SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties

STATUS
Finalized June 12, 2006

Current Authoritative Guidance for Settlement Requirements for Intercompany Transactions: SSAP No. 25

This issue paper may not be directly related to the current authoritative statement.

Original SSAP from Issue Paper: SSAP No. 96

Type of Issue:

Common Area

SUMMARY OF ISSUE

1. Current statutory guidance relating to intercompany transactions is included in *SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties* (SSAP No. 25). SSAP No. 25 does not explicitly impose an aging threshold for admission of loans and advances to related parties outstanding as of the reporting date. In addition, no explicit aging threshold exists for admission of receivables associated with transactions for services provided to related parties outstanding as of the reporting date.

2. While SSAP No. 25 established statutory accounting principles and disclosure requirements for related party transactions, the purpose of this issue paper is to amend this guidance to include an explicit aging threshold for admissibility for these transactions. A threshold will further clarify the current requirement in paragraph 6 of SSAP No. 25 regarding the maintenance of accounts "on a current basis." In addition, a threshold provides explicit parameters in which to apply the fair and reasonable standard established by Appendix A-440, which is referenced in paragraph 15, of SSAP No. 25.

SUMMARY CONCLUSION

3. This issue paper shall amend SSAP No. 25 to insert the following additional paragraph numbered six and to renumber the remaining paragraphs of the statement:

Transactions between related parties must be in the form of a written agreement. The written agreement must provide for timely settlement of amounts owed, with a specified due date. Amounts owed to the reporting entity over ninety days from the written agreement due date shall be nonadmitted. If the due date is not addressed by the written agreement any uncollected receivable is nonadmitted.

Disclosures

4. This issue paper requires no additional disclosures.

Effective Date and Transition

5. After adoption of this issue paper, the NAIC will release a Statement of Statutory Accounting Principle (SSAP) for comment. The initial draft of the SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the *Accounting Practices and Procedures Manual* should note

that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will be effective for reporting periods beginning on or after January 1, 2007.

DISCUSSION

6. This issue paper will help ensure transactions between the reporting entity and its parent, affiliates and related parties, are current. This inclusion of a 90-day rule is consistent with other statements of statutory accounting principles.

Drafting Notes/Comments

7. None

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

8. The concept of an aging threshold for admissibility (i.e., 90-day rule) is contained in *SSAP No. 6—Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due From Agents and Brokers* (SSAP No. 6) as follows:

> 9. Nonadmitted amounts are determined as follows:
>
> a. Uncollected Premium—To the extent that there is no related unearned premium, any uncollected premium balances which are over ninety days due shall be nonadmitted. If an installment premium is over ninety days due, the amount over ninety days due plus all future installments that have been recorded on that policy shall be nonadmitted;
>
> b. Bills Receivable—Bills receivable shall be nonadmitted if either of the following conditions are present:
>
> i. If any installment is past due, the entire bills receivable balance from that policy is nonadmitted; or
>
> ii. If the bills receivable balance due exceeds the unearned premium on the policy for which the note was accepted, the amount in excess of the unearned premium is nonadmitted.
>
> c. Agents' Balances—The uncollected agent's receivable on a policy by policy basis which is over ninety days due shall be nonadmitted regardless of any unearned premium;
>
> i. If amounts are both payable to and receivable from an agent on the same underlying policy, and the contractual agreements between the agent and the reporting entity permit offsetting, the nonadmitted portion of amounts due from that agent shall not be greater than the net balance due, by agent;
>
> If reconciling items between a reporting entity's account and an agent's account are over ninety days due, the amounts shall be nonadmitted.

9. This aging concept is also include in *SSAP No. 10—Income Taxes* (SSAP No. 10) as follows:

> 13. Amounts owed to a reporting entity pursuant to a recognized transaction shall be treated as a loan or advance, and nonadmitted, pursuant to SSAP No. 25, to the extent that the

recoverable is not settled within 90 days of the filing of a consolidated income tax return, or where a refund is due the reporting entity's parent, within 90 days of the receipt of such refund.

Generally Accepted Accounting Principles

10. GAAP does not address the concept of admitted assets.

RELEVANT LITERATURE

Statutory Accounting

- *SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties*

Generally Accepted Accounting Principles

- None

State Regulations

- No additional guidance obtained from state statutes or regulations.

EXHIBIT A: Illustration of Marked Changes to Amended SSAP No. 25

The following depicts the amendment made by this issue paper as “marked changes”: (new text underlined):

SCOPE OF STATEMENT

1. Related party transactions are subject to abuse because reporting entities may be induced to enter transactions that may not reflect economic realities or may not be fair and reasonable to the reporting entity or its policyholders. As such, related party transactions require specialized accounting rules and increased regulatory scrutiny. This statement establishes statutory accounting principles and disclosure requirements for related party transactions.

SUMMARY CONCLUSION

2. Related parties are defined as entities that have common interests as a result of ownership, control, affiliation or by contract. Related parties shall include but are not limited to the following:

a. Affiliates of the reporting entity, as defined in paragraph 3;

b. Trusts for the benefit of employees, such as pension and profit-sharing trusts and Employee Stock Ownership Plans that are managed by or under the trusteeship of management of the reporting entity, its parent or affiliates;

c. The principal owners of the reporting entity;

d. The management of the reporting entity, its parent or affiliates (including directors);

e. Members of the immediate families of principal owners and management of the reporting entity, its parent or affiliates and their management;

f. Parties with which the reporting entity may deal if either party directly or indirectly controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interest;

g. A party which can, directly or indirectly, significantly influence the management or operating policies of the reporting entity, which may include a provider who is contracting with the reporting entity. This is not intended to suggest that all provider contracts create related party relationships;

h. A party which has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests;

i. Attorney-in-fact of a reciprocal reporting entity or any affiliate of the attorney-in-fact; and

j. A U.S. manager of a U.S. Branch or any affiliate of the U.S. manager of a U.S. Branch.

3. An affiliate is defined as an entity that is within the holding company system or a party that, directly or indirectly, through one or more intermediaries, controls, is controlled by, or is under common control with the reporting entity. An affiliate includes a parent or subsidiary and may also include partnerships, joint ventures, and limited liability companies as defined in *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies* (SSAP No. 48). Those entities are accounted for under the

guidance provided in SSAP No. 48, which requires an equity method for all such investments. An affiliate is any person that is directly or indirectly, owned or controlled by the same person or by the same group of persons, that, directly or indirectly, own or control the reporting entity.

4. Control is defined as the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of the investee, whether through the (a) ownership of voting securities, (b) by contract other than a commercial contract for goods or nonmanagement services, (c) by contract for goods or nonmanagement services where the volume of activity results in a reliance relationship (d) by common management, or (e) otherwise. Control shall be presumed to exist if a reporting entity and its affiliates directly or indirectly, own, control, hold with the power to vote, or hold proxies representing 10% or more of the voting interests of the entity.

5. Control as defined in paragraph 4 shall be measured at the holding company level. For example, if one member of an affiliated group has a 5% interest in an entity and a second member of the group has an 8% interest in the same entity, the total interest is 13%, and therefore, each member of the affiliated group shall be presumed to have control. This presumption will stand until rebutted by an evaluation of all the facts and circumstances relating to the investment based on the criteria in *FASB Interpretation No. 35, Criteria for Applying the Equity Method of Accounting for Investments in Common Stock, an Interpretation of APB Opinion No. 18*. The corollary is required to demonstrate control when a reporting entity owns less than 10% of the voting securities of an investee. The insurer shall maintain documents substantiating its determination for review by the domiciliary commissioner. Examples of situations where the presumption of control may be in doubt include the following:

a. Any limited partner investment in a limited partnership, unless the limited partner is affiliated with the general partner.

b. An entity where the insurer owns less than 50% of an entity and there is an unaffiliated individual or group of investors who own a controlling interest.

c. An entity where the insurer has given up participation rights[1] as a shareholder to the investee.

6. Transactions between related parties must be in the form of a written agreement. The written agreement must provide for timely settlement of amounts owed, with a specified due date. Amounts owed to the reporting entity over ninety days from the written agreement due date shall be nonadmitted. If the due date is not addressed by the written agreement any uncollected receivable is nonadmitted.

Related Party Loans

~~6.~~7. Loans or advances (including debt, public or private) made by a reporting entity to its parent or principal owner shall be admitted if approval for the transaction has been obtained from the domiciliary commissioner and the loan or advance is determined to be collectible based on the parent or principal owner's independent payment ability. An affiliate's ability to pay shall be determined after consideration of the liquid assets or revenues available from external sources (i.e., determination shall not include dividend paying ability of the subsidiary making the loan or advance) which are available to repay the balance and/or maintain its account on a current basis. Evaluation of the collectibility of loans or

[1] The term “participating rights” refers to the type of rights that allows an investor to effectively participate in significant decisions related to an investee’s ordinary course of business and is distinguished from the more limited type of rights referred to as “protective rights”. Refer to the sections entitled: “Protective Rights” and “Substantive Participating Rights” in *EITF 96-16, Investor’s Accounting for an Investee When the Investor Owns a Majority of the Voting Stock but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights*. The term “participating rights” shall be used consistent with the discussion of substantive participating rights in the EITF.

advances shall be made periodically. If, in accordance with *SSAP No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets* (SSAP No. 5), it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made.

~~7.~~8. Loans or advances by a reporting entity to all other related parties shall be evaluated by management and nonadmitted if they do not constitute arm's-length transactions as defined in paragraph 10. Loans or advances made by a reporting entity to related parties (other than its parent or principal owner) that are economic transactions as defined in paragraph 10 shall be admitted. This includes financing arrangements with providers of health care services with whom the reporting entity contracts with from time to time. Such arrangements can include both loans and advances to these providers. Evaluation of the collectibility of loans or advances shall be made periodically. If, in accordance with SSAP No. 5, it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made.

~~8.~~9. Any advances under capitation arrangements made directly to providers, or to intermediaries that represent providers, that exceed one month's payment shall be nonadmitted assets.

~~9.~~10. Indirect loans are loans or extensions of credit to any person who is not an affiliate, where the reporting entity makes loans or extensions of credit with the agreement or understanding that the proceeds of the transactions, in whole or in substantial part, are to be used to make loans or extensions of credit to, to purchase assets of, or to make investments in, any affiliate of the reporting entity making the loans or extensions of credit. The admissibility of indirect loans made by a reporting entity for the benefit of its parent or principal owner shall be determined in accordance with the guidelines in paragraph 6. Indirect loans or advances made for the benefit of all other related parties shall be evaluated and accounted for consistent with loans or advances to related parties as described in paragraphs 7 and 8.

Transactions Involving the Exchange of Assets or Liabilities

~~10.~~11. An arm's-length transaction is defined as a transaction in which willing parties, each being reasonably aware of all relevant facts and neither under compulsion to buy, sell, or loan, would be willing to participate. A transaction between related parties involving the exchange of assets or liabilities shall be designated as either an economic transaction or non-economic transaction. An economic transaction is defined as an arm's-length transaction which results in the transfer of the risks and rewards of ownership and represents a consummated act thereof, i.e., "permanence." The appearance of permanence is also an important criterion in assessing the economic substance of a transaction. In order for a transaction to have economic substance and thus warrant revenue (loss) recognition, it must appear unlikely to be reversed. If subsequent events or transactions reverse the effect of an earlier transaction prior to the issuance of the financial statements, the reversal shall be considered in determining whether economic substance existed in the case of the original transaction. Subsequent events are addressed in *SSAP No. 9—Subsequent Events*. An economic transaction must represent a bonafide business purpose demonstrable in measurable terms. A transaction which results in the mere inflation of surplus without any other demonstrable and measurable betterment is not an economic transaction. The statutory accounting shall follow the substance, not the form of the transaction.

~~11.~~12. In determining whether there has been a transfer of the risks and rewards of ownership in the transfer of assets or liabilities between related parties, the following—and any other relevant facts and circumstances related to the transaction—shall be considered:

a. Whether the seller has a continuing involvement in the transaction or in the financial interest transferred, such as through the exercise of managerial authority to a degree usually associated with ownership;

b. Whether there is an absence of significant financial investment by the buyer in the financial interest transferred, as evidenced, for example, by a token down payment or by a concurrent loan to the buyer;

c. Whether repayment of debt that constitutes the principal consideration in the transaction is dependent on the generation of sufficient funds from the asset transferred;

d. Whether limitations or restrictions exist on the buyer's use of the financial interest transferred or on the profits arising from it;

e. Whether there is retention of effective control of the financial interest by the seller.

~~12.~~13. A transaction between related parties may meet the criteria for treatment as an economic transaction at one level of financial reporting, but may not meet such criteria at another level of financial reporting. An example of such a transaction is a reporting entity purchasing securities at fair value from an affiliated reporting entity that carried the securities at amortized cost. This transaction meets the criteria of an economic transaction at this level of financial reporting, and therefore, the selling reporting entity would record a gain and the acquiring reporting entity would record the securities at their cost (fair value on the transaction date). At the common parent level of reporting, this transaction has resulted in the mere inflation of surplus, and therefore, is a non-economic transaction. The parent reporting entity shall defer the net effects of any gain or increase in surplus resulting from such transactions by recording a deferred gain and an unrealized loss. The deferred gain shall not be recognized by the parent reporting entity unless and until arms-length transaction(s) with independent third parties give rise to appropriate recognition of the gain.

~~13.~~14. A non-economic transaction is defined as any transaction that does not meet the criteria of an economic transaction. Similar to the situation described in paragraph 12, transfers of assets from a parent reporting entity to a subsidiary, controlled or affiliated entity shall be treated as non-economic transactions at the parent reporting level because the parent has continuing indirect involvement in the assets.

~~14.~~15. When accounting for a specific transaction, reporting entities shall use the following valuation methods:

a. Economic transactions between related parties shall be recorded at fair value at the date of the transaction. To the extent that the related parties are affiliates under common control, the controlling reporting entity shall defer the effects of such transactions that result in gains or increases in surplus (see paragraph 12);

b. Non-economic transactions between reporting entities, which meet the definition of related parties above, shall be recorded at the lower of existing book values or fair values at the date of the transaction;

c. Non-economic transactions between a reporting entity and an entity that has no significant ongoing operations other than to hold assets that are primarily for the direct or indirect benefit or use of the reporting entity or it's affiliates, shall be recorded at the fair value at the date of the transaction; however, to the extent that the transaction results in a gain, that gain shall be deferred until such time as permanence can be verified;

d. Transactions which are designed to avoid statutory accounting practices shall be reported as if the reporting entity continued to own the assets or to be obligated for a liability directly instead of through a subsidiary.

Examples of transactions deemed to be non-economic include security swaps of similar issues between or among affiliated companies, and swaps of dissimilar issues accompanied by exchanges of liabilities between or among affiliates.

Transactions Involving Services

~~15.~~16. Transactions involving services between related parties can take a variety of different forms. One of the significant factors as to whether these transactions will be deemed to be arm's length is the amount charged for such services. In general, amounts charged for services are based either on current market rates or on allocations of costs. Determining market rates for services is difficult because the circumstances surrounding each transaction are unique. Unlike transactions involving the exchange of assets and liabilities between related parties, transactions for services create income on one party's books and expense on the second party's books, and therefore, do not lend themselves to the mere inflation of surplus. These arrangements are generally subject to regulatory approval.

~~16.~~17. Transactions involving services provided between related parties shall be recorded at the amount charged. Regulatory scrutiny of related party transactions where amounts charged for services do not meet the fair and reasonable standard established by Appendix A-440, may result in (a) amounts charged being recharacterized as dividends or capital contributions, (b) transactions being reversed, (c) receivable balances being nonadmitted, or (d) other regulatory action. Expenses that result from cost allocations shall be allocated subject to the same fair and reasonable standards, and the books and records of each party shall disclose clearly and accurately the precise nature and details of the transaction. See *SSAP No. 70—Allocation of Expenses* for additional discussion regarding the allocation of expenses.

Disclosures

~~17.~~18. The financial statements shall include disclosures of all material related party transactions. In some cases, aggregation of similar transactions may be appropriate. Sometimes, the effect of the relationship between the parties may be so pervasive that disclosure of the relationship alone will be sufficient. If necessary to the understanding of the relationship, the name of the related party should be disclosed. Transactions shall not be purported to be arm's-length transactions unless there is demonstrable evidence to support such statement. The disclosures shall include:

a. The nature of the relationships involved;

b. A description of the transactions for each of the periods for which financial statements are presented, and such other information considered necessary to obtain an understanding of the effects of the transactions on the financial statements. Exclude reinsurance transactions, any non-insurance transactions which involve less than 1/2 of 1% of the total admitted assets of the reporting entity, and cost allocation transactions. The following information shall be provided if applicable:

i. Date of transaction;

ii. Explanation of transaction;

iii. Name of reporting entity;

iv. Name of affiliate;

v. Description of assets received by reporting entity;

vi. Statement value of assets received by reporting entity;

vii. Description of assets transferred by reporting entity; and

viii. Statement value of assets transferred by reporting entity.

c. The dollar amounts of transactions for each of the periods for which financial statements are presented and the effects of any change in the method of establishing the terms from that used in the preceding period;

d. Amounts due from or to related parties as of the date of each balance sheet presented and, if not otherwise apparent, the terms and manner of settlement;

e. Any guarantees or undertakings, written or otherwise, for the benefit of an affiliate or related party which result in a material contingent exposure of the reporting entity's or any related party's assets or liabilities;

f. A description of material management or service contracts and cost-sharing arrangements involving the reporting entity and any related party. This shall include, but is not limited to, sale lease-back arrangements, computer or fixed asset leasing arrangements, and agency contracts, which remove assets otherwise recordable (and potentially nonadmitted) on the reporting entity's financial statements;

g. The nature of the control relationship whereby the reporting entity and one or more other enterprises are under common ownership or control and the existence of that control could result in operating results or financial position of the reporting entity significantly different from those that would have been obtained if the enterprises were autonomous. The relationship shall be disclosed even though there are no transactions between the enterprises; and

h. The amount deducted from the value of an upstream intermediate entity or ultimate parent owned, either directly or indirectly, via a downstream subsidiary, controlled, or affiliated entity, in accordance with the *Purposes and Procedures Manual of the NAIC Securities Valuation Office*, "Procedures for Valuing Common Stocks and Stock Warrants."

~~18.~~19. Refer to the preamble for further discussion regarding disclosure requirements.

Relevant Literature

~~19.~~20. This statement adopts *FASB Statement No. 57, Related Party Disclosures* with a modification to paragraph 2 to require disclosure of compensation arrangements, expense allowances, and other similar items in the ordinary course of business.

~~20.~~21. This statement rejects *AICPA Accounting Interpretations, Business Combinations: Accounting Interpretations of APB Opinion No. 16, #39, "Transfers and Exchanges Between Companies Under Common Control".*

Effective Date and Transition

~~21.~~22. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*.

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Statutory Issue Paper No. 129

Share-Based Payment, A Replacement of SSAP No. 13—Stock Options and Stock Purchase Plans

STATUS:
Adopted March 3, 2012

Current Authoritative Guidance for Stock Options and Stock Purchase Plans: SSAP No. 104R
This issue paper may not be directly related to the current authoritative statement.

Original SSAP: SSAP No. 104

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. The Financial Accounting Standards Board (FASB) issued FAS 123(R): *Share-Based Payments* (FAS 123(R)) in December of 2004. FAS 123(R) is a revision of *FASB Statement No. 123: Accounting for Stock-Based Compensation* (FAS 123) and supersedes *APB Opinion No. 25, Accounting for Stock Issued to Employees* (APB Opinion No. 25), and its related implementation guidance. The scope of FAS 123(R) establishes standards for the accounting of transactions in which an entity exchanges its equity instruments for goods or services. It also addresses transactions in which an entity incurs liabilities in exchange for goods or services that are based on the fair value of the entity's equity instruments or that may be settled by the issuance of those equity instruments. FAS 123(R) focuses primarily on accounting for transactions in which an entity obtains employee services in share-based payment transactions. FAS 123(R) does not change the accounting guidance for share-based payment transactions with parties other than employees provided in Statement 123 as originally issued and *EITF Issue No. 96-18, Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services*. FAS 123(R) does not address the accounting for employee share ownership plans, which are subject to *AICPA Statement of Position 93-6, Employers' Accounting for Employee Stock Ownership Plans*. (SOP 93-6 is adopted with modification in *SSAP No. 12—Employee Stock Ownership Plans* and EITF 96-18, and other guidance regarding share-based payment transaction with non-employees has been rejected as not applicable to statutory accounting.)

2. FAS 123(R) requires a public entity to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award (with limited exceptions). That cost will be recognized over the period during which an employee is required to provide service in exchange for the award—the requisite service period (usually the vesting period). No compensation cost is recognized for equity instruments for which employees do not render the requisite service. Employee share purchase plans will not result in recognition of compensation cost if certain conditions are met; those conditions are much the same as the related conditions in FAS 123.

3. Under FAS 123(R), a nonpublic entity, likewise, measures the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of those instruments, except in certain circumstances. Specifically, if it is not possible to reasonably estimate the fair value of equity share options and similar instruments because it is not practicable to estimate the expected volatility of the entity's share price, a nonpublic entity is required to measure its awards of equity share options and similar instruments based on a value calculated using the historical volatility of an appropriate industry sector index instead of the expected volatility of its share price.

4. Under FAS 123(R), a public entity initially measures the cost of employee services received in exchange for an award of liability instruments based on its current fair value; the fair value of that award are remeasured subsequently at each reporting date through the settlement date. Changes in fair value during the requisite service period will be recognized as compensation cost over that period. A nonpublic entity may elect to measure its liability awards at their intrinsic value through the date of settlement.

5. Under FAS 123(R), the grant-date fair value of employee share options and similar instruments are estimated using option-pricing models adjusted for the unique characteristics of those instruments (unless observable market prices for the same or similar instruments are available). If an equity award is modified after the grant date, incremental compensation cost is recognized in an amount equal to the excess of the fair value of the modified award over the fair value of the original award immediately before the modification.

6. Under FAS 123(R), excess tax benefits are recognized as an addition to paid-in capital. In addition, cash retained as a result of those excess tax benefits are presented in the statement of cash flows as financing cash inflows. The write-off of deferred tax assets relating to unrealized tax benefits associated with recognized compensation cost are recognized as income tax expense unless there are excess tax benefits from previous awards remaining in paid-in capital to which it can be offset.

7. Under FAS 123(R), the notes to financial statements of both public and nonpublic entities disclose information to assist users of financial information to understand the nature of share-based payment transactions and the effects of those transactions on the financial statements.

8. The purpose of this issue paper is to update statutory accounting principles for the accounting of transactions in which an entity exchanges its equity instruments to employees in share-based payment transactions and proposes the issuance of a new *SSAP No. 104—Stock Options and Stock Purchase Plans* (SSAP No. 104) that adopts, with modification, the guidance from FAS 123(R) and related accounting guidance and interpretations as noted within this issue paper. This issue paper proposes application of the substantively revised SSAP No. 104 for new awards and awards modified, repurchased, or cancelled after the required effective date. This issue paper also addresses transactions in which an entity incurs liabilities in exchange for goods or services that are based on the fair value of the entity's equity instruments or that may be settled by the issuance of those equity instruments.

9. As noted in footnote 1 (paragraph 11), the fair value measurement objective in this issue paper is generally consistent with the fair value measurement objective in *SSAP No. 100—Fair Value Measurements* (SSAP No. 100). However, for certain share-based payment transactions with employees, the measurements at the grant date are fair-value-based measurements, not fair value measurements. Although some measurements in this issue paper are fair value measurements, for practical reasons this issue paper is proposed to be excluded in its entirety from SSAP No. 100. To be consistent with GAAP guidance on share-based payment transactions, the definition of fair value for use in this issue paper is: "The amount at which the asset (or liability) could be bought (or incurred) or sold (settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale." Observable market prices of identical or similar equity or liability instruments in active markets are the best estimate of fair value and, if available, should be used as the basis for the measurement of equity and liability instruments awarded in a share-based payment transaction with employees. To clarify the exclusion, the following revision is also proposed to SSAP No. 100:

> 3. This standard applies under other statutory accounting pronouncements that require or permit fair value measurements, except as follows
>
> a. This standard does not eliminate the practicality exceptions to fair value measurements in accounting pronouncements within the scope of this standard.
>
> b. This standard does not apply under *SSAP No. 22—Leases* (SSAP No. 22) and other accounting pronouncements that address fair value measurements for

purposes of lease classification to measurement under SSAP No. 22. This scope exception does not apply to assets acquired or liabilities assumed in a business combination that are required to be measured at fair value under *SSAP No. 68—Business Combinations and Goodwill* (SSAP No. 68), regardless of whether those assets and liabilities are related to leases. This standard does not apply to share-based payment transactions captured within *SSAP No. 104—Stock Options and Stock Purchase Plans* (SSAP No. 104).

SUMMARY CONCLUSION

Objectives

10. The objective of accounting for transactions under share-based payment arrangements with employees is to recognize in the financial statements the employee services received in exchange for equity instruments issued or liabilities incurred and the related cost to the entity as those services are consumed. This issue paper uses the terms compensation and payment in their broadest senses to refer to the consideration paid for employee services.

11. This issue paper requires that the cost resulting from all share-based payment transactions be recognized in the financial statements. This issue paper establishes fair value as the measurement objective in accounting for share-based payment arrangements and requires all entities to apply a fair-value-based measurement method[1] in accounting for share-based payment transactions with employees except for equity instruments held by employee stock ownership plans.

Scope and Scope Exceptions

12. This issue paper applies to all share-based payment transactions in which an entity acquires employee services by issuing (or offering to issue) its shares, share options, or other equity instruments or by incurring liabilities to an employee that meet either of the following conditions:

a. The amounts are based, at least in part, on the price of the entity's shares or other equity instruments. (The phrase "*at least in part*" is used because an award of share-based compensation may be indexed to both the price of an entity's shares and something else that is neither the price of the entity's shares nor a market, performance, or service condition.)

b. The awards require or may require settlement by issuing the entity's equity shares or other equity instruments.

13. Share-based payments awarded to an employee of the reporting entity by a related party or other holder of an economic interest in the entity as compensation for services provided to the entity are share-based payment transactions to be accounted for under this issue paper unless the transfer is clearly for a purpose other than compensation for services to the reporting entity. The substance of such a transaction is that the economic interest holder makes a capital contribution to the reporting entity, and that entity makes a share-based payment to its employee in exchange for services rendered. An example of a

[1] Accounting pronouncements that require fair value measurements but that are excluded from *SSAP No. 100—Fair Value Measurements* is limited to this issue paper addressing share-based payment transactions. The fair value measurement objective in this issue paper is generally consistent with the fair value measurement objective in SSAP No. 100. However, for certain share-based payment transactions with employees, the measurements at the grant date are fair-value-based measurements, not fair value measurements. Although some measurements in this issue paper are fair value measurements, for practical reasons this issue paper is excluded in its entirety from SSAP No. 100. To be consistent with GAAP guidance on share-based payment transactions, the definition of fair value for use in this issue paper is: "The amount at which the asset (or liability) could be bought (or incurred) or sold (settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale." Observable market prices of identical or similar equity or liability instruments in active markets are the best estimate of fair value and, if available, should be used as the basis for the measurement of equity and liability instruments awarded in a share-based payment transaction with employees.

situation in which such a transfer is not compensation is a transfer to settle an obligation of the economic interest holder to the employee that is unrelated to employment by the entity.

14. The guidance in this issue paper does not apply to share-based transactions for other than employee services.

15. The guidance in this issue paper does not apply to equity instruments held by an employee stock ownership plan. Such equity instruments shall follow the guidance in *SSAP No. 12—Employee Stock Ownership Plans* (SSAP No. 12).

16. The guidance in this statement is divided as follows:

a. Compensatory Share-Based Payment Plans: Paragraphs 17-112.

b. Noncompensatory Share-Based Payment Plans: Paragraphs 113-119.

c. Consolidated / Holding Company Share-Based Payment Plans: Paragraphs: 120-121.

Compensatory Share-Based Payment Plans

Recognition

Recognition Principle for Share-Based Payment Transactions

17. Stock purchase and stock option plans that do not meet the criteria of a non-compensatory plan (paragraphs 113-119) and are not otherwise excluded from the scope of this issue paper shall be classified as compensatory and follow the recognition, measurement and disclosure guidance in paragraphs 18-112.

18. An entity shall recognize the services received in a share-based payment transaction with an employee as services are received. Employee services themselves are not recognized before they are received. The entity shall recognize either a corresponding increase in equity or a liability, depending on whether the instruments granted satisfy the equity or liability classification criteria (see paragraphs 22-35.) As the services are consumed, the entity shall recognize the related cost.

19. The accounting for all share-based payment transactions shall reflect the rights conveyed to the holder of the instruments and the obligations imposed on the issuer of the instruments, regardless of how those transactions are structured. For example, the rights and obligations embodied in a transfer of equity shares to an employee for a note that provides no recourse to other assets of the employee (that is, other than the shares) are substantially the same as those embodied in a grant of equity share options. Thus, that transaction shall be accounted for as a substantive grant of equity share options.

20. Assessment of both the rights and obligations in a share-based payment award and any related arrangement and how those rights and obligations affect the fair value of an award requires the exercise of judgment in considering the relevant facts and circumstances.

Determining the Grant Date

21. As a practical accommodation, in determining the grant date of an award subject to this issue paper, assuming all other criteria in the grant date definition have been met, a mutual understanding of the key terms and conditions of an award to an individual employee shall be presumed to exist at the date the award is approved in accordance with the relevant corporate governance requirements (that is, by the Board or management with the relevant authority) if both of the following conditions are met:

a. The award is a unilateral grant and, therefore, the recipient does not have the ability to negotiate the key terms and conditions of the award with the employer.

b. The key terms and conditions of the award are expected to be communicated to an individual recipient within a relatively short time period from the date of approval. A relatively short time period is that period in which an entity could reasonably complete all actions necessary to communicate the awards to the recipients in accordance with the entity's customary human resource practices.

Determining Whether to Classify a Financial Instrument as a Liability or As Equity

22. This paragraph, through paragraph 35, provides guidance for determining whether certain financial instruments awarded in share-based payment transactions are liabilities. In determining whether an instrument not specifically discussed in those paragraphs shall be classified as a liability or as equity, an entity shall apply statutory accounting principles applicable to financial instruments issued in transactions not involving share-based payment.

23. Unless paragraphs 24-35 require otherwise, an entity shall apply the classification criteria in Appendix A, as they are effective at the reporting date, in determining whether to classify as a liability a freestanding financial instrument given to an employee in a share-based payment transaction. Paragraphs 73-77 provide criteria for determining when instruments subject to this issue paper subsequently become subject to other applicable statutory accounting principles.

24. In determining the classification of an instrument, an entity shall take into account the classification requirements that are effective for that specific entity at the reporting date as established by Appendix A. In addition, a call option written on an instrument that is not classified as a liability under those classification requirements also shall be classified as equity so long as those equity classification requirements for the entity continue to be met, unless liability classification is required under the provisions of paragraphs 27 and 28.

25. Appendix A does not apply to outstanding shares embodying a conditional obligation to transfer assets, for example, shares that give the employee the right to require the employer to repurchase them for cash equal to their fair value (puttable shares). A put right may be granted to the employee in a transaction that is related to a share-based compensation arrangement. If exercise of such a put right would require the entity to repurchase shares issued under the share-based compensation arrangement, the shares shall be accounted for as puttable shares. A puttable (or callable) share awarded to an employee as compensation shall be classified as a liability if either of the following conditions is met:

a. The repurchase feature permits the employee to avoid bearing the risks and rewards normally associated with equity share ownership for a reasonable period of time from the date the requisite service is rendered and the share is issued. An employee begins to bear the risks and rewards normally associated with equity share ownership when all the requisite service has been rendered. A repurchase feature that can be exercised only upon the occurrence of a contingent event that is outside the employee's control (such as an initial public offering) would not meet this condition until it becomes probable that the event will occur within the reasonable period of time.

b. It is probable that the employer would prevent the employee from bearing those risks and rewards for a reasonable period of time from the date the share is issued.

For this purpose, a period of six months or more is a reasonable period of time.

26. A puttable (or callable) share that does not meet either of those conditions shall be classified as equity.

27. Options or similar instruments on shares shall be classified as liabilities if either of the following conditions is met:

a. The underlying shares are classified as liabilities.

b. The entity can be required under any circumstances to settle the option or similar instrument by transferring cash or other assets. A cash settlement feature that can be exercised only upon the occurrence of a contingent event that is outside the employee's control (such as an initial public offering) would not meet this condition until it becomes probable that event will occur.

28. For example, a reporting entity that is a Securities and Exchange Commission (SEC) registrant may grant an option to an employee that, upon exercise, would be settled by issuing a mandatorily redeemable share. Because the mandatorily redeemable share would be classified as a liability under Appendix A (as well as under *SSAP No. 72—Surplus and Reorganizations*), the option also would be classified as a liability.

29. An award may be indexed to a factor in addition to the entity's share price. If that additional factor is not a market, performance, or service condition, the award shall be classified as a liability for purposes of this issue paper, and the additional factor shall be reflected in estimating the fair value of the award.

30. For this purpose, an award of equity share options granted to an employee of an entity's foreign operation that provides for a fixed exercise price denominated either in the foreign operation's functional currency or in the currency in which the employee's pay is denominated shall not be considered to contain a condition that is not a market, performance, or service condition. Therefore, such an award is not required to be classified as a liability if it otherwise qualifies as equity. For example, equity share options with an exercise price denominated in euros granted to employees of a U.S. entity's foreign operation whose functional currency is the euro are not required to be classified as liabilities if those options otherwise qualify as equity. In addition, such options are not required to be classified as liabilities even if the functional currency of the foreign operation is the U.S. dollar, provided that the employees to whom the options are granted are paid in euros.

31. The accounting for an award of share-based payment shall reflect the substantive terms of the award and any related arrangement. Generally, the written terms provide the best evidence of the substantive terms of an award. However, an entity's past practice may indicate that the substantive terms of an award differ from its written terms. For example, an entity that grants a tandem award under which an employee receives either a stock option or a cash-settled stock appreciation right is obligated to pay cash on demand if the choice is the employee's, and the entity thus incurs a liability to the employee. In contrast, if the choice is the entity's, it can avoid transferring its assets by choosing to settle in stock, and the award qualifies as an equity instrument. However, if an entity that nominally has the choice of settling awards by issuing stock predominately settles in cash or if the entity usually settles in cash whenever an employee asks for cash settlement, the entity is settling a substantive liability rather than repurchasing an equity instrument. In determining whether an entity that has the choice of settling an award by issuing equity shares has a substantive liability, the entity also shall consider whether:

a. It has the ability to deliver the shares. (Federal securities law generally requires that transactions involving offerings of shares under employee share option arrangements be registered, unless there is an available exemption. For purposes of this issue paper, such requirements do not, by themselves, imply that an entity does not have the ability to deliver shares and thus do not require an award that otherwise qualifies as equity to be classified as a liability.)

b. It is required to pay cash if a contingent event occurs (see paragraphs 27-28).

32. A provision that permits employees to effect a broker-assisted cashless exercise of part or all of an award of share options through a broker does not result in liability classification for instruments that otherwise would be classified as equity if both of the following criteria are satisfied:

a. The cashless exercise requires a valid exercise of the share options.

b. The employee is the legal owner of the shares subject to the option (even though the employee has not paid the exercise price before the sale of the shares subject to the option).

33. A broker that is a related party of the entity must sell the shares in the open market within a normal settlement period, which generally is three days, for the award to qualify as equity.

34. Similarly, a provision for either direct or indirect (through a net-settlement feature) repurchase of shares issued upon exercise of options (or the vesting of nonvested shares), with any payment due employees withheld to meet the employer's minimum statutory withholding requirements resulting from the exercise, does not, by itself, result in liability classification of instruments that otherwise would be classified as equity. However, if an amount in excess of the minimum statutory requirement is withheld, or may be withheld at the employee's discretion, the entire award shall be classified and accounted for as a liability.

35. Minimum statutory withholding requirements are to be based on the applicable minimum statutory withholding rates required by the relevant tax authority (or authorities, for example, federal, state, and local), including the employee's share of payroll taxes that are applicable to such supplemental taxable income.

Market, Performance, and Service Conditions

36. Accruals of compensation cost for an award with a performance condition shall be based on the probable outcome of that performance condition—compensation cost shall be accrued if it is probable that the performance condition will be achieved and shall not be accrued if it is not probable that the performance condition will be achieved. If an award has multiple performance conditions (for example, if the number of options or shares an employee earns varies depending on which, if any, of two or more performance conditions is satisfied), compensation cost shall be accrued if it is probable that a performance condition will be satisfied. In making that assessment, it may be necessary to take into account the interrelationship of those performance conditions.

37. If an award requires satisfaction of one or more market, performance, or service conditions (or any combination thereof), compensation cost shall be recognized if the requisite service is rendered, and no compensation cost shall be recognized if the requisite service is not rendered.

Payroll Taxes

38. A liability for employee payroll taxes on employee stock compensation shall be recognized on the date of the event triggering the measurement and payment of the tax to the taxing authority (for a nonqualified option in the United States, generally the exercise date). Payroll taxes, even though directly related to the appreciation on stock options, are operating expenses and shall be reflected as such in the statement of operations.

Initial Measurement

39. While some of the material in paragraphs 39-42 was written in terms of awards classified as equity, it applies equally to awards classified as liabilities. The subparagraphs of paragraph 44 provide specific guidance for awards classified as liabilities.

40. A share-based payment transaction with employees shall be measured based on the fair value (or in certain situations specified in this issue paper, a calculated value or intrinsic value) of the equity instruments issued.

41. An entity shall account for the compensation cost from share-based payment transactions with employees in accordance with the fair-value-based method set forth in this issue paper. That is, the cost of services received from employees in exchange for awards of share-based compensation generally shall be measured based on the grant-date fair value of the equity instruments issued or on the fair value of the liabilities incurred. The cost of services received by an entity as consideration for equity instruments issued or liabilities incurred in share-based compensation transactions with employees shall be measured based on the fair value of the equity instruments issued or the liabilities settled. The portion of the fair value of an instrument attributed to employee service is net of any amount that an employee pays (or becomes obligated to pay) for that instrument when it is granted. For example, if an employee pays $5 at the grant date for an option with a grant-date fair value of $50, the amount attributed to employee service is $45.

42. However, this issue paper provides certain exceptions (see paragraph 58) to that measurement method if it is not possible to reasonably estimate the fair value of an award at the grant date. A reporting entity that is not able to reasonably estimate the fair value of its equity options and similar instruments may measure its liabilities under share-based payment arrangements at intrinsic value (see paragraphs 57 and 44.b.).

Terms of the Award Affect Fair Value

43. The terms of a share-based payment award and any related arrangement affect its value and, except for certain explicitly excluded features, such as a reload feature, shall be reflected in determining the fair value of the equity or liability instruments granted. For example, the fair value of a substantive option structured as the exchange of equity shares for a nonrecourse note will differ depending on whether the employee is required to pay nonrefundable interest on the note.

Measurement Objective – Fair Value at Grant Date

44. The measurement objective for equity instruments awarded to employees is to estimate the fair value at the grant date of the equity instruments that the entity is obligated to issue when employees have rendered the requisite service and satisfied any other conditions necessary to earn the right to benefit from the instruments (for example, to exercise share options). That estimate is based on the share price and other pertinent factors, such as expected volatility, at the grant date. The following subparagraphs provide guidance regarding the measurement objective and measurement date for liability instruments:

a. Measurement Objective and Measurement Date for Liabilities (Public Entity): At the grant date, the measurement objective for liabilities incurred under share-based compensation arrangements is the same as the measurement objective for equity instruments awarded to employees as described in paragraph 44. However, the measurement date for liability instruments is the date of settlement.

b. Measurement Objective and Measurement Date for Liabilities (Non-Public Entity): An entity subject to paragraph 57 shall make a policy decision of whether to measure all of its liabilities incurred under share-based payment arrangements at fair value or to measure all such liabilities at intrinsic value. Consistent with the guidance in paragraph 57, an entity that is not able to reasonably estimate the fair value of its equity share options and similar instruments because it is not practicable for it to estimate the expected volatility of its share price shall make a policy choice of whether to measure its liabilities under share-based payment arrangements at calculated value or at intrinsic value.

45. The fair value of an equity share option or similar instrument shall be measured based on the observable market price of an option with the same or similar terms and conditions.

46. Such market prices for equity share options and similar instruments granted to employees are frequently not available; however, they may become so in the future.

47. As such, the fair value of an equity share option or similar instrument shall be estimated using a valuation technique such as an option-pricing model. For this purpose, a similar instrument is one whose fair value differs from its intrinsic value, that is, an instrument that has time value. For example, a share appreciation right that requires net settlement in equity shares has time value; an equity share does not.

Factors or Restrictions that Impact the Determination of Fair Value at Grant Date

Vesting Versus Nontransferability

48. To satisfy the measurement objective in paragraph 44, the restrictions and conditions inherent in equity instruments awarded to employees are treated differently depending on whether they continue in effect after the requisite service period. A restriction that continues in effect after an entity has issued instruments to employees, such as the inability to transfer vested equity share options to third parties or the inability to sell vested shares for a period of time, is considered in estimating the fair value of the instruments at the grant date. For equity share options and similar instruments, the effect of nontransferability (and nonhedgeability, which has a similar effect) is taken into account by reflecting the effects of employees' expected exercise and postvesting employment termination behavior in estimating fair value (referred to as an option's expected term).

Forfeitability

49. A restriction that stems from the forfeitability of instruments to which employees have not yet earned the right, such as the inability either to exercise a nonvested equity share option or to sell nonvested shares, is not reflected in estimating the fair value of the related instruments at the grant date. Instead, those restrictions are taken into account by recognizing compensation cost only for awards for which employees render the requisite service.

Performance of Service Conditions

50. Awards of share-based employee compensation ordinarily specify a performance condition or a service condition (or both) that must be satisfied for an employee to earn the right to benefit from the award. No compensation cost is recognized for instruments that employees forfeit because a service condition or a performance condition is not satisfied (that is, instruments for which the requisite service is not rendered).

51. The fair-value-based method described in paragraphs 44 and 48-52 uses fair value measurement techniques, and the grant-date share price and other pertinent factors are used in applying those techniques. However, the effects on the grant-date fair value of service and performance conditions that apply only during the requisite service period are reflected based on the outcomes of those conditions. This issue paper refers to the required measure as fair value.*)*

Market Conditions

52. Some awards contain a market condition. The effect of a market condition is reflected in the grant-date fair value of an award. (Valuation techniques have been developed to value path-dependent options as well as other options with complex terms. Awards with market conditions, as defined in this issue paper, are path-dependent options.) Compensation cost thus is recognized for an award with a market condition provided that the requisite service is rendered, regardless of when, if ever, the market condition is satisfied.

Market, Performance, and Service Conditions That Affect Conditions Other than Vesting or Exercisability

53. Market, performance, and service conditions (or any combination thereof) may affect an award's exercise price, contractual term, quantity, conversion ratio, or other factors that are considered in measuring an award's grant-date fair value. A grant-date fair value shall be estimated for each possible outcome of such a performance or service condition, and the final measure of compensation cost shall be based on the amount estimated at the grant date for the condition or outcome that is actually satisfied.

Nonvested or Restricted Shares

54. A nonvested equity share or nonvested equity share unit awarded to an employee shall be measured at its fair value as if it were vested and issued on the grant date.*)*

55. Nonvested shares granted to employees usually are referred to as restricted shares, but this issue paper reserves that term for fully vested and outstanding shares whose sale is contractually or governmentally prohibited for a specified period of time.*)*

56. A restricted share awarded to an employee, that is, a share that will be restricted after the employee has a vested right to it, shall be measured at its fair value, which is the same amount for which a similarly restricted share would be issued to third parties.

Calculated Value for Entities Not Reasonably Able to Estimate Fair Value

57. An entity may not be able to reasonably estimate the fair value of its equity share options and similar instruments because it is not practicable for it to estimate the expected volatility of its share price. In that situation, the entity shall account for its equity share options and similar instruments based on a value calculated using the historical volatility of an appropriate industry sector index instead of the expected volatility of the entity's share price (the calculated value). Throughout the remainder of this issue paper, provisions that apply to accounting for share options and similar instruments at fair value also apply to calculated value.

Difficulty of Estimation

58. It should be possible to reasonably estimate the fair value of most equity share options and other equity instruments at the date they are granted. However, in rare circumstances, it may not be possible to reasonably estimate the fair value of an equity share option or other equity instrument at the grant date because of the complexity of its terms.

59. An equity instrument for which it is not possible to reasonably estimate fair value at the grant date shall be accounted for based on its intrinsic value (see paragraph 79 for measurement after issue date).

Reload and Contingent Features

60. The fair value of each award of equity instruments, including an award of options with a reload feature (reload options), shall be measured separately based on its terms and the share price and other pertinent factors at the grant date. The effect of a reload feature in the terms of an award shall not be included in estimating the grant-date fair value of the award. Rather, a subsequent grant of reload options pursuant to that provision shall be accounted for as a separate award when the reload options are granted.

61. A contingent feature of an award that might cause an employee to return to the entity either equity instruments earned or realized gains from the sale of equity instruments earned for consideration that is less than fair value on the date of transfer (including no consideration), such as a clawback feature shall not be reflected in estimating the grant-date fair value of an equity instrument.

Requisite Service Period

62. An entity shall make its initial best estimate of the requisite service period at the grant date (or at the service inception date, if that date precedes the grant date) and shall base accruals of compensation cost on that period.

63. The initial best estimate and any subsequent adjustment to that estimate of the requisite service period for an award with a combination of market, performance, or service conditions shall be based on an analysis of all of the following:

a. All vesting and exercisability conditions

b. All explicit, implicit, and derived service periods

c. The probability that performance or service conditions will be satisfied.

Market, Performance, and Service Conditions

64. Performance or service conditions that affect vesting are not reflected in estimating the fair value of an award at the grant date because those conditions are restrictions that stem from the forfeitability of instruments to which employees have not yet earned the right. However, the effect of a market condition is reflected in estimating the fair value of an award at the grant date (see paragraph 52). For purposes of this issue paper, a market condition is not considered to be a vesting condition, and an award is not deemed to be forfeited solely because a market condition is not satisfied.

Subsequent Measurement

65. Guidance that equally applies to both liabilities and equity is generally found in paragraphs 66-78. Paragraphs 79-87 provide additional subsequent measurement guidance for awards classified as equity and paragraphs 88-91 provide additional subsequent measurement guidance for awards classified as liabilities**.**

Recognition of Compensation Costs Over the Requisite Service

66. The compensation cost for an award of share-based employee compensation classified as equity shall be recognized over the requisite service period, with a corresponding credit to equity (generally, paid-in capital). The requisite service period is the period during which an employee is required to provide service in exchange for an award, which often is the vesting period. The requisite service period is estimated based on an analysis of the terms of the share-based payment award.

67. The total amount of compensation cost recognized at the end of the requisite service period for an award of share-based compensation shall be based on the number of instruments for which the requisite service has been rendered (that is, for which the requisite service period has been completed). An entity shall base initial accruals of compensation cost on the estimated number of instruments for which the requisite service is expected to be rendered. That estimate shall be revised if subsequent information indicates that the actual number of instruments is likely to differ from previous estimates. The cumulative effect on current and prior periods of a change in the estimated number of instruments for which the requisite service is expected to be or has been rendered shall be recognized in compensation cost in the period of the change. Previously recognized compensation cost shall not be reversed if an employee share option (or share unit) for which the requisite service has been rendered expires unexercised (or unconverted).

68. An entity shall reverse previously recognized compensation cost for an award with a market condition only if the requisite service is not rendered.

Estimating the Requisite Service Period

69. The requisite service period may be explicit or it may be implicit, being inferred from an analysis of other terms in the award, including other explicit service or performance conditions. The requisite service period for an award that contains a market condition can be derived from certain valuation techniques that may be used to estimate grant-date fair value. An award may have one or more explicit, implicit, or derived service periods; however, an award may have only one requisite service period for accounting purposes unless it is accounted for as in-substance multiple awards. An award with a graded vesting schedule that is accounted for as in-substance multiple awards is an example of an award that has more than one requisite service period (see paragraph 72).

70. The service inception date is the beginning of the requisite service period. If the service inception date precedes the grant date, accrual of compensation cost for periods before the grant date shall be based on the fair value of the award at the reporting date. In the period in which the grant date occurs, cumulative compensation cost shall be adjusted to reflect the cumulative effect of measuring compensation cost based on fair value at the grant date rather than the fair value previously used at the service inception date (or any subsequent reporting date).

71. An entity shall adjust that initial best estimate in light of changes in facts and circumstances. Whether and how the initial best estimate of the requisite service period is adjusted depends on both the nature of the conditions identified in paragraph 63 and the manner in which they are combined, for example, whether an award vests or becomes exercisable when either a market or a performance condition is satisfied or whether both conditions must be satisfied.

Graded Vesting Awards

72. An entity shall make a policy decision about whether to recognize compensation cost for an award with only service conditions that has a graded vesting schedule in either of the following ways:

a. On a straight-line basis over the requisite service period for each separately vesting portion of the award as if the award was, in-substance, multiple awards

b. On a straight-line basis over the requisite service period for the entire award (that is, over the requisite service period of the last separately vesting portion of the award).

However, the amount of compensation cost recognized at any date must at least equal the portion of the grant-date value of the award that is vested at that date.

Awards May Become Subject to Other Guidance

73. Paragraphs 74-77 are intended to apply to those instruments issued in share-based payment transactions with employees accounted for under this issue paper, and to instruments exchanged in a business combination for share-based payment awards of the acquired business that were originally granted to employees of the acquired business and are outstanding as of the date of the business combination. Instruments issued, in whole or in part, as consideration for goods or services other than employee service shall not be considered to have been issued in exchange for employee service when applying the guidance in those paragraphs, irrespective of the employment status of the recipient of the award on the grant date.

74. A freestanding financial instrument issued to an employee in exchange for past or future employee services that is subject to initial recognition and measurement guidance within this issue paper shall continue to be subject to the recognition and measurement provisions of this issue paper throughout the life of the instrument, unless its terms are modified when the holder is no longer an employee. Only for purposes of this paragraph, a modification does not include a change to the terms of an award if that

change is made solely to reflect an equity restructuring provided that both of the following conditions are met:

a. There is no increase in fair value of the award (or the ratio of intrinsic value to the exercise price of the award is preserved, that is, the holder is made whole) or the antidilution provision is not added to the terms of the award in contemplation of an equity restructuring.

b. All holders of the same class of equity instruments (for example, stock options) are treated in the same manner.

75. Other modifications of that instrument that take place when the holder is no longer an employee shall be subject to the modification guidance in paragraph 77. Following modification, recognition and measurement of the instrument should be determined through reference to other applicable statutory accounting principles

76. Once the classification of an instrument is determined, the recognition and measurement provisions of this issue paper shall be applied until the instrument ceases to be subject to the requirements discussed in paragraph 74. Other applicable statutory accounting principles apply to a freestanding financial instrument that was issued under a share-based payment arrangement but that is no longer subject to this issue paper.

77. An entity may modify (including cancel and replace) or settle a fully vested, freestanding financial instrument after it becomes subject to other applicable statutory accounting principles. Such a modification or settlement shall be accounted for under the provisions of this issue paper unless it applies equally to all financial instruments of the same class regardless of whether the holder is (or was) an employee (or an employee's beneficiary). Following the modification, the instrument continues to be accounted for under other applicable statutory accounting principles. A modification or settlement of a class of financial instrument that is designed exclusively for and held only by current or former employees (or their beneficiaries) may stem from the employment relationship depending on the terms of the modification or settlement. Thus, such a modification or settlement may be subject to the requirements of this issue paper. See paragraph 74 for a discussion of changes to awards made solely to reflect an equity restructuring.

Change in Classification Due to Change in Probable Settlement Outcome

78. An option or similar instrument that is classified as equity, but subsequently becomes a liability because the contingent cash settlement event is probable of occurring, shall be accounted for similar to a modification from an equity to liability award. That is, on the date the contingent event becomes probable of occurring (and therefore the award must be recognized as a liability), the entity recognizes a share-based liability equal to the portion of the award attributed to past service (which reflects any provision for acceleration of vesting) multiplied by the award's fair value on that date. To the extent the liability equals or is less than the amount previously recognized in equity, the offsetting debit is a charge to equity. To the extent that the liability exceeds the amount previously recognized in equity, the excess is recognized as compensation cost. The total recognized compensation cost for an award with a contingent cash settlement feature shall at least equal the fair value of the award at the grant date. The guidance in this paragraph is applicable only for options or similar instruments issued as part of employee compensation arrangements. That is, the guidance included in this paragraph is not applicable, by analogy or otherwise, to instruments outside employee share-based payment arrangements.

Subsequent Measurement For Awards Classified as Equity

Fair Value Not Reasonably Estimable

79. An equity instrument for which it is not possible to reasonably estimate fair value at the grant date shall be remeasured at each reporting date through the date of exercise or other settlement. The final measure of compensation cost shall be the intrinsic value of the instrument at the date it is settled. Compensation cost for each period until settlement shall be based on the change (or a portion of the change, depending on the percentage of the requisite service that has been rendered at the reporting date) in the intrinsic value of the instrument in each reporting period. The entity shall continue to use the intrinsic value method for those instruments even if it subsequently concludes that it is possible to reasonably estimate their fair value.

Contingent Features

80. A contingent feature of an award that might cause an employee to return to the entity either equity instruments earned or realized gains from the sale of equity instruments earned for consideration that is less than fair value on the date of transfer (including no consideration), such as a clawback feature, shall be accounted for if and when the contingent event occurs.

Modification of An Award

81. A modification of the terms or conditions of an equity award shall be treated as an exchange of the original award for a new award. In substance, the entity repurchases the original instrument by issuing a new instrument of equal or greater value, incurring additional compensation cost for any incremental value. The effects of a modification shall be measured as follows:

a. Incremental compensation cost shall be measured as the excess, if any, of the fair value of the modified award determined in accordance with the provisions of this issue paper over the fair value of the original award immediately before its terms are modified, measured based on the share price and other pertinent factors at that date. As indicated in paragraph 57, references to fair value throughout this issue paper shall be read also to encompass calculated value. The effect of the modification on the number of instruments expected to vest also shall be reflected in determining incremental compensation cost. The estimate at the modification date of the portion of the award expected to vest shall be subsequently adjusted, if necessary, in accordance with paragraph 67.

b. Total recognized compensation cost for an equity award shall at least equal the fair value of the award at the grant date unless at the date of the modification the performance or service conditions of the original award are not expected to be satisfied. Thus, the total compensation cost measured at the date of a modification shall be the sum of the following:

   i. The portion of the grant-date fair value of the original award for which the requisite service is expected to be rendered (or has already been rendered) at that date

   ii. The incremental cost resulting from the modification.

   Compensation cost shall be subsequently adjusted, if necessary, in accordance with paragraph 67.

c. A change in compensation cost for an equity award measured at intrinsic value in accordance with paragraph 79 shall be measured by comparing the intrinsic value of the modified award, if any, with the intrinsic value of the original award, if any, immediately before the modification.

82. Paragraphs 73-77 provide additional guidance on accounting for modifications of certain freestanding financial instruments that initially were subject to this issue paper but subsequently became subject to other applicable statutory accounting principles.

Short-Term Inducements

83. A short-term inducement shall be accounted for as a modification of the terms of only the awards of employees who accept the inducement. Other inducements are modifications of the terms of all awards subject to them and shall be accounted for as such.

Equity Restructuring or Business Combination

84. Exchanges of share options or other equity instruments or changes to their terms in conjunction with an equity restructuring or a business combination are modifications for purposes of this issue paper. Except for a modification to add an antidilution provision that is not made in contemplation of an equity restructuring, accounting for a modification in conjunction with an equity restructuring requires a comparison of the fair value of the modified award with the fair value of the original award immediately before the modification in accordance with paragraph 81. If those amounts are the same, for instance, because the modification is designed to equalize the fair value of an award before and after an equity restructuring, no incremental compensation cost is recognized. See paragraph 74 for an additional exception.

Repurchase or Cancellation

85. The amount of cash or other assets transferred (or liabilities incurred) to repurchase an equity award shall be charged to equity, to the extent that the amount paid does not exceed the fair value of the equity instruments repurchased at the repurchase date. Any excess of the repurchase price over the fair value of the instruments repurchased shall be recognized as additional compensation cost. An entity that repurchases an award for which the requisite service has not been rendered has, in effect, modified the requisite service period to the period for which service already has been rendered, and thus the amount of compensation cost measured at the grant date but not yet recognized shall be recognized at the repurchase date.

Cancellation and Replacement

86. Cancellation of an award accompanied by the concurrent grant of (or offer to grant) a replacement award or other valuable consideration shall be accounted for as a modification of the terms of the cancelled award. (The phrase *offer to grant* is intended to cover situations in which the service inception date precedes the grant date.) Therefore, incremental compensation cost shall be measured as the excess of the fair value of the replacement award or other valuable consideration over the fair value of the cancelled award at the cancellation date in accordance with paragraph 81. Thus, the total compensation cost measured at the date of a cancellation and replacement shall be the portion of the grant-date fair value of the original award for which the requisite service is expected to be rendered (or has already been rendered) at that date plus the incremental cost resulting from the cancellation and replacement.

87. A cancellation of an award that is not accompanied by the concurrent grant of (or offer to grant) a replacement award or other valuable consideration shall be accounted for as a repurchase for no consideration. Accordingly, any previously unrecognized compensation cost shall be recognized at the cancellation date.

Subsequent Measurement For Awards Classified as Liabilities

Measurement

88. The fair value of liabilities incurred in share-based payment transactions with employees shall be remeasured at the end of each reporting period through settlement.

89. Changes in the fair value (or intrinsic value for an entity that elects that method) of a liability incurred under a share-based payment arrangement that occur during the requisite service period shall be recognized as compensation cost over that period. The percentage of the fair value (or intrinsic value) that is accrued as compensation cost at the end of each period shall equal the percentage of the requisite service that has been rendered at that date. Changes in the fair value (or intrinsic value) of a liability that occur after the end of the requisite service period are compensation costs of the period in which the changes occur. Any difference between the amount for which a liability award is settled and its fair value at the settlement date as estimated in accordance with the provisions of this issue paper is an adjustment of compensation cost in the period of settlement.

90. Reporting entities shall measure a liability award under a share-based payment arrangement based on the award's fair value (or calculated value in accordance with paragraph 57) remeasured at each reporting date until the date of settlement. Compensation cost for each period until settlement shall be based on the change (or a portion of the change, depending on the percentage of the requisite service that has been rendered at the reporting date) in the fair value of the instrument for each reporting period.

Modification of an Award

91. A modification of a liability award is accounted for as the exchange of the original award for a new award. However, because liability awards are remeasured at their fair value (or calculated value for an entity subject to paragraph 57) at each reporting date, no special guidance is necessary in accounting for a modification of a liability award that remains a liability after the modification.

Look-Back Plans

92. The accounting guidance in this section addresses the accounting for certain employee stock purchase plans with a look-back option. An example of a look-back option is a provision that establishes the purchase price as an amount based on the lessor of the stock's market price at the grant date or its market price at the exercise date (or purchase date).

93. As with all employee share purchase plans, the objective of the measurement process for employee share purchase plans with a look-back option is to reasonably measure fair value of the award at the grant date. Paragraph 79 provides guidance on the measurement requirements if it is not possible to reasonably estimate fair value at the grant date.

Accounting for Tax Effects of Share-Based Compensation Awards

94. Income tax regulations specify allowable tax deductions for instruments issued under share-based payment arrangements in determining an entity's income tax liability. For example, under tax law, allowable tax deductions may be measured as the intrinsic value of an instrument on a specified date. The time value component, if any, of the fair value of an instrument generally may not be tax deductible. Therefore, tax deductions may arise in different amounts and in different periods from compensation costs recognized in financial statements. Similarly, the amount of expense reported for an employee stock ownership plan during a period may differ from the amount of the related income tax deduction prescribed by income tax rules and regulations.

95. This guidance addresses how temporary differences are recognized for share-based payment arrangement awards that are classified either as equity or as liabilities under the requirements of

paragraphs 23-35. Incremental guidance is also provided for issues related to employee stock ownership plans.

Tax Effects for Instruments Classified as Equity

96. The cumulative amount of compensation cost recognized for instruments classified as equity that ordinarily would result in a future tax deduction under existing tax law shall be considered to be a deductible temporary difference in applying the requirements of *SSAP No. 101—Income Taxes* (SSAP No. 101). The deductible temporary difference shall be based on the compensation cost recognized for financial reporting purposes. Compensation costs that are capitalized as part of the cost of an asset, such as inventory, shall be considered to be part of the tax basis of that asset for financial reporting purposes.

97. Recognition of compensation cost for instruments that ordinarily do not result in tax deductions under existing tax law shall not be considered to result in a deductible temporary difference. A future event can give rise to a tax deduction for instruments that ordinarily do not result in a tax deduction. The tax effects of such an event shall be recognized only when it occurs. An example of a future event that would be recognized only when it occurs is an employee's sale of shares obtained from an award before meeting a tax law's holding period requirement, sometimes referred to as a disqualifying disposition, which results in a tax deduction not ordinarily available for such an award.

Tax Effects for Instruments Classified as Liability

98. The cumulative amount of compensation cost recognized for instruments classified as liabilities that ordinarily would result in a future tax deduction under existing tax law also shall be considered to be a deductible temporary difference. The deductible temporary difference shall be based on the compensation costs recognized for financial reporting purposes.

Accounting for Tax Effects – Initial Measurement

99. SSAP No. 101 requires a deferred tax asset to be evaluated for future realization and to be reduced by a statutory valuation allowance to the amount that is more likely than not to be realized. Differences between the deductible temporary difference computed pursuant to paragraphs 96 and 97 and the tax deduction that would result based on the current fair value of the entity’s shares shall not be considered in measuring the gross deferred tax asset or determining the need for a valuation allowance for a deferred tax asset recognized under these requirements.

Accounting for Tax Effects – Subsequent Measurement

100. If a deduction reported on a tax return for an award of equity instruments exceeds the cumulative compensation cost for those instruments recognized for financial reporting, any resulting realized tax benefit that exceeds the previously recognized deferred tax asset for those instruments is the excess tax benefit. If only a portion of an award is exercised, determination of the excess tax benefits shall be based on the portion of the award that is exercised.

101. The amount deductible for an award of equity instruments on the employer’s tax return may be less than the cumulative compensation cost recognized for financial reporting purposes. The write-off of a deferred tax asset related to that deficiency, net of the related statutory valuation allowance, if any, shall first be offset to the extent of any remaining gross paid-in and contributed surplus from excess tax benefits arising from previous awards granted, modified, or settled in cash and measured in accordance with a fair value based method of accounting. An entity shall exclude from that amount excess tax benefits from share-based payment arrangements that are outside the scope of this issue paper, excess tax benefits from employee stock ownership plans, and excess tax benefits that have not been realized pursuant to the requirements established in SSAP No. 101.

102. An excess tax benefit determined pursuant to paragraph 100 shall be recognized as gross paid-in and contributed surplus, except that an excess of a realized tax benefit for an award over the deferred tax asset for that award shall be recognized in the income statement to the extent that the excess stems from a reason other than changes in the fair value of an entity's shares between the measurement date for accounting purposes and a later measurement date for tax purposes.

103. Paragraph 101 contains measurement guidance on how much, if any, of the write-off of a deferred tax asset from a tax deficiency shall be offset against additional paid-in capital. The remaining balance, if any, of the write-off of a deferred tax asset related to a tax deficiency shall be recognized in the income statement.

Tax Benefits of Dividends on Share-Based Payment Awards to Employees

104. A realized income tax benefit from dividends or dividend equivalents that are charged to unassigned-funds (surplus) and are paid to employees for any of the following equity classified awards shall be recognized as an increase to gross paid-in and contributed surplus:

a. Nonvested equity shares

b. Nonvested equity share units

c. Outstanding equity share options.

105. The amount recognized in gross paid-in and contributed surplus for the realized income tax benefit from dividends on the awards identified in the preceding paragraph shall be included in the pool of excess tax benefits available to absorb tax deficiencies on share-based payment awards.

106. Dividends or dividend equivalents paid to employees for the awards identified in paragraph 104 may result in a tax deduction prior to the actual realization of the related tax benefit because the employer, for example, has a net operating loss carryforward. The income tax benefit of those dividends shall not be recognized until the deduction reduces income taxes payable. Unrealized income tax benefits from dividends on equity-classified employee share-based payment awards shall be excluded from the pool of excess tax benefits available to absorb potential future tax deficiencies on share-based payment awards.

107. Dividends or dividend equivalents paid to employees on the portion of an award of equity shares or other equity instruments that vests be charged to unassigned-funds (surplus). If the related award is not expected to vest, dividends or dividend equivalents shall be recognized as compensation costs. Dividends and dividend equivalents shall be reclassified between unassigned-funds (surplus) and compensation costs in a subsequent period if the entity changes its forfeiture estimates (or actual forfeitures differ from previous estimates).

108. Adjustments to gross paid-in and contributed surplus for reclassifications of the tax benefits from dividends on the awards discussed in the preceding paragraph in subsequent periods increase or decrease the entity's pool of excess tax benefits available to absorb tax deficiencies by a corresponding amount. Additionally, the tax benefits from dividends that are reclassified from gross paid-in and contributed surplus to the income statement (that is, as a reduction of income tax expense or an increase of income tax benefit) if an entity's estimate of forfeitures increases (or actual forfeitures exceed the entity's estimates) shall be limited to the entity's pool of excess tax benefits available to absorb tax deficiencies on the date of the reclassification.

Accounting for Rabbi Trusts

109. Rabbi trusts are grantor trusts generally set up to fund compensation for a select group of management or highly paid executives. To qualify as a rabbi trust for income tax purposes, the terms of

the trust agreement must explicitly state that the assets of the trust are available to satisfy the claims of general creditors in the event of bankruptcy of the employer.

110. There are four potential scenarios for deferred compensation arrangements where amounts earned by an employee are invested in the stock of the employer and placed in a "rabbi trust."

Plan A: The plan does not permit diversification and must be settled by the delivery of a fixed number of shares of employer stock.

Plan B: The plan does not permit diversification and may be settled by the delivery of cash or shares of employer stock.

Plan C: The plan permits diversification; however, the employee has not diversified (the plan may be settled in cash, shares of employer stock, or diversified assets).

Plan D: The plan permits diversification and the employee has diversified (the plan may be settled in cash, shares of employer stock, or diversified assets).

111. The accounts of the rabbi trust should be consolidated with the accounts of the employer in the financial statements of the employer.

a. For Plan A, employer stock held by the rabbi trust should be classified in equity in a manner similar to the manner in which treasury stock is accounted for. Subsequent changes in the fair value of the employer's stock should not be recognized. The deferred compensation obligation should be classified as an equity instrument and changes in the fair value of the amount owed to the employee should not be recognized.

b. For Plans B and C, employer stock held by the rabbi trust should be classified in equity in a manner similar to the manner in which treasury stock is accounted for. Subsequent changes in the fair value of the employer's stock should not be recognized. The deferred compensation obligation should be classified as a liability and adjusted with a corresponding charge (or credit) to compensation cost, to reflect the changes in the fair value of the amount owed to the employee.

c. For Plan D, assets held by the rabbi trust should be accounted for in accordance with statutory accounting principles for the particular asset (for example, if the diversified asset is a marketable equity security, that security would be accounted for in accordance with SSAP No. 30). The deferred compensation obligation should be classified as a liability and adjusted, with a corresponding charge (or credit) to compensation cost, to reflect changes in the fair value of the amount owed to the employee. Changes in the fair value of the deferred compensation obligation should not be recorded in unrealized gains or losses, even if changes in the fair value of the assets held by the rabbi trust are recorded, pursuant to SSAP No. 30, in surplus.

Disclosure

112. An entity with one or more share-based payment arrangements shall disclose information that enables users of the financial statements to understand all of the following:

a. The nature and terms of such arrangements that existed during the period and the potential effects of those arrangements on shareholders

b. The effect of compensation costs arising from share-based payment arrangements on the income statement

c. The method of estimating the fair value of the goods or services received, or the fair value of the equity instruments granted (or offered to grant), during the period

d. The cash flow effects resulting from share-based payment arrangements.

The disclosures in paragraph 112 are for annual audited statutory financial reports only. Appendix B provides the information needed to achieve the objectives in this paragraph.

Noncompensatory Employee Share Purchase Plans

Overview and Background

113. This section provides guidance to all entities that use employee share purchase plans. The entity must first determine whether the plan is compensatory or noncompensatory. This is determined by the terms of the plan (see paragraphs 114 and 115). A plan with an option feature, for example a look-back feature, is considered compensatory.

Recognition

114. An employee share purchase plan that satisfies all of the following criteria does not give rise to recognizable compensation costs (that is, the plan is noncompensatory):

a. The plan satisfies either of the following conditions:

i. The terms of the plan are no more favorable than those available to all holders of the same class of shares. Note that a transaction subject to an employee share purchase plan that involves a class of equity shares designed exclusively for and held only by current or former employees or their beneficiaries may be compensatory depending on the terms of the arrangement.

ii. Any purchase discount from the market price does not exceed the per-share amount of share issuance costs that would have been incurred to raise a significant amount of capital by a public offering. A purchase discount of five percent or less from the market price shall be considered to comply with this condition without further justification. A purchase discount greater than five percent that cannot be justified under this condition results in compensation cost for the entire amount of the discount. Note that an entity that justifies a purchase discount in excess of five percent shall reassess at least annually, and no later than the first share purchase offer during the fiscal year, whether it can continue to justify that discount pursuant to this paragraph.

b. Substantially all employees that meet limited employment qualifications may participate on an equitable basis.

c. The plan incorporates no option features, other than the following:

i. Employees are permitted a short period of time—not exceeding 31 days—after the purchase price has been fixed to enroll in the plan.

ii. The purchase price is based solely on the market price of the shares at the date of purchase, and employees are permitted to cancel participation before the purchase date and obtain a refund of amounts previously paid (such as those paid by payroll withholdings).

115. A plan provision that establishes the purchase price as an amount based on the lesser of the equity share's market price at date of grant or its market price at date of purchase, commonly called a look-back plan, is an example of an option feature that causes the plan to be compensatory. Similarly, a plan in which the purchase price is based on the share's market price at date of grant and that permits a participating employee to cancel participation before the purchase date and obtain a refund of amounts previously paid contains an option feature that causes the plan to be compensatory.

116. The requisite service period for any compensation cost resulting from an employee share purchase plan is the period over which the employee participates in the plan and pays for the shares.

Initial Measurement

117. The objective in paragraph 44 also applies to the fair value measurements associated with grants under a compensatory employee share purchase plan. The objective in this paragraph states that the fair value measurement method is to estimate the fair value of the equity instruments, based on the share price and other measurement assumptions at the grant date, that are issued in exchange for employee services.

Subsequent Measurement

118. Changes in total employee withholdings during a purchase period that occur solely as a result of salary increases, commissions, or bonus payments are not plan modifications if they do not represent changes to the terms of the award that was offered by the employer and initially agreed to by the employee at the grant (or measurement) date. Under those circumstances, the only incremental compensation cost is that which results from the additional shares that may be purchased with the additional amounts withheld (using the fair value calculated at the grant date). For example, an employee may elect to participate in the plan on the grant date by requesting that five percent of the employee's annual salary be withheld for future purchases of stock. If the employee receives an increase in salary during the term of the award, the base salary on which the five percent withholding amount is applied will increase, thus increasing the total amount withheld for future share purchases. That increase in withholdings as a result of the salary increase is not considered a plan modification and thus only increases the total compensation cost associated with the award by the grant date fair value associated with the incremental number of shares that may be purchased with the additional withholdings during the period. The incremental number of shares that may be purchased is calculated by dividing the incremental amount withheld by the exercise price as of the grant date (for example, 85 percent of the grant date stock price).

119. Any decreases in the withholding amounts (or percentages) shall be disregarded for purposes of recognizing compensation cost unless the employee services that were valued at the grant date will no longer be provided to the employer due to a termination. However, no compensation cost shall be recognized for awards that an employee forfeits because of failure to satisfy a service requirement for vesting. The accounting for decreases in withholdings is consistent with the requirement in paragraph 67 that the total amount of compensation cost that must be recognized for an award be based on the number of instruments for which the requisite service has been rendered (that is, for which the requisite service period has been completed).

Consolidated / Holding Company Plans

120. Except for the disclosure requirement in paragraph 121, the provisions of this issue paper do not apply to a reporting entity, as long as:

a. The reporting entity is not directly liable for obligations under the share-based payment plan.

b. Compensation costs associated with share-based payments provided by a related party or holder of an economic interest in the reporting entity, equal to the required contribution to the plan for the period, are included in allocated expenses to the reporting entity. A liability shall be established for any such contributions due and unpaid.

121. The reporting entity shall disclose in the financial statements that its employees participate in a plan sponsored by the holding company for which the reporting entity has no legal obligation. The amount of the expense incurred and the allocation methodology utilized by the provider of such benefits shall also be disclosed. If the reporting entity is directly liability for the share-based payment plan, then the other provisions of this issue paper apply.

Relevant Literature

122. This issue paper adopts, with modification, GAAP guidance regarding stock options and stock purchase plans reflected in *Topic 718: Compensation – Stock Compensation,* as amended by *ASU 2010-13, Compensation – Stock Compensation (Topic 18): Effect of Denominating the Exercise Price of a Share-Based Payment Award in the Current of the Market in Which the Underlying Equity Security Trades,* with the exception of *FASB Codification Subtopic 718-40: Employee Stock Ownership Plans*. Statutory guidance on employee stock ownership plans is provided in *SSAP No. 12—Employee Stock Ownership Plans*. This adoption with modification includes the related implementation guidance reflected within the FASB Codification Topic 718, not reflected within this issue paper.

123. The adoption, with modification, of FASB Codification Topic 718 identified in paragraph 122 also reflects adoption, with modification, of the following pre-codification GAAP standards:

a. *FAS 123R, Share-Based Payment* (FAS 123R), establishes accounting for transactions in which an entity exchanges its equity instruments for goods or services. It also addresses liabilities in exchange for goods or services that are based on the fair value if the entity's equity instruments or that may be settled by the issuance of those equity instruments. The guidance from FAS 123R has been incorporated within the FASB Codification in *Topic 718, Compensation – Stock Compensation* and is the underlying base of guidance included within this issue paper. (FASB Codification Topic *718-40, Employee Stock Ownership Plans* is excluded from this issue paper as it generally reflects guidance from *AICPA SOP 93-6; Employer's Accounting for Employee Stock Ownership Plans,* and is adopted, with modification in SSAP No. 12.)

b. *FAS 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity* (FAS 150) establishes GAAP standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. The guidance in FAS 150 was previously under consideration by the Statutory Accounting Principles Working Group, and in November 2007, the Valuation of Securities Task Force advised that it is not prevalent for insurers to issue securities or financial instruments within the scope of FAS 150. As a result of that information, in March 2008, FAS 150 was rejected by the Statutory Accounting Principles Working Group as not applicable to statutory accounting. Although originally rejected as not applicable, the guidance in FAS 150 (included within *Topic 480: Distinguishing Liabilities from Equity* (Topic 480) of the FASB Codification) referenced in FAS 123R for classifying instruments as equity or liability is adopted for application in this issue paper. The adopted guidance is reflected in Appendix A of this issue paper.

c. *FASB Staff Position FAS 123(R)-1: Classification and Measurement of Freestanding Financial Instruments Originally issued in Exchange for Employee Services under FASB Statement No. 123(R)* (FAS 123R-1). Under FSP FAS 123R-1, certain freestanding instruments shall continue to be subject to the recognition and measurement provisions of

FAS 123(R) throughout the life of the instrument, unless its terms are modified when the holder is no longer an employee. The guidance from FSP FAS 123R-1 has been incorporated within the FASB Codification in *Topic 718-10, Compensation – Stock Compensation, Overall* in paragraphs 718-10-35-9 through 718-10-35-11.

d. *FASB Staff Position (FSP) FAS 123(R)-2: Practical Accommodation to the Application of Grant Date as Defined in FASB Statement No. 123(R)* (FSP FAS 123R-2). This FSP provided a practical solution for when a mutual understanding of key concepts of a share-based payment award exist. The guidance from FSP FAS 123R-2 has been incorporated within the FASB Condition in *Topic 718-10, Compensation – Stock Compensation, Overall* in paragraph 718-10-25-5.

e. *FASB Staff Position (FSP) FAS123(R)-4: Classification of Options and Similar Instruments Issued as Employee Compensation That Allow for Cash Settlement upon the Occurrence of a Contingent Event* (FSP FAS 123R-4). The guidance in this FSP revised FAS 123R to clarify that an option or instrument classified as equity with a cash settlement feature shall not be reclassified to a liability until it becomes probable that the event will occur. The guidance from FSP FAS 123R-4 has been incorporated within the FASB Condition in *Topic 718-10, Compensation – Stock Compensation, Overall* in paragraph 718-10-35-14.

f. *FASB Staff Position (FSP) FAS 123(R)-5: Amendment of FASB Staff Position FAS 123R-1* (FSP FAS 123R-5). This FSP addresses a question on whether an entity that executes a restructuring must, in all cases, reassess whether the recognition and measurement of an instrument whose holder is no longer an employee becomes subject to other applicable GAAP. The guidance from FSP FAS 123R-5 has been incorporated within the FASB Codification (included through the reference of FSP FAS 123R-1) in *Topic 718-10, Compensation – Stock Compensation, Overall* in paragraph 718-10-35-10.

g. *FASB Staff Position (FSP) FAS 123(R)-6: Technical Corrections of FASB Statement No. 123(R)* (FSP FAS 123R-6). This FSP provides technical corrections. The guidance from FSP FAS 123R-6 has been incorporated within the FASB Codification in paragraphs 710-10-50-2, 718-20-55-32, 718-20-55-121 and the FASB Master Glossary.

h. *EITF 00-16, Recognition and Measurement of Employer Payroll Taxes on Employee Stock-Based Compensation* (EITF 00-16). This EITF was previously considered by the NAIC Emerging Accounting Issues (E) Task Force with adoption in INT 01-14. The adopted guidance from EITF 00-16 is included within this issue paper (as it is included in the FASB Codification 718-10-25-22) with a proposal to nullify INT 01-14.

i. *FASB Technical Bulletin 97-01, Accounting under Statement 123 for Certain Employee Stock Purchase Plans with a Look-Back Option* (TB 97-01). The accounting guidance in TB 97-1 addresses the accounting for certain stock purchase plans with a look-back option. The guidance in TB 97-1 has been incorporated within the FASB Codification in *Topic 718-50, Compensation – Stock Compensation, Employee Share Purchase Plans*.

124. The adoption, with modification of FASB Codification Topic 718 in this issue paper reflects rejection of the following pre-codification GAAP standards:

a. *FASB Staff Position (FSP) FAS 123(R)-3: Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards* (FSP FAS 123R-3). This FSP provided a practical transition election related to accounting for the tax effects of share-based payment awards to employees. This guidance, as it relates to transition of FAS 123R in

2005, has not been incorporated in the FASB Codification. FSP FAS 123R-3 is rejected for statutory accounting, with transition guidance established within this issue paper.

b. *FASB Staff Position (FSP) EITF 03-6-1; Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities* (FSP EITF 03-6-1), issued in June 2008. This FSP addresses whether instruments granted in share-based payment transactions are participating securities prior to vesting and, therefore, need to be included in earnings allocation in computing earnings per share (EPS). The guidance from this FSP has been included in the FASB Codification within *Topic 260-10, Earnings Per Share, Overall*. However, as this guidance pertains to calculating EPS, this issue paper rejects this guidance as not applicable for statutory accounting.

125. Modifications to the adopted GAAP guidance are as follows:

a. GAAP references are revised to reference applicable statutory accounting guidance;

b. GAAP reporting line items (either explicitly provided in the issue paper or adopted by reference – such as the GAAP implementation guidance) shall be replaced to reference applicable annual statement line items. (For example, GAAP references to “other comprehensive income” shall be reflected within “Surplus - Unassigned Funds”).

c. GAAP guidance to calculate earnings per share is not applicable to statutory accounting and has not been included within this issue paper.

d. GAAP effective date and transition, and transition disclosures have not been incorporated. Reporting entities shall follow the effective date and transition elements provided within this issue paper.

e. Inclusion of guidance specific to statutory for consolidated/holding company plans.

Effective Date and Transition

126. Upon adoption of this issue paper, the NAIC will release a new *SSAP No. 104—Stock Options and Stock Purchase Plans* (SSAP No. 104) for comment. The SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the *Accounting Practices and Procedures Manual* should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will contain an effective date of years beginning on or after January 1, 2013, with early adoption permitted for Dec. 31, 2012, financial statements.

127. Reporting entities with existing share-based payment instruments that applied the guidance contained in *SSAP No. 13—Stock Options and Stock Purchase Plans* (SSAP No. 13) shall apply the requirements of the adopted SSAP No. 104 prospectively to new awards and to awards modified, repurchased, or cancelled after the required effective date. Those reporting entities shall continue to account for any portion of awards outstanding at the date of initial application using the accounting principles originally applied to those awards (SSAP No. 13).

DISCUSSION

128. The Financial Accounting Standards Board (FASB) originally issued FAS 123(R) in December of 2004. FAS 123(R) is a revision of *FASB Statement No. 123: Accounting for Stock-Based Compensation* (FAS 123) and supersedes *APB Opinion No. 25, Accounting for Stock Issued to Employees* (APB Opinion No. 25), and its related implementation guidance. The scope of FAS 123(R) establishes standards for the

accounting for transactions in which an entity exchanges its equity instruments for goods or services. It also addresses transactions in which an entity incurs liabilities in exchange for goods or services that are based on the fair value of the entity's equity instruments or that may be settled by the issuance of those equity instruments. FAS 123(R) focuses primarily on accounting for transactions in which an entity obtains employee services in share-based payment transactions. FAS 123(R) does not change the accounting guidance for share-based payment transactions with parties other than employees provided in Statement 123 as originally issued and *EITF Issue No. 96-18, Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services*. FAS 123(R) does not address the accounting for employee share ownership plans, which are subject to *AICPA Statement of Position 93-6, Employers' Accounting for Employee Stock Ownership Plans*.

129. FASB's reasons for issuing FAS 123(R) are as follows:

a. Addressing concerns of users and others by requiring an entity to recognize the cost of employee services received in share-based payment transactions, thereby reflecting the economic consequences of the transactions in the financial statements.

b. Improves comparability of reporting financial information by eliminating alternative accounting methods.

c. Simplifies U.S. GAAP.

d. Convergence with international accounting standards.

130. Typically, stock option plans issue options that are "at the money", where the exercise price equals that of the market value for the underlying security and requires a vesting period to earn the stock option. These stock options are issued as an incentive for employees to work to increase the market value of the company's stock and thus shareholder value. As the intrinsic value method (required in SSAP No. 13) measures compensation expense as the fair value (market value) of the underlying stock less the amount by the employee is required to pay, this results in zero compensation expense for stock options issued to employees issued at the money. FAS 123(R) requires that the stock option be measured at fair value on the date of grant using option-pricing models adjusted for the unique characteristics of the instruments issued. This accounting treatment captures the costs of employee services relative to the awards granted, which is now more conservative than current SAP guidance.

131. NAIC staff notes that SSAP No. 13 rejected FAS 123. Although the rationale for rejection is based on the impact on statutory assets and liabilities. The Working Group considers the optionality of FAS 123 to be an additional reason why FAS 123 was rejected. FAS 123(R) now eliminates the optional accounting treatment by requiring recognition of compensation expense for all employee services received in share-based payment transactions using a fair-value-based method. As a result, this statement recognizes transactions that affect the issuer's reported financial condition and results of operations that previous guidance, and guidance adopted in SSAP No. 13, fails to capture.

132. This issue paper proposes adoption, with modifications, of FAS 123(R), as reflected in the FASB Codification *Topic 718, Compensation – Stock Compensation*. Consideration of FAS 123(R), as it is reflected in the FASB Codification, also resulted with consideration of the following guidance:

a. *ASU 2010-13 – Compensation – Stock Compensation (Topic 718): Effect of Denominating the Exercise Price of a Share-Based Payment Award in the Currency of the Market in Which the Underlying Equity Security Trades – a consensus of the FASB Emerging Issues Task Force*, issued in April 2010. The accounting guidance in ASU 2010-13 clarifies that an that an employee share-based payment award with an exercise price denominated in the currency of a market in which a substantial portion of the entity's equity securities trades should not be considered to contain a condition that is not a market, performance, or service condition. Therefore, an entity would not classify such an award as a liability if it otherwise qualifies as equity. The guidance in ASU 2010-13 has been incorporated within the FASB Codification in *Topic 718-10, Compensation – Stock Compensation, Overall*. This issue paper proposes to adopt, with modification, ASU 2010-13.

b. *FAS 150: Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity* (FAS 150), issued May 2003, establishes GAAP standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. The guidance in FAS 150 was previously under consideration by the Statutory Accounting Principles Working Group, and in November 2007, the Valuation of Securities Task Force advised that it is not prevalent for insurers to issue securities or financial instruments within the scope of FAS 150. As a result of that information, in March 2008, FAS 150 was rejected by the Statutory Accounting Principles Working Group as not applicable to statutory accounting. Although originally rejected as not applicable, the guidance in FAS 150 (included within *Topic 480: Distinguishing Liabilities from Equity* (Topic 480) of the FASB Codification) as it is referenced in FAS 123R for classifying instruments as equity or liability is proposed to be adopted within Appendix A of this issue paper. This reversal of position on FAS 150 is considered necessary to prevent a GAAP to SAP difference regarding the classification of share-based payments. (If desired by the Working Group, subsequent consideration of Topic 480 could occur to provide criteria for liability or equity classification for instruments outside the scope of this issue paper.)

c. *FASB Technical Bulletin 97-01, Accounting under Statement 123 for Certain Employee Stock Purchase Plans with a Look-Back Option* (TB 97-01), issued in December 1997. The accounting guidance in TB 97-1 addresses the accounting for certain stock purchase plans with a look-back option. An example of a look-back option is a provision that establishes the purchase price as an amount based on the lessor of the stock market's price at the grant date or its market price at the exercise (or purchase) date. The guidance in TB 97-1 originally revised *FAS 123, Share-Based Payment* (FAS 123), but was amended after the issuance of FAS 123(R). The guidance in TB 97-1 has been incorporated within the FASB Codification in *Topic 718-50, Compensation – Stock Compensation, Employee Share Purchase Plans*. This issue paper proposes to adopt, with modification, TB 97-01. (Guidance from TP 97-01 included within the implementation guidance of the FASB Codification guidance is also considered adopted for statutory, but is not explicitly included within this issue paper.)

d. *FASB Staff Position FAS 123(R)-1: Classification and Measurement of Freestanding Financial Instruments Originally issued in Exchange for Employee Services under FASB Statement No. 123(R)* (FAS 123R-1), issued in August 2005. This Statement defers the guidance in FAS 123R that requires a freestanding financial instrument issued to an employee in exchange for past or future employee services subject to FAS 123(R) or was subject to FAS 123(R) upon initial adoption, to be subject to the recognition and measurement requirements of other applicable GAAP when the rights conveyed by the instrument to the holder are no longer dependent on the holder being an employee of the entity. With this FSP FAS 123R-1 deferral, such freestanding instruments shall continue to be subject to the recognition and measurement provisions of FAS 123(R) throughout the life of the instrument, unless its terms are modified when the holder is no longer an employee. The guidance from FSP FAS 123R-1 has been incorporated within the FASB Codification in *Topic 718-10, Compensation – Stock Compensation, Overall* in paragraphs 718-10-35-9 through 718-10-35-11. This guidance is proposed to be adopted, with modification, for statutory accounting.

e. *FASB Staff Position (FSP) FAS 123(R)-2: Practical Accommodation to the Application of Grant Date as Defined in FASB Statement No. 123(R)* (FSP FAS 123R-2), issued in October 2005. This FSP provides a practical solution for when a mutual understanding of key concepts of a share-based payment award exist. Under this guidance, a mutual understanding of key terms and concepts of an award to an individual employee shall be presumed to exist at the date the award is approved in accordance with the relevant corporate governance requirements if the following two conditions are met: (1) the award is a unilateral grant, therefore the recipient does not have the ability to negotiate key terms and conditions with the employer; and (2) The key terms and conditions of the award are expected to be communicated to an individual recipient within a relatively short-period form the date of approval. The guidance from FSP FAS 123R-2 has been incorporated within the FASB Condition in *Topic 718-10, Compensation – Stock Compensation, Overall* in paragraph 718-10-25-5. This guidance is proposed to be adopted, with modification, for statutory accounting.

f. *FASB Staff Position (FSP) FAS 123(R)-3: Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards* (FSP FAS 123R-3), issued in November 2005. This FSP provided a practical transition election related to accounting for the tax effects of share-based payment awards to employees. This guidance, as it relates to transition of FAS 123R in 2005, has not been incorporated the FASB Codification. As the guidance from FSP FAS 123R-3 results in two transition options, for consistency purposes it is presumed that a single transition method will be desired for statutory. As such, it is proposed that the guidance from FSP FAS 123R-3 be rejected for statutory accounting, with transition guidance established within this issue paper.

g. *FASB Staff Position (FSP) FAS123(R)-4: Classification of Options and Similar Instruments Issued as Employee Compensation That Allow for Cash Settlement upon the Occurrence of a Contingent Event* (FSP FAS 123R-4), issued in February 2006. This FSP addresses the classification of options and similar instruments issued as employee compensation that allow for cash settlement upon the occurrence of a contingent event. The guidance in this FSP revised FAS 123R to clarify that an option or instrument classified as equity with a cash settlement feature shall not be reclassified to a liability until it becomes probable that the event will occur. The guidance from FSP FAS 123R-4 has been incorporated within the FASB Condition in *Topic 718-10, Compensation – Stock Compensation, Overall* in paragraph 718-10-35-14. This guidance is proposed to be adopted, with modification, for statutory accounting.

h. *FASB Staff Position (FSP) FAS 123(R)-5: Amendment of FASB Staff Position FAS 123R-1* (FSP FAS 123R-5), issued in October 2006. This FSP addresses a question on whether an entity that executes a restructuring must, in all cases, reassess whether the recognition and measurement of an instrument whose holder is no longer an employee becomes subject to other applicable GAAP. Under the guidance in the FSP, instruments that were originally issued as employee compensation and then modified, and that modification is made to the terms of the instrument solely to reflect an equity restructuring that occurs when the holders are no longer employees, no change in the recognition and measurement (due to a change in classification) of those instruments will result if both of the following conditions are met: (a) there is no increase in the fair value of the award, or the anti-dilution provision is not added to the terms of the award in contemplation of an equity restructuring; and (b) all holders of the same class of equity instruments are treated in the same manner. The guidance from FSP FAS 123R-5 has been incorporated within the FASB Codification (included through the reference of FSP FAS 123R-1) in *Topic 718-10, Compensation – Stock Compensation, Overall* in paragraph 718-10-35-10. This guidance is proposed to be adopted, with modification, for statutory accounting. (This

FSP revised FSP FAS 123R-1 (which revised FAS 123R), thus, the guidance is included in the FASB Codification through incorporation of those standards, but FSP FAS 123(R)-5 is not specifically referenced in the codification.)

i. *FASB Staff Position (FSP) FAS 123(R)-6: Technical Corrections of FASB Statement No. 123(R)* (FSP FAS 123R-6), issued in October 2006. This FSP addresses technical corrections and specifically amends (a) paragraph A240(d)(1) to exempt nonpublic entities from disclosing the aggregate intrinsic value of outstanding fully vested share options (or share units) and share options expected to vest; (b) paragraph A102 of illustration 4(b) to revise the computation of minimum compensation cost that must be recognized to comply with paragraph 42 of FAS 123R; (c) paragraph A107 of Illustration 13(e) to indicate that at the date that the illustrative awards were no longer probable of vesting, any previously recognized compensation cost should have been reversed; and (d) paragraph E1 to amend the definition of "short-term inducement" to exclude an offer to settle an award. The guidance from FSP FAS 123R-6 has been incorporated within the FASB Codification (This FSP revised FAS 123R, thus the guidance is included within the FASB Codification through incorporation of that standard, but FSP FAS 123R-6 is not specifically included in the FASB Codification.) The guidance is reflected in paragraphs 710-10-50-2, 718-20-55-32, 718-20-55-121 and the FASB Master Glossary. With the exception of the glossary term, the revisions impact the related implementation guidance. This guidance is proposed to be adopted, with modification, for statutory.

j. *FASB Staff Position (FSP) EITF 03-6-1; Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities* (FSP EITF 03-6-1), issued in June 2008. This FSP addresses whether instruments granted in share-based payment transactions are participating securities prior to vesting and, therefore, need to be included in earnings allocation in computing earnings per share (EPS) under the two-class method described in *FASB Statement No. 128, Earnings Per Share*. Pursuant to the FSP, unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and shall be included in the computation of EPS pursuant to the two-class method. The guidance from this FSP has been included in the FASB Codification within *Topic 260-10, Earnings Per Share, Overall*. As this guidance pertains to calculating EPS, this issue paper proposes for this guidance to be rejected as not applicable for statutory accounting.

k. *EITF 00-12; Accounting by an Investor for Stock-Based Compensation Granted to Employees of an Equity Method Investee* (EITF 00-12), issued in July 2000. This EITF addresses the accounting for stock-based compensation based on the investor's stock granted to employees of an investee accounted for under the equity method when no proportionate funding by the other investors occurs and the investor does not receive any increase in the investor's relative ownership percentage of the investee. This EITF clarifies that an investee shall recognize the costs of the stock-based compensation incurred by the investor on its behalf, and a corresponding capital contribution, as the costs are incurred on its behalf. A contributing investor should expense the cost of stock-based compensation (based on fair value) granted to employees of an equity method investee as incurred to the extent that the investor's claim on the investee's book value has not increased. This EITF also clarifies that other (noncontributing) investors should recognize income equal to the amount that their interest in the investee's net book value has increased (that is, their percentage share of the contributed capital recognized by the investee) as a result of the disproportionate funding of the compensation costs. Further, other investors should recognize their percentage share of earnings or losses in the investee (inclusive of any expense recognized by the investee for the stock-based compensation funded on its behalf). This EITF has been updated to reference FAS 123R, but the issuance of FAS 123R did not change the consensus reached in EITF 00-12. The guidance in EITF 00-12 has been included in the FASB Codification primarily within *Topic 323-10, Investments—Equity Method and Joint Ventures, Overall.* Although there is reference to FAS 123R within EITF 00-12, as this does not revise the guidance for stock options or stock purchase plans, this item is not included within this issue paper and is still considered pending for statutory accounting.

l. *EITF 00-16, Recognition and Measurement of Employer Payroll Taxes on Employee Stock-Based Compensation* (EITF 00-16), issued July 2000. This EITF was previously considered by the NAIC Emerging Accounting Issues (E) Task Force with adoption of the following EITF 00-16 position within Interpretation INT 01-14: *A liability for employee payroll taxes on employee stock compensation should be recognized on the date of the event triggering the measurement and payment of the tax to the taxing authority (for a nonqualifying option in the United States, generally the exercise date.)* The adopted guidance from EITF 00-16 is proposed to be included within this issue paper (as it is included in the FASB Codification 718-10-25-22) with INT 01-14 nullified as the guidance has been incorporated within SSAP No. 104.

m. *EITF 00-18; Accounting Recognition for Certain Transactions Involving Equity Instruments Granted to Other Than Employees* (EITF 00-18), issued in July 2000. This issue provides symmetrical guidance in determining the measurement date for both the grantor and the grantee under *EITF 96-18; Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services* (EITF 96-18) and *EITF 00-08; Accounting by a Grantee for an Equity Instrument to be Received in Conjunction with Providing Good and Services* (EITF 00-08). Although there is reference to FAS 123R within EITF 00-18, as this issue within EITF 00-18 specifically pertains to "other than employees" and FAS 123R is specific to "employee" awards, this item is not included within this issue paper and is still considered pending for statutory accounting.

133. In evaluating the guidance for share-based payments, it is proposed that statutory accounting principles adopt related GAAP guidance as there are no identified insurance-specific reasons to incorporate statutory accounting guidance that differs from GAAP for share-based payment transactions. This issue paper proposes adoption of the GAAP guidance with limited modifications as follows:

a. GAAP references are revised to reference applicable statutory accounting guidance;

b. GAAP reporting items (either explicitly provided in the issue paper or adopted by reference – such as the GAAP implementation guidance) shall be replaced to reference applicable annual statement line items. (For example, GAAP references to "other comprehensive income" shall be reflected within "Surplus - Unassigned Funds").

c. GAAP guidance to calculate earnings per share is not applicable to statutory accounting and is therefore not adopted for statutory.

d. GAAP effective date and transition, and transition disclosures have not been incorporated. Reporting entities shall follow the effective date and transition elements provided within this issue paper.

e. Inclusion of guidance specific to statutory for consolidated/holding company plans.

134. With adoption of a SSAP related to this issue paper (SSAP No. 104) that supersedes SSAP No. 13, previous adoptions of GAAP guidance in SSAP No. 13 may no longer be applicable. As a result of

the adoption of SSAP No. 104, GAAP guidance in Appendix D of the *NAIC Accounting Practices and Procedures Manual* (GAAP Cross-Reference to SAP) will reflect the following conclusions:

a. *ASU 2010-13 – Compensation – Stock Compensation (Topic 718): Effect of Denominating the Exercise Price of a Share-Based Payment Award in the Currency of the Market in Which the Underlying Equity Security Trades – A Consensus of the Emerging Issues Task Force*: This guidance will be identified as adopted with modification in SSAP No. 104.

b. *FASB Statement No. 123(R), Share-Based Payment* (FAS 123R): This guidance will be identified as adopted with modification in SSAP No. 104.

c. *FASB Statement No. 123, Accounting for Stock-Based Compensation* (FAS 123): This guidance was superseded by FAS 123R. As this guidance was previously rejected in SSAP No. 13 no change will be reflected within Appendix D.

d. *FASB Statement No. 148, Accounting for Stock-Based Compensation – Transition and Disclosures – and Amendment of FAS 123* (FAS 148): This guidance was superseded by FAS 123R. As this guidance was previously rejected in SSAP No. 13 no change will be reflected in Appendix D.

e. *FASB Statement No. 150, Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity* (FAS 150): This guidance was previously identified as not applicable to statutory accounting. This reference will be updated to reflect adoption as it is referenced in SSAP No. 104, but to continue to reject as not applicable for all other transactions.

f. *FASB Interpretation No. 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans* (FIN 28) – This guidance was superseded by FAS 123R. As this guidance was previously adopted in SSAP No. 13, reference will be added to identify that this guidance is no longer applicable within SSAP No. 104.

g. *FASB Interpretation No. 38, Determining the Measurement Date for Stock Option, Purchase, and Award Plans Involving Junior Stock* (FIN 38): This guidance was superseded by FAS 123R. As this guidance was previously adopted in SSAP No. 13, reference will be added to identify that this guidance is no longer applicable within SSAP No. 104.

h. *FASB Interpretation No. 44, Accounting for Certain Transactions Involving Stock Compensation* (FIN 44): This guidance was superseded by FAS 123R. Although this guidance was not previously reviewed for statutory accounting, reference will be added to identify that this guidance is not applicable within SSAP No. 104.

i. *Accounting Principles Bulletin No. 25, Accounting for Stock Issued to Employees* (APB 25): This guidance was superseded by FAS 123R. As this guidance was previously adopted in SSAP No. 13, reference will be added to identify that this guidance is no longer applicable within SSAP No. 104.

j. *Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins - Chapter 13B*: This guidance was deleted by FAS 123R. As this guidance was previously adopted in SSAP No. 13, reference will be added to identify that this guidance is no longer applicable within SSAP No. 104.

k. *FASB Technical Bulletin 97-1, Accounting Under Statement 123 for Certain Employee Stock Purchase Plans with a Look-Back Option* (TB 97-1): This guidance has been amended after the issuance of FAS 123R, and this amended guidance has been included within the FASB Codification. Under the proposal of this issue paper, this guidance will be identified as adopted with modification in SSAP No. 104.

l. *FASB Staff Position FAS 123(R)-1: Classification and Measurement of Freestanding Financial Instruments Originally issued in Exchange for Employee Services under FASB Statement No. 123(R)* (FAS 123R-1): This guidance was issued to defer a provision within FAS 123R related to freestanding instruments when the holder is no longer an employee. Under the proposal of this issue paper, this guidance will be identified as adopted with modification in SSAP No. 104.

m. *FASB Staff Position (FSP) FAS 123(R)-2: Practical Accommodation to the Application of Grant Date as Defined in FASB Statement No. 123(R)* (FSP FAS 123R-2): This guidance was issued to provide a practical application of FAS 123R. Under the proposal of this issue paper, this guidance will be identified as adopted with modification in SSAP No. 104.

n. *FASB Staff Position (FSP) FAS 123(R)-3: Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards* (FSP FAS 123R-3): This guidance provides a practical transition election under FAS 123R related to accounting for the tax effects of share-based payment awards to employees. Under the proposal of this issue paper, this guidance will be identified as rejected in SSAP No. 104.

o. *FASB Staff Position (FSP) FAS123(R)-4: Classification of Options and Similar Instruments Issued as Employee Compensation That Allow for Cash Settlement upon the Occurrence of a Contingent Event* (FSP FAS 123R-4): This guidance addresses the FAS 123R classification of options and similar instruments issued as employee compensation that allow for cash settlement upon the occurrence of a contingent event. Under the proposal of this issue paper, this guidance will be identified as adopted with modification in SSAP No. 104.

p. *FASB Staff Position (FSP) FAS 123(R)-5: Amendment of FASB Staff Position FAS 123R-1* (FSP FAS 123R-5): This guidance addresses a FAS 123R question on whether an entity that executes a restructuring must, in all cases, reassess whether the recognition and measurement of an instrument whose holder is no longer an employee becomes subject to other applicable GAAP. Under the proposal of this issue paper, this guidance will be identified as adopted with modification in SSAP No. 104.

q. *FASB Staff Position (FSP) FAS 123(R)-6: Technical Corrections of FASB Statement No. 123(R)* (FSP FAS 123R-6): This FSP guidance addresses technical corrections within FAS 123R. Under the proposal of this issue paper, this guidance will be identified as adopted with modification in SSAP No. 104.

r. *FASB Staff Position (FSP) EITF 03-6-1; Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities* (FSP EITF 03-6-1): This guidance addresses whether instruments granted in share-based payment transactions are participating securities prior to vesting and, therefore, need to be included in computing earnings per share (EPS). Under the proposal of this issue paper, this guidance will be identified as rejected in SSAP No. 104.

s. *EITF 84-8, Variable Stock Purchase Warrants Given by Supplies to Customers* (EITF 84-08): This guidance was resolved by FAS 123R. Although this guidance was not previously reviewed for statutory accounting, reference will be added to identify that consideration of this EITF is unnecessary with the issuance of SSAP No. 104.

t. *EITF 84-13, Purchase of Stock Options and Stock Appreciation Rights in a Leveraged Buyout* (EITF 84-13): This guidance was nullified by FAS 123R. As this guidance was previously adopted in SSAP No. 13, reference will be added to identify that the adoption of this EITF is nullified with the issuance of SSAP No. 104.

u. *EITF 84-18, Stock Option Pyramiding* (EITF 84-18): This guidance was nullified by FAS 123R. As this guidance was previously adopted in SSAP No. 13, reference will be added to identify that the adoption of this EITF is nullified with the issuance of SSAP No. 104.

v. *EITF 84-34, Permanent Discount Restricted Stock Purchase* (EITF 84-34): This guidance was nullified by FAS 123R. Although this guidance was not previously reviewed for statutory accounting, reference will be added to identify that consideration of this EITF is unnecessary with the issuance of SSAP No. 104.

w. *EITF 85-45, Business Combinations: Settlement of Stock Options and Awards* (EITF 85-45): This guidance was nullified by FAS 123R. As this guidance was previously adopted in SSAP No. 13, reference will be added to identify that the adoption of this EITF is nullified with the issuance of SSAP No. 104.

x. *EITF 87-6, Adjustments Relating to Stock Compensation* (EITF 87-6): This guidance was nullified by FIN 44. As this guidance was previously adopted in SSAP No. 13 (and as FAS 123R superseded FIN 44), reference will be added to identify that the adoption of this EITF is nullified with the issuance of SSAP No. 104.

y. *EITF 87-23, Book Value Stock Purchase Plans* (EITF 87-23): This guidance was nullified by FAS 123R. As this guidance was previously adopted in SSAP No. 13, reference will be added to identify that the adoption of this EITF is nullified with the issuance of SSAP No. 104.

z. *EITF 87-33, Stock Compensation Issues Related to Market Decline* (EITF 87-33): This guidance was nullified by FIN 44. As this guidance was previously adopted in SSAP No. 13 (and as FAS 123R superseded FIN 44), reference will be added to identify that the adoption of this EITF is nullified with the issuance of SSAP No. 104.

aa. *EITF 88-6, Book Value Stock Plans in an Initial Public Offering* (EITF 88-6): This guidance was nullified by FAS 123R. As this guidance was previously adopted in SSAP No. 13, reference will be added to identify that the adoption of this EITF is nullified with the issuance of SSAP No. 104.

bb. *EITF 90-7, Accounting for Reload Stock Option (EITF 90-6):* This guidance was nullified by FAS 123R. As this guidance was previously adopted in SSAP No. 13, reference will be added to identify that the adoption of this EITF is nullified with the issuance of SSAP No. 104.

cc. *EITF 90-9, Changes to Fixed Employee Stock Option Plans as a Result of Equity Restructuring* (EITF 90-9). This guidance was nullified by FIN 44. As this guidance was previously adopted in SSAP No. 13 (and as FAS 123R superseded FIN 44), reference will be added to identify that the adoption of this EITF is nullified with the issuance of SSAP No. 104.

dd. *EITF 94-6, Accounting for the Buyout of Compensatory Stock Options* (EITF 94-6). This guidance was nullified by FIN 44. As this guidance was previously adopted in SSAP No. 13 (and as FAS 123R superseded FIN 44), reference will be added to identify that the adoption of this EITF is nullified with the issuance of SSAP No. 104.

ee. *EITF 95-16, Accounting for Stock Compensation Arrangements with Employer Loan Features under APB Opinion No. 25* (EITF 95-16): This guidance was nullified by FAS 123R. As this guidance was previously adopted in SSAP No. 13, reference will be added to identify that the adoption of this EITF is nullified with the issuance of SSAP No. 104.

ff. *EITF 97-5, Accounting for the Delayed Receipt of Option Shares upon Exercise Under APB Opinion No. 25* (EITF 97-5): This guidance was nullified by FAS 123R. Although this guidance was not previously reviewed for statutory accounting, reference will be added to identify that consideration of this EITF is unnecessary with the issuance of SSAP No. 104.

gg. *EITF 97-12, Accounting for Increased Share Authorizations in an IRS Section 423 Employee Stock Purchase Plan under APB Opinion No. 25* (EITF 97-12): This guidance was nullified by FAS 123R. This guidance was adopted for statutory in INT 99-17. Upon the issuance of SSAP No. 104, INT 99-17 will be nullified, with reference in Appendix D that the adoption of EITF 97-12 is nullified with the issuance of SSAP No. 104.

hh. *EITF 00-15, Classification in the Statement of Cash Flows of the Income Tax Benefits Received by a Company upon Exercise of a Nonqualified Employee Stock Option* (EITF 00-15): This guidance was nullified by FAS 123R. As this guidance was previously reviewed and considered to be not applicable to statutory accounting, no changes will be reflected in Appendix D.

ii. *EITF 00-16, Recognition and Measurement of Employer Payroll Taxes on Employee Stock-Based Compensation* (EITF 00-16): This guidance was previously considered by the NAIC Emerging Accounting Issues (E) Task Force with adoption in INT 01-14. Under the proposal of this issue paper, INT 01-14 will be nullified, with reference to SSAP No. 104 regarding the adoption of this guidance.

jj. *EITF 00-23, Issues Related to the Accounting for Stock Compensation under APB Opinion No. 25 and FASB Interpretation No. 44* (EITF 00-23): This guidance was nullified by FAS 123R. Although this guidance was not previously reviewed for statutory accounting, reference will be added to identify that consideration of this EITF is unnecessary with the issuance of SSAP No. 104.

kk. *AIN-APB 25, Accounting for Stock Issued to Employees: Accounting Interpretations of APB Opinion No. 25* (AIN-APB 25): Interpretation 1 was superseded with the issuance of FAS 123R. As this guidance was previously adopted in SSAP No. 13, reference will be added to identify that this guidance is no longer applicable within SSAP No. 104.

135. The following item that provides interpretative guidance to SSAP No. 13 will continue to provide interpretative guidance after the adoption of SSAP No. 104. Reference will be updated in the respective interpretation to reference SSAP No. 104 instead of SSAP No. 13:

a. *INT 00-32: EITF 00-08, Accounting by a Grantee for an Equity Instrument to be Received in Conjunction with Providing Goods or Services*. INT 00-32 adopts with modification EITF 00-08.

136. This issue paper proposes issuance of a new SSAP No. 104 (SSAP No. 104) for new awards and awards modified, repurchased, or cancelled after the required effective date. This issue paper also addresses transactions in which an entity incurs liabilities in exchange for goods or services that are based on the fair value of the entity's equity instruments or that may be settled by the issuance of those equity instruments. This issue paper focuses primarily on accounting for transactions in which an entity obtains employee services in share-based payment transactions.

137. The conclusions above are consistent with the recognition concept included in the Statement of Concepts.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

- *SSAP No. 12—Employee Stock Ownership Plans*

- *SSAP No. 13—Stock Options and Stock Purchase Plans*

- *INT 99-17: EITF 97-12: Accounting for Increased Share Authorizations in an IRS Section 423 Employee Stock Purchase Plan under APB Opinion No. 25* (EITF adopted with modifications)

- *INT 00-06: EITF 97-14: Accounting for Deferred Compensation Arrangements Where Amounts Earned Are Held in a Rabbi Trust and Invested* (EITF adopted with modifications)

- *INT 00-32: EITF 00-8: Accounting by a Grantee for an Equity Instrument to Be Received in Conjunction with Providing Goods or Services* (EITF adopted with modifications)

- *INT 01-14: EITF 00-16: Recognition and Measurement of Employer Payroll Taxes on Employee Stock-Based Compensation* (EITF adopted with modifications)

Generally Accepted Accounting Principles

- *ASU 2010-13 – Compensation – Stock Compensation (Topic 718): Effect of Denominating the Exercise Price of a Share-Based Payment Award in the Currency of the Market in Which the Underlying Equity Security Trades – A Consensus of the Emerging Issues Task Force* (Pending)

- *FASB Statement No. 123(R): Share-Based Payment* (Pending)

- *FASB Statement No. 123: Accounting for Stock-Based Compensation* (Rejected)

- *FASB Statement No. 148: Accounting for Stock-Based Compensation – Transition and Disclosure – an amendment of FASB Statement No. 123* (Rejected)

- *FASB Statement No. 150, Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity* (Nonapplicable for SSAP)

- *FASB Interpretation No. 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans* (Adopted in SSAP No. 13)

- *FASB Interpretation No. 38, Determining the Measurement Date for Stock Option, Purchase, and Award Plans Involving Junior Stock* (Adopted in SSAP No. 13)

- *FASB Interpretation No. 44, Accounting for Certain Transactions involving Stock Compensation* (Not Reviewed - Superseded by FAS 123(R))

- *APB Opinion No. 25, Accounting for Stock Issued to Employees* (Adopted with modifications in SSAP No. 13)

- *Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins*, Chapter 13, *Compensation*, *Section B—Compensation Involved in Stock Option and Stock Purchase Plans* (Adopted with modifications in SSAP No. 13)

- *FASB Technical Bulletin 97-1, Accounting Under Statement 123 for Certain Employee Stock Purchase Plans with a Look-Back Option* (Pending)

- *FASB Staff Position FAS 123(R)-1: Classification and Measurement of Freestanding Financial Instruments Originally Issued in Exchange for Employee Services under FASB Statement No. 123(R)* (Pending)

- *FASB Staff Position (FSP) FAS 123(R)-2: Practical Accommodation to the Application of Grant Date as Defined in FASB Statement No. 123(R)* (Pending)

- *FASB Staff Position (FSP) FAS 123(R)-3: Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards* (Pending)

- *FASB Staff Position (FSP) FAS123(R)-4: Classification of Options and Similar Instruments Issued as Employee Compensation That Allow for Cash Settlement upon the Occurrence of a Contingent Event* (Pending)

- *FASB Staff Position (FSP) FAS 123(R)-5: Amendment of FASB Staff Position FAS 123R-1* (Pending)

- *FASB Staff Position (FSP) FAS 123(R)-6: Technical Corrections of FASB Statement No. 123(R)* (Pending)

- *FASB Staff Position (FSP) EITF 03-6-1; Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities* (Pending)

- *FASB Emerging Issues Task Force 84-8, Variable Stock Purchase Warrants Given by Supplies to Customers (EITF 84-08):* (Resolved by FAS 123R)

- *FASB Emerging Issues Task Force No. 84-13, Purchase of Stock Options and Stock Appreciation Rights in a Leveraged Buyout* (Adopted in SSAP No. 13 – Nullified by FAS 123(R))

- *FASB Emerging Issues Task Force No. 84-18, Stock Option Pyramiding* (Adopted in SSAP No. 13 – Nullified by FAS 123(R))

- *FASB Emerging Issues Task Force No. 84-34, Permanent Discount Restricted Stock Purchase (*Nullified by FAS 123R)

- *FASB Emerging Issues Task Force No. 85-45, Business Combinations: Settlement of Stock Options and Awards* (Adopted in SSAP No. 13 – Nullified by FAS 123(R))

- *FASB Emerging Issues Task Force No. 87-6, Adjustments Relating to Stock Compensation Plans* (Adopted in SSAP No. 13 – Nullified by FIN 44)

- *FASB Emerging Issues Task Force No. 87-23, Book Value Stock Purchase Plans* (Adopted in SSAP No. 13 – Nullified by FAS 123(R))

- *FASB Emerging Issues Task Force No. 87-33, Stock Compensation Issues Related to Market Decline* (Adopted in SSAP No. 13 – Nullified by FIN 44)

- *FASB Emerging Issues Task Force No. 88-6, Book Value Plans in an Initial Public Offering* (Adopted in SSAP No. 13 – Nullified by FAS 123(R))

- *FASB Emerging Issues Task Force No. 90-7, Accounting for a Reload Stock Option* (Adopted in SSAP No. 13 – Nullified by FAS 123(R))

- *FASB Emerging Issues Task Force No. 90-9, Changes to Fixed Employee Stock Option Plans as a Result of Equity Restructuring* (Adopted in SSAP No. 13 – Nullified by FIN 44)

- *FASB Emerging Issues Task Force No. 94-6, Accounting for the Buyout of Compensatory Stock Options* (Adopted in SSAP No. 13 – Nullified by FIN 44)

- *FASB Emerging Issues Task Force No. 95-16, Accounting for Stock Compensation Arrangements with Employer Loan Features under APB Opinion No. 25* (Adopted in SSAP No. 13 – Nullified by FAS 123(R))

- *FASB Emerging Issues Task Force No. 97-12, Accounting for Increased Share Authorizations in an IRS Section 423 Employee Stock Purchase Plan under APB Opinion No. 25 This guidance was nullified by FAS 123R.* (Adopted in INT 99-17, Nullified by FAS 123R)

- *FASB Emerging Issues Task Force No. 00-12, Accounting by an Investor for Stock-Based Compensation Granted to Employees of an Equity Method Investee* (Pending)

- *EITF 00-15, Classification in the Statement of Cash Flows of the Income Tax Benefits Received by a Company upon Exercise of a Nonqualified Employee Stock Option* (Not Applicable – Nullified by FAS 123R)

- *EITF 00-16, Recognition and Measurement of Employer Payroll Taxes on Employee Stock-Based Compensation:* (Adopted in INT 01-14, Nullified by FAS 123R)

- *EITF 00-23, Issues Related to the Accounting for Stock Compensation under APB Opinion No. 25 and FASB Interpretation No. 44 (EITF 00-23): This guidance was nullified by FAS 123R. Although this guidance was not previously reviewed for statutory accounting, reference will be added to identify that consideration of this EITF is unnecessary with the issuance of SSAP No. 104. (Not Reviewed – Nullified by FAS 123R)*

- *AICPA Accounting Interpretations, Accounting for Stock Issued to Employees: Accounting Interpretations of APB Opinion No. 25* (Adopted in SSAP No. 13 – Superseded by FAS 123R)

STATE REGULATIONS

- No additional guidance obtained from state statutes or regulations.

APPENDIX A: Classification Criteria: Liability or Equity

Classification Criteria

1. As detailed in paragraph 22 of the issue paper, an entity shall apply the classification criteria detailed in paragraphs 22 through 35 in the issue paper, as they are effective at the reporting date, in determining whether to classify as a liability a freestanding financial instrument given to an employee in a share-based payment transaction.

2. The guidance in this Section shall be applied to a freestanding financial instrument in its entirety. Any nonsubstantive or minimal features shall be disregarded in applying the classification provisions of this Section. Judgment, based on consideration of all the terms of an instrument and other relevant facts and circumstances, is necessary to distinguish substantive, nonminimal features from nonsubstantive or minimal features.

Mandatorily Redeemable Financial Instruments

3. A mandatorily redeemable financial instrument shall be classified as a liability unless the redemption is required to occur only upon the liquidation or termination of the reporting entity.

4. A financial instrument that embodies a conditional obligation to redeem the instrument by transferring assets upon an event not certain to occur becomes mandatorily redeemable if that event occurs, the condition is resolved, or the event becomes certain to occur.

5. In determining if an instrument is mandatorily redeemable, all terms within a redeemable instrument shall be considered. The following items do not affect the classification of a mandatorily redeemable financial instrument as a liability:

a. A term extension option

b. A provision that defers redemption until a specified liquidity level is reached

c. A similar provision that may delay or accelerate the timing of a mandatory redemption.

6. If a financial instrument will be redeemed only upon the occurrence of a conditional event, redemption of that instrument is conditional and, therefore, the instrument does not meet the definition of mandatorily redeemable financial instrument in this issue paper. However, that financial instrument would be assessed at each reporting period to determine whether circumstances have changed such that the instrument now meets the definition of a mandatorily redeemable instrument (that is, the event is no longer conditional). If the event has occurred, the condition is resolved, or the event has become certain to occur, the financial instrument is reclassified as a liability.

Obligations to Repurchase Issuer's Equity Shares by Transferring Assets

7. An entity shall classify as a liability (or an asset in some circumstances) any financial instrument, other than an outstanding share, that, at inception, has both of the following characteristics:

a. It embodies an obligation to repurchase the issuer's equity shares, or is indexed to such an obligation.

b. It requires or may require the issuer to settle the obligation by transferring assets.

8. In this issue paper, *indexed to* is used interchangeably with *based on variations in the fair value of*. The phrase *requires or may require* encompasses instruments that either conditionally or

unconditionally obligate the issuer to transfer assets. If the obligation is conditional, the number of conditions leading up to the transfer of assets is irrelevant.

9. Examples of financial instruments that meet the criteria in paragraph 7 of Appendix A include forward purchase contracts or written put options on the issuer's equity shares that are to be physically settled or net cash settled.

10. All obligations that permit the holder to require the issuer to transfer assets result in liabilities, regardless of whether the settlement alternatives have the potential to differ.

11. Certain financial instruments that embody obligations that are liabilities within the scope of this issue paper also may contain characteristics of assets but be reported as single items. Some examples include the following:

a. Net-cash-settled or net-share-settled forward purchase contracts

b. Certain combined options to repurchase the issuer's shares.

Those instruments are classified as assets or liabilities initially or subsequently depending on the instrument's fair value on the reporting date.

12. An instrument that requires the issuer to settle its obligation by issuing another instrument (for example, a note payable in cash) ultimately requires settlement by a transfer of assets, accordingly:

a. When applying paragraphs 7-12 of Appendix A, this also would apply for an instrument settled with another instrument that ultimately may require settlement by a transfer of assets (warrants for puttable shares).

b. It is clear that a warrant for mandatorily redeemable shares would be a liability under this issue paper.

Certain Obligations to Issue a Variable Number of Shares

13. A financial instrument that embodies an unconditional obligation, or a financial instrument other than an outstanding share that embodies a conditional obligation, that the issuer must or may settle by issuing a variable number of its equity shares shall be classified as a liability (or an asset in some circumstances) if, at inception, the monetary value of the obligation is based solely or predominantly on any one of the following:

a. A fixed monetary amount known at inception (for example, a payable settleable with a variable number of the issuer's equity shares)

b. Variations in something other than the fair value of the issuer's equity shares (for example, a financial instrument indexed to the Standard and Poor's S&P 500 Index and settleable with a variable number of the issuer's equity shares)

c. Variations inversely related to changes in the fair value of the issuer's equity shares (for example, a written put option that could be net share settled).

Prohibition on Combining Freestanding Financial Instruments

14. A freestanding financial instrument that is within the scope of this issue paper shall not be combined with another freestanding financial instrument in applying paragraphs 3-13 of Appendix A. For example, a freestanding written put option that is classified as a liability under this issue paper shall not be combined with an outstanding equity share.

Distinguishing Liability from Equity – Scope and Scope Exclusions

15. The guidance in paragraphs 22-35 of this issue paper applies to any freestanding financial instrument, including one that has any of the following attributes:

a. Comprises more than one option or forward contract

b. Has characteristics of both a liability and equity and, in some circumstances, also has characteristics of an asset (for example, a forward contract to purchase the issuer's equity shares that is to be net cash settled). Accordingly, this issue paper does not address an instrument that has only characteristics of an asset.

16. For example, an instrument that consists of a written put option for an issuer's equity shares and a purchased call option and nothing else is a freestanding financial instrument. That freestanding financial instrument embodies an obligation to repurchase the issuer's equity shares and is subject to the requirements of this issue paper.

APPENDIX B: Disclosure Information

1. The following list indicates the minimum information needed to achieve the objectives in paragraph 112 and illustrates how the disclosure requirements might be satisfied. In some circumstances, an entity may need to disclose information beyond the following to achieve the disclosure objectives:

a. A description of the share-based payment arrangement(s), including the general terms of awards under the arrangement(s), such as:

i. The requisite service period(s) and any other substantive conditions (including those related to vesting)

ii. The maximum contractual term of equity (or liability) share options or similar instruments

iii. The number of shares authorized for awards of equity share options or other equity instruments.

b. The method it uses for measuring compensation cost from share-based payment arrangements with employees.

c. For the most recent year for which an income statement is provided, both of the following:

i. The number and weighted-average exercise prices (or conversion ratios) for each of the following groups of share options (or share units):

(a) Those outstanding at the beginning of the year

(b) Those outstanding at the end of the year

(c) Those exercisable or convertible at the end of the year

(d) Those that during the year were:

(1) Granted

(2) Exercised or converted

(3) Forfeited

(4) Expired.

ii. The number and weighted-average grant-date fair value (or calculated value for an entity that uses that method or intrinsic value for awards measured pursuant to paragraph 58) of equity instruments not specified in (c)(1), for all of the following groups of equity instruments:

(a) Those nonvested at the beginning of the year

(b) Those nonvested at the end of the year

(c) Those that during the year were:

(1) Granted

(2) Vested

(3) Forfeited.

d. For each year for which an income statement is provided, both of the following:

i. The weighted-average grant-date fair value (or calculated value for an entity that uses that method or intrinsic value for awards measured at that value pursuant to paragraphs 58-59) of equity options or other equity instruments granted during the year .

ii. The total intrinsic value of options exercised (or share units converted), share-based liabilities paid, and the total fair value of shares vested during the year.

e. For fully vested share options (or share units) and share options expected to vest at the date of the latest statement of financial position, both of the following:

i. The number, weighted-average exercise price (or conversion ratio), aggregate intrinsic value, and weighted-average remaining contractual term of options (or share units) outstanding.

ii. The number, weighted-average exercise price (or conversion ratio), aggregate intrinsic value, and weighted-average remaining contractual term of options (or share units) currently exercisable (or convertible).

f. For each year for which an income statement is presented, both of the following (An entity that uses the intrinsic value method pursuant to paragraphs 58-59 is not required to disclose the following information for awards accounted for under that method):

i. A description of the method used during the year to estimate the fair value (or calculated value) of awards under share-based payment arrangements

ii. A description of the significant assumptions used during the year to estimate the fair value (or calculated value) of share-based compensation awards, including (if applicable):

(a) Expected term of share options and similar instruments, including a discussion of the method used to incorporate the contractual term of the instruments and employees' expected exercise and postvesting employment termination behavior into the fair value (or calculated value) of the instrument.

(b) Expected volatility of the entity's shares and the method used to estimate it. An entity that uses a method that employs different volatilities during the contractual term shall disclose the range of expected volatilities used and the weighted-average expected volatility. An entity that uses the calculated value method shall disclose the reasons why it is not practicable for it to estimate the expected volatility of its share price, the appropriate industry sector index that it has selected, the reasons for selecting that particular index, and how it has calculated historical volatility using that index.

(c) Expected dividends. An entity that uses a method that employs different dividend rates during the contractual term shall disclose the range of expected dividends used and the weighted-average expected dividends.

(d) Risk-free rate(s). An entity that uses a method that employs different risk-free rates shall disclose the range of risk-free rates used.

(e) Discount for post-vesting restrictions and the method for estimating it.

g. An entity that grants equity or liability instruments under multiple share-based payment arrangements with employees shall provide the information specified in paragraph (a) through (f) separately for different types of awards to the extent that the differences in the characteristics of the awards make separate disclosure important to an understanding of the entity's use of share-based compensation. For example, separate disclosure of weighted-average exercise prices (or conversion ratios) at the end of the year for options (or share units) with a fixed exercise price (or conversion ratio) and those with an indexed exercise price (or conversion ratio) could be important. It also could be important to segregate the number of options (or share units) not yet exercisable into those that will become exercisable (or convertible) based solely on fulfilling a service condition and those for which a performance condition must be met for the options (share units) to become exercisable (convertible). It could be equally important to provide separate disclosures for awards that are classified as equity and those classified as liabilities. In addition, an entity that has multiple share-based payment arrangements with employees shall disclose information separately for different types of awards under those arrangements to the extent that differences in the characteristics of the awards make separate disclosure important to an understanding of the entity's use of share-based compensation.

h. For each year for which an income statement is presented, both of the following:

i. Total compensation cost for share-based payment arrangements

(a) Recognized in income as well as the total recognized tax benefit related thereto

(b) Capitalized as part of the cost of an asset.

ii. A description of significant modifications, including:

(a) The terms of the modifications

(b) The number of employees affected

(c) The total incremental compensation cost resulting from the modifications.

i. As of the latest balance sheet date presented, the total compensation cost related to nonvested awards not yet recognized and the weighted-average period over which it is expected to be recognized

j. If not separately disclosed elsewhere, the amount of cash received from exercise of share options and similar instruments granted under share-based payment arrangements and the tax benefit realized from stock options exercised during the annual period

k. If not separately disclosed elsewhere, the amount of cash used to settle equity instruments granted under share-based payment arrangements

l. A description of the entity's policy, if any, for issuing shares upon share option exercise (or share unit conversion), including the source of those shares (that is, new shares or treasury shares). If as a result of its policy, an entity expects to repurchase shares in the following annual period, the entity shall disclose an estimate of the amount (or a range, if more appropriate) of shares to be repurchased during that period.

2. In addition to the information required by this issue paper, an entity may disclose supplemental information that it believes would be useful to investors and creditors, such as a range of values calculated on the basis of different assumptions, provided that the supplemental information is reasonable and does not lessen the prominence and credibility of the information required by this issue paper. The alternative assumptions shall be described to enable users of the financial statements to understand the basis for the supplemental information.

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Statutory Issue Paper No. 131

Accounting for Certain Securities Subsequent to an Other-Than-Temporary Impairment

STATUS
Finalized March 29, 2008

Current Authoritative Guidance for Certain Securities Subsequent to an Other-Than-Temporary Impairment: SSAP No. 26, SSAP No. 32 and SSAP No. 34

> *This issue paper may not be directly related to the current authoritative impairment guidance in SSAP No. 43R.*

Original SSAP from Issue Paper: SSAP No. 99

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. In November of 2005, the FASB issued *FSP FAS 115-1/124-1*: *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments* (FSP FAS 115-1/124-1) to address several issues related other-than-temporary impairment for investments. In December of 2006, the Emerging Accounting Issues Working Group of the NAIC released *INT 06-07: Definition of Phrase "Other Than Temporary"* (INT 06-07), which addressed all but two issues contained within FSP FAS 115-1/124-1. The purpose of this issue paper is to address one of those remaining issues, specifically the guidance provided in paragraph 16 of FSP FAS 115-1/124-1 regarding treatment of premium or discount for a debt security subsequent to other-than-temporary impairment recognition.

2. Current statutory guidance on accounting for impairment of debt securities, amortization of premium and accrual of discount is provided in *SSAP No. 26—Bonds, excluding Loan-backed and Structured Securities* (SSAP No. 26), *SSAP No. 32—Investments in Preferred Stock (including investments in preferred stock of subsidiary, controlled, or affiliated entities)* (SSAP No. 32), *SSAP No. 34—Investment Income Due and Accrued* (SSAP No. 34), and *SSAP No. 43—Loan-backed and Structured Securities* (SSAP No. 43).

3. Subsequent to recognition of an other-than-temporary impairment for a debt security, the GAAP guidance in FSP FAS 115-1/124-1 requires that a reporting entity account for the security as if the security had been purchased on the measurement date of the other-than-temporary impairment. As such, the recorded discount or reduced premium should be amortized over the remaining life of the security in a prospective manner based on the amount and timing of future estimated cash flows. Statutory accounting statements currently contain no explicit guidance on the issue of whether to continue amortization of premium or accrual of discount subsequent to other-than-temporary impairment recognition.

SUMMARY CONCLUSION

4. This issue paper adopts the guidance in paragraph 16 of FSP FAS 115-1/124-1, with modification to the applicable statutory accounting statements to be consistent with the statutory language in each respective statement as indicated in the following paragraphs.

Bonds, excluding Loan-backed and Structured Securities

5. The guidance in paragraphs 6 and 7 of this issue paper shall supersede the guidance in paragraph 9 of SSAP No. 26.

Impairment

6. An other-than-temporary impairment shall be considered to have occurred if it is probable that the reporting entity will be unable to collect all amounts due according to the contractual terms of a debt security in effect at the date of acquisition. A decline in fair value which is other-than-temporary includes situations where a reporting entity has made a decision to sell a security prior to its maturity at an amount below its carrying value. If it is determined that a decline in the fair value of a bond is other-than-temporary, an impairment loss shall be recognized as a realized loss equal to the entire difference between the bonds carrying value and its fair value at the balance sheet date of the reporting period for which the assessment is made. The measurement of the impairment loss shall not include partial recoveries of fair value subsequent to the balance sheet date. For reporting entities required to maintain an AVR/IMR, the accounting for the entire amount of the realized capital loss shall be in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*. Credit related other-than-temporary impairment losses shall be recorded through the AVR; interest related other-than-temporary impairment losses shall be recorded through the IMR.

7. In periods subsequent to the recognition of an other-than-temporary impairment loss for a bond, the reporting entity shall account for the other-than-temporarily impaired security as if the security had been purchased on the measurement date of the other-than-temporary impairment. The fair value of the bond on the measurement date shall become the new cost basis of the bond and the new cost basis shall not be adjusted for subsequent recoveries in fair value. The discount or reduced premium recorded for the security, based on the new cost basis, shall be amortized over the remaining life of the security in the prospective manner based on the amount and timing of future estimated cash flows. The security shall continue to be subject to impairment analysis for each subsequent reporting period. Future declines in fair value which are determined to be other-than-temporary shall be recorded as realized losses.

Preferred Stock

8. The guidance in paragraphs 9-12 of this issue paper shall supersede the guidance in paragraphs 22-24 of SSAP No. 32.

Impairment of Redeemable Preferred Stock

9. An other-than-temporary impairment shall be considered to have occurred if it is probable that the reporting entity will be unable to collect all amounts due according to the contractual terms of the security in effect at the date of acquisition. A decline in fair value which is other-than-temporary includes situations where the reporting entity has made a decision to sell a security prior to its maturity at an amount below its carrying value (i.e., amortized cost). If it is determined that a decline in the fair value of a redeemable preferred stock is other-than-temporary, an impairment loss shall be recognized as a realized loss equal to the entire difference between the redeemable preferred stock's carrying value and its fair value at the balance sheet date of the reporting period for which the assessment is made. The measurement of the impairment loss shall not include partial recoveries of fair value subsequent to the balance sheet date. For reporting entities required to maintain an AVR, realized losses shall be accounted for in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserves.*

10. In periods subsequent to the recognition of other-than-temporary impairment loss for a redeemable preferred stock, the reporting entity shall account for the other-than-temporarily impaired security as if the security had been purchased on the measurement date of the other-than-temporary impairment, and in accordance with paragraph 18 or paragraph 20 of SSAP No. 32, as applicable. The fair

value of the redeemable preferred stock on the measurement date shall become the new cost basis of the redeemable preferred stock and the new cost basis shall not be adjusted for subsequent recoveries in fair value. The discount or reduced premium recorded for the security, based on the new cost basis, shall be amortized over the remaining life of the security in the prospective manner based on the amount and timing of future estimated cash flows. The security shall continue to be subject to impairment analysis for each subsequent reporting period. Future declines in fair value which are determined to be other-than-temporary shall be recorded as realized losses.

Impairment of Perpetual Preferred Stock

11. If it is determined that a decline in the fair value of a perpetual preferred stock is other-than-temporary, an impairment loss shall be recognized as a realized loss equal to the entire difference between the perpetual preferred stock's carrying value and its fair value at the balance sheet date of the reporting period for which the assessment is made. The measurement of the impairment loss shall not include partial recoveries of fair value subsequent to the balance sheet date. For reporting entities required to maintain an AVR, realized losses shall be accounted for in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*.

12. In periods subsequent to the recognition of an other-than-temporary impairment loss for a perpetual preferred stock, the reporting entity shall account for the other-than-temporarily impaired security as if the security had been purchased on the measurement date of the other-than-temporary impairment, and in accordance with paragraph 19 or paragraph 21 of SSAP No. 32, as applicable. The fair value of the perpetual preferred stock on the measurement date shall become the new cost basis of the perpetual preferred stock and the new cost basis shall not be adjusted for subsequent recoveries in fair value. Future declines in fair value which are determined to be other-than-temporary, shall be recorded as realized losses.

Investment Income Due and Accrued

13. The guidance in SSAP No. 34, paragraph 3, shall be modified by this issue paper as follows:

> 3. In general, gross investment income shall be recorded as earned and shall include investment income collected during the period, the change in investment income due and accrued, the change in unearned investment income plus any amortization (e.g., discounts or premiums on bonds, origination fees on mortgage loans, etc.) Immediate amortization of premium which occurs upon recognition of an other-than-temporary impairment loss for a debt security with a recorded premium shall be reported as a realized loss and shall not be included in investment income.

Loan-backed and Structured Securities

14. This issue paper shall insert the following new paragraph 17 into SSAP No. 43, with subsequent paragraphs of SSAP No. 43 to be renumbered accordingly:

> 17. In periods subsequent to the recognition of an other than temporary impairment loss for a loan-backed or structured security, the reporting entity shall account for the other-than-temporarily impaired security as if the security had been purchased on the measurement date of the other-than-temporary impairment. The fair value of the security on the measurement date shall become the new cost basis. The discount or reduced premium recorded for the security, based on the new cost basis, shall be amortized in the prospective manner over the remaining period in which repayment of principal is expected to occur. The security shall continue to be subject to impairment analysis for each subsequent reporting period. The new cost basis shall not be changed for subsequent recoveries in fair value. Therefore, the prospective adjustment method

must be utilized for periods subsequent to the impairment loss recognition. Future declines in fair value which are determined to be other-than-temporary shall be recorded as realized losses.

Disclosures

15. This issue paper requires no additional disclosures.

Relevant Literature

16. This issue paper adopts FSP FAS 115-1/124-1, paragraph 16, with modification to be consistent with statutory language in the respective statutory accounting statements.

Effective Date and Transition

17. After adoption of this issue paper, it is expected that the NAIC will release a Statement of Statutory Accounting Principle (SSAP) for comment. The initial draft of the SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the Accounting Practices and Procedures Manual should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. To allow time for any necessary system related changes, it is expected that the SSAP will be effective for reporting periods ending on or after December 31, 2008.

DISCUSSION

18. Though statutory accounting statements include instructions on accounting for impaired debt securities, guidance is currently silent regarding the treatment of premium or discount subsequent to recognition of an other-than-temporary impairment loss. Prior to issuance of FSP FAS 115-1/124-1, GAAP guidance was also silent on the issue. This has led to inconsistent accounting practices.

19. The FASB guidance requires that amortization of premium or accrual of discount continues in periods subsequent to other-than-temporary impairment recognition. Statutory accounting guidance should provide for consistent accounting treatment in this subsequent period, and there appears to be no compelling reason for statutory guidance to diverge from GAAP on this issue. As such, this issue paper adopts the GAAP guidance contained in FSP FAS 115-1/124-1, paragraph 16, with modifications to be consistent with existing statutory accounting language.

20. The term “cost” is used in GAAP for evaluation, measurement and subsequent accounting treatment related to impairment of debt securities. FSP FAS 115-1 / 124-1, footnote 2 to paragraph 7, defines cost to include adjustments made to the cost basis of an investment for accretion, amortization, previous other-than-temporary impairments, and hedging. Based on this definition, cost for GAAP purposes would be the equivalent of the book adjusted carrying value relevant to statutory accounting.

21. The guidance adopted by this issue paper requires that subsequent to impairment recognition, a debt security be accounted for as if the security had been purchased on the measurement date of the other-than-temporary impairment. For debt securities carried with unamortized premium, the impairment loss is first applied to any unamortized premium, and the reduced premium is amortized over the remaining life of the security in a prospective manner based on the amount and timing of future estimated cash flows. If an impairment loss is so significant that the unamortized premium is fully expensed upon recognition of the realized loss, any remaining impairment loss is applied to the cost of the security and amortization would no longer be applicable.

22. For securities carried with unaccrued discount, the impairment loss is recorded as a reduction of cost, with no effect on the unaccrued discount. The sum of the new cost basis plus the unaccrued discount

becomes the maximum amortized value, or the maximum value to which the security is allowed to be accreted. The unaccrued discount is then accrued over the remaining life of the security based on the amount and timing of future estimated cash flows. As the carrying value shall not be adjusted for subsequent recoveries in fair value, the book adjusted carrying value shall not exceed the maximum amortized value during the remaining life of the security.

23. This exposure draft also includes clarifying guidance for SSAP No. 26 regarding the proper recording of impairment losses for reporting entities required to maintain an Asset Valuation Reserve (AVR) and an Interest Maintenance Reserve (IMR). The language was added to paragraph 6 of this issue paper to clarify that for reporting entities required to maintain such reserves, credit related other-than-temporary impairment losses are to be recorded through the AVR, while interest related other-than-temporary impairment losses are to be recorded through the IMR.

24. The guidance adopted by this issue paper is consistent with the concepts of statutory accounting.

Drafting Notes/Comments

25. None

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

26. Statutory guidance for amortization of premium, accrual of discount, and impairment for bonds, excluding loan-backed and structured securities, is provided in SSAP No. 26:

> Amortized Cost
>
> 6. Amortization of bond premium or discount shall be calculated using the scientific (constant yield) interest method taking into consideration specified interest and principal provisions over the life of the bond. Bonds containing call provisions (where the issue can be called away from the reporting entity at the issuer's discretion) shall be amortized to the call or maturity value/date which produces the lowest asset value (yield to worst).
>
> Impairment
>
> 9. If it is determined that a decline in the fair value of a bond is other than temporary, the cost basis of the bond shall be written down to fair value as a new cost basis and the amount of the write down shall be accounted for as a realized loss. The new cost basis shall not be changed for subsequent recoveries in fair value. Future declines in fair value which are determined to be other than temporary, shall be recorded as realized losses. An impairment shall be considered to have occurred if it is probable that the reporting entity will be unable to collect all amounts due according to the contractual terms of a debt security in effect at the date of acquisition. A decline in fair value which is other than temporary includes situations where a reporting entity has made a decision to sell a security prior to its maturity at an amount below its carrying value.

27. Statutory guidance for amortization of premium, accrual of discount, and impairment for preferred stock is provided in SSAP No. 32:

> Amortization
>
> 12. Redeemable preferred stock purchased at a premium shall be amortized to reduce the carrying value to the call or redemption value over the period to the call or earliest redemption date, whichever produces the lowest asset value (yield to worst). Redeemable preferred stock

purchased at a discount shall be amortized to increase the carrying value to par value over the period to maturity or the latest redemption date.

13. PIK preferred stock shall be amortized to the lower of the call price or par value, measured in either case at the end of the stock dividend period and based on all of the shares expected to be held at the end of that period, including those received as dividends.

14. Amortization shall be calculated using the interest method and shall be reported as increases or decreases in dividends collected during the year.

Impairment

22. If it is determined that a decline in the fair value of a preferred stock is other than temporary, the preferred stock shall be written down to fair value as a new cost basis and the amount of the write down shall be accounted for as a realized loss. For those reporting entities required to maintain an AVR, realized losses shall be accounted for in accordance with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve.

23. Perpetual preferred stock shall be accounted for in accordance with paragraph 19 or paragraph 21, as applicable, subsequent to the recognition of an other than temporary impairment. Future declines in fair value which are determined to be other than temporary, shall be recorded as realized losses. A decline in fair value which is other than temporary includes situations where the reporting entity has made a decision to sell a security at an amount below its carrying value.

24. Redeemable preferred stock shall be accounted for in accordance with paragraph 18 or paragraph 20, as applicable, subsequent to the recognition of an other than temporary impairment. Future declines in fair value which are determined to be other than temporary, shall be recorded as realized losses. An impairment shall be considered to have occurred if it is probable that the reporting entity will be unable to collect all amounts due according to the contractual terms of the security in effect at the date of acquisition. A decline in fair value which is other than temporary includes situations where the reporting entity has made a decision to sell a security prior to its maturity at an amount below its carrying value (i.e., amortized cost).

28. Statutory guidance in SSAP No. 34 provides items to be included in gross investment income:

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for investment income due and accrued.

SUMMARY CONCLUSION

2. Investment income due shall be defined as investment income earned and legally due to be paid to the reporting entity (i.e., receivable) as of the reporting date. Investment income accrued shall be defined as investment income earned as of the reporting date but not legally due to be paid to the reporting entity until subsequent to the reporting date.

3. In general, gross investment income shall be recorded as earned and shall include investment income collected during the period, the change in investment income due and accrued, the change in unearned investment income plus any amortization (e.g., discounts or premiums on bonds, origination fees on mortgage loans, etc.).

4. Investment income due and accrued shall be recorded as an asset in accordance with SSAP No. 4—Assets and Nonadmitted Assets (SSAP No. 4). An evaluation shall be made of such assets in accordance with SSAP No. 5—Liabilities, Contingencies and Impairments of Assets (SSAP No. 5), to determine whether an impairment exists. Amounts determined to be uncollectible shall be written off through the statement of operations. Then an evaluation shall be made to determine nonadmitted amounts.

5. This two-step process is set forth below.

a. Investment income due and accrued shall be assessed for collectibility. If, in accordance with SSAP No. 5, it is probable the investment income due and accrued balance is uncollectible, the amount shall be written off and shall be charged against investment income in the period such determination is made;

b. Any remaining investment income due and accrued (i.e., amounts considered probable of collection) representing either (1) amounts that are over 90 days past due (generated by any invested asset except mortgage loans in default), or (2) amounts designated elsewhere in the Accounting Practices and Procedures Manual as nonadmitted shall be considered nonadmitted assets and recognized through a direct charge to surplus in accordance with SSAP No. 4. These nonadmitted amounts shall be subject to continuing assessments of collectibility and, if determined to be uncollectible, a write-off shall be recorded in the period such determination is made in accordance with subparagraph a. above.

6. Accrued interest on mortgage loans that are in default (as defined in SSAP No. 37—Mortgage Loans) shall be recorded as Investment Income Due and Accrued when such interest is deemed collectible. Interest can be accrued on mortgage loans in default if deemed collectible; if interest is deemed uncollectible, it shall not be accrued and any previously accrued amounts are to be written off in accordance with the guidelines in paragraph 5.a. above. If a mortgage loan in default has interest 180 days past due which has been assessed as collectible, all interest shall be considered a nonadmitted asset and recognized through a direct charge to surplus as outlined in paragraph 5.b. above.

29. Statutory guidance for amortization of premium, accrual of discount, and impairment for loan-backed and structured securities is provided in SSAP No. 43:

Amortization

7. Amortization of premium or discount shall be calculated using the scientific (constant yield) interest method and shall be recorded as an adjustment to investment income. The interest method results in a constant effective yield equal to the prevailing rate at the time of purchase or at the time of subsequent adjustments to book value. The amortization period shall reflect estimates of the period over which repayment of principal of the loan-backed securities is expected to occur, not the stated maturity period.

Impairment

16. Regardless of whether a reporting entity is using a prospective or retrospective method, if the revaluation based on new currently estimated cash flows results in a negative yield (i.e., undiscounted estimated future cash flows are less than the current book value), an other than temporary impairment shall be considered to have occurred. If it is determined an other than temporary impairment has occurred, the cost basis of the security shall be written down to the undiscounted estimated future cash flows and the amount of the write down shall be accounted for as a realized loss. For reporting entities required to maintain an AVR/IMR, the accounting for the entire amount of the realized capital loss shall be in accordance with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve. The new cost basis shall not be changed for subsequent recoveries in fair value. Therefore, the prospective adjustment method must be utilized for periods subsequent to the loss recognition.

Generally Accepted Accounting Principles

30. FSP FAS 115-1/124-1, paragraph 16 contains the GAAP guidance which is addressed by this issue paper:

> Accounting for Debt Securities Subsequent to an Other-Than-Temporary Impairment
>
> 16. In periods subsequent to the recognition of an other-than-temporary impairment loss for debt securities, an investor shall account for the other-than-temporarily impaired debt security as if the debt security had been purchased on the measurement date of the other-than-temporary impairment. That is, the discount or reduced premium recorded for the debt security, based on the new cost basis, would be amortized over the remaining life of the debt security in a prospective manner based on the amount and timing of future estimated cash flows.

31. Footnote 2 to paragraph 7 of FSP FAS 115-1/124-1, provides the GAAP definition of cost, which is used in impairment evaluation:

> Cost includes adjustments made to the cost basis of an investment for accretion, amortization, previous other-than-temporary impairments, and hedging.

RELEVANT LITERATURE

Statutory Accounting

- SSAP No. 26—*Bonds, excluding Loan-Backed and Structured Securities*
- SSAP No. 32—*Investments in Preferred Stock (including investments in preferred stock of subsidiary, controlled, or affiliated entities)*
- SSAP No. 43—*Loan-Backed and Structured Securities*

Generally Accepted Accounting Principles

- FASB Staff Position FAS 115-1/124-1

State Regulations

- No additional guidance obtained from state statutes or regulations.

Statutory Issue Paper No. 132

Accounting for Pensions, A Replacement of SSAP No. 89

STATUS:
Initially Adopted – December 5, 2008
Adopted to Reflect SSAP No. 102 – December 18, 2012

Original SSAP and Current Authoritative Guidance: SSAP No. 102

Type of Issue:
Common Area

SUMMARY OF ISSUE:

1. In September 2006, the Financial Accounting Standards Board (FASB) issued *FASB Statement No. 158: Accounting for Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106 and 132(R)* (FAS 158). The adoption with modification of FAS 158 requires entities that sponsor one or more single-employer defined benefit plan to:

   a. Recognize the overfunded or underfunded status of a defined benefit postretirement plan (other than a multiemployer plan) as an asset or liability in the statement of financial position.

   b. Aggregate the statuses of all overfunded plans and recognize that amount as a nonadmitted asset in its statement of financial position. It also shall aggregate the statuses of all underfunded plans and recognize that amount as a liability in its statement of financial position.

   c. Recognize as a component of unassigned funds (surplus) the gains and losses and prior service costs or credits that arise during the period but were not recognized as components of net periodic benefit cost of the period pursuant to SSAP No. 89 and SSAP No. 14.

   d. Recognize corresponding adjustments in unassigned funds (surplus) when the gains and losses, prior service costs or credits and transition assets and obligations remaining from the initial application of SSAP No. 89 and SSAP No. 14 are subsequently recognized as components of net periodic benefit cost pursuant to the recognition and amortization provisions of SSAP No. 89 and SSAP No. 14.

2. Current statutory accounting guidance for pensions is provided within *SSAP No. 89—Accounting for Pension, A Replacement of SSAP No. 8* (SSAP No. 89). The conclusions reached in SSAP No. 89 resulted from adoption *of FASB Statement No. 87: Employers' Accounting for Pensions* (FAS 87), *FASB Statement No. 88: Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits* (FAS 88), *FASB Statement No. 132, Employers' Disclosures about Pensions and Other Postretirement Benefits an amendment of FASB Statements No. 87, 88, and 106* (FAS 132) with certain modifications and *FASB Statement No. 132 (R), Employers' Disclosures about Pensions and Other Postretirement Benefits, and amendment of FASB Statements No. 87, 88, and 106* (FAS 132R) with certain modifications.

3. The purpose of this issue paper is to update statutory accounting principles for pensions, including both defined benefit plans and defined contribution plans. Consequently, this issue paper adopts FAS 158 with modifications considered necessary for consistent statutory reporting. The result will be a new SSAP (SSAP No. 102) superseding SSAP No. 89.

SCOPE OF STATEMENT

4. This issue paper establishes financial accounting and reporting standards for an insurer that offers pension benefits to its employees. Ordinarily, such benefits are periodic pension payments to retired employees or their survivors, but they may also include benefits payable as a single lump sum and other types of benefits, such as death benefits provided through a pension plan. (This issue paper does not apply to life insurance benefits provided outside a pension plan or postretirement health and welfare benefits.) Arrangements to provide pension benefits may take a variety of forms and may be financed in different ways. This issue paper applies to any arrangement that is similar in substance to a pension plan regardless of form or financing. This issue paper applies to a written plan and to a plan whose existence may be implied from a well-defined, although perhaps unwritten, practice of paying postretirement benefits. This issue paper supersedes the guidance in *SSAP No. 89—Accounting for Pensions, A Replacement of SSAP No. 8* (SSAP No. 89), nullifies and incorporates the guidance in *Interpretation 99-26: Offsetting Pension Assets and Liabilities* (INT 99-26)*,* and *INT 04-12: Determining the Classification and Benefit Attribution Method for a Cash Balance Pension Plan* (INT 04-12), and nullifies *INT 01-16: Measurement Date for SSAP No. 8 Actuarial Valuations* (INT 01-16), *INT 03-18—Accounting for a Change in the Additional Minimum Liability in SSAP No. 8 (INT 03-18)* and *INT 04-03: Clarification for Calculating the Additional Minimum Pension Liability under SSAP No. 89* (INT 04-03) This issue paper also modifies *INT 04-17: Impact of Medicare Modernization on Postretirement Benefits* (INT 04-17) to remove reference to pensions as this interpretation only addresses postretirement benefits other than pensions.

SUMMARY CONCLUSION

Defined Benefit Plans

Single-Employer Defined Benefit Pension Plans

5. A defined benefit pension plan is one that defines an amount of pension benefit to be provided, usually as a function of one or more factors such as age, years of service, or compensation. (Hybrid pension plans that refer to an account balance, rather than a monthly annuity at retirement (also known as cash balance plans) are considered defined benefit plans for purposes of applying this issue paper.) For defined benefit plans, reporting entities shall adopt *FAS 158: Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106, and 132(R)* and *FASB Staff Position FAS 136(R)-1, Employers' Disclosures about Postretirement Benefit Plan Assets* (FSP FAS 136(R)-1), with modifications as discussed within paragraph 83.

6. A pension benefit is part of the compensation paid to an employee for services. In a defined benefit pension plan, the employer promises to provide, in addition to current wages, retirement income payments in future years after the employee retires or terminates service. Generally, the amount of benefit to be paid depends on a number of future events that are incorporated in the plan's benefit formula, often including how long the employee and any survivors live, how many years of service the employee renders, and the employee's compensation in the years immediately before retirement or termination. In most cases, services are rendered over a number of years before an employee retires and begins collecting the pension. Even though the services rendered by an employee are complete and the employee has retired, the total amount of benefit that the employer has promised and the cost to the employer of the services rendered are not precisely determinable but can only be estimated using the benefit formula and estimates of the relevant future events, many of which the employer cannot control.

Elements of Pension Accounting

7. Net periodic pension cost is made up of several components that reflect different aspects of the employer's financial arrangements as well as the cost of benefits earned by employees. The cost of a benefit can be determined without regard to how the employer decides to finance the plan. The service cost component of net periodic pension cost is the actuarial present value of benefits attributed by the plan's benefit formula to services rendered by employees during the period. The service cost component is conceptually the same for an unfunded plan, a plan with minimal funding, and a well-funded plan. The other components of net periodic pension cost are interest cost (interest on the projected benefit obligation, which is a discounted amount), actual[1] return on plan assets, amortization of any prior service cost or credit included in unassigned funds (surplus), and gain or loss, which includes, to the extent recognized, amortization of the net gain or loss included in unassigned funds (surplus) (refer to paragraph 26).

8. The projected benefit obligation is the actuarial present value of all benefits attributed by the plan's benefit formula to employee service rendered prior to that date. The projected benefit obligation is measured using an assumption as to future compensation levels if the pension benefit formula is based on those future compensation levels. The projected benefit obligation is a measure of benefits attributed to service to date assuming that the plan continues in effect and that estimated future events (including compensation increases, turnover, and mortality) occur.

9. The accumulated benefit obligation is the actuarial present value of benefits attributed by the pension benefit formula to employee service rendered prior to that date and based on current and past compensation levels. The accumulated benefit obligation differs from the projected benefit obligation in that it includes no assumption about future compensation levels. For plans with flat-benefit or non-pay-related pension benefit formulas, the accumulated benefit obligation and the projected benefit obligation are the same.

10. Plan assets are assets that have been segregated and restricted to provide for pension benefits. The amount of plan assets includes amounts contributed by the employer and amounts earned from investing the contributions, less benefits paid. Assets not segregated in a trust or otherwise effectively restricted so that they cannot be used by the employer for other purposes are not considered plan assets even though it may be intended that such assets be used to provide for pension benefits. Amounts accrued by the employer but not yet paid to the plan are also not considered plan assets. Securities of the employer held by the plan are includable in plan assets provided they are transferable.

Recognition of Net Periodic Pension Cost

11. The following components shall be included in the net pension cost for a period by an employer sponsoring a defined benefit pension plan: a) Service cost; b) Interest cost; c) Actual return on plan assets; d) Amortization of any prior service cost or credit included in unassigned funds (surplus); e) Gain or loss (including the effects of changes in assumptions) to the extent recognized; and f) Amortization of any net transition asset or obligation existing at the date of initial application of this issue paper and remaining in unassigned funds (surplus).

[1] To address a question on how the expected return on plan assets affects the determination of net periodic pension cost if the actual return on plan assets for a period is a component of net periodic pension cost, it is noted that the expected return on plan assets generally will be different from the actual return on plan assets for the year. This statement provides for recognition of that difference (a net gain or loss) in unassigned funds in the period it arises. The amount recognized in unassigned funds is also a component of net periodic pension cost for the current period. Thus, the amount recognized in unassigned funds and the actual return on plan assets, when aggregated, equal the expected return on plan assets. The amount recognized in unassigned funds affects future net periodic pension cost through subsequent amortization, if any, of the net gain or loss. (This footnote reflects guidance included in E12 of FSP FAS 158-1.)

Service Cost

12. The service cost component recognized in a period shall be determined as the actuarial present value of benefits attributed by the pension benefit formula to employee service (including both vested and nonvested employees) during that period.

13. The prior service cost for nonvested employees not previously recognized[2] is not required to be included in net periodic pension cost entirely in the year this issue paper is adopted. Unrecognized prior service cost for nonvested employees shall be amortized as a component of net periodic pension cost by assigning an equal amount to each expected future period of service before vesting occurs for nonvested employees active at the date of the amendment. Unassigned funds (surplus) is adjusted each period as prior service cost is amortized (refer to paragraphs 85-87 for transition guidance related to the recognition of the prior service cost for nonvested employees though unassigned surplus).

Interest Cost

14. The interest cost component recognized in a period shall be determined as the increase in the projected benefit obligation due to the passage of time. Measuring the projected benefit obligation as a present value requires accrual of an interest cost at rates equal to the assumed discount rates.

Actual Return on Plan Assets

15. For a funded plan, the actual return on plan assets shall be determined based on the fair value of plan assets at the beginning and the end of the period, adjusted for contributions and benefit payments.

Prior Service Cost

16. Plan amendments (including initiation of a plan) often include provisions that grant increased benefits based on services rendered in prior periods. Because plan amendments are granted with the expectation that the employer will realize economic benefits in future periods, the cost of providing such retroactive benefits (prior service cost) is not required to be included in net periodic pension cost entirely in the year of the amendment but provides for recognition during the future service periods of those employees active at the date of the amendment who are expected to receive benefits under the plan.

17. A plan amendment that retroactively increases benefits (including benefits that are granted to retirees) increases the projected benefit obligation. The cost of the benefit improvement shall be recognized as a charge to unassigned funds (surplus) at the date of the amendment. Except as specified in paragraphs 18-19, that prior service cost shall be amortized as a component of net periodic pension cost by assigning an equal amount to each future period of service of each employee active at the date of the amendment who is expected to receive benefits under the plan. If all or almost all of a plan's participants are inactive, the cost of retroactive plan amendments affecting benefits of inactive participants shall be amortized based on the remaining life expectancy of those participants instead of based on the remaining service period. Unassigned funds (surplus) is adjusted each period as prior service cost is amortized.

18. Consistent use of an alternative approach that more rapidly amortizes the cost of retroactive amendments is acceptable. For example, a straight-line amortization of the cost over the average remaining service period of employees expected to receive benefits under the plan is acceptable. The alternative method used shall be disclosed.

[2] The previous statutory accounting guidance in *SSAP No. 89—Accounting for Pensions, A Replacement of SSAP No. 8* excluded nonvested employees from the service cost calculation. This exclusion has been eliminated with the issuance of this issue paper.

19. In some situations a history of regular plan amendments and other evidence may indicate that the period during which the employer expects to realize economic benefits from an amendment granting retroactive benefits is shorter than the entire remaining service period of the active employees. Identification of such situations requires an assessment of the individual circumstances and the substance of the particular plan situation. In those circumstances, the amortization of prior service cost shall be accelerated to reflect the more rapid expiration of the employer's economic benefits and to recognize the cost in the periods benefited.

20. A plan amendment that retroactively reduces, rather than increases, benefits decreases the projected benefit obligation. The reduction in benefits shall be recognized as a credit (prior service credit) to unassigned funds (surplus) that shall be used first to reduce any remaining prior service cost included in unassigned funds (surplus). Any remaining prior service credit shall be amortized as a component of net periodic pension cost on the same basis as the cost of a benefit increase.

Gains and Losses

21. Gains and losses are changes in the amount of either the projected benefit obligation or plan assets resulting from experience different from that assumed and from changes in assumptions. This issue paper does not distinguish between those sources of gains and losses. Gains and losses include amounts that have been realized, as well as amounts that are unrealized. Because gains and losses may reflect refinements in estimates as well as real changes in economic values and because some gains in one period may be offset by losses in another or vice versa, recognition of gains and losses as components of net pension cost of the period in which they arise is not required. Gains and losses that are not recognized immediately as a component of net periodic pension cost shall be recognized as increases or decreases in unassigned funds (surplus) as they arise.

22. The expected return on plan assets shall be determined based on the expected long-term rate of return on plan assets and the fair value of plan assets.

23. Asset gains and losses are differences between the actual return on assets during a period and the expected return on assets for that period. Asset gains and losses include changes reflected in the fair value of assets.

24. As a minimum, amortization of a net gain or loss included in unassigned funds (surplus) shall be included as a component of net pension cost for a year if, as of the beginning of the year, that net gain or loss exceeds 10 percent of the greater of the projected benefit obligation or the fair value of plan assets. If amortization is required, the minimum amortization shall be that excess divided by the average remaining service period of active employees expected to receive benefits under the plan. If all or almost all of a plan's participants are inactive, the average remaining life expectancy of the inactive participants shall be used instead of average remaining service.

25. Any systematic method of amortizing gains or losses may be used in lieu of the minimum specified in the previous paragraph provided that (a) the minimum is used in any period in which the minimum amortization is greater (reduces the net balance included in unassigned funds (surplus) by more), (b) the method is applied consistently, (c) the method is applied similarly to both gains and losses, and (d) the method used is disclosed.

26. The gain or loss component of net periodic pension cost shall consist of (a) the difference between the actual return on plan assets and the expected return on plan assets and (b) amortization of the net gain or loss included in unassigned funds (surplus).

Recognition of Liabilities and Assets

27. If the projected benefit obligation (considering both vested and nonvested participants) exceeds the fair value of plan assets, the employer shall recognize in its statement of financial position a liability that equals the unfunded projected benefit obligation. If the fair value of plan assets exceeds the projected benefit obligation, the employer shall recognize in its statement of financial position an asset that equals the overfunded projected benefit obligation. This prepaid asset resulting from the excess of the fair value of plan assets over the projected benefit obligation shall be nonadmitted.

28. If multiple single-employer plans exist, the employer shall aggregate the statuses of all overfunded plans and recognize that amount as an asset in its statement of financial position. It also shall aggregate the statuses of all underfunded plans and recognize that amount as a liability in its statement of financial position. It is not acceptable statutory accounting practice to offset pension or postretirement benefits other than pensions liability generated by one plan against the prepaid assets of another plan.

29. The asset or liability that is recognized pursuant to paragraph 27 may result in a temporary difference, as defined in *SSAP No. 101—Income Taxes – A Replacement of SSAP No. 10R and 10* (SSAP No. 101). The deferred tax effects of any temporary differences shall be recognized in income tax expense or benefit for the year and shall be allocated pursuant to SSAP No. 101.

30. If a new determination of the funded status of a plan to be recognized as an asset or a liability in the employer's statement of financial position is made, or when net gains or losses, prior service costs or credits, or the net transition asset or obligation existing at the date of initial application of this issue paper are amortized as components of net periodic pension cost, the related balances for those net gains or losses, prior service costs or credits, and transition asset or obligation in unassigned funds (surplus) shall be adjusted as necessary and reported in unassigned funds (surplus).

Measurement of Cost and Obligations

31. The service component of net periodic pension cost, the projected benefit obligation, and the accumulated benefit obligation are based on an attribution of pension benefits to periods of employee service and on the use of actuarial assumptions to calculate the actuarial present value of those benefits. Actuarial assumptions reflect the time value of money (discount rate) and the probability of payment (assumptions as to mortality, turnover, early retirement, and so forth).

Attribution

32. Pension benefits ordinarily shall be attributed to periods of employee service based on the plan's benefit formula to the extent that the formula states or implies an attribution. In some situations a history of regular increases and other evidence may indicate that an employer has a present commitment to make future amendments and that the substance of the plan is to provide benefits attributable to prior service that are greater than the benefits defined by the written terms of the plan. In those situations, the substantive commitment shall be the basis for the accounting, and the existence and nature of the commitment to make future amendments shall be disclosed.

33. In some situations a history of regular increases in non-pay-related benefits or benefits under a career-average-pay plan and other evidence may indicate that an employer has a present commitment to make future amendments and that the substance of the plan is to provide benefits attributable to prior service that are greater than the benefits defined by the written terms of the plan. In those situations, the substantive commitment shall be the basis for the accounting, and the existence and nature of the commitment to make future amendments shall be disclosed.

34. Some plans may have benefit formulas that attribute all or a disproportionate share of the total benefits provided to later years of service, thereby achieving in substance a delayed vesting of benefits. For such plans the total projected benefit shall be considered to accumulate in proportion to the ratio of the number of completed years of service to the number that will have been completed when the benefit is first fully vested. If a plan's benefit formula does not specify how a particular benefit relates to services rendered, the benefit shall be considered to accumulate as follows:

a. For benefits of a type includable in vested benefits, in proportion to the ratio of the number of completed years of service to the number that will have been completed when the benefit is first fully vested.

b. For benefits of a type not includable in vested benefits, in proportion to the ratio of completed years of service to total projected years of service.

Assumptions

35. Each significant actuarial assumption used shall reflect the best estimate solely with respect to that individual assumption. All assumptions shall presume that the plan will continue in effect in the absence of evidence that it will not continue.

36. Assumed discount rates shall reflect the rates at which the pension benefits could be effectively settled. It is appropriate in estimating those rates to look to available information about rates implicit in current prices of annuity contracts that could be used to effect settlement of the obligation. In making those estimates, employers may also look to rates of return on high-quality fixed-income investments currently available and expected to be available during the period to maturity of the pension benefits. Assumed discount rates are used in measurements of the projected, accumulated, and vested benefit obligations and the service and interest cost components of net periodic pension cost.

37. The objective of selecting assumed discount rates using the method noted in paragraph 36 is to measure the single amount that, if invested at the measurement date in a portfolio of high-quality debt instruments, would provide the necessary future cash flows to pay the pension benefits when due. Notionally, that single amount, the projected benefit obligation, would equal the fair value of a portfolio of high-quality zero coupon bonds whose maturity dates and amounts would be the same as the timing and amount of the expected future benefit payments. Because cash inflows would equal cash outflows in timing and amount, there would be no reinvestment risk in the yields to maturity of the portfolio. However, in other than a zero coupon portfolio, such as a portfolio of long-term debt instruments that pay semiannual interest payments or whose maturities do not extend far enough into the future to meet expected benefit payments, the assumed discount rates (the yield to maturity) need to incorporate expected reinvestment rates available in the future. Those rates shall be extrapolated from the existing yield curve at the measurement date. The determination of the assumed discount rate is separate from the determination of the expected rate of return on plan assets whenever the actual portfolio differs from the hypothetical portfolio above. Assumed discount rates shall be reevaluated at each measurement date. If the general level of interest rates rises or declines, the assumed discount rates shall change in a similar manner.

38. The expected long-term rate of return on plan assets shall reflect the average rate of earnings expected on the funds invested or to be invested to provide for the benefits included in the projected benefit obligation. In estimating that rate, appropriate consideration should be given to the returns being earned by the plan assets in the fund and the rates of return expected to be available for reinvestment. The expected long-term rate of return on plan assets is used to compute the expected return on assets.

39. The service cost component of net periodic pension cost and the projected benefit obligation shall reflect future compensation levels to the extent that the pension benefit formula defines pension benefits

wholly or partially as a function of future compensation levels. Future increases for which a present commitment exists shall be similarly considered. Assumed compensation levels shall reflect an estimate of the actual future compensation levels of the individual employees involved, including future changes attributed to general price levels, productivity, seniority, promotion, and other factors. All assumptions shall be consistent to the extent that each reflects expectations of the same future economic conditions, such as future rates of inflation. Measuring service cost and the projected benefit obligation based on estimated future compensation levels entails considering indirect effects, such as changes under existing law in social security benefits or benefit limitations that would affect benefits provided by the plan.

40. The accumulated benefit obligation shall be measured based on employees' history of service and compensation without an estimate of future compensation levels. Excluding estimated future compensation levels also means excluding indirect effects of future changes such as increases in the social security wage base. In measuring the accumulated benefit obligation, projected years of service shall be a factor only in determining employees' expected eligibility for particular benefits, such as:

a. Increased benefits that are granted provided a specified number of years of service are rendered

b. Early retirement benefits

c. Death benefits

d. Disability benefits

41. Automatic benefit increases specified by the plan (for example, automatic cost-of-living increases) that are expected to occur shall be included in measurements of the projected, accumulated, and vested benefit obligations, and the service cost component. Also, retroactive plan amendments shall be included in the computation of the projected and accumulated benefit obligations once they have been contractually agreed to, even if some provisions take effect only in future periods.

Measurement of Plan Assets

42. Plan investments, whether equity or debt securities, real estate, or other, shall be measured at their fair value as of the measurement date. The fair value of an investment shall be reduced by brokerage commissions and other costs normally incurred in a sale, if those costs are significant (similar to fair value less costs to sell).

43. Plan assets used in plan operations (for example, buildings, equipment, furniture and fixtures, and leasehold improvements) shall be measured at cost less accumulated depreciation or amortization for all purposes.

44. The measurements of plan assets and benefit obligations shall be as of the date of the employer’s fiscal year-end statement of financial position. Requiring that the pension measurements be as of a particular date is not intended to require that all procedures be performed after that date. As with other financial statement items requiring estimates, much of the information can be prepared as of an earlier date and projected forward to account for subsequent events (for example, employee service). Unless a business entity remeasures both its plan assets and benefit obligations during the fiscal year, the funded status it reports in its interim-period statement of financial position shall be the same asset or liability recognized in the previous year-end statement of financial position adjusted for (1) subsequent accruals of net periodic pension cost that exclude the amortization of amounts previously recognized in other unassigned funds (surplus) (for example, subsequent accruals of service cost, interest cost, and return on plan assets) and (2) contributions to a funded plan, or benefit payments. Sometimes, a business entity remeasures both plan assets and benefit obligations during the fiscal year. That is the case, for example,

when a significant event such as a plan amendment, settlement, or curtailment occurs that calls for a remeasurement. Upon remeasurement, a business entity shall adjust its statement of financial position in a subsequent interim period to reflect the overfunded or underfunded status of the plan consistent with that measurement date.

45. Measurements of net periodic pension cost for both interim and annual financial statements shall be based on the assumptions used for the previous year-end measurements unless more recent measurements of both plan assets and obligations are available or a significant event occurs, such as a plan amendment, that would ordinarily call for such measurements.

Employers with Two or More Plans

46. An employer that sponsors two or more separate defined benefit pension plans shall determine net periodic pension cost, liabilities, and assets by separately applying the provisions of this issue paper to each plan. In particular, unless an employer clearly has a right to use the assets of one plan to pay benefits of another, a liability required to be recognized for one plan shall not be reduced or eliminated because the employer has recognized an asset for another plan that has assets in excess of its projected benefit obligation. (As noted within paragraph 28, overfunded plans shall be aggregated for asset reporting (nonadmitted) and underfunded plans shall be aggregated for liability reporting.)

Annuity Contracts

47. An annuity contract is a contract in which an insurance company unconditionally undertakes a legal obligation to provide specified benefits to specific individuals in return for a fixed consideration or premium. An annuity contract is irrevocable and involves the transfer of significant risk from the employer to the insurance company. Some annuity contracts (participating annuity contracts) provide that the purchaser (either the plan or the employer) may participate in the experience of the insurance company. Under those contracts, the insurance company ordinarily pays dividends to the purchaser. If the substance of a participating contract is such that the employer remains subject to all or most of the risks and rewards associated with the benefit obligation covered and the assets transferred to the insurance company, that contract is not an annuity contract for purposes of this issue paper.

48. To the extent that benefits currently earned are covered by annuity contracts, the cost of those benefits shall be the cost of purchasing the contracts, except as provided in paragraph 51. That is, if all the benefits attributed by the plan's benefit formula to service in the current period are covered by nonparticipating annuity contracts, the cost of the contracts determines the service cost component of net pension cost for that period.

49. Benefits provided by the pension benefit formula beyond benefits provided by annuity contracts (for example, benefits related to future compensation levels) shall be accounted for according to the provisions of this issue paper applicable to plans not involving insurance contracts.

50. Benefits covered by annuity contracts shall be excluded from the projected benefit obligation and the accumulated benefit obligation. Except as provided in paragraph 51, annuity contracts shall be excluded from plan assets.

51. Some annuity contracts provide that the purchaser (either the plan or the employer) may participate in the experience of the insurance company. Under those contracts, the insurance company ordinarily pays dividends to the purchaser, the effect of which is to reduce the cost of the plan. The purchase price of a participating annuity contract ordinarily is higher than the price of an equivalent contract without participation rights. The difference is the cost of the participation right. The cost of the participation right shall be recognized at the date of purchase as a nonadmitted asset. In subsequent periods, the participation right shall be nonadmitted and measured at its fair value if the contract is such

that fair value is reasonably estimable. Otherwise, the participation right shall be measured at its amortized cost (not in excess of its net realizable value), and the cost shall be amortized systematically over the expected dividend period under the contract.

Other Contracts with Insurance Companies

52. Insurance contracts that are in substance equivalent to the purchase of annuities shall be accounted for as such. Other contracts with insurance companies shall be accounted for as investments and measured at fair value. For some contracts, the best available evidence of fair value may be contract value. If a contract has a determinable cash surrender value or conversion value, that is presumed to be its fair value.

Defined Benefit Plans – Settlements and Curtailments

53. A settlement is defined as a transaction that (a) is an irrevocable action, (b) relieves the employer (or the plan) of primary responsibility for a pension benefit obligation, and (c) eliminates significant risks related to the obligation and the assets used to effect the settlement. Examples of transactions that constitute a settlement include (a) making lump-sum cash payments to plan participants in exchange for their rights to receive specified pension benefits and (b) purchasing nonparticipating annuity contracts to cover vested benefits.

54. A transaction that does not meet all of the above three criteria does not constitute a settlement for purposes of this issue paper. For example, investing in a portfolio of high-quality fixed-income securities with principal and interest payment dates similar to the estimated payment dates of benefits may avoid or minimize certain risks. However, that does not constitute a settlement because the investment decision can be reversed and such a strategy does not relieve the employer (or the plan) of primary responsibility for a pension obligation nor does it eliminate significant risks related to the obligation.

Annuity Contracts

55. The definition of an annuity contract is included in paragraph 47. If the substance of a participating annuity contract is such that the employer remains subject to all or most of the risks and rewards associated with the benefit obligation covered or the assets transferred to the insurance company, the purchase of the contract does not constitute a settlement.

Curtailment

56. A curtailment is an event that significantly reduces the expected years of future service of present employees or eliminates for a significant number of employees the accrual of defined benefits for some or all of their future services. Curtailments include:

a. Termination of employees' services earlier than expected, which may or may not involve closing a facility or discontinuing a component of an entity.

b. Termination or suspension of a plan so that employees do not earn additional defined benefits for future services. In the latter situation, future service may be counted toward vesting of benefits accumulated based on past service.

Relationship of Settlements and Curtailments to Other Events

57. A settlement and a curtailment may occur separately or together. If benefits to be accumulated in future periods are reduced but the plan remains in existence and continues to pay benefits, to invest assets, and to receive contributions, a curtailment has occurred but not a settlement. If an employer purchases

nonparticipating annuity contracts for vested benefits and continues to provide defined benefits for future service, either in the same plan or in a successor plan, a settlement has occurred but not a curtailment. If a plan is terminated (that is, the obligation is settled and the plan ceases to exist) and not replaced by a successor defined benefit plan, both a settlement and a curtailment have occurred (whether or not the employees continue to work for the employer).

Accounting for the Settlement of the Pension Obligation

58. The maximum gain or loss subject to recognition in earnings when a pension obligation is settled is the net gain or loss remaining in unassigned funds (surplus) plus any transition asset remaining in unassigned funds (surplus) from initial application of SSAP No. 89. That maximum amount includes any gain or loss first measured at the time of settlement. The maximum amount shall be recognized in earnings if the entire projected benefit obligation is settled. If only part of the projected benefit obligation is settled, the employer shall recognize in earnings a pro rata portion of the maximum amount equal to the percentage reduction in the projected benefit obligation.

59. If the purchase of a participating annuity contract constitutes a settlement, the maximum gain (but not the maximum loss) shall be reduced by the cost of the participation right before determining the amount to be recognized in earnings.

60. If the cost of all settlements in a year is less than or equal to the sum of the service cost and interest cost components of net periodic pension cost for the plan for the year, gain or loss recognition is permitted but not required for those settlements. However, the accounting policy adopted shall be applied consistently from year to year.

Accounting for a Plan Curtailment

61. The prior service cost included in unassigned funds (surplus) associated with years of service no longer expected to be rendered as the result of a curtailment is a loss. For example, if a curtailment eliminates half of the estimated remaining future years of service of those who were employed at the date of a prior plan amendment and were expected to receive benefits under the plan, then the loss associated with the curtailment is half of the prior service cost included in unassigned funds (surplus) related to that amendment that has not been amortized as a component of net periodic pension cost. For purposes of applying the provisions of this paragraph, prior service cost includes the cost of retroactive plan amendments and any transition obligation remaining in unassigned funds (surplus) from initial application of SSAP No. 89.

62. The projected benefit obligation may be decreased (a gain) or increased (a loss) by a curtailment.

a. To the extent that such a gain exceeds any net loss included in unassigned funds (surplus) (or the entire gain, if a net gain exists), it is a curtailment gain.

b. To the extent that such a loss exceeds any net gain included in unassigned funds (surplus) (or the entire loss, if a net loss exists), it is a curtailment loss.

For purposes of applying the provisions of this paragraph, any transition asset remaining in unassigned funds (surplus) from initial application of SSAP No. 89 shall be treated as a net gain and shall be combined with the net gain or loss arising subsequent to transition to SSAP No. 89.

63. If the sum of the effects identified in paragraphs 61 and 62 is a net loss, it shall be recognized in earnings when it is probable that a curtailment will occur and the effects described are reasonably estimable. If the sum of those effects is a net gain, it shall be recognized in earnings when the related employees terminate or the plan suspension or amendment is adopted.

Termination Benefits

64. An employer may provide benefits to employees in connection with their termination of employment. They may be either special termination benefits offered only for a short period of time or contractual termination benefits required by the terms of a plan only if a specified event, such as a plant closing, occurs. An employer that offers special termination benefits to employees shall recognize a liability and a loss when the employees accept the offer and the amount can be reasonably estimated. An employer that provides contractual termination benefits shall recognize a liability and a loss when it is probable that employees will be entitled to benefits and the amount can be reasonably estimated. Termination benefits may take various forms including lump-sum payments, periodic future payments, or both. They may be paid directly from an employer's assets, an existing pension plan, a new employee benefit plan, or a combination of those means. The cost of termination benefits recognized as a liability and a loss shall include the amount of any lump-sum payments and the present value of any expected future payments. A situation involving termination benefits may also involve a curtailment to be accounted for under paragraphs 61-63.

Disclosures – Single Employer Defined Benefit Plans

65. An employer that sponsors one or more defined benefit pension plans or one or more other defined benefit postretirement plans shall provide the following information, separately for pension plans and other postretirement benefit plans. Amounts related to the employer’s results of operations shall be disclosed for each period for which a statement of income is presented. Amounts related to the employer’s statement of financial position, shall be disclosed as of the date of each statement of financial position presented.

a. A reconciliation of beginning and ending balances of the benefit obligation showing separately, if applicable, the effects during the period attributable to each of the following: service cost, interest cost, contributions by plan participants, actuarial gains and losses, foreign currency exchange rate changes, benefits paid, plan amendments, business combinations, divestitures, curtailments, settlements, and special termination benefits.

b. A reconciliation of beginning and ending balances of the fair value of plan assets showing separately, if applicable, the effects during the period attributable to each of the following: actual return on plan assets, foreign currency exchange rate changes, contributions by the employer, contributions by plan participants, benefits paid, business combinations, divestitures, and settlements.

c. The funded status of the plans and the amounts recognized in the statement of financial position, showing separately the assets and liabilities recognized.

d. The objectives of the disclosures about postretirement benefit plan assets are to provide users of financial statements with an understanding of:

   i. How investment allocation decisions are made, including the factors that are pertinent to an understanding of investment policies and strategies

   ii. The classes of plan assets

   iii. The inputs and valuation techniques used to measure the fair value of plan assets

iv. The effect of fair value measurements using significant unobservable inputs (Level 3) on changes in plan assets for the period

v. Significant concentrations of risk within plan assets.

An employer shall consider those overall objectives in providing the following information about plan assets:

(a) A narrative description of investment policies and strategies, including target allocation percentages or range of percentages considering the classes of plan assets disclosed pursuant to 65.d.v.(b), as of the latest statement of financial position presented (on a weighted-average basis for employers with more than one plan), and other factors that are pertinent to an understanding of those policies and strategies such as investment goals, risk management practices, permitted and prohibited investments including the use of derivatives, diversification, and the relationship between plan assets and benefit obligations. For investment funds disclosed as classes as described in 65.d.v.(b), a description of the significant investment strategies of those funds shall be provided.

(b) The fair value of each class of plan assets as of each date for which a statement of financial position is presented. Asset classes shall be based on the nature and risks of assets in an employer's plan(s). Examples of classes of assets could include, but are not limited to, the following: cash and cash equivalents; equity securities, (segregated by industry type, company size, or investment objective); debt securities, issued by national, state, and local governments; corporate debt securities; asset-backed securities; structured debt; derivatives on a gross basis (segregated by type of underlying risk in the contract, for example, interest rate contracts, foreign exchange contracts, equity contracts, commodity contracts, credit contracts, and other contracts); investment funds (segregated by type of fund); and real estate. Those examples are not meant to be all inclusive. An employer should consider the overall objectives in paragraph 65.d. in determining whether additional classes of plan assets or further disaggregation of classes should be disclosed.

(c) A narrative description of the basis used to determine the overall expected long-term rate-of-return-on-assets assumption, such as the general approach used, the extent to which the overall rate-of-return-on-assets assumption was based on historical returns, the extent to which adjustments were made to those historical returns in order to reflect expectations of future returns, and how those adjustments were determined. The description should consider the classes of assets described in 65.d.v.(b)., as appropriate.

(d) Information that enables users of financial statements to assess the inputs and valuation techniques used to develop fair value measurements of plan assets at the reporting date. For fair value measurements using significant unobservable inputs, an employer shall disclose the effect of the measurements on changes in plan assets for the period. To meet those objectives, the employer shall disclose the following information for each class of plan assets disclosed pursuant to 65.d.v.(b)., for each annual period:

(1) The level within the fair value hierarchy in which the fair value measurements in their entirety fall,[3] segregating fair value measurements using quoted prices in active markets for identical assets or liabilities (Level 1), significant other observable inputs (Level 2), and significant unobservable inputs (Level 3)

(2) For fair value measurements of plan assets using significant unobservable inputs (Level 3), a reconciliation of the beginning and ending balances, separately presenting changes during the period attributable to the following:

(i) Actual return on plan assets, separately identifying the amount related to assets still held at the reporting date and the amount related to assets sold during the period

(ii) Purchases, sales, and settlements, net

(iii) Transfers in and/or out of Level 3 (for example, transfers due to changes in the observability of significant inputs)

(3) Information about the valuation technique(s) and inputs used to measure fair value and a discussion of changes in valuation techniques and inputs, if any, during the period.

e. For defined benefit pension plans, the accumulated benefit obligation.

f. The benefits (as of the date of the latest statement of financial position presented) expected to be paid in each of the next five fiscal years, and in the aggregate for the five fiscal years thereafter. The expected benefits should be estimated based on the same assumptions used to measure the company's benefit obligation at the end of the year and should include benefits attributable to estimated future employee service.

g. The employer's best estimate, as soon as it can reasonably be determined, of contributions expected to be paid to the plan during the next fiscal year beginning after the date of the latest statement of financial position presented. Estimated contributions may be presented in the aggregate combining (1) contributions required by funding regulations or laws, (2) discretionary contributions, and (3) noncash contributions.

h. The amount of net benefit cost recognized, showing separately the service cost component, the interest cost component, the expected return on plan assets for the period, the gain or loss component, the prior service cost or credit component, the transition asset or obligation component, and the gain or loss recognized due to settlements or curtailments.

i. Separately the net gain or loss and net prior service cost or credit recognized in unassigned funds (surplus) for the period pursuant to paragraphs 17 and 21 and reclassification adjustments of unassigned funds (surplus) for the period, as those

[3] In some cases, the inputs used to measure fair value might fall in different levels of the fair value hierarchy. The level in the fair value hierarchy within which the fair value measurement in its entirety falls shall be determined based on the lowest level input that is significant to the fair value measurement in its entirety. Assessing the significance of a particular input to the fair value measurement in its entirety requires judgment, considering factors specific to the asset or liability.

amounts, including amortization of the net transition asset or obligation, are recognized as components of net periodic benefit cost.

j. The amounts in unassigned funds (surplus) that have not yet been recognized as components of net periodic benefit cost, showing separately the net gain or loss, net prior service cost or credit, and net transition asset or obligation.

k. On a weighted-average basis, the following assumptions used in the accounting for the plans: assumed discount rates, rates of compensation increase (for pay-related plans), and expected long-term rates of return on plan assets specifying, in a tabular format, the assumptions used to determine the benefit obligation and the assumptions used to determine net benefit cost.

l. If applicable, the amounts and types of securities of the employer and related parties included in plan assets, the approximate amount of future annual benefits of plan participants covered by insurance contracts issued by the employer or related parties, and any significant transactions between the employer or related parties and the plan during the period.

m. If applicable, any alternative method used to amortize prior service amounts or net gains and losses pursuant to paragraphs 18 and 25.

n. If applicable, any substantive commitment, such as past practice or a history of regular benefit increases, used as the basis for accounting for the benefit obligation.

o. If applicable, the cost of providing special or contractual termination benefits recognized during the period and a description of the nature of the event.

p. An explanation of any significant change in the benefit obligation or plan assets not otherwise apparent in the other disclosures required by this issue paper.

q. The amounts in unassigned funds (surplus) expected to be recognized as components of net periodic benefit cost over the fiscal year that follows the most recent annual statement of financial position presented, showing separately the net gain or loss, net prior service cost or credit, and net transition asset or obligation.

r. The amount and timing of any plan assets expected to be returned to the employer during the 12-month period, or operating cycle if longer, that follows the most recent annual statement of financial position presented.

Disclosures – Employers with Two or More Defined Benefit Plans

66. The disclosures required by this issue paper shall be aggregated for all of an employer's defined benefit pension plans and for all of an employer's other defined benefit postretirement plans unless disaggregating in groups is considered to provide useful information or is otherwise required by this paragraph and paragraph 67. Disclosures shall be as of the date of each statement of financial position presented. Disclosures about pension plans with assets in excess of the accumulated benefit obligation generally may be aggregated with disclosures about pension plans with accumulated benefit obligations in excess of assets. The same aggregation is permitted for other postretirement benefit plans. If aggregate disclosures are presented, an employer shall disclose:

a. The aggregate benefit obligation and aggregate fair value of plan assets for plans with benefit obligations in excess of plan assets as of the measurement date of each statement of financial position presented.

b. The aggregate pension accumulated benefit obligation and aggregate fair value of plan assets for pension plans with accumulated benefit obligations in excess of plan assets.

67. A U.S. reporting entity may combine disclosures about pension plans or other postretirement benefit plans outside the United States with those for U.S. plans unless the benefit obligations of the plans outside the United States are significant relative to the total benefit obligation and those plans use significantly different assumptions.

Interim Financial Disclosures –Defined Benefit Plans

68. The following shall be disclosed within interim financial statements that include a statement of income:

a. The amount of net periodic benefit cost recognized, for each period for which a statement of income is presented, showing separately the service cost component, the interest cost component, the expected return on plan assets for the period, the gain or loss component, the amount of prior service cost or credit component, the transition asset or obligation component, and the gain or loss recognized due to a settlement or curtailment.

b. The total amount of the employer’s contributions paid, and expected to be paid, during the current fiscal year, if significantly different from amounts previously disclosed pursuant to paragraph 65.g. Estimated contributions may be presented in the aggregate combining (1) contributions required by funding regulations or laws, (2) discretionary contributions, and (3) noncash contributions.

Defined Contribution Plans

69. A defined contribution pension plan is a plan that provides pension benefits in return for services rendered, provides an individual account for each participant, and has terms that specify how contributions to the individual's account are to be determined rather than the amount of pension benefits the individual is to receive. Under a defined contribution plan, the pension benefits a participant will receive depend only on the amount contributed to the participant's account, the returns earned on investments of those contributions, and forfeitures of other participants' benefits that may be allocated to the participant's account.

70. To the extent that a plan's defined contributions to an individual's account are to be made for periods in which that individual renders services, the net pension cost for a period shall be the contribution called for in that period. If a plan calls for contributions for periods after an individual retires or terminates, the estimated cost shall be accrued during the employee's service period.

71. A pension plan having characteristics of both a defined benefit plan and a defined contribution plan requires careful analysis. If the substance of the plan is to provide a defined benefit, as may be the case with some "target benefit" plans, the accounting requirements shall be determined in accordance with the provisions applicable to a defined benefit plan and the disclosure requirements within paragraph 65 shall be followed.

Disclosures - Defined Contribution Plans

72. An employer shall disclose the amount of cost recognized for defined contribution pension plans and for other defined contribution postretirement benefit plans for all periods presented separately from the amount of cost recognized for defined benefit plans. The disclosures shall include a description of the nature and effect of any significant changes during the period affecting comparability, such as a change in the rate of employer contributions, a business combination, or a divestiture.

Multiemployer Plans

73. A multiemployer plan is a pension plan to which two or more unrelated employers contribute, usually pursuant to one or more collective-bargaining agreements. A characteristic of multiemployer plans is that assets contributed by one participating employer may be used to provide benefits to employees of other participating employers since assets contributed by an employer are not segregated in a separate account or restricted to provide benefits only to employees of that employer.

74. A reporting entity participating in a multiemployer plan shall recognize as net pension cost the required contribution for the period and shall recognize as a liability any contributions due and unpaid.

75. In some situations, withdrawal from a multiemployer plan may result in a reporting entity having an obligation to the plan for a portion of its unfunded benefit obligations. If withdrawal under circumstances that would give rise to an obligation is either probable or reasonably possible, the provisions of *SSAP No. 5—Liabilities, Contingencies and Impairment of Assets – Revised* (SSAP No. 5R) shall apply.

Disclosures - Multiemployers Plans

76. A reporting entity shall disclose the amount of contributions to multiemployer plans for each annual period for which a statement of income is presented. A reporting entity may disclose total contributions to multiemployer plans without disaggregating the amounts attributable to pension plans and other postretirement benefit plans. The disclosures shall include a description of the nature and effect of any changes affecting comparability, such as a change in the rate of employer contributions, a business combination, or a divestiture.

77. In some situations, withdrawal from a multiemployer plan may result in a reporting entity having an obligation to the plan for a portion of the unfunded benefit obligation of the pension plans and other postretirement benefit plans. If withdrawal under circumstances that would give rise to an obligation is either probable or reasonably possible, the provisions of SSAP No. 5R shall apply. If it is either probable or reasonably possible that (a) an employer would withdraw from the plan under circumstances that would give rise to an obligation or (b) an employer's contribution to the fund would be increased during the remainder of the contract period to make up a shortfall in the funds necessary to maintain the negotiated level of benefit coverage (a "maintenance of benefits" clause), the employer shall apply the provisions of SSAP No. 5R.

Multiple Employer Plans

78. Some pension plans to which two or more unrelated employers contribute are not multiemployer plans. Rather, they are in substance aggregations of single-employer plans combined to allow participating employers to pool their assets for investment purposes and to reduce the costs of plan administration. Those plans ordinarily do not involve collective-bargaining agreements. They may also have features that allow participating employers to have different benefit formulas, with the employer's contributions to the plan based on the benefit formula selected by the employer. Such plans shall be

considered single-employer plans rather than multiemployer plans, and each reporting entity's accounting shall be based on its respective interest in the plan.

Non-U.S. Pension Plans

79. Except for its effective date, this issue paper includes no special provisions applicable to pension arrangements outside the United States. To the extent that those arrangements are in substance similar to pension plans in the United States, they are subject to the provisions of this issue paper. The substance of an arrangement is determined by the nature of the obligation and by the terms or conditions that define the amount of benefits to be paid, not by whether (or how) a plan is funded, whether benefits are payable at intervals or as a single amount, or whether the benefits are required by law or custom or are provided under a plan the employer has elected to sponsor.

80. It is customary or required in some countries to provide benefits in the event of a voluntary or involuntary severance of employment (also called termination indemnities). If such an arrangement is in substance a pension plan (for example, if the benefits are paid for virtually all terminations), it is subject to the provisions of this issue paper.

Business Combinations

81. When an employer is acquired in a business combination and that employer sponsors a single-employer defined benefit pension plan, the assignment of the purchase price to individual assets acquired and liabilities assumed shall include a liability for the projected benefit obligation in excess of plan assets or an asset for plan assets in excess of the projected benefit obligation, thereby eliminating any previously existing net gain or loss, prior service cost or credit, or transition asset or obligation recognized in unassigned funds (surplus). If it is expected that the plan will be terminated or curtailed, the effects of those actions shall be considered in measuring the projected benefit obligation.

Consolidated/Holding Company Plans

82. The employees of many reporting entities are members of a plan sponsored by a parent company or holding company. A reporting entity that participates in these plans and is not directly liable for obligations under the plan shall recognize pension expense equal to its allocation from the holding company or parent company of the required contribution to the plan for the period. A liability shall be established for any such contributions due and unpaid. Furthermore, the reporting entity shall disclose in the notes to the financial statements that its employees participate in a plan sponsored by the holding company for which the reporting entity has no legal obligation. The amount of expense incurred and the allocation methodology utilized by the provider of such benefits shall also be disclosed. If the reporting entity is directly liable for obligations under the plan, then the requirements outlined above in paragraphs 4-81 and 84-92 of this issue paper shall be applied.

Relevant Literature

83. This issue paper adopts with modification paragraphs 1-7 and 16-17 as well as Appendix C – Amendments to Statements 87 and 88 and Appendix E – Amendments to Statement 132(R) of *FASB Statement No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106 and 132(R)* (FAS 158). Paragraphs 8-10 providing specific guidance for not-for-profit organizations is rejected. Paragraphs 11-15 regarding the effective dates for FAS 158 is rejected and paragraph 19 providing an alternative method for remeasuring plan assets and benefits obligations as of the fiscal year the measurement date provisions are applied is also rejected. Appendix D – Amendments to Statement 106 has not been incorporated within this statutory statement as it will be considered in accordance with revisions to *SSAP No. 14—Postretirement Benefits Other Than Pensions* (SSAP No. 14). Disclosures included within FAS 132 (R), as amended by FAS 158,

pertaining to health care (paragraphs 5.l. and 5.m.) have been rejected for inclusion within this standard, but will also be considered in accordance with revisions to SSAP No. 14. This issue paper adopts the revisions to paragraph 5.d. of FAS 132(R) as amended by *FASB Staff Position FAS 132(R)-1, Employers' Disclosures about Postretirement Benefit Plan Assets* (FSP FAS 132(R)-1) and *ASU 2010-06, Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements* (ASU 2010-06). Other revisions to disclosures requirements as amended by FSP FAS 132(R)-1 relate to nonpublic entities and are rejected. This Statement adopts by reference *FSP FASB 158-1, Conforming Amendments to the Illustrations in FASB Statements No. 87, No. 88, and No. 106 and to the Related Staff Implementation Guides* (FSP FAS 158-1) to the extent that the examples and related implementation guides comply with the adopted GAAP guidance previously identified within this statement, as modified for statutory accounting. The following modifications from the adopted paragraphs of FAS 158 have been incorporated within this standard:

a. All references to 'other comprehensive income' or 'accumulated other comprehensive income' within FAS 158 have been revised to reflect unassigned funds (surplus).

b. Any prepaid asset resulting from the excess of the fair value of plan assets over the projected benefit obligation shall be nonadmitted. Furthermore, any asset recognized from the cost of a 'participation right' of an annuity contract per paragraph 51 shall also be nonadmitted.

c. Provisions within paragraph 30 of FAS 87, as amended by FAS 158, permitting a market-related value of plan assets have been eliminated with only the fair value measurement method for plan assets being retained.

d. The reduced disclosure requirements for nonpublic entities described in paragraph 8 of FAS 132(R), as amended by FAS 158, are rejected. All reporting entities shall follow the disclosure requirements included in paragraph 5 of FAS 132(R) as amended by FAS 158.

e. Clarification has been included within this standard to ensure both vested and nonvested employees are included within the recognition of net periodic pension cost and in the pension benefit obligation. Although this is consistent with GAAP, this is a change from previous statutory accounting. As nonvested employees were excluded from statutory accounting under SSAP No. 89, guidance has been included to indicate that the unrecognized prior service cost attributed to nonvested individuals is not required to be included in net periodic pension cost entirely in the year this standard is adopted. The unrecognized prior service cost for nonvested employees shall be amortized as a component of net periodic pension cost by assigning an equal amount to each expected future period of service before vesting occurs for nonvested employees active at the date of the amendment. Unassigned funds (surplus) is then adjusted each period as prior service cost is amortized. (Guidance is included within the transition related to the recognition of the prior service cost for nonvested employees through unassigned funds (surplus).)

f. Conclusion of Interpretation 04-12*: EITF 03-4: Determining the Classification and Benefit Attribution Method for a "Cash Balance" Pension Plan* (INT 04-12) indicating that 'cash balance' plans are considered defined benefit plans has been incorporated within paragraph 5 of this issue paper.

g. Conclusion of Interpretation 99-26*: Offsetting Pension Assets and Liabilities* (INT 99-26) prohibiting the offset of defined benefit liabilities of one plan with prepaid assets of another plan has been incorporated within paragraph 28 of this issue paper.

h. Provisions within paragraph 36 of FAS 87, as amended by FAS 158, regarding the classification of underfunded liabilities as current or noncurrent liabilities and the classification of assets from overfunded plans as noncurrent assets has been rejected as inconsistent with statutory accounting.

i. Provisions within paragraph 49 of FAS 87, as amended by FAS 158, defining the fair value of investments have been rejected. Fair value definitions and measurement for investments shall be determined in accordance with statutory accounting guidance.

j. Provisions within paragraph 52 of FAS 87, as amended by FAS 158, regarding the plan assets measurement date for consolidating subsidiaries or entities utilizing the equity method under APB Opinion No. 18 has been rejected. For statutory accounting, all entities shall follow the measurement date guidance within paragraph 44 of this statement.

k. Transition under FAS 158 is different from this issue paper. FAS 158 requires entities with publicly traded equity securities to initially apply the requirement to recognize the funded status of a benefit plan; the gains/losses, prior service costs/credits and transition obligations/assets that have not yet been included in net periodic benefit cost; and the disclosure requirements as of the end of the fiscal year ending after December 15, 2006. Transition guidelines for statutory accounting are defined in paragraphs 84-92.

l. FAS 158 provided two approaches for an employer to transition to a fiscal year-end measurement date. For purposes of statutory accounting, the second approach permitting reporting entities to use earlier measurements determined for year-end reporting as of the fiscal year immediately preceding the year that the measurement date provisions is rejected. For consistency purposes, all reporting entities shall follow the first approach and remeasure plan assets and benefit obligations as of the beginning of the fiscal year that the measurement date provisions are applied.

Effective Date and Transition

84. Reporting entities are required to disclose the projected benefit obligation, the accumulated benefit obligation and the fair value of plan assets for defined benefit pension plans in the first reporting period after the effective date of this standard and in each subsequent reporting period. This disclosure shall specifically note the funded/underfunded status of the pension plan based on the projected benefit obligation. Reporting entities shall also specifically note the surplus impact necessary, at each reporting date, to reflect the full projected benefit obligation within the financial statements.

85. The SSAP that results from this issue paper is effective for quarterly and annual reporting periods beginning on or after January 1, 2013 (transition date) with early adoption permitted. Any unfunded defined benefit pension amounts, as determined when the projected benefit obligation exceeds the fair value of plan assets, is a liability under SSAP No. 5R and shall be reported in the first quarter statutory financial statements after the transition date with a corresponding entry to unassigned funds (surplus). If the fair value of plan assets exceeds the projected benefit obligation, the asset shall be considered a nonadmitted asset. Net periodic pension cost shall include a component for unrecognized prior service cost for nonvested employees beginning in 2013.

86. Gains or losses, prior service costs or credits (including prior service costs for non-vested participants pursuant to paragraph 13), and remaining transition assets or obligations from prior application of SSAP No. 89 (collectively referred to as “unrecognized items”) that have not yet been

included in net periodic benefit cost as of December 31, 2012[4] shall be recognized as components of the balance of unassigned funds (surplus), net of tax, as of January 1, 2013 (provided that alternative transition is not elected per paragraph 87.b.). The offset to unassigned funds is reported separately as an "Aggregate Write-In for Other-Than-Invested Assets" or as an "Aggregate Write-In for Other Liabilities". After recognition, the full unfunded or overfunded status of the plan shall be reflected within the financial statements[5]. Any prepaid asset resulting from an overfunded plan shall be nonadmitted.

87. Due to the potential impact to surplus as a result of immediately applying the accounting guidance in paragraph 86, reporting entities may elect one of the following two methods, on an individual plan basis, to recognize the transition surplus impact:

a. Reporting entities may elect to recognize the entire transition surplus impact calculated from applying paragraph 86, on an individual plan basis, as of January 1, 2013.

b. Alternatively, reporting entities may elect to recognize the entire surplus impact from applying paragraph 86, on an individual plan basis, over a period not to exceed ten (10) years. The surplus impact initially recognized as of January 1, 2013, under this transition option, and subsequently over the transition period, shall be the greater of:

i. Ten percent of the calculated surplus impact as of the transition date;

ii. Amortization[6] of the "unrecognized items" (defined in paragraph 86) into net periodic pension cost, including any accelerated amortization of these items from curtailments or settlements that occur after the transition date. (If the amortization cannot be determined at transition, at a minimum, the amount amortized for "unrecognized items" during the prior year shall be utilized for this component of the calculation. If the amount recognized for transition (greater of all three components in paragraph 87.b.) is subsequently determined to be less than what is amortized for the year (87.b.ii.), the difference between what was recognized for transition, and what is amortized must immediately be recognized as an adjustment to the transition impact to unassigned funds (surplus).);

[4] The intent of the guidance is to recognize the unrecognized amounts as of December 31, 2012 annual statements, even if new actuarial projections (accumulated benefit obligation/projected benefit obligation amounts) are calculated as of January 1, 2013. (These projections would be considered in the recognition of the 2013 pension cost.)

[5] Upon the effective date of this statement, reporting entities are required to reflect the full unfunded or overfunded status of their defined benefit pension plans. As such, the concept of an "additional minimum liability" previously reflected in *SSAP No. 89—Pensions* is not incorporated within this Statement. If an additional minimum liability (and a corresponding intangible asset) had been recognized under SSAP No. 89, such items shall be eliminated with the implementation of this Statement, and the guidance in paragraph 87 shall be followed. The elimination of any additional minimum liability and corresponding intangible asset shall also occur if the entity elects the transition option reflected in paragraph 87.b.

[6] Unless otherwise impacted from the provisions within this Statement or in accordance with changes to the pension plan, the amortization of the unrecognized items into net periodic pension cost shall continue to follow the existing amortization schedules in effect on the transition date.

iii. Amount necessary to establish a total liability that is equal to any unfunded accumulated benefit obligation (the accumulated benefit obligation less the fair value of plan assets)[7].

If the surplus deferral is elected at the transition date, subsequently, starting with the 2014 year-end financial statement, the reporting entity shall annually recognize the remaining surplus impact (collectively referred to as the "transition liability"[8]) on a systematic basis over a period not to exceed nine years. The minimum amount recognized each subsequent year shall be an amount that reflects the conditions within paragraph 87.b. Additionally, reporting entities must recognize any remaining transition liability to the extent that the plan reflects a prepaid benefit cost. (For example, if changes in circumstances have resulted with the plan reflecting an overfunded status, the remaining transition liability must be recognized to the extent that the plan is overfunded.) Furthermore, if circumstances result with a subsequent gain attributed to the plan that will be recognized in earnings, the entity must recognize an additional amount of the remaining transition liability to offset the recognized gain. Reporting entities are permitted to recognize the remaining transition liability, or an amount in excess of the minimum requirement, at any time after the transition date. This transition guidance is specific to the transition surplus impact from initially applying this statement on Jan. 1, 2013. Thus, this transition guidance does not apply to additional liability calculated from subsequent comparison of the fair value of plan assets to the projected benefit obligation, or the impact of subsequent plan amendments.

88. Reporting entities electing to apply the transition guidance in paragraph 87.b. must disclose the full transition surplus impact calculated from applying paragraph 86 in the first quarter statutory financial statements after the transition date and each reporting period thereafter. This disclosure shall include the initial "transition liability" calculated under paragraph 86, the annual amortization amount of the "unrecognized items" into net periodic pension cost, the amount of the unfunded accumulated benefit obligation, and the remaining unrecognized transition impact. This disclosure shall include a schedule of the entity's anticipated recognition of the remaining surplus impact over the transition period.

89. The requirement to measure plan assets and benefit obligations as of the date of the reporting entity's financial statement year-end is effective in SSAP No. 102 for financial statement years beginning January 1, 2014. (The measurement date change will be initially reflected in the Dec. 31, 2014, financial statements.)

90. In order to transition to a fiscal year-end measurement date, the reporting entity shall remeasure plan assets and benefit obligations as of the beginning of the fiscal year that the measurement date provisions are applied. The reporting entity shall use those new measurements to determine the effects of the measurement date change as of the beginning of the fiscal year that the measurement date provisions are applied.

[7] The intent of this standard is to ensure that under the deferral option the liability initially recognized for an unfunded plan reflects the minimum liability previously recognized under SSAP No. 89. For any instances in which an additional minimum liability recognized under SSAP No. 89 is greater than the unfunded ABO at transition, an amount equal to the previously recognized additional minimum liability shall be used in determining this component of 87.b.iii. The deferral option under this standard is not intended to allow a surplus benefit to be recognized at initial transition for an unfunded plan.

[8] If the surplus deferral from paragraph 87.b. is elected, the deferred liability, although comprised of the previous "unrecognized items" shall be collectively referred to as the "transition liability". Although reporting entities will need to continue to track the unrecognized items for amortization into net periodic cost (offset through unassigned funds), reporting entities shall not allocate the recognized surplus impact from transition to these categories. As noted in paragraph 87.b.ii., the minimum amount of liability recognized under the deferral option must cover the annual amortization of the "unrecognized items" into net periodic pension cost to prevent a surplus benefit.

91. The reporting entity shall measure plan assets and benefit obligations as of the beginning of the fiscal year that the measurement date provisions are applied. This would result with the following:

a. Net periodic benefit cost for the period between the measurement date that is used for the immediately preceding fiscal year-end and the beginning of the fiscal year that the measurement date provisions are applied, exclusive of any curtailment or settlement gain or loss, shall be recognized, net of tax, as a separate adjustment of the opening balance unassigned funds (surplus). That is, the pretax amount recognized as an adjustment to unassigned funds (surplus) is the net periodic benefit cost that without a change in measurement date otherwise would have been recognized on a delayed basis during the first interim period for the fiscal year that the measurement date provisions are applied.

b. Any gain or loss arising from a curtailment or settlement between the measurement date that is used for the immediately preceding fiscal year-end and the beginning of the fiscal year that the measurement date provisions are applied shall be recognized in earnings in that period and not as an adjustment to unassigned funds (surplus). This provision prohibits a reporting entity from early application of the measurement date provisions when the reporting entity has issued financial statements for the prior year without recognition of such a settlement or curtailment.

c. Other changes in the fair value of plan assets and the benefit obligations (for example, gains or losses) for the period between the measurement date that is used for the immediately preceding fiscal year-end and the beginning of the fiscal year that the measurement date provisions are applied shall be recognized, net of tax, as a separate adjustment of the opening balance of unassigned funds (surplus) for the fiscal year that the measurement date provisions are applied.

92. Earlier application of the recognition or measurement date provisions is encouraged, however, early applications must be for all of the reporting entity's benefit plans. If early application is elected, the transition date shall reflect the January 1st of the year in which SSAP No. 102 is initially applied. Retrospective application is not permitted.

93. After adoption of this issue paper, the NAIC will release a Statement of Statutory Accounting Principles (SSAP) for comment. The initial draft of the SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the *Accounting Practices and Procedures Manual* should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will be effective for reporting periods beginning on or after January 1, 2013.

DISCUSSION:

94. The FASB issued FAS 158 to address concerns that existing accounting for postretirement benefit plans failed to communicate the funded status of those plans in a complete and understandable way. The prior standards did not require an employer to report in its statement of financial position the overfunded or underfunded status of a defined benefit postretirement plan. The prior standards also did not require an employer to recognize completely in earnings or other comprehensive income the financial effects of certain events affecting the plan's funded status when those events occurred.

95. Within the prior GAAP standards, an employer was allowed to recognize in its statement of financial position an asset or liability arising from the defined benefit postretirement plan, which almost always differed from the plan's overfunded or underfunded status. Those standards allowed an employer to delay recognition of economic events that affected the costs of providing postretirement benefits—

changes in plan assets and benefit obligations—and recognize a liability that was sometimes significantly less than the underfunded status of the plan as well as recognize an asset in its statement of financial position, in some situations, for a plan that was underfunded. Furthermore, information regarding the overfunded or underfunded status of a plan was relegated to the notes to the financial statements. That information was in the form of a reconciliation of the overfunded or underfunded status to amounts recognized in the employer's statement of financial position. By presenting this information only in the notes it was difficult for users of financial statements to assess an employer's financial position and ability to satisfy postretirement benefits.

96. In issuing FAS 158, the FASB concluded that the reporting requirements of other standards did not provide representationally faithful and understandable financial information and might lead to the inefficient allocation of resources in capital markets. The issuance of FAS 158 is the first step of a project to comprehensively reconsider FAS 87, 88, 106, 132(R), and related pronouncements.

97. In accordance with the Statutory Accounting Principles Statement of Concepts, the conservatism concept supports the adoption of FAS 158 to ensure proper liability recognition and in accordance with the responsibility to regulate financial solvency.

98. Modifications to FAS 158 have been established primarily to clarify the components for liability consideration and to ensure consistency within reporting and recognition among reporting entities. Guidance related to not-for-profit entities, transition, and alternative methods for remeasuring plan assets and benefit obligations for the first year application have been rejected to ensure consistent application for statutory purposes. Revisions incorporated within FAS 158 specifically attributed to FAS 106 or postretirement benefits other than pensions have not been addressed within this issue paper and will be considered in accordance with revisions to SSAP No. 14. Modifications from FAS 158 incorporated within this issue paper include:

a. All references to 'other comprehensive income' or 'accumulated other comprehensive income' within FAS 158 have been revised to reflect 'unassigned funds (surplus)'. This modification simply alters the guidance within FAS 158 to adhere to the reporting captions for statutory accounting.

b. Any prepaid asset resulting from the excess of the fair value of plan assets over the projected benefit obligation shall be nonadmitted. Furthermore, any asset recognized from the cost of a "participation right" of an annuity contract per paragraph 51 shall also be nonadmitted. These modifications are consistent with the definition of assets and nonadmitted assets set forth in *SSAP No. 4—Assets and Nonadmitted Assets* as assets recognized from overfunding postretirement plans or participating rights from annuity contracts cannot be readily converted to cash to satisfy policyholder obligations.

c. Provisions within paragraph 30 of FAS 87, as amended by FAS 158, permitting a calculated market-related value of plan assets has been eliminated with only the fair value measurement method for plan assets being retained. The calculated market-related value is a process to systematically and rationally recognize changes in fair value over a period of five years. This modification eliminates the potential for inconsistent measurement methods among reporting entities.

d. The reduced disclosure requirements for nonpublic entities described in paragraph 8 of FAS 132(R), as amended by FAS 158, are rejected. All reporting entities shall follow the disclosure requirements in paragraph 5 of FAS 132(R), as amended by FAS 158.

e. Clarification has been included within this standard to ensure both vested and nonvested employees are included within the recognition of net periodic pension cost and in the pension benefit obligation. Although this is consistent with GAAP, this is a change from previous statutory accounting. As nonvested employees were excluded from statutory accounting under SSAP No. 89, guidance has been included to indicate that the unrecognized prior service cost attributed to nonvested individuals is not required to be included in net periodic pension cost entirely in the year this standard is adopted. The unrecognized prior service cost for nonvested employees shall be amortized as a component of net periodic pension cost by assigning an equal amount to each expected future period of service before vesting occurs for nonvested employees active at the date of the amendment. Unassigned funds (surplus) is then adjusted each period as prior service cost is amortized.

f. Conclusion of Interpretation 04-12*: EITF 03-4: Determining the Classification and Benefit Attribution Method for a "Cash Balance" Pension Plan* (INT 04-12) indicating that 'cash balance' plans are considered defined benefit plans has been incorporated within paragraph 5 of this issue paper.

g. Conclusion of Interpretation 99-26*: Offsetting Pension Assets and Liabilities* (INT 99-26) prohibiting the offset of defined benefit liabilities of one plan with prepaid assets of another plan has been incorporated within paragraph 28 of this issue paper.

h. Provisions within paragraph 36 of FAS 87, as amended by FAS 158, regarding the classification of underfunded liabilities as current or noncurrent liabilities and the classification of assets from overfunded plans as noncurrent assets has been rejected as inconsistent with statutory accounting.

i. Provisions within paragraph 49 of FAS 87, as amended by FAS 158, defining the fair value of investments have been rejected. Fair value definitions and measurement for investments shall be determined in accordance with statutory accounting guidance.

j. Provisions within paragraph 52 of FAS 87, as amended by FAS 158, regarding the plan assets measurement date for consolidating subsidiaries or entities utilizing the equity method under APB Opinion No. 18 has been rejected. For statutory accounting, all entities shall follow the measurement date guidance within paragraph 44 of this statement.

k. Transition under FAS 158 is different from this issue paper. FAS 158 requires entities with publicly traded equity securities to initially apply the requirement to recognize the funded status of a benefit plan; the gains/losses, prior service costs/credits and transition obligations/assets that have not yet been included in net periodic benefit cost; and the disclosure requirements as of the end of the fiscal year ending after December 15, 2006. Transition guidelines for statutory accounting are defined in paragraphs 84-92.

l. FAS 158 provided two approaches for an employer to transition to a fiscal year-end measurement date. For purposes of statutory accounting, the second approach permitting reporting entities to use earlier measurements determined for year-end reporting as of the fiscal year immediately preceding the year that the measurement date provisions was rejected. For consistency purposes, all reporting entities shall follow the first approach and shall remeasure plan assets and benefit obligations as of the beginning of the fiscal year that the measurement date provisions are applied.

99. Application of this issue paper as a new Statutory Accounting Principle is expected to generate an increased projected benefit obligation as a result of the inclusion of nonvested participants. (In SSAP No. 89, nonvested participants were excluded from the projected benefit obligation. This exclusion has been

eliminated.) The increase to the projected benefit obligation is not anticipated to be significant for pension plans as federal legislature already exists that requires vesting within a fairly short timeframe after the start of employment (seven years maximum).

WORKING GROUP RESEARCH AND KEY ISSUES CONSIDERED:

100. During the Statutory Accounting Principles (E) Working Group's discussions on this issue paper, the Working Group conducted research and considered key issues to determine the appropriate course of action in response to comments received. Summaries of the key topics discussed, the research conducted, and the Working Group's conclusions have been detailed in the paragraphs below:

101. *Admittance of Prepaid Pension Costs for Overfunded Assets* – During the Spring 2008 Hearing, comments were received that prohibiting admittance of the asset established from overfunded plans would be punitive in comparison to GAAP reporting. A comment was also received proposing an offsetting admission for overfunded plan assets, whereas, an asset from overfunded plans would be admitted to the extent that a separate plan was underfunded. In considering these comments, the Working Group identified that there is a punitive tax that significantly hinders a company's ability to reclaim overfunded defined benefit assets. The 4980 Excise Tax on Reversions is a punitive, non-deductible excise tax imposed on the reversion of excess defined benefit assets to the employer. In 2008, the law imposed a confiscatory 50% tax on a simple reversion of excess assets to the employer. Because the excise tax is not deductible, ordinary income tax also applies on the entire amount of the reversion. Assuming federal and states income taxes total 40%, with the excise tax, a combined 90% tax is levied on the reversion. The Working Group identified that there are exceptions to when the tax is reduced to 20% and if the excess assets of a terminating defined benefit plan are transferred to a qualifying replacement plan, no excise tax would be due on the transferred assets.

102. In considering this research, the Working Group agreed that continued nonadmittance of overfunded plan assets was appropriate as the excise tax would significantly reduce the amount of assets that could be reclaimed by the company and utilized for policyholder claims. This conclusion is consistent with the existing statutory guidance in *SSAP No. 29—Prepaid Expenses*, in which prepaid assets were previously concluded to be nonadmitted assets as they are not readily available to satisfy policyholder obligations. The Working Group did further consider whether admittance of overfunded assets could occur if the company had plans to transfer the overfunded assets into a qualified replacement plan. However, after identifying that plan assets can only be transferred excise tax-free to a qualified replacement plan if in connection with a qualified plan termination, it was noted that no allowance should be permitted to admit overfunded plan assets for such circumstances or to offset an underfunded plan's liability. (A transfer of overfunded plan assets from an existing plan to a new or different plan would not be excise-tax free as the original plan would not meet the requirements of a qualified plan termination.)

103. *Admission of Deferred Tax Assets from Pension Liabilities* – During the Spring 2008 Hearing, comments were received regarding how reporting the full liabilities for pension or OPEB plans would result in a need to consider revisions to *SSAP No. 10—Income Taxes* (SSAP No. 10) as statutory guidance currently limits the amount of deferred tax assets (DTAs) that can be admitted. In considering these comments, the Working Group identified that the Pension Protection Act of 2006 would seem to reduce the extent of deferred tax assets for defined benefit pension plans and that existing SSAP No. 10 guidance would allow companies to admit additional DTAs if they have a tax-planning strategy. (A DTA is created when pension/OPEB liabilities are accrued in the financial statements, but are only recognized/removed when contributions are made to the plan.)

104. The Pension Protection Act of 2006 (PPA), which goes into effect in 2008, is anticipated to reduce the extent that DTAs are created. Under the PPA funding requirements, plans must stay fully funded (assets must equal or exceed liabilities). If the plan is not fully funded, the funding contribution must also include the amount necessary to amortize over seven years the difference between the fund's

liabilities and assets. Although the establishment of the PPA is not anticipated to eliminate DTAs (the PPA liability calculation to which funds must be contributed is a different calculation from one that compares funded plan assets to the projected benefit obligation as required by FAS 158 and this issue paper), it is anticipated that DTAs for pensions will be reduced in accordance with contributions required by the PPA.

105. Current statutory accounting guidance in SSAP No. 10 does not make specific allowances for deferred tax assets resulting from pension obligations. However, SSAP No. 10 currently allows the admittance of deferred tax assets expected to be realized within one year, if less than 10% of capital and surplus, as well as tax-planning strategies to be considered in determining admitted DTAs. Pursuant to the guidance within SSAP No. 10, an entity is permitted to admit a DTA in response to a prudent and feasible tax-planning strategy that if implemented would result in realization of DTAs within one year of the balance sheet date. The entity is not required to implement the strategy within the 12-month period, but it must have the ability to implement the strategy within such time period. The entity must demonstrate that while it ordinarily might not take such actions, it would do so to prevent an operating loss credit carryforward or other similar item from expiring unused. If the tax-planning strategy criteria is met, an entity may recognize as admitted assets the related DTAs that are realizable as a result of the available tax-planning strategy in accordance with paragraphs SSAP No. 10.

106. As a result of the above information, the Working Group agreed not to further consider revisions to SSAP No. 10 to add specific guidance to admit DTAs resulting from pension or OPEB plans. Update 2012[9]: SSAP No. 10 has been superseded by *SSAP No. 101—Income Taxes* (SSAP No. 101). Guidance in SSAP No. 101 is similar to SSAP No. 10 as it also does not make specific allowances for deferred tax assets resulting from pension obligations. Although, the DTA admittance calculation has been revised from SSAP No. 10 – allowing greater timeframes for recovery and realization of DTAs, and a higher percentage for a realization threshold – SSAP No. 101 continues with the approach to determine admittance of DTAs in accordance with a three-component admittance calculation. Also, tax planning-strategies are still permitted to be considered in admitting DTAs.

107. *Inclusion of Nonvested Employees in Determining Pension Liability* - During the 2008 Spring Hearing, the Working Group received comments that nonvested employees in a pension or OPEB plan do not have a current claim, and should be excluded from pension and OPEB obligation determinations. In considering this issue, the Working Group identified current requirements under federal statute regarding company obligations for nonvested employees in terminated pension plans. Additionally, the Working Group identified that the exclusion of nonvested participants would result in less conservative liability requirements for statutory accounting in comparison to other regulations.

108. The Working Group identified guidelines within the Employee Retirement Income Security Act of 1974 (ERISA) and the Pension Benefit Guaranty Corporation (PBGC) that limit the vesting period for defined benefit plans and require consideration of nonvested employees if such plans are terminated. As of 2007, employees' benefits in a defined benefit pension plan must become vested at 100% after five years, or under a seven-year graded-vesting schedule. Furthermore, an employer may terminate a single-employer plan under a standard termination if the plan's assets equal or exceed its liabilities. If the assets are less than the liabilities, the employer must contribute the amount necessary to fully fund the plan. In a standard termination, all accrued benefits under the plan become 100% vested and the plan must purchase annuity contracts for all participants. This means that employees have a right to all the benefits that were earned at the time of the plan termination, even benefits in which they were not vested and would have lost if the employee had left the employer.

[9] Issue papers are considered non-authoritative and provide historical discussion for the development of a SSAP. Issue papers are generally updated after the initial adoption of the related SSAP but not typically thereafter. SSAP No. 102 was adopted in March 2012, the Working Group directed staff to update this issue paper to reflect the final decisions in that SSAP.

109. The Working Group identified that the Financial Accounting Standards Board (FASB) has concluded that accrual accounting (recognition when events and circumstances occur – i.e., employee service) is more representationally faithful and more relevant to financial statement users. Furthermore, actuarial assumptions used in determining pension liabilities already consider that some existing or future retirees will live longer than others and that some individuals will terminate employment before becoming eligible for the benefits. Based on the requirements by FASB, if the statutory accounting guidelines were to require liability determination based on vested employees only, the statutory accounting liabilities for pension plans would be inconsistent and less conservative than GAAP.

110. As a result of the above information, the Working Group agreed that all employees (vested and nonvested) should be included in the pension plan liability determination for statutory accounting. Update 2012: During the development of SSAP No. 102, the Working Group heard additional comments regarding the inclusion of non-vested participants from the American Academy of Actuaries. These comments addressed the inclusion of liabilities within statutory financial statements that are not binding and that may be discontinued when insolvency is imminent, and therefore not a solvency obligation. In considering these comments, the Working Group responded that obligations for pension and other postemployment benefits should be reflected in the financial statements, even if the employer has the discretion to unilaterally freeze, reduce or withdraw those benefits. When the employer or reporting entity freezes or reduces the pension or other postemployment benefit, then it would be appropriate to adjust the obligation accordingly.

111. *Consideration of Using ABO Versus PBO in Establishing Liability* – During the 2008 Spring Hearing, comments were received that the movement to utilize the projected benefit obligation (PBO) instead of the accumulated benefit obligation (ABO) continues to remain a controversial issue. It was noted that the American Academy of Actuaries had previously submitted comments to the FASB indicating that the ABO was a better measure than the PBO as the ABO does not include estimated future increases in compensation which have not yet occurred. In considering these comments, the Working Group identified information included within FASB statements that detail the FASB's considerations of utilizing either the ABO or the PBO, and their decision to require use of the PBO for the liability determination in FAS 158.

112. In discussing the FASB conclusions, the Working Group identified that pension obligations are considered to meet the GAAP definition of a liability and that the PBO is considered to be the most relevant measure of the pension obligation. It was noted that the FASB perceives a difference between an employer promise to pay a benefit of 1% of an employee's final pay and a promise to pay an employee a fixed amount that happens to equal 1% of current pay. If the ABO was utilized, this would result with a practice that ignores the future variable (future pay) and not recognizing a difference between these commitments.

113. Although additional discussion was considered by the Working Group, including comments that ABO is better for a statutory accounting solvency focus as it reflects an obligation at a point of time, the Working Group agreed to be consistent with GAAP on this issue.

114. *Transition and Effective Date* – With the adoption of Issue Paper No. 132 in December 2008, the Statutory Accounting Principles (E) Working Group directed NAIC staff to draft SSAP No. 102 with reconsideration of the effective date to 2011 and expanding the proposed transition period from 5 years to 10 years. In discussing the draft SSAP, an effective date of Jan. 1, 2013, was ultimately adopted.

115. The transition guidance originally proposed in Issue Paper No. 132 required companies with a surplus impact of less than 1% from initial application of the standard to recognize the full surplus impact, including a liability that equaled the full unfunded projected benefit obligation. Reporting entities with a surplus impact of greater than 1% from initial application of the standard would have the option to defer

recognition of the full surplus impact for a period not to exceed five years. This guidance required a minimum of 20% to be recognized in subsequent years. In working with interested parties, actuaries, plan administrators, representatives of the AICPA, and members of the Working Group, the transition guidance was revised to include the following elements:

a. In the first reporting period after transition, reporting entities are required to disclose the obligation and the fair value of plan assets. This disclosure shall specifically note the funded/unfunded status of the plan, and the surplus impact necessary to reflect the full unfunded benefit obligation. Any unfunded defined benefit amounts are considered a liability under SSAP No. 5R and are to be reported in the first quarter financial statements with a corresponding entry to surplus. If the fair value of plan assets exceeds the obligation, the asset is nonadmitted. Items previously recognized from SSAP No. 14 or SSAP No. 89 (gains or losses, prior service costs or credits, and remaining transition items from the original application of those standards) are to be recognized in unassigned funds (surplus). After this recognition, the full unfunded or overfunded status of the plan shall be reflected in the financial statements.

b. Transition Election: Due to the potential surplus impact, reporting entities may elect one of two methods in initially applying the standards:

    i. Reporting entities may elect to recognize the entire transition surplus impact calculated, on an individual plan basis, as of January 1, 2013 (no transition).

    ii. Alternatively, reporting entities may elect to recognize the entire surplus impact, on an individual plan basis, over a period not to exceed ten (10) years. The surplus impact initially recognized as of January 1, 2013, under this transition option, and subsequently over the transition period, shall be the greater of:

        (a) Ten percent of the calculated surplus impact as of the transition date;

        (b) Amortization[10] of the "unrecognized items" into net periodic pension cost, including any accelerated amortization of these items from curtailments or settlements that occur after the transition date. (If the amortization cannot be determined at transition, at a minimum, the amount amortized for "unrecognized items" during the prior year shall be utilized for this component of the calculation. If the amount recognized for transition (greater of all three components) is subsequently determined to be less than what is amortized for the year, the difference between what was recognized for transition, and what is amortized must immediately be recognized as an adjustment to the transition impact to unassigned funds (surplus).);

        (c) Amount necessary to establish a total liability that is equal to any unfunded accumulated benefit obligation (the accumulated benefit obligation less the fair value of plan assets).

If the surplus deferral is elected at the transition date, subsequently, starting with the 2014 year-end financial statement, the reporting entity shall annually recognize the remaining surplus

[10] Unless otherwise impacted from the provisions within this issue paper or in accordance with changes to the pension plan, the amortization of the unrecognized items into net periodic pension cost shall continue to follow the existing amortization schedules in effect on the transition date.

impact (collectively referred to as the "transition liability"[11]) on a systematic basis over a period not to exceed nine years. The minimum amount recognized each subsequent year shall be an amount that reflects the three components identified above. Additionally, reporting entities must recognize any remaining transition liability to the extent that the plan reflects a prepaid benefit cost. (For example, if changes in circumstances have resulted with the plan reflecting an overfunded status, the remaining transition liability must be recognized to the extent that the plan is overfunded.) Furthermore, if circumstances result with a subsequent gain attributed to the plan that will be recognized in earnings, the entity must recognize an additional amount of the remaining transition liability to offset the recognized gain. Reporting entities are permitted to recognize the remaining transition liability, or an amount in excess of the minimum requirement, at any time after the transition date. This transition guidance is specific to the transition surplus impact from initially applying this statement on Jan. 1, 2013. Thus, this transition guidance does not apply to additional liability calculated from subsequent comparison of the fair value of plan assets to the projected benefit obligation, or the impact of subsequent plan amendments.

116. Reporting entities electing to apply the transition guidance must disclose the full transition surplus impact calculated in the first quarter statutory financial statements after the transition date and each reporting period thereafter. This disclosure shall include the initial "transition liability" calculated, the annual amortization amount of the "unrecognized items" into net periodic pension cost, the amount of the unfunded accumulated benefit obligation, and the remaining unrecognized transition impact. This disclosure shall include a schedule of the entity's anticipated recognition of the remaining surplus impact over the transition period.

117. In establishing the final transition guidance, the following key elements were noted:

a. All reporting entities are equally allowed to participate in the transition election. However, reporting entities are not required to elect the surplus deferral, and at transition, or at any time subsequent to transition, reporting entities are permitted to recognize the full transition surplus impact.

b. A 10% minimum surplus recognition threshold provides the potential for a longer transition period (potentially 10 years) to mitigate the surplus impact. However, the transition guidance is not intended to allow reporting entities to improve their surplus position simply by electing to defer recognition of the surplus impact at initial application. Therefore, reporting entities electing the transition option must consider a three-component calculation to determine the minimum surplus impact that must be recognized. This calculation is utilized each time recognition is required for the transition surplus impact to determine the minimum required. Although the guidance allows up to a 10-year transition timeframe, the actual transition timeframe permitted for each reporting entity will depend on the three-component calculation.

c. The transition guidance is specific that it requires a minimum of 10% of the "surplus impact" to be recognized at each reporting period. This guidance was written to prevent an interpretation that would allow a systematic reduction of nonadmitted prepaid benefit cost over the transition timeframe before recognition of any unfunded liability. (As the prepaid benefit cost is nonadmitted, a reduction of this amount is offset by an equal

[11] If the surplus deferral is elected, the deferred liability, although comprised of the previous "unrecognized items" shall be collectively referred to as the "transition liability". Although reporting entities will need to continue to track the unrecognized items for amortization into net periodic cost (offset through unassigned funds), reporting entities shall not allocate the recognized surplus impact from transition to these categories. The minimum amount of liability recognized under the deferral option must cover the annual amortization of the "unrecognized items" into net periodic pension cost to prevent a surplus benefit.

change to the nonadmitted assets. As such, this action alone results in a zero surplus impact.)

d. At initial adoption on Jan. 1, 2013, reporting entities are required to recognize the minimum calculated transition surplus impact. Subsequently, reporting entities are not required to recognize the minimum surplus impact until Dec. 31, 2014. This spread from the initial and first subsequent recognition prevents reporting entities from incurring a surplus impact twice in the same reporting year.

e. Reporting entities must recognize any remaining transition liability to the extent that a plan reflects a prepaid benefit cost, overfunded plan asset or when a gain is subsequently recognized in earnings. For example, if changes in circumstances have resulted with the plan reflecting an overfunded status, the remaining transition liability must be recognized to the extent that the plan is overfunded. Additionally, if circumstances result with a subsequent gain attributed to the plan that will be recognized in earnings, the entity must recognize an additional amount of the remaining transition liability to offset the recognized gain.

f. Transition guidance is specific to the transition surplus impact from initially applying the adopted SSAP. The transition guidance does not apply to additional liabilities calculated from subsequent comparison of the fair value of plan assets to the projected benefit obligation or the impact of subsequent plan amendments. (Subsequent plan amendments resulting in a gain would be considered under paragraph 115.e. above.)

118. *Reporting Unfunded Liabilities in the Financial Statements* – During the 2010 Summer National Meeting, the Statutory Accounting Principles (E) Working Group exposed draft SSAPs for pensions and other postretirement benefit benefits. As a result of this exposure, comments were received from interested parties on the reporting of the unfunded benefit obligations and benefits. These comments noted that the proposed SSAPs appear to commingle the accounting for prepaid and accrued pension costs with the adjustments to surplus necessary to reflect the funded status of the plan on the balance sheet date. It was noted that only some of the transactions impact the income statement, and commingling the amounts on the balance sheet would create cross-check errors with the associated general expense exhibits.

119. After researching the statutory reporting options, it was concluded that there was no viable option that would result with the use of a single financial statement line that will provide regulators with the unfunded pension obligation on the face of the financial statements in a manner similar to GAAP without significant revisions to existing schedules and cross-checks. As a result of these findings, the Working Group agreed that separate reporting will be necessary in the financial statements for "unpaid expenses" and the "transition liability" for pension and postretirement obligations. This could result in situations when a plan reflects a prepaid benefit (nonadmitted prepaid benefit cost) as well as a liability for pension benefits (unfunded obligations). To address these situations and ensure a liability presentation on the balance sheet for unfunded plans, a contra-asset is utilized as an aggregate write-in for other-than-invested assets to offset the prepaid benefit, resulting in a net zero asset presentation on the balance sheet. In order to address concerns that the reporting may be unclear, disclosures are required to separately show the assets and liabilities recognized.

120. *SSAP Amendments_– SSAP No. 102—Accounting for Pensions* was adopted March 2012. Subsequent to adoption, but before finalization of this issue paper, two agenda items were proposed to clarify guidance:

a. Agenda Item 2012-18: Additional Pension Examples - This agenda proposed three additional implementation examples for inclusion in SSAP No. 102. These examples include (1) prepaid benefit cost with unfunded liability – no surplus deferral elected, (3) prepaid benefit cost with unfunded liability – surplus deferral elected with funded accumulated benefit obligation, and (3) prepaid benefit cost with unfunded liability – surplus deferral elected with unfunded accumulated benefit obligation. These examples were adopted Nov. 29, 2012, and have been reflected within the implementation guide of this issue paper.

b. Agenda Item 2012-19: Clarification of Measurement Date Change in SSAP No. 92 & SSAP No. 102 and Applicability of INT 03-18 for SSAP No. 102 – This agenda item proposed revisions to clarify the effective date of the measurement date change for plan assets and benefit obligations reflected in paragraph 89 of this issue paper. This particular aspect is intended to have an effective date subsequent to the effective date of the SSAP. The delayed effective date for the measurement date change is consistent with GAAP. This agenda item also proposed revisions to clarify that *INT 03-18—Accounting for a Change in the Additional Minimum Liability in SSAP No. 8—Pensions* (INT 03-18) is nullified, and incorporate minor revisions to clarify how existing additional minimum liability from SSAP No. 89 is addressed with the adoption of SSAP No. 102. The revisions from agenda item 2012-19 were adopted Nov. 29, 2012, and have been reflected within paragraph 4, 89, 123 and footnote numbers 5 and 7 to paragraph 87.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE:

Statutory Accounting

121. Statutory Accounting Principles currently exist for pensions in SSAP No. 89. The conclusions reached in SSAP No. 89 resulted from adoption *of FASB Statement No. 87: Employers' Accounting for Pensions* (FAS 87), *FASB Statement No. 88: Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits* (FAS 88), *FASB Statement No. 132, Employers' Disclosures about Pensions and Other Postretirement Benefits an amendment of FASB Statements No. 87, 88, and 106* (FAS 132) with certain modifications and *FASB Statement No. 132 (R), Employers' Disclosures about Pensions and Other Postretirement Benefits, and amendment of FASB Statements No. 87, 88, and 106* (FAS 132R) with certain modifications. SSAP No. 89 superseded previous guidance within *SSAP No. 8—Pensions* (SSAP No. 8). The guidance within SSAP No. 8 was derived from adoption of FAS 87, FAS 88 and FAS 132 with modifications.

122. The adoption of SSAP No. 89 nullified the following interpretations:

a. *INT 99-24: Accounting for Restructuring Changes*

b. *INT 01-17: Accounting for Nonqualified Retirement Plans, Nonvested Ancillary Benefits Within Retirement Plans, and Protected Benefits Such as Early Retirement Subsidies in Retirement Plans*

c. *INT 02-18: Accounting for the Intangible Asset as Described in SSAP No. 8 Paragraph 9.d.v. and 9.f.*

123. Upon the establishment of a new statutory accounting principle that adopts FAS 158 with modification and supersedes SSAP No. 89, the following interpretations will be nullified:

a. *INT 99-26: Offsetting Pension Assets and Liabilities* (INT 99-26). This interpretation has been incorporated within paragraph 28 of this issue paper.

b. *INT 01-16: Measurement Date for SSAP No. 8 Actuarial Valuations* (INT 01-16). The 'measurement date' guidance referencing FAS 87 within this interpretation has been revised in accordance with FAS 158. The measurement date guidance included within paragraphs 89-90 of the issue paper should be followed.

c. INT 03-18: Accounting for a Change in the Additional Minimum Liability in SSAP No. 8—Pensions. This INT will be nullified as this issue paper eliminates the additional minimum liability.

d. *INT 04-03: Clarification for Calculating the Additional Minimum Pension Liability Under SSAP No. 89—Accounting for Pensions, A Replacement of SSAP No. 8, paragraph 16.f.* (INT 04-03). This INT will be nullified as this issue paper eliminates the need of an additional pension liability.

e. *INT 04-12: EITF 03-4: Determining the Classification and Benefit Attribution Method for a "Cash Balance" Pension Plan* (INT 04-12). This INT will be nullified as 'cash balance' pension plans have been classified as defined benefit plans for purposes of this issue paper.

124. Upon the establishment of a new statutory accounting principle that adopts FAS 158 with modification and supersedes SSAP No. 89, *INT 04-17: Impact of Medicare Modernization Act on Postretirement Benefits* will no longer provide interpretative guidance for pensions. INT 04-17 adopts with modification the FASB staff position pertaining to whether prescription drug coverage under the Medicare Prescription Drug, Improvement and Modernization Act of 2003 should impact accumulated postretirement benefit obligations. Although this interpretation is specific to postretirement benefits other than pensions, it has historically been referenced on the pension SSAP. With the adoption of SSAP No. 102, this reference will no longer occur, and INT 04-17 will be specific for *SSAP No. 92—Postretirement Benefits Other Than Pensions*.

Generally Accepted Accounting Principles

125. This issue paper adopts with modifications guidance included within FAS 158 and the resulting amended guidance within FAS 87, 88 and 132(R).

126. FAS 158 also references related EITF guidance previously adopted by statutory accounting:

a. *EITF 88-1: Determination of a Vested Benefit Obligation for a Defined Benefit Pension Plan* (EITF 88-1) – This EITF issue is whether the vested benefit obligation is the actuarial present value of the vested benefits to which the employee is entitled if the employee separates immediately (approach 1) or the actuarial present value of the vested benefits to which the employee is currently entitled but based on the employee's expected date of separation or retirement (approach 2). The consensus reached that either approach is acceptable for situations not specifically addressed by FAS 87 for facts and circumstances analogous to EITF 88-1.

b. *EITF 90-3: Accounting for Employers' Obligations for Future Contributions to a Multiemployer Pension Plan* (EITF 90-3) – This EITF issue is whether an employer must record a liability for the total future payments for prior service costs pursuant to the agreement at the date the employer enters the plan or improves benefits under the plan. The consensus reached was that, per paragraph 87 of FAS 87, as amended by FAS 158, the existence of the executed agreement does not require that a liability be reported beyond any contributions currently due and unpaid.

c. *EITF 91-7: Accounting for Pension Benefits Paid by Employers after Insurance Companies Fail to Provide Annuity Benefits* (EITF 97-1) – This EITF issue is how an employer should account for the cost of making up the deficiency in annuity payments to the retirees. The consensus reached that the employer should recognize a loss at the time the deficiency is assumed by the employer if any gain was recognized on the original settlement. The loss recognized would be the lesser of any gain recognized on the original settlement or the amount of the benefit obligation assumed by the employer. The excess obligation assumed by the employer over the loss recognized should be accounted for as a plan amendment or plan initiation in accordance with paragraphs 24-28 of FAS 87, as amended by FAS 158.

d. *EITF 96-5: Recognition of Liabilities for Contractual Termination Benefits or Changing Benefit Plan Assumptions in Anticipation of a Business Combination* (EITF 96-5) – This EITF issue is whether a liability for the contractual termination benefits and the curtailment losses under employee benefit plans that will be triggered by the consummation of the business combination should be recognized when it is probable that the business combination will be consummated or when the business combination is consummated. The consensus reached is that the liability for the contractual termination benefits and the curtailment losses under employee benefit plans that will be triggered by the consummation of the business commutation and should be recognized when the business combination is consummated.

127. The following is excerpted from *FASB Statement No. 130, Other Comprehensive Income* (FAS 130):

> 10. This Statement uses the term comprehensive income to describe the total of all components of comprehensive income, including net income. [4] This Statement uses the term other comprehensive income to refer to revenues, expenses, gains, and losses that under generally accepted accounting principles are included in comprehensive income but excluded from net income. This Statement does not require that an enterprise use the terms comprehensive income or other comprehensive income in its financial statements, even though those terms are used throughout this Statement. [5]
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> [4] FAS130, Footnote 4--This Statement uses the term net income to describe a measure of financial performance resulting from the aggregation of revenues, expenses, gains, and losses that are not items of other comprehensive income as identified in this Statement. A variety of other terms such as net earnings or earnings may be used to describe that measure.
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> [5] FAS130, Footnote 5--Paragraph 40 of Concepts Statement 5 states that "just as a variety of terms are used for net income in present practice, the Board anticipates that total nonowner changes in equity, comprehensive loss, and other equivalent terms will be used in future financial statements as names for comprehensive income."

128. See Issue Paper No. 123 and Issue Paper No. 8 for additional GAAP references.

RELEVANT LITERATURE:

Statutory Accounting

- *Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy*
- *SSAP No. 8—Pensions*
- *SSAP No. 10—Income Taxes*
- *SSAP No. 89—Accounting for Pensions, A Replacement of SSAP No. 8*
- *Issue Paper No. 3—Accounting Changes*
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 8—Accounting for Pensions*

- *Issue Paper No. 123—Accounting for Pensions, A Replacement of SSAP No. 8*
- *INT 04-03: Clarification for Calculating the Additional Minimum Pension Liability Under SSAP No. 89—Accounting for Pensions, A Replacement of SSAP No. 8, paragraph 16.f.*
- *INT 04-11: EITF 03-2: Accounting for the Transfer to the Japanese Government of the Substitutional Portion of Employee Pension Fund Liabilities*
- *INT 04-12: EITF 03-4: Determining the Classification and Benefit Attribution Method for a "Cash Balance" Pension Plan.*
- *INT 04-17: Impact of Medicare Modernization Act on Postretirement Benefits*
- *INT 02-18: Accounting for the Intangible Asset as Described in SSAP No. 8 Paragraph 9.d.v. and 9.f.*
- *INT 01-16: Measurement Date for SSAP No. 8 Actuarial Valuations*
- *INT 01-17: Accounting for Nonqualified Retirement Plans, Nonvested Ancillary Benefits Within Retirement Plans, and Protected Benefits Such as Early Retirement Subsidies in Retirement Plans*
- *INT 99-24: Accounting for Restructuring Charges*
- *INT 99-26: Offsetting Pension Assets and Liabilities*

Generally Accepted Accounting Principles

- *FASB Statement No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106 and 132(R)*
- *FASB Statement No. 87, Employers' Accounting for Pensions*
- *FASB Statement No. 88, Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*
- *FASB Statement No. 130, Other Comprehensive Income*
- *FASB Statement No. 132(R), Employers' Disclosures about Pensions and Other Postretirement Benefits*
- *FASB Emerging Issues Task Force No. 88-1, Determination of Vested Benefits Obligation for a Defined Benefit Pension Plan*
- *FASB Emerging Issues Task Force No. 90-3, Accounting for Employers' Obligations for Future Contributions to a Mutliemployer Pension Plan*
- *FASB Emerging Issues Task Force No. 91-7, Accounting for Pension Benefits Paid by Employers after Insurance Companies Fail to Provide Annuity Benefits*
- *FASB Emerging Issues Task Force No. 96-5, Recognition of Liabilities for Contractual Termination Benefits or Changing Benefit Plan Assumptions in Anticipation of a Business Combination*

STATE REGULATIONS:

— No additional guidance obtained from state statutes or regulations.

EXHIBIT A - IMPLEMENTATION GUIDE

Note: Implementation guidance included in SSAP No. 102 has not been duplicated within this Issue Paper.

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Statutory Issue Paper No. 133

Accounting for Postretirement Benefits Other Than Pensions, A Replacement of SSAP No. 14

STATUS:

Initially Adopted – December 5, 2008
Adopted to Reflect SSAP No. 92 – December 18, 2012

Original SSAP and Current Authoritative Guidance: SSAP No. 92

Type of Issue:
Common Area

SUMMARY OF ISSUE:

1. In September 2006, the Financial Accounting Standards Board (FASB) issued *FASB Statement No. 158: Accounting for Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106 and 132(R)* (FAS 158). The adoption with modification of FAS 158 requires entities that sponsor one or more single-employer defined benefit plan to:

a. Recognize the overfunded or underfunded status of a defined benefit postretirement plan (other than a multiemployer plan) as an asset or liability in the statement of financial position.

b. Aggregate the statuses of all overfunded plans and recognize that amount as a nonadmitted asset in its statement of financial position. It also shall aggregate the statuses of all underfunded plans and recognize that amount as a liability in its statement of financial position.

c. Recognize as a component of unassigned funds (surplus) the gains and losses and prior service costs or credits that arise during the period but were not recognized as components of net periodic benefit cost of the period pursuant to SSAP No. 89 and SSAP No. 14.

d. Recognize corresponding adjustments in unassigned funds (surplus) when the gains and losses, prior service costs or credits and transition assets and obligations remaining from the initial application of SSAP No. 89 and SSAP No. 14 are subsequently recognized as components of net periodic benefit cost pursuant to the recognition and amortization provisions of SSAP No. 89 and SSAP No. 14.

2. Current statutory accounting guidance for postretirement plans other than pensions is provided within *SSAP No. 14—Postretirement Benefits Other Than Pensions* (SSAP No. 14). The conclusions reached within this SSAP resulted from adoption with modification *of FASB Statement No. 106—Employers' Accounting for Postretirement Benefits Other Than Pensions* (FAS 106), *FASB Statement No. 132, Employers' Disclosures about Pensions and Other Postretirement Benefits an amendment of FASB Statements No. 87, 88, and 106* (FAS 132) and *FASB Statement No. 132 (R), Employers' Disclosures about Pensions and Other Postretirement Benefits, and amendment of FASB Statements No. 87, 88, and 106* (FAS 132R).

3. The purpose of this issue paper is to update statutory accounting principles for postretirement benefits other than pensions. Consequently, this issue paper adopts FAS 158 with modifications

considered necessary for consistent statutory reporting. The result will be a new SSAP (SSAP No. 92) superseding SSAP No. 14.

SCOPE OF STATEMENT

4. This issue paper applies to all postretirement benefits expected to be provided by an employer to current and former employees (including retirees, disabled employees, and other former employees who are expected to receive postretirement benefits), their beneficiaries, and covered dependents, pursuant to the terms of an employer's undertaking to provide those benefits. Other postretirement benefits include, but are not limited to, postretirement health care; life insurance provided outside a pension plan to retirees; and other welfare benefits such as tuition assistance, day care, legal services, and housing subsidies provided after retirement. Often those benefits are in the form of a reimbursement to plan participants or direct payment to providers for the cost of specified services as the need for those services arises, but they may also include benefits payable as a lump sum, such as death benefits. Much of the guidance in this Statement focuses on postretirement health care plans. Nevertheless, this issue paper applies equally to all postretirement benefits other than pensions. A postretirement benefit plan may be part of a larger plan or arrangement that provides benefits currently to active employees as well as to retirees. In those circumstances, the promise to provide benefits to present and future retirees under the plan shall be segregated from the promise to provide benefits currently to active employees and shall be accounted for in accordance with the provisions of this Statement. Absent evidence to the contrary, it shall be presumed that an employer that has provided postretirement benefits in the past or is currently promising those benefits to employees will continue to provide those future benefits. This issue paper supersedes the guidance in *SSAP No. 14—Postretirement Plans Other Than Pensions* (SSAP No. 14), nullifies and incorporates the guidance in *Interpretation 99-26: Offsetting Pension Assets and Liabilities* (INT 99-26) and nullifies *INT 01-16: Measurement Date for SSAP No. 8 Actuarial Valuations* (INT 01-16).

SUMMARY CONCLUSION

Defined Postretirement Plans

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Single-Employer Defined Benefit Pension Plans

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5. A defined benefit postretirement plan is one that defines the postretirement benefits in terms of (a) monetary amounts or (b) benefit coverage to be provided. In some cases, an employer may limit its obligation through an individual or an aggregate "cap" on the employer's cost or benefit obligation. Plans of that nature are considered to be defined benefit postretirement plans. (Hybrid postretirement plans or ‘cash-balance’ plans are considered defined benefit plans for purposes of applying this issue paper.) For defined benefit plans, reporting entities shall adopt *FAS 158: Employers’ Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106 and 132 (R)* (FAS 158) and *FASB Staff Position FAS 136(R)-1, Employers’ Disclosures about Postretirement Benefit Plan Assets* (FSP FAS 136(R)-1) with modifications as discussed in paragraph 101.

6. A postretirement benefit is part of the compensation paid to an employee for services rendered. In a defined benefit plan, the employer promises to provide, in addition to current wages and benefits, future benefits during retirement. Generally, the amount of those benefits depends on the benefit formula (which may include factors such as the number of years of service rendered or the employee's compensation before retirement or termination), the longevity of the retiree and any beneficiaries and covered dependents, and the incidence of events requiring benefit payments (for example, illnesses affecting the amount of health care required). In most cases, services are rendered over a number of years before an employee retires and begins to receive benefits or is entitled to receive benefits as a need arises. Even though the services rendered by the employee are complete and the employee has retired, the total amount of benefits the employer has promised and the cost to the employer of the services rendered are not

precisely determinable but can be estimated using the plan's benefit formula and estimates of the effects of relevant future events.

Elements of Accounting for Postretirement Benefits

7. Any method of accounting that recognizes the cost of postretirement benefits over employee service periods (before the payment of benefits to retirees) must deal with two factors that stem from the nature of the arrangement. First, estimates or assumptions must be made about the future events that will determine the amount and timing of the benefit payments. Second, an attribution approach that assigns benefits and the cost of those benefits to individual years of service must be selected.

8. The expected postretirement benefit obligation for an employee is the actuarial present value as of a particular date of the postretirement benefits expected to be paid by the employer's plan to or for the employee, the employee's beneficiaries, and any covered dependents pursuant to the terms of the plan. Measurement of the expected postretirement benefit obligation is based on the expected amount and timing of future benefits, taking into consideration the expected future cost of providing the benefits and the extent to which those costs are shared by the employer, the employee (including consideration of contributions required during the employee's active service period and following retirement, deductibles, coinsurance provisions, and so forth), or others (such as through governmental programs).

9. The accumulated postretirement benefit obligation as of a particular date is the actuarial present value of all future benefits attributed to an employee's service rendered to that date pursuant to paragraphs 32-33 and 44-47, assuming the plan continues in effect and that all assumptions about future events are fulfilled. Prior to the date on which an employee attains full eligibility for the benefits that employee is expected to earn under the terms of the postretirement benefit plan (the full eligibility date), the accumulated postretirement benefit obligation for an employee is a portion of the expected postretirement benefit obligation. On and after the full eligibility date, the accumulated postretirement benefit obligation and the expected postretirement benefit obligation for an employee are the same. Determination of the full eligibility date is affected by plan terms that provide incremental benefits expected to be received by or on behalf of an employee for additional years of service, unless those incremental benefits are trivial. Determination of the full eligibility date is not affected by plan terms that define when benefit payments commence or by an employee's current dependency status.

10. Net periodic postretirement benefit cost comprises several components that reflect different aspects of the employer's financial arrangements. The service cost component of net periodic postretirement benefit cost is the actuarial present value of benefits attributed to services rendered by employees during the period (the portion of the expected postretirement benefit obligation attributed to service in the period). The service cost component is the same for an unfunded plan, a plan with minimal funding, and a well-funded plan. The other components of net periodic postretirement benefit cost are interest cost (interest on the accumulated postretirement benefit obligation, which is a discounted amount), actual return on plan assets[1], amortization of any prior service cost or credit included in unassigned funds (surplus), amortization of the transition obligation or transition asset, and the gain or loss component which includes, to the extent recognized, amortization of the net gain or loss included in unassigned funds (surplus) (refer to paragraph 51).

[1] To address a question on how the expected return on plan assets affects the determination of net periodic benefit cost if the actual return on plan assets for a period is a component of net periodic benefit cost, it is noted that the expected return on plan assets generally will be different from the actual return on plan assets for the year. This issue paper provides for recognition of that difference (a net gain or loss) in unassigned funds (surplus) in the period it arises. The amount recognized in unassigned funds (surplus) is also a component of net periodic benefit cost for the current period. Thus, the amount recognized in unassigned funds (surplus) and the actual return on plan assets, when aggregated, equal the expected return on plan assets. The amount recognized in unassigned funds (surplus) affects future net periodic benefit cost through subsequent amortization, if any, of the net gain or loss. (This footnote reflects guidance included in E12 of FSP FAS 158-1.)

Measurement of Cost and Obligations

Accounting for the Substantive Plan

11. An objective of this issue paper is that the accounting reflects the terms of the exchange transaction that takes place between an employer that provides postretirement benefits and the employees who render services in exchange for those benefits, as those terms are understood by both parties to the transaction. Generally, the extant written plan provides the best evidence of the terms of that exchange transaction. However, in some situations, an employer's cost-sharing policy, as evidenced by past practice or by communication of intended changes to a plan's cost-sharing provisions, or a past practice of regular increases in certain monetary benefits may indicate that the substantive plan—the plan as understood by the parties to the exchange transaction—differs from the extant written plan. The substantive plan shall be the basis for the accounting.

12. Except as provided in paragraph 13, an employer's cost-sharing policy, as evidenced by the following past practice or communication, shall constitute the cost-sharing provisions of the substantive plan if either of the following conditions exist. Otherwise, the extant written plan shall be considered to be the substantive plan.

a. The employer has a past practice of (1) maintaining a consistent level of cost sharing between the employer and its retirees through changes in deductibles, coinsurance provisions, retiree contributions, or some combination of those changes or (2) consistently increasing or reducing the employer's share of the cost of the covered benefits through changes in retired or active plan participants' contributions toward their retiree health care benefits, deductibles, coinsurance provisions, out-of-pocket limitations, and so forth, in accordance with the employer's established cost-sharing policy.

b. The employer has the ability, and has communicated to affected plan participants its intent, to institute different cost-sharing provisions at a specified time or when certain conditions exist (for example, when health care cost increases exceed a certain level).

13. An employer's past practice of maintaining a consistent level of cost sharing with its retirees or consistently increasing or reducing its share of the cost of providing the covered benefits shall not constitute provisions of the substantive plan if accompanied by identifiable offsetting changes in other benefits or compensation or if the employer incurred significant costs, such as work stoppages, to effect that cost-sharing policy. Similarly, an employer's communication of its intent to institute cost-sharing provisions that differ from the extant written plan or the past cost-sharing practice shall not constitute provisions of the substantive plan (a) if the plan participants would be unwilling to accept the change without adverse consequences to the employer's operations or (b) if other modifications of the plan, such as the level of benefit coverage, or providing offsetting changes in other benefits, such as pension benefits, would be required to gain plan participants' acceptance of the change to the cost-sharing arrangement.

14. A past practice of regular increases in postretirement benefits defined in terms of monetary amounts may indicate that the employer has a present commitment to make future improvements to the plan and that the plan will provide monetary benefits attributable to prior service that are greater than the monetary benefits defined by the extant written plan. In those situations, the substantive commitment to increase those benefits shall be the basis for the accounting. Changes in the benefits, other than benefits defined in terms of monetary amounts, covered by a postretirement health care plan or by other postretirement benefit plans shall not be anticipated.

15. Contributions expected to be received from active employees toward the cost of their postretirement benefits and from retired plan participants are treated similarly for purposes of measuring an employer's expected postretirement benefit obligation. That obligation is measured as the actuarial present value of the benefits expected to be provided under the plan, reduced by the actuarial present value of contributions expected to be received from the plan participants during their remaining active service and postretirement periods. In determining the amount of the contributions expected to be received from those participants toward the cost of their postretirement benefits, consideration is given to any related substantive plan provisions, such as an employer's past practice of consistently increasing or reducing the contribution rates as described in paragraphs 12-13. An obligation to return contributions received from employees who do not attain eligibility for postretirement benefits and, if applicable, any interest accrued on those contributions shall be recognized as a component of an employer's postretirement benefit obligation.

16. Automatic benefit changes specified by the plan that are expected to occur shall be included in measurements of the expected and accumulated postretirement benefit obligations and the service cost component of net periodic postretirement benefit cost. Also, plan amendments shall be included in the computation of the expected and accumulated postretirement benefit obligations once they have been contractually agreed to, even if some provisions take effect only in future periods. For example, if a plan amendment grants a different benefit level for employees retiring after a future date, that increased or reduced benefit level shall be included in current-period measurements for employees expected to retire after that date.

17. Measuring the net periodic postretirement benefit cost and accumulated postretirement benefit obligation based on best estimates is superior to implying, by a failure to accrue, that no cost or obligation exists prior to the payment of benefits. This issue paper requires the use of explicit assumptions, each of which individually represents the best estimate of a particular future event, to measure the expected postretirement benefit obligation. A portion of that expected postretirement benefit obligation is attributed to each period of an employee's service associated with earning the postretirement benefits, and that amount is accrued as service cost for that period.

18. The service cost component of postretirement benefit cost, any prior service cost, and the accumulated postretirement benefit obligation are measured using actuarial assumptions and present value techniques to calculate the actuarial present value of the expected future benefits attributed to periods of employee service. Each assumption used shall reflect the best estimate solely with respect to that individual assumption. All assumptions shall presume that the plan will continue in effect in the absence of evidence that it will not continue. Principal actuarial assumptions include the time value of money (discount rates); participation rates (for contributory plans); retirement age; factors affecting the amount and timing of future benefit payments, which for postretirement health care benefits consider past and present per capita claims cost by age, health care cost trend rates, Medicare reimbursement rates, and so forth; salary progression (for pay-related plans); and the probability of payment (turnover, dependency status, mortality, and so forth).

19. Assumed discount rates shall reflect the time value of money as of the measurement date in determining the present value of future cash outflows currently expected to be required to satisfy the postretirement benefit obligation. In making that assumption, employers shall look to rates of return on high-quality fixed-income investments currently available whose cash flows match the timing and amount of expected benefit payments. If settlement of the obligation with third-party insurers is possible (for example, the purchase of nonparticipating life insurance contracts to provide death benefits), the interest rates inherent in the amount at which the postretirement benefit obligation could be settled are relevant in determining the assumed discount rates. Assumed discount rates are used in measurements of the expected and accumulated postretirement benefit obligations and the service cost and interest cost components of net periodic postretirement benefit cost.

20. Pursuant to paragraph 19, an employer shall look to rates of return on high-quality fixed-income investments in determining assumed discount rates. The objective of selecting assumed discount rates using that method is to measure the single amount that, if invested at the measurement date in a portfolio of high-quality debt instruments, would provide the necessary future cash flows to pay the postretirement benefits when due. Notionally, that single amount, the accumulated postretirement benefit obligation, would equal the current fair value of a portfolio of high-quality zero coupon bonds whose maturity dates and amounts would be the same as the timing and amount of the expected future benefit payments. Because cash inflows would equal cash outflows in timing and amount, there would be no reinvestment risk in the yields to maturity of the portfolio. However, in other than a zero coupon portfolio, such as a portfolio of long-term debt instruments that pay semiannual interest payments or whose maturities do not extend far enough into the future to meet expected benefit payments, the assumed discount rates (the yield to maturity) need to incorporate expected reinvestment rates available in the future. Those rates shall be extrapolated from the existing yield curve at the measurement date. The determination of the assumed discount rate is separate from the determination of the expected rate of return on plan assets whenever the actual portfolio differs from the hypothetical portfolio described above. Assumed discount rates shall be reevaluated at each measurement date. If the general level of interest rates rises or declines, the assumed discount rates shall change in a similar manner.

21. The expected long-term rate of return on plan assets shall reflect the average rate of earnings expected on the existing assets that qualify as plan assets and contributions to the plan expected to be made during the period. In estimating that rate, appropriate consideration should be given to the returns being earned on the plan assets currently invested and the rates of return expected to be available for reinvestment. If the return on plan assets is taxable to the trust or other fund under the plan, the expected long-term rate of return shall be reduced to reflect the related income taxes expected to be paid under existing law. There is no assumption of an expected long-term rate of return on plan assets for plans that are unfunded or that have no assets that qualify as plan assets pursuant to this issue paper.

22. The service cost component of net periodic postretirement benefit cost and the expected and accumulated postretirement benefit obligations shall reflect future compensation levels to the extent the postretirement benefit formula defines the benefits wholly or partially as a function of future compensation levels. For pay-related plans, assumed compensation levels shall reflect the best estimate of the actual future compensation levels of the individual employees involved, including future changes attributed to general price levels, productivity, seniority, promotion, and other factors. All assumptions shall be consistent to the extent that each reflects expectations about the same future economic conditions, such as future rates of inflation. Measuring service cost and the expected and accumulated postretirement benefit obligations based on estimated future compensation levels entails considering any indirect effects, such as benefit limitations, that would affect benefits provided by the plan.

Assumptions Unique to the Postretirement Health Care Benefits

23. Measurement of an employer's postretirement health care obligation requires the use of several assumptions unique to health care benefits. Most significantly, it includes several assumptions about factors that will affect the amount and timing of future benefit payments for postretirement health care. Those factors include consideration of historical per capita claims cost by age, health care cost trend rates (for plans that provide a benefit in kind), and medical coverage to be paid by governmental authorities and other providers of health care benefits.

24. In principle, an employer's share of the expected future postretirement health care cost for a plan participant is developed by reducing the assumed per capita claims cost at each age at which the plan participant is expected to receive benefits under the plan by (a) the effects of coverage by Medicare and other providers of health care benefits, and (b) the effects of the cost-sharing provisions of the plan (deductibles, copayment provisions, out-of-pocket limitations, caps on the limits of the employer-provided payments, and retiree contributions). The resulting amount represents the assumed net incurred

claims cost at each age at which the plan participant is expected to receive benefits under the plan. If contributions are required to be paid by active plan participants toward their postretirement health care benefits, the actuarial present value of the plan participants' future contributions reduces the actuarial present value of the aggregate assumed net incurred claims costs.

25. The assumed per capita claims cost by age is the annual per capita cost, for periods after the measurement date, of providing the postretirement health care benefits covered by the plan from the earliest age at which an individual could begin to receive benefits under the plan through the remainder of the individual's life or the covered period, if shorter. The assumed per capita claims cost shall be the best estimate of the expected future cost of the benefits covered by the plan. It may be appropriate to consider other factors in addition to age, such as sex and geographical location, in developing the assumed per capita claims cost.

26. Past and present claims data for the plan, such as a historical pattern of gross claims by age (claims curve), should be used in developing the current per capita claims cost to the extent that those data are considered to be indicative of the current cost of providing the benefits covered by the plan. Those current claims data shall be adjusted by the assumed health care cost trend rate. The resulting assumed per capita claims cost by age, together with the plan demographics, determines the amount and timing of expected future gross eligible charges.

27. In the absence of sufficiently reliable plan data about the current cost of the benefits covered by the plan, the current per capita claims cost should be based, entirely or in part, on the claims information of other employers to the extent those costs are indicative of the current cost of providing the benefits covered by the plan. For example, the current per capita claims cost may be based on the claims experience of other employers derived from information in data files developed by insurance companies, actuarial firms, or employee benefits consulting firms. The current per capita claims cost developed on those bases shall be adjusted to best reflect the terms of the employer's plan and the plan demographics. For example, the information should be adjusted, as necessary, for differing demographics, such as the age and sex of plan participants, health care utilization patterns by men and women at various ages, and the expected geographical location of retirees and their dependents, and for significant differences between the nature and types of benefits covered by the employer's plan and those encompassed by the underlying data.

28. The assumption about health care cost trend rates represents the expected annual rates of change in the cost of health care benefits currently provided by the postretirement benefit plan, due to factors other than changes in the demographics of the plan participants, for each year from the measurement date until the end of the period in which benefits are expected to be paid. Past and current health care cost trends shall be used in developing an employer's assumed health care cost trend rates, which implicitly consider estimates of health care inflation, changes in health care utilization or delivery patterns, technological advances, and changes in the health status of plan participants. Differing services, such as hospital care and dental care, may require the use of different health care cost trend rates. It is appropriate for that assumption to reflect changes in health care cost trend rates over time. For example, the health care cost trend rates may be assumed to continue at the present level for the near term, or increase for a period of time, and then grade down over time to an estimated health care cost trend rate ultimately expected to prevail.

29. Certain medical claims may be covered by governmental programs under existing law or by other providers of health care benefits. Benefit coverage by those governmental programs shall be assumed to continue as provided by the present law and by other providers pursuant to their present plans. Presently enacted changes in the law or amendments of the plans of other health care providers that take effect in future periods and that will affect the future level of their benefit coverage shall be considered in current-period measurements for benefits expected to be provided in those future periods. Future changes in laws

concerning medical costs covered by governmental programs and future changes in the plans of other providers shall not be anticipated.

30. In some cases, determining the assumed per capita claims cost by age as described in paragraphs 25-27 may not be practical because credible historical information about the gross per capita cost of covered benefits may not be available or determinable to satisfy the stated measurement approach. However, credible historical information about incurred claims costs may be available. In those cases, an alternative method of developing the assumed per capita claims cost may be used provided the method results in a measure that is the best estimate of the expected future cost of the benefits covered by the plan. For example, the assumed health care cost trend rates may be determined by adjusting the expected change in the employer's share of per capita incurred claims cost by age by a factor that reflects the effects of the plan's cost-sharing provisions. However, an approach that projects net incurred claims costs using unadjusted assumed health care cost trend rates would implicitly assume changes in the plan's cost-sharing provisions at those assumed rates and, therefore, is not acceptable unless the plan's cost-sharing provisions are indexed in that manner or the substantive plan operates in that manner.

31. Assumed discount rates include an inflationary element that reflects the expected general rate of inflation. Assumed compensation levels include consideration of future changes attributable to general price levels. Similarly, assumed health care cost trend rates include an element that reflects expected general rates of inflation for the economy overall and an element that reflects price changes of health care costs in particular. To the extent that those assumptions consider similar inflationary effects, the assumptions about those effects shall be consistent.

Attribution

32. An equal amount of the expected postretirement benefit obligation for an employee generally shall be attributed to each year of service in the attribution period (a benefit/years-of-service approach). However, some plans may have benefit formulas that attribute a disproportionate share of the expected postretirement benefit obligation to employees' early years of service. For that type of plan, the expected postretirement benefit obligation shall be attributed in accordance with the plan's benefit formula.

33. The beginning of the attribution period generally shall be the date of hire. However, if the plan's benefit formula grants credit only for service from a later date and that credited service period is not nominal in relation to employees' total years of service prior to their full eligibility dates, the expected postretirement benefit obligation shall be attributed from the beginning of that credited service period. In all cases, the end of the attribution period shall be the full eligibility date.

Recognition of Liabilities and Assets

34. An employer that sponsors one or more single-employer defined benefit postretirement plans other than pensions shall recognize in its statement of financial position the funded statuses of those plans. The status for each plan shall be measured as the difference between the fair value of plan assets and the accumulated postretirement benefit obligation (considering both vested and nonvested employees) as it is defined in this issue paper.

35. The employer shall aggregate the statuses of all overfunded plans and recognize that amount as a nonadmitted asset in its statement of financial position. It also shall aggregate the statuses of all underfunded plans and recognize that amount as a liability in its statement of financial position. It is not acceptable statutory accounting practice to offset pension or postretirement benefits other than pensions liability generated by one plan against the prepaid assets of another plan.

Recognition of Net Periodic Postretirement Benefit Cost

36. As with other forms of deferred compensation, the cost of providing postretirement benefits shall be attributed to the periods of employee service rendered in exchange for those future benefits pursuant to the terms of the plan. That cost notionally represents the change in the unfunded accumulated postretirement benefit obligation for the period, ignoring employer contributions to the plan, plan settlements, and payments made by the employer directly to retirees. However, changes in that unfunded obligation that arise from experience gains and losses and the effects of changes in assumptions may be recognized as a component of net periodic postretirement benefit cost on a delayed basis. In addition, the effects of a plan initiation or amendment generally are recognized on a delayed basis.

37. The following components shall be included in the net postretirement benefit cost recognized for a period by an employer sponsoring a defined benefit postretirement plan: a) service cost; b) interest cost; c) actual return on plan assets, if any; d) amortization of any prior service cost or credit included in unassigned funds (surplus) to the extent required by paragraphs 42-47; e) gain or loss (including the effects of changes in assumptions) to the extent recognized ; and f) amortization of any obligation or asset existing at the date of initial application of this issue paper, hereinafter referred to as the transition obligation or transition asset remaining in unassigned funds (surplus).

Service Cost

38. The service cost component recognized in a period shall be determined as the portion of the expected postretirement benefit obligation attributed to employee service during that period. The measurement of the service cost component requires identification of the substantive plan and the use of assumptions and an attribution method, which are discussed in paragraphs 11-33.

39. The prior service cost for nonvested employees not previously recognized[2] is not required to be included in net postretirement benefit cost entirely in the year this standard is adopted. Unrecognized prior service cost for nonvested employees shall be amortized as a component of the net postretirement benefit cost by assigning an equal amount to each expected future period of service before vesting occurs for nonvested employees active at the date of the amendment. Unassigned funds (surplus) is adjusted each period as prior service cost is amortized (refer to paragraphs 102-105 for transition guidance related to the recognition of the prior service cost for nonvested employees through unassigned funds (surplus)).

Interest Cost

40. The interest cost component recognized in a period shall be determined as the increase in the accumulated postretirement benefit obligation to recognize the effects of the passage of time. Measuring the accumulated postretirement benefit obligation as a present value requires accrual of an interest cost at rates equal to the assumed discount rates.

Actual Return on Plan Assets

41. For a funded plan, the actual return on plan assets shall be determined based on the fair value of plan assets at the beginning and end of the period, adjusted for contributions and benefit payments. If the fund holding the plan assets is a taxable entity, the actual return on plan assets shall reflect the tax expense or benefit for the period determined in accordance with generally accepted accounting principles. Otherwise, no provision for taxes shall be included in the actual return on plan assets.

[2] The previous statutory accounting guidance in *SSAP No. 14—Postretirement Benefits Other Than Pensions* excluded nonvested employees from the service cost calculation. This exclusion has been eliminated with the issuance of this SSAP.

Prior Service Cost

42. Plan amendments (including initiation of a plan) may include provisions that attribute the increase or reduction in benefits to employee service rendered in prior periods or only to employee service to be rendered in future periods. For purposes of measuring the accumulated postretirement benefit obligation, the effect of a plan amendment on a plan participant's expected postretirement benefit obligation shall be attributed to each year of service in that plan participant's attribution period, including years of service already rendered by that plan participant, in accordance with the attribution of the expected postretirement benefit obligation to years of service as discussed in paragraphs 32-33. If a plan is initiated that grants benefits solely in exchange for employee service after the date of the plan initiation or a future date, no portion of the expected postretirement benefit obligation is attributed to prior service periods because, in that case, the credited service period for the current employees who are expected to receive benefits under the plan begins at the date of the plan initiation or the future date.

43. Plan amendments that improve benefits are granted with the expectation that the employer will realize economic benefits in future periods. Consequently, except as discussed in paragraph 46, this issue paper does not permit the cost of benefit improvements (that is, prior service cost) to be included in net periodic postretirement benefit cost entirely in the year of the amendment. Rather, paragraph 44 provides for recognition of prior service cost arising from benefit improvements during the remaining years of service to the full eligibility dates of those plan participants active at the date of the plan amendment.

44. A plan amendment that retroactively increases benefits (including benefits that are granted to fully eligible plan participants) increases the accumulated postretirement benefit obligation. The cost of the benefit improvement shall be recognized as a charge to unassigned funds (surplus) at the date of the amendment. Except as specified in the next sentence and in paragraphs 45-46, that prior service cost shall be amortized as a component of net periodic postretirement benefit cost by assigning an equal amount to each remaining year of service to the full eligibility date of each plan participant active at the date of the amendment who was not yet fully eligible for benefits at that date. If all or almost all of a plan's participants are fully eligible for benefits, the prior service cost shall be amortized based on the remaining life expectancy of those plan participants rather than on the remaining years of service to the full eligibility dates of the active plan participants. Unassigned funds (surplus) is adjusted as a result of amortizing prior service cost.

45. To reduce the complexity and detail of the computations required, consistent use of an alternative approach that more rapidly amortizes the prior service cost recognized in unassigned funds (surplus) is permitted. For example, a straight-line amortization of the cost over the average remaining years of service to full eligibility for benefits of the active plan participants is acceptable.

46. In some situations, a history of regular plan amendments and other evidence may indicate that the period during which the employer expects to realize economic benefits from an amendment that grants increased benefits is shorter than the remaining years of service to full eligibility for benefits of the active plan participants. Identification of those situations requires an assessment of the individual circumstances of the particular plan. In those circumstances, the amortization of prior service cost shall be accelerated to reflect the more rapid expiration of the employer's economic benefits and to recognize the cost in the periods benefited.

47. A plan amendment that retroactively reduces, rather than increases, benefits decreases the accumulated postretirement benefit obligation. The reduction in benefits shall be recognized as a corresponding credit (prior service credit) to unassigned funds (surplus) that shall be used first to reduce any remaining prior service cost included in unassigned funds (surplus), then to reduce any transition obligation remaining in unassigned funds (surplus). The excess, if any, shall be amortized as a component of net periodic postretirement benefit cost on the same basis as specified in paragraph 44 for prior service cost. Immediate recognition of the excess is not permitted.

Gains and Losses

48. Gains and losses are changes in the amount of either the accumulated postretirement benefit obligation or plan assets resulting from experience different from that assumed or from changes in assumptions. This issue paper generally does not distinguish between those sources of gains and losses. Gains and losses include amounts that have been realized as well as amounts that are unrealized. Because gains and losses may reflect refinements in estimates as well as real changes in economic values and because some gains in one period may be offset by losses in another or vice versa, this issue paper does not require recognition of gains and losses as components of net postretirement benefit cost in the period in which they arise, except as described in paragraph 53. Gains and losses that are not recognized immediately as a component of net periodic postretirement benefit cost shall be recognized as increases or decreases in unassigned funds (surplus) as they arise.

49. The expected return on plan assets shall be determined based on the expected long-term rate of return on plan assets and the fair value of plan assets.

50. Plan asset gains and losses are differences between the actual return on plan assets during a period and the expected return on plan assets for that period. Plan asset gains and losses include changes reflected in the fair value of plan assets.

51. As a minimum, amortization of a net gain or loss included in unassigned funds (surplus) shall be included as a component of net periodic postretirement benefit cost for a year if, as of the beginning of the year, that net gain or loss exceeds 10 percent of the greater of the accumulated postretirement benefit obligation or the fair value of plan assets. If amortization is required, the minimum amortization shall be that excess divided by the average remaining service period of active plan participants. If all or almost all of a plan's participants are inactive, the average remaining life expectancy of the inactive participants shall be used instead of the average remaining service period.

52. Any systematic method of amortizing gains and losses included in unassigned funds (surplus) may be used in place of the minimum amortization specified in paragraph 51 provided that (a) the minimum amortization is recognized in any period in which it is greater (reduces the net gain or loss balance by more) than the amount that would be recognized under the method used, (b) the method is applied consistently, (c) the method is applied similarly to both gains and losses, and (d) the method used is disclosed. If an enterprise uses a method of consistently recognizing gains and losses immediately, any gain that does not offset a loss previously recognized in income pursuant to this paragraph shall first offset any transition obligation remaining in unassigned funds (surplus); any loss that does not offset a gain previously recognized in income pursuant to this paragraph shall first offset any transition asset remaining in unassigned funds (surplus).

53. In some situations, an employer may forgive a retrospective adjustment of the current or past years' cost-sharing provisions of the plan as they relate to benefit costs already incurred by retirees or may otherwise deviate from the provisions of the substantive plan to increase or decrease the employer's share of the benefit costs incurred in the current or past periods. The effect of a decision to temporarily deviate from the substantive plan shall be immediately recognized as a loss or gain.

54. The gain or loss component of net periodic postretirement benefit cost shall consist of (a) the difference between the actual return on plan assets and the expected return on plan assets, (b) any gain or loss immediately recognized or the amortization of the net gain or loss included in unassigned funds (surplus), and (c) any amount immediately recognized as a gain or loss pursuant to paragraph 53.

Measurement of Plan Assets

55. Plan assets are assets—usually stocks, bonds, and other investments (except certain insurance contracts as noted in paragraph 59)—that have been segregated and restricted (usually in a trust) to be used for postretirement benefits. The amount of plan assets includes amounts contributed by the employer, and by plan participants for a contributory plan, and amounts earned from investing the contributions, less benefits, income taxes, and other expenses incurred. Plan assets ordinarily cannot be withdrawn by the employer except under certain circumstances when a plan has assets in excess of obligations and the employer has taken certain steps to satisfy existing obligations. Securities of the employer held by the plan are includable in plan assets provided they are transferable.

56. Assets not segregated in a trust, or otherwise effectively restricted, so that they cannot be used by the employer for other purposes are not plan assets for purposes of this issue paper, even though the employer may intend that those assets be used to provide postretirement benefits. Those assets shall be accounted for in the same manner as other employer assets of a similar nature and with similar restrictions. Amounts accrued by the employer but not yet paid to the plan are not plan assets for purposes of this issue paper.

57. Plan investments, whether equity or debt securities, real estate, or other, shall be measured at their fair value as of the measurement date.

58. Plan assets used in plan operations (for example, buildings, equipment, furniture and fixtures, and leasehold improvements) shall be measured at cost less accumulated depreciation or amortization for all purposes.

Insurance Contracts

59. For purposes of this issue paper, an insurance contract is defined as a contract in which an insurance company unconditionally undertakes a legal obligation to provide specified benefits to specific individuals in return for a fixed consideration or premium; an insurance contract is irrevocable and involves the transfer of significant risk from the employer (or the plan) to the insurance company. Benefits covered by insurance contracts shall be excluded from the accumulated postretirement benefit obligation. Insurance contracts shall be excluded from plan assets.

60. Some insurance contracts (participating insurance contracts) provide that the purchaser (either the plan or the employer) may participate in the experience of the insurance company. Under those contracts, the insurance company ordinarily pays dividends to the purchaser, the effect of which is to reduce the cost of the plan. If the participating insurance contract causes the employer to remain subject to all or most of the risks and rewards associated with the benefit obligation covered or the assets transferred to the insurance company, that contract is not an insurance contract for purposes of this issue paper, and the purchase of that contract does not constitute a settlement pursuant to paragraphs 82-87.

61. The purchase price of a participating insurance contract ordinarily is higher than the price of an equivalent contract without a participation right. The difference is the cost of the participation right. The cost of the participation right shall be recognized at the date of purchase as a nonadmitted asset. In subsequent periods, the participation right shall be nonadmitted and measured at its fair value if the contract is such that fair value is reasonably estimable. Otherwise the participation right shall be measured at its amortized cost (not in excess of its net realizable value), and the cost shall be amortized systematically over the expected dividend period under the contract.

62. To the extent that insurance contracts are purchased during the period to cover postretirement benefits attributed to service in the current period (such as life insurance benefits), the cost of those benefits shall be the cost of purchasing the coverage under the contracts, except as provided in paragraph

61 for the cost of a participation right. If all the postretirement benefits attributed to service in the current period are covered by nonparticipating insurance contracts purchased during that period, the cost of the contracts determines the service cost component of net postretirement benefit cost for that period. Benefits attributed to current service in excess of benefits provided by nonparticipating insurance contracts purchased during the current period shall be accounted for according to the provisions of this issue paper applicable to plans not involving insurance contracts.

63. Other contracts with insurance companies may not meet the definition of an insurance contract because the insurance company does not unconditionally undertake a legal obligation to provide specified benefits to specified individuals. Those contracts shall be accounted for as investments and measured at fair value. If a contract has a determinable cash surrender value or conversion value, that is presumed to be its fair value. For some contracts, the best available estimate of fair value may be contract value.

Measurement Date

64. The measurements of plan assets and benefit obligations required by this issue paper shall be as of the date of the employer's fiscal year-end statement of financial position. Even though the postretirement benefit measurements are required as of a particular date, all procedures are not required to be performed after that date. As with other financial statement items requiring estimates, much of the information can be prepared as of an earlier date and projected forward to account for subsequent events (for example, employee service).

65. Measurements of net periodic postretirement benefit cost for both interim and annual financial statements generally shall be based on the assumptions at the beginning of the year (assumptions used for the previous year-end measurements of plan assets and obligations) unless more recent measurements of both plan assets and the accumulated postretirement benefit obligation are available. For example, if a significant event occurs, such as a plan amendment, settlement, or curtailment, that ordinarily would call for remeasurement, the assumptions used for those later measurements shall be used to remeasure net periodic postretirement benefit cost from the date of the event to the year-end measurement date. Unless an employer remeasures both its plan assets and benefit obligations during the fiscal year, the funded status it reports in its interim-period statement of financial position shall be the same asset or liability recognized in the previous year-end statement of financial position adjusted for (a) subsequent accruals of net periodic postretirement benefit cost that exclude the amortization of amounts previously recognized in unassigned funds (surplus) (for example, subsequent accruals of service cost, interest cost, and return on plan assets) and (b) contributions to a funded plan, or benefit payments. Upon remeasurement, a reporting entity shall adjust its statement of financial position in a subsequent interim period to reflect the overfunded or underfunded status of the plan consistent with that measurement date.

Disclosures - Single-Employer Defined Postretirement Plans

66. An employer that sponsors one or more other defined benefit postretirement plans shall provide the following information for postretirement benefit plans other than pensions. Amounts related to the employer's results of operations shall be disclosed for each period for which a statement of income is presented. Amounts related to the employer's statement of financial position, shall be disclosed as of the date of each statement of financial position presented.

a. A reconciliation of beginning and ending balances of the benefit obligation showing separately, if applicable, the effects during the period attributable to each of the following: service cost, interest cost, contributions by plan participants, actuarial gains and losses, foreign currency exchange rate changes, benefits paid, plan amendments, business combinations, divestitures, curtailments, settlements, and special termination benefits.

b. A reconciliation of beginning and ending balances of the fair value of plan assets showing separately, if applicable, the effects during the period attributable to each of the following: actual return on plan assets, foreign currency exchange rate changes, contributions by the employer, contributions by plan participants, benefits paid, business combinations, divestitures, and settlements.

c. The funded status of the plans and the amounts recognized in the statement of financial position, showing separately the assets (nonadmitted) and liabilities recognized.

d. The objectives of the disclosures about postretirement benefit plan assets are to provide users of financial statements with an understanding of:

i. How investment allocation decisions are made, including the factors that are pertinent to an understanding of investment policies and strategies

ii. The classes of plan assets

iii. The inputs and valuation techniques used to measure the fair value of plan assets

iv. The effect of fair value measurements using significant unobservable inputs (Level 3) on changes in plan assets for the period

v. Significant concentrations of risk within plan assets.

An employer shall consider those overall objectives in providing the following information about plan assets:

(a) A narrative description of investment policies and strategies, including target allocation percentages or range of percentages considering the classes of plan assets disclosed pursuant to 66.d.v.(b) below, as of the latest statement of financial position presented (on a weighted-average basis for employers with more than one plan), and other factors that are pertinent to an understanding of those policies and strategies such as investment goals, risk management practices, permitted and prohibited investments including the use of derivatives, diversification, and the relationship between plan assets and benefit obligations. For investment funds disclosed as classes as described in 66.d.v.(b), a description of the significant investment strategies of those funds shall be provided.

(b) The fair value of each class of plan assets as of each date for which a statement of financial position is presented. Asset classes shall be based on the nature and risks of assets in an employer's plan(s). Examples of classes of assets include, but are not limited to, the following: cash and cash equivalents; equity securities, (segregated by industry type, company size, or investment objective); debt securities, issued by national, state, and local governments; corporate debt securities; asset-backed securities; structured debt; derivatives on a gross basis (segregated by type of underlying risk in the contract, for example, interest rate contracts, foreign exchange contracts, equity contracts, commodity contracts, credit contracts, and other contracts); investment funds (segregated by type of fund); and real estate. Those examples are not meant to be all inclusive. An employer should consider the overall objectives in paragraph 66.d. in determining whether additional classes of plan assets or further disaggregation of classes should be disclosed.

(c) A narrative description of the basis used to determine the overall expected long-term rate-of-return-on-assets assumption, such as the general approach used, the extent to which the overall rate-of-return-on-assets assumption was based on historical returns, the extent to which adjustments were made to those historical returns in order to reflect expectations of future returns, and how those adjustments were determined. The description should consider the classes of assets described in 66.d.v.(b) as appropriate.

(d) Information that enables users of financial statements to assess the inputs and valuation techniques used to develop fair value measurements of plan assets at the reporting date. For fair value measurements using significant unobservable inputs, an employer shall disclose the effect of the measurements on changes in plan assets for the period. To meet those objectives, the employer shall disclose the following information for each class of plan assets disclosed pursuant to 66.d.v.(b) above for each annual period:

(1) The level within the fair value hierarchy in which the fair value measurements in their entirety fall,[3] segregating fair value measurements using quoted prices in active markets for identical assets or liabilities (Level 1), significant other observable inputs (Level 2), and significant unobservable inputs (Level 3)

(2) For fair value measurements of plan assets using significant unobservable inputs (Level 3), a reconciliation of the beginning and ending balances, separately presenting changes during the period attributable to the following:

(i) Actual return on plan assets, separately identifying the amount related to assets still held at the reporting date and the amount related to assets sold during the period

(ii) Purchases, sales, and settlements, net

(iii) Transfers in and/or out of Level 3 (for example, transfers due to changes in the observability of significant inputs)

(3) Information about the valuation technique(s) and inputs used to measure fair value and a discussion of changes in valuation techniques and inputs, if any, during the period.

e. The benefits (as of the date of the latest statement of financial position presented) expected to be paid in each of the next five fiscal years, and in the aggregate for the five

[3] In some cases, the inputs used to measure fair value might fall in different levels of the fair value hierarchy. The level in the fair value hierarchy within which the fair value measurement in its entirety falls shall be determined based on the lowest level input that is significant to the fair value measurement in its entirety. Assessing the significance of a particular input to the fair value measurement in its entirety requires judgment, considering factors specific to the asset or liability.

fiscal years thereafter. The expected benefits should be estimated based on the same assumptions used to measure the company's benefit obligation at the end of the year and should include benefits attributable to estimated future employee service.

f. The employer's best estimate, as soon as it can reasonably be determined, of contributions expected to be paid to the plan during the next fiscal year beginning after the date of the latest statement of financial position presented. Estimated contributions may be presented in the aggregate combining (1) contributions required by funding regulations or laws, (2) discretionary contributions, and (3) noncash contributions.

g. The amount of net periodic benefit cost recognized, showing separately the service cost component, the interest cost component, the expected return on plan assets for the period, the gain or loss component, the prior service cost or credit component, the transition asset or obligation component, and the gain or loss recognized due to settlements or curtailments.

h. Separately the net gain or loss and net prior service cost or credit recognized in unassigned funds (surplus) for the period pursuant to paragraphs 44 and 48, and reclassification adjustments of unassigned funds (surplus) for the period, as those amounts, including amortization of the net transition asset or obligation, are recognized as components of net periodic benefit cost.

i. The amounts in unassigned funds (surplus) that have not yet been recognized as components of net periodic benefit cost, showing separately the net gain or loss, net prior service cost or credit, and net transition asset or obligation.

j. On a weighted-average basis, the following assumptions used in the accounting for the plans: assumed discount rates, rates of compensation increase (for pay-related plans), and expected long-term rates of return on plan assets specifying, in a tabular format, the assumptions used to determine the benefit obligation and the assumptions used to determine net benefit cost.

k. The assumed health care cost trend rate(s) for the next year used to measure the expected cost of benefits covered by the plan (gross eligible charges), and a general description of the direction and pattern of change in the assumed trend rates thereafter, together with the ultimate trend rate(s) and when that rate is expected to be achieved.

l. The effect of a one-percentage-point increase and the effect of a one-percentage- point decrease in the assumed health care cost trend rates on (1) the aggregate of the service and interest cost components of net periodic postretirement health care benefit costs and (2) the accumulated postretirement benefit obligation for health care benefits. (For purposes of this disclosure, all other assumptions shall be held constant, and the effects shall be measured based on the substantive plan that is the basis for the accounting.)

m. If applicable, the amounts and types of securities of the employer and related parties included in plan assets, the approximate amount of future annual benefits of plan participants covered by insurance contracts issued by the employer or related parties, and any significant transactions between the employer or related parties and the plan during the period.

n. If applicable, any alternative method used to amortize prior service amounts or net gains and losses pursuant to paragraphs 45 and 52.

o. If applicable, any substantive commitment, such as past practice or a history of regular benefit increases, used as the basis for accounting for the benefit obligation.

p. If applicable, the cost of providing special or contractual termination benefits recognized during the period and a description of the nature of the event.

q. An explanation of any significant change in the benefit obligation or plan assets not otherwise apparent in the other disclosures required by this issue paper.

r. The amounts in unassigned funds (surplus) expected to be recognized as components of net periodic benefit cost over the fiscal year that follows the most recent annual statement of financial position presented, showing separately the net gain or loss, net prior service cost or credit, and net transition asset or obligation.

s. The amount and timing of any plan assets expected to be returned to the employer during the 12-month period, or operating cycle if longer, that follows the most recent annual statement of financial position presented.

Employers with Two or More Plans

67. Postretirement benefits offered by an employer may vary in nature and may be provided to different groups of employees. As discussed in paragraph 68, in some cases an employer may aggregate data from unfunded plans for measurement purposes in lieu of performing separate measurements for each unfunded plan (including plans whose designated assets are not appropriately segregated and restricted and thus have no plan assets as that term is used in this issue paper). Net periodic postretirement benefit cost, the accumulated postretirement benefit obligation, and plan assets shall be determined for each separately measured plan or aggregation of plans by applying the provisions of this issue paper to each such plan or aggregation of plans.

68. The data from all unfunded postretirement health care plans may be aggregated for measurement purposes if (a) those plans provide different benefits to the same group of employees or (b) those plans provide the same benefits to different groups of employees. Data from other unfunded postretirement welfare benefit plans may be aggregated for measurement purposes in similar circumstances, such as when an employer has a variety of welfare benefit plans that provide benefits to the same group of employees. However, a plan that has plan assets (as defined herein) shall not be aggregated with other plans but shall be measured separately.

Disclosures – Employers with Two or More Defined Benefit Plans

69. The disclosures required by this issue paper shall be aggregated for all of an employer's other defined benefit postretirement plans unless disaggregating in groups is considered to provide useful information or is otherwise required by this paragraph and paragraph 70 of this issue paper. Disclosures shall be as of the date of each statement of financial position presented. If aggregate disclosures are presented, an employer shall disclose:

a. The aggregate benefit obligation and aggregate fair value of plan assets for plans with benefit obligations in excess of plan assets as of the measurement date of each statement of financial position presented.

70. A U.S. reporting entity may combine disclosures about pension plans or other postretirement benefit plans outside the United States with those for U.S. plans unless the benefit obligations of the plans outside the United States are significant relative to the total benefit obligation and those plans use significantly different assumptions.

Interim Financial Disclosures – Defined Benefit Plans

71. The following shall be disclosed within interim financial statements that include a statement of income:

a. The amount of net periodic benefit cost recognized, for each period for which a statement of income is presented, showing separately the service cost component, the interest cost component, the expected return on plan assets for the period, the gain or loss component, the amount of prior service cost or credit component, the transition asset or obligation component, and the gain or loss recognized due to a settlement or curtailment.

b. The total amount of the employer’s contributions paid, and expected to be paid, during the current fiscal year, if significantly different from amounts previously disclosed pursuant to paragraph 66.f. of this issue paper. Estimated contributions may be presented in the aggregate combining (1) contributions required by funding regulations or laws, (2) discretionary contributions, and (3) noncash contributions.

Multiemployer Plans

72. For purposes of this issue paper, a multiemployer plan is a postretirement benefit plan to which two or more unrelated employers contribute, usually pursuant to one or more collective-bargaining agreements. A characteristic of multiemployer plans is that assets contributed by one participating employer may be used to provide benefits to employees of other participating employers since assets contributed by an employer are not segregated in a separate account or restricted to provide benefits only to employees of that employer.

73. An employer participating in a multiemployer plan shall recognize as net postretirement benefit cost the required contribution for the period, which shall include both cash and the fair value of noncash contributions, and shall recognize as a liability any unpaid contributions required for the period.

74. In some situations, withdrawal from a multiemployer plan may result in an employer having an obligation to the plan for a portion of the plan's unfunded accumulated postretirement benefit obligation. If it is either probable or reasonably possible that (a) an employer would withdraw from the plan under circumstances that would give rise to an obligation or (b) an employer's contribution to the fund would be increased during the remainder of the contract period to make up a shortfall in the funds necessary to maintain the negotiated level of benefit coverage (a "maintenance of benefits" clause), the employer shall apply the provisions *SSAP No. 5—Liabilities, Contingencies, and Impairments of Assets - Revised* (SSAP No. 5R).

Disclosures - Multiemployer Plans

75. An employer shall disclose the amount of contributions to multiemployer plans for each annual period for which a statement of income is presented. An employer may disclose total contributions to multiemployer plans without disaggregating the amounts attributable to pension plans and other postretirement benefit plans. The disclosures shall include a description of the nature and effect of any changes affecting comparability, such as a change in the rate of employer contributions, a business combination, or a divestiture.

76. Pursuant to paragraph 74, if withdrawal under circumstances that would give rise to an obligation is either probable or reasonably possible, the provisions and disclosures of SSAP No. 5R, shall apply.

Multiple-Employer Plans

77. Some postretirement benefit plans to which two or more unrelated employers contribute are not multiemployer plans. Rather, those multiple-employer plans are in substance aggregations of single-employer plans, combined to allow participating employers to pool plan assets for investment purposes or to reduce the costs of plan administration. Those plans ordinarily do not involve collective-bargaining agreements. They may also have features that allow participating employers to have different benefit formulas, with the employer's contributions to the plan based on the benefit formula selected by the employer. Those plans shall be considered single-employer plans rather than multiemployer plans for purposes of this issue paper, and each employer's accounting shall be based on its respective interest in the plan.

Postretirement Benefit Plans Outside the United States

78. This issue paper includes no special provisions applicable to postretirement benefit arrangements outside the United States. Those arrangements are subject to the provisions of this issue paper. The applicability of this issue paper to those arrangements is determined by the nature of the obligation and by the terms or conditions that define the amount of benefits to be paid, not by whether or how a plan is funded, whether benefits are payable at intervals or as a single amount, or whether the benefits are required by law or custom or are provided under a plan the employer has elected to sponsor.

Business Combinations

79. When an employer is acquired in a business combination and that employer sponsors a single-employer defined benefit postretirement plan, the assignment of the purchase price to individual assets acquired and liabilities assumed shall include a liability for the accumulated postretirement benefit obligation in excess of the fair value of the plan assets or an asset for the fair value of the plan assets in excess of the accumulated postretirement benefit obligation. The accumulated postretirement benefit obligation assumed shall be measured based on the benefits attributed by the acquired entity to employee service prior to the date the business combination is consummated, adjusted to reflect (a) any changes in assumptions based on the purchaser's assessment of relevant future events (as discussed in paragraphs 11-31) and (b) the terms of the substantive plan (as discussed in paragraphs 11-16) to be provided by the purchaser to the extent they differ from the terms of the acquired entity's substantive plan.

80. If the postretirement benefit plan of the acquired entity is amended as a condition of the business combination (for example, if the change is required by the seller as part of the consummation of the acquisition), the effects of any improvements attributed to services rendered by the participants of the acquired entity's plan prior to the date of the business combination shall be accounted for as part of the accumulated postretirement benefit obligation of the acquired entity. Otherwise, if improvements to the postretirement benefit plan of the acquired entity are not a condition of the business combination, credit granted for prior service shall be recognized as a plan amendment as discussed in paragraphs 42-47. If it is expected that the plan will be terminated or curtailed, the effects of those actions shall be considered in measuring the accumulated postretirement benefit obligation. Otherwise, no future changes to the plan shall be anticipated.

81. As a result of applying the provisions of paragraphs 79-80, any previously existing net gain or loss, prior service cost or credit, or transition obligation or transition asset remaining in unassigned funds (surplus) is eliminated for the acquired employer's plan.

Accounting for Settlement of a Postretirement Benefit Obligation

82. For purposes of this issue paper, a settlement is defined as a transaction that (a) is an irrevocable action, (b) relieves the employer (or the plan) of primary responsibility for a postretirement benefit

obligation, and (c) eliminates significant risks related to the obligation and the assets used to effect the settlement. Examples of transactions that constitute a settlement include making lump-sum cash payments to plan participants in exchange for their rights to receive specified postretirement benefits and purchasing long-term nonparticipating insurance contracts for the accumulated postretirement benefit obligation for some or all of the plan participants.

83. A transaction that does not meet the three criteria of paragraph 82 does not constitute a settlement for purposes of this issue paper. For example, investing in a portfolio of high-quality fixed-income securities with principal and interest payment dates similar to the estimated payment dates of benefits may avoid or minimize certain risks. However, that investment decision does not constitute a settlement because that decision can be reversed, and investing in that portfolio does not relieve the employer (or the plan) of primary responsibility for a postretirement benefit obligation nor does it eliminate significant risks related to that obligation.

84. For purposes of this issue paper, the maximum gain or loss subject to recognition in income when a postretirement benefit obligation is settled is the net gain or loss included in unassigned funds (surplus) defined in paragraphs 48-52 plus any transition asset remaining in unassigned funds (surplus). That maximum gain or loss includes any gain or loss resulting from remeasurements of plan assets and the accumulated postretirement benefit obligation at the time of settlement.

85. If the entire accumulated postretirement benefit obligation is settled and the maximum amount subject to recognition is a gain, the settlement gain shall first reduce any transition obligation remaining in unassigned funds (surplus); any excess gain shall be recognized in income. If the entire accumulated postretirement benefit obligation is settled and the maximum amount subject to recognition is a loss, the maximum settlement loss shall be recognized in income. If only part of the accumulated postretirement benefit obligation is settled, the employer shall recognize in income the excess of the pro rata portion (equal to the percentage reduction in the accumulated postretirement benefit obligation) of the maximum settlement gain over any remaining transition obligation or a pro rata portion of the maximum settlement loss.

86. If the purchase of a participating insurance contract constitutes a settlement, the maximum gain (but not the maximum loss) shall be reduced by the cost of the participation right before determining the amount to be recognized in income.

87. If the cost of all settlements in a year is less than or equal to the sum of the service cost and interest cost components of net postretirement benefit cost for the plan for the year, gain or loss recognition is permitted but not required for those settlements. However, the accounting policy adopted shall be applied consistently from year to year.

Accounting for a Plan Curtailment

88. For purposes of this issue paper, a curtailment is an event that significantly reduces the expected years of future service of active plan participants or eliminates the accrual of defined benefits for some or all of the future services of a significant number of active plan participants. Curtailments include:

a. Termination of employees' services earlier than expected, which may or may not involve closing a facility or discontinuing a component of an entity.

b. Termination or suspension of a plan so that employees do not earn additional benefits for future service. In the latter situation, future service may be counted toward eligibility for benefits accumulated based on past service.

89. The prior service cost included in unassigned funds (surplus) associated with the portion of the future years of service that had been expected to be rendered, but as a result of a curtailment are no longer expected to be rendered, is a loss. For purposes of measuring the effect of a curtailment, prior service cost includes the cost of plan amendments and any remaining transition obligation. For example, a curtailment may result from the termination of a significant number of employees who were plan participants at the date of a prior plan amendment. The loss associated with that curtailment is measured as the portion of the remaining prior service cost included in unassigned funds (surplus) related to that (and any prior) plan amendment attributable to the previously expected remaining future years of service of the employees who were terminated and the portion of the remaining transition obligation attributable to the previously expected remaining future years of service of the terminated employees who were plan participants at the date of transition.

90. The accumulated postretirement benefit obligation may be decreased (a gain) or increased (a loss) by a curtailment. That (gain) loss shall reduce any net loss (gain) included in unassigned funds (surplus).

a. To the extent that such a gain exceeds any net loss included in unassigned funds (surplus) (or the entire gain, if a net gain exists), it is a curtailment gain.

b. To the extent that such a loss exceeds any net gain included in unassigned funds (surplus) (or the entire loss, if a net loss exists), it is a curtailment loss.

For purposes of applying the provisions of this paragraph, any transition asset remaining in unassigned funds (surplus) shall be treated as a net gain and shall be combined with the unrecognized net gain or loss arising subsequent to transition to this issue paper.

91. If the sum of the effects identified in paragraphs 89-90 is a net loss, it shall be recognized in income when it is probable that a curtailment will occur and the net effect is reasonably estimable. If the sum of those effects is a net gain, it shall be recognized in income when the related employees terminate or the plan suspension or amendment is adopted.

92. A settlement and a curtailment may occur separately or together. If benefits expected to be paid in future periods are eliminated for some plan participants (for example, because a significant portion of the work force is dismissed or a plant is closed) but the plan remains in existence and continues to pay benefits, to invest assets, and to receive contributions, a curtailment has occurred but not a settlement. If an employer purchases nonparticipating insurance contracts for the accumulated postretirement benefit obligation and continues to provide defined benefits for future service, either in the same plan or in a successor plan, a settlement has occurred but not a curtailment. If a plan termination occurs (that is, the obligation is settled and the plan ceases to exist) and the plan is not replaced by a successor defined benefit plan, both a settlement and a curtailment have occurred (whether or not the employees continue to work for the employer).

Measurement of the Effects of Termination Benefits

93. An employer that offers special or contractual termination benefits to employees shall recognize a liability and a loss when the employees accept the offer and the amount can be reasonably estimated. An employer that provides contractual termination benefits shall recognize a liability and a loss when it is probable that employees will be entitled to benefits and the amount can be reasonably estimated. A situation involving special or contractual termination benefits may also result in a curtailment to be accounted for under paragraphs 88-91.

94. The liability and loss recognized for employees who accept an offer of special termination benefits to be provided by a postretirement benefit plan shall be the difference between (a) the accumulated postretirement benefit obligation for those employees, assuming that those employees

(active plan participants) not yet fully eligible for benefits would terminate at their full eligibility date and that fully eligible plan participants would retire immediately, without considering any special termination benefits and (b) the accumulated postretirement benefit obligation as measured in (a) adjusted to reflect the special termination benefits.

Defined Contribution Plans

95. For purposes of this issue paper, a defined contribution postretirement plan is a plan that provides postretirement benefits in return for services rendered, provides an individual account for each participant, and has terms that specify how contributions to the individual's account are to be determined rather than the amount of postretirement benefits the individual is to receive. Under a defined contribution plan, the postretirement benefits a plan participant will receive are limited to the amount contributed to the plan participant's account, the returns earned on investments of those contributions, and forfeitures of other plan participants' benefits that may be allocated to the plan participant's account.

96. To the extent a plan's defined contributions to an individual's account are to be made for periods in which that individual renders services, the net postretirement benefit cost for a period shall be the contribution called for in that period. If a plan calls for contributions for periods after an individual retires or terminates, the estimated cost shall be accrued during the employee's service period.

97. A postretirement benefit plan having characteristics of both a defined benefit plan and a defined contribution plan requires careful analysis. If the substance of the plan is to provide a defined benefit, as may be the case with some "target benefit" plans, the accounting requirements shall be determined in accordance with the provisions of this issue paper applicable to a defined benefit plan and the disclosure requirements within paragraph 66 shall be followed.

Disclosures - Defined Contribution Plans

98. An employer shall disclose the amount of cost recognized for defined contribution postretirement benefit plans for all periods presented separately from the amount of cost recognized for defined benefit plans. The disclosures shall include a description of the nature and effect of any significant changes during the period affecting comparability, such as a change in the rate of employer contributions, a business combination, or a divestiture.

Consolidated/Holding Company Plans

99. The employees of many reporting entities are eligible for certain postretirement benefits other than pensions provided by a parent company or holding company. A reporting entity with employees who are eligible for those benefits and is not directly liable for those related obligations shall recognize an expense equal to its allocation of the benefits earned during the period. A liability shall be established for any such amounts due but not yet paid.

100. The reporting entity shall disclose in the financial statements that its employees participate in a plan sponsored by the holding company for which the reporting entity has no legal obligation. The amount of the postretirement benefit expense incurred and the allocation methodology utilized by the provider of such benefits shall also be disclosed. If the reporting entity is directly liable for postretirement benefits other than pensions, then the requirements outlined in paragraphs 4-98 and paragraphs 101-110 of this issue paper shall be applied.

Relevant Literature

101. This issue paper adopts with modification paragraphs 1-7 and 16-17 as well as Appendix D – Amendments to Statement 106 and Appendix E – Amendments to Statement 132(R) of *FASB Statement*

No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106 and 132(R) (FAS 158). Paragraphs 8-10 and D2u providing specific guidance for not-for-profit organizations is rejected. Paragraphs 11-15 regarding the effective dates for FAS 158 is rejected and paragraph 19 providing an alternative method for remeasuring plan assets and benefits obligations as of the fiscal year the measurement date provisions are applied is also rejected. The disclosure included within FAS 132 (R), as amended by FAS 158, pertaining specifically to pensions (paragraph 5.e.) has been rejected for inclusion within this standard. This issue paper adopts the revisions to paragraph 5.d. of FAS 132(R) as amended by *FASB Staff Position FAS 132(R)-1, Employers' Disclosures about Postretirement Benefit Plan Assets* (FSP FAS 132(R)-1) and *ASU 2010-06, Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements* (ASU 2010-06). Other revisions to disclosure requirements as amended by FSP FAS 132(R)-1 relate to nonpublic entities and are rejected. This issue paper adopts by reference *FSP FASB 158-1, Conforming Amendments to the Illustrations in FASB Statements No. 87, No. 88, and No. 106 and to the Related Staff Implementation Guides* (FSP FAS 158-1) to the extent that the examples and related implementation guides comply with the adopted GAAP guidance previously identified within this issue paper, as modified for statutory accounting. The following modifications from the adopted paragraphs of FAS 158 and FAS 106 have been incorporated within this issue paper:

a. All references to 'other comprehensive income' or 'accumulated other comprehensive income' within FAS 158 have been revised to reflect 'unassigned funds (surplus)'.

b. Any prepaid asset resulting from the excess of the fair value of plan assets over the accumulated postretirement benefit obligation shall be nonadmitted. Furthermore, any asset recognized from the cost of a 'participation right' of an annuity contract per paragraph 61 shall also be nonadmitted.

c. Provisions within paragraph 57 and 58 of FAS 106, as amended by FAS 158, permitting a calculated market-related value of plan assets has been eliminated with only the fair value measurement method for plan assets retained.

d. The reduced disclosure requirements for nonpublic entities described in paragraph 8 of FAS 132(R), as amended by FAS 158, are rejected. All reporting entities shall follow the disclosure requirements within this issue paper which have been adopted from paragraph 5 of FAS 132(R), as amended by FAS 158.

e. Clarification has been included within this standard to ensure both vested and nonvested employees are included within the recognition of net postretirement benefit cost and in the accumulated postretirement benefit obligation. Although this is consistent with GAAP, this is a change from previous statutory accounting. As nonvested employees were excluded from statutory accounting under SSAP No. 14, guidance has been included to indicate that the unrecognized prior service cost attributed to nonvested individuals is not required to be included in net postretirement benefit cost entirely in the year this standard is adopted. The unrecognized prior service cost for nonvested employees shall be amortized as a component of net postretirement benefit cost by assigning an equal amount to each expected future period of service before vesting occurs for nonvested employees active at the date of the amendment. Unassigned funds (surplus) is then adjusted each period as prior service cost is amortized. (Guidance is included within the transition related to the recognition of the prior service cost for nonvested employees through unassigned funds (surplus).)

f. Conclusion of *Interpretation 99-26: Offsetting Pension Assets and Liabilities* (INT 99-26) prohibiting the offset of defined benefit liabilities of one plan with prepaid assets of another plan has been incorporated within paragraph 35 of this issue paper.

g. Provisions within paragraph 44B of FAS 106, as amended by FAS 158, regarding the classification of underfunded liabilities as current or noncurrent liabilities and the classification of assets from overfunded plans as noncurrent assets has been rejected as inconsistent with statutory accounting.

h. Provisions within paragraph 65 of FAS 106, as amended by FAS 158, defining the fair value of investments have been rejected. Fair value definitions and measurement for investments shall be determined in accordance with statutory accounting guidance.

i. Provisions within paragraph 72 of FAS 106, as amended by FAS 158, regarding the plan assets measurement date for consolidating subsidiaries or entities utilizing the equity method under APB Opinion No. 18 has been rejected. For statutory accounting, all entities shall follow the measurement date guidance within paragraph 64 of this issue paper.

j. The disclosure requirement included within paragraph 5.e. of FAS 132(R) has been rejected for this issue paper as it specifically pertains to pensions.

k. Transition under FAS 158 is different from the requirements of this issue paper. FAS 158 requires publicly traded equity securities to initially apply the requirement to recognize the funded status of a postretirement benefit plan; the gains/losses, prior service costs/credits and transition obligations/assets that have not yet been included in net periodic benefit cost; and the disclosure requirements as of the end of the fiscal year ending after December 15, 2006. Transition guidelines for statutory accounting are defined in paragraphs 102-110.

l. FAS 158 provided two approaches for an employer to transition to a fiscal year-end measurement date. For purposes of statutory accounting, the second approach permitting reporting entities to use earlier measurements determined for year-end reporting as of the fiscal year immediately preceding the year that the measurement date provisions was rejected. For consistency purposes, all reporting entities shall follow the first approach and remeasure plan assets and benefit obligations as of the beginning of the fiscal year that the measurement date provisions are applied.

Effective Date and Transition

102. Reporting entities are required to disclose the accumulated postretirement benefit obligation and the fair value of plan assets for defined postretirement benefit plans in the first reporting period after the effective date of SSAP No. 92 and in each subsequent reporting period. This disclosure shall specifically note the funded/unfunded status of the postretirement benefit plan. Reporting entities shall also specifically note the surplus impact necessary, at each reporting date, to reflect the full benefit obligation within the financial statements.

103. The SSAP that results from this issue paper is effective for quarterly and annual reporting periods beginning on or after January 1, 2013 (transition date) with early adoption permitted. Any unfunded defined benefit postretirement amounts, as determined when the accumulated benefit obligation exceeds the fair value of plan assets is a liability under SSAP No. 5R and shall be reported in the first quarter statutory financial statements after the transition date with a corresponding entry to unassigned funds (surplus). If the fair value of plan assets exceeds the accumulated benefit obligation, the asset shall be considered a nonadmitted asset. Net periodic benefit cost shall include a component for unrecognized prior service cost for nonvested employees beginning in 2013.

104. Gains or losses, prior service costs or credits (including prior service costs for nonvested participants pursuant to paragraph 39), and remaining transition assets or obligations (collectively referred to as "unrecognized items") from prior application of SSAP No. 14 that have not yet been included in net periodic benefit cost as of December 31, 2012[4] shall be recognized as components of the ending balance of unassigned funds (surplus), net of tax, as of January 1, 2013 (provided that alternative transition is not elected per paragraph 105.b.). The offset to unassigned funds (surplus) is reported separately as an "Aggregate Write-In for Other-Than-Invested Assets" or as an "Aggregate Write-In for Other Liabilities". After recognition, the full unfunded or overfunded status of the plan shall be reflected within the financial statements. Any prepaid asset resulting from an overfunded plan shall be nonadmitted.

105. Due to the potential impact to surplus as a result of immediately applying the accounting guidance in paragraph 104, reporting entities may elect one of the following two methods, on an individual plan basis, to recognize the surplus impact:

a. Reporting entities may elect to recognize the entire transition surplus impact calculated from applying paragraph 104, on an individual plan basis, as of January 1, 2013.

b. Alternatively, reporting entities may elect to recognize the entire surplus impact from applying paragraph 104, on an individual plan basis, over a period not to exceed ten (10) years. The surplus impact initially recognized as of January 1, 2013, under this transition option, and subsequently over the transition period, shall be the greater of:

i. Ten percent of the calculated surplus impact as of the transition date; and

ii. Amortization[5] of the "unrecognized items" (defined in paragraph 104) into net periodic benefit cost, including any accelerated amortization of these items from curtailments or settlements that occur after the transition date. (If the amortization cannot be determined at transition, at a minimum, the amount amortized for "unrecognized items" during the prior year shall be utilized for this component of the calculation. If the amount recognized for transition (greater of both components in paragraph 105.b.) is subsequently determined to be less than what is amortized for the year (105.b.ii.), the difference between what was recognized for transition, and what is amortized must immediately be recognized as an adjustment to the transition impact to unassigned funds (surplus).)

If the surplus deferral is elected at the transition date, subsequently, starting with the 2014 year-end financial statement, the reporting entity shall annually recognize the remaining surplus impact (collectively referred to as the "transition liability"[6]) on a systematic basis over a period not to exceed

[4] The intent of the guidance is to recognize the unrecognized amounts as of Dec. 31, 2012, annual statements, even if new actuarial projections (expected postretirement benefit obligations) are calculated as of Jan. 1, 2013. (These projections would be considered in the recognition of the 2013 net periodic benefit cost.)

[5] Unless otherwise impacted from the provisions within this Statement or in accordance with changes to the benefit plan, the amortization of the unrecognized items into net periodic benefit cost shall continue to follow the existing amortization schedules in effect on the transition date.

[6] If the surplus deferral from paragraph 105.b. is elected, the deferred liability, although comprised of the previous "unrecognized items" shall be collectively referred to as the "transition liability". Although reporting entities will need to continue to track the unrecognized items for amortization into net periodic cost (offset through unassigned funds (surplus)), reporting entities shall not allocate the recognized surplus impact from transition to these categories. As noted in paragraph 105.b.ii., the minimum amount of liability recognized under the deferral option must cover the annual amortization of the "unrecognized items" into net periodic benefit cost to prevent a surplus benefit.

nine years. The minimum amount recognized each subsequent year shall be an amount that reflects the conditions within paragraph 105.b. Additionally, reporting entities must recognize any remaining transition liability to the extent that the plan reflects a prepaid benefit cost. (For example, if changes in circumstances have resulted with the plan reflecting an overfunded status, the remaining transition liability must be recognized to the extent that the plan is overfunded.) Furthermore, if circumstances result with a subsequent gain attributed to the plan that will be recognized in earnings, the entity must recognize an additional amount of the remaining transition liability to offset the recognized gain. Reporting entities are permitted to recognize the remaining transition liability, or an amount in excess of the minimum requirement, at any time after the transition date. This transition guidance is specific to the transition surplus impact from initially applying this statement on Jan. 1, 2013. Thus, this transition guidance does not apply to additional liability calculated from subsequent comparison of the fair value of plan assets to the accumulated benefit obligation, or the impact of subsequent plan amendments.

106. Reporting entities electing to apply the transition guidance in paragraph 105.b. must disclose the full transition surplus impact calculated from applying paragraph 104 in the first quarter statutory financial statements after the transition date and each reporting period thereafter. This disclosure shall include the initial "transition liability" calculated under paragraph 104 and the annual amortization amount of the "unrecognized items" into net periodic benefit cost. This disclosure shall include a schedule of the entity's anticipated recognition of the remaining surplus impact over the transition period.

107. The requirement to measure plan assets and benefit obligations as of the date of the reporting entity's financial statement year-end is effective per SSAP No. 92 for financial statement years beginning January 1, 2014. (The measurement date change will be initially reflected in the Dec. 31, 2014 financial statements.).

108. In order to transition to a fiscal year-end measurement date, the reporting entity shall remeasure plan assets and benefit obligations as of the beginning of the fiscal year that the measurement date provisions are applied. The reporting entity shall use those new measurements to determine the effects of the measurement date change as of the beginning of the fiscal year that the measurement date provisions are applied.

109. The reporting entity shall measure plan assets and benefit obligations as of the beginning of the fiscal year that the measurement date provisions are applied. This would result with the following:

a. Net periodic benefit cost for the period between the measurement date that is used for the immediately preceding fiscal year-end and the beginning of the fiscal year that the measurement date provisions are applied, exclusive of any curtailment or settlement gain or loss, shall be recognized, net of tax, as a separate adjustment of the opening balance of unassigned funds (surplus). That is, the pretax amount recognized as an adjustment to unassigned funds (surplus) is the net periodic benefit cost that without a change in measurement date otherwise would have been recognized on a delayed basis during the first interim period for the fiscal year that the measurement date provisions are applied.

b. Any gain or loss arising from a curtailment or settlement between the measurement date that is used for the immediately preceding fiscal year-end and the beginning of the fiscal year that the measurement date provisions are applied shall be recognized in earnings in that period and not as an adjustment to unassigned funds (surplus). This provision prohibits a reporting entity from early application of the measurement date provisions when the reporting entity has issued financial statements for the prior year without recognition of such a settlement or curtailment.

c. Other changes in the fair value of plan assets and the benefit obligations (for example, gains or losses) for the period between the measurement date that is used for the immediately preceding fiscal year-end and the beginning of the fiscal year that the measurement date provisions are applied shall be recognized, net of tax, as a separate adjustment of the opening balance of unassigned funds (surplus) for the fiscal year that the measurement date provisions are applied.

110. Earlier application of the recognition or measurement date provisions is encouraged, however, early applications must be for all of the reporting entity's benefit plans. If early application is elected, the transition date shall reflect the January 1st of the year in which SSAP No. 92 is initially applied. Retrospective application is not permitted.

111. After adoption of this issue paper, the NAIC will release a Statement of Statutory Accounting Principle (SSAP) for comment. The initial draft of the SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the *Accounting Practices and Procedures Manual* should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will be effective for reporting periods beginning on or after January 1, 2013.

DISCUSSION:

112. The FASB issued FAS 158 to address concerns that existing accounting for postretirement benefit plans failed to communicate the funded status of those plans in a complete and understandable way. The prior standards did not require an employer to report in its statement of financial position the overfunded or underfunded status of a defined benefit postretirement plan. The prior standards also did not require an employer to recognize completely in earnings or other comprehensive income the financial effects of certain events affecting the plan's funded status when those events occurred.

113. Within the prior GAAP standard, an employer was allowed to recognize in its statement of financial position an asset or liability arising from the defined benefit postretirement plan, which almost always differed from the plan's overfunded or underfunded status. Those standards allowed an employer to delay recognition of economic events that affected the costs of providing postretirement benefits—changes in plan assets and benefit obligations—and recognize a liability that was sometimes significantly less than the underfunded status of the plan as well as recognize an asset in its statement of financial position, in some situations, for a plan that was underfunded. Furthermore, information regarding the overfunded or underfunded status of a plan was relegated to the notes to the financial statements. That information was in the form of a reconciliation of the overfunded or underfunded status to amounts recognized in the employer's statement of financial position. By presenting this information only in the notes it was difficult for users of financial statements to assess an employer's financial position and ability to satisfy postretirement benefits.

114. In issuing FAS 158, the FASB concluded that the reporting requirements of other standards did not provide representationally faithful and understandable financial information and might lead to the inefficient allocation of resources in capital markets. The issuance of FAS 158 is the first step of a project to comprehensively reconsider FAS 87, 88, 106, 132(R), and related pronouncements.

115. In accordance with the Statutory Accounting Principles Statement of Concepts, the conservatism concept supports the adoption of FAS 158 to ensure proper liability recognition and in accordance with the responsibility to regulate financial solvency.

116. Modifications to FAS 158 have been established primarily to clarify the components for liability consideration and to ensure consistency within reporting and recognition among reporting entities. Guidance related to not-for-profit entities, transition, and alternative methods for remeasuring plan assets

and benefit obligations for the first year application have been rejected to ensure consistent application for statutory purposes. Revisions incorporated within FAS 158 specifically attributed to FAS 87 and FAS 88 or pensions have not been addressed within this issue paper and will be considered in accordance with revisions to SSAP No. 89. Modifications from FAS 158 incorporated within this issue paper include:

a. All references to 'other comprehensive income' or 'accumulated other comprehensive income' within FAS 158 have been revised to reflect 'unassigned funds (surplus)'. This modification simply alters the guidance within FAS 158 to adhere to the reporting captions for statutory accounting.

b. Any prepaid asset resulting from the excess of the fair value of plan assets over the accumulated postretirement benefit obligation shall be nonadmitted. Furthermore, any asset recognized from the cost of a "participation right" of an annuity contract per paragraph 61 shall also be nonadmitted. These modifications are consistent with the definition of assets and nonadmitted assets set forth in *SSAP No. 4—Assets and Nonadmitted Assets* as assets recognized from overfunding postretirement plans or participating rights from annuity contracts cannot be readily converted to cash to satisfy policyholder obligations.

c. Provisions within paragraph 57 and 58 of FAS 106, as amended by FAS 158, permitting a calculated market-related value of plan assets has been eliminated with only the fair value measurement method for plan assets being retained. The calculated market-related value is a process to systematically and rationally recognize changes in fair value over a period of five years. This modification eliminates the potential for inconsistent measurement methods among reporting entities.

d. The reduced disclosure requirements for nonpublic entities described in paragraph 8 of FAS 132(R), as amended by FAS 158, are rejected. All reporting entities shall follow the disclosure requirements within this issue paper which have been adopted from paragraph 5 of FAS 132(R), as amended by FAS 158.

e. Clarification has been included within this standard to ensure both vested and nonvested employees are included within the recognition of net postretirement benefit cost and in the accumulated postretirement benefit obligation. Although this is consistent with GAAP, this is a change from previous statutory accounting. As nonvested employees were excluded from statutory accounting under SSAP No. 14, guidance has been included to indicate that the unrecognized prior service cost attributed to nonvested individuals is not required to be included in net postretirement benefit cost entirely in the year this standard is adopted. The unrecognized prior service cost for nonvested employees shall be amortized as a component of net postretirement benefit cost by assigning an equal amount to each expected future period of service before vesting occurs for nonvested employees active at the date of the amendment. Unassigned funds (surplus) is then adjusted each period as prior service cost is amortized.

f. Conclusion of Interpretation 99-26*: Offsetting Pension Assets and Liabilities* (INT 99-26) prohibiting the offset of defined benefit liabilities of one plan with prepaid assets of another plan has been incorporated within paragraph 35 of this issue paper.

g. Provisions within paragraph 44B of FAS 106, as amended by FAS 158, regarding the classification of underfunded liabilities as current or noncurrent liabilities and the classification of assets from overfunded plans as noncurrent assets has been rejected as inconsistent with statutory accounting.

h. Provisions within paragraph 65 of FAS 106, as amended by FAS 158, defining the fair value of investments have been rejected. Fair value definitions and measurement for investments shall be determined in accordance with statutory accounting guidance.

i. Provisions within paragraph 72 of FAS 106, as amended by FAS 158, regarding the plan assets measurement date for consolidating subsidiaries or entities utilizing the equity method under APB Opinion No. 18 has been rejected. For statutory accounting, all entities shall follow the measurement date guidance within paragraph 64 of this issue paper.

j. The disclosure requirement included within paragraph 5.e. of FAS 132(R) has been rejected for this issue paper as it specifically pertains to pensions.

k. Transition under FAS 158 is different from the requirements of this issue paper. FAS 158 requires publicly traded equity securities to initially apply the requirement to recognize the funded status of a postretirement benefit plan, the gains/losses prior service costs/credits and transition obligations/assets that have not yet been included in net periodic benefit cost and the disclosure requirements as of the end of the fiscal year ending after December 15, 2006. Transition guidelines for statutory accounting are defined in paragraphs 102-110.

l. FAS 158 provided two approaches for an employer to transition to a fiscal year-end measurement date. For purposes of statutory accounting, the second approach permitting reporting entities to use earlier measurements determined for year-end reporting as of the fiscal year immediately preceding the year that the measurement date provisions was rejected. For consistency purposes, all reporting entities shall follow the first approach and remeasure plan assets and benefit obligations as of the beginning of the fiscal year that the measurement date provisions are applied.

WORKING GROUP RESEARCH AND KEY ISSUES CONSIDERED:

117. During the Statutory Accounting Principles (E) Working Group's discussions on this issue paper, the Working Group conducted research and considered key issues to determine the appropriate course of action in response to comments received. Summaries of the key topics discussed, the research conducted, and the Working Group's conclusions has been detailed in the paragraphs below:

118. *Admittance of Prepaid Pension Costs for Overfunded Assets* – During the Spring 2008 Hearing, comments were received that prohibiting admittance of the asset established from overfunded plans would be punitive in comparison to GAAP reporting. A comment was also received proposing an offsetting admission for overfunded plan assets, whereas, an asset from overfunded plans would be admitted to the extent that a separate plan was underfunded. In considering these comments, the Working Group identified that there is a punitive tax that significantly hinders a company's ability to reclaim overfunded defined benefit assets. The 4980 Excise Tax on Reversions is a punitive, non-deductible excise tax imposed on the reversion of excess defined benefit assets to the employer. In 2008, the law imposed a confiscatory 50% tax on a simple reversion of excess assets to the employer. Because the excise tax is not deductible, ordinary income tax also applies on the entire amount of the reversion. Assuming federal and states income taxes total 40%, with the excise tax, a combined 90% tax is levied on the reversion. The Working Group identified that there are exceptions to when the tax is reduced to 20% and if the excess assets of a terminating defined benefit plan are transferred to a qualifying replacement plan, no excise tax would be due on the transferred assets.

119. In considering this research, the Working Group agreed that continued nonadmittance of overfunded plan assets was appropriate as the excise tax would significantly reduce the amount of assets that could be reclaimed by the company and utilized for policyholder claims. This conclusion is consistent with the existing statutory guidance in *SSAP No. 29—Prepaid Expenses*, in which prepaid assets were previously concluded to be nonadmitted assets as they are not readily available to satisfy policyholder obligations. The Working Group did further consider whether admittance of overfunded assets could occur if the company had the ability to transfer the overfunded assets into a qualified replacement plan. However, after identifying that plan assets can only be transferred excise tax-free to a qualified replacement plan if in connection with a qualified plan termination, it was noted that no allowance should be permitted to admit overfunded plan assets for such circumstances or to offset an underfunded plan's liability. (A transfer of overfunded plan assets from an existing plan to a new or different plan would not be excise-tax free as the original plan would not meet the requirements of a qualified plan termination.)

120. *Admission of Deferred Tax Assets from Other Post Employee Benefit (OPEB) Liabilities* – During the Spring 2008 Hearing, comments were received regarding how reporting the full liabilities for pension or OPEB plans would result in a need to consider revisions to *SSAP No. 10—Income Taxes* (SSAP No. 10) as statutory guidance currently limits the amount of deferred tax assets (DTAs) that can be admitted. In considering these comments, the Working Group identified that existing SSAP No. 10 guidance would allow companies to admit additional DTAs if they have a tax-planning strategy. (A DTA is created when pension/OPEB liabilities are accrued in the financial statements, but are only recognized/removed when contributions are made to the plan.)

121. Current statutory accounting guidance in SSAP No. 10 does not make specific allowances for deferred tax assets resulting from postretirement obligations. However, SSAP No. 10 currently allows the admittance of deferred tax assets expected to be realized within one year, if less than 10% of capital and surplus, as well as the consideration of tax-planning strategies in determining admitted DTAs. Pursuant to the guidance within SSAP No. 10, an entity is permitted to admit a DTA in response to a prudent and feasible tax-planning strategy that, if implemented, would result in realization of DTAs within one year of the balance sheet date. The entity is not required to implement the strategy within the 12-month period, but it must have the ability to implement the strategy within such time period. The entity must demonstrate that while it ordinarily might not take such actions, it would do so to prevent an operating loss credit carryforward or other similar item from expiring unused. If the tax-planning strategy criteria is met, an entity may recognize as admitted assets the related DTAs that are realizable as a result of the available tax-planning strategy in accordance with SSAP No. 10. As a result of the options currently available under SSAP No. 10, the Working Group agreed not to further consider revisions to add specific guidance to admit DTAs resulting from pension or OPEB plans. Update 2012[7]: SSAP No. 10 has been superseded by *SSAP No. 101—Income Taxes*. Guidance in SSAP No. 101 is similar to SSAP No. 10 as it also does not make specific allowances for deferred tax assets resulting from postretirement obligations. Although, the DTA admittance calculation has been revised from SSAP No. 10 – allowing greater timeframes for recovery and realization of DTAs, and a higher percentage for a realization threshold – SSAP No. 101 continues with the approach to determine admittance of DTAs in accordance with a three-component admittance calculation. Also, tax planning-strategies are still permitted to be considered in admitting DTAs.

122. *Inclusion of Nonvested Employees in Determining Pension Liability* - During the 2008 Spring Hearing, the Working Group received comments that nonvested employees in a pension or OPEB plan do not have a current claim, and should be excluded from pension and OPEB obligation determinations. In

[7] Issue papers are considered non-authoritative and provide historical discussion for the development of a SSAP. Issue papers are generally updated after initial adoption of the related of the related SSAP but not typically thereafter. SSAP No. 92 was adopted in March 2012; the Working Group directed staff to update this issue paper to reflect the final decisions in that SSAP.

considering this issue, the Working Group identified that the inclusion of nonvested participants would have a significant impact to surplus for OPEB plans. However, the exclusion of nonvested participants would result in less conservative liability requirements for statutory accounting in comparison to GAAP.

123. Application of this issue paper as a new statutory accounting principle is expected to generate a significant increase to accumulated postretirement benefit obligations as a result of the inclusion of nonvested participants. Unlike pension plans, OPEB plans do not have federal vesting requirements or federal oversight. Generally, vesting in OPEB plans occurs when an employee reaches early retirement age. Consequently, the inclusion of employees under early retirement age results in a very significant increase in the accumulated postretirement benefit obligation. (Nonvested participants were excluded from the accumulated benefit obligation in SSAP No. 14.)

124. The Working Group identified that the Financial Accounting Standards Board (FASB) concluded that accrual accounting is more representationally faithful and more relevant to financial statement users. Furthermore, actuarial assumptions used in determining liabilities already consider that some existing or future retirees will live longer than others and that some individuals will terminate employment before becoming eligible for the benefits. The reasons provided by FASB for including nonvested participants were included within FAS 106 and FAS 158:

a. Accrual accounting (and not terminal accounting or cash basis accounting) is more representationally faithful and more relevant to financial statement users. The basis of accrual accounting is that the entity recognizes financial effects of transactions and other events and circumstances that have future cash consequences when those events and transactions occur. (For pension and OPEB obligations, the service of the employee is the event that triggers future cash consequences.)

b. Uncertainty does not change the nature of a promise. Actuarial assumptions consider that some existing or future retirees will live longer than others and that some individuals will terminate employment before becoming eligible for the benefits or die before receiving any benefits. These factors are considered in measuring the probable future sacrifice that will result from the existing promise of benefits to former and current employees.

125. As a result of the above information, and the desire not to have financial statements that are less conservative than GAAP, the Working Group agreed that all employees (vested and nonvested) should be included in the accumulated postretirement plan liability for statutory accounting. Update 2012: During the development of SSAP No. 92, the Working Group heard additional comments regarding the inclusion of non-vested participants from the American Academy of Actuaries. These comments addressed the inclusion of liabilities within statutory financial statements that are not binding and that may be discontinued when insolvency is imminent, and therefore not a solvency obligation. In considering these comments, the Working Group responded that obligations for pension and other postemployment benefits should be reflected in the financial statements, even if the employer has the discretion to unilaterally freeze, reduce or withdraw those benefits. When the employer or reporting entity freezes or reduces the pension or other postemployment benefit, then it would be appropriate to adjust the obligation accordingly.

126. *Transition and Effective Date* – With the adoption of Issue Paper No. 133 in December 2008, the Statutory Accounting Principles (E) Working Group directed NAIC staff to draft SSAP No. 92 with reconsideration of the effective date to 2011 and expanding the proposed transition period from 5 years to 10 years. In discussing the draft SSAP, an effective date of Jan. 1, 2013, was ultimately adopted.

127. The transition guidance originally proposed in Issue Paper No. 133 required companies with a surplus impact of less than 1% from initial application of the standard to recognize the full surplus impact, including a liability that equaled the full unfunded projected benefit obligation. Reporting entities with a

surplus impact of greater than 1% from initial application of the standard would have the option to defer recognition of the full surplus impact for a period not to exceed five years. This guidance required a minimum of 20% to be recognized in subsequent years. In working with interested parties, actuaries, plan administrators, representatives of the AICPA, and members of the Working Group, the transition guidance was revised to include the following elements:

a. In the first reporting period after transition, reporting entities are required to disclose the obligation and the fair value of plan assets. This disclosure shall specifically note the funded/unfunded status of the plan, and the surplus impact necessary to reflect the full unfunded benefit obligation. Any unfunded defined benefit amounts are considered a liability under SSAP No. 5R and are to be reported in the first quarter financial statements with a corresponding entry to surplus. If the fair value of plan assets exceeds the obligation, the asset is nonadmitted. Items previously recognized from SSAP No. 14 or SSAP No. 89 (gains or losses, prior service costs or credits, and remaining transition items from the original application of those standards) are to be recognized in unassigned funds (surplus). After this recognition, the full unfunded or overfunded status of the plan shall be reflected in the financial statements.

b. Transition Election: Due to the potential surplus impact, reporting entities may elect one of two methods in initially applying the standards:

    i. Reporting entities may elect to recognize the entire transition surplus impact calculated, on an individual plan basis, as of January 1, 2013.

    ii. Alternatively, reporting entities may elect to recognize the entire surplus impact, on an individual plan basis, over a period not to exceed ten (10) years. The surplus impact initially recognized as of January 1, 2013, under this transition option, and subsequently over the transition period, shall be the greater of:

        (a) Ten percent of the calculated surplus impact as of the transition date; and

        (b) Amortization[8] of the "unrecognized items" into net periodic benefit cost, including any accelerated amortization of these items from curtailments or settlements that occur after the transition date. (If the amortization cannot be determined at transition, at a minimum, the amount amortized for "unrecognized items" during the prior year shall be utilized for this component of the calculation. If the amount recognized for transition (greater of both components) is subsequently determined to be less than what is amortized for the year, the difference between what was recognized for transition, and what is amortized must immediately be recognized as an adjustment to the transition impact to unassigned funds (surplus).);

If the surplus deferral is elected at the transition date, subsequently, starting with the 2014 year-end financial statement, the reporting entity shall annually recognize the remaining surplus impact

[8] Unless otherwise impacted from the provisions within this Statement or in accordance with changes to the benefit plan, the amortization of the unrecognized items into net periodic benefit cost shall continue to follow the existing amortization schedules in effect on the transition date.

(collectively referred to as the "transition liability"[9]) on a systematic basis over a period not to exceed nine years. The minimum amount recognized each subsequent year shall be an amount that reflects the conditions identified above. Additionally, reporting entities must recognize any remaining transition liability to the extent that the plan reflects a prepaid benefit cost. (For example, if changes in circumstances have resulted with the plan reflecting an overfunded status, the remaining transition liability must be recognized to the extent that the plan is overfunded.) Furthermore, if circumstances result with a subsequent gain attributed to the plan that will be recognized in earnings, the entity must recognize an additional amount of the remaining transition liability to offset the recognized gain. Reporting entities are permitted to recognize the remaining transition liability, or an amount in excess of the minimum requirement, at any time after the transition date. This transition guidance is specific to the transition surplus impact from initially applying SSAP No. 92 on Jan. 1, 2013. Thus, this transition guidance does not apply to additional liability calculated from subsequent comparison of the fair value of plan assets to the accumulated benefit obligation, or the impact of subsequent plan amendments.

128. Reporting entities electing to apply the transition guidance must disclose the full transition surplus impact calculated in the first quarter statutory financial statements after the transition date and each reporting period thereafter. This disclosure shall include the initial "transition liability" calculated, the annual amortization amount of the "unrecognized items" into net periodic pension cost, the amount of the unfunded accumulated benefit obligation, and the remaining unrecognized transition impact. This disclosure shall include a schedule of the entity's anticipated recognition of the remaining surplus impact over the transition period.

129. In establishing the final transition guidance, the following key elements were noted:

a. All reporting entities are equally allowed to participate in the transition election. However, reporting entities are not required to elect the surplus deferral, and at transition, or at any time subsequent to transition, reporting entities are permitted to recognize the full transition surplus impact.

b. A 10% minimum surplus recognition threshold provides the potential for a longer transition period (potentially 10 years) to mitigate the surplus impact. However, the transition guidance is not intended to allow reporting entities to improve their surplus position simply by electing to defer recognition of the surplus impact at initial application. Therefore, reporting entities electing the transition option must consider a two-component calculation to determine the minimum surplus impact that must be recognized. This calculation is utilized each time recognition is required for the transition surplus impact to determine the minimum required. Although the guidance allows up to a 10-year transition timeframe, the actual transition timeframe permitted for each reporting entity will depend on the two-component calculation.

c. The transition guidance is specific that it requires a minimum of 10% of the "surplus impact" to be recognized at each reporting period. This guidance was written to prevent an interpretation that would allow a systematic reduction of nonadmitted prepaid benefit cost over the transition timeframe before recognition of any unfunded liability. (As the prepaid benefit cost is nonadmitted, a reduction of this amount is offset by an equal change to the nonadmitted assets. As such, this action alone results in a zero surplus impact.)

[9] If the surplus deferral is elected, the deferred liability, although comprised of the previous "unrecognized items" shall be collectively referred to as the "transition liability". Although reporting entities will need to continue to track the unrecognized items for amortization into net periodic cost (offset through unassigned funds (surplus)), reporting entities shall not allocate the recognized surplus impact from transition to these categories. The minimum amount of liability recognized under the deferral option must cover the annual amortization of the "unrecognized items" into net periodic benefit cost to prevent a surplus benefit.

d. At initial adoption on Jan. 1, 2013, reporting entities are required to recognize the minimum calculated transition surplus impact. Subsequently, reporting entities are not required to recognize the minimum surplus impact until Dec. 31, 2014. This spread from the initial and first subsequent recognition prevents reporting entities from incurring a surplus impact twice in the same reporting year.

e. Reporting entities must recognize any remaining transition liability to the extent that a plan reflects a prepaid benefit cost, overfunded plan asset or when a gain is subsequently recognized in earnings. For example, if changes in circumstances have resulted with the plan reflecting an overfunded status, the remaining transition liability must be recognized to the extent that the plan is overfunded. Additionally, if circumstances result with a subsequent gain attributed to the plan that will be recognized in earnings, the entity must recognize an additional amount of the remaining transition liability to offset the recognized gain.

f. Transition guidance is specific to the transition surplus impact from initially applying the adopted SSAP. The transition guidance does not apply to additional liabilities calculated from subsequent comparison of the fair value of plan assets to the projected benefit obligation or the impact of subsequent plan amendments. (Subsequent plan amendments resulting in a gain would be considered under paragraph 129.e. above.)

130. *Reporting Unfunded Liabilities in the Financial Statements* – During the 2010 Summer National Meeting, the Statutory Accounting Principles (E) Working Group exposed draft SSAPs for pensions and other postretirement benefit benefits. As a result of this exposure, comments were received from interested parties on the reporting of the unfunded benefit obligations and benefits. These comments noted that the proposed SSAPs appear to commingle the accounting for prepaid and accrued pension costs with the adjustments to surplus necessary to reflect the funded status of the plan on the balance sheet date. It was noted that only some of comingled transactions impact the income statement, and commingling the amounts on the balance sheet would create cross-check errors with the associated general expense exhibits.

131. After researching the statutory reporting options, it was concluded that there was no viable option that would result with the use of a single financial statement line that will provide regulators with the unfunded pension obligation on the face of the financial statements in a manner similar to GAAP without significant revisions to existing schedules and cross-checks. As a result of these findings, the Working Group agreed that separate reporting will be necessary in the financial statements for "unpaid expenses" and the "transition liability" for pension and postretirement obligations. This could result in situations when a plan reflects a prepaid benefit (nonadmitted prepaid benefit cost) as well as a liability for pension benefits (unfunded obligations). To address these situations and ensure a liability presentation on the balance sheet for unfunded plans, a contra-asset is utilized as an aggregate write-in for other-than-invested assets to offset the prepaid benefit, resulting in a net zero asset presentation on the balance sheet. In order to address concerns that the reporting may be unclear, disclosures are required to separately show the assets and liabilities recognized.

132. *SSAP Amendments – SSAP No. 92—Accounting for Postretirement Benefits Other Than Pensions* was adopted March 2012. Subsequent to adoption, but before finalization of this issue paper, the following agenda item was proposed to clarify guidance:

a. Agenda Item 2012-19: Clarification of Measurement Date Change in SSAP No. 92 & SSAP No. 102 and Applicability of INT 03-18 for SSAP No. 102 – This agenda item proposed revisions to clarify the effective date of the measurement date change for plan assets and benefit obligations reflected in paragraph 107 of this issue paper. This particular aspect is intended to have an effective date subsequent to the effective date of the SSAP. The delayed effective date for the measurement date change is consistent with GAAP. The revisions from agenda item 2012-19 were adopted Nov. 29, 2012.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE:

Statutory Accounting

133. Statutory accounting principles currently exist for postretirement benefits in SSAP No. 14. The conclusions reached in SSAP No. 14 resulted from adoption with modification *of FASB Statement No. 106, Employers' Accounting for Postretirement Benefits Other Than Pension (FAS 106), FASB Statement No. 132, Employers' Disclosures about Pensions and Other Postretirement Benefits an amendment of FASB Statements No. 87, 88, and 106* (FAS 132) with certain modifications and *FASB Statement No. 132 (R), Employers' Disclosures about Pensions and Other Postretirement Benefits, and amendment of FASB Statements No. 87, 88, and 106* (FAS 132R).

134. SSAP No. 14 was previously interpreted by the following interpretations:

a. *INT 99-26: Offsetting Pension Assets and Liabilities* (INT 99-26)

b. *INT 01-16: Measurement Date for SSAP No. 8 Actuarial Valuations* (INT 01-16)

c. *INT 04-12: EITF 03-4: Determining the Classification and Benefit Attribution Method for a "Cash Balance" Pension Plan* (INT 04-12) Reference to this interpretation has not been incorporated within this issue paper as the issue specifically pertains to pension plans. This item has been incorporated within *Issue Paper No. 132—Accounting for Pensions, A Replacement of SSAP No. 89.*

d. *INT 04-17: Impact of Medicare Modernization Act on Postretirement Benefits (INT 04-17)*

135. Upon the establishment of a new statutory accounting principle that adopts FAS 158 with modification and supersedes SSAP No. 87, the following interpretations will be nullified:

a. *INT 99-26: Offsetting Pension Assets and Liabilities* (INT 99-26). This interpretation has been incorporated within paragraph 35 of this issue paper.

b. *INT 01-16: Measurement Date for SSAP No. 8 Actuarial Valuations* (INT 01-16). The 'measurement date' guidance referencing FAS 87 within this interpretation has been revised in accordance with FAS 158. The measurement date guidance included within paragraphs 106-108 of the issue paper should be followed.

c. *INT 04-12: EITF 03-4: Determining the Classification and Benefit Attribution Method for a "Cash Balance" Pension Plan* (INT 04-12). This INT is specific for pension plans. The guidance within this INT has been incorporated into *SSAP No. 102—Accounting for Pensions*.

136. Upon the establishment of a new statutory accounting principle that adopts FAS 158 with modification and supersedes SSAP No. 89, the following interpretations will be modified:

a. *INT 04-17: Impact of Medicare Modernization Act on Postretirement Benefits* – This interpretation adopts with modification the FASB staff position pertaining to whether prescription drug coverage under the Medicare Prescription Drug, Improvement and Modernization Act of 2003 should impact accumulated postretirement benefit obligations. Although this interpretation primarily impacts *SSAP No. 14—Postretirement Benefits Other Than Pensions*, this interpretation has been revised to conclude that calculations shall include non-vested employees consistent with the revised SSAP.

4. The working group reached a consensus to adopt the final conclusions reached in FSP FAS 106-2 with the following modifications:

    a. Postretirement benefits should be accounted for in accordance with SSAP No. 92~~14~~.

    b. Income Taxes should be accounted for in accordance with SSAP No. 101.

    c. Calculations shall not exclude non-vested employees.~~ Partially invested employees are included only to the extent of their vested amounts.~~

    d. Any references to *FSP FAS 106-1, Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003* are removed as this guidance was superseded by FSP FAS 106-2.

9. In interim and annual financial statements for the first period in which an employer includes the effects of the subsidy in measuring the net postretirement benefit cost and the first period in which an employer includes the effects of the subsidy in measuring net periodic postretirement benefit cost, it shall disclose the following:

    a. The reduction in the net postretirement benefit cost for the subsidy related to benefits attributed to former employees.

    b. The effect of the subsidy on the measurement of net periodic postretirement benefit cost for the current period. That effect includes (1) any amortization of the actuarial experience gain in (a) as a component of the net amortization called for by paragraph 49 of SSAP No. 92, (2) the reduction in current period service cost due to the subsidy, and (3) the resulting reduction in interest cost on the net postretirement benefit cost as a result of the subsidy.

    c. Any other disclosures required by paragraph 64.q. of SSAP No. 92 which requires disclosure of "An explanation of any significant change in the benefit obligation or plan assets not otherwise apparent in the other disclosures required by this statement."

10. For purposes of the disclosures required by paragraphs 64.a. of SSAP No. 92, an employer shall disclose gross benefit payments (paid and expected, respectively), including prescription drug benefits, and separately the gross amount of the subsidy receipts (received and expected, respectively).

Generally Accepted Accounting Principles

137. This issue paper adopts with modifications guidance included within FAS 158 and the resulting amended guidance within FAS 87, 88 and 132(R).

138. FAS 158 also references related EITF guidance previously adopted by statutory accounting:

- *EITF 93-3: Plan Assets under FASB Statement No. 106 (EITF 93-3) – This EITF issue is whether trusts established to pay postretirement benefits must be determined to be bankruptcy-proof in order for the assets in the trust to qualify as plan assets under FAS 106. The consensus reached clarified that it is not necessary to determine that a trust is bankruptcy-proof for the assets of the trust to qualify as plan assets under FAS 106.*

> *However, if the trust explicitly provides that such assets are available to the general creditors of the employer in the event of the employer's bankruptcy, the assets held by that trust would not qualify as plan assets under FAS 106.*

139. The following is excerpted from *FASB Statement No. 130, Other Comprehensive Income* (FAS 130):

> 10. This Statement uses the term comprehensive income to describe the total of all components of comprehensive income, including net income.[4] This Statement uses the term other comprehensive income to refer to revenues, expenses, gains, and losses that under generally accepted accounting principles are included in comprehensive income but excluded from net income. This Statement does not require that an enterprise use the terms comprehensive income or other comprehensive income in its financial statements, even though those terms are used throughout this Statement.[5]
>
> [4]FAS130, Footnote 4 – This Statement uses the term net income to describe a measure of financial performance resulting from the aggregation of revenues, expenses, gains, and losses that are not items of other comprehensive income as identified in this Statement. A variety of other terms such as net earnings or earnings may be used to describe that measure.
>
> [5]FAS130, Footnote 5 – Paragraph 40 of Concepts Statement 5 states that "just as a variety of terms are used for net income in present practice, the Board anticipates that total nonowner changes in equity, comprehensive loss, and other equivalent terms will be used in future financial statements as names for comprehensive income."

140. See Issue Paper No. 14 for additional GAAP references

RELEVANT LITERATURE:

Statutory Accounting

- *Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy*
- *SSAP No. 14—Employers' Accounting for Postretirement Benefits Other Than Pensions*
- *SSAP No. 10—Income Taxes*
- *Issue Paper No. 3—Accounting Changes*
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 14—Employers' Accounting for Postretirement Benefits Other Than Pensions*
- *INT 04-12: EITF 03-4: Determining the Classification and Benefit Attribution Method for a "Cash Balance" Pension Plan.*
- *INT 04-17: Impact of Medicare Modernization Act on Postretirement Benefits*
- *INT 01-16: Measurement Date for SSAP No. 8 Actuarial Valuations*
- *INT 99-26: Offsetting Pension Assets and Liabilities*

Generally Accepted Accounting Principles

- *FASB Statement No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106 and 132(R)*
- *FASB Statement No. 106, Employers' Accounting for Postretirement Benefits Other Than Pensions*
- *FASB Statement No. 132(R), Employers' Disclosures about Pensions and Other Postretirement Benefits*
- *FASB Emerging Issues Task Force No. 93-3, Plan Assets under FASB Statement No. 106*
- *FASB Statement No. 130, Other Comprehensive Income*

STATE REGULATIONS:

- No additional guidance obtained from state statutes or regulations.

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Statutory Issue Paper No. 134

Servicing Assets/Liabilities, An Amendment of SSAP No. 91

STATUS
Finalized March 29, 2008

Current Authoritative Guidance for Servicing Assets/Liabilities: SSAP No. 103
This issue paper may not be directly related to the current authoritative statement.

Original SSAP from Issue Paper: SSAP No. 91R

Type of Issue:

Common Area

SUMMARY OF ISSUE:

1. In March 2006, the Financial Accounting Standards Board (FASB) issued *FASB Statement No. 156: Accounting for Servicing of Financial Assets, an amendment of FASB Statement No. 140* (FAS 156) to amend several aspects of accounting for servicing assets. The purpose of this issue paper is to incorporate and/or clarify specific amendments from FAS 156 into statutory accounting principles:

a. Require subsequent fair value measurement of servicing assets and servicing liabilities;

b. Clarify separate recognition of servicing assets and servicing liabilities resulting from a transfer of financial assets to a qualifying SPE in guaranteed mortgage securitizations in which the transferor retains all of the resulting securities;

c. Include separately recognized servicing assets and servicing liabilities in the calculation for determining proceeds from the sale of assets; and

d. Incorporate revised terminology, amending the term 'retained interests' to 'interests that continue to be held by a transferor'.

2. Current statutory accounting guidance for servicing assets and servicing liabilities is located within *SSAP No. 91—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (SSAP No. 91). The conclusions reached within SSAP No. 91 resulted from adoption with modification *of FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (FAS 140).*

3. The purpose of this issue paper is to update statutory accounting principles for servicing assets and servicing liabilities. The result will be the incorporation of substantive and nonsubstantive revisions to SSAP No. 91. In accordance with the *NAIC Policy Statement on Statutory Accounting Principles Maintenance Agenda Process* (Maintenance Agenda Policy Statement), substantive revisions require the issuance of a new SSAP. However, as only some aspects of the revisions from FAS 156 are considered substantive, it is requested that the Statutory Accounting Principles Working Group approve the exposure of the adopted FAS 156 revisions within the existing SSAP No. 91, after the adoption of this issue paper.

SUMMARY CONCLUSION

4. This issue paper adopts revisions to FAS 156 indicating that all servicing assets and servicing liabilities should initially be measured at fair value. Consistent with these revisions, this issue paper

adopts guidance from FAS 156 requiring the inclusion of separately recognized servicing assets and servicing liabilities in the calculation of proceeds from the sale of assets and modifies the illustrations included within SSAP No. 91 accordingly. This issue paper rejects the optionality provided within FAS 156 for subsequent measurement of servicing assets and servicing liabilities, but revises the SSAP No. 91 accounting measurement method for such items to a fair value measurement method. This issue paper confirms adoption of guidance previously adopted from FAS 140 regarding servicing assets and servicing liabilities established from the transfer of financial assets to a qualifying SPE in a guaranteed mortgage securitization in which the transferor retains all of the resulting securities. This issue paper also adopts nonsubstantive revisions from FAS 156 in which the term 'retained interests' is replaced with 'interests that continue to be held by the transferor', with amendments to the definition to exclude servicing assets and servicing liabilities.

5. Substantive revisions to SSAP No. 91 from this issue paper are illustrated below:

6. Upon completion of any transfer of financial assets, the transferor shall:

a. Initially recognize and measure at fair value, if practicable, servicing assets and servicing liabilities assumed under a separate contractual obligation to service financial assets (see paragraph 49);

~~a.~~b. Allocate the previous carrying amount between the assets sold, if any, and the ~~retained interests~~interests that continue to be held by a transferor, if any, based on their relative fair values at the date of transfer (see paragraphs 47 and 48).

~~b.~~c. Continue to carry in its balance sheet any ~~retained~~ interest it continues to hold in the transferred assets, including, if applicable, beneficial interests in assets transferred to a qualifying special-purpose entity in a securitization, and retained undivided interests (see paragraphs 7 c., 47 and 48); and

Recognition and Measurement of Servicing Assets and Liabilities

11. Servicing rights become a distinct asset or liability only when contractually separated from the underlying assets by sale or securitization of the assets with servicing retained, or separate purchase or assumption of the servicing. Servicing rights become a distinct asset or liability of the reporting entity pursuant to:

a. A transfer of the servicer's financial assets that meets the requirements for sale accounting;

b. A transfer of financial assets to a qualifying SPE in a guaranteed mortgage obligation in which the transferor retains all of the resulting securities; or

c. An acquisition or assumption of a servicing obligation that does not relate to financial assets of the servicer.

A servicer that transfers or securitizes financial assets in a transaction that does not meet the requirements for sale accounting and is accounted for as a secured borrowing with the underlying assets remaining on the transferor's balance sheet shall not be recognized as a servicing asset or servicing liability.

12. *(New paragraph – renumbering accordingly)* If distinct servicing rights ~~to transferred assets~~ exist in accordance with the above guidelines,~~and are retained by the reporting entity,~~ the reporting entity shall recognize a servicing asset or liability. When the servicing fees to be received exceed the cost of servicing the transferred assets, a servicing asset is recognized and nonadmitted. When the cost of servicing the transferred assets is greater than the servicing fees to be received, a liability shall be recorded for the excess to recognize this obligation. A corresponding loss shall be recorded through the Summary of Operations in other income. ~~If the servicing asset or liability was purchased or assumed rather than undertaken in a sale or~~

~~securitization of the financial assets being serviced,~~ Servicing assets and servicing liabilities ~~it~~ shall be measured initially at ~~its~~ fair value, presumptively the price paid. ~~The s~~Servicing assets or liabilities~~y~~ shall be measured subsequently at fair value at each reporting date with fluctuations in fair value reported as unrealized gains or losses. Declines in fair value which are determined to be other than temporary shall be recorded as realized losses. ~~shall be amortized into income in proportion to, and over the period of estimated servicing income (if an asset) or estimated servicing loss (if a liability). A servicing asset or liability shall be assessed for impairment or increased obligation based on its fair value.~~

Assets Obtained and Liabilities Incurred as Proceeds

46. The proceeds from a sale of financial assets consist of the cash and any other assets obtained, including separately recognized servicing assets, in the transfer less any liabilities incurred, including separately recognized servicing liabilities. Any asset obtained that is not an interest in the transferred asset is part of the proceeds from the sale. Any liability incurred, even if it is related to the transferred assets, is a reduction of the proceeds. Any derivative financial instrument entered into concurrently with a transfer of financial assets is either an asset obtained or a liability incurred and part of the proceeds received in the transfer. All proceeds and reductions of proceeds from a sale shall be initially measured at fair value.

Disclosures

88. A reporting entity shall disclose the following:

~~1.~~j. For all servicing assets and servicing liabilities:

~~1.~~i. ~~The amounts of servicing assets nonadmitted or liabilities recognized and amortized during the period; and~~A description of the valuation techniques or other models, including significant assumptions within models, used to estimate the fair value of servicing assets and servicing liabilities.

~~2.~~ii. ~~The fair value of recognized servicing assets and liabilities for which it is practicable to estimate that value and the method and significant assumptions used to estimate the fair value.~~Changes in fair value resulting from changes in valuation inputs or assumptions used in models and descriptions of other changes in fair value.

6. SSAP No. 91, Exhibit B provides illustrations to assist with the accounting of items subject to this standard. Pursuant to the substantive revisions noted above to paragraph 46 of SSAP No. 91, the proceeds from the sale of financial assets consist of the cash and any other assets obtained, including separately recognized servicing assets. Exhibit B illustrations three, four and five have been modified to convey these revisions:

Illustration—Sale of Receivables with Servicing ~~Retained~~Obtained

3. Company C originates $1,000 of loans that yield 10 percent interest income for their estimated lives of 9 years. Company C sells the $1,000 principal plus the right to receive interest income of 8 percent to another entity for $1,000. Company C will continue to service the loans, and the contract stipulates that its compensation for performing the servicing is the right to receive half of the interest income not sold. The remaining half of the interest income not sold is considered an interest-only strip receivable. At the date of the transfer, the fair value of the loans~~,~~ ~~including servicing,~~ is $1,100. The fair values of the servicing asset and the interest-only strip receivable are~~is~~ $40 and $60, respectively.

Fair values	
Cash proceeds	$1,000
Servicing asset	40
Interest-only strip receivable	60

Net Proceeds	
Cash proceeds	$1,000
Servicing asset	40
Net Proceeds	$1,040

Carrying Amount Based on Relative Fair Values

	Fair Value	**Percentage Of Total Fair Value**	**Allocated Carrying Amount**
Loans sold	$ 1,04~~00~~	~~91.0~~94.55	$~~910~~945.50
~~Servicing asset~~	~~40~~	~~3.6~~	~~36~~
Interest-only strip receivable	60	5.4	~~54~~54.50
Total	$ 1,100	100.0	$ 1,000

Gain on Sale	
Net proceeds	$~~1000~~1,040
Carrying amount of loans sold	~~910~~945
Gain on sale	$ ~~90~~94.50

Journal Entries		
Cash	1,000	
Interest-only strip receivable	54.50	
Servicing Asset	40	
Loans		~~910~~1,000
Gain on sale		~~90~~94.50

To record transfer and to recognize interest-only strip receivable and servicing asset

~~Servicing asset~~	~~36~~	
~~Interest-only strip receivable~~	~~54~~	
~~Loans~~		~~90~~

~~*To record servicing asset and interest-only strip receivable*~~

Interest-only strip receivable	~~6~~5.50	
Equity		~~6~~5.50

To begin to subsequently measure interest-only strip receivable like an available-for-sale security (FAS 140, paragraph 14)

Illustration—Recording Transfers of Partial Interests with Proceeds of Cash, Derivatives, Other Liabilities, and Servicing

4. Company D originates $1,000 of prepayable loans that yield 10 percent interest income for their 9-year expected lives. Company D sells nine-tenths of the principal plus interest of 8 percent to another entity. Company D will continue to service the loans, and the contract stipulates that its compensation for performing the servicing is the 2 percent of the interest income not sold. Company D obtains an option to purchase from the transferee loans similar to the loans sold (which are readily obtainable in the marketplace) and incurs a limited recourse

obligation to repurchase delinquent loans. At the date of transfer, the fair value of the loans is $1,100.

Fair values

Cash proceeds	$900
Call option	70
Recourse obligation	60
Servicing asset	90
One-tenth interest retained	100

Net Proceeds

Cash received	$900
Plus: Servicing Asset	90
Plus: Call option	70
Less: Recourse obligation	(60)
Net proceeds	$~~910~~1,000

Carrying Amount Based on Relative Fair Values

	Fair Value	Percentage Of Total Fair Value	Allocated Carrying Amount
Interest sold	$ ~~910~~1,000	~~83~~90.9	$ ~~830~~909
~~Servicing asset~~	~~90~~	~~8~~	~~80~~
One-tenth interest ~~retained~~continued to be held by transferor	100	9.1	~~90~~91
Total	$ 1,100	100	$ 1,000

Gain on Sale

Net proceeds	$ ~~910~~1,000
Less: Carrying amount of loans sold	~~830~~(909)
Gain on sale	$ ~~80~~91

Loans Sold

Carrying Amount of Loans	$1,000
Less: Allocated carrying amount of interest that continues to be held by the transferor	(91)
Loans Sold	$ 909

Journal Entries

Cash	900	
Call option	70	
Servicing Asset	90	
Loans		~~830~~909
Recourse obligation		60
Gain on sale		~~80~~91

To record transfer and to recognize servicing asset, call option and recourse obligation.

~~Servicing asset~~	~~80~~	
~~Loans~~		~~80~~

~~*To record servicing asset*~~

~~At the time of the transfer, Company D reports its one-tenth retained interest in the loans at its allocated carrying amount of $90.~~

Illustration—Recording Transfers If It Is Not Practicable to Estimate a Fair Value

5. Company E sells loans with a carrying amount of $1,000 to another entity for cash proceeds of $1,050 plus a call option to purchase loans similar to the loans sold (which are readily obtainable in the marketplace) and incurs a limited recourse obligation to repurchase any delinquent loans. Company E undertakes an obligation to service the transferred assets for the other entity. In Case 1, Company E finds it impracticable to estimate the fair value of the servicing contract, although it is confident that servicing revenues will be more than adequate compensation for performing the servicing. In Case 2, Company E finds it impracticable to estimate the fair value of the recourse obligation.

Fair Values	Case 1	Case 2
Cash proceeds	$1,050	$1,050
Servicing asset	XX*	40
Call option	70	70
Recourse obligation	60	XX*
Fair value of loans transferred	1,100	1,100

* Not practicable to estimate fair value

Net Proceeds	Case 1	Case 2
Cash received	$1,050	$1,050
Plus: Servicing Asset	XX*	40
Plus: Call option	70	70
Less: Recourse obligation	(60)	XX
Net proceeds	$1,060	$~~1,120~~1,160

~~**Carrying Amount Based on Relative Fair Values (Case 1)**~~

	~~Fair Value~~	~~Percentage Of Total Fair Value~~	~~Allocated Carrying Amount~~
~~Loans sold~~	~~$ 1,060~~	~~100~~	~~$ 1,000~~
~~Servicing asset~~	~~0~~	~~0~~	~~0~~
~~Total~~	~~$ 1,060~~	~~100~~	~~$ 1,000~~

~~**Carrying Amount Based on Relative Fair Values (Case 2)**~~

	~~Fair Value~~	~~Percentage Of Total Fair Value~~	~~Allocated Carrying Amount~~
~~Loans sold~~	~~$1,120~~	~~97~~	~~$970~~
~~Servicing asset~~	~~40~~	~~3~~	~~30~~
~~Total~~	~~$1,160~~	~~100~~	~~$1,000~~

Gain on Sale		Case 1	Case 2
	Cash received	$1,060	$1,060
	Carrying	1,000	1,000

Amount of Loans Less: Recourse obligation	0	(160)
Gain on Sale	$60	$0

Journal Entries	Case 1		Case 2	
Cash	1,050		1,050	
Servicing asset	0*		~~30~~40	
Call option	70		70	
Loans		1,000		1,000
Recourse obligation		60		1~~5~~60†
Gain on sale		60		0
To record transfer				

* Assets shall be recorded at zero if an estimate of the fair value of the assets is not practicable.
† The amount recorded as a liability in this example equals the sum of the known assets less the fair value of the known liabilities, that is, the amount that results in no gain or loss.

Effective Date and Transition

7. Upon adoption of this issue paper, the NAIC will release an updated SSAP No. 91 for comment. The SSAP will contain the adopted nonsubstantive changes to SSAP No. 91, shown in this issue paper. Users of the Accounting Practices and Procedures Manual should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will contain an effective date of years beginning on or after January 1, 2009.

DISCUSSION

Initial Recognition and Measurement of Fair Value

8. Revisions to FAS 156 amended guidance regarding how servicing assets and servicing liabilities should be initially recognized and measured. FAS 140 requirements for initial measurement of servicing assets and servicing liabilities varied depending on whether they were purchased separately, assumed, or obtained in a sale or securitization transaction, as well as whether they were assets or liabilities. The revisions in FAS 156 clarified that servicing assets and servicing liabilities should be accounted for similarly, regardless of how they are obtained and that fair value is the most relevant measurement attribute.

9. For statutory accounting, guidance within SSAP No. 91 had previously adopted guidance within paragraph 13 of FAS 140 requiring initial fair value measurement for purchased and assumed servicing assets and servicing liabilities. Similar to GAAP rationale for FAS 156, it is appropriate for statutory accounting that all servicing assets and servicing liabilities be accounted for similarly. As such, this issue paper adopts the FAS 156 guidance that all servicing assets and servicing liabilities should be initially measured at fair value, regardless if such items are purchased, assumed, or undertaken in a sale or securitization.

10. Pursuant to the FAS 156 revisions to initially measure all servicing assets and liabilities at fair value, revisions were incorporated in FAS 156 to include separately recognized servicing assets as part of the proceeds of a sale in order to simplify the application of the accounting guidance and provide

consistency between servicing assets and servicing liabilities obtained in a transfer of financial assets that meet the requirements for sale accounting. These modifications have also been adopted for statutory accounting, with adjustments to statutory accounting illustrations accordingly.

11. Prior to the issuance of FAS 156, separately recognized servicing assets were included as part of retained interests. This issue paper incorporates nonsubstantive revisions to SSAP No. 91, similar to those included within FAS 156, to restate the term 'retained interests' with 'interests that continue to be held by a transferor' and to clarify within paragraph 47 that servicing assets are not considered within the context of this term. (Nonsubstantive revisions to SSAP No. 91 are included as a supplement to this issue paper.)

Subsequent Fair Value Measurement of Servicing Assets and Servicing Liabilities

12. Revisions to FAS 156 permit an entity to choose either an amortization method or fair value measurement method for the subsequent measurement of servicing assets and servicing liabilities. For statutory accounting, it is perceived that this subsequent measurement option hinders the comparability and consistency of financial statements. Although extensive disclosure requirements have been established within FAS 156 to counter the non-comparability created on the face of the financials, such disclosures cannot be considered a substitute for consistent and comparable measurement of similar items for statutory accounting.

13. Existing guidance within SSAP No. 91 requires amortization of servicing assets and servicing liabilities, however, based on the rationale provided below, SSAP No. 91 will be revised to require subsequent fair value measurement of servicing assets and servicing liabilities at each reporting date:

a. SSAP No. 91 already requires an existing fair value consideration each reporting date for a servicing assets/liabilities impairment assessment;

b. SSAP No. 91 already requires disclosure of fair value, if practicable, of recognized servicing assets/liabilities and the method and significant assumptions used to estimate that fair value.

c. SSAP No. 91 nonadmits servicing assets, so positive fluctuations in fair value would not impact earnings;

d. Fair value is the most appropriate measurement method for servicing assets/liabilities as it illustrates the value of the asset or obligation at the financial statement reporting date;

e. There are no identified insurance industry specific characteristics of servicing assets/liabilities that would justify continued reporting of servicing assets/liabilities in a manner that does not represent the fair value of the asset or obligation at the financial statement reporting date.

f. The FASB rationale permitting entities the option to continue using amortized cost, versus a fair value measurement, was based on some entities using non-derivative financial instruments to offset risks inherent in the servicing assets/liabilities (thus, avoiding volatility from the use of derivatives), and some entities considering servicing assets/liabilities to be contracts for services and not financial instruments. For these situations, subsequent measurement of servicing assets/liabilities at fair value would result in a new source of income statement volatility, which is viewed as not representationally faithful of their performance. Although this rationale was considered, for statutory accounting the recognition and measurement of assets and liabilities is a more relevant factor in assessing an insurer's financial position. By utilizing fair value, the insurer's financial position is more appropriately stated.

14. Pursuant to the revisions to require subsequent fair value measurement of servicing assets and servicing liabilities, corresponding disclosure requirements will adequately document the valuation methods and models and the fair value impact caused by input and assumption changes within such models and methods. These revisions will not alter the existing guidance within paragraph 49 of SSAP No. 91 regarding instances in which it is not practicable to estimate fair value:

> **If It Is Not Practicable to Estimate Fair Values**
>
> 49. If it is not practicable to estimate the fair values of assets, the transferor shall record those assets at an allocated cost basis of zero. If it is not practicable to estimate the fair values of liabilities, the transferor shall recognize no gain on the transaction and shall record those liabilities at the greater of:
>
> a. The excess, if any, of (i) the fair values of assets obtained less the fair values of other liabilities incurred, over (ii) the sum of the carrying values of the assets transferred;
>
> b. The amount that would be recognized in accordance with SSAP No. 5.

Servicing Assets and Servicing Liabilities from Securitizations

15. This issue paper confirms adoption of guidance previously included within FAS 140, and revised within FAS 156, that requires separate recognition of servicing assets and servicing liabilities resulting from a transfer of financial assets to a qualifying SPE in a guaranteed mortgage securitization in which the transferor retains all of the resulting securities. This guidance was previously adopted from FAS 140 and noted in paragraph 11 of SSAP No. 91: (bolded for emphasis)

> 11. Servicing rights become a distinct asset or liability only when contractually separated from the underlying assets by sale **or securitization of the assets with servicing retained**, or separate purchase or assumption of the servicing. ..

16. The guidance regarding servicing assets and servicing liabilities from such securitizations within FAS 140, revised in FAS 156, included caveats regarding when servicing assets and servicing liabilities could be recognized in accordance with such securitizations. As these limitations were determined through the classification status of the resulting securities (held-for-maturity, available-for-sale, and trading) prescribed by *FAS 115, Accounting for Certain Investments in Debt and Equity Securities* (FAS 115), which was previously rejected for statutory accounting, the caveats for the guaranteed mortgage securitizations were not originally incorporated into SSAP No. 91 for statutory accounting. To clarify the appropriate recognition of servicing assets and servicing liabilities for such securitizations, revisions have been incorporated to mirror the language including within FAS 156, with the exclusion of any limitation imposed by the debt security classification of the resulting securities. (Per FAS 156, securities resulting from such securitizations that are classified as available-for-sale or trading pursuant to FAS 115 should be recognized as a servicing asset or servicing liability. Entities that classify such securities as held-to-maturity are given an option to recognize them as servicing assets or servicing liabilities or report the servicing assets or servicing liabilities with the asset being serviced. FAS 156 was revised from FAS 140 in which entities with held-to-maturity securities were prohibited from recognizing these retained securities as servicing assets or servicing liabilities.)

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

17. Statutory accounting for the transfers, servicing of financial assets and extinguishments of liabilities is provided in SSAP No. 91. The accounting guidance in SSAP No. 91 was established from the

guidance provided in *SSAP No. 18—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (SSAP No. 18), *SSAP No. 33—Securitization* (SSAP No. 33) and *SSAP No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements* (SSAP No. 45), and was expanded to include issues addressed in *FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 140).

18. SSAP No. 91 adopted FAS 140 with the following modifications:

a. Servicing rights assets are nonadmitted;

b. Sales treatment is not permitted for transactions including recourse provisions or removal-of-accounts provisions on the transferred assets whereas GAAP would permit the recognition of the transfer as a sale under some circumstances;

c. As statutory financial statements are prepared on a legal entity basis, special-purpose entities shall not be consolidated in a reporting entity's statutory financial statements;

d. Leases shall be accounted for in accordance with *SSAP No. 22—Leases*;

e. Reporting entities required to maintain an IMR shall account for realized and unrealized capital gains and losses in accordance with SSAP No. 7; and

f. The concepts of revolving-period securitizations, banker's acceptances and risk participations in banker's acceptances are not applicable for statutory accounting purposes.

g. This statement does not adopt the accounting for collateral as outlined in FAS 140.

19. With the adoption of this issue paper, SSAP No. 91 will be substantively revised (referred as SSAP No. 91R – Jan. 2009) to reflect the adoption of FAS 156 with the following modifications:

a. This statement adopts provisions within FAS 156 requiring an entity to recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract in any of the following situations:

i. A transfer of the servicer's financial assets that meets the requirements for sale accounting.

ii. A transfer of the servicer's financial assets to a qualifying special-purpose entity in a guaranteed mortgage securitization in which the transferor retains all of the resulting securities. (This rejects FAS 156 language that considers the classification of such securities (held-to-maturity, available-for-sale or trading) prescribed in accordance with FAS 115.)

iii. An acquisition or assumption of an obligation to service a financial asset that does not relate to financial assets of the servicer. (This rejects FAS 156 language pertaining to consolidated affiliates.)

b. This statement adopts provisions within FAS 156 requiring all separately recognized servicing assets and servicing liabilities to be initially measured at fair value, if practicable.

c. This statement rejects provisions provided within FAS 156 allowing entities to choose either an amortization method or a fair value measurement method for subsequent measurement of separately recognized servicing assets and servicing liabilities. In accordance with this issue paper, subsequent measurement of such items should be completed in accordance with a fair value measurement method. If fair value is not practicable to determine, the guidance in paragraph 49 of SSAP No. 91 should be followed.

d. This statement rejects FAS 156 provisions permitting a one-time reclassification of available-for-sale securities to trading securities by entities with recognized servicing rights, without calling into question the treatment of other available-for-sale securities under FAS 115, provided that the available-for-sale securities are identified in some manner as offsetting the entity's exposure to changes in fair value of servicing assets or servicing liabilities that a servicer elects to subsequently measure at fair value. (FAS 115 was rejected for statutory accounting, thus these classifications are not relevant to statutory accounting and do not impact the measurement of securities.)

e. This statement adopts provisions within FAS 156 requiring separate presentation of servicing assets and servicing liabilities subsequently measured at fair value in the statement of financial position and additional disclosures for all separately recognized servicing assets and servicing liabilities.

Generally Accepted Accounting Principles

20. This issue paper adopts with modifications guidance included within FAS 156.

21. FAS 156 nullifies *EITF Issue No. 88-11, Allocation of Recorded Investment When a Loan or Part of a Loan is Sold (EITF No. 88-11)*. This issue was adopted within *SSAP No. 18—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (SSAP No. 18) and SSAP No. 91. EITF No. 88-11 addressed how a recorded investment in a loan should be allocated between the portion of the loan sold and the portion retained. Per the consensus issued within this statement, such allocation should be based on the relative fair value on the date the loan was acquired, adjusted for payments and other activity from the date of sale. Similar to GAAP's nullification of this consensus, this item is no longer relevant for statutory accounting.

22. With the exception of the nullification of EITF 88-11, there is no other impact to the GAAP guidance referenced within paragraphs 94 and 95 of SSAP No. 91:

> 94. This statement adopts AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as used In Certain Audit Guides and a Statement of Position. This statement adopts FASB Emerging Issues Task Force (EITF) No. 87-34, Sale of Mortgage Servicing Rights with a Subservicing Agreement, ~~FASB EITF No. 88-11, Allocation of Recorded Investment When a Loan as Part of a Loan is Sold,~~ FASB EITF No. 88-18, Sales of Future Revenues, FASB EITF No. 88-22, Securitization of Credit Card and Other Receivable Portfolios, FASB EITF No. 90-21, Balance Sheet Treatment of a Sale of Mortgage Servicing Rights with a Subservicing Agreement, FASB EITF No. 95-5, Determination of What Risks and Rewards, If Any, Can Be Retained and Whether Any Unresolved Contingencies May Exist in a Sale of Mortgage Loan Servicing Rights and FASB EITF No. 96-19, Debtor's Accounting for a Modification or Exchange of Debt Instruments.
>
> 95. This statement rejects FASB EITF No. 84-5, Sale of Marketable Securities with a Put Option, and FASB EITF No. 92-2, Measuring Loss Accruals by Transferors of Receivables with Recourse and FASB Technical Bulletin 01-1: Effective Date for Certain Financial Institutions of Certain Provisions of Statement 140 related to Isolation of Transferred Financial Assets.

RELEVANT LITERATURE:

Statutory Accounting

- *SSAP No. 91—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
- *INT 99-07: EITF 97-3: Accounting for Fees and Casts Associated with Loan Syndications and Loan Participations after the Issuance of FASB Statement No. 125*
- *INT 99-08: EITF 97-6: Application of Issue No. 96-20 to Qualifying Special-Purpose Entities Receiving Transferred Financial Assets Prior to the Effective Date of FASB Statement No. 125*
- *INT 99-14: EITF 96-16: Debtor's Accounting for a Modification or Exchange of Debt Instruments*
- *INT 99-22: EITF 98-8: Accounting for Transfers of Investments That Are in Substance Real Estate*
- *INT 00-11: EITF 98-15: Structured Notes Acquired for a Specified Investment Strategy*
- *INT 01-31: Assets Pledged as Collateral*
- *INT 03-05: EITF 01-7: Creditor's Accounting for a Modification or Exchange of Debt Instruments*
- *INT 04-21: EITF 02-9: Accounting for Changes That Result in a Transferor Regaining Control of Financial Assets Sold*

Generally Accepted Accounting Principles

- *FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
- *AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as used In Certain Audit Guides and a Statement of Position*
- *FASB Emerging Issues Task Force No. 87-34, Sale of Mortgage Servicing Rights with a Subservicing Agreement*
- *FASB Emerging Issues Task Force No. 88-18, Sales of Future Revenues*
- *FASB Emerging Issues Task Force No. 88-22, Securitization of Credit Card and Other Receivable Portfolios*
- *FASB Emerging Issues Task Force No. 90-21, Balance Sheet Treatment of a Sale of Mortgage Servicing Rights with a Subservicing Agreement*
- *FASB Emerging Issues Task Force No. 95-5, Determination of What Risks and Rewards, If Any, Can Be Retained and Whether Any Unresolved Contingencies May Exist in a Sale of Mortgage Loan Servicing Rights*
- *FASB Emerging Issues Task Force No. 96-19, Debtor's Accounting for a Modification or Exchange of Debt Instruments*

STATE REGULATIONS:

- No additional guidance obtained from state statutes or regulations.

Issue Paper No. 134—Supplement of Nonsubstantive Revisions

1. As noted within paragraph 4, this issue paper adopts nonsubstantive revisions to SSAP No. 91R regarding the definition and terminology for 'interests that continue to be held by the transferor'. The following paragraphs illustrate the nonsubstantive revisions that will be made in accordance with this change in terminology or additional nonsubstantive revisions incorporated within SSAP No. 91R:

> 7. Upon completion of a transfer of financial assets that satisfies the conditions to be accounted for as a sale (see paragraph 5), the transferor (seller) shall:
>
> ### ~~Retained Interests~~Interests That Continue to be Held by a Transferor
>
> 47. Other interests in transferred assets, those that are not part of the proceeds of the transfer, are ~~retained interests~~interests that continue to be held by a transferor over which the transferor has not relinquished control. They shall be measured at the date of the transfer by allocating the previous carrying amount between the assets sold, if any, and the ~~retained interests~~interests that continue to be held by a transferor, based on their relative fair values. That procedure shall be applied to all transfers in which interests are retained, even those that do not qualify as sales. Examples of ~~retained interests~~interests that continue to be held by a transferor include securities backed by the transferred assets, undivided interests, ~~servicing assets,~~ and cash reserve accounts and residual interests in securitization trusts. If a transferor cannot determine whether an asset is a retained interest or proceeds from the sale, the asset shall be treated as proceeds from the sale and accounted for in accordance with paragraph 46.
>
> 48. If the ~~retained interests~~interests that continue to be held by a transferor are subordinated to more senior interests held by others, that subordination may concentrate into the ~~retained interests~~interests that continue to be held by a transferor most of the risks inherent in the transferred assets and shall be taken into consideration in estimating the fair value of the ~~retained interests~~interests that continue to be held by a transferor. For example, if the amount of the gain recognized, after allocation, on a securitization with a subordinated retained interest is greater than the gain would have been had the entire asset been sold, the transferor needs to be able to identify why that can occur. Otherwise, it is likely that the impact of the retained interest being subordinate to a senior interest has not been adequately considered in the determination of the fair value of the subordinated retained interest.
>
> ### Disclosures
>
> 88. A reporting entity shall disclose the following:
>
> d. If the entity has securitized financial assets during any period presented and accounts for that transfer as a sale, for each major asset type (for example, mortgage loans):
>
> i. Its accounting policies for initially measuring the ~~retained interests~~interests that continue to be held by a transferor, if any, including the methodology (whether quoted market price, prices based on sales of similar assets and liabilities, or prices based on valuation techniques) used in determining their fair value (Glossary to the Statements of Statutory Accounting Principles); and
>
> ii. The characteristics of securitizations (a description of the transferor's continuing involvement with the transferred assets, including, but not limited to, servicing, recourse, and restrictions on ~~retained interests~~interests that continue to be held by a transferor) and the gain or loss from sale of financial assets in securitizations;
>
> iii. The key assumptions used in measuring the fair value of ~~retained interests~~interests that continue to be held by a transferor at the time of

securitization (including, at a minimum, quantitative information about discount rates, expected prepayments including the expected weighted-average life of prepayable financial assets, and anticipated credit losses, if applicable); and

iv. Cash flows between the securitization SPE and the transferor (including proceeds from new securitizations, purchases of delinquent or foreclosed loans, servicing fees, and cash flows received on interests retained.)

g. If the entity has ~~retained interests~~interests that continue to be held by a transferor in securitized financial assets at the date of the latest statement of financial position presented, for each major asset type (for example, mortgage loans):

i. Its accounting policies for subsequently measuring those ~~retained interests~~interests that continue to be held by a transferor, including the methodology (whether quoted market price, prices based on sales of similar assets and liabilities, or prices based on valuation techniques) used in determining their fair value (Glossary to the Statements of Statutory Accounting Principles);

ii. The key assumptions used in subsequently measuring the fair value of those interests (including, at a minimum, quantitative information about discount rates, expected prepayments including the expected weighted-average life of prepayable financial assets, and anticipated credit losses, including expected static pool losses, if applicable);

iii. A sensitivity analysis or stress test showing the hypothetical effect on the fair value of those interests of two or more unfavorable variations from the expected levels for each key assumption that is reported under ii. above independently from any change in another key assumption, and a description of the objectives, methodology, and limitations of the sensitivity analysis or stress test; and

iv. For the securitized assets and any other financial assets that the entity manages together with the ~~retained interests~~interests that continue to be held by a transferor[1]:

(a) The total principal amount outstanding, the portion that has been derecognized, and the portion that continues to be recognized in each category reported in the statement of financial position, at the end of the period;

(b) Delinquencies at the end of the period; and

(c) Credit losses, net of recoveries, during the period.

v. Disclosure of average balances during the period is encouraged, but not required.

2. Additionally, the illustration 'Recording Transfers of Partial Interests' will have nonsubstantive revisions as the terms 'one-tenth interest retained' will be revised to reflect 'One-tenth interest that continues to be held by the transferor'. Replication of this illustration in this Issue Paper for these terminology revisions was not considered necessary.

[1] Excluding securitized assets that an entity continues to service but with which it has no other continuing involvement.

EXHIBIT A - GLOSSARY

Asset Securitization

An asset securitization is the process of converting assets which would normally serve as collateral for a loan into securities. The largest category of securitized assets is real estate mortgage loans, which serve as collateral for mortgage-backed securities.

Beneficial Interests

Rights to receive all or portions of specified cash inflows to a trust or other entity, including senior and subordinated shares of interest, principal, or other cash inflows to be passed-through or paid-through, premiums due to guarantors, commercial paper obligations and residual interests, whether in the form of debt or equity.

Beneficial Interest Holder ("BIH")

Holder of beneficial interests

Cleanup Call

An option held by the servicer, which may be the transferor, to purchase transferred financial assets, or the remaining beneficial interests not held by the transferor, its affiliates, or its agents in a qualifying SPE (or in a series of beneficial interests in transferred assets within a qualifying SPE), when the amount of outstanding assets falls to a level at which the cost of servicing those assets becomes burdensome in relation to the benefits or servicing.

Collateral

Personal or real property in which a security interest has been given.

Derecognize

Remove previously recognized assets or liabilities from the balance sheet.

Derivative Financial Instrument

A derivative instrument (as defined in *SSAP No. 86—Accounting for Derivative Instruments and Hedging, Income Generation, and Replication (Synthetic Asset) Transactions*) that is a financial instrument (refer to *SSAP No. 27—Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk, Financial Instruments with Concentrations of Credit Risk and Disclosures about Fair Value of Financial Instruments*, paragraph 2).

Embedded Call (See paragraphs 40 and 42)

A call option held by the issuer of a financial instrument that is part of and trades with the underlying instrument. For example, a bond may allow the issuer to call it by posting a public notice well before its stated maturity that asks the current holder to submit it for early redemption and provides that interest ceases to accrue on the bond after the early redemption date. Rather than being an obligation of the initial purchaser of the bond, an embedded call trades with and diminishes the value of the underlying bond.

Financial Asset

Cash, evidence of an ownership interest in an entity, or a contract that conveys to a second entity a contractual right (a) to receive cash or another financial instrument from a first entity or (b) to exchange other financial instruments on potentially favorable terms with the first entity.

Financial Liability

A contract that imposes on one entity a contractual obligation (a) to deliver cash or another financial instrument to a second entity or (b) to exchange other financial instruments on potentially unfavorable terms with the second entity.

Guaranteed Mortgage Securitization

A securitization of mortgage loans which includes a substantive guarantee by a third party.

Interests that continue to be held by a transferor

Other interests in transferred assets, those that are not part of the proceeds of the transfer, over which the transferor has not relinquished control. Includes securities backed by the transferred assets, undivided interests, and cash reserve accounts and residual interests in securitization trusts

Proceeds

Cash, derivatives, or other assets that are obtained in a transfer of financial assets, less any liabilities incurred.

Recourse

The right of a transferee of receivables to receive payment from the transferor of those receivables for (a) failure of debtors to pay when due, (b) the effects of prepayments, or (c) adjustments resulting from defects in the eligibility of the transferred receivables.

Residual

Residuals are a class of retained or purchased beneficial interests that have rights to the last cash flows from the pool of securitized assets and are not rated by a Nationally Recognized Statistical Rating Organization (NRSRO). Residuals are to be carried at fair value with the difference between fair value and the allocated cost basis recognized as an unrealized gain or loss;

Securitization

The process by which financial assets are transformed into securities.

Security Interest

A form of interest in property that provides that upon default of the obligation for which the security interest is given, the property may be sold in order to satisfy that obligation.

Seller

A transferor that relinquishes control over financial assets by transferring them to a transferee in exchange for consideration.

Servicing Asset

A contract to service financial assets under which the estimated future revenues from contractually specified servicing fees, late charges, and other ancillary revenues are expected to more than adequately compensate the servicer for performing the servicing. A servicing contract is either (a) undertaken in conjunction with selling or securitizing the financial assets being serviced or (b) purchased or assumed separately.

Servicing Liability

A contract to service financial assets under which the estimated future revenues from stated servicing fees, late charges, and other ancillary revenues are not expected to adequately compensate the servicer for performing the servicing.

Transfer

The conveyance of a noncash financial asset by and to someone other than the issuer of that financial asset. Thus, a transfer includes selling a receivable, putting it into a securitization trust, or posting it as collateral but excludes the origination of that receivable, the settlement of that receivable, or the restructuring of that receivable into a security in a troubled debt restructuring.

Transferee

An entity that receives a financial asset, a portion of a financial asset, or a group of financial assets from a transferor.

Transferor

An entity that transfers a financial asset, a portion of a financial asset, or a group of financial assets that it controls to another entity.

Undivided Interest

Partial legal or beneficial ownership of an asset as a tenant in common with others. The proportion owned may be pro rata, for example, the right to receive 50 percent of all cash flows from a security, or non-pro rata, for example, the right to receive the interest from a security while another has the right to the principal.

Unrestricted Collateral

Securities received that may be sold or repledged and which were obtained under agreements that are not subject to repurchase or redemption on short notice, for example, by substitution of other collateral or termination of the contract.

Unilateral Ability (See paragraphs 40 and 41)

A capacity for action not dependent on the actions (or failure to act) of any other party.

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Issue Paper No. 135

Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others

STATUS
Finalized October 18, 2010

Original SSAP and Current Authoritative Guidance: SSAP No. 5R

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. In November 2002, the Financial Accounting Standards Board (FASB) issued *FASB Interpretation No. 45: Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, an interpretation of FASB Statements No. 5, 57, and 107 and rescission of FASB interpretation No. 34* (FIN 45) to elaborate on the disclosures required for obligations issued under certain guarantees and to clarify that a guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. In November 2005, the FASB issued FASB Staff Position *FIN 45-3, Application of FASB Interpretation No. 45 to Minimum Revenue Guarantees Granted to a Business or its Owners* (FSP FIN 45-3). This FSP modified the scope of FIN 45 to expressly include guarantees granted to a business or owner guarantying that the revenue of the business (or a specific portion of the business) for a specified period will be at least a specified amount within the scope of FIN 45. For purposes of this Issue Paper, the Statutory Accounting Principles Working Group will consider FIN 45, as modified by FSP FIN 45-3 for statutory accounting.

2. Current statutory accounting guidance for guarantees is limited to the disclosure requirements in paragraph 16 of *SSAP No. 5—Liabilities, Contingencies and Impairments of Assets* (SSAP No. 5). In accordance with this existing guidance, guarantees shall be disclosed in the financial statements even though the possibility of loss may be remote and disclosures are required regarding the indebtedness of others. These disclosure requirements were incorporated through the adoption of *FASB Interpretation No. 34—Disclosure of Indirect Guarantees on Indebtedness of Others, An Interpretation of FASB Statement No. 5* (FIN 34) and *FSP FAS 133-1 and FIN 45-4: Disclosures about Credit Derivatives and Certain Guarantees, An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45 and Clarification of the Effective Date of FASB Statement No. 161* (FSP FAS 133-1 and FIN 45-4). With the issuance of FIN 45, FASB superseded FIN 34.

3. The purpose of this issue paper is to update statutory accounting principles for guarantees. The proposed result will be adoption, with modification, of guidance from FIN 45, and the incorporation of substantive revisions to SSAP No. 5 and nonsubstantive revisions to *SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties* (SSAP No. 25). In accordance with the adoption, with modification, of FIN 45, guarantors will be required to recognize, at the inception of the guarantee, a liability for the obligations it has undertaken in issuing the guarantee, including its obligation to stand ready to perform over the term of the guarantee in the event that the specified triggering events or conditions occur. The adoption, with modification, of FIN 45 will also require the following disclosures by guarantors: (a) the nature of the guarantee, including the approximate term of the guarantee, how the guarantee arose, and the events or circumstances that would require the guarantor to perform under the guarantee; (b) the maximum potential amount of future payments under the guarantee;

(c) the carrying amount of the liability, if any, for the guarantor's obligations under the guarantee; and (d) the nature and extent of any recourse provisions or available collateral that would enable the guarantor to recover the amounts paid under the guarantee.

SUMMARY CONCLUSION

4. This issue paper adopts, with modification, guidance within FIN 45, as modified by FSP FIN 45-3, indicating that at the inception of a guarantee, the guarantor shall recognize in its statement of financial position a liability for that guarantee, which generally equals the fair value of the guarantee at its inception. This issue paper also adopts the disclosures within the modified FIN 45 to ensure proper information is provided within the financial statements regarding guarantees, even if the likelihood of having to make payments under a guarantee is remote.

DISCUSSION

5. The FASB issued FIN 45 as a result of observing differing interpretations about the disclosures required of guarantors under *FASB Statement No. 5, Accounting for Contingencies* (FAS 5) and about the need for a guarantor to recognize an initial liability for its obligation under a guarantee. As some constituents believed that FAS 5 prohibited a guarantor from initially recognizing a liability for a guarantee issued unless it is probable that payments will be required under that guarantee, the issuance of FIN 45 clarified the requirements of FAS 5 relating to the guarantor's accounting for and disclosures of certain guarantees issued.

6. FIN 45 clarified that a guarantor is required to disclose (a) the nature of the guarantee, including the approximate term of the guarantee, how the guarantee arose, and the events or circumstances that would require the guarantor to perform under the guarantee; (b) the maximum potential amount of future payments under the guarantee; (c) the carrying amount of the liability, if any, for the guarantor's obligations under the guarantee; and (d) the nature and extent of any recourse provisions or available collateral that would enable the guarantor to recover the amounts paid under the guarantee. For product warranties, instead of disclosing the maximum potential amount of future payments under the guarantee, a guarantor is required to disclose its accounting policy and methodology used in determining its liability for product warranties as well as a tabular reconciliation of the changes in the guarantor's product warranty liability for the reporting period. In issuing FIN 45, the FASB noted that disclosures under the prior practice generally included only the nature and amount of guarantees, but did not provide the same level of useful information as required by FIN 45.

7. FIN 45 also clarified that a guarantor is required to recognize, at the inception of a guarantee, a liability for the obligations it has undertaken in issuing the guarantee, including its ongoing obligation to stand ready to perform over the term of the guarantee in the event that the specified triggering events or conditions occur. The objective of the initial measurement of that liability is the fair value of the guarantee at its inception. Before the issuance of FIN 45, the FASB believed that many entities may not be recognizing a liability for a guarantee because the recognition requirements in FAS 5 (pertaining to loss contingencies) have not been met at the inception of the guarantee and the premium for the guarantee was not separately identified because it was embedded in purchase or sales agreements, service contracts, joint venture agreements, or other commercial agreements.

8. In issuing FIN 45, and requiring recognition of a liability for the obligations undertaken upon issuing a guarantee, the FASB believed that it resulted with a more representationally faithful depiction of the guarantor's assets and liabilities. When a guarantee is issued without a separately identified premium in conjunction with another transaction, the gain or loss recognized on that other transaction would be misstated if the guarantor fails to recognize a liability for the guarantee. For example, if a seller-guarantor issues to its customer's bank a guarantee of the customer's loan to facilitate the customer's obtaining funds to pay the seller for the assets being purchased, the failure to recognize a liability for the issuance of

the guarantee overstates the profit on the sale. In those circumstances, the recognition of the liability for the guarantee results in a more representationally faithful depiction of the seller-guarantor's liabilities and results of operations. The initial recognition and initial measurement requirements within FIN 45 were expected to affect primarily the accounting for multiple-element transactions that include issuance of a guarantee by one party to the other. Additionally, the FASB concluded that the disclosures required by FIN 45 improve the transparency of the financial statement information about the guarantor's obligations and liquidity risks related to guarantees issued.

9. The FASB concluded that the disclosures and initial recognition of guarantees required by FIN 45 complies with the *FASB Concept Statement No. 1, Objectives of Financial Reporting by Business Enterprises*, as financial reporting should provide information to help users assess the amounts, timing, and uncertainty of the guarantor's prospective net cash flows. Furthermore, the FASB concluded that recognition of a liability at the inception of a guarantee is consistent with the definition of a liability in *FASB Concepts Statement No. 6, Elements of Financial Statements*.

10. In November 2005, the FASB issued FASB Staff Position *FIN 45-3, Application of FASB Interpretation No. 45 to Minimum Revenue Guarantees Granted to a Business or its Owners* (FSP FIN 45-3). This FSP modified the scope of FIN 45 to expressly include guarantees granted to a business or owner guarantying that the revenue of the business (or a specific portion of the business) for a specified period will be at least a specified amount within the scope of FIN 45. In making this decision, the FASB concluded that a minimum revenue guarantee granted to a business or its owners meets the characteristics in paragraph 3.a. of FIN 45 because the guarantee's underlying (business gross revenues) is related to an asset or equity security of the guaranteed party. The FASB also clarified that the five examples included within paragraph 3.a. do not constitute an all-inclusive listing of the contracts that would meet the scope provisions of FIN 45.

11. In considering FIN 45, as modified for FIN 45-3, for statutory accounting purposes, the adoption of the guidance in FIN 45 is consistent with the conservatism concept stated within the preamble: "In order to provide a margin of protection for policyholders, the concept of conservatism should be followed when developing estimates as well as establishing accounting principles for statutory reporting." In accordance with this concept, it is presumed that there must be a compelling reason to have statutory accounting principles that are less conservative then GAAP. In reviewing this issue, staff was unable to identify any such compelling reasons, however, until FIN 45 is adopted for statutory accounting, it will result with less-conservative financial statements for statutory accounting.

12. It is anticipated that comments will be received indicating that the initial recognition of a liability will not represent a "probable" occurrence, and thus will not meet the definition of a liability per SSAP No. 5, paragraph 3. Similar to the FASB's response to such comments, the probability of performance under the guarantee will affect the measurement of the liability at inception, but the probability of performance does not change the fact that a liability has been created upon the issuance of the guarantee and should be reflected in the financial statements. The recognition of a liability for a guarantee is a valid under SSAP No. 5 because it clarifies that the definition of a liability within SSAP No. 5 should not be understood as prohibiting the recognition of a liability for the obligations undertaken in issuing a guarantee, even if the likelihood of the event that would trigger performance under the guarantee is less than remote.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

13. Statutory accounting guidance regarding guarantees is included within *SSAP No. 5—Liabilities, Contingencies and Impairments of Assets* (SSAP No. 5). The guidance for guarantees is limited to disclosures within paragraph 16. The current disclosure requirements, which require disclosure of guarantees even if the possibility of loss is remote and disclosures on guarantees on the indebtedness of others, were adopted from *FASB Interpretation No. 34, Disclosure of Indirect Guarantees of Indebtedness of Others, An Interpretation of FASB Statement No. 5* and *FSP FAS 133-1 and FIN 45-4: Disclosures about Credit Derivatives and Certain Guarantees, An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45 and Clarification of the Effective Date of FASB Statement No. 161.*

> 16. Certain loss contingencies, the common characteristic of each being a guarantee, shall be disclosed in financial statements even though the possibility of loss may be remote. Examples include (a) guarantees of indebtedness of others, and (b) guarantees to repurchase receivables (or, in some cases, to repurchase related properties) that have been sold or otherwise assigned. The disclosure of those loss contingencies, and others that in substance have the same characteristics, shall be applied to statutory financial statements. The disclosure shall include the nature and amount of the guarantee. Consideration shall be given to disclosing, if estimable, the value of any recovery that could be expected to result, such as from the guarantor's right to proceed against an outside party.
>
> a. For guarantees on indebtedness of others, disclosure shall include the nature of the guarantee, including the approximate term of the guarantee, how the guarantee arose, the events and circumstances that would require the guarantor to perform under the guarantee, and the current status as of the reporting date of the payment/performance risk of the guarantee. For example, the current status of the payment/performance risk of a credit-risk related guarantee could be based on either recently issued external credit ratings or current internal groupings used by the guarantor to manage its risk. An entity that uses internal groupings shall disclose how those groupings are determined and used for managing risk.

14. With the adoption of this issue paper, SSAP No. 5 will reflect the adoption, with modification, of FIN 45, as modified by FSP FIN 45-3. The statutory modifications require an initial liability recognition for guarantees issued as part of intercompany or related party transactions, require assessment and recognition of non-contingent guarantee obligations after recognition and settlement of a contingent obligation and revise the GAAP guidance to reflect statutory accounting terms and restrictions. (For example, a GAAP exclusion for capital leases will not be incorporated within SSAP No. 5 as the concept of capital leases has previously been rejected for statutory accounting.) Although FIN 45 does not require initial liability recognition for the following guarantees: 1) guarantee issued either between parents and their subsidiaries or between corporations under common control; 2) parent's guarantee of its subsidiary debt to a third party, and 3) subsidiary's guarantee of the debt owed to a third party by either its parent or another subsidiary of that parent, this Issue Paper requires an initial liability recognition under statutory accounting for such guarantees. For these instances, and other intercompany and related party guarantees, this Issue Paper requires that an initial liability must be recognized for the guarantee unless the guarantee is considered "unlimited" or is a guarantee made to/or on behalf of a wholly-owned subsidiary. (An example of an intercompany "unlimited" guarantee would be a guarantee issued in response to a rating agency's requirement to provide a commitment to support.) In instances in which an "unlimited" guarantee exists or a guarantee has been made to/or on behalf of a wholly-owned subsidiary, this Issue Paper would require disclosure, pursuant to the disclosure requirements adopted from FIN 45. These disclosure requirements include the maximum potential amount of future payments of the guarantee, and if the guarantor is unable to determine the maximum potential, the reasons why this amount cannot be

determined. The adoption of this Issue Paper will also revise the current disclosure requirements, presented within SSAP No. 5, paragraph 16.a., regarding guarantees on the indebtedness of others. These disclosure requirements, adopted from FSP FAS 133-1 and FIN 45-4, will be reorganized within SSAP No. 5 and presented in a manner consistent with the modifications incorporated within FIN 45 pursuant to the adoption of this FASB Staff Position.

15. Upon adoption of this Issue Paper, the NAIC will release an updated SSAP No. 5 for comment. The SSAP will contain the adopted substantive changes to SSAP No. 5, shown in this Issue Paper. Users of the Accounting Practices and Procedures Manual should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted.

16. Guidance is currently included within paragraph 18.e. of *SSAP No. 25—Accounting for and Disclosures About Transactions with Affiliates and Other Related Parties* (SSAP No. 25) that requires related party disclosures for guarantees or undertakings that result in a material contingent exposure:

> 18. The financial statements shall include disclosures of all material related party transactions. In some cases, aggregation of similar transactions may be appropriate. Sometimes, the effect of the relationship between the parties may be so pervasive that disclosure of the relationship alone will be sufficient. If necessary to the understanding of the relationship, the name of the related party should be disclosed. Transactions shall not be purported to be arm's-length transactions unless there is demonstrable evidence to support such statement. The disclosures shall include:
>
> e. Any guarantees or undertakings, written or otherwise, for the benefit of an affiliate or related party which result in a material contingent exposure of the reporting entity's or any related party's assets or liabilities;

17. This Issue Paper also proposes nonsubstantive revisions to the SSAP No. 25, paragraph 18.e. guidance to require the FIN 45 disclosure requirements for related party guarantees, including those issued between parents and their subsidiaries or between corporations under common control and situations in which a parent guarantees its subsidiary's debt to a third party or the subsidiary has guaranteed debt owed to a third party by either its parent or another subsidiary of that parent.

18. The adoption of FIN 45 or FSP FIN 45-4 will not impact any of the existing statutory interpretations of SSAP No. 5:

a. *INT 01-31: Assets Pledged as Collateral* (INT 01-31) – This interpretation addresses the accounting issues on whether assets pledged as collateral under specific situations should be considered admitted assets. The consensus reached for INT 01-31 is that the collateral would continue to be recorded as an admitted asset until the reporting entity has committed a contract default that has not been cured in accordance with the contract provisions. To the extent that an uncured default remains without the secured party utilizing the collateral to offset the obligation, the pledging insurer should only record an admitted asset for the amount of collateral that it can redeem.

b. *INT 01-32: EITF 01-10: Accounting for the Impact of the Terrorist Attacks of September 11, 2001* (INT 01-32) – This interpretation incorporated specific disclosures for losses and costs incurred as a result of the September 11, 2001 events. On June 2, 2007, these disclosure requirements were deemed no longer useful by the Statutory Accounting Principles Working Group.

c. *INT 03-07: EITF 00-19: Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, A Company's Own Stock* (INT 03-07) – This interpretation rejected the guidance in EITF 00-19 as not applicable to statutory accounting.

d. *INT 04-05: Clarification of SSAP No. 5 Guidance on When a Judgment is Deemed Rendered* (INT 04-05) – The consensus reached under INT 04-05 incorporated guidance within SSAP No. 5 that a judgment is considered "rendered" when a court enters a verdict, notwithstanding the entity's ability to file post trial motions and to appeal.

19. The Form A summary of this issue also identified *INT 01-03: Assets Pledged as Collateral or Restricted for the Benefit of a Related Party* (INT 01-03) as a possible interpretation that may be affected with FIN 45. The consensus under INT 01-03 indicates that if an asset of an insurance entity is pledged or otherwise restricted by a related party, the assets are not under the exclusive control of the insurance entity, and should not be recognized ion the balance sheet. As this interpretation specifically addresses the treatment of the pledged asset, and not the recording or disclosure of a guarantee, it is anticipated that no revisions will be necessary to this interpretation with the adoption of this Issue Paper.

Generally Accepted Accounting Principles

20. This issue paper adopts, with modifications, guidance included within FIN 45, as modified by FSP FIN 45-3. (Guidance from FSP FAS 133-1 and FIN 45-4 has previously been adopted for statutory accounting. However, the current version of FIN 45, including the revisions from FSP FAS 133-1 and FIN 45-4 are reflected below.)

FIN 45, as Modified by FSP FIN 45-3 and FSP FIN 45-4:

INTRODUCTION

1. The Board observed differences in interpretation about the disclosures required of issuers of guarantees and about the need for an issuer of a guarantee to recognize an initial liability for its obligations under the guarantee. This Interpretation clarifies the requirements for a guarantor's accounting for and disclosures of certain guarantees issued and outstanding. This Interpretation also incorporates without reconsideration the guidance in FASB Interpretation No. 34, Disclosure of Indirect Guarantees of Indebtedness of Others, which is being superseded.

SCOPE

2. This Interpretation addresses the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under guarantees. This Interpretation also clarifies the requirements related to the recognition of a liability by a guarantor at the inception of a guarantee for the obligations the guarantor has undertaken in issuing that guarantee. As discussed in paragraph 12, this Interpretation does not specify the subsequent measurement of the guarantor's recognized liability for either the noncontingent aspect of the guarantee or the contingent aspect of the guarantee. The accounting for the contingent aspect of the guarantee, if it is not accounted for as a derivative under FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, is covered by FASB Statement No. 5, Accounting for Contingencies. The provisions in Statement 5 about disclosure of a loss that is reasonably possible are not affected by this Interpretation.

3. Except as provided in paragraphs 6 and 7, the provisions of this Interpretation apply to guarantee contracts that have any of the following characteristics:

a. Contracts that contingently require the guarantor to make payments (either in cash, financial instruments, other assets, shares of its stock, 1 or provision of services) to the guaranteed party based on changes in an underlying 2 that is related to an asset, a liability, or an equity security of the guaranteed party. Thus, for example, the provisions apply to the following:

(1) A financial standby letter of credit, which is an irrevocable undertaking (typically by a financial institution) to guarantee payment of a specified financial obligation

(2) A market value guarantee on either a financial asset (such as a security) or a nonfinancial asset owned by the guaranteed party

(3) A guarantee of the market price of the common stock of the guaranteed party

(4) A guarantee of the collection of the scheduled contractual cash flows from individual financial assets held by a special-purpose entity (SPE)

(5) A guarantee granted to a business or its owner(s) that the revenue of the business (or a specific portion of the business) for a specified period of time will be at least a specified amount.

b. Contracts that contingently require the guarantor to make payments (either in cash, financial instruments, other assets, shares of its stock, or provision of services) to the guaranteed party based on another entity's failure to perform under an obligating agreement (performance guarantees). Thus, for example, the provisions apply to a performance standby letter of credit, which is an irrevocable undertaking by a guarantor to make payments in the event a specified third party fails to perform under a nonfinancial contractual obligation.

c. Indemnification agreements (contracts) that contingently require the indemnifying party (guarantor) to make payments to the indemnified party (guaranteed party) based on changes in an underlying that is related to an asset, a liability, or an equity security of the indemnified party, such as an adverse judgment in a lawsuit or the imposition of additional taxes due to either a change in the tax law or an adverse interpretation of the tax law.

d. Indirect guarantees of the indebtedness of others, as that phrase is used in paragraphs 17 and 18 (and originally in Interpretation 34), even though the payment to the guaranteed party may not be based on changes in an underlying that is related to an asset, a liability, or an equity security of the guaranteed party.

4. Commercial letters of credit and other loan commitments, which are commonly thought of as guarantees of funding, are not included in the scope of this Interpretation because those arrangements do not meet any of the four characteristics identified in paragraph 3 above. Similarly, the scope of this Interpretation does not encompass indemnifications or guarantees of an entity's own future performance (for example, a guarantee that the guarantor will not take a certain future action). It does not include a noncontingent forward contract for which the net settlement can flow from either party to the other party; however, a contingent forward contract may meet one of the characteristics in paragraph 3 and be included in the scope of this Interpretation.

5. Some securitizations and other arrangements involve the subordination of the rights of some investors (or creditors) to the rights of others, in which case, for example, the investors in one (subordinated) class or tranche of an entity's securities might not receive any cash flows until the investors in another (priority) class or tranche are fully paid. Because that type of subordination provides credit protection by the subordinated

investors, those subordination arrangements are commonly thought of as guarantees issued by the subordinated investors. Such subordination arrangements do not meet the characteristic-based scope provisions in paragraph 3 and, thus, are not included in the scope of this Interpretation.

Scope Exceptions from the Entire Interpretation

6. Notwithstanding the characteristic-based scope provisions in paragraph 3, this Interpretation does not apply to the following guarantee contracts:

   a. A guarantee or an indemnification that is excluded from the scope of Statement 5 under paragraph 7 of that Statement.

   b. A lessee's guarantee of the residual value of the leased property at the expiration of the lease term, if the lessee (guarantor) accounts for the lease as a capital lease under FASB Statement No. 13, Accounting for Leases.

   c. A contract that meets the characteristics in paragraph 3.a. but is accounted for as contingent rent under Statement 13.

   d. A guarantee (or an indemnification) that is issued by either an insurance company or a reinsurance company and accounted for under FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises, No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments, No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts, or No. 120, Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts (including guarantees embedded in either insurance contracts or investment contracts).

   e. A contract that meets the characteristics in paragraph 3.a. but provides for payments that constitute a vendor rebate (by the guarantor) based on either the sales revenues of, or the number of units sold by, the guaranteed party. (Vendor rebates based on the volume of purchases by the buyer would not meet the characteristics in paragraph 3.a. because the underlying relates to an asset of the seller, not the buyer who receives the rebates.)

   f. A guarantee (or an indemnification) whose existence prevents the guarantor from being able to either account for a transaction as the sale of an asset that is related to the guarantee's underlying or recognize in earnings the profit from that sale transaction.

   g. A registration payment arrangement within the scope of FSP EITF 00-19-2, "Accounting for Registration Payment Arrangements."

   h. A guarantee that is accounted for as a credit derivative instrument at fair value under Statement 133, as described in paragraph 44DD of Statement 133.

Scope Exceptions from Only the Initial Recognition and Initial Measurement Provisions

7. The following types of guarantees are not subject to the initial recognition and initial measurement provisions of this Interpretation but are subject to its disclosure requirements:

   a. A guarantee, other than a credit derivative as described in paragraph 44DD of Statement 133, that is accounted for as a derivative instrument at fair value under Statement 133.

b. A guarantee for which the underlying is related to the performance (regarding function, not price) of nonfinancial assets that are owned by the guaranteed party. Thus, the initial recognition and initial measurement provisions of this Interpretation do not apply to product warranties issued by the guarantor, regardless of whether the guarantor is required to make payment in services or cash, including separately priced extended warranty or product maintenance contracts that are addressed in FASB Technical Bulletin No. 90-1, Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts.

c. A guarantee issued in a business combination that represents contingent consideration (as addressed in FASB Statement No. 141, Business Combinations).

d. A guarantee for which the guarantor's obligation would be reported as an equity item (rather than a liability) under generally accepted accounting principles (GAAP).

e. A guarantee by an original lessee that has become secondarily liable under a new lease that relieved the original lessee from being the primary obligor (that is, principal debtor) under the original lease, as discussed in paragraph 38 of Statement 13, as amended by FASB Statement No. 145, Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections. This exception shall not be applied by analogy to secondary obligations that are not accounted for under paragraph 38 of Statement 13. (The disclosure requirements of this Interpretation do apply to the original lessee that has become secondarily liable for the lease payments.)

f. A guarantee issued either between parents and their subsidiaries or between corporations under common control.

g. A parent's guarantee of its subsidiary's debt to a third party (whether the parent is a corporation or an individual).

h. A subsidiary's guarantee of the debt owed to a third party by either its parent or another subsidiary of that parent.

INTERPRETATION

Initial Recognition and Initial Measurement of the Liability for a Guarantor's Obligations

8. The issuance of a guarantee obligates the guarantor (the issuer) in two respects: (a) the guarantor undertakes an obligation to stand ready to perform over the term of the guarantee in the event that the specified triggering events or conditions occur (the noncontingent aspect) and (b) the guarantor undertakes a contingent obligation to make future payments if those triggering events or conditions occur (the contingent aspect).

9. Because the issuance of a guarantee imposes a noncontingent obligation to stand ready to perform in the event that the specified triggering events or conditions occur, the provisions of paragraphs 8-12 of Statement 5 regarding the guarantor's contingent obligation under a guarantee should not be interpreted as prohibiting the guarantor from initially recognizing a liability for that guarantee even though it is not probable that payments will be required under that guarantee. At the inception of a guarantee, the guarantor shall recognize in its statement of financial position a liability for that guarantee. Except as indicated in paragraph 10, the objective of the initial measurement of the liability is the fair value of the guarantee at its inception.

a. When a guarantee is issued in a standalone arm's-length transaction with an unrelated party, the liability recognized at the inception of the guarantee should be the premium received or receivable by the guarantor as a practical expedient.

b. When a guarantee is issued as part of a transaction with multiple elements with an unrelated party (such as in conjunction with selling an asset or entering into an operating lease), the liability recognized at the inception of the guarantee should be an estimate of the guarantee's fair value. In that circumstance, guarantors should consider what premium would be required by the guarantor to issue the same guarantee in a standalone arm's-length transaction with an unrelated party as a practical expedient.

c. When a guarantee is issued as a contribution to an unrelated party, the liability recognized at the inception of the guarantee should be measured at its fair value, consistent with the requirement to measure the contribution made at fair value, as prescribed in paragraph 18 of FASB Statement No. 116, Accounting for Contributions Received and Contributions Made. For example, a community foundation may have a loan guarantee program to assist not-for-profit organizations in obtaining bank financing at a reasonable cost. Under that program, the community foundation may issue a guarantee of a not-for-profit organization's bank debt. Upon the issuance of the guarantee, the community foundation would recognize a liability for the fair value of that guarantee. The issuance of that guarantee would not be considered merely a conditional promise to give under paragraph 22 of Statement 116 because, upon the issuance of the guarantee, the not-for-profit organization will have received the gift of the community foundation's credit support, which enables the not-for-profit organization to obtain a lower interest rate on its borrowing.

10. In the event that, at the inception of the guarantee, the guarantor is required to recognize a liability under Statement 5 for the related contingent loss, the liability to be initially recognized for that guarantee shall be the greater of (a) the amount that satisfies the fair value objective as discussed in paragraph 9 or (b) the contingent liability amount required to be recognized at inception of the guarantee by paragraph 8 of Statement 5. For many guarantors, it would be unusual for the contingent liability amount under (b) above to exceed the amount that satisfies the fair value objective under (a) above at the inception of the guarantee.

11. This Interpretation does not prescribe a specific account for the guarantor's offsetting entry when it recognizes the liability at the inception of a guarantee. That offsetting entry depends on the circumstances in which the guarantee was issued, as illustrated by the following examples:

a. If the guarantee were issued in a standalone transaction for a premium, the offsetting entry would be consideration received (such as cash or a receivable).

b. If the guarantee were issued in conjunction with the sale of assets, a product, or a business, the overall proceeds (such as the cash received or receivable) would be allocated between the consideration being remitted to the guarantor for issuing the guarantee and the proceeds from the sale. That allocation would affect the calculation of the gain or loss on the sale transaction.

c. If the guarantee were issued in conjunction with the formation of a partially owned business or a venture accounted for under the equity method, the recognition of the liability for the guarantee would result in an increase to the carrying amount of the investment.

d. If a residual value guarantee were provided by a lessee-guarantor when entering into an operating lease, the offsetting entry (representing a payment in kind made by the lessee when entering into the operating lease) would be reflected as prepaid rent, which would be accounted for under paragraph 15 of Statement 13.

e. If a guarantee were issued to an unrelated party for no consideration on a standalone basis (that is, not in conjunction with any other transaction or ownership relationship), the offsetting entry would be to expense.

12. This Interpretation does not describe in detail how the guarantor's liability for its obligations under the guarantee would be measured subsequent to its initial recognition. The liability that the guarantor initially recognized under paragraph 9 consistent with the fair value objective discussed in that paragraph would typically be reduced (by a credit to earnings) as the guarantor is released from risk under the guarantee. Depending on the nature of the guarantee, the guarantor's release from risk has typically been recognized over the term of the guarantee (a) only upon either expiration or settlement of the guarantee, (b) by a systematic and rational amortization method, or (c) as the fair value of the guarantee changes (as is done, for example, for guarantees accounted for as derivatives). The discussion in this paragraph about how the guarantor typically reduces the liability that it initially recognized does not encompass the recognition and subsequent adjustment of the contingent liability recognized under Statement 5 related to the contingent loss for the guarantee.

Disclosures about a Guarantor's Obligations under Guarantees

13. A guarantor shall disclose the following information about each guarantee, or each group of similar guarantees, even if the likelihood of the guarantor's having to make any payments under the guarantee is remote, except as provided in paragraph 14 with respect to the disclosure specified in paragraph 13.b.:

a. The nature of the guarantee, including the approximate term of the guarantee, how the guarantee arose, the events or circumstances that would require the guarantor to perform under the guarantee and the current status (that is, as of the date of the statement of financial position) of the payment/performance risk of the guarantee. For example, the current status of the payment/performance risk of a credit-risk-related guarantee could be based on either recently issued external credit ratings or current internal groupings used by the guarantor to manage its risk. An entity that uses internal groupings shall disclose how those groupings are determined and used for managing risk.

b. The maximum potential amount of future payments (undiscounted) the guarantor could be required to make under the guarantee. That maximum potential amount of future payments shall not be reduced by the effect of any amounts that may possibly be recovered under recourse or collateralization provisions in the guarantee (which are addressed under (d) below). If the terms of the guarantee provide for no limitation to the maximum potential future payments under the guarantee, that fact shall be disclosed. If the guarantor is unable to develop an estimate of the maximum potential amount of future payments under its guarantee, the guarantor shall disclose the reasons why it cannot estimate the maximum potential amount. (Refer to the following paragraph for an exception to the requirements of this subparagraph.)

c. The current carrying amount of the liability, if any, for the guarantor's obligations under the guarantee (including the amount, if any, recognized under paragraph 8 of Statement 5), regardless of whether the guarantee is freestanding or embedded in another contract.

d. The nature of (1) any recourse provisions that would enable the guarantor to recover from third parties any of the amounts paid under the guarantee and (2) any assets held either as collateral or by third parties that, upon the occurrence of any triggering event or condition under the guarantee, the guarantor can obtain and liquidate to recover all or a portion of the amounts paid under the guarantee. The guarantor shall indicate, if estimable, the approximate extent to which the proceeds from liquidation of those assets would be expected to cover the maximum potential amount of future payments under the guarantee.

14. For product warranties and other guarantee contracts that are excluded from the initial recognition and initial measurement requirements of this Interpretation pursuant to paragraph 7.b. (collectively referred to as product warranties), a guarantor is not required to disclose the maximum potential amount of future payments specified in paragraph 13.b. above. Instead, the guarantor is required to disclose for those product warranties the following information:

    a. The guarantor’s accounting policy and methodology used in determining its liability for product warranties (including any liability [such as deferred revenue] associated with extended warranties).

    b. A tabular reconciliation of the changes in the guarantor’s aggregate product warranty liability for the reporting period. That reconciliation should present the beginning balance of the aggregate product warranty liability, the aggregate reductions in that liability for payments made (in cash or in kind) under the warranty, the aggregate changes in the liability for accruals related to product warranties issued during the reporting period, the aggregate changes in the liability for accruals related to preexisting warranties (including adjustments related to changes in estimates), and the ending balance of the aggregate product warranty liability.

15. The disclosures required by this Interpretation do not eliminate or affect the requirement in FASB Statement No. 107, Disclosures about Fair Value of Financial Instruments, as amended by FASB Statement No. 126, Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities, that certain entities disclose the fair value of their financial guarantees issued.

16. Some guarantees are issued to benefit entities that meet the definition of a related party in paragraph 24.f. of FASB Statement No. 57, Related Party Disclosures, such as joint ventures, equity method investees, and certain entities for which the controlling financial interest cannot be assessed by analyzing voting interests. In those cases, the disclosures required by this Interpretation are incremental to the disclosures required by Statement 57.

Indirect Guarantees of Indebtedness of Others Encompassed by Paragraph 12 of Statement 5

17. An indirect guarantee of the indebtedness of another arises under an agreement that obligates one entity to transfer funds to a second entity upon the occurrence of specified events, under conditions whereby (a) the funds become legally available to creditors of the second entity and (b) those creditors may enforce the second entity’s claims against the first entity under the agreement. Examples of indirect guarantees include agreements to advance funds if a second entity’s net income, coverage of fixed charges, or working capital falls below a specified minimum.

18. The term guarantees of indebtedness of others in paragraph 12 of Statement 5 includes indirect guarantees of indebtedness of others as described in paragraph 17 of this Interpretation.

RESCISSION OF INTERPRETATION 34

19. Interpretation 34 is superseded by this Interpretation.

EFFECTIVE DATE AND TRANSITION

20. The initial recognition and initial measurement provisions in paragraphs 9 and 10 shall be applied only on a prospective basis to guarantees issued or modified after December 31, 2002, irrespective of the guarantor's fiscal year-end. The guarantor's previous accounting for guarantees issued prior to the date of this Interpretation's initial application shall not be revised or restated to reflect the effect of the recognition and measurement provisions of the Interpretation.

21. The disclosure requirements in paragraphs 13-16 are effective for financial statements of interim or annual periods ending after December 15, 2002. The guidance on indirect guarantees of the indebtedness of others in paragraph 18 continues to apply to financial statements for fiscal years ending after June 15, 1981.

21. FIN 45 supersedes FASB Interpretation No. 34, Disclosure of Indirect Guarantees of Indebtedness of Others, An Interpretation of FASB Statement No. 5 (FIN 34). FIN 34 had previously been adopted within SSAP No. 5 and resulted with disclosure requirements for guarantees, even if the possibility of payment under the guarantee was remote. The guidance in FIN 45 has incorporated more conservative accounting and disclosure requirements for guarantees than FIN 34.

22. The NAIC Statutory Accounting Principles Working Group previously considered *FSP FAS 133-1 and FIN 45-4: Disclosures about Credit Derivatives and Certain Guarantees: An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45; and Clarification of the Effective Date of FASB Statement No. 161* (FSP FAS 133-1 and FIN 45-4), and adopted revisions to SSAP No. 5 to incorporate the revised disclosures within paragraph 13.a. of FIN 45 as modified by FSP FAS 133-1 and FIN 45-4. (The revisions to FIN 45 from FSP FAS 133-1 and FIN 45-4 are reflected within the FIN 45 guidance included in paragraph 20 of this Issue paper.)

RELEVANT LITERATURE:

Statutory Accounting

- *SSAP No. 5—Liabilities, Contingencies and Impairments of Assets*

Generally Accepted Accounting Principles

- *FASB Statement No. 5, Accounting for Contingencies*
- *FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan*
- *FASB Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements*
- *FASB Interpretation No. 14, Reasonable Estimation of the Amount of a Loss, An Interpretation of FASB Statement No. 5*
- *FASB Interpretation No. 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, an interpretation of FASB Statements No. 5, 57, 107 and rescission of FASB Interpretation No. 35*
- *FASB Interpretation No. 45-3, Application of FASB Interpretation No. 45 to Minimum Revenue Guarantees Grated to a Business or Owner*
- *FSP FAS 133-1 and FIN 45-4: Disclosures about Credit Derivatives and Certain Guarantees, an Amendment of FASB Statement No. 133 and FASB Interpretation No. 45. and Clarification of the Effective Date of FASB Statement No. 161.*
- *Accounting Principles Board Opinions No. 12, Omnibus Opinion—1967, paragraphs 2 and 3*

State Regulations

No additional guidance obtained from state statutes or regulations.

Appendix A: Substantive Revisions to SSAP No. 5 Adopting, with Modification, FIN 45

SCOPE OF STATEMENT

1. This statement defines and establishes statutory accounting principles for liabilities, contingencies and impairments of assets.

SUMMARY CONCLUSION

Liabilities

2. A liability is defined as certain or probable[1] future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or to provide services to other entities in the future as a result of a past transaction(s) or event(s).

3. A liability has three essential characteristics: (a) it embodies a present duty or responsibility to one or more other entities that entails settlement by probable1 future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand, (b) the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice, and (c) the transaction or other event obligating the entity has already happened. This includes, but is not limited to, liabilities arising from policyholder obligations (e.g., policyholder benefits, reported claims and reserves for incurred but not reported claims). Liabilities shall be recorded on a reporting entity's financial statements when incurred.

4. Estimates (e.g., loss reserves) are required in financial statements for many ongoing and recurring activities of a reporting entity. The mere fact that an estimate is involved does not of itself constitute a loss contingency. For example, estimates of losses utilizing appropriate actuarial methodologies meet the definition of liabilities as outlined above and are not loss contingencies.

Loss Contingencies or Impairments of Assets

5. For purposes of implementing the statutory accounting principles of loss contingency or impairment of an asset described below, the following additional definitions shall apply:

   a. Probable—The future event or events are likely to occur;

   b. Reasonably Possible—The chance of the future event or events occurring is more than remote but less than probable;

   c. Remote—The chance of the future event or events occurring is slight.

6. A loss contingency or impairment of an asset is defined as an existing condition, situation, or set of circumstances involving uncertainty as to possible loss to an enterprise that will ultimately be resolved when one or more future event(s) occur or fail to occur (e.g., collection of receivables).

[1] FASB Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements, states:

> Probable is used with its usual general meaning, rather than in a specific accounting or technical sense (such as that in *FASB Statement 5, Accounting for Contingencies*, paragraph 3), and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved.

7. An estimated loss from a loss contingency or the impairment of an asset shall be recorded by a charge to operations if both of the following conditions are met:

   a. Information available prior to issuance of the statutory financial statements indicates that it is probable that an asset has been impaired or a liability has been incurred at the date of the statutory financial statements. It is implicit in this condition that it is probable that one or more future events will occur confirming the fact of the loss or incurrence of a liability; and

   b. The amount of loss can be reasonably estimated.

8. This accounting shall be followed even though the application of other prescribed statutory accounting principles or valuation criteria may not require, or does not address, the recording of a particular liability or impairment of an asset (e.g., a known impairment of a bond even though the VOS manual has not recognized the impairment).

9. Additionally, in instances where a judgment, assessment or fine has been rendered against a reporting entity, there is a presumption that the criteria in paragraph 7.a. and 7.b. have been met. The amount of the liability shall include the anticipated settlement amount, legal costs, insurance recoveries and other related amounts and shall take into account factors such as the nature of the litigation, progress of the case, opinions of legal counsel, and management's intended response to the litigation, claim, or assessment.

10. When condition 7 a. above is met with respect to a particular loss contingency, and the reasonable estimate of the loss is a range, which meets condition 7 b. above, an amount shall be accrued for the loss. When an amount within management's estimate of the range of a loss appears to be a better estimate than any other amount within the range, that amount shall be accrued. When, in management's opinion, no amount within management's estimate of the range is a better estimate than any other amount, however, the midpoint (mean) of management's estimate in the range shall be accrued. For purposes of this paragraph, it is assumed that management can quantify the high end of the range. If management determines that the high end of the range cannot be quantified, then a range does not exist, and management's best estimate shall be used.

11. The use of the midpoint in a range will be applicable only in the rare instance where there is a continuous range of possible values, and no amount within that range is any more probable than any other. This guidance is not applicable when there are several point estimates which have been determined as equally possible values, but those point estimates do not constitute a range. If there are several point estimates with equal probabilities, management should determine their best estimate of the liability.

Gain Contingencies

12. A gain is defined as an increase in surplus which results from peripheral or incidental transactions of a reporting entity and from all other transactions and other events and circumstances affecting the reporting entity except those that result from revenues or investments by owners. If, on or before the balance sheet date, (a) the transaction or event has been fully completed, and (b) the amount of the gain is determinable, then the transaction or event is considered a gain, and is recognized in the financial statements. The definition of a gain excludes increases in surplus that result from activities that constitute a reporting entity's ongoing major or central operations or activities. Because investment activities are central to an insurer's operations, increases in surplus that result from such investment activities are excluded from the definition of gains. Revenues are inflows or other enhancements of assets of a reporting entity or settlements of its liabilities (or a combination of both) from providing products, rendering services, or other activities that constitute the reporting entity's ongoing major or central operations. Investments by owners include any type of capital infused into the surplus of the reporting entity.

13. A gain contingency is defined as an existing condition, situation, or set of circumstances involving uncertainty as to possible gain (as defined in the preceding paragraph) to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur (e.g., a plaintiff has filed suit for damages associated with an event occurring prior to the balance sheet, but the outcome of the suit is not known as of the balance sheet date). Gain contingencies shall not be recognized in a reporting entity's financial statements. However, if subsequent to the balance sheet date but prior to the issuance of the financial statements, the gain contingency is realized, the gain shall be disclosed in the notes to financial statements and the unissued financial statements should not be adjusted to record the gain. A gain is generally considered realizable when noncash resources or rights are readily convertible to known amounts of cash or claims to cash.

Guarantees

14. A guarantee contract is a contract that contingently requires the guarantor to make payments (either in cash, financial instruments, other assets, shares of its stock, or provision of services) to the guaranteed party based on changes in the underlying that is related to an asset, a liability, or an equity security of the guaranteed party. Commercial letters of credit and loan commitments, by definition, are not considered guarantee contracts. Also excluded from the definition are indemnifications or guarantees of an entity's own performance, subordination arrangements or a noncontingent forward contract. This definition could include contingent forward contracts if the characteristics of this paragraph are met.

15. The following guarantee contracts are not subject to the guidance in paragraphs 18-23 and paragraphs 26-29:

a. Guarantees already excluded from the scope of SSAP No. 5R;

b. Guarantee contracts accounted for as contingent rent;

c. Insurance contract guarantees, including guarantees embedded in deposit-type contracts;

d. Contracts that provide for payments that constitute a vender rebate by the guarantor based on either the sales revenue or the number of units sold by the guaranteed party;

e. A guarantee or indemnification whose existence prevents the guarantor from being able to either account for a transaction as the sale of an asset that is related to the guarantee's underlying or recognize in earnings the profit from that sale transaction;

f. Registration payment arrangements; and

g. A guarantee that is accounted for as a credit derivative instrument at fair value under SSAP No. 86, as described in paragraph 53.e. of SSAP No. 86.

16. The following types of guarantees are exempted from the initial liability recognition in paragraphs 18-23, but are subject to the to the disclosure requirements in paragraphs 26-29:

a. Guarantee that is accounted for as a derivative instrument, other than credit derivatives within SSAP No. 86;

b. Guarantee for which the underlying is related to the performance of nonfinancial assets that are owned by the guaranteed party, including product warranties;

c. Guarantee issued in a business combination that represents contingent consideration;

d. Guarantee in which the guarantor's obligation would be reported as an equity item;

e. Guarantee by an original lessee that has become secondarily liable under a new lease that relieved the original lessee from being the primary obligator; and

f. Guarantees (as defined in paragraph 14) made to/or on behalf of a wholly-owned subsidiary.

g. Intercompany and related party guarantees that are considered "unlimited" (e.g., typically in response to a rating agency's requirement to provide a commitment to support).

17. With the exception of the provision for guarantees made to/or on behalf of a wholly-owned subsidiaries in paragraph 16.f. and "unlimited" guarantees in 16.g, this guidance does not exclude guarantees issued as intercompany transactions or between related parties from the initial liability recognition requirement. Thus, unless the guarantee is provided on behalf of a wholly-owned subsidiary or considered "unlimited," guarantees issued between the following parties are subject to the initial recognition and disclosure requirements:

a. Guarantee issued either between parents and their subsidiaries or between corporations under common control;

b. A parent's guarantee of its subsidiary's debt to a third party; and

c. A subsidiary's guarantee of the debt owed to a third party by either its parent or another subsidiary of that parent.

18. At the inception of a guarantee, the guarantor shall recognize in its statement of financial position a liability for that guarantee. Except as indicated in paragraph 20, the objective of the initial measurement of the liability is the fair value[2] of the guarantee at its inception.

19. The issuance of a guarantee obligates the guarantor (the issuer) in two respects: (a) the guarantor undertakes an obligation to stand ready to perform over the term of the guarantee in the event that the specified triggering events or conditions occur (the noncontingent aspect) and (b) the guarantor undertakes a contingent obligation to make future payments if those triggering events or conditions occur (the contingent aspect). Because the issuance of a guarantee imposes a noncontingent obligation to stand ready to perform in the event that the specified triggering event occurs, the provisions of paragraph 7 should not be interpreted as prohibiting the guarantor from initially recognizing a liability for that guarantee even though it is not probable that payments will be required under that guarantee.

20. In the event that, at the inception of the guarantee, the guarantor is required to recognize a liability under paragraph 7 for the related contingent loss, the liability to be initially recognized for that guarantee shall be the greater of (a) the amount the satisfies the fair value objective as discussed in paragraph 18 or (b) the contingent liability amount

[2] As practical expedients, when a guarantee is issued in a standalone arm's-length transaction, the liability recognized at the inception of the guarantee should be the premium received or receivable by the guarantor. When a guarantee is issued as part of a transaction with multiple elements, the liability recognized at the inception of the guarantee should be an estimate of the guarantee's fair value. In that circumstance, guarantors should consider what premium would be required by the guarantor to issue the same guarantee in a standalone arm's-length transaction.

required to be recognized at inception of the guarantee by paragraph 7. For many guarantors, it would be unusual for the contingent liability under (b) above to exceed the amount that satisfies the fair value objective at the inception of the guarantee.

21. The offsetting entry pursuant to the liability recognition at the inception of the guarantee depends on the circumstances in which the guarantee was issued. Examples include:

a. If the guarantee was issued in a standalone transaction for a premium, the offsetting entry would the consideration received.

b. If the guarantee was issued in conjunction with the sale of assets, a product, or a business, the overall proceeds would be allocated between the consideration being remitted to the guarantor for issuing the guarantee and the proceeds from that sale. That allocation would affect the calculation of the gain or loss on the sale transaction.

c. If a residual value guarantee were provided by a lessee-guarantor when entering into an operating lease, the offsetting entry would be reflected as prepaid rent, which would nonadmitted under SSAP No. 29.

d. If a guarantee were issued to an unrelated or related party for no consideration on a standalone basis, the offsetting entry would be to expense.

22. Except for the measurement and recognition of continued guarantee obligations after the settlement of a contingent guarantee liability described in paragraph 23, this standard does not describe in detail how the guarantor's liability for its obligations under the guarantee would be measured subsequent to initial recognition. The liability that the guarantor initially recognized in accordance with paragraph 18 would typically be reduced (as a credit to income) as the guarantor is released from risk under the guarantee. Depending on the nature of the guarantee, the guarantor's release from risk has typically been recognized over the term of the guarantee (a) only upon either expiration or settlement of the guarantee, (b) by a systematic and rational amortization method, or (c) as the fair value of the guarantee changes (for example, guarantees accounted for as derivatives). The reduction of liability does not encompass the recognition and subsequent adjustment of the contingent liability recognized under paragraph 7 related to the contingent loss for the guarantee. If the guarantor is required to subsequently recognize a contingent liability for the guarantee, the guarantor shall eliminate any remaining noncontingent liability for that guarantee and recognize a contingent liability in accordance with paragraph 7.

23. After recognition and settlement of a contingent guarantee liability in accordance with paragraph 7, a guarantor shall assess whether remaining potential obligations exist under the guarantee agreement. If the guarantor still has potential obligations under the guarantee contract, the guarantor shall recognize the remaining noncontingent guarantee that represents the current fair value of the potential obligation remaining under the guarantee agreement. This noncontingent guarantee liability shall be released in accordance with paragraph 22.

Disclosures

~~14~~24. If a loss contingency or impairment of an asset is not recorded because only one of the conditions 7 a. or 7 b. is met, or if exposure to a loss exists in excess of the amount accrued pursuant to the provisions described above, disclosure of the loss contingency or impairment of the asset shall be made in the financial statements when there is at least a reasonable possibility that a loss or an additional loss may have been incurred. The disclosure shall indicate the nature of the contingency and shall give an estimate of the possible loss or range of loss or state that such an estimate cannot be made.

~~15~~25. Disclosure is not required of a loss contingency involving an unasserted claim or assessment when there has been no manifestation by a potential claimant of an awareness of a possible claim or assessment unless it is considered probable that a claim will be asserted and there is a reasonable possibility that the outcome will be unfavorable.

~~16.~~26. Certain loss contingencies, the common characteristic of each being a guarantee, shall be disclosed in financial statements even though the possibility of loss may be remote. Examples include (a) guarantees of indebtedness of others, and (b) guarantees to repurchase receivables (or, in some cases, to repurchase related properties) that have been sold or otherwise assigned. The disclosure of those loss contingencies, and others that in substance have the same characteristics, shall be applied to statutory financial statements. The disclosure shall include the nature and amount of the guarantee. Consideration shall be given to disclosing, if estimable, the value of any recovery that could be expected to result, such as from the guarantor's right to proceed against an outside party.

~~a. For guarantees on indebtedness of others, disclosure shall include the nature of the guarantee, including the approximate term of the guarantee, how the guarantee arose, the events and circumstances that would require the guarantor to perform under the guarantee, and the current status as of the reporting date of the payment/performance risk of the guarantee. For example, the current status of the payment/performance risk of a credit-risk related guarantee could be based on either recently issued external credit ratings or current internal groupings used by the guarantor to manage its risk. An entity that uses internal groupings shall disclose how those groupings are determined and used for managing risk.~~

27. A guarantor shall disclose the following information about each guarantee, or each group or similar guarantees (except product warranties addressed in paragraph 29), even if the likelihood of the guarantor's having to make any payments under the guarantee is remote. In addition, the nature of the relationship to the beneficiary of the guarantee or undertaking (affiliated or unaffiliated) shall also be disclosed:

a. The nature of the guarantee, including the approximate term of the guarantee, how the guarantee arose, and the events and circumstances that would require the guarantor to perform under the guarantee, the ultimate impact to the financial statements (specific financial statement line item) after the settlement of the contract guarantee if action under the guarantee was required (e.g., increase to the investment, dividends to stockholder, etc) and the current status (that is, as of the date of the statement of financial position) of the payment/performance risk of the guarantee. For example, the current status of the payment/performance risk of a credit-risk-related guarantee could be based on either recently issued external credit ratings or current internal groupings used by the guarantor to manage its risk. An entity that uses internal groupings shall disclose how those groupings are determined and used for managing risk.

b. The potential amount of future payments (undiscounted) the guarantor could be required to make under the guarantee. That maximum potential amount of future payments shall not be reduced by the effect of any amounts that may possibly be recovered under recourse or collateralization provisions in the guarantee (which are addressed under (d) below). If the terms of the guarantee provide for no limitation to the maximum potential future payments under the guarantee, that fact shall be disclosed. If the guarantor is unable to develop an estimate of the maximum potential amount of future payments under its guarantee, the guarantor shall disclose the reasons why it cannot estimate the maximum potential amount.

c. The current carrying amount of the liability, if any, for the guarantor's obligations under the guarantee (including the amount, if any, recognized under paragraph 7), regardless of whether the guarantee is freestanding or embedded in another contract.

d. The nature of (1) any recourse provisions that would enable the guarantor to recover from third parties any of the amounts paid under the guarantee and (2) any assets held either as collateral or by third parties that, upon the occurrence of any triggering event or condition under the guarantee, the guarantor can obtain and liquidate to recover all or a portion of the amounts paid under the guarantee. The guarantor shall indicate, if estimable, the approximate extent to which the proceeds from liquidation of those assets would be expected to cover the maximum potential amount of future payments under the guarantee.

28. An aggregate compilation of guarantee obligations shall include the maximum potential of future payments of all guarantees (undiscounted), the current liability (contingent and noncontingent) reported in the financial statements, and the ultimate financial statement impact based on maximum potential payments (undiscounted) if performance under those guarantees had been triggered.

29. As product warranties are excluded from the initial recognition and initial measurement requirements for guarantees, a guarantor is not required to disclose the maximum potential amount of future payments. Instead the guarantor is required to disclose for product warranties the following information:

a. The guarantor's accounting policy and methodology used in determining its liability for product warranties (Including any liability associated with extended warranties).

b. A tabular reconciliation of the changes in the guarantor's aggregate product warranty liability for the reporting period. That reconciliation should present the beginning balance of the aggregate product warranty liability, the aggregate reductions in that liability for payments made (in cash or in kind) under the warranty, the aggregate changes in the liability for accruals related to product warranties issued during the reporting period, the aggregate changes in the liability for accruals related to preexisting warranties (including adjustments related to changes in estimates), and the ending balance of the aggregate product warranty liability.

~~17.~~30. The financial statements shall contain adequate disclosure about the nature of any gain contingency. However, care should be exercised to avoid misleading implications as to the likelihood of realization.

~~18~~31. Refer to the preamble for further discussion regarding disclosure requirements.

Relevant Literature

~~19~~32. This statement adopts *FASB Statement No. 5, Accounting for Contingencies* (FAS 5), *FASB Statement 114, Accounting by Creditors for Impairment of a Loan* only as it amends in part FAS 5 and paragraphs 35 and 36 of *FASB Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements*. *FASB Interpretation No. 14, Reasonable Estimation of the Amount of a Loss, An Interpretation of FASB Statement No. 5 (*FIN No. 14) is adopted with the modification to accrue the loss amount as the midpoint of the range rather than the minimum as discussed in paragraph 3 of FIN No. 14.

33. This statement ~~also~~ adopts, with modification, *FASB Interpretation No. 45: Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, an interpretation of FASB Statements No. 5, 57, and 107 and rescission*

of FASB Interpretation No. 34 (FIN 45), *FASB Interpretation No. 45-3, Application of FASB Interpretation No. 45 to Minimum Revenue Guarantees Grated to a Business or Owner* (FSP FIN 45-3), *and FASB Staff Position FAS 133-1 and FIN 45-4, Disclosures about Credit Derivatives and Certain Guarantees, An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45* (FSP FAS 133-1 and FIN 45-4). Statutory Modifications to FIN 45 include initial liability recognition for guarantees issued as part of intercompany or related party transactions, assessment and recognition of non-contingent guarantee obligations after recognition and settlement of a contingent obligation and revise the GAAP guidance to reflect statutory accounting terms and restrictions. Under this SSAP, intercompany and related party guarantees (including guarantees between parents and subsidiaries) should have an initial liability recognition unless the guarantee is considered "unlimited" or is made to/or on behalf of a wholly-owned subsidiary. (An example of an intercompany "unlimited" guarantee would be a guarantee issued in response to a rating agency's requirement to provide a commitment to support.) In instances in which an "unlimited" guarantee exists or a guarantee has been made to/or on behalf of a wholly-owned subsidiary, this statement requires disclosure, pursuant to the disclosure requirements adopted from FIN 45. The adoption of FIN 45 superseded the previously adopted guidance *in FASB Interpretation No. 34, Disclosure of Indirect Guarantees of Indebtedness of Others, An interpretation of FASB Statement No. 5.* ~~FASB Interpretation No. 34, Disclosure of Indirect Guarantees of Indebtedness of Others, An interpretation of FASB Statement No. 5 and~~ This statement also adopts Accounting Principles Board Opinion No. 12, Omnibus Opinion—1967, paragraphs 2 and 3 with the modification that AVR, IMR and Schedule F Penalty shall be shown gross. Appropriation of retained earnings discussed in paragraph 15 of FAS 5 is addressed in *SSAP No. 72—Surplus and Quasi-Reorganizations*. ~~This statement adopts FSP FAS 133-1 and FIN 45-5~~~~*: Disclosures about Credit Derivatives and Certain Guarantees, An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45 and Clarification of the Effective Date of FASB Statement No. 161 (*~~~~FSP FAS 133-1 and FIN 45-4) and requires disclosures by sellers of credit guarantees.~~

Effective Date and Transition

~~20.~~34. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with SSAP No. 3—Accounting Changes and Corrections of Errors.

35. The guidance for guarantees included within paragraphs 14-23 and 27-29 shall be applicable to all guarantees issued or outstanding as of December 31, 2011. Thereafter, disclosure of all guarantees shall be annually reported, with interim reporting required for new guarantees issued, and/or existing guarantees when significant changes are made.

Authoritative Literature

Generally Accepted Accounting Principles

- *FASB Statement No. 5, Accounting for Contingencies*
- *FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan*
- *FASB Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements*
- *FASB Interpretation No. 14, Reasonable Estimation of the Amount of a Loss, An Interpretation of FASB Statement No. 5*
- ~~*FASB Interpretation No. 34, Disclosure of Indirect Guarantees of Indebtedness of Others, an Interpretation of FASB Statement No. 5*~~

- *FASB Interpretation No. 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, an interpretation of FASB Statements No. 5, 57, 107 and rescission of FASB Interpretation No. 35*

- *FASB Interpretation No. 45-3, Application of FASB Interpretation No. 45 to Minimum Revenue Guarantees Grated to a Business or Owner*

- *FSP FAS 133-1 and FIN 45-4: Disclosures about Credit Derivatives and Certain Guarantees, An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45 and Clarification of the Effective Date of FASB Statement No. 161.*

- *Accounting Principles Board Opinions No. 12, Omnibus Opinion—1967, paragraphs 2 and 3*

SSAP No. 5R – Appendix A – Disclosure Illustrations

Example illustration for paragraph 27.a, including the potential maximum guarantee from paragraph 27.b:

Nature and circumstances of guarantee and key attributes, including date and duration of agreement	Liability recognition of guarantee. (Include amount recognized at inception. If no initial recognition, document exception allowed under SSAP No. 5R)	Ultimate financial statement impact if action under the guarantee is required	Maximum potential amount of future payments (undiscounted) the guarantor could be required to make under the guarantee. If unable to develop an estimate, this should be specifically noted	Current status of payment or performance risk of guarantee. Also provide additional discussion as warranted

Example Illustration – Paragraph 28:

1. Aggregate Maximum Potential of Future Payments of All Guarantees (undiscounted) the guarantor could be required to make under guarantees. (This amount should agree to the total amount reported for all guarantees within paragraph 27.b (illustrated above), thus it excludes guarantees for which estimates of potential future payment cannot be made.)	$
2. Current Liability Recognized in F/S:	
a. Noncontingent Liabilities	$
b. Contingent Liabilities	$
3. Ultimate Financial Statement Impact if action under the guarantee is required. (This should equal the total reported in line 1 reflected in the applicable financial statement line items.)	
a. Investments in SCA	$
b. Joint Venture	$
c. Dividends to Stockholders (capital contribution)	$
d. Expense	$
e. Other	$

Appendix B: Nonsubstantive Revisions to paragraph 18.e of SSAP No. 25

18. The financial statements shall include disclosures of all material related party transactions. In some cases, aggregation of similar transactions may be appropriate. Sometimes, the effect of the relationship between the parties may be so pervasive that disclosure of the relationship alone will be sufficient. If necessary to the understanding of the relationship, the name of the related party should be disclosed. Transactions shall not be purported to be arm's-length transactions unless there is demonstrable evidence to support such statement. The disclosures shall include:

e. Any guarantees or undertakings, written or otherwise, shall be disclosed in accordance with the requirements of SSAP No. 5R.~~for the benefit of an affiliate or related party which result in a material contingent exposure of the reporting entity's or any related party's assets or liabilities~~;

Statutory Issue Paper No. 137

Transfer of Property and Casualty Reinsurance Agreements in Run-Off

STATUS
Finalized September 21, 2009

Original SSAP and Current Authoritative Guidance: SSAP No. 62R

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory guidance relating to property and casualty reinsurance agreements is found in *SSAP No. 62—Property and Casualty Reinsurance* (SSAP No. 62). SSAP No. 62 currently requires that property and casualty reinsurance agreements which transfer insurance risk, but cover liabilities which occurred prior to the effective date of the agreement receive retroactive accounting treatment unless specified exceptions are met.

2. SSAP No. 62 currently allows four specified exceptions to retroactive reinsurance accounting including: structured settlements; novations; termination of, or reduction in participation in, reinsurance treaties entered into in the ordinary course of business; or intercompany reinsurance agreements, provided there is no gain in surplus as a result of the transaction.

3. The purpose of this issue paper is to amend SSAP No. 62 to expand the exceptions to retroactive accounting treatment to include property and casualty reinsurance run-off agreements which meet specified criteria. Reinsurance agreements and retrocession agreements which meet insurance risk transfer requirements and meet the specified criteria will receive specified accounting treatment.

SUMMARY CONCLUSION

4. This issue paper shall amend SSAP No. 62 to insert the following subparagraph e into paragraph 31:

> 31. The accounting principles for retroactive reinsurance agreements in paragraph 29 shall not apply to the following types of agreements (which shall be accounted for as prospective reinsurance agreements unless otherwise provided in this statement):
>
> a. Structured settlement annuities for individual claims purchased to implement settlements of policy obligations;
>
> b. Novations, (i.e., (i) transactions in which the original direct insurer's obligations are completely extinguished, resulting in no further exposure to loss arising on the business novated or (ii) transactions in which the original assuming entity's obligations are completely extinguished) resulting in no further exposure to loss arising on the business novated, provided that (1) the parties to the transaction are not affiliates (or if affiliates, that the transaction has the prior approval of the domiciliary regulators of the parties) and (2) the accounting for the original reinsurance agreement will not be altered from retroactive to prospective;
>
> c. The termination of, or reduction in participation in, reinsurance treaties entered into in the ordinary course of business;

d. Intercompany reinsurance agreements and any amendments thereto, among companies 100% owned by a common parent or ultimate controlling person provided there is no gain in surplus as a result of the transaction; or

e. Reinsurance and or retrocession agreements that meet the criteria of property and casualty run-off agreements described in paragraphs 68-71.

5. This issue paper shall amend SSAP No. 62 to insert and renumber the remaining paragraphs of the statement:

Accounting for the Transfer of Property and Casualty Run-off Agreements

68. Property and casualty run-off agreements are reinsurance or retrocession agreements that are intended to transfer essentially all of the risks and benefits of a specific line of business or market segment that is no longer actively marketed by the transferring insurer or reinsurer. A property and casualty run-off agreement is not a novation as the transferring insurer or reinsurer remains primarily liable to the policyholder or ceding entity under the original contracts of insurance or reinsurance. Reinsurance agreements between affiliates or between insurers under common control (as those terms are defined in Appendix A-440) are not eligible for the exception for property and casualty run-off agreements in subparagraph 31.e. of SSAP No. 62.

Criteria

69. The accounting treatment for property and casualty run-off agreements must be approved by the domiciliary regulators of the transferring entity (either the original direct insurer in the case of a reinsurance agreement or the original assuming reinsurer in the case of a retrocession agreement) and the assuming entity. If the transferring entity and assuming entity are domiciled in the same state, then the regulator of the state where the majority of the transferred liabilities is located shall be asked to approve the accounting treatment. In determining whether to approve an agreement for this accounting treatment, the regulators shall require the following:

a. Assuming Entity Properly Licensed – The entity assuming the run-off agreement must have the appropriate authority or license to write the business being assumed.

b. Limits and Coverages – the reinsurance or retrocession agreement shall provide the same limits and coverages that were afforded in the original insurance or reinsurance agreement.

c. Non-recourse – The reinsurance or retrocession agreement shall not contain any adjustable features or profit share or retrospective rating, and there shall be no recourse (other than normal representations and warranties that would be associated with a purchase and sale agreement) directly or indirectly against the transferring entity.

d. Risk Transfer – the reinsurance or retrocession agreement must meet the requirements of risk transfer as described in this statement.

e. Financial Strength of Reinsurer – the assuming reinsurer shall have a financial strength rating from at least two independent rating agencies (from NAIC acceptable rating agencies) which is equal to or greater than the current ratings of the transferring entity. The lowest financial strength rating received from an NAIC acceptable rating organization rating agency will be used to compare the financial strength ratings of the transferring and assuming entities.

f. Assessments – the assuming reinsurer or retrocessionaire (if required in the original reinsurance contract) shall be financially responsible for any and all assessments, including guaranty fund assessments, that are assessed against the transferring entity related to the insurance business being assumed.

g. Applicable Only to “Run-off” Business – the reinsurance or retrocession agreement shall only cover liabilities relating to a line(s) of business or specific market segments no longer actively marketed by the transferring entity.

h. Non-cancelable Reinsurance – the reinsurance or retrocession agreement shall provide that the reinsurance or retrocessional coverage provided by the proposed agreement cannot be cancelable by either party for any reason. (However, this provision will not override standard contract law and principles and will not prevent any remedies, including rescission or termination that might be available for breach, misrepresentation, etc.)

Statutory Schedules and Exhibits

70. At the inception of the transaction, the transferring entity shall record the consideration paid to the assuming entity as a paid loss. If the consideration paid by the transferring entity is less than the loss reserves transferred, the difference shall be recorded by the ceding entity as a decrease in losses incurred. The assuming entity shall record the consideration received as a negative paid loss. In addition, the transferring entity shall record an increase to ceded reinsurance recoverable for the amount of the transferred reserve. Journal entries illustrating these transactions, including situations in which the transaction includes an unearned premium reserve, are included in Exhibit B of this Statement.

71. The assuming entity will report the business in the same line of business as reported by the original insurer or reinsurer. The assuming entity will report the business at the same level of detail using the appropriate statutory schedules and exhibits.

Disclosures

6. This issue paper amends the disclosures section of SSAP No. 62 to add new paragraph 86 requiring additional disclosures and renumbering subsequent paragraphs:

86. Disclosures for the Transfer of Property and Casualty Run-off Agreements

a. Disclose if the reporting entity has entered into any agreements which have been approved by their domiciliary regulator and have qualified pursuant to SSAP No. 62, subparagraph 31.e., Accounting for the Transfer of Property and Casualty Run-off Agreements.

b. If affirmative, provide a description of the agreement and the amount of consideration paid and liabilities transferred.

Effective Date and Transition

7. After adoption of this issue paper, the NAIC will release an amended Statement of Statutory Accounting Principle (SSAP) for comment. The initial draft of the amended SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the *Accounting Practices and Procedures Manual* should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will be effective for reporting periods beginning on or after January 1, 2010.

DISCUSSION

8. This issue paper will expand the exceptions to retroactive reinsurance to more easily allow property and casualty reinsurers to transfer existing blocks of business that the company is no longer actively writing and marketing. Although paragraph 28 of SSAP No. 62 notes that reinsurance of existing liabilities is subject to abuse, the Statutory Accounting Principles Working Group determined that the requirements in this statement were sufficient to mitigate the concerns which would otherwise require retroactive accounting treatment.

9. It is contemplated that insurers and reinsurers would primarily use this option to exit unprofitable lines or products or as a way to cede off business the company is no longer writing. As it is possible that circumstances that might have made the product unattractive can change, this guidance is not intended to permanently prevent a company from reentering a line that was previously ceded in run-off. If questioned, the reporting entity shall be able to explain to the satisfaction of the affected states the change in circumstances regarding why a product that was previously considered a run-off product is now actively marketed.

10. Reinsurance between affiliates can result in abuse that retroactive reinsurance accounting is designed to prevent. The subparagraph 31.e. exception for property and casualty run-off agreements is not intended to be applied to agreements between affiliated reinsurers or reinsurers under common control. There is a currently existing exception to retroactive reinsurance accounting for intercompany reinsurance agreements and any amendments thereto, among companies 100% owned by a common parent or ultimate controlling person provided there is no gain in surplus as a result of the transaction in subparagraph 31.d. This issue paper does not affect or modify that guidance.

11. Retroactive reinsurance agreements between affiliates that result in surplus gain to the ceding entity, receive an accounting penalty under SSAP No. 62, paragraph 32. This issue paper does not affect or modify that guidance.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

12. As noted above existing property and casualty reinsurance accounting guidance is in SSAP No. 62. Tracked changes to SSAP No. 62 proposed by this statement are shown in appendix A. The exceptions to retroactive reinsurance accounting are a statutory accounting concept.

RELEVANT LITERATURE

Statutory Accounting

- *SSAP No. 62—Property and Casualty Reinsurance*
- *Issue Paper No. 75—Property and Casualty Reinsurance*

Generally Accepted Accounting Principles

- *FASB Statement No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts* (FAS 113) with modification and *FASB Emerging Issues Task Force No. 93-6, Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises* is adopted with modification in SSAP No. 62 and discussed in Issue Paper No. 75. This issue paper does not change the previous review of GAAP statements.

State Regulations

- No additional guidance obtained from state statutes or regulations.

Initial Transaction
Paid Loss or Ceded Premium?

Illustration of the rationale for treating the initial transaction as a paid loss by the Cedent/Transferor and a negative paid loss by the Reinsurer/Transferee.

Rationale:

1. This is a transfer of an existing block of business in which typically all premiums have been earned. The cedent is essentially transferring the reserves on an existing block of runoff business for a final negotiated premium.
2. Treating the initial transaction as ceded premium would distort the income statement and standard ratios of the cedent.
3. Additionally, Schedule P for the Cedent/Transferor would be distorted since existing loss reserves would never be paid, resulting in favorable reserve development in Schedule P.
4. Treating the initial transaction as a paid loss is consistent with similar transactions like assumption reinsurance and LPTs (when there is no surplus gain) and better presents the true economics of the transaction.
5. Treating the initial transaction as a paid loss preserves the logical data flow in all of the underwriting and investment exhibits, Schedule P and Schedule F.

Illustration: Assume $110,000 of earned premiums and the transfer of a runoff block of business representing $50,000 in reserves for $50,000 cash

Cedent I/S	Before Transaction	Recorded As Paid Loss	Recorded As Ceded Premium
Premiums Earned	110,000	110,000	**60,000**
Losses Incurred	85,000	85,000	**35,000**
Other U/W Expenses	30,000	30,000	30,000
Net U/W Gain (Loss)	(5,000)	(5,000)	(5,000)
Investment Income	7,000	7,000	7,000
Other Income	1,000	1,000	1,000
Net income	3,000	3,000	3,000
Loss Ratio	77%	77%	**58%**
Expense Ratio	27%	27%	**50%**
Combined Ratio	104%	104%	**108%**

Cedent B/S	Before Transaction	Recorded As Paid Loss	Recorded As Ceded Premium
Cash & Invested Assets	445,000	**395,000**	**395,000**
Reinsurance Recoverable on Unpaid Losses	45,000	45,000	45,000
EDP Equipment	1,000	1,000	1,000
Other Assets	9,000	9,000	9,000
Total Assets	500,000	450,000	450,000
Unpaid Losses and LAE	175,000	**125,000**	**125,000**
Unearned Premium	45,000	45,000	45,000
A/P and Accrued Expenses	3,000	3,000	3,000
Other Liabilities	2,000	2,000	2,000
Total Liabilities	225,000	175,000	175,000
Common Stock	10,000	10,000	10,000
PIC	90,000	90,000	90,000
Unassigned Surplus	175,000	175,000	175,000
Total Capital & Surplus	275,000	275,000	275,000
Total Liab., Capital & Surplus	500,000	450,000	450,000

Conclusion:

1. If you report the consideration paid by the Cedent/Transferor as a Paid Loss, there is no net effect on the balance sheet or income statement or key underwriting ratios.
2. If you report the consideration paid by the Cedent/Transferor as a Ceded Premium, the effect on the income statement and underwriting ratios is dramatic.
3. Additionally, Schedule P for the Cedent/Transferor would be distorted since existing loss reserves would never be paid, resulting in favorable reserve development in Schedule P.

EXHIBIT A: Illustration of Marked Changes to Amended SSAP No. 62R

The following depicts the amendments from this issue paper as "marked changes" (new text underlined):

Property and Casualty Reinsurance

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for property and casualty reinsurance. A wide range of methods for structuring reinsurance arrangements can be employed depending on the requirements of individual companies. This statement deals with the more commonly employed methods.

SUMMARY CONCLUSION

General

2. Reinsurance is the assumption by an insurer of all or part of a risk undertaken originally by another insurer. The transaction whereby a reinsurer cedes all or part of the reinsurance it has assumed to another reinsurer is known as a retrocession.

3. Reinsurance has many beneficial purposes. Among them are that it enables an insurance entity to (a) expand its capacity, (b) share large risks with other insurers, (c) spread the risk of potential catastrophes and stabilize its underwriting results, (d) finance expanding volume by sharing the financial burden of reserves, (e) withdraw from a line or class of business, and (f) reduce its net liability to amounts appropriate to its financial resources.

4. Reinsurance agreements are generally classified as treaty or facultative. Treaty reinsurance refers to an arrangement involving a class or type of business written, while facultative reinsurance involves individual risks offered and accepted.

5. Reinsurance coverage can be pro rata (i.e., proportional reinsurance) where the reinsurer shares a pro rata portion of the losses and premium of the ceding entity or excess of loss (i.e., non-proportional) where the reinsurer, subject to a specified limit, indemnifies the ceding entity against the amount of loss in excess of a specified retention. Most reinsurance agreements fall into one of the following categories:

I. Treaty Reinsurance Contracts—Pro Rata:

A. Quota Share Reinsurance—The ceding entity is indemnified against a fixed percentage of loss on each risk covered in the agreement;

B. Surplus Share Reinsurance—The ceding entity establishes a retention or "line" on the risks to be covered and cedes a fraction or a multiple of that line on each policy subject to a specified maximum cession;

II. Treaty Reinsurance Contracts—Excess of Loss:

A. Excess Per Risk Reinsurance—The ceding entity is indemnified, subject to a specified limit, against the amount of loss in excess of a specified retention with respect to each risk covered by a treaty;

B. Aggregate Excess of Loss Reinsurance—The ceding entity is indemnified against the amount by which the ceding entity's net retained losses incurred during a specific period exceed either a predetermined dollar amount or a percentage of the entity's subject premiums for the specific period subject to a specified limit;

III. Treaty Reinsurance Contracts—Catastrophe: The ceding entity is indemnified, subject to a specified limit, against the amount of loss in excess of a specified retention with respect to an accumulation of losses resulting from a catastrophic event or series of events;

IV. Facultative Reinsurance Contracts—Pro Rata: The ceding entity is indemnified for a specified percentage of losses and loss expenses arising under a specific insurance policy in exchange for that percentage of the policy's premium;

V. Facultative Reinsurance Contracts—Excess of Loss: The ceding entity is indemnified, subject to a specified limit, for losses in excess of its retention with respect to a particular risk.

Characteristics of Reinsurance Agreements

6. Common contract provisions that may affect accounting practices include:

a. Reporting responsibility of the ceding entity—Details required and time schedules shall be established;

b. Payment terms—Time schedules, currencies intended, and the rights of the parties to withhold funds shall be established;

c. Payment of premium taxes—Customarily the responsibility of the ceding entity, a recital of nonliability of the reinsurer may be found;

d. Termination—May be on a cut-off or run-off basis. A cut-off provision stipulates that the reinsurer shall not be liable for loss as a result of occurrences taking place after the date of termination. A run-off provision stipulates that the reinsurer shall remain liable for loss under reinsured policies in force at the date of termination as a result of occurrences taking place after the date of termination until such time as the policies expire or are canceled; and

e. Insolvency clause—Provides for the survival of the reinsurer's obligations in the event of insolvency of the ceding entity, without diminution because of the insolvency.

7. Reinsurance contracts shall not permit entry of an order of rehabilitation or liquidation to constitute an anticipatory breach by the reporting entity, nor grounds for retroactive revocation or retroactive cancellation of any contracts of the reporting entity.

Required Terms for Reinsurance Agreements

8. In addition to credit for reinsurance requirements applicable to reinsurance transactions generally, no credit or deduction from liabilities shall be allowed by the ceding entity for reinsurance recoverable where the agreement was entered into after the effective date of these requirements (see paragraphs ~~86~~ 90 and ~~87~~91) unless each of the following conditions is satisfied:

a. The agreement must contain an acceptable insolvency clause;

b. Recoveries due the ceding entity must be available without delay for payment of losses and claim obligations incurred under the agreement, in a manner consistent with orderly payment of incurred policy obligations by the ceding entity;

c. The agreement shall constitute the entire contract between the parties and must provide no guarantee of profit, directly or indirectly, from the reinsurer to the ceding entity or from the ceding entity to the reinsurer;

d. The agreement must provide for reports of premiums and losses, and payment of losses, no less frequently than on a quarterly basis, unless there is no activity during the period. The report of premiums and losses shall set forth the ceding entity's total loss and loss expense reserves on the policy obligations subject to the agreement, so that the respective obligations of the ceding entity and reinsurer will be recorded and reported on a basis consistent with this statement; and

e. With respect to retroactive reinsurance agreements, the following additional conditions apply:

i. The consideration to be paid by the ceding entity for the retroactive reinsurance must be a sum certain stated in the agreement;

ii. Direct or indirect compensation to the ceding entity or reinsurer is prohibited;

iii. Any provision for subsequent adjustment on the basis of actual experience in regard to policy obligations transferred, or on the basis of any other formula, is prohibited in connection with a retroactive reinsurance transaction, except that provision may be made for the ceding entity's participation in the reinsurer's ultimate profit, if any, under the agreement;

iv. A retroactive reinsurance agreement shall not be canceled or rescinded without the approval of the commissioner of the domiciliary state of the ceding entity.

Reinsurance Agreements with Multiple Cedents

9. Reinsurance agreements with multiple cedents require allocation agreements. The allocation agreement can be part of the reinsurance agreement or a separate agreement. If the agreement has multiple cedents:

a. The allocation must be in writing and

b. The terms of the allocation agreement must be fair and equitable.

Reinsurance Contracts Must Include Transfer of Risk

10. The essential ingredient of a reinsurance contract is the transfer of risk. The essential element of every true reinsurance agreement is the undertaking by the reinsurer to indemnify the ceding entity, i.e., reinsured entity, not only in form but in fact, against loss or liability by reason of the original insurance. Unless the agreement contains this essential element of risk transfer, no credit shall be recorded.

11. Insurance risk involves uncertainties about both (a) the ultimate amount of net cash flows from premiums, commissions, claims, and claims settlement expenses (underwriting risk) and (b) the timing of the receipt and payment of those cash flows (timing risk). Actual or imputed investment returns are not an element of insurance risk. Insurance risk is fortuitous—the possibility of adverse events occurring is outside the control of the insured.

12. Determining whether an agreement with a reinsurer provides indemnification against loss or liability (transfer of risk) relating to insurance risk requires a complete understanding of that contract and other contracts or agreements between the ceding entity and related reinsurers. A complete understanding includes an evaluation of all contractual features that (a) limit the amount of insurance risk to which the reinsurer is subject (e.g., experience refunds, cancellation provisions, adjustable features, or additions of profitable lines of business to the reinsurance

contract) or (b) delay the timely reimbursement of claims by the reinsurer (e.g., payment schedules or accumulating retentions from multiple years).

13. Indemnification of the ceding entity against loss or liability relating to insurance risk in reinsurance requires both of the following:

a. The reinsurer assumes significant insurance risk under the reinsured portions of the underlying insurance agreements; and

b. It is reasonably possible that the reinsurer may realize a significant loss from the transaction.

14. A reinsurer shall not have assumed significant insurance risk under the reinsured contracts if the probability of a significant variation in either the amount or timing of payments by the reinsurer is remote. Implicit in this condition is the requirement that both the amount and timing of the reinsurer's payments depend on and directly vary with the amount and timing of claims settled by the ceding entity. Contractual provisions that delay timely reimbursement to the ceding entity prevent this condition from being met.

15. The ceding entity's evaluation of whether it is reasonably possible for a reinsurer to realize a significant loss from the transaction shall be based on the present value of all cash flows between the ceding and assuming companies under reasonably possible outcomes, without regard to how the individual cash flows are described or characterized. An outcome is reasonably possible if its probability is more than remote. The same interest rate shall be used to compute the present value of cash flows for each reasonably possible outcome tested. A constant interest rate shall be used in determining those present values because the possibility of investment income varying from expectations is not an element of insurance risk. Judgment is required to identify a reasonable and appropriate interest rate.

16. Significance of loss shall be evaluated by comparing the present value of all cash flows, determined as described in paragraph 15, with the present value of the amounts paid or deemed to have been paid to the reinsurer. If, based on this comparison, the reinsurer is not exposed to the reasonable possibility of significant loss, the ceding entity shall be considered indemnified against loss or liability relating to insurance risk only if substantially all of the insurance risk relating to the reinsured portions of the underlying insurance agreements has been assumed by the reinsurer. In this narrow circumstance, the reinsurer's economic position is virtually equivalent to having written the insurance contract directly. This condition is met only if insignificant insurance risk is retained by the ceding entity on the retained portions of the underlying insurance contracts, so that the reinsurer's exposure to loss is essentially the same as the reporting entity's.

17. Payment schedules and accumulating retentions from multiple years are contractual features inherently designed to delay the timing of reimbursement to the ceding entity. Regardless of what a particular feature might be called, any feature that can delay timely reimbursement violates the conditions for reinsurance accounting. Transfer of insurance risk requires that the reinsurer's payment to the ceding entity depend on and directly vary with the amount and timing of claims settled under the reinsured contracts. Contractual features that can delay timely reimbursement prevent this condition from being met. Therefore, any feature that may affect the timing of the reinsurer's reimbursement to the ceding entity shall be closely scrutinized.

Accounting for Reinsurance

18. Reinsurance recoverables shall be recognized in a manner consistent with the liabilities (including estimated amounts for claims incurred but not reported) relating to the underlying reinsured contracts. Assumptions used in estimating reinsurance recoverables shall be consistent with those used in estimating the related liabilities. Certain assets and liabilities are created by entities when they engage in reinsurance contracts. Reinsurance assets meet the definition of assets as defined by *SSAP No. 4—Assets and Nonadmitted Assets* and are admitted to the extent they conform to the requirements of this statement.

19. Accounting for members of a reinsurance pool shall follow the accounting for the pool member which issued the underlying policy. Specific accounting rules for underwriting pools and associations are addressed in SSAP No. 63—Underwriting Pools and Associations Including Intercompany Pools.

20. Reinsurance recoverable on loss payments is an admitted asset. Notwithstanding the fact that reinsurance recoverables on paid losses may meet the criteria for offsetting under the provisions of SSAP No. 64—Offsetting and Netting of Assets and Liabilities (SSAP No. 64), reinsurance recoverables on paid losses shall be reported as an asset without any available offset. Unauthorized reinsurance is included in this asset and reflected separately as a liability to the extent required. Penalty for overdue authorized reinsurance shall be reflected as a liability.

21. Funds held or deposited with reinsured companies, whether premiums withheld as security for unearned premium and outstanding loss reserves or advances for loss payments, are admitted assets provided they do not exceed the liabilities they secure and provided the reinsured is solvent. Those funds which are in excess of the liabilities, and any funds held by an insolvent reinsured shall be nonadmitted.

22. Prospective reinsurance is defined as reinsurance in which a reinsurer agrees to reimburse a ceding entity for losses that may be incurred as a result of future insurable events covered under contracts subject to the reinsurance. Retroactive reinsurance is defined as reinsurance in which a reinsurer agrees to reimburse a ceding entity for liabilities incurred as a result of past insurable events covered under contracts subject to the reinsurance. A reinsurance agreement may include both prospective and retroactive reinsurance provisions.

23. The distinction between prospective and retroactive reinsurance agreements is based on whether the agreement reinsures future or past insured events covered by the underlying insurance policies. For example, in occurrence-based insurance, the insured event is the occurrence of a loss covered by the insurance contract. In claims-made insurance, the insured event is the reporting to the insurer, within the period specified by the policy, of a claim for a loss covered by the insurance agreement. A claims-made reinsurance contract that reinsures claims asserted to the reinsurer in a future period as a result of insured events that occurred prior to entering into the reinsurance agreement is a retroactive agreement. (However, a reinsurance agreement that reinsures claims reported to an insurer that are covered under currently effective claims-made insurance policies is a prospective reinsurance agreement.)

24. It is not uncommon for a reinsurance arrangement to be initiated before the beginning of a policy period but not finalized until after the policy period begins. Whether there was agreement in principle at the beginning of the policy period and, therefore, the agreement is substantively prospective shall be determined based on the facts and circumstances. However, except as respects business assumed by a U.S. reinsurer from ceding companies domiciled outside the U.S. and not affiliated with such reinsurer, or business assumed by a U.S. reinsurer where either the lead reinsurer or a majority of the capacity on the agreement is domiciled outside the U.S. and is not affiliated with such reinsurer, if an agreement entered into, renewed or amended on or after January 1, 1994 has not been finalized, reduced to a written form and signed by the parties within nine months after the commencement of the policy period covered by the reinsurance arrangement, then the arrangement is presumed to be retroactive and shall be accounted for as a retroactive reinsurance agreement. This presumption shall not apply to: (a) facultative reinsurance contracts, nor to (b) reinsurance agreements with more than one reinsurer which are signed by the lead reinsurer (i.e., the reinsurer setting the terms of the agreement for the reinsurers) within nine months after the commencement of the policy period covered by the reinsurance agreement, nor to (c) reinsurance agreements with more than one reinsurer (whether signed by the lead reinsurer or not) which were entered into, renewed or amended on or before December 31, 1996, (and which were not renewed or amended after that date) if reinsurers representing more than 50% of the capacity on the agreement have signed cover notes, placement slips or similar documents describing the essential terms of coverage and exclusions within nine months after the commencement of the policy period covered by the reinsurance arrangement. Also exempt from this presumption are reinsurance agreements where one of the parties is in conservation, rehabilitation, receivership or liquidation proceedings.

25. Prospective and retroactive provisions included within a single agreement shall be accounted for separately. If separate accounting for prospective and retroactive provisions included within a single agreement is impracticable, the agreement shall be accounted for as a retroactive agreement provided the conditions for reinsurance accounting are met.

Accounting for Prospective Reinsurance Agreements

26. Amounts paid for prospective reinsurance that meet the conditions for reinsurance accounting shall be reported as a reduction of written and earned premiums by the ceding entity and shall be earned over the remaining contract period in proportion to the amount of reinsurance protection provided or, if applicable, until the reinsurer's maximum liability under the agreement has been exhausted. If the amounts paid are subject to adjustment and can be reasonably estimated, the basis for amortization shall be the estimated ultimate amount to be paid. Reinstatement premium, if any, shall be earned over the period from the reinstatement of the limit to the expiration of the agreement.

27. Changes in amounts of estimated reinsurance recoverables shall be recognized as a reduction of gross losses and loss expenses incurred in the current period statement of income. Reinsurance recoverables on paid losses shall be reported as an asset, reinsurance recoverables on loss and loss adjustment expense payments, in the balance sheet. Reinsurance recoverables on unpaid case-basis and incurred but not reported losses and loss adjustment expenses shall be netted against the liability for gross losses and loss adjustment expenses.

Accounting for Retroactive Reinsurance Agreements

28. Certain reinsurance agreements which transfer both components of insurance risk cover liabilities which occurred prior to the effective date of the agreement. Due to potential abuses involving the creation of surplus to policyholders and the distortion of underwriting results, special accounting treatment for these agreements is warranted.

29. All retroactive reinsurance agreements entered into, renewed or amended on or after January 1, 1994 (including subsequent development of such transactions) shall be accounted for and reported in the following manner:

a. The ceding entity shall record, without recognition of the retroactive reinsurance, loss and loss expense reserves on a gross basis on the balance sheet and in all schedules and exhibits;

b. The assuming entity shall exclude the retroactive reinsurance from loss and loss expense reserves and from all schedules and exhibits;

c. The ceding entity and the assuming entity shall report by write-in item on the balance sheet, the total amount of all retroactive reinsurance, identified as retroactive reinsurance reserve ceded or assumed, recorded as a contra-liability by the ceding entity and as a liability by the assuming entity;

d. The ceding entity shall, by write-in item on the balance sheet, restrict surplus resulting from any retroactive reinsurance as a special surplus fund, designated as special surplus from retroactive reinsurance account;

e. The surplus gain from any retroactive reinsurance shall not be classified as unassigned funds (surplus) until the actual retroactive reinsurance recovered exceeds the consideration paid;

f. The special surplus from retroactive reinsurance account for each respective retroactive reinsurance agreement shall be reduced at the time the ceding entity begins to recover funds from the assuming entity in amounts exceeding the consideration paid by the ceding entity under such agreement, or adjusted as provided in subparagraph 29.j.;

g. For each agreement, the reduction in the special surplus from retroactive reinsurance account shall be limited to the lesser of (i) the actual amount recovered in excess of consideration paid or (ii) the initial surplus gain resulting from the respective retroactive reinsurance agreement. Any remaining balance in the special surplus from retroactive reinsurance account derived from any such agreement shall be returned to unassigned funds (surplus) upon elimination of all policy obligations subject to the retroactive reinsurance agreement;

h. The ceding entity shall report the initial gain arising from a retroactive reinsurance transaction (i.e., the difference between the consideration paid to the reinsurer and the total reserves ceded to the reinsurer) as a write-in item on the statement of income, to be identified as Retroactive Reinsurance Gain and included under Other Income;

i. The assuming entity shall report the initial loss arising from a retroactive reinsurance transaction, as defined in the preceding subparagraph 29.g., as a write-in item on the statement of income, to be identified as Retroactive Reinsurance Loss and included under Other Income;

j. Any subsequent increase or reduction in the total reserves ceded under a retroactive reinsurance agreement shall be reported in the manner described in the preceding subparagraphs 29.h. and 29.i., in order to recognize the gain or loss arising from such increase or reduction in reserves ceded. The Special Surplus from Retroactive Reinsurance Account write-in entry on the balance sheet shall be adjusted, upward or downward, to reflect such increase or reduction in reserves ceded. The Special Surplus from Retroactive Reinsurance Account write-in entry shall be equal to or less than the total ceded reserves under all retroactive reinsurance agreements in-force as of the date of the financial statement. Special surplus arising from a retroactive reinsurance transaction shall be considered to be earned surplus (i.e., transferred to unassigned funds (surplus)) only when cash recoveries from the assuming entity exceed the consideration paid by the ceding entity as respects such retroactive reinsurance transaction; and

k. The consideration paid for a retroactive reinsurance agreement shall be reported as a decrease in ledger assets by the ceding entity and as an increase in ledger assets by the assuming entity.

(For an illustration of ceding entity accounting entries see Question 33 in Exhibit A.)

30. Portfolio reinsurance is the transfer of an insurer's entire liability for in force policies or outstanding losses, or both, of a segment of the insurer's business. Loss portfolio transactions are to be accounted for as retroactive reinsurance.

31. The accounting principles for retroactive reinsurance agreements in paragraph 29 shall not apply to the following types of agreements (which shall be accounted for as prospective reinsurance agreements unless otherwise provided in this statement):

a. Structured settlement annuities for individual claims purchased to implement settlements of policy obligations;

b. Novations, (i.e., (i) transactions in which the original direct insurer's obligations are completely extinguished, resulting in no further exposure to loss arising on the business novated or (ii) transactions in which the original assuming entity's obligations are completely extinguished) resulting in no further exposure to loss arising on the business novated, provided that (1) the parties to the transaction are not affiliates (or if affiliates, that the transaction has the prior approval of the domiciliary regulators of the parties) and (2) the accounting for the original reinsurance agreement will not be altered from retroactive to prospective;

c. The termination of, or reduction in participation in, reinsurance treaties entered into in the ordinary course of business;~~ or~~

d. Intercompany reinsurance agreements, and any amendments thereto, among companies 100% owned by a common parent or ultimate controlling person provided there is no gain in surplus as a result of the transaction~~.~~; or

e. Reinsurance/retrocession agreements that meet the criteria of property/casualty run-off agreements described in paragraphs 68-71.

32. Retroactive reinsurance agreements resulting in surplus gain to the ceding entity (with or without risk transfer) entered into between affiliates or between insurers under common control (as those terms are defined in Appendix A-440) shall be reported as follows:

a. The consideration paid by the ceding entity shall be recorded as a deposit and reported as a nonadmitted asset; and

b. No deduction shall be made from loss and loss adjustment expense reserves on the ceding entity's balance sheet, schedules, and exhibits.

33. The accounting and reporting provisions applicable to retroactive reinsurance apply to all transactions transferring liabilities in connection with a court-ordered rehabilitation, liquidation, or receivership. The requirement to include stipulated contract provisions in the reinsurance agreements shall not apply to these transactions, with written approval of the ceding entity's domiciliary commissioner.

34. Novations meeting the requirements of subparagraph 31.b. shall be accounted for as prospective reinsurance agreements. The original direct insurer, or the original assuming insurer, shall report amounts paid as a reduction of written and earned premiums, and unearned premiums to the extent that premiums have not been earned. Novated balances (e.g., loss and loss adjustment expense reserves) shall be written off through the accounts, exhibits, and schedules in which they were originally recorded. The assuming insurer shall report amounts received as written and earned premiums, and obligations assumed as incurred losses in the statement of income.

Deposit Accounting

35. To the extent that a reinsurance agreement does not, despite its form, transfer both components of insurance risk, all or part of the agreement shall be accounted for and reported as deposits in the following manner:

a. At the outset of the reinsurance agreement the net consideration paid by the ceding entity (premiums less commissions or other allowances) shall be recorded as a deposit by the ceding entity and as a liability by the assuming entity. The deposit shall be reported as an admitted asset by the ceding entity if (i) the assuming entity is licensed, accredited or otherwise qualified in the ceding entity's state of domicile as described in Appendix A-785 or (ii) there are funds held by or on behalf of the ceding entity as described in Appendix A-785;

b. Throughout the life of the agreement, receipts and disbursements shall be recorded through the deposit/liability accounts;

c. When individual case reserves are the basis for the deposit and the assuming entity pays in excess of the amount transferred by the ceding entity, the amount paid in excess of the deposit received shall be recognized as a loss by the assuming entity and as a gain by the ceding entity as Other Income in the statement of income;

d. When the agreement is completed, or when there is a loss payment in excess of the deposit, any difference between consideration and recoveries shall be recorded in the Other Income or Loss account as a loss to the reinsurer and as a gain in the Other Income or Loss account by the reinsured;

e. With regard to bulk reserves,(i.e., IBNR) it shall be assumed that any cash transactions for the settlement of losses will reduce the asset/liability accounts by the amount of the cash transferred. When the remaining losses are revalued upward, an increase in the liability shall be recorded as a loss recognized by the assuming entity. Conversely, the ceding entity shall increase its deposit (asset) and outstanding loss liability;

f. No deduction shall be made from the loss and loss adjustment expense reserves on the ceding entity's balance sheet, schedules, and exhibits; and

g. The assuming entity shall record net consideration to be returned to the ceding entity as liabilities.

Assumed Reinsurance

36. Reinsurance premiums receivable at the end of the accounting period are combined with direct business receivables and reported as agents' balances or uncollected premiums. Where the ceding entity withholds premium funds pursuant to the terms of the reinsurance agreement, such assets shall be shown by the assuming entity as funds held by or deposited with reinsured companies. Reporting entities shall record any interest earned or receivable on the funds withheld as a component of aggregate write-ins for miscellaneous income.

37. If the assuming entity receives reinsurance premium prior to the effective date of the reinsurance contract, consistent with *SSAP No. 53—Property Casualty Contracts-Premiums*, paragraph 14, advance premiums shall be reported as a liability in the statutory financial statement and not considered income until the effective date of the coverage. Such amounts are not included in written premium or the unearned premium reserve. If the assuming entity receives reinsurance premium after the effective date of the reinsurance contract but prior to the due date, the amount received shall be reported as a reduction of the asset for deferred but not yet due (earned but unbilled premiums).

38. Reinsurance premiums more than 90 days overdue shall be nonadmitted except (a) to the extent the assuming entity maintains unearned premium and loss reserves as to the ceding entity, under principles of offset accounting as discussed in SSAP No. 64, or (b) where the ceding entity is licensed and in good standing in assuming entity's state of domicile. Reinsurance premiums are due pursuant to the original contract terms (as the agreement stood on the date of execution). In the absence of a specific contract date, reinsurance premiums will be deemed due thirty (30) days after the date on which (i) notice or demand of premium due is provided to the ceding entity or (ii) the assuming entity books the premium (see SSAP No. 6—Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due From Agents and Brokers).

39. A lag will develop between the time of the entry of the underlying policy transaction on the books of the ceding entity and the transmittal of information and entry on the books of the assuming entity. Assuming companies shall estimate unreported premiums and related costs to the extent necessary to prevent material distortions in the loss development contained in the assuming entity's annual statement schedules where calendar year premiums are compared to accident year losses.

40. Proportional reinsurance (i.e., first dollar pro rata reinsurance) premiums shall be allocated to the appropriate annual statement lines of business in the Underwriting and Investment exhibits. Non-proportional assumed reinsurance premiums shall be classified as reinsurance under the appropriate subcategories.

41. Assumed retroactive reinsurance premiums shall be excluded from all schedules and exhibits as addressed in subparagraph 29.k.

42. Amounts payable by reinsurers on losses shall be classified as unpaid losses. Assumed reinsurance payable on paid losses shall be classified as a separate liability item on the balance sheet. IBNR losses on assumed reinsurance business shall be netted with ceded losses on the balance sheet and listed separately by annual statement line of business in the Underwriting and Investment exhibits.

Ceded Reinsurance

43. Ceded reinsurance premiums payable (net of ceding commission) shall be classified as a liability. Consistent with SSAP No. 64, ceded reinsurance premiums payable may be deducted from amounts due from the reinsurer, such as amounts due on assumed reinsurance, when a legal right of offset exists.

44. With regard to reinsurance premium paid prior to the effective date of the contract, the ceding entity shall reflect the prepaid item as a write-in admitted asset and it should not be recognized in the income statement until the effective date of the coverage. Such amounts are not included in ceded written premiums or ceded unearned premium but should be subject to impairment analysis. With regard to reinsurance premium paid by ceding entity after the reinsurance contract is in effect but prior to the due date, the ceding entity shall treat this item as a reduction to the liability for ceded reinsurance premiums payable. That liability reflects not only premiums unpaid but also amounts booked but deferred and not yet due.

45. Amounts withheld by the ceding entity that would otherwise be payable under the reinsurance agreement shall be reported as funds held by entity under reinsurance treaties. Reporting entities shall record any interest due or payable on the amounts withheld as a component of aggregate write-ins for miscellaneous income.

46. Ceded reinsurance transactions shall be classified in the annual statement line of business which relates to the direct or assumed transactions creating the cession or retrocession.

47. Ceded retroactive reinsurance premiums shall be excluded from all schedules and exhibits as addressed in subparagraph 29.k.

Adjustable Features/Retrospective Rating

48. Reinsurance treaties may provide for adjustment of commission, premium, or amount of coverage, based on loss experience. The accounting for common examples is outlined in the following paragraphs:

Commission Adjustments

49. An accrual shall be maintained for the following adjustable features based upon the experience recorded for the accounting period:

a. Contingent or Straight Profit—The reinsurer returns to the ceding entity a stipulated percentage of the profit produced by the business assumed from the ceding entity. Profit may be calculated for any specified period of time, but the calculation is often based on an average over a period of years; and

b. Sliding Scale—A provisional rate of commission is paid over the course of the agreement, with a final adjustment based on the experience of the business ceded under the agreement.

Premium Adjustments

50. If the reinsurance agreement incorporates an obligation on the part of the ceding entity to pay additional premium to the assuming entity based upon loss experience under the agreement, a liability in the amount of such additional premium shall be recognized by the ceding entity during the accounting period in which the loss event(s) giving rise to the obligation to pay such additional premium occur(s). The assuming entity shall recognize an asset in a consistent manner. If the reinsurance agreement incorporates an obligation on the part of the assuming entity to refund to the ceding entity any portion of the consideration received by the assuming entity based upon loss experience under the agreement, an asset in the amount of any such refund shall be recognized by the ceding entity during the accounting period in which the loss event(s) giving rise to the obligation to make such refund occur(s). The initial provisional or deposit premium is recalculated retrospectively, based on loss experience under the agreement during a specified period of time; the calculation is often based on an average over a period of years. The assuming entity shall recognize a liability in a consistent manner.

Adjustments in the Amount of Coverage

51. The amount of coverage available for future periods is adjusted, upward or downward, based on loss experience under the agreement during a specified period of time. If the reinsurance agreement incorporates a provision under which the reinsurance coverage afforded to the ceding entity may be increased or reduced based upon loss experience under the agreement, an asset or a liability shall be recognized by the ceding entity in an amount equal to that percentage of the consideration received by the assuming entity which the increase or reduction in coverage represents of the amount of coverage originally afforded. The asset or liability shall be recognized during the accounting period in which the loss event(s) (or absence thereof) giving rise to the increase or decrease in reinsurance coverage occur(s), and shall be amortized over all accounting periods for which the increased or reduced coverage is applicable. The term “consideration” shall mean, for this purpose, the annualized deposit premium for the period used as the basis for calculating the adjustment in the amount of coverage to be afforded thereafter under the agreement.

Impairment

52. Include as a nonadmitted asset, amounts accrued for premium adjustments on retrospectively rated reinsurance agreements with respect to which all uncollected balances due from the ceding company have been classified as nonadmitted.

Commissions

53. Commissions payable on reinsurance assumed business shall be included as an offset to Agents’ Balances or Uncollected Premiums. Commissions receivable on reinsurance ceded business shall be included as an offset to Ceded Reinsurance Balances Payable.

54. If the ceding commission paid under a reinsurance agreement exceeds the anticipated acquisition cost of the business ceded, the ceding entity shall establish a liability, equal to the difference between the anticipated acquisition cost and the reinsurance commissions received, to be amortized pro rata over the effective period of the reinsurance agreement in proportion to the amount of coverage provided under the reinsurance contract.

Provision for Reinsurance

55. The NAIC Annual Statement Instructions for Property and Casualty Companies for Schedule F—Provision for Overdue Reinsurance, provide for a minimum reserve for uncollectible reinsurance with an additional reserve required if an entity’s experience indicates that a higher amount should be provided. The minimum reserve Provision for Reinsurance is recorded as a liability and the change between years is recorded as a gain or loss directly to unassigned funds (surplus). Any reserve over the minimum amount shall be recorded on the statement of income by reversing the accounts previously utilized to establish the reinsurance recoverable.

56. The provision for reinsurance is calculated separately for unauthorized and authorized companies. An authorized reinsurer is licensed, accredited or approved by the ceding entity's state of domicile; an unauthorized reinsurer is not so licensed, accredited or approved.

Disputed Items

57. Occasionally a reinsurer will question whether an individual claim is covered under a reinsurance agreement or may even attempt to nullify an entire agreement. A ceding entity, depending upon the individual facts, may or may not choose to continue to take credit for such disputed balances. A ceding entity shall take no credit whatsoever for reinsurance recoverables in dispute with an affiliate.

58. Items in dispute are those claims with respect to which the ceding entity has received formal written communication from the reinsurer denying the validity of coverage.

Uncollectible Reinsurance

59. Uncollectible reinsurance balances shall be written off through the accounts, exhibits, and schedules in which they were originally recorded.

Commutations

60. A commutation of a reinsurance agreement, or any portion thereof, is a transaction which results in the complete and final settlement and discharge of all, or the commuted portion thereof, present and future obligations between the parties arising out of the reinsurance agreement.

61. In commutation agreements, an agreed upon amount determined by the parties is paid by the reinsurer to the ceding entity. The ceding entity immediately eliminates the reinsurance recoverable recorded against the ultimate loss reserve and records the cash received as a negative paid loss. Any net gain or loss shall be reported in underwriting income in the statement of income.

62. The reinsurer eliminates a loss reserve carried at ultimate cost for a cash payout calculated at present value. Any net gain or loss shall be reported in underwriting income in the statement of income.

63. Commuted balances shall be written off through the accounts, exhibits, and schedules in which they were originally recorded.

National Flood Insurance Program

64. The National Flood Insurance Program was created by the Federal Emergency Management Agency (FEMA) and is designed to involve private insurers in a write-your-own (WYO) flood insurance program financially backed by FEMA at no risk to the insurer. To become a participating WYO entity, the entity signs a document with the Federal Insurance Administration (FIA) of the Federal Emergency Management Agency known as the Financial Assistance/Subsidy Arrangement.

65. Premium rates are set by FEMA. The WYO participating companies write the flood insurance coverage qualifying for the program on their own policies, perform their own underwriting, premium collections, claim payments, administration, and premium tax payments for policies written under the program.

66. Monthly accountings are made to FIA and participants draw upon FEMA letters of credit for deficiencies of losses, loss expenses, and administrative expenses in excess of premiums, subject to certain percentage limitations on expenses.

67. Balances due from or to FEMA shall be reported as ceded reinsurance balances receivable or payable.

Accounting for the Transfer of Property and Casualty Run-off Agreements

68. Property and casualty run-off agreements are reinsurance or retrocession agreements that are intended to transfer essentially all of the risks and benefits of a specific line of business or market segment that is no longer actively marketed by the transferring insurer or reinsurer. A property and casualty run-off agreement is not a novation as the transferring insurer or reinsurer remains primarily liable to the policyholder or ceding entity under the original contracts of insurance or reinsurance. Reinsurance agreements between affiliates or between insurers under common control (as those terms are defined in Appendix A-440) are not eligible for the exception for property and casualty run-off agreements in subparagraph 31.e. of SSAP No. 62R.

Criteria

69. The accounting treatment for property and casualty run-off agreements must be approved by the domiciliary regulators of the transferring entity (either the original direct insurer in the case of a reinsurance agreement or the original assuming reinsurer in the case of a retrocession agreement) and the assuming entity. If the transferring entity and assuming entity are domiciled in the same state, then the regulator of the state where the majority of the transferred liabilities is located shall be asked to approve the accounting treatment. In determining whether to approve an agreement for this accounting treatment, the regulators shall require the following:

a. Assuming Entity Properly Licensed – The entity assuming the run-off agreement must have the appropriate authority or license to write the business being assumed.

b. Limits and Coverages – the reinsurance or retrocession agreement shall provide the same limits and coverages that were afforded in the original insurance or reinsurance agreement.

c. Non-recourse – The reinsurance or retrocession agreement shall not contain any adjustable features or profit share or retrospective rating, and there shall be no recourse (other than normal representations and warranties that would be associated with a purchase and sale agreement) directly or indirectly against the transferring entity.

d. Risk Transfer – the reinsurance or retrocession agreement must meet the requirements of risk transfer as described in this statement.

e. Financial Strength of Reinsurer – the assuming reinsurer shall have a financial strength rating from at least two independent rating agencies (from NAIC acceptable rating agencies) which is equal to or greater than the current ratings of the transferring entity. The lowest financial strength rating received from an NAIC acceptable rating organization rating agency will be used to compare the financial strength ratings of the transferring and assuming entities.

f. Assessments – the assuming reinsurer or retrocessionaire (if required in the original reinsurance contract) shall be financially responsible for any and all assessments, including guaranty fund assessments, that are assessed against the transferring entity related to the insurance business being assumed.

g. Applicable Only to “Run-off” Business – the reinsurance or retrocession agreement shall only cover liabilities relating to a line(s) of business or specific market segments no longer actively marketed by the transferring entity.

h. Non-cancelable Reinsurance – the reinsurance or retrocession agreement shall provide that the reinsurance or retrocessional coverage provided by the proposed agreement cannot be cancelable by either party for any reason. (However, this provision will not override standard contracts law and principles and will not prevent any remedies, including rescission or termination that might be available for breach, misrepresentation, etc.)

Statutory Schedules and Exhibits

70. At the inception of the transaction, the transferring entity shall record the consideration paid to the assuming entity as a paid loss. If the consideration paid by the transferring entity is less than the loss reserves transferred, the difference shall be recorded by the ceding entity as a decrease in losses incurred. The assuming entity shall record the consideration received as a negative paid loss. In addition, the transferring entity shall record an increase to ceded reinsurance recoverable for the amount of the transferred reserve. Journal entries illustrating these transactions, including situations in which the transaction includes an unearned premium reserve, are included in Exhibit B of this Statement.

71. The assuming entity will report the business in the same line of business as reported by the original insurer or reinsurer. The assuming entity will report the business at the same level of detail using the appropriate statutory schedules and exhibits.

Disclosures

~~68.~~72. Unsecured Reinsurance Recoverables:

a. If the entity has with any individual reinsurers, authorized or unauthorized, an unsecured aggregate recoverable for losses, paid and unpaid including IBNR, loss adjustment expenses, and unearned premium, that exceeds 3% of the entity’s policyholder surplus, list each individual reinsurer and the unsecured aggregate recoverable pertaining to that reinsurer; and

b. If the individual reinsurer is part of a group, list the individual reinsurers, each of its related group members having reinsurance with the reporting entity, and the total unsecured aggregate recoverables for the entire group.

~~69.~~73. Reinsurance Recoverables in Dispute—Reinsurance recoverable on paid and unpaid (including IBNR) losses in dispute by reason of notification, arbitration or litigation shall be identified if the amounts in dispute from any entity (and/or affiliate) exceed 5% of the ceding entity’s policyholders surplus or if the aggregate of all disputed items exceeds 10% of the ceding entity’s policyholders surplus. Notification means a formal written communication from a reinsurer denying the validity of coverage.

~~70.~~74. Uncollectible Reinsurance—Describe uncollectible reinsurance written off during the year reported in the following annual statement classifications, including the name(s) of the reinsurer(s):

a. Losses incurred;

b. Loss adjustment expenses incurred;

c. Premiums earned; and

d. Other.

~~71.~~75. Commutation of Ceded Reinsurance—Describe commutation of ceded reinsurance during the year reported in the following annual statement classifications, including the name(s) of the reinsurer(s):

a. Losses incurred;

b. Loss adjustment expenses incurred;

c. Premiums earned; and

d. Other.

~~72.~~76. Retroactive Reinsurance—The table illustrated in the NAIC Annual Statement Instructions for Property and Casualty Companies under Retroactive Reinsurance in the Notes to Financial Statements section shall be completed for all retroactive reinsurance agreements that transfer liabilities for losses that have already occurred and that will generate special surplus transactions. The insurer (assuming or ceding) shall assign a unique number to each retroactive reinsurance agreement and shall utilize this number for as long as the agreement exists. Transactions utilizing deposit accounting shall not be reported in this note.

~~73.~~77. Reinsurance Assumed and Ceded—The tables illustrated in the NAIC Annual Statement Instructions for Property and Casualty Companies under "Reinsurance Assumed and Ceded in the Notes to Financial Statements" section shall be completed as follows:

a. The financial statements shall disclose the maximum amount of return commission which would have been due reinsurers if all reinsurance were canceled with the return of the unearned premium reserve; and

b. The financial statements shall disclose the accrual of additional or return commission, predicated on loss experience or on any other form of profit sharing arrangements as a result of existing contractual arrangements.

~~74.~~78. A specific interrogatory requires information on reinsurance of risk accompanied by an agreement to release the reinsurer from liability, in whole or in part, from any loss that may occur on the risk or portion thereof.

~~75.~~79. Disclosures for paragraphs ~~76-81~~ 80-85 represent annual statement interrogatories, which are required to be included with the annual audit report beginning with audit reports on financial statements as of and for the period ended December 31, 2006. The disclosures required within paragraphs ~~76-81~~80-85 shall be included in accompanying supplemental schedules of the annual audit report beginning in year-end 2006. These disclosures shall be limited to reinsurance contracts entered into, renewed or amended on or after January 1, 1994. This limitation applies to the annual audit report only and does not apply to the statutory annual statement interrogatories and the reinsurance summary supplemental filing.

~~76.~~80. Disclose if any risks are reinsured under a quota share reinsurance contract with any other entity that includes a provision that would limit the reinsurer's losses below the stated quota share percentage (e.g. a deductible, a loss ratio corridor, a loss cap, an aggregate limit or any similar provisions)? If yes, indicate the number of reinsurance contracts containing such provisions and if the amount of reinsurance credit taken reflects the reduction in quota share coverage caused by any applicable limiting provision(s).

~~77.~~81. Disclose if the reporting entity ceded any risk under any reinsurance contract (or under multiple contracts with the same reinsurer or its affiliates) for which during the period covered by the statement: (i) it recorded a positive or negative underwriting result greater than 5% of prior year-end surplus as regards policyholders or it reported calendar year written premium ceded or year-end loss and loss expense reserves ceded greater than 5% of prior year-end surplus as regards policyholders; (ii) it accounted for that contract as reinsurance and not as a deposit; and (iii) the contract(s) contain one or more of the following features or other features that would have similar results:

a. A contract term longer than two years and the contract is noncancellable by the reporting entity during the contract term;

b. A limited or conditional cancellation provision under which cancellation triggers an obligation by the reporting entity, or an affiliate of the reporting entity, to enter into a new reinsurance contract with the reinsurer, or an affiliate of the reinsurer;

c. Aggregate stop loss reinsurance coverage;

d. A unilateral right by either party (or both parties) to commute the reinsurance contract, whether conditional or not, except for such provisions which are only triggered by a decline in the credit status of the other party;

e. A provision permitting reporting of losses, or payment of losses, less frequently than on a quarterly basis (unless there is no activity during the period); or

f. Payment schedule, accumulating retentions from multiple years or any features inherently designed to delay timing of the reimbursement to the ceding entity.

~~78.~~82. Disclose if the reporting entity during the period covered by the statement ceded any risk under any reinsurance contract (or under multiple contracts with the same reinsurer or its affiliates) for which during the period covered by the statement it recorded a positive or negative underwriting result greater than 5% of prior year-end surplus as regards policyholders or it reported calendar year written premium ceded or year-end loss and loss expense reserves ceded greater than 5% of prior year-end surplus as regards policyholders; excluding cessions to approved pooling arrangements or to captive insurance companies that are directly or indirectly controlling, controlled by, or under common control with (i) one or more unaffiliated policyholders of the reporting entity, or (ii) an association of which one or more unaffiliated policyholders of the reporting entity is a member, where:

a. The written premium ceded to the reinsurer by the reporting entity or its affiliates represents fifty percent (50%) or more of the entire direct and assumed premium written by the reinsurer based on its most recently available financial statement; or

b. Twenty–five percent (25%) or more of the written premium ceded to the reinsurer has been retroceded back to the reporting entity or its affiliates in separate reinsurance contract.

~~79.~~83. If affirmative disclosure is required for paragraph ~~77~~ 81 or ~~78~~82, provide the following information:

a. A summary of the reinsurance contract terms and indicate whether it applies to the contracts meeting paragraph ~~77~~ 81 or ~~78~~82;

b. A brief discussion of management's principal objectives in entering into the reinsurance contract including the economic purpose to be achieved; and

c. The aggregate financial statement impact gross of all such ceded reinsurance contracts on the balance sheet and statement of income.

~~80.~~84. Except for transactions meeting the requirements of paragraph 31 of *SSAP No. 62R—Property and Casualty Reinsurance*, disclose if the reporting entity ceded any risk under any reinsurance contract (or multiple contracts with the same reinsurer or its affiliates) during the period covered by the financial statement, and either:

a. Accounted for that contract as reinsurance (either prospective or retroactive) under statutory accounting principles (SAP) and as a deposit under generally accepted accounting principles (GAAP); or

b. Accounted for that contract as reinsurance under GAAP and as a deposit under SAP.

~~81.~~85. If affirmative disclosure is required for paragraph ~~80~~84, explain in a supplemental filing why the contract(s) is treated differently for GAAP and SAP.

86. Disclosures for the Transfer of Property and Casualty Run-off Agreements

a. Disclose if the reporting entity has entered into any agreements which have been approved by their domiciliary regulator and have qualified pursuant to SSAP No. 62R, subparagraph 31.e., Accounting for the Transfer of Property and Casualty Run-off Agreements.

b. If affirmative, provide a description of the agreement and the amount of consideration paid and liabilities transferred.

~~82.~~87. Refer to the preamble for further discussion regarding disclosure requirements.

Relevant Literature

~~83.~~88. This statement adopts *FASB Statement No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts* (FAS 113) with modification and FASB *Emerging Issues Task Force No. 93-6, Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises* with modification for the following:

a. Reinsurance recoverables on unpaid case-basis and incurred but not reported losses and loss adjustment expenses shall be reported as a contra-liability netted against the liability for gross losses and loss adjustment expenses;

b. Amounts paid for prospective reinsurance that meet the conditions for reinsurance accounting shall be reported as a reduction of unearned premiums;

c. The gain created by a retroactive reinsurance agreement because the amount paid to the reinsurer is less than the gross liabilities for losses and loss adjustment expenses ceded to the reinsurer is reported in the statement of income as a write-in gain in other income by the ceding entity and a write-in loss by the assuming entity. The gain created by a retroactive reinsurance agreement is restricted as a special surplus account until the actual retroactive reinsurance recovered is in excess of the consideration paid;

d. This statement requires that a liability be established through a provision reducing unassigned funds (surplus) for unsecured reinsurance recoverables from unauthorized reinsurers and for certain overdue balances due from authorized reinsurers;

e. Some reinsurance agreements contain adjustable features that provide for adjustment of commission, premium or amount of coverage, based on loss experience. This statement requires that the asset or liability arising from the adjustable feature be computed based on experience to date under the agreement, and the impact of early termination may only be considered at the time the agreement has actually been terminated;

f. Structured settlements are addressed in *SSAP No. 65—Property and Casualty Contracts*. Statutory accounting and FAS 113 are consistent in accounting for structured settlement annuities where the reporting entity is the owner and payee and where the claimant is the payee and the reporting entity has been released from its obligation. FAS 113 distinguishes structured settlement annuities where the claimant is the payee and a legally enforceable release from the reporting entity's liability is obtained from those where the claimant is the payee but the reporting entity has not been released from its obligation. GAAP requires the deferral of any gain resulting from the purchase of a structured settlement annuity where the reporting entity has not been released from its obligation; and

g. This statement requires that reinsurance recoverables on unpaid losses and loss adjustment expenses be presented as a contra-liability. Requirements for offsetting and netting are addressed in SSAP No. 64.

~~84.~~89. This statement rejects AICPA *Statement of Position No. 92-5, Accounting for Foreign Property and Liability Reinsurance*. This statement incorporates Appendix A-785 as applicable.

Effective Date and Transition

~~85.~~90. This statement shall apply to:

a. Reinsurance agreements entered into, renewed, or amended on or after January 1, 1994. An amendment is any revision or adjustment of contractual terms. The payment of premiums or reimbursement of losses recoverable under the agreement shall not constitute an amendment; and

b. Reinsurance agreements in force on January 1, 1995, which cover losses occurring or claims made on or after that date on policies reinsured under such agreements.

~~86.~~91. The guidance shall not apply to:

a. Reinsurance agreements which cover only losses occurring or claims made before January 1, 1994, and which were entered into before January 1, 1994, and were not subsequently renewed or amended; and

b. Reinsurance agreements that expired before and were not renewed or amended after January 1, 1995.

~~87.~~92. The guidance in paragraphs 48 through 52 shall be effective for all accounting periods beginning on or after January 1, 1996, and shall apply to reinsurance agreements entered into, renewed or amended on or after January 1, 1994.

93. ~~88~~This statement is effective for years beginning January 1, 2001. Changes resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*. Revisions to subparagraph 31.e., related paragraphs 68-71, and new disclosures in paragraph 86 documented in *Issue Paper No. 137—Transfer of Property and Casualty Reinsurance Run-off Agreements* are effective for contracts entered on or after January 1, 2010.

AUTHORITATIVE LITERATURE

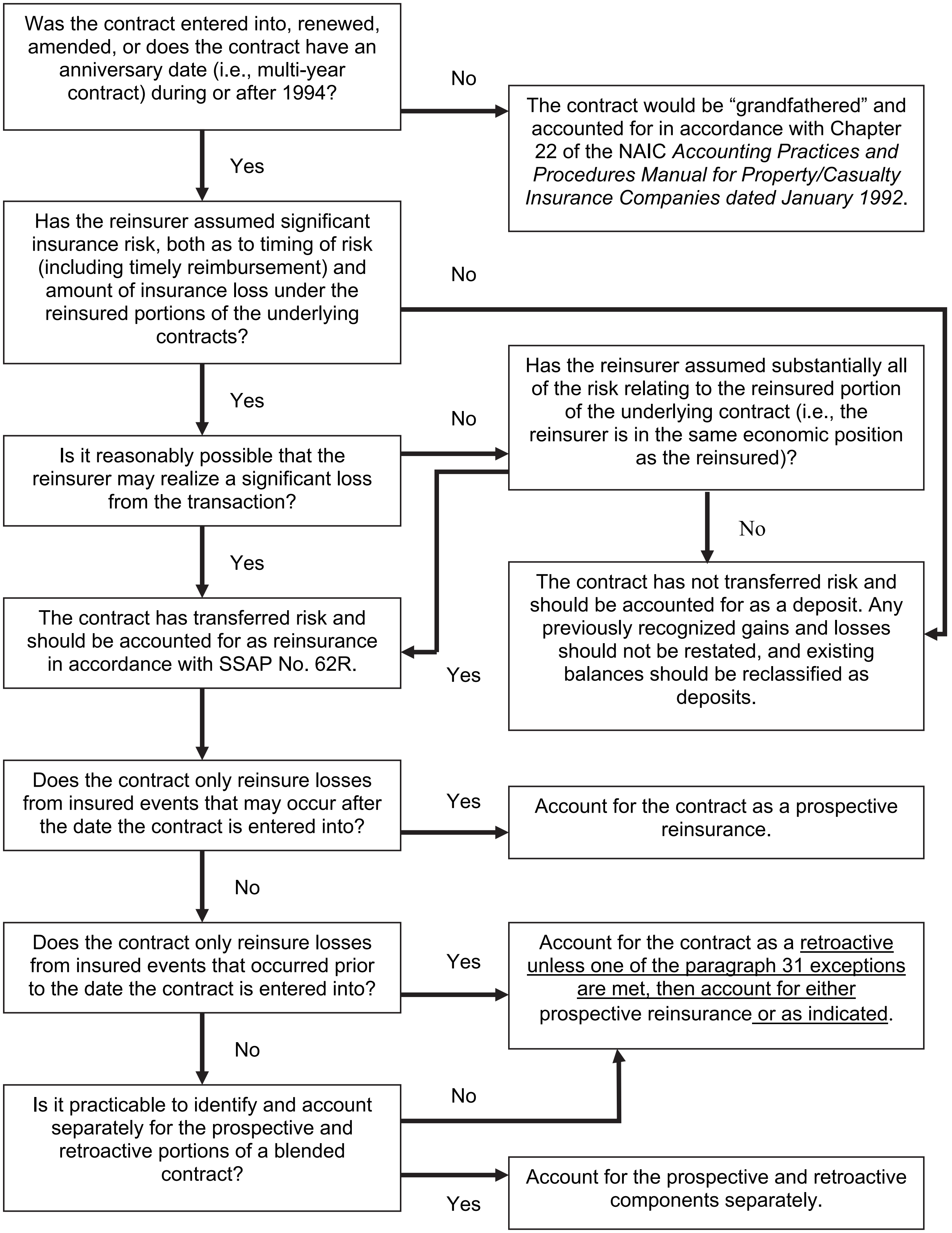
Generally Accepted Accounting Principles

- *FASB Statement No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*
- *FASB Emerging Issues Task Force Issue No. 93-6, Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises*

RELEVANT ISSUE PAPERS

- *Issue Paper No. 75—Property and Casualty Reinsurance*
- *Issue Paper No. 137—Transfer of Property and Casualty Reinsurance Run-off Agreements*

CLASSIFYING REINSURANCE CONTRACTS


Was the contract entered into, renewed, amended, or does the contract have an anniversary date (i.e., multi-year contract) during or after 1994?
No
The contract would be "grandfathered" and accounted for in accordance with Chapter 22 of the NAIC *Accounting Practices and Procedures Manual for Property/Casualty Insurance Companies dated January 1992*.
Yes
Has the reinsurer assumed significant insurance risk, both as to timing of risk (including timely reimbursement) and amount of insurance loss under the reinsured portions of the underlying contracts?
No
Yes
Has the reinsurer assumed substantially all of the risk relating to the reinsured portion of the underlying contract (i.e., the reinsurer is in the same economic position as the reinsured)?
No
Is it reasonably possible that the reinsurer may realize a significant loss from the transaction?
No
Yes
The contract has not transferred risk and should be accounted for as a deposit. Any previously recognized gains and losses should not be restated, and existing balances should be reclassified as deposits.
The contract has transferred risk and should be accounted for as reinsurance in accordance with SSAP No. 62R.
Yes
Does the contract only reinsure losses from insured events that may occur after the date the contract is entered into?
Yes
Account for the contract as a prospective reinsurance.
No
Does the contract only reinsure losses from insured events that occurred prior to the date the contract is entered into?
Yes
Account for the contract as a retroactive unless one of the paragraph 31 exceptions are met, then account for either prospective reinsurance or as indicated.
No
Is it practicable to identify and account separately for the prospective and retroactive portions of a blended contract?
No
Yes
Account for the prospective and retroactive components separately.

SSAP NO. 62R—EXHIBIT A

Implementation Questions and Answers

Applicability

1. Q: The accounting practices in SSAP No. 62R specify the accounting and reporting for reinsurance contracts. What contracts are considered reinsurance contracts for purposes of applying these accounting practices?

   A: Any transaction that indemnifies an insurer against loss or liability relating to insurance risk shall be accounted for in accordance with the accounting practices included in SSAP No. 62R. Therefore, all contracts, including contracts that may not be structured or described as reinsurance, shall be accounted for as reinsurance when those conditions are met.

2. Q: The provisions of this statement will apply to (a) reinsurance contracts entered into, renewed or amended on or after January 1, 1994, and (b) any other reinsurance contracts that are in force on January 1, 1995 and cover insurable events on the underlying insurance policies that occur on or after that date. What contracts would be exempt from the new accounting rules included in SSAP No. ~~62~~62R?

   A: The only exempt contracts are:

   1) Purely retroactive reinsurance contracts that cover only insured events occurring before January 1, 1994, provided those contracts were entered into before that date and are not subsequently amended and

   2) Contracts that expired before January 1, 1995 and are not amended after that date.

3. Q: This statement is to be applied to contracts which are amended on or after January 1, 1994. What if the change in terms is not significant, or the terms changed have no financial effect on the contract?

   A: In general, the term amendment should be viewed broadly to include all but the most trivial changes. Examples of amendments include, but are not limited to, replacing one assuming entity with another (including an affiliated entity), or modifying the contract's limit, coverage, premiums, commissions, or experience-related adjustable features. No distinction is made between financial and non-financial terms.

4. Q: Must the accounting provisions of SSAP No. ~~62~~62R be applied to an *otherwise exempt* contract if the ceding entity pays additional premiums under the contract on or after January 1, 1994?

   A: The answer depends on why the additional premiums are paid. If the additional premiums are the result of a renegotiation, adjustment, or extension of terms, the contract is subject to the accounting provisions of SSAP No. ~~62~~62R. However, additional premiums paid without renegotiation, adjustment, or extension of terms would not make an otherwise exempt contract subject to those provisions.

5. Q: Prospective and retroactive portions of a reinsurance contract are allowed to be accounted for separately, if practicable. Can the retroactive portion of an existing contract be segregated and, therefore, exempted with other retroactive contracts covering insured events occurring prior to January 1, 1994?

   A: No. The transition provisions apply to an entire contract, which is either subject to or exempt from the revised provisions of SSAP No. ~~62~~62R. A ceding entity may bifurcate a contract already subject to the new accounting rules in SSAP No. ~~62~~62R and then account for both the prospective and retroactive portions in accordance with the new accounting standard.

Risk Transfer

6. Q: Do the new risk transfer provisions apply to existing contracts?

A: Yes, the new risk transfer provisions apply to some existing contracts. SSAP No. ~~62~~62R applies in its entirety only to existing contracts which were renewed or amended on or after January 1, 1994, or which cover losses occurring or claims made after that date. Therefore, those contracts must be evaluated to determine whether they transfer risk and qualify for reinsurance accounting. For accounting periods commencing on or after January 1, 1995, balances relating to such contracts which do not transfer insurance risk shall be reclassified as deposits and shall be accounted for and reported in the manner described under the caption Reinsurance Contracts Must Include Transfer of Risk.

SSAP No. ~~62~~62R does not apply to existing contracts which were entered into before, and were not renewed or amended on or after, January 1, 1994, and which cover only losses occurring or claims made before that date, nor to contracts which expired before, and were not renewed or amended on or after, January 1, 1995. Those contracts will continue to be accounted for in the manner provided by SSAP No. ~~62~~62R before these revisions.

7. Q: How does the effective date affect the assessment of whether a significant loss to the reinsurer was reasonably possible?

A: The risk transfer assessment is made at contract inception, based on facts and circumstances known at the time. Because that point in time has passed for existing contracts, some have suggested that the risk transfer provisions be applied as of the effective date. However, that approach to the risk transfer assessment would violate the requirement to consider all cash flows from the contract. Therefore, the test must be applied from contract inception, considering the effect of any subsequent contract amendments. Careful evaluation and considered judgment will be required to determine whether a significant loss to the reinsurer was reasonably possible at inception.

8. Q: Should risk transfer be reassessed if contractual terms are subsequently amended?

A: Yes. When contractual terms are amended, risk transfer should be reassessed. For example, a contract that upon inception met the conditions for reinsurance accounting could later be amended so that it no longer meets those conditions. The contract should then be reclassified and accounted for as a deposit.

9. Q: How should the risk transfer assessment be made when a contract has been amended?

A: No particular method is prescribed for assessing risk transfer in light of a contract amendment. Whether an amended contract in substance transfers risk must be determined considering all of the facts and circumstances in light of the risk transfer requirements. Judgment also will be required to determine whether an amendment in effect creates a new contract.

10. Q: For purposes of evaluating whether a contract with a reinsurer transfers risk, what constitutes a contract?

A: A contract is not defined, but is essentially a question of substance. It may be difficult in some circumstances to determine the boundaries of a contract. For example, the profit-sharing provisions of one contract may refer to experience on other contracts and, therefore, raise the question of whether, in substance, one contract rather than several contracts exist.

The inconsistency that could result from varying interpretations of the term *contract* is limited by requiring that features of the contract or other contracts or agreements that directly or indirectly compensate the reinsurer or related reinsurers for losses be considered in evaluating whether a particular contract transfers risk. Therefore, if agreements with the reinsurer or related reinsurers, in the aggregate, do not transfer risk, the individual contracts that make up those agreements also would not be considered to transfer risk, regardless of how they are structured.

11. Q: If the assessment of risk transfer changes after the initial assessment at contract inception, how should the ceding entity account for the change?

A: The status of a contract should be determinable at inception and, absent amendment, subsequent changes should be very rare. If the risk of significant loss was not deemed reasonably possible at inception, and a significant loss subsequently occurred, the initial assessment was not necessarily wrong, because remote events do occur. Likewise, once a reasonable possibility of significant loss has been established, such loss need not occur in order to maintain the contract's status as reinsurance.

12. Q: SSAP No. ~~62~~62R requires that reasonably possible outcomes be evaluated to determine the reinsurer's exposure to significant loss. What factors should be considered in determining whether a scenario being evaluated is reasonably possible?

A: The term *reasonably possible* means that the probability is more than remote. The test is applied to a particular scenario, not to the individual assumptions used in the scenario. Therefore, a scenario is not reasonably possible unless the likelihood of the entire set of assumptions used in the scenario occurring together is reasonably possible.

13. Q: In determining the amount of the reinsurer's loss under reasonably possible outcomes, may cash flows directly related to the contract other than those between the ceding and assuming companies, such as taxes and operating expenses of the reinsurer, be considered in the calculation?

A: No. The evaluation is based on the present value of all cash flows *between the ceding and assuming enterprises* under reasonably possible outcomes and, therefore, precludes considering other expenses of the reinsurer in the calculation.

14. Q: In evaluating the significance of a reasonably possible loss, should the reasonably possible loss be compared to gross or net premiums?

A: Gross premiums should be used.

15. Q: How does a commutation clause affect the period of time over which cash flows are evaluated for reasonable possibility of significant loss to the reinsurer?

A: All cash flows are to be assessed under reasonably possible outcomes. Therefore, unless commutation is expected in the scenario being evaluated, it should not be assumed in the calculation. Further, the assumptions used in a scenario must be internally consistent and economically rational in order for that scenario's outcome to be considered reasonably possible.

16. Q: What interest rate should be used in each evaluated scenario to make the present value calculation?

A: A reasonable and appropriate rate is required, which generally would reflect the expected timing of payments to the reinsurer and the duration over which those cash flows are expected to be invested by the reinsurer.

17. Q: SSAP No. ~~62~~62R refers to payment schedules and accumulating retentions from multiple years as features that delay timely reimbursement of claims. Does the presence of those

features generally prevent a contract from meeting the conditions for reinsurance accounting?

A: Yes. Payment schedules and accumulating retentions from multiple years are contractual features inherently designed to delay the timing of reimbursement to the ceding entity. Regardless of what a particular feature might be called, any feature that can delay timely reimbursement violates the conditions for reinsurance accounting. Transfer of insurance risk requires that the reinsurer's payments to the ceding entity depend on and directly vary with the amount and timing of claims settled under the reinsured contracts. Contractual features that can delay timely reimbursement prevent this condition from being met. Therefore, any feature that may affect the timing of the reinsurer's reimbursement to the ceding entity should be closely scrutinized.

18. Q: What if a contract contains a feature such as a payment schedule or accumulating retention but could still result in the reasonable possibility of significant loss to the reinsurer?

A: Both of the following conditions are required for reinsurance accounting:

a. Transfer of significant risk arising from uncertainties about both (i) the ultimate amount of net cash flows from premiums, commission, claims, and claim settlement expenses paid under a contract (underwriting risk) and (ii) the timing of the receipt and payment of those cash flows (timing risk); and

b. Reasonable possibility of significant loss to the reinsurer.

Because both condition (a) and condition (b) must be met, failure to transfer significant timing and underwriting risk is not overcome by the possibility of significant loss to the reinsurer.

19. Q: Is it permissible to evaluate timely reimbursement on a present value basis?

A: No. The word timely is used in the ordinary temporal sense to refer to the length of time between payment of the underlying reinsured claims and reimbursement by the reinsurer.

While the test for reasonable possibility of significant loss to the reinsurer provides for a present value-based assessment of the economic characteristics of the reinsurance contract, the concept of timely reimbursement relates to the transfer of insurance risk (condition a above), not the reasonable possibility of significant loss (condition b above). Accordingly, timely reimbursement should be evaluated based solely on the length of time between payment of the underlying reinsured losses and reimbursement by the reinsurer.

20. Q: Are there any circumstances under which the conditions for risk transfer need not be met?

A: Yes. An extremely narrow and limited exemption is provided for contracts that reinsure either an individual risk or an underlying book of business that is inherently profitable. When substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts has been assumed by the reinsurer, the contract meets the conditions for reinsurance accounting. To qualify under this exception, no more than trivial insurance risk on the reinsured portions of the underlying insurance contracts may be retained by the ceding entity. The reinsurer's economic position must be virtually equivalent to having written the relevant portions of the reinsured contracts directly.

21. Q: In determining whether a reinsurance contract qualifies under the exception referred to in the preceding question, how should the economic position of the reinsurer be assessed in relation to that of the ceding entity?

A: The assessment should be made by comparing the net cash flows of the reinsurer under the reinsurance contract with the net cash flows of ceding entity on the reinsured portions of the underlying insurance contracts. This may be relatively easy for reinsurance of individual risks or for unlimited-risk quota-share reinsurance, because the premiums and losses on these types of reinsurance generally are the same as the premiums and losses on the reinsured portions of the underlying insurance policies.

In other types of reinsurance, determining the reinsurer's net cash flows relative to the insurer is likely to be substantially more difficult. For example, it generally would be difficult to demonstrate that the ceding entity's premiums and losses for a particular layer of insurance are the same as the reinsurer's premiums and losses related to that layer. If the economic position of the reinsurer relative to the insurer cannot be determined, the contract would not qualify under the exception.

Accounting Provisions

22. Q: An existing contract that was accounted for as reinsurance no longer qualifies for reinsurance accounting under the new accounting rules included in SSAP No. ~~62~~62R. How should the ceding and assuming companies account for the contract in future periods?

A: Because the statement of income cannot be restated, previously recognized gains and losses are not revised. If the contract was entered into before, and not renewed or amended on or after, January 1, 1994 and covers only losses occurring or claims made before that date, or the contract expired before January 1, 1995 and was not renewed or amended on or after that date, it would continue to be accounted for in the manner provided before these revisions.

For accounting periods commencing on or after January 1, 1995, existing balances relating to contracts which do not transfer insurance risk and which were entered into on or after January 1, 1994 (covering losses occurring or claims made after that date) would be reclassified as deposits.

Premium payments to a reinsurer would be recorded as deposits. Likewise, losses recoverable from a reinsurer would not be recognized as receivables. Rather, any reimbursement for losses would be accounted for upon receipt as a refund of a deposit.

23. Q: What is the definition of past insurable events that governs whether reinsurance coverage is prospective or retroactive? For example, could a reinsurance contract that covers losses from asbestos and pollution claims on occurrence-based insurance policies effective during previous periods be considered prospective if the reinsurance coverage is triggered by a court interpretation that a loss is covered within the terms of the underlying insurance policies?

A: The distinction between prospective and retroactive reinsurance is based on whether a contract reinsures future or past insured events covered by the underlying reinsurance contracts. In the example above, the insured event is the occurrence of loss within the coverage of the underlying insurance contracts, not the finding of a court. Therefore, the fact that the asbestos exposure or pollution is covered under insurance policies effective during prior periods makes the reinsurance coverage in this example retroactive.

24. Q: Would the answer to the above question change if the reinsurance were written on a claims-made basis?

A: No. The form of the reinsurance—whether claims-made or occurrence-based—does not determine whether the reinsurance is prospective or retroactive. A claims-made reinsurance contract that reinsures claims asserted to the reinsurer in a future period as a result of insured events that occurred prior to entering into the reinsurance contract is a retroactive contract.

25. Q: What is the effect of adjustments to future premiums or coverage in determining whether reinsurance is prospective or retroactive?

A: Adjustments to future premiums or coverage may affect the accounting for a reinsurance contract. Whenever an adjustment results in a reinsurer providing new or additional coverage for past insurable events, that coverage is retroactive. For example, if subsequent years' premiums under a multiple accident year contract create additional coverage for previous accident years, the additional coverage is retroactive, even if the original coverage provided in the contract for those accident years was prospective. Likewise, if current losses under a multiple-year contract eliminate coverage in future periods, some or all of the premiums to be paid in those future periods should be charged to the current period.

26. Q: A reinsurance contract is entered into after the contract's effective date. Is the coverage between the contract's effective date and the date the contract was entered into prospective or retroactive?

A: The portion of the contract related to the period of time between the effective date of the contract and the date the contract was entered into is retroactive because it covers insured events that occurred prior to entering into the reinsurance contract.

27. Q: How is the date the reinsurance contract was entered into determined?

A: It is not uncommon for a reinsurance arrangement to be initiated before the beginning of a policy period but not finalized until after the policy period begins. Whether there was agreement in principle at the beginning of the policy period and, therefore, the contract is substantively prospective must be determined based on the facts and circumstances. For example, a contract may be considered to have been substantively entered into even though regulatory approval of that contract has not taken place.

The absence of agreement on significant terms, or the intention to establish or amend those terms at a later date based on experience or other factors, generally indicates that the parties to the contract have not entered into a reinsurance contact, but rather have agreed to enter into a reinsurance contract at a future date. If contractual provisions under a contract substantively entered into at a future date covered insurable events prior to that date, that coverage is retroactive.

In any event, SSAP No. ~~62~~62R provides that if a contract (except facultative contracts and contracts signed by the lead reinsurer and certain cover notes or similar documents signed by reinsurers representing more than 50% of the capacity on the contract) has not been finalized, reduced to written form and signed by the parties within 9 months after its effective date, it is presumed to be retroactive.

28. Q: Are contracts to reinsure calendar-year incurred losses considered blended contracts that have both prospective and retroactive elements?

A: Yes. Most reinsurance contracts covering calendar-year incurred losses combine coverage for insured events that occurred prior to entering into the reinsurance contract with coverage for future insured events and, therefore, include both prospective and retroactive elements.

In any event, SSAP No. ~~62~~62R provides that if a contract (except facultative contracts, contracts signed by the lead reinsurer and certain cover notes or similar documents signed by reinsurers representing more than 50% of the capacity on the contract) has not been finalized, reduced to written form and signed by the parties within 9 months after its effective date it is presumed retroactive.

29. Q: When the prospective and retroactive portions of a contract are being accounted for separately, how should premiums be allocated to each portion of the contract?

A: No specific method for allocating the reinsurance premiums to the risks covered by the prospective and retroactive portions of a contract is required. However, separate accounting for the prospective and retroactive portions of a contract may take place only when an allocation is practicable.

Practicability requires a reasonable basis for allocating the reinsurance premiums to the risks covered by the prospective and retroactive portions of the contract, considering all amounts paid or deemed to have been paid regardless of the timing of payment. If a reasonable basis for allocating the premiums between the prospective and retroactive coverage does not exist, the entire contract must be accounted for as a retroactive contract.

30. Q: A retroactive reinsurance contract contains a cut-through provision that provides the ceding entity's policyholders and claimants with the right to recover their claims directly from the reinsurer. May the ceding entity immediately recognize earned surplus associated with this type of contract?

A: No. SSAP No. ~~62~~62R states that earned surplus may not be recognized "until the actual retroactive reinsurance recovered exceeds the consideration paid."

31. Q: A ceding entity enters into a retroactive reinsurance agreement that gives rise to segregated surplus. If the reinsurer prepays its obligation under the contract, may the ceding entity recognize earned surplus at the time the prepayment is received?

A: Segregated surplus arising from retroactive reinsurance transactions is earned as actual liabilities that have been transferred are recovered or terminated. Therefore, earned surplus is based on when the reinsurer settles its obligations to the ceding entity, and it may be appropriate to recognize earned surplus at the time the prepayment is received.

However, all of the facts and circumstances must be considered to determine whether the ceding entity has substantively recovered the liabilities transferred to the reinsurer. For example, if the ceding entity agrees to compensate the reinsurer for the prepayment, such as by crediting the reinsurer with investment income on prepaid amounts or balances held, the ceding entity has not, in substance, recovered its transferred liabilities but rather has received a deposit from the reinsurer that should be accounted for accordingly.

32. Q: If the ceding entity does not expect to receive any recoveries because the reinsurer has agreed to reimburse claimants under the reinsured contracts directly, would the ceding entity be considered to have recovered or terminated its transferred liabilities?

A: No. In the example given, the reinsurer is substantively acting as disbursing agent for the ceding entity. Therefore, the ceding entity cannot be said to have recovered amounts due from the reinsurer before payment is made to the claimant.

33. Q: What accounting entries would a ceding entity make to report a retroactive reinsurance contract?

A: Accounting Entries for a Ceding Entity to Report a Retroactive Reinsurance Contract:

Entry 1

Retroactive Reinsurance Reserves		
Ceded or Assumed (B/S)	10,000	
Retroactive Reinsurance Gain (I/S)		2,000
Cash		8,000

To record initial portfolio transfer see items #3 and #8. The ceding entity must establish the segregated surplus per item #4.

Entry 1A

Retro. Reins. Gain	2,000	
Profit/Loss Account		2,000

To close gain from retroactive transaction.

Entry 1B

Profit/Loss Account	2,000	
Special Surplus from Retro. Reins.		2,000

To close profit from retroactive reinsurance to special surplus.

Entry 2

Cash	2,000	
Retroactive Reinsurance Reserves Ceded or Assumed (B/S)		2,000

To record recovery of paid losses from the reinsurer. Outstanding ceded reserves after this recovery equals $8,000, and special surplus from retroactive reinsurance account equals $2,000; therefore, segregated surplus account is not changed per item #10.

Entry 3

Retroactive Reinsurance Reserves Ceded or Assumed (B/S)	3,000	
Retroactive Reinsurance Gain (I/S)		3,000

To record subsequent revision of the initial reserves ceded per item #10. The segregated surplus account is increased to $5,000 as a result of this upward development.

Entry 3A

Retro. Reinsurance Gain	3,000	
Profit/Loss Account		3,000

To close profit from retroactive reinsurance.

Entry 3B

Profit/Loss (I/S)	3,000	
Special Surplus from Retro. Reins.		3,000

To close profit and loss account to special surplus. (Retroactive reinsurance reserves ceded or assumed account balance equals $11,000. Special Surplus from retroactive reinsurance balance equals $5,000.)

Entry 4

Cash	4,000	
Retroactive Reinsurance Reserves Ceded or Assumed (B/S)		4,000

To record recovery of paid losses from the reinsurer. Outstanding ceded reserves after this recovery equals $7,000, therefore segregated surplus account is not changed per item #10.

Entry 5

Cash	3,000	
Retroactive Reinsurance Reserves Ceded or Assumed (B/S)		3,000

To record recovery of paid losses from reinsurer. Outstanding ceded reserves after recovery equals $4,000, therefore the following entry is needed per items #6 and #10.

Entry 5A

Special Surplus—Retro. Reins.	1,000	
Unassigned Funds		1,000

Retroactive Reinsurance reserves ceded or assumed after this entry equals $4,000.

Entry 6

Retroactive Reinsurance Loss (I/S)	1,000	
Retroactive Reinsurance Reserves Ceded or Assumed (B/S)		1,000

To record subsequent revision of the initial reserves ceded per item #10. The segregated surplus account is decreased as a result of this downward development to $3,000. The following entry is needed per items #6 and #10.

Entry 6A

Profit/Loss Account	1,000	
Retro. Reins. Loss		1,000

To close loss to profit and loss account.

Entry 6B

Special Surplus from Retro. Reins.	1,000	
Profit/Loss Account		1,000

To close profit and loss account to special surplus. (Remaining balance of retroactive reinsurance reserve ceded or assumed account equals $3,000.) (Special surplus from retro. reins. account balance equals $3,000.)

Entry 7

Cash	2,500	
Retroactive Reinsurance Gain (I/S)	500	
Retroactive Reinsurance Reserves Ceded or Assumed (B/S)		3,000

Entry 7A

Profit and Loss Account	500	
Retro. Reins. Gain		500

To close other income to profit and loss account.

Entry 7B

Special Surplus from Retro. Reins.	500	
Profit/Loss Account		500

To close profit and loss account to special surplus. (Remaining balance of special surplus from retro. reins. account equals $2,500.) (Remaining balance of retroactive reinsurance reserve ceded or assumed account -0-.)

Entry 7C

Special Surplus from Retro. Reins.	2,500	
Unassigned Funds		2,500

To close remaining special surplus account to unassigned surplus.

34. Q: How should the parties account for an adverse loss development reinsurance contract where, as of the statement date, the attachment level of the contract exceeds the ceding company's current case and IBNR reserves for the covered accident years (i.e. no surplus gain and no reinsurance recoverable as of the statement date), and the ceding company transferred cash to the reinsurer at the inception of the contract?

A: An adverse loss development reinsurance contract covering prior accident years meets the definition of "retroactive reinsurance" set forth in paragraph 22 of SSAP No. ~~62~~62R:

> ….reinsurance in which a reinsurer agrees to reimburse a ceding entity for liabilities incurred as a result of past insurable events covered under contracts subject to the reinsurance….

Subparagraph 29.k. of SSAP No. ~~62~~62R specifically provides that the consideration paid for a retroactive reinsurance contract is to be recorded as a decrease in ledger assets by the ceding entity and an increase in ledger assets by the assuming entity.

Question 33 illustrates the accounting entries for retroactive reinsurance contracts.

If the retroactive reinsurance contract transfers both components of insurance risk then, pursuant to paragraph 29 of SSAP No. ~~62~~62R, the ceding company would record the consideration paid as a decrease in ledger assets, recognize an expense for the reinsurance ceded through Other Income or Loss accounts as a write-in item identified as "Retroactive Reinsurance Ceded", and record the recoverable from the reinsurer as a contra liability.

No contra liability is established until and unless (and then only to the extent that) the ceding company establishes reserves which exceed the attachment point.

For the contract described, at inception no contra liability is recorded to offset current liability for the business ceded, since the ceded retroactive reinsurance premium relates to coverage in excess of the current liabilities recorded by the ceding company.

Once the ceding company's recorded liabilities exceed the attachment point of the adverse loss development reinsurance contract and triggers reinsurance recoverable from the reinsurer, a contra liability is established by the ceding company for the amount of the reinsurance recoverable. Any surplus resulting from the retroactive reinsurance is carried as a write-in item on the balance sheet designated as "Special Surplus from Retroactive Reinsurance Account." The surplus gain may not be classified as unassigned funds (surplus) until the actual retroactive reinsurance recovered exceeds the consideration paid.

If any portion of a retroactive reinsurance contract does not transfer insurance risk, then the portion which does not transfer risk is accounted for as a deposit pursuant to paragraph 35 of SSAP No. ~~62~~62R. The deposit is reported as an admitted asset of the ceding company if the reinsurer is licensed, accredited or otherwise qualified in the ceding company's state of domicile as described in Appendix A-785, or if there are funds held by or on behalf of the ceding company as described in that appendix. Receipts and disbursements under the contract are recorded through the deposit/liability accounts. Amounts received in excess of the deposit made are recognized as a gain in the Other Income or Loss account.

Accounting entries for a ceding entity to report a retroactive reinsurance contract at the inception of which the cedent's reserves are lower than the attachment point of the reinsurance coverage:

Assume the company pays $16m to purchase adverse development coverage of $50m, above an attachment point.

Entry 1: Payment of Retrospective Reinsurance Premium

Retrospective Reinsurance Expense*	$16m	
Cash		$16m

The company pays $16m premium for the retrospective reinsurance contract.
*This is an Other Expense item, it does not flow through Schedule F or Schedule P.

Entry 2: Adverse Development Reaches the Attachment Point

Losses Incurred	$25m	
Gross Loss Reserve		$25m
Recoverable on Retro Reinsurance Contract**	$25m	
Other Income*		$9m
Contra – Retro Reinsurance Expense*		$16m
Surplus***	$9m	
Segregated Surplus***		$9m

The company incurs $25m development on reserves related to the contract.
*These are Other Income/Expense items do not flow through Schedule F or Schedule P.
**A contra-liability write-in item, not netted against loss reserves.
***Surplus is segregated in the amount of [$25m - $16m = $9m] recoverables less consideration paid.

Entry 3: Cash is Recovered on Paid Losses

Cash	$20m	
Recoverable on Retrospective Reinsurance Contract		$20m
Segregated Surplus	$4m	
Surplus		$4m

The company recovers $20m cash from reinsurer on this retro contract. Segregated Surplus decreases in the amount of [$20m - $16m = $4m] (decreases for amount recovered in excess of consideration paid).

35. Q: How should a ceding company account for payment of the premium for a retroactive reinsurance contract by the ceding company's parent company or some other person not a party to the reinsurance contract (for example, adverse loss development reinsurance contracts purchased by the parent company in the context of the purchase or sale of the ceding company)?

A: If the reinsurance premium is not paid directly by the ceding company but is instead paid on behalf of the ceding company by the ceding company's parent company or some other entity not a party to the reinsurance contract, then the ceding company should (1) record an increase in gross paid in and contributed surplus in the amount of the reinsurance premium to reflect the contribution to surplus by the parent or third party payor, and (2) record an expense in the amount of the reinsurance premium and account for the contract as provided in Questions 33 and 34.

SSAP NO. 62R—EXHIBIT B

P&C Runoff Reinsurance Transactions

The following provides illustrative journal entries for P&C Runoff Reinsurance Transactions.

Example 1: Transfer of existing block of runoff business with no residual UPR on books of Transferor

Cedent/Transferor		**DR**	**CR**
Day 1 - Cedent transfers 50,000 in reserves for 50,000			
Ceded Reinsurance Recoverable (U&I Part 2A & Sch. F)	Contra Liab ↑	50,000	
Cash	Asset ↓		50,000
Losses Paid (U/W Part 2 & Sch. P)	I/S ↓	50,000	
Change in Reserves - Incurred Losses (U&I Part 2~~.~~)	I/S ↑		50,000
Unlike novation –gross reserves stay on books of transferor			
Day 360 - Negative Development on Transferred Business - 3,000~~:~~			
Reinsurance Recoverable on Unpaid Losses (Sch~~e~~. F)	Contra Liab ↑	3,000	
Reserves for Unpaid Losses (U&I Part 2A & Sch. P)	Liab ↑		3,000
Day 540 – Reinsurer Pays the Loss @ Reported Reserve			
Reserves for Unpaid Losses (U&I Part 2A & Sch. P)	Liab ↓	53,000	
Ceded Reinsurance Recoverable (U&I Part 2A & Sch. F)	Contra Liab ↓		53,000
Reinsurer/Transferee			
Day 1 - Cedent transfers 50,000 in reserves for 50,000			
Cash	Asset ↑	50,000	
Reported Losses on Reins. Assumed (U&I Part 2A & Sch. P)	Liab ↑		50,000
Change In Reserves – Incurred Losses (U&I Part 2)	I/S ↓	50,000	
Losses Paid or Incurred (negative) (U&I Part 2 &Sch. P)	I/S ↑		50,000
Day 360 - Negative Development on Transferred Business - 3,000:			
Change in Reserves – Incurred Losses (U&I Part 2)	I/S↓	3,000	
Reserves for Unpaid Losses (U&I Part 2A & Sch. P)	Liab ↑		3,000
Day 540 – Reinsurer Pays the Loss			
Reserves for Unpaid Losses (U&I Part 2A & Sch. P)	Liab ↓	53,000	
Cash	Asset ↓		53,000

Comments:
Since the Transferor is ceding incurred losses neither party should have premium impacted. To do that would distort many financial ratios.

Example 2: Transfer of existing block of runoff business with some residual UPR of 10,000 on books of Transferor (this should be less common).

Cedent/Transferor		**DR**	**CR**
Day 1 - Cedent transfers 50k in reserves & 10k UPR for 60,000			
Ceded Reinsurance Recoverable (U&I Part 2A & Sch. F)	Contra Liab ↑	50,000	
Unearned Premium Reserve (U&I Part 1& 1A)	Liab ↓	10,000	
Cash	Asset ↓		60,000
Ceded Premium Written (U&I Part 1B)	I/S ↓	10,000	
Losses Paid (U&I Part 2 & Sch. P)	I/S ↓	50,000	
Change in Reserves - Incurred Losses (U&I Part 2~~.~~)	I/S ↑		50,000
Change in UPR (U&I Part 1& 1A)	I/S ↑		10,000
Unlike novation –gross reserves stay on books of transferor			
Day 180 – Premium is Fully Earned (Assumes 80% Loss Ratio)			
Ceded Reinsurance Recoverable (U&I Part 2A & Sch. F)	Contra Liab ↑	8,000	
Reserves for Unpaid Losses (U&I Part 2A & Sch. P)	Liab ↑		8,000
To mirror the increase in unpaid losses by the transferee			
Day 360 - Negative Development on Transferred Business -3,000:			
Reinsurance Recoverable on Unpaid Losses (Sch. F)	Contra Liab ↑	3,000	
Reserves for Unpaid Losses (U&I Part 2A & Sch. P)	Liab ↑		3,000
Day 540 – Reinsurer Pays the Loss @ Reported Reserves (50+8+3)			
Reserves for Unpaid Losses (U&I Part 2A & Sch. P)	Liab ↓	61,000	
Ceded Reinsurance Recoverable (U&I Part 2A & Sch. F)	Contra Liab ↓		61,000

Reinsurer/ Transferee			
Day 1 - Cedent transfers 50k in reserves & 10k UPR for 60,000			
Cash	Asset ↑	60,000	
Reported Losses on Reins. Assumed (U&I Part 2A & Sch. P)	Liab ↑		50,000
Unearned Premium Reserve (U&I Part 1& 1A)	Liab ↑		10,000
Assumed Premium Written (U&I Part 1B)	I/S ↑		10,000
Change In Reserves – Incurred Losses (U&I Part 2)	I/S ↓	50,000	
Change in UPR (U&I Part 1& 1A)	I/S ↓	10,000	
Losses Paid or Incurred (negative) (U&I Part 2 &Sch. P)	I/S ↑		50,000
Day 180 – Premium is Fully Earned (Assumes 80% Loss Ratio)			
Unearned Premium Reserve (U&I Part 1& 1A)	Liab ↓	10,000	
Reserves for Unpaid Losses (U&I Part 2A & Sch. P)	Liab ↑		8,000
Change In Reserves – Incurred Losses (U&I Part 2)	I/S↓	8,000	
Change in UPR (U&I Part 1& 1A)	I/S ↑		10,000
To record the increase in unpaid losses by the transferee			
Day 360 - Negative Development on Transferred Business -3,000:			
Change In Reserves – Incurred Losses (U&I Part 2)	I/S↓	3,000	
Reserves for Unpaid Losses (U&I Part 2A & Sch. P)	Liab ↑		3,000
Day 540 – Reinsurer Pays the Loss @ Reported Reserves (50+8+3)			
Reserves for Unpaid Losses (U&I Part 2A & Sch. P)	Liab ↓	61,000	
Cash	Asset ↓		61,000

Comments:

In this second example, the portion of the runoff business that has an UPR associated with it is essentially booked as prospective reinsurance. Other elements of the example are the same except that we assumed an 80% loss ratio on the unearned portion of the business.

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Statutory Issue Paper No. 138

Fair Value Measurements

STATUS
Finalized September 21, 2009

Original SSAP and Current Authoritative Guidance: SSAP No. 100

Type of Issue:
Common Area

SUMMARY OF ISSUE:

1. In September 2006, the Financial Accounting Standards Board (FASB) issued *FAS 157, Fair Value Measurements* (FAS 157) to define fair value, establish a framework for measuring fair value in generally accepted accounting principles (GAAP) and to expand disclosures about fair value measurements. Since the issuance of FAS 157, the FASB has issued four FASB staff positions (FSPs) and one EITF to provide clarification of the guidance under FAS 157.

a. *FSP FAS 157-1: Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13* (FSP FAS 157-1). This FSP revised FAS 157 to exclude accounting pronouncements that address lease accounting. This FSP identifies that the term fair value will be used differently under *FAS 13, Accounting for Leases*, (FAS 13) than under FAS 157.

b. *FSP FAS 157-2: Effective Date of FASB Statement No. 157* (FSP FAS 157-2). This FSP defers the effective date of FAS 157 for nonfinancial assets and nonfinancial liabilities to fiscal years beginning after November 15, 2008.

c. *FSP FAS 157-3: Determining the Fair Value of a Financial Asset When the Market for That Asset is Not Active* (FSP FAS 157-3). This FSP initially clarified the application of FAS 157 for a market that is not active and provided an illustration in determining the fair value of a financial asset when the market for that financial asset is not active. With the issuance of FSP FAS 157-4, FSP FAS 157-3 was superseded, thus all of the amendments to FAS 157 from this FSP were deleted or amended.

d. *FSP FAS 157-4: Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transaction That Are Not Orderly* (FSP FAS 157-4). This FSP provides guidance for estimating fair value in accordance with FAS 157 when the volume and level of activity for the asset and liability have significantly decreased. This FSP also includes guidance on identifying circumstances that indicate a transaction is not orderly.

e. *EITF Issue No. 08-5, Issuer's Accounting for Liabilities Measured at Fair Value with a Third-Party Credit Enhancement* (EITF 08-5). This EITF provides guidance in determining an issuer's unit of accounting for a liability issued with an inseparable third-party credit enhancement when it is measured or disclosed at fair value on a recurring basis. As noted within this EITF, the issuer of a liability with a third-party credit enhancement that is inseparable from the liability shall not include the effect of the credit enhancement in the fair value measurement of the liability. For example, in determining the fair value of debt with a third-party guarantee, the issuer would consider its own credit standing and not that of the third-party guarantor. The issuer should disclose the existence of the third-party credit enhancement.

2. This issue paper proposes adoption, with modification, of FAS 157, FSP FAS 157-1 and FSP FAS 157-4. As components of FSP FAS 157-4 have been incorporated within INT 09-04, with the issuance of a final SSAP on fair value measurements INT 09-04 will be nullified. Guidance within FSP FAS 157-2 on the effective date for nonfinancial assets and nonfinancial liabilities is not considered applicable for statutory accounting, as the effective date of a new SSAP on fair value measurements will be after the effective date established by FSP FAS 157-2. FSP FAS 157-3 is considered rejected for statutory accounting purposes as the modifications made to FAS 157 from the issuance of that FSP have been amended or deleted with the issuance of FSP FAS 157-4. EITF 08-5 is considered rejected for statutory accounting purposes as the concept of considering non-performance risk (own credit risk) is inconsistent with the statutory accounting concept of conservatism and the assessment of financial solvency for insurers. Liabilities reported at fair value shall reflect the guidance adopted within FAS 157, as provided within this issue paper, without consideration of own-performance risk and without reflection of any third-party guarantee.

3. Current statutory accounting guidance for the definition of ‘fair value’ is primarily located within the Glossary to the Accounting Practices and Procedures Manual. There are instances throughout the Statements of Statutory Principles (SSAPs) in which guidance on the definition of fair value is located within a specific SSAP. It is intended that all statutory references to “fair value” will be defined in accordance with the provisions established within this issue paper, except where specifically excluded.

Summary Conclusion

4. This issue paper defines fair value, establishes a framework for measuring fair value in statutory accounting principles, and expands disclosures about fair value measurements. This issue paper applies under other accounting pronouncements that require or permit fair value measurements, but this issue paper does not require any new fair value amendments. However, the application of this issue paper may change current practice. This issue paper does not eliminate the practicability exceptions to fair value measurements in accounting pronouncements within the scope of this issue paper.

Scope

5. This issue paper applies under other statutory accounting pronouncements that require or permit fair value measurements, except as follows

a. This issue paper does not eliminate the practicality exceptions to fair value measurements in accounting pronouncements within the scope of this issue paper.

b. This issue paper does not apply under *SSAP No. 22—Leases* (SSAP No. 22) and other accounting pronouncements that address fair value measurements for purposes of lease classification to measurement under SSAP No. 22. This scope exception does not apply to assets acquired or liabilities assumed in a business combination that are required to be measured at fair value under *SSAP No. 68—Business Combinations and Goodwill* (SSAP No. 68), regardless of whether those assets and liabilities are related to leases.

Definition of Fair Value

6. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Components of the Fair Value Definition

7. *Asset/Liability* - A fair value measurement is for a particular asset or liability. Therefore, the measurement should consider attributes specific to the asset or liability, for example, the condition and/or location of the asset or liability and restrictions, if any, on the sale or use of the asset at the measurement date. The asset or liability might be a standalone asset or liability (for example, a financial instrument or an operating asset) or a group of assets and/or liabilities (for example, an asset group, a reporting unit, or a business).

8. *Price* - A fair value measurement assumes that the asset or liability is exchanged in an orderly transaction between market participants to sell the asset or transfer the liability at the measurement date. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale). The transaction to sell the asset or transfer the liability is a hypothetical transaction at the measurement date, considered from the perspective of a market participant that holds the asset or owes the liability. Therefore, the objective of a fair value measurement is to determine the price that would be received to sell the asset or paid to transfer the liability at the measurement date (an exit price).

9. *Principal (or Most Advantageous) Market* - A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. The principal market is the market in which the reporting entity would sell the asset or transfer the liability with the greatest volume and level of activity for the asset or liability. The most advantageous market is the market in which the reporting entity would sell the asset or transfer the liability with the price that maximizes the amount that would be received for the asset or minimizes the amount that would be paid to transfer the liability, considering transaction costs in the respective market(s). In either case, the principal (or most advantageous) market (and thus, market participants) should be considered from the perspective of the reporting entity, thereby allowing for differences between and among entities with different activities. If there is a principal market for the asset or liability, the fair value measurement shall represent the price in that market (whether that price is directly observable or otherwise determined using a valuation technique), even if the price in a different market is potentially more advantageous at the measurement date.

10. The price in the principal (or most advantageous) market used to measure the fair value of the asset or liability shall not be adjusted for transaction costs. Transaction costs represent the incremental direct costs to sell the asset or transfer the liability in the principal (or most advantageous) market for the asset or liability. Transaction costs are not an attribute of the asset or liability; rather, they are specific to the transaction and will differ depending on how the reporting entity transacts. However, transaction costs do not include the costs that would be incurred to transport the asset or liability to (or from) its principal (or most advantageous) market. If location is an attribute of the asset or liability (as might be the case for a commodity), the price in the principal (or most advantageous) market used to measure the fair value of the asset or liability shall be adjusted for the costs, if any, that would be incurred to transport the asset or liability to (or from) its principal (or most advantageous) market.

11. *Market Participants* - Market participants are buyers and sellers in the principal (or most advantageous) market for the asset or liability that are:

a. Independent of the reporting entity; that is, they are not related parties;

b. Knowledgeable, having a reasonable understanding about the asset or liability and the transaction based on all available information, including information that might be obtained through due diligence efforts that are usual and customary;

c. Able to transact for the asset or liability; and

d. Willing to transact for the asset or liability; that is, they are motivated but not forced or otherwise compelled to do so.

12. The fair value of the asset or liability shall be determined based on the assumptions that market participants would use in pricing the asset or liability. In developing those assumptions, the reporting entity need not identify specific market participants. Rather, the reporting entity should identify characteristics that distinguish market participants generally, considering factors specific to (a) the asset or liability, (b) the principal (or most advantageous) market for the asset or liability, and (c) market participants with whom the reporting entity would transact in that market.

13. *Application to Assets* - A fair value measurement assumes the highest and best use of the asset by market participants, considering the use of the asset that is physically possible, legally permissible, and financially feasible at the measurement date. In broad terms, highest and best use refers to the use of an asset by market participants that would maximize the value of the asset or the group of assets within which the asset would be used. Highest and best use is determined based on the use of the asset by market participants, even if the intended use of the asset by the reporting entity is different.

14. The highest and best use of the asset establishes the valuation premise used to measure the fair value of the asset. Specifically:

a. In-use - The highest and best use of the asset is in-use if the asset would provide maximum value to market participants principally through its use in combination with other assets as a group (as installed or otherwise configured for use). For example, that might be the case for certain nonfinancial assets. If the highest and best use of the asset is in-use, the fair value of the asset shall be measured using an in-use valuation premise. When using an in-use valuation premise, the fair value of the asset is determined based on the price that would be received in a current transaction to sell the asset assuming that the asset would be used with other assets as a group and that those assets would be available to market participants. Generally, assumptions about the highest and best use of the asset should be consistent for all of the assets of the group within which it would be used.

b. In-exchange - The highest and best use of the asset is in-exchange if the asset would provide maximum value to market participants principally on a standalone basis. For example, that might be the case for a financial asset. If the highest and best use of the asset is in-exchange, the fair value of the asset shall be measured using an in-exchange valuation premise. When using an in-exchange valuation premise, the fair value of the asset is determined based on the price that would be received in a current transaction to sell the asset standalone.

15. Because the highest and best use of the asset is determined based on its use by market participants, the fair value measurement considers the assumptions that market participants would use in pricing the asset, whether using an in-use or an in-exchange valuation premise.

16. *Application to Liabilities* - Consideration of non-performance risk (own credit-risk) should not be reflected in the fair value calculation for liabilities (including derivative liabilities) at subsequent measurement. At initial recognition, it is perceived that the consideration of own-credit risk may be inherent in the contractual negotiations resulting in the liability. The consideration of non-performance risk for subsequent measurement is inconsistent with the conservatism and recognition concepts as well as the assessment of financial solvency for insurers, as a decrease in credit standing would effectively

decrease reported liabilities and thus seemingly increase the appearance of solvency. Furthermore, liabilities reported or disclosed at "fair value" shall not reflect any third-party credit guarantee of debt.

Fair Value at Initial Recognition

17. When an asset is acquired or a liability is assumed in an exchange transaction for that asset or liability, the transaction price represents the price paid to acquire the asset or received to assume the liability (an entry price). In contrast, the fair value of the asset or liability represents the price that would be received to sell the asset or paid to transfer the liability (an exit price). Conceptually, entry prices and exit prices are different. Entities do not necessarily sell assets at the prices paid to acquire them. Similarly, entities do not necessarily transfer liabilities at the prices received to assume them.

18. In many cases, the transaction price will equal the exit price and, therefore, represent the fair value of the asset or liability at initial recognition. In determining whether a transaction price represents the fair value of the asset or liability at initial recognition, the reporting entity shall consider factors specific to the transaction and the asset or liability. For example, a transaction price might not represent the fair value of an asset or liability at initial recognition if:

a. The transaction is between related parties.

b. The transaction occurs under duress or the seller is forced to accept the price in the transaction. For example, that might be the case if the seller is experiencing financial difficulty.

c. The market in which the transaction occurs is different from the market in which the reporting entity would sell the asset or transfer the liability, that is, the principal or most advantageous market. For example, those markets might be different if the reporting entity is a securities dealer that transacts in different markets, depending on whether the counterparty is a retail customer (retail market) or another securities dealer (inter-dealer market).

d. For liabilities, differences may exist as non-performance risk (own credit risk) is not reflected in the fair value (i.e., exit price) determination of all liabilities (including derivatives).

Valuation Techniques

19. Valuation techniques consistent with the market approach, income approach, and/or cost approach shall be used to measure fair value. Key aspects of those approaches are summarized below:

a. Market approach. The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities (including a business). For example, valuation techniques consistent with the market approach often use market multiples derived from a set of comparables. Multiples might lie in ranges with a different multiple for each comparable. The selection of where within the range the appropriate multiple falls requires judgment, considering factors specific to the measurement (qualitative and quantitative). Valuation techniques consistent with the market approach include matrix pricing. Matrix pricing is a mathematical technique used principally to value debt securities without relying exclusively on quoted prices for the specific securities, but rather by relying on the securities' relationship to other benchmark quoted securities.

b. Income approach. The income approach uses valuation techniques to convert future amounts (for example, cash flows or earnings) to a single present amount (discounted). The measurement is based on the value indicated by current market expectations about those future amounts. Those valuation techniques include present value techniques; option-pricing models, such as the Black-Scholes-Merton formula (a closed-form model) and a binomial model (a lattice model), which incorporate present value techniques; and the multiperiod excess earnings method, which is used to measure the fair value of certain intangible assets.

c. Cost approach. The cost approach is based on the amount that currently would be required to replace the service capacity of an asset (often referred to as current replacement cost). From the perspective of a market participant (seller), the price that would be received for the asset is determined based on the cost to a market participant (buyer) to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence. Obsolescence encompasses physical deterioration, functional (technological) obsolescence, and economic (external) obsolescence and is broader than depreciation for financial reporting purposes (an allocation of historical cost) or tax purposes (based on specified service lives).

20. Valuation techniques that are appropriate in the circumstances and for which sufficient data are available shall be used to measure fair value. In some cases, a single valuation technique will be appropriate (for example, when valuing an asset or liability using quoted prices in an active market for identical assets or liabilities). In other cases, multiple valuation techniques will be appropriate (for example, as might be the case when valuing a reporting unit). If multiple valuation techniques are used to measure fair value, the results (respective indications of fair value) shall be evaluated and weighted, as appropriate, considering the reasonableness of the range indicated by those results. A fair value measurement is the point within that range that is most representative of fair value in the circumstances.

21. Valuation techniques used to measure fair value shall be consistently applied. However, a change in a valuation technique or its application (for example, a change in its weighting when multiple valuation techniques are used) is appropriate if the change results in a measurement that is equally or more representative of fair value in the circumstances. That might be the case if, for example, new markets develop, new information becomes available, information previously used is no longer available, or valuation techniques improve. Revisions resulting from a change in the valuation technique or its application shall be accounted for as a change in accounting estimate pursuant to SSAP No. 3—Accounting Changes and Corrections of Errors (SSAP No. 3). The disclosure provisions of SSAP No. 3 for a change in accounting estimate are not required for revisions resulting from a change in a valuation technique or its application.

Inputs to Valuation Techniques

22. In this issue paper, inputs refer broadly to the assumptions that market participants would use in pricing the asset or liability, including assumptions about risk, for example, the risk inherent in a particular valuation technique used to measure fair value (such as a pricing model) and/or the risk inherent in the inputs to the valuation technique. Inputs may be observable or unobservable:

a. Observable inputs are inputs that reflect the assumptions market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the reporting entity.

b. Unobservable inputs are inputs that reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances.

Valuation techniques used to measure fair value shall maximize the use of observable inputs and minimize the use of unobservable inputs.

Fair Value Hierarchy

23. To increase consistency and comparability in fair value measurements and related disclosures, the fair value hierarchy prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. The fair value hierarchy gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). In some cases, the inputs used to measure fair value might fall in different levels of the fair value hierarchy. The level in the fair value hierarchy within which the fair value measurement in its entirety falls shall be determined based on the lowest level input that is significant to the fair value measurement in its entirety. Assessing the significance of a particular input to the fair value measurement in its entirety requires judgment, considering factors specific to the asset or liability.

24. The availability of inputs relevant to the asset or liability and the relative reliability of the inputs might affect the selection of appropriate valuation techniques. However, the fair value hierarchy prioritizes the inputs to valuation techniques, not the valuation techniques. For example, a fair value measurement using a present value technique might fall within Level 2 or Level 3, depending on the inputs that are significant to the measurement in its entirety and the level in the fair value hierarchy within which those inputs fall.

Level 1 Inputs

25. Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. An active market for the asset or liability is a market in which transactions for the asset or liability occur with sufficient frequency and volume to provide pricing information on an ongoing basis. A quoted price in an active market provides the most reliable evidence of fair value and shall be used to measure fair value whenever available, except as discussed in paragraphs 26 and 27.

26. If the reporting entity holds a large number of similar assets or liabilities (for example, debt securities) that are required to be measured at fair value, a quoted price in an active market might be available but not readily accessible for each of those assets or liabilities individually. In that case, fair value may be measured using an alternative pricing method that does not rely exclusively on quoted prices (for example, matrix pricing) as a practical expedient. However, the use of an alternative pricing method renders the fair value measurement a lower level measurement.

27. In some situations, a quoted price in an active market might not represent fair value at the measurement date. That might be the case if, for example, significant events (principal-to-principal transactions, brokered trades, or announcements) occur after the close of a market but before the measurement date. The reporting entity should establish and consistently apply a policy for identifying those events that might affect fair value measurements. However, if the quoted price is adjusted for new information, the adjustment renders the fair value measurement a lower level measurement.

28. If the reporting entity holds a position in a single financial instrument (including a block) and the instrument is traded in an active market, the fair value of the position shall be measured within Level 1 as the product of the quoted price for the individual instrument times the quantity held. The quoted price shall not be adjusted because of the size of the position relative to trading volume (blockage factor). The use of a blockage factor is prohibited, even if a market's normal daily trading volume is not sufficient to absorb the quantity held and placing orders to sell the position in a single transaction might affect the quoted price.

Level 2 Inputs

29. Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. If the asset or liability has a specified (contractual) term, a Level 2 input must be observable for substantially the full term of the asset or liability. Level 2 inputs include the following:

a. Quoted prices for similar assets or liabilities in active markets

b. Quoted prices for identical or similar assets or liabilities in markets that are not active, that is, markets in which there are few transactions for the asset or liability, the prices are not current, or price quotations vary substantially either over time or among market makers (for example, some brokered markets), or in which little information is released publicly (for example, a principal-to-principal market)

c. Inputs other than quoted prices that are observable for the asset or liability (for example, interest rates and yield curves observable at commonly quoted intervals, volatilities, prepayment speeds, loss severities, credit risks, and default rates)

d. Inputs that are derived principally from or corroborated by observable market data by correlation or other means (market-corroborated inputs).

30. Adjustments to Level 2 inputs will vary depending on factors specific to the asset or liability. Those factors include the condition and/or location of the asset or liability, the extent to which the inputs relate to items that are comparable to the asset or liability, and the volume and level of activity in the markets within which the inputs are observed. An adjustment that is significant to the fair value measurement in its entirety might render the measurement a Level 3 measurement, depending on the level in the fair value hierarchy within which the inputs used to determine the adjustment fall.

31. The reporting entity should evaluate the following factors to determine whether there has been a significant decrease in the volume and level of activity for the asset or liability when compared with normal market activity for the asset or liability (or similar assets or liabilities). The factors include, but are not limited to:

a. There are few recent transactions.

b. Price quotations are not based on current information.

c. Price quotations vary substantially either over time or among market makers (for example, some brokered markets).

d. Indexes that previously were highly correlated with the fair values of the asset or liability are demonstrably uncorrelated with recent indications of fair value for that asset or liability.

e. There is a significant increase in implied liquidity risk premiums, yields, or performance indicators (such as delinquency rates or loss severities) for observed transactions or quoted prices when compared with the reporting entity’s estimate of expected cash flows, considering all available market data about credit and other nonperformance risk for the asset or liability.

f. There is a wide bid-ask spread or significant increase in the bid-ask spread.

g. There is a significant decline or absence of a market for new issuances (that is, a primary market) for the asset or liability or similar assets or liabilities.

h. Little information is released publicly (for example, a principal-to-principal market).

The reporting entity shall evaluate the significance and relevance of the factors to determine whether, based on the weight of the evidence, there has been a significant decrease in the volume and level of activity for the asset or liability.

32. If the reporting entity concludes there has been a significant decrease in the volume and level of activity for the asset or liability in relation to normal market activity for the asset or liability (or similar assets or liabilities), transactions or quoted prices may not be determinative of fair value (for example, there may be increased instances of transactions that are not orderly). Further analysis of the transactions or quoted prices is needed, and a significant adjustment to the transactions or quoted prices may be necessary to estimate fair value in accordance with this issue paper. Significant adjustments also may be necessary in other circumstances (for example, when a price for a similar asset requires significant adjustment to make it more comparable to the asset being measured or when the price is stale).

33. This issue paper does not prescribe a methodology for making significant adjustments to transactions or quoted prices when estimating fair value. Paragraphs 19-21 discuss the use of valuation techniques in estimating fair value. If there has been a significant decrease in the volume and level of activity for the asset or liability, a change in valuation technique or the use of multiple valuation techniques may be appropriate (for example, the use of a market approach and a present value technique). When weighting indications of fair value resulting from the use of multiple valuation techniques, the reporting entity shall consider the reasonableness of the range of fair value estimates. The objective is to determine the point within that range that is most representative of fair value under current market conditions. A wide range of fair value estimates may be an indication that further analysis is needed.

34. Even in circumstances where there has been a significant decrease in the volume and level of activity for the asset or liability and regardless of the valuation technique(s) used, the objective of a fair value measurement remains the same. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. Determining the price at which willing market participants would transact at the measurement date under current market conditions if there has been a significant decrease in the volume and level of activity for the asset or liability depends on the facts and circumstances and requires the use of significant judgment. However, the reporting entity's intention to hold the asset or liability is not relevant in estimating fair value. Fair value is a market-based measurement, not an entity-specific measurement.

35. Even if there has been a significant decrease in the volume and level of activity for the asset or liability, it is not appropriate to conclude that all transactions are not orderly (that is, distressed or forced). Circumstances that may indicate that a transaction is not orderly include, but are not limited to:

a. There was not adequate exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities under current market conditions.

b. There was a usual and customary marketing period, but the seller marketed the asset or liability to a single market participant.

c. The seller is in or near bankruptcy or receivership (that is, distressed), or the seller was required to sell to meet regulatory or legal requirements (that is, forced).

d. The transaction price is an outlier when compared with other recent transactions for the same or similar asset or liability.

The reporting entity shall evaluate the circumstances to determine whether the transaction is orderly based on the weight of the evidence.

36. The determination of whether a transaction is orderly (or not orderly) is more difficult if there has been a significant decrease in the volume and level of activity for the asset or liability. Accordingly, the reporting entity shall consider the following guidance:

a. If the weight of the evidence indicates the transaction is not orderly, the reporting entity shall place little, if any, weight (compared with other indications of fair value) on that transaction price when estimating fair value or market risk premiums.

b. If the weight of the evidence indicates the transaction is orderly, the reporting entity shall consider that transaction price when estimating fair value or market risk premiums. The amount of weight placed on that transaction price when compared with other indications of fair value will depend on the facts and circumstances such as the volume of the transaction, the comparability of the transaction to the asset or liability being measured at fair value, and the proximity of the transaction to the measurement date.

c. If the reporting entity does not have sufficient information to conclude that the transaction is orderly or that the transaction is not orderly, it shall consider that transaction price when estimating fair value or market risk premiums. However, that transaction price may not be determinative of fair value (that is, that transaction price may not be the sole or primary basis for estimating fair value or market risk premiums). The reporting entity shall place less weight on transactions on which the reporting entity does not have sufficient information to conclude whether the transaction is orderly when compared with other transactions that are known to be orderly.

In its determinations, the reporting entity need not undertake all possible efforts, but shall not ignore information that is available without undue cost and effort. The reporting entity would be expected to have sufficient information to conclude whether a transaction is orderly when it is party to the transaction.

37. Regardless of the valuation technique(s) used, the reporting entity shall include appropriate risk adjustments. Risk-averse market participants generally seek compensation for bearing the uncertainty inherent in the cash flows of an asset or liability (risk premium). A fair value measurement should include a risk premium reflecting the amount market participants would demand because of the risk (uncertainty) in the cash flows. Otherwise, the measurement would not faithfully represent fair value. In some cases, determining the appropriate risk premium might be difficult. However, the degree of difficulty alone is not a sufficient basis on which to exclude a risk adjustment. Risk premiums should be reflective of an orderly transaction (that is, not a forced or distressed sale) between market participants at the measurement date under current market conditions.

38. When estimating fair value, this issue paper does not preclude the use of quoted prices provided by third parties, such as pricing services or brokers, when the reporting entity has determined that the quoted prices provided by those parties are determined in accordance with this issue paper. However, when there has been a significant decrease in the Volume or level of activity for the asset or liability, the reporting entity should evaluate whether those quoted prices are based on current information that reflects orderly transactions or a valuation technique that reflects market participant assumptions (including assumptions about risks). In weighting a quoted price as an input to a fair value measurement, the reporting entity should place less weight (when compared with other indications of fair value that are based on transactions) on quotes that do not reflect the result of transactions. Furthermore, the nature of

the quote (for example, whether the quote is an indicative price or a binding offer) should be considered when weighting the available evidence, with more weight given to quotes based on binding offers.

Level 3 Inputs

39. Level 3 inputs are unobservable inputs for the asset or liability. Unobservable inputs shall be used to measure fair value to the extent that relevant observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. However, the fair value measurement objective remains the same, that is, an exit price from the perspective of a market participant that holds the asset or owes the liability. Therefore, unobservable inputs shall reflect the reporting entity's own assumptions about the assumptions that market participants would use in pricing the asset or liability (including assumptions about risk). Unobservable inputs shall be developed based on the best information available in the circumstances, which might include the reporting entity's own data. In developing unobservable inputs, the reporting entity need not undertake all possible efforts to obtain information about market participant assumptions. However, the reporting entity shall not ignore information about market participant assumptions that is reasonably available without undue cost and effort. Therefore, the reporting entity's own data used to develop unobservable inputs shall be adjusted if information is reasonably available without undue cost and effort that indicates that market participants would use different assumptions.

Inputs Based on Bid and Ask Prices

40. If an input used to measure fair value is based on bid and ask prices (for example, in a dealer market), the price within the bid-ask spread that is most representative of fair value in the circumstances shall be used to measure fair value, regardless of where in the fair value hierarchy the input falls (Level 1, 2, or 3). This issue paper does not preclude the use of mid-market pricing or other pricing conventions as a practical expedient for fair value measurements within a bid-ask spread.

Disclosures

41. For assets and liabilities that are measured at fair value on a recurring basis in periods subsequent to initial recognition (for example, common stock), the reporting entity shall disclose information that enables users of its financial statements to assess the inputs used to develop those measurements and for recurring fair value measurements using significant unobservable inputs (Level 3), the effect of the measurements on earnings (or changes in net assets) for the period. To meet that objective, the reporting entity shall disclose the following information for each interim and annual period separately for each major category of assets and liabilities (for equity and debt securities), major category shall be defined as major security type:

a. The fair value measurements at the reporting date and the source of the fair value measurement. (Source of fair value measurement is only required in annual audited reporting periods.)

b. The level within the fair value hierarchy in which the fair value measurements in their entirety fall, segregating fair value measurements using quoted prices in active markets for identical assets or liabilities (Level 1), significant other observable inputs (Level 2), and significant unobservable inputs (Level 3)

c. For fair value measurements using significant unobservable inputs (Level 3), a reconciliation of the beginning and ending balances, separately presenting changes during the period attributable to the following:

(1) Total gains or losses for the period (realized and unrealized), segregating those gains or losses included in earnings (or changes in net assets), and a description of where those gains or losses included in earnings (or changes in net assets) are reported in the statement of income (or activities)

(2) Purchases, sales, issuances, and settlements (net)

(3) Transfers in and/or out of Level 3 (for example, transfers due to changes in the observability of significant inputs)

d. The amount of the total gains or losses for the period in subparagraph (c) (1) above included in earnings (or changes in net assets) that are attributable to the change in unrealized gains or losses relating to those assets and liabilities still held at the reporting date and a description of where those unrealized gains or losses are reported in the statement of income (or activities)

e. The inputs and valuation technique(s) used to measure fair value and a discussion of changes in valuation techniques and related inputs, if any, during the period.

42. For assets and liabilities that are measured at fair value on a nonrecurring basis in periods subsequent to initial recognition (for example, impaired assets), the reporting entity shall disclose information that enables users of its financial statements to assess the inputs used to develop those measurements. To meet that objective, the reporting entity shall disclose the following information for each interim and annual period separately for each major category of assets and liabilities (for equity and debt securities major category shall be defined as major security type):

a. The fair value measurements recorded during the period and the reasons for the measurements

b. The level within the fair value hierarchy in which the fair value measurements in their entirety fall, segregating fair value measurements using quoted prices in active markets for identical assets or liabilities (Level 1), significant other observable inputs (Level 2), and significant unobservable inputs (Level 3)

c. For fair value measurements using significant unobservable inputs (Level 3), a description of the inputs and the information used to develop the inputs

d. The inputs and valuation technique(s) used to measure fair value and a discussion of changes, if any, in the valuation technique(s) and related inputs used to measure similar assets and/or liabilities in prior periods.

43. The quantitative disclosures required by this issue paper shall be presented using a tabular format. (See Exhibit A.)

44. The reporting entity is encouraged, but not required, to combine the fair value information disclosed under this issue paper with the fair value information disclosed under other accounting pronouncements (for example, disclosures about fair value of financial instruments) in the periods in which those disclosures are required, if practicable. The reporting entity also is encouraged, but not required, to disclose information about other similar measurements, if practicable.

Disclosures about Fair Value of Financial Instruments ***(Copied from SSAP No. 27 and modified to reflect adoption of FSP FAS 107-1 and APB 28-1. This modification would require disclosures for annual and quarter financial statements.)***

45. A reporting entity shall disclose in the notes to the financial statements, as of each date for which a statement of financial position is presented in the quarterly or annual financial statements, the aggregate fair value of all financial instruments, summarized by type of financial instrument, for which it is practicable to estimate fair value, except for certain financial instruments identified in paragraph 46. Fair value disclosed in the notes shall be presented together with the related admitted values in a form that makes it clear whether the fair values and admitted values represent assets or liabilities and to which line items in the Statement of Assets, Liabilities, Surplus and Other Funds they relate. Unless specified otherwise in another SSAP, the disclosures may be made net of encumbrances, if the asset or liability is so reported. A reporting entity shall also disclose the method(s) and significant assumptions used to estimate the fair value of financial instruments.

46. The disclosures about fair value prescribed in paragraph 45 are not required for the following:

a. Employers' and plans' obligations for pension benefits, other postretirement benefits including health care and life insurance benefits, postemployment benefits, employee stock option and stock purchase plans, and other forms of deferred compensation arrangements, as defined in *SSAP No. 12—Employee Stock Ownership Plans* (SSAP No. 12), *Stock Options and Stock Purchase Plans* (SSAP No. 13), *SSAP No. 14—Postretirement Benefits Other Than Pensions* (SSAP No. 14), and *SSAP No. 89—Accounting for Pensions, A Replacement of SSAP No. 8* (SSAP No. 89).)

b. Substantively extinguished debt subject to the disclosure requirements of *SSAP No. 91R—Accounting for Transfer and Servicing of Financial Assets and Extinguishments of Liabilities* (SSAP No. 91R).

c. Insurance contracts, other than financial guarantees and deposit-type contracts

d. Lease contracts as defined in *SSAP No. 22—Leases* (SSAP No. 22).

e. Warranty obligations and rights.

f. Investments accounted for under the equity method.

g. Equity instruments issued by the entity.

47. If it is not practicable for an entity to estimate the fair value of a financial instrument or a class of financial instruments, the following shall be disclosed:

a. Information pertinent to estimating the fair value of that financial instrument or class of financial instruments, such as the carrying amount, effective interest rate, and maturity; and

b. The reasons why it is not practicable to estimate fair value.

48. In the context of this issue paper, practicable means that an estimate of fair value can be made without incurring excessive costs. It is a dynamic concept: what is practicable for one entity might not be for another; what is not practicable in one year might be in another. For example, it might not be practicable for an entity to estimate the fair value of a class of financial instruments for which a quoted market price is not available because it has not yet obtained or developed the valuation model necessary

to make the estimate, and the cost of obtaining an independent valuation appears excessive considering the materiality of the instruments to the entity. Practicability, that is, cost considerations, also may affect the required precision of the estimate; for example, while in many cases it might seem impracticable to estimate fair value on an individual instrument basis, it may be practicable for a class of financial instruments in a portfolio or on a portfolio basis. In those cases, the fair value of that class or of the portfolio should be disclosed. Finally, it might be practicable for an entity to estimate the fair value only of a subset of a class of financial instruments; the fair value of that subset should be disclosed.

Relevant Literature

49. This issue paper adopts with modification *FAS 157, Fair Value Measurements*; (FAS 157) *FSP FAS 157-1, Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement Under Statement 13*, (FSP FAS 157-1) and *FSP FAS 157-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly* (FSP FAS 157-4). Modifications from FAS 157, FSP FAS 157-1 and FSP FAS 157-4 include:

a. This issue paper does not adopt the scope exclusion within paragraph 2.a. of FAS 157 regarding share-based payment transactions. *FASB Statement No. 123, Share-Based Payment*, and its related interpretive accounting pronouncements that address share-based payment transactions are still being considered for statutory accounting. If these GAAP standards are adopted for statutory accounting, consideration will be given to incorporating an exclusion for determining fair value in accordance with the guidance under this issue paper. This issue paper is considered applicable under *SSAP No. 13—Stock Options and Stock Purchase Plans* (SSAP No. 13)

b. This issue paper does not adopt the scope exclusions within paragraph 3 of FAS 157 for accounting pronouncements that require or permit measurements that are similar to fair value but that are not intended to measure fair value, including (a) accounting pronouncements that permit measurements that are based on, or otherwise use, vendor-specific objective evidence of fair value and (b) inventory pricing. These items are excluded as they are not prevalent within statutory accounting.

c. This issue paper does not adopt guidance from FAS 157 regarding the consideration of non-performance risk (own credit risk) in determining the fair value measurement of liabilities. The consideration of own credit-risk in the measurement of fair value liabilities is inconsistent with the statutory accounting concept of conservatism and the assessment of financial solvency for insurers. The fair value determination for liabilities should follow the guidance adopted from FAS 157, with the exception of the consideration of own-performance risk.

d. This issue paper includes revisions to reference statutory standards or terms instead of GAAP standards or terms.

e. This issue paper incorporates the guidance from SSAP No. 27 regarding disclosures about fair value of financial instruments. This incorporated SSAP No. 27 guidance was adopted from *FAS 107, Disclosures about Fair Value of Financial Instruments* (FAS 107) and was revised to adopt *FSP FAS 107-1 and APB-1, Interim Disclosures about Fair Value of Financial Instruments* (FSP FAS 107-1 and APB-1). For statutory purposes, the incorporation of this guidance within one standard results in having one comprehensive standard addressing fair value measurements and disclosures.

50. Paragraphs 42-44 adopt FAS 107 as amended by *FASB Statement No. 119, Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (FAS 119), except that paragraph 15.c. of FAS 119 relating to disclosure of financial instruments held or issued for trading is rejected and *FASB Emerging Issues Task Force No. 85-20, Recognition of Fees for Guaranteeing a Loan*. Financial instruments named within paragraph 8 of FAS 107 that are exempt from disclosure are adopted to the extent applicable for statutory accounting and are reflected in paragraph 46. This issue paper also adopts revisions to FAS 107 reflected in *FSP FAS 107-1 and APB-1, Interim Disclosures about Fair Value of Financial Instruments* (FSP FAS 107-1 and APB-1), and thus requires disclosure in both annual and quarterly financial statements. In addition, this issue paper rejects FASB Statement No. 126, Exemptions from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities, an amendment of FAS 107. FAS 119 is addressed in SSAP No. 31.

Effective Date and Transition

51. This issue paper shall be effective for December 31, 2010 annual financial statements, with interim and annual financial statement reporting thereafter. Early adoption is permitted for December 31, 2009 annual financial statements, with interim and annual reporting thereafter.

Exhibit A - Disclosure Illustrations:

52. **Assets Measured at Fair Value on a Recurring Basis:**

(In millions)	**Level 1**	**Level 2**	**Level 3**	**Total**
Assets at fair value:	$	$	$	$
Preferred Stock				
Common Stock				
Sub-Total	$	$	$	$
Derivative Assets				
Separate Account Assets				
Total Assets at Fair Value	$	$	$	$
Liabilities at Fair Value:				
Derivatives Liabilities				
Total Liabilities at Fair Value	$	$	$	$

53. **Assets Measured at Fair Value on a Recurring Basis Using Significant Unobservable Inputs (Level 3):**

		Separate			
	Equity	**Account**	**Derivative**	**Derivative**	
(In millions)	**Securities**	**Assets**	**Assets**	**Liabilities**	**Total**
Balance at 1/1/0X:	**$**	**$**	**$**	**$**	**$**
Total Gains or Losses (realized/unrealized)					
Included in net income					
Included in surplus					
Purchases, issuances and settlements					
Transfers in (out) of Level 3					
Balance at 12/31/0X					
Total gains (losses) included in income attributable to instruments held at the reporting date	**$**	**$**	**$**	**$**	

54. **Assets Measured at Fair Value on a Nonrecurring Basis:**

Description	12/31/0X	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Gains (Losses)
Bonds					
Preferred Stock					

DISCUSSION:

55. In considering FAS 157 for statutory accounting, the Statutory Accounting Principles Working Group agreed that a consistent definition of fair value should be established to address inconsistencies that may exist on the definition and application of fair value within individual statements of statutory accounting principles. Furthermore, the Working Group agreed that the statutory definition and application of fair value should be similar to the GAAP definition of fair value to minimize situations in which "fair value" is calculated differently between GAAP and SAP. By having similar fair value definitions, it is presumed that assets reported at fair value will not vary between GAAP and SAP financial statements. As illustrated within this issue paper, for determining the fair value of liabilities, the concept of considering own credit risk has been rejected for statutory accounting. Thus, it is presumed that in some instances fair value measurements under GAAP and SAP for liabilities will differ.

Modifications to Generally Accepted Accounting Principles

56. This issue paper does not incorporate the GAAP concept of "unit of account". This GAAP concept reflects the application of the fair value measurement guidance to assets or liabilities that are based in groups or lots. Statutory accounting has not previously endorsed the concept of "unit of account" as the statutory measurement of financial instruments is calculated in accordance with single securities. Thus, this term has not been reflected within the statutory accounting fair value measurement guidance.

57. This issue paper does not adopt the scope exclusion within paragraph 2.a. of FAS 157 regarding share-based payment transactions. *FASB Statement No. 123R, Share-Based Payment*, and its related interpretive accounting pronouncements that address share-based payment transactions are still being considered for statutory accounting. If these GAAP standards are adopted for statutory accounting, consideration will be given to incorporating an exclusion for determining fair value in accordance with the guidance under this issue paper. This issue paper is considered applicable under *SSAP No. 13—Stock Options and Stock Purchase Plans* (SSAP No. 13).

58. This issue paper does not adopt the scope exclusions within paragraph 3 of FAS 157 for accounting pronouncements that require or permit measurements that are similar to fair value but that are not intended to measure fair value, including (a) accounting pronouncements that permit measurements that are based on, or otherwise use, vendor-specific objective evidence of fair value and (b) inventory pricing. These items are excluded as they are not prevalent within statutory accounting.

59. This issue paper does not adopt guidance from FAS 157 regarding the consideration of non-performance risk (own credit risk) in determining the fair value measurement of liabilities. The consideration of own credit-risk in the measurement of fair value liabilities is inconsistent with the statutory accounting concept of conservatism and the assessment of financial solvency for insurers. The fair value determination for liabilities should follow the guidance adopted from FAS 157, with the exception of the consideration of own-performance risk. This issue paper also rejects guidance within

EITF 08-05, Issuer's Accounting for Liabilities Measured at Fair Value with a Third-Party Credit Enhancement (EITF 08-05). Thus, under statutory accounting, liabilities measured at fair value shall not include the issuer's own credit risk, or reflect any third-party guarantee of debt. The consideration of non-performance risk is considered inconsistent with the recognition concept as protection of the policyholders can only be maintained through continued monitoring of the financial condition of the insurance enterprise. If statutory liabilities reflected the reporting entity's non-performance risk, the balance sheet would ineffectively illustrate the financial condition of the insurer.

60. This issue paper includes revisions to reference statutory standards or terms instead of GAAP standards or terms.

61. This issue paper incorporates the guidance from SSAP No. 27 regarding disclosures about fair value of financial instruments. This incorporated SSAP No. 27 guidance was adopted from *FAS 107, Disclosures about Fair Value of Financial Instruments* (FAS 107) and was revised to adopt *FSP FAS 107-1 and APB-1, Interim Disclosures about Fair Value of Financial Instruments* (FSP FAS 107-1 and APB-1). For statutory purposes, the incorporation of this guidance within one standard results in having one comprehensive standard addressing fair value measurements and disclosures.

Modifications to Statutory Accounting Principles

62. This issue paper proposes the establishment of a singular standard to define fair value, establish a framework for measuring fair value and to address disclosures about fair value measurements. In order to implement a single standard for fair value guidance, with the adoption of the final standard the following corresponding modifications will be incorporated within existing statutory accounting guidance: (Appendix A illustrates these statutory accounting modifications.)

a. *SSAP No. 2—Cash, Drafts, and Short-Term Investments* (SSAP No. 2) – Reference to SSAP No. 27 in paragraph 13.a. will be deleted, and replaced with reference to the SSAP on fair value measurements.

b. *SSAP No. 13—Stock Options and Stock Purchase Plans* (SSAP No. 13) – Paragraph 8 will be deleted with the issuance of the fair value measurements SSAP. (FAS 157 does not apply under any pronouncements that address share-based payment transactions. Thus deleting paragraph 8 may be considered inconsistent with GAAP as references to fair value in this standard would inherently follow the guidance in the new SSAP. However, the determination of fair value currently included within paragraph 8 of SSAP No. 13 does not appear to contradict with the fair value definition proposed within this issue paper.) Reference to market price in paragraphs 3.d., 6 and 14 will be revised to reflect fair value.

c. *SSAP No. 26—Bonds, Excluding Loan-Backed and Structured Securities* (SSAP No. 26) - Reference to SSAP No. 27 in paragraph 17.a. will be replaced with reference to the new SSAP on fair value measurements. Paragraph 4 will be revised to remove the phrase "which cannot exceed the fair value at the date of acquisition". Retention of this phrase would result with a difference between GAAP and SAP if FAS 157 is adopted, as proposed within this issue paper, for statutory accounting.

d. *SSAP No. 27—Disclosure of Information about Financial Instruments with Off-Balance Sheet Risk, Financial Instruments with Concentrations of Credit Risk and Disclosures about Fair Value of Financial Instruments* (SSAP No. 27) – Paragraphs 8-10 and 13-14 will be deleted with the issuance of the fair value measurements standard. Furthermore, all references to fair value disclosures included throughout the standard (including the title) and the reference to adopted FAS 107 GAAP guidance will be deleted. All fair value disclosure requirements, including financial instruments disclosures, and references to adopted GAAP guidance pertaining to fair value will be incorporated within the new SSAP on fair value measurements. (SSAP No. 27 will be retained for the other items addressed within this standard.) The modification proposed is a variation from GAAP as FAS 107 still includes fair value disclosure requirements for financial instruments. However, this issue paper concludes that the paragraphs currently included within SSAP No. 27 for statutory financial instrument disclosures would be more appropriately placed, and improve the ease of application, if included in the new SSAP on fair value measurements.

e. *SSAP No. 30—Investments in Common Stock (excluding investments in common stock of subsidiary, controlled or affiliated entities)* (SSAP No. 30) – Reference to SSAP No. 27 in paragraphs 13.d. and 13.f. will be revised to reference the new SSAP on fair value measurements. Paragraph 5 will be revised to remove the sentence “Cost shall not exceed fair value.” Retention of this sentence would result with a difference between GAAP and SAP if FAS 157 is adopted, as proposed within this issue paper, for statutory accounting. In accordance with FAS 157, transaction costs would be initially included in ‘cost’ at acquisition. For subsequent reporting, unrealized gains/losses would be reflected to illustrate the difference between the acquisition cost and fair value. If the existing SSAP No. 30, paragraph 5 guidance was retained for statutory accounting, the initial recognition of the asset would have an immediate unrecognized loss (assumed to represent transaction costs if purchased at fair value). As at subsequent reporting, the GAAP and SAP valuation of the asset would both reflect fair value, and as transaction costs are typically immaterial, the existing variation from GAAP seems to generate an operational difference between GAAP and SAP that would not provide a significant impact to capital and surplus for statutory purposes.

f. *SSAP No. 32—Investments in Preferred Stock (including investments in preferred stock of subsidiary, controlled or affiliated entities)* (SSAP No. 32) - Reference to SSAP No. 27 in paragraphs 29.a. and 29.f. will be revised to reference the new SSAP on fair value measurements. Paragraph 10 will be revised to remove the sentence “Cost shall not exceed fair value.” Retention of this sentence would result with a difference between GAAP and SAP if FAS 157 is adopted, as proposed within this issue paper, for statutory accounting. In accordance with FAS 157, transaction costs would be initially included in ‘cost’ at acquisition. For subsequent reporting, unrealized gains/losses would be reflected to illustrate the difference between the acquisition cost and fair value. If the existing SSAP No. 32, paragraph 10 guidance was retained for statutory accounting, the initial recognition of the asset would have an immediate unrecognized loss (assumed to represent transaction costs if purchased at fair value). As at subsequent reporting, the GAAP and SAP valuation of the asset would both reflect fair value, and as transaction costs are typically immaterial, the existing variation from GAAP seems to generate an operational difference between GAAP and SAP that would not provide a significant impact to capital and surplus for statutory purposes.

g. *SSAP No. 36—Troubled Debt Restructuring* (SSAP No. 36) – Revisions are incorporated to paragraphs 10 and 11 to clarify the determination of fair value in accordance with the new SSAP on fair value measurements.

h. *SSAP No. 37—Mortgage Loans* (SSAP No. 37) - Reference to SSAP No. 27 in paragraph 20.a. will be revised to reference the new SSAP on fair value measurements.

i. *SSAP No. 40—Real Estate Investments* (SSAP No. 40) – Guidance in paragraph 11 for the regarding the definition of fair value will be deleted, but the requirement to obtain an appraisal if market quotes are unavailable will be retained. Reference to "market value" in paragraphs 19, 20 and 24.b. will be deleted and replaced with the term "fair value".

j. *SSAP No. 43R—Loan-Backed and Structured Securities*-*Revised* (SSAP No. 43R) – Reference to SSAP No. 27 in paragraph 48 will be revised to reference the new SSAP on fair value measurements. Paragraph 7 will be revised to remove the sentence "Cost shall not exceed fair value." Retention of this sentence would result with a difference between GAAP and SAP if FAS 157 is adopted, as proposed within this issue paper, for statutory accounting. In accordance with FAS 157, transaction costs would be initially included in 'cost' at acquisition. For subsequent reporting, unrealized gains/losses would be reflected to illustrate the difference between the acquisition cost and fair value. If the existing SSAP No. 43, paragraph 6 guidance was retained for statutory accounting, the initial recognition of the asset would have an immediate unrecognized loss (assumed to represent transaction costs if purchased at fair value). As at subsequent reporting, the GAAP and SAP valuation of the asset would both reflect fair value, and as transaction costs are typically immaterial, the existing variation from GAAP seems to generate an operational difference between GAAP and SAP that would not provide a significant impact to capital and surplus for statutory purposes.

k. *SSAP No. 51—Life Contracts* (SSAP No. 51) – The term "market value" included within paragraphs 38.a.iii. and 38.a.iv. will be revised to refer to "fair value".

l. *SSAP No. 52—Deposit-Type Contracts* (SSAP No. 52) – The term "market value" included within paragraphs 17.a.iii. and 17.a.iv. will be revised to refer to "fair value".

m. *SSAP No. 56—Separate Accounts* (SSAP No. 56) – The term "market value" included within paragraphs 17, 18, 18.a., 20, 22, 26, 31.b., 32 and 41 will be revised to refer to "fair value". The use of the term "market value adjusted contracted" as illustrated in paragraphs 20 and 29.c. will be retained.

n. *SSAP No. 61—Life, Deposit-Type and Accident and Health Reinsurance* (SSAP No. 61) – The term "market value" included within paragraphs 55, 59.a.iii. and 59.a.iv. will be revised to refer to "fair value". The term "market-value adjustments" included within paragraph 59.a. will be retained.

o. *SSAP No. 73—Health Care Delivery Assets – Supplies, Pharmaceuticals and Surgical Supplies, Durable Medical Equipment, Furniture, Medical Equipment and Fixtures, and Leasehold Improvement in Health Care Facilities* (SSAP No. 73) - The reference to "market" in paragraph 5 will be revised to refer to "fair value".

p. *SSAP No. 74—Accounting for the Issuance of Insurance-Linked Securities Issued by a Property and Casualty Insurer Through a Protected Cell* (SSAP No. 74) – In the glossary to this statement, the term "fair value" will be redefined to reference the new SSAP on fair value measurements.

q. *SSAP No. 86—Accounting for Derivatives, Instruments and Hedging Activities* (SSAP No. 86) – Reference to SSAP No. 27 in paragraph 14 will be revised to reflect the new SSAP No. 27 title (as modified pursuant to the inclusion of all fair value disclosures within the new SSAP on fair value measurements). Throughout SSAP No. 86, Exhibit C, the term "marked-to-market" will be deleted.

r. *SSAP No. 90—Accounting for the Impairment or Disposal of Real Estate Investments* (SSAP No. 90) – Reference to the definition of fair value included within the Glossary to the AP&P manual in paragraphs 16 and 41.d. will be revised to refer to the new SSAP on fair value measurements. Additionally, the term "market price" in paragraph 5.a. will be replaced with the term "fair value".

s. *SSAP No. 91R—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (SSAP No. 91R) – Paragraph 7.e. will be revised to eliminate the reference to the glossary and instead reference the new SSAP on fair value measurements. Paragraphs 8 and 12 will be revised to remove the parenthetical definition of fair value "presumably, the price paid". Paragraphs 95.f.i. and 95.g.i. will be revised to remove the parenthetical instruction on determining fair value and be revised to reference the new SSAP on fair value measurements. The Glossary to SSAP No. 91R will revise the definition of "Derivative Financial Instrument" to update the title of SSAP No. 27 pursuant to the revisions adopted by the new SSAP on fair value measurements.

t. *SSAP No. 93—Accounting for Low Income Housing Tax Credit Property Investments* (SSAP No. 93) – References to "market value" in paragraphs 1.c., 1.d., 5 and 20.b. will be revised to refer to "fair value"

u. *SSAP No. 95—Exchanges of Nonmonetary Assets, A Replacement of SSAP No. 28—Nonmonetary Transactions* (SSAP No. 95) – Revisions will be incorporated to paragraph 14 to define fair value in accordance with the new SSAP on fair value measurements. (No revisions will be incorporated to paragraph 7, as the 'fair value' is based on the measurement method used for each type of asset pursuant to SSAP that provides guidance for that asset type. If the SSAP was to prescribe a fair value measurement, then the new SSAP on fair value measurements would be utilized.)

v. *SSAP No. 97—Insurance in Subsidiary, Controlled and Affiliated Entities, A Replacement of SSAP No. 88* (SSAP No. 97) – Reference to "market " in 31a will be revised to refer to "fair value". Reference to "quoted market price" in 31b, will be revised to refer to "quoted price".

w. *Glossary to the Statements of the Statutory Accounting Principles* (Glossary) – The definition of fair value will be revised to refer to the new SSAP on fair value measurements.

x. *INT 99-17: EITF 97-12: Accounting for Increased Share Authorizations in an IRS Section 423 Employee Stock Purchase Plan Under APB Opinion No. 25* (INT 99-17) – Consistent with the proposed revisions to SSAP No. 13, the term "market" in paragraph 2 will be revised to reflect "fair value."

y. *INT 99-29*: *Classification of Step-Up Preferred Stock* (INT 99-29) – The reference to "market" in paragraph 4 will be revised to reflect "fair value"

z. *INT 01-14: EITF 00-16: Recognition and Measurement of Employer Payroll Taxes on Employee Stock-Based Compensation* (INT 01-14) – The reference to "market value" in paragraph 1 will be revised to reflect "fair value". (The reference to "market sectors" within that paragraph will be retained.)

aa. *INT 01-31: Assets Pledged as Collateral* (INT 01-31) – The reference to "market value" in paragraph 6 will be revised to reflect "fair value".

bb. *INT 02-05: Accounting for Zero Coupon Convertible Bonds* (INT 02-05) – The reference to "marked to market" within paragraph 3 will be revised to reflect "fair value". Also in paragraph 3, the term “market” in the last paragraph will be revised to reflect “fair value”. In paragraph 4, the statement “Mark AFS and Trading to market” will be revised to read “Mark AFS and Trading to fair value”.

cc. *INT 03-03: Admissibility of Investments Recorded Based on the Audited GAAP Equity of the Investee when a Qualified Opinion is Provided* (INT 03-03) – Reference to “market value” in paragraph 2 will be revised to reflect “fair value”.

dd. *INT 04-07: EITF 02-15: Determining Whether Certain Conversations of Convertible Debt to Equity Securities Are Within the Scope of FASB Statement No. 84* (INT 04-07) – The term “fair market value” throughout paragraph 4 will be revised to reflect “fair value”.

ee. *INT 06-07: Definition of Phrase “Other Than Temporary”* (INT 06-07) – The reference to the definition of fair value within the Glossary will be revised to reflect the new SSAP on fair value measurements.

ff. *INT 09-04, Application of the Fair Value Definition* (INT 09-04) – This interpretation will be nullified with the issuance of this standard. (As this item will be completely nullified, this item has not been included within Appendix A.)

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

63. Statutory accounting guidance for the definition of fair value is primarily included within the Glossary to Statutory Accounting Principles. In limited situations the definition of fair value is further defined within individual SSAPs, but the guidance within the Glossary is the underlying guidance for the previous definition of fair value within statutory accounting statements:

> Fair Value - The fair value of an asset (or liability) is the amount at which that asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available. If a quoted market price is available, the fair value is the product of the number of trading units times market price.
>
> If quoted market prices are not available, the estimate of fair value shall be based on the best information available. The estimate of fair value shall consider prices for similar assets and liabilities and the results of valuation techniques to the extent available in the circumstances. Examples of valuation techniques include the present value of estimated expected future cash flows using a discount rate commensurate with the risks involved, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis. Valuation techniques for measuring financial assets and liabilities and servicing assets and liabilities shall be consistent with the objective of measuring fair value. Those techniques shall incorporate assumptions that market participants would use in their estimates of values, future revenues, and future expenses, including assumptions about interest rates, default, prepayment, and volatility. In measuring financial liabilities and servicing liabilities at fair value by discounting estimated future cash flows, an objective is to use discount rates at which those liabilities could be settled in an arm's-length transaction.
>
> Estimates of expected future cash flows, if used to estimate fair value, shall be the best estimate based on reasonable and supportable assumptions and projections. All available evidence shall be considered in developing estimates of expected future cash flows. The weight given to the evidence shall be commensurate with the extent to which the evidence can be verified

> objectively. If a range is estimated for either the amount or timing of possible cash flows, the likelihood of possible outcomes shall be considered in determining the best estimate of future cash flows.

64. The guidance incorporated within the Glossary was previously established from GAAP guidance in paragraph 13 of *FAS 15, Accounting for Debtors* (FAS 15). (This guidance has been superseded by FAS 157):

> 13 …The fair value of the assets transferred is the amount that the debtor could reasonably expect to receive for them in a current sale between a willing buyer and a willing seller, that is, other than in a forced or liquidation sale. Fair value of assets shall be measured by their market value if an active market for them exists. If no active market exists for the assets transferred but exists for similar assets, the selling prices in that market may be helpful in estimating the fair value of the assets transferred. If no market price is available, a forecast of expected cash flows may aid in estimating the fair value of assets transferred, provided the expected cash flows are discounted at a rate commensurate with the risk involved.

65. The adoption of a new SSAP, that adopts, with modification, FAS 157 to define fair value, establish a framework for measuring fair value in generally accepted accounting principles (GAAP) and to expand disclosures about fair value measurements will result with continued fair value measurements that are essentially identical for statutory and GAAP purposes. Furthermore, developing a specific statement to address fair value will address the need to have consistent and comparable guidance throughout the SSAPs.

66. The adoption, with modification, of FAS 157 will change the statutory approach to determining fair value. With the guidance proposed under this issue paper, the transaction to sell an asset or liability, and determine fair value, is a hypothetical transaction at the measurement date considered from the perspective of a market participant that holds the asset or owes the liability. Thus, the definition focuses on the price that would be received to sell the asset or paid to transfer the liability (an exit price), not the price that would be paid to acquire the asset or received to assume the liability (an entry price).

67. By adopting, with modification, FAS 157, statutory accounting principles will incorporate the following key aspects of FAS 157:

a. Fair value is a market-based measurement, not an entity-specific measurement. Thus, fair value measurements shall be determined based on the assumptions that market participants would use in pricing the asset or liability.

b. The fair value hierarchy distinguishes between (1) market participant assumptions developed based on market data obtained from sources independent of the reporting entity (observable inputs) and (2) the reporting entity's own assumptions about market participant assumptions based on the best information available in the circumstances (unobservable inputs).

c. Market participant assumptions include assumptions about risk. A fair value measurement should include an adjustment for risk if market participants would include one in pricing the related asset or liability, even if the adjustment is difficult to determine. Therefore, a measurement that does not include an adjustment for risk would not represent a fair value measurement if market participants would include one in pricing the related asset or liability.

Generally Accepted Accounting Principles

68. The GAAP guidance for the fair value measurements is included within FAS 157, as modified by FSP FAS 157-1, FSP FAS 157-2 and FSP FAS 157-4: (Note: FSP FAS 157-3 is not reflected in the amended FAS 157, as the modifications included within FSP FAS 157-4 deleted all revisions originally incorporated by FSP FAS 157-3.)

> 1. This Statement defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. Where applicable, this Statement simplifies and codifies related guidance within generally accepted accounting principles (GAAP).
>
> Scope
> 2. This Statement applies under other accounting pronouncements 1 that require or permit fair value measurements, except as follows:
>
> a. This Statement does not apply under accounting pronouncements that address share-based payment transactions: *FASB Statement No. 123 (revised 2004), Share-Based Payment*, and its related interpretive accounting pronouncements that address share-based payment transactions.
>
> b. This Statement does not eliminate the practicability exceptions to fair value measurements in accounting pronouncements within the scope of this Statement.
>
> c. This Statement does not apply under *FASB Statement No. 13, Accounting for Leases*, and other accounting pronouncements that address fair value measurements for purposes of lease classification or measurement under Statement 13. This scope exception does not apply to assets acquired and liabilities assumed in a business combination that are required to be measured at fair value under Statement 141 or Statement 141(R), regardless of whether those assets and liabilities are related to leases.
>
> 3. This Statement does not apply under accounting pronouncements that require or permit measurements that are similar to fair value but that are not intended to measure fair value, including the following:
>
> a. Accounting pronouncements that permit measurements that are based on, or otherwise use, vendor-specific objective evidence of fair value
>
> b. ARB No. 43, Chapter 4, "Inventory Pricing."
>
> 4. Appendix D lists pronouncements of the Accounting Principles Board (APB) and the FASB existing at the date of this Statement that are within the scope of this Statement. Appendix E lists those APB and FASB pronouncements that are amended by this Statement.
>
> Measurement
>
> *Definition* of *Fair Value*
> 5. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

The Asset or Liability

6. A fair value measurement is for a particular asset or liability. 4 Therefore, the measurement should consider attributes specific to the asset or liability, for example, the condition and/or location of the asset or liability and restrictions, if any, on the sale or use of the asset at the measurement date. The asset or liability might be a standalone asset or liability (for example, a financial instrument or an operating asset) or a group of assets and/or liabilities (for example, an asset group, a reporting unit, or a business). Whether the asset or liability is a standalone asset or liability or a group of assets and/or liabilities depends on its unit of account. The unit of account determines what is being measured by reference to the level at which the asset or liability is aggregated (or disaggregated) for purposes of applying other accounting pronouncements. The unit of account for the asset or liability should be determined in accordance with the provisions of other accounting pronouncements, except as provided in paragraph 27.

The Price

7. A fair value measurement assumes that the asset or liability is exchanged in an orderly transaction between market participants to sell the asset or transfer the liability at the measurement date. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale). The transaction to sell the asset or transfer the liability is a hypothetical transaction at the measurement date, considered from the perspective of a market participant that holds the asset or owes the liability. Therefore, the objective of a fair value measurement is to determine the price that would be received to sell the asset or paid to transfer the liability at the measurement date (an exit price).

The Principal (or Most Advantageous) Market

8. A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. The principal market is the market in which the reporting entity would sell the asset or transfer the liability with the greatest volume and level of activity for the asset or liability. The most advantageous market is the market in which the reporting entity would sell the asset or transfer the liability with the price that maximizes the amount that would be received for the asset or minimizes the amount that would be paid to transfer the liability, considering transaction costs in the respective market(s). In either case, the principal (or most advantageous) market (and thus, market participants) should be considered from the perspective of the reporting entity, thereby allowing for differences between and among entities with different activities. If there is a principal market for the asset or liability, the fair value measurement shall represent the price in that market (whether that price is directly observable or otherwise determined using a valuation technique), even if the price in a different market is potentially more advantageous at the measurement date.

9. The price in the principal (or most advantageous) market used to measure the fair value of the asset or liability shall not be adjusted for transaction costs. 5 Transaction costs represent the incremental direct costs to sell the asset or transfer the liability in the principal (or most advantageous) market for the asset or liability. 6 Transaction costs are not an attribute of the asset or liability; rather, they are specific to the transaction and will differ depending on how the reporting entity transacts. However, transaction costs do not include the costs that would be incurred to transport the asset or liability to (or from) its principal (or most advantageous) market. If location is an attribute of the asset or liability (as might be the case for a commodity), the price in the principal (or most advantageous) market used to measure the fair value of the asset or liability shall be adjusted for the costs, if any, that would be incurred to transport the asset or liability to (or from) its principal (or most advantageous) market.

Market Participants

10. Market participants are buyers and sellers in the principal (or most advantageous) market for the asset or liability that are:

a. Independent of the reporting entity; that is, they are not related parties

b. Knowledgeable, having a reasonable understanding about the asset or liability and the transaction based on all available information, including information that might be obtained through due diligence efforts that are usual and customary

c. Able to transact for the asset or liability

d. Willing to transact for the asset or liability; that is, they are motivated but not forced or otherwise compelled to do so.

11. The fair value of the asset or liability shall be determined based on the assumptions that market participants would use in pricing the asset or liability. In developing those assumptions, the reporting entity need not identify specific market participants. Rather, the reporting entity should identify characteristics that distinguish market participants generally, considering factors specific to (a) the asset or liability, (b) the principal (or most advantageous) market for the asset or liability, and (c) market participants with whom the reporting entity would transact in that market.

Application to Assets

12. A fair value measurement assumes the highest and best use of the asset by market participants, considering the use of the asset that is physically possible, legally permissible, and financially feasible at the measurement date. In broad terms, highest and best use refers to the use of an asset by market participants that would maximize the value of the asset or the group of assets within which the asset would be used. Highest and best use is determined based on the use of the asset by market participants, even if the intended use of the asset by the reporting entity is different.

13. The highest and best use of the asset establishes the valuation premise used to measure the fair value of the asset. Specifically:

a. In-use. The highest and best use of the asset is in-use if the asset would provide maximum value to market participants principally through its use in combination with other assets as a group (as installed or otherwise configured for use). For example, that might be the case for certain nonfinancial assets. If the highest and best use of the asset is in-use, the fair value of the asset shall be measured using an in-use valuation premise. When using an in-use valuation premise, the fair value of the asset is determined based on the price that would be received in a current transaction to sell the asset assuming that the asset would be used with other assets as a group and that those assets would be available to market participants. Generally, assumptions about the highest and best use of the asset should be consistent for all of the assets of the group within which it would be used.

b. In-exchange. The highest and best use of the asset is in-exchange if the asset would provide maximum value to market participants principally on a standalone basis. For example, that might be the case for a financial asset. If the highest and best use of the asset is in-exchange, the fair value of the asset shall be measured using an in-exchange valuation premise. When using an in-exchange valuation premise, the fair value of the asset is determined based on the price that would be received in a current transaction to sell the asset standalone.

14. Because the highest and best use of the asset is determined based on its use by market participants, the fair value measurement considers the assumptions that market participants would use in pricing the asset, whether using an in-use or an in-exchange valuation premise.

Application to Liabilities

15. A fair value measurement assumes that the liability is transferred to a market participant at the measurement date (the liability to the counterparty continues; it is not settled) and that the nonperformance risk relating to that liability is the same before and after its transfer. Nonperformance risk refers to the risk that the obligation will not be fulfilled and affects the value at which the liability is transferred. Therefore, the fair value of the liability shall reflect the nonperformance risk relating to that liability. Nonperformance risk includes but may not be limited to the reporting entity's own credit risk. The reporting entity shall consider the effect of its credit risk (credit standing) on the fair value of the liability in all periods in which the liability is measured at fair value. That effect may differ depending on the liability, for example, whether the liability is an obligation to deliver cash (a financial liability) or an obligation to deliver goods or services (a nonfinancial liability), and the terms of credit enhancements related to the liability, if any.

Fair Value at Initial Recognition

16. When an asset is acquired or a liability is assumed in an exchange transaction for that asset or liability, the transaction price represents the price paid to acquire the asset or received to assume the liability (an entry price). In contrast, the fair value of the asset or liability represents the price that would be received to sell the asset or paid to transfer the liability (an exit price). Conceptually, entry prices and exit prices are different. Entities do not necessarily sell assets at the prices paid to acquire them. Similarly, entities do not necessarily transfer liabilities at the prices received to assume them.

17. In many cases, the transaction price will equal the exit price and, therefore, represent the fair value of the asset or liability at initial recognition. In determining whether a transaction price represents the fair value of the asset or liability at initial recognition, the reporting entity shall consider factors specific to the transaction and the asset or liability. For example, a transaction price might not represent the fair value of an asset or liability at initial recognition if:

a. The transaction is between related parties.

b. The transaction occurs under duress or the seller is forced to accept the price in the transaction. For example, that might be the case if the seller is experiencing financial difficulty.

c. The unit of account represented by the transaction price is different from the unit of account for the asset or liability measured at fair value. For example, that might be the case if the asset or liability measured at fair value is only one of the elements in the transaction, the transaction includes unstated rights and privileges that should be separately measured, or the transaction price includes transaction costs.

d. The market in which the transaction occurs is different from the market in which the reporting entity would sell the asset or transfer the liability, that is, the principal or most advantageous market. For example, those markets might be different if the reporting entity is a securities dealer that transacts in different markets, depending on whether the counterparty is a retail customer (retail market) or another securities dealer (inter-dealer market).

Valuation Techniques

18. Valuation techniques consistent with the market approach, income approach, and/or cost approach shall be used to measure fair value. Key aspects of those approaches are summarized below:

a. Market approach. The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities (including a business). For example, valuation techniques consistent with the market approach often use market multiples derived from a set of comparables. Multiples might lie in ranges with a different multiple for each comparable. The selection of where within the range the appropriate multiple falls requires judgment, considering factors specific to the measurement (qualitative and quantitative). Valuation techniques consistent with the market approach include matrix pricing. Matrix pricing is a mathematical technique used principally to value debt securities without relying exclusively on quoted prices for the specific securities, but rather by relying on the securities' relationship to other benchmark quoted securities.

b. Income approach. The income approach uses valuation techniques to convert future amounts (for example, cash flows or earnings) to a single present amount (discounted). The measurement is based on the value indicated by current market expectations about those future amounts. Those valuation techniques include present value techniques; option-pricing models, such as the Black-Scholes-Merton formula (a closed-form model) and a binomial model (a lattice model), which incorporate present value techniques; 9 and the multiperiod excess earnings method, which is used to measure the fair value of certain intangible assets.

c. Cost approach. The cost approach is based on the amount that currently would be required to replace the service capacity of an asset (often referred to as current replacement cost). From the perspective of a market participant (seller), the price that would be received for the asset is determined based on the cost to a market participant (buyer) to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence. Obsolescence encompasses physical deterioration, functional (technological) obsolescence, and economic (external) obsolescence and is broader than depreciation for financial reporting purposes (an allocation of historical cost) or tax purposes (based on specified service lives).

19. Valuation techniques that are appropriate in the circumstances and for which sufficient data are available shall be used to measure fair value. In some cases, a single valuation technique will be appropriate (for example, when valuing an asset or liability using quoted prices in an active market for identical assets or liabilities). In other cases, multiple valuation techniques will be appropriate (for example, as might be the case when valuing a reporting unit). If multiple valuation techniques are used to measure fair value, the results (respective indications of fair value) shall be evaluated and weighted, as appropriate, considering the reasonableness of the range indicated by those results. A fair value measurement is the point within that range that is most representative of fair value in the circumstances.

20. Valuation techniques used to measure fair value shall be consistently applied. However, a change in a valuation technique or its application (for example, a change in its weighting when multiple valuation techniques are used) is appropriate if the change results in a measurement that is equally or more representative of fair value in the circumstances. That might be the case if, for example, new markets develop, new information becomes available, information previously used is no longer available, or valuation techniques improve. Revisions resulting from a change in the valuation technique or its application shall be accounted for as a change in accounting estimate (FASB Statement No. 154, Accounting Changes and Error Corrections, paragraph 19). The disclosure provisions of Statement 154 for a change in accounting estimate are not required for revisions resulting from a change in a valuation technique or its application.

Inputs to Valuation Techniques

21. In this Statement, inputs refer broadly to the assumptions that market participants would use in pricing the asset or liability, including assumptions about risk, for example, the risk inherent in a particular valuation technique used to measure fair value (such as a pricing model) and/or the risk inherent in the inputs to the valuation technique. Inputs may be observable or unobservable:

a. Observable inputs are inputs that reflect the assumptions market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the reporting entity.

b. Unobservable inputs are inputs that reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances.

Valuation techniques used to measure fair value shall maximize the use of relevant observable inputs (that is Level 1 and Level 2 inputs that do not require significant adjustment) and minimize the use of unobservable inputs.

Fair Value Hierarchy

22. To increase consistency and comparability in fair value measurements and related disclosures, the fair value hierarchy prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. The fair value hierarchy gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). In some cases, the inputs used to measure fair value might fall in different levels of the fair value hierarchy. The level in the fair value hierarchy within which the fair value measurement in its entirety falls shall be determined based on the lowest level input that is significant to the fair value measurement in its entirety. Assessing the significance of a particular input to the fair value measurement in its entirety requires judgment, considering factors specific to the asset or liability.

23. The availability of inputs relevant to the asset or liability and the relative reliability of the inputs might affect the selection of appropriate valuation techniques. However, the fair value hierarchy prioritizes the inputs to valuation techniques, not the valuation techniques. For example, a fair value measurement using a present value technique might fall within Level 2 or Level 3, depending on the inputs that are significant to the measurement in its entirety and the level in the fair value hierarchy within which those inputs fall.

Level 1 Inputs

24. Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. An active market for the asset or liability is a market in which transactions for the asset or liability occur with sufficient frequency and volume to provide pricing information on an ongoing basis. A quoted price in an active market provides the most reliable evidence of fair value and shall be used to measure fair value whenever available, except as discussed in paragraphs 25 and 26.

25. If the reporting entity holds a large number of similar assets or liabilities (for example, debt securities) that are required to be measured at fair value, a quoted price in an active market might be available but not readily accessible for each of those assets or liabilities individually. In that case, fair value may be measured using an alternative pricing method that does not rely exclusively on quoted prices (for example, matrix pricing) as a practical expedient. However, the use of an alternative pricing method renders the fair value measurement a lower level measurement.

26. In some situations, a quoted price in an active market might not represent fair value at the measurement date. That might be the case if, for example, significant events (principal-to-principal transactions, brokered trades, or announcements) occur after the close of a market but before the measurement date. The reporting entity should establish and consistently apply a policy for identifying those events that might affect fair value measurements. However, if the quoted price is adjusted for new information, the adjustment renders the fair value measurement a lower level measurement.

27. If the reporting entity holds a position in a single financial instrument (including a block) and the instrument is traded in an active market, the fair value of the position shall be measured within Level 1 as the product of the quoted price for the individual instrument times the quantity held. The quoted price shall not be adjusted because of the size of the position relative to trading volume (blockage factor). The use of a blockage factor is prohibited, even if a market's normal

daily trading volume is not sufficient to absorb the quantity held and placing orders to sell the position in a single transaction might affect the quoted price.

Level 2 Inputs

28. Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. If the asset or liability has a specified (contractual) term, a Level 2 input must be observable for substantially the full term of the asset or liability. Level 2 inputs include the following:

a. Quoted prices for similar assets or liabilities in active markets

b. Quoted prices for identical or similar assets or liabilities in markets that are not active. (Paragraph 29A includes example factors that may indicate that a market is not active or that there has been a significant decrease in the volume and level of activity for the asset or liability when compared to normal market activity for the asset or liability (or similar assets or liabilities), depending on the degree to which the factors exist.)

c. Inputs other than quoted prices that are observable for the asset or liability (for example, interest rates and yield curves observable at commonly quoted intervals, volatilities, prepayment speeds, loss severities, credit risks, and default rates)

d. Inputs that are derived principally from or corroborated by observable market data by correlation or other means (market-corroborated inputs).

29. Adjustments to Level 2 inputs will vary depending on factors specific to the asset or liability. Those factors include the condition and/or location of the asset or liability, the extent to which the inputs relate to items that are comparable to the asset or liability, and the volume and level of activity in the markets within which the inputs are observed. An adjustment that is significant to the fair value measurement in its entirety might render the measurement a Level 3 measurement, depending on the level in the fair value hierarchy within which the inputs used to determine the adjustment fall.

29A. The reporting entity should evaluate the following factors to determine whether there has been a significant decrease in the volume and level of activity for the asset or liability when compared with normal market activity for the asset or liability (or similar assets or liabilities). The factors include, but are not limited to:

a. There are few recent transactions.

b. Price quotations are not based on current information.

c. Price quotations vary substantially either over time or among market makers (for example, some brokered markets).

d. Indexes that previously were highly correlated with the fair values of the asset or liability are demonstrably uncorrelated with recent indications of fair value for that asset or liability.

e. There is a significant increase in implied liquidity risk premiums, yields, or performance indicators (such as delinquency rates or loss severities) for observed transactions or quoted prices when compared with the reporting entity’s estimate of expected cash flows, considering all available market data about credit and other nonperformance risk for the asset or liability.

f. There is a wide bid-ask spread or significant increase in the bid-ask spread.

g. There is a significant decline or absence of a market for new issuances (that is, a primary market) for the asset or liability or similar assets or liabilities.

h. Little information is released publicly (for example, a principal-to-principal market).

The reporting entity shall evaluate the significance and relevance of the factors to determine whether, based on the weight of the evidence, there has been a significant decrease in the volume and level of activity for the asset or liability.

29B. If the reporting entity concludes there has been a significant decrease in the volume and level of activity for the asset or liability in relation to normal market activity for the asset or liability (or similar assets or liabilities), transactions or quoted prices may not be determinative of fair value (for example, there may be increased instances of transactions that are not orderly). Further analysis of the transactions or quoted prices is needed, and a significant adjustment to the transactions or quoted prices may be necessary to estimate fair value in accordance with this Statement. Significant adjustments also may be necessary in other circumstances (for example, when a price for a similar asset requires significant adjustment to make it more comparable to the asset being measured or when the price is stale).

29C. This Statement does not prescribe a methodology for making significant adjustments to transactions or quoted prices when estimating fair value. Paragraphs 18-20 discuss the use of valuation techniques in estimating fair value. If there has been a significant decrease in the volume and level of activity for the asset or liability, a change in valuation technique or the use of multiple valuation techniques may be appropriate (for example, the use of a market approach and a present value technique). When weighting indications of fair value resulting from the use of multiple valuation techniques, the reporting entity shall consider the reasonableness of the range of fair value estimates. The objective is to determine the point within that range that is most representative of fair value under current market conditions. A wide range of fair value estimates may be an indication that further analysis is needed.

29D. Even in circumstances where there has been a significant decrease in the volume and level of activity for the asset or liability and regardless of the valuation technique(s) used, the objective of a fair value measurement remains the same. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. Determining the price at which willing market participants would transact at the measurement date under current market conditions if there has been a significant decrease in the volume and level of activity for the asset or liability depends on the facts and circumstances and requires the use of significant judgment. However, the reporting entity's intention to hold the asset or liability is not relevant in estimating fair value. Fair value is a market-based measurement, not an entity-specific measurement.

29E. Even if there has been a significant decrease in the volume and level of activity for the asset or liability, it is not appropriate to conclude that all transactions are not orderly (that is, distressed or forced). Circumstances that may indicate that a transaction is not orderly include, but are not limited to:

a. There was not adequate exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities under current market conditions.

b. There was a usual and customary marketing period, but the seller marketed the asset or liability to a single market participant.

c. The seller is in or near bankruptcy or receivership (that is, distressed), or the seller was required to sell to meet regulatory or legal requirements (that is, forced).

d. The transaction price is an outlier when compared with other recent transactions for the same or similar asset or liability.

The reporting entity shall evaluate the circumstances to determine whether the transaction is orderly based on the weight of the evidence.

29F. The determination of whether a transaction is orderly (or not orderly) is more difficult if there has been a significant decrease in the volume and level of activity for the asset or liability. Accordingly, the reporting entity shall consider the following guidance:

a. If the weight of the evidence indicates the transaction is not orderly, the reporting entity shall place little, if any, weight (compared with other indications of fair value) on that transaction price when estimating fair value or market risk premiums.

b. If the weight of the evidence indicates the transaction is orderly, the reporting entity shall consider that transaction price when estimating fair value or market risk premiums. The amount of weight placed on that transaction price when compared with other indications of fair value will depend on the facts and circumstances such as the volume of the transaction, the comparability of the transaction to the asset or liability being measured at fair value, and the proximity of the transaction to the measurement date.

c. If the reporting entity does not have sufficient information to conclude that the transaction is orderly or that the transaction is not orderly, it shall consider that transaction price when estimating fair value or market risk premiums. However, that transaction price may not be determinative of fair value (that is, that transaction price may not be the sole or primary basis for estimating fair value or market risk premiums). The reporting entity shall place less weight on transactions on which the reporting entity does not have sufficient information to conclude whether the transaction is orderly when compared with other transactions that are known to be orderly.

In its determinations, the reporting entity need not undertake all possible efforts, but shall not ignore information that is available without undue cost and effort. The reporting entity would be expected to have sufficient information to conclude whether a transaction is orderly when it is party to the transaction.

29G. Regardless of the valuation technique(s) used, the reporting entity shall include appropriate risk adjustments. Paragraph B5 of this Statement indicates that “risk-averse market participants generally seek compensation for bearing the uncertainty inherent in the cash flows of an asset or liability (risk premium). A fair value measurement should include a risk premium reflecting the amount market participants would demand because of the risk (uncertainty) in the cash flows. Otherwise, the measurement would not faithfully represent fair value. In some cases, determining the appropriate risk premium might be difficult. However, the degree of difficulty alone is not a sufficient basis on which to exclude a risk adjustment.” Risk premiums should be reflective of an orderly transaction (that is, not a forced or distressed sale) between market participants at the measurement date under current market conditions.

29H. When estimating fair value, this Statement does not preclude the use of quoted prices provided by third parties, such as pricing services or brokers, when the reporting entity has determined that the quoted prices provided by those parties are determined in accordance with this Statement. However, when there has been a significant decrease in the Volume or level of activity for the asset or liability, the reporting entity should evaluate whether those quoted prices are based on current information that reflects orderly transactions or a valuation technique that reflects market participant assumptions (including assumptions about risks). In weighting a quoted price as an input to a fair value measurement, the reporting entity should place less weight (when compared with other indications of fair value that are based on transactions) on quotes that do not reflect the result of transactions. Furthermore, the nature of the quote (for example, whether the quote is an indicative price or a binding offer) should be considered when weighting the available evidence, with more weight given to quotes based on binding offers.

Level 3 Inputs

30. Level 3 inputs are unobservable inputs for the asset or liability. Unobservable inputs shall be used to measure fair value to the extent that relevant observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. However, the fair value measurement objective remains the same, that is, an exit price from the perspective of a market participant that holds the asset or owes the liability. Therefore, unobservable inputs shall reflect the reporting entity's own assumptions about the assumptions that market participants would use in pricing the asset or liability (including assumptions about risk). Unobservable inputs shall be developed based on the best information available in the circumstances, which might include the reporting entity's own data. In developing unobservable inputs, the reporting entity need not undertake all possible efforts to obtain information about market participant assumptions. However, the reporting entity shall not ignore information about market participant assumptions that is reasonably available without undue cost and effort. Therefore, the reporting entity's own data used to develop unobservable inputs shall be adjusted if information is reasonably available without undue cost and effort that indicates that market participants would use different assumptions.

Inputs Based on Bid and Ask Prices

31. If an input used to measure fair value is based on bid and ask prices (for example, in a dealer market), the price within the bid-ask spread that is most representative of fair value in the circumstances shall be used to measure fair value, regardless of where in the fair value hierarchy the input falls (Level 1, 2, or 3). This Statement does not preclude the use of mid-market pricing or other pricing conventions as a practical expedient for fair value measurements within a bid-ask spread.

Disclosures

32. For assets and liabilities that are measured at fair value on a recurring basis in periods subsequent to initial recognition (for example, trading securities), the reporting entity shall disclose information that enables users of its financial statements to assess the inputs used to develop those measurements and for recurring fair value measurements using significant unobservable inputs (Level 3), the effect of the measurements on earnings (or changes in net assets) for the period. To meet that objective, the reporting entity shall disclose the following information for each interim and annual period separately for each major category of assets and liabilities (for equity and debt securities *major category* shall be defined as *major category type* as described in paragraph 19 of *FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities* even if the equity securities or debt securities are not within the scope of Statement 115):

a. The fair value measurements at the reporting date

b. The level within the fair value hierarchy in which the fair value measurements in their entirety fall, segregating fair value measurements using quoted prices in active markets for identical assets or liabilities (Level 1), significant other observable inputs (Level 2), and significant unobservable inputs (Level 3)

c. For fair value measurements using significant unobservable inputs (Level 3), a reconciliation of the beginning and ending balances, separately presenting changes during the period attributable to the following:

(1) Total gains or losses for the period (realized and unrealized), segregating those gains or losses included in earnings (or

changes in net assets), and a description of where those gains or losses included in earnings (or changes in net assets) are reported in the statement of income (or activities)

(2) Purchases, sales, issuances, and settlements (net)

(3) Transfers in and/or out of Level 3 (for example, transfers due to changes in the observability of significant inputs)

d. The amount of the total gains or losses for the period in subparagraph (c)(1) above included in earnings (or changes in net assets) that are attributable to the change in unrealized gains or losses relating to those assets and liabilities still held at the reporting date and a description of where those unrealized gains or losses are reported in the statement of income (or activities)

e. The inputs and valuation technique(s) used to measure fair value and a discussion of changes in valuation techniques and related inputs, if any, during the period.

33. For assets and liabilities that are measured at fair value on a nonrecurring basis in periods subsequent to initial recognition (for example, impaired assets), the reporting entity shall disclose information that enables users of its financial statements to assess the inputs used to develop those measurements. To meet that objective, the reporting entity shall disclose the following information for each interim and annual period separately for each major category of assets and liabilities (for equity and debt securities *major category* shall be defined as *major category type* as described in paragraph 19 of Statement 115 even if the equity securities or debt securities are not within the scope of Statement 115):

a. The fair value measurements recorded during the period and the reasons for the measurements

b. The level within the fair value hierarchy in which the fair value measurements in their entirety fall, segregating fair value measurements using quoted prices in active markets for identical assets or liabilities (Level 1), significant other observable inputs (Level 2), and significant unobservable inputs (Level 3)

c. For fair value measurements using significant unobservable inputs (Level 3), a description of the inputs and the information used to develop the inputs

d. The inputs and valuation technique(s) used to measure fair value and a discussion of changes, if any, in the valuation technique(s) and related inputs used to measure similar assets and/or liabilities in prior periods.

34. The quantitative disclosures required by this Statement shall be presented using a tabular format.

35. The reporting entity is encouraged, but not required, to combine the fair value information disclosed under this Statement with the fair value information disclosed under other accounting pronouncements (for example, *FASB Statement No. 107, Disclosures about Fair Value of Financial Instruments*) in the periods in which those disclosures are required, if practicable. The reporting entity also is encouraged, but not required, to disclose information about other similar measurements (for example, inventories measured at market value under ARB 43, Chapter 4), if practicable.

Effective Date and Transition

36. Except as provided in subparagraphs 36.a. and 36.b. below, this Statement shall be effective for financial statements issued for fiscal years beginning after November 15, 2007, and

interim periods within those fiscal years. Earlier application is encouraged, provided that the reporting entity has not yet issued financial statements for that fiscal year, including any financial statements for an interim period within that fiscal year.

a. Delayed application of this Statement is permitted for nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), until fiscal years beginning after November 15, 2008, and interim periods within those fiscal years.

b. An entity that has issued interim or annual financial statements reflecting the application of the measurement and disclosure provisions of this Statement prior to the issuance of *FSP FAS 157-2, Effective Date of FASB Statement No. 157*, must continue to apply all of the provisions of this Statement.

37. This Statement shall be applied prospectively as of the beginning of the fiscal year in which this Statement is initially applied, except as follows. This Statement shall be applied retrospectively to the following financial instruments as of the beginning of the fiscal year in which this Statement is initially applied (a limited form of retrospective application):

a. A position in a financial instrument that trades in an active market held by a broker-dealer or investment company within the scope of the AICPA Audit and Accounting Guides for those industries that was measured at fair value using a blockage factor prior to initial application of this Statement

b. A financial instrument that was measured at fair value at initial recognition under Statement 133 using the transaction price in accordance with the guidance in footnote 3 of EITF Issue No. 02-3, "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities," prior to initial application of this Statement

c. A hybrid financial instrument that was measured at fair value at initial recognition under Statement 133 using the transaction price in accordance with the guidance in Statement 133 (added by FASB Statement No. 155, Accounting for Certain Hybrid Financial Instruments) prior to initial application of this Statement.

38. At the date this Statement is initially applied to the financial instruments in paragraph 37.a.-37.c., a difference between the carrying amounts and the fair values of those instruments shall be recognized as a cumulative-effect adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that fiscal year, presented separately. The disclosure requirements of Statement 154 for a change in accounting principle do not apply.

39. The disclosure requirements of this Statement (paragraphs 32-35), including those disclosures that are required in annual periods only, shall be applied in the first interim period of the fiscal year in which this Statement is initially applied. The disclosure requirements of this Statement need not be applied for financial statements for periods presented prior to initial application of this Statement.

Appendix A - Illustrations of Modifications to Statutory Accounting Guidance:

SSAP No. 2—Cash, Drafts and Short-Term Investments:

13. The following disclosures shall be made for short-term investments in the financial statements:

a. Fair values in accordance with *SSAP No. 100—Fair Value Measurements* ~~*SSAP No. 27—Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk, Financial Instruments with Concentrations of Credit Risk and Disclosures about Fair Value of Financial Instruments* (SSAP No. 27~~);

SSAP No. 13—Stock Options and Stock Purchase Plans:

3. A reporting entity recognizes no compensation expense for services received in return for stock issued through noncompensatory plans. The following four characteristics are essential in a noncompensatory plan:

d. The discount from the ~~market price~~fair value of the stock is no greater than would be reasonable in an offer of stock to stockholders or others.

6. The measurement date for determining compensation cost in stock option, purchase, and award plans is the first date on which are known both (a) the number of shares that an individual employee is entitled to receive and (b) the option or purchase price, if any. That date for many or most plans is the date an option or purchase right is granted or stock is awarded to an individual employee. However, the measurement date may be later than the date of grant or award in plans with variable terms that depend on events after the date of grant or award. Thus, a reporting entity recognizes compensation cost for stock issued through compensatory plans unless the employee pays an amount that is at least equal to the quoted ~~market price~~fair value of the stock at the measurement date.

~~8. Quoted market prices in active markets are the best evidence of fair value and shall be used as fair value, if available. If quoted market prices are not available, the estimate of fair value shall be based on the best information available in the circumstances.~~

14. Compensation expense related to stock appreciation rights and other variable stock option or award plans shall be measured at the end of each period as the amount by which the quoted ~~market price~~fair value ~~or value~~ of the shares of the enterprise's stock covered by a grant exceeds the option price or value specified under the plan and should be accrued as a charge to expense over the periods the employee performs the related services. Changes in the quoted ~~market price or value~~fair value should be reflected as an adjustment of accrued compensation and compensation expense in the periods in which the changes occur until the date the number of shares and purchase price, if any, are both known.

SSAP No. 26—Bonds, Excluding Loan-Backed and Structured Securities:

4. A bond acquisition or disposal shall be recorded on the trade date, not the settlement date, except for the acquisition of private placement bonds which shall be recorded on the funding date. At acquisition, bonds shall be reported at their cost, including brokerage and other related fees~~, which cannot exceed the fair value at the date of acquisition~~.

17. The financial statements shall include the following disclosures:

a. Fair value~~s~~ disclosures in accordance with *SSAP No, 100—Fair Value Measurements* ~~*SSAP No. 27—Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk, Financial Instruments with Concentrations of Credit Risk and Disclosures about Fair Value of Financial Instruments* (SSAP No. 27);~~

SSAP No. 27—Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk, Financial Instruments with Concentrations of Credit Risk and Disclosures about Fair Value of Financial Instruments

~~8. A reporting entity shall disclose in the notes to the financial statements the aggregate fair value of all financial instruments, summarized by type of financial instrument, for which it is practicable to estimate fair value, except for certain financial instruments named in paragraph 8 of *FASB Statement No. 107, Disclosures about Fair Value of Financial Instruments* (FAS 107). Fair value disclosed in the notes shall be presented together with the related admitted values in a form that makes it clear whether the fair values and admitted values represent assets or liabilities and to which line items in the Statement of Assets, Liabilities, Surplus and Other Funds they relate. Separate disclosure of this information in the notes is required even if such information is presented elsewhere in the financial statements. Unless specified otherwise in another SSAP, the disclosures may be made net of encumbrances, if the asset or liability is so reported. A reporting entity shall also disclose the method(s) and significant assumptions used to estimate the fair value of financial instruments.~~

~~9. For purposes of this statement, the fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. If quoted market prices are not available, management's best estimate of fair value shall be based on the quoted market price of a financial instrument with similar characteristics, or on industry recognized valuation techniques (for example, the present value of estimated future cash flows using a discount rate commensurate with the risks involved).~~

~~10. If it is not practicable for an entity to estimate the fair value of a financial instrument or a class of financial instruments, the following shall be disclosed:~~

~~a. Information pertinent to estimating the fair value of that financial instrument or class of financial instruments, such as the carrying amount, effective interest rate, and maturity; and~~
~~b. The reasons why it is not practicable to estimate fair value.~~

~~13. This statement adopts FAS 107 as amended by *FASB Statement No. 119, Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (FAS 119), except that paragraph 15(c) of FAS 119 relating to disclosure of financial instruments held or issued for trading is rejected and *FASB Emerging Issues Task Force No. 85-20, Recognition of Fees for Guaranteeing a Loan*. In addition, this statement rejects *FASB Statement No. 126, Exemptions from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities, an amendment of FAS 107*. FAS 119 is addressed in SSAP No. 31.~~

~~14. Paragraph 8 of FAS 107 discusses financial instruments which are exempt from fair value disclosure. Included as exempt instruments are insurance contracts, except for financial guaranty contracts.~~

SSAP No. 30—Investments in Common Stock (excluding investments in common stock of subsidiary, controlled, or affiliated entities)

5. At acquisition, common stocks shall be reported at their cost, including brokerage and other related fees. ~~Cost shall not exceed fair value.~~ Common stock acquisitions and dispositions shall be recorded on the trade date. Private placement stock transactions shall be recorded on the funding date.

13. The following disclosures regarding common stocks shall be made in the financial statements:

d. The disclosures in (i) and (ii) above should be segregated by those common stocks that have been in a continuous unrealized loss position for less than 12 months and those that have been in a continuous unrealized loss position for 12 months or longer using fair values determined in accordance with~~ SSAP No. 27~~*SSAP No. 100—Fair Value Measurements*.

f. When it is not practicable to estimate fair value~~ in accordance with SSAP No. 27~~, the investor should disclose the following additional information, if applicable, as of each date for which a statement of financial position is presented in its annual financial statements:

SSAP No. 32—Investments in Preferred Stock (including investments in preferred stock of subsidiary, controlled, or affiliated entities)

10. At acquisition, preferred stock shall be reported at cost, including brokerage and other related fees. ~~Cost shall not exceed fair value.~~ PIK stock received as dividends shall be recorded at fair value. Acquisitions and dispositions shall be recorded on the trade date. Private placement stock transactions shall be recorded on the funding date.

29. The following disclosures regarding preferred stocks shall be made in the financial statements:

a. *Fair values* in accordance with *SSAP No. 100—Fair Value Measurements* ~~*SSAP No. 27—Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk, Financial Instruments with Concentrations of Credit Risk and Disclosures about Fair Value of Financial Instruments* (SSAP No. 27)~~;

f. The disclosures in (i) and (ii) above should be segregated by those preferred stocks that have been in a continuous unrealized loss position for less than 12 months and those that have been in a continuous unrealized loss position for 12 months or longer using fair values determined in accordance with ~~SSAP No. 27~~*SSAP No. 100—Fair Value Measurements*.

h. When it is not practicable to estimate fair value~~ in accordance with SSAP No. 27~~, the investor should disclose the following additional information, if applicable, as of each date for which a statement of financial position is presented in its annual financial statements:

i. The aggregate carrying value of the investments not evaluated for impairment, and

ii. The circumstances that may have a significant adverse effect on the fair value.

SSAP No. 36—Troubled Debt Restructuring

10. A creditor shall account for a troubled debt restructuring according to the type of the restructuring (receipt of assets in full satisfaction, modification of terms, combination of types). Generally, troubled debt restructuring involving the transfer of assets shall be accounted for at the fair value of the assets received. Troubled debt restructuring involving modification of terms shall be accounted for at fair value (as determined by acceptable appraisal methodologies~~ or, if applicable, the value determined in accordance with the *NAIC Purposes and Procedures of the Securities Valuation Office* (SVO Purposes and Procedures)~~) in accordance ~~.~~ with *SSAP No. 100—Fair Value Measurements*. If the restructured loan is collateral dependent, fair value shall be the fair value of the collateral. If the restructured loan is not collateral dependent, fair value shall be determined in accordance ~~with the SVO Purposes and Procedures, if applicable, or at the present value of expected future cash flows~~with SSAP No. 100 (reference new SSAP). If the

determined fair value of the loan is less than the recorded investment in the loan (including accrued interest, net deferred loan fees or costs, and unamortized premium or discount), a new cost basis shall be established at the fair value with the difference being recorded as a realized loss in the statement of operations. After the troubled debt restructuring, a creditor shall account for the assets consistent with the statutory guidance for such assets.

11. A creditor shall account for assets, including foreclosed property and equity interests in corporations, joint ventures, or partnerships, received in satisfaction of the loan at their fair value (as determined by acceptable appraisal methodologies~~ or, if applicable, the value determined in accordance with the SVO Purposes and Procedures~~) at the time of restructuring or at the book value of the loan if lower. If the fair value is less than the book value, the required writedown shall be recognized as a realized capital loss. The creditor shall reclassify the asset from loans to the appropriate asset account, such as real estate or other invested assets, at the time that the creditor obtains clear title to the asset except for mortgage loans which shall be reclassified at the beginning of the redemption period unless it is probable that the mortgage loan will be redeemed. After the troubled debt restructuring, a creditor shall account for the assets received in satisfaction of the loan consistent with the statutory guidance for similar assets.

SSAP No. 37—Mortgage Loans

20. The following disclosures shall be made in the financial statements:

a. Fair values in accordance with *SSAP No. 100—Fair Value Measurement*~~ *SSAP No. 27—Disclosure of Information About Financial Instruments with Off-Balance-Sheet Risk, Financial Instruments with Concentrations of Credit Risk and Disclosures about Fair Value of Financial Instruments* (SSAP No. 27)~~;

SSAP No. 40—Real Estate Investments

11. The current fair value of real estate shall be determined on a property by property basis (i.e., increases in the fair value of one property shall not be used to offset declines in fair value of another)~~ and shall be defined as the price that a property would bring in a competitive and open market under all conditions requisite to a fair sale (i.e., the buyer and seller acting prudently and knowledgeably with the price not affected by any undue stimulus)~~. If market quotes are unavailable, estimates of fair value shall be determined by an appraisal (internal or third party), which is based upon an evaluation of all relevant data about the market, considering the following:

a. A physical inspection of the premises;

b. The present value of future cash flows generated by the property (Discounted Cash Flows), or capitalization of stabilized net operating income (Direct Capitalization);

c. Current sales prices of similar properties with adjustments for differences in the properties (Sales Comparison Approach);

d. Costs to sell the property if the reporting entity does not have the intent or ability to hold the real estate as an investment; and

e. Replacement costs of the improvements, less depreciation, plus the value of the land (Cost Approach).

19. A participating mortgage loan is established when the lender is entitled to participate in appreciation of the ~~market value~~fair value of mortgaged real estate, the results of operations of the mortgaged real estate project, or in both. Mortgage loan participation features should be recorded at fair value at inception of the loan. The borrower should recognize a participation liability for the determined fair valued amount, with a corresponding debit to a debt discount

account. The debt discount should be amortized by the interest method, using the effective interest rate. After inception, adjustment of the participation liability should occur at each reporting date to current fair value. The corresponding debit or credit should be to the related debt discount account. The revised debt discount should be amortized prospectively, using the effective interest rate method.

20. The real estate investment with the participating mortgage loan should be reported in accordance with paragraph 4, with no adjustment for appreciation of ~~market value~~fair value.

24. An entity that holds real estate investments with participating mortgage loan features should disclose:

a. Aggregate amount of participating mortgage obligations at the balance-sheet date, with separate disclosure of the aggregate participation liabilities and related debt discounts.

b. Terms of participations by the lender in either the appreciation in the ~~market value~~fair value of the mortgaged real estate project or the results of operations of the mortgaged real estate project, or both.

SSAP No. 43R—Loan-Backed and Structured Securities - Revised

6. At acquisition, loan-backed securities, except for loan-backed or structured securities that are beneficial interests that are not of high credit quality or can contractually be prepaid or otherwise settled in such a way that the reporting entity would not recover substantially all of its recorded amount[1] (see paragraphs 20-24), shall be reported at cost, including brokerage and related fees.~~ Cost shall not exceed fair value~~. Acquisitions and dispositions shall be recorded on the trade date, not the settlement date, except for the acquisition of private placement loan-backed securities which shall be recorded on the funding date. For securities where all information is not known as of the trade date (e.g., actual payment factors and specific pools), a reporting entity shall make its best estimate based on known facts.

48. In addition to the disclosures required for invested assets in general, the following disclosures regarding loan-backed securities shall be made in the financial statements:.

a. Fair values in accordance with *SSAP No. 100—Fair Value Measurements*.~~ *SSAP No. 27—Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk, Financial Instruments with Concentrations of Credit Risk and Disclosures about Fair Value of Financial Instruments* (SSAP No. 27~~);

i. The disclosures in (i) and (ii) above should be segregated by those securities that have been in a continuous unrealized loss position for less than 12 months and those that have been in a continuous unrealized loss position for 12 months or longer using fair values determined in accordance with ~~SSAP No. 27~~SSAP No. 100.~~.~~

k. When it is not practicable to estimate fair value~~ in accordance with SSAP No. 27~~, the investor should disclose the following additional information, if applicable, as of each date for which a statement of financial position is presented in its annual financial statements:

i. The aggregate carrying value of the investments not evaluated for impairment, and

[1] As referenced in the Relevant Literature section, this Statement adopts EITF 99-20, including the scope requirements of that guidance.

ii. The circumstances that may have a significant adverse effect on the fair value.

SSAP No. 51—Life Contracts

38. Disclose the amount of annuity actuarial reserves and deposit liabilities by withdrawal characteristics as follows:

a. Subject to discretionary withdrawal:

iii. At ~~market~~ fair value, where the withdrawal of funds is payable at current ~~market value~~fair value of the assets supporting the liabilities, the assets are stated at current ~~market~~ fair value, and the liabilities are stated at the current ~~market~~ fair value or per unit value of the assets supporting the liabilities. These liabilities are for contracts where the customer bears the entire investment risk;

iv. Total with adjustment or at ~~market~~ fair value;

SSAP No. 52—Deposit-Type Contracts

17. Disclose the amount of annuity actuarial reserves and deposit liabilities by withdrawal characteristics as follows:

a. Subject to discretionary withdrawal:

iii. At ~~market~~ fair value, where the withdrawal of funds is payable at current ~~market~~ fair value of the assets supporting the liabilities, the assets are stated at current ~~market~~ fair value, and the liabilities are stated at the current ~~market~~ fair value or per unit value of the assets supporting the liabilities. These liabilities are for contracts where the customer bears the entire investment risk;

iv. Total with adjustment or at ~~market~~ fair value;

SSAP No. 56—Separate Accounts

17. Assets supporting fund accumulation contracts (GICs), which do not participate in underlying portfolio experience, with a fixed interest rate guarantee, purchased under a retirement plan or plan of deferred compensation, established or maintained by an employer, will be recorded as if the assets were held in the general account. Assets supporting all other contractual benefits shall be recorded at ~~market~~ fair value on the date of valuation, or if there is no readily available market, then in accordance with the valuation procedures in the applicable contract.

18. An AVR is generally required for separate accounts when the insurer, rather than the policyholder/contractholder, suffers the loss in the event of asset default or ~~market~~ fair value loss. An AVR is required unless:

a. The asset default or ~~market~~ fair value risk is borne directly by the policyholders; or

20. Assets supporting typical modified guaranteed contracts, market value adjusted contracts, and contracts with book value guarantees similar to contracts generally found in the general account do require an AVR because the insurer is responsible for credit related asset or ~~market~~ fair value loss.

22. An IMR is required for separate accounts with assets recorded at book value, but is not required for separate accounts with assets recorded at ~~market~~ fair value. For example, separate accounts for traditional variable annuities or variable life insurance do not require an IMR because assets and liabilities are valued at ~~market~~ fair value.

26. Where separate account contracts have guaranteed elements, the basis for determining the value of the liability shall be consistent with the basis used for asset values (i.e., valuation interest rates as defined in Appendix A-820 shall be used when assets are recorded as if held in the general account and current interest rates based on market rates shall be used when assets are recorded at ~~market~~fair value). Further, policy reserves shall be in compliance with those Actuarial Standards of Practice promulgated by the Actuarial Standards Board.

31. For each risk-based capital grouping (as detailed in paragraph 32), the following shall be disclosed:

a. Premiums, considerations or deposits received during the year;

b. Reserves by the valuation basis of the investments supporting the reserves at the financial statement date. List reserves for separate accounts whose assets are carried at ~~market~~ fair value separately from those whose assets are carried at amortized cost/book value;

c. Reserves by withdrawal characteristics, i.e., whether or not the separate account is subject to discretionary withdrawal or market value adjustment, or to withdrawal at book value with or without surrender charge;

32. For the disclosures required in paragraph 31, separate accounts shall be addressed in the following groupings (which are the same as those used for risk-based capital):

b. Nonguaranteed Separate Accounts-Variable separate accounts, where the benefit is determined by the performance and/or ~~market~~ fair value of the investments held in the separate account. Include variable accounts with incidental risks, nominal expense, and minimum death benefit guarantees.

41. This statement is effective for years beginning January 1, 2001. Contracts with assets held in a Separate Account that were issued in accordance with applicable state laws and regulations and issued prior to that effective date, for which assets and liabilities have been recorded using a consistent basis since issue, i.e., both assets and liabilities are recorded either as if in the general account ("book value") or as at ~~market~~ fair value (current interest rates based on market rates shall be used for liabilities when assets are recorded at ~~market~~ fair value), shall continue to be recorded using such basis until such time as the applicable contract terms or provisions are substantially changed, such as by a contract amendment modifying interest rate or withdrawal provisions. State laws and regulations shall be understood to include anything considered authoritative by the domiciliary state under the individual state's statutory authority and due process procedures. Changes that do not require change in the basis of recording would include: address changes, continued deposits, and other non-substantive changes such as these. For example, additional funds received after January 1, 2001 under contracts issued prior to January 1, 2001 may continue to be recorded using the basis in effect prior to January 1, 2001 until such time as a triggering change is made. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*.

SSAP No. 61—Life, Deposit-Type and Accident and Health Reinsurance

55. The assuming entity is to value the assets acquired at the date of acquisition at their ~~market~~ fair values, and the reserves are to be established according to statutory requirements based on the benefits in the individual policies reinsured. If the liabilities exceed the assets, the difference represents goodwill that must be amortized into operations using the interest method

over the life of the policies, but for a period not to exceed 10 years. Goodwill resulting from assumption reinsurance transactions shall be included in the total goodwill of an entity when calculating the amount of goodwill that is a nonadmitted asset pursuant to SSAP No. 68—Business Combinations and Goodwill. If the assets exceed the liabilities, the assuming entity shall record a deferred liability and amortize the amount into operations using the interest method over the expected life of the business but not to exceed ten years.

59. Disclose the amount of annuity actuarial reserves and deposit liabilities by withdrawal characteristics as follows:

a. Subject to discretionary withdrawal:

iii. At ~~market~~ fair value, where the withdrawal of funds is payable at current market value of the assets supporting the liabilities, the assets are stated at current ~~market~~ fair value, and the liabilities are stated at the current ~~market~~ fair value or per unit value of the assets supporting the liabilities. These liabilities are for contracts where the customer bears the entire investment risk;

iv. Total with adjustment or at ~~market~~ fair value;

SSAP No. 73—Health Care Delivery Assets – Supplies, Pharmaceuticals and Surgical Supplies, Durable Medical Equipment, Furniture, Medical Equipment and Fixtures, and Leasehold Improvements in Health Care Facilities

5. The reporting entity shall maintain a control system that provides for identification of quantities on hand and appropriate valuation (lower of cost or ~~market~~fair value) of supplies, pharmaceuticals and surgical supplies, and durable medical equipment.

SSAP No. 74—Accounting for Issuance of Insurance-Linked Securities Issued by a Property and Casualty Insurer through a Protected Cell

Glossary:

Fair value - See ~~GLOSSARY to the Statements of Statutory Accounting *Principles*~~*SSAP No. 100—Fair Value Measurements*.

SSAP No. 86—Accounting for Derivative Instruments and Hedging, Income Generation, and Replication (Synthetic Asset) Transactions (Note – 106 hits of 'fair' and 15 hits of 'market')

14. Derivative instruments represent rights or obligations that meet the definitions of assets (SSAP No. 4—Assets and Nonadmitted Assets) or liabilities (SSAP No. 5) and shall be reported in financial statements. In addition, derivative instruments also meet the definition of financial instruments as defined in SSAP No. 27—Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and~~,~~ Financial Instruments with Concentrations of Credit Risk. ~~and Disclosures about Fair Value of Financial Instruments~~ (SSAP No. 27). Should the cost basis of the derivative instrument be undefined (i.e., no premium is paid), the instrument shall be disclosed in accordance with paragraphs 8-10 of SSAP No. 27. Derivative instruments are admitted assets to the extent they conform to the requirements of this statement.

Exhibit C – SSAP No. 86

1.b.i.(e) - If during the life of the derivative it or a designated portion of the derivative is no longer effective as a hedge, valuation at amortized cost ceases and the derivative or the designated portion of the derivative shall be valued at its current fair value ~~(marked to market)~~ with gains and losses recognized in unrealized gains or unrealized losses to the extent it ceased to be an effective hedge.

1.b.ii(a) - Options, warrants, caps, or floors purchased or written shall be valued at current fair value ~~(marked to market)~~ with changes in fair value recognized currently consistent with the hedged item; this will result in unrealized gain/loss treatment with adjustment to unassigned funds (surplus).

1.b.iii. - Open derivatives hedging items recorded at fair value, where gains and losses on the hedged item are recognized currently in earnings: options, warrants, caps, or floors purchased or written shall be valued at current fair value ~~(marked to market)~~ with changes in fair value recognized currently in earnings together with the gains and losses on the hedged item.

1.b.iii.(b) - If during the life of the derivative it or a designated portion of the derivative is no longer effective as a hedge, recognition of changes in fair value through earnings ceases. The derivative or the designated portion of the derivative shall continue to be valued at its current fair value ~~(marked to market)~~, but thereafter gains or losses shall be recognized in unrealized gains or unrealized losses to the extent it ceased to be an effective hedge.

2.b.i.(5) - If during the life of the derivative it or a designated portion of the derivative is no longer effective as a hedge, valuation at amortized cost ceases and the derivative or a designated portion of the derivative shall be valued at its current fair value ~~(marked to market)~~ with gains and losses recorded in unrealized gains or unrealized losses to the extent that it ceased to be an effective hedge. Upon redesignation into an effective hedging relationship, the derivative's mark to fair value through unrealized gain or loss shall be reversed.

2.b.ii(a) - Swaps, collars, or forwards shall be valued at current fair value ~~(marked to market)~~ with changes in fair value recognized currently consistent with the hedged item; this will result in unrealized gain/loss treatment with adjustment to unassigned funds (surplus);

2.b.iv. - Open derivatives hedging items recorded at fair value, where gains and losses on the hedged item are recognized currently in earnings: swaps, collars and forwards shall be valued at current fair value ~~(marked to market)~~ with changes in fair value recognized currently in earnings together with the gains and losses on the hedged item.

(a) If during the life of the derivative it or a designated portion of the derivative is no longer effective as a hedge, recognition of changes in fair value through earnings ceases. The derivative shall continue to be valued at its current fair value ~~(marked to market)~~, but thereafter gains or losses shall be recognized in unrealized gains or unrealized losses to the extent it ceased to be an effective hedge.

iv. Open futures hedging items recorded at fair value, where gains and losses on the hedging item are recognized currently in earnings shall be valued at current fair value ~~(marked to market)~~ with changes in fair value recognized currently in earnings.

SSAP No. 90—Accounting for the Impairment of Disposal of Real Estate Investments

5. A long-lived asset shall be tested for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable. The following are examples of such events or changes in circumstances:

a. A significant decrease in the ~~market price~~fair value of a long-lived asset

Fair Value

16. A discussion of fair value is contained in ~~the Glossary to the Statements of Statutory Accounting *Principles*~~*SSAP No. 100—Fair Value Measurement*. This statement requires properties occupied by the company, that are determined to be subject to recoverability testing as discussed in paragraphs 6 and 7, to follow the guidance in SSAP No. 40, paragraph 11.

41. The modifications to FAS 144 were made in order to maintain consistency with current statutory accounting principles and the Statement of Concepts:

d. Paragraphs 22-24 which discuss fair value, are rejected. The definition of fair value is in *SSAP No. 100—Fair Value Measurements*. ~~the glossary to the Statement of Statutory Accounting Principles. In addition, this statement allows a modification to use for determining the fair value of properties occupied by company.~~

SSAP No. 91R—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities

7. Upon completion of a transfer of assets that satisfies the conditions to be accounted for as a sale (see paragraph 5), the transferor (seller) shall:

e. Initially measure such additional assets obtained and liabilities incurred in the sale at fair value (see ~~Glossary to the Statements of Statutory Accounting *Principles*~~*SSAP No. 100—Fair Value Measurements*), or if it is not practicable to estimate the fair value of an asset or a liability, apply alternative measures (paragraph 49); and

8. The transferee shall recognize all assets obtained and any liabilities incurred, and initially measure them at fair value ~~(in aggregate, presumptively the price paid)~~.

12. If distinct servicing rights exist in accordance with the above guidelines, the reporting entity shall recognize a servicing asset or liability. When the servicing fees to be received exceed the cost of servicing the transferred assets, a servicing asset is recognized and nonadmitted. When the cost of servicing the transferred assets is greater than the servicing fees to be received, a liability shall be recorded for the excess to recognize this obligation. A corresponding loss shall be recorded through the Summary of Operations in other income. Servicing assets and servicing liabilities shall be measured initially at fair value~~, presumptively the price paid~~. Servicing assets or liabilities shall be measured subsequently at fair value at each reporting date with fluctuations in fair value reported as unrealized gains and losses. Declines in fair value which are determined to be other than temporary shall be recorded as realized losses. shall be amortized into income in proportion to, and over the period of estimated servicing income

95. A reporting entity shall disclose the following:

f. If the entity has securitized financial assets during any period presented and accounts for that transfer as a sale, for each major asset type (for example, mortgage loans):

i. Its accounting policies for initially measuring the interests that continue to be held by a transferor, if any, ~~including the methodology (whether quoted market price, prices based on sales of similar assets and liabilities, or prices based on valuation techniques)~~ used in determining their fair value. (Fair value shall be determined in accordance with *SSAP No. 100—Fair Value Measurements*) ~~(Glossary to the Statements of Statutory Accounting Principles)~~; and

g. If the entity has interests that continue to be held by a transferor in securitized financial assets at the date of the latest statement of financial position presented, for each major asset type (for example, mortgage loans):

i. Its accounting policies for subsequently measuring those interests that continue to be held by a transferor, including the methodology (~~whether quoted market price, prices based on sales of similar assets and liabilities, or prices based on valuation techniques)~~ used in determining their fair value. (Fair value shall be determined in accordance with *SSAP No. 100—Fair Value Measurements* ~~(Glossary to the Statements of Statutory Accounting Principles~~);

Glossary: Derivative financial instrument - A derivative instrument (as defined in *SSAP No. 86—Accounting for Derivative Instruments and Hedging, Income Generation, and Replication (Synthetic Asset) Transactions*) that is a financial instrument (refer to *SSAP No. 27—Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk~~,~~ and Financial Instruments with Concentrations of Credit ~~Risk and Disclosures about Fair Value of Financial Instruments~~*, paragraph 2).

SSAP No. 93—Accounting for Low Income Housing Tax Credit Property Investments

1. This statement establishes statutory accounting principles for investments in federal and certain state sponsored Low Income Housing Tax Credit (LIHTC) properties. State sponsored LIHTC programs that have the following characteristics are within the scope of and shall be accounted for in accordance with this statement:

c. Resale value of the investment is not based upon the ~~market value~~fair value of the underlying real estate.

d. ~~Market value~~Fair value of the investment is directly tied to the remaining stream of tax credits and deductible losses

5. Resale valuation of these investments is based on the present value of the future stream of tax credits and deductible losses, and not the ~~market value~~fair value of the underlying real estate.

20. The significance of an investment to the reporting entity's financial position and results of operations shall be considered in evaluating the extent of disclosures of the financial position and results of operations of an investment in a LIHTC. If in the aggregate the LIHTC investments exceed 10% of the total admitted assets of the reporting entity the following disclosures shall be made:

b. For partnerships, and limited liability companies for which a quoted ~~market price~~fair value is available, the aggregate value of each partnership, or limited liability company investment based on the quoted ~~market price~~fair value; and

SSAP No. 95—Exchanges of Nonmonetary Assets, A Replacement of SSAP No. 28—Nonmonetary Transactions

14. Fair value of a nonmonetary asset transferred to or from a reporting entity in a nonmonetary transaction should be determined in accordance with *SSAP No. 100—Fair Value Measurements*. ~~by referring to estimated realizable values in cash transactions of the same or similar assets, quoted market prices, independent appraisals, estimated fair values of assets or services received in exchange, and other available evidence.~~ If one of the parties in a nonmonetary transaction could have elected to receive cash instead of the nonmonetary asset, the amount of cash that could have been received may be evidence of the fair value of the nonmonetary assets exchanged.

SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities, A Replacement of SSAP No. 88

31. The significance of an investment to the reporting entity's financial position and results of operations shall be considered in evaluating the extent of disclosures of the financial position and results of operations of an investee. The following disclosures shall be made for all investments in SCA entities that exceed 10% of the total admitted assets of the reporting entity:

a. Financial statements of a reporting entity shall disclose (i) the name of each SCA entity and percentage of ownership of common stock, (ii) the accounting policies of the reporting entity with respect to investments in SCA entities, and (iii) the difference, if any, between the amount at which the investment is carried and the amount of underlying equity in net assets (i.e., goodwill, other nonadmitted assets, ~~market~~ fair value or discounted ~~market~~ fair value adjustments) and the accounting treatment of the difference;

b. For those SCA entities for which a quoted market price is available, the aggregate value of each SCA investment based on the quoted ~~market price~~ price and the difference, if any, between the amount at which the investment is carried and the quoted ~~market price~~ price shall be disclosed;

Glossary to the Statements of Statutory Accounting Principles

Fair Value ~~-~~— Fair value is defined in *SSAP No. 100—Fair Value Measurements*.~~The fair value of an asset (or liability) is the amount at which that asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available. If a quoted market price is available, the fair value is the product of the number of trading units times market price.~~

~~If quoted market prices are not available, the estimate of fair value shall be based on the best information available. The estimate of fair value shall consider prices for similar assets and liabilities and the results of valuation techniques to the extent available in the circumstances. Examples of valuation techniques include the present value of estimated expected future cash flows using a discount rate commensurate with the risks involved, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis. Valuation techniques for measuring financial assets and liabilities and servicing assets and liabilities shall be consistent with the objective of measuring fair value. Those techniques shall incorporate assumptions that market participants would use in their estimates of values, future revenues, and future expenses, including assumptions about interest rates, default, prepayment, and volatility. In measuring financial liabilities and servicing liabilities at fair value by discounting estimated future cash flows, an objective is to use discount rates at which those liabilities could be settled in an arm's-length transaction.~~

~~Estimates of expected future cash flows, if used to estimate fair value, shall be the best estimate based on reasonable and supportable assumptions and projections. All available evidence shall be considered in developing estimates of expected future cash flows. The weight given to the evidence shall be commensurate with the extent to which the evidence can be verified objectively. If a range is estimated for either the amount or timing of possible cash flows, the likelihood of possible outcomes shall be considered in determining the best estimate of future cash flows.~~

~~Market Value - Market value is equivalent to fair value.~~

INT 99-17: EITF 97-12: Accounting for Increased Share Authorizations in an IRS Section 423 Employee Stock Purchase Plan under APB Opinion No. 25.

2. The working group reached a consensus that EITF 97-12 should be adopted to require that additional shares granted in a stock purchase plan be classified as compensatory or noncompensatory at the grant date of the additional shares. If the discount at that date does not meet the ~~market~~ fair value discount criterion in paragraph 3.d. of SSAP No. 13, then the new grant would be treated as a compensatory award under SSAP No. 13, which would result in compensation cost.

INT 99-29: Classification of Step-up Preferred Stock

4. A strict reading of the perpetual preferred stock definition further complicates the issue in that step-ups do not have redemption features: thus, they meet the definition of perpetual preferred stock. The valuation of step-up preferred stock would not be consistent with the economic substance of the security if it were valued at ~~market~~fair value.

INT 01-14: EITF 00-16: Recognition and Measurement of Employer Payroll Taxes on Employee Stock-Based Compensation

1. *Topic No. D-83, Accounting for Payroll Taxes Associated with Stock Option Exercises* requires that payroll taxes incurred in connection with stock-based compensation be recognized as an expense, but it does not address the timing of that expense recognition. Costs incurred by companies for employer payroll taxes on employee stock-based compensation have become more significant for U.S. companies as a result of the increased use of options as a form of employee compensation and the rapid growth in the ~~market~~ fair value of underlying stocks in certain market sectors. Consequently, the predominant current practice of recognizing those costs when the event that triggers payment to the taxing authority occurs (for an option, that event is employee exercise), has been called into question.

INT 01-31: Assets Pledged as Collateral

6. The working group reached a consensus that if the collateral had not been pledged in the examples described above, it is assumed the underlying asset would be recorded as an admitted asset under SSAP No. 4 (e.g. they are readily marketable assets available to meet both current and future policyholder obligations). In addition, it is assumed that the asset would not be considered impaired under SSAP No. 5 due to a default,~~-~~ ~~market~~fair value decline, or other loss contingency.

INT 02-05: Accounting for Zero Coupon Convertible Bonds

3. A convertible bond really consists of a bond and an embedded derivative in the form of a warrant. Under GAAP, the holder accounts for the two components separately. The bond and warrants are fair valued at date of purchase. The bond is typically classified as available for sell (AFS) or held to maturity (HTM) and the scientific method of amortization is used on any premium or discount. This amortization of the premium or discount produces a market yield when combined with the coupon rate. In addition, the available for sale is ~~marked to market~~recorded at fair value with the unrealized gains and losses recorded as a component of equity in other comprehensive income. The warrant is fair valued at each reporting date and classified as trading with ~~the~~ adjustments to ~~market~~ fair value recorded through the income statement, as it is considered a derivative (no hedge).

4. For GAAP, assuming a purchase price was $900,000 at 1/1/x1 and the fair value of the warrants was $150,000 at 1/1/x1, the following entries would be recorded during the year:

At 1/1/X1:		
Purchase Price		$900,000
Bond Fair Value		$750,000
Yield	8.87%	
Warrant Fair Value	$150,000	
At 12/31/X1:		
Bond Fair Value		$780,000
Warrant Fair Value	$200,000	

Entries 1/1/X1:

Bonds-AFS	$750,000	
Warrants-Trading	$150,000	
Cash		($900,000)

Entries 12/31/X1:

Cash (coupon rate)	$50,000	
Bonds-AFS (amortization)	$16,554	
Investment income		($66,554)

Record discount accretion and cash from coupon rate

Bonds-AFS	13,446	
Warrants-Trading	50,000	
Unrealized gains-OCI		(13,446)
Realized gains		(50,000)

Mark AFS and Trading to ~~market~~fair value

INT 03-03: Admissibility of Investments Recorded Based on the Audited GAAP Equity of the Investee When a Qualified Opinion is Provided

2. Certain situations may exist in which a qualified opinion is provided due to a GAAP departure, while information is available to determine the appropriate balances under a GAAP basis of accounting. For example, a qualified opinion would be given if a cost sharing agreement requires the cost basis of accounting to be used to value investments in a limited partnership in which the reporting entity owned more than a 5% interest, as GAAP requires such investments to be recorded based upon the GAAP equity method. Since the notes to the financial statements disclose the ~~market~~ fair value of investments held by the limited partnership, information is readily available to allocate the unrealized appreciation on investments to determine what the appropriate GAAP equity balance would be. A qualified opinion could also result if the unrealized appreciation on investments is not allocated in accordance with a partnership agreement. Another example occurs when a qualified opinion is issued due to a departure from GAAP and the departure is related to the valuation of an U.S. insurance entity on the basis of U.S. statutory accounting principles.

INT 04-07: EITF 02-15: Determining Whether Certain Conversions of Convertible Debt to Equity Securities Are Within the Scope of FASB Statement No. 84

3. The following is excerpted from EITF 02-15:

> 3. Statement 84 was issued to amend Opinion 26, to exclude from its scope convertible debt that is converted to equity securities of the debtor pursuant to conversion privileges different from those included in the terms of the debt at issuance, and the change in conversion privileges is effective for a limited period of time, involves additional consideration, and is made to induce conversion. That Statement applies only to conversions that both (a) occur pursuant to changed conversion privileges that are exercisable only for a limited period of time and (b) include the issuance of all of the equity securities issuable pursuant to conversion privileges included in the terms of the debt at issuance for each debt instrument that is converted. When convertible debt is converted to equity securities of the debtor pursuant to an inducement offer (described above), the debtor shall recognize an expense equal to the excess of the fair value of all securities and other consideration transferred in the transaction over the fair value of securities issuable pursuant to the original conversion terms.
>
> 4. A question has arisen as to whether Statement 84 applies to conversions of convertible debt when the "offer" for consideration in excess of the original conversion terms was made by the debt holder rather than the debtor. In certain circumstances, for

example, a bondholder may be a third party that purchased the bonds in the open market (often at a significant discount from face value) and approached the debtor to increase the conversion terms of the notes. In many of those circumstances, the offer to induce conversion is not extended to all debt holders; rather, the conversion involves only the specific debt holder that approached the debtor. The following example is provided:

Company A issued publicly traded convertible bonds (the Bonds) during a prior period. Currently, the Bonds are trading at a price that is significantly less than the carrying value (possibly due to a decline in Company A's stock price or credit rating or both). The original conversion price of the Bonds is $50 (20 shares of common stock per bond), and Company A's common stock is currently trading at $25 per share. On an individual basis, bondholders approach Company A with an offer for Company A to purchase the Bonds by providing consideration in excess of the conversion terms. Assume that on the date of the exchange, each Bond has the following values:

Company A's carrying value of the Bonds	$1,000
Current fair ~~market~~ value of the Bonds	$ 750

A bondholder approaches Company A with the following two independent offers that are exercisable by Company A for a limited period of time:

1. Company A may purchase the Bonds in exchange for the Bonds' original conversion of 20 shares of Company A common stock ($500 fair ~~market~~ value) and $300 cash.

2. Company A may purchase the Bonds in exchange for 32 shares of Company A common stock ($800 fair ~~market~~ value).

INT 06-07: Definition of Phrase "Other Than Temporary"

2. The decision for determining when an investment is considered impaired is dictated by the applicable SSAP and the respective impairment indicators included in each of the SSAPs. If an impairment indicator is present, the determination of an impairment shall be assessed at the individual security or investment level as reported in the annual statement and supporting schedules. For those SSAPs that require the reporting entity to use the fair value to determine if an impairment has occurred, the determination of that value shall be consistent with how the term fair value is defined within ~~the Glossary of the Accounting Practices and Procedures Manual~~*SSAP No. 100—Fair Value Measurements*. Once a reporting entity has determined that an impairment indicator is present, the reporting entity shall continue to evaluate whether the investment is impaired each subsequent reporting period until either (a) the investment experiences a recovery of the fair value up to (or beyond) its carrying value or (b) the investor recognizes an other-than-temporary impairment loss.

Statutory Issue Paper No. 140

Substantive Revisions to SSAP No. 43—Loan-Backed and Structured Securities

STATUS
Adopted December 5, 2009

Original SSAP and Current Authoritative Guidance: SSAP No. 43R

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. The purpose of this issue paper is to retain for historical purposes the statutory guidance superseded with the issuance of *SSAP No. 43R—Loan-Backed and Structured Securities – Revised* (SSAP No. 43R):

   a. *SSAP No. 43—Loan-Backed and Structured Securities* (SSAP No. 43);

   b. *SSAP No. 98—Treatment of Cash Flows When Quantifying Changes in Valuation and Impairments, an Amendment of SSAP No. 43—Loan-Backed and Structured Securities* (SSAP No. 98);

   c. Paragraph 13 of *SSAP No. 99—Accounting for Certain Securities to an Other-Than-Temporary Impairment* (SSAP No. 99)

2. This Issue Paper also details SSAP No. 43R as initially adopted in September 2009. The substantive revisions adopted within SSAP No. 43R include accounting guidance for securities acquired in a transfer, beneficial interests, recognition of impairment and disclosures.

3. SSAP No. 43R supersedes SSAP No. 98 (impairment to fair value) and revises valuation and impairment requirements based on the cash flows expected to be collected for the securities, rather than fair value. Since the impairment requirements are based upon expected cash flows, most impairment charges recognized will be based upon cash flows that the reporting entity does NOT expect to collect (credit related). Reporting entities would only impair to fair value if there is intent to sell the security, or the reporting entity cannot assert that they have the intent and ability to retain the investment for a period of time sufficient to recover the amortized cost basis. No. 43R provides differences in impairment recognition for situations when: 1) there is an intent to sell; 2) the entity does not have the intent and ability to hold the security; and 3) there is a non-interest related decline, when there is no intent to sell and when the entity has the intent and ability to hold the security.

4. For historical record, the guidance within SSAP No. 43, SSAP No. 98, and paragraph 13 of SSAP No. 99, which has been superseded by SSAP No. 43R, has been included as the 'Relevant Statutory Accounting' guidance within paragraphs 7, 8 and 9.

5. The adopted guidance within SSAP No. 43R has been included below:

> 1. This statement establishes statutory accounting principles for investments in loan-backed securities and structured securities. In accordance with *SSAP No. 91R—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (SSAP No. 91R), retained

beneficial interests from the sale of loan-backed securities and structured securities are accounted for in accordance with this statement. In this statement loan-backed securities and structured securities are collectively referred to as loan-backed securities.

SUMMARY CONCLUSION

2. Loan-backed securities are defined as pass-through certificates, collateralized mortgage obligations (CMOs), and other securitized loans not included in structured securities, as defined below, for which the payment of interest and/or principal is directly proportional to the interest and/or principal received by the issuer from the mortgage pool or other underlying securities.

3. Structured securities are defined as loan-backed securities which have been divided into two or more classes for which the payment of interest and/or principal of any class of securities has been allocated in a manner which is not proportional to interest and/or principal received by the issuer from the mortgage pool or other underlying securities.

4. Loan-backed securities are issued by special-purpose corporations or trusts (issuer) established by a sponsoring parent organization. Mortgage loans or other securities securing the loan-backed obligation are acquired by the issuer and pledged to an independent trustee until the issuer's obligation has been fully satisfied. The investor can look only to the issuer's assets (primarily the trusteed assets or third parties such as insurers or guarantors) for repayment of the obligation. As a result, the sponsor and its other affiliates may have no financial obligation under the instrument, although one of those entities may retain the responsibility for servicing the underlying mortgage loans or other securities. Some sponsors do guarantee the performance of the underlying loans.

5. Loan-backed securities meet the definition of assets as defined in SSAP No. 4—Assets and Nonadmitted Assets and are admitted assets to the extent they conform to the requirements of this statement.

6. The scope of this statement encompasses all types of loan-backed and structured securities, including, but not limited to, the following:

a. Loan-backed and structured securities acquired at origination,

b. Loan-backed and structured securities acquired subsequent to origination for which it is probable, at acquisition, that the reporting entity will be **able** to collect all contractually required payments receivable, and are accounted for at acquisition under SSAP No. 91R,

c. Loan-backed and structured securities for which it is probable, either known at acquisition or identified during the holding period[1], that the reporting entity will be **unable** to collect all contractually required payments receivable, and

d. Beneficial interests that continue to be held by a reporting entity (transferor) in securitization transactions that are accounted for as sales under SSAP No. 91R and purchased beneficial interests in securitized financial assets[2].

7. At acquisition, loan-backed securities, except for loan-backed or structured securities that are beneficial interests that are not of high credit quality or can contractually be prepaid or otherwise settled in such a way that the reporting entity would not recover substantially all of its

[1] Securities classified within the type of paragraph 6.a. or 6.b. may be required to change classification to type 6.c. when it becomes probable that the reporting entity will be unable to collect all contractually required payments receivable.

[2] The accounting requirements related to these type of securities included in paragraphs 20-24 shall be determined at acquisition or initial transfer.

recorded amount[3] (see paragraphs 20-24), shall be reported at cost, including brokerage and related fees. Cost shall not exceed fair value. Acquisitions and dispositions shall be recorded on the trade date, not the settlement date, except for the acquisition of private placement loan-backed securities which shall be recorded on the funding date. For securities where all information is not known as of the trade date (e.g., actual payment factors and specific pools), a reporting entity shall make its best estimate based on known facts.

8. Amortization of premium or discount shall be calculated using the scientific (constant yield) interest method and shall be recorded as an adjustment to investment income. The interest method results in a constant effective yield equal to the prevailing rate at the time of purchase or at the time of subsequent adjustments to book value. The amortization period shall reflect estimates of the period over which repayment of principal of the loan-backed securities is expected to occur, not the stated maturity period.

9. Interest shall be accrued using the effective-yield method using the redemption prices and redemption dates used for amortizing premiums and discounts. Interest income consists of interest collected during the period, the change in the due and accrued interest between the beginning and end of the period as well as reductions for premium amortization and interest paid on acquisition of loan-backed securities, and the addition of discount accrual. Contingent interest may be accrued if the applicable provisions of the underlying contract and the prerequisite conditions have been met.

10. For reporting entities required to maintain an IMR, the accounting for realized capital gains and losses on sales of loan-backed securities shall be in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*. For reporting entities not required to maintain an IMR, realized gains and losses on sales of loan-backed securities shall be recorded on the trade date and shall be reported as net realized capital gains or losses in the Statement of Income.

11. A loan-backed security may provide for a prepayment penalty or acceleration fee in the event the investment is liquidated prior to its scheduled termination date. These fees shall be reported as investment income when received.

Collection of All Contractual Cashflows is Probable

12. The following guidance applies to loan-backed and structured securities for which it is probable that the investor will be able to collect all contractually required payments receivable. (Paragraphs 17-19 provide guidance for securities in which collection of all contractual cash flows is not probable and paragraphs 20-24 provide guidance for beneficial interests.) Prepayments are a significant variable element in the cash flow of loan-backed securities because they affect the yield and determine the expected maturity against which the yield is evaluated. Falling interest rates generate faster prepayment of the mortgages underlying the security, shortening its duration. This causes the reporting entity to reinvest assets sooner than expected at potentially less advantageous rates. This is called prepayment risk. Extension risk is created by rising interest rates which slow repayment and can significantly lengthen the duration of the security. Differences in cash flows can also result from other changes in the cash flows from the underlying assets. If assets are delinquent or otherwise not generating cash flow, which should be reflected in the cash flow analysis through diminishing security cash flows, even if assets have not been liquidated and gain/losses have not been booked.

13. Changes in currently estimated cash flows, including the effect of prepayment assumptions, on loan-backed securities shall be reviewed periodically, at least quarterly. The prepayment rates of the underlying loans shall be used to determine prepayment assumptions. Prepayment assumptions shall be applied consistently across portfolios to all securities backed by similar collateral (similar with respect to coupon, issuer, and age of collateral). Reporting entities shall use consistent assumptions across portfolios for similar collateral within controlled

[3] As referenced in the Relevant Literature section, this Statement adopts EITF 99-20, including the scope requirements of that guidance.

affiliated groups. Since each reporting entity may have a unique method for determining the prepayment assumptions, it is impractical to set standard assumptions for the industry. Relevant sources and rationale used to determine each prepayment assumption shall be documented by the reporting entity.

14. Loan-backed securities shall be revalued using the currently estimated cash flows, including new prepayment assumptions, using either the prospective or retrospective adjustment methodologies, consistently applied by type of securities. However, if at anytime during the holding period, the reporting entity determines it is no longer probable that they will collect all contractual cashflows, the reporting entity shall apply the accounting requirements in paragraphs 17-19.

15. The prospective approach recognizes, through the recalculation of the effective yield to be applied to future periods, the effects of all cash flows whose amounts differ from those estimated earlier and the effects and changes in projected cash flows. Under the prospective method, the recalculated effective yield will equate the carrying amount of the investment to the present value of the anticipated future cash flows. The recalculated yield is then used to accrue income on the investment balance for subsequent accounting periods. There are no accounting changes in the current period unless the security is determined to be other than temporarily impaired.

16. The retrospective methodology changes both the yield and the asset balance so that expected future cash flows produce a return on the investment equal to the return now expected over the life of the investment as measured from the date of acquisition. Under the retrospective method, the recalculated effective yield will equate the present value of the actual and anticipated cash flows with the original cost of the investment. The current balance is then increased or decreased to the amount that would have resulted had the revised yield been applied since inception, and investment income is correspondingly decreased or increased.

Collection of All Contractual Cashflows is Not Probable

17. The following guidance applies to loan-backed and structured securities with evidence of deterioration of credit quality since origination for which it is probable, either known at acquisition or identified during the holding period, that the investor will be unable to collect all contractually required payments receivable, except for those beneficial interests that are not of high credit quality or can contractually be prepaid or otherwise settled in such a way that the reporting entity would not recover substantially all of its recorded amount determined at acquisition (see paragraphs 20-24).

18. The reporting entity shall recognize the excess of all cash flows expected at acquisition over the investor's initial investment in the loan-backed or structured security as interest income on an effective-yield basis over the life of the loan-backed or structured security (accretable yield).[4] Any excess of contractually required cash flows over the cash flows expected to be collected is the nonaccretable difference. Expected prepayments shall be treated consistently for determining cash flows expected to be collected and projections of contractual cash flows such that the nonaccretable difference is not affected. Similarly, the difference between actual prepayments and expected prepayments shall not affect the nonaccretable difference.

19. An investor shall continue to estimate cash flows expected to be collected over the life of the loan-backed or structured security. If, upon subsequent evaluation:

a. The fair value of the loan-backed or structured security has declined below its amortized cost basis, an entity shall determine whether the decline is other than temporary. For example, if, based on current information and events, there is a

[4] A loan-backed or structured security may be acquired at a discount because of a change in credit quality or rate or both. When a loan-backed or structured security is acquired at a discount that relates, at least in part, to the security's credit quality, the effective interest rate is the discount rate that equates the present value of the investor's estimate of the security's future cash flows with the purchase price of the loan-backed or structured security.

decrease in cash flows expected to be collected (that is, the investor is unable to collect all cash flows expected at acquisition plus any additional cash flows expected to be collected arising from changes in estimate after acquisition (in accordance with paragraph 19.b.), an other-than-temporary impairment shall be considered to have occurred. The investor shall consider both the timing and amount of cash flows expected to be collected in making a determination about whether there has been a decrease in cash flows expected to be collected.

b. Based on current information and events, if there is a significant increase in cash flows previously expected to be collected or if actual cash flows are significantly greater than cash flows previously expected, the investor shall recalculate the amount of accretable yield for the loan-backed or structured security as the excess of the revised cash flows expected to be collected over the sum of (1) the initial investment less (2) cash collected less (3) other-than-temporary impairments plus (4) amount of yield accreted to date. The investor shall adjust the amount of accretable yield by reclassification from nonaccretable difference. The adjustment shall be accounted for as a change in estimate in conformity with SSAP No. 3—Accounting Changes and Corrections of Errors (SSAP No. 3), with the amount of periodic accretion adjusted over the remaining life of the loan-backed or structured security (prospective method).

Beneficial Interests

20. The following paragraphs provide statutory accounting guidance for interest income and impairment for a reporting entity that continues to hold an interest in securitized financial assets accounted for as sales under SSAP No. 91R, or that purchases a beneficial interest in securitized financial assets that are not of high credit quality or can contractually be prepaid or otherwise settled in such a way that the reporting entity would not recover substantially all of its recorded amount, determined at acquisition or the date of transfer[5]. Beneficial interests that are of high credit quality and cannot contractually be prepaid or otherwise settled in such a way that the reporting entity would not recover substantially all of its recorded investment, shall be accounted for in accordance with paragraphs 12-16.

21. The reporting entity shall recognize the excess of all cash flows attributable to the beneficial interest estimated at the acquisition/transaction date (referred to herein as the transaction date) over the initial investment (the accretable yield) as interest income over the life of the beneficial interest using the effective yield method. If the holder of the beneficial interest is the reporting entity that transferred the financial assets for securitization, the initial investment would be the allocated carrying amount after application of the relative fair value allocation method required by SSAP No. 91R. The amount of accretable yield shall not be displayed in the balance sheet.

22. The reporting entity that holds a beneficial interest shall continue to update the estimate of cash flows over the life of the beneficial interest. If upon evaluation:

a. Based on current information and events it is probable that there is a favorable (or an adverse) change in estimated cash flows from the cash flows previously projected, then the investor shall recalculate the amount of accretable yield for the beneficial interest on the date of evaluation as the excess of estimated cash flows over the beneficial interest's reference amount (the reference amount is equal to (1) the initial investment less (2) cash received to date less (3) other-than-temporary impairments recognized to date [as described in paragraph 22.b.] plus (4) the yield accreted to date. The adjustment shall be accounted for prospectively as a change in estimate in conformity with SSAP No. 3, with the amount of periodic accretion adjusted over the remaining life of the beneficial

[5] The accounting requirements related to these type of securities included in paragraphs 20-24 shall be determined at acquisition or initial transfer. As referenced in the Relevant Literature section, this Statement adopts EITF 99-20, including the scope requirements of that guidance.

interest. Based on estimated cash flows, interest income may be recognized on a beneficial interest even if the net investment in the beneficial interest is accreted to an amount greater than the amount at which the beneficial interest could be settled if prepaid immediately in its entirety.

b. The fair value of the beneficial interest has declined below its reference amount; a reporting entity shall determine whether the decline is other-than-temporary. If, based on current information and events it is probable that there has been an adverse change in estimated cash flows (in accordance with paragraph 22.a. above), then (1) an other-than-temporary impairment shall be considered to have occurred and (2) the beneficial interest shall be written down to the current estimate of cash flows at the financial reporting date discounted at a rate equal to the current yield used to accrete the beneficial interest with the resulting change being recognized as a realized loss. Determining whether there has been a favorable (or an adverse) change in estimated cash flows from the cash flows previously projected (taking into consideration both the timing and amount of the estimated cash flows) involves comparing the present value of the remaining cash flows as estimated at the initial transaction date (or at the last date previously revised) against the present value of the cash flows estimated at the current financial reporting date. The cash flows shall be discounted at a rate equal to the current yield used to accrete the beneficial interest. If the present value of the original cash flows estimated at the initial transaction date (or the last date previously revised) is less than the present value of the current estimate of cash flows expected to be collected, the change is considered favorable (that is, an other-than-temporary impairment shall be considered to have not occurred). If the present value of the original cash flows estimated at the initial transaction date (or the last date previously revised) is greater than the present value of the current estimated cash flows, the change is considered adverse (that is, an other-than-temporary impairment shall be considered to have occurred). However, absent any other factors that indicate an other-than-temporary impairment has occurred, changes in the interest rate of a "plain-vanilla," variable-rate beneficial interest generally shall not result in the recognition of an other-than-temporary impairment[6] (a plain-vanilla, variable-rate beneficial interest does not include those variable-rate beneficial interests with interest rate reset formulas that involve either leverage or an inverse floater).

23. All cash flows estimated at the transaction date are defined as the holder's estimate of the amount and timing of estimated future principal and interest cash flows used in determining the purchase price or the holder's fair value determination for purposes of determining a gain or loss under SSAP No. 91R. Subsequent to the transaction date, estimated cash flows are defined as the holder's estimate of the amount and timing of estimated principal and interest cash flows based on the holder's best estimate of current information and events. A change in estimated cash flows is considered in the context of both timing and amount of the estimated cash flows.

24. In situations in which it is not practicable for a transferor to estimate the fair value of the beneficial interest at the initial transfer date, interest income shall not be recognized using the interest method. For these beneficial interests (that is, those beneficial interests that continue to be held by a transferor that are recorded at $0 pursuant to SSAP No. 91R), the transferor shall use the cash basis for recognizing interest income because the beneficial interest will have an allocated carrying amount of zero.

[6] Changes in the interest rate of a "plain-vanilla," variable-rate beneficial interest (a plain-vanilla, variable-rate beneficial interest does not include those variable-rate beneficial interests with interest rate reset formulas that involve either leverage or an inverse floater) generally should not result in the recognition of an other-than-temporary impairment. For plain-vanilla, variable-rate beneficial interests, the yield is changed to reflect the revised interest rate based on the contractual interest rate reset formula. For example, if a beneficial interest pays interest quarterly at a rate equal to LIBOR plus 2 percent, the yield of that beneficial interest is changed prospectively to reflect changes in LIBOR. However, changes in the fair value of a plain-vanilla, variable-rate beneficial interest due to credit events should be considered when evaluating whether there has been an other-than-temporary impairment.

Reporting and Impairment Guidance for All Loan-Backed and Structured Securities

25. Loan-backed securities shall be valued and reported in accordance with this statement, the *Purposes and Procedures Manual of the NAIC Securities Valuation Office*, and the designation assigned in the NAIC Valuations of Securities product prepared by the NAIC Securities Valuation Office. For reporting entities that maintain an Asset Valuation Reserve (AVR), loan-backed securities shall be reported at amortized cost, except for those with an NAIC designation of 6, which shall be reported at the lower of amortized cost or fair value. For reporting entities that do not maintain an AVR, loan-backed securities designated highest-quality and high-quality (NAIC designations 1 and 2, respectively) shall be reported at amortized cost; loan-backed securities that are designated medium quality, low quality, lowest quality and in or near default (NAIC designations 3 to 6, respectively) shall be reported at the lower of amortized cost or fair value.

26. For reporting entities required to maintain an AVR, the accounting for unrealized gains and losses shall be in accordance *with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve* (SSAP No. 7). For reporting entities not required to maintain an AVR, unrealized gains and losses shall be recorded as a direct credit or charge to unassigned funds (surplus).

27. The application of this reporting requirement resulting from NAIC designation (i.e., lower of cost or fair value) is not a substitute for other-than-temporary impairment recognition (paragraphs 32-36). For securities reported at fair value where an other-than-temporary impairment has been determined to have occurred, the realized loss recognized from the other-than-temporary impairment shall first be applied towards the realization of any unrealized losses previously recorded as a result of fluctuations in the security's fair value due to the reporting requirements. After the recognition of the other-than-temporary impairment, the security shall continue to report unrealized gains and losses as a result of fluctuations in fair value.

28. If the fair value of a loan-backed or structured security is less than its amortized cost basis at the balance sheet date, an entity shall assess whether the impairment is other than temporary. Amortized cost basis includes adjustments made to the cost of an investment for accretion, amortization, collection of cash, previous other-than-temporary impairments recognized as a realized loss (including any cumulative-effect adjustments recognized in accordance with paragraphs 55-57 of this Statement).

29. If an entity intends to sell the loan-backed or structured security (that is, it has decided to sell the security), an other-than-temporary impairment shall be considered to have occurred.

30. If an entity does not intend to sell the loan-backed or structured security, the entity shall assess whether it has the intent and ability[7] to retain the investment in the security for a period of time sufficient to recover the amortized cost basis. If the entity does not have the intent and ability to retain the investment for the time sufficient to recover the amortized cost basis, an other-than-temporary impairment shall be considered to have occurred.

31. If the entity does not expect to recover the entire amortized cost basis of the security, the entity would be unable to assert that it will recover its amortized cost basis even if it does not intend to sell the security and the entity has the intent and ability to hold. Therefore, in those situations, an other-than temporary impairment shall be considered to have occurred. In assessing whether the entire amortized cost basis of the security will be recovered, an entity shall compare the present value of cash flows expected to be collected from the security with the amortized cost basis of the security. If present value of cash flows expected to be collected is less than the amortized cost basis of the security, the entire amortized cost basis of the security will

[7] This assessment shall be considered a high standard due to the accounting measurement method established for the securities within the scope of this Statement (amortized cost).

not be recovered (that is, a non-interest related decline[8] exists), and an other-than-temporary impairment shall be considered to have occurred. A decrease in cashflows expected to be collected on a loaned-backed or structured security that results from an increase in prepayments on the underlying assets shall be considered in the estimate of the present value of cashflows expected to be collected.

32. In determining whether a non-interest related decline exists, an entity shall calculate the present value of cash flows expected to be collected based on an estimate of the expected future cash flows of the impaired loan-backed or structured security, discounted at the security's effective interest rate.

a. For securities accounted for under paragraphs 12-16 – the effective interest rate of the loan-backed or structured security is the rate of return implicit in the security (that is, the contractual interest rate adjusted for any net deferred fees or costs, premium, or discount existing at the origination or acquisition of the security).[9]

b. For securities accounted for under paragraphs 17-19 – the effective interest rate is the rate implicit immediately prior to the recognition of the other-than-temporary impairment.

c. For securities accounted for under paragraphs 20-24 – the reporting entity shall apply the guidance in paragraph 22.b.

33. When an other-than-temporary impairment has occurred because the entity intends to sell the security or has assessed that that they do not have the intent and ability to retain the investments in the security for a period of time sufficient to recover the amortized cost basis, the amount of the other-than-temporary impairment recognized in earnings as a realized loss shall equal the entire difference between the investment's amortized cost basis and its fair value at the balance sheet date. (This guidance includes loan-backed securities previously held at lower of cost or market. For these securities, upon recognition of an other-than-temporary impairment, unrealized losses would be considered realized.)

34. When an other-than-temporary impairment has occurred because the entity does not expect to recover the entire amortized cost basis of the security even if the entity has no intent to sell and the entity has the intent and ability to hold, the amount of the other-than-temporary impairment recognized as a realized loss shall equal the difference between the investment's amortized cost basis and the present value of cash flows expected to be collected, discounted at the loan-backed or structured security's effective interest rate in accordance with paragraph 32. (This guidance includes loan-backed securities previously held at lower of cost or market. For these securities, upon recognition of an other-than-temporary impairment, unrealized losses would be considered realized for the non-interest related decline. Hence, unrealized losses could continue to be reflected for these securities due to the reporting requirements.)

35. For reporting entities required to maintain an AVR or IMR, the accounting for the other-than-temporary impairment shall be in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*. Non-interest related other-than-temporary impairment losses shall be recorded through the AVR. If the reporting entity wrote the security down to fair value due to the intent to sell or does not have the intent and ability to retain the investment in the security for a period of time sufficient to recover the amortized cost basis, the non-interest related portion of the other-than-temporary impairment losses shall be recorded through the AVR; the interest related other-than-temporary impairment losses shall be recorded through the IMR.

[8] A non-interest related decline is a decline in value due to fundamental credit problems of the issuer. Fundamental credit problems exist with the issuer when there is evidence of financial difficulty that may result in the issuer being unable to pay principal or interest when due. An interest related decline in value may be due to both increases in the risk-free interest rate and general credit spread widening.

[9] See Footnote 1.

36. For situations where an other-than-temporary impairment is recognized pursuant to paragraphs 33 and 34 of this Statement, the previous amortized cost basis less the other-than-temporary impairment recognized as a realized loss shall become the new amortized cost basis of the investment. That new amortized cost basis shall not be adjusted for subsequent recoveries in fair value. Therefore, the prospective adjustment method shall be used for periods subsequent to loss recognition.
37. In periods subsequent to the recognition of an other than temporary impairment loss for a loan-backed or structured security, the reporting entity shall account for the other-than-temporarily impaired security as if the security had been purchased on the measurement date of the other-than-temporary impairment at an amortized cost basis equal to the previous amortized cost basis less the other-than-temporary impairment recognized as a realized loss. The difference between the new amortized cost basis and the cash flows expected to be collected shall be accreted as interest income. A reporting entity shall continue to estimate the present value of cash flows expected to be collected over the life of the loan-backed or structured security.

a. For securities accounted for under paragraphs 12-19, if upon subsequent evaluation, there is a significant increase in the cash flows expected to be collected or if actual cash flows are significantly greater than cash flows previously expected, such changes shall be accounted for as a prospective adjustment to the accretable yield in accordance with paragraphs 17-19. The security shall continue to be subject to impairment analysis for each subsequent reporting period. The new amortized cost basis shall not be changed for subsequent recoveries in fair value. Future declines in fair value which are determined to be other-than-temporary shall be recorded as realized losses.

b. For beneficial interests accounted for under paragraphs 20-24, a reporting entity shall apply the guidance in paragraphs 21-22 to account for changes in cash flows expected to be collected.

38. It is inappropriate to automatically conclude that a security is not other-than-temporarily impaired because all of the scheduled payments to date have been received. However, it also is inappropriate to automatically conclude that every decline in fair value represents an other-than-temporary impairment. Further analysis and judgment are required to assess whether a decline in fair value indicates that it is probable that the holder will not collect all of the contractual or estimated cash flows from the security. In addition, the length of time and extent to which the fair value has been less than cost can indicate a decline is other than temporary. The longer and/or the more severe the decline in fair value, the more persuasive the evidence that is needed to overcome the premise that it is probable that the holder will not collect all of the contractual or estimated cash flows from the issuer of the security.

39. In making its other-than-temporary impairment assessment, the holder shall consider all available information relevant to the collectibility of the security, including information about past events, current conditions, and reasonable and supportable forecasts, when developing the estimate of future cash flows. Such information generally shall include the remaining payment terms of the security, prepayment speeds, the financial condition of the issuer(s), expected defaults, and the value of any underlying collateral. To achieve that objective, the holder shall consider, for example, industry analyst reports and forecasts, sector credit ratings, and other market data that are relevant to the collectibility of the security. The holder also shall consider how other credit enhancements affect the expected performance of the security, including consideration of the current financial condition of the guarantor of a security (if the guarantee is not a separate contract) and/or whether any subordinated interests are capable of absorbing estimated losses on the loans underlying the security. The remaining payment terms of the security could be significantly different from the payment terms in prior periods (such as for some securities backed by "nontraditional loans"[10]). Thus, the holder shall consider whether a security

[10] A nontraditional loan may have features such as (a) terms that permit principal payment deferral or payments smaller than interest accruals (negative amortization), (b) a high loan-to-value ratio, (c) multiple loans on the same collateral that when combined result in a high loan-to value ratio, (d) option adjustable-rate mortgages (option ARMs) or similar products that may expose the borrower to

backed by currently performing loans will continue to perform when required payments increase in the future (including “balloon” payments). The holder also shall consider how the value of any collateral would affect the expected performance of the security. If the fair value of the collateral has declined, the holder needs to assess the effect of that decline on the ability of the holder to collect the balloon payment.

Origination Fees

40. Origination fees represent fees charged to the borrower in connection with the process of originating or restructuring a transaction. The fees include, but are not limited to, points, management, arrangement, placement, application, underwriting, and other fees pursuant to such a transaction. Origination fees shall not be recorded until received in cash. Origination fees intended to compensate the reporting entity for interest rate risks (e.g., points), shall be amortized into income over the term of the loan-backed security consistent with paragraph 8 of this statement. Other origination fees shall be recorded as income upon receipt.

Origination, Acquisition, and Commitment Costs

41. Costs related to origination when paid in the form of brokerage and other related fees shall be capitalized as part of the cost of the loan-backed security, consistent with paragraph 7 of this statement. All other costs, including internal costs or costs paid to an affiliated entity related to origination, purchase, or commitment to purchase loan-backed securities, shall be charged to expense when incurred.

Commitment Fees

42. Commitment fees are fees paid to the reporting entity that obligate the reporting entity to make available funds for future borrowing under a specified condition. A fee paid to the reporting entity to obtain a commitment to make funds available at some time in the future, generally, is refundable only if the loan-backed security is issued. If the loan-backed security is not issued, then the fees shall be recorded as investment income by the reporting entity when the commitment expires.

43. A fee paid to the reporting entity to obtain a commitment to borrow funds at a specified rate and with specified terms quoted in the commitment agreement, generally, is not refundable unless the commitment is refused by the reporting entity. This type of fee shall be deferred, and amortization shall depend on whether or not the commitment is exercised. If the commitment is exercised, then the fee shall be amortized in accordance with paragraph 8 of this statement over the life of the loan-backed security as an adjustment to the investment income on the loan-backed security. If the commitment expires unexercised, the commitment fee shall be recognized in income on the commitment expiration date.

Giantization/Megatization of FHLMC or FNMA Mortgage Backed Securities

44. Giantization/megatization of mortgage backed securities is defined as existing pools of FHLMC or FNMA mortgage-backed securities (MBS) with like coupon and prefix which are repooled together by the issuing agency creating a new larger security. The new Fannie Mae “Mega” or Freddie Mac “Giant” is a guaranteed MBS pass-through representing an undivided interest in the underlying pools of loans.

45. The benefits derived from giantization/megatization include:

a. Increased liquidity: Smaller MBS pools (particularly those with current face of less than $1 million) are less liquid than mortgage pools with current faces

future increases in repayments in excess of increases that result solely from increases in the market interest rate (for example, once negative amortization results in the loan reaching a maximum principal accrual limit), (e) an initial interest rate that is below the market interest rate for the initial period of the loan term and that may increase significantly when that period ends, and (f) interest-only loans that should be considered in developing an estimate of future cash flows.

exceeding $5 million. Repooling smaller MBS pools into one larger pool improves the marketability for the aggregate package;

b. Geographic diversity: Regrouping of multiple pools generally will create greater geographic pool loan diversity resulting in less prepayment variation due to regional economic factors;

c. Reduced administrative expenses: The reduced number of pools lowers bank custodial fees, pricing/factor service fees, and increases efficiency for the accounting and investment departments.

46. Repooled FHLMC and FNMA securities meet the definition of substantially the same as defined in *SSAP No. 91R—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. The transaction shall not be considered a sale/purchase and no gain or loss shall be recognized. To properly document the repooling, the transaction shall be reported through Schedule D of the Annual Statement as a disposition and an acquisition.

47. Transaction fees charged by the issuing agencies shall be capitalized and amortized over the life of the repooled security.

Disclosures

48. In addition to the disclosures required for invested assets in general, the following disclosures regarding loan-backed securities shall be made in the financial statements. Regardless of the allowances within paragraph 59 of the Preamble, the disclosures in paragraph 48.f., 48.g. and 48.h. are required in separate, distinct notes to the financial statements:

a. Fair values in accordance with *SSAP No. 27—Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk, Financial Instruments with Concentrations of Credit Risk and Disclosures about Fair Value of Financial Instruments* (SSAP No. 27);

b. Concentrations of credit risk in accordance with SSAP No. 27;

c. Basis at which the loan-backed securities are stated;

d. The adjustment methodology used for each type of security (prospective or retrospective);

e. Descriptions of sources used to determine prepayment assumptions.

f. All securities within the scope of this statement with a recognized other-than-temporary impairment, disclosed in the aggregate, classified on the basis for the other-than-temporary impairment: (1) intent to sell, (2) inability or lack of intent to retain the investment in the security for a period of time sufficient to recover the amortized cost basis, or (3) present value of cash flows expected to be collected is less than the amortized cost basis of the security.

g. For each security with a recognized other-than-temporary impairment, currently held by the reporting entity, as the present value of cash flows expected to be collected is less than the amortized cost basis of the securities:

i. The amortized cost basis, prior to any current-period other-than-temporary impairment.

ii. The other-than-temporary impairment recognized in earnings as a realized loss.

iii. The fair value of the security.

iv. The amortized cost basis after the current-period other-than-temporary impairment.

h. All impaired securities (fair value is less than cost or amortized cost) for which an other-than-temporary impairment has not been recognized in earnings as a realized loss (including securities with a recognized other-than-temporary impairment for non-interest related declines when a non-recognized interest related impairment remains):

i. The aggregate amount of unrealized losses (that is, the amount by which cost or amortized cost exceeds fair value) and

ii. The aggregate related fair value of securities with unrealized losses.

i. The disclosures in (i) and (ii) above should be segregated by those securities that have been in a continuous unrealized loss position for less than 12 months and those that have been in a continuous unrealized loss position for 12 months or longer using fair values determined in accordance with SSAP No. 27.

j. Additional information should be included describing the general categories of information that the investor considered in reaching the conclusion that the impairments are not other-than-temporary.

k. When it is not practicable to estimate fair value in accordance with SSAP No. 27, the investor should disclose the following additional information, if applicable:

i. The aggregate carrying value of the investments not evaluated for impairment, and

ii. The circumstances that may have a significant adverse effect on the fair value.

49. Refer to the preamble for further discussion regarding disclosure requirements. All disclosures within this Statement shall be included within the interim and annual statutory financial statements.

Relevant Literature

50. This statement adopts *FASB Emerging Issues Task Force No. 99-20*, *Exchange of Interest-Only and Principal-Only Securities for a Mortgage-Backed Security and FASB Staff Position EITF 99-20-1, Amendments to the Impairment Guidance of EITF Issue No. 99-20.* This statement adopts paragraphs 5, 7 and 9 of AICPA *Statement of Position 03-03, Accounting for Certain Loans or Debt Securities Acquired in a Transfer* (SOP 03-03) for loan-backed and structured securities only. With the exception of this specific adoption, consideration of SOP 03-03 is still pending consideration for statutory accounting.

51. This statement rejects *FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities* and *FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*.

52. This statement also rejects *FASB Emerging Issues Task Force No. 89-4, Accounting for a Purchased Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate, FASB Emerging Issues Task Force No. 90-2, Exchange of Interest-Only and Principal-Only Securities for a Mortgage-Backed Security, FASB Emerging Issues Task Force No. 93-18, Recognition of Impairment for an Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate*, and *FASB Emerging Issues Task Force No. 96-12, Recognition of Interest Income and Balance Sheet Classification of Structured Notes*.

Effective Date and Transition

53. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*.

54. For securities purchased prior to January 1, 1994, where historical cash flows are not readily available for applying the retrospective method, the reporting entity may use January 1, 1994 as the acquisition date and the then book value as the cost for purposes of determining yield adjustments in future periods.

55. This revised statement supersedes SSAP No. 98 and paragraph 13 of SSAP No. 99 effective September 30, 2009. For reporting entities that either early adopted the requirements of SSAP No. 98 or previously adopted a statutory accounting policy that was in accord with the prescriptions of SSAP No. 98, for which an other-than-temporary impairment was previously recognized, and if such reporting entities do not intend to sell the security, and have the intent and ability to retain the investment in the security for a period of time sufficient to recover the amortized cost basis, those reporting entities shall recognize the cumulative effect of reversing the impact of the adoption of SSAP No. 98, or an equivalent statutory accounting policy, and paragraph 13 of SSAP No. 99 as an adjustment to the opening balance of unassigned funds (surplus) as of July 1, 2009, with a corresponding adjustment to applicable financial statement elements.

56. The accounting and reporting requirements of this revised statement shall be applied to existing and new investments held by a reporting entity on or after September 30, 2009. For loan-backed and structured securities held at the beginning of the interim period of adoption (July 1, 2009) and continue to be held as of September 30, 2009, for which an other-than-temporary impairment was previously recognized under SSAP No. 43, if a reporting entity does not intend to sell the security, and has the intent and ability to retain the investment in the security for a period of time sufficient to recover the amortized cost basis, the reporting entity shall recognize the cumulative effect of initially applying this revised statement as an adjustment to the opening balance of unassigned funds (surplus) as of July 1, 2009, with a corresponding adjustment to applicable financial statement elements. The cumulative effect on unassigned funds (surplus) shall be calculated by comparing the present value of the cash flows expected to be collected determined in accordance with the methodology in paragraph 32, as applicable, with the amortized cost basis of the loan-backed and structured security as of the beginning of the interim period in which this revised statement is adopted (July 1, 2009). The cumulative-effect adjustment shall include related tax effects. The discount rate used to calculate the present value of the cash flows expected to be collected shall be the rate in effect before recognizing any other-than-temporary impairments and not a rate that has been adjusted to reflect those impairments.

57. The amortized cost basis of a security for which an other-than-temporary impairment was previously recognized shall be adjusted by the amount of the cumulative-effect adjustment before taxes. The difference between the new amortized cost basis and the cash flows expected to be collected shall be accreted as interest income (see paragraph 37).

58. In the period of adoption, an entity shall provide the disclosures required by SSAP No. 3 for changes in accounting principles.

AUTHORITATIVE LITERATURE

Statutory Accounting

- *Purposes and Procedures Manual of the NAIC Securities Valuation Office*
- NAIC *Valuations of Securities* manual prepared by the Securities Valuation Office

RELEVANT ISSUE PAPERS

- *Issue Paper No. 43—Loan-Backed and Structured Securities*
- *Issue Paper No. 140—Substantive Revisions to SSAP No. 43—Loan-Backed and Structured Securities*, Revised September, 2009

DISCUSSION

6. This Issue Paper is intended to provide a historical reference of SSAP No. 43, SSAP No. 98 and SSAP No. 99 prior to the adoption of SSAP No. 43R. SSAP No. 43R was adopted in September 2009 with an effective date of September 30, 2009.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

7. Statutory accounting principles for loan-backed and structured securities was included within *SSAP No. 43—Loan-Backed and Structured Securities* (SSAP No. 43). This guidance has been superseded by SSAP No. 43R:

> SCOPE OF STATEMENT
>
> 1. This statement establishes statutory accounting principles for investments in loan-backed securities and structured securities. In accordance with SSAP No. 91R, retained beneficial interests from the sale of loan-backed securities and structured securities are accounted for in accordance with this statement. In this statement loan-backed securities and structured securities are collectively referred to as loan-backed securities.
>
> SUMMARY CONCLUSION
>
> 2. Loan-backed securities are defined as pass-through certificates, collateralized mortgage obligations (CMOs), and other securitized loans not included in structured securities, as defined below, for which the payment of interest and/or principal is directly proportional to the interest and/or principal received by the issuer from the mortgage pool or other underlying securities.
>
> 3. Structured securities are defined as loan-backed securities which have been divided into two or more classes for which the payment of interest and/or principal of any class of securities has been allocated in a manner which is not proportional to interest and/or principal received by the issuer from the mortgage pool or other underlying securities.
>
> 4. Loan-backed securities are issued by special-purpose corporations or trusts (issuer) established by a sponsoring parent organization. Mortgage loans or other securities securing the loan-backed obligation are acquired by the issuer and pledged to an independent trustee until the issuer's obligation has been fully satisfied. The investor can look only to the issuer's assets (primarily the trusteed assets or third parties such as insurers or guarantors) for repayment of the obligation. As a result, the sponsor and its other affiliates may have no financial obligation under the instrument, although one of those entities may retain the responsibility for servicing the underlying mortgage loans. Some sponsors do guarantee the performance of the underlying loans.
>
> 5. Loan-backed securities meet the definition of assets as defined in *SSAP No. 4—Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this statement.

Acquisitions and Sales

6. At acquisition, loan-backed securities shall be reported at cost, including brokerage and related fees. Cost shall not exceed fair value. Acquisitions and dispositions shall be recorded on the trade date, not the settlement date, except for the acquisition of private placement loan-backed securities which shall be recorded on the funding date. For securities where all information is not known as of the trade date (e.g., actual payment factors and specific pools), a reporting entity shall make its best estimate based on known facts.

Amortization

7. Amortization of premium or discount shall be calculated using the scientific (constant yield) interest method and shall be recorded as an adjustment to investment income. The interest method results in a constant effective yield equal to the prevailing rate at the time of purchase or at the time of subsequent adjustments to book value. The amortization period shall reflect estimates of the period over which repayment of principal of the loan-backed securities is expected to occur, not the stated maturity period.

Balance Sheet Amount

8. Loan-backed securities shall be valued and reported in accordance with this statement, the *Purposes and Procedures Manual of the NAIC Securities Valuation Office*, and the designation assigned in the NAIC *Valuations of Securities* product prepared by the NAIC Securities Valuation Office. For reporting entities that maintain an Asset Valuation Reserve (AVR), loan-backed securities shall be reported at amortized cost, except for those with an NAIC designation of 6, which shall be reported at the lower of amortized cost or fair value. For reporting entities that do not maintain an AVR, loan-backed securities designated highest-quality and high-quality (NAIC designations 1 and 2, respectively) shall be reported at amortized cost; loan-backed securities that are designated medium quality, low quality, lowest quality and in or near default (NAIC designations 3 to 6, respectively) shall be reported at the lower of amortized cost or fair value.

9. For reporting entities required to maintain an AVR, the accounting for unrealized gains and losses shall be in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve* (SSAP No. 7). For reporting entities not required to maintain an AVR, unrealized gains and losses shall be recorded as a direct credit or charge to unassigned funds (surplus).

Changes in Valuation

10. Prepayments are a significant variable element in the cash flow of loan-backed securities because they affect the yield and determine the expected maturity against which the yield is evaluated. Falling interest rates generate faster prepayment of the mortgages underlying the security, shortening its duration. This causes the reporting entity to reinvest assets sooner than expected at potentially less advantageous rates. This is called prepayment risk. Extension risk is created by rising interest rates which slow repayment and can significantly lengthen the duration of the security. Differences in cash flows can also result from other changes in the cash flows from the underlying assets. If assets are delinquent or otherwise not generating cash flow, that should be reflected in the cash flow analysis through diminishing security cash flows, even if assets have not been liquidated and gain/losses have not been booked.

11. Changes in currently estimated cash flows, including the effect of prepayment assumptions, on loan-backed securities shall be reviewed periodically. For securities that have the potential for loss of a portion of the original investment, the review shall be performed at least quarterly. For other securities, the review shall be performed at least annually. In addition to assets that are delinquent or otherwise not generating cash flows, other examples of securities that have the potential for loss of a portion of the original investment include CMO residuals and mortgage-backed interest-only certificates. For these securities, an effective yield or internal rate

of return is calculated at acquisition based on the purchase price and anticipated future cash flows.

12. The prepayment rates of the underlying loans shall be used to determine prepayment assumptions. Prepayment assumptions shall be applied consistently across portfolios to all securities backed by similar collateral (similar with respect to coupon, issuer, and age of collateral). Reporting entities shall use consistent assumptions across portfolios for similar collateral within controlled affiliated groups. Since each reporting entity may have a unique method for determining the prepayment assumptions, it is impractical to set standard assumptions for the industry. Relevant sources and rationale used to determine each prepayment assumption shall be documented by the reporting entity.

13. Loan-backed securities shall be revalued using the currently estimated cash flows, including new prepayment assumptions, using either the prospective or retrospective adjustment methodologies, consistently applied by type of securities.

14. The prospective approach recognizes, through the recalculation of the effective yield to be applied to future periods, the effects of all cash flows whose amounts differ from those estimated earlier and the effects and changes in projected cash flows. Under the prospective method, the recalculated effective yield will equate the carrying amount of the investment to the present value of the anticipated future cash flows. The recalculated yield is then used to accrue income on the investment balance for subsequent accounting periods. There are no accounting changes in the current period unless the undiscounted anticipated cash flow is less than the carrying amount of the investment.

15. The retrospective methodology changes both the yield and the asset balance so that expected future cash flows produce a return on the investment equal to the return now expected over the life of the investment as measured from the date of acquisition. Under the retrospective method, the recalculated effective yield will equate the present value of the actual and anticipated cash flows with the original cost of the investment. The current balance is then increased or decreased to the amount that would have resulted had the revised yield been applied since inception, and investment income is correspondingly decreased or increased.

Impairment

16. Regardless of whether a reporting entity is using a prospective or retrospective method, if the revaluation based on new currently estimated cash flows results in a negative yield (i.e., undiscounted estimated future cash flows are less than the current book value), an other than temporary impairment shall be considered to have occurred. If it is determined an other than temporary impairment has occurred, the cost basis of the security shall be written down to the undiscounted estimated future cash flows and the amount of the write down shall be accounted for as a realized loss. For reporting entities required to maintain an AVR/IMR, the accounting for the entire amount of the realized capital loss shall be in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*. The new cost basis shall not be changed for subsequent recoveries in fair value. Therefore, the prospective adjustment method must be utilized for periods subsequent to the loss recognition.

17. NOTE: This paragraph is added by *SSAP No. 99—Accounting for Certain Securities Subsequent to an Other-Than-Temporary Impairment.* Remaining paragraphs are renumbered.

In periods subsequent to the recognition of an other than temporary impairment loss for a loan-backed or structured security, the reporting entity shall account for the other-than-temporarily impaired security as if the security had been purchased on the measurement date of the other-than-temporary impairment. The fair value of the security on the measurement date shall become the new cost basis. The discount or reduced premium recorded for the security, based on the new cost basis, shall be amortized in the prospective manner over the remaining period in which repayment of principal is expected to occur. The security shall continue to be subject to impairment analysis for each subsequent reporting period. The new cost basis shall not be changed for subsequent recoveries in fair value. Therefore, the prospective adjustment method must be utilized for periods subsequent to the impairment loss recognition. Future declines in fair value which are determined to be other-than-temporary shall be recorded as realized losses.

Income

18. Interest shall be accrued using the interest method using the redemption prices and redemption dates used for amortizing premiums and discounts. Interest income consists of interest collected during the period, the change in the due and accrued interest between the beginning and end of the period as well as reductions for premium amortization and interest paid on acquisition of loan-backed securities, and the addition of discount accrual. Contingent interest may be accrued if the applicable provisions of the underlying contract and the prerequisite conditions have been met.

19. For reporting entities required to maintain an IMR, the accounting for realized capital gains and losses on sales of loan-backed securities shall be in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*. For reporting entities not required to maintain an IMR, realized gains and losses on sales of loan-backed securities shall be recorded on the trade date and shall be reported as net realized capital gains or losses in the Statement of Income.

20. A loan-backed security may provide for a prepayment penalty or acceleration fee in the event the investment is liquidated prior to its scheduled termination date. These fees shall be reported as investment income when received.

Beneficial Interests

21. A holder of a beneficial interest in securitized financial assets should recognize the excess of all cash flows attributable to the beneficial interest estimated at the acquisition/transaction date over the initial investment as interest income over the life of the beneficial interest using the effective yield method.

22. The holder of a beneficial interest should continue to update the estimate of cash flows over the life of the beneficial interest. Based on current information and events, if a favorable or adverse change in estimated cash flows is projected, the holder should recalculate the amount of interest income for the beneficial interest on the date of evaluation. The recalculated yield should be used to recognize interest income as a prospective change over the remaining life of the beneficial interest. Impairment for beneficial interests shall be determined in accordance with paragraph 16.

Origination Fees

23. Origination fees represent fees charged to the borrower in connection with the process of originating or restructuring a transaction. The fees include, but are not limited to, points, management, arrangement, placement, application, underwriting, and other fees pursuant to such a transaction. Origination fees shall not be recorded until received in cash. Origination fees intended to compensate the reporting entity for interest rate risks (e.g., points), shall be amortized into income over the term of the loan-backed security consistent with paragraph 7 of this statement. Other origination fees shall be recorded as income upon receipt.

Origination, Acquisition, and Commitment Costs

24. Costs related to origination when paid in the form of brokerage and other related fees shall be capitalized as part of the cost of the loan-backed security, consistent with paragraph 6 of this statement. All other costs, including internal costs or costs paid to an affiliated entity related to origination, purchase, or commitment to purchase loan-backed securities, shall be charged to expense when incurred.

Commitment Fees

25. Commitment fees are fees paid to the reporting entity that obligate the reporting entity to make available funds for future borrowing under a specified condition. A fee paid to the reporting entity to obtain a commitment to make funds available at some time in the future, generally, is refundable only if the loan-backed security is issued. If the loan-backed security is not issued, then the fees shall be recorded as investment income by the reporting entity when the commitment expires.

26. A fee paid to the reporting entity to obtain a commitment to borrow funds at a specified rate and with specified terms quoted in the commitment agreement, generally, is not refundable unless the commitment is refused by the reporting entity. This type of fee shall be deferred, and amortization shall depend on whether or not the commitment is exercised. If the commitment is exercised, then the fee shall be amortized in accordance with paragraph 7 of this statement over the life of the loan-backed security as an adjustment to the investment income on the loan-backed security. If the commitment expires unexercised, the commitment fee shall be recognized in income on the commitment expiration date.

Giantization/Megatization of FHLMC or FNMA Mortgage Backed Securities

27. Giantization/megatization of mortgage backed securities is defined as existing pools of FHLMC or FNMA mortgage-backed securities (MBS) with like coupon and prefix which are repooled together by the issuing agency creating a new larger security. The new Fannie Mae "Mega" or Freddie Mac "Giant" is a guaranteed MBS pass-through representing an undivided interest in the underlying pools of loans.

28. The benefits derived from giantization/megatization include:

a. Increased liquidity: Smaller MBS pools (particularly those with current face of less than $1 million) are less liquid than mortgage pools with current faces exceeding $5 million. Repooling smaller MBS pools into one larger pool improves the marketability for the aggregate package;

b. Geographic diversity: Regrouping of multiple pools generally will create greater geographic pool loan diversity resulting in less prepayment variation due to regional economic factors;

c. Reduced administrative expenses: The reduced number of pools lowers bank custodial fees, pricing/factor service fees, and increases efficiency for the accounting and investment departments.

29. Repooled FHLMC and FNMA securities meet the definition of substantially the same as defined in *SSAP No. 91R—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. The transaction shall not be considered a sale/purchase and no gain or loss shall be recognized. To properly document the repooling, the transaction shall be reported through Schedule D of the Annual Statement as a disposition and an acquisition.

30. Transaction fees charged by the issuing agencies shall be capitalized and amortized over the life of the repooled security.

Disclosures

31. In addition to the disclosures required for invested assets in general, the following disclosures regarding loan-backed securities shall be made in the financial statements:

a. Fair values in accordance with SSAP No. 27—Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk, Financial Instruments with Concentrations of Credit Risk and Disclosures about Fair Value of Financial Instruments (SSAP No. 27);

b. Concentrations of credit risk in accordance with SSAP No. 27;

c. Basis at which the loan-backed securities are stated;

d. The adjustment methodology used for each type of security (prospective or retrospective);

e. Changes from the retrospective to the prospective adjustment methodology due to negative yield on specific securities;

f. If, for applying the retrospective method, the reporting entity has elected to use book value as of January 1, 1994 as the cost for securities purchased prior to January 1, 1994 where historical cash flows are not readily available; and

g. Descriptions of sources used to determine prepayment assumptions.

h. For each balance sheet presented, all securities in an unrealized loss position for which other-than-temporary declines in value have not been recognized

  i. The aggregate amount of unrealized losses (that is, the amount by which cost or amortized cost exceeds fair value) and

  ii. The aggregate related fair value of securities with unrealized losses.

i. The disclosures in (i) and (ii) above should be segregated by those securities that have been in a continuous unrealized loss position for less than 12 months and those that have been in a continuous unrealized loss position for 12 months or longer using fair values determined in accordance with SSAP No. 27.

j. As of the date of the most recent balance sheet presented, additional information should be included describing the general categories of information that the investor considered in reaching the conclusion that the impairments are not other-than-temporary.

k. When it is not practicable to estimate fair value in accordance with SSAP No. 27, the investor should disclose the following additional information, if applicable, as of each date for which a statement of financial position is presented in its annual financial statements:

  i. The aggregate carrying value of the investments not evaluated for impairment, and

  ii. The circumstances that may have a significant adverse effect on the fair value.

32. Refer to the preamble for further discussion regarding disclosure requirements. The disclosures in paragraphs 31.a., 31.b., 31.h., 31.i., 31.j., and 31.k. above shall be included in the annual audited statutory financial reports only.

Relevant Literature

33. This statement rejects *FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities* and *FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*.

34. This statement also rejects FASB Emerging Issues Task Force No. 89-4, *Accounting for a Purchased Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate,* FASB Emerging Issues Task Force No. 90-2, *Exchange of Interest-Only and Principal-Only Securities for a Mortgage-Backed Security,* FASB Emerging

Issues Task Force No. 93-18, *Recognition of Impairment for an Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate, and FASB Emerging Issues Task Force No. 96-12, Recognition of Interest Income and Balance Sheet Classification of Structured Notes, and FASB Emerging Issues Task Force No. 99-20, Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets.*

Effective Date and Transition

35. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors.*

36. For securities purchased prior to January 1, 1994, where historical cash flows are not readily available for applying the retrospective method, the reporting entity may use January 1, 1994 as the acquisition date and the then book value as the cost for purposes of determining yield adjustments in future periods.

8. *SSAP No. 98—Treatment of Cash Flows When Quantifying Changes in Valuation and Impairments, an Amendment of SSAP No. 43—Loan-Backed and Structured Securities* (SSAP No. 98) amended paragraphs 14-16 of SSAP No. 43. This guidance was superseded with the issuance of SSAP No. 43R:

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for impairment analysis and subsequent valuation of loan-backed and structured securities.

SUMMARY CONCLUSION

2. This statement amends paragraphs 14-16 of SSAP No. 43—*Loan-Backed and Structured Securities* to the following:

14. The prospective approach recognizes, through the recalculation of the effective yield to be applied to future periods, the effects of all cash flows whose amounts differ from those estimated earlier and the effects and changes in projected cash flows. Under the prospective method, the recalculated effective yield will equate the carrying amount of the investment to the present value of the anticipated future cash flows. The recalculated yield is then used to accrue income on the investment balance for subsequent accounting periods. There are no accounting changes in the current period unless the security is determined to be other than temporarily impaired.

15. The retrospective methodology changes both the yield and the asset balance so that expected future cash flows produce a return on the investment equal to the return now expected over the life of the investment as measured from the date of acquisition. Under the retrospective method, the recalculated effective yield will equate the present value of the actual and anticipated cash flows with the original cost of the investment. The current balance is then increased or decreased to the amount that would have resulted had the revised yield been applied since inception, and investment income is correspondingly decreased or increased.

Impairment

16. If it is determined that the decline in fair value of the security is other than temporary, then the cost basis of the security shall be written down to fair value. The amount of the write down shall be accounted for as a realized loss. An interest related decline in value shall be considered other than temporary only when a reporting entity has the intent to sell the investment, at the reporting date, before recovery of the cost of

> the investment. For reporting entities required to maintain an AVR/IMR, the accounting for the entire amount of the realized capital loss shall be in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*. Credit related other than temporary impairment losses shall be recorded through the AVR; interest related other than temporary impairment losses shall be recorded through the IMR. The new cost basis shall not be changed for subsequent recoveries in fair value. Therefore, the prospective adjustment method must be utilized for periods subsequent to the loss recognition.
>
> **Disclosures**
>
> 3. This statement requires no additional disclosures.
>
> **Effective Date and Transition**
>
> 4. This statement is effective for quarterly and annual reporting periods beginning on or after January 1, 2009, with early adoption permitted and encouraged. A change resulting from the adoption of this statement shall be accounted for prospectively. No cumulative effect adjustments or application of the new guidance to prior events or periods are required, similar to a change in accounting estimate.

9. *SSAP No. 99—Accounting for Certain Securities Subsequent to an Other-Than-Temporary Impairment* (SSAP No. 99) establishes statutory accounting principles for the treatment of premium or discount applicable to certain securities subsequent to the recognition of an other-than-temporary impairment. Paragraph 13 of SSAP No. 99 inserted a new paragraph into SSAP No. 43. Consistent with the superseding of SSAP No. 43 by SSAP No. 43R, paragraph 13 of SSAP No. 99 (and the new paragraph inserted within SSAP No. 43) have also been superseded:

> **Loan-Backed and Structured Securities**
>
> 13. This statement shall insert the following new paragraph 17 into SSAP No. 43, with subsequent paragraphs of SSAP No. 43 to be renumbered accordingly:
>
> > 17. In periods subsequent to the recognition of an other than temporary impairment loss for a loan-backed or structured security, the reporting entity shall account for the other-than-temporarily impaired security as if the security had been purchased on the measurement date of the other-than-temporary impairment. The fair value of the security on the measurement date shall become the new cost basis. The discount or reduced premium recorded for the security, based on the new cost basis, shall be amortized in the prospective manner over the remaining period in which repayment of principal is expected to occur. The security shall continue to be subject to impairment analysis for each subsequent reporting period. The new cost basis shall not be changed for subsequent recoveries in fair value. Therefore, the prospective adjustment method must be utilized for periods subsequent to the impairment loss recognition. Future declines in fair value which are determined to be other-than-temporary shall be recorded as realized losses.
>
> **Disclosures**
>
> 14. This statement requires no additional disclosures.

Generally Accepted Accounting Principles

10. The adoption of SSAP No. 43R did not adopt or reject any GAAP standards.

RELEVANT LITERATURE

Statutory Accounting

- *SSAP No. 43—Loan-Backed and Structured Securities*
- *SSAP No. 98—Treatment of Cash Flows When Quantifying Changes in Valuation and Impairments, an Amendment of SSAP No. 43—Loan-Backed and Structured Securities*
- *SSAP No. 99—Accounting for Certain Securities Subsequent to an Other-Than-Temporary Impairment*
- *Issue Paper No. 43—Loan-Backed and Structured Securities*
- *Issue Paper No. 124—Treatment of Cash Flows When Quantifying Changes in Valuation and Impairments: An Amendment to SSAP No. 43—Loan-Backed and Structured Securities*
- *Issue Paper No. 131—Accounting for Certain Securities Subsequent to an Other-Than-Temporary Impairment*

Generally Accepted Accounting Principles

- None

State Regulations

- No additional guidance obtained from state statutes or regulations.

Statutory Issue Paper No. 141

Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities

STATUS:
Finalized August 31, 2011

Original SSAP and Current Authoritative Guidance: SSAP No. 103

Type of Issue:
Common Area

SUMMARY OF ISSUE:

1. In June 2009, the Financial Accounting Standards Board (FASB) issued *FAS 166, Accounting for Transfers of Financial Assets* (FAS 166) to improve the relevance, representational faithfulness and comparability of the information that a reporting entity provides in its financial reports about a transfer of financial assets; the effects of a transfer on its financial position, financial performance, and cash flows; and a transferor's continuing involvement in transferred financial assets. FAS 166 is effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009, for interim periods within the first annual reporting period and for interim and annual reporting periods thereafter. Earlier application is prohibited.

2. The issuance of FAS 166 amended *FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 140) as follows:

   a. Removes the concept of a qualifying special-purpose entity and removes the exception that requires consolidation from applying *FASB Interpretation No. 46–Revised, Consolidation of Variable Interest Entities* (FIN 46R), to variable interest entities that are qualifying special-purpose entities.

   b. Modifies the financial-components approach used in FAS 140 and limits the circumstances in which a transferor derecognizes a portion or component of a financial asset when the transferor has not transferred the original financial asset to an entity that is not consolidated with the transferor in the financial statements being presented and/or when the transferor has continuing involvement with the financial asset.

   c. Establishes the following conditions for reporting a transfer of a portion (or portions) of a financial asset as a sale:

      i. The transferred portion (or portions) and any portion that continues to be held by the transferor must be participating interests.

      ii. The transfer of the participating interest (or participating interests) must meet the conditions for surrender of control.

   If the transfer does not meet these conditions, sale accounting can be achieved only by transferring an entire financial asset or group of entire financial assets in a transaction that meets the sale accounting conditions.

   d. Defines a participating interest as a portion of a financial asset that:

i. Conveys proportionate ownership rights with equal priority to each participating interest holder.

ii. Involves no recourse (other than standard representations and warranties) to, or subordination by, any participating interest holder.

iii. Does not entitle any participating interest holder to receive cash before any other participating interest holder.

e. Clarifies that an entity must consider all arrangements, or agreements made contemporaneously with, or in contemplation of, a transfer, even if not entered into at the time of the transfer, when applying the condition for sale accounting. In addition, it explicitly clarifies that the application of the conditions for sale accounting must consider the transferor's continuing involvement with the transferred financial assets.

f. Clarifies the isolation analysis to ensure that the financial asset has been put beyond the reach of the transferor, any of its consolidated affiliates (that are not entities designed to make remote the possibility that they would enter bankruptcy or other receivership) included in the financial statements being presented, and its creditors.

g. Removes the exception for sale accounting for transfers to qualifying special-purpose entities. It requires that a transferor, in a transfer to an entity whose sole purpose is to engage in securitization or asset-backed financing activities, determine whether each third-party holder of a beneficial interest in that entity has the right to pledge or exchange its beneficial interest and that no condition both:

i. Constrains the third-party beneficial interest holder from taking advantage of its right to pledge or exchange; and

ii. Provides more than a trivial-benefit to the transferor.

h. Clarifies the principle for sale accounting that the transferor must evaluate whether it, its consolidated affiliates included in the financial statements being presented, or its agents effectively control the transferred financial asset directly or indirectly.

i. Requires that a transferor recognize and initially measure at fair value all assets obtained (including a transferor's beneficial interest) and liabilities incurred as a result of a transfer of an entire financial asset or a group of financial assets accounted for as a sale.

j. Removes the special provisions in FAS 140 and FASB Statement No. 65, Accounting for Certain Mortgage Banking Activities (FAS 65), for guaranteed mortgage securitizations to require them to be treated the same, as any other transfer of financial assets within the scope of FAS 140. If such a transfer does not meet the conditions for sale accounting, the securitized mortgage loans shall continue to be classified as loans.

k. Removes the fair value practicability exception from measuring the proceeds received by a transferor in a transfer that meets the conditions for sale accounting at fair value.

l. Requires enhanced disclosures to provide financial statement users with greater transparency about transfers of financial assets and a transferor's continuing involvement with transfers of financial assets accounted for as sales.

3. In addition to the modifications to FAS 140, the issuance of FAS 166 also incorporated revisions to the following GAAP guidance:

a. Superseded *FSP FAS 140-2, Clarification of the Application of Paragraphs 40(b) and 40(c) of FASB Statement No. 140* (FSP FAS 140-2) and *FSP FAS 140-4 and FIN 46(R)-8, Disclosures by Public Entities (Enterprises) about Transfers of Financial Assets and Interests in Variable Interest Entities* (FSP FAS 140-4 and FIN 46(R)-8). Neither of these GAAP statements were previously adopted for statutory accounting.

b. Amended *FAS No. 65, Accounting for Certain Mortgage Banking Activities* (FAS 65). This GAAP statement was previously deemed not applicable for statutory accounting.

c. Amended *FAS 155, Accounting for Certain Hybrid Financial Instruments* (FAS 155). This GAAP statement is still pending review for statutory accounting.

d. Amended *FAS 156, Accounting for Servicing of Financial Assets* (FAS 156). This GAAP statement was previously adopted, with modification, for statutory accounting. In accordance with the previous adoption, with modification of FAS 156, for statutory accounting, subsequent measurement of servicing assets and servicing liabilities shall be at fair value.

e. Removed reference to FAS 140 from *FAS No. 157, Fair Value Measurements* (FAS 157).

f. Amended *FASB Interpretation No. 46 Revised, Consolidation of Variable Interest Entities* (FIN 46R). This GAAP statement is still review pending for statutory accounting.

g. Amended *FASB Technical Bulletin, Accounting for Mortgage Servicing Fees and Rights* (TB 87-3). This GAAP statement was previously deemed not applicable for statutory accounting.

h. Amended *Statement 133 Implementation Issues No. D1, Application of Statement 133 to Beneficial Interests in Securitized Financial Assets* (FAS 133 Issue No. D1) and *Issue No. F8, Hedging Mortgage Service Right Assets Using Preset Hedge Coverage Ratios* (FAS 133 Issue No. F8). Pursuant to previous decisions of the Statutory Accounting Principles (E) Working Group, FAS 133 Implementation Issues are not reviewed for statutory accounting unless considered significant or relevant to statutory accounting and specifically requested for review as part of the maintenance process, or in accordance with future projects in which review of a specific FAS 133 Implementation Issue would be considered beneficial.

4. This issue paper proposes adoption, with modification, of FAS 166 and the corresponding amendments to FAS 140 and FAS 156, including the revised FAS 140 glossary and illustrations. Statutory modifications from the adoption of amendments to FAS 140 and FAS 156 reflected in FAS 166 include:

a. Rejects the GAAP consideration for "consolidated affiliates" as the concept of consolidation has not been adopted for statutory accounting.

b. Rejects reference to GAAP standards and GAAP methods not adopted for statutory as well as concepts that are not pertinent for insurers. For example, references to investments "held-to-maturity", "available for sale" or "trading" and reference to FASB standards were removed and replaced with statutory terms and references to statutory standards.

c. Rejects GAAP reference and guidance regarding "Revolving-Period Securitizations" as this GAAP guidance is not applicable to statutory accounting. This concept was also deemed not applicable to statutory accounting under SSAP No. 91R.

d. Rejects GAAP guidance for "Sale-Type and Direct-Financing Lease Receivables" as leases shall be accounted for in accordance with *SSAP No. 22—Leases* (SSAP No. 22). This conclusion is consistent with SSAP No. 91R.

e. Rejects GAAP guidance for "Banker's Acceptances and Risk Participations in Them," as not applicable for statutory accounting. This GAAP guidance was also deemed not applicable to statutory accounting under SSAP No. 91R.

f. Rejects GAAP guidance for "Removal of Account Provisions" that allows recognition of sale accounting. For statutory, transfers that would empower the transferor to reclaim assets under certain conditions (considered "removal-of-accounts provisions") are precluded from being accounted for as sales. This conclusion is consistent with SSAP No. 91R.

g. Rejects GAAP guidance for "Transfers of Receivables with Recourse" that allows transfers of receivables in their entirety with recourse to be accounted for as sales. For statutory, a transfer of receivables with recourse shall be accounted for as a secured borrowing. This conclusion is consistent with SSAP No. 91R.

h. Rejects illustrations for transactions involving transfers of lease financing receivables with residual values and banker's acceptances with a risk participation as the GAAP guidance in FAS 166 related to these topics has been rejected for statutory accounting.

i. Incorporates additional disclosure requirements for collateral requirements when the reporting entity is not permitted by contract or custom to sell or repledge.

j. Incorporates guidance previously included in SSAP No. 91R specific to insurance entities, and guidance that was adopted from GAAP guidance not revised through the issuance of FAS 166. Items incorporated include:

    i. Clarification that transfers of financial assets that are in substance real estate shall be accounted for in accordance with *SSAP No. 40—Real Estate Investments*.

    ii. Clarification that transactions between related parties or affiliates are accounted for in accordance with *SSAP No. 25—Accounting For and Disclosures About Transactions with Affiliates and Other Related Parties*.

    iii. Clarification that the guidance does not address the securitization of mortality or morbidity risk.

    iv. Guidance on the accounting of sale transactions for entities required to maintain an interest maintenance reserve (IMR).

    v. Clarification of when servicing assets and servicing liabilities shall be recognized as well as measurement of these items. This guidance continues the adoption, with modification, of FAS 156, including the requirement to subsequently measure servicing assets and servicing liabilities at fair value. Furthermore, continues the prior decision that servicing assets shall be nonadmitted.

    vi. Guidance on the accounting for transactions that require the granting of a security interest in certain assets to another party to serve as collateral for their performance under a contract.

vii. Disclosures on loaned securities; securities underlying repurchase and reverse repurchase agreements, dollar repurchase and dollar reverse repurchase agreements; receivables with recourse; and wash sales.

viii. Guidance on the sales of future revenues.

ix. Guidance on collateral requirements for securities lending transactions that requires collateral of 102 percent (105 percent for foreign securities) of the fair value of the loaned securities. Guidance recently adopted by the Statutory Accounting Principles (E) Working Group related to collateral received for securities lending transactions has been reflected within the proposed issue paper.

x. Disclosures on securities lending transactions specific to aggregate open positions and aggregate positions under 30-day, 60-day and 90-day terms, disclosures for collateral that extend beyond one year from the reporting date, and detail of loaned securities within the separate account and if the policies and procedures differ from the general account.

xi. Clarification that repurchase agreements, reverse repurchase agreements and dollar repurchase agreements meet the definition of assets as defined in *SSAP No. 4—Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this guidance.

xii. Guidance on Repurchase Agreements. This guidance retains recent revisions to SSAP No. 91R that ensured the proper terms are being utilized for the proper scenario. This guidance retains the recently adopted guidance from *FSP FAS 140-3, Accounting for Transfers of Financial Assets and Repurchase Financing Transactions* (FSP FAS 140-3). This GAAP guidance was not revised with the issuance of FAS 166.

xiii. Guidance on Reverse Repurchase Agreements. This guidance retains recent revisions to SSAP No. 91R that ensured the proper terms are being utilized for the proper scenario.

xiv. Guidance on Collateral for Reverse and Repurchase Agreements. This guidance retains recent revisions to SSAP No. 91R that ensured the proper terms are being utilized for the proper scenario.

xv. Guidance on Dollar Repurchase Agreements. This guidance retains recent revisions to SSAP No. 91R that ensured the proper terms are being utilized for the proper scenario.

xvi. Guidance for Separate Transactions.

xvii. Guidance for Offsetting.

xviii. Guidance for Transfers of Receivables with Recourse.

5. With the exception of INT 99-07, INT 99-08, INT 99-14 and INT 99-21, as discussed below, this issue paper will be interpreted by the statutory interpretations to SSAP No. 91R:

a. *INT 99-07: EITF 97-3: Accounting for Fees and Costs Associated with Loan Syndications and Loan Participations after the Issuance of FASB Statement No. 125* (INT 99-07) – As this interpretation rejected EITF 97-3 for statutory accounting, there is no impact to this interpretation from adoption of FAS 166. As this interpretation is now included in *INT 99-00—Compilation of Rejected EITFs* (INT 99-00), the reference to INT 99-00, and not INT 99-07, will be referenced in the new SSAP to supersede SSAP No. 91R.

b. *INT 99-08: EITF 97-6: Application of Issue No. 96-20 to Qualifying Special-Purpose Entities Received Transferred Financial Assets Prior to the Effective Date of FASB Statement No. 125* (INT 99-08) – As this interpretation rejected EITF 96-20 for statutory accounting, there is no impact to this interpretation from adoption of FAS 166. As this interpretation is now included in *INT 99-00—Compilation of Rejected EITFs* (INT 99-00), the reference to INT 99-00, and not INT 99-07, will be referenced in the new SSAP to supersede SSAP No. 91R.

c. *INT 99-14: EITF 96-19: Debtor's Accounting for a Modification or Exchange of Debt Instruments* (INT 99-14) – This interpretation adopted EITF 99-14 for statutory accounting. As such, an exchange of debt instruments with substantially different terms is considered a debt extinguishment. This guidance also clarifies that if the cash flows under the terms of the new debt instrument is at least 10 percent different from the present value of the remaining cash flows under the terms of the original instrument, then the exchange of debt instruments are considered substantially different. The GAAP status of EITF 96-19 was updated to identify that FAS 166 amended FAS 140 without reconsideration. As such, there is no impact to the statutory interpretation from the adoption of FAS 166. However, pursuant to a project to incorporate guidance from statutory INTs into the related SSAPs, the guidance from this INT is proposed to be included within SSAP No. 91R, as well as the proposed SSAP to supersede SSAP No. 91R. This guidance has been included in paragraph 126 of this issue paper.

d. *INT 99-21: EITF 98-7: Accounting for Exchanges of Similar Equity Method Investments* (INT 99-21) – This interpretation was nullified with the issuance of *SSAP No. 95—Exchanges of Nonmonetary Assets, A Replacement of SSAP No. 28—Nonmonetary Transactions* (SSAP No. 95). With the issuance of a new SSAP, there will be no future reference to this interpretation.

e. *INT 99-22: EITF 98-8: Accounting for Transfers of Investments That Are in Substance Real Estate* (INT 99-22) – This interpretation adopted EITF 98-8 indicating that transfers of financial assets that are in substance real estate shall be accounted for in accordance with *SSAP No. 40—Real Estate Investments* (SSAP No. 40). The GAAP status of EITF 96-19 was updated to delete the effective date reference and identify that FAS 166 amended FAS 140 without reconsideration. As such, there is no impact to the statutory interpretation from the adoption of FAS 166. However, pursuant to a project to incorporate guidance from statutory INTs into the related SSAPs, the guidance from this INT is proposed to be included within SSAP No. 91R as well as the proposed SSAP to supersede SSAP No. 91R. This guidance has been included in paragraph 6 of this issue paper.

f. *INT 00-11: EITF 98-15: Structured Notes Acquired for a Specified Investment Strategy* (INT 00-11) – This interpretation rejected the consensus position in EITF 98-15 pursuant to a recommendation from the Invested Assets (E) Working Group. It was noted that any attempt on the part of the Emerging Accounting Issues (E) Working Group to promulgate EITF 95-18 into accounting guidance (bonds accounted for at fair value rather than amortized cost) will require the Valuation of Securities (E) Task Force to change the mission of the Securities Valuation Office. The issuance of FAS 166 incorporated guidance to EITF 98-15 to identify that paragraph 11 of FAS 166 (accounting for transfers of entire financial assets or groups of entire financial assets that qualify as sales) shall be applied to each structured note upon transfer. This update is proposed for inclusion within INT 00-11, but as there is no proposed change to the previous statutory conclusion, there will be no impact to this interpretation as a result of adopting FAS 166.

g. *INT 01-31: Assets Pledged as Collateral* (INT 01-31) – This interpretation provides guidance on whether assets pledged as collateral shall be considered admitted assets. There is no impact to this interpretation conclusion from the adoption of FAS 166. (References to SSAP No. 91R will be replaced with references to the new SSAP.)

h. *INT 03-05: EITF 01-7: Creditor's Accounting for a Modification or Exchange of Debt Instruments* (INT 03-05) – This interpretation adopts the consensus position of EITF 01-7. This EITF clarifies that a debt instrument modification should be considered more than minor if the present value of the cash flows under the terms of the new debt instrument is at least 10 percent different from the present value of the remaining cash flows under the terms of the original instrument. This EITF also concludes that the guidance in EITF 96-19 (adopted within INT 99-14) should be used to calculate the present value of cash flows for purposes of applying the 10 percent test. There is no impact to this interpretation from the adoption of FAS 166.

i. *INT 04-21: EITF 02-9: Accounting for Changes that Result in a Transferor Regaining Control of Financial Assets Sold* (INT 04-21) – This interpretation adopts EITF 02-9 with modification for statutory terms and references. Pursuant to this adoption, a transferred asset that has been accounted for as sold is to be accounted for as "re-purchased" if the basis for that sale accounting subsequently becomes invalid. With the issuance of FAS 166, guidance in EITF 02-9 was updated to reflect the revised terminology in FAS 166 as well as delete the issue and conclusion pertaining to qualified special purpose entities as the concept of a QSPE is no longer captured within FAS 166. Although there is no impact to the statutory conclusion to adopt this EITF with modifications for statutory references, the guidance in INT 04-21 will be revised to reflect the revisions adopted from FAS 166.

j. *INT 09-08: Accounting for Loans Received under the Federal TALF Program* (INT 99-08). This interpretation provides statutory guidance on whether TALF loans received and the corresponding collateral provided by the reporting entity shall be reported net within the statutory financial statements. With the exception of updating references from SSAP No. 91R to the new SSAP, there is no anticipated change proposed to this interpretation.

SCOPE OF STATEMENT

5A. Transfers of financial assets take many forms. Accounting for transfers in which the transferor has no continuing involvement with the transferred financial assets or with the transferee are generally straightforward. However, transfers of financial assets often occur in which the transferor has some continuing involvement either with the assets transferred or with the transferee. Examples of continuing involvement include, but are not limited to, servicing arrangements, recourse or guarantee arrangements, agreements to purchase or redeem transferred financial assets, options written or held, derivative financial instruments that are entered into contemporaneously with, or in contemplation of the transfer, arrangements to provide financial support, pledges of collateral, and the transferor's beneficial interests in the transferred financial assets. Transfers of financial assets with continuing involvement raise issues about the circumstances under which the transfers should be considered as sales of all or part of the assets or as secured borrowings. An objective in accounting for transfers of financial assets is for each reporting entity that is a party to the transaction to recognize only assets it controls and liabilities it has incurred, to **derecognize** assets only when control has been surrendered, and to derecognize liabilities only when they have been extinguished. Sales and other transfers may frequently result in a disaggregation of financial assets and liabilities into components, which become separate assets and liabilities.

6. This issue paper focuses on the issues of accounting for **transfers**[1] and servicing of **financial assets** and extinguishments of liabilities. This issue paper establishes statutory accounting principles for transfers and servicing of financial assets, including asset **securitizations** and securitizations of policy acquisition costs, extinguishments of liabilities, repurchase agreements, repurchase financing and reverse repurchase agreements, including dollar repurchase and dollar reverse repurchase agreements that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts). This statement discusses generalized situations. Facts and circumstances and specific contracts need to be considered carefully in applying this statement. Securitizations of nonfinancial assets are outside the scope of this statement. Transfers of financial assets that are in substance real estate shall be accounted for in accordance with *SSAP No. 40—Real Estate Investments*. Additionally, retained beneficial interests from the sale of loan-backed or structured securities are to be accounted for in accordance with *SSAP No. 43R—Loan-Backed and Structured Securities, Revised.*

7. *SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties* (SSAP No. 25) shall be followed for accounting and disclosure requirements for all related party transactions.

8. *SSAP No. 91R—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (SSAP No. 91R) has been superseded by this statement.

9. This issue paper does not address the securitization of mortality or morbidity risk. The National Association of Insurance Commissioners' (NAIC's) Insurance Securitization Working Group of the Financial Condition (E) Committee is charged with the development of model laws, model regulations and proposed accounting guidance for the securitization of mortality and morbidity risk. When such proposed accounting guidance is finalized the development of an issue paper will be considered.

SUMMARY CONCLUSION

Accounting for Transfers and Servicing of Financial Assets

10. The objective of paragraph 12 and related implementation guidance is to determine whether a **transferor** has surrendered control over transferred financial assets. This determination must consider the transferor's **continuing involvement** in the transferred financial assets and requires the use of judgment that must consider all arrangements or agreements made contemporaneously with, or in contemplation of, the transfer, even if they were not entered into at the time of the transfer.

11. The requirements of paragraph 12 apply to transfers of an entire financial asset, transfers of a group of entire financial assets, and transfers of a **participating interest** in an entire financial asset (all of which are referred to collectively in this issue paper as transferred financial assets). A participating interest has all of the following characteristics:

a. From the date of the transfer, it represents a proportionate (pro rata) ownership interest in an entire financial asset. The percentage of ownership interests held by the transferor in the entire financial asset may vary over time, while the entire financial asset remains outstanding as long as the resulting portions held by the transferor (including any participating interest retained by the transferor or its **agents**) and the **transferee**(s) meet the other characteristics of a participating interest. For example, if the transferor's interest in an entire financial asset changes because it subsequently sells another interest in the entire financial asset, the interest held initially and subsequently by the transferor must meet the definition of a participating interest.

[1] Terms defined in the glossary to this issue paper are set in boldface type the first time they appear.

b. From the date of the transfer, all cash flows received from the entire financial asset are divided proportionately among the participating interest holders in an amount equal to their share of ownership. Cash flows allocated as compensation for services performed, if any, shall not be included in that determination provided those cash flows are not subordinate to the proportionate cash flows of the participating interest and are not significantly above an amount that would fairly compensate a substitute service provider, should one be required, which includes the profit that would be demanded in the marketplace. In addition, any cash flows received by the transferor as **proceeds** of the transfer of the participating interest shall be excluded from the determination of proportionate cash flows provided that the transfer does not result in the transferor receiving an ownership interest in the financial asset that permits it to receive disproportionate cash flows.

c. The rights of each participating interest holder (including the transferor in its role as a participating interest holder) have the same priority, and no participating interest holder's interest is subordinated to the interest of another participating interest holder. That priority does not change in the event of bankruptcy or other receivership of the transferor, the original debtor, or any other participating interest holder. Participating interest holders have no **recourse** to the transferor, its agents or to each other, other than **standard representations and warranties,** ongoing contractual obligations to service the entire financial asset and administer the transfer contract, and contractual obligations to share in any set-off benefits received by any participating interest holder. That is, no participating interest holder is entitled to receive cash before any other participating interest holder under its contractual rights as a participating interest holder. For example, if a participating interest holder also is the servicer of the entire financial asset and receives cash in its role as servicer, that arrangement would not violate this requirement.

d. No party has the right to pledge or exchange the entire financial asset unless all participating interest holders agree to pledge or exchange the entire financial asset.

If a transfer of a portion of an entire financial asset meets the definition of a participating interest, the transferor shall apply the guidance in paragraph 12. If a transfer of a portion of a financial asset does not meet the definition of a participating interest, the transferor and transferee shall account for the transfer in accordance with the guidance in paragraph 18 as a secured borrowing. However, if the transferor transfers an entire financial asset in portions that do not individually meet the participating interest definition, paragraph 12 shall be applied to the entire financial asset once all portions have been transferred.

12. A transfer of an entire financial asset, a group of entire financial assets, or a participating interest in an entire financial asset in which the transferor surrenders control over those financial assets shall be accounted for as a sale if, and only if, all of the following conditions are met:

a. The transferred financial assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership. Transferred financial assets are isolated in bankruptcy or other receivership only if the transferred financial assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor.

b. Each transferee (or, if the transferee is an entity whose sole purpose is to engage in securitization or asset-backed financing activities and that entity is constrained from pledging or exchanging the assets it receives, each third-party holder of its **beneficial interests**) has the right to pledge or exchange the assets (or beneficial interests) it received, and no condition both constrains the transferee (or third-party holder of its beneficial interests) from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor (paragraphs 46-49).

c. The transferor or its agents do not maintain effective control over the transferred financial assets or third-party beneficial interests related to those transferred assets (paragraph 53). Examples of a transferor's effective control over the transferred financial assets include, but are not limited to (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (paragraphs 54-56), (2) an agreement that provides the transferor with both the **unilateral ability** to cause the holder to return specific financial assets and a more-than-trivial benefit attributable to that ability, other than through a **cleanup call** (paragraphs 57-61), or (3) an agreement that permits the transferee to require the transferor to repurchase the transferred financial assets at a price that is so favorable to the transferee that it is probable that the transferee will require the transferor to repurchase them (paragraph 62).

Accounting for Transfers of Participating Interests

13. Upon completion of a transfer of a participating interest that satisfies the conditions to be accounted for as a sale (paragraph 12), the transferor (**seller**) shall:

a. Allocate the previous carrying amount of the entire financial asset between the participating interests sold and the participating interest that continues to be held by the transferor on the basis of their relative fair values at the date of the transfer (paragraph 65).

b. **Derecognize** the participating interest(s) sold.

c. Recognize and initially measure at fair value **servicing assets**, **servicing liabilities**, and any other assets obtained and liabilities incurred in the sale (such as cash) (paragraphs 66-70).

d. Recognize in earnings any gain or loss on the sale.

e. Report any participating interest or interests that continue to be held by the transferor as the difference between the previous carrying amount of the entire financial asset and the amount derecognized.

The transferee shall recognize the participating interest(s) obtained, other assets obtained, and any liabilities incurred and initially measure them at fair value.

14. Upon completion of a transfer of participating interests that does not satisfy the conditions to be accounted for as a sale, the guidance in paragraph 18 shall be applied.

Accounting for Transfers of an Entire Financial Asset or Group of Entire Financial Assets

15. Upon completion of a transfer of an entire financial assets or a group of entire financial assets that satisfies the conditions to be accounted for as a sale (see paragraph 12), the transferor (seller) shall:

a. Derecognize the transferred financial assets;

b. Recognize and initially measure at fair value servicing assets, servicing liabilities, and any other assets obtained (including a transferor's beneficial interest in the transferred financial assets) and liabilities incurred[2] in the sale (paragraphs 64 and 66-70).

[2] Some assets that might be obtained and liabilities that might be incurred include cash, put or call options that are held or written (for example, guarantee or recourse obligations), forward commitments (for example, commitments to deliver additional

c. For reporting entities required to maintain an Interest Maintenance Reserve (IMR), the accounting for realized and unrealized capital gains and losses shall be determined per the guidance in the SSAP for the specific type of investment (e.g., SSAP No. 43R for loan-backed and structured securities), or if not specifically stated in the related SSAP, in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*. For reporting entities not required to maintain an IMR, realized capital gains and losses shall be reported as net realized capital gains or losses in the statement of income, and unrealized capital gains and losses shall be reported as net unrealized gains and losses in unassigned funds (surplus).

The transferee shall recognize all assets obtained and any liabilities incurred, and initially measure them at fair value.

16. Repurchase agreements, reverse repurchase agreements, repurchase financing, **collateral** requirements and dollar repurchase agreements are described in paragraphs 97-113. When an asset is sold and the proceeds are reinvested within 30 days in the same or substantially the same security, such transfers shall be considered to be wash sales and shall be accounted for as sales as discussed in paragraphs 91-96 and disclosed as required by paragraph 31. Unless there is a concurrent contract to repurchase or redeem the transferred financial assets from the transferee, the transferor does not maintain effective control over the transferred financial assets.

17. Upon completion of a transfer of an entire financial asset or a group of entire financial assets that does not satisfy the conditions to be accounted for as a sale in its entirety, the guidance in paragraph 18 shall be applied.

Secured Borrowing

18. If a transfer of an entire financial asset, a group of entire financial assets, or a participating interest in an entire financial asset does not meet the conditions for a sale in paragraph 12, or if a transfer of a portion of an entire financial asset does not meet the definition of a participating interest (paragraph 11), the transferor and transferee shall account for the transfer as a secured borrowing with pledge of collateral (paragraph 23). The transferor shall continue to report the transferred financial assets in its statement of financial position with no change in their measurement (that is, basis of accounting).

Recognition and Measurement of Servicing Assets and Liabilities

19. An entity shall recognize and initially measure at fair value, a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract in either of the following situations:

a. A servicer's transfer of an entire financial asset, a group of entire financial assets, or a participating interest in an entire financial asset that meets the requirements for sale accounting; or

b. An acquisition or assumption of a servicing obligation that does not relate to financial assets of the servicer.

An entity that transfers its financial assets to an entity in a transfer that qualifies as a sale in which the transferor obtains the resulting securities and classifies them as debt securities shall separately recognize its servicing assets or servicing liabilities.

receivables during the revolving periods of some securitizations) and swaps (for example, provisions that convert interest rates from fixed to variable).

20. A servicer that transfers or securitizes financial assets in a transaction that does not meet the requirements for sale accounting and is accounted for as a secured borrowing with the underlying assets remaining on the transferor's balance sheet shall not be recognized as a servicing asset or servicing liability.

21. If distinct servicing rights exist in accordance with the above guidelines, the reporting entity shall recognize a servicing asset or liability. When the servicing fees to be received exceed the cost of servicing the transferred assets, a servicing asset is recognized and nonadmitted. When the cost of servicing the transferred assets is greater than the servicing fees to be received, a liability shall be recorded for the excess to recognize this obligation. A corresponding loss shall be recorded through the Summary of Operations in other income. Servicing assets or liabilities shall be measured subsequently at fair value at each reporting date with fluctuations in fair value reported as unrealized gains and losses. Declines in fair value which are determined to be other than temporary shall be recorded as realized losses.

Financial Assets Subject to Prepayment

22. Financial assets, except for instruments that are within the scope of SSAP No. 86, that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment shall be subsequently measured like investments in debt securities and loan-backed and structured securities in accordance with SSAP No. 43R. Examples of such financial assets include, but are not limited to, **interest-only strips**, other beneficial interests, loans, or other receivables.

Secured Borrowings and Collateral

23. A debtor may grant a **security interest** in certain assets to a lender (the secured party) to serve as collateral for its obligation under a borrowing, with or without recourse to other assets of the debtor. An obligor under other kinds of current or potential obligations, for example, interest rate swaps, also may grant a security interest in certain assets to a secured party. If collateral is transferred to the secured party, the custodial arrangement is commonly referred to as a pledge. Secured parties sometimes are permitted to sell or repledge (or otherwise transfer) collateral held under a pledge. The same relationships occur, under different names, in transfers documented as sales that are accounted for as secured borrowings (paragraph 18 secured borrowing). The accounting for noncash[3] collateral by the debtor (or obligor) and the secured party depends on whether the secured party or its agent has the right to sell or repledge the collateral and on whether the debtor has defaulted.

a. If the secured party (transferee) or its agent has the right by contract or custom to sell or repledge the collateral, then the debtor (transferor) shall report that asset in its balance sheet.

b. If the secured party (transferee) sells collateral pledged to it, it shall recognize the proceeds from the sale and its obligation to return the collateral. The sale of the collateral is a transfer subject to the provisions of this issue paper.

c. If the debtor (transferor) defaults under the terms of the secured contract and is no longer entitled to redeem the pledged asset, it shall derecognize the pledged asset, and the secured party (transferee) shall recognize the collateral as its asset initially measured at fair value or, if it has already sold the collateral, derecognize its obligation to return the collateral.

[3] Cash "collateral," sometimes used, for example, in securities lending transactions, shall be derecognized by the payer and recognized by the recipient, not as collateral, but rather as proceeds of either a sale or a borrowing.

d. Except as provided in paragraph 23.c., the debtor (transferor) shall continue to carry the collateral as its asset, and the secured party (transferee) shall not recognize the pledged asset.

24. Reporting entities may enter into certain transactions that require the granting of a security interest in certain assets to another party to serve as collateral for their performance under a contract. If the assets pledged are recorded as admitted assets under *SSAP No. 4—Assets and Nonadmitted Assets* (SSAP No. 4) and are not impaired under the provisions of *SSAP No. 5—Liabilities, Contingencies and Impairments of Assets* (SSAP No. 5), the pledging entity records the collateral as an admitted asset until committing a contract default that has not been cured in accordance with the contract provisions. At the time of an uncured default, the provisions of paragraph 23 above shall be used to determine the appropriate accounting treatment for the collateral. If the secured party utilizes collateral to offset all or a portion of the liability owed by the pledging entity as a result of the default, then the collateral amount utilized to offset the liability shall be removed from the balance sheet. At the same time, the amount of the liability that was offset shall be removed from the balance sheet since that obligation has been satisfied through the secured party's utilization of that collateral. To the extent that an uncured default remains without the secured party utilizing the collateral to offset the obligation, the pledging insurer shall only record an admitted asset for the amount of collateral that it can redeem.

Extinguishments of Liabilities

25. A debtor shall derecognize a liability if and only if it has been extinguished (see *SSAP No. 15—Debt and Holding Company Obligations* (SSAP No. 15)). A liability has been extinguished if either of the following conditions is met:

a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes delivery of cash, other financial assets, goods, or services or reacquisition by the debtor of its outstanding debt securities whether the securities are canceled or held as so-called treasury bonds; or

b. The debtor is legally released[4] from being the primary obligor under the liability, either judicially or by the creditor.

Disclosures

26. The principal objectives of the disclosures required by this issue paper are to provide users of the financial statements with an understanding of all of the following:

a. A transferor's continuing involvement (as defined in the glossary of this issue paper), if any, with transferred financial assets.

b. The nature of any restrictions on assets reported by an entity in its statement of financial position that relate to a transferred financial asset, including the carrying amounts of those assets.

c. How servicing assets and servicing liabilities are reported under this issue paper.

d. For transfers accounted for as sales when a transferor has continuing involvement with the transferred financial assets and for transfers of financial assets accounted for as

[4] If nonrecourse debt (such as certain mortgage loans) is assumed by a third party in conjunction with the sale of an asset that serves as sole collateral for that debt, the sale and related assumption effectively accomplish a legal release of the seller-debtor for purposes of applying this statement.

secured borrowings, how the transfer of financial assets affects a transferor's financial position, financial performance, and cash flows.

Those objectives apply regardless of whether this issue paper requires specific disclosures. The specific disclosures required by this issue paper are minimum requirements and an entity may need to supplement the required disclosures specified in paragraph 31 depending on the facts and circumstances of a transfer, the nature of an entity's continuing involvement with the transferred financial assets, and the effect of an entity's continuing involvement on the transferor's financial position, financial performance, and cash flows. Disclosures required by other Statement of Statutory Accounting Principles (SSAPs) for a particular form of continuing involvement shall be considered when determining whether the disclosure objectives of this issue paper have been met.

27. Disclosures required by this issue paper may be reported in the aggregate for similar transfers if separate reporting of each transfer would not provide more useful information to financial statement users. A transferor shall disclose how similar transfers are aggregated. A transferor shall distinguish transfers that are accounted for as sales from transfers that are accounted for as secured borrowings. In determining whether to aggregate the disclosures for multiple transfers, the reporting entity shall consider quantitative and qualitative information about the characteristics of the transferred financial assets. For example, consideration should be given, but not limited, to the following:

a. The nature of the transferor's continuing involvement.

b. The types of financial assets transferred.

c. Risks related to the transferred financial assets to which the transferor continues to be exposed after the transfer and the change in the transferor's risk profile as a result of the transfer.

28. The disclosures shall be presented in a manner that clearly and fully explains to financial statement users the transferor's risk exposure related to the transferred financial assets and any restrictions on the assets of the entity. An entity shall determine, in light of the facts and circumstances, how much detail it must provide to satisfy the disclosure requirements of this issue paper and how it aggregates information for assets with different risk characteristics. The entity must strike a balance between obscuring important information as a result of too much aggregation and excessive detail that may not assist financial statement users to understand the entity's financial position. For example, an entity shall not obscure important information by including it with a large amount of insignificant detail. Similarly, an entity shall not disclose information that is so aggregated that it obscures important differences between the different types of involvement or associated risks.

29. The disclosures in paragraph 31.f. of this issue paper apply to transfers accounted for as sales when the transferor has continuing involvement with transferred financial assets as a result of a securitization, asset-backed financing arrangement, or a similar transfer. If specific disclosures are required for a particular form of the transferor's continuing involvement by other SSAPs, the transferor shall provide the information required in paragraphs 31.f.i.(a) and 31.f.ii.(a) of this issue paper with a cross-reference to the separate notes to financial statements so a financial statement user can understand the risks retained in the transfer. The entity need not provide each specific disclosure required in paragraphs 31.f.i.(b), 31.f.ii.(a)(1)–(4), and 31.f.ii.(b)–(e) if the disclosure is not required by other SSAPs and the objectives of paragraph 26 are met. For example, if the transferor's only form of continuing involvement is a derivative, the entity shall provide the disclosures required in paragraphs 31.f.i.(a) and 31.f.ii.(a) of this issue paper and the disclosures about derivatives required by applicable SSAPs. In addition, the entity would evaluate whether the other disclosures in paragraph 31.f. are necessary for the entity to meet the objectives in paragraph 26.

30. To apply the disclosures in paragraph 31, an entity shall consider all involvements by the transferor or its agents to be involvements by the transferor.

31. A reporting entity shall disclose the following:

a. For collateral:

i. If the entity has entered into repurchase agreements or securities lending transactions, its policy for requiring collateral or other security and the fair value of the loaned security;

ii. If the entity has pledged any of its assets as collateral that are not reclassified and separately reported in the statement of financial position pursuant to paragraph 23. a, the carrying amounts and classifications of both those assets and associated liabilities as of the date of the latest statement of financial position presented, including qualitative information about the relationship(s) between those assets and associated liabilities. For example, if assets are restricted solely to satisfy a specific obligation, the carrying amounts of those assets and associated liabilities, including a description of the nature of restrictions placed on the assets, shall be disclosed.

iii. If the entity or its agent has accepted collateral that it is permitted by contract or custom to sell or repledge, the fair value as of the date of each statement of financial position presented of that collateral and of the portion of that collateral that it has sold or repledged, and information about the sources and uses of that collateral. Additionally, the reporting entity shall disclose the aggregate amount of contractually obligated open collateral positions (aggregate amount of securities at current fair value or cash received for which the borrower may request the return of on demand) and the aggregate amount of contractually obligated collateral positions under 30-day, 60-day, 90-day, and greater than 90-day terms.

iv. If the entity has accepted collateral that it is not permitted by contract or custom to sell or repledge, provide detail on these transactions, including the terms of the contract, and the current fair value of the collateral.

v. For all securities lending transactions, disclose collateral for transactions that extend beyond one year from the reporting date; and

vi. For securities lending transactions administered by an affiliated agent in which "one-line" reporting (per paragraph 87.a.) of the reinvested collateral per paragraph 87.c. is optional, at the discretion of the reporting entity, disclose the aggregate value of the reinvested collateral which is "one line" reported and the aggregate value of items which are reported in the investment schedules (per paragraph 87.b.). Identify the rational between the items which are one line reported and those that are investment schedule reported and if the treatment has changed from the prior period and

vii. For securities lending transactions, include separately, the amount of any loaned securities within the separate account and if the policy and procedures for the separate account differ from the general account.

b. The reporting entity shall provide the following information by type of program (repurchase agreement, securities lending or dollar repurchase agreement) with respect to the reinvestment of the cash collateral and any securities which it or its agent receives as collateral that can be sold or repledged.

i. The aggregate amount of the reinvested cash collateral (amortized cost and fair value). Reinvested cash collateral shall be broken down by the maturity date of the invested asset – under 30-day, 60-day, 90-day, 120-day, 180-day, less than 1year, 1-2 years, 2-3 years and greater than 3 years.

ii. To the extent that the maturity dates of the liability (collateral to be returned) does not match the invested assets, the reporting entity shall explain the additional sources of liquidity to manage those mismatches.

c. For in-substance defeasance of debt

i. If debt was considered to be extinguished by in-substance defeasance, a general description of the transaction and the amount of debt that is considered extinguished at the end of each the period so long as that debt remains outstanding.

d. For all servicing assets and servicing liabilities:

i. A description of the risks inherent in servicing assets and servicing liabilities and, if applicable, the instruments used to mitigate the income statement effect of changes in fair value to the servicing assets and servicing liabilities. (Disclosure of quantitative information about the instruments used to manage the risks inherent in servicing assets and servicing liabilities is encouraged but not required.)

ii. The amount of contractually specified servicing fees, late fees and ancillary fees earned for each period for which results of operations are presented, including a description of where each amount is reported in the statement of income.

iii. Quantitative and qualitative information about the assumptions used to estimate the fair value (for example, discount rates, anticipated credit losses, and prepayment speeds). (An entity that provides quantitative information about the instruments used to manage the risks inherent in the servicing assets and servicing liabilities, as encouraged by paragraph 31.d.i., also is encouraged, but not required to disclose the quantitative and qualitative information about the assumptions used to estimate the fair value of those instruments.

e. When servicing assets and servicing liabilities are subsequently measured at fair value:

i. For each class of servicing assets and servicing liabilities, the activity in the balance of servicing assets and the activity in the balance of servicing liabilities (including a description of where changes in fair value are reported in the statement of income for each period for which results of operations are presented), including, but not limited to, the following:

(a) The beginning and ending balances

(b) Additions (through purchases of servicing assets, assumptions of servicing obligations, and recognition of servicing obligations that result from transfers of financial assets)

(c) Disposals

(d) Changes in fair value during the period resulting from (i) changes in valuation inputs or assumptions used in the valuation model and (ii) other changes in fair value and a description of those changes

(e) Other changes that affect the balance and a description of those changes.

f. For securitizations, asset-backed financing arrangements, and similar transfers accounted for as sales when the transferor has continuing involvement (as defined in the glossary) with the transferred financial assets:

i. For each income statement presented:

(a) The characteristics of the transfer (including a description of the transferor's continuing involvement with the transferred financial assets, the nature and initial fair value of the assets obtained as proceeds and the liabilities incurred in the transfer, and the gain or loss from sale of transferred financial assets. For initial fair value measurements of assets obtained and liabilities incurred in the transfer, the following information:

(1) The level within the fair value hierarchy in which the fair value measurements in their entirety fall, segregating fair value measurements using quoted prices in active markets for identical assets or liabilities (Level 1), significant other observable inputs (Level 2), and significant unobservable inputs (Level 3)

(2) The key inputs and assumptions[5] used in measuring the fair value of assets obtained and liabilities incurred as a result of the sale that relate to the transferor's continuing involvement (including, at a minimum, but not limited to, and if applicable, quantitative information about discount rates, expected prepayments including the expected weighted-average life of prepayable[6] financial assets, and anticipated credit losses, including expected static pool losses[7])[8]

(b) Cash flows between a transferor and transferee, including proceeds from new transfers, proceeds from collections reinvested in revolving-period transfers, purchases of previously transferred financial assets, servicing fees, and cash flows received from a transferor's beneficial interests.

[5] If an entity has aggregated multiple transfers during a period in accordance with paragraphs 27 and 28, it may disclose the range of assumptions.

[6] The weighted-average life of prepayable assets in periods (for example, months or years) can be calculated by multiplying the principal collections expected in each future period by the number of periods until that future period, summing those products, and dividing the sum by the initial principal balance.

[7] Expected static pool losses can be calculated by summing the actual and projected future credit losses and dividing the sum by the original balance of the pool of assets.

[8] The timing and amount of future cash flows for transferor's interests in transferred financial assets are commonly uncertain, especially if those interests are subordinate to more senior beneficial interests. Thus, estimates of future cash flows used for a fair value measurement depend heavily on assumptions about default and prepayment of all the financial assets transferred, because of the implicit credit or prepayment risk enhancement arising from the subordination.

ii. For each statement of financial position presented, regardless of when the transfer occurred:

(a) Qualitative and quantitative information about the transferor's continuing involvement with transferred financial assets that provides financial statement users with sufficient information to assess the reasons for the continuing involvement and the risks related to the transferred financial assets to which the transferor continues to be exposed after the transfer and the extent that the transferor's risk profile has changed as a result of the transfer (including, but not limited to, credit risk, interest rate risk, and other risks), including:

(1) The total principal amount outstanding, the amount that has been derecognized, and the amount that continues to be recognized in the statement of financial position.

(2) The terms of any arrangements that could require the transferor to provide financial support (for example, liquidity arrangements and obligations to purchase assets) to the transferee or its beneficial interest holders, including a description of any events or circumstances that could expose the transferor to loss and the amount of the maximum exposure to loss.

(3) Whether the transferor has provided financial or other support during the periods presented that it was not previously contractually required to provide to the transferee or its beneficial interest holders, including when the transferor assisted the transferee or its beneficial interest holders in obtaining support, including:

(i.) The type and amount of support

(ii.) The primary reasons for providing the support

(4) Information is encouraged about any liquidity arrangements, guarantees, and/or other commitments provided by third parties related to the transferred financial assets that may affect the transferor's exposure to loss or risk of the related transferor's interest.

(b) The entity's accounting policies for subsequently measuring assets and liabilities that relate to the continuing involvement with the transferred financial assets;

(c) The key inputs and assumptions used in measuring the fair value of assets or liabilities that relate to the transferor's continuing involvement (including, at a minimum, but not limited to, and if applicable, quantitative information about discount rates, expected prepayments including the expected weighted-average life of prepayable financial assets, and anticipated credit losses, including expected static pool losses);

(d) For the transferor's interests in the transferred financial assets, a sensitivity analysis or stress test showing the hypothetical effect on the fair value of those interests (including any servicing assets or servicing liabilities) of two or more unfavorable variations from the expected levels for each key assumption that is reported under paragraph 31.f.ii.(c) above independently from any change in another key assumption, and a description of the objectives, methodology, and limitations of the sensitivity analysis or stress test

(e) Information about the asset quality of transferred financial assets and any other assets that it manages together with them. This information shall be separated between assets that have been derecognized and assets that continue to be recognized in the statement of financial position. This information is intended to provide financial statement users with an understanding of the risks inherent in the transferred financial assets as well as in other assets and liabilities that it manages together with transferred financial assets. For example, information for receivables shall include, but is not limited to:

(i) Delinquencies at the end of the period; and

(ii) Credit losses, net of recoveries, during the period.

g. Disclosure requirements for transfers of financial assets accounted for as secured borrowing:

i. The carrying amounts and classifications of both assets and associated liabilities recognized in the transferor's statement of financial position at the end of each period presented, including qualitative information about the relationship(s) between those assets and associated liabilities. For example, if assets are restricted solely to satisfy a specific obligation, the carrying amounts of those assets and associated liabilities, including a description of the nature of restrictions placed on the assets.

h. Description of any loaned securities, including the amount, a description of, and the policy for, requiring collateral, and whether or not the collateral is restricted;

i. A description of the securities underlying repurchase and reverse repurchase agreements, dollar repurchase and dollar reverse repurchase agreements, including book values and fair values, maturities, and weighted average interest rates for the following categories: (i) securities subject to reverse repurchase agreements; (ii) securities subject to repurchase agreements; (iii) securities subject to dollar repurchase agreements; and (iv) securities subject to dollar reverse repurchase agreements; and

j. A description of the terms of reverse repurchase agreements whose amounts are included in borrowed money.

k. Disclose any transfers of receivables with recourse.

l. A reporting entity shall disclose the following information for wash sales, as defined in paragraph 16, involving transactions for securities with a NAIC designation of 3 or below, or unrated:

i. A description of the reporting entity's objectives regarding these transactions;

ii. An aggregation of transactions by NAIC designation 3 or below, or unrated;

iii. The number of transactions involved during the reporting period;

iv. The book value of securities sold;

v. The cost of securities repurchased; and

vi. The realized gains/losses associated with the securities involved.

32. Refer to the preamble for further discussion regarding disclosure requirements. The disclosures required by paragraph 31 shall be made for the current quarter in the quarterly statement and for the year in the annual statement.

Appendix A – Implementation Guidance

33. This appendix describes certain provisions of this issue paper in more detail and describes how they apply to certain types of transactions. This appendix discusses generalized situations. Facts and circumstances and specific contracts need to be considered carefully in applying this issue paper. This appendix is an integral part of the standards provided in this issue paper.

34. Paragraph 10 of this issue paper states that the objective of paragraph 12 and related implementation guidance is to determine whether a transferor has surrendered control over transferred financial assets.

Unit of Account

35. Paragraph 11 establishes the unit of account to which the sale accounting conditions in paragraph 12 shall be applied. Paragraph 11 states that paragraph 12 shall be applied to transfers of an entire financial asset, transfers of a group of entire financial assets, and transfers of a participating interest in an entire financial asset. Inherent in that principle is that to be eligible for sale accounting an entire financial asset cannot be divided into components before a transfer unless all of the components meet the definition of a participating interest.

36. The legal form of the asset and what the asset conveys to its holders shall be considered in determining what constitutes an entire financial asset. The following examples illustrate the application of what constitutes an entire financial asset:

a. A loan to one borrower in accordance with a single contract that is transferred to a securitization entity before securitization shall be considered an entire financial asset. Similarly, a beneficial interest in securitized financial assets after the securitization process has been completed shall be considered an entire financial asset. In contrast, a transferred interest in an individual loan shall not be considered an entire financial asset; however, if the transferred interest meets the definition of a participating interest, the participating interest would be eligible for sale accounting.

b. In a transaction in which the transferor creates an interest-only strip from a loan and transfers the interest-only strip, the interest-only strip does not meet the definition of an entire financial asset (and an interest-only strip does not meet the definition of a participating interest; therefore, sale accounting would be precluded). In contrast, if an entire financial asset is transferred to a securitization entity and the transfer meets the conditions for sale accounting, the transferor may obtain an interest-only strip as proceeds from the sale. An interest-only strip received as proceeds of a sale is an entire financial asset for purposes of evaluating any future transfers that could then be eligible for sale accounting.

c. If multiple advances are made to one borrower in accordance with a single contract (such as a line of credit, credit card loan, or a construction loan), an advance on that contract would be a separate unit of account if the advance retains its identity, does not become part of a larger loan balance, and is transferred in its entirety. However, if the transferor transfers an advance in its entirety and the advance loses its identity and becomes part of a larger loan balance, the transfer would be eligible for sale accounting only if the transfer of the advance does not result in the transferor retaining any interest in the larger balance or if the transfer results in the transferor's interest in the larger balance meeting the definition of a participating interest. Similarly, if the transferor transfers an interest in an advance that has lost its identity, the interest must be a participating interest in the larger balance to be eligible for sale accounting.

Participating Interests in an Entire Financial Asset

37. Paragraph 11.b. requires that all cash flows received from the entire financial asset be divided among the participating interest holders (including any interest retained by the transferor or its agents) in proportion to their share of ownership. That is, the participating interest definition does not allow for the allocation of specified cash flows unless each cash flow is proportionately allocated to the participating interest holders. For example, in the case of an individual loan in which the borrower is required to make a contractual payment that consists of a principal amount and interest amount on the loan, the transferor and transferee shall share in the principal and interest payments on the basis of their proportionate ownership interest in the loan. In contrast, if the transferor is entitled to receive an amount that represents the principal payments and the transferee is entitled to receive an amount that represents the interest payments on the loan, that arrangement would not be consistent with the participating interest definition because the transferor and transferee do not share proportionately in the cash flows received from the loan. In other cases, a transferor may transfer a portion of an individual loan that represents either a senior interest or a junior interest in an individual loan. In both of those cases, the transferor would account for the transfer as a secured borrowing because the senior interest or junior interest in the loan do not meet the requirements to be participating interests (see paragraph 41).

38. Paragraph 11.b. states that cash flows allocated as compensation for services performed, if any, shall not be included in that determination provided that those cash flows are not subordinate to the proportionate cash flows of the participating interest and are not significantly above an amount that would fairly compensate a substitute service provider, should one be required, including any profit that would be demanded in the marketplace. Cash flows allocated as compensation for services performed that are significantly above an amount that would fairly compensate a substitute service provider would result in a disproportionate division of cash flows of the entire financial asset among the participating interest holders and, therefore, would preclude the portion of a transferred financial asset from meeting the definition of a participating interest. Examples of cash flows that are compensation for services performed include loan origination fees paid by the borrower to the transferor, fees necessary to arrange and complete the transfer paid by the transferee to the transferor, and fees for servicing the financial asset.

39. The transfer of a portion of an entire financial asset may result in a gain or loss on the transfer when the contractual interest rate on the entire financial asset differs from the market rate at the time of transfer. Paragraph 11.b. states that any cash flows received by the transferor as proceeds of a transfer of a participating interest shall be excluded from the determination of whether the cash flows of the participating interest are proportionate provided that the transfer does not result in the transferor receiving an ownership interest in the financial asset that permits it to receive disproportionate cash flows. For example, if the transferor transfers an interest in an entire financial asset and the transferee agrees to incorporate the excess interest (between the contractual interest rate on the financial asset and the market interest rate at the date of transfer) into the contractually specified servicing fee, the excess interest would likely result in the conveyance of an interest-only strip to the transferor from the transferee. An interest-only strip would result in a disproportionate division of cash flows of the financial asset among the

participating interest holders and would preclude the portion from meeting the definition of a participating interest.

40. Paragraph 11.c. requires that the rights of each participating interest holder (including the transferor in its role as participating interest holder) have the same priority and that no participating interest holder's interest is subordinated to the interest of another participating interest holder. In certain transfers, recourse is provided to the transferee that requires the transferor to reimburse any premium paid by the transferee if the underlying financial asset is prepaid within a defined timeframe of the transfer date. Such recourse would preclude the transferred portion from meeting the definition of a participating interest. However, once the recourse provision expires, the transferred portion shall be reevaluated to determine if it meets the participating interest definition.

41. Paragraph 11.c. also requires that participating interest holders have no recourse to the transferor (or its agents) or to each other, other than standard representations and warranties, ongoing contractual obligations to service the entire financial asset and administer the transfer contract, and contractual obligations to share in any set-off benefits. Recourse in the form of an independent third-party guarantee shall be excluded from the evaluation of whether the participating interest definition is met. Similarly, cash flows allocated to a third-party guarantor for the guarantee fee shall be excluded from the determination of whether the cash flows are divided proportionately among the participating interest holders.

Isolation Beyond the Reach of the Transferor and Its Creditors

42. The nature and extent of supporting evidence required for an assertion in financial statements that an entire financial asset, a group of entire financial assets, or a participating interest in an entire financial asset (which are referred to collectively in this issue paper as transferred financial assets) have been isolated—put presumptively beyond the reach of the transferor and its creditors, either by a single transaction or a series of transactions taken as a whole—depend on the facts and circumstances. All available evidence that either supports or questions an assertion shall be considered, including whether the contract or circumstances permit the transferor to revoke the transfer. It also may include consideration of the legal consequences of the transfer in the jurisdiction in which bankruptcy or other receivership would take place, whether a transfer of financial assets would likely be deemed a true sale at law (as described in paragraph 43) or otherwise isolated (as described in paragraph 44), whether the transferor is affiliated with the transferee, and other factors pertinent under applicable law. Derecognition of transferred financial assets is appropriate only if the available evidence provides reasonable assurance that the transferred financial assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor and its creditors (paragraph 78.c.). Transactions between related parties or affiliates are accounted for in accordance with SSAP No. 25.

43. In the context of U.S. bankruptcy laws, a true sale opinion from an attorney is often required to support a conclusion that transferred financial assets are isolated from the transferor, and its creditors. In addition, a nonconsolidation opinion is often required if the transfer is to an affiliated entity. In the context of U.S. bankruptcy laws:

a. A true sale opinion is an attorney's conclusion that the transferred financial assets have been sold and are beyond the reach of the transferor's creditors and that a court would conclude that the transferred financial assets would not be included in the transferor's bankruptcy estate.

b. A nonconsolidation opinion is an attorney's conclusion that a court would recognize that an entity holding the transferred financial assets exists separately from the transferor. Additionally, a nonconsolidation opinion is an attorney's conclusion that a court would not order the substantive consolidation of the assets and liabilities of the entity holding the transferred financial assets and the assets and liabilities of the transferor in the event of the transferor's bankruptcy or receivership.

A legal opinion may not be required if a transferor has a reasonable basis to conclude that the appropriate legal opinion(s) would be given if requested. For example, the transferor might reach a conclusion without consulting an attorney if (1) the transfer is a routine transfer of financial assets that does not result in any continuing involvement by the transferor or (2) the transferor had experience with other transfers with similar facts and circumstances under the same applicable laws and regulations.

44. For insurers that are subject to conservatorship, or other receivership procedures, judgments about whether transferred financial assets have been isolated need to be made in relation to the powers of conservators or receivers in those jurisdictions.

45. Whether securitizations isolate transferred financial assets may depend on such factors as whether the securitization is accomplished in one step or multiple step transfers (paragraphs 75-80). Some common financial transactions, for example, typical repurchase agreements and securities lending transactions, may isolate transferred financial assets from the transferor, although they may not meet the other conditions for surrender of control (paragraph 12).

Conditions That Constrain a Transferee

46. Sale accounting is allowed under paragraph 12.b. only if each transferee (or, if the transferee is an entity whose sole purpose is to engage in securitization or asset-backed financing arrangements and that entity is constrained from pledging or exchanging the assets it receives, each third-party holder of its beneficial interests) has the right to pledge or exchange the assets or beneficial interests it received, and no condition both constrains the transferee (or third-party holder of its beneficial interests) from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor. Many transferor-imposed or other conditions on a transferee's right to pledge or exchange both constrain a transferee from pledging or exchanging and, through that constraint, provide more than a trivial benefit to the transferor. Judgment is required to assess whether a particular condition results in a constraint. Judgment also is required to assess whether a constraint provides a more-than-trivial benefit to the transferor. If the transferee is an entity whose sole purpose is to engage in securitization or asset-backed financing activities, that entity may be constrained from pledging or exchanging the transferred financial assets to protect the rights of beneficial interest holders in the financial assets of the entity. Paragraph 12.b. requires that the transferor look through the constrained entity to determine whether each third-party holder of its beneficial interests has the right to pledge or exchange the beneficial interests that it holds. The considerations in paragraphs 47-50 apply to the transferee or the third-party holders of its beneficial interests in an entity that is constrained from pledging or exchanging the assets it receives and whose sole purpose is to engage in securitization or asset-backed financing activities

47. Some conditions may constrain a transferee from pledging or exchanging the financial asset and may provide the transferor with more than a trivial benefit. For example, a provision that prohibits selling or pledging a transferred loan receivable not only constrains the transferee but also provides the transferor with the more-than-trivial benefit of knowing who holds the financial asset (a prerequisite to repurchasing the financial asset) and of being able to block the financial asset from being transferred to a competitor for the loan customer's business. Transferor-imposed contractual constraints that narrowly limit timing or terms, for example, allowing a transferee to pledge only on the day assets are obtained or only on terms agreed to with the transferor, also constrain the transferee and presumptively provide the transferor with more-than-trivial benefits. In some circumstances in which the transferor has no continuing involvement with the transferred financial assets, some conditions may constrain a transferee from pledging or exchanging the financial assets. If the transferor and its agents have no continuing involvement with the transferred financial assets, the condition under paragraph 12.b. is met. For example, if a transferor receives only cash in return for the transferred financial assets and the transferor and its agents have no continuing involvement with the transferred financial assets, sale accounting is allowed under paragraph

12.b. even if the transferee entity is significantly limited in its ability to pledge or exchange the transferred assets.

48. However, some conditions may not constrain a transferee from pledging or exchanging the transferred financial asset. For example, a transferor's right of first refusal on the occurrence of a bona fide offer to the transferee from a third party presumptively would not constrain a transferee. This is because the right in itself does not enable the transferor to compel the transferee to sell the financial asset and the transferee would be in a position to receive the sum offered by exchanging the financial asset, albeit possibly from the transferor rather than the third party. Further examples of conditions that presumptively would not constrain a transferee for purposes of this issue paper include (a) a requirement to obtain the transferor's permission to sell or pledge that is not to be unreasonably withheld, (b) a prohibition on sale to the transferor's competitor if other potential willing buyers exist, (c) a regulatory limitation such as on the number or nature of eligible transferees (as in the case of securities issued under Securities Act Rule 144A or debt placed privately), and (d) illiquidity, for example, the absence of an active market. However, judgment is required to assess the significance of some conditions. For example, a prohibition on sale to the transferor's competitor would be a constraint if that competitor were the only potential willing buyer other than the transferor.

49. A condition imposed by a transferor that constrains the transferee presumptively provides more than a trivial benefit to the transferor. A condition not imposed by the transferor that constrains the transferee may or may not provide more than a trivial benefit to the transferor. For example, if the transferor refrains from imposing its usual contractual constraint on a specific transfer because it knows an equivalent constraint is already imposed on the transferee by a third party, it presumptively benefits more than trivially from that constraint. However, the transferor cannot benefit from a constraint if it is unaware at the time of the transfer that the transferee is constrained.

Transferor's Rights or Obligations to Reacquire Transferred Assets or Beneficial Interests

50. Some rights or obligations to reacquire transferred financial assets or beneficial interests both constrain the transferee and provide more than a trivial benefit to the transferor, thus precluding sale accounting under paragraph 12.b.. A **freestanding call** option written by a transferee to the transferor may benefit the transferor and, if the transferred financial assets are not readily obtainable in the marketplace, is likely to constrain a transferee because the transferee might have to default if the call was exercised and the transferee had pledged or exchanged the financial assets. For example, if a transferor in a securitization transaction has a call option to repurchase third-party beneficial interests at the price paid plus a stated return, that arrangement conveys more than a trivial benefit to the transferor (paragraphs 57 and 58). If the third-party holders of its beneficial interests are constrained from pledging or exchanging their beneficial interests due to that call option, the transferor would be precluded from accounting for the transfer of financial assets to the securitization entity as a sale. Similarly, a freestanding forward purchase-sale contract between the transferor and the transferee on transferred financial assets not readily obtainable in the marketplace would benefit the transferor and is likely to constrain a transferee in much the same manner. Alternatively, freestanding rights to reacquire transferred assets that are readily obtainable presumptively do not constrain the transferee from pledging or exchanging them and thus do not preclude sale accounting under paragraph 12.b.

51. Other rights or obligations to reacquire transferred financial assets, regardless of whether they constrain the transferee, may result in the transferor's maintaining effective control over the transferred financial assets, as discussed in paragraphs 53-62, thus precluding sale accounting under paragraph 12.c. For example, an **attached call** in itself would not constrain a transferee who is able, by exchanging or pledging the asset subject to that call, to obtain substantially all of its economic benefits. However, an attached call could result in the transferor's maintaining effective control over the transferred asset(s) because the attached call gives the transferor the unilateral ability to cause whoever holds that specific asset to return it.

52. The concept of qualified special-purpose entities (QSPEs) was previously included within SSAP No. 91R. With the issuance of this issue paper, this concept is no longer included within statutory accounting guidance. Although this concept has been eliminated and is no longer a factor in determining whether a transfer of assets qualifies for sale accounting, reporting entities may continue to form, conduct transfers between, or have investments in trusts or other such legal vehicles that may have previously met the conditions to be considered a QSPE. Accounting for transfers of assets between the insurer and such trusts or other legal vehicles, including whether such transfers qualify for sale accounting, are subject to the provisions of this issue paper. As noted within paragraph 7, SSAP No. 25 shall be followed for accounting and disclosure requirements for all related party transactions.

Effective Control Over Transferred Financial Assets or Beneficial Interests

53. Judgment is required to assess whether the transferor maintains effective control over transferred financial assets or third-party beneficial interests. The transferor must evaluate whether a combination of multiple arrangements maintains effective control of transferred financial assets. When the transferee issues beneficial interests in the transferred financial assets, the evaluation of whether the transferor maintains effective control over the transferred financial assets also shall consider whether the transferor maintains effective control over the transferred financial assets through its control over the third-party beneficial interests. To assess whether the transferor maintains effective control over the transferred financial assets, all continuing involvement by the transferor or its agents shall be considered continuing involvement by the transferor. When assessing effective control, the transferor only considers the involvements of an agent when the agent acts for and on behalf of the transferor. In other words, if the transferor and transferee have the same agent, the agent's activities on behalf of the transferee would not be considered in the transferor's evaluation of whether it has effective control over a transferred financial asset. For example, an investment manager may act as a fiduciary (agent) for both the transferor and the transferee; therefore, the transferor need only consider the involvements of the investment manager when it is acting on its behalf.

Agreement to Repurchase or Redeem Transferred Financial Assets

54. An agreement that both entitles and obligates the transferor to repurchase or redeem transferred financial assets from the transferee maintains the transferor's effective control over those assets as described in paragraph 12.c.(1) when all of the following conditions are met:

a. The financial assets to be repurchased or redeemed are the same or substantially the same as those transferred (paragraph 56).

b. The transferor is able to repurchase or redeem them on substantially the agreed terms, even in the event of default by the transferee (paragraph 56).

c. The agreement is to repurchase or redeem them before maturity, at a fixed or determinable price.

d. The agreement is entered into contemporaneously with, or in contemplation of, the transfer.

55. To be substantially the same, the financial asset that was transferred and the financial asset that is to be repurchased or redeemed need to have all of the following characteristics:

a. The same primary obligor (except for debt guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and the terms of the guarantee must be the same);

b. Identical form and type so as to provide the same risks and rights;

c. The same maturity (or in the case of mortgage-backed pass-through and pay-through securities similar remaining weighted-average maturities that result in approximately the same market yield);

d. Identical contractual interest rates;

e. Similar assets as collateral; and

f. The same aggregate unpaid principal amount or principal amounts within accepted “good delivery" standards for the type of security involved.

56. To be able to repurchase or redeem financial assets on substantially all of the agreed terms, even in the event of default by the transferee, a transferor must at all times during the contract term have obtained cash or other collateral sufficient to fund substantially all of the cost of purchasing replacement financial assets from others.

Unilateral Ability to Cause the Return of Specific Transferred Financial Assets

57. A transferor maintains effective control over transferred financial assets when the transferor has the unilateral ability to cause the holder to return specific financial assets and that ability provides more than a trivial benefit to the transferor. A cleanup call, however, is permitted as an exception to that general principle. A call on a transferred financial asset provides the transferor with effective control over that financial asset if, under its price and other terms, the call provides the transferor with the unilateral ability to reclaim the transferred financial asset and conveys more than a trivial benefit to the transferor. A call or other right conveys more than a trivial benefit if the price to be paid is fixed, determinable, or otherwise potentially advantageous, unless because that price is so far out of the money or for other reasons it is probable when the option is written that the transferor will not exercise it. A transferor’s unilateral ability to cause a securitization entity to return to the transferor or otherwise dispose of specific transferred financial assets, for example, in response to its decision to exit a market or a particular activity, would provide the transferor with effective control over the transferred financial assets if it provides more than a trivial benefit to the transferor. However, a call on readily obtainable assets at fair value may not provide the transferor with more than a trivial benefit. (Paragraph 60 provides an example in which, due to the combination of arrangements, the transferor would maintain effective control.).

58. Effective control over transferred financial assets can be present even if the right to reclaim is indirect. For example, if a call allows a transferor to buy back the beneficial interests at a fixed price, the transferor may maintain effective control of the financial assets underlying those beneficial interests. If the transferee is an entity whose sole purpose is to engage in securitization or asset-backed financing activities, that entity may be constrained from choosing to pledge or exchange the transferred financial assets. In that circumstance, any call held by the transferor on third-party beneficial interests is effectively an attached call on the transferred financial assets. Depending on the price and other terms of the call, the transferor may maintain effective control over the transferred financial assets.

59. An **embedded call** would not result in the transferor’s maintaining effective control because it is the issuer rather than the transferor who holds the call and the call does not provide more than a trivial benefit to the transferor. For example, a call embedded by the issuer of a callable bond or the borrower of a prepayable mortgage loan would not provide the transferor with effective control over the transferred financial asset.

60. A right to reclaim specific transferred financial assets by paying their fair value when reclaimed generally does not maintain effective control when it does not convey a more than trivial benefit to the transferor. However, a transferor has maintained effective control if it has such a right and also holds the residual interest in the transferred financial assets. For example, if a transferor holds the residual interest in securitized financial assets and can reclaim the transferred financial assets at termination of the

securitization entity by purchasing them in an auction, and thus at what might appear to be fair value, then sale accounting for the transfer of those financial assets it can reclaim would be precluded. Such circumstances provide the transferor with a more than trivial benefit and effective control over the financial assets, because it can pay any price it chooses in the auction and recover any excess paid over fair value through its residual interest in the transferred financial assets.

61. Removal-of-account provisions do not result in the transferor's maintaining effective control, and are thus precluded from being accounted for as sales under statutory accounting as discussed in paragraph 82.

Arrangements to Reacquire Transferred Financial Assets

62. A transferor maintains effective control over the transferred financial asset as described in paragraph 12.c.(3) through an agreement that permits the transferee to require the transferor to repurchase the transferred financial asset at a price that is so favorable to the transferee at the date of the transfer that it is probable that the transferee will require the transferor to repurchase the transferred financial asset. For example, a put option written to the transferee generally does not provide the transferor with effective control over the transferred financial asset. However, a put option that is sufficiently deep in the money when it is written would provide the transferor effective control over the transferred financial asset because it is probable that the transferee will exercise the option and the transferor will be required to repurchase the transferred financial asset. In contrast, a sufficiently out-of-the-money put option held by the transferee would not provide the transferor with effective control over the transferred financial asset if it is probable when the option is written that the option will not be exercised. Likewise, a put option held by the transferee at fair value would not provide the transferor with effective control over the transferred financial asset.

Changes That Result in the Transferor's Regaining Control of Financial Assets Sold

63. A change in law or other circumstance may result in a transferred portion of an entire financial asset no longer meeting the conditions of a participating interest (paragraph 11) or the transferor's regaining control of transferred financial assets after a transfer that was previously accounted for as a sale, because one or more of the conditions in paragraph 12 are no longer met. Such changes, unless they arise solely from the initial application of this issue paper or from a change in market prices (for example, an increase in price that moves into-the-money a freestanding call on a non-readily-obtainable transferred financial asset that was originally sufficiently out-of-the-money that it was judged not to constrain the transferee), are accounted for in the same manner as a purchase of the transferred financial assets from the former transferee(s) in exchange for liabilities assumed (paragraph 13 or 15). (This "re-purchase" premise is consistent with INT 04-21.) After that change, the transferor recognizes in its financial statements those transferred financial assets together with liabilities to the former transferee(s) or beneficial interest holders of the former transferee(s). The transferor initially measures those transferred financial assets and liabilities at fair value on the date of the change, as if the transferor purchased the transferred financial assets and assumed the liabilities on that date. The former transferee would derecognize the transferred financial assets on that date, as if it had sold the transferred financial assets in exchange for a receivable from the transferor.

Measurement of Interests Held after a Transfer of Financial Assets

Assets Obtained and Liabilities Incurred as Proceeds

64. The proceeds from a sale of financial assets consist of the cash and any other assets obtained, including beneficial interests and separately recognized servicing assets, in the transfer less any liabilities incurred, including separately recognized servicing liabilities. Any asset obtained is part of the proceeds from the sale. Any liability incurred, even if it is related to the transferred financial assets, is a reduction of the proceeds. Any **derivative financial instrument** entered into concurrently with a transfer of

financial assets is either an asset obtained or a liability incurred and part of the proceeds received in the transfer. All proceeds and reductions of proceeds from a sale shall be initially measured at fair value.

Participating Interests in Financial Assets That Continue to be Held by a Transferor

65. Participating interests in financial assets that continue to be held by a transferor are not part of the proceeds of the transfer, and the carrying amount of those participating interests shall be measured at the date of the transfer by allocating the previous carrying amount between the participating interests transferred and sold, and the participating interests that are not transferred and continue to be held by a transferor, based on their relative fair values.

Servicing Assets and Liabilities

66. Servicing of mortgage loans, credit card receivables, or other financial assets commonly includes, but is not limited to, collecting principal, interest, and escrow payments from borrowers; paying taxes and insurance from escrowed funds; monitoring delinquencies; executing foreclosure if necessary; temporarily investing funds pending distribution; remitting fees to guarantors, trustees, and others providing services; and accounting for and remitting principal and interest payments to the holders of beneficial interests or participating interests in the financial assets. Servicing is inherent in all financial assets; it becomes a distinct asset or liability for accounting purposes only in the circumstances described in paragraph 67. If a transferor sells a participating interest in an entire financial asset, it would recognize a servicing asset or a servicing liability only related to the participating interest sold.

67. An entity that undertakes a contract to service financial assets shall recognize either a servicing asset or a servicing liability, each time it undertakes an obligation to service a financial asset that (a) results from a servicer’s transfer of an entire financial asset, a group of entire financial assets, or a participating interest in an entire financial asset that meets the requirements for sale accounting, or (b) is acquired or assumed and the servicing obligation does not relate to financial assets of the servicer. However, if the transferor transfers the assets to an entity in a transfer that qualifies as a sale in which the transferor obtains the resulting securities, and classifies them as debt securities, the servicing asset or servicing liability may be reported together with the asset being serviced and not recognized separately. A servicer of financial assets commonly receives the **benefits of servicing**—revenues from contractually specified servicing fees, a portion of the interest from the financial assets, late charges, and other ancillary sources, including “float,” all of which it is entitled to receive only if it performs the servicing—and incurs the costs of servicing the financial assets. Typically, the benefits of servicing are expected to be more than **adequate compensation** to a servicer for performing the servicing, and the contract results in a servicing asset. However, if the benefits of servicing are not expected to adequately compensate a servicer for performing the servicing, the contract results in a servicing liability. (A servicing asset may become a servicing liability, or vice versa, if circumstances change, and the initial measure for servicing may be zero if the benefits of servicing are just adequate to compensate the servicer for its servicing responsibilities.) A servicer would account for its servicing contract that qualifies for separate recognition as a servicing asset or a servicing liability initially measured at its fair value regardless of whether explicit consideration was exchanged.

68. A servicer that transfers or securitizes financial assets in a transaction that does not meet the requirements for sale accounting and is accounted for as a secured borrowing with the underlying financial assets remaining on the transferor’s balance sheet shall not recognize a servicing asset or a servicing liability.

69. A servicer that recognizes a servicing asset or servicing liability shall account for the contract to service financial assets separately from those financial assets, as follows:

a. Report servicing assets separately from servicing liabilities as a nonadmitted asset in the statement of financial position.

b. Initially measure servicing assets and servicing liabilities at fair value, (paragraph 19).

c. Account separately for rights to future interest income from the serviced assets that exceed contractually specified servicing fees. Those rights are not servicing assets; they are financial assets, effectively interest-only strips to be accounted for in accordance with paragraph 22 of this issue paper. (Interest-only strips preclude a portion of a financial asset from meeting the definition of a participating interest; see paragraph 39.)

d. Identify classes of servicing assets and servicing liabilities based on (1) the availability of market inputs used in determining the fair value of servicing assets and servicing liabilities, (2) an entity's method for managing the risks of its servicing assets and servicing liabilities, or (3) both.

e. Subsequently measure each class of separately recognized servicing assets and servicing liabilities at fair value. Changes in fair value should be reported as unrealized gains and losses (paragraph 21). Declines in fair value which are determined to be other-than-temporary shall be recorded as realized losses.

70. As indicated above, transferors sometimes agree to take on servicing responsibilities when the future benefits of servicing are not expected to adequately compensate them for performing that servicing. In that circumstance, the result is a servicing liability rather than a servicing asset. For example, if in the transaction illustrated in Exhibit B – Illustration 3 the transferor had agreed to service the loans without explicit compensation and it estimated the fair value of that servicing obligation at $50, net proceeds would be reduced to $980, gain on sale would become a loss on sale of $20, and the transferor would report a servicing liability of $50.

Securitizations

71. Financial assets, such as mortgage loans, are commonly transferred in securitizations. Securitizations of mortgage loans may include pools of single-family residential mortgages or other types of real estate mortgage loans, for example, multifamily residential mortgages and commercial property mortgages. Both financial and nonfinancial assets can be securitized; life insurance policy loans, patent and copyright royalties, and even taxi medallions also have been securitized. But securitizations of nonfinancial assets are outside the scope of this issue paper.

72. An originator of a typical securitization (the transferor) transfers a portfolio of financial assets to a securitization entity, commonly a trust. In "pass-through" and "pay-through" securitizations, receivables are transferred to the entity at the inception of the securitization, and no further transfers are made; all cash collections are paid to the holders of beneficial interests in the entity.

73. Beneficial interests in the securitization entity are sold to investors and the proceeds are used to pay the transferor for the assets transferred financial assets. Those beneficial interests may comprise either a single class having equity characteristics or multiple classes of interests, some having debt characteristics and others having equity characteristics. The cash collected from the portfolio is distributed to the investors and others as specified by the legal documents that established the entity.

74. Pass-through and pay-through securitizations that meet the conditions in paragraph 12 qualify for sale accounting under this issue paper. All financial assets obtained and liabilities incurred by the transferor of a securitization that qualifies as a sale shall be recognized and measured as provided in paragraphs 13 and 15; that includes the implicit forward contract to sell additional financial assets during a revolving period, which may become valuable or onerous to the transferor as interest rates and other market conditions change.

Isolation of Transferred Financial Assets in Securitizations

75. A securitization carried out in one transfer or a series of transfers may or may not isolate the transferred financial assets beyond the reach of the transferor and its creditors. Whether it does depends on the structure of the securitization transaction taken as a whole, considering such factors as the type and extent of further involvement in arrangements to protect investors from credit, and interest rate, and other risks, the availability of other financial assets, and the powers of bankruptcy courts or other receivers. The discussion in paragraphs 76-78 relates only to the isolation condition in paragraph 12.a. The conditions in paragraphs 12.b. and 12.c. also must be considered to determine whether a transferor has surrendered control over the transferred financial assets.

76. In certain securitizations, a corporation that, if it failed, would be subject to the U.S. Bankruptcy Code transfers financial assets to a securitization entity exchange for cash. The entity raises that cash by issuing to investors beneficial interests that pass through all cash received from the financial assets, and the transferor has no further involvement with the trust or the transferred financial assets. The Board understands that those securitizations generally would be judged as having isolated the assets, because, in the absence of any continuing involvement, there would be reasonable assurance that the transfer would be found to be a true sale at law that places the assets beyond the reach of the transferor, and its creditors, even in bankruptcy or other receivership.

77. In other securitizations, a similar corporation transfers financial assets to a securitization entity in exchange for cash and beneficial interests in the transferred financial assets. That entity raises the cash by issuing to investors commercial paper that gives them a senior beneficial interest in cash received from the financial assets. The beneficial interests obtained by the transferring corporation represent a junior interest to be reduced by any credit losses on the financial assets in the entity. The senior beneficial interests (commercial paper) are highly rated by credit rating agencies only if both (a) the credit enhancement from the junior interest is sufficient and (b) the transferor is highly rated. Depending on facts and circumstances, the Board understands that those "single-step" securitizations often would be judged in the United States as not having isolated the financial assets, because the nature of the continuing involvement may make it difficult to obtain reasonable assurance that the transfer would be found to be a true sale at law that places the financial assets beyond the reach of the transferor and its creditors in U.S. bankruptcy (paragraph 43). If the transferor fell into bankruptcy and the transfer was found not to be a true sale at law, investors in the transferred financial assets might be subjected to an automatic stay that would delay payments due them, and they might have to share in bankruptcy expenses and suffer further losses if the transfer was recharacterized as a secured loan.

78. Still other securitizations use multiple transfers intended to isolate transferred financial assets beyond the reach of the transferor and its creditors, even in bankruptcy. For example, in "two-step" structures:

a. First, the corporation transfers a group of financial assets to a special-purpose corporation that, although wholly owned, is so designed that the possibility is remote that the transferor or its creditors could reclaim the financial assets. This first transfer is designed to be judged to be a true sale at law, in part because the transferor does not provide "excessive" credit or yield protection to the special-purpose corporation, and the Board understands that transferred financial assets are likely to be judged beyond the reach of the transferor or the transferor's creditors even in bankruptcy or other receivership.

b. Second, the special-purpose corporation transfers a group of financial assets to a trust or other legal vehicle with a sufficient increase in the credit or yield protection on the second transfer (provided by a transferor's junior beneficial interest or other means) to merit the high credit rating sought by third-party investors who buy senior beneficial interests in the trust. Because of that aspect of its design, that second transfer might not be judged to be a true sale at law and, thus, the transferred financial assets could at least in theory be reached by a bankruptcy trustee for the special-purpose corporation.

c. However, the special-purpose corporation is designed to make remote the possibility that it would enter bankruptcy. For example, its charter forbids it from undertaking any other business or incurring any liabilities, so that there can be no creditors to petition to place it in bankruptcy. Furthermore, its dedication to a single purpose is intended to make it extremely unlikely, even if it somehow entered bankruptcy, that a receiver under the U.S. Bankruptcy Code could reclaim the transferred financial assets because it has no other assets to substitute for the transferred financial assets.

79. The Board understands that the "two-step" securitizations described above, taken as a whole, generally would be judged under present U.S. law as having isolated the financial assets beyond the reach of the transferorand its creditors, even in bankruptcy or other receivership. However, each entity involved in a transfer must be evaluated under the applicable accounting guidance.

80. The powers of receivers vary considerably by state of domicile, and therefore some receivers may be able to reach financial assets transferred under a particular arrangement and others may not. A securitization may isolate transferred financial assets from a transferor subject to such a receiver and its creditors even though it is accomplished by only one transfer directly to a securitization entity that issues beneficial interests to investors and the transferor provides credit or yield protection.

Sales of Future Revenues

81. In addition to securitization of assets, some reporting entities have entered into transactions characterized as a sale of future revenues. These transactions are sometimes referred to as securitizations and are sometimes characterized as selling deferred acquisition costs. A sale of future revenues by a reporting entity shall not result in the immediate recognition of income or surplus. The proceeds of any such sale shall be established as a liability and shall be reduced as the proceeds are repaid.

Removal-of-Accounts Provisions

82. Many transfers of financial assets that involve transfers of a group of entire financial assets to an entity whose sole purpose is to engage in securitization or asset-backed financing activities empower the transferor to reclaim assets subject to certain restrictions. Such a power is sometimes called a removal-of-accounts provision (ROAP). Transfers of assets that include ROAP provisions are precluded from being accounted for as sales under statutory accounting and shall follow the guidance in paragraph 18 for secured borrowing.

Securities Lending Transactions

83. Securities lending transactions are generally initiated by broker-dealers and other financial institutions that need specific securities to cover a short sale or a customer's failure to deliver securities sold. Securities lending transactions typically extend less than one year. Transferees (borrowers) of securities generally are required to provide collateral to the transferor (lender) of securities, commonly cash but sometimes other securities or standby letters of credit, with a value slightly higher than that of the securities borrowed. If the collateral is cash, the transferor typically earns a return by investing that cash at rates higher than the rate paid or rebated to the transferee. If the collateral is other than cash, the transferor typically receives a fee. Securities custodians or other agents commonly carry out securities lending activities on behalf of clients. Because of the protection of collateral (typically valued daily and adjusted frequently for changes in the market price of the securities transferred) and the short terms of the transactions, most securities lending transactions in themselves do not impose significant credit risks on either party. Other risks arise from what the parties to the transaction do with the assets they receive. For example, investments made with cash collateral impose market and credit risks on the transferor.

84. If the criteria conditions in paragraph 12 are met, securities lending transactions shall be accounted for:

a. By the transferor as a sale of the "loaned" securities for proceeds consisting of the cash collateral"[9] and a forward repurchase commitment.

b. By the transferee as a purchase of the "borrowed" securities in exchange for the collateral and a forward resale commitment. During the term of that agreement, the transferor has surrendered control over the securities transferred and the transferee has obtained control over those securities with the ability to sell or transfer them at will. In that case, creditors of the transferor have a claim only to the "collateral" and the forward repurchase commitment.

85. Many securities lending transactions are accompanied by an agreement that entitles and obligates the transferor to repurchase or redeem the transferred financial assets before their maturity under which the transferor maintains effective control over those financial assets (paragraphs 54-56 maintain effective control criteria). Those transactions shall be accounted for as secured borrowings, in which cash (or securities that the holder or its agent is permitted by contract or custom to sell or repledge) received as collateral is considered the amount borrowed, the securities loaned are considered pledged as collateral against the cash or securities borrowed and reclassified as set forth in paragraph 23.a., and any rebate paid to the transferee of securities is interest on the cash or securities the transferor is considered to have borrowed.

86. The transferor of securities being "loaned" accounts for cash received in the same way whether the transfer is accounted for as a sale or a secured borrowing. The cash received shall be recognized as the transferor's asset—as shall investments made with that cash, even if made by agents or in pools with other securities lenders—along with the obligation to return the cash. If securities that may be sold or repledged are received, the transferor of the securities being "loaned" accounts for those securities in the same way as it would account for cash received.

87. The transferor of securities being "loaned" accounts for collateral received in the same way whether the transfer is accounted for as a sale or a secured borrowing. The collateral received shall be recognized as the transferor's asset—as shall investments made with that collateral, even if made by agents or in pools with other securities lenders—along with the obligation to return the collateral. If securities that may be sold or repledged are received by the transferor or its agent, the transferor of the securities being "loaned" accounts for those securities in the same way as it would account for collateral received. Collateral which may be sold or repledged by the transferor or its agent is reflected on balance sheet, along with the obligation to return the asset[10]. Collateral received which may not be sold or repledged by the transferor or its agent is off balance sheet[11]. For collateral on the balance sheet, the reporting is determined by the administration of the program.

[9] If the "collateral" in a transaction that meets the criteria in paragraph 12 is a financial asset that the holder or its agent is permitted by contract or custom to sell or repledge, that financial asset is proceeds of the sale of the "loaned" securities. To the extent that the "collateral" consists of letters of credit or other financial instruments that the holder or its agent is not permitted by contract or custom to sell or repledge, a securities lending transaction does not satisfy the sale criteria and is accounted for as a loan of securities by the transferor to the transferee.

[10] If cash is received by the transferor or its agent and reinvested or repledged it is reported on balance sheet. It is explicitly intended that when the lender bears reinvestment risk, that collateral is on balance sheet.

[11] An example of collateral which is off balance sheet is securities are received by the transferor or its agent in which the collateral must be held and returned, without the ability to transfer or repledge the collateral. This would involve limited situations in which the transferor or agent is prohibited from reinvesting the collateral.

a. Securities lending programs where the collateral received by the reporting entity's unaffiliated agent that can be sold or repledged is reported on the balance sheet. The collateral received and reinvestment of that collateral by the reporting entity's unaffiliated agent shall be reflected as a one-line entry on the balance sheet (Securities Lending Collateral) and a detailed schedule will be required each quarter and at year-end to list the description of the collateral asset. This description shall include the NAIC rating, fair value; book adjusted carrying value and maturity date. A separate liability shall also be established to record the obligation to return the collateral (Collateral from Securities Lending Activities)

b. Securities lending programs where the collateral received by the reporting entity that can be sold or repledged is reported on the balance sheet. If the reporting entity is the administrator of the program, then, the collateral received and any reinvestment of that collateral is reported with the invested assets of the reporting entity based on the type of investment (i.e. bond, common stock, etc). A separate liability shall also be established to record the obligation to return the collateral (Collateral from Securities Lending Activities)

c. Securities lending programs where the collateral received by the reporting entity's affiliated agent can report using either one line reporting (paragraph 87. a. above) or investment schedule reporting (paragraph 87. b. above).

88. Reinvestment of the collateral by the reporting entity or its agent, shall follow the same impairment guidance as other similar invested assets reported on the balance sheet. Any fees received by the transferor for loaning the securities shall be recorded as miscellaneous investment income.

Securities Lending Transactions – Collateral Requirements

89. The reporting entity shall receive collateral having a fair value as of the transaction date at least equal to 102 percent of the fair value of the loaned securities at that date. If at any time the fair value of the collateral received from the counterparty is less than 100 percent of the fair value of the loaned securities, the counterparty shall be obligated to deliver additional collateral by the end of the next business day, the fair value of which, together with the fair value of all collateral then held in connection with the transaction at least equals 102 percent of the fair value of the loaned securities. If the collateral received from the counterparty is less than 100 percent at the reporting date, the difference between the actual collateral and 100 percent will be nonadmitted. Collateral value is measured and compared to the loaned securities in aggregate by counterparty.

90. In the event that foreign securities are loaned and the denomination of the currency of the collateral is other than the denomination of the currency of the loaned foreign securities, the amount of collateral shall be at least equal to 105 percent of the fair value of the loaned securities at that date. If at any time the fair value of the collateral received from the counterparty is less than 102 percent of the fair value of the loaned securities, the reporting entity must obtain additional collateral by the end of the next business day, the fair value of which together with the fair value of all collateral then held in connection with the transaction at least equals 105 percent of the fair value of the loaned securities. If the collateral received from the counterparty is less than 100 percent at the reporting date, the difference between the actual collateral and 100 percent will be nonadmitted. Collateral value is measured and compared to the loaned securities in aggregate by counterparty.

Repurchase Agreements and "Wash Sales"

91. Government securities dealers, banks, other financial institutions, and corporate investors commonly use repurchase agreements to obtain or use short-term funds. Under those agreements, the transferor ("repo party") transfers a security to a transferee ("repo counterparty" or "reverse party") in

exchange for cash[12] and concurrently agrees to reacquire that security at a future date for an amount equal to the cash exchanged plus a stipulated "interest" factor. Repurchase agreements, reverse repurchase agreements and dollar repurchase agreements meet the definition of assets as defined in *SSAP No. 4—Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this issue paper.

92. Repurchase agreements can be affected in a variety of ways. Some repurchase agreements are similar to securities lending transactions in that the transferee or its agent has the right to sell or repledge the securities to a third party during the term of the repurchase agreement. In other repurchase agreements, the transferee does not have the right to sell or repledge the securities during the term of the repurchase agreement. For example, in a tri-party repurchase agreement, the transferor transfers securities to an independent third-party custodian that holds the securities during the term of the repurchase agreement. Also, many repurchase agreements are for short terms, often overnight, or have indefinite terms that allow either party to terminate the arrangement on short notice. However, other repurchase agreements are for longer terms, sometimes until the maturity of the transferred financial asset. Some repurchase agreements call for repurchase of securities that need not be identical to the securities transferred.

93. If the conditions in paragraph 12 are met, the transferor shall account for the repurchase agreement as a sale of financial assets and a forward repurchase commitment, and the transferee shall account for the agreement as a purchase of financial assets and a forward resale commitment. Other transfers that are accompanied by an agreement to repurchase the transferred financial assets that may be accounted for as sales include transfers with agreements to repurchase at maturity and transfers with repurchase agreements in which the [transferor] has not obtained collateral sufficient to fund substantially all of the cost of purchasing replacement financial assets. (Repurchase financing is addressed in paragraphs 100-105.)

94. Furthermore, "wash sales" that previously were not recognized if the same financial asset was purchased within 30 days before or after the sale shall be accounted for as sales under this issue paper. Unless there is a concurrent contract to repurchase or redeem the transferred financial assets from the transferee, the transferor does not maintain effective control over the transferred financial assets.

95. As with securities lending transactions, under many agreements to repurchase transferred financial assets before their maturity the transferor maintains effective control over those financial assets. Repurchase agreements that do not meet all the conditions in paragraph 12 shall be treated as secured borrowings. Fixed-coupon and dollar-roll repurchase agreements, and other contracts under which the securities to be repurchased need not be the same as the securities sold, qualify as borrowings if the return of substantially the same (paragraph 55) securities as those concurrently transferred is assured. Therefore, those transactions shall be accounted for as secured borrowings by both parties to the transfer.

96. If a transferor has transferred securities to an independent third-party custodian, or to a transferee, under conditions that preclude the transferee from selling or repledging the assets during the term of the repurchase agreement (as in most tri-party repurchase agreements), the transferor has not surrendered control over those assets.

Repurchase Agreements

97. Repurchase agreements are defined as agreements under which a reporting entity sells securities and simultaneously agrees to repurchase the same or substantially the same securities at a stated price on a

[12] Instead of cash, other securities or letters of credit sometimes are exchanged. Those transactions are accounted for in the same manner as securities lending transactions (paragraphs 83-89).

specified date. For securities to be substantially the same, the criteria defined in paragraph 55 (substantially the same criteria) must be met, and for mortgage-backed securities excluding mortgage pass-through securities, the projected cash flows of the securities must be substantially the same under multiple scenario prepayment assumptions.

98. For repurchase agreements that are accounted for as collateralized borrowings in accordance with paragraph 95 of this issue paper, the underlying securities shall continue to be accounted for as an investment owned by the reporting entity. The proceeds from the sale of the securities shall be recorded as a liability, and the difference between the proceeds and the amount at which the securities will be subsequently reacquired shall be reported as interest expense, calculated on the straight-line method or the scientific interest (constant yield) method, over the term of the agreement.

99. Reporting entities generally take possession of the underlying collateral under repurchase agreements and in many cases may obtain additional collateral when the estimated fair value of such securities falls below their current contract value. However, to the extent that the current fair value of the collateral is less than the recorded amount, the shortfall shall reduce the admitted asset value of the repurchase agreement.

Repurchase Financing

100. Repurchase financing is a repurchase agreement that relates to a previously transferred financial asset between the same counterparties (or affiliates of either counterparty) that is entered into contemporaneously with, or in contemplation of, the initial transfer.

101. A repurchase financing involves the transfer of a previously transferred financial asset back to the initial transferor as collateral for a financing between the initial transferee (the borrower) and the initial transferor (the lendor). A repurchase financing also typically involves the initial transferor returning the transferred financial asset (or substantially the same asset) to the initial transferee when the financing is repaid on a state date. A repurchase financing is entered into in contemplation of the initial transfer if both transactions are considered together at the execution of the initial transfer.

102. When the transferor transfer a financial asset and also enters into a repurchase financing with the transferee, there are typically three transfers of the financial assets:

a. Initial transfer – An initial transferor transfers a financial asset to an initial transferee.

b. Repurchase financing – The initial transferee (the borrower) transfer the previously transferred financial asset back to the initial transferor (the lender) as collateral for a financing between the initial transferor and initial transferee.

c. Settlement – The initial transferor (the lender) returns the financial asset (or substantially the same asset) to the initial transferee (the borrower) upon receipt of payment from the initial transferee.

103. Repurchase financing that is entered into contemporaneously with, or in contemplation of, an initial transfer of financial asset between the same counterparties (or affiliates of either counterparty) shall not be separately accounted for as a transfer of a financial asset and a related repurchase financing unless (a) the two transactions have a valid and distinct business or economic purpose for being entered into separately and (b) the repurchase financing does not result in the initial transferor regaining control over the financial asset. Unless the provisions in paragraph 104 are met, the initial transfer and repurchase financing shall be evaluated as a linked transaction. The linked transaction shall be evaluated to determine whether it meets the requirements for sale accounting per paragraph 12, If the linked transaction does not meet the requirements for sale accounting, the linked transaction shall be accounted for based on the economies of the combined transactions, which generally represent a forward contract. *SSAP No. 86—*

Accounting for Derivative Instruments and Hedging, Income Generation, and Replication (Synthetic Asset) Transactions shall be used to evaluate whether the linked transaction shall be accounted for as a derivative.

104. An initial transfer of a financial asset and repurchase financing that are entered into contemporaneously with, or in contemplation of, one another shall be considered linked unless all of the following criteria are met at the inception of the transaction:

a. The initial transfer and the repurchase financing are not contractually contingent on one another. Even if no contractual relationship exists, the pricing and performance of either the initial transfer or the repurchase financing must not be dependent on the terms and execution of the other transaction.

b. The repurchase financing provides the initial transferor with recourse to the initial transferee upon default. That recourse must expose the initial transferor to the credit risk of the initial transferee, or its affiliates, and not solely to the market risk of the transferred financial asset. The initial transferee's agreement to repurchase the previously transferred financial asset (or substantially the same asset) for a fixed price and not fair value.

c. The financial asset subject to the initial transfer and repurchase financing is readily obtainable in the marketplace. In addition, the initial transfer of a financial asset and the repurchase financing are executed at market rates. This criterion may not be circumvented by embedding off-market terms in a separate transaction contemplated with the initial transfer or the repurchase financing.

d. The financial asset and repurchase agreement are not coterminous (the maturity of the repurchase financing must be before the maturity of the financial asset.)

105. In accordance with paragraph 103, an initial transfer of assets and a repurchase financing shall not be considered separate transactions unless the provisions of paragraph 104 are met. If the provisions of paragraph 104 are met, the initial transfer shall be evaluated to determine whether it meets the requirements for sale accounting without taking into consideration the repurchase financing. In such situations, the repurchase financing shall then be separately analyzed as a repurchase agreement.

Reverse Repurchase Agreements

106. Reverse repurchase agreements are defined as agreements under which a reporting entity purchases securities and simultaneously agrees to resell the same or substantially the same securities at a stated price on a specified date. For securities to be substantially the same, the criteria defined in paragraph 55 (substantially the same criteria) must be met, and for mortgage-backed securities excluding mortgage pass-through securities, the projected cash flows of the securities must be substantially the same under multiple scenario prepayment assumptions.

107. For reverse repurchase agreements that are accounted for as collateralized lendings in accordance with paragraph 95 of this issue paper, the underlying securities shall not be accounted for as investments owned by the reporting entity. The amount paid for the securities shall be reported as a short-term investment, and the difference between the amount paid and the amount at which the securities will be subsequently resold shall be reported as interest income, calculated on the straight-line method or the scientific interest (constant yield) method, over the term of the agreement.

Collateral Requirements – Repurchase and Reverse Repurchase Agreements

108. The collateral requirements for repurchase and reverse repurchase agreements are as follows:

Repurchase Transaction

a. The reporting entity shall receive collateral having a fair value as of the transaction date at least equal to 95 percent of the fair value of the securities transferred by the reporting entity in the transaction as of that date. If at anytime the fair value of the collateral received from the counterparty is less than 95 percent of the fair value of the securities so transferred, the counterparty shall be obligated to deliver additional collateral by the end of the next business day the fair value of which, together with the fair value of all collateral then held in connection with the transaction, at least equals 95 percent of the fair value of the transferred securities. If the collateral is less than 95 percent at the reporting date, the difference between the actual collateral and 95 percent will be nonadmitted.

Reverse Repurchase Transaction

b. The reporting entity shall receive as collateral transferred securities having a fair value at least equal to 102 percent of the purchase price paid by the reporting entity for the securities. If at any time the fair value of the collateral is less than 100 percent of the purchase price paid by the reporting entity, the counterparty shall be obligated to provide additional collateral, the fair value of which, together with fair value of all collateral then held in connection with the transaction, at least equals 102 percent of the purchase price.

Dollar Repurchase Agreements

109. Dollar repurchase and dollar reverse repurchase agreements are defined as repurchase and reverse repurchase agreements involving debt instruments that are pay-through securities collateralized with Government National Mortgage Association (GNMA), Federal Home Loan Mortgage Corporation (FHLMC) and Federal National Mortgage Association (FNMA) collateral, and pass-through certificates sponsored by GNMA, mortgage participation certificates issued by the FHLMC or similar securities issued by the FNMA. Dollar repurchase agreements are also commonly referred to as dollar roll transactions. To meet the definition of dollar repurchase and dollar reverse repurchase agreements, the securities underlying the agreements must meet the criteria defined in paragraph 55, and for mortgage-backed securities excluding mortgage pass-through securities, the projected cash flows of the securities must be substantially the same under multiple scenario prepayment assumptions.

110. For the seller in a dollar repurchase agreement accounted for as collateralized borrowing in accordance with paragraph 95 of this issue paper, a liability is recorded for the amount of proceeds of the sale and the sold mortgage-backed securities are not removed from the accounting records. During the period of the agreement, interest income is recorded as if the mortgage-backed security had been held during the term of the agreement. This is offset by an equal amount of interest expense related to the proceeds received from the sale. Additional interest expense is recorded representing the difference between the sales price and the repurchase price of the mortgage-backed securities sold.

111. When the mortgage-backed securities are repurchased under the agreement, the original mortgage-backed securities sold are removed from the accounting records and the purchased mortgage-backed securities are recorded. The principal amount of the mortgage-backed securities repurchased must be in good delivery form consistent with paragraph 55.

112. If the principal amount repurchased is greater than the amount sold, the cash paid is recorded as an additional investment in the newly acquired certificates. If the principal amount repurchased is less than the amount sold, a gain or loss relating to the original certificates held is recorded.

113. For the purchaser in a dollar reverse repurchase agreement accounted for as collateralized lending in accordance with paragraph 95 of this issue paper, an asset is recorded for the amount of the purchase.

Upon completion of the reverse repurchase agreement, cash is received in exchange for a "substantially the same" security. The difference between the purchase and reselling price represents interest income for the lending of short-term funds.

Separate Transactions

114. Agreements to repurchase and resell securities that do not meet the definitions in paragraphs 83-96 of this issue paper shall be accounted for as two separate transactions, that is, as a sale and purchase or as a purchase and sale, in accordance with the relevant statutory accounting guidance. For example, sales of bonds would result in recognition of realized gains or losses.

Offsetting

115. Reporting entities may operate on both sides of the repurchase agreement market resulting in recording of liabilities and assets representing repurchase and reverse repurchase agreements, respectively.

116. Reporting entities shall offset such liabilities and assets only to the extent that one of the following occurs:

a. A legal right of offset exists as defined in *SSAP No. 64—Offsetting and Netting of Assets and Liabilities* (SSAP No. 64); or

b. The securities have the same settlement date, are executed with the same counterparty in accordance with a master netting arrangement, involve securities that exist in "book entry" form, and settle on securities transfer systems that have the same key elements and operating characteristics as the Fedwire Securities Transfer System.

117. Otherwise, separate assets and liabilities shall be recognized.

Loan Syndications

118. Borrowers often borrow amounts greater than any one lender is willing to lend. Therefore, it is common for groups of lenders to jointly fund those loans. That may be accomplished by a syndication under which several lenders share in lending to a single borrower, but each lender loans a specific amount to the borrower and has the right to repayment from the borrower.

119. A loan syndication is not a transfer of financial assets. Each lender in the syndication shall account for the amounts it is owed by the borrower. Repayments by the borrower may be made to a lead lender who then distributes the collections to the other lenders of the syndicate. In those circumstances, the lead lender is also functioning as a servicer and, therefore, shall only recognize its portion of the loan as a financial asset.

Loan Participations

120. Groups of banks or other entities also may jointly fund large borrowings through loan participations in which a single lender makes a large loan to a borrower and subsequently transfers interests in the loan to other entities.

121. Transfers by the originating lender may take the legal form of either assignments or participations. The transfers are usually on a nonrecourse basis, and the transferor (originating lender) continues to service the loan. The transferee (participating entity) may or may not have the right to sell or transfer its participation during the term of the loan, depending upon the terms of the participation agreement.

122. If the loan participation agreement transfers a participating interest in an entire financial asset (as described in paragraph 11 of this issue paper) and the conditions in paragraph 12 are met, the transfer shall be accounted for by the transferor as a sale of a participating interest. A transferor's right of first refusal on a bona fide offer from a third party, a requirement to obtain the transferor's permission that shall not be unreasonably withheld, or a prohibition on sale to the transferor's competitor is a limitation on the transferee's rights but presumptively does not constrain a transferee from exercising its right to pledge or exchange. However, if the loan participation agreement constrains the transferees from pledging or exchanging its participating interest and that constraint provides a more-than-trivial benefit to the transferor, the transferor has not relinquished control and shall account for the transfer as a secured borrowing.

Factoring Arrangements

123. Factoring arrangements are a means of discounting accounts receivable on a nonrecourse, notification basis. Accounts receivable in their entireties are sold outright, usually to a transferee (the factor) that assumes the full risk of collection, without recourse to the transferor in the event of a loss. Debtors are directed to send payments to the transferee. Factoring arrangements that meet the conditions in paragraph 12 shall be accounted for as sales of financial assets because the transferor surrenders control over the receivables to the factor.

Transfers of Receivables with Recourse

124. In a transfer of an entire receivable, a group of entire receivables, or a portion of an entire receivable with recourse, the transferor provides the transferee with full or limited recourse. The transferor is obligated under the terms of the recourse provision to make payments to the transferee or to repurchase receivables sold under certain circumstances, typically for defaults up to a specified percentage. A transfer of receivables with recourse shall not be recognized as a sale, but rather as secured borrowing. (This provision is applied regardless if the transfer was comprised of the entire receivable, a group of the entire receivable, or a portion of the entire receivable.) A transfer of receivables without recourse shall only be recognized if the transferor receives cash for the receivables. The sale shall be recognized when cash is received. Sales of premium receivables are addressed in *SSAP No. 42—Sale of Premium Receivables*.

Extinguishments of Liabilities

125. If a creditor releases a debtor from primary obligation on the condition that a third party assumes the obligation and that the original debtor becomes secondarily liable, that release extinguishes the original debtor's liability. However, in those circumstances, whether or not explicit consideration was paid for that guarantee, the original debtor becomes a guarantor. As a guarantor, it shall recognize a guarantee obligation in the same manner as would a guarantor that had never been primarily liable to that creditor, with due regard for the likelihood that the third party will carry out its obligations. The guarantee obligation shall be initially measured at fair value, and that amount reduces the gain or increases the loss recognized on extinguishment.

126. An exchange of debt instruments or debt instrument modifications are considered extinguishments if the exchange or modification results with substantially different terms or is considered more than minor. If the cash flows under the terms of the new debt instrument are at least 10 percent different from the present value of the remaining cash flows under the terms of the original instrument, then the exchange of, or modification to, debt instruments is consider substantially different and/or more than minor.

Effective Date and Transition

127. After adoption of this issue paper, it is expected that the NAIC will release a Statement of Statutory Accounting Principle (SSAP) for comment. The initial draft of the SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the Accounting Practices and Procedures Manual should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will be effective as of Jan 1, 20XX. The provisions within the adopted SSAP shall be reflected in the interim periods within that first annual reporting period, and for interim and annual reporting periods thereafter. Earlier application is prohibited. The recognition and measurement provisions of the adopted standard shall be applied to transfers that occur on or after the effective date. The disclosure provisions shall be applied to transfers that occurred both before and after the effective date of the adopted standard.

EXHIBIT A – GLOSSARY

Adequate Compensation

The amount of benefits of servicing that would fairly compensate a substitute servicer should one be required, which includes the profit that would be demanded in the marketplace.

Agent

A party that acts for and on behalf of another party. For example, a third-party intermediary is an agent of the transferor if it acts on behalf of the transferor.

Attached Call

A call option held by the transferor of a financial asset that becomes part of and is traded with the underlying instrument. Rather than being an obligation of the transferee, an attached call is traded with and diminishes the value of the underlying instrument transferred subject to that call.

Beneficial Interests

Rights to receive all or portions of specified cash inflows to received by a trust or other entity, including, but not limited to, senior and subordinated shares of interest, principal, or other cash inflows to be "passed-through" or "paid-through," premiums due to guarantors, commercial paper obligations, and residual interests, whether in the form of debt or equity.

Benefits of Servicing

Revenues from contractually specified servicing fees, late charges, and other ancillary sources, including "float."

Cleanup Call

An option held by the servicer or its affiliate, which may be the transferor, to purchase the remaining transferred financial assets, or the remaining beneficial interests not held by the transferor, its affiliates, or its agents in an entity (or in a series of beneficial interests in transferred financial assets within an entity), if the amount of outstanding financial assets or beneficial interests falls to a level at which the cost of servicing those assets or beneficial interests becomes burdensome in relation to the benefits of servicing.

Collateral

Personal or real property in which a security interest has been given.

Continuing Involvement

Any involvement with the transferred financial assets that permits the transferor to receive cash flows or other benefits that arise from the transferred financial assets or that obligates the transferor to provide additional cash flows or other assets to any party related to the transfer. All available evidence shall be considered, including, but not limited to, explicit written arrangements, communications between the transferor and the transferee or its beneficial interest holders, and unwritten arrangements customary to similar transfers. Examples of continuing involvement with the transferred financial assets include, but are not limited to, servicing arrangements, recourse or guarantee arrangements, agreements to purchase or redeem transferred financial assets, options written or held, derivative financial instruments that are entered into contemporaneously with, or in contemplation of, the transfer, arrangements to provide financial support, pledges of collateral, and the transferor's beneficial interests in the transferred financial assets.

Contractually Specified Servicing Fees

All amounts that, per contract, are due to the servicer in exchange for servicing the financial asset and would no longer be received by a servicer if the beneficial owners of the serviced assets (or their trustees or agents) were to exercise their actual or potential authority under the contract to shift the servicing to another servicer. Depending on the servicing contract, those fees may include some or all of the difference between the interest rate collectible on the financial asset being serviced and the rate to be paid to the beneficial owners of those financial assets.

Derecognize

Remove previously recognized assets or liabilities from the statement of financial position.

Derivative Financial Instrument

A derivative instrument (as defined in *SSAP No. 86—Accounting for Derivative Instruments and Hedging, Income Generation, and Replication (Synthetic Asset) Transactions*) that is a financial instrument (refer to *SSAP No. 27—Disclosure of Information about Financial Instruments with Off-*Balance-*Sheet Risk, Financial Instruments with Concentrations of Credit Risk and Disclosures about Fair Value of Financial Instruments*, paragraph 2).

Embedded Call

A call option held by the issuer of a financial instrument that is part of and trades with the underlying instrument. For example, a bond may allow the issuer to call it by posting a public notice well before its stated maturity that asks the current holder to submit it for early redemption and provides that interest ceases to accrue on the bond after the early redemption date. Rather than being an obligation of the initial purchaser of the bond, an embedded call trades with and diminishes the value of the underlying bond.

Financial Asset

Cash, evidence of an ownership interest in an entity, or a contract that conveys to a one entity a right (a) to receive cash or another financial instrument from a second entity or (b) to exchange other financial instruments on potentially favorable terms with the second entity.

Financial Liability

A contract that imposes on one entity an obligation (a) to deliver cash or another financial instrument to a second entity or (b) to exchange other financial instruments on potentially unfavorable terms with the second entity.

Freestanding Call

A call that is neither embedded in nor attached to an asset subject to that call.

Interest-Only Strip

A contractual right to receive some or all of the interest due on a bond, mortgage loan, collateralized mortgage obligation, or other interest-bearing financial asset.

Participating Interest

A participating interest has the following characteristics:

a. From the date of the transfer, it represents a proportionate (pro rata) ownership interest in an entire financial asset. The percentage of ownership interests held by the transferor in the entire financial asset may vary over time, while the entire financial asset remains outstanding as long as the resulting portions held by the transferor or its agents) and the transferee(s) meet the other characteristics of a participating interest. For example, if the transferor's interest in an entire financial asset changes because it subsequently sells another interest in the entire financial asset, the interest held initially and subsequently by the transferor must meet the definition of a participating interest.

b. From the date of the transfer, all cash flows received from the entire financial asset are divided proportionately among the participating interest holders in an amount equal to their share of ownership. Cash flows allocated as compensation for services performed, if any, shall not be included in that determination provided those cash flows are not subordinate to the proportionate cash flows of the participating interest and are not significantly above an amount that would fairly compensate a substitute service provider, should one be required, which includes the profit that would be demanded in the marketplace. In addition, any cash flows received by the transferor as proceeds of the transfer of the participating interest shall be excluded from the determination of proportionate cash flows provided that the transfer does not result in the transferor receiving an ownership interest in the financial asset that permits it to receive disproportionate cash flows.

c. The rights of each participating interest holder (including the transferor in its role as a participating interest holder) have the same priority, and no participating interest holder's interest is subordinated to the interest of another participating interest holder. That priority does not change in the event of bankruptcy or other receivership of the transferor, the original debtor, or any other participating interest holder. Participating interest holders have no recourse to the transferor, its agents or to each other, other than standard representations and warranties, ongoing contractual obligations to service the entire financial asset and administer the transfer contract, and contractual obligations to share in any set-off benefits received by any participating interest holder. That is, no participating interest holder is entitled to receive cash before any other participating interest holder under its contractual rights as a participating interest holder. For example, if a participating interest holder also is the servicer of the entire financial asset and receives cash in its role as servicer, that arrangement would not violate this requirement.

d. No party has the right to pledge or exchange the entire financial asset unless all participating interest holders agree to pledge or exchange the entire financial asset.

Proceeds

Cash, beneficial interests, servicing assets, derivatives, or other assets that are obtained in a transfer of financial assets, less any liabilities incurred.

Recourse

The right of a transferee of receivables to receive payment from the transferor of those receivables for (a) failure of debtors to pay when due, (b) the effects of prepayments, or (c) adjustments resulting from defects in the eligibility of the transferred receivables.

Securitization

The process by which financial assets are transformed into securities.

Security Interest

A form of interest in property that provides that upon default of the obligation for which the security interest is given, the property may be sold in order to satisfy that obligation.

Seller

A transferor that relinquishes control over financial assets by transferring them to a transferee in exchange for consideration.

Servicing Asset

A contract to service financial assets under which the estimated future revenues from contractually specified servicing fees, late charges, and other ancillary revenues are expected to more than adequately compensate the servicer for performing the servicing. A servicing contract is either (a) undertaken in conjunction with selling or securitizing the financial assets being serviced or (b) purchased or assumed separately.

Servicing Liability

A contract to service financial assets under which the estimated future revenues from contractually specified servicing fees, late charges, and other ancillary revenues are not expected to adequately compensate the servicer for performing the servicing.

Standard Representations and Warranties

Representations and warranties that assert the financial asset being transferred is what it is purported to be at the transfer date. Examples include representations and warranties about (a) the characteristics, nature, and quality of the underlying financial asset, including characteristics of the underlying borrower and the type and nature of the collateral securing the underlying financial asset, (b) the quality, accuracy, and delivery of documentation relating to the transfer and the underlying financial asset, and (c) the accuracy of the transferor's representations in relation to the underlying financial asset.

Transfer

The conveyance of a noncash financial asset by and to someone other than the issuer of that financial asset. Thus, a transfer includes selling a receivable, putting it into a securitization trust, or posting it as collateral but excludes the origination of that receivable, the settlement of that receivable, or the restructuring of that receivable into a security in a troubled debt restructuring.

Transferee

An entity that receives a financial asset, an interest in a financial asset, or a group of financial assets from a transferor.

Transferor

An entity that transfers a financial asset, an interest in a financial asset, or a group of financial assets that it controls to another entity.

Unilateral Ability (See paragraphs 57 and 58)

A capacity for action not dependent on the actions (or failure to act) of any other party.

EXHIBIT B – ILLUSTRATIONS

Illustration—Recording Transfers with Proceeds of Cash, Derivatives, and Other Liabilities

1. Company A transfers entire loans with a carrying amount of $1,000 to a subsidiary and receives proceeds with a fair value of $1,030 and the transfer is accounted for as a sale. Company A undertakes no servicing responsibilities and assumes a limited recourse obligation to repurchase delinquent loans.

Company A agrees to provide the transferee a return at a floating rate of interest even though the contractual terms of the loan are fixed rate in nature (that provision is effectively an interest rate swap).

Fair Values	
Cash proceeds	$1,050
Interest rate swap asset	40
Recourse obligation	60

Net Proceeds	
Cash received	$1,050
Plus: Interest rate swap asset	40
Less: Recourse obligation	(60)
Net proceeds	$1,030

Gain on Sale	$1,030
Net proceeds	1,000
Carrying amount of loans sold	$ 30
Gain on sale	

Journal Entry		
Cash	1,050	
Interest rate swap asset	40	
Loans		1,000
Recourse obligation		60
Gain on sale		30
To record transfer		

Illustration—Recording Transfers of Participating Interests

2. Company B transfers a nine-tenths participating interest in a loan with a fair value of $1,100 and a carrying amount of $1,000, and the transfer is accounted for as a sale. The servicing contract has a fair value of zero because Company B estimates that the benefits of servicing are just adequate to compensate it for its servicing responsibilities.

Fair Values	
Cash proceeds for nine-tenths sold ($1,100 x 9/10)	$990
One-tenth interest continued to be held by the transferor ($1,100 x 1/10)	110

Allocated Carrying Amount Based on Relative Fair Values

	Fair Value	**Percentage Of Total Fair Value**	**Allocated Carrying Amount**
Nine-tenths participating interest sold ($1,100 x 9/10)	$990	90	$900
One-tenth participating interest continued to be held by the transferor ($1,100 x 1/10)	110	10	100
Total	$ 1,100	100	$1,000

Gain on Sale	
Net proceeds	$ 990
Less: Carrying amount of loans sold	(900)
Gain on sale	$90

Journal Entry		
Cash	990	
Loans		900
Gain on sale		90
To record transfer		

Illustration—Sale of Receivables with Servicing Obtained

3. Company C originates $1,000 of loans that yield 10 percent interest income for their estimated lives of 9 years. Company C transfers the entire loans to an entity and the transfer is accounted for as a sale. Company C receives as proceeds $1,000 cash, a beneficial interest to receive 1 percent on the contractual interest on the loans (an interest-only strip receivable), and an additional 1 percent of the contractual interest as compensation for servicing the loans. The fair values of the servicing asset and the interest-only strip receivable are $40 and $60, respectively.

Fair Values	
Cash proceeds	$1,000
Servicing asset	40
Interest-only strip receivable	60

Net Proceeds		
Cash proceeds		$1,000
Servicing asset		40
Interest-only strip receivable		60
	Net Proceeds	$1,100

Gain on Sale	
Net proceeds	$1,100
Less: Carrying amount of loans sold	(1,000)
Gain on sale	$ 100

Journal Entries		
Cash	1,000	
Interest-only strip receivable	60	
Servicing asset	40	
Loans		1,000
Gain on sale		100
To record transfer and to recognize interest-only strip receivable and servicing asset		

Illustration—Securities Lending Transaction Treated as a Secured Borrowing

4. The following example illustrates the accounting for a securities lending transaction treated as a secured borrowing, in which the securities borrower sells the securities upon receipt and later buys similar securities to return to the securities lender:

Facts

Transferor's carrying amount and fair value of security loaned	$1,000
Cash "collateral"	1,020
Transferor's return from investing cash collateral at a 5 percent annual rate	5
Transferor's rebate to the securities borrower at a 4 percent annual rate	4

For simplicity, the fair value of the security is assumed not to change during the 35-day term of the transaction.

Journal Entries for the Transferor

At inception:		
Cash	1,020	
Payable under securities loan agreements		1,020
To record the receipt of cash collateral		
Securities pledged to creditors	1,000	
Securities		1,000
To reclassify loaned securities that the secured party has the right to sell or repledge		
Money market instrument	1,020	
Cash		1,020
To record investment of cash collateral		
At conclusion:		
Cash	1,025	
Interest		5
Money market instrument		1,020
To record results of investment		
Securities	1,000	
Securities pledged to creditors		1,000
To record return of security		
Payable under securities loan agreements	1,020	
Interest ("rebate")	4	
Cash		1,024
To record repayment of cash collateral plus interest		

Journal Entries for the Transferee

At inception:		
Receivable under securities loan agreements	1,020	
Cash		1,020
To record transfer of cash collateral		

Cash	1,000	
Obligation to return borrowed securities		1,000

To record sale of borrowed securities to a third party and the resulting obligation to return securities that it no longer holds

At conclusion:

Obligation to return borrowed securities	1,000	
Cash		1,000

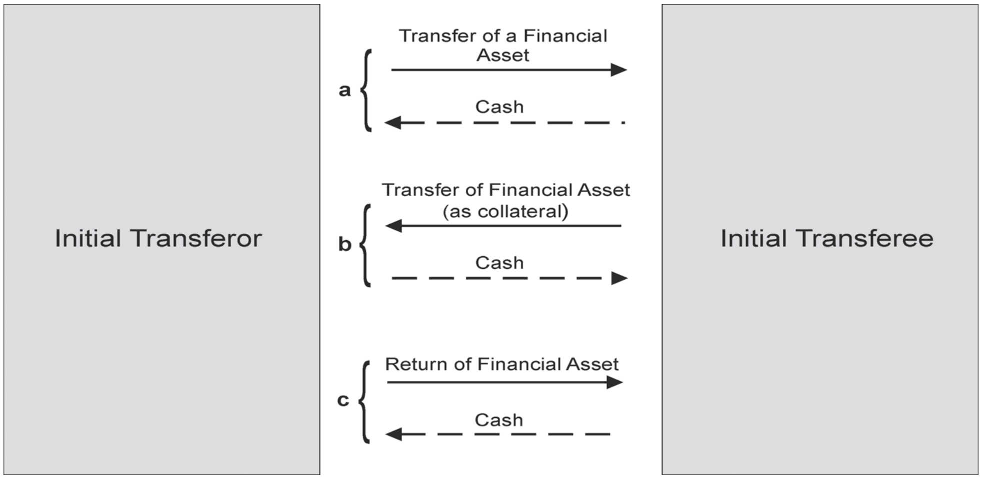
To record the repurchase of securities borrowed

Cash	1,024	
Receivable under securities loan agreements		1,020
Interest revenue ("rebate")		4

To record the receipt of cash collateral and rebate interest

Illustration—Initial Transfer and Repurchase Financing

5. The following diagram is an example of an initial transfer of a financial asset and a subsequent repurchase financing, as described in paragraphs 100-105.


Initial Transferor
a
Transfer of a Financial Asset
Cash
b
Transfer of Financial Asset (as collateral)
Cash
c
Return of Financial Asset
Cash
Initial Transferee

DISCUSSION

Overview

128. The accounting guidance in this issue paper is consistent with the GAAP guidance for the accounting for transfers and servicing of financial assets and extinguishments of liabilities as reflected in FAS 166 with modifications deemed appropriate for statutory accounting. Previous statutory guidance within SSAP No. 91R adopted, with modification, the guidance within *FAS 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 140).

129. Revising statutory accounting by superseding SSAP No. 91R, to adopt, with modification, *FAS 166, Accounting for transfers of financial assets, an amendment to FASB Statement No. 140* (FAS 166) is considered necessary to ensure the consistent and proper application of accounting guidance for transfers of financial assets. Furthermore, the elimination of qualifying special-purpose entities, as well as the incorporation of enhanced criteria for when a transfer qualifies as a "sale" will result with statutory financial statements that are more transparent and more reflective of the reporting entity's financial position. The need for timely revisions is further supported by the following FASB conclusions and actions:

a. In establishing the effective date for FAS 166, the FASB identified that there is an urgent need to improve transparency related to certain entities that are off-balance sheet and certain transactions that are currently reported as sales. It was also noted that there is significant diversity and frequent application questions regarding the application of FAS 140.

b. It is also noted that FAS 166 does not fully converge with International Financial Reporting Standards. Although the IASB and FASB have a long-term project to work on a converged standard for derecognition of financial assets, the FASB believed that the urgent need to eliminate the QSPE concept overrode the need for a convergent standard. The issuance of FAS 166 does improve convergence as the concept of a QSPE does not exist in International Financial Reporting Standards.

Sale Accounting

130. In the prior GAAP guidance, and in SSAP No. 91R, a "financial-components approach" for sale accounting had been incorporated. This approach analyzed a transfer of financial assets by examining the component assets and liabilities that existed after a transfer. Each party to the transfer recognized the assets that it controlled and the liabilities that it assumed as a result of the transfer and no longer recognized the assets and liabilities that were surrendered or extinguished in the transfer. A key component of this approach was that a transferor should no longer recognize a transferred financial asset if it had surrendered control. Although guidance was provided on when control is considered surrendered, no explicit guidance had been provided on what constitutes a portion or a component of a financial asset.

131. In accordance with the application of the FAS 140, concerns were raised about certain transfers of portions of financial assets that were being accounted for as sales. In particular, concerns were raised about sales of undivided interests in pools of financial assets because of credit support provided by affiliates of the transferor. Also, it was noted that in some cases, transferred financial assets appeared to remain under the control of the transferor while being reported as sales. This was noted with highly-structured transactions in which the transferor continued to control the transferred financial assets, as they were in the custody of the transferor and/or affiliates and the transferor had significant continuing involvements through its interests in the underlying financial assets. As noted by the FASB, it is difficult to determine whether a transferor has surrendered control over a component of a financial asset or a component of a group of financial assets if the transferor continues to maintain custody of the original asset.

132. Pursuant to the statutory accounting concept of conservatism, in assessing FAS 166, there is no identified insurance-specific rationale that would support deviation from the enhanced GAAP requirements in determining "sale" accounting, and the treatment of participating interests and beneficial interests retained or obtained from the transfers of financial assets, in a manner that would result in less-conservative, or less-restrictive, guidelines for statutory accounting. Thus, this issue paper adopts the following GAAP provisions for statutory accounting:

a. Sale accounting is only met in a transfer of an entire financial asset, a transfer of a group of entire financial assets, or if a transfer meets all of the participating interests conditions, including the surrender of control. This guidance indicates that an entity must consider all arrangements made in contemplation of, or contemporaneously with, the transfer, consider the continuing involvement of the transferred assets, as well as consider whether the financial assets have been put beyond the reach of the transferor or creditors if the reporting entity was to enter receivership.

b. Upon a transfer that qualifies for sale accounting, the transferor recognizes and initially measures at fair value all servicing assets, servicing liabilities, any other asset obtained, including beneficial interests, and liabilities incurred at fair value. This measurement is considered appropriate as a clear exchange has occurred which warrants initial measurement at fair value.

c. Participating interests in financial assets that continue to be held by a transferor are not part of the proceeds of a transfer, and the carrying amount of those participating interests shall be measured at the date of the transfer by allocating the previous carrying amount between the participating interests transferred and sold, and the participating interests that are not transferred and continued to be held by a transferor, based on their relative fair values. This measurement is considered appropriate, as the retained participating interests were not part of the transfer, and there has been no surrendering of control.

133. Mirroring the FASB conclusion, inherent in the sale accounting principle that requires transfer of an entire asset, in order to be eligible for sale accounting, an entire financial asset cannot be divided into components before the transfer unless those components meet the definition of a participating interest. Pursuant to this position, circumstances for sale accounting are limited as the conditions for surrender of control can be applied only to a transfer of an entire financial asset, a group of entire financial assets, or a participating interest in the entire financial asset.

134. In determining the participating interest criteria, the statutory accounting guidance proposes to adopt the requirements incorporated within FAS 166. In adopting the GAAP participating interest conditions, an interest-only strip received as proceeds would not meet the definition of a participating interest. The concept of a participating interest is consistently applied only when a premium, if any, is not dependent on the cash flows received from the transferred participating interest. A transferor cannot receive an interest-only strip as proceeds from a transfer of a participating interest because the future cash flows would not be proportionately shared by all participating interest holders.

135. Key aspects of the FAS 166 participating interest characteristics adopted for statutory:

a. From the date of transfer, it represents a proportionate (pro rata) ownership interest in an entire financial asset.

b. From the date of transfer, all cash flows received from the entire financial asset are divided proportionately among the participating interest holders in an amount equal to their share of ownership. Cash flows compensating for services are not included in this determination if those cash flows are not subordinate to the proportionate cash flows of the participating interest and are not significantly above an amount that would fairly compensate a substitute service provider. Cash flows received by the transferor as proceeds of the transfer are excluded from the determination of proportionate cash flows provided that the transfer does not result with the transferor receiving an ownership interest in the financial asset that permits it to receive disproportionate cash flows.

c. The rights of each participating interest hold (including the transferor) have the same priority, and no holder's interest is subordinated to the interest of another interest holder. This priority cannot change in the event of bankruptcy or other receivership of the transferor, the original debtor, or any other participating interest holder. Participating interest holders have no recourse to the transferor other than standard representations and warranties. No participating interest holder can be entitled to receive cash before any other holder. Thus, if a participating interest holder is also the servicer of the financial asset and receives cash for the role as servicer, the transfer would not meet the definition of a participating interest.

d. No party has the right to pledge or exchange the entire financial asset unless all participating interest holder agree to pledge or exchange the entire financial asset.

136. This issue paper, through the adoption of FAS 166, retains the concept from SSAP No. 91R that a transferor shall recognize assets obtained and liabilities incurred in a transfer of financial assets accounted for as a sale. As such, a transferor is allowed to obtain a beneficial interest in the transferred financial asset as proceeds from the transfer, but only if it has surrendered control over the original financial asset, thus meeting all of the conditions for sale accounting. It is noted that the "obtained" beneficial interest resulting from the transfer may be very similar to a "component" of the actual transferred asset.

137. In accordance with the continued recognition of obtained beneficial interests from a sale of financial assets, it is noted that similar assets resulting from different transactions will be accounted for differently depending on whether the transaction involves a securitization entity. This was also noted by the FASB, and can be evidenced by comparing a sale of a participating interest directly to a third party and a sale of the whole loan to an entity in which entity was to "obtain" the same participating interest as part of the proceeds from the transfer.

a. For a sale of a participating interest directly to a third party, the retained participating interest would not be remeasured at fair value, rather its carrying value would be allocated on the basis of the relative fair value of the portion sold and portion retained.

b. For a sale of a whole loan to an entity in which the entity was to take-back the same participating interest, the beneficial interest "obtained" as part of the sale would be measured at fair value, with a gain or loss effectively recognized on the portion retained.

Although the asset ultimately held by the entity would be the same in both these scenarios, the measurement is driven in accordance with the transaction that occurred. To address such situations, the FASB decided to add disclosures about assets obtained and liabilities incurred as a result of a transfer accounted for as a sale. Similar disclosures are proposed for statutory accounting. The inclusion of these enhanced disclosures should provide adequate information to the users of the financial statements.

138. If the sale accounting criteria is not met, the adoption of FAS 166 would retain the "secured borrowing" concept within SSAP No. 91R. It is perceived that with the more restrictive sale accounting guidelines, transactions will either be restructured accordingly to meet the enhanced sale criteria, or an increased amount of transactions will be accounted for as secured borrowings. Pursuant to the guidance for secured borrowings, the transferred financial assets will continued to be reported in the financial statements, with no change in measurement, and accordingly, no gain or loss on the result of the transfer.

139. In considering the application of the FAS 166 guidance for Re-REMIC transactions:

a. If the entire financial asset is transferred in a sale transaction, satisfying the surrender of control, then any beneficial interests "obtained" or "taken back" as part of the proceeds of the sale would be accounted for at fair value.

b. If a "participating interest" was transferred in a sale transaction, satisfying the surrender of control, remaining "participating interests" retained (not part of the sale transfer), would be held at an amount representing the difference between the carrying amount of the entire financial asset, and the amount derecognized — previous carrying value allocated between the participating interests sold and retained based on relative fair values at the date of the transfer. If an aspect of the transferred participating interest was "taken back" as proceeds from the transfer, it would then be accounted for at fair value.

c. Transfers that do not meet the sale criteria would be considered secured borrowings. In such instances, the transferor would continue to report the transferred financial assets in the financial statements with no change in measurement. With secured borrowings, there is no derecognition of the transferred asset at the time of transfer.

d. Transfers conducted among trusts or legal vehicles previously captured within the QSPE concept, are not exempt from being considered affiliated or related party transactions. Consideration must be given to the guidance within *SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties* on all transfers within the confines of this issue paper. If concluded that the transaction is a related party or affiliated transaction, then the valuation methods identified within SSAP No. 25 shall be utilized:

i. Economic transactions shall be reported at fair value at the date of the transaction. To the extent that the related parties are affiliates under common control, the controlling reporting entity shall defer the effects of such transactions that result in gains or increases in surplus.

ii. Non-economic transactions shall be recorded at the lower of existing book values or fair values at the date of the transactions.

iii. Non-economic transactions between a reporting entity and an entity that has no significant ongoing operations other than to hold assets that are primarily for the direct or indirect benefit of the reporting entity or its affiliates, shall be recorded at the fair value at the date of the transaction; however, to the extent that the transaction results in a gain, that gain shall be deferred until such time as permanence can be verified.

iv. Transactions designed to avoid statutory practices shall be reported as if the reporting entity continued to own the asset or to be obligated for a liability directly.

Qualifying Special Purpose Entities (QSPE)

140. Previous GAAP and statutory accounting guidance in SSAP No. 91R provided that if there was a transfer of financial assets to a qualifying special-purpose entity (QSPE) that cannot pledge or exchange the transferred financial assets, the transferor should nevertheless generally be permitted to derecognize the transferred financial assets if (a) the holders of interests issued by that entity could pledge or exchange their interests and (b) the transfer met the other conditions for sale accounting. In the development of this guidance, it was perceived that the QSPE entity would be so passive that control would not be an issue. Accordingly, under GAAP, such entities were excluded from consolidation because (1) the entity's primary purpose was limited to passively holding financial assets on behalf of its beneficial interest holders, and (2) the understanding that no individual party would have the ability to control such an entity.

141. As noted by the FASB, in practice, the conditions specified in FAS 140, adopted within SSAP No. 91R, paragraph 25, that require a QSPE activities to be "significantly limited" and "entirely specified" were being applied more broadly than originally intended in many securitizations that were reported as sales. The practice of rollovers of beneficial interests, servicer discretion, and the inability of QSPEs to maintain their qualifying status when responding to unexpected events (i.e., modify loans to reduce risk of default), raised questions on whether the passivity conditions required for QSPEs were being met and enforced in practice. As a result of the broad QSPE application, FASB decided to remove the concept of QSPEs entirely from FAS 166.

QSPEs – Rollovers of Beneficial Interests

142. The FASB origination of the FAS 166 project began to address whether a QSPE (or its designee or agent) is permitted to establish the terms of replacement beneficial interests issued after inception of the QSPE. Also, the FASB questioned whether the existing QSPE (or its designee or agent) that

determines the beneficial interests issued after the inception of the QSPE satisfies the passivity requirements.

143. The FASB learned that QSPEs often finance long-term financial assets by issuing short-term beneficial interests in the form of commercial paper or other debt instruments that, in the aggregate, do not receive all the cash inflows from the pool of assets. When those beneficial interests mature, they are paid off from the proceeds from issuing new beneficial interest, rather than from the cash inflows from the pool of financial assets. Frequently, such entities are supported by liquidity commitments from the transferor or other parties to ensure that the obligations of the entity to redeem beneficial interests are met on a timely basis.

144. The roll-over of beneficial interests, and the combination of an entity's ability to make decisions about future refinancing and the involvement of a liquidity provider causes FASB concern with whether the limitations on QSPE activities to be "significantly limited" and "entirely specified" are being met.

QSPEs – Servicer Discretion

145. The FASB identified that questions have also been raised about the amount of discretion a servicer is permitted in servicing the financial assets of a QSPE. Requests had been made for clarification of the requirement that the activities of a QSPE be "significantly limited" and "entirely specified" in the legal documents that establish the QSPE or that create the beneficial interests in the transferred financial asset.

146. After meeting with constituents, the FASB concluded that in practice, many QSPEs hold financial assets that do not appear to be passive in nature. In addition, many entities require a servicer to exercise a level of decision making that does not appear to have been entirely pre-specified if unforeseen events occur or to engage in activities that reach beyond the requirement that the activities of a QSPE be "significantly limited".

147. In considering this situation, it was noted that the long-term nature of many QSPE transactions makes it impractical to predict all of the possible events that may occur during the life of the transferred financial asset. In addition, it is impractical to predict all of the potential responses a servicer might be required to make to protect the interests of the beneficial interest holders. As such, the FASB concluded that it would not be feasible or fruitful to define at inception the parameters required by the definition of a QSPE for many types of financial assets, most notably, financial assets with longer terms.

QSPEs – Loan Modification

148. In light of a statement from the federal financial institutions' regulatory agencies encouraging financial institutions to work constructively with residential borrowers who were unable to make their contractual payments on their home loans, consideration was given to how loan modifications, for loans not in default, but for which default would be imminent, would impact a QSPE. It was noted that the prior GAAP guidance and interpretations were ambiguous about when an entity could modify a loan without effecting the QSPE status, because the interpretative guidance stated only that the servicer is permitted to work out a loan if it become delinquent or is in default. This guidance also required that the discretion inherent in the decision be "significantly limited" and its parameters be "entirely specified" in the QSPE's legal documents.

QSPE – Conclusion

149. Due to the range of financial assets being securitized and the complexity of securitization structures and arrangements, the applicabtion of the conditions for a QSPE have been extended beyond the scope of their original intent, thus rendering the conditions no longer operational in practice. Although the FASB considered an approach that would have strengthened the passivity requirement of the

permitted assets of a QSPE, the FASB concluded that few classes of financial assets are truly passive as envisioned in the QSPE concept. As such, the concept of a QSPE has been removed from FAS 140. The removal of this concept from FAS 140, resulted with a need to remove the scope exception for such entities from consolidation requirements and complete another project (FAS 167) to reconsider the guidance in Interpretation 46R.

150. The elimination of the concept of "qualified special purpose entities" (QSPE) for statutory accounting, similar to the FASB rationale, is necessary to address concerns that the application of entities classified as QPSEs has been applied more broadly then intended. Pursuant to the FASB conclusions, it was noted that in practice, QSPEs hold financial assets that do not appear to be passive in nature. Also, with the range of financial assets being securitized and the complexity of securitization structures and arrangements, the application of the conditions for a qualifying QSPE have been extended in some cases beyond the intent of the original guidance.

151. For statutory accounting, it is presumed that insurers will continue to form, conduct transfers of assets between, and hold investments in trusts or legal vehicles that would have met the prior conditions to be considered a QSPE. The accounting for transfers between the insurer and these trusts and other legal vehicles, including whether sale accounting should be applied, will be determined in accordance with the provisions of this issue paper. Furthermore, without retaining the concept of a "QSPE", transactions completed with entities previously captured within this term must be assessed in accordance with *SSAP No. 25—Accounting for and Disclosure about Transactions with Affiliates and Other Related Parties* (SSAP No. 25). As previously noted, if concluded that the transaction is a related party or affiliated transaction, then the valuation methods identified within SSAP No. 25 shall be utilized.

Isolation of Transferred Assets

Legal Opinions

152. This issue paper proposes adoption of the FAS 166 guidance regarding the "isolation" of transferred assets from the transferor in order to qualify for sale accounting. This guidance indicates that all evidence that supports an assertion for isolation should be considered, which includes consideration of the legal consequences of the transfer in the jurisdiction in which receivership would take place. This issue paper, similar to FAS 166, indicates that derecognition of transferred financial assets is appropriate only if the available evidence provides reasonable assurance that the transferred financial assets would be beyond the reach of the bankruptcy trustee or receiver for the transferor.

153. This issue paper incorporates information regarding legal opinions ("true sale opinions" and "nonconsolidation opinions") to identify aspects that should be considered in reviewing evidence to support isolation assertions. The guidance identifies that a legal opinion may not be required if the transferor has a reasonable basis to conclude that the appropriate legal opinion would be given if requested. Although the legal opinion is not necessary to support an assertion in all instances, similar to GAAP, the inclusion of this guidance, is intended to reduce practice issues and provide a sense of consistency in assessing whether isolation has occurred.

Transferability

154. This issue paper concurs with the FASB conclusion that the ability of a transferee to use the financial asset it receives is an important indication that a transferor has surrendered control over the transferred financial asset. Similar to the GAAP conclusion, for instances of transfers in which beneficial interests are created and distributed, this assessment may require consideration as to whether the third-party beneficial interest holders have the ability to pledge or exchange their beneficial interests:

a. Certain transferees issue beneficial interests of various types (debt, participations, residual interests or otherwise) as required by the transfer agreements. To issue beneficial

> interests, the transferee is typically restricted from pledging or exchanging the assets it holds because it is effectively distributing ownership rights in those assets to the beneficial interest holders. This transaction is effectuated by establishing a separate legal entity that merges the contractual rights in the transferred financial assets and allocates ownership interests in them (beneficial interests). As such, a third-party holder's right to pledge or exchange beneficial interests is the counterpart of a transferee's right to pledge or exchange the transferred assets themselves. Thus, a constraint on the transferee that issues beneficial interests would not necessarily indicate that the transferor has retained control over the transferred financial assets. In considering this conclusion for cases in which (a) a financial asset is transferred to an entity whose sole purpose is to facilitate a securitization or asset-backed financing and (b) the transferee entity is constrained from pledging to exchanging the asset it receives, the transferor should evaluate whether the third-party beneficial holders have the ability to pledge or exchange their beneficial interests.

Effective Control

155. This issue paper concurs with the FASB conclusion that the transferor cannot maintain effective control over the transferred financial assets. In considering whether control exists, the transferor must consider any direct continuing involvement with the transferred financial assets as well as consider any indirect continuing involvement that could enable it to maintain effective control through an arrangement made with beneficial interest holders of the transferred financial assets.

156. This issue paper also adopts the FASB conclusion that to account for a transfer of financial assets as a sale, the transferor must surrender control over the entire financial asset, except for limited circumstances in which the transferred portion meets the definition of a participating interest. Under this guidance, it is not possible to account for a transferred financial asset partially as a sale and partially as secured borrowing in situations in which the effective control is only maintained on a portion of the transferred assets. Such transactions, unless involving participating interests, would not meet the sale criteria and would be accounted for as secured borrowings — until all of the portions have been transferred in a manner that meet the sale criteria. This is further supported by the guidance that indicates any assets obtained from the sale of an entire financial asset are to be considered proceeds from the sale. If the transferor maintained effective control over a portion of the asset it has transferred, it would be inappropriate for that portion to be considered proceeds from the sale.

Securities Lendings

157. This issue paper also proposes adoption of the FAS 166 securities lending guidance. The statutory accounting guidance for securities lending transactions previously included within SSAP No. 91R established different guidelines from GAAP for when securities lending transactions, and related collateral, should be reported within the balance sheet. This prior guidance utilized the terms "restricted" and "unrestricted" and defined those terms in accordance with whether the collateral pledged by the transferee was or was not available for "general use of the transferor".

158. In 2008, the Statutory Accounting Principles (E) Working Group identified that various reporting entities had interpreted the security lending definitions differently, resulting with inconsistency in application and instances in which the guidance for "off-balance sheet" reporting was being applied in a broader manner than intended. It was identified that some entities had concluded the collateral requirement for "general use of the transferor" to mean that the collateral was to be considered "restricted" if the reporting entity had been prohibited from using the collateral in any form. However, although use of the collateral may have been limited in some manner, perhaps unavailable for policyholder claims, the reporting entity may still have been permitted to reinvest the collateral. The ability to reinvest the collateral, coupled with off-balance sheet reporting caused concern for regulators

due to the lack of information and transparency on the transactions that occurred, as well as the potential financial risk if the reinvested collateral was to significantly decrease in value.

159. By adopting the GAAP guidance for securities lending transactions, the collateral received in such transactions will be assessed in accordance with "sale" criteria. Thus, if the holder is permitted by contract or custom to sell or repledge, the collateral is considered proceeds of the sale of the "loaned" securities. If the collateral received is in a form that is not permitted by contract or custom to sell or repledge, the securities lending transaction would not satisfy the sale criteria and would be accounted for as a loan of securities by the transferor to the transferee.

Statutory-Specific Revisions

160. This issue paper proposes adoption, with modification to the FAS 166 guidance to further restrict sale accounting treatment for statutory accounting in specific instances in which GAAP would permit sale recognition. These revisions are proposed in accordance with the conservatism principle, as in the noted instances, the potential continuing involvement is considered significant to preclude sale accounting under statutory accounting principles. Specifically, these modifications are included for transactions with removal-of-account provisions and transfers of receivables with recourse. Modifications have also been proposed to incorporate guidance previously included in SSAP No. 91R specific to insurance entities, as well as to include guidance that was previously adopted from GAAP, and not revised through the issuance of FAS 166.

161. This issue paper proposes adoption, with modification, of FAS 166 and the corresponding amendments to FAS 140 and FAS 156, including the revised FAS 140 glossary and illustrations. Statutory modifications from the adoption of amendments to FAS 140 and FAS 156 reflected in FAS 166 include:

a. Rejects the GAAP consideration for "consolidated affiliates" as the concept of consolidation has not been adopted for statutory accounting.

b. Rejects reference to GAAP standards and GAAP methods not adopted for statutory as well as concepts that are not pertinent for insurers. For example references to investments 'held-to-maturity', 'available for sale' or 'trading' and reference to FASB standards were removed and replaced with statutory terms and references to statutory standards.

c. Rejects GAAP reference and guidance regarding "Revolving-Period Securitizations" as this GAAP guidance is not applicable to statutory accounting. This concept was also deemed not applicable to statutory accounting under SSAP No. 91R.

d. Rejects GAAP guidance for "Sale-Type and Direct-Financing Lease Receivables" as leases shall be accounted for in accordance with *SSAP No. 22—Leases* (SSAP No. 22). This conclusion is consistent with SSAP No. 91R.

e. Rejects GAAP guidance for "Banker's Acceptances and Risk Participations in Them" as not applicable for statutory accounting. This GAAP guidance was also deemed not applicable to statutory accounting under SSAP No. 91R.

f. Rejects GAAP guidance for "Removal of Account Provisions" that allows recognition of sale accounting. For statutory, transfers that would empower the transferor to reclaim assets under certain conditions (considered 'removal-of-accounts provisions') are precluded from being accounted for as sales. This conclusion is consistent with SSAP No. 91R.

g. Rejects GAAP guidance for "Transfers of Receivables with Recourse" that allows transfers of receivables in their entirety with recourse to be accounted for as sales. For statutory, a transfer of receivables with recourse shall be accounted for as a secured borrowing. This conclusion is consistent with SSAP No. 91R.

h. Rejects illustrations for transactions involving transfers of lease financing receivables with residual values and banker's acceptances with a risk participation as the GAAP guidance in FAS 166 related to these topics has been rejected for statutory accounting.

i. Incorporates additional disclosure requirements for collateral requirements when the reporting entity is not permitted by contract or custom to sell or repledge.

j. Incorporates guidance previously included in SSAP No. 91R specific to insurance entities, and guidance that was adopted from GAAP guidance not revised through the issuance of FAS 166. Items incorporated include:

   i. Clarification that transfers of financial assets that are in substance real estate shall be accounted for in accordance with *SSAP No. 40—Real Estate* Investments.

   ii. Clarification that transactions between related parties or affiliates are accounted for in accordance with *SSAP No. 25—Accounting For and Disclosures About Transactions with Affiliates and Other Related Parties*.

   iii. Clarification that the guidance does not address the securitization of mortality or morbidity risk.

   iv. Guidance on the accounting of sale transactions for entities required to maintain an interest maintenance reserve (IMR).

   v. Clarification of when servicing assets and servicing liabilities shall be recognized as well as measurement of these items. This guidance continues the adoption, with modification, of FAS 156, including the requirement to subsequently measure servicing assets and servicing liabilities at fair value. Furthermore, continues the prior decision that servicing assets shall be nonadmitted.

   vi. Guidance on the accounting for transactions that require the granting of a security interest in certain assets to another party to serve as collateral for their performance under a contract.

   vii. Disclosures on loaned securities; securities underlying repurchase and reverse repurchase agreements, dollar repurchase and dollar reverse repurchase agreements; receivables with recourse; and wash sales.

   viii. Guidance on the sales of future revenues.

   ix. Guidance on collateral requirements for securities lending transactions that requires collateral of 102 percent (105 percent for foreign securities) of the fair value of the loaned securities. Guidance recently adopted by the Statutory Accounting Principles (E) Working Group related to collateral received for securities lending transactions has been reflected within the proposed issue paper.

   x. Disclosures on securities lending transactions specific to aggregate open positions and aggregate positions under 30-day, 60-day and 90-day terms, disclosures for collateral that extend beyond one year from the reporting date, and detail of loaned securities within the separate account and if the policies and procedures differ from the general account.

xi. Clarification that repurchase agreements, reverse repurchase agreements and dollar repurchase agreements meet the definition of assets as defined in *SSAP No. 4—Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this guidance.

xii. Guidance on Repurchase Agreements. This guidance retains recent revisions to SSAP No. 91R that ensured the proper terms are being utilized for the proper scenario. This guidance retains the recently adopted guidance from FSP FAS 140-3, Accounting for Transfers of Financial Assets and Repurchase Financing Transactions (FSP FAS 140-3). This GAAP guidance was not revised with the issuance of FAS 166.

xiii. Guidance on Reverse Repurchase Agreements. This guidance retains recent revisions to SSAP No. 91R that ensured the proper terms are being utilized for the proper scenario.

xiv. Guidance on Collateral for Reverse and Repurchase Agreements. This guidance retains recent revisions to SSAP No. 91R that ensured the proper terms are being utilized for the proper scenario..

xv. Guidance on Dollar Repurchase Agreements. This guidance retains recent revisions to SSAP No. 91R that ensured the proper terms are being utilized for the proper scenario.

xvi. Guidance for Separate Transactions.

xvii. Guidance for Offsetting.

xviii. Guidance for Transfers of Receivables with Recourse.

162. With the exception of INT 99-21, as discussed below, this issue paper will be interpreted by the statutory interpretations to SSAP No. 91R:

a. *INT 99-07: EITF 97-3: Accounting for Fees and Costs Associated with Loan Syndications and Loan Participations after the Issuance of FASB Statement No. 125* (INT 99-07) – As this interpretation rejected EITF 97-3 for statutory accounting, there is no impact to this interpretation from adoption of FAS 166.

b. *INT 99-08: EITF 97-6: Application of Issue No. 96-20 to Qualifying Special-Purpose Entities Received Transferred Financial Assets Prior to the Effective Date of FASB Statement No. 125* (INT 99-08) – As this interpretation rejected EITF 96-20 for statutory accounting, there is no impact to this interpretation from adoption of FAS 166.

c. *INT 99-14: EITF 96-19: Debtor's Accounting for a Modification or Exchange of Debt Instruments* (INT 99-14) – This interpretation adopted EITF 99-14 for statutory accounting. As such, an exchange of debt instruments with substantially different terms is considered a debt extinguishment. This guidance also clarifies that if the cash flows under the terms of the new debt instrument is at least 10 percent different from the present value of the remaining cash flows under the terms of the original instrument, then the exchange of debt instruments are considered substantially different. There is no impact to this interpretation from the adoption of FAS 166.

d. *INT 99-21: EITF 98-7: Accounting for Exchanges of Similar Equity Method Investments* (INT 99-21) – This interpretation was nullified with the issuance of *SSAP No. 95—Exchanges of Nonmonetary Assets, A Replacement of SSAP No. 28—Nonmonetary*

Transactions (SSAP No. 95). With the issuance of a new SSAP, there will be no future reference to this interpretation.

e. *INT 99-22: EITF 98-8: Accounting for Transfers of Investments That Are in Substance Real Estate* (INT 99-22) – This interpretation adopted EITF 98-8 indicating that transfers of financial assets that are in substance real estate shall be accounted for in accordance with *SSAP No. 40—Real Estate Investments* (SSAP No. 40). There is no impact to this interpretation from the adoption of FAS 166.

f. *INT 00-11: EITF 98-15: Structured Notes Acquired for a Specified Investment Strategy* (INT 00-11) – This interpretation rejected the consensus position in EITF 98-15 pursuant to a recommendation from the Invested Assets (E) Working Group. It was noted that any attempt on the part of the Emerging Accounting Issues (E) Working Group to promulgate EITF 95-18 into accounting guidance will require the Valuation of Securities (E) Task Force to change the mission of the Securities Valuation Office. As such, there will be no impact to this interpretation as a result of adopting FAS 166.

g. *INT 01-31: Assets Pledged as Collateral* (INT 01-31) – This interpretation provides guidance on whether assets pledged as collateral shall be considered admitted assets. There is no impact to this interpretation from the adoption of FAS 166.

h. *INT 03-05: EITF 01-7: Creditor's Accounting for a Modification or Exchange of Debt Instruments* (INT 03-05) – This interpretation adopts the consensus position of EITF 01-7. This EITF clarifies that a debt instrument modification should be considered more than minor if the present value of the cash flows under the terms of the new debt instrument is at least 10 percent different from the present value of the remaining cash flows under the terms of the original instrument. This EITF also concludes that the guidance in EITF 96-19 (adopted within INT 99-14) should be used to calculate the present value of cash flows for purposes of applying the 10 percent test. There is no impact to this interpretation from the adoption of FAS 166.

i. *INT 04-21: EITF 02-9: Accounting for Changes that Result in a Transferor Regaining Control of Financial Assets Sold* (INT 04-21) – This interpretation adopts EITF 02-9 with modification for statutory terms and references. Pursuant to this adoption, a transferred asset that has been accounted for as sold is to be accounted for as "re-purchased" if the basis for that sale accounting subsequently becomes invalid. There is no impact to this interpretation from the adoption of FAS 166.

Drafting Notes/Comments

163. None

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

164. SSAP No. 91R provides the following guidance: **(This has been updated to include the SSAP No. 91R revisions adopted in May 2010 for securities lending transactions.)**

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for transfers and servicing of financial assets, including asset securitizations and securitizations of policy acquisition costs, extinguishments of liabilities, repurchase agreements and reverse repurchase agreements, including dollar repurchase and dollar reverse repurchase agreements that

are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts). This statement discusses generalized situations. Facts and circumstances and specific contracts need to be considered carefully in applying this statement. Securitizations of nonfinancial assets are outside the scope of this statement.

SUMMARY CONCLUSION

2. See *SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties* (SSAP No. 25) for additional accounting and disclosure guidance concerning related party transactions. In addition the guidance for the following topics have been addressed in Interpretations of the Emerging Accounting Issues (E) Working Group (INT):

   a. Transfers of ownership interest that are in substance sales of real estate - INT 99-22 resolved this conflict between application of *SSAP No. 40—Real Estate* (SSAP No. 40) and *SSAP No. 18—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (SSAP No. 18).

   b. Exchanges of equity method investments for similar productive assets - INT 99-21 resolved this conflict between application of *SSAP No. 28—Nonmonetary Transactions* (SSAP No. 28) and SSAP No. 18.

3. SSAP No. 18, *SSAP No. 33—Securitization* (SSAP No. 33) and *SSAP No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements* (SSAP No. 45) are superseded by the conclusions outlined in this statement.

4. This statement does not address the securitization of mortality or morbidity risk. The National Association of Insurance Commissioners' (NAIC's) Insurance Securitization Working Group of the Financial Condition (E) Committee is charged with the development of model laws, model regulations and proposed accounting guidance for the securitization of mortality and morbidity risk. When such proposed accounting guidance is finalized, the development of a statement will be considered.

5. Except as discussed in paragraphs 56 and 97, a transfer of a group of financial assets, or a portion of a financial asset in which the transferor surrenders control over those financial assets shall be accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if, and only if, all of the following conditions are met:

   a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership (see paragraphs 17 and 18);

   b. Either (i) each transferee obtains the right, free of conditions that constrain it from taking advantage of that right (see paragraphs 19-23), to pledge or exchange the transferred assets or (ii) the transferee is a qualifying special-purpose entity as defined in paragraph 25 and the holders of beneficial interests in that entity have the right, free of conditions that constrain them from taking advantage of that right (see paragraph 24), to pledge or exchange those interests and no condition both constrains the transferee (or holder) from taking advantage of its right to pledge or exchange and provide more than a trivial benefit to the transferor; and

   c. The transferor does not maintain effective control over the transferred assets through (i) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (see paragraphs 38-40) or (ii) the ability to unilaterally cause the holder to return specific assets, other than through a cleanup call (see paragraphs 22-23 and 41-45).

6. Upon completion of any transfer of financial assets, the transferor shall:

   a. Initially recognize and measure at fair value, if practicable, servicing assets and servicing liabilities assumed under a separate contractual obligation to service financial assets (see paragraphs 11 and 50);

   b. Allocate the previous carrying amount between the assets sold, if any, and the interests that continue to be held by a transferor, if any, based on their relative fair values at the date of transfer (see paragraphs 48 and 49); and

   c. Continue to carry in its balance sheet any interest it continues to hold in the transferred assets, including, if applicable, beneficial interests in assets transferred to a qualifying special-purpose entity in a securitization, and undivided interests continued to be held by the transferor (see paragraphs 7c., 48 and 49).

7. Upon completion of a transfer of financial assets that satisfies the conditions to be accounted for as a sale (see paragraph 5), the transferor (seller) shall:

   a. Eliminate the transferred assets from the balance sheet;

   b. Allocate the previous carrying amount of the transferred assets to the securities representing beneficial interests continued to be held by the reporting entity, if any, and the securities representing beneficial interests not continued to be held, if any, based on the relative fair values of the transferred assets at the date of transfer;

   c. Record in its balance sheet, the allocated carrying value of the securities representing beneficial interests continued to be held in the assets (e.g., loan-backed securities). Subsequent to the transfer of assets:

      i. Retained residuals are to be carried at fair value with the difference between fair value and the allocated cost basis recognized as an unrealized gain or loss;

      ii. Beneficial interests continued to be held shall be accounted for in accordance with the statutory accounting principles for the specific asset type (e.g., bonds shall be accounted for in accordance with *SSAP No. 26—Bonds, excluding Loan–backed and Structured Securities*, loan-backed securities shall be accounted for in accordance with *SSAP No. 43R—Loan-backed and Structured Securities* (SSAP No. 43R), preferred stock in accordance with *SSAP No. 32—Investments in Preferred Stock (excluding investments in preferred stock of subsidiary, controlled, or affiliated entities)* (SSAP No. 32).

   d. Recognize all additional assets obtained (i.e., other than the securities representing beneficial interests continued to be held which are recorded in accordance with 7 c.) and liabilities incurred in consideration as proceeds of the sale;

   e. Initially measure such additional assets obtained and liabilities incurred in the sale at fair value (see *SSAP No. 100—Fair Value Measurements*), or if it is not practicable to estimate the fair value of an asset or a liability, apply alternative measures (paragraph 50); and

f. For reporting entities required to maintain an Interest Maintenance Reserve (IMR), the accounting for realized and unrealized capital gains and losses shall be in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*. For reporting entities not required to maintain an IMR, realized capital gains and losses shall be reported as net realized capital gains or losses in the statement of income, and unrealized capital gains and losses shall be reported as net unrealized gains and losses in unassigned funds (surplus).

8. The transferee shall recognize all assets obtained and any liabilities incurred, and initially measure them at fair value.

9. Repurchase agreements, reverse repurchase agreements, collateral requirements, and dollar repurchase agreements are described in paragraphs 64-86. When an asset is sold and the proceeds are reinvested within 30 days in the same or substantially the same security, such transfers shall be considered to be wash sales and shall be accounted for as sales as discussed in paragraphs 67-69 and disclosed as required by paragraph 100. Unless there is a concurrent contract to repurchase or redeem the transferred financial assets from the transferee, the transferor does not maintain effective control over the transferred assets.

10. If a transfer of financial assets in exchange for cash or other consideration (other than beneficial interests in the transferred assets) (a) does not meet the criteria for a sale in paragraph 5, or (b) is a sale of receivables with recourse (see paragraph 97); the transferor and transferee shall account for the transfer as a secured borrowing with pledge of collateral (see paragraph 13).

Recognition and Measurement of Servicing Assets and Liabilities

11. Servicing rights become a distinct asset or liability only when contractually separated from the underlying assets by sale or securitization of the assets with servicing retained, or separate purchase or assumption of the servicing. Servicing rights become a distinct asset or liability of the reporting entity pursuant to:

a. A transfer of the servicer's financial assets that meets the requirements for sale accounting;

b. A transfer of financial assets to a qualifying SPE in a guaranteed mortgage obligation in which the transferor retains all of the resulting securities; or

c. An acquisition or assumption of a servicing obligation that does not relate to financial assets of the servicer.

A servicer that transfers or securitizes financial assets in a transaction that does not meet the requirements for sale accounting and is accounted for as a secured borrowing with the underlying assets remaining on the transferor's balance sheet shall not be recognized as a servicing asset or servicing liability.

12. If distinct servicing rights exist in accordance with the above guidelines, the reporting entity shall recognize a servicing asset or liability. When the servicing fees to be received exceed the cost of servicing the transferred assets, a servicing asset is recognized and nonadmitted. When the cost of servicing the transferred assets is greater than the servicing fees to be received, a liability shall be recorded for the excess to recognize this obligation. A corresponding loss shall be recorded through the Summary of Operations in other income. Servicing assets and servicing liabilities shall be measured initially at fair value. Servicing assets or liabilities shall be measured subsequently at fair value at each reporting date with fluctuations in fair value reported as unrealized gains and losses. Declines in fair value which are determined to be other than temporary shall be recorded as realized losses.

Secured Borrowings and Collateral

13. A debtor may grant a security interest in certain assets to a lender (the secured party) to serve as collateral for its obligation under a borrowing, with or without recourse to other assets of the debtor. An obligor under other kinds of current or potential obligations, for example, interest rate swaps, also may grant a security interest in certain assets to a secured party. If collateral is transferred to the secured party, the custodial arrangement is commonly referred to as a pledge. Secured parties sometimes are permitted to sell or repledge (or otherwise transfer) collateral held under a pledge. The same relationships occur, under different names, in transfers documented as sales that are accounted for as secured borrowings (see paragraph 10). The accounting for noncash[1] collateral by the debtor (or obligor) and the secured party depends on whether the secured party or its agent has the right to sell or repledge the collateral and on whether the debtor has defaulted.

Footnote 1: Cash "collateral," sometimes used, for example, in securities lending transactions, shall be derecognized by the payer and recognized by the recipient, not as collateral, but rather as proceeds of either a sale or a borrowing.

a. If the secured party (transferee) or its agent has the right by contract or custom to sell or repledge the collateral, then the debtor (transferor) shall report that asset in its balance sheet.

b. If the secured party (transferee) sells collateral pledged to it, it shall recognize the proceeds from the sale and its obligation to return the collateral. The sale of the collateral is a transfer subject to the provisions of this statement.

c. If the debtor (transferor) defaults under the terms of the secured contract and is no longer entitled to redeem the pledged asset, it shall derecognize the pledged asset, and the secured party (transferee) shall recognize the collateral as its asset initially measured at fair value or, if it has already sold the collateral, derecognize its obligation to return the collateral.

d. Except as provided in paragraph 13 (c above), the debtor (transferor) shall continue to carry the collateral as its asset, and the secured party (transferee) shall not recognize the pledged asset.

14. Reporting entities may enter into certain transactions that require the granting of a security interest in certain assets to another party to serve as collateral for their performance under a contract. If the assets pledged are recorded as admitted assets under *SSAP No. 4—Assets and Nonadmitted Assets* (SSAP No. 4) and are not impaired under the provisions of *SSAP No. 5—Liabilities, Contingencies and Impairments of Assets* (SSAP No. 5), the pledging entity records the collateral as an admitted asset until committing a contract default that has not been cured in accordance with the contract provisions. At the time of an uncured default, the provisions of paragraph 13 above shall be used to determine the appropriate accounting treatment for the collateral. If the secured party utilizes collateral to offset all or a portion of the liability owed by the pledging entity as a result of the default, then the collateral amount utilized to offset the liability shall be removed from the balance sheet. At the same time, the amount of the liability that was offset shall be removed from the balance sheet since that obligation has been satisfied through the secured party's utilization of that collateral. To the extent that an uncured default remains without the secured party utilizing the collateral to offset the obligation, the pledging insurer shall only record an admitted asset for the amount of collateral that it can redeem.

Extinguishments of Liabilities

15. A debtor shall derecognize a liability if, and only if, it has been extinguished (see *SSAP No. 15—Debt and Holding Company Obligations* (SSAP No. 15)). A liability has been extinguished if either of the following conditions is met:

    a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes delivery of cash, other financial assets, goods, or services or reacquisition by the debtor of its outstanding debt securities whether the securities are canceled or held as so-called treasury bonds; or

    b. The debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor.

16. If a creditor releases a debtor from primary obligation on the condition that a third party assumes the obligation and that the original debtor becomes secondarily liable, that release extinguishes the original debtor's liability. However, in those circumstances, whether or not explicit consideration was paid for that guarantee, the original debtor becomes a guarantor. As a guarantor, it shall recognize a guarantee obligation in the same manner as would a guarantor that had never been primarily liable to that creditor, with due regard for the likelihood that the third party will carry out its obligations. The guarantee obligation shall be initially measured at fair value, and that amount reduces the gain or increases the loss recognized on extinguishment.

Isolation Beyond the Reach of the Transferor and Its Creditors

17. The nature and extent of supporting evidence required for an assertion in financial statements that transferred financial assets have been isolated—put presumptively beyond the reach of the transferor and its creditors, either by a single transaction or a series of transactions taken as a whole—depends on the facts and circumstances. All available evidence that either supports or questions an assertion shall be considered. That consideration includes making judgments about whether the contract or circumstances permit the transferor to revoke the transfer. It also may include making judgments about the kind of bankruptcy or other receivership into which a transferor or special-purpose entity might be placed, whether a transfer of financial assets would likely be deemed a true sale at law, whether the transferor is affiliated with the transferee and other factors pertinent under applicable law. Derecognition of transferred assets is appropriate only if the available evidence provides reasonable assurance that the transferred assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor. Transactions between related parties or affiliates are accounted for in accordance with SSAP No. 25.

18. Many common financial transactions, for example, typical repurchase agreements and securities lending transactions, isolate transferred assets from the transferor, although they may not meet the other criteria for surrender of control.

Conditions That Constrain a Transferee

19. Sale accounting is allowed under paragraph 5 only if each transferee has the right to pledge, or the right to exchange, the transferred assets or beneficial interests it received, but constraints on that right also matter. Many transferor-imposed or other conditions on a transferee's right to pledge or exchange a transferred asset both constrain a transferee from pledging or exchanging the transferred assets and, through that constraint, provide more than a trivial benefit to the transferor. For example, a provision in the transfer contract that prohibits selling or pledging a transferred loan receivable not only constrains the transferee but also provides the transferor with the more-than-trivial benefits of knowing who has the asset, a prerequisite to repurchasing the asset, and of being able to block the asset from finding its way into the hands of a competitor for the loan customer's business or someone that the loan customer might consider an undesirable creditor.

Transferor-imposed contractual constraints that narrowly limit timing or terms, for example, allowing a transferee to pledge only on the day assets are obtained or only on terms agreed with the transferor, also constrain the transferee and presumptively provide the transferor with more-than-trivial benefits.

20. However, some conditions do not constrain a transferee from pledging or exchanging the asset and therefore do not preclude a transfer subject to such a condition from being accounted for as a sale. For example, a transferor's right of first refusal on the occurrence of a bona fide offer to the transferee from a third party presumptively would not constrain a transferee, because that right in itself does not enable the transferor to compel the transferee to sell the assets and the transferee would be in a position to receive the sum offered by exchanging the asset, albeit possibly from the transferor rather than the third party. Further examples of conditions that presumptively would not constrain a transferee include (a) a requirement to obtain the transferor's permission to sell or pledge that is not to be unreasonably withheld, (b) a prohibition on sale to the transferor's competitor if other potential willing buyers exist, (c) a regulatory limitation such as on the number or nature of eligible transferees (as in the case of securities issued under Securities Act Rule 144A or debt placed privately), and (d) illiquidity, for example, the absence of an active market. Judgment is required to assess the significance of some conditions. For example, a prohibition on sale to the transferor's competitor would be a significant constraint if that competitor were the only potential willing buyer other than the transferor.

21. A condition imposed by a transferor that constrains the transferee presumptively provides more than a trivial benefit to the transferor. A condition not imposed by the transferor that constrains the transferee may or may not provide more than a trivial benefit to the transferor. For example, if the transferor refrains from imposing its usual contractual constraint on a specific transfer because it knows an equivalent constraint is already imposed on the transferee by a third party, it presumptively benefits more than trivially from that constraint. However, the transferor cannot benefit from a constraint if it is unaware at the time of the transfer that the transferee is constrained.

Transferor's Rights or Obligations to Reacquire Transferred Assets

22. Some rights or obligations to reacquire transferred assets both constrain the transferee and provide more than a trivial benefit to the transferor, thus precluding sale accounting under paragraph 5. For example, a freestanding call option written by a transferee to the transferor benefits the transferor and, if the transferred assets are not readily obtainable in the marketplace, is likely to constrain a transferee because it might have to default if the call was exercised and it had exchanged or pledged the assets. A freestanding forward purchase-sale contract between the transferor and the transferee on transferred assets not readily obtainable in the marketplace would benefit the transferor and is likely to constrain a transferee in much the same manner. Judgment is necessary to assess constraint and benefit. For example, put options written to the transferee generally do not constrain it, but a put option on a not-readily-obtainable asset may benefit the transferor and effectively constrain the transferee if the option is sufficiently deep-in-the-money when it is written that it is probable that the transferee will exercise it and the transferor will reacquire the transferred asset. In contrast, a sufficiently out-of-the-money call option held by the transferor may not constrain a transferee if it is probable when the option is written that it will not be exercised. Freestanding rights to reacquire transferred assets that are readily obtainable presumptively do not constrain the transferee from exchanging or pledging them and thus do not preclude sale accounting under paragraph 5.

23. Other rights or obligations to reacquire transferred assets, regardless of whether they constrain the transferee, may result in the transferor's maintaining effective control over the transferred assets, as discussed in paragraphs 38-45, thus precluding sale accounting under paragraph 5.

Conditions That Constrain a Holder of Beneficial Interests in a Qualifying SPE

24. The considerations in paragraphs 19-23, about conditions that may or may not constrain a transferee that is not a qualifying SPE from pledging or exchanging the transferred assets, also extend to conditions that may or may not constrain a beneficial interest holder (BIH) from pledging or exchanging its beneficial interests in assets transferred to a qualifying SPE. For example, if BIHs agree to sell their beneficial interests in a qualifying SPE back to the transferor upon request at the price paid plus a stated return, that arrangement clearly conveys more than a trivial benefit to the transferor; sale accounting for the transfer to the qualifying SPE would be precluded if that agreement constrained a BIH from exchanging or pledging its beneficial interest.

Qualifying SPE

25. A qualifying SPE is a trust or other legal vehicle that meets all of the following conditions:

    a. It is demonstrably distinct from the transferor (paragraphs 26 and 27);

    b. Its permitted activities:

        i. Are significantly limited;

        ii. Were entirely specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds; and

        iii. May be significantly changed only with the approval of the holders of at least a majority of the beneficial interests held by entities other than any transferor, its affiliates, and its agents (paragraphs 28 and 29).

    c. It shall hold only:

        i. Financial assets transferred to it that are passive in nature (paragraph 30);

        ii. Passive derivative financial instruments that pertain to beneficial interests (other than another derivative financial instrument) issued or sold to parties other than the transferor, its affiliates, or its agents (paragraphs 30 and 31);

        iii. Financial assets (for example, guarantees or rights to collateral) that would reimburse it if others were to fail to adequately service financial assets transferred to it or to timely pay obligations due to it and that it entered into when it was established, when assets were transferred to it, or when beneficial interests (other than derivative financial instruments) were issued by the SPE;

        iv. Servicing rights related to financial assets that it holds;

        v. Temporarily, nonfinancial assets obtained in connection with the collection of financial assets that it holds (paragraph 32);

        vi. Cash collected from assets that it holds and investments purchased with that cash pending distribution to holders of beneficial interests that are appropriate for that purpose (that is, money-market or other relatively risk-free instruments without options and with maturities no later than the expected distribution date).

d. If it can sell or otherwise dispose of noncash financial assets, it can do so only in automatic response to one of the following conditions:

i. Occurrence of an event or circumstance that:

(a) Is specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds;

(b) Is outside the control of the transferor, its affiliates, or its agents; and

(c) Causes, or is expected at the date of transfer to cause, the fair value of those financial assets to decline by a specified degree below the fair value of those assets when the SPE obtained them (paragraphs 33 and 34.)

ii. Exercise by a BIH (other than the transferor, its affiliates, or its agents) of a right to put that holder's beneficial interest back to the SPE (paragraph 35);

iii. Exercise by the transferor of a call specified in the legal documents that established the SPE, transferred assets to the SPE, or created the beneficial interests in the transferred assets that it holds (paragraphs 41-45);

iv. Termination of the SPE or maturity of the beneficial interests in those financial assets on a fixed or determinable date that is specified at inception (paragraph 36).

Need to Be Demonstrably Distinct from the Transferor

26. A qualifying SPE is demonstrably distinct from the transferor only if it cannot be unilaterally dissolved by any transferor, its affiliates, or its agents and either:

a. At least 10 percent of the fair value of its beneficial interests is held by parties other than any transferor, its affiliates, or its agents; or

b. The transfer is a guaranteed mortgage securitization.

27. An ability to unilaterally dissolve an SPE can take many forms, including but not limited to holding sufficient beneficial interests to demand that the trustee dissolve the SPE, the right to call all the assets transferred to the SPE, and a right to call or a prepayment privilege on the beneficial interests held by other parties.

Limits on Permitted Activities

28. The powers of the SPE must be limited to those activities allowed by paragraph 25 for it to be a qualifying SPE. Many kinds of entities are not so limited. For example, any bank, insurance company, pension plan, or investment company has powers that cannot be sufficiently limited for it to be a qualifying SPE.

29. The BIHs other than any transferor, its affiliates, or its agents may have the ability to change the powers of a qualifying SPE. If the powers of a previously qualifying SPE are changed so that the SPE is no longer qualifying, unless the conditions in paragraph 5b. are then met by the SPE itself and the conditions in paragraphs 5a. and 5c. continue to be met, that change would bring the transferred assets held in the SPE back under the control of the transferor (paragraph 46).

Limits on What a Qualifying SPE May Hold

30. A financial asset or derivative financial instrument is passive only if holding the asset or instrument does not involve its holder in making decisions other than the decisions inherent in servicing. An equity instrument is not passive if the qualifying SPE can exercise the voting rights and is permitted to choose how to vote. Investments are not passive if through them, either in themselves or in combination with other investments or rights, the SPE or any related entity, such as the transferor, its affiliates, or its agents, is able to exercise control, as defined in *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities, A Replacement of SSAP No.* 88 (SSAP No. 97) over the investee. A derivative financial instrument is not passive if, for example, it includes an option allowing the SPE to choose to call or put other financial instruments that would allow it and its related entities to control 10% of more of the financial instruments issuer; but other derivative financial instruments can be passive, for example, interest rate caps and swaps and forward contracts. Derivative financial instruments that result in liabilities, like other liabilities of a qualifying SPE, are a kind of beneficial interest in the qualifying SPE's assets.

31. A derivative financial instrument pertains to beneficial interests (other than another derivative financial instrument) issued only if it:

    a. Is entered into:

        i. When the beneficial interests are issued by the qualifying SPE to parties other than the transferor, its affiliates, or its agents or sold to such other parties after being issued by the qualifying SPE to the transferor, its affiliates, or its agents; or

        ii. When a passive derivative financial instrument needs to be replaced upon occurrence of an event or circumstance (specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds) outside the control of the transferor, its affiliates, or its agents, for example, when the counterparty to the derivative defaults or is downgraded below a specified threshold.

    b. Has a notional amount that does not initially exceed the amount of those beneficial interests and is not expected to exceed them subsequently;

    c. Has characteristics that relate to, and partly or fully but not excessively counteract, some risk associated with those beneficial interests or the related transferred assets.

32. A qualifying SPE may hold nonfinancial assets other than servicing rights only temporarily and only if those nonfinancial assets result from collecting the transferred financial assets. For example, a qualifying SPE could be permitted to temporarily hold foreclosed nonfinancial collateral. In contrast, an entity cannot be a qualifying SPE if, for example, it receives from a transferor significant secured financial assets likely to default with the expectation that it will foreclose on and profitably manage the securing nonfinancial assets.

Limits on Sales or Other Dispositions of Assets

33. Examples of requirements to sell, exchange, put, or distribute (hereinafter referred to collectively as dispose of) noncash financial assets that are permitted activities of a qualifying SPE—because they respond automatically to the occurrence of an event or circumstance that:

    a. Is specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds;

b. Is outside the control of the transferor, its affiliates, or its agents; and

c. Causes, or is expected to cause, the fair value of those assets to decline by a specified degree below the fair value of those assets when the qualifying SPE obtained them include requirements to dispose of transferred assets in response to:

   i. A failure to properly service transferred assets that could result in the loss of a substantial third-party credit guarantee;

   ii. A default by the obligor;

   iii. A downgrade by a major rating agency of the transferred assets or of the underlying obligor to a rating below a specified minimum rating;

   iv. The involuntary insolvency of the transferor; or

   v. A decline in the fair value of the transferred assets to a specified value less than their fair value at the time they were transferred to the SPE.

34. The following are examples of powers or requirements to dispose of noncash financial assets that are not permitted activities of a qualifying SPE, because they do not respond automatically to the occurrence of a specified event or circumstance outside the control of the transferor, its affiliates, or its agents that causes, or is expected to cause, the fair value of those transferred assets to decline by a specified degree below the fair value of those assets when the SPE obtained them:

a. A power that allows an SPE to choose to either dispose of transferred assets or hold them in response to a default, a downgrade, a decline in fair value, or a servicing failure;

b. A requirement to dispose of marketable equity securities upon a specified decline from their “highest fair value” if that power could result in disposing of the asset in exchange for an amount that is more than the fair value of those assets at the time they were transferred to the SPE;

c. A requirement to dispose of transferred assets in response to the violation of a nonsubstantive contractual provision (that is, a provision for which there is not a sufficiently large disincentive to ensure performance).

35. A qualifying SPE may dispose of transferred assets automatically to the extent necessary to comply with the exercise by a BIH (other than the transferor, its affiliates, or its agents) of its right to put beneficial interests back to the SPE in exchange for:

a. A full or partial distribution of those assets;

b. Cash (which may require that the SPE dispose of those assets or issue beneficial interests to generate cash to fund settlement of the put);

c. New beneficial interests in those assets.

36. A qualifying SPE may have the power to dispose of assets to a party other than the transferor, its affiliate, or its agent on termination of the SPE or maturity of the beneficial interests, but only automatically on fixed or determinable dates that are specified at inception. For example, if an SPE is required to dispose of long-term mortgage loans and terminate itself at the earlier of (a) the specified maturity of beneficial interests in those mortgage loans or (b) the date of prepayment of a specified amount of the transferred mortgage loans, the termination date is a fixed or determinable date that was specified at inception. In contrast, if that SPE has the power to dispose of transferred assets on two

specified dates and the SPE can decide which transferred assets to sell on each date, the termination date is not a fixed or determinable date that was specified at inception.

Investments in Special-Purpose Entities

37. Reporting entities that have qualifying special-purpose entities as affiliates shall carry their investment in such entity at its underlying statutory book value in accordance with *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities, A Replacement of SSAP No. 88* (SSAP No. 97). Additionally, transactions entered involving affiliated qualifying special-purpose entities are subject to the provisions of SSAP No. 25.

Agreements That Maintain Effective Control Over Transferred Assets

38. An agreement that both entitles and obligates the transferor to repurchase or redeem transferred assets from the transferee maintains the transferor's effective control over those assets, and the transfer is therefore to be accounted for as a secured borrowing, if and only if all of the following conditions are met:

    a. The assets to be repurchased or redeemed are the same or substantially the same as those transferred (paragraph 39);

    b. The transferor is able to repurchase or redeem them on substantially the agreed terms, even in the event of default by the transferee (paragraph 40);

    c. The agreement is to repurchase or redeem them before maturity, at a fixed or determinable price; and

    d. The agreement is entered into concurrently with the transfer.

39. To be substantially the same, the asset that was transferred and the asset that is to be repurchased or redeemed need to have all of the following characteristics:

    a. The same primary obligor (except for debt guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and the terms of the guarantee must be the same);

    b. Identical form and type so as to provide the same risks and rights;

    c. The same maturity (or in the case of mortgage-backed pass-through and pay-through securities have similar remaining weighted-average maturities that result in approximately the same market yield);

    d. Identical contractual interest rates;

    e. Similar assets as collateral; and

    f. The same aggregate unpaid principal amount or principal amounts within accepted good delivery standards for the type of security involved.

40. To be able to repurchase or redeem assets on substantially all of the agreed terms, even in the event of default by the transferee, a transferor must at all times during the contract term have obtained cash or other collateral sufficient to fund substantially all of the cost of purchasing replacement assets from others.

Ability to Unilaterally Cause the Return of Specific Transferred Assets

41. Some rights to reacquire transferred assets (or to acquire beneficial interests in transferred assets held by a qualifying SPE), regardless of whether they constrain the transferee, may result in the transferor's maintaining effective control over the transferred

assets through the unilateral ability to cause the return of specific transferred assets. Such rights preclude sale accounting under paragraph 5. For example, an attached call in itself would not constrain a transferee who is able, by exchanging or pledging the asset subject to that call, to obtain substantially all of its economic benefits. An attached call could result, however, in the transferor's maintaining effective control over the transferred asset(s) because the attached call gives the transferor the ability to unilaterally cause whoever holds that specific asset to return it. In contrast, transfers of financial assets subject to calls embedded by the issuers of the financial instruments, for example, callable bonds or prepayable mortgage loans, do not preclude sale accounting. Such an embedded call does not result in the transferor's maintaining effective control, because it is the issuer rather than the transferor who holds the call.

42. If the transferee is a qualifying SPE, it has met the conditions in paragraph 25 and therefore must be constrained from choosing to exchange or pledge the transferred assets. In that circumstance, any call held by the transferor is effectively attached to the assets and could—depending on the price and other terms of the call—maintain the transferor's effective control over transferred assets through the ability to unilaterally cause the transferee to return specific assets. For example, a transferor's unilateral ability to cause a qualifying SPE to return to the transferor or otherwise dispose of specific transferred assets at will or, for example, in response to its decision to exit a market or a particular activity, could provide the transferor with effective control over the transferred assets.

43. A call that is attached to transferred assets maintains the transferor's effective control over those assets if, under its price and other terms, the call conveys more than a trivial benefit to the transferor. Similarly, any unilateral right to reclaim specific assets transferred to a qualifying SPE maintains the transferor's effective control over those assets if the right conveys more than a trivial benefit to the transferor. A call or other right conveys more than a trivial benefit if the price to be paid is fixed, determinable, or otherwise potentially advantageous, unless because that price is so far out of the money or for other reasons it is probable when the option is written that the transferor will not exercise it. Thus, for example, a call on specific assets transferred to a qualifying SPE at a price fixed at their principal amount maintains the transferor's effective control over the assets subject to that call. Effective control over transferred assets can be present even if the right to reclaim is indirect. For example, if an embedded call allows a transferor to buy back the beneficial interests of a qualifying SPE at a fixed price, then the transferor remains in effective control of the assets underlying those beneficial interests. A cleanup call, however, is permitted as an exception to that general principle.

44. A right to reclaim specific transferred assets by paying their fair value when reclaimed generally does not maintain effective control, because it does not convey a more than trivial benefit to the transferor. However, a transferor has maintained effective control if it has such a right and also holds the residual interest in the transferred assets. For example, if a transferor can reclaim such assets at termination of the qualifying SPE by purchasing them in an auction, and thus at what might appear to be fair value, then sale accounting for the assets it can reclaim would be precluded. Such circumstances provide the transferor with a more than trivial benefit and effective control over the assets; because it can pay any price it chooses in the auction and recover any excess paid over fair value through its residual interest.

45. A transferor that has a right to reacquire transferred assets from a qualifying SPE does not maintain effective control if the reclaimed assets would be randomly selected and the amount of the assets reacquired is sufficiently limited because that would not be a right to reacquire specific assets. Nor does a transferor maintain effective control through an obligation to reacquire transferred assets from a qualifying SPE if the transfer could occur only after a specified failure of the servicer to properly service the transferred assets that could result in the loss of a third-party guarantee (paragraph 33.c.i.) or only after a BIH other than the transferor, its affiliate, or its agent requires a qualifying SPE to repurchase

that beneficial interest (paragraph 35.b.), because the transferor could not cause that reacquisition unilaterally.

Changes That Result in the Transferor's Regaining Control of Assets Sold

46. A change in law, status of the transferee as a qualifying SPE, or other circumstance may result in the transferor's regaining control of assets previously accounted for appropriately as having been sold, because one or more of the conditions in paragraph 5 are no longer met. Such a change, unless it arises solely from either the initial application of this statement or a change in market prices (for example, an increase in price that moves into-the-money a freestanding call that was originally sufficiently out-of-the-money that it was judged not to constrain the transferee), is accounted for in the same manner as a purchase of the assets from the former transferee(s) in exchange for liabilities assumed (paragraph 7). After that change, the transferor recognizes in its financial statements those assets together with liabilities to the former transferee(s) or BIHs in those assets (paragraph 29). The transferor initially measures those assets and liabilities at fair value on the date of the change, as if the transferor purchased the assets and assumed the liabilities on that date. The former transferee would derecognize the assets on that date, as if it had sold the assets in exchange for a receivable from the transferor. Subsequent to that date, the reporting entity shall follow statutory accounting for the assets and liabilities in accordance with the guidance in the SSAPs.

Assets Obtained and Liabilities Incurred as Proceeds

47. The proceeds from a sale of financial assets consist of the cash and any other assets obtained, including separately recognized servicing assets, in the transfer less any liabilities incurred, including separately recognized servicing liabilities. Any asset obtained that is not an interest in the transferred asset is part of the proceeds from the sale. Any liability incurred, even if it is related to the transferred assets, is a reduction of the proceeds. Any derivative financial instrument entered into concurrently with a transfer of financial assets is either an asset obtained or a liability incurred and part of the proceeds received in the transfer. All proceeds and reductions of proceeds from a sale shall be initially measured at fair value.

Interests That Continue to be Held by a Transferor

48. Other interests in transferred assets, those that are not part of the proceeds of the transfer, are interests that continue to be held by a transferor over which the transferor has not relinquished control. They shall be measured at the date of the transfer by allocating the previous carrying amount between the assets sold, if any, and the interests that continue to be held by a transferor, based on their relative fair values. That procedure shall be applied to all transfers in which interests continue to be held by the transferor, even those that do not qualify as sales. Examples of interests that continue to be held by a transferor include securities backed by the transferred assets, undivided interests, and cash reserve accounts and residual interests in securitization trusts. If a transferor cannot determine whether an asset is an interest continued to be held or proceeds from the sale, the asset shall be treated as proceeds from the sale and accounted for in accordance with paragraph 47.

49. If the interests that continue to be held by a transferor are subordinated to more senior interests held by others, that subordination may concentrate into the interests that continue to be held by a transferor most of the risks inherent in the transferred assets and shall be taken into consideration in estimating the fair value of the interests that continue to be held by a transferor. For example, if the amount of the gain recognized, after allocation, on a securitization with a subordinated interest continued to be held is greater than the gain would have been had the entire asset been sold, the transferor needs to be able to identify why that can occur. Otherwise, it is likely that the impact of the interest continued to be held being subordinate to a senior interest has not been

adequately considered in the determination of the fair value of the subordinated interest continued to be held.

If It Is Not Practicable to Estimate Fair Values

50. If it is not practicable to estimate the fair values of assets, the transferor shall record those assets at an allocated cost basis of zero. If it is not practicable to estimate the fair values of liabilities, the transferor shall recognize no gain on the transaction and shall record those liabilities at the greater of:

    a. The excess, if any, of (i) the fair values of assets obtained less the fair values of other liabilities incurred, over (ii) the sum of the carrying values of the assets transferred;

    b. The amount that would be recognized in accordance with SSAP No. 5.

Securitizations

51. Financial assets such as mortgage loans are assets commonly transferred in securitizations. Securitizations of mortgage loans may include pools of single-family residential mortgages or other types of real estate mortgage loans, for example, multifamily residential mortgages and commercial property mortgages. Both financial and nonfinancial assets can be securitized; life insurance policy loans, patent and copyright royalties also have been securitized. Securitizations of nonfinancial assets are outside the scope of this statement.

52. An originator of a typical securitization (the transferor) transfers a portfolio of financial assets to an SPE, commonly a trust. In "pass-through" and "pay-through" securitizations, receivables are transferred to the SPE at the inception of the securitization, and no further transfers are made; all cash collections are paid to the holders of beneficial interests in the SPE. In "revolving-period" securitizations, receivables are transferred at the inception and also periodically (daily or monthly) thereafter for a defined period (commonly three to eight years), referred to as the revolving period. During the revolving period, the SPE uses most of the cash collections to purchase additional receivables from the transferor on prearranged terms.

53. Beneficial interests in the SPE are sold to investors and the proceeds are used to pay the transferor for the assets transferred. Those beneficial interests may comprise either a single class having equity characteristics or multiple classes of interests, some having debt characteristics and others having equity characteristics. The cash collected from the portfolio is distributed to the investors and others as specified by the legal documents that established the SPE.

54. Pass-through, pay-through, and revolving-period securitizations that meet the criteria in paragraph 5 qualify for sale accounting under this statement. All financial assets obtained or continued to be held and liabilities incurred by the originator of a securitization that qualifies as a sale shall be recognized and measured as provided in paragraph 7; that includes the implicit forward contract to sell new receivables during a revolving period, which may become valuable or onerous to the transferor as interest rates and other market conditions change.

Sales of Future Revenues

55. In addition to securitization of assets, some reporting entities have entered into transactions characterized as a sale of future revenues. These transactions are sometimes referred to as securitizations and are sometimes characterized as selling deferred acquisition costs. A sale of future revenues by a reporting entity shall not result in the immediate recognition of income or surplus. The proceeds of any such sale shall be established as a liability and shall be reduced as the proceeds are repaid.

Removal-of-Accounts Provisions

56. Many transfers of financial assets in securitizations empower the transferor to reclaim assets subject to certain restrictions. Such a power is sometimes called a removal-of-accounts provision (ROAP). If there is a ROAP, the transfer of assets shall not be accounted for as a sale.

Securities Lending Transactions

57. Securities lending transactions are generally initiated by broker-dealers and other financial institutions that need specific securities to cover a short sale or a customer's failure to deliver securities sold. Securities lending transactions typically extend less than one year. Transferees (borrowers) of securities generally are required to provide collateral to the transferor (lender) of securities, commonly cash but sometimes other securities or standby letters of credit, with a value slightly higher than that of the securities borrowed. If the collateral is cash, the transferor typically earns a return by investing that cash at rates higher than the rate paid or rebated to the transferee. If the collateral is other than cash, the transferor typically receives a fee. Securities custodians or other agents commonly carry out securities lending activities on behalf of clients. Because of the protection of collateral (typically valued daily and adjusted frequently for changes in the market price of the securities transferred) and the short terms of the transactions, most securities lending transactions in themselves do not impose significant credit risks on either party. Other risks arise from what the parties to the transaction do with the assets they receive. For example, investments made with cash collateral impose market and credit risks on the transferor.

58. Many securities lending transactions are accompanied by an agreement that entitles and obligates the transferor to repurchase or redeem the transferred assets before their maturity under which the transferor maintains effective control over those assets (paragraphs 38-40 maintain effective control criteria). Those transactions shall be accounted for as secured borrowings, in which cash (or securities that the holder or its agent is permitted by contract or custom to sell or repledge) received as collateral is considered the amount borrowed, the securities loaned are considered pledged as collateral against the cash or securities borrowed, and any rebate paid to the transferee of securities is interest on the cash or securities the transferor is considered to have borrowed.

59. If the criteria conditions in paragraph 5 are met, securities lending transactions shall be accounted for:

    a. By the transferor as a sale of the "loaned" securities, for proceeds consisting of the collateral[2] and a forward repurchase commitment; and

    b. By the transferee as a purchase of the "borrowed" securities in exchange for the collateral and a forward resale commitment. During the term of that agreement, the transferor has surrendered control over the securities transferred and the transferee has obtained control over those securities with the ability to sell or transfer them at will. In that case, creditors of the transferor have a claim only to the "collateral" and the forward repurchase commitment.

[2] If the "collateral" in a transaction that meets the criteria in paragraph 5 is a financial asset that the holder or its agent is permitted by contract or custom to sell or repledge, that financial asset is proceeds of the sale of the "loaned" securities. To the extent that the "collateral" consists of letters of credit or other financial instruments that the holder or its agent is not permitted by contract or custom to sell or repledge, a securities lending transaction does not satisfy the sale criteria and is accounted for as a loan of securities by the transferor to the transferee.

60. The transferor of securities being "loaned" accounts for collateral received in the same way whether the transfer is accounted for as a sale or a secured borrowing. The collateral received shall be recognized as the transferor's asset—as shall investments made with that collateral, even if made by agents or in pools with other securities lenders—along with the obligation to return the collateral. If securities that may be sold or repledged are received by the transferor or its agent, the transferor of the securities being "loaned" accounts for those securities in the same way as it would account for collateral received. Collateral which may be sold or repledged by the transferor or its agent is reflected on balance sheet, along with the obligation to return the asset[3]. Collateral received which may not be sold or repledged by the transferor or its agent is off balance sheet[4]. For collateral on the balance sheet, the reporting is determined by the administration of the program.

a. Securities lending programs where the collateral received by the reporting entity's unaffiliated agent that can be sold or repledged is reported on the balance sheet. The collateral received and reinvestment of that collateral by the reporting entity's unaffiliated agent shall be reflected as a one-line entry on the balance sheet (Securities Lending Collateral) and a detailed schedule will be required each quarter and at year-end to list the description of the collateral asset. This description shall include the NAIC rating, fair value; book adjusted carrying value and maturity date. A separate liability shall also be established to record the obligation to return the collateral (Collateral from Securities Lending Activities)

b. Securities lending programs where the collateral received by the reporting entity that can be sold or repledged is reported on the balance sheet. If the reporting entity is the administrator of the program, then, the collateral received and any reinvestment of that collateral is reported with the invested assets of the reporting entity based on the type of investment (i.e. bond, common stock, etc). A separate liability shall also be established to record the obligation to return the collateral (Collateral from Securities Lending Activities)

c. Securities lending programs where the collateral received by the reporting entity's affiliated agent can report using either one line reporting (paragraph 60 a. above) or investment schedule reporting (paragraph 60 b. above).

61. Reinvestment of the collateral by the reporting entity or its agent, shall follow the same impairment guidance as other similar invested assets reported on the balance sheet. Any fees received by the transferor for loaning the securities shall be recorded as miscellaneous investment income.

Securities Lending Transactions – Collateral Requirements

62. The reporting entity shall receive collateral having a fair value as of the transaction date at least equal to 102 percent of the fair value of the loaned securities at that date. If at any time the fair value of the collateral received from the counterparty is less than 100 percent of the fair value of the loaned securities, the counterparty shall be obligated to deliver additional collateral by the end of the next business day, the fair value of which, together with the fair value of all collateral then held in connection with the transaction at least equals 102 percent of the fair value of the loaned securities. If the collateral

[3] If cash is received by the transferor or its agent and reinvested or repledged it is reported on balance sheet. It is explicitly intended that when the lender bears reinvestment risk, that collateral is on balance sheet.

[4] An example of collateral which is off balance sheet is securities are received by the transferor or its agent in which the collateral must be held and returned, without the ability to transfer or repledge the collateral. This would involve limited situations in which the transferor or agent is prohibited from reinvesting the collateral.

received from the counterparty is less than 100 percent at the reporting date, the difference between the actual collateral and 100 percent will be nonadmitted. Collateral value is measured and compared to the loaned securities in aggregate by counterparty.

63. In the event that foreign securities are loaned and the denomination of the currency of the collateral is other than the denomination of the currency of the loaned foreign securities, the amount of collateral shall be at least equal to 105 percent of the fair value of the loaned securities at that date. If at any time the fair value of the collateral received from the counterparty is less than 102 percent of the fair value of the loaned securities, the reporting entity must obtain additional collateral by the end of the next business day, the fair value of which together with the fair value of all collateral then held in connection with the transaction at least equals 105 percent of the fair value of the loaned securities. If the collateral received from the counterparty is less than 100 percent at the reporting date, the difference between the actual collateral and 100 percent will be nonadmitted. Collateral value is measured and compared to the loaned securities in aggregate by counterparty.

Repurchase Agreements and "Wash Sales"

64. Government securities dealers, banks, other financial institutions, and corporate investors commonly use repurchase agreements to obtain or use short-term funds. Under those agreements, the transferor ("repo party") transfers a security to a transferee ("repo counterparty" or "reverse party") in exchange for cash[5] and concurrently agrees to reacquire that security at a future date for an amount equal to the cash exchanged plus a stipulated "interest" factor. Repurchase agreements, reverse repurchase agreements and dollar repurchase agreements meet the definition of assets as defined in *SSAP No. 4—Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this statement.

65. Repurchase agreements can be affected in a variety of ways. Some repurchase agreements are similar to securities lending transactions in that the transferee or its agent has the right to sell or repledge the securities to a third party during the term of the repurchase agreement. In other repurchase agreements, the transferee does not have the right to sell or repledge the securities during the term of the repurchase agreement. For example, in a tri-party repurchase agreement, the transferor transfers securities to an independent third-party custodian that holds the securities during the term of the repurchase agreement. Also, many repurchase agreements are for short terms, often overnight, or have indefinite terms that allow either party to terminate the arrangement on short notice. However, other repurchase agreements are for longer terms, sometimes until the maturity of the transferred asset. Some repurchase agreements call for repurchase of securities that need not be identical to the securities transferred.

66. If the conditions in paragraph 5 are met, including the criterion in paragraph 5c., the transferor shall account for the repurchase agreement as a sale of financial assets and a forward repurchase commitment, and the transferee shall account for the agreement as a purchase of financial assets and a forward resale commitment. Other transfers that are accompanied by an agreement to repurchase the transferred assets that shall be accounted for as sales include transfers with agreements to repurchase at maturity and transfers with repurchase agreements in which the transferee has not obtained collateral sufficient to fund substantially all of the cost of purchasing replacement assets. (Repurchase financing is addressed in paragraphs 73-78.)

67. Furthermore, "wash sales" that previously were not recognized if the same financial asset was purchased within 30 days before or after the sale shall be accounted for as sales

[5] Instead of cash, other securities or letters of credit sometimes are exchanged. Those transactions are accounted for in the same manner as securities lending transactions (paragraphs 82-87).

under this statement. Unless there is a concurrent contract to repurchase or redeem the transferred financial assets from the transferee, the transferor does not maintain effective control over the transferred assets.

68. As with securities lending transactions, under many agreements to repurchase transferred assets before their maturity the transferor maintains effective control over those assets. Repurchase agreements that do not meet all the criteria in paragraph 5 shall be treated as secured borrowings. Fixed-coupon and dollar-roll repurchase agreements, and other contracts under which the securities to be repurchased need not be the same as the securities sold, qualify as borrowings if the return of substantially the same (paragraph 39 substantially the same criteria) securities as those concurrently transferred is assured. Therefore, those transactions shall be accounted for as secured borrowings by both parties to the transfer.

69. If a transferor has transferred securities to an independent third-party custodian, or to a transferee, under conditions that preclude the transferee from selling or repledging the assets during the term of the repurchase agreement (as in most tri-party repurchase agreements), the transferor has not surrendered control over those assets.

Repurchase Agreements

70. Repurchase agreements are defined as agreements under which a reporting entity sells securities and simultaneously agrees to repurchase the same or substantially the same securities at a stated price on a specified date. For securities to be substantially the same, the criteria defined in paragraph 39 (substantially the same criteria) must be met, and for mortgage-backed securities excluding mortgage pass-through securities, the projected cash flows of the securities must be substantially the same under multiple scenario prepayment assumptions.

71. For repurchase agreements that are accounted for as collateralized borrowings in accordance with paragraph 68 of this statement, the underlying securities shall continue to be accounted for as an investment owned by the reporting entity. The proceeds from the sale of the securities shall be recorded as a liability, and the difference between the proceeds and the amount at which the securities will be subsequently reacquired shall be reported as interest expense, calculated on the straight-line method or the scientific interest (constant yield) method, over the term of the agreement.

72. Reporting entities generally take possession of the underlying collateral under repurchase agreements and in many cases may obtain additional collateral when the estimated fair value of such securities falls below their current contract value. However, to the extent that the current fair value of the collateral is less than the recorded amount, the shortfall shall reduce the admitted asset value of the repurchase agreement.

Repurchase Financing

73. Repurchase financing is a repurchase agreement that relates to a previously transferred financial asset between the same counterparties (or affiliates of either counterparty) that is entered into contemporaneously with, or in contemplation of, the initial transfer.

74. A repurchase financing involves the transfer of a previously transferred financial asset back to the initial transferor as collateral for a financing between the initial transferee (the borrower) and the initial transferor (the lendor). A repurchase financing also typically involves the initial transferor returning the transferred financial asset (or substantially the same asset) to the initial transferee when the financing is repaid on a state date. A repurchase financing is entered into in contemplation of the initial transfer if both transactions are considered together at the execution of the initial transfer.

75. When the transferor transfers a financial asset and also enters into a repurchase financing with the transferee, there are typically three transfers of the financial assets:

a. Initial transfer – An initial transferor transfers a financial asset to an initial transferee.

b. Repurchase financing – The initial transferee (the borrower) transfer the previously transferred financial asset back to the initial transferor (the lender) as collateral for a financing between the initial transferor and initial transferee.

c. Settlement – The initial transferor (the lender) returns the financial asset (or substantially the same asset) to the initial transferee (the borrower) upon receipt of payment from the initial transferee.

76. Repurchase financing that is entered into contemporaneously with, or in contemplation of, an initial transfer of a financial asset between the same counterparties (or affiliates of either counterparty) shall not be separately accounted for as a transfer of a financial asset and a related repurchase financing unless (a) the two transactions have a valid and distinct business or economic purpose for being entered into separately and (b) the repurchase financing does not result in the initial transferor regaining control over the financial asset. Unless the provisions in paragraphs 77 are met, the initial transfer and repurchase financing shall be evaluated as a linked transaction. The linked transaction shall be evaluated to determine whether it meets the requirements for sale accounting per paragraph 5 including paragraph 5.c. If the linked transaction does not meet the requirements for sale accounting, the linked transaction shall be accounted for based on the economies of the combined transactions, which generally represent a forward contract. *SSAP No. 86—Accounting for Derivative Instruments and Hedging, Income Generation, and Replication (Synthetic Asset) Transactions* shall be used to evaluate whether the linked transaction shall be accounted for as a derivative.

77. An initial transfer of a financial asset and repurchase financing that are entered into contemporaneously with, or in contemplation of, one another shall be considered linked unless all of the following criteria are met at the inception of the transaction:

a. The initial transfer and the repurchase financing are not contractually contingent on one another. Even if no contractual relationship exists, the pricing and performance of either the initial transfer or the repurchase financing must not be dependent on the terms and execution of the other transaction.

b. The repurchase financing provides the initial transferor with recourse to the initial transferee upon default. That recourse must expose the initial transferor to the credit risk of the initial transferee, or its affiliates, and not solely to the market risk of the transferred financial asset. The initial transferee's agreement to repurchase the previously transferred financial asset (or substantially the same asset) for a fixed price and not fair value.

c. The financial asset subject to the initial transfer and repurchase financing is readily obtainable in the marketplace. In addition, the initial transfer of a financial asset and the repurchase financing are executed at market rates. This criterion may not be circumvented by embedding off-market terms in a separate transaction contemplated with the initial transfer or the repurchase financing.

d. The financial asset and repurchase agreement are not coterminous (the maturity of the repurchase financing must be before the maturity of the financial asset.)

78. In accordance with paragraph 77, an initial transfer of assets and a repurchase financing shall not be considered separate transactions unless the provisions of paragraph 78, are met. If the provisions of paragraph 77 are met, the initial transfer shall be evaluated to determine whether it meets the requirements for sale accounting without taking into consideration the repurchase financing. In such situations, the repurchase financing shall then be separately analyzed as a repurchase agreement.

Reverse Repurchase Agreements

79. Reverse repurchase agreements are defined as agreements under which a reporting entity purchases securities and simultaneously agrees to resell the same or substantially the same securities at a stated price on a specified date. For securities to be substantially the same, the criteria defined in paragraph 39 (substantially the same criteria) must be met, and for mortgage-backed securities excluding mortgage pass-through securities, the projected cash flows of the securities must be substantially the same under multiple scenario prepayment assumptions.

80. For reverse repurchase agreements that are accounted for as collateralized lendings in accordance with paragraph 68 of this statement, the underlying securities shall not be accounted for as investments owned by the reporting entity. The amount paid for the securities shall be reported as a short-term investment, and the difference between the amount paid and the amount at which the securities will be subsequently resold shall be reported as interest income, calculated on the straight-line method or the scientific interest (constant yield) method, over the term of the agreement.

Collateral Requirements

81. The collateral requirements for repurchase and reverse repurchase agreements are as follows:

Repurchase Transaction

a. The reporting entity shall receive collateral having a fair value as of the transaction date at least equal to 95 percent of the fair value of the securities transferred by the reporting entity in the transaction as of that date. If at anytime the fair value of the collateral received from the counterparty is less than 95 percent of the fair value of the securities so transferred, the counterparty shall be obligated to deliver additional collateral by the end of the next business day the fair value of which, together with the fair value of all collateral then held in connection with the transaction, at least equals 95 percent of the fair value of the transferred securities. If the collateral is less than 95 percent at the reporting date, the difference between the actual collateral and 95 percent will be nonadmitted.

Reverse Repurchase Transaction

b. The reporting entity shall receive as collateral transferred securities having a fair value at least equal to 102 percent of the purchase price paid by the reporting entity for the securities. If at any time the fair value of the collateral is less than 100 percent of the purchase price paid by the reporting entity, the counterparty shall be obligated to provide additional collateral, the fair value of which, together with fair value of all collateral then held in connection with the transaction, at least equals 102 percent of the purchase price. Dollar Repurchase Agreements

82. Dollar repurchase and dollar reverse repurchase agreements are defined as repurchase and reverse repurchase agreements involving debt instruments that are pay-through securities collateralized with Government National Mortgage Association (GNMA), Federal Home Loan Mortgage Corporation (FHLMC) and Federal National Mortgage Association (FNMA) collateral, and pass-through certificates sponsored by GNMA, mortgage participation certificates issued by the FHLMC or similar securities issued by the FNMA. Dollar repurchase agreements are also commonly referred to as dollar roll transactions. To meet the definition of dollar repurchase and dollar reverse repurchase agreements, the securities underlying the agreements must meet the criteria defined in paragraph 39, and for mortgage-backed securities excluding mortgage pass-through securities, the projected cash flows of the securities must be substantially the same under multiple scenario prepayment assumptions.

83. For the seller in a dollar reverse repurchase agreement accounted for as collateralized borrowing in accordance with paragraph 68 of this statement, a liability is recorded for the amount of proceeds of the sale and the sold mortgage-backed securities are not removed from the accounting records. During the period of the agreement, interest income is recorded as if the mortgage-backed security had been held during the term of the agreement. This is offset by an equal amount of interest expense related to the proceeds received from the sale. Additional interest expense is recorded representing the difference between the sales price and the repurchase price of the mortgage-backed securities sold.

84. When the mortgage-backed securities are repurchased under the agreement, the original mortgage-backed securities sold are removed from the accounting records and the purchased mortgage-backed securities are recorded. The principal amount of the mortgage-backed securities repurchased must be in good delivery form consistent with paragraph 39.

85. If the principal amount repurchased is greater than the amount sold, the cash paid is recorded as an additional investment in the newly acquired certificates. If the principal amount repurchased is less than the amount sold, a gain or loss relating to the original certificates held is recorded.

86. For the purchaser in a dollar repurchase agreement accounted for as collateralized lending in accordance with paragraph 68 of this statement, an asset is recorded for the amount of the purchase. Upon completion of the reverse repurchase agreement, cash is received in exchange for a "substantially the same" security. The difference between the purchase and reselling price represents interest income for the lending of short-term funds.

Separate Transactions

87. Agreements to repurchase and resell securities that do not meet the definitions in paragraphs 58 and 64 of this statement shall be accounted for as two separate transactions, that is, as a sale and purchase or as a purchase and sale, in accordance with the relevant statutory accounting guidance. For example, sales of bonds would result in recognition of realized gains or losses.

Offsetting

88. Reporting entities may operate on both sides of the repurchase agreement market resulting in recording of liabilities and assets representing repurchase and reverse repurchase agreements, respectively.

89. Reporting entities shall offset such liabilities and assets only to the extent that one of the following occurs:

a. A legal right of offset exists as defined in *SSAP No. 64—Offsetting and Netting of Assets and Liabilities*; or

b. The securities have the same settlement date, are executed with the same counterparty in accordance with a master netting arrangement, involve securities that exist in "book entry" form, and settle on securities transfer systems that have the same key elements and operating characteristics as the Fedwire Securities Transfer System.

90. Otherwise, separate assets and liabilities shall be recognized.

Loan Syndications

91. Borrowers often borrow amounts greater than any one lender is willing to lend. Therefore, it is common for groups of lenders to jointly fund those loans. That may be accomplished by a syndication under which several lenders share in lending to a single borrower, but each lender loans a specific amount to the borrower and has the right to repayment from the borrower.

92. A loan syndication is not a transfer of financial assets. Each lender in the syndication shall account for the amounts it is owed by the borrower. Repayments by the borrower may be made to a lead lender who then distributes the collections to the other lenders of the syndicate. In those circumstances, the lead lender is also functioning as a servicer and, therefore, shall only recognize its portion of the loan as an asset.

Loan Participations

93. Groups of banks or other entities also may jointly fund large borrowings through loan participations in which a single lender makes a large loan to a borrower and subsequently transfers undivided interests in the loan to other entities.

94. Transfers by the originating lender may take the legal form of either assignments or participations. The transfers are usually on a nonrecourse basis, and the transferor (originating lender) continues to service the loan. The transferee (participating entity) may or may not have the right to sell or transfer its participation during the term of the loan, depending upon the terms of the participation agreement.

95. If the loan participation agreement gives the transferee the right to pledge or exchange those participations and the other criteria in paragraph 5 are met, the transfers to the transferee shall be accounted for by the transferor as sales of financial assets. A transferor’s right of first refusal on a bona fide offer from a third party, a requirement to obtain the transferor’s permission that shall not be unreasonably withheld, or a prohibition on sale to the transferor’s competitor is a limitation on the transferee’s rights but presumptively does not constrain a transferee from exercising its right to pledge or exchange. However, if the loan participation agreement constrains the transferees from pledging or exchanging their participations, the transferor has not relinquished control over the loan and shall account for the transfers as secured borrowings.

Factoring Arrangements

96. Factoring arrangements are a means of discounting accounts receivable on a nonrecourse, notification basis. Accounts receivable are sold outright, usually to a transferee (the factor) that assumes the full risk of collection, without recourse to the transferor in the event of a loss. Debtors are directed to send payments to the transferee. Factoring arrangements that meet the criteria in paragraph 5 shall be accounted for as sales of financial assets because the transferor surrenders control over the receivables to the factor.

Transfers of Receivables with Recourse

97. In a transfer of receivables with recourse, the transferor is obligated under the terms of the recourse provision to make payments to the transferee or to repurchase receivables sold under certain circumstances, typically for defaults up to a specified percentage. A transfer of receivables with recourse shall not be recognized as a sale but rather, as a financing. A transfer of receivables without recourse shall only be recognized if the transferor receives cash for the receivables. The sale shall be recognized when cash is received. Sales of premium receivables are addressed in *SSAP No. 42—Sale of Premium Receivables*.

Disclosures

98. A reporting entity shall disclose the following:

a. For collateral:

i. If the entity has entered into repurchase agreements or securities lending transactions, its policy for requiring collateral or other security and the fair value of the loaned security. This would also apply to separate accounts;

ii. If the entity has pledged any of its assets as collateral, the carrying amount and classification of those assets as of the date of the latest statement of financial position presented;

iii. If the entity or its agent has accepted collateral that it is permitted by contract or custom to sell or repledge it shall be recorded on the balance sheet. Regardless of whether the transaction is considered "on-balance sheet" or "off-balance sheet", the reporting entity shall provide the following information by type of program (repurchase agreement securities lending or dollar repurchase agreement) as of the date of each statement of financial position: (1) the aggregate amount of contractually obligated open collateral positions (aggregate amount of securities at current fair value or cash received for which the borrower may request the return of on demand) and the aggregate amount of contractually obligated collateral positions under 30-day, 60-day, 90-day, and greater than 90-day terms, (2) the aggregate fair value of all securities acquired from the sale, trade and use of the accepted collateral (reinvested collateral), and (3) information about the sources and uses of that collateral;

iv. For securities lending transactions, disclose collateral for transactions that extend beyond one year from the reporting date;

v. For securities lending transactions administered by an affiliated agent in which "one-line" reporting (per paragraph 60.a) of the reinvested collateral per paragraph 60.c. is optional, at the discretion of the reporting entity, disclose the aggregate value of the reinvested collateral which is "one line" reported and the aggregate value of items which are reported in the investment schedules (per paragraph 60.b). Identify the rational between the items which are one line reported and those that are investment schedule reported and if the treatment has changed from the prior period and

vi. Include separately, the amount of any loaned securities within the separate account and if the policy and procedures for the separate account differ from the general account.

b. The reporting entity shall provide the following information by type of program (repurchase agreement, securities lending or dollar repurchase agreement) with respect to the reinvestment of the cash collateral and any securities which it or its agent receives as collateral that can be sold or repledged.

i. The aggregate amount of the reinvested cash collateral (amortized cost and fair value). Reinvested cash collateral shall be broken down by the maturity date of the invested asset – under 30-day, 60-day, 90-day, 120-day, 180-day, less than 1 year, 1-2 years, 2-3 years and greater than 3 years.

ii. To the extent that the maturity dates of the liability (collateral to be returned) does not match the invested assets, the reporting entity shall explain the additional sources of liquidity to manage those mismatches.

c. If debt was considered to be extinguished by in-substance defeasance, a general description of the transaction and the amount of debt that is considered extinguished at the end of the period so long as that debt remains outstanding;

d. If assets are set aside solely for satisfying scheduled payments of a specific obligation, a description of the nature of restrictions placed on those assets;

e. If it is not practicable to estimate the fair value of certain assets obtained or liabilities incurred in transfers of financial assets during the period, a description of those items and the reasons why it is not practicable to estimate their fair value;

f. For all servicing assets and servicing liabilities:

i. A description of the valuation techniques or other models, including significant assumptions within models, used to estimate the fair value of servicing assets and servicing liabilities; and

ii. Changes in fair value resulting from changes in valuation inputs or assumptions used in models and descriptions of other changes in fair value.

g. If the entity has securitized financial assets during any period presented and accounts for that transfer as a sale, for each major asset type (for example, mortgage loans):

i. Its accounting policies for initially measuring the interests that continue to be held by a transferor, if any, used in determining their fair value. (Fair value shall be determined in accordance with *SSAP No. 100—Fair Value Measurements*.); and

ii. The characteristics of securitizations (a description of the transferor’s continuing involvement with the transferred assets, including, but not limited to, servicing, recourse, and restrictions on interests that continue to be held by a transferor) and the gain or loss from sale of financial assets in securitizations;

iii. The key assumptions used in measuring the fair value of interests that continue to be held by a transferor at the time of securitization (including, at a minimum, quantitative information about discount rates, expected prepayments including the expected weighted-average life of prepayable financial assets, and anticipated credit losses, if applicable); and

iv. Cash flows between the securitization SPE and the transferor (including proceeds from new securitizations, purchases of delinquent or foreclosed loans, servicing fees, and cash flows received on interests continued to be held.)

h. If the entity has interests that continue to be held by a transferor in securitized financial assets at the date of the latest statement of financial position presented, for each major asset type (for example, mortgage loans):

i. Its accounting policies for subsequently measuring those interests that continue to be held by a transferor, including the methodology used in determining their fair value. (Fair value shall be determined in accordance with *SSAP No. 100—Fair Value Measurements*.);

ii. The key assumptions used in subsequently measuring the fair value of those interests (including, at a minimum, quantitative information about discount rates, expected prepayments including the expected weighted-average life of prepayable financial assets, and anticipated credit losses, including expected static pool losses, if applicable);

iii. A sensitivity analysis or stress test showing the hypothetical effect on the fair value of those interests of two or more unfavorable variations from the expected levels for each key assumption that is reported under ii. above independently from any change in another key assumption, and a description of the objectives, methodology, and limitations of the sensitivity analysis or stress test; and

iv. For the securitized assets and any other financial assets that the entity manages together with the interests that continue to be held by the transferor[6]:

(a) The total principal amount outstanding, the portion that has been derecognized, and the portion that continues to be recognized in each category reported in the statement of financial position, at the end of the period;

(b) Delinquencies at the end of the period; and

(c) Credit losses, net of recoveries, during the period.

v. Disclosure of average balances during the period is encouraged, but not required.

i. Description of any loaned securities, including the amount, a description of, and the policy for, requiring collateral, and whether or not the collateral is restricted;

j. A description of the securities underlying repurchase and reverse repurchase agreements, dollar repurchase and dollar reverse repurchase agreements, including book values and fair values, maturities, and weighted average interest rates for the following categories: (i) securities subject to reverse repurchase agreements; (ii) securities subject to repurchase agreements; (iii) securities subject to dollar repurchase agreements; and (iv) securities subject to dollar reverse repurchase agreements; and

k. A description of the terms of reverse repurchase agreements whose amounts are included in borrowed money.

99. Disclose any transfers of receivables with recourse.

100. A reporting entity shall disclose the following information for wash sales, as defined in paragraph 9 above, involving transactions for securities with a NAIC designation of 3 or below, or unrated:

a. A description of the reporting entity’s objectives regarding these transactions;

b. An aggregation of transactions by NAIC designation 3 or below, or unrated;

[6] Excluding securitized assets that an entity continues to service but with which it has no other continuing involvement.

c. The number of transactions involved during the reporting period;

d. The book value of securities sold;

e. The cost of securities repurchased; and

f. The realized gains/losses associated with the securities involved.

101. Refer to the preamble for further discussion regarding disclosure requirements. The disclosures required by paragraph 100 above (wash sales) shall be made for the current quarter in the quarterly statement and for the year in the annual statement.

Relevant Literature

102. The accounting guidance in this statement is consistent with the guidance included in SSAP No. 18, SSAP No. 33 and SSAP No. 45, and is expanded to include issues addressed in *FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 140).

103. This statement adopts FAS 140 with the following modifications:

a. Servicing rights assets are nonadmitted;

b. Sales treatment is not permitted for transactions including recourse provisions or removal-of-accounts provisions on the transferred assets whereas GAAP would permit the recognition of the transfer as a sale under some circumstances;

c. As statutory financial statements are prepared on a legal entity basis, special purpose entities shall not be consolidated in a reporting entity's statutory financial statements;

d. Leases shall be accounted for in accordance with *SSAP No. 22—Leases*;

e. Reporting entities required to maintain an IMR shall account for realized and unrealized capital gains and losses in accordance with SSAP No. 7; and

f. The concepts of revolving-period securitizations, banker's acceptances and risk participations in banker's acceptances are not applicable for statutory accounting purposes.

g. This statement does not adopt the accounting for collateral as outlined in FAS 140.

104. This statement adopts with modification *FASB Statement No. 156: Accounting for Servicing of Financial Assets, an amendment of FASB Statement No. 140* (FAS 156). Specific items adopted or rejected are identified below. Items within FAS 156 not specifically noted as adopted shall be considered rejected:

a. This statement adopts FAS 156 guidance indicating that all servicing assets and servicing liabilities should initially be measured at fair value.

b. This statement adopts FAS 156 guidance requiring the inclusion of separately recognized servicing assets and servicing liabilities in the calculation of proceeds from the sale of assets.

c. This statement rejects the optionality provided within FAS 156 for subsequent measurement of servicing assets and servicing liabilities using either fair value or an amortization method. This statement requires application of a fair value method for subsequent measurement.

d. This statement adopts guidance in FAS 156 confirming adoption of guidance previously adopted from FAS 140 regarding servicing assets and servicing liabilities established from the transfer of financial assets to a qualifying SPE in a guaranteed mortgage securitization in which the transferor retains all of the resulting securities.

e. This statement adopts revisions in FAS 156 replacing the term 'retained interests' with 'interests that continue to be held by the transferor' with amendments to the definition to exclude servicing assets and servicing liabilities from this definition.

105. This statement adopts *FASB Staff Position 140-3, Accounting for Transfers of Financial Assets and Repurchase Financing Transactions* (FSP FAS 140-3) and *AICPA Statement of Position 90-3*, *Definition of the Term Substantially the Same for Holders of Debt Instruments, as used In Certain Audit Guides and a Statement of Position*. This statement adopts *FASB Emerging Issues Task Force (EITF) No. 87-34, Sale of Mortgage Servicing Rights with a Subservicing Agreement, FASB EITF No. 88-11, Allocation of Recorded Investment When a Loan as Part of a Loan is Sold, FASB EITF No. 88-18, Sales of Future Revenues, FASB EITF No. 88-22, Securitization of Credit Card and Other Receivable Portfolios, FASB EITF No. 90-21, Balance Sheet Treatment of a Sale of Mortgage Servicing Rights with a Subservicing Agreement, FASB EITF No. 95-5, Determination of What Risks and Rewards, If Any, Can Be Retained and Whether Any Unresolved Contingencies May Exist in a Sale of Mortgage Loan Servicing Rights* and *FASB EITF No. 96-19, Debtor's Accounting for a Modification or Exchange of Debt Instruments*.

106. This statement rejects *FASB EITF No. 84-5, Sale of Marketable Securities with a Put Option*, and *FASB EITF No. 92-2, Measuring Loss Accruals by Transferors of Receivables with Recourse* and *FTB 01-1: Effective Date for Certain Financial Institutions of Certain Provisions of Statement 140 related to Isolation of Transferred Financial Assets*.

Effective Date and Transition

107. This statement is effective for years beginning on and after January 1, 2005 and shall be applied prospectively. Substantive revisions in paragraphs 6, 11-12, 98f, 104 and Exhibit B illustrations are effective January 1, 2009. Substantive revisions in paragraphs 13, 14, 57-81, 98-101 regarding securities lending transactions and repurchase agreements and additional disclosures were adopted in May 2010 and are effective December 31, 2010. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*.

108. For each servicing contract in existence before January 1, 2005, previously recognized or nonadmitted servicing rights and excess servicing receivables shall be combined, net of any previously recognized servicing obligations under that contract, as a servicing asset (nonadmitted) or liability. Thereafter, the subsequent measurement provisions of this statement shall be applied to the servicing assets (nonadmitted) or liabilities for those servicing contracts.

AUTHORITATIVE LITERATURE

Statutory Accounting

- *SSAP No. 18—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*

- *SSAP No. 33—Securitization*

- *SSAP No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements*
- *Purposes and Procedures Manual of the NAIC Securities Valuation Office*
- *Issue Paper No. 134—Servicing Assets/Liabilities, An Amendment of SSAP No. 91*

Generally Accepted Accounting Principles

- *FASB Statement No. 156, Accounting for Servicing of Financial Assets, an amendment of FASB Statement No. 140*
- *FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
- *FASB Staff Position 140-3, Accounting for Transfers of Financial Assets and Repurchase Financing Transactions*
- *AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as used In Certain Audit Guides and a Statement of Position*
- *FASB Emerging Issues Task Force No. 87-34, Sale of Mortgage Servicing Rights with a Subservicing Agreement*
- *FASB Emerging Issues Task Force No. 88-11, Allocation of Recorded Investment When a Loan as Part of a Loan is Sold*
- *FASB Emerging Issues Task Force No. 88-18, Sales of Future Revenues*
- *FASB Emerging Issues Task Force No. 88-22, Securitization of Credit Card and Other Receivable Portfolios*
- *FASB Emerging Issues Task Force No. 90-21, Balance Sheet Treatment of a Sale of Mortgage Servicing Rights with a Subservicing Agreement*
- *FASB Emerging Issues Task Force No. 95-5, Determination of What Risks and Rewards, If Any, Can Be Retained and Whether Any Unresolved Contingencies May Exist in a Sale of Mortgage Loan Servicing Rights*
- *FASB Emerging Issues Task Force No. 96-19, Debtor's Accounting for a Modification or Exchange of Debt Instruments*

RELEVANT ISSUE PAPERS

- *Issue Paper* No. *122—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
- *Issue Paper* No. *134—Servicing Assets/Liabilities, An Amendment of SSAP No. 91*
- *Issue* Paper *No. 144—Substantive Revisions to SSAP No. 91R—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities - Revised*

EXHIBIT A - GLOSSARY

Asset Securitization

An asset securitization is the process of converting assets which would normally serve as collateral for a loan into securities. The largest category of securitized assets is real estate mortgage loans, which serve as collateral for mortgage-backed securities.

Beneficial Interests

Rights to receive all or portions of specified cash inflows to a trust or other entity, including senior and subordinated shares of interest, principal, or other cash inflows to be passed-through or paid-through, premiums due to guarantors, commercial paper obligations and residual interests, whether in the form of debt or equity.

Beneficial Interest Holder ("BIH")

Holder of beneficial interests

Cleanup Call

An option held by the servicer, which may be the transferor, to purchase transferred financial assets, or the remaining beneficial interests not held by the transferor, its affiliates, or its agents in a qualifying SPE (or in a series of beneficial interests in transferred assets within a qualifying SPE), when the amount of outstanding assets falls to a level at which the cost of servicing those assets becomes burdensome in relation to the benefits or servicing.

Collateral

Personal or real property in which a security interest has been given.

Derecognize

Remove previously recognized assets or liabilities from the balance sheet.

Derivative Financial Instrument

A derivative instrument (as defined in *SSAP No. 86—Accounting for Derivative Instruments and Hedging, Income Generation, and Replication (Synthetic Asset) Transactions*) that is a financial instrument (refer to *SSAP No. 27—Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, paragraph 2).

Embedded Call (See paragraphs 41 and 43)

A call option held by the issuer of a financial instrument that is part of and trades with the underlying instrument. For example, a bond may allow the issuer to call it by posting a public notice well before its stated maturity that asks the current holder to submit it for early redemption and provides that interest ceases to accrue on the bond after the early redemption date. Rather than being an obligation of the initial purchaser of the bond, an embedded call trades with and diminishes the value of the underlying bond.

Financial Asset

Cash, evidence of an ownership interest in an entity, or a contract that conveys to a second entity a contractual right (a) to receive cash or another financial instrument from a first entity or (b) to exchange other financial instruments on potentially favorable terms with the first entity.

Financial Liability

A contract that imposes on one entity a contractual obligation (a) to deliver cash or another financial instrument to a second entity or (b) to exchange other financial instruments on potentially unfavorable terms with the second entity.

Guaranteed Mortgage Securitization

A securitization of mortgage loans which includes a substantive guarantee by a third party.

Interests that Continue to be Held by a Transferor

Other interests in transferred assets, those that are not part of the proceeds of the transfer, over which the transferor has not relinquished control. Includes securities backed by the transferred assets, undivided interests, and cash reserve accounts and residual interests in securitization trusts.

Proceeds

Cash, derivatives, or other assets that are obtained in a transfer of financial assets, less any liabilities incurred.

Recourse

The right of a transferee of receivables to receive payment from the transferor of those receivables for (a) failure of debtors to pay when due, (b) the effects of prepayments, or (c) adjustments resulting from defects in the eligibility of the transferred receivables.

Residual

Residuals are a class of purchased beneficial interests or interests that continue to be held by the transferor that have rights to the last cash flows from the pool of securitized assets and are not rated by a Nationally Recognized Statistical Rating Organization (NRSRO). Residuals are to be carried at fair value with the difference between fair value and the allocated cost basis recognized as an unrealized gain or loss;

Securitization

The process by which financial assets are transformed into securities.

Security Interest

A form of interest in property that provides that upon default of the obligation for which the security interest is given, the property may be sold in order to satisfy that obligation.

Seller

A transferor that relinquishes control over financial assets by transferring them to a transferee in exchange for consideration.

Servicing Asset

A contract to service financial assets under which the estimated future revenues from contractually specified servicing fees, late charges, and other ancillary revenues are expected to more than adequately compensate the servicer for performing the servicing. A servicing contract is either (a) undertaken in conjunction with selling or securitizing the financial assets being serviced or (b) purchased or assumed separately.

Servicing Liability

A contract to service financial assets under which the estimated future revenues from stated servicing fees, late charges, and other ancillary revenues are not expected to adequately compensate the servicer for performing the servicing.

Transfer

The conveyance of a noncash financial asset by and to someone other than the issuer of that financial asset. Thus, a transfer includes selling a receivable, putting it into a securitization trust, or posting it as collateral but excludes the origination of that receivable, the settlement of that receivable, or the restructuring of that receivable into a security in a troubled debt restructuring.

Transferee

An entity that receives a financial asset, a portion of a financial asset, or a group of financial assets from a transferor.

Transferor

An entity that transfers a financial asset, a portion of a financial asset, or a group of financial assets that it controls to another entity.

Undivided Interest

Partial legal or beneficial ownership of an asset as a tenant in common with others. The proportion owned may be pro rata, for example, the right to receive 50 percent of all cash flows from a security, or non-pro rata, for example, the right to receive the interest from a security while another has the right to the principal.

Unilateral Ability (See paragraphs 41 and 42)

A capacity for action not dependent on the actions (or failure to act) of any other party.

EXHIBIT B – ILLUSTRATIONS

Illustration—Recording Transfers with Proceeds of Cash, Derivatives, and Other Liabilities

1. Company A sells loans with a fair value of $1,100 and a carrying amount of $1,000. Company A retains no servicing responsibilities but obtains an option to purchase from the transferee loans similar to the loans sold (which are readily obtainable in the marketplace) and assumes a limited recourse obligation to repurchase delinquent loans.

   Company A agrees to provide the transferee a return at a floating rate of interest even though the contractual terms of the loan are fixed rate in nature (that provision is effectively an interest rate swap).

Fair Values	
Cash proceeds	$1,050
Interest rate swap	40
Call option	70
Recourse obligation	60

Net Proceeds		
Cash received		$1,050
Plus:	Call option	70
	Interest rate swap	40
Less:	Recourse obligation	(60)
Net proceeds		$1,100

Gain on Sale	$1,100
Net proceeds	1,000
Carrying amount of loans sold	$ 100
Gain on sale	

Journal Entry		
Cash	1,050	
Interest rate swap	40	
Call option	70	
Loans		1,000
Recourse obligation		60
Gain on sale		100
To record transfer		

Illustration—Recording Transfers of Partial Interests

2. Company B sells a pro rata nine-tenths interest in loans with a fair value of $1,100 and a carrying amount of $1,000. There is no servicing asset or liability, because Company B estimates that the benefits of servicing are just adequate to compensate it for its servicing responsibilities.

Fair values	
Cash proceeds for nine-tenths sold	$99
One-tenth interest continued to be held by the transferor [($990 ÷9/10)×1/10]	110

Carrying Amount Based on Relative Fair Values

	Fair Value	Percentage Of Total Fair Value	Allocated Carrying Amount
Nine-tenths interest sold	$990	90	$900
One-tenth interest continued to be held by the transferor	110	10	100
Total	$1,100	100	$1,000

Gain on Sale

Net proceeds	$990
Carrying amount of loans sold	900
Gain on sale	$90

Journal Entry

Cash	990	
Loans		900
Gain on sale		90
To record transfer		

Illustration—Sale of Receivables with Servicing Obtained

3. Company C originates $1,000 of loans that yield 10 percent interest income for their estimated lives of 9 years. Company C sells the $1,000 principal plus the right to receive interest income of 8 percent to another entity for $1,000. Company C will continue to service the loans, and the contract stipulates that its compensation for performing the servicing is the right to receive half of the interest income not sold. The remaining half of the interest income not sold is considered an interest-only strip receivable. At the date of the transfer, the fair value of the loans is $1,100. The fair values of the servicing asset and the interest-only strip receivable are $40 and $60, respectively.

Fair Values

Cash proceeds	$1,000
Servicing asset	40
Interest-only strip receivable	60

Net Proceeds

Cash proceeds		$1,000
Servicing asset		40
	Net Proceeds	$1,040

Carrying Amount Based on Relative Fair Values

	Fair Value	Percentage Of Total Fair Value	Allocated Carrying Amount
Loans sold	$ 1,040	94.55	$945.50
Interest-only strip receivable	60	5.4	54.50
Total	$ 1,100	100.0	$ 1,000.00

Gain on Sale

Net proceeds	$1,040
Carrying amount of loans sold	945
Gain on sale	$ 94.50

Journal Entries

Cash	1,000	
Interest-only strip receivable	54.50	
Servicing Asset	40	
Loans		1,000
Gain on sale		94.50

To record transfer and to recognize interest-only strip receivable and servicing asset

Interest-only strip receivable	5.50	
Equity		5.50

To begin to subsequently measure interest-only strip receivable like an available-for-sale security (FAS 140, paragraph 14 as revised by FAS 156)

Illustration—Recording Transfers of Partial Interests with Proceeds of Cash, Derivatives, Other Liabilities, and Servicing

4. Company D originates $1,000 of prepayable loans that yield 10 percent interest income for their 9-year expected lives. Company D sells nine-tenths of the principal plus interest of 8 percent to another entity. Company D will continue to service the loans, and the contract stipulates that its compensation for performing the servicing is the 2 percent of the interest income not sold. Company D obtains an option to purchase from the transferee loans similar to the loans sold (which are readily obtainable in the marketplace) and incurs a limited recourse obligation to repurchase delinquent loans. At the date of transfer, the fair value of the loans is $1,100.

Fair Values	
Cash proceeds	$900
Call option	70
Recourse obligation	60
Servicing asset	90
One-tenth interest continued to be held by transferor	100

Net Proceeds	
Cash received	$900
Plus: Servicing Asset	90
Plus: Call option	70
Less: Recourse obligation	(60)
Net proceeds	$1,00

Carrying Amount Based on Relative Fair Values

	Fair Value	Percentage Of Total Fair Value	Allocated Carrying Amount
Interest sold	$1,000	90.9	$909
One-tenth interest continued to be held by transferor	100	9.1	91
Total	$1,100	100	$1,000

Gain on Sale	
Net proceeds	$1,00
Less: Carrying amount of loans sold	(909)
Gain on sale	$ 91

Loans Sold	
Carrying Amount of Loans	$1,00
Less: Allocated carrying amount of interest that continues to be held by the transferor	(91)
Loans Sold	$ 909

Journal Entries

Cash	900	
Call option	70	
Servicing Asset	90	
Loans		909
Recourse obligation		60
Gain on sale		91

To record transfer and to recognize servicing asset, call option and recourse obligation

Illustration—Recording Transfers If It Is Not Practicable to Estimate a Fair Value

5. Company E sells loans with a carrying amount of $1,000 to another entity for cash proceeds of $1,050 plus a call option to purchase loans similar to the loans sold (which are readily obtainable in the marketplace) and incurs a limited recourse obligation to repurchase any delinquent loans. Company E undertakes an obligation to service the transferred assets for the other entity. In Case 1, Company E finds it impracticable to estimate the fair value of the servicing contract, although it is confident that servicing revenues will be more than adequate compensation for performing the servicing. In Case 2, Company E finds it impracticable to estimate the fair value of the recourse obligation.

Fair Values	Case	Case 2
Cash proceeds	$1,050	$1,050
Servicing asset	XX*	40
Call option	70	70
Recourse obligation	60	XX*
Fair value of loans transferred	1,100	1,100

* Not practicable to estimate fair value

Net Proceeds	Case	Case 2
Cash received	$1,050	$1,050
Plus: Servicing asset	XX*	40
Plus: Call option	70	70
Less: Recourse obligation	(60)	XX
Net proceeds	$1,060	$1,160

Gain on Sale	Case 1	Case 2
Cash received	$1,060	$1,060
Carrying amount of loans	1,000	1,000
Less: Recourse obligation	0	(160)
Gain on sale	$ 60	$ 0

Journal Entries	Case 1		Case 2	
Cash	1,050		1,050	
Servicing asset	0*		40	
Call option	70		70	
Loans		1,000		1,000
Recourse obligation		60		160†
Gain on sale		60		0
To record transfer				

* Assets shall be recorded at zero if an estimate of the fair value of the assets is not practicable.

† The amount recorded as a liability in this example equals the sum of the known assets less the fair value of the known liabilities, that is, the amount that results in no gain or loss.

Illustration—Secured Borrowing

6. The following example illustrates the accounting for a securities lending transaction treated as a secured borrowing, in which the securities borrower sells the securities upon receipt and later buys similar securities to return to the securities lender:

Facts

Transferor's carrying amount and fair value of security loaned	$1,000
Cash "collateral"	1,020
Transferor's return from investing cash collateral at a 5 percent annual rate	5
Transferor's rebate to the securities borrower at a 4 percent annual rate	4

For simplicity, the fair value of the security is assumed not to change during the 35-day term of the transaction.

Journal Entries for the Transferor

At inception:

Cash	1,020	
Payable under securities loan agreements		1,020

To record the receipt of cash collateral

Securities pledged to creditors	1,000	
Securities		1,000

To reclassify loaned securities that the secured party has the right to sell or repledge

Money market instrument	1,020	
Cash		1,020

To record investment of cash collateral

At conclusion:

Cash	1,025	
Interest		5
Money market instrument		1,020

To record results of investment

Securities	1,000	
Securities pledged to creditors		1,000

To record return of security

Payable under securities loan agreements	1,020	
Interest ("rebate")	4	
Cash		1,024

To record repayment of cash collateral plus interest

Journal Entries for the Transferee

At inception:

Receivable under securities loan agreements	1,020	
Cash		1,020

To record transfer of cash collateral

Cash	1,000	
Obligation to return borrowed securities		1,000

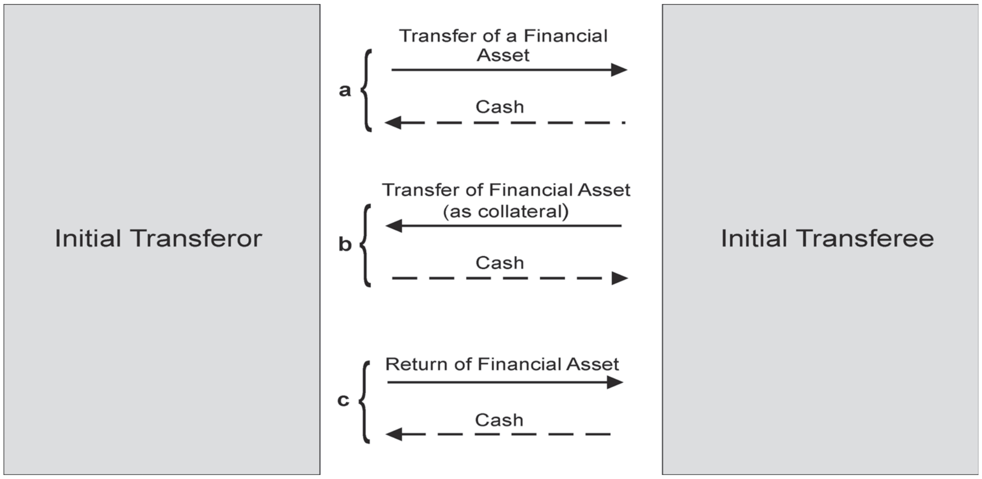
To record sale of borrowed securities to a third party and the resulting obligation to return securities that it no longer holds

At conclusion:

Obligation to return borrowed securities	1,000	
Cash		1,000
To record the repurchase of securities borrowed		
Cash	1,024	
Receivable under securities loan agreements		1,020
Interest revenue ("rebate")		4
To record the receipt of cash collateral and rebate interest		

Illustration—Initial Transfer and Repurchase Financing

7. The following diagram is an example of an initial transfer of a financial asset and a subsequent repurchase financing, as described in paragraphs 73 and 74, which should be analyzed using the provisions in paragraphs 75-78. The purpose of this example is to illustrate the characteristics of the transaction and to prevent an inappropriate analogy to other financing transactions that are outside the scope of this SSAP.


Initial Transferor
Transfer of a Financial Asset
a
Cash
Transfer of Financial Asset (as collateral)
b
Cash
Return of Financial Asset
c
Cash
Initial Transferee

Generally Accepted Accounting Principles

The GAAP guidance has not been reproduced in this issue paper. Please refer to FAS 166, *FAS 166, Accounting for Transfers of Financial Assets* (FAS 166).

RELEVANT LITERATURE

Statutory Accounting

Generally Accepted Accounting Principles

State Regulations

- No additional guidance obtained from state statutes or regulations.

APPENDIX A – ILLUSTRATION OF REVISIONS TO INTS

NOTE: THIS APPENDIX WAS INCLUDED IN THE EXPOSED SSAP NO. 103 TO IDENTIFY REVISIONS TO INTS THAT WILL BE INCORPORATED ONCE THE SSAP IS ADOPTED.

SSAP NO. 103—ACCOUNTING FOR TRANSFERS AND SERVICING OF FINANCIAL ASSETS AND EXTINGUISHMENTS OF LIABILITIES WAS ADOPTED AT THE SPRING 2012 NATIONAL MEETING. UPON ADOPTION, THE WORKING GROUP DIRECTED FOR THIS APPENDIX TO BE INCLUDED IN ISSUE PAPER NO. 141 FOR HISTORICAL PURPOSES.

Issue Paper No. 141 identified the statutory INTs that will interpret this new SSAP, noting whether there would be a change from the previous conclusion noted in SSAP No. 91R. Although these original conclusions are considered accurate, it was noted that INT 00-11 (rejecting EITF 98-15) and INT 04-21(adopting with modification EITF 02-9) should reflect the GAAP revisions from FAS 166. Furthermore, since the development of the INT, initiatives have occurred to reference non-applicable INTs into INT 99-00, as well as to incorporate INT guidance in to specific SSAPs.

This Appendix proposes revisions to the related INT's to reflect the FAS 166 revisions. **It is recommended that these revisions be adopted into the related interpretations, but that this appendix not be retained within the adopted SSAP. This appendix will be incorporated within Issue Paper No. 141 for historical purposes**.

Proposed Revisions to Issue Paper No. 141, paragraph 5

5. With the exception of INT 99-07, INT 99-08, INT 99-14, and INT 99-21, as discussed below, this issue paper will be interpreted by the statutory interpretations to SSAP No. 91R:

a. *INT 99-07: EITF 97-3: Accounting for Fees and Costs Associated with Loan Syndications and Loan Participations after the Issuance of FASB Statement No. 125* (INT 99-07) – As this interpretation rejected EITF 97-3 for statutory accounting, there is no impact to this interpretation from adoption of FAS 166. As this interpretation is now included in *INT 99-00—Compilation of Rejected EITFs* (INT 99-00), the reference to INT 99-00, and not INT 99-07, will be referenced in the new SSAP to supersede SSAP No. 91R.

b. *INT 99-08: EITF 97-6: Application of Issue No. 96-20 to Qualifying Special-Purpose Entities Received Transferred Financial Assets Prior to the Effective Date of FASB Statement No. 125* (INT 99-08) – As this interpretation rejected EITF 96-20 for statutory accounting, there is no impact to this interpretation from adoption of FAS 166. As this interpretation is now included in *INT 99-00—Compilation of Rejected EITFs* (INT 99-00), the reference to INT 99-00, and not INT 99-08, will be referenced in the new SSAP to supersede SSAP No. 91R.

c. *INT 99-14: EITF 96-19: Debtor's Accounting for a Modification or Exchange of Debt Instruments* (INT 99-14) – This interpretation adopted EITF 99-14 for statutory accounting. As such, an exchange of debt instruments with substantially different terms is considered a debt extinguishment. This guidance also clarifies that if the cash flows under the terms of the new debt instrument are at least 10 percent different from the present value of the remaining cash flows under the terms of the original instrument, then the exchange of debt instruments are considered substantially different. The GAAP status of EITF 96-19 was updated to identify that FAS 166 amended FAS 140 without reconsideration. As such, ~~T~~there is no impact to ~~this ~~the statutory interpretation from the adoption of FAS 166. However, pursuant to a project to incorporate guidance from statutory INTs into the related SSAPs, the guidance from this INT is proposed to be included within SSAP No. 91R, as well as the proposed SSAP to supersede

SSAP No. 91R. This guidance has been included in paragraph 126 of this issue paper.

d. *INT 99-21: EITF 98-7: Accounting for Exchanges of Similar Equity Method Investments* (INT 99-21) – This interpretation was nullified with the issuance of *SSAP No. 95—Exchanges of Nonmonetary Assets, A Replacement of SSAP No. 28—Nonmonetary Transactions* (SSAP No. 95). With the issuance of a new SSAP, there will be no future reference to this interpretation.

Staff Note: EITF 98-7 was not revised in FAS 166.

e. *INT 99-22: EITF 98-8: Accounting for Transfers of Investments That Are in Substance Real Estate* (INT 99-22) – This interpretation adopted EITF 98-8 indicating that transfers of financial assets that are in substance real estate shall be accounted for in accordance with *SSAP No. 40—Real Estate Investments* (SSAP No. 40). The GAAP status of EITF 96-19 was updated to deleted the effective date reference and identify that FAS 166 amended FAS 140 without reconsideration. As such, ~~T~~there is no impact to the~~is~~ statutory interpretation from the adoption of FAS 166. However, pursuant to a project to incorporate guidance from statutory INTs into the related SSAPs, the guidance from this INT is proposed to be included within SSAP No. 91R, as well as the proposed SSAP to supersede SSAP No. 91R. This guidance has been included in paragraph 6 of this issue paper.

f. *INT 00-11: EITF 98-15: Structured Notes Acquired for a Specified Investment Strategy* (INT 00-11) – This interpretation rejected the consensus position in EITF 98-15 pursuant to a recommendation from the Invested Assets (E) Working Group. It was noted that any attempt on the part of the Emerging Accounting Issues (E) Working Group to promulgate EITF 95-18 into accounting guidance (bonds accounted for at fair value rather than amortized cost) will require the Valuation of Securities (E) Task Force to change the mission of the Securities Valuation Office. The issuance of FAS 166 incorporated guidance to EITF 98-15 to identify that paragraph 11 of FAS 166 (accounting for transfers of entire financial assets or groups of entire financial assets that qualify as sales) shall be applied to each structured note upon transfer. This update is proposed for inclusion within INT 00-11, but as there is no proposed change to the previous statutory conclusion, ~~As such,~~ there will be no impact to this interpretation as a result of adopting FAS 166.

g. *INT 01-31: Assets Pledged as Collateral* (INT 01-31) – This interpretation provides guidance on whether assets pledged as collateral shall be considered admitted assets. There is no impact to this interpretation conclusion from the adoption of FAS 166. (References to SSAP No. 91R will be replaced with references to the new SSAP.)

Staff Note: This INT does not relate to a GAAP EITF, therefore no changes from FAS 166.

h. *INT 03-05: EITF 01-7: Creditor's Accounting for a Modification or Exchange of Debt Instruments* (INT 03-05) – This interpretation adopts the consensus position of EITF 01-7. This EITF clarifies that a debt instrument modification should be considered more than minor if the present value of the cash flows under the terms of the new debt instrument is at least 10 percent different from the present value of the remaining cash flows under the terms of the original instrument. This EITF also concludes that the guidance in EITF 96-19 (adopted within INT 99-14) should be used to calculate the present value of cash flows for purposes of applying the 10 percent test. There is no impact to this interpretation from the adoption of FAS 166.

Staff Note: EITF 01-7 was not revised in FAS 166.

i. *INT 04-21: EITF 02-9: Accounting for Changes that Result in a Transferor Regaining Control of Financial Assets Sold* (INT 04-21) – This interpretation adopts EITF 02-9 with modification for statutory terms and references. Pursuant to this adoption, a transferred asset that has been accounted for as sold is to be accounted for as "re-purchased" if the basis for that sale accounting subsequently becomes invalid. With the issuance of FAS 166, guidance in EITF 02-9 was updated to reflect the revised terminology in FAS 166 as well as delete the issue and conclusion pertaining to qualified special purpose entities as the concept of a QSPE is no longer captured within FAS 166. Although there is no impact to the statutory conclusion to adopt this EITF with modifications for statutory references, the guidance in INT 04-21 will be revised to reflect the revisions adopted from FAS 166~~There is no impact to this interpretation from the adoption of FAS 166~~.

j. *INT 09-08: Accounting for Loans Received under the Federal TALF Program.* This interpretation provides statutory guidance on whether TALF loans received and the corresponding collateral provided by the reporting entity shall be reported net within the statutory financial statements. With the exception of updating references from SSAP No. 91R to the new SSAP, there is no anticipated change proposed to this interpretation.

Proposed Revisions to Interpretations: ***(To be included in an Exhibit to Issue Paper No. 141)***

This Exhibit identifies the revisions proposed to interpretations as a result of adopting, with modification, FAS 166 in a new SSAP to supersede SSAP No. 91R. (All interpretations identified in SSAP No. 91R are discussed below.)

1. *INT 99-07—EITF 97-3: Accounting for Fees and Costs Associated with Loan Syndications and Loan Participations after the Issuance of FASB Statement No. 125*

   Proposed Changes: No changes are proposed to this INT as it is no longer captured in the AP&P Manual, but is instead referenced as rejected in INT 99-00. A change will occur to INT 99-00 to reference the new SSAP instead of SSAP No. 91R.

2. *INT 99-08—EITF 97-6: Application of Issue No. 96-20 to Qualifying Special-Purpose Entities Received Transferred Financial Assets Prior to the Effective Date of FASB Statement No. 125*

   Proposed Changes: No changes are proposed to this INT as it is no longer captured in the AP&P Manual, but is instead referenced as rejected in INT 99-00. A change will occur to INT 99-00 to reference the new SSAP instead of SSAP No. 91R.

3. *INT 99-14—EITF 96-19: Debtor's Accounting for a Modification or Exchange of Debt Instruments*

   Proposed Changes: No changes are proposed to this INT as it is no longer captured within the authoritative guidance of the AP&P Manual. This INT has been nullified, with the guidance reflected in the underlying SSAP (SSAP No. 91R). These revisions are also reflected in the proposed SSAP to supersede SSAP No. 91R in paragraph 22.

4. *INT 99-21: EITF 98-7: Accounting for Exchanges of Similar Equity Method Investments*

   Proposed Changes: No changes are proposed to this INT as it was nullified with the issuance of *SSAP No. 95—Exchanges of Nonmonetary Assets, A Replacement of SSAP No. 28—Nonmonetary Transactions* (SSAP No. 95).

5. *INT 99-22—EITF 98-8: Accounting for Transfers of Investments That Are in Substance Real Estate*

Proposed Changes: No changes are proposed to this INT as it is no longer captured within the authoritative guidance of the AP&P Manual. This INT has been nullified, with the guidance reflected in the underlying SSAP (SSAP No. 91R). These revisions are also reflected in the proposed SSAP to supersede SSAP No. 91R in paragraph 2.

6. *INT 00-11—EITF 98-15: Structured Notes Acquired for a Specified Investment Strategy*

Proposed Changes: Revisions are proposed to update the reference and status section of this INT:

INT 00-11 References

SSAP No. 43R—Loan-Backed and Structured Securities (SSAP No. 43R)
SSAP No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements (SSAP No. 45)
SSAP No. 91R—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (SSAP No. 91R) (Add Shading)

SSAP No. 103—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (Add new SSAP reference)

SSAP No. 98—Treatment of Cash Flows When Quantifying Changes in Valuation and Impairments, an Amendment of SSAP No. 43—Loan-Backed and Structured Securities (SSAP No. 98)

INT 00-11 Status

4. In 2009, *FAS 166, Accounting for Transfers of Financial Assets, an Amendment of FAS 140*, was issued. In addition to amending FAS 140, it also amended FASB EITF 98-15 to clarify that paragraph 11 (Accounting for Transfers of an Entire Financial Asset or Group of Entire Financial Assets) of FAS 166 should be applied to each structured note upon transfer. This revision to EITF 98-15 does not impact the previous conclusion to reject this EITF for statutory accounting.

45. No further discussion is planned.

Note: The EAIWG project to incorporate guidance from INTs into SSAPs may impact this proposal

7. *INT 01-31—Assets Pledged as Collateral*

Proposed Changes: Revisions are proposed to update references and the status section of this INT:

INT 01-31 References

SSAP No. 4—Assets and Nonadmitted Assets (SSAP No. 4)

SSAP No. 5R—Liabilities, Contingencies and Impairment of Assets (SSAP No. 5R)

SSAP No. 18—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (SSAP No. 18)

SSAP No. 33—Securitization (SSAP No. 33)

SSAP No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements (SSAP No. 45)

SSAP No. 91R—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (SSAP No. 91R) (Added Shading)

SSAP No. 103—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (Add new SSAP reference)

INT 99-02: Accounting for Collateral in Excess of Debt Principal (INT 99-02)

7. Therefore, for the examples described above, the pledging insurer would record the collateral (including the overcollateralization amount) as an admitted asset until they have committed a contract default that has not been cured in accordance with the contract provisions. This accounting is in accordance with the provisions of ~~SSAP No. 91R~~ SSAP No. 103. This consensus of reporting collateral as an admitted asset is further supported by SSAP Nos. 4 and 5 since generally, the insurer can readily substitute pledged assets. Additionally, an insurer may typically unwind the transaction allowing the assets to be available to the pledging insurer to meet policyholder obligations. Furthermore, no event has occurred to indicate an impairment or potential loss contingency with respect to such pledged assets. The fact that some pledged assets may constitute an overcollaterlization amount does not change this analysis. Accordingly, all assets pledged in support of these type transactions should also be admitted.

8. At the time of an uncured default, the provisions of paragraph ~~14~~ 20 of ~~SSAP No. 91R~~ SSAP No. 103 shall be used to determine the appropriate accounting treatment for the collateral. If the secured party utilizes collateral to offset all or a portion of the liability owed by the pledging insurer as a result of the default, then the collateral amount utilized to offset the liability shall be removed from the balance sheet. At the same time, the amount of the liability that was offset should be removed from the balance sheet since that obligation has been satisfied through the secured party's utilization of that collateral. To the extent that an uncured default remains without the secured party utilizing the collateral to offset the obligation, the pledging insurer should only record an admitted asset for the amount of collateral that it can redeem.

9. As of March 18, 2002, the consensus position of this interpretation is consistent with the position of the NAIC Invested Asset (E) Working Group. This interpretation will be reviewed by the FAS 140 Subgroup of the NAIC Statutory Accounting Principles (E) Working Group in conjunction of its consideration of incorporating GAAP pronouncement *FAS 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, a replacement of FASB Statement 125* into the statutory accounting model. As such, this interpretation is subject to amendment pending disposition of the FAS 140 Subgroup's review of collateral and FAS 140 in its entirety.

10. On September 12, 2004, the Working Group noted that the review of FAS 140 was complete and INT 01-31 was listed as an interpretation of SSAP No. 91R. On March 3, 2012, the Working Group adopted, with modification, *FAS 166—Accounting for Transfers of Financial Assets, an Amendment of FAS 140* (FAS 166). With this adoption, there was no change to the consensus opinion within this interpretation, and this INT was listed as an interpretation of SSAP No. 103.

11. No further discussion is planned.

8. *INT 03-05—EITF 01-7: Creditor's Accounting for a Modification or Exchange of Debt Instruments*

Proposed Changes: There is no impact to this interpretation from the adoption, with modification of FAS 166. However, changes will occur to reference the new SSAP, rather than SSAP No. 91R:

INT 03-05 References

SSAP No. 18—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (SSAP No. 18)

SSAP No. 91R—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (SSAP No. 91R) (Added Shading)

SSAP No. 103—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities

9. *INT 04-07—EITF 02-15: Determining Whether Certain Conversions of Convertible Debt to Equity Securities Are Within the Scope of FAS Statement No. 84*

Proposed Changes: Revisions are proposed to update references in this INT:

2. EITF 02-15 utilizes guidance from several sources in the GAAP hierarchy. The statutory accounting status of these statements is listed below:

a. *FASB Statement No. 15*, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, which was adopted by *SSAP No. 36—Troubled Debt Restructuring.*

b. FAS 84, which was adopted by SSAP No. 15.

c. *FASB Statement No. 140*, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, which was adopted with modification in *SSAP No. 91R—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* and refers back to SSAP No. 15 for guidance regarding any troubled debt restructuring. (FAS 166 amended FAS 140 and was adopted, with modification in SSAP No. 103. SSAP No. 103 superseded SSAP No. 91R, but continues to reference SSAP No. 15 for guidance regarding trouble debt restructuring.)

10. *INT 04-21—EITF 02-9: Accounting for Changes that Result in a Transferor Regaining Control of Financial Assets Sold*

Proposed Changes: With the issuance of FAS 166 guidance in EITF 02-9 was updated to reflect the revised terminology in FAS 166 as well as to delete the issue and conclusion pertaining to qualified special-purpose entities as the concept of a QSPE is no longer captured within FAS 166. Revisions are proposed to reflect the revised guidance from FAS 166:

INT 04-21 References

SSAP No. 91R—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (SSAP No. 91R) (Added Shading)
SSAP No. 103—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities

1. EITF No. 02-9, *Accounting for Changes That Result in a Transferor Regaining Control of Financial Assets Sold* (EITF 02-9) expands on a key concept presented in FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 140), paragraph 55. This key concept requires a transferred financial asset that has been accounted for as sold to be accounted for as "re-purchased" if the basis for that sale accounting subsequently becomes invalid.

2. The following is excerpted from EITF 02-9:

1. ~~Two~~ One circumstance~~s~~ that has~~have~~ raised questions about the application of paragraph 55 occurs when the provisions of paragraph 55 are triggered because ~~(a) a qualifying special-purpose entity (SPE) becomes nonqualifying and (b)~~ the transferor holds a contingent right such as a contingent call option on the transferred financial assets (for example, a removal of accounts provision or "ROAP") and the contingency has been met. This issue assumes that the transferee is not consolidated by the transferor.

2. ~~A qualifying SPE may become nonqualifying or "tainted" for several reasons, including a decision by the outside beneficial interest holders to grant the SPE decision-making powers that are prohibited for qualifying SPEs. Under the requirements of paragraph 55, the disqualification of a formerly qualifying SPE will generally result in the "re-purchase" by the transferor of all assets sold to and still held by the SPE because the transferee (the SPE that is no longer qualifying) is constrained from pledging or exchanging the financial assets and this condition provides more than a trivial benefit to the transferor (refer to paragraph 9(b) of Statement 140). This Issue considers the application of the guidance in paragraph 55 prior to any consideration of whether the transferee (for example, an SPE) should be consolidated and, therefore, prior to considering any eliminating entries that may result from consolidation.~~

3. Under Statement 140, rights held by the transferor (typically in the form of purchased options or forward purchase contracts) only preclude sale accounting under paragraph 9(c)(2) if they provide the transferor with (a) the unilateral right to cause the holder to return specific transferred financial assets and (b) more than a trivial benefit. One class of contingent rights (including certain ROAPs 1) does not preclude sale accounting because it does not include unilateral rights. The most common type of ROAP is a default ROAP, which gives the holder the right but not the obligation to purchase (call) a loan that is in default (the meaning of default typically is specifically defined in each transaction). Such rights are common in credit card securitizations and in securitizations sponsored by the Government National Mortgage Association (GNMA) 2 and other governmental or quasi-governmental agencies. Once the contingency is met (in this case, when a given loan goes into default), the call option on that asset (loan) is no longer contingent. At that point, the transfer fails the criterion in paragraph 9(c)(2) of Statement 140 because the transferor has the unilateral right to purchase a specific transferred financial asset and obtains more than a trivial benefit. Under the requirements of paragraph 55, when a contingency related to a transferor's contingent right has been met, the transferor generally must account for the "re-purchase" of a specific subset of the financial assets transferred to and held by the qualifying ~~SPE~~entity. The transferor must do so regardless of whether it intends to exercise its call option.

3. Per EITF 02-9, the issues are:

Issue 1—How the transferor should account for the transferor's ~~retained~~ beneficial interests when the underlying assets are re-recognized under the provisions of paragraph 55 because the transferor's contingent right (for example, a ROAP or other contingent call option on the transferred financial assets) becomes exercisable, including whether any gain or loss should be recognized by the transferor when paragraph 55 is applied.

~~Issue 2—How assets re-recognized by the transferor that were previously sold to an SPE that was formerly considered qualifying should be accounted for when the entire SPE becomes nonqualifying under the provisions of paragraph 55, including whether any gain or loss should be recognized by the transferor when paragraph 55 is applied.~~

Issue 3—Whether under any circumstances a loan loss allowance should initially be recorded for loans that do not meet the definition of a security when they are re-recognized under the provisions of paragraph 55

Issue 4—How re-recognition under paragraph 55 of assets sold affects the accounting for the related servicing asset.

Issue 5—After a paragraph 55 event, how the transferor should account for the transferor's ~~its retained~~ interests (other than the servicing asset).

4. EITF 02-9 consensus on each issue is as follows:

5. The Task Force reached a consensus on Issue 1 that upon application of paragraph 55, no gain or loss should be recognized in earnings with respect to any of the transferor's beneficial interests ~~retained by the transferor~~. Beneficial interests should be evaluated periodically for possible impairment, including at the time paragraph 55 is applied. A gain or loss may be recognized upon the exercise of a ROAP or similar contingent right with respect to the "re-purchased" ~~portion of the~~ transferred financial assets that were sold if the ROAP or similar contingent right held by the transferor is not accounted for as a derivative under Statement 133 and is not at-the-money, resulting in the fair value of those repurchased assets being greater or less than the related obligation to the transferee.

~~6. The Task Force reached a consensus on Issue 2 that in the event the entire SPE becomes nonqualifying upon application of paragraph 55, no gain or loss should be recognized with respect to the "re-purchase" by the transferor of the financial assets originally sold that remain outstanding in the SPE (or the portion thereof if the transferor retained a partial interest in those assets). The fair value of the re-recognized assets will equal the fair value of the liability assumed by the transferor because the transferor is contractually required to pass on 100 percent of the cash flows from the re-recognized assets to the SPE for distribution in accordance with the contractual documents governing the SPE. The process of determining the fair value of both the re-recognized assets and the assumed liability may require a careful analysis of all of the expected cash flows of the securitization vehicle, including cash flows of assets within the vehicle that are not subject to paragraph 55 (for example, proceeds that are temporarily reinvested by the SPE). In performing that analysis, the transferor would need to consider both the timing and the amounts of the expected cash flows and also which party has rights to such expected cash flows at the time of the paragraph 55 event.~~

6~~7~~. The Task Force reached a consensus on Issue 3 that under no circumstances should a loan loss allowance be initially recorded for loans that do not meet the definition of a security when they are re-recognized pursuant to paragraph 55.

7~~8~~. The Task Force reached a consensus on Issue 4 that when a paragraph 55 event occurs, the accounting for the servicing asset related to the previously sold financial assets does not change as a result of the application of paragraph 55. That is, even though the transferor has regained control over the previously sold assets, the cash flows from those assets will contractually be paid to the SPE, which will then distribute the proceeds to satisfy its contractual obligations (including obligations to the beneficial interest holders). Because the transferor, as servicer, is still contractually required to collect the asset's cash flows for the benefit of the SPE and otherwise service the assets, it should continue to recognize the servicing asset and assess the asset for impairment as required by Statement 140.

8~~9~~. The Task Force reached a consensus on Issue 5 that when a paragraph 55 event occurs, the transferor should continue to account for the transferor's ~~its retained~~ interests in those underlying financial assets apart from any re-recognized financial assets. That is, the transferor's ~~retained~~ interests should not be combined with and accounted for with the re-recognized financial assets. However, a subsequent event that results in the transferor reclaiming those financial assets from the transferee-for example, the exercise of a ROAP or the consolidation by the transferor of the ~~SPE~~ securitization entity in accordance with applicable generally accepted accounting principles, including

Interpretation 46R would result in a recombination of the transferor's ~~retained~~ interests with the underlying financial assets.

5. The Working Group reached a consensus to adopt EITF 02-9 as an interpretation of SSAP No. 91R, with modification as follows:

a. Change references to FAS 140 to ~~SSAP 91R~~SSAP No. 103 including paragraph specific references. Modify FAS 140, paragraph 55 references to refer to SSAP No. ~~91R~~103, paragraph 59~~46~~.

b. Change references to FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* to SSAP No. 86 as an interpretation of SSAP No. 91R.

c. Remove reference to Interpretation 46 as FASB Interpretation No. 46R, *Consolidation of Variable Interest Entities,* is pending review for statutory accounting. (The prior GAAP guidance in FASB Interpretation FIN 46 was rejected for statutory accounting in *SSAP No. 3—Accounting Changes and Corrections of Errors*.)

d. Limit the applicability of EITF 02-9, Issue 3 to only valuation allowances applicable to statutory accounting for mortgage loans and real estate under development as provided in *SSAP No. 37—Mortgage Loans* and real estate under development as discussed in *SSAP No. 38—Acquisition, Development and Construction Arrangements*.

6. This interpretation was originally ~~is~~ effective for years beginning January 1, 2005 to be consistent with the original effective date of SSAP No. 91R. Revisions adopted to this interpretation on March 3, 2012 are in accordance with the adoption with modification of FAS 166 in a new SSAP to supersede SSAP No. 91R.

INT 04-21 STATUS

7. In 2009, *FAS 166, Accounting for Transfers of Financial Assets, an Amendment of FAS 140*, was issued. In addition to amending FAS 140, it also amended FASB EITF 02-9. FAS 166 was adopted for statutory accounting in SSAP No. 103 to supersede SSAP No. 91R. On March 3, 2012, corresponding revisions to INT 04-21 were also adopted to reflect the updated GAAP guidance adopted for statutory interpreting SSAP No. 103. These changes will not be tracked in subsequent editions of the Manual.

8~~7~~. No further discussion is planned.

11. *INT 09-08—Accounting for Loans Received under the Federal TALF Program*

Proposed Changes: Revisions are proposed to update references in this INT:

INT 09-08 References

SSAP No. 64—Offsetting and Netting of Assets and Liabilities

SSAP No. 91R—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities – Revised (Added shading)

SSAP No. 103—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities

9. In considering whether a provision should be incorporated within a specific statutory accounting principle to permit netting, although no valid right of setoff exists, it is noted that guidance for collateral is included within *SSAP No. ~~91R~~103—Accounting for Transfers and*

Servicing of Financial Assets and Extinguishments of Liabilities (SSAP No. ~~91R~~103). Pursuant to guidance within this SSAP, unless the transferor defaults on the secured contract, the transferor shall continue to carry the collateral as an asset. It is only after default that the reporting entity would remove the collateral as an asset, with a corresponding reduction to the liability. It is noted that a specific provision for TALF loans would be inconsistent with existing SSAP No. ~~91R~~ 103 guidance for the reporting of loans and collateral.

APPENDIX B – ILLUSTRATIONS OF REVISIONS TO SSAPS:

NOTE: THIS APPENDIX WAS INCLUDED IN THE EXPOSED SSAP NO. 103 TO IDENTIFY REVISIONS TO SSAPS THAT WILL BE INCORPORATED ONCE THE SSAP IS ADOPTED.

SSAP NO. 103—ACCOUNTING FOR TRANSFERS AND SERVICING OF FINANCIAL ASSETS AND EXTINGUISHMENTS OF LIABILITIES WAS ADOPTED AT THE SPRING 2012 NATIONAL MEETING. UPON ADOPTION, THE WORKING GROUP DIRECTED FOR THIS APPENDIX TO BE INCLUDED IN ISSUE PAPER NO. 141 FOR HISTORICAL PURPOSES.

This Appendix proposes revisions to the SSAPs to reflect revisions from the adoption, with modification, of FAS 166 in a new SSAP to supersede SSAP No. 91R. **It is recommended that these revisions be adopted into the related SSAPs, but that this appendix not be retained within the adopted SSAP. This appendix will be incorporated within Issue Paper No. 141 for historical purposes**.

1. *SSAP No. 40—Real Estate Investments*

Proposed Changes: Revisions are proposed to update references in this SSAP:

23. Extinguishment of participating mortgage loans prior to the due date should be determined in accordance with *SSAP No. ~~91R~~103—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* ~~(SSAP No. 91R)~~. Gains or losses from early extinguishment should be determined in considering the difference between the recorded amount of debt (including unamortized debt discount and the participation liability) and the amount exchanged to extinguish the debt.

2. *SSAP No. 42—Sale of Premium Receivables*

Proposed Changes: Revisions are proposed to update references in this SSAP:

9. This statement rejects paragraph 83 of *FASB Statement No. 125*, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 125) to the extent that it permits sales recognition for sales of receivables with recourse provisions. FAS 125 is addressed in its entirety in *SSAP No. 18—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, which was superseded by *SSAP No. 91R—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. SSAP No. 103—Accounting for Transfers and Servicing of Financial Assets adopts, with modification, *FAS 166, Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140* and supersedes SSAP No. 91R.

3. *SSAP No. 43R—Loan-Backed and Structured Securities*

Proposed Changes: Revisions are proposed:

1. This statement establishes statutory accounting principles for investments in loan-backed securities and structured securities. In accordance with *SSAP No. ~~91R~~103—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (SSAP No. ~~91R~~103), retained beneficial interests from the sale of loan-backed securities and structured securities are accounted for in accordance with this statement. In this statement loan-backed securities and structured securities are collectively referred to as loan-backed securities.

6. The scope of this statement encompasses all types of loan-backed and structured securities, including, but not limited to, the following:

a. Loan-backed and structured securities acquired at origination,

b. Loan-backed and structured securities acquired subsequent to origination for which it is probable, at acquisition, that the reporting entity will be **able** to collect all contractually required payments receivable, and are accounted for at acquisition under SSAP No. ~~91R~~103,

c. Loan-backed and structured securities for which it is probable, either known at acquisition or identified during the holding period[1], that the reporting entity will be **unable** to collect all contractually required payments receivable, and

d. Transferor's ~~B~~beneficial interests ~~that continue to be held by a reporting entity (transferor)~~ in securitization transactions that are accounted for as sales under SSAP No. ~~91R~~ 103 and purchased beneficial interests in securitized financial assets.

Beneficial Interests

20. The following paragraphs provide statutory accounting guidance for interest income and impairment for a reporting entity that continues to hold an interest in securitized financial assets accounted for as sales under SSAP No. ~~91R~~103, or that purchases a beneficial interest in securitized financial assets that are not of high credit quality or can contractually be prepaid or otherwise settled in such a way that the reporting entity would not recover substantially all of its recorded amount, determined at acquisition or the date of transfer[5]. Beneficial interests that are of high credit quality and cannot contractually be prepaid or otherwise settled in such a way that the reporting entity would not recover substantially all of its recorded investment, shall be accounted for in accordance with paragraphs 12 through 16.

Footnote 5: The accounting requirements related to these types of securities included in paragraphs 20-24 shall be determined at acquisition or initial transfer. As referenced in the Relevant Literature section, this Statement adopts EITF 99-20 (as amended by FAS 166), including the scope requirements of that guidance.

21. The reporting entity shall recognize the excess of all cash flows attributable to the beneficial interest estimated at the acquisition/transaction date (referred to herein as the transaction date) over the initial investment (the accretable yield) as interest income over the life of the beneficial interest using the effective yield method. If the holder of the beneficial interest is the reporting entity that transferred the financial assets for securitization, the initial investment would be the ~~allocated carrying amount after application of the relative~~ fair value of the beneficial interest as of the date of transfer, ~~allocation method~~ as required by SSAP No. 103~~91R~~. The amount of accretable yield shall not be displayed in the balance sheet.

23. All cash flows estimated at the transaction date are defined as the holder's estimate of the amount and timing of estimated future principal and interest cash flows used in determining the purchase price or the holder's fair value determination for purposes of determining a gain or loss under SSAP No. 103~~91R~~. Subsequent to the transaction date, estimated cash flows are defined as the holder's estimate of the amount and timing of estimated principal and interest cash flows based on the holder's best estimate of current information and events. A change in estimated cash flows is considered in the context of both timing and amount of the estimated cash flows.

[1] Securities classified within the type of paragraph 6.a. or 6.b. may be required to change classification to type 6.c. when it becomes probable that the reporting entity will be unable to collect all contractually required payments receivable.

24. ~~In situations in which it is not practicable for a transferor to estimate the fair value of the beneficial interest at the initial transfer date, interest income shall not be recognized using the interest method. For these beneficial interests (that is, those beneficial interests that continue to be held by a transferor that are recorded at $0 pursuant to SSAP No. 91R), the transferor shall use the cash basis for recognizing interest income because the beneficial interest will have an allocated carrying amount of zero.~~

45. Repooled FHLMC and FNMA securities meet the definition of substantially the same as defined in *SSAP No. ~~91R~~103—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. The transaction shall not be considered a sale/purchase and no gain or loss shall be recognized. To properly document the repooling, the transaction shall be reported through Schedule D of the Annual Statement as a disposition and an acquisition.

51. This statement adopts *FASB Emerging Issues Task Force No. 99-20*, *Exchange of Interest-Only and Principal-Only Securities for a Mortgage-Backed Security*, as amended by *FAS 166, Accounting for Transfers of Financial Assets, an Amendment of FAS 140,* *and FASB Staff Position EITF 99-20-1, Amendments to the Impairment Guidance of EITF Issue No. 99-20.* This statement adopts paragraphs 5, 7 and 9 of AICPA *Statement of Position 03-03, Accounting for Certain Loans or Debt Securities Acquired in a Transfer* (SOP 03-03) for loan-backed and structured securities only. With the exception of this specific adoption, consideration of SOP 03-03 is still pending consideration for statutory accounting.

4. *SSAP No. 95—Exchanges of Nonmonetary Assets, A Replacement of SSAP No. 28*

Proposed Changes: Reference revisions are proposed:

5. Nonmonetary transactions shall be accounted for in accordance with this statement, except as addressed by other statements or interpretations including but not limited to *SSAP No. 12—Employee Stock Ownership Plans* (SSAP No. 12), *SSAP No. 13—Stock Option and Stock Purchase Plans* (SSAP No. 13), *SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties* (SSAP No. 25), *SSAP No. 68—Business Combinations and Goodwill* (SSAP No. 68), *SSAP No. 72—Surplus and Quasi-reorganizations* (SSAP No. 72), *SSAP No. ~~91R~~103—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (SSAP No. ~~91R~~103), *INT 00-12: EITF 99-4: Accounting for Stock Received from the Demutualization of a Mutual Insurance Company, INT 00-26: EITF 98-3: Determining Whether a Nonmonetary Transactions Involves Receipt of Productive Assets or of a Business* (INT 00-26), *INT 00-29: EITF 99-17: Accounting for Advertising Barter Transactions* (INT 00-29), *INT 02-19: EITF 01-1:Accounting for a Convertible Instrument Granted or Issued to a Nonemployee for Goods or Services or a Combination of Goods or Services and Cash* (INT 02-19) and *INT 03-16: Contribution of Stock* (INT 03-16).

21. Although not meant to be all inclusive, accounting for specific nonmonetary transactions and unique circumstances is addressed in the following statements of statutory accounting principles:

- *SSAP No. 12—Employee Stock Ownership Plans* (SSAP No. 12)
- *SSAP No. 13—Stock Options and Stock Purchase Plans* (SSAP No. 13)
- *SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties* (SSAP No. 25)
- *SSAP No. 68—Business Combinations and Goodwill* (SSAP No. 68)
- *SSAP No. 72—Surplus and Quasi-reorganizations* (SSAP No. 72)

- *SSAP No. ~~91R~~103—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (SSAP No. ~~91R~~103)

- *INT 00-12: EITF 99-4: Accounting for Stock Received from the Demutualization of a Mutual Insurance Company* (INT 00-12)

- *INT 00-26: EITF 98-3: Determining Whether a Nonmonetary Transactions Involves Receipt of Productive Assets or of a Business* (INT 00-26)

- *INT 00-29: EITF 99-17: Accounting for Advertising Barter Transactions* (INT 00-29)

- *INT 03-16: Contribution of Stock* (INT 03-16)

6. *SSAP No. 100—Fair Value Measurements*

Proposed Changes: Reference revisions are proposed:

44. The disclosures about fair value prescribed in paragraph 43 are not required for the following:

a. Employers' and plans' obligations for pension benefits, other postretirement benefits including health care and life insurance benefits, postemployment benefits, employee stock option and stock purchase plans, and other forms of deferred compensation arrangements, as defined in *SSAP No. 12—Employee Stock Ownership Plans* (SSAP No. 12), *SSAP No. 13—Stock Options and Stock Purchase Plans* (SSAP No. 13), *SSAP No. 14—Postretirement Benefits Other Than Pensions* (SSAP No. 14), and *SSAP No. 89—Accounting for Pensions, A Replacement of SSAP No. 8* (SSAP No. 89)

b. Substantively extinguished debt subject to the disclosure requirements of *SSAP No. ~~91R~~103—Accounting for Transfer and Servicing of Financial Assets and Extinguishments of Liabilities* (SSAP No. ~~91R~~103)

c. Insurance contracts, other than financial guarantees and deposit-type contracts

d. Lease contracts as defined in *SSAP No. 22—Leases* (SSAP No. 22)

e. Warranty obligations and rights

f. Investments accounted for under the equity method

g. Equity instruments issued by the entity

APPENDIX C – IDENTIFICATION OF OTHER GAAP GUIDANCE IMPACTED BY FAS 166:

NOTE: THIS APPENDIX WAS INCLUDED IN THE EXPOSED SSAP NO. 103 TO IDENTIFY THE IMPACT TO OTHER GAAP GUIDANCE IMPACTED BY FAS 166.

SSAP NO. 103—ACCOUNTING FOR TRANSFERS AND SERVICING OF FINANCIAL ASSETS AND EXTINGUISHMENTS OF LIABILITIES WAS ADOPTED AT THE SPRING 2012 NATIONAL MEETING. UPON ADOPTION, THE WORKING GROUP DIRECTED FOR THIS APPENDIX TO BE INCLUDED IN ISSUE PAPER NO. 141 FOR HISTORICAL PURPOSES.

In addition to the GAAP EITFs adopted (or adopted through an INT) in SSAP No. 91R, the issuance of FAS 166 also revised other GAAP EITFs. This table identifies all GAAP EITFs (not including the EITF Appendix D Topics) and the revisions incorporated from FAS 166.

This Exhibit is not recommended to be retained within the adopted SSAP. This exhibit is for informational purposes only and will be incorporated within Issue Paper No. 141 for historical purposes.

(This does not include the identified revisions to the "Special Report on Statement 140" from the issuance of FAS 140 as it is a question and answer guidance not previously reviewed for statutory accounting.)

GAAP EITF	Summary of FAS 166 Revisions	SAP Status (Appendix D)	Recommendation
84-5	Updated to refer to FAS 166 examples of when the transferor maintains effective control over transferred financial assets (rather than the example regarding put options originally provided in the EITF), updated to refer that FAS 140 is amended by FAS 166, and updated to note that FAS 166 removed the practicability exception for the requirement to measure proceeds of a sale at fair value.	Rejected in SSAP No. 18 & 91R	No Change The statement includes specific statutory guidance for put options in paragraph 59.
84-20	Updated to note that FAS 140 was amended by FAS 166. No reconsideration of the GAAP issue.	Adopted in SSAP No. 45	No Change
85-25	Updated to refer to FAS 166 examples of when the transferor maintains effective control over transferred financial assets (rather than the examples for put options originally included). Also updated to refer that FAS 140 is amended by FAS 166.	Nullified by FAS 125, 133 & 140	No Change
85-40	Updated to refer to FAS 166 examples of when the transferor maintains effective control over transferred financial assets (rather than the example regarding put options originally provided in the EITF), updated to refer that FAS 140 is amended by FAS 166, and updated to note that FAS 166 removed the practicability exception for the requirement to measure proceeds of a	Nullified by FAS 125 and partially nullified by FAS 140	No Change

GAAP EITF	Summary of FAS 166 Revisions	SAP Status (Appendix D)	Recommendation
	sale at fair value.		
86-36	Not applicable in FASB Codification	Adopted in SSAP No. 15	No Change
87-18	Updated to note that FAS 140 was amended by FAS 166. No reconsideration of the GAAP issue.	Adopted with modification in SSAP No. 36	No Change
87-30	Updated to refer to FAS 166 examples of when the transferor maintains effective control over transferred financial assets (rather than the example regarding put options originally provided in the EITF), updated to refer that FAS 140 is amended by FAS 166, and updated to note that FAS 166 removed the practicability exception for the requirement to measure proceeds of a sale at fair value.	N/A in INT 99-00	No Change
88-20	Updated to note that FAS 140 was amended by FAS 166. No reconsideration of the GAAP issue.	N/A in INT 99-00	No Change
88-22	Updated to note that FAS 140 was amended by FAS 166. No reconsideration of the GAAP issues.	Adopted in SSAP No. 91R	No Change Referenced as adopted within the SSAP to supersede SSAP No. 91R.
89-2	Not applicable in FASB Codification	Nullified by FAS 125 and partially nullified in FAS 140	No Change
90-18	Not applicable in FASB Codification	N/A in INT 99-00	No Change
92-2	Not applicable in FASB Codification	Reject in SSAP No. 18 & 91R	No Change
96-10	Updated to note that FAS 140 was amended by FAS 166. No reconsideration of the GAAP issues.	Rejected in SSAP No. 26	No Change
96-19	Updated to note that FAS 140 was amended by FAS 166. No reconsideration of the GAAP issue.	Adopted in SSAP No. 18, 91R and INT 99-14	No Change Guidance from INT 99-14 has been included in the SSAP to supersede SSAP No. 91R.
97-3	Updated to note that FAS 140 was amended by FAS 166. No reconsideration of the GAAP issue.	Reject in INT 99-00	No Change
98-8	Updated to note that FAS 140 was amended by FAS 166. No reconsideration of the GAAP issue.	Adopted in INT 99-22	No Change Guidance from INT 99-22 has been included in the

GAAP EITF	Summary of FAS 166 Revisions	SAP Status (Appendix D)	Recommendation
			SSAP to supersede SSAP No. 91R.
98-14	Updated to note that FAS 140 was amended by FAS 166. No reconsideration of the GAAP issue.	Reject in INT 00-10	No Change
98-15	Updated to note that FAS 140 was amended by FAS 166. Identifies that the guidance in paragraph 11 of FAS 166 shall be applied to each structured note upon transfer.	Reject INT 00-11	No Change
99-8	Updated to note that FAS 140 was amended by FAS 166. No reconsideration of the GAAP issue.	Adopt with modification in SSAP No. 86	No Change
99-20	Updated to note that FAS 140 was amended by FAS 166. Also includes the following changes:	Adopted in SSAP No. 43R	Consideration of the revisions from FAS 166 to EITF 99-20 should occur. Recommends separate project to review this updated EITF for SSAP No. 43R.
	1. Reference "beneficial interests obtained as proceeds" rather than "beneficial interests that continue to be held by a transferor".	The term "beneficial interests that continue to be held by a transferor" is used in SSAP No. 43R.	
	2. Revise guidance to use "fair value of the beneficial interest as of the date of transfer" rather than "the allocated carrying amount after application of the relative fair value allocation method" for paragraph 11 of EITF 99-20.	Guidance from paragraph 11 of EITF 99-20 is included in SSAP No. 43R, paragraph 21.	
	3. Deleted paragraph 14 of EITF 99-20. This guidance pertains to recognitions of unrealized gains or losses as interest income.	SSAP No. 43R provides guidance on recognition of interest income for beneficial interests.	
	4. Deleted paragraph 16 of EITF 99-20. This guidance provided guidance for situations when it was not practicable to estimate the fair value of the beneficial interest at the initial transfer date.	Guidance from paragraph 16 is duplicated in SSAP No. 43R, paragraph 24	
	5. Revised paragraphs 20 to discuss the removal of the concept of a QSPE.	Paragraph 6.d. of SSAP No. 43R	

GAAP EITF	Summary of FAS 166 Revisions	SAP Status (Appendix D)	Recommendation
	Also provides guidance from FAS 166 on the conditions that must be met for sale accounting. 6. Revised paragraph 21 to reference FAS 167 (variable interest entities and consolidation). 7. Revised paragraph 27 to delete the prior change to replace the term "retained interests" with "interests that continue to be held by a transferor"	addresses securitization transactions that are accounted for as sales under SSAP No. 91R. FAS 167 is still pending statutory accounting review. The phrase "interests that continue to be held by a transferor" is used in SSAP No. 43R.	
02-9	Updated to reflect the revised terminology in FAS 166 as well as delete the issue and conclusion pertaining to qualified special purpose entities as the concept of a QSPE is no longer captured within FAS 166.	Although there is no impact to the statutory conclusion to adopt this EITF with modifications to statutory references, proposes the guidance in INT 04-21 be revised to reflect the revisions adopted from FAS 166.	Update INT 04-21, but do not change conclusion.
02-12	Nullified by FAS 166	Listed as No EITF Consensus	Update Appendix D to identify as nullified.

Statutory Issue Paper No. 143

Prospective-Based Guaranty Fund Assessments

STATUS
Finalized October 18, 2010

Original SSAP and Current Authoritative Guidance: SSAP No. 35R

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory accounting guidance on guaranty funds and assessments is provided within *SSAP No. 35—Guaranty Fund and Other Assessments* (SSAP No. 35). SSAP No. 35 rejected the GAAP guidance for recording guaranty fund and other assessments previously contained within AICPA *Statement of Position 97-3, Accounting by Insurance and Other Enterprises for Insurance-Related Assessments* (SOP 97-3) and currently included within the *Accounting Standards Codification 405-30, Insurance Related Assessments* (ASC 405-30).

2. As detailed within *Issue Paper No. 35, Accounting for Guaranty Fund and Other Assessments* (Issue Paper No. 35), SOP 97-3 defined the condition of obligation differently than Issue Paper No. 35. Issue Paper No. 35 identified that probability and obligation have been satisfied when insolvency has occurred, regardless of whether the assessment is based upon premiums or losses written, incurred or paid before or after the insolvency. Issue Paper No. 35 also identified that SOP 97-3 was rejected because it was inconsistent with the concepts of conservatism and recognition outlined in the Statement of Concepts, as well as the accounting principles set out in *Issue Paper No. 5, Definition of Liabilities, Loss Contingencies and Impairments of Assets* (Issue Paper No. 5). Issue Paper No. 35 identified that language from SOP 97-3 regarding the 'Ability to Reasonably Estimate the Liability' was incorporated into statutory accounting.

3. The purpose of this Issue Paper is to re-evaluate the previous conclusion within Issue Paper No. 35, and reflected within SSAP No. 35, regarding the adoption of SOP 97-3 (ASC 405-30) for statutory accounting.

SUMMARY CONCLUSION

4. Entities subject to assessments should recognize liabilities for insurance-related assessments when all of the following conditions are met:

a. An assessment has been imposed or information available prior to the issuance of the financial statements indicates it is probable that an assessment will be imposed.

b. The event obligating an entity to pay (underlying cause of) an imposed or probable assessment has occurred on or before the date of the financial statements.

c. The amount of the assessment can be reasonably estimated.

5. Premium-based guaranty-fund assessments, except those that are prefunded, are presumed probable when a formal determination of insolvency occurs, and presumed not probable prior to a formal determination of insolvency. Pre-funded guaranty fund assessments and premium-based administrative-type assessments are presumed probable when the premiums on which the assessments are expected to be

based are written. Loss-based administrative-type and second-injury fund assessments are presumed probable when the losses on which the assessments are expected to be based are incurred.

6. For premium-based assessments, the event that obligates the entity is generally writing the premiums or becoming obligated to write or renew (such as multiple-year, noncancelable policies) the premiums on which the assessments are expected to be based. Some states, through law or regulatory practice, provide that an insurance enterprise cannot avoid paying a particular assessment even if that insurance enterprise reduces its premium writing in the future. In such circumstances, the event that obligates the entity is a formal determination of insolvency or similar triggering event. Regulatory practice would be determined based on the stated intentions or prior history of the insurance regulators.

7. For loss-based assessments, the event that obligates the entity is an entity incurring the losses on which the assessments are expected to be based.

8. The following provides guidance on how guaranty-fund assessments and other insurance-related assessments should be applied:

a. *Retrospective-premium-based guaranty-fund assessments* – An assessment is probable of being imposed when a formal determination of insolvency occurs. At that time, the premium that obligates the entity for the assessment liability has already been written. Accordingly, an entity that has the ability to reasonably estimate the amount of the assessment should recognize a liability for the entire amount of future assessments related to a particular insolvency when a formal determination of insolvency is rendered.

b. *Prospective-premium-based guaranty-fund assessments* – The event that obligates the entity for the assessment liability generally is the writing of, or becoming obligated to write or renew, the premiums on which the expected future assessments are to be based. Therefore, the event that obligates the entity generally will not have occurred at the time of the insolvency.

i. In states that, through law or regulatory practice, provide that an entity cannot avoid paying a particular assessment in the future (even if the entity reduces premium writings in the future), the event that obligates the entity is a formal determination of insolvency or a similar event. An entity that has the ability to reasonably estimate the amount of the assessment should recognize a liability for the entire amount of future assessments that cannot be avoided related to a particular insolvency when a formal determination of insolvency occurs.

ii. In states without such a law or regulator practice, the event that obligates the entity is the writing of, or becoming obligated to write, the premiums on which the expected future assessments are to be based. An entity that has the ability to reasonably estimate the amount of the assessments should recognize a liability when the related premiums are written or when the entity becomes obligated to write the premiums.

c. *Prefunded-premium-based guaranty fund assessments* – A liability for an assessment arises when premiums are written. Accordingly, an entity that has the ability to reasonably estimate the amount of the assessment should recognize a liability as the related premiums are written.

d. *Other premium-based assessments* – Other premium-based assessments shall be accounted for in the same manner as prefunded-premium-based guaranty-fund assessments.

e. *Loss-based assessments* – An assessment is probable of being asserted when the loss occurs. The obligating event of the assessment also has occurred when the loss occurs. Accordingly, an entity that has the ability to reasonably estimate the amount of the assessment should recognize a liability as the related loss is incurred.

DISCUSSION

9. Current statutory accounting guidance within SSAP No. 35 rejected the provisions of SOP 97-3, and required assessments for guaranty fund obligations to be accrued at the time of the insolvency, regardless of whether an event that "obligates" the reporting entity (i.e., the writing of premiums) has occurred. This position was considered necessary to be consistent with the concepts of conservatism and recognition outlined in the Statement of Concepts.

10. Before codification (and SSAP No. 35), the statutory accounting practice was driven by the line of insurance written by the reporting entity. For life insurers, assessments were accrued at the time of the insolvency, as the guaranty fund obligations were based on premiums written prior to the insolvency. For property and casualty insurers, the practice varied to reflect when the premiums were written. For assessments based on premiums written after an insolvency, the assessment was accrued when the premiums were written, as this was considered the event that obligated the entity.

11. Interested parties have identified that after the adoption of SSAP No. 35, property and casualty insurers have been able to develop estimates of their respective market shares, but that these insurers have had difficulty in trying to estimate the ultimate loss expected from insolvencies. Although property and casualty insurers have worked with the National Conference of Insurance Guaranty Funds (NCIGF) and various State Guaranty Fund Associations in an attempt to obtain additional information related to the ultimate loss expected from insolvencies, the rate information provided by the NCIGF does not extend beyond one year. Additionally, the NCIGF information does not provide sufficient data to allow for the calculation of an ultimate expected assessment exposure, which is necessary to meet the SSAP No. 35 requirements.

12. Interested parties also identified that the range of outcomes among property and casualty insurers illustrates that there is a lack of consistency of estimates among these reporting entities. This lack of consistency creates concern as to the extent SSAP No. 35 can be applied reliably. Based on the request of interested parties, the Statutory Accounting Principles Working Group formed the Guaranty Fund Subgroup to review the current statutory requirements within SSAP No. 35 and reconsider the adoption of SOP 97-3 (ASC 405-30).

13. To complete an assessment, the Subgroup conducted state surveys and received information from the NCIGF. In considering the results of state surveys, several states noted that waiting to record prospective-based guaranty fund assessments until the obligating premium was written would not impact their assessment of the insurers. A few states indicated that waiting would actually improve their assessment of the insurer as the liability information would be more accurate. In contrast, two states specifically noted that insurers should not wait to record the liability on their financial statements, and thus favored the current SSAP No. 35 approach.

14. After considering the presentation by NCIGF, the Subgroup concluded that in addition to mirroring the GAAP requirements, adopting the approach within ACS 405-30 (SOP 97-3) would result with the recognition of liabilities that are better estimates, more consistently determined, and more verifiable than the existing statutory approach.

a. *Better Estimates* - Using the current approach, it has been communicated that insurers do not have adequate information to calculate ultimate expected assessment exposure as of the liquidation date. It has been communicated that relying on the last annual statement filed of the insolvent insurer would not be timely or provide the best estimate for assessments. This is due to limited filed financial statement information, if any, if rehabilitation or runoff has occurred prior to insolvency. Insurers have communicated that they can use the NCIGF "Assessment Liability Report" to estimate their assessment liabilities and that this report is accepted by auditors as support for determining assessment liabilities under ACS 405-30 (SOP 97-3).

b. *More Consistently Determined* – The guaranty associations determine annually how much to assess the insurance industry according to their funding needs. State laws establish the maximum assessment percentage that can be assessed by a guaranty association per year. Under the prospective assessment method, used by 54 of the 57 guaranty associations (as reported by the NCIGF), the assessment amount is a percentage of direct written premiums for the prior year for lines covered by the guaranty association. Assessments received by the guaranty association in a particular year are used to fund claims originating from all insolvencies, regardless of when those insolvencies occurred. Prospective-premium based assessments are assessments made on premiums written after an insolvency occurs; assessments in any year are generally limited to a percentage of premiums written the year before the assessment is made.

c. *More Verifiable* – It has been communicated that utilizing the GAAP method improves the auditability of property and casualty insurer estimates as the information is based on "real" data. As previously stated in this issue paper, it has been communicated that the information provided by the NCIGF, which is in accordance with the GAAP standards, is accepted as support for the insurance company's assessment liability.

15. The Subgroup also noted that the inconsistencies in reporting and the lack of verifiable information reduced the conservative benefits received under the existing guidance in SSAP No. 35. As the result of these findings, the Subgroup agreed to present an Issue Paper to the Working Group proposing substantive revisions to SSAP No. 35 to incorporate the ASC 405-30 (SOP 97-3) approach for guaranty fund liability recognition. Under this approach, accounting requirements for guaranty fund assessments would be determined in accordance with the type of guaranty-fund assessment imposed, and incorporate the concept of an 'obligating event' for prospective-based premium assessments in determining whether liability accrual should occur.

16. Exhibit A includes the proposed substantive revisions to reflect the adoption with modification of ASC 405-30 (SOP 97-3), in the form of *SSAP No. 35R—Guaranty Form and Other Assessments – Revised* (SSAP No. 35R). The substantive revisions are proposed to be initially effective for the reporting period beginning January 1, 2011.

17. Statutory accounting modifications from ASC 405-30 (SOP 97-3) are as follows:

a. The option to discount accrued liabilities (and reflect the time value of money of anticipated recoverables) is rejected for statutory accounting. Liabilities for guaranty funds or other assessments shall not be discounted.

b. The use of a valuation allowance for premium tax offsets and policy surcharges no longer probable for realization has been rejected for statutory accounting. Evaluation of assets shall be made in accordance with SSAP No. 5, and if it is probable that the asset is no longer realizable, the asset shall be written off and charged to income in the period the determination is made.

c. Guidance within ASC 405-30 pertaining to noninsurance entities has been rejected as not applicable for statutory accounting.

18. SSAP No. 35 has three statutory accounting interpretations (INTs). No revisions are considered necessary to these interpretations as a result of the substantive revisions proposed within SSAP No. 35R:

a. *INT 02-22: Accounting for the U.S. Terrorism Risk Insurance Program* (INT 02-22) – This interpretation indicates that there is a transfer of underwriting insurance risk under the Terrorism Insurance Program and accordingly, the recovery of such losses should be reported as reinsured losses. This interpretation also indicates that because the terrorism loss risk-spreading premium is imposed on policyholders as a surcharge, and that the Department of Treasury provides for insurers to collect the surcharge and "remit amounts collected to the Secretary", the surcharge generally meets the requirements of paragraph 10 of SSAP No. 35:

> 10. In certain circumstances, a reporting entity acts as an agent for certain state or federal agencies in the collection and remittance of fees or assessments. In these circumstances, the liability for the fees and assessments rests with the policyholder rather than with the reporting entity. The reporting entity's obligation is to collect and subsequently remit the fee or assessment. When both the following conditions are met, an assessment shall not be reported in the statement of operations of a reporting entity:
>
> a. The assessment is reflected as a separately identifiable item on the billing to the policyholder; and
>
> b. Remittance of the assessment by the reporting entity to the state or federal agency is contingent upon collection from the insured.

b. *INT 03-01: Application of SSAP No. 35 to the Florida Hurricane Catastrophe Fund* (INT 03-01) – This interpretation was nullified due to Florida Legislative Changes.

c. *INT 07-03: EITF 06-3: How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That is, Gross versus Net Presentation)* (INT 07-03) – This interpretation discusses the correct accounting treatment of taxes charged to a customer by collected and remitted by a reporting entity. Similar to INT 02-22, this interpretation focuses on the application of paragraph 10 and how the collection of assessments or charges from policyholders shall impact the reporting entity's financial statements.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

19. SSAP No. 35 provides the following guidance:

> 1. This statement establishes statutory accounting principles for guaranty fund and other assessments.
>
> 2. Guaranty fund assessments represent a funding mechanism employed by states to provide funds to cover policyholder obligations of insolvent reporting entities. Most states have enacted legislation establishing guaranty funds for both life and health insurance and for property and casualty insurance to provide for covered claims or to meet other insurance obligations of insolvent reporting entities in the state. Guaranty funds generally make assessments after an insolvency based upon retrospective premium writings.
>
> 3. This statement addresses other assessments including but not limited to workers' compensation second injury funds and for funds that pay operating costs of an insurance department, a state guaranty fund, and/or the workers' compensation board. This statement also

addresses health related assessments including but not limited to state health insurance high-risk pools, health insurance small group and individual reinsurance pools, state health demographic or risk adjustment assessments.

SUMMARY CONCLUSION

4. This statement applies *SSAP No. 5—Liabilities, Contingencies and Impairments of Assets* (SSAP No. 5) to guaranty fund and other assessments. SSAP No. 5 requires accrual of a liability when both of the following conditions are met:

a. Information available prior to issuance of the statutory financial statements indicates that it is probable that an asset has been impaired or a liability has been incurred at the date of the statutory financial statements. It is implicit in this condition that it is probable that one or more future events will occur confirming the fact of the loss or incurrence of a liability; and

b. The amount of loss can be reasonably estimated.

For the purposes of subparagraph 4 b., loss generally means assessment or assessment rate. Guaranty fund and other assessments shall be charged to expense (Taxes, Licenses and Fees) and a liability shall be accrued when the above criteria are met except for certain health related assessments which shall be reported as a part of claims. Health related assessments that are reported as a part of claims instead of taxes, licenses and fees are those assessments that are designed for the purpose of spreading the risk of severe claims or adverse enrollment selection among all participating entities, and where the funds collected via the assessment are re-distributed back to the participating entities based upon the cost of specific claims, enrollment demographics, or other criteria affecting health care expenses.

5. For refunded guaranty or other fund assessments and assessments used to fund state operating expenses, reporting entities shall credit the refund or charge the assessment to expense when notification of the refund or assessment is made.

6. For guaranty fund assessments, subparagraph 4 a. is met when the insolvency has occurred, regardless of whether the assessments are based on premiums written before or after the insolvency. For purposes of applying this guidance, the insolvency shall be considered to have occurred when a reporting entity meets a state's (ordinarily the state of domicile of the insolvent reporting entity) statutory definition of an insolvent reporting entity. In most states, the reporting entity must be declared to be financially insolvent by a court of competent jurisdiction. In some states, there must also be a final order of liquidation. Loss-based administrative-type and second injury fund assessments are presumed probable when the losses on which the assessments are expected to be based are incurred.

7. Subparagraph 4 b. requires that the amounts can be reasonably estimated. For guaranty fund assessments, a reporting entity's estimate of the liability shall reflect an estimate of its share of the ultimate loss expected from the insolvency. The reporting entity shall also estimate any applicable premium tax credits and policy surcharges. An entity need not be able to compute the exact amounts of the assessments or be formally notified of such assessments by a guaranty fund to make a reasonable estimate of its liability. Entities subject to assessments may have to make assumptions about future events, such as when the fund making the assessment will incur costs and pay claims to determine the amounts and the timing of assessments. The best available information about market share or premiums by state and premiums by line of business generally should be used to estimate the amount of future assessments. Estimates of loss-based assessments should be consistent with estimates of the underlying incurred losses and should be developed based upon enacted laws or regulations and expected assessment rates. Premium tax credits or policy surcharges may only be considered in the estimate if it is probable they will be realized. Changes in the amount of the liability (or asset) as a result of the passage of time and revisions to estimates in the amount or timing of the payments shall be recorded in taxes, licenses and fees.

8. In accordance with SSAP No. 5, when the reasonable estimate of the loss is a range, the amount in the range that is considered the best estimate shall be accrued. When, in management's opinion, no amount within management's estimate of the range is a better estimate than any other amount, however, the midpoint (mean) of management's estimate in the range shall be accrued. For purposes of this statement, it is assumed that management can quantify the high end of the range. If management determines that the high end of the range cannot be quantified, then a range does not exist, and management's best estimate shall be accrued.

9. The liability for assessments shall be established gross of any probable and estimable recoveries from premium tax credits and premium surcharges. Because assessments are generally paid before premium tax credits are realized or policy surcharges are collected, an asset may result, which represents a receivable for premium tax credits that will be taken and policy surcharges which will be collected in the future. These amounts, to the extent it is probable they will be realized, meet the definition of assets, as specified in *SSAP No. 4—Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this statement. The asset shall be established and reported independent from the liability (not reported net).

10. In certain circumstances, a reporting entity acts as an agent for certain state or federal agencies in the collection and remittance of fees or assessments. In these circumstances, the liability for the fees and assessments rests with the policyholder rather than with the reporting entity. The reporting entity's obligation is to collect and subsequently remit the fee or assessment. When both the following conditions are met, an assessment shall not be reported in the statement of operations of a reporting entity:

a. The assessment is reflected as a separately identifiable item on the billing to the policyholder; and

b. Remittance of the assessment by the reporting entity to the state or federal agency is contingent upon collection from the insured.

Disclosures

11. Describe the nature of any assessments that could have a material financial effect and state the estimate of the liability or that an estimate cannot be made. To the extent assessments have been accrued disclose the amounts of the liabilities, any related asset for premium tax credits or policy surcharges, the periods over which the assessments are expected to be paid, and the period over which the recorded premium tax offsets or policy surcharges are expected to be realized.

12. Refer to the preamble for further discussion regarding disclosure requirements.

Relevant Literature

13. This statement rejects GAAP guidance for recording guaranty fund and other assessments, which is contained in *AICPA Statement of Position 97-3, Accounting by Insurance and Other Enterprises for Insurance-Related Assessments*.

Generally Accepted Accounting Principles

14. *Accounting Standards Codification 405-30, Insurance-Related Assessments* (ASC 405-30) provides the following guidance:

405-30-05 Overview and Background

05-1 Insurance entities as well as noninsurance entities are subject to a variety of assessments related to insurance activities, including those by state guaranty funds and workers' compensation second-injury funds. Some entities may be subject to insurance-related assessments because they self-insure against loss or liability. This Subtopic provides guidance on accounting for insurance-related assessments.

State Guaranty Funds

05-2 States have enacted legislation establishing guaranty funds. The state guaranty funds assess entities licensed to sell insurance in the state to provide for the payment of covered claims or to meet other insurance obligations—subject to prescribed limits—of insolvent insurance entities. The assessments are generally based on premium volume for certain covered lines of business. Most state guaranty funds assess entities for costs related to a particular insolvency after the insolvency occurs. At least one state, however, assesses entities before insolvencies.

05-3 State guaranty funds use a variety of methods for assessing entities. This Subtopic identifies the following four primary methods of guaranty-fund assessments:

a. *Retrospective-premium-based assessments*. Guaranty funds covering benefit payments of insolvent life, annuity, and health insurance entities typically assess entities based on premiums written or received in one or more years before the year of insolvency. Assessments in any year are generally limited to an established percentage of an entity's average premiums for the three years preceding the insolvency. Assessments for a given insolvency may take place over several years.

b. *Prospective-premium-based assessments*. Guaranty funds covering claims of insolvent property and casualty insurance entities typically assess entities based on premiums written in one or more years after the insolvency. Assessments in any year are generally limited to an established percentage of an entity's premiums written or received for the year preceding the assessment. Assessments for a given insolvency may take place over several years.

c. *Prefunded-premium-based assessments*. At least one state uses this kind of assessment to cover claims of insolvent property and casualty insurance entities. This kind of assessment is intended to prefund the costs of future insolvencies. Assessments are imposed before any particular insolvency and are based on the current level of written premiums. Rates to be applied to future premiums are adjusted as necessary.

d. *Administrative-type assessments*. These assessments are typically a flat (annual) amount per entity to fund operations of the guaranty association, regardless of the existence of an insolvency.

05-4 State laws often allow for recoveries of guaranty-fund assessments by entities subject to assessments through such mechanisms as premium tax offsets, policy surcharges, and future premium rate structures. The policy surcharges referred to in this Subtopic are those surcharges that are intended to provide an opportunity for assessed entities to recover some or all of the amounts assessed over a period of time.

Other Insurance-Related Assessments

05-5 Entities are subject to a variety of other insurance-related assessments. Many states and a number of local governmental units have established other funds supported by assessments. The two most prevalent uses for such assessments are as follows:

a. To fund operating expenses of state insurance regulatory bodies (for example, the state insurance department or workers' compensation board)

b. To fund second-injury funds, which provide reimbursement to insurance carriers or employers for workers' compensation claims when the cost of a second injury combined with a prior accident or disability is greater than what the second accident alone would have produced. The employer of an injured or handicapped worker is responsible only for the workers' compensation benefit for the most recent injury; the second-injury fund would cover the cost of any additional benefits for aggravation of a prior condition or injury. The intent of the fund is to help insure that employers are not made to suffer a greater monetary loss or increased insurance costs because of hiring previously injured or handicapped employees.

05-6 The primary methods used to assess for these other insurance-related assessments are the following:

a. *Premium-based*. The assessing entity imposes the assessment based on the entity's written premiums. The assessing entity may be at the state, county, municipality, or other such level. The base year of premiums is generally either the current year or the year preceding the assessment.

b. *Loss-based*. The assessing entity imposes the assessment based on the entity's incurred losses or paid losses in relation to that amount for all entities subject to that assessment in the particular jurisdiction.

405-30-10 Objectives

10-1 The objective of this Subtopic is to establish consistent accounting and disclosures for guaranty-fund and other insurance-related assessments to improve comparability of reported information.

405-30-15 Scope and Scope Exceptions

Entities

15-1 The guidance in this Subtopic applies to all entities that are subject to guaranty-fund and other insurance-related assessments, including entities that are subject to insurance-related assessments because they self-insure against loss or liability. For example, one state specifies that self-insurers of workers' compensation should use as a base for assessment the amount of premium the self-insurer would have paid if it had insured its liability with an insurer for the previous calendar year.

Transactions

15-2 The guidance in this Subtopic applies to assessments mandated by statute or regulatory authority that are related directly or indirectly to underwriting activities (including self-insurance), except for income taxes and premium taxes.

15-3 The guidance in this Subtopic does not apply to the following transactions and activities:

a. Amounts payable or paid as a result of reinsurance contracts or arrangements that are in substance reinsurance, including assumed reinsurance activities and certain involuntary pools that are covered by Topic 944.

b. Assessments of depository institutions related to bank insurance and similar funds.

405-30-25 Recognition

Reporting Liabilities

25-1 Entities subject to assessments shall recognize liabilities for insurance-related assessments when all of the following conditions are met:

a. *Probability of assessment*. An assessment has been imposed or information available before the financial statements are issued or are available to be issued (as discussed in Section 855-10-25) indicates it is probable that an assessment will be imposed.

b. *Obligating event*. The event obligating an entity to pay (underlying cause of) an imposed or probable assessment has occurred on or before the date of the financial statements.

c. *Ability to reasonably estimate*. The amount of the assessment can be reasonably estimated.

See Examples 1 through 3 (paragraphs 405-30-55-1 through 55-15) for illustrations of the computation of assessment liabilities.

Probability of Assessment

25-2 Premium-based guaranty-fund assessments, except those that are prefunded, are presumed probable when a formal determination of insolvency occurs, and presumed not probable before a formal determination of insolvency. For purposes of this Subtopic, a formal determination of insolvency occurs when an entity meets a state's (ordinarily the state of domicile of the insolvent insurer) statutory definition of an insolvent insurer. In most states, the entity must be declared to be financially insolvent by a court of competent jurisdiction. In some states, there must also be a final order of liquidation.

25-3 Prefunded guaranty-fund assessments and premium-based administrative-type assessments, as defined in paragraph 405-30-05-3, are presumed probable when the premiums on which the assessments are expected to be based are written. Loss-based administrative-type and second-injury fund assessments are presumed probable when the losses on which the assessments are expected to be based are incurred.

Obligating Event

25-4 Because of the fundamental differences in how assessment mechanisms operate, the event that makes an assessment probable (for example, an insolvency) may not be the event that obligates an entity. The following defines the event that obligates an entity to pay an assessment for each kind of assessment identified in this Subtopic:

a. For premium-based assessments, the event that obligates the entity is generally writing the premiums or becoming obligated to write or renew (such as multiple-year, noncancelable policies) the premiums on which the assessments are expected to be based. Some states, through law or regulatory practice, provide that an insurance entity cannot avoid paying a particular assessment even if that insurance entity reduces its premium writing in the future. In such circumstances, the event that obligates the entity is a formal determination of insolvency or similar triggering event. For example, in certain states, an insurance entity may remain liable for assessments even though the insurance entity discontinues the writing of premiums. In this circumstance, the underlying cause of the liability is not the writing of the premium, but the insolvency. Regulatory practice would be determined based on the stated intentions or prior history of the insurance regulators.

b. For loss-based assessments, the event that obligates an entity is an entity's incurring the losses on which the assessments are expected to be based.

Ability to Reasonably Estimate

25-5 One of the conditions (see paragraph 450-20-25-2(b)) for recognition of a liability is that the amount can be reasonably estimated. Paragraph 450-20-25-5 provides that some amount of loss can be reasonably estimated when available information indicates that the estimated amount of the loss is within a range of amounts. Paragraph 450-20-30-1 explains that, if no amount within the range is a better estimate than any other amount, the minimum amount in the range should be accrued.

Applying the Recognition Criteria

25-6 Application of the recognition criteria in paragraphs 405-30-25-1 through 25-5 to the methods used to address guaranty-fund assessments and other insurance-related assessments, as described in paragraphs 405-30-05-3 through 05-6, is as follows:

a. *Retrospective-premium-based guaranty-fund assessments*. An assessment is probable of being imposed when a formal determination of insolvency occurs. At that time, the premium that obligates the entity for the assessment liability has already been written. Accordingly, an entity that has the ability to reasonably estimate the amount of the assessment shall recognize a liability for the entire amount of future assessments related to a particular insolvency when a formal determination of insolvency is rendered.

b. *Prospective-premium-based guaranty-fund assessments*. The event that obligates the entity for the assessment liability generally is the writing of, or becoming obligated to write or renew, the premiums on which the expected future assessments are to be based (for example, multiple-year contracts under which an insurance entity has no discretion to avoid writing future premiums). Therefore, the event that obligates the entity generally will not have occurred at the time of the insolvency. Law or regulatory practice affects the event that obligates the entity in either of the following ways:

    1. In states that, through law or regulatory practice, provide that an entity cannot avoid paying a particular assessment in the future (even if the entity reduces premium writings in the future), the event that obligates the entity is a formal determination of insolvency or a similar event. An entity that has the ability to reasonably estimate the amount of the assessment shall recognize a liability for the entire amount of future assessments that cannot be avoided related to a particular insolvency when a formal determination of insolvency occurs.

    2. In states without such a law or regulatory practice, the event that obligates the entity is the writing of, or becoming obligated to write, the premiums on which the expected future assessments are to be based. An entity that has the ability to reasonably estimate the amount of the assessments shall recognize a liability when the related premiums are written or when the entity becomes obligated to write the premiums.

c. *Prefunded-premium-based guaranty-fund assessments*. A liability for an assessment arises when premiums are written. Accordingly, an entity that has the ability to reasonably estimate the amount of the assessment shall recognize a liability as the related premiums are written.

d. *Other premium-based assessments*. Other premium-based assessments, as described in paragraph 405-30-05-5, would be accounted for in the same manner as prefunded-premium-based guaranty-fund assessments.

e. *Loss-based assessments*. An assessment is probable of being asserted when the loss occurs. The obligating event of the assessment also has occurred when the loss occurs. Accordingly, an entity that has the ability to reasonably estimate the amount of the assessment shall recognize a liability as the related loss is incurred.

25-7 Administrative-type assessments are generally expensed in the period assessed.

Asset for Premium Tax Offsets and Policy Surcharges

25-8 When it is probable that a paid or accrued assessment will result in an amount that is recoverable from premium tax offsets or policy surcharges, an asset shall be recognized for that recovery.

25-9 For retrospective-premium-based assessments, to the extent that it is probable that paid or accrued assessments will result in a recoverable amount in a future period from business currently in force considering appropriate persistency rates for long-duration contracts (see paragraph 405-30-30-11), an asset shall be recognized at the time the liability is recorded.

25-10 An asset shall not be established for paid or accrued assessments that are recoverable through future premium rate structures.

25-11 Policy surcharges that are required as a pass-through to the state or other regulatory bodies shall be accounted for in a manner such that amounts collected or receivable are not recorded as revenues and amounts due or paid are not expensed (meaning, similar to accounting for sales tax).

405-30-30 Initial Measurement

Estimating the Liability

30-1 Entities subject to assessments may be able to obtain information to assist in estimating the total guaranty-fund cost or the following years' assessments, as appropriate, for an insolvency from entities such as the state guaranty fund associations, the National Organization of Life and Health Insurance Guaranty Associations, and the National Conference of Insurance Guaranty Funds.

30-2 An entity need not be able to compute the exact amounts of the assessments or be formally notified of such assessments by a guaranty fund to make a reasonable estimate of its liability. Entities subject to assessments may have to make assumptions about future events, such as when the fund will incur costs and pay claims that will determine the amounts and the timing of assessments.

30-3 The best available information about market share or premiums by state and premiums by line of business shall be used to estimate the amount of an insurance entity's future assessments.

30-4 If a noninsurance entity's assessments are based on premiums, it may be necessary to consider the amount of premium the self-insurer would have paid if it had insured its liability with an insurer. If a noninsurance entity's assessments are based on losses, it shall consider the losses that have been incurred by the entity when determining the liability. Most often, assessments that have an impact on noninsurance entities that self-insure workers' compensation obligations are for second-injury funds. Second-injury funds generally assess insurance entities and self-insurers based on paid losses.

30-5 A noninsurance entity may develop an accrual for its second-injury liability based on any of the following:

a. The ratio of the entity's prior period paid workers' compensation claims to aggregate workers' compensation claims in the state that was used as a basis for previous assessments

b. Total fund assessments in prior periods

c. Known changes in the current period to either the number of employees self-insured by the entity or the number of workers who are the subject of recoveries from the second-injury fund that might alter total fund assessments and the entity's proportion of the total fund assessments.

30-6 Estimates of loss-based assessments shall be consistent with estimates of the underlying incurred losses and shall be developed based on enacted laws or regulations and expected assessment rates.

30-7 Estimates of some insurance-related assessment liabilities may be difficult to derive. The development or determination of estimates is particularly difficult for guaranty-fund assessments because of uncertainties about the cost of the insolvency to the guaranty fund and the portion that will be recovered through assessment. Examples of uncertainties include the following:

a. Limitations, as provided by statute, on the amount of individual contract liabilities that the guaranty fund will assume, that cause the guaranty fund associations' liability to be less than the amount by which the entity is insolvent

b. Contract provisions (for example, credited rates) that may be modified at the time of the insolvency or alternative payout options that may be offered to contract holders that affect the level and payout of the guaranty fund's liability

c. The extent and timing of available reinsurance recoveries, which may be subject to significant uncertainties

d. Alternative strategies for the liquidation of assets of the insolvent entity that affect the timing and level of assessments

e. Certain liabilities of the insolvent insurer that may be particularly difficult to estimate (for example, asbestos or environmental liabilities).

30-8 Because of the uncertainties surrounding some insurance-related assessments, the range of assessment liability may have to be reevaluated regularly during the assessment process. For some ranges, there may be amounts that appear to be better estimates than any other within the range. If this is the case, the liability recorded shall be based on the best estimate within the range. For ranges in which there is no such best estimate, the liability that should be recorded shall be based on the amount representing the minimum amount in the range.

Present Value Measurement of the Obligation

30-9 Current practice in the insurance industry is to allow, but not require (with limited exceptions, such as pensions and postretirement benefits), the discounting of liabilities to reflect the time value of money when the aggregate amount of the obligation and the amount and timing of the cash payments are fixed or reliably determinable for a particular liability.

30-10 Similarly, for assessments that meet those criteria, the liability may be recorded at its present value by discounting the estimated future cash flows at an appropriate interest rate.

Asset for Premium Tax Offsets and Policy Surcharges

30-11 The asset recognized under paragraph 405-30-25-8 shall be measured based on current laws and projections of future premium collections or policy surcharges from in-force policies. In determining the asset to be recorded, in-force policies do not include expected renewals of short-duration contracts but do include assumptions as to persistency rates for long-duration contracts.

30-12 The time value of money need not be considered in the determination of the recorded amount of a potential recovery if the liability is not discounted. In instances in which the recovery period for an asset is substantially longer than the payout period for the liability, it may be appropriate to record the asset on a discounted basis regardless of whether the liability is discounted.

30-13 The recognition of such assets related to prospective-premium-based assessments is limited to the amount of premium an entity has written or is obligated to write and to the amounts recoverable over the life of the in-force policies. The expected premium tax offset or policy surcharge asset related to the accrual of prospective-premium-based assessments shall be based on and limited to the amount recoverable as a result of premiums the insurer has written or is obligated to write.

405-30-35 Subsequent Measurement

Asset for Premium Tax Offsets and Policy Surcharges

35-1 The asset recorded under paragraph 405-30-25-8 for premium tax offsets and policy surcharges shall be subject to a valuation allowance to reflect any portion of the asset that is no longer probable of realization. Considering expected future premiums other than on in-force policies in evaluating the recoverability of premium tax offsets or policy surcharges is not appropriate.

405-30-50 Disclosure

50-1 Sections 275-10-50 and 450-20-55 address disclosures related to loss contingencies. That guidance is applicable to assessments covered by this Subtopic. Additionally, if amounts have been discounted, the entity shall disclose in the financial statements the undiscounted amounts of the liability and any related asset for premium tax offsets or policy surcharges as well as the discount rate used. If amounts have not been discounted, the entity shall disclose in the financial statements the amounts of the liability, any related asset for premium tax offsets or policy surcharges, the periods over which the assessments are expected to be paid, and the period over which the recorded premium tax offsets or policy surcharges are expected to be realized.

405-30-55 Implementation Guidance and Illustrations

Illustrations

Example 1: Prospective-Premium-Based Assessment

55-1 This Example illustrates application of the recognition and measurement guidance in this Subtopic to a prospective-premium-based assessment. This kind of assessment is considered prospective because the assessment relates to premium written after the insolvency. As a result of insolvencies in prior years, ABC Property & Liability Insurance Company (ABC) expects to be assessed in the future by the guaranty fund in a state where it writes premiums. Any such assessments will be limited to 2 percent of premium writings in the prior year and are recoverable through premium tax offsets on a ratable basis over the 5-year period following the year of each assessment.

55-2 Although it does not expect to do so, ABC is free to cease writing the lines of business that are subject to the guaranty-fund assessments.

55-3 As of December 31, 19X0, ABC has neither paid nor received a notice of an assessment related to the insolvencies. Based on communications from the state guaranty association, ABC expects to receive an assessment in 19X1, which is allocated among entities based on 19X0 market share, for at least 1 percent of 19X0 premiums that are subject to the assessment. A best estimate cannot be determined, and no amount within the range of estimates (meaning, from 1 to

2 percent of 19X0 premiums) is a better estimate than any other amount, therefore the minimum amount in the range shall be accrued.

55-4 As of December 31, 19X0, ABC should recognize a liability equal to 1 percent of the premiums written in 19X0 that are subject to the assessment. No additional liability should be recognized, and no asset related to the premium tax offset should be recognized. Disclosure of the loss contingency of up to an additional 1 percent of the subject premiums should be considered.

55-5 ABC would recognize a liability only for those future assessments it is obligated to pay as a result of the premiums written. Because ABC is not obligated to write any future premiums, its liability is limited to that related to premiums written in 19X0. Because no amount within the range of estimates is a better estimate than any other amount, the minimum amount in the range is accrued. Further, because the premium tax offset is realizable only on business that will be written in the future (that is, 19X2 and subsequent years), no asset or receivable is recognized as of December 31, 19X0.

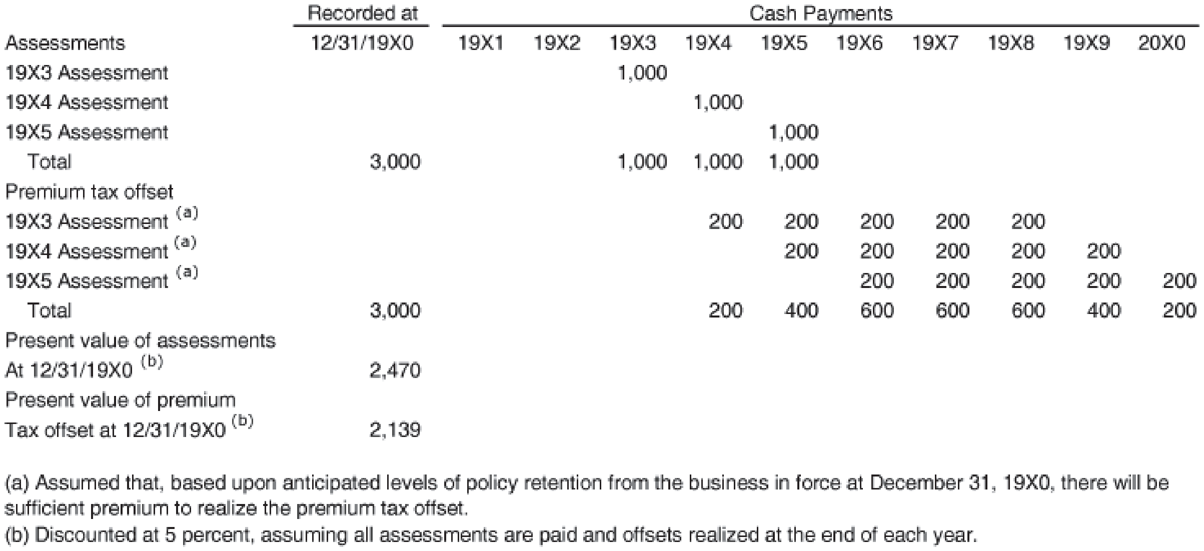
Example 2: Retrospective-Premium-Based Assessment

55-6 This Example illustrates application of the recognition and measurement guidance in this Subtopic to a retrospective-premium-based assessment. As a result of an insolvency that occurred during 19X0, DEF Life and Health Insurance Company (DEF) expects to be assessed in the future by the guaranty fund in a state where it has written business. Any such assessment will be based on DEF's average market share, determined based on premiums that are subject to the assessment for the three years before the insolvency, and limited to 2 percent of the average annual subject premiums for the three years before the insolvency. Further, such assessments are recoverable through premium tax offsets over the five-year period following the year of payment for each assessment.

55-7 As of December 31, 19X0, DEF has not paid or received a notice of an assessment related to the insolvency. Based on initial input from the National Organization of Life and Health Insurance Guaranty Associations and experience with other insolvencies, DEF assumes that the first assessment will not be made until 19X3 and that it will take three to five annual assessments for the guaranty fund to be able to meet its obligations. Based on the estimated nationwide cost of the insolvency and the distribution of the insolvent entity's business, DEF estimates that its assessment will be at least 1 percent of the average annual premiums that are subject to the assessment. No amount within the range of estimates (meaning, from 1 to 2 percent of the average annual premiums for 3 to 5 years) is a better estimate than any other amount, therefore the minimum amount in the range shall be accrued.

55-8 As of December 31, 19X0, DEF should recognize a liability for 3 years of assessments at 1 percent of the average annual premiums that are subject to the assessment (that is, the assessments expected in 19X3, 19X4, and 19X5). Disclosure of the loss contingency for additional assessments (meaning, in 19X6 and 19X7) or assessment of greater than 1 percent of the average annual premiums that are subject to the assessment should be considered. An asset related to premium tax offsets that are available on accrued assessments would be recorded provided there were sufficient premium taxes based on business in force at December 31, 19X0 (with assumed levels of policy retention), to allow realization of the asset.

55-9 The resulting recognized liability and asset are as follows (shown on both a discounted and undiscounted basis, based on paragraphs 405-30-30-9 through 30-12, discounting is optional), assuming average annual subject premiums of $100,000 for the 3 years before the insolvency.



	Recorded at	Cash Payments									
Assessments	12/31/19X0	19X1	19X2	19X3	19X4	19X5	19X6	19X7	19X8	19X9	20X0
19X3 Assessment				1,000							
19X4 Assessment					1,000						
19X5 Assessment						1,000					
Total	3,000			1,000	1,000	1,000					
Premium tax offset											
19X3 Assessment (a)					200	200	200	200	200		
19X4 Assessment (a)						200	200	200	200	200	
19X5 Assessment (a)							200	200	200	200	200
Total	3,000				200	400	600	600	600	400	200
Present value of assessments At 12/31/19X0 (b)	2,470										
Present value of premium Tax offset at 12/31/19X0 (b)	2,139										

(a) Assumed that, based upon anticipated levels of policy retention from the business in force at December 31, 19X0, there will be sufficient premium to realize the premium tax offset.

(b) Discounted at 5 percent, assuming all assessments are paid and offsets realized at the end of each year.

55-10 DEF would record a liability for all future assessments related to the insolvency. Because no amount within the range of estimates (meaning, from 1 to 2 percent of the average annual premiums for 3 to 5 years) is a better estimate than any other amount, the minimum amount in the range (meaning, 1 percent per year for 3 years of assessments) is accrued.

55-11 Since it is assumed that based on the anticipated levels of policy retention from the business in force at December 31, 19X0, there will be sufficient premium to realize the premium tax offset, the premium tax offset is recorded.

Example 3: Loss-Based Assessment

55-12 This Example illustrates application of the recognition and measurement guidance in this Subtopic to a loss-based assessment. GHI Industrial Company (GHI) is self-insured for workers' compensation and therefore participates in the second injury fund in the state where it conducts operations. GHI is entitled to recover from the fund some or all of the indemnity claims for previously injured workers. GHI is also subject to annual assessments (maximum of 1 percent per year) on indemnity claims paid each year.

55-13 Assessment rates have been climbing steadily, from 0.6 percent 5 years previous to 0.75 percent in 19X0.

55-14 As of December 31, 19X0, GHI should have an assessment liability recognized for 0.75 percent of its liability for the payment of future indemnity claims, unless there was information to support the assessment rate being reduced or the assessments being eliminated in the future. Disclosure of the loss contingency of up to an additional 0.25 percent of the liability for the payment of future indemnity claims should be considered.

55-15 GHI would recognize a liability based on the current assessment rate, unless there was clear evidence that the rate would change. The liability would be based on the entire liability base that was subject to the assessment.

RELEVANT LITERATURE

Statutory Accounting

- *SSAP No. 5—Liabilities, Contingencies and Impairments of Assets*
- *SSAP No. 35—Guaranty Fund and Other Assessments*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 35—Accounting for Guaranty Fund and Other Assessments*

Generally Accepted Accounting Principles

- *Accounting Standards Codification 405-30, Insurance-Related Assessments*
- *SOP 97-3, Accounting by Insurance and Other Enterprises for Insurance-Related Assessments*

State Regulations

- No additional guidance obtained from state statutes or regulations.

Exhibit A: ILLUSTRATION OF MARKED CHANGES TO AMENDED SSAP NO. 35R

The following depicts the amendments from this issue paper as “marked changes” (new text underlined):

Guaranty Fund and Other Assessments

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for guaranty fund and other assessments.

2. Guaranty fund assessments represent a funding mechanism employed by states to provide funds to cover policyholder obligations of insolvent reporting entities. Most states have enacted legislation establishing guaranty funds for both life and health insurance and for property and casualty insurance to provide for covered claims or to meet other insurance obligations of insolvent reporting entities in the state. ~~Guaranty funds generally make assessments after an insolvency based upon retrospective premium writings.~~

3. This statement addresses other assessments including but not limited to workers’ compensation second injury funds and for funds that pay operating costs of an insurance department, a state guaranty fund, and/or the workers’ compensation board. This statement also addresses health related assessments including but not limited to state health insurance high-risk pools, health insurance small group and individual reinsurance pools, state health demographic or risk adjustment assessments.

SUMMARY CONCLUSION

4. This statement adopts with modification guidance from *Accounting Standard Codification 405-30, Insurance-Related Assessments* (ASC 405-30) as reflected within this SSAP. Consistent with ASC 405-30-25-1, entities subject to assessments shall recognize liabilities for insurance-related assessments when all of the following conditions are met (paragraph 13 provides guidance on applying the recognition criteria): ~~applies *SSAP No. 5—Liabilities, Contingencies and Impairments of Assets* (SSAP No. 5) to guaranty fund and other assessments. SSAP No. 5 requires accrual of a liability when both of the following conditions are met:~~

a. An assessment has been imposed or information available ~~Information available~~ prior to issuance of the statutory financial statements indicates that it is probable that an assessment will be imposed. ~~an asset has been impaired or a liability has been incurred at the date of the statutory financial statements. It is implicit in this condition that it is probable that one or more future events will occur confirming the fact of the loss or incurrence of a liability; and~~

b. The event obligating an entity to pay an imposed or probable assessment has occurred on or before the date of the financial statements.

~~b.~~c. The amount of ~~loss~~ the assessment can be reasonably estimated.

~~For the purposes of subparagraph 4 b., loss generally means assessment or assessment rate.~~ Guaranty fund and other assessments shall be charged to expense (Taxes, Licenses and Fees) and a liability shall be accrued when the above criteria are met except for certain health related assessments which shall be reported as a part of claims. Health related assessments that are reported as a part of claims instead of taxes, licenses and fees are those assessments that are designed for the purpose of spreading the risk of severe claims or adverse enrollment selection among all participating entities, and where the funds collected via the assessment are re-distributed back to the participating entities based upon the cost of specific claims, enrollment demographics, or other criteria affecting health care expenses. This standard does not permit liabilities for guaranty funds or other assessments to be discounted.

5. For refunded guaranty or other fund assessments and assessments used to fund state operating expenses, reporting entities shall credit the refund or charge the assessment to expense when notification of the refund or assessment is made.

6. For premium-based guaranty fund assessments, except those that are prefunded, subparagraph 4a. is met when the insolvency has occurred~~, regardless of whether the assessments are based on premiums written before or after the insolvency~~. For purposes of applying this guidance, the insolvency shall be considered to have occurred when a reporting entity meets a state's (ordinarily the state of domicile of the insolvent reporting entity) statutory definition of an insolvent reporting entity. In most states, the reporting entity must be declared to be financially insolvent by a court of competent jurisdiction. In some states, there must also be a final order of liquidation. Prefunded guaranty-fund assessments and premium-based administrative type assessment are presumed probable when the premiums on which the assessments are expected to be based are written. Loss-based administrative-type and second injury fund assessments are presumed probable when the losses on which the assessments are expected to be based are incurred.

7. Subparagraph 4b requires that the event obligating an entity to pay an imposed or probable assessment has occurred on or before the date of the financial statements. Based on the fundamental differences in how assessment mechanisms operate, the event that makes an assessment probable (for example, an insolvency) may not be the event that obligates an entity. The following defines the event that obligates an entity to pay an assessment:

a. For premium-based assessments, the event that obligates the entity is generally writing the premiums or becoming obligated to write or renew (such as multiple-year, noncancelable policies) the premiums on which the assessments are expected to be based. Some states, through law or regulatory practice, provide that an insurance entity cannot avoid paying a particular assessment even if that insurance entity reduces its premium writing in the future. In such circumstances, the event that obligates the entity is a formal determination of insolvency or similar triggering event. For example, in certain states, an insurance entity may remain liable for assessments even though the insurance entity discontinues the writing of premiums. In this circumstance, the underlying cause of the liability is not the writing of the premium, but the insolvency. Regulatory practice would be determined based on the stated intentions or prior history of the insurance regulators.

b. For loss-based assessments, the event that obligates an entity is an entity's incurring the losses on which the assessments are expected to be based.

~~7.~~8. Subparagraph 4 ~~b~~c. requires that the amounts can be reasonably estimated. For retrospective-premium-based guaranty fund assessments, a reporting entity's estimate of the liability shall reflect an estimate of its share of the ultimate loss expected from the insolvency. The reporting entity shall also estimate any applicable premium tax credits and policy surcharges. An entity need not be able to compute the exact amounts of the assessments or be formally notified of such assessments by a guaranty fund to make a reasonable estimate of its liability. Entities subject to assessments may have to make assumptions about future events, such as when the fund making the assessment will incur costs and pay claims to determine the amounts and the timing of assessments. The best available information about market share or premiums by state and premiums by line of business generally should be used to estimate the amount of future assessments. Estimates of loss-based assessments should be consistent with estimates of the underlying incurred losses and should be developed based upon enacted laws or regulations and expected assessment rates. Premium tax credits or policy surcharges may only be considered in the estimate if it is probable they will be realized. Because of the uncertainties surrounding some insurance-related assessments, the range of assessment liability may have to be re-evaluated regularly during the assessment process. Changes in the amount of the liability (or asset) as information becomes available over time~~a result of the passage of time~~ and revisions to estimates in the amount or timing of the payments shall be recorded in taxes, licenses and fees.

~~8.~~9. In accordance with SSAP No. 5, when the reasonable estimate of the loss is a range, the amount in the range that is considered the best estimate shall be accrued. When, in management's opinion, no amount within management's estimate of the range is a better estimate than any other amount, however, the midpoint (mean) of management's estimate in the range shall be accrued. For purposes of this statement, it is assumed that management can quantify the high end of the range. If management determines that the high end of the range cannot be quantified, then a range does not exist, and management's best estimate shall be accrued.

Reporting Assets for Premium Tax Offsets and Policy Surcharges

10. The liability for accrued assessments shall be established gross of any probable and estimable recoveries from premium tax credits and premium surcharges. When it is probable that a paid or accrued assessment will result in an amount that is recoverable from premium tax offsets or policy surcharges, an asset shall be recognized for that recovery in an amount that is determined based on current laws, projections of future premium collections or policy surcharges from in-force policies, and as permitted in accordance with subparagraphs 10a, 10b and 10c. Any recognized asset from premium tax credits or policy surcharges shall be re-evaluated regularly to ensure recoverability. Upon expiration, tax credits no longer meet the definition of an asset and shall be written off.

a. For ~~Because~~ assessments ~~are generally~~ paid before premium tax credits are realized or policy surcharges are collected, an asset ~~may~~ results, which represents a receivable for premium tax credits that will be taken and policy surcharges which will be collected in the future. These ~~amounts~~receivables, to the extent it is probable they will be realized, meet the definition of assets, as specified in *SSAP No. 4—Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this statement. The asset shall be established and reported independent from the liability (not reported net).

~~a.~~b. Assets recognized from accrued liability assessments shall be determined in accordance with the type of guaranty fund assessment as detailed in the following subparagraphs. Assets recognized from accrued liability assessments meet the definition of an asset under SSAP No. 4, and are admitted assets to the extent they conform to the requirements of this statement.

i. For retrospective-premium-based and loss-based assessments, to the extent that it is probable that accrued liability assessments will result in a recoverable amount in a future period from business currently in-force considering appropriate persistency rates for long-duration contracts, an asset shall be recognized at the time the liability is recorded. (In-force policies do not include expected renewals of short-term contracts.

ii. For prospective-premium-based assessments, the recognition of assets from accrued liability assessments is limited to the amount of premium an entity has written or is obligated to write and to the amounts recoverable over the life of the in-force policies. This SSAP requires reporting entities to recognize prospective-based-premium assessments as the premium is written or obligated to be written by the reporting entity. Accordingly, the expected premium tax offset or policy surcharge asset related to the accrual of prospective-premium-based assessments shall be based on and limited to the amount recoverable as a result of premiums the insurer has written or is obligated to write.

c. An asset shall not be established for paid or accrued assessments that are recoverable through future premium rate structures.

11. An evaluation of assets recognized under paragraph 10 shall be made in accordance with *SSAP No. 5—Liabilities, Contingencies and Impairments of Assets* (SSAP No. 5) to determine if there is any impairment. If, in accordance with SSAP No. 5, it is probable that the asset is no longer realizable, the asset shall be written off to the extent it is not realizable and charged to income in the period the determination is made. Considering expected future premiums other than on in-force policies in evaluating recoverability of premium tax offsets or policy surcharges is not permitted.

Acting as an Agent for Collection and Remittance of Fees and Assessments

~~10.~~12. In certain circumstances, a reporting entity acts as an agent for certain state or federal agencies in the collection and remittance of fees or assessments. In these circumstances, the liability for the fees and assessments rests with the policyholder rather than with the reporting entity. The reporting entity's obligation is to collect and subsequently remit the fee or assessment. When both the following conditions are met, an assessment shall not be reported in the statement of operations of a reporting entity:

a. The assessment is reflected as a separately identifiable item on the billing to the policyholder; and

b. Remittance of the assessment by the reporting entity to the state or federal agency is contingent upon collection from the insured.

Applying the Recognition Criteria

13. Application of the recognition criteria in paragraph 4:

a. *Retrospective-premium-based guaranty-fund assessments* - An assessment is probable of being imposed when a formal determination of insolvency occurs[1]. At that time, the premium that obligates the entity for the assessment liability has already been written. Accordingly, an entity that has the ability to reasonably estimate the amount of the assessment shall recognize a liability for the entire amount of future assessments related to a particular insolvency when a formal determination of insolvency is rendered.

b. *Prospective-premium-based guaranty-fund assessments* - The event that obligates the entity for the assessment liability generally is the writing of, or becoming obligated to write or renew, the premiums on which the expected future assessments are to be based (for example, multiple-year contracts under which an insurance entity has no discretion to avoid writing future premiums). Therefore, the event that obligates the entity generally will not have occurred at the time of the insolvency. Law or regulatory practice affects the event that obligates the entity in either of the following ways:

i. In states that, through law or regulatory practice, provide that an entity cannot avoid paying a particular assessment in the future (even if the entity reduces premium writings in the future), the event that obligates the entity is a formal determination of insolvency or a similar event. An entity that has the ability to reasonably estimate the amount of the assessment shall recognize a liability for the entire amount of future assessments that cannot be avoided related to a particular insolvency when a formal determination of insolvency occurs.

[1] As detailed within paragraph 6 for premium-based guaranty-fund assessments, an insolvency shall be considered to have occurred when a reporting entity meets a state's (ordinarily the state of domicile of the insolvent reporting entity) statutory definition of an insolvent reporting entity. In most states, the reporting entity must be declared to be financially insolvent by a court of competent jurisdiction. In some states, there must also be a final order of liquidation.

ii. In states without such a law or regulatory practice, the event that obligates the entity is the writing of, or becoming obligated to write, the premiums on which the expected future assessments are to be based. An entity that has the ability to reasonably estimate the amount of the assessments shall recognize a liability when the related premiums are written or when the entity becomes obligated to write the premiums.

c. *Prefunded-premium-based guaranty-fund assessments* - A liability for an assessment arises when premiums are written. Accordingly, an entity that has the ability to reasonably estimate the amount of the assessment shall recognize a liability as the related premiums are written.

d. *Other premium-based assessments* - Other premium-based assessments shall be accounted for in the same manner as prefunded premium-based guaranty-fund assessments.

e. *Loss-based assessments* - An assessment is probable of being asserted when the loss occurs. The obligating event of the assessment also has occurred when the loss occurs. Accordingly, an entity that has the ability to reasonably estimate the amount of the assessment shall recognize a liability as the related loss is incurred.

f. *Administrative-type assessments* – As this assessment is typically an annual amount per entity assessed to fund operations of the guaranty association, regardless of the existence of an insolvency, such assessments are generally expensed in the period assessed.

Disclosures

~~11.~~14. A reporting entity shall disclose the following:

a. Describe the nature of any assessments that could have a material financial effect, by type of assessment, and state the estimate of the liability, identifying whether the corresponding liability has been recognized under paragraph 4, a liability has not been recognized as the obligating event has not yet occurred, or that an estimate cannot be made.

b. For ~~To the extent~~ assessments with liabilities recognized under paragraph 4, ~~have been accrued~~ disclose the amount~~s~~ of the recognized liabilities, any related asset for premium tax credits or policy surcharges, the periods over which the assessments are expected to be paid, and the period over which the recorded premium tax offsets or policy surcharges are expected to be realized.

c. Disclose assets recognized from paid and accrued premium tax offsets or policy surcharges, and include a reconciliation of assets recognized within the previous year's Annual Statement to the assets recognized in the current year's Annual Statement. The reconciliation shall reflect, in aggregate, each component of the increase and decrease in paid and accrued premium tax offsets and policy surcharges, including the amount charged off.

d. Disclosures shall be made in accordance with paragraph 14 of SSAP No. 5 when there is at least a reasonable possibility that the impairment of an asset from premium tax offsets or policy surcharges may have been incurred.

~~12.~~15. Refer to the preamble for further discussion regarding disclosure requirements.

Relevant Literature

16. This statement ~~rejects~~ adopts GAAP guidance for recording guaranty fund and other assessments, which is contained in *Accounting Standards Codification 405-30, Insurance Related Assessments* (ASC 405-30) to the extent reflected in this SSAP.~~*AICPA Statement of Position 97-3, Accounting by Insurance and Other Enterprises for Insurance-Related Assessments*.~~ Statutory accounting modifications from ASC 405-30 are as follows:

a. The option to discount accrued liabilities (and reflect the time value of money in anticipated recoverables) is rejected for statutory accounting. Liabilities for guaranty funds or other assessments shall not be discounted.

b. The use of a valuation allowance for premium tax offsets and policy surcharges no longer probable for realization has been rejected for statutory accounting. Evaluation of assets shall be made in accordance with SSAP No. 5, and if it is probable that the asset is no longer realizable, the asset shall be written off and charged to income in the period the determination is made.

c. Guidance within ASC 405-30 pertaining to noninsurance entities has been rejected as not applicable for statutory accounting.

Effective Date and Transition

17. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*. Substantive revisions to paragraphs 4, 6, 7, 8, 10, 11, 13 and 14 are initially effective for the reporting period beginning January 1, 2011. The result of applying this revised Statement shall be considered a change in accounting principle in accordance with SSAP No. 3. Pursuant to SSAP No. 3, the cumulative effect of changes in accounting principles shall be reported as an adjustment to unassigned funds (surplus) in the period of the change in accounting principle. The cumulative effect recognized through surplus from initial application of this Statement shall reflect the removal of liabilities established under SSAP No. 35, and the re-establishment of liabilities required under SSAP No. 35R. If there is no change in the liabilities recognized (for example, retrospective-premium based assessments), no cumulative effect adjustment shall occur. With regards to assets, the entity shall complete an assessment of the SSAP No. 35 asset reported as of the transition date. If it is determined that the reported asset exceeds what is allowed under SSAP No. 35R, then the excess asset shall be written-off, through unassigned funds, so the ultimate asset reflected corresponds with what is permitted under SSAP No. 35R. Although it is possible that the excess asset will be reinstated once the liability assessment is recognized (prospective-premium based assessments), it is inappropriate to continue to reflect an asset for assessments that are not reflected within the financial statements.

RELEVANT ISSUE PAPERS

- *Issue Paper No. 35—Accounting for Guaranty Fund and Other Assessments*
- *Issue Paper No. 143—Prospective-Based Guaranty Fund Assessments*

Exhibit A – Primary Methods of Guaranty Fund Assessments:

a. *Retrospective-premium-based assessments* - Guaranty funds covering benefit payments of insolvent life, annuity, and health insurance entities typically assess entities based on premiums written or received in one or more years before the year of insolvency. Assessments in any year are generally limited to an established percentage of an entity's average premiums for the three years preceding the insolvency. Assessments for a given insolvency may take place over several years.

b. *Prospective-premium-based assessments* - Guaranty funds covering claims of insolvent property and casualty insurance entities typically assess entities based on premiums written in one or more years after the insolvency. Assessments in any year are generally limited to an established percentage of an entity's premiums written or received for the year preceding the assessment. Assessments for a given insolvency may take place over several years.

c. *Prefunded-premium-based assessments* - This kind of assessment is intended to prefund the costs of future insolvencies. Assessments are imposed before any particular insolvency and are based on the current level of written premiums. Rates to be applied to future premiums are adjusted as necessary.

d. *Administrative-type assessments* - These assessments are typically a flat (annual) amount per entity to fund operations of the guaranty association, regardless of the existence of an insolvency.

d. *Other premium-based assessments* - Entities are subject to a variety of other insurance-related assessments. Many states and a number of local governmental units have established other funds supported by assessments. The most prevalent uses for such assessments are (*a*) to fund operating expenses of state insurance regulatory bodies (for example, the state insurance department or workers' compensation board) and (*b*) to fund second-injury funds.

    i. *Premium-based* - The assessing organization imposes the assessment based on the entity's written premiums. The base year of premiums is generally either the current year or the year preceding the assessment.

    ii. *Loss-based* - The assessing organization imposes the assessment based on the entity's incurred losses or paid losses in relation to that amount for all entities subject to that assessment in the particular jurisdiction.

Statutory Issue Paper No. 144

Substantive Revisions to SSAP No. 91R: Securities Lending

STATUS
Finalized November 29, 2010

Current Authoritative Guidance for Securities Lending: SSAP No. 103
This issue paper may not be directly related to the current authoritative statement.

Original SSAP from Issue Paper: SSAP No. 91R

Type of Issue:

Common Area

SUMMARY OF ISSUE

1. The purpose of this issue paper is to document for the historical record the substantive changes to statutory accounting guidance adopted in May 2010 within *SSAP No. 91R—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities– Revised* (SSAP No. 91R).

2. This Issue Paper illustrates tracked changes adopted in SSAP No. 91R, with an effective date of December 31, 2010. The substantive revisions adopted within SSAP No. 91R include revised accounting guidance for securities lending, repurchase agreements, reverse repurchase agreements and disclosures.

3. For historical record, the adopted guidance reflected as tracked changes has been included as appendix A.

DISCUSSION

4. This Issue Paper is intended to provide as a historical reference tracked changes adopted within SSAP No. 91R. The substantive changes were proposed by the Securities Lending Subgroup of the Statutory Accounting Principles Working Group, which was composed of interested parties and regulators. The primary goal of the group was to clarify securities lending accounting, including rules on collateral.

5. The Working Group determined that changes were necessary, as the existing guidance for collateral for securities lending was inconsistently applied.

6. In addition, the repurchase and reverse repurchase agreement definitions were essentially reversed to be more consistent with the investment industry use of the terms.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

7. Prior statutory accounting guidance in SSAP No. 91R regarding securities lending is superseded by the updates to SSAP No. 91R adopted in May 2010.

Generally Accepted Accounting Principles

8. The substantive revisions adopted in SSAP No. 91R did not adopt or reject any new GAAP standards but it did incorporate guidance regarding the determination of whether collateral is on balance sheet or off balance sheet which is closer to the existing GAAP guidance. There are still modifications from GAAP in that the SSAP No. 91R guidance indicates that "if the reporting entity or its agent can sell or repledge the collateral, it shall be recorded on the balance sheet."

AUTHORITATIVE LITERATURE

Statutory Accounting

- *SSAP No. 18—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
- *SSAP No. 33—Securitization*
- *SSAP No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements*
- *NAIC Purposes and Procedures Manual of the NAIC Securities Valuation Office*
- *Issue Paper No. 134—Servicing Assets/Liabilities, An Amendment of SSAP No. 91*

Generally Accepted Accounting Principles

- *FASB Statement No. 156, Accounting for Servicing of Financial Assets, an amendment of FASB Statement No. 140*
- *FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
- *FASB Staff Position 140-3, Accounting for Transfers of Financial Assets and Repurchase Financing Transactions*
- *AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as used In Certain Audit Guides and a Statement of Position*
- *FASB Emerging Issues Task Force No. 87-34, Sale of Mortgage Servicing Rights with a Subservicing Agreement*
- *FASB Emerging Issues Task Force No. 88-11, Allocation of Recorded Investment When a Loan as Part of a Loan is Sold*
- *FASB Emerging Issues Task Force No. 88-18, Sales of Future Revenues*
- *FASB Emerging Issues Task Force No. 88-22, Securitization of Credit Card and Other Receivable Portfolios*
- *FASB Emerging Issues Task Force No. 90-21, Balance Sheet Treatment of a Sale of Mortgage Servicing Rights with a Subservicing Agreement*
- *FASB Emerging Issues Task Force No. 95-5, Determination of What Risks and Rewards, If Any, Can Be Retained and Whether Any Unresolved Contingencies May Exist in a Sale of Mortgage Loan Servicing Rights*

- *FASB Emerging Issues Task Force No. 96-19, Debtor's Accounting for a Modification or Exchange of Debt Instruments*

RELEVANT ISSUE PAPERS

- *Issue Paper No. 122—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*

- *Issue Paper No. 134—Servicing Assets/Liabilities, An Amendment of SSAP No. 91*

State Regulations

– No additional guidance obtained from state statutes or regulations.

APPENDIX A – TRACKED CHANGES TO SSAP NO. 91R

Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for transfers and servicing of financial assets, including asset securitizations and securitizations of policy acquisition costs, extinguishments of liabilities, repurchase agreements and reverse repurchase agreements, including dollar repurchase and dollar reverse repurchase agreements that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts). This statement discusses generalized situations. Facts and circumstances and specific contracts need to be considered carefully in applying this statement. Securitizations of nonfinancial assets are outside the scope of this statement.

SUMMARY CONCLUSION

2. See *SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties* (SSAP No. 25) for additional accounting and disclosure guidance concerning related party transactions. In addition the guidance for the following topics have been addressed in Interpretations of the Emerging Accounting Issues Working Group (INT):

a. Transfers of ownership interest that are in substance sales of real estate - INT 99-22 resolved this conflict between application of *SSAP No. 40—Real Estate* (SSAP No. 40) and *SSAP No. 18—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (SSAP No. 18).

b. Exchanges of equity method investments for similar productive assets - INT 99-21 resolved this conflict between application of *SSAP No. 28—Nonmonetary Transactions* (SSAP No. 28) and SSAP No. 18.

3. SSAP No. 18, *SSAP No. 33—Securitization* (SSAP No. 33) and *SSAP No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements* (SSAP No. 45) are superseded by the conclusions outlined in this statement.

4. This statement does not address the securitization of mortality or morbidity risk. The National Association of Insurance Commissioners' (NAIC's) Insurance Securitization Working Group of the Financial Condition (E) Committee is charged with the development of model laws, model regulations and proposed accounting guidance for the securitization of mortality and morbidity risk. When such proposed accounting guidance is finalized, the development of a statement will be considered.

5. Except as discussed in paragraphs 56 and ~~94~~97, a transfer of a group of financial assets, or a portion of a financial asset in which the transferor surrenders control over those financial assets shall be accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if, and only if, all of the following conditions are met:

a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership (see paragraphs 17 and 18);

b. Either (i) each transferee obtains the right, free of conditions that constrain it from taking advantage of that right (see paragraphs 19-23), to pledge or exchange the transferred assets or (ii) the transferee is a qualifying special-purpose entity as defined in paragraph 25 and the holders of beneficial interests in that entity have the right, free of conditions that constrain them from taking advantage of that right (see paragraph 24), to pledge or exchange those interests and no condition both constrains the transferee (or holder) from taking advantage of its right to pledge or exchange and provide more than a trivial benefit to the transferor; and

c. The transferor does not maintain effective control over the transferred assets through (i) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (see paragraphs 38-40) or (ii) the ability to unilaterally cause the holder to return specific assets, other than through a cleanup call (see paragraphs 22-23 and 41-45).

6. Upon completion of any transfer of financial assets, the transferor shall:

a. Initially recognize and measure at fair value, if practicable, servicing assets and servicing liabilities assumed under a separate contractual obligation to service financial assets (see paragraphs ~~51~~11 and 50);

b. Allocate the previous carrying amount between the assets sold, if any, and the interests that continue to be held by a transferor, if any, based on their relative fair values at the date of transfer (see paragraphs 48 and 49); and

c. Continue to carry in its balance sheet any interest it continues to hold in the transferred assets, including, if applicable, beneficial interests in assets transferred to a qualifying special-purpose entity in a securitization, and undivided interests continued to be held by the transferor (see paragraphs 7.c., 48 and 49).

7. Upon completion of a transfer of financial assets that satisfies the conditions to be accounted for as a sale (see paragraph 5), the transferor (seller) shall:

a. Eliminate the transferred assets from the balance sheet;

b. Allocate the previous carrying amount of the transferred assets to the securities representing beneficial interests continued to be held by the reporting entity, if any, and the securities representing beneficial interests not continued to be held, if any, based on the relative fair values of the transferred assets at the date of transfer;

c. Record in its balance sheet, the allocated carrying value of the securities representing beneficial interests continued to be held in the assets (e.g., loan-backed securities). Subsequent to the transfer of assets:

i. Retained residuals are to be carried at fair value with the difference between fair value and the allocated cost basis recognized as an unrealized gain or loss;

ii. Beneficial interests continued to be held shall be accounted for in accordance with the statutory accounting principles for the specific asset type (e.g., bonds shall be accounted for in accordance with *SSAP No. 26—Bonds, Excluding Loan–Backed and Structured Securities*, loan-backed securities shall be accounted for in accordance with *SSAP No. 43R—Loan-Backed and Structured Securities* (SSAP No. 43R), preferred stock in accordance with *SSAP No. 32—Investments in Preferred Stock (including investments in preferred stock of subsidiary, controlled, or affiliated entities)* (SSAP No. 32).

d. Recognize all additional assets obtained (i.e., other than the securities representing beneficial interests continued to be held which are recorded in accordance with 7 c.) and liabilities incurred in consideration as proceeds of the sale;

e. Initially measure such additional assets obtained and liabilities incurred in the sale at fair value (see *SSAP No. 100—Fair Value Measurements*), or if it is not practicable to estimate the fair value of an asset or a liability, apply alternative measures (paragraph 50); and

f. For reporting entities required to maintain an Interest Maintenance Reserve (IMR), the accounting for realized and unrealized capital gains and losses shall be in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*. For reporting entities not required to maintain an IMR, realized capital gains and losses shall be reported as net realized capital gains or losses in the statement of income, and unrealized capital gains and losses shall be reported as net unrealized gains and losses in unassigned funds (surplus).

8. The transferee shall recognize all assets obtained and any liabilities incurred, and initially measure them at fair value.

9. Repurchase agreements, reverse repurchase agreements, collateral requirements, and dollar repurchase agreements are described in paragraphs ~~61-83~~64-86. When an asset is sold and the proceeds are reinvested within 30 days in the same or substantially the same security, such transfers shall be considered to be wash sales and shall be accounted for as sales as discussed in paragraphs ~~64-66~~67-69 and disclosed as required by paragraph ~~97~~100. Unless there is a concurrent contract to repurchase or redeem the transferred financial assets from the transferee, the transferor does not maintain effective control over the transferred assets.

10. If a transfer of financial assets in exchange for cash or other consideration (other than beneficial interests in the transferred assets) (a) does not meet the criteria for a sale in paragraph 5, or (b) is a sale of receivables with recourse (see paragraph ~~94~~97); the transferor and transferee shall account for the transfer as a secured borrowing with pledge of collateral (see paragraph 13).

Recognition and Measurement of Servicing Assets and Liabilities

11. Servicing rights become a distinct asset or liability only when contractually separated from the underlying assets by sale or securitization of the assets with servicing retained, or separate purchase or assumption of the servicing. Servicing rights become a distinct asset or liability of the reporting entity pursuant to:

a. A transfer of the servicer's financial assets that meets the requirements for sale accounting;

b. A transfer of financial assets to a qualifying SPE in a guaranteed mortgage obligation in which the transferor retains all of the resulting securities; or

c. An acquisition or assumption of a servicing obligation that does not relate to financial assets of the servicer.

A servicer that transfers or securitizes financial assets in a transaction that does not meet the requirements for sale accounting and is accounted for as a secured borrowing with the underlying assets remaining on the transferor's balance sheet shall not be recognized as a servicing asset or servicing liability.

12. If distinct servicing rights exist in accordance with the above guidelines, the reporting entity shall recognize a servicing asset or liability. When the servicing fees to be received exceed the cost of servicing the transferred assets, a servicing asset is recognized and nonadmitted. When the cost of servicing the transferred assets is greater than the servicing fees to be received, a liability shall be recorded for the excess to recognize this obligation. A corresponding loss shall be recorded through the Summary of Operations in other income. Servicing assets and servicing liabilities shall be measured initially at fair value. Servicing assets or liabilities shall be measured subsequently at fair value at each reporting date with fluctuations in fair value reported

as unrealized gains and losses. Declines in fair value which are determined to be other than temporary shall be recorded as realized losses.

Secured Borrowings and Collateral

13. A debtor may grant a security interest in certain assets to a lender (the secured party) to serve as collateral for its obligation under a borrowing, with or without recourse to other assets of the debtor. An obligor under other kinds of current or potential obligations, for example, interest rate swaps, also may grant a security interest in certain assets to a secured party. If collateral is transferred to the secured party, the custodial arrangement is commonly referred to as a pledge. Secured parties sometimes are permitted to sell or repledge (or otherwise transfer) collateral held under a pledge. The same relationships occur, under different names, in transfers documented as sales that are accounted for as secured borrowings (see paragraph 10). The accounting for noncash[1] collateral by the debtor (or obligor) and the secured party depends on whether the secured party or its agent has ~~taken control over the collateral, and on~~ the right~~s~~ to sell or repledge~~and obligations that result from~~ the collateral ~~arrangement:~~and on whether the debtor has defaulted.

a. If the secured party (transferee) or its agent has the right by contract ~~is permitted~~ or custom to sell or repledge the collateral, ~~and~~then the debtor (transferor) shall report that asset in its balance sheet. ~~does not have the right and ability to redeem the collateral on short notice, (e.g., by substituting other collateral or terminating the contract), then:~~

~~i.The debtor shall reclassify that asset and report that asset in its balance sheet separately (for example, as security pledged to creditors) from other assets not so encumbered;~~

~~ii.The secured party shall recognize that collateral as its asset, initially measure it at fair value, and also recognize its obligation to return it.~~

b. If the secured party (transferee) sells ~~or repledges~~ collateral pledged to it, ~~on terms that do not give it the right and ability to repurchase or redeem the collateral from the transferee on short notice, the secured party~~it shall recognize the proceeds from the sale ~~or the asset repledged~~ and its obligation to return the ~~asset to the extent that it has not already recognized them~~collateral. The sale ~~or repledging~~ of the collateral ~~asset~~ is a transfer subject to the provisions of this statement.

c. If the debtor (transferor) defaults under the terms of the secured contract and is no longer entitled to redeem the ~~collateral~~pledged asset, it shall derecognize the ~~collateral~~pledged asset, and~~. T~~ the secured party (transferee) shall recognize the collateral as its~~an~~ asset ~~(to the extent it has not already recognized it) and~~ initially measured ~~it~~ at fair value~~;~~ or, if it has already sold the collateral, derecognize its obligation to return the collateral.

d. Except as provided in paragraph 13.c., the debtor (transferor) shall continue to carry the collateral as its asset, and the secured party (transferee) shall not recognize the pledged asset.

14. ~~Insurers~~Reporting entities may enter into certain transactions that require the granting of a security interest in certain assets to another party to serve as collateral for their performance under a contract. If the assets pledged are recorded as admitted assets under *SSAP No. 4—*

[1] Cash "collateral," sometimes used, for example, in securities lending transactions, shall be derecognized by the payer and recognized by the recipient, not as collateral, but rather as proceeds of either a sale or a borrowing.

Assets and Nonadmitted Assets (SSAP No. 4) and are not impaired under the provisions of *SSAP No. 5—Liabilities, Contingencies and Impairments of Assets* (SSAP No. 5), the pledging ~~insurer~~entity records the collateral as an admitted asset until committing a contract default that has not been cured in accordance with the contract provisions. At the time of an uncured default, the provisions of paragraph 13 above shall be used to determine the appropriate accounting treatment for the collateral. If the secured party utilizes collateral to offset all or a portion of the liability owed by the pledging ~~insurer~~entity as a result of the default, then the collateral amount utilized to offset the liability shall be removed from the balance sheet. At the same time, the amount of the liability that was offset shall be removed from the balance sheet since that obligation has been satisfied through the secured party's utilization of that collateral. To the extent that an uncured default remains without the secured party utilizing the collateral to offset the obligation, the pledging insurer shall only record an admitted asset for the amount of collateral that it can redeem.

Extinguishments of Liabilities

15. A debtor shall derecognize a liability if, and only if, it has been extinguished (see *SSAP No. 15—Debt and Holding Company Obligations* (SSAP No. 15)). A liability has been extinguished if either of the following conditions is met:

a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes delivery of cash, other financial assets, goods, or services or reacquisition by the debtor of its outstanding debt securities whether the securities are canceled or held as so-called treasury bonds; or

b. The debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor.

16. If a creditor releases a debtor from primary obligation on the condition that a third party assumes the obligation and that the original debtor becomes secondarily liable, that release extinguishes the original debtor's liability. However, in those circumstances, whether or not explicit consideration was paid for that guarantee, the original debtor becomes a guarantor. As a guarantor, it shall recognize a guarantee obligation in the same manner as would a guarantor that had never been primarily liable to that creditor, with due regard for the likelihood that the third party will carry out its obligations. The guarantee obligation shall be initially measured at fair value, and that amount reduces the gain or increases the loss recognized on extinguishment.

Isolation Beyond the Reach of the Transferor and Its Creditors

17. The nature and extent of supporting evidence required for an assertion in financial statements that transferred financial assets have been isolated—put presumptively beyond the reach of the transferor and its creditors, either by a single transaction or a series of transactions taken as a whole—depends on the facts and circumstances. All available evidence that either supports or questions an assertion shall be considered. That consideration includes making judgments about whether the contract or circumstances permit the transferor to revoke the transfer. It also may include making judgments about the kind of bankruptcy or other receivership into which a transferor or special-purpose entity might be placed, whether a transfer of financial assets would likely be deemed a true sale at law, whether the transferor is affiliated with the transferee and other factors pertinent under applicable law. Derecognition of transferred assets is appropriate only if the available evidence provides reasonable assurance that the transferred assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor. Transactions between related parties or affiliates are accounted for in accordance with SSAP No. 25.

18. Many common financial transactions, for example, typical repurchase agreements and securities lending transactions, isolate transferred assets from the transferor, although they may not meet the other criteria for surrender of control.

Conditions That Constrain a Transferee

19. Sale accounting is allowed under paragraph 5 only if each transferee has the right to pledge, or the right to exchange, the transferred assets or beneficial interests it received, but constraints on that right also matter. Many transferor-imposed or other conditions on a transferee's right to pledge or exchange a transferred asset both constrain a transferee from pledging or exchanging the transferred assets and, through that constraint, provide more than a trivial benefit to the transferor. For example, a provision in the transfer contract that prohibits selling or pledging a transferred loan receivable not only constrains the transferee but also provides the transferor with the more-than-trivial benefits of knowing who has the asset, a prerequisite to repurchasing the asset, and of being able to block the asset from finding its way into the hands of a competitor for the loan customer's business or someone that the loan customer might consider an undesirable creditor. Transferor-imposed contractual constraints that narrowly limit timing or terms, for example, allowing a transferee to pledge only on the day assets are obtained or only on terms agreed with the transferor, also constrain the transferee and presumptively provide the transferor with more-than-trivial benefits.

20. However, some conditions do not constrain a transferee from pledging or exchanging the asset and therefore do not preclude a transfer subject to such a condition from being accounted for as a sale. For example, a transferor's right of first refusal on the occurrence of a bona fide offer to the transferee from a third party presumptively would not constrain a transferee, because that right in itself does not enable the transferor to compel the transferee to sell the assets and the transferee would be in a position to receive the sum offered by exchanging the asset, albeit possibly from the transferor rather than the third party. Further examples of conditions that presumptively would not constrain a transferee include (a) a requirement to obtain the transferor's permission to sell or pledge that is not to be unreasonably withheld, (b) a prohibition on sale to the transferor's competitor if other potential willing buyers exist, (c) a regulatory limitation such as on the number or nature of eligible transferees (as in the case of securities issued under Securities Act Rule 144A or debt placed privately), and (d) illiquidity, for example, the absence of an active market. Judgment is required to assess the significance of some conditions. For example, a prohibition on sale to the transferor's competitor would be a significant constraint if that competitor were the only potential willing buyer other than the transferor.

21. A condition imposed by a transferor that constrains the transferee presumptively provides more than a trivial benefit to the transferor. A condition not imposed by the transferor that constrains the transferee may or may not provide more than a trivial benefit to the transferor. For example, if the transferor refrains from imposing its usual contractual constraint on a specific transfer because it knows an equivalent constraint is already imposed on the transferee by a third party, it presumptively benefits more than trivially from that constraint. However, the transferor cannot benefit from a constraint if it is unaware at the time of the transfer that the transferee is constrained.

Transferor's Rights or Obligations to Reacquire Transferred Assets

22. Some rights or obligations to reacquire transferred assets both constrain the transferee and provide more than a trivial benefit to the transferor, thus precluding sale accounting under paragraph 5. For example, a freestanding call option written by a transferee to the transferor benefits the transferor and, if the transferred assets are not readily obtainable in the marketplace, is likely to constrain a transferee because it might have to default if the call was exercised and it had exchanged or pledged the assets. A freestanding forward purchase-sale contract between the transferor and the transferee on transferred assets not readily obtainable in the marketplace would benefit the transferor and is likely to constrain a transferee in much the same manner. Judgment is necessary to assess constraint and benefit. For example, put options written to the transferee generally do not constrain it, but a put option on a not-readily-obtainable asset may benefit the transferor and effectively constrain the transferee if the option is sufficiently deep-in-the-money when it is written that it is probable that the transferee will exercise it and the transferor will reacquire the transferred asset. In contrast, a sufficiently out-of-the-money call option held by the transferor may not constrain a transferee if it is probable when the option is written that it will not be exercised. Freestanding rights to reacquire transferred assets that are

readily obtainable presumptively do not constrain the transferee from exchanging or pledging them and thus do not preclude sale accounting under paragraph 5.

23. Other rights or obligations to reacquire transferred assets, regardless of whether they constrain the transferee, may result in the transferor's maintaining effective control over the transferred assets, as discussed in paragraphs 41-45, thus precluding sale accounting under paragraph 5.

Conditions That Constrain a Holder of Beneficial Interests in a Qualifying SPE

24. The considerations in paragraphs 19-23, about conditions that may or may not constrain a transferee that is not a qualifying SPE from pledging or exchanging the transferred assets, also extend to conditions that may or may not constrain a beneficial interest holder (BIH) from pledging or exchanging its beneficial interests in assets transferred to a qualifying SPE. For example, if BIHs agree to sell their beneficial interests in a qualifying SPE back to the transferor upon request at the price paid plus a stated return, that arrangement clearly conveys more than a trivial benefit to the transferor; sale accounting for the transfer to the qualifying SPE would be precluded if that agreement constrained a BIH from exchanging or pledging its beneficial interest.

Qualifying SPE

25. A qualifying SPE is a trust or other legal vehicle that meets all of the following conditions:

a. It is demonstrably distinct from the transferor (paragraphs 26 and 27);

b. Its permitted activities:

i. Are significantly limited;

ii. Were entirely specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds; and

iii. May be significantly changed only with the approval of the holders of at least a majority of the beneficial interests held by entities other than any transferor, its affiliates, and its agents (paragraphs 28 and 29).

c. It shall hold only:

i. Financial assets transferred to it that are passive in nature (paragraph 30);

ii. Passive derivative financial instruments that pertain to beneficial interests (other than another derivative financial instrument) issued or sold to parties other than the transferor, its affiliates, or its agents (paragraphs 30 and 31);

iii. Financial assets (for example, guarantees or rights to collateral) that would reimburse it if others were to fail to adequately service financial assets transferred to it or to timely pay obligations due to it and that it entered into when it was established, when assets were transferred to it, or when beneficial interests (other than derivative financial instruments) were issued by the SPE;

iv. Servicing rights related to financial assets that it holds;

v. Temporarily, nonfinancial assets obtained in connection with the collection of financial assets that it holds (paragraph 32);

vi. Cash collected from assets that it holds and investments purchased with that cash pending distribution to holders of beneficial interests that are appropriate for that purpose (that is, money-market or other relatively risk-free instruments without options and with maturities no later than the expected distribution date).

d. If it can sell or otherwise dispose of noncash financial assets, it can do so only in automatic response to one of the following conditions:

i. Occurrence of an event or circumstance that:

(a) Is specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds;

(b) Is outside the control of the transferor, its affiliates, or its agents; and

(c) Causes, or is expected at the date of transfer to cause, the fair value of those financial assets to decline by a specified degree below the fair value of those assets when the SPE obtained them (paragraphs 33 and 34.)

ii. Exercise by a BIH (other than the transferor, its affiliates, or its agents) of a right to put that holder's beneficial interest back to the SPE (paragraph 35);

iii. Exercise by the transferor of a call specified in the legal documents that established the SPE, transferred assets to the SPE, or created the beneficial interests in the transferred assets that it holds (paragraphs 41-45);

iv. Termination of the SPE or maturity of the beneficial interests in those financial assets on a fixed or determinable date that is specified at inception (paragraph 36).

Need to Be Demonstrably Distinct from the Transferor

26. A qualifying SPE is demonstrably distinct from the transferor only if it cannot be unilaterally dissolved by any transferor, its affiliates, or its agents and either:

a. At least 10 percent of the fair value of its beneficial interests is held by parties other than any transferor, its affiliates, or its agents; or

b. The transfer is a guaranteed mortgage securitization.

27. An ability to unilaterally dissolve an SPE can take many forms, including but not limited to holding sufficient beneficial interests to demand that the trustee dissolve the SPE, the right to call all the assets transferred to the SPE, and a right to call or a prepayment privilege on the beneficial interests held by other parties.

Limits on Permitted Activities

28. The powers of the SPE must be limited to those activities allowed by paragraph 25 for it to be a qualifying SPE. Many kinds of entities are not so limited. For example, any bank, insurance company, pension plan, or investment company has powers that cannot be sufficiently limited for it to be a qualifying SPE.

29. The BIHs other than any transferor, its affiliates, or its agents may have the ability to change the powers of a qualifying SPE. If the powers of a previously qualifying SPE are changed so that the SPE is no longer qualifying, unless the conditions in paragraph 5.b. are then met by the SPE itself and the conditions in paragraphs 5.a. and 5.c. continue to be met, that change would bring the transferred assets held in the SPE back under the control of the transferor (paragraph 46).

Limits on What a Qualifying SPE May Hold

30. A financial asset or derivative financial instrument is passive only if holding the asset or instrument does not involve its holder in making decisions other than the decisions inherent in servicing. An equity instrument is not passive if the qualifying SPE can exercise the voting rights and is permitted to choose how to vote. Investments are not passive if through them, either in themselves or in combination with other investments or rights, the SPE or any related entity, such as the transferor, its affiliates, or its agents, is able to exercise control, as defined in *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities, A Replacement of SSAP No.* 88 (SSAP No. 97) over the investee. A derivative financial instrument is not passive if, for example, it includes an option allowing the SPE to choose to call or put other financial instruments that would allow it and its related entities to control 10% of more of the financial instruments issuer; but other derivative financial instruments can be passive, for example, interest rate caps and swaps and forward contracts. Derivative financial instruments that result in liabilities, like other liabilities of a qualifying SPE, are a kind of beneficial interest in the qualifying SPE's assets.

31. A derivative financial instrument pertains to beneficial interests (other than another derivative financial instrument) issued only if it:

a. Is entered into:

i. When the beneficial interests are issued by the qualifying SPE to parties other than the transferor, its affiliates, or its agents or sold to such other parties after being issued by the qualifying SPE to the transferor, its affiliates, or its agents; or

ii. When a passive derivative financial instrument needs to be replaced upon occurrence of an event or circumstance (specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds) outside the control of the transferor, its affiliates, or its agents, for example, when the counterparty to the derivative defaults or is downgraded below a specified threshold.

b. Has a notional amount that does not initially exceed the amount of those beneficial interests and is not expected to exceed them subsequently;

c. Has characteristics that relate to, and partly or fully but not excessively counteract, some risk associated with those beneficial interests or the related transferred assets.

32. A qualifying SPE may hold nonfinancial assets other than servicing rights only temporarily and only if those nonfinancial assets result from collecting the transferred financial assets. For example, a qualifying SPE could be permitted to temporarily hold foreclosed nonfinancial collateral. In contrast, an entity cannot be a qualifying SPE if, for example, it receives from a transferor significant secured financial assets likely to default with the expectation that it will foreclose on and profitably manage the securing nonfinancial assets.

Limits on Sales or Other Dispositions of Assets

33. Examples of requirements to sell, exchange, put, or distribute (hereinafter referred to collectively as dispose of) noncash financial assets that are permitted activities of a qualifying SPE—because they respond automatically to the occurrence of an event or circumstance that:

a. Is specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds;

b. Is outside the control of the transferor, its affiliates, or its agents; and

c. Causes, or is expected to cause, the fair value of those assets to decline by a specified degree below the fair value of those assets when the qualifying SPE obtained them include requirements to dispose of transferred assets in response to:

i. A failure to properly service transferred assets that could result in the loss of a substantial third-party credit guarantee;

ii. A default by the obligor;

iii. A downgrade by a major rating agency of the transferred assets or of the underlying obligor to a rating below a specified minimum rating;

iv. The involuntary insolvency of the transferor; or

v. A decline in the fair value of the transferred assets to a specified value less than their fair value at the time they were transferred to the SPE.

34. The following are examples of powers or requirements to dispose of noncash financial assets that are not permitted activities of a qualifying SPE, because they do not respond automatically to the occurrence of a specified event or circumstance outside the control of the transferor, its affiliates, or its agents that causes, or is expected to cause, the fair value of those transferred assets to decline by a specified degree below the fair value of those assets when the SPE obtained them:

a. A power that allows an SPE to choose to either dispose of transferred assets or hold them in response to a default, a downgrade, a decline in fair value, or a servicing failure;

b. A requirement to dispose of marketable equity securities upon a specified decline from their "highest fair value" if that power could result in disposing of the asset in exchange for an amount that is more than the fair value of those assets at the time they were transferred to the SPE;

c. A requirement to dispose of transferred assets in response to the violation of a nonsubstantive contractual provision (that is, a provision for which there is not a sufficiently large disincentive to ensure performance).

35. A qualifying SPE may dispose of transferred assets automatically to the extent necessary to comply with the exercise by a BIH (other than the transferor, its affiliates, or its agents) of its right to put beneficial interests back to the SPE in exchange for:

a. A full or partial distribution of those assets;

b. Cash (which may require that the SPE dispose of those assets or issue beneficial interests to generate cash to fund settlement of the put);

c. New beneficial interests in those assets.

36. A qualifying SPE may have the power to dispose of assets to a party other than the transferor, its affiliate, or its agent on termination of the SPE or maturity of the beneficial interests, but only automatically on fixed or determinable dates that are specified at inception. For example, if an SPE is required to dispose of long-term mortgage loans and terminate itself at the earlier of (a) the specified maturity of beneficial interests in those mortgage loans or (b) the date of

prepayment of a specified amount of the transferred mortgage loans, the termination date is a fixed or determinable date that was specified at inception. In contrast, if that SPE has the power to dispose of transferred assets on two specified dates and the SPE can decide which transferred assets to sell on each date, the termination date is not a fixed or determinable date that was specified at inception.

Investments in Special-Purpose Entities

37. Reporting entities that have qualifying special-purpose entities as affiliates shall carry their investment in such entity at its underlying statutory book value in accordance with *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities, A Replacement of SSAP No. 88* (SSAP No. 97). Additionally, transactions entered involving affiliated qualifying special-purpose entities are subject to the provisions of SSAP No. 25.

Agreements That Maintain Effective Control Over Transferred Assets

38. An agreement that both entitles and obligates the transferor to repurchase or redeem transferred assets from the transferee maintains the transferor's effective control over those assets, and the transfer is therefore to be accounted for as a secured borrowing, if and only if all of the following conditions are met:

a. The assets to be repurchased or redeemed are the same or substantially the same as those transferred (paragraph 39);

b. The transferor is able to repurchase or redeem them on substantially the agreed terms, even in the event of default by the transferee (paragraph 40);

c. The agreement is to repurchase or redeem them before maturity, at a fixed or determinable price; and

d. The agreement is entered into concurrently with the transfer.

39. To be substantially the same, the asset that was transferred and the asset that is to be repurchased or redeemed need to have all of the following characteristics:

a. The same primary obligor (except for debt guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and the terms of the guarantee must be the same);

b. Identical form and type so as to provide the same risks and rights;

c. The same maturity (or in the case of mortgage-backed pass-through and pay-through securities have similar remaining weighted-average maturities that result in approximately the same market yield);

d. Identical contractual interest rates;

e. Similar assets as collateral; and

f. The same aggregate unpaid principal amount or principal amounts within accepted good delivery standards for the type of security involved.

40. To be able to repurchase or redeem assets on substantially all of the agreed terms, even in the event of default by the transferee, a transferor must at all times during the contract term have obtained cash or other collateral sufficient to fund substantially all of the cost of purchasing replacement assets from others.

Ability to Unilaterally Cause the Return of Specific Transferred Assets

41. Some rights to reacquire transferred assets (or to acquire beneficial interests in transferred assets held by a qualifying SPE), regardless of whether they constrain the transferee, may result in the transferor's maintaining effective control over the transferred assets through the unilateral ability to cause the return of specific transferred assets. Such rights preclude sale accounting under paragraph 5. For example, an attached call in itself would not constrain a transferee who is able, by exchanging or pledging the asset subject to that call, to obtain substantially all of its economic benefits. An attached call could result, however, in the transferor's maintaining effective control over the transferred asset(s) because the attached call gives the transferor the ability to unilaterally cause whoever holds that specific asset to return it. In contrast, transfers of financial assets subject to calls embedded by the issuers of the financial instruments, for example, callable bonds or prepayable mortgage loans, do not preclude sale accounting. Such an embedded call does not result in the transferor's maintaining effective control, because it is the issuer rather than the transferor who holds the call.

42. If the transferee is a qualifying SPE, it has met the conditions in paragraph 25 and therefore must be constrained from choosing to exchange or pledge the transferred assets. In that circumstance, any call held by the transferor is effectively attached to the assets and could—depending on the price and other terms of the call—maintain the transferor's effective control over transferred assets through the ability to unilaterally cause the transferee to return specific assets. For example, a transferor's unilateral ability to cause a qualifying SPE to return to the transferor or otherwise dispose of specific transferred assets at will or, for example, in response to its decision to exit a market or a particular activity, could provide the transferor with effective control over the transferred assets.

43. A call that is attached to transferred assets maintains the transferor's effective control over those assets if, under its price and other terms, the call conveys more than a trivial benefit to the transferor. Similarly, any unilateral right to reclaim specific assets transferred to a qualifying SPE maintains the transferor's effective control over those assets if the right conveys more than a trivial benefit to the transferor. A call or other right conveys more than a trivial benefit if the price to be paid is fixed, determinable, or otherwise potentially advantageous, unless because that price is so far out of the money or for other reasons it is probable when the option is written that the transferor will not exercise it. Thus, for example, a call on specific assets transferred to a qualifying SPE at a price fixed at their principal amount maintains the transferor's effective control over the assets subject to that call. Effective control over transferred assets can be present even if the right to reclaim is indirect. For example, if an embedded call allows a transferor to buy back the beneficial interests of a qualifying SPE at a fixed price, then the transferor remains in effective control of the assets underlying those beneficial interests. A cleanup call, however, is permitted as an exception to that general principle.

44. A right to reclaim specific transferred assets by paying their fair value when reclaimed generally does not maintain effective control, because it does not convey a more than trivial benefit to the transferor. However, a transferor has maintained effective control if it has such a right and also holds the residual interest in the transferred assets. For example, if a transferor can reclaim such assets at termination of the qualifying SPE by purchasing them in an auction, and thus at what might appear to be fair value, then sale accounting for the assets it can reclaim would be precluded. Such circumstances provide the transferor with a more than trivial benefit and effective control over the assets; because it can pay any price it chooses in the auction and recover any excess paid over fair value through its residual interest.

45. A transferor that has a right to reacquire transferred assets from a qualifying SPE does not maintain effective control if the reclaimed assets would be randomly selected and the amount of the assets reacquired is sufficiently limited because that would not be a right to reacquire specific assets. Nor does a transferor maintain effective control through an obligation to reacquire transferred assets from a qualifying SPE if the transfer could occur only after a specified failure of the servicer to properly service the transferred assets that could result in the loss of a third-party guarantee (paragraph 33.c.i.) or only after a BIH other than the transferor, its affiliate, or its agent

requires a qualifying SPE to repurchase that beneficial interest (paragraph 35.b.), because the transferor could not cause that reacquisition unilaterally.

Changes That Result in the Transferor's Regaining Control of Assets Sold

46. A change in law, status of the transferee as a qualifying SPE, or other circumstance may result in the transferor's regaining control of assets previously accounted for appropriately as having been sold, because one or more of the conditions in paragraph 5 are no longer met. Such a change, unless it arises solely from either the initial application of this statement or a change in market prices (for example, an increase in price that moves into-the-money a freestanding call that was originally sufficiently out-of-the-money that it was judged not to constrain the transferee), is accounted for in the same manner as a purchase of the assets from the former transferee(s) in exchange for liabilities assumed (paragraph 7). After that change, the transferor recognizes in its financial statements those assets together with liabilities to the former transferee(s) or BIHs in those assets (paragraph 29). The transferor initially measures those assets and liabilities at fair value on the date of the change, as if the transferor purchased the assets and assumed the liabilities on that date. The former transferee would derecognize the assets on that date, as if it had sold the assets in exchange for a receivable from the transferor. Subsequent to that date, the reporting entity shall follow statutory accounting for the assets and liabilities in accordance with the guidance in the SSAPs.

Assets Obtained and Liabilities Incurred as Proceeds

47. The proceeds from a sale of financial assets consist of the cash and any other assets obtained, including separately recognized servicing assets, in the transfer less any liabilities incurred, including separately recognized servicing liabilities. Any asset obtained that is not an interest in the transferred asset is part of the proceeds from the sale. Any liability incurred, even if it is related to the transferred assets, is a reduction of the proceeds. Any derivative financial instrument entered into concurrently with a transfer of financial assets is either an asset obtained or a liability incurred and part of the proceeds received in the transfer. All proceeds and reductions of proceeds from a sale shall be initially measured at fair value.

Interests That Continue to be Held by a Transferor

48. Other interests in transferred assets, those that are not part of the proceeds of the transfer, are interests that continue to be held by a transferor over which the transferor has not relinquished control. They shall be measured at the date of the transfer by allocating the previous carrying amount between the assets sold, if any, and the interests that continue to be held by a transferor, based on their relative fair values. That procedure shall be applied to all transfers in which interests continue to be held by the transferor, even those that do not qualify as sales. Examples of interests that continue to be held by a transferor include securities backed by the transferred assets, undivided interests, and cash reserve accounts and residual interests in securitization trusts. If a transferor cannot determine whether an asset is an interest continued to be held or proceeds from the sale, the asset shall be treated as proceeds from the sale and accounted for in accordance with paragraph 47.

49. If the interests that continue to be held by a transferor are subordinated to more senior interests held by others, that subordination may concentrate into the interests that continue to be held by a transferor most of the risks inherent in the transferred assets and shall be taken into consideration in estimating the fair value of the interests that continue to be held by a transferor. For example, if the amount of the gain recognized, after allocation, on a securitization with a subordinated interest continued to be held is greater than the gain would have been had the entire asset been sold, the transferor needs to be able to identify why that can occur. Otherwise, it is likely that the impact of the interest continued to be held being subordinate to a senior interest has not been adequately considered in the determination of the fair value of the subordinated interest continued to be held.

If It Is Not Practicable to Estimate Fair Values

50. If it is not practicable to estimate the fair values of assets, the transferor shall record those assets at an allocated cost basis of zero. If it is not practicable to estimate the fair values of liabilities, the transferor shall recognize no gain on the transaction and shall record those liabilities at the greater of:

a. The excess, if any, of (i) the fair values of assets obtained less the fair values of other liabilities incurred, over (ii) the sum of the carrying values of the assets transferred;

b. The amount that would be recognized in accordance with SSAP No. 5.

Securitizations

51. Financial assets such as mortgage loans are assets commonly transferred in securitizations. Securitizations of mortgage loans may include pools of single-family residential mortgages or other types of real estate mortgage loans, for example, multifamily residential mortgages and commercial property mortgages. Both financial and nonfinancial assets can be securitized; life insurance policy loans, patent and copyright royalties also have been securitized. Securitizations of nonfinancial assets are outside the scope of this statement.

52. An originator of a typical securitization (the transferor) transfers a portfolio of financial assets to an SPE, commonly a trust. In "pass-through" and "pay-through" securitizations, receivables are transferred to the SPE at the inception of the securitization, and no further transfers are made; all cash collections are paid to the holders of beneficial interests in the SPE. In "revolving-period" securitizations, receivables are transferred at the inception and also periodically (daily or monthly) thereafter for a defined period (commonly three to eight years), referred to as the revolving period. During the revolving period, the SPE uses most of the cash collections to purchase additional receivables from the transferor on prearranged terms.

53. Beneficial interests in the SPE are sold to investors and the proceeds are used to pay the transferor for the assets transferred. Those beneficial interests may comprise either a single class having equity characteristics or multiple classes of interests, some having debt characteristics and others having equity characteristics. The cash collected from the portfolio is distributed to the investors and others as specified by the legal documents that established the SPE.

54. Pass-through, pay-through, and revolving-period securitizations that meet the criteria in paragraph 5 qualify for sale accounting under this statement. All financial assets obtained or continued to be held and liabilities incurred by the originator of a securitization that qualifies as a sale shall be recognized and measured as provided in paragraph 7; that includes the implicit forward contract to sell new receivables during a revolving period, which may become valuable or onerous to the transferor as interest rates and other market conditions change.

Sales of Future Revenues

55. In addition to securitization of assets, some reporting entities have entered into transactions characterized as a sale of future revenues. These transactions are sometimes referred to as securitizations and are sometimes characterized as selling deferred acquisition costs. A sale of future revenues by a reporting entity shall not result in the immediate recognition of income or surplus. The proceeds of any such sale shall be established as a liability and shall be reduced as the proceeds are repaid.

Removal-of-Accounts Provisions

56. Many transfers of financial assets in securitizations empower the transferor to reclaim assets subject to certain restrictions. Such a power is sometimes called a removal-of-accounts provision (ROAP). If there is a ROAP, the transfer of assets shall not be accounted for as a sale.

Securities Lending Transactions

~~57. When securities are loaned, they remain assets of the reporting entity and are not removed from the accounting records. Any fees received by the transferor for loaning the securities shall be recorded as miscellaneous income. During a securities lending transaction, collateral is pledged by the transferee to the transferor that has loaned the securities. If the collateral pledged by the transferee is not available for the general use of the transferor (restricted), then the transferor shall not reflect the collateral in the transferor's balance sheet as an asset, and the transferor shall not establish a liability for the return of the collateral. However, if the collateral pledged is available for the general use of the transferor (unrestricted), then the collateral shall be recorded as an asset on the transferor's balance sheet and a separate liability shall be established on the transferor's balance sheet to record the obligation to return the collateral. The failure by the transferor to maintain sufficient collateral for the loaned securities would result in nonadmission of the undercollateralized portion. The specific collateral requirements are as follows:~~

~~a. The reporting entity shall receive collateral having a fair value as of the transaction date at least equal to 102 percent of the fair value of the loaned securities at that date. If at any time the fair value collateral is less than 100 percent of the fair value of the loaned securities, the counterparty shall be obligated to deliver additional collateral, the fair value of which, together with the fair value of all collateral then held in connection with the transaction at least equals 102 percent of the fair value of the loaned securities;~~

~~b. In the event that foreign securities are loaned and the denomination of the currency of the collateral is other than the denomination of the currency of the loaned foreign securities, the amount of collateral shall be at least equal to 105 percent of the fair value of the loaned securities at that date. If at any time the fair value is less than 102 percent of the fair value of the loaned securities, the reporting entity must obtain additional collateral, the fair value of which together with the fair value of all collateral then held in connection with the transaction at least equals 105 percent of the fair value of the loaned securities.~~

~~58~~57. Securities lending transactions are generally initiated by broker-dealers and other financial institutions that need specific securities to cover a short sale or a customer's failure to deliver securities sold. Securities lending transactions typically extend less than one year. Transferees (borrowers) of securities generally are required to provide collateral to the transferor (lender) of securities, commonly cash but sometimes other securities or standby letters of credit, with a value slightly higher than that of the securities borrowed. If the collateral is cash, the transferor typically earns a return by investing that cash at rates higher than the rate paid or rebated to the transferee. If the collateral is other than cash, the transferor typically receives a fee. Securities custodians or other agents commonly carry out securities lending activities on behalf of clients. Because of the protection of collateral (typically valued daily and adjusted frequently for changes in the market price of the securities transferred) and the short terms of the transactions, most securities lending transactions in themselves do not impose significant credit risks on either party. Other risks arise from what the parties to the transaction do with the assets they receive. For example, investments made with cash collateral impose market and credit risks on the transferor.

~~59~~58. Many securities lending transactions are accompanied by an agreement that entitles and obligates the transferor to repurchase or redeem the transferred assets before their maturity under which the transferor maintains effective control over those assets (paragraphs 38-40). Those transactions shall be accounted for as secured borrowings, in which cash (or securities that the holder or its agent is permitted by contract or custom to sell or repledge) received as collateral is considered the amount borrowed, the securities loaned are considered pledged as collateral against the cash or securities borrowed, and any rebate paid to the transferee of securities is interest on the cash or securities the transferor is considered to have borrowed. ~~Collateral provided in securities lending transactions that are accounted for as secured~~

~~borrowings shall be reported and disclosed like other collateral, as set forth in paragraphs 13 and 57.~~

~~60~~59. ~~In some transactions, characterized as securities lending, all of~~If the conditions in paragraph 5 are met, securities lending transactions shall be accounted for:~~, including the effective control criterion in paragraph 5c., and consideration other than beneficial interests in the transferred assets is received. During the term of such agreements, the transferor has surrendered control over the securities transferred and the transferee has obtained control over those securities, with the ability to sell or transfer them at will. In that case, creditors of the transferor have a claim only to the collateral and the forward repurchase commitment. Those transactions shall be accounted for:~~

a. By the transferor as a sale of the "loaned" securities, for proceeds consisting of the collateral[2] and a forward repurchase commitment~~. (If the collateral is a financial asset that the holder is permitted to sell or repledge and the debtor does not have the right and ability to redeem the collateral on short notice, e.g., by substituting other collateral or terminating the contract, that financial asset is proceeds of the sale of the loaned securities. To the extent that the collateral consists of letters of credit or other financial instruments that the holder is not permitted to sell or pledge, a securities lending transaction does not satisfy the sale criteria and is accounted for as a loan of securities by the transferor to the transferee)~~; and

b. By the transferee as a purchase of the "borrowed" securities in exchange for the collateral and a forward resale commitment. During the term of that agreement, the transferor has surrendered control over the securities transferred and the transferee has obtained control over those securities with the ability to sell or transfer them at will. In that case, creditors of the transferor have a claim only to the "collateral" and the forward repurchase commitment.

~~61~~60. The transferor of securities being "loaned" accounts for collateral received in the same way whether the transfer is accounted for as a sale or a secured borrowing. The collateral received shall be recognized as the transferor's asset—as shall investments made with that collateral, even if made by agents or in pools with other securities lenders—along with the obligation to return the collateral. If securities that may be sold or repledged are received by the transferor or its agent, the transferor of the securities being "loaned" accounts for those securities in the same way as it would account for collateral received. Collateral which may be sold or repledged by the transferor or its agent is reflected on balance sheet, along with the obligation to return the asset[3]. Collateral received which may not be sold or repledged by the transferor or its agent is off balance sheet[4]. For collateral on the balance sheet, the reporting is determined by the administration of the program.

a. Securities lending programs where the collateral received by the reporting entity's unaffiliated agent that can be sold or repledged is reported on the balance sheet. The collateral received and reinvestment of that collateral by the reporting entity's unaffiliated agent shall be reflected as a one-line entry on the

[2] If the "collateral" in a transaction that meets the criteria in paragraph 5 is a financial asset that the holder or its agent is permitted by contract or custom to sell or repledge, that financial asset is proceeds of the sale of the "loaned" securities. To the extent that the "collateral" consists of letters of credit or other financial instruments that the holder or its agent is not permitted by contract or custom to sell or repledge, a securities lending transaction does not satisfy the sale criteria and is accounted for as a loan of securities by the transferor to the transferee.

[3]If cash is received by the transferor or its agent and reinvested or repledged it is reported on balance sheet. It is explicitly intended that when the lender bears reinvestment risk, that collateral is on balance sheet.

[4] An example of collateral which is off balance sheet is securities are received by the transferor or its agent in which the collateral must be held and returned, without the ability to transfer or repledge the collateral. This would involve limited situations in which the transferor or agent is prohibited from reinvesting the collateral.

balance sheet (Securities Lending Collateral) and a detailed schedule will be required each quarter and at year-end to list the description of the collateral asset. This description shall include the NAIC rating, fair value; book adjusted carrying value and maturity date. A separate liability shall also be established to record the obligation to return the collateral (Collateral from Securities Lending Activities)

~~a.~~b. Securities lending programs where the collateral received by the reporting entity that can be sold or repledged is reported on the balance sheet. If the reporting entity is the administrator of the program, then, the collateral received and any reinvestment of that collateral is reported with the invested assets of the reporting entity based on the type of investment (i.e. bond, common stock, etc). A separate liability shall also be established to record the obligation to return the collateral (Collateral from Securities Lending Activities)

c. Securities lending programs where the collateral received by the reporting entity's affiliated agent can report using either one line reporting (paragraph 60 a.) or investment schedule reporting (paragraph 60.b.).

~~62~~61. Reinvestment of the collateral by the reporting entity or its agent, shall follow the same impairment guidance as other similar invested assets reported on the balance sheet. Any fees received by the transferor for loaning the securities shall be recorded as miscellaneous investment income.

Securities Lending Transactions – Collateral Requirements

~~63~~62. The reporting entity shall receive collateral having a fair value as of the transaction date at least equal to 102 percent of the fair value of the loaned securities at that date. If at any time the fair value of the collateral received from the counterparty is less than 100 percent of the fair value of the loaned securities, the counterparty shall be obligated to deliver additional collateral by the end of the next business day, the fair value of which, together with the fair value of all collateral then held in connection with the transaction at least equals 102 percent of the fair value of the loaned securities. If the collateral received from the counterparty is less than 100 percent at the reporting date, the difference between the actual collateral and 100 percent will be nonadmitted. Collateral value is measured and compared to the loaned securities in aggregate by counterparty.

~~64~~63. In the event that foreign securities are loaned and the denomination of the currency of the collateral is other than the denomination of the currency of the loaned foreign securities, the amount of collateral shall be at least equal to 105 percent of the fair value of the loaned securities at that date. If at any time the fair value of the collateral received from the counterparty is less than 102 percent of the fair value of the loaned securities, the reporting entity must obtain additional collateral by the end of the next business day, the fair value of which together with the fair value of all collateral then held in connection with the transaction at least equals 105 percent of the fair value of the loaned securities. If the collateral received from the counterparty is less than 100 percent at the reporting date, the difference between the actual collateral and 100 percent will be nonadmitted. Collateral value is measured and compared to the loaned securities in aggregate by counterparty.

Repurchase Agreements and "Wash Sales"

~~61.~~64. Government securities dealers, banks, other financial institutions, and corporate investors commonly use repurchase agreements to obtain or use short-term funds. Under those agreements, the transferor ("repo party") transfers a security to a transferee ("repo counterparty" or "reverse party") in exchange for cash[5] and concurrently agrees to reacquire that security at a future date for an amount equal to the cash exchanged plus a stipulated "interest" factor. Repurchase agreements, reverse repurchase agreements and dollar repurchase agreements

[5] Instead of cash, other securities or letters of credit sometimes are exchanged.

meet the definition of assets as defined in *SSAP No. 4—Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this statement.

~~62.~~65. Repurchase agreements can be affected in a variety of ways. Some repurchase agreements are similar to securities lending transactions in that the transferee or its agent has the right to sell or repledge the securities to a third party during the term of the repurchase agreement. In other repurchase agreements, the transferee does not have the right to sell or repledge the securities during the term of the repurchase agreement. For example, in a tri-party repurchase agreement, the transferor transfers securities to an independent third-party custodian that holds the securities during the term of the repurchase agreement. Also, many repurchase agreements are for short terms, often overnight, or have indefinite terms that allow either party to terminate the arrangement on short notice. However, other repurchase agreements are for longer terms, sometimes until the maturity of the transferred asset. Some repurchase agreements call for repurchase of securities that need not be identical to the securities transferred.

~~63.~~66. If the ~~criteria~~conditions in paragraph 5 are met, including the criterion in paragraph 5.c., the transferor shall account for the repurchase agreement as a sale of financial assets and a forward repurchase commitment, and the transferee shall account for the agreement as a purchase of financial assets and a forward resale commitment. Other transfers that are accompanied by an agreement to repurchase the transferred assets that shall be accounted for as sales include transfers with agreements to repurchase at maturity and transfers with repurchase agreements in which the transferee has not obtained collateral sufficient to fund substantially all of the cost of purchasing replacement assets. (Repurchase financing is addressed in paragraphs ~~70-75~~73-78.)

~~64.~~ 67. Furthermore, "wash sales" that previously were not recognized if the same financial asset was purchased within 30 days before or after the sale shall be accounted for as sales under this statement. Unless there is a concurrent contract to repurchase or redeem the transferred financial assets from the transferee, the transferor does not maintain effective control over the transferred assets.

~~65.~~68. As with securities lending transactions, under many agreements to repurchase transferred assets before their maturity the transferor maintains effective control over those assets. Repurchase agreements that do not meet all the criteria in paragraph 5 shall be treated as secured borrowings. Fixed-coupon and dollar-roll repurchase agreements, and other contracts under which the securities to be repurchased need not be the same as the securities sold, qualify as borrowings if the return of substantially the same (paragraph 39) securities as those concurrently transferred is assured. Therefore, those transactions shall be accounted for as secured borrowings by both parties to the transfer.

69~~66~~. If a transferor has transferred securities to an independent third-party custodian, or to a transferee, under conditions that preclude the transferee from selling or repledging the assets during the term of the repurchase agreement (as in most tri-party repurchase agreements), the transferor has not surrendered control over those assets.

Repurchase Agreements

~~67.~~70. Repurchase agreements are defined as agreements under which a reporting entity ~~purchases~~ sells securities and simultaneously agrees to repurchase ~~resell~~ the same or substantially the same securities at a stated price on a specified date. For securities to be substantially the same, the criteria defined in paragraph 39 must be met, and for mortgage-backed securities excluding mortgage pass-through securities, the projected cash flows of the securities must be substantially the same under multiple scenario prepayment assumptions.

~~68.~~71. For repurchase agreements that are accounted for as collateralized borrowings~~lendings~~ in accordance with paragraph ~~65~~ 68 of this statement, the underlying securities shall ~~not~~ continue to be accounted for as an investment~~s~~ owned by the reporting entity. ~~The amount paid for the securities shall be reported as a short-term investment, and the difference between the amount~~

~~paid and the amount at which the securities will be subsequently resold shall be reported as interest income,~~ The proceeds from the sale of the securities shall be recorded as a liability, and the difference between the proceeds and the amount at which the securities will be subsequently reacquired shall be reported as interest expense, calculated on the straight-line method or the scientific interest (constant yield) method, over the term of the agreement.

72~~69~~. Reporting entities generally take possession of the underlying collateral under repurchase agreements and in many cases may obtain additional collateral when the estimated fair value of such securities falls below their current contract value. However, to the extent that the current fair value of the collateral is less than the recorded amount, the shortfall shall reduce the admitted asset value of the repurchase agreement.

Repurchase Financing

73~~0~~. Repurchase financing is a repurchase agreement that relates to a previously transferred financial asset between the same counterparties (or affiliates of either counterparty) that is entered into contemporaneously with, or in contemplation of, the initial transfer.

74~~1~~. A repurchase financing involves the transfer of a previously transferred financial asset back to the initial transferor as collateral for a financing between the initial transferee (the borrower) and the initial transferor (the lender). A repurchase financing also typically involves the initial transferor returning the transferred financial asset (or substantially the same asset) to the initial transferee when the financing is repaid on a stated date. A repurchase financing is entered into in contemplation of the initial transfer if both transactions are considered together at the execution of the initial transfer.

75~~2~~. When the transferor transfers a financial asset and also enters into a repurchase financing with the transferee, there are typically three transfers of the financial assets:

a. Initial transfer – An initial transferor transfers a financial asset to an initial transferee.

b. Repurchase financing – The initial transferee (the borrower) transfer the previously transferred financial asset back to the initial transferor (the lender) as collateral for a financing between the initial transferor and initial transferee.

c. Settlement – The initial transferor (the lender) returns the financial asset (or substantially the same asset) to the initial transferee (the borrower) upon receipt of payment from the initial transferee.

76~~3~~. Repurchase financing that is entered into contemporaneously with, or in contemplation of, an initial transfer of a financial asset between the same counterparties (or affiliates of either counterparty) shall not be separately accounted for as a transfer of a financial asset and a related repurchase financing unless (a) the two transactions have a valid and distinct business or economic purpose for being entered into separately and (b) the repurchase financing does not result in the initial transferor regaining control over the financial asset. Unless the provisions in paragraphs ~~74~~77 rare met, the initial transfer and repurchase financing shall be evaluated as a linked transaction. The linked transaction shall be evaluated to determined whether it meets the requirements for sale accounting per paragraph 5, including paragraph 5.c. If the linked transaction does not meet the requirements for sale accounting, the linked transaction shall be accounted for based on the economies of the combined transactions, which generally represent a forward contract. *SSAP No. 86—Accounting for Derivative Instruments and Hedging, Income Generation, and Replication (Synthetic Asset) Transactions* shall be used to evaluate whether the linked transaction ~~should~~shall be accounted for as a derivative.

77~~4~~. An initial transfer of a financial asset and repurchase financing that are entered into contemporaneously with, or in contemplation of, one another shall be considered linked unless all of the following criteria are met at the inception of the transaction:

a. The initial transfer and the repurchase financing are not contractually contingent on one another. Even if no contractual relationship exists, the pricing and performance of either the initial transfer or the repurchase financing must not be dependent on the terms and execution of the other transaction.

b. The repurchase financing provides the initial transferor with recourse to the initial transferee upon default. That recourse must expose the initial transferor to the credit risk of the initial transferee, or its affiliates, and not solely to the market risk of the transferred financial asset. The initial transferee's agreement to repurchase the previously transferred financial asset (or substantially the same asset) for a fixed price and not fair value.

c. The financial asset subject to the initial transfer and repurchase financing is readily obtainable in the marketplace. In addition, the initial transfer of a financial asset and the repurchase financing are executed at market rates. This criterion may not be circumvented by embedding off-market terms in a separate transaction contemplated with the initial transfer or the repurchase financing.

d. The financial asset and repurchase agreement are not coterminous (the maturity of the repurchase financing must be before the maturity of the financial asset.)

78~~5~~. In accordance with paragraph 76~~3~~, an initial transfer of assets and a repurchase financing shall not be considered separate transactions unless the provisions of paragraph ~~74~~77 are met. If the provisions of paragraph ~~73~~ 77 are met, the initial transfer shall be evaluated to determine whether it meets the requirements for sale accounting without taking into consideration the repurchase financing. In such situations, the repurchase financing shall then be separately analyzed as a repurchase agreement.

Reverse Repurchase Agreements

~~76.~~79. Reverse repurchase agreements are defined as agreements under which a reporting entity ~~sells~~ purchases securities and simultaneously agrees to resell~~repurchase~~ the same or substantially the same securities at a stated price on a specified date. For securities to be substantially the same, the criteria defined in paragraph 39 must be met, and for mortgage-backed securities excluding mortgage pass-through securities, the projected cash flows of the securities must be substantially the same under multiple scenario prepayment assumptions.

~~77~~80. For reverse repurchase agreements that are accounted for as collateralized lendings ~~borrowings~~ in accordance with paragraph ~~13~~ 68 of this statement, the underlying securities shall not be accounted for as investments owned by the reporting entity. The amount paid for the securities shall be reported as a short-term investment, and the difference between the amount paid and the amount at which the securities will be subsequently resold shall be reported as interest income, ~~The proceeds from the sale of the securities shall be recorded as a liability, and the difference between the proceeds and the amount at which the securities will be subsequently reacquired shall be reported as interest expense,~~ calculated on the straight-line method or the scientific interest (constant yield) method, over the term of the agreement.

Collateral Requirements

81~~78~~. The collateral requirements for repurchase and reverse repurchase agreements are as follows:

Repurchase Transaction

a. The reporting entity shall receive collateral having a fair value as of the transaction date at least equal to 95 percent of the fair value of the securities transferred by the reporting entity in the transaction as of that date. If at anytime the fair value of the collateral received from the counterparty is less than 95 percent of the fair value of the securities so transferred, the counterparty shall be obligated to deliver additional collateral by the end of the next business day the fair value of which, together with the fair value of all collateral then held in connection with the transaction, at least equals 95 percent of the fair value of the transferred securities. If the collateral is less than 95 percent at the reporting date, the difference between the actual collateral and 95 percent will be nonadmitted.

Reverse Repurchase Transaction

b. The reporting entity shall receive as collateral transferred securities having a fair value at least equal to 102 percent of the purchase price paid by the reporting entity for the securities. If at anytime the fair value of the collateral is less than 100 percent of the purchase price paid by the reporting entity, the counterparty shall be obligated to provide additional collateral, the fair value of which, together with fair value of all collateral then held in connection with the transaction, at least equals 102 percent of the purchase price.

~~a. The reporting entity shall receive as collateral transferred securities having a fair value at least equal to 102 percent of the purchase price paid by the reporting entity for the securities. If at anytime the fair value of the collateral is less than 100 percent of the purchase price paid by the reporting entity, the counterparty shall be obligated to provide additional collateral, the fair value of which, together with fair value of all collateral then held in connection with the transaction, at least equals 102 percent of the purchase price.~~

~~Reverse Repurchase Transaction~~

~~b. The reporting entity shall receive collateral having a fair value as of the transaction date at least equal to 95 percent of the fair value of the securities transferred by the reporting entity in the transaction as of that date. If at anytime the fair value of the collateral is less than 95 percent of the fair value of the securities so transferred, the counterparty shall be obligated to deliver additional collateral, the fair value of which, together with the fair value of all collateral then held in connection with the transaction, at least equals 95 percent of the fair value of the transferred securities.~~

Dollar Repurchase Agreements

82~~79~~. Dollar repurchase and dollar reverse repurchase agreements are defined as repurchase and reverse repurchase agreements involving debt instruments that are pay-through securities collateralized with Government National Mortgage Association (GNMA), Federal Home Loan Mortgage Corporation (FHLMC) and Federal National Mortgage Association (FNMA) collateral, and pass-through certificates sponsored by GNMA, mortgage participation certificates issued by the FHLMC or similar securities issued by the FNMA. Dollar repurchase agreements are also commonly referred to as dollar roll transactions. To meet the definition of dollar repurchase and dollar reverse repurchase agreements, the securities underlying the agreements must meet the criteria defined in paragraph 39, and for mortgage-backed securities excluding mortgage pass-through securities, the projected cash flows of the securities must be substantially the same under multiple scenario prepayment assumptions.

83~~80~~. For the seller in a dollar reverse repurchase agreement accounted for as collateralized borrowing in accordance with paragraph ~~65~~ 68 of this statement, a liability is recorded for the amount of proceeds of the sale and the sold mortgage-backed securities are not removed from the accounting records. During the period of the agreement, interest income is recorded as if the mortgage-backed security had been held during the term of the agreement. This is offset by an equal amount of interest expense related to the proceeds received from the sale. Additional interest expense is recorded representing the difference between the sales price and the repurchase price of the mortgage-backed securities sold.

~~81.~~84. When the mortgage-backed securities are repurchased under the agreement, the original mortgage-backed securities sold are removed from the accounting records and the purchased mortgage-backed securities are recorded. The principal amount of the mortgage-backed securities repurchased must be in good delivery form consistent with paragraph 39.

~~82~~85. If the principal amount repurchased is greater than the amount sold, the cash paid is recorded as an additional investment in the newly acquired certificates. If the principal amount repurchased is less than the amount sold, a gain or loss relating to the original certificates held is recorded.

~~83.~~86. For the purchaser in a dollar repurchase agreement accounted for as collateralized lending in accordance with paragraph ~~65~~ 68 of this statement, an asset is recorded for the amount of the purchase. Upon completion of the reverse repurchase agreement, cash is received in exchange for a "substantially the same" security. The difference between the purchase and reselling price represents interest income for the lending of short-term funds.

Separate Transactions

~~84.~~87. Agreements to repurchase and resell securities that do not meet the definitions in paragraphs 58 and ~~64~~ 68 of this statement shall be accounted for as two separate transactions, that is, as a sale and purchase or as a purchase and sale, in accordance with the relevant statutory accounting guidance. For example, sales of bonds would result in recognition of realized gains or losses.

Offsetting

~~85.~~88. Reporting entities may operate on both sides of the repurchase agreement market resulting in recording of liabilities and assets representing repurchase and reverse repurchase agreements, respectively.

~~86.~~89. Reporting entities shall offset such liabilities and assets only to the extent that one of the following occurs:

a. A legal right of offset exists as defined in SSAP No. 64—Offsetting and Netting of Assets and Liabilities; or

b. The securities have the same settlement date, are executed with the same counterparty in accordance with a master netting arrangement, involve securities that exist in "book entry" form, and settle on securities transfer systems that have the same key elements and operating characteristics as the Fedwire Securities Transfer System.

~~87.~~90. Otherwise, separate assets and liabilities shall be recognized.

Loan Syndications

~~88.~~91. Borrowers often borrow amounts greater than any one lender is willing to lend. Therefore, it is common for groups of lenders to jointly fund those loans. That may be accomplished by a syndication under which several lenders share in lending to a single borrower, but each lender loans a specific amount to the borrower and has the right to repayment from the borrower.

~~89.~~92. A loan syndication is not a transfer of financial assets. Each lender in the syndication shall account for the amounts it is owed by the borrower. Repayments by the borrower may be made to a lead lender who then distributes the collections to the other lenders of the syndicate. In those circumstances, the lead lender is also functioning as a servicer and, therefore, shall only recognize its portion of the loan as an asset.

Loan Participations

~~90.~~93. Groups of banks or other entities also may jointly fund large borrowings through loan participations in which a single lender makes a large loan to a borrower and subsequently transfers undivided interests in the loan to other entities.

~~91.~~94. Transfers by the originating lender may take the legal form of either assignments or participations. The transfers are usually on a nonrecourse basis, and the transferor (originating lender) continues to service the loan. The transferee (participating entity) may or may not have the right to sell or transfer its participation during the term of the loan, depending upon the terms of the participation agreement.

~~92.~~95. If the loan participation agreement gives the transferee the right to pledge or exchange those participations and the other criteria in paragraph 5 are met, the transfers to the transferee shall be accounted for by the transferor as sales of financial assets. A transferor's right of first refusal on a bona fide offer from a third party, a requirement to obtain the transferor's permission that shall not be unreasonably withheld, or a prohibition on sale to the transferor's competitor is a limitation on the transferee's rights but presumptively does not constrain a transferee from exercising its right to pledge or exchange. However, if the loan participation agreement constrains the transferees from pledging or exchanging their participations, the transferor has not relinquished control over the loan and shall account for the transfers as secured borrowings.

Factoring Arrangements

~~93.~~96. Factoring arrangements are a means of discounting accounts receivable on a nonrecourse, notification basis. Accounts receivable are sold outright, usually to a transferee (the factor) that assumes the full risk of collection, without recourse to the transferor in the event of a loss. Debtors are directed to send payments to the transferee. Factoring arrangements that meet the criteria in paragraph 5 shall be accounted for as sales of financial assets because the transferor surrenders control over the receivables to the factor.

Transfers of Receivables with Recourse

~~94.~~97. In a transfer of receivables with recourse, the transferor is obligated under the terms of the recourse provision to make payments to the transferee or to repurchase receivables sold under certain circumstances, typically for defaults up to a specified percentage. A transfer of receivables with recourse shall not be recognized as a sale but rather, as a financing. A transfer of receivables without recourse shall only be recognized if the transferor receives cash for the receivables. The sale shall be recognized when cash is received. Sales of premium receivables are addressed in SSAP No. 42—Sale of Premium Receivables.

Disclosures

~~95.~~98. A reporting entity shall disclose the following:

a. For collateral:

i. If the entity has entered into repurchase agreements or securities lending transactions, its policy for requiring collateral or other security and the fair value of the loaned security. This would also apply to separate accounts;

ii. If the entity has pledged any of its assets as collateral, the carrying amount and classification of those assets as of the date of the latest statement of financial position presented;

iii. If the entity or its agent has accepted collateral that it is permitted by contract or custom to sell or repledge it shall be recorded on the balance sheet. ~~, r~~Regardless of whether the transaction is considered "on-balance sheet" or "off-balance sheet", the reporting entity shall provide the following information by type of program (repurchase agreement, securities lending, or dollar repurchase agreement) as of the date of each statement of financial position: (1) the aggregate amount of contractually obligated open collateral positions (aggregate amount of securities at current fair value or cash received for which the borrower may request the return of on demand) and the aggregate amount of contractually obligated collateral positions under 30-day, 60-day, 90-day, and greater than 90-day terms, (2) the aggregate fair value of all securities acquired from the sale, trade and use of the accepted collateral (reinvested collateral), and (3) information about the sources and uses of that collateral;

iv. For securities lending transactions, disclose collateral for transactions that extend beyond one year from the reporting date;~~ and~~

v. For securities lending transactions administered by an affiliated agent in which "one-line" reporting (per paragraph 60.a.) of the reinvested collateral per paragraph 60.c. is optional, at the discretion of the reporting entity, disclose the aggregate value of the reinvested collateral which is "one line" reported and the aggregate value of items which are reported in the investment schedules (per paragraph 60.b.). Identify the rational between the items which are one line reported and those that are investment schedule reported and if the treatment has changed from the prior period and

vi. Include separately, the amount of any loaned securities within the separate account and if the policy and procedures for the separate account differ from the general account.

b. The reporting entity shall provide the following information by type of program (repurchase agreement, securities lending or dollar repurchase agreement) with respect to the reinvestment of the cash collateral and any securities which it or its agent receives as collateral that can be sold or repledged.

i. The aggregate amount of the reinvested cash collateral (amortized cost and fair value). Reinvested cash collateral shall be broken down by the maturity date of the invested asset – under 30-day, 60-day, 90-day, 120-day, 180-day, less than 1 year, 1-2 years, 2-3 years and greater than 3 years.

ii. To the extent that the maturity dates of the liability (collateral to be returned) does not match the invested assets, the reporting entity shall explain the additional sources of liquidity to manage those mismatches.

c. If debt was considered to be extinguished by in-substance defeasance, a general description of the transaction and the amount of debt that is considered extinguished at the end of the period so long as that debt remains outstanding;

d. If assets are set aside solely for satisfying scheduled payments of a specific obligation, a description of the nature of restrictions placed on those assets;

e. If it is not practicable to estimate the fair value of certain assets obtained or liabilities incurred in transfers of financial assets during the period, a description of those items and the reasons why it is not practicable to estimate their fair value;

f. For all servicing assets and servicing liabilities:

i. A description of the valuation techniques or other models, including significant assumptions within models, used to estimate the fair value of servicing assets and servicing liabilities; and

ii. Changes in fair value resulting from changes in valuation inputs or assumptions used in models and descriptions of other changes in fair value.

g. If the entity has securitized financial assets during any period presented and accounts for that transfer as a sale, for each major asset type (for example, mortgage loans):

i. Its accounting policies for initially measuring the interests that continue to be held by a transferor, if any, used in determining their fair value. (Fair value shall be determined in accordance with *SSAP No. 100—Fair Value Measurements*.); and

ii. The characteristics of securitizations (a description of the transferor's continuing involvement with the transferred assets, including, but not limited to, servicing, recourse, and restrictions on interests that continue to be held by a transferor) and the gain or loss from sale of financial assets in securitizations;

iii. The key assumptions used in measuring the fair value of interests that continue to be held by a transferor at the time of securitization (including, at a minimum, quantitative information about discount rates, expected prepayments including the expected weighted-average life of prepayable financial assets, and anticipated credit losses, if applicable); and

iv. Cash flows between the securitization SPE and the transferor (including proceeds from new securitizations, purchases of delinquent or foreclosed loans, servicing fees, and cash flows received on interests continued to be held.)

h. If the entity has interests that continue to be held by a transferor in securitized financial assets at the date of the latest statement of financial position presented, for each major asset type (for example, mortgage loans):

i. Its accounting policies for subsequently measuring those interests that continue to be held by a transferor, including the methodology used in determining their fair value. (Fair value shall be determined in accordance with *SSAP No. 100—Fair Value Measurements*.);

ii. The key assumptions used in subsequently measuring the fair value of those interests (including, at a minimum, quantitative information about discount rates, expected prepayments including the expected weighted-average life of prepayable financial assets, and anticipated credit losses, including expected static pool losses, if applicable);

iii. A sensitivity analysis or stress test showing the hypothetical effect on the fair value of those interests of two or more unfavorable variations from the expected levels for each key assumption that is reported under ii. above independently from any change in another key assumption, and a description of the objectives, methodology, and limitations of the sensitivity analysis or stress test; and

iv. For the securitized assets and any other financial assets that the entity manages together with the interests that continue to be held by the transferor[6]:

(a) The total principal amount outstanding, the portion that has been derecognized, and the portion that continues to be recognized in each category reported in the statement of financial position, at the end of the period;

(b) Delinquencies at the end of the period; and

(c) Credit losses, net of recoveries, during the period.

v. Disclosure of average balances during the period is encouraged, but not required.

i. Description of any loaned securities, including the amount, a description of, and the policy for, requiring collateral, and whether or not the collateral is restricted;

j. A description of the securities underlying repurchase and reverse repurchase agreements, dollar repurchase and dollar reverse repurchase agreements, including book values and fair values, maturities, and weighted average interest rates for the following categories: (i) securities subject to reverse repurchase agreements; (ii) securities subject to repurchase agreements; (iii) securities subject to dollar repurchase agreements; and (iv) securities subject to dollar reverse repurchase agreements; and

k. A description of the terms of reverse repurchase agreements whose amounts are included in borrowed money.

~~96~~99. Disclose any transfers of receivables with recourse.

~~97~~100. A reporting entity shall disclose the following information for wash sales, as defined in paragraph 9, involving transactions for securities with a NAIC designation of 3 or below, or unrated:

a. A description of the reporting entity's objectives regarding these transactions;

b. An aggregation of transactions by NAIC designation 3 or below, or unrated;

c. The number of transactions involved during the reporting period;

d. The book value of securities sold;

e. The cost of securities repurchased; and

f. The realized gains/losses associated with the securities involved.

~~98.~~101. Refer to the preamble for further discussion regarding disclosure requirements. The disclosures required by paragraph ~~97~~100 shall be made for the current quarter in the quarterly statement and for the year in the annual statement.

[6] Excluding securitized assets that an entity continues to service but with which it has no other continuing involvement.

Relevant Literature

~~99.~~102.The accounting guidance in this statement is consistent with the guidance included in SSAP No. 18, SSAP No. 33 and SSAP No. 45, and is expanded to include issues addressed in *FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 140).

~~100.~~103.This statement adopts FAS 140 with the following modifications:

a. Servicing rights assets are nonadmitted;

b. Sales treatment is not permitted for transactions including recourse provisions or removal-of-accounts provisions on the transferred assets whereas GAAP would permit the recognition of the transfer as a sale under some circumstances;

c. As statutory financial statements are prepared on a legal entity basis, special purpose entities shall not be consolidated in a reporting entity's statutory financial statements;

d. Leases shall be accounted for in accordance with *SSAP No. 22—Leases*;

e. Reporting entities required to maintain an IMR shall account for realized and unrealized capital gains and losses in accordance with SSAP No. 7; and

f. The concepts of revolving-period securitizations, banker's acceptances and risk participations in banker's acceptances are not applicable for statutory accounting purposes.

g. This statement does not adopt the accounting for collateral as outlined in FAS 140.

~~101.~~104. This statement adopts with modification *FASB Statement No. 156: Accounting for Servicing of Financial Assets, an amendment of FASB Statement No. 140* (FAS 156). Specific items adopted or rejected are identified below. Items within FAS 156 not specifically noted as adopted shall be considered rejected:

a. This statement adopts FAS 156 guidance indicating that all servicing assets and servicing liabilities should initially be measured at fair value.

b. This statement adopts FAS 156 guidance requiring the inclusion of separately recognized servicing assets and servicing liabilities in the calculation of proceeds from the sale of assets.

c. This statement rejects the optionality provided within FAS 156 for subsequent measurement of servicing assets and servicing liabilities using either fair value or an amortization method. This statement requires application of a fair value method for subsequent measurement.

d. This statement adopts guidance in FAS 156 confirming adoption of guidance previously adopted from FAS 140 regarding servicing assets and servicing liabilities established from the transfer of financial assets to a qualifying SPE in a guaranteed mortgage securitization in which the transferor retains all of the resulting securities.

e. This statement adopts revisions in FAS 156 replacing the term 'retained interests' with 'interests that continue to be held by the transferor' with amendments to the definition to exclude servicing assets and servicing liabilities from this definition.

~~102.~~105.This statement adopts *FASB Staff Position 140-3, Accounting for Transfers of Financial Assets and Repurchase Financing Transactions* (FSP FAS 140-3) and *AICPA Statement of Position 90-3*, *Definition of the Term Substantially the Same for Holders of Debt Instruments, as used In Certain Audit Guides and a Statement of Position*. This statement adopts *FASB Emerging Issues Task Force (EITF) No. 87-34, Sale of Mortgage Servicing Rights with a Subservicing Agreement, FASB EITF No. 88-11, Allocation of Recorded Investment When a Loan as Part of a Loan is Sold, FASB EITF No. 88-18, Sales of Future Revenues, FASB EITF No. 88-22, Securitization of Credit Card and Other Receivable Portfolios, FASB EITF No. 90-21, Balance Sheet Treatment of a Sale of Mortgage Servicing Rights with a Subservicing Agreement, FASB EITF No. 95-5, Determination of What Risks and Rewards, If Any, Can Be Retained and Whether Any Unresolved Contingencies May Exist in a Sale of Mortgage Loan Servicing Rights* and *FASB EITF No. 96-19, Debtor's Accounting for a Modification or Exchange of Debt Instruments*.

~~103.~~106. This statement rejects *FASB EITF No. 84-5, Sale of Marketable Securities with a Put Option*, and *FASB EITF No. 92-2, Measuring Loss Accruals by Transferors of Receivables with Recourse* and *FTB 01-1: Effective Date for Certain Financial Institutions of Certain Provisions of Statement 140 related to Isolation of Transferred Financial Assets*.

Effective Date and Transition

~~104.~~107. This statement is effective for years beginning on and after January 1, 2005 and shall be applied prospectively. Substantive revisions in paragraphs 6, 11-12, 98.f, 104 and Exhibit B illustrations are effective January 1, 2009. Substantive revisions in paragraphs 13, 59-63, 65, 71, 80, 81 and 98 regarding securities lending transactions and repurchase agreements and additional disclosures were adopted in May 2010 and are effective December 31, 2010. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*.

~~105.~~108. For each servicing contract in existence before January 1, 2005, previously recognized or nonadmitted servicing rights and excess servicing receivables shall be combined, net of any previously recognized servicing obligations under that contract, as a servicing asset (nonadmitted) or liability. Thereafter, the subsequent measurement provisions of this statement shall be applied to the servicing assets (nonadmitted) or liabilities for those servicing contracts.

AUTHORITATIVE LITERATURE

Statutory Accounting

- *SSAP No. 18—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
- *SSAP No. 33—Securitization*
- *SSAP No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements*
- *NAIC Purposes and Procedures Manual of the NAIC Securities Valuation Office*
- *Issue Paper No. 134—Servicing Assets/Liabilities, An Amendment of SSAP No. 91*

Generally Accepted Accounting Principles

- *FASB Statement No. 156, Accounting for Servicing of Financial Assets, an amendment of FASB Statement No. 140*
- *FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
- *FASB Staff Position 140-3, Accounting for Transfers of Financial Assets and Repurchase Financing Transactions*
- *AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as used In Certain Audit Guides and a Statement of Position*

- *FASB Emerging Issues Task Force No. 87-34, Sale of Mortgage Servicing Rights with a Subservicing Agreement*
- *FASB Emerging Issues Task Force No. 88-11, Allocation of Recorded Investment When a Loan as Part of a Loan is Sold*
- *FASB Emerging Issues Task Force No. 88-18, Sales of Future Revenues*
- *FASB Emerging Issues Task Force No. 88-22, Securitization of Credit Card and Other Receivable Portfolios*
- *FASB Emerging Issues Task Force No. 90-21, Balance Sheet Treatment of a Sale of Mortgage Servicing Rights with a Subservicing Agreement*
- *FASB Emerging Issues Task Force No. 95-5, Determination of What Risks and Rewards, If Any, Can Be Retained and Whether Any Unresolved Contingencies May Exist in a Sale of Mortgage Loan Servicing Rights*
- *FASB Emerging Issues Task Force No. 96-19, Debtor's Accounting for a Modification or Exchange of Debt Instruments*

RELEVANT ISSUE PAPERS

- *Issue Paper No. 122—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
- *Issue Paper No. 134—Servicing Assets/Liabilities, An Amendment of SSAP No. 91*
- *Issue Paper No. 144—Substantive Revisions to SSAP No. 91R: Securities Lending*

EXHIBIT A - GLOSSARY

Asset Securitization

An asset securitization is the process of converting assets which would normally serve as collateral for a loan into securities. The largest category of securitized assets is real estate mortgage loans, which serve as collateral for mortgage-backed securities.

Beneficial Interests

Rights to receive all or portions of specified cash inflows to a trust or other entity, including senior and subordinated shares of interest, principal, or other cash inflows to be passed-through or paid-through, premiums due to guarantors, commercial paper obligations and residual interests, whether in the form of debt or equity.

Beneficial Interest Holder ("BIH")

Holder of beneficial interests

Cleanup Call

An option held by the servicer, which may be the transferor, to purchase transferred financial assets, or the remaining beneficial interests not held by the transferor, its affiliates, or its agents in a qualifying SPE (or in a series of beneficial interests in transferred assets within a qualifying SPE), when the amount of outstanding assets falls to a level at which the cost of servicing those assets becomes burdensome in relation to the benefits or servicing.

Collateral

Personal or real property in which a security interest has been given.

Derecognize

Remove previously recognized assets or liabilities from the balance sheet.

Derivative Financial Instrument

A derivative instrument (as defined in *SSAP No. 86—Accounting for Derivative Instruments and Hedging, Income Generation, and Replication (Synthetic Asset) Transactions*) that is a financial instrument (refer to *SSAP No. 27—Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, paragraph 2).

Embedded Call (See paragraphs 41 and 43)

A call option held by the issuer of a financial instrument that is part of and trades with the underlying instrument. For example, a bond may allow the issuer to call it by posting a public notice well before its stated maturity that asks the current holder to submit it for early redemption and provides that interest ceases to accrue on the bond after the early redemption date. Rather than being an obligation of the initial purchaser of the bond, an embedded call trades with and diminishes the value of the underlying bond.

Financial Asset

Cash, evidence of an ownership interest in an entity, or a contract that conveys to a second entity a contractual right (a) to receive cash or another financial instrument from a first entity or (b) to exchange other financial instruments on potentially favorable terms with the first entity.

Financial Liability

A contract that imposes on one entity a contractual obligation (a) to deliver cash or another financial instrument to a second entity or (b) to exchange other financial instruments on potentially unfavorable terms with the second entity.

Guaranteed Mortgage Securitization

A securitization of mortgage loans which includes a substantive guarantee by a third party.

Interests That Continue to be Held by a Transferor

Other interests in transferred assets, those that are not part of the proceeds of the transfer, over which the transferor has not relinquished control. Includes securities backed by the transferred assets, undivided interests, and cash reserve accounts and residual interests in securitization trusts.

Proceeds

Cash, derivatives, or other assets that are obtained in a transfer of financial assets, less any liabilities incurred.

Recourse

The right of a transferee of receivables to receive payment from the transferor of those receivables for (a) failure of debtors to pay when due, (b) the effects of prepayments, or (c) adjustments resulting from defects in the eligibility of the transferred receivables.

Residual

Residuals are a class of purchased beneficial interests or interests that continue to be held by the transferor that have rights to the last cash flows from the pool of securitized assets and are not rated by a Nationally Recognized Statistical Rating Organization (NRSRO). Residuals are to be carried at fair value with the difference between fair value and the allocated cost basis recognized as an unrealized gain or loss;

Securitization

The process by which financial assets are transformed into securities.

Security Interest

A form of interest in property that provides that upon default of the obligation for which the security interest is given, the property may be sold in order to satisfy that obligation.

Seller

A transferor that relinquishes control over financial assets by transferring them to a transferee in exchange for consideration.

Servicing Asset

A contract to service financial assets under which the estimated future revenues from contractually specified servicing fees, late charges, and other ancillary revenues are expected to more than adequately compensate the servicer for performing the servicing. A servicing contract is either (a) undertaken in conjunction with selling or securitizing the financial assets being serviced or (b) purchased or assumed separately.

Servicing Liability

A contract to service financial assets under which the estimated future revenues from stated servicing fees, late charges, and other ancillary revenues are not expected to adequately compensate the servicer for performing the servicing.

Transfer

The conveyance of a noncash financial asset by and to someone other than the issuer of that financial asset. Thus, a transfer includes selling a receivable, putting it into a securitization trust, or posting it as collateral but excludes the origination of that receivable, the settlement of that receivable, or the restructuring of that receivable into a security in a troubled debt restructuring.

Transferee

An entity that receives a financial asset, a portion of a financial asset, or a group of financial assets from a transferor.

Transferor

An entity that transfers a financial asset, a portion of a financial asset, or a group of financial assets that it controls to another entity.

Undivided Interest

Partial legal or beneficial ownership of an asset as a tenant in common with others. The proportion owned may be pro rata, for example, the right to receive 50 percent of all cash flows from a security, or non-pro rata, for example, the right to receive the interest from a security while another has the right to the principal.

~~**Unrestricted collateral**~~

~~Securities received that may be sold or repledged and which were obtained under agreements that are not subject to repurchase or redemption on short notice, for example, by substitution of other collateral or termination of the contract.~~

Unilateral ability (See paragraphs 41 and 42)

A capacity for action not dependent on the actions (or failure to act) of any other party.

EXHIBIT B - ILLUSTRATIONS

Illustration—Recording Transfers with Proceeds of Cash, Derivatives, and Other Liabilities

1. Company A sells loans with a fair value of $1,100 and a carrying amount of $1,000. Company A retains no servicing responsibilities but obtains an option to purchase from the transferee loans similar to the loans sold (which are readily obtainable in the marketplace) and assumes a limited recourse obligation to repurchase delinquent loans.

Company A agrees to provide the transferee a return at a floating rate of interest even though the contractual terms of the loan are fixed rate in nature (that provision is effectively an interest rate swap).

Fair Values	
Cash proceeds	$1,050
Interest rate swap	40
Call option	70
Recourse obligation	60

Net Proceeds		
Cash received		$1,050
Plus:	Call option	70
	Interest rate swap	40
Less:	Recourse obligation	(60)
Net proceeds		$1,100

Gain on Sale	
Net proceeds	$1,100
Carrying amount of loans sold	1,000
Gain on sale	$ 100

Journal Entry		
Cash	1,050	
Interest rate swap	40	
Call option	70	
Loans		1,000
Recourse obligation		60
Gain on sale		100
To record transfer		

Illustration—Recording Transfers of Partial Interests

2. Company B sells a pro rata nine-tenths interest in loans with a fair value of $1,100 and a carrying amount of $1,000. There is no servicing asset or liability, because Company B estimates that the benefits of servicing are just adequate to compensate it for its servicing responsibilities.

Fair values	
Cash proceeds for nine-tenths sold	$990
One-tenth interest continued to be held by the transferor [($990 ÷9/10)×1/10]	110

Carrying Amount Based on Relative Fair Values

	Fair Value	Percentage of Total Fair Value	Allocated Carrying Amount
Nine-tenths interest sold	$990	90	$900
One-tenth interest continued to be held by the transferor	110	10	100
Total	$ 1,100	100	$1,000

Gain on Sale	
Net proceeds	$ 990
Carrying amount of loans sold	900
Gain on sale	$90

Journal Entry		
Cash	990	
Loans		900
Gain on sale		90
To record transfer		

Illustration—Sale of Receivables with Servicing Obtained

3. Company C originates $1,000 of loans that yield 10 percent interest income for their estimated lives of 9 years. Company C sells the $1,000 principal plus the right to receive interest income of 8 percent to another entity for $1,000. Company C will continue to service the loans, and the contract stipulates that its compensation for performing the servicing is the right to receive half of the interest income not sold. The remaining half of the interest income not sold is considered an interest-only strip receivable. At the date of the transfer, the fair value of the loans is $1,100. The fair values of the servicing asset and the interest-only strip receivable are $40 and $60, respectively.

Fair values	
Cash proceeds	$1,000
Servicing asset	40
Interest-only strip receivable	60

Net Proceeds		
Cash proceeds		$1,000
Servicing asset		40
	Net Proceeds	$1,040

Carrying Amount Based on Relative Fair Values

	Fair Value	Percentage of Total Fair Value	Allocated Carrying Amount
Loans sold	$ 1,040	94.55	$945.50
Interest-only strip receivable	60	5.4	54.50
Total	$ 1,100	100.0	$ 1,000.00

Gain on Sale

Net proceeds	$1,040
Carrying amount of loans sold	945
Gain on sale	$ 94.50

Journal Entries

Cash	1,000	
Interest-only strip receivable	54.50	
Servicing Asset	40	
Loans		1,000
Gain on sale		94.50

To record transfer and to recognize interest-only strip receivable and servicing asset

Interest-only strip receivable	5.50	
Equity		5.50

To begin to subsequently measure interest-only strip receivable like an available-for-sale security (FAS 140, paragraph 14 as revised by FAS 156)

Illustration—Recording Transfers of Partial Interests with Proceeds of Cash, Derivatives, Other Liabilities, and Servicing

4. Company D originates $1,000 of prepayable loans that yield 10 percent interest income for their 9-year expected lives. Company D sells nine-tenths of the principal plus interest of 8 percent to another entity. Company D will continue to service the loans, and the contract stipulates that its compensation for performing the servicing is the 2 percent of the interest income not sold. Company D obtains an option to purchase from the transferee loans similar to the loans sold (which are readily obtainable in the marketplace) and incurs a limited recourse obligation to repurchase delinquent loans. At the date of transfer, the fair value of the loans is $1,100.

Fair values	
Cash proceeds	$900
Call option	70
Recourse obligation	60
Servicing asset	90
One-tenth interest continued to be held by transferor	100

Net Proceeds	
Cash received	$900
Plus: Servicing Asset	90
Plus: Call option	70
Less: Recourse obligation	(60)
Net proceeds	$1,000

Carrying Amount Based on Relative Fair Values

	Fair Value	Percentage of Total Fair Value	Allocated Carrying Amount
Interest sold	$ 1,000	90.9	$ 909
One-tenth interest continued to be held by transferor	100	9.1	91
Total	$ 1,100	100	$ 1,000

Gain on Sale	
Net proceeds	$1,000
Less: Carrying amount of loans sold	(909)
Gain on sale	$ 91

Loans Sold	
Carrying Amount of Loans	$1,000
Less: Allocated carrying amount of interest that continues to be held by the transferor	(91)
Loans Sold	$ 909

Journal Entries		
Cash	900	
Call option	70	
Servicing Asset	90	
Loans		909
Recourse obligation		60
Gain on sale		91
To record transfer and to recognize servicing asset, call option and recourse obligation		

Illustration—Recording Transfers If It Is Not Practicable to Estimate a Fair Value

5. Company E sells loans with a carrying amount of $1,000 to another entity for cash proceeds of $1,050 plus a call option to purchase loans similar to the loans sold (which are readily obtainable in the marketplace) and incurs a limited recourse obligation to repurchase any delinquent loans. Company E undertakes an obligation to service the transferred assets for the other entity. In Case 1, Company E finds it impracticable to estimate the fair value of the servicing contract, although it is confident that servicing revenues will be more than adequate

compensation for performing the servicing. In Case 2, Company E finds it impracticable to estimate the fair value of the recourse obligation.

Fair Values	**Case 1**	**Case 2**
Cash proceeds	$1,050	$1,050
Servicing asset	XX*	40
Call option	70	70
Recourse obligation	60	XX*
Fair value of loans transferred	1,100	1,100

* Not practicable to estimate fair value

Net Proceeds	**Case 1**	**Case 2**
Cash received	$1,050	$1,050
Plus: Servicing Asset	XX*	40
Plus: Call option	70	70
Less: Recourse obligation	(60)	XX
Net proceeds	$1,060	$1,160

Gain on Sale	**Case 1**	**Case 2**
Cash received	$1,060	$1,060
Carrying Amount of Loans	1,000	1,000
Less: Recourse obligation	0	(160)
Gain on Sale	$ 60	$ 0

Journal Entries	**Case 1**		**Case 2**	
Cash	1,050		1,050	
Servicing asset	0*		40	
Call option	70		70	
Loans		1,000		1,000
Recourse obligation		60		160†
Gain on sale		60		0
To record transfer				

* Assets shall be recorded at zero if an estimate of the fair value of the assets is not practicable.

† The amount recorded as a liability in this example equals the sum of the known assets less the fair value of the known liabilities, that is, the amount that results in no gain or loss.

Illustration—Secured Borrowing

6. The following example illustrates the accounting for a securities lending transaction treated as a secured borrowing, in which the securities borrower sells the securities upon receipt and later buys similar securities to return to the securities lender:

Facts	
Transferor’s carrying amount and fair value of security loaned	$1,000
Cash “collateral”	1,020
Transferor’s return from investing cash collateral at a 5 percent annual rate	5
Transferor’s rebate to the securities borrower at a 4 percent annual rate	4

For simplicity, the fair value of the security is assumed not to change during the 35-day term of the transaction.

Journal Entries for the Transferor

At inception:

Cash	1,020	
Payable under securities loan agreements		1,020

To record the receipt of cash collateral

Securities pledged to creditors	1,000	
Securities		1,000

To reclassify loaned securities that the secured party has the right to sell or repledge

Money market instrument	1,020	
Cash		1,020

To record investment of cash collateral

At conclusion:

Cash	1,025	
Interest		5
Money market instrument		1,020

To record results of investment

Securities	1,000	
Securities pledged to creditors		1,000

To record return of security

Payable under securities loan agreements	1,020	
Interest ("rebate")	4	
Cash		1,024

To record repayment of cash collateral plus interest

Journal Entries for the Transferee

At inception:

Receivable under securities loan agreements	1,020	
Cash		1,020

To record transfer of cash collateral

Cash	1,000	
Obligation to return borrowed securities		1,000

To record sale of borrowed securities to a third party and the resulting obligation to return securities that it no longer holds

At conclusion:

Obligation to return borrowed securities	1,000	
Cash		1,000

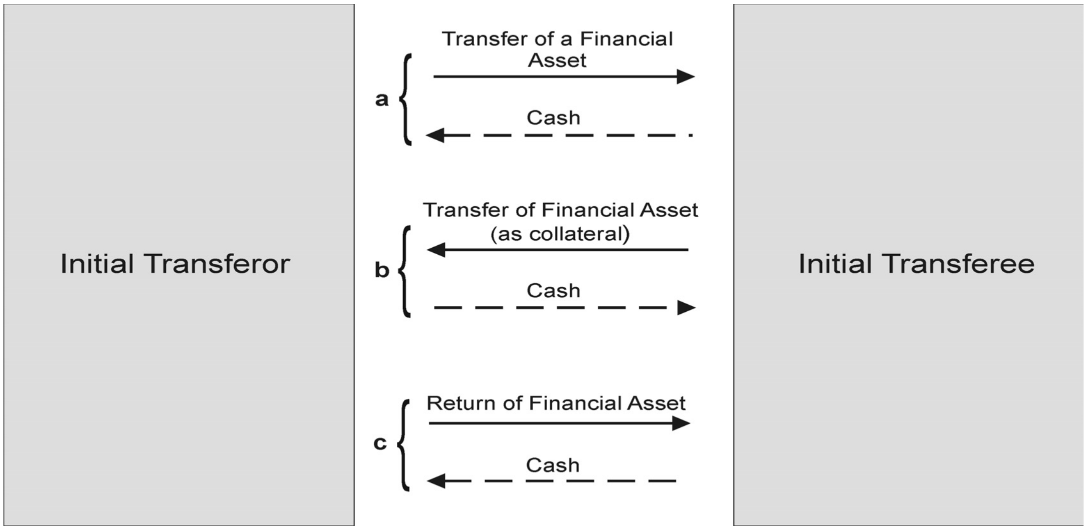
To record the repurchase of securities borrowed

Cash	1,024	
Receivable under securities loan agreements		1,020
Interest revenue ("rebate")		4

To record the receipt of cash collateral and rebate interest

Illustration—Initial Transfer and Repurchase Financing

7. The following diagram is an example of an initial transfer of a financial asset and a subsequent repurchase financing, as described in paragraphs ~~70~~ 73 and ~~71~~74, which should be analyzed using the provisions in paragraphs ~~72-~~75-78. The purpose of this example is to illustrate the characteristics of the transaction and to prevent an inappropriate analogy to other financing transactions that are outside the scope of this SSAP.


Initial Transferor
a
Transfer of a Financial Asset
Cash
b
Transfer of Financial Asset (as collateral)
Cash
c
Return of Financial Asset
Cash
Initial Transferee

Statutory Issue Paper No. 145

Accounting for Transferable and Non-Transferable State Tax Credits

STATUS
Finalized December 7, 2011

Original SSAP and Current Authoritative Guidance: SSAP No. 94R

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory guidance allows for transferable state tax credits to be admitted assets as long as they comply with the requirements of *SSAP No. 94—Accounting for Transferable State Tax Credits*. It has been identified that some states have requested to allow non-transferable tax credits to be admitted based on specific criteria.

2. Currently, generally accepted accounting principles do not provide separate guidance for transferable state tax credits; general guidance for income taxes is found in *FASB Accounting Standards Codification Topic 740, Income Taxes* which incorporated *FASB Statement No. 109, Accounting for Income Taxes* (FAS 109). *SSAP No. 101—Income Taxes, A Replacement of SSAP No. 10R and SSAP No. 10* (SSAP No. 101) notes the adoption of FAS 109 with modifications for state income taxes, the realization criteria for deferred tax assets, and the recording of the impact of changes in its deferred tax balances. The Office of the Comptroller of the Currency in Interpretive Letter #948 dated December 2002 concluded that "purchasing, holding and subsequently reselling **transferable** state tax credits are permissible activities for national banks" (bolding added for emphasis).

3. The purpose of this issue paper is to amend SSAP No. 94 to expand the admittance criteria to include non-transferable state tax credits that meet specific criteria.

SUMMARY CONCLUSION

4. This issue paper amends guidance included in SSAP No. 94 by 1) substantively revising the title; 2) incorporating the criteria for non-transferable state tax credits as described in paragraphs 7 and 8; 3) adding a disclosure; and 4) updating terminology throughout the document as appropriate.

5. The primary proposed revisions to the guidance allowing admission for non-transferable state tax credits are tracked below. Illustration of the substantively revised SSAP No. 94 (reflected as SSAP No. 94R) is reflected in Illustration A.

> 4. The criteria in paragraphs 5 and 6 are for transferable state tax credits (i.e. credits which may be sold or assigned). The criteria in paragraphs 7 and 8 are for non-transferable state tax credits (i.e., those which cannot be sold or assigned to other parties).
>
> **Transferable State Tax Credits**
>
> 45. Some states have enacted laws that create programs by which transferable state tax credits are granted to entities under certain specified conditions (e.g., an entity makes an investment in a particular industry). The terms of these state tax credits vary from state to state and, within a state, from program to program. However, many of these transferable state tax credit programs share the following four characteristics:

a. The tax credit is nonrefundable;

b. The holder of the transferable state tax credit may sell or otherwise transfer a transferable state tax credit to another entity, which can likewise resell or transfer the credit;

c. The transferable state tax credit will expire if not used by a predetermined date; and

d. The transferable state tax credit can be applied against either state income tax or state premium tax.

~~5~~6. For purposes of this statement, such programs will be referred to as "transferable state tax credits." The criteria in subparagraphs ~~4~~5.b., ~~4~~5.c. and ~~4~~5.d. must be present in order for the transferable state tax credit to receive the accounting treatment described in this statement. When a reporting entity purchases a transferable state tax credit from another entity, the transaction does not result in a continuing investment in a business entity (i.e. limited partnership).

Non-transferable State Tax Credits

7. If the original or subsequent holder of the transferable tax credit is not able to transfer the tax credit, then the admissibility criteria in paragraph 8 for non-transferable tax credits apply. These non-transferable state tax credits share the following characteristics:

a. The tax credit is nonrefundable;

b. The successive holder of a state tax credit must redeem the credit, by April 15 of the subsequent year to the entity's acquisition of the state tax credit and is not permitted to carry-over, carry-back, obtain a refund, sell or assign the credit.

c. The non-transferable state tax credit will expire if not used by the predetermined date; and

d. The non-transferable state tax credit can be applied against either state income tax or state premium tax.

8. The criteria in subparagraphs 7.b., 7.c. and 7.d. must be present in order for the non-transferable state tax credit to receive the accounting treatment described in this statement.

~~68~~9. Transferable and non-transferable state tax credits as defined within this SSAP held by reporting entities ~~will~~ meet the definition of assets as specified in *SSAP No. 4—Assets and Nonadmitted Assets* and ~~will be~~are admissible assets to the extent that they comply with the requirements of this statement. If the criteria in paragraphs 6 or 8 are not met, the tax credits are nonadmitted.

DISCUSSION

6. This issue paper amends SSAP No. 94 to expand the admittance criteria to include non-transferable state tax credits that meet specific provisions. Although the transferability of state tax credits was previously identified as a characteristic needed for admittance within statutory accounting, it has been identified that specific state laws regarding the use of state tax credits by April 15th of the subsequent year provide conservative treatment that also warrants admittance within statutory financial statements. The original request included the phrase "required by the applicable states' laws." It was felt that this did not achieve the statutory accounting goals of consistency and comparability. It was replaced with the phrase "specific criteria." This issue paper also expands the disclosures required by identifying transferable and non-transferable state tax credits, and the admitted and nonadmitted portions of each classification.

History of SSAP No. 94 Guidance

7. As detailed in *Issue Paper No. 126—Accounting for Transferable State Tax Credits*, SSAP No. 94 was established as a result of consideration from an interested parties' request in 2003. Interested parties proposed that state tax credits (1) should qualify as an admitted asset to the extent it is probable they will be realized, consistent with the treatment in SSAP No. 35 of credits granted directly to the reporting entity; (2) should not be netted against the tax liability consistent with the treatment in SSAP No. 35 of credits granted directly to the reporting entity; and (3) any gain that accrues to the reporting entity through the use of these tax credits should be reported as miscellaneous income at the time the credits are used. To accomplish this, interested parties' proposed nonsubstantive changes to SSAP No. 35.

8. In considering the interested parties' 2002 proposal, the Statutory Accounting Principles Working Group considered the December 2002, Office of the Comptroller of the Currency (the regulatory body for national banks) Interpretive Letter #948, which indicated that "purchasing, holding, and subsequently reselling transferable state tax credits is a permissible activity for national banks". In its ruling, the OCC stated that "transferable state tax credits … offset a tax liability, dollar-for-dollar, and are therefore the functional equivalent of money." The Working Group noted that this interpretive letter focused attention on Missouri's transferable state tax credit programs, but that the characterizations that "the purchase and transfer of … state tax credits is a noncomplex and fairly rapid process" and that "demand for these tax credits typically exceeds supply during tax season" are likely to apply more generally to other states' programs.

9. Although the interested parties had recommended a nonsubstantive change to *SSAP No. 35—Guaranty Fund and Other Assessments,* the Working Group concluded that this placement was not consistent with the scope paragraphs in SSAP No. 35, as that SSAP includes assessments or mechanisms to fund insolvent reporting entities. Since transferable state tax credits are not assessments or mechanisms to fund insolvent reporting entities, the Working Group concluded that transferable state tax credits do not seem to have been contemplated when SSAP No. 35 was developed and that interested parties' proposed revisions did not meet the criteria for a nonsubstantive change. The Working Group moved this item to the substantive active list with an issue paper to be developed, with guidance from the Working Group, particularly as to the admissibility and possible limitations on the admissibility of the transferable state tax credits. In considering this issue, the following was included in the agenda item:

> If statutory accounting guidance is developed, it may be appropriate to address transferable state tax credits as an admitted asset. They seem to be marketable and can generate economic benefits to the reporting entity, even if they are not immediately available to pay policyholder obligations. **However, the transferable state tax credits represent a prepayment of premium taxes, statutory accounting usually nonadmits prepaid expenses, as they are not readily available to pay policyholder obligations. The difference between these transferable state tax credits and other prepaid expenses is the ability to sell the state tax credits. This ability to sell the transferable state tax credits** is what helps it to meet the other *SSAP No. 4—Assets and Nonadmitted Assets* criteria of an asset.

10. Paragraph 19 of Issue Paper No. 126 identifies the transferability of a state tax credit as a major factor in allowing admittance:

> 19. This issue paper provides new statutory accounting guidance for a type of investment, which is not currently addressed in the *Accounting Practices and Procedures Manual*. Therefore, in accordance with SSAP No. 4, they default to a nonadmitted asset. In evaluating transferable state tax credits, several points were considered. **The transferable characteristics of these state tax credits are a major factor in developing statutory accounting guidance, which would admit investments in transferable state tax credits that comply with the guidance.**

Consideration of Non-Transferable State Tax Credits:

11. As identified in Issue Paper No. 126, even though transferable state tax credits represent a prepayment of premium taxes which would be nonadmitted, they were deemed to be admitted based on the fact that they can be sold. The proposed revision would be a distinct change in the admissibility guidance currently reflected within SSAP No. 94 as non-transferable state tax credits would be allowed to be admitted.

12. One of the reasons that transferability was a key issue in developing SSAP No. 94 was due to variations among states regarding the terms and limitations on the use of state tax credits. By requiring transferability, these various terms and limitations (e.g., limitations in the amount of tax credits that could be used in a tax year) were concluded not to be as relevant since the tax credits could be subsequently sold.

13. The following reasons were noted for the working group's support of the admittance of non-transferable state tax credits if the specific criteria illustrated in paragraph 6 of Issue Paper No. 126 is met:

a. This proposal is presented as a good public policy issue and economic development, allowing companies domiciled within states with laws that require usage of tax credits within a designated timeframe and that limit transferability to also be allowed to reflect state tax credits as admitted assets.

b. The short-term usage requirement identified within the proposal is a conservative requirement. It was noted that there is no confirmation on a market for state tax credits, so just because they are transferable, does not mean that they could actually be subsequently sold. By requiring usage within a specific time frame, these assets will be reflected within a reporting entity's financials for a short period of time. It was noted that "transferable" state tax credits could be reflected for an extensive period of time until the tax credit expires or an impairment has been identified.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

14. As noted above, existing guidance for transferable state tax credits is in SSAP No. 94. Tracked changes to SSAP No. 94 are shown in Illustration A.

RELEVANT LITERATURE:

Statutory Accounting

- *Issue Paper No. 126—Accounting for Transferable State Tax Credits*

Generally Accepted Accounting Principles

- *FASB Statement No. 109, Accounting for Income Taxes* was adopted with modification in *SSAP No. 101—Income Taxes, A Replacement of SSAP No. 10R and SSAP No. 10* (SSAP No. 101).

State Regulations:

State laws may prescribe specific criteria regarding the use of state tax credits. The revisions proposed in this issue paper are intended to allow admittance for state laws that require use of a state tax credit before April 15 of the year subsequent in which the purchase or assignment of a state tax credit is made, and that prohibit subsequent transfer of the state tax credit.

ILLUSTRATION A

Statements of Statutory Accounting Principles No. 94 - Revised

Accounting for Transferable and Non-Transferable State Tax Credits

STATUS

Type of Issue:	Common Area
Issued:	June 12, 2006; Substantively revised December 7, 2011
Effective Date:	December 31, 2006; Substantive revisions detailed in Issue Paper No. 145 are effective December 31, 2011
Affects:	No other pronouncements
Affected by:	No other pronouncements
Interpreted by:	No other pronouncements

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for transferable and non-transferable state tax credits that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

2. Investments in Low Income Housing Tax Credits as discussed in *SSAP No. 93—Accounting for Low Income Housing Tax Credit Property Investments*, which involve an investment by a reporting entity in a limited liability company or similar entity that earns tax credits as a consequence of its operating activities involving low income housing developments and passes those tax credits to its investors, are not within the scope of this statement.

3. Investments in a CAPCO (Certified Capital Company), organized as a partnership or an LLC, which is a company, authorized by state statute that borrows from investors (insurance companies), in order to make venture capital investments in "qualified" businesses, are not within the scope of this statement. Although associated with tax credits, the insurance company is paid principal and interest on its investment with the CAPCO. Depending upon the terms of the CAPCO offering, principal and interest payments to the insurance company will come from the CAPCO and/or the state. The CAPCO will make cash payments directly to the insurance company while the state will make payments in the form of premium or income tax credits.

SUMMARY CONCLUSION

4. The criteria in paragraphs 5 and 6 are for transferable state tax credits (i.e., credits which may be sold or assigned). The criteria in paragraphs 7 and 8 are for non-transferable state tax credits (i.e., those which cannot be sold or assigned to other parties).

45. Some states have enacted laws that create programs by which transferable state tax credits are granted to entities under certain specified conditions (e.g., an entity makes an investment in a particular industry). The terms of these state tax credits vary from state to state and, within a state, from program to program. However, many of these transferable state tax credit programs share the following four characteristics:

a. The tax credit is nonrefundable;

b. The holder of the transferable state tax credit may sell or otherwise transfer the transferable state tax credit to another entity, which can likewise resell or transfer the credit;

c. The transferable state tax credit will expire if not used by a predetermined date; and

d. The transferable state tax credit can be applied against either state income tax or state premium tax.

~~5~~6. For purposes of this statement, such programs will be referred to as "transferable state tax credits." The criteria in subparagraphs ~~4~~5.b., ~~4~~5.c. and ~~4~~5.d. must be present in order for the transferable state tax credit to receive the accounting treatment described in this statement. When a reporting entity purchases a transferable state tax credit from another entity, the transaction does not result in a continuing investment in a business entity (i.e. limited partnership).

Non-Transferable State Tax Credits

7. If the original or subsequent holder of the transferable tax credit is not able to transfer the tax credit, then the admissibility criteria in paragraph 8 for non-transferable tax credits apply. These non-transferable state tax credits share the following characteristics:

a. The tax credit is nonrefundable;

b. The successive holder of a state tax credit must redeem the credit by April 15 of the subsequent year to the entity's acquisition of the state tax credit and is not permitted to carry-over, carry-back, obtain a refund, sell or assign the credit;

c. The non-transferable state tax credit will expire if not used by the predetermined date; and

d. The non-transferable state tax credit can be applied against either state income tax or state premium tax.

8. The criteria in subparagraphs 7.b., 7.c. and 7.d. must be present in order for the non-transferable state tax credit to receive the accounting treatment described in this statement.

~~6~~9. Transferable and non-transferable state tax credits as defined within this SSAP held by reporting entities ~~will~~ meet the definition of assets as specified in *SSAP No. 4—Assets and Nonadmitted Assets* and ~~will be~~are admissible assets to the extent that they comply with the requirements of this statement. If the criteria in paragraphs 6 or 8 are not met, the tax credits are nonadmitted.

Acquisition

~~7~~10. Transferable and non-transferable state tax credits are recorded at cost at the date of acquisition.

Balance Sheet Treatment

~~8~~11. Transferable and non-transferable state tax credits expected to be realized are initially recorded at cost.

~~9~~12. Transferable and non-transferable state tax credits shall be established gross of any related state tax liabilities and reported in the category of other-than-invested assets (not reported net).

~~10~~13. As transferable and non-transferable state tax credits are redeemed, the carrying value of the tax credits is reduced dollar for dollar by the amount of ~~transferable~~ state tax credits applied toward the reporting entity's applicable state tax liability.

Income Statement Treatment

~~11~~14. Gains on transferable and non-transferable state tax credits are deferred until the value of the ~~transferable~~ state tax credits utilized exceeds the cost of the ~~transferable~~ state tax credits or until the ~~transferable~~ state tax credits are sold to other entities and the payment received is greater than the book value.

~~12~~15. Losses on transferable and non-transferable state tax credits are recognized when known.

~~13~~16. Gains and losses on transferable and non-transferable state tax credits are reflected in other income.

Impairment

~~14~~17. An impairment shall be considered to have occurred if it is probable that the reporting entity will be unable to recover the carrying amount of the transferable or non-transferable state tax credits. ~~Transferable s~~State tax credits should be evaluated for impairment at each reporting date.

~~15~~18. When there is a decline in the realizability of a transferable or non-transferable state tax credit owned by the reporting entity that is other than temporary, the asset shall be written down to the expected realizable amount and the amount of the write down shall be accounted for as a realized loss. The expected realizable value is the new cost basis.

~~16~~19. The new cost basis shall not be changed for subsequent recoveries in realizability.

Disclosures

~~17~~20. The following disclosures shall be made in the financial statements. For purposes of this disclosure, total unused transferable and non-transferable state tax credits represent the entire transferable and non-transferable state tax credits available:

a. Carrying value of transferable and non-transferable state tax credits gross of any related state tax liabilities by state and in total,

b. Total unused transferable and non-transferable state tax credits by state;

c. Method of estimating utilization of remaining transferable and non-transferable state tax credits or other projected recovery of the current carrying value.

d. Impairment amount recognized in the reporting period, if any.

e. Identify state tax credits by transferable and non-transferable classifications, and identify the admitted and nonadmitted portions of each classification.

Effective Date and Transition

~~18~~21. This statement is effective for reporting periods ending on or after December 31, 2006. Early adoption is permitted. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with SSAP No. 3. Substantive revisions to 1) revising the title; 2) incorporating the criteria for non-transferable state tax credits as described in paragraphs 7 and 8;

3) adding a disclosure; and 4) updating terminology throughout the document as appropriate, are effective for reporting periods ending on or after December 31, 2011.

AUTHORITATIVE LITERATURE

Generally Accepted Accounting Principles

- *FASB Statement No. 109, Accounting for Income Taxes was adopted with modification in SSAP No. 101—Income Taxes, A Replacement of SSAP No. 10R and SSAP No. 10 (SSAP No. 101)~~SSAP No. 10R—Income Taxes - A Temporary Replacement of SSAP No. 10~~.*

RELEVANT ISSUE PAPERS

- *Issue Paper No. 126—Accounting for Transferable State Tax Credits*
- *Issue Paper No. 145—Accounting for Transferable and Non-Transferable State Tax Credits*

Appendix A – Accounting for Transferable State Tax Credits

On 1/1/X1 SAM Insurance Company purchased transferable state tax credits for a cost of $100,000. The transferable state tax credits are redeemable for $160,000 and expire at the end of 12/31/X4. SAM initially expects to utilize the tax credits before expiration in their state of domicile in the amount of $40,000 per year. In year X4, SAM sells the remaining $30,000 in transferable state tax credits for $20,000.

1/1/x1	Transferable state tax credits	100,000	
	Cash		100,000
	To record the purchase of the tax credits		
6/30/x1	Premium tax expense	40,000	
	Premium taxes payable to domiciliary state		40,000
	To record premium tax expense and accrue the liability in Year 1.		
10/1/x1	Premium tax payable	40,000	
	Transferable state tax credits		40,000
	To record the use of tax credits in Year 1. The reporting entity expects to be able to utilize remaining tax credits before expiration.		
6/30/x2	Premium tax expense	60,000	
	Premium taxes payable to domiciliary state		60,000
	To record premium tax expense and accrue the liability in Year 2.		
9/30/x2	Premium tax payable	60,000	
	Transferable state tax credits		60,000
	To record the use of taxes credits in Year 2. The reporting entity expects to be able to utilize remaining tax credits before expiration.		
6/30/x3	Premium tax expense	30,000	
	Premium taxes payable to domiciliary state		30,000
	To record premium tax expense and accrue the liability in Year 3.		
9/30/x3	Premium tax payable	30,000	
	Other income		30,000
	To record the use of premium tax credits in excess of cost and recognize a gain on premium tax credits in other income. The Company intends to sell the remaining tax credits in year 4.		
6/30/x4	Cash	20,000	
	Other income		20,000
	To record the sale of the remaining tax credits.		

Appendix B – Accounting for Non-Transferable State Tax Credits

On 7/1/X1 LJW Insurance Company purchased non-transferable state tax credits for a cost of $100,000. The state tax credits are redeemable for $110,000, are not transferable and expire on, April 15, 20x2. LJW expects to utilize the tax credits before expiration in their state of domicile in the amount of $110,000.

7/1/x1	State tax credits	100,000	
	Cash		100,000
	To record the purchase of the tax credits		
9/30/x1	Premium tax expense	200,000	
	Premium taxes payable to domiciliary state		200,000
	To record premium tax expense and accrue the liability.		
3/15/x2	Premium tax payable	110,000	
	Other Income		10,000
	State tax credits		100,000
	To record the use of premium tax credits in excess of cost and recognize a gain on premium tax credits in other income. (The additional $90,000 of premium taxes payable would still be due.)		

Issue Paper No. 146

Share-Based Payments With Non-Employees

STATUS
Adopted November 12, 2013

Original SSAP and Current Authoritative Guidance: SSAP No. 104R

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. *SSAP No. 104—Share-Based Payments* provides statutory accounting principles for transactions in which an entity exchanges its equity instruments with employees in share-based payment transactions. SSAP No. 104 (effective Jan. 1. 2013), adopts with modification GAAP guidance for stock options and stock purchase plans within GAAP *Accounting Standards Codification Topic 718: Compensation – Stock Compensation, as amended by ASU 2010-13.* SSAP No. 104 does not currently provide guidance for share-based payment transactions with non-employees.

2. This issue paper provides substantive revisions to adopt, with modification, GAAP *Accounting Standards Codification Topic 505-50, Equity, Equity Payments to Non-Employees* within SSAP No. 104, resulting in a substantively revised SSAP No. 104 (SSAP No. 104R).

3. ASC 505-50 addresses the accounting and reporting for both the issuer (that is the purchaser or grantor) and recipient (that is, the goods or service provider or grantee) for a subset of share-based payment transactions depending on whether the grantee meets the definition of an employee. The guidance in ASC 505-50 addresses transactions in which the grantee receives shares of stock, stock options or other equity instruments in settlement of the entire transaction or, if the transaction is part cash and part equity instruments, in settlement of the portion of the transaction for which the equity instruments constitute the consideration.

4. The adoption, with modification, of ASC 505-50 within this Issue Paper will reflect adoption with modification of the following pre-codification GAAP standards, revising previous statutory accounting conclusions regarding these standards:

a. *EITF 96-18, Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services:* EITF 96-18 is currently listed as rejected as not applicable in *INT 99-00: Compilation of Rejected EITFs*. Under the guidance in this issue paper, and the adoption of a substantively revised SSAP to adopt with modification ASC 505-50, the GAAP Cross-Reference to SAP (Appendix D) will be revised to identify that EITF 96-18 is adopted with modification in SSAP No. 104R.

b. *EITF 00-08, Accounting by a Grantee for an Equity Instrument to Be Received in Conjunction with Providing Goods or Services:* EITF 00-08 is currently adopted with modification in INT 00-32. Under the guidance in this issue paper, and the adoption of a substantively revised SSAP to adopt with modification ASC 505-50, the GAAP Cross-Reference to SAP (Appendix D) will be revised to identify that EITF 00-08 is adopted with modification in SSAP No.104R, and INT 00-32 will be nullified.

c. *EITF 00-18, Accounting Recognition for Certain Transactions Involving Equity Instruments Granted to Other Than Employees*: EITF 00-18 is currently pending statutory review. Under the guidance in this issue paper, and the adoption of a substantively revised SSAP to adopt with modification ASC 505-50, the GAAP Cross-Reference to SAP (Appendix D) will be revised to identify that EITF 00-18 is adopted with modification in SSAP No.104R.

SUMMARY CONCLUSION

5. This issue paper provides statutory accounting principles for transactions in which an entity exchanges its equity instruments to non-employees in share-based payment transactions. It incorporates the GAAP objective for these transactions, requiring recognition in the financial statements of the most reliably measurable fair values of such transactions. Furthermore, it indicates that the accounting for these share-based payment transactions shall reflect the rights conveyed to the holder of the instruments and the obligations imposed on the issuer of the instruments, regardless of how the transactions are structured.

6. The adoption, with modification, of ASC 505-50 will be reflected in a substantively revised SSAP No. 104R. The tracked changes to reflect this guidance are in Illustration A.

DISCUSSION

7. Per information received from industry representatives, share-based payments with non-employees are conducted by insurers, and consideration of related GAAP guidance should occur, with expansion of SSAP No. 104 for these transactions.

8. Similar to the conclusions reached in *Issue Paper No. 129, Share-Based Payment, A Replacement of SSAP No. 13—Stock Options and Stock Purchase Plans*, which are adopted in SSAP No. 104, the statutory accounting revisions predominantly adopt GAAP guidance for share-based payments with limited modifications to reflect existing statutory accounting concepts. As such, this issue paper adopts the GAAP guidance in ASC 505-50 with modifications as follows:

a. To reduce variations from the GAAP guidance, this issue paper does not restrict a reporting entity from recognizing a prepaid asset to reflect the cost for the exchange of share-based payment before the receipt of goods or services. However, consistent with statutory accounting principles in *SSAP No. 29—Prepaid Expenses*, these assets are nonadmitted as they are not readily available to satisfy policyholder obligations.

b. Pursuant to the statutory accounting concept of consistency, this issue paper clarifies that the minimum value method is not an acceptable method for determining the fair value of non-employee awards for all (public/non-public) entities.

c. Consistent with guidance in *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets* for recognition of loss contingency estimates, the recognition of expected costs based on different possible outcomes, the amount recognized should reflect management's best estimate. If an amount within a range of possible outcomes cannot be deemed a better estimate, the midpoint of the range shall be recognized. This is different from the GAAP guidance that allows recognition of the lowest aggregate amount within a range.

d. GAAP references are revised to reflect applicable statutory accounting guidance.

EFFECTIVE DATE

9. Upon adoption of this issue paper, the NAIC will release a Statement of Statutory Accounting Principles (SSAP) for comment. The SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the Accounting Practices and Procedures Manual should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions

reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will contain an effective date of reporting periods beginning on or after January 1, 2014, with early adoption permitted.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

- *SSAP No. 104—Share-Based Payments*

Generally Accepted Accounting Principles

- *Accounting Standards Codification Topic 505-50, Equity, Equity Payments to Non-Employees*

The GAAP guidance in the ASC 505-50 has not been duplicated within this issue paper. This is similar to the process reflected in Issue Paper No. 129—Share-Based Payments, A Replacement of SSAP No. 13—Stock Options and Stock Purchase Plans (Issue Paper No. 129) as the GAAP guidance reflected the bulk of the proposed statutory guidance. (A similar process was also followed for Issue Paper No. 132—Accounting for Pensions, A Replacement of SSAP No. 89, Issue Paper No. 133—Accounting for Postretirement Benefits Other Than Pensions, A Replacement of SSAP No. 14, and Issue Paper No. 134—Servicing Assets/Liabilities, An Amendment of SSAP No. 91.) The tracked changes to reflect ASC 505-50 in SSAP No. 104R are shown in illustration A.

ILLUSTRATION A – SSAP NO. 104 - REVISED

SCOPE OF STATEMENT

1. This statement provides statutory accounting principles for transactions in which an entity exchanges its equity instruments to employees and non-employees in share-based payment transactions. This statement does not provide statutory accounting principles for employee share ownership plans;~~,~~ those transactions are addressed in *SSAP No. 12—Employee Stock Ownership Plans*.

SUMMARY OF ISSUE

2. The objective of accounting for transactions under share-based payment arrangements with employees is to recognize in the financial statements the employee services received in exchange for equity instruments issued or liabilities incurred and the related cost to the entity as those services are consumed. The objective of accounting for share-based payment transactions with non-employees is to recognize in the financial statements the most reliably measurable fair values of such transactions. This statement uses the terms compensation and payment in their broadest senses to refer to the consideration paid for employee services and goods and services regardless of whether the supplier is an employee.

3. The accounting for all share-based payment transactions shall reflect the rights conveyed to the holder of the instruments and the obligations imposed on the issuer of the instruments, regardless of how those transactions are structured. This statement requires that the cost resulting from all share-based payment transactions be recognized in the financial statements. This statement establishes fair value as the measurement objective in accounting for share-based payment arrangements and requires all entities to apply a fair-value-based measurement method[1] in accounting for share-based payment transactions with employees except for equity instruments held by employee stock ownership plans.

Scope and Scope Exceptions

4. Employees - This statement applies to all share-based payment transactions in which an entity acquires employee services by issuing (or offering to issue) its shares, share options, or other equity instruments or by incurring liabilities to an employee that meet either of the following conditions:

   a. The amounts are based, at least in part[2], on the price of the entity's shares or other equity instruments. ~~(The phrase "at least in part" is used because an award of share-based compensation may be indexed to both the price of an entity's shares and something else that is neither the price of the entity's shares nor a market, performance, or service condition.)~~

   b. The awards require or may require settlement by issuing the entity's equity shares or other equity instruments.

[1] Accounting pronouncements that require fair value measurements but that are excluded from *SSAP No. 100—Fair Value Measurements* is limited to this statement addressing share-based payment transactions. The fair value measurement objective in this statement is generally consistent with the fair value measurement objective in SSAP No. 100. However, for certain share-based payment transactions with employees, the measurements at the grant date are fair-value-based measurements, not fair value measurements. Although some measurements in this statement are fair value measurements, for practical reasons this statement is excluded in its entirety from SSAP No. 100. To be consistent with GAAP guidance on share-based payment transactions, the definition of fair value for use in this statement is: "the amount at which the asset (or liability) could be bought (or incurred) or sold (settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale." Observable market prices of identical or similar equity or liability instruments in active markets are the best estimate of fair value and, if available, should be used as the basis for the measurement of equity and liability instruments awarded in a share-based payment transaction with employees.

[2] The phrase "at least in part" is used because an award of share-based compensation may be indexed to both the price of an entity's shares and something else that is neither the price of the entity's shares nor a market, performance, or service condition.

5. Share-based payments awarded to an employee of the reporting entity by a related party or other holder of an economic interest in the entity as compensation for services provided to the entity are share-based payment transactions to be accounted for under this statement unless the transfer is clearly for a purpose other than compensation for services to the reporting entity. The substance of such a transaction is that the economic interest holder makes a capital contribution to the reporting entity, and that entity makes a share-based payment to its employee in exchange for services rendered. An example of a situation in which such a transfer is not compensation is a transfer to settle an obligation of the economic interest holder to the employee that is unrelated to employment by the entity.

6. ~~The guidance in this statement does not apply to share-based transactions for other than employee services.~~ Non-Employees - This statement applies to all share-based payment transactions in which an entity acquires goods or services by issuing (or offering to issue) its shares, share-options, or other equity instruments or by incurring liabilities to a goods or service provider that is not an employee in amounts based, at least in part[3], on the price of the entity's shares or other equity instruments or that require or may require settlement by issuing the entity's equity shares or other equity instrument.

7. The guidance in this statement does not apply to equity instruments held by an employee stock ownership plan. Such equity instruments shall follow the guidance in *SSAP No. 12—Employee Stock Ownership Plans* (SSAP No. 12). The guidance in this statement does not apply to transactions involving equity instruments either issued to a lender or investor that provides financing to the issuer or issued in a business combination.

8. The guidance for share-based payments to employees is contained in paragraphs 9-114, and the guidance for share-based payments to non-employees is contained in paragraphs 115-142. The guidance for employees is further ~~in this statement is~~ divided as follows:

a. Compensatory Share-Based Payment Plans: Paragraphs 9-104.

b. Noncompensatory Share-Based Payment Plans: Paragraphs 105-111.

c. Consolidated/Holding Company Share-Based Payment Plans: Paragraphs 112-114.

Employee Share-Based Payments - Compensatory ~~Share-Based Payment Plans~~

~~RECOGNITION~~

Recognition Principle for Share-Based Payment Transactions

9. Stock purchase and stock option plans that do not meet the criteria of a non-compensatory plan (paragraphs 105-111) and are not otherwise excluded from the scope of this statement shall be classified as compensatory and follow the recognition, measurement and disclosure guidance in paragraphs 10-104.

10. An entity shall recognize the services received in a share-based payment transaction with an employee as services are received. Employee services themselves are not recognized before they are received. The entity shall recognize either a corresponding increase in equity or a liability, depending on whether the instruments granted satisfy the equity or liability classification criteria (see paragraphs 14-27). As the services are consumed, the entity shall recognize the related cost.

11. The accounting for all share-based payment transactions shall reflect the rights conveyed to the holder of the instruments and the obligations imposed on the issuer of the instruments, regardless of how those transactions are structured. For example, the rights and obligations embodied in a transfer of equity shares to an employee for a note that provides no recourse to other assets of the employee (that is, other

[3] See Footnote 2

than the shares) are substantially the same as those embodied in a grant of equity share options. Thus, that transaction shall be accounted for as a substantive grant of equity share options.

12. Assessment of both the rights and obligations in a share-based payment award and any related arrangement and how those rights and obligations affect the fair value of an award requires the exercise of judgment in considering the relevant facts and circumstances.

Determining the Grant Date

13. As a practical accommodation, in determining the grant date of an award subject to this statement, assuming all other criteria in the grant date definition have been met, a mutual understanding of the key terms and conditions of an award to an individual employee shall be presumed to exist at the date the award is approved in accordance with the relevant corporate governance requirements (that is, by the Board or management with the relevant authority) if both of the following conditions are met:

a. The award is a unilateral grant and, therefore, the recipient does not have the ability to negotiate the key terms and conditions of the award with the employer.

b. The key terms and conditions of the award are expected to be communicated to an individual recipient within a relatively short time period from the date of approval. A relatively short time period is that period in which an entity could reasonably complete all actions necessary to communicate the awards to the recipients in accordance with the entity's customary human resource practices.

Determining Whether to Classify a Financial Instrument as a Liability or As Equity

14. ~~This p~~Paragraphs 14~~,through paragrap~~-27, provide~~s~~ guidance for determining whether certain financial instruments awarded in share-based payment transactions are liabilities. In determining whether an instrument not specifically discussed in those paragraphs shall be classified as a liability or as equity, an entity shall apply statutory accounting principles applicable to financial instruments issued in transactions not involving share-based payment.

15. Unless paragraphs 16-27 require otherwise, an entity shall apply the classification criteria in Appendix A, as they are effective at the reporting date, in determining whether to classify as a liability a freestanding financial instrument given to an employee in a share-based payment transaction. Paragraphs 64-68 provide criteria for determining when instruments subject to this statement subsequently become subject to other applicable statutory accounting principles.

16. In determining the classification of an instrument, an entity shall take into account the classification requirements that are effective for that specific entity at the reporting date as established by Appendix A. In addition, a call option written on an instrument that is not classified as a liability under those classification requirements also shall be classified as equity so long as those equity classification requirements for the entity continue to be met, unless liability classification is required under the provisions of paragraphs 19 and 20.

17. Appendix A does not apply to outstanding shares embodying a conditional obligation to transfer assets, for example, shares that give the employee the right to require the employer to repurchase them for cash equal to their fair value (puttable shares). A put right may be granted to the employee in a transaction that is related to a share-based compensation arrangement. If exercise of such a put right would require the entity to repurchase shares issued under the share-based compensation arrangement, the shares shall be accounted for as puttable shares. A puttable (or callable) share awarded to an employee as compensation shall be classified as a liability if either of the following conditions is met:

a. The repurchase feature permits the employee to avoid bearing the risks and rewards normally associated with equity share ownership for a reasonable period of time from the date the requisite service is rendered and the share is issued. An employee begins to bear the risks and rewards normally associated with equity share ownership when all the requisite service has been rendered. A repurchase feature that can be exercised only upon the occurrence of a contingent event that is outside the employee's control (such as an initial public offering) would not meet this condition until it becomes probable that the event will occur within the reasonable period of time.

b. It is probable that the employer would prevent the employee from bearing those risks and rewards for a reasonable period of time from the date the share is issued.

For this purpose, a period of six months or more is a reasonable period of time.

18. A puttable (or callable) share that does not meet either of those conditions shall be classified as equity.

19. Options or similar instruments on shares shall be classified as liabilities if either of the following conditions is met:

a. The underlying shares are classified as liabilities.

b. The entity can be required under any circumstances to settle the option or similar instrument by transferring cash or other assets. A cash settlement feature that can be exercised only upon the occurrence of a contingent event that is outside the employee's control (such as an initial public offering) would not meet this condition until it becomes probable that event will occur.

20. For example, a reporting entity that is a Securities and Exchange Commission (SEC) registrant may grant an option to an employee that, upon exercise, would be settled by issuing a mandatorily redeemable share. Because the mandatorily redeemable share would be classified as a liability under Appendix A (as well as under *SSAP No. 72—Surplus and Quasi-Reorganizations*), the option also would be classified as a liability.

21. An award may be indexed to a factor in addition to the entity's share price. If that additional factor is not a market, performance, or service condition, the award shall be classified as a liability for purposes of this statement, and the additional factor shall be reflected in estimating the fair value of the award.

22. For this purpose, an award of equity share options granted to an employee of an entity's foreign operation that provides for a fixed exercise price denominated either in the foreign operation's functional currency or in the currency in which the employee's pay is denominated shall not be considered to contain a condition that is not a market, performance, or service condition. Therefore, such an award is not required to be classified as a liability if it otherwise qualifies as equity. For example, equity share options with an exercise price denominated in euros granted to employees of a U.S. entity's foreign operation whose functional currency is the euro are not required to be classified as liabilities if those options otherwise qualify as equity. In addition, such options are not required to be classified as liabilities even if the functional currency of the foreign operation is the U.S. dollar, provided that the employees to whom the options are granted are paid in euros.

23. The accounting for an award of a share-based payment shall reflect the substantive terms of the award and any related arrangement. Generally, the written terms provide the best evidence of the substantive terms of an award. However, an entity's past practice may indicate that the substantive terms of an award differ from its written terms. For example, an entity that grants a tandem award under which an employee receives either a stock option or a cash-settled stock appreciation right is obligated to pay

cash on demand if the choice is the employee's, and the entity thus incurs a liability to the employee. In contrast, if the choice is the entity's, it can avoid transferring its assets by choosing to settle in stock, and the award qualifies as an equity instrument. However, if an entity that nominally has the choice of settling awards by issuing stock predominately settles in cash or if the entity usually settles in cash whenever an employee asks for cash settlement, the entity is settling a substantive liability rather than repurchasing an equity instrument. In determining whether an entity that has the choice of settling an award by issuing equity shares has a substantive liability, the entity also shall consider whether:

a. It has the ability to deliver the shares. (Federal securities law generally requires that transactions involving offerings of shares under employee share option arrangements be registered, unless there is an available exemption. For purposes of this statement, such requirements do not, by themselves, imply that an entity does not have the ability to deliver shares and thus do not require an award that otherwise qualifies as equity to be classified as a liability.)

b. It is required to pay cash if a contingent event occurs (see paragraphs 19-20).

24. A provision that permits employees to effect a broker-assisted cashless exercise of part or all of an award of share options through a broker does not result in liability classification for instruments that otherwise would be classified as equity if both of the following criteria are satisfied:

a. The cashless exercise requires a valid exercise of the share options.

b. The employee is the legal owner of the shares subject to the option (even though the employee has not paid the exercise price before the sale of the shares subject to the option).

25. A broker that is a related party of the entity must sell the shares in the open market within a normal settlement period, which generally is three days, for the award to qualify as equity.

26. Similarly, a provision for either direct or indirect (through a net-settlement feature) repurchase of shares issued upon exercise of options (or the vesting of nonvested shares), with any payment due employees withheld to meet the employer's minimum statutory withholding requirements resulting from the exercise, does not, by itself, result in liability classification of instruments that otherwise would be classified as equity. However, if an amount in excess of the minimum statutory requirement is withheld, or may be withheld at the employee's discretion, the entire award shall be classified and accounted for as a liability.

27. Minimum statutory withholding requirements are to be based on the applicable minimum statutory withholding rates required by the relevant tax authority (or authorities, for example, federal, state, and local), including the employee's share of payroll taxes that are applicable to such supplemental taxable income.

Market, Performance, and Service Conditions

28. Accruals of compensation cost for an award with a performance condition shall be based on the probable outcome of that performance condition—compensation cost shall be accrued if it is probable that the performance condition will be achieved and shall not be accrued if it is not probable that the performance condition will be achieved. If an award has multiple performance conditions (for example, if the number of options or shares an employee earns varies depending on which, if any, of two or more performance conditions is satisfied), compensation cost shall be accrued if it is probable that a performance condition will be satisfied. In making that assessment, it may be necessary to take into account the interrelationship of those performance conditions.

29. If an award requires satisfaction of one or more market, performance, or service conditions (or any combination thereof), compensation cost shall be recognized if the requisite service is rendered, and no compensation cost shall be recognized if the requisite service is not rendered.

Payroll Taxes

30. A liability for employee payroll taxes on employee stock compensation shall be recognized on the date of the event triggering the measurement and payment of the tax to the taxing authority (for a nonqualified option in the United States, generally the exercise date). Payroll taxes, even though directly related to the appreciation on stock options, are operating expenses and shall be reflected as such in the statement of operations.

Initial Measurement

31. While some of the material in paragraphs 31-34 was written in terms of awards classified as equity, it applies equally to awards classified as liabilities. The subparagraphs of paragraph 36 provide specific guidance for awards classified as liabilities.

32. A share-based payment transaction with employees shall be measured based on the fair value (or in certain situations specified in this statement, a calculated value or intrinsic value) of the equity instruments issued.

33. An entity shall account for the compensation cost from share-based payment transactions with employees in accordance with the fair-value-based method set forth in this statement. That is, the cost of services received from employees in exchange for awards of share-based compensation generally shall be measured based on the grant-date fair value of the equity instruments issued or on the fair value of the liabilities incurred. The cost of services received by an entity as consideration for equity instruments issued or liabilities incurred in share-based compensation transactions with employees shall be measured based on the fair value of the equity instruments issued or the liabilities settled. The portion of the fair value of an instrument attributed to employee service is net of any amount that an employee pays (or becomes obligated to pay) for that instrument when it is granted. For example, if an employee pays $5 at the grant date for an option with a grant-date fair value of $50, the amount attributed to employee service is $45.

34. However, this statement provides certain exceptions (paragraph 49) to that measurement method if it is not possible to reasonably estimate the fair value of an award at the grant date. A reporting entity that is not able to reasonably estimate the fair value of its equity options and similar instruments may measure its liabilities under share-based payment arrangements at intrinsic value (see paragraphs 36.b. and 48).

Terms of the Award Affect Fair Value

35. The terms of a share-based payment award and any related arrangement affect its value and, except for certain explicitly excluded features, such as a reload feature, shall be reflected in determining the fair value of the equity or liability instruments granted. For example, the fair value of a substantive option structured as the exchange of equity shares for a nonrecourse note will differ depending on whether the employee is required to pay nonrefundable interest on the note.

Measurement Objective – Fair Value at Grant Date

36. The measurement objective for equity instruments awarded to employees is to estimate the fair value at the grant date of the equity instruments that the entity is obligated to issue when employees have rendered the requisite service and satisfied any other conditions necessary to earn the right to benefit from the instruments (for example, to exercise share options). That estimate is based on the share price and

other pertinent factors, such as expected volatility, at the grant date. The following subparagraphs provide guidance regarding the measurement objective and measurement date for liability instruments:

a. Measurement Objective and Measurement Date for Liabilities: At the grant date, the measurement objective for liabilities incurred under share-based compensation arrangements is the same as the measurement objective for equity instruments awarded to employees as described in paragraph 36. However, the measurement date for liability instruments is the date of settlement.

b. Measurement Objective and Measurement Date for Liabilities of Entities Subject to Paragraph 48: An entity subject to paragraph 48 shall make a policy decision of whether to measure all of its liabilities incurred under share-based payment arrangements at fair value or to measure all such liabilities at intrinsic value. Consistent with the guidance in paragraph 48, an entity that is not able to reasonably estimate the fair value of its equity share options and similar instruments because it is not practicable for it to estimate the expected volatility of its share price shall make a policy choice of whether to measure its liabilities under share-based payment arrangements at calculated value or at intrinsic value.

37. The fair value of an equity share option or similar instrument shall be measured based on the observable market price of an option with the same or similar terms and conditions.

38. Such market prices for equity share options and similar instruments granted to employees are frequently not available; however, they may become so in the future. As such, the fair value of an equity share option or similar instrument shall be estimated using a valuation technique such as an option-pricing model. For this purpose, a similar instrument is one whose fair value differs from its intrinsic value, that is, an instrument that has time value. For example, a share appreciation right that requires net settlement in equity shares has time value; an equity share does not.

Factors or Restrictions that Impact the Determination of Fair Value at Grant Date

Vesting Versus Nontransferability

39. To satisfy the measurement objective in paragraph 36, the restrictions and conditions inherent in equity instruments awarded to employees are treated differently depending on whether they continue in effect after the requisite service period. A restriction that continues in effect after an entity has issued instruments to employees, such as the inability to transfer vested equity share options to third parties or the inability to sell vested shares for a period of time, is considered in estimating the fair value of the instruments at the grant date. For equity share options and similar instruments, the effect of nontransferability (and nonhedgeability, which has a similar effect) is taken into account by reflecting the effects of employees' expected exercise and postvesting employment termination behavior in estimating fair value (referred to as an option's expected term).

Forfeitability

40. A restriction that stems from the forfeitability of instruments to which employees have not yet earned the right, such as the inability either to exercise a nonvested equity share option or to sell nonvested shares, is not reflected in estimating the fair value of the related instruments at the grant date. Instead, those restrictions are taken into account by recognizing compensation cost only for awards for which employees render the requisite service.

Performance of Service Conditions

41. Awards of share-based employee compensation ordinarily specify a performance condition or a service condition (or both) that must be satisfied for an employee to earn the right to benefit from the award. No compensation cost is recognized for instruments that employees forfeit because a service condition or a performance condition is not satisfied (that is, instruments for which the requisite service is not rendered).

42. The fair-value-based method described in paragraphs 36 and 39-43 uses fair value measurement techniques, and the grant-date share price and other pertinent factors are used in applying those techniques. However, the effects on the grant-date fair value of service and performance conditions that apply only during the requisite service period are reflected based on the outcomes of those conditions. This statement refers to the required measure as fair value.

Market Conditions

43. Some awards contain a market condition. The effect of a market condition is reflected in the grant-date fair value of an award. (Valuation techniques have been developed to value path-dependent options as well as other options with complex terms. Awards with market conditions, as defined in this statement, are path-dependent options.) Compensation cost thus is recognized for an award with a market condition provided that the requisite service is rendered, regardless of when, if ever, the market condition is satisfied.

Market, Performance, and Service Conditions That Affect Conditions Other than Vesting or Exercisability

44. Market, performance, and service conditions (or any combination thereof) may affect an award's exercise price, contractual term, quantity, conversion ratio, or other factors that are considered in measuring an award's grant-date fair value. A grant-date fair value shall be estimated for each possible outcome of such a performance or service condition, and the final measure of compensation cost shall be based on the amount estimated at the grant date for the condition or outcome that is actually satisfied.

Nonvested or Restricted Shares

45. A nonvested equity share or nonvested equity share unit awarded to an employee shall be measured at its fair value as if it were vested and issued on the grant date.

46. Nonvested shares granted to employees usually are referred to as restricted shares, but this statement reserves that term for fully vested and outstanding shares whose sale is contractually or governmentally prohibited for a specified period of time.

47. A restricted share awarded to an employee, that is, a share that will be restricted after the employee has a vested right to it, shall be measured at its fair value, which is the same amount for which a similarly restricted share would be issued to third parties.

Calculated Value for Entities Not Reasonably Able to Estimate Fair Value

48. An entity may not be able to reasonably estimate the fair value of its equity share options and similar instruments because it is not practicable for it to estimate the expected volatility of its share price. In that situation, the entity shall account for its equity share options and similar instruments based on a value calculated using the historical volatility of an appropriate industry sector index instead of the expected volatility of the entity's share price (the calculated value). Throughout the remainder of this statement, provisions that apply to accounting for share options and similar instruments at fair value also apply to calculated value.

Difficulty of Estimation

49. It should be possible to reasonably estimate the fair value of most equity share options and other equity instruments at the date they are granted. However, in rare circumstances, it may not be possible to reasonably estimate the fair value of an equity share option or other equity instrument at the grant date because of the complexity of its terms.

50. An equity instrument for which it is not possible to reasonably estimate fair value at the grant date shall be accounted for based on its intrinsic value (paragraph 70) for measurement after issue date.

Reload and Contingent Features

51. The fair value of each award of equity instruments, including an award of options with a reload feature (reload options), shall be measured separately based on its terms and the share price and other pertinent factors at the grant date. The effect of a reload feature in the terms of an award shall not be included in estimating the grant-date fair value of the award. Rather, a subsequent grant of reload options pursuant to that provision shall be accounted for as a separate award when the reload options are granted.

52. A contingent feature of an award that might cause an employee to return to the entity either equity instruments earned or realized gains from the sale of equity instruments earned for consideration that is less than fair value on the date of transfer (including no consideration), such as a clawback feature shall not be reflected in estimating the grant-date fair value of an equity instrument.

Requisite Service Period

53. An entity shall make its initial best estimate of the requisite service period at the grant date (or at the service inception date, if that date precedes the grant date) and shall base accruals of compensation cost on that period.

54. The initial best estimate and any subsequent adjustment to that estimate of the requisite service period for an award with a combination of market, performance, or service conditions shall be based on an analysis of all of the following:

a. All vesting and exercisability conditions

b. All explicit, implicit, and derived service periods

c. The probability that performance or service conditions will be satisfied.

Market, Performance, and Service Conditions

55. Performance or service conditions that affect vesting are not reflected in estimating the fair value of an award at the grant date because those conditions are restrictions that stem from the forfeitability of instruments to which employees have not yet earned the right. However, the effect of a market condition is reflected in estimating the fair value of an award at the grant date (paragraph 43). For purposes of this statement, a market condition is not considered to be a vesting condition, and an award is not deemed to be forfeited solely because a market condition is not satisfied.

Subsequent Measurement

56. Guidance that equally applies to both liabilities and equity is generally found in paragraphs 57-69. Paragraphs 70-78 provide additional subsequent measurement guidance for awards classified as equity and paragraphs 79-82 provide additional subsequent measurement guidance for awards classified as liabilities.

Recognition of Compensation Costs Over the Requisite Service

57. The compensation cost for an award of share-based employee compensation classified as equity shall be recognized over the requisite service period, with a corresponding credit to equity (generally, paid-in capital). The requisite service period is the period during which an employee is required to provide service in exchange for an award, which often is the vesting period. The requisite service period is estimated based on an analysis of the terms of the share-based payment award.

58. The total amount of compensation cost recognized at the end of the requisite service period for an award of share-based compensation shall be based on the number of instruments for which the requisite service has been rendered (that is, for which the requisite service period has been completed). An entity shall base initial accruals of compensation cost on the estimated number of instruments for which the requisite service is expected to be rendered. That estimate shall be revised if subsequent information indicates that the actual number of instruments is likely to differ from previous estimates. The cumulative effect on current and prior periods of a change in the estimated number of instruments for which the requisite service is expected to be or has been rendered shall be recognized in compensation cost in the period of the change. Previously recognized compensation cost shall not be reversed if an employee share option (or share unit) for which the requisite service has been rendered expires unexercised (or unconverted).

59. An entity shall reverse previously recognized compensation cost for an award with a market condition only if the requisite service is not rendered.

Estimating the Requisite Service Period

60. The requisite service period may be explicit or it may be implicit, being inferred from an analysis of other terms in the award, including other explicit service or performance conditions. The requisite service period for an award that contains a market condition can be derived from certain valuation techniques that may be used to estimate grant-date fair value. An award may have one or more explicit, implicit, or derived service periods; however, an award may have only one requisite service period for accounting purposes unless it is accounted for as in-substance multiple awards. An award with a graded vesting schedule that is accounted for as in-substance multiple awards is an example of an award that has more than one requisite service period (paragraph 63).

61. The service inception date is the beginning of the requisite service period. If the service inception date precedes the grant date, accrual of compensation cost for periods before the grant date shall be based on the fair value of the award at the reporting date. In the period in which the grant date occurs, cumulative compensation cost shall be adjusted to reflect the cumulative effect of measuring compensation cost based on fair value at the grant date rather than the fair value previously used at the service inception date (or any subsequent reporting date).

62. An entity shall adjust that initial best estimate in light of changes in facts and circumstances. Whether and how the initial best estimate of the requisite service period is adjusted depends on both the nature of the conditions identified in paragraph 54 and the manner in which they are combined, for example, whether an award vests or becomes exercisable when either a market or a performance condition is satisfied or whether both conditions must be satisfied.

Graded Vesting Awards

63. An entity shall make a policy decision about whether to recognize compensation cost for an award with only service conditions that has a graded vesting schedule in either of the following ways:

a. On a straight-line basis over the requisite service period for each separately vesting portion of the award as if the award was, in-substance, multiple awards.

b. On a straight-line basis over the requisite service period for the entire award (that is, over the requisite service period of the last separately vesting portion of the award).

However, the amount of compensation cost recognized at any date must at least equal the portion of the grant-date value of the award that is vested at that date.

Awards May Become Subject to Other Guidance

64. Paragraphs 65-68 are intended to apply to those instruments issued in share-based payment transactions with employees accounted for under this statement, and to instruments exchanged in a business combination for share-based payment awards of the acquired business that were originally granted to employees of the acquired business and are outstanding as of the date of the business combination. Instruments issued, in whole or in part, as consideration for goods or services other than employee service shall not be considered to have been issued in exchange for employee service when applying the guidance in those paragraphs, irrespective of the employment status of the recipient of the award on the grant date.

65. A freestanding financial instrument issued to an employee in exchange for past or future employee services that is subject to initial recognition and measurement guidance within this statement shall continue to be subject to the recognition and measurement provisions of this statement throughout the life of the instrument, unless its terms are modified when the holder is no longer an employee. Only for purposes of this paragraph, a modification does not include a change to the terms of an award if that change is made solely to reflect an equity restructuring provided that both of the following conditions are met:

a. There is no increase in fair value of the award (or the ratio of intrinsic value to the exercise price of the award is preserved, that is, the holder is made whole) or the antidilution provision is not added to the terms of the award in contemplation of an equity restructuring.

b. All holders of the same class of equity instruments (for example, stock options) are treated in the same manner.

66. Other modifications of that instrument that take place when the holder is no longer an employee shall be subject to the modification guidance in paragraph 68. Following modification, recognition and measurement of the instrument should be determined through reference to other applicable statutory accounting principles.

67. Once the classification of an instrument is determined, the recognition and measurement provisions of this statement shall be applied until the instrument ceases to be subject to the requirements discussed in paragraph 65. Other applicable statutory accounting principles applies to a freestanding financial instrument that was issued under a share-based payment arrangement but that is no longer subject to this statement.

68. An entity may modify (including cancel and replace) or settle a fully vested, freestanding financial instrument after it becomes subject to other applicable statutory accounting principles. Such a modification or settlement shall be accounted for under the provisions of this statement unless it applies equally to all financial instruments of the same class regardless of whether the holder is (or was) an employee (or an employee’s beneficiary). Following the modification, the instrument continues to be accounted for under other applicable statutory accounting principles. A modification or settlement of a class of financial instrument that is designed exclusively for and held only by current or former employees (or their beneficiaries) may stem from the employment relationship depending on the terms of the modification or settlement. Thus, such a modification or settlement may be subject to the

requirements of this statement. See paragraph 65 for a discussion of changes to awards made solely to reflect an equity restructuring.

Change in Classification Due to Change in Probable Settlement Outcome

69. An option or similar instrument that is classified as equity, but subsequently becomes a liability because the contingent cash settlement event is probable of occurring, shall be accounted for similar to a modification from an equity to liability award. That is, on the date the contingent event becomes probable of occurring (and therefore the award must be recognized as a liability), the entity recognizes a share-based liability equal to the portion of the award attributed to past service (which reflects any provision for acceleration of vesting) multiplied by the award's fair value on that date. To the extent the liability equals or is less than the amount previously recognized in equity, the offsetting debit is a charge to equity. To the extent that the liability exceeds the amount previously recognized in equity, the excess is recognized as compensation cost. The total recognized compensation cost for an award with a contingent cash settlement feature shall at least equal the fair value of the award at the grant date. The guidance in this paragraph is applicable only for options or similar instruments issued as part of employee compensation arrangements. That is, the guidance included in this paragraph is not applicable, by analogy or otherwise, to instruments outside employee share-based payment arrangements.

Subsequent Measurement - Awards Classified as Equity

Fair Value Not Reasonably Estimable

70. An equity instrument for which it is not possible to reasonably estimate fair value at the grant date shall be remeasured at each reporting date through the date of exercise or other settlement. The final measure of compensation cost shall be the intrinsic value of the instrument at the date it is settled. Compensation cost for each period until settlement shall be based on the change (or a portion of the change, depending on the percentage of the requisite service that has been rendered at the reporting date) in the intrinsic value of the instrument in each reporting period. The entity shall continue to use the intrinsic value method for those instruments even if it subsequently concludes that it is possible to reasonably estimate their fair value.

Contingent Features

71. A contingent feature of an award that might cause an employee to return to the entity either equity instruments earned or realized gains from the sale of equity instruments earned for consideration that is less than fair value on the date of transfer (including no consideration), such as a clawback feature, shall be accounted for if and when the contingent event occurs.

Modification of An Award

72. A modification of the terms or conditions of an equity award shall be treated as an exchange of the original award for a new award. In substance, the entity repurchases the original instrument by issuing a new instrument of equal or greater value, incurring additional compensation cost for any incremental value. The effects of a modification shall be measured as follows:

a. Incremental compensation cost shall be measured as the excess, if any, of the fair value of the modified award determined in accordance with the provisions of this statement over the fair value of the original award immediately before its terms are modified, measured based on the share price and other pertinent factors at that date. As indicated in paragraph 48, references to fair value throughout this statement shall be read also to encompass calculated value. The effect of the modification on the number of instruments expected to vest also shall be reflected in determining incremental compensation cost.

The estimate at the modification date of the portion of the award expected to vest shall be subsequently adjusted, if necessary, in accordance with paragraph 58.

b. Total recognized compensation cost for an equity award shall at least equal the fair value of the award at the grant date unless at the date of the modification the performance or service conditions of the original award are not expected to be satisfied. Thus, the total compensation cost measured at the date of a modification shall be the sum of the following:

i. The portion of the grant-date fair value of the original award for which the requisite service is expected to be rendered (or has already been rendered) at that date, and

ii. The incremental cost resulting from the modification.

Compensation cost shall be subsequently adjusted, if necessary, in accordance with paragraph 58.

c. A change in compensation cost for an equity award measured at intrinsic value in accordance with paragraph 70 shall be measured by comparing the intrinsic value of the modified award, if any, with the intrinsic value of the original award, if any, immediately before the modification.

73. Paragraphs 64-68 provide additional guidance on accounting for modifications of certain freestanding financial instruments that initially were subject to this statement but subsequently became subject to other applicable statutory accounting principles.

Short-Term Inducements

74. A short-term inducement shall be accounted for as a modification of the terms of only the awards of employees who accept the inducement. Other inducements are modifications of the terms of all awards subject to them and shall be accounted for as such.

Equity Restructuring or Business Combination

75. Exchanges of share options or other equity instruments or changes to their terms in conjunction with an equity restructuring or a business combination are modifications for purposes of this statement. Except for a modification to add an antidilution provision that is not made in contemplation of an equity restructuring, accounting for a modification in conjunction with an equity restructuring requires a comparison of the fair value of the modified award with the fair value of the original award immediately before the modification in accordance with paragraph 72. If those amounts are the same, for instance, because the modification is designed to equalize the fair value of an award before and after an equity restructuring, no incremental compensation cost is recognized. See paragraph 65 for an additional exception.

Repurchase or Cancellation

76. The amount of cash or other assets transferred (or liabilities incurred) to repurchase an equity award shall be charged to equity, to the extent that the amount paid does not exceed the fair value of the equity instruments repurchased at the repurchase date. Any excess of the repurchase price over the fair value of the instruments repurchased shall be recognized as additional compensation cost. An entity that repurchases an award for which the requisite service has not been rendered has, in effect, modified the requisite service period to the period for which service already has been rendered, and thus the amount of

compensation cost measured at the grant date but not yet recognized shall be recognized at the repurchase date.

Cancellation and Replacement

77. Cancellation of an award accompanied by the concurrent grant of (or offer to grant) a replacement award or other valuable consideration shall be accounted for as a modification of the terms of the cancelled award. (The phrase *offer to grant* is intended to cover situations in which the service inception date precedes the grant date.) Therefore, incremental compensation cost shall be measured as the excess of the fair value of the replacement award or other valuable consideration over the fair value of the cancelled award at the cancellation date in accordance with paragraph 72. Thus, the total compensation cost measured at the date of a cancellation and replacement shall be the portion of the grant-date fair value of the original award for which the requisite service is expected to be rendered (or has already been rendered) at that date plus the incremental cost resulting from the cancellation and replacement.

78. A cancellation of an award that is not accompanied by the concurrent grant of (or offer to grant) a replacement award or other valuable consideration shall be accounted for as a repurchase for no consideration. Accordingly, any previously unrecognized compensation cost shall be recognized at the cancellation date.

Subsequent Measurement - Awards Classified as Liabilities

Measurement

79. The fair value of liabilities incurred in share-based payment transactions with employees shall be remeasured at the end of each reporting period through settlement.

80. Changes in the fair value (or intrinsic value for an entity that elects that method) of a liability incurred under a share-based payment arrangement that occur during the requisite service period shall be recognized as compensation cost over that period. The percentage of the fair value (or intrinsic value) that is accrued as compensation cost at the end of each period shall equal the percentage of the requisite service that has been rendered at that date. Changes in the fair value (or intrinsic value) of a liability that occur after the end of the requisite service period are compensation costs of the period in which the changes occur. Any difference between the amount for which a liability award is settled and its fair value at the settlement date as estimated in accordance with the provisions of this statement is an adjustment of compensation cost in the period of settlement.

81. Reporting entities shall measure a liability award under a share-based payment arrangement based on the award's fair value (or calculated value in accordance with paragraph 48) remeasured at each reporting date until the date of settlement. Compensation costs for each period until settlement shall be based on the change (or a portion of the change, depending on the percentage of the requisite service that has been rendered at the reporting date) in the fair value of the instrument for each reporting period.

Modification of an Award

82. A modification of a liability award is accounted for as the exchange of the original award for a new award. However, because liability awards are remeasured at their fair value (or calculated value for an entity subject to paragraph 48) at each reporting date, no special guidance is necessary in accounting for a modification of a liability award that remains a liability after the modification.

Look-Back Plans

83. The accounting guidance in this section addresses the accounting for certain employee stock purchase plans with a look-back option. An example of a look-back option is a provision that establishes

the purchase price as an amount based on the lesser of the stock's market price at the grant date or its market price at the exercise date (or purchase date).

84. As with all employee share purchase plans, the objective of the measurement process for employee share purchase plans with a look-back option is to reasonably measure fair value of the award at the grant date. Paragraph 70 provides guidance on the measurement requirements if it is not possible to reasonably estimate fair value at the grant date.

Accounting for Tax Effects of Share-Based Compensation Awards

85. Income tax regulations specify allowable tax deductions for instruments issued under share-based payment arrangements in determining an entity's income tax liability. For example, under tax law, allowable tax deductions may be measured as the intrinsic value of an instrument on a specified date. The time value component, if any, of the fair value of an instrument generally may not be tax deductible. Therefore, tax deductions may arise in different amounts and in different periods from compensation costs recognized in financial statements. Similarly, the amount of expense reported for an employee stock ownership plan during a period may differ from the amount of the related income tax deduction prescribed by income tax rules and regulations.

86. This guidance addresses how temporary differences are recognized for share-based payment arrangement awards that are classified either as equity or as liabilities under the requirements of paragraphs 14-27. Incremental guidance is also provided for issues related to employee stock ownership plans.

Tax Effects for Instruments Classified as Equity

87. The cumulative amount of compensation cost recognized for instruments classified as equity that ordinarily would result in a future tax deduction under existing tax law shall be considered to be a deductible temporary difference in applying the requirements of *SSAP No. 101—Income Taxes, a Replacement of SSAP No. 10R and SSAP No. 10* (SSAP No. 101). The deductible temporary difference shall be based on the compensation cost recognized for financial reporting purposes. Compensation cost that is capitalized as part of the cost of an asset, such as inventory, shall be considered to be part of the tax basis of that asset for financial reporting purposes.

88. Recognition of compensation cost for instruments that ordinarily do not result in tax deductions under existing tax law shall not be considered to result in a deductible temporary difference. A future event can give rise to a tax deduction for instruments that ordinarily do not result in a tax deduction. The tax effects of such an event shall be recognized only when it occurs. An example of a future event that would be recognized only when it occurs is an employee's sale of shares obtained from an award before meeting a tax law's holding period requirement, sometimes referred to as a disqualifying disposition, which results in a tax deduction not ordinarily available for such an award.

Tax Effects for Instruments Classified as Liability

89. The cumulative amount of compensation cost recognized for instruments classified as liabilities that ordinarily would result in a future tax deduction under existing tax law also shall be considered to be a deductible temporary difference. The deductible temporary difference shall be based on the compensation costs recognized for financial reporting purposes.

Accounting for Tax Effects – Initial Measurement

90. SSAP No. 101 requires a deferred tax asset to be evaluated for future realization and to be reduced by a statutory valuation allowance to the amount that is more likely than not to be realized. Differences between the deductible temporary difference computed pursuant to paragraphs 87-88 and the

tax deduction that would result based on the current fair value of the entity's shares shall not be considered in measuring the gross deferred tax asset or determining the need for a valuation allowance for a deferred tax asset recognized under these requirements.

Accounting for Tax Effects – Subsequent Measurement

91. If a deduction reported on a tax return for an award of equity instruments exceeds the cumulative compensation cost for those instruments recognized for financial reporting, any resulting realized tax benefit that exceeds the previously recognized deferred tax asset for those instruments is the excess tax benefit. If only a portion of an award is exercised, determination of the excess tax benefits shall be based on the portion of the award that is exercised.

92. The amount deductible for an award of equity instruments on the employer's tax return may be less than the cumulative compensation costs recognized for financial reporting purposes. The write-off of a deferred tax asset related to that deficiency, net of the related statutory valuation allowance, if any, shall first be offset to the extent of any remaining gross paid-in and contributed surplus from excess tax benefits arising from previous awards granted, modified, or settled in cash and measured in accordance with a fair value based method of accounting. An entity shall exclude from that amount excess tax benefits from share-based payment arrangements that are outside the scope of this statement, excess tax benefits from employee stock ownership plans, and excess tax benefits that have not been realized pursuant to the requirements established in SSAP No. 101.

93. An excess tax benefit determined pursuant to paragraph 91 shall be recognized as gross paid-in and contributed surplus, except that an excess of a realized tax benefit for an award over the deferred tax asset for that award shall be recognized in the income statement to the extent that the excess stems from a reason other than changes in the fair value of an entity's shares between the measurement date for accounting purposes and a later measurement date for tax purposes.

94. Paragraph 92 contains measurement guidance on how much, if any, of the write-off of a deferred tax asset from a tax deficiency shall be offset against additional paid-in capital. The remaining balance, if any, of the write-off of a deferred tax asset related to a tax deficiency shall be recognized in the income statement.

Tax Benefits of Dividends on Share-Based Payment Awards to Employees

95. A realized income tax benefit from dividends or dividend equivalents that are charged to unassigned-funds (surplus) and are paid to employees for any of the following equity classified awards shall be recognized as an increase to gross paid-in and contributed surplus:

a. Nonvested equity shares

b. Nonvested equity share units

c. Outstanding equity share options.

96. The amount recognized in gross paid-in and contributed surplus for the realized income tax benefit from dividends on the awards identified in the preceding paragraph shall be included in the pool of excess tax benefits available to absorb tax deficiencies on share-based payment awards.

97. Dividends or dividend equivalents paid to employees for the awards identified in paragraph 95 may result in a tax deduction prior to the actual realization of the related tax benefit because the employer, for example, has a net operating loss carryforward. The income tax benefit of those dividends shall not be recognized until the deduction reduces income taxes payable. Unrealized income tax benefits from dividends on equity-classified employee share-based payment awards shall be excluded from the

pool of excess tax benefits available to absorb potential future tax deficiencies on share-based payment awards.

98. Dividends or dividend equivalents paid to employees on the portion of an award of equity shares or other equity instruments that vests shall be charged to unassigned funds (surplus). If the related award is not expected to vest, dividends or dividend equivalents shall be recognized as compensation costs. Dividends and dividend equivalents shall be reclassified between unassigned funds (surplus) and compensation costs in a subsequent period if the entity changes its forfeiture estimates (or actual forfeitures differ from previous estimates).

99. Adjustments to gross paid-in and contributed surplus for reclassifications of the tax benefits from dividends on the awards discussed in the preceding paragraph in subsequent periods increase or decrease the entity's pool of excess tax benefits available to absorb tax deficiencies by a corresponding amount. Additionally, the tax benefits from dividends that are reclassified from gross paid-in and contributed surplus to the income statement (that is, as a reduction of income tax expense or an increase of income tax benefit) if an entity's estimate of forfeitures increases (or actual forfeitures exceed the entity's estimates) shall be limited to the entity's pool of excess tax benefits available to absorb tax deficiencies on the date of the reclassification.

Accounting for Rabbi Trusts

100. Rabbi trusts are grantor trusts generally set up to fund compensation for a select group of management or highly paid executives. To qualify as a rabbi trust for income tax purposes, the terms of the trust agreement must explicitly state that the assets of the trust are available to satisfy the claims of general creditors in the event of bankruptcy of the employer.

101. There are four potential scenarios for deferred compensation arrangements where amounts earned by an employee are invested in the stock of the employer and placed in a "rabbi trust."

Plan A: The plan does not permit diversification and must be settled by the delivery of a fixed number of shares of employer stock.

Plan B: The plan does not permit diversification and may be settled by the delivery of cash or shares of employer stock.

Plan C: The plan permits diversification; however, the employee has not diversified (the plan may be settled in cash, shares of employer stock, or diversified assets).

Plan D: The plan permits diversification and the employee has diversified (the plan may be settled in cash, shares of employer stock, or diversified assets).

102. The accounts of the rabbi trust should be consolidated with the accounts of the employer in the financial statements of the employer.

a. For Plan A, employer stock held by the rabbi trust should be classified in equity in a manner similar to the manner in which treasury stock is accounted for. Subsequent changes in the fair value of the employer's stock should not be recognized. The deferred compensation obligation should be classified as an equity instrument and changes in the fair value of the amount owed to the employee should not be recognized.

b. For Plans B and C, employer stock held by the rabbi trust should be classified in equity in a manner similar to the manner in which treasury stock is accounted for. Subsequent changes in the fair value of the employer's stock should not be recognized. The deferred compensation obligation should be classified as a liability and adjusted with a corresponding charge (or credit) to compensation cost, to reflect the changes in the fair value of the amount owed to the employee.

c. For Plan D, assets held by the rabbi trust should be accounted for in accordance with statutory accounting principles for the particular asset (for example, if the diversified asset is a marketable equity security, that security would be accounted for in accordance with SSAP No. 30). The deferred compensation obligation should be classified as a liability and adjusted, with a corresponding charge (or credit) to compensation cost, to reflect changes in the fair value of the amount owed to the employee. Changes in the fair value of the deferred compensation obligation should not be recorded in unrealized gains or losses, even if changes in the fair value of the assets held by the rabbi trust are recorded in surplus~~,~~ pursuant to *SSAP No. 30—Investments in Common Stock (excluding investments in common stock of subsidiary, controlled or affiliated entities)*.~~, in surplus.~~

Disclosures – Employee Share-Based Payments

103. An entity with one or more share-based payment arrangements shall disclose information that enables users of the financial statements to understand all of the following:

a. The nature and terms of such arrangements that existed during the period and the potential effects of those arrangements on shareholders;

b. The effect of compensation costs arising from share-based payment arrangements on the income statement;

c. The method of estimating the fair value of the goods or services received, or the fair value of the equity instruments granted (or offered to grant), during the period; and

d. The cash flow effects resulting from share-based payment arrangements.

104. The disclosures in paragraph 103 are for annual audited statutory financial statements only. Appendix B ~~provides~~ illustrates the information needed to achieve the objectives in this paragraph.

Employee Share-Based Payments - Noncompensatory ~~Employee Share Purchase~~ Plans

Overview and Background

105. This section provides guidance to all entities that use employee share purchase plans. The entity must first determine whether the plan is compensatory or noncompensatory. This is determined by the terms of the plan (paragraphs 106-107). A plan with an option feature, for example a look-back feature, is considered compensatory.

Recognition

106. An employee share purchase plan that satisfies all of the following criteria does not give rise to recognizable compensation costs (that is, the plan is noncompensatory):

a. The plan satisfies either of the following conditions:

i. The terms of the plan are no more favorable than those available to all holders of the same class of shares. Note that a transaction subject to an employee share purchase plan that involves a class of equity shares designed exclusively for and held only by current or former employees or their beneficiaries may be compensatory depending on the terms of the arrangement.

ii. Any purchase discount from the market price does not exceed the per-share amount of share issuance costs that would have been incurred to raise a significant amount of capital by a public offering. A purchase discount of 5 percent or less from the market price shall be considered to comply with this condition without further justification. A purchase discount greater than 5 percent that cannot be justified under this condition results in compensation cost for the entire amount of the discount. Note that an entity that justifies a purchase discount in excess of 5 percent shall reassess at least annually, and no later than the first share purchase offer during the fiscal year, whether it can continue to justify that discount pursuant to this paragraph.

b. Substantially all employees that meet limited employment qualifications may participate on an equitable basis.

c. The plan incorporates no option features, other than the following:

i. Employees are permitted a short period of time—not exceeding 31 days—after the purchase price has been fixed to enroll in the plan.

ii. The purchase price is based solely on the market price of the shares at the date of purchase, and employees are permitted to cancel participation before the purchase date and obtain a refund of amounts previously paid (such as those paid by payroll withholdings).

107. A plan provision that establishes the purchase price as an amount based on the lesser of the equity share's market price at date of grant or its market price at date of purchase, commonly called a look-back plan, is an example of an option feature that causes the plan to be compensatory. Similarly, a plan in which the purchase price is based on the share's market price at date of grant and that permits a participating employee to cancel participation before the purchase date and obtain a refund of amounts previously paid contains an option feature that causes the plan to be compensatory.

108. The requisite service period for any compensation cost resulting from an employee share purchase plan is the period over which the employee participates in the plan and pays for the shares.

Initial Measurement

109. The objective in paragraph 36 also applies to the fair value measurements associated with grants under a compensatory employee share purchase plan. The objective in this paragraph states that the fair value measurement method is to estimate the fair value of the equity instruments, based on the share price and other measurement assumptions at the grant date, that are issued in exchange for employee services.

Subsequent Measurement

110. Changes in total employee withholdings during a purchase period that occur solely as a result of salary increases, commissions, or bonus payments are not plan modifications if they do not represent changes to the terms of the award that was offered by the employer and initially agreed to by the employee at the grant (or measurement) date. Under those circumstances, the only incremental compensation cost is that which results from the additional shares that may be purchased with the additional amounts withheld (using the fair value calculated at the grant date). For example, an employee may elect to participate in the plan on the grant date by requesting that 5 percent of the employee's annual salary be withheld for future purchases of stock. If the employee receives an increase in salary during the term of the award, the base salary on which the 5 percent withholding amount is applied will increase, thus increasing the total amount withheld for future share purchases. That increase in withholdings as a result of the salary increase is not considered a plan modification and thus only increases the total

compensation cost associated with the award by the grant date fair value associated with the incremental number of shares that may be purchased with the additional withholdings during the period. The incremental number of shares that may be purchased is calculated by dividing the incremental amount withheld by the exercise price as of the grant date (for example, 85 percent of the grant date stock price).

111. Any decreases in the withholding amounts (or percentages) shall be disregarded for purposes of recognizing compensation cost unless the employee services that were valued at the grant date will no longer be provided to the employer due to a termination. However, no compensation cost shall be recognized for awards that an employee forfeits because of failure to satisfy a service requirement for vesting. The accounting for decreases in withholdings is consistent with the requirement in paragraph 58 that the total amount of compensation cost that must be recognized for an award be based on the number of instruments for which the requisite service has been rendered (that is, for which the requisite service period has been completed).

Employee Share-Based Payments - Consolidated / Holding Company Plans

112. Except for the disclosure requirement in paragraph 113 below, the provisions of this statement do not apply to a reporting entity, as long as:

a. The reporting entity is not directly liable for obligations under the share-based payment plan.

b. Compensation costs associated with share-based payments provided by a related party or holder of an economic interest in the reporting entity, equal to the required contribution to the plan for the period, are included in allocated expenses to the reporting entity. A liability shall be established for any such contributions due and unpaid.

113. The reporting entity shall disclose in the financial statements that its employees participate in a plan sponsored by the holding company for which the reporting entity has no legal obligation. The amount of the expense incurred and the allocation methodology utilized by the provider of such benefits shall also be disclosed.

114. If the reporting entity is directly liable for the share-based payment plan, then the other provisions of this statement apply.

Non-Employee Share-Based Payments

115. Reporting entities that grant share-based payments to non-employees shall recognize the goods acquired or services received as part of the transaction when it obtains the goods or as services are received. A grantor may need to recognize a *nonadmitted prepaid* asset before it actually receives goods or services if it first exchanges share-based payment for an enforceable right to receive those goods or services. Nonetheless, the goods or services shall not be recognized before they are received. *(The nonadmitted asset recognized prior to the goods and services would be eliminated upon receipt of the goods and services that are recognized.)*

116. If fully vested, nonforfeitable equity instruments are issued at the date the grantor and grantee enter into an agreement for goods or services (no specific performance is required by the grantee to retain those equity instruments), then, because of the elimination of any obligation on the part of the counterparty to earn the equity instruments, a measurement date has been reached. A grantor shall recognize the equity instruments when they are issued (in most cases, when the agreement is entered into). Whether the corresponding cost is an immediate expense or a *nonadmitted* prepaid asset depends on the specific facts and circumstances. A grantor may conclude that an asset (other than a note or a receivable) has been received in return for fully-vested, nonforfeitable equity instruments that are issued at the date the grantor and grantee enter into an agreement for goods or services (and no specific

performance is required by the grantee in order to retain those equity instruments). Such an asset shall not be displayed as contra-equity by the grantor of the equity instrument. The transferability (or lack thereof) of the equity instruments shall not affect the balance sheet display of this *nonadmitted prepaid* asset. This guidance is limited to transactions in which equity instruments are transferred to other than employees in exchange for goods or services.

117. An entity may grant fully vested, nonforfeitable equity instruments that are exercisable by the grantee only after a specified period of time if the terms of the agreement provide for earlier exercisability if the grantee achieves specified performance conditions. Any measured cost of the transaction shall be recognized in the same period(s) and in the same manner as if the entity had paid cash for the goods or services or used cash rebates as a sales discount instead of paying with, or using, the equity instruments.

118. A recognized *nonadmitted prepaid* asset, expense, or sales discount shall not be reversed if a stock option that the counterparty has the right to exercise expires unexercised. *As noted in paragraph 115, the goods and services shall not be recognized before they are received.*

119. A grantor shall recognize either a corresponding increase in equity or a liability, depending on whether the instruments granted satisfy the equity or liability classification criteria established in paragraphs 14-27 *for employee share-based payments*. As the goods or services are disposed of or consumed, the grantor shall recognize the related cost, unless other statutory accounting principles require costs to be expensed when incurred. In these instances, when the goods or services are received, the grantor shall recognize the related cost.

Initial Measurement – Reporting Entity Grantor/Issuer

120. Share-based payment transactions with non-employees shall be measured at the fair value of the consideration received or the fair value of the equity instruments issued, whichever is more reliably measurable.

121. The accounting for all share-based payment transactions shall reflect the rights conveyed to the holder of the instruments and the obligations imposed on the issuer of the instruments, regardless of how those transactions are structured. The terms of a share-based payment award and any related arrangement affect its value and, except for certain explicitly excluded features, such as a reload feature, shall be reflected in determining the fair value of the equity or liability instruments granted. Assessment of both the rights and obligations in a share-based payment award and any related arrangement and how those rights and obligations affect the fair value of an award requires the exercise of judgment in considering the relevant facts and circumstances. The minimum value method (a method that reflects the time value of an option but ignores the volatility value) is not an acceptable method for determining the fair value of non-employee awards.

122. If the fair value of goods or services received in a share-based payment transaction with non-employees is more reliably measurable than the fair value of the equity instruments issued, the fair value of the goods or services received shall be used to measure the transaction. In contrast, if the fair value of the equity instruments issued in a share-based payment transaction with non-employees is more reliably measurable than the fair value of the consideration received, the transaction shall be measured based on the fair value of the equity instruments issued.

123. Sales incentives in the form of equity instruments shall be measured at the fair value of the sales incentive or the fair value of the equity instruments issued, whichever is more reliably measurable.

124. The issuer/*grantor* shall measure the fair value of the equity instruments *provided in share-based payment* transactions using the stock price and other measurement assumptions as of the earlier of the following dates, referred to as the measurement date:

a. The date at which a commitment for performance by the counterparty to earn the equity instruments is reached (a performance commitment[4])

b. The date at which the counterparty's performance is complete.

125. The counterparty's performance is complete when the counterparty has delivered or, in the case of sales incentives, purchased the goods or services, despite the fact that at that date the quantity or all the terms of the equity instruments may yet depend on other events (this would occur, for example, if a target stock price requirement has not been met when the counterparty has delivered the goods or services).

126. Situations may arise in which counterparty performance may be required over a period of time but the equity award granted to the party performing the services is fully vested and nonforfeitable on the date the parties enter into the contract. While this type of arrangement may be rare, because, typically, vesting provisions do exist, the measurement date for an award that is nonforfeitable and that vests immediately could be the date the parties enter into the contract, even though services have not yet been performed.

127. If fully vested, nonforfeitable equity instruments are issued at the date the grantor and grantee enter into an agreement for goods or services (no specific performance is required by the grantee to retain those equity instruments), then, because of the elimination of any obligation on the part of the counterparty to earn the equity instruments, a measurement date has been reached.

128. If an entity grants fully vested, nonforfeitable equity instruments that are exercisable by the grantee only after a specified period of time and the terms of the agreement provide for earlier exercisability if the grantee achieves specified performance conditions, the grantor shall measure the fair value of the equity instruments at the date of grant and shall recognize that measured cost in the same period(s) and in the same manner as if the grantor had paid cash.

Initial Measurement – Reporting Entity Grantee/Provider

129. An entity (the grantee or provider) may enter into transactions to provide goods or services in exchange for equity instruments. The grantee shall measure the fair value of the equity instruments in these transactions using the stock price and other measurement assumptions as of the earlier of either of the following dates referred to as the measurement date:

a. The date the parties come to a mutual understanding of the terms of the equity-based compensation arrangement and a commitment for performance by the grantee to earn the equity instruments (a performance commitment[5]) is reached, or

b. The date at which the grantee's performance necessary to earn the equity instruments is complete (that is, the vesting date).

[4] A performance commitment is a commitment under which performance by the grantee to earn the equity instruments is probable because of sufficiently large disincentives for nonperformance. The disincentives must result from the relationship between the grantor and the grantee. Forfeiture of the equity instruments as the sole remedy in the event of the grantee's nonperformance is not considered a sufficiently large disincentive for purposes of applying the guidance. In addition, the ability to sue for nonperformance, in and of itself, does not represent a sufficiently large disincentive to ensure that performance is probable. (A granting entity may always be able to sue for nonperformance but it is not always clear whether any significant damages would result.)

[5] See Footnote 4.

Measurement Before the Measurement Date

130. In accordance with other accounting guidance, it may be appropriate for an issuer to recognize costs related to share-based payment transactions with non-employees before a measurement date has occurred:

a. If the quantity and terms of the equity instruments are known up front, the equity instruments shall be measured at their then-current fair values at each interim financial reporting date.

b. If the quantity and terms of the equity instruments are not known up front, and the transaction is only impacted by market conditions, the equity instruments shall be measured at their then-current fair values at each interim financial reporting date.

c. If the quantity and terms of the equity instruments are not known up front, and the transaction is only impacted by counterparty performance conditions or both market conditions and counterparty performance conditions, the equity instruments shall be measured at their then-current *best estimate of the possible outcomes. When no amount within a range can be deemed a better estimate, then the midpoint of the range shall be used.*

Measurement at the Measurement Date – Transactions Involve Only Market Conditions

131. The quantity or terms of an equity instrument may be dependent only on market conditions. If, on the measurement date, the quantity or any of the terms of the equity instruments are dependent on the achievement of market conditions, then the issuer shall use the fair value of the equity instruments for recognition purposes. That fair value shall be calculated as the fair value of the equity instruments without regard to the market condition plus the fair value of the issuer's commitment to change the quantity or terms of the equity instruments based on whether the market condition is met.

132. As it relates to a grantee, if on the measurement date the quantity or any of the terms of the equity instrument are dependent on the achievement of a market condition, then the grantee shall measure revenue based on the fair value of the equity instruments inclusive of the adjustment provisions. That fair value would be calculated as the fair value of the equity instruments without regard to the market condition plus the fair value of the commitment to change the quantity or terms of the equity instruments if the market condition is met. That is, the existence of a market condition that, if achieved, results in an adjustment to an equity instrument generally affects the value of the instrument. Pricing models have been adapted to value many of those path-dependent equity instruments.

133. The quantity or terms of an equity instrument may be dependent on counterparty performance conditions. If, on the measurement date, the quantity or any of the terms of the equity instruments are dependent on the achievement of counterparty performance conditions that, based on the different possible outcomes, result in a range of aggregate fair values for the equity instruments as of that date, then the issuer should utilize the *best estimate* (that is, the variable terms times the applicable number of equity instruments) amount within that range for recognition purposes. *When no amount within the range can be deemed a better estimate, then the midpoint of the range shall be used*. The amount may be zero *only if zero is determined to be the best estimate*. This guidance also applies if the quantity or terms of an equity instrument is dependent on both market conditions and counterparty performance conditions.

Subsequent Measurement

134. After the issuer measures the then-current fair value of the issuer's commitment related to the market condition as described in paragraph 131, the issuer shall, to the extent necessary, recognize and

classify future changes in the fair value of this commitment in accordance with any relevant accounting guidance on financial instruments.

135. Paragraph 133 provides measurement date guidance on the measurement of transactions that involve counterparty performance conditions. As each quantity and term become known and until all the quantities and terms that stem from the counterparty's performance become known, the best estimate or midpoint aggregate fair value measured pursuant to the guidance in that paragraph shall be adjusted, to reflect additional cost of the transaction, using the modification accounting methodology described in paragraphs 72-73. That is, the adjustment shall be measured at the date of the revision of the quantity or terms of the equity instruments as the difference between the then-current fair value of the revised instruments utilizing the then-known quantity or term and the then-current fair value of the old equity instruments immediately before the quantity or term becomes known. The then-current fair value is calculated using the assumptions that result in the *best estimate or midpoint* aggregate fair value (in accordance with paragraph 133) if the quantity or any other terms remain unknown.

136. Paragraph 133 also provides measurement date guidance on the measurement of transactions that involve both market conditions and counterparty performance conditions. Through the date the last performance-related condition is resolved, the issuer shall apply modification accounting (paragraphs 72-73) for the resolution of both counterparty performance conditions and market conditions. If, at the time the last counterparty performance-related condition is resolved, any market conditions remain, then the issuer shall measure the then-current fair value of the issuer's commitment to issue additional equity instruments or change the terms of the equity instruments based on whether the market condition is met. This measured amount is an additional cost of the transaction. After the issuer measures the then-current fair value of the issuer's commitment related to the market condition, the issuer shall, to the extent necessary, recognize and classify future changes in the fair value of this commitment in accordance with any relevant accounting literature on financial instruments.

137. Paragraph 128 addresses the situation in which an entity grants fully vested, nonforfeitable equity instruments with terms that provide for potential acceleration of exercisability and establishes that the grantor shall measure the fair value of the equity instruments at the date of grant and shall recognize that measured cost in the same period(s) and in the same manner as if the grantor had paid cash. For these situations, if, after the arrangement date, the grantee performs as specified and exercisability is accelerated, the grantor shall record incremental cost measured at the date of the revision of the terms of the equity instruments (that is, the acceleration date) as the difference between the then-current fair value of the revised instruments utilizing the accelerated exercisability date and the then-current fair value of the old equity instruments immediately before exercisability is accelerated. If the only change in the terms of the equity instruments is the acceleration of exercisability, the application of this methodology will only result in a significant additional charge if the expected dividend on the underlying instrument exceeds the sum of the effect of discounting the exercise price and the loss of time value (exclusive of the effect of discounting the exercise price) resulting from the early exercise of the equity instrument.

Subsequent Measurement – Grantee Accounting

138. A grantee may be party to an arrangement in which the terms of the equity instruments are subject to adjustment after the measurement date. Paragraphs 139-140 address transactions in which any of the terms of the equity instruments are subject to adjustment after the measurement date (that is, the terms of the equity instrument are subject to adjustment based on performance above the level committed to in a performance commitment, performance after the instrument is earned, or market conditions) and how the grantee shall account for an increase in fair value as a result of an adjustment (upon resolution of the contingency after the measurement date) as revenue.

139. If, on the measurement date, the quantity or any of the terms of the equity instruments are dependent on the achievement of grantee performance conditions (beyond those conditions for which a performance commitment exists), then changes in fair value of the equity instrument that result from an

adjustment to the instrument upon the achievement of a performance condition shall be measured as additional revenue from the transaction using a methodology consistent with modification accounting described in paragraphs 72-73. That is, the adjustment shall be measured at the date of the revision of the quantity or terms of the equity instrument as the difference between the then-current fair value of the revised instruments utilizing the then-known quantity and terms and the then-current fair value of the old equity instruments immediately before the adjustment.

140. Changes in fair value of the equity instruments after the measurement date unrelated to the achievement of performance conditions shall be accounted for in accordance with any relevant guidance on the accounting and reporting for investments in equity instruments.

Disclosures - Non-Employee Share Based Payment

141. An entity (grantor) that acquires goods or services other than employee services in share-based payment transactions shall provide disclosures similar to those required by paragraphs 103-104 to the extent that those disclosures are important to an understanding of the effects of those transactions on the financial statements. These disclosures, if applicable, are for annual audited statutory financial statements only.

142. An entity (grantee) shall disclose, in each period's financial statements, the amount of gross operating revenue recognized as a result of nonmonetary transactions addressed within this statement. These disclosures, if applicable, are for annual audited statutory financial statements only.

Relevant Literature

~~115.~~143. This statement adopts, with modification, GAAP guidance regarding stock options and stock purchase plans reflected in *Topic 718: Compensation – Stock Compensation, as amended by ASU 2010-13, Compensation – Stock Compensation (Topic 18): Effect of Denominating the Exercise Price of a Share-Based Payment Award in the Current of the Market in Which the Underlying Equity Security Trades*, with the exception of FASB Codification *Subtopic 718-40: Employee Stock Ownership Plans*. Statutory guidance on employee stock ownership plans is provided in *SSAP No. 12—Employee Stock Ownership Plans*. This adoption with modification includes the related implementation guidance reflected within the FASB Codification Topic 718, not reflected within this standard. Modifications to the adopted GAAP guidance are as follows:

a. GAAP references are revised to reference applicable statutory accounting guidance;

b. GAAP reporting line items (either explicitly provided in the statement or adopted by reference – such as the GAAP implementation guidance) shall be replaced to reference applicable statutory annual statement line items. (For example, GAAP references to "other comprehensive income" shall be reflected within "Surplus - Unassigned Funds").

c. GAAP guidance to calculate earnings per share is not applicable to statutory accounting and has not been included within the statement.

d. GAAP effective date and transition, and transition disclosures have not been incorporated. Reporting entities shall follow the effective date and transition elements provided within this statement.

e. Inclusion of guidance specific to statutory for consolidated/holding company plans.

144. This statement adopts, with modification, GAAP guidance regarding the exchange of equity instruments for goods or services with non-employees as reflected *in Subtopic 505-50 – Equity, Equity-Payments to Non-Employees*. Modifications to this adopted GAAP guidance are as follows:

a. Prepaid assets are nonadmitted.

b. Costs for goods and services shall be recognized when the goods or services are received consistent with other statutory accounting principles.

c. Minimum value method for determining fair value is rejected for all entities.

d. Estimates of expected costs for the exchange of equity instruments dependent on market conditions or performance obligations shall be determined based on the best estimate of fair values. If a better estimate cannot be determined, then the midpoint (rather than the lowest amount) of aggregate fair values within the range shall be used.

e. GAAP references are revised to reference applicable statutory accounting guidance.

~~116.~~145. The adoption, with modification, of FASB Codification Topic 718 and Subtopic 505-50 detailed in paragraphs ~~115~~143-144 also reflects adoption, with modification, of the following pre-codification GAAP standards:

a. *FAS 123R, Share-Based Payment* (FAS 123R);

b. *FAS 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity* (FAS 150) – (Adopted only to the extent referenced in FAS 123R for classifying instruments as equity or liability for application in this statement. Adopted guidance is reflected in Appendix A);

c. *FASB Staff Position FAS 123(R)-1: Classification and Measurement of Freestanding Financial Instruments Originally issued in Exchange for Employee Services under FASB Statement No. 123(R)* (FAS 123R-1);

d. *FASB Staff Position (FSP) FAS 123(R)-2: Practical Accommodation to the Application of Grant Date as Defined in FASB Statement No. 123(R)* (FSP FAS 123R-2);

e. *FASB Staff Position (FSP) FAS123(R)-4: Classification of Options and Similar Instruments Issued as Employee Compensation That Allow for Cash Settlement upon the Occurrence of a Contingent Event* (FSP FAS 123R-4);

f. *FASB Staff Position (FSP) FAS 123(R)-5: Amendment of FASB Staff Position FAS 123R-1* (FSP FAS 123R-5);

g. *FASB Staff Position (FSP) FAS 123(R)-6: Technical Corrections of FASB Statement No. 123(R)* (FSP FAS 123R-6);

h. *FASB Emerging Issues Task Force 96-18: Accounting for Equity Instruments That are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling Goods or Services.*

~~h.~~i. *FASB Emerging Issues Task Force 97-14: Accounting for Deferred Compensation Arrangements Where Amounts Earned Are Held in a Rabbi Trust and Invested* (EITF 97-14);

j. *FASB Emerging Issues Task Force 00-08: Accounting by a Grantee for an Equity Instrument to Be Received in Conjunction with Providing Goods or Services.*

~~i.~~k. *FASB Emerging Issues Task Force 00-16: Recognition and Measurement of Employer Payroll Taxes on Employee Stock-Based Compensation* (EITF 00-16);~~ and~~

l. *FASB Emerging Issues Task Force 00-18: Accounting Recognition for Certain Transactions Involving Equity Instruments Granted to Other Than Employees*; and~~.~~

~~j.~~m. *FASB Technical Bulletin 97-01, Accounting under Statement 123 for Certain Employee Stock Purchase Plans with a Look-Back Option* (TB 97-01).

~~117.~~146. The adoption, with modification of FASB Codification Topic 718 in this statement reflects rejection of the following pre-codification GAAP standards:

a. *FASB Staff Position (FSP) FAS 123(R)-3: Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards* (FSP FAS 123R-3); and

b. *FASB Staff Position (FSP) EITF 03-6-1; Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities* (FSP EITF 03-6-1),.

Effective Date and Transition

~~118.~~147. This statement shall be effective prospectively (paragraph 119) for years beginning January 1, 2013, with interim and annual financial reporting thereafter. The cumulative effect of initially applying this statement, if any, shall be recognized as of the required effective date as a change in accounting principle under SSAP No. 3. Early adoption is permitted for December 31, 2012, financial statements, with interim and annual reporting thereafter.

~~119.~~148. Reporting entities with existing share-based payment instruments that applied the guidance contained in *SSAP No. 13—Stock Options and Stock Purchase Plans* (SSAP No. 13) shall apply the requirements of the adopted SSAP No. 104 prospectively to new awards and to awards modified, repurchased, or cancelled after the required effective date. Those reporting entities shall continue to account for any portion of awards outstanding at the date of initial application using the accounting principles originally applied to those awards (SSAP No. 13).

149. The substantive revisions to this statement to incorporate guidance for share-based payment transactions for non-employees, reflected predominantly in paragraphs 115-142, are effective prospectively initially for years ending December 31, 2014. The cumulative effect of initially applying this statement, if any, shall be recognized as of the required effective date as a change in accounting principle under *SSAP No. 3—Accounting Changes and Corrections of Errors* (SSAP No. 3).

REFERENCES

Other

- *SSAP No. 12—Employee Stock Ownership Plans*

Relevant Issue Papers

- *Issue Paper No. 129—Share-Based Payment, A Replacement of SSAP No. 13*

- *Issue Paper No. 146— Share-Based Payments With Non-Employees*

APPENDIX A: Classification Criteria: Liability or Equity

Classification Criteria

1. As detailed in paragraph 14 of the statement, an entity shall apply the classification criteria detailed in paragraphs 14-27 in the statement, as they are effective at the reporting date, in determining whether to classify as a liability a freestanding financial instrument given to an employee in a share-based payment transaction.

2. The guidance in this Section shall be applied to a freestanding financial instrument in its entirety. Any nonsubstantive or minimal features shall be disregarded in applying the classification provisions of this Section. Judgment, based on consideration of all the terms of an instrument and other relevant facts and circumstances, is necessary to distinguish substantive, nonminimal features from nonsubstantive or minimal features.

Mandatorily Redeemable Financial Instruments

3. A mandatorily redeemable financial instrument shall be classified as a liability unless the redemption is required to occur only upon the liquidation or termination of the reporting entity.

4. A financial instrument that embodies a conditional obligation to redeem the instrument by transferring assets upon an event not certain to occur becomes mandatorily redeemable if that event occurs, the condition is resolved, or the event becomes certain to occur.

5. In determining if an instrument is mandatorily redeemable, all terms within a redeemable instrument shall be considered. The following items do not affect the classification of a mandatorily redeemable financial instrument as a liability:

a. A term extension option

b. A provision that defers redemption until a specified liquidity level is reached

c. A similar provision that may delay or accelerate the timing of a mandatory redemption.

6. If a financial instrument will be redeemed only upon the occurrence of a conditional event, redemption of that instrument is conditional and, therefore, the instrument does not meet the definition of mandatorily redeemable financial instrument in this statement. However, that financial instrument would be assessed at each reporting period to determine whether circumstances have changed such that the instrument now meets the definition of a mandatorily redeemable instrument (that is, the event is no longer conditional). If the event has occurred, the condition is resolved, or the event has become certain to occur, the financial instrument is reclassified as a liability.

Obligations to Repurchase Issuer's Equity Shares by Transferring Assets

7. An entity shall classify as a liability (or an asset in some circumstances) any financial instrument, other than an outstanding share, that, at inception, has both of the following characteristics:

a. It embodies an obligation to repurchase the issuer's equity shares, or is indexed to such an obligation, and~~.~~

b. It requires or may require the issuer to settle the obligation by transferring assets.

8. In this statement, "indexed to" is used interchangeably with "based on variations in the fair value of." The phrase "requires or may require" encompasses instruments that either conditionally or

unconditionally obligate the issuer to transfer assets. If the obligation is conditional, the number of conditions leading up to the transfer of assets is irrelevant.

9. Examples of financial instruments that meet the criteria in paragraph 7 of Appendix A include forward purchase contracts or written put options on the issuer's equity shares that are to be physically settled or net cash settled.

10. All obligations that permit the holder to require the issuer to transfer assets result in liabilities, regardless of whether the settlement alternatives have the potential to differ.

11. Certain financial instruments that embody obligations that are liabilities within the scope of this statement also may contain characteristics of assets but be reported as single items. Some examples include the following:

a. Net-cash-settled or net-share-settled forward purchase contracts.

b. Certain combined options to repurchase the issuer's shares.

Those instruments are classified as assets or liabilities initially or subsequently depending on the instrument's fair value on the reporting date.

12. An instrument that requires the issuer to settle its obligation by issuing another instrument (for example, a note payable in cash) ultimately requires settlement by a transfer of assets, accordingly:

a. When applying paragraphs 7-11 of Appendix A, this also would apply for an instrument settled with another instrument that ultimately may require settlement by a transfer of assets (warrants for puttable shares).

b. It is clear that a warrant for mandatorily redeemable shares would be a liability under this statement.

Certain Obligations to Issue a Variable Number of Shares

13. A financial instrument that embodies an unconditional obligation, or a financial instrument other than an outstanding share that embodies a conditional obligation, that the issuer must or may settle by issuing a variable number of its equity shares shall be classified as a liability (or an asset in some circumstances) if, at inception, the monetary value of the obligation is based solely or predominantly on any one of the following:

a. A fixed monetary amount known at inception (for example, a payable settleable with a variable number of the issuer's equity shares),

b. Variations in something other than the fair value of the issuer's equity shares (for example, a financial instrument indexed to the Standard and Poor's S&P 500 Index and settleable with a variable number of the issuer's equity shares), or

c. Variations inversely related to changes in the fair value of the issuer's equity shares (for example, a written put option that could be net share settled).

Prohibition on Combining Freestanding Financial Instruments

14. A freestanding financial instrument that is within the scope of this statement shall not be combined with another freestanding financial instrument in applying paragraphs 3-13 of Appendix A. For example, a freestanding written put option that is classified as a liability under this statement shall not be combined with an outstanding equity share.

Distinguishing Liability from Equity – Scope and Scope Exclusions

15. The guidance in paragraphs 14-27 of this statement applies to any freestanding financial instrument, including one that has any of the following attributes:

a. Comprises more than one option or forward contract, or

b. Has characteristics of both a liability and equity and, in some circumstances, also has characteristics of an asset (for example, a forward contract to purchase the issuer's equity shares that is to be net cash settled). Accordingly, this statement does not address an instrument that has only characteristics of an asset.

For example, an instrument that consists of a written put option for an issuer's equity shares and a purchased call option and nothing else is a freestanding financial instrument. That freestanding financial instrument embodies an obligation to repurchase the issuer's equity shares and is subject to the requirements of this statement.

APPENDIX B: Disclosure Information

1. The following list indicates the minimum information needed to achieve the objectives in paragraph 103 and 141 and illustrates how the disclosure requirements might be satisfied. In some circumstances, an entity may need to disclose information beyond the following to achieve the disclosure objectives:

a. A description of the share-based payment arrangement(s), including the general terms of awards under the arrangement(s), such as:

i. The requisite service period(s) and any other substantive conditions (including those related to vesting)

ii. The maximum contractual term of equity (or liability) share options or similar instruments

iii. The number of shares authorized for awards of equity share options or other equity instruments.

b. The method it uses for measuring compensation cost from share-based payment arrangements with employees.

c. For the most recent year for which an income statement is provided, both of the following:

i. The number and weighted-average exercise prices (or conversion ratios) for each of the following groups of share options (or share units):

(a) Those outstanding at the beginning of the year

(b) Those outstanding at the end of the year

(c) Those exercisable or convertible at the end of the year

(d) Those that during the year were:

(1) Granted

(2) Exercised or converted

(3) Forfeited

(4) Expired.

ii. The number and weighted-average grant-date fair value (or calculated value for an entity that uses that method or intrinsic value for awards measured pursuant to paragraph 49) of equity instruments not specified in (c)(1), for all of the following groups of equity instruments:

(a) Those nonvested at the beginning of the year

(b) Those nonvested at the end of the year

(c) Those that during the year were:

(1) Granted

(2) Vested

(3) Forfeited.

d. For each year for which an income statement is provided, both of the following:

i. The weighted-average grant-date fair value (or calculated value for an entity that uses that method or intrinsic value for awards measured at that value pursuant to paragraphs 49-50) of equity options or other equity instruments granted during the year, and

ii. The total intrinsic value of options exercised (or share units converted), share-based liabilities paid, and the total fair value of shares vested during the year.

e. For fully vested share options (or share units) and share options expected to vest at the date of the latest statement of financial position, both of the following:

i. The number, weighted-average exercise price (or conversion ratio), aggregate intrinsic value, and weighted-average remaining contractual term of options (or share units) outstanding, and

ii. The number, weighted-average exercise price (or conversion ratio), aggregate intrinsic value, and weighted-average remaining contractual term of options (or share units) currently exercisable (or convertible).

f. For each year for which an income statement is presented, both of the following (An entity that uses the intrinsic value method pursuant to paragraphs 49-50 is not required to disclose the following information for awards accounted for under that method):

i. A description of the method used during the year to estimate the fair value (or calculated value) of awards under share-based payment arrangements, and

ii. A description of the significant assumptions used during the year to estimate the fair value (or calculated value) of share-based compensation awards, including (if applicable):

(a) Expected term of share options and similar instruments, including a discussion of the method used to incorporate the contractual term of the instruments and employees' expected exercise and postvesting employment termination behavior into the fair value (or calculated value) of the instrument.

(b) Expected volatility of the entity's shares and the method used to estimate it. An entity that uses a method that employs different volatilities during the contractual term shall disclose the range of expected volatilities used and the weighted-average expected volatility. An entity that uses the calculated value method shall disclose the reasons why it is not practicable for it to estimate the expected volatility of its share price, the appropriate industry sector index that it has selected, the reasons for selecting that particular index, and how it has calculated historical volatility using that index.

(c) Expected dividends. An entity that uses a method that employs different dividend rates during the contractual term shall disclose the range of expected dividends used and the weighted-average expected dividends.

(d) Risk-free rate(s). An entity that uses a method that employs different risk-free rates shall disclose the range of risk-free rates used.

(e) Discount for post-vesting restrictions and the method for estimating it.

g. An entity that grants equity or liability instruments under multiple share-based payment arrangements with employees shall provide the information specified in paragraph (a) through (f) separately for different types of awards to the extent that the differences in the characteristics of the awards make separate disclosure important to an understanding of the entity's use of share-based compensation. For example, separate disclosure of weighted-average exercise prices (or conversion ratios) at the end of the year for options (or share units) with a fixed exercise price (or conversion ratio) and those with an indexed exercise price (or conversion ratio) could be important. It also could be important to segregate the number of options (or share units) not yet exercisable into those that will become exercisable (or convertible) based solely on fulfilling a service condition and those for which a performance condition must be met for the options (share units) to become exercisable (convertible). It could be equally important to provide separate disclosures for awards that are classified as equity and those classified as liabilities. In addition, an entity that has multiple share-based payment arrangements with employees shall disclose information separately for different types of awards under those arrangements to the extent that differences in the characteristics of the awards make separate disclosure important to an understanding of the entity's use of share-based compensation.

h. For each year for which an income statement is presented, both of the following:

i. Total compensation cost for share-based payment arrangements

(a) Recognized in income as well as the total recognized tax benefit related thereto

(b) Capitalized as part of the cost of an asset.

ii. A description of significant modifications, including:

(a) The terms of the modifications,

(b) The number of employees affected,

(c) The total incremental compensation cost resulting from the modifications.

i. As of the latest balance sheet date presented, the total compensation cost related to nonvested awards not yet recognized and the weighted-average period over which it is expected to be recognized.

j. If not separately disclosed elsewhere, the amount of cash received from exercise of share options and similar instruments granted under share-based payment arrangements and the tax benefit realized from stock options exercised during the annual period.

k. If not separately disclosed elsewhere, the amount of cash used to settle equity instruments granted under share-based payment arrangements.

l. A description of the entity's policy, if any, for issuing shares upon share option exercise (or share unit conversion), including the source of those shares (that is, new shares or treasury shares). If as a result of its policy, an entity expects to repurchase shares in the following annual period, the entity shall disclose an estimate of the amount (or a range, if more appropriate) of shares to be repurchased during that period.

2. In addition to the information required by this statement, an entity may disclose supplemental information that it believes would be useful to investors and creditors, such as a range of values calculated on the basis of different assumptions, provided that the supplemental information is reasonable and does not lessen the prominence and credibility of the information required by this statement. The alternative assumptions shall be described to enable users of the financial statements to understand the basis for the supplemental information.

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Issue Paper No. 147

Working Capital Finance Investments

STATUS
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Original SSAP and Current Authoritative Guidance: SSAP No. 105

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Common Area

SUMMARY OF ISSUE

1. This issue paper establishes statutory accounting principles for working capital finance investments held by reporting entities. This issue paper amends *SSAP No. 20—Nonadmitted Assets* (SSAP No. 20) to allow working capital finance investments as admitted assets to the extent they conform to the requirements of this issue paper.

SUMMARY CONCLUSION

2. Working capital finance investments represent a confirmed short-term obligation[1] to pay a specified amount owed by one party (the obligor) to another (typically a supplier of goods), generated as a part of a working capital finance investment program currently designated by the NAIC Securities Valuation Office. Pursuant to the working capital finance investment program, this short-term obligation has been transferred by the entity entitled to payment (typically a supplier of goods) to a third party investor.

3. Working capital finance investments held by a reporting entity represent a right for the reporting entity to receive future payment. This issue paper provides accounting and reporting guidelines for the right to receive payment under working capital finance programs that meet particular criteria working capital finance program that meet particular criteria.

Working Capital Finance Program - Definitions and Conditions

4. A "working capital finance program" is an open account program under which an investor may purchase interests, or evidence thereof, in commercial non-insurance receivables. A working capital finance program is created for the benefit of a commercial investment-grade obligor and its suppliers of goods or services, and facilitated by a finance agent.

5. A working capital finance program transfers a right to payment to an investor from a short-term obligation and arises from transactions among:

a. a buyer of goods or services that becomes an obligor to the supplier of goods or services,

b. the supplier(s) of those goods or services,

c. a finance agent , and

d. an investor.

[1] All references to short-term obligations in this issue paper refer to obligations not exceeding one year.

6. A "working capital finance investment" is an interest in payment(s) from a confirmed supplier receivable issued pursuant to a working capital finance program. The payment (maturity) date must not exceed one year from the date of invoice from the supplier to the obligor. This investment is created when the investor purchases from a working capital finance program that is currently designated as NAIC "1" or "2" by the NAIC Securities Valuation Office, any of the following:

a. One or more confirmed supplier receivables;

b. in case of a participation, a participation interest in one or more confirmed supplier receivables issued by the finance agent or lead lender holding confirmed supplier receivables; or

c. a certificate, note or other interest manifestation, documented in a way that is verifiable by regulators, representing a legally enforceable interest in a right to payment from a trust, other special purpose entity or pool holding confirmed supplier receivables.

7. "Obligor" is the party that purchases the goods or services that generates the original supplier receivable (and payable for the Obligor). The obligor must be a single entity, which has an NAIC designation of "1" or "2" or a Credit Rating Provider equivalent. The obligor must confirm the supplier receivable described in paragraph 11 as described in the confirmation process in paragraphs 12-14.

8. "Supplier" is the party that sells the goods or services to the obligor. The supplier sells the confirmed supplier receivables in accordance with the terms of the working capital finance program designated by the NAIC Securities Valuation Office at a price agreed to by the finance agent and/or investor.

9. "Investor" is the party purchasing a working capital finance investment in accordance with the terms of the working capital finance program designated by the NAIC Securities Valuation Office.

10. The "finance agent" is a bank, financial institution, other financial intermediary, or service provider that facilitates the working capital finance program, arranges the sale, assignment or transfer of the confirmed supplier receivable to the investor for a fee and administers the payment mechanism. In the case of participation, the finance agent must inform the reporting entity investor of a default or event of default as soon as it becomes aware of such default or event of default. For the working capital finance program to qualify under this SSAP, the finance agent must meet the requirements of either paragraph 10.a. or 10.b.:

a. The finance agent is directly regulated by, or falls under the supervision of, a financial regulator of its domiciliary country provided that such country appears on the *Purposes and Procedures Manual of the NAIC Securities Valuation Office* List of Jurisdictions Eligible for Netting and that the Securities Valuation Office determines that the regulator is the functional equivalent of the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, or the Federal Deposit Insurance Corporation; or

b. Payments from the obligor must 1) be paid directly to the reporting entity (investor) and cannot flow through the finance agent and 2) there can be no commingling of payments or assets with those of the obligor, supplier, servicer or trust administrator or other investors.

11. A "confirmed supplier receivable" is a first priority perfected security interest or right to payment a monetary obligation from the obligor arising from the sale of goods or services from the supplier to the obligor the payment of which has been confirmed by the obligor committing and stating that the obligations under the agreement and any payment shall not be affected by the invalidity, unenforceability,

existence, performance or non-performance of the underlying commercial trade transaction or any related contract or undertaking nor that it will not protest, delay, or deny, nor offer nor assert any defenses, personal or otherwise, against payment to the supplier or any party taking claims, interests, or rights to payments made by the supplier.

a. The confirmed supplier receivable must be sold, assigned or otherwise transferred in a manner that results in an absolute, irrevocable and legally enforceable obligation that has been confirmed by the Obligor.

b. In the case of a participation, the certificates or other evidence of participation provide an absolute, irrevocable, and legally enforceable obligation of the finance agent or holder of the confirmed supplier receivable to pay to the reporting entity investor all of the amounts due to it under the confirmed supplier receivable, without reduction or delay arising from any claims that the finance agent may have against the reporting entity investor. The reporting entity investor's ability to exercise its rights as creditor, or to direct the finance agent to exercise the rights of a creditor on its behalf, shall not be subject to the discretion of the finance agent or other lenders or investors. The reporting entity investor's ability to exercise its rights as creditor, or to direct the finance agent to exercise the rights of a creditor on its behalf, shall not be subject to, other than during a cure period not to exceed thirty days, the discretion of the finance agent or other lenders or investors.

Confirmation Process

12. In the case of a purchase, the investor shall verify, prior to the sale that the obligor has confirmed the respective amounts, payment dates and related invoice numbers' specified dates and has waived all defenses to payment. in the case of a participation, the finance agent must verify that the obligor has confirmed the respective amounts, payment dates and related invoice numbers' specified due dates, and has waived all defenses to payment in accordance with the confirmation process.

13. The obligor must commit and state that upon confirmation of a supplier receivable it is obligated to pay to the investor, the finance agent, or any third party acting as agent or trustee for the investor, a sum equal to the full amount of that confirmed supplier receivable(s) on a date certain stated in the confirmation and that it waives any right of setoff or other defenses to avoid or delay the full and timely payment of such confirmed supplier receivable. The documents establishing the working capital finance program or the confirmation must state and confirm that the obligation to pay must be independent of any other contracts or claims that might be raised in defense arising from any transaction financed in connection with the WCFP, the confirmed supplier receivable, or any other courses of performance or courses of dealing with the supplier.

14. In the case of participation, the investor must certify that it has a commercially reasonable belief that its participation interest meets the Uniform Commercial Code's standards for creating and preserving first priority security interests in the payments due and in the confirmed supplier receivables. Commercially reasonable belief shall mean the SVO deems the investor's belief reasonable in light of the systems, policies, or practices commonly recognized in the field of investing in participations. The investor must be able to demonstrate to a regulator or to the SVO, upon either's request, the basis for its commercially reasonable belief that the WCFP creates and preserves the investor's ability to enforce a first priority perfected security interest in the confirmed supplier receivables.

15. In the case of a certificate, note, or other manifestation, capable of verification, representing a right to payment from a trust, other special purpose entity, or special purpose pool holding confirmed supplier receivables, the investor must certify that it has a commercially reasonable belief that the documents establishing and governing the working capital finance program create and preserve interests in the confirmed supplier receivables capable of being enforced by the trustee or other entity holding confirmed supplier receivables as first priority perfected security interests under the Uniform Commercial

Code. The investor must be able to demonstrate the basis for such belief to a regulator or to the SVO upon either's request. Commercially reasonable belief shall mean the SVO deems the investor's belief reasonable in light of the systems, policies, and practices commonly recognized in the field of investing in securitizations, loan backed, structured, or trust-issued securities.

Program Requirements

16. The Working Capital Finance Program investor must provide in its annual filing with the Securities Valuation Office an annual audit of the consolidated financial statements of the group of which the finance agent is part, which does not report any qualifications related to servicing, and one of the following:

a. An annual independent report according to Statement on Standards for Attestation Engagements (SSAE) No. 16, reporting on controls at a service organization related to the administration of the investment; or

b. An annual audit of the internal controls of the consolidated group of which the finance agent is part, which does not note any material weaknesses related to servicing.

The NAIC Securities Valuation Office would review the materiality of the report findings in making their determination of the assignment of a designation.

17. If the credit rating of the working capital finance program or obligor falls to non-investment grade (below the equivalent of NAIC designation "1" or "2"), the reporting entity shall nonadmit the working capital finance investments obtained under the related working capital finance program and/or the related obligor. Due to the short-term nature of these investments, once an investment is nonadmitted due to the credit rating of the working capital finance program or the obligor, those investments will continue to be nonadmitted.

18. Reporting entity investors must have the ability to monitor the working capital finance program and the credit-related activities of the obligor. Reporting entity investors must provide information as requested to the state of domicile indicating that they have the ability to monitor on an ongoing basis the activities of the working capital finance program. Initial permission to invest in Working Capital Finance Investment Programs may be required from the domiciliary commissioner.

19. All contracts or agreements that are a part of or that together constitute a working capital finance program must provide that if a dispute arises among any of the parties under any of the contracts or agreements that are a part of or that together constitute the working capital finance program, each party agrees that the dispute will be submitted to a court of competent jurisdiction in the United States or a constituent state thereof or of an alternative dispute resolution process recognized thereby. All contracts or agreements that are a part of or that together constitute a working capital finance program must provide that any dispute arising under any of the contracts or agreements that are a part of or that together constitute the working capital finance program must be resolved pursuant to the laws of the United States or a constituent state thereof that address the substance of the dispute but excluding those laws addressing conflicts of law.

Exclusions

20. A working capital finance investment excludes any receivables financed through:

a. Factoring: the purchase of receivables in bulk from a supplier where the receivables represent the payment obligations of potentially thousands of buyers to a single supplier, in which the buyers have no relationship with or contractual obligation to pay the factor and retain all legal defenses to payment they may have against the supplier;

b. Forfaiting: the purchase of one or a series of receivables from exporters by a forfaiter to enable the exporter (seller) to finance a commercial transaction with a buyer in which the Obligor has no relationship with or contractual obligation to pay the forfaiter and retains all legal defenses to pay it may have against the seller;

c. Invoice discounting: the advancement of funds by a finance company to a business entity with the funds advanced limited to a defined percentage of the business entity's eligible and outstanding receivables.

21. Eligible Confirmed Supplier Receivables must not:

a. Include insurance or insurance related assets;

b. Be impaired or in default at the time of purchase;

c. Have a payment (maturity) date longer than one year from the date of the invoice from the Supplier to the Obligor giving rise to the confirmed supplier receivable, and the maturity date must not be subject to change or rolling; nor

d. Include any receivable of any parent or affiliate of the reporting entity investor, and neither the Obligor nor any Supplier may be affiliated with the reporting entity investor. Working Capital Finance Investments that have obligors or vendors that are affiliated with the investor are ineligible, and therefore, nonadmitted assets.

ACCOUNTING AND REPORTING

22. The right to receive payment generated by a working capital finance investment issued under a working capital finance program is considered to meet the definition of an asset as defined in *SSAP No. 4—Assets and Nonadmitted Assets*, and is an admitted asset to the extent the investment conforms to the requirements of this issue paper and the *Purposes and Procedures Manual of the NAIC Securities Valuation Office*. For programs that comply with all of these elements, working capital finance investments shall be valued and reported in accordance with this issue paper, the *Purposes and Procedures Manual of the NAIC Securities Valuation Office*, and the designation assigned in the NAIC Valuations of Securities product. Programs that do not comply with the elements in this Issue Paper are nonadmitted. Working Capital Finance Investments are reported as other invested assets in the financial statements.

23. A Working Capital Finance Investment shall be recorded on the trade date. At acquisition, the Working Capital Finance Investment shall be initially reported at cost, excluding brokerage and other related fees, and all other costs (internal costs, or costs paid for origination, purchase or commitment to purchase such investments), which shall be expensed as incurred.

24. After initial acquisition, the Working Capital Finance Investment shall be reported at amortized cost until the specified maturity date, unless the investment, or a portion thereof, is deemed to be uncollectible or when an other-than-temporary impairment has occurred. In the event that a working capital finance investment is purchased by a reporting entity investor at a premium (amount to be received by the entity under the confirmed supplier receivable is less than the price paid for the investment), the excess paid by the reporting entity investor in comparison to the amount receivable under the confirmed supplier receivable must be immediately expensed.

25. For reporting entities required to maintain an Interest Maintenance Reserve (IMR), the accounting for realized capital gains and losses from working capital finance investments shall be in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve* (SSAP No. 7). For reporting entities not required to maintain an IMR, realized gains and losses from working capital finance investments shall be reported as net realized capital gains or losses in the statement of income.

For reporting entities not required to maintain an AVR, unrealized gains and losses shall be recorded as a direct credit or charge to unassigned funds (surplus).

26. A Working Capital Finance Investment may provide for a prepayment penalty or acceleration fee in the event the working capital finance investment is liquidated prior to its scheduled termination date. Such fees shall be reported as investment income when received.

27. *SSAP No. 34—Investment Income Due and Accrued* shall be followed for determining and recording investment income earned on working capital finance investments acquired at a discount. In accordance with *SSAP No. 34—Investment Income Due and Accrued*, investment income shall be reduced for amounts that have been determined to be uncollectible, however amounts more than 15 days overdue are nonadmitted.

Default

28. A working capital finance investment payment that is uncollected by the reporting entity within fifteen days after the due date shall be considered in default and nonadmitted. If the reporting entity has any other working capital finance investment assets from the same defaulting counterparty, all other working capital finance investments from that counterparty shall be nonadmitted. All working capital finance investments from a counterparty identified in default shall be evaluated for impairment.

Impairment

29. An other-than-temporary impairment INT 06-07 shall be considered to have occurred if it is probable that the reporting entity will be unable to collect all amounts due according to the contractual terms of a confirmed supplier receivable, including the payment on the established due date. Pursuant to this guidance, assessment of other-than-temporary impairment shall include an evaluation of the financial condition and short-term prospects of the obligor. If it is determined that a decline in the fair value of a working capital finance investment below book/adjusted carrying value is due to an other-than-temporary impairment, an impairment loss shall be recognized as a realized loss equal to the entire difference between the working capital finance investment's carrying value and fair value as of the reporting period for which the assessment is made. Fair value shall be determined in accordance with *SSAP No. 100—Fair Value Measurements*, and reflect the price to sell the asset in an orderly market between market participants. As such, the fair value shall reflect the assumptions market participants will use in pricing the asset, including assumptions about risk.

30. For reporting entities required to maintain an AVR/IMR, the entire amount of the realized loss from the other-than temporary impairment shall be recorded through the AVR, in accordance with SSAP No. 7.

31. Upon recognition of an other-than-temporary impairment, the fair value of the working capital finance investment on the measurement date shall become the new cost basis of the working capital finance investment and the new cost basis shall not be adjusted for subsequent recoveries in fair value. Once an investment is determined to be other-than-temporarily impaired, until all expected payments are received, the reporting entity must re-evaluate the investment quarterly and reassess fair value, with recognized realized losses for the difference between the book/adjusted carrying value and the current fair value. This process shall continue until either all expected payments are received, or the entity has recognized a realized loss for the entire uncollected carrying value.

Disclosures

32. The financial statements shall include the following disclosures:

a. Fair value in accordance with *SSAP No. 100—Fair Value Measurements*

b. Concentrations of credit risk in accordance with SSAP No. 27—*Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* (SSAP No. 27) in the annual audited statutory financial reports only.

c. Information regarding the aggregate book/adjusted carrying value of working capital finance investment by designation including gross assets with nonadmitted and net admitted amounts annually. (Note that programs designated 3-6 are nonadmitted.)

	Gross Asset CY	Non-admitted Asset CY	Net Admitted Asset CY
WCFI Designation 1			
WCFI Designation 2			
WCFI Designation 3			
WCFI Designation 4			
WCFI Designation 5			
WCFI Designation 6			
Total			

d. Annual and quarterly information regarding the aggregate book/adjusted carrying value maturity distribution on the underlying working capital finance investments by the following categories: maturities up to 180 days and 181 to 365 days.

e. Any events of default of working capital finance investments during the reporting period.

33. Refer to the preamble for further discussion regarding disclosure requirements.

DISCUSSION

34. Bills receivable in general are an asset class that has been historically nonadmitted by statutory accounting. They were nonadmitted prior to codification and explicitly nonadmitted in *SSAP No. 20—Nonadmitted Assets*.

35. This work was originated by discussions with the Valuation of Securities (E) Task Force. In May 2011, the Statutory Accounting Principles (E) Working Group replied to the Valuation of Securities (E) Task Force regarding a current exposure they had to the *Purposes and Procedures of the Securities Valuation Office*. The Statutory Accounting Principles (E) Working Group indicated that such assets are nonadmitted by statutory accounting and that a more defined and structured program for working capital finance investments would be required before consideration for admitted asset status. The Working Group noted that because bills receivable are explicitly nonadmitted under statutory accounting, a robust discussion was needed.

Date: May 9, 2011
RE: SVO exposure draft of Working Capital Notes.

This memo is to provide brief formal comments on the exposure draft of proposed changes to the Purposes and Procedures Manual of the Securities Valuation Office for Working Capital Notes. It does not provide detailed comments on the proposed wording, at this time. The Statutory Accounting Principles Working Group is willing to hold meetings to learn more about the proposed new invested asset class which are based on bills receivable. Currently under *SSAP No. 20—Nonadmitted Assets* the following are nonadmitted assets.

4. Consistent with paragraph 2, the following assets shall be nonadmitted:

   b. Bills Receivable Not for Premium and Loans Unsecured or Secured by Assets That Do Not Qualify As Investments—In accordance with SSAP No. 5R, amounts determined to be uncollectible or otherwise impaired shall be written off. Amounts in excess of that written off are not considered to be properly collateralized as there are no underlying assets, which would otherwise be admitted assets. Such amounts shall be nonadmitted as they may be of questionable economic value if needed to fulfill policyholder obligations;

According to our preliminary understanding of the proposal, these Working Capital Notes would, in substance, be uncollateralized bills receivable, not for premium, and would be **nonadmitted** under current statutory accounting guidance. Any reporting entity currently investing in these as admitted assets, would need some type of state prescribed or permitted practice to be an admitted asset; this practice would be listed in the annual statement as part of note 1. Formal changes would be needed to the statutory accounting guidance before these could be considered admitted invested assets without a prescribed or permitted practice.

Because bills receivable are explicitly nonadmitted under statutory accounting, we believe a robust discussion is needed. The Working Group urges Valuation of Securities Task Force to delay the adoption of changes to the Purposes and Procedures Manual of the Securities Valuation Office until such time as a comprehensive discussion throughout the solvency framework can occur to fully review and address this proposed new invested asset class. We are also concerned about the potential to have the SVO assign NAIC designation (unless requested by a state) for what is ultimately a nonadmitted asset under the NAIC Accounting Practices and Procedures Manual.

The Statutory Accounting Principles Working Group is planning a call with the company to hear more about the proposed admitted invested assets in May. Because admitting a new invested asset class involves changes in valuation, accounting, reporting and risk based capital, we believe that it is preferable to have a comprehensive proposal submitted by industry to the multiple groups which would be impacted, similar to the type of multi-faceted proposal that was submitted for low income housing tax credits a few years ago. Historically, some of this work has been coordinated by the Invested Assets Working Group, and we would support a referral to that working group for a more robust discussion and coordination between the various relevant working groups and task forces of the proposed new invested assets. Regardless of the outcome of a referral, we urge that the proposed changes to the SVO P&P Manual be delayed until such time as the asset has been comprehensively addressed by Statutory Accounting Principles Working Group, Blanks Working Group and Capital Adequacy Task Force.

The Working Group stands ready to accept a comprehensive proposal on this topic from industry.

36. The Valuation of Securities (E) Task Force and the Invested Assets (E) Working Group both conducted calls on this issue in 2011 and 2012. In addition, the Statutory Accounting Principles (E) Working Group also received a presentation from a finance agent regarding their program.

37. In October 2012, a referral from the Valuation of Securities (E) Task Force recommended consideration of granting Securities Valuation Office designated programs admitted other invested assets status. The referral is excerpted in Appendix A. The referral was based on a New York proposal and also recommended annual statement Schedule BA treatment. If supported, changes will also need to be adopted into the *Purposes and Procedures Manual of the Securities Valuation Office*.

38. Some regulators continued to expressed concerns regarding the ability of smaller entities to monitor the investments in such programs on an ongoing basis. That concern was the basis of the recommendation reflected in the initial draft presented to the Working Group to have department of insurance approval.

39. The October 2012 referral incorporated a statutory accounting request to include information in the filing to the Securities Valuation Office that includes an annual audit of the consolidated financial statements of the finance agent which does not report any qualifications relating to servicing, and one of the following:

> a. An annual independent report according to Statement on Standards for Attestation Engagements (SSAE) No. 16, reporting on controls at a service organization related to the administration of the investment; or
>
> b. An annual audit of the internal controls of the consolidated group of which the finance agent is part, which does not note any material weaknesses related to servicing.

This request was to address internal control risk concerns with regard the program.

40. Capital Adequacy (E) Task Force has also determined a capital charge for the receivables.

RELEVANT STATUTORY ACCOUNTING

Statutory Accounting

41. *SSAP No. 20—Nonadmitted Assets*, paragraph 4.b. explicitly prohibited bills receivable as admitted assets:

> 4. Consistent with paragraph 2, the following assets shall be nonadmitted:
>
> > b. Bills Receivable Not for Premium and Loans Unsecured or Secured by Assets That Do Not Qualify As Investments—In accordance with SSAP No. 5R, amounts determined to be uncollectible or otherwise impaired shall be written off. Amounts in excess of that written off are not considered to be properly collateralized, as there are no underlying assets, which would otherwise be admitted assets. Such amounts shall be nonadmitted as they may be of questionable economic value if needed to fulfill policyholder obligations.

Effective Date and Transition

42. Upon adoption of this issue paper, the NAIC will release a Statement of Statutory Accounting Principle (SSAP) for comment. The SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the *Accounting Practices and Procedures Manual* should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and, therefore, the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will contain an effective date of years beginning on or after January 1, 2014. A change resulting from the adoption of the resulting SSAP shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3–Accounting Changes and Corrections of Errors*.

Amendment to SSAP No. 20—Nonadmitted Assets

43. Upon adoption of the statement related to this issue paper, *SSAP No. 20—Nonadmitted Assets* paragraph 4.b. is amended to allow the admission of working capital finance investments as follows:

> 4. Consistent with paragraph 2, the following assets shall be nonadmitted:
>
> > b. Bills Receivable Not for Premium and Loans Unsecured or Secured by Assets That Do Not Qualify As Investments—In accordance with SSAP No. 5R, amounts determined to be uncollectible or otherwise impaired shall be written off. Amounts in excess of that written off are not considered to be properly collateralized, as

there are no underlying assets, which would otherwise be admitted assets. Such amounts shall be nonadmitted as they may be of questionable economic value if needed to fulfill policyholder obligations. Receivables arising from working capital finance programs designated by the Securities Valuation Office are subject to the guidance in SSAP No. 105;

Appendix A: October 2012 Valuation of Securities Task Force Referral

During a conference call held on September 6, 2012, the Valuation of Securities (E) Task Force adopted a New York proposal (Attached) that would provide statutory accounting guidance for Working Capital Finance Investments (WCFI), described is the attachment. During the discussion held on September 6, the Task Force agreed to adopt and refer the proposal to the Statutory Accounting Principles (E) Working Group - so it can determine statutory accounting guidance; the Capital Adequacy (E) Task Force - so it can consider risk-based capital issues and the Blanks Working Group - so it could consider reporting and related issues.

We recommend that the Statutory Accounting Principles (E) Working Group adopt the proposed statutory accounting guidance. In addition, the Task Force recommends that the Capital Adequacy (E) Task Force consider that WCFIs must be preapproved by the SVO before an insurer can engage in them and that the SVO has developed a corporate methodology which would assign NAIC 1 or 2 Designations based on the credit risk associated with the corporate obligor, as it currently does for other bonds. The Task Force urges the Blanks (E) Working Group to consider the Task Force's opinion that WCFIs be reported on Schedule BA. The Task Force discussed the relative benefits between Schedule BA and DA and concluded that WCFIs should be reported as Other Invested Assets and therefore Schedule BA provides an enhanced disclosure framework deemed more appropriate for the investment.

It would be desirable to permit investments in WCFIs effective January 1, 2013. However, we recognize that the time remaining in this calendar year may not permit the Statutory Accounting Principles (E) Working Group, the Capital Adequacy (E) Task Force and the Blanks Working Group to finalize and implement regulatory instructions for this asset class. In that case, we would support the development of an interim process to permit insurers to purchase WCFIs beginning January 1, 2013.

NY Proposal:

Refer the language below, defining Working Capital Finance Investments, to Statutory Accounting Principles (E) Working Group, with a request for an amendment to SSAP No. 20 and additional SSAP guidance as necessary, if SAPWG determines that WCFIs should be admitted assets.

Background:

The SAPWG returned to VOS TF an earlier proposal and asked for additional criteria that would cover these investments to be added to that original proposal. The responsibility to develop the additional criteria was given to IAWG, which presented a list of criteria at the NAIC 2012 Spring Meeting.

This proposal on Working Capital Finance Investments and Working Capital Finance Arrangement incorporates, as appropriate, the criteria developed by the IAWG and those set forth in the SVO Staff Proposal ("Permit Working Capital Finance Notes to be Invested Assets". dated March 2, 2011) and adds certain criteria and controls to the requirements as necessary.

Changes to earlier language on WCFI/WCFA

This proposal:

- provides an alternative to the requirement that WCFIs are bought directly from the vendor;
- helps preserve Investors' interests by requiring first priority perfected security interests;
- only requires ledgers to be filed upon request (instead of continuously);

- permits participations;
- permits obligations arising from transactions outside of the United States;
- allows all insurers to invest in WCFI;
- allows affiliates of parties (e.g., vendors or Finance Agent) to the transaction to make transfers to the program;
- permits WCFI to be denominated in currencies other than USD;
- permits vendors and Obligors to be non-U.S. entities; and
- permits servicers and trust administrators to be entities subject to supervision by non-U.S. financial regulators.

Working Capital Finance Investment (WCFI)

Definition: Each investment in Confirmed Supplier Receivables (as defined below) under a program that is approved by the SVO as meeting the criteria specified in the *Purposes and Procedures Manual of the NAIC Securities Valuation Office.*

A WCFI manifests a right to payment and arises from transactions among:

- a buyer of goods or services that becomes an obligor of a supplier of goods or services,
- the supplier/s of those goods or services,
- a financial intermediary, and
- an investor.

A WCFI represents the transfer of the right to payment from the supplier to the investor and confirms the investor's right to payment free of any holdback, delay, or other stoppage in payment arising from claims that the obligor might otherwise assert against the supplier.

The supplier and the financial intermediary negotiate the discount rate to be applied to the receivable.

The obligor, prior to or upon transfer to the investor or financial intermediary confirms its obligation to make payments due under the investment:

- the sum due on that receivable;
- the date on which payments under it are to be made; and
- free of any and all defenses to payment arising from claims that it otherwise assert against the supplier or anyone taking interests from the supplier.

The financial intermediary or the investor then pays the supplier in exchange for the confirmed receivable.

Only investments that are commercial non-insurance receivables, meet the criteria specified in the NAIC *Accounting Practices and Procedures Manual*, accord with all applicable Statutory Accounting Principles, that are not impaired or in default, and that have been issued by a program to which the SVO has assigned a NAIC designation of "1" or "2" may be considered to be eligible for admitted asset treatment.

Investments in Confirmed Supplier Receivables of obligors affiliated with the investor are ineligible, and therefore non-admitted, assets.

Working Capital Finance Arrangement (WCFA)

A Working Capital Finance Arrangement (WCFA) is an open account program under which an Investor may purchase interests, or evidence thereof, in commercial non-insurance receivables. A WFCA is created for the benefit of a commercial investment grade obligor and its suppliers of goods or services, and facilitated by a financial intermediary.

Under a WCFA, an Investor reviews individual supplier receivables or evidence of interests therein presented to it by either the obligor or supplier itself or an intervening financial intermediary and then exercises its discretion to purchase of finance, or refrain from purchasing or financing, the receivables.

All contracts or agreements that are a part of or that together constitute a WCFA must state expressly that if a dispute arises among any of the parties under of any of the contracts or agreements that are a part of or that together constitute the WCFA, each party agrees that the dispute will be submitted to a court of competent jurisdiction in the United States or a constituent state thereof or of an alternative dispute resolution process recognized thereby. All contracts or agreements that are a part of or that together constitute a WCFA must state expressly that any dispute arising under any of the contracts or agreements that are a part of or that together constitute the WCFA must be resolved pursuant to the laws of the United States or a constituent state thereof that address the substance of the dispute but excluding those laws addressing conflicts of law.

A WCFA must include the availability, from the servicer or another third party, of a detailed ledger recording details of each trade receivable purchased, including but not limited to the origination date, purchase date, confirmed payment date, actual dates when payments are received, face value and purchase cost. Upon request, the ledger must be submitted to the SVO or the regulator of the state of domicile of the Investor.

The Investor in a WCFA must have a reasonable belief, based on express representations and warranties, and must be able to demonstrate (through, for example, proof of funding, possession, the filing of UCC financing statements) to its regulators and the SVO upon request, that the holder in a WCFI under an approved WCFA has a first priority perfected security interest in the WCFI.

For WCFAs structured as sales, assignments, or transfers to the Investor, the Investor is considered to be the holder.

For WCFAs structured as participations where the Finance Agent is the payee of the confirmed supplier receivables, the Finance Agent is considered to be the holder.

For WCFAs structured as participations where each participant is a payee, the Investor is considered to be the holder.

For WCFAs where the WCFIs under the program are transferred to a trust or other legal structure, the trust or legal structure is considered to be the holder.

WCFI – Detailed Defined Terms

Working Capital Finance Investment (WCFI)

A Working Capital Finance Investment (WCFI) is an interest in a Confirmed Supplier Receivable issued pursuant to a WCFA. It is created when the Investor purchases from a WCFA that has been assigned a NAIC 1 or 2 designation:

- one or more Confirmed Supplier Receivables;
- in case of a participation, a participation certificate issued by the Finance Agent or lead; or

- in case of a securitization, a certificate or note representing an interest in and right to payment from a trust, other separate special purpose entity, or pool holding Confirmed Supplier Receivables.

Confirmed Supplier Receivables
A Confirmed Supplier Receivable is a first priority perfected security interest claim or right to payment of a monetary obligation from the Obligor arising from the sale of goods or services from the Supplier to the Obligor the payment of which the Obligor has confirmed by representing and warranting that it will not protest, delay, or deny, nor offer nor assert any defenses against, payment to the supplier or any party taking claim or right to payment from the supplier.

Once confirmed, a confirmed supplier receivables may be sold, assigned, or otherwise transferred by the Supplier to:

- the Investor; or
- a Finance Agent that:
  a. in turn resells, the rights as payee to the Investor or to a trust or other legal structure that is obligated to transfer payments received from the Obligor with respect to the confirmed supplier receivables to the Investor; or
  b. acts as a "lead" in a participation in which the Finance Agent is the payee under the WCFI and is obligated to transfer to the Investor, payments received from the Obligor with respect to the confirmed supplier receivables and without reduction for any reason other than those specifically identified in the WCFA and directly related to the WCFA program (e.g., there be no reduction for cross-default provisions under other arrangements between the Finance Agent and the Investor).

Eligible confirmed supplier receivables cannot include insurance or insurance related assets.

Confirmed supplier receivables are sold, assigned, or otherwise transferred under the terms of a WCFA individually from the Suppliers.

Confirmed supplier receivables must be sold, assigned, or otherwise transferred in a manner that results in an absolute, irrevocable and legally enforceable obligation that the Obligor pay the amount represented by the confirmed supplier receivables and provide the new owner or holder (Seller or Investor) with the full legal rights to the Obligor's payment and, either directly or through the Finance Agent, to the exercise of creditor rights to receive the payments flow associated with the confirmed supplier receivables.

In the case of a participation, the certificates or other evidence of participation provide an absolute, irrevocable, and legally enforceable obligation that the Finance Agent or holder of the confirmed supplier receivables to pay to the Investor all of the amounts due to it under the confirmed supplier receivables, without reduction or delay arising from any claims that the Finance Agent may have against the Investor, and that the Investor's ability to exercise its rights as creditor, or to direct the Finance Agent to exercise the rights of a creditor on its behalf, not be subject to the discretion of the Finance Agent or other lenders or investors, other than for a period of cure not to exceed 30 days.

Obligor
Obligor is the party that purchases the goods or services that generate the original supplier receivable (and payable for the Obligor).

Obligor must be a single entity that itself must be rated investment grade. No receivable of any parent or affiliate may be transferred under, or serve as an underlying for any evidence issued pursuant to, the program.

Obligor sets up the program with the eligible/approved Finance Agent.

Obligor must have a NAIC Designation of 1 or 2 or CRP equivalent.

Obligor must confirm the Supplier receivable as described in the Confirmation Process below.

Supplier
Supplier is the party that sells the goods or services to the Obligor.

Supplier sells the confirmed supplier receivables in accordance with the terms of the SVO approved WCFA at a discounted price agreed to by the Investor.

Investor
Investor is the party purchasing a WCFI in accordance with the terms of the WCFA.

Finance Agent
The Finance Agent is a bank, financial institution, service provider, or other financial intermediary that facilitates the program; arranges the sale, assignment or transfer of the Confirmed Supplier Receivable to the Investor for a fee and administers the payment mechanism. The payment mechanism may be, for example, a lockbox arrangement. Prior to the sale, this party verifies that the Obligor has confirmed both the amount due and the due date, and has waived defenses to payment.

One of these requirements must be in effect:

a. The Finance Agent is directly regulated by or falls under the supervision of a financial regulator of its domiciliary country provided that such country appears on the SVO P&P Manual's List of Jurisdictions Eligible for Netting and that the SVO determines that the regulator is the equivalent of the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, or the Federal Deposit Insurance Corporation; or

b. payments from the Obligor must be paid directly to the insurer or into a lockbox and cannot flow through the Finance Agent and there can be no commingling of payments or assets with those of the Obligor, servicer, or trust administrator or other Investors.

The annual SVO filing regarding the program must include an annual audit of the consolidated financial statements of the Finance Agent that does not note any qualifications relating to servicing; and one of the following:

a. an annual independent report according to Statement on Standards for Attestation Engagements (SSAE) No. 16, reporting on Controls at a Service Organization related to the administration of the investment; or

b. an annual audit of the internal controls of the consolidated group of which the Finance Agent is part, which does not note any material weaknesses relating to servicing.

Confirmation Process
The Obligor confirms that it has an obligation, independent of any other contracts or claims which might be raised in defense against such payment arising from the transactions financed by the WFCA, or any other courses of performance or courses of dealing with the Supplier, to pay to the Finance Agent or Investor a sum equal to the amount of the supplier receivable to be purchased by the Finance Agent or Investor. The Obligor must expressly waive any right of setoff or other defenses to the full and timely payment of such Confirmed Supplier Receivable.
The Obligor asserts that it will not assert any right which it may have acquired, or may acquire, to not pay the Supplier (the amounts due under the supplier receivable) as a result of a dispute arising under the

commercial transaction between Obligor and Supplier against payments due to the Finance Agent or Investor.

Maximum Maturity

The maximum maturity of a WFCI of a confirmed supplier receivables must not exceed a final maturity of one year from the date of the extension or advance from the Supplier to the Obligor giving rise to the confirmed supplier receivables.

Participations

In the case of a participation, in considering whether the Investors' interests meet the Uniform Commercial Code's standards for preserving first priority perfected security interests, the SVO must

a. consider, among other factors, where relevant:
   - the extent to which the relationships among the parties are stated expressly;
   - the extent to which financial covenants exist that may provide early warning signs of deteriorating credit;
   - the obligations of the Finance Agent, administrator, or other lead to inform the Investor of a default or an event of default;
   - whether the Investor's ability to exercise its rights in a default or event of default are subject to the consent or agreement of the Finance Agent, lead, or other Investors;
   - the extent of management and administration by the Finance Agent or lead, whether the Finance Agent or lead is required to notify participants of events of it is aware that may constitute a default or an event of default under the agreement with the Obligor;
   - the standard of care by which the lead's liability or duties to the participants should be defined;
   - the allocation of payments; and the presence of any third party guarantees in favor of the Finance Agent, the lead, or any other participants;
   - the manner of sharing expenses;
   - how liabilities and losses are addressed;
   - the ability of the Finance Agent, lead, or a participant to assign or encumber its interests;
   - the existence of cross-purchase agreements;
   - the existence of an option exercisable by the Finance Agent, lead, or another participant to buy the interests of other participants;
   - and the ability of another participant, other than the Finance Agent, to assume the administration and management of the transaction, or;

b. require that the insurance company certify that its participation interest meets the Uniform Commercial Code's standards for preserving first priority perfected security interests

In the case of a participation, the Finance Agent from which the Investor took the note must inform the Investor of a default or event of default as soon as it becomes aware of such default or event of default.

Exclusions

A WCFI excludes any receivable/s financed through:

- Factoring: the purchase of receivables in bulk from a supplier where the receivables represent the payment obligations of potentially thousands of buyers to a single supplier, in which the buyers have no relationship with or contractual obligation to pay the factor and retain all legal defenses to payment they may have against the supplier;
- Forfaiting: the purchase of one or a series of receivables from exporters by a forfaiter to enable the exporter (seller) to finance a commercial transaction with a buyer in which the Obligor has no relationship with or contractual obligation to pay the forfaiter and retains all legal defenses to pay it may have against the seller; or

- Invoice discounting: the advancement of funds by a finance company to a business entity with the funds advanced limited to a defined percentage of the business entity's eligible and outstanding receivables.

SVO Approval and Designation

Any amendment to the WCFA, and any WCFI issued thereunder that differs from those approved by the SVO, must be filed with the SVO.

An insurance company that files a WCFI with the SVO must have in place such policies and procedures as they consider necessary to monitor and manage risks associated with this investment activity. Such policies and procedures must reflect an understanding of the private nature of the receivables market, the tri-party nature of WCFI and confirmed supplier receivables, the risks identified and provided for by the SVO credit assessment process, such other issues as may be relevant to recovery of the loan assuming a default has occurred as well as such aspects usages of trade in receivables financing as they determine are consistent with their underlying due diligence obligations. Insurance companies are encouraged to build such protections as they believe are necessary to them into the terms of the programs they intend to invest in.

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Issue Paper No. 148

Affordable Care Act Section 9010 Assessment

STATUS:
Initially Adopted – December 15, 2013
Adopted to Reflect SSAP No. 106 – June 12, 2014

Current Authoritative Guidance for Affordable Care Act Section 9010 Assessment: SSAP No. 106

Original SSAP from Issue Paper: SSAP No. 35R

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. This issue paper establishes statutory accounting principles for the fee payable under Section 9010 of the federal Affordable Care Act (ACA) by reporting entities. This issue paper provides historical documentation of the substantive revisions to *SSAP No. 35—Guaranty Fund and Other Assessments – Revised* (SSAP No. 35R) in Appendix A. The changes reflected in Appendix A were adopted in SSAP No. 35R in December 2013 and were subsequently moved in 2014 to a separate statement, *SSAP No. 106—Affordable Care Act Section 9010 Assessment*. Also at that time, additional disclosures related to the risk-sharing provisions of the Affordable Care Act were incorporated. These changes are shown in Appendix B. In addition, this issue paper provides documentation of the extended discussion related to the Section 9010 ACA assessment including the two major viewpoints on the topic. Paragraphs 2 through 8 of this issue paper provide the proposed new guidance to SSAP No. 35R, and paragraph 9 shows the tracked changes to the existing 2013 disclosure as well as expanding the 2014 disclosure. Paragraphs 10 through 21 detail the discussions, paragraphs 22 through 33 provided comments on the Statement of Concepts, and the remaining paragraphs contain relevant literature.

SUMMARY CONCLUSION

Affordable Care Act Section 9010 Assessment

2. *ASU 2011-06: Other Expenses – Fees Paid to the Federal Government by Health Insurers* (ASU 2011-06) provides specific guidance related to the assessment in Section 9010 of the Affordable Care Act. ASU 2011-06 is a consensus of the Financial Accounting Standards Board (FASB) Emerging Issues Task Force. This issue paper proposes to adopt ASU 2011-06 with the following modifications: 1) to require full expense recognition on January 1 of the fee year and 2) to require the reclassification from unassigned surplus to special surplus in the data year for the estimated amount payable in the upcoming year, and 3) other modifications for statutory accounting terminology as reflected in this issue paper.

3. The Affordable Care Act (ACA) imposes an assessment on entities that issue health insurance for each calendar year beginning on or after January 1, 2014. Pursuant to Section 9010 of the ACA, a reporting entity's portion of the assessment is paid no later than September 30 of the applicable calendar year (the fee year) beginning in 2014 and is not tax deductible. The amount of the assessment for the reporting entity is based on the ratio of the amount of an entity's subject net health premiums written for any U.S. health risk during the preceding calendar year (data year) to the aggregate amount of subject net health premiums written by all subject U.S. health insurance providers during the preceding calendar year. The ACA includes some significant exclusions regarding which entities are required to pay the assessment. This guidance applies to all entities that are subject to the fee. The guidance in this section (paragraphs 3-9) applies to the unique facts and circumstances in the ACA; accordingly, an entity should

apply judgment when evaluating the facts and circumstances of other assessment arrangements before analogizing to the guidance for Section 9010 of the ACA.

4. Throughout this discussion of the Section 9010 assessment of the ACA, the following terms apply:

a. The term “data year” means the calendar year immediately before the fee year. For example, 2014 is the data year for fee year 2015.

b. The “term fee” year means the calendar year in which the assessment must be paid to the U.S. Treasury.

5. A reporting entity’s portion of the annual assessment becomes payable to the U.S. Treasury once the reporting entity provides health insurance (in the fee year) for any subject U.S. health risk for each calendar year beginning on or after January 1, 2014.

6. The liability related to the Section 9010 ACA assessment shall be estimated and recorded in full once the entity provides qualifying health insurance (typically January 1) in the applicable calendar year in which the assessment is paid (fee year) with a corresponding entry to expense. The Section 9010 ACA assessment shall be recognized in full on January 1 of the fee year, in the operating expense category of Taxes, Licenses and Fees.

7. Liability recognition of the Section 9010 fee is not required in the data year. In the data year, the reporting entity is required to reclassify from unassigned surplus to special surplus an amount equal to its estimated subsequent fee year assessment. This segregation in special surplus is accrued monthly throughout the data year. The reclassification from unassigned surplus to special surplus does not reduce total surplus. On January 1 of the fee year, the prior year segregation in special surplus is reversed and the full current fee year assessment liability shall be accrued.

8. The Section 9010 ACA annual assessment does not represent a cost related to the acquisition of policies that is consistent with the definition of acquisition costs in *SSAP No. 71—Policy Acquisition Costs and Commissions.*

Disclosures

9. A disclosure for year-end 2013 was adopted in SSAP No. 35R early in the discussion on the Section 9010 fee. The disclosure was subsequently extended to include years on and after 2014. In addition, for 2014 and thereafter, the disclosure was also expanded to include information on the amounts reflected in special surplus in the data year as detailed below:

23. For the Section 9010 ACA assessment:

a. For the annual reporting period ending December 31, 2013 and thereafter, a reporting entity subject to the assessment under Section 9010 of the Affordable Care Act, shall provide a disclosure of the assessment payable in the upcoming year consistent with the guidance provided under *SSAP No. 9—Subsequent Events* for a Type II subsequent event. The disclosure shall provide information regarding the nature of the assessment and an estimate of its financial impact, including the impact on its risk based capital position as if it had occurred on the balance sheet date. In accordance with SSAP No. 9, paragraph 9, the reporting entity shall also consider whether there is a need to present pro forma financial statements regarding the impact of the assessment, based on its judgment of the materiality of the assessment.

b. Additionally for annual reporting periods ending on or after December 31, 2014, the disclosure in paragraph 23.a. is expanded to include information on the amounts reflected in special surplus in the data year. The disclosure shall provide information regarding the nature of the assessment and the Total Adjusted Capital and Authorized Control Level (in dollars) before and after adjustment (as reported in its estimate of special surplus applicable to the 9010 fee) to reflect the fee as of the annual reporting date as if it had been reported on the balance sheet date. The disclosure shall also provide a statement as to whether an RBC action level would have been triggered had the fee been reported as of the balance sheet date.

DISCUSSION

10. This topic was discussed at the Statutory Accounting Principles (E) Working Group with input from the Financial Condition (E) Committee. In addition, the Health Insurance and Managed Care (B) Committee and the Accounting Practices and Procedures (E) Task Force were invited to participate in a number of the discussions via conference call. The Working Group reviewed Section 9010 of the ACA and the generally accepted accounting principles (GAAP) guidance in ASU 2011-06 (excerpted in the relevant literature section of this issue paper).

Timing of Liability Recognition

11. During this review, the Working Group had a series of discussions regarding the timing of the recognition of the liability. Section 9010 of the ACA allocates the assessment based on the ratio of prior year premium to total subject premium. Section 9010 further notes, "the term 'covered entity' means any entity which provides health insurance for any United States health risk during the calendar year in which the fee under this section is due." Different parties participating in the discussions put varying degrees of emphasis on the ACA phrase "provides insurance."

12. ASU 2011-06 specifies that the liability for the fee should be estimated and recorded in full once the entity provides qualifying health insurance in the applicable calendar year in which the fee is payable, with a corresponding deferred cost that is amortized to expense using a straight-line method of allocation unless another method better allocates the fee over the calendar year that it is payable.

13. The discussions coalesced into two primary views regarding the timing of the recognition of the liability for the Section 9010 ACA fee. These views are summarized below as the data year view and as the fee year view. Data year and fee year terms are defined in the summary conclusion section of this issue paper. Although both views had some impact on the ultimate decisions, the fee year view is the primary view reflected in the summary conclusion.

Data Year Recognition View

14. The group that advocated liability recognition at December 31 of the data year had the following primary points:

a. This group was in support of the generally accepted accounting principles (GAAP) dissenter opinion detailed in ASU 2011-06, which advocated data year liability recognition. This dissenter opinion was based on the view that an entity subject to the fee incurs a constructive liability throughout the year as related revenues are recognized. Following that view, the constructive liability then becomes a legal liability the first day revenues are recognized in the subsequent year; a relatively inconsequential event for a going concern. Therefore, absent a decision (before the start of the next calendar year) to cease doing business, an entity should record a liability in the same year related revenues are recognized.

b. This group noted the objectives of GAAP reporting differ from the objectives of statutory accounting principles (SAP) reporting. GAAP is designed to meet the varying needs of the different users of financial statements, while SAP is designed to address the concerns of regulators, who are the primary users of statutory financial statements. The differences in objectives between GAAP and SAP are especially pronounced in the FASB Emerging Issues Task Force opinion detailed in ASU 2011-06. The summary of ASU 2011-06 states that the objective is to address questions about how health insurers should recognize and classify in their income statements fees mandated by the ACA. It is clear from this language that FASB's focus was on the impact of the ACA fee on the income statement with limited focus on when the ACA fee liability should be recognized.

c. This group advocated that the fee, at a minimum, represents a loss contingency in the data year.

d. As a practical matter, insurers legally commit to provide insurance for the subsequent year (fee year) before the end of the year (data year). This view places emphasis on the fact that the reporting entity has "committed to provide insurance" in the year the fee is paid on or before December 31 of the data year. This group contended that "committing to provide insurance" is the same as the "provides insurance" liability threshold in the ACA.

e. Advocates of this view noted that the obligation to recognize a liability in *SSAP No. 5—Liabilities, Contingencies and Impairments of Assets – Revised* (SSAP No. 5R) had been met because it factors in the ACA law, contract law and the federal Health Insurance Portability and Accountability Act (HIPAA). Some of the federal laws, in particular, require 3 to 6 months' notice if a policy will not be renewed or will be cancelled.

f. A significant percentage of policies are non-calendar year policies. Policies have level-term payments and, as such, billings in the data year include anticipated costs for the fee year amount. Members of industry confirmed that amounts were being collected in the data year for non-calendar year policies. Advocates of this view noted that if there is not a corresponding accrual in the data year, then data year income and assets are overstated. Correspondingly, there would be a permanent increase (overstatement) in capital in the year-end financial statements.

g. Supporters of this view noted that it is also consistent with the existing liability recognition principles in SSAP No. 35R regarding guaranty fund assessments which are recognized on the date of insolvency, instead of on the date of assessment. In addition, it is consistent with the existing guidance for premium-based assessments in SSAP No. 35R, which notes that the event that obligates the entity is generally writing the premiums or becoming obligated to write or renew (such as multiple-year, noncancelable policies) the premiums on which the assessments are expected to be based.

h. Supporters of this view noted that failure to recognize the liability for the fee in the data year's financial statements hampers the regulators' ability to utilize critical solvency tools that are dependent on an accurate assessment of an insurer's total surplus. Solvency monitoring tools such as risk-based capital (RBC), Insurance Regulatory Information System (IRIS) ratios, Financial Analysis Solvency Tools (FAST) including scores, holding company approval thresholds, standards for companies deemed to be in hazardous financial condition, investment law limitations, and extraordinary dividend approval thresholds will be rendered ineffective due to the failure to record the liability for the fee.

i. Supporters of this view noted that it is consistent with statutory Statement of Concepts **conservatism** principle.

j. In the event of liquidation, the ACA fee may have higher priority for payment than certain recorded liabilities.

Fee Year Recognition View

15. The group that advocates liability recognition on January 1 of the fee year had the following primary points:

a. This group was in support of the GAAP majority (adopted) FASB Emerging Issues Task Force opinion detailed in ASU 2011-06, which requires liability recognition in the year the fee is paid. This group advocated for statutory accounting principles (SAP) and GAAP to be consistent regarding accrual of the Section 9010 ACA fee.

b. This group contended that the criteria of an incurred liability in SSAP No. 5R and SSAP No. 35R have not been met in the data year. This group contends that the insurer must actually "provide coverage in the fee year" before the liability is incurred. They view the obligating event as providing coverage on or after January 1 of the fee year.

c. As a practical matter, insurers legally commit to provide insurance for the subsequent year (fee year) before the end of the year (data year). Supporters of this view contended that legally committing to provide insurance in the fee year was not enough to trigger the liability.

d. In response to the issue of contract law cancellation requirements of the federal Health Insurance Portability and Accountability Act (HIPAA) that require, in some cases, 3 to 6 months' notice by an insurer if a policy is not going to be renewed, or is planned to be cancelled; this group noted that it is possible for policyholders to cancel without notice.

e. A significant percentage of policies are non-calendar year policies. Policies have level-term payments and, as such, billings in the data year include anticipated costs for the fee year amount. Members of industry confirmed that amounts were being collected in the data year for non-calendar year policies. They expressed concerns regarding Medical Loss Ratio (MLR) treatment of these amounts and recommended as a possible compromise, to include in the unearned premium liability, the amount collected in the data year. This liability was not included in the proposed guidance because it was determined this treatment would not be consistent with unearned premium guidance currently within statutory accounting, as well as some MLR guidance issued by the U.S. Department of Health and Human Services which prohibited deduction of fee amounts in the data year for the MLR calculation.

f. Although the assessment is based on prior year premium, supporters of this view argued that it should be viewed as an annual operating expense consistent with the ASU 2011-06 as opposed to the existing liability recognition for premium based assessment guidance in SSAP No. 35R.

Timing of Expense Recognition and Surplus Impact

16. The Working Group discussed the timing of the surplus reduction and expense recognition and exposed multiple documents for discussion including various proposals for phasing in liability recognition in the data year. The phase-in proposals were an attempt to ease the concerns raised by industry regarding rate-shock and the inability of some insurers to raise rates for the next couple of years due to various issues. The August 2013 and November 2013 Working Group exposures reflect a modified GAAP approach with fee year recognition modified for full surplus recognition on January 1 of the fee year.

17. The Working Group discussed various options for the timing of expense recognition including expensing 1) in the data year; 2) in full January 1 of the fee year; 3) over nine months in the fee year; 4)

over 12 calendar months of the fee year and 5) over 12 months from October 1 of the data year through payment on September 30 of the fee year.

18. ASU 2011-06 recognizes the expense over the calendar year or another method if it is more accurate. Industry representatives advocated for a similar expense recognition approach with modifications using a nonadmitted deferred expense asset. Industry advocated an approach, which recognized the full impact in surplus on January 1, and then establishes a nonadmitted deferred expense asset. The deferred expense asset is then amortized to expense over the calendar year similar to GAAP expense recognition timing.

19. Deferring expenses over 12 months of the fee year was determined to be inconsistent with explicit language in the Statement of Concepts Recognition guidance which notes that:

> Accounting treatments, which tend to defer expense recognition, do not generally represent acceptable SAP treatment.

In addition, some members of the Working Group noted that the nonadmitted deferred cost asset does not meet the definition of an asset. The Working Group's exposure adopts GAAP with modification to require full expense recognition on January 1 of the fee year. and 2) to require the reclassification from unassigned surplus to special surplus in the data year for the estimated amount payable.

Special Surplus Segregation

20. It was noted that the year-end financial statements are used in many of the regulatory financial solvency tools, such as risk-based capital (RBC), dividend limitations noted in the Insurance Holding Company System Regulatory Act (Model 440), various financial analysis and regulatory tools. Therefore, omitting this material liability from year-end recognition in the data year would hamper year-end analysis of insurers and require state regulators to perform additional manual reviews. Partially to address these concerns, disclosures regarding the estimated fee year amount and the impact on RBC were adopted. However, Working Group members noted that the regulatory ability to act on disclosures is weaker than the regulatory ability to act on liability recognition.

21. An industry compromise was developed to require the estimated amount payable for the fee year to be reflected as a reclassification of surplus from unassigned surplus to special surplus in the data year. This reclassification does not decrease total surplus. While this does provide transparency to the financial statements and somewhat limits the source of dividend payments, it does not fully limit the amount of dividends which may be paid. The primary determinant of whether a dividend is extraordinary is ten percent of total surplus. If a dividend is not extraordinary, a company may pay it without prior approval. The Working Group noted that an insurer would get an artificial increase in the ordinary/extraordinary dividend data year threshold equal to ten percent of the amount payable for the fee year. This accrual in special surplus is subsequently reversed on January 1 of the fee year when the fee year payable is recognized.

Statutory Statement of Concepts

22. The Working Group discussion directed that an analysis of the proposed guidance with the statutory statement of concepts be prepared for inclusion in this Issue Paper.

Conservatism

23. The Preamble, paragraph 30 calls for accounting to be reasonably conservative. Section 9010 of the Affordable Care Act (ACA) indicates the amount of the fee is allocated based on prior year health premium (data year) if the reporting entity is a provider of health insurance coverage as of January 1 of the year the fee is paid (fee year). The unusual wording in the ACA creates questions regarding when the

liability is triggered. *ASU 2011-06 – Fees Paid to the Federal Government by Health Insurers* (ASU 2011-06) determined that the liability is incurred on January 1 of the year the fee is paid. ASU 2011-06 also explicitly scoped the liability as separate from insurance-related assessments and notes that the fee does not meet the GAAP definition of a policy acquisition cost. The definition of a liability incorporated by statutory accounting in *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets –Revised* (SSAP No. 5R) is based on the GAAP definition of a liability. Therefore, SAP and GAAP should have similar conclusions regarding the incurral of a liability.

24. The fee year view currently exposed by the Working Group and the position adopted by the Emerging Issues Task Force in ASU 2011-06 indicates that a liability has not been incurred until provision of insurance coverage in the fee year. If the obligating event for the liability is viewed as January 1 of the fee year, then it is conservative to recognize the liability in full as soon as it is incurred on January 1 of the fee year.

25. The fee year view is not considered as conservative as the data year view with regard to recognition of the ACA fee liability, but it is consistent with the GAAP guidance in ASU 2011-06 that was adopted.

Consistency

26. Paragraph 31 of the Preamble highlights the importance of meaningful and comparable financial information. Statutory accounting requires expensing of acquisition costs and establishing loss reserves at policy inception. Other administrative costs of policies are recognized as a liability when incurred. Policy pricing includes some elements, such as administrative overhead, which are not recognized as liabilities until they are incurred.

27. Preamble, paragraph 31 also calls for "consistency in the development and application of statutory accounting principles." This proposal preserves that consistency without imposing a different standard for recognition of the future fee payments.

Recognition

28. The Preamble, paragraph 34 states that liabilities require recognition as they are incurred. Under this proposal, GAAP and SAP define liability recognition consistently. Given the dual trigger in the law of writing premium in the data year and providing insurance in the fee year, recognition in the fee year is consistent with the FASB Emerging Issues Task Force conclusion in ASU 2011-06. Therefore, defining the liability triggering event as providing insurance in the fee year is consistent with U.S. GAAP.

29. The Fee can be invoiced any time during the fee year, but must be paid no later than September 30. GAAP guidance in ASU 2011-06 amortizes the Fee through December of the fee year. Statutory accounting recognizes expenses as incurred, as they are no longer available to pay policyholders. This is consistent with the statement of concepts regarding recognition and conservatism. However, ASU 2011-06 varies from statutory conservatism, by deferring recognition of the liability expense over the course of the fee calendar year. Deferring expenses is explicitly in conflict with the following quote in the Recognition concept in paragraph 35 of the Preamble, "Accounting treatments which tend to defer expense recognition do not generally represent acceptable SAP treatment." A deferred expense asset is also inconsistent with the definition of an asset as it does not represent a future benefit and no expenses have been prepaid. The current exposure by the Working Group is to expense in full on January 1 of the fee year.

30. The Working Group noted that provision of coverage to a single policyholder in the fee year triggers the obligation of the full liability based on all subject policies in the preceding year. Policyholder acceptance on January 1 of the fee year of a calendar year policy is further evidence of a liability existing in the data year.

31. The proposal requires that reporting entities establish in special surplus funds an amount equal to the anticipated Fee payable in the next year. This segregation in special surplus in the data year is to provide transparency on the face of the financial statements regarding the subsequent year's fee payable. This provides regulators additional information for year-end regulatory decisions and financial analysis. In addition, there are annual disclosures, including a disclosure that reflects RBC as if the liability was accrued in the data year.

Conclusion

32. The proposal generally defers recognition of the Fee liability until the fee year consistent with GAAP. It also provides transparency with the segregation in special surplus.

Data Year Recognition (Dissenting Opinion) Statutory Statement of Concepts

33. The group that advocated liability recognition at December 31 of the data year conducted its own analysis that reflects how the proposed guidance aligns with the statutory accounting principles Statement of Concepts:

Conservatism

34. The Working Group is concerned regarding the material amount of the Fee that will be recognized as a liability on January 1 of the fee year without substantive commercial action of the insurer. It was further concerned that not recognizing the liability in the data year was inconsistent with the concept of conservatism.

35. The most fundamental question that the Working Group addresses in the proposed guidance is the timing of the liability for the ACA fee. Should the liability be accrued at year-end of the data year or accrued on January 1 of each fee year? The general concept of conservatism states that if there is uncertainty about incurring a loss, one should tend toward recording such loss. Although there may be disagreement with respect to the appropriate timing for recognition of this liability, recording the liability at year-end is the most conservative approach. Since the primary responsibility of statutory accounting is to regulate for financial solvency, the use of conservatism by the SAPWG in developing accounting principles for statutory reporting purposes is critical and cannot be ignored.

36. The proposed guidance clearly violates the concept of conservatism when focusing on the fundamental question: when should the liability for the ACA fees be established.

Consistency

37. Current statutory accounting in SSAP No. 35R requires that entities subject to premium-based administrative type assessments recognize a liability for such assessment when the entity writes the premium or becomes obligated to write the premium. However, the proposed guidance ignores this approach and creates a special exception for health insurance entities subject to the ACA fee. This special treatment is inconsistent with the existing liability recognition principles in SSAP No. 35R.

38. One of the three essential characteristics of a liability is that the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice. Some advocates of the proposed guidance have argued that an entity can avoid tax obligations by not providing any health insurance coverage during the fee year by choosing to go or be out of business each December 31; and, therefore, the health insurers should not have to record a liability for the ACA fee. However, the same health insurers that make this contention are also reporting significant amounts of deferred tax assets that are dependent on the existence of sufficient taxable income of the appropriate character in the carryfoward period. These contradictory outlooks on future operations and earnings are inconsistent.

39. The proposed guidance violates the concept of consistency and the regulators' need for meaningful, comparable financial information to determine an insurer's financial condition.

Recognition

40. The fee meets the definition of a liability when the premium subject to the assessment has been written or the reporting entity is obligated to write the premium. In order to meet Health Insurance Portability and Accountability Act (HIPAA) requirements or to comply with contractual commitments, insurers are legally obligated to provide insurance in the subsequent year when entering into contracts during the previous year that have policy periods that extend into that same subsequent year. When a reporting entity has committed, or has a legal obligation, to provide insurance in the year the assessment is payable, it has met the secondary trigger in the ACA and a liability should be required to be accrued in that year's financial statements.

41. Advocates of the proposed guidance have argued that while a health insurer may be contractually bound to provide coverage in the payment year, the policyholder has no reciprocal obligation to accept such coverage. However, *SSAP No. 9—Subsequent Events* (SSAP No. 9) would address this particular situation. SSAP No. 9 requires an entity to recognize in the financial statements the effects of all material Type I subsequent events that provide additional evidence about conditions that existed at the date of the balance sheet. The health insurer's contractual obligation to provide coverage in the payment year is the condition that existed at the date of the balance sheet date. The policyholders' actions on January 1 provide the additional evidence about those same conditions. If all of the policyholders of the health insurer do not accept coverage, there is no need to establish an ACA fee liability. However, if any single policyholder does accept coverage, that acceptance provides the additional evidence about conditions that existed at the date of the balance sheet (the contractual obligation), and an ACA fee liability needs to be recognized in the financial statements.

42. The revised SSAP No. 35R violates the concept of recognition and the principal focus of solvency measurement: the determination of financial condition though analysis of the balance sheet.

Data Year (Dissenting Opinion) Conclusion

43. The proposed guidance clearly violates the fundamental concepts on which statutory financial accounting and reporting standards are based.

RELEVANT LITERATURE

Generally Accepted Accounting Principles

44. *Accounting Standards Update 2011-06 Other Expenses (Topic 720) Fees Paid to the Federal Government by Health Insurers* (ASU 2011-06) was issued in July 2011. The amendments in this update specify that the liability for the fee should be estimated and recorded in full once the entity provides qualifying health insurance in the applicable calendar year in which the fee is payable with a corresponding deferred cost that is amortized to expense using a straight-line method of allocation unless another method better allocates the fee over the calendar year that it is payable. Additionally, this Update indicates that the fee would not meet the definition of an acquisition cost. Excerpts from ASU 2011-06 are as follows:

> **Scope and Scope Exceptions**
>
> **405-30-15-3** The guidance in this Subtopic does not apply to the following transactions and activities:

a. Amounts payable or paid as a result of reinsurance contracts or arrangements that are in substance reinsurance, including assumed reinsurance activities and certain **involuntary pools** that are covered by Topic 944.

b. Assessments of depository institutions related to bank insurance and similar funds.

c. The annual fee imposed on health insurers by the Patient Protection and Affordable Care Act as amended by the Health Care and Education Reconciliation Act (the Acts). The accounting for the Acts' fee is addressed in Subtopic 720-50.

Other Expenses—Fees Paid to the Federal Government by Pharmaceutical Manufacturers and Health Insurers

Overview and Background

720-50-05-1 This Subtopic provides guidance on the annual ~~fee~~fees paid by pharmaceutical manufacturers and health insurers to the U.S. Treasury in accordance with the Patient Protection and Affordable Care Act as amended by the Health Care and Education Reconciliation Act (the Acts).

720-50-05-2 The Acts impose ~~an~~ annual ~~fee~~fees on the pharmaceutical manufacturing industry for each calendar year beginning on or after January 1, 2011, and on the health insurance industry for each calendar year beginning on or after ~~January 1, 2011~~January 1, 2014. An entity's portion of the annual fee is payable no later than September 30 of the applicable calendar year and is not tax deductible. ~~The annual fee ranges from $2.5 billion to $4.1 billion in total, a portion of which will be allocated to individual entities on the basis of the amount of their branded prescription drug sales for the preceding year as a percentage of the industry's branded prescription drug sales for the same period. An entity's portion of the annual fee becomes payable to the U.S. Treasury once a pharmaceutical manufacturing entity has a gross receipt from branded prescription drug sales to any specified government program or in accordance with coverage under any government program for each calendar year beginning on or after January 1, 2011.~~ **[Content amended and moved to paragraph 720-50-05-3]**

720-50-05-3 For the pharmaceutical manufacturing industry, the~~The~~ annual fee ~~ranges from $2.5 billion to $4.1 billion in total, a portion of~~ which will be allocated to individual ~~entities~~pharmaceutical manufacturers on the basis of the amount of their branded prescription drug sales for the preceding year as a percentage of the industry's branded prescription drug sales for the same period. ~~An~~A pharmaceutical manufacturing entity's portion of the annual fee becomes payable to the U.S. Treasury once the ~~a pharmaceutical manufacturing~~ entity has a gross receipt from branded prescription drug sales to any specified government program or in accordance with coverage under any government program for each calendar year beginning on or after January 1, 2011. **[Content amended as shown and moved from paragraph 720-50-05-2]**

720-50-05-4 For the health insurance industry, the annual fee will be allocated to individual health insurers based on the ratio of the amount of an entity's net premiums written during the preceding calendar year to the amount of health insurance for any U.S. health risk that is written during the preceding calendar year. A health insurance entity's portion of the annual fee becomes payable to the U.S. Treasury once the entity provides health insurance for any U.S. health risk for each calendar year beginning on or after January 1, 2014.

Scope and Scope Exceptions

720-50-15-1 The guidance in this Subtopic applies to all pharmaceutical manufacturers and health insurers that are subject to the annual fee imposed by the Acts described in paragraphs 720-50-05-1 ~~and 720-50-05-2~~through 05-4. The guidance in this Subtopic is based on the unique facts and circumstances of the fee to be paid by pharmaceutical manufacturers and health insurers in accordance with the Acts; accordingly, an entity should apply judgment when evaluating the facts and circumstances of other fee arrangements before analogizing to the guidance in this Subtopic.

Recognition

720-50-25-1 The liability related to the annual fee described in ~~paragraph~~paragraphs 720-50-05-1 through 05-4 shall be estimated and recorded in full upon the first qualifying sale for pharmaceutical manufacturers or once the entity provides qualifying health insurance for health insurers in the applicable calendar year in which the fee is payable with a corresponding deferred cost that is amortized to expense using a straight-line method of allocation unless another method better allocates the fee over the calendar year that it is payable. The annual fee imposed on health insurers does not represent a cost related to the acquisition of policies that is consistent with the definition of an *acquisition cost* in Subtopic 944-30.

Other Presentation Matters

720-50-45-1 The annual fee described in ~~paragraph~~paragraphs 720-50-05-1 through 05-4 shall be presented as an operating expense.

Transition Related to Accounting Standards Update No. 2011-06, *Other Expenses (Topic 720): Fees Paid to the Federal Government by Health Insurers*

720-50-65-2 The following represents the transition and effective date information related to Accounting Standards Update No. 2011-06, *Other Expenses (Topic 720): Fees Paid to the Federal Government by Health Insurers:*

a. The pending content that links to this paragraph shall be effective for calendar years beginning after December 31, 2013.

b. The pending content that links to this paragraph does not require an entity to reevaluate its existing policies related to similar fees assessed by governmental authorities.

45. The amendments in ASU 2011-06 were adopted by the affirmative vote of six members of the Financial Accounting Standards Board. The Statutory Accounting Principles (E) Working Group also noted and discussed the dissenting opinion.

Mr. Schroeder objects to the issuance of the amendments in this Update. Mr. Schroeder agrees with recognition of the liability for the fee, but disagrees with the timing of its recognition and the related deferred cost being amortized over the calendar year the fee is payable. Mr. Schroeder believes that the fee generally meets the essential characteristics of a liability, as outlined in paragraphs 35 through 40 of FASB Concepts Statement No. 6, *Elements of Financial Statements*, in the year used to calculate the fee and should be accrued over the course of that year. This is based on the view that an entity subject to the fee incurs a constructive liability throughout the year as related revenues are recognized. Following that view, the constructive liability then becomes a legal liability the first day revenues are recognized in the subsequent year; a relatively inconsequential event for a going concern. Mr. Schroeder believes that absent a decision (before the start of the next calendar year) to cease doing business, an entity should record a liability in the same year related revenues are recognized.

46. Excerpts of the federal Affordable Care Act, Section 9010, are as follows:

SEC. 9010. IMPOSITION OF ANNUAL FEE ON HEALTH INSURANCE PROVIDERS.
(a) IMPOSITION OF FEE.—

(1) IN GENERAL.—Each covered entity engaged in the business of providing health insurance shall pay to the Secretary not later than the annual payment date of each

calendar year beginning after 2013 a fee in an amount determined under subsection (b). [*Amended by section 10905(f)(1) and section 1406(a)(1) of HCERA*.]

(2) ANNUAL PAYMENT DATE.—For purposes of this section, the term ‘‘annual payment date’’ means with respect to any calendar year the date determined by the Secretary, but in no event later than September 30 of such calendar year.

(b) DETERMINATION OF FEE AMOUNT.—[*Replaced by section 10905(b)*.]

(1) IN GENERAL.—With respect to each covered entity, the fee under this section for any calendar year shall be equal to an amount that bears the same ratio to the applicable amount as—

(A) the covered entity's net premiums written with respect to health insurance for any United States health risk that are taken into account during the preceding calendar year, bears to

(B) the aggregate net premiums written with respect to such health insurance of all covered entities that are taken into account during such preceding calendar year.

(2) AMOUNTS TAKEN INTO ACCOUNT.—For purposes of paragraph (1)—[*As revised by section 1406(a)(2) of HCERA*.]

(A) IN GENERAL.—The net premiums written with respect to health insurance for any United States health risk that are taken into account during any calendar year with respect to any covered entity shall be determined in accordance with the following table:

With respect to a covered entity's net premiums written during the calendar year that are:	*The percentage of net premiums written that are taken into account is:*
Not more than $25,000,000	0 percent
More than $25,000,000 but not more than $50,000,000.	50 percent
More than $50,000,000............................	100 percent

(B) PARTIAL EXCLUSION FOR CERTAIN EXEMPT ACTIVITIES.—
After the application of subparagraph (A), only 50 percent of the remaining net premiums written with respect to health insurance for any United States health risk that are attributable to the activities (other than activities of an unrelated trade or business as defined in section 513 of the Internal Revenue Code of 1986) of any covered entity qualifying under paragraph (3), (4), (26), or (29) of section 501(c) of such Code and exempt from tax under section 501(a) of such Code shall be taken into account.

(3) SECRETARIAL DETERMINATION.—The Secretary shall calculate the amount of each covered entity's fee for any calendar year under paragraph (1). In calculating such amount, the Secretary shall determine such covered entity's net premiums written with respect to any United States health risk on the basis of reports submitted by the covered entity under subsection (g) and through the use of any other source of information available to the Secretary.

(c) COVERED ENTITY.—[*As revised by section 1406(a)(3) of HCERA*.]

(1) IN GENERAL.—For purposes of this section, the term ‘‘covered entity’’ means any entity which provides health insurance for any United States health risk during the calendar year in which the fee under this section is due.

(2) EXCLUSION.—Such term does not include—

(A) any employer to the extent that such employer self-insures its employees' health risks,

(B) any governmental entity, [*As revised by section 10905(f)(2)*.]

(C) any entity— [*Subparagraphs (C) through (E) revised by section 10905(c) and subsequently rewritten in entirety, including striking subparagraph (E), by section 1406(a)(3) of HCERA*.]

(i) which is incorporated as a nonprofit corporation under a State law,

(ii) no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in section 501(h) of the Internal Revenue Code of 1986), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office, and

(iii) more than 80 percent of the gross revenues of which is received from government programs that target low-income, elderly, or disabled populations under titles XVIII, XIX, and XXI of the Social Security Act, and

(D) any entity which is described in section 501(c)(9) of such Code and which is established by an entity (other than by an employer or employers) for purposes of providing health care benefits.

(3) CONTROLLED GROUPS.—

(A) IN GENERAL.—For purposes of this subsection, all persons treated as a single employer under subsection (a) or (b) of section 52 of the Internal Revenue Code of 1986 or subsection (m) or (o) of section 414 of such Code shall be treated as a single covered entity (or employer for purposes of paragraph (2)). [*Note: sentence at end should have been inserted at end of this subparagraph*.]

(B) INCLUSION OF FOREIGN CORPORATIONS.—For purposes of subparagraph (A), in applying subsections (a) and (b) of section 52 of such Code to this section, section 1563 of such Code shall be applied without regard to subsection (b)(2)(C) thereof. If any entity described in [*executed to reflect probable intent of amendment made by section 1406(a)(3)(C)*] subparagraph (C) or (D) of paragraph (2) is treated as a covered entity by reason of the application of the preceding sentence, the net premiums written with respect to health insurance for any United States health risk of such entity shall not be taken into account for purposes of this section. [*Previous sentence added by section 10905(f)(3) "at the end" of this paragraph; likely placement should have been at end of subparagraph (A).]*.

(4) JOINT AND SEVERAL LIABILITY.—[*As added by section 1406(a)(3)(D) of HCERA*.] If more than one person is liable for payment of the fee under subsection (a) with respect to a single covered entity by reason of the application of paragraph (3), all such persons shall be jointly and severally liable for payment of such fee.

(d) UNITED STATES HEALTH RISK.—For purposes of this section, the term ''United States health risk'' means the health risk of any individual who is—

(1) a United States citizen,

(2) a resident of the United States (within the meaning of section 7701(b)(1)(A) of the Internal Revenue Code of 1986), or

(3) located in the United States, with respect to the period such individual is so located.

(e) APPLICABLE AMOUNT.—[*Replaced by section 10905(b) and subsequently revised by section 1306(a)(4) of HCERA*.] For purposes of subsection (b)(1)—

(1) YEARS BEFORE 2019.—In the case of calendar years beginning before 2019, the applicable amount shall be determined in accordance with the following table:

Calendar year	**Applicable amount**
2014	$8,000,000,000
2015	$11,300,000,000
2016	$11,300,000,000
2017	$13,900,000,000
2018	$14,300,000,000.

(2) YEARS AFTER 2018.—In the case of any calendar year beginning after 2018, the applicable amount shall be the applicable amount for the preceding calendar year increased by the rate of premium growth (within the meaning of section 36B(b)(3)(A)(ii) of the Internal Revenue Code of 1986) for such preceding calendar year.

(f) TAX TREATMENT OF FEES.—The fees imposed by this section—

(1) for purposes of subtitle F of the Internal Revenue Code of 1986, shall be treated as excise taxes with respect to which only civil actions for refund under procedures of such subtitle shall apply, and

(2) for purposes of section 275 of such Code shall be considered to be a tax described in section 275(a)(6).

(g) REPORTING REQUIREMENT.—

(1) IN GENERAL.—Not later than the date determined by the Secretary following the end of any calendar year, each covered entity shall report to the Secretary, in such manner as the Secretary prescribes, the covered entity's net premiums written with respect to health insurance for any United States health risk for such calendar year. [*As revised by section 10904(f)(4)*.]

(2) PENALTY FOR FAILURE TO REPORT.—

(A) IN GENERAL.—In the case of any failure to make a report containing the information required by paragraph (1) on the date prescribed therefor (determined with regard to any extension of time for filing), unless it is shown that such failure is due to reasonable cause, there shall be paid by the covered entity failing to file such report, an amount equal to—

(i) $10,000, plus

(ii) the lesser of—

(I) an amount equal to $1,000, multiplied by the number of days during which such failure continues, or

(II) the amount of the fee imposed by this section for which such report was required.

(B) TREATMENT OF PENALTY.—The penalty imposed under subparagraph (A)—

(i) shall be treated as a penalty for purposes of subtitle F of the Internal Revenue Code of 1986,

(ii) shall be paid on notice and demand by the Secretary and in the same manner as tax under such Code, and

(iii) with respect to which only civil actions for refund under procedures of such subtitle F shall apply.

(3) ACCURACY-RELATED PENALTY.—[*As added by section 1406(a)(5) of HCERA*.]

(A) IN GENERAL.—In the case of any understatement of a covered entity's net premiums written with respect to health insurance for any United States health risk for any calendar year, there shall be paid by the covered entity making such understatement, an amount equal to the excess of—

(i) the amount of the covered entity's fee under this section for the calendar year the Secretary determines should have been paid in the absence of any such understatement, over

(ii) the amount of such fee the Secretary determined based on such understatement.

(B) UNDERSTATEMENT.—For purposes of this paragraph, an understatement of a covered entity's net premiums written with respect to health insurance for any United States health risk for any calendar year is the difference between the amount of such net premiums written as reported on the return filed by the covered entity under paragraph (1) and the amount of such net premiums written that should have been reported on such return.

(C) TREATMENT OF PENALTY.—The penalty imposed under subparagraph (A) shall be subject to the provisions of subtitle F of the Internal Revenue Code of 1986 that apply to assessable penalties imposed under chapter 68 of such Code.

(4) TREATMENT OF INFORMATION.—[*As added by section 1406(a)(5) of HCERA*.] Section 6103 of the Internal Revenue Code of 1986 shall not apply to any information reported under this subsection.

(h) ADDITIONAL DEFINITIONS.—For purposes of this section—

(1) SECRETARY.—The term ''Secretary'' means the Secretary of the Treasury or the Secretary's delegate.

(2) UNITED STATES.—The term ''United States'' means the several States, the District of Columbia, the Commonwealth of Puerto Rico, and the possessions of the United States.

(3) HEALTH INSURANCE.—[*Replaced by section 10905(d)*.]

The term ''health insurance'' shall not include—

(A) any insurance coverage described in paragraph (1)(A) or (3) of section 9832(c) of the Internal Revenue Code of 1986,

(B) any insurance for long-term care, or

(C) any medicare supplemental health insurance (as defined in section 1882(g)(1) of the Social Security Act).

(i) GUIDANCE.—The Secretary shall publish guidance necessary to carry out the purposes of this section and shall prescribe such regulations as are necessary or appropriate to prevent avoidance of the purposes of this section, including inappropriate actions taken to qualify as an exempt entity under subsection (c)(2). [*As revised by section 10905(e)*.]

(j) EFFECTIVE DATE.—[*Replaced by section 1406(a)(6) of HCERA; previous amendment by section 19095(f)(5)(A) was unexecutable*.] This section shall apply to calendar years beginning after December 31, 2013.

Effective Date and Transition

47. Upon adoption of this issue paper, the NAIC will release a Statement of Statutory Accounting Principles (SSAP) for comment. The SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the *Accounting Practices and Procedures Manual* should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and, therefore, the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will contain an effective date of years beginning on or after January 1, 2014.

Appendix A – Tracked Changes to SSAP No. 35R

Note – The changes reflected in this Appendix illustrate the revisions to SSAP No. 35R adopted in December 2013. This guidance was subsequently moved in 2014 into *SSAP No. 106—Affordable Care Act Section 9010 Assessment* as illustrated in Appendix B.

Statement of Statutory Accounting Principles No. 35 – Revised

Guaranty Fund and Other Assessments

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for guaranty fund and other assessments.

2. Guaranty fund assessments represent a funding mechanism employed by states to provide funds to cover policyholder obligations of insolvent reporting entities. Most states have enacted legislation establishing guaranty funds for both life and health insurance and for property and casualty insurance to provide for covered claims or to meet other insurance obligations of insolvent reporting entities in the state.

3. This statement addresses other assessments including but not limited to workers' compensation second injury funds and for funds that pay operating costs of an insurance department, a state guaranty fund, and/or the workers' compensation board. This statement also addresses health related assessments including but not limited to state health insurance high-risk pools, health insurance small group and individual reinsurance pools, state health demographic or risk adjustment assessments.

SUMMARY CONCLUSION

4. This statement adopts with modification guidance from *Accounting Standard Codification 405-30, Insurance-Related Assessments* (ASC 405-30) as reflected within this SSAP. Consistent with ASC 405-30-25-1, entities subject to assessments shall recognize liabilities for insurance-related assessments when all of the following conditions are met (paragraph ~~13~~15 provides guidance on applying the recognition criteria):

a. An assessment has been imposed or information available prior to issuance of the statutory financial statements indicates that it is probable that an assessment will be imposed.

b. The event obligating an entity to pay an imposed or probable assessment has occurred on or before the date of the financial statements.

c. The amount of the assessment can be reasonably estimated.

Guaranty fund and other assessments shall be charged to expense (Taxes, Licenses and Fees) and a liability shall be accrued when the above criteria are met except for certain health related assessments which shall be reported as a part of claims. Health related assessments that are reported as a part of claims instead of taxes, licenses and fees are those assessments that are designed for the purpose of spreading the risk of severe claims or adverse enrollment selection among all participating entities, and where the funds collected via the assessment are re-distributed back to the participating entities based upon the cost of specific claims, enrollment demographics, or other criteria affecting health care expenses. This standard does not permit liabilities for guaranty funds or other assessments to be discounted.

5. *ASU 2011-06: Other Expenses – Fees Paid to the Federal Government by Health Insurers* (ASU 2011-06) is adopted with modifications reflected in this statement. ASU 2011-06 provides specific guidance related to the assessment in Section 9010 of the Affordable Care Act and the statutory accounting guidance is included in paragraphs 16-21.

~~5.~~6. For refunded guaranty or other fund assessments and assessments used to fund state operating expenses, reporting entities shall credit the refund or charge the assessment to expense when notification of the refund or assessment is made.

~~6.~~7. For premium-based guaranty fund assessments, except those that are prefunded, paragraph 4.a. is met when the insolvency has occurred. For purposes of applying this guidance, the insolvency shall be considered to have occurred when a reporting entity meets a state's (ordinarily the state of domicile of the insolvent reporting entity) statutory definition of an insolvent reporting entity. In most states, the reporting entity must be declared to be financially insolvent by a court of competent jurisdiction. In some states, there must also be a final order of liquidation. Prefunded guaranty-fund assessments and premium-based administrative type assessment are presumed probable when the premiums on which the assessments are expected to be based are written. Loss-based administrative-type and second injury fund assessments are presumed probable when the losses on which the assessments are expected to be based are incurred.

~~7.~~8. Paragraph 4.b. requires that the event obligating an entity to pay an imposed or probable assessment has occurred on or before the date of the financial statements. Based on the fundamental differences in how assessment mechanisms operate, the event that makes an assessment probable (for example, an insolvency) may not be the event that obligates an entity. The following defines the event that obligates an entity to pay an assessment:

a. For premium-based assessments, the event that obligates the entity is generally writing the premiums or becoming obligated to write or renew (such as multiple-year, noncancelable policies) the premiums on which the assessments are expected to be based. Some states, through law or regulatory practice, provide that an insurance entity cannot avoid paying a particular assessment even if that insurance entity reduces its premium writing in the future. In such circumstances, the event that obligates the entity is a formal determination of insolvency or similar triggering event. For example, in certain states, an insurance entity may remain liable for assessments even though the insurance entity discontinues the writing of premiums. In this circumstance, the underlying cause of the liability is not the writing of the premium, but the insolvency. Regulatory practice would be determined based on the stated intentions or prior history of the insurance regulators.

b. For loss-based assessments, the event that obligates an entity is an entity's incurring the losses on which the assessments are expected to be based.

~~8.~~9. Paragraph 4.c. requires that the amounts can be reasonably estimated. For retrospective-premium-based guaranty fund assessments, a reporting entity's estimate of the liability shall reflect an estimate of its share of the ultimate loss expected from the insolvency. The reporting entity shall also estimate any applicable premium tax credits and policy surcharges. An entity need not be able to compute the exact amounts of the assessments or be formally notified of such assessments by a guaranty fund to make a reasonable estimate of its liability. Entities subject to assessments may have to make assumptions about future events, such as when the fund making the assessment will incur costs and pay claims to determine the amounts and the timing of assessments. The best available information about market share or premiums by state and premiums by line of business generally should be used to estimate the amount of future assessments. Estimates of loss-based assessments should be consistent with estimates of the underlying incurred losses and should be developed based upon enacted laws or regulations and expected assessment rates. Premium tax credits or policy surcharges may only be considered in the estimate if it is probable they will be realized. Because of the uncertainties surrounding some insurance-related assessments, the range of assessment liability may have to be re-evaluated regularly during the assessment process. Changes in the amount of the liability (or asset) as information becomes available over time and revisions to estimates in the amount or timing of the payments shall be recorded in taxes, licenses and fees.

~~9.~~10. In accordance with SSAP No. 5R, when the reasonable estimate of the loss is a range, the amount in the range that is considered the best estimate shall be accrued. When, in management's opinion, no amount within management's estimate of the range is a better estimate than any other amount, however, the midpoint (mean) of management's estimate in the range shall be accrued. For purposes of this statement, it is assumed that management can quantify the high end of the range. If management determines that the high end of the range cannot be quantified, then a range does not exist, and management's best estimate shall be accrued.

Reporting Assets for Premium Tax Offsets and Policy Surcharges

~~10.~~11. The liability for accrued assessments shall be established gross of any probable and estimable recoveries from premium tax credits and premium surcharges. When it is probable that a paid or accrued assessment will result in an amount that is recoverable from premium tax offsets or policy surcharges, an asset shall be recognized for that recovery in an amount that is determined based on current laws, projections of future premium collections or policy surcharges from in-force policies, and as permitted in accordance with paragraphs ~~10~~11.a., ~~10~~11.b. and ~~10~~11.c. Any recognized asset from premium tax credits or policy surcharges shall be re-evaluated regularly to ensure recoverability. Upon expiration, tax credits no longer meet the definition of an asset and shall be written off.

a. For assessments paid before premium tax credits are realized or policy surcharges are collected, an asset results, which represents a receivable for premium tax credits that will be taken and policy surcharges which will be collected in the future. These receivables, to the extent it is probable they will be realized, meet the definition of assets, as specified in *SSAP No. 4—Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this statement. The asset shall be established and reported independent from the liability (not reported net).

b. Assets recognized from accrued liability assessments shall be determined in accordance with the type of guaranty fund assessment as detailed in the following subparagraphs. Assets recognized from accrued liability assessments meet the definition of an asset under SSAP No. 4, and are admitted assets to the extent they conform to the requirements of this statement.

i. For retrospective-premium-based and loss-based assessments, to the extent that it is probable that accrued liability assessments will result in a recoverable amount in a future period from business currently in-force considering appropriate persistency rates for long-duration contracts, an asset shall be recognized at the time the liability is recorded. (In-force policies do not include expected renewals of short-term contracts.

ii. For prospective-premium-based assessments, the recognition of assets from accrued liability assessments is limited to the amount of premium an entity has written or is obligated to write and to the amounts recoverable over the life of the in-force policies. This SSAP requires reporting entities to recognize prospective-based-premium assessments as the premium is written or obligated to be written by the reporting entity. Accordingly, the expected premium tax offset or policy surcharge asset related to the accrual of prospective-premium-based assessments shall be based on and limited to the amount recoverable as a result of premiums the insurer has written or is obligated to write.

c. An asset shall not be established for paid or accrued assessments that are recoverable through future premium rate structures.

~~11.~~12. An evaluation of assets recognized under paragraph ~~10~~ 11 shall be made in accordance with *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets* (SSAP No. 5R) to determine if there is any impairment. If, in accordance with SSAP No. 5R, it is probable that the asset is no longer realizable, the asset shall be written off to the extent it is not realizable and charged to income in the period the determination is made. Considering expected future premiums other than on in-force policies in evaluating recoverability of premium tax offsets or policy surcharges is not permitted.

Acting as an Agent for Collection and Remittance of Fees and Assessments

~~12.~~13. In certain circumstances, a reporting entity acts as an agent for certain state or federal agencies in the collection and remittance of fees or assessments. In these circumstances, the liability for the fees and assessments rests with the policyholder rather than with the reporting entity. The reporting entity's obligation is to collect and subsequently remit the fee or assessment. When both the following conditions are met, an assessment shall not be reported in the statement of operations of a reporting entity:

a. The assessment is reflected as a separately identifiable item on the billing to the policyholder; and

b. Remittance of the assessment by the reporting entity to the state or federal agency is contingent upon collection from the insured.

~~13.~~14. The impact to the statement of operations depends on the nature of the charge:

a. For charges which are the ultimate responsibility of the policyholder, follow existing guidance in paragraph ~~12~~13, and pass these charges and recoveries through the balance sheet with no impact to the statement of operations.

b. For charges which are the ultimate responsibility of the reporting entity and may be recovered all or in part, apply gross or net reporting in the statement of operations as appropriate based on the nature of the charge and recovery. For example, charges which are considered in rate development or for which the recovery is classified as premium should be reported gross, charges for which recovery is considered a reduction of the expense should be reported net.

c. For collection or administrative fees, report such fees as revenue in the statement of operations as "Finance and Service Charges Not Included in Premiums" or "Aggregate Write-Ins for Miscellaneous Income".

Applying the Recognition Criteria

~~14.~~15. Application of the recognition criteria in paragraph 4:

a. *Retrospective-premium-based guaranty-fund assessments* - An assessment is probable of being imposed when a formal determination of insolvency occurs[1]. At that time, the premium that obligates the entity for the assessment liability has already been written. Accordingly, an entity that has the ability to reasonably estimate the amount of the

[1] As detailed within paragraph ~~6~~ 7 for premium-based guaranty-fund assessments, an insolvency shall be considered to have occurred when a reporting entity meets a state's (ordinarily the state of domicile of the insolvent reporting entity) statutory definition of an insolvent reporting entity. In most states, the reporting entity must be declared to be financially insolvent by a court of competent jurisdiction. In some states, there must also be a final order of liquidation.

assessment shall recognize a liability for the entire amount of future assessments related to a particular insolvency when a formal determination of insolvency is rendered.

b. *Prospective-premium-based guaranty-fund assessments* - The event that obligates the entity for the assessment liability generally is the writing of, or becoming obligated to write or renew, the premiums on which the expected future assessments are to be based (for example, multiple-year contracts under which an insurance entity has no discretion to avoid writing future premiums). Therefore, the event that obligates the entity generally will not have occurred at the time of the insolvency. Law or regulatory practice affects the event that obligates the entity in either of the following ways:

i. In states that, through law or regulatory practice, provide that an entity cannot avoid paying a particular assessment in the future (even if the entity reduces premium writings in the future), the event that obligates the entity is a formal determination of insolvency or a similar event. An entity that has the ability to reasonably estimate the amount of the assessment shall recognize a liability for the entire amount of future assessments that cannot be avoided related to a particular insolvency when a formal determination of insolvency occurs.

ii. In states without such a law or regulatory practice, the event that obligates the entity is the writing of, or becoming obligated to write, the premiums on which the expected future assessments are to be based. An entity that has the ability to reasonably estimate the amount of the assessments shall recognize a liability when the related premiums are written or when the entity becomes obligated to write the premiums.

c. *Prefunded-premium-based guaranty-fund assessments* - A liability for an assessment arises when premiums are written. Accordingly, an entity that has the ability to reasonably estimate the amount of the assessment shall recognize a liability as the related premiums are written.

d. *Other premium-based assessments* - Other premium-based assessments shall be accounted for in the same manner as prefunded premium-based guaranty-fund assessments.

e. *Loss-based assessments* - An assessment is probable of being asserted when the loss occurs. The obligating event of the assessment also has occurred when the loss occurs. Accordingly, an entity that has the ability to reasonably estimate the amount of the assessment shall recognize a liability as the related loss is incurred.

f. *Administrative-type assessments* – As this assessment is typically an annual amount per entity assessed to fund operations of the guaranty association, regardless of the existence of an insolvency, such assessments are generally expensed in the period assessed.

Affordable Care Act Section 9010 Assessment

16. The Affordable Care Act (ACA) imposes an assessment on entities that issue health insurance for each calendar year beginning on or after January 1, 2014. Pursuant to Section 9010 of the ACA, a reporting entity's portion of the assessment is paid no later than September 30 of the applicable calendar year (the fee year) beginning in 2014 and is not tax deductible. The amount of the assessment for the reporting entity is based on the ratio of the amount of an entity's subject net health premiums written for any U.S. health risk during the preceding calendar year (data year) to the aggregate amount of subject net health premiums written by all subject U.S. health insurance providers during the preceding calendar year. The ACA includes some significant exclusions regarding which entities are required to pay the assessment. This guidance applies to all entities that are subject to the fee. The guidance in this Section

(paragraphs 16-21) applies to the unique facts and circumstances in the ACA; accordingly, an entity should apply judgment when evaluating the facts and circumstances of other assessment~~s~~ arrangements before analogizing to the guidance for Section 9010 of the ACA.

17. Throughout this discussion of the Section 9010 assessment of the ACA, the following terms apply:

a. The term ”data year” means the calendar year immediately before the fee year. ~~Thus,~~ For example, 2014 is the data year for fee year 2015.

b. The term “fee year" means the calendar year in which the assessment must be paid to the U.S. Treasury.

18. A reporting entity’s portion of the annual assessment becomes payable to the U.S. Treasury once the reporting entity provides health insurance (in the fee year) for any subject U.S. health risk for each calendar year beginning on or after January 1, 2014.

19. The liability related to the Section 9010 ACA assessment shall be estimated and recorded in full once the entity provides qualifying health insurance (typically January 1) in the applicable calendar year in which the assessment is paid (fee year) with a corresponding entry to expense. The Section 9010 ACA assessment shall be recognized in full on January 1 of the fee year, in the operating expense category of Taxes, Licenses and Fees.

20. Liability recognition of the Section 9010 fee is not required in the data year. In the data year, the reporting entity is required to reclassify from unassigned surplus to special surplus an amount equal to its estimated subsequent fee year assessment. This segregation in special surplus is accrued monthly throughout the data year. The reclassification from unassigned surplus to special surplus does not reduce total surplus. On January 1 of the fee year, the prior year segregation in special surplus is reversed and the full current fee year assessment liability shall be accrued.

21. The Section 9010 ACA annual assessment does not represent a cost related to the acquisition of policies that is consistent with the definition of acquisition costs in *SSAP No. 71—Policy Acquisition Costs and Commissions.*

Disclosures

~~15.~~22. For guaranty fund and other non-Section 9010 ACA assessments, a reporting entity shall disclose the following:

a. Describe the nature of any assessments that could have a material financial effect, by type of assessment, and state the estimate of the liability, identifying whether the corresponding liability has been recognized under paragraph 4, a liability has not been recognized as the obligating event has not yet occurred, or that an estimate cannot be made.

b. For assessments with liabilities recognized under paragraph 4, disclose the amount of the recognized liabilities, any related asset for premium tax credits or policy surcharges, the periods over which the assessments are expected to be paid, and the period over which the recorded premium tax offsets or policy surcharges are expected to be realized.

c. Disclose assets recognized from paid and accrued premium tax offsets or policy surcharges, and include a reconciliation of assets recognized within the previous year’s Annual Statement to the assets recognized in the current year’s Annual Statement. The reconciliation shall reflect, in aggregate, each component of the increase and decrease in paid and accrued premium tax offsets and policy surcharges, including the amount charged off.

d. Disclosures shall be made in accordance with paragraph 25 of SSAP No. 5R when there is at least a reasonable possibility that the impairment of an asset from premium tax offsets or policy surcharges may have been incurred.

~~16.~~23. For the Section 9010 ACA assessment:

a. For the annual reporting period ending December 31, 2013 and thereafter, a reporting entity subject to the assessment under Section 9010 of the Affordable Care Act, shall provide a disclosure of the assessment payable in the upcoming year consistent with the guidance provided under *SSAP No. 9—Subsequent Events* for a Type II subsequent event. The disclosure shall provide information regarding the nature of the assessment and an estimate of its financial impact, including the impact on its risk based capital position as if it had occurred on the balance sheet date. In accordance with SSAP No. 9, paragraph 9, the reporting entity shall also consider whether there is a need to present pro forma financial statements regarding the impact of the assessment, based on its judgment of the materiality of the assessment.

b. Additionally, for annual reporting periods ending on or after December 31, 2014, the disclosure in paragraph 23.a.is expanded to include information on the amounts reflected in special surplus in the data year. The disclosure shall provide information regarding the nature of the assessment and the Total Adjusted Capital and Authorized Control Level (in dollars) before and after adjustment (as reported in its estimate of special surplus applicable to the 9010 fee) to reflect the fee as of the annual reporting date as if it had been reported on the balance sheet date. The disclosure shall also provide a statement as to whether an RBC action level would have been triggered had the fee been reported as of the balance sheet date.

~~17.~~24. Refer to the preamble for further discussion regarding disclosure requirements.

Relevant Literature

~~18.~~25. This statement adopts GAAP guidance for recording guaranty fund and other assessments, which is contained in *Accounting Standards Codification 405-30, Insurance Related Assessments* (ASC 405-30) to the extent reflected in this SSAP. Statutory accounting modifications from ASC 405-30 are as follows:

a. The option to discount accrued liabilities (and reflect the time value of money in anticipated recoverables) is rejected for statutory accounting. Liabilities for guaranty funds or other assessments shall not be discounted.

b. The use of a valuation allowance for premium tax offsets and policy surcharges no longer probable for realization has been rejected for statutory accounting. Evaluation of assets shall be made in accordance with SSAP No. 5R, and if it is probable that the asset is no longer realizable, the asset shall be written off and charged to income in the period the determination is made.

c. Guidance within ASC 405-30 pertaining to noninsurance entities has been rejected as not applicable for statutory accounting.

26. The guidance in paragraph ~~13~~ 14 adopted *Emerging Issues Task Force No. 06-3: How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That is, Gross versus Net Presentation)* and was effective September 2007.

~~19.~~27. *ASU 2011-06: Other Expenses – Fees Paid to the Federal Government by Health Insurers* is adopted with modifications: 1) to require full expense recognition on January 1 of the fee year and 2) to require the reclassification from unassigned surplus to special surplus in the data year for the estimated amount payable, and 3) other modifications for statutory accounting terminology as reflected in paragraphs 16-21.

Effective Date and Transition

~~20.~~28. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*. Substantive revisions to paragraphs 4, ~~6~~7, ~~7~~8, ~~8~~9, ~~10~~11, ~~11~~12, ~~13~~15 and ~~14~~22 are initially effective for the reporting period beginning January 1, 2011. The result of applying this revised Statement shall be considered a change in accounting principle in accordance with SSAP No. 3. Pursuant to SSAP No. 3, the cumulative effect of changes in accounting principles shall be reported as an adjustment to unassigned funds (surplus) in the period of the change in accounting principle. The cumulative effect recognized through surplus from initial application of this Statement shall reflect the removal of liabilities established under SSAP No. 35, and the re-establishment of liabilities required under SSAP No. 35R. If there is no change in the liabilities recognized (for example, retrospective-premium based assessments), no cumulative effect adjustment shall occur. With regards to assets, the entity shall complete an assessment of the SSAP No. 35 asset reported as of the transition date. If it is determined that the reported asset exceeds what is allowed under SSAP No. 35R, then the excess asset shall be written-off, through unassigned funds, so the ultimate asset reflected corresponds with what is permitted under SSAP No. 35R. Although it is possible that the excess asset will be reinstated once the liability assessment is recognized (prospective-premium based assessments), it is inappropriate to continue to reflect an asset for assessments that are not reflected within the financial statements. The guidance in paragraph ~~13~~ 14 adopted *Emerging Issues Task Force No. 06-3: How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That is, Gross versus Net Presentation)* and was effective September 2007. The Section 9010 ACA fee has specific guidance (adopted December 2013), detailed in paragraphs 16-21, that is initially effective for annual reporting periods beginning January 1, 2014.

RELEVANT ISSUE PAPERS

- *Issue Paper No. 35—Accounting for Guaranty Fund and Other Assessments*
- *Issue Paper No. 143—Prospective-Based Guaranty Fund Assessments*

EXHIBIT A – PRIMARY METHODS OF GUARANTY FUND ASSESSMENTS

a. *Retrospective-premium-based assessments* - Guaranty funds covering benefit payments of insolvent life, annuity, and health insurance entities typically assess entities based on premiums written or received in one or more years before the year of insolvency. Assessments in any year are generally limited to an established percentage of an entity's average premiums for the three years preceding the insolvency. Assessments for a given insolvency may take place over several years.

b. *Prospective-premium-based assessments* - Guaranty funds covering claims of insolvent property and casualty insurance entities typically assess entities based on premiums written in one or more years after the insolvency. Assessments in any year are generally limited to an established percentage of an entity's premiums written or received for the year preceding the assessment. Assessments for a given insolvency may take place over several years.

c. *Prefunded-premium-based assessments* - This kind of assessment is intended to prefund the costs of future insolvencies. Assessments are imposed before any particular insolvency and are based on the current level of written premiums. Rates to be applied to future premiums are adjusted as necessary.

d. *Administrative-type assessments* - These assessments are typically a flat (annual) amount per entity to fund operations of the guaranty association, regardless of the existence of an insolvency.

e. *Other premium-based assessments* - Entities are subject to a variety of other insurance-related assessments. Many states and a number of local governmental units have established other funds supported by assessments. The most prevalent uses for such assessments are (*a*) to fund operating expenses of state insurance regulatory bodies (for example, the state insurance department or workers' compensation board) and (*b*) to fund second-injury funds.

   i. *Premium-based* - The assessing organization imposes the assessment based on the entity's written premiums. The base year of premiums is generally either the current year or the year preceding the assessment.

   ii. *Loss-based* - The assessing organization imposes the assessment based on the entity's incurred losses or paid losses in relation to that amount for all entities subject to that assessment in the particular jurisdiction.

Appendix B – Illustration of SSAP No. 106: ACA Assessments

Note – The changes reflected in this Appendix illustrate the substantive placement revisions to SSAP No. 35R adopted in December 2013 (reflected in Appendix A), which were subsequently moved in 2014 into *SSAP No. 106—Affordable Care Act Section 9010 Assessments*. Also at that time, additional disclosures related to the Section 9010 fee of the Affordable Care Act were incorporated. The changes to the disclosures are reflected as tracked revisions in this issue paper.

Statement of Statutory Accounting Principles No. 106

Affordable Care Act Assessments

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for the Affordable Care Act Section 9010 assessment and disclosures related to the risk sharing provisions of the Affordable Care Act.

SUMMARY CONCLUSION

2. This statement adopts *ASU 2011-06: Other Expenses – Fees Paid to the Federal Government by Health Insurers* (ASU 2011-06) with modifications identified in paragraph 11. ASU 2011-06 provides specific guidance related to the assessment in Section 9010 of the Affordable Care Act.

Affordable Care Act Section 9010 Assessment

3. The Affordable Care Act (ACA) imposes an assessment on entities that issue health insurance for each calendar year beginning on or after January 1, 2014. Pursuant to Section 9010 of the ACA, a reporting entity's portion of the assessment is paid no later than September 30 of the applicable calendar year (the fee year) beginning in 2014 and is not tax deductible. The amount of the assessment for the reporting entity is based on the ratio of the amount of an entity's subject net health premiums written for any U.S. health risk during the preceding calendar year (data year) to the aggregate amount of subject net health premiums written by all subject U.S. health insurance providers during the preceding calendar year. The ACA includes some significant exclusions regarding which entities are required to pay the assessment. The guidance in this statement applies to all reporting entities that are subject to the fee. The guidance in this statement applies to the unique facts and circumstances in the ACA; accordingly, an entity should apply judgment when evaluating the facts and circumstances of other assessments arrangements before analogizing the guidance for Section 9010 of the ACA.

4. Throughout this discussion of the Section 9010 assessment of the ACA, the following terms apply:

a. The term "data year" means the calendar year immediately before the fee year. For example, 2014 is the data year for fee year 2015.

b. The term "fee year" means the calendar year in which the assessment must be paid to the U.S. Treasury.

5. A reporting entity's portion of the annual assessment becomes payable to the U.S. Treasury once the reporting entity provides health insurance (in the fee year) for any subject U.S. health risk for each calendar year beginning on or after January 1, 2014.

6. The liability related to the Section 9010 ACA assessment shall be estimated and recorded in full once the entity provides qualifying health insurance (typically January 1) in the applicable calendar year in which the assessment is paid (fee year) with a corresponding entry to expense. The Section 9010 ACA

assessment shall be recognized in full on January 1 of the fee year, in the operating expense category of Taxes, Licenses and Fees.

7. Liability recognition of the Section 9010 fee is not required in the data year. In the data year, the reporting entity is required to reclassify from unassigned surplus to special surplus an amount equal to its estimated subsequent fee year assessment. This segregation in special surplus is accrued monthly throughout the data year. The reclassification from unassigned surplus to special surplus does not reduce total surplus. On January 1 of the fee year, the prior year segregation in special surplus is reversed and the full current fee year assessment liability shall be accrued.

8. The Section 9010 ACA annual assessment does not represent a cost related to the acquisition of policies that is consistent with the definition of acquisition costs in *SSAP No. 71—Policy Acquisition Costs and Commissions*.

Disclosures

9. For the Section 9010 ACA assessment:

a. For the annual reporting period ending December 31, 2013, and thereafter, a reporting entity subject to the assessment under section 9010 of the Affordable Care Act, shall provide a disclosure of the assessment payable in the upcoming year consistent with the guidance provided under *SSAP No. 9—Subsequent Events* for a Type II subsequent event. The disclosure shall provide information regarding the nature of the assessment and an estimate of its financial impact, including the impact on its risk-based capital position as if it had occurred on the balance sheet date. In accordance with SSAP No. 9, paragraph 9, the reporting entity shall also consider whether there is a need to present pro forma financial statements regarding the impact of the assessment, based on its judgment of the materiality of the assessment.

b. Additionally, for annual reporting periods ending on or after December 31, 2014, the disclosure in paragraph 9.a. is expanded to include information on the amounts reflected in special surplus in the data year.

i. The reporting entity shall disclose the amount of premium written for the current year that is the basis for the determination of the section 9010 fee assessment to be paid in the subsequent year (net assessable premium). Prior year amounts shall also be included for comparative purposes;

~~i.~~ii. Reporting entities shall provide information regarding the nature of the assessment, the estimated amount of the assessment payable in the upcoming year (current and prior year)and the amount of assessment paid (current and prior year), and ;

~~ii.~~iii. The disclosure shall also provide the Total Adjusted Capital and Authorized Control Level (in dollars) before and after adjustment (as reported in its estimate of special surplus applicable to the 9010 fee) to reflect the fee as of the annual reporting date as if it had been reported on the balance sheet date. The disclosure shall also provide a statement as to whether an RBC action level would have been triggered had the fee been reported as of the balance sheet date.

10. Refer to the preamble for further discussion regarding disclosure requirements.

Relevant Literature

11. *A*SU *2011-06: Other Expenses – Fees Paid to the Federal Government by Health Insurers* is adopted with the following modifications: 1) to require full expense recognition on January 1 of the fee year, 2) to require the reclassification from unassigned surplus to special surplus in the data year for the estimated amount payable, and 3) other modifications for statutory accounting terminology as reflected in this statement.

Effective Date and Transition

12. This statement is effective for years beginning January 1, 2014. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*. The Section 9010 ACA fee specific guidance in paragraphs 2-8 and paragraph 9.b. was adopted December 2013 with a January 1, 2014, effective date. This guidance was originally reflected in *SSAP No. 35—Guaranty Fund and Other Assessments – Revised* (SSAP No. 35R). The disclosure language in paragraph 9a was also moved from SSAP No. 35R, but was originally effective December 31, 2013. The guidance from SSAP No. 35R was moved into this statement in month/year. This movement was a placement change and did not result revisions to the accounting guidance previously included in SSAP No. 35R.

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 148—Affordable Care Act Section 9010 Assessment*

Issue Paper No. 149

Wholly-Owned Single Real Estate Property in an LLC

STATUS
Finalized December 12, 2014

Original SSAP and Current Authoritative Guidance: SSAP No. 40R
Also refer to SSAP No. 48.

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory accounting guidance for real estate investments is in *SSAP No. 40—Real Estate Investments* (SSAP No. 40), and guidance for investments in joint ventures, partnership, and limited liability companies (LLC) is in *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies* (SSAP No. 48). Reporting entities can own real estate through an LLC to provide a liability shield against the risks of holding real estate. Single property real estate that is wholly-owned (100%) by a single reporting entity in an LLC, if specific criteria are met, is in substance a real estate investment.

2. This issue paper provides substantive revisions to incorporate individual real estate investments wholly-owned by a single entity through an LLC, which meet specific criteria, within the scope of SSAP No. 40. The revisions also exclude these investments from SSAP No. 48.

SUMMARY CONCLUSION

3. This issue paper substantively revises the scope of SSAP No. 40 and SSAP No. 48. The substantive revisions to SSAP No. 40 and SSAP No. 48 are shown below.

Substantive Revisions to SSAP No. 40:

> 2. Real estate investments are defined as directly-owned real estate properties and single real estate property investments that are directly and wholly-owned through a limited liability company (LLC) that meet all of the criteria in paragraph 4. ~~These~~ Real estate investments may be acquired in exchange for consideration (including but not limited to cash, a contract for deed or mortgage, or other non-cash consideration), obtained through foreclosure or voluntary conveyance in satisfaction of a mortgage loan, or received as contributed surplus. Real estate investments meet the definition of assets as defined in *SSAP No. 4—Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this statement.
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> 3. Real estate investments include certain acquisition, development and construction arrangements (ADC) as defined in *SSAP No. 38—Acquisition, Development and Construction Arrangements* (SSAP No. 38).
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> 4. A single real estate property investment that is wholly-owned by an LLC that is directly[1] and wholly-owned by the reporting entity shall be captured within this statement, and reported on Schedule A – Real Estate if all of the following criteria are met. Real estate owned through an

[1] For example, qualifying LLCs that are owned by a downstream holding company are not within scope of this statement regardless if the downstream holding company is wholly-owned by the reporting entity.

LLC that meets the stated criteria shall follow all statutory requirements within this statement[2]. Real estate owned through an LLC that does not meet the criteria shall be reported on Schedule BA – Other Long-Term Invested Assets. Regardless if reported on Schedule A or Schedule BA, all LLC's owned by the reporting entity shall be detailed in Schedule Y.

a. The real estate LLC has no transactions of its own other than transactions associated with an ownership structure utilized only for the ownership and management of a single real estate investment exclusively for the reporting entity (e.g., real estate taxes). A reporting entity may have more than one LLC that wholly-owns a single real estate property investment, but each LLC must separately comply with the paragraph 4 conditions, and be separately reported on Schedule A. All transactions of the LLC shall be reported as transactions of the reporting entity pursuant to the guidance in paragraphs 15-17.

b. The LLC only owns a single real estate property supported by an appraisal pursuant to paragraphs 13-14. A single real estate property can include multiple parcels of land and more-than-one structure; however, to be considered a single real estate property, the multiple of parcels of land and structure(s) must be contiguously located and managed together as a single asset (with reasonable allowances for public access routes). Criteria that may assist with determining a single real estate property would include the legal definition of the property, real estate tax assessments, postal address, the appraisal and the management and use of the property.

c. The reporting entity solely controls the real estate property in a manner similar to directly-owned real estate. As such, the reporting entity controls others' access to the real estate, and the real estate must be able to be sold exactly as, and as promptly as, directly-owned real estate.

d. The reporting entity solely and distinctly possesses all risks (other than the limitation of potential liability afforded by the LLC structure itself) and rewards of ownership of the real estate investment, without any constraints imposed by the LLC.

e. The reporting entity is the only member of the LLC. The LLC is not comprised of any other members, including: groups, competing interests, mutual beneficial interests, or co-venturers. The single-member ownership is required even if other members in the LLC are affiliates. An LLC comprised of affiliated parties is not within scope of this statement.

f. There shall be no apportionment by the LLC or the reporting entity of the appraised value, expenses or income from the single real estate property to any other entity or between the general or separate account.

Disclosures (New Paragraph 27)

27. An entity that holds real estate investments through an LLC, which qualifies for inclusion in this statement because all the criteria in paragraph 4 are met, shall separately report each investment on Schedule A, and code the real estate as wholly-owned through an LLC.

Effective Date and Transition (New Paragraphs 36-37)

36. The substantive revisions to incorporate real estate property investments that are wholly-owned by an LLC that is directly and wholly-owned by the reporting entity in accordance with the

[2] The inclusion in this statement of real estate owned by a single member LLC is not an election by the reporting entity. All real estate owned in an LLC meeting the criteria in paragraph 4 are required to be captured within this statement, and are subject to this statement's requirements for valuation and admittance. Departures from the requirements within this SSAP, or continuing to follow SSAP No. 48 for these investments would be considered a departure from NAIC statutory accounting principles subject to permitted or prescribed practice disclosure requirements.

criteria detailed in paragraph 4 are effective as of January 1, 2015**.** For these investments previously reported within SSAP No. 48, and owned as of the effective date, the reporting entity shall recognize a cumulative effect of a change in accounting principle as if the entity had followed this statement since acquisition of the real estate investment property. The change from applying these substantive revisions shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors.*

37. To determine statement value for real estate owned through an LLC as of the paragraph 36 effective date, the reporting entity shall:

a. Allocate the original cost of the real estate investment to land and property other-than-land pursuant to paragraph 8.

b. To arrive at the current depreciated cost for property (excluding land), the entity shall apply the depreciation that would have occurred if this statement had been applied since acquisition, in accordance with the original expected useful life, adjusted for subsequent capital improvements pursuant to paragraph 16.

c. The depreciated cost calculated under paragraph 37.b. shall be compared to a current appraisal to determine if an impairment assessment is required under SSAP No. 90. Recognition of impairment shall result in a new cost basis for the property, with recalculation of the depreciation based on the property's remaining useful life, as limited by the terms of this statement.

d. The depreciated cost, reflecting any impairment from paragraph 37.c., less encumbrances, shall be recognized as the real estate investment as of the effective date.

Substantive Revisions to SSAP No. 48:

SCOPE OF THE STATEMENT

1. This statement establishes statutory accounting principles for investments in any joint ventures, partnerships, and limited liability companies, including investments in certified capital companies (CAPCO) per *INT 06-02: Accounting and Reporting for Investments in a Certified Capital Company (CAPCO)*, whether or not it is considered to be controlled by or affiliated with the reporting entity. Single real estate property investments that are wholly-owned by an LLC that is directly and wholly-owned by the reporting entity, and that meet the criteria established in *SSAP No. 40—Real Estate Investments*, are excluded from this statement. This statement does not address the accounting for investments in partnerships and limited liability companies that invest in Low Income Housing Tax Credit Properties as discussed in *SSAP No. 93—Accounting for Low Income Housing Tax Credit Property Investments* (SSAP No. 93). However, investments in certain state Low Income Housing Tax Credit Property Investments that do not fall within the scope of SSAP No. 93 are covered by the requirements of this statement.

EFFECTIVE DATE AND TRANSITION (NEW PARAGRAPH 26)

26. The substantive revisions to incorporate single real estate property investments wholly-owned by an LLC that is directly and wholly-owned by the reporting entity in accordance with the criteria detailed in SSAP No. 40 are effective as of January 1, 2015**.** For these investments previously reported within the scope of this statement, the reporting entity shall follow the transition guidance in SSAP No. 40.

DISCUSSION

4. In August 2013, a sponsor submitted an agenda item (Ref #2013-17) to the Statutory Accounting Principles (E) Working Group recommending revisions to indicate that if the substance of a real estate transaction means that absolute control and all rights over the real estate are with the insurer, and just the

insurer, then the accounting and reporting should be in accordance with *SSAP No. 40—Real Estate Investments* and *SSAP No. 90—Accounting for the Impairment or Disposal of Real Estate*.

5. Within the submitted agenda item, the sponsor advocated that for these transactions, the arm's length economic transaction is the purchase of real estate, not an investment in an LLC. The single member / single asset LLC is a conduit that one invests "through" not "in," and the insurer's control over the real estate is total and absolute, as control is equivalent to direct ownership. The sponsor noted that the insurer can establish absolute control equivalent to direct ownership by meeting all of the following conditions:

a. The insurer controls others' access to the real estate to the extent that the real estate is the "asset" with an appraisal. It can be sold exactly as and, as promptly as, any other real estate sale. From the perspective of *SSAP No. 4—Assets and Nonadmitted Assets* (SSAP No. 4), it is real estate that is the asset standing ready to satisfy policy owner needs;

b. Risks and rewards of ownership of the real estate as discussed in *SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties* (SSAP No. 25), are solely and distinctly in possession of the insurer without any constraints imposed by the LLC with constraints defined as in *SSAP No. 103—Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities* (SSAP No. 103);

c. No members are in the single-member/single asset LLC except for the insurer itself, no "group" or competing interest, "mutual" beneficial interest or "co venturer", affiliated or not, having any ownership interest in the real estate as anticipated by SSAP No. 48;

d. The single-member/single-asset LLC has no transactions of its own;

e. Lacking any interests outside of the insurer's general account, there is absolutely no need or reason to apportion the appraised value, expenses or income from the real estate. All accounting requirements of SSAP No. 40 are met to the extent that the asset could reasonably meet the comment in Schedule BA instructions that it could be "normally includable" in Schedule A;

f. The LLC is not a business in itself but is an administrative device. It follows the model of an "Investment Affiliate" in RBC Instructions that is organized to engage in the ownership and management of investments exclusively for the insurer for which risk based capital factors are those of the underlying asset; and,

g. The insurer will disclose use of single-member/single-asset LLCs as required by *SSAP No. 1—Disclosure of Accounting Policies, Risk and Uncertainties, and Other Disclosures* (SSAP No. 1).

6. In reviewing the sponsor-submitted agenda item, NAIC staff identified that some real estate transactions are separately housed in LLC structures for legal liability reasons, and under existing statutory accounting guidance, these wholly-owned structures would be within the scope of SSAP No. 48, and be reported using an equity method as defined in *SSAP No. 97—Investments in Subsidiary, Controlled or Affiliated Entities* (SSAP No. 97). Pursuant to guidance in SSAP No. 97, these investments would be considered U.S. noninsurance SCA entities and be recorded based on the audited U.S. GAAP equity of the investee.

7. In identifying the differences that would occur if these real estate structures were moved to SSAP No. 40, NAIC staff noted the following:

a. Reduction of RBC: For real estate reported on Schedule A (SSAP No. 40), the health/P&C RBC charge is 0.10 of the book/adjusted carrying value and 0.10 of the encumbrances, the life RBC charge is 0.15 of the book/adjusted carrying value and 0.12 of the encumbrances. For life annual statement filers, these investments reported on Schedule BA through an LLC receive a 0.23 RBC pre-tax charge on the book/adjusted carrying value, with an additional 0.20 pre-tax charge on the encumbrances. For property and health annual statement filers, these investments receive a 0.20 RBC charge on the book/adjusted carrying value.

b. Reduction of Carrying Value: Real estate accounted for under SSAP No. 40 is valued at depreciated cost, and generally reported at depreciated cost less encumbrances. (Property held for sale is reported at the lower of fair value, or depreciated cost less encumbrances.)

c. Depreciating Asset: Real estate property other than land accounted for under SSAP No. 40 is depreciated over its estimated useful life, not to exceed fifty years. Expenditures to put the real estate asset back into good condition or to keep it in good operating condition are expensed as incurred. Expenditures that add or prolong the life of the property are added to the cost of the property and depreciated over the remaining estimated useful life.

d. Admitted Asset Restrictions: Real estate property held for the production of income, or held for sale under SSAP No. 40 are required to have a current appraisal. A current appraisal is defined as one that is no more than five years old. Property not supported by a current appraisal is nonadmitted. Under SSAP No. 48, investments in an LLC were nonadmitted if not supported by audited financial statements.

e. Disallowance of Fair Value Gains: Real estate properties held under SSAP No. 40 are not permitted to reflect fair value increases in value.

8. In December 2013, after initially exposing the agenda item for comment, and submitting a referral to the Capital Adequacy (E) Task Force, the Statutory Accounting Principles (E) Working Group noted that comments received from interested parties supported the concepts and conditions within the agenda item. Additionally, the comments requested an expansion of the scope of the agenda item to include multi-member insurers and real estate held in a holding company system. In discussing this proposed expansion, the Working Group agreed to limit consideration to single-member/single-asset situations, and potentially consider a broader project under the investment classification project (Ref #2013-36).

9. In August 2014, the Statutory Accounting Principles (E) Working Group considered comments from the Capital Adequacy (E) Task Force and directed staff to proceed with drafting guidance to incorporate these assets into SSAP No. 40 with a caveat that the guidance could be amended under the Working Group’s current investment classification project. In discussing this option, representatives from interested parties’ stated support for this approach, and noted that the proposed move between SSAPs would be fairly easy to incorporate within their financial reporting systems.

10. During the August 2014 discussion, NAIC staff clarified that the current Working Group direction would be to draft guidance to not allow optionality in determining whether the real estate assets fall within SSAP No. 48 or SSAP No. 40, therefore the assets that meet the criteria would be solely captured within SSAP No. 40. This discussion highlighted that this change would allow a reporting change from Schedule BA to Schedule A, resulting in a lower RBC charge, but the change would also possibly result in a lower asset value, as SSAP No. 40 requires a depreciated cost value net of encumbrances instead of GAAP equity. Additionally, under SSAP No. 40, an appraisal is required for the asset to be admitted, and an appraisal is not required for the asset to be admitted under SSAP No. 48. Comments received from Working Group members stated support for the improved reporting

transparency if these investments were captured under SSAP No. 40, and noted that industry seems aware of the accounting impact that will occur with implementation of these changes.

EFFECTIVE DATE

11. Upon adoption of this issue paper, the NAIC will release a substantively revised statement of statutory accounting principles (SSAP) for comment. The SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the *Accounting Practices and Procedures Manual* should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will contain an effective date of reporting periods after January 1, 2015.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

- *SSAP No. 40—Real Estate Investments*
- *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies*
- *SSAP No. 90—Accounting for the Impairment or Disposal of Real Estate Investments*

Generally Accepted Accounting Principles

- The above mentioned SSAPs have several GAAP references. As this issue paper is specific to statutory accounting reporting between SSAPs, the GAAP guidance has not been duplicated.

Statutory Issue Paper No. 150

Accounting for the Risk-Sharing Provisions of the Affordable Care Act

STATUS
Finalized November 16, 2014

Original SSAP and Current Authoritative Guidance: SSAP No. 107

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. The Affordable Care Act (ACA) imposes fees and premium stabilization provisions on health insurance issuers offering commercial health insurance. This issue paper recommends accounting for three programs known as risk adjustment, reinsurance and risk corridors that take effect in 2014. Risk adjustment is a permanent risk-spreading program (ACA Section 1343). The temporary transitional reinsurance program (ACA Section 1341) and temporary risk corridors program (ACA Section 1342) are for years 2014 through 2016.

2. Specific terms included in Appendix A are unique to these programs and should not be applied to other aspects of statutory accounting. The required payments to the programs by reporting entities are described as "contributions" in the program literature but are referred to in this guidance as assessments for clarity. Amounts redistributed by the programs back to reporting entities are termed "payments" by the programs. These "payments" are recoverables/receivables for the reporting entity and are termed program distributions or receivables (to the reporting entity) in this guidance. The reporting of payable or receivable amounts in this guidance is from the perspective of the reporting entity. The statement based on this issue paper will nullify *INT 13-04: Accounting for the Risk-Sharing Provisions of the Affordable Care Act.*

SUMMARY CONCLUSION

3. This issue paper establishes statutory accounting principles for the risk-sharing provisions of the ACA. The manner in which these provisions are applied in the determination of the medical loss ratios (MLR) and rebates may be different from these as the MLR calculations are based on the ACA Section 2718(b).

Risk Adjustment Program – Description and Overview

4. The risk adjustment program based on Section 1343 of the ACA is effective beginning in the 2014 benefit year and continues as a permanent program.

5. The risk adjustment program includes health plans (except certain exempt and grandfathered plans) in the individual or small group markets both on and off the exchange. All covered risk adjustment plans are required to participate in the risk adjustment program.

6. The purpose of the risk adjustment program is to transfer funds from lower risk plans to higher risk plans within similar plans in the same state in order to adjust premiums for adverse selection among carriers caused by membership shifts due to guarantee issue and community rating mandates. States may set up their own risk adjustment programs, or they may permit Health and Human Services (HHS) to develop and manage the program in the state. In addition to the risk adjustment amount, HHS determines the user fee. In states operating their own risk adjustment program, the state will determine the fee.

7. Risk adjustment assessments and distributions will be computed based on the reporting entity's risk score versus the overall market risk score after applying adjustments. Risk adjustment assessments will be made if the plan average actuarial risk of all of their enrollees in a market and state is lower than the plan average risk of all enrollees in fully insured plans in that market and state risk pool. Risk adjustment distributions will be made to health plan issuers whose plans have an average actuarial risk that is greater than the plan average actuarial risk scores in that market and state risk pool. The reinsurance program is not considered in the computation.

8. HHS will collect a user fee to support the administration of the HHS-operated risk adjustment program. This fee applies to issuers of risk adjustment covered plans in states in which HHS is operating the risk adjustment program. For example, HHS projects that the per capita risk adjustment user fee for 2014 is approximately $1 per enrollee per year. Similar terms will apply for the user fees of state operated programs.

9. All risk adjustment distributions made to issuers are completely funded through the amounts assessed to other issuers within the same market in the same state to ensure equality between program distributions and assessments. Consequently, risk adjustment assessments will be invoiced prior to processing program distributions to issuers. Once applicable risk adjustment assessments by issuers are received by HHS or the state, funds will be redistributed to the higher risk plans. Each issuer that offers a risk adjustment covered plan will be notified of risk adjustment distributions or assessments by June 30 of the year following the benefit year to align with the program distributions and assessment processing. Risk adjustment assessments owed by an issuer to HHS or the state are required to be remitted within 30 days of notification of the assessment. Once applicable assessments are received by HHS or the state, funds will be redistributed to the higher risk plans.

Risk Adjustment Program – Accounting Treatment

10. The accounting elements of the ACA permanent risk adjustment program, which are considered separately, include the user fee and the risk adjustment assessments and distributions.

11. The user fee is paid to HHS in states where the risk adjustment program is being operated by HHS and to the state program if operated by the state. Risk adjustment user fees shall be treated as government assessments. These fees are treated the same as other non-income-based governmental taxes and fees in that they are recognized as an expense and liability when the premium subject to the assessment is written.

12. Premium adjustments pursuant to the risk adjustment program will be based upon the risk scores (health status) of enrollees, participating in risk adjustment covered plans rather than the actual loss experience of the insured. This program bears some similarities to the Medicare Advantage risk adjustment program[1] under which the plan receives additional funding (or pays additional amounts) based on adjustments to risk scores of enrollees (see *INT 05-05: Accounting for Revenues Under Medicare Part D Coverage*).

13. The risk adjustment payables and receivables shall be accounted for as premium adjustments subject to redetermination as specified in this issue paper.

a. Risk adjustment payables meet the definition of liabilities as set forth in *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets* (SSAP No. 5R). Risk adjustment receivables meet the definition of an asset and are admissible to the extent that they meet all of the criteria in this issue paper.

[1] The ACA program also has significant differences from the Medicare Advantage risk adjustment program, which is retrospective, administered as a single national program, with most enrollees administered by the federal government. By contrast, the ACA risk adjustment is not retrospective, and is administered by each entity by state and by plan.

b. Risk adjustment payables and receivables shall be estimated based on experience to date. The method used to estimate the payables and receivables shall be reasonable and consistent between reporting periods. Reporting entities shall be aware of the significant uncertainties involved in preparing estimates and be both diligent and conservative in their estimations. In exercising the judgment required to prepare reasonable estimates for the financial reporting of risk adjustment program payables and receivables, the statutory accounting concept of conservatism shall be followed. In addition, reporting entities are required to have sufficient data to determine a reasonable estimate. Ensuring sufficient data requires that the reporting entity's estimate is based on demonstrated knowledge of the marketplace and annual information which includes patient encounter and diagnosis code data to determine the differences in the actuarial risk profile of the reporting entity's insureds versus the market participants in the particular market and state risk pool. Sufficient data shall incorporate patient default scores, if applicable, under the terms of the risk adjustment program. In addition, the estimates shall be consistent with other financial statement assertions and the pricing scenarios used by the reporting entity.

c. Premium revenue adjustments for the risk adjustment program are estimated for the portion of the policy period that has expired and shall be reported as an immediate adjustment to premium. Accrued risk adjustment receivables shall be recorded as a write-in for other-than-invested assets, with a corresponding entry to premiums; accrued risk adjustment payables shall be recorded as a liability with a corresponding entry to premiums. Reporting entities shall record additions or reductions to revenue resulting from the risk adjustment program in the period in which the changes in risk scores of enrollees result in reasonably estimable additions or reductions. The risk adjustment program receivables shall be reported gross of payables.

d. The risk adjustment receivables are administered through a federal governmental program. Once amounts are collected by the governmental entity, there is an obligation to distribute the funds. Amounts over 90 days due shall not cause the receivable to be treated as a nonadmitted asset based solely on aging.

e. Provided that the risk adjustment receivables due the reporting entity are determined in a manner that is consistent with the requirements of this issue paper, the receivables are admitted assets until determination of impairment or payment denial is received from the governmental entity or government-sponsored entity administering the program. Upon notification that payments to be paid to the reporting entity will be less than the recorded receivables, any amount in excess of the confirmed amount shall be written off and charged to income, except for amounts that are under appeal. Any receivable for risk adjustment amounts under appeal shall be reflected as a nonadmitted asset.

f. Evaluation of the collectibility of all amounts receivable from the risk adjustment program shall be made for each reporting period. If, in accordance with SSAP No. 5R, it is probable that the risk adjustment receivables are uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made. If it is reasonably possible that a portion of the balance determined in accordance with this paragraph is not anticipated to be collected and is therefore not written off, the disclosure requirements outlined in SSAP No. 5R shall be followed.

Transitional Reinsurance Program – Description and Overview

14. The transitional reinsurance program based on Section 1341 of the ACA is effective for plan years 2014 through 2016. Reinsurance assessments will be collected and distributions will be issued during the three-year term.

15. All issuers of major medical commercial products and third party administrators (TPAs) on behalf of uninsured group health plans are required to contribute funding at the national contribution rate to HHS. States establishing reinsurance programs may collect additional funding. Non-grandfathered individual plans are eligible to receive benefit program distributions via an excess-of-loss reinsurance system. Grandfathered plans are ineligible. Group plans are required to contribute funding, but are not eligible to receive reinsurance program distributions.

16. In general, this transitional reinsurance program provides funding to issuers in the individual market that incur high claims costs for enrollees. The program requires assessments from all issuers and TPAs on behalf of group health plans based on a per member annual fee established by HHS. The reinsurance assessment will fund reinsurance program distributions plus disbursements to the U.S. Treasury, in addition to covering administrative expenses of the program.

17. Consequently, the term "reinsurance" does not represent actual reinsurance between licensed insurers as defined by *SSAP No. 61—Revised—Life, Deposit-Type and Accident and Health Reinsurance* (SSAP No. 61R). This program is similar to an involuntary pool in *SSAP No. 63—Underwriting Pools and Associations Including Intercompany Pools* (SSAP No. 63) for the individual insured health products subject to the 2014 ACA market reforms. For the group plans, which are required to contribute funding but are not eligible to receive program distributions, the program is an assessment payable by the reporting entity and not a pool.

18. The national transitional reinsurance program assessment rate for all issuers and TPAs will be established by HHS and will be designed to collect more than $12 billion in 2014 to cover the required $10 billion for the reinsurance program, the $2 billion contribution to the U.S. Treasury, and additional amounts to cover the administrative costs of the federal government entity and applicable reinsurance entities. States electing to operate their own reinsurance program have the option to increase the reinsurance assessment rate to provide additional funding for the reinsurance program or to fund the administrative expenses of the applicable reinsurance entity. Assessments for the reinsurance program must fund the reinsurance program of $10 billion in 2014, $6 billion in 2015 and $4 billion in 2016, plus disbursements to the U.S. Treasury of $2 billion, $2 billion and $1 billion for years 2014 through 2016, in addition to covering administrative expenses of the applicable reinsurance entity or HHS.

19. Reinsurance program distributions will be processed either by the applicable reinsurance entity or by HHS and will be made to issuers of non-grandfathered individual market plans for high claim costs of enrollees. Distributions from the applicable reinsurance entity to insurers providing individual coverage will be calculated as a coinsurance rate multiplied by the eligible claims submitted for an individual enrollee's covered benefits between an attachment point and the reinsurance cap for each benefit year. The coinsurance rate, attachment point and reinsurance cap are initially determined by HHS, but may be modified by the state, if the state chooses to establish its own reinsurance program.

20. Each state is eligible to establish a reinsurance program, regardless of whether the state establishes a Marketplace Exchange. If a state establishes a reinsurance program, the state must enter into a contract with an applicable reinsurance entity or entities or establish a reinsurance entity to carry out the program. If a state does not elect to establish its own reinsurance program, HHS will administer the reinsurance program on behalf of that state. HHS establishes the annual administrative portion for the fee. (For example, the 2014 fee will be $0.11 per-member per-year resulting in $20.3 million of administrative expense funding).

21. Reinsurance assessments to fund the program are made on an annual basis with billing beginning December 15, 2014. An insurer may submit claims for reimbursement when an enrollee of the reinsurance-eligible plan has met the applicable criteria as determined by either the state or HHS. Claims may be submitted through April 30 of the year following the benefit year. HHS will distribute reinsurance program funds among issuers nationally based on submitted claims. Issuers will be notified of pending reinsurance distributions by June 30 following the benefit year. If the requests for distributions exceed the

actual assessments collected, HHS will reduce reinsurance distributions on a pro-rata basis. If the requests for distributions are less than actual assessments collected, HHS will increase reinsurance distributions on a pro-rata basis.

Transitional Reinsurance Program – Accounting Treatment

22. Due to the diverse elements of the transitional reinsurance program, which includes characteristics of traditional reinsurance, involuntary pools and governmental assessments, a hybrid accounting approach is required. The accounting treatment for the transitional reinsurance program outlined below is discussed in terms of the payables and receivables and the impact to the health insurance products subject to the program.

23. The following are the broad groupings of the health insurance products subject to the transitional reinsurance program:

a. Individual insured health products subject to the 2014 ACA market reforms. This excludes grandfathered and non-grandfathered 2013 products (referred to as subject individual insured products);

b. Other insured health products. This encompasses products which are not subject to the ACA market reforms including individual grandfathered and non-grandfathered (referred to as other insured health products);

c. Self-insured health products.

24. The guidance in this section will provide treatment for each of the assessments payable and program distribution receivable elements of the program listed below for the health insurance products listed in paragraph 23.

a. Assessments for reinsurance

b. Administrative costs assessments

c. Additional U.S. Treasury assessment

d. Reinsurance distributions

Subject Individual Insured Health Products

Subject Individual Insured Issuers - Assessments Payable for Reinsurance

25. Transitional reinsurance assessments attributable to enrollees in individual plans are treated as ceded reinsurance premium. This applies both to assessments made at the national assessment rate and to any state-elected additional assessments that will fund reinsurance program distributions. Ceded premiums would be reported as a reinsurance cession and follow reinsurance accounting in accordance with SSAP No. 61R, paragraph 17 and paragraphs 25-26:

> Transfer of Risk
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> 17. Reinsurance agreements must transfer risk from the ceding entity to the reinsurer in order to receive the reinsurance accounting treatment discussed in this statement. If the terms of the agreement violate the risk transfer criteria contained herein, (i.e., limits or diminishes the transfer of risk by the ceding entity to the reinsurer), the agreement shall follow the guidance for Deposit Accounting. In addition, any contractual feature that delays timely reimbursement violates the conditions of reinsurance accounting.

> Reinsurance Premiums
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> 25. For all reinsurance arrangements, the assuming entity must report premiums under the terms of the reinsurance contract as income and establish any asset or liability consistent with the methods and assumptions used to establish its policy reserves and guidance contained in *SSAP No. 51—Life Contracts*, *SSAP No. 54—Individual and Group Accident and Health Contracts*, and *SSAP No. 59—Credit Life and Accident and Health Insurance Contracts*. The ceding entity shall reduce premium income by the amounts paid or payable to the reinsurers. The ceding entity shall reduce its deferred and uncollected premiums reported as an asset by the corresponding proportionate amount of any deferred and uncollected premium attributable to those insurance policies reinsured. When the ceding entity has collected the premium but has not remitted the proportionate share to the reinsurer, the ceding entity shall establish a liability for the amount due the reinsurer. The assuming entity shall record an asset for premiums receivable from the ceding entity.
>
> 26. If the assuming entity receives reinsurance premium prior to the due date, consistent with SSAP No. 51, paragraph 7, and SSAP No. 54, paragraph 6, advance premiums are reported as a liability for the reinsurer in the statutory financial statement and not considered income until due. Such amounts are not included in premium or the unearned premium reserve (if applicable) until the due date. If the ceding entity pays reinsurance premium prior to the due date, the amount of the prepaid item shall be reflected as a write-in admitted asset and it should not be recognized in the income statement until due. Such amounts are not included in ceded premiums or ceded unearned premium but should be subject to impairment analysis.

26. For the individual coverage issuers, this is an involuntary pool and under the terms of the transitional reinsurance program, the transfer of risk and timely reimbursement requirements of SSAP No. 61R are deemed to be met.

27. With regard to individual coverage issuers, the transitional reinsurance program is more similar to traditional reinsurance than it is to an assessment, because program assessments are made to and program distributions are received from the government or government-sponsored entity. Accordingly, the program is accounted for as reinsurance for individual insured products subject to the transitional reinsurance program.

28. The provisions of SSAP No. 63, paragraph 3, define involuntary pools as follows:

> 3. Involuntary pools represent a mechanism employed by states to provide insurance coverage to those with higher than average probability of loss who otherwise would be excluded from obtaining coverage. Reporting entities are generally required to participate in the underwriting results, including premiums, losses, expenses, and other operations of involuntary pools, based on their proportionate share of similar business written in the state. Involuntary plans are also referred to as residual market plans, involuntary risk pools, and mandatory pools.

29. The transitional reinsurance program differs from an involuntary pool as just described, in that there is not a proportionate sharing of the entire results of a pool. However, the purpose is very similar: to address the additional costs associated with high-risk individuals. Furthermore, HHS has noted, *"the Affordable Care Act ... requires that states eliminate or modify high-risk pools to the extent necessary to carry out the reinsurance program,"* which likewise highlights the similar purposes of the two mechanisms. Therefore, SSAP No. 63, paragraph 8, provides additional relevant guidance:

> 8. Underwriting results relating to voluntary and involuntary pools shall be accounted for on a gross basis whereby the participant's portion of premiums, losses, expenses, and other operations of the pools are recorded separately in the financial statements rather than netted against each other. Premiums and losses shall be recorded as direct, assumed, and/or ceded as applicable. If the reporting entity is a direct writer of the business, premiums shall be recorded as directly written and accounted for in the same manner as other business which is directly written

> by the entity. To the extent that premium is ceded to a pool, premiums and losses shall be recorded in the same manner as any other reinsurance arrangement. A reporting entity who is a member of a pool shall record its participation in the pool as assumed business as in any other reinsurance arrangement.

As the transitional reinsurance program is a mechanism for sharing the additional costs associated with high-risk individuals, it is accounted for as traditional reinsurance.

Subject Individual Insured Issuers - Reinsurance Administrative Expense Assessments

30. The assessment payable by the reporting entity for administrative expenses attributable to individual coverage is reflected as ceded premium. This applies both to assessments made at the national assessment rate and to any state-required assessments that will provide additional funding for administrative expenses.

31. Normally reinsurance premiums are set at a level intended to cover anticipated claim costs and include an administrative charge component. Therefore, as a matter of consistency, it is appropriate to include the administrative charge component for the transitional reinsurance program in ceded premium for individual insured products.

Subject Individual Insured Issuers - U.S. Treasury Assessment

32. Because this portion of the assessment is earmarked for the U.S. Treasury and not for the reimbursement of claims or to cover the operating costs of the reinsurance program, it is a federal assessment not based on income. This portion of the assessment is not treated as ceded premium, but as an assessment under SSAP No. 35R and is reflected in the same expense category as taxes, licenses and fees. This is also consistent with annual statement expense reporting categories.

Subject Individual Insured Issuers - Reinsurance Program Distributions

33. Program distributions received from the ACA transitional reinsurance program for individual insurance is reflected as ceded claim benefit recoveries. This applies both to distributions received pursuant to the uniform federal reinsurance parameters and to any state distribution received.

34. In keeping with the rationale for reinsurance assessments above, distributions receivable from the transitional reinsurance program for individual insurance products is reflected the same as traditional reinsurance recoveries. SSAP No. 61R, paragraph 27, states:

> 27. Policy benefit payments paid or payable by the reinsurer shall be reported in the summary of operations and reduces the ceding entity's reported benefit payments. The reinsurer shall establish a liability for its share of any unpaid claim payments and the ceding entity shall reduce any policy and contract claim liability with respect to the reinsured policies or establish a receivable for the amount due from the reinsurer for claims paid.

35. Therefore, recoveries received are reported in the summary of operations and will reduce the ceding entity’s reported benefits paid.

36. HHS and all applicable reinsurance entities shall be reported consistent with providers to an involuntary pool and will be treated as authorized reinsurers for the purposes of financial reporting for subject individual health products.

37. All receivables from the transitional reinsurance program are subject to the 90-day nonadmission rule beginning from when program receivables are due to be disbursed by the government or a government-sponsored entity. That is, the 90-day rule begins when governmental receivables are due, not from the date of initial accrual. The announced governmental or government-sponsored entity distribution date shall be the contractual due date similar to Appendix A-791, paragraph 2h, which requires that

payments due from the reinsurer are made in cash within ninety (90) days of the settlement date. The receivable is also subject to impairment analysis.

Other Insured Health Products

Other Insured Health Products – Assessments Payable for Reinsurance

38. Transitional reinsurance program reinsurance assessments made for enrollees in fully insured plans other than individual plans are treated as an assessment payable by the reporting entity and charged to taxes, licenses and fees. This applies both to assessments made at the national assessment rate and to any state assessments that will fund reinsurance program distributions. In this case, for fully insured non-individual plans, the entity cannot, under the terms of the program, be deemed to be "participating," as funds for claim recoveries will not be re-distributed back to the issuer for the coverage that is being assessed. Therefore, issuers of other insured health products that are not for individuals are paying an involuntary fee but are not participating in an involuntary pool.

39. The treatment of the transitional reinsurance program reinsurance assessments for non-individual fully insured plans differs from the treatment for individual plans. Since the non-individual plans are not eligible for reimbursement, they are not participating in a reinsurance arrangement, and thus, the assessments are not treated as ceded premium. As an involuntary assessment, the transitional reinsurance program reinsurance assessments, consistent with SSAP No. 35R are treated as an assessment payable by the reporting entity and charged to taxes, licenses and fees expense. The expense is accrued in proportion to the other insured health enrollees base that will be used to determine the assessments payable as the premium subject to the assessment is written.

Other Insured Health Products - Reinsurance Administrative Expense Assessments

40. The reinsurance program administrative costs for other insured health products are an assessment payable by the reporting entity. This applies both to assessments made at the national assessment rate and to any state assessment that will fund administrative expenses and is reflected in the same expense category as taxes, licenses and fees.

Other Insured Health Products - U.S. Treasury Assessment

41. The additional U.S. Treasury assessment for other insured health products is a federal assessment payable by the reporting entity which is not based on income and is reflected in the same expense category as taxes, licenses and fees.

Other Insured Health Products - Reinsurance Program Distributions (not applicable)

42. Reinsurance recoveries will not occur for insured health products other than individual. Other insured health products will pay the transitional reinsurance program assessments payable but not receive program distributions for claims.

Self-Insured Health Products

Self-Insured Health Products - Assessments Payable for Reinsurance

43. Assessments made on behalf of self-insured plans which are administered by the reporting entity are uninsured plans and are excluded from the reporting entity's statement of operations, with respect to both monies received from the plans and assessments disbursed by the reporting entity. Any resulting liabilities or receivables shall be reported as liabilities and receivables held in connection with uninsured plans. This treatment is consistent with *SSAP No. 47—Uninsured Plans* (SSAP No. 47)*,* paragraphs 5 and 8-11.

44. The self-insured plan, not the reporting entity, is legally liable for assessments for the transitional reinsurance program. The funds are a bona fide pass-through by the reporting entity, which is merely providing a service for the self-insured (uninsured) plan. Therefore, the reporting entity will not report revenues or expenses for the assessments for the transitional reinsurance program.

45. The reporting entity may have received funds from the self-insured plans in advance of making disbursements. In that event, a liability is established for funds held in connection with self-insured plans.

46. The reporting entity, depending on its arrangement with the (uninsured) plan, may make a disbursement before receiving full funding from the plan. In that event, an asset is established for amounts receivable in connection with uninsured plans. The asset would be subject to the rules for admissibility and impairment as prescribed in SSAP No. 47, paragraphs 9-10.

Self-Insured Health Products - Reinsurance Administrative Expense Assessments Payable and U.S. Treasury Assessment

47. A reporting entity providing a service for a self-insured plan that is uninsured shall apply the pass-through treatment for the transitional reinsurance program’s administrative cost assessments and additional U.S. Treasury contribution amounts. The uninsured plan, not the reporting entity, is legally liable. Therefore, the reporting entity will not report revenues or expenses with respect to the transitional reinsurance program’s administrative cost assessments and additional U.S. Treasury contribution amounts.

Self-Insured Health Products - Reinsurance Payments (not applicable)

48. Reinsurance recoveries will not occur for self-insured health products, as these products will pay fees but not receive claims reimbursements.

Risk Corridors – Description and Overview

49. The risk corridors program based on Section 1342 of the ACA is effective for benefit years beginning in 2014 through 2016. The risk corridors program applies to Qualified Health Plans (QHPs) in the individual and small group markets whether sold on or outside of an exchange.

50. The purpose of the risk corridors program is to provide limitations on issuer losses and gains for QHPs through additional protection against initial pricing risk. The program creates a mechanism for sharing the risk for allowable costs between the federal government and the QHP issuers. The program is applied at the QHP level, not the issuer or market segment level. Although the risk-corridor program provides protection against extreme bounds of experience, there is a substantial corridor in which all variance in experience directly affects the financial return of the reporting entity.

51. To determine whether an issuer pays into (contributes), or receives distributions from, the risk corridors program, HHS will compare Allowable Costs[2] and the Target Amount[3] based on a formula that compares allowable costs. Below is an example (before transition requirements) for a QHP.

a. When a QHP’s Allowable Costs for any benefit year are more than 103% but not more than 108% of the Target Amount, HHS will pay the QHP issuer an amount equal to 50% of the Allowable Costs in excess of 103% of the target amount.

[2] With respect to a QHP, Allowable Costs is an amount equal to the sum of incurred claims of the QHP issuer, adjusted to include qualifying expenditures by the QHP for activities that improve health care quality, expenditures for health information technology and meaningful use requirements and other required adjustments.

[3] With respect to a QHP, the Target Amount is an amount equal to the total premiums earned with respect to a QHP, including any premium tax credit under any governmental program, reduced by the allowable administrative costs of the plan.

b. When a QHP's Allowable Costs for any benefit year are more than 108% of the Target Amount, HHS will pay the QHP issuer an amount equal to 2.5% of the Target Amount plus 80% of the Allowable Costs in excess of 108% of the target Amount.

c. If a QHP's Allowable Costs for any benefit year are less than 97% but not less than 92% of the Target Amount, the QHP issuer must remit assessments payable to HHS in an amount equal to 50% of the difference between 97% of the Target Amount and the Allowable Costs.

d. When a QHP's Allowable Costs for any benefit year are less than 92% of the Target Amount, the QHP issuer must remit assessments payable to HHS in an amount equal to the sum of 2.5% of the Target Amount plus 80% of the difference between 92% of the Target Amount and the Allowable Costs.

52. The risk corridors program creates a mechanism for sharing risk for allowable costs between the federal government and QHP issuers. The ACA establishes the risk corridors program as a federal program; consequently, HHS will operate the risk corridors program under federal rules without state variations. The risk corridors program is intended to protect against inaccurate rate setting in the early years of the exchanges by limiting the extent of issuer losses and gains. In the event that risk corridors programs collections are not sufficient to cover all the required distributions, the ACA requires the use of other sources of federal funding for the required distributions, subject to the availability of appropriations.

53. The final risk corridors settlement calculation will be communicated by HHS after the end of the benefit year and after premium and loss adjustments related to the reinsurance and risk adjustment programs have been determined.

Risk Corridors – Accounting Treatment

54. This program is similar to the risk corridors program established for the Medicare Part D prescription drug coverage[4]. However, due to the asymmetrical nature of the risk-corridor calculation, an overstatement of expense in one cell, which is theoretically offset by the understatement of expense in another cell, does not necessarily result in zero financial impact.

55. Payables and receivables pursuant to the temporary risk corridors program shall be accounted for as specified in this issue paper.

56. Risk corridor assessments meet the definition of liabilities as set forth in SSAP No. 5R. Risk corridor receivables due to the reporting entity meet the definition of an asset and are admissible to the extent that they meet all of the criteria in this issue paper.

a. Assumptions used in estimating retrospective premium adjustments shall be consistent with the assumptions made in recording other assets and liabilities necessary to reflect the underwriting results of the reporting entity such as claim and loss reserves (including IBNR) and contingent commissions. Contingent commissions and other related expenses shall be adjusted in the same period the additional or return retrospective premiums are recorded.

b. The additions or reductions to premium revenue resulting from the risk corridors program are recognized over the contractual period of coverage, to the extent that such additions or reductions are reasonably estimable. Reporting entities shall be aware of the

[4] The ACA risk corridors program also has significant differences between the Medicare risk corridors program. The ACA risk corridors program is performed at a significantly more granular plan specific level with a pro-rata allocation of the issuer's overall claim costs for the plan's state/ market cell.

significant uncertainties involved in preparing estimates and be both diligent and conservative in their estimations. Risk corridors payables and receivables shall be estimated based on experience to date. The method used to estimate the payables and receivables shall be reasonable and consistent between reporting periods. In exercising the judgment required to prepare reasonable estimates for the financial reporting of risk corridors program payables and receivables, the statutory accounting concept of conservatism shall be followed. In addition, reporting entities are required to have sufficient information to determine a reasonable estimate. Part of ensuring sufficient information requires that the reporting entity's estimate is based on demonstrated knowledge of the impacts of the other risk-sharing programs on the risk corridors program and the terms of the risk corridors program. In addition, the estimates shall be consistent with other financial statement assertions and the pricing scenarios used by the reporting entity.

c. The risk corridors receivables are from a federal governmental program. Amounts over 90 days due shall not cause the receivable to be treated as a nonadmitted asset based solely on aging.

d. Provided that the risk corridors receivables due the reporting entity are determined in a manner that is consistent with the requirements of this issue paper, the receivables are admitted assets until determination of impairment or payment denial is received from the governmental entity or government-sponsored entity administering the program. Upon notification that payments to be paid to the reporting entity will be less than the recorded receivables, any amount in excess of the confirmed amount shall be written off and charged to income, except for amounts that are under appeal. Any receivable for risk adjustment amounts under appeal shall be reflected as a nonadmitted asset.

e. Evaluation of the collectibility of all amounts receivable from the risk corridors program shall be made for each reporting period. If, in accordance with SSAP No. 5R, it is probable that the risk corridors receivables are uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made. If it is reasonably possible, that a portion of the balance determined in accordance with this paragraph is not anticipated to be collected and is therefore not written off, the disclosure requirements outlined in SSAP No. 5R shall be followed.

f. Reporting shall be consistent with *SSAP No. 66—Retrospectively Rated Contracts* (SSAP No. 66), paragraph 9 guidance on reporting for retrospective premium.

> 9. Retrospective premium adjustments are estimated for the portion of the policy period that has expired and shall be considered an immediate adjustment to premium. Additional retrospective premiums and return retrospective premiums shall be recorded as follows:
>
> a. Property and Casualty Reporting Entities:
>
> i. Accrued additional retrospective premiums shall be recorded as a receivable with a corresponding entry made either to written premiums or as an adjustment to earned premiums. Premiums not recorded through written premium when accrued shall be recorded through written premium when billed.
>
> ii. Accrued return retrospective premiums shall be recorded as part of the change in unearned premium (detailed in the underwriting and investment exhibit) liability with a corresponding entry made either to written premiums or as an adjustment to earned premiums. Premiums not recorded through written premium

when accrued shall be recorded through written premium when billed.

iii. Ceded retrospective premium balances payable shall be recorded as liabilities, consistent with SSAP No. 62R. Ceded retrospective premiums recoverable shall be recorded as an asset. Consistent with *SSAP No. 64—Offsetting and Netting of Assets and Liabilities* (SSAP No. 64), ceded retrospective premium balances payable may be deducted from ceded retrospective premiums recoverable when a legal right of setoff exists.

b. Life and Accident and Health Reporting Entities:

i. Accrued additional retrospective premiums shall be recorded as an asset, accrued retrospective premiums with a corresponding entry to premiums;

ii. Accrued return retrospective premiums shall be recorded as a liability, provision for experience rating refunds, with a corresponding entry to premiums.

c. Managed Care/Accident and Health Reporting Entities

i. Accrued additional retrospective premiums shall be recorded as an asset, accrued retrospective premiums with a corresponding entry to premiums;

ii. Accrued return retrospective premiums shall be recorded as a liability, as part of Accident and Health Reserves (reserve for rate credits or experience rating refunds), with a corresponding entry to premiums.

Disclosures

57. The financial statements shall disclose on an annual and quarterly basis beginning in the first quarter of 2014, the assets, liabilities and revenue elements by program regarding the risk-sharing provisions of the Affordable Care Act for the reporting periods which are impacted by the programs including the listing in sections a-c below. Reporting entities shall also indicate if they wrote any accident and health insurance premium, which is subject to the Affordable Care Act risk-sharing provisions. In the event that the balances are zero, the reporting entity should provide context to explain the reasons for the zero balances, including insufficient data to make an estimate, no balances or premium was excluded from the program, etc. Asset balances shall reflect admitted asset balances. The disclosure shall include the following:

a. ACA Permanent Risk Adjustment Program

i. Premium adjustments receivable due to ACA Risk Adjustment

ii. Risk adjustment user fees payable for ACA Risk Adjustment

iii. Premium adjustments payable due to ACA Risk Adjustment

iv. Reported as revenue in premium for accident and health contracts (written/collected) due to ACA Risk Adjustment

v. Reported in expenses as ACA risk adjustment user fees (incurred/paid)

b. ACA Transitional Reinsurance Program

i. Amounts recoverable for claims paid due to ACA Reinsurance

ii. Amounts recoverable for claims unpaid due to ACA Reinsurance (contra-liability)

iii. Amounts receivable relating to uninsured plans for contributions for ACA Reinsurance

iv. Liabilities for contributions payable due to ACA Reinsurance - not reported as ceded premium

v. Ceded reinsurance premiums payable due to ACA Reinsurance

vi. Liability for amounts held under uninsured plans contributions for ACA Reinsurance

vii. Ceded reinsurance premiums due to ACA Reinsurance

viii. Reinsurance recoveries (income statement) due to ACA Reinsurance payments or expected payments

ix. ACA Reinsurance Contributions – not reported as ceded premium

c. ACA Temporary Risk Corridors Program

i. Accrued retrospective premium due from ACA Risk Corridors

ii. Reserve for rate credits or policy experience rating refunds due to ACA Risk Corridors

iii. Effect of ACA Risk Corridors on net premium income (paid/received)

iv. Effect of ACA Risk Corridors on change in reserves for rate credits

58. In addition, beginning in annual 2014 and both quarterly and annual thereafter, a roll forward of prior year ACA risk-sharing provisions specified asset and liability balances shall be disclosed in the annual statutory Notes to Financial Statements, as illustrated in Appendix B. Note for the roll forward illustration, assets shall be reflected gross of any nonadmission. The reasons for adjustments to prior year balances (i.e. federal audits, revised participant counts, information which impacted risk score projections, etc.) shall also be disclosed. For year-end 2014, all columns and rows are expected to be zero since 2014 is the first year that a receivable or liability will be recorded.

Effective Date and Transition

59. Upon adoption of this issue paper, the NAIC will release a Statement of Statutory Accounting Principles (SSAP) for comment. The SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the *Accounting Practices and Procedures Manual* should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and, therefore, the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will contain an effective date of years ending on or after December 15, 2014.

DISCUSSION

60. The Emerging Accounting Issues (E) Working Group adopted *INT 13-04: Accounting for the Risk-Sharing Provisions of the Affordable Care Act* in April 2014*,* and made a simultaneous referral to the Statutory Accounting Principles (E) Working Group to consider accounting guidance for the ACA risk-sharing provisions, including potential nonadmittance for receivables for the risk adjustment and risk corridors receivables in excess of payables, in an issue paper and SSAP as soon as possible.

61. The overall parameters of the risk adjustment program create uncertainties in the estimation process and ultimately in the reporting entities' financial statements, particularly in 2014.

a. The reporting entity/issuer does not have all of the data that is relevant to calculating its risk score because the reporting of risk score data will lag. For example, it is unlikely that encounter data will be complete for October, November and December. This fact will likely cause the issuer to employ one of two courses of action:

i. The reporting entity might seek to perform a complex estimation on the incurred but unpaid claims in order to attempt to translate the information to increases in enrollees' risk scores as of year-end, or

ii. The reporting entity might conclude that it is unable to reliably estimate the risk score attributable to incurred but unpaid claims and derive its risk adjustment score estimate from claims already paid. In that case, the issuer will expect to see favorable development in its risk adjustment estimate in successive calendar years as the estimate is adjusted to reflect the improved accuracy in risk scores from claims paid after year–end.

b. The reporting entity/issuer's ultimate assessment payable or receivable for a risk adjustment cell is based on the relative relationships between its aggregate risk score and the risk scores of all issuers participating in the risk adjustment cell. Although some states will ask issuers to propose data prior to the close of the benefit year, changes by one issuer of information or classification can significantly impact the risk adjustment estimates for all issuers. The American Academy of Actuaries has noted that this uncertainty will be greater in 2014 than in subsequent periods because after 2014, carriers will have an understanding of what the aggregate risk score is for each risk adjustment cell from prior year's data[5].

c. The ACA will increase existing uncertainty at year–end regarding exposure to the number of insureds since the ACA requires that reporting entity/ issuers extend a grace period from the typical historical practice of 30 days to 90 days for insureds receiving a premium subsidy via the exchanges.

62. The risk corridors program has elements of federal responsibility and industry representatives requested that this be treated as a federal governmental obligation and not subject to the 90-day rule similarly to a government uninsured or insured plan similar to the treatment in *SSAP No. 47—Uninsured Plans* and *SSAP No. 84—Certain Health Care Receivables and Receivables Under Government Insured Plans*. This was subsequently extended to the risk adjustment program after the Working Group heard comments on the first exposure draft.

63. For a number of reasons, the Working Group directed redrafting of the nonadmission of receivables in excess of payables for the risk adjustment and risk corridors programs to allow admission of the receivables subject to specified criteria. The Working Group noted that the Capital Adequacy (E)

[5] Financial Reporting Implications Under the Affordable Care Act, developed by the Health Practice Financial Reporting Committee of the American Academy of Actuaries.

Task Force has adopted a health RBC sensitivity test related to the Section 9010 ACA fee and that this issue paper will incorporate the balance and roll-forward disclosures which were originally placed in SSAP No. 35R by a separate agenda item. Premium deficiency reserve guidance in SSAP No. 54 continues to apply to the health products and must be considered in the development of the actuarial opinion. In addition, it was noted that the transitional reinsurance program and the risk adjustment program have mitigating effects to the possible errors in the risk corridors program.

64. The replacement language stressed conservatism in the preparation of estimates, having sufficient data to base estimates on and having knowledge of the marketplace. In addition, impairment evaluations were stressed and nonadmission of amounts after notification of denial even if appeals are pending was added. While SSAP No. 54 provides guidance on contracts subject to redetermination, and SSAP No. 66 provides guidance on retrospectively rated contracts, this issue paper provided more explicit guidance which shall be followed to fit the facts and circumstances of the risk adjustment and risk corridors programs.

RELEVANT LITERATURE

Statutory Accounting

65. Statutory accounting provides guidance in various statements that are relevant to the accounting for risk-sharing provisions.

66. Excerpts of SSAP No. 6 on Determination of Due Date

> Determination of Due Date
>
> 7. The due date for all premium balances addressed by this statement is determined as follows:
>
> The due date for all premium balances addressed by this statement is determined as follows:
>
> a. Original and deposit premiums—governed by the effective date of the underlying insurance contract and not the agent/reporting entity contractual relationship;
>
> b. Endorsement premiums—governed by the effective date of the insurance policy endorsement;
>
> c. Installment premiums—governed by the contractual due date of the installment from the insured;
>
> d. Audit premiums and retrospective premiums—governed by insurance policy or insurance contract provisions. If the due date for receivables relating to these policies is not addressed by insurance policy provisions or insurance contract provisions, any uncollected audit premium (either accrued or billed) is nonadmitted.
>
> 8. The provisions of paragraph 7 shall be applied to all balances due except those arising from force placed insurance obtained by a lender for collateral protection, certain policies, known as Trustee Sales Guarantees (TSGs), issued by title insurance companies to lenders on defaulted real estate loans and crop/hail policies. For forced placed insurance policies, the due date for purposes of applying paragraph 9 shall be the date of billing. For TSGs, the due date for purposes of applying paragraph 9 shall be the expiration of the grace period given to the defaulted debtor, which is provided by statute. Crop/hail premiums are considered installment premiums in accordance with paragraph 7 and accordingly, the due date for purposes of applying paragraph 9 shall be governed by the contractual due date of the installment.

67. SSAP No. 54 provides the following regarding contracts subject to redetermination:

> Contracts Subject to Redetermination
>
> 27. This statement also applies to other contracts which are subject to redetermination such as Federal (and State) Groups - subject to rate adjustments through audits by the Office of Personnel Management (OPM). Reporting entities are required to give Federal Groups the lowest rates that are being charged to similar groups.
>
> 28. Amounts due from insureds or subscribers and amounts due to insureds or subscribers under contracts subject to redetermination meet the definitions of assets and liabilities as set forth in *SSAP No. 4—Assets and Nonadmitted Assets* and SSAP No. 5R, respectively.
>
> 29. Contract redeterminations shall be estimated based on the experience to date. The method used to estimate the liability shall be reasonable based on the reporting entity's procedures, and consistent among reporting periods. An examination of contract requirements in relation to the rates being charged and the current status of applicable audits (e.g., OPM, Centers for Medicare and Medicaid Services (or such other name that this entity shall be known as) and other Federal, state or government department) is a common method used to estimate such contract redeterminations.
>
> 30. Premium adjustments for contracts subject to redetermination are estimated for the portion of the policy period that has expired and shall be considered an immediate adjustment to premium. Accrued premium adjustments shall be recorded as a write-in for other-than-invested assets, with a corresponding entry to premiums; accrued return premium adjustments shall be recorded as a liability with a corresponding entry to premiums.
>
> 31. If, in accordance with SSAP No. 5R, it is probable that the additional premium adjustment is uncollectible, any uncollectible premium shall be written off against operations in the period the determination is made and the disclosure requirements outlined in SSAP No. 5R shall be made.
>
> 32. Premium adjustments for contracts subject to redetermination shall be determined and billed or refunded in accordance with the policy provisions or contract provisions. If such premiums are not billed in accordance with the policy provisions or contract provisions, or the policy provisions or contract provisions do not address the due date of such premiums, the accrual shall be nonadmitted. This is consistent with the guidance for audit premiums established in SSAP No. 6.

68. SSAP No. 61R, paragraph 27, provides the following regarding treatment of the transitional reinsurance program for individual insurance products and is reflected the same as traditional reinsurance recoveries:

> Policy benefit payments paid or payable by the reinsurer shall be reported in the summary of operations and reduces the ceding entity's reported benefit payments. The reinsurer shall establish a liability for its share of any unpaid claim payments and the ceding entity shall reduce any policy and contract claim liability with respect to the reinsured policies or establish a receivable for the amount due from the reinsurer for claims paid.

69. The provisions of SSAP No. 63, paragraph 3, defines involuntary pools and paragraph 8 provides additional relevant guidance:

> 3. Involuntary pools represent a mechanism employed by states to provide insurance coverage to those with higher than average probability of loss who otherwise would be excluded from obtaining coverage. Reporting entities are generally required to participate in the underwriting results, including premiums, losses, expenses, and other operations of involuntary pools, based on their proportionate share of similar business written in the state. Involuntary plans are also referred to as residual market plans, involuntary risk pools, and mandatory pools.

> 8. Underwriting results relating to voluntary and involuntary pools shall be accounted for on a gross basis whereby the participant's portion of premiums, losses, expenses, and other operations of the pools are recorded separately in the financial statements rather than netted against each other. Premiums and losses shall be recorded as direct, assumed, and/or ceded as applicable. If the reporting entity is a direct writer of the business, premiums shall be recorded as directly written and accounted for in the same manner as other business which is directly written by the entity. To the extent that premium is ceded to a pool, premiums and losses shall be recorded in the same manner as any other reinsurance arrangement. A reporting entity who is a member of a pool shall record its participation in the pool as assumed business as in any other reinsurance arrangement.

70. SSAP No. 66, provides the following regarding retrospectively rated contracts:

> 3. *A retrospectively rated contract is one which has the final policy premium calculated based* on the loss experience of the insured during the term of the policy (including loss development after the term of the policy) and the stipulated formula set forth in the policy or a formula required by law. The periodic adjustments may involve either the payment of return premium to the insured or payment of an additional premium by the insured, or both, depending on experience. Retrospective rating features are common in certain property and casualty contracts, group life, and group accident and health contracts. Some contracts have retrospective features required by law. Contracts with retrospective rating features are referred to as loss sensitive contracts.
>
> 8. Assumptions used in estimating retrospective premium adjustments shall be consistent with the assumptions made in recording other assets and liabilities necessary to reflect the underwriting results of the reporting entity such as claim and loss reserves (including IBNR) and contingent commissions. Contingent commissions and other related expenses shall be adjusted in the same period the additional or return retrospective premiums are recorded.
>
> 9. Retrospective premium adjustments are estimated for the portion of the policy period that has expired and shall be considered an immediate adjustment to premium. Additional retrospective premiums and return retrospective premiums shall be recorded as follows:
>
> a. Property and Casualty Reporting Entities:
>
> i. Accrued additional retrospective premiums shall be recorded as a receivable with a corresponding entry made either to written premiums or as an adjustment to earned premiums. Premiums not recorded through written premium when accrued shall be recorded through written premium when billed.
>
> ii. Accrued return retrospective premiums shall be recorded as part of the change in unearned premium (detailed in the underwriting and investment exhibit) liability with a corresponding entry made either to written premiums or as an adjustment to earned premiums. Premiums not recorded through written premium when accrued shall be recorded through written premium when billed.
>
> iii. Ceded retrospective premium balances payable shall be recorded as liabilities, consistent with SSAP No. 62R. Ceded retrospective premiums recoverable shall be recorded as an asset. Consistent with *SSAP No. 64—Offsetting and Netting of Assets and Liabilities* (SSAP No. 64), ceded retrospective premium balances payable may be deducted from ceded retrospective premiums recoverable when a legal right of setoff exists.

b. Life and Accident and Health Reporting Entities:

i. Accrued additional retrospective premiums shall be recorded as an asset, accrued retrospective premiums with a corresponding entry to premiums;

ii. Accrued return retrospective premiums shall be recorded as a liability, provision for experience rating refunds, with a corresponding entry to premiums.

c. Managed Care/Accident and Health Reporting Entities

i. Accrued additional retrospective premiums shall be recorded as an asset, accrued retrospective premiums with a corresponding entry to premiums;

ii. Accrued return retrospective premiums shall be recorded as a liability, as part of Accident and Health Reserves (reserve for rate credits or experience rating refunds), with a corresponding entry to premiums. Retrospective premium adjustments are estimated for the portion of the policy period that has expired and shall be considered an immediate adjustment to premium.

11. Once accrued retrospective premium is billed, the due date is governed by *SSAP No. 6—Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due From Agents and Brokers*. Life and accident and health reporting entities shall nonadmit any accrued retrospective premium that is more than 90 days due. If a reporting entity has issued more than one policy to the same insured, retrospective balances shall be netted in accordance with SSAP No. 64.

12. If, in accordance with SSAP No. 5R, it is probable that the additional retrospective premium is uncollectible, any uncollectible additional retrospective premium shall be written off against operations in the period the determination is made. If it is reasonably possible a portion of the balance in excess of the nonadmitted portion determined in accordance with paragraph 109 is not anticipated to be collected, the disclosure requirements outlined in SSAP No. 5R shall be made.

Generally Accepted Accounting Principles

71. GAAP did not issue additional guidance to address the risk-sharing provisions of the ACA.

REFERENCES

Other

– *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets* (SSAP No. 5R)
– *SSAP No. 35—Revised—Guaranty Fund and Other Assessments* (SSAP No. 35R)
– *SSAP No. 47—Uninsured Plans* (SSAP No. 47)
– *SSAP No. 54—Individual and Group Accident and Health Contracts* (SSAP No. 54)
– *SSAP No. 61—Revised—Life, Deposit-Type and Accident and Health Reinsurance* (SSAP No. 61*)*
– *SSAP No. 63—Underwriting Pools and Associations Including Intercompany Pools* (SSAP No. 63)
– *SSAP No. 66—Retrospectively Rated Contracts* (SSAP No. 66)
– *SSAP No. 84—Certain Health Care Receivables and Receivables Under Government Insured Plans* (SSAP No. 84)

APPENDIX A: GLOSSARY

The terms included in this appendix are specific to the risk-sharing provisions of the ACA; accordingly, they are not intended to be applied to other topics.

Affordable Care Act (ACA) – The Patient Protection and Affordable Care Act (PPACA), commonly called the Affordable Care Act (ACA), is a United States federal statute signed into law on March 23, 2010.

Applicable Reinsurance Entity – A tax-exempt not-for-profit organization, the duties of which shall be to carry out the transitional reinsurance program by coordinating the funding and operation of the risk-spreading mechanisms designed to stabilize the individual markets during the implementation of health reform.

Cell – The risk corridor calculation is done at the QHP (Qualified Health Plan) level – the cell is state, market (individual or small group), QHP.

Assessment – Required payments into the applicable reinsurance entity by all issuers of major medical commercial products and third-party administrators to fund the transitional reinsurance program.

Exchange – Health insurance marketplaces, also called Health Exchanges, are organizations set up to facilitate the purchase of health insurance in every state of the United States in accordance with the Patient Protection and Affordable Care Act. The exchanges are regulated, online marketplaces, administered by either federal or state government, where individuals, families and small businesses can purchase qualified health insurance plans starting October 1, 2013, with coverage beginning January 1, 2014. Exchanges will also determine who qualifies for subsidies and make subsidy payments to insurers on behalf of individuals receiving them. They will also accept applications for other health coverage programs such as Medicaid and Children's Health Insurance Program (CHIP).

Exempt Plans – Certain health plans that are determined not to be a risk adjustment covered plan in the applicable federally certified risk adjustment methodology (45 C.F.R. § 153.20), grandfathered health plans, group health insurance coverage benefits that are not an integral part of a group health plan, are limited scope, or supplemental benefits (45 C.F.R. § 146.145(c)), and individual health insurance coverage excepted benefits (45 C.F.R. § 148.220).

Grandfathered Plans – A group health plan that was created or an individual health insurance policy that was purchased on or before March 23, 2010. Grandfathered plans are exempted from many changes required under the ACA. Plans or policies may lose their "grandfathered" status if they make certain significant changes that reduce benefits or increase costs to consumers. New employees and new family members may be added to grandfathered group plans after March 23, 2010.

Health & Human Services (HHS) – The Department of Health and Human Services (HHS) is the United States government's principal agency that oversees CMS, which administers programs for protecting the health of all Americans and providing essential human services.

Market Segment – Subset of consumers with its own set of demographic and other assumptions such as individual, state/federal, small group, group, Medicaid or Medicare.

Program Distribution– Amounts payable to or redistributed by the applicable reinsurance entity or the HHS to issuers of non-grandfathered individual market plans that incur high claims costs for enrollees and are eligible to receive benefit payments (recoveries).

Qualified Health Plan (QHP) – Under the Affordable Care Act, starting in 2014, an insurance plan that is certified by the Health Insurance Marketplace, provides essential health benefits and follows established limits on cost-sharing (such as deductibles, copayments, and out-of-pocket maximum amounts).

Risk Score – Individual risk score means a relative measure of predicted health care costs for a particular enrollee that is the result of a risk adjustment model. Claims-based risk-assessment models use data, typically from a 12-month period, to identify underlying conditions and assign a risk score for each individual based on an algorithm.

APPENDIX B: ACA Risk-Sharing Provisions Roll-Forward Illustration

Receivables are reflected gross of any nonadmission for this illustration.

	Accrued During the Prior Year on Business Written Before December 31 of the Prior Year		Received or Paid as of the Current Year on Business Written Before December 31 of the Prior Year		Differences		Adjustments			Unsettled Balances as of the Reporting Date	
					Prior Year Accrued Less Payments (Col 1 - 3)	Prior Year Accrued Less Payments (Col 2 - 4)	To Prior Year Balances	To Prior Year Balances		Cumulative Balance from Prior Years (Col 1 – 3 +7)	Cumulative Balance from Prior Years (Col 2 – 4 +8)
	1	2	3	4	5	6	7	8	9	10	11
	Receivable	(Payable)	Receivable	(Payable)	Receivable	(Payable)	Receivable	(Payable)	Ref	Receivable	(Payable)
a. Permanent ACA Risk Adjustment Program											
1. Premium adjustments receivable	4,000,000		3,000,000		1,000,000		-800,000		A	200,000	0
2. Premium adjustments (payable)		8,000,000		9,000,000		-1,000,000		1,000,000	B		0
3. Subtotal ACA Permanent Risk Adjustment Program	**4,000,000**	**8,000,000**	**3,000,000**	**9,000,000**	**1,000,000**	**-1,000,000**	**-800,000**	**1,000,000**		**200,000**	**0**
b. Transitional ACA Reinsurance Program											
1. Amounts recoverable for claims paid	22,000,000		15,000,000		7,000,000		-7,000,000		C	0	
2. Amounts recoverable for claims unpaid (contra liability)	8,000,000		9,000,000		-1,000,000		990,000		D	-10,000	
3. Amounts receivable relating to uninsured plans	3,000,000		2,800,000		200,000		-100,000		E	100,000	
4. Liabilities for contributions payable due to ACA Reinsurance – not reported as ceded premium		90,000		75,000		15,000		-14,000	G		1,000
5. Ceded reinsurance premiums payable		100		200		-100		100	I		0
6. Liability for amounts held under uninsured plans		125,000		15,000		110,000		90,000	J		200,000
7. Subtotal ACA Transitional Reinsurance Program	**33,000,000**	**215,100**	**26,800,000**	**90,200**	**6,200,000**	**124,900**	**- 6,110,000-**	**76,100**		**90,000**	**201,000**
c. Temporary ACA Risk Corridors Program											
1. Accrued retrospective premium	12,000,000		14,000,000		-2,000,000		1,750,000		K	-250,000	
2. Reserve for rate credits or policy experience rating refunds		150,000		250,000		-100,000		100,000	L		0
3. Subtotal ACA Risk Corridors Program	**12,000,000**	**150,000**	**14,000,000**	**250,000**	**-2,000,000**	**-100,000**	**1,750,000**	**100,000**	**M**	**-250,000**	**0**
d. Total for ACA Risk-Sharing Provisions	**49,000,000**	**8,365,100**	**43,800,000**	**9,340,200**	**5,200,000**	**-975,100**	**-5,160,000**	**1,176,100**		**40,000**	**201,000**

Explanation of Adjustments

a. Adjusted due to federal audit
b. Adjusted because of revised participant count
c. Adjusted due to poor experience of other participants in the reinsurance pool.
d. Revised risk score information in the state of substantially impacted risk scores

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Appendix F
Policy Statements

Introduction

The Policy Statements contained within Appendix F are not included within the Statutory Hierarchy and thus should not be considered accounting guidance. As such, the Policy Statements are included for informational purposes only.

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NAIC Policy Statement on Maintenance of Statutory Accounting Principles

Statutory accounting principles (SAPs) provide the basis for insurers to prepare financial statements to be filed with and utilized by state insurance departments for financial regulation purposes. Accuracy and completeness of such filings are critical to meaningful solvency monitoring. Accordingly, maintenance of SAP guidance for changes in the industry and changes in regulatory concerns is vital to preserving the usefulness of SAP financial statements.

The promulgation of new SAP guidance by the NAIC ultimately requires action of the entire membership. Responsibility for proposing new SAP will be delegated through the NAIC committee structure to the Accounting Practices and Procedures (E) Task Force (Task Force). The Task Force will employ two working groups with distinctly different functions to carry out the charge of maintaining SAP. The Statutory Accounting Principles (E) Working Group (SAPWG) shall have the exclusive responsibility of developing and proposing new Statements of Statutory Accounting Principles (SSAPs). The Emerging Accounting Issues (E) Working Group (EAIWG) will respond to questions of application, interpretation, and clarification that are generally much narrower in scope than development of a new SSAP.

Composition of the Working Groups

The chair of the Task Force shall determine membership on both working groups subject to approval by the Financial Condition (E) Committee. The groups shall be limited in size to no more than 13 members and will include representation from the four zones of the NAIC. Membership shall be vested in the state (until such time as the membership may be changed) but continuity of individuals, to the extent possible, is extremely desirable.

Development of New SSAPs

New SSAPs will be developed from time-to-time that: 1) address issues not covered by existing SAP guidance; 2) amend existing SSAPs; or, 3) supersede existing SSAPs. The decision to undertake development of a new SSAP will rest with the SAPWG subject to approval of the Task Force. The SAPWG will report to the Task Force on its agenda and progress, if any, at each national meeting of the NAIC.

As new Statements of Statutory Accounting Principles (SSAPs) are developed, it is essential to review and, if necessary, update the status of Interpretations of the Emerging Accounting Issues (E) Working Group related to the SSAPs that are being replaced and/or the new SSAP being developed.

The following list of options is available to the SAPWG when a SSAP with existing interpretations is replaced:

a. **Interpretation of the new SSAP -** If the SAPWG would like to maintain the Interpretation, the new SSAP can be added to the list of statements interpreted by the Interpretation. In addition, the status section of the new SSAP will list the Interpretation number next to the heading “Interpreted by.”

b. **Nullification** - When an Interpretation is nullified by a subsequent SSAP or superseded by another Interpretation, the Interpretation is deemed no longer technically helpful, is shaded and moved to Appendix H (Superseded SSAPs and Nullified Interpretations), and the reason for the change is noted beneath the title of the Interpretation. The status section of the SSAP describes the impact of the new guidance and the effect on the Interpretation (for example, nullifies, incorporated in the new SSAP with paragraph reference, etc.).

c. **Incorporation** - When an Interpretation is incorporated into a new SSAP, the SAPWG can choose from the following two options:

i. If the Interpretation only interprets one SSAP, then the Interpretation is listed as being nullified under the "affects" section of the SSAP and the Interpretation is not referenced under the "interpreted by" section of the status page of the SSAP.

ii. If the Interpretation references additional SSAPs, and the SAPWG intends to maintain the guidance, the Interpretation is unchanged (no nullification). The new SSAP (Summary of Issue section) reflects that the Interpretation issue has been incorporated into the new statement.

Research and drafting on new SSAPs will be performed by the NAIC staff under the direction and supervision of the SAPWG which may enlist the assistance of interested parties with requisite technical expertise as needed or desired. The first step in developing new SSAPs will usually be the drafting of an Issue Paper (IP), which will contain summary conclusion, discussion and relevant literature sections. Public comment will be solicited on the IPs, and at least one public hearing will be held on an IP before it is converted to a SSAP. Upon approval by the SAPWG, all proposed SSAPs will be exposed for public comment for a period commensurate with the length of the draft and the complexities of the issue. Adoption of SSAPs by the SAPWG, after hearing and any further amendments, may be by simple majority. All SSAPs must be on the agenda for at least one public hearing before presentation to the Task Force for consideration. Adoption by the Task Force, its parent and the NAIC membership shall be governed by the NAIC bylaws.

If accounting guidance, reserving standards, asset valuation standards, or any other standards or rules affecting accounting practices and procedures are developed by other NAIC working groups, task forces, subcommittees, or committees, such guidance, standards or rules must be reviewed by the SAPWG and converted to an SSAP or a revised appendix. In cases where such guidance has already been subjected to substantial due process (e.g., public comment periods or public hearings), the SAPWG may recommend to the Task Force that either the IP or SSAP comment periods may be shortened or eliminated or the hearings may be eliminated.

Procedures for Emerging Accounting Issues (E) Working Group

The EAIWG will be responsible for responding to SAP questions that generally relate to application, interpretation and clarification. In no event shall a consensus opinion of the EAIWG amend, supersede or otherwise conflict with existing, effective SSAPs. In no event will a consensus be less than six out of a quorum of nine members of the EAIWG; a consensus will also be determined by a vote of seven of 10 members, eight of 11 or 12 members, and nine of 13 members. In the rare event that an opinion of the EAIWG would create SAP not addressed by SSAPs, concurrence of SAPWG (as determined by a majority vote) will be necessary before the guidance becomes effective.

The EAIWG's agenda will be established at the discretion of the chair, subject to approval of the Task Force. Every issue taken up by the EAIWG must be discussed at no less than two open meetings with opportunity for interested parties to present comments. The guidance contained in the consensus opinions of the group will become effective upon publication unless otherwise stated in the opinion. Consensus opinions can be overturned, amended or deferred only by a two-thirds majority of the Task Force.

NAIC Policy Statement on Comments to GAAP Exposure Drafts

As expressed in the Statement of Concepts, Statutory Accounting Principles (SAP) utilizes the framework established by Generally Accepted Accounting Principles (GAAP). The NAIC's guidance on SAP (defined in the *Accounting Practices and Procedures Manual*) is comprehensive for those principles that differ from GAAP based on the concepts of statutory accounting. Those GAAP Pronouncements that are not applicable to insurance companies will not be adopted by the NAIC. For GAAP Pronouncements that do not differ from SAP, the NAIC may specifically adopt those GAAP Pronouncements to be included in statutory accounting. GAAP Pronouncements do not become part of SAP until and unless adopted by the NAIC. Future SAP Pronouncements will specifically identify any GAAP Pronouncements that are to be included in SAP whether in whole, in part, or with modification as well as any GAAP Pronouncements that are rejected. Future GAAP Pronouncements, which SAP has not yet addressed, shall not be considered as providing authoritative statutory guidance.

As illustrated by the previous paragraph, the NAIC believes it is important to comment on GAAP exposure drafts that will affect SAP before such guidance is finalized. Exposing potentially contentious issues to the applicable GAAP bodies before completion will create a more efficient and effective maintenance process for the Statutory Accounting Principles (E) Working Group (SAPWG). In addition, this also allows the NAIC to be proactive to GAAP rather than reactive under the current system.

Comments on exposed GAAP Pronouncements affecting financial accounting and reporting will be developed at the discretion of the SAPWG chair. After the comment letter has been agreed to by the SAPWG, the chair of the Accounting Practices and Procedures (E) Task Force and the Financial Condition (E) Committee must review and approve the letter before it is sent to the applicable GAAP body. Every reasonable attempt will be made to provide an adequate comment period to interested parties; however, FASB/American Institute of Certified Public Accountants (AICPA) deadlines may inhibit exposure in every instance. The chair will consider factors such as comment deadline and level of controversy surrounding the issue. The chair of the parent task force and Committee may override such decision at any time.

Comments on exposed Pronouncements promulgated by the AICPA will be developed at the discretion of the NAIC/AICPA Working Group chair. The chair may defer comment to the SAPWG if the pronouncement affects financial accounting guidance. After the comment letter has been agreed to by the NAIC/AICPA Working Group, the chair of the Financial Condition (E) Committee must review and approve the letter before it is sent to the applicable GAAP body. Every reasonable attempt will be made to provide an adequate comment period to interested parties, however FASB/AICPA deadlines may inhibit exposure in every instance. The chair will consider factors such as comment deadline and level of controversy surrounding the issue. The chair of the parent Committee may override such decision at any time.

These comment letters may be considered during the maintenance of finalized GAAP Pronouncements by the SAPWG (as defined in the NAIC Policy Statement on Maintenance of Statutory Accounting Principles). Nevertheless, these letters will not bind the SAPWG to its tentative position during its deliberation to adopt, modify or reject the final GAAP guidance.

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NAIC Policy Statement On Statutory Accounting Principles Maintenance Agenda Process

The purpose of the following Policy Statement is to document the Statutory Accounting Principles (E) Working Group (SAPWG) maintenance agenda process.

As acknowledged in the *NAIC Policy Statement on Maintenance of Statutory Accounting Principles*, the promulgation of new SAP guidance by the NAIC ultimately requires action of the entire membership. Responsibility for proposing new SAP will be delegated through the NAIC committee structure to the Accounting Practices and Procedures (E) Task Force (Task Force). The Task Force will employ two working groups with distinctly different functions to carry out the charge of maintaining SAP. The SAPWG shall have the exclusive responsibility of developing and proposing new Statements of Statutory Accounting Principles (SSAPs). The Emerging Accounting Issues (E) Working Group will respond to questions of application, interpretation, and clarification that are generally much narrower in scope than development of a new SSAP.

Information and issues can be presented to the SAPWG in a variety of ways. Issues can be recommended or forwarded from other NAIC working groups or task forces, or from interested parties. Also, if any guidance within the Generally Accepted Accounting Principles (GAAP) Hierarchy (see § IV of the Preamble to the *Accounting Practices and Procedures Manual*) is added or revised, those changes must be considered by the SAPWG. In order for an issue to be placed on the **Pending List**, the recommending party must complete a Statutory Accounting Principles Maintenance Agenda Submission Form (Form A) and submit it to the NAIC SAPWG support staff no later than 20 business days prior to the next scheduled SAPWG meeting. The NAIC staff will prepare a submission form for all GAAP pronouncements that have not been previously addressed by the SAPWG. NAIC staff will update the **Pending List** before each National Meeting and will notify the recommending party of such action. If the SAPWG does not wish to address the issue (e.g.; issue deemed not applicable to statutory accounting) or rejects the position presented, then the item is moved to the **Rejected Report**. Should the SAPWG choose to address an issue, it is moved to either the **Substantive** or **Nonsubstantive Listings**.

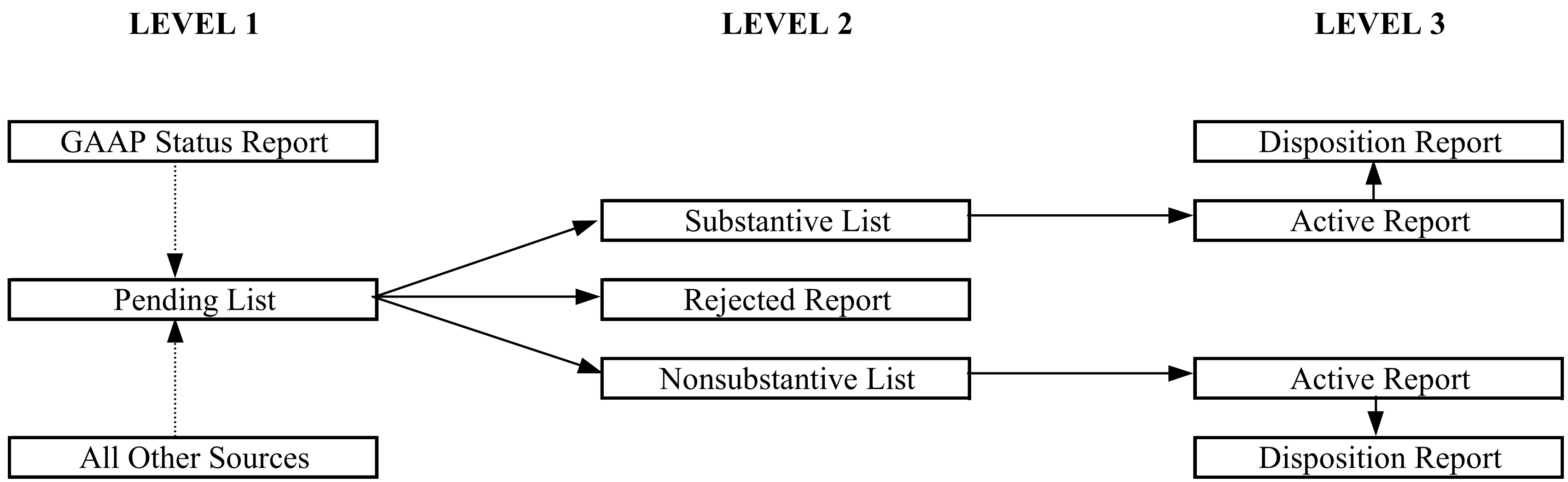
The **Substantive Listing** are items that require a new issue paper and SSAP to address the issue. Once items are placed on this listing, they are prioritized and the formal maintenance policy is followed (see *NAIC Policy Statement on Maintenance of Statutory Accounting Principles*). The SAPWG will utilize the NAIC website for exposure of substantive items. The **Nonsubstantive Listing** contains items that are considered editorial or technical in nature and therefore a new SSAP will not be developed. In other words, a revision to a SSAP for these items will not be deemed to modify its conclusion or original intent. The **Rejected Report** identifies all the items that were proposed to the SAPWG and rejected or deemed not applicable to statutory accounting. The **Active Report** identifies items that are in the process of completion. The **Active Report** is prioritized and shows the status of issue papers and SSAPs. The **Disposition Report** captures the conclusions of the SAPWG.

It should be noted that this Policy Statement addresses the process and the flow of information. The timing is left to the discretion of the SAPWG. For instance, an item can move from the pending list to the substantive disposition report in one, two or three National Meetings.

The NAIC staff will maintain a current Maintenance Agenda on the NAIC website at www.naic.org. Attachment A to this Policy Statement includes a flowchart depicting the flow of information. Attachment B includes a blank Form A. Attachment C is an example of the document that will be attached to all exposed documents and will serve as the notice of public hearing and request for written comments.

Attachment A

Statutory Accounting Principles Maintenance Process
Illustration of Flow of Information


LEVEL 1
LEVEL 2
LEVEL 3
GAAP Status Report
Pending List
All Other Sources
Substantive List
Rejected Report
Nonsubstantive List
Disposition Report
Active Report
Active Report
Disposition Report

Attachment B

Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A

Issue:

____

Check (applicable entity):

	P/C	Life	Health
Correction of existing SSAP	□	□	□
New Issue or SSAP	□	□	□

*Description of Issue:

____

*Existing Authoritative Literature:

____

*Activity to Date (issues previously addressed by SAPWG, Emerging Accounting Issues WG, SEC, FASB, other State Departments of Insurance or other NAIC groups):

____

*Information or issues (included in *Description of Issue*) not previously contemplated by the SAPWG:

____

Recommended Conclusion or Future Action on Issue:

____

Recommending Party:

____
(Organization)

____
(Person Submitting, Title)

____
(Address, City, State, ZIP)

____
(Phone and E-mail Address)

____
(Date Submitted)

* Indicates required information before NAIC staff will accept form as a final document.

Attachment C

EXPOSURE DRAFT NUMBER - TITLE

Notice of Public Hearing and Request for Written Comments

Hearing Date: _________________ **Location: ________________**
Deadline for Written Notice of Intent to speak: **Deadline for Receipt of Written Comments:**

Basis for hearings. The Statutory Accounting Principles (E) Working Group (SAPWG) will hold a public hearing to obtain information from and views of interested individuals and organizations about the standards proposed in this Exposure Draft. The SAPWG will conduct the hearing in accordance with the National Association of Insurance Commissioners (NAIC) policy statement on open meetings. An individual or organization desiring to speak must notify the NAIC in writing by . Speakers will be notified as to the date, location, and other details of the hearings.

Oral presentation requirements. The intended speaker must submit a position paper, a detailed outline of a proposed presentation or comment letter addressing the standards proposed in the Exposure Draft by __________. Individuals or organizations whose submission is not received by that date will only be granted permission to present at the discretion of the SAPWG chair. All submissions should be addressed to the NAIC staff at the address listed below. Comments can also be submitted by electronic mail to ___________@naic.org.

Format of the hearings. Speakers will be allotted up to 10 minutes for their presentations to be followed by a period for answering questions from the SAPWG. Speakers should use their allotted time to provide information in addition to their already submitted written comments as those comments will have been read and analyzed by the SAPWG. Those submissions will be included in the public record and will be available at the hearings for inspection.

Copies. Exposure Drafts can be obtained on the Internet at the NAIC Home Page (http://www.naic.org). The documents can be downloaded using Microsoft Word or WordPerfect.

Written comments. Participation at a public hearing is not a prerequisite to submitting written comments on this Exposure Draft. Written comments are given the same consideration as public hearing testimony.

The Statutory Accounting Principles Statement of Concepts was adopted by the Accounting Practices & Procedures (EX4) Task Force on September 20, 1994, in order to provide a foundation for the evaluation of alternative accounting treatments. All issues considered by the SAPWG will be evaluated in conjunction with the objectives of statutory reporting and the concepts set forth in the Statutory Accounting Principles Statement of Concepts. Whenever possible, establish a relationship between your comments and the principles defining statutory accounting.

The exposure period is not meant to measure support for, or opposition to, a particular accounting treatment but rather to accumulate an analysis of the issues from other perspectives and persuasive comments supporting them. Therefore, form letters and objections without valid support for their conclusions are not helpful in the deliberations of the working group. Comments should not simply register your agreement or disagreement without a detailed explanation, a description of the impact of the proposed guidelines, or possible alternative recommendations for accomplishing the regulatory objective.

Any individual or organization may send written comments to ____________ at the address listed below, no later than _________. Comments can also be submitted by electronic mail to _______@naic.org. Electronic submission followed by signed hardcopy is preferred. After they have been reviewed by the SAPWG, these letters will be available for public inspection and may be obtained by contacting the NAIC Insurance Products and Services Division (816) 783-8300.

National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197 (816) 842-3600

NAIC Policy Statement on Emerging Accounting Issues Agenda Process

The purpose of the following Policy Statement is to document the Emerging Accounting Issues (E) Working Group (EAIWG) agenda process.

As acknowledged in the *NAIC Policy Statement on Maintenance of Statutory Accounting Principles*, the promulgation of new SAP guidance by the NAIC ultimately requires action of the entire membership. Responsibility for proposing new SAP will be delegated through the NAIC committee structure to the Accounting Practices and Procedures (E) Task Force (Task Force). The Task Force will employ two working groups with distinctly different functions to carry out the charge of maintaining SAP. The Statutory Accounting Principles (E) Working Group shall have the exclusive responsibility of developing and proposing new Statements of Statutory Accounting Principles (SSAPs). The EAIWG will respond to questions of application, interpretation, and clarification that are generally much narrower in scope than development of a new SSAP.

Information and issues can be presented to the EAIWG in a variety of ways. Issues can be recommended or forwarded from other NAIC working groups or task forces, from interested parties or from the NAIC staff. In order for an issue to be placed on the Agenda, the recommending party must complete an Emerging Accounting Issues (E) Working Group Agenda Submission Form (Form B) and submit it to the NAIC staff no later than 20 business days prior to the next scheduled EAIWG meeting. NAIC staff will update the Agenda before each National Meeting and will notify the recommending party of such action. Every issue taken up by the EAIWG must be discussed at no less than two open meetings with opportunity for interested parties to present comments. The NAIC website will be utilized for such exposures. The website will maintain the applicable Form B and the tentative consensus opinions. Final consensus opinions will be published annually in Appendix B to the *Accounting Practices and Procedures Manual*. The guidance contained in the consensus opinions of the EAIWG will become effective upon publication unless otherwise stated in the opinion.

Exhibit A includes a blank Form B.

Exhibit A

Emerging Accounting Issues (E) Working Group
Agenda Submission Form
Form B

Issue:

____

*Description of Transaction/Event/Issue:

____

*Accounting Issues:

____

*Authoritative Literature (excerpt applicable references):

____

*Activity to Date (issues previously addressed by Statutory Accounting Principles WG, Emerging Accounting Issues WG, SEC, FASB, other State Departments of Insurance or other NAIC groups):

____

*Recommended Conclusion or Future Action on Issue:

____

+NAIC Staff Recommendation:

____

Recommending Party:

____
(Organization)

____
(Person Submitting, Title)

____
(Address, City, State, Zip)

____
(Phone and E-mail Address)

+NAIC Staff Review Completed by:

____

____
(Date Submitted)

* Indicates required information before NAIC staff will accept form as a final document
+ NAIC Staff will complete before presentation to the EAIWG

NAIC Policy Statement on the Impact of Statements of Statutory Accounting Principles on NAIC Publications

The purpose of the following Policy Statement is to document the process and procedure for identifying the impact of Statements of Statutory Accounting Principles (SSAP) on NAIC publications.

As referenced in the *NAIC Policy Statement on Maintenance of Statutory Accounting Principles*, the promulgation of new SAP guidance by the NAIC ultimately requires action of the entire membership. Responsibility for proposing new SAP will be delegated through the NAIC committee structure to the Accounting Practices and Procedures (E) Task Force (Task Force). The Task Force will employ two working groups with distinctly different functions to carry out the charge of maintaining SAP. The Statutory Accounting Principles (E) Working Group (SAPWG) shall have the exclusive responsibility of developing and proposing new SSAPs. The Emerging Accounting Issues (E) Working Group will respond to questions of application, interpretation, and clarification that are generally much narrower in scope than development of a new SSAP.

An SSAP can affect the various NAIC publications in many different ways. New accounting practices or procedures may result in new disclosures and reporting requirements (affecting Annual Statement Blank and Instructions), modified analysis techniques (affecting RBC formula or IRIS ratios), or new examination procedures (affecting Examiners Handbook).

The SAPWG shall evaluate the impact that newly adopted SSAPs will have on other NAIC publications. To that end, the SAPWG will complete a SSAP Impact on NAIC Publications form after adoption of every SSAP. This form will be used to evaluate the impact of the SSAP, and to recommend a modification as the SAPWG deems appropriate. The SAPWG may seek the assistance of NAIC staff or interested parties in drafting specific language for the affected publication.

After completion of the form, it will be forwarded with a recommendation to the affected working group or task force. The NAIC staff will update the SAPWG as to the progress of the recommendation.

Exhibit A includes a blank SSAP Impact on NAIC Publications form.

Exhibit A

SSAP Impact on NAIC Publications Form

SSAP No. and Title:

____

Affected NAIC Publication(s) (check):

□ Accreditation Standards
□ Actuarial Opinion
□ Annual Statement Blank
□ Annual Statement Instructions
□ *Financial Analysis Handbook*
□ *Financial Condition Examiners Handbook*

□ *IRIS Ratio Results*
□ *Model Laws, Regulations and Guidelines*
□ RBC Formula
□ *SVO Purposes & Procedures Manual*
□ Other: ___________________

Background and Description of SSAP:

____

Issues Affecting NAIC Publication(s)

____

Specific Recommendation or Future Action on Issue (attached separate sheet if necessary):

____

Recommending Party:

Statutory Accounting Principles (E) Working Group

____
(Chair)

____
(Date Adopted by SAPWG)

NAIC Policy Statement on Coordination of the Accounting Practices and Procedures Manual and the Annual Statement Blank

The purpose of the codification of statutory accounting principles (SAP) project was to produce a comprehensive guide to SAP for use by insurance departments, insurers, and auditors. Statutory accounting principles, as they existed prior to codification did not always provide a consistent and comprehensive basis of accounting and reporting. Insurance companies were sometimes uncertain about what rules to follow and regulators were sometimes unfamiliar with the accounting rules followed by insurers in other states. This was due in part to the fact that prior to codification, accounting guidance could be found in the NAIC Accounting Manual, Annual Statement Instructions, Examiners Handbook, and various states' laws and regulations. As a result, insurers' financial statements were not prepared on a comparable basis. Now that accounting requirements have been more rigidly stipulated by the NAIC, it is imperative that the accounting requirements and the reporting and disclosure requirements remain synchronized. This is an excellent opportunity to create a system of parallel requirements. This effort has already been recognized by the NAIC/AICPA Working Group. In 1999, the working group modified the *Model Regulation Requiring Annual Audited Financial Reports* to require the following for audited financial statements:

> Notes to financial statements. These notes shall be those required by the appropriate NAIC Annual Statement Instructions and the NAIC *Accounting Practices and Procedures Manual*. The notes shall include a reconciliation of differences, if any, between the audited statutory financial statements and the annual statement filed pursuant to Section [insert applicable section] of the [insert state] insurance law with a written description of the nature of these differences.

As stated in the model regulation, the NAIC/AICPA Working Group has an expectation that the requirements of the Annual Statement Instructions and the *Accounting Practices and Procedures Manual* will be identical in all pertinent parts that are subject to audit. There is no reason to create a different set of audit requirements in the Annual Statement Instructions when a complete and comprehensive guide to statutory accounting exists. However, it must be noted that the Statements of Statutory Accounting Principles (SSAPs) are not intended to prescribe the specific format of the detailed financial statements.

The scope of this Policy Statement is defined as follows:

> Any change to the annual statement core financials (balance sheet, income statement, cash flow and notes to the financial statements) must reviewed by the Statutory Accounting Principles (E) Working Group to determine whether it conflicts with the disclosure requirements of the SSAPs.

The scope is defined in broad terms because it is very difficult to specify what constitutes a conflict with the SSAPs. For example, the renumbering of the assets page does not conflict because there is not a SSAP that prescribes the order of asset presentation. Contrast this with a seemingly innocuous proposal to modify column 23 of Schedule P - Part 1 (salvage and subrogation anticipated) that would create a disclosure conflict with SSAP No. 55, paragraph 14.

In order to ascertain that the requirements of the Annual Statement Instructions and Blank are in harmony with the SSAPs (as they relate solely to the core financial statements), the following procedures shall be followed:

1. The Blanks Agenda Item Submission Form will include an interrogatory that will indicate to the Blanks (E) Working Group whether the proposal:

a. Affects the core financial statements
b. Conflicts with an existing SSAP
c. Is not currently required by a SSAP
d. Has been reviewed by the Statutory Accounting Principles (E) Working Group

2. One staff member from the Statutory Accounting Principles (E) Working Group and the Blanks (E) Working Group is charged with verifying the accuracy of the interrogatory proposed in (1) above. After the staff member reviews the proposals, they will report their findings back to the applicable groups before each national meeting of the Blanks (E) Working Group. If the staff member identifies issues that need further exploration or consultation, the chairs of the two groups or certain members from each group will hold a joint meeting before the national meeting.

3. The Blanks (E) Working Group will reject proposals that will delete/modify information contained within the core financial statements that are required by an existing SSAP.

4. The Blanks (E) Working Group will either reject proposals that would require additional audited disclosure or audited information within the core financial statements if that same item is not required by an existing SSAP; or move it outside the core financial statements. The sponsoring party will still have the option of placing this information outside the core financial statements (e.g., general interrogatories or interrogatories to schedules) until the disclosure is included in a SSAP. If the disclosure were added to a SSAP in the future, it could be moved to the Notes to the Financial Statements and subject to audit at that time.

5. The NAIC will maintain a SSAP to Annual Statement cross-reference. This cross-reference will contain two significant features. First, it will list all of the SSAP disclosures and reference them to where in the Annual Statement the disclosure requirement is met. Second, the cross-reference will identify the Annual Statement components that are required by a SSAP. The cross-reference can be used by the Blanks (E) Working Group and interested parties in completing the new Blanks Agenda Item Submission Form Interrogatory.

The procedures included in this Policy Statement represent a significant change in the current process, but can only result in increased coordination between the Accounting Practices and Procedures (E) Task Force and the Blanks (E) Working Group. This coordination can only give rise to more consistent, meaningful guidance to the regulators, companies and auditors.

Appendix G
Implementation Guide (Guide)
for the
Annual Financial Reporting Model Regulation (Model)

Introduction

The new requirements within the Annual Financial Reporting Model Regulation related to auditor independence, corporate governance and internal control over financial reporting became effective in 2010. The Implementation Guide is being published to assist companies in planning and preparing for compliance with the new requirements.

The Implementation Guide (Guide) is intended to supplement the Model, not to create additional requirements, by providing interpretive guidance and clarifying the meaning of terms used in the Model. Such guidance is important to ensure common understanding between insurers and regulators and to memorialize the intent of the changes. Because issues and questions will occur from time-to-time, by placing the Guide outside of the Model, maintenance can be achieved in a cost effective way without reopening the Model especially when the issue under consideration is an interpretation of the requirements. The Guide should not be viewed as a requirement of complying with the *Accounting Practices and Procedures Manual*.

Maintaining the Guide

The responsibility of developing and maintaining the Guide resides with the NAIC/AICPA (E) Working Group with changes to the Guide following the NAIC regulatory due process. The Guide resides as an informational appendix to the NAIC *Accounting Practices & Procedures Manual* (AP&P Manual). The AP&P Manual was selected as the logical repository since the Guide provides instruction about compliance with the Model, which directly relates to financial reporting and statutory accounting.

The regulatory due process for modifying this Guide requires the NAIC/AICPA (E) Working Group to send adopted proposals to the Accounting Practices and Procedures (E) Task Force for adoption and inclusion in the AP&P Manual. If the Accounting Practices and Procedures (E) Task Force recommends substantive changes to the proposal received from the NAIC/AICPA (E) Working Group, the proposal should be returned to the NAIC/AICPA (E) Working Group for further deliberation.

Table of Contents

The Table of Contents for the Guide mirrors that of the Model. However, not all sections of the Model require interpretive guidance. Consequently, only those sections containing guidance are contained in the Guide. The presentation of the Guide is organized by the Section Title with the Section number of the Model appearing after the title.

Title	Section	Page
Definitions	3	2
General Requirements Related to Filing and Extensions for Filing of Annual Audited Financial Reports and Audit Committee Appointment	4	4
Qualifications of Independent Certified Public Accountant	7	4
Communication of Internal Control Related Matters Noted in an Audit	11	10
Requirements for Audit Committees	14	11
Management's Report of Internal Control over Financial Reporting	16	13
Exemptions and Effective Dates	17	17
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Definitions (Section 3)

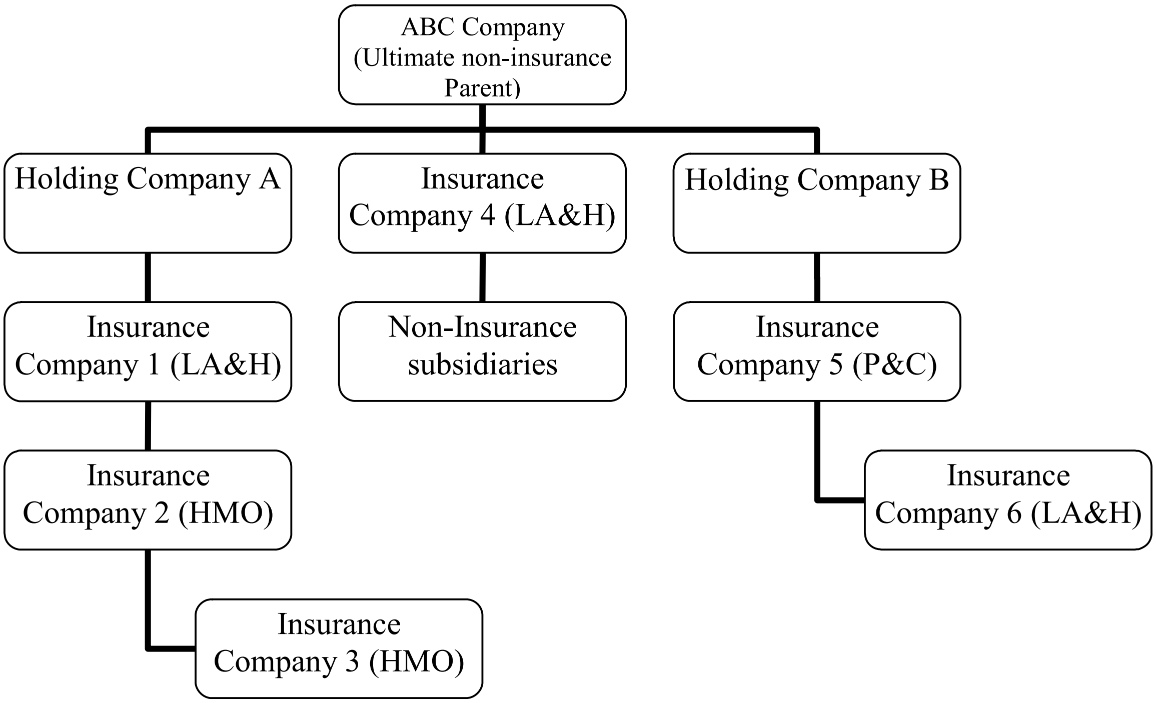
Certain terms and definitions contained in the Model need no further explanation. The Guide provides additional information for preparers and users for some definitions to facilitate their understanding.

"**Audited financial report**" (D), differs from the term "financial statements" in that the Audited financial report (see Section 5 of the Model) includes the financial statements plus the report of the independent certified public accountant. "Financial statements," therefore, excludes the report of the independent certified public accountant.

"**Group of insurers**" (H), as intended for use in the Model is to recognize the variety of structures that may exist. Companies within a holding company structure, or other set of insurers identified by management, may often share common management, systems or processes. Consequently, when management asserts to the effectiveness of their internal controls, it is appropriate to make such an assertion for those companies based upon the organization management determines to be most relevant to meet the reporting requirements. Because holding company structures, and other groups of insurers, can be complex and organized to meet corporate objectives, that structure may not align with the organizations that are responsible for managing and preparing the financial statements of the insurer. The Model provides flexibility to insurers to identify a "Group of insurers" for purposes of evaluating the effectiveness of their internal control over financial reporting. In determining the appropriate scope and level of testing for systems that are shared by a group of insurers, management is not required to expand the scope or perform additional testing that would be redundant for each legal entity included within the group of insurers. To the extent that a specific internal control or system is unique to and has a material impact on the preparation of the audited statutory financial statements of a legal entity included in a group of insurers and the legal entity exceeds the premium thresholds contained in Section 16, that control or system is to be included in management's evaluation of internal controls.

A “Group of insurers” that has been granted approval to file audited statutory consolidated or combined financial statements of a group of insurers (as described in Section 8) may set the scope and level of testing for purposes of determining effectiveness of internal controls over financial reporting consistent with the basis on which the audited statutory financial statements for the Group are prepared (i.e., at the combined or consolidated level).

The following example is intended to illustrate various ways that a “Group of insurers” could be determined. The example is not intended to be limiting in any way. Rather, it is intended to show the flexibility to be in compliance with the Model. Insurers are encouraged to notify the Commissioner of its initial “Group of insurers” and any subsequent changes to such group.


ABC Company (Ultimate non-insurance Parent)
Holding Company A
Insurance Company 4 (LA&H)
Holding Company B
Insurance Company 1 (LA&H)
Non-Insurance subsidiaries
Insurance Company 5 (P&C)
Insurance Company 2 (HMO)
Insurance Company 6 (LA&H)
Insurance Company 3 (HMO)

1. “Group of insurers” could be established at the ultimate parent level, i.e., one report of the effectiveness of internal controls for all insurers in the group-insurance companies 1-6.
2. Two “Group of insurers” could be established at the holding company level, i.e., holding company A and B. In this case, a separate report would be required for holding company A, holding company B, and if it met the reporting threshold, insurance company 4 since it is not in either group.
3. Two “Group of insurers” could be established based upon the type of insurance company, i.e., LA&H companies 1, 4 and 6 could be one group and HMO companies 2 and 3 in the second group. In this case, a separate report would be required for the LA&H companies, the HMO companies and if it met the reporting threshold, insurance company 5 since it is not in either group.
4. Two “Group of insurers” could be established based upon the way the entities are managed. For example, companies, 1, 2, 3 and 5 have the same management while companies 4 and 5 have common management.
5. If management elects not to identify a “Group of insurers” for purposes of evaluating the effectiveness of internal control over financial reporting then each reporting entity meeting the reporting requirements of Section 16 would prepare such a report.

"**Internal control over financial reporting**" (I), as defined in the Model is intended to have the same meaning as understood in the public sector to comply with the requirements of the Sarbanes-Oxley Act of 2002. Because some terms might not be fully defined and to avoid misunderstanding, this Guide attempts to clarify such terms. For example, the word "reliability" used in the phrase "reliability of financial statements" has the same meaning as that contained in the generally accepted accounting principles (GAAP) framework, Statement of Financial Accounting Concepts Two. This Statement is referenced in the Preamble, Part III, paragraph 24 of the AP&P Manual.

General Requirements Related to Filing and Extensions for Filing of Annual Audited Financial Reports and Audit Committee Appointment (Section 4)

Section 4D stipulates that each insurer required to file an annual Audited financial report pursuant to the Model shall designate a group of individuals as constituting its Audit committee. Section 4D further states that the Audit committee of an entity that controls an insurer may be deemed to be the insurer's Audit committee for purposes of this regulation at the election of the controlling person. The definition of Audit committee in Section 3 of the Model references Section 14E for exercising this election. However, a disclaimer within Section 14 of the Model indicates that the section shall not apply to SOX Compliant Entities or wholly-owned subsidiaries of SOX Compliant Entities. Regardless of the disclaimer, in order to comply with the second sentence in Section 4D, the Audit committee of any entity that controls an insurer (a SOX Compliant entity or a non-SOX Compliant Entity) may be deemed to be the insurer's Audit committee at the election of the controlling person, and only if such election is completed in the manner outlined in Section 14E.

The responsibility of the Audit committee is defined in Section 14 of the Model. Section 14 states that each member of the Audit committee shall be a member of the Board of Directors and sets forth the requirements for the proportion of independent Audit committee members based on the insurer's direct written and assumed premiums. The definition of an independent Audit committee member is outlined in Section 14.

Qualifications of Independent Certified Public Accountant (Section 7)

Lead Audit Partner Rotation Requirement (Section 7D)

Purpose
The purpose of this section is to provide companies and their independent accountants with guidance to enable an orderly transition in meeting the revised lead audit partner rotation requirements as set forth in Section 7.

Background
Section 7 provides certain limitations on the number of years an audit partner may serve in the capacity of lead audit partner for an insurance company audit. Previously, the lead audit partner was permitted to serve for seven consecutive years in that capacity with a two year break in service. Under the revised Model "…the lead …audit partner (having primary responsibility for the audit) may not act in that capacity for more than five (5) consecutive years. The person shall be disqualified from acting in that or a similar capacity for the same company or its insurance subsidiaries or affiliates for a period of five (5) consecutive years."

The new rotation requirements under Section 7 are effective beginning with audits of the 2010 financial statements. The rotation requirements of the Model and the interpretative guidance provided are applicable for statutory reporting and regulatory purposes. An insurer and its affiliates that are subject to the rotation requirements of the Securities and Exchange Commission (SEC) and Public Company Accounting Oversight Board (PCAOB) must also continue to comply with those rotation requirements.

Relief from the Lead Audit Partner Rotation Requirement (Section 7D)

The Model states:

> An insurer may make application to the Commissioner for relief from the above rotation requirement on the basis of unusual circumstances. This application should be made at least thirty (30) days before the end of the calendar year. The Commissioner may consider the following factors in determining if the relief should be granted:
>
> (a) Number of partners, expertise of the partners or the number of insurance clients in the currently registered firm;
>
> (b) Premium volume of the insurer; or
>
> (c) Number of jurisdictions in which the insurer transacts business.

The following examples illustrate circumstances that the Commissioner may consider in determining if relief from the lead partner rotation requirement shall be granted:

1. No other partners in the firm's local office have the qualifications to serve as lead audit partner and the use of a qualified partner resident in another location could result in increased audit risk and higher audit fees.
2. Limited number of partners in the firm that have the qualifications to serve as the lead audit partner.
3. Switching firms could result in increased audit risk due to the new engagement team's lack of familiarity with the insurer.
4. Limited availability of other firms in a particular location with the requisite expertise.
5. The regulator believes that complex issues at an insurer make a particular partner best suited to continue as lead audit partner
6. Short-term relief due to the occurrence of an unforeseeable event that renders a partner unable to continue as the lead audit partner on the engagement.
7. Short-term relief due to unexpected delays in the state's licensing or admission process that prevent the "new" lead audit partner from assuming that role.

Also, the granting of transitional relief may be warranted when the non-insurance parent or ultimate parent of an insurance company is an SEC registrant and the current lead audit partner on the SEC registrant has completed his or her rotation as the lead audit partner on insurance subsidiaries prior to completing his or her five-year rotation as the lead partner on the audit of the GAAP financial statements of the SEC registrant. In this situation the relief would allow the lead audit partner to complete his or her rotation on the SEC registrant as long as he or she no longer acts in the capacity of lead audit partner for any insurance subsidiaries and/or any downstream affiliates of the insurance subsidiaries.

Frequently Asked Questions (Section 7D)

Following are a series of frequently asked questions to assist companies and their independent accountants in interpreting this guidance. Dates provided refer to the year of financial statements under audit.

In determining when the lead audit partner must rotate, consecutive time served in the capacity of lead audit partner prior to the effective date of these rules would be counted (i.e., the lead audit partner is not afforded a "fresh start"). If the lead audit partner completed the two year break in service required by the previous version of the Model prior to the effective date of these rules, the partner is eligible to resume service as a lead audit partner for a five year period and need not wait additional years to accomplish a five year break in service.

1. 2010 would be the fifth year that a partner would serve as lead audit partner of an insurance company. Would that partner be able to complete the 2010 year-end audit?

   Yes. The partner would be able to complete the 2010 year-end audit; however, the partner would be required to rotate off the engagement after the 2010 year-end audit.

2. 2010 would be the sixth or seventh year that a partner would serve as the lead audit partner. Would that partner be able to serve in that capacity for the 2010 audit?

   No. The partner would be required to rotate off for the 2010 year-end audit. In determining when the lead audit partner must rotate, consecutive time served in the capacity of lead audit partner since the most recent two year break in service prior to the effective date of these rules would be counted.

3. If a partner serves as the concurring partner from 2007 – 2010, can that partner serve as the lead audit partner in 2011? If so, for how many years?

   Yes. The Model does not prohibit a partner that has served as the concurring partner from subsequently serving as the lead audit partner. The time served as concurring partner does not count towards the five year limitation. In the situation above, the partner would be permitted to serve as lead audit partner from the 2011 year-end audit through the 2015 year-end audit.

4. Can a lead audit partner serve as the concurring review partner during the required five year break in service?

   Yes. The Model specifies that a partner may not act in "that or a similar capacity for the same company or its insurance subsidiaries or affiliates for a period of five (5) consecutive years" where "that" refers to the role of lead audit partner. Therefore, the Model does not prohibit that partner from serving as concurring partner during that partner's five year break in service.

5. During the five-year break in service, can a partner serve as lead audit partner on an insurance company affiliate of that company?

   No. The Model specifies a "person shall be disqualified from acting in that or a similar capacity for the same company or its insurance subsidiaries or affiliates for a period of five (5) consecutive years." The phrase "insurance subsidiaries or affiliates" is interpreted to mean any subsidiaries and affiliates (whether insurance or non insurance).

6. If a lead audit partner serves for six years prior to the effective date of the revised Model (year-end audits from 2003 – 2008) then rotates off the engagement for two years (year-end audits 2009 – 2010), can that partner serve for five additional consecutive years (year-end audits from 2011 – 2015) as the lead audit partner?

   No. The requirement for a break in service of five consecutive years becomes effective for the 2010 year-end audits. If the partner has not completed the two-year break in service prior to the effective date of the new requirement, the partner becomes subject to the new requirement and must complete a five-year break in service. However, if the lead audit partner completes the two year break in service by 2009 instead of 2010, that partner would be permitted to resume the lead audit partner role in 2010.

7. A partner that served seven years as lead audit partner has not worked on the engagement for two years. Assuming 2010 otherwise would be year three of the break in service, can that partner assume the lead audit partner role for the 2010 year-end audit?

Yes. The requirement for the five year break in service starts with engagement years beginning 2010. Prior to 2010, the rotation requirement is for a two year break in service.

8. If a lead audit partner served in that capacity for years 2007 – 2009 and was not on the engagement (or that of any subsidiary or affiliate) for 2010, would that partner have to complete a five year break in service before again serving as the lead audit partner?

No. However, the partner could only serve as the lead audit partner for two more years since the partner has already served three years on this engagement.

9. Can a former lead audit partner currently in a break in service continue to serve the client in a role other than the lead audit partner, for example concurring partner or auxiliary partner, such as tax review partner or other assisting role?

Yes. The Model auditor rotation rules apply only to the role of lead audit partner on the audit of the insurance company and its insurance subsidiaries or affiliates.

10. 2010 is the first year that a partner serves as the lead audit partner on an insurer. The partner serves as the lead audit partner on that insurer for year-end audits of 2010 – 2012; however, during 2013 – 2015 that partner does not serve as the lead audit partner on that insurer or any of its affiliates. If that partner again serves the insurer (or any of its insurance subsidiaries or affiliates) as the lead audit partner for 2016 year-end audit, when must that partner rotate off the engagement?

The partner is permitted to serve as the lead audit partner for the 2016 and 2017 year-end audits and must begin a five-year break in service with the year-end 2018 audit. The break in service during 2013 – 2015 would be for less than the five-year period required by the Model. In order for the partner to be permitted to begin a new five-year service period as lead audit partner on the insurer or any of its insurance subsidiaries or affiliates, a full five-year break in service is required to be completed by that partner.

11. How is service as the lead audit partner on the audit of the GAAP-basis financial statements of a separate account evaluated under the Model?

A separate account is not a legal entity, but an accounting entity with accounting records for variable contract assets, liabilities, income, and expenses segregated as a discrete operation within the insurance company. Therefore, the separate account is considered to be an insurance affiliate for purposes of applying the Model.

If the insurer is a part of a mutual fund complex, the mutual funds are considered to be non insurance affiliates even if held as investments in the insurer's separate accounts.

12. An insurer changes to a new independent accounting firm. At the same time, the lead audit partner for that insurer joins the new independent accounting firm. Would the lead audit partner's time at the previous accounting firm count toward the five year rule at the new accounting firm?

Yes. The rule specifically applies to the lead audit partner and not the independent accounting firm.

13. Some firms have individuals that are CPAs but not partners (i.e., nonequity participants such as directors or principals) that serve in the role of the lead audit partner. Can such a CPA serve in the role of the lead audit partner of an insurance company?

Yes. The Model defines the lead audit partner as the individual having "primary responsibility for the audit." Whether this capacity is served by a partner or other CPA with the equivalent qualifications is at the discretion of the independent accounting firm. As such, the individual would be subject to the rotation requirements of the lead audit partner under Section 7.

Questions 14 through 23 are based on the following hypothetical fact pattern and assume there are no public registrants in the group.

Neither insurance subsidiary A nor insurance subsidiary B has any investment in non insurance subsidiary C.

- Partner Smith served as the lead audit partner on non insurance holding company H for six years through the 2010 year-end audit.
- Partner Jones served as the lead audit partner on insurance subsidiary A for four years through the 2010 year-end audit.
- Partner Little served as the lead audit partner on insurance subsidiary B for three years through the 2010 year-end audit.
- Partner Brown served as the lead audit partner on non insurance subsidiary C for two years through the 2010 year-end audit.
- Partner Miller served as the lead audit partner on insurance subsidiary D for three years through the 2010 year-end audit.
- Partner King served as the lead audit partner on non insurance subsidiary E for seven years through the 2010 year-end audit.

14. Can Partner Smith rotate from serving as the lead audit partner on non insurance holding company H to serving as the lead audit partner on insurance subsidiary B for the 2011 year-end audit?

Yes. The limitation under Section 7 initiates with service as the lead audit partner of an *insurer*. Assuming Partner Smith has not previously served as the lead audit partner on an insurer, he or she can then serve as the lead audit partner on insurance subsidiary B or any of its affiliates for up to five years.

15. Can Partner King rotate from serving as the lead audit partner on non insurance subsidiary E to serving as the lead audit partner on insurance subsidiary B for the 2011 year-end audit?

Yes. The limitation initiates with service as the lead audit partner of an *insurer*. Assuming Partner King has not previously served as the lead audit partner on an insurer, he or she can then serve as the lead audit partner on insurance subsidiary B or any of its affiliates for up to five years.

16. Can Partner Brown rotate from serving as the lead audit partner on non insurance subsidiary C to serving as lead audit partner on insurance subsidiary B for the 2011 year-end audit?

Yes. The limitation initiates with service as the lead audit partner of an *insurer*. Assuming Partner Brown has not previously served as the lead audit partner on an insurer, he or she can then serve as the lead audit partner on insurance subsidiary B or any of its affiliates for up to five years.

Therefore, Brown could serve insurance subsidiary B for five years beginning with the 2011 year-end audit.

17. Can Partner Brown rotate from serving as the lead audit partner on non insurance subsidiary C to serving as lead audit partner on Holding Company H for the 2011 year-end audit?

    Yes. C is a non insurance subsidiary and H is a non insurance holding company; therefore, assuming Partner Brown has not previously served as the lead audit partner on an insurer, the partner rotation requirements of Section 7 are not applicable relative to non insurance subsidiary C and non insurance holding company H.

18. Can Partner Jones rotate from serving as the lead audit partner on insurance subsidiary A to serving as the lead audit partner for insurance subsidiary B for the 2011 year-end audit?

    Yes. However, Jones can only serve for one year due to four years prior service as the lead audit partner on insurance subsidiary A (an insurance affiliate).

19. Can Partner Jones rotate from serving as the lead audit partner on insurance subsidiary A to serving as the lead audit partner on non insurance subsidiary C for the 2011 year-end audit?

    Yes. However, Jones can only serve for one year due to four years prior service as the lead audit partner on insurance subsidiary A (an insurance affiliate). The limitation initiates with serving as the lead audit partner on an insurer.

20. Can Partner King rotate from serving as the lead audit partner on non insurance subsidiary E to serving as the lead audit partner on non insurance subsidiary C for the 2011 year-end audit?

    Yes. E is a non insurance subsidiary and C is a non insurance subsidiary; therefore, assuming Partner King has not previously served as the lead audit partner on an insurer, the partner rotation requirements of Section 7 are not applicable relative to non insurance subsidiary E and non insurance subsidiary C.

21. Can Partner Jones rotate from serving as the lead audit partner on insurance subsidiary A to serving as the lead audit partner on non insurance subsidiary E for the 2011 year-end audit?

    Yes. However, Jones can only serve for one year due to four years prior service as the lead audit partner on insurance subsidiary A (an insurance affiliate). The limitation initiates with serving as the lead audit partner on an insurer.

22. Can Partner Jones rotate from serving as the lead audit partner on insurance subsidiary A to serving as the lead audit partner on insurance subsidiary D for the 2011 year-end audit?

    Yes. However, Jones can only serve for one year due to four years prior service as the lead audit partner on insurance subsidiary A (an insurance affiliate). The limitation initiates with serving as the lead audit partner on an insurer.

23. Can Partner Little rotate from serving as the lead audit partner on insurance subsidiary B to serving as the lead audit partner on non insurance subsidiary E for the 2011 year-end audit?

    Yes. However, Little can only serve for two years due to three years prior service as the lead audit partner on insurance subsidiary B (an insurance affiliate). The limitation initiates with serving as the lead audit partner on an insurer.

Prohibited Services (Section 7 G)

The Model does not allow the Commissioner to accept an Audited financial report prepared by an accountant who provides the insurer, contemporaneously with the audit, non-audit services as outlined within the Model. One of the prohibited services outlined in the Model consists of bookkeeping or other services related to the accounting records or financial statements of the insurer. The prohibition in this area should include, but is not limited to, services related to the preparation of the Annual Statement to be submitted by the insurer. However, the drafting of the Audited financial report would not be prohibited, provided that the accountant does not assume decision-making authority (e.g., approval of journal entries) in compiling the draft report.

Communication of Internal Control Related Matters Noted in an Audit (Section 11)

In addition to the annual Audited financial report, each insurer must furnish the Commissioner with a written communication as to any unremediated material weakness in its internal control over financial reporting noted during the audit. The communication is prepared by the accountant within 60 days after the filing of the annual Audited financial report and is filed by the insurer. Recognizing it may not always be practical, insurers are encouraged to file the communication concurrently with the filing of the annual Audited financial report for those years in which the insurer is aware that a financial condition examination has been scheduled. The insurer is required to provide a description of remedial actions taken or proposed to correct unremediated material weaknesses, if the actions are not described in the accountant's communication.

The Model requires that the Commissioner be notified when unremediated material weaknesses in internal control over financial reporting were noted during the audit. Previous versions of the Model required such communication when any significant deficiencies in internal control over financial reporting were noted during the audit, whether remediated or not. This distinction is important because of the level of severity of the internal control deficiency that is applicable to each term. The terms "material weakness" and "significant deficiency" have the same meaning respectively as used in PCAOB or American Institute of Certified Public Accountants (AICPA) auditing literature - PCAOB Auditing Standard No. 5, An Audit of Internal Control over Financial Reporting That is Integrated With an Audit of Financial Statements or AICPA AU Section 325, Communicating Internal Control Matters Identified in an Audit (see Section 16E of this Guide for the definitions of material weakness and significant deficiency that are included in the auditing literature). However, the insurer is expected to maintain information about significant deficiencies that were communicated by its auditors and such information should be available for review during the financial condition examination.

The following is an example of the type of communication that an insurer should prepare to communicate the remedial actions taken or proposed to correct a material weakness in its internal control over financial reporting noted during an audit.

Communication of Internal Control Related Matter Noted in an Audit - Sample

Honorable Commissioner
State of Domicile Insurance Department
State of Domicile

Dear Honorable Commissioner:

During the audit completed for the year ended December 31, 20XX, for XYZ Holding Company Inc ("XYZ"), a material weakness was noted in XYZ's internal control over financial reporting related to the calculation of insurance reserves. Due to the manner in which the data for homeowners policies are captured by the systems used in its Southeastern US regional office, changes in XYZ's estimate of insurance reserves for certain policies are not reviewed by XYZ's Actuarial Department prior to being recorded in the company's accounting records.

A material weakness is a deficiency or a combination of deficiencies in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. In connection with the weakness noted above, XYZ's management has taken remedial actions to change its procedures for coding policies issued in the states affected so that all homeowners' policy data are included in the Actuarial Department review of estimate of insurance reserves. This change was effective on July 1, 20XX.

Should you have any questions regarding this matter, please do not hesitate to contact me at the number noted above.

Regards,

XYZ Holding Company, Inc.

Requirements for Audit Committees (Section 14)

A disclaimer within Section 14 of the Model indicates that the section shall not apply to SOX Compliant Entities or wholly-owned subsidiaries of SOX Compliant Entities. This disclaimer was placed within the Model to avoid conflicts between the independence requirements of the Model and those required of public companies under Section 301 of the Sarbanes Oxley Act of 2002. The expectation of regulators in developing this disclaimer was that the same independent Audit committee required of public companies under Section 301 would be deemed to be the insurer's Audit committee for purposes of this regulation (pursuant to Section 4D of the Model) or would participate in the oversight of the insurers within the group. Therefore, if material weaknesses, significant deficiencies and/or significant solvency concerns are identified at the legal entity level, the independent Audit committee should be involved in addressing these issues, regardless of their materiality at the consolidated, parent company level.

Independence of an Audit Committee Member (Section 14C)

A policyholder would be considered "independent" unless they receive direct compensation from the insurer for other unrelated services.

A person who is otherwise considered independent and also serves on the Board of Directors of a contracting entity (e.g., medical provider, vendors, banks, etc.) is considered independent.

An otherwise non-independent member of the Board of Directors is considered independent for Audit committee purposes if state law requires participation on the Board (e.g., Medical providers) as long as the member is not an officer or employee of the insurer or one of its affiliates.

Notification letter (Section 14E)

In accordance with Section 14E, upon the initial election by the insurer to designate the Audit committee of an entity that controls the insurer as its Audit committee, the insurer shall provide written notification to the Commissioner of the affected insurer. This notification shall identify the controlling entity and the basis for the election. This election remains in effect for perpetuity, until rescinded, at which time written notification would need to be provided to the Commissioner of the insurer. The notification letter should be timely filed with the Commissioner by the ultimate controlling person prior to the issuance of the statutory Audited financial report. However, each of the affected insurers (i.e. those that will have an Audit committee designated by its ultimate controlling person) that is subject to the provisions of Section 14 shall ensure that the notification letter is filed with the Commissioner. Absence such filing, each of the affected insurers would be individually responsible for complying with Section 14. For example, referring to the "Group of insurers" chart in Section 3, if the ABC Company is the ultimate controlling person and elects to have its Audit committee serve as the Audit committee for insurance company 5, then ABC Company would file the notification letter (insurance company 5 would have to ensure that the notification letter is filed or comply with Section 14 as a single entity). Once submitted, the election remains in effect until rescinded. The following example illustrates the reporting requirement.

> The XYZ insurance company (e.g., insurance company 5) is an indirect subsidiary of and controlled by ABC Company. ABC Company has an independent Audit committee comprised of directors of ABC Company. XYZ insurance Company has elected to designate the Audit committee of ABC Company as the Audit committee of XYZ insurance Company for purposes of complying with Audit committee requirements of the Annual Financial Reporting Model Regulation.

(Signed)____ (Date)______________
(XYZ Insurance Company Chief Executive Officer)
(Signed)____ (Date)______________
(ABC Company Chief Executive Officer)

Transitional Guidance (Section 14G)

Once a company exceeds the requisite thresholds for Audit committee requirements contained in Section 14 of the Model, it is required to comply with the Audit committee requirements by January 1 following one (1) complete calendar year. The following are examples of transitional period requirements.

A: Company surpasses $300 million threshold:

ABC Insurance Company has reached the $300 million requisite threshold in its December 31, 2011 audited statutory statement and therefore will be required to meet "majority (50% or more) member independence" Audit committee requirements by January 1, 2013, providing the company necessary time for recruitment and approvals.

B: Company surpasses $500 million threshold:

ABC Insurance Company has subsequently reached the $500 million requisite threshold in its December 31, 2014 audited statutory statement and therefore will be required to meet the "Supermajority (75% or more) member independence" Audit committee requirements by January 1, 2016.

C: Company drops below threshold amount:

If ABC Insurance Company has penetrated the requisite $500 million threshold and has been in compliance with the requirements but subsequently drops below the $500 million threshold, e.g., $450 million in its December 31, 2018 audited statutory statements, the company would be subject to the "majority (50% or more) member independence" requirement and could reduce the Audit committee independence in 2019. Companies, however, are encouraged to structure their Audit committees with at least a supermajority of independent Audit committee members.

Hardship Waiver (Section 14H)

An insurer may make application to the Commissioner for a waiver from the Section 14 requirements based upon hardship. Examples may include, but are not limited to, requests based on the business type of the entity, the availability of qualified board members, or the ownership (e.g., entities owned by non-profit health systems) or organizational structure of the entity. If the application for a waiver is approved, the insurer would file, with its annual statement filing, the approval for relief from Section 14 with the states that it is licensed in or doing business in and the NAIC. If the nondomestic state accepts electronic filing with the NAIC, the insurer would file the approval in an electronic format acceptable to the NAIC.

Management's Report of Internal Control over Financial Reporting (Section 16)

Premium Threshold (Section 16A)

The term "direct written premium" is frequently associated with the property/casualty business. While the Model continues to use the term, it raises the question for other businesses, e.g., life and fraternal, what is the appropriate measure for assessing compliance? The following examples have been developed to illustrate the computation since the starting point is the audited financial statements of the reporting entity, and it is possible that the amount reported may not be consistent with written premium as reported in the regulatory reporting blank.

The annual direct written and assumed premium:

- ♦ will be derived from the annual Audited financial report of an individual insurer, as of December 31 immediately preceding
- ♦ are generally reported in the Statement of Operations of the Audited Financial Report on an 'earned' and a 'net of reinsurance ceded' basis
- ♦ will be computed by making the following adjustments:

P/C, Health and Title entities:

	$
Premiums earned (Statement of Income in Audited financial report)	A
Add/Deduct: Change in unearned premium	B
Add: Reinsurance ceded	C
Direct written and assumed premium *	D=A+B+C

*Note: Direct written and assumed premium would be reduced by any premiums reinsured with the Federal Crop Insurance Corporation and Federal Flood Program

- A - Premiums earned per the Statement of Income will generally equal the Annual Statement, Page 4.
- B - Change in unearned premium is the difference between the current period amount and the prior year-end amount reported in the liabilities section of the balance sheet. The amount may also be derived from other company prepared exhibits.
- C - Reinsurance ceded may be derived from the notes to the Audited financial report, if disclosed, or other company prepared exhibits or schedules. If the Statement of Income or Statement of Operations separately presents reinsurance ceded, an adjustment is not required.
- D - Must be equal to, or greater than, $500 million in order to be subject to Section 16 reporting.

Life and Fraternal entities:

	$
Premiums earned (Statement of Operations in Audited financial report)	A
Add: Reinsurance ceded	B
Direct written and assumed premium	C=A+B

- A - Premiums earned per the Statement of Operations will generally equal the Annual Statement, Page 4.
- B - Reinsurance ceded may be derived from the notes to the Audited financial report, if disclosed, or other company prepared exhibits or schedules. If the Statement of Operations separately presents reinsurance ceded, an adjustment is not required.
- C - Must be equal to, or greater than, $500 million in order to be subject to Section 16 reporting.

Companies in an RBC Level Event or in Hazardous Financial Condition (Section 16B)

For purposes of this subsection, the phrase “RBC level event” refers to any of the regulatory action levels described in the Risk-Based Capital requirements or the trend test. For example, if the reporting entity’s total adjusted capital is equal to or less than 200% of the required risk-based capital, the result would trigger regulatory action.

Management’s Report of Internal Control over Financial Reporting (Sections 16C & 16D)

Management must annually provide their domiciliary insurance department with a report on internal controls over the statutory financial statement process. Recognizing it may not always be practical, insurers are encouraged to file the report concurrently with the filing of the annual Audited financial report for those years in which the insurer is aware that a financial condition examination has been scheduled. The elements to be included in the report are outlined in 16D.

As outlined in Section 16C, an addendum is required for all reports that rely on a Section 404 Report (Sarbanes-Oxley). The Model states that the Section 404 Report means management’s report on internal control over financial reporting as defined by the SEC and the related attestation report of the independent certified public accountant. However, in 2010, the Dodd-Frank Act exempted non-accelerated SEC filers (those reporting companies that do not meet the definition of either an “accelerated filer” or a “large accelerated filer” under Exchange Act Rule 12b-2.) from the requirement to obtain the related attestation report of the independent certified public accountant. As such, non-accelerated SEC filers may file a Section 404 Report that does not include an attestation report of the independent certified public accountant, along with the appropriate addendum, to fulfill requirements in this area.

Alternately, insurers may utilize a report received as a result of work performed in accordance with Statement of Standards in Attestation Engagements (SSAE) No. 15 in a similar fashion to a Section 404 Report. As such, there are two main types of reports that can be provided:

- Reports from entities that have complied with all required elements of Section 404 of the Sarbanes-Oxley Act (or have received an SSAE No. 15 report) either as a requirement or on a voluntary basis.
- Reports from entities that have not complied with Section 404 of the Sarbanes-Oxley Act (or have not received an SSAE No. 15 report).

Appendix 1 of this guide provides examples of Management’s Report of Internal Controls over Financial Reporting utilizing various facts and circumstances.

Section 16D(2): Management must make an assertion regarding the effectiveness of the insurer’s Internal control over financial reporting to the best of its knowledge and belief after diligent inquiry. For purposes of filing the report, “diligent inquiry” means conducting a search and thorough review of relevant documents which are reasonably likely to contain significant information with regards to Internal control over financial reporting and making reasonable inquiries of current employees and agents whose duties include responsibility for Internal control over financial reporting.

Section 16D(5): The report must disclose any unremediated material weaknesses in Internal control over financial reporting that exist as of the balance sheet date. If the insurer or Group of insurers has identified an unremediated material weakness, management is not permitted to conclude that its Internal control over financial reporting is effective and it must include a description of the nature of any unremediated material weakness in the report. December 31 is used as the measurement date to whether a material control weakness is unremediated for purposes of reporting under this section of the Model.

Section 16D(6): Users of the report should be aware of the inherent limitations in Internal control over financial reporting. PCAOB Auditing Standard No. 5, An Audit of Internal Control over Financial Reporting That is Integrated With an Audit of Financial Statements provides the following description of such inherent limitations:

> Internal control over financial reporting has inherent limitations. Internal control over financial reporting is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. Internal control over financial reporting also can be circumvented by collusion or improper management override. Because of such limitations, there is a risk that material misstatements will not be prevented or detected on a timely basis by internal control over financial reporting. However, these inherent limitations are known features of the financial reporting process. Therefore, it is possible to design into the process safeguards to reduce, though not eliminate, this risk.

Additionally, readers of the report should be aware that projecting management's assertion regarding the effectiveness of Internal control over financial reporting to future periods is subject to the risk that controls may become inadequate because of changes in conditions, or the degree of compliance with policies or procedures may deteriorate.

Section 16D(7): The report must include signatures of the chief executive officer and chief financial officer (or the equivalent position/title). If a report is being filed on behalf of a Group of insurers, management should identify the officeholders (i.e., the CEO and CFO of Company ABC) that have the authority to sign the report on behalf of the all of the legal entities being reported upon within the Group of insurers.

Basis for Management's Review and Assertions (Section 16E)

One of the primary reasons for the new Section 16 of the Model is to bring additional focus and attention to internal control over financial reporting. Financial reporting is the underpinning of many of the solvency oversight activities of insurance regulators. Section 16 of the Model identifies management's responsibilities for internal control over financial reporting and provides regulators additional assurances of the effectiveness of internal control practices in a cost effective manner.

The basis for Management's Report of Internal Control over Financial Reporting shall be subject to insurance departments' financial condition examinations. Because of this and other solvency tools available to regulators, there is no requirement that the independent certified public accountant be engaged to perform an examination of the effectiveness of internal control over financial reporting. However, Section 9 requires the independent public accountant to consider (as that term is defined in AICPA Statement on Auditing Standards (SAS) No. 102, Defining Professional Requirements in Statements on Auditing Standards, or its replacement) the most recently available Management's Report of Internal Control over Financial Reporting in planning and performing the audit of the statutory financial statements. SAS No. 102, paragraph 4 states, "If a SAS provides that a procedure or action is one that the auditor "should consider," the consideration of the procedure or action is presumptively required, whereas carrying out the procedure or action is not." AU Section 319 of the Professional Standards of the AICPA, Consideration of Internal Control in a Financial Statement Audit, requires that the auditor obtain an understanding of internal control sufficient to plan and execute the audit. It is in this context that the auditor is required to "consider" management's report. There is no requirement that the auditor test or otherwise use management's report.

The Model does not mandate a specific framework for management’s review and evaluation of internal controls. SEC registrants typically (but are not required to) use the COSO Internal Control-Integrated Framework in assessing the effectiveness of internal control over financial reporting. The COSO-sponsored “Enterprise Risk Management-Integrated Framework” and the PCAOB Guidance for Smaller Public Companies Reporting on Internal Control over Financial Reporting are other examples of relevant literature companies may want to consider in applying such a framework. Under the Model, however, management, when making its assessment and preparing its report, has discretion as to the nature of the internal control framework used. Insurers shall have flexibility as to the frequency and scope of testing activities and the documentation provided upon examination to support the assertions. Management should assess and select an appropriate framework or approach based upon its business risks and objectives.

Management’s assertions about the effectiveness of internal controls enhance oversight and understanding of insurer solvency by allowing regulators to have greater confidence in the accuracy of financial reporting, which also provides a benefit to policyholders and creditors. An expected benefit of this enhancement, where internal controls are effective, is that financial examinations will become more efficient and risk-focused.

Management’s Report of Internal Control over Financial Reporting may span more than one legal entity. Because internal controls are primarily about processes and these processes are often applied across multiple legal entities within an organization, (e.g., investment systems, premium and loss/benefit systems, and financial reporting processes), management may consider common processes and the associated controls when determining the Group of insurers for reporting purposes.

The Model provides flexibility in meeting the requirements of Section 16D and E. The controls included in the scope of management’s report should only include those controls deemed significant or critical by management. The following examples represent aspects and components of internal control that insurers may want to consider when making the assertions and determining relevant documentary evidence. These are not intended to serve as, and should not be considered, requirements:

- The internal control environment including oversight provided by the Audit committee of the Board of Directors. Insurers may want to consider how they can demonstrate “Tone at the Top.” The insurer’s compliance programs, code of conduct and the processes for reporting policy exceptions and overrides of controls may also be appropriate to consider.

- The risk assessment process utilized and identification of the areas of potential material internal control risk related to the financial statement. Risk areas that one might typically find for an insurance enterprise include:
    - Investments (including capital expenditures)
    - Policy and Claim Reserves
    - Benefit Payments
    - Premiums / Agent’s Balances
    - Reinsurance
    - Related Party (Affiliate) Transactions
    - Operating Expenses/Taxes

- The control activities in place including procedures over financial reporting, which in management’s judgment are appropriate under the circumstances. These might include the daily or monthly controls management relies upon in the normal course of its activities. They would also include any SAS 70 reports received from vendors upon which management relies. General information systems and technology controls might also be considered.

- The monitoring and testing processes used in the normal course of business to ascertain that the internal controls are in place and are working as intended. Insurers may want to consider describing the purpose, function or role of an internal audit department and/or describe other self-audit and analysis activities.

- The information and communication processes, including the frequency of reporting and monitoring activities and communication of internal control responsibilities.

Section 16D(5) of the Model indicates that if one or more unremediated material weaknesses in Internal control over financial reporting exists as of the balance sheet date, then management is not permitted to conclude that internal control over financial reporting is effective and it must include a description of the nature of any unremediated material weaknesses in the report. For purposes of this determination, material weakness has the same meaning as used in PCAOB or AICPA auditing literature – PCAOB Auditing Standard No. 5, An Audit of Internal Control over Financial Reporting That is Integrated With an Audit of Financial Statements or AICPA AU Section 325, Communicating Internal Control Related Matters Identified in an Audit. Such guidance provides the following definitions:

> Significant Deficiency – A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.
>
> Material Weakness – A material weakness is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

Insurers filing Management's Report of Internal Control over Financial Reporting as a Group of insurers may want to also consider identifying or documenting common systems and controls used by multiple companies within an insurance holding company system and how such information was used in the development of the Group of insurers for reporting purposes.

To allow insurers to comply with Section 16 in a cost effective manner, management may base its assertions, in part, upon its review, monitoring and testing processes performed in the normal course of it activities. Management may also consider diligent inquiry of key process owners throughout the organization to provide additional assurance as to the operating effectiveness of its internal control over financial reporting. For purposes of filing the report, "diligent inquiry" means conducting a search and thorough review of relevant documents which are reasonably likely to contain significant information with regards to Internal control over financial reporting and making reasonable inquiries of current employees and agents whose duties include responsibility for Internal control over financial reporting.

Exemptions and Effective Dates (Section 17)

Hardship Waivers (Section 17A)

Notwithstanding any other provision of the Model, an insurer may make written application to the Commissioner for waiver from any or all provisions of the Model based upon financial or organizational hardship. For example, the Commissioner could under this section grant a waiver of the Section 14B audit committee independence requirements to a company exceeding the $500 million premium threshold, even though the Section 14H waiver would not apply. This exemption is granted at the discretion of the Commissioner, and may be granted at any time for a specified period or periods.

Specific Effective Dates (Section 17F)

An insurer will be required to file a Section 16 report if the insurer exceeds the premium threshold (as defined in Section 16A.)

1. Assume the insurer reports premiums as follows (note that the direct written and assumed premium in these examples would be reduced by any premiums reinsured with the Federal Crop Insurance Corporation and Federal Flood Program) :

$ millions	201x	201x+1	201x+2	201x+3	201x+4
Net (written) premiums, per Statement of Operations in Audited financial report	350.3	390.8	410.5	425.7	450.8
Add: Reinsurance ceded	100.5	115.7	115.8	120.1	127.2
Gross direct written and assumed premium	450.8	506.5	526.3	545.8	578.0

In the above example, the insurer has reached the requisite threshold in 201x+1 and therefore will file its first Section 16 report effective December 31, 201x+3.

2. Assume the insurer reports premiums as follows:

$ millions	201x	201x+1	201x+2	201x+3	201x+4
Net (written) premiums, per Statement of Operations in Audited financial report	350.3	380.5	390.8	410.5	425.7
Add: Reinsurance ceded	100.5	110.7	115.7	115.8	120.1
Gross direct written and assumed premium	450.8	491.2	506.5	526.3	545.8

In the above example, the insurer has reached the requisite threshold in 201x+2 and therefore will file its first Section 16 report effective December 31, 201x+4.

3. Assume the insurer reports premiums as follows:

$ millions	201x	201x+1	201x+2	201x+3	201x+4
Net (written) premiums, per Statement of Operations in Audited financial report	350.3	390.8	380.5	410.5	425.7
Add: Reinsurance ceded	100.5	115.7	110.7	115.8	120.1
Gross direct written and assumed premium	450.8	506.5	491.2	526.3	545.8

In the above example, the insurer has reached the requisite threshold in 201x+1 and therefore will file its first Section 16 report effective December 31, 201x+3. Because the insurer dropped below the threshold in 201x+2, the insurer is not required to file a Section 16 report and thus, the reporting period starts over. The insurer reaches the threshold in 201x+3 and therefore, required to file the Section 16 report effective December 31, 201x+5. The insurer may choose to begin voluntarily filing the Section 16 report beginning with 201x+3 especially if the insurer has done the work to prepare the report.

Business Combination

A business combination is defined as acquisition of insurance/reinsurance business through:

A. a stock acquisition,
B. inforce reinsurance assumption, or
C. a merger of insurers in a Group of insurers

A. Stock Acquisitions

Assume Company A, which has premiums of $500m or more, buys Company B and retains Company B as a separate legal entity.

If Company B has premiums of less than $500m (as derived from Section 16A), no Section 16 report is required.

If Company B has premiums of $500m or more (as derived from Section 16A), a Section 16 report is required.

1. Assume Company B is acquired effective January 1, 201x and subsequently reports premiums as follows. Assume further that Company A and B elect to file separate Section 16 reports:

$ millions	201x	201x+1	201x+2	201x+3	201x+4
Net (written) premiums, per Statement of Operations in Audited financial report	350.3	390.8	410.5	425.7	450.8
Add: Reinsurance ceded	100.5	115.7	115.8	120.1	127.2
Gross direct written and assumed premium	450.8	506.5	526.3	545.8	578.0

In the above example, Company B has reached the requisite threshold in 201x+1 and therefore will file its first Section 16 report effective December 31, 201x+3.

1. Assume Company B is acquired June 30, 201x+2 by Company A and Company B has premiums as follows. Assume further that Company A elects to file a single Section 16 report with the Group of insurers consisting of Company A and B:

$ millions	201x	201x+1	201x+2	201x+3	201x+4
Net (written) premiums, per Statement of Operations in Audited financial report	350.3	390.8	410.5	425.7	450.8
Add: Reinsurance ceded	100.5	115.7	115.8	120.1	127.2
Gross direct written and assumed premium	450.8	506.5	526.3	545.8	578.0

In the above example, Company B has reached the requisite threshold in 201x+1 and therefore will file its first Section 16 report effective December 31, 201x+3. However due to the acquisition in 201x+2, the first combined Section 16 report, i.e., Group of insurers, would be effective December 31, 201x+4, two years subsequent to acquisition.

B. *Inforce Reinsurance Assumption*

For the purposes of determining premiums pursuant to Section 16A, assumed premiums from the assumption of an inforce reinsurance transaction will be excluded from the measurement of premiums, for two calendar years subsequent to acquisition.

Assume the insurer assumed an inforce transaction effective June 30, 201x+2 and reports premiums as follows:

$ millions	201x	201x+1	201x+2	201x+3	201x+4
Net (written) premiums, per Statement of Operations in Audited financial report	350.3	390.8	610.5	850.7	875.8
Add: Reinsurance ceded	100.5	115.7	115.8	120.1	127.2
Gross direct written and assumed premium	450.8	506.5	726.3	970.8	1,003.0
Less: Gross assumed premium resulting from a business combination	0	0	200.0	425.0	425.0
Gross direct written and assumed premium, subject to Section 16	450.8	506.5	526.3	545.8	578.0

In the above example, the insurer has reached the requisite threshold in 201x+1 and therefore will file its first Section 16 report effective December 31, 201x+3, however only for business inforce in 201x+1 and still inforce in 201x+3. The business assumed at June 30, 201x+2 will be subject to a Section 16 report effective December 31, 201x+4, two calendar years after acquisition.

C. *Mergers of Insurers in a Group of Insurers*

If the merged insurer has premiums of less than $500m (as derived from Section 16A), a Section 16 report is not required.

If the merged insurer has premiums of $500m or more (as derived from Section 16A), a Section 16 report is required.

1. Assume that Insurer A and Insurer B have Gross direct written and assumed premiums as follows, and agree to merge effective January 1, 201x+1, with Insurer A as the surviving entity:

$ millions	201x	201x+1	201x+2	201x+3	201x+4
Gross direct written and assumed premium – Insurer A	450.3	460.8	510.5	n/a	n/a
Gross direct written and assumed premium – Insurer B	100.5	115.7	115.8	n/a	n/a
Less: Intercompany transactions – gross	-	65.3	62.2	n/a	n/a
Combined gross direct written and assumed premiums Insurer A	-	511.2	564.1	n/a	n/a

In the above example, the merged entity (insurer A) has reached the requisite threshold in 201x+1, and will file its first Section 16 report effective December 31, 201x+3.

2. Assume that Insurer A and Insurer B have Gross direct written and assumed premiums as follows, and agree to merge effective January 1, 201x+2, with Insurer A as the surviving entity:

$ millions	201x	201x+1	201x+2	201x+3	201x+4
Gross direct written and assumed premium – Insurer A	450.3	460.8	510.5	n/a	n/a
Gross direct written and assumed premium – Insurer B	100.5	115.7	115.8	n/a	n/a
Less: Intercompany transactions – gross	-	-	62.2	n/a	n/a
Combined gross direct written and assumed premiums Insurer A	-	-	564.1	n/a	n/a

In the above example, the merged entity (insurer A) has reached the requisite threshold in 201x+2, and will file its first Section 16 report effective December 31, 201x+4, two years subsequent to merger.

APPENDIX 1

Illustrative Examples of Management's Report of Internal Control over Financial Reporting

The following are examples of Management's Report of Internal Controls over Financial Reporting utilizing different facts and circumstances. These are only examples and individual company facts and circumstances will dictate the contents of their report. However, there are common elements that should be included in all reports as discussed in Sections 16C and 16D of the Model.

Example A: An SEC registrant or a member of a holding company system whose parent is an SEC registrant that had all material control processes over statutory financial reporting addressed in its Section 404 report .... Page 23

Example B: An SEC registrant or a member of a holding company system who is a SEC registrant and is a non-accelerated filer that had all material control processes over statutory financial reporting addressed in its Section 404 report. For these non-accelerated filers, the Section 404 report does not require the report of independent registered public accounting firm on internal control over financial reporting .... Page 25

Example C: An SEC registrant or a member of a holding company system whose parent is an SEC registrant that did not have all material control processes over statutory financial reporting addressed in its Section 404 report .... Page 27

Example D: An SEC registrant or a member of a holding company system who is a SEC registrant and is a non-accelerated filer that did not have all material control processes over statutory financial reporting addressed in its Section 404 report. For these non-accelerated filers, the Section 404 report does not require the report of independent registered public accounting firm on internal control over financial reporting .... Page 30

Example E: A non-SEC registrant or a member of a holding company system that voluntarily complied with Section 404 of the Sarbanes-Oxley Act and produced a report on internal controls which included an auditor's opinion .... Page 33

Example F: A company [or "group of insurers"] that is not subject to Section 404 and utilized their own framework to evaluate controls .... Page 35

Example G: An SEC registrant or a member of a holding company system whose parent is an SEC registrant that had all material control processes addressed in their Section 404 report and had an unremediated material weakness .... Page 37

Example H: An SEC registrant or member of a holding company system whose parent is an SEC registrant that did not include all material processes over statutory financial reporting addressed in its Section 404 report and had an unremediated material weakness noted .... Page 39

Example I: An SEC registrant or member of a holding company system whose parent is an SEC registrant that had all material processes over statutory financial reporting addressed in its Section 404 report. However, they recently acquired another insurer that is not included in their assessment .... Page 42

EXAMPLE A: AN SEC REGISTRANT OR A MEMBER OF A HOLDING COMPANY SYSTEM WHOSE PARENT IS AN SEC REGISTRANT THAT HAD ALL MATERIAL CONTROL PROCESSES OVER STATUTORY FINANCIAL REPORTING ADDRESSED IN ITS SECTION 404 REPORT

Management's Report of Internal Control over Financial Reporting

XYZ Holding Company Inc ("XYZ") is required to file annual reports on Form 10-K/20-F with the U.S. Securities and Exchange Commission. Each of the insurance companies listed on Attachment B is a wholly owned subsidiary of XYZ. For the purpose of XYZ's Management's Report of Internal Control over Financial Reporting, management has identified its "Group of insurers," as that term is defined in [relevant state statute or Section 3H of the Model], as the insurance companies listed on Attachment B.

Management of XYZ is responsible for establishing and maintaining adequate internal control over statutory financial reporting. XYZ's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of statutory financial statements in accordance with statutory accounting principles. Management conducted an assessment of the effectiveness, as of December 31, 201X, of the Group of insurers' internal control over statutory financial reporting, based on the framework established in *Internal Control—Integrated Framework Issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).* Based on our assessment under that framework, management concluded that the Group of insurers' internal control over statutory financial reporting is effective to provide reasonable assurance regarding the reliability of financial reporting and the preparation of statutory financial statements as of December 31, 201X.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Projections of any evaluation of effectiveness to future periods are also subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In satisfaction of the Group of insurers' obligation to deliver Management's Report of Internal Control over Financial Reporting for the fiscal year ended December 31, 201X, as permitted by [relevant state statute or Section 16C of the Model], XYZ is hereby providing the Insurance Commissioner of [domiciliary state] copies of Management's Report of Internal Control over Financial Reporting and the report of independent registered public accounting firm on internal control over financial reporting for XYZ included in XYZ's Form 10-K/20-F for the fiscal year ended December 31, 201X (or alternatively the Annual Report to Stockholders). In addition, an Addendum (Attachment A) is included to this report which identifies the material processes that were not included in the Section 404 Report (as defined in Attachment A).

Based on management review of internal controls, there were no unremediated material weaknesses as of December 31, 201X identified as part of the Group of insurers' internal control structure over the statutory financial statements for the year ended December 31, 201X.

(Signed)____ (Date)______________
(Chief Executive Officer)

(Signed)____ (Date)______________
(Chief Financial Officer)

ATTACHMENT A

XYZ Holding Company, Inc.
Addendum to Management's Report of Internal Control over Financial Reporting
For the Year Ended December 31, 201X

For purposes of this addendum, the "Section 404 Report" means Management's Report on Internal Control over Financial Reporting and the report of independent registered public accounting firm on internal control over financial reporting contained in or incorporated by reference in the Form 10-K/20-F. Accordingly, as required by [relevant state statute or Section 16C of the Model], management of XYZ hereby affirms that there are no material processes with respect to the preparation of the audited statutory financial statements of the Group of insurers that were excluded from the Section 404 Report.

ATTACHMENT B

XYZ Holding Company, Inc.
Management's Report of Internal Control over Financial Reporting
List of Companies that are part of the Group of insurers
Pursuant to [relevant state statute or Section 16 of the Model]

Name	NAIC No
ABC Insurance Subsidiary	12345
DEF Insurance Subsidiary	12346
GHI Insurance Subsidiary	12347
JKL Insurance Subsidiary	12348
MNO Insurance Subsidiary	12349

EXAMPLE B: AN SEC REGISTRANT OR A MEMBER OF A HOLDING COMPANY SYSTEM WHO IS A SEC REGISTRANT AND IS A NON-ACCELERATED FILER THAT HAD ALL MATERIAL CONTROL PROCESSES OVER STATUTORY REPORTING ADDRESSED IN ITS SECTION 404 REPORT. FOR THIS NON-ACCELERATED FILER, THE SECTION 404 REPORT DOES NOT REQUIRE THE REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM ON INTERNAL CONTROL OVER FINANCIAL REPORTING.

Management's Report of Internal Control over Financial Reporting

XYZ Holding Company, Inc. ("XYZ") is required to file annual reports on Form 10-K/20-F with the U.S. Securities and Exchange Commission. Each of the insurance companies listed on Attachment B is a wholly owned subsidiary of XYZ. For the purpose of XYZ's Management's Report of Internal Control over Financial Reporting, management has identified its "Group of insurers," as that term is defined in [relevant state statute or Section 3H of the Model] as the insurance companies listed on Attachment B.

Management of XYZ is responsible for establishing and maintaining adequate internal control over statutory financial reporting. XYZ's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of statutory financial statements in accordance with statutory accounting principles. Management conducted an assessment of the effectiveness, as of December 31, 201X, of the Group of insurers' internal control over statutory financial reporting, based on the framework established in Internal Control—Integrated Framework Issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on our assessment under that framework, management concluded that the Group of insurers' internal control over statutory financial reporting is effective to provide reasonable assurance regarding the reliability of financial reporting and the preparation of statutory financial statements as of December 31, 201X.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Projections of any evaluation of effectiveness to future periods are also subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In satisfaction of the Group of insurers' obligation to deliver Management's Report of Internal Control over Financial Reporting for the fiscal year ended December 31, 201X, as permitted by [relevant state statute or Section 16 of the Model], XYZ is hereby providing the Insurance Commissioner of [domiciliary state] copies of Management's Report of Internal Control over Financial Reporting included in XYZ's Form 10-K/20-F for the fiscal year ended December 31, 201X (or alternatively the Annual Report to Stockholders). This does not include a report of independent registered public accounting firm on internal control over financial reporting for XYZ, as it is not required for non-accelerated filers In addition, an Addendum (Attachment A) is included to this report which identifies the material processes that were not included in the Section 404 Report (as defined in Attachment A).

Based on management review of internal controls, there were no unremediated material weaknesses as of December 31, 201X identified as part of the Group of insurers' internal control structure over the statutory financial statements for the year ended December 31, 201X.

(Signed)____ (Date)______________
(Chief Executive Officer)

(Signed)____ (Date)______________
(Chief Financial Officer)

ATTACHMENT A

XYZ Holding Company, Inc.
Addendum to Management's Report of Internal Control over Financial Reporting
For the Year Ended December 31, 201X

For purposes of this filing, the "Section 404 Report" means Management's Report of Internal Control over Financial Reporting only contained in or incorporated by reference in the Company's Form 10-K/20-F. This does not include a report of independent registered public accounting firm on internal control over financial reporting, as it is not required for non-accelerated filers. Accordingly, as required by [relevant state statute or Section 16 of the Model], management of XYZ hereby affirms that there are no material processes with respect to the preparation of the audited statutory financial statements of the Group of insurers that were excluded from the Section 404 Report.

ATTACHMENT B

XYZ Holding Company, Inc.
Management's Report of Internal Control over Financial Reporting
List of Companies that are part of the Group of insurers
Pursuant to [relevant state statute or Section 16 of the Model]

Name	NAIC No
ABC Insurance Subsidiary	12345
DEF Insurance Subsidiary	12346
GHI Insurance Subsidiary	12347
JKL Insurance Subsidiary	12348
MNO Insurance Subsidiary	12349

EXAMPLE C: AN SEC REGISTRANT OR A MEMBER OF A HOLDING COMPANY SYSTEM WHOSE PARENT IS AN SEC REGISTRANT THAT DID NOT HAVE ALL MATERIAL CONTROL PROCESSES OVER STATUTORY FINANCIAL REPORTING ADDRESSED IN ITS SECTION 404 REPORT

Management's Report of Internal Control over Financial Reporting

XYZ Holding Company, Inc. ("XYZ") is required to file annual reports on Form 10-K/20-F with the U.S. Securities and Exchange Commission. Each of the insurance companies listed on Attachment B is a wholly owned subsidiary of XYZ. For the purpose of XYZ's Management's Report of Internal Control over Financial Reporting, management has identified its "Group of insurers," as that term is defined in [relevant state statute or Section 3H of the Model] as the insurance companies listed on Attachment B.

Management of XYZ is responsible for establishing and maintaining adequate internal control over statutory financial reporting. XYZ's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of statutory financial statements in accordance with statutory accounting principles. Management conducted an assessment of the effectiveness, as of December 31, 201X, of the Group of insurers' internal control over statutory financial reporting, based on the framework established in *Internal Control—Integrated Framework Issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).* Based on our assessment under that framework, management concluded that the Group of insurers' internal control over statutory financial reporting is effective to provide reasonable assurance regarding the reliability of financial reporting and the preparation of statutory financial statements as of December 31, 201X.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Projections of any evaluation of effectiveness to future periods are also subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In satisfaction of the Group of insurers' obligation to deliver Management's Report of Internal Control over Financial Reporting for the fiscal year ended December 31, 201X, as permitted by [relevant state statute or Section 16C of the Model], XYZ is hereby providing the Insurance Commissioner of [domiciliary state] copies of Management's Report of Internal Control over Financial Reporting and the report of independent registered public accounting firm on internal control over financial reporting for XYZ included in XYZ's Form 10-K/20-F for the fiscal year ended December 31, 201X (or alternatively the Annual Report to Stockholders). In addition, an Addendum (Attachment A) is included to this report which identifies the material processes that were not included in the Section 404 Report (as defined in Attachment A).

Based on management review of internal controls, there were no unremediated material weaknesses as of December 31, 201X identified as part of the Group of insurers' internal control structure over the statutory financial statements for the year ended December 31, 201X.

(Signed)____ (Date)______________
(Chief Executive Officer)

(Signed)____ (Date)______________
(Chief Financial Officer)

ATTACHMENT A

XYZ Holding Company, Inc.
Addendum to Management's Report of Internal Control over Financial Reporting
For the Year Ended December 31, 201X

For purposes of this filing, the "Section 404 Report" means Management's Report of Internal Control over Financial Reporting and the report of independent registered public accounting firm on internal control over financial reporting contained in or incorporated by reference in the Company's Form 10-K/20-F. Accordingly, as required by [relevant state statute or Section 16C of the Model], management of XYZ hereby affirms that the only material processes with respect to the preparation of the audited statutory financial statements of the Group of insurers that were excluded from the Section 404 Report are the processes discussed below. Management of XYZ hereby affirms that all other material processes with respect to the preparation of the audited statutory financial statements of the Group of insurers were included in the Section 404 Report. The following statutory financial reporting processes were reviewed separately from the internal controls reported by the Group of insurers in its Section 404 report:

Significant Control Processes not tested due to Group Materiality Considerations

The Section 404 report excludes certain control processes deemed material to individual insurance legal entities included within the Group of insurers. This exclusion was due to group materiality decisions made at the parent company level. These processes, and the legal entities within the Group of insurers impacted, are listed as follows:

Workers' Compensation Claims Processing – The HIJ claims processing system is utilized to process workers' compensation claims material to ABC Insurance Subsidiary and DEF Insurance Subsidiary.

Related Party Transactions Eliminated through Consolidation

The Section 404 report does not consider controls surrounding related party transactions as the effects of those transactions are eliminated through consolidation at the holding company financial statement level. Significant related party transactions, and the legal entities within the Group of insurers impacted, are listed as follows:

Affiliate reinsurance agreements – A significant amount of reinsurance coverage is obtained by ABC Insurance Subsidiary and DEF Insurance Subsidiary through contracts with XYZ Parent Company.

Management service agreements – ABC Insurance Subsidiary receives all of its management services through an agreement with XYZ Parent Company.

Tax allocation agreements – ABC Insurance Subsidiary and DEF Insurance Subsidiary are subject to an intercompany tax allocation agreement with XYZ Parent Company.

Deferred Income Taxes

Federal income taxes are provided for XYZ's estimated current and deferred liability. Deferred taxes are provided for differences between the financial statement and tax bases of assets and liabilities. Pursuant to *SSAP No. 101—Income Taxes, A Replacement of SSAP No. 10R and SSAP No. 10*, changes in deferred tax assets and liabilities are recognized as a separate component of gains and losses in statutory surplus, while under GAAP/IFRS, these changes are included in income tax expense or benefit. Gross deferred tax assets not meeting the realization criteria outlined in SSAP No. 101 are not admitted.

Nonadmitted Assets

Certain XYZ assets (principally furniture, equipment, prepaid expenses, agents' balances, and certain deferred tax assets) have been designated as nonadmitted assets under statutory accounting guidance (primarily in *SSAP No. 4—Assets and Nonadmitted Assets* and *SSAP No. 20—Nonadmitted Assets*). Such nonadmitted assets are excluded from assets by a charge to statutory surplus. Under GAAP/IFRS, such amounts are carried at amortized cost with an appropriate valuation allowance, as necessary.

Asset Valuation Reserve ("AVR")

The AVR represents a statutory contingency reserve for life and health insurers for credit related risk on most invested assets, and is charged to surplus pursuant to *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve.* No such reserve is required under GAAP/IFRS accounting.

Interest Maintenance Reserve ("IMR")

The IMR represents the deferral of interest-related realized gains and losses, net of tax, on primarily fixed maturity investments, amortized into income over the remaining life of the investment sold pursuant to *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*. No such reserve is required under GAAP/IFRS accounting.

Management of XYZ conducted an assessment of the internal controls over these processes and concluded that they were effective with respect to the audited statutory financial statements.

(Please note that this is not intended to be an all-inclusive list. It should only include material process that were not covered in the Section 404 Report. The facts and circumstances of each situation will determine the items to be included.)

ATTACHMENT B

XYZ Holding Company, Inc.
Management's Report of Internal Control over Financial Reporting
List of Companies that are part of the Group of insurers
Pursuant to [relevant state statute or Section 16 of the Model]

Name	NAIC No
ABC Insurance Subsidiary	12345
DEF Insurance Subsidiary	12346
GHI Insurance Subsidiary	12347
JKL Insurance Subsidiary	12348
MNO Insurance Subsidiary	12349

EXAMPLE D: AN SEC REGISTRANT OR A MEMBER OF A HOLDING COMPANY SYSTEM WHO IS A SEC REGISTRANT AND IS A NON-ACCLERATED FILER THAT DID NOT HAVE ALL MATERIAL CONTROL PROCESSES OVER STATUTORY FINANCIAL REPORTING ADDRESSED IN ITS SECTION 404 REPORT. FOR THESE NON-ACCELERATED FILERS, THE SECTION 404 REPORT DOES NOT REQUIRE THE REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM ON INTERNAL CONTROL OVER FINANCIAL REPORTING.

Management's Report of Internal Control over Financial Reporting

XYZ Holding Company, Inc. ("XYZ") is required to file annual reports on Form 10-K/20-F with the U.S. Securities and Exchange Commission. Each of the insurance companies listed on Attachment B is a wholly owned subsidiary of XYZ. For the purpose of XYZ's Management's Report of Internal Control over Financial Reporting, management has identified its "Group of insurers," as that term is defined in [relevant state statute or Section 3H of the Model] as the insurance companies listed on Attachment B.

Management of XYZ is responsible for establishing and maintaining adequate internal control over statutory financial reporting. XYZ's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of statutory financial statements in accordance with statutory accounting principles. Management conducted an assessment of the effectiveness, as of December 31, 201X, of the Group of insurers' internal control over statutory financial reporting, based on the framework established in Internal Control—Integrated Framework Issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on our assessment under that framework, management concluded that the Group of insurers' internal control over statutory financial reporting is effective to provide reasonable assurance regarding the reliability of financial reporting and the preparation of statutory financial statements as of December 31, 201X.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Projections of any evaluation of effectiveness to future periods are also subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In satisfaction of the Group of insurers' obligation to deliver Management's Report of Internal Control over Financial Reporting for the fiscal year ended December 31, 201X, as permitted by [relevant state statute or Section 16 of the Model], XYZ is hereby providing the Insurance Commissioner of [domiciliary state] copies of Management's Report of Internal Control over Financial Reporting included in XYZ's Form 10-K/20-F for the fiscal year ended December 31, 201X (or alternatively the Annual Report to Stockholders). This does not include a report of independent registered public accounting firm on internal control over financial reporting for XYZ, as it is not required for non-accelerated filers. In addition, an Addendum (Attachment A) is included to this report which identifies the material processes that were not included in the Section 404 Report (as defined in Attachment A).

Based on management review of internal controls, there were no unremediated material weaknesses as of December 31, 201X identified as part of the Group of insurers' internal control structure over the statutory financial statements for the year ended December 31, 201X.

(Signed)____ (Date)______________
(Chief Executive Officer)

(Signed)____ (Date)______________
(Chief Financial Officer)

ATTACHMENT A

XYZ Holding Company, Inc.
Addendum to Management's Report of Internal Control over Financial Reporting
For the Year Ended December 31, 201X

For purposes of this filing, the "Section 404 Report" means Management's Report of Internal Control over Financial Reporting only contained in or incorporated by reference in the Company's Form 10-K/20-F. This does not include a report of independent registered public accounting firm on internal control over financial reporting, as it is not required for non-accelerated filers. Accordingly, as required by [relevant state statute or Section 16 of the Model], management of XYZ hereby affirms that the only material processes with respect to the preparation of the audited statutory financial statements of the Group of insurers that were excluded from the Section 404 Report are the processes discussed below. Management of XYZ hereby affirms that all other material processes with respect to the preparation of the audited statutory financial statements of the Group of insurers were included in the Section 404 Report.

Significant Control Processes not tested due to Group Materiality Considerations

The Section 404 report excludes certain control processes deemed material to individual insurance legal entities included within the Group of insurers. This exclusion was due to group materiality decisions made at the parent company level. These processes, and the legal entities within the Group of insurers impacted, are listed as follows:

Workers' Compensation Claims Processing – The HIJ claims processing system is utilized to process workers' compensation claims material to ABC Insurance Subsidiary and DEF Insurance Subsidiary.

Related Party Transactions Eliminated through Consolidation

The Section 404 report does not consider controls surrounding related party transactions as the effects of those transactions are eliminated through consolidation at the holding company financial statement level. Significant related party transactions, and the legal entities within the Group of insurers impacted, are listed as follows:

Affiliate reinsurance agreements – A significant amount of reinsurance coverage is obtained by ABC Insurance Subsidiary and DEF Insurance Subsidiary through contracts with XYZ Parent Company.

Management service agreements – ABC Insurance Subsidiary receives all of its management services through an agreement with XYZ Parent Company.

Tax allocation agreements – ABC Insurance Subsidiary and DEF Insurance Subsidiary are subject to an intercompany tax allocation agreement with XYZ Parent Company.

Deferred Income Taxes

Federal income taxes are provided for XYZ's estimated current and deferred liability. Deferred taxes are provided for differences between the financial statement and tax bases of assets and liabilities. Pursuant to *SSAP No. 101—Income Taxes, A Replacement of SSAP No. 10R and SSAP No. 10*, changes in deferred tax assets and liabilities are recognized as a separate component of gains and losses in statutory surplus, while under GAAP/IFRS, these changes are included in income tax expense or benefit. Gross deferred tax assets not meeting the realization criteria outlined in SSAP No. 101 are not admitted.

Nonadmitted Assets

Certain XYZ assets (principally furniture, equipment, prepaid expenses, agents' balances, and certain deferred tax assets) have been designated as nonadmitted assets under statutory accounting guidance (primarily in *SSAP No. 4—Assets and Nonadmitted Assets* and *SSAP No. 20—Nonadmitted Assets*). Such nonadmitted assets are excluded from assets by a charge to statutory surplus. Under GAAP/IFRS, such amounts are carried at amortized cost with an appropriate valuation allowance, as necessary.

Asset Valuation Reserve ("AVR")

The AVR represents a statutory contingency reserve for life and health insurers for credit related risk on most invested assets, and is charged to surplus pursuant to *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*. No such reserve is required under GAAP/IFRS accounting.

Interest Maintenance Reserve ("IMR")

The IMR represents the deferral of interest-related realized gains and losses, net of tax, on primarily fixed maturity investments, amortized into income over the remaining life of the investment sold pursuant to *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*. No such reserve is required under GAAP/IFRS accounting.

Management of XYZ conducted an assessment of the internal controls over these processes and concluded that they were effective with respect to the audited statutory financial statements.

(Please note that this is not intended to be an all-inclusive list. It should only include material process that were not covered in the Section 404 Report. The facts and circumstances of each situation will determine the items to be included.)

ATTACHMENT B

XYZ Holding Company, Inc.
Management's Report of Internal Control over Financial Reporting
List of Companies that are part of the Group of insurers
Pursuant to [relevant state statute or Section 16 of the Model]

Name	NAIC No
ABC Insurance Subsidiary	12345
DEF Insurance Subsidiary	12346
GHI Insurance Subsidiary	12347
JKL Insurance Subsidiary	12348
MNO Insurance Subsidiary	12349

EXAMPLE E: A NON-SEC REGISTRANT OR A MEMBER OF A HOLDING COMPANY SYSTEM THAT VOLUNTARILY COMPLIED WITH SECTION 404 OF THE SARBANES-OXLEY ACT AND PRODUCED A REPORT ON INTERNAL CONTROLS WHICH INCLUDED AN AUDITOR'S OPINION

Management's Report of Internal Control over Financial Reporting

As a non-SEC registrant, XYZ Holding Company, Inc. ("XYZ") is not required to prepare or file with the U.S. Securities and Exchange Commission a Sarbanes-Oxley Act Section 404 report on internal control over financial reporting. However, management has elected to prepare, and have audited by XYZ's independent certified public accountant, such a report for the fiscal year-ended December 31, 201X.

Each of the insurance companies listed on Attachment B is a wholly owned subsidiary of XYZ. For the purpose of XYZ's Management's Report of Internal Control over Financial Reporting, management has identified its "Group of insurers," as that term is defined in [relevant state statute or Section 3H of the Model], as the insurance companies listed on Attachment B.

Management of XYZ is responsible for establishing and maintaining adequate internal control over statutory financial reporting. XYZ's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of statutory financial statements in accordance with statutory accounting principles. Management conducted an assessment of the effectiveness, as of December 31, 201X, of the Group of insurers' internal control over statutory financial reporting, based on the framework established in *Internal Control—Integrated Framework Issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).* Based on our assessment under that framework, management concluded that the Group of insurers' internal control over statutory financial reporting is effective to provide reasonable assurance regarding the reliability of financial reporting and the preparation of statutory financial statements as of December 31, 201X.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Projections of any evaluation of effectiveness to future periods are also subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In satisfaction of the Group of insurers' obligation to deliver Management's Report of Internal Control over Financial Reporting for the fiscal year ended December 31, 201X, as permitted by [relevant state statute or Section 16C of the Model], XYZ is hereby providing the Insurance Commissioner of [domiciliary state] the attached copy of XYZ's Section 404 Report for the fiscal year ended December 31, 201X, which includes Management's Report of Internal Control over Financial Reporting and report of independent registered public accounting firm on internal control over financial reporting for XYZ. In addition, an Addendum (Attachment A) is included to this report that identifies the material processes that were not included in the Section 404 Report (as defined in Attachment A).

Based on management review of internal controls, there were no unremediated material weaknesses as of December 31, 201X identified as part of the Group of insurers' internal control structure over the statutory financial statements for the year ended December 31, 201X.

(Signed)____ (Date)______________
Chief Executive Officer)

(Signed)____ (Date)______________
(Chief Financial Officer)

ATTACHMENT A

XYZ Holding Company, Inc.
Addendum to Management's Report of Internal Control over Financial Reporting
For the Year Ended December 31, 201X

For purposes of this addendum, the "Section 404 Report" means Management's Report of Internal Control over Financial Reporting and the report of independent registered public accounting firm on internal control over financial reporting contained in or incorporated by reference in the Annual Report to Stockholders. Accordingly, as required by [relevant state statute or Section 16C of the Model], management of XYZ hereby affirms that there are no material processes with respect to the preparation of the audited statutory financial statements of the Group of insurers that were excluded from the Section 404 Report.

ATTACHMENT B

XYZ Holding Company, Inc.
Management's Report of Internal Control over Financial Reporting
List of Companies that are part of the Group of insurers
Pursuant to [relevant state statute or Section 16 of the Model]

Name	NAIC No
ABC Insurance Subsidiary	12345
DEF Insurance Subsidiary	12346
GHI Insurance Subsidiary	12347
JKL Insurance Subsidiary	12348
MNO Insurance Subsidiary	12349

EXAMPLE F: A COMPANY [OR "GROUP OF INSURERS"] THAT IS NOT SUBJECT TO SECTION 404 AND UTILIZED THEIR OWN FRAMEWORK TO EVALUATE CONTROLS

Management's Report of Internal Control over Financial Reporting

[As a non-SEC registrant, XYZ Holding Company, Inc. ("XYZ") is not required to prepare or file with the U.S. Securities and Exchange Commission a Sarbanes-Oxley Act Section 404 report on internal control over financial reporting. Each of the insurance companies listed on Attachment A is a wholly owned subsidiary of XYZ. For the purpose of XYZ's Management's Report of Internal Control over Financial Reporting, management has identified its "Group of insurers," as that term is defined in [relevant state statute or Section 3H of the Model], as the insurance companies listed on Attachment A.]

Management of ABC Insurance Company [or XYZ] is responsible for establishing and maintaining adequate internal control over statutory financial reporting. The Company has established an internal control system designed to provide reasonable assurance regarding the fair presentation of statutory financial reporting. The Company developed its own internal framework for evaluating the effectiveness of internal control over statutory financial reporting. The Company's framework includes the identification and evaluation of the company's internal control environment and areas of potential material internal control risk, documentation of existing internal controls, monitoring and testing of those key controls, documentation of remedial actions planned or taken, if any, and communication of the findings of the evaluation by the Company's senior management to the Audit committee of the Board of Directors.

Management conducted an assessment of the effectiveness, as of December 31, 201X, of the Company's internal control over statutory financial reporting, which included identifying, reviewing, monitoring and testing significant internal controls over statutory financial reporting. Based on our assessment under the above described approach and through diligent inquiry, management has concluded that the Company's internal control over statutory financial reporting is effective to provide reasonable assurance regarding the reliability of financial reporting and the preparation of statutory financial statements as of December 31, 201X.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Projections of any evaluation of effectiveness to future periods are also subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Based on management review of internal controls, there were no unremediated material weaknesses as of December 31, 201X identified as part of the Company's internal control structure over the statutory financial statements for the year ended December 31, 201X.

(Signed)____ (Date)______________
(Chief Executive Officer)

(Signed)____ (Date)______________
(Chief Financial Officer)

ATTACHMENT A

XYZ Holding Company, Inc.
Management's Report of Internal Control over Financial Reporting
List of Companies that are part of the Group of Insurers
Pursuant to [relevant state statute or Section 16 of the Model]

Name	NAIC No
ABC Insurance Subsidiary	12345
DEF Insurance Subsidiary	12346
GHI Insurance Subsidiary	12347
JKL Insurance Subsidiary	12348
MNO Insurance Subsidiary	12349

EXAMPLE G: AN SEC REGISTRANT OR A MEMBER OF A HOLDING COMPANY SYSTEM WHOSE PARENT IS AN SEC REGISTRANT THAT HAD ALL MATERIAL CONTROL PROCESSES ADDRESSED IN THEIR SECTION 404 REPORT AND HAD AN UNREMEDIATED MATERIAL WEAKNESS

Management's Report of Internal Control over Financial Reporting

XYZ Holding Company, Inc. ("XYZ") is required to file annual reports on Form 10-K/20-F with the U.S. Securities and Exchange Commission. Each of the insurance companies listed on Attachment B is a wholly-owned subsidiary of XYZ. For the purpose of XYZ's Management's Report of Internal Control over Financial Reporting, management has identified its "Group of insurers," as that term is defined in [relevant state statute or Section 3H of the Model], as the insurance companies listed on Attachment B.

Management of XYZ is responsible for establishing and maintaining adequate internal control over statutory financial reporting. XYZ's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of statutory financial statements in accordance with statutory accounting principles.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Projections of any evaluation of effectiveness to future periods are also subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management conducted an assessment of the effectiveness, as of December 31, 201X, of the Group of insurers' internal control over statutory financial reporting, based on the framework established in *Internal Control—Integrated Framework Issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).*

A material weakness was noted in XYZ's internal control over financial reporting related to the calculation of insurance reserves. Due to the manner in which the data for homeowners policies are captured by the systems used in its Southeastern US regional office, changes in XYZ's estimate of insurance reserves for certain policies are not reviewed by XYZ's Actuarial Department prior to being recorded in the company's accounting records.

A material weakness is a deficiency or a combination of deficiencies in internal control, such that there is a reasonable possibility that a material misstatement of the company's financial statements will not be prevented, or detected and corrected on a timely basis. In connection with the weakness noted above, XYZ's management has taken remedial actions to change its procedures for coding policies issued in the states affected so that all homeowners policy data are included in the Actuarial Department review of estimate of insurance reserves. This change was effective on July 1, 20XX.

As a result of the unremediated material weakness described above, XYZ management has concluded that, as of December 31, 201X, XYZ's internal control over statutory financial reporting was not effective.

In satisfaction of the Group of insurers' obligation to deliver Management's Report of Internal Control over Financial Reporting for the fiscal year ended December 31, 201X, as permitted by [relevant state statute or Section 16C of the Model], XYZ is hereby providing the Insurance Commissioner of [domiciliary state] copies of Management's Report of Internal Control over Financial Reporting and the report of independent registered public accounting firm on internal control over financial reporting for XYZ included in XYZ's Form 10-K/20-F for the fiscal year ended December 31, 201X (or alternatively the Annual Report to Stockholders). In addition, an Addendum (Attachment A) is included to this report which identifies the material processes that were not included in the Section 404 Report (as defined in Attachment A).

(Signed)____ (Date)______________
(Chief Executive Officer)

(Signed)____ (Date)______________
(Chief Financial Officer)

ATTACHMENT A

XYZ Holding Company, Inc.
Addendum to Management's Report of Internal Control over Financial Reporting
For the Year Ended December 31, 201X

For purposes of this addendum, the "Section 404 Report" means Management's Report of Internal Control over Financial Reporting and the report of independent registered public accounting firm on internal control over financial reporting contained in or incorporated by reference in the Form 10-K/20-F. Accordingly, as required by [relevant state statute or Section 16C of the Model], management of XYZ hereby affirms that there are no material processes with respect to the preparation of the audited statutory financial statements of the Group of insurers that were excluded from the Section 404 Report.

ATTACHMENT B

XYZ Holding Company Inc.
Management's Report of Internal Control over Financial Reporting
List of Companies that are part of the Group of insurers
Pursuant to [relevant state statute or Section 16 of the Model]

Name	NAIC No
ABC Insurance Subsidiary	12345
DEF Insurance Subsidiary	12346
GHI Insurance Subsidiary	12347
JKL Insurance Subsidiary	12348
MNO Insurance Subsidiary	12349

EXAMPLE H: AN SEC REGISTRANT OR MEMBER OF A HOLDING COMPANY SYSTEM WHOSE PARENT IS AN SEC REGISTRANT THAT DID NOT INCLUDE ALL MATERIAL PROCESSES OVER STATUTORY FINANCIAL REPORTING ADDRESSED IN ITS SECTION 404 REPORT AND HAD AN UNREMEDIATED MATERIAL WEAKNESS NOTED

Management's Report of Internal Control over Financial Reporting

XYZ Holding Company, Inc. ("XYZ") is required to file annual reports on Form 10-K/20-F with the U.S. Securities and Exchange Commission. Each of the insurance companies listed on Attachment B is a wholly-owned subsidiary of XYZ. For the purpose of XYZ's Management's Report of Internal Control over Financial Reporting, management has identified its "Group of insurers," as that term is defined in [relevant state statute or Section 3H of the Model], as the insurance companies listed on Attachment B.

Management of XYZ is responsible for establishing and maintaining adequate internal control over statutory financial reporting. XYZ's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of statutory financial statements in accordance with statutory accounting principles. Management conducted an assessment of the effectiveness, as of December 31, 201X, of the Group of insurers' internal control over statutory financial reporting, based on the framework established in *Internal Control—Integrated Framework Issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).*

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Projections of any evaluation of effectiveness to future periods are also subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

A material weakness was noted in XYZ's internal control over financial reporting related to the calculation of insurance reserves. Due to the manner in which the data for homeowners policies are captured by the systems used in its Southeastern US regional office, changes in XYZ's estimate of insurance reserves for certain policies are not reviewed by XYZ's Actuarial Department prior to being recorded in the company's accounting records.

A material weakness is a deficiency or a combination of deficiencies in internal control, such that there is a reasonable possibility that a material misstatement of the company's financial statements will not be prevented, or detected and corrected on a timely basis. In connection with the assessment above, XYZ's management identified a material weakness as of December 31, 201X in the controls over the calculation of insurance reserves.

As a result of the unremediated material weakness described above, XYZ management has concluded that, as of December 31, 201X, XYZ's internal control over statutory financial reporting was not effective.

In satisfaction of the Group of insurers' obligation to deliver Management's Report of Internal Control over Financial Reporting for the fiscal year ended December 31, 201X, as permitted by [relevant state statute or Section 16C of the Model], XYZ is hereby providing the Insurance Commissioner of [domiciliary state] copies of Management's Report of Internal Control over Financial Reporting and the report of independent registered public accounting firm on internal control over financial reporting for XYZ included in XYZ's Form 10-K for the fiscal year ended December 31, 201X (or alternatively the Annual Report to Stockholders). In addition, an Addendum (Attachment A) is included to this report which identifies the material processes that were not included in the Section 404 Report (as defined in Attachment A).

(Signed)____ (Date)______________
(Chief Executive Officer)

(Signed)____ (Date)______________
(Chief Financial Officer)

ATTACHMENT A

XYZ Holding Company, Inc.
Addendum to Management's Report of Internal Control over Financial Reporting
For the Year Ended December 31, 201X

For purposes of this filing, the "Section 404 Report" means Management's Report of Internal Control over Financial Reporting and the report of independent registered public accounting firm on internal control over financial reporting contained in or incorporated by reference in the Company's Form 10-K/20-F. Accordingly, as required by [relevant state statute or Section 16C of the Model], management of XYZ hereby affirms that the only material processes with respect to the preparation of the audited statutory financial statements of the Group of insurers that were excluded from the Section 404 Report are the processes discussed below. Management of XYZ hereby affirms that all other material processes with respect to the preparation of the audited statutory financial statements of the Group of insurers were included in the Section 404 Report. The following statutory financial reporting processes were reviewed separately from the internal controls reported by the Group of insurers in its Section 404 report:

Significant Control Processes not tested due to Group Materiality Considerations

The Section 404 report excludes certain control processes deemed material to individual insurance legal entities included within the Group of insurers. This exclusion was due to group materiality decisions made at the parent company level. These processes, and the legal entities within the Group of insurers impacted, are listed as follows:

Workers' Compensation Claims Processing – The HIJ claims processing system is utilized to process workers' compensation claims material to ABC Insurance Subsidiary and DEF Insurance Subsidiary.

Related Party Transactions Eliminated through Consolidation

The Section 404 report does not consider controls surrounding related party transactions as the effects of those transactions are eliminated through consolidation at the holding company financial statement level. Significant related party transactions, and the legal entities within the Group of insurers impacted, are listed as follows:

Affiliate reinsurance agreements – A significant amount of reinsurance coverage is obtained by ABC Insurance Subsidiary and DEF Insurance Subsidiary through contracts with XYZ Parent Company.

Management service agreements – ABC Insurance Subsidiary receives all of its management services through an agreement with XYZ Parent Company.

Tax allocation agreements – ABC Insurance Subsidiary and DEF Insurance Subsidiary are subject to an intercompany tax allocation agreement with XYZ Parent Company.

Deferred Income Taxes

Federal income taxes are provided for XYZ's estimated current and deferred liability. Deferred taxes are provided for differences between the financial statement and tax bases of assets and liabilities. Pursuant to

SSAP No. 101—Income Taxes, A Replacement of SSAP No. 10R and SSAP No. 10, changes in deferred tax assets and liabilities are recognized as a separate component of gains and losses in statutory surplus, while under GAAP/IFRS, these changes are included in income tax expense or benefit. Gross deferred tax assets not meeting the realization criteria outlined in SSAP No. 101 are not admitted.

Nonadmitted Assets

Certain XYZ assets (principally furniture, equipment, prepaid expenses, agents' balances, and certain deferred tax assets) have been designated as nonadmitted assets under statutory accounting guidance (primarily in *SSAP No. 4—Assets and Nonadmitted Assets* and *SSAP No. 20—Nonadmitted Assets*). Such nonadmitted assets are excluded from assets by a charge to statutory surplus. Under GAAP/IFRS, such amounts are carried at amortized cost with an appropriate valuation allowance, as necessary.

Asset Valuation Reserve ("AVR")

The AVR represents a statutory contingency reserve for life and health insurers for credit related risk on most invested assets, and is charged to surplus pursuant to *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve.* No such reserve is required under GAAP/IFRS accounting.

Interest Maintenance Reserve ("IMR")

The IMR represents the deferral of interest-related realized gains and losses, net of tax, on primarily fixed maturity investments, amortized into income over the remaining life of the investment sold pursuant to *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve.* No such reserve is required under GAAP/IFRS accounting.

Management of XYZ conducted an assessment of the internal controls over these processes and concluded that they were effective with respect to the audited statutory financial statements.

(Please note that this is not intended to be an all-inclusive list. It should only include material processes that were not covered in the Section 404 Report. The facts and circumstances of each situation will determine the items to be included.)

ATTACHMENT B

XYZ Holding Company, Inc.
Management's Report of Internal Control over Financial Reporting
List of Companies that are part of the Group of insurers
Pursuant to [relevant state statute or Section 16 of the Model]

Name	NAIC No
ABC Insurance Subsidiary	12345
DEF Insurance Subsidiary	12346
GHI Insurance Subsidiary	12347
JKL Insurance Subsidiary	12348
MNO Insurance Subsidiary	12349

EXAMPLE I: AN SEC REGISTRANT OR MEMBER OF A HOLDING COMPANY SYSTEM WHOSE PARENT IS AN SEC REGISTRANT THAT HAD ALL MATERIAL PROCESSES OVER STATUTORY FINANCIAL REPORTING ADDRESSED IN ITS SECTION 404 REPORT. HOWEVER, THEY RECENTLY ACQUIRED ANOTHER INSURER THAT IS NOT INCLUDED IN THEIR ASSESSMENT

Management's Report of Internal Control over Financial Reporting

XYZ Holding Company, Inc. ("XYZ") is required to file annual reports on Form 10-K/20-F with the U.S. Securities and Exchange Commission. Each of the insurance companies listed on Attachment B is a wholly owned subsidiary of XYZ. For the purpose of XYZ's Management's Report of Internal Control over Financial Reporting, management has identified its "Group of insurers," as that term is defined in [relevant state statute or Section 3H of the Model], as the insurance companies listed on Attachment B.

Management of XYZ is responsible for establishing and maintaining adequate internal control over statutory financial reporting. XYZ's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of statutory financial statements in accordance with statutory accounting principles. Management conducted an assessment of the effectiveness, as of December 31, 201X, of the Group of insurers' internal control over statutory financial reporting, based on the framework established in *Internal Control—Integrated Framework Issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).* This assessment excluded an evaluation of internal controls over financial reporting for RST Insurance Company which was recently acquired. Based on our assessment under that framework, management concluded that the Group of insurers' internal control over statutory financial reporting is effective to provide reasonable assurance regarding the reliability of financial reporting and the preparation of statutory financial statements as of December 31, 201X.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Projections of any evaluation of effectiveness to future periods are also subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In satisfaction of the Group of insurers' obligation to deliver Management's Report of Internal Control over Financial Reporting for the fiscal year ended December 31, 201X, as permitted by [relevant state statute or Section 16C of the Model], XYZ is hereby providing the Insurance Commissioner of [domiciliary state] copies of Management's Report of Internal Control over Financial Reporting and the report of independent registered public accounting firm on internal control over financial reporting for XYZ included in XYZ's Form 10-K/20-F for the fiscal year ended December 31, 201X (or alternatively the Annual Report to Stockholders). In addition, an Addendum (Attachment A) is included to this report which identifies the material processes that were not included in the Section 404 Report (as defined in Attachment A).

Based on management review of internal controls, there were no unremediated material weaknesses as of December 31, 201X identified as part of the Group of insurers' internal control structure over the statutory financial statements for the year ended December 31, 201X.

(Signed)____ (Date)______________
(Chief Executive Officer)
(Signed)____ (Date)______________
(Chief Financial Officer)

ATTACHMENT A

XYZ Holding Company, Inc.
Addendum to Management's Report of Internal Control over Financial Reporting
For the Year Ended December 31, 201X

For purposes of this addendum, the "Section 404 Report" means Management's Report of Internal Control over Financial Reporting and the report of independent registered public accounting firm on internal control over financial reporting contained in or incorporated by reference in the Form 10-K. Accordingly, as required by [relevant state statute or Section 16C of the Model], management of XYZ hereby affirms that there are no material processes with respect to the preparation of the audited statutory financial statements of the Group of insurers that were excluded from the Section 404 Report.

ATTACHMENT B

XYZ Holding Company, Inc.
Management's Report of Internal Control over Financial Reporting
List of Companies that are part of the Group of insurers
Pursuant to [relevant state statute or Section 16 of the Model]

Name	NAIC No
ABC Insurance Subsidiary	12345
DEF Insurance Subsidiary	12346
GHI Insurance Subsidiary	12347
JKL Insurance Subsidiary	12348
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